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CHINA

Opportunities and Options for Outsourcing in China

ISG

ISG WHITE PAPER

INTRODUCTION

China, with 20 percent of the world's population[1] and now the second-largest economy in the world[2], is no stranger to outsourcing. The country has become both a substantial buyer and seller of outsourcing services. Enterprises operating in China are asking themselves how much outsourcing can and should be a part of their business strategies in the country.

Chinese and international outsourcing buyers confront complex decisions about the capabilities, experience and stability of providers who have a presence in China. They face an array of sourcing options, from shared services to captive and third-party outsourcing arrangements. This white paper will concentrate on the opportunities for engaging third-party service providers — both China-heritage and non-Chinese providers. It also will describe the advantages and disadvantages of each of these provider groups. Clearly, the overall buying and selling dynamics in the emerging Chinese domestic market are still evolving, so for those interested in this country, outsourcing potential represents a promising but complicated moving target.

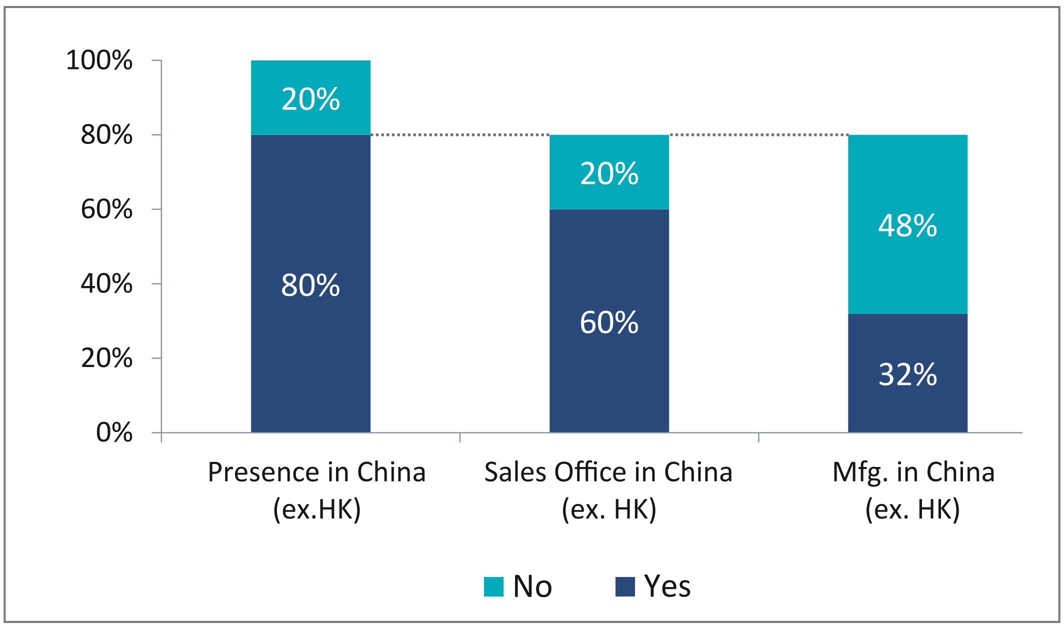
[1]"China Population," by Matt Rosenberg, About.com, November 17, 2010
[2]British Broadcasting Corporation, February 14, 2011

COMPANIES THAT CAN BENEFIT FROM OUTSOURCING IN CHINA

Some international companies have done business in China for decades. In the 1970s, major global players such as Volkswagen, Coca-Cola and 3M gained an initial toehold in the country. During the 1980s, Motorola, Philips, NEC and others were welcomed. These international companies had the advantage of corporate tax rates that were half those imposed on local companies, and they paid no duties on their capital goods imports. Since the turn of the century, especially in 2001 when China joined the World Trade Organization, both the Chinese government and consumers have more closely examined foreign operations for their fit with national interests. The favored international companies began getting local treatment, as corporate tax rates for local and foreign companies were equalized[3].

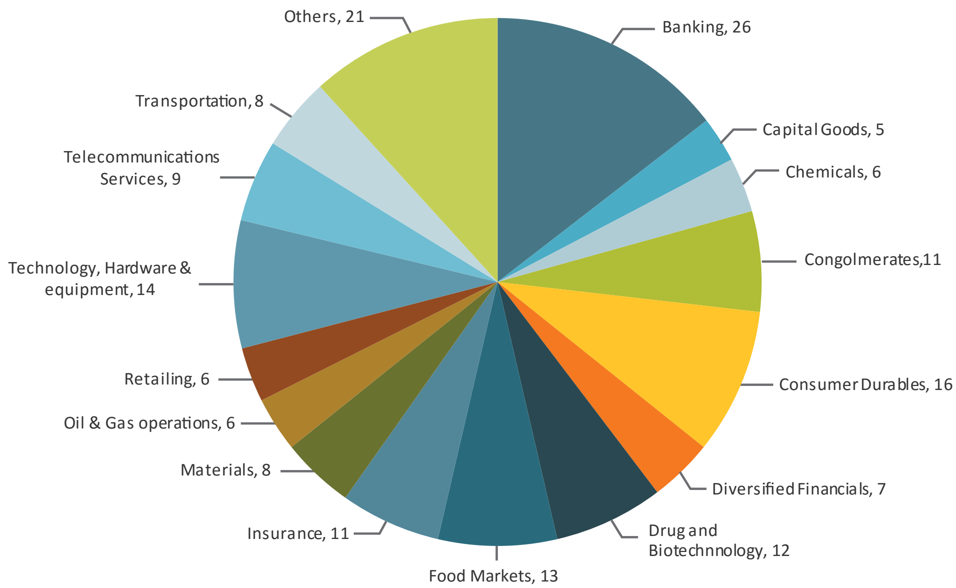
More than 220 Global 2000 companies have operations in China that might benefit from third-party outsourcing.

Today, more than 220 Global 2000 companies have operations in China that might benefit from third-party outsourcing. As the following chart shows, 80 percent of those companies have an actual presence in China, 60 percent have sales offices and 32 percent have manufacturing facilities[4].



Among industries represented by the 220 companies, the banking industry has the predominant presence in China, with 26 companies having operations in that country. The banking industry and other industries with more than four G2000 companies in China are shown in the chart that follows.

[3]MIT Sloan Management Review, July 1, 2007
[4]ISG research, May 24, 2011



Industries represented by fewer than four companies

Source: TPI research, May 24, 2011

Not only are a growing number of global companies operating in China, but the Chinese domestic company base itself is large and expanding. The domestic company group includes government state-owned enterprises (SOEs), state government agencies, multinational Chinese enterprises, large local enterprises, and small and midsize businesses (SMBs).

In 2010, China's domestic market size was about US$2 trillion, an amount exceeding the country's estimated exports[5].

The potential growth of the Chinese information technology (IT) services market is compelling -- it is expected to grow at an attractive range of better than 20 percent a year during the next few years.

The vast domestic market allows substantial business opportunities for both local and foreign businesses and prompts some questions. Is this opportunity big enough for my company? Could outsourcing in this country give me an advantage? What are the drawbacks and payoffs?

Both global and Chinese companies are acknowledging the benefits of outsourcing, so that industry sector is taking off. In 2008, the domestic market of China's software and information outsourcing industry reached US$633.2 billion[6]. By 2010, total outsourcing industry revenues in China had reached an estimated US$20 billion[7]. The potential growth of the Chinese information technology (IT) services market is compelling — it is expected to grow at an attractive range of better than 20 percent a year during the next few years[8].

[5]Chong Quan, China's Deputy International Trade Representative, at a forum on imports and exports as reported in China Knowledge, September 9, 2010
[6]Michael Rehkopf, Americas Sourcing Industry Conference, June 20 – 21, 2011, Chicago, Illinois
[7]TPI 1Q11 Index Call
[8]UBS – June 23, 2011

No matter how we look at it, the demand for outsourcing services in China is on a growth track, and so are the available outsourcing services that can address that demand.

CHINA-HERITAGE OUTSOURCING PROVIDERS

China-heritage providers are indigenous Chinese companies that are tapping the outsourcing potential around the globe and in their own country. There are currently some 13,000 Chinese IT services firms. Most are small, with fewer than 1,000 employees. In all, about 2.3 million people work for these companies and together earned about US$20 billion in 2010. The average firm employs about 200 people and earns an average of US$9,000 per employee[9].

The major China heritage firms are present in about 90 locations. Of the 90 centers, 72 percent focus on IT outsourcing (ITO), 9 percent focus on business process outsourcing (BPO), and 19 percent offer both BPO and ITO. Employees in these delivery centers speak Mandarin, Cantonese, Taiwanese, Japanese, Korean, English and German. Most tend to focus on clients in mainland China and Asia Pacific. Some are more global in their client base.

The following table lists alphabetically 10 of the largest Chinese service providers as measured by revenue and employees:

These 10 Chinese firms accounted for more than 85,000 employees and US$2.4 billion in revenue in 2010.

BeyondSoft
Camelot
Chinasoft
hiSoft
Insigma
iSoftStone
Neusoft
Rayoo Tech
SinoCom
VanceInfo

[9]Michael Rehkopf, Americas Sourcing Industry Conference, June 20 – 21, 2011, Chicago, Illinois

These 10 Chinese firms accounted for more than 85,000 employees and US$2.4 billion in revenue in 2010. Together, they employ 40 times as many people as the average China-heritage providers, and they generate 4 to 5 times the revenue the average Chinese firm creates. Although the China-heritage "Big 10" represents a substantial portion of the Chinese market, it is still a highly fragmented group. What is interesting, and perhaps coincidental, is that the size of the leading Chinese providers today (employees and revenue) is roughly equivalent to the size of the leading providers in India a decade ago[10].

NON-CHINESE OUTSOURCING PROVIDERS

Major non-Chinese service providers with international operations in China include large firms based on the United States, EMEA and Japan, as well as India-heritage providers. Several of the foreign providers have been in China since the 1980s.

All told, they represent about 30,000 to 50,000 seats, or potential employee service capacity, less than the combined staffing of the 10 largest China-heritage providers. They are present in more than 80 locations in China, from large cities to small towns. IBM, for example, has a presence in Shanghai and Beijing, but also in Ningbo and Langfang.

About 60 percent of their centers focus on ITO, almost 20 percent on BPO and another 20 percent on both. The primary languages in these centers are Mandarin, Cantonese, English, Japanese and Korean. Center employees also speak some European languages and languages of Indonesia and Malaysia.

The clients who engage the non-Chinese firms to help them outsource largely include global firms with headquarters outside of China, but these providers also serve Chinese firms such as China Telecom and China Mobile[11].

CONSIDERATIONS WHEN CHOOSING A SERVICE PROVIDER IN CHINA

As you might expect, each provider group and each company within each group has something slightly different to offer. Some general considerations provide a useful starting point.

The Chinese providers come well equipped with languages and cultural knowledge that especially prepare them to address their own domestic market. Further, high inflation rates currently challenging China tend to force firms out of Tier 1 cities. Chinese-heritage firms are proving more able to adapt to this challenge with more manageable disruption.
The non-Chinese firms can have trouble getting expatriate management comfortable with living in or visiting Tier 2 and 3 cities in China. This provider group, as we have noted, has a

[10]All major points about the seats, locations, languages, capabilities and clients of the Chinese-heritage providers are based on the TPI GeoLocations database.
[11]All major points about the seats, locations, languages, capabilities and clients of *non-Chinese* providers are based on the TPI GeoLocations database.

relatively small footprint in China, which can limit the availability and use of their services. It appears that these non-Chinese providers are hedging their bets carefully — establishing a China presence for public relations purposes, but only truly growing when opportunities can be converted to revenue streams.

Both provider groups have difficulties finding and developing qualified middle managers. Experience and training can remedy this for both groups.

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Consider the plight of foreign clients with operations in China who are considering outsourcing. They must "think locally but act globally," mastering the fine points of local operations, while sustaining their global standards, as expected by the Chinese[12]. Many multinational enterprises that establish businesses in China have significantly smaller outsourcing requirements in that country than in other more mature countries in which they operate. This alters their demand patterns for these services in China.

They are sometimes challenged to find traditional non-Chinese service providers to meet their localized requirements in the more remote areas of the country. Companies that hire non-Chinese providers for their China operations tend to value them for following international standards of data privacy and intellectual property management. The consistency of their service provision is particularly attractive to multinational clients in China.

However, they also find it difficult to get mature services from the local Chinese service providers with sites in some of these desired locations.

Incidentally, this dilemma is sometimes solved to mutual advantage when the non-Chinese providers contract out to China-heritage firms. This approach sometimes results, however, in a company hiring a major non-Chinese provider without knowing it is also engaging China-heritage companies for part of the work. Even when a client knows there will be such a contractor arrangement, that client needs to be able to count on the dynamics between the different providers to be more cooperative than competitive.

Finally, it's not always possible to know whether government policies will favor or disfavor one provider group or another. The Chinese government might develop and enforce policies that favor China-heritage service providers, such as tax rebates and credit support, but the government might alternatively support the outsourcing industry in general in the country, including non-Chinese firms. Government policy uncertainties call for constant monitoring of developments.

Time will tell if the two major provider groups will "split" or "share" markets and specialize by the clients they win, the industries they serve or the capabilities they offer.

[12]MIT Sloan Management Review, July 1, 2007

By 2025, Asia is expected to boast upward of 20 of the top 50 global cities, and Shanghai and Beijing will have GDPs higher than those of Los Angeles and London.

NAVIGATING OUTSOURCING OPPORTUNITIES AND OPTIONS IN CHINA

Companies that ignore or hesitate to explore opportunities to outsource in China may be surprised at how soon they fall behind the curve in this rapidly developing country.

By 2025, Asia is expected to boast upward of 20 of the top 50 global cities (measured by gross domestic product [GDP]), and Shanghai and Beijing will have GDPs higher than those of Los Angeles and London[13]. At the same time, China's major companies are quickly making their strength known. China has seen an increase from four companies in the Forbes G-500 in 2004 to 25 G-500 companies in 2011[14]. The now-emerging nation is expected to develop quickly.

For companies that want to consider outsourcing in China right away — and in the right way — an outsourcing advisor can help expedite and improve the process. An outsourcing advisor can help a company adapt and adjust quickly in a unique and constantly changing business environment. The advisor can help an outsourcer cope with the massive scale required as well as attract and retain talent from China's huge labor pool, and learn how to accelerate what can be done in "China time." Finally, an advisor can guide the company in its optimal choice of an outsourcing provider.

As both the market and providers are nourished by their mutual growth, outsourcing in China has become a "seize the day" proposition for companies that wish to grasp it.

[13]"Urban economic clout moves east," by Richard Dobbs, Jaana Remes and Sven Smit, McKinsey Global Institute, March 2011
[14]3Q11 TPI Index research, October, 2011

ABOUT ISG

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