Palestinian Market
Development Programme

MNEs outsourcing to Palestinians

Market System Analysis

EXECUTIVE SUMMARY

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1. Executive Summary

1.1 Introduction

In order to promote broader based economic growth in the occupied Palestinian territories (oPt), the Palestinian Market Development Programme (PMDP) analyses specific market systems from within the broader target sectors with strong potential for growth. This study on the multinational enterprises (MNEs) solutions outsourcing sector is designed to highlight the potential for growth and the binding constraints to that growth along with the underlying causes of these constraints. With properly coordinated support to address the constraints, we estimate that the MNE segment can double in size in the next three years and quadruple in five years.

1.2 Background of the MNEs Outsourcing Sector

MNEs solutions outsourcing has a global market of about $480 billion relying on software programmers around the world to design software solutions to address corporate business problems, write and test the code, integrate it, and roll it out.

The MNEs solutions outsourcing industry in the oPt is a subset of the overall Information and Communication Technology (ICT) sub-sector. Comprised of 10-12 software development companies out of a total of more than 100 firms involved in software product development, it accounts for around $15-20 million in sales per annum and employs 400-500 software engineers. While the oldest firms in the sector were founded as long as 15 years ago, growth in the MNEs outsourcing segment expanded only after 2008 with support from a program initiated by Cisco. The sector has been growing steadily since 2009. In 2014, the industry is comprised of a combination of home-grown Palestinian firms, which contract directly with MNEs and offshore companies (subsidiaries of Palestinian-owned firms based in other countries), which started to grow in 2009. The offshore companies, which sell their services primarily through their parent companies, have been growing more rapidly.

1.3 The services provided by the oPt to the MNEs Solutions Market System

The Palestinian ICT solutions firms provide three main types of services to the global industry:

- **Team augmentation:** is an outsourcing strategy which is used to staff a project and respond to business objectives, and providing staff to expand teams for companies. This segment represents 40-45% of the total outsourcing in the oPt.);
- **Unit software coding and testing product delivery:** Providing contract services for quality assurance (QA) for programs developed elsewhere. This segment represents 40-45% of the business; and
- **End-to-end product development:** Engaging with the end-user and providing the full range of functions to develop the ICT solution, representing 10-20% of the business.

Close analysis reveals that Palestinian firms predominantly provide services in unit coding and testing, which are the lowest value services in the MNEs solutions value chain. They have little actual engagement with end-users and are dependent on larger software companies to contract them.

1.4 The Market

Currently, local Palestinian firms work primarily with Israeli-based branches of multinational firms for software development. They compete mainly with other providers from India and China, which are able to offer a broader range of services at a lower cost than Palestinian firms. In contrast, offshore companies work with their parent companies as part of the broader parent company strategy.

1.5 Constraining Factors

The factors constraining the growth of Palestinian ICT services to MNEs include constraints at the supply side, the demand side and the broader enabling environment.

1.5.1 Supply Side Constraints

Three main sets of supply side constraints hold back the local ICT sector:

1. There is a limited supply of qualified engineers who are able to meet international standards. While the Palestinian education system provides more than 1,600 ICT graduates per year, they are under-qualified;
2. Palestinian firms have limited market information about potential clients and low access to MNEs; and
3. The overall capacity of the existing ICT firms is weak:
   - Limited mid-high level management and project management skills;
   - Limited ability to manage a full project (Project Management Professional, PMP);
   - High staff attrition and mobility of engineers;
   - Weak marketing skills and ability to speak the international and ICT business language; and
   - Small size and inability to reach scale.

1.5.2 Demand Side Constraints

1. Limited awareness of the oPt as an outsourcing destination: oPt is not known as an outsourcing destination, and many MNEs are not aware of the capabilities and advantages of local ICT firms;;
2. Many of the MNEs that are aware of the oPt as a possible outsourcing destination have a poor perception of the Palestinian supply, including:
   - Few qualified Palestinian engineers; and
   - High political risk of working in the oPt; and
3. Decisions to outsource to the oPt have been largely made from a Corporate Social Responsibility (CSR) perspective rather than from a business perspective. The fact that the focus remains on CSR perspective has a negative impact on getting into the mainstream business and building long-term cooperative agreements.

1.5.3 Broader Enabling Environment Constraints

In addition to the supply and demand side constraints, the oPt suffers from many broader enabling environment issues:

- Difficulty in movement and ability to access the oPt and Israel;
- Weak broadband infrastructure;
- Government policies and support to education not focused on the market demand requirement;
- Weak set of supporting business service providers (BSPs); and
- Outdated intellectual property rights (IPR)/legal protection laws (primarily for content development).

1.6 Past and Current Support to the Sector

The support from Cisco, initiated in 2008, helped jumpstart the Palestinian ICT sector. Since then, there has been substantial external support to the sector. There is a strong interest from many fronts to increase the oPt's ICT outsourcing sector. There are currently four different strategies on the table by the Palestinian Information Technology Association of Companies (PITA), the Office of the Quartet's Representative (OQR) Economic Initiative for Palestine (EIP), the Portland Trust's Beyond Aid, and the Palestine Trade Centre (Paltrade) and the Ministry of National Economy's (MoNE) National Export Strategy (NES)/ICT. Meanwhile, there are a number of donor programs (including Mercy Corps, the United States Agency for International Development (USAID) Compete Project, and others) with their own supporting activities, which are not necessarily linked to the broader strategies.

In the past six years, millions of dollars have been poured into the sector from abroad. While there has been strong engagement from the Palestinian private sector, the reliance on external support has undermined the development of strong market-based systems to promote long-term sustainable growth of the sector.

1.7 PMDP Conclusions and Recommendations

The ICT MNEs outsourcing sector offers a realistic potential to double in size in the next three years to 800-1,000 engineers and $30-40 million in sales by adding new products and capturing higher value functions in the value chain. If many of the key systemic issues are resolved, the sector should be able to double again within five years to 2,000 engineers and $80 million in sales.

Building a dynamic, Palestinian-driven outsourcing sector requires moving beyond CSR. It necessitates serious development at the different levels of the value chain. Interventions by and interactions between the stakeholders and donors in cooperation with the supply side, the demand side, academia, and support institutions are needed to bridge the gap and eliminate the binding constraints. In order to achieve this goal Stakeholders, donors, and other partners need to implement actions in both the short and the long term through consistent policies and programs.

1.7.1 Improved Coordination for Systemic Transformation

Given the many strategies sponsored by different donors, the relatively thin market for supporting services, and the limited absorptive capacity, a more coordinated approach will prevent wasting investment. An ICT Advisory Forum (ICTAF), or working group/task force, can bring together the different stakeholders, including donors, international entities, and the local public and private sectors concerned with the Palestinian ICT sector along with the various initiatives implemented by the partners to share information and coordinate efforts.

1.7.2 Qualified Engineers and Mid-Level Management

There is a need for both an immediate, short-term response to the demand from ICT outsourcing companies and a long-term transformation of the ICT education system. Both sets of initiatives (short- and long-term) will develop a supply of highly qualified engineers to meet the job market needs and allow for scaling of the segment. These initiatives (short- and long-term) will provide local ICT firms with the required by MNEs pool of engineers to support the current and new projects, while reducing the turnover between local ICT firms.

1.7.3 Attracting Palestinian Diaspora to Open Offshore Offices

A targeted initiative focusing on attracting the Palestinian Diaspora to open offshore offices for their ICT international firms (US, Canadian, German, Saudi Arabian, and from the United Arab Emirates) in the oPt is likely to be an effective approach to expanding the total sales and exports of the sector. This may be achieved through concentrated efforts from the Palestine Investment Promotion Agency (PIPA), PalTrade, PITA, and others tying into diaspora networks.

1.7.4 Improved Access to Market

Improving Palestinian firms' ability to access markets requires a combination of efforts, including:

- Improving export marketing skills;
- Improving strategic approaches to the market;
- Facilitating MNEs' access to Palestinian firms; and
- Opening additional markets.

1.7.5 Policies, Regulations, and Enabling Environment

Many of the items in the list of policy and business enabling environment constraints are beyond the control of the oPt, but they need to be addressed realistically by the Palestinian Authority.