The overlooked potential for outsourcing in Eastern Europe

Companies that seek to outsource their IT and business processes seldom head for the region—but soon more of them will.

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With less than 1 percent of the world's $30 billion market for offshore IT and business process outsourcing (BPO), Eastern Europe lags far behind more prominent locations, including India, Ireland, Malaysia, and the Philippines (Exhibit 1). Our research suggests that this may soon change: demand for offshoring[1] among Western European companies rose by half from 2004 to 2006, with Eastern Europe emerging as a favorite destination.

Although Eastern Europe's governments have not wooed business as effectively as those of the more established destinations, offshoring in that region offers three primary advantages: low wages comparable to India's, a relatively low risk profile for key factors such as reliable infrastructure, and cultural and geographical proximity to Western Europe. McKinsey estimates that offshoring activity in Eastern Europe could triple, to more than 130,000 jobs, from 2005 to the end of 2008 (Exhibit 2). What's more, given the relatively low pace of the region's wage inflation (Exhibit 3), along with abundant output from local universities, this talent source could remain economically competitive for at least 15 years.

Eastern Europe is a particularly attractive option for Western European companies. Not only is it nearby, but companies can often find language capabilities (especially French and German) that are less readily available in India or Southeast Asia. At the same time, the new members of the European Union—particularly the Czech Republic, Hungary, Poland, and Slovakia—can offer average labor cost savings of 40 to 60 percent over costs in Western Europe, while cities in EU-candidate and non-EU countries can offer cost advantages of 60 to 80 percent.

However, choosing a suitable location isn't just a matter of picking the right country; employment costs differ widely among cities because of limited labor mobility and varying

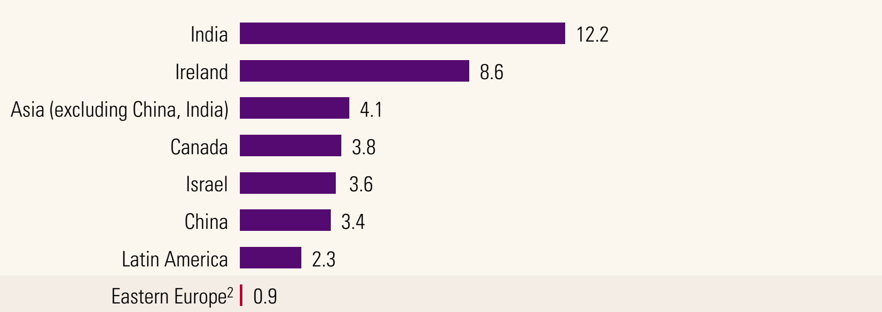
[1] Offshoring and its close cousin nearshoring are relative terms. North American corporations refer to the transfer of work to Caribbean countries as nearshoring. Western European companies use that term for the transfer of work to Eastern Europe.

Exhibit 1

A small share

Historically, Eastern Europe captured only a fraction of global offshoring activities.

Size of global market for offshored services,[1] 2003, $ billion



[1] Include business process offshoring and IT, both captive and outsourced.
[2] Only includes data for Czech Republic, Hungary, Poland, Romania, Russia, Ukraine.

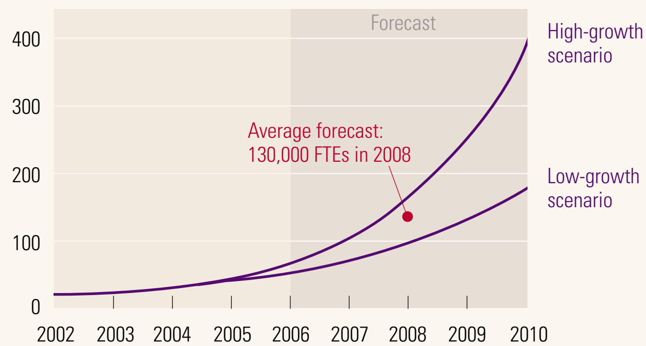
Source: Enterprise Ireland; Gartner; IDC; government Web sites and software associations for countries shown; ministry of information technology for various countries; National Association of Software and Service Companies (Nasscom); US country commercial reports; McKinsey Global Institute analysis

Exhibit 2

Forecast for growth

Demand for Eastern European offshoring is expected to grow to 130,000 FTEs in 2008.

Demand for offshoring in Eastern Europe, thousands of FTEs, cumulative[1]



[1] Offshoring = business process offshoring and IT, both captive and outsourced; Eastern Europe = Bulgaria, Czech Republic, Hungary, Poland, Romania, Russia, Slovakia; FTEs = full-time equivalents.

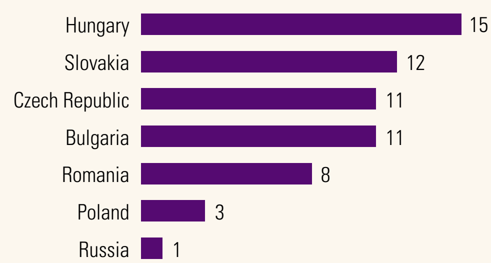
Source: McKinsey Global Institute analysis

Exhibit 3

Modest wage growth

Wage levels are expected to rise only slightly.

Compound annual growth rate of wages, 2000–04,[1] %



[1] For LABORSTA category "Financial intermediation"; wages expressed as euros.

Source: LABORSTA; McKinsey analysis

unemployment rates. Companies should look beyond the first-wave locations (such as Bratislava, Budapest, Krakòw, and Prague), where wages for experienced workers are rising faster than inflation. Instead, they should begin to explore midsize cities with little or no offshoring activity but large talent pools, where the labor cost advantage is more likely to remain attractive for the next decade.

Beyond the well-known capitals, Eastern Europe has 40 to 50 provincial cities with universities large enough to supply a highly skilled labor force, along with cultural environments that lend themselves to the creation of suitable clusters of employers for university graduates (Exhibit 4). This wealth of options can help companies reduce their labor costs and spread potential risks across a portfolio of locations with different risk profiles by taking into account the reliability of infrastructure, political stability, and the possibility that talent might emigrate, be enticed by competitors, or prove less capable than anticipated.

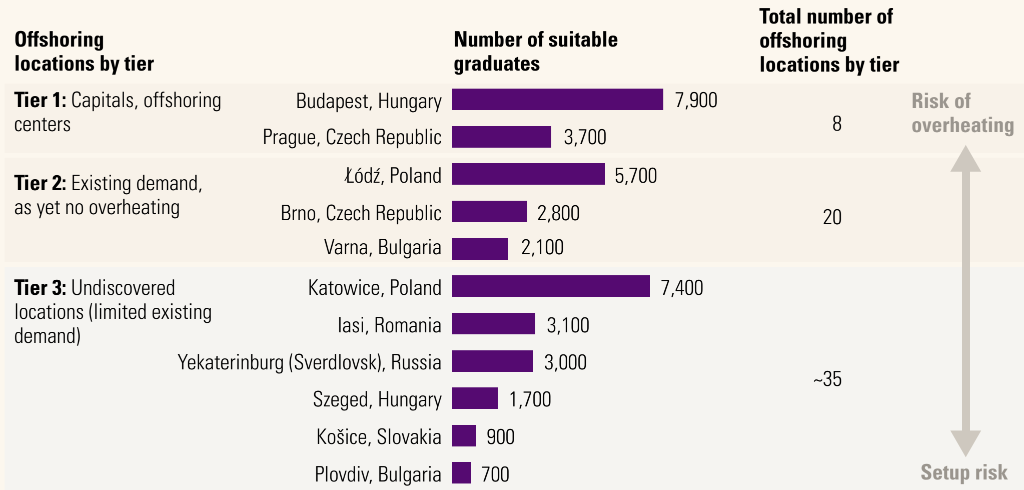
Most service centers in Eastern Europe today are so-called captives—they are owned by

Exhibit 4

The path less taken

Many seemingly undiscovered locations for offshoring exist in Eastern Europe.

Selected Eastern European cities with universities, by tier



the companies sending them work. Independent Eastern European providers of IT and business process services have a significant opportunity. But with few exceptions—Luxoft in Russia and Ericpol Telecom in Poland, for example—these companies are not on the map compared with better-known global and Indian players, some of which are setting up their own centers in Eastern Europe. So far, homegrown players have merely responded to local opportunities instead of seeking out seemingly more difficult global markets.

There are several reasons for this caution. First, Eastern European IT services providers, at their current scale, have difficulty keeping up with the 20 percent growth they can generate in their domestic markets. Second, regulations and inconsistencies in labor laws complicate expansion beyond national borders—expansion that is a necessary precursor to gaining scale comparable to that of the global providers. Finally, continental European companies have been slower to embrace offshore outsourcing than have those in the United Kingdom and the United States, which traditionally favor the English-speaking countries in Asia. The opportunity for local service providers prepared to step up to the challenge, either alone or with the help of private equity firms, is tempting. Luxoft, for example, has grown at an annual rate of 60 to 70 percent for each of the past five years. In 2005 the company had revenues of $45 million.

Cities and nations also have a stake in this growth opportunity. Perhaps drawing on the experiences of the Indian trade association Nasscom,[2] they should work with service providers to develop a regional effort to expand the market. A full-time team that promotes a city as an offshoring destination and supports investors in their search for talent and infrastructure can make a big difference to the development of a local market. Łódź, in Poland, has undertaken one such initiative, which has been helping to make the city a developing hub for services in business process outsourcing and IT. Local governments also can work with companies to restructure regulations in ways that facilitate cross-border growth. MoIT

[2] National Association of Software and Service Companies. The group includes the country's leading IT services providers.

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