The Hidden Costs of Offshore Outsourcing

Moving jobs overseas can be a much more expensive proposition than you may think.
BY STEPHANIE OVERBY

INTERACTIVE WORK SHEET

You can figure out your own best and worst case scenarios for going offshore when you calculate the costs for yourself. Use our online calculators.

Detailed version: Use this to include the individual amounts to be spent in each category.

Summary version: Use this if you want to enter one overall cost for the entire contract.

The current stampede toward offshore outsourcing should come as no surprise. For months now, the business press has been regurgitating claims from offshore vendors that IT work costing $100 an hour in the United States can be done for $20 an hour in Bangalore or Beijing.

If those figures sound too good to be true, that's because they are.

In fact, such bargain-basement labor rates tell only a fraction of the story about offshore outsourcing costs. The truth is, no one saves 80 percent by shipping IT work to India or any other country. Few can say they save even half that. As just one example, United Technologies, an acknowledged leader in developing offshore best practices, is saving just over 20 percent by outsourcing to India. (For more, read "Inside Outsourcing in India.")

That's still substantial savings, to be sure. But it takes years of effort and a huge up-front investment. For many companies, it simply may not be worth it. "Someone working for $10,000 a year in Hyderabad can end up costing an American company four to eight times that amount," says Hank Zupnick, CIO of GE Real Estate. Yet all too often, companies do not make the outlays required to make offshore outsourcing work. And then they are shocked when they wind up not saving a nickel.

Hank Zupnick, CIO of GE Real Estate, found that because of cultural differences you cannot simply replace one American worker with one offshore worker.

In this article, we will explore a new TCO—the total cost of offshoring. We will uncover all the hidden costs of outsourcing—areas in which you'll have to invest more up front than you might think, places where things such as productivity and poor processes can eat away at potential savings, and spots where, if you're not careful, you could wind up spending just as much as you would in the U.S. of A. (For more on how to calculate your own TCO, see the worksheet "Do the Math" on bottom of this page.)

"You can't expect day-one or even month-six gains," Zupnick says. "You have to look at offshore outsourcing as a long-term investment with long-term payback."

Talk to David Raspallo

Outsourcing is a tangled, more expensive web than you think. **What are the real costs of going offshore?** David Raspallo, CIO of Textron Financial, knows. Until Sept. 15, go to **ASK THE SOURCE** to query him on offshore issues—costly and otherwise.

The Cost of Selecting a Vendor

With any outsourced service, the expense of selecting a service provider can cost from .2 percent to 2 percent in addition to the annual cost of the deal. In other words, if you're sending $10 million worth of work to India, selecting a vendor could cost you anywhere from $20,000 to $200,000 each year.

These selection costs include documenting requirements, sending out RFPs and evaluating the responses, and negotiating a contract. A project leader may be working full time on this, with others chipping in, and all of this represents an opportunity cost. And then there are the legal fees. Some companies hire an outsourcing adviser for about the same cost as doing it themselves. To top it off, the entire process can take from six months to a year, depending on the nature of the relationship.

Vice President of Program Solutions and Management Ron Kifer spent several months on vendor selection before contracting with Bangalore, India-based Infosys to handle a whopping 90 percent of development and maintenance work for DHL Worldwide Express, a shipping company. "There's a lot of money wrapped up in a contract this size, so it's not something you take lightly or hurry with," Kifer says. "There has to be a high degree of due diligence making sure that the [offshore] company can respond to your needs."

Ron Kifer, VP of program solutions and management at DHL Worldwide Express, ran into delays and additional costs in shifting jobs offshore when it took longer than expected to install the necessary hardware in India.

Even when there is an existing tie between customer and offshore vendors, the expensive and lengthy step of vendor selection is a must-do for successful outsourcing. The chairman of Tata Consultancy Services (TCS), a Mumbai, India-based outsourcer, sat on the international advisory board of Textron, a manufacturing company that owns such brands as Cessna Aircraft and E-Z-GO Golf Carts, for several years. However, when David Raspallo, CIO of business unit Textron Financial, began exploring offshore outsourcing in 1999, he still spent five months doing what he calls "the usual Betty Crocker Bake-Off" with service providers Covansys, ITS, TCS and Wipro. Ultimately, he went with U.S.-based Covansys, which has three development centers in India. Selecting the vendor took 500 hours in total, involved Raspallo and three senior managers, and cost $20,000 in additional expenses.

At this stage, travel expenses enter the picture as well. A trip overseas helps CIOs get comfortable with their choice. After all, offshore vendors can send their best and brightest over for a dog and pony show, but checking out the company on its home turf provides more insight. John Dean, the CIO of Steelcase, an office furniture manufacturer, spent several thousand dollars to send one of his IT executives to Intelligroup Asia in Hyderabad, India, for a week before signing on the dotted line.

"You can read everything you want to read and ask for advice as much as you want, but you have to make it a fact-based decision," Dean says. "So it was important to visit India to validate our thinking."

Bottom line: Expect to spend an additional 1 percent to 10 percent on vendor selection and initial travel costs.

The Cost of Transition

The transition period is perhaps the most expensive stage of an offshore endeavor. It takes from three months to a full year to completely hand the work over to an offshore partner. If company executives aren't aware that there will be no savings—but rather significant expenses—during this period, they are in for a nasty surprise.

"You have to bring people to America to learn your applications, and that takes time, particularly if you're doing it with a new vendor for the first time," explains GE Real Estate's Zupnick, who maintains a handful of three-year contracts with offshore vendors, including TCS and smaller vendor LSI Outsourcing. In GE Real Estate's case, the transition time for each vendor was three months at the very least and up to a year in some cases, in addition to the money-draining vendor selection period of several months.

Zupnick, who has seven years of offshore experience, says most of his peers don't appreciate the time and money it takes to get a relationship up and running. "The vendors say you can throw it over the wall and start saving money right away. As a result, I've heard of CIOs who have tried to go the India or China route, and nine months later they pulled the plug because they weren't saving money," Zupnick says. "You have to build in up to a year for knowledge transfer and ironing out cultural differences."

"The vendors say you can throw offshore jobs over the wall and start saving money right away. You have to build in up to a year for ironing out cultural differences."

—HANK ZUPNICK, CIO OF GE REAL ESTATE

CIOs must bring a certain number of offshore developers to their U.S. headquarters to analyze the technology and architecture before those developers can head back to their home country to begin the actual work. And CIOs must pay the prevailing U.S. hourly rate to offshore employees on temporary visas, so obviously there's no savings during that period of time, which can take months. And the offshore employees have to work in parallel with similarly costly in-house employees for much of this time. Basically, it's costing the company double the price for each employee assigned to the outsourcing arrangement (the offshore worker and the in-house trainer). In addition, neither the offshore nor in-house employee is producing anything during this training period.

But it has to be done. "We made a mistake in the beginning of just packing up the specs and shipping them over, looking at it from a pure cost standpoint," says Craig Hergenroether, CIO of Barry-Wehmiller, a packaging manufacturer that has its own development center, Barry-Wehmiller International Resources, in Chennai, India, and works with other offshore vendors. "Silly mistakes were made because we didn't take the time to have them come over. It's a false savings to keep costs down by communicating only by phone."

During the transition, the offshore partner must put infrastructure in place. While the offshore partner incurs that expense, the customer should monitor the process carefully. Often it can take longer than expected. "It took an awful lot of time to bridge the Pacific [networking our company to the Indian vendor] and getting that to work correctly," remembers Textron Financial's Raspallo, who spent six months and $100,000 to set up a transoceanic data line with Infosys in 1998 for Y2K work. It also cost an extra $10,000 a month to keep that network functional. "You have to know hands down that the technology infrastructure you put in place is fully functional and will operate at the same performance level as it would if you were connecting to someone on the next floor. Otherwise, you'll have a lot of costly issues to deal with."

DHL's Kifer had similar problems. Long lead times for acquiring the necessary hardware in India delayed development work, he says. The hardware holdup put off the start of offshore work for several months, requiring DHL to continue to keep vendor workers employed onsite at the more expensive rate.

During the transition period, the ratio of offshore employees in the United States to offshore employees working at the vendor's overseas headquarters is high. But after the transition is complete, CIOs have to get those employees out of the office if offshoring is to be a money-saving move. "It's got to be 80 percent or 85 percent working offshore or the numbers just don't work," explains GE Real Estate's Zupnick.

It makes sense for offshore service providers to place as many of their employees in the United States as possible. The provider's margins—already quite decent for offshore work (Indian companies charge U.S. companies $20 an hour for an employee they pay around

Learn More...

When the Customer Isn't Right
Indian I.T. vendors have an unmatched commitment to customer service, but that positive can turn to a negative when eager-to-please vendors ignore flaws in software specifications.

Inside Outsourcing in India
Outsourcing to India can provide a huge payback—if you're willing to work at it. Two offshore veterans share their hard-earned lessons to help you determine if Indian outsourcing is right for your company.

Leadership and Management Research Center

Outsourcing Research Center

Staffing and Retention Research Center

$10)—really skyrocket when they're on American soil. "They make more money and often the client feels better having them close," says Praba Manivasager, CEO of Minneapolis-based offshore adviser Renodis. "But the customer immediately loses all of the bill-rate savings." If not included in the original contract, additional travel and visa costs also must be figured in. Tally it all up and you will pay as much as you would for one of your own employees.

It's a difficult area for CIOs to manage. Work is much easier to do with offshore workers onsite, but to cut costs they must push as much overseas as possible. Conversely, the more manpower based offshore, the more project problems and delays. Barry-Wehmiller's Hergenroether says the amount of workers you can reasonably send offshore depends on the type of work being done. Industry- or company-specific system development requires more developers onsite. Legacy maintenance or simple upgrades may not require a soul.

"On some of our projects, up to 50 percent of offshore workers are onshore; on others it's closer to 10 percent," Hergenroether says. In some cases—where specific skills are the reason for offshoring—he may even bring in offshore talent over long term. "But if you're going to do that, your cost savings diminish dramatically," he says. In fact, there may be no savings at all.

Bottom line: Expect to spend an additional 2 percent to 3 percent on transition costs.

The Cost of Layoffs

Laying off American employees as a result of your offshore contract poses other sometimes unanticipated costs. To begin with, you have to pay many of those workers severance and retention bonuses. "You need to keep employees there long enough to share their knowledge with their Indian replacements," Zupnick explains. "People think if they give generous retention bonuses it will destroy the business proposition. They cut corners because they want quick payback. But then they lose the people that can help with the transition and incur the even bigger cost of not doing the transition right."

Layoffs can also cause major morale problems among in-house "survivors," in some cases leading to disaffection and work slowdowns. Companies with experience in offshoring factor productivity dips and potential legal action from laid-off employees into the cost-benefit analysis.

"You can never underestimate the effect these issues will have on the success of [your offshore venture]," says Textron Financial's Raspallo. CIOs must take time to communicate with their staffs, being "brutally honest," he says. "If your intention is to lay off some workers and move work offshore, let them know. If you want to move legacy systems offshore and retrain staff for other systems, tell them that. And constantly reinforce what the vision is."

Raspallo sets aside time for a monthly meeting with all staff (offshore included) by video. "In the beginning, we spent the whole time talking about the offshore proposition," he says. "If you don't spend that time doing that, your staff is going to make up stories about what's happening themselves."

Without this kind of effort, offshore endeavors are doomed.

"Internal people will refuse to transition to the offshore model because they have a certain comfort level, or they don't want their buddy to lose his job," Renodis's Manivasager says.

"There has to be a mandate. Trying to build consensus can take a very, very long time." Manivasager has seen some relationships take as long as three years to get off the ground because the strategy was neither shared with nor embraced by employees.

Bottom line: Expect to pay an extra 3 percent to 5 percent on layoffs and related costs.

The Cultural Cost

One of the biggest impediments to offshore savings is productivity. "You simply *cannot* take a person sitting here in America and replace them with one offshore worker," GE Real Estate's Zupnick says. "Whether they're in India or Ireland or Israel."

One reason for that is the American workers' comfort level with speaking up and offering suggestions. "A good American programmer will push back and say, What you're asking for doesn't make sense, you idiot," Zupnick says. "Indian programmers have been known to say, This doesn't make sense, but this is the way the client wants it." Thus, work takes more time and money to complete. And a project that's common sense for a U.S. worker—like creating an automation system for consumer credit cards—may be a foreign concept offshore. Additionally, offshore vendors often lack developer experience (the average experience of offshore developers is six years).

On average, IT organizations going offshore will experience a 20 percent decline in application development efficiency during the first two years of a contract as a result of such differences, Meta Group Vice President of Service Management Strategies Dean Davison says. According to Meta Group, lags in productivity can add as much as 20 percent in additional costs to the offshore contract.

Another productivity killer is high turnover at offshore vendors. Attrition rates climb as high as 35 percent in India, according to the National Association of Software and Service Companies. "Unless you can somehow address that in your contract, you're paying for someone to learn your product and then they're gone," Zupnick says. Turnover can cost an additional 1 percent to 2 percent.

Finally, communication issues can slow things to a halt. "We had to do a lot more face-to-face interaction than originally anticipated because [offshore workers] just didn't interpret things the same way," says DHL's Kifer. "That resulted in a lot more travel there or bringing them onshore to bridge that gap. We did that a lot more often than the model would have prescribed." Language and other cultural differences can cost an extra 2 percent to 5 percent, according to Meta Group.

Bottom line: Expect to spend an extra 3 percent to 27 percent on productivity lags.

The Cost of Ramping Up

Well-defined and accepted internal software development and maintenance processes are also key to making an offshore situation work. "If you're an organization that develops and maintains by the seat of your pants, or it's a case where Mary Jo and Fred have been here for 30 years and they know how to do everything, you are in *trouble*," says Raspallo, who currently sends 65,000 man-hours of work to India.

Raspallo spent five months and $80,000 in consulting fees to get ISO certified in 1998, which puts his company at about Level 3 in terms of his employees' "capability maturity" in developing software. He also invested in an automated Web-based system to support the

Doing Your Offshore Homework

Offshore outsourcing may save you money; then again, it may not. Rather than accept offshore vendors' claims, you need to calculate your own ROI. Here are some tips to get started.

1. Know what your internal costs are. If you don't know what your own real labor rates are for accomplishing tasks you plan to send offshore, how can you know how much you'll really save?

2. Ask your peers. Organizations such as the Society for Information Management and CIO conferences are great places to get the real information from peers who are outsourcing offshore.

3. Contact vendor references. Ask these CIOs what unforeseen costs they've encountered in their offshore engagements.

4. Estimate potential soft costs. As much as possible, figure in factors such as lower morale and cultural changes.

5. Create a three- to five-year plan. Include your identified hidden costs as well as anticipated scope changes.

new software development and labor management practices. Most of the Indian offshore companies are ISO certified and at Capability Maturity Model (CMM) Level 3 or 5. "If your own staff can't get used to working at that level, you're going to have a major disconnect," Raspallo says.

If a company doesn't create solid in-house processes, "the vendor will have to put more people onsite to compensate for your inadequacies, and they'll spend all of your savings," says Meta Group's Davison.

DHL America's IT department spent a full year to get to CMM Level 2 in 2002. Kifer is aiming to be at Level 3 in the United States this year, with the ultimate goal of achieving Level 3 across the entire global IS team. "It's a big project, and it entails a significant level of training and education," he says. "But if you're going to take full advantage of offshore outsourcing, you have to raise your own maturity level." Not everyone was gung ho about the new level of discipline required, but Kifer lit a fire under them with annual bonuses tied to certification.

The ability to write clear specifications is also critical to achieving offshore savings.

"When you're doing this stuff internally, you tend to be much more cavalier," says Hergenroether. "When you have to package specs to go outside the company, that has to be done exceptionally well." Creating a great spec package is costly and time-consuming. On a 1,000 man-hour project for example, Hergenroether's staff will spend 100 hours to create a spec package.

At the other end of the process is quality assurance (QA) testing, an area which must become more robust in an offshore arrangement. "We essentially picked up two shifts of people at Cognizant in India working while we slept. The work we sent out at 4 p.m. came back to us at 10 a.m., and we didn't have a QA funnel big enough to handle that," says Radio Shack CIO Evelyn Follitt, who now hires more temporary QA staffers during development time.

Bottom line: Expect to spend an extra 1 percent to 10 percent on improving software development processes.

The Cost of Managing an Offshore Contract

Managing the actual offshore relationship is also a major additional cost. "There's a significant amount of work in invoicing, in auditing, in ensuring cost centers are charged correctly, in making sure time is properly recorded," explains DHL's Kifer. "We have as many as 100 projects a year, all with an offshore component, so you can imagine the number of invoices and time sheets that have to be audited on any given day."

At DHL, each project manager oversees the effort. He audits the time sheets from the vendor and rolls the figure into an invoice, which then has to be audited against the overall project, which is then funneled to finance for payment. Kifer's staff has been a bit overwhelmed. "We knew there would be invoicing and auditing," he says. "But we didn't fully appreciate the due diligence and time it would require."

At GE Real Estate, managing the offshore vendor is such a big task that Zupnick assigned someone to handle it on a half-time basis at a $50,000 salary. The individual makes sure projects move forward, and develops and analyzes vendor proposals against the RFPs when it comes time to bid out new work.

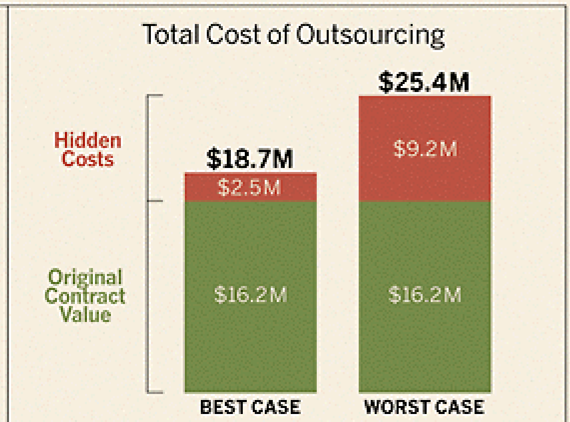
"It's a critical job," Zupnick says. "That's the price you have to pay to make this work."

Bottom line: Expect to pay an additional 6 percent to 10 percent on managing your offshore contract. CIO

Share your offshore outsourcing stories with Senior Writer Stephanie Overby at *soverby@cio.com*.

Do the Math

IF YOUR COMPANY spends $16.2 million on offshore outsourcing contracts (the average value of offshore contracts for the 101 companies recently surveyed by *CIO*), even in the best-case scenario, you will actually spend 15.2 percent, or $2.5 million, in extra costs on everything from transition costs to productivity lags as a result of cultural differences. In the worst-case scenario—meaning you have unexpectedly high layoff and transitioning costs and the productivity of your software development drops dramatically—you can expect to pay up to 57 percent, or $9.2 million, in additional costs on top of the $16.2 million cost of your offshore contracts.



HIDDEN COSTS	BEST CASE contract value			WORST CASE contract value		
1. Vendor selection*	$ 16.2M	x .002 =	$ 32.4K	$ 16.2M	x .02 =	$ 324 K
2. Transitioning the work	$	x .02 =	$ 324 K	$	x .03 =	$ 486 K
3. Layoffs and retention	$	x .03 =	$ 486 K	$	x .05 =	$ 810 K
4. Lost productivity/Cultural issues**	$	x .03 =	$ 486 K	$	x .27 =	$ 4.4 M
5. Improving development processes	$	x .01 =	$ 162 K	$	x .10 =	$ 1.6M
6. Managing the contract	$	x .06 =	$ 972 K	$	x .10 =	$ 1.6M
Total hidden costs		15.2% =	$ 2.5 M		57% =	$ 9.2M
Original contract value		+	$ 16.2M		+	$ 16.2M
Total Cost of Outsourcing (TCO)		**BEST CASE =**	$ 18.7 M		**WORST CASE =**	$ 25.4 M

SOURCES: Meta Group, Gartner and Renodis

* Annualized percentage from an initial five-year cost of 1 percent to 10 percent

** This varies widely depending on the maturity of the offshore vendor and an understanding of cultural differences among offshore and onshore workers, as well the rate of turnover among offshore workers and the length of contract.

To calculate your hidden costs online, go to *www.cio.com/printlinks*.