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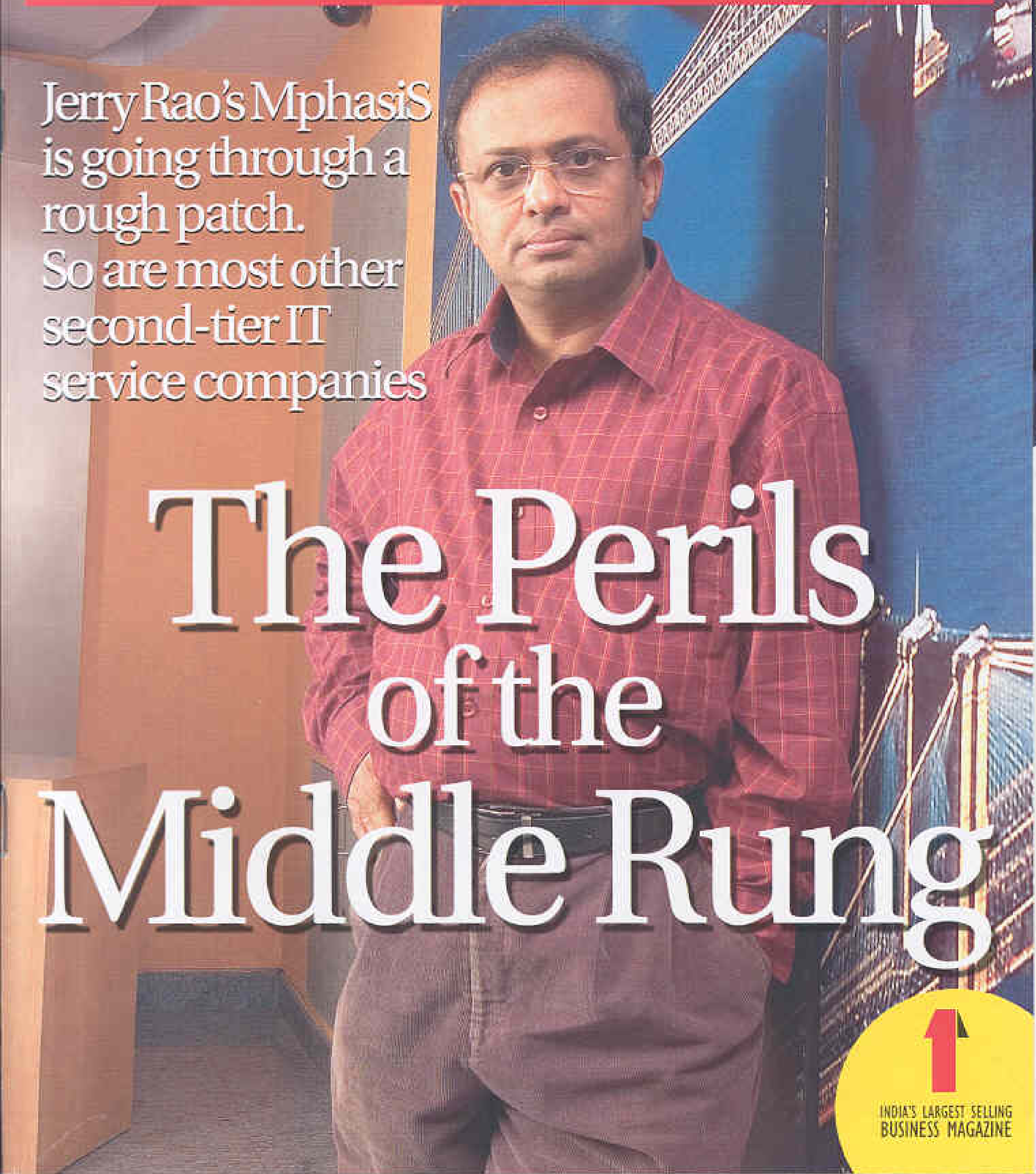

Jerry Rao's MphasiS is going through a rough patch. So are most other second-tier IT service companies

The Perils of the Middle Rung

1 INDIA'S LARGEST SELLING BUSINESS MAGAZINE

COMPANY	Net sales (Rs crore) 2002-03	2003-04	2004-05
Patni Computer	903.7	1143.5 ▲ +26.5%	1413.1 ▲ +23.5%
i-flex Solutions	610	788 ▲ +29%	1139 ▲ +44%
MBT	NA	NA	NA
Polaris	428.2	646.4 ▲ +51%	787.12 ▲ +22%
NIIT	NA	NA	NA
iGate	421	570 ▲ +35%	580 ▲ +1.7%
BirlaSoft	NA	NA	NA
MphasiS	429.27	580.58 ▲ +35%	765.67 ▲ +32%
Mastek	379.4	410.7 ▲ +8.2%	NA
Hexaware	249	344 ▲ +38%	546 ▲ +58%
L&T Infotech	NA	NA	NA
Tata Infotech	453	585.5 ▲ +29%	763 ▲ +30%

NA- Unlisted companies Source: Company releases and CMIE

A crisis is looming for mid-tier IT companies. Patni Computers, NIIT, Mastek, i-flex, Polaris and the like have chalked out their survival strategies. But do they have time on their side?

By Snigdha Sengupta

The Perils of being in the Middle Rung

COMPANY	Net profit (Rs crore) 2002-03	2003-04	2004-05
Patni Computer	172.8	192.2 ▲ +11.2%	251.7 ▲ +31%
i-flex Solutions	171	178.8 ▲ +4.5%	232 ▲ +30%
MBT	NA	NA	NA
Polaris	54.5	69.8 ▲ +28%	58.04 ▲ +17%
NIIT	NA	NA	NA
iGate	28.35	0.08 ▲ +99.7%	21.2 ▲ +200%
BirlaSoft	NA	NA	NA
MphasiS	66.93	98.58 ▲ +47%	124.62 ▲ +26.4%
Mastek	50.3	29.6 ▼ -41%	NA
Hexaware	5.7	33 ▲ +479%	63.7 ▲ +93%
L&T Infotech	NA	NA	NA
Tata Infotech	30.4	59.4 ▲ +95%	80.2 ▲ +35%

NA- Unlisted companies Source: Company releases and CMIE

IT is not typical of Jerry Rao, the 52-year-old chairman and CEO of MphasiS, to duck meeting the media. But on 6 May, Rao's office called in last minute to cancel a breakfast meeting with *BW* in Mumbai. The reason for the ditch became clear that evening. The Bangalore-based IT services firm and its largest shareholder, Barings India Private Equity, put out a joint statement informing shareholders that the private equity investor had retained Standard Chartered Bank to advise it on the sale of its 35.6 per cent stake in MphasiS. Suddenly, one of the bellwethers of the Indian middle-tier IT service was facing an acute crisis. The company's promoters faced the prospect of ceding majority control to an external investor — anybody who buys Barings' stake will necessarily have to make an open offer for an additional 20 per cent.

Four days later, when *BW* caught up with Rao at his Bangalore headquarters, damage control was under way. The chairman had formed a core team — CFO Ravi Ramu, vice-chairman Jeroen Tas and Rao himself — to focus on the task at hand. "We've insulated the operating management from the process. It's business as usual for the rest," said Rao. But for him, Barings' imminent exit commands top mind share. "When a 36 per cent shareholder wants to sell, you can't pretend it's a non-event." Barings' bankers had already received bids from three top-tier Indian IT services firms. (See 'Inside The Mphasis Deal')

Barings' decision to exit could not have been more ill-timed for Rao. But analysts who have been tracking the MphasiS stock say the private equity investor is probably keen on cashing in on its investment before it's too late. "Things have been amiss at MphasiS for well over a year now," says an equity analyst in Mumbai. The scrip has plunged 60 per cent in 12 months — from Rs 543.55 per share on 31 March 2004, to Rs 223.2 at the close of the 2005 fiscal. The stock is currently trading at Rs 277, which roughly puts MphasiS' valuation at $500 million. The company's IT service business hit a trough during the past fiscal and it was forced to lower its growth guidance — it had originally pegged revenue growth at 35-40 per cent and profits at 40-45 per cent. The company closed the fiscal with a 32 per cent topline and 26 per cent bottomline growth.

This increase came primarily on the back of key acquisitions like Kshema Technologies, and with a relatively stable growth in the BPO business. The management has tried to take some corrective action by bringing in consultants McKinsey & Company to rejig the business model, but the success of that initiative now hinges on who buys Barings' stake.

But MphasiS is not the only mid-tier firm facing tough times. The middle-tier, as per Nasscom data for 2004-2005, comprises 12 firms that account for 20-25 per cent of the country's $12.2 billion software and services export revenues. And quite a few of them seem to be grappling with problems.

Chennai-based Polaris Software Lab's scrip has declined 60 per cent from Rs 268 at the time of its merger with Orbitech in August 2002 to Rs 100-110 now. Mumbai-based Mastek, which made its second public offering in 1996 at Rs 180, had seen its scrip almost touching Rs 600 by January 2003. But it has plunged since, and is now trading in the Rs 300-400 range. Currently, the two companies are grappling with internal issues that will have a bearing on how they weather the next few quarters. Market sources say Citigroup, which had a 54 per cent stake in Polaris, wants to demerge Orbitech. "Citi may be taking a relook at its IT service outsourcing arrangements in India. It could be looking at a larger captive strategy," says a source. Polaris CEO Arun Jain denies this, but says: "Citi is agreeable to bringing down its stake in favour of a strategic investor." Citi did not respond to queries from *BW*.

Meanwhile, Mastek's two BPO joint ventures with UK-based Capita Group (60:40) and Deloitte (50:50) are floundering. Capita has hiked its stake in the JV to 90 per cent and intends to pursue BPO in India on its own, says Mastek chairman Ashank Desai. Deloitte, meanwhile, has reworked the terms of its JV with the caveat that ramp-ups at its captive centre in Hyderabad will get first preference. Desai maintains that none of this will set back Mastek's growth. The Capita JV incurred losses of Rs 6.6 crore in the 10 months between March and December 2004. Capita hiked its stake soon afterwards. The Deloitte JV accounted for 16.8 per cent of Mastek's revenues for the half-year ending 31 December 2004. The company closes its fiscal on June 30.

Delhi-based NIIT slipped into the red in 2001-02 with a loss of Rs 19.2 crore against a net profit of Rs 71 crore the previous year. It was able to profit in 2003-04 (Rs 41.7 crore), but only after it had changed its fiscal year from October-September to April-March. It also spun out its software business into a separate company, NIIT Technologies, in September 2003.

What the MphasiS deal could look like

IN less than a week, Bangalore-based MphasiS' largest shareholder, Barings Private Equity, will pick the winner of the pack of bidders for its 35.6 per cent stake in the middle-rung IT and BPO services blue chip. "By next Friday, we should know who the buyer is," says Subbu Subramaniam, partner at Barings India. The private equity investor is hoping to achieve a return of at least 5-7 times on its original investment of $16.6 million. The names doing the rounds in investment banking circles include TCS, Wipro, IBM Global Services, EDS and Cap Gemini. More interesting is the talk about buyout funds sniffing at the deal.

Of course, ultimately valuations will determine the final buyer. MphasiS is valued at approximately $500 million. Barings' wants a 20 per cent premium on the current market price, say sources. But that might be difficult given MphasiS' recent track record on growth rates. Some quarters peg the valuation for Barings' stake at between $140-200 million. "Any bidder will keep in mind that the final payout will be much higher considering that it will have to make an open offer for 20 per cent," say sources.

Why does Barings want to exit now? To be fair, it's been an investor in MphasiS for almost nine years. It does seem to have an immediate compulsion — it simply wants to move on to the next fund. But the question is: Will chairman Jerry Rao stay on?

MphasiS CEO Jerry Rao

HEMANT MISHRA

Narendra Patni (L), CEO of Patni Computer, is betting on acquisitions to become one of the big boys

Deepak Ghaisas, CFO, i-flex, has shown the path to niche strategy is by not going the IT services way, but by betting on products

The firm is currently scouting for an investor, according to CEO Arvind Thakur.

If market analysts are to be believed, the number of mid-tier firms headed for a rough ride is growing by the day. It may not be a full-blown crisis yet, but seems to be building up fast. Valuations are also under pressure. Last year, mid-tier stocks were trading at price earning ratios (P/Es) in the 15-20 range. This year the P/Es are in the 9-12 range, bar a few honourable exceptions like Patni and i-flex. (See 'How The Numbers Stack Up')

The Maturing Of An Industry

Why is the mid-tier coming under so much pressure? To get a clue, first look at how the structure in IT services industry has changed in the past few years.

According to Nasscom's 2003-04 review, the tier-I players, the top five IT vendors, accounted for 36 per cent of the industry's $9.2-billion export revenues. The mid-tier firms accounted for 16 per cent, and the MNCs 31 per cent. The balance was shared between niche players (3-4 per cent) and smaller firms chasing generic work (5-6 per cent).

By the end of 2004-05, when export revenues grew to $12.2 billion, the top five IT firms had increased their market share to 49 per cent. The mid-tier had grown to 21 per cent but only because players like Patni, iGate and Hexaware, had completely overhauled their businesses in the previous year. All three had taken pains to differentiate their market offerings. For example, iGate had started experimenting with the transaction-based pricing model. Patni started selling clients end-to-end solutions. And Hexaware's go-to-market strategy was built around its technology expertise in packaged software solutions (Peoplesoft, SAP, Oracle).

However, the rest of the middle-tier players, largely offering generic, me-too services, had started floundering. This is, in fact, a sign that the IT service industry is entering its mature phase, say analysts. In a mature sector, there are a few large players who dominate the market and smaller players who survive in niches. There aren't too many mid-level players in a mature industry.

This is just how things are shaping up in the Indian IT service industry today. But before going any further, look at how the squeeze in the mid-tier began.

What Went Wrong?

The genesis of today's churn can be traced to the big slowdown of 2000-03. Since then, the hierarchy of the mid-tier has been changing practically every year. Take a look at the line-up at the end of 2001-02. Based on revenues, the top five players in the category were Patni Computer, Silverline Technologies, Mahindra British Telecom (MBT), Pentasoft Technologies and HCL Perot Systems. In 2003, Silverline had dropped off altogether and Pentasoft had plunged to number 17. The new line-up included Patni, MBT, i-flex, HCL Perot and NIIT. But this would not last for long. Polaris jumped 10 ranks from 14 to 4 in 2004 and i-flex pushed past MBT to reach No. 2. (HCL Perot Systems got merged with HCL Technologies). The only constant has been Patni, which retains its numero uno position till date.

During the slowdown, the early casualties were Silverline and Pentasoft. None of the two rising stars of the mid tier proved resilient enough to weather the turn. By March 2002, Silverline had turned its $86.8-million working capital surplus in December 2000 into a $109-million deficit. The promoters had to re-

HEMANT MISHRA

sort to selling their top accounts — Greenpoint and Citicorp — to another mid-tier firm, i-flex, to repay their bankers. Pentasoft's stock is currently trading at Rs 2.70 per share. It reported revenues of Rs 56 crore and net profits of Rs 2.4 crore for the year ended 31 March 2005. In April this year, the Chennai-based firm announced it was merging with the Kolkata-based Silicon Valley Infotech. Silverline and Pentasoft had some fundamental weaknesses in their business models. Both were driven by promoters who gave their professional managers little leeway on strategic business decisions. Silverline saw two CEO changes within six months in 2002. The transience of the top management impeded the company from taking critical decisions at the right time.

While its better-known peers were floundering, MphasiS had been busy. As early as April 2000, Rao and his team realised the importance of having a diversified service line and building an offshore delivery capability that was as robust as the onsite side. In 2000, at the behest of Barings, Rao pushed through the merger of his California-based start-up, MphasiS Corp, with Bangalore-based BFL Software. Though both were incurring losses then, the merger provided end-to-end e-business solutions across five verticals. But 70 per cent of the company's revenues came from the US market and 54 per cent of its projects were still onsite. But that was not a cause for concern, yet.

Till the slowdown hit the Indian IT service industry, most players in the mid tier followed a generic model: 50 per cent of revenues from the US and the bulk of the delivery onsite. The financial services sector was their main revenue driver. Most were able to sustain growth of 60-70 per cent, sometimes more, on the basis of 1-2 large client relationships. But issues like derisking the client base and differentiating on the basis of solutions-driven services were relatively unknown.

All that changed in 2001. With the US economy facing its worst recession, customers cut back IT budgets and Indian software export revenue growth slowed from upwards of 50 per cent year-on-year to the 25-30 per cent levels. Even market leader Infosys was forced to revise its revenue guidance for 2001-02 from 50-60 per cent to 30 per cent.

The hardest hit, of course, was the mid tier. Suddenly it found itself competing for even the smallest deals with larger players. "In a crunch, where customers become as concerned about business continuity as about saving costs, the brand pull of the larger vendor often wins the day," says an industry analyst. While the larger players were able to sustain the impact of slower growth rates because of their 10-year head-start (they had built up fairly robust offshore delivery capabilities and had already started diversifying into markets like Europe, the mid tier did not have that advantage. Many saw their earlier gambit of putting the bulk of their delivery resources onsite backfire. A higher onsite presence not only meant higher billing rates, but also higher operating costs. MphasiS, Silverline and Mascot (now iGate Solutions) had 53 per cent, 64 per cent and 82 per cent respectively, of their delivery onsite. With operating costs under pressure, they were restrained from diverting resources to build offshore delivery capabilities. And even if they wanted to move work offshore, it wasn't simple. "Customers were wary of offshoring work out to a company with a weak balance sheet because they didn't know if the company would be around tomorrow," says Ranjan Biswas, partner, Ernst & Young.

A New Phase

Though the slowdown ended two years ago, it hasn't brought much succour yet. Post-slowdown, one of the key changes in the marketplace was that customers had reoriented outsourcing strategies. "Three years ago, customers had a very distributed offshore strategy. Every division's IT team had its own vendor. So a lot of second-tier vendors were doing as well as the top tier. Now, clients have centralised governance and, therefore, vendor management has also become centralised. So, while they've ramped up their offshore activity, they've consoli-

Key mid tier M&A deals

DATE	ACQUIRER,TARGET,DEAL SIZE
Aug 2003	iGate,Quintant,$19 mn
Dec 2003	i-flex, SuperSolutions, $11.5 mn
Apr 2004	Mphasis,Kshema Tech $21 mn
Jun 2004	Flextronics, Hughes Software, $226 mn
Oct 2004	Patni, Cymbal Tech, $68 mn
Nov 2004	i-flex, Equinox, N.A.
Feb 2005	MphasiS, Princeton Consulting, $14 mn
Mar 2005	Mphasis, El Dorado, $16.5 mn
May 2005	MindTree, Linc Software, $10-12 mn

dated down the number of suppliers," says John.C.McCarthy, vice-president, Forrester Research. Nasscom says out of the overall projected $94-billion global outsourcing spend by 2008, $48 billion is expected to be outsourced to India.

This essentially means that contracts are getting bigger and more complex. What may start out as a $1 million-5 million contract, could have the potential to be scaled up to $10 million-100 million or more over 3-5 years. The other big change seen is that *Fortune 1000* firms have started to offshore. Says Gartner analyst Ravindar Datar: "This category of customers is more risk averse and cost conscious at the same time. The norms for vendor selection are much more stringent due to issues like business continuity."

Then again, there is the growing threat from tech multinationals (MNCs), which have been building up their India bases. Till last year, with the exception of IBM, most tech MNCs had not yet started ramping up their India-centric business aggressively. This could change in the current year. There's already talk of Accenture and Cap Gemini seeking out acquisitions in the mid-tier segment. EDS is also likely to join the pack. The market structures could change radically once the MNCs ramp up enough to go after the business that Indian companies have been privy to so far.

R.A. CHANDROO

Polaris CEO **Arun Jain** is scouting actively for a strategic investor

Course Correction

So what can the mid-tier vendors do to differentiate themselves? If you look at the current players, there are two broad categories. First, broad-based players that are microcosms of the top tier. They have tried to differentiate themselves by focusing on fewer verticals than the top tier does and offering end-to-end solutions in the chosen verticals.

Patni is a good example of a player chasing this strategy. It has moved up the value chain from application development and maintenance to infrastructure management and packaged services. It is focusing on six verticals in which it has built up some sort of critical mass and can offer end-to-end solutions. To that end, it has chosen to run BPO as an integrated value-added service instead of a separate business. Says Vijay Khare, executive vice-president, Patni: "The idea is to engage customers in the chosen verticals through domain expertise and then cross-sell. So, you sell a business solution which also helps deepen client penetration."

The essence of the Patni strategy is to scale up and become one of the big boys. And it intends to get that scale as much through acquisitions. Last year, it did the biggest IT service acquisition when it picked up the US-based Cymbal for $68 million. "They have $150 million or so in reserves and are now raising money through an ADR. So funds are not a problem. It is clear they want to touch the $1- billion mark within the next few years and about $300 million of that is expected to come through acquisitions," said investment banking sources. The fact that Patni is backed by General Atlantic Partners has also played a significant part in the company's repositioning.

MphasiS, meanwhile, is trying to differentiate itself from the pack with some help from McKinsey. The consulting firm's advice saw MphasiS restructure itself around six businesses, or what Rao calls the 'six box' strategy. Unlike Patni, the financial services sector will be at the core of MphasiS' 'six-box' strategy over the next 2-3 years. It had entered the retail, airlines and logistics businesses before, but has now decided to shift focus from them. Rao thinks that focusing on these six will take the firm to the Rs 1,000-crore revenue mark by the end of 2005. When choosing the six, MphasiS has identified three foundation businesses — voice-based BPO, application development for the financial services, and embedded systems. "These three businesses clearly have scale and brand recognition. So we will invest in growing them," says Rao.

Meanwhile, he is scouting for opportunities where he could get in early and ride the wave. "It will take us 5-6 years to do $1 billion in revenues," he says. For this, he has identified three emerging businesses — platform-based BPO, healthcare and consulting — which complete the six focus strategy.

MphasiS, like Patni, is banking on acquisitions to add size quickly. It has done five in the last 18 months, with Kshema being its biggest at $21 million. The acquisition also makes MphasiS the second-largest player in the embedded systems place, after Wipro.

Expect more acquisitions in the next 9-18 months as the mid tier players chase size. "If you look at deals that have taken place in the mid tier since 2002, acquisitions have been driven by the compulsion to add new domains or verticals and diversify client bases," says Ranu Vohra, Avendus Advisors, which advised Cymbal on its $68-million acquisition by Patni in 2004. Vohra says the size of the deals in the future will be in the $20 million-100 million range.

But unlike Patni and MphasiS, several others are trying to grow by dominating niches, either in terms of horizontal expertise or vertical focus. Polaris is trying to turn itself from a generic services company into a banking specialist that can provide patent-based solutions to top tier banks. This, of course, is a result of the merger with Orbitech, which brought along a suite of 66 specialised banking products.

Mumbai-based i-flex Solutions is a good example of a company using the niche strategy. When the company started out in the early 1990s, with Rs 4 crore of working capital (which was 40 per cent subscribed by Citibank) it decided not to go the IT services way, but bet on products for the banking and financial services space. Further, it decided to keep services capped at 25 per cent of its revenues. Since then, i-flex has grown to $260 million in revenues and $46 million in profits. This has come primarily on the back of its flagship banking software product, Flexcube. In the next few years, the company intends to get into the top banks. "This is a market segment we have not addressed so far," says Deepak Ghaisas, CFO, i-flex. This also means that it will have a larger presence in the US market, which accounts for 35 per cent of its revenues. To get into the large banks, the company has forged an alliance with IBM, which operates mainframes for most large global banks. Market sources say that i-flex's push into the big league may necessitate Citi's exit. Citi has a 43 per cent stake in i-flex and this could become a hindrance when it approaches the top banks for business. The company has filed papers with the Sebi for an ADR issue. Sources say Citi may dilute at least 15-20 per cent when the listing takes place.

"It takes courage and market discipline to segment the market. Infosys or Wipro may have more resources, but they have to spread those resources across 10 businesses. Domain expertise and the ability to talk business solutions are what will differentiate the mid-tiers," says Forrester's McCarthy.

At iGate Global Solutions, CEO and managing director Phaneesh Murthy is trying to get the company's transaction-based pricing model a wider coverage. The company has a focus on four verticals — insurance, banking, financial markets and retail. "The credibility for the model is building up. We actually got a couple of clients to redesign the requests for proposal, so that the bidding could be done on a per transaction basis rather than on per-man per-hour billing basis," he says. Murthy took charge at iGate in August 2003, when his start-up, Quintant, merged with it. Since then, the company's challenge has been to carve out a niche in the crowded banking and financial services sector. Moving customers to a new pricing model as well as reversing its offshore-onsite mix from 60:40 has not been easy on profits.

At iGate Global Solutions, CEO and managing director **Phaneesh Murthy** is trying to get the company's transaction-based pricing model wider coverage

Time Is Running Out

Over the next 6-8 months, the mid-tier players will face pressure at home as the global tech MNCs drive up their India expansion plans. In fact, the mid-tier already has a taste of it. Last year, Accenture, IBM and Cognizant alone recruited 15,000 people, while Microsoft, Oracle and HP and others recruited an additional 10,000. The top six Indian tech majors have been on a hiring spree as well. In contrast, the mid-tier hired just 7,000-8,000. Spiralling wage costs are only the beginning of the problems.

While each company has drawn up survival strategies, the big question is: do they have enough time? According to McCarthy: "They probably have only till the end of this fiscal to show real traction in differentiation. The best case scenario is 18 months." The silver lining is that with valuations in the mid-tier still at decent levels, some promoters may be able to cash in before it's too late. There's certainly no dearth of potential buyers. IBM is already looking for its next acquisition and EDS is likely to beef up its offshore presence in India. Cognizant has stated that acquisitions are an integral part of its plans. By the time Nasscom compiles its list for 2005, the cast of characters may have changed well beyond recognition. ■

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