

RESEARCH SUMMARY:**Offshore & Nearshore ITO Salary Report 2004**

By neolT

How would the wage rate differential contribute to my firm's global sourcing decision?

Would the changing salaries impact the wage differential?

Ultimately... how would this influence my firm's decision to outsource?

Abstract

Not all offshore/nearshore locations were created equal. This white paper discusses the differences among popular offshore and nearshore sourcing locations. The specific intent of the paper is to offer a comprehensive look at the cost-saving potential in global sourcing to select offshore and nearshore locations and to provide a roadmap for understanding what factors influence each country's cost-saving potential.

We'll discuss the direct and hidden costs in global services sourcing and address the differences in costs between onshore and offshore or nearshore locations – in this way we'll frame the rest of the discussion to focus on how firms can use these differences to maximize cost savings in their global sourcing decisions.

This paper focuses specifically on how the wage rate differential contributes to firms' cost savings determinations, and ultimately, to their global sourcing decision. We'll talk about the key country-specific and industry-specific factors that influence salaries in all locations. And we'll analyze the relationship between salaries and skills.

The bulk of this paper is an investigation of salaries across experience levels in specific offshore and nearshore locations and the particular characteristics of each country that affect its ability to offer global sourcing services. A look at how IT salaries in each country have changed and are expected to change is included.

With an understanding of the factors affecting the global sourcing climate in each country, a knowledge of the ability of each country to meet specific requirements, and an awareness of the wage differential between onshore and offshore or nearshore operations, a firm will be able to make global sourcing decisions that maximize its cost-saving potential given its unique circumstances.

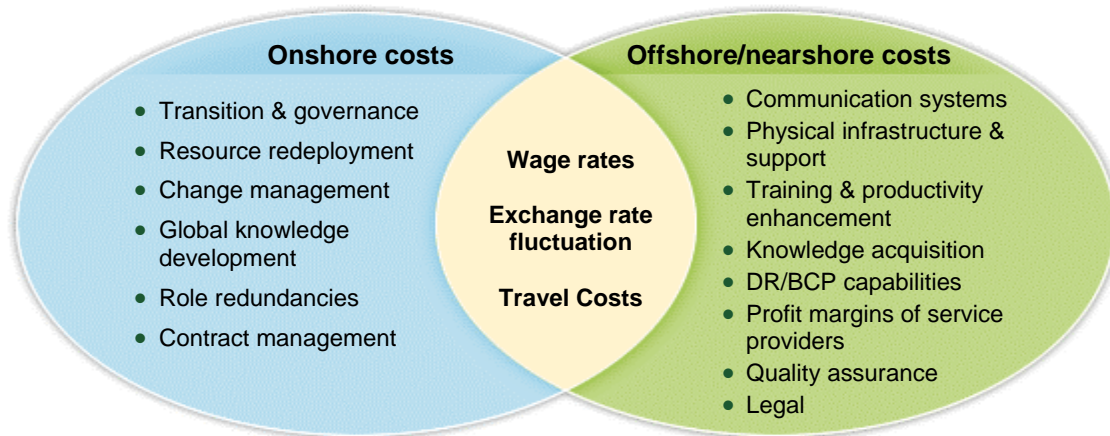
The following key questions will be addressed:

- *What are the different hidden and direct costs associated with global sourcing?*
- *How does the wage rate differential influence a firm's global sourcing decision?*
- *How do changing salaries affect the wage differential and, ultimately, a firm's global sourcing decision?*
- *What other considerations should firms account for when making global sourcing decisions?*

Introduction

The growth of global services sourcing is driven by several factors, but cost savings is the most significant. The potential to utilize the resources of developing, low-cost economies to substitute service delivery from developed, high-cost countries is the core of services globalization. There are many factors that contribute to the cost-saving potential of any global sourcing scenario. A clear understanding and ability to weigh each of the factors is critical in any firm's successful implementation and optimization of a global sourcing initiative. The factors, described in the figure below include both direct-cost and hidden-cost elements and play a role at both the low-cost delivery location (either offshore or nearshore) as well as the high-cost onshore location.

Figure 1: **Direct and Hidden Costs in Global Services Sourcing**



Source: *neolT*

Of all of these cost components, the wage rate differential between onshore and offshore or nearshore locations provides the most compelling reason for the global sourcing of IT services. Employee salaries make up a large percentage of a firm's costs whether the employees are at an onshore or offshore/nearshore location. The following table presents the breakup of direct-cost components in an offshore/nearshore outsourcing initiative to further explain the importance of salaries in choosing a sourcing location and to highlight the difference in cost-saving potential between offshore and nearshore locations.

Table 1: **Components of Offshore Outsourcing Costs**

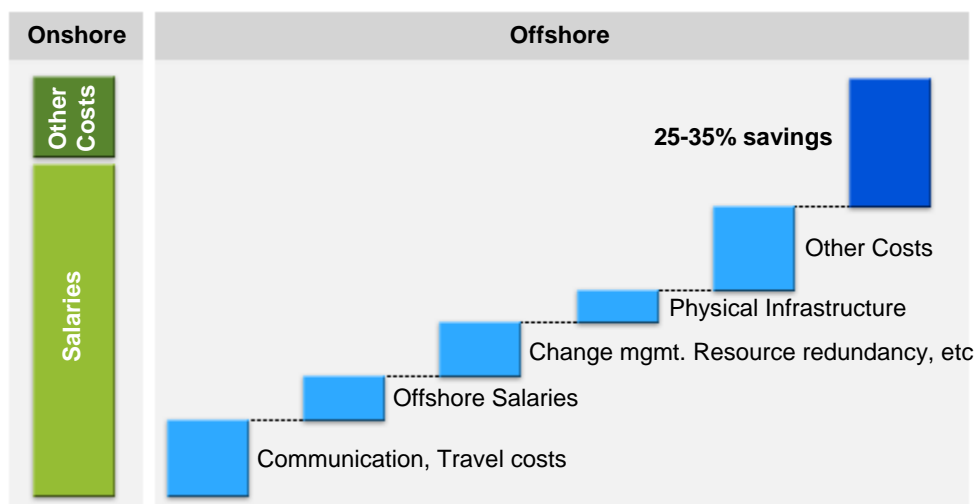
Direct-cost components, percent of total costs	Offshore	Nearshore
Wage Rate	35-45%	55-65%
Communication Systems	6-10%	2-3%
Physical Infrastructure and Support	15-17%	8-10%
Transition and Governance	5-6%	4-5%
Resource Redeployment, HR Change Management, Training and Productivity	10-17%	10-15%
Disaster Recovery and Business Continuity Capabilities	3-5%	2-3%
Travel	2-3%	1%
Others	7-10%	7-10%

Source: *neolT*

Even though the proportional influence of salaries is higher at nearshore locations compared to offshore locations, the other cost factors are lower there than at the offshore locations. While salaries make up a larger percentage of total costs, and therefore savings from the wage differential is not as great at nearshore locations, the other factors – less costly at nearshore locations – offer greater cost-savings. Whether the cost-saving potential from the wage differential at offshore locations outweighs the cost-saving potential from other factors at nearshore locations depends uniquely on the individual firm.

Figure 2 focuses specifically on the costs associated with offshore operations compared to the costs associated with onshore operations. The figure clearly demonstrates the cost-saving potential inherent in offshore sourcing, made possible in part by the wage differential and the fact that salaries are a much larger relative cost component in onshore activities than offshore activities.

Figure 2: **The Economics of Offshore Outsourcing**



Source: *neolT*

Note: *Chart not to scale*

The wage differential between onshore and offshore locations is significant enough to offset the additional costs that are incurred in the process of operationalizing an offshore outsourcing initiative. With offshore salaries 70-75% lower than onshore salaries, organizations can gain enough leverage to realize 20-30% absolute savings on the overall initiative. The wage differential between onshore and nearshore locations is not as significant, but as the additional costs of outsourcing to a nearshore location are much lower than outsourcing offshore, organizations can generate from 10-15% in absolute savings.

What are the factors that influence ITO salaries?

A country's macroeconomic environment is the primary determinant of its wage rates. Additional relevant factors include each country's specific social, political, and cultural characteristics. The table below details the different components of these factors as well as our assumptions about the impact of these factors on salaries.

Table 2: **Factors Influencing ITO Salaries**

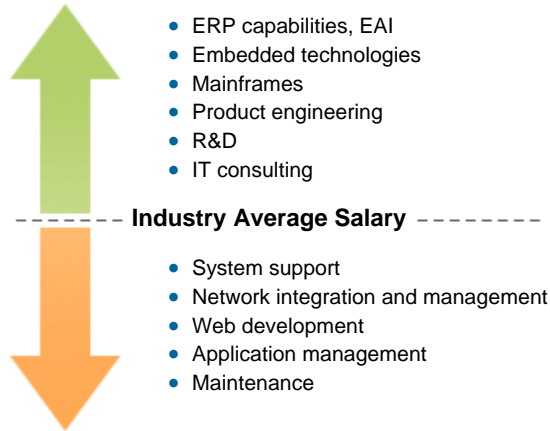
Factor	Sub-Factor	neoIT Assumptions	Impact on Salaries
Country-specific factors	Inflation	Growing inflation rates in all developing economies that are offshore locations.	Salaries grow at higher rates than inflation.
	Exchange rates	No major changes in the short and midterm. However, the USD is expected to weaken in the long term.	Profitability pressures resulting from weakened dollar will drive salaries down.
	GDP/Economic growth	Stable growth in all developing economies. Services' share in GDP expected to grow.	As the economy booms, salaries will increase.
	Broad-based growth	Service providers will look at smaller towns to expand.	Lower salaries in the smaller towns will drive the industry's average salaries down.
Industry- (IT/BPO) specific factors	Supply-demand equation of ITO/BPO professionals	Varies from country to country. Depends on labor available for the specific competency requirement.	An abundant supply of resources results in lower salary growth while scarce resources accelerate salaries.
	Country's competitive position in global ITO/BPO market	As offshore outsourcing matures, competitive activity will intensify between countries. Pricing pressures will strengthen.	Pricing pressures impact profitability; cascades into lower salary growth.
	Global companies setting base / expanding in country	Global service providers will set base/expand in offshore locations.	Propensity of global companies to pay high salaries will result in increasing overall salary levels in the industry.
	Process complexity	Firms will begin to move more complex processes to offshore locations.	Industry average salaries will increase as more complex processes are outsourced.
	Captive operations	More and more captive centers will start operations.	Captive units typically pay higher salaries than third party service providers. Average salaries will increase industry-wide.
	Competitive scenario	Intense competitive activity in offshore/nearshore locations among and between pure offshore companies and global service providers.	The strive to integrate the competitors' best resources results in accelerating growth of salaries.

The presence of these factors and the relative influence that they have on the movement of salaries vary from country to country. Most of these factors are interrelated and thus the absolute impact of any single factor on salary movement in a particular country cannot be assessed. Given our assumptions, the one factor that has the most bearing on ITO salaries in a given country is the supply of and demand for labor resources possessing the required skill set.

The complexity of services delivered and skill-set requirements of employees play a major role in the determination of salaries for ITO professionals. Technological competency that includes platforms, applications, and environment and vertical domain competency are both integral competencies in an employee's skill set. From an outsourcing industry perspective, while both of these competencies hold immense value, technological competency has the maximum impact on salaries. Salaries of employees

engaged in specialized technology solutions are much higher (at times more than double) than the industry average, while salaries of employees engaged in wide-spread and low-end technology solutions are much below industry average. The following figure distinguishes salary differences in relation to an employee's level of technological skill.

Figure 3: **The Correlation between ITO Job-specific Skill Levels and Salaries**

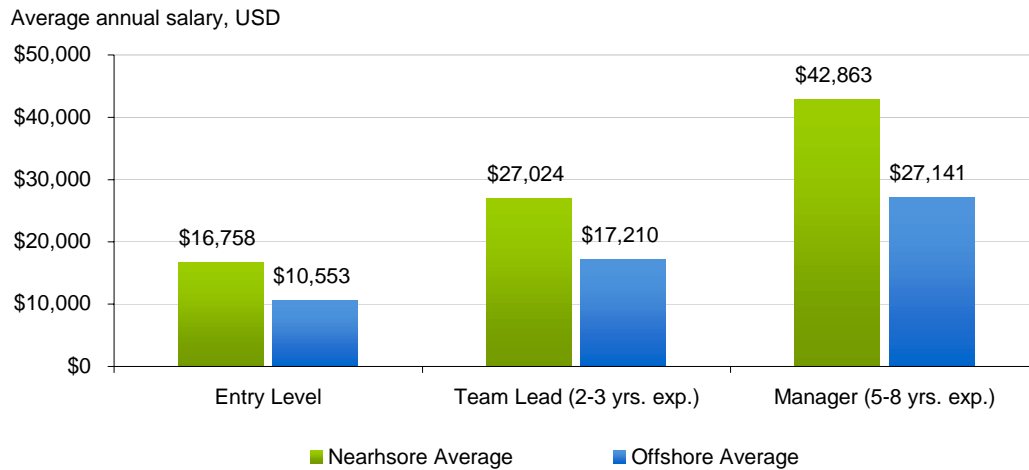


Offshore/nearshore ITO industry salaries

While offshore outsourcing delivers the maximum cost savings for the client organization, nearshore outsourcing offers a combination of relatively smaller savings and features similar to the firm's onshore operations. The trade-off between offshore and nearshore outsourcing thus depends not only on the cost savings from the wage rate differential but also on the specific objective of the outsourcing initiative. The following sections provide data and analysis about the prevailing ITO salaries in offshore and nearshore countries as well as insights into the potential savings that organizations can realize through outsourcing initiatives.

ITO salaries are significantly lower in offshore locations than in nearshore locations. In most cases, offshore salaries can be 50-60% less than nearshore salaries across experience levels. The following figure presents the industry average salaries in offshore and nearshore locations.

Figure 4: **Average ITO Salaries in Offshore and Nearshore Locations, by Level of Experience**



Source: **neolT Research**

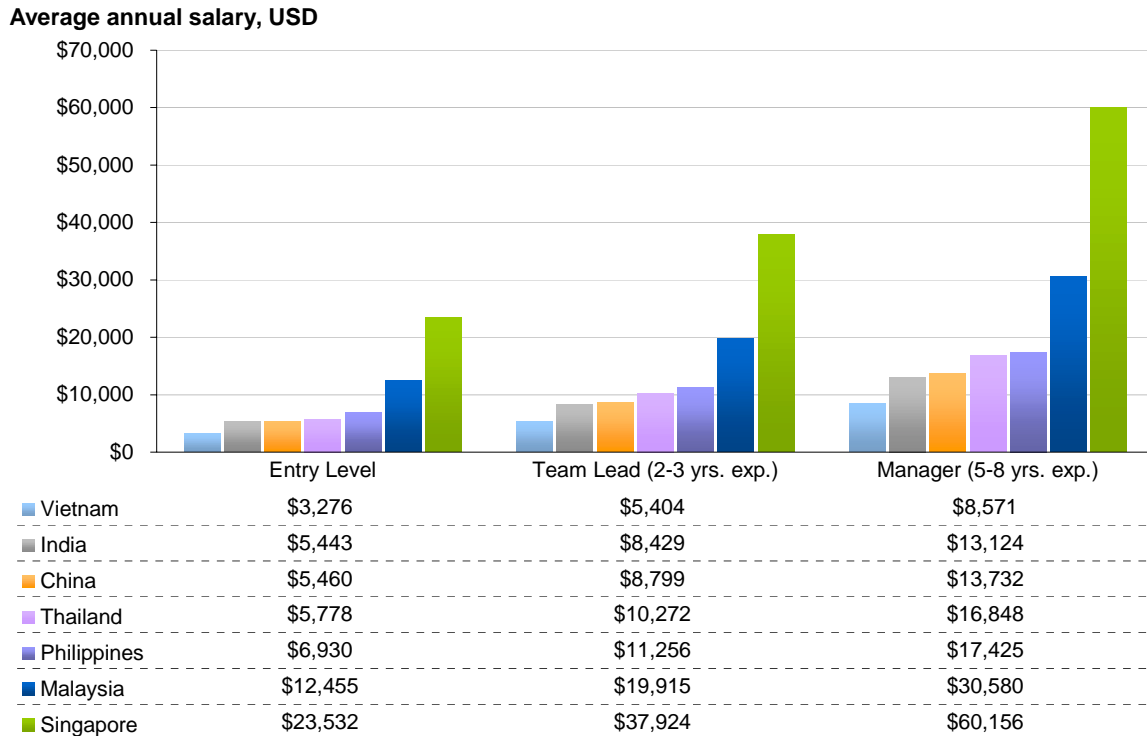
- *Nearshore Destinations include: Brazil, Canada, Hungary, Ireland, Mexico, Poland and Romania*
- *Offshore Destinations include: China, Costa Rica, India, Malaysia, Philippines, Russia, Singapore, South Africa, Thailand and Vietnam*

The variation in the supply – and demand situations of IT professionals in offshore and nearshore locations certainly impacts the wage differential. At the entry level, the supply of competent labor is not a major concern in either location, but more experienced professionals become more expensive in nearshore locations than in offshore locations. For organizations planning very large global IT operations, offshore locations thus become a more attractive proposition.

ITO SALARIES IN THE APAC REGION

The Asia and Pacific (APAC) region includes many countries that are strong emerging players in the services globalization landscape. The success of these countries in the outsourcing industry is driven primarily by lower salary levels that offer firms extensive savings while outsourcing. The following chart outlines the average salary of IT professionals with different experience levels in select offshore outsourcing locations in the APAC region.

Figure 5: Average ITO Salaries in APAC Countries, by Level of Experience



Source: *neolT Research*

Characteristics of key offshore outsourcing locations in APAC countries:

- Vietnam:** Vietnam is hampered by the scarcity of professionals competent enough to handle complex IT applications and processes. As a result, IT outsourcing to Vietnam is restricted to activities that utilize low-end resources, such as standardized application management and IT technical helpdesk. Though Vietnam offers the highest cost advantage, its labor supply may not meet the requirements necessary for an organization to outsource complex or high volume processes there.
- India:** As the most successful country in offshore outsourcing, India attributes its advantage to the abundant supply of competent labor. Salary levels in this country grew considerably over the past 2-3 years as the complexity of offshored processes increased and many global corporations chose India as a key base to offer global delivery services to their clients. Today, India still offers the best advantage to organizations in many IT outsourcing domains.
- China:** China is widely believed to be the next big contender for a piece of the offshore outsourcing pie. The country's primary strength is an abundant supply of skilled professionals. IT salaries in China are currently competitive compared to India. However, as the country becomes an offshore location with a labor force technically competent enough to handle complex processes and also address the U.S. market (as India does) average salaries will increase.
- The Philippines:** The Philippines is a small but emerging contender in offshore IT outsourcing. The IT salary levels there are comparable to other offshore locations, but the limitation in the supply of qualified IT labor confines the country in replicating its success in the offshore call center industry.

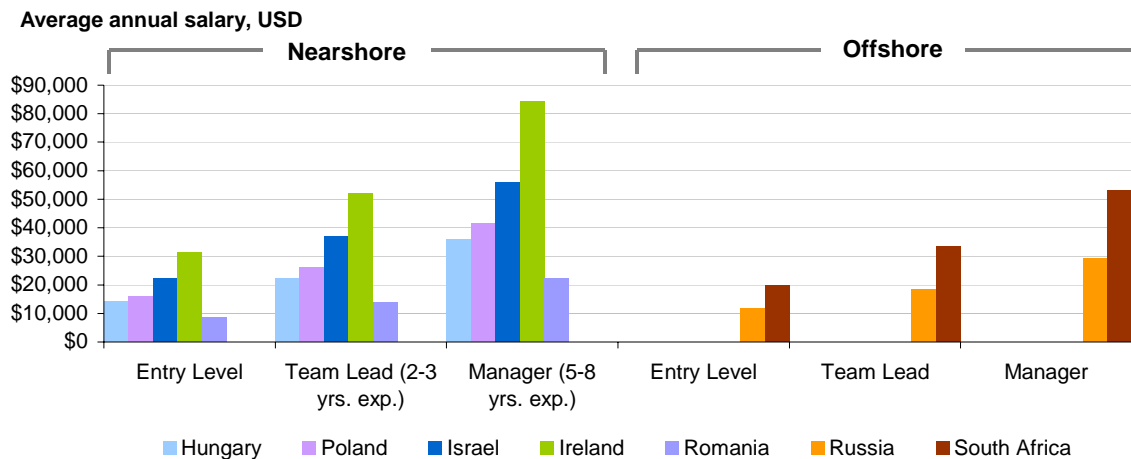
ITO SALARIES IN THE EMEA REGION

IT sourcing activities to countries in the EMEA (Europe, Middle East, and Africa) region include both offshore and nearshore outsourcing. The salaries for IT professionals in offshore outsourcing locations in the EMEA region are much higher than those in APAC, thus offering firms a relatively smaller savings potential. But the business and cultural environments in the EMEA countries are much more similar to those of onshore markets, adding a benefit that many countries in the APAC region cannot.

- Nearshore locations in the EMEA include Eastern European countries such as Poland, Romania, Hungary and Czech Republic, which are well-positioned as nearshore outsourcing countries for Western European firms. Ireland offers companies in the U.K. a strong value proposition as a nearshore location.
- Offshore locations in the EMEA region include countries such as South Africa and Russia, which support the U.S., the U.K. and Western European countries.

The following chart outlines the average salary of IT professionals with different experience levels in each of the offshore/nearshore outsourcing locations in the EMEA region.

Figure 6: **Average ITO Salaries in EMEA Countries, by Level of Experience**



Country	Entry Level	Team Lead (2-3 yrs. experience)	Manager (5-8 yrs. experience)
Average annual salaries, USD			
Nearshore			
Hungary	\$14,112	\$22,211	\$35,805
Poland	\$15,900	\$26,028	\$41,616
Ireland	\$31,500	\$51,963	\$84,397
Romania	\$8,736	\$13,856	\$22,328
Israel	\$22,152	\$36,821	\$56,065
Offshore			
South Africa	\$19,764	\$33,360	\$52,920
Russia	\$11,664	\$18,503	\$29,353

Source: *neolT Research*

Characteristics of key offshore/nearshore outsourcing locations in EMEA countries:

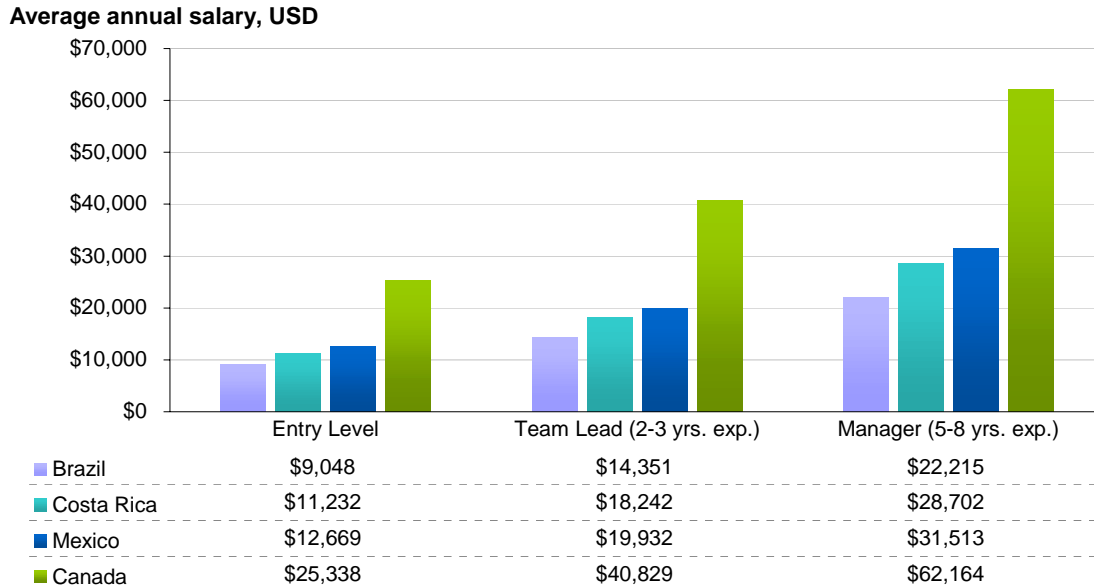
- **Central and Eastern Europe:** Countries in the Central and Eastern European (CEE) region - Hungary, Czech Republic, Romania and Poland - have emerged as nearshore outsourcing locations for Western European companies. These countries have excellent infrastructures, good pools of qualified resources and offer substantial cost-saving potential, as the wage rates in CEE countries are 15-40% lower than in corresponding onshore markets. The hidden costs involved in outsourcing are comparatively lower in these countries than offshore locations, offering savings opportunities for firms with lower risk tolerance.
- **Ireland:** Ireland has been the shared services hub for the U.K., as Canada has been for the U.S. Ireland has an excellent supply of IT labor resources, renowned particularly for their expertise in software product development - Independent software vendors (ISVs) in the U.K. have been very active in tapping this talent pool. There used to be a marked salary differential between the U.K. and Ireland but as the outsourcing industry has matured in Ireland this differential has shrunk. Additionally, the maturation of the IT market in Ireland has put increasing pressure on the availability of qualified IT resources there.
- **Russia:** Russia offers tremendous savings potential for American and European organizations, specifically in the IT product research and development area. This savings potential is available primarily because Russia has a large supply of low-cost labor resources with engineering and software talent. Salary levels for Russian IT professionals are growing but will not neutralize the salary differential in the short to medium term.

ITO SALARIES IN THE AMERICAS

Brazil, Mexico, Costa Rica and Canada are the key nearshore outsourcing destinations for organizations in the U.S. As the outsourcing industry in Latin America matured, U.S. firms began to realize the region's potential for delivering cost-effective services, due largely to the significant wage rate differential between Latin American countries and the U.S. The outsourcing industry in the region has thus grown significantly over the past several years.

Canada possesses the most mature IT outsourcing industry in the Americas. The industry's growth in Canada has been aided by the historic presence of American firms' shared services centers in the country. American companies have leveraged the salary differential between the two countries and have found additional benefit in the exchange rate differential.

Figure 7: Average ITO Salaries in the Americas, by Level of Experience



Source: *neolT Research*

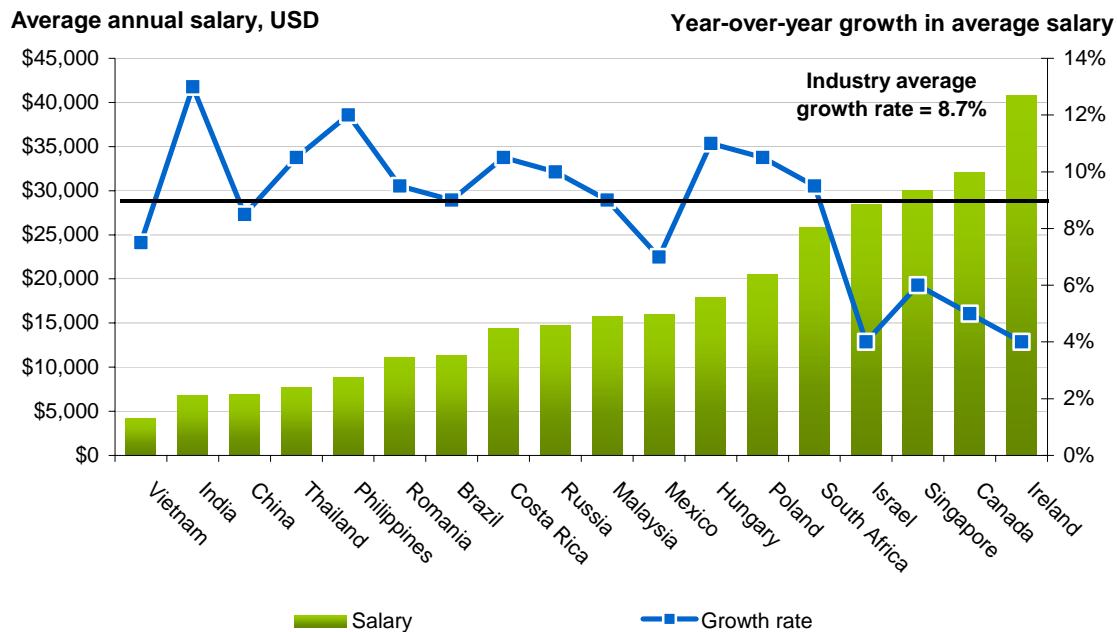
Characteristics of key outsourcing locations in the Americas:

- **Mexico:** U.S. organizations have selectively used Mexican resources for both IT and BPO services. Although not as mature as markets in the EMEA and APAC regions, the Mexican IT outsourcing industry is experiencing strong growth, primarily due to the availability of qualified resources, geographic proximity and attractive labor rates compared to the U.S. market.
- **Canada:** Canada is the shared services hub for U.S. companies. Leveraging Canada's lower salaries, the availability of competent IT labor resources, and the exchange rate differential, global corporations and outsourcing service providers have set up global delivery centers there. Average salaries in the country have increased considerably over the years and as a result, organizations are now evaluating other low-cost locations for their outsourced IT operations.

Growth in ITO salaries in offshore/nearshore destinations

As firms in client markets have become increasingly inclined to utilize lower-cost outsourcing locations, the ITO industry in those offshore/nearshore locations has matured. The explosive ITO industry growth in some of the key offshore/nearshore locations has significantly impacted the growth rate of average salary levels of ITO professionals in those locations. The rates of growth of ITO salaries among key offshore/nearshore outsourcing destinations are provided in the figure below. The growth rates mentioned are aggregated across experience levels for each country indicated. Typically, the percentage growth of salaries at the entry level is significantly higher than the aggregate while the growth of salaries among the most experienced professionals is lower than the aggregate.

Figure 8: **2004 Salaries and Year-over-year Growth Rates for ITO Professionals at All Experience Levels in Key Outsourcing Locations**



Source: **neolT Research**

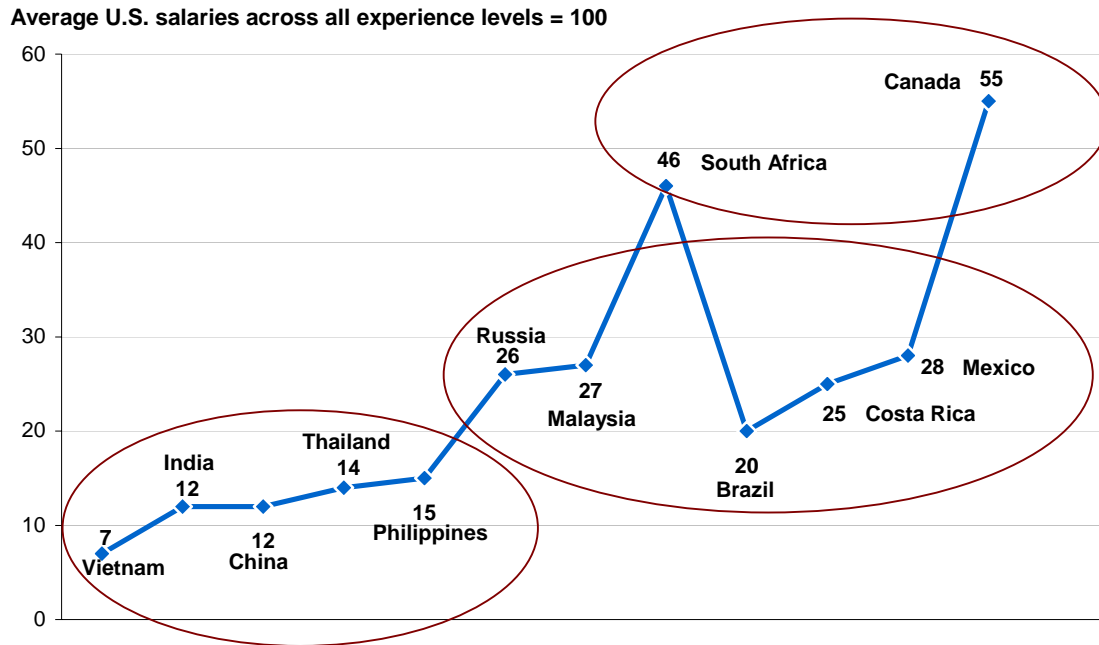
In 2004, ITO salaries in India experienced the most significant growth compared to all other geographic markets. Industry maturity, increasing competition, increasing complexity of outsourced projects, stable demand, and exponential scaling plans of local as well as multinational IT service providers were the key drivers behind this increase. Nearshore locations such as Poland and Hungary also witnessed above-average salary appreciation due to the countries' entrance into the European Union and resource supply constraints. Constraints in the supply of ITO labor resources also fueled the sharp salary growth in The Philippines.

In the short term, salary growth in attractive offshore/nearshore destinations may not negate the potential benefits of outsourcing to these countries. However, disproportionate salary increases will certainly impact firms' outsourcing decisions as well as the competitiveness of these offshore/nearshore destinations.

Direct savings in offshore/nearshore outsourcing

The following section analyzes the cost savings that U.S. organizations can realize by outsourcing IT operations to offshore/nearshore countries. The following figure explains the wage rate differential between the U.S. and offshore/nearshore countries.

Figure 9: **Direct Savings on Salaries for U.S. Companies Outsourcing to Offshore/nearshore Locations**



Source: *neolT Research*

Based on direct-cost savings potential alone, three sets of locations emerge as superior options for outsourcing operations.

Set 1: Offshore locations such as Vietnam, India, China, Thailand and The Philippines offer the highest direct savings for U.S. companies. Excepting India, outsourcing industry in these countries is still maturing, such that most of the services currently provided from these countries are low-end. Firms planning to outsource to these countries should consider other evaluation parameters such as competency level, labor supply, and the maturity of existing service providers in addition to cost-saving potential. In the case of outsourcing to India, organizations should diligently evaluate the hidden costs of outsourcing there, as those costs could be significantly higher than the hidden costs of outsourcing to nearshore locations.

Set 2: The second set of countries includes both offshore and nearshore destinations. These countries are characterized by the availability of labor resources with a particular skill set and by significant cost-saving potential. Fast-emerging countries such as Russia and Mexico are capable of addressing the specialized needs of U.S. organizations.

Set 3: While the direct-savings potential that Canada offers is relatively low compared to other locations, the capability of its talent pool, maturity of service providers, and close proximity to the U.S. make the country a preferred location for U.S. firms' outsourcing operations. Because outsourcing to Canada involves lower indirect costs, the

country is able to neutralize part of the cost advantage that other low-cost countries possess. Canada will remain the preferred location for risk-averse organizations and for the outsourcing of critical applications. South Africa also falls into this third set of countries. Its outsourcing industry is relatively small compared to other emerging locations; organizations leveraging South African resources are typically addressing the local market or view these resources as part of a diversified global sourcing portfolio.

Conclusions

Firms have realized net cost savings in the range of 10-35% by outsourcing IT operations to lower-cost offshore and nearshore locations. This wide-spread trend among businesses, combined with a competitive global IT environment and an ample supply of skilled professionals has led to the significant adoption of IT services globalization by US and European companies.

Many countries have such skilled labor resources that they are able to raise salaries significantly while still maintaining their cost-saving allure. Other countries' labor resources are still largely unsophisticated, making those countries particularly attractive to firms seeking low-end sourcing solutions. Specifically, Asian countries have emerged as attractive offshore locations for U.S. and European clients and Eastern European and Latin American countries have emerged as competent nearshore locations for European and North American organizations.

While the current rise in salaries may not offset the advantages of global services sourcing in the near future, it may very well impact the structure and make-up of clients' future-state global sourcing portfolios.

More information about the offshore outsourcing industry can be found within neoIT's research center at www.neoOffshore.com. For more details about neoIT's offshore advisory and management services, please contact:

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