Mexico's Hybrid Virtual Captive Model:

Best of Both Worlds for International Outsourcers Considering Nearshore Services Delivery

There is no doubt. The global evolution towards outsourcing is here to stay. Global outsourcing has gone through many phases, and the outsourcing ecosystem now includes a diversity of species: Nearshoring, Offshoring, Shared Services, Rural Sourcing, Impact Sourcing. The challenge for today's global executive is not so much anymore whether or not to outsource, rather how to do it.

India has been a pioneer in servicing English-language destinations such as Great Britain and North America. However, in the past two decades, other locations have begun to eat into India's traditional dominance, as North American customers look to take advantage of proximity, free trade agreements, and second language advantages (Spanish, the 2nd language of the USA), and even cultural affinities.

This is not to say that international firms are missing out; quite the contrary. Global outsourcing firms have been some of the first-movers in bringing their outsourcing expertise to Latin America and the Caribbean to continue to service long term clients on their terms and closer to their home turf. Additionally, outsourcing firms realize the lucrative $4+ trillion economy of Latin America is not to be ignored as a trade market, either.

THE CHALLENGE

Setting up and managing a business from zero in a new country is almost never easy. If it were, then there would be no need for outsourcing. Companies would just show up in a new location and ramp up operations. Outsourcing leaves the operational, business, and even legal expertise to the provider to deal with, in the provider's domicile country. When global firms consider expanding operations into offshore (for them) locations, they face the same daunting challenges that drove their clients to them in the first place.

The challenge that outsourcers face is how to set up nearshore delivery centers of excellence to service their North American—and global clients while avoiding the pitfalls of setting up business operations in a distant, often unfamiliar country?

The Virtual Captive

The country of Mexico has taken innovative steps to make itself attractive as an outsourcing destination, leveraging its proximity to the United States and Canada, both geographically and culturally. Mexico has a long and successful track record in traditional businesses such as agriculture and manufacturing. The latter is where the shelter concept arose.

Under the shelter model, as it was originally applied to manufacturing, a Mexican company was established to handle administrative functions such as maintenance, facilities, and basic human resources. The foreign company sent in professional workers as supervisors and knowledge workers, and sent in raw materials to be assembled or fabricated by the local workforce. The foreign company retained protection from local taxes and corporate regulation, as they were not operating as if they were domiciled in Mexico, rather as close customers of the third-party shelter that they in fact, controlled.

That model has proven very successful for Mexico, especially in the post-NAFTA (North American Free Trade Agreement) era, which has seen extremely tight integration between Mexico and the markets of the United States, and of Canada. Mexico has thus taken the innovative step of allowing the shelter model to be applied to other businesses beyond manufacturing, such as global delivery, shared services, information technology, contact centers, and business process outsourcing.

The *virtual captive* model applies the shelter concept to business process outsourcing and shared services. The foreign operator—outsourcer or in house operator— is able to set up operations in Mexico, selecting and hiring skilled and bilingual Mexican employees to their specifications. The virtual captive is set up with a local administrator, like NDS, who understands the local requirements, laws, customs, and has the contacts and relationships to ramp up operations smoothly. The local administrator acts as a partner, navigating the laws, and local environment on behalf of the operator, allowing the operator to focus on innovation and service delivery. To successfully implement the *virtual captive*, it is essential that the operator partner with an administrator that has on the ground expertise and experience in the particular market selected. This is key to mitigating risk, and ensuring a smooth ramp up and long term success.

It is critical to understand that the outsourcer is not outsourcing their own core functions, which would often complicate pricing and contractual covenants with the outsourcing clients. What the *virtual captive* model does is enable the outsourcer or service provider to offer their own internal or external clients both flexibility, as well as the advantages that nearshoring provides, without losing the client to another provider.

The *virtual captive* model is especially attractive to the international outsourcing provider, as it overcomes the obstacles created by the significant differences in language, culture, regulatory climate, and even government structure between country of origin and The Americas.

Why Mexico?

The second question an Asian executive might ask, after "should I consider a virtual captive model?" is "why Mexico?"

- **CULTURAL AFFINITY:** Mexico is culturally intertwined with the United States. Not only do millions of Mexicans live in the United States, commuting back and forth across the border, a significant amount of North Americans reside in Mexico long term as well. These family ties mean that Mexican employees have a built in advantage serving and communicating with the North American Market

- **LANGUAGE:** Mexicans learn North American English, not only academically, but in many cases, from spending time across the border in the United States (and Canada) for education, family, and work. Because of these close ties, the Mexican accent is not considered foreign in large parts of the United States.

- **EDUCATION:** Mexico has an excellent university system featuring several world class business and engineering universities, graduating students that meet or exceed global standards and expectations. Furthermore, many of these students have spent part of their matriculation studying in the United States. Mexico's population of 120 million contains a growing portion of professionals, engineers, programmers, designers, and financial knowledge workers.

- **NAFTA:** Mexico has long established free trade and close relations with the United States. 80% of Mexico's exports are destined to the United States market, and that includes a good portion of high-tech goods. Almost all major North American firms doing any international business whatsoever have a significant presence in Mexico, and Mexican firms have a significant presence in the United States. In some cases, being the market leaders.

- **PROXIMITY:** With a roughly two thousand kilometer shared border with the United States, and common time zones, most of Mexico is no more than a three or four hour flight from most of the United States, and there are direct connections between all major cities. This is a major productivity factor when visiting North American clients, or when North American clients consider visiting your facilities.

- **THE MEXICAN MARKET:** Mexico itself is a middle income country with advanced infrastructure—both transportation and communications—and a population of 120 million consumers. Foreign operators should not overlook the Mexican market when establishing operations. Many globally significant companies are based in Mexico, such as telecom giant America Movil, global cement provider Cemex (Cementos de México) and worldwide food purveyor Bimbo as examples.

What to consider in the virtual captive:

The shelter model is a long established business model with legal stability and a track record of success in Mexico. As it is applied to the *virtual captive,* there are several factors that the operator should consider when conducting due diligence:

- **OPERATIONAL RISK:** Because the virtual captive is designed to allow maximum flexibility to the operator, losses, as well as gains, or surpluses are passed through to the operator customer. The administrator works as a facilitator and charges for the administrative and support services as set forth in the agreement, generally in the form of a management fee, though there may be other additional arrangements, cost-sharing, and optional components.

- **STAFFING:** The administrator offers expertise and counsel in the recruiting, selection, and vetting of candidates, but the final decision, unlike in a true outsourcing arrangement, is up to the operator. The operator sets the criteria, while the administrator provides input, especially as relevant to the local employment market, wages, competition, employment sources, etc.

- **GOVERNANCE:** *Virtual captives,* by their nature, are generally more transparent than traditional outsourcing arrangements, as expenses and surpluses are generally passed through to the operator. The operator requires adequate data and operational insight to make effective management decisions, forecasting, and financial modeling. The administrator provides the critical service of ensuring compliance with local labor, environmental, zoning, and other laws.

- **CORPORATE IDENTITY:** Unless the operator chooses not to, one advantage of the *virtual captive* model is that it is typically branded with the operator's identity. The operator then has the prestige and advantages of establishing a corporate presence in a new country, while avoiding many of the long term risks and liabilities that a traditional incorporation or subsidiary operation would entail.

Build Operate Transfer

- One model used with historical success around the globe is the *Build Operate Transfer* model. In this scenario, a service provider familiar with the local laws, logistics, and operational peculiarities will establish an enterprise in a jurisdiction, often as a joint venture, handle the build-out of the physical facilities, staff the facilities, and manage operations for a pre-defined period of time. During this period, the facility in many respects resembles a traditional outsourcing delivery site, or a shared services center, depending upon the level of shared responsibility between the provider and client.

- What is unique to the *Build Operate Transfer* model, is that after a period of time, the client may exercise the option to take over the entire operation, absorbing it into their operations, thus converting the operation into a shared services center. Under circumstances defined in the initial agreement, the client may also walk away from the operations completely, leaving the risk with the provider, or the client may renegotiate and renew the contract, continuing to operate under what will appear to be a more traditional BPO agreement to outside observers.

The Hybrid Virtual Captive

What NDS has done is to innovatively marry together the best features of the build operate transfer model with the *virtual captive* to create the *hybrid virtual captive*. In NDS' *hybrid virtual captive* model, NDS handles all the logistics of establishment and ramp-up of operations, and then provides administrative support to the operator just as in a standard *virtual captive* model. What is different though is that the entity is established such that the operator may step in and assume control and ownership of the entity at any time.

This provides maximum flexibility and benefits to the operator: The operator may continue to operate under the *hybrid virtual captive* model indefinitely or until certain milestones or benchmarks are reached. The operator has considerable protection against the risk of operating in a new country, until the operator is comfortable and ready to make a long term commitment. At some point in the future, the operator may absorb the hybrid virtual captive into their global corporate structure, or, if strategically the operator decides to go in a different direction after some time, they are not faced with the legal, human resources, and publicity ramifications of laying off considerable numbers of internal employees.

The *hybrid virtual captive* model is ideal for the global operator understanding the need to invest in North American nearshore operations, but wants to mitigate the long term risks and uncertainty inherent in setting up operations in a country where the operator may lack considerable experience and familiarity.

The *hybrid virtual captive* model provides the operator with an experienced strategic partner that understands the nuances of the region, and unburdens the operator with that risk and uncertainty. The operator can in fact "try before they buy"—and then, when the operator is ready, on the operator's terms, take over nearshore operations completely once the competency has been achieved, the operator can continue to partner with NDS as the administrator on an ongoing basis, or if conditions change over time, withdraw from the market without suffering the complications of shutting down internal business operations in a country, and massive layoffs.

The NDS hybrid virtual captive model, by combining the best of two innovative business structures, offers maximum benefit to the international outsourcing provider ready to make the strategic move to nearshore operations.

The Key To Success

The *hybrid virtual captive* model enables a distant operator to enter a new market, possibly for sales and marketing, but especially for outsourcing and global services, by leveraging local expertise to establish operations, and then partnering with the local expert to navigate the local laws, labor market, and regulations. Because of this, the selection of the right administrator partner is critical to success. The operator will be relying on the administrator to keep operations running smoothly, and to facilitate good relations with both the employees, and the external stakeholders such as the government and local community.

The operator will want to carefully vet potential administrator partners; it is critical to select a partner who not only understands the local culture and operational peculiarities, but one that also understands the operator, that "speaks the operator's language" whether figuratively or even literally, and that also has experience with the operator's business model and industry.

Steps forward

Global outsourcing firms are unsurpassed in the world when it comes to business process outsourcing experience, from contact centers to IT and software development. There is no longer any need for outsourcing providers to lose clients that prefer nearshore operations. The *hybrid virtual captive* is the best-of-both-worlds solution for servicing existing clients and going after those clients that were heretofore inaccessible because of their preference for nearshore operations.

The operator considering a virtual captive model should think strategically, making sure that the decision is aligned with clearly defined strategic objectives. Certain activities can be performed practically anywhere, whereas other functions are ideally suited to nearshore hybrid virtual captives. Activities that require significant management oversight and involvement of the outsourcing client lend themselves easily to the nearshore *hybrid virtual captive* model, as on site meetings can be arranged, even same-day, with the end client. Access to talent familiar with North American standards, procedures, and regulations is also easier in the nearshore, and the closer to the United States, the more available that talent becomes.

In many cases, it is necessary to bring client personnel, management, or trainers to the operator's location for extended stays. This becomes much easier when those employees remain close to home, and connected, both with their business and social network of family and friends. Whereas most Americans have never seen a cricket match, millions of Mexicans could tell you instantly their favorite American-style football team, and even play the sport in their universities. A weekly commute across the US-Mexico border is no big deal. A weekly commute across the Pacific is a different matter entirely.

In addition to considering the advantages that a country like Mexico has to offer, the potential operator will want to conduct due diligence on site selection. Mexico offers several major cities that may be suitable for outsourcing, and then several secondary cities that still offer very impressive infrastructure, workforces, and quality of life.

Mexico City: Mexico's largest city, and one of the largest cities in the world, at 24 million people is the seat of government and home to many of Mexico's major companies and universities. Mexico City's airport also offers global connections with nonstop flights to major destinations.

Guadalajara: Guadalajara likes to bill itself as Mexico's answer to Silicon Valley, with many multinational technology firms such as IBM and HP basing major operations in this city, the capital of the Mexican state of Jalisco. Guadalajara offers lower costs for real estate and labor than Mexico City, and there is considerable government support available to encourage foreign investment, especially in the technology sector. The city is home to government backed technology incubators, and has been designated a digital smart city.

In 2014, Guadalajara was home to the annual World Congress on Information Technology, the global event

Monterrey: Only 2 hours by car from the US Border, Monterrey is home to many global manufacturing and technology operations. Samsung, Cisco, Polaris, and Kia are located in metropolitan Monterrey, and the government is actively seeking additional investors with tax benefits and free trade zones.

Monterrey is also rated very highly for quality of life factors. While all three cities offer a plethora of direct flights to and from the United States, Monterrey boasts the ability to reach Texas with a short drive. Like all of industrialized Mexico, the transportation infrastructure is excellent and data connectivity is not a problem. Monterrey is home to Tec de Monterrey, one of the highest rated universities anywhere in the Americas—including United States and Canadian universities.

Conclusion

The decision to open operations in new country is not one taken lightly. The executive should consider many factors, and conduct considerable due diligence. Still, the tide has turned for many global clients towards a nearshore business model, and for North American clients, that means Latin America and the Caribbean. No other country in the Americas offers the combination of benefits that Mexico does, from their long land border with the United States, advanced transportation and information infrastructure, and highly skilled workforce, including knowledge workers, capable managers and professionals, and highly trained IT staff.

In addition to the geographic benefits, the *hybrid virtual captive* model offers unique advantages and protections to the foreign firm wishing to adapt to client needs and remain competitive, while mitigating liability, risk, and tax exposure.

About Nearshore Americas

Nearshore Americas is among the world's most popular media websites covering the outsourced services industry, based on web traffic. The brand investigates key trends driving the emergence of Americas-based investment and outsourcing, providing exclusive interviews and case studies, video reports and other features. The site is dedicated to providing valid, high quality analysis about developing successful partnerships in the region. The primary audience for Nearshore Americas includes C-level executives, investors and sourcing decision-makers.

About Nearshore Delivery Solutions

For IT Service firms who are interested in setting-up nearshore delivery capabilities in Mexico to serve North American customers who want same time zone service, NDS enables them to offer low-cost nearshore service by making it easy and affordable to have their own sheltered virtual captive delivery center in Mexico while avoiding liabilities and taxes. Imagine having a base of operations in Mexico staffed by a mix of qualified English speaking Mexican engineers working alongside your expat managers, allowing your firm to overcome difficulties related to different time zones, the unavailability of H1B visas, long travel times and higher costs of hiring personnel in the US. NDS makes all of this is possible without the need to establish legal presence in Mexico, thus eliminating typical issues related to government bureaucracy, taxes, liabilities and other "country issues".