The Philippines Contact Center Cluster

Course Project
Microeconomics of Competitiveness

May 4, 2007

Yukiko Kase

Kate Lavin

Victor Liwanag

Sonya Thomas

Achi Yaffe

I. Introduction

This paper analyzes the potential for a Contact Center Cluster in the Philippines. First, it provides an overview of the Philippines, including an assessment of its recent economic performance and competitiveness. Next, it describes the contact center world market and the contact center cluster in the Philippines. The final section presents a set of recommendations to further improve the competitiveness of the cluster.

II. The Philippines Overview

Due to a unique history that aligned the country with the West, the Philippines pursued a relatively open economic strategy over the last thirty years. However, the country was unable to adjust to the challenges of an open economy, and it stagnated for close to thirty years. Despite generally high levels of social development, the current government under Arroyo faces a challenging cycle of low investment, low productivity and low competitiveness.

The Evolution of a Unique Culture with Strong Links to the US

The Philippines is part of the increasingly dynamic Southeast Asia region. There are more than 7,000 islands (total 300,000 sq km), but the bulk of its fast-growing population[1] lives on just 11; approximately 62% of the 91M population is in urban areas such as Manila and Cebu (CIA Factbook). The government is a Republic, and the official languages are Filipino and English.[2] The population is young, with a median age of 22.5 years; this is significantly younger than the US, for example, which has a median age of 36.6 years (CIA Factbook).

The Philippines has been under the rule of three different countries, each of which has had a significant influence on its people and culture. First, Spain colonized the islands for 331

[1] Population growth is 1.8% per year (2007 est. by CIA Factbook)
[2] The Philippines is the 3rd largest English-speaking country in the world

years between 1565-1896. The colonial culture had a significant influence on the Philippines: Roman Catholicism became the dominant religion,[3] and many Spanish words became integrated into Filipino. Spanish rule lasted until a Filipino uprising in 1896 dovetailed with the Spanish American War, through which the US pushed the Spanish out of the Philippines. This began the US Colonial period (1896-1910). During this period, US practice shaped the political structures, as well as the education system. Between 1910-1933, the country was run by a "puppet government", and in 1933, the US granted the Philippines Dominion status. However, this was interrupted by WWII and the Japanese occupation of the islands from 1941-1945. US military intervention again ended this colonization effort, and in 1946, the Republic of the Philippines was declared with US support. This reinforced the generally favorable view of the US within the Philippines. Ties with the US continued with generous immigration policies, and a macroeconomic policy that hewed closely to US recommendations.

An Economic Strategy with Mixed Results: 1946 – 2001

Immediately following its independence, the country pursued an import substitution model that was bolstered by an exchange rate fixed to the US dollar. This was fairly successful in industrializing the country. However, this exchange rate was highly overvalued, and with the support of the US, the Philippines devalued the peso in January 1962. The economy went into crisis, and the Philippines turned to the US, IMF and World Bank for advice. Their response was an export-oriented industrialization that used low wage rates to attract foreign capital and increase employment. This strategy was fully embraced and implemented by President Ferdinand Marcos. Through Presidential Decree 66 (PD 66) in 1972, the government provided incentives for export production through the Bataan Export Processing Zone (BEPZ). However, the oil shocks of the 1970s hampered this strategy, because the Philippines was heavily

[3] 80.6% (2000 Philippines National Census)

dependent on oil imported in dollars. In addition, after the institution of martial law in 1972, the Marcos regime was marred by pervasive corruption, cronyism and despotism. The economy stagnated, and over the next twenty years, the Philippines fell from its position as the richest country in the Southeast Asian region (see **Exhibit 1**).

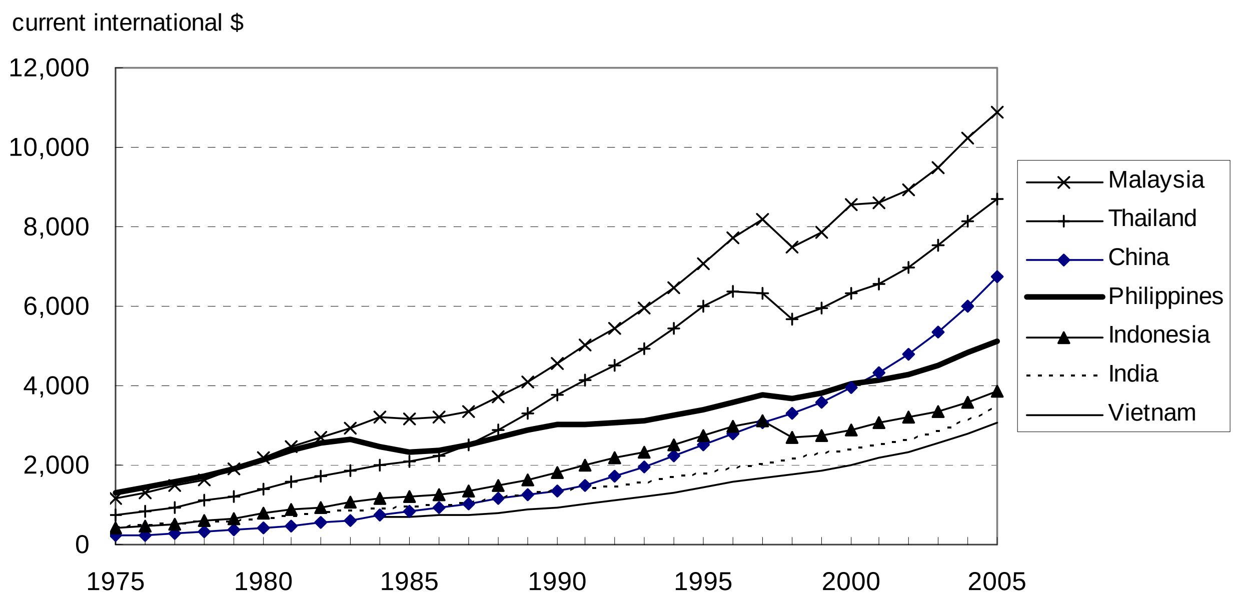


Exhibit 1: GDP per capita, PPP

After a non-violent protest dubbed "People Power," the Marcos government was overthrown and Corazon Aquino took office in 1986. However, the return of democracy and government reforms were hampered by massive national debt, government corruption, coup attempts, a communist insurgency, and a Muslim separatist movement.[4] Aquino's defense minister, Fidel Ramos, succeeded Aquino in 1992; he introduced a broad range of economic reforms and initiatives designed to spur business growth and foreign investment, such as trade liberalization, deregulation and privatization programs. The Philippines did see a period of rapid sustained growth after this (growth rates ranged between 2.1-5.8% from 1993-1997), but the 1997 Asian financial crisis, and poor weather in 1998 once again slowed economic development

[4] 5% of the population is Muslim (CIA Factbook)

in the Philippines. Growth fell to about -0.6% in 1998 from 5.2% in 1997, but recovered to 3.4% by 1999 (World Development Indicators (WDI)).

However, domestic political instability continued to interfere with economic growth. Former filmstar Joseph Estrada took power from Ramos in May 1998 in an economic downturn but tried to resist protectionist measures. Efforts to continue the reforms begun by the Ramos administration made significant progress. However, a major bank failure in April 2000 and the impeachment of President Estrada, on corruption charges, in the beginning of 2001 led to lower growth of 1.8% (WDI). After the impeachment trial broke down due to political maneuverings, the president was forced from office by popular for the second time in 15 years.

Prospects for Growth

Estrada's successor, Gloria Macapagal-Arroyo, has inherited a complex economic picture. Economic strengths build on the Philippines' ties to the West and relatively advanced social development. However, the economy has found it difficult to capitalize on these advantages; and future economic growth is limited by a vicious cycle of low investment, productivity and competitiveness.

The Philippines' early export orientation and links with the West are evident in its export/import profile. The majority of exports go to other Asian countries (61.7%, National Economic and Development Authority 2005 (NEDA)). However, the largest export partner is the US (18.0%), with Japan following closely (17.5%) (NEDA, 2005). A similar pattern holds for imports: 66.8% of imports are from other Asian countries; and the US and Japan provides 17.0% and 19.2% of imports respectively (NEDA, 2005). As illustrated by its trade relationship with US and Japan, the Philippines imports electronic products and exports semiconductors and electronic products; the largest traded clusters are relatively sophisticated, with the largest clusters in Information Technology and Communications Equipment (International Cluster Competitiveness Project, 2007).

In addition, the Philippines is the regional leader for education. It has the highest literacy rate (92.6%, which is higher than Singapore's 92.5%), and the 2nd highest education index (0.89) in the region (Singapore has 0.91). Its competitor India compares unfavorably across both these measures: with 61% literacy and 0.61 education index respectively (UNDP, HDR 2006).

However, the Philippine economy has not been able to accommodate productively these levels of social development. Unemployment and underemployment are very high, at 11.8%, 17.4% respectively (ADB ADO 2005); population has grown on average by 2% per year, and employment growth has not kept pace during 2000-2006 (IMF, 2007). In response, Filipinos have been emigrating overseas in search of better jobs and wages. There are an estimated 7.75M Overseas Filipino Workers (OFW), equivalent to about 25% of the domestic work force (IMF, 2005). As the world's third largest recipient of remittances (behind India and Mexico), remittances have grown to just over 10% of GDP in 2006 (The Nations, 2007). This is due, not only to an increase in the number of workers deployed abroad, but also to a shift to emigration of higher-value labor: while the majority of workers used to be in construction, many doctors and nurses are now working all over the world in search of higher wages.

It is clear that remittances benefit the economy through their significant support of domestic consumption, particularly in the service sector, which employs 50% of the labor force (CIA Factbook). However, their relative importance to the economy is also a sign of a deep challenge for the Philippines: relatively low prospects for long term economic growth. The economy seems stuck in a vicious cycle of low investment rates, low productivity and low competitiveness. Although the Arroyo government plans to tackle these issues, addressing all three simultaneously will be difficult.

Low Investment Rates

Investment rates, both foreign and domestic, are significantly lower than regional competitors, severely limiting capital formation. Since Marcos, FDI Policy in the Philippines has been focused on Special Economic Zones (SEZ), and has made generous allowance for foreign ownership of local operations (ADB Improving Investment Climate (ADB IIC)). However, although FDI for the region has been highly volatile in the last ten years, the Philippines has seen a sharp decline in foreign investment amounts during the same period; FDI was only 1.1 % of GDP in 2005. Domestically, investment rates as a percentage of GDP are significantly less than China, Indonesia, India and Vietnam (WDI).

The productivity and competitiveness issues discussed below limit perceived potential returns to investment, and thus inhibit foreign and domestic investment rates. In addition, public investment is highly constrained by continued high levels of sovereign debt and government deficits. Reducing the Philippine debt burden has been a priority of the Arroyo government since the formulation of the Medium-Term Philippine Development Plan in 2004; however, recent downgrades by international ratings agencies highlight a lack of progress, and have further inhibited investment. In addition, the debt burden is thought to have "crowded out" private investment through high domestic interest rates (ADB Country Economic Review, 2004).

Investment (particularly FDI) has also been negatively affected by continued political turmoil. Arroyo's administration has been hounded by allegations of corruption and election rigging. Most recently, she fought off an attempted coup in February 2006, and there has been continued separatist-inspired terrorism in the south. Not only does this raise fears among investors about the security of property rights and the stability needed for growth, but it also limits the ability of the government to implement reforms needed for further growth. For example, although Arroyo has recently been able to reduce the government deficit by introducing a 12% Value Added Tax on alcohol, cigarettes, energy products and professional services (IMF, 2007), additional reforms may be difficult without consolidated control of the country.

Low Labor and Capital Productivity

The Philippines has low labor productivity compared to other Asian countries: the yearly output per worker for the Philippines was $679, versus $6,883 for Malaysia; only Cambodia and Vietnam have lower productivity in the region. In addition, Filipino labor is expensive compared to regional competitors. For example, the Philippines has the highest minimum wage rates in the region. Although Thailand has a GDP per capita 2x that of the Philippines, the minimum wage in Metro Bangkok is $3.39, while the wage rate in Metro Manila is $5.31. Similarly, Malaysia, which has a GDP per capita nearly 4x greater than the Philippines, has an entry-level wage of $4.22 (ECOP 2005). Furthermore, only three of the ASEAN countries have regional minimal wage fixing: the Philippines, Thailand and Indonesia. This can lead to regional inconsistencies that further inhibit investment and firm expansion.

Not only is Philippine labor unproductive and costly, but it is also linked to relatively unproductive capital. Only around 0.35 pesos of GDP is created per peso of capital stock (ADB ADO 2005). These productivity issues are summarized by negative Philippine Total Factor Productivity Growth from 1960-2000; some hypothesize that this is due to significant "brain drain" as OFW move abroad (ADB, Asian Development Review (ADB ADR)). Improvement of these unproductive patterns requires technological upgrades and movement of labor/capital into more productive sectors of the economy (e.g. out of agriculture). However, as long as regional competitors provide more productive, cheaper labor and capital, and more competitive business environments (see below) investment rates are unlikely to increase.

Low National Competitiveness

The Global Competitiveness Report's Business Competitiveness Index ranks the Philippines 58th out of the 74 countries assessed. This is only slightly better than the country's GDP/capita at PPP rank of 61. Unfortunately, both of the components are declining: Company Operations and Strategy continues as a relative strength, but both it and the Quality of the National Business Environment have declined in competitiveness (see **Exhibit 2**). Not only does this limit the incentive to invest, but it also reduces the growth impact of existing investment.

	2001	2002	2003	2004	2005	2006
Business competitiveness index ranking	53	59	62	60	56	58
Quality of national business environment ranking	53	61	63	61	61	59
Company operations and strategy ranking	41	47	50	45	38	45

Exhibit 2: Global Competitiveness Ranking

Company Operations and Strategy

Philippine firms continue to perform strongly on human capital elements within this category (e.g. "Extent of staff training" and "Reliance on professional management"). They also continue to have strong consumer orientations (e.g. "Extent of marketing" and "Degree of customer orientation").

However, the rankings of individual elements indicate a decline in industry sophistication. The "Nature of competitive advantage" and "Production process sophistication" both fell 23 spots over the past five years, and are now relative disadvantages for the Philippines. In addition, the "Prevalence of foreign technology licensing" and the "Extent of incentive compensation" have both declined during the same period by 12 and 17 spots respectively.

Quality of the National Business Environment

Generally, factor conditions have been the strongest component of the National Business Environment for the Philippines; unfortunately, many of its elements—particularly financial markets, infrastructure and specialized human capital—have not kept pace with improvements by competitors. Considering that it is a developing country, demand conditions are relatively strong. However, related and supporting industries are not particularly strong; and the context for firm strategy and rivalry is a definite weakness for the Philippines—particularly regarding corruption.

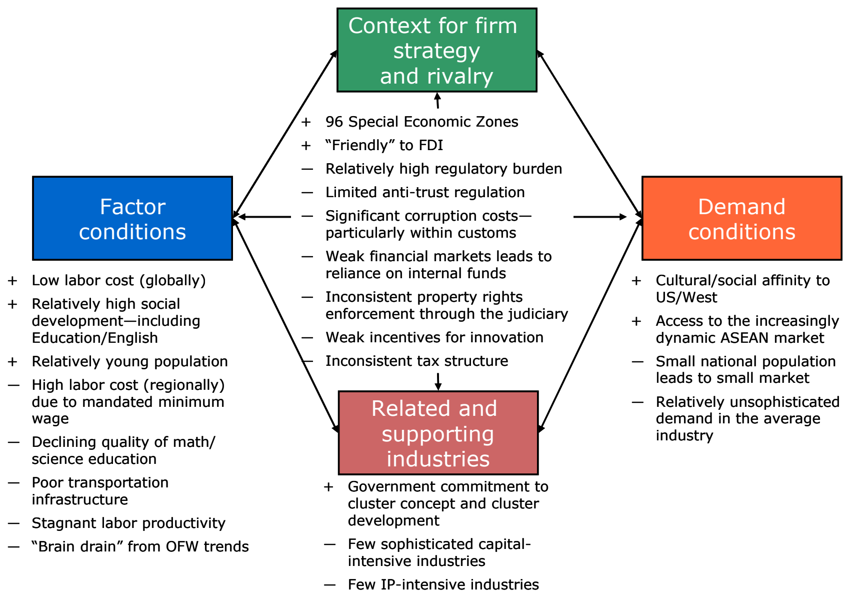


Exhibit 3: Country Diamond

<u>Factor Conditions</u>

The past five years have seen a significant deterioration in factor condition competitiveness. The Philippines is now relatively limited by its financial markets, its infrastructure, and even some forms of specialized human capital.

Lack of access to capital has been a serious issue for Philippine firms. Not only is there limited investment (as described above), but a weak financial sector limits the efficient allocation of the money that is invested. Overall sophistication of the sector has fallen 16 spots over the past five years; Ease of access to loans has fallen 12 spots; and VC availability has fallen 11 spots. The government has made some effort to open the financial system to foreign competition and to raise capital standards. However, although credit is generally available at market terms, the government requires banks to lend specified portions of their funds to preferred sectors, thus limiting credit access for entrepreneurs or non-specified industry. In addition, because of the "crowding out" effects described above, a high cost of borrowing limits financing through bank loans (ADB IIC). As a result, the ADB estimates that only 21% of business financing is through bank loans (ADB IIC). This is compounded by limited credit ratings services for small and medium enterprises (NEDA MTPDP).

Infrastructure has historically been a weakness for the Philippines, and it continues to limit competitiveness (e.g. Overall infrastructure quality is ranked 64th of 74). This particularly includes ports, air and road infrastructure. For example, only 20% of roads are paved, versus 98% and 76% for Thailand and Malaysia respectively (ADB IIC). Telecom and electricity infrastructure is actually less of an issue for the Philippines; for example, after multiple energy crises (in the 1970s and 1990s), the government deregulated the industry and the power supply is now relatively consistent (although costly) (ADB IIC).

Despite generally high education levels compared to the region, math/science and management-focused factors have been in decline over the past five years. The "quality of math/science education" is a competitive disadvantage, and the "quality of research" has fallen 10 spots; in addition, the "quality of management education" has also fallen significantly: 19 spots to 42nd. This is aligned with the fact that although the Philippines has a relatively high college graduation rate, it has relatively low graduation rates in science/technology (ADB ADR).

Related and Supporting Industries

The Philippines has a slight competitive advantage in this area, and it seems to be improving over time. Supplier quantity is increasing strongly (it has increased by 11 spots over the last five years to 47th). However, "supplier quality" has remained unchanged.

Demand Conditions

Thanks to long-standing links with the US, demand conditions have historically been very strong compared to other developing countries. For example, "buyer sophistication" was ranked 42nd out of 74 countries. The Philippines also has relatively strong "laws relating to ICT" and stringent "environmental regulations". However, although environmental regulations have become stricter over the past five years, competitiveness of the other two elements has been in decline. In addition, "government procurement" of advanced technologies and strictness of "regulatory standards" are relative disadvantages, and have also declined.

Context for Firm Strategy and Rivalry

The Philippines has relative strengths in competitive intensity and globalization. Intensity of local competition has risen 13 ranks in the past 5 years, and the Philippines has relatively low trade barriers (39th).

However, it faces significant governance and corruption constraints. Although still a relative advantage, "efficacy of corporate boards" has declined 10 spots. Corruption and the "centralization of economic policymaking" are also relative disadvantages for the Philippines. According to Transparency International, the Philippines is ranked 121st out of 163 countries in corruption, (Malaysia is 44th and India is 70th). This has led to significant costs for firms in the Philippines. According to the World Economic Forum 2006 Global Competitiveness Report, the Philippines was ranked 81 out of 125 countries in business costs of corruption. In contrast, countries such as Thailand, Malaysia, Indonesia and India are all ranked 46 or higher.

The Arroyo Government Response

In response to these challenges, the Arroyo government has prioritized a coordinated set of strategic fiscal and monetary policy priorities that support a sound fiscal and debt position, low rates and inflation, and healthy current account levels. For example, it has proposed reduction of debt through privatization, deregulation and stringent tax measures. The government has also committed to doubling the yearly infrastructure budget by 2007 (Landingin 2007). Once this is in place, the government has aggressive GDP growth goals: 7% in 2007, 8% in 2008, and 9% in 2009. As the ADB describes, the government is embarking on an "extended investment push to create a virtuous cycle of higher rates of productivity, wages, and employment." (ADB ADO 2005) However, given the challenges described above, and the lack of support for the Arroyo government, this could be difficult to achieve.

III. World Contact Center Outsourcing Market

The contact center outsourcing sector is a subset of the broader business process outsourcing (BPO) industry. As shown in **Exhibit 4** below, the cluster is a mosaic of services that span industries (e.g., technology, financial services), functions (e.g, sales, human resources, customer service) and levels of complexity (e.g., simple credit card servicing to complex technical support). However, despite their diversity, these services share three common traits: (1) they are provided by third-party outsourcers (i.e., they are not captive centers); (2) they involve an interaction with a contact center agent; and (3) the interaction is conducted via voice (live call) or non-voice (web chat, email).

Contact Center components

Business Process Outsourcing						IT Outsourcing
Marketing / Customer Care	Human Resources	Administration	Logistics & Distribution	Finance & Accounting	Payment Services/ Transaction Processing	Technology
Database Marketing	Payroll	Claims Processing	Materials Management	AP/AR	Card Processing	Data Center Operations
Telesales & Telemarketing	Benefits	Asset Management	Warehouse Management	General Accounting	Loan Processing	LAN / WAN Management
Web Sales & Marketing	Education & Training	Document/ Information Management	Transportation	Risk Management	Check Processing	Application Development & Maintenance
Customer Analysis	Hiring	Legal Documentation	Procurement	Financial Reporting	ATM Processing	Security
Call Center	Recruiting & Staffing	Shareholder Services	Order Fulfillment	Financial Management	Computer Reservation Systems	Help Desk Support
Billing	401(k) Admin Services			Tax Processing		Connectivity Management
	Investment Services					Disaster/Data Recovery Services
						Internet & eCommerce Services
						Desktop Management

Source: Jefferies, The Calgary Group

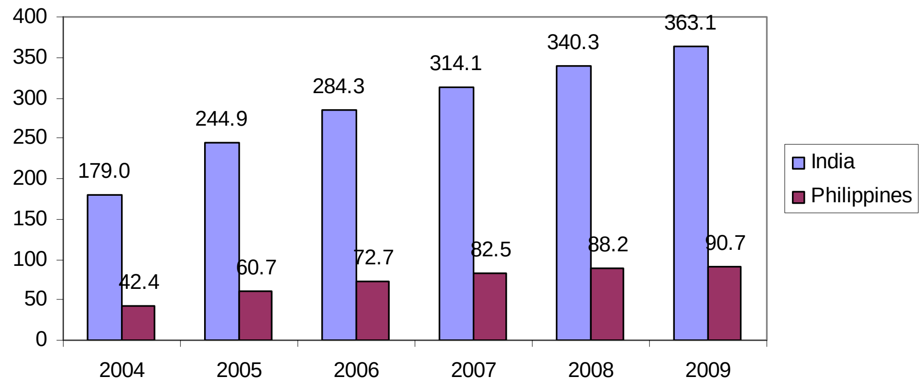
Exhibit 4: BPO Taxonomy

The global contact center outsourcing market is projected to grow from $51.4B in 2005 to $92.2B in 2010 at a comparable growth rate across all geographies. For the most part, this growth will be fueled by increased outsourcing of contact center services. In 2005, over $300B was spent on contact centers, but only 17% was outsourced to third-party providers; by 2010 this figure is projected to increase to 25% (Penny 2006, 4).

Offshore Contact Centers

Offshore contact centers are poised to benefit from this projected growth given their highly-skilled, low-cost labor pools. Despite the significant media attention that offshore locations have attracted, they are still in their infancy and have only captured 8% of the addressable market (Chakrabarty 2006, 2).

India is the largest offshore contact center location, four times larger than its second place rival, the Philippines. As shown in **Exhibit 5**, both locations are projected to grow at 15% per year through 2009. Conservatively, assuming $25K in revenue per agent, by 2009, India and the Philippines are projected to grow to $9.0B and $2.3B, respectively. (DataMonitor 2005, 25, 46).



Source: DataMonitor

Exhibit 5: Projected Contact Center Agent Headcount

IV. The Philippine Contact Center Cluster

What Makes a Good Contact Center Location?

Contact center locations compete on a variety of factors. Baseline criteria necessary to attract blue chip companies are listed in the column on the left, while criteria that vary by type of work (e.g., languages served, industry expertise) are in the right-hand column.

Generic Factors affecting location choice		**Enterprise-Specific Factors affecting location choice**	
Factor	**Sub-Factor**	**Factor**	**Sub-Factor**
Human Capital	Access to labor pool, Attrition levels, Overheating	**Language Fluency**	Fluency in English, German, French, Spanish
Costs	Compensation, Real estate, Telecom and Power costs, Wage inflation	**Physical Proximity**	Air travel time to reach remote center
Infrastructure	Telecom, Power, Office space, Airline connectivity and road Infrastructure	**Economic/Business System Affinity**	Awareness and compatibility with source country economic system
Business living and environment	Government support, Social environment, Attractiveness to ex-pats	**Industry-specific suitability**	Existence of BPOs catering to a specific industry
Risk Factors	Crime rates, Political instability, Natural disasters	**Enterprise-specific suitability**	Enterprise globalization maturity, Enterprise culture

Source: NeoIT

According to The Calgary Group, a BPO advisory firm, in addition to offering low labor costs, the Philippines scores highly on key buying criteria relative to other prominent contact center outsourcing locations (**Exhibit 6**). For example, given the Philippines' strong affinity to the United States, Filipino agents are lauded for their "soft, non-place-able accents" that enable them to build rapport with customers.[5] In addition, as many contact center companies have become employers of choice for graduates from many universities, their low agent attrition relative to India and the US, has led to reduced training costs and improved quality from longer tenure. This attractive balance of cost and quality has attracted 15 of the top 20 contact center outsourcing companies in the world to the Philippines.[6]

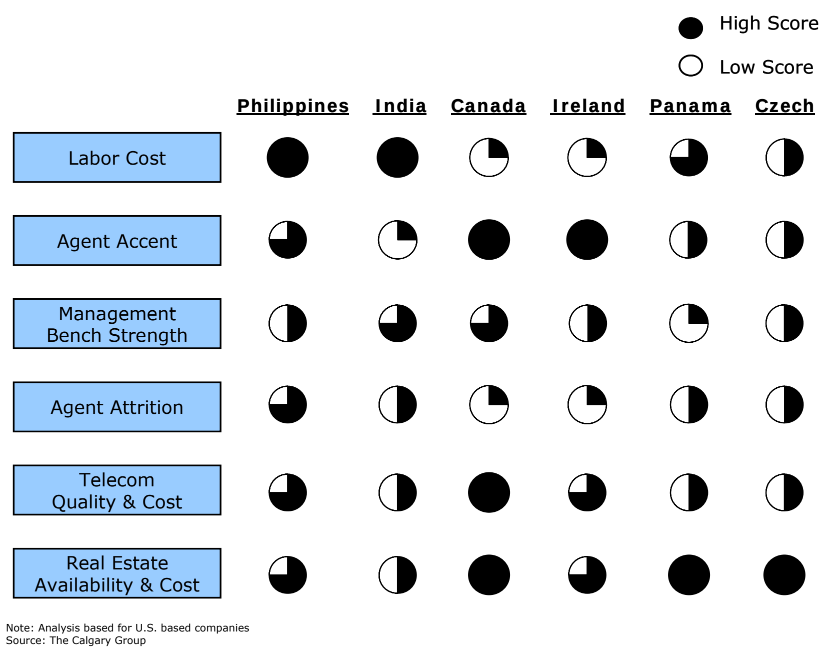


Exhibit 6: Comparison with Contact Center Competitors

The Evolution of the Philippine Contact Center Cluster

The Philippine Contact Center Cluster can be traced back to the 1980s when companies outsourced services such as animation and indexing to leverage the country's skilled, yet

[5] Mikhalev, Peter. Interview by Achi Yaffe. Via phone.
[6] Visited websites of top 20 contact center companies (according to IDC) to analyze their geographic footprint

inexpensive, labor. These services were provided offline (no live contact with end customer) and were performed during regular business hours as they were not time sensitive.

Despite its relatively low GDP per capita, the Philippines was an "early adopter" in terms of deregulating telecommunications and proliferating internet connectivity (both dial-up and high-speed). AOL was the first company to leverage this trend and outsource email support to a non-voice contact center near Clark Air Force Base in the late 1990s. AOL email support was innovative since the service was performed "real-time" during US daytime / Philippine nighttime hours.

Telecom deregulation, coupled with investments to increase bandwidth, steeply reduced long-distance rates at the turn of the millennium. eTelecare International leveraged this trend and launched the first voice contact center in 2000. Like the AOL email support services, these services were performed "real-time," but with voice calls instead of non-voice media.

Over the past seven years, the cluster has experienced tremendous growth. Two contact center companies that were launched in the Philippines, PeopleSupport and eTelecare are listed on the NASDAQ. Furthermore, the CEO of Convergys, the largest player in the industry, recently declared the Philippines as the company's preferred location for future growth.[7]

The Cluster as Part of the Philippines BPO Industry

As discussed above, the contact center cluster is part of the larger Philippine BPO industry, which in 2006 generated $3.5B in gross revenue, employed 240,000 Filipinos (Sañez 2007) and accounted for 95% of the new jobs created within the information and communication technology sector (Kinnear 2006, 2). As shown in the exhibit below, the Philippine BPO industry has more than doubled between 2004 and 2006 and is projected to exceed $12B in 2010,

---

[7] Orr, James F., interview by CNBC reporter, CNBC, Jan 24, 2007.

of which approximately 25% will be comprised by contact center services.

Revenues	2004	2005	2006				2010
Customer Care	1,024	1,792	2,680				5,296
Back Office	120	180	288				2,392
Medical Transcription	42	70	98				1,708
Legal Transcription	4	6	9				36
Other Data Trans	26	39	52				169
Animation	52	74	97				759
SW Devt (Export)	170	204	272				1,275
Engineering Design	34	48	68				357
Digital Content	3	7	13				208
Revenues $ Million	$1,474	$ 2,419	$ 3,457				$ 12,199

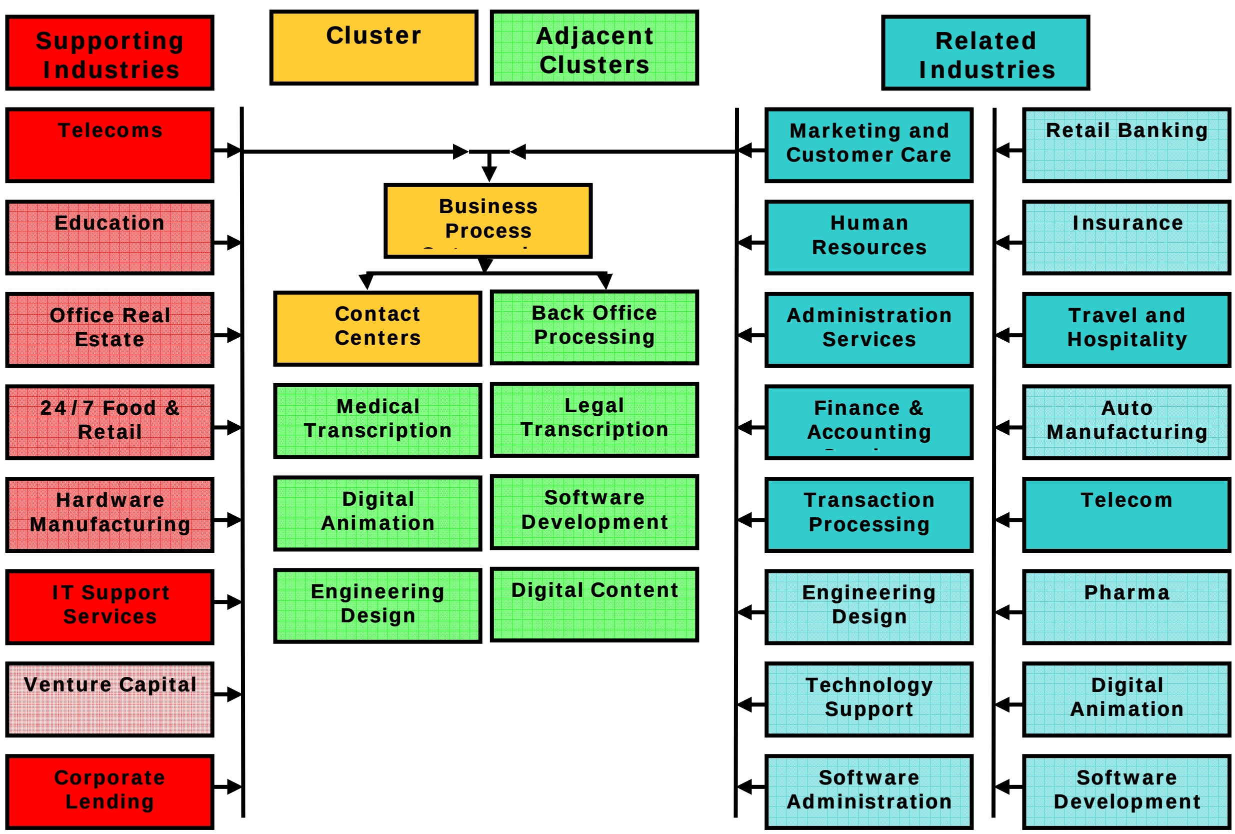
Source: Philippine Board of Investments, CITC, and Business Processing Association of the Philippines

Exhibit 7: Philippine BPO Industry

The Contact Center cluster is also considered the “sunshine industry” of the Philippines where graduates from many universities compete for entry-level positions with the industry’s most prestigious firms. For example, the most sought after contact center companies only hire 2-3% of applicants. Successful managers can earn close to western-level salaries, providing them with a high quality of life given the low cost structure of the country. In addition, it is estimated that every new job at a contact center company creates an additional three to four jobs in the form of local services (e.g., restaurants) and hired help at home. Therefore, although the cluster currently representing a relatively small percentage of exports and GDP, it provides tangential benefits across the economy.

Contact Center Cluster Map

While analyzing the cluster map, it is important to bear in mind that the contact center cluster shares many characteristics and links with adjacent clusters like (a) back office processing, (b) medical transcription, (c) legal transcription, (d) digital animation production, (e) software development, and (f) engineering design; these make up the remainder of the local BPO industry (Sañez 2007). In the Philippines, these clusters emerged and expanded together following the decision of many firms in developed countries, like the US, to increase their competitiveness by outsourcing parts of their business operations. These clusters all depend on a highly educated workforce with a strong customer service orientation, a reliable and cost-effective telecommunications system, and technically up-to-date information technology support, in order to satisfy the needs of their offshore customers.



Note: Color intensity indicates relative stage of development

Exhibit 8: Cluster Map

Of the supporting industries, the local telecommunications, education, and IT support services cluster are particularly important in keeping the Philippine Contact Center cluster competitive in the world market. Other supporting industries like office real estate, corporate lending, and 24-hour services in food, public transportation, and retail are also vital for the cluster to function properly at competitive rates.

The cluster requires an adequate supply of highly-educated agents and managers trained in industry- and function-specific skills. Therefore, having local industries with business processes and practices that match those in developed countries ("Related Industries" on the cluster map) is critical to create a well-trained labor pool that understands the work requirements of end-customers from other countries.

Diamond Analysis

The next section examines each component of the cluster diamond, highlighting the key strengths and challenges.

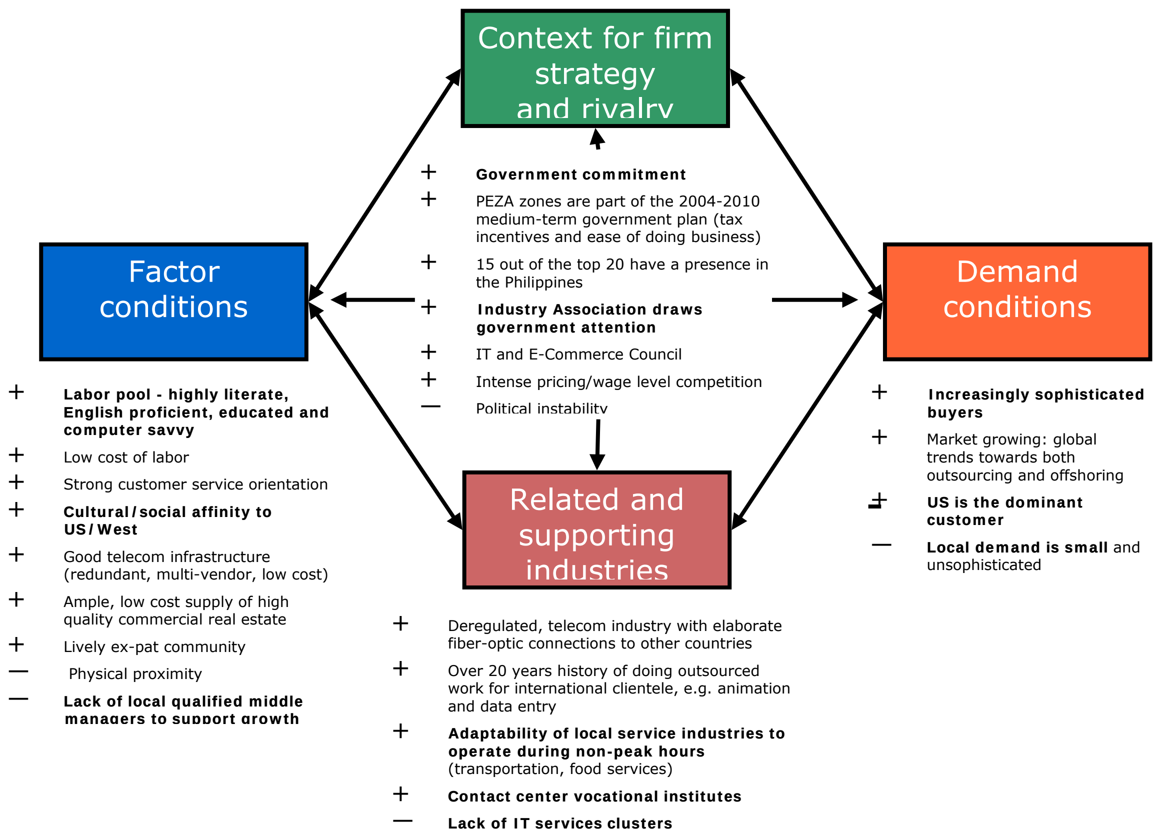


Exhibit 9: Cluster Diamond

Factor Conditions

The availability of a large, low-cost labor pool that is young, highly literate, and Englishproficient is perhaps the biggest attraction for most contact center companies setting up operations in the Philippines (Aquino, 2006). Since Filipinos have a strong customer service orientation, a close affinity to the United States and an ability to mimic accents of customers in other countries, the Philippines is able to distinguish itself from many of its competitors.

This labor pool ic complemented by multi-vendor telecommunications infrastructure with redundant capabilities that allows for low-cost and reliable transfer of voice and data. Since local demand for telecommunication services has been strong and lucrative, many local telecom companies have entered the market and invested in infrastructure and systems. This has kept voice and data transfer costs low and extremely competitive in the world market.

However, there are several challenges for the cluster in terms of factor conditions that should be addressed to enhance the cluster's competitiveness. These include:

Key Challenges – Factor Conditions

- The lack of experienced local managers, ready to take over middle and senior management positions currently occupied by expatriates, creates a bottleneck for rapid growth. The biggest deterrent for most qualified managers is the graveyard shift, when the bulk of contact center operations occur.
- Some "overheating" in Manila, the city where most of the investments in contact center operations have been made in recent years (Madlansacay, 2005)
- The distance to the US (between 7,000 and 10,000 miles) where over 90% of customers are based, presents challenges to maintaining operational oversight in the Philippines

Much of the dramatic growth in the cluster has taken place in Manila, the country's capital, and the surrounding metropolitan area. As a result, increased competition over available office real estate and human capital has led to modest wage and cost appreciation. In addition, labor attrition rates exceeded 30% in 2005 as many employees switched between firms in an attempt to accelerate career progression. This has therefore increased total labor costs (both wages and training) in Manila and posed a threat to previously strong operating margins (Ibid).

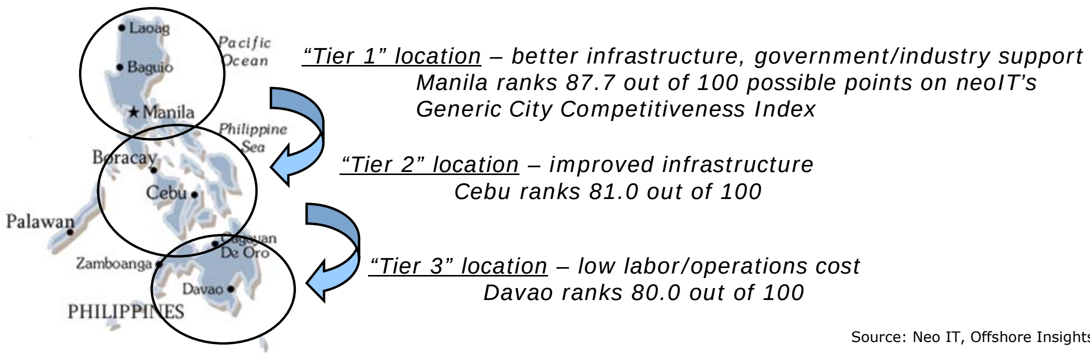


Exhibit 10: Contact Center Locations in the Philippines

However, the government, has started to invest in the "Cyberservices Corridor" – a zone that stretches 600 miles, served by a $10B high-bond with Profiber backbone and digital network – which is expected to create the same quality of information and communication technology infrastructure available in Manila in other cities like Cebu and Davao in the south and Baguio in the north (Kinnear 2006, 2).

Supporting and Related Industries

Supporting industries for the Contact Center cluster, at least in Manila, are quite strong. As mentioned above, liberalization of the telecom industry has pushed telecommunications costs down to very competitive rates. An number of for-profit training centers have been launched by local entrepreneurs to provide the available talent pool with skills specific to the contact center industry. In addition, many local businesses such as restaurants, retailers, and transportation providers have extended their operating hours to serve the unique needs of contact center agents, many of whom work graveyard shifts.

Nevertheless, there are still challenges for the supporting and related industries.

Key Challenges – Supporting and Related Industries

- In Tier 2 and Tier 3 cities such as Cebu, Davao, and Baguio, industry-specific training centers are in their infancy, high quality office real estate is inadequate and robust 24/7 operations of retail centers are lacking
- Limited local presence of industries that are avid consumers of contact center services (e.g., financial services) constrains the industry-specific capabilities that cluster firms can develop

As shown in Exhibit 11, Philippine contact center hubs score low on industry-specific metrics relative to Indian contact center hubs (Sharma, 2006). This limited local expertise may cause Philippine firms to lose large contracts in the future, as companies start to look beyond costs and seek out industry-specific expertise.

Industry Rank (1=low, 5=high)	Manila	Cebu	Davao	Clark	Bangalore	Delhi
Financial Services	3	2	3	2	4	5
Retail	2	2	2	2	5	2
Healthcare	2	2	2	2	2	3
High-Tech	2	4	4	4	5	4

Source:NEO IT, Offshore insights

Exhibit 11: Ranking of Locations based on industry-specific BPO capabilities

Context for Firm Strategy and Rivalry

The Philippine context for firm strategy and rivalry is favorable for the cluster. In addition to identifying the BPO industry as a high-priority investment sector for the Philippines and providing financial incentives for local and foreign investors through the programs of the Board of Investment and the Philippine Economic Zone Authority, the government has also implemented the following initiatives (SGV Industry Bulletin, 2006):

a. Developing IT business parks: "ready-to-occupy" locations for contact center investors

b. Passing the E-Commerce Law and the Data Privacy Law & Securities Guidelines

c. Investing in infrastructure through the Cyberservices Corridor program

d. Forming the Commission on Information and Communication Technology and appointing it as the "lead government agency in promoting, developing, and regulating the information and communication technology". The commission has responsibility for building local know-how and expertise through education and specialized training, fostering the growth of ICT industries in the country, and promoting the right legal and regulatory framework for firms

In addition to these government actions, private players have been actively involved in efforts to coordinate their actions and promote the overall growth of the industry. Currently, the interests of contact center companies are voiced through an industry association, the Business Processing Association of the Philippines. For example, the Association partnered with the government to create a scholarship fund to enable "near-hires" to go to vocational centers and learn skills that will make them more employable. Additionally, the Association commissioned a 2005-2010 roadmap and, with the help of McKinsey, is identifying the key opportunities and challenges for the industry moving forward. Finally, the Association is also taking the lead in the marketing the Philippines to other customer countries outside the United States.[8]

Despite this favorable context for strategy and rivalry, there are some key challenges that need to be addressed to enhance the cluster's competitiveness.

Key Challenges – Context for Firm Strategy and Rivalry

- Ensuring that the industry association will be effective in fostering healthy competition within the right regulatory environment

[8] Business Processing Association of the Philippines, www.bpap.org

- Overcoming the bureaucracy problems that plague the entire country and raise the costs of doing business in the Philippines
- Creating an effective feedback loop that would allow local firms to benchmark themselves against their competitors in other offshore locations such as China and India

Demand Conditions

Demand conditions are not strong or on a positive trajectory. Typically, nations can gain competitive advantage when local demand helps local companies anticipate the future needs of customers (Porter 1998, 174). However, like many export-driven clusters, local demand for contact center services is marginal, as over 90% of the work in the cluster serves US-based customers. When competing against other outsourcing locations, that also lack local demand, this may not be a concern; however, the Philippines also needs to draw business away from in-house contact centers. Therefore, as the cluster aims to establish itself as a location-of-choice for offshore contact center services, it should leverage its close ties and affinity to the United States. A strong partnership and continuous dialogue could allow the cluster to benefit from the sophisticated demand conditions that exist in the United States.

In addition, the majority of services provided are relatively simple in nature; this prevents the Philippines from exploiting what many experts believe to be an intrinsic manpower advantage in complex services that require a high degree of quality and customer service (Kinnear 2006, 2).

Key Challenges – Demand Conditions

- Compensating for weak local demand for contact center services by developing an understanding of demand conditions through relationships with foreign companies

V. Recommendations

There are many "up and coming" contact center locations around the world, countries that have seen the success of India and the Philippines and hope to capture a portion of the market by offering lower cost services. While the Philippines has already gained a strong foothold in contact center outsourcing, the cluster will need to take some short-term and long-term steps in order to maintain and enhance its competitive position.

As mentioned in the diamond analysis, the main area for concern is demand conditions. Since local demand for these services is marginal and unlikely to expand in the near-term, the cluster should focus on strengthening relationships with customers to better understand the external demand conditions. To compensate for the lack of local demand, the cluster should adopt the standards of their sophisticated target markets, and also partner with blue chip companies from these markets, in collaborative industry association efforts.

In the short-term, the cluster must strive to stay ahead of competing countries by building on factor condition strengths and increasing its attractiveness to foreign firms. Specifically, in the short-term, the cluster should work to **establish Tier 2 and Tier 3 locations** to offer alternatives to the "heated" Manila market. Additionally, the cluster should try to make the Philippines a more attractive location for foreign firms by **increasing the ease of doing business** and **improving the quality of service**. In the long term, the cluster should fuel further expansion by **moving up the value chain** and protect its competitive position and better serve foreign demand **by providing more specialized, industry-specific offerings**.

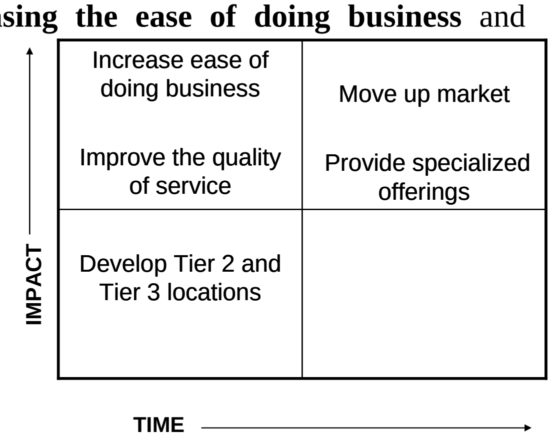


Exhibit 12: Recommendations Matrix

Short-Term Recommendations

I. Develop Tier 2 and Tier 3 locations

Currently, the Philippines Contact Center cluster is largely focused in Manila. Manila has good infrastructure and a great supply of talent given that there are many universities in the region. Local businesses now provide off-peak services to support contact center employees who work during nighttime hours and adapt to their schedules (e.g., nighttime public transportation, 6 a.m. "Happy Hour"). However, labor costs have been rising and real estate availability has been declining in the Metro-Manila area. In order to continue to attract large customers and capitalize on the growth of the cluster, the Philippines will need to develop Tier 2 and Tier 3 locations. These locations have less developed infrastructure and a smaller supply of experienced middle management, but should provide labor and other operating cost advantages. The actions necessary for developing these cities into top-tier locations are detailed below.

Government	**Firms and Industry Association**
- Continue the rollout of the Cyberservices Corridor, improving the physical and telecommunications infrastructure in select cities both in the north and south of Manila. - Strengthen English-proficiency training at the secondary school level in these cities - Create PEZA zones (IT business parks) within these Tier 2 and Tier 3 cities - Foster an attractive investment environment not just for contact center companies but for supporting industries as well - Promote public safety especially during the odd hours of 10pm-6am in these cities	- Build an industry association chapter specific to cities outside Manila, that will champion these locations as alternative centers in international marketing efforts of the cluster - Fund the training of near-hires who marginally miss employment requirements, so that they can enter the labor pool through specialized training courses - Identify priority cities for contact center cluster development to spur investment by local real estate firms -Provide support for Tier 2 and 3 off-peak services to demonstrate viability

II. Increase Ease of Doing Business

The country and cluster analyses suggest that inefficiencies in the current registration process and incidences of corruption make it challenging for firms to conduct business in the Philippines. While this directly impacts the Contact Center cluster, which requires a great deal of foreign investment, it also affects the broader economy. There are some short-term steps that the government and cluster participants can take to ameliorate this process and ensure that the Philippines makes it onto the "short list" of desirable contact center locations.

Government	**Firms and Industry Association**
-Reduce cost of doing business by reducing permit bureaucracy and regulatory uncertainty -Enforce anti-corruption laws -Implement consistent tax structure/incentives for foreign organizations -Create "one-stop-setup-shop" bureau for foreign organizations	-Work with government to consolidate BOI, PEZA and Council for IT to create one point of contact for industry -Advocate for standardization of certification requirements

III. Improve the quality of services provided

The cluster has built its reputation on a strong customer service foundation. To become even more competitive versus alternative locations, the cluster should constantly focus on improving the quality of service by introducing more advanced training and monitoring cluster performance to identify potential areas for concern. Achieving superior performance metrics, coupled with existing factor conditions, will help prepare the cluster for the next stage of its development.

Government	**Firms and Industry Association**
-Institutionalize development of targeted IT and English skills through secondary-level curriculum changes -Provide government certification for high quality services -Encourage technology diffusion by utilizing latest technology in government operations and schools	-Collaborate with educational institutions to provide BPO-focused management training programs -Work more closely with vocational institutes to expand contact-center specific training programs and specialized certification programs -Compile detailed industry data and

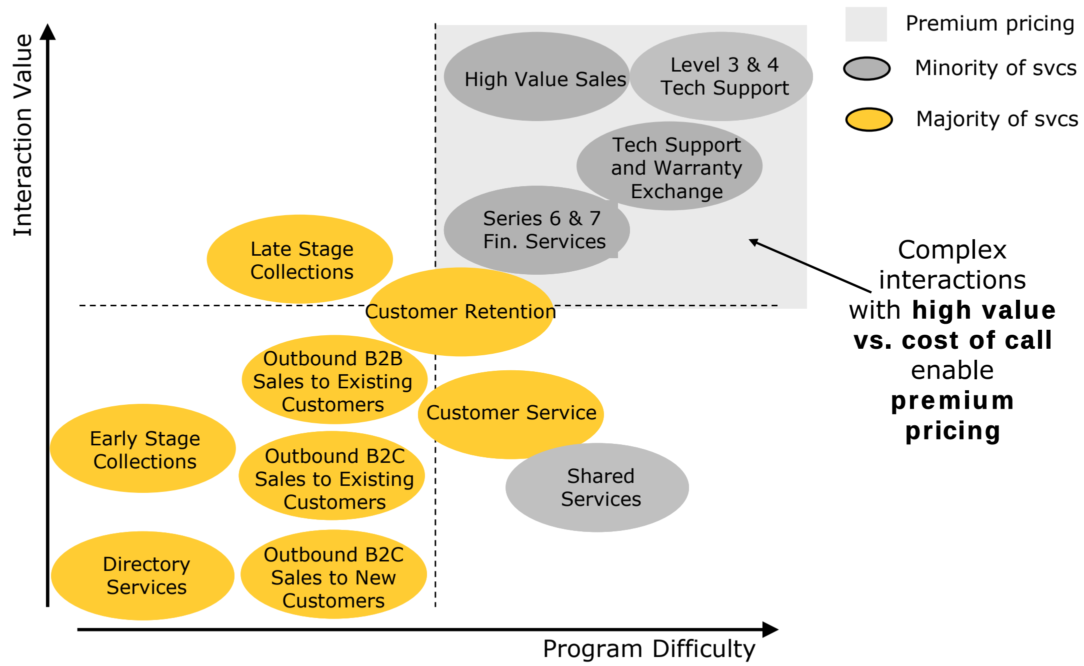
	identify relevant metrics to monitor firm performance -Invest in adjacent clusters such as IT, Telecom and Real Estate

Long-term Recommendations

IV. Move up-market

The majority of contact center services performed in the Philippines have relatively low levels of difficulty and interaction. Moving up-market to perform more complex services would allow cluster participants to charge higher prices and maintain higher margins, thus expanding the potential market for the Philippines. By leveraging existing customer relationships, firms will be able to increase their value-add, thereby mitigating competitive pressures from new low cost contact center locations. Additionally, this should create challenging and exciting career development opportunities to attract and retain top talent. The Philippines also has an opportunity to compensate for a lack of local demand conditions by including US-based consumers in industry association discussions regarding this addition of services.

Government	**Firms and Industry Association**
-Allocate funding for specialized IT training -Fund industry research organization to promote innovation -Provide tax incentives for R&D -Combat “brain drain” through encouragement of high-value service sector serving international markets	-Evaluate current trends in order to develop an industry roadmap that will guide the decisions of cluster participants -Set up offices in the US and other target markets to collectively market the Philippines contact center industry -Continue assessing cluster needs and communicating with the government to obtain resources - Include customer companies in industry association discussions



Source: The Calgary Group

Exhibit 13: Services Currently Offered and Recommended Services

V. Provide specialized, industry-specific offerings

According to an industry report, "As global offshoring becomes commonplace, the generic factors are becoming more "hygiene" in nature, whereas the enterprise-specific level factors are becoming the true decision drivers." (Sharma 2005, 10) As mentioned earlier, enterprise-specific factors relate to industry and company-specific suitability. Therefore, in the longer-term, industry-specific offerings can help attract firms to the Philippines and should also increase the stickiness of this investment. As the Philippines cluster participants develop expertise in specific industry verticals, these customer relationships will transition towards more of a collaborative partnership rather than just a contract outsourcing relationship. This will make it more difficult for foreign firms to switch providers.

Government	**Firms and Industry Association**
-Ensure that local standards in related industries match international standards	-Identify the most important contact center growth areas and focus on attracting

-Collect industry-wide data to identify areas in need of improvement	customers in these specific industries to develop expertise in those verticals -Leverage existing industries and capabilities to become premier destination for specialized services -Ensure that local standards in related industries match US-based standards (e.g. customer service norms)

VI. Conclusion

Our outlook for the Philippines Contact Center cluster is quite strong. While there are many challenges facing this young cluster, we believe that it can leverage many of the deeply rooted historical and cultural strengths of the Philippines. An analysis of the cluster diamond suggests that the cluster already has a strong foundation. While local demand is lacking, the cluster can counteract this by building relationships with customers and engaging them in a collaborative process with government, firms and the industry association. We are confident that continued collaboration will position the cluster for future long-term success.

Sources

Aquino, Liezl. "Business process outsourcing brings in big bucks, creates new jobs", Business World Special Report, June 2005

Asian Development Bank. *Asian Development Outlook 2005*. http://www.adb.org/Economics/.

Asian Development Bank. *Asian Development Outlook 2007*. http://www.adb.org/Economics/

Asian Development Bank (2005). *Asian Development Review: Total Factor Productivity Growth in the Philippines: 1960-2000, P.97.*

Asian Development Bank. *Country Economic Review- Philippines 2004.* http://www.adb.org/Documents/CERs/PHI/default.asp

Asian Development Bank (2005). *Improving the Investment Climate in the Philippines,* http://www.asiandevbank.org/Statistics/ics/pdf/PHI-Full-Report.pdf.

Central Intelligence Agency. *The World Factbook 2007.* https://www.cia.gov/cia/publications/factbook/, accessed February, April 2007.

Chakrabarty, Sujit K., Prashant Gandhi and Noshir Kaka. "The untapped market for offshore services." *The McKinsey Quarterly*, no. 2, 2006, http://www.mckinseyquarterly.com, accessed February 2007.

"CICT Presentation." BPA/P General Membership Assembly, February 26, 2007, http://www.bpap.org/bpap/research/CICT_presentation.pdf, accessed March 2007.

Datamonitor. *The Future of Contact Center Outsourcing in India and the Philippines*, February 2005.

Economist Intelligence Unit. *Philippines*, January 2007, via Baker Library EIU.com database, accessed February 2007.

Employers Confederation of the Philippines. *ECOP opposes P125 across the board daily wage increase, accessed May 2007.* http://www.ecop.org.ph/news.php?id=25

Frost and Sullivan. *Strategic Assessment of the Philippines Contact Center Market*, 2005, http://www.frost.com, accessed February 2007.

Financial Time. *Philippines to boost infrastructure spending, February 20, 2007.*

IMF (International Monetary Fund) (1998). *Migration Memorandum of Economic and Financial Policies of the Philippines.* http://www.imf.org/external/np/loi/031198.htm

IMF (International Monetary Fund) (2005). *Migration and Foreign Remittances in the Philippines,* WP/05/11.

IMF (International Monetary Fund) (2007). *Philippines: Selected Issues. IMF Country* Report, No. 07/131, March 2007.

"In a Global Economy, Competition Among BPO Rivals Heats Up," *Knowledge @ Wharton,* http://knowledge.wharton.upenn.edu/100902_ss5.html, accessed March 2007.

Jefferies Broadview. "Business Process Outsourcing (BPO) Market Perspectives," June 2006.

Kinnear, David. "From 1989 to the Present: A Story of BPO in the Philippines," *FS Outsourcing*, Nov 2005-Jan 2006, http://www.bpap.org/bpap/research/DDC_HRO-BPO_in_the_Philippines.pdf, accessed March 2007.

Koning, David J. and Eric S. Schlipf. "Business Services: Contact Center Outsourcing," *Baird*, March 22, 2006.

Madlansacay, Cef M., N Roshan and Sabyasachi Satpathy. "Research Summary: Outsourcing to The Philippines : Metro Manila and Beyond," Offshore Insights Market Report Series Volume 3, Issue 9, October 2005, http://www.bpap.org/bpap/research/ 110705.pdf, accessed March 2007.

Mikhalev, Peter. Interview by Achi Yaffe. via Phone, February 22, 2007.

Mikhalev, Peter. Interview by Achi Yaffe. via Phone, March 14, 2007.

Mikhalev, Peter. Interview by Achi Yaffe. via Phone, April 2, 2007.

Monthly Review. *Monthly Review* Volume 51, Number 7,accessed April 2007. http://www.monthlyreview.org/1299scip.htm

National Economic and Development Authority. *Economic Indicator Online* accessed February 2007. http://localweb.neda.gov.ph/~ioneda/

National Economic and Development Authority (NEDA). *Medium-Term Philippine Development Plan 2004-2010*.

National Wages and Production Commission. *Current Regional Daily Minimum Wage Rates.* http://www.nwpc.dole.gov.ph/right.html

"Networked Readiness Index 2005," *Forbes,* March 9, 2005, http://www.forbes.com/ technology/2005/03/09/cx_0309wefranking.html, accessed March 2007.

Orr, James F., interview by CNBC reporter, *CNBC,* Jan 24, 2007.

Penny, Chris and Michael McCormack. "Technology, Media & Telecom: Enterprise Services," *Friedman Billings Ramsey*, June 14, 2006.

Philippine Business.com *Merchandise imports grows 5.3% in dollar terms, drops 1.9% in peso equivalent, accessed April 2007.* http://www.philippinebusiness.com.ph/news_updates/trade.htm

Philippines National Statistics Office. *Index of Price/Inflation Statistics*, accessed April 2007. http://www.census.gov.ph/data/sectordata/datacpi.html

Porter, Michael. *On Competition*. Boston, MA: Harvard Business School Publishing, 1998.

Sañez, Oscar. "Driving Breakthrough Growth in BPO/IT –Services" BPA/P, February 26, 2007, http://www.bpap.org/bpap/research/SanezBPAPgoals.pdf, accessed March 2007.

SGV & Co., Industry Bulletin: Business Process Outsourcing Edition, August 2006

Sharma, Abhishek, Pareekh Jain and Sabyasachi Satpathy. "Research Summary: Global City Competitiveness." Offshore Insights 4:8 (October 2006), www.neoit.com, accessed February 2007.

Transparency International. *Transparency International Annual report 2006*, http://www.transparency.org/publications/publications/ar_2006

The Heritage Foundation and The Wall Street Journal. *Index of Economic Freedom*, http://www.heritage.org/index/, accessed February 2007

The Nations. *Philippines' reliance on foreign remittances carries significant costs*, accessed April 2007. http://nationmultimedia.com/2007/05/01/opinion/opinion_30033088.php

United Nations Development Program. Human *Development Report 2006.* http://hdr.undp.org/hdr2006/statistics/

Vashistha, Atul, Avinash Vashistha and Eugene Kublanov. *"Research Summary: Global ITO and BPO Trends in 2006." Offshore Insights 3: 11* (December 2005), www.neoit.com, accessed February 2007.

World Bank. *World Development Indicators*, via Baker Library WDI online database, accessed February, April 2007.

World Economic Forum. *Global Competitiveness Report 2006-2007,* Palgrave Macmillan.