

## 15.967 Professional Outsourcing and Offshoring

### **FINAL PAPER ASSIGNMENT**

#### **Outsourcing and Offshoring in the Japanese Market**

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#### **Introduction**

Other than manufacturing, in the past most Japanese companies did not even consider professional outsourcing overseas because of language and cultural barriers which impacted communications and work processes alike. Also, the Japanese policy of lifetime employment, comparative lack of strict work processes, tendency among Japanese firms to “do everything by themselves”, and other reasons kept Japanese companies away from outsourcing.

However, due to the current never-ending recession in Japan and intense competition (partly stemming from increased globalization), cost-cutting is becoming increasingly important these days. Outsourcing in-country to other Japanese companies is of course one solution and is already very popular, but it would be much more effective (not only in terms of cost but also from other viewpoints such as securing workforce flexibility or gaining additional skills) if they could outsource to countries such as India or China where labor costs are significantly lower than that in Japan. Some companies have already begun to outsource R&D/IT functions to these countries.

On the other hand, many Indian and Chinese outsourcing providers are increasingly focused on the Japanese market. They are enhancing their ability to service clients using the Japanese language by increasing the number of staff who can serve their clients in Japanese. The language barrier, which is probably the largest obstacle, could be partly solved by the above efforts of outsourcing providers.

So, how big is the Japanese outsourcing market now? Which Japanese companies are thinking about outsourcing? Why hasn't outsourcing become popular in Japan? I did my research by interviewing many Japanese companies as well as several Indian outsourcing providers to try and find answers to these questions as accurately as possible.

### **Current Japanese outsourcing market**

According to both IDC and McKinsey, the total Japanese outsourcing market was \$53 billion in 2001. This accounts for 70 percent of the Asian market and represents more than 12 percent of the global outsourcing pie<sup>1</sup>. Software development, IT related services, and call centers are the largest areas to be outsourced by Japanese companies.

The Japanese IT outsourcing market in 2003 is estimated to be ¥2.85 trillion (\$26 billion) according to IDC Japan. IDC's estimate for the 2002 global IT outsourcing market was \$68.5 billion.

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<sup>1</sup> Express Computer "Indian software develops a yen for the rising sun" (2002) by Indian Express Group

As far as the current trend is concerned, in the US, many companies have been shifting from simple outsourcing to more strategic, sophisticated, and value-adding BPO (business process outsourcing) or BTO (business transformation outsourcing). Japan is not as far along in the use of outsourcing; only a few companies have just started Total IT Outsourcing.

The top five local IT services players in Japan are Fujitsu, Hitachi, NTT Data, NEC, and IBM, who together control more than 70 percent of the market. Other players in the top ten include Nihon Unisys and CSK. There are two US companies in the top ten, but they have been in Japan for a long time, and are considered Japanese companies in terms of their manner of conducting business.

Traditionally, Japanese companies have outsourced only part of their IT functions such as data entry and coding. The main businesses of the above providers of course include such services, but the demand towards Total IT Outsourcing has been increasing since 1999. The primary reason to outsource is of course to reduce costs, but outsourcing can help companies to reduce costs in two ways according to some of the Japanese companies I interviewed. First is of course reduction in direct labor costs. By avoiding the hiring of new employees and securing their resource needs from outside the firm, they can effectively change fixed costs into variable costs. This is especially helpful for companies in competitive industries because they can control the total amount of workforce to some extent depending upon the market without laying off their employees.

With the parent company's experience in the US, IBM Japan has been unrivaled in the Total IT Outsourcing area (see below for IBM Japan's recent deal). Since 2002 NTT Data has become somewhat successful in this area also, but main-flame companies such as NEC, Fujitsu, and

Hitachi which are also in this area seem to be struggling after entering into contracts. The other outsourcing providers are still way behind.

***(IBM's recent outsourcing deals with Japanese companies (1999-2003))<sup>2</sup>***

**Japan Airlines:** More than \$646 million over 10 years

**Honda Motor Co.:** Terms not disclosed

**Juroku Bank Ltd.:** \$380 million over 10 years

**Sharp:** \$850 million over 10 years

**Nissan Motor Co.:** More than \$1 billion over 10.5 years

**Sumitomo Metal Industries Ltd.:** \$660 million over 10 years

**Mitsui Mutual Life Insurance Co.:** \$1.4 billion over 10 years / \$347 million over 10 years (BTO)

**JACCS Co.:** \$370 million over 6.5 years

**Daishi Bank Ltd.:** \$270 million over 10 years

**Meiji Life Insurance Co.:** \$533 million over 10 years

**Mazda Motor Corp.:** \$472 million over 10 years

**Nisshin Steel :** \$283 million over 10 years

**Kobe Steel :** \$579 million over 10 years

As mentioned above, it is apparent that Total IT Outsourcing has become popular in Japan since 1999. In the US, on the other hand, Total IT Outsourcing started when Eastman Kodak, which had a very capable IS department, outsourced a significant part of it in 1989. Kodak's approach quickly became the model for successful outsourcing and many companies followed suit.

In these terms, it could be said that Japanese companies are about ten years behind their American counterparts when it comes to outsourcing.

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<sup>2</sup> Computerworld "Outsourcing wave hits Japanese market" (Aug 2001) by Julekha Dash, Computerworld Inc.

## **Overseas Outsourcing (Offshoring)**

### **(1) Global Offshore Outsourcing Market**

In the US, outsourcing has become a controversial topic for the presidential election since late 2003. This is because outsourcing overseas to countries such as India and China, so called “offshore outsourcing”, is becoming more and more popular in the US, and this means that many US workers are losing their jobs to workers in other countries. By 2015, Forrester Research estimates that as many as 3.3 million U.S. jobs and \$136 billion in wages could be moved to such countries as India, China, and Russia.

While there are several purposes for offshore outsourcing, the primary one is of course labor cost reduction. As labor cost in India is often as low as 1/10 of that in the US, companies can easily get 50% savings in the cost base even when they take communication costs and management costs of the offshore facility into account.

The global offshore outsourcing market is estimated to be a \$7 billion market in 2003 according to Meta Group, and it is expected to grow by more than 20% annually, making it a \$10 billion market by 2005. Based on McKinsey Global Institutes’ report in 2003, US businesses dominate the global share of offshore outsourcing, accounting for approximately 70% of the total market, with the UK being the only other dominant player. Other European countries and Japan account for only a tiny share<sup>3</sup>.

Where is it outsourced to? Everest Group estimates that India has become the back office of the world with US and UK companies sending as much as \$5 billion in work to Indian outsourcing

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<sup>3</sup> McKinsey Global Institute “Offshoring: Is It a Win-Win Game?” (Aug. 2003)

providers<sup>4</sup>. ConnectITChina, a Shanghai-based consultancy, has estimated that China's software outsourcing revenue is currently about \$2 billion<sup>5</sup>.

## **(2) Japanese Offshore Outsourcing Market**

Offshore outsourcing hasn't really taken off in Japan yet although the practice is increasing rapidly. Major consumer electronics, IT services and semiconductor companies such as NEC, Toshiba, Hitachi, Matsushita, Sony and others have been outsourcing mainly to Asian countries such as China and India since some time ago, but practice has traditionally been very limited.

It seems that offshore outsourcing started around the mid-1990s when India first became famous for its excellence in low-cost software development. According to the Electronics and Software Exports Promotion Council, an autonomous exports promotion body under Ministry of Commerce of India, software exports increased dramatically in 1996-97 to reach \$30 million and continued to increase to over \$220 in 2001-02, and to approximately \$400-500 million in 2003<sup>6</sup>. However, this growth wasn't as high as expected, and there seemed to be both linguistic and cultural reasons for this. Many Japanese companies actually selected China in the late 1990s, but while outsourcing to China went well for some companies, it didn't work out well for others. I will refer to the possible reasons for this later, but because outsourcing to China wasn't so successful, the whole concept of offshore outsourcing didn't take off.

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<sup>4</sup> OutsourcingAsia.com "China: The Next Big Wave in Offshore Outsourcing" (June 2003) by Todd Furmiss, COO, Everest Group.

<sup>5</sup> The Times of India Online "China can be BPO hub by 2007: Report (Aug. 2003) by Bennett, Coleman and Co., Ltd

<sup>6</sup> Express Computer "Indian software develops yen for the rising sun." (Sept. 2002) by Indian Express Group

## Situation for Chinese Outsourcing Providers

As far as China is concerned, many Japanese companies have been outsourcing manufacturing functions for a long time, using the country as a low-cost manufacturing base. For instance, Matsushita has outsourced about 40 percent of its total production to China. As such, it was somewhat natural for these companies to consider outsourcing their R&D functions as well. Several Japanese companies including Matsushita and some other blue chip manufacturing companies either have already outsourced or are planning to outsource R&D function to China. Many IT service companies, including NEC and Toshiba, outsource software development for their clients to China on a project basis. The typical manner in which Japanese companies outsource work is different from that of US companies. In most cases, Japanese companies set up local subsidiaries or development centers, or create alliances with local outsourcing providers in order to basically control the whole process, but outsource parts of their work such as R&D to Chinese companies, usually on a project-by-project basis. Some of the R&D work performed in China is destined for the Chinese market, and it is difficult to clearly determine the breakdown.

Call center outsourcing is also becoming very popular.

Here are some of recent examples of offshore outsourcing by Japanese companies.

### (Software Development Outsourcing)<sup>7</sup>

- **Fujitsu** (2002): Software development for its clients
- **Shin-Nittetsu Solutions** (2002): Construction of its ERP and SCM

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<sup>7</sup> Navigation and Solution “BPO wave about to hit Japanese market” (Dec. 2003) by Nomura Research Institute

- **TIS** (2002): Construction of its sales management system
- **NEC** (2003): Enhanced its SI function
- **NRI** (2003): Internet related software development
- **Argo 21** (2003): Its own application software development

**(Other Professional Outsourcing)**

- **Nihon Life Insurance** (2002): Outbound call center
- **Exxon-Mobil Japan** (2002): Admin work and call center
- **Dell Japan** (2002): Call center
- **Generali Services Japan** (2002): Japanese data entry
- **GE Japan** (2003): Accounting, Salary calculation, Invoice management
- **CSK, Accenture** (2003): Call center

However, it is also the fact that most of the Japanese companies outsourcing to China still perceive Chinese companies as providers of staff or as low-cost contractors that replace Japanese high-cost contractors. Japanese companies have to change their view of Chinese companies as partners in order for them to be successful in outsourcing.

### **Situation for Indian Outsourcing Providers**

Software export seems to be expanding and the area of embedded software has experienced a boom recently. On the other hand, high-end services which Chinese companies are not so good at, including custom application development, IT management services, and system integration and deployment, are increasingly becoming popular among Japanese companies. The current Japanese outsourcing market for Indian companies is estimated to be around \$400-500 million in 2003 according to Nasscom<sup>8</sup>. However, the top Indian outsourcing providers I interviewed

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<sup>8</sup> Express Computer “Indian software develops yen for the rising sun.” (Sept. 2002) by Indian Express Group

said that it was only around \$200-300 million. The two main areas are IT related services/management/development, and product design.

According to a McKinsey report from 2002, the largest Indian outsourcing provider serving the Japanese market is Wipro. The head of Wipro's Japan operations said that Wipro draws approximately \$40 million in outsourcing revenue from a total of just over 35 Japanese customers. To serve this market, Wipro employs more than 150 employees in Japan, and another 700 hundred in development centers in India. According to the head of Infosys Japan, the second largest Indian player in Japan, Infosys has about \$30 million in revenue from more than 15 customers and has more employees serving them than Wipro. TCS, the largest outsourcing provider in India, was a little bit late in entering the Japanese outsourcing market but is quickly increasing its revenue, although its main business at the moment stems from foreign company subsidiaries in Japan. I interviewed most of the top seven Indian outsourcing providers, and Satyam seems to be in the top five as far as the revenue from outsourcing is concerned, although it wasn't in McKinsey's report two years ago. I-flex and Polaris Software are also worth mentioning, as they have been quite successful in the Japanese market providing banks with software development and IT consulting services.

### **Why hasn't outsourcing prevailed in Japan?**

Why hasn't outsourcing become popular in Japan? This is a very difficult question to answer perfectly, but based on interviews and data-collecting from twelve Japanese companies and six Indian outsourcing providers, and my own personal experiences working in a traditional Japanese company for more than ten years, I believe it is for the following reasons.

## 1) Language barriers

I believe that language is the largest reason why outsourcing hasn't become popular in Japan. If the outsourcing provider doesn't understand Japanese well, there is little chance that it can get business from Japanese companies, because most Japanese companies require their vendors to speak Japanese fluently. Part of the reason why I am giving the language reason first is that many Japanese subsidiaries in the US are outsourcing all of their IT functions to Indian companies. A large main-frame company that I interview said that it often uses Chinese and Indian outsourcing providers based on the purpose of its customers' system development. If the customer is using the system for only Japanese market, the system will be in Japanese and the main-frame company will ask the Chinese outsourcing providers to develop the system. On the other hand, if the customer is using the system for its global account, the system should be in English, and the company will ask Indian providers.

As mentioned before, outsourcing market is dominated by the US (60-70%) and UK (20-25%) so far, but part of the reason for this is because they are the English speaking countries. English is spoken in more than 51 countries as a common language or an official language. As the level of professional outsourcing services gets higher (from simple data entry type of work to application development/maintenance or BPO), language becomes more important. If the customer is looking for BPO and/or SI provider, it has to be really good at Japanese. Processes are all in Japanese.

Language is also important in order for the provider to have a good communication with the customers and to understand the Japanese business culture. In order for offshore outsourcing to be successful, good communication and mutual understanding between the customers and the

outsourcing provider is essential. To realize this with Japanese companies, you have to speak and understand Japanese almost perfectly.

## **2) Lack of system and process**

In general, Japanese companies don't have articulated system or processes for day-to-day work. They usually don't have such things for running a company as well. They didn't need any because Japan is a homogenous country where employees and management can basically understand what has to be done including tacit parts without many systems or processes in place. There were no manual sort of things, and it was up to the individual management/employees how to do their work. Of course this was possible because most Japanese companies had lifetime employment policy, and the employees knew well how things work within their companies. Companies didn't necessarily have to create well-defined systems or processes. When employees transfer within the company, it is common practice to spend a couple of days or even up to a week or so to explain their work to their successor, a practice which is called "hiki-tsugi" or takeover. There wasn't an occasion that they have to explain their work to outsiders who know nothing about their work. Investors also appreciated this because most of them were also Japanese.

Hence, it is very difficult for outsourcing providers to understand how they should do the outsourced work, especially if the work is part of some process. They have to spend a long time with their customers in order to understand them, and even if they did so, it is still very difficult because each employee might take their own approach. Actually, two of the Indian outsourcing providers I interviewed mentioned that the lack of systems and processes was the largest obstacle for them to be successful in the Japanese market. They said that the problem is more

serious than the language problem because the language problem could be somewhat solved by training their employees.

### **3) Culture / National character / Custom Problem**

Japanese companies are exclusive in nature. This means that they tend to do everything by themselves or within their close-knit group or “keiretsu.” Vertical integration has many advantages such as keeping trade secret within the group or eliminating hold-up problems, but as far as outsourcing is concerned, vertical integration would function as a barrier. Also, traditionally any kind of consulting services were performed as a “free additional service” in Japan, so companies are very reluctant or resistant to pay fees for consulting services. This business culture creates resistance to the outsourcing business model even within Japan.

The case is worse for offshore outsourcing because Japanese culture as a whole is not as open as American culture, especially towards foreign firms. Most Japanese companies are reluctant to do business with a country that they are culturally unfamiliar with.

Another difficulty that foreign outsourcing providers face is the fact that Japanese companies don't switch vendors very often. As previously mentioned, the top five IT services companies in Japan control over 70 percent of the IT outsourcing market, and for a good reason. They have built very good relationships with their clients over long periods of time. Their relationships are based on a deep mutual understanding and trust. This makes it very difficult for customers to switch vendors, because switching means doing everything from scratch again. To make the matters worse, many major companies belong to so called “keiretsu” and are sister concerns of trading companies such as Mitsubishi, Mitsui, and Itochu. These trading companies often control the distribution and licensing of many packaged software applications.

Therefore, it will be very difficult for offshore outsourcing providers to enter into contracts with Japanese companies.

Furthermore, Japanese companies tend to view outsourcing providers as “shita-uke” or “mere low-cost contractors” rather than as partners. This stems mainly from their experience in Japan where contractors usually only do the easy and simple repetitive work such as data-entry and coding. This makes it difficult for outsourcing providers to communicate with Japanese companies.

#### **4) History**

##### **- No large Japanese outsourcing players in the market**

The largest global outsourcing market is IT outsourcing, and the market size is approximately \$68.5 billion as previously mentioned. Here, large companies such as IBM and EDS have been providing IT outsourcing services for a long time in the US. IBM claimed about 22 percent of the global IT outsourcing market in 2002 with \$15.3 billion in outsourcing services revenues according IDC’s recently published report. EDS, Computer Sciences, and Fujitsu follow IBM with \$11.1 billion, \$3.8 billion, and \$3.3 billion (IDC’s report) revenues<sup>9</sup>.

In Japan, there were no such major outsourcing or IT service providers capable of serving large IT companies. It is only recently that the outsourcing industry became somewhat large with players like IBM Japan, NTT Data, Hitachi, Fujitsu and Nihon Unisys. Because there was less need, the industry didn’t take off. Another more fundamental reason might be the fact that IT industry, especially the software industry, has been very weak in Japan. Part of this is because the industry’s popularity is not high and not many of the best university students choose IT

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<sup>9</sup> CNET News.com October 1, 2003 article by Alorie Gilbert “Report: Big Blue still biggest in IT outsourcing”

industry as a career. In general, it is difficult for new industries to be acknowledged by graduating university students, and most of the top graduates prefer large brand-name companies to new industries or emerging companies, especially during recessionary times. Also, most major companies will try to do most of the important and/or challenging work on their own, and only outsource such work that they think is too easy for them to do.

### **- History of outsourcing failure**

The general offshore outsourcing trend in Japan seems to be as follows.

**- 1995-97: Many failures in outsourcing to India**

**- 1997-01: Some shift to China, but not so successful**

**- 2002- : Revisiting India**

The main reason for these outsourcing failures seems to be the lack of communication and understanding between Japanese companies and outsourcing providers, part of which is derived from language and cultural problems. As one of the companies I interviewed had mentioned, this was probably because Japanese companies were not used to outsourcing professional services, and the Indian providers were focusing mostly on their US clients, and weren't so keen on serving Japanese companies.

## **5) Employment system**

Japanese companies are generally resistant to outsourcing from the employment point of view as well. Most companies still have a lifetime employment system, and therefore would like to keep as much work as possible within their company or group. Companies generally want to maintain good relations with trade unions, and thus strive to avoid lay-offs. As far as the IT

function is concerned, most companies own their IT subsidiaries and outsource the work to them.

## **6) Organizational problem**

Japanese organizational structure also makes outsourcing difficult. When I sent out questionnaires related to outsourcing to more than two dozen large Japanese companies, more than half of the companies could not answer my questions because their companies were decentralized to the point that they did not even know which departments were outsourcing what. I believe that no single person in the company including the management knows exactly what's happening within the company. On the other hand, each department is only interested in improving the efficiency of their own work or what they are in charge of, and not interested in improving the whole system or process for the company. Additionally, management is generally conservative and doesn't like to take risks and doesn't (or maybe cannot) make big decisions such as offshore outsourcing, because success is not guaranteed. In order for large companies to fully outsource certain functions like IT, the top management (or the CIO in the case of IT) has to make the decision for the company, because outsourcing decisions are currently made by the various department managers who only take their own work into account. This is why many Japanese companies have many small outsourcing contracts with many different outsourcing providers. Names like NEC or Toshiba are common in almost all the major outsourcing contracts. These factors make offshore outsourcing extremely difficult.

## **7) Information security and quality conscious problem**

Lastly, information security is also a concern for Japanese companies especially when outsourcing to overseas countries such as China where security systems are not as stable. Also,

the quality consciousness of Japanese consumers is very high, and Japanese companies care about quality much more than companies in countries such as the US or UK.

## **Conclusion**

I have explained many of the obstacles for both outsourcing and offshore outsourcing within Japan. In talking about the future, there is no doubt that both domestic outsourcing and offshore outsourcing will expand quickly. Japanese companies are under great pressure to improve their revenue as well as their profitability in spite of the long-lasting recession, and offshore outsourcing has great potential to help realize these goals.

The Japanese IT market is estimated to be worth about US\$900 billion. Its software market is also profitable, with an estimated value of US\$100 billion. These lucrative markets consist of more than 1,000 system integrators, 370 information service providers, and 160 information service providers (end of 2002)<sup>10</sup>. With the expansion of the market for ERP and CRM applications moving to the next stage of growth, Japanese companies are planning to outsource more and more of their IT functions. Demand is also fueled by the growth in broadband, mobile commerce, enterprise internet portal services, and 3G technology.

Domestic players such as IBM Japan will focus further on total IT outsourcing and BPO, and this market will expand for sure. On the other hand, it is interesting to see which, either Chinese companies or Indian companies, will be more successful in the Japanese offshore outsourcing market.

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<sup>10</sup> Computerworld "RP is poor 5<sup>th</sup> on Japan's outsourcing partner list" (Oct. 2002) by WS Computer Publishing Corp.

Chinese companies have linguistic, cultural, and geographical advantages over the Indian companies, and labor costs are generally cheaper than in India. Also, the Government is very supportive in providing management synergies to Japanese companies who outsource to China. But there are problems too. Generally speaking, Chinese firms are not good at managing projects or processes. Resources, i.e. the number of people who can speak Japanese and manage a process/project effectively, seem scarce, and therefore, the turnover rate of the capable workers are very high in China, which is another concern. Also, there are no big outsourcing providers in China. China's largest software exporters such as Dalian Hi-Think or Neusoft are much smaller than their Indian competitors such as Wipro and TCS.

On the other hand, Indian companies have linguistic/ cultural and geographic obstacles. Also, the Indian Government is not as supportive as the Chinese Government in expanding the market for outsourcing with Japan. However, Indians are good at BPM, system integration, and high end IT "solution services", and the passion of these companies to do business with Japanese companies is also very high.

Generally speaking, I believe that Chinese companies still have the advantage overall over Indian companies to succeed in the Japanese outsourcing market. However, if Indian companies can overcome their obstacles by showing their passion, and if the Indian Government becomes more supportive, their business in Japan might explode. Needless to say, in order to overcome the obstacles, considerable amounts of investment will be required to set up a language and cultural knowledge teaching facility, and excellent marketing teams that are totally familiar with the Japanese way of doing business. Also, the companies have to keep in mind that it might take a long time to achieve success in the Japanese market. Patience might be the most important factor in doing business with Japanese companies because it takes a long time for Japanese companies to change, given their consensus making decision process. But

Chinese/Indian players should also know that once some of the Japanese companies start outsourcing successfully, others will quickly follow the “early movers.” “Imitating the successful companies” happens very fast especially within the industry.

Japanese companies have to change many things in order to compete as global companies, and the behavior towards professional outsourcing is one of them. However, as the history shows, it takes time for Japanese companies to change. Hence the Indian/Chinese companies should not wait for the change but they should adapt to the Japanese companies as far as outsourcing is concerned.