Labour arbitrage – the end of an era?

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The end of an era…….?  

When I started talking to people about this article, I was pretty sure that there would be a consistent view: labour arbitrage was on the way out.

What surprised me was that there was such a wide range of views. So I spread the net further, and talked to more people.

The views in this article come from US headquartered companies: HP and Accenture; an Indian headquartered company: Wipro; a European company: Atos Origin, and also two sourcing advisors: Equaterra and TPI.

Before we get into the argument, let's have a swift look at the history.

The origins of labour arbitrage, in less than a hundred words

The origins can be traced back to the 1980s when ADP and EDS started the outsourcing industry, and effectively dominated it, as there was no real traction beyond them until 1988, when IBM won a major Kodak contract. Then, in 1989 EDS won a landmark deal with Xerox - and this really was labour arbitrage. It was about delivering from Texas and overseas, rather than from New York. And about younger people delivering the IT, rather than those with 20+ years of tenure.

But where are we now?

A wide range of current views

Views spanned the full spectrum from ‘Arbitrage for ever’ to ‘Arbitrage is dead and buried’, and everything in between.

Taking each in turn…

1) Arbitrage for ever: First I spoke with Mark Hodges, Chairman of Equaterra. His view is that this is not the end of arbitrage; “Labour arbitrage has always been part of the industry, and it will be a top three lever going forward. The location is just moving. In the 1990s Dublin, Amsterdam, and Brussels were low cost locations; then Eastern Europe, Nova Scotia, and India. Not anymore. Now it’s the Philippines, Vietnam, China, Latin America and Africa.”

Mark’s contention is that there are a small number of margin-generating levers in the outsourcing world – and that labour arbitrage is by far the biggest. Others include access to specialist resources and proprietary tools; automation through technology,
discipline around paying appropriately for each role; output-based, variable compensation; and a distinct lack of paternalism, so fully loaded costs are lower; plus, of course, scale and the lower unit costs that this confers.

2) **Arbitrage is on its last legs.** Greg Southwell, Partner F&A BPO, felt that arbitrage was not yet dead as it continues to drive most deals and will continue to do so for some time: “However, if you’re planning to continue in outsourcing, you’d better think about how you’re improving your client’s business outcomes, and how you’re going to be doing it. Leading delivery scale, analytics capabilities and deep industry experience are becoming prerequisites across the market. Clients are looking for outsourcing providers to bring industry expertise, analytics and innovation to the table, leading to better business insight and greater value creation.”

Les Mara, HP’s Head of BPO EMEA, concurred: “Labour arbitrage is simply not sustainable. One gets a one-off structural benefit from utilising cheaper labour. This has been done, and the early adopters got the biggest benefit - there is no great benefit to come.”

3) **Arbitrage was never a major driver.** Andrew Marsh, and Anne Ware, respectively General Manager and Vice President for Hi-Tech Transactional Services at Atos Origin, made the point that if arbitrage was never the driving force behind what you do, then you’re free to develop other skills and approaches, which may well serve you better in the long run. As Anne said; “Our heritage in the UK is very different. Other companies offshored. We had significant public sector business. Government wanted operational efficiency and we, mindful of data privacy issues, had to find smart ways of delivering this.”

4) **Arbitrage is dead and buried.** John Keppel, Partner and President at TPI, was clear: “Arbitrage was big news in 2005 and 2006, not now. It isn’t even the story in India, any more. The story is all about global delivery capability, and concomitant scale. Providers are looking at new regions now but it is less about arbitrage and more about completing their Global Delivery capabilities and proximity to growth markets. My customers don’t talk to me about arbitrage: its old news. Maybe the recession has triggered something of a revival, but at best this is temporary.”

So, a broad range of views, but let’s look more closely at some of the practical steps we, as an industry, need to take – no matter which of the views above you align behind.

**Some practical next steps**

If you’re of the **arbitrage for ever** persuasion, then it’s all about consolidation for you. Look out for companies in the next wave of low labour cost countries that have real, deep knowledge of the local regulation and legislation; big, multi-national clients, not just small local clients; and perhaps even some unique capability. And take heart from the fact that every year since 1988, while there is vendor consolidation by the major players, nonetheless, each year there are more outsourcers than the year before.
If you’re of the opinion that **arbitrage is just one driver**, then it’s about working with clients who see BPO, for example, as being strategic for their back office extending to the middle and front office. As Greg Southwell says, clients still want cost efficiencies, but what they really want is a back office capable of supporting their strategic direction — e.g. becoming properly global, having a back office that enables, scales, and unleashes the power of the front office. “Clients are looking to outsourcers to give them an advantage in their global business services. Sure, they want to be consolidated, but they also want a partner that can cope with the scalability. They want us to work up the value chain with them, so that we can support them end to end, it’s not about low cost transactional processing anymore.” That’s not to say that low cost delivery capability isn’t important. It is, and everyone has it — it’s not a differentiator. Key practical steps for delivering back office as an enabler of business outcomes require solid analytics tools; reporting which delivers business insight; and vertical industry knowledge (freight forwarding is very different from consumer products, for example), plus, of course, horizontal knowledge. Greg’s key point is that, in the BPO world, it’s not vanilla Order to Cash anymore, it’s a talent race to secure the people who really know horizontal BPO and have the vertical specific knowledge.

For those companies for whom **arbitrage was never a major driver, or for whom it’s already dead and buried**, then it’s all about gaining real vertical knowledge and capability. Anita Bradshaw, from Wipro’s Business Advisory Services, is a Banking specialist. Wipro’s view is that, for banks, there are significant data protection issues, which mean that they need provider capability in country, and near shore as well — which means that savings from labour arbitrage are dwarfed by the other savings. As Anita says; “Banks want to find more reusable and interesting ways to cut costs and increase efficiency. It’s about improving cross selling ratios, and reducing risk, as much as it’s about driving cost savings.”

Andrew Marsh, from Atos Origin, agrees that the complex stuff just doesn’t work with the simple arbitrage model. Retail banks have found out from bitter experience that simple arbitrage kills customer loyalty. And that customer loyalty is more important than cost reduction. As Andrew says; “The conversation should never be just about arbitrage. Atos Origin doesn’t want to be a cost base, we provide revenue and profit streams for customers. We improve our customers’ top line.” He cites one customer of Atos’ Hi-Tech Transactional Services who experienced a 20% improvement in revenues. The key point here with Atos’ service is that if consumers can’t spend money, stores don’t make money, banks don’t make money, and neither does Atos Origin. So, for Andrew and the team, it’s about providing a business service which is delivering revenue and profit to the customer’s business, and every touch point along the way.

So, if these are the practical next steps, who’s going to win the race?

**Who is best placed to win?**

1) **Companies with the best looking, flexible cost bases.** To a certain extent, as John Keppel says; the companies that are best placed to win are the fast adopters, the ones that leveraged arbitrage in its heyday, and used it to sort out their cost bases, developing integrated global delivery capabilities and using the arbitrage
wave experienced in the 2000s to become trusted providers to the large global corporates.

For Mark Hodges, the companies that win will be the ones that aggressively, and successfully, adopt new waves of arbitrage before clients; the companies for whom this is a core competency. His word of warning is to the first generation of outsourcers, who have a heavy cost base to manage. And he sees the opportunity as being in the hands of the start-ups in Vietnam, Libya, and South Africa, which have an exit strategy of selling to first generation outsourcers with a view to helping alleviate the cost base. As he says; “The first generation outsourcers that survive will be the ones that buy low cost base, well geographically placed 3rd and 4th generation outsourcers. It’s all about keeping ahead of the arbitrage curve.”

This view maintains that labour arbitrage will remain as a key part of the outsourcing equation, delivering savings to overcome hurdle rates and create momentum for change. And this isn’t to say that excellent execution can’t deliver improved quality and service levels, which in turn provide customer-perceived differentiators in delivery. It’s not always about transformation – sometime execution is all.

And remember, the cost bases of newly established outsourcers is much lower than that of established ones. New captives can achieve significant labour arbitrage which allows them to show initial margin improvement and attract skilled labour with higher than market rates of compensation. This won’t last forever, but it will last for as long as significant skilled under-employment exists.

2) **Companies that invest in business service.** For Andrew Marsh, it’s about having a business service mentality, not just a service mentality. It’s about investing to ensure the success of the service, and to generate revenue and profits for both parties.

For Les Mara, successful outsourcers will own the capability all the way through from the stack (e.g. from smart phone to server), to the business service provided, the revenue generated, and profits distributed.

3) **Companies that invest in technology and human capital, and are prepared to take the long term view.** One of the reasons that labour arbitrage has hung around for so long is that investing in technology, and in human capital, and taking the long term view are all expensive. Greg Southwell’s view is that the companies that are willing to invest, and thus effectively moving the opportunity forward are the ones that will succeed.

Anita Bradshaw agrees; “The companies that will win are the ones that are willing to take the longest term view. Long term wins over short term. It’s about long term, trust based relationships. After all, outsourcing makes sense as part of a wider partner strategy with the client.”

And finally…
Having explored many angles on this issue, my abiding sense is that arbitrage will be side-lined by the decreasing importance of and dependence on labour.

Also, conviction wins. Know where you stand, where you’re going, and place your bets with conviction. Half-heartedness loses every time.