KATA CONSULTING

The Risks Ahead: India

An Analysis of the Future of Offshoring in India

India has been the most popular location for offshoring since the 1990s but what does the future hold?

By Wayne Simmons
Founder
Kata Consulting

A Look Back

In his book *The World is Flat* Thomas Friedman states that the emergence of India as the preeminent outsourcing location was due to a convergence of several factors: Y2K, overcapacity in communication lines, and the dotcom bust. US companies were able to hire inexpensive Indian programmers to perform the tedious code changes required to fix their Y2K problems. The inexpensive communication lines made it possible for the programmers in India to remain in India. When the dotcom bubble burst and IT budgets across the US were slashed India was there as a proven provider of low cost IT services.

Inflation

Today, Indian outsourcing companies may be falling victim to their own success. As demand for skilled workers increases so does the salary those workers demand. A survey by IDC India for the magazine Dataquest shows that the annual salary for a software worker has risen by 18.7% this year and 18.3% last year. According to a Towers Perrin report this means that India has the highest wage inflation in the world for 2007. The salaries remain low by western standards ($15,300 per year) however the higher salaries decrease the value proposition of outsourcing.

Another indication of wage inflation is the growing number of expatriates from countries such as the US and Britain taking executive jobs in outsourcing companies. The Financial Times reports that the percentage of expatriate executives hired over the past three years has grown from 5% to 15%. Executive salaries in India are nearly on par with western executive salaries reaching $245,000 to $845,000 for chief executives.

Valuation of the rupee is also cutting into the bottom line of outsourcing companies. Both Tata Consultancy Services and Infosys Technologies had to adjust earnings downward this year due to a combination of strong performance of the rupee and wage inflation. Although net profits have increased since last year the margins have decreased.

Staff Sophistication

Due to time zone differences with the US and Europe having a job at an outsourcing company has meant shift work. Those unwilling to do shift work were not able to land a lucrative job with an outsourcing firm. However, this may be changing.

In June of this 2007, Tata Consultancy announced plans to hire 5,000 employees in Mexico. This move was not based on wage inflation as the salaries in Mexico are 30% higher than in India. This move aims to increase the

number of Tata employees in the US time zone - a sign that workers in India are becoming less willing to do shift work.

Advanced Education

Indian undergraduate and technical schools are producing around 1 million science and engineering graduates each year. However, of the 7,000 Indians who receive PhDs each year, only 50 of them are received in India. Most Indians with PhDs receive their degrees outside the country and remain there. This lack of local PhDs will limit India's ability to move up the value chain of technical abilities.

Both Microsoft and IBM have warned that the lack of computer science PhDs could threaten India's leadership position in software development outsourcing.

Inequality

Despite the success of outsourcing companies, India is still a country with extreme poverty. There is a rising sense of inequality among Indians. Manmohan Sing, India's prime minister, has warned industry to be modest in its salary levels to avoid social unrest. He has also warned advertisers to be socially sensitive and avoid vulgar displays of wealth in advertising so as not to insult the poverty of the less privileged.

Using the Gini coefficient, a measure of the inequality of wealth distribution where 0 represents perfect equality and 1 represents perfect inequality, India scores .325 which is in the bottom 1/3 of all countries.

Conclusion

The risks examined above indicate that the outsourcing market in India is still growing but the value proposition to onshore companies is decreasing. Over time a steady state will develop forcing Indian outsourcing companies to expand beyond India in order to increase revenues and margins. Indian outsourcers are already looking to countries like Russia, China, and Vietnam for sources of cheap labor. Indian outsourcing companies may remain the most popular choice for outsourcing but the work may not always be done in India.