



The Philippines' Offshoring Opportunity

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Preface

"The Philippines Offshoring Opportunity" is a joint effort between the McKinsey Global Institute (MGI) and McKinsey & Company's Philippines office. It is based on the McKinsey Global Institute's ongoing research on the impact of offshoring and conducted as part of a broader effort to understand the process of global economic integration and its implications.

This perspective is part of the fulfillment of MGI's mission to help global leaders understand the forces transforming the global economy, improve company performance, and work for better national and international policies.

MGI combines McKinsey's business experience with the rigor of academic discipline. This document reflects active dialogue with Philippines' and global thinkers, industry experts, researchers from leading institutions, and joint work from MGI, our Philippines office, as well as our worldwide business process outsourcing and offshoring practice. We would particularly like to thank Jaeson Rosenfeld, Martha Laboissière, Susan Lund, Sascha Stürze, and Fusayo Umezawa for their contributions to this work.

As with all MGI research, we would like to emphasize that this perspective is independent and has not been commissioned or sponsored in any way by any business, government, or other institution.

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McKinsey Global Institute

The McKinsey Global Institute (MGI) was established in 1990 as an independent economics think tank within McKinsey & Company to conduct original research on important global issues. Its primary purpose is to provide insights into the workings of the global economy and a fact base for decision-making for the benefit of business leaders and policymakers.

MGI's staff members are drawn primarily from McKinsey's consultants. They serve 6- to 12-month assignments and then return to client work. MGI also commissions leading academics to participate in its research. MGI's director is Diana Farrell, a McKinsey director.

The Philippines' Offshoring Opportunity

Global demand for offshored services labor has been growing rapidly, and will continue to do so for the foreseeable future. Between 2003 and 2008 alone, the McKinsey Global Institute (MGI) estimates an additional 2.6 million offshored services jobs will be created globally, offering a valuable source of employment and export growth for the low-wage countries that capture them.¹

India has, thus far, been dominant in attracting these jobs, but it is beginning to show the strain of sustained demand. In India's most popular offshoring centers, supply constraints are now evident in rising wages and high turnover among engineers. Smaller economies now sense a real opportunity to take some of the strain of strong demand—and a larger slice of the action.

The Philippines is already emerging as a strong player in this rapidly evolving industry, demonstrating that it can compete with India and other low-wage destinations in creating value. In 2003, the Philippines exported more than \$1.5 billion worth of services.² Today it employs around 100,000 people in call centers, and the country is beginning to attract work in shared services, data entry/medical transcription, and animation. Overall, it aims to win 5 percent of worldwide global business process revenues by 2010, creating an industry worth as much as \$10 billion.

Yet, for all its potential, the Philippines faces enormous challenges in achieving this goal. MGI research shows that, although it boasts widespread English language skills, very low costs, and promising human resource capabilities, it lags behind India and many other potential offshoring locations on several of the key criteria companies examine when choosing an offshoring location. These include risk, infrastructure, the availability of vendors, and the supply of middle managers who are key to establishing large offshore operations quickly.

If the Philippines is to capitalize on the opportunities that are undoubtedly there for the taking, the government, together with the private sector, must work to strengthen the perceived attractiveness and reality of offshoring to the Philippines.

¹ See *The Emerging Global Labor Market*, available for free at www.mckinsey.com/mgi, or "Sizing the emerging global labor market," *The McKinsey Quarterly*, 2005, Number 3.

² Gartner reports that the Philippines exported \$1.3 billion of services in 2002; figure cited is extrapolated based on 30 percent growth rate.

SOME HIGH MARKS FOR OFFSHORING

We compared the Philippines with fifteen other offshoring locations, and it emerged as an attractive contender on several critical fronts. It nearly matches India in providing the lowest labor cost for offshoring professionals. In India, hourly labor costs (including wages and benefits) for eight service occupations averaged 12 percent of U.S. levels; in the Philippines, that figure is 13 percent. Wages were about half of Malaysia's and one-third of the average in Eastern European countries. For the most cost-conscious segment of offshorers, these wage differences are significant and attractive.

The Philippines also scores well on its strong English language skills, a function of its historical closeness to the United States. Despite the fact that English is an official language of India, some call centers have been relocated from there to the Philippines because customers have complained about bad English and strong regional accents. The Philippines is also particularly attractive to U.S. companies because English tends to be spoken with a more American accent.

In addition, the Philippines has a larger pool of suitable labor for multinational companies than its relatively small population would suggest. For instance, although the population of India is 10 times the size of the Philippines, the Philippines produces one suitable accounting/finance graduate for every two available in India; China's population is 16 times the size of that in the Philippines, but its pool of suitable young professional engineers is only three times bigger.

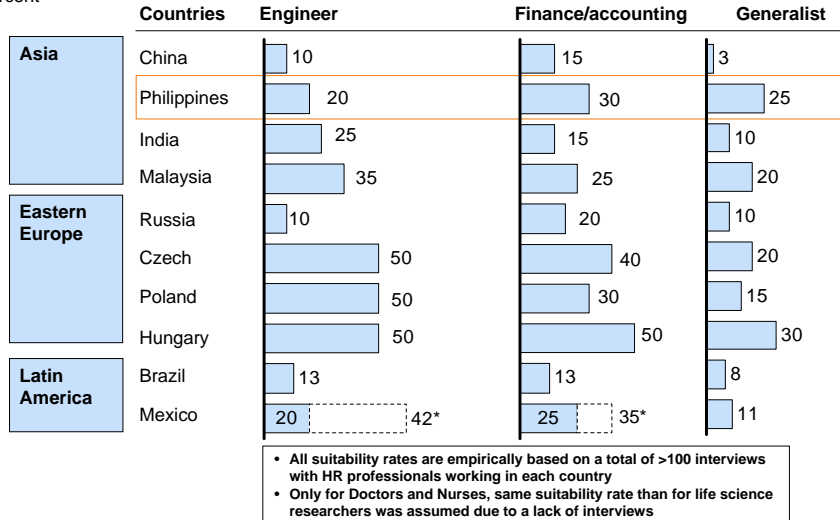
This surprisingly abundant supply of suitable graduates cuts across different fields such as generalist and call center jobs, finance and accounting, and the engineering professions. The Philippines produces roughly 350,000 college graduates each year and the suitability of labor is higher than India. When asked, human resource executives at multinational companies said that, of every 100 random college graduates in finance and economics, they would hire 30 in the Philippines against just 15 in India (see Exhibit 1); in the case of generalists, 25 versus 10; and among life science researchers, executives would hire 20 against 15 (Exhibit 2). Even in engineering, the Philippines is close to India in suitability and has a higher percentage of the population attaining a college degree—explaining why the skilled labor supply in the Philippines is much more competitive than one might expect.

Exhibit 1

THE PHILIPPINES' LABOR SUITABILITY IS HIGHER THAN RUSSIA AND CHINA BUT LAGS EASTERN EUROPE

"Of 100 graduates with the correct degree, how many could you employ if you had demand for all?"

Percent



* Mexico is the only country where interview results (higher number) were adjusted post mortem since interview base was thinner and risk of misunderstanding high

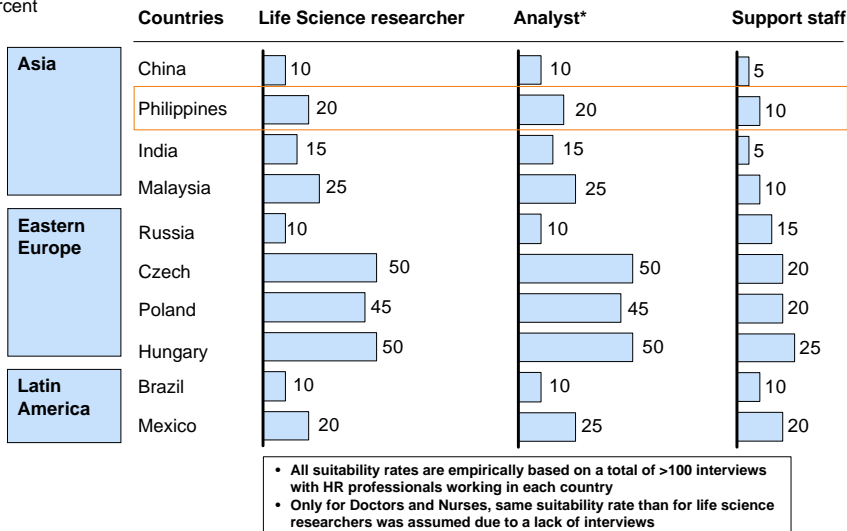
Source: Interviews with HR managers, HR agencies and Heads of Global Resourcing centers; McKinsey Global Institute

Exhibit 2

THE PHILIPPINES' LABOR SUITABILITY IS HIGHER THAN RUSSIA AND CHINA BUT LAGS EASTERN EUROPE

"Of 100 graduates with the correct degree, how many could you employ if you had demand for all?"

Percent



* Used engineers as proxy in some cases

Source: Interviews with HR managers, HR agencies and Heads of Global Resourcing centers; McKinsey Global Institute

These results might lead one to expect that India and the Philippines would attract offshoring equally. But they don't; India's offshoring industry exports around seven times that of the Philippines. It is clear that the Philippines has been slower and much less organized than India in exploiting opportunities; but it also compares unfavorably on some of the location measures beyond cost and skills that offshoring companies analyze.

CHALLENGES FOR THE PHILIPPINES

Our research shows that companies look at a range of factors beyond labor costs and skills in choosing an offshore location. These include quantifiable ones such as the cost of non-labor inputs like telecommunications, land, taxes, and electricity; and less easily quantifiable measures such as risk profile and the convenience of doing business. All these add up to what might be described as the total cost of accessing labor in a location.

In our experience, companies focus on six key criteria which we aggregate into a Location Cost Index (LCI): operating cost (both labor and non-labor); vendor landscape; infrastructure; business and living environment; domestic market attractiveness; and risk profile. Naturally, this LCI will vary from company to company, depending upon the weight each applies to the various factors. For example, a company offshoring a highly critical and bandwidth intensive process such as server maintenance will put more weight on the quality of a location's infrastructure than, say, operating costs.

Unfortunately for the Philippines, while it scores at the top in costs and well in availability of suitable labor, it scores at, or below, average on the other criteria (Exhibit 3).

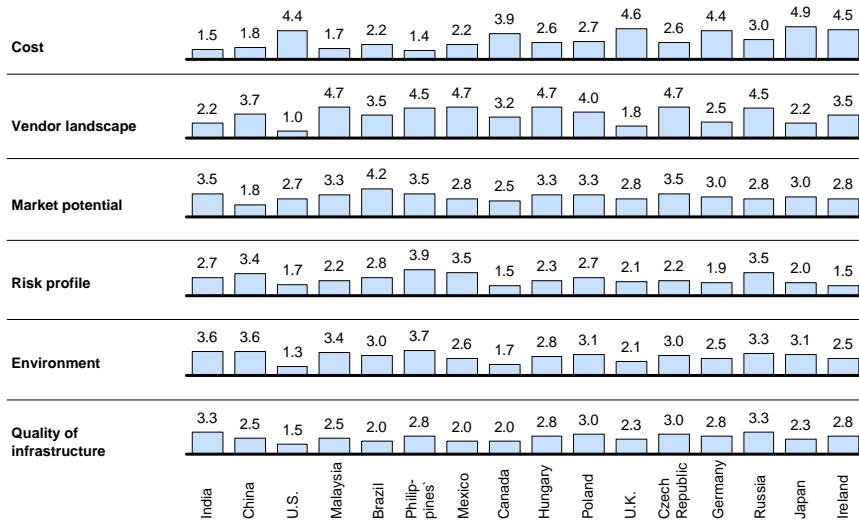
High non-labor costs

Although the Philippines has low labor costs, additional efforts are needed to further improve its leadership position in overall costs. Electricity is particularly expensive in the Philippines, at \$0.109 per kilowatt hour, compared to \$0.076 in India and \$0.066 in China. Recently, telecom costs have declined significantly, with a 2MB line from the U.S. to the Philippines dropping to approximately \$5,000 monthly in 2005, on par with other

competing locations. Its telecom networks, the backbone of most offshoring operations, are rated only average on reliability. Improving them to world class levels would give the Philippines a competitive advantage.

Exhibit 3

THE PHILIPPINES HAS MANY WEAKNESSES IN LOCATION ATTRACTIVENESS*



* In this ranking 1 is the most attractive and 5 is the least attractive. Source: Location cost index database

Risks to offshoring companies

Multinational companies seeking to set up offshoring operations in the Philippines face many risks. On its risk profile, the Philippines is the least attractive in our sample, due to security threats, natural disasters, and data theft. One consultant to offshoring vendors, Sykes, has said that one of the challenges it faces is convincing clients that doing business in the Philippines is safe. Moreover, although the Philippines has some well-known third-party vendors such as eTelecare and Vertex in call-centers, the Philippines' vendor landscape scores far below India, which has the strongest low-wage vendor group in our sample. This means that companies will probably need to set up their own captive operations.

Unwelcoming business environment

The Philippines also suffers on the criterion of business and living environment. This is partly an accident of geography—a major reason behind its relatively low score is its distance from many demand markets and a paucity of direct flights from those markets. In one sub-category of the environment factor—government support—the Philippines lags behind countries such as China and Malaysia. It is hobbled by a surfeit of bureaucracy (for example, it takes as much as double the time to achieve the proper approvals for opening a call-center as it does in Malaysia or India), strict labor laws, and high levels of corruption. Moreover, the Philippines' market potential—the prospect for selling services to the domestic market of the country—is only a fraction of that in both India and China, due to its far smaller economy and slower growth rate.

Managerial scarcity

Although there is currently a surplus of talent in all occupations at the entry level in the Philippines, this is not matched by management ability. Management talent is generally acquired from several sources—from lower-level workers trained in existing offshoring enterprises, from other industries within the economy that produce managers with relevant skills, and from returnees who have worked and/or studied in developed economies.

India and China, in particular, stand to benefit from the skills brought by immigrant returnees—in 1998, a stock of 400,000 highly skilled Chinese and 300,000 highly skilled Indians had emigrated to the United States. We found that multinational companies frequently transfer Chinese managers in their home countries back to China to set up operations there. According to a study by the World Bank, Indian entrepreneurs and venture capitalists have helped promote India as an outsourcing destination and will continue to do so. The report particularly noted the organized networking and mentoring that the diaspora community receives as a key positive for outsourcing to India.

The Philippines, however, does not have a strong pool of ready management coming from any of the normal channels; offshoring is still nascent, the broader economy is dominated by small and medium-sized (often family-owned) enterprises that do not produce a lot of suitable management talent, and study/work abroad rates are low.

The Philippines does have a reasonably large diaspora, contributing at least \$8.5 billion a year in overseas remittances—worth more than the country's agricultural sector. However, Filipinos tend to leave their country due to a lack of job opportunities and better pay abroad, and they have traditionally moved to low-level jobs such as contract workers and nurses. This makes it more difficult to leverage the resources of the diaspora to the extent that India does.

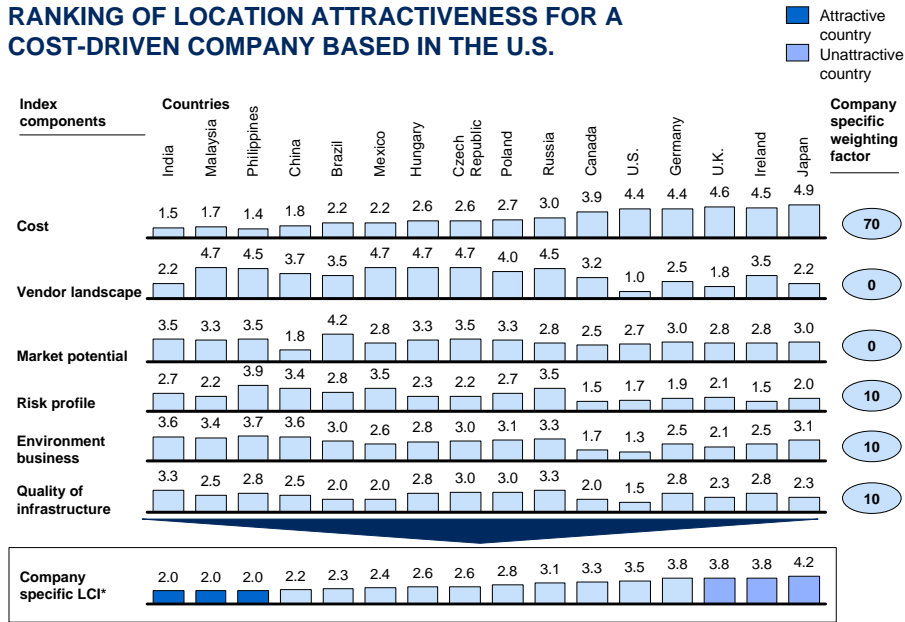
MEETING THE CHALLENGES

The prospect of the Philippines meeting its goals in offshoring depends on how companies looking at offshoring locations weigh the various factors. For instance, one particularly cost-conscious U.S.-based company gives cost a 70 percent weighting, but only 10 percent for risk profiles, business environments, and infrastructure. For this company, the Philippines is judged an attractive location, alongside India and Malaysia (Exhibits 4 and 5). However, for another U.S.-based company that still prioritizes low costs but gives this factor a less dominant weighting of 40 percent—with other variables such as vendor landscape, risk, and the quality of infrastructure given ratings of between 10 and 20 percent—the three most attractive offshoring locations are India, the United States itself, and Brazil. In this case, the Philippines was ranked sixth. The success in this case of the United States, which has low attractiveness scores for cost but high scores for vendor landscape, business environment and infrastructure, is a graphic illustration of the importance of non-cost and non-skill factors in which the Philippines has distinct weaknesses.

The Philippines thus has an opportunity to benefit from growth in offshoring, and to leverage the growing interest in companies to diversify their business process offshoring operations outside of India. It has very low labor costs and abundant talent, two of the most important factors in attracting offshoring opportunities. But in order to compete more strongly with India and other potential competitor locations, the Philippines must get some big things right. Below are some pragmatic actions that can be taken to help the Philippines achieve increased growth in offshoring, most of which are relatively low-cost.

Exhibit 4

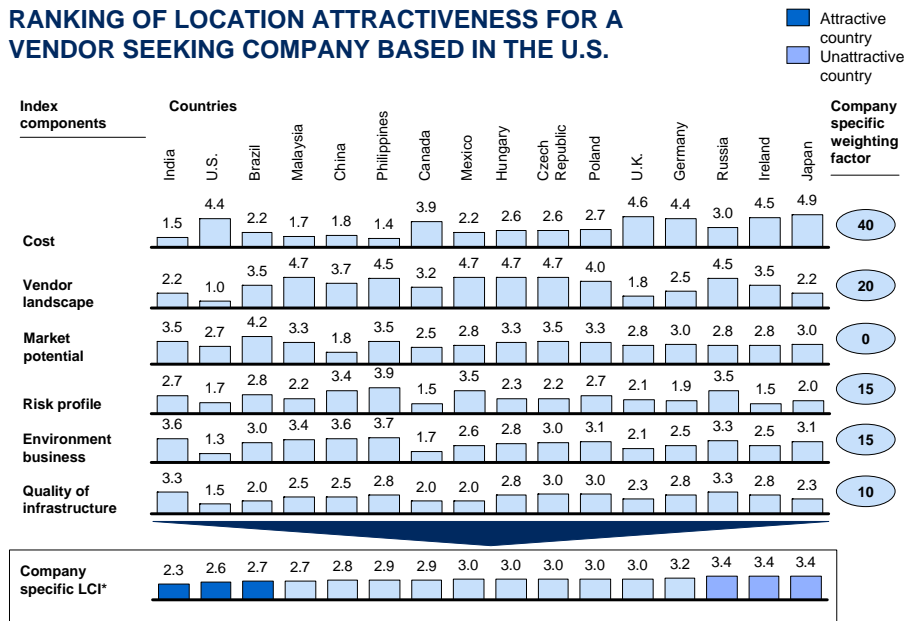
RANKING OF LOCATION ATTRACTIVENESS FOR A COST-DRIVEN COMPANY BASED IN THE U.S.



* In this ranking, 1 is the most attractive and 5 is the least attractive.
Source: Location cost index database

Exhibit 5

RANKING OF LOCATION ATTRACTIVENESS FOR A VENDOR SEEKING COMPANY BASED IN THE U.S.



* In this ranking, 1 is the most attractive and 5 is the least attractive.
Source: Location cost index database

Develop a clear strategy to attract investment from offshoring companies. The Philippines needs to develop a clearer market strategy, selling itself on its strengths, and shoring up weaknesses in key areas. It may make sense, for instance, to brand itself—as India has done with IT and China has done with manufacturing—as "the world's call center." On top of this baseload business, it could also focus on markets in which no country has a strong lead, such as non-voice BPO (e.g., accounting and financial services). The Philippines also should work to help existing vendors who already know how to operate and mitigate the additional costs and risks in the Philippines environment become more effective. As this will take several years at a minimum to achieve, in parallel the Philippines should target multinational companies that prefer to set up their own captive operations rather than outsource. Another strategy is to attract investment from IT services firms in India, rather than encouraging the startup of Philippine rivals. As India faces an impending talent crunch in IT services, it may look abroad for additional sources of low-cost engineers. An ancillary benefit of this strategy is that it may infuse skilled managers into the marketplace to work with the abundant supply of entry-level labor.

Tackle infrastructure weaknesses. The infrastructure in the Philippines has clear drawbacks. The country has had some success in developing Cyberparks with concentrated "world-class" infrastructure; it must now extend the capacity of these parks and lower the costs of their operation. Investments to improve infrastructure need not be huge, particularly when they are concentrated into cyber parks. These parks should also have enhanced security (both physical and digital) in order to tackle the Philippines' negative risk ratings.

Enhance the suitable labor supply. Some interviewees cited a decline in the level of English spoken in the Philippines, a worrying problem given the comparative advantage the Philippines has had in English proficiency and its potential leadership position in call centers. To reverse this trend, the Philippines needs to encourage a continuous improvement in English language education. It also urgently needs to tackle its shortage of management capacity. This can be overcome partly through public/private partnerships (in Russia, for example, Russoft—an association of software and IT providers—is offering management education in cooperation with regional governments). And Filipinos in the diaspora who, as we have noted, are reasonably proficient

in English and have exposure to American culture, should be offered attractive pay packages to attract them back to their home market.

Attract more flagship clients. General Electric pioneered offshoring to India, helping to overcome a perception of "high risk" and, leading by example, kick-started growth in the IT/BPO sector in India. The Philippines has been successful in attracting signature locators such as Citibank, DHL, Caltex, and Proctor and Gamble, but India has considerably more. The Philippines still suffers from a perception that it is high-risk, and attracting a few more flagship companies would help to overcome this and catalyze growth in its offshoring sector.

Establish an industry association. Many countries have mounted organized, aggressive strategies targeted at key segments and aimed at building a greater share of the offshoring market. The Philippines has made some attempt to brand itself as an offshoring center, but this effort has been led by a loosely-coordinated industry body and the government, and it has plainly not been sufficient. The Philippines needs to develop a well-functioning, well-funded industry association, like NASSCOM in India (see sidebar) to formulate a strategy for the industry, counter negative perceptions such as the Philippines being a risky place to do business, catalyze action at government level (such as harmonizing incentives) and at industry level (enhanced manager training); run marketing campaigns; and lobby the government to reduce bureaucracy and improve the country's regulatory competitiveness.

Do not yield to granting incentives. No country should waste scarce resources on tax and other incentives to attract foreign direct investment. Because many other countries do grant incentives, the temptation can be great. However, these incentives are not only costly to governments who can ill afford them, but also they create distortions in the market that undermine healthy, long term growth. MGI research has found consistently in many emerging markets that other factors, such as quality of infrastructure, labor, and domestic market, are more important factors in determining where to invest.³ The Philippines would thus do best by investing its resources in improved infrastructure and education, not tax breaks for multinational companies.

³ See "The truth about foreign investment in emerging markets", *The McKinsey Quarterly*, 2004, Number 1.

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The Philippines is already an established success in the fast-evolving offshoring sector, largely on the back of low costs and high volumes. With its clear cost and skills advantage, it can put itself on a trajectory to capture a disproportionate share of the global marketplace over the next 5 years, creating an extra million jobs and billions of dollars in GDP. But industry and the government need to implement a concerted strategy, based on a defined set of "game-changing" policy actions, if the Philippines is to fulfill its undoubted potential to become a central shaper in the marketplace.

NASSCOM'S ROLE IN DEVELOPING INDIA AS A BPO HUB

Created in 1988, NASSCOM is the trade body of the IT software and services industry in India, and it has played a central role in establishing India as the leading software outsourcing destination in the world.

It has also played an active role in developing India's BPO sector. NASSCOM focused early on the call center trend; developed concentrated IT centers to create network effects and leverage technological infrastructure; worked closely with the government to create the right regulatory framework; developed new products and services, including higher value-added BPO services; and built a conveyor belt of talent. It is a cheerleader for free trade, zero tariff protection, strong intellectual property and data protection laws, deregulation of the telecom market and the creation of software technology parks and private sector participation in the education system.

And the results? Growth in India's offshoring sector has been phenomenal, with revenues increasing from \$0.6 billion in 1999 to \$3.6 billion—an average annual growth rate of 43 percent. By the end of fiscal year 2004, employment was more than 250,000 and another 100,000 jobs are expected to be added during the current fiscal year. NASSCOM has become a global organization with a membership of 900 companies accounting for more than 95 percent of the IT services and IT-enabled services industry in India, 150 of them from the U.S., U.K., European Union, Japan, and China.