A New Dawn
China’s Emerging Role in Global Outsourcing

INFORMATION, COMMUNICATIONS & ENTERTAINMENT
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Foreword by Egidio Zarrella and Ning Wright

Over recent years, China has made major strides in laying the groundwork for a diverse and successful outsourcing market.

Central and local authorities alike have demonstrated a quiet determination to promote IT and other business services industries in locations across the country. Their vision is a long-term one, reflected by initiatives to develop education, training and other supporting infrastructure. What is remarkable, however, is how quickly the vision is now becoming a reality.

For all the progress that has been made, this report illustrates some of the challenges that still lie ahead. Many domestic business leaders recognise that the Chinese outsourcing market could better market its strengths to the international community. There is no one voice to represent the Chinese industry and establish its credentials.

This also has implications for the buyers of outsourcing services, who see a wide array of choices in terms of locations and vendors. These buyers have choices across the globe as well as in China and are seeking ways to align their operations among different vendors with different strengths.

China’s emerging outsourcing players already have strong credentials. Where India’s emergence as an outsourcing location was very much export-driven, China has the strength in its domestic market to create a deep services base and already has a track record serving companies in other parts of East Asia. This is particularly encouraging in light of the current economic difficulties facing organizations across the world.

We see evidence that many companies in Southeast Asia are in favor of outsourcing from China. Moreover, many global outsourcing companies are setting up operations in China to target regional markets, including Japan.

We hope you find this report insightful and we would like to thank the executives and government officials who gave their time to speak to us, including those who appear in the following pages as case studies.
Message from Gary Matuszak and Edwin Fung

We are pleased to present this report looking at China’s growing importance in global outsourcing. A number of technology and industry trends that are reshaping some of the ways in which companies around the world and across industries operate are, in turn, helping to support the increased use of outsourcing:

**Cost savings:** Today’s global economic crisis is inspiring companies to explore ways to reduce their operating costs and improve efficiencies, and companies are increasingly growing comfortable partnering with service providers in a broader range of geographies, including China.

**Cloud Computing:** In recent years, many companies have taken a cautious ‘wait-and-see’ attitude toward the idea of relying on IT-related capabilities provided ‘as a service’ using Internet technologies to multiple external customers reliability. Although cloud computing is hardly new from a technology perspective, it nevertheless offers the technical flexibility and financial practicality that increasingly make it a serious business consideration. As a result, more companies are becoming interested in outsourcing business-critical IT functions such as customer relationship management, network security software, analytics, application maintenance and development, and others to external providers.

**Sustainable IT:** Many companies are looking to expand their computing power or IT resources, but also don’t want to make larger investments in buying hardware or to spend more on IT infrastructure costs such as electrical power, cooling equipment, and data center real estate. Outsourcing can help companies consolidate and virtualize their infrastructure and purchase IT capacity, often on an as-needed basis, to produce a lower total cost of ownership.

**Beyond cost:** Cost remains an important factor in any outsourcing discussion, but companies are also taking more sophisticated approaches to sourcing their IT providers, services, and resources. Instead of merely seeking the lowest cost, companies are increasingly using outsourcing to blend flexible capabilities from a range of service providers in diverse locations into an effective, customized mix that addresses their information and communications needs.

Despite the global recession, IT continues to be a critical factor to the success of many enterprises. With today’s economic conditions providing severe challenges for businesses, more companies looking to position themselves for the eventual recovery are evaluating the effective use of external providers to help them support and expand their IT organizations. Outsourcing offers the technical flexibility and financial practicality that increasingly make it an important business consideration as companies across all industries reinvent themselves to be more competitive.
Acknowledgments

KPMG would like to thank Rebecca A. Fannin for her support in writing, researching and conducting interviews for this report.

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Outsourcing – growing through good times and bad

Over the past five years, the global outsourcing market has grown into a trillion-dollar business, employing millions of people across the world. The current economic slowdown has affected both the rate and the nature of its growth, but has not threatened the emergence of the sector more broadly. Forecasts show the market downturn will weaken outsourcing revenues during 2009, but volume could pick up toward the end of the year and demand in many non-financial sectors has been virtually unaffected.

A growing number of companies, from large multinationals to small and medium-size enterprises, have adopted outsourcing to help deal with financial pressures and competitive challenges in their markets. Initially, outsourcing was seen as a way to extract financial gains from labor arbitrage, standardization and scale – such as developing IT applications and providing customer support. Increasingly, outsourcing is seen as a way to achieve optimal business models, with both strategic and operational significance, through knowledge services and research and development. This is especially true in any business which demands a relatively flat expense base and continual productivity improvements.

In 2002, only 10 percent of multinationals outsourced IT work offshore, but by 2008 that figure had risen to 70 percent. By 2012, the worldwide IT services market, the largest segment within the outsourcing industry as a whole, is expected to top US$ 1 trillion.

India has been at the forefront of growth in the technology sourcing market, but the saturation of the Indian market and subsequent increase in costs has allowed many other locations to emerge and demonstrate the capability and capacity to meet different business demands. Information technology outsourcing (ITO) and business process outsourcing (BPO) have become established sectors in such diverse countries as the Philippines, Ireland, Romania, Malaysia and, increasingly, China.

As the business has become increasingly sophisticated, suppliers have also progressed to specialize in niche areas such as the following:

- Legal process outsourcing: Projected to be the second fastest-growing segment of global BPO and to increase from approximately US$ 80 million in 2006 to US$ 4 billion by 2010.
- Animation and gaming: Estimated to reach US$ 76 billion globally this year, with an annual growth rate of 8 percent.
• E-learning: Has grown ten-fold since 2000 to more than US$ 20 billion globally and expected to grow beyond US$ 52.6 billion by 2010. Online tutoring is a US$ 4 billion industry increasing by 10-15 percent annually.5

• Offshore engineering: Expected to grow to US$ 150-225 billion by 2020. High-tech and telecommunications engineering comprise a fast-growing sector, with 30 percent of the market.10

• Pharmaceutical R&D: Predictions for a 41 percent growth rate in 2009 from 2008 revenues of US$ 21 billion.11 One-third of spending in this sector is outsourced.

Impact of the financial crisis
The current economic slowdown is arguably the first global challenge that the industry has had to face, given that the offshoring of IT and business services was still in its infancy during the last downturn, in 2001.

There has been some stunting in the growth of outsourcing, but if previous economic shocks are a gauge, business will soon rebound. The long-term trends suggest that demand from multinational corporations will remain strong. Indeed, even in times of financial crisis, companies typically turn to outsourcing for what is perceived to be faster and more cost-effective business options.12

In the short term, however, rapid growth rates have not been enough to fully shield the industry from widespread economic volatility. Apart from a slowdown in revenue growth, billing rates fell during the early months of 2009 as clients sought to lower costs further and receive more work for the same cost.

Economic woes have affected different business sectors to varying degrees. In the healthcare, education, retail, telecommunications and legal sectors, work has continued to move to offshore service providers.13 However, budget cutbacks in the banking and insurance sectors have inevitably had some impact. Global outsourcing of financial services shrunk 39 percent in the first nine months of 2008 to US$ 11 billion in total contracts.14

As financial institutions have restructured and rationalized to deal with setbacks, part of that exercise has involved consolidating contracts to fewer vendors than in the past.15 Examples of this trend include Citigroup and Deutsche Bank, which have both sought to expand their outsourcing with existing providers in the Philippines.16

As the biggest outsourcing market and focused on export, primarily to the U.S., India is feeling the effects of the financial crisis more than most nations. In 2009, export revenues for India’s IT-BPO industry were projected to climb by 16 percent to reach US$ 47 billion,17 after a 28 percent increase in 2008. Still, India’s market is expected to roar to revenues of US$ 60 billion by 2011.

5 "Investing in e-learning proves to be lucrative," The Financial Express, 26 May 2008
10 Booz Allen Hamilton: "Growing Demand for Engineering Services Creates Opportunities for Emerging Economies," May 2006
17 NASSCOM Indian IT Software and Services: "Fiscal Year 2009 Performance and Future Trends"
In China, where GDP growth has dipped after double-digit gains for most of the past decade, the outlook for outsourcing remains relatively stable. While IT outsourcing was sluggish during the third and fourth quarter of 2008, the full year figures were anticipated to demonstrate good growth. Likewise, China’s BPO sector, while affected by the weakening economic environment, is still on track for growth.

Protectionism

In the wake of the global financial crisis, political pressures have increased and there have been greater demands for protectionist measures in key buyer markets. As part of the economic stimulus package unveiled by U.S. President Obama, and with a view to unemployment crossing the 10 percent mark in the U.S., legislation will place restrictions on firms that receive financial bailout funds. Some of these restrictions include the removal of tax breaks for U.S. companies that create jobs offshore, restrictions on hiring H-1B visa workers, and “Buy American” supplier provisions.

If protectionist policies are enacted, the impact may be felt most immediately in India, which largely serves U.S. and European clients. However, at present executives at outsourcing suppliers have expressed little concern about the impact of protectionism. Many large corporate buyers have indicated that they do not plan to reduce their work offshore and many plan to increase budgets for outsourcing as a way to reduce overall operating costs.

The buyer’s market

In the current economic downturn, the astute buyer of outsourcing services has the advantage. There are opportunities to move work offshore to deal with budget pressures and also to reassess outsourcing strategies toward a long-term goal of improving efficiency. Buyers are seeking lower rates (with discounts of between 5 and 10 percent now common) and negotiating more flexibility in their contract terms with outsourcing providers.

Buyers are shopping around more, lured by vendors offering favorable deals as a way to meet quarterly sales quotas. In an indication of this trend, approximately 76 percent of outsourcing contracts in 2008 represented new deals, while the remainder comprised contract extensions, renewals or expansions. Flexible contract terms are helping companies to handle unexpected, sudden changes in business needs in the current economic climate. This climate will provide an important test of the durability of outsourcing relationships.

With competition amongst vendors increasing, smaller and less efficient players are being absorbed by larger vendors in a string of strategic, niche acquisitions. Providers that can differentiate their services from rivals - either by skill or specialization – will be the winners. The onus is on vendors to demonstrate value by emphasizing innovation, technology expertise and high-level research and development capabilities.

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The move towards multiple sourcing locations

For multinational corporations, strategic evaluations about how and where to outsource today are more complex than ever. Decision makers need to calculate which markets score best on a host of criteria. These include language, the labor pool, infrastructure, educational and training facilities, cost, the political and economic environment, government support, cultural compatibility, global and legal maturity, and data and intellectual property security and privacy.

Certain factors, such as business domain knowledge, are becoming more important as large enterprises increasingly look to outsourcing vendors as valuable partners who understand their market. Moreover, government support is a bigger factor today given that several cities have used subsidies and incentives to promote their location as an outsourcing destination. This is particularly true in China.

In one prominent example, it was due to the vision of former mayor Bo Xilai that Dalian emerged as a well-known outsourcing hub. He enticed such outsourcing leaders as Neusoft to set up there in the 1990s, and today Dalian sports a major software park and even a Neusoft technology university with some 14,000 graduates annually.

“The Chinese government incentives focus on creating job opportunities for China. We do need to help the outsourcing industry to build up the ‘China Sourcing’ brand so more work can come to China,” says Fanny Chan, CEO of IT outsourcing services at ChinaSoft Intl.

Given the complexities, buyers at multinational corporations have gained knowledge and insights about how to manage outsourcing from a global perspective. Buyers are developing a more sophisticated mix of locations that encompasses multi-sourcing, near-shore and offshore.
At GE Capital, for instance, this trend is already pronounced. Zhu YeQing, Director of IT Vendor Management, says GE Capital, as part of its regular strategic review of outsourcing partnerships, has made a decision to increasingly outsource to multiple locations. Over the past three years, the company has reduced the volume of work going to India while increasing China’s share from less than 5 percent previously to approximately 20 percent of its offshoring. Latin America receives another 20 percent of GE Capital outsourcing contracts with the remaining 10 percent divided up among other markets around the world. “For a big global company like ours, it is risky to rely on one country. We need back-up plans and China is one of the best options for us,” he says. Even in China, GE divides the work among eight vendors, splitting the projects equally among well-qualified and screened global and local providers.

Correspondingly, multiple outsourcing destinations around the world have sprung up as supplier bases. Besides India and China, popular locations include the Philippines, Malaysia, Romania, Ukraine, Brazil and Mexico.25

Multiple surveys point to new location preferences and trends:

- Alternatives to India are being mixed in with greater frequency. Latin America and China ranked as the most popular alternatives to India in one recent survey.26

- According to a number of rankings, China is gaining ground on criteria such as financial attractiveness, people and skills, and business environment.27

- Of 30 top destinations identified as best for offshore IT operations, ten countries were from Asia (China, India, Thailand, Vietnam, Australia, New Zealand, Singapore, Malaysia, Pakistan, and the Philippines). Thailand was a newcomer to the list, as were a few other emerging markets such as Egypt, Morocco and Panama.28

A checklist of each destination reveals different strengths and weaknesses. The Philippines has the advantage of strong English-language skills and has emerged as a preferred location for business process outsourcing among multinationals. Malaysia makes for a good hub for its stability, excellent infrastructure, low attrition rates coupled with financial sector expertise, while Vietnam is emerging in IT services.29

India, the pioneer of the global technology outsourcing industry thanks to giants such as Wipro, Infosys and Tata, offers many advantages including mature and expert skills, and strong written and verbal English skills among its young, educated workforce. However, weaknesses have started to show - in recent years as the market expanded, high attrition rates and rising wages have resulted. India also faces the perennial issues around poor infrastructure, a competitive disadvantage for buyers considering disruptions to their business resulting from unreliable transportation, roadways and power. More recently, the Indian market has been troubled by financial governance and domestic security concerns.

26 NearT Global Services Confidence Index, March 2008
27 A.T. Kearney Global Services Location Index, 2007 and Oppenheimer: “China: Well-Positioned to ride the next wave of offshoring,” July 2008

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Today, China is quietly asserting its position in the global outsourcing market. China’s outsourcing industry has been shaped by different factors to those of India. Its growth has been founded on the domestic market as well as nearby overseas markets such as Japan and Korea. In the current economic downturn, China continues to branch out into new markets, taking advantage of its strong infrastructure and talent pool, as well as diverse language skills.

Strategic decisions on a choice of one or more outsourcing destinations require a complex series of evaluations and ultimately, trade-offs. No one destination will offer everything on the checklist. A new paradigm is emerging in which multinational companies assess several attractive markets, scoring them on their existing strengths. The companies combine the complementary strengths of several markets; the result is more robust and flexible than relying on a single supplier. Increasingly, it is not a decision of one area versus another, but an opportunity to make them work together as effectively as possible.

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

China’s emergence, as a center for IT and other service industries, is the result of a combination of government focus, investment and demographics. The availability of skills and growing evidence of a track record in supporting major projects, has allowed China to build out its credentials in four critical areas relating to global outsourcing.

Government focus
Since the early 1980s, in a series of Five Year Plans, the Chinese government has laid the foundation stones for the future of the China outsourcing market. This has been done through significant investments and commitment to a long-term strategy to develop national capabilities in computing, IT and related services. In 2006, the government announced the 1,000-100-10 Project, with key objectives including the following:

- Develop a base of 10 internationally competitive cities for service outsourcing
- Encourage 100 well-known transnational corporations to transfer their outsourcing businesses to China
- Cultivate 1,000 large and medium-sized service outsourcing enterprises with international qualifications

30 NASSCOM “Tracing China’s IT Software and Services Industry Evolution,” August 2007
Other key areas the Chinese government has focused on include the provision of high quality infrastructure, which extends from modern ports, highways and airports to consistent power supply, modern telecommunications and high-speed broadband, as well as education and more specifically, English language capability.

A concerted effort is underway to upgrade infrastructure and communication networks and introduce favorable policies to foster expansion of the technology and outsourcing industries.

Investments
Investments to develop the outsourcing market has taken several forms. First, the government has invested significantly through policy, education as well as specific initiatives to develop the outsourcing industry in China. Second, some investments have taken the form of “captives” that have been set up by individual companies. A captive is an organization which is effectively part of the parent company, but established in a manner where specific processes and/or activities have been selected to be performed at a separate location where there are cost, operational or strategic benefits. Third, there are investments from key Indian players who have observed the potential of the Chinese market and have positioned themselves to be a part of the growth market in China.

The government has demonstrated significant investments in education, infrastructure and initiatives such as the 1,000-100-10 Project.

Favorable demographics
China’s demographic strength includes a strong culture of entrepreneurship and inventiveness coupled with a pool of well-educated engineers. There is a strong pipeline of young, educated and eager university graduates which allows for growth in the outsourcing market.

The other interesting demographic phenomenon presently being observed is the “reverse brain drain”, whereby Chinese engineers and businessmen who have been educated abroad and who have been working abroad, return to China to share their knowledge and western management styles with organizations in China. This type of knowledge exchange has made a significant contribution to the growth in outsourcing.

Current progress
The slowdown in exports since late 2008 has further stiffened the resolve of Chinese officials, for whom the future vision of China rests on a strong services base and a move up the value chain in high technology industries. The government is moving ahead determinedly with a blueprint to increase spending on research and development to US$ 110 billion in 2020. This is part of a plan to become a world leader in science and technology.

The acceleration of patent applications is one signal of this. For the past several years, China has had the fastest growth in new patents in the world and in 2008, it ranked sixth globally with 6,089 patent applications. For the first time, a Chinese company, Huawei Technologies Co., filed for the most new patents.
The enormous potential of China is obvious, but it may only be at a starting point. For example, the share of IT and IT-based services in China’s export revenues barely surpasses 3 percent, compared to over 26 percent in India. Between 1988 and 2008, India built up its outsourcing market to a near-US$ 50 billion business with such giants as Wipro and Infosys. Now, China aims to have its own tower of strength.

China’s outsourcing market is currently in its infancy, accounting for a fraction of the US$ 1 trillion-plus global market for offshoring and outsourcing, but it is quickly evolving.

In 2007, the Chinese outsourcing market weighed in at US$ 15.2 billion, with information technology at US$ 9.04 billion and business process outsourcing at US$ 6.16 billion. Offshore revenues grew more than 40 percent in 2007 to US$ 2.28 billion or 15 percent of total volume. By 2010, China’s offshore work is expected to more than double to US$ 5.6 billion – or 20 percent of total revenues.

Gains in China’s offshore contracts, largely for IT, are far outpacing that of the global market. This segment’s growth is forecast to soar at 30 percent annually from 2009-2013, compared with more modest 19 percent growth rate elsewhere in the world.

Other sources predict similarly large gains for China’s offshore outsourcing - US$ 7.1 billion in 2010, and up to US$ 8.9 billion in 2012.

Meanwhile, the number of outsourcing enterprises in China has multiplied to more than 3,000. While the market is therefore highly fragmented, there are now numerous service providers that have bulked up to a scale where their revenues exceed US$ 50 million per year.

Several studies and rankings track China’s progress as a popular destination for outsourcing of IT and other business services. These benchmarks include:

- Three Chinese cities – Dalian, Shanghai and Beijing – made the top 10 list as most attractive for outsourcing. By 2011, Shanghai could be challenging Bangalore for the leading spot and Dalian and Beijing will move up into the top five, according to forecasts by IDC.
- China ranks second in the world as an outsourcing destination in terms of A.T. Kearney’s scorecard that weighs financial attractiveness, people and skills availability, and business environment.
- An R&D Magazine survey of 400 U.S.-based organizations that sent their R&D work offshore showed that about 18 percent chose China and 17 percent opted for India.
Case study

VancelInfo

Of the larger Chinese outsourcing vendors, VancelInfo Technologies Inc. is noteworthy for its strong links to the U.S. It is the only Chinese outsourcing company that is publicly listed in the U.S., having made its debut on the New York Stock Exchange in December 2007. Moreover, the U.S. is the biggest customer for the Beijing-based company, accounting for 54.7 percent of revenues in 2008.

Many of its top managers are U.S.-educated Chinese who have earned their career stripes at leading technology multinationals. Likewise, the company’s primary venture capital investors—Doll Capital Management and Sequoia Capital—hail from Silicon Valley.

Founded in 1995, VancelInfo has blossomed considerably. Last year, revenues climbed 63.7 percent to US$ 102.7 million while net income rose 69 percent to US$ 16.2 million.

“We focused on profitability from day one and on structured growth that is client focused,” says chairman and CEO Chris Chen. “We have maintained a rapid growth but kept a healthy and stable margin.”

Even in the fourth quarter of 2008, revenue was up 8.7 percent sequentially and 56.3 percent year over year. However, the effects of the global economic downturn could slow growth rates in 2009, says Chen. He points out that market conditions for IT outsourcing typically lag the general economy by three quarters.

An engineering graduate of the prestigious Tsinghua University and a former project manager in China for IBM, Chen has great ambitions for the company he founded with US$ 30,000 of his own money and a loan from a friend. When asked if he wants VancelInfo to become the next Wipro or Infosys, Chen does not hesitate. “Our goal is grow our company as the biggest outsourcing company in the world.” He acknowledges that one reason he wanted to list VancelInfo on the NYSE is to compete directly with India. “Our India peers are already listed on New York Stock Exchange,” he explains.

VancelInfo employs 5,457 people in China, the U.S., Japan, the UK and Malaysia, and sports an enviable list of customers, including Microsoft, IBM, HP, NEC and Huawei. Nearly 29 percent of its revenues came from its two top clients. Additionally, IDC ranks VancelInfo as the top Chinese vendor for the North American and European markets, with a market share of 6.2 percent.

In recent years, most increases in business for VancelInfo have come from clients headquartered in the U.S. Now in a sign of future growth in the market, China is taking the lead. Revenue from China was up more than 200 percent in the fourth quarter of 2008 compared to the corresponding quarter of 2007. Overall in 2008, China brought in 21.5 percent of VancelInfo’s revenues, up from 11.7 percent in 2007. Measured another way – by location of entities signing contracts – China accounted for 70.8 percent of VancelInfo’s 2008 revenues.

The company has thrived by keeping a balance between high and low-end work while offering a wide range of services. Chen points out that low-end jobs provide steady cash flow and ‘sticky’ business, while high-level assignments are big revenue generators but can be risky, primarily because an uneven work flow can lead to idle time for staff.

The strategy is to offer a full range of services and grow with clients. One example is U.S.-based middleware provider TIBCO. VancelInfo got its first project from TIBCO in 2005, when the company was seeking to diversify away from India, get closer to its end market, improve efficiency, and lower software R&D costs. Working closely with VancelInfo, TIBCO built a full-fledged slate of technical services across the product life cycle, launched new marketing efforts to win several important bids, secured two Chinese banking customers in 2007 and continued to expand its business with these customers in 2008.

Such work or R&D services from software services accounted for about 60 percent of VancelInfo’s revenues in the fourth quarter of 2008. Of the remainder, 6.9 percent was for testing, 16.7 percent for application development, 3.7 percent for localization and globalization of products, and 12.8 percent for enterprise solutions. Analyst Friedman notes that the emphasis on R&D bodes well for VancelInfo. “It has the healthiest bill rates, and consecutively strong gross margins.”

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Case study

Shanghai Hyron

Shanghai Hyron Software Co. stands out as a notable example amongst the several smaller Chinese outsourcing companies along the eastern coast with a focus on nearby neighbor, Japan.

Shanghai Hyron was formed in 1989 by Japan’s Omron as a joint venture with the Shanghai government, specifically to provide software development to the Japanese industrial automation and electronic components manufacturer. Its Chairman Dr. Bao Shuping, who earned a PhD from Kyoto University, was a researcher at Omron’s IT Innovation Center.

Aside from a brief detour into the Chinese domestic market in the early 1990s after the Japanese bubble economy burst, Shanghai Hyron has remained focused on its core Japanese base.

Today, Shanghai Hyron has 1,000 people – 200 of whom work in Japan. As a result of the company’s heritage, its business culture is a unique fusion of Japanese and Chinese business cultures. All new hires must complete six months of training in Japanese language and culture. Members of its executive team even greet visitors with a bow.

Some 95 percent of the vendor’s 35 corporate customers are from Japan, and naturally, Omron is one of the biggest. Among its list of banking, insurance, and securities clients, the top six clients contribute 80 percent of revenues.

By emphasizing managed and profitable growth, the company has expanded at an average annual rate of 30 percent for the past nine years to reach US$ 22 million. Net profits are in the 20 percent range.

As with other Chinese vendors that have graduated to the top leagues of technical workmanship, Shanghai Hyron takes pride in its advanced information technology and research and development capabilities, honoring in on offering high-end services to customers. Virtually all employees are software engineers by background and more than 15 percent have a Masters degree.

In addition to offering skills in software development, Shanghai Hyron has progressed in understanding the importance of business domain knowledge. “Outsourcing is not just a factory,” says Shanghai Hyron vice president Pan Shilei. “We focus on the business, not just the IT solution.”

Maintaining high quality standards, even at the expense of breakneck growth, is also a key part of the company’s culture. “We control the speed of our growth because we understand that our people growth must match the business growth,” explains Shilei. “We always consider the customer first. If we think what they are doing is not a good idea, we will tell them. If the customer wins, we win. If the customer fails, we will lose our customer,” he emphasizes.

Despite its decidedly Japanese core, Shanghai Hyron is outward looking. Plans are under consideration to add a branch in the western Chinese city of Chengdu – one of the cities earmarked by the government as an outsourcing hub. For many vendors, Chengdu is increasingly looked at as a hedge against higher costs in Shanghai.

Moreover, Shanghai Hyron is now a publicly traded company in Mainland China. After its investor base was broadened in 2000 to bring in major stockholder Shanghai Jiao Tong University as well as management as part owners, Shanghai Hyron listed on the Shenzhen SME Board in December 2007. Today, about 33 percent of the shares are publicly traded; Omron, Shanghai Jiao Tong University, a Chinese investment company and employees hold the remainder.

Tomorrow holds hope for new business from Europe and the US – a new frontier for Shanghai Hyron which has typically stayed closer to home.

Recently, top management was on a fact-finding mission to Germany to assess market opportunities.

“In the future, we believe China will become just as strong as India in outsourcing,” says Shilei. “We have the market, the engineers and the knowhow to do the high-end work. There is no doubt that China’s outsourcing sector will continue to grow.”

Shilei and the management team are staying focused. “We want stability and long-term growth,” says Shilei. “But it is dangerous to only focus on fast, large-scale growth. We want to keep our approach steady for the next three to four years.”
Outsourcing with Chinese characteristics

The development of China’s outsourcing business has important implications for multinational customers seeking to explore China as a new destination for outsourcing work. Decision makers primarily judge outsourcing locations by cost, availability of skills and manpower, both current and future and across all these areas, China scores well. Another positive factor is China’s fast-growing domestic market.

Chinese service providers have developed their own strategies and business models to support growth, move up the value chain and expand globally.

Moving up the value chain

Most of the early work of the Chinese outsourcing pioneers comprised low-end projects such as localization and software testing. Today, Chinese providers work with companies from around the world and have signed long-term contracts with blue-chip customers including Microsoft, Hewlett-Packard and Oracle. They provide these multinationals with a range of services from back office administrative work and customer service requests, to increasingly, high-end IT, business process and knowledge management activities.

Quality improvements in skill levels have been steady. A study of 75 domestic software and IT services companies found that the number of Chinese vendors achieving CMM level 4 or 5 certification grew by 39 percent annually over a four-year period ending 2007.

Chinese vendors have also advanced to offering specific business knowledge in such areas as banking, insurance, and healthcare. Such insight creates closer links between vendor and client, resulting in higher productivity and profitability for both.

Market breadth

Historically, Japan and Korea have been the primary clients for China’s offshore market. In 2007, these two countries comprised 52 percent of China’s offshore software development market. However, Chinese service providers are adapting their strategy, expanding globally to win and serve significant contracts from major multinationals. Subsidiaries of multinationals in China presently account for a large portion of the software development market.

In 2007, 40 percent of Chinese offshore work comprised North American and European business, and revenues grew by 60.6 percent, compared to a more modest 32.2 percent increase from Japanese and Korean markets. By 2010, these Western markets are forecast to account for 50 percent of China’s offshore software market.
Capturing increased business from the West, which dominates spending on outsourcing, is one of the opportunities for Chinese companies seeking to diversify. The U.S. and Canada account for 47 percent of IT expenditures and the Americas provide 70 percent of BPO spending. By contrast, Asia Pacific accounts for only 15 percent of IT spending and 11 percent of BPO spending globally, with Japan contributing more than 50 percent of that region-wide expenditure.47

Hong Kong’s role

Chinese vendors are beginning to tap the international business hub of Hong Kong to bring in business from banks, insurance companies and law firms. Hong Kong offers several key advantages, as an avenue for raising funds, a hub for project management and a center of management support offering understanding of international business requirements and expectations. There is also an opportunity for Chinese vendors to provide lower-cost back office support to other local Hong Kong companies.

The domestic market

The next wave of customers is likely to come from enterprises that are new to outsourcing, most notably home-grown domestic Chinese companies. Already an emerging force, local demand for IT and BPO services in China is projected to nearly double to US$ 20.6 billion in 2010 from US$ 10.5 billion in 2006.48

As more Chinese companies recognize the need for outsourcing to scale, low cost – not big brand names – will be the priority. China’s numerous smaller providers are well-positioned to deliver on this.

By international standards, Chinese companies still are reluctant to turn over IT tasks to external service providers. IT outsourcing accounts for less than 10 percent of the IT market in China, compared with nearly one-third in the U.S.49 The same pattern holds true in China for the BPO sector. Many Chinese companies, from state-owned enterprises to large privately held outfits, remain unsure about which business processes should be outsourced or do not fully recognise what efficiency gains can be achieved.50

47 Nasscom: “Strategic Review, 2008”
48 Tracing China’s IT Software and Services Industry Evolution, Nasscom, August 2007
50 Deutsche Bank Research: “Offshoring to China,” January 2009
Domestic businesses have tended to outsource high-volume, low-skill tasks with little added value, examples being insurance claims processing and credit card applications. Yet to date, only a small percentage of such work is outsourced by banks and insurance companies in China, according to interviews with Chinese vendors that provide BPO services. Most Chinese banks, for instance, prefer to have their own back office operation. “They are still risk averse and would prefer to do it in-house for security and political reasons,” indicated one executive at a Chinese BPO service provider.

Eventually, growing local demand from emerging Chinese companies as well as a more open attitude toward outsourcing among management could lead to the softening of those attitudes. The home market may ultimately provide domestic vendors with the launch pad to develop a greater global market presence, with relatively lower entry risks and fewer cultural and language barriers.

Consolidation

Most multinationals opt for larger, well-established providers for their outsourcing needs. However, the decision can be easier in China, where the market is so fragmented that less than 20 percent of the market comprises the 10 largest suppliers. (This contrasts with India, where the three largest vendors account for more than 46 percent of Indian IT exports.)

Consolidation is underway in China as the still-young industry develops and winners emerge. Larger players are jockeying for leadership and some vendors, such as Neusoft and VanceInfo, have already achieved scale and distinct market focus.

Market share is being built by increasingly aggressive merger and acquisition strategies. Several major outsourcing vendors in China have begun to buy up smaller, specialized companies, in order to reinforce their main product offering and gain critical mass in the market (see table).

While much of this merger and acquisition activity is domestic, more Chinese providers are looking outside their home market for targets. Through mergers or strategic partnering arrangements, Chinese firms can gain operating leverage and added clout with existing and new customers over the years to come.

One major Chinese outsourcing vendor that has adopted an aggressive acquisition strategy is iSoftStone. Early this year, the Beijing-based company acquired two specialist vendors in addition to making two acquisitions last year— one of which was in the U.S., Akona Consulting in Seattle. Further extending its global presence, iSoftStone has purchased three Japanese IT companies over the last three years. “We are globalizing and growing fast. That model has been proven out by Indian companies,” says Seth Pinegar of iSoftStone. “We’re deliberately focused on benchmarking against the leading Indian companies,” he adds.
China’s strengths

While few of China’s vendors have more than 15 years’ experience, signs of professionalism are evident. This is reassuring to executives checking out China for the first time as a possible outsourcing location and conducting site visits. Many vendors now offer thorough, months-long training programs in technical skills and customer service, sometimes stationing workers overseas for extended period at customer locations to become more familiar with the client’s business operations.

At Shanghai Chuwa Software Co., new employees undergo a one-year training program with intensive lessons in Japanese; Japan is the company’s main source of business. In addition to this, Zhao Zhifan, general manager at Shanghai Chuwa Software Co. (and also chairman of the Shanghai Software Offshore Business Union), continues to pursue improvements to attract more overseas business. “The number one challenge is how to keep developing the team. If the company wants to add clients from the U.S. and Europe, we need to have an understanding of those markets,” he says.

Many also groom up-and-coming managers, for example by enrolling them in executive MBA classes at leading universities in Shanghai and Beijing. In several cases, a large number of employees have an equity ownership stake. Senior-level executives have experience with international organizations and diplomas from the leading universities. Most are proficient in English and comfortable with the expectations placed upon them for well-polished PowerPoint presentation and well-organized, modern facilities.

A number of leading players have also boosted their profile by listing publicly on stock exchanges outside mainland China. Examples include ChinaSoft listing on the Hong Kong Stock Exchange and VancelInfo listing on the New York Stock Exchange.

The tools of the financial world, including joint ventures, mergers and acquisitions, and venture capital financing, have all become part of the culture of China’s outsourcing and are frequently used by the top vendors.

Favorable policies

For several years, economic planning in China has emphasized the development of information technology as a complement to the nation’s stronghold in manufacturing. The initial focus was on hardware production, but the government’s eleventh five-year plan (2006-2010) shifted the emphasis towards information technology services. A broader strategy through to 2020 calls for development of an IT economy, driven by science and home-grown innovation.

The government’s helping hand in strengthening its service economy meets several objectives. These include increasing employment without endangering the environment and propping up job growth at a time when the manufacturing sector is vulnerable to weakening global demand.
At the forefront of this push is long-term development of a robust domestic outsourcing business. Favorable tax policies and other financial support and subsidies have been created to foster growth and create 1.2 million new jobs in outsourcing by 2013.

**The 1,000-100-10 project**

Core to the initiatives is a major building block crafted by the Ministry of Commerce and dubbed 1,000-100-10.

This ambitious plan, with total funding in excess of US$ 1 billion, set out to double China’s service exports by establishing 10 Chinese cities as outsourcing bases, attracting 100 international corporate customers to offshore in these cities, and assisting in developing 1,000 outsourcing vendors that can meet the demands of multinational customers. The plan consists of several facets.

- Funds and incentives for improved training in technical skills and upgrading of quality standards to achieve international certification levels
- A framework for better protection of intellectual property
- A centralised website providing an information resource on China’s outsourcing market for academia, research institutes and businesses
- Improvements in infrastructure
- Loans and credit insurance for outsourcing enterprises
- A subsidy of US$ 650 to vendors for every college graduate recruit employed for at least a year
- Interest rates which favor exporters of software services
- Priority to software businesses when applying for public listings on domestic or overseas exchanges
- Support to research and development centers set up by domestic businesses with academic institutions.
- Taxation which encourages development outside key outsourcing centers.

Since these details were announced, the government has identified 20 cities as service outsourcing hubs (see map, page 20). Outside of these 20 locations, a number of other cities have strong capabilities in outsourcing.

This sign of commitment towards development of a home-grown outsourcing business underscores that China is not to be underestimated as an emerging player in global outsourcing. As the government showed with the successful staging of the 2008 Olympics in Beijing, major projects are clearly within its grasp. If there is a risk, it is the sheer scale of the vision, with 20 designated cities and other established outsourcing locations, all striving to win business.

For potential outsourcers, understanding the relative strengths and weaknesses of these different locations, and the ability of these locations to complement one another, is critical.
To make its mark globally before positions are taken, China needs to jump-start this promising young industry. Considering how far the country has come since economic reforms began three decades ago, perhaps moving to the next level is within its grasp.

Infrastructure

Probably no country in the world has invested as much in infrastructure in recent years as China has, enhancing the credibility of China’s outsourcing proposition. In addition to financing modern ports, highways and airports, the government has authorized major capital expenditures to ensure a steady power supply and modernized telecommunications network with high-speed broadband connections in key strategic locations and major cities. More upgrades are on the way as the Chinese government invests RMB 4 trillion (US$ 590 billion) in infrastructure to boost the domestic economy.

All this is not to mention the sprawling new software parks that have sprung up in Shanghai, Beijing, Hangzhou and many other cities. These state-of-the-art facilities have played a major role in supporting the flourishing of this nascent business in China.

One of the earliest software industrial parks to open was Shanghai Pudong Software Park, back in 1992. Today, it houses more than 250 companies, including several major outsourcing vendors. China has dozens of other software parks in cities across the country. Shanghai alone has at least seven software centers.
Shanghai’s Zhangjiang Park is a vast high-tech zone covering 25 square kilometers where 130,000 employees work at more than 5,000 companies, 40 percent of them foreign-invested. It is accessible using the Shanghai Maglev train from Pudong Airport or a 20-minute metro ride from the city centre. A planned metro line extension will open two more stations within the park.

The Shanghai municipal government, aiming to speed up development of Shanghai as an international financial center, has designated a significant area of this industrial park as a financial information service hub focusing on providing BPO services.

The park boasts a large support center for Ping An Insurance Company, and across the road sits a new information center for Bank of China. Nine projects for data processing facilities, customer service centers and research and development laboratories are under construction, in addition to a residential community complete with a shopping mall.

Another Chinese city vying for financial service contracts is Hangzhou, the capital of East China’s Zhejiang province. It offers a lower-cost alternative to nearby Shanghai. Some 43 percent of the outsourcing work done in Hangzhou is for financial services. One example is State Street Bank, which is served by outsourcing provider Insigma Technology Co. "We want to be known as China’s outsourcing destination,” says Tong Guili, deputy mayor of the Municipal Government of Hangzhou. “We have a strong software sector and we guarantee a steady talent pool of graduates from our universities and colleges. We also have a pleasant environment.” Hangzhou gained initial technology fame for being home to China’s leading e-commerce company, Alibaba.

Not to be outdone is Dalian Software Park in Northeast China, a major outsourcing zone where nearly 400 companies employ 25,000 people over three square kilometers. The harbor city is known for its temperate climate and has numerous Japanese companies due to its close proximity to Japan and Korea. It has also emerged as an outsourcing base for multinationals such
as GE Capital and SAP. Dalian Software Park prides itself on offering a “build, operate, transfer” operation for smaller businesses whereby the park puts up the investment money, hires the staff and builds up the facility and equipment. Then as the smaller company gains sufficient scale, it begins to pay back the park, typically over a period of one or two years.

Technical skills
Not the least of China’s strengths in outsourcing is its vast talent pool of hard-working skilled technicians and engineers. By one official estimate, China has 600,000 engineering graduates, compared to 400,000 in India and 70,000 in the U.S. Moreover, China produced 50,000 PhD graduates in 2007, of whom nearly 3,000 had computer science specialties. Another source of high quality skills is the large number of Chinese returning home from the U.S., Canada and the U.K. with degrees from top schools.

While China has a massive pool of engineers at the entry level, it is widely acknowledged that it will take more time and experience before there are enough senior project managers. Mrs. Chan, ChinaSoft’s CEO of IT outsourcing services, points out that senior-level program managers and architects are still a low percentage of the workers in the China domestic outsourcing market. “For China to advance in offshoring, there needs to be a move from special domain expertise so that China outsourcing can create more value for sustainable growth,” she says.

Language
Chinese officials and outsourcing companies have fully recognized the need for good English language skills to win business from western markets, and compete with rival locations in India and the Philippines. The Chinese government has made English instruction a strategic priority at universities and even in primary school, where English as a foreign language is now mandatory.

Another boost to China’s outsourcing market is the approximate 2 million Chinese who speak Japanese or Korean, a particularly key consideration in northeastern hubs such as Dalian.

Pricing
China also compares favorably in terms of wage levels, although average billing rates vary widely, from Shanghai and Beijing on the high end, to Wuxi and Chengdu at the lower end. China is generally acknowledged to offer a 30 percent to 50 percent discount over India’s prevailing rates. NASSCOM recently estimated that a newly-graduated Chinese engineer might receive US$ 250-300 per month, a steep discount in comparison to average rates in India of US$ 750-1,000 per month.

It is important to note that for the higher-level IT jobs, the wage gap between China and India is already more negligible, partly due to annual wage increases of 15 percent in China’s software industry.
Case study

Neusoft

Dr. Liu Jiren recalls the days back in 1991 when he was a professor at Northeastern University with a big dream to put Shenyang on the global map with a home-grown Chinese information technology company. His vision was expansive – thanks in part to the year he had spent in the U.S. working on his PhD – but his resources were limited. He had just US$ 3,000 in capital, and three people working with old personal computers on a broken table.

All that changed when Dr. Liu was asked to develop a software package for Japan’s Alpine Electronics, his first client. That led to a US$ 300,000 contract from Alpine and soon, 50 people working in a new facility that targeted the nascent telecom market in China. For the first eight years of its short history, Neusoft doubled in size every year.

Today, Neusoft is the largest IT outsourcing company in China, with US$ 540 million in 2008 revenues and 15,000 employees. In addition to its castle-like headquarters in Shenyang, the company that Dr. Liu chairs has eight regional headquarters, four software parks, 16 software development and technical support centres, five software research and development hubs, a sales network and three training institutes. In addition, Neusoft has set up subsidiaries in the U.S., Japan and Europe.

Its 8,000-plus customers span the fields of telecoms, social security, electric power, healthcare, manufacturing, e-government and finance. In the Chinese market, Neusoft commands a leading market share in several of these vertical sectors: 50 percent in social security, 35 percent in power and 30 percent in telecom. Moreover, it has a 10 percent share in financial services, a field Dr. Liu says Neusoft entered “a little bit late.”

Its list of clients includes both domestic and global heavyweights in the telecoms and electronics sectors. Moreover, Neusoft is still growing fast – with a 20 percent increase in 2008 alone – mostly through organic growth rather than acquisition.

The company has faced few setbacks, such as a recently nixed plan to acquire Dalian Hi-Think Computer Technology Co. due to disagreements over price following the slowdown of business from the target’s Japanese customer base.

Although Neusoft went public on the Shanghai Stock Exchange in August 2008, it has stayed close to its origins. Northeastern University holds a 15 percent stake in Neusoft while employees own another 14 percent. Nearly 20 percent of employees have shares in the company and the worker turnover rate is low.

The economic recession has had surprisingly little impact on the company’s business so far. Remarkably, the last quarter of 2008 was the best period of the year, according to Dr. Liu, and the first two months of 2009 look good. Dr. Liu is forecasting a 20 percent growth rate for 2009. “The impact is uncertain,” admits Dr. Liu. “Our clients don’t know when they will recover, so it’s harder for us to make strategic decisions as well.”

Neusoft is becoming known globally, not least of all because its chairman is frequently on the speaker circuit, and was even quoted from an appearance at the World Economic Forum in Davos. Unlike other Chinese vendors that are looking across borders for increased business, Neusoft is staying focused on customers in China, which make up some 80 percent of its revenues.

“We are very focused on the domestic market. We think China will be our great opportunity for the next 20 years,” says Dr. Liu.

He ticks off the reasons he believes China is – and will be – the key market for Neusoft. First, Chinese companies are at the beginning stages of their maturity, and as they grow, so will Neusoft. Indeed, he predicts that China’s software market in China will eventually surpass Japan in size. Secondly, multinational corporations are continuing to set up R&D centres in China. Thirdly, China is moving from a manufacturing-based economy to more innovative digital services, creating a growing need for more sophisticated IT infrastructure.

Many industry experts forecast China that has a growing edge in outsourcing for these very reasons. Dr. Liu himself is convinced that China’s infrastructure, lower costs and bigger domestic market will all work in its favour in the long term. However, he is also aware that the Chinese outsourcing market is not without its challenges, such as language capabilities and perceived risk about intellectual property protection.

But the most important issue, he says, is that Chinese outsourcing brands “need time to develop a global reputation.” That’s why Dr. Liu is committed to putting Neusoft at the forefront of the many Chinese outsourcing brands that are emerging. “Now we are like a baby and we will grow fast. We hope to be five times bigger than today,” he vows. “This is not just a dream – this is a reality. We are ready for this level of expansion.”
Case study

ChinaSoft International

Given its long history in serving the information technology needs of the Chinese government, it is not surprising that ChinaSoft International continues to be best known for providing outsourced services to the public sector. Its projects range from the ticketing system for the Shanghai 2010 World Expo to software design and development for the Chinese State Food and Drug Administration.

But the Beijing-based information technology consulting and outsourcing company has a far deeper grounding. ChinaSoft Intl has been on a high-growth trajectory since 2000, when it was established by Dr. Yu Hong “Henry” Chen, the current CEO and a key figure behind China’s “informatisation” of e-government.

The company’s revenue growth has averaged 60 percent for the past seven years and today, ChinaSoft Intl has more than 5,600 employees in 18 cities in addition to three global delivery centers in China, one in the U.S. and one in Japan.

Of the company’s 2007 revenues of US$ 110 million, about half came from domestic consulting while the rest was from providing outsourcing, primarily to the U.S., Europe and Japan.

Since the company’s public listing on the Growth Enterprise Market in Hong Kong in June 2003 and subsequent strategic investment from large companies such as Microsoft, the IFC, JP Morgan and ABN Amro, ChinaSoft Intl has made significant inroads. Late last year the company successfully jumped to the main board of the Hong Kong Stock Exchange.

Like many others in China outsourcing, ChinaSoft Intl is relying on mergers and acquisitions to help fuel growth, although it has achieved strong revenue gains organically as well. ChinaSoft Intl made six acquisitions between 2003 and 2007 to expand its reach geographically in Japan, Europe and the U.S. and strengthen services for specific sectors.

One of ChinaSoft Intl’s biggest claims to fame is that it is one of Microsoft’s key outsourcing vendors in China. ChinaSoft Intl has assigned as many as 900 engineers across China as well as the U.S. to work on jobs for the software titan. It also runs a training and certification program for the company.

ChinaSoft Intl’s CEO of IT outsourcing services Fanny Chan says she regards the firm’s progress so far as only a start. She explains that ChinaSoft Intl has a three-pronged business model that distinguishes it from domestic rivals: domestic consulting, global outsourcing and training. She notes that the consulting business focuses on a few specialized industries, including the public sector, financial services and healthcare. “The outsourcing leg of the business allows ChinaSoft Intl to grow in step with each customer’s growth,” she says.

As for training, that all-important ingredient to success, ChinaSoft Intl runs five Excellency Training Centers throughout China, tapping into talent from more than 150 universities. That also affords an opportunity to cherry pick top engineering and computer science graduates.

“Our focus on consulting and outsourcing along with training creates the right business model for our growth,” states Mrs. Chan.

She sees not only a positive future for ChinaSoft Intl but also for the outsourcing business in China. The few downsides she cites are concerns over security and intellectual property issues, and a low percentage of senior-level program managers and architects in the talent mix.

She also sees a need for the still relatively young and small Chinese outsourcing market to develop a stronger brand and marketing image – a view shared by many in the business. “What the sector really needs is for the Chinese government to help the industry build up the ‘China Sourcing’ brand, to position China as an outsourcing destination,” she says.

Even so, she ticks off several factors that set the stage for further development: China’s vast population, the high number of mobile and Internet users, a large IT market, good infrastructure, hard-working and technically proficient talent and government support. “With the proven success of the Chinese outsourcing industry,” she says, “we are providing international customers an outsourcing alternative to places such as India.”

And unlike India, which largely serves the export market, Chinese outsourcing has a huge domestic market to turn to. “For the work coming from the U.S. to China, I believe that as long as the company is demonstrating its unique value, changes in international sentiment including the prospect of heightened protectionism will not impact us too much,” says Mrs. Chan.
Challenges to consider

As the world’s most populous nation and third largest economy, China has made major strides in laying the groundwork for a successful outsourcing market. However, there is still a perception in many overseas markets that Chinese companies may struggle with sophisticated offshoring tasks and that the country remains a risky place to do business.

It is important to recognize and understand the risks that accompany different outsourcing choices and to put measures in place to mitigate the threats they pose. This could include developing contingency plans, risk mitigation strategies and back-ups, as well as evaluating what would be a key loss.

While being far from an exhaustive list, key considerations when offshoring to any location include the following:

- Quality of services
- Language capability
- Intellectual property rights
- Information security and data privacy
- Compliance exposure
- Business resilience and continuity
- Remote service delivery
- Transition of processes
- Experience in delivering on large contracts
- Location differences
- Political influences
- Quality of technology and graduate talent
- Staff loyalty and turnover
- Labor laws
- Costs, currency fluctuations and inflation
- Cultural differences
Location exposure

One parallel to draw with India is to recognize is that China is not monolithic - the availability of technical skills, language skills and other resources varies enormously from one location to the next. With many sites within China competing for investment, understanding the configuration of these strengths and weaknesses for each specific location is critical.

Some cities that have emerged in recent years as new IT and BPO destinations have positioned themselves as market sector specialists.

For example, Changsha, the capital of Hunan province with a population of 6.5 million, is building on its education, research and training foundation to become a hub for outsourced animation services.

Hangzhou, home to 6.7 million people along the Yangtze River delta, has positioned itself as a hub for financial services outsourcing; contracts in this sector accounted for about 43 percent of the city’s offshore service outsourcing contract values in the first three quarters of 2008.65

Dalian, a harbor city of 6.2 million people in China’s northeast province of Liaoning, is known as an important IT and BPO center for large Japanese companies such as Sony, Panasonic and NEC. Hundreds of domestic and international outsourcing vendors use the expansive high-tech and software parks in Dalian as a hub. IBM and Hewlett-Packard also use it as an outsourcing base.

Intellectual Property Rights (IPR)

IPR protection is a particularly important issue in outsourcing where vendors have access to sensitive data. Vendors in China have adopted strict security measures to prevent customers’ intellectual property from falling into the wrong hands.

Due to past incidences of software piracy in China, there is still a negative image of the treatment of IPR.66 Government efforts to resolve the problem, such as promoting the installation of licensed software at enterprises, have led to a drastic reduction in piracy.67 Further headway has been made with China’s entry into the World Trade Organization and clearer measures to protect copyrights and patents. More work is still required on this issue in order to tackle the issue and change perceptions.

Neusoft chairman Liu Jiren admits that intellectual property rights protection is still seen as a risk in China by multinational buyers. “India started much earlier than China,” he says. “China needs time to develop and build its reputation.”

Market fragmentation

For multinationals planning to test China’s capabilities, the task of identifying vendors can be daunting. The sheer number of choices can make it difficult to assess vendors, particularly where there are multiple locations vying for contracts with attractive incentives.

Currently, the market is highly fragmented with thousands of smaller enterprises all wanting their share. Opportunities exist for the large players to consolidate and gain economies of scale and service expertise to compete for

65 Hangzhou government statistics (2008)
significant contracts. Large multinationals tend to gravitate to major providers for services. To fully realize the government’s vision for a services economy led by outsourcing, domestic Chinese providers need to pursue mergers and acquisitions as well as internal growth.

For providers with commoditized services in BPO and ITO, the goal of getting big fast is highly important, but is a less critical factor for those in niche areas. Only major players that can showcase their strengths – not only in size but also in capabilities – will stand the chance of competing for major outsourcing contracts from multinational companies.

“Compared to the tier one Indian companies, Chinese companies are still very young and small in size. The size limitation prevents us from getting the major, mega-size projects,” observes Mrs. Chan of ChinaSoft Intl. This is true not only in the domestic Chinese competitive arena but also amongst the many emerging destinations around the world that are all vying to be added to the list of “alternatives to India” destinations.

China has many unique strengths it can leverage. Outsourcing centers in China can serve as a base to do business in Asia or as a side-by-side operation to existing product sourcing sites for exports. With its strong technical skills, China can also be home to more research and development centers for multinational corporations. These are all areas of opportunity for Chinese companies over the coming decade.

**Competition and collaboration with India**

The issue of market fragmentation is becoming more pronounced as competition from external – especially Indian – players increases. Indian companies, including Infosys, Wipro and Tata, are rapidly establishing footprints in China, bringing with them many more years of experience in working with large multinational customers.
While their entry is creating greater scale and helping to foster an ecosystem for the entire industry in China, it is up to Chinese vendors to compete and grow. Only by differentiating their services by location and vertical specialization, as well as by staying competitive on rates, can they compete for the big, repeat contracts.

Some forward-thinking service providers are already considering how to work with Indian vendors in complementary ways. This collaboration could include sharing human resources and natural resources. Indian and Chinese companies could also team up to provide end-to-end technology jobs – China focusing on its strengths in hardware and India on software. Finally, Indian companies could leverage lower costs in China for back-office work, while Chinese firms can gain maturity and experience by serving international clients.

For all the strides China has made, there is wide acknowledgment among the emerging leaders in the domestic business that the Chinese outsourcing market could better market its strengths to the international community. There is no one voice to represent the Chinese industry and establish its credentials—yet there are continued misconceptions about its potential and too few success stories that are widely touted as evidence of the industry’s achievements.

“It is difficult in China because every company is doing business on its own and there is not a concerted effort to share information. The number one challenge that China outsourcing has is a branding issue. We don’t have one body to represent us and promote us,” says Zhao Zhifan, chairman of the Shanghai Software Offshore Business Union, a consortium of Shanghai-based outsourcing companies.

Moreover, there are competing and overlapping voices at the local and provincial level that are each vying for a portion of this emerging home-grown Chinese market and making for a confused message overall. China could benefit from an industry association similar to NASSCOM in India to raise its profile worldwide and position this still-young outsourcing business clearly on the map of top global destinations.
Case study

Beyondsoft

Beyondsoft (Beijing) Co., Ltd was set up in early 1995 and in the tradition of a pioneer, it remains forward-looking.

Take for example the company’s strategy to increasingly focus on the Asia Pacific region for new business – at a time when many rivals have earmarked the U.S. or Europe for growth. Consider too its 2007 acquisition of an Indian outsourcing vendor to pursue e-business from Indian and international customers.

The company has also adopted what it hopes will be a recession-beating strategy. Following a client review in 2008, Beyondsoft took the bold step of scaling back its customer base to hone in on high-quality clients whose primary needs are technology prowess, not manpower.

Such bold moves are in the company’s culture. Founded by President and CEO Ben Wang with three computer science classmates, Beyondsoft survived for the first 10 years on operating cash flow and capital infusion of US$ 3 million in 2005 and US$ 5 million in 2007 from venture firm TOA Capital.

In the early years, business steadily grew from multinational companies that needed localization of their software products into simplified Chinese, Japanese and Korean languages. In 2001, Beyondsoft set a new standard by moving beyond localization and providing more engineering services for product development.

While many local competitors were looking to expand quickly, Wang says his team took a longer-term strategy of controlled growth, mostly by building up business organically from both existing clients and new customers. To supplement its growth, the company has made three acquisitions to tuck specialized services into its portfolio of offerings. Its growth rate averaged 60 percent from 2003 to 2008, Wang notes.

Last year, Beyondsoft reached around US$ 50 million in revenues and a 12 percent net profit. For 2009, Wang predicts that the current downturn in the economic cycle will cause revenue growth to slow, but he is still targeting a 30 percent increase.

Beyondsoft is not merely pursuing revenue. Drawing a distinction between his company’s gradual gains and the rapid ramp-up of Internet companies in over the past decade, Wang states, “What we are doing is a service business, and the business model is different from those high-flying Internet companies’. We want to provide value to our clients, which means we pay more attention to our earnings, focusing on price/earnings ratios.” He continues, “In 2005-2008, there was a lot of noise in this market. Many companies just wanted to get through their IPO and lost focus on their clients.”

Beyondsoft is renowned for working with some of the world’s best technology companies and some of the world’s leading enterprises in vertical markets. The list includes Microsoft, its first client, as well as Hewlett-Packard. These two clients, both long-term customers, account for 40 percent of the firm’s revenues. Beyondsoft also considers vertical industries in China such as financial services and biopharma within its “sweet spot.” Additionally, the company recently helped a leading search engine company develop a software application for people to find missing relatives in the aftermath of last year’s earthquake in Sichuan province.

About 60 percent of Beyondsoft’s revenues come from U.S. and European multinationals while Japan contributes 10 percent and China another 25-30 percent, according to Wang. A majority of the 3,000 employees are in China, reflecting a focus of many companies in the industry that operate ODCs in China for offshore clients, as well as those who serve branch offices of multinational clients in the domestic Chinese market. Besides its headquarters in the Zhongguancun Software Park in Beijing, Beyondsoft has logically extended its reach to pursue international customers from locations in India, the U.S., Japan and Singapore.

Wang views the company’s foundation as “very solid,” something he attributes to its comparatively long history, and a customer-oriented culture. Beyondsoft has been adjusting business service offerings to provide value to clients. He points out that, for instance, localization of products for multinational customers, which used to be Beyondsoft’s proverbial bread and butter, today accounts for only 2 percent of the company’s business, since clients need more support from Beyondsoft.

Like other market leaders who are pushing the boundaries of Chinese work in outsourcing, he takes pride that the company has moved up the value chain to providing complex work in research and development and enterprise solutions. To continue pushing forward, Beyondsoft sends senior-level managers on a two-year executive MBA programme.

“We want to be seen as a technology company first, and not just a manpower company,” says Wang.
When Roc Yang and his co-founder Wang Lei formed China Data Group in 2005, they set out to do things differently. Their goal was to conquer the Chinese market first as a world-class BPO provider, and then expand to other markets.

That strategy is working well, says Yang. Today, CDG has US$ 15 million in revenue and is working with 15 of the top 20 insurers in the market, nine of the largest 10 commercial banks, and three out of five state-owned banks in China. Last year, its 3,500 workers in Beijing, Shanghai, Guangzhou and Kunshan processed 8 million insurance policies and medical claims as well as 20 million credit card applications. Its clients represent a who’s-who in financial services: Deutsche Bank, HSBC, Citibank, Prudential, Sun Life, Aviva, and the Bank of China – and Yang is proud of the loyal relationships he has developed with these clients.

A former translator, consultant and senior official with the Ministry of Trade and Foreign Investment (now the Ministry of Commerce), Yang teamed up with his colleague Lei to co-found CDG after selling a banking solutions company. In the first year, CDG brought in US$ 100,000 in revenue. Since then, there’s been no looking back. Even in the current year, Yang is hopeful that his company will see sales grow by more than 50 percent.

CDG owes its success in the domestic market to an ability to offer customers fast time to market, Yang notes. CDG has skillfully borrowed the Japanese manufacturing approach of just-in-time delivery for its operations. “Chinese customers are not only looking for cost reduction,” explained Yang. “Time to market is their number-one concern.”

CDG has looked for efficiency as it grows, but Yang still sees room to expand in China’s nascent market. He points out that while CDG enjoys an 80 percent market share in BPO for financial services within China, the vendor is “doing less than 5 percent of the processes that could be outsourced.” He explains that “many Chinese banks remain relatively risk averse and have a big back office that is unlikely to get restructured too quickly.”

Gradually, CDG is gaining entry. In the second half of 2008, CDG signed a major contract with the Bank of China. CDG assigned 600 workers to the account, and subsequently picked up follow-on work and a larger individual assignments. Yang observes that becoming an integral part of the bank’s operation is key. “Once a customer works with you and trusts you, they will rely on you,” he says. “Chinese financial services are becoming more and more open to outsourcing.”

As a relatively young entrant, CDG has yet to reach profitability and as such the company continues to be highly cost-conscious. This is reflected in the fact that it hires vocationally-trained workers as well as college graduates and has chosen to locate in suburban areas rather than more expensive business districts. Yang hopes this discipline will soon pay off as he predicts the company could achieve profitability by the third quarter of 2009.

The company is further supported by substantial funding from a number of leading international and domestic private equity funds. It raised US$ 10 million last June before the financial crisis hit, on top of US$ 12 million in 2006. The Chinese private equity fund CDH also provided substantial funding in 2006.

Looking ahead, Yang is among several market leaders who has added his voice to the need for an industry-like association such as India’s NASSCOM help to promote China outsourcing. To that end, he has taken up roles as a board chairman of the Beijing Association of Service Sourcing and president of the Capital Financial Services Outsourcing Council.
A New Dawn: China’s Emerging Role in Global Outsourcing

Case study

TCS

When India’s Tata Consultancy Services set up in China, it was mindful to develop a strategy that took the country’s heritage and customs into account.

Part of the huge Indian conglomerate Tata Group, TCS entered the Chinese outsourcing arena by tapping multinational corporations in China, before focusing on regional companies and finally the domestic Chinese market.

“We have grown steadily and profitably since inception,” says Girija Pande, executive vice president and Asia Pacific head for TCS. “We did not believe in spending millions before getting to the first customer. TCS in China is a very profitable operation.”

The Indian company’s history in China is a reflection of governmental support and collaboration. In 2002, TCS became the first Indian software company to establish a wholly owned foreign enterprise in China. It followed quickly in 2005 with plans to establish a landmark software joint venture in Beijing with the Chinese government’s National Development and Reforms Commission and Microsoft Corp. The JV was inaugurated in February 2007 in a high-profile ceremony.

Today, TCS has a 65 percent stake in the entity while the Chinese government holds 25 percent and Microsoft the remaining 10 percent. In a sign of growing Sino-India teamwork, TCS is merging its subsidiary with the joint venture, a move that will dilute the government’s share to 10 percent.

Like other Indian companies that have entered the Chinese market, TCS has a growing footprint in the market. It has multiple offices in China (including new premises at Beijing’s sprawling Zhongguancun Software Park), 1,200 employees and a mix of global and local customers. Seventy percent of revenues come from U.S. but it also has a smattering of domestic clients including Chinese banks. Finance is the strongest sector, representing 40 percent of volume, while telecoms is eyed as the next promising vertical sector.

Compared with the local Chinese service providers, TCS considers its main advantages to be size and scale, global and regional reach, and international quality standards. Such attributes have helped in winning business from such large clients as General Electric Co., Motorola Inc. and Cummins Inc.

Moving deeper into the Chinese market, TCS recently won a significant multi-million dollar contract to implement a comprehensive international trading system for China Foreign Exchange Trade System, part of the People’s Bank of China. This next generation Chinese renminbi trading platform, modeled after a system TCS implemented in India, is designed to be scalable and bilingual.

“As the renminbi becomes a more flexible, convertible currency, we are planning to have a robust trading system,” says Pande. “It is part of the globalization of the Chinese market.”

While language barriers have not proven to be a barrier, TCS deals with noticeable cultural differences. “We find that our people in India are more global,” says Pande, adding “China will become more global.” Moreover, Chinese workers tend to be more regimented. “In India, if you ask, ‘when will you finish,’ the answer might be seven or eight days,” observes Pande. “In China, you get a precise time.”

Certainly, there are trade-offs in fishing for lucrative contracts in the rapid growth market of China. Continuing upstream, Pande says TCS has a goal of building up its workforce in China to 5,000 in the next five years.
Conclusion

China’s rising importance in global outsourcing is unmistakable. With focus and key investments from the government in the areas of technology, education, and infrastructure, China has emerged as a favourable destination for information technology and business process outsourcing.

China’s strong entrepreneurial culture supports the government initiatives aimed at growing the information technology sector in China. By 2020, the government plans to have a robust technology economy supporting the domestic and global market, providing higher-value service jobs outside of the manufacturing sector.

China has moved up the IT value chain by serving companies from a variety of global markets including Japan, Korea and the United States. The domestic market within China should not be underestimated, this market holds tremendous potential for outsourcing service providers. China’s large companies and financial institutions are exploring outsourcing, and represent an attractive market with considerable potential.

Future success is not without challenges and risks. This paper outlines many of those risks but also makes clear that a competitive advantage can be achieved by those who understand and manage those risks effectively.

With today’s economic conditions providing severe challenges for business, more companies are looking to position themselves for the eventual recovery and are evaluating the effective use of external providers to help them support and expand their operations. China has positioned itself as a key location for consideration, by enhancing skill availability, making focused investments, addressing IPR concerns and highlighting success stories.

All of these factors combine to make the China outsourcing market an interesting place to watch.
About KPMG

KPMG is a global network of professional firms providing audit, tax, and advisory services, with an industry focus. With more than 137,000 people worldwide, the aim of KPMG member firms is to turn knowledge into value for the benefit of clients, people, and the capital markets.

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