China Observer

# The Strategic Perspective April 2005

## From the desk of Bill Lewis, Editor, China Observer

**Press Release: February 28, 2007. 1200hrs:**

"In the New York Headquarters of American Banking Corporation a deal was signed today between the Corporation's Commercial Banking Division and Guangsheng Software Company of Beijing. Guangsheng will provide their Software On Demand Retail Banking solution for use across American Banking Corporation's North American network of retail branches.

In citing the reasons for using Guangsheng and the On Demand Model an American Banking Corporation spokesman said that after extensive trials and reviews of functionality – which met the Bank's stringent requirements – the final decision was down to cost. Guangsheng can deliver the solution to us that undercut all other competing products by a factor of 60 percent.

Guangsheng Retail Banking Development Center's extensive experience and presence in the Chinese and Asian Financial and Banking Sectors and their competitive cost position driven by their China cost base allows the Bank to make massive savings which we can pass to our customers and shareholders.

The On Demand Solution will be delivered by secure satellite links from the massive 8000 person Guangsheng Data Center in Chengdu, China, to the Bank's new network distribution facility in Arizona and then to the Bank's 1400 Branches and 21,000 users." (1)

In the current edition of China Observer a compelling case for the On Demand Software model articulated and discussed (2). The case for China's adoption of this software delivery model as the de facto standard is also forcefully made by Dr Timothy Chou.

We believe that the pace at which China adopts the On Demand model could have a dramatic impact for the Global Software industry. The pace will be influenced by both the efficiency of infrastructure and the willingness of China companies to transfer the perceived "ownership" of applications and data to a trusted third party. Indications that this shift is underway, albeit slowly, is evidenced by recent major Outsourcing Deals, an example of which is the Bank of Shanghai's Application Center Outsourcing to HP (3) .

The costs associated with software delivery, implementation, and use are found on both the supply side and the demand side (i.e. the software vendor, and the software user). The traditional software supply chain is arguably inefficient and the On Demand model seeks to redress this.

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1 Is this a draft of a Press release that could be real in, or is it a "spoof"?
2 See Timothy Chou's Strategy Paper "China and Software On Demand"
3 Announced in February 2005 – see Interview with William Poon, HP China, in this edition of China Observer.

In the On Demand Model software becomes a service that is bought and paid for – on a transaction basis, time basis or by a similar formula. The responsibility for the whole of the software supply chain rests with the Software Service provider. The costs incurred by software service provider include research and development, design, build, test, install, support, application maintenance, and delivery. In the On Demand model all of these processes are brought “in house” by the Software Service vendor. The user accesses the Software Application and uses the associated Technology Enabled Business Processes to conduct business. None of the traditional costs of software acquisition and a corporate burgeoning IT department are incurred. On the supply side, the Software Service provider seeks to lower costs by “scale efficiencies” and unified operational processes.

Let us assume that a major Chinese software company decides to offer Enterprise Class Software via an On Demand model. Two economic dynamics come into play – the costs of Production, and Margin arbitrage. Costs of production include labor, buildings, overheads, hardware, networks, etc – all of these costs are markedly lower in China than elsewhere. Software Engineers cost around US$1.60 per hour (and are being delivered to the market in increasing numbers by China’s Universities(4)); Property, Hardware and Networking costs are comparably lower than elsewhere. Thus the cost of design, supply and delivery of an Application On Demand in China is a fraction of that which is incurred in other parts of the world.

Now consider the vast Chinese domestic market for software – in 2004 this market was valued at US$25bn and growing at 38 per cent pa – and consider the Chinese business thinking which trades margin today for market share and long term volume growth. The Chinese business will operate on wafer thin margin capturing volume and long term market position. We could see very low margins being sought in the On Demand Pricing Model as Software vendors seek to capture the lion’s share of this largely untapped market. But it is not only the Chinese domestic market that is critical in this scenario. Global communications allow software to be delivered from anywhere to anywhere.

In his book, China Inc, Ted Fishman(5)argues that “China Price” has entered the lexicon of Procurement Specialists across the industrialized world. Today, North American and European Manufacturers are being forced to match the prices of their China competitors or loose contracts.

How soon will the “China Price” be the benchmark for delivery of On Demand Software across the globe?

**Recommendation:**

**CEO’s of all software businesses should seriously consider both the future provision of On Demand Applications and the sourcing of an On Demand Service in China to service both the China domestic market and the global market.**

**CEO’s of Service and Manufacturing businesses should maintain a watching brief on the On Demand Software model and the sourcing of such services from Chinese suppliers and Global suppliers located in China.**

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4 In 2005, over 220,000 English speaking computer science graduates will leave Chinese Universities, future years will see this number increasing.
5 China Inc by Ted C Fishman; published 2005

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