



Impact of Recent Developments in the US Economy on Indian IT-BPO Sector: Analyst Views

TPI

The events of the last few weeks indicate a broad-based failure of financial systems that will have a global impact. Over the past quarters, typical bets were that the credit crunch, while leading to recession, also meant good news for the outsourcing and offshoring industries. The expectation was that outsourcing/offshoring activity would pick up ahead of the upswing in economic/industry indicators. This was also borne out by the TPI Index of the first half of 2008. The sourcing industry bagged the largest number of outsourcing contracts, with the highest Total Contract Value (TCV) and Annualised Contract Value (ACV) during the first half of 2008, as compared to the last 10 years!

What we are now seeing as a result of the financial turmoil, is that the fortunes of the IT-BPO services industry will dip even more than expected and the uptick will be further down the road – probably several quarters before it happens as confirmed by the latest release of the TPI Index (Q3 2008) that shows a drop in outsourcing volumes even in an otherwise booming EMEA region.

The near-term impact is non-trivial for the India-heritage providers, who enjoy a relatively higher concentration of discretionary, staff-oriented, contractual relationships. Compared to some of the Western heritage providers, Indian IT service providers are also less well-diversified geographically and vertically. Going forward, service providers are

likely to see their sales cycles lengthen; witness a slow or delayed ramping up of projects, experience consolidation in multi-sourced deals and not be able to command better prices from their clients.

In times such as this, clients expect greater flexibility and business value from service providers. The tighter governance and regulatory environment that will evolve as a result of the financial turmoil will offer opportunities to service providers in the medium to long-term.

The extent and duration of this impact will not be apparent now. It's full effect will become known only a couple of quarters later. Within the financial services sector, and related industries that are dependent on consumer credit for spending, there is likely to be a pull back on investments for the next several months. The return to growth for applications-oriented projects will come in all likelihood through a new paradigm for making such investment decisions, one that looks to maximise leverage in development, maintenance and operations. According to TPI projects, we will begin to experience this in the 2Q-2009 timeframe.

Outsourcing and offshoring are secular trends that will continue in the months ahead. At the same time, the trends will remain weak for several quarters going forward.

*** Authored by Dinesh Goel and Indy Banerjee, Directors at TPI**

Impact and guidance for IT-BPO industry

KPMG

The changing economic scenario and the unprecedented restructuring in the global financial services sector is raising concerns about the impact of a potential recession on the global outsourcing industry. As corporations across the world put expansion plans and discretionary spending temporarily on hold, large transformational outsourcing contracts may be postponed for at least six to nine months. Existing contracts and outsourcing in conventional

“ In the medium to long-term, 12-24 months and beyond—cost efficiencies and business transformation in companies will likely gain greater precedence than ever. The more resilient vendors can anticipate future opportunity areas and build new and differentiated offerings for companies emerging from the turmoil. ”

Kumar Parakala, KPMG

areas such as routine F&A or technical support will continue, but growth in the hard-hit sectors (especially BFSI) will be limited. In sectors, which are not seeing as much slowdown, competition for the few available outsourcing contracts will be strong.

The short-term focus of the IT-BPO industry will inevitably be remaining viable with low growth rates. Globally, IT-BPO vendors too are building in slower growth expectations and taking measures such as lowering their revenue guidance, holding back salary rises, or reducing their workforce.

In the medium to long-term, 12-24 months and beyond—cost efficiencies and business transformation in companies will likely gain greater precedence than ever. The more resilient vendors can anticipate future opportunity areas and build new and differentiated offerings for companies emerging from the turmoil. Some of these areas may include:

Integration – Following consolidation/changes in the market landscape, vendors will be called upon to help leverage legacy systems and processes of merged entities.

Transformation – Lowering operating costs and restructuring will be top priorities for corporations as conditions stabilise. The larger global vendors with proven maturity in business transformation will have a head-start in positioning themselves to serve this need.

Regulation – Sweeping regulatory change can be expected going forward adding to the risk management needs of companies. A boom in compliance-related outsourcing, similar to the one post the introduction of SOX for instance, may be forthcoming. Further, there may be huge demand for IT system upgrades and process transformation.

Knowledge Services – As newer ways to cut costs are explored, offshoring of higher value adding, knowledge-based work to lower cost locations is likely. Established destinations such as India may benefit due to higher experience and maturity in these areas.

Captives – As cash-starved companies focus on survival, they may look to monetise their investments in captive operations. The larger third party vendors can gain by acquiring such operations at modest valuations, and secure the parent company's business through long-term deals.

*** Authored Kumar R Parakala, Global Chief Operating Officer and Global Head of Sourcing, IT Advisory, KPMG**

Impact on credit market crisis on takeup of technology and business process outsourcing

AMR Research

Unprecedented as the current situation is, AMR Research is betting that the global services and outsourcing market will not experience a major retrenchment as a result of market upheaval. Our 2008-2009 research agenda is based on our belief that macroeconomic and demographic forces are trumping the pain companies feel in the capital markets – there is a systemic shift afoot in how companies operate that translates into increased reliance on outsiders for both projects and outsourcing. In fact, our most recent research of 44 financial institutions – less than one week old, indicates that 45 per cent of services buyers will not be altering their spending as a direct result of the financial crisis, 39 per cent will actually increase outsourcing expenditure and only 16 per cent declared they would be reducing outsourcing spend. The major areas of short-term focus for further outsourcing investments were applications outsourcing and finance and accounting business process outsourcing. IT infrastructure outsourcing and specific banking BPO services were cited as longer term targets for future investment.

In this sector, crises generate nearly as many opportunities as flusher times, with more outsourcing initiatives making up for a slowdown in project spend. As we've discussed in previous writings, a noticeable spike in outsourcing engagements is unlikely, but it is probable that enough activity will be generated as a byproduct of the financial sector's woes to smooth out reduced project spend in the medium-term. As the dust settles from the recent spate of financial services M&A activity, for example, expect to see major consulting and outsourcing spend on consolidation and integration of IT and business processes.

Of course, a service provider's ability to weather the storm depends on how it is structured. Companies that are consulting and systems integration-anchored feel more pain than outsourcing firms in lean times.

“Our 2008-2009 research agenda is based on our belief that macroeconomic and demographic forces are trumping the pain companies feel in the capital markets – there is a systemic shift afoot in how companies operate that translates into increased reliance on outsiders for both projects and outsourcing.”

Phil Fersht and Dana Stiffler, AMR Research

Companies that have robust recurring revenue streams – i.e., managed services and outsourcing service providers – are better insulated. Finally, firms that have invested in strong global delivery networks are in a much better position to survive and even benefit from this upheaval. For the few consulting and integration service providers that have not invested meaningfully in global delivery, their very survival will be at stake.

***Authored by Phil Fersht and Dana Stiffler, Research Directors for AMR's Global Business Services and Outsourcing Practice**

Indian IT and BPO amid a global slowdown

CLSA Asia-Pacific Markets

Indian IT and BPO export growth is slowing down. This has been an inevitable reality ever since the sub-prime crisis began, though once more, the industry has taken time to accept and respond to changed market conditions. Commentary around the slowdown has changed from “we have not seen anything yet” to “we are less impacted” and then to “we will be net gainers as offshore budgets gain further share.” Yet, like the last slowdown, the Indian IT and BPO service providers are passing through a phase of near freeze in decision making, prolonged uncertainty, and more often than not, substantially reduced business growth.

Yet, slowdowns can be useful when they provoke introspection on issues such as Indian IT and BPO's business models. After all, the 2001-2003 period saw the seeding of several initiatives that have driven Indian IT's export growth ever since, the expansion into Europe, the rise of ERP, BPO, Testing and Infrastructure Management as services, and finally, the evolution of Indian service providers away from their 'low cost' roots to full fledged outsourcing partners of their customers. Where could this slowdown lead?

The industry could use this slowdown to improve middle management bandwidth, change the character of its sales force globally (perhaps using local hires), weed out low paying customers, re-focus on cost containment, streamline hiring procedures from Indian campuses, and above all, re-position at the front-end of customer priorities when spending begins again.

Are Indian vendors ready to help integrate operations across the widespread mergers in their client roster? Are Indian vendors ready to proactively seek business opportunities, rather than wait for the RFP process to begin again? Will the industry stay disciplined on

“**Slowdowns can be useful when they provoke introspection on issues such as business models. After all, the 2001-2003 period saw the seeding of several initiatives that have driven Indian IT's export growth ever since – the expansion into Europe, the rise of ERP, BPO, Testing and Infrastructure Management as services, and finally, the evolution of Indian service providers away from their 'low cost' roots to full-fledged outsourcing partners of their customers. Where could this slowdown lead?**”

Bhavtosh Vajpayee, CLSA India

pricing through this slowdown? Is this the right time to set up beach-heads in new markets? Is this the right time to acquire large or boutique local firms? There are no easy answers. And as always, most of the questions regarding the future of Indian IT and BPO lead back to one basic question. What are the long-term margins that the industry considers sustainable? Slowdowns have seen step changes in profitability of Indian IT firms, and this slowdown may be no different. Given how many viable investments have been pushed back by the industry's near term profitability focus, it is just as well that the slowdown drives some risk-taking. This is the time to think about solutions, products, and non-linear growth initiatives, which were an avoidable distraction when growth was over 30 per cent + and pricing was robust.

Eventually, Indian IT's initial prognosis on the slowdown may well-prove correct. The slowdown will benefit the industry, but not equally so across vendors. The long-term winners will be those who use cash judiciously, seed the investments today that can become scalable revenue streams in the future, and above all, those who are willing to use this phase of inactivity to look within their business models and take the next steps towards becoming truly global outsourcing partners to their customers. CLSA expects a recovery no earlier than mid-2010, and we believe that a technical recession in both America and the Euro Zone has already begun in September 2008 quarter. 2009 looks tough, but like 2001, it can also be transformational.

***Authored by Bhavtosh Vajpayee, CFA, CLSA India**

What does the financial crisis mean to the tech market?

Forrester Research

In the September 24, 2008, review of the US IT market, as of the third quarter of 2008, Forrester predicted

a distinct slowdown in the growth for US business and government purchases of technology goods and services due to an assumed recession starting in the third quarter. Since then, an acute financial crisis has hit not only the US but also countries in Europe and Asia. Stock markets have fallen at a pace not seen since the 1929 stock market crash and bank failures have hit both the US and Europe – with ripple effects in other markets.

Yet, we are still sticking to our forecast of a sharp slowdown in growth for the US tech purchases and not contraction. Why? Forrester's tech market forecast already presumes the recession that is actually happening. We also expect that governments and central banks will take actions to stabilise financial markets and prevent an economic disaster.

At the same time, with the financial crisis now spreading around the world, risks have grown that the US and other major countries will experience a longer and deeper recession than we had expected. And to help technology vendors to be prepared with the prolonged recession and its business environment, Forrester has recently outlined a scenario to this effect. According to this scenario, if a longer and deeper recession takes place, the tech market will see several quarters of declines in purchases, not just two or three quarters with little or no growth in late 2008 and the first half 2009.

In this case, the US IT market growth in 2009 will slip to two to three per cent, with several quarters of declining purchases, instead of our current projection of six per cent for 2009. The global IT market growth will experience a similar deceleration, moving from seven to eight per cent that we currently project for 2009, to much slower growth of three to four per cent.

“**Though the risk of a protracted global financial meltdown is increasing, we believe that intervention by the governments and central banks of major economies will keep that from happening.**”

Andrew Bartels, Forrester Research

Though the risk of a protracted global financial meltdown is increasing, we believe that intervention by the governments and central banks of major economies will keep that from happening. And we expect the tech market to weaken, but still grow – though with a sharp fall in the (growth) rate.

***Authored by Andrew Bartels, Vice President and Principal Analyst, Forrester Research and is reachable at incomment@forrester.com**