Outsourcing to China: Removing the Risk & Maximizing Competitive Advantage

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Synopsis

As the economic downturn starts to wane and conditions become more favorable, CIOs are moving from a “battening down the hatches” type mentality to one of preparing for growth. Although this seems like good news, many organizations will continue to insist that IT budgets remain relatively flat, while at the same time asking CIOs to deliver more in order to not only maintain, but increase competitive advantage.

One way of achieving these seemingly opposing objectives is to consider the use of, or indeed broaden the use of outsourcing and in particular offshoring as part of the delivery method. China as a major provider of offshored IT services is now normally considered for this kind of work.

This paper begins with an introduction to the key trends driving the use of outsourcing and more specifically offshoring and discusses the drivers and inhibitors for choosing China as the offshoring destination.

Eight common negative perceptions about the risks of doing business with Chinese IT Service providers are then explored, including those relating to cultural differences, language, access to skilled resources, quality and intellectual property. Recommendations include tips for effectively engaging with Chinese outsourcers including how to select a Chinese IT Services provider with the aim of mitigating these eight risks via a vendor evaluation framework, checklist and scorecard.
Introduction

Globalisation, Competition and Productivity
In the new globalised and hi-tech enabled economy, managers face a plethora of challenges that were not present or were of a much smaller scale less than 15 years ago. Apart from the challenges of dealing with issues arising within their own enterprises, managers must also deal with numerous external forces over which they often have little control.

These trends include but are not limited to: shortages of skilled talent; the influx of new business models; complete paradigm shifts in many industries; increased fluctuations in geopolitical stability; globalisation and with it the challenges of competing with producers from economies with more advantageous costs of production and distribution. In addition, whole new markets are being opened up across the globe as a new ‘middle-class’ emerges in densely populated markets such as China and India, as well as other rapidly advancing markets such as Brazil, Russia, parts of Eastern Europe and even Africa.

If companies are to remain competitive, these macroeconomic, societal and business trends cannot be ignored. Being competitive is becoming more and more closely linked with information technology, especially in managing processes that enable a fast, flexible response to changes in the market and competitive environment, and that increases productivity in general.

The Waning Economic Downturn as a Driver for Outsourcing and Offshoring
As the economic downturn starts to wane and conditions become more favorable for growth, many CIOs and other IT decision makers have moved from a “batten down the hatches” type mentality to one of preparing for growth.

Although this seems like good news, many organizations will continue to insist that IT budgets remain relatively flat, while at the same time asking CIOs to deliver more in order to not only maintain, but increase competitive advantage1. One way of achieving these seemingly opposing objectives, is to consider the use of Outsourcing, and in particular Offshoring as a viable delivery method.

In addition to increasing the flow of communications between business and nations, the use of technology has lead to the rise in the use of ‘outsourced’ (use of external third parties) and ‘offshored’ (use of IT service providers based in another country) human resources by many businesses in the developed world as a means of reducing costs, or at least improving productivity or output for the same cost.

Redistribution of Economic Power and China’s Offshoring Emergence
In spite of some publicity against offshoring in the developed world, especially the US and Western Europe, the use of various forms of outsourcing of IT processes and systems to other countries continues to be a strategy increasingly favored by many businesses. This has lead to the creation of new players in the global IT industry, which has changed the competitive landscape, especially in the IT Services sector, and which in turn has the potential to change the balance of the global IT sector and the source of IT. (I find this last sentence very complex) As the Economist Intelligence Unit’s Foresight 2020 report puts its “It’s too early to talk of Asia’s century, but there will a redistribution of economic power” especially led

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1 IT Decision Maker Survey – Asia/Pacific Profile of 1493 CIOs, Frost & Sullivan, Oct 2009
by the emerging markets of India and China\textsuperscript{2} – or the combination of the two forces in the form of ‘CHINDIA’ or ICT (India and China Together – a common phrase in Asian IT circles).

According to KPMG, the share of Asia Pacific in global demand for IT-BPO (Business Process Outsourcing Services) alone is estimated to increase from approximately 17 percent in 2008 to around 31 percent by 2020, with similar growth rates predicted for almost all other forms of offshored IT services.

The impact of new technologies and the benefits to the larger developing economies in terms of increasing their global reach and allowing their workers to perform work “offshore” for the western and developed economies is now increasingly understood. India has historically been the major focus for much of these activities but China with its 300,000 (a number of studies put the figure at 600,000) technology graduates a year is now increasingly a focus for this kind of work.

\textsuperscript{2} EIU Foresight 2020
The Outsourcing Motivation and Alignment with Organizational Needs

Although as a service delivery strategy outsourcing and off-shoring are valid approaches, a number of questions need to be answered by an organization before they embark on this strategy.

**What Problem are You Trying to Solve?**
The first questions at their most basic are ‘what problem(s) are you trying to solve?’ and ‘what outcomes are you trying to achieve?’ Without a clear understanding of your motivations for evaluating outsourcing as an option and without a very clear set of parameters against which to measure the progress of achieving your outcomes and the level of success required, the risk of project failure is great.

In much of the research performed globally in attempting to identify why organizations outsource (including research conducted by Frost and Sullivan in the last month³) the key reasons that organizations cite for outsourcing (generally in this order) were to:
1. Cut costs
2. Simplify projects
3. Tap into expertise not found in house

However in many cases organizations reported that outsourcing:
1. Didn’t save any money
2. Created complexities in management that they had not prepared for
3. Cost more than they originally estimated due to ‘hidden costs’ not factored in

Nevertheless, when properly evaluated, tested and implemented, the benefits of a successful outsourcing arrangement generally outweigh the disadvantages and the industry is rapidly maturing as more companies use outsourcing as part and parcel of their IT delivery strategy. One piece of evidence supporting this is the continued growth of the global IT Services market in general which stood at approximately US$819 Billion in 2008 and is estimated to top US$1 trillion by 2012⁴.

**What is the Total Cost of Ownership?**
The decision to outsource an activity must be justified via a straightforward ‘…cost-benefit analysis that quantifies all the relevant costs associated with the prospect of outsourcing a function and weighs them against the projected benefits…’ ⁵ of outsourcing.

In addition the Total Cost of Outsourcing must be taken into account. The concept of TCO (Total Cost of Ownership) was pioneered by Gartner Inc specifically related to the IT Hardware industry, where the cost of purchasing a specific piece of Hardware (generally a PC or Server) was identified to be only a small proportion of the actual cost of owning and running the PC.

Such elements as ongoing maintenance and support; power usage; downtime; finance and leasing and hidden costs such a non-IT worker helping a co-worker…all added up to a total cost of ownership much greater than the ‘sticker’ price.

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³ IT Decision Maker Survey – Asia/Pacific Profile of 1493 CIOs, Frost & Sullivan, Oct 2009
⁴ Gartner, Market Size and Forecast for IT Services, quoted by Anthon Savvas, viewed Nov 7th, 2009
⁵ University of California, Berkely VOL. 50 No.1 Fall 2007
For an IT Services relationship, especially an offshored one, the same concept can be applied. When evaluating the cost of outsourcing against the benefits, firms need to take into account not just the cost of the service whether ongoing (maybe as an annuity type arrangement) or on a project basis. In a survey by *InformationWeek* of 420 business technology professionals regarding their outsourcing experiences, the ‘…real hidden costs that most often adversely affected the bottom line…’ were in ‘….the transfer of knowledge and scope of work’…to the outsourcer…‘along with ‘…the costs of ongoing management of the outsourcing relationship.’ i.e. the cost to your organization for setting up the outsourcing arrangement and managing the service provider. These costs are generally referred to under the headings of *contract management* and *vendor management* and are often overlooked when creating the business case for outsourcing in general.

| Cut Costs | - Didn’t Save Money |
| + Simplify Projects | - Created Management Complexities |
| + Tap Expertise | - Hidden Costs ballooned |

**Your Organization needs to Answer These Questions First:**
1. What Problem Are You Trying to Solve?
2. What is The Total Cost of Outsourcing?
3. What is required in terms of cost vs productivity vs fit for purpose

**Fig 1: Drivers, Inhibitors and Recommendations for Outsourcing, Source: Frost & Sullivan, Nov. 2009**

**Cost vs. Productivity, Quality and ‘Fit for Purpose’**
In regard to an off-shored outsourcing relationship the cost-benefit allowance and the TCO calculation becomes a bit more complex. Apart from dealing with an external service provider, other factors such as culture, language, IP protection and more as discussed later in this document must be taken into account.

When creating a TCO model to be applied to an offshore engagement, one of the key issues that is sometimes ignored is that of comparing employee salaries/hourly rates and other related staffing costs. At Frost & Sullivan we have created a number of IT Services related TCO models for various organizations. In our discussions we have found that organizations comparing internal staff salary rates and oncosts with externally provided rates often forget to take into account the three important factors of *quality,*

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6 *Information Week, May 2006*
Productivity
In terms of productivity, when comparing say the rates of US or EU workers against the rates of say Chinese, Indian or other popular offshore destinations, many companies just use the base $ rate and subtract one from the other. In general this results in a much lower hourly rate for the offshored work, when compared to the local rate. So on the surface it appears that a lot of money will be saved by offshoring. A similar calculation is then performed to compare the rates of each country and then (assuming the cultural and other issues can be mitigated successfully) the country is then selected.

In reality, the key factor that must be introduced into the calculation to make a much more effective comparison is that of not just how much per hour the staff are paid but how many hours they will take to perform the work multiplied by the hourly cost with the addition of the hidden costs of managing the offshored resource over the lifecycle of the project. This includes the ease of negotiating, specifying, setting up service level agreements, staff management, review meetings, reporting mechanism, support/help desk, escalation procedures, increasing the scope of work or adding new projects and many other related factors. Having a very detailed understanding of these costs for each country and then each service provider in each country is essential to creating a more accurate cost-benefit analysis and ultimate decision.

Quality
In terms of quality, at a bare minimum you should ensure that your IT services provider has good detailed answers for how they handle the issues of culture, communication, language, IP security and other factors as listed in the 8 ‘perceptions’ below. Of particular importance is the issue of the actual quality of delivery of the final product which is mostly influenced by the skill-sets of the IT services provider, and the project management maturity and capability of the provider.

There is an old adage that if you ‘pay peanuts, you get monkeys’. A lower per hour salary rate does not necessarily indicate a lower level of skill-set, but it is important to compare rates for the same skill-sets within the same country (e.g. Chinese rate vs. Chinese rate, Indian rate vs. Indian rate) as well as against other countries. The word ‘programmer’ means many different things to different organizations, as does the phrase ‘excellent English’. Some service providers pay a premium rate for high quality; high level English speaking staff with very good academic and technical qualifications and this will be reflected in their rate. So it is important to very clearly identify what skill set you need against what you are getting and at what level.

Another aspect of quality is the effectiveness of the service provider’s project management capability and level. Ineffective project management skill sets and processes, combined with a low level of English business communications capabilities and poor technical skills may result in missed deadlines, low quality output, lack of flexibility and unnecessary rework. All of these costs contribute to a much higher cost per hour than the actual rate quoted.

Fit-For-Purpose
When selecting an offshored service provider it is also important to ensure the provider is ‘fit for purpose’ for the kind of work you require performed.

There are many different levels of outsourcing. Large total outsourcing ‘lock, stock and barrel’ mega-deals still occur, where the entire IT department (including all physical assets and infrastructure) are transferred to a service provider in exchange for a one off capital injection from the provider (as payment for the assets) and an ongoing annuity based contract for the provider to continue to provide IT services to the outsourced organization. This type of arrangement may require very complex business transactions, project management, and business communications.

Other offshore IT services deals may be as simple as applications coding/testing at an offshore location on behalf of the head office IT department of a multinational corporation, typically involving very little interaction with the head office. In these cases the offshore developers (Chinese, India, etc) will require little day to day interaction with anyone other than their local project manager, and communications which are mostly internal can be conducted in the local language.

Another model which is somewhere in between, especially in relation to applications development and testing, is that of the Offshore Development Centre (ODC). In this model a multinational firm (maybe based in the US or EU) forms a relationship with a third party IT services firm based in another country. An ODC’s main role is to operate as the applications development and testing arm of the outsourced firms IT department and work on substantial large scale applications based projects specifically for that firm, over a number of years. As the work requires a high level of understanding of their client’s business, processes and systems (i.e. it is not merely based on a single small project), the management and staffing of an ODC is also quite complex. This type of arrangement also requires a long-term view of the relationship, staff dedicated to the client (rather than allocated on a project by project basis), excellent English business communication skills and a high degree of quality control and project management.

In selecting an offshore provider, it is extremely important that you select one that aligns with your needs first (i.e. fit-for-purpose), before creating your cost-benefit and TCO analysis.
Why Do Firms Offshore?

The drivers for offshoring have many parallels to the drivers for outsourcing in general (as discussed above), but a number of factors drive the push for the potentially extra level of complexity involved in offshoring.

For millennia civilizations, governments and businesses have procured resources in various forms from other countries. In its most basic form this involved the sourcing of raw materials such as salt, gold, stone, and wood from other countries, with the key driver being a lack of local availability of these resources or the quality of resources. From the beginning of the industrial revolution the manufacturing industry has been the heaviest user of offshoring production in places where large labor pools of skilled low cost talent existed. Since the 1990s the US and other developed countries have looked offshore to contain their labor costs, secure new sources of talent and more quickly bring their products to market².

Recent advances in technology including the internet and increased access to power and broadband infrastructure have increased the ability of organizations to not only outsource production of hard goods such as appliances and cars to lower cost locations (‘blue collar production’), but to increasingly outsource ‘white collar’ skill sets offshore⁸, and even more recently, executive level management and leadership skill sets (‘gold collar’) in a similar manner. So what is driving the move toward offshoring?

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### Drivers Toward Offshoring?

[Fig2: Drivers, Inhibitors and Recommendations for Offshoring, Source: Frost & Sullivan, Nov. 2009]

Your Organization needs to:
1. Develop your own list of drivers and inhibitors
2. Develop your own list of criteria for selecting an offshore location
3. Develop strategies for dealing with these general risk factors

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7 IT The ‘Enabler’ of Global Outsourcing, Financial Executive, June 2009
A study conducted by Duke University\(^9\) revealed the following drivers for outsourcing (for companies with less outsourcing experience) in the following order:

1. Labor Cost Savings
2. Growth Strategy
3. Access to Qualified Personnel
4. Other Cost Savings
5. Competitive Pressure
6. Business Process Redesign
7. Improved Service Levels
8. Increasing Speed to Market
9. Part of a Larger Global Strategy

It is not only large mega-firms that are taking the offshoring route. As technology evolves, a broader set of companies are participating in global outsourcing, with technology enabling almost any size company to pursue a global outsourcing or offshoring strategy\(^10\).

Although there are many drivers towards offshoring, there are an equal number of inhibitors or risk factors that must also be taken into account when deciding whether to offshore or not. There are numerous studies in this area, but one widely quoted study\(^11\) lists the following as the most common challenges in offshore outsourcing:

1. Instability because of geo-politics
2. Mismatch in cultures, values and norms
3. Protection of intellectual capital
4. Imperfect information about offshore vendors
5. Unrealistic expectations on cost savings
6. Difference in time zones
7. Location of client and vendor team members
8. Knowledge transfer difficulties in both directions
9. Layoff and loss of human capital
10. Disruption of work practices for employees
11. Lack of due diligence resulting from offshore bandwagon mindset

Each of these challenges exists to different extents in different geographies, so it is very important to develop your own criteria for both selecting an offshore destination and strategies for dealing with these and other potential risk factors within the geography chosen. Later in this paper we introduce a number of factors or negative perceptions about offshoring to China in general and recommend a framework for ensuring that these China specific risks are evaluated thoroughly during the service provider selection process.

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\(^10\) Financial Executive, June 2009
\(^11\) Ranganathan and Balaji, 2007, Critical Capabilities of Offshore Outsourcing of Information Systems, MIS Quarterly Executive, 6(3)
Why Do Firms Outsource or Offshore to China?

The Offshoring Industry is Growing and More Countries are Becoming Providers
Global spending on IT will grow by ‘…just on 0.5% year on year in 2009, down from a November 2008 forecast of 2.6% growth.’12 This is in stark contrast to the Asia/Pacific and Japan (APEJ) IT Services Market which is expected to grow to US$49.4 billion in 2009, reflecting a 9.6% growth rate over 200813, with the key drivers being ‘…continued demand for managed services and outsourcing…’.

The trend towards offshoring has passed the stage of just being a phenomenon and now is part and parcel of the global IT delivery landscape, with Asia/Pacific being a strong beneficiary from this growth as well as a strong contributor as evidenced by the following statistics:

- The offshoring market (a part of the IT Services market) has grown from approximately US$119 million in 2000 by more than 2.5 times to reach US$300 billion by the end of 200814.
- This US$300 billion represents only 10% of the potential total market for offshoring services15.

Currently India is generally acknowledged as the premier offshore location; however the sheer imbalance between global demands and India’s supply of IT Services has lead to creeping costs and strain on India as an offshoring destination16. This has lead to the development of what Gartner17 calls the ‘global delivery model’ where firms offshore not just to one location (like India), but to an optimized delivery structure that involves resourcing skills and resources from several global locations. These locations may be geographically dispersed so that an appropriate mix of onsite, onshore, near shore (countries close to the firm such as a US firm using Mexico) and offshore resources. An effective global delivery model allows companies to tap into the skills and resources of many different service providers across the globe. Apart from allowing a great degree of flexibility, this approach also offers advantages in terms of mitigation of geopolitical risk, natural disasters, and facilitates true 24 hour follow-the-sun delivery of services and support.

The rapid take up of various forms of global delivery have allowed many other countries18 besides India to emerge as valid competitors for a share of the offshoring dollar, including Mexico, Australia, New Zealand, Brazil, Canada, Hungary, Ireland, Poland, Russia, Rumania, the Philippines, Malaysia, South Africa, and of course China, which is the key focus of this paper.

China as a Destination for Offshoring – even the Indian Service Providers Offshore There!
Even as early as 2005, China had been identified in a number of studies as the second most popular place for UK organizations to outsource to with Poland being closer to home coming in third place19. China continues to develop rapidly with IDC20 stating recently that ‘…2008 was a fruitful year…’ for China ‘…despite the global financial crisis’ and that the Chinese IT Services market grew by over 24% over 2007 and will grow at a Compound Annual Growth (CAGR) of 13.8% through to 2012.

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12 IDC Black Book, IDG Media Release, IDC Forecasts W/Wide Spending Growth of 0.5% in 2009, Feb 25 2009
13 As Above
14 Decision Sciences, Vol 39 Number 3, Aug 2008, Cultural Intelligence and Offshore Outsourcing Success,
15 As above
16 As Above
17 Marriot and Matlus, Gartner on Outsourcing, The growing use of global delivery, 2007-2008
18 NEOIt, as quoted in 20 above
19 Offshoring, Ocean Drive, www.peoplemanagement.uk, Jan 2006
20 IDC, China Services Market, viewed online 6th Nove, 2009
A significant contributor to this growth is the offshoring services market. Although China currently accounts for less than 10 percent of the existing global market for offshoring and outsourcing of services, recent government and industry developments could see China capture offshore revenues worth US$56 billion a year by 2015. It is also well known within the industry that as the leading technology outsourcer and service providers in India deal with creeping wage inflation and high staff attrition rates they are also fast establishing a presence in China to remain competitive in the market. Even as early as 2003 WIPRO had already established a small development centre in Shanghai.

MGI (The McKinsey Global Institute) has published a series of papers comparing offshoring locations and rated China’s market potential as the highest among 28 low-wage countries and 8 moderate to-high wage ones. These included Brazil, Chile, China, Czech Republic, Hungary, India, Malaysia, the Philippines, Poland, and Russia.

The Chinese Offshore Market is Increasingly Attractive:
1. China is the Second Most Popular Offshoring Destination
2. China accounts for 10% of Global Delivery and Is Growing Rapidly
3. Even Indian Firms Offshore to China to Remain Competitive
4. China’s Domestic IT Services Market is Robust

Fig 3: Drivers and Inhibitors for Outsourcing to China, Source: Frost & Sullivan, Nov. 2009

A Growing Number of IT Service Providers Equals a Strong Local Industry
One sign of a strong and developing capability for the delivery of IT Services is the strength of the local market in terms of its ability to source its own IT Services needs. Almost 90 percent of China’s own domestic IT services market is provided by local providers as opposed to foreign firms. This compares to India’s domestic services market where only 28 to 30 percent of its IT services are performed by local firms.

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21 China’s Opportunity in offshore services, McKinsey Quarterly, 2008
22 Will China Dominate Outsourcing’s Future? CNET News, March 18, 2004
24 Promantra Synergy Solutions quoting McKinsey, March 5 2009
One of the contributors to this growth is the maturation of the Chinese IT Services markets as ‘…forward looking vendors are speeding up resource integration to enhance their competitive power and position…’ and Chinese vendors ‘…service productisation will play a key role in this…’.

**Drivers to Outsourcing to China**

According to the Outsourcing Institute there at least 5 drivers for the growth of the number and quality of IT Services providers in China (over and above China’s robust domestic IT Services industry as compared to India) which are normally ignored by IT researchers, including:

1. **Zero Duty** – allows providers to be more competitive in terms of pricing
2. **Standards Development on Core IT technologies** – China’s influence on standards from operating systems to 3G has already been significant and China is emerging as a key player in shaping industry standards that will define the nature of global competition in the technology area
3. **Tougher Penalties for IP Rights (IPR) Abuse** – China continues to enforce its 2004 dictate to the highest courts for prosecution, fines and longer prison sentences. This includes more thorough enforcement of explicitly forbidden distribution of pirated goods or software over the internet
4. **Outbound M&A Activities** – Unlike the Indian firms which grew their firms organically over time the Chinese firms show a strong willingness to acquire well known brands to grow and expand. This has already been seen in the purchase of the IBM PC division by Lenovo, and TCLs majority control of Thomson’s television business. The same approach is also viable for IT Services.
5. **Growing IT Talent** – China has a reverse brain-drain with many overseas educated Chinese returning home to set up businesses focused on export markets and bringing with them the business experience and contacts gained overseas.

**Other Drivers:**

In addition to the above often ignored drivers there are others that are more commonly cited as follows:

- Implement Global Delivery
- Diversify Risk
- Access to Large Talent Pool
- Lower Attrition Rates
- Cost/ROI
- Strong Technology
- Infrastructure (comparative)
- Access to Local Market and Networks

Many companies offshore to China as part of developing a ‘footprint’ in the Chinese market itself. Having experience in dealing with Chinese companies or visiting your ODC in China starts to sensitize your firm to other opportunities in China. Investing in China in this way also enables you to start entering the business network, develop local business and government contacts and contribute to the local community in the form of employing and training locals. If there is a match between the products/applications you are developing in China for your firm’s own use and that of local market needs, opportunities for domestic expansion of your firm may also be created due to your local partnership and presence.

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25 IDC, China Services market, viewed online 6th Nov, 2009
26 IT Outsourcing in China, The Outsourcing Institute, undated, viewed on Nov 4th, 2009
China is not only useful for serving the English language markets but also has over 2 million Japanese and Korean speakers\textsuperscript{27}, making it an excellent place for the development of IT applications and provision of services targeted at these huge markets, especially in the area of Business Process Outsourcing (BPO) services such as ‘near shore’ call centers and transactional processing services such as payroll processing.

Taking all of the above into account, China appears to be very well positioned as a supplier of labor and services to the global offshoring market along many different measures as cited throughout this report.

\textsuperscript{27} China’s Opportunity in offshore services. McKinsey Quarterly, 2008, Issue 3
The Outsourcing/Offshoring Decision Process in Summary

The figure below (Fig.4) summarizes the outsourcing/offshoring decision process as discussed above.

*Fig.4. Process Flow for IT Services Provider Selection, Source: Frost & Sullivan, Nov 2009*

**Step 1: Identify the problem you are trying to solve and objective you want to achieve**
As already discussed above, the first step requires you to identify the problem you want to solve and or the objectives/outcomes you want to achieve. Without a clear understanding of your motivations for evaluating outsourcing as an option, and without a very clear set of parameters against which to measure the progress of achieving your outcomes, and the level of success, the risk of project failure is great.

**Step 2: Decide Whether to Use Inhouse or Outsourced Resources**
There are many different models and processes designed to assist you in making the decision whether to provide all or part of your IT needs inhouse or use outsourcers including the ‘decision tree approach’ as introduced in the University of California Berkely publication ‘The Innovative Organization: Creating Value Through Outsourcing’ 28 where the decision is split into a number of checkpoints revolving around the culture of the company, type of company (e.g. multinational or Local), and other factors.

**Step 3: Decide Whether to Use Local IT Services or Offshore**
Whether to outsource is considered to be a separate decision about where to outsource. Once you have decided to outsource, the next step is generally deciding whether to use local resources or whether to offshore and then to what geographic location.

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28 University of California, Berkely Vol 50, NO. 1
The major driver for considering offshoring is still that of labor arbitrage or put more simply to cut costs even further than that possible by the use of a local onshore service provider.

Although cost is still a major driver the cultural *intelligence* level of the company which is defined ‘…as a form of organizational intelligence or firm-level capability in functioning effectively in culturally diverse situations.’ 29 also plays a major role in determining whether a firm will be successful in offshoring.

### Step 4: Decide What Country to Offshore To
The next step is to evaluate which country best meets your needs. The choice of where to outsource is considered by many to be closely related to the question of whether to outsource. According to McKinsey Global institute 30 there are six dimensions that a company needs to consider when choosing an offshore location. These are costs; market potential; the vendor or provider themselves; country risk profiles; the overall environments (which includes business and living environments as well as accessibility) and the quality of the infrastructure. These factors need to be considered over and above the list of drivers and inhibitors to outsourcing already discussed above.

### Step 5: If China is Selected Evaluate the Providers Against The Framework Provided
If this set of processes leads you to China after identifying appropriate providers at a high level, you will need to evaluate if they have the facilities, staff and processes in place to ensure that all of the issues discussed above are addressed to your satisfaction.

At a minimum, the *Chinese IT Services Evaluation Framework* below (*Table 2*) should be used to compare how well each of the providers selected for evaluation performs against each criterion. This Evaluation Framework is designed to address the selected short list of eight common perception and issues specific to outsourcing to China. It is not an all encompassing evaluation tool and should be used mainly as a supplement to your organization’s standard IT Services/Vendor Selection process and framework.

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29 Cultural Intelligence and Offshore Outsourcing Success, Decision Sciences Vol 30, No. 3, Aug 2008
Best Practices for Productive Engagement with Chinese Outsourcers

8 Perceived Risk Factors or Inhibitors to Outsourcing to China
If relying on some western media for information about the true state of outsourcing across the globe, one could get the impression that the only safe place (politically, culturally, technologically, and IP related) to consider outsourcing is your home country, preferably with a well known global outsourcer. Nevertheless, the global market for ‘offshoring’ is growing rapidly (refer prior statistics), and many countries, including China, are increasing their share of the overall IT services pie.

As markets mature and interest spreads, more and more issues about dealing with these countries surface. While many of these issues are based in truth, the capabilities of IT services providers in places like China have developed rapidly over the last five years leaving a big gap between older perceptions and newer realities.

In terms of overall Country Risk, D&B International provides a regular ‘Country Risk Indicator’ which provides a comparative, cross border assessment of the risk in doing business in a country across the risk categories of political, commercial, macroeconomic, and external risk. These risks are ranked from DB1 which is the lowest risk, to DB7 which is the highest risk. China was ranked as DB331 (Slight Risk) alongside Taiwan and Korea, with India ranked as DB4 (Moderate Risk), and HK and Singapore as DB2 (Low Risk)….countries in the DB7 (highest) category included Nth Korea and Afghanistan. So in terms of its suitability as an offshoring location it is in good shape compared to other locations.

Nevertheless, there are some very specific commonly cited perceptions about the risk of offshoring to China and these are discussed below. Note that although many of the risks associated with offshoring to China have been reduced, the ability of all Chinese outsourcers to provide the required services varies considerably, so the advice below is to be read as a general guide and may not be applicable to the whole Chinese IT services market.

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<td>Project Mgmt/Certification</td>
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<td>Security/IP</td>
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<tr>
<td>Retaining Talent</td>
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<tr>
<td>Productivity</td>
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</table>

Many of the risks associated with offshoring to China have been reduced, but they still exist.

A key factor to acknowledge is that you are not dealing with ‘all of China’—only the service providers you have selected.

So each of these risk factors must be evaluated against individual Chinese IT Services Providers.

Table 1: Eight Perceived Chinese Offshoring Risk Factors, Source: Frost & Sullivan, Nov. 2009

31 China Session SIIA GIIS, 3/8/09
The Eight Perceived Chinese Offshoring Risk Factors are as follows:

1: **Quality of delivery is lacking amongst Chinese IT Services providers**
China’s problems with quality in general but especially in manufacturing have been quite well documented. This includes the mass recall of Chinese meat products in Japan, prescription drug recalls in the US, children’s face paints in the UK, and powdered baby milk recall in many countries. So when one thinks of China these things instantly come to mind. Even the phrase ‘Made in China’ often connotes low quality in the same way that the phrase ‘Made in Japan’ caused similar reactions in the 50s and 60s. However, things change and China is making a concerted effort to address the issue of quality across many fronts including in the area of ISO standards for information technology.

There is no instant cure for quality, ‘Quality is a process and it’s a process that has to be identified and has to be constantly verified. The process is what gives you the quality…’ The key to ensuring a high level of quality from your service provider is to gain a thorough understanding of the commitment to quality, and the international standards to which they adhere, and then clearly document the agreed processes, checkpoints, tests and deliverables.

2: **Monitoring and preventing unauthorized access to your company data, and preventing IP theft is a real problem for Chinese outsourcers**
Although improving dramatically due to efforts of the Chinese Government, World Trade Organization and other organizations such as the American Chamber of Commerce in China, China’s relatively poor protection of intellectual property rights poses a challenge that must be overcome as part of your overall outsourcing arrangement.

Although IP is still an issue for business in China as a whole, you will not be doing business with all of China. You will be working with an IT services provider you have selected based on certain criteria. So the key to successfully ensuring the safety of your IP and company data is to ensure that the service provider you have chosen is beyond reproach in this area and has the processes, systems, training and staff in place to ensure the highest degree of privacy and protection for your IP resources.

3: **Chinese IT Services providers have very few or no staff who can speak English, let alone conduct day to day business communications and manage your work**
Developing countries (including China) efforts to increase their trade in services have been hampered by a lack of competent English speakers but this is changing rapidly though as by 2015 three billion people (almost half the global population) are expected to speak more or less fluent English. Currently there are more people in China learning English than there are learning it in the US, with the Chinese government investing more than $5.4 billion in English education in universities.

Nevertheless, language and cultural differences sometimes make it difficult to communicate and lead to misunderstandings; this especially applies to overseas call centers where consumer complaints have been well documented.

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33 World Trade, Feb 2009, Vol. 22 Issue 2
34 McKinsey Quarterly 2008, Issue 3
35 The Tough Game you Have to Play, Financial Executive, May 2009
36 Outsourcing to China, Sourcingmmag.com, viewed Nov 11th, 2009
If your firm is conducting China to China product development (i.e. development of applications in China to serve the Chinese market), then the language challenges isn’t much of an issue other than for the key conduit between the service provider and your firm (e.g. for project based work as discussed above).

However, if the Chinese services provider is commissioned to provide applications and services for use in the West or directly supporting a western team or clients, then your provider’s team needs to ‘live and breathe’ English.

4: **Chinese IT Services providers have limited project management and applications experience and are not as well qualified in internationally recognized certification such as CMM, ITIL and the like**

Project management credentials are still an issue for many Chinese IT services companies and finding a service provider with the correct approach to project management and internationally recognized certifications such as CMM, SEI and the like still poses challenges.

This situation is also changing dramatically as the Chinese domestic services market continues to grow and as more firms turn towards China for the provision of offshoring. An increase in the number and quality of project managers is essential for China’s continued growth. ‘Trained and credentialed project managers can help China unlock its potential…’ said PMI in its March 2009 media release upon announcing the appointment of a new CEO to spearhead the provision of project management courses and accreditation in the fast growing Chinese market.

Currently China has more than 25,000 PMI-certified Project Management Professionals (PMP). PMI anticipates that China will be a clear global leader in PMP certifications with the total number of PMPs expected to increase by 700% to around 200,000 over the next 5 years to 2014.

Ensuring that your Chinese service provider has suitable qualifications in project management will go a long way towards procuring a successful outcome.

5: **Culturally dealing with a Chinese Outsourcer is fraught with danger, social minefields, and requires an understanding of local business practices and legal and contractual frameworks**

Cultural differences, business practices and norms can cause problems even between firms dealing with firms in a different state or region of the same country. These cultural differences can be magnified tremendously when dealing with firms in different countries, with different languages and interpretations of what ‘good’ business practice is.

In addition foreign service providers often don’t have a legal presence in the West, nor any assets against which performance bonds or guarantees can be secured. So offshoring firms need to understand the local country rules as well as to what extent clauses in a contract will be enforced.

Selecting a service provider who can clearly show how they can mitigate the cultural, contractual and legal risks is mandatory. Over time however the contract becomes less important than the relationship between the client and the vendor as the relationship matures, communication and trust between the parties develops and both parties begin to work in mutually beneficial ways.

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37 Chen Yong Tao Named MD of PMI China, PMI Media Release, 10th March 2009, www.pmi.org
38 Creating Better Governance of Offshore Services, Information Systems Management, 26, 2009
6: Identifying, employing and retaining qualified staff is a real issue for Chinese service providers
Over the last 10 years or so the global supply of highly qualified, university educated human resources has shifted from being provided by Western universities to a more diversified pool of universities globally. It is no longer the case that an elite degree or highly respected MBA can only be obtained from the US or Europe…with 10 out of the top 25 business programs located outside the US 39. Similar shifts have also occurred in electronics, engineering, and computer science disciplines. Currently China has 2.368 million IT workers. To put this into perspective India has only 830,00040.

This creates challenges and opportunities for the providers. Those with well developed processes and systems for identifying, developing, training and retaining good staff will benefit from this steady supply of skills as access to talent will eventually become more important than cost 41. Those who provide good training, but which are less developed in terms of staff development programs will lose their good staff to the providers who offer better pay and benefits; chances for advancement; better work environments; access to better technology and training and a broad range of roles and interesting projects to work on.

When selecting your service provider it is imperative that you gain a thorough understanding of the staff selection, development and other HR processes, as their ability to resource your work is a critical factor in the success of your offshoring arrangement.

7: Ensuring productivity is not only maintained, but improved over the life of the contract is difficult for Chinese outsourcers
One issue influencing productivity in Chinese firms is that Chinese tend to be uncomfortable with project ownership and responsibility, often escalating problems to superiors rather than resolving at the peer or team level42. This can cause unnecessary delays and may result in valuable peer review or peer input being absent from the problem solving process.

Productivity is very closely linked to the issues of Quality; acquiring/retaining the right skill sets; and effective project management. The productivity of your IT services firm’s staff can not be guaranteed by you as you don’t hire them…but high staff turnover and poor processes can mean increased costs and large losses of efficiency as staff are continually retrained. Engaging a firm that has passed the test in terms of project management, HR processes and systems, problem solving capability and strict quality control and certifications will go a long way to ensuring a higher degree of productivity.

8: Technologically, China is way behind the west in terms of access to infrastructure, reliable power supplies, bandwidth and systems
This is one area that is changing dramatically. In the past few years a number of very high profile global events in China, including acceptance into the WTO and the Beijing Olympics, has seen a substantial government driven increase in infrastructure in particular that relating to ICT.

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39 Financial Executive, May 2009
40 China Session SIIA GIIS, 3/8/09
41 As above
42 Decision Sciences, Vol 39, Number 3
Although China is still behind the West, in terms of comparisons with other offshoring destinations China more than holds its own. A broad range of statistics presented at the recent SIIA/BIIA\textsuperscript{43} conference by Intrepid Explorers, Inc compared China’s ICT Capacity and usage with that of India.

In summary the findings were that China had a substantially greater penetration in terms of:

- Teledensity - 57 per 100 persons compared to India’s 11 per 100 persons
- Total Subscribers - 750 million compared to India’s 123.85 million
- Bandwidth - 43 GBPs compared to India’s 1 GBPs
- Broadband Connections - 64.3 million compared to India’s 300,000
- Internet Subscribers - 210 million compared to India’s 60 Million
- Host Computers - 45.6 million compared to India’s 10 Million

In addition, China had almost three times as many IT workers (2.368 million) than India (830,000) to make use of more importantly, support all of this capacity.

The Chinese government has also adopted an ICT strategy focusing on a number of key areas including: increased investment in education; promotion of e-commerce; construction of an e-government infrastructure; closing the digital divide between developed and undeveloped regions and many other areas. So this is one perceived risk factor that is rapidly decreasing.

\textsuperscript{43} China Informatization Strategy www.biia.com/library.php#69
Chinese IT Services Providers Evaluation against 8 perceived Risk Factors:

In order to mitigate the risks associated with the above eight factors you should at the very least ask each of the providers you are evaluating to answer the following questions (ref table 2), and provide appropriate documentation where specified in the expansion of each of these questions below.

| Cultural: | • How does the service provider ensure that differences between Chinese and western culture are minimized? |
| Technology | • How does the service provider ensure that their organization and staff remains up to date with changes in technology? |
| Language | • How does the service provider ensure a high level of business communication level English language skills? |
| Project Mgmt/Certification | • What project management approaches are used by the provider, what certifications are held, how are they maintained? |
| Quality | • How does the service provider ensure that delivery quality is maintained throughout the life of the relationship? |
| Security/IP | • What physical and logical security measures are in place to prevent unauthorized access, and protection of IP? |
| Retaining Talent | • How does the service provider identify, select and maintain a steady pool of talent for projects? |
| Productivity | • How does the service provider measure productivity, and ensure that high levels are maintained throughout the relationship? |

Table 2. Chinese IT Services Provider Evaluation Checklist, Source: Frost & Sullivan, Nov. 2009

Cultural:
How does the service provider ensure that differences between Chinese and western culture are minimized during all phases of development of the relationship, through to kickoff, development and ongoing delivery of services? What documentation, processes and systems are in place to ensure that miscommunication and cultural differences do not impede the offshored work progress? What problem solving and escalation processes are in place? Who are the key people and what are their roles?

Technology:
How does the service provider ensure that their organization and staff remains up to date with changes in technology related to the services to be delivered? What certifications does the company have and what does the staff have? Ask for a copy of their technical training program for each role and type of technology whether it be applications development, testing, hardware maintenance and support, network management and the like.
Language:
How does the service provider ensure that the English language skills of their staff are developed and maintained at a high level for effective written and spoken business communication? What are their entry criteria in regard to English language proficiency? How do they develop specialist English language skills as well as competent business communication skills? What is their language policy in the office – do they have an ‘English only’ policy for ALL communication within the company? What external certifications do they expect staff to have?

Project Mgmt/Certifications:
What project management approaches are used by the organization? What internationally recognized certifications (as appropriate to the type of work being outsourced) are held by the organization and how do they maintain these certifications? How many PMI certified staff are there?

Quality:
How does the service provider ensure that delivery quality is maintained throughout the life of the relationship? This is closely related to Project management, talent and language as discussed under those headings, so many of the same questions apply. In addition ascertain what quality training and certifications are held by the company and the staff. What processes are in place to check on the deliverables at all stages including initial design, testing and right through to handover, training and implementation of applications and projects.

Security/Intellectual Property Safeguards:
What physical and logical security measures are in place to not only monitor but prevent unauthorized use of your organization’s assets, resources and data, including but not limited to protection of intellectual property? Look at the precautions the vendor has taken to protect you. Ask for a copy of their employment and IPR contract? What is their Security framework?

Retaining Talent:
How does the service provider identify, select and maintain a steady pool of talent for your work and other projects? In terms of recruitment ask for a complete description of their recruitment process and examples of documentation at all stages including sample advertisement, job descriptions, interviewing questions, personality, psychological, aptitude and other tests (including English language). In regard to development and retention ask for their career progression plans, pay scales, promotion criteria, training plans and curricula, company benefits and other documents that will show how they manage this critical resource.

Productivity:
How does the service provider measure productivity, and ensure that high levels are maintained throughout the relationship? Same questions as for quality, talent and language plus ask for any specific processes designed to ensure high levels of productivity.

After collecting the information, based on each IT Service Provider’s Response to these questions, provide a score, and enter it into the Score Card Below
IT Services Providers Evaluation Scorecard

Use the scorecard below (Table 3.) to enter a numerical score that can be used to compare providers. Enter an importance weighting (out of 100%), based on your organization's needs, against each of the criteria above.

Score each evaluated IT Services Provider out of 10 (1 is Poor, 10 is Outstanding conformance to the criteria) and then multiply the score by the weighting for each criterion. Add the scores up to give a total evaluation score for that provider.

<table>
<thead>
<tr>
<th>Evaluation Point</th>
<th>Score 1 = Poor, 10 = Outstanding</th>
<th>Weighting - Out of 100%</th>
<th>Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cultural</td>
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<td>Technology</td>
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<tr>
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</tr>
<tr>
<td>Productivity</td>
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<td>10</td>
<td>80</td>
</tr>
<tr>
<td>TOTAL SCORE</td>
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<td>715</td>
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</table>

Table 3. Chinese IT Services Evaluation Scorecard, Source: Frost & Sullivan, Nov. 2009
Summary of Recommendations

A number of recommendations have been made throughout this document and these are summarized here:

1. In attempting to meet the seemingly opposing objectives of increasing the use of IT to maximize competitive advantage, whilst keeping costs relatively flat – CIOs are continuing to increase their use of outsourcing and in particular offshoring

2. In selecting an offshoring location enterprises should diversify their geographic choices to minimize risk

3. China should now be included on the potential list of countries to offshore to

4. Before outsourcing CIOs should identify: (you need to think whether we want this to be second or third person – you vs their – a lot also depends on whether you want this purely targeted at CIOs or at heads of procurement etc etc)
   - What problem they are trying to solve
   - What is The Total Cost of Outsourcing
   - What is required in terms of cost vs. productivity vs. ‘fit for purpose

5. Before offshoring CIOs should:
   - Develop your own list of drivers and inhibitors
   - Develop your own list of criteria for selecting an offshore location
   - Develop strategies for dealing with these general risk factors

6. When selecting China CIOs should:
   - Evaluate the potential risks against your company’s maturity and risk profile
   - Use the 8 perceived risk factors Evaluation Framework as a base and add your own risk factors and question
   - Use the IT Services Evaluation Scorecard to score and rank potential providers

Conclusion

A large list of macroeconomic forces, among them globalization, are increasing organizational demands for dramatic improvements in productivity as a means of improving (or at least maintaining) their competitiveness. As global economies start to improve, organizations are increasing their focus on the effective use of technology as a means of obtaining competitive advantage…but at the same time attempting to keep IT budgets relatively flat.

In achieving these seemingly opposing objectives (increased use of technology while maintaining existing budget levels) CIOs are continuing to turn to Outsourcing, and in particular Offshoring as a viable delivery method.

There are an increasing number of countries entering the market as offshore providers and competition is fierce. The number one destination is still India, but China, which also has a more robust local IT services industry, has developed significant capabilities as a major provider of offshored IT services and is the fastest growing major country for this kind of work.

A number of risks still exist when considering offshoring to anywhere, not just China, but these can be mitigated by ensuring that you understand your motivations for outsourcing; clearly define the outcomes expected from offshoring; and carefully evaluate each of the shortlisted Chinese IT Services providers against a framework such as the one suggested in this paper.