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IT SERVICES IN CHINA – OPPORTUNITIES & CHALLENGES.

BRIEFINGS FROM THE LAND OF THE DRAGON: THE SECOND IN THE SERIES

In this article the author presents some excellent opportunities and challenges in the Chinese Information Technology (IT) market. The information is intended to help BITSians develop an understanding of the key issues as well as an appreciation of the associated risks and rewards, so that you can plan a forward looking China strategy.

China. China. China. We can't seem to go through a single day without hearing about the new economic frontier in the East. From giant multi-billion dollar corporations to entrepreneurial outfits in Silicon Valley, they all want a slice of the profit pie. China's put the "C" back in the big proverbial Cheese!

BACKGROUND

The world's greatest industrial revolution is taking place in the shortest possible time in our lifetimes, and will never be repeated. McKinsey & Co.'s worldwide managing director Ian Davis, in a conversation with Fortune Magazine, says that for Fortune 500 CEOs China is "Absolutely center stage." Goldman Sachs predicts that China's economy will overtake the US by 2039. A staggering amount of wealth is being created in every sphere, and it is key for Indian entrepreneurs to recognize this gold rush and try to exploit it.

IT companies should ignore this at their own peril.

China is however a very different marketplace, and plays by different sets of rules that require keen understanding and appreciation of local business and cultural issues. The next five years will provide tremendous opportunities for committed firms to build the market share, profit from local ventures, and acquire skills required to face the expected onslaught of competition in the global marketplace from China-bred firms.

INDIA'S OPPORTUNITY: PLAY IN THE WORLD'S SECOND LARGEST IT MARKET IS THE OPPORTUNITY

The size of the domestic IT market in China in 2001 was US$30 billion. The hardware sector takes the lion share of 80% and the rest 20% is made up of software and services. According to the Tenth Five-Year plan, the Chinese Government will invest Rmb 500 billion (US$60 billion) in IT sector. It is hoped that the contribution of IT sector to GDP will reach 7% in 2005. This is in line with government forecasts that China will become the second largest IT market after the United States in 5 years.

The Chinese appear to be first targeting local markets, gaining the experience and confidence in developing and servicing markets, and then using this as a springboard to compete in the world market. It is to be noted that there is already some groundswell of activity wherein Chinese returnees from United States and Europe are getting into the act of bringing offshore work to China. Their attempts are aimed explicitly at mimicking Indian firms' models for success in IT offshoring. As an inducement to promote IT, local and central governments in

China provide preferential policies that provide office space, facilities, tax incentives and reduced paperwork specifically for overseas Chinese who can bring technology to China.

WHY IT WILL EXPLODE IN CHINA

The Chinese IT market is growing by leaps and bounds prodded on by market forces combined with active encouragement and inducements by central and local governments.

With its dominance in manufacturing assured China now realizes that expertise in IT is critical in order to sustain the current growth levels. Without self-sufficiency in IT markets, China realizes it is going to be far more difficult to compete or be taken seriously in world markets. This appears to be the unstated driver of Beijing's technocrats.

There are of course barriers to implementing this vision. Western companies don't think China has proven its mettle in software development. It is primitive compared to the West and India. There is also a lack of world-class level mid-to-high level IT professionals, a fear about IP being stolen, and the regular linguistic / cultural barriers. The Chinese government recognizes that these issues exist, and if the past is any indication, they will effectively address this quickly.

There is also substantial spending in IT for the Beijing Olympics in 2008, as well as significant development in the financial services industry. The Chinese government is also focused on a major initiative to promote Linux and other open source technologies.

The rich and vast manufacturing sector of China has realized that IT is going to become a competitive advantage in the years to come.

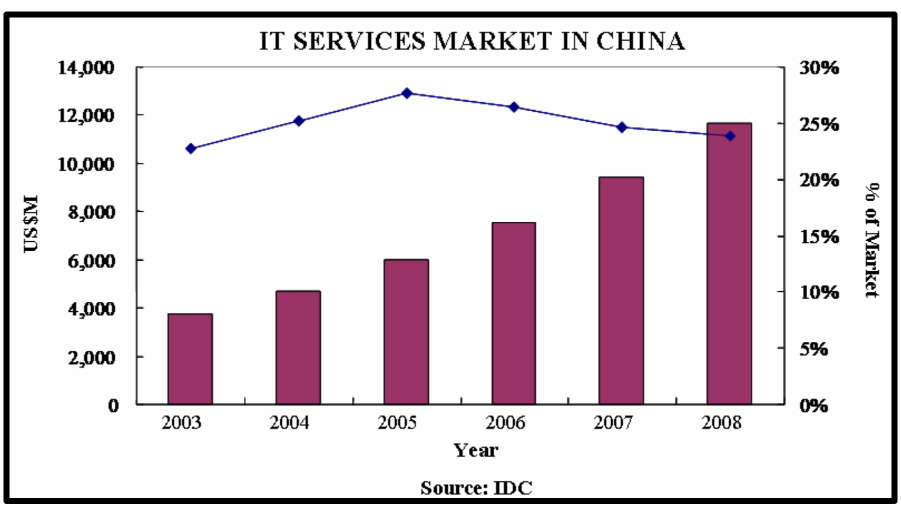
The Japanese IT Services market is estimated to grow to US$15 billion by 2005. Even though the Japanese are latecomers to the Offshoring bandwagon, they are determined to make up for lost time. Many of the Japanese IT firms such as NEC and Hitachi already have significant presence in China. The CIO of a prestigious Japanese Consumer Electronics and IT company opined that in five years time China is going to narrow the software process maturity gap with India. The Japanese clients have already made up their mind that their offshoring destination is going to be China.

SHOULD INDIA WORRY?

India continues to believe that the language barrier will make it harder for China to work with English-speaking customers. The biggest barrier is language which is being effectively addressed. English has become mandatory learning in Chinese schools. Students in high schools and universities are being told to put their energies to learn English skills rather than Chinese. Even while traveling in the interior provinces, this commitment can be seen in action. Most places now boast both Chinese and English billboards. In four visits to China since 1997, I noticed a gradual improvement in the English speaking and understanding level in Chinese people.

The other thing that Indian companies say is that Chinese companies don't have the same adherence to international

software standards. The Chinese are excellent students, and have demonstrated the ability to take complex processes in manufacturing, copy them, refine them and then to improve on them, in a very short span of time. The Chinese will quickly master software development processes such as CMM, and provide leadership and innovation in that space. In my role of managing the subsidiary of a major IT multinational in China, I have experienced first-hand an all-Chinese workforce in China. A Fortune 50 Client recently confided to me that my Chinese Team has outdone the equivalent Indian Team with



their dedication, hard work and promptness in spite of the language weakness in English. Chinese are fast learners with regard to processes and technologies. India should be worried.

China may end up leading the charge in creation of real products as well. If the innovations coming out of the Chinese-run Microsoft R&D Center in Beijing are any indication, China will rapidly surpass India in being recognized as world-leading, innovative software research center.

By it sheer size, China is going to be a breeding ground for some world-class local players. It is therefore very critical for an aspiring global player to play in this competitive market. An Indian company who hasn't learnt to live and thrive in this cut-throat environment will soon see its core-advantages vanish pretty quickly amidst the onslaught of the Dragons.

Currently, the local and central governments are throwing a welcome mat for foreign IT firms, especially for Indian IT firms. It is quid-pro-quo arrangement. China wants to give access to its local markets for Indian IT firms, but it also wants to learn from Indian firms. A few years from now it is quite conceivable that the Indian IT firms will have to compete with the same firms/people they trained. It is to be noted that with or without the help of Indian IT firms, China is certain to develop a robust IT industry that can challenge the built-in cost advantages and service efficiencies that Indian IT firms currently enjoy. To learn to compete against these players inside and outside China, Indian companies need to be in China now.

Strategies for Indian Companies

The question is – should one set up in China today to focus on the domestic business, or should one set up a center to focus on Japan. It's going to be difficult to do both at least initially. We examine both options.

Establish a full-scale solutions delivery center in China for competing for domestic business in Greater China (China / Hong Kong / Taiwan)

There are tremendous amount of business opportunities in Greater China region in the next few years, which can only be exploited through a full-scale delivery center in China. Make acquisitions or meaningful alliances as to fill gaps in solutions delivery or market expertise. This clearly will put the firm in the "thick of things", giving a greater understanding of the way business operates in China. Due to the first mover advantage, firms with world-class capabilities will win a greater share of the contracts, and be able to pick and choose the local firms to enter into JVs/ partnerships with. Clearly there is a risk too. Doing business in China means being patient with the returns on investment. The choice of a local partner is critical to success in China as well, especially when bidding for the large government or state-owned enterprise contracts.

Set up a development center in China for attracting Japanese & Southeast Asian business

Japan is going to be a $15 billion IT offshoring next year. Setting up a center focused on the better-understood Japanese customer base presents a less risky option. By setting up in China, it allows Indian companies to take advantage of the cost advantage with Chinese software developers. The Japanese are certainly going to be easier to do business with, and understand and appreciate the Indian brand name. They are also not likely to require difficult-to-run JVs with Chinese companies. The threat of knowledge transfers and the creation of domestic Chinese companies diminish as a result. Due to the heavy investments in China by Japan and the resulting business flows, having a Chinese center will be seen favorably. Japan and China have a shared, albeit difficult history, and a more similar cultural heritage than India.

This strategy is not without risks. The Indian companies could get blindsided by the local competitors. Secondly, it is a case of risk versus return. The Chinese market is going to be many times larger than the Japanese offshoring opportunity.

The alternative is to wait now for consolidation to begin

One can believe that the markets in China are not developed. Therefore it might make sense to let it develop, and when it is ready, enter the market with a big-bang approach combined with flawless execution of plans. This is the lowest risk strategy, but is fraught with risk. An Indian company may risk being left out of a growing and very important market. Plus, China may set the standards for pricing in IT. A foreign company may need to have the infrastructure that China presents to compete in a new pricing environment. Lastly, China makes it quite difficult for international companies to acquire domestic firms, especially the market leaders. This option may end up being a complex and expensive one.

Risks Exist

The IT market in China has to be understood in the context of Chinese economy, history and political climate. The growth opportunities of the Chinese market are certainly tempting. There are however political, economical and regulatory challenges and risks that one should be aware of. There is the usual litany of issues such as lack of legal framework, Intellectual Property protection and others. But they are manageable with proper insight and localization.

Due to the increasing income disparities China might face growing social unrest in the coming years, which can destabilize the growth trajectory of the economy. It is recognized that China has the widest disparity in the world today between the rich and the poor. The economic liberalization policies in China have lifted hundreds of millions of Chinese out of poverty since the 1980s.

There are also cultural risks to be considered. Most of business relationships in China occur through the informal "Guanxi" network. A foreign company will find it daunting to operate in China if it is expecting a familiar business and legal framework that it is used to operate in. There is quite a danger that foreign firms that seek to set up business operations in China, instead of taking the longer term picture, get bogged down trying to resolve issues such as branch Vs subsidiary dilemma, repatriation of profits and Visa issues within a legal framework. Workarounds for such issues can easily be found with the proper connections within the Chinese society and business circles. The roads in Beijing and Shanghai are littered with the remnants of foreign firms that failed to understand this fact. One should also understand that the local administration has significant leeway in interpreting the legal framework and very often they can set their own rules overriding the ones set by Beijing.

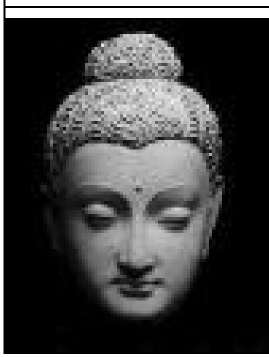
Lastly, the Chinese favor their own over foreign companies which implies that it will be difficult to dominate the local markets.

In Conclusion

China offers incredible opportunities for entrepreneurs and large corporations alike in the IT space. It is akin to the gold rush of IT that Indian companies had in entering the US in the 1980s. To continue its dominance, Indian companies need to enter this market, and not ignore it.

A clear long-term commitment and strategy aligned with Chinese cultural preferences and executed by a driven, dynamic team with local know how is however a pre requisite for success. ♦

INDIA'S FIRST EXPORTS TO CHINA: BUDDHISM & KUNG-FU



Two important foreign concepts from India have been accepted, adapted and made to thrive in China. The first is Buddhism, which thrived in the Tang Dynasty and still has considerable influence in the philosophy and daily lives of Chinese. Second is Kung-fu. The first person who introduced this to China was an Indian monk named Bodhi-Dharma who founded the famed Shaolin Temple. He is reputed to have meditated in front of a bare wall for 9 years and developed the martial art using just bare hands