

March 2009

## Guest CEO Editorial

**THOLONS**

Advisory • Investments • Research



### Mr. David Chen

President  
VancelInfo Technologies Inc.

**David Chen** Under David's stewardship as President, VancelInfo has grown from 150 employees to over 5000 employees. David has led key customer wins for VancelInfo including the exclusive VancelInfo-managed PeopleSoft ODC and the VancelInfo-managed Citibank Global Testing Center in China. Since most of VancelInfo's customers are headquartered in the US, David is heavily involved in outsourcing-related activities both in China and the US. David has played a leadership role in securing venture capital funding for VancelInfo, first from Doll Capital Management (DCM) in 2005, and then from Sequoia Capital in 2006. The following year (2007), David led VancelInfo to become the first and only software outsourcing company to go public in the US (NYSE:VIT).

Prior to leading VancelInfo, David held management positions at IT Services companies IBM and Oracle and at KPMG where he led an ERP consulting group. David holds degrees from schools in China and the US, receiving his Master of Science in Computer Engineering from the University of California, Irvine and his Bachelor of Science in Electrical Engineering from Tongji University. Today, David stays involved with academic institutions in their research about VancelInfo's global success story. He regularly hosts visiting MBA classes, providing input for the Stanford Graduate School of Business case study about VancelInfo published in January'09.

“China: Poised to leapfrog economic and political rival India? Not anytime soon, but the trend looks promising”

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## Tholons: China Outsourcing Market Size and growth

**David Chen:** The total global offshore IT Services Industry was nearly US\$50 billion in 2007, and is estimated to have grown to ~US\$58 billion in 2008. India offshore providers continue to take the lion's share of this business, leaving a relatively small amount of US\$2 billion (4%) in 2007 to neighboring China. The growth rate over the next five years will favor China and it is estimated that China's share will double to 8% by 2012. China-based providers is expected to double that of the overall market in the foreseeable future,

Given uncertain economic conditions, however, annual growth rate estimates have dropped across the board. Infosys, the leading India-based provider, has enjoyed growth rates of 30% over the past decade. However, these outstanding growth rates are likely to slow over the foreseeable future. IDC has recently dropped their 2009 estimated growth rates for the China-based offshore market by 6% to 23%. Although it appears the China-based providers are not immune to the global economic slowdown, it is interesting to note that future growth rates are likely to outpace the overall offshore outsourcing market (essentially signified by India-based providers) by a significant margin. Below we explore some of the factors that have been favorable to China-based providers such as VancelInfo.

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## Tholons: China Advantage

**David Chen:** China's remarkable growth in offshore software outsourcing has been due to a number of factors, including:

1. The government of China, recognizing catastrophic impact on the environment by heavy industry, has enacted favorable policies to nourish sustainable and profitable industries including software outsourcing. There are a host of government programs, tax policies, and investment options designed for high tech companies and service providers.
2. Top-notch IT and physical infrastructure. China's outsourcing growth can be attributed to massive investments in areas favorable towards off shoring, such as infrastructure development, technical skills, security, and internet connectivity. Anyone having traveled to India's outsourcing hub Bangalore, a high-tech Mecca stuck with a colonial-era infrastructure, will appreciate this level of infrastructure investment. Global events such as the 2008 Beijing Olympics and 2010 Shanghai World Expo are also helping to drive further infrastructure investment in key outsourcing cities and software parks across China.
3. World-class engineering talent. China has an increasing supply of software engineers. Every year, more software related graduates enter the workplace compared with both India and U.S. Chinese universities graduate over 5 million students per year with more than 700,000 of those being engineers. Nearly 3000 PhDs in Computer Science graduate each year. A study released in late 2008 by PricewaterhouseCoopers (PwC) and Duke University shows that China is gradually taking

market share from India in the technically sophisticated global software product development market. India's share has dropped from 68% in 2002 to 50% in 2007. The country's share is expected to drop another ten percent during the next five years to 40%. China has capitalized on India's loss by growing from 1% pre-2002 to 9% in 2007. This continuing trend has its roots in China's huge advantage in engineering talent.

4. Risk diversification - The vast majority of Fortune 500 firms have engaged with and continue to engage with Indian outsourcing vendors for their software development needs. China is increasingly seen as a choice for Risk Mitigation & Diversification from India-only sourcing exposure. In light of recent political and economic instabilities, China is being seen as an outsourcing destination that must be considered by corporate decision makers. CEOs are ultimately responsible to shareholders, and are expected to minimize risks by proactively searching for ways to diversify company portfolios – including outsourcing portfolios. The old adage applies here as well – do not place all of your outsourcing eggs in one basket.
5. The China economy and market growth. After having grown in the 10-11% range the past 5 years, China's 2009 GDP growth is forecast to fall back to year 2000 levels – 8%. While this is a significant slowdown from recent growth, it still far outpaces growth forecast for the rest of the world (both developed and developing economies). Multinational Corporations (MNCs) recognize this, and are in no mood to cut back on investments in the single fastest growing economy in the world. As a complement to their China/APAC expansion plans, MNCs often select local China-based vendors to assist with their regional software system rollouts. ISVs, which may or may not have China-based operations, also recognize the criticality of penetrating the China market to maintain positive growth rates. In the Middle Kingdom, where strong and long-term relationships are often important to business success, partnering with a China-based provider to tap into the relationship ecosystem for software product development, customization, and delivery, can make more sense than going with an India-based provider. India-based outsourcing providers, although keen on expanding their capabilities in China for several years now, have been far less competitive than even they themselves initially forecast.

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## Tholons: Challenges facing outsourcing providers in China

**David Chen:** The above factors will continue to drive growth for China-based providers into the foreseeable future. They have enabled China to enter the outsourcing industry with a strong push. Its world class IT infrastructure, rapidly growing talent base and government policy support are strengthening the outsourcing providers there. Many have predicted that China's outsourcing growth will outpace the average growth rate of the outsourcing industry as a whole. According to a study by IDC, Chinese cities will overtake their Indian counterparts as top destinations for offshore global delivery by 2011.

At the same time, in order to be successful of the long haul VancelInfo and other Chinese providers will have to overcome unique challenges:

1. The relative scarcity of domain knowledge in China. China is very strong in engineering with a rapidly growing talent pool growing with an abundance of new computer science graduates each year. However, its service providers often lack the business domain knowledge required to compete with global and India-based players and win large-scale implementation projects.
  2. The scale of providers in China has not reached a level required to create and maintain a valuable brand when compared with leaders such as IBM, HP, Accenture, or even India-based players Wipro and Infosys. Without strong branding, margins for China-based service providers will remain lower due to competing providers with the same level of relatively low brand recognition.
  3. Middle management and project management talent. There are abundant junior resources and experienced software engineers in China, but experienced mid-level managers and project managers are comparatively scarce resources.
  4. Ability to attract and retain tier-1 development talent. Outsourcing jobs have a tough reputation in China, characterized by frequent overtime and low pay. Providers often lack capital for competitive salaries. Foreign multi-national companies (MNCs) are expanding into China and offering attractive compensation packages and career growth opportunities.
  5. Lack of an international brand, channels and subsequent international market reach. Service providers in China frequently do not have a strong presence at overseas locations where their target market is. A lack of marketing and means to penetrate and expand their market also hinders their ability to move up the value chain into less commoditized services.
  6. English capabilities still improving. English can still be a challenge when working with China-based offshore vendors that have traditionally serviced Japanese customers. English skills as a whole are improving rapidly, however. As witnessed by those visiting the 2008 Beijing Olympics with its tens of thousands of University student volunteers, the young generation of educated Chinese youth is able to effectively communicate with the outside world both with regards to language and culture.
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## Tholons: China outsourcing Landscape

**David Chen:** Leading estimates indicate that the top 10 China-based offshore providers that service the North America / EU market based on 2007 revenues account for only 37% of the total market. The remaining 63% is highly fragmented and split by the hundreds if not thousands of smaller firms. Relative to India where outsourcing behemoths of greater than 70,000 employees exist, the Chinese outsourcing industry remains highly fragmented and ripe for consolidation. Average employee count for the top 10 players in China has scarcely passed 3,000 employees.

Japan and Korea, due to geographic and cultural proximity, have historically been the primary customers for China-based outsourcers. They comprised about 50% of the market in 2008. Although North America / EU customers stood as a minority 40% of outsourcing activity in China, the growth rate of these Western customers is expected to continue outpacing Japanese and Korean customers in the future. Therefore, vendors such as VancelInfo that have the experience and strength to service Western markets are well-positioned for continued market-leading results.

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