

Consensus Report

Offshoring

Introduction

In the 2004 U.S. presidential political campaign, the subject of the flow of jobs overseas was a major debating point. Some politicians thought it was helping the U.S. economy and others thought it was hurting it.

However, according to Summit Strategies, a leading IT analyst firm specializing in the IT vendor community, IT vendors are between a rock and a hard place: “With an up-and-down economic recovery, IT vendors have a dual mission. They must offer products and services that are cutting-edge and affordable so that customers are willing to sign a deal. At the same time, vendors are facing cutthroat competition and cost pressures and must operate leaner and more cost efficiently than ever before. Every business must walk this tightrope, but the stakes are higher in the world of technology where the market may perceive one bad quarter as meaning a vendor’s products are not up to snuff, or that the vendor is losing competitive ground. As a result, IT vendors are on a constant quest to cut costs without sacrificing quality, and to deliver relevant products and services without taxing their financial resources to the limit. With this mission in mind, many U.S.-based IT vendors and, in particular, services firms, are looking overseas.”

Summit Strategies even places some of the blame for the poor perception of offshore outsourcing on the IT service vendors themselves: “While their offshore investments may make sense from a business standpoint, larger IT services and SI firms have done a poor job communicating and defending themselves against the tide of bad publicity related to offshore outsourcing.”

But no matter what side of the debate you are on, offshoring continues to flourish, and it appears that it will to do so for a long time.

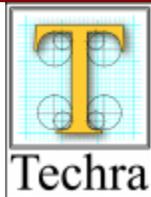
Offshoring Studies and Statistics

META Group claimed in a recent press release the “offshore outsourcing market will grow 20% annually through 2008.” According to META:

- By 2006, most IT organizations will have an offshore strategy
- The offshore outsourcing market currently exceeds \$10 billion
- The average enterprise will offshore 60% of its application work by 2009
- Political backlash toward offshore is not deterring market adoption

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“Offshore labor is proving to be a disruptive alternative in the outsourcing industry,” said Dean Davison, vice president at META Group. “With global resources costing one-third to one-fifth that of American employees - without accounting for hidden costs - and having higher process discipline, offshore strategies now pervade North American IT organizations. Offshore outsourcing provides access to worldwide resources otherwise unavailable to most enterprises. Application development and maintenance constitutes approximately 30 percent of spending for the average IT organization. Offshore typically reduces that expense by 30 percent, but introduces additional risks and challenges.”

A recent study conducted by AMR Research corroborates META Group's findings. According to AMR, “Manufacturers plan to increase outsource spending 9.3 percent in 2005 in an effort to contain internal IT costs. The study shows that executives plan to increase cost containment and outsourcing initiatives to help free funds for strategic investments that address customer demands. These investments include product innovation, improving service delivery and reducing supply chain costs.”

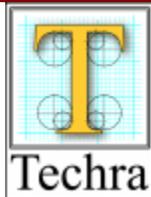
Some statistics from AMR's study indicate that:

- 25 percent of IT work is currently outsourced
- 53 percent intend to increase outsource spending vs. five percent that plan to decrease spending
- Growth for outsourcing offshore is double that of overall outsourcing
- Companies reinvest 60-80 percent of the money saved from outsourcing in IT and non-IT related projects

IDC also points to increased offshoring. A recent IDC study indicated the 2003 worldwide market for offshore IT services was \$7 billion, and it projects that number to grow to \$17 billion by 2008 – an annual compound growth rate of 20 percent.

IDC goes on to say that “spending by U.S. customers on offshore IT services will continue to be heavily concentrated on applications, with the most activity being in the custom application development, application management, and systems integration areas.”

IDC’s study also states that “The countries exporting the most IT services will be India, the Philippines, and China, joined by Central and Eastern Europe.” Summit Strategies also reports on an A.T. Kearney study that ranked countries based on their “offshore location attractiveness.” According to the study, the top 10 attractive countries for offshoring are:



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1. India
2. China
3. Malaysia
4. Czech Republic
5. Singapore
6. Philippines
7. Brazil
8. Canada
9. Chile
10. Poland

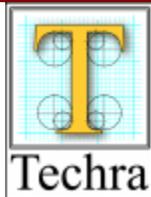
India – The Offshoring Powerhouse

Analyst firms agree that India is the leader in offshoring. According to Summit Strategies, “India is far and away the leading country” for offshoring. According to NASSCOM (India's National Association of Software and Service Companies), India's software and services export business revenue was \$12.5 billion for the year ending March 31, 2004, up from \$9.8 billion for 2003. This represents an annual growth rate of 30.5 percent. When contrasted with IDC's 20 percent compound annual growth rate for the worldwide market for offshore IT services, it indicates that India is not only the market leader, but it is increasing its market share.

The three leading Indian outsourcing companies, Wipro, Tata, and Infosys, account for a combined revenue of over \$3 billion and they employ well over 100,000 people (see Table 5). These companies have gotten so large that they are now viewed by many in the same light as global powerhouses IBM Global Services and EDS. The competition in India is so fierce that Indian outsourcing firms have begun offshoring some of their own work to China and other even lower-cost markets. According to Gartner, this trend, combined with the growth and maturation of other offshore markets and a potential shortage of qualified workers in India will contribute to a decline in India's share of the offshoring market over the next five years (see Table 7).

Risks and Challenges of Offshoring

As META Group points out, offshoring is not without risks and challenges. One of the main risks facing companies engaged in offshoring is security. Gartner addressed this issue in a press release from its IT Security Summit in London. In the release, Gartner stated, “Information security



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concerns surrounding global sourcing will gradually take center stage alongside public concern over job losses. As offshore outsourcing evolves from low value/low exposure projects to increasingly complex global projects involving core competencies, the cost and exposure of inadequate attention to security will increase significantly.”

Gartner went on to urge “enterprises and service providers to start an informed dialogue to address security early and to perform due diligence throughout the outsourcing life cycle. Although security issues will lengthen the sales cycles of global delivery, it will not stop enterprises from adopting global sourcing models.”

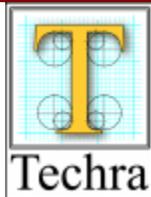
To help enterprises evaluate the high-level risks posed by security regulations in global delivery, Gartner created a country status risk model. In this model, Gartner recommends companies evaluate the following risk categories:

- Security Risks
- Privacy Protection Risks
- Government Interception Risks
- IP Risks
- Employee/Labor Laws
- Contractual/Legal Risks

Effects on U.S. IT Employment

There has been a great deal of focus in the mainstream press on U.S. IT job losses caused by offshoring. Although this report does not provide an in-depth view U.S. IT employment issues, it's important to note several analyst firms disagree with the perception that offshoring has had a completely negative effect on the U.S. IT job market. According to Culpepper and Associates, “After shedding thousands of jobs in 2001 and 2002, jobs in IT Professional Services firms bounced back with a 22 percent increase over the past year.” This is in line with ITAA’s findings that “incremental economic activity from offshore outsourcing created more than 90,000 net new jobs in the U.S. last year, and is expected to create 317,000 net new jobs in four years.” ITAA also claims, “Total vendor savings from outsourcing is expected to climb from \$6.7 billion in 2003 to \$20.9 billion in four years.” Companies are reportedly re-investing this money in new projects and initiatives aimed at making them more competitive in the global marketplace.

IDC also reports on a trend whereby offshore companies are opening offices in the U.S. and hiring local workers. According to IDC, "There is still a lot of work that requires a presence close to the



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client." Analysts have also found that much of this hiring is at the very senior level – people who can interact with executives and senior management at U.S.-based clients and prospects.

Areas of Analyst Agreement

- The worldwide offshoring market will continue to grow through at least 2008.
- Salaries are increasing rapidly in offshore locations such as India and China.
- These offshore salary and benefit cost increases, combined with declining domestic salaries, are eroding the price differential between domestic and offshore resources.
- There is a growing shortage of hireable people in India, forcing some Indian providers to offshore some of their work to China and other cheaper markets.
- Offshore service providers are starting to open up operations in the U.S. to be closer to their customers.

Areas of Analyst Differences

The major areas of analyst disagreement surround the effects of offshoring on the job markets in the U.S. and Western European countries and the long-term future of India and other countries as hotbeds of offshoring.

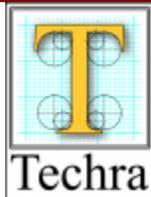
Although most firms agree that offshoring has resulted in a decline in U.S.-based IT jobs, opinions on the severity of the decline vary. Some firms believe offshoring has resulted in permanent damage to the U.S. IT job market, while others believe the changes are short-term and that recovery will occur (or has already started). Some firms point to the recent announcements by leading Indian firms that they are opening up operations in the U.S. and Europe. Unfortunately, most of the positions being filled are for senior project leaders or account managers, and not for rank-and-file programmers and analysts.

The future of India as the leading source of offshoring is also under debate. Although there is universal agreement that India is way ahead of the pack of potential offshoring locations, some firms feel that India's success may be the cause of an eventual lessening of their status. Several firms point to the increasing salaries in India and the resulting erosion of the pricing differential between onshore and offshore workers. Some also note several Indian firms are already starting to offshore some of their work to other locations, such as China, Malaysia, and others. However, some analysts believe the leading, established firms such as Wipro, Tata, and Infosys will emerge as leading IT outsourcing firms that can compete with global powerhouses such as IBM Global Services and EDS.

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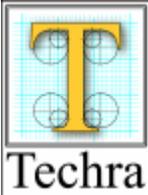
We are all part of a global economy, and the practice of using the best and most cost-effective resources to get a job done will not go away - either voluntarily or by legislation. Offshoring is with us now; it is growing rapidly; and it will continue to grow as long as U.S. and European firms view these regions as providers of quality, low-cost IT services.

India will continue to evolve as a provider of offshoring services. Its university system will continue to pump out well-educated, English-speaking IT professionals, but the price differential between Indian workers and onshore workers will continue to erode. Expect India to evolve into a middleman between the U.S. and European markets and the low-cost Asia-Pacific markets.

China is well positioned to be the next high-growth area for offshoring. Although the lack of a democratic government and a lesser command of the English language poses challenges, the sheer volume of qualified IT professionals and a university system that can churn out hundreds-of-thousands of new professionals each year will continue to keep China as one of the lowest cost sources of IT services.

The effect on the U.S. and western European IT job markets will continue for at least the next several years. The long-term effect will be a reduction of salaries as IT professionals are faced with the challenge of competing against offshore providers. The combination of lower salaries in the U.S. and Europe and rising labor costs in the leading offshoring countries will contribute to a degree of leveling of the playing field and an easing of the job crunch for onshore employees.

Based on opinions of several analyst firms, it appears that the average growth rate for offshoring will be about 25 percent per year through 2008.



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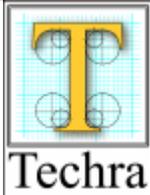
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Summaries Of Analyst Views and Predictions

2003 Worldwide market for offshore IT services	\$7 billion
2008 Worldwide market for offshore IT services	\$17 billion
Worldwide market for offshore IT services – Compound Annual Growth Rate	+20%
Source: IDC	

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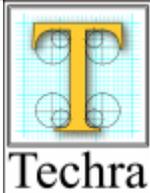
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Table 2 - Use Of Offshoring By U.S. Businesses					
	AMR	Gartner	ITAA	META Group	Forrester
2004 Offshore IT Spending By US Businesses				\$10 billion	
U.S. Spending with Offshore IT Services Providers as a Portion of Total IT Services Spending					
- 2003	3% or approx. \$5 billion				
- 2008	6% or approx. \$12.6 billion				
Annual growth rate of the use of offshore services by US businesses through 2008.	20%				
Growth of spending on IT outsourcing in 2004	7%				
Amount of application work that will disappear in the US because of automated tools and offshoring	70%				
Percent of U.S. businesses that outsource some or all of their IT operations today	<10%				
Percent of total amount spent by U.S. corporations for IT software and services that went to offshore outsourcing operations					
- 2003	2.3%				
- 2008	<10% of total market				
Market share by offshore services providers of U.S. custom application development, systems integration, and application management services					
- 2003	11%				
- 2004	17%				
- 2008	24%				

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Table 3 - Additional Amount Over Contract Costs That Businesses Spend To Create and Operate Management and Audit Teams to Supervise Outsourcing Contracts

	AMR	META Group
- 2003	11%	3% to 6%
- 2004	17%	
- 2008	24%	

Table 4 - Most Influential Factors When Deciding to Use a Firm's Offshore Professional Services and/or Integration Services

Cost	59%
Faster Time To Market	46%
Available Skill Sets	43%

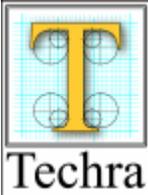
Source: Summit Strategies – from a 2004 survey of more than 200 IT and business leaders at enterprise and SMB customers currently using professional services or integration services

Table 5 – The Three Leading Indian Outsourcing Firms

Wipro Technologies	
Headquarters	Bangalore
# employees	28,500
Approximate Revenue	\$1.2 billion
Infosys Technologies Ltd.	
Headquarters	Bangalore
# employees as of Sept. 30, 2004	32,949
# employees as of Sept. 30, 2003	18,580
Approximate Revenue	\$1 billion
Tata Consultancy Services Ltd.	
Headquarters	Mumbai
# employees as of Sept. 30, 2004	40,948
# employees as of June 30, 2003	24,000
Approximate Revenue	\$1 billion

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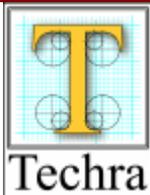
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Table 6 - India's Software and Services Exports Business Revenue	
- for the year ending March 31, 2004	\$12.5 billion (includes billings both by Indian outsourcers as well as wholly owned software development and Business Process Outsourcing (BPO) operations in India of multinational companies)
- for fiscal year 2003	\$9.8 billion
- Growth rate	30.5 percent

Source: NASSCOM

Table 7 - India's share of the offshore Business Process Outsourcing market	
- 2004	80%
- 2007	55%

Source: Gartner



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