

A Sense of Perspective: Indian Service Providers – Has the Share Market Gotten Out-of-Hand?

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KEY POINTS

- Offshore services provision has been a significant driver of change for the enablement of IT and process-related services and this will continue.
- Often the drive to offshore is for more than cost savings, it also increases access to resources and quality trained labor pools.
- Indian providers have been at the forefront of this drive to cost savings and offshore delivery, which Springboard Research expects to continue.
- Due to hyper-inflated market capitalization rates and tightly held share registers, the largest Indian providers cannot rationally be acquired, but can acquire. Perhaps only HP and IBM are theoretically safe.
 - To highlight this extreme bubble, the stock market currently values one dollar of revenue at T.C.S as worth 32.8 times more than one dollar of Fujitsu revenue. It also values \$1 of revenue at Infosys at 17.3 times more “valuable” than \$1 dollar of CSC revenue.
 - As a result, the possibility for mergers is obvious and immediate.
 - Acquisition opportunities for traditional services providers exist with smaller tier 2 and 3 providers who have lower profiles and tend to be listed on the Indian and smaller trading boards.
- Automation of technology will have profound outcomes for all services providers and force them to radically change their delivery and human resource strategies. This clearly includes the future legacy offshore providers.

INTRODUCTION

This Springboard Research document presents an analysis of the leading global delivery and traditional service providers from an angle of comparative share values and revenue that is often overlooked by technology analysts. *(Please note that this document is not equity research, and Springboard Research is not an equity research organization).* While market watchers have long been vocal in their expectation of the consolidation of providers in this market, the direction the consolidation will take is not fully realized. At the time of this writing (March 15th) despite revenues of just US\$2.8 billion, the market capitalization of Infosys is nearly equivalent to that of Fujitsu, CSC and Cap Gemini combined. These vendors represent US\$63 billion in revenue – an astounding figure when compared to Infosys. The sustainability of this disparity is in the opinion of Springboard Research, impossible and there will have to be a “shakeout” of some description. The implications of any industry restructuring are going to be significant for Indian and other “low cost” providers, the traditional vendors, and most importantly for the clients of service providers.

THE RISE OF THE INDIAN GLOBAL PROVIDERS

The rise of the Indian service provider market has been long documented. It has been an extraordinary success story for India, for other emerging countries developing their capabilities, and for the individuals and regions that have benefited from this growth. As this report will highlight, most significant Indian service providers wisely and promptly made a decision to list on the share market (notably the US and Bombay Stock Exchanges). Now that the Indian vendor market has matured, there has been a clear and documented emergence of the Big Five Indian service providers, notably:

- Infosys
- Tata Consultancy Services (TCS)
- Wipro
- Satyam
- HCL Technologies

These companies have had a varied historical background and basis. TCS of course is a subsidiary of the Tata conglomerate. HCL Technologies is an offshoot of the largest Indian-based PC manufacturer, Hindustan Computers Limited. Wipro famously started life as an oil and soap processing firm in Western India.

Perhaps as a portent for the future, it is worth noting that at the peak of the enterprise resource planning (ERP) integration revolution, there were also the Big 5 consulting firms and only two of these exist now in their own right. One of those firms, Accenture is a true industry force, with Deloitte maintaining a role as the only end-to-end tax/audit/consulting firm remaining.

The reasons for the success of the Indian providers have been varied. There is no single overarching reason for this market's success, but several factors have contributed to it:

- **Historical Impact** – Many events from India's rich history provided the country with the optimum political/social environment in which Indian providers can thrive. These include but are not limited to:
 - **Education** – A positive outcome of British colonialism was the establishment of a robust educational system.
 - **English as the language of business** – Clearly India has had an extraordinary advantage over other economically emerging countries in its status as the country with the largest number of English speakers (although primarily non-native).
 - **Democratic society** – India is often touted as the world's largest democracy. While arguably, India's democratic government is not a perfect system, given the immense size and diversity of the population, it works.
 - **Legal Transparency** – Critical to India's ongoing success has been a strong and largely transparent legal system. This has made the establishment of enterprises a relatively simple and clear procedure, particularly when compared with China.
- **Population Base** – Clearly with its status as the world's second largest country, population-wise, India has a massive potential base from which to draw

employees for all industries. What has become abundantly clear in recent times is the increasing options within India for the location of global delivery centers. It is not a matter of choosing from Bangalore, Delhi or Mumbai metropolitan areas, and has not been for several years. These centers are essential, often as the fulcrum for a delivery network, but have been joined by numerous cities across the Indian subcontinent, and of course from outside India. Chennai, Kolkata, Pune and Hyderabad have been significant medium term locations, with recent investment in cities such as Mysore, Chandigarh and Ahmedabad.

- **Human Services Culture** – Just as it is a gross over-generalization to post China as a neconomy with natural strengths in just manufacturing India, while diversifying its traditionally weak manufacturing base (particularly from an export orientation), has shown strong advantage and capability in the services industry. This is a benefit that it has exploited unequivocally.
- **Low Labor Costs** – This is of course not unique to India, but in some respects it could be considered as the crucial factor that pulls India's success together. What has become clear with the maturation of the Indian offshore market, and the subsequent geographic diversification, is that while prices for quality work in Bangalore and Mumbai are at an absolute premium, it is possible to find major cost differentials in secondary or tertiary markets. The bottom line is that there is still a significant opportunity for low labor costs in India, but it does have the consequence of increased risk and management to ensure quality control metrics are met.
- **Quality and Intellectual Property** – The quality inherent in the Indian IT and business process industry is by any comparison excellent. From the birth of the industry, there has been a culture of quality (no doubt helped by several of the factors noted previously, notably English as the dominant business language and a strong educational focus). Various quality control and process management tools have been improved and developed in India, which was critical for the country's rapid establishment of credibility.

Bangalore's history of a strong focus on education, as well as the legacy of the Indian Space program, instilled in the city a culture of research and process discipline, notably in its educational facilities. This provided (most notably in the earlier stages of evolution), foreign (eg U.S or UK based enterprises with significant comfort levels when transferring responsibility of processes and people) offshore to India.

Another measure of the success of this focus on IP and quality is the lack of tabloid fodder for headlines such as information hacking or operations disruption by rogue employees. Naturally enough, rare occurrences of such things have occurred, but not to a significant long term concern (and certainly not in a proportion that is fundamentally higher than traditional service delivery), and not to an extent that perhaps the popular media may have hoped for.

ANALYSIS OF THE MARKET CAPITALIZATION OF INDIAN SERVICE PROVIDERS

Table 1 below provides insight into the 2006 revenues for a selection of key global services vendors. On the basis of revenue alone, the influence of the Indian providers is less significant than one would anticipate. The top 5 Indian providers have a total revenue of US\$12.34 billion for their 2006 fiscal year. As a combined entity, this would place them as the 7th largest services provider globally, behind CSC's US\$14.68B in revenue.

As has been widely discussed, HP recently beat IBM in terms of total revenue for 2006. As a result, HP is now the largest global IT company. In contrast, from a services perspective, the status quo remains with IBM as the largest global services provider, followed by Fujitsu and Accenture. HP is the 5th largest provider of services.

Table 1: Revenue of Selected Service Providers

Focus Areas	Total Revenue (US\$M)	Total Services Revenue (US\$B)
IBM	91.42	48.30
Fujitsu	40.26	26.19
EDS	21.27	21.27
Accenture	18.85	18.85
HP	91.66	15.62
CSC	14.68	14.68
Cap Gemini	8.24	8.24
Wipro	3.13	3.13
Infosys	2.82	2.82
TCS	2.53	2.53
HCL Technologies	1.47	1.47
Satyam	1.39	1.39
Patni Computer Systems	0.58	0.58
Polaris Software Lab Ltd.	0.21	0.21
Hexaware Technologies	0.19	0.19
Rolta India Inc.	0.12	0.12
3i Infotech	0.08	0.08

Source: Springboard Research, 2007

Note – Numbers are correct at time of writing – March 15th, 2007

Note: Numbers are for the 4 most recently reported quarters

Table 2 highlights the market capitalization of the services vendors included above. For the vendors included, IBM is clearly the largest IT company from a market capitalization standpoint, followed by HP. To provide some perspective from the software industry, Microsoft's capitalization is over US\$272 billion, and Oracle's is

approximately US\$89 billion (for the purposes of comparison). However, what is stunning is the relative position of the leading Indian firms: Infosys, TCS and Wipro all have market capitalizations at a significant premium to the largest pure play services providers, especially Fujitsu, CSC and EDS.

As has been well highlighted in recent weeks, there has been a recent decline in share-markets globally. This appears to have had a disproportionately high impact upon the Indian providers. In mid-February 2007, the disparity between the Indian and traditional providers was even more significant. Given this historical data, we must assume that the disparity will continue.

Revenue growth is critical for the services businesses and this is where emerging providers have the advantage. This has appeared to have impacted vendors in relative proportion, i.e. all have been impacted to a degree, but there have been no catastrophic losses.

Table 2: Market Capitalization of Selected Services Providers

Focus Areas	Market Capitalization (in US\$ billion)
IBM	140.69
HP	106.25
TCS	30.34
Infosys	29.25
Accenture	21.83
Wipro	18.29
EDS	14.18
Fujitsu	13.47
Cap Gemini	10.42
CSC	8.88
Satyam	7.20
HCL Technologies	2.28
Patni Computer Systems	1.17
Rolta India Ltd	0.64
Hexaware Technologies	0.45
Polaris Software Lab Limited	0.38
3i Infotech	0.30

Source: Springboard Research, 2007

Note - Market Capitalization numbers are as of March 15th, 2007

Note - No adjustment or pro-rata calculation has been made for IBM

HP or Fujitsu based on revenue

In Table 3, we can see the relationship between revenue and market capitalization. This clearly shows how much of a price bubble there is, with Infosys in the extreme case of having a market capitalization ratio (market capitalization value per dollar of

revenue) of 10.81 and T.C.S an almost equally astounding 10.37. At the other end of the scale is Fujitsu with a ratio of 0.33, amidst its concerns of growth in Japan and its ability to excel in the non-Japanese market. To put this in perspective, each dollar of Infosys revenue is valued 32.9 times greater than Fujitsu. Another insight is that if Infosys were to have the same revenue as Accenture, it would be potentially valued at US\$195 billion, based on current market capitalization ratios.

This bubble is mainly impacting the largest Indian providers. Mid and comparatively small vendors are not as radically overpriced, emphasizing the relationship between exposure on US capital markets, as well as the impact of public image to the rise of Indian providers. These numbers are also a reflection of the economies of scale enjoyed by the largest Indian providers.

Data also shows that IBM, HP and Accenture are the top performing non-Indian-based vendors. EDS and CSC, along with Fujitsu, have ratios well below 1, despite having met most of the business challenges they have faced in recent years.

Table 3: Market Capitalization to Revenue Ratio

Focus Areas	Cap/Rev
TCS	11.99
Infosys	10.37
Wipro	5.84
Rolta India Ltd	5.26
Satyam	5.18
3i Infotech	3.74
Hexaware Technologies	2.39
Patni Computer Systems	2.02
Polaris Software Lab Limited	1.80
HCL Technologies	1.56
IBM	1.54
Cap Gemini	1.27
HP	1.16
Accenture	1.16
EDS	0.67
CSC	0.60
Fujitsu	0.33

Source: Springboard Research, 2007

Note - Market Capitalization numbers are as of March 15th, 2007

THE COMPETITIVE ADVANTAGE FOR INDIAN PROVIDERS – IS IT AS STARK AS MARKET CAPITALIZATION SUGGESTS?

If one were to base analysis on market capitalization alone, it would be easy to assume that the Indian providers have a "secret sauce" and market position in excess of the overall market for global delivery. This is only partially true. While Indian providers do have strong market advantages, it can be argued that for some traditional services providers, this advantage has been significantly met and in some instances exceeded. There has now been a convergence of capabilities. Accenture and IBM in particular have made huge investments in India. By Springboard Research's estimate, IBM will have well in excess of 70,000 employees in India by the end of 2007. IBM currently has development centers in the following locations:

- Bangalore
- Pune
- New Delhi
- Gurgaon
- Hyderabad
- Kolkata
- Mumbai
- Chandigarh
- Chennai

This is clearly a location portfolio that can provide a similar, if not greater, depth of global delivery resources in India than even the Indian-based providers. From a headcount perspective alone, IBM has considerably more people than the Indian-based providers. By way of context, IBM is also looking to have approximately 10,000 employees in Brazil and Argentina by the end of 2007 and currently has 10,000 staff in China. Accenture is looking to have 35,000 employees in India by year end as well. From an integrated portfolio point of view, IBM and Accenture in particular, but not exclusively, have significant flexibility in service delivery strategy from a location perspective.

The mature offshore providers are also benefiting greatly from economies of scale and connectivity between their various centers. Therefore on some measures and notably at the corporate end of the market, these advantages and potential for lower cost delivery locations are the role of traditional providers. Legacy vendor disadvantages include the logistical difficulties of managing a large operation and the high financial and organizational costs they have to continuously manage and scale back.

A challenge for all providers in India are rising costs. Without a doubt, costs in India are rising between 10-20% per year, and this has a significant impact on market dynamics. Vendors such as the Indian providers who over-rely on the Indian labor force will face this issue increasingly in the future. Globally, emerging market salaries are rising, but for global and local providers alike, a reliance on limited geographic (city or country) markets for employees will have a negative impact. To highlight how this is an issue for all, Hewlett-Packard, who has a strong global network is, in the opinion of Springboard Research, still too focused on Bangalore for global delivery and as a result will potentially suffer increased cost pressures before other providers do.

In addition, as geographic expansion occurs, the impact of the need for ongoing capital investment by global providers in infrastructure and facilities has potentially been overlooked by the equity markets and must be considered in a proper and thorough examination of the industry.

IMPLICATIONS FOR ACQUISITIONS

This Springboard Research analysis is focused on how the over capitalization of Indian service providers impacts the market for the procurement of IT and Business Service. Clearly Springboard Research is not making a prediction of whether or not the price of shares in Indian-based offshore providers will rise or fall, but that Indian based providers have changed the dynamic of the marketplace just as the dot-com boom changed how companies did business.

Unless the traditional vendors are able to conjure a significant amount of capital for limited cost (a highly unlikely scenario), it is clear that the likes of EDS (who has purchased MPhasis, another mid-tier Indian firm) or CSC or IBM for that matter is highly unlikely, if not impossible from a capital point of view to acquire one of the Big 5 Indian providers. Bottom line is that any significant acquisition will be by the Indian providers in order to provide scale, client capabilities and to make a key show of intent in the market. The only other alternative is for mergers between the Indian providers, a possible, yet complex issue due to factors such as competing corporate ego, vision and status.

The element that could change the market dynamic would be a correction of the Indian providers share prices. However this would have to be a very significant adjustment. It is worth considering the broader implication of this given the weighting of the Mumbai Stock market (in particular) from the Indian-based software/services companies. Clearly a collapse in the share prices of the Indian IT service providers would have a monumental impact on the entire Bombay Stock Exchange and potentially on the Indian economy.

As highlighted earlier, there is also an opportunity for the smaller Indian providers to consolidate. These firms are definitely seen as cheaper acquisitions, and as opportunities to provide or complement scale. At the same time, these companies' smaller size translates into limited capabilities. For some vendors this is a benefit, as capabilities can be focused.

The Indian vendors have been vocal in their acquisition strategies. In fact, all the leading Indian vendors, with Infosys and T.C.S at the forefront, have been aggressively acquiring companies on a global scale. This has typically been to fulfill a combination of the following objectives:

- Geographic Expansion
- Vertical Market Expertise
- Movement up a services "value chain"

These acquisitions have been undertaken to enable IT services providers to integrate themselves more deeply into the enterprise, and to gain greater access to the CIO and other key decision makers. This strategy is not that dissimilar to vendors such as IBM

and HP who have been very active in acquiring companies. The key differentiation is that the focus for HP and IBM has been more in acquiring software companies to help enable services and/or software solutions. Springboard Research expects that Indian providers will also continue to make strong and aggressive steps toward the acquisition of software providers, particularly if the BPO market is still reticent.

THE NEXT EVOLUTION FOR SERVICES DELIVERY?

Clearly offshore services delivery is a long way from full maturity, but it is a step in the fundamental shift of technology from a people-centric industry to an automated process focused business. This (r)evolution from a people to process industry will have a profound impact on traditional IT providers. Offshore provision of services is just one of the components of this shift, with "productization of services" and software-as-a-service (SaaS) an equally fundamental part of the transition. For the Indian and other lower cost vendors who have smaller employee-to-revenue ratios, this is going to be a particularly critical time. In some respects, the most pertinent impact of this will be from a geographic point of view, with cities such as Bangalore, Dalian and others having to continue to evolve the skills and capabilities of their citizens to keep one step ahead of the competition and become more sophisticated technology providers.

Just as IT professionals whose jobs were at risk of being offshored have had to undergo a major shift in expectation, education and outcomes, a similar route is anticipated for those in the current wave of employment for offshore services. There has to be an allowance for the growth of technology to enable automation, such as "Interactive Voice Response" (IVR) and self-healing computing.

CONCLUSIONS

Springboard Research believes that the growth of Indian services providers has been a significant event that has fundamentally changed the way in which IT services are delivered globally. It has forced the incumbent services providers to radically change their service delivery models just as the emergence of offshore manufacturing forced auto manufacturers to improve process and capabilities or leave the market. Clearly this is still happening in the auto sector, so it is probable to assume that the services space will still feel the impact from global delivery into the future.

The challenge for Indian providers is to overcome the expanding bubble that is their share price and market position. The offering is successful and credible but may not necessarily be the best long-term economic position. Over-valued stock inhibits the march toward consolidation, and creates unreal market expectations.

The Indian services competitive advantage still exists and Indian based providers and vendors such as IBM, HP and Accenture have successfully harvested it. The challenge for Indian providers is extraordinarily difficult, as the market is in a state of extreme flux and change. As a result, IT service providers need to continuously innovate and initiate new process improvements to justify their lofty positions. If these companies can drive the market into the future, collectively or individually, it will reshape the IT industry.