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Offshoring to and from Turkey as an Emerging Economy: IT and other sectors

Stefan Koch
Bogazici University, stefan.koch@boun.edu.tr

Emre Bertan
Nortel Netas, emre.bertan@gmail.com

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Stefan Koch
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Abstract

The aim of this paper is to determine the reasons and strategic drivers of offshoring activities of multinational companies (MNCs) in Turkey and compare those reasons with the ones found in other emerging countries. The primary data source is a series of in-depth interviews with professionals from several industries in Turkey. It was found that similar to other offshoring destinations, the reasons and strategic drivers for offshoring are market penetration and cost minimization. However three main points came up across all industries on why especially Turkey had been chosen as a offshore destination even though India and China are much more competitive in cost and market size: An ability to produce quality output in western norms; existence of motivated, flexible and highly educated work force which also has a passion for winning and an entrepreneurship spirit; and stable legal and technical infrastructure, serving as an international safe hub for MNCs to enter emerging markets in east and south. It was also found that mid to small size local firms tend to offshore out of Turkey because of competitive incentives and tax regulations in the neighboring countries.

Keywords

Offshoring, IT industry, Emerging Economy.

1. Introduction

Offshoring is a widely used strategic tool by multinationals to gain competitive advantages in cost and market share among their rivals. As the home country companies gain competitiveness, the host countries also gain through foreign direct investments and its spillover effect. In this study we try to understand the driving factors for offshoring to Turkey from the perspective of multinationals which had already invested in Turkey as well as understand the factors affecting offshoring decisions of local Turkish firms out of Turkey. We would like to find out the similarities and differences between Turkey and other developing economies in the sense of offshoring activities (captive offshoring and offshore outsourcing) and try to foresee the future of offshoring activities in Turkey. In order to get proper information from the business world, thirteen interviews had been conducted with upper level management professionals of multinational companies operating in Turkey along with professionals working for Turkish companies which chose to offshore out of Turkey. The participants currently work in MNCs and local companies operating in information technologies, telecommunications, fast moving consumer goods, steel, textile and automotive industry. Although there is much literature about offshoring to two big emerging counties, i.e. India and China, and effects of offshoring in home and host countries, there is little research on offshoring in and out of other emerging economies. The paper is divided in to three parts, first section literature review, summarizes strategic drivers of MNCs investing in emerging markets. Next the methodology used in interviews is explained followed by the results section divided in two parts; Offshoring to Turkey, and Offshoring out of Turkey. Finally common views shared by participants are summarized in the conclusion section.

2. Literature Review

Due to rapid growth rates and growing population in emerging economies, many multinational companies had focused their attention to create a powerful emerging-market strategy since in the next fifteen years it is expected that 57 percent of the nearly one billion households with earnings greater than $20,000 a year will live in the developing world. Predictions of coming decade also show that seven emerging economies—China, India, Brazil, Mexico, Russia, Turkey, and Indonesia—are expected to contribute about 45% of global GDP growth (Atsmon et al. 2011).

Offshoring is used by MNCs as a strategic tool, whether it is captive offshoring via setting up subsidiaries or joint-ventures, or offshore outsourcing mainly for cost reduction purposes. Globalization and technical developments enable many businesses to consider offshore outsourcing as it gives managers a more prominent role in strategic decision making and reduces their concerns about their everyday business (Gonzales et al. 2010) as well as reducing production costs and increasing profitability of the firm in some cases. Emerging sourcing destinations are competing against each other to differentiate themselves from others to attract investments. The host countries not only compete on cost of labor but also on their skills of the educated workforce (including language capabilities), environment , quality of infrastructure, risk profile and the market potential (Kotlarsky 2010). The vendors in emerging countries also seek cross-border outsourcers who match their strategic orientation and by their knowledge acquirement potentials (Li et al. 2010).

In many studies the effects of offshoring are examined. One research has shown that firms engaged in offshoring activities for cost reduction concerns have improved their operating and stock return performance in subsequent years, whereas the ones who offshore for other reasons such as improving company focus, entering a new market, sharing risks etc did not enjoy ‘assumed” benefits of offshoring and had to reverse their offshoring decisions (Prezas et al. 2010). Although when used for cost reduction it generates performance, offshoring comes with a price. Offshoring is often used by senior executives as a strategic choice and success is closely related to the deep understanding of the expectations of the middle management who will implement this strategy in a volatile and harsh environment. Offshore outsourcing in information technologies is harder than domestic outsourcing because of time zone differences, coordination efforts, cultural differences and difficulties in managing dispersed teams, managers have to handle two different conflicts; one with the headquarters and one with the local users (Yu et al. 2008). As a result 6 positive and 21 negative effects of offshoring are identified by client project managers. Negative effects were mostly process related, and knowledge transfer issues due to time constraints. Some positive effects were faster development when time zone differences are well coordinated and offshore supplier employees are bright and eager to please, India was given as an example (Rottman et al. 2009).

In order to overcome knowledge transfer related issues, knowledge transfer methods in the case of offshore outsourcing can vary depending on the level of recipient absorptive and retentive capacity. Research shows that for different experience levels of knowledge recipients, different methods should be used for effective knowledge transfer (McQueen et al. 2010). In a study institutional and cultural factors influencing offshore IT outsourcing decisions are examined for Japanese MNCs outsourcing to India and China. Results showed that old business relations, language requirements, cultural similarity and understanding of business logic were essential factors driving Japanese IT outsourcing decisions along with labor cost (Simeon 2010). In a similar study it has been found that R&D wage difference and knowledge infrastructure difference between home and host countries, the science and engineering talent pool size and political risk level of host countries are important determining factors (Demirbag et al., 2010). One other important factor for offshore outsourcing success is mutual trust. Trust between the service provider and the receiver is very important for knowledge sharing and success where initial perception of trust is an important factor contributing to the outcome of such a partnership from the view of the service receiver (Lee et al. 2008).

3. Methodology

Based on a review of literature, a structured interview was chosen to gather qualitative information. As this was still considered exploratory research, main factors were not considered determined enough to warrant a survey-based study. Structured interviews allow for more richness in captured aspects, which was a main goal of our research. The main questions used where: Why do companies choose to offshore in Turkey and not in India or China? How do Turkey based firms that try to get offshoring contracts manage this situation, what do they think their major Unique Selling Proposition (USP) is, and how do they sell and get the contract? Why do local companies offshore out of Turkey? Why not outsourcing but offshoring out of Turkey? Informants were free to comment on each topic as they wished. The face-to-face interviews lasted in the mean 45 minutes, and were recorded and afterwards analyzed by the authors independently for common themes.

Thirteen informants took part in this interview-based research, commenting upon the reasons behind offshoring to or out of Turkey. A total of 26 interview requests had been send out, 20 replied positively however 7 of them had to cancel the interviews later due to their business schedule changes. Three of the interview partners are from telecommunications industry, another three from information technologies industry, four from steel industry, one from each fast moving consumer goods industry, food and agriculture industry and from textile industry. Convenience sampling method was used for selecting the first round of interview participants, then afterwards snowball sampling was employed. Social media (particularly the following LinkedIn groups; Galatasaray Alumni, Bogazici Universitesi Mezunlari/Alumni, Istanbul Technical University, Turkish business Network) were also used to find contacts.

4. Results

In the results section, we will first focus on offshoring to Turkey (captive offshoring) and the main reasons, respectively any USP of Turkey. In the second part, we will focus on offshore outsourcing activities.

4.1 Reasons for offshoring to Turkey

Mostly large scale global companies choose to offshore to Turkey for various reasons depending on their industry. While conducting this research the first question asked to the participants was to explain the main reason why they think the multinationals, especially their corporation, had chosen Turkey as an offshore destination. Although the answers were slightly different in different sectors, the main view shared by all professionals was Turkey's flexible educated work force, and economical and geographical position. In other words although the market size and growth potential is much smaller then India and China, because of Turkey's educated and very flexible labor force and it's closeness to new markets in Near / Middle East and Africa, Turkey was able to attract offshoring activities by serving as a hub to MNCs. The cultural closeness and adoptability to both western norms and eastern way of doing business is seen as an important advantage of Turkey where new trend in global business is to focus on East and South. According to professionals from telecommunications industry, offshore outsourcing was successful in home countries which are culturally fit to this concept such as USA. At first the North American MNCs gained competitive advantage through cost benefits not by value generation. In the case of Europe due to strong cultural roots, offshore outsourcing had not been as successful as in USA. The main motive for offshoring in this domain is cost reduction purposes, however it is not the only motive. MNCs use offshoring as a tool to control and enter the local emerging markets as well. To do this they enter emerging market by setting up subsidiaries or joint ventures and offshore R&D facilities.

Participants from all sectors agree that a very important factor in a positive MNC offshoring decision to Turkey is the Turkish man power quality, quality of the end products and the passion for winning. The educated professional quality is higher than most of the competing emerging countries, in some sectors such as telecommunication and software development the engineer quality is as good as developed country levels. The youth is also an advantage because young professionals adapt to international processes and MNC standards much easier. The transfer of knowledge is efficient and faster which minimizes the transaction costs. Offshoring to Turkey in this sense is more profitable compared to other emerging countries.

According to the participants, cultural fit is also an advantage of Turkey whereas some North American technology firms had decided to freeze offshore outsourcing due to diversity problems and amount of rework done in China and India. As stated by a executive in telecommunications sector, the way of thinking and the basic knowledge about technology is a must in transfer of knowledge and hard when cultural fit is not achieved. If the knowledge is not transferred properly, even though cost is minimized, efficiency and sustainability of the process will be questioned by home countries. Due to the new economic environment where unemployment numbers are posing a problem in home countries (especially in USA) therefore withdraw of offshoring activities might be expected in R&D and operations. Another professional from the same industry stated that the trend to offshore to India and China is reversed due to huge transaction costs in software industry since the demand defines business, to be able to create successful products understanding of business is a must which is lacking in India and China. However he stated that Turkey has an advantage because the Turkish software engineers are not only extremely capable and open to new developments due to young age average (as compared to Germany), they are also mentally closer to developed countries. Likewise, a professional from information technologies thinks that in Turkey talented software engineers create good quality end products just like in developed countries, but for a better price so in this regard Turkey is not a competitor of India or China as a "software mass production" location; it is more like a boutique quality center. Other participants in telecommunication and information technologies sector also tend to agree with this view. A top level executive in telecommunication industry states that offshoring is not sustainable and a giant like India can keep up with high attrition rates (30-40%) due to high number of software and technology engineers available in its job market. Turkey was able to attract offshore outsourcing because of its young population, time zone advantage (middle of western and eastern business centers) and quality of engineers, however, according to him Turkey cannot (and should not compete) with India or China to be an offshore center because of scale. Turkey should use its stronger abilities such as young population and hardworking quality workforce in software industry and combine it with culture, art and climate (like Silicon Valley) to make reverse innovations for itself, emerging countries and for the whole world. A professional from software industry states that although Turkey is a very attractive offshoring location compared to other emerging countries in this region, it has sufficient resources to be able to create its own brand and good quality products.

In FMCG sector, a top level manager states that offshoring decisions of MNCs in manufacturing sector are based on profitability plans of the corporation. Big MNCs generally work with 10 years of NPV therefore they have a big absorption capability. The trend in manufacturing was to build mega plants and minimize running costs and serve a big region like Europe. This model served the MNCs well until petrol prices tripled because unit costs became an issue due to transportation and distribution. This mega plants needed mega supply chains however many countries did not have the infrastructure to support the extra traffic generated in land and sea. All MNCs in FMCG today face east and south in their strategies and there is a race for growth. One might think that since the target is east these companies should produce these goods in India or China, however the investment requirements for such an attempt is huge due to the lack of infrastructure and skilled labor in these countries. On the other hand a green field investment in Istanbul region means easy access to transportation (via ports and land) and skilled and low cost labor although it is high compared to other countries in the region. Compared to others Turkish labor force is highly educated and quality is very high. In short labor capability and infrastructure are the main reasons for MNCs to offshore to Turkey. Turkish labor is not cheap and the neighboring ex-soviet countries has very well established infrastructure (especially rail road). Apart from man power quality, Turkish labor force has a passion for winning which is reflected in their work. Another positive factor is the young population, this means market size will be growing in the future too. The social change and family structure also feed this market growth in FMCG sector as big families dissolve and young couples tend to separate their homes. Turkish professionals are super flexible and very ambitious which not the case in other countries. They are very rigid. The passion for winning in Turkish professionals most possibly is due to education system in Turkey where people are used to be in a race to get in good schools from the early years of childhood. As a result, now the MNCs are recruiting directly from the universities' qualified and flexible labor force is very important factor in offshoring decisions.

In steel industry, offshoring decisions of MNCs also consider cost structure. In this regard Turkey is advantageous however it is not the only reason. The biggest steel producer in the world has a joint venture steel factory in Turkey because it is close to the market. A manager in automotive steel industry states that as Turkey produces more automotives the steel producers follow the trend and start offshoring. Even during the financial crisis the steel demand of Turkey has increased. In automotive industry there is constant growth which attracts attention of MNCs. Another senior manager from steel industry states that in Middle East region there is huge demand for construction steel as well and this also has huge effect on offshoring to Turkey since MNCs uses Turkey as a distribution hub for logistics. Easy access to supply chains and low cost sea transportation is also very critical. One other reason for offshoring to Turkey and not to other emerging Middle Eastern countries is Turkey's relations with Israel. Most of the MNCs cannot use their Middle East offices which are also considered as low cost centers for exporting to Israel and vice a versa. In a way Turkey is closing the bridge between Israel and MNCs. Also the quality of the work produced is high compared to others and the Turkish blue collar workforce is more passionate about their work. A top level executive from steel industry also shares these views and adds that western companies tend to have problems in Near and Middle East business world since there most of the business agreements rely on promises rather than agreements. Also the entrepreneurship and crisis management abilities (as a result of past economic crisis) of Turkish professionals attract the attention of the MNCs. MNCs offshore to Turkey to be able to hire skilled professionals who can easily fill the gap between the two worlds.

In food and agriculture industry, an executive states also that the quality of the products made in host country and the work force know-how is considered to be important in offshoring decisions of MNCs. He states that reverse know-how transfer was started in this area especially in dried foods sector as the know-how surpassed the developed country levels through experience and initiative taking attitude of Turkish professionals in this sector. The climate and variety of plantation available in Turkey along with closeness to distribution channels and supply chains brings an advantage to Turkey.

The general view on the USP of Turkey is the same across all participants from different sectors. Turkey can attract offshoring because of highly educated young workforce who have a passion for winning and an entrepreneurial spirit which reflects in high quality products / services. In India the attrition rate is very high, leading to high defect and rework rates. So India cannot achieve the targets for outsourcing even though it is much cheaper than North America. If the defect rate and quality problem costs more than expected it is not sustainable for the MNC since the challenge in business is that the profit margins has to be competitive. This is how Turkey had achieved to get contracts from the North American market in telecommunications R&D offshoring, due to quality and low defect rate as well as the cost of employees. The cost of living in Istanbul area is getting more expensive everyday and this affects the cost competitiveness of every sector. Most of the talented young workforce lives in urban areas of Istanbul therefore low cost is not considered as a USP of Turkey in most of the sectors, however the USP is quality with a better price. Closeness to supply chains is also an advantage, as the world economy shifts from west to east a new form of "silk road" is forming and Turkey is seen as an important bridge linking the developed world and the developing world. Most participants agree that MNCs choose Turkey for offshoring to have access to an international hub. Uniqueness of Turkey in its region in this sense is that the legal and technical infrastructure is solid therefore Turkey offers MNCs a safe passage to emerging markets.

In general all participants also pointed out that in its region Turkey is a good offshoring location because of the growth figures and its young population which promises further growth in market size as well. Therefore we can say that being a developing market and to be able to serve as an international hub at the same time brings an advantage to Turkey to be selected as an offshoring location. According to IMF (IMF 2009), Turkey's annual GDP growth rate is one of the biggest in Europe and it's nominal GDP reaching 742 billion dollars way beyond most of the countries in its region. Turkey is expected to be the fastest growing economy among OECD countries between 2011-2017 and this growing economy attracts attention (OECD 2009).

Another factor which differs Turkey and other emerging economies is that Turkey is considered to have the 5th most liberal trade policies in the world (The World Bank 2008). It has Customs Union with the 27 EU Countries and also Free Trade Agreements with 15 countries: Albania, Bosnia & Herzegovina, Croatia, Egypt, Georgia, Iceland, Israel, Lichtenstein, Macedonia, Morocco, Norway, Palestine, Switzerland, Syria and Tunisia. Again the young population is considered to be an important factor by all participants with 26% under 15 years old (Eurostat 2008). Availability of skilled labor force is highest in its region with the number of competent managers (IMD 2009). As all participants stated Turkey also outperforms the emerging markets in its region in efficiency of labor measured in terms of output per worker (real GDP per person employed) (Economist Intelligence Unit, 2010). It is also very close to emerging markets with two hours time difference and can serve as an international hub between multiple markets i.e. a total of 1,5 billion people and $25 trillion GDP (IMF 2009).

In short, Turkey is an attractive option for offshoring in different sectors for different reasons due to its lower cost of living than the EU, lower labor rates high productivity and work quality, entrepreneurship spirit of professionals and the passion of winning. Because of its location there is also a relatively short travel time to Turkey from anywhere in Europe and Middle East.

4.2 Reasons for offshoring out of Turkey

Almost all firms in Turkey who seek for cost reduction with an international perspective are involved in offshoring strategies out of Turkey, mostly to neighboring countries where the transportation and labor costs are advantageous along with high government incentives and tax regulations. The main reasons for offshoring out of Turkey are lack of incentives, cost minimization efforts and market entry strategies. For FMCG sector although infrastructure in Istanbul is well established, in general lack of rail road transportation makes the distribution channels bound to petrol prices whereas ex-Soviet countries with strong rail road systems are immune to petrol price variations. Today sending finished goods from Poland to Azerbaijan through rail roads is cheaper than sending goods from Istanbul to Baku. Especially in chemistry sector there is too much dependence on imported raw materials which brings a cost disadvantage. Again the taxation system and hidden taxes in distribution channels in Turkey pose a problem and create a barrier in offshoring decisions of MNCs and a reason why local firms choose to offshore out of Turkey. The incentives in Turkey are not sufficient when compared to neighboring countries although some regions in Turkey are prioritized; the attempts of the government in these areas fail due to lack of infrastructure and lack of skilled workers in these

regions. However for example in Romania, to attract investments land is given very cheap and tax regulations are adjusted so that investors are exempt from tax for 3 years. The bureaucracy makes it very difficult to invest in Turkey. Now most of the companies look at NPV for 3 years in Central Eastern Europe and Middle East Africa region. FMCG companies used to have 3% of its income from this region however now it is considered as a growth engine and it generates 35% of the income of FMCG companies. Therefore losing money for 8 years is not acceptable anymore and investments are chosen as such so that they will pay out in 3 to 5 years. In this respect emerging countries in the region such as Romania, Nigeria or Egypt become much more profitable alternatives for MNCs in FMCG sector which also reflects local Turkish firms' views.
In textile industry also local firms offshore to the neighbor emerging economies because of cost reduction reasons. Although there are some complaints about the end product quality and rework, with the tax incentives these countries are considered as more profitable locations.
As a manager in local software and technology firm states, they also offshore projects and sales activities to Dubai as a result of market entry strategy. He states that even though software engineering capabilities are very high in Turkey it is hard to find enough skilled labor in the IT field. Especially in Dubai the firms can operate with very much flexibility in terms of contracts with its employees and the composition of the workforce. In other words companies can recruit or lay off personnel very easily from multiple nationalities which is not the case in Turkey. Also closeness to market is very crucial. Turkey's image in Middle East region is very positive and this also reflects in the buying decisions of the Middle Eastern companies.

5. Conclusion

This study has contributed to our understanding of the factors determining offshoring decisions to emerging economies. The results also highlight the positioning of Turkey within this group of countries. Throughout the interviews three common reasons came up as to why MNCs choose to offshore to Turkey: The ability to produce quality output in western norms for a lower price and short distribution times due to closeness to supply chains, a motivated, flexible and highly educated work force which also has a passion for winning and an entrepreneurial spirit, and stable legal and technical infrastructure, serving as an international safe hub for MNCs to enter emerging markets in east and south, and a young population promising growing local market size as well. The general view among the participants was that Turkey should not compete with India or China in terms of being an back office or factory of the world but should come up with more focused quality oriented innovative end to end solutions / products and create a brand, in the mean time serve as a bridge between emerging economies in the East & South and developed markets in the modern silk road of energy and commerce in the 21st century.
It was found that although Turkey is very advantageous as an offshoring destination for MNCs, local companies seeking for cost reductions themselves are offshoring out to neighboring countries which have much favorable incentives and tax regulations. This underlines that offshoring is used less strategically by local companies.
Further research should be conducted to gather more information from several industries with more participants to confirm the findings of this interview-based study. This study has produced a series of factors to be included in such a survey. The number of participants was limited and mostly from IT and telecommunication industries, and therefore the results could be biased.

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