

# What's Happening in China

A Curtain-Raiser on the IT and Business Process Services Exports Market

Sheetal Bahl, Research Director  
Jimit Arora, Senior Research Analyst  
Aminisha Gupta, Information Analyst

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## Introduction

As global sourcing becomes a fundamental part of almost all sourcing decisions today, and as the appetite for offshoring increases, buyers as well as suppliers are looking beyond traditional destinations like India to source Information Technology (IT) and Business Process Outsourcing (BPO) services. While a lot of locations are making their presence felt, China as a sourcing destination has captured the fancy of buyers and suppliers alike. China's position of leadership as the manufacturing destination of the world remains undisputed. There is significant buzz in the market that China has the potential to also become a leading sourcing destination for services. While there is little doubt regarding this growth potential, it is still too early to say how much of this potential will be realized, and how soon.

The Everest Research Institute undertook an intensive research effort to get beneath the market buzz about China and to provide a fact-based approach to understanding the current state from which the Chinese sourcing market is maturing.

This whitepaper, the first in a series, addresses the following themes:

- Current state of play
- Macro factors driving growth
- Risks and challenges
- Key implications

Future whitepapers will explore China's sourcing landscape in greater detail and provide additional insight on supplier capabilities in the country.

## Summary of Key Messages

- The Chinese offshore IT and BPO markets are still in the early stages of maturity, with IT clearly leading between the two
- The potential demand for Chinese services is very strong due to three important factors besides simple labor arbitrage: risk diversification across multiple low-cost locations, China's potential labor pool, and the attractiveness of China as a huge demand source for global products and services
- On the supply side, China faces many serious challenges such as Intellectual Property (IP) and data security concerns and the employability of the workforce, which threaten fundamental growth. The Chinese government and suppliers are implementing new measures, however, to address these concerns
- We are optimistic about China's ability to become a major offshore destination for IT and BPO, but it remains to be seen just how quickly China can build traction

## State of Play

### Market size and maturity

The Chinese offshore IT & BPO services market is estimated to be about US\$2 billion (2006), representing approximately 3% of the global offshore market

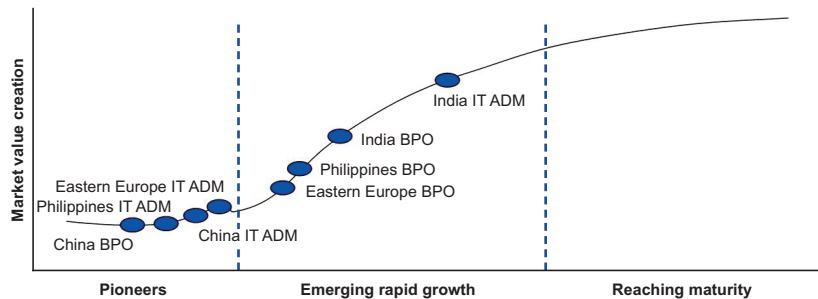
Despite the significant buzz in the market regarding China, it is important to note that the Chinese sourcing market is still in the early stages of development, which is reflected in the size of the Chinese IT and BPO markets. Recent estimates by the Everest Research Institute sized the Chinese offshore services market at about US\$2 billion in 2006, contributing approximately 3% to the total global sourcing market. The market is estimated to grow at a compounded annual growth rate of 38% to cross US\$7 billion by 2010.

The above numbers along with other factors like buyer adoption, adequate supply, and availability of standards indicate that both the IT and BPO markets in China are still in the pioneer stage of maturity (**Exhibit 1**). However, with the rapid growth in the number of suppliers (local as well as global) and corporations that have set up captive organizations in China, we expect the growth rate to begin to accelerate. Additionally, initiatives by the Chinese government to promote outsourcing are likely to help the market move rapidly up the maturity curve.

### EXHIBIT 1

Maturity of select locations for offshore BPO and IT Application Development & Maintenance (ADM) services

Source: Everest Research Institute (2007)



#### Adoption

- |  |   |  |
|--|---|--|
| <ul style="list-style-type: none"> <li>Value proposition identified but untapped</li> <li>Early adopters/limited adoption</li> </ul> | <ul style="list-style-type: none"> <li>Acceleration of adoption rates</li> <li>Increased scope and scale penetration</li> </ul> | <ul style="list-style-type: none"> <li>Decrease in adoption rates</li> <li>Continued growth and scope</li> </ul> |
|--|---|--|

#### Supply

- |   |   |  |
|---|---|--|
| <ul style="list-style-type: none"> <li>Presence of VC-type suppliers</li> <li>Limited location options</li> </ul> | <ul style="list-style-type: none"> <li>Suppliers are more established execution varies widely</li> <li>Market M&amp;A increases as new players enter with proprietary skills</li> <li>Location options with differences in capabilities increase</li> </ul> | <ul style="list-style-type: none"> <li>Clearly established players</li> <li>Clearly established locations</li> </ul> |
|---|---|--|

#### Standards

- |   |  |   |
|---|--|---|
| <ul style="list-style-type: none"> <li>Multiple models</li> <li>Unclear standards with high risk for buyers to select between models</li> </ul> | <ul style="list-style-type: none"> <li>Fewer, better established models meaning lower risk in choosing the appropriate design</li> </ul> | <ul style="list-style-type: none"> <li>Accepted model(s) and standards</li> </ul> |
|---|--|---|

## Market segments

The markets China is serving can be segmented along three primary dimensions: services, geographic focus, and industry vertical segments.

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The primary focus area in China is IT applications work, specifically web technologies (Java, .NET, etc.) and programming for embedded systems

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### Services focus:

- The primary focus area in China is IT applications work, specifically web technologies (Java, .NET, etc.), and programming for embedded systems
- Maturity in enterprise software like SAP, Oracle, etc. is relatively low as few suppliers are focusing on that space
- A large portion of the delivery is project-based work, and experience in large, multi-year agreements is low. This is possibly explained by the lack of scale and process maturity of Chinese suppliers
- Firms are trying to overcome the above challenges by investing in quality and security standards to increase buyer confidence
- Maturity in services like IT infrastructure outsourcing and BPO is still fairly low, with limited activity in these services. Suppliers are selectively testing some of these services with domestic clients before targeting international businesses

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Japan and Korea contribute about 60% of IT services export revenues and also a significant chunk of BPO revenues

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### Geographic focus:

- The historical interdependencies, cultural and linguistic similarities, and physical proximities have helped China establish itself as a key nearshore destination for Japan and Korea. These two countries alone contribute about 60% of IT services export revenues and also a significant chunk of BPO revenues
- North America (primarily the United States) and the United Kingdom make up the bulk of the remaining revenues. Chinese suppliers have now identified these geographies as key focus areas for future growth

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China is following a focused growth strategy and is not seeking to spread itself too thin by focusing on multiple offerings in multiple verticals and geographies

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**Industry vertical focus:**

- The Chinese services market is riding on the coat tails of the growth in the domestic financial services market, with the industry being a key contributor to domestic as well as exports revenues
- Another key focus segment is the ICT (Information, Communication, and Technology) vertical, with many suppliers providing services for technology, software, and hi-tech companies. In fact, suppliers are now establishing offshore delivery centers with client-dedicated resources, a practice that is common for buyers in this vertical. Services for this vertical include not only basic application design and testing, but also complex software engineering and, in certain cases, end-to-end ownership (i.e., from design to prototyping to actual production and delivery)

Looking at these market segments, the most interesting aspect is that China is following a focused growth strategy and is not seeking to spread itself too thin by focusing on multiple offerings in multiple verticals and geographies. This is a healthy sign in a nascent market and should bode well for China as it competes in the global arena.

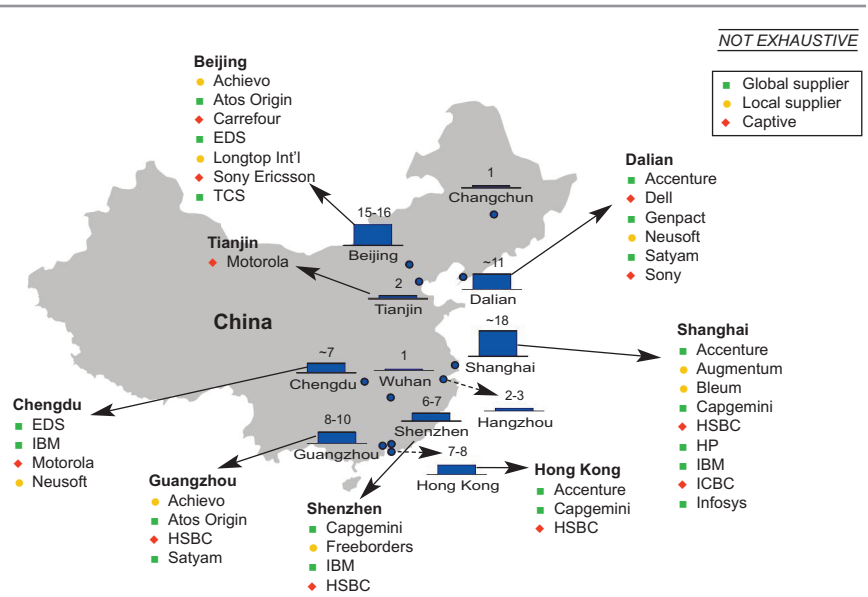
**Locations**

From a delivery perspective, about 10 cities have emerged as favored locations for service delivery. Suppliers as well as captive organizations are already spreading themselves across multiple Chinese cities fairly early in the game. An analysis of select organizations operating in China (suppliers as well as captives) indicates that they are looking beyond Tier-1 Chinese cities and are also establishing a delivery footprint across smaller cities in China (Exhibit 2).

**EXHIBIT 2**

Supplier/captive presence in China

Source: Everest Research Institute (2007)

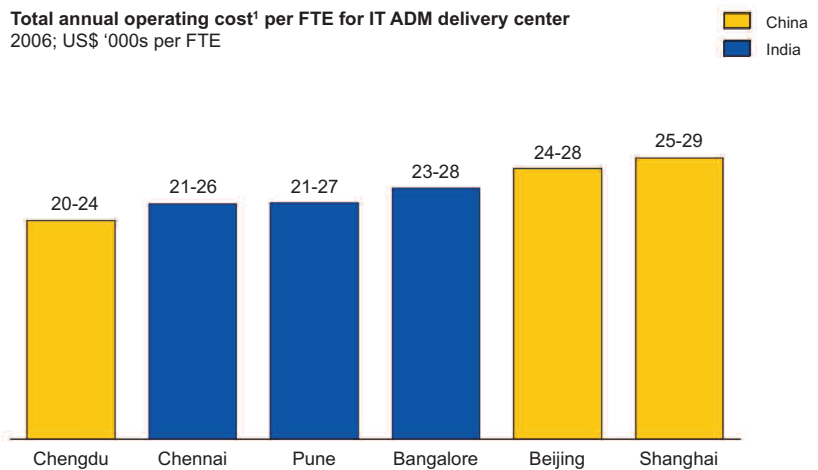


**Cost structures**

Pricing of services in China in comparison to India is a key theme in any conversation regarding sourcing services from China. A detailed independent assessment of costs in China by the Everest Research Institute reveals that, while there are some differences in costs across Chinese cities, these are largely comparable to costs in India (**Exhibit 3**). Tier-1 Chinese cities like Beijing and Shanghai are typically more expensive than Tier-1 Indian cities like Bangalore and Mumbai. However, there are other cities in China that offer significantly greater savings opportunities than Tier-1 Chinese cities. At an aggregate country level, it remains difficult to generalize which of the two countries is cheaper, as both are in the same general range. As a result, factors other than relative cost differences generally guide the decision to locate a center in one country versus the other.

**EXHIBIT 3**  
Operating cost in select Chinese and Indian cities

Source: Everest Research Institute (2007)



<sup>1</sup> Operating cost includes cost for direct salary, benefits, management overheads, facilities, equipment, telecom, etc.

## Macro Factors Driving Growth in China

Given the existing state of play, this section explores the key growth drivers for the Chinese outsourcing market. The following are the key drivers that will sustain the current momentum and help fuel further growth:

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Given the increased focus on wage inflation pressures, attrition, and other supply issues in India, companies are seeking to explore other offshore destinations to reduce the reliance and the risks associated with sourcing from a single country. This risk-diversification approach is one of the key reasons why companies are looking to source services from China

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- **Risk diversification:** A large number of companies sourcing services from China are also sourcing similar services from India. Given the increased focus on wage inflation pressures, attrition, and other supply issues in India, companies are seeking to explore other offshore destinations to reduce the reliance and the risks associated with sourcing from a single country. This risk-diversification approach is one of the key reasons why companies are looking to source services from China. Overall, there has been a shift in the thinking associated with outsourcing services to China. Contrary to its earlier positioning as a competitor to India, China is now hailed as being supplementary to India.
- **China market entry:** A large number of global firms are seeking to enter China to sell their proprietary products and services. As a complementary effort, these companies are trying to establish familiarity with the market and are also trying to establish their brands by sourcing IT and other support services from local providers that have a better understanding of the domestic Chinese market.
- **Future labor pool availability:** While several countries have emerged as potential alternatives to India, apart from China no other country has the potential labor pool size to sustain large global demand over an extended period of time. China is generating a large number of technical graduates every year and while current employability and language skills are still an area for concern, the situation is expected to improve over the next few years. The promise of this potential labor pool is reason enough for many companies to invest in China now and in order to reap the benefits later.
- **Labor arbitrage:** Not surprisingly, labor arbitrage is a key consideration in sourcing from China. As mentioned earlier, although costs vary by city in China, they are almost in line with costs in India and, hence, provide significant arbitrage opportunities to most of the developed economies.

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Unlike three to five years ago, the Chinese government is now focusing intently on promoting outsourcing services to China. The government is offering significant incentives such as cheap land grants, subsidized amenities, and tax incentives. There are also recent instances in which the government offered to absorb the first two years of payroll costs for multinational suppliers setting up services operations in China. These incentives have not only helped local Chinese providers but have also encouraged global suppliers and India-centric suppliers to enter China.

The *1,000, 100, and 10 Project*, announced in July 2006, further highlights the government's commitment to establishing China as an international services outsourcing base. This initiative aims to build service outsourcing bases in 10 cities, attract 100 world-renowned multinational corporations to outsource their services to China, and foster 1,000 domestic large and medium-sized outsourcing companies with internationally recognized certifications.

High-quality infrastructure in China is also a macro-force, prompting companies to look at China as a preferred sourcing destination. The Chinese government is investing heavily in improving roads, airports, public transportation, hotels, utilities, telecom, etc., even in a situation where the existing infrastructure is quite superior to India. These additional investments will make it much easier for companies to operate in China.

## Risk and Challenges Facing China

China's potential to be an extremely attractive offshore destination comes with a set of risks and challenges that need to be addressed in order for companies to fully benefit from the many advantages the country has to offer. The most prominent challenges include:

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While suppliers of services are able to address some of the concerns around IP and data security by implementing adequate security measures, the overall situation leaves much to be desired

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- **Intellectual Property (IP) and data security:** One of the biggest concerns that buyers have when outsourcing to China is IP and data security. After its entry into the World Trade Organization (WTO), the Chinese government created several laws to combat this problem and thus promote foreign investment into the country. However, due to lack of resources, as well as local protectionism and corruption, the effectiveness and enforcement of these laws is questionable. While suppliers of services are able to address some of these concerns by implementing adequate security measures for both data and IP, the overall situation leaves much to be desired. While the situation does appear to be improving, it still has a long way to go before reaching an acceptable level.
- **Language and culture:** Another area of concern regarding China is the limited number of English-speaking professionals available for employment in the services sector. Despite the large population and the sizable labor pool, lack of language skills is likely to severely dampen the success of the Chinese outsourcing market. Although the government has introduced English into the school curriculum, the reality is that the supply situation is still bleak. Suppliers that have a majority of their buyers located in the United States and United Kingdom have stringent language requirements. To counter these supply constraints, suppliers have dedicated in-house staff not only to train new hires in English, but to also sensitize them to Western culture. Suppliers are also trying to circumvent the problem by following a model in which they minimize client-delivery team interactions by having all communications routed via onsite account executives and teams in client geographies. The language situation, although improving, is still far removed from what most companies will demand.

Like language, culture also has an important role to play in the selection of an offshore location for service delivery. Eastern Europe has a culture that is similar to Western Europe, and India has historically adopted many cultural aspects from the United Kingdom. On the other hand, the Chinese culture has little in common with the Western world, which partially explains China's relatively low success with clients from that region. Conversely, this explains China's success with regional buyers from Japan and Korea. Similar to the effect of language, cultural differences may also dampen the growth of the Chinese offshore services market.

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While over three million graduates enter the Chinese workforce each year, the actual employability of the pool remains a serious concern

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- **Employability:** While over three million graduates enter the Chinese workforce each year, the actual employability of the pool remains a serious concern. A large majority of these graduates lack the basic technical, management, language, and communication skills required to succeed in a professional environment. Suppliers are beginning to address this challenge, and some have established their own training divisions to train and educate employees on these critical skills.
- **Market fragmentation:** The Chinese supplier landscape is highly fragmented, with a disproportionately large number of small, subscale (less than 100 employees) suppliers. This poses risks and challenges for companies looking to outsource to China in two ways: lack of suppliers with adequate capabilities and the risk of ongoing consolidation of the supplier pool.
- **Geo-political stability:** The political situation in China has improved over the last few years, after China's entry into WTO. The confidence of global companies in China has increased, as is evident by the phenomenal growth in the manufacturing sector. Nevertheless, while the current risk assessment from a geo-political risk perspective is low, this factor cannot be ignored.

## Key Implications

### Implications for companies looking to offshore services

- If serious about offshoring on a large scale in the long-term, start evaluating China seriously today. Keep in mind, however, that China is unlikely to substitute for India or other mature offshore destinations in the short or medium-term – it will work best as a supplement that matures over the coming years
- China is not yet ready for large scale projects – test the waters with pilot programs before committing to larger or more complicated contracts
- Hand-pick onsite supplier teams that can understand and adequately manage the offshore teams in a manner that reduces cultural and linguistic challenges
- Structure contracts robustly to ensure IP and data security objectives are achieved – do not expect the contract or the Chinese legal system to provide true protection. Assume that full protection will not be attained and select the work offshored to China accordingly

### Implications for suppliers

- Position China carefully – the role of China as a substitute for India is unlikely to be true in the short-term. However, as a supplement to India, China can play a valuable role
- The need for improved delivery scale is high. As a result, consolidation and M&A activity appears inevitable – be prepared for it!
- Invest proactively with the government to increase talent availability and improve employability of the labor pool in the long-term
- In the short-term, over-invest in account management teams, onsite resources, and local managers who can effectively address current market concerns
- Mitigate security concerns by taking concrete steps to ensure IP protection and data security and also provide contractual protections that will offset the concerns of clients

While China is seeing a lot of activity from both global companies and suppliers of offshore services, a lot still needs to happen in order to sustain the growth and maintain the pace of investments. The overall situation is beginning to move in the right direction with global companies, suppliers, and the government all becoming more serious about making China a prominent offshoring destination. The fledgling dragon has taken wings and is ready to fly, but how far and how fast remains to be seen.

## About the Everest Research Institute

**Everest Research Institute** ([www.everestresearchinstitute.com](http://www.everestresearchinstitute.com)) serves as a central source of independent and objective strategic intelligence, analysis, and actionable insight for leading corporations, service providers, technology providers and investors in the global outsourcing and offshoring marketplace. The Institute addresses both business process and information technology sourcing topics, providing the global outsourcing and offshoring community with information that empowers highly productive, sustainable sourcing strategies and relationships.

The Institute's distinguished Board of Advisors oversees the Institute's research agenda to ensure that it fully supports the business needs of the outsourcing and offshoring communities. Everest Research Institute clients receive access to unparalleled analytical and advisory services, including access to Everest analysts, detailed reports and whitepapers on outsourcing and offshoring topics, and webinars designed to provide insight and information about important market trends. The Institute's wealth of knowledge and experience provides clients with unique perspectives into today's marketplace and the competitive edge required to take advantage of emerging opportunities.

Everest Research Institute is the research arm of the Everest Group ([www.everestgrp.com](http://www.everestgrp.com)), a global consulting firm that assists corporations in developing and implementing leading-edge sourcing strategies. Since 1991, Everest Group has served as the trusted business advisor on hundreds of IT and business process outsourcing transactions worldwide.

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**For more information about Everest Research Institute, please contact:**

Everest Research Institute  
+1-214-451-3110  
[info@everestresearchinstitute.com](mailto:info@everestresearchinstitute.com)

**For more information about this topic please contact the author(s):**

Sheetal Bahl, Research Director  
[sbahl@everestgrp.com](mailto:sbahl@everestgrp.com)

Jimit Arora, Senior Research Analyst  
[jarora@everestgrp.com](mailto:jarora@everestgrp.com)

Aminisha Gupta, Information Analyst  
[agupta@everestgrp.com](mailto:agupta@everestgrp.com)