GUEST EDITORIAL

Global sourcing: recent trends and issues

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Abstract

Purpose – The purpose of this paper is to review recent trends and issues in global IT sourcing and to introduce papers in the special issue: “Social, managerial and knowledge aspects in global IT sourcing”.

Design/methodology/approach – The paper examines trends by regions including Brazil, Russia, India and China and also trends in Captive Centres and their strategies.

Findings – There will be a continuing rise in outsourcing revenues for global outsourcing, with BPO overtaking ITO within five years. Multi-sourcing will continue to be the dominant trend. India will continue to dominate but its role will change. China heralds promise but will still struggle to achieve scale in Western European and North American markets. Emerging country competition will intensify. Software as a service will be a “slow burner” but will gain momentum in the second half of the next decade. Near-shoring will be a strong trend. Outsourcing, by offering a potential alternative, will help discipline in-house capabilities and service. Knowledge process outsourcing will increase as the BRIC and emerging countries move up the value chain. Captive activity – both buying and selling – will increase (see below). Outsourcing successes and disappointments will continue as both clients and suppliers struggle to deal with a highly dynamic set of possibilities.

Originality/value – The paper is of value to both academics and practitioners working in the field of IT sourcing. The study of captive centres is in its early stages and the paper introduces further work in this area.

Keywords Outsourcing, Communication technologies, Business process re-engineering

Paper type Conceptual paper

The global offshore outsourcing market for IT and business services exceeded $55 billion USD[1] in 2008, and some estimates suggest an annual growth rate of 15-20 per cent over the next five years. In 2008 India posted some 65 per cent of the ITO and 43 per cent of the BPO market (Willcocks and Lacity, 2009)[2]. It is common to talk of Brazil, Russia, India and China as the BRIC inheritors of globalisation, offering both offshore IT and back-office services, and also, with their vast populations and
developing economies, huge potential markets. Indeed, in 2008 India exported $40 billion of such services, while China, Russia, and Brazil achieved $5 billion, $3.65 billion, and $800 million respectively. However, by 2009 there were over 120 other active offshore locations offering IT and business process services or captive locations for these. All were looking for new business. Moreover, the BRIC countries are not without their problems, with Brazil and China hardly leveraging their potential. Russia lacks government support and is being led into high-value but niche work, while India and China may even be seen turning to non-BRIC locations for some solutions, for example to secure low costs and labour availability.

A recent review suggests seven pressures shaping 11 major trends in global sourcing over the next five years. The LSE Outsourcing Unit points to the following key pressures in global offshoring/outsourcing markets: large Indian players moving up the value chain, best-shoring, vendors acquiring small outlets and moving into new sectors; large players offering “multi-tower” service across IT, HR, procurement, finance, and/or administration; client pressure towards multiple suppliers that are better managed and bound in; developing outsourcing services in many countries (see below); world economic and business pressures exerting continuing downward pressure on costs, but also towards innovation, exacerbated by the 2008-20010 recession; more sub-contracting and its hidden costs; and the unending search for new sources of skills, and for better labour models at more attractive pressures (Willcocks et al., 2009).

The most probable major trends can also be spelled out. There will be a continuing rise in outsourcing revenues for global outsourcing, with BPO overtaking ITO within five years. Multi-sourcing will continue to be the dominant trend. India will continue to dominate but its role will change. China heralds promise but will still struggle to achieve scale in Western European and North American markets. Emerging country competition will intensify. Software as a service will be a “slow burner” but will gain momentum in the second half of the next decade. Near-shoring will be a strong trend. Outsourcing, by offering a potential alternative, will help discipline in-house capabilities and service. Knowledge process outsourcing will increase as the BRIC and emerging countries move up the value chain. Captive activity – both buying and selling – will increase (see below). Outsourcing successes and disappointments will continue as both clients and suppliers struggle to deal with a highly dynamic set of possibilities (Willcocks et al., 2009). Let us now look at some of these trends and related issues more closely.

**Trends in India and China**

As mentioned earlier, India still holds the clear lead as the preferred destination for outsourced services, both ITO and BPO. Its role as the primary sourcing destination was cemented in the late 1990s as multi-national corporations struggled to deal with the looming Y2K conversion effort. India was well positioned due to its educated work force, foreign investment friendly government policies, stable political climate and English language proficiency. India has steadily grown in its delivery capacity, higher value capabilities and reputation throughout the last twenty years. All signs point to India’s continued dominance in both the ITO and BPO markets for the near future.

China, however, hopes to increase its role and presence on the global sourcing stage. Despite the relatively low percentage of software production that is exported (10 per
cent for China versus 78 per cent for India), the dollar value of the Chinese software industry itself is twice that of India's (Carmel et al., 2008). China continues to register impressive growth in its software industry. According to China Tech News, China's 18,000 software companies registered 50,000 software products and the industry realized a year-on-year growth rate of 30.4 per cent in the first half of 2008 (China Tech News, 2008).

What is enabling this growth is the strength of the Chinese economy and also significant government support for the domestic software industry. China's economy continues to be the fastest economy in the world and its GDP has been growing at more than 8 per cent per year. While the effects of the current global economic slowdown are still unfolding, China's national economic growth is likely to continue to outpace that of the rest of the world. Government support for the software industry and a national move towards increasing the importance and prevalence of exporting IT services promise to increase China's role in global sourcing markets.

A national policy entitled the "1,000, 100 and 10 Plan", begun in 2006, aims to support the establishment and growth of 1,000 software firms with global sourcing expertise, attract 100 global firms to establish a significant presence in China and promote ten cities within China as destinations for world class software development parks. This plan, specifically designed to enhance China's role in the global IT sourcing market, was created in concert with another national program started in 2000: “From Made in China to China Service”. This program includes tax incentives, tax-free zones, local incentives to ease creation of software parks, and special tax rates for employers of IT staff.

The combination of government support and a growing economy have created a vibrant if fragmented IT sourcing industry within China. In comparison to the much larger Indian outsourcing market, the Chinese market is less mature, more fragmented and more reliant on a single country, Japan, for revenue. Based on 2008 revenue, the top ten Chinese software development firms engaged in outsourcing, taken together, have similar revenue and headcounts to that of the fifth largest Indian outsourcing company. The top ten firms account for less than 30 per cent of the Chinese outsourcing market share (Ziqun et al., 2007).

This fragmentation of the market, combined with the growth rate, will produce significant mergers and acquisitions, and a consolidation of the market. The trend will be for the larger, more mature firms such as Neusoft, Inspur and DHC, to grow both organically and through merger activity.

While India's leadership role in global outsourcing is secure for the near future, China's national policies and its growing economy are encouraging multi-national firms to seriously consider China as a major complement in their sourcing strategy. China offers an educated workforce, strong government support, similar language and cultural compatibility for Asian-centric operations, and is making progress to address important issues of intellectual property protection and security. Using China as a location also allows firms to diversify the geo-political risks in their sourcing portfolio.

**Trends in non-BRIC countries**

BRIC countries, also known as Tier 1, are considered the most attractive sourcing destinations for ITO and BPO. This is mainly because of the scale of services, availability of skills, and the maturity of outsourcing services achieved by these
countries. Vendors as well as captive centres based in these countries, in particular in India, tend to move up the value chain, departing from specific and repetitive tasks which are usually captured by new entrants, so called Tier 2 and Tier 3 countries. By 2009 there were over 120 offshore locations in Tiers 2 and 3 involved in providing ITO and BPO services.

The relative attractiveness of BRIC and non-BRIC countries as sourcing destinations is dynamic. Their attractiveness needs to be understood in the context of the long-term global sourcing trends discussed earlier and the current global economic climate. In line with this trend, a highly competitive global services market presents opportunities for non-BRIC countries which are able to offer the right mix of costs, skills and reliable service.

Emerging sourcing destinations are attempting to differentiate their offerings from BRIC countries and from Tier 2 and Tier 3 rivals when competing for a contract. For example, Egypt is promoting itself as a low-cost destination for call centres that specialise in European languages. Dubai and Singapore are presenting their IT security systems and legal systems as an advantage in particular with regard to the outsourcing of high-security and business-continuity services. The Philippines, being a former US colony, stresses its long cultural ties with the USA and the excellent English skills of its population in order to attract English-speaking call centres. Morocco is trying to attract French-speaking European clients to set up call centres, while Central and South American Spanish-speaking countries are hoping to establish call centres that can provide services to the Hispanic market in the USA. In fact, recent studies have shown that some non-BRIC destinations have been successful in competing with BRIC by positioning their specialized skills-sets in particular areas, and often by offering lower costs than other potential destinations (Kotlarsky and Oshri, 2008).

Many US clients already use Central American suppliers for Spanish-speaking business processes such as help-desks, patient scheduling, and data entry. Synchronous time zones are one of the drivers for US firms that outsource work to Central or South America. Furthermore, access to skills and scale are two factors that clients consider in their assessment of attractive locations. In this regard, while Brazil has the advantage of a large population, the innovative creativity of its engineers and government programs supporting the outsourcing industry, Chile and Uruguay, for example, have exploited their time zone advantages, back-office proficiencies and government incentives to attract outsourcing work.

While South America is emerging as an attractive destination for offshoring and offshore-outsourcing, Willcocks and Lacity (2009) also predict that in the coming years organizations from Western Europe will increasingly source IT and businesses services to providers located in Central Eastern Europe (CEE). Among the key drivers of this trend are the closer proximity to the supplier, limited time zone differences, and lower transaction costs than those incurred through using Asian alternatives. In fact we have seen a trend in which specific CEE regions and in some cases even cities have been considered particularly attractive for sourcing (e.g. Budapest and Sofia).

In sub-Saharan Africa, several countries are actively seeking to become players in the global ITO and BPO markets. These countries have rapidly established their economies partly on the competitiveness of IT and IT services, for example Botswana and Kenya. Another example is South Africa, which is exporting IT and BP services primarily to UK-based clients, because of similar time zones, cultural similarities,
English-speaking capabilities and a good infrastructure. Mediterranean North Africa already exports IT services to Europe. For example, Moroccan IT suppliers are attractive for clients in France because of the common language, similar time zone, and cultural understanding. Still, there is a challenge for clients to assess which location is most suitable for their services, in particular with regard to non-BRIC locations. We discuss location selection criteria for non-BRIC countries in our book, *The Handbook of Global Outsourcing and Offshoring* (Oshri *et al.*, 2009 (forthcoming)). One observation regarding recent trends in non-BRIC countries is the growing number of captive centres established in Central Eastern Europe. The next section will discuss the captive centre phenomenon.

Trends in captive centres
Captive centres are wholly-owned subsidiaries located in an offshore location that perform work for the parent company. The work that is offshored to a captive centre varies from business processes, some even critical for the firm, to most common maintenance and development of the firm’s IT systems.

Captive centres surfaced in the mid-1990s. Genpac, formerly known as General Electric Capital International Services, was among the first large captive centre to be established in India in 1997. From the year 2000, the number of captive centres in India increased significantly. Among the Forbes 2000 companies, 44 had captive centres in India in 2000, 71 in 2003 and 110 in 2006, with about $9 billion worth of IT and BPO activities shifted to Indian captive centres in 2006 alone. We also learned that among the Fortune Global 250 companies, 153 had captive centres and in total these firms established over 350 captive centres around the globe (Oshri *et al.*, 2008). Among the most active sectors in setting up captive centres are the banking and finance, computer and electronics sectors. Based on our recent studies we expect that the captive centre market will grow by 30 per cent yearly. While the shift of work to offshore locations through captive centres is accelerating, there are several trends relating to the way parent companies utilize their offshore assets that need more attention. For example, in 2006 SAP Hosting Services in Bangalore outsourced several hosting services to Tata Consultancy Services (TCS), also based in Bangalore. Other companies, such as Standard Chartered and Hewlett Packard (HP), have followed a different approach in which their captive centres provided services to both parent company and external service providers. British Airways, on the other hand, sold a majority stake of its captive centre to the private equity firm Warburg Pincus in 2002. Apple Inc went even further and closed down its development centre in India in 2006. The captive centre landscape is changing and therefore calls for an examination of the strategies applied by the parent companies.

Captive centre strategies
We submit that parent companies of captive centres can follow three different strategies that will change the way offshore assets are utilized. The key strategies are: the hybrid, shared, and divested captive strategy. There are additional trends in the land of captive centres, such as the recent phenomenon known as “virtual captive centre” or some recent cases in which captive centres have been terminated or migrated to a new location. These, in our opinion, are not key strategies but rather either a specific arrangement or an outcome of a key offshoring strategy. We claim that the
The three key strategies form an evolutionary path of the basic captive centre model through which the parent firm gains experience in an offshore location and, over time and along with certain market conditions and business opportunities, one of these three key strategies will be pursued to improve the return on the investment of the offshore asset.

Pursuing a hybrid strategy means that the captive centre outsources units of work to a local service provider. The captive centre still performs work for the parent firm, but will source out work through either outsourcing or insourcing of activities that in most cases are non-core activities for the captive centre. In doing so, the captive centre seeks to focus on value-adding activities as well as seeking to reduce costs by contracting work to a local 3rd party vendor. There are risks associated with this strategy, we have learned. In the case studies we conducted, we have noticed that captive centres in India tend to outsource to a local vendor “a problem”. The main driver behind such behaviour is the high attrition levels and the rising costs in these specific regions. Clearly such an approach by the captive centre will not solve the problem, simply because the local vendor suffers from similar market conditions and therefore will not be able to protect its clients from the negative effects of worsening market conditions. We have also noticed that most captive centres lack advanced vendor management capabilities, which could even further undermine the client’s ability to manage its relationships with the vendor under such circumstances. Furthermore, as such outsourcing projects are small and limited in terms of their scale and growth potential, large sophisticated vendors tend to shy away from these projects, which leaves the client with small vendors who often lack vendor capabilities to assist the client throughout the outsourcing project lifecycle.

The second strategy involves the captive centre seeking to take on business from external clients. The rationale behind such a strategy is to turn the captive centre into a profit centre and to increase the volume of work performed by the captive centre so that the cost of unit work is reduced. By achieving these two objectives, the captive centre may become attractive for acquisition by a private equity firm. However, pursuing a shared strategy requires the development of sales capabilities offshore as well as a massive investment in the captive centre by the parent company. British Airways faced such a decision when its captive centre, World Network Services (WNS) grew quickly and was in a need of a massive investment by BA. In some cases, the magnitude of the investment might lead the parent company to rethink their approach regarding the role that the captive centre plays in its global strategy.

The third strategy is divestment. Arriving at a decision to divest part or the entire captive centre is often driven by two factors. First, the parent company realizes the opportunity to divest the captive centre because of its attractiveness to a local vendor or a private equity firm. A captive centre becomes attractive as an acquisition when it develops large scale operations through which the cost of unit work is on a par with the local vendor’s. The second factor that causes the parent company to consider selling its captive centre is its degree of confidence that service will not be interrupted because the ownership has changed. In other words, the parent company believes that the new owners will maintain or even improve the level of services provided by the captive centre. WNS is a good example of a divestment strategy which indeed was driven by these two factors.
We have often been asked the following question: which captive centre strategy should we follow and how would we know that we should switch strategies at some point? Our guidelines are simple: clarify your strategic intent behind the investment in an offshore subsidiary and keep an eye on local market conditions.

There are two main reasons for an investment in an offshore subsidiary. One is to reduce costs, and the second is to seek penetration to growth areas. When the key reason is costs, the parent firm should seek ways to reduce the cost per unit processed by the captive centre through a hybrid strategy. The risk with such an approach is that if the local market where the captive centre is located is not developed, there might not be sophisticated vendors that have developed the scale and skills to work in partnership with the captive centre. If the strategic intent is growth, we propose that the captive centre should quickly switch to a shared strategy in order to increase scale and reduce the cost per unit processed by the captive centre. When significant scale has been built into the captive centre’s operations, the parent firm could decide whether to divest the captive centre while contracting with the new owner for services or to maintain ownership. Such an evolutionary path requires a dynamic and demanding local market that is populated with sophisticated local vendors.

We have noticed that the study of captive centres is in its early stages. There are, therefore, various opportunities to build on our initial observations in order to expand the body of knowledge on this recent phenomenon. The paper by Penter, Pervan and Wreford in this special issue is a step in this direction. Additional research is needed to understand the entry strategy of captive centres and the impact that each entry strategy would have on the success of the captive centre. Furthermore, we have observed that many of the managers of successful captive centres, in particular those that have evolved into a shared strategy, are frustrated mainly because of a misalignment between the captive centre strategy and the parent firm’s global strategy. Often, the source of this misalignment is in the parent firm’s perception that the captive centre should perform simple and repetitive tasks in low cost locations. We therefore believe that there is an opportunity to contribute to both theory and practice by further examining this aspect.

The papers in this issue
The issues discussed above were at the heart of the second Global Sourcing Workshop that was held in Val d’Isere (France) in March 2008. This annual gathering of academics and practitioners offers a stage to discuss cutting edge ideas concerning BP and IT outsourcing and offshoring. In 2008 the workshop focused on social, managerial and knowledge aspects in outsourcing and offshoring. From the 18 papers presented and discussed in the workshop, four were eventually selected for this special issue.

The first paper is by Kevan Penter, Graham Pervan and John Wreford. The paper discusses success factors in BPO captive centres. By examining the existing literature on the success factors in outsourcing, the paper offers a framework that considers some key factors that affect the perception of value delivered from the captive centre. The paper examines two BPOs: one of them is the well-known captive centre, WNS, formally held by British Airways, and the other captive centre is from the banking sector. The paper arrives at a conclusion that the imperative factors affecting success in BPOs are cost savings, technical service quality and strategic issues. The paper
concludes with 12 guidelines to firms that are considering setting up a BPO captive centre.

The second paper by Robert Gregory, Michael Prifling and Roman Beck discusses the role of cultural intelligence in the emergence of a negotiated culture in IT offshore outsourcing projects. The authors analyse how individual project members in such projects cope with culture-specific behaviour, and how their cultural intelligence which comprises cognitive, motivational and behavioural dimensions) enables the emergence of a negotiated culture. Based on an in-depth case study of outsourcing relationship between the operations of a large German international bank and an Indian IT service provider which uses a cultural intelligence framework as a “sensitizing device”, Gregory, Prifling and Beck develop a model of cross-cultural interaction in IT offshore outsourcing projects.

The third paper by Elisa Mattarelli and Amar Gupta investigates social dynamics that emerge across subgroups of onsite-offshore teams and how they affect the process of knowledge sharing. Empirical investigation of social dynamics in subgroups is based on a qualitative study of eight onsite-offshore teams globally distributed between the USA and India and involved in knowledge intensive work. Their findings suggest that the specific status cue of being onsite drives status differentials across subgroups. These differentials are reduced when a client is directly involved with the activities of the globally distributed team. The negative effect of high status differentials on knowledge sharing is mitigated by the presence of straddlers liaisons who facilitate coordination and knowledge sharing across subgroups. Conversely, when status differentials are low, straddlers hamper spontaneous direct learning between onsite and offshore members.

The fourth paper by Erik Beulen examines the contribution of Human Resource Information Systems (HRIS) to the ongoing efforts by a firms to retain talents. The paper examines the challenges that firms face following the shortage of talent and skills in some particular areas. One particular challenge is the high attrition levels that IT vendors face, often on a global scale. While the majority of incentives are outside the IS realm, HRIS provides some support that is mainly supplementary to activities carried out by HR and project managers. The key contribution of this study, which is based on data collected in multiple sites, is in highlighting the need to localize some of the practices.

Notes
1. All financial figures are in US Dollars unless otherwise stated.
2. This figure is based on various sources, and reflects the more conservative of the estimates given.

References


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