OLIVER WYMAN

IT SERVICES

WINNING IN THE NEXT DECADE: FROM INDUSTRIALIZED TO AGILE

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Today, the global IT services[1] market is estimated at $964 BN and is expected to reach about $1,200 BN by 2018. Over the next four years, annual growth is forecast at 5.1%, mainly driven by increased business in consulting and infrastructure outsourcing (related to the Cloud expansion).

Despite this growth forecast, IT services providers will no longer be able to rely on their traditional tactics to gain market share. In this ever-evolving industry, the historical key success factors are changing. Indeed, industrialization driven by offshoring, economies of scale, and specialization will remain a critical factor; however, it will no longer be sufficient to prosper in the market. Instead, three mega trends are radically changing the success parameters:

- **Disruptive technology trends** (such as cloud computing, big data, social media, and increased mobility) will **commoditize 50-60% of current services offerings.**
- **A change of clients' buying patterns**, shifting from buying capabilities-based services to **solutions-based services** in a multi-vendor environment, and **reducing by 50% the average size of contracts.**
- **New competition rules:** labor costs will become less and less a differentiating factor between providers in the Western countries and those in emerging countries. At the same time, **new players,** including web companies and temporary agencies, **will arise and represent 15–20% of the market.**

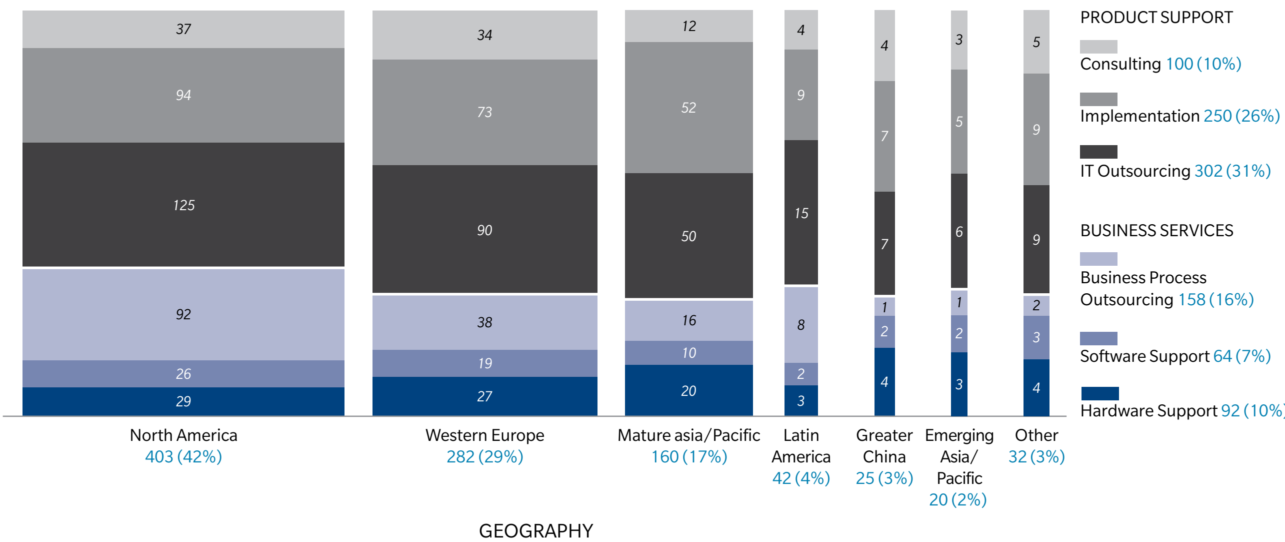
Players that are eager to succeed in the new IT services era will need to undertake an ambitious transformation towards an "agile" model motivated by two key "plays":

- **An accelerated value repositioning** by developing compelling and innovative offers targeted at the high-growth segments while repositioning commoditized offerings.
- **A flexible operating model** by developing the ability to adjust and redeploy the sales effort, the cost structure and the talents to the volatility of the activity but also to the fast-paced change driven by clients' needs.

1 IT services refers to the application of business and technical expertise to enable organizations in the creation, management, and optimization of or access to information and business processes (Gartner).

Exhibit 1: IT Services Market Overview

IN 2014, THE GLOBAL MARKET FOR IT SERVICES IS ESTIMATED AT $ 964 BN;
30% OF WHICH IS IT OUTSOURCING

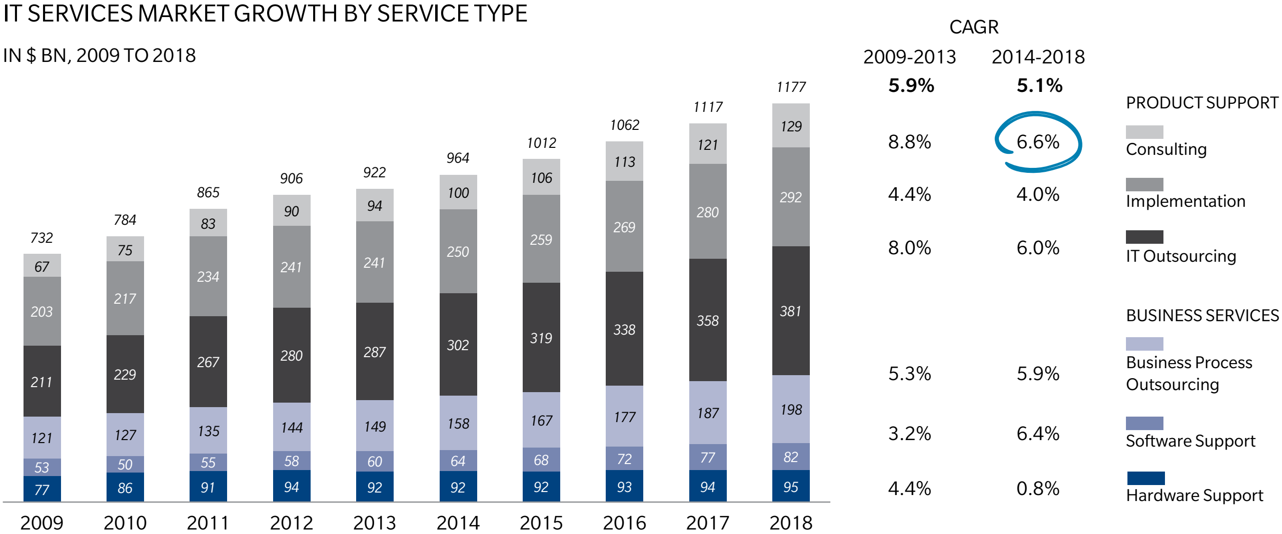


Note: Others include Eastern Europe, Eurasia, Middle East & North Africa and Sub-Saharan Africa.
Source: Gartner Market Statistics, IT Services, 2012-2018, 1Q14 update – Calculation performed by Oliver Wyman.

Exhibit 2: IT Services Market Overview

IT SERVICES MARKET GROWTH BY SERVICE TYPE

IN $ BN, 2009 TO 2018



Note: Others include Eastern Europe, Eurasia, Middle East & North Africa and Sub-Saharan Africa.
Source: Gartner Market Statistics, IT Services, 2012-2018, 1Q14 update – Calculation performed by Oliver Wyman.

PART 1) INDUSTRIALIZATION THROUGH OFFSHORING, ECONOMIES OF SCALE, AND SPECIALIZATION: THE KEY SUCCESS FACTOR OF THE PAST DECADE

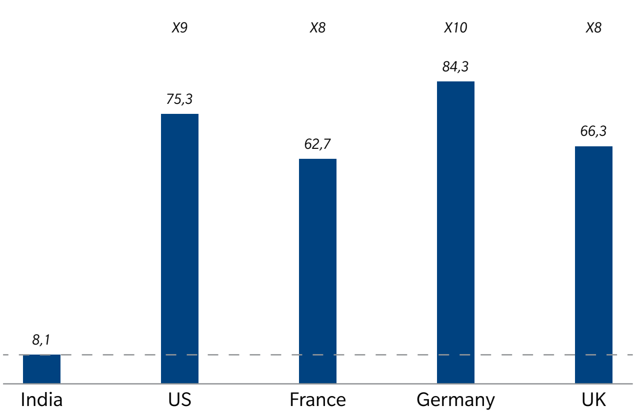
OFFSHORING HAS ENABLED INDIAN PLAYERS TO CAPTURE A SIGNIFICANT SHARE OF THE MARKET

Over the past decade, Indian-based IT services players have benefited from a comparative advantage in terms of labor unit costs to respond to the growth in offshoring demand from mainly English speaking global players. As a basis for comparison, the annual base salary of an Indian senior professional is estimated to be eight times lower than one in the United Kingdom or France, nine times lower than in the United States, and 10 times lower than in Germany.[2]

As a result, Indian players such as Tata Consultancy Services, Infosys, and Wipro have experienced double-digit growth of more than 25% per year between 2000 and 2012. They have managed to maintain their positioning in the market thanks to India's investments in education, which has steadily improved the pool of talent available locally with, for example, schools like the Indian Institutes of Technology training quality engineers (See Exhibit 3).

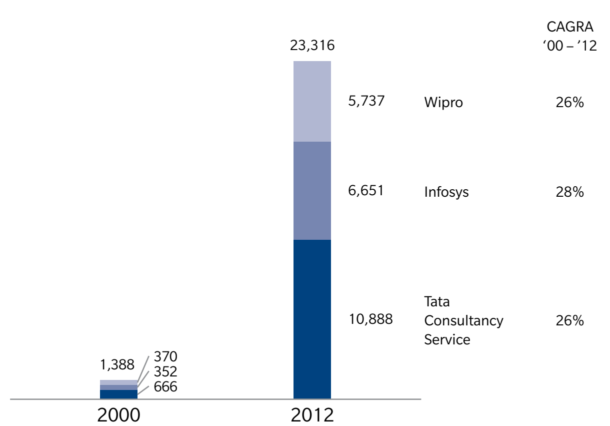
Exhibit 3: Offshoring

ANNUAL BASE SALARY FOR SENIOR PROFESSIONAL IN K$ – 2012



Source: Total Employment Costs around the World, Mercer 2013.

REVENUES GROWTH OF INDIAN BASED ACTORS IN M$ – 2000 AND 2012



Source: Server 2000 IT Services 2003 Oct 2001, Server IT Services 2013 – Calculation performed by Oliver Wyman.

2 Total employment costs around the world, Mercer (2013).

LARGE COMPANIES HAVE LEVERAGED THEIR SIZE TO GAIN MARKET SHARE

Over the past decade, companies with revenues greater than $2 BN have experienced the strongest growth rate in market share (61% of the total market in 2011 vs. 32% in 2000). To do so, these companies have leveraged their size, deploying industrialized models across multiple geographies that, in turn, have enabled them to secure larger IT contracts.

For example, the big names in the industry (such as IBM, HP, Cap Gemini, Accenture, and CSC) have developed "Centers of Excellence" or industrialized delivery centers across geographies, mainly in the managed services area, that are platforms based on preconfigured solutions that are highly automated, reliable, and re-usable. Consequently, their capacity to deliver IT services from offshore delivery centers has also increased. Over the past decade, the big names in the industry have relocated more than 500,000 jobs to low-cost countries. In addition, these companies have leveraged their size to support the international expansion strategies of their clients. For example, Indra, the Spanish IT service market leader, has grown significantly in Latin America by accompanying some key Spanish clients there.

SPECIALIZED NICHE PLAYERS HAVE SURFACED

Different archetypes of specialized niche players have surfaced in the past decade:

- **IT players with strong vertical specialization** have chosen to dedicate their portfolio of service offerings to a specific industry. An example is FitNetix, based in London. FitNetix exclusively targets leading global banks, hedge funds, and proprietary trading groups with niche offerings such as outsourcing services for ultra-low latency trading, hosting and infrastructure connectivity, and risk-management solutions.
- **IT players with niche know-how** for example in Security.
- **IT players with strong transformation value propositions** have focused their strategy on developing an impact-led model that targets one core offering. For example, Solucom, a French firm, has based its value proposition on information systems management dedicated to companies' transformation.

PART 2) THREE GAME CHANGERS FOR THE NEXT DECADE

DISRUPTIVE TECHNOLOGY TRENDS WILL COMMODITIZE AROUND 50-60% OF CURRENT SERVICE OFFERINGS

Four major technology trends are revolutionizing the role, positioning, and business model of the IT function and of the technology in the business: cloud computing, big data, social media, and increased mobility. These trends have greatly affected the value of the solutions provided by IT services players both in infrastructure management and in application development and maintenance. One of the main changes is the shift from a customized "one size fits all" solution (for example, ERP) to a solution crafted to the customer's requirements. In the world of diverse "as a service" cloud solutions, complexity does not stem from customization but rather from the aggregation of multiple solutions within a secure environment. In our experience, this shift will lead to a "commoditization" of 50% to 60% of the current portfolio offerings of most IT services providers over the next five years. Consequently, it will also have a significant impact on the current skill set of the workforce.

Exhibit 4: IT Paradigm

	FROM			TO	
	IT PARADIGM	KEY SERVICE DRIVERS		IT PARADIGM	KEY SERVICE DRIVERS
Infrastructure	Dedicated and fragmented infrastructure	Infrastructure consolidation and management	〉	Infrastructure as a service	• Sourcing optimization • Vendor management and service monitoring • Security
Applications	ERP centric owned by the IT department	Application customization and maintenance	〉	Limited ERP and multiple applications owned by the business	• Sourcing optimization • Service aggregation • Security

A SOPHISTICATION OF CLIENTS' BUYING PATTERNS WILL TEND TO PROMOTE A SOLUTIONS-DRIVEN PORTFOLIO AND REDUCE BY 50% THE AVERAGE SIZE OF THE CONTRACT

Client buying patterns are becoming more sophisticated as clients shift from buying capabilities (technological or functional know-how) to buying "outcomes":

- For "commoditized IT" (such as service desk or service management), clients focus on cost reductions. Their internal purchasing departments have applied pressure on managers to understand the underlying economics of the cost structure of IT services. Thus, the selling price of standard services has drastically dropped in the past years. Typical deal contracts include clauses that set the price decline year over year by 5% to 10% at constant volume demand.
- For "business-oriented IT," clients focus on return on investment. They rely on the ability of the IT services provider to support the transformation of their internal processes with results-oriented pricing models. These offerings are no longer targeted only to the IT managers but to C-level executives.

In addition, clients now prefer contracting with multiple vendors instead of concentrating the major part of their activity with a unique IT services provider. Even if managing multi-sourcing instead of mono-sourcing complicates the clients' internal processes, it also offers substantial advantages such as providing access to best-in-class services, reducing concentration risk, and the ability to match culture to service recipient. In the IT services market, large clients are increasingly segmenting their needs in blocks and preferring to partner with one specialist provider per block rather than with one multi-specialist for all blocks. And in Western countries, the market is now mainly about contract prolongations and no longer about new contracts, which has changed the set of requirements to win. These trends result in significant pressure to decrease contract size by around 50% in the next five years.

Consider, for example, Accenture, which has repositioned its offerings as a business process outsourcing solution with a strong verticalization, all the while reinforcing its value proposition on business optimization (the company has, for instance, formed the joint venture Taleris with General Electric to enable airlines to predict aircraft maintenance issues and take preventive action). In addition, Accenture has gained significant market share through a dedicated account plan, building on long-term partnerships with clients. By adapting its sales strategy, among other key success factors, Accenture has doubled its revenues and attained a 15% operating margin over the past decade.

COMPETITION RULES WILL CHANGE AND NEW PLAYERS WILL REPRESENT AROUND 15-20% OF THE MARKET

In the coming years, labor costs will become less and less a differentiating factor between providers in the Western countries and those in emerging countries. As large competitors based in North America and Europe (such as Accenture and Cap Gemini) develop offshore platforms to compete on costs, Indian-based companies (such as Tata and Infosys) are developing commercial hubs in Europe, the Middle East, and Africa (EMEA) to grow their client base so as to maintain a sustainable market position.

In comparison, mid-sized companies will be losing ground as they do not have the critical size required to profit from an industrialization strategy, nor do they have the agility to adjust their product portfolios to push specialized offers. As a result, the market will experience a “collapse of the middle” and become polarized around global and ultra-niche players. To survive, mid-sized companies need to evolve to position themselves either as global players, specialized service providers or, as Tier 2 service providers to Tier 1 players that are looking to outsource non-core activities through lower cost and price structures.

In addition to the traditional players, some companies, with very significant investment power, are progressively extending the competition landscape:

- Some Web companies like Amazon and Google recently extended their offerings to cloud services (such as through the “Amazon Cloud Drive” and “Google Cloud Platform”) and are planning to broaden their IT services offerings in the near future. Given how fast these firms are growing and the strength of their impact on the IT market today, they could pose a strong challenge to the incumbent IT services providers.
- In parallel, Indian companies have developed strong platforms that now allow them to climb up the value chain. For example, Infosys acquired the Swiss consulting firm Lodestone for $350 MM in 2012 in order to compete more effectively in the SAP deployment space at scale in high-spend EMEA markets; Cognizant acquired six small IT services companies that were part of Germany’s C1 Group for an undisclosed sum in 2012; and Tata Consultancy Services acquired Alti SA (1,200 employees) for €75 MM. These three acquisition strategies have helped diversify the current portfolio of activities of their companies all while expanding their operations geographically to Western Europe.
- Finally, some temporary agencies are also climbing up the value chain by developing IT services centers on low-qualification services. As an illustration, one pillar of the ManpowerGroup’s strategy is to establish itself in the IT services market by creating its own brand Experis. To do so, the group has acquired Proservia, Damilo Consulting, and the outsourcing and consulting capabilities of Segula Technologies.

“To survive, mid-sized companies need to evolve to position themselves either as global players, specialized service providers or, as Tier 2 service providers to Tier 1 players that are looking to outsource non-core activities through lower cost and price structures.”

PART 3) BUILDING AN AGILE COMPANY

Given these emerging trends, IT services providers will need to reinvent their playbooks by designing growth and cash-generating plays catered to the segments they want to serve, all while ensuring agility in these models to refresh and evolve as the market needs and trends continue to shift.

Exhibit 5: "Agile" IT Services Playbook

VALUE REPOSITIONING

1. OFFER LIFECYCLE

- Exiting commoditized offers
- Industrialization of high runners
- Design and ramp up of emerging offers

2. FOOTPRINT

- Selective market consolidation
- Vertical specialization
- High growth international market development

3. DIVERSIFICATION

- Untapped asset utilization:
  - Development of industry/application specific offerings

OPERATING MODEL

4. COMMERCIAL MODEL

- Pricing optimization
- Sales coverage models
- Sales force effectiveness
- Channel strategy and enablement

5. LABOR COST TRANSFORMATION

- Flexible labor solutions
- Tight and flex capacity model
- Subcontracting optimization
- Labor migration
- Overhead optimization

6. PURCHASING OPTIMIZATION

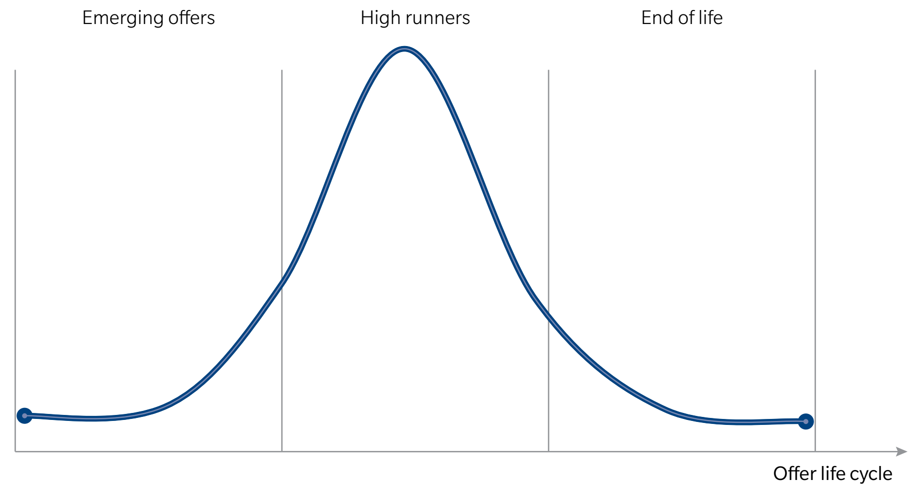
- Good/service for resale margin engineering
- Delivery asset optimization
- Indirect purchasing

PLAY #1: DRIVE A MAJOR VALUE REPOSITIONING

To meet the sophisticated customer's expectations and embrace the new technological trends, IT services providers will need to reposition a significant part of their product portfolio. Companies will need to understand the "vitality" of their current portfolio and anticipate the "commoditizing" areas, and they must also manage the right balance between investing in emerging offerings while maintaining the "high runners" that represent the bulk of their profits.

Exhibit 6: Portfolio Management

OFFERS PORTFOLIO MANAGEMENT



	Emerging offers	High runners	End of life
Characteristics	• Innovative offer tackling a key customer hassle • Low competition	• Increasing demand • Increasing competition	• Decreasing demand • Commoditization
Stakes	• Invest and develop • Make the client pay a price premium	• Consolidate and industrialize	• Re-segment • Upgrade • Leave

In addition, most companies will need to select their areas of specialization and focus on developing their new core offerings so as to accumulate the required critical mass on an intersection between (1) business segment, (2) industry, and/or (3) geography. This critical mass will allow for an improved pricing power and industrialized delivery and may require significant actions in terms of portfolio management (such as with acquisitions or divestments targeted to improve the portfolio's return).

PLAY #2: BUILD A FLEXIBLE AND NIMBLE OPERATING MODEL

Given the rapid commoditization of the product portfolio and the trend of clients wanting to consume services "on demand" in a scalable way, the agility of the operating model will become a critical factor.

On the delivery side

- **Right size and adjust the capacity at a high pace.** This will not only require a significant improvement in demand-forecasting and supply-planning capabilities but also innovative vehicles to adjust the workforce capacity in highly regulated countries.
- **Re-skill and re-deploy efficiently commoditized skills towards new areas of expertise.** This implies advanced resource- and talent-management capabilities (training, staffing, and so on).

- **Diversify the cost base through an extensive use of third parties for low value-added and highly volatile capabilities.** As an example, IBM has implemented "the liquid challenge" program to develop and allocate tasks to specialized parties. The program focuses on a small core group of permanent employees handling key business processes/functions (such as project management, sales, governance, and strategy) while the actual service is delegated to business partners (for example, freelancers with a sophisticated skill set as opposed to usual contingency work). This approach requires that tasks can be split into independent parts (such as software code components) and that projects can be assigned based on skill-set and/or auction.

On the commercial side

- **Upgrade capabilities and talent to sell more sophisticated, complex, and impact-led solutions to the client.**
- **Shift the sales effort towards business and C-level positions.** As the key stakeholders shift from IT managers to business leaders, the sales strategy also needs to be adjusted accordingly to manage complex sales.
- **Reinforce account management by allocating the sales effort based on the commercial strategy.** This can be achieved with a sales team dedicated to acquiring new clients while the consultants involved in delivery, who are best-suited to identify new project opportunities, are used as a key commercial arm to farm current accounts.
- **Develop creative value-based pricing models.**

Exhibit 7: Commercial Model Shift

		FROM		TO
CLIENTS	Scope	IT FUNCTION AND PURCHASING FUNCTION	〉	IT FUNCTION, PURCHASING FUNCTION AND BUSINESS LEADERS
	Level	N-X		C-LEVEL
SELLING POINTS		CAPABILITIES AND RESOURCES	〉	SOLUTIONS AND IMPACT
PRICING		COST PLUS APPROACH	〉	VALUE-BASED PRICING

ABOUT OLIVER WYMAN

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