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2
Six ways to make Web 2.0 work

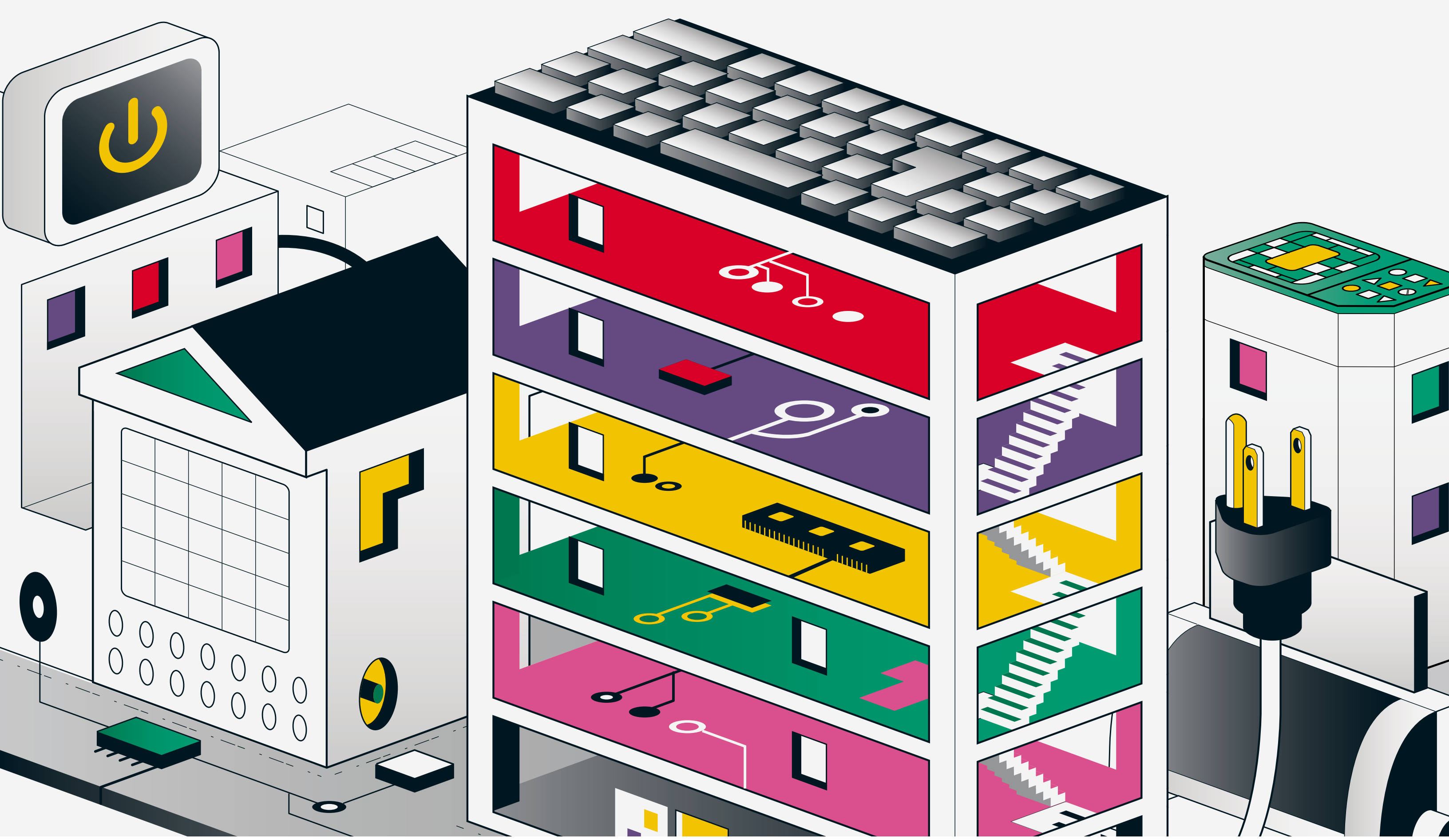
11
Where IT infra-structure and business strategy meet

14
Getting infrastructure offshoring right

19
Strengthening India's offshoring industry

22
IT architecture: Cutting costs and complexity

30
Rethinking the model for offshoring services



Strengthening India's offshoring industry

Noshir Kaka

India's technology and business services industry can defend and even expand its global market share, but only if it learns to innovate.

The global economic downturn has slowed the growth of India's technology and business services industry, but beyond the current crisis the industry faces a changing global environment that will probably cut into the country's worldwide market share.

McKinsey analysis suggests that there is little immediate risk to India's dominance of the market for offshore technology and business services. But the country's share could sink to 40 percent by 2020, from just over 50 percent at the end of 2008, primarily as a result of increased competition from other countries, talent and infrastructure constraints, and an unhelpful regulatory environment. But changes in the global market could also give India opportunities, especially if its companies become more innovative and rely less on low labor costs.

The revenues of India's business and technology services companies have grown to about $58 billion at the end of 2008 (including about $46 billion in exports), from $4 billion in 1998. In 2005, India's National Association of Software and Services Companies (Nasscom) suggested that export revenues could reach $60 billion a year by 2010, but the global downturn will probably delay the achievement of this goal by three or four quarters.

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Looking past the immediate situation, McKinsey expects the global market for offshore business and technology services to grow to about $500 billion by 2020, from the current $80 billion a year. Even with this more than sixfold growth, the industry will serve less than a third of the potential market, which McKinsey estimates at $1.65 trillion to $1.80 trillion in 2020.

Several factors will contribute to this global growth. Core markets—for instance, large financial-services and telecommunications companies in developed economies—should continue to expand along with the global economy, once growth returns. The pace of growth could slow down, however, if processes are automated and standardized more quickly than seems likely now. Corporate budget cuts during the downturn and protectionist regulation could also dampen demand from core and other markets.

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Much of the industry's expansion will come from nontraditional customers. Increased demand from emerging markets (primarily China and India, but also Brazil and Russia) could add $450 billion to $500 billion to the global market by 2020. Individuals and small and midsize enterprises will find it easier to use offshore services as communications technologies advance, costs go down, and business models evolve, adding $240 billion to $260 billion to the market. Finally, new kinds of customers—particularly in the public sector (including state-owned enterprises), as well as health care providers—will likely turn to outsourced business and technology services, expanding the global market by an additional $210 billion to $260 billion.

But as the pie expands, India will be hard pressed to maintain its 51 percent market share, which we expect will drop to around 40 percent by 2020 unless Indian providers become more innovative and global.

First, the industry faces domestic constraints. Talent will be a severe problem: India produces no more than 3 million university graduates a year—too few to maintain its market share. An inadequate physical infrastructure will also hinder the industry's expansion. Transportation systems and power and water supplies are already strained in the country's leading cities, including offshoring hubs such as Hyderabad and Chennai. At the same time, infrastructure deficiencies and talent shortages have prevented the industry from moving aggressively into smaller cities.

Another problem is that everyone wants to join the party. China, Egypt, many Eastern European countries, and dozens of others are fighting aggressively to build their domestic business and technology services industries, offering tax benefits and improved infrastructure as incentives. Egypt, for example, is

Innovation will be the key to maintaining and even expanding India's market share

developing university programs intended to provide the industry with 32,000 employable graduates by 2010.

Finally, government policies—which have over the years supported the industry—have become less favorable in recent times. For example, at present there is a lack of clarity surrounding the continuation of fiscal incentives the government has used to spur industry development. Meanwhile, the industry continues to be regulated by the Shops and Establishments Act and other laws not tailored to the service sector's requirements. Adding to the burden, these laws are applied inconsistently from state to state.

Indian business and technology services companies needn't stand by passively and watch their global market share decline. Innovation will be the key to maintaining and even expanding their market share. Business models that continue to focus on low labor costs won't suffice.

Unfortunately, innovation isn't the industry's strong suit. Over the past decade, India's companies captured more than half of the global business and technology services market, but the country still accounts for less than 1 percent of the patents issued around the world annually.[1] To address the opportunities in new geographic and industry markets and to serve individuals and small and midsize enterprises, business and technology services companies must create innovative products that address the needs of these new customers.

Areas that appear ripe include clinical research, mobile applications and platforms, and energy efficiency. Much as offshore companies remotely manage their customers' IT infrastructures, for example, they could remotely manage the energy consumed by their customers' air conditioning and heating systems. If successful, such efforts could contribute $100 billion to $130 billion in export revenues to India's offshoring industry by 2020, expanding its global market share to almost 60 percent.

India's technology and business services industry has flourished over the past decade, with export revenues in 2008 reaching $46 billion, which covers roughly 74 percent of the country's net oil imports that year. Apart from an isolated failure in corporate governance, India's brand abroad has been burnished by the success of this industry. But it will retain its luster and advantage over up-and-coming locations only by reinventing itself and looking beyond the low-cost labor model that served it well in the past.

[1] See Mark A. Dutz, ed., *Unleashing India's Innovation: Towards Sustainable and Inclusive Growth*, Washington, DC: World Bank, 2007.

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