



# HAS EUROPE LOST THE OFFSHORE WAR?

As European IT services firms wake up to the realisation that they have lost serious ground to their offshore rivals, Peter Schumacher, founder, president and CEO of the Value Leadership Group, analyses why Europe was so ill prepared for this paradigm shift.

**A**t the Globalization & Offshoring Strategy Conference in Stockholm in June 2007, attended by over 100 senior executives from 18 countries, Lakshmi Narayanan, chairman of Nasscom and vice chairman of Cognizant Technology Solutions, discussed the rapid growth of offshore services in Europe.

Announcing that Cognizant's European revenues grew 98% in 2006, he predicted its very rapid growth to continue. Even more interesting, he also presented comparative data from a 2006 Goldman Sachs report. The data revealed that European IT services firms have fallen far behind in building up resources and capabilities to take advantage of offshoring and globalisation opportunities in Europe.

This echoed a July 2002 Goldman Sachs report entitled 'From inflection point to stallpoint', which asserted: 'We are more convinced than ever that this imperative [move to offshore to reduce costs] is critical if firms want to survive ... We point out that offshoring will likely disrupt the fundamentals of the sector.'

While five years have passed, Goldman Sachs' message has not changed. Can it be that the European IT services industry is falling behind, trapped in outdated business models, practices and paradigms? Essentially, have European IT services firms failed to see and pursue this huge opportunity in their home markets?

There are five reasons why offshore firms such as Cognizant will keep on winning in Europe. First of all, European IT services firms have failed to see the emerging competitive scenario. Secondly, offshore firms are inflicting a double whammy with a smart arbitrage strategy. At the same time, European companies are finding it difficult to face the transformational challenges posed by offshore IT firms. In addition, offshore

firms have the financial strength to drive the game and with further investment, more rule breakers are on the way.

## Missing the paradigm shift

European firms badly underestimated the competitive threat they faced, believing that offshoring would never grow beyond a niche in Europe. Risk was emphasised over opportunity, which the European press reinforced with an endless number of stories about failed offshore projects, creating a false sense of security.

In fact, by viewing the future as simply an extension of the past, European firms failed to see that the very nature of their competitive space was changing.

TietoEnator's 2003 annual report expressed an opinion typical of many European IT services firms at the time: 'I forecast that this offshore business will find its niche [as eBusiness did] once the worst hype died down.'

Yet in 2006, just three years later, TietoEnator confirmed that Indian players had become its biggest competitors. Did the world change so fundamentally in just a few years?

## Why Europe is losing the offshoring battle

European IT services firms:

- 1 Have failed to see the emerging competitive scenario
- 2 Face revenue deflation pressure from a smart arbitrage strategy
- 3 Have not addressed the holistic transformational challenges posed by offshore IT firms
- 4 Lack the financial resources to challenge offshore firms head-on, which are now driving the game
- 5 Will need to compete with powerful rule-breaker companies funded by private equity and venture capital firms

Lakshmi's presentation in Stockholm presented an opportunity to compare how these two companies have fared over the past five years. While TietoEnator has experienced years of disappointing results and finds itself on a slippery treadmill, Cognizant is one of the fastest growing services firms worldwide. Its revenues grew six-fold and are expected to exceed \$2.1 billion in 2007. The company has no debt, almost \$1 billion in cash and a market cap exceeding \$10 billion. Its operating cash flow ratio tops TietoEnator's by a factor of six.

Aggressive offshore challengers have hit TietoEnator hard, which has been the most successful Nordic IT services firm. Analysts expect the competitive environment to worsen. TietoEnator has started to move in the right direction, but is this just another case of too little, too late?

What is more worrying is that TietoEnator is not alone. Many European firms have failed to see this paradigm shift. A 2006 German study of IT services firms found that 92% saw no competitive threat from offshore services firms.

By not paying attention to major business trends, European companies that once aspired to become world leaders have become laggards.

## The smart arbitrage double whammy

The efficient market theory teaches that arbitrage strategies at best offer a temporary advantage. Nevertheless, arbitrage has shaped the offshore services market for years – and is expected to last for at least another ten years.

Offshore firms had the insight and capabilities to exploit a smart global arbitrage strategy to drive a new competitive paradigm in European IT services. Rather than pocketing the arbitrage benefit, the offshore firms give

most of it to their clients, enabling them to undercut European IT services firms by 30–50%, while upping the bar on quality and project performance.

However, lower prices are not at the centre of this strategy. The advantage is in the cost of the restructuring burden imposed on European IT services firms. Closing the gap mandates a strategic response and simple cost cutting will not do the trick. Incumbents are forced to completely rethink their business – a tough challenge in Europe where operational flexibility is limited.

## ‘Based on new business logic, the centre-based offshore model represents a turning point for the IT services industry that will trigger a huge structural shift.’

In addition, deflationary pressure is creating a double whammy. Contracts sold for €10 million may be worth only €7 million when up for renewal. Some firms have seen their revenue productivity drop 40% within just two years of accelerating their offshore business.

The offshore firms are putting enormous pressure on incumbents. Even IBM Global Services is reinventing itself in India. European firms need years to realign their business to these new realities. In essence, the arbitrage strategy changed the rules of the game in ways that put European firms at a material disadvantage. And this advantage is expected to last as long as ten years in some European markets.

### The transformational challenge

While wage level differentials make good headlines, the real kicker is the delivery model that lets offshore companies bring cost and talent pool advantages to market efficiently. The offshore firms pioneered and perfected the development of the centre-based offshore services delivery model.

Based on new business logic, the centre-based offshore model represents a turning point for the IT services industry that will trigger a huge structural shift.

More than 60 years ago, the economist Joseph Schumpeter pointed out that in

competition it is not price that counts, but striking at a firm’s foundations. Today, the offshore services model does exactly this. Offshoring is a disruptive operating model innovation that is driving the industry towards a strategic inflection point.

The offshore operating model is based on a broader set of interlinked competitive assets that individually and as a system are very difficult to imitate. Moving to a global operating model requires a new way of managing organisations and processes, leveraging global talent, skills and capabilities.

In other words, activities performed in distributed onshore and offshore teams need to be efficiently reintegrated into a compelling value proposition that the organisation can deliver seamlessly.

The centre-based offshore model has become the benchmark to beat. As Intel’s Andy Grove said: ‘Sooner or later, something fundamental in your world will change.’ This moment has now arrived in the European IT services industry. How businesses manage this transition will determine their future. Migrating to this new way of working represents a huge transformation challenge, and many European firms lack such experience.

### Lower profitability narrows options

In Europe, offshore services firms are significantly outperforming European firms in terms of growth, profitability and cash flow generation – the key metrics of success in this industry.

As is typical in industries undergoing disruptive change, market value migrates from incumbents to companies that are driving the new competitive frontier, and the European IT services industry is no exception. The top five offshore services firms have a combined market capitalisation of approximately \$100 billion – five times that of the top five European firms.

### Peter Schumacher

Originally from the US, Peter Schumacher is a global entrepreneur with 10 years of India experience. His work addresses difficult issues in the areas of global business strategy, business model innovation, and growth. Schumacher started his management consulting career with CSC Index. His previous experience includes building an innovative logistics business in Asia from the ground up and M&A. He holds an MBA in finance and strategy from the Stern School of Business at New York University.

While some might argue that market capitalisation represents only paper money, offshore firms have strong fundamentals. In 2006, two offshore firms – TCS and Infosys – earned a combined profit after tax of \$1.7 billion, which is more than the entire European IT services industry. Independent studies show that offshore firms lead corporate governance rankings and have become power brands. With soon 150,000 employees assigned to European projects, the top five offshore services firms have the critical mass to build on their gains.

### More rule breakers on the way

The enormous growth of the IT industry in India is creating a services and value hub around which a globally significant ecosystem is developing. By leveraging this new competitive landscape, offshoring will unleash even more energy.

Private equity and venture capital firms are funding innovative rule-breaker companies that aim to redefine the European IT services industry. India has become a launch pad for a new breed of globally minded entrepreneurs who are changing the very nature of globalisation.

Offshoring will shake up the traditional competitive structure of the European IT services industry. The industry has become a test bed for creative destruction and just emulating the global delivery capabilities of offshore firms is not a winning strategy in this new competitive paradigm.

But the question remains, is the European IT services industry prepared for the new competitive paradigm? ■

### Further information

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