



Myths & Truth Every European SME Should Know About Software Development Outsourcing

Introduction

Small and medium size enterprises (SMEs) represent a significant proportion of the European Union (EU) economy. Within the EU there are more than **18 million SMEs** representing **59%** of the total economy, generating **67%** of employment and contributing around **two thirds** of the EU GDP¹. Since SMEs are recognized to play a pivotal role in the EU economic development, it is critical to their competitiveness and survival to widely use IT and telecom solutions. Although the European SMEs appear **on par** with large organizations in terms of computer usage, they **lag behind** in terms of usage of complex applications and emerging technologies. This disparity can be partly explained by the fact that most of SMEs do not need the same level of IT sophistication and grasp of innovation as the large corporations. Additionally, the limited use of extensive IT infrastructures and emerging technologies is due to such factors as financial constraints, lack of organizational readiness and technical skills, and high cost of technology ownership as well as in-house application development and maintenance. Although **IT outsourcing** (ITO) has already become a **global commodity** practice, research shows that many SMEs are still **afraid** of transferring their IT function / elements to be fulfilled by a 3d party **nearshore** (within/close to the same time zone) or

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¹ Meletiou, G., Molla, A., & Okunoye, A., 2009, *Factors that influence SMEs' adoption of application service providers* in 'Emerging Trends & Challenges in IT Management', pp. 635-638



offshore (2 and more time zones away)². Among reasons keeping SMEs away from the outsourced development, **more than 10% said they think they are too small and immature to outsource.**

However, we claim that **company size is irrelevant when it comes to unlocking the benefits of IT outsourcing and SMEs can gain as many long-term benefits from their outsourced development as their larger counterparts.**

Outsourcing Myths SMEs Believe In

Today's SME segment in Europe is largely penetrated and represented by the **high-tech startups** and **venture capital backed companies** who do **100%** of business online. As they are dependent on venture capital and/or cash inflows from investors, they have very **limited IT budgets** and/or are often **pressed to reduce operating expenses** (OPEX) via such a well-known practice as **IT outsourcing** (ITO). However, SMEs are quite resistant to adopt ITO strategies because of several common beliefs such as:

- **Outsourcing can be beneficial for large companies only who have mature processes, well-established infrastructures and financial ability to collaborate with the most skilled and experienced outsourcing gurus and consultancies;**
- **Only non-core elements such as application upgrade, support, QA and testing etc can be successfully outsourced to the 3d party, but core end-to-end development should be retained within own house;**
- **Managing an outsourcing relationship will eventually cost more money, administrative hassle and require management bandwidth extension, compared to the in-house development**

While it may be true that most of the outsourced projects involve hundreds of staff members and millions of Euro and it is extremely important for companies, especially those in the SME segment, to **have absolute managerial control** of their core development, there are several arguments which disrupt this truth:

1. Today's technology is **moving so quickly** that it is difficult for an internal IT department or individual in a SME to remain **on top of trends** including security, new products, managing mobility, the move to Social Media and other issues³
2. Numerous studies commissioned between 2009 and 2010 point to a **significant shortage of qualified IT and human resources** within the EU⁴. The most skillful ones are usually employed by large companies, while it may take a while for a SME to hire an appropriate human

² *European IT Outsourcing Intelligence Report 2010: Western and Northern Europe* by IT Sourcing Europe

³ "Report highlights SME IT outsourcing benefits", 2010, *EUCommerz.Com*



resource within own country. It creates a **huge barrier** to flexibility and fast time to market which are crucial for SMEs to survive and withstand the tough market competition.

3. The statistics says that **nearly 70%** of new businesses **fail** within the first five years for two main reasons: the owners lack a solid business plan or their attention is divided among so many tasks that they suffer from "**attention diffusion**"⁵. In other words, **focusing too much on the core development, SMEs can easily lose their sales, marketing and customer relations capabilities and, vice versa, focusing too much on sales, marketing and customer relations capabilities, companies may lose control of their core development**. Additionally, in smaller businesses, with either a small or a non-existent IT department, the responsibility for IT provision is often assumed by someone who is busy with the day job. 'This usually means that the **main day-to-day focus** is on keeping the existing equipment working – with **little or no time** for ensuring that the data is **safe**, the environment **stable** or how IT can best **serve** the business in the **medium to long term**,⁶ says Caroline Godsil, Joint Managing Director at Hibernia Evros Technology Group.

To Outsource Or Not To Outsource?

"Perhaps the biggest benefit outsourcing provides small and medium-sized companies is giving them the gift of time"

Ajay Sirsi

Marketing Professor at Schulich School of Business / Toronto

Study on global ITO adoption by SMEs⁷

63% of SMEs adopt IT outsourcing to focus on core business, 51% - to save costs and 47% - to release internal IT staff for more strategic work

Study on European ITO adoption by SMEs⁸

39% of SMEs outsource to reduce operating costs, 21% - to accelerate time to market and 17% - to free internal IT staff for more strategic work

⁴ IT Sourcing Europe, Ieee.Org, HRO Europe, 2010

⁵ HRO Europe, 2010

⁶ "Report highlights SME IT outsourcing benefits", 2010, *EUCommerz.Com*

⁷ Study by Hibernia Evros Technology Group, 2010

⁸ European ITO Intelligence Report 2010: Western and Northern Europe, by IT Sourcing Europe



Today's level of **competition** is very **high** due to the presence of **numerous market players**, **stringent demand** for **innovation** and **quality** and direct and indirect **price control/influence** by the customers. In the past years most of SMEs simply **copied** successful products designed and developed by **large corporations** and marketed them at a **lower price** and with **fewer** license restrictions in order to win their own niche in both domestic and foreign markets. It allowed them to keep the head above water. However, today **it is not enough** to simply put a copycat product to the market, as **customer behaviors change** immensely under the **influence** of the **Internet**, **travel** and other **globalization** features. Both large corporations and SMEs **have to be creative and inventive in how to adjust existing products and services to the cloud environment** and **how to offer customers the most state-of-the-art products using emerging technology and development sophistication**. Thus, **strategic mindset** needs to **supplement business acumen** and provide a **clear roadmap to success**.

But many SMEs **underestimate huge advantages** they have over their large fellow businesses.

Large organizations	SMEs
<ul style="list-style-type: none">- complex organizational structures- executive role hierarchies- process- and procedure-packaging- bureaucracy- distance from customers	<ul style="list-style-type: none">- ability to react quickly to market trends and respond to them in a very short fraction of time- short decision making time- smaller overhead costs- proximity to customers
Innovative ideas	
<ul style="list-style-type: none">- take a while to move from the marketing department to the IT department to the final decision maker- get lost in the long way of moving through hierarchy (continuous needs analysis, multi-level strategic planning, resource accumulation etc)	<ul style="list-style-type: none">- are put to the decision maker's desk and implemented quickly- are able to better meet current customers' needs and expectations

And still there is one big **BUT** which may strike out all of the above arguments: **to grasp innovation and achieve unsurpassed technological sophistication, people are needed!**



Research says:

- a shortage of IT engineers has been an issue in Western Europe for years⁹
- those shortages are going to get worse and worse because of the aging population¹⁰
- number of people going to universities and competing for jobs in IT/engineering is declining from year to year¹¹

Bare Facts	Experts Opinion
<p>In the UK, only half as many high school students go on to university to study IT/electronics as did five years ago¹²</p>	<p>“We may be looking for more engineers, but the reality is that there may only be five that are of the quality that we’re looking for,” says Bill Parsons, Executive Vice President, Human Resources, ARM Holdings</p>
<p>Staff skills in C#, SQL, .Net and Java script were in short supply in the second quarter of 2010, with the number of related jobseekers in decline¹³</p>	<p>“In several skill areas, we will continue to experience shortage of supply and this will put pressure on pay and contract rates,” says Jeff Brooks, Chairman of REC Technology</p>

Competition in **IT headhunting** is really **fierce** and the greatest **advantage** of large companies is that they **are able to attract the best IT talent by offering higher wages and social packages which SMEs are unable to offer.**

Statistics shows that the **Central and Eastern European** region is demonstrating steady **growth** in **numbers** of IT graduates and IT staff employed:

- In 2009, the **number** of IT specialists employed in companies providing **IT outsourcing** and **software development services** in the CEE region reached **95,000 (Romania** led in growth in the number of IT specialists with **12.33 %; Ukraine** followed with **9.51% growth)**¹⁴

⁹ IEEE, 2010

⁹ Schneiderman, R., 2010, “Economy, Shortages Impact European Job Outlook “ in Careers.Ieee.Org

¹⁰ Ibid

¹¹ Ibid

¹² Williams, J, “Shortage of C#, SQL and .Net skills as IT vacancies rise,” 2010, in ComputerWeekly.Com

¹⁴ CEEOA ITO Review 2010



- Ukraine, Romania, Belarus, Hungary, Poland and Bulgaria account for **75%** of all specialists in the region¹⁵
- Strong engineering schools and large numbers of students in IT specialties have created **good prospects** for further market development against the backdrop of the recovering global economy and rising demand for outsourcing services

Now let us compare **engineering skill rates** in Western and Northern Europe vs. those in Central and Eastern Europe:

Country	United Kingdom	Germany	Denmark	Ukraine	Belarus
Average net pay for software engineer (EUR/month) ¹⁶	3,110	3,074	6,580	1,700	1,600

Now let us calculate roughly the approximate **Total Cost of Ownership (TCO)** of software development operations in the United Kingdom vs. some of the prospective CEE countries¹⁷:

	United Kingdom	Ukraine	Belarus	Romania
Software developer's average salary + benefits, in EUR/month	4,500	2,200	2,000	2,600
Project Manager's average salary + benefits, in EUR/month	5,300	2,600	2,400	3,200
Office occupancy costs, in EUR, per 1 employee workstation/month	1,400*2=2,800	350*2=700	370*2=740	340*2=680
Travel costs		800	700	750
TCO (in EUR/month)	12,600	6,300	5,840	7,230

The above rough calculations demonstrate well that any UK-based SME can run a 2-person development team located nearshore at a **double lower price**, compared to the in-house capabilities.

¹⁵ CEEOA ITO Review 2010

¹⁶ Source: WestEastCafe.Eu, 2010

¹⁷ Sources: ITjobswatch.Co.Uk, Developers.Org.Ua, Payscale.Com, Diz-By.Biz, DTZ's 13th Annual Global Office Occupancy Costs Survey 2010, Wego.Com, Hotel.Ua, Booked.Net, Booking.Com, KyivRestaurants.Com, VirtualTourist.Com, WayToRussia.Net



To summarize the above findings, SMEs should outsource their software development because of the **3 critical reasons**:

- 1) Accelerate time to market
- 2) Get access to the qualified IT talent and specific skills (which are difficult to find and are a way too expensive within the homeland) and
- 3) Reduce OPEX

Where to Transfer Development – Offshore or Nearshore?

"It is horses for courses. The Indians have become brilliant at marketing their outsourcing services, but delivery is the key"

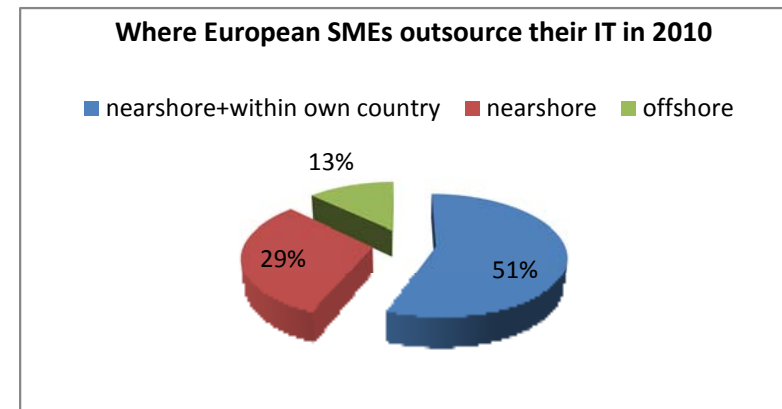
Daniel Marovitz

COO / Deutsche Bank's global banking division

The **perception** of sub-continental Asia as an **easy place** to do business with is holding up well, with **45%** of respondents rating it as the easiest region¹⁸. However, the same survey shows **Nearshoring centers** in Central and Eastern Europe **"treading on the Asian coat-tails"**, with **41%** of respondents rating it as the **easiest region** to do business with.

IT Sourcing Europe has surveyed 5 Western European and 3 Nordic countries between April and November 2010 for the purpose of **benchmarking** current/predicted level of **IT outsourcing adoption** among companies representing all of the major verticals. More than **80%** of companies surveyed were in the SME segment.

Further, those SMEs who outsource their development **nearshore** or **nearshore + within own country** are much more **satisfied** with their outsourced development, compared to offshore outsourcers. **Delayed delivery** and **missed project milestones**, **poor client-vendor relationships** and **poor project**

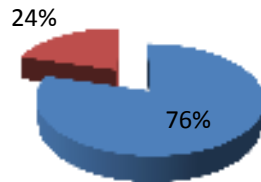


¹⁸ National Outsourcing Association, 2007



Level of satisfaction with the outsourced development

■ nearshorers ■ offshorers



management on vendor's side were mentioned among the **most crucial challenges** of the outsourced development facing offshore outsourcers. Regarding nearshore outsourcers, their major concerns related to **intellectual property security** issues and the **lack of appropriate resources** on vendor's side.

Central and Eastern European vendors are claimed to provide **innovative solutions** and **added-value services** rather than just a cheaper offering of routine processing requirements and coding¹⁹. This expertise is generated largely by a **pool of talent** educated to the highest technical standards – in Ukraine, Belarus and Russia it is a **legacy** of the old Soviet system which still offers clout in today's highly capitalistic environment. This means that **clients can specify the problem**

or **new business approach** and then **collaborate** with the outsourcing supplier to **come up with the solution** rather than specifying the technical issues and looking for an outsourcing supplier to implement the plan.

What Business Model Best Fits SMEs?

“Clients expect more from vendors. They seek reliable partners helping them to solve business problems creatively”

Franco Dal Molin, Country Manager / Ciklum

Creativity is always linked to **innovation**, so to be able to find creative solutions to IT challenges in an outsourcing environment, SMEs should engage with their ITO partners via innovative business models.

We carefully compared and contrasted **one traditional** and **one innovative** ITO models in terms of their **factual capability to bring long-term value** to SMEs and their core development. We excluded a **project oriented** (fixed price, T&M) model, as it is **unable to bring any long-term value** within today's **Outsourcing 2.0** domain characterized by **high demand of agility** and **project requirements changeability**. Although this model may be **good for small non-core projects** with clearly specified and unalterable specifications, it is **not recommended** for **core development** where project requirements can change very quickly in line with rapid changes in industry and/or customer needs.

¹⁸ Hewitt, M., 2007, “Innovation is the nearshore lure,” in ComputerWeekly.Com



Dedicated Development Center / Managed Team

What vendor does:

- provides all of the necessary resources, facilities and project teams that are supposed to correspond to client's business needs, culture, mission, objectives and be engaged in the client's project
- "squeezes" the most from their on-staff developers and uses them on multiple clients' projects rather than hires new people to work exclusively on each client's project

What client does:

- transfers the project to the vendor
- communicates with team members via vendor's PMs

What client pays:

- a fixed price for the received services (as per the contract)
- overheads to cover vendor's staff training, qualification advancement, employee turnover, infrastructure upgrade

Results:

- stressed-out, demotivated developers
- high turnover
- hidden agenda
- delayed project delivery and unmet milestones

Conclusions:

- Non-transparent pricing structure
- Actual incurred costs of the outsourced services far exceed the contracted ones (in many cases 25% to 50% higher²⁰)
- Poor/inappropriate project management (PM) on vendor's side is one of the key drivers of the failed outsourcing operations. Since the client is dependent on vendor's PM, he is at risk of losing project control and/or failing a project due to vendor's PM mistakes/lack of expertise or track record within the team
- The risk of losing data/Intellectual Property security is high, since the vendor should often be granted access to client's sensitive data for successful project execution

Dedicated / Own Software Team

What vendor does:

- provides all of the necessary resources and facilities and recommends candidates with required skills/experience to be selected by the client
- solves client's administrative and taxation issues (in compliance with the country's laws)
- provides adding-value services such as consultancy, networking etc

What client does:

- sets up own development team, selects people to be involved in his own project, sets compensation and benefits for each member on the outsourced team, creates own retention/promotion/training strategies and works directly with the software team avoiding/reducing any project management on the vendor's side
- evaluates each team member's contribution to the project, replaces slow achieving developers with brighter talent and reduces/eliminates staff turnover by different creative incentives
- fully manages the project

What client pays:

- a single monthly bill comprised of each outsourced team member's salary plus tax and vendor's service fee (no overheads or hidden agenda)

Results:

- better / transparent project management
- satisfied developers (as they feel like part of client's in-house team and have a chance to openly communicate their problems/requests to the client)
- lower staff turnover
- less misunderstanding between client and vendor

Conclusions:

- The model is equivalent to running own IT department, but for a much lower price and with no administrative hassle
- The model is agile and easily scalable and allows SME to expand/shrink its HR bandwidth depending on current business needs
- It allows better savings in a long-term perspective
- The chance of putting IP at risk is lower, as the vendor doesn't have / has a limited access to client's data

²⁰ European ITO Intelligence Report 2010: Western and Northern Europe, by IT Sourcing Europe



Conclusions & Recommendations

Considering today's tough competition in the EU IT headhunting, lack of appropriate domestic skills and resources, pressures from customers and large organizations, it is **a must** for SMEs to find effective ways to **optimize** and **leverage** operating costs, **accelerate** time to market via **flexibility** and **sustainability** and **lower down** overall IT spending. Within this white paper we have tried to argumentatively prove that **SMEs do have a good chance to leverage costs and develop an unsurpassed solution via outsourcing**. However, they should be very careful selecting an outsourcing destination and partner, as not all traditional business models fit their sourcing strategy. Here are some of the recommendations that SMEs may consider while making their outsourcing decisions:

- Take some time and resources to **hire a competent IT manager** with an extensive outsourcing experience to develop project specification and milestones.
- Hire a consultancy to help you **select an outsourcing destination** and suggest on **appropriate ITO vendors** (but always consider outsourcing nearshore to ensure minimal time, distance and cultural differences).
- Send your RFP to **several vendors** in **several low-cost regions**, then **narrow** your selection to the ones matching your requirements and **challenge** them to prove their expertise (make them complete a pilot project for free or call their past and current clients to ask for references).
- Make sure the contract to be signed offers a pricing structure **as transparent as possible**.
- Make sure you **engage** with your outsourcing partner via an **innovative business** model such as **Dedicated / Own Software Team** rather than traditional process-packaged models such as DDC or managed team.
- Make sure the vendor creates a **realistic HR/team growth strategy** for you (both in short- and long-term perspectives).
- Make sure it is **you**, not your vendor, who has **100% managerial control** of your team members' compensation and retention. The vendor should only act as your **recruitment agent** and **space and resource provider**, but not as **a sole project manager!**
- Start your outsourcing relationship with **few developers** on the outsourced team and **grow** your team in a consequent way.
- Make your personnel on the outsourced team **feel** like part of your company, share your **business mission** and **vision** with them and involve in **decision making**. It will eventually help you **retain** your team members for as long as your project needs.

SMEs should always remember that the **success of the ITO relationships** depends much on whether or not they have managed to make the **right sourcing decisions** and have got a chance to **develop own development team** in the ways which best meet their business needs and challenges.



About IT Sourcing Europe

IT Sourcing Europe Ltd is a UK-based research and consultancy company specializing in nearshore IT/software development Outsourcing. Our services include:

- Independent IT Outsourcing market research and analysis
- Independent surveys of Western European outsourcers and their ITO demand
- Independent surveys of Central and Eastern Europe's ITO services providers and their factual capability to deliver top quality products and services on time and on budget
- Consultancy and recommendations to companies planning to change their current outsourcing strategies
- Consultancy and recommendations to companies planning to outsource their IT function nearshore
- Custom market and competition research and surveys

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