



## Monetization of Captives: How Long Will the Opportunity Last?

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During the last few years, captives – wholly owned subsidiaries set up with the goal of providing services only to the parent company – have mushroomed in India and other offshore locations. This development has taken place in parallel to the strong growth of India-based service providers, as well as the rapid expansion in India of service providers based elsewhere.

Interestingly, in the recent past, parent companies of some of these captives have sold or otherwise exited the majority ownership and the management of their offshore captive operations, a phenomenon commonly referred to as “monetization.”

The reason often cited for these exits is that these captives are not necessarily efficient models for delivery of non core services – in fact, some consider them as management distractions – since a service provider can potentially deliver the functions more cost-efficiently in today’s market and offer several other benefits which we will discuss later. The timing of such decisions could not have been better due to the following factors:

- Service providers are trying to scale up their capabilities and credentials.
- Large non-India-based providers (for example, IBM and EDS) are in India with aggressive plans to expand operations (organic or inorganic) in the country.
- The investor community – that is, pri-

vate equity firms – considers the sector an attractive investment opportunity.

- A small subset of captives, primarily in the Financial Services industry, have now reached the size (more than 5,000 employees) at which they can become service providers in their own right.

That said, TPI’s view is that the window of opportunity for the monetization of captives will not last long. Firms considering such a move would be wise to cash in on the opportunity, which may not extend beyond the next 18–24 months. Potential buyers of captive operations – the large global service providers – are engaged in a race to dominate global rankings, a race which we predict will be decided within two years.

Additionally, for a substantial captive that is considering becoming a service provider in its own right, monetization will allow for growth to a competitive position in the market, if done now – any later, and the service landscape will have changed so dramatically that the captive will simply be relatively too small to compete as an independent provider.

### WHY CAPTIVES?

Why did parent companies decide to set up captives in the first place?



TPI's experience, gained directly from working with several large captive operations as well as by advising on commercial outsourcing transactions, suggests the following reasons why captives were set up in India:

- **Lack of Mature Service Providers**

A primary reason for the original decision to set up a captive was the lack of mature service providers that could offer the desired set of services. Prior to the year 2000, service providers that could meet the business demands of companies, such as American Express, British Airways, Citibank and GE simply did not exist. This same reason continues to be relevant for some of the newer service areas such as knowledge services, data analytics, product engineering and primary research.

- **Desire for Direct and Complete Control**

Several parent companies wanted to have direct and full control over offshore operations in order to manage strategic and core processes and to use these operations to enter the rapidly expanding Indian market.

- **Regulatory Restrictions**

Regulators, most often in the Financial Services industry, preclude the work from being outsourced (but not necessarily from being offshored).

- **Risk Mitigation**

With the growth and maturity of the offshore service delivery model, this factor has become less important over

time but it was certainly an early contributor in the decision to set up captive operations.

- **Service Delivery Cost**

Several parent companies believe they can avoid paying the profit margins to service providers and use this surplus to either reward their offshore employees or deliver services at a lower cost.

- **Scale of Operations**

Companies with the capacity to scale up beyond a few thousand employees in India considered a captive operation to be a more viable alternative, especially in an environment in which economies of scale significantly reduced the per unit apportionment of fixed start-up costs.

- **Corporate Culture**

The parent company's culture may prevent outsourcing the work to an outside provider.

## WHY EXIT (OR MONETIZE)?

Some of the original reasons to go captive are less relevant today, thus promoting the decision to monetize. The following table depicts the current situation in relation to the reasons that originally supported a captive decision.



| REASON TO GO CAPTIVE  | CURRENT SITUATION  |
|---|--|
| Lack of maturity of Service Providers to offer the services | Service providers with the right credentials available who can provide such services   |
| The desire for direct and complete control                  | Increasingly considered as management distraction if provider can deliver the same services  |
| Regulatory restrictions                                     | Potential to multi-source - retain such work which is too proprietary but outsource what's possible  |
| A risk perception in sourcing from a Service Provider       | With the track record of many years and the scale at which the work is being performed, the risk perception has certainly reduced  |
| The cost - value equation                                   | Service providers can potentially provide better cost-value equation and its possible to leverage their cross industry and customer capabilities and innovation programs |
| Having a large enough scale for captive viability           | Despite scale, captives risk saturation over time in terms of retaining employees and offering them careers  |
| Corporate culture will not allow outsourcing services       | Change in management attitude and/or potential to multisource  |

The opportunity for monetization is being driven both by changes in the environment that led to the setup of captives, as well as the emerging dynamics of the global offshoring market. With the commoditization of services, the market is now competitive in terms of service delivery costs. In addition, a number of captives that have reached a certain size and scale have nearly maximized on the opportunity for cost savings.

### HOW LONG WILL THE OPPORTUNITY LAST?

Additionally, other benefits can be gained from outsourcing captive functions to a service provider or having access to a competitive marketplace through the outsourcing of such services:

- Service providers offer variable cost and capacity models that can give a much higher level of flexibility.
- It is now possible to enter into flexible arrangements that provide the desired degree of control over operations that are run by a third party.
- There is a potential to share risks (and commensurate rewards) with the chosen service provider.
- The freeing up of key management resources allows companies to focus on their core business.
- Companies can be aligned and benchmarked with the prevalent cost-value equation for the type of service rendered.

Before we answer this question, it is imperative to consider the principal exit options based on the empirical evidence.

The exit options for captives have been either an outright acquisition by an existing service provider or the conversion of the captive into a service provider – either as an independent or in combination with another captive/service provider.

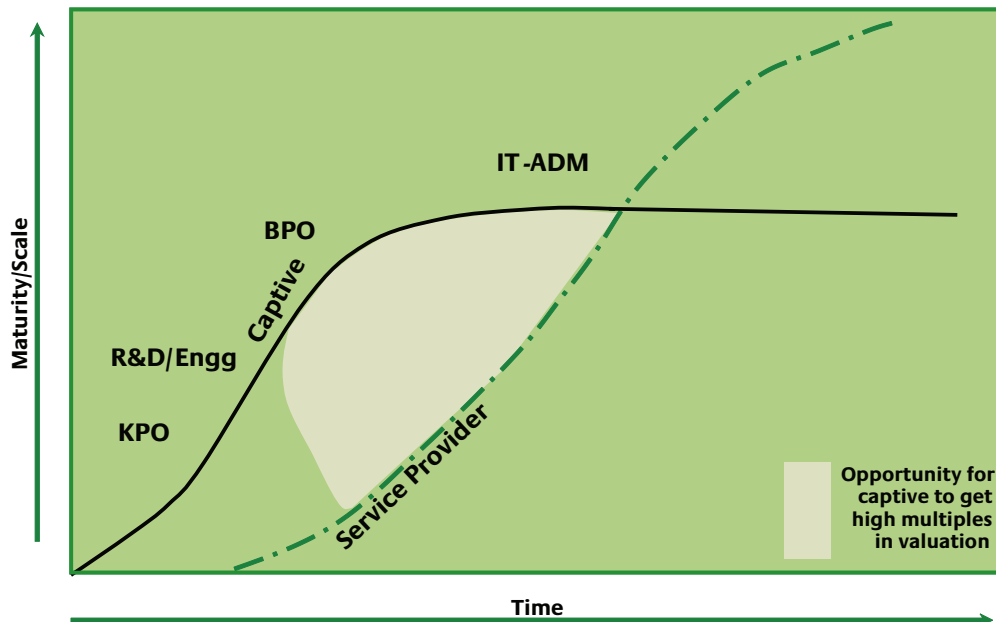
The rationale for such an acquisition by a service provider typically is one of the following:

- To rapidly grow the size of its existing book of business and its maturity.
- To gain capability and/or a first-mover advantage in a high-growth niche area (domain or technical), such as insurance or actuarial risk management.



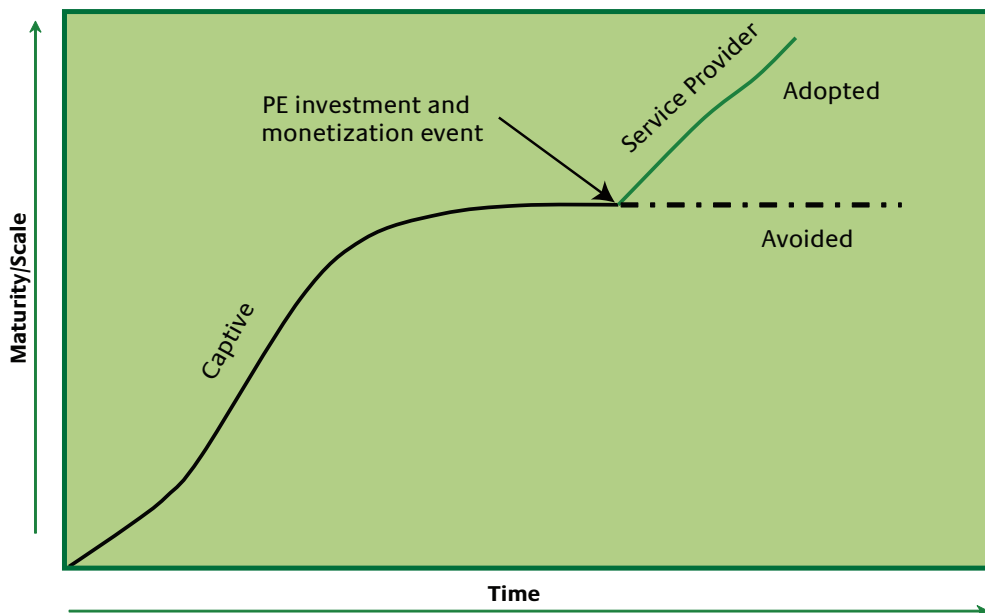
A company would take the exit route in which a private equity (PE) player makes an investment or a management buyout – to create value via higher growth and operational efficiency.

PICTORIAL REPRESENTATION OF MONETIZATION OPPORTUNITY



Shows the current maturity of segments along the captive maturity lifecycle curve; doesn't indicate that every segment will see monetization since that's driven by several factors as explained in the paper

CONVERSION OF MATURE CAPTIVE INTO SERVICE PROVIDER





In view of the potential for growth in valuation of captives, we see another interesting possibility, in which parent companies convert captives into third-party service firms without exiting ownership immediately – in essence, shifting the growth curve of the captive without a change in ownership. This potentially will allow them to cash out at higher valuations at a later point in time. A case in point is Genpact, a former GE captive, known as GE Capital International Services, or GECIS. Less than three years after GE sold its majority stake, Genpact has experienced significant growth in its enterprise value.

Depending on the maturity of the specific service area, the opportunity for captives to earn attractive valuations will diminish over time in view of the following:

- Service providers are expanding very rapidly, organically and inorganically, in a high-growth industry, hence the attraction to acquire a captive merely to add scale will lessen with time.
- With the growth and maturity of the marketplace, private investors may not find it attractive to invest in a “me-too” operation in an overcrowded market.

We believe that this opportunity only exists for captives that have already reached several thousand employees in their India-based headcount. There are only about a half dozen Financial Services captives in India that fit this description. As stated earlier, in our view, this window of opportunity is unlikely to have a span longer

than 18–24 months. That said, captives that are being set up to operate in new and niche areas, and offer an attractive set of capabilities to service providers, will continue to offer attractive monetization opportunities as strategic capability acquisition targets over longer period of time since this is linked to the maturity of the marketplace for specific services.

The race to win the offshore stakes and top the list of global service providers is being run now. Large multinational providers, such as Accenture and IBM, have been present in India for some time, but the past three years have seen aggressive moves by these firms to acquire a critical mass in India. For instance, IBM Global Services has scaled from 23,000 to 60,000 employees in India during this time, and EDS grew from 2,400 to 18,000. Accenture and Capgemini are planning to make India their largest resource base in the next year or two. India-based providers such as TCS, Infosys and Wipro have been on a steep growth curve and continue to grow at more than 40 percent every year.

This battle for global supremacy in the service provider segment is being fought in India, and we will see who the winners are in the not too distance future.

For more information about captives and other forms of global service delivery strategy, design, implementation and management, please contact Dinesh Goel, Project Director, TPI at [danny.goel@tpi.net](mailto:danny.goel@tpi.net).



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**ABOUT TPI:** TPI is the founder and innovator for the sourcing advisory industry, and the largest sourcing advisory firm in the world. We are expert at a broad range of business support functions and related research methodologies. Utilizing deep functional domain expertise of accomplished industry experts who possess extensive practical experience, TPI collaboratively works with organizations to help them optimize their business operations through the best combination of insourcing, offshoring, shared services and outsourcing. For additional information, visit [www.tpi.net](http://www.tpi.net).

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