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Small Businesses Struggle to Offshore

By Dan Briody

In the scramble to save money overseas, small companies are at a serious disadvantage.

Being a CIO isn't always as glamorous as it sounds, particularly when you've got the top tech spot at a small company. Just ask Bruce Lehrman, the CIO at RuffaloCODY, a Cedar Rapids, Iowa-based provider of fund-raising software and consulting services to nonprofit organizations. With just 300 full-time employees, his company does less than $40 million a year in business. So when RuffaloCODY was looking to offer its software on new operating systems, Lehrman decided it was time to offshore the development. But there was no one to whom he could delegate the task of finding the right vendor. So, in the end, Lehrman himself had to schlep overseas to research vendors. "The Ukraine was the most difficult," he says. "I had to learn a lot about the culture, and the language was a big barrier. In the hotel, I wasn't sure if I was going into the business office or the ladies room."

Lehrman's adventures in offshoring are not uncommon among small and medium-size businesses looking to reap the same cost benefits their billion-dollar brethren have been enjoying for decades. For the small business, farming IT work out overseas can be a daunting, and occasionally comical, task.

The hurdles facing executives of small companies when they offshore go well beyond finding the bathroom. To begin with, very few of these companies have any knowledge of the vendor community overseas, aside from the big names they see advertised in magazines. And finding a vendor of appropriate size is crucial for companies that don't want to be swallowed up by the Tatas and Wipros of the world. In addition, small companies lack the resources to manage the relationship from start to finish. There are no procurement specialists. There is no vendor-management team. There is no in-house legal counsel.

"This market is underserved," says Eugene Goland, founder of Offshore Outsourcing Best Practices (OOBP), an association of small and medium-size businesses chartered with educating the small-business community in the art of offshoring. "There are structural difficulties that prevent smaller companies from taking advantage of offshoring, and yet these are the companies that have the most to gain."

And more and more scrappy little companies are looking to go global from the get-go. CIO Insight's own research indicates that 27 percent of small companies—those with less than $100 million in revenue—are planning to offshore IT work in 2006, up from 20 percent the year before. (See Research, page 69.) And some venture capital firms go so far as to require an offshoring strategy as part of a prospect's business plan.

So how are companies of limited means managing to navigate the international waters of global commerce? Very carefully. Using a combination of grass-roots vendor research, word-of-mouth, relationship building, and just plain luck, more and more small companies are taking the plunge. Some jump right in, others dip a toe in, and still others avoid it entirely. Andjust as the approaches to offshoring vary greatly among this group, so do the results.

There are many reasons why small and midsize businesses feel overmatched when it comes to offshoring, some more real than others. Many of these firms struggle to find the resources to manage the kind of complex business relationships offshoring brings with it. But other, more psychological reasons also come into play.

According to Robert Brown, a research director at Gartner Inc., small businesses suffer from the mother of all inferiority complexes. "There is a perception among these companies that the size of their business is too small to justify offshoring," Brown says. "It is a deeply held notion with no basis in fact, and I just don't buy it." While it is true that the more work you offshore, the more money you're likely to save, most of the application development and call-center work is priced by headcount. So even if you offshore the work of only one employee, says Brown, you're still likely to save.

Small companies are also grappling with the fear of losing control—something most Fortune 500 companies got over years ago. "People believe that if their data is 10,000 miles away, there's a good chance something will go horribly wrong," says Brown. "They want to be able to drive down the road and kick the server if something doesn't work right. It's irrational."

But perhaps the single biggest factor holding back small firms is that no one is begging for their business. The offshore market catering to small and midsize businesses is immature, at best. "We went to people we knew, did online searches, and did phone interviews with firms," says RuffaloCODY's Lehrman. "And many of the companies we looked at had very little experience." All that for a company that was looking to offshore a pretty sizeable job—about 100,000 development hours.

"A lot of the major offshore vendors have not been actively marketing to these businesses," says Gartner's Brown. "The offshore companies have bigger fish to fry. These guys are drinking from the fire hose right now. So between that and the hemming and hawing of the small businesses, it's like two ships passing in the night."

Lehrman gave up on the Ukrainian firm after having trouble communicating his needs to the senior executives. "If we had trouble talking to the senior team, we knew it would be worse with the team members," he said. He finally narrowed his exhaustive search to two Indian firms. He then ran what's known as a "dual pilot," in which a client gives two small projects to two different firms in order to gauge their abilities. Each project ran four weeks and had specific deliverables. "We wanted to find out if they would ask the right questions, hit the right timelines and produce quality work," Lehrman says.

After the dual pilot, Lehrman selected Lambent Technologies Pvt. Ltd., a small firm in Nagpur, India. But he has been slightly disappointed with the savings his company has realized. "We've had to spend a lot more time documenting and testing than we anticipated," he says. "And there have been some cultural difficulties. They've produced a lot of decent code, but if you depend on them to make judgment calls, you get into trouble. Overall, it's been slightly cheaper [than outsourcing in the U.S.], but not as cheap as we'd anticipated."

The most important single factor in choosing the right offshore vendor may be finding one of appropriate size. The obvious fear is that a small firm's project will not represent a sufficient portion of a large offshore vendor's revenues to make them stand up and take notice. In that small-fish/big-pond scenario, the small firm often ends up with the offshorer's less experienced team members assigned to their account, and gets very little access to the vendor's senior-level executives. The OOBP's Goland has a hard and fast rule for small firms evaluating offshore vendors: If your project constitutes less than 5 percent of a vendor's total revenue, walk away.

By the same token, however, signing up a small vendor has its own set of perils. The smaller the vendor, the less stable it is. Giving up control over major IT projects is hard enough without worrying if the vendor can survive downturns in the market. For that, Goland has another rule: The offshore vendor must have been in business for at least five years and have more than 100 employees.

"You must find a vendor that is small enough that the project you give him is of significant importance," Goland says. "If that's not the case, you will never get the right people to work on it. And if you cannot staff the project with the best people, it will fail. At the same time, the vendor should be strong enough to weather changes."

That all sounds good. Trouble is, offshore vendors that fit those criteria are hard to come by—a lesson Al Garcia learned the hard way. Garcia is the vice president at Comac Inc., a $30 million fulfillment house for presales marketing materials, based in Milpitas, Calif. Two and a half years ago he started looking for an outside vendor to help develop a more sophisticated warehouse-management and online-order system. "We were looking to outsource," Garcia says. "Onshore, offshore, it didn't make a difference."

Garcia researched three different options: large offshore vendors; small offshore vendors; and small onshore vendors. His research was extensive. He even attended a seminar given by the CEO of Tata, and later met him personally. But when Tata realized how small a job Comac had to offer, "they lost interest," Garcia says.

With Tata off the table, Garcia focused his search on vendors that would be a "good cultural fit." But he found that no two offshore vendors had the same approach to managing the relationship. Some would assign a project manager to the account but would not guarantee that this person would reside in the U.S. Others would promise a local representative that would take up residence at the client site. Garcia ultimately decided that he "wanted someone we could grab around the neck and choke, if necessary."

A company called Miracle Software Systems Inc. seemed to fit the bill. But Garcia had grave doubts that the company would be able to handle Comac's need for what he calls "agile programming." "We don't worry about specs," Garcia says. "We worry about concepts, and use programmers working together and delivering quickly, then tweaking later. We want to move fast, and we found the whole concept of agile programming was difficult to offshore."

He also had reservations about the claims that Indian companies were making in their zeal to win new business. "I couldn't do a Dun & Bradstreet or Hoover's on these companies," Garcia says. "I got some references, and of course everybody said they were wonderful, but it gave me no confidence. And when you talk to the vendors themselves, and ask them if they do this or that, they all say, 'Yeah, we do everything.' So there were some serious credibility issues with the Indian companies."

Finally, Garcia decided the risks of going offshore were just too great. He went with a company called The Refactory Inc., based in Champaign, Ill. Comac is Refactory's only client. "We're not a small fish, we're their only fish, so I know I'm getting the A-Team." He also says that when he looks at all the costs associated with managing an offshore vendor, he believes he's actually paying less to stay in the U.S.

Even if a company is lucky enough to find an offshore vendor of suitable size, things very rarely stay that way. In the worst-case scenario, a vendor struggles to survive, closes its doors, and seriously endangers the client's survival. But the opposite can also be true. Railinc Corp., based in Cary, N.C., is a provider of data-exchange services for the freight-railroad industry with about $50 million in annual revenue. Back in 1998, the company thought it had found the perfect offshore vendor.

Over the next four years, however, the vendor, Business Management Data, was acquired three different times: first by PSINet Consulting; then by SignalTree Solutions; and finally by Keane Inc., the $956 million, Boston-based global outsourcing giant. "They were small at the time," says Paul Neville, vice president of IT at Railinc. As one would expect, the team that Railinc had come to rely on dispersed when Keane bought SignalTree. "When Keane stepped in, things changed," Neville says. "Initially, we didn't see any worsening of service. But then the higher-ups moved on, and they brought in a new team." Though the transition was bumpy, Railinc worked hard to keep Keane's attention, and today is satisfied with their level of service. "There may be cheaper alternatives, but considering we're a small fish in a big pond, Keane's been quite responsive," says Neville.

If all this is sounding a little too scary for your company, there are some services that offer offshore training wheels. Designed to allay the fears that frequently hold back small firms, these "build-operate-transfer" services are the outsourcing equivalent of renting-to-own. And for Jeff Stenger, vice president of development at Burlington, Mass.-based St. Croix Systems Corp., it was just the right speed.

Stenger's company develops software for the healthcare industry that tracks the utilization and depreciation of medical equipment. When Stenger came onboard three years ago, he knew he wanted to get the cost savings that offshore development promised, but the company was still grappling with control issues. "We wanted our own employees, rather than contracting out, because we wanted that level of control," recalls Stenger. "This is our IP, and it's basically our company. We wanted it to be more like a company in the U.S. that is colocated, with everybody focused on the same mission. Only the programmers would be offshore. We wanted to nurture them, and be certain their loyalty was to St. Croix."

Before joining St. Croix, Stenger had worked as a project manager for a company called i-Vantage Inc., and he knew the cofounder. I-Vantage offers two offshoring models to small firms: an incubator model, in which i-Vantage provides the facility, resources, network infrastructure and team of employees, all of which are managed but not owned by the client; and a subsidiary model, in which i-Vantage provides the facility and network infrastructure but hires the client's employees and creates a legal entity in India. "If you don't want to embrace the Indian model wholeheartedly, this is a low-risk, trial way to do it," says Sandeep Kaujalgi, president and CEO of i-Vantage.

Stenger started with a group of eight developers, working as subcontractors, but quickly moved to the subsidiary model. His discomfort level with doing business in India abated almost immediately after he began working with i-Vantage. "It was almost a nondecision," he says. Stenger visits St. Croix's subsidiary in India once a year, and someone from India comes to the U.S. every year or two as well. And the arrangement has yielded the kind of unity Stenger was after. "We're all part of one company moving toward a common goal," Stenger says. "That sounds like a warm and fuzzy thing, but it's real."

What is also real are the wage increases Stenger has been absorbing at St. Croix's Indian subsidiary. Salaries have been increasing 30 percent a year. In the first year of offshoring, Stenger estimated that he was getting five times the resources in India than he could get at home. But because of the ballooning salaries, "it is getting to the point that we are starting to ask how much of a benefit we're getting," he says.

So, for the time being, offshoring for small businesses is a decidedly mixed bag. Finding vendors appears random. Negotiating with them is informal, at best. And managing the relationship is a work in progress. But as more small companies recognize offshoring as a viable sourcing option, the market of vendors will expand and mature, and best practices will be adopted. In the meantime, the offshore process will remain a rough voyage that may not meet the expectations of small companies. And despite the overwhelming hype around offshoring, even the OOBP's Goland has to admit, "Sometimes, you're just better off staying home."