

Human Resource Outsourcing in China

by: Vibhash Ranjan

A business footprint in China has become essential for any company with global aspirations. And many global organisations that have made considerable investments in China are now seeking to transform investments into profits by streamlining their operations and business processes. In response China, while thriving on its manufacturing industry, is now making a valiant attempt to build its services industry. As a result, a broader Business Process Outsourcing (BPO) services industry and more particularly the HR Outsourcing (HRO) industry is rapidly maturing and expanding.

When it comes to HRO, Chinese companies are wrestling with how to scale their labour pool whilst facing the twin challenges of talent management in a fiercely competitive market, and compliance in a complex regulatory environment. The natural outcome is a growing demand for high quality, flexible, outsourced services.

On one hand the industry development in China conforms to the global HRO trends, but on the other hand, it is gradually developing a unique flavour influenced by the local political, cultural and operational environment. Although, HRO in some form has existed for more than a decade in China, the notion was restricted to the public sector. These pioneer HRO service providers included a myriad of smaller regional players driven in part by regional variation in payroll legislation, but the lack of demand limited the growth of HRO more broadly in other sectors.

The Chinese business landscape has steadily undergone a dramatic change in the past few years. The demand for HRO services is rising which is attracting many global HRO suppliers such as Hewitt and Convergys, and leading domestic players such as FESCO, CIIC, China Star, and China Talent Group are also responding by offering customised products and solutions.

It is expected that the attractiveness of HRO will continue to grow, facilitating the growth of suppliers in the market.

An Overview of HRO in China

Demand by domestic Chinese corporations has in the past been sluggish because labour costs and technology needs have been relatively low. A few China based organisations have long since outsourced HR-related software development via purchased software but most still maintain and support software and do the administrative work internally. The concept of HR outsourcing services is unfamiliar to many, and a lack of service providers with relevant experience is also an issue. Conversely, 'start ups' for foreign multinationals frequently used HRO providers for HR services. This is one of the most common services used by foreign enterprises as foreign firms need to hire a local workforce through these Chinese providers, as per government regulation.

However, the recent spectacular growth in the Chinese economy is compelling foreign owned organisations based in China to adopt sophisticated HR related practices which require specialised and experienced suppliers. It is this transformation that is facilitating the growth in HRO. Key factors influencing the growth of HRO include rising labour costs, new types of employee supplemental benefits and a rise in the focus on employee engagement and talent management. Additionally, technology needs including the acceptance of employee self-service approaches are increasing. As compliance issues are becoming increasingly complex multinational organisations are utilising their experiences from elsewhere.

Chinese Government-Promoted Service Providers Play Key Role in HRO Evolution

The HR Outsourcing market started evolving in China from the late 1990s. It was supported by two leading Government sponsored service providers FESCO and CIIC in providing multinational companies with employee data management and payroll services. These service providers also helped foreign enterprises with the establishment of representative offices and facilitated ongoing relations with central and local governments. As the representative offices needed local people, FESCO started offering talent outsourcing services and further expanded the market to include large and established multinationals and local enterprises as well. As the market for such services expanded, an array of Government promoted and private HR services firms mushroomed, mostly to serve regional markets. Currently, the major players in China HRO market are FESCO, CIIC and China Star. Private HR services firms like China Talent Group are also growing at a brisk pace. Global HRO providers such as Hewitt, ADP and Convergys are also present in China though their China operations are very small compared to the local Chinese players.

The Market is Witnessing Rapid Growth

In 2008 and 2009, the HRO market is expected to expand by at least 25 per cent, however due to the prevailing operational complexities in China, most multinational companies choose to adopt the services of Chinese HR service providers such as FESCO or CIIC. As the economy has grown at a cracking pace (annual average of around 10 per cent during the last several years) companies have required more domestic talent and other related HR services to manage the local workforce. In this aspect, the evolution of HR outsourcing in China was largely due to the growth of the Chinese economy during the last five years, clocking an average CAGR of more than 40 per cent

Estimated Market Size 2003-2008, RMB millions

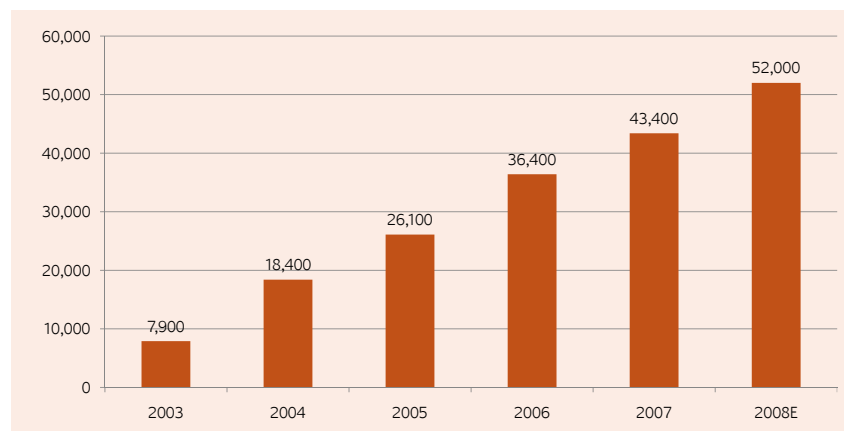


Figure 1

Source: EquaTerra Research¹

¹ Qualitative research undertaken by EquaTerra via a series of in-depth 1:1 interviews with 15 leading China based HR Directors of foreign business.

Drivers of HRO in China Differ Significantly from Global Drivers

In line with developing into a more mature marketplace, Chinese businesses are now challenged with attracting, retaining and motivating their workforce, and this is proving to be a tough proposition for many multinational enterprises. Subsequently, one of the key reasons that an organisation will choose to implement a HRO strategy is to free up the HR department from transactional and administrative tasks and let them focus on strategic tasks of planning and management.

As per the interviews with HR directors of leading companies, other major drivers of HRO are as outlined below:

Evolving drivers of HRO (Buyer perspective)

Primary drivers:	Secondary drivers:
<ul style="list-style-type: none"> • Shift of HR focus to strategic organizational needs • Limit transactional processes done in-house • Expertise and resources of HRO service providers to provide value-added processes (Training & development) • Guanxi of HRO service providers (especially tasks associated with Labor bureau/compliance) • Compliance/Auditing (service providers have advanced systems) 	<ul style="list-style-type: none"> • Limited HR resources (or reduce HR resources/headcount) • Capital avoidance and Cost savings • Domestic talent needs (vast resources of RPO firms) • Follow Global strategy in HRO • Organizational standardization of HR systems

Figure 2

Integrated HR Deals are Rare, Most Buyers Outsource Only One or Two HR Processes

Most HR processes are performed in-house due to an understanding of latent organisational procedures and knowledge by internal HR personnel (subject matter experts). This can provide difficulties for service providers wishing to assimilate quickly and deliver on their obligations.

The key arguments against HRO cited by HR directors in China are:

- Lack of understanding of organisational processes and culture
- Loss of control
- Concerns on data security and privacy
- Concern on conflicts with key stakeholders within the organisation
- Reliability factor
- Business case for cost savings from outsourcing is less relevant in China (no offshore component)
- Supplier sophistication lags behind buyer requirements

It is also evident that most HR directors are grappling with the adoption of suitable governance structure to manage service provider relationships. The impact on change management and service levels in the future can be huge unless respective responsibilities of both the parties are well understood and documented.

Key Regional Markets in China

The adoption of HRO in China has traditionally been driven by multinational client companies, using Chinese government service providers. These account for over 90 per cent of the number of deals and total contract value. As these companies have their major operations based in Shanghai, Beijing and Guangdong regions, these three areas account for approximately 85 per cent of the market. Other major contributors include Tianjin, Dalian, Hangzhou, Xian, Xiamen, Qingdao and Nanjing.

Market Structure (by Geography)

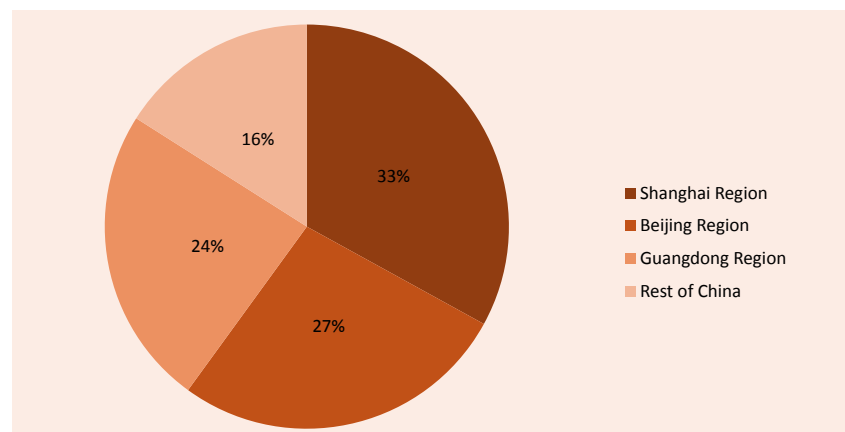


Figure 3

Source: EquaTerra Estimate

The Importance of 'Guanxi'

Many multinational organisations based in China prefer outsourcing selected HR functions to domestic players due to their extensive knowledge of the Chinese regulatory landscape and the 'Guanxi' relationship network (essential to navigate business environment in China). Leading domestic players such as FESCO, CIIC and China Star (owing to State ownership), have access to privileged information and resources. In particular, some services associated with the Labour bureau and certification services are provided only by domestic firms approved by the Ministry of Labour. A possible flip side of Guanxi is that customers need to be equipped with measures to mitigate the risk of non-performance, should the provider not meet the agreed service levels. As the regulations vary widely across different provinces (especially in payroll for calculation of social security contributions), many Chinese HRO providers have mushroomed to address provincial markets. Despite this challenging market situation, major global HRO service providers have committed significant resources in the Chinese market to explore domestic market and offshore HRO opportunities.

Estimated Market Positions of Major Players

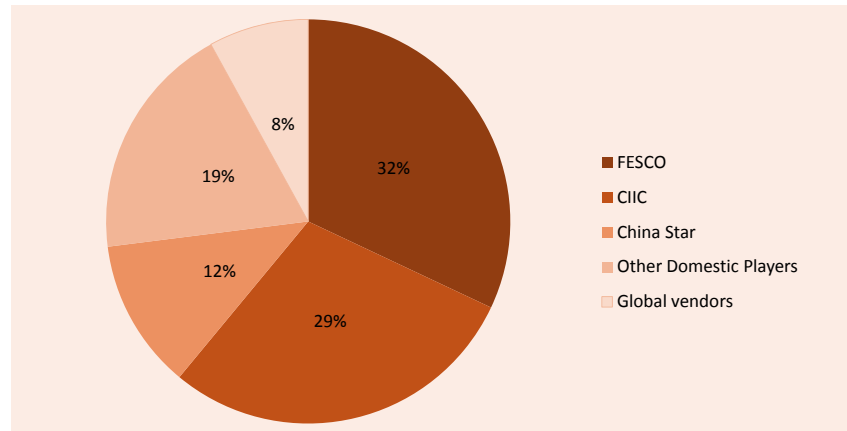


Figure 4

Source: EquaTerra Research

Who Focuses on What?

The large players, FESCO and CIIC lead the market in product and service attributes and offer end to end HR Outsourcing solutions. Some of the services provided by them include:

Primary services:	Secondary services:
<ul style="list-style-type: none"> • Employee Leasing • Payroll Administration • Compensation & Benefits administration • Training & Development • Personnel administration/Compliance 	<ul style="list-style-type: none"> • HR Business Process Outsourcing • Enterprise Services • Employee relationships management • Labor Security Legal Consulting • Nationwide One-stop Solution

Figure 5

The maturity and adoption level of HRO solutions vary widely. For instance, employee leasing, payroll, Human Resource Management Systems and regulatory compliance services are highly matured, with leading domestic service providers extending comprehensive support systems in this space. However, training and development, employee relationship management and compensation and benefits are still evolving with more than 80 per cent of multinational enterprises choosing to perform these functions in-house. Currently, few multinational firms are also evaluating business cases for integrated outsourcing of HR functions.

As global service providers looking to expand their presence in China garner knowledge about the country and its culture, and subsequently gain credibility, it is expected that they will aggressively expand the market and bring best practices to the local subsidiaries of global corporations. The current market structure (which is heavily skewed towards employee leasing, payroll, personnel administration and related services) will have more transactions with higher value added solutions such as employee relationships and performance management.

Recent Trends point to Higher Adoption Levels Among Mid-Market Companies

The head of HR at a global service provider describes the market in China as “very distorted”. He points out that the monopoly of FESCO and CIIC in the Chinese HRO market is slowing the adoption of higher ‘value added’ HRO solutions in China. As these two companies are dominant (especially in interactions with Labour bureau and certification and employee leasing business) most of the clients have no choice but to retain their services. The absence of a level playing field is hampering the efforts of global service providers to offer comprehensive suite of solutions to clients. This view is also echoed by other service providers.

The global service providers have now renewed their efforts in serving the small and medium enterprise (SME) sector, and have obtained moderate success during the last 12 months. The SME definition also includes local operations of big multinational corporations (those with less than 1000 employees in China). According to the regional HR director of a leading entertainment company, the solutions of global service providers are beyond the needs of small and medium enterprises. Some of the global service providers have already started realising this aspect and have partnered with leading domestic HRO providers.

Future Outlook

Payroll outsourcing will continue to lead the list of HR processes to be outsourced; compensation services will see some outsourcing; while performance management processes will continue to remain largely in-house. The Chinese market is expected to mirror some of these global trends while closing in on HR technology adoption.

- A significant proportion of HR administration functions are expected to be outsourced in the next 3-5 years. Leading Chinese corporations will embrace HRO in a step by step manner and will remain cautious on integrated HRO services.
- Adoption of RPO (Recruitment Process Outsourcing) will increase drastically in the next 5 years. This is already evident in the wake of many innovative proposals being evaluated by interviewee companies. The supplier landscape will change significantly with many leading RPO companies setting up shop in China to serve domestic and offshore services market.
- The tipping point in HRO services will happen in the next 3-5 years with large scale adoption of HRO by small and medium size enterprises.
- Global service providers will increase their share, especially on climbing the learning curve (after execution of China part of global HRO contracts).
- The quality metrics of HRO service agreements will closely align with that of global metrics. Global companies considering HRO in China will reflect on the learnings of implementation in their home countries and accordingly redraw the scale, scope and delivery metrics in HRO service level agreements.

To date, China still does not have enough skilled manpower to meet the growing demand of the HRO services market. This will lead to wage acceleration for providers, margin erosion and raiding other providers (especially of benefits administration and compensation providers) for resources. Ultimately, the dominant provider players will be those companies that can obtain and retain quality delivery people.

About EquaTerra

EquaTerra sourcing advisors help clients achieve sustainable value in their IT and business processes. Our advisors average more than 20 years of industry experience and have supported over 2000 transformation and outsourcing projects across more than 60 countries. Supporting clients throughout the Americas, Europe, and Asia Pacific, we have deep functional knowledge in Finance and Accounting, HR, IT, Procurement and other critical business processes. EquaTerra helps clients achieve significant cost savings and process improvement with internal transformation, shared services and outsourcing solutions.

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