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Offshore outsourcing to Russian IT providers: Opportunities, risks and best practice procedures

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SCHUMPETER DISCUSSION PAPERS

Offshore Outsourcing to Russian IT Providers: Opportunities, Risks and Best Practice Procedures

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Abstract

Outsourcing IT to specialized providers 'off-shore' has become an important option for many western companies for maintaining or improving their competitiveness. The vast majority of those specialized IT providers are located in Asia, especially in India. Relatively little is known though about the Russian IT provider market.

To provide IT decision makers with deeper insights, this article provides the necessary theoretical foundations as well as practical information about the Russian IT provider market based on extensive market research and project experiences.

Offshore Outsourcing to Russian IT Providers: Opportunities, Risks and Best Practice Procedures

Dr. Stephan Weinert / Dr. Mathias Weber / Dr. David Vasak

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1 Introduction

Outsourcing IT to specialized providers 'off-shore' has become an important option for many western companies for maintaining or improving their competitiveness. The vast majority of those specialized IT providers are located in Asia, especially in India. Relatively little is known though about the Russian IT provider market, a challenging market but also a market with untapped potential.

The aim of this article is thus to shed light on the Russian IT offshore outsourcing provider market. To do so, we will first of all introduce the reader to the IT offshoring phenomenon. Special attention will be given to the terminology applied in this article and the theoretical foundations on which offshore outsourcing is build on, followed by a discussion of the main IT offshore outsourcing drivers. Based on this foundation, the Russian IT provider market will be analyzed in detail. This will be followed by a discussion about the risks when doing business with Russian IT providers. To limit these risks, a generic IT offshoring methodology which addresses key areas of concern will be presented.

2 Essentials for Understanding the IT Offshoring Phenomenon

Before focusing on the Russian IT provider market we review the terminology applied, and briefly outline the underlying theoretical foundations for understanding the reasons for and the growth of IT offshore outsourcing.

2.1 Terminology

By 'offshoring' we understand the relocation of various tasks previously performed in-house by a 'home' company to third parties located abroad ('off-shore'), mostly in low cost countries.¹

It is important to stress that the receiving party can be part of the intra- as well as the inter-organizational network of the home company.² Accordingly, the receiver can be a unit of the company, such as a subsidiary, or it can be an external 'outsourcing' provider. The receiving party, or outsourcing provider, can be located in the same country as the home company or it can be located abroad.

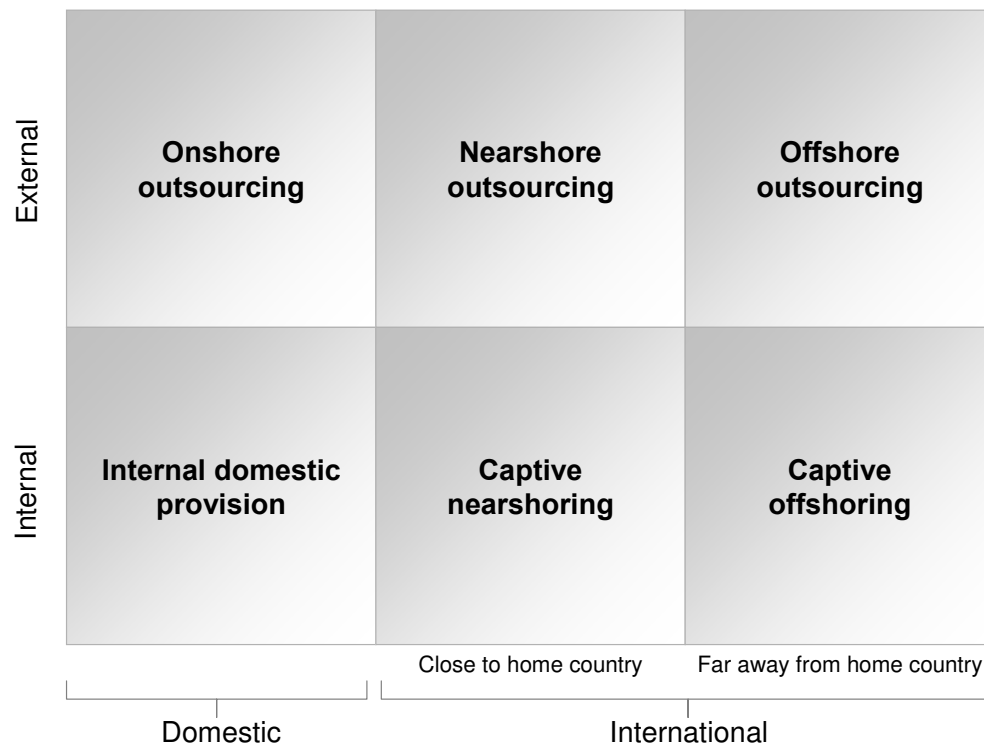
¹ Although the vast majority of offshoring is related to transferring activities to low cost countries, some preferred offshoring locations are actually high cost. Singapore is a good example in this context. Despite its high costs, it is among the top five offshoring locations. Cf. AT Kearney (2004), p. 2.

² See for a distinction between intra- and inter-organisational network Kutschker / Schmid (2004), pp. 526-537.

If the receiving party is located abroad the term 'offshoring' is usually applied. However, some authors even sub-classify offshoring further by also speaking of 'nearshoring'. The difference between off- and nearshoring is simply the geographical distance from the point of view of the home company. If the offshoring location is in the country of origin the term 'onshoring' is sometimes used.³

Giving these differences, it is possible to differentiate between six generic sourcing strategies (figure 1).

Figure 1: Main sourcing types⁴



As this article focuses on transferring IT activities to specialized providers from Russia, attention will be paid solely to nearshore outsourcing or offshore outsourcing respectively.⁵

The difference between near- and offshore outsourcing is, however, rather subjective because it always depends on the individual location of the 'home' company. We will therefore not continue to differentiate between the two but refer to both of them as 'offshore outsourcing'.

2.2 Theoretical Foundations

The rationale for outsourcing and offshore outsourcing is deeply rooted in the resource based view (RBV).⁶ Its main message is that the key to sustainable competitive advantage (SCA) lies in certain combinations of firm resources.

³ Cf. Schwarz (2005), p. 33; Erber / Sayed-Ahmed (2005), p. 100.

⁴ Cf. Koubek / Weinert (2006), p. 44.

⁵ For more detailed information about 'captive offshoring' see, for instance, Weinert (2007).

⁶ Cf. for instance, Barney (1991); Grant (1991); Collis / Montgomery (1995).

These resources can generally be grouped into two categories: physical or tangible resources (e.g. machines) on the one side and intangible resources (e.g. brand names, expert knowledge, and company culture) on the other side.

It has been argued though that the latter are of higher significance for SCA than the former. This led to the creation of the 'core competence' stream developed, in particular, by Prahalad and Hamel.⁷ The essence of their work – and of all following contributions in the area of core competencies – is that the advantages related to tangible resources are hard to defend. Core competencies, on the contrary, are based on knowledge which allows the coordination of diverse production skills and the integration of multiple streams of technologies better than competitors.⁸ As knowledge often takes the form of tacit knowledge on the one hand, and as it is often embedded in organizational routines on the other hand, it is difficult for competitors to copy core competencies of rival companies. This makes core competencies so fundamentally important and it explains why managers strive to build up new core competencies as well as to identify, defend and nurture existing ones.

Building on this argumentation, Quinn and Hilmer concluded in their ground breaking article 'Strategic Outsourcing' that companies can best achieve above-average performance when focusing their efforts more on their core competencies and strategically outsourcing non-core activities.⁹ As a result, managers are eager to outsource IT activities as these are often viewed as being neither core competencies nor strategically critical.

3 IT Offshore Outsourcing Drivers

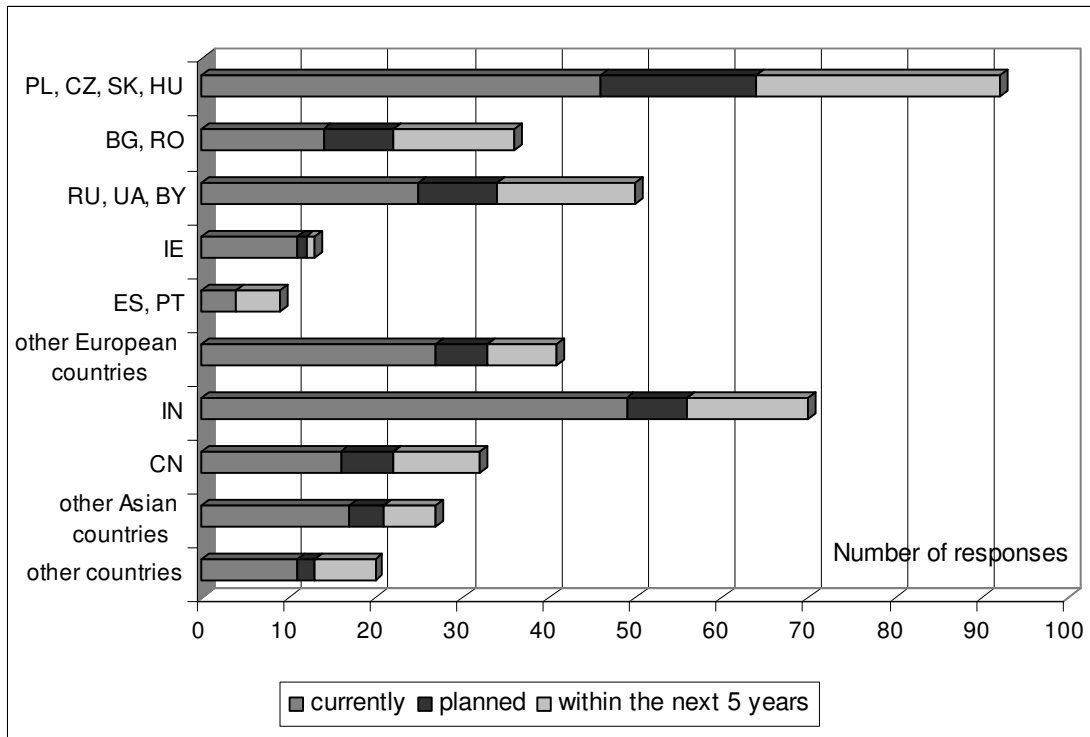
Recent research does not only show that outsourcing will continue to grow significantly in the future, it also shows that German companies become increasingly interested in nearshoring to Eastern and Central Europe in general and to Russia in particular (figure 2).

⁷ Cf. Prahalad / Hamel (1990).

⁸ Cf. Prahalad / Hamel (1990), p. 82.

⁹ Cf. Quinn / Hilmer (1994).

Figure 2: Preferred offshoring destinations of German companies¹⁰

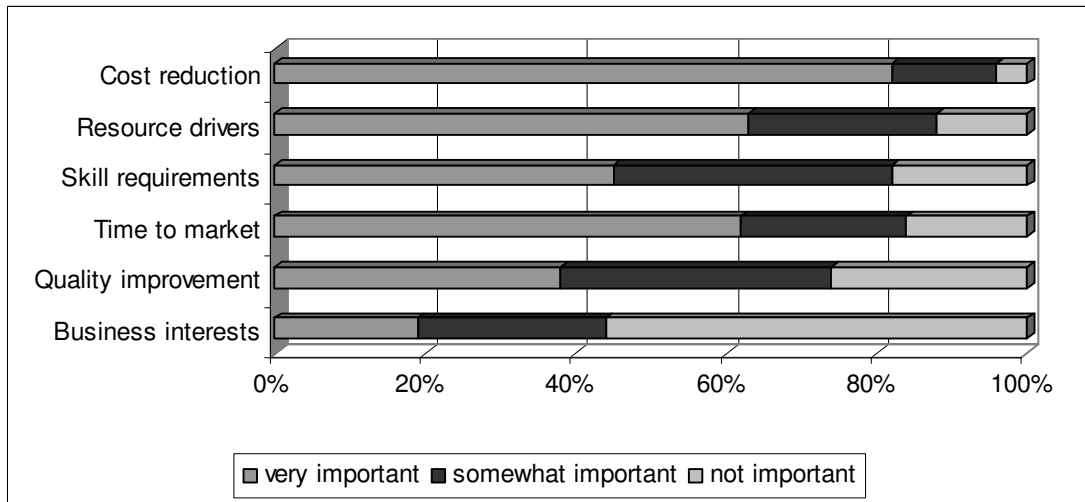


Although India currently leads the way, Eastern and Central European countries as well as Russia, the Ukraine and Belarus have also become popular offshoring destinations for German companies. And these countries seem to increase their importance even more in the future.

Giving these results, the question comes to mind what exactly drives companies to offshore increasingly to Eastern Europe and Russia in particular. A global cross-industry survey targeted at companies being involved in IT offshoring to Russian providers (figure 3) sheds more light on this question.

¹⁰ Schaaf / Weber (2005), p. 17.

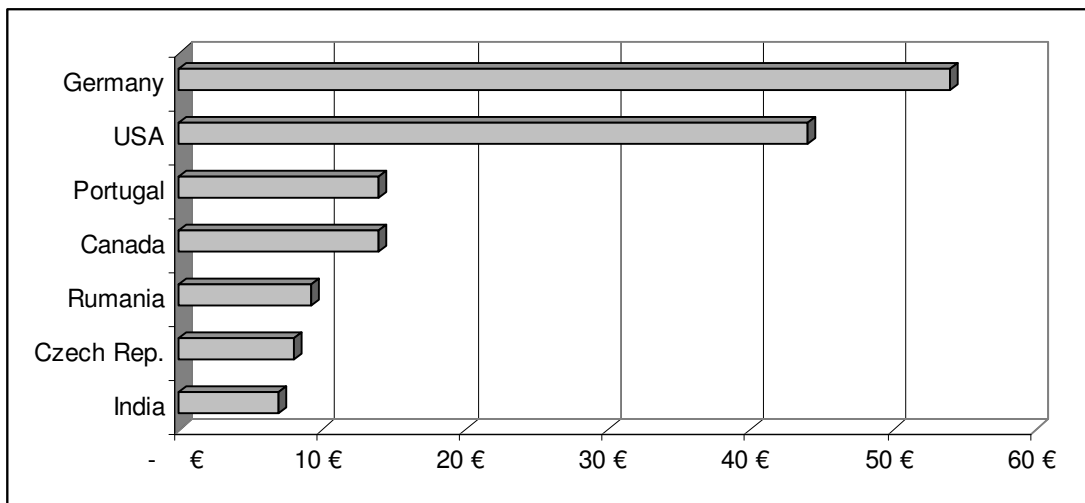
Figure 3: Main IT offshoring drivers¹¹



Obviously the key driver for offshoring IT activities to Russian providers is cost reduction. About 82 percent of the respondents regard it as very important, and about 12 percent as somewhat important. Thus, cost reduction is of no significance for only a very small minority of the companies having participated in the survey.

The corresponding savings potential is determined by the wage rates for software engineers. Figure 4 shows that software engineers in Germany cost on average about six times as much as their Russian counterparts.

Figure 4: Wage rate differentials of software engineers¹²



The next most important offshoring driver is resource scarcity. Germany, for example, faces a shortage of IT experts. Many companies are already

¹¹ Aberdeen Group (2003), p. 22.

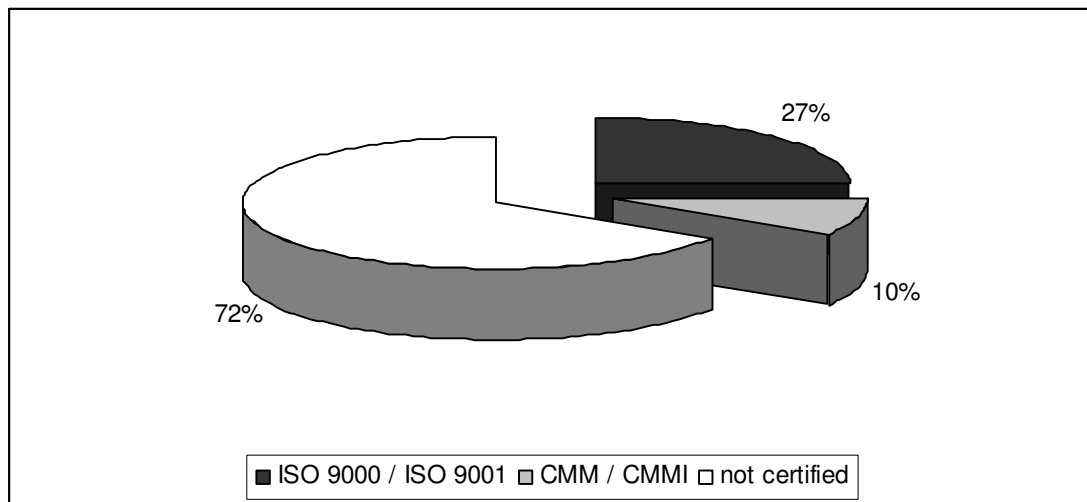
¹² Weinert (2007), p. 14. It should be noted though that the wages shown in figure 4 represent means. Significant wage differentials can be found in Russia though. Especially wage rates in Moscow are increasing drastically. Cf. Makarov (2007), p. 28.

rejecting lucrative orders because the labour market is of short supply of qualified IT staff. By offshoring IT activities to Russia, German companies are able to take advantage of external and highly-skilled personnel which can positively affect profitability and reduce overall commercial risk.

Time to market refers to the ability to take advantage of time differences between multiple geographies in order to lengthen workdays. This is especially an advantage for US companies dealing with Russian offshoring providers. The eight-hour time difference between the US East Coast and Moscow for instance allows shifting work to the partner unit abroad and by doing so shortening the overall project schedules.

Another driver is quality improvement. An increasing number of Russian offshore outsourcing providers meet international quality standards. About one third of all certified Russian IT providers meet the ISO 9000 and ISO 9001 standards. About 10 percent meet key CMM standards (figure 5). However, the actual number of certified Russian companies is small compared to Indian IT providers in particular. (India shows the highest percentage in CMM certified companies. In fact, 60 out of the 80 with CMM 5 certified companies world-wide are from India.¹³)

Figure 5: Distribution of quality standards among certified Russian IT providers¹⁴

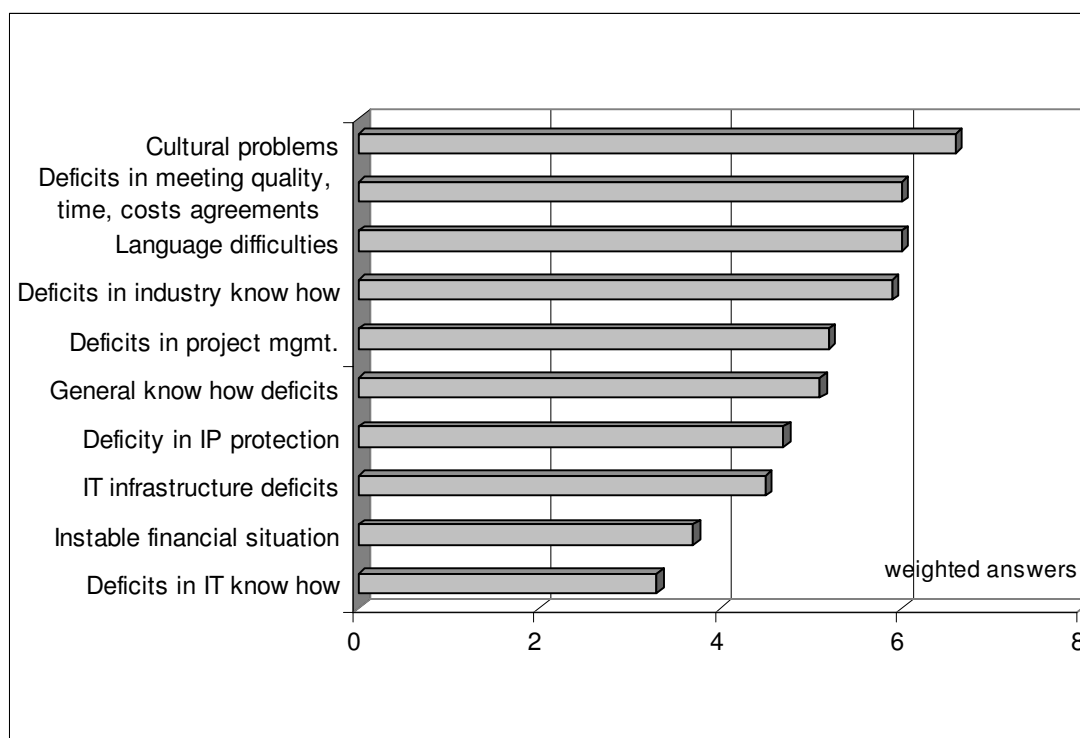


Market entry is another albeit less significant driver. As Russia's economy shows increasing growth after suffering during the late 1990s the Russian market is becoming more and more attractive for foreign companies. Offshore outsourcing can be the first step to entering that market.

Figure 6 shows another important aspect: Cultural differences still pose a major challenge for IT offshoring projects despite the growing international experience of large (and increasingly medium-size) German companies.

¹³ Cf. Weinert (2007), p. 16.

¹⁴ Makarov (2007), p. 33. Totally there are more than 100 percent because several companies have compliance certificates with several standards.

Figure 6: Main problem areas when working with offshoring providers¹⁵

Especially conflicting leadership and communication styles endanger the relationship between the offshoring partners.

The differences that exist between the German and Russian cultures are, however, not as substantial as the differences between Germany and India in particular. Many values and beliefs are often shared between Germans and Russians. This provides a foundation on which lasting relationships can be built. Moreover, English is usually spoken sufficiently by Russian IT providers' employees and sometimes even German. Thus, problems related to communication are generally less significant.

4 The Russian IT Provider Market

The following sections provide a deeper insight into the Russian IT offshore outsourcing market. First of all, the market structure will be analyzed. Secondly, it will be investigated which markets Russian IT providers try to target the most. Thirdly, the main services offered by Russian IT providers will be presented and its implications discussed.

¹⁵ Schaaf / Weber (2005), p. 21.

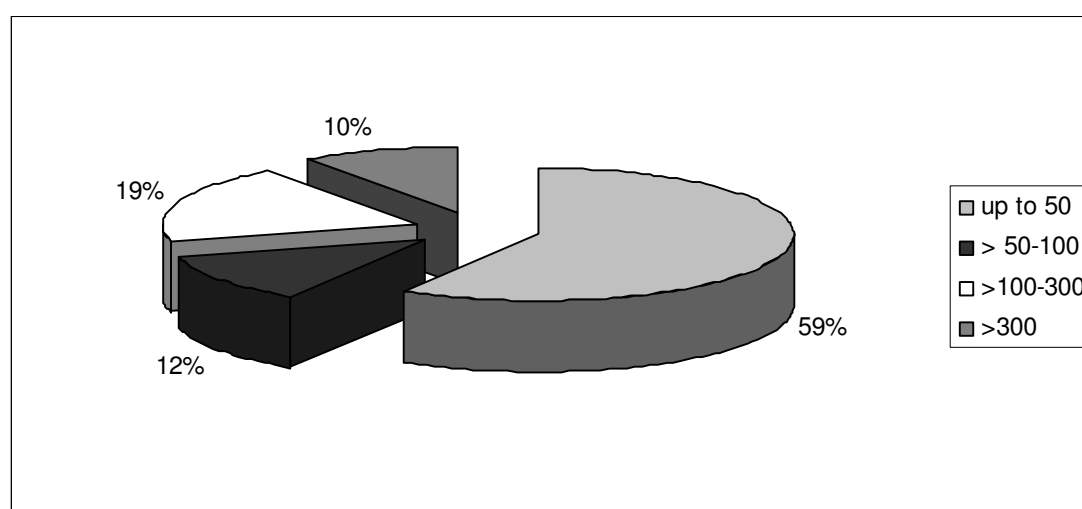
4.1 Market Structure

The Russian IT offshore outsourcing provider market can still be regarded as being in an early stage, highly fragmented, heterogeneous and entrepreneurial compared, in particular, to the Indian market.

The entire market volume for Russian software services, measured in terms of software export volume, is estimated to be about US\$ 2.1bn in 2007.¹⁶

When analyzing Russian IT providers it is first of all striking that no companies with considerable size exist. This holds true when, for instance, size is measured in terms of staff employed. The vast majority of IT providers employ less than 50 people. Only 10 percent employ more than 300 (figure 7).

Figure 7: Number of employees working for Russian IT providers¹⁷



In contrast to this, the Indian IT company Wipro, which is amongst the leading offshoring providers world-wide, employs more than 40,000 people in India alone.

Although it has been reported that average staff growth is about 37 percent p.a., most companies will remain to be medium-size with about 400 to 500 people employed.¹⁸

The fact that the Russian IT provider market is dominated medium-size companies is further supported by research measuring size in terms of turnover. A survey by PA Consulting Group, for example, which focused on the IT nearshore provider market, concludes that Russian IT providers are rather small with turnovers ranging only between € 2-10m.¹⁹

¹⁶ Cf. Makarov (2007), p. 11.

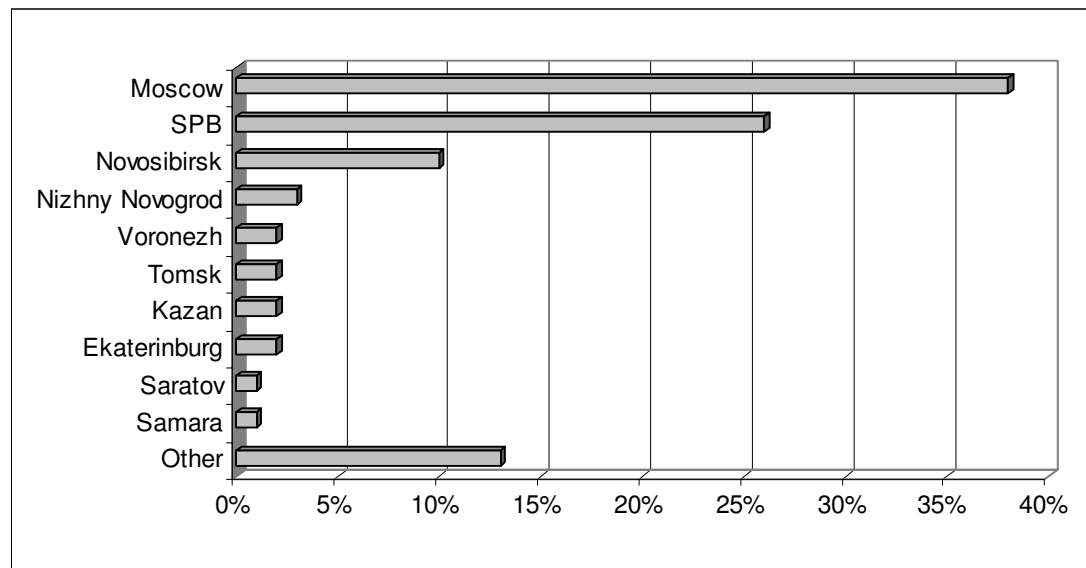
¹⁷ Outsourcing-Russia (2005).

¹⁸ Cf. Hoppermann / Parker (2004), p. 2.

¹⁹ Cf. PA Consulting Group (2006), p. 1.

Another important aspect of the Russian IT offshore outsourcing provider market is its geographical concentration. The majority of providers are located either in Moscow, St. Petersburg or Novosibirsk (figure 8).

Figure 8: Headquarters of Russian IT providers²⁰



Reasons for this are in particular the availability of qualified personnel, a reasonable infrastructure as well as the possibility to establish relationships to potential clients (Most large domestic as well as foreign companies can be found here) or partner organizations to name just a few aspects. This regional concentration might foster the emergence of innovative and highly competitive IT clusters in the future. Especially the Indian IT industry's success derives largely from such clusters. The most prominent one can be found in Bangalore, the 'New Silicon Valley'.

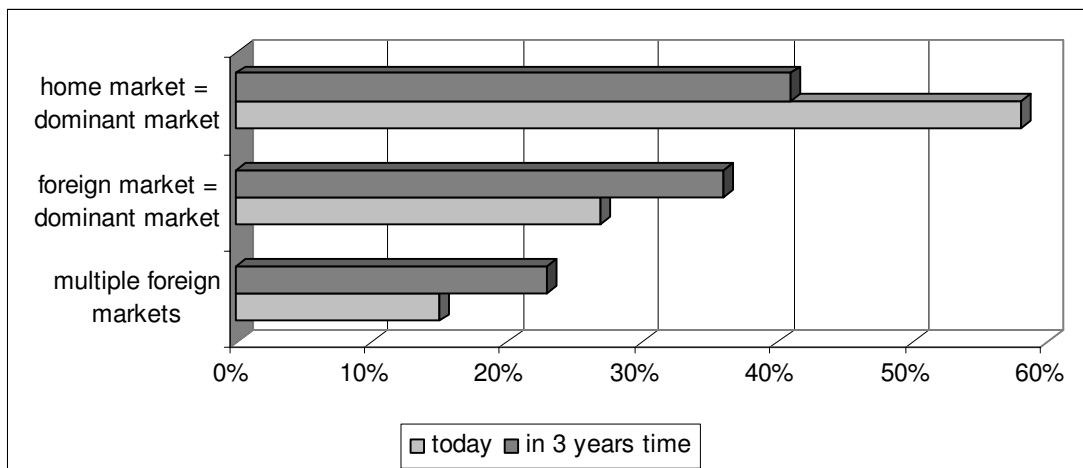
Accordingly, it can be concluded that today's Russian IT offshore outsourcing market is still rather small in terms of volume. Furthermore, it is geographically highly concentrated, fragmented and consists mainly of specialized niche players.

4.2 Market Coverage

Research focusing on various nearshoring locations (including Russia) for German companies provides important insights on the markets Russian IT offshore outsourcing providers primarily target with their services. Currently about two-thirds of all foreign IT providers consider their home market to be their dominant market. About one third regard one foreign market as their main market, and only a minority considers multiple foreign markets as their dominant markets (figure 9).

²⁰ Outsourcing-Russia (2005).

Figure 9: Key markets of nearshore providers²¹



The current focus of international IT providers on domestic markets will not persist though. The number of companies selling exclusively at home is expected to decline from almost 60% to 40%, due to increasing activities abroad. This trend can be observed also for the Russian IT providers.

Figure 10: Primary target markets of Russian IT providers in 2006²²

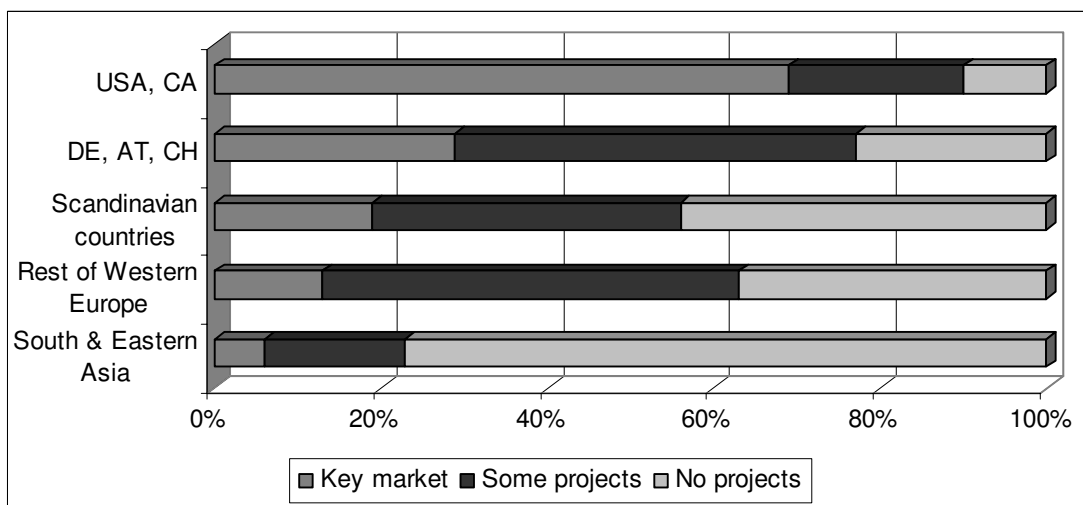


Figure 10 shows that North America and Western Europe are the main foreign markets for Russian IT providers. Especially Germany, Austria and Switzerland but also the Scandinavian countries are of high significance. Asia on the contrary plays hardly any role. It is obviously difficult to penetrate that market against Asian competitors.

The analysis also shows that Russian offshore outsourcing companies successfully expand their international footprint with highest growth in the German speaking countries Germany, Austria and Switzerland.

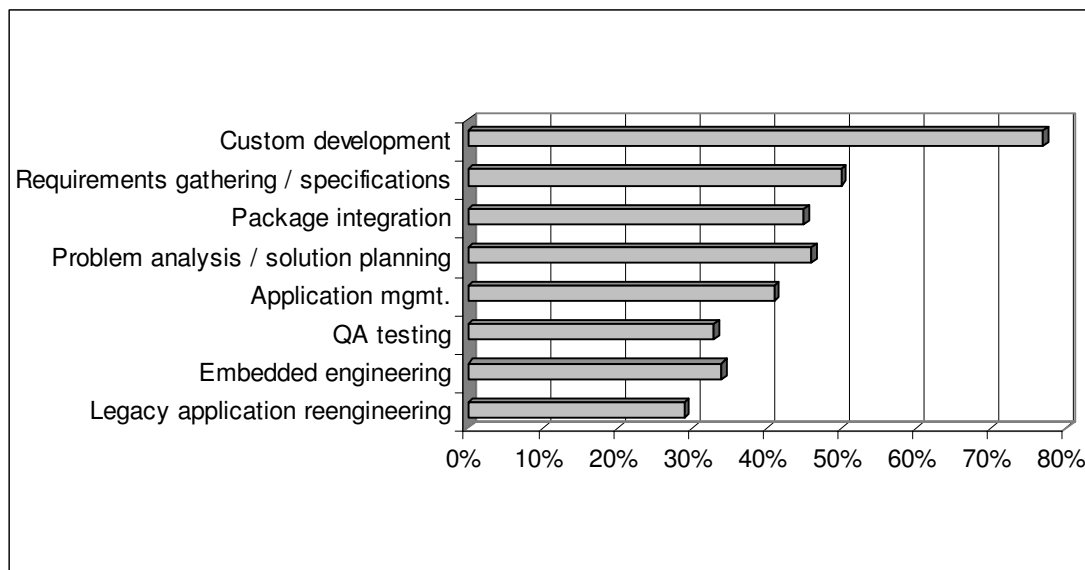
²¹ PA Consulting Group (2006), p. 2.

²² Outsourcing-Russia (2005).

4.3 Service Portfolio

In general, the service portfolio comprises the full range of IT services (figure 11). Research shows however that customers value Russian IT providers especially for a handful of specific services. Custom application development ranks first of all in this context. It represents the majority of Russian software services that are delivered to domestic as well as to foreign customers. This work typically affects core business functions or products of client companies.

Figure 11: Services offered by Russian IT providers²³



On the other hand, Russian IT providers usually do not support non-core software development, application maintenance and customer support. The level of IT expertise is generally extremely high in Russia, perhaps even higher than in most other offshoring locations. Especially the relatively high level of involvement by Russian software services companies in project planning and analysis is striking given that these life cycle activities are not typically associated with IT offshore outsourcing. The value from Russian IT providers might best be characterized as technology problem-solving rather than simple low-cost programming.

Apart from custom development, Russian IT providers deliver services in the areas of package integration, and to a lesser extent in the development of internal operations and e-commerce applications. Specialists providing services in testing, embedded engineering and legacy application reengineering can also be allocated.

²³ Aberdeen Group (2003), p. 10.

5 Managing the Risk when Dealing with Russian IT Offshore Outsourcing Providers

The process of offshoring IT is complex and imposes high risks on the business. To manage these risks effectively, an IT offshoring methodology is presented which captures key lessons learned. Following this methodology has proved to deliver the desired results in numerous IT offshoring projects.

Making it Essential

This is the initial ‘thought experiment’ in which the management reviews the current IT services and develops a high level structure of required service and technologies, together with careful consideration of associated risks and expected financial impacts. It is important to clearly identify core business applications and data that must remain fully controlled by the business, and develop strategic options and a plan for sourcing prioritized service packages (figure 12) with clearly defined contents, service levels, and business cases.

Figure 12: High-level IT service structure

Consulting & Project Support				
Application Services				
Communication applications	Commercial bespoke applications	SAP-based applications		
Infrastructure Services				
Desktop	Helpdesk	Data center		
		Speed & data communic.	Server & storage service	Data management
Security Services				

The rationale for the outsourcing exercise must be robust and finally approved by all involved stakeholders.

Making it Ready

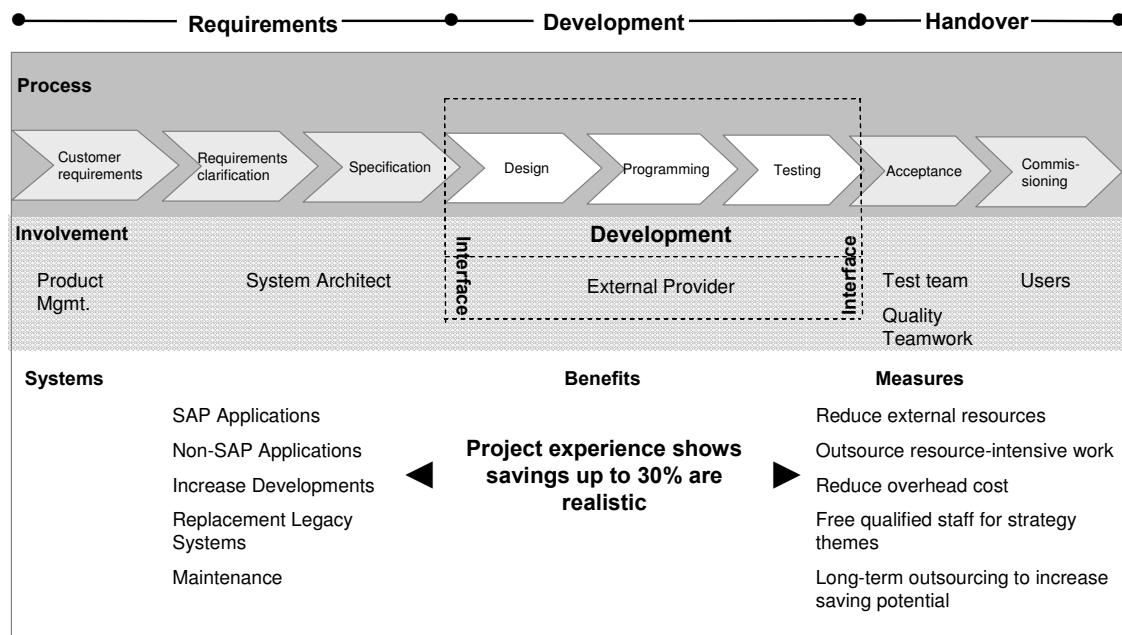
In this step the analysis will be extended to:

- Identify suitable service providers (price, quality, culture)
- Conduct due diligence to minimize risks (the figure below shows the risk analysis for various providers)

- Design the contract and select provider
- Develop a win-win strategy for outsourcing and a communication plan
- Outline transition process and change management approach

Essential is a good preparation of the existing IT (technology, processes, organization structure and people) for offshoring. Open issues should be resolved upfront. The remaining IT organization needs to develop a process and build skills to manage the outsourced operations (figure 13).

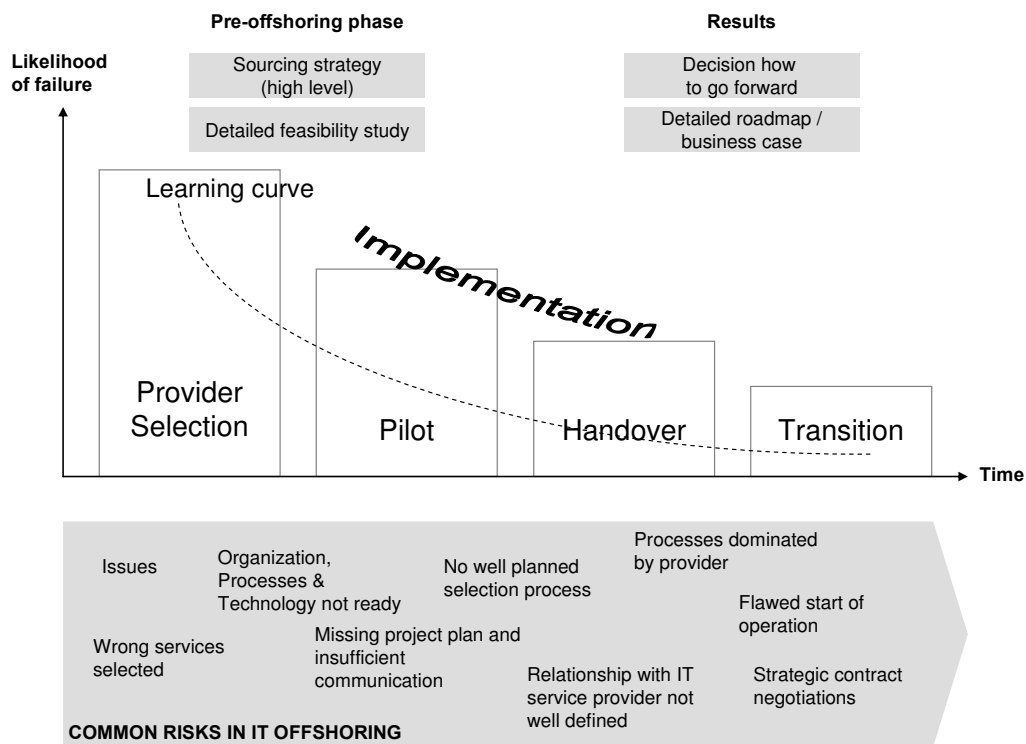
Figure 13: IT offshoring process



Making it Happen

The objective of this step is to facilitate a conflict-poor transition of the IT services without any negative impact on the business. The organization will be restructured and adjusted to the new way of receiving, managing and monitoring IT services. The corresponding change process needs a strong leadership with committed change agents, and a defined and operating escalation process. The pitfalls of the implementation need to be avoided by a pro-active and rigorous risk management (figure 14).

Figure 14: The IT offshoring process and its implied levels of risks



Making it Stick

In order to ensure and sustain high quality and cost-effective IT services with clear responsibilities, stable processes and minimum conflicts, a continuous performance monitoring and rigorous management of deviations is needed. Best-practice and adoptions to changes in the business requirements must be rapidly and effectively incorporated.

6 Conclusion

Offshoring IT has been a popular topic among business leaders in developed economies. It promises high cost saving potentials but it can also be a mean to improve service quality.

So far, IT has been offshored predominantly to Asia, in particular to India, which has become a partner of first choice for many western companies.

However, transferring IT to India does not always pay off. An increasing number of western clients complain about deficiencies in service standards, often caused by cultural misunderstandings. The cost savings are also not guaranteed, especially when expatriates need to be transferred to India who build up and manage the offshored IT services.

An alternative to offshoring IT to India can be Russia. This is in particular the case for German and other western European companies due to the low geographical and, more importantly, low cultural distance. Although the

country's IT provider market is still quite small and highly fragmented it can be an attractive option which offers exceptional returns. This implies though that a thorough business case and a project plan exist which likewise take into account potential gains as well as implied risks.

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