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# Mitigate, tolerate or relocate? Offshoring challenges, strategic imperatives and resource constraints

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ABSTRACT

This paper examines key firm-level factors influencing initial strategic responses to offshoring implementation challenges. Comparative case findings indicate that firms are likely to try to mitigate challenges if they perceive to have control over their cause; if strategic objectives are diverse; and if firms have abundant resources available. By comparison, firms tolerate challenges if cost is a strategic imperative, or if resource endowments are limited. Firms relocate operations temporarily or permanently in particular if challenges are externally caused, whereby temporary relocation requires investments into flexible global infrastructures. Findings reveal critical contingencies of capability development and learning in offshoring and beyond.



## 1. Introduction

Offshoring, i.e. sourcing of administrative and technical work from outside the home country in support of both domestic and global operations, has become a mainstream business practice (Doh, 2005; Kenney, Massini, & Murtha, 2009; Manning, Massini, & Lewin, 2008). Over time, firms have expanded both the scale and scope of offshored business processes, ranging from more standardized services, such as IT (Henley, 2006) and HR (Pereira & Anderson, 2012), to knowledge work (Lewin, Massini, & Peeters, 2009). However, despite growing offshoring experience across industries, firms continue to face various operational challenges, ranging from low service quality (Narayahan, Jayaraman, Luo, & Swaminathan, 2011) and data security issues (Luo, Zheng, & Jayaraman, 2010), to finding qualified personnel (Manning, Sydow, & Windeler, 2012) and employee turnover (Demirbag, Mellahi, Sahadev, & Elliston, 2012). This article seeks to better understand how firms initially respond to such challenges, and how differences in responses relate to perceived control over the cause of a challenge, the strategic orientation of the firm, and resource endowments.

Despite growing knowledge about typical offshoring implementation challenges (see e.g. Lahiri, Kedia, & Mukherjee, 2012), we still know relatively little about how firms *respond* to the encounter of such challenges (e.g. Bunyaratavej, Doh, Hahn, Lewin, & Massini, 2011). Most studies have focused on how firms anticipate and mitigate perceived risks *before* launching particular projects. For example, studies indicate that data security risks are often mitigated by choosing captive over external governance models (Luo, Wang, Jayaraman, & Zheng, 2013; Mudambi & Tallman, 2010), and that location-specific risks, such as political instability, are mitigated by selecting less 'risky' locations (Doh, Bunyaratavej, & Hahn, 2009; Hahn, Doh, & Bunyaratavej, 2009). However, studies indicate that several challenges, such as coordination problems and employee turnover, are often unanticipated and occur only *after* offshoring decisions are made (Jensen, 2009; Vlaar, van Fenema, & Tiwari, 2008).

More recently, studies have shifted emphasis from ex ante risks to processes of learning and capability development (Jensen, 2009, 2012; Lahiri et al., 2012). One main finding is that firms learn by experience to increase performance, e.g. through better training, process integration and coordination across units (Jensen, 2012; Luo et al., 2010). Most studies share the notion that firms gain experience over time, and thereby develop problem-solving capabilities 'semi-automatically' (see e.g. Zollo & Winter, 2002). Other studies however question this assumption. For example, Massini, Perm-Ajchariyawong, and Lewin (2010) find that, independent of experience, differences in strategic attention may affect offshoring performance. In more general, research on capability development suggests that effective firm learning not only depends on accumulated related knowledge (March, 1991), but on whether challenges are internal or external to the firm (Oliver, 1991); strategic goals and priorities (Helfat & Peteraf,

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2003); and the availability of resources needed to invest into capabilities (Kogut & Kulatilaka, 2001).

Based on these insights, this study investigates, using a comprehensive multi-case study of early offshore implementation projects of U.S.-based firms, how strategic objectives, available resources and perceived degree of control over the cause of a challenge affect initial organizational responses, whereby mitigation is treated as only *one* possible response. In order to control for the intervening role of experience, this study specifically compares firms with little prior experience when facing particular challenges. Also, to avoid a large firm bias, this study compares firms across different sizes. Findings indicate that firms respond to challenges in mainly three different ways: mitigating, tolerating or relocating. If a firm perceives to have control over the cause of a challenge (=internal challenge), mitigating or tolerating are likely responses; if challenges are perceived to be caused by factors outside of a firm's control (=external challenge), tolerating or relocating become more likely. However, mitigation attempts are most likely if offshoring projects are guided by diverse strategic objectives rather than just cost, and if firms have abundant resources available. In other cases, i.e. if cost objectives dominate or if resources are limited, firms tend to tolerate challenges, or relocate in response to particularly external challenges. Yet, some firms choose to relocate temporarily rather than permanently, whereby the former requires prior investments into global firm infrastructures which are more likely to happen if strategic objectives are diverse and if sufficient resources are available. Findings have important implications both for offshoring research and research on capability development in international business and beyond.

The article continues with a review of prior research on offshoring challenges and firm responses. Three main firm-level factors are discussed: perceived control over the cause of a challenge; firm strategic orientation; and resource endowments. Then, data and method of this explorative multi-case study are introduced, and findings are presented. The article concludes with theoretical propositions and broader implications for theory and managerial practice.

## 2. Responses to offshoring challenges: a review and critique of prior literature

The identification of operational risks and challenges has been a key dimension of research on offshoring (see e.g. Rilla & Squicciarini, 2011). Risks denote ex ante perceptions of *potential* obstacles prior to making a decision (March, 1994). Challenges, by contrast, occur ex post and cause negative deviations between expected and actual performance (Harrison & March, 1984). While many offshoring studies have focused on risks (see e.g. Hahn et al., 2009; Luo et al., 2013), this study focuses on challenges *after* offshoring decisions are made. This is because firms often do not or insufficiently anticipate operational challenges, such as coordination problems (Levina & Vaast, 2008) and employee turnover (Demirbag et al., 2012). It is therefore critical to better understand what causes operational challenges and how firms respond to them.

Challenges can be categorized as internal or external. *Internal* challenges are largely caused by factors within the firm or within client-provider relationships. Examples include internal resistance (see e.g. Lewin & Couto, 2007); miscommunications between internal clients and offshore staff (e.g. Hanna & Daim, 2009; Vlaar et al., 2008); and service quality problems (Leonardi & Bailey, 2008; Manning, Hutzschenreuter, & Strathmann, 2013). *External* challenges, by comparison, are typically caused by factors outside of the control of the organization. They do however affect the firm's operations and performance. Examples include insufficient intellectual property protection (Hahn et al., 2009); and limited labor market size or outdated higher education affecting the availability of high-skilled labor (Manning et al., 2012). Notably, some challenges can have both internal and external causes. High employee turnover, for example, is often driven by lack of financial and career incentives within the organization, but also lack of loyalty and external job opportunities (Demirbag et al., 2012).

### 2.1. What we know about responses: the role of experience, task features and local environment

Several studies have started to analyze firm responses to offshoring challenges. With respect to *internal* challenges, several studies indicate how service quality problems are mitigated by coaching, personnel rotation and interface managers who help communicate tasks (e.g. Manning et al., 2013; Srikanth & Puranam, 2011). Other studies show how loss of managerial control and operational inefficiencies are often managed by improving process and personnel integration (Luo et al., 2010; Narayahan et al., 2011). With respect to *external* challenges, most have been looked at primarily as ex ante risks (Hahn et al., 2009). A few studies, however, have dealt with ex post management of external challenges. Manning et al. (2012) show for example how challenges in finding qualified personnel are mitigated by joint ventures with local universities. Other studies have indicated how pioneer foreign investors, e.g. Texas Instrument in India (Patibandla & Petersen, 2002) or Motorola in Argentina (Manning, Ricart, Rosatti Rique, & Lewin, 2010), have responded to underdeveloped local business contexts, e.g. lack of satellite connections in India or lack of software process standards (CMMI) in Argentina, by shaping policies of local authorities and capabilities of local providers and industry associations (see also Dossani & Kenney, 2007).

The underlying assumption of most prior studies is that firms are not only *motivated* to mitigate operational challenges, but that they develop the *capability* to do so over time. This view is rooted in the notion that mitigation capabilities may develop 'semi-automatically' through *experience* and problem-driven organizational learning (Nickerson & Zenger, 2004; Zollo & Winter, 2002). Whereas a number of studies (e.g. Jensen, 2009, 2012) convincingly show that firms develop offshoring capabilities through experience, other studies indicate that even experienced firms often continue to face operational challenges, such as service quality (Manning et al., 2013). What's more, some operational challenges, such as employee turnover, may even *increase* as firms grow offshore operations (Demirbag et al., 2012; Heijmen, Lewin, Manning, Perm-Ajchariyawong, & Russell, 2009). In turn, research suggests that some firms with little experience seem to manage certain challenges much better than others (Lewin & Couto, 2007). I seek to better understand why this is, by focusing on firms that encounter – and respond to – challenges with *little prior experience*. By doing that, I exclude the somewhat fuzzy experience factor and focus on conditions that can explain how likely firms will invest into mitigation capabilities in the first place.

Beside experience, prior research has explored two other major contingencies: task features and the local environment. As for *task features*, one major argument has been that task complexity and knowledge intensity trigger operational challenges and difficulties in responding to them effectively. For example, the more complex the task, i.e. the more interdependencies and interfaces there are between sub-processes, the more difficult coordination and communication will become (e.g. Kumar, van Fenema, & von Glinow, 2009; Larsen, Manning, & Pedersen, 2013). Similarly, knowledge intensity, including the need for tacit knowledge, has been associated with difficulties in specifying tasks and monitoring service delivery (Brusoni, 2005; Gertler, 2003; Gerybadze & Reger, 1999). As for the