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Build-operate-transfer Outsourcing Contracts in Services – Boon or Bane to Emerging Market Vendor Firms?

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ABSTRACT

Build-operate-transfer (BOT) contracting has been widely used in the engineering and construction industry and has recently spread into the service industry domains. Notably, service provider firms from emerging markets, India in particular, are now offering BOT outsourcing contracts in which the client firms are allotted call options, i.e. the right, but not the obligation, to transfer pre-specified assets from the service provider. As such, BOT outsourcing contracts seems to be an interesting contractual novelty that combines the advantages of outsourced and captive offshoring operations. In this paper we investigate under which circumstances a BOT outsourcing contract (i.e. a contract where the client firm exercises its call option) is beneficial, or the opposite, to the emerging market vendor firm. Whether BOT outsourcing contracts are boon or bane to an emerging market vendor basically hinges, we submit, on its internal diffusion of client-specific knowledge and capabilities prior to the execution of the call option.

1. Introduction

Emerging market firms (EMFs) are entering the global sourcing market as vendors of still more sophisticated and knowledge-intensive services (Bruche, 2009; Hill and Mudambi, 2010; UNCTAD, 2004, 2005). In order to further spur developed market firms (DMFs) to engage in business process outsourcing (BPO) and knowledge process outsourcing (KPO) and similar contractual alliances (Mudambi and Tallman, 2010) EMF vendors have started offering build-operate-transfer (BOT) outsourcing contracts. BOT contracting has been widely used in the engineering and construction industry, but has expanded into the service industry domains. Notably, service provider firms from emerging markets are now offering BOT outsourcing contracts in which the client firms are allotted call options, i.e. the right, but not the obligation, to transfer pre-specified assets from the service provider. As such, BOT outsourcing contracts seems to be an interesting contractual novelty that combines the advantages of outsourced and captive offshoring operations. In this paper we investigate under which circumstances a BOT outsourcing contract (i.e. a contract where the client firm exercises its call option) is beneficial, or the opposite, to the EMF vendor firm. In doing so, we draw on two research streams: real option studies and studies of EMFs' catching-up with developed market firms (DMFs). It seems as the real option literature is rather sparse concerning the implications to (EMF) vendors that extend call options to clients on a non-reciprocal basis. With one notable exception, namely Jiang et al. (2008), real option studies apply the perspective of the party holding the call option – not the party extending it. Real option studies simply assume that a pre-fixed transfer fee indemnifies the party handing over the assets. However, one may question the realism of this assumption for various reasons: First, strong bargaining power may enable one of the (two) parties to negotiate a favorable transfer fee. Second, the parties may not possess the predicting and contractual design capabilities (Janney and Dess, 2004; Mayer and Argyres, 2004) needed for accurate transfer fee estimations. In particular, the valuation of human assets at a future

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point in time is much more challenging than estimating the future value of physical assets, such as machinery, IT hardware, and buildings. Third, whether or not the transfer fee indemnifies a service vendor firm most likely hinges on the ability to replicate the resources and capabilities transferred to the holder of the call option. A successful replication implies that a 'hollowing-out effect' is avoided. In the case of BPO and KPO the assets transferred are typically human capital: vendor firm employees are hired by the client firm and embodied knowledge and capabilities shift host organization. It is this third transfer aspect our study will focus on.

Thus far, the real option literature has paid scant attention to BOT contracts in the BPO and KPO markets.[2] Our search of the real option literature revealed only two studies in which real option clauses are observed and documented: Gorovaia (2011) and Ziedonis (2007) observed real option clauses in franchising and licensing, respectively. Empirical studies of equity joint venture – the preferred empirical context of real option researchers (see, e.g., Folta and Miller, 2002; Kogut, 1991; Reuer and Tong, 2005) – have, so far, not been able to discern whether the JV agreements included explicit rights (call options) to acquire majority stakes. In contrast to research of JVs, studies of outsourcing contracts as real option phenomena are rare: only the studies by Alvarez and Stenbacka (2006), Benaroch et al. (2010), and Hult et al. (2010) supplement the abovementioned study by Jiang et al. (2008) and these studies take the perspective of the client firm.

Hence, we find that only to a limited extent does the real option literature inform us about how exercised call options potentially affect (EMF) vendors. We therefore turn to the development economics literature for inspiration to our analysis of the BOT implications to EMF vendors. Early development economics literature predominantly described relations between firms from developed and developing countries as relations between dominating and dominated firms, and as relations largely driven by exploitation motives (see, e.g., Martinussen, 1999). More recently, however, a growing literature on firm linkages and global value chains have brought more nuances into the characterization of such inter-firm relations, concerning their antecedents, types, processes, governance structure as well as their outcomes (Altenburg, 2000; Gereffi et al., 2005; Hansen and Schaumburg-Müller, 2006; Hansen et al., 2009; Jensen, 2009; Meyer, 2004). Following the typology of firm relations and governance types by Gereffi et al. (2005), we focus on inter-firm linkages that fall under the "relational governance" category. That is, a type of inter-firm linkage which is characterized by a relatively equal distribution of power between the two parties and contains "(…) complex interactions between buyers and sellers, which often creates mutual dependence and high levels of asset specificity" (Gereffi et al., 2005, p. 84). We are particularly inspired by Mathew's (2006) linkage–leverage–learning framework. Based on earlier work by Peng (2001) on the role of firm resources in internationalization, Mathews (2006) also focuses on the firm's resources in an international setting. Mathews' central argument is that emerging market multinational firms' (EMNC) international expansion is driven by resource "linkage, leverage and learning", which Mathews presents as the "LLL framework" (Mathews, 2006: 18). The LLL framework is positioned as an alternative approach to John Dunning's eclectic OLI framework (Dunning, 1981; Dunning and Lundan, 2008). The OLI framework is based on the assumption that MNCs possess superior ownership advantages (O advantages) that it can exploit in foreign locations through FDI. Mathews' (2006) alternative argument is that EMNC from the outset do not possess such competitive O advantages and therefore need to base their internationalization strategy and process on other types of advantages, namely the ability of the EMF to: (1) form inter-firm *linkages*; (2) *leverage* external resources for internal use; (3) improve these linkage and leverage skills through experiential *learning*. In a related argument, Kumaraswamy et al. (2012) argue that putative EMNCs must first access technology through arms' length transactions like licensing in order to "skill up" to world standards and gain credibility, before they can build relationships with global players.

Hence, drawing on insights from real option and development economics literature our paper largely presents a theoretical outline and discussion of the implications of BOT services contracts for vendor EMFs. Based on three scenarios that outline different implications of BOT contracts for vendor EMFs, we find that BOT contracts, under certain circumstances, may imply benefits of process and knowledge upgrading on the part of the vendor EMF. However, we also argue that, given different sets of circumstances, engaging in a BOT contract carries important competitive risks for the vendor EMF, in terms of a gradual downgrading of the vendor EMF's role in the collaboration with clients, and the ensuing hollowing out of knowledge competences.

The paper proceeds as follows: In Section 2 we describe the specific features of the BOT outsourcing contract for knowledge services and illustrates with a BOT case example. In Section 3 we extend this description by making a theoretical account for BOT outsourcing contracts as real options. We outline a range of antecedents of BOT outsourcing contracts, including three rationales of call options seen from the perspective of a vendor firm. In Section 4 we progress to an inquiry of the possible implications of BOT outsourcing contracts – or rather, the actual exercise of a call option – for vendor EMFs. Our analysis includes three scenarios that each portrays a challenging but plausible image of the competitive implications of BOT for vendor EMFs. Section 5 presents an extended model for BOT contract implications to EMFs where the local institutional context is considered. We conclude and discuss managerial implications in Section 6.

[2] Through available primary and secondary sources we have identified 14 EMF vendor firms that since 2002 have offered BOT outsourcing contracts. However, the real number can be significantly higher inasmuch as many contract parties presumably prefer not to disclose the call option agreement to the public (and perhaps not even to their own employees). The majority of the vendor firms – eight – were offering IT services (Covansys, Hexaware, Ness Technologies, Datamatics, Aztech Software, Symphony, MahindraSatyam, Profix, and Infopulse); the other six were offering services within insurance (ICICI and EXL), finance (Firstsource), support (Hexaware and HCL), and engineering (eInfochips). With the exceptions of the Ukranian IT firms, Profix and InfoPulse, all were Indian firms.