The Rise of ‘Nearshoring’

Can Manchester Compete with Mumbai?
Overview
The Rise of ‘Nearshoring’

As the economic pressures of long-term recession are still being felt in most of the developed world, offshoring and outsourcing remain key levers for most major corporates in trying to reduce their cost base. But with local political pressure intensifying against sending jobs offshore and many of the typical offshore destinations continuing to experience double-digit rates of inflation, are there any alternatives closer to home that cost-conscious executives can explore?

‘Nearshoring’, the concept of finding lower-cost locations for business activities on or close to home turf, is not intrinsically a new idea – for decades at least companies have exploited the lower real estate costs and lower competition for skills in second tier cities and regions, locating production and support functions out of the major trading and financial hubs.

However, the newly emerging trend is to see companies using second-tier locations in their home country or very nearby as alternates to the major offshoring centres that have grown up in the last 15-20 years in India, the Philippines, Central and Eastern Europe and more recently in China and South America.

In the UK, major regional cities such as Manchester, Glasgow, Belfast and Newcastle have gained popularity as well as places like Dublin which while in a different country offers many similar characteristics. In the US, States with lower costs of salaries and infrastructure are providing back office services for many major corporations; Florida, Texas, Ohio and the Carolinas to name but a few, as well as cities across the border in neighbouring Canada.

As political rhetoric and legislation against offshoring becomes more commonplace it is likely we will see more and more companies opting to build capabilities closer to home.

Even the Indian vendors are getting in on the act – there have been spates of acquisitions by the big outsourcers of the subcontinent in Europe, the US and further afield, as they realise that to compete in the long term they will need to be global sourcing providers, not tied to a single geography at the mercy of inflation and spiralling salary costs.

In this paper, we examine the reasons for this shift and consider the factors that should inform decisions on whether to locate (or relocate) services ‘nearshore’ or offshore. In the following pages we examine these arguments for ‘nearshoring’:

- Social and political pressures
- Legislative considerations and restrictions
- Operational and managerial benefits
- Shifting economic arguments
Nearshoring Popularity Increases

Nearshoring is becoming commonplace across a broad range of industries and functions. There are multiple examples of companies bringing or building support functions in ‘nearshore’ locations across practically every industry sector. Nor has this been confined to companies of a certain scale or type – there are major corporates, niche players and even outsourcing service providers who are also looking to exploit the benefits of siting services closer to their clients.

Recent significant examples:
Banks have led the way - Citibank has developed nearshore operations and IT centres in Florida for its US business and in Northern Ireland for its European/UK business in addition to its sites in more typical offshore locations like India, the Philippines and Hungary.

- Deutsche Bank has built customer service operations for its Capital Markets clients in Birmingham, UK and has significant operations in Raleigh, North Carolina, as does Credit Suisse.

This approach is particularly common for call-centres where the value of cultural alignment in customer-facing staff is of high importance – several UK banks such as NatWest and Halifax have centres in Scotland and the North of England and companies such as Vodafone have sited call-centres in areas like Stoke-on-Trent and greater Manchester.

For those companies that have brought existing offshore operations back onshore, the main driver has been quality of service issues. Even software development companies, the drivers of much offshoring in the 2000s, are opening up onshore centres – with campaigns such as GalaxE’s 'Offshore to Detroit'.

<table>
<thead>
<tr>
<th>Company</th>
<th>Nearshore location</th>
<th>Function / Service</th>
<th>Rationale / Description</th>
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<tr>
<td>Citi</td>
<td>Belfast, Jacksonville</td>
<td>IT development &amp; support</td>
<td>Government grants, lower ease of management</td>
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<td>Deutsche Bank</td>
<td>Birmingham, Raleigh</td>
<td>Call-centre for institutional capital markets clients Operations &amp; IT</td>
<td>Lower cost of real estate and salaries than London. Lower cost, timezone benefits Infrastructure cost, taxation</td>
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<tr>
<td>Aviva</td>
<td>Norwich</td>
<td>Call-centres</td>
<td>Quality issues experienced in India</td>
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<td>Sky</td>
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<td>Vodafone</td>
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<td>NCR</td>
<td>Columbus</td>
<td>Manufacturing</td>
<td>Opened new ATM plant, bring production back from China</td>
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<td>Ford</td>
<td>Avon Lake</td>
<td>Manufacturing</td>
<td>Replacing production in Mexico due to tax relief</td>
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<td>Caterpillar</td>
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<td>Manufacturing</td>
<td>Expanding onshore plant capacity</td>
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<td>Capita</td>
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<td>Acquisition of UK based call-centre businesses to expand its onshore delivery capabilities</td>
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<td>GalaxE</td>
<td>Detroit, Michigan</td>
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<td>HCL</td>
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<td>Acquisition of BT call-centre</td>
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Elix-IRR: The Rise of ‘Nearshoring’
Offshoring Popularity Declines
The Turning of the Political Tide

From the onset of the global recession, the political climate in developed countries began to turn against offshoring even as their corporates sought to leverage it to reduce costs. This has translated into both punitive measures and positive incentives to retain jobs nearer to home.

The language from the White House in particular has been consistently anti-offshoring and outsourcing. This tone has spread to Western Europe too, with politicians in the UK also increasingly defensive about UK jobs going abroad, particularly in the public sector where plans for significant offshoring of NHS IT and recent guidelines from the Cabinet Office stated stringent criteria for any public sector services offshored. It also highlights the public relations element of offshoring, acknowledging that it can stir up hostility due to the loss of UK jobs. It says officials should take instructions from ministers.

The ‘Stick’

So far it is only really in the US where punitive measures have been devised to dissuade companies from offshoring; most noticeably with the U.S. ‘Call Center Worker and Consumer Protection Act’. This, if passed, will make companies who offshore call-centres ineligible for any indirect federal loans or loan guarantees for five years. The legislation also would require overseas call-centre employees to reveal their location to U.S. consumers and give them the right to be transferred to a call-centre in the US.

There are more restrictive measures in place already at a state level – for example in Arizona, any transaction via a call-centre where the operator does not disclose their location can be voided, the Florida senate passed a similar bill requiring disclosure of location in the first 30 seconds and before any personal information is disclosed by the customer.

The ‘Carrot’

Beyond these examples of coercive motivation, there is more evidence of the ‘carrot’ approach from governments with positive incentives being provided at a national and local level to encourage those creating jobs onshore or bringing employment back from overseas, particularly in areas suffering heavily from unemployment.

In the UK there are multiple tax schemes and grants for creation of jobs, particularly at a regional level – Northern Ireland in particular has been successful with the grants provided by ‘Invest NI’ which have attracted businesses like Microsoft and Citibank to set up sites there. The Republic of Ireland is operating similar incentive programmes.

In the US many states including Ohio, Utah and Florida provide significant incentives and tax breaks for companies creating employment. Moreover, at a federal level, a package of tax incentives has been agreed by the White House in discussion with several major US corporations including Ford that will form part of their 2013 budget.

Again Barack Obama has been at the forefront of such messages – saying in January this year “Ask yourselves what you can do to bring jobs back to your country, and your country will do everything we can to help you succeed”

“I will stop giving tax breaks to companies that ship jobs overseas, and I will start giving them to companies that create good jobs right here in America”

Barack Obama
Aside from the political environment there are many potential management and operational benefits of managing support functions closer to home:

**Cultural Alignment**

In particular for customer and front-office facing functions, the importance of cultural alignment is increasingly recognised. While training has gone some way to alleviate such issues, particularly for call-centres and so-called ‘vertical’ rather than horizontal support functions (i.e. those requiring more in depth /channel specific expertise), Santander, BSkyB and New Call Telecom are among the UK companies who have recently moved call-centre operations to low cost locations in the UK from offshore in India.

**Language**

Language skills are an obvious advantage of onshore/nearshore locations. While this is less of a challenge for English language skills, Western European countries have found language skills scarcer and often of lower quality – for example German companies have used local delivery solutions or nearby countries such as Czech Republic and Slovakia.

**Staff retention & relocation**

One benefit of re-locating to a nearshore location is the ability to retain or redeploy key staff, at least during transition and stabilisation periods.

Deutsche Bank experienced this benefit when relocating its capital markets client services operations from London to Birmingham – they were able to retain key management staff which significantly reduced the risk of knowledge loss and reduced time to transfer.

**Time zones & proximity**

Even when key staff are not transferred to the new location, there are significant operational benefits from proximity and working on common time-zones.

When Citibank relocated some IT development and support from London to Belfast in Northern Ireland, they found at critical moments in projects or during severe incidents it was very simple for management from London to go on-site and be more hands-on. Even during normal operating conditions the location made it much easier for management in head office to spend time there and maintain strong working relationships that would likely have been more difficult and certainly more expensive if the support had been offshore in India/China.

**Data security**

There is much anecdotal evidence of the risks of offshoring data (stolen credit card details et al.). Though many of these can be effectively managed, risks are generally perceived by regulators and governments to be far lower in nearshore locations.

There are several statutes already in force in the US, and many more pending, such as the Health Insurance Portability and Accountability Act (‘HIPAA’), in the case of electronically stored or transmitted health related information, and the Gramm-Leach-Bliley Act (‘GLBA’) which restrict the movement of data or at least mandate clear accountability and responsibility for companies operating in offshore locations.
Offshore Arbitrage Opportunities
Not always what they might seem...

The primary motivation for offshoring has historically been the savings from salary arbitrage – while these are still attractive, there are several factors which must be considered and can make the business case far less attractive in the near future.

For many corporations, staff costs are the chief deciding factor in offshoring. However there are multiple factors which can impact this seemingly attractive arbitrage opportunity. Recent analysis by Elix-IRR, as shown in Figure 2 below, reveals that in some situations this could be diminished by over 40% and business cases based on this alone should be carefully reviewed.

Inflation

As unemployment figures remain high in the US and UK, the wage inflation remains low around 2 – 3%. However in India, salary inflation continues to outstrip basic inflation at around 11 – 13%. China is in a special situation where the government is keeping consumer prices inflation artificially low, but the salary costs are increasing at high single digit rates due to increasing domestic consumption and according to some sources underlying rates maybe over 20%. Latin American nations are also typically seeing substantial wage inflation as their economies grow though in Central & Eastern Europe, inflation has largely stabilised.

Attrition

Attrition rates in offshore sites continue to outstrip the mature markets. BPO in India currently suffers from an attrition rate of up to 55% pa, especially in basic CSR roles. China is estimated at around 30%. Compared to these figures, US and UK BPO industries enjoy attrition rates of around 20% or lower. Elix-IRR research shows that attrition costs per resource can be anything between 25 – 40% of the average annual salary cost for one resource.

Productivity Loss

Finally, with offshoring comes additional costs of productivity loss, especially in the early stages of the deal. Elix-IRR experience with our clients shows that offshoring operations can cost a company anything from 20 – 60% in the first 1-3 years depending on the quality and skillset of the resources at the offshore location. A similar relocation to nearshore location can cost firms something between 5-10% if well managed.

Figure 2: Potential cumulative impact of factors on staff cost arbitrage* (US & UK vs. offshore locations)
(NB: Staff cost comparisons include salary and basic benefits)
Real Estate Costs
Nearshore Locations are Increasingly Competitive

The price of real estate is an important cost factor organisations must take into consideration when defining their offshoring strategy. The basic motive to cut costs can well be disrupted in the long term if adequate analysis is not done before choosing the location, especially if significant growth is planned.

Rising cost of offshore real estate

Such has become the case with cities like Mumbai in India and Guangzhou in China. The shortage of supply for office space and emergence of these cities as global economic centres in their own right has seen dramatic price increases in the last decade. Couple this with the property crisis in many parts of the US and Western Europe where years of boom saw an overstock when recession hit and now Tier 2 locations in the UK and US look attractively priced, certainly compared with Tier 1 locations in the offshore countries, and this trend looks set to continue for several years. According to real estate services firm Jones Lang LaSalle there have been record take up of office spaces in offshore locations for 2011 and the trend is slated to continue into the next year as well. Rents and capital values are also still rising in most markets. The good old days where one would offshore operations in order to capitalise on the arbitrage opportunities provided by the real estate costs of the emerging markets are numbered, certainly unless you look further afield at so called ‘Tier 2’ city locations.

Increasing nearshore appeal

Comparatively, prices for office space look attractive in several domestic cities within US and UK. Recent studies show that office space prices have gone down considerably in regional UK cities like Birmingham, Manchester, Newcastle, Belfast and Cardiff. Currently, the average serviced office rents (per person) is at £125 per month in Birmingham and £82 in Manchester, down from 2011 highs of £159 and £96 per person per month (around 20 per cent) respectively. Such trends are also true for US cities like Jacksonville, Raleigh, Detroit and Atlanta where office space is both plentiful and cheap compared to Tier 1 cities in low cost emerging markets.

Figure 3 shows how prime rent of office spaces per month in traditional outsourcing locations within Asia, CEE and Latin America is now comparable to that in Tier 2 domestic locations within US or UK

Figure 4 forecasts the movement of the prime rents for the same cities for the coming years. The rents in traditional offshore locations are typically growing, whereas the same in domestic cities within US or UK are stabilising.

Figure 3: 2011 Office Space prime rents for sample offshore and nearshore locations (USD/sqft./month)

Figure 4: Forecast for rental price movement, 2012 onwards
‘Hidden’ Costs

Unforeseen costs in set-up and on-going management can also affect offshoring business cases

The bargain-basement labour rates that tempt firms to ship operations to India or China tell only a fraction of the story about cost savings related to offshoring. In reality there are a lot more hidden costs involved in this process. Indeed there are substantial savings but depending on the methods adopted and sourcing decisions made, it can take years of effort and large up-front investment to reach that optimum cost saving phase.

These costs can be broadly categorised into upfront capital investments and one-off project spend which is required to manage transition, and on-going management expenses necessary for proper integration.

The cost of transition management can vary significantly depending on scale and complexity but we estimate between 3 – 5% of the total deal value. The costs of this transition phase is the costs for licensing before setting up at the offshore location, costs for setting up an infrastructure and communications at the location, costs of internal resources assigned for project management and costs of training resources from offshore locations in order to iron out the knowledge gap. In addition to this the process demands a lot of international travel so there are ancillary expenses like visa costs, travelling expenses and allowances. Even more significantly, during this transition there may be significant expenditure in severance and redeployment costs resulting from layoffs.

The offshoring and/or outsourcing of services does entail additional overhead for effective management – retained onshore management staff, vendor and service management, auditing the processes, additional training and travel expenses to name a few – and can account for up to 5 – 8% of the total deal value.

In totality, these expenses may well be between 10 – 15% the total deal value, or more if the scale of offshore implementation is relatively small (say sub 100 FTEs). Hence in those situations nearshoring becomes an attractive option. The proportion of these expenses reduces considerably on selecting the right location, preferably a city closer to the home country.

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**On-going Management Costs**
- Capital costs of licensing, telecoms and other technology infrastructure
- Training
- Recruiting
- Travel, visas and other knowledge transfer costs
- Severance, and staff incentive programmes

**Transition Costs**
- Retained management team and vendor managers
- Auditing
- Invoicing and financial management
- Travel and visa costs
- Additional infrastructure and technology licensing opex

**Figure 5:** Other costs as percentage of total offshoring deal value. Source: Elix-IRR analysis, CIO Magazine 2011
Conclusion

‘Nearshoring’ as part of a balanced sourcing strategy

Offshoring has been an excellent and proven management tool for improving cost, productivity and quality. However with changes in the macroeconomic factors that made offshoring attractive, organisations need to reconfirm their strategy. As well as the expansion of potential offshoring destinations into Tier 2 cities and new regions like South America and Africa, there are many attractive nearshore locations for countries like the USA, UK, Germany, France and Japan which will have an increasing role to play in the global sourcing landscape.

That is not to suggest that offshoring will disappear as a viable strategy; many of the offshoring risks and issues highlighted in this report can be overcome and indeed many companies are now using offshore outsourced capabilities to enhance their skills and productivity beyond unit cost improvements. Rather, a consideration of nearshore delivery should be part of any location and/or sourcing decisions and increasingly, we believe, companies must diversify their portfolio of nearshore and offshore operations in order to minimise economic, operational, geopolitical and cultural risk, while optimising competencies and costs. Realising the potential of having a local presence, service providers are expanding their footprint and establishing operations across the globe. Firms should capitalise on these moves to create strategic alliances with service providers with a flexible balance of offshore, nearshore and onsite delivery capabilities.
About Elix-IRR:

Elix-IRR is a strategic advisory firm specialising in all forms of transformation, change, operating models and sourcing strategies. It is comprised of senior professionals from consulting and services firms such as McKinsey, Deloitte, IBM and Accenture, as well as experienced practitioners from industry.

We provide practical, pragmatic advice that leads to real results.

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