IT EUROPA

Everything up for grabs in Europe

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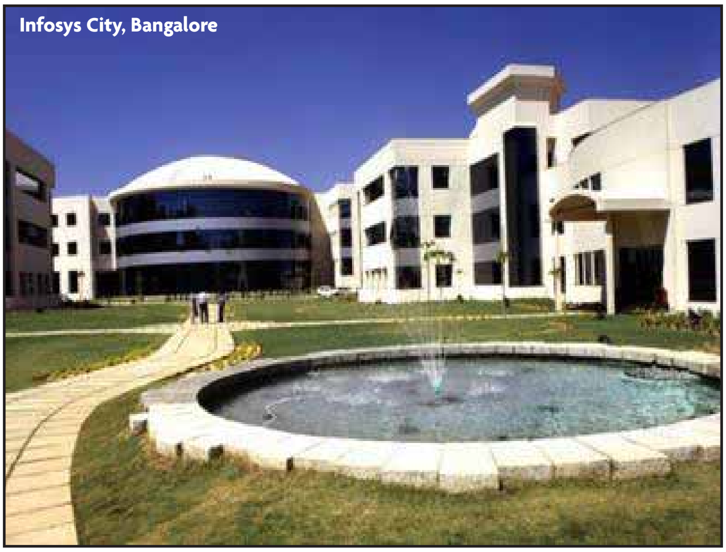
Indian IT services companies are feeling the need to diversify geographically from their traditional hunting grounds of the US and the UK, and continental Europe is coming more and more under their spotlight. But how do they compete with Europe's best - and should the locals feel threatened?



Infosys City, Bangalore

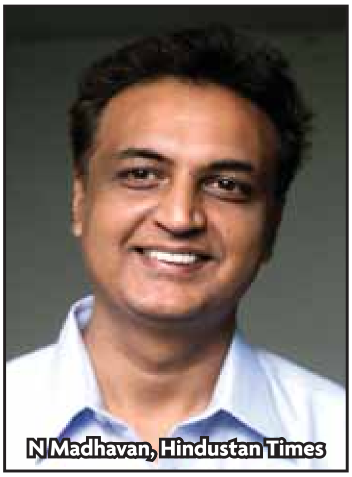
"European companies need Indian capacity", asserts N Madhavan, associate editor of the *Hindustan Times*, "as much as Indian companies need customers in Europe." Everyone knows that continental Europe is hostile to offshoring its work - even hostile to outsourcing at all. But does that old cliché still hold true? And how can the issues that lie behind that hostility be overcome?

Indian companies have been feeling the need to diversify geographically, according to Madhavan, since about 2002. "There were a lot of low-hanging fruits plucked in the US to begin with", he says, but soon the offshoring companies realised they had too many eggs in one, American, basket. The need to "de-risk the model" has become more pressing over the last year, however, with the fall of the dollar against the rupee - and against the European currencies.

One major reason why the US and the UK have been more successful markets for Indian outsourcers is linguistic. English is an official language in India, spoken by most educated people. Cultural issues are linked; the UK and India have a lot of shared history, and much of modern India's economic and legal structure is a legacy of the colonial era. But the Indian outsourcers are becoming, in a sense, less Indian. Instead, they like to think of themselves as global companies, and are moving towards a 'global delivery model' - "like Coca-Cola", says Madhavan, "who set up a factory in every market they enter."

Three years ago, *IT Europa* ran a feature on nearshoring in central and eastern Europe, one conclusion of which was that "even the Indian offshore masters can improve their offerings through nearshoring in CEE." The main reasons for this are threefold: firstly, CEE is culturally closer to continental Europe than is India, and its educated workforce commonly has proficiency in major European languages such as German and French. Secondly, nearshoring is often more attractive to European companies than is offshoring to India, purely by dint of its being, well, nearer. It's a factor which John Torrie, UK CEO of French IT services player Steria, finds hard to get his head around. "I struggle with the nearshore argument", he tells us. "If something's going offshore, then what does it matter how far away it is? However, our customers do want it." Talking to other industry figures, some reasoning emerges: having a processing centre just two hours' flight away is not only psychologically more comforting than having it half the way across the world, but also more practical in terms of being able to visit; sharing a timezone, too, is seen as an important factor.

The third reason is purely economic. Back in 2004, Ashkaya Bhargava, then CEO of Progeon (which has since become Infosys), told us that the wage ratio between India and CEE was about 1:2. That has since shrunk dramatically; Dataquest's latest salary survey shows typical wages for IT professionals in India rising 18.3% in FY 2006 and 18.7% FY 2007, so any remaining difference is being rapidly eroded.


N Madhavan, Hindustan Times

So the Indians are coming to Europe. But is the reception they're getting any better than that which continental Europe has traditionally given them? Reasons remain why they might struggle, regardless of whether they can offer a nearshore location. The UK's economy makes a particularly good outsourcer, with its emphasis on the IT-heavy financial sector - compared with manufacturing, which is much stronger in continental Europe and lends itself less readily to the kind of services Indian outsourcers offer.

Added to that are the rigid labour markets on the continent, and a greater level of sensitivity about the outsourcing of jobs. As Anjan Lahiri of Mindtree says, "In the UK and the US, our discussions with customers are just about business - how can we make them money. In Europe, more social factors come into play. It's a completely different conversation." IT is therefore more likely to be kept in-house, rather than be outsourced - even to a domestic outsourcer. Where offshoring is used, it is commonly using a captive offshore base. But things may be changing: new centre-right governments in France and Germany are doing what they can to free up labour markets; and, in our research this year, we've found attitudes to outsourcing softening, as companies come to accept it as an economic inevitability. For example, a recent study by the German government found a serious shortage of computer science graduates, for example, which they estimate cost the country 1% growth in GDP.

The Indian players have not only 'gone global', though. "A new global economic paradigm" is how Value Leadership Group, a global consultancy focusing on offshoring and globalisation, characterises the current state of play - a paradigm in which "everything's up for grabs". "People always talk about labour rates", says Peter Schumacher (*below*), Value Leadership's founder, president and CEO. "But the game has shifted to assets and success drivers that are much more difficult to imitate. Labour cost advantages are easily replicated; but the barriers to imitation have increased tremendously and continue to grow." In other words, the Indians have moved up the value chain. Consequently, the Indian players are increasingly competing with companies like Accenture, IBM and CapGemini for richer, high-end contracts.

> *"To survive in the new competitive paradigm, European companies must completely rethink their model"*
> Peter Schumacher, Value Leadership Group

Traditionally, the offshoring model has been about sending simple operations to India to be done at rock-bottom prices. Now, while labour costs in India are rising rapidly, the IT services industry there is becoming just as competent as its counterparts in Europe and the US. This means two things: firstly, that the European players are having to fight harder for contracts on their own turf; and secondly, that Indian providers are finding it makes more and more sense to have a presence in Europe – often in western Europe. Madhavan highlights one way in which this can be achieved: "Europe has some excellent small engineering companies, at the high end of the value chain. These are important to the 'string of pearls' strategy, followed by Wipro, among others."

Peter Schumacher agrees, expecting "the offshore services firms to continue their strategy of selected acquisitions to fill selected gaps in capabilities and customers." Girish Ramachandran, Tata Consultancy Services' head of Europe, says their strategy "focuses on strategic


Peter Schumacher
Value Leadership Group

Did Infosys lack the 'guts' to go for CapGemini?

One of the stories of the summer was the rumour that Infosys was planning an audacious bid for CapGemini. While the parties involved either denied it or refused to comment, most analysts described the deal as highly unlikely, claiming Cap was simply too big for Infosys to absorb effectively. One dissenting voice, however, was Madhavan of the Hindustan Times who, seeing the cash pile that the likes of Infy are sitting on, surmises that it would be better invested in a large purchase - such as that of CapGemini - than sitting in the bank. "They have the cash", he says of the big Indian players, "but not the guts to go for a big one in Europe."

acquisitions, both in terms of capabilities and in terms of new geographies." A classic example of Wipro's string of pearls strategy was its purchase of Enabler in Portugal in 2006; Infosys' purchase of Philips' captive processing centres this year represents another way in. Kees ten Nijenhuis (*left*) describes how Wipro integrates its 'pearls': "We leave a grace period of about a year before sending any work to India. Then we embrace them tighter, and use them as a fully integrated part of the Wipro company. They grow a lot faster within Wipro than they are used to. As a result of the integration they are eligible to do more, and larger, projects."

Another big deal this year in an outsourcing industry that is rapidly consolidating was Steria's purchase of UK-based Xansa. John Torrie confided to us that his biggest fear was getting gazumped by an Indian company, and acknowledges that Steria will always be seen as a likely takeover target for the bigger players. Industry analysts mostly agreed that Xansa's purchase was a shrewd move for Steria, although they paid a large premium; Peter Schumacher is more sceptical. "As a company with intent to lead the industry, [Steria] should have started implementing a compelling offshore strategy five years ago. With the acquisition of Xansa it faces a huge revenue deflation risk. Customers [...] will be asking for offshore service pricing, which could easily knock 30% off many of their contracts. At Xansa, the shift offshore [a few years ago] cut revenues per employee almost in half within two years. Steria's shareholders should be having a lot of sleepless nights these coming years."

> *"The advantage in the short-to-medium term lies with local companies"*
>
> Ian Marriott, Gartner

Kees ten Nijenhuis, Wipro's senior VP for European sales, makes a similar point: "I see them [the European players] struggling to move offshore; it will be self-cannibalisation." Ian Marriott, an analyst at Gartner, brings the other side of the argument, however. "It is politically easier to offshore through a local firm", he argues. "If [a French firm] outsources to CapGemini, for example, it's less obvious - even if the work does go offshore."

Peter Schumacher makes the point that Steria's revenue per employee is currently about five times that of the best performing Indian companies, which carries risks for Steria if customers now seek offshore prices; however, surely the risk is also there for the Indian companies, as local wages catch up with the West?

So then, risks exist in the 'new paradigm' both for Indian and European service providers. The Europeans risk seeing their revenues plummet as offshoring becomes de rigueur on the continent; and the Indians risk seeing their costs rocket as Indian wages shoot upwards, and the need for nearshoring becomes more pressing in order to win juicy European contracts.

Kees ten Nijenhuis, Wipro

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A few years ago, the choice facing consumers of outsourced services was clear. The more complicated operations, if not kept in-house, should be outsourced to a western firm, while the simpler tasks could be sent offshore to be done more cheaply. The main conclusion now, however, seems to be that that distinction is fading rapidly. The two sides of the divide, Indian and western IT services providers, are each feeling the need to become more like the other.

Their strategies for achieving this, each mirror the other's; while India's Wipro buys Infocrossing in the US, French CapGemini buys Kanbay, an Indian outsourcer (although based in the US). Both sides are investing heavily in nearshore centres in central and eastern Europe, as well as North Africa and the Middle East. Which side will prevail in the battle for Europe's outsourcing? Ian Marriott of Gartner believes that "the advantage in the short-to-medium term lies with local companies."

Peter Schumacher, of Value Leadership Group, argues that "the offshore firms have fundamentally changed the game in ways that put the European incumbents at a significant disadvantage."

But perhaps the question itself is now passé. The winners will be those companies, Indian or western, which are most successful at implementing a global delivery model; who get the mix right between offshoring, nearshoring, and working locally; who can offer the best services and build the best relationships with their clients. As the distinction between local and offshore players blurs, everything really is up for grabs.