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Cash-rich IT majors find Deal St too risky to tread

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NEW DELHI: For the past few years, India's outsourcing giants, sitting on piles of cash, have only watched global rivals IBM and HP take a definite inorganic route without attempting a single billion-dollar deal of their own. As TCS, Infosys and Wipro seek to raise their profile and compete better with bigger rivals, they are caught in a dilemma of whether to sacrifice profitability and gain market share by buying large firms that can boost their topline multi-fold.

And with companies such as Infosys sitting on $3.5-billion in cash, it's definitely not about the size of war chest "but more to do with their risk averse, profit-obsessed and India-centric growth strategy," said the chief executive of a multinational outsourcing firm, which competes with Indian software exporters. Until last year, investment banking firms were holding hectic parleys with TCS, Infosys and Wipro proposing M&A opportunities such as CapGemini, Atos Origin, and Logica, among others. Now, Indian technology firms are realising that such acquisitions will not only be too heavy to pull off, but also bring several complexities that may affect their profitability and double-digit growth rates.

"Why would they acquire troubled companies, all you would be getting is headaches and huge cultural disconnect," argues John McCarthy, principal analyst and vice-president at US-headquartered Forrester Research.

Already, large European services firms are struggling to trim their high-cost payroll and increase offshoring to cheaper locations such as India. "In Europe, when you lay off someone it's very expensive and you try to delay it, that has a weight on margin. We at Capgemini said with offshoring it will move to double digits pretty soon," says Paul Hermelin, the group chief executive of Capgemini. The company, which serves top government customers such as UK's tax authority HMRC, aims to have nearly 36% of its staff in offshore locations including India by this year-end.

"We do not plan to build large empires of hardware and services, and it's not about being risk averse. We want to bite what we can chew," says chief executive of a top Indian technology firm. He requests anonymity because his company is in a financial silent period.

Compared with some of their top European rivals scrambling to push operating margins to double digits, the top three Indian tech firms boast of margins well above 20%. "Last year, Infosys on its own earned more net income, than then entire European IT services industry," says Peter Schumacher of European strategy consulting firm Value Leadership.

In his analysis of nearly 100 mergers in European IT services market, Mr. Schumacher found that most of them were failures. "In IT services, acquisitions are toxic," he said. "The cases of the European firms Logica, Atos Origin, GFI Informatique and Tieto show that strategies to create empires through acquisitions flop," Mr. Schumacher adds.

Over the past two years, tech firms including Wipro, Infosys, Patni and several others have had discussions with potential targets such as Globant of Argentina, Ciber in the

US and IDS Scheer of Germany. While Software AG acquired IDS Scheer earlier this year, both Globant and Ciber decided to discontinue their dialogues with potential acquirers. In 2008, Infosys made a $753-million offer for UK-based SAP aggregator Axon. However, it backed out when domestic rival HCL made a competing bid, bettering Infosys' original 600-pence offer, and finally completed the acquisition.

According to Grant Thornton, the cross-border mergers and acquisitions involving Indian IT and IT-enabled companies increased by nearly 12% between January and December 15, 2008, to $3.22 billion (in 98 deals) compared with $2.88 billion (in 159 deals) in 2007. The average deal size in 2008 increased to $32.86 million, up from $18.15 million in 2007. "We believe Indian IT services firms should focus on acquiring smaller and medium-size European IT services firms with e50-200 million in annual revenues," says Mr. Schumacher. He adds that the Nordics offer more attractive acquisition opportunities when compared to Germany.

Some experts however, say the Indian companies need to acquire large European companies and challenge bigger multinational rivals. "Customers especially expect their providers to have flexibility and global reach. This cannot be offered by focus on one region (India) and insignificant footprint in Europe or the US," says Sridhar Vedala, managing director of outsourcing advisory firm Quantum Step. "At some stage the focus will have to shift from short-term margins to a long-term strategic growth, which is when the European firms will start looking lucrative," Mr. Vedala adds.