THE MATURING CHINESE OFFSHORE IT SERVICES INDUSTRY: IT TAKES 10 YEARS TO SHARPEN A SWORD

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Executive Summary

American and European IT managers are increasingly considering whether to outsource IT services to China-based companies. While these Western IT managers are familiar with the large Indian companies that provide offshore IT services, they are not familiar with their Chinese counterparts. This article provides an analysis of the Chinese offshore IT services industry, with a focus on the large, dominant players. We examined the Top 39 firms in detail, categorizing them into three types—Multinational Ventures, Legacy, and New Generation. Each of these types is described and illustrated by examples of firms.

The subtitle of this article is an old Chinese saying derived from the ancient sword masters who took a long time to hone their skills and temper their weapons in preparation for a major battle. We believe this saying aptly describes the evolution of the Chinese offshoring industry. To date, the growth of the industry has been slow and deliberate, in preparation for making a major impact on the market for offshore IT services. In terms of maturity, the industry is currently at Stage 1 (Initial Growth), although Stage 2 (Shake-out/Consolidation) may not be far off.

We describe the implications of our analysis for potential customers of Chinese offshore providers. In choosing a Chinese provider, business will need to make trade-offs determined by the attributes of the three types of provider.

NEED FOR A DEEPER UNDERSTANDING OF CHINA’S IT SERVICES INDUSTRY

China’s emergence as an economic superpower has led to predictions that the country’s offshore IT services industry would soon compete with India’s. After all, many leading corporations in North America and Europe now contract with Chinese providers for at least some of their IT services. Yet, China’s offshore IT services industry has received far less attention than its Indian counterpart. IT managers in the West need a deeper understanding of China’s industry to enable them to successfully include China-based providers in their companies’ offshore sourcing strategies.

THE EMERGENCE OF CHINA’S OFFSHORE IT SERVICES INDUSTRY

China’s offshore IT services industry cannot be understood without putting it in the context of the Chinese economy and its software industry. Since China’s economic reform in 1978, the Chinese economy has grown by an average of 9.5% a year (real gross domestic product [GDP] growth rate). From 1978 to 2006, the country’s GDP increased by a factor of more than 12, compared to only 2.25 times for the U.S.

1 Carol Brown is the accepting senior editor for this article.
2 The authors acknowledge the help of Shyam Chidamber for early ideas that helped shape this article.
4 According to www.bea.gov/national/xls/gdplev.xls, U.S. GDP was $5.01 trillion in 1978 and $11.3 trillion in 2006 (measured in year 2000 dollar values).
sustained economic growth has led to an increase in China’s domestic demand for IT, and its software industry has flourished as well. During the 1990s, the software industry grew at an annual rate of over 30%—three times the growth rate of China’s GDP. China’s overall software industry is now twice the size of India’s in dollar value.

But China’s software industry has been domestic-focused, and its offshore IT services industry has been lack-luster compared to India’s. Although China and India’s offshore industries both emerged in the late 1980s, China’s total software exports (including offshore) in 2006 were only about a quarter of India’s: $6 billion compared to India’s $24 billion (see Figure 1). While most of India’s software industry revenue is accounted for by exports, China’s software exports are small. In 2004, only about 10% of the 720,000 employees in China’s software industry were engaged in software exports. Moreover, the majority of China’s software exports are embedded software. To gain an understanding of the Chinese offshore IT services industry, it is important to recognize the strong influence of the government. The Chinese government is a major customer of the country’s software companies, which are awarded highly profitable government contracts—like the “12 golden projects” that comprise the first phase of e-government in China.

In 2000, the Chinese government recognized the importance of offshore IT services and began to issue targeted policies to foster their growth. In 2006, for example, the government established a plan called “From Made in China to China Service,” which set out China’s intention to concentrate on, and increase its presence in, the global IT services market. The plan also set a goal to increase exports in software and related information services to more than $10 billion by 2010.

![Figure 1: Software Industry Exports, China vs. India, 2001-2006](image)

Numbers on bars show the percentage of total domestic software production that was exported. (Sources: China Software Industry Association, and National Association of Software and Service Companies [India])

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7. Data for India are published by fiscal year, which creates problems in international comparisons. For example, data for fiscal 2005 is shown as 2005 in Figure 1. Because there has been consistent growth, the impact on Figure 1 is to under-represent the size of Indian software exports.


With favorable policies in place and strong global demand, China’s offshore IT services industry began to grow rapidly. According to a 2007 report from CCID Group, this industry generated revenues of $1.43 billion in 2006 (part of the $6.06 billion total software exports in that year) and grew at an annual rate of 55.4%.

Since 2000, Chinese IT services firms have made a strategic shift in the international markets they concentrate on. Japan and South Korea used to be their main export markets, but in recent years, the focus has shifted more to European and North American markets. For example, the share of China’s total software exports accounted for by Japan dropped from 66.3% in 2003 to 58.1% in 2006, while the share of revenue from European and North American markets has increased.

THREE PERIODS OF GROWTH

We divide the evolution of China’s offshore IT services industry into three periods—nascent, transition, and current.

The Nascent Period: Pre-1995

Before the advent of the public Internet, there was relatively little global trade in IT services. Even the “Three Is” of software—India, Israel, and Ireland—had very small industries. But there was a tiny amount of offshore software development in China, with Japanese firms contracting with Chinese providers. The geographic proximity of the two countries, and their cultural similarities, meant that Japanese firms helped to lay the foundations of China’s offshore IT services industry. In the late 1980s and early 1990s, Japanese multinationals like Omron, NEC, and Fujitsu set up joint ventures, mainly with higher education institutes or local government. During this period, China-based firms providing offshore software services mainly engaged in low-end software development. Japanese multinationals commonly divided large projects into small pieces and then offshore some of these to Chinese providers. This tradition lingers today and distinguishes the type of offshore services provided to Japanese firms from the work done for other Western firms.


Several events happened in 1995-96, all of which spurred the growth of China’s offshore IT services industry:

- The Internet began to grow rapidly.
- In early 1996, China’s Ministry of Science and Technology started to boost software parks under the “National Torch Program,” which helped domestic start-up companies. (By the end of 2006, there were 33 software parks across the country.)
- High levels of competition and decreasing profits in the domestic software market caused domestic IT firms (such as Neusoft) to diversify into the newly emerging offshore market.
- The booming Internet economy attracted foreign investors to China, leading to foreign start-ups.
- Chinese indigenous start-ups, like SinoCom, focusing on providing offshore IT services, began to appear.

The Current Period: Post-2000

The major milestone that signaled the start of this period was when the Chinese government formally recognized the importance of the IT services sector. In June 2000, the China State Council issued the “18th File Policy on the Encouragement of Software and Integrated Circuit Industry.” This policy was the first step taken by the Chinese government to launch the national campaign to support and promote the entire IT services industry. The policy provided inducements such as venture capital programs, tax-free zones, and tax benefits.

The government followed with several other significant actions:

- In June 2004, the Ministry of Science and Technology launched the “China Offshore Software Engineering Program” to encourage more software exports.
- In September 2006, nine ministries—including the Ministry of Commerce and the Ministry of Science and Technology—jointly issued “Advice on increasing software and information technology service export.”

10 Beijing-based CCID is a large-scale information service enterprise funded entirely by the China Center for Information Industry Development.
In 2006, the government set up five outsourcing zones distributed in cities across China, with numerous finance and tax benefits. This was followed by the second batch of six cities in 2007, including Beijing. Local governments soon followed this lead. Regional policies were implemented, designed to cultivate competitiveness within major cities and attract foreign investment.

In 2006, the Ministry of Commerce set up the “1000-100-10 Project” to nurture 1,000 outsourcing companies, to attract 100 major foreign companies to use offshore services in China, and to establish 10 outsourcing parks. All these actions have helped spur the development of China’s offshore IT services industry.

Since 2000, more firms have entered the industry and existing companies have grown in one of three ways:

- Through a stock market initial public offering (IPO)—e.g., in 2003, Chinasoft International became a public company quoted on the Hong Kong Stock Exchange.
- Strategic investment—e.g., Neusoft received $40 million investment from Intel in 2006, and Inspur received $25 million from Microsoft.
- Mergers and acquisitions—e.g., iSoftStone Technologies has acquired several companies since 2005; its size, measured by number of employees, jumped from less than 100 in 2002 to over 4,000 in 2007.

The market focus of China’s offshore IT services industry has expanded from Japan to the U.S. and Europe. Until 2000, the industry was characterized by low-end coding work and localization. Since 2000, Chinese firms have moved into higher-level activities like system design and providing whole solutions. Accumulated experience, more trust from clients, and larger size have all contributed to this trend.

THREE TYPES OF CHINESE OFFSHORE IT SERVICES FIRMS

When assessing the state of a country’s offshore IT services industry, the most important firms to examine are the largest companies. In the U.S., these are companies like IBM, Accenture, and, now, HP. In India, they are companies like TCS and Infosys. We have identified the Top 39 Chinese offshore IT services firms that set the tone of the industry (see Figure 2).

Most of these 39 firms are concentrated in the north and east of the country (see the map in Figure 3). Specifically, 22 (56%) have their headquarters in Beijing or Shanghai. Southern manufacturing hubs, such as those in and around Shenzhen, play a lesser role in the software industry. This geographic distribution results from the concentration of the scientific elite in the northern and eastern cities. The top universities continue to be in Beijing and Shanghai, and the software industry has therefore emerged in and around these cities. In particular, there is a high concentration of software companies in Beijing’s Z-Park (short for Zhongguancun Science Park) and in Pudong in Shanghai.

We have classified the Top 39 firms based on several attributes: strategy at origin, customer focus, management style, capacity, strengths, and growth path. Three types of firms emerged from this classification, which we label:

1. **Multinational Ventures**, which are initiated by a multinational company (though may be owned jointly by the Chinese government or institutes). They typically focus on serving the parent multinational. Most of these firms serve Japanese multinationals. Twelve of the Top 39 fall into this category.

2. **Legacy** firms are large and well-established Chinese IT firms, now typically with over 1,000 employees, that have served the domestic market and later also turned to serving multinationals in China or foreign markets, or both. Twelve of the Top 39 are Legacy firms.

3. **New Generation** firms are start-ups focusing on non-Chinese clients from their inception. Fifteen of the Top 39 fall into this category.

Figure 4 shows which of the Top 39 firms fall into each type. It also indicates the size of each firm in terms of number of employees and shows in which of the three evolutionary periods a firm first started to serve non-Chinese clients.

**Multinational Ventures**

Major multinationals began to enter China as far back as the 1980s. Some came to penetrate the domestic

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11 The Appendix describes the research methodology, including the way in which the Top 39 list was constructed.
### Figure 2: The Top 39 Chinese Offshore IT Services Firms

<table>
<thead>
<tr>
<th>AsiaInfo Holdings, Inc.</th>
<th>NEC Advanced Software Technology (Beijing)</th>
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<tr>
<td>Bleum Inc.</td>
<td>Neusoft Group Ltd.</td>
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<tr>
<td>Changxiang Computer Co., Ltd</td>
<td>Newtouch Software Co., Ltd.</td>
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<tr>
<td>Chinasoft International Co., Ltd</td>
<td>Objectiva Software Solutions (Beijing) Inc.</td>
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<tr>
<td>Datang Software Technologies, Co., Ltd</td>
<td>PFU Shanghai Co., Ltd.</td>
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<td>Double-Bridge Technologies, Inc.</td>
<td>Powerise Group</td>
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<td>Freeborders Co. Ltd.</td>
<td>Prosoft Technology Co., Ltd.</td>
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<td>Fujitsu Nanda Software Technology Co., Ltd</td>
<td>Safe Software Co., Ltd.</td>
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<td>HiSoft Technology International Ltd.</td>
<td>SinoCom Computer System (Beijing) Co., Ltd</td>
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<td>Hi-Think Computer Technology Co., Ltd.</td>
<td>Sorun Beijing Co., Ltd.</td>
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<td>Hundsun Electronics Co., Ltd.</td>
<td>Summit Software Co., Ltd.</td>
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<td>Insgima Technology Co., Ltd.</td>
<td>SunJapan Information Systems Co., Ltd.</td>
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<td>Inspur Group Ltd.</td>
<td>Tata Information Technology (Shanghai) Co.</td>
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<td>Intasect Communications (Chengdu) Co., Ltd.</td>
<td>Toyu Soft Co., Ltd.</td>
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<td>iSoftStone Technologies Ltd.</td>
<td>U-soft Co., Ltd.</td>
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<td>I.T. United Corporation</td>
<td>Venus Software Corporation Ltd.</td>
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<tr>
<td>Jianfeng Computer Systems Co., Ltd. (Beijing)</td>
<td>Wicresoft Co., Ltd.</td>
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<td>JT-Hyron Software Co., Ltd.</td>
<td>Yinhai Software Limited Liability Co. (Sichuan)</td>
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<tr>
<td>Kingdee International Software Group Company Limited</td>
<td>Yuandong Digital Co., Ltd.</td>
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<td>Megainfo Tech Co., Ltd.</td>
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### Figure 3: Geographic Distribution of the Top 39 Chinese Firms

Source: The authors; this study is based on firms in mainland China.
Figure 4: Timeline of Top 39 Chinese Firms by Type, Company Size, and Year Non-Chinese Clients First Served

- **Nascent Period: 1988-1994**
  - Fjitsu Nanda

- **Multinational Ventures**
  - 1998 1999
  - PFU

- **Legacy Firms**
  - 1998 1999
  - Nec

- **New Generation Firms**
  - 1998 1999
  - SunJapan

- **Transition Period: 1995-1999**
  - 2000 2001 2002 2003 2004
  - Fujitsu Nanda

- **Current Period: 2000-2004**
  - 2000 2001 2002 2003 2004
  - Venus JT-HyonSun Japan

- **Small (under 500 employees)**
  - Year (over 1,000 employees)
  - Employee numbers in 2006, or best available data.

- **Medium (500-999 employees)**
  - Year (over 1,000 employees)

- **Large (over 1,000 employees)**
  - Year (over 1,000 employees)
The Maturing Chinese Offshore IT Services Industry: It Takes 10 Years to Sharpen a Sword

market; others wanted to exploit China’s labor cost advantage, mainly to provide services to the parent multinational or the parent’s customers back home. These businesses were thus the first to serve non-Chinese clients.

In the 1980s and early 1990s, Chinese government regulation did not allow foreign investors to own more than 49% of a Chinese firm. The multinationals therefore created joint ventures with Chinese government or university institutes. The Chinese partner also helped to provide access to high-quality and low-cost labor. Examples of Multinational Ventures are described in Figure 5.

Ten out of the 12 top firms classified as Multinational Ventures were established by Japanese multinationals. However, since 2000, non-Japanese multinationals have begun to enter the market. For example, in 2002, Tata (from India) set up a facility in Shanghai. And in 2003, Microsoft established a joint venture company in Shanghai called Wicresoft to provide call center services to Windows customers in both China and North America.

Being associated with a multinational gives these offshore services firms great benefits during their initial period because the founding multinational guarantees business for the new firm. But there are also downsides. Future business expansion of the offshore services firm might be stifled because the multinational set up the company mainly to serve itself. In spite of their relatively long history of providing offshore IT services, most of these firms are still small, with most still having fewer than 1,000 employees (see Figure 4).

When firms in this category began to mature, their ownership tended to be adjusted to better fit the growth of the company. For example, JT-Hyron became a Chinese domestic firm in 2000 when Shanghai Jiaotong University bought most of the foreign partner’s shares. Observers felt that the company had accumulated sufficient experience and faced a booming offshoring market where quick decision making is critical, making the joint venture arrangement inefficient. There are also reverse cases—when the multinational buys out the joint venture, especially since the recent relaxation of regulation on foreign ownership. For example, in 2006, NEC converted its joint venture with China Academy of Science into a wholly owned foreign company to better fit its strategy in China.

Legacy Firms

Legacy firms are relatively large and well-established Chinese IT services firms that have served the domestic market and then, at a later stage, turned to serving multinationals in China or overseas.

Although China has a strong and fast-growing domestic IT industry, competition in the domestic market has intensified since the late 1990s. Some firms started to expand their business to providing offshore IT services because such services are more profitable. Examples of Legacy firms are given in Figure 6.

Legacy firms are relatively large and well-established, and their scale and experience provide them with advantages in the offshore IT services business. They are also more likely to obtain support from local governments in China, which were often their customers in the past. As a result, once these firms enter the offshoring market, they can scale up much faster than other types. For example, Neusoft’s revenue from offshore IT software and services jumped from $33 million in 2004 to $62.7 million in 2005 and to $101 million in 2006, when it had over 4,000 employees working in offshoring.
Similarly, in the past three years, Inspur’s revenue from offshore IT services has grown at over 200% annually, and it has established subsidiaries in both Japan and the U.S. Inspur was not listed in the Top 20 Chinese offshore IT services companies in 2004 but had jumped to No. 4 in 2005.

Since Legacy firms are new to the offshore business, they lack expertise and international recognition. One way to overcome these deficiencies is to partner with multinationals. For example, Inspur formed an alliance with Microsoft and received a $25 million strategic investment from that company in 2005. This helped Inspur gain offshore contracts from the North American market. Another way for these big domestic firms to expand into the offshore market is to use some of their abundant financial resources to acquire existing foreign firms to gain a foothold in the market. For example, in 2006, Inspur acquired Shinwa, a Japanese company, so it could enter the Japanese market.

New Generation Firms

In the second half of the 1990s, a new type of offshore IT services firm began to emerge in China. Unlike Multinational Ventures and Legacy firms, these New Generation firms did not have a captive client base. Rather, they were established to target the offshore market. Like the new generation of hi-tech firms that emerged in other nations around the world in the 1990s’ technology boom, these Chinese offshore IT services companies were “born global.” They bypassed the traditional incremental transition route to internationalization—first domestic, then foreign.

There are marked differences between New Generation firms and the other two types described above. Unlike Legacy firms, most New Generation companies are start-ups. They are also different from Multinational Ventures in that they aim at the general offshoring market rather than limiting themselves to serving a specific multinational. Finally, unlike the other two types, New Generation firms are more likely to be oriented to providing services to U.S. clients.

New Generation firms can be further divided into two subcategories, depending on the nationality of the founders: Chinese-owned (nine out of the 15 in the Top 39 list) and foreign-owned (six firms). The nine Chinese-owned companies in this group are growing very quickly: four of them have over 1,000 employees, which is remarkable considering their relatively young age.

Figure 7 provides brief descriptions of two New Generation firms.

The assumption might be that a Chinese-founded company has disadvantages in accessing foreign clients compared to a foreign-owned firm, but in practice, this is not so. First, most Chinese founders of New Generation firms have either an overseas education or multinational work experience. Second, these firms quickly bring in professional managers who have broad overseas connections. Third, they enhance their access to overseas markets by either making strategic foreign investments or acquiring small foreign companies, as HiSoft as done (see Figure 7).

12 Changxiang, HiSoft, Hi-Think, Prosoft, Safe, SinoCom, Summit, U-soft, and Yuandong.
MATURITY OF THE CHINESE OFFSHORE IT SERVICES INDUSTRY

Klepper and colleagues have proposed a generic three-stage industry maturity model (see Figure 8). In Stage 1 (Initial Growth), the number of firms is growing; Stage 2 is characterized as the shake-out period, where the number of firms is decreasing; and Stage 3 is when the number of firms stabilizes.

The Chinese Offshore IT Services Industry is at Stage 1 Maturity

Four characteristics indicate that the Chinese offshore IT services industry is still in Stage 1 (Initial Growth) of Klepper’s model. First, there have been many new entrants in recent years. About 60% of the top offshore IT services firms (23 out of 39) entered the market in 2000 or later (see timeline in Figure 4). Most of these more recent entrants into offshoring are either Legacy firms or New Generation firms set up by “Sea Turtles” (a Chinese term for Chinese people returning from overseas).

Second, the majority of today’s top Chinese technology firms—Digital China, Eusoft, Founder, Huawei, Putain, Zhongxin, and so on—do not participate in the offshore IT services industry. Instead, they currently focus either on hardware equipment or on the domestic market. This would be analogous to American companies like IBM and HP, which started life as hardware firms, choosing not to participate in the global IT services market. The lack of involvement of the largest technology firms may indicate that the offshore IT services industry is still a long way from Stage 3 (Stabilization).

Third, the concentration ratio is very small—i.e., industry fragmentation is still fairly high. The industry mainly comprises relatively small players in many categories, which is a typical indicator of an early stage of maturity. Unlike Indian offshore IT services providers, there are no dominant players in the Chinese industry. The top 10 Chinese firms in 2005 accounted for less than 20% of the total revenue for offshore IT services. However, there are signs that this may be quickly changing: the top three companies—Neusoft, HiSoft, and Hi-Think—accounted for 15% of total revenue in 2006.

Another concentration measure is employee size, and the average size of Chinese offshore IT services providers is still small. Figure 4 depicts the number of employees for each of the Top 39 firms. Twenty-seven are small- or medium-size firms with fewer than 1,000 employees. Of the 12 large firms, only Neusoft and Inspur had more than 10,000 employees in 2006, although this is for the entire company. In both cases, revenue from providing offshore services is a small part of the total business.

Fourth, the rankings of the players are still changing rapidly. This is also a characteristic of early maturity; in more mature industries, there are few significant changes in the relative rankings of industry leaders.

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The Shake-out Stage May Be on the Horizon

However, there are indicators suggesting that the Chinese offshore IT services industry may be near the peak of Stage 1 and will soon be entering Stage 2 as consolidation begins. Clearly, one driver of consolidation is that Chinese offshore IT services firms need to grow so they can provide full services to large global firms and can successfully market their services in multiple locations.

From about 2005, merger and acquisition (M&A) activity in the industry has picked up. Three of the Top 10 companies in the China Import and Export Software Network (CIESN)\textsuperscript{14} 2004 ranking disappeared when they were acquired by other companies—Chinasoft Resource was acquired by Chinasoft, Ensemble International was acquired by HiSoft, and Beijing Innovation Software became part of Insigma. Additionally, Prosoft was acquired by VanceInfo in 2006, and iSoftStone merged with Shanghai Jiefeng in 2008.

Investment capital is also spurring M&A activity. For example, HiSoft received a $30 million investment from Granite Global Ventures, which enabled it to acquire two other offshore providers in Beijing. And Neusoft received a $40 million investment from Intel in 2006, which helped it to scale up its offshoring business.

Another indicator of the growing maturity of China’s offshore IT services industry is that top firms are being acquired by foreign companies. Objectiva Software Solutions was acquired in 2004 by Document Sciences Corporation, which was subsequently taken over in 2008 by EMC, an American technology conglomerate. And, in 2007, I.T. United was acquired by Softtek, Mexico’s largest IT services firm.

IMPLICATIONS FOR POTENTIAL CUSTOMERS OF OFFSHORE IT SERVICES

As the subtitle of this article indicates, the sword of the Chinese offshore IT services industry is beginning to sharpen. Offshoring IT services to Chinese providers will become increasingly viable, and businesses will need to decide which type of provider to engage with and how to make outsourcing a success. The three types are distinctive in terms of their origins, ownership structure, expertise, management style, and culture. Potential pros and cons of offshoring to each type are summarized in Figure 9.

Multinational Ventures

One advantage of offshoring to Multinational Ventures is their modern management practices, which they have assimilated from their parent multinationals. Employee rotation in both directions is typical: expatriate managers are assigned from the parent multinational, and newly hired employees are sent to the multinational for training.

On the other hand, because these firms mainly serve the parent multinational, their expertise tends to be more specialized. Take Fujitsu Nanda as an example. As the China-based R&D center of the Japan Fujitsu

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\textsuperscript{14} See Appendix.
Software Department, this organization is focused on Fujitsu’s large servers.

Contract negotiations with Multinational Ventures may take longer because of the need to involve the parent multinational. For example, one reason for JT-Hyron changing its ownership structure was the long decision process, which had to involve the headquarters of its multinational partner.

**Legacy Firms**

Legacy firms tend to be larger than firms in the other two types, and their years of experience in the domestic market provides them with technical competence. These firms also have the capability to develop large-scale projects. They may also be eager to gain a foothold in the offshore IT services market and therefore more willing to negotiate on price.

On the other hand, there can be some “hidden” costs of offshoring to Legacy firms. First, the big legacy firms, especially those that are state-owned, are used to doing business with domestic clients, and their culture is thus typically Chinese—based on the “iron rice bowl”\(^{16}\) and “Guanxi.”\(^{17}\) As a consequence, they may be less able to meet the standards of responsiveness and accuracy demanded by foreign clients. Their bureaucratic mentality also limits lower-level employee involvement in quality management. To adhere to the specifications of foreign clients, Legacy firms may therefore need to restructure their service processes, and clients may need to closely monitor their work.

Additionally, the costs of setting up an offshore project with a Legacy firm may be higher because of their more limited experience with outsourcing, which means that standard business routines may not yet be well established. Higher set-up costs suggest that Legacy firms are most suitable for long-term and large-scale projects.

Another advantage of Legacy firms, compared to Multinational Ventures and New Generation firms, is that they will likely remain dominant since they have experienced workforces that will enable them to quickly grow their offshoring businesses. An example is Inspur, which entered the offshoring market relatively late but then moved quickly into the CIESN rankings.

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16 A Chinese term used to refer to an occupation with guaranteed job security as well as steady income and benefits.

17 Guanxi describes the basic dynamic in personalized networks of influence and is a central concept in Chinese society.
New Generation Firms

New Generation firms are mostly private Chinese firms or wholly owned foreign enterprises set-up either by Sea Turtles or by foreigners. There is less of a language barrier with these firms and, culturally, they have been built from the ground up using Western management practices. This suggests that using New Generation firms to provide offshore IT services may involve lower coordination costs.

A distinguishing characteristic of these firms is their agility and entrepreneurial spirit. They are more willing to make big changes in their production processes, so may be more willing to customize their services to better meet the demands of their customers. The founder usually has a great influence on staffing and decisions can be made very quickly.

On the other hand, given their relatively short history, New Generation firms may lack experience in delivering big projects. They are also more likely to be subject to industry restructuring, so potential customers should consider the stability of the firm and its staff. Nearly all of the M&A activity in the Chinese offshore IT services industry to date has involved New Generation firms—Prosoft, I.T. United, iSoftStone, and others.

Comparison between Chinese and Indian offshore IT services industries

Many U.S. and European IT professionals are familiar with the evolution of the Indian offshore IT services industry and recognize its largest players. But, as this analysis of China’s industry shows, the Indian and Chinese industries have evolved in quite different ways.

The Indian offshore IT services industry is dominated by five companies—TCS, Infosys, Wipro, Satyam, and HCL. Although they all emerged in the 1970s and 1980s, most of them had no overseas clients until after 1990. During their early years of working with foreign clients, all of these companies were primarily “body shops” (providing human resources but little managerial value added). Wipro and HCL began as computer hardware companies and then evolved into IT services. TCS and Wipro evolved from their parent conglomerates, the former being one of India’s largest.

Unlike the Top 39 Chinese providers, all of India’s Top 5 would be classified as Legacy firms. The difference here, though, is that during the 1990s, each of them shifted their focus from the domestic market to an aggressive export-oriented strategy. Also remember that, when Indian offshore providers were emerging in the 1980s, the global software industry was too young and immature for there to be a New Generation classification.

In summary, the Chinese industry is evolving quite differently from the Indian industry (which in turn evolved quite differently from the Israeli software industry, which in turn evolved differently from the Irish software industry). Each of these major national software industries took different trajectories in their early and middle stages, and now look quite distinct.

CONCLUSION

In conclusion, our analysis of the Chinese offshore IT services industry shows that it is growing rapidly but is still at the early stage of maturity. The industry is still fragmented and is still heavily influenced by foreign firms. However, there are indications that the industry will soon move into the Shake-out stage of maturity. With consolidation just around the corner, the sword of the Chinese offshore IT services industry will soon be sharp enough to become a major force in the global market.

APPENDIX: METHODOLOGY FOR CREATING THE TOP 39 LIST

We used several industry rankings to generate the list of 39 firms included in our analysis. We began with the Top 20 offshore Chinese IT services companies listed by CIESN for 2004 and 2005 (published in late 2005 and late 2006). CIESN is regarded as the authority on ranking Chinese IT services firms. The combination of the two years’ rankings produced 31 firms, although three firms merged with others in 2006. We augmented the CIESN lists with emerging offshoring firms from Global Services magazine’s “Offshore 100 list” for 2005 and 2006. There were 12 Chinese firms in those lists, only two of which—Neusoft and Kingdee—were also listed by CIESN. We also added the China division of Tata Consultancy Services to our list to represent the trend for Indian IT services firms to expand into China (14 large Indian firms now have IT services operations in the country). Tata is not only the largest, but also the earliest to enter the Chinese market.
Once we had created the Top 39 list, we collected information on each firm’s history since its founding. We paid special attention to how a firm’s offshoring business originated, its major clients, and industry focus. We also collected data on the number of employees, location, and major financing events.

We excluded major Western firms such as Microsoft, IBM, Oracle, and SAP that were establishing a presence in China in 2005-06 because they were serving mainly domestic clients and therefore were not providing offshore IT services. In any further investigation of the Chinese offshore IT services industry, we would recommend including these organizations’ cross-border operations.

FURTHER READING

China’s offshore IT services industry has received far less attention than its Indian counterpart. However, the following recent studies provide some insights into the Chinese industry:


• Suggests that the transaction costs of offshoring to China are much higher than to India.


• Provides an overview of the Chinese software industry but not specific to the offshoring sector.


• This McKinsey report found that Chinese firms are too small for large-scale projects.


• Highlights that Chinese software firms have had to rely on guanxi—relationships with the government.


• Examines the impact of the emergence of China and India on high-tech outsourcing and the competitiveness of Western companies.


• Examines the development of internal capabilities in indigenous Chinese vendors.


• Uses internationalization theory to examine six large Chinese firms.

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