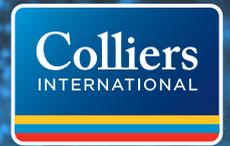


White Paper

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Eastern Europe | Office



Outsourcing and Offshoring in CEE: A Rapidly Changing Landscape

Outsourcing and Offshoring in CEE: A Rapidly Changing Landscape

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Table of Contents:

EXECUTIVE SUMMARY	2
INTRODUCTION	4
WHAT'S CHANGED	5
THE EXPANSION OF O&O SECTOR	6
CHANGING O&O ACTIVITY BY LOCATION	7
CAPACITY AND COST	7
LABOUR MARKET	8
O&O OCCUPIED SPACE	9
O&O BY SECTOR	9
NEW TECHNOLOGY	10
CONCLUSION	11

Executive Summary

A strong growth story to date.....

Our analysis of office demand across a range of known 'Offshoring and Outsourcing' (O&O) cities in the region highlights that there has been very strong demand for office space from the sector since 2010. Following the early phase of growth up to 'pre-crisis' times, the sector has grown by 80% in terms of the volume of office space occupied over a four-year period. Not only has there been strong demand from new companies wishing to enter the regional O&O market, there is also evidence of a maturation of the sector with a large number of established operators having expanded their footprint across a wider geographical area.

The markets that have attracted the majority of new demand continue to be the early front-runners - Prague, Budapest, Warsaw and Krakow. This is a reflection of the strong depth of skills and experience available in these markets which is allowing existing companies to evolve their service offering to provide higher value-added functions. In turn, this is attracting more new companies to the region.

This trend also highlights that once a business is established in a location, the quality and depth of the talent pool is more important than cost: the most active locations are also the most expensive. When compared to the donor markets of western Europe and OECD countries, however, the CEE region exhibits much lower labour costs - the recent McKinsey report 'A new dawn: Reigniting growth in Central and Eastern Europe, December 2013' highlights that the average hourly wage of core-CEE markets is 75% less than in the EU-15; in Bulgaria and Romania they are 90% lower (and lower than China).

While existing regional leaders have grown strongly, there has also been very sharp growth in O&O occupiers positioning operations into less-experienced and lower-cost locations such as Belgrade and Kyiv. These locations offer a significant pool of latent talent. As they become more transparent places in which to do business, their combination of untapped talent and lower cost profile means they are likely to become serious competitors to existing regional locations.

Definitions:

CEE Region:

For the purposes of this report we have confined our analysis to those markets we believe to be the most active O&O markets in recent years, for which we were able to monitor leasing activity. This includes the cities and locations highlighted by the map below.

The report also refers to the Eastern Europe/CIS region, when discussing the World Bank 'Ease of Doing Business' country rankings. The CEE markets we have analysed form only a part of this much wider geographic territory.

O&O:

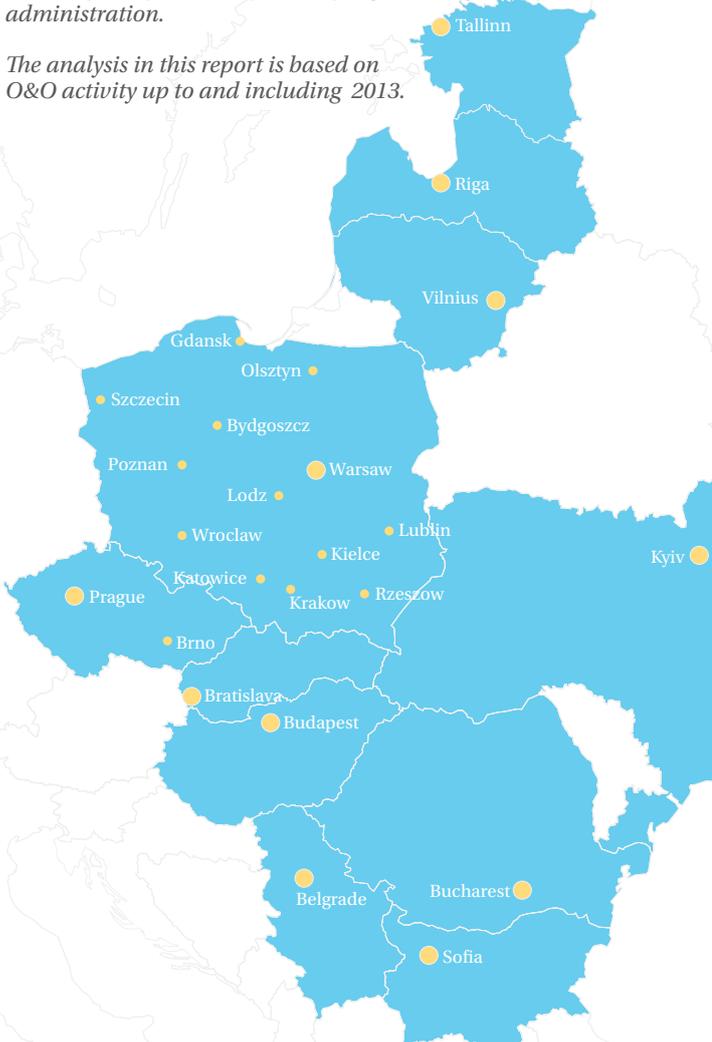
This refers to all forms of office-based 'outsourcing and offshoring' activity. This encompasses the various sub-groups of O&O activity including:

BPO (Business Process Outsourcing),
ITO (Information Technology Outsourcing) and
SSC (Shared Service Centres) operations.

The geographic and service lines operated by these organisations varies considerably, from SSCs providing centralised pan-European and pan-Global services to its own organisation, to those providing the local 'back-office functions' of banks.

BPO and ITO operators also cover a wide range of services from procurement and programming to payroll administration.

The analysis in this report is based on O&O activity up to and including 2013.



...more growth to come?

Our analysis of O&O companies located in CEE shows that only 30% of the top 100 global outsourcing companies are already here. This suggests a strong growth opportunity to capture some of the remaining 70%. Secondly, the CEE region now stands ahead of other globally competitive O&O regions in terms of the World Bank 'Ease of Doing Business' rankings. In addition to providing a strong cultural fit with established OECD countries, there is increasing impetus for O&O companies to build true partnerships with customers that sustain their culture and brand.

The IT and telecoms sector has been the major source of growth in the sector alongside professional business services, which is something we expect to continue. We have also seen signs of O&O growth in the retail and logistics sectors - a direct result of growth in e-retailing and e-commerce. Given the vast scope for the evolution of this business regionally, not to mention globally, this is a definitive growth area for the regional industry to service. Public-sector-oriented O&O services is another untapped market. We are also likely to see existing operations evolve to provide much more advanced combinations of 'software and service', using web/cloud platform-based solutions for services that depend on judgement and analysis, rather than simply process or transactional-based activities.

Despite these strong growth drivers, there are a number of challenges to the more generic business process functions which continue to be undertaken. Some senior operators in the O&O business believe that generic BPO processes will be almost completely automated within five years as a result of virtual workers and 'back-office automation'. Other generic and domain-specific processing, e.g. insurance-policy administration could follow so that within the next decade, most of these tasks will be effectively automated. Companies such as BluePrism have already launched 'virtual workforce' tools for clients in the financial services, energy, telco, BPO and healthcare sectors. Infosys adopted its own IPsoft's self-learning software in 2013 to automate tasks in some of their operations, cutting the need for human labour.

If 'back-office automation' gains traction, which we believe it will, this could significantly dent office-demand-based growth derived from the sector. With around 20% of occupied office space in the region filled by O&O operators, the next wave of change in the O&O sector could be significant for many cities in the region, particularly those markets predicated on continued growth in O&O demand derived from lower-cost, generic functions. On the flip side, however, increasing volumes of virtual work will require greater operational IT capacity, leading to demand growth for data centres.

Where does that leave the O&O market in CEE? Good question. It's certainly a strong growth opportunity, but one where new technology poses a serious risk to growth as well as being an enabler. We hope you enjoy the report.

Introduction

In 2010, we produced a report on the outsourcing sector with AT Kearney called 'Improving with Moving.' The report looked in detail at a number of cities across CEE that had been active destinations for the 'Outsourcing and Offshoring' (O&O) sector, in order to determine how cities compared with each other in terms of:

- a) The size of the O&O sector in each market as of end-2009, i.e. the estimated number of employees working in the sector, and the estimated volume of office space occupied in m².
- b) The approximate cost of operating a 1,000 m² O&O facility, accounting primarily for labour costs and real-estate costs as of end-2009.
- c) The size of each city in terms of the working population, providing some context compared with the potential size of the O&O market.

The report illustrated that each city had a different position in terms of its 'cost and critical mass/experience' profile, as per Figure 1 below. This provided the region with a range of locations capable of satisfying a broad and growing range of O&O services and companies.

There were some clear leaders in the region - markets that had developed critical mass by attracting the outsourcing industry: namely Budapest, Prague, Bratislava, Krakow and Warsaw.

These cities were also the most expensive locations within the region in which to operate an O&O facility.

There were other cities that were emerging as significant players in the regional sector that had plentiful labour capacity (and a lower operational-costs base) that are ideal locations to 'rapidly absorb' new O&O facilities. These included cities such as Bucharest, Sofia, Varna, Belgrade and Polish regional cities such as Wroclaw, Katowice, Olsztyn, Szczecin and Torun.

With such a range of locations offering different levels of O&O experience, skill sets and cost profiles, we summarised our report by suggesting the region was very well placed to continue absorbing an increasing number of O&O functions, which would lead to an increase in the size of the sector in the near future.

However, we also pointed out that there were a number of risks to the growth of the sector in the region. Certain locations appeared to be close to capacity - notably Krakow, Warsaw, Budapest and Prague - based on the types of jobs which were being relocated to/established in these markets. Problems were being recognised by operators in these cities, whereby high levels of staff attrition were taking place between competitors, which have been driving up the cost base.

Fig. 1: O&O Matrix - Activity up to End-2009

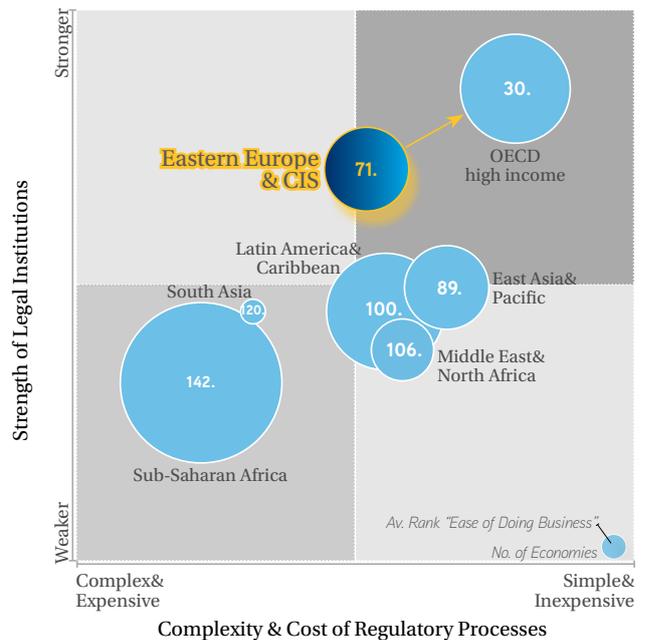


Source: Colliers International

Ultimately we suggested that these established locations would have to move up the value chain and attract better, more complex jobs and functions or face losing their occupier base to lower-cost competitors in the region. Equally, new technology could render some existing job functions redundant, particularly those best suited for automation.

The purpose of this report is to examine what has changed in the sector from 2010 to end-2013, and to understand what the future may hold for the evolution of the sector in the region.

Fig. 2: Doing Business Regimes 'Simple&Cost Effective' vs 'Complex&Expensive'



Source: World Bank

What's Changed: Business Reforms and Regulations

Since the publication of our first report, it is clear that the Eastern European/CIS (EE/CIS) region has changed and improved in a number of ways. Firstly, a review of the World Bank's 'Doing Business' report highlights the extent to which the EE/CIS region has improved relative to other competitive global regions for the O&O business.

The EE/CIS region collectively undertook more positive business reforms than any other region in 2013 and now stands ahead of global competitors in terms of it being 'simpler and more cost-effective' to establish and run a business there than in other global regions such as East Asia and Pacific, South Asia Latin America/Caribbean, Sub-Saharan Africa, Middle-East and North Africa.

When we look in more detail at the country's leading the 'Doing Business' rankings in the region, we also see some interesting trends.

Fig. 3: Business Regulation Reforms in 2012/2013 Eastern Europe/CIS - The Global Leader



Represents % of economies undertaking at least two 'Doing Business' reforms since 2012, making it easier and more cost effective to do business in the region.

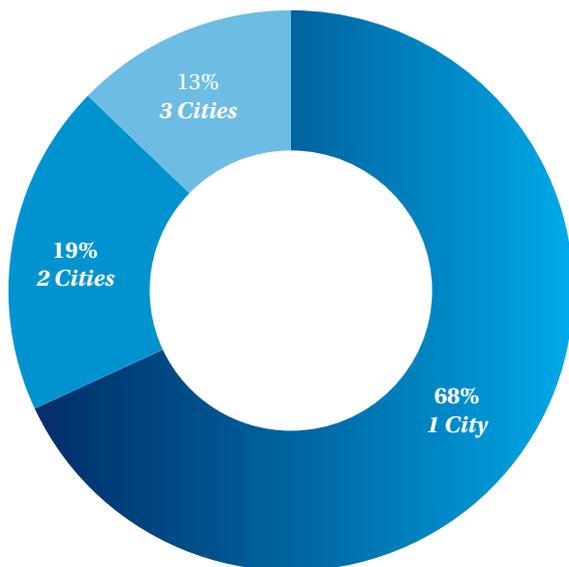
Source: World Bank

Fig. 4: Ease of Doing Business - Global Ranking

COUNTRY	2006	2013	CHANGE SINCE 2006
Singapore	2	1	↑
UK	5	10	↓
Lithuania	15	17	↓
Germany	21	21	→
Estonia	17	22	↓
Latvia	15	24	↓
Poland	74	45	↑
Slovakia	34	49	↓
Hungary	60	54	↑
Bulgaria	59	58	↑
Romania	71	73	↓
Czech Republic	50	75	↓
Croatia	134	89	↑
Serbia	95	93	↑
China	108	96	↑
Vietnam	98	99	↓
Ukraine	132	112	↑
Brazil	122	116	↑
India	138	134	↑

Source: World Bank

Fig. 5: The O&O Business Net-Expansion: 2010-2013



Source: Colliers International

Firstly, the Baltics are the leading countries in the region, with Lithuania positioned ahead of the likes of Germany as a place to do business. The Baltics are closely followed by the main O&O regional leaders of Poland, Slovakia, Hungary, Bulgaria, Romania and the Czech Republic. Then come Croatia and Serbia - the 'newest, and soon to be' EU members in the region.

Although the CEE market as a whole has improved, not all countries have progressed at the same relative rate since they were first consistently ranked in 2006. Slovakia, the Czech Republic and Romania have slipped down the rankings while Poland, Bulgaria, Croatia and Serbia have improved their relative positions.

More recently (since 2012), the biggest mover in the region is Ukraine, ranked 112. While behind all other locations in the region, and aside from the current ongoing conflict, Ukraine had made the most positive improvements and reforms to business conditions/regulations year-on-year than any other country in the global ranking. It now sits higher in the ranking than the likes of India and Brazil. As our report findings will show, once current insurgencies settle in Ukraine, it has the potential to be a major player in the CEE O&O market.

In summary, these 'Doing Business' ranking provide a good indication of how well positioned a country is in attracting and expanding its O&O sector. Collectively, the CEE region is increasingly recognised as a competent and competitive destination for O&O companies to do business, especially when transparency and cultural fit relative to the 'donor' markets of the OECD will continue to be critical success factors in attracting more and more O&O business in the years ahead.

The Expansion of the O&O Sector

Just as the business environment in CEE has continued to improve, so has the number of O&O business operators. Based on our analysis of companies operating in the sector, we have identified that since 2010:

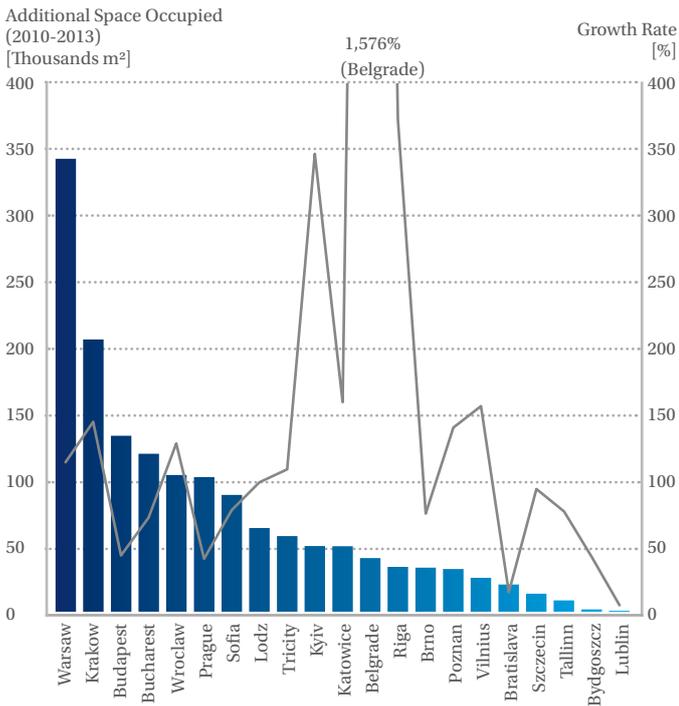
- Some 199 O&O companies have acquired modern office space within one of the target city markets for the first time.
- A further 144 companies have maintained their presence within one of the target city markets.
- Of those companies that had an existing presence in the region, 47 have expanded their operations into other cities in the region.

As Figure 5 highlights:

- 68% have expanded into one additional city,
- 19% have expanded into two additional cities, and
- 13% have expanded operations into three additional cities.

Not only does this illustrate strong growth in demand within the sector based on the large number of new companies entering the regional O&O market, it also provides evidence of a maturing market. This trend is further supported by the large number of established operators that have expanded their footprint across a wider geographical area.

Fig. 6: O&O Growth by City: 2010-2013



Source: Colliers International

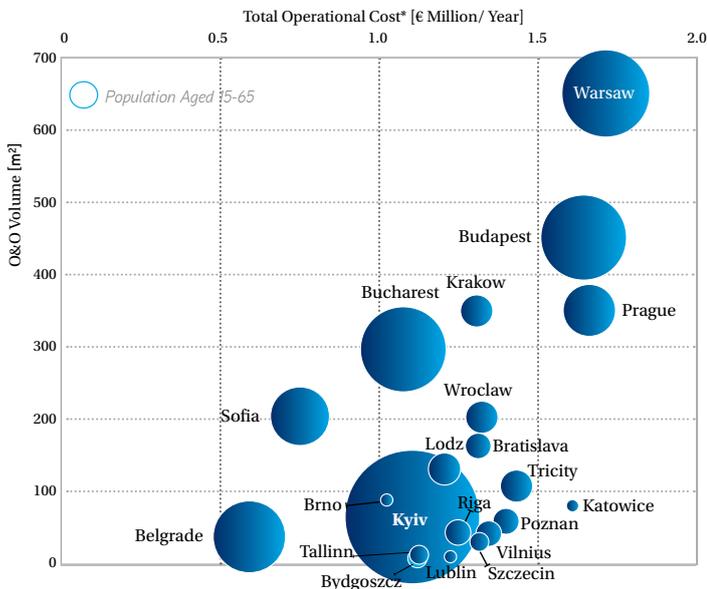
Changing O&O Activity by Location

If we look at Figure 6, we can see the extent of this expansion by geography. The markets which have attracted the majority of new demand since 2010, measured in m², are primarily those markets which were the early front-runners in the sector - Warsaw, Krakow, Budapest and Prague. There has also been significant growth in other leading regional contenders with Bucharest and Sofia playing catch-up with the front-runners, and other local cities in Poland such as Wroclaw, Lodz and Tricity also rapidly expanding their O&O occupier base. Cities such as Bratislava, however, appear to have peaked showing limited growth in operations over the same time period.

In the more peripheral CEE O&O cities of Belgrade, Kyiv and Riga, the expansion of the sector is even more dramatic on a percentage-change basis. This is due to these markets moving from a very low base. This change highlights the fact that expansion in the sector has occurred in both existing, mature markets, where there is a strong depth of skills and experience, and in new markets that are evolving and being tested out by O&O operators.

Overall, the ranking of cities according to the size of their O&O sector has seen limited change. Across the region as a whole, however, the volume of space occupied by the sector since 2010 represents growth of around 80%.

Fig. 7: O&O Space vs Cost/Working Population



*Estimated Base Operational Cost for a 1,000 m² office facility employing 100 staff includes annualised headline office rent and service charge and basic employee salaries; excludes employer contributions and taxation, parking and any other rental or fit-out incentives.

Source: Colliers International

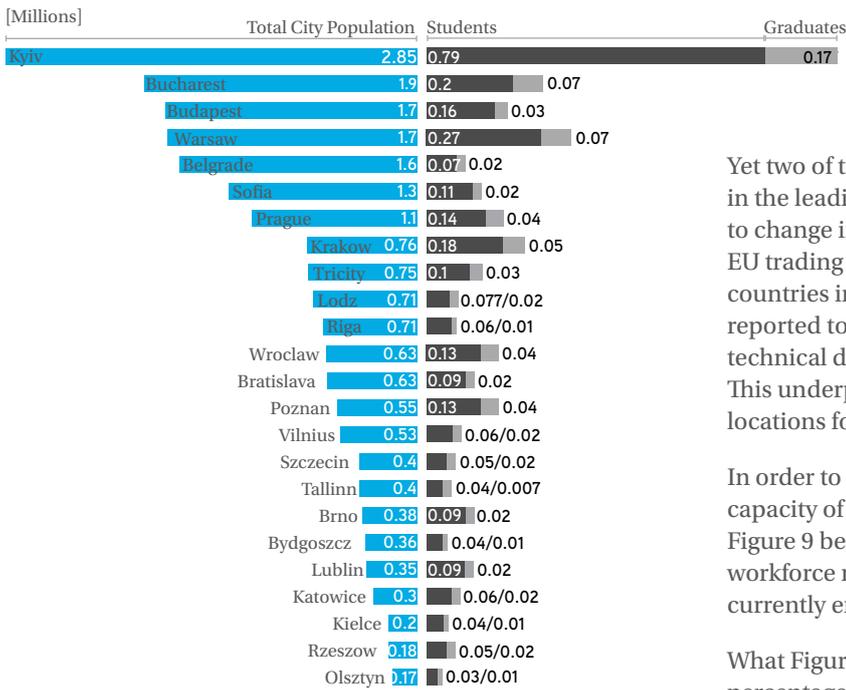
Capacity and Cost

When we consider the size of the O&O sector in each city, relative to the operational cost of doing business in that city and the size of its talent pool, it is clear that the expansion of the industry within the region is not cost-driven. Despite the fact that O&O growth is a function of cost-saving/process efficiency, it is the 'O&O experience' of a market which appears to count ahead of cost in the current evolutionary stage of the business in the region.

In time, we believe it is inevitable that certain lower-cost functions will either be made obsolete through new technology and automation or move to other emerging O&O lower-cost locations such as Romania, Bulgaria, Serbia and the Ukraine. All these locations offer large technical and language-skilled labour pools and attractive modern office space at much lower wages and overall costs to their more experienced peers. Although we said this was a very likely part of the evolution of the business in our initial 2010 report, it is yet to happen. But we believe this is a question of 'when rather than if'.

How well the more peripheral markets can compete with existing locations and automation will not only depend on their operational capacity and cost, but will also be determined by the quality of their marketing and inward-investment agencies. Of all the countries in the region, Poland has done the best job of marketing itself as a diversified location for the growth of the business, with the government inward-investment agency "PAIiZ" playing a large promotional role. "PAIiZ" stands out as the most proactive agency across CEE. While this makes a big difference to winning business, the bottom line in this sector is the size, scope and quality of the talent pool.

Fig. 8: Talent Pool: City Population - Students & Graduates



Source: UNCTAD/Statistical Offices

Labour Market

Size does matter. As the population pyramid above illustrates, there is significant divergence regarding the size of the local labour pool in terms of the size of the working population and the number of students and graduates emerging into the labour market via tertiary (higher) education. Kyiv stands out as a clear regional leader, as do the likes of Bucharest, Budapest, Warsaw, Belgrade, Sofia and Prague.

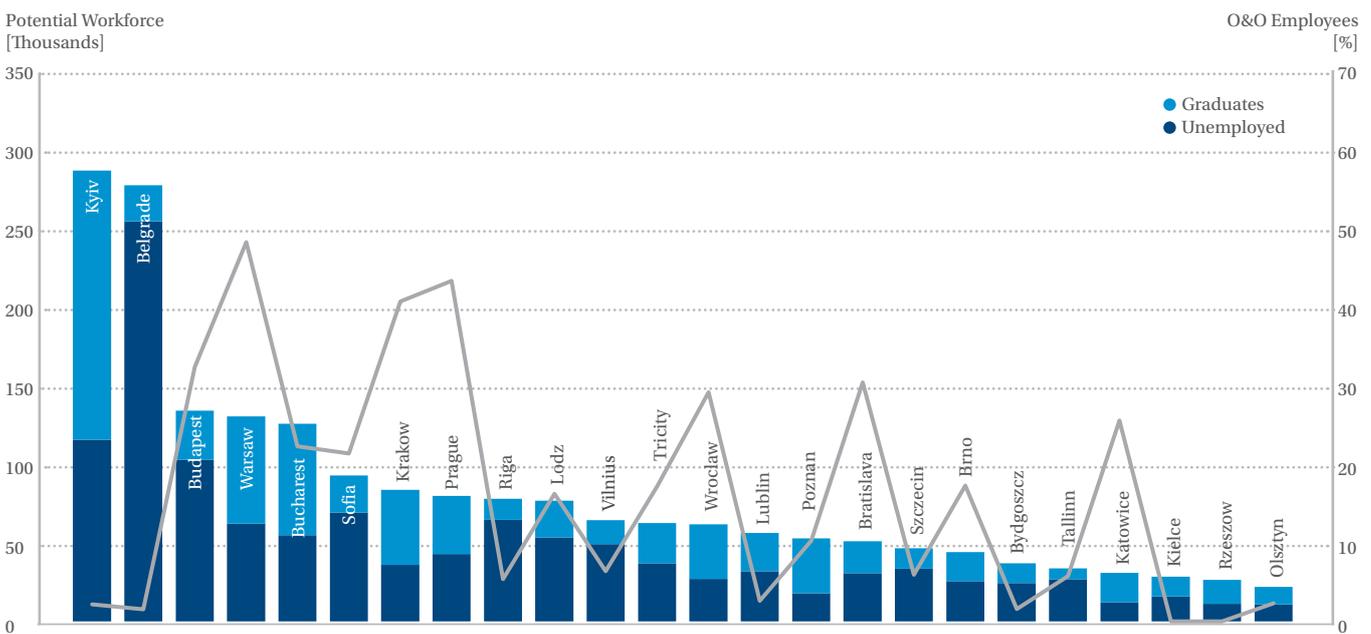
Yet two of these markets (Belgrade and Kyiv) still have to feature in the leading O&O pack in the region – a fact which is likely to change in time as they slowly orientate themselves to the EU trading pact. Belgrade represents one of two south-Eastern countries in the CEE region - Bulgaria and Serbia - which are reported to have the highest percentage of graduates holding technical degrees in IT and engineering across the CEE region. This underpins the potential of these locations as suitable locations for O&O operators.

In order to measure the comparable labour market absorption/capacity of the key O&O cities in the region, we have created Figure 9 below. This illustrates the size of the potential workforce relative to the estimated size of the labour force currently employed by the O&O industry, by city.

What Figure 9 indicates is that those cities with a higher percentage of current O&O employees relative to the potential labour pool, such as Budapest, Prague and Warsaw, will increasingly struggle to increase the volume of O&O jobs without creating higher levels of staff attrition and salaries. Cities at the other end of the scale such as Kyiv, Belgrade and even smaller cities such as Olsztyn and Bydgoszcz have a greater opportunity to increase operational capacity without inducing greater costs.

The other factor that will influence the ability of cities to attract O&O occuieris is, of course, the availability of quality office space.

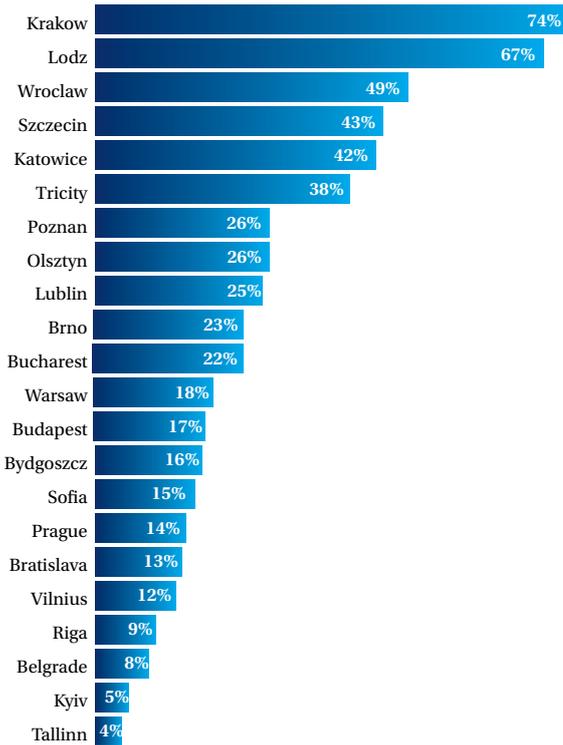
Fig. 9: O&O Employees as % of 'Potential Workforce' as of 2013



Source: Eurostat

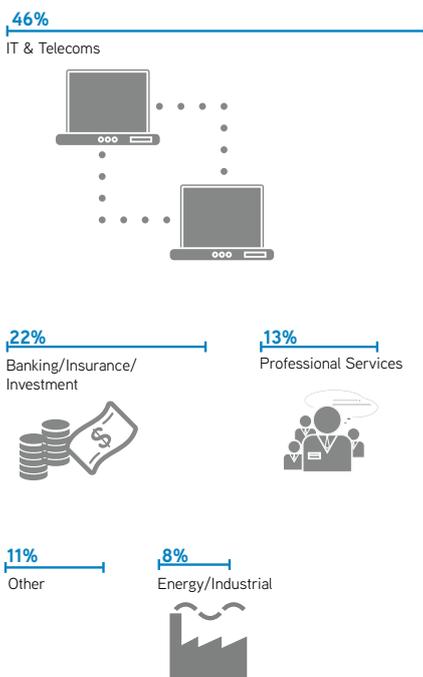
The 'Potential Workforce' shows the sum of graduates and unemployed.

Fig. 10: Occupied Stock - Share of O&O Businesses



Source: Colliers International

Fig. 11: O&O Business Sectors



Source: Colliers International

O&O Occupied Space

If we look at the amount of modern office space occupied by the O&O sector, in percentage terms, it is possible to see the extent to which the Polish markets have moved ahead in the last three years, with nine representatives in the top 10. In five markets the O&O sector occupies more than 38% of modern space, which is way above of the regional average of around 19%. Krakow has an estimated 74% of all occupiers within the O&O business – whether this is a good thing or a bad thing remains to be seen – but such a lack of diversification is something of a concern. That said, the ability of the city to continue to grow and diversify the range of outsourcing companies, functions and jobs over the last three years highlights how O&O has matured and diversified as a sector in its own right.

At the other end of the table we have Tallinn, which certainly appears to be punching below its weight, as are Kyiv, Belgrade, Riga and Vilnius. How these locations will fare in the future will depend largely on the orientation of the businesses they are looking to serve and how well prepared they are to compete with other locations in the region.

O&O by Sector

The O&O sector in the CEE region is dominated by the IT and telecoms sector with a 46% share of all O&O occupiers. The banking/insurance and investment sector takes up 23%, followed by the professional services sector with a 13% share. The energy/industrial and other business sectors make up the remaining 20%.

Although our analysis of occupiers shows us that the IT sector is the most likely sector to drive outsourcing in the region, each CEE country seems to specialise in one or another business discipline, judging by activity to date.

Besides a high representation of the financial and the IT sectors in Poland, there is a more colourful mix of business sectors present in the country's main O&O hubs. For example, Gdansk has a relatively high concentration of life-sciences businesses alongside professional services. Katowice, at the heart of the Upper Silesia manufacturing belt, has attracted more manufacturing-driven O&O companies. Poznan, on the other hand, has a strong base of media-oriented companies.

Romania provides a strong diversification of language skills, with companies such as Oracle, IBM, HP and, more recently, Huawei running operations in the country. Oracle, IBM and HP have maintained a position in the market since the mid-2000's.

Hungary is well known for its variety of multilingual graduates, and its overall high educational standard attracted Microsoft to open their 7,000 m² R&D centre in Budapest in 2007.

As the former main supplier of IT to the Soviet Union, Bulgaria has a large labour pool with a high number of technical graduates, particularly in engineering. This has been reason enough for companies such as Samsung, SAP and Sutherland to outsource some of their business there.

If one looks closely at Figure 12, logistics and retail have shown strong growth relative to pre-2010. We suspect this correlates to the strong growth in e-retailing across the region and is evidence of how structural business changes can influence the O&O sector. Figure 12 also demonstrates the extent to which media and the public sector are yet to really feature as drivers of O&O activity.

In the UK and other OECD countries, the public sector in particular is a major donor of O&O jobs. Given the need for increased productivity and efficiency from within the (debt-saddled) public sector, this could be a major source of O&O business growth in CEE over the next decade.

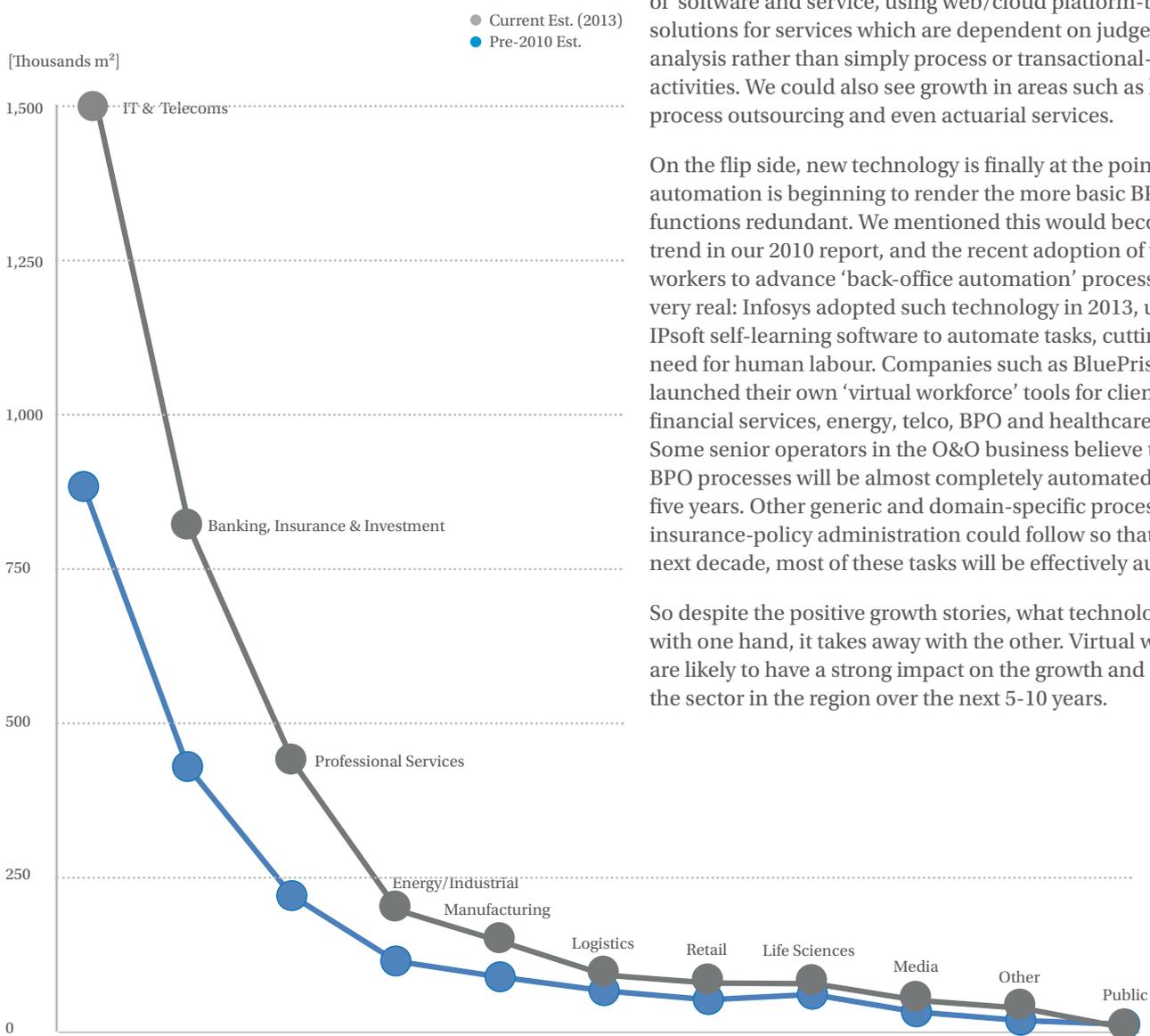
New Technology

The other factor to consider in future is the impact of new technology. On the plus side, we are likely to see existing operations evolve to provide more advanced combinations of 'software and service', using web/cloud platform-based solutions for services which are dependent on judgement and analysis rather than simply process or transactional-based activities. We could also see growth in areas such as legal-process outsourcing and even actuarial services.

On the flip side, new technology is finally at the point where automation is beginning to render the more basic BPO functions redundant. We mentioned this would become a trend in our 2010 report, and the recent adoption of virtual workers to advance 'back-office automation' processes is now very real: Infosys adopted such technology in 2013, using their IPsoft self-learning software to automate tasks, cutting the need for human labour. Companies such as BluePrism have launched their own 'virtual workforce' tools for clients in the financial services, energy, telco, BPO and healthcare sectors. Some senior operators in the O&O business believe that generic BPO processes will be almost completely automated within five years. Other generic and domain-specific processing, e.g. insurance-policy administration could follow so that within the next decade, most of these tasks will be effectively automated.

So despite the positive growth stories, what technology gives with one hand, it takes away with the other. Virtual workforces are likely to have a strong impact on the growth and evolution of the sector in the region over the next 5-10 years.

Fig. 12: O&O Occupied Space by Business Sector [Pre-2010 vs Current Est. (2013)]



Source: Colliers International

Conclusion

At a global level, the outsourcing and offshoring concept is now well over 40 years old, and over 10 years old in the region. Despite signs that the sector would diversify geographically across CEE following the initial growth phase of the industry pre-crisis, the evolution of the business since 2010 demonstrates that the majority of O&O occupiers have consolidated into the larger O&O centres of expertise.

These markets provide operators with the largest depth of experienced talent, and O&O services in the near future are likely to grow and evolve around these locations in order to satisfy new business and technological demands. Operators (and thus staff) will need to provide increasingly innovative partnerships with their clients that not only save money but also improve the service offering and add value to the customer. According to McKinsey, the future of O&O is forecast to become a much more interactive, mutually-beneficial network that is strongly driven by social media and IT developments.

Ultimately, the need to manage costs and the adoption of virtual workforces via new technology will reduce office demand from within the sector and displace activity to lower-cost, but of well-connected locations. We are only just starting to see this trend filter through and it does have significant implications for the overall size, growth and distribution of the business in the next stage of its evolution.

Yet we are only part way through the evolution of the O&O business in the region, with many new sectors to help drive and grow this activity. There are newer technologically-driven platforms and service lines to build and adopt,

improving the number of clients which can be serviced by new and existing operators.

As Figure 13 demonstrates, each city within the region is at a different evolutionary stage in terms of the maturity of the business and the range of O&O services on offer. When we map this O&O business functionality relative to the respective talent pools, cost and current O&O critical mass, it gives us some idea of the competitive position of each location looking forward.

City Summary:

The main existing centres of Prague, Warsaw and Krakow are most likely to evolve the soonest, with Bucharest catching up relatively quickly at the expense of Bratislava.

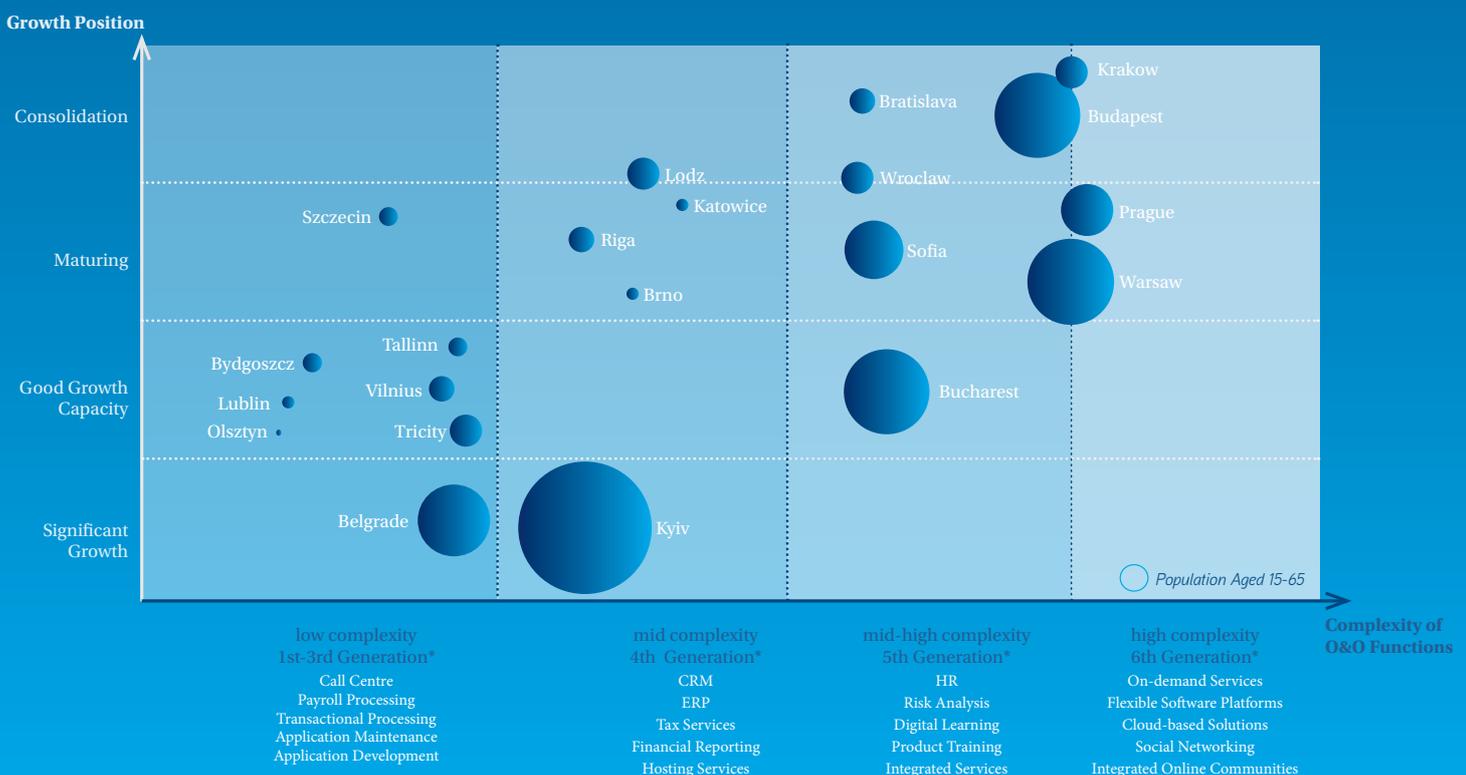
Belgrade and Kyiv are the markets with the 'biggest potential' – Belgrade is most likely to first be expand, given its impending EU status. Although Kyiv has the most significant potential to ramp up as a key O&O location in future, current political difficulties in Ukraine will hamper this progress.

Poland has a number of secondary cities capable of reasonable expansion, but needs to be aware of the competitive risk to each market via lower-cost competitors and automation.

Just as the larger Polish cities have a speciality, many other markets, including the Baltics, need to understand what they are best at. Promoting their unique selling point position (USP) will help them to compete with other cities in the region, and Europe at large, as well as help increase their market share of the sector.

The one thing we can say with certainty is that the O&O sector will become an increasingly competitive marketplace.

Fig. 13: O&O Matrix - as of end-2013



Source: Colliers International

* Accenture "Next Generation BPO"

485 offices in 63 countries on 6 continents

United States: **146**

Canada: **44**

Latin America: **25**

Asia Pacific: **186**

EMEA: **84**

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\$2

billion in
annual revenue

1.12

billion square feet
under management

15,700

professionals
and staff

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