Offshore outsourcing loses a bit of luster

But few firms in survey plan to pull back

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New York — Companies that have outsourced business functions to offshore providers are becoming increasingly unhappy about their results, and that's starting to have a chilling effect on companies' future offshoring plans.

This year, only 62 percent of companies were satisfied with their offshore providers, down from 79 percent last year, according to a study by DiamondCluster International, a Chicago-based consultancy. In contrast, 81 percent said they were satisfied with their onshore outsourcing providers, up from 74 percent in 2004.

This dissatisfaction has buyers less optimistic about using offshore providers in the future. Seventy percent of participants said they were going to increase their use of offshore outsourcing over the next 12 months. This represents a "significant decline" from 86 percent a year ago, said the report, which was based on responses from 210 buyers and 242 providers of outsourcing services in late 2004 and early 2005. Moreover, 5 percent said that they were going to decrease their use of offshore outsourcing.

"People are realizing more and more that it is harder than they thought, benefits are not as huge as they were led to believe, and there are many more difficulties than they imagined," said Tom Weakland, managing partner in the global sourcing practice at DiamondCluster. "People are still going to get good returns but not as much or as easily as they thought."

Cost reductions from offshoring can be in the 10 percent to 30 percent range, said Weakland. "The days of people thinking they can get 80 percent savings are over," he added.

Among the most common factors eating into savings from offshoring are setup costs, local taxes, security costs and competition for staff.

The big problem is that companies aren't doing their due diligence beforehand, said Helen Huntley, research vice president at Gartner Inc., a research firm based in Stamford, Conn.

"People just look at the wage differential," she said. "They are really short-changing what it takes to support this. They are going in and executing on these deals without looking at the hidden costs."

Ton Heijmen, senior adviser for offshoring and outsourcing at the Conference Board, a New York-based industry organization, said that while savings in the 25 percent to 45 percent range are "quite feasible," it's not a "slam dunk."

"For every success story, there is a failure," he said, "and by failure I mean that they didn't get the savings that they expected because they didn't do their homework."

If they had done their homework, they would have discovered that a number of "hidden costs" erode the wage differential advantage of offshoring, said Heijmen. "For instance, transition costs."

The Conference Board estimates that the typical upfront setup cost per worker runs around $10,000 for the average business process. If those investments aren't paid for by the company upfront, then the provider will build in yearly amortization of the investment over the life of the contract.

During the transition, many companies will send their own managers or teams to the vendor's facility to help with training — and in some cases, hiring — and monitor progress. According to a Conference Board study, these overseas costs can quickly become exorbitant and must therefore be accounted for upfront.