



How to Lead the Market with Innovative Solutions while Keeping Costs Down: Offshore IT Outsourcing to Eastern Europe

Many organisations today unquestionably embrace offshore IT outsourcing to reduce costs and increase their competitiveness in the globalised market.

While offshore outsourcing objectives are frequently met, an increasingly large number of companies are facing substantial challenges with their offshore service providers. Five commonly raised issues are:

1. High staff turnover at the offshore service provider, which is detrimental to knowledge continuity, productivity and service quality.
2. Offshore teams are mostly resourced by inexperienced developers, as the typical offshore remuneration practices result in quick promotion of employees out of technical roles.
3. Low productivity as direct consequence of the junior and inexperienced teams. Numerous studies show that productivity differences between the best and the worst developers are frequently more than 10 to 1 (Boehm, 2000; DeMarco, 1985).
4. Reluctance of traditional offshore service providers to contractually commit to outcomes and share risks using a fixed price model. Most offshore IT outsourcing engagements are structured on a times and materials basis. Required outcomes are frequently not delivered within the agreed timeframe or with the required quality.
5. Increasing offshore costs due to ongoing wage increases in major offshoring centres.

This white paper will analyse the factors underlying these challenges, and explore how they can be mitigated using alternative offshore multisourcing strategies.

We will review the emerging trend of IT offshore outsourcing to Eastern Europe and examine the benefits of a multisourcing approach.



Offshore Outsourcing Market Trends

The global offshore outsourcing environment has grown significantly in recent years. In 2002, only 10 percent of multinationals outsourced IT work offshore, but by 2008 this figure rose to 70 percent (Oppenheimer Equity Research, 2008). In 2012, spending on global IT Outsourcing (ITO) services is estimated at US\$ 251.7 billion (Gartner Research, 2012).

As the benefits of IT offshore outsourcing are realised and implementation capabilities are refined, the cost and performance gap continues to grow between organisations that have outsourced their IT offshore and those that have not.

While the Global Financial Crisis (GFC) caused uncertainty and a softening in overall market demand and volume of business activities, the current economic climate is generating additional demand for selective outsourcing and offshoring, as companies are looking to further increase their competitiveness.

Major catalysts for the expansion of offshore IT outsourcing are new technologies such as cloud computing and the availability of low priced telecommunications services. These new technologies can facilitate highly cost effective operations using globally distributed IT teams. They contribute to the reduction of offshore outsourcing overhead costs, lowering entry barriers. Offshore outsourcing benefits can even be achieved in the smaller projects that are typically undertaken by small and medium enterprises (SMEs).

With the emergence of micro offshore outsourcing businesses and websites such as freelancer.com, small businesses, or even individuals, can obtain easy access to a large variety of offshore outsourcing services provided by individuals or small teams across the globe.

Challenges of the Traditional Offshore Outsourcing Approach

While traditional offshore locations, including India, China, and the Philippines, continue to be the major destination for offshoring, there has been increasing expansion to new locations, with Eastern Europe emerging as one of the major new outsourcing locations.

The reason for this diversification lies in some of the challenges facing traditional offshore locations:



Wage Inflation

Given the ongoing and significant growth of IT Outsourcings service volumes, major established offshoring centres are starting to face a supply constraint on skills and talent. Due to companies competing for a limited supply of talent, wages inflation is increasing.

Recent research showed that labour costs for IT outsource providers in key offshore markets, including India and China, are increasing on an average of 8-11% per year (IDC, 2011).

Increasing Attrition Rates

Attrition rates in India have doubled in the last decade as the local work force has become more affluent and discerning.

Given the high demand for skilled workers, there is increasing competition between companies looking to fulfil resourcing requirements. This generates not only pressure on salaries but it also increases attrition rates. For employees, moving to a new company is the quickest way to obtain a salary rise or a promotion.

Scarcity of Senior Experts

One of the challenges facing outsourcers in India is the limited number of senior software developers with more than 5 years of experience. This is the result of the salary pyramid, where project managers are paid significantly more than software developers. Individuals with over 5 years of experience who are not in management, or minimally, team lead positions, are considered professionally unsuccessful.

This results in a predominance of junior teams, who may be reasonably skilled in coding, but lack a good understanding of the business domain and so do not have enough experience to produce a high quality solution design.

Low Productivity

India's workers continue to suffer from poor productivity. Despite working in modern facilities, most Indian IT workers (including recent graduates) lack basic technical skills and the required level of English language proficiency. The Wall Street Journal reported that 75% of India's technical graduates are unemployable by their IT sector (Anand, 2011). There is a more frequent perception in businesses that are outsourcing that the benefits of lower labour costs are being eroded by much lower productivity.



Reluctance to Share Risks

Times & Materials based engagements are still the norm for offshore IT outsourcing. Most of the engagements are based on the extended team model where a stipulated number of resources are engaged over an agreed period of time. With costs defined on a T&M basis, most risks are transferred to the client, while productivity and the business outcomes remain uncertain. Due to issues with productivity and resource attrition rates, a low daily rate doesn't necessarily equate to cost effective outcomes.

Ideally, we would see in the future a more frequent use of the hybrid engagement model, in which the initial scope/solution definition phase is based on time and materials, while the solution implementation is based on a fixed price model.

An Alternative Approach to Offshore Outsourcing

Typically, when faced with repeated challenges using a traditional offshore outsourcing model, companies will conclude that offshoring is not working for them. They may either attempt to do onshore outsourcing or insource their IT projects/operations.

We suggest that an alternative approach should be considered:

Multisourcing – Diversify Your Offshore Outsourcing Locations

Multisourcing is being adopted with increasing frequency. Companies are diversifying and expanding their outsourcing service locations to new emerging countries in order to mitigate concentration risk and to take advantage of additional skill pools at competitive costs.

One of the emerging trends is to select Indian outsourcers for Call Centres, Maintenance & Support Services, and choose Eastern Europe outsourcers for Custom Application Development, COTS Customisation and System Integration Services.

Aim for Innovation and Flexibility, not only Cost Saving

Traditionally, the motivation for offshoring or outsourcing was to cut costs. However, today the decision is influenced by numerous strategic factors. To be competitive, organisations need to drive innovation, enable growth and increase flexibility. Offshoring or outsourcing activities can help organisations become more flexible and adaptive, and react faster to changing markets.



With most competitors utilising traditional Indian based outsourcers, the opportunity exists to drive innovation, enable growth and increase flexibility via an alternative approach. Namely, by diversifying outsourcing options through multi-sourcing and utilising the benefits of Eastern Europe based outsourcers.

The Rise of Eastern Europe Outsource Service Providers

The most important reasons for the rise of Eastern Europe Outsourcers are:

1. Excellent Education and Technical Skills

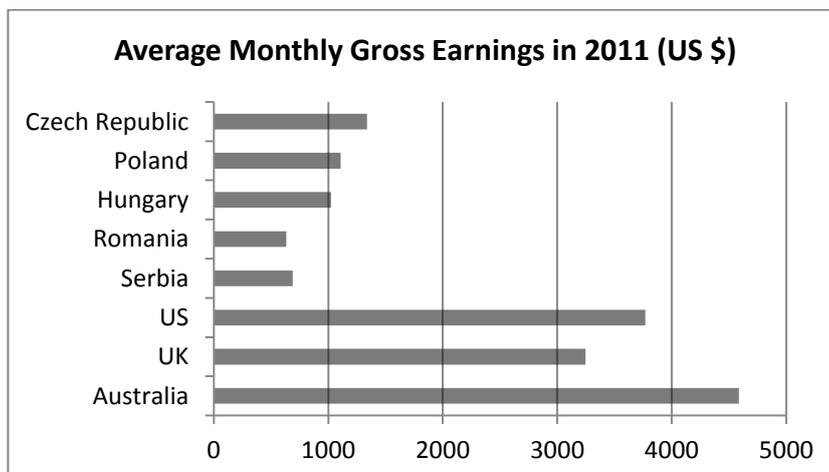
Eastern Europe is known for their excellent education system, which is focused on technical sciences and imparts strong skills in mathematics, physics, and computer science.

An example is the specialist Mathematics Gymnasium in Serbia, a selective high school for gifted and talented students of mathematics, physics and informatics. It ranks number one at the International Science Olympiads according to the number of medals won by its students (more than 400). This exceptionally well trained talent pool is a perfect basis for building a highly innovative, yet cost effective IT Industry.

2. Competitive Labour Cost

Labour arbitrage is still one of the most significant drivers for offshore outsourcing. As it can be seen in Figure 1 below, the labour cost in Eastern European countries is in the range of 15%-35% of those in major western economies.

Figure 1: Labour Arbitrage - Eastern Europe vs Western Countries



Source: Vienna Institute, Australian Bureau of Statistics, UK Office for National Statistics

It may be surprising to discover that some of the lower wage countries, such as Serbia, have more competitive labour costs than India. Table 1 below, provides a



comparison of the hourly net wage for application developers in India and Serbia.

Table 1: Hourly Wage Comparison India/Serbia for IT SW Developer

Experience	Av. Hourly Net Wage in India	Av. Hourly Net Wage in Serbia
Junior Application Developer	US \$3.7	US \$3
Medior Application Developer	US \$8	US \$5
Senior Application Developer	US \$12	US \$9

Source: ZDNet Asia India IT Salary Benchmark 2012, SIEPA ICT in Serbia 2011

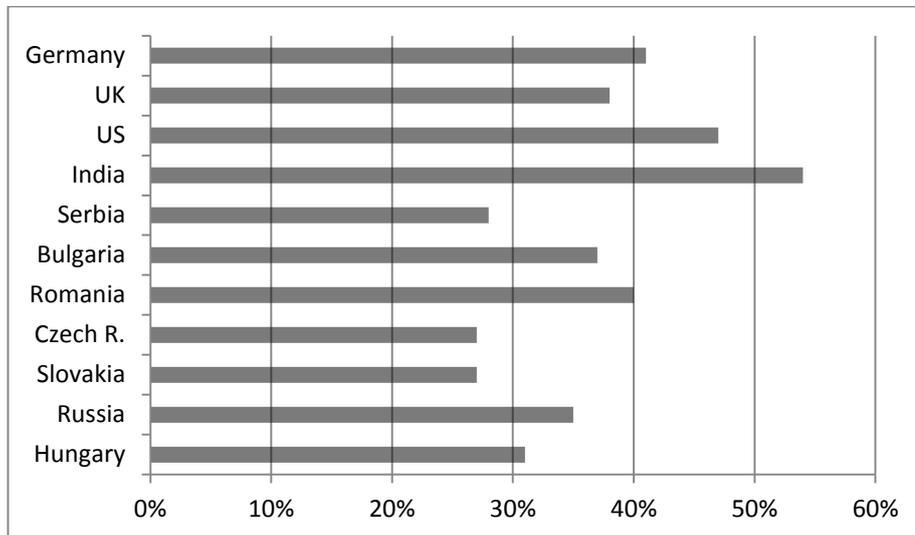
3. Low Attrition Rates

One of the characteristics of the region is low attrition rates. This can be contributed to multiple factors:

- Lifetime employment in a single company was the norm in Eastern Europe during socialist times. While this is slowly changing, there is still a high level of mutual loyalty between employers and employees
- IT and engineering professions are highly valued, in most cases more than low/mid-level management roles. As a consequence, software engineers do not strive to become managers but rather pursue a long term technical career. This results in teams with highly experienced, long term employees.
- As the outsourcing industry is still in the early stages of development, the demand for skills is still not at the levels of an established outsourcing nation such as India. Post GFC unemployment levels are frequently above 20%, with significant number of unemployed college and university graduates.



Figure 2: Percentage of Employees Actively Looking for Job Change



Source: GfK Custom Research, 2011

4. Cultural Similarities

Cultural aspects are subtle and more challenging to quantify, but certain patterns can be observed:

- Eastern European Outsourcers are more technically and bottom-up driven, rather than mostly top-down management driven. A culture promoting questioning and criticism results in higher levels of innovation and a more proactive approach. A drawback is that greater attention is necessary to ensure all management directives are followed.
- Eastern European Outsourcers are quite comfortable dealing with uncertainty and changing requirements. This helps them to fully adopt Agile Development Methodologies, which are commonly used across the region.
- Individuals in Eastern Europe are largely driven by exposure to technical challenges rather than solely by promotion and salary. Learning and increased insight becomes natural to the team and is also very well suited for agile development.
- The company hierarchy in Eastern Europe is generally flat and teams find it natural to be agile.

5. Privacy, Intellectual Property and Data Protection

Most Eastern European countries are either EU members or are in the waiting line to become one. As such, they have harmonised their relevant Intellectual



Property, Patent and Privacy Protection laws with EU laws. Enforcement practice is being continuously expanded, with significant improvements from the situation a decade ago.

6. Excellent English Skills

English language classes are an integral part of education at all levels in Eastern European countries. The IPSOS strategy marketing survey conducted in 2010 showed that 87% of young unemployed people in Serbia speak English well (Very good 16%, Good 35%, Medium 34%). The same survey showed that over 50% of young people also speak other languages, primarily French, Spanish, Russian and German.

Main Eastern Europe Outsourcing Locations

The main Eastern Europe outsourcing countries are:

- Tier 1 Established Outsourcers: Russia, Ukraine, Romania, Hungary Poland, Bulgaria
- Tier 2 Fast Growing Outsourcers: Belarus, Czech Republic, Bulgaria and Serbia
- Tier 3 Emerging Outsourcers: Estonia, Slovakia, Croatia, Moldova and Latvia

(Source: CENTRAL & EASTERN EUROPE IT OUTSOURCING REVIEW 2010 by CEE Outsourcing Association)

Even Indian companies are recognizing the advantages of outsourcing to Eastern Europe and are opening outsourcing centres in the region. One example is the Embassy Techzones IT Park in Serbia, which is a maiden venture of the Embassy Group, a leading Indian real estate development firm (Embassy Group, 2012).

Summary

In the post GFC environment, IT Offshore Outsourcing has been fully embraced as a critical element in increasing competitiveness in the current market environment.

Looking to differentiate and overcome challenges with traditional outsourcing locations, companies are increasingly turning to multisourcing strategies to complement their current vendors with Eastern European outsourcers.

The next 5-10 years offers a window to leverage offshore outsourcing opportunities to emerging centres in Eastern Europe, where there is still a plentiful supply of highly skilled IT labour and very competitive costs.



While we can predict that in the future, as outsourcing to emerging centres in Eastern Europe becomes established, the skill availability and labour cost arbitrage advantages will decline, technical superiority over alternative outsourcing destinations is likely to remain.

Global IT Factory

Global IT Factory is an Australian IT Professional Services company, specialising in the provision of technically leading edge and cost effective IT Services. We leverage our Central & Eastern Europe based delivery teams & partners, combined with our experienced local team. Our IT Factory approach emphasises strong project management and efficient and repeatable IT Solution Delivery processes. Global IT Factory brings offshoring cost efficiency to both large and small-to-medium enterprises

For more information visit our website: www.globalitfactory.com

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