GLOBAL TRENDS IN OFFSHORING AND OUTSOURCING

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ABSTRACT

The rapid growth of offshoring and outsourcing has transformed the way businesses are managing their operations in this global world. This has brought considerable benefits as well as challenges and often political backlash. In this paper, we analyze the basic facts and trends surrounding the offshoring and outsourcing phenomenon. We attempt to understand the genesis and basic drivers behind offshoring and outsourcing. We examine market trends, the prospects for growth, and the operational models followed in offshoring and outsourcing. We analyze buyer trends and the geographic source of buyers and the location trends for offshoring.

Keywords: Global Outsourcing, Offshoring, Business Process Outsourcing, Global Trends in Outsourcing, Trends in Offshoring.

INTRODUCTION

The use of the terms outsourcing, business process outsourcing (BPO), and offshoring have been used interchangeably and have caused considerable confusion. In the popular press, outsourcing is many times incorrectly referred to as companies employing service providers from other countries. Outsourcing refers to the decision of a firm whether to handle the function internally or to have another firm handle the function while offshoring refers to the location of the function. In other words, outsourcing and offshoring refer to different dimensions of a firm's decisions. Outsourcing occurs when a company uses another company to undertake some function previously performed internally or in-house. For example, many companies use other companies to handle their payroll functions. One of the pioneer providers of such payroll and finance services is EDS. Outsourcing is not a new concept.

In fact, outsourcing of manufacturing or production processes is the normal way of producing goods and services. Most companies are not sufficiently vertically integrated to undertake all their business and manufacturing functions. The new phenomenon of outsourcing refers to the recent dramatic growth of outsourcing of *services*, particularly of IT services and business process services as opposed to the outsourcing of manufacturing processes. Offshoring occurs when a company performs a production or service function in another country. The function or process can be performed within the same company (also referred to as a subsidiary, captive or shared service division) or can be performed by another firm. When the process is undertaken by another firm, referred to as a third party, the function or process is both offshored and outsourced. Figure 1 summarizes the distinction between outsourcing and offshoring.

GLOBAL OFFSHORING TRENDS

Offshoring and Outsourcing Services

The globalization of service offshoring and outsourcing begun to take off in late 1990s. The basic driving force was the growth and technological improvements in information and communication technology (ICT).

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In essence, these new technologies in ICT allowed digitization which in turn allowed the separation of service processes. Before the ICT revolution, services had to be done on site "in situ." For example, call centers and help desks were mainly based in-house prior to the ICT revolution because communication facilities in other locations were inadequate or expensive to set up or both. Offshored services begun with relatively simple processes such as computer coding, data management, help desk operations, and call centers. They are constantly expanding and evolving. These services are varied and include human resource administration, benefits administration, check processing services, financial reporting and analysis, asset management services, legal services, procurement services. Offshored services are usually categorized under two major classifications, either as an information technology (IT) service or as a business process service. If undertaken by a third party, these services are referred to as information technology outsourcing (ITO) services and business process outsourcing (BPO) services.[1]

ITO includes low-end services such as software coding, testing, and maintenance as well as higher-end services such as systems integration and consulting. Offshoring begun with low-end services for IT as a result of the labor shortage for skilled programmers in the United States and other countries. ITO is often classified into three major types, namely, infrastructure services, software services, and IT consulting. Infrastructure services include applications management and network management while software services (often referred to as applications development and maintenance or ADM) include desktop management, application development, application integration, and enterprise resource planning (ERP). BPO is often categorized according to the major business processes involved. These business process include finance and accounting, procurement, logistics, supply chain management, human resource management, and customer relationship management

Global Market Trends

The global offshoring market has grown rapidly from its initial phase of evolution in 1995-2000. The initial offshore market consisted of IT services as a result of the increased demand arising from the increased adoption of computer technologies by businesses. Much of these IT offshoring went to India. In 1999, software exports from India amounted to $4 billion (Evalueserve, 2004). By 2009, global ITO has grown to $56 billion (IDC-NASSCOM Strategic Review, 2009). Business process offshoring expanded together with the offshoring of IT services. By 2009, BPO has grown to $38 billion from $12 billion in 2004. Figure 3 shows the growth of the global offshoring market from 2004 to 2009. As evident from figure 3, the market for offshoring was impacted by the recession of 2008-2009. Particularly affected was the offshoring of finance functions. Despite the recession, the market did not decline on aggregate and is expected to resume its previous growth trend in 2010 and beyond

Offshoring services has as evolved from mainly IT services towards business process services and from low end to higher value added services and more knowledge based services such as research and analytics. The trend to more business processes is a logical consequence of the fact that the basic enabling technology of business process offshoring is the availability of software and effective infrastructure to handle business process outsourcing. There also appears to be a significant learning by doing involved both on the part of the clients as they transform their processes and on the part of the suppliers as they learn about their capabilities. The initial stage of the evolution of ITO and BPO was mainly to take advantage of cost arbitrage and to take advantage of skills. As clients learn more about their processes and the opportunities for outsourcing they are able to identify processes that can be potentially outsourced and thus are able transform their operating models to further concentrate on core processes.

Offshore Source Market Trends

ITO and BPO will continue to be dominated by clients from developed countries particularly the United States and those in Europe (particularly UK). In 2008, the U.S. alone accounted for 60 per cent of Indian IT and BPO exports. In terms of growth rates, the European market has grown significantly at a rate of 41% for the UK and more than 50% for the rest of continental Europe. Thus it is expected that among the developed countries, European countries will increase their adoption of the outsourcing service model. Other emerging markets for offshoring include countries in Asia Pacific (China, and Japan) and countries form Latin America (Brazil, Argentina, Mexico).

[1] To emphasize the fact that the major enabling factor of BPO is telecommunication technology, BPO is sometimes referred to as information and communication technology (ICT)-enabled services or ITES – information technology enabled services.

A closer look at TCS, the leading IT and BPO service provider in India, indicates the dominance of the United States and Europe as a major source of offshore services. As shown in figure 4 the United States, together with UK and the rest of Europe, accounted for 79 per cent of TCS's revenues in 2009.

Offshoring Buyer Trends

BPO will continue to be dominated by large buyers. BPO was pioneered by large sized companies particularly those in the global 100 then quickly expanded to the global 500. This dominance by large buyers is expected to continue. Figure 5 shows that 93% of all multi-process BPO contracts from 1996-2006 were accounted for by companies with annual revenues of at least US1 billion While ITO and BPO will continue to be largely dominated by large players, mid-market buyers are starting to emerge. Figure 6 shows the growth of the mid-market in the BPO space. The cumulative number of contract has risen from 3 contracts in 2000 to 20 contract in 2006. The emergence of mid-market and other smaller clients is attributed to several factors. First, BPO delivery providers have matured sufficiently in scale and experience to accommodate smaller organizations. Secondly, delivery models have migrated towards third-party providers allowing for the servicing of a diverse set of clientele (see discussion on delivery models below). Thirdly, common standards of delivery and execution have emerged and fourth, risks associated with outsourcing have diminished following experience and the learning curve

Adoption Trends

The bank, financial services, and insurance (BFSI) sector has been the major adopter of offshoring services in both ITO and BPO accounting for about 40-45 per cent of in total offshoring. Some of the largest offshore deals in IT were undertaken by financial services companies including banks and insurance companies. Other sectors that have adopted the offshoring strategy include high technology and telecommunications, manufacturing, travel, media and entertainment, pharmaceuticals, retail, healthcare, as well as governments. Figure 7 below shows the adoption rates by various sectors. A more detailed analysis of the BFSI sector indicates the substantial adoption of outsourcing and offshoring by banks as a strategic tool. In 2007, about 58% of banks outsourced some or all of their IT functions (operations, maintenance and development) and back office functions including payments, life insurance, mortgage, consumer credit. (Figure 8). Furthermore, 27% of banks outsourced their support functions including accounts payables, accounts receivables, human resources, treasury, procurement, property management, and general ledger. In 2012, the adoption rates are estimated to increase to 65% for back office and IT functions and to 40% for support functions.

Location Trends

Traditional offshore locations including India, China, and the Philippines will continue to be the major destination for offshoring. India will remain the dominant player and in a class by itself especially in ITO. In 2008, India accounted for 55 per cent of IT offshoring and about 35% of BPO (Everest Institute). The other second-tier countries, the Philippines and China, are expected to rise in prominence in BPO and ITO respectively. In the last 12 months, India and the Philippines together accounted for nearly 40% of new service delivery centers. A significant number of new delivery centers are expansions in terms of scale and in terms of new locations into tier 2/3 locations. The continued dominance of these locations is attributed to low cost, large scale, highly skilled talent pool and high degree of offshoring maturity. Delivery centers within the existing countries will become increasingly located in tier 2/3 cities in the traditional offshore locations India and the Philippines. Figure 9 shows more delivery centers were set up in tier 2/3 cities in 2008-2009 than in the major metropolitan areas.

The reasons for this migration to tier 2/3 locations include: wage inflation in the major metropolitan areas in India and the Philippines, supply constraint on skills and talent, infrastructure constraints in the major metropolitan areas and the improvement of operating and local environments in tier 2/3 cities across all geographies including the physical infrastructure (telecommunications, cost and availability) and social infrastructure. Global diversification of IT and BPO services offshoring will become a more prominent trend particularly for BPO. As reported by UNCTAD, five countries (India, China, Canada, Ireland, and the Philippines) accounted for 95 percent of the total market for BP offshoring in 2004. By 2008, the share of these five countries has declined to 80 percent. The countries that have made some inroads in the market for BPO include Malaysia , Vietnam, Thailand and Singapore in Asia; Czech Republic, Hungary, Poland, Ukraine, and Romania in Europe; and Argentina, Brazil and Guatemala, El Salvador, Costa Rica, and Mexico in Latin America. The global market will experience geographical diversification as new locations compete and become viable for offshoring. Global diversification is occurring partly as a result of multisource strategies adopted by service providers and by competition among destination countries.

Multisourcing appears to be a strategy that is being adopted with increasing frequency. Clients and providers are diversifying and expanding their service delivery locations to new emerging countries in order to mitigate concentration risk, to take advantage of skills and lower cost, and to take advantage of new markets. The following illustrates examples of comparative advantages and skills of specific countries that can provide further motivations for geographic diversification of offshoring. Vietnam is emerging as a low cost IT destination whose cost for IT functions is lower than that of China and India. Thailand is an alternative to mature destinations for tapping low cost English speaking talent pool. Ukraine is another emerging IT destination with technical skills derived from its Soviet-era legacy. South Africa has a significant number of skilled personnel in the actuarial field. Turkey has language skills for supporting European clients' particularly German speaking clients. Similarly, Guatemala and El Salvador is an emerging destination for bi-lingual English and Spanish talent besides being in the same time zone as the United States which is the major market for IT and BPO offshoring.

Trends in Delivery Models

There are primarily two types of delivery models: captives or third-party suppliers. The delivery model chosen appear to depend on the type of service, and the availability and maturity of service providers (suppliers). Captives refer to divisions or subsidiaries of multinational companies that provide services to the home company. Sometimes they are referred to as shared services division if they are serving different divisions of the same conglomerate company. One of the pioneers of this form of delivery model is GE Capital services. Third party suppliers are service providers or vendors of IT and BPO services. These can be local companies or other multinational companies serving other foreign companies. (There are other delivery models such as joint ventures and strategic alliances but these are not dominant). In the initial stages of the evolution of outsourcing, the primary service providers were the clients themselves owning subsidiaries in other countries to take advantage of cost differences and skills. As outsourcing evolved, local third party suppliers emerged and begun to acquire substantial capabilities. This trend has given rise to Indian multinationals. As reported by the World Bank, among the top 20 service providers sixteen are based in the United States and other developed countries while four are new multinationals from India (TCS, Wipro, Infosys, and Genpact).

In IT, third party service providers are the dominant service providers particularly in India comprising about 70% of the offshore market while captives account for the remaining. This pattern, however, is not observed in other countries that are characterized by the lack of local service providers with sufficient capability and scale. In these countries captives dominate the supplier landscape in both IT and BPO. In the case of the Philippines, about 90% of offshore exports are accounted for by foreign firms that are mainly captives of multinational companies. While captives are the major delivery models for new offshore locations, this pattern appear to be experiencing an evolution towards more third party providers for two reasons. There appears to be a growing trend for captives to divest. This is particularly true of financial services. The motivation for the client includes the need to consolidate their finances as a response to the recession and the financial crisis. At the same time, on the supply side, many third party providers have acquired sufficient maturity and financial capability to assume operations of captives not only in their own country but others as well. Thus third party providers especially from India have begun to multisource across different countries which in turn have increased the presence of third party players in the global IT and BPO market.

CONCLUDING DISCUSSION

The dramatic decade-old growth of outsourcing and offshoring of services has transformed the way businesses have managed their operations. In this paper, we have described some of the major trends that affect the offshoring and outsourcing market. If there is one theme that can summarize these trends is the fact that the offshoring market is very dynamic and is still continuing to evolve. New types of services are being offshored as businesses have identified processes that can be separated from core processes. New offshore locations are emerging. Markets are expanding not only in the United States but in Europe and Asia. Adoption rates by existing industries are rising and new industries are starting to accept the transforming model of outsourcing and offshoring.

FIGURES

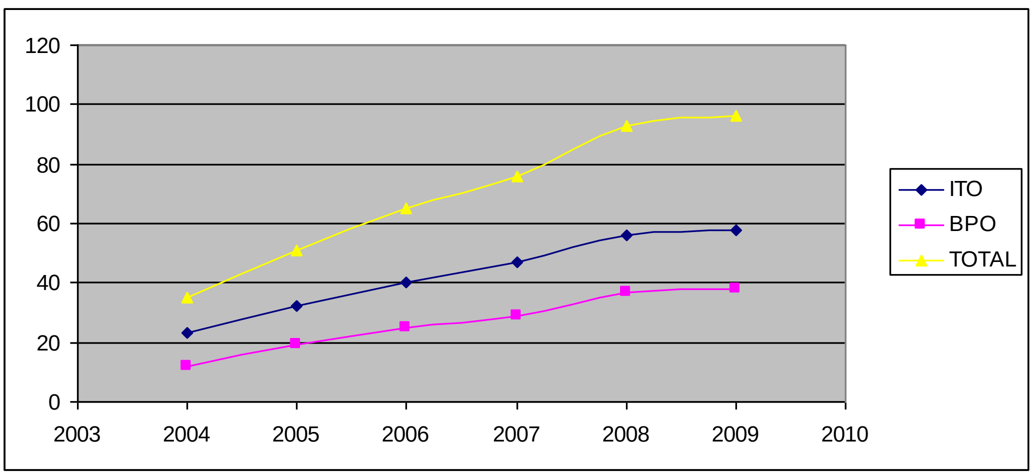
Figure 1. Distinction Between Offshoring and Outsourcing

	Where is the Function Located?	
	Domestic	Foreign
Function Performed Internally	In-house	In-house Offshored
Function Performed Externally by another firm	Outsourced	Offshored and Outsourced Third Party Offshoring

Figure 2. Business Process Outsourcing and Offshoring Services (BPO)

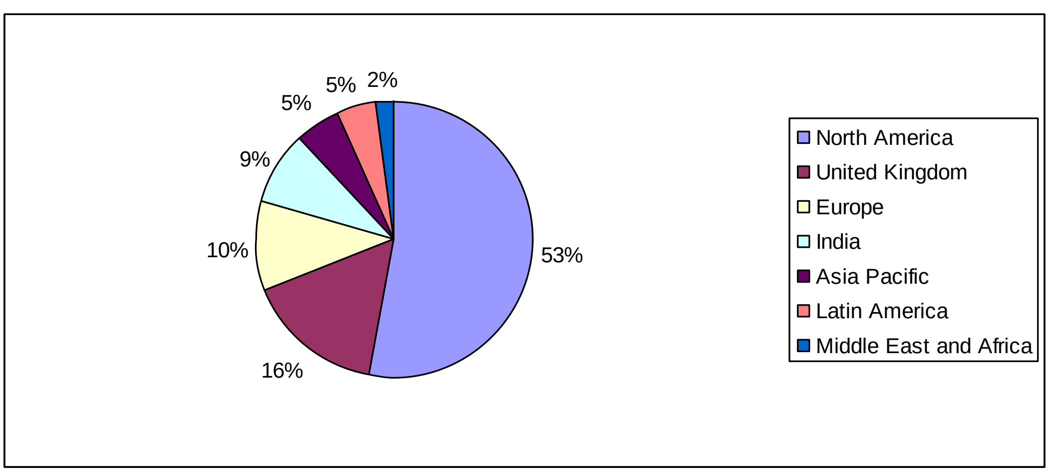
Procurement and Logistics	Supply chain management,
Finance and Accounting	Billing and Payments , bank processing, sales ledger, financial reporting, accounts receivables
Health Care	Medical transcription, medical billing, coding, tele-radiology
Payment Services	Credit card services, check processing, loan processing, electronic data interchange
Human Resource Management	Recruiting; Training; Talent Management, Pension fund administration
Content Development	Engineering and design, Animation
Customer Relationship Management	Contact Centers, Call Centers, Help Desk, Marketing, Sales
Knowledge Process Outsourcing	Legal Services, Patent Research, Business analytics, Marketing Intelligence, Pharmaceutical Contract Research

Figure 3. Global Offshore Market, 2004-2009, Billion US$



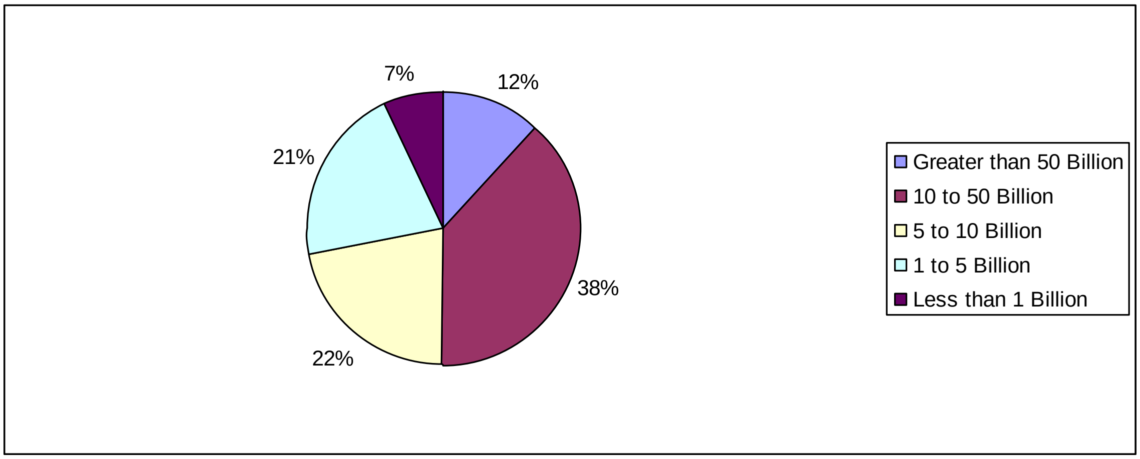
Source: Everest Research Institute and IDC-NASSCOM Strategic Review, 2009

Figure 4: Geographic Distribution of TCS Revenue, 2009-2010



Source: TCS, 2010

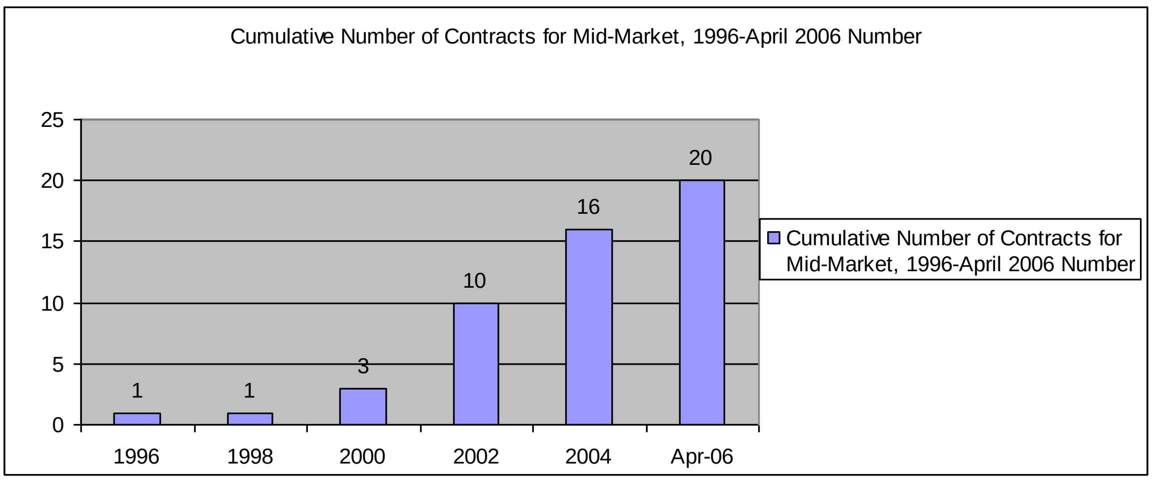
Figure 5. Multi-Process Contracts by Buyer Size, 1996-2006, In Percent



Note: Multi-process BPO contracts are defined as those with a least 2 minimum processes, at least US 1 million in annualized contract value, and a minimum contract term of 3 years.

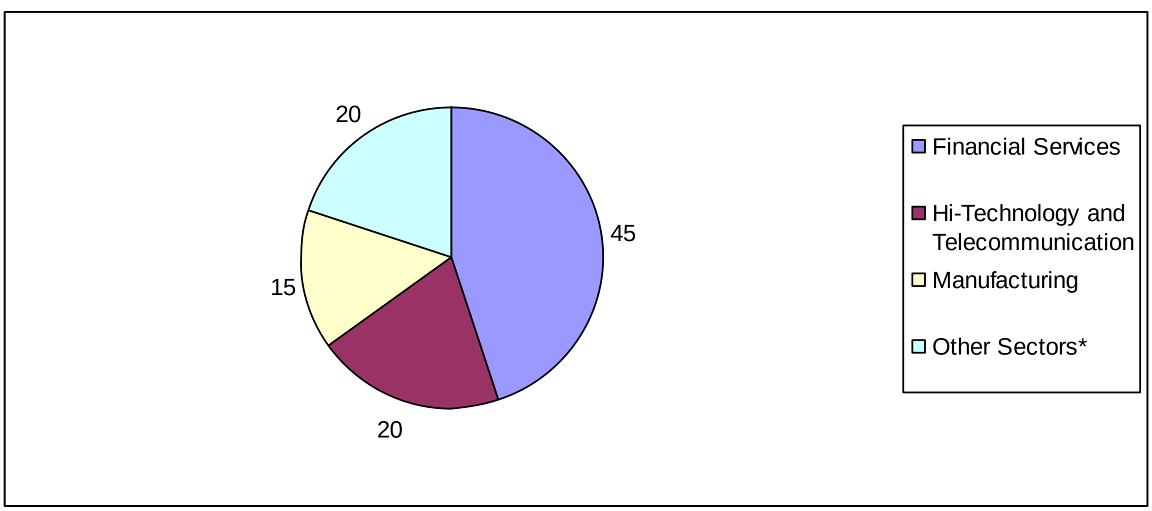
Source: Everest, 2007

Figure 6: Cumulative Mid-Market Contracts, 1996-April 2006



Source: Everest Research Institute, 2007

Figure 7. Offshoring Adoption Rates by Sector, 2007



Source: Everest Institute, 2008

Figure 8. Percentage of Banks that Outsource

% of Banks that Outsource	2007	2012
Back Office	58	65
IT	58	65
Support Functions	27	40

Source: Cap Gemini, World Retail Banking Report, 2007

Figure 9. Delivery Centers Established in 2008-2009

New Delivery Center Locations, 2008-2009	Tier 1 Cities	Tier 2/3 Cities
India	15	33
Philippines	10	15
Eastern Europe	7	15
Latin America	6	19

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