



IT Outsourcing in China: How China's Five Emerging Drivers Are Changing the Technology Landscape and IT Industry

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Truth be told, researchers can use statistics to argue just about any point of view. Case in point: A recent study by McKinsey concluded that China's IT outsourcing industry, often mentioned in the same breath as India's these days, won't pose a threat to its continental rival for many years. According to the study, "The Chinese must consolidate their highly fragmented industry to gain the size and expertise needed to capture large international projects."

We could not disagree more about the prediction. On the contrary, China is in a remarkable position to become an IT outsourcing superpower in less than five years' time. Recent fundamental changes and trends also will accelerate the growth of the China IT services industry.

Let's take a look at the statistics. According to Gartner Dataquest, a U.S.-based research firm, IT services revenue in China is projected to reach \$8.9 billion in 2006, a compound annual growth rate of 19.6 percent. Another report from IDC, also a U.S.-based researcher, states that China's IT services market has grown nearly 42 percent a year since 1997.

According to a January 2005 report from Yu Guangzhou, Vice Minister of the Ministry of Commerce in China, the Chinese software industry has developed rapidly, with an average annual growth rate of 30 percent for the past five years. Software exports have grown a whopping sevenfold during the past five years. In addition, sales revenue of China's software industry increased from USD 7.16B in the year 2000 to USD 19.3B in 2003, while software exports increased from USD 0.25B to USD 2B in the same period.

The McKinsey report also stated that 90 percent of China's IT services work is done locally, and that it accounted for \$6 billion (nearly half of India's total revenues) in 2003; in comparison, only 30 percent of India's IT services are done locally. China's IT services growth in the domestic market should be seen as a sign of strength, not weakness. The drivers of the growth, including China's membership in the World Trade Organization more than three years ago and the upcoming 2008 Olympics in Beijing, are great indicators of the long-term success of China's IT software industry. Without a strong local market, India's IT services are far more vulnerable.

There are five key drivers for China's IT outsourcing market growth. Many of the research companies ignore these drivers, but all are critical to the success of China's IT software and services sectors:

1. **Zero Duty** –In 2005, all 251 tax items related to IT products adopted zero duty. This presents both challenges and opportunities for the domestic IT industry. It will allow providers to be more competitive in terms of pricing, but also may invite foreign competition from India. It also means more opportunities for U.S.-based IT services providers and multinational companies, since they can increase both their business and their profits.
2. **Standards Development on Core IT Technologies** - From operating systems to 3G, China has already made an impact on standards, and, with major events such as the Olympics in 2008 and World's Fair in Shanghai in 2010, its influence will continue to grow over the next five years. Standards development has already become an important influencing factor in China's IT industry development. On one hand, technological standards are the lifeline that determines the prosperity of an IT enterprise and function as a

key information industry development index for the nation. On the other hand, disputes on domestic IT industry-related standards are becoming more and more intense. The domestic IT industry is eagerly awaiting the launch of the standards, and China is emerging as a key player in shaping the standards that will define the nature of global competition in the technology arena.

As we all know, technology standards are established in a marketplace when a critical mass of vendors and customers adopt a certain technology. In the near term, China will be successful in defining standards, as its large domestic market, low-cost IT services sectors and centralized government provide a competitive advantage. The Chinese government and its IT services industries can realize huge benefits by attracting investment capital, building technology know-how and using its market potential to attract global IT services providers. China's IT software and services industries are poised to move from catch-up position to leadership in a much shorter period of time than India's.

Some other interesting facts include a recent announcement by the Chinese government of a major commitment to Linux, for which it will be drafting a new standard specifically for the Chinese market. Last November, Sun Microsystems announced a multimillion-dollar deal to provide Sun's Java Desktop to an estimated 200 million Chinese workers at an affordable price. Java Desktop is a toolkit that includes the StarOffice 7 (sorry Microsoft), the Mozilla Web Browser (sorry Internet Explorer), and customized applications for e-mail and instant messaging.

3. **Tougher Penalties for Intellectual Property Rights (IPR)** – To boost enforcement in the face of growing international pressure, on Dec. 23, 2004, China's highest courts announced stricter interpretation of China's existing IPR laws. According to the courts, China has lowered the threshold for punishable offenses to USD 6,000 from USD 12,000-24,000 and has increased prison sentences from three to seven years. And for the first time, dissemination of pirated goods or software over the Internet is explicitly forbidden.
4. **Outbound M&A activities** – China will take a very different path than India to becoming an IT outsourcing superpower. Unlike India's leading IT outsourcing firms such as Infosys and Satyam, which fundamentally grew their businesses organically and became powerhouses in the IT outsourcing world, the Chinese are willing to acquire well-known brands to grow and expand. Many state-owned enterprises (SOEs) operate like "super-capitalists," combining entrepreneurial agility and government support, both in a financial and regulatory sense. The recent purchase of IBM PC division from Lenovo is a good example. China-based TCL, the largest TV manufacturer in the world, obtained majority control of Thomson's television business, which also owns the RCA trademark. It won't be surprising at all for a major Chinese IT services provider to conduct a joint venture or outright acquisition to become one of the well-known names in the IT outsourcing world.
5. **The Growing IT Talent and "Sea Turtle"** – China has a reverse brain-drain situation and a fast-growing IT talent pool. According to research, there are about 2 million software developers in China, with a CAGR of 22 percent over the last five years; in addition, there are currently 5.86 million engineering graduates, with a CAGR of 13 percent. Moreover, many China-born, U.S.-educated businesspeople and IT executives, known as "Sea Turtles" or "Hai-Gui," are going back to China to start their "China Dream." These savvy executives are importing the knowledge and experiences they gleaned from the best universities and companies in America and reaping the rewards in their homeland. One of the best-known Sea Turtles is Charles Zhang, Ph.D., founder of Chinese Internet Portal Sohu.com (market cap: \$540 million). Zhang, a 1994 physics graduate from the Massachusetts Institute of Technology, got in on the ground floor of the Internet market in China. He started the company in 1996 as a copycat of Yahoo with personal savings and a loan of USD 225,000.

Peggy Yu, another Sea Turtle, came back to China in 1998 after 11 years in the U.S. to start DangDang.com (the Amazon.com of China), and she now heads up a successful online bookstore in China.

China's efforts in becoming a future IT outsourcing powerhouse are also supported by government officials, many of whom are forging partnerships with multinationals to train information technology engineers. For example, IBM has signed deals to train 100,000 software specialists over the next three years. Microsoft is spending \$750 million to build a technology center that will expose Chinese hardware and software engineers to Microsoft technology. In addition, Microsoft is donating \$25 million over the next three years to develop software for schools, and another \$10 million over the next five years to put Microsoft products in elementary schools.

Outsourcing IT to China brings more opportunities in the fast-growing Chinese market. Technology services companies must pay careful attention to China's regulations and changing technology standards and adapt their strategies accordingly. China will become the largest IT outsourcing player, and it will be to your own peril to ignore this powerful and important market.