

2Q13 CIO Survey – IT Services Takeaways

Better Than 1Q13 for Most Services Cos – EPAM, CTSH Shine

- **Key Takeaway(s)** — **(1)** Our survey of 260 CIOs across the U.S., Europe and Asia continues to point to a flattish budget environment, consistent with our industry thesis. **(2)** Combining this survey with our anecdotal observations, we continue to see a difference in "IT Buying Culture" across geos – the U.S. has modest growth + more outsourcing; Europe has a modest decline and is beginning to outsource more and Asia continues to be volatile and economically sensitive, with a tendency to more quickly adopt outsourcing than Europe, albeit off a smaller base. **(3)** Where is the spending focus? Analytics; Moving work to lower cost locations; Vendor consolidation; BPO in Europe and Asia. **(4)** Pricing is stable-to-positive, lending support to our "constrained supply" thesis. **(5)** Wallet share – CTSH and EPAM looked good, with the latter building on strength and the former showing a better-than-1Q13 performance. On the BPO side, WNS showed a strong performance. **(6)** On the U.S. immigration question, most buyers will take a wait-and-see approach but it's quite clear that no one wants their U.S. costs to increase so it will likely result in more outsourcing.
- **Stock Takeaways – Lead with EPAM and WNS** — We remain bullish on EPAM and WNS, which are our go-to stocks in the IT side of our coverage. Beyond this, we believe that investors should pick a "core IT stock" and based on risk level that should be either CTSH or ACN or IBM (co-covered with Jim Suva). We also like EXLS, but note that is a 12-month view – nearer-term, they may have an adverse currency impact as far as revenues are concerned – EPS is unlikely to be affected. We are Neutral on CSC or G.
- **Look Beyond the CIO...Remains Key Part of our Industry Thesis** — A core part of our industry thesis for the better part of 12 months now has been that CIOs are increasingly mandated to keep the IT costs they control flat. CIOs achieve this through increased outsourcing; the use of cloud/virtualization and the consolidation of hardware and software assets and vendor consolidation. Meanwhile, Tech Spending growth flows directly from Chief Marketing Officers (CMOs) and business executives who can more directly justify such spending by tying it to clear business priorities. Lastly, the productivity push within corporations is clearly embracing non-IT processes, leading to BPO growth. Our 2Q13 CIO survey offered support to these elements of our thesis.
- **Wallet and Market Share** — Our charts are inside. EPAM, CTSH and WNS lead the charts while HPQ continues to close out the bottom, albeit in a much improved way.
- **U.S. Immigration Reform Update** — Chart inside. Most CIOs are taking a "wait and see" approach. The one clear point of agreement – zero CIOs said they were fine with a higher U.S. Services spend...in our view, this eventually drives more outsourcing.
- **Pricing** — Chart inside. The key is pricing is stable-to-up due to a shortage of talent.

Ashwin Shirvaikar, CFA

+1-212-816-0822

ashwin.shirvaikar@citi.com

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Wallet Share – Who's Winning and Losing

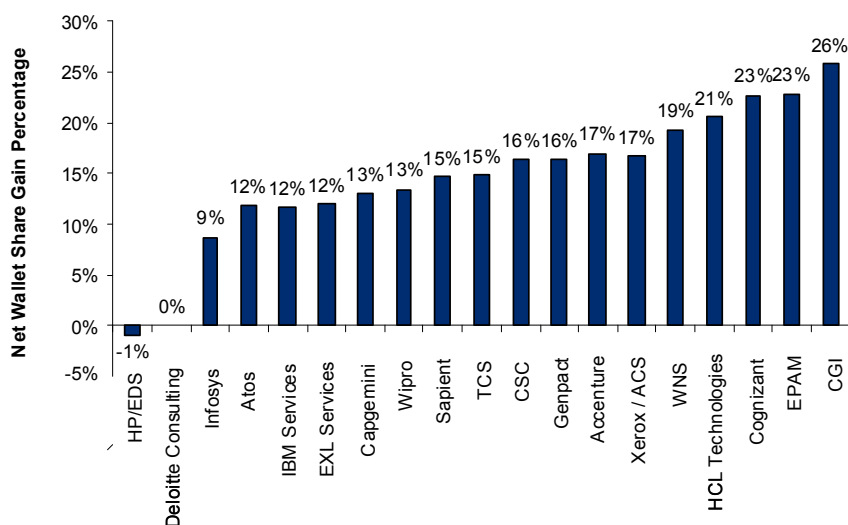
Our Quarterly CIO Survey gives us many nuggets of information – one we have mined over the past several quarters is our "Wallet Share" insight. This insight is derived from asking 260 CIOs whether they would use more /less / same of the list of vendors provided below.

Based on the responses, we look for two separate insights.

1. Figure 1 provides a glimpse of the net wallet share gain / loss. This is qualitative and directional. Please pay attention to the note below the chart to determine how this chart data is computed and what it means.
2. Figure 2 provides a more specific "Who is winning / losing against whom" view.

While neither view provides specific client names or contract magnitudes, the significant number of respondents in each case makes this data useful, in our view. In particular, it seems the data is suited to track inflections in how a particular vendor is viewed by a large number of CIOs.

Figure 1. Net Wallet Share Gain/Loss in 2Q13 Citi CIO Survey



Note: When reading this chart, note that vendor share is calculated using the cumulative number of wallet share "gain" responses minus "losing" responses for a specific vendor, divided by the number of respondents who use the vendor. It is meant to be a directional indication of wallet share performance, not an indicator of forward revenue growth rates.

Source: Citi Research

Some company-specific takeaways from Figure 1

1. EPAM continued its strong recent showing in our survey. We believe it is benefiting from multiple secular trends including the rise of near-shore outsourcing in Europe and the need for non-India resources that many clients have. Further, as we commented following our recent trip to see management (see [EPAM Trip Supports Bullish View](#)), its investments in sales, delivery and resource management should help the company deliver on its growth potential.
2. Similarly, CTSH seems to be doing quite well on a fundamental basis. While immigration will likely continue to be an overhang on the stock, our confidence in the company's ability to deliver solid results in a wide range of outcomes remains.

- Beyond this, (i) we continue to like WNS and recently raised our price target ([WNS Remains a Buy](#)) on the stock; and (ii) we note the buying opportunity created by the recent pullback in ACN – one of the crucial questions is the seeming disconnect between strong bookings and weak revenues and our survey gives some credence to the consistency of their bookings..

Figure 2. Wallet Share in 2Q13, per our survey of 260 CIOs, who were asked whether they would work more/less with a specific vendor

	Net Gain	ACN	ATOS	CAP	CSC	CTSH	Deloitte	EPAM	EXLS	G	GIB	HCLT	HPQ	IBM	INFY	SAPE	TCS	WIT	WNS	XXR
ACN	15						2			2			3	4	1		1	3		
ATOS	7																			
CAP	10	3			1	1	3						1	2		1	2	2		
CSC	12								1				3	1	1	2		2		
CTSH	15		1	1			2					1	1	1	2		3	1	1	1
Deloitte	0	1	1							2			2	2						1
EPAM	11	1		1		1	2						2							1
EXLS	7				1		1						2	2		1		1		
G	11		1	2									2	1	1			1		3
GIB	8	1	1	1			1													
HCLT	14	1	1	1	1					3			4	1	1					
HPQ	-1				2		1			1		1		1	1			2		
IBM	15	2		3	1	1	2		2	1		1	3		2		1			3
INFY	7	3	1	1			2						3	1			1	1		2
SAPE	9									1			1		2					
TCS	11			2	1			1	1	2			4	1	2	1		1		1
WIT	9				1								4	3	4		1		1	
WNS	12	1		1			1			1			1	2	1		1	1		1
XXR	16	2								1			8	3	2		1	1		

Note: "Net Gain" column represents the count of CIOs who would do more with a vendor less those who would work less with that vendor.

Note 2: How to read the matrix? e.g., for ACN row, in 4 cases CIOs who said they would use ACN more also said they would use IBM less. In 3 cases Capgemini seemed to gain wallet share against ACN, and in 2 cases IBM seemed to gain wallet share against ACN. etc.

Source: Citi Research

Takeaways from Figure 2

While there are clearly a lot of company-specific takeaways from Figure 2, it is also possible to gather directional insights.

- HPQ's client losses seem to be widespread even now. In other words, they were at the losing end of the share shift against practically every company listed – only Atos and CGI seemed to not have such share shift situations against HPQ. In all, HPQ lost share against 16 out of 18 competitors, while simultaneously winning share against 7 out of 18 competitors (obviously at different clients).
- IBM lost share against 14 out of 18 competitors while gaining against 12 competitors.
- Infosys lost share against 12 out of 18 competitors while gaining against 9 competitors.
- CTSH continued its trend of "minimizing leakage" – they have historically clamped down on "wallet share loss" and this continued with only three competitors who managed to win share against CTSH in some situations. To us, it is remarkable how CTSH has managed to do well for long periods of time not necessarily by winning a lot of new deals but by retaining and steadily growing its base of existing clients.

Market Share – A Quick Glimpse

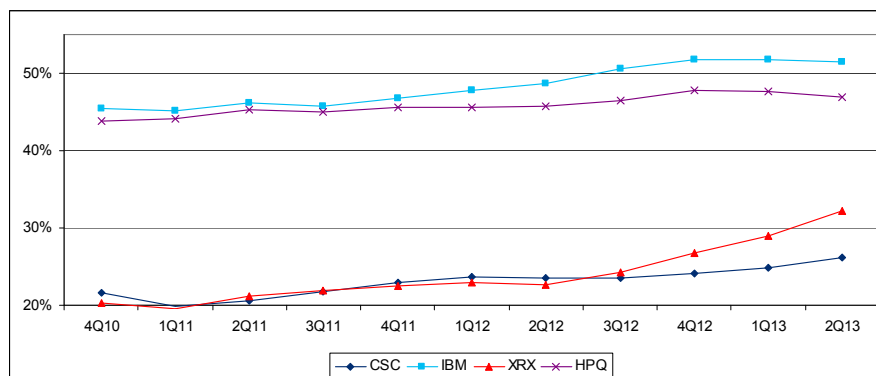
One might ask why we lead off with Wallet Share and not Market Share. IT Services is won in the trenches – to use a sports analogy, think singles and doubles in baseball; or 4-yard run plays in American football; or ones and twos (rather than fours or sixes) in cricket. It may not seem glamorous, but eventually it puts one in a better position in terms of winning.

Having said this, a steady diet of new customers to mine is crucial to attain above-average growth, and so we look for which companies have done better on this metric over time as well.

In our survey we ask 260 CIOs if they use a list of vendors and the charts below are based on the cumulative responses. Given the number of respondents, it seems like a reasonably proxy for market share.

Figure 3 below shows: (i) IBM holding steady in terms of share, (ii) HPQ beginning to slip after several quarters of dismal performance, (iii) slow ascent from CSC, under new management, and (iv) good performance from XRX.

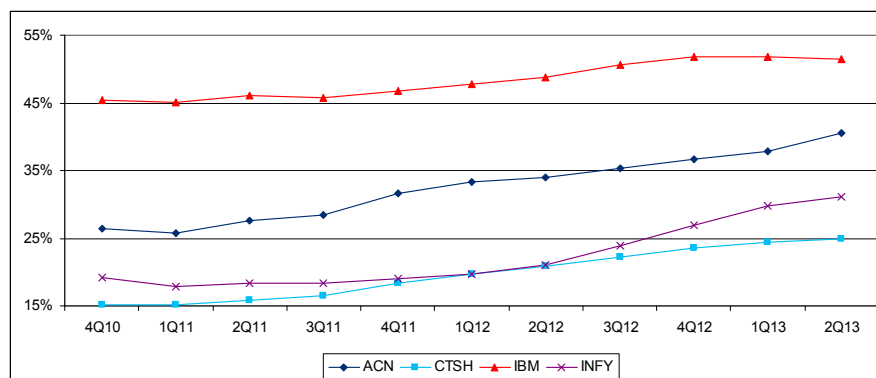
Figure 3. Percent of respondents who use vendors with good-sized ITO businesses



Source: Citi Research

As illustrated in Figure 4 below, ACN and CTSH show a steady improvement over time, while INFY shows a recent recovery. Given CTSH has a modestly higher quarterly run-rate than INFY, we believe looking at this in conjunction with the wallet share data over times gives credence to CTSH's historical investment in account management.

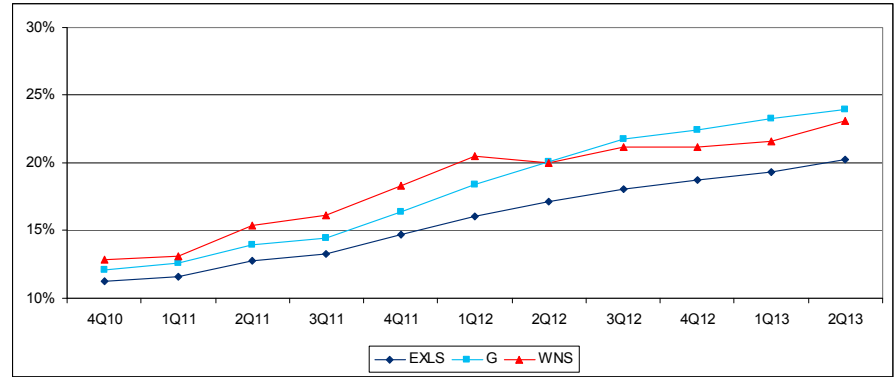
Figure 4. Percent of respondents who use vendors with good-sized SI and ADM biz



Source: Citi Research

Lastly, Figure 5 shows that on the BPO front, all three pure-play BPO companies we cover – EXLS, G and WNS – have done a good job over time signing up new clients although WNS clearly went through a tough time a couple of years ago due to problems that the current management team has resolved.

Figure 5. Percent of respondents who use vendors with good-sized BPO businesses



Source: Citi Research

Immigration Reform

Since early April and the U.S. push for broad-based immigration reform, immigration has been a sector-wide worry. While the proposed legislation around work visas is not the primary intent of the broader legislation, a lot of energy has clearly been devoted to it given the hardened positions of certain legislators.

We have done our share of work on the topic along with our Mumbai-based counterpart, Surendra Goyal.

1. Scenario Analysis – Immigration Reform: [click here](#)
2. CTSH earnings – Company commentary: [click here](#)
3. Recent House-related update: [click here](#)

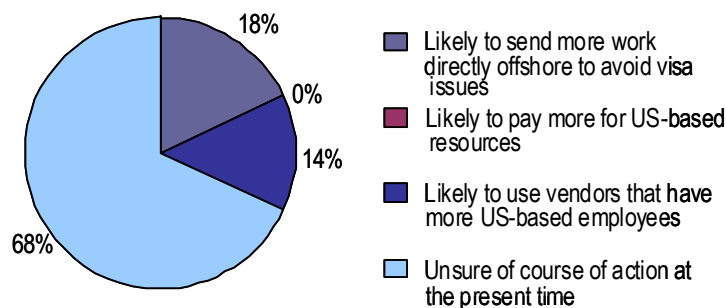
Interest on the topic ebbs and flows – it seemed to reach a crescendo following the Senate's passage of its version of immigration reform. Subsequently, as the House has dragged its feet on the matter and seemed more likely to consider focused legislation that does not really address work visas, it has been beneficial to the space. With this weekend's Barron's article on the name, we may see a bit more negative interest.

Interestingly, the people that matter the most – IT buyers that use these visas – have largely been unwilling to comment on the matter. Initially, it was a matter of educating them as many buyers we spoke with were actually unaware of the implications of this legislation. Now, our survey shows that most CIOs will take a "wait-and-see" approach.

Figure 6. How will CIOs respond to Immigration Reform?

CIOs were asked the following: If you use offshore outsourcing currently, will the potential work visa changes in US immigration reform affect your use of offshore outsourcing vendors?

Note: Of the 260 CIO's that responded, we removed 188 responses that were either "Not currently using offshore outsourcing" and "Not US-based, does not matter to me."



Source: Citi Research

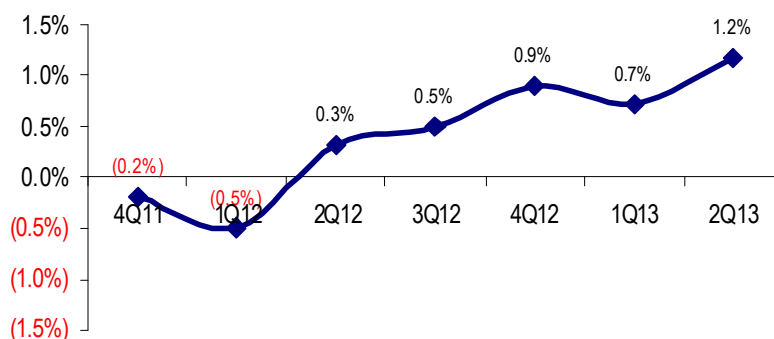
Of 72 CIO's who said they would be affected by U.S Visa Immigration reform, 68% were unsure of their course of action and will take a wait-and-see approach. The remaining 32% were roughly evenly split between "sending more work offshore to avoid visa issues" and "looking to use vendors that have more US-based employees."...But given ZERO CIO's responded that they would be willing to pay more for US-based resources, we believe incremental outsourcing is likely to be the natural outcome over time if this legislation prevails.

Pricing – Better Than Believed

We have long held a belief that supply-side dynamics determine pricing far more than demand trends – the two are reasonably related but, at a minimum, the relationship is asynchronous. The one constant in our surveys is that a high proportion of CIOs want to get a lower price, but most of the time they do not succeed in lowering the unit price

Figure 7. Pricing Trends over Time, based on our CIO Survey

CIOs were asked: What level of unit price increase or decrease do you expect from your IT services vendor in 2013?



Source: Citi Research

Pricing Reality: Our data indicates per unit pricing for IT Services has stabilized at a modest positive level – it was positive for the fifth quarter in a row. The average unit price change across the 260 CIOs is expected to be +1.2% based on the 2Q13 survey data. This compares favorably to our 1Q13 survey result of +0.7% (+0.9% in 4Q12, +0.5% in 3Q12, +0.3% in 2Q12, and -0.49% in 1Q12 [see chart below]).

Pricing Intent: The percentage of CIOs looking for price reductions rose in 2Q13 to ~80%. Prior data is as follows: 69% in 1Q13; 79% in 4Q12; 74% in 3Q12, 67% in 2Q12, and 72% in 1Q12.

Our View: While most CIOs look at unit price reductions as a lever to control costs, the tight labor supply situation leads them to alternate solutions to the problem: using more lower-cost resources and consolidating hardware and applications to reduce operating cost are key “pricing” components. This correlates well with our recent channel checks where most vendors have an outlook of “stable” pricing.

Figure 8. Companies mentioned

Company	RIC	Rating	Currency	Price	TP
Accenture	ACN.N	1	USD	75.52	84.50
Atos	ATOS.PA	1	EUR	57.83	67.00
CAP Gemini	CAPP.PA	1	EUR	39.95	46.00
Computer Science	CSC.N	2 H	USD	47.79	47.00
Cognizant	CTSH.O	1	USD	71.43	90.00
EPAM	EPAM.N	1	USD	28.72	29.00
ExlService	EXLS.O	1	USD	30.33	35.00
Genpact	G.N	2	USD	21.19	
HCL Techno	HCLT.BO	1	INR	860.10	895.00
Hewlett-Packard	HPQ.N	1	USD	26.19	32.00
IBM	IBM.N	1	USD	192.07	250.00
Infosys	INFY.BO	1	INR	2802.75	3130.00
Tata Consult	TCS.BO	2	INR	1606.10	1625.00
Wipro	WIPR.BO	1	INR	375.50	420.00
WNS Hldg	WNS.N	1	USD	17.45	21.00
Xerox Corp	XRX.N	2	USD	9.82	8.00

Source: dataCentral

Appendix A-1

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