



Extending Cost Arbitrage – The Rural Way

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We hope that with such an encouragement we can scale better heights and come up with more and more such novel articles from time to time.

Abstract

This paper attempts to highlight the hidden opportunities that exist for outsourcing service providers in India. With a fleeting reference to automation as the ultimate goal, the paper emphasizes the concept of a “rural BPO” that will give the Indian service providers the much needed arbitrage extension.

Genesis of Outsourcing

Ideally business organizations are expected to do only business. They should also work constantly to keep up their competitive advantage to remain in business. For any organization, activities that contribute directly to competitive advantage involve high levels of complex human interactions. From an article in a McKinsey Quarterly of 2005, such activities are considered to be tacit in nature because the people working on such activities have to draw heavily from tacit knowledge and there are no pre-defined rules in this game. Activities like analysis, innovation, planning, negotiation, coordination, customer interactions and relationship management are examples of tacit activities.

But the very nature of all tacit activities brings in a few overheads in the form of support activities. Some of the support activities are transactional in nature and do not contribute directly to business. These support activities tend to be routine in nature and are generally rule-based. Activities like data entry, verification, etc fall under this category.

One way for businesses to improve their market position is to improve the productivity and efficiency of tacit workers to the most optimal levels. This clearly will enable organizations to emerge as leaders because generally innovations that improve the efficacy of tacit work are not imitable by the competitors and help organizations prolong their competitive advantage. This is an area that still requires lot of research.

A second and an equally effective way of improving competitive advantage, albeit in the short term, is for organizations to reduce the costs and efforts involved in carrying out transactional activities. These activities are definitely not avoidable. But the means of carrying out these activities can be “manipulated” to improve bottom-lines of organizations. For example, one such manipulation is to “virtualize” these activities to get them done from a low cost area. Similarly such work can be automated to a great extent with properly defined controls. In other word, transactional work, being rule based lends itself to virtualization and automation.

Expanding the thought process set in the previous paragraph, we start off envisaging an ideal scenario in which there is an intelligent machine that runs the entire business by itself. The machine is self-learning and can also perform tacit works. The only cost associated with such a machine would be the one-time investment cost and relatively small operating expenses. An organization capable of building such a virtual machine would have the “most ideal competitive advantage”. Building such a machine is tantamount to “total automation”. Since tacit work involves high level of complex interaction, we leave the scope of building a machine with tacit abilities to other domains such as artificial intelligence. Such an evolution would take sufficiently long time that no organization can wait for gaining that ideal competitive advantage.

In a shorter term, compared to such a high level of evolution, probably this intelligent machine can be entrusted with the job of taking up all the transactional kind of activity that is not contributing to the business interests. This is the ideal case of “automating” all transactional activities. In such a case, the organization would have spent only on building or purchasing such a machine and there would be very few operating expenses related to this machine.

This is where we jump into a more realistic scenario where the ideal scenarios mentioned so far will take some time to evolve and organizations need to develop mechanisms to keep up their competitive advantage in the interim. This is the genesis of outsourcing. While “automation” is very much desirable from the point of view of an organization’s competitive advantage, some other forms of outsourcing have to be considered till a scenario of total automation sets in. This is how the entire concept of outsourcing started and evolved. Companies started looking at cheaper and better ways of getting their transaction-oriented work done and quite successfully “outsourced” a good amount of such work.

Defining the arbitrage life cycle

The business of outsourcing in general is based on some arbitrage that is likely to have its own life cycle. The arbitrage tends to diminish over a period of time owing to factors like competition and exploitation. The end point would be the death of arbitrage when the outsourcing organizations cease to perceive any advantage due to outsourcing. This is where these organizations start looking at alternative ways to outsource and the service providers will be forced to innovate to keep up their cost advantage. If we capture the arbitrage on a time dimension, conceptually the graph would look as below:

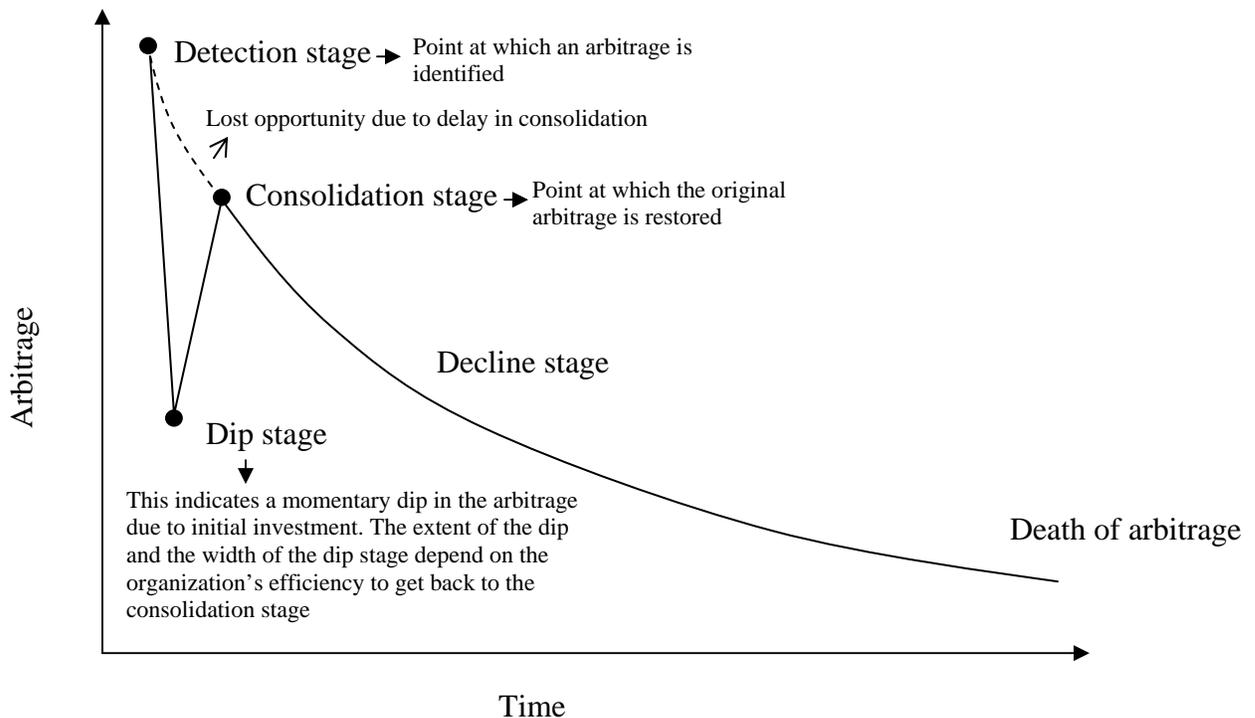


Fig 1. Outsourcing arbitrage life cycle – A Conceptual View

This paper attempts to highlight the consequences of diminishing arbitrage and suggest a viable idea to take advantage of the “manipulability” and “virtualisability” of transaction oriented activities in terms of outsourcing to mitigate the risk attached with the arbitrage

life cycle. At this juncture it is very pertinent to discuss how India has evolved as an outsourcing destination and how dynamically it is changing.

How India became a hub for outsourcing

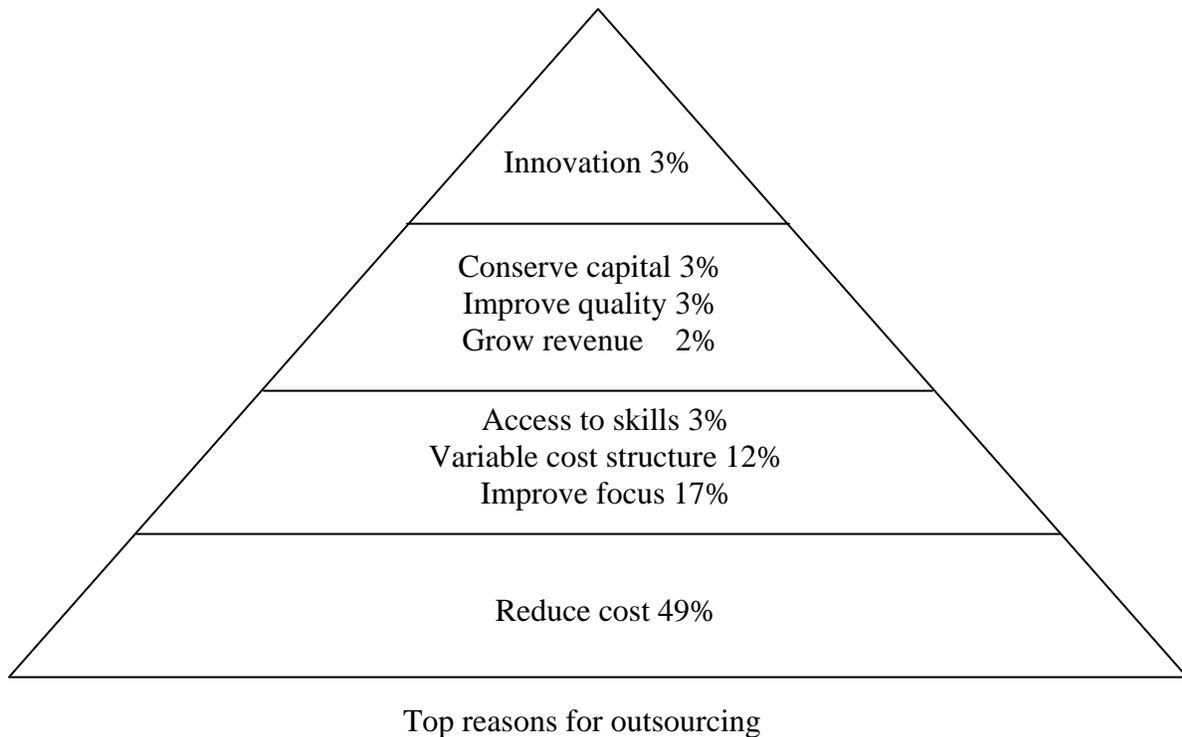
Outsourcing is being used extensively in today's business world. Organizations of all kinds use outsourcing to improve the competitiveness of their products and services. Outsourcing as a phenomenon has been used by organizations to free up capital and manpower from mundane activities, to focus on their core competence. A lot of literature is available on outsourcing which shows the attention that this phenomenon is currently enjoying. Harvard Business Review commented that outsourcing has been one of the most important management concepts of the present times.

The concept of outsourcing gained visibility with the recession of 1990-1994, which forced companies to outsource transaction oriented activities to other countries where the cost of undertaking such activities was cheaper. Thus, reducing cost and increasing efficiency were the driving factors which propelled companies to outsource from 1990 onwards. Though technology and process improvement activities did turn out to be great saviors in terms of increasing the efficiency of organizations, they did not altogether obliterate transaction related activities.

Rapid commoditization resulted in the power shifting from producers to consumers. As a result the ability of organizations to command a higher price for their unique value propositions only lasted for a fleeting amount of time. Organizations had to find some way to improve their efficiencies and keep up their competitive advantage. Thus the modern concept of outsourcing was born out of a hypercompetitive environment that companies in the West started facing.

Cost reduction dominated the mind space of companies outsourcing in the last decade. But with passage of time the concept of professional execution of transactional activities by lower cost countries started contributing to an improvement in the efficiency and the

economy of managing work. Thus what started off with the motive of capitalizing on “cost arbitrage” started being analyzed for other non-cost advantages – the most significant of which is an “improved focus” on the activities that are being outsourced. This increased focus in turn led to improved efficiency and quality of the output. India as a provider had all the qualities that made it the most happening ground for outsourcing. The ability and the educational level of the workforce handling assignments have contributed significantly towards the efficiency of handling work. The availability of large numbers of qualified people meant an improved productivity, shrinking turnaround times and above all tremendous scalability.



Source: The 2004 outsourcing world summit

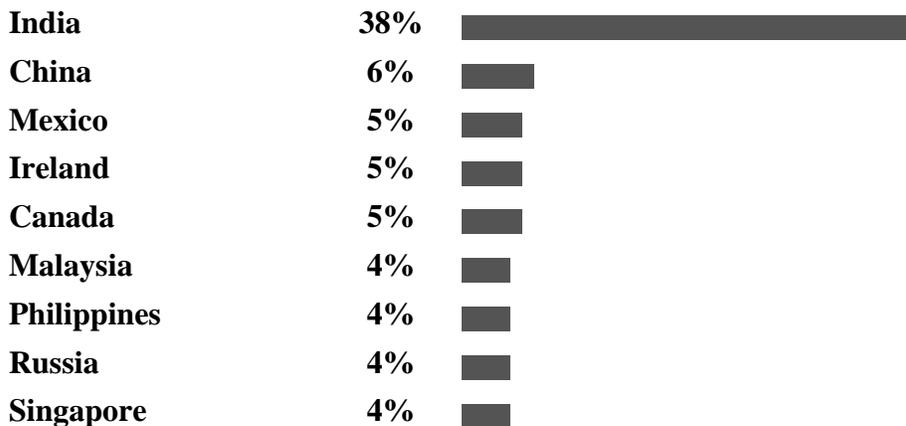
The first wave started with companies like TCS and Satyam which developed world-class expertise in software "application development and maintenance", and their low-cost developers became the preferred partners of many Western IT firms. In the second wave,

Indian firms and the local "captive" operations of multinationals started offering transaction oriented back-office services that could take place a continent away. India became a global destination for operations like customer care, medical transcription, insurance claims processing and so on. In the third wave, in both IT and the broader spectrum of other "business processes", even more sophisticated functions are happening in India. For example, according to Frost and Sullivan, research and development outsourcing market for information technology in India is estimated to grow to \$9.1 billion by 2010 from \$1.3 billion in 2003.

The Scenario of diminishing arbitrage

India is clearly the leader in offshore IT outsourcing today. The following graphs, drawn from a 2003 survey gives a picture of India's leadership position vis-à-vis other potential countries with respect to outsourcing.

Survey respondents say they're currently outsourcing IT work to the following countries:



Base: Survey of 252 corporate IT managers in the U.S.; multiple responses allowed

Source: Computerworld and InterUnity Group Inc., Concord, Mass., April and May 2003

But as wage costs are rising, the market in India is consolidating around a handful of big vendors, and countries such as China and Philippines are gearing up to compete as outsourcing centers with even lower costs. A Gartner report warns about a labor crunch and rising wages possibly eroding as much as 45 percent of India's market share by 2007. As per another report based on Asia-Pacific Salary Increase Survey conducted by Hewitt Associates, India in 2005 reported the highest average salary increase at 13.9 percent, and

employees in the Indian IT-enabled industry received the highest increase across five groups surveyed at 17.9 percent. In a yet another study, Assocham Eco Pulse analysis of the second quarter performance (2005) of around 100 Indian companies has indicated that while their net profit went up by 18 per cent and total income of these firms grew by 20 per cent across different sectors, manpower expenses rose at a greater pace of 22 per cent. Pertaining to IT and ITeS industry of India, the rise in wage costs is much higher. This sector recorded the maximum rise in staff expenses, which went up by 36 per cent against the net profit growth of 29 per cent and growth in total income by 30.5 per cent in the second quarter, an extension of the Assocham study estimates. Salary increments at such a rate can clearly offset the cost arbitrage that India is enjoying currently.

If we analyze the presence of IT / ITeS units in India we will find a large concentration of the units Tier-I cities which include Mumbai, Gurgaon, Chennai, Bangalore and Hyderabad. So, apart from the increase in wage costs, the realty costs have also increased considerably. With presence of large number of IT and ITeS firms have resulted in tremendous mobility of the employees of different organizations among themselves. This has resulted in huge attrition that is leading to increased wage costs.

This means that the advantage which helped India corner a large share of the outsourcing market is going to get wiped in few years time and if not entirely, a major portion of outsourcing business will be lost to low cost players like China. The present paper tries to challenge the above statements by suggesting a sensible outsourcing strategy of setting up operations in lower cost areas within the country (India) itself.

The step ahead – Rural BPO

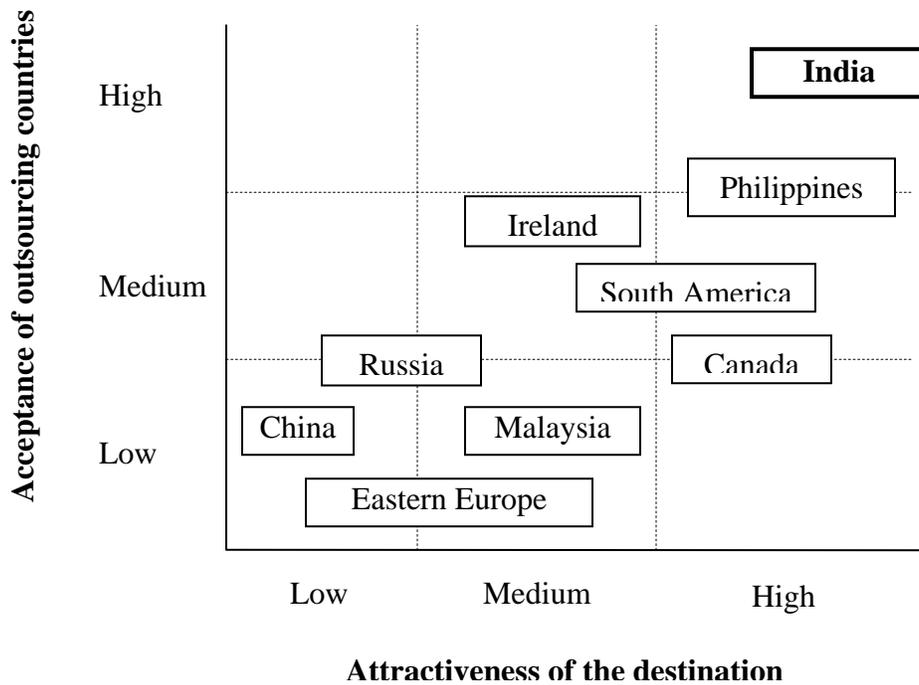
The first step in containing this difficulty would be for IT / ITES companies to start migrating their operations to lower cost destinations. There have been many solutions which are being forwarded to retain the advantage that India enjoys. Two of such significant alternatives are:

- Shifting operations or a part of the operations to potential low cost areas like China, Malaysia, Philippines
- Tapping the vast pool skilled and cheap work force in rural areas in India itself

These alternatives essentially address the issues of diminishing cost arbitrage and also of lost business opportunities due to a paucity of qualified people to take on the growing business.

Both these solutions have their own advantages and disadvantages. In case of the companies shifting to low cost countries, the cost arbitrage which seemed to be extinguishing from Indian companies will remain. The expertise that Indian companies have achieved so far will be used in these countries which will reduce the gestation period normally associated with an ITeS operation and will start resulting in greater returns. The low cost countries which have language issues will have got it sorted by then; for example it is being said that China will produce its first batch of English speaking students by the year 2010, who can be used by Indian ITeS operators. This will also give Indian companies access to other potential markets that are linked with the new low cost country of operation.

However on the flip side, though it is clear that the cost advantage will always be there in countries like China and Philippines, it is still not clear about the quality of this manpower to effectively deal with requirement of international ITeS. Moreover the time that would be required to bring this manpower to meet the requirements of the industry puts a double cost disadvantage to the Indian ITeS companies in terms of cost of training as well as cost of setting up of centre in overseas market. Also if we analyze countries in terms of their stability vis-à-vis India all the potential low cost areas fare very poorly. India tops the chart when it comes to being an attractive destination (in terms of factors like cost advantage, etc) and its acceptance of outsourcing countries (in terms of factors like government policies, etc)



Source: Outsourcing Revolution: Why It Makes Sense and How to Do It Right, Michael F., p 49,

That leaves us with the second alternative of trying to tap the resources of the Tier-II cities and rural areas which have a vast pool of talent. According to 2001 census estimates, there are around 75 lakhs rural graduates in the age group of 20-34 years. The urban counterparts amount to around 1.2 crores. One argument that justifies the claim Indian companies should start looking at rural areas to expand their operations is that the average urban graduate has more opportunities and has the ability to shift jobs. There is a high incidence of attrition associated with the average urban graduate, whereas in the case of rural graduates, the biggest employment generator is agriculture and rarely does any other opportunity exist. So if Indian companies start looking at rural areas, they get to tap the most sizeable population of graduates and expect to retain them for a much longer period of time. This would help companies reduce their human costs in terms of hiring and training. McKinsey has predicted a shortage of man power in terms people having requisite skills for running BPO industry by 2008. However if industry and the Government take active steps, there is a vast mine of talent lying to be tapped in the rural areas.

Going rural would also give companies the necessary cost arbitrage extension that we had mentioned in the earlier section. A rough estimate based on a sample survey indicates that the rural cost is about a quarter of the urban cost. The calculation is based on the current levels of costs and a similar activity being carried out in both places. If we also compare the growth rate of cost in both urban and rural, the mentioned cost advantage becomes even more appealing. Though we do not have an accurate estimate of the growth rate of salary cost in rural areas, it definitely would be much lesser compared to the average growth rate of around 20% in urban areas. Rural areas would still remain sluggish in terms of increasing costs, because of various reasons. The first reason is that the rural graduates have no benchmarks and do not expect huge increase in their wages. The second and a more pertinent reason is that they do not need to move out of their villages and this would in turn keep a lot of their incidental costs like house rents, etc under check. In fact these costs would not exist for many of the graduates in question. In this case the arbitrage life cycle mentioned in fig.1 in the earlier section gets modified as follows:

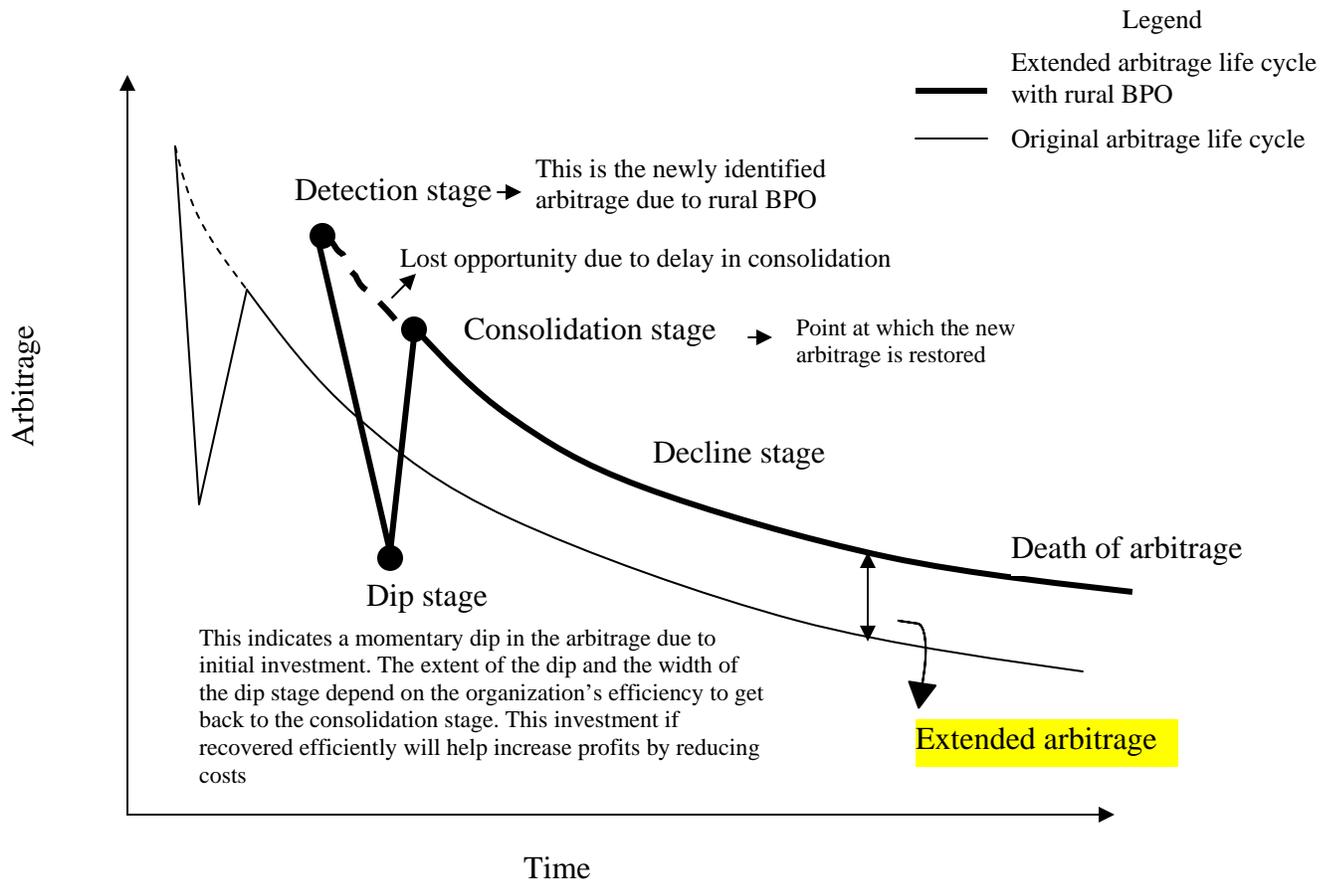


Fig 2. Outsourcing arbitrage life cycle – New opportunity

Another important reason why the rural option is attractive is the easy scalability of the operations if situation demands. Recruiting people locally would be much easier and cost-effective compared to sourcing talent from other locations as is the case with companies operating out of cities. It is pertinent to quote NASSCOM President Mr. Kiran Karnik's statement that "the best advantage which Indian BPOs have vis-à-vis any other BPO industry is its scalability. Nowhere in the world can a 300-seater BPO centre be created in such a short span of time". The "scalability advantage" becomes more pronounced in case of rural operations because of the easy availability of qualified manpower and low attrition rates.

Risks & Mitigation

With all these advantages of a rural BPO there are a few concerns that need to be addressed or answered. Expertise in English is a critical requirement especially for a BPO setup. This is an area that rural graduates might be lagging behind their urban counterparts. But with suitable training, these people can definitely be brought up to a desired level of performance. The second biggest challenge is the confidence level of rural graduates in facing clients and presenting themselves. This obstacle can be overcome through proper orientation and training. Through a structured and a scientifically designed methodology, these obstacles can be overcome.

Another big challenge is the availability of reliable and fast network connectivity in rural areas. The very nature of IT / ITeS operations demands a high level of real time connectivity with many parts of the world. But with the connectivity becoming cheaper by the day and more service providers coming into the fray, this problem is already being addressed to a large extent. Issues of governance have to be carefully worked out to suit the local socio-economic-political situations. Nevertheless, issues concerning governance would seem trivial compared vis-à-vis the operations being expanded to other countries. Moreover expanding to rural areas will help the companies in meeting their corporate social responsibility (CSR) objectives. This would also open up new vistas for Indian BPO industry which at present is dependent on work from offshore business only. Based

on the cost advantage that accrues out of such an exercise, even Indian companies would start looking at rural BPO centers to get their transactional work done and concentrate on their core competencies and improve their performance in the global market. This in turn would increase the prospects of rural BPO centers beyond the expected and projected.

The larger picture

Concepts like rural BPO as with the GramIT initiative promoted by Satyam Computer Services are triggers to a better wealth distribution in the country. Satyam Computers through its ambitious Virtual Delivery of Services as a platform is gearing up to reap the benefits of this concept. There have been a few pilots in which Satyam is getting its own work of support functions (largely transactional in nature) by GramIT, a 100-seater BPO facility present in a village of Andhra Pradesh. As this concept proliferates, more and more people would be able to benefit from the advantages of this boom leading to a more prosperous nation. It will help bridge the technology divide between urban and rural India by promoting reverse migration and put Indian villages on the global IT map. Indian companies in turn will be able to capture and retain a large share of the global IT / ITeS business by keeping up their well-established competitive advantage.

The above concept requires the active involvement of all the stakeholders (the government, industry leaders, politicians, academicians, bureaucracy and the local people) to become a success. We can take a cue from the Chinese government's efforts to educate its masses in English. Similarly the Indian Government and the State Governments should pitch in to promote the concept of rural BPO.

Linking this with the concept of "total automation" mentioned at the beginning of the paper, a logical conclusion would be to suggest that rural BPOs in the longer run would move up in the technology value chain and start taking up work related to tacit activities as all transaction oriented activities keep getting automated. How accelerated this pace is would decide the competitiveness of Indian firms that made their mark based on a sound business logic in the past.

Case studies

As already mentioned in the previous sections, Satyam Computer Services is working aggressively to get a cost advantage by outsourcing its support unit activities to GramIT, a rural BPO centre in Andhra Pradesh. At a macro level, by doing so the company is also aiming to bridge the urban-rural technology divide and set the new trend of “rural BPO”. The outsourcing experience has been quite encouraging. To start with, Satyam constituted a task force comprising associates from multiple functions under its eSupport (Virtual Delivery of Services) umbrella. This team with the active intervention of the stakeholders, business specialists, the process owners and the eSupport program management office devised a proprietary methodology to evaluate the outsourceability of transaction oriented activities of support units. This methodology is based on various factors that determine the degree of outsourceability and the time required for outsourcing. Factors like the level of complexity of the task under consideration, the training requirements, confidentiality of data, infrastructure requirement, capability of virtualising the task to get it done from a remote location, etc were considered as the key parameters for decision making. The team attempted to evaluate all these factors objectively and arrived at the “outsourceability index” and the “phase-out” index.

As a first step, the team identified the HR activity of processing around a lakh of resumes to put them in a searchable database. The entire activity was completed in a record 25 working days that was clearly ahead of the schedule as per the service level agreement (SLA) with the process owner. The quality (accuracy) of the output as evaluated by the process owner stood at an amazing 99.5%. This helped the HR department reduce its recruitment cycle time drastically thereby obviating the opportunity cost of losing valuable human resources to competitors. One thing that helped achieve this magnificent result was the scalability of the bench working for GramIT. On the softer side, the team administering the business to GramIT also attributed this success to the unflinching enthusiasm and dedication of the rural youth to the task assigned to them.

In another bold step, with the Finance department's support and three days of intensive training to 3 GramIT associates, a pilot was run on vendor bill verification and processing (accounts payable). In a move to curtail physical movement of original documents, Satyam proposed scanning of documents and transmitting it through FTP. Two GramIT resources were identified for this purpose at Satyam's office in Hyderabad. In this entire exercise, GramIT has been able to process bills worth 50 lakhs of rupees over a period of 2 months using the billing application developed by eSupport. GramIT also maintains detailed records of their activity that helps the team at Satyam to track the progress of the project. These details also are helping Satyam to identify pain areas and devise suitable remedies for the same. The pilot went off successfully, albeit with some operational level problems. Due to the learning curve effect, initially there was a deviation from the service level agreement (SLA). A change in the workflow during the pilot added to this difficulty. But again with the help of the process owner, the task force managed to clear off all the backlogs and streamline the entire activity. Outsourcing this process has allowed Satyam to relieve and redeploy four person-months of effort towards its developmental activities related to virtualization. Learning from the pilot experience is helping the task force team to plan for the processes earmarked for outsourcing.

Conclusion

The outsourcing business in India is based on sound fundamentals. But as the market gets over exposed, certain chinks develop that threaten the very basis of the existence of the business. Resting on laurels will lead to a deterioration of the competitive advantage that helped India to capture a good share of the global outsourcing market. Only constant innovation and spotting new opportunities can help rejuvenate this competitive advantage and rural BPO is definitely one of those business innovations. The pace with which the concept of rural BPO proliferates will decide the future of the Indian outsourcing business vis-à-vis the global competition.

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