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Outsourcing in eastern Europe

The rise of nearshoring

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Ex-communist Europe is grabbing a lucrative niche in the global outsourcing business

IN a nondescript Soviet-era building in a suburb of Estonia's capital, Tallinn, is one of the telecommunications world's most important research outfits. It is the development centre for Skype, a software product that allows free, or very cheap, phone calls from any internet-connected computer. Skype is a global company recently bought by eBay, an internet auction site, for $2.6 billion. Its Scandinavian founders used programmers not from pricey Silicon Valley or faraway India, but from a small east European country that has barely figured on the business landscape in software, or anything else.

That is one face of what those involved like to call nearshoring: the business of moving production, research and business processes to countries that are quite cheap and very close rather than very cheap and far away. On the other side of Tallinn is another face: the factory of Elcoteq, a Finnish firm that makes mobile phones for Nokia and other companies. Whereas Skype employs more than 130 highly paid people, around a fifth of them foreigners, with an average age of 28, Elcoteq's factory workforce is big (more than 3,000), middle-aged, performs repetitive, semi-skilled tasks, is modestly paid and entirely local.

The story of outsourcing in central and eastern Europe these days is that Elcoteq's model is struggling to stay competitive, while Skype's is booming. The region's most obvious advantage, low labour costs, is diminishing, partly because of the even greater price advantage in China and partly because of the upward drift in wages brought by the march of prosperity. That is leading companies to hunt much harder for lasting advantages—based on talent and geography, rather than low wages and plentiful labour.

By the standards of the former captive nations' rocky past, that is still a nice problem to have. In the early 1990s, when Elcoteq opened in eastern Europe, even owning a factory there seemed risky; outsourcing crucial development work would have seemed mad. Bureaucrats were capricious, logistics dreadful, telephone lines bad, business manners eccentric. Doing deals needed strong nerves, iron-clad innards and relentless patience. “It's like Africa, but closer,” was the dismissive view of one western executive, struggling in the Lithuanian textiles industry in 1993. In those days simply getting a lorry to Poland could involve a weeklong wait at the congested and corrupt border crossing.

Now eastern Europe is beginning to look different: much more like China than Africa, closer geographically and culturally than either, and easier to do business in. Since the collapse of communism, habits, attitudes and values have changed out of all recognition. Economies that were teetering on the verge of hyperinflation only 15 years ago are now preparing to adopt the euro. The European Union has imposed a familiar legal environment; even those like Romania and Bulgaria, still outside but hoping to join, are at least heading in the right direction. Politics may be murky, but are rarely worrisome.

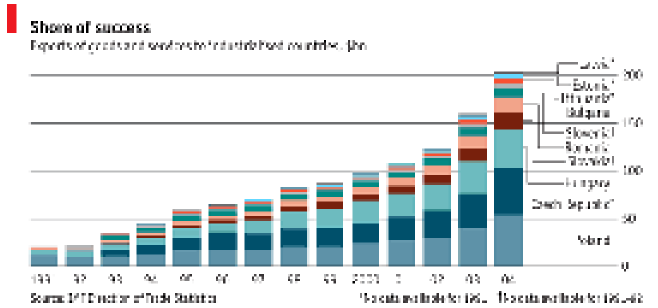
So western contracts and investment are flooding into eastern Europe. The annual value of outsourcing contracts is hard to estimate—it includes everything from big companies that own factories to small contractors doing one-off deals. But it's clear that the phenomenon is sizeable and growing. Clothing imports from the east European countries into the existing EU in 2004 were 2 billion pieces, with a value of €22.3 billion ($25 billion), representing a 19% share of the EU's clothing imports, according to Liz Leffman of Clothesource, a consultancy. Libor Krkoska, an economist at the European Bank for Reconstruction and Development, reckons that the best proxy for the growth in outsourcing is the post-communist countries' total trade (see chart) with the rich world.

So far, the biggest fuel for the boom has been wage costs that are typically still half western levels. Tünde Gulyás of Colling, a Hungarian consultancy that helps firms outsource backroom processes, chiefly accounting, reckons that wage costs are 50-60% below western levels in eastern Europe; in India they are 75% cheaper.

Best in class

In the Czech Republic alone, that has prompted companies such as DHL, Siemens and Lufthansa recently to move big data-processing operations there. “The quality of work is world-class. It matches and sometimes even surpasses the best we do in India,” says Amitabh Chaudhry, chief operating officer of Progeon, a division of India's Infosys IT group that deals with business-process outsourcing. It has opened a centre in the Czech city of Brno, with roughly 100 people working in 13 languages. Mr Chaudhry also highlights the friendly time-zone, good political and regulatory environment, multilingual workers and “cultural affinity”. “We couldn't have handled this from India,” says Ratnesh Mathur, who runs the Brno centre. Infosys has a further office in Prague, supplying around 100 IT support staff to multinational companies there.

That highlights an essential point: cost is only part of the picture. “If I want a huge English-language call-centre, or to design an aircraft engine using tens of thousands of man years, I will go to India,” says Stephen Bullas, whose company eCODE assesses outsourcing locations. “But if I want a small controllable team of telesales people, or back-office workers with a cultural fit to the continental EU or Britain, then it can be much more appropriate to choose an east European country.”



It is the same story in manufacturing, For time-insensitive goods and long production runs, China is still the clear winner for global factory relocation. But when businesses need products finely tailored and delivered quickly and flexibly, then eastern Europe scores highly.

In the garment industry, for example, foreign companies are doing a booming trade with east European countries in the business of “fast fashion”—ordered and manufactured in speedy response to sales trends. “Fast fashion is a pound or two more per piece from central and eastern Europe, but customers are prepared to pay,” says Ralph Goodstone, a textile entrepreneur who brokers deals between low-cost suppliers and rich-country customers. The product cycle for garments from China, he explains, is about three months—with four weeks of that time spent at sea. From eastern Europe, by contrast, it is just four to six weeks, including a day or two for delivery by lorry.

So, too, with fashionable electronic gadgets. “Every brand owner has several models; the lead time and the lifecycle of the product are shortening. So it makes sense to localise to the area of sales,” says Risto Gaggl, Elcoteq's boss in Tallinn. For the next few years at least, there are still big gains to be made in this field. Surprisingly, despite EU and NATO membership, many find the region unfamiliar and scary. “People still ask questions like ‘Will my mobile work?' and ‘Do you have a McDonald's?',” says Ms Gulyás of Colling wearily.

But there are disadvantages too. It is not just steadily rising costs: rising productivity can cushion that, at least in part, and labour may be only a small component of the ultimate price. The biggest shortcoming is a legacy of communism: a shallow talent pool, particularly for middle managers who need to be customerfocused and conscious of quality. These were not qualities that the planned economy demanded. Mr Goodstone's most recent deal, with a Latvian supplier, has been hobbled by the gulf between each side's expectations: “They throw up their hands and say, ‘Oh Ralph, we're only a couple of weeks late—our customers round here never worry about that'. When they run into problems they think: ‘Oh we'll sort it out', but you can't—you have to get it right first time.”

Other industries are also short of managers. At a recent outsourcing conference in Budapest organised by Ms Gulyás's firm, a bunch of consultants and providers swirled round Jackie Raybould, a director of SCC, a $3 billion company that is considering moving its expert multilingual IT support for big international companies from call-centres in London and southern Europe to somewhere like Hungary. “There's a ready pool of IT-literate, multilingual graduates. But the management experience isn't as developed,” says Ms Raybould. “For programming it would be fine, but we're talking about direct services to customers. If we wanted to deliver this from central and eastern Europe, we would need to manage it ourselves.”

The big question at the cheaper end of the market is how to sort out middle-management. In manufacturing, the danger is that badly run businesses will perish before they have a chance to prosper. Mr Goodstone reckons that without better bosses, the mass-produced garment business in central Europe will be “dead in five to ten years”. Call-centres are rather better placed, as central Europe's language skills give it a big advantage over most other locations. German, French and English are all widely enough spoken to create a good pool of potential workers. And other languages can be learnt quickly. One Bulgarian call-centre, for example, reckons that it takes only four months to teach German-speaking employees to answer calls in Dutch as well.

It can be taught

Part of the problem is simply size. The top ten east European countries' combined population is around 100m. Vietnam alone is 81m. The answer is to go upmarket with better education. But that's something that every post-communist country is still grappling with. Schools and universities have still to reform Soviet-era pedagogy and curriculums, and are often short of both capacity and teaching talent. “We need a lot more engineers, yesterday,” says a senior Elcoteq manager. His company and others now sponsor university faculties in the hope that high pay will bring bright graduates back to dull-sounding, difficult disciplines such as computing and production engineering and away from soft subjects such as marketing, law and economics that flourished after the collapse of communism. But good east European managers tend to gravitate to such industries as information technology, which pays world-class salaries. Pawel Zak, who manages the Polish operations of IMPAQ, a German-owned IT outsourcing company, recalls: “in the beginning we had good programmers and the project managers were all expats. But we did a good job learning from them.”

A quick fix is to rely on expats from western countries to bridge the gap. But that is pricey. The new trend in central Europe is for investment by firms from other outsourcing locations in places such as China, India and Turkey. Firms there are eager to gain an edge on their rivals by moving closer to the customer. Turkish entrepreneurs, for example, have bought textile factories in neighbouring Romania, installing new management there. That takes advantage of local labour costs, and brings big productivity gains. A big Hong Kong-based trading company, Li & Fung, has opened offices in two east European locations. Infosys is just one of several big Indian software companies with newly opened offices in central Europe.

In the long run, says Mr Chaudhry of Progeon, “geography is history”. His company will sell where clients get most value, get capital where it is most abundant, find resources in the most cost-effective location and organise production where it is most convenient. That is true—but presents a demanding future for former captive nations still struggling with the basics of modern business life. The big question now is which of them best grasps the opportunities in outsourcing, and which will let them slip by. “The cost is pretty much the same,” says Ms Gulyás. “The difference is the impression they create.”

Location, location

Stephen Bullas of eCODE says that although no single country is ideal, Poland is “truly open for business”. The Czech Republic, though improving rapidly, “can still be too bureaucratic”. He recalls recently a firm there that “snatched defeat from the jaws of victory” by refusing to convene the early board meeting needed to close the deal (the contract went to the second-placed Polish company). Hungarians have “great technical ability”, he says, but can often be complacent, harking back to the imperial Austro-Hungarian era and “thinking the world owes them a living”. Despite impressive IT skills, the Baltic states will win only a niche in the business unless they start co-operating with other countries in the region. Romanians largely “still don't get it—they smoke in client meetings and cite official corruption as a competitive advantage,” he says. That's a pity: in eCODE's comparative analyses, Romania is the most multilingual country in Europe after the Netherlands for potential business-process outsourcers and it can also demonstrate above-average IT skills.

The good news is that pressure to stay competitive is slowly forcing governments to acknowledge and remove bureaucratic barriers. Czech and Polish officials promoting their countries at the Colling conference in Budapest shifted nervously when questioned about archaic, restrictive labour laws and intrusive bureaucracy. “They don't understand that a call-centre can't just close down because of a national holiday,” complained one outsourcer. In Estonia, companies such as Skype want the government to liberalise the country's tough visa laws. “We wanted to interview a Pakistani guy living in Stockholm and we couldn't get him over for a weekend—it was easier for us to go there,” complains Sten Tamkivi, Skype's boss in Tallinn.

A more business-friendly environment can help maintain an edge, but in the end the prosperity that it brings inevitably forces change. Allan Martinson, a Tallinn-based financier, reckons that Elcoteq has at most four more years before it will become necessary to switch production to Russia. The value-added it creates in Tallinn, he calculates, is only half that achieved by the country's notoriously inefficient timber industry. But by then another niche will have come along. The Estonians working at Skype, he says, have now seen how a world-beating young company works from the inside. Next time, they will want a big chunk of the action for themselves.