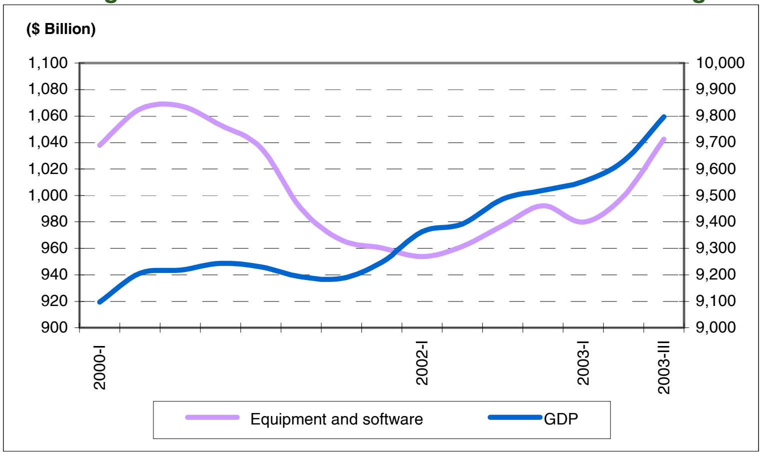
1.0 Executive Summary

Global IT spend on the upswing

Although corporations across the world have started showing signs of recovery, IT spending has been slow off the blocks. This is mainly a reaction to the over-investment in information technology (IT) in the past decade. Businesses are a lot more circumspect on IT spending now. They are no longer as eager to throw their dollars behind tech investments in mindless abandon as they were before, looking for the Holy Grail of instant productivity gains. The new corporate tech strategy will increasingly spell out clear-cut return-on-investment goals. Companies will also look for ease of implementation and integration when considering investments. As a result, tech companies will now to have to find new ways of courting more demanding customers.

US spending on equipment & software has lagged

US GDP growth **Figure 1**



GDP: Gross domestic product

Source: US Bureau of Economic Analysis

Our estimate of growth in global IT spending for the next 5 years is about 5 per cent an annually. Although volume growth will be higher, the pricing pressures that have built up in the last 2 years will keep the growth at the above levels. (The pricing pressure is also partly due to the global phenomenon of offshoring work at lower rates).

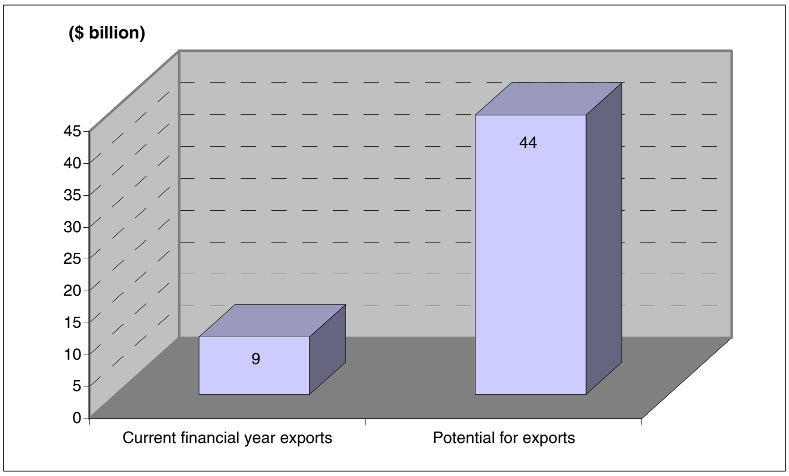
Offshoring goes mainstream, presenting huge business potential

In a buoyant IT spending scenario, Indian players will naturally do well. Indian players, with their low-cost, high-quality proposition, have established a name for themselves in the IT services space. Clients are today more comfortable outsourcing their IT services requirements to offshore vendors, and more convinced about the offshore delivery model of the Indian players.

Indian players have also expanded the breadth of their service offerings and started offering higher-end work such as infrastructure management, package implementation and IT consulting. Hence, the addressable market size has increased for the Indian players.

In the light of the recent study by McKinsey, which has stated that every dollar of work offshored added $1.12 to the US economy, we expect a further surge in offshore outsourcing to destinations like India. Overall, the global economy benefits from outsourcing and this economic justification will make sure that the trend continues.

IT Services - Exports from India **Figure 2**



Note
Figures are estimated.
Source: CRIS INFAC

Our estimate of the potential IT services exports from India is $44 billion, as against the current global IT spending of $875 billion (global IT services amounts to $385 billion). Currently, the share of India in global IT services is about 2 per cent, which, we expect, will grow to 12 per cent.

CRIS INFAC's estimate for IT services exports from India for 2003-04 is $9 billion (25 per cent Y-o-Y growth).

Growth drivers for offshore outsourcing

Traditional service lines and verticals will continue to drive growth in the coming years. Apart from these, new service lines like infrastructure management services and package implementation will also contribute a higher percentage to the topline of Indian software companies.

Verticals: Utilities, healthcare and retail largely untapped

In terms of verticals, although manufacturing and telecom have been laggards over the past 24 months, a recovery in these sectors and focus on reducing costs will lead them to increase offshore outsourcing. The icing on the cake is that verticals like utilities, healthcare and retail have started offshoring work and there is a huge untapped potential.

Expected growth rates and drivers of growth **Table 1**

Verticals	Growth (CAGR) for the next 3-4 years (per cent)	Drivers
Financial services	25-30	Increased competition, Basel II requirements, CRM, e-Solutions, banking software
Telecom	15	Need to save on costs and realign R&D spends
Manufacturing	20-25	Increased focus on ROI and implementation of SCM, ERP across the enterprise
Utilities	40-45	Deregulation of markets in US and Europe
Healthcare	40-45	Regulatory compliances like HIPAA, HL7, 21CFR 11
Retail	40-45	Recent tax breaks and robust increase in consumer spending in the US
Transportation & logistics	35-40	Revival in business travel/tourism, robust economic growth and need for better supply chain management

Source: CRIS INFAC

Service lines

Infrastructure management services: The market size for infrastructure management services is estimated to be as big as application development. It is estimated that 18 per cent of the IT budget is spent on infrastructure management services. Of the total infrastructure management services, 5 per cent are currently remotely managed, and approximately 25 per cent can be potentially offshored.

Package implementation: This service line also has large potential in terms of growth. Indian companies have been late entrants in this service line, but of late have carved out a niche for themselves and are competing against the biggies in this space.

The growth in this service line is mainly due to

- Corporations rolling out packages across the divisions and geographies. In the short term, growth would continue to come from corporations rolling out packages across the enterprise.
- The verticals driving growth for this service line are high-tech manufacturing, financial services, retail and logistics.

Player strategies and the payoff

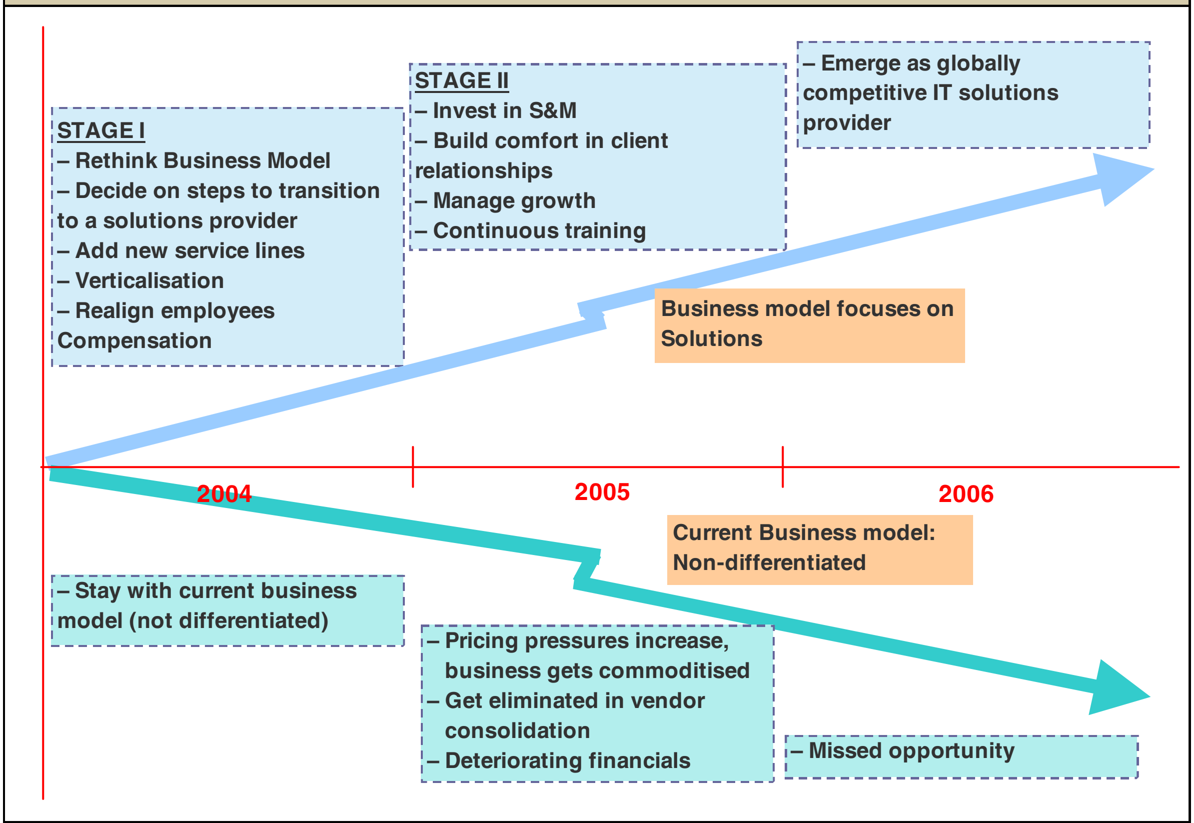
The intensity of competition in any industry is neither a matter of coincidence nor bad luck. Rather, competition in an industry is rooted in its underlying economic structure. With “offshoring” now emerging as a proven and cost-competitive option, the proportion of offshore services is also rapidly expanding. The increasing size of orders and the widening breadth of client base are clear illustrations of this unmistakable trend. Given the potential of this trend, everybody wants a piece of the action. At the same time, what the client is looking for is a long-term partnership model with the vendor. The key attributes of the partnership model are:

- Vendor consolidation … a client will look at only 2-3 strategic long-term vendors.
- Large deal sizes.
- Vendors need to have deep industry expertise and domain knowledge.
- Comfort in the relationship … top-level management involvement, integrity and commitment.
- Ability to address the problem areas of the client.

Therefore, if Indian vendors want to enhance long-term competitiveness and sustain growth rates, they need to address the competition, and more important, the needs of their clients. To cut a long story short, the value proposition needs to shift from "IT service provider" to "solution provider". This way they can achieve differentiation.

Illustration: Staying competitive

Fate of current versus desired business model **Chart 1**



Source: CRIS INFAC

Differentiation is also necessary, as the global MNCs will double their Indian manpower to 25,000-30,000 people by December 2004, from the current 10,000-12,000. In our view, the global majors will only use their Indian presence as a back-office for the global delivery franchise, due to their own structural and strategic dilemmas. Global vendors are constrained by risks of profit declines worldwide as offshoring expands.

As a result, there is no volume risk for Indian frontliners.

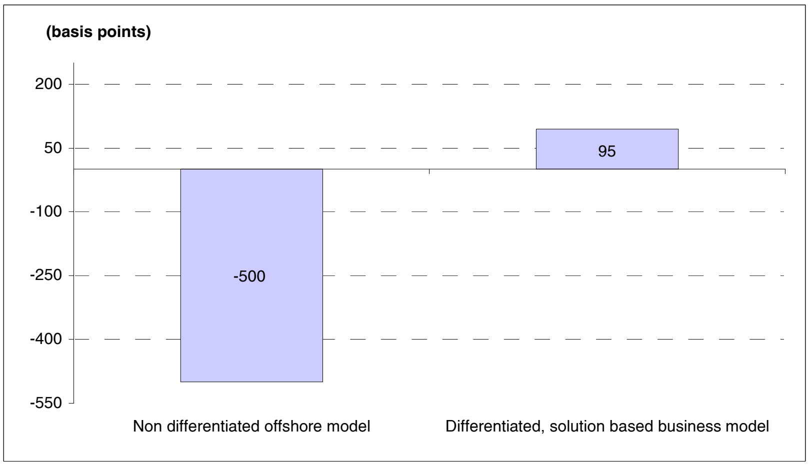
Operating margins to be determined by choice of business model

Companies need to take proactive measures to improve their productivity, to arrest a major fall in margins. The increase in employee costs and higher selling and marketing expenses could lead to a fall in operating margins by 500 basis points over the next two years.

However, players with differentiated, solution-based business models can arrest the margin fall. The key to maintaining or increasing margins is improving productivity in the following ways:

- Transition to higher value-added solutions-based services.
- Improve utilisation rates.
- Manage attrition levels by providing better growth opportunities and pay packages to employees.
- Improve delivery processes and project management skills.
- Improve relationship management with clients, which will help to mine deeper into the account and increase the average deal size.

Impact on margins **Figure 3**



Source: CRIS INFAC

CRIS INFAC SoftBand: A Study in Global Competitiveness

The CRIS INFAC SoftBand is an evaluation method developed to arrive at the competitiveness for various companies. It will tell us which companies have been preparing themselves for the next orbit of growth, and in which areas other incumbents need to improve to capture the gigantic market opportunity out there.

CRIS INFAC SoftBand focuses on three parameters:

Strategic choice:

Measures the positioning of the company, or, in other words, how a company defines its potential (addressable) market. Till now, most Indian companies have first determined what they are good at and then offered those services to clients. A better approach is to ask what the problem areas of the clients are and then work on the company's competencies and skills to address these areas (i.e. the solution provider business model).

Operational effectiveness:

Measures the ability to translate potential into operational excellence. Execution is largely based on management's ability to put in place systems and processes. Also important is the ability to attract and retain talent, a critical part of management's job in a service industry. Increasing the run rate of clients and mining deeper into accounts requires a focus on customer service and relationship management.

Financial Performance:

Measures returns from the business and consistency of performance. In the final analysis, the bottomline speaks for the management and value derived from the strategic positioning of the company.

Where Vendors stand on SoftBand **Table 2**

CRIS INFAC SoftBand	Global Vendors	Indian Vendors
Strategic Choice	4.1	3.6
Band	B1	B2
Operational Effectiveness	3.6	3.8
Band	B2	B2
Financial Performance	2.7	3.8
Band	B4	B2
Grand Total Score	3.67	3.68
SoftBand	B2	B2

Source: CRIS INFAC

Not surprisingly, global vendors score higher than Indian vendors on strategic choice, and lower from an operational perspective. What is interesting is that the strategic score of Indian vendors is likely to improve as they acquire more domain knowledge and offer business solutions. On the other hand, the operational effectiveness score for global vendors is not likely to improve much. As a result, we believe that over the next two years, the gap between the SoftBand score of Indian and global vendors will widen. In other words, the competitive position of Indian vendors will get better.