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India’s IT firms face challenges: China is not one of them
By Marty Wolf

To remain competitive globally over the long haul, Indian IT companies must enhance efforts to expand their geographic footprint and move up the value chain.

Chinese IT services firms will one day pose a threat to the Indian IT services industry in its quest to keep and grow customers in North American and Europe. That day is not today.

A far greater and more immediate threat is a dramatic shift in the types of services large enterprise customers in these key geographies are buying.

According to Gartner, spending on application outsourcing services – an historical strength of Indian IT companies – now is dwarfed by infrastructure outsourcing services. Furthermore, the compound annual growth rates (CAGR) in spending in these categories are forecast to be just 3.1% and 3.5%, in 2011 and 2017, respectively.

In the same timeframe, Gartner expects tablet sales to increase at a 70% CAGR and end-user spending on cloud services such as cloud computing, storage as service and cloud print services to increase at a 38% CAGR. Indian IT services providers are not yet major players in these emerging segments.

For the last decade, Indian IT companies’ main appeals globally have been their favourable cost structure, strong English language skills and an appetite for acquisitions designed to add new capabilities and expand their reach into geographies that bring them closer to their customers.

These attributes, combined with concerns in the West over corporate governance and national security issues in doing business with Chinese companies, have helped create a natural barrier of protection for India’s IT services firms.

So despite the shift in IT spending globally, it is no surprise that Indian companies have continued to do well in the West.

However, the Indian IT firms that have done well are primarily Tier 1 companies, those with annual revenue more than $1 billion. These companies have the resources to grow both organically and through acquisitions designed to move up the value chain of services. Many of the acquisitions by Tier 1 companies have helped them add higher margin offerings to their portfolios such as services specialised for vertical industries and functions.

These acquisitions also have propelled India-based IT services firms’ market share, which continues to outpace that of competitors. According to Gartner, the top five Indian vendors grew their market share by 13% in 2012 over 2011; it now stands at 7.0% of the total global market.

As a result, Tier 1 companies increased their valuations by 20% over the past year. Tier 2 companies (more than $500 million but less than $1 billion) have not fared as well; their valuations declined 20% in the same time period.

And, for at least the next three to five years, I expect Tier 1 Indian IT companies to remain relatively strong, but for Tier 2 companies to suffer from lack of scale.

I recently delivered these messages to high-level IT services executives and investors at the 'Enterprise IT Valuation Summit 2013' in Bangalore. I heard that despite a relatively positive near-term outlook, the Indian IT services industry is still concerned about three things—how to retain existing large enterprise customers in North America and Europe, attract new business and maintain its competitive advantages over China on a global stage.

Here is what I said:

Go big or go niche: As Tier 1 Indian companies and their US counterparts prove, size matters in this space and commitment to growth through acquisition, hyper-specialisation or some combination of the two is essential.

Develop a culture of innovation: According to data compiled from Capital IQ, spending by Indian Tier 1 IT companies on R&D as a percentage of revenue has been steadily declining since 2008. Current investment as a percentage of revenue was 0.8% in 2012 – just half of what US IT companies spent on R&D in 2012 – and down from 2.5% in 2008. With the recession mostly behind us, now is the time for Indian companies to re-commit to creating intellectual property (IP) – especially SaaS-based IP, which leads to competitive advantage and ultimately higher valuations.

Diversify your customer base: As of the third quarter of 2013, according to Capital IQ data, 56% of Tier 1 Indian IT companies' revenue came from customers in North America and 22% from customers in Europe. In contrast, just 1% of revenue was derived from customers in Asia Pacific, where they face the strongest challenge from Chinese companies today.

Move up the value chain: With global demand shifting to increasingly sophisticated services, Indian companies that can fulfill these new customer needs quickly and skillfully will win. An effective acquisition strategy is the key here, as developing new service offerings and creating distinctive IP to stay relevant cannot be done through organic growth alone.

Be aggressive about M&A: M&A – and especially cross-border transactions – can quickly bridge gaps in resources and capabilities. But Indian IT companies' cross-border M&A activity peaked between 2006 and 2008. Since 2009, the total number of cross-border transactions by Indian and Chinese companies has been similar. This year, Chinese IT companies have been more active with cross-border M&A, completing 36 deals (including 15 in Hong Kong) compared with 28 completed by Indian IT companies.

Be smart about M&A: While being aggressive about M&A is important, so is being smart. Many cross-border acquisitions fail for lack of a well-thought-out and executed integration strategy that takes into account cultural differences.

For now, Indian IT companies remain more attractive partners than Chinese companies for large enterprise customers in North America and Europe than Chinese companies. But that could change in time.

And in the meantime, the situation in the fast-growing Asia-Pacific market is reversed, with Chinese partners preferred over those in India.

So to remain competitive globally over the long haul, Indian IT companies must re-double efforts to expand their geographic footprint and move up the value chain. If they don't, key customers in important geographies could leave them behind – and open the door to China.

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