



China's Outsourcing Market – A Perspective

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Since 2006, China's market for the outsourcing of technology services (outsourcing services) has experienced fast growth. Over the past 5 years, both foreign IT service providers and home grown IT and BPO service providers have established and expanded business operations in China primarily to serve domestic and East Asian region customers. The Chinese outsourcing services market has now attained such a position of importance that its value proposition cannot be ignored by those contemplating global sourcing strategies. This paper provides a perspective on the market dynamics and potential of China's outsourcing services market. Below are some key insights that Avasant's analysts have observed with respect to China's development as a hub for outsourcing services:

- The growth in China's outsourcing services market has been powered by unique geographic and political factors. The outsourcing services market has grown 43% over the past 5 years. The Chinese government has been actively involved in the development of the industry to an atypical degree, providing a myriad of incentives and benefits to local and foreign companies to invest in China. In addition, China's presence as a regional power with the ability to provide specialized support to the diverse markets of the Asia-Pacific region has also spurred the growth of the outsourcing services industry.*
- China will continue to play a leading role in the Asia-Pacific region as an offshoring center as well as a strategic location for Asia-Pacific based multi-national corporations (MNCs).*
- Vast differences in economic development, culture and labor skill-sets have provided outsourcing cities with their own specialized competencies (e.g. Dalian with Eastern Asia Language support, and Shanghai with back office for Financial Services.)*
- Companies interested in establishing a presence in China will need to employ a structured approach in order to select the right city/industry park in China to meet business objectives.*

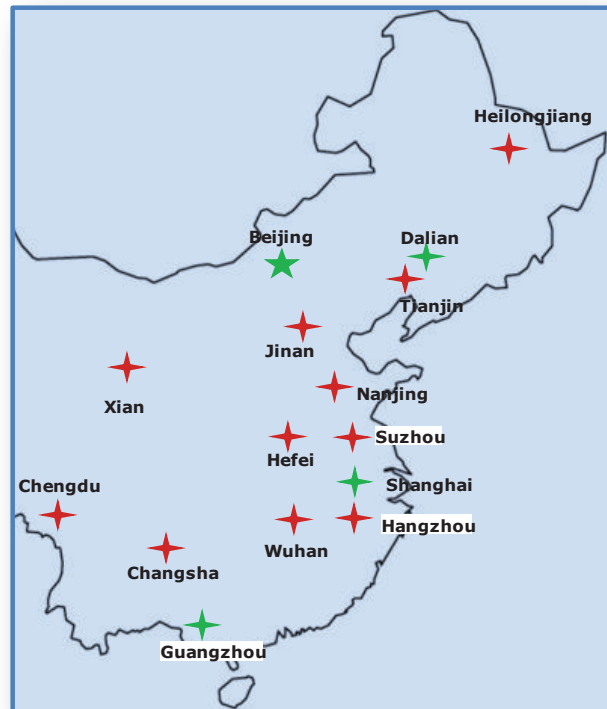
China Outsourcing Market-Growth and Challenges

- Active Government Involvement

In 2006, the Chinese government launched the “Thousand-Hundred-Ten” project, to give a boost to China’s outsourcing services market. The stated objective of the Thousand-Hundred-Ten project was part of the Government’s 11th Five-Year Plan (2006 -2010) and entailed the following goals and objectives:

- Incubate 1,000 China based technology services outsourcing companies that meet international standards and are capable of serving domestic and international markets;
- Attract 100 MNCs to outsource IT or BPO services to China; and
- Create 10 designated outsourcing service centers at various locations within China.

Since the adoption of the 2006 Five-Year Plan, China has set up 14 base cities and the government has offered attractive incentives for overseas service providers and companies to set up operations in these cities.



★ Tier One City
 ★ Tier Two City

Since 2006, an increasing number of global technology service providers have established operations in these locations, taking advantage of the generous incentives doled out by Chinese central government as well as provincial governments. The service providers have set up operations to serve customers in near shore markets like Japan and South Korea as well as the large and growing Chinese domestic market. Leading MNCs like IBM and Accenture and large Indian outsourcing firms (such as Infosys, TCS, Genpact, Cognizant and Wipro) have all established operations in China. A number of China based service providers have also grown rapidly both domestically and internationally, setting up onshore delivery centers outside of China, to service clients.

Despite growth in providing outsourcing services to the domestic and regional Asian markets, Chinese service providers have had less success with respect to penetrating western markets. These challenges are primarily rooted in language capability, cultural understanding, the ability to meet global service delivery standards and the ability to differentiate their services against competition from established Tier 1 global service providers. The ensuing sections provide an overview of some of these perceived strengths and weaknesses.

Market trends and dynamics

By the end of 2010, the number of registered “Service Outsourcing” companies in China had exceeded 10,000. Among them, 3000 companies have engaged in some form of offshore transactions (Source: Ministry of Industry and Information Technology, China). The industry has employed 2.3 Million workers. 1.65 Million or 71% of the total workforce has at least a college degree or better. However, the size and maturity of most Chinese service providers, barring a handful, are yet to reach the global standard required by most discerning buyers of outsourcing services, particularly large MNCs and public entities around the world.

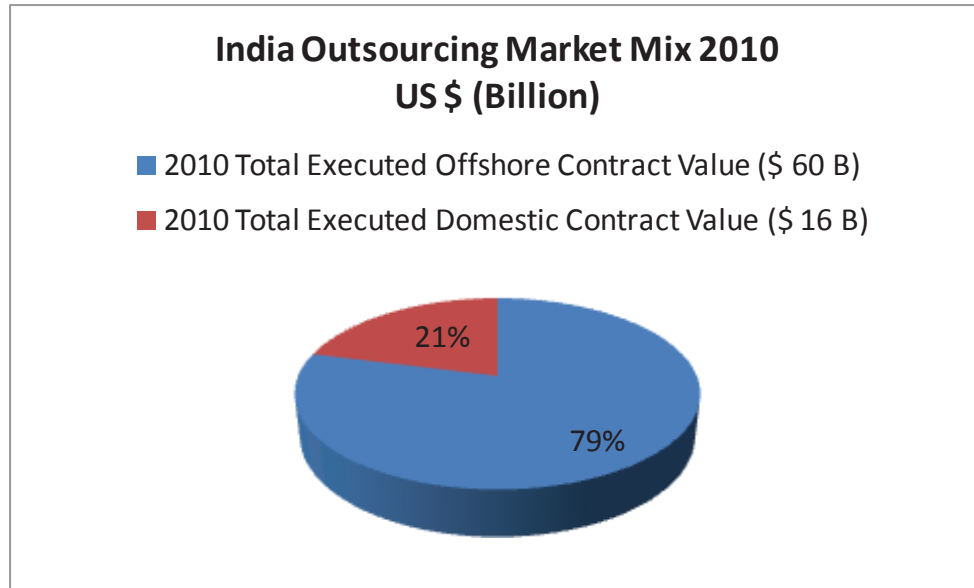
- **Fast Growing Domestic and Offshore Market**

According to China’s Ministry of Commerce, the total contract value of executed outsourcing contracts with Chinese based service providers was approximately US \$19.8 Billion, a 43.1% increase from the prior year. The value of offshore contracts in 2010 was estimated at US \$ 14.5 Billion, a 43.1% increase from 2009. The sharp increase in offshore business is tied to China’s unique linguistic and demographic advantages in supporting East and Southeast Asia. For example, China has leveraged the unique demographic make-up of Dalian (e.g. 500,000 Ethnic Korean residents in Liaoning Province, and a long history of Japanese companies tapping Japanese-speaking Chinese as resources since the late 1980s) to make it one of the premier offshore service provider destinations for large Japanese and Korean companies, including those that appear on the Fortune 500 or Fortune 1000 lists. A number of leading global service providers such as IBM, Genpact and Accenture have established global delivery centers in Dalian and have developed mature service delivery model and capabilities to cater to the demands of East Asia’s major companies.

China’s growth in providing outsourcing services to its domestic market is based on increasing demand from large, state-owned enterprises (banks, telecom, public sector) and Chinese subsidiaries and affiliates of global MNCs. Additionally, more public sector entities are relying on Chinese based third party service providers to perform back office functions and services, which has also contributed to industry growth.

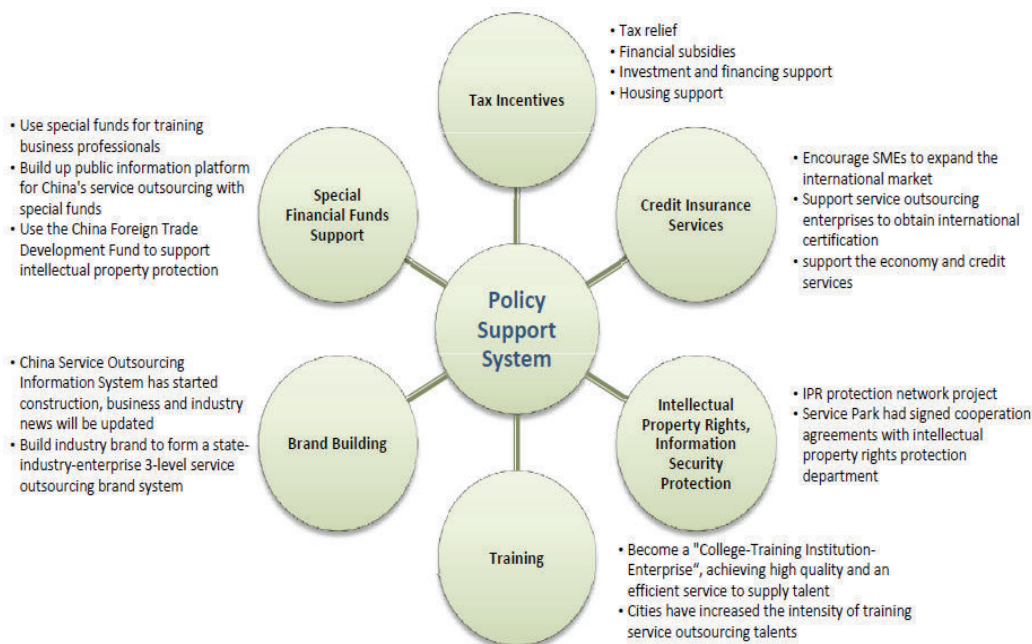


Though China's market for outsourcing services has grown rapidly, it is still somewhat dwarfed by India. The total India outsourcing market amounts to approximately US \$76 Billion (almost 4 times greater than China's current market value). India's domestic market for services is approximately US\$ 16 Billion, which aligns well with China's current performance. However, India's dominance remains in the export market for services, which are approximately US \$60 billion, and reflect India's premier market position as a global destination for IT outsourcing service providers.



- **Strong Government Support**

Since 2006, under a general guideline from China's Central Government, different outsourcing base cities have provided various incentives and direct investment into infrastructure development to attract overseas investors as well as promote the outsourcing services Industry. These incentives range from tax incentives and financial subsidies to human resources development subsidies and business facilitation incentives. China's program of incentives and direct investments is seen as the best practice for other emerging countries to emulate. Moreover, the Chinese government has become viewed by foreign companies as more responsive to intellectual property enforcement concerns, and that has lowered a commonly perceived risk to foreign companies of doing business in China. An overview of government support initiatives is provided below.



Some examples of key incentives offered by the Chinese government across all outsourcing cities include the following:

Incentive Category	Key Incentives
Incentive policy Objective	<ul style="list-style-type: none"> • Special-purpose funds available for the construction of public information platforms, the development of HR, and the improvement of infrastructure and investment environments.
Corporate Tax Incentive	<ul style="list-style-type: none"> • Foreign invested technology companies may be exempt from corporate income tax from the year it becomes profitable, for a period of two years. • Foreign Invested Companies in the relevant industry and located in the Middle and Western part of China may pay a reduced income tax rate of 15% (VS 25% for normal companies) • The actual salary and training costs of software companies are allowed to be deducted from income taxes • 5 year depreciation period for electronic equipment VS 10 years for other equipment • Foreign Invested Companies that reinvest profits and has operated for less than 5 years are entitled to 40% of the paid tax amount over its reinvestment amount.
Other Tax Incentive	<ul style="list-style-type: none"> • Foreign Invested Project, Government funded projects and UN funded projects are exempt from Custom Tax and Value Added Tax for self-use equipment • Foreign Invested Companies that are in the targeted industry, foreign invested R&D centers and other advanced technology companies are exempt from Custom Tax and Value Added tax for self-use equipment which cannot be supplied in China • 17% VAT for software products, and actual levied portion over 3% will be refunded

In addition, different outsourcing cities and/or Industry Zones also offer their own incentives, for example,

Below are some key incentives offered by Chengdu:

Incentive Category	Key Incentives offered by Government of Chengdu
Infrastructure	<ul style="list-style-type: none"> An amount of up to 50 million RMB is set aside for outsourcing industry development to build an internet platform with a dedicated overseas exit with a bandwidth of 6G.
Economic Incentives	<ul style="list-style-type: none"> An amount of 50 million RMB is set aside for outsourcing industry development Special funding support for leading enterprises and key projects Financial support for IPO and other public fund raising Office rental subsidy for software companies Preferential land price for companies setting up self-built office 70% fee subsidy for CMM certification application 1% of total export amount subsidy for IT and BPO companies Export oriented software company and BPO companies are entitled to a subsidy with an amount of 1% of its annual total export, not exceeding 500,000 RMB Companies whose revenues exceed 1 Billion RMB, 3 Billion RMB, 5 Billion RMB are entitled for 100,000 RMB, 300, 000 RMB, 500,000 RMB respectively
Business Incubation	<ul style="list-style-type: none"> An amount of \$70 million is set up for entrepreneurship activities
Business Facilitation	<ul style="list-style-type: none"> Setup government service centers in the industry park to conduct “One Stop” services with “Zero fee” policy
Human Capital Development	<ul style="list-style-type: none"> Managerial and technical staff will be awarded bonuses of 20% to 100% of their personal income tax Training subsidy for software companies and software talent training Institutes

Location Differentiation

- Unique Local Capabilities

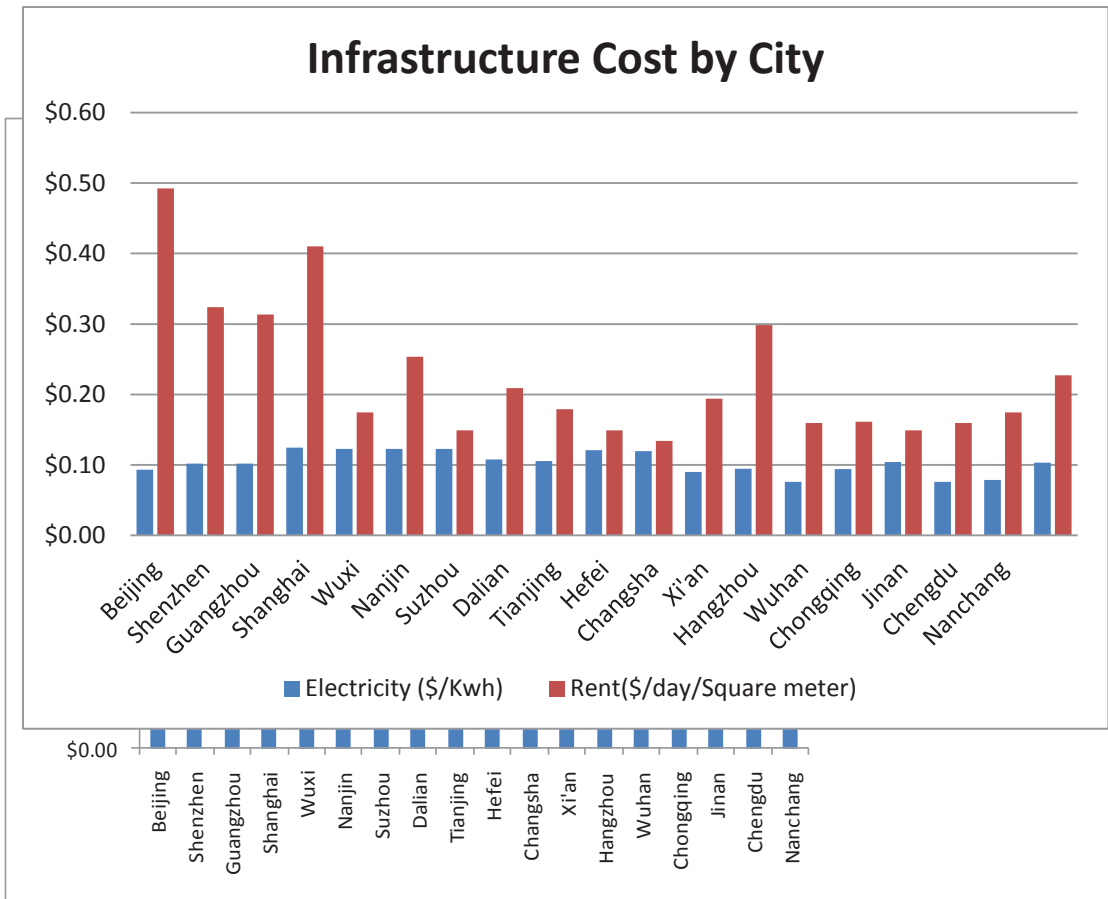
Significant outsourcing services industry growth has occurred in geographic areas that possess unique competitive advantages (e.g. Japanese support in Dalian, Financial back office services in Shanghai). Avasant has conducted an independent study of the key competitive advantages possessed by each Chinese outsourcing location in order to provide a working guide for potential customers who desire to select China as an outsourcing destination. (See Figure Below)

Key China Outsourcing Destinations	Key Industry Park	Key ITES/BPO Advantage						
		Unique language capabilities	Large Service Provider Presence	Low infrastructure & salary costs	Close to Hub Cities	Large Talent Base	Mature Business Environment	MNC Presence
Beijing	Zhongguancun National Demonstration Zone	●	●	●	●	●	●	●
Shenzhen	Shenzhen Software Park	●	●	●	●	●	●	●
Guangzhou	Tianhe Software Park	●	●	●	●	●	●	●
Shanghai	Caohejing Hi Tech Park	●	●	●	●	●	●	●
Wuxi	Wuxi National Software Park	●	●	●	●	●	●	●
Nanjin	Nanjin New Technology Development Zone	●	●	●	●	●	●	●
Suzhou	Qunshan Hua Qiao Economic Development Zone	●	●	●	●	●	●	●
Dalian	Dalian Software Park	●	●	●	●	●	●	●
Tianjing	Tianjin Economic Development Zone	●	●	●	●	●	●	●
Hefei	Hi Technomogy Park	●	●	●	●	●	●	●
Changsha	Hi Tech Development Zone	●	●	●	●	●	●	●
Xi'an	Xian Software Park	●	●	●	●	●	●	●
Hangzhou	Hangzhou Econommic Development Zone	●	●	●	●	●	●	●
Wuhan	Donghu New Technology Development Zone	●	●	●	●	●	●	●
Chongqing	Jinyunshan Software Park	●	●	●	●	●	●	●
Jinan	Qinu Software Park	●	●	●	●	●	●	●
Chengdu	Chengdu Hitech Park	●	●	●	●	●	●	●
Nanchang	New Technology Development Zone	●	●	●	●	●	●	●

- Service Delivery Cost

Although China has made strides in trying to position itself as a key alternative location to India, it has faced certain challenges due to higher inflation and a rising local currency against key international currencies. In addition, China’s relative lack of middle-level management resources has also inflated the cost of higher-end labor in the Tier One cities.

Attrition is also becoming a challenge for service providers in China as the current educational system is not able to provide sufficient skilled labor resources to meet the demands of the global ITES/BPO industry. Nonetheless, China retains some advantages in labor cost differential as there is a large gap in labor costs between Tier 1 cities on the one hand and Tier 2 & 3 cities on the other. As Tier 2 & Tier 3 cities have continued to be aggressive in attracting investment and have taken advantage of



class infrastructure and an improving talent pool, they have become more attractive to global service providers as a potential destination.

Conclusion

Since 2006, China has undertaken significant efforts to position itself as a major competing location to India for IT & BPO services. Although these efforts have not yet resulted in significant acceptance of China as an alternative to India for outsourcing companies, China's outsourcing market has experienced strong regional growth driven by demand in the domestic market and from near-shore Asian countries like Japan and South Korea.

Chinese service providers continue to face the challenges of managing language barriers and cultural gaps to service the demand of western, and these challenges are not likely to be overcome soon. In addition, to become a credible alternative to India, Chinese service providers will need to enhance their delivery capabilities and create a brand differentiator to successfully compete against Tier 1 Indian and US based service providers. China will continue to thrive on its domestic market and also in providing off shoring services to Customers in the Asia-Pacific region as well as North American and European MNCs who need to support an East Asian customer base.

In short, China is becoming a more attractive destination for foreign companies that desire to outsource IT or BPO services, particularly if the objective is to provide services to an East Asian customer base or East Asian based entities. The main challenge for foreign companies that desire to select an 'anchor city' in China is to develop and implement a robust framework to evaluate the competitive

advantages and market differentiators among the competing industry parks and locations. In addition, foreign companies will need to navigate the complex cultural and political landscape of China in order to identify the right fit to meet the strategic objectives and ensure an optimal experience.

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