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Bachelor of Electronics Engineering from Nagpur University, Maharashtra

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*Process Consultant* at Infosys Technologies, Bangalore

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**Pros and Cons of Setting up a Research Off-Shoring  
(KPO) Delivery Centre in Eastern Europe**

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*Submitted by*

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## **Executive Summary**

With low cost economies like India and China facing inflation, the cost advantage has started diminishing for companies that have traditionally outsourced their work to these nations. Moreover, to reduce risk, companies have started diversifying their portfolio in outsourcing activities. This has opened up new markets in regions like Eastern Europe, which can offer long term advantage to potential outsourcing clients. Countries in the Eastern European Bloc are relatively new entrants in the Knowledge Process Outsourcing, but have huge potential to capture the 1.2 billion USD KPO market.

Eastern Europe has many advantages as an offshore destination – highly skilled manpower, readily available talent pool, cultural proximity to the western countries, favorable regulatory and technological environment, existing infrastructure and mainly membership in the EU. However there are also institutional and macroeconomic risks associated with these poor economies. Also these nations do not have the established expertise like its competitors India and China.

The forerunners in the EE region are Poland, Hungary and Czech Republic. Many leading firms already have presence in these countries, covering an entire range of services from high end research and analytics to low end processing and transactional work. However, the younger countries like Romania and Bulgaria, though in the nascent stage, offer huge cost benefits and long term advantage.

This paper aims to analyze the operating environment of Eastern Europe in Research Offshoring, compare its positioning with respect to global players, outline the strengths and weaknesses of the region, evaluate the pros and cons and finally present recommendations for companies looking at EE as an offshore destination.

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## Offshoring to Eastern Europe

Eastern Europe currently holds less than 1 percent of the world's offshore Outsourcing market, but by the end of 2008, offshoring to Eastern Europe could triple, to more than 130,000 jobs<sup>1</sup>. Among major outsourcing hubs in the world, differences exist in terms of their specialization, driven by the specific country conditions and development priorities. Central and Eastern Europe(CEE) as a whole is becoming the home of outsourcing operations for a large number of European and US companies, with increasing forays of companies from Asia. This is evident by the growth in the Region's share of the world's outsourcing market in recent years. Central & Eastern Europe topped the list of preferred relocation sites for outsourcing for 40% of MNCs especially for R&D and manufacturing operations. (*Refer Fig 1*)

### *Destinations*

In the context of Offshoring, Eastern Europe can be classified into three categories (*Ref Appendix 1*) –

- ☑ **Central Eastern Europe (CEE):** Hungary, Poland, Czech Republic

*The most popular destinations in Eastern Europe belong to this bloc- Czech Republic, Hungary and Poland.*

- ☑ **South Eastern Europe (SEE):** Romania and Bulgaria

*This region is relatively new to offshoring and is its nascent stage. Countries like Romania and Bulgaria are gaining increased importance in the outsourcing market lately.*

- ☑ **Commonwealth of Independent States (CIS) –** Russia, Ukraine, Belarus

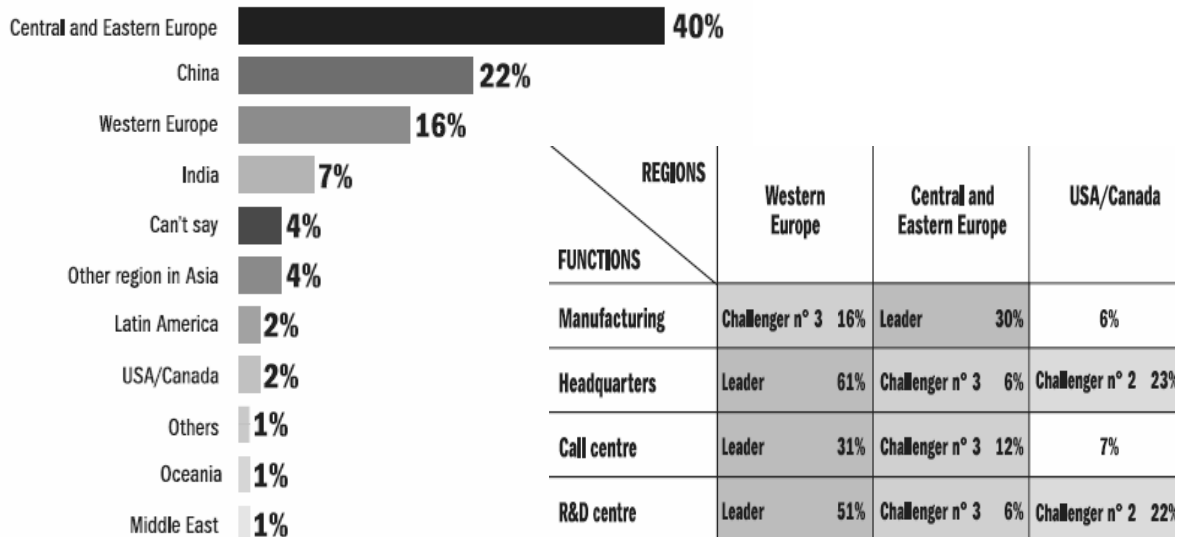
*Russia is the most populous of all, but is currently a rookie in the outsourcing/offshoring market. The other attractive offshore work centres are Ukraine and Belarus.*

Besides these, EE has close to 40-50 undiscovered cities which can offer cost advantage over other cities for a longer period of time.

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<sup>1</sup> "The Overlooked Potential for Outsourcing in Eastern Europe," McKinsey Report, 2006

**Figure 1: Relocation Sites and functions considered for offshoring by companies worldwide**



Source: E&Y Report on European Attractiveness Survey 2005

### Potential of KPO Market

The global KPO industry stands at US\$ 1.2 billion today. According to the Global Sourcing Now report, this is expected to grow at a CAGR of around 45% and will touch the US\$17 billion mark by 2010<sup>2</sup>. In KPO, the emphasis is on higher complexity processes which require the talent of professionals with extensive education and experience credentials. The types of work performed require specific and advanced knowledge of a particular domain, technology, industry, or specialty. Eastern Europe has lately been under the radar of many companies from North American and West European nations looking to offshore such work.

The comparative strength of CEE lies in more complex back-office processes. The cultural background shared by providers and their clients in CEE is particularly important for more complex business processes. Clients from outside English-speaking countries also appreciate the widespread language skills in CEE. Hence the region is more popular for knowledge process outsourcing and research based offshoring activities. EE nations already have considerable expertise in the fields of Clinical/Pharmaceutical, Legal, and Financial research. Russia is a popular locale for clinical trials and patents. Romania and Bulgaria handle a lot of legal research

<sup>2</sup> Global Sourcing Now Report on Knowledge Process Outsourcing Industry, 2006

work. Poland and Hungary are gaining importance as more and more financial research activities are being offshored by companies in the banking and finance sector. Besides specialization, the EE nations have a spread of companies from diverse sectors like manufacturing, financial services, logistics, insurance etc.

However, due to lack of IT specialization, IT-based services account for less than 4% of total exports in CEE, whereas the share in India is 17%. It is therefore unlikely that offshore production of standard IT services will become as important for CEE as is the case for India

## **Operating Environment**

A number of factors contribute to the growing attractiveness of the region for outsourcing, besides of course the most important one - Costs. These are mainly talent pool, location, culture, infrastructure and regulatory environment. We will examine in detail how Eastern Europe fares on these parameters.

### ***Cost***

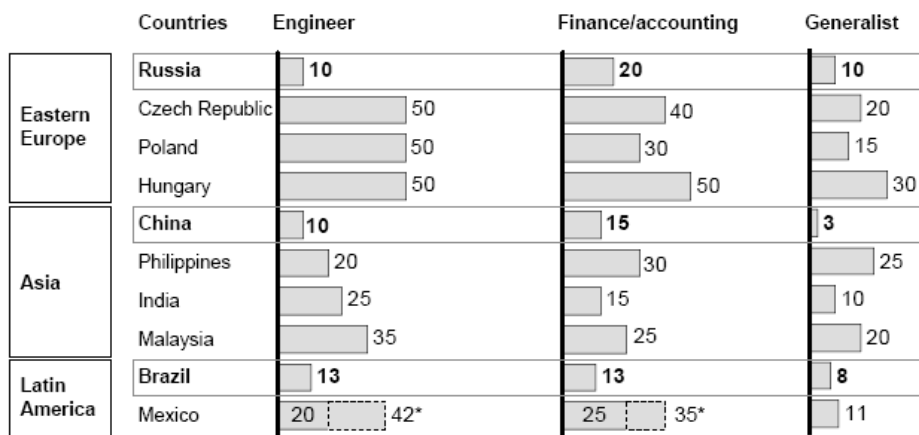
While the hourly costs for an engineer in EE can vary between individual countries, they are invariably lower than in Western Europe or the US, but still do not match competitors India and China. However the wage inflations in EE have been relatively stable. Additionally, the cultural proximity of EE reduces the transactional costs involved. However, comparative advantages between countries and regions can change relatively fast, and they do. Ultimately, no lower-cost country can remain low cost indefinitely.

### ***Talent Pool***

Talent pool does not just mean the raw number of graduates meeting the requirements but in fact the availability of suitable talent - encompassing factors such as language skills, education and its applicability in practice, and cultural fit including a number of other soft skills. Eastern Europe scores really high on this factor as it has highly efficient school system that adds thousands of skilled labor every year to its professionals. There is also a strong focus on research in fields of science and mathematics in the education system. Graduates from Eastern Europe have been found to be more employable by many companies from US/UK as compared to even leading outsourcing nations like India and China. MNC companies consider employing 50% of engineering graduates from Czech, Polish or Hungarian universities, as compared to only 25%

from India or 10% from Russia and China (Ref Fig 2). However lack of IT specialization is a big disadvantage in EE as the number of graduates gaining information technology degrees is far lesser than the Indian/western averages.

**Figure 2: Employability of Graduates across offshore destinations (in %)**



Source: McKinsey Report on Emerging Global Labor Market: The Supply of Offshore Talent in Services

### **Location**

EE region’s position close to the large economies in Europe, as well as the benefits of membership in the European Union (EU) allow companies in the region to benefit from the possibilities of same-time-zone communication and easy and fast travel between cities. EU membership dramatically simplifies administration procedures and reduces costs. Nations of EU have the advantage of being located strategically, making it attractive to North American as well as West European companies.

### **Culture**

On this parameter, EE has a huge advantage as cultural proximity is a critical element in the total costs of outsourcing. Using Oliver Williamson’s transactional costs theory, the cultural proximity, language knowledge, “can-do” attitude and other soft skills of the labor force in EE all help to reduce the overall costs of conducting transactions between clients and service providers located in the region. The work ethics in much of CEE has been frequently observed and cited as a differentiating factor by companies.

## ***Infrastructure***

Compared with competing regions around the world, Eastern Europe is a relatively low-risk location for investing, due to the reliable infrastructure already in place. The telecom infrastructure is especially robust in many countries like Poland and Hungary. Though the infrastructure reliability is lower, as one moves further towards the east – Russia, Serbia etc, on an average the infrastructure is robust and well developed in the EE bloc.

## ***Regulatory & Political Environment***

The regulatory environment of the EE nations is a source of competitive advantage as it perceived to have the third healthiest legal and regulatory environment after US and Ireland. More so because Information Security has become a top concern among companies evaluating current and potential knowledge based outsourcing relationships<sup>3</sup>. However, the political environment is perceived to be quite unstable for the nations like Russia, Slovakia and other Baltic states.

## ***Competitive landscape***

### **Within Eastern Europe**

EE regions have diverse focus areas and expertise. There is no one clear leader, however attractiveness differs among nations.

Hungary is more attractive as a nearshore outsourcing location for western European countries specifically for IT application development and maintenance than other EE nations.

The Czech Republic is predicted to take the third place after India and China in offshore outsourcing.

Poland scores very high on talent availability - The educational system currently produces approximately 40,000 engineering graduates annually. It is also more attractive to German companies as it has high share of German literate population.

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<sup>3</sup> Booz Allen Hamilton Report "Outsourcing Security: Concerns Growing.", March 2006

Romania is emerging as the most cost effective EE nation. It is also especially interesting for French companies as 85% of schoolchildren there learn French.

Bulgaria, according to the AT Kearney Report "Offshoring for long term advantage", will emerge as the most attractive destination in EE.

Russia offers abundant labour at cheap costs, but its acceptance as an outsourcing destination has been lukewarm as it is widely perceived as having an unstable economy and an inadequate technology infrastructure. The attractiveness of the EE locations, as per an AT Kearney GLS Index is shown in the figure below.



Source: The 2007 A.T. Kearney Global Services Location Index

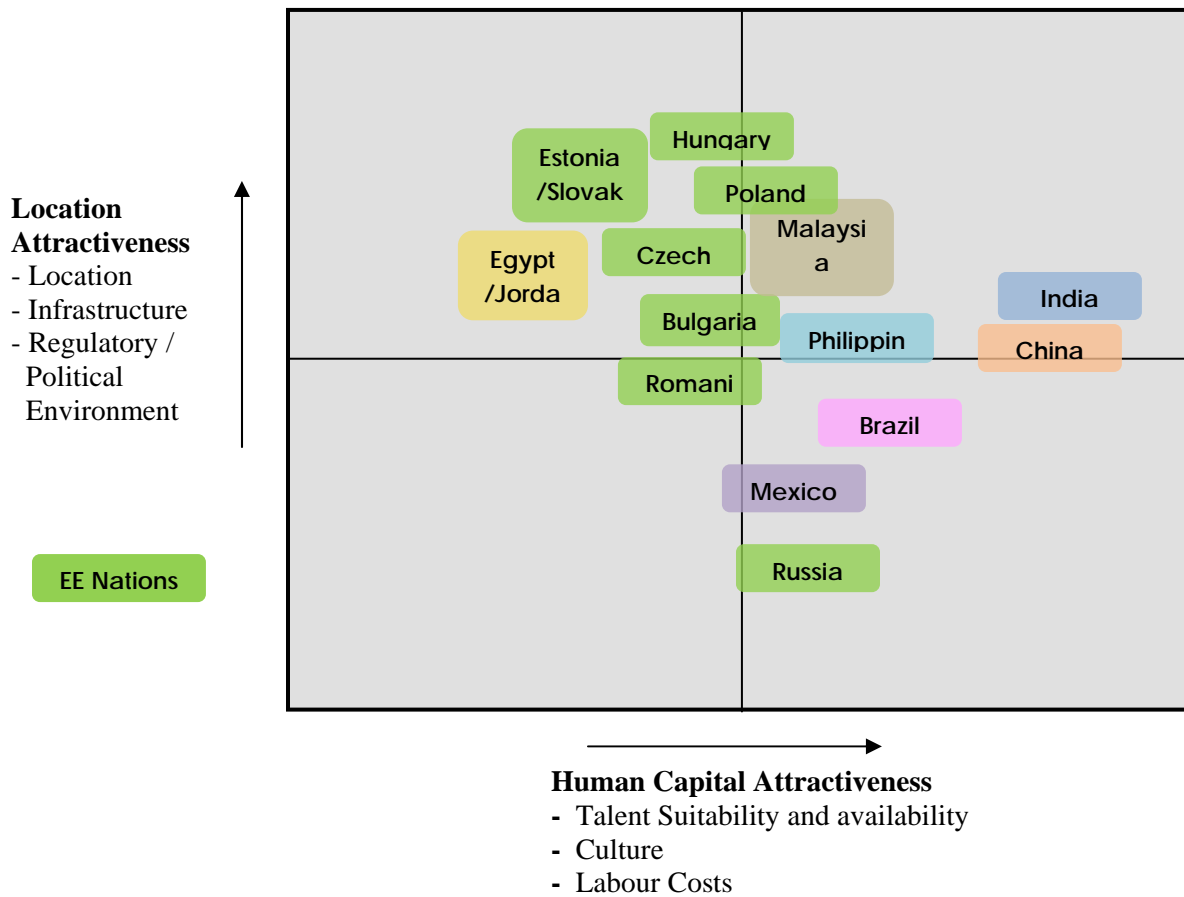
### Global Competitors

If one considers the Central and Eastern Europe (CEE) region as a single cluster of the world outsourcing market, based on indices such as the volume of the market, talent pool, regulatory environment, infrastructure etc, CEE could be compared with traditional world centers of

outsourcing. Poland, Hungary, Russia, and the Czech Republic together have as many suitable generalists as India, and nearly as many suitable engineers. EE nations have more favorable regulatory environment and cultural context than their Asian counterparts like India and China.

For a clearer perspective on the competitive positioning of the global outsourcing hubs, all players can be plotted on a two-by-two matrix, with respect to the key parameters considered by companies for outsourcing/offshoring activities. The grid in the figure below is an attempt to capture the attractiveness of global players including the EE nations.

### Competitive Analysis of Outsourcing Destinations Globally



# SWOT Analysis

## Strengths

- ✓ *Talent Suitability- highly skilled labor*
- ✓ *Strong Research focus*
- ✓ *Large pool of untapped talent available*
- ✓ *Cultural Proximity to Europe and US*
- ✓ *Reliable, existing infrastructure*
- ✓ *Attractive regulatory environment*
- ✓ *Time zone advantages*
- ✓ *Membership in the European Union*

## Weaknesses

- ✗ *Lack of Managerial Talent*
- ✗ *Lack of IT specialization in exports or education*
- ✗ *EE region, being formerly socialist bloc is considered to lack entrepreneurial zeal*
- ✗ *Some EE nations like Russia and Baltic states lack political stability and secure working environment*
- ✗ *Institutional and Macroeconomic risks*

## Opportunities

- ✓ *EE has 40-50 virgin territories with no offshoring activity but large talent pools, where the labor cost advantage is more likely to remain attractive for the next decade.*
- ✓ *Recent global trends show that companies are having a diverse portfolio of offshoring locations to minimize potential risk, hence opens up market for newer locations like EE*
- ✓ *Near shoring from European Markets*

## Threats

- ✗ *With growing economy, wage inflation bound to go rise lowering cost attractiveness. Cheaper destinations like Philippines, Mexico already pose stiff competition in labour costs*
- ✗ *Many European firms have started looking further east – India, China for established expertise. These nations have also started setting shops in EE as well*
- ✗ *EU accession might drive prices up*

## **Recommendations**

Though Asia might continue to be most the attractive destination for BPO/IT centric offshoring, emerging economies like EE will gain popularity with research centric offshoring (KPO). This is because of factors like high talent availability, easy accessibility, and cultural proximity of the EE region.

For companies based out of West Europe - UK, Ireland, Germany, France, nearshoring to EE nations makes more sense for research related work – because for KPOs factors like high cultural proximity, minimum time zone differences, information security, easy accessibility are very important.

Legal Process Offshoring (LPO), Clinical Research and Patents, Financial and Business Research are areas that the EE has considerable expertise in. Companies in the Manufacturing (especially Automotive), Logistics, Pharmaceutical, Legal, Banking and Financial and Business services sectors should look at EE positively because FDI in these sectors have been high in this region (*Ref Appendix 2&3*).

The accession of countries like the Czech Republic, Poland and Hungary to the EU will undoubtedly drive numerous benefits for both Western clients as well as service providers in the new member markets. At the same time, however, as the Central and Eastern European markets enter the EU, the cost of living in these markets will likely increase driving an inflationary trend among local salaries and over time diminishing the cost advantage associated with outsourcing to those markets. As a result, during the next several years there will be a continued eastward migration of KPO services to ever lower cost destinations. Although relatively young markets today, Romania, Bulgaria, the Ukraine and Belarus are expected to become increasingly larger players in the global sourcing market in the coming years. So companies exploring this region must focus on these newer players for long term cost benefits and sustainable advantage.

Overall, the EE region seems to have the right ingredients, at the right time, to make for a compelling proposition. However, the macroeconomic and institutional risks increase when processes are offshored to particularly poor countries. This can become a problem if there is very heavy dependence on the outsourced process or sensitive data is being processed. So companies venturing into EE must evaluate the risks of institutional shortcomings as well.

## Successful Initiatives

A few of the key successful initiatives in Offshoring in Eastern Europe include:

- ☑ DHL has shifted activities from Britain to the Czech capital, where it has announced investment plans for €500m over five years and aim to employ 1,000 people in Prague to track customer shipments and billing in Europe.
- ☑ Leading global services supplier, Accenture, has plans to increase employees fivefold at its finance and accounting outsourcing center in Prague, over five years, to 1,500.
- ☑ In Budapest, General Electric opened an IT and back-office support centre in 2002 that will employ 500 people by 2005. Diageo opened a back-office support center in Budapest, employing 300 people.
- ☑ In Lodz, West of Warsaw, Philips opened a services center with capacity to employ 400 people in 2006 when it takes over human resources management, purchasing, finances and accounting for all European operations.
- ☑ Financial major Citibank employs 300 people in a settlement center in Olsztyn, North of Warsaw, processing transactions for Poland, the Czech Republic and Slovakia. They have plans to soon expand processing coverage to include Hungary and Romania

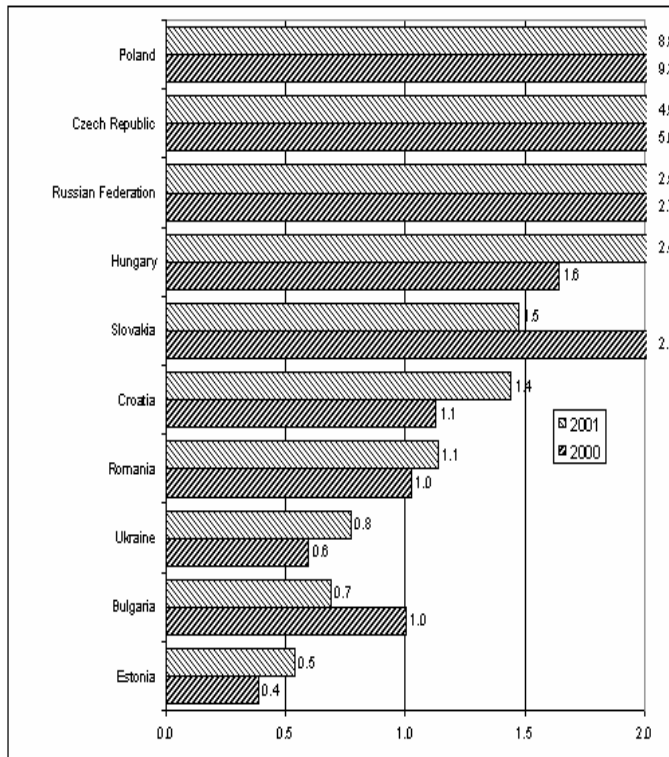
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# Appendix

## Appendix 1: Map of Eastern Europe



## Appendix 2: Central and Eastern Europe: FDI inflows by region and sector



Sector Name	Market share 2003 %	Number of FDI in 2004*	Market share 2004 %	Evolution in market share 2003/2004
Automotive	12.0%	335	11.6%	-3%
Software	9.3%	315	10.9%	17%
Business Services	7.5%	217	7.5%	1%
Electronics	6.3%	196	6.8%	8%
Food	6.8%	180	6.2%	-8%
Machinery & Equipment	5.8%	163	5.6%	-3%
Pharmaceuticals	6.6%	144	5.0%	-24%
Plastic & Rubber	3.7%	125	4.3%	18%
Financial Intermediation	2.9%	118	4.1%	41%
Chemicals	5.3%	116	4.0%	-25%
Transport services	2.5%	103	3.6%	41%
Non metal/mineral products	3.2%	80	2.8%	-14%
Fabricated Metals	1.4%	79	2.7%	96%
Telecommunications & Post	2.4%	64	2.2%	-7%
Computers	2.5%	55	1.9%	-23%
Others	21.8%	595	20.8%	
<b>Total</b>	<b>100%</b>	<b>2885</b>	<b>100%</b>	<b>----</b>

Source: UNCTAD, World Investment Report 2002

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