Executive summary

- The offshoring and outsourcing industry has gathered momentum quickly: in 2002 just 10% of multinationals outsourced IT work offshore, but by 2008 that figure had risen to 70%

- India is still the dominant player in the outsourcing market and has potential for offshoring; major cities like Mumbai and Bangalore continue to be hubs for IT business process outsourcing (BPO), telecommunications and service industry operations

- The manufacturing market is growing in India with key players like Dell, Nokia, Toyota, DaimlerChrysler, Siemens, Honeywell and ABB manufacturing there

- China’s vision to be a leading provider of international offshoring and outsourcing services is on track - about 10,000 businesses are now operating in the IT software and services sector across China, it is widely perceived as the manufacturing centre of the world and its offshore and outsourcing revenue increased by 40% in 2007 to reach US $ 2.3 billion

- The 1000-100-10 Project is set to double China’s service exports by establishing 20 Chinese cities as outsourcing bases

- The volume of research and development and customer service offshoring to China is expected to almost double, while manufacturing and IT offshoring will continue to grow; the offshoring of finance activities to China is attracting less interest

- Africa is showing similarities to the India of the early 1990s – it has a population of one billion, half of which are under 20 years old; competitive labour costs; and, particularly attractive to European corporations, a vast number of European languages spoken, closer proximity than India and China, and similar time zones

- Knowledge processing and innovation outsourcing, such as creative industries, research and development, recruitment and legal services, is growing in popularity

- Offshoring businesses are beginning to service the indigenous market, a lucrative repercussion of this business model.

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For further information about CoreNet Global, visit www.corenetglobal.org
1. Introduction

The global offshoring and outsourcing market is a trillion-dollar business, employing millions of people across the world and providing significant economic regeneration for many developing countries. Though the recession slowed down its growth, the industry has learnt lessons that will help it to reshape and gather new momentum. Traditionally India and China have monopolised the market, but competition is emerging from an increasingly diverse range of locations.

This paper examines the opportunities and challenges for the offshoring and outsourcing market and where in the world they are most likely to flourish.

2. Market evolution

The current wave of popular success for offshoring and outsourcing started almost twenty years ago when a minority of large multinationals saw it as an opportunity to reduce financial pressures and meet new challenges in their sectors.

Outsourcing has evolved to address cost reduction strategies. Manufacturing production and information technology has led the way with software application development, data centres, maintenance and IT support. Large organisations realised too the benefits of outsourcing entire business process functions, from call centres to human resources and back office functions.

Cost remains a big imperative but it is no longer the whole story; increasingly outsourcing is seen as a way to optimise business processes, with both strategic and operational significance, through knowledge services and research and development.

Offshoring has added a further means for financial slimming. Investment in manufacturing overseas, most noticeably to China, is the most established form of offshoring, but inevitably the attraction of inward foreign investment to emerging economies has led to a surge of outsourcing companies offering to take on business process servicing in their own countries. The industry has gathered momentum fast; in 2002 just 10% of multinationals outsourced IT work offshore, but by 2008 that figure had risen to 70%.

3. India: a jewel of an opportunity

Despite many pretenders to its throne, India remains the global king of outsourcing, alongside China and Malaysia, according to the 2009 Global Services Location Index.

Generalisations about India as an outsourcing centre no longer apply. The picture has shifted both subtly and dramatically through variables like the economic downturn, the influence of new sectors entering the outsourcing market and India’s growing indigenous business muscle. But amid all the change and complexity, India remains a genuine beacon of opportunity.

Past masters

Since the early 1990s when the modern meaning of outsourcing became commonplace, the Indian economy began to be dominated by the development of three new industries: IT, business process outsourcing (BPO) and telecommunications. The services industry has become India’s biggest, contributing the highest percentage to the national GDP.

The offshoring trend started with a trickle of multinationals such as British Airways, General Electric and American Express exporting some back office functions to India. Encouraged by the success of the model, others followed, and by the beginning of this century cities such as Bangalore and Chennai became established BPO hubs, particularly for IT.

Second and third waves of BPO were characterised by a rise in government incentives and relaxation of local bureaucracy, new geographical frontiers of opportunity and new industry sectors entering the picture. Expansion was driven by low cost skilled labour, developments in technology and massive improvement to the telecommunications infrastructure in India.

Definitions

- **Offshoring** – the relocation of business functions to a different, and generally cheaper, foreign location
- **Outsourcing** – contracting with an external service provider to perform specific functions
India: a jewel of an opportunity

Applying the brakes

Businesses face conflicting pressures: the imperative to reduce operating costs, the squeeze on originator countries’ labour markets, and the drive to adapt and diversify.

Businesses trying to weather the recession have to weigh up the cost benefits of outsourcing or offshoring against barriers like a shortage of credit for funding such enterprises, or an impulse to focus on survival of the core business.

They agree however that India is still one of the most fertile destinations in the world for offshoring and outsourcing. The downturn has not affected India as much as it has many other economies – the overall slowdown is from 8-9% to 6-7% - and the continued investment in infrastructure and education combined with government incentives and the relaxation of licensing rules means the growth is expected to continue.

India’s growing talent pool is one of the most compelling pointers to its success as an offshoring and outsourcing destination. Business leaders within the service industry have for some time felt confident that when they establish operations in India they will find a ready-made team which they can scale according to their needs and easily engender with the values and culture of their organisation.

This is now becoming true of manufacturing. Two of the main barriers to a mass manufacturing capability – poor infrastructure and bureaucratic obstacles – are being addressed in certain Indian offshoring destinations, albeit on a piecemeal basis rather than as a part of a nationwide policy.

Map 1: The number of global BPO companies per city

- There are still a large number of BPO companies in the developed economies, although there is a risk that operations serving only one client will relocate to lower cost locations, in particular India
- High value added service functions, such as upselling, are likely to remain in the same country as their markets
- Africa currently has few BPO companies, although this is expected to change as the economic infrastructure improves and wage cost differentials can be realised by inward investors.
Leading global firms are taking advantage of this transition. Key players like Dell, Nokia, Toyota, DaimlerChrysler, Siemens, Honeywell and ABB all manufacture in India, while several foreign investors are increasingly active in chemicals. All of which points to India broadening from being an IT and BPO powerhouse to a manufacturing centre.

Back to the future

There is no doubt that despite wholesale shifts in world markets and the barriers created by global recession, India is still a destination of choice for outsourcing or offshoring. India’s workforce offers the largest pool of technical skills in the world, and the country’s universities add 180,000 engineering graduates to its ranks annually. Informed investors can enhance their established due diligence processes to identify and evaluate risks earlier, optimise the process and maximise their investments.

4. China: catching up fast

India may continue to dominate, but China is not far behind as a very credible alternative and a global economic force. Farsighted initiatives to develop education, training and a more robust infrastructure are paying off and their vision to be a leader in the international offshoring and outsourcing market is confidently on track. While most of the wealthier Western economies have reduced their share of the world’s manufacturing output China has doubled its own.

Unlike India whose growth was export driven, China’s outsourcing industry started from its domestic market, expanding to nearby overseas markets such as Japan and Korea and now has a global reach. Its more sophisticated infrastructure, financial status, strong skill base, good language skills and thriving business environment continue to earn it speedy commercial interest from around the world. A first imperative for wanting to trade from China might be cost and an abundant supply of cheaper labour, but being close to the local Chinese market is rapidly catching up as an invaluable plus.

Keeping up the pace

The top line statistics back up China’s recent success in the market – about 10,000 businesses are now operating in the IT software and services sector across China, it is widely perceived as the manufacturing centre of the world and its offshore and outsourcing revenue increased by 40% in 2007 to reach US $ 2.3 billion. The government’s commitment to maintaining this growth is clear – China’s Ministry of Commerce has put more than US $ 1 billion into launching the visionary 1000-100-10 Project which gives training and development to people for employment in services and outsourcing jobs. It is also helping to develop 20 cities for services and outsourcing across the country. These cities are Beijing, Tianjin, Shanghai, Chongqing, Dalian, Shenzhen, Guangzhou, Wuhan, Haerbin, Chengdu, Nanjing, Xi’an, Jinan, Hangzhou, Hefei, Nanchang, Changsha, Daqing, Suzhou and Wuxi.

Investment incentives make a big difference too – the Chinese government offers a package of very attractive tax benefits, including value added tax, customs and income tax benefits.

Happy days?

In general, businesses who have relocated or outsourced to China are positive about the practices and relationships they are developing there. A 2007 survey found that only 19% of respondents have any issues about working with their Chinese partners. Problems that were raised concerned steering a clear route through tricky local rules and regulations and learning to adapt to a different culture. A typical mismatch is that Chinese colleagues often say yes to a request but do not deliver. Many foreign companies have learned from these initial difficulties and have started to work with expatriates to monitor and control day to day business. Chinese companies rely much more heavily on expats for managing their operations than they do in India – 59% of all Indian operations are managed by locals compared to 37% in China.

Language is still a much bigger issue in China than in India where most people speak English, although the government is investing heavily in language skills to turn this round. Most university graduates now have an acceptable level of English but people in their forties and beyond often do not.

Fast forward

It is likely that the breadth of activities being offshored and outsourced to China will continue to increase in the next three years. In particular, research and development and customer service offshoring is expected to almost double, while growth of manufacturing and IT offshoring will not slow down. Paradoxically businesses are less interested in increasing the offshoring of finance activities to China.

Poised for continued growth the Chinese government still needs to maintain big investment in an infrastructure which has already moved on with startling speed thanks to massive commercial and political commitment. The danger is that as the established tier one cities reach capacity or become prohibitively expensive, the tier two and tier three cities need to prepare their own
infrastructures to attract significant sustainable interest. Without these resources and necessary technological competency in outlying cities, the risk is that potential businesses will move some of their operations to other parts of Asia.

5. Likely partnerships

Choosing the right outsourcing and offshoring destinations is a complex process and increasingly businesses are finding that no one destination gives them everything on their wish list.

Multinational companies are looking at several potential markets, scoring them on their strengths and choosing a mix of their complementary strengths wherever they are in the world. It is not a decision of one area versus another, but an opportunity to make all locations work together as effectively as possible.

‘We see that more companies want global sourcing, not simply from India or China, but from both,’ says Seth Pinegar, head of corporate development at Chinese vendor iSoftStone Information Service Corp in Beijing. ‘They want diversification, but also support from companies with global perspective and experience.’

Appendix I provides a summary of the factors that companies should consider when offshoring and outsourcing their operations.

6. Location selection

The drivers that attract us to different locations are many but cost reduction, access to specific skills and resources, entrance to new markets and process re-engineering opportunities are four key catalysts. In reality a mix of these imperatives will underline a business’ decision to move.

Businesses looking to offshore to relatively unexplored cities can often get hold of invaluable incentives such as government grants. Undoubtedly they will also have more power at the negotiating table because they got there first.

Across the world new offshoring and outsourcing opportunities are emerging and are summarised in Appendix II. Africa deserves a special mention.

Africa: a new horizon

In the league of emerging outsourcing destinations, Africa is a recent contender. The conventional wisdom of a continent frayed by problems and instability is giving way to a fresh view of Africa as a new frontier of opportunity.

The world is watching as a number of emerging destinations are paving the way for a more widespread inflow of foreign investment. Hotspots include Egypt, South Africa, Mauritius and Tunisia, but other countries are waiting in the wings.

Africa is demonstrating a raft of conditions to match India of 20 years ago. Africa has a population of one billion, half of which are under 20 years old. It has a growing pool of underemployed people whose competitive labour costs are rivalling those in India.

Language is also a significant advantage. Africa’s history of colonial rule means a variety of European languages are spoken on the continent, including English, France, German, Portuguese, Dutch (Afrikaans), Spanish and Italian. For European businesses, it also has a favourable time zone and is easier to reach than India and China.

7. Responding to changing demands

Over the last year or so, many of the outsourcing giants have experienced something of a hiatus. Three of the top four global players have seen revenues decline; yet in all cases, margins have held steady or even increased. This can be largely attributed to taking clients’ business offshore where lower labour costs, government incentives and a maturing customer service ethic delivers quality of service at a good price. This is ongoing. In November 2009, CapGemini announced they were to open a new business information unit in Bangalore, which would take its Indian staffing to over 21,000 employees, over a thousand more than their own domestic workforce in France.

Orange Business Services have understood the intellectual advantages of siting innovation centres at the heart of offshore markets. The Orange Labs in Cairo, for example, opened just two years ago to strengthen the operator’s capacity for innovative customer product and service development for African and Middle Eastern markets, such as the development of voice services and content access in Arabic. The Cairo labs are 90% staffed by Egyptians and have been successful in creating what will become enduring local relationships and partnerships.

Orange also provides technical customer support from a base in Cairo, employs 1,500 engineers there and now works with around 150 local and foreign multinational companies, as well as 50 airlines. The traditionally pro-Western attitude of the local workforce - and its high service ethic borne from Egypt’s rich heritage and tourist trade – has provided an excellent brand fit with the Orange commitment to its customers; and by being at the cultural coal face, the company will be best placed to
understand and manage any attitudinal or social shifts that might occur in the future.

Such initiatives from major players are the lifeblood of emerging offshore destinations. First movers like Orange provide assurance to others who will follow and act as a catalyst for the development of a better local support infrastructure. This creates a virtuous spiral which makes offshoring decisions far easier.

Intriguingly, offshoring businesses are also reaping unexpected benefits from the other side of this spiral; finding opportunities to service the indigenous market. Take General Electric, for example, who established an offshored research and development facility in 2000 in Bangalore to service the multinational needs of the whole organisation. Over time, while staff met global development targets, management understood the potential to harness some of the group’s local intellectual power for the market on their doorstep. Successful outcomes include a low cost handheld electrocardiogram unit for rural Indian patients who cannot get to hospital.

There are also changes in the type of outsourcing and offshoring services being demanded. Whilst BPO, manufacturing and production are likely to remain the mainstay of offshoring and outsourcing for the foreseeable future, many multinational corporations are demanding research, development and innovation centres and services too. As well as finding cost advantage in bright, young and talented labour pools, organisations are realising the cultural and learning benefits from working in high value-added services with an indigenous workforce.

8. Conclusion

The offshoring and outsourcing world is changing shape. Whilst India and China will continue to dominate, Africa presents significant opportunities for companies prepared to take higher risks. Research and development, knowledge process and innovation outsourcing will be offered more widely alongside the established BPO, telecommunications and manufacturing offshoring and outsourced operations.

Companies must continue to consider a vast array of factors to determine the most suitable place to locate their business functions in order to maximise profit and maintain high service standards.
Map 2: The current and future state of offshoring and outsourcing operations

- Developed economies are characterised by a mature outsourcing capability. Higher value added services, such as sales, are likely to continue to be supplied by BPO operators in developed economies as companies drive to ensure the right cultural fit and customer empathy. Lower value added processing activities will continue to shift from the developed economies to lower cost geographies.

- The mature outsourcing / offshoring countries are those where the offshoring element is relatively close to the host market, such as Canada serving the USA and Eastern Europe serving Western Europe. Traditionally, the rationale for this decision has been a need for specific skills (languages in the case of Europe) and cost advantage (in the case of Europe and Canada). However, the cost advantage may not persist due to exchange rate fluctuations and labour supply issues in some of the more established cities and we are likely to see a shift to the emerging outsourcing / offshoring countries.

- The emerging outsourcing / offshoring countries are those where the major companies have established operations but where there is still capacity for further expansion. Countries where labour costs are low, skills are readily available, the prevailing business climate is favourable to foreign investors and risk levels are acceptable will be the most successful. Currently these would include Egypt and South Africa.

- Potential countries have little or no outsourcing at present but are likely to attract future investment as a result of continuing economic development and ability to do business, wage cost arbitrage and the availability of the right labour skills. Many African countries are potential contenders due to the legacy of English and other language capabilities coupled with their low cost status.
## Appendix I: Factors companies need to consider when offshoring and outsourcing their operations

### Attractiveness of location
- What other companies or sectors are the local investment promotion agencies targeting? If there is support for your sector, the business infrastructure is likely to be more advanced. However, if the location is likely to attract a large number of competitors there will be pressure on costs.

### Incentives offered
- Financial incentives, whilst attractive, should not be overestimated in their importance to the location decision. They are generally one-off payments to attract companies to areas which have an inherent economic weakness or market failure, and therefore should not drive any decision.

### Availability of labour
- How sustainable is the location’s labour supply?
- Are the local education institutions producing sufficiently skilled staff?
- Is the region able to attract workers from other parts of the country, or does it tend to lose labour to other places?
- Will the area attract relocations from the host country?
- Some Eastern European cities have seen annual labour costs increase by 25-50% p.a. in the short term. Whilst this is from a low base salary, there is still a lag until education and training programmes can be introduced or migrant labour is able to move.

### Labour costs
- Have you taken into account all labour costs?
  - Employer tax rates, for example, vary dramatically between countries and can change the relative cost profile of cities in cross-border location decisions.

### Connectivity
- Is it worth selecting a location with good air links if the journeys between the host country and offshore location are infrequent?
- There will generally be labour and property cost premiums around transport hubs.

### Exit strategy
- What problems are likely to arise if you decide to exit a location?
- Are the statutory severance obligations particularly onerous or costly?
Appendix II: Emerging offshoring and outsourcing opportunities

The Americas

- Outsourcing is more dominant than offshoring for services; data protection legislation and high customer service expectations have restricted opportunities to offshore
- Canada became the hub for many operations serving the US – initially this was a low cost option because of the exchange rate advantage but this has been significantly eroded. Puerto Rico also emerged as a viable offshore location
- Outsourcing of back office operations is popular especially in financial services, much through acquisition of small and mid-tier banks’ back office functions by global outsourcing companies who streamline processes and try to win more work to utilise spare labour capacity
- Manufacturing has been offshored or outsourced to companies based in lower cost locations, eg: Apple in China and Nike in Southeast Asia
- Outsourcing companies in the US or Canada who only serve one client are under threat as the outsourcing company is free to locate to lower cost locations. Despite this, there will continue to be a requirement for some value-added activities to service US customers from within America and Canada owing to customer demand expectations
- Despite its large talent pool and proximity to the US, Mexico has not attracted the expected level of cross border investment from America, and it ranked only 60 out of 144 countries in the Global Economic Forum's 2009-2010 Competitiveness Report. Mexico is still very bureaucratic and the unions are powerful enough to cause problems for companies. Furthermore, along with Columbia, its international reputation for drug-related violence reduces its perceived level of safety
- South American countries generally offer multiple language skills and cities in Argentina and Chile are capitalising on their bilingual workforce. Governments across the region are spending money on marketing the local services industry heavily and supporting them to flourish so as they can confidently meet the global need.

Asia Pacific

- Malaysia and Philippines are established locations for offshore service sector activities. The Philippines in particular has a large English speaking population, this together with their strong cultural assimilation with the US allows them to compete for US offshore and outsourced projects
- Manufacturing infrastructure is strong in a number of sectors, eg: clothing in Indonesia; food is increasingly an important sector
- Relatively low labour regulation and lack of employee representation mean an ample (unprotected) workforce but this, together with concerns about ethical production and child labour, can put businesses off
- The Philippines has the lowest corruption perception in the region
- There are many strong investment promotion agencies in the Philippines, Malaysia and Thailand. Malaysia is using the media to strongly promote ease of doing business there and new legislation to tackle corruption is underway
- Vietnam continues to attract high investment; having established Saigon Software Park in Ho Chi Minh as Vietnam’s first software development centre in 2001, the country now boasts over 750 domestic software companies, employing more than 35,000 people, and has attracted foreign investment from the likes of Oracle, IBM, Microsoft and Intel.

Europe

- A highly developed outsourcing model where outsourced firms often nearshore / offshore
- Multilingual hubs have developed for back office / customer service operations. London, Amsterdam and Brussels were initially strong, followed by Dublin, Barcelona and Stockholm. Then Prague, Budapest and Warsaw became popular, before Brno, Krakow and Wroclaw were strong contenders, but the labour supply issues and wage cost inflation in certain cities of Eastern Europe have raised challenges in all of these places
- EU accession was not a driver as many companies had already moved into eastern European cities: it does however continue to reassure investors from outside the EU who are unfamiliar with the region
- There has been some migration of call centres back to the host country (eg: India to UK) after consumer demand expectations
- Manufacturing has been offshored from west to east Europe for labour cost arbitrage. Some eastern European companies are now looking to offshore to Ukraine and Russia for similar reasons.
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