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Global IT Services

Industry Reboot: Europe Opportunity – The 'New Normal'

- **The 'New Normal' – a Deep Dive into Outsourcing in Europe** — With only ~25% of IT Services from EU outsourced and lower penetration for offshore, we believe Europe remains a significant and relatively untapped opportunity ([Industry Reboot: The Potential and the Perils](#)). Persistently sluggish growth prospects following the multi-year slowdown have led to a hard reassessment of priorities, resulting in the shaping of a 'New Normal' in Europe. We believe this 'New Normal' is being characterized by an increasing acceptance of outsourcing and offshoring.
- **The 'Old Normal'** — The potential to grow outsourcing/offshoring always existed but the opportunity did not fully materialize due to socio-cultural considerations (ex U.K., which is largely similar to the U.S.) and language barriers, especially in larger markets like Germany and France.
- **Who benefits from the 'New Normal'** — Based on our qualitative comparison of leading players' current positioning, we conclude that Accenture and Capgemini have an advantage in terms of incumbency and relationships, but this can be a double-edged sword – the positive is client retention and the likely negative is the prospect of revenue cannibalization. TCS fares best among challengers although other offshore players are rapidly building/acquiring local front-office capabilities. Meanwhile, European proclivity for a near-shore alternative is helping the viability of alternatives like EPAM. Companies that acquire European client relationships and also specific capabilities (e.g., BPO) that help broaden their appeal can benefit and so we continue to believe in [our thesis on industry consolidation](#).
- **Shift toward greater outsourcing and offshoring will be structural...** — driven by (a) increased international competitiveness; (b) improved focus on core competencies; (c) demand-supply gap in IT skills; and (d) wider labor reforms.
- **...But the shift will not be uniform** — Europe is not a homogenous entity, and we believe each country/sub-region's own distinct set of cultural, linguistic, and social norms as well as implementation of state welfare will influence the pace of acceptance. Our analysis shows Germany and Nordics could lead the overall transition to the "New Normal" while Spain is well-positioned in Southern Europe.
- **Citi IT Services view** — The IT Services industry is witnessing a number of significant changes with key trends – (a) emergence of new buyers in client organizations; (b) commoditization at the lower end of value chain; (c) digital being a significant multi-year opportunity. ITO/BPO remains a good opportunity and given the opportunity, annuity nature of business and attractive financials, we believe it is a good secular growth story. Weighting the outlook with valuation and other factors, EPAM/Capgemini/HCL Tech are our top picks in the space.

Amit B Harchandani

+44-20-7986-4246
amit.harchandani@citi.com

Surendra Goyal, CFA

+91-22-6175-9870
surendra.goyal@citi.com

Ashwin Shirvaikar, CFA

+1-212-816-0822
ashwin.shirvaikar@citi.com

Rishi V Iyer

+91-22-6175-9871
rishi.iyer@citi.com

Sashi Tanuku

sashidhar.tanuku@citi.com

[Click to play](#)

Amit B Harchandani



See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Portfolio Manager Summary

One of the most powerful secular trends within IT Services is the combination of factors that is driving a higher level of outsourcing and offshoring in Europe. A persistently sluggish economy on the continent has led to a hard reassessment of priorities, resulting in the shaping of this 'New Normal'.

We believe this shift towards greater outsourcing and offshoring is structural in nature. At the same time, we don't anticipate the shift to happen uniformly across the continent. With this in mind, we present a set of evaluation criteria to rank the main geographical entities (countries / sub-regions) on the continent in terms of their attractiveness vis-à-vis outsourcing.

As in the case of any opportunity, there are some companies better positioned than others to exploit this "New Normal", and so we also carry out a qualitative comparison exercise to assess the current relative positioning of leading IT Services vendors. We conclude that Accenture and Capgemini lead among the incumbents in terms of the ability to help their clients with this transition (although this is a double-edged sword with possible cannibalization being the negative aspect), TCS among the challengers while EPAM is a top play on near-shore outsourcing. It is worth noting that this solely represents our assessment of a vendor's positioning in terms of its current ability to exploit the European opportunity and not our overall recommendation on the investment case.

Beyond the company-specific upside/downside inherent in this "New Normal", the global IT services sub-sector remains an attractive investment choice in the medium term for a number of good reasons including (i) other secular trends that support top line growth, including the growth of BPO and still-healthy outsourcing trends in core geographies like the U.S. (ii) the ability of consultants to advise on, and influence the direction of, corporate investments, and (iii) attractive financial metrics, such as margins, cash flow, and healthy balance sheets. Relatively stable unit pricing and capable management teams round out the bullish outlook.

EMEA accounts for ~30% of the worldwide IT/BPO services spending

The Big Picture – Where is the Opportunity?

- **Europe within the global context** — EMEA is one of the key IT/BPO services markets globally, accounting for than 30% of the worldwide spending. This spending is largely dominated by the Western Europe (WE) market. UK is understandably the biggest market, accounting for roughly a third of the spending. Beyond UK, the key markets are Germany, France, Nordics and Benelux.
- **Significant potential for Outsourcing** — Results from a survey of more than 3,500 respondents carried out by consultancy firm Ernst & Young across eight European countries last year show that only a quarter of IT Services are outsourced in these organizations, with an even lower ratio in BPO services.
- **Lifecycle of offshoring in geographies** — Offshoring has been highest in the U.S. and U.K., where early/easy market share gains seem to be behind us. The next leg of opportunity seems to be Europe (ex U.K.), which has been a traditionally difficult market due to language / labor barriers.

Due to continued sluggish growth prospects following multiple years of downturn, European companies are increasingly amenable to higher outsourcing, despite socio-political headwinds.

From the 'Old Normal' to the 'New Normal'

- **The 'Old Normal'** — The penetration of outsourcing and offshoring has always been relatively lower in Europe, but so far, the socio-cultural considerations have outweighed the competitive / economic benefits in our view. In other words, the potential to raise the levels has always been there, but the opportunity never really materialized.
- **'New Normal' post multiple years of sluggishness** — We believe that continued sluggish growth prospects following multiple years of downturn has led to a hard reassessment of priorities, resulting in the shaping of a 'New Normal' in

Europe. And specific to IT Services, based on the evidence in front of us in the form of company commentary / anecdotal evidence, results of market research and one-off case studies / surveys, we see this 'New Normal' being characterized by an increasing acceptance of outsourcing and offshoring.

■ **The shift toward greater outsourcing and offshoring will be structural —**

- **Increased international competitiveness** — We estimate that the profitability of European-listed firms on average remains more than 17% below pre-crisis levels. We believe this in turn can be attributed to some degree to a greater growth in unit labor costs compared to the US. Higher levels of outsourcing could help manage this better.
- **Improved focus on core competencies** — An integral part of the restructuring in the “post-crisis” world is concentration on “core competencies”. Pre-crisis, we believe the emphasis in terms of outsourcing in Europe was more skewed towards globalization of manufacturing/production of goods. We now expect an equal emphasis on outsourcing of services across all sectors.
- **Demand-supply gap in IT skills** — We believe outsourcing and more pertinently offshoring also helps address one of the issues increasingly likely to be faced by European corporates – access to specific knowledge, expertise and tools. According to a study by BUSINESSEUROPE, the estimated shortage of qualified IT staff in EU will rise to between 384,000 and 700,000.
- **Wider Labor reforms** — Traditionally, the relatively rigid labor rules have served as one of the deterrents when it came to outsourcing and more so offshoring on the continent. However, we understand that the crisis has resulted in reforms that suggest lowered barriers in the future when it comes to embarking on outsourcing.

But the shift won't happen uniformly

We think Germany and Nordics are the most promising markets for IT outsourcing and Spain is relatively better placed in the south

- **Europe is not homogenous** — While the regional bloc has made significant strides in terms of adopting a common framework for fiscal and monetary policies as well as promoting easy migration of talent across borders, we believe each country / sub-region will continue to be characterized by its own distinct set of cultural, linguistic, and social norms as well as implementation of state welfare.
- **Assessing the attractiveness of each market for vendors** — We present our “Attractiveness Assessment” Framework for each market along four key dimensions – Relative Size, Penetration Potential, Cultural Acceptance, Economic Health, Labor reforms and Linguistic Compatibility.
- **Germany and Nordics look most promising** — Based on our evaluation criteria, Germany and Nordics look most promising on the continent, in terms of their ability to ramp up outsourcing. In the south, Spain stands out for us as an emerging adopter of outsourcing. The risk-reward for the opportunity within Italy seems the least attractive on a relative basis.

How are the vendors positioned?

ACN and CAPP are the best-placed incumbents, TCS is the lead challenger and EPAM is the leading play on near-shore outsourcing

- **Accenture, Capgemini, TCS, EPAM** — Based on our analysis, Accenture and Capgemini stand out as best positioned among the incumbents, purely on the ability to retain and grow client relationships by adding an outsourcing element – the risk for them is that this may result in a revenue mix shift as they cannibalize some existing revenues. Among the challengers, TCS leads the pack and EPAM is the leading play on near-shore outsourcing. It is important to note that the

vendors we are analyzing here are actually the leaders and potential leaders in Europe and they could all be gainers at the cost of (a) in house and (b) a long tail of IT providers in each market.

- **Implications contingent on their positioning** — The implication for each vendor would also vary contingent upon their positioning. We present a qualitative assessment exercise for each vendor along four dimensions that we believe are critical but not necessarily equally weighted (may vary from market to market) – Market penetration potential, CxO relationships and awareness of the ecosystem, offshore delivery and nearshore presence.
- **M&A will be a critical tool** — It is imperative, in our view, that the 'challengers' (India-centric players) in particular, place a significant emphasis on inorganic growth on the mainland in a bid to enhance their onshore footprint, and raise their profile. Meanwhile, we see the incumbents too making opportunistic moves to add scale, diversify regional footprint, and acquire new offerings (e.g. BPO).

Opportunity not without its challenges / risks

- **Legislation** — Although reforms appear to be lowering barriers across the continent, as we highlighted earlier in the report, there exist country-wise differences in terms of implementations of relevant European Union. In addition to differences in implementations, associated legislations also continue to evolve.
- **Unemployment** — Although we have talked about shortage of STEM / IT skills, the overall unemployment levels in Europe still remain elevated – according to Eurostat estimates, ~25 million people were unemployed in the EU-28 in June 2014, or an unemployment rate of 10.2%. And while this is down from 10.9% in June 2013, it is still higher than pre-crisis levels (low of 6.8% in 1Q08) and well above the corresponding June-2014 number for the US, of 6.1%.

Figure 1. Sector Valuation Table

Name	Rating	Share price currency	Share price	Target price	ETR	PE		Dividend Yield		EV/Sales		EV/EBITDA		EBIT margin	
						2014E	2015E	2014E	2015E	2014E	2015E	2014E	2015E	2014E	2015E
IT Services															
Accenture Ltd	Neutral	USD	79.3	84.0	9%	17.1	15.8	2%	3%	1.6x	1.6x	10.0x	9.6x	14%	15%
ATOS	Buy	EUR	56.9	69.0	23%	12.4	11.6	1%	1%	0.7x	0.7x	6.7x	6.3x	7%	8%
Capgemini SA	Buy	EUR	56.1	61.0	11%	15.1	14.8	2%	2%	0.8x	0.8x	8.0x	7.8x	8%	9%
CSC	Neutral	USD	56.6	62.0	11%	12.8	11.5	2%	2%	0.8x	0.7x	4.5x	4.6x	9%	9%
Cognizant	Buy	USD	44.8	52.0	16%	17.6	15.7	0%	0%	2.3x	2.0x	11.2x	10.1x	20%	20%
Amdocs Ltd	Buy	USD	46.3	53.0	16%	14.3	13.2	1%	2%	1.7x	1.7x	8.9x	8.4x	17%	17%
EPAM Systems, Inc.	Buy	USD	42.3	48.0	13%	20.8	18.0	0%	0%	2.7x	2.2x	15.2x	12.5x	16%	16%
ExlService	Buy	USD	24.9	34.5	38%	13.6	12.2	0%	0%	1.6x	1.5x	8.1x	7.1x	16%	18%
Genpact Ltd	Buy	USD	16.7	20.0	20%	15.9	14.4	0%	0%	1.8x	1.7x	11.3x	10.5x	13%	13%
HCL Technologies	Buy	INR	1713.0	1785.0	6%	17.9	15.9	1%	2%	2.8x	2.5x	11.0x	10.1x	24%	23%
IBM	Neutral	USD	190.1	200.0	8%	10.6	9.5	2%	2%	2.2x	2.2x	8.4x	7.8x	22%	24%
Infosys	Buy	INR	3695.0	3875.0	7%	18.2	16.6	2%	3%	3.1x	2.8x	11.3x	10.4x	25%	25%
TCS	Neutral	INR	2684.1	2470.0	-6%	25.1	22.4	3%	2%	5.0x	4.4x	16.8x	15.1x	28%	28%
Wipro	Buy	INR	586.5	670.0	16%	16.8	15.2	2%	2%	2.7x	2.5x	11.4x	10.5x	21%	21%
WNS Holdings Ltd	Buy	USD	22.5	28.0	24%	14.6	13.0	0%	0%	1.8x	1.6x	8.8x	7.8x	18%	18%
Xerox Corp	Neutral	USD	13.2	13.0	0%	11.9	10.8	2%	2%	1.0x	1.0x	6.9x	6.5x	9%	10%

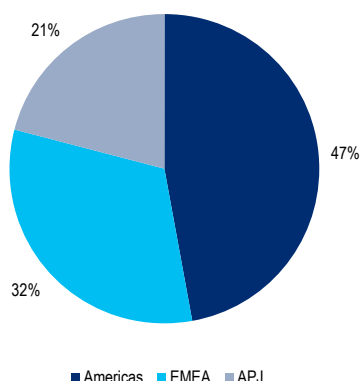
Source: Data Central, Bloomberg, Citi Research (Based on share prices as of end of day Sep 26, 2014)

The Big Picture – Where is the Opportunity?

Western Europe accounts for ~29% of the global IT/BPO services spending

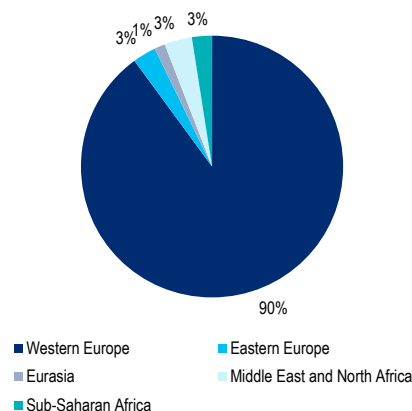
- **Europe in the global context** — EMEA is one of the key IT/BPO services markets globally, accounting for than 30% of the worldwide spending, as per data from industry research firm Gartner. Unsurprisingly, the spending in EMEA is largely dominated by the Western Europe (WE) market.
- **Large continental Europe markets** — In Western Europe, UK is understandably the biggest market accounting for roughly a third of the total spending. Beyond UK, the key markets are Germany, France, Nordics and Benelux.

Figure 2. Global IT/BPO services spending by super-region (2013)



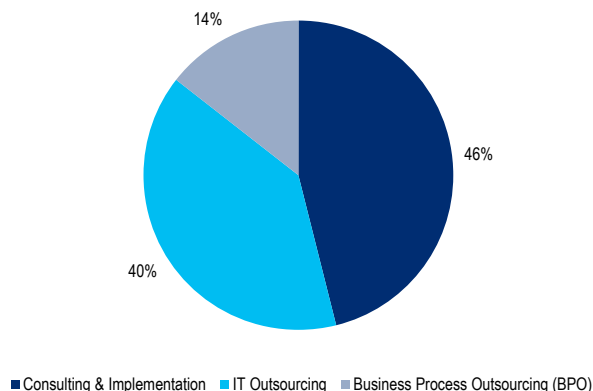
Source: Gartner, Citi Research

Figure 3. 2013 EMEA IT/BPO services spending by region (2013)



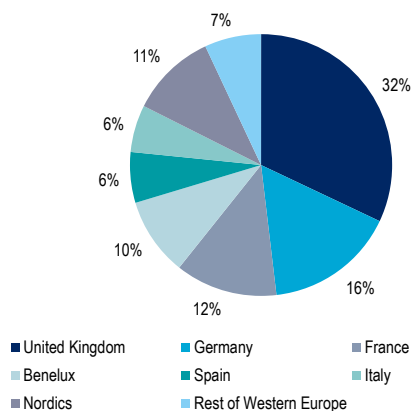
Source: Gartner, Citi Research

Figure 4. Western Europe (WE) IT/BPO services spending by segment



Source: Gartner, Citi Research

Figure 5. Western Europe (WE) IT/BPO services spending by region

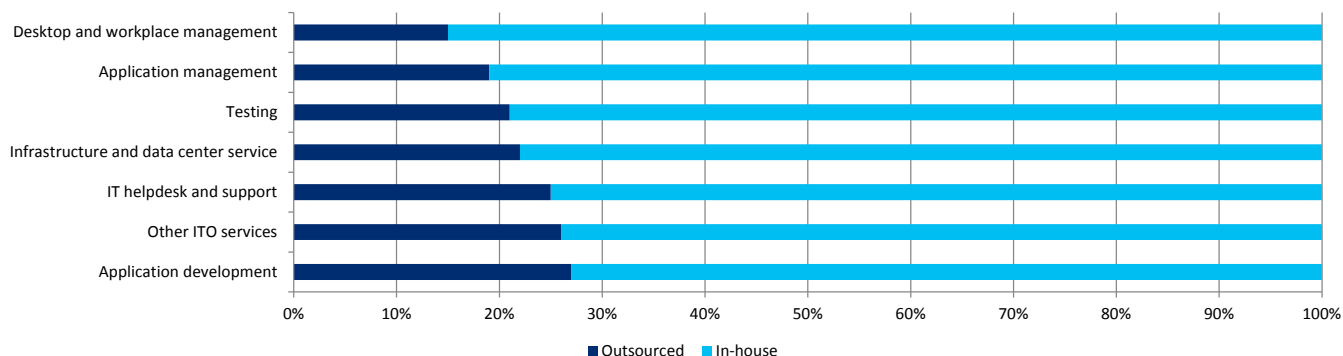


Source: Gartner, Citi Research

Significant potential for Outsourcing

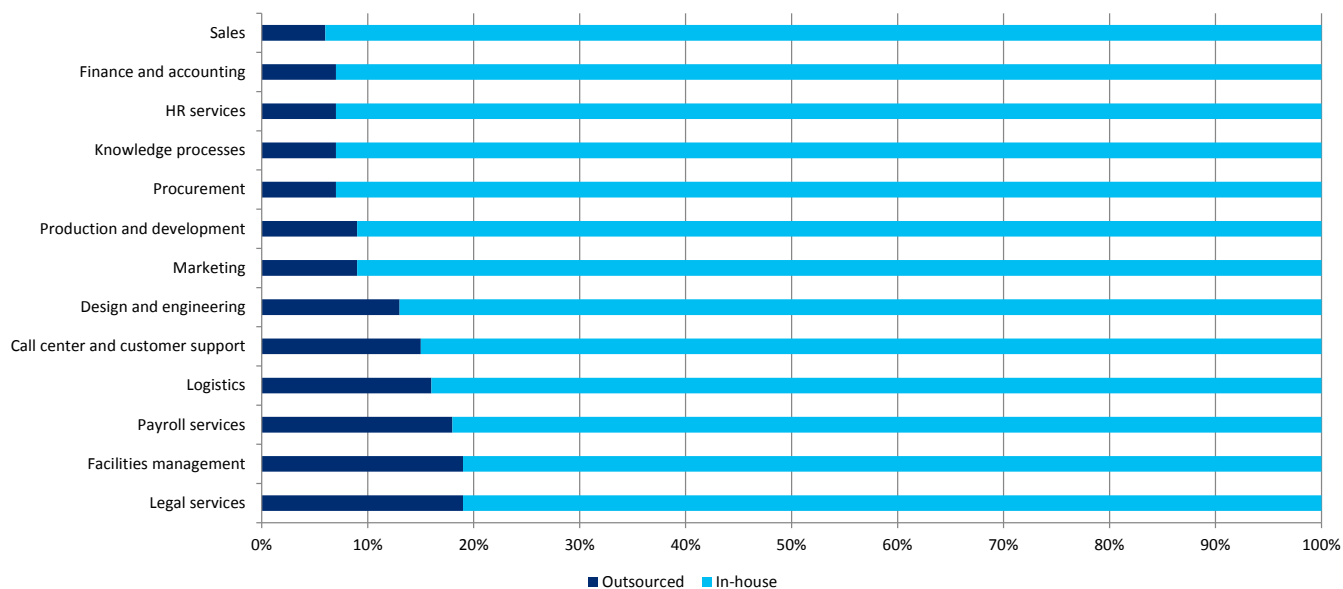
- Evidence supports significant potential for outsourcing in Europe, across both IT and BPO services. Results from a survey of more than 3,500 respondents carried out by consultancy firm EY across eight European countries last year indicates that only a quarter of IT Services at respondent organizations are outsourced, with an even lower ratio in case of BPO services (not surprising given that IT services have historically been the starting point for organizations looking to adopt outsourcing).

Figure 6. EY survey indicates that only a quarter of IT Services are outsourced in Europe



Source: 2013 Outsourcing in Europe report (EY), Citi Research

Figure 7. The proportion of BPO services outsourced is even lower, according to the EY survey



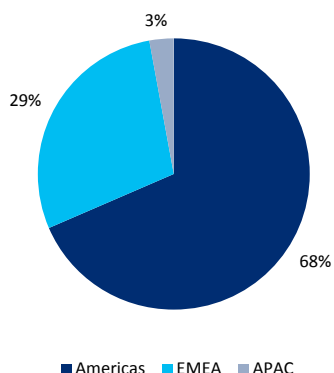
Source: 2013 Outsourcing in Europe report (EY), Citi Research

Lifecycle of Offshoring

- **Lifecycle of offshoring in geographies** — Offshoring has been highest in the U.S. and U.K., where early/easy market share gains seem to be behind us. The next leg of opportunity seems to be Europe (ex U.K.). It has been a traditionally difficult market due to language / labor barriers. With the current macro environment exerting pressure on several European companies with a high cost structure, there seems to be an increasing acceptance towards greater offshoring on the continent.
- **Offshore penetration varies across services** — Offshoring is not uniform across all service segments – data from industry research firm IDC indicates that the extent of offshoring penetration varies ranging from less than 5% for infrastructure outsourcing to more than 25% for custom application development.

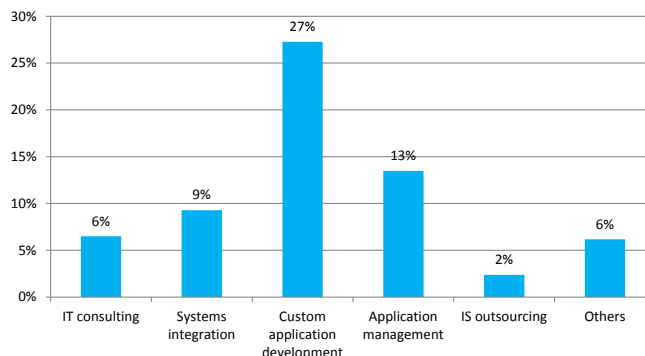
Note: It is worth highlighting that we have used data / metrics provided by different industry research firms - while exact values vary depending upon market definition / methodology used by the respective firm, the variances in our view are within acceptable limits. The idea of using these metrics is to provide the user with an understanding of the underlying dynamics and aid in investment making decision process, rather than arrive at a precise estimate of the overall European market opportunity.

Figure 8. Worldwide Offshore penetration by region (2013)



Source: IDC, Citi Research

Figure 9. Worldwide Offshore penetration by Services segment (2013)

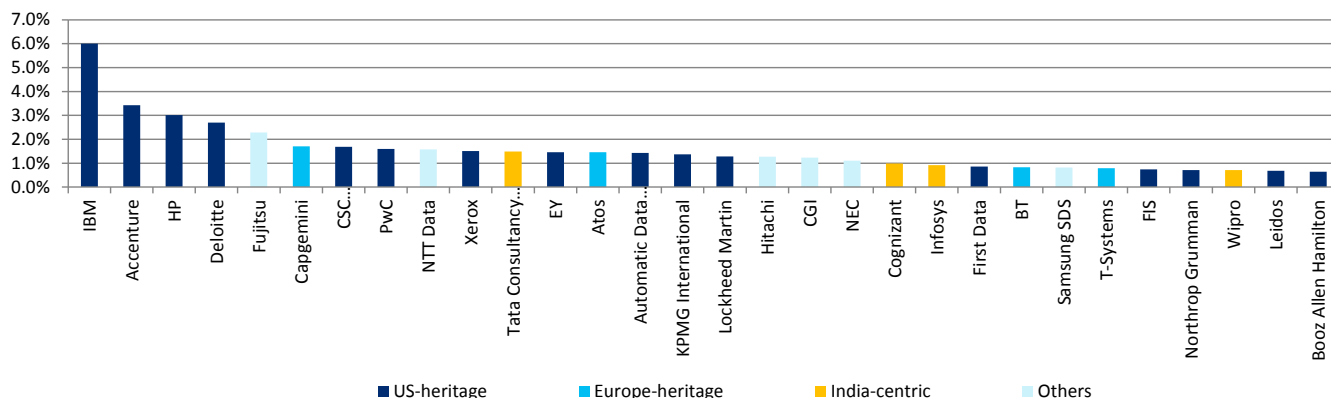


Source: IDC, Citi Research

Vendor positioning in Europe

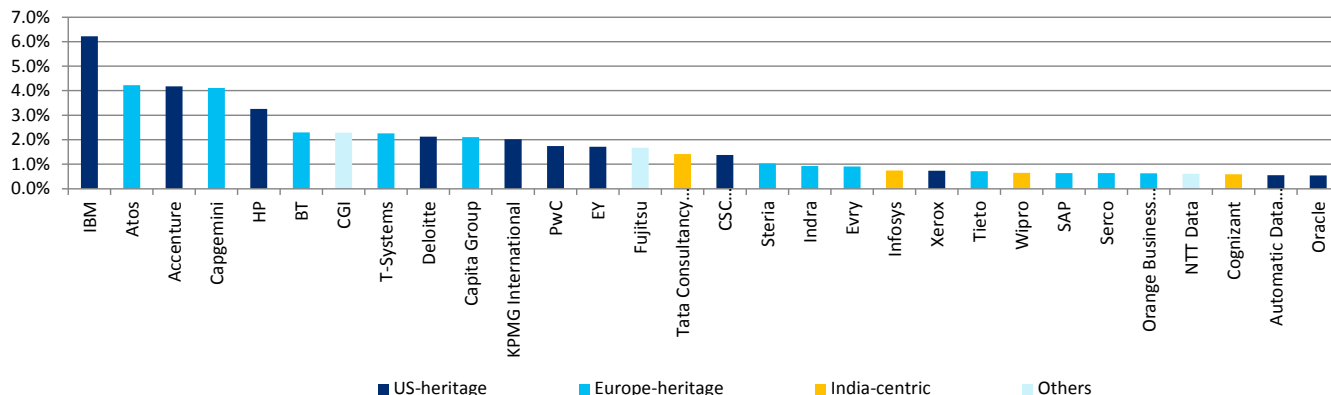
- **US/European heritage vendors dominate** — IT/BPO services market globally is relatively fragmented and this is also the case in Europe. However, unlike in the US, where India-centric firms such as Cognizant and Tata Consultancy Services (TCS) are top-10 vendors, the leading positions in Europe are dominated by US and Western-European heritage players. The country/sub-region-wise market share data further reveals the meaningful presence of local players such as Tieto in the Nordics and T-Systems in Germany.
- **India-centric vendors** — TCS is the only 'India-centric' vendor that just makes it into the top-15 in Europe, and if UK is excluded, TCS moves outside the top-20. However, a similar exercise carried out in US a decade ago would have yielded a very similar picture; and we believe this highlights the significant opportunity that this scenario presents to the India-centric players.

Figure 10. 2013 Global IT/BPO services market shares – top 30 vendors



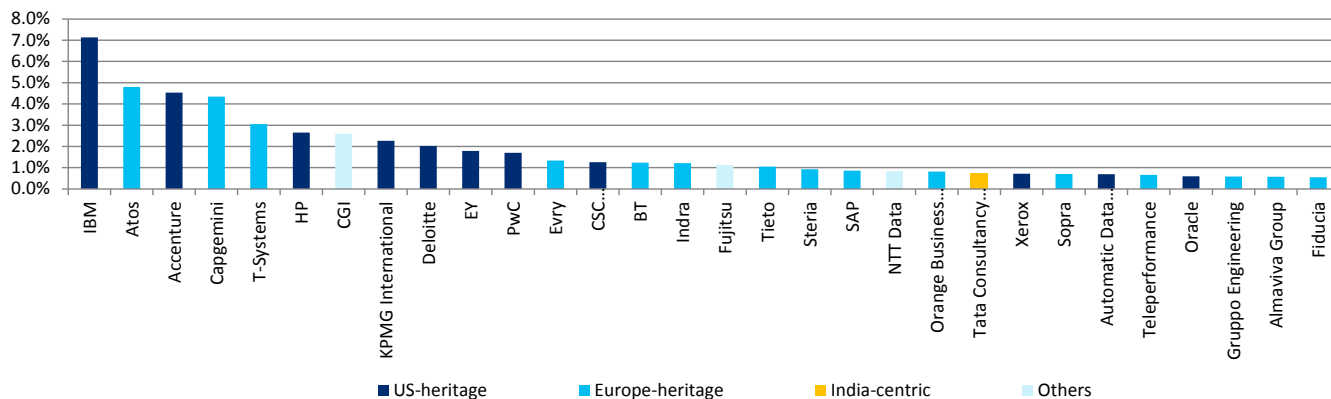
Source: Gartner, Citi Research

Figure 11. 2013 Western Europe IT/BPO services market shares – top 30 vendors



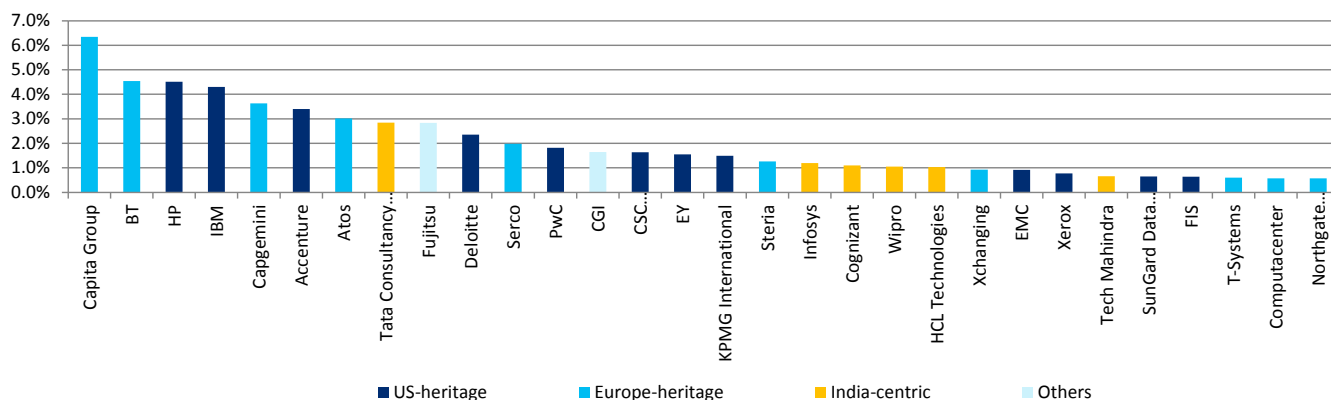
Source: Gartner, Citi Research

Figure 12. 2013 Western Europe ex UK (Mainland WE) IT/BPO services market shares – top 30 vendors



Source: Gartner, Citi Research

Figure 13. 2013 UK IT/BPO services market shares – top 30 vendors



Source: Gartner, Citi Research

Europe is opening up ...

- **Increasing acceptance of outsourcing / offshoring** — We believe there is an increasing acceptance of outsourcing and offshoring in Europe. This view is primarily predicated upon company commentary / anecdotal evidence, results of market research and one-off case studies / surveys, and directionally supported by evidence from statistical indicators.
- **Feedback from IT services vendors and other anecdotal evidence** — As outlined below, we note that companies across the board (European, US and Indian heritage) are increasingly emphasizing the rising demand for outsourcing / offshoring within continental Europe, within their communication to the market. Further, anecdotal evidence based on our conversations with participants at wider industry events also supports the companies' rhetoric.

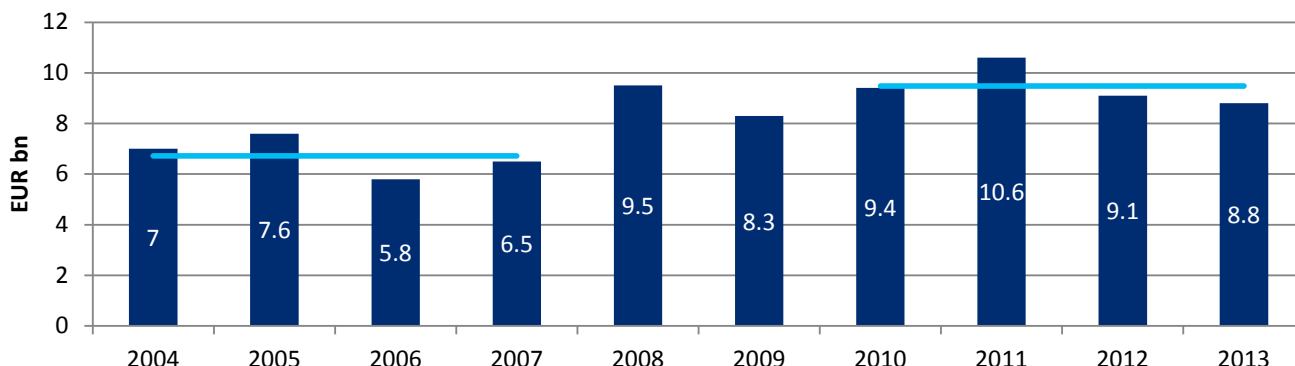
Figure 14. Anecdotal evidence / company commentary increasingly points towards rising demand for outsourcing / offshoring within Europe

Company	Event	Commentary
Capgemini	C2Q14 Results	"... we continue to see many opportunities for outsourcing and managed service offerings, particularly in Continental Europe ..."
Capgemini	C1Q14 Results	"... Today, the offshore shift is delivered, it's behind us in the U.S, it's behind us in the commercial market in the UK, it's ahead of us in Continental Europe ..."
AtoS	C2Q14 Results	"... On the offshore and on the win rate, it's clear that now to win a deal you need to have an offshore rate which is pretty high ..."
AtoS	C1Q14 Results	"... We have one of the highest pipeline ever regarding first-generation outsourcing with companies intending to move scope of activities currently delivered internally with sometimes the support of many small vendors to a big outsourcer. And it is really absolutely a key trend in our pipe given that's what we have today. I would like to mention four geographies whereas it's really very clear: Netherlands, Nordic, Germany and even France ..."
Infosys	1QFY15 Results	"...in Europe, spend is more towards consolidation and renewal of old contracts. Deal pipeline is better in Europe, especially in infrastructure deals... While we have seen a pickup in momentum in some of the Western European countries, decision cycles remain protracted and cost reduction continues to be strongly emphasized within banks..."
TCS	Business Update in Jun'14	".....Europe, where the primary demand is actually an outsourcing-led..."
Wipro	1QFY15 Results	"....Continental Europe continues to have significant potential for outsourcing IT Services"
HCL Tech	4QFY14 Results	"...We're also seeing some good traction in some of the first-time outsourcing clients in Asia Pac and Continental Europe....From a geography perspective, we believe that Europe will continue to drive a larger portion of the renewable market....they've been normally late entrant into the outsourcing arena in Gen2. But in the last couple of years they've caught up..."
ACN	2QFY14 Results	"And what we see which might be – let's put that in the new-new – is Europe is moving now offshore in a more robust way....So if you look at this offshoring waves, first U.S. probably 10 years ago, and then they moved to, what I like to call, the Anglo-Saxon corridor, for whatever it means for you, U.S., U.K., Nordic, probably all the countries not speaking the same language like mine. And here you have for all sorts of reasons for earlier offshoring pick up. Now, and I'm thinking that it's a good news for Accenture, Continental Europe, and I'm thinking about Germany, France, Italy, Spain, we see this offshoring picking up."
ACN	3QFY14 Results	"And we invested a lot in EMEA around client opportunities, especially around large-scale transformations program, combining consulting, outsourcing, and BPO across the board. And as we expected, starting in Q3, we see EMEA coming back. And what I'm particularly pleased with is when you look at the countries contributing to EMEA growth both from a consulting and outsourcing standpoint we have quite our largest markets in country and countries in Europe. I'm thinking about France, Italy, Germany, the UK."
CTSH	C1Q14 Results	"... on Europe, at a macro level, Europe is embracing our model a lot more. The economic crisis in Continental Europe served as a catalyst for people to think very differently about how they acquire and utilize technology and business process services. ...But clearly, we're feeling good about our position in Europe, our customers in Europe, and I think Europe, particularly Continental Europe, is ready to embrace a global delivery model."
CTSH	C2Q14 Results	"When I look at our traditional Horizon 1 businesses, clearly Europe is a lot better than it had been. And that's a combination of the market is more open to it and quite honestly our execution has gotten better as we've done some acquisitions and as we've won some marquee names."
CTSH	C2Q14 Results	"We expect solid growth in the continent, and we anticipate that the structural shift towards larger multi-year outsourcing programs will continue to drive opportunities over the coming years"

Source: Company data, Citi Research

- **ACV awards are up ~40% post-crisis** — Based on data released by industry research and IT advisory firm ISG One, we estimate that the average annual contract value (ACV) of outsourcing contracts awarded within EMEA has gone up by ~40% during the post-crisis period (2010-2013) as compared to the pre-crisis period (2004-2007). Near-term trends also seem encouraging, with 1H14 being the second best 1H performance ever in terms of ACV. *It is however worthwhile sharing that the ISG One data is more useful in terms of observing the directional trends, with absolute metrics being less relevant, owing to the fact that ISG One only has visibility to those contracts where it is either involved in an advisory capacity or those which come up for an open bid.*

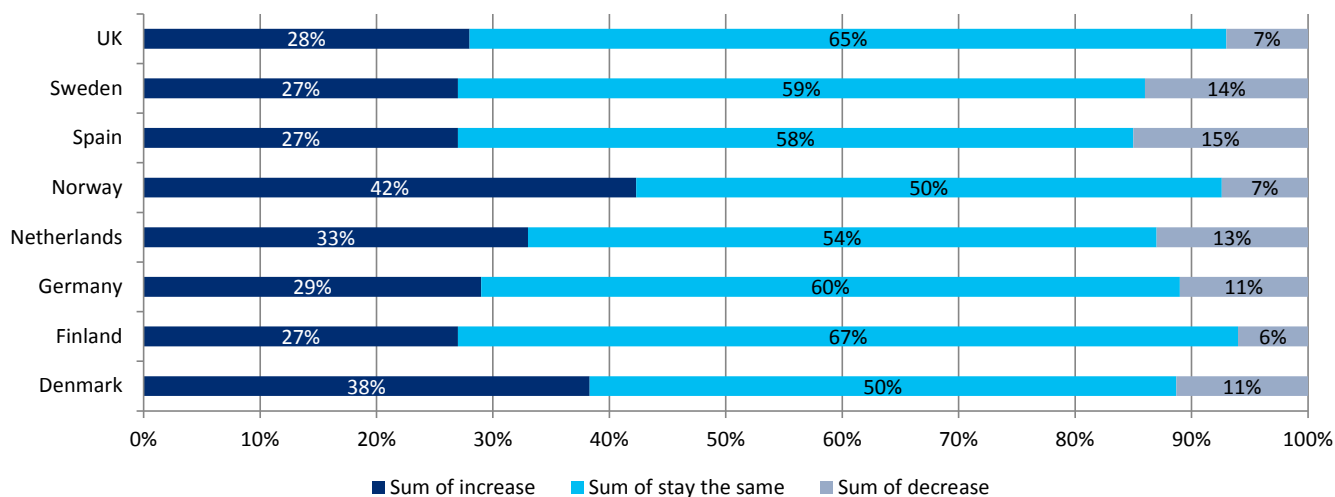
Figure 15. The average value of ACV in EMEA has picked up by 40% in the period post the crisis (2010-2013) compared to pre-crisis (2004-2007)



Source: ISG One, Citi Research, Data shows contracts with ACV ≥ EUR 4m

■ **Industry studies also point to an increase in outsourcing** — We also look at one-off case studies / surveys associated with the topic. The 2013 Outsourcing in Europe report published by consultancy firm EY contains findings based on an online survey of 3,700 respondents from eight European countries, and in-depth interviews with executives from client organizations and service providers. According to the survey, between 27-42% of respondents expect outsourcing to increase, as opposed to between 6-15% who anticipate a reduction.

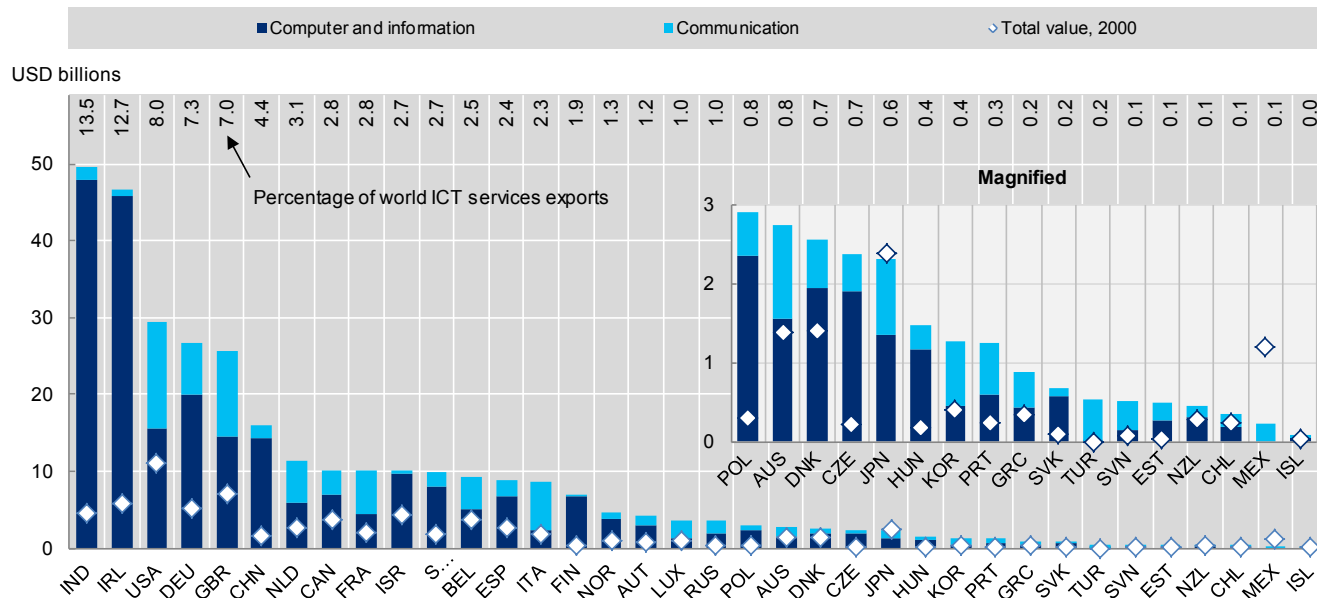
Figure 16. 27-42% of respondents across different countries expect outsourcing to grow in coming years



Source: 2013 Outsourcing in Europe report (EY), Citi Research

■ **Evidence from statistical indicators** — Finally, the intangible nature of business services (including IT / BPO services) and the fact that they transmitted digitally in a variety of ways, under many possible contractual agreements, makes it difficult to obtain conclusive evidence of the form of statistical indicators. Hence we do not base our view on this evidence – however, we do note that observing the trends in trade / occupational / employment statistics over a period time is directionally supportive of rising adoption of outsourcing / offshoring.

Figure 17. We observe that countries such as India, Ireland, and Poland have substantially grown their share of the global ICT services exports, and particularly within computer and information. And while India's growth is more a function of work being outsourced from US and UK, Poland in our view reflects increasing outsourcing from Western Europe over the past decade.



Source: OECD, UNCTAD, UNCTADStat (June 2013), Citi Research

The 'New Normal' transition is Structural...

"... Let's make no mistake: there is no way back to business as usual. Some people believe that after this everything will come back as it was before. They are wrong, this crisis is different. This is not a cyclical crisis, but a structural one. We will not come back to the old normal. We have to shape a new normal ..."

- José Manuel Durão Barroso, President of the European Commission in his State of the Union address in September 2013

"... we frankly really think the page have been turned in markets like Scandinavia, Benelux and now Germany. I don't think there will be any temptation to go back to local protectionism ... But my view, I would not anticipate any way backward. I think people have now understood the benefits ..."

- Capgemini CEO Paul Hermelin at the company's C1H14 earnings conference call (July 2014)

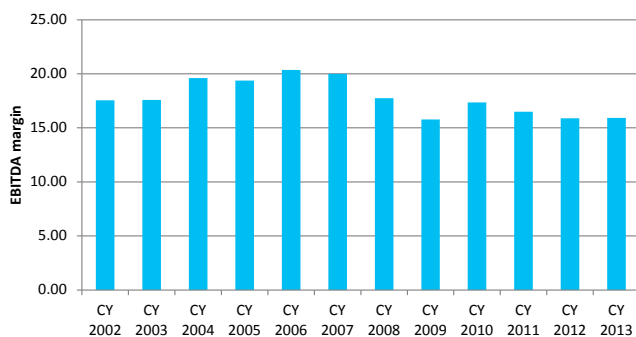
We think increasing adoption of outsourcing and offshoring of IT/BPO services will be an integral part of the 'new normal' in Europe

In our view, the adoption of outsourcing and offshoring of IT/BPO services will become an increasingly integral part of the 'New Normal' in Europe over time. While cost reduction and greater efficiency will likely be the leading drivers as European firms (particularly transnational corporations) look to increase and maintain their international competitiveness in globalizing value chains, we also expect increased adoption by organizations aiming to improve focus on core competencies. Meanwhile, in terms of human capital, we believe that a widening demand-supply gap in IT skills and wider labor reforms will also emerge as influential drivers.

Increased international competitiveness

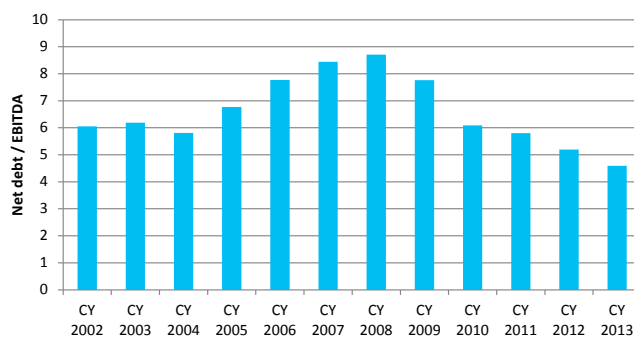
■ **Crisis has left European corporates less profitable** — We note that the macroeconomic situation in Europe remains difficult. While GDP expectations for 2014 remain higher year/year, Citi's economists have already down-shifted their expectations in many EU countries, from what they expected in early 2014. We estimate that the profitability of European-listed firms on average remains more than 17% below pre-crisis levels. And while part of this may be attributed to a deliberately lowered risk profile (as reflected in financial leverage), we believe that overall labor throughput has also been impacted by the crisis.

Figure 18. Aggregate EBITDA margin for STOXX Europe 600 Index



Source: Citi Research, Bloomberg

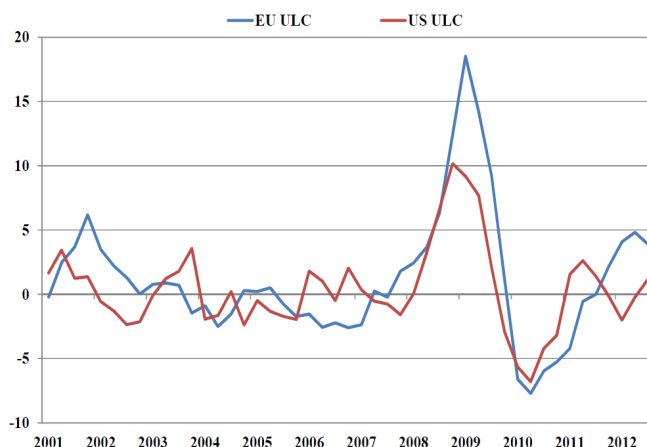
Figure 19. Aggregate net debt / EBITDA for STOXX Europe 600 Index



Source: Citi Research, Bloomberg

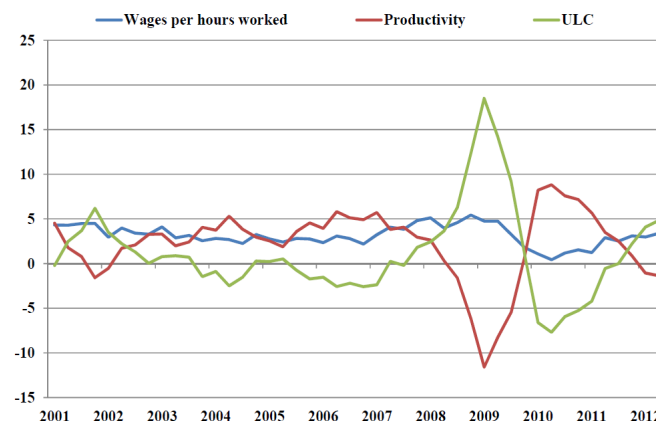
■ **Labor productivity has been affected** — Specific to throughput, we note that, for example, based on data from the European Commission, unit labor costs (ULCs) in manufacturing in Europe have shown greater growth compared to the US following the outbreak of the crisis, and this can be put down to fluctuations in labor productivity growth.

Figure 20. Unit Labour Costs (ULCs) in EU and US manufacturing



Source: EU Industrial Structure Report 2013: Competing in Global Value Chains (European Commission), Citi Research

Figure 21. Fluctuations in EU ULCs are caused mainly by variations in labour productivity growth



Source: EU Industrial Structure Report 2013: Competing in Global Value Chains (European Commission), Citi Research

Unit Labor Cost (ULC) is defined as the ratio of labor compensation to labor productivity. The index measures whether labor costs rise in line with productivity gains. Negative ULC growth indicates that productivity is growing faster than labor costs, while positive ULCs indicate that wages rise more than productivity.

Improve focus on core competencies

- **Crisis has served as a catalyst for accelerating restructuring** — In our view, the crisis has served as a catalyst for accelerating restructuring and reforms within Europe. An integral part of the restructuring is concentration on "core competencies" and as a result outsourcing of non-core activities – this is true not only for transnational corporations (TNCs) competing internationally, but also for relatively smaller regional organizations. While there are high socio-political headwinds towards outsourcing, sluggish growth over multiple years of downturn has made European companies more amenable to higher outsourcing/offshoring.
- **Post-crisis we expect equal emphasis on outsourcing of services** — Pre-crisis, we believe the emphasis in terms of outsourcing within Europe was more skewed towards globalization of manufacturing / production of goods. Post-crisis, we expect an equal emphasis also on outsourcing of services across all sectors, as firms tighten their focus on core competencies – couple of examples to demonstrate this point are the sale of its IT business by Siemens to AtoS in 2010, and the more recent acquisition of AREVA- subsidiary Euriware by Capgemini.
- **Managing IT Risks** — With increasing adoption of IT and rising complexity and sophistication of systems, regulators and institutions alike are becoming more focused and aware of the need to manage the consequent risks. Anecdotally, EU supervisory authorities are now warning banks to reinforce IT controls and audits on third-party technology providers and to ring-fence budgets related to operational risk. In several instances, there is a growing recognition that management of these risks is better left to the IT companies given their higher subject-matter expertise.

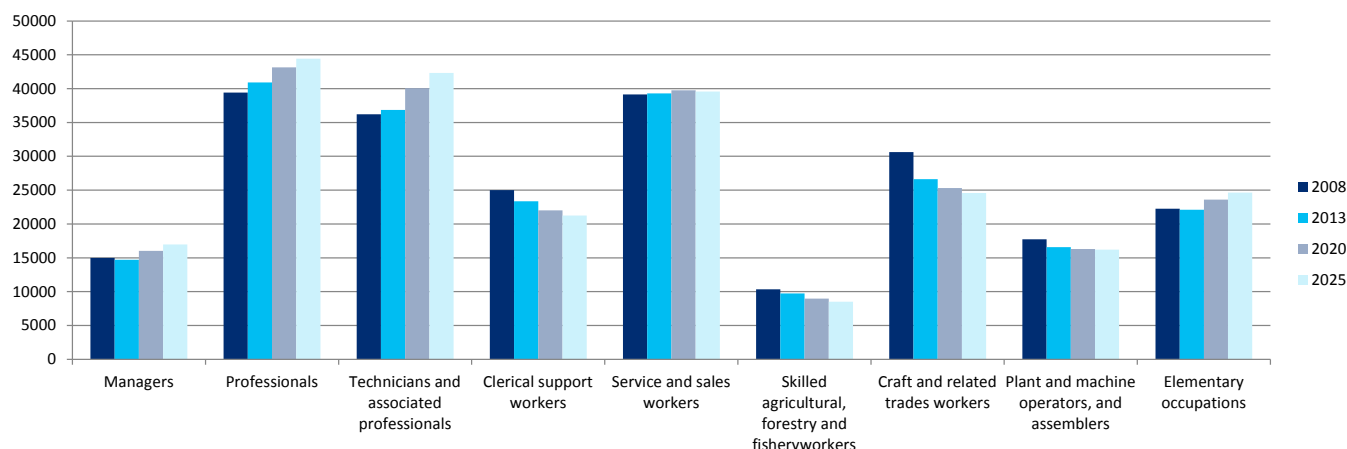
In December 2010, Siemens announced the sale of IT Solutions and Services business to AtoS (then called Atos Origin) for €850m, as the conglomerate looked to sharpen its focus on core businesses including healthcare, energy and industrial. As part of the transaction, Siemens also concluded a seven-year outsourcing contract worth around €5.5 billion, under which the IT services vendor would provide Managed Services and Systems Integration to Siemens.

Earlier this year, Capgemini completed the acquisition of IT outsourcing and systems integrator Euriware and its subsidiaries from French Nuclear power group AREVA for an undisclosed amount. As part of the agreement, Capgemini has signed a €1billion, 10-year agreement to provide IT services to AREVA.

Demand-supply gap in IT skills

- **Offshoring should enable Europe to meet IT skills demand** — In addition to increased competitiveness through reduced costs, higher efficiencies and greater emphasis on core competencies, we believe outsourcing, and more pertinently offshoring, also help address one of the issues increasingly likely to be faced by European corporates – access to specific knowledge, expertise and tools. According to a study by BUSINESSEUROPE, an industry body representing enterprises in 35 European countries, the estimated shortage of qualified Information and communications technology (ICT) staff in EU, will rise to somewhere between 384,000 and 700,000.

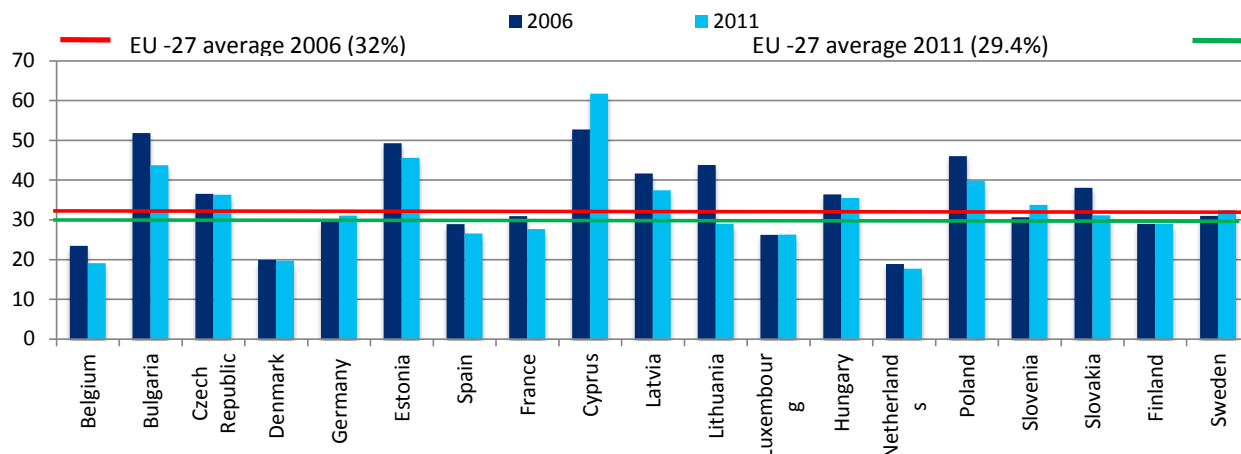
Figure 22. Employment trends by occupation (EU 28+) – demand for Technicians and associated professionals is expected to grow by ~8%



Source: Cedefop, Citi Research

- **Recent supply trends point towards a widening gap** — Further, BUSINESSEUROPE also asserts that the supply of Science, Technology, Engineering and Mathematics (STEM) skills will not match the increasing demand of companies. Projections by Cedefop, the European center for development of vocational education and training, indicate that demand for STEM professionals and associate professionals is expected to grow by around 8% between now and 2025 – supply on the other hand appears to be moving in the other direction, and Cedefop calculates a slight decline in the proportion of upper-secondary Vocational education and training (VET) graduates in STEM-related subjects, with the estimated EU average dropping from 32% in 2006 to 29.4% in 2011.

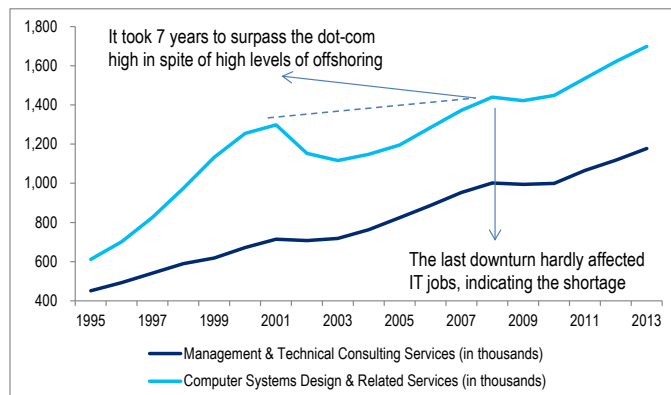
Figure 23. Proportion of upper-secondary VET graduates in STEM-related subjects has shown a slight decline.



Source: Cedefop, Citi Research

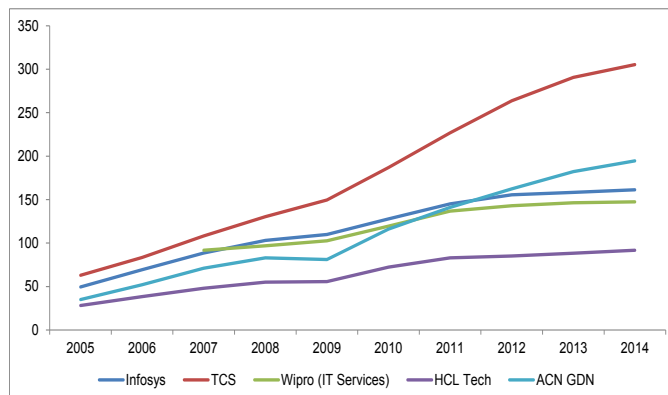
- **Drawing from the US experience** — Even in a more mature market like the US, concerns have been occasionally voiced as to whether ‘offshoring’ results in a pressure on local employment. On the contrary, historical data suggests that despite offshoring picking up over the last decade IT jobs in the US have gone up. The last downturn hardly affected IT jobs in the US, indicating the shortage of talent. This suggests that the key forces that lead to outsourcing are economic savings, core competency and labor availability.

Figure 24. US IT Jobs – Going up despite offshoring (in 000's)



Source: Haver Analytics, Citi Research

Figure 25. IT Services headcount over the years (in 000's)



Source: Company Reports, Citi Research

Wider Labor reforms

- **Barriers are being lowered** — Traditionally, the relatively rigid labor rules have served as one of the deterrents when it came to outsourcing and more so offshoring on the continent. We note that this has particularly been the case when it comes to collective redundancies associated with restructuring. However, we understand that the crisis has resulted in reforms that suggest lowered barriers in the future when it comes to embarking on outsourcing. In fact, this view is also supported by observations made by the European Trade Union Institute (ETUI) in one of its working papers published in February 2014.

"... Recent labor law reforms show a loosening of employment protection law in respect of the protection of workers in case of collective dismissals ..." - Labor law reforms in Europe: adjusting employment protection legislation for the worse? ETUI (Feb 2014)

"... All reforms, however, are structural and based on the same grounds: reforming labor markets to provide more flexibility by reducing the costs of dismissal protection and simplifying procedures." - Labor law reforms in Europe: adjusting employment protection legislation for the worse? ETUI (Feb 2014)

Desire to Outsource Extends Beyond IT

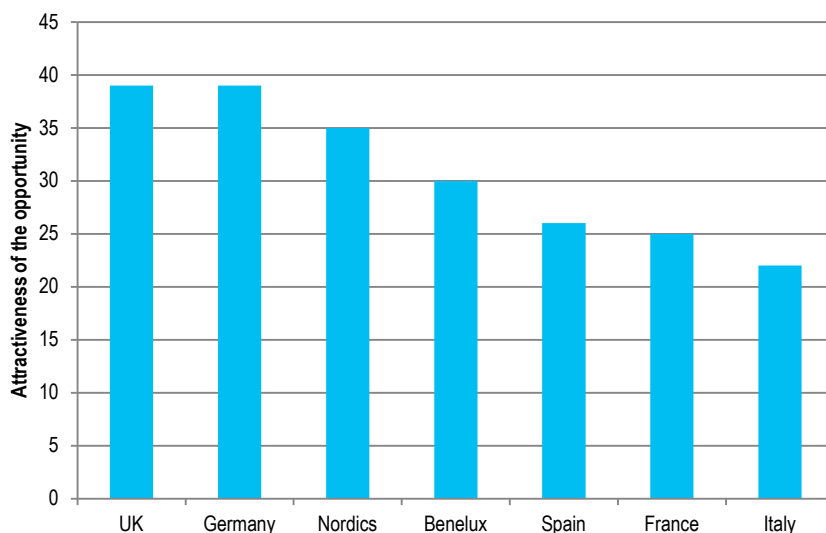
Our relevant IT/BPO M&A notes are: [Why we like BPO](#) and [IT/BPO M&A](#).

- **BPO is a strong growth opportunity also** — The BPO industry grew in the U.S. with a lag and has often struggled to meet its initially lofty expectations. But as the capability of BPO vendors has evolved and the “law of large numbers” has curtailed IT growth expectations, the growth opportunity that BPO represents is better represented today. These capabilities are difficult to develop both from a time- and investment standpoint and so there is inherent value in what pure-play BPO vendors such as EXL Service, Genpact and WNS have built. Moreover, two of the BPO vendors – WNS (~57% of revenues) and EXLS (~27%) have meaningful European exposure (including the U.K.) and so they would make excellent acquisition candidates, in our view.

Key European Markets: A Deep Dive

- **The outsourcing shift will not be homogenous** — In our view, the structural shift towards increased outsourcing and offshoring in Europe will not be uniform, as Europe is not a homogenous entity. The regional bloc has made significant strides in terms of adopting a common framework for fiscal and monetary policies as well as promoting easy migration of talent across borders, yet we believe each country / sub-region will continue to be characterized by its own distinct set of cultural, linguistic, and social norms as well as implementation of state welfare.
- **“Non-economic” factors to influence the pace of adoption** — Indeed these 'non-economic' factors have played their role in inhibiting the widespread adoption of outsourcing and offshoring in the past - and we believe going forward as well, these will significantly influence the pace of penetration, in combination with the drivers underpinned by economics and competitiveness.
- **The “Attractiveness Assessment” Framework** — With this background, we have assessed the attractiveness of the opportunity in terms of seven distinct geographical entities – UK, Germany, France, Benelux, Nordics, Spain, and Italy.
 - **6 key dimensions** — Our framework is based on six dimensions (relative size, penetration potential, cultural acceptance, economic health, labo(u)r reforms and linguistic compatibility) to measure the attractiveness for each location. We rank each location along these dimensions based on our analysis of sub-sector newsflow, conversations with industry representatives, knowledge experts, company commentary and anecdotal evidence.
 - **Nordics and Germany are attractive markets** — We infer that despite its relatively higher penetration, UK still represents the best opportunity thanks to the size of its private sector. On the mainland, we like Germany closely followed by Nordics and then Benelux (in that order).

Figure 26. The Europe opportunity – Relative attractiveness assessment

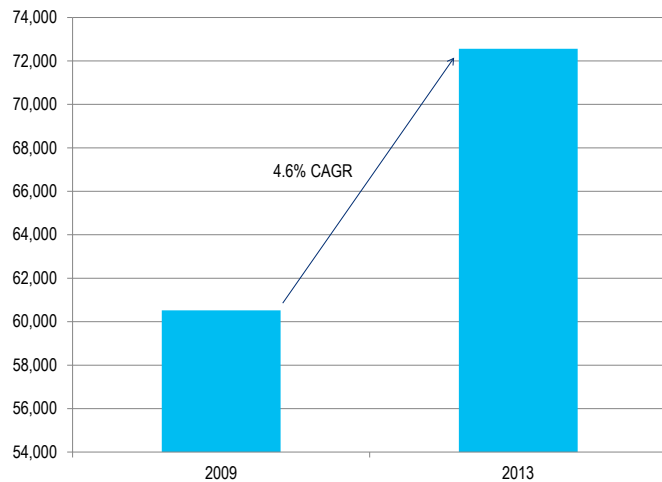


Source: Citi Research

UK

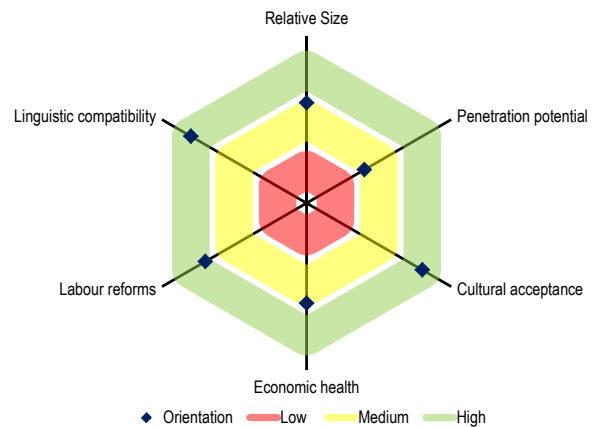
- **A ~\$73bn market** — The UK is unsurprisingly the largest market in Europe, with IT services spending of ~\$73bn, growing at a healthy clip of ~4.6% CAGR in recent years. Like in most markets, there is a high level of fragmentation. The Capita Group is currently the market leader, followed by other major vendors like BT, HP, IBM, Capgemini, Accenture and Atos (see Fig 13).

Figure 27. UK – IT/BPO services market (\$ mn)



Source: Citi Research

Figure 28. UK – Attractiveness assessment

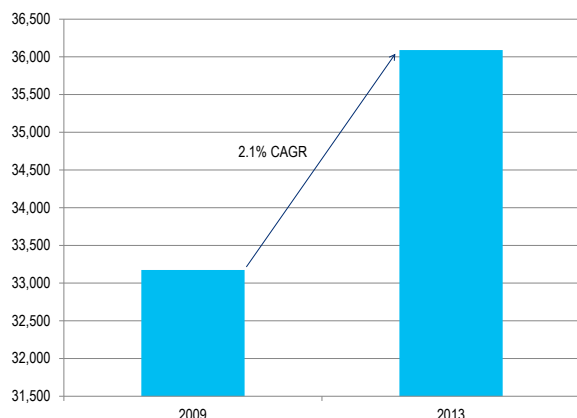


Source: Citi Research

Germany

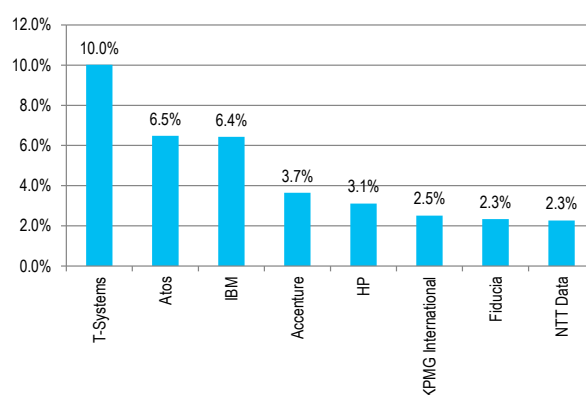
- **A ~\$36bn market** — Germany is the largest market in continental Europe with IT services spending of ~\$36bn, roughly half that of the UK market today, despite ~30% higher GDP. Like in most markets, there is a high level of fragmentation. There is a meaningful presence of local players such as T-Systems who is currently the market leader, followed by US/European vendors like Atos and IBM. Infosys/CTSH made a push in this market with their Lodestone/C1 acquisitions, which provides multiple relationships they can exploit to sell offshoring.
- **Most attractive market in continental Europe** — We believe that Germany represents the most attractive market in continental Europe, drawing from our “Attractiveness Assessment” Framework discussed earlier. The large market size, coupled with relatively better economic health and cultural acceptance (within the context of the rest of Continental Europe) are the key factors.

Figure 29. Germany – IT/BPO services market (\$ mn)



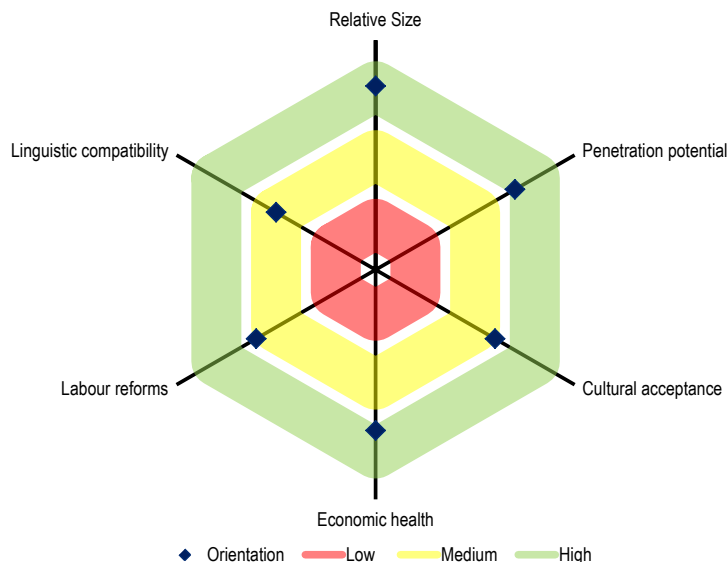
Source: Gartner, Citi Research

Figure 30. Germany IT/BPO services market shares – top 8 (2013)



Source: Gartner, Citi Research

Figure 31. Germany – Attractiveness assessment

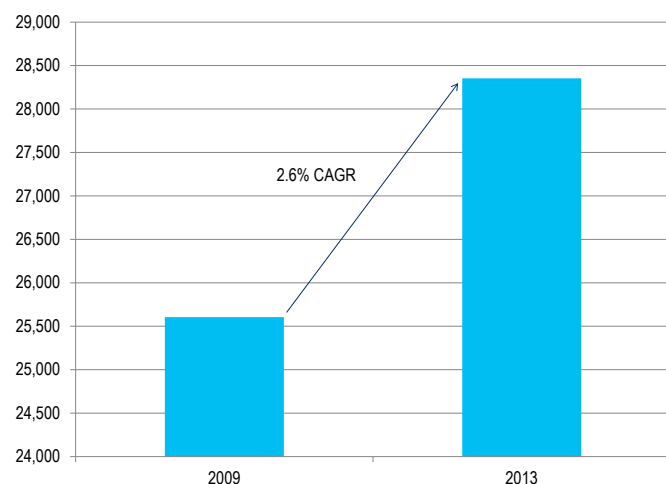


Source: Citi Research

France

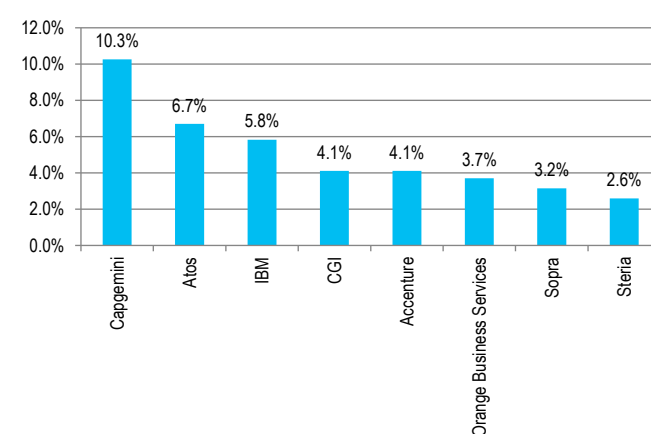
- **A ~\$28bn market** — France is the second largest market in continental Europe, with IT services spending of ~\$28bn, growing at ~2-3% CAGR over the past few years. There is a high level of fragmentation with European vendors like Capgemini and Atos dominating the market. Smaller players have begun selling out (witness AtoS' Groupe Bull deal, and TCS's Alti acquisition).
- **Relatively less optimistic on the prospects in France** — We are less optimistic on the prospects in France, particularly for offshoring, owing to our pessimistic view for cultural acceptance and labor reforms.

Figure 32. France – IT/BPO services market (\$ mn)



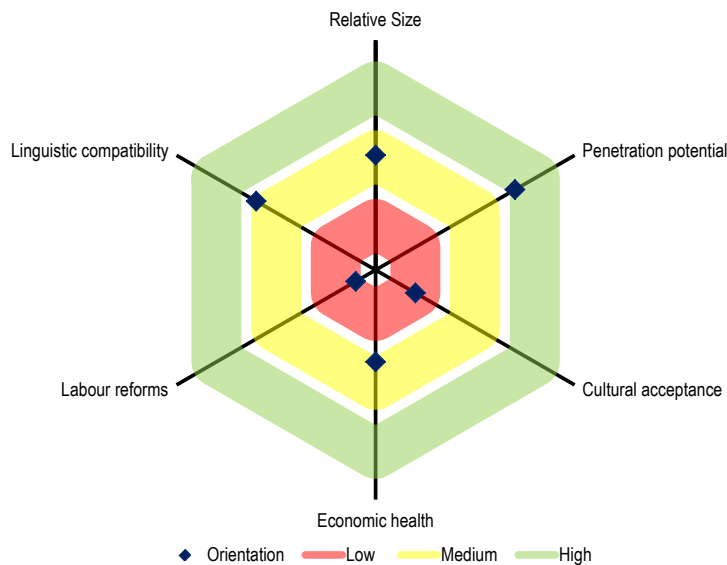
Source: Gartner, Citi Research

Figure 33. France IT/BPO services market shares – top 8 (2013)



Source: Gartner, Citi Research

Figure 34. France – Attractiveness assessment

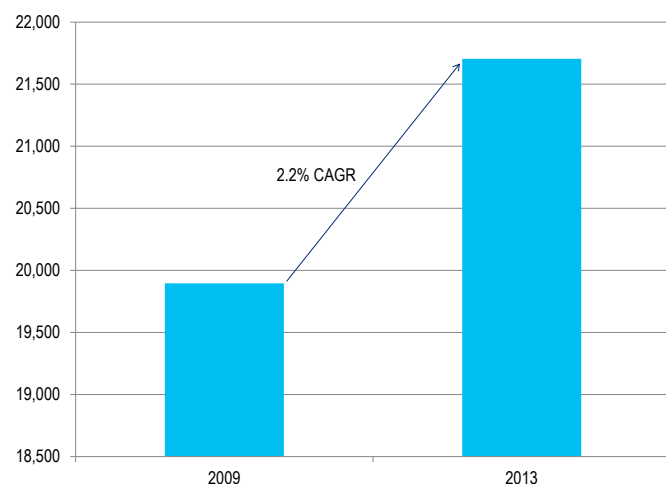


Source: Citi Research

Benelux

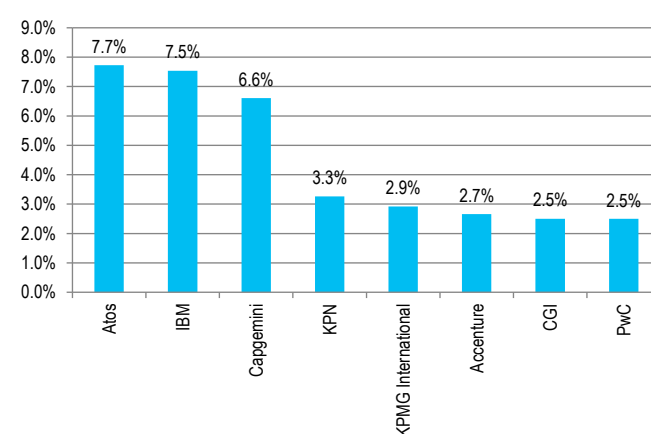
- **A ~\$22bn market** — Benelux is another large market in continental Europe with IT services spending of ~\$22bn, growing at ~2% CAGR over the past few years. While a high level of fragmentation remains, there does not seem to be any stand-out vendor who dominates the market meaningfully. Atos, IBM and Capgemini are the leading vendors.
- **Reasonably attractive** — We believe Benelux represents a reasonably attractive market, particularly relative to the Southern European markets, with reasonable size and higher cultural acceptance.

Figure 35. Benelux – IT/BPO services market (\$ mn)



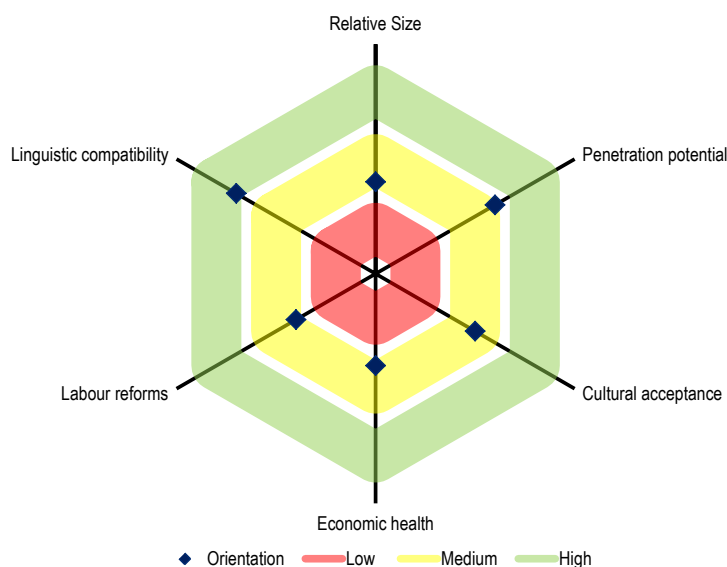
Source: Gartner, Citi Research

Figure 36. Benelux IT/BPO services market shares – top 8 (2013)



Source: Gartner, Citi Research

Figure 37. Benelux – Attractiveness assessment

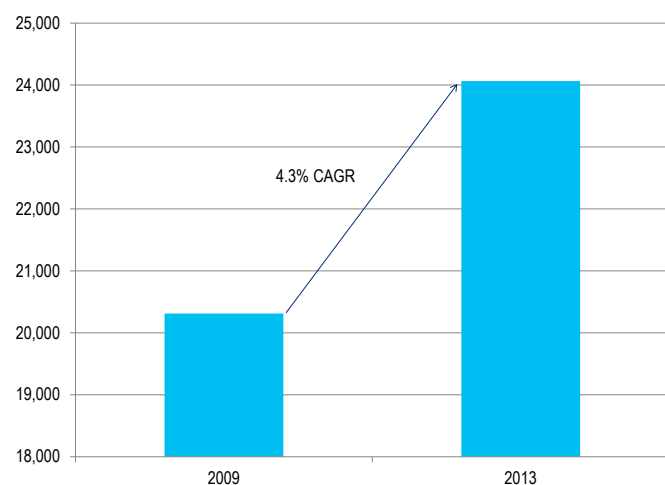


Source: Citi Research

Nordics

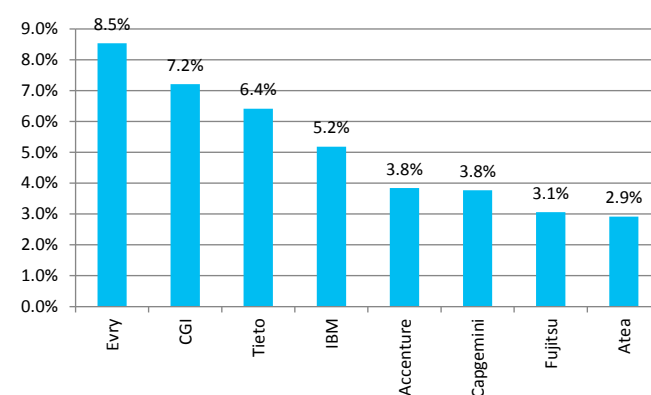
- **A ~\$24bn market** — Nordics is the fastest growing among the major markets in continental Europe, with IT services spending of ~\$24bn, growing at ~4.3% CAGR over the past few years. As we indicated earlier, there is a meaningful presence of local players such as Evry (currently the market leader) and Tieto. US/European vendors like IBM, Accenture and Capgemini are other key players.
- **Highly attractive market in continental Europe** — We believe that Nordics represents the second most attractive market in continental Europe. Relatively better economic health and cultural acceptance (within the context of the rest of Continental Europe) are the key factors.

Figure 38. Nordics – IT/BPO services market (\$ mn)



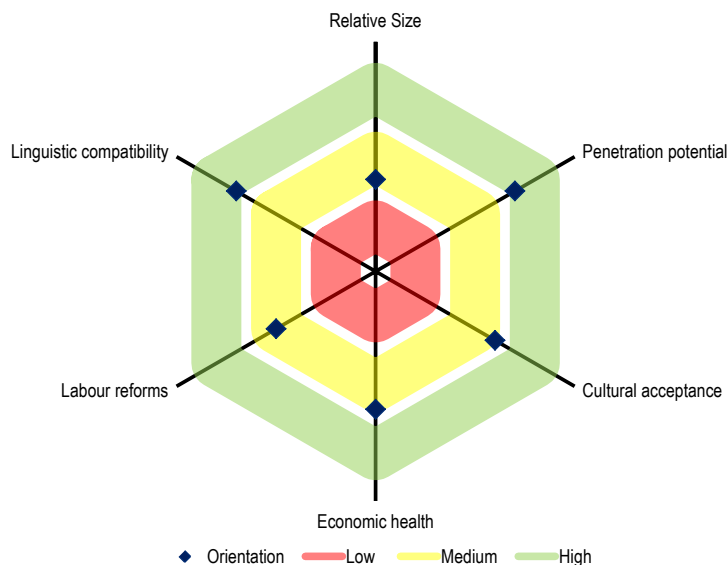
Source: Gartner, Citi Research

Figure 39. Nordics IT/BPO services market shares – top 8 (2013)



Source: Gartner, Citi Research

Figure 40. Nordics – Attractiveness assessment

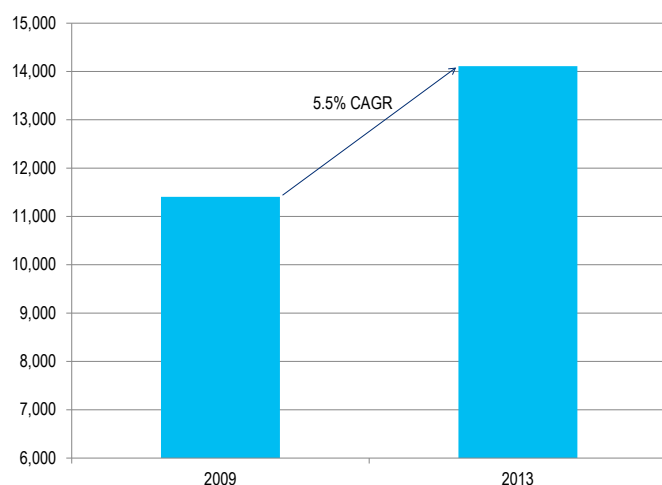


Source: Citi Research

Spain

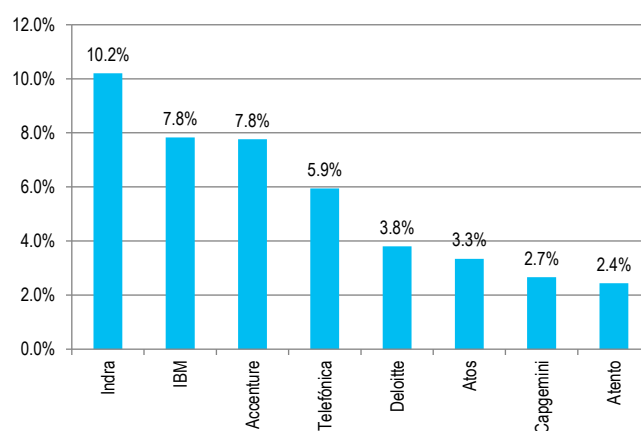
- **A ~\$14bn market** — Spain is a relatively smaller market in continental Europe, with IT services spending of ~\$14bn, but growing at ~5.5% CAGR over the past few years. Indra, a local player, is currently the market leader with large global vendors like IBM and Accenture being the other key players.
- **Spain better placed in Southern Europe** — Within southern Europe, where penetration has historically been the lowest and which has also been the region most impacted by the crisis, Spain stands out for us as an emerging adopter of outsourcing, amidst an increasing acknowledgement among worker councils of the need for labor reforms.

Figure 41. Spain – IT/BPO services market (\$ mn)



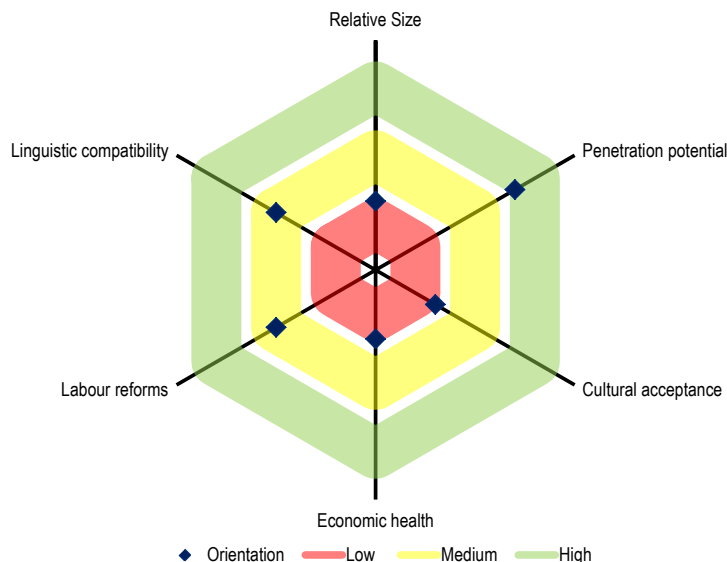
Source: Gartner, Citi Research

Figure 42. Spain IT/BPO services market shares – top 8 (2013)



Source: Gartner, Citi Research

Figure 43. Spain – Attractiveness assessment

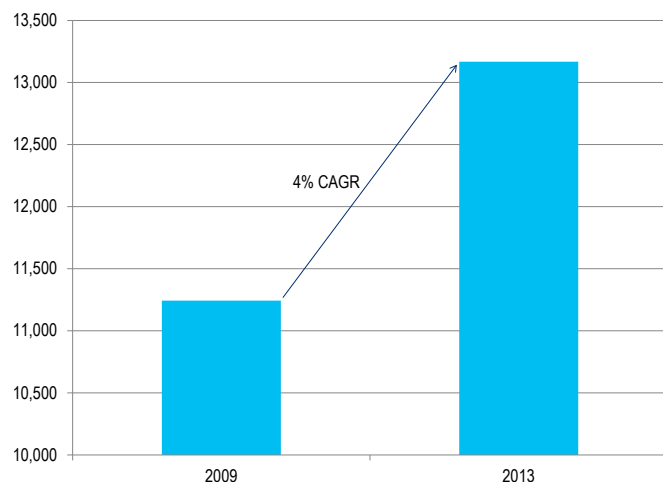


Source: Citi Research

Italy

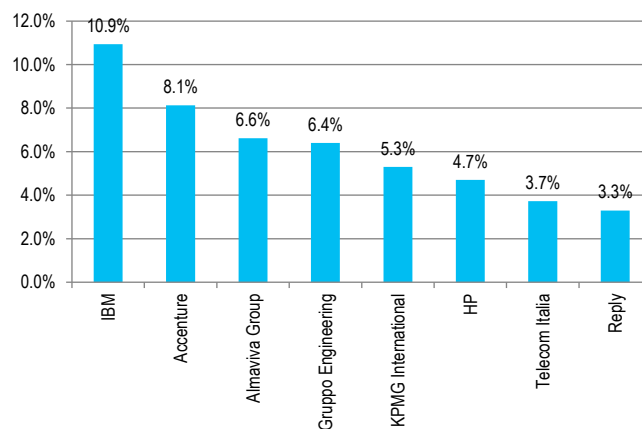
- **A ~\$13bn market** — Italy is another relatively smaller market in continental Europe, with IT services spending of ~\$13bn. There is a high level of fragmentation, with large global vendors like IBM and Accenture dominating the market. And although it has been growing at ~4% CAGR over the past few years, the risk-reward for the opportunity based on overall assessment seems the least attractive relative to others in our view.

Figure 44. Italy – IT/BPO services market (\$ mn)



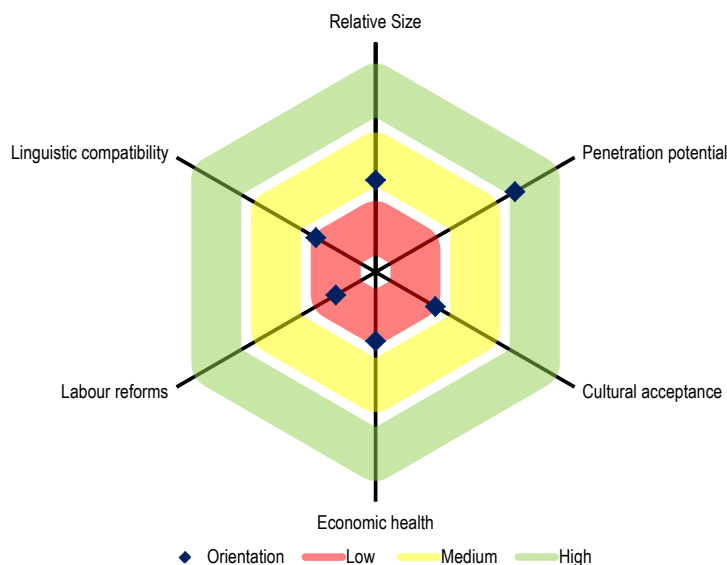
Source: Gartner, Citi Research

Figure 45. Italy IT/BPO services market shares – top 8 (2013)



Source: Gartner, Citi Research

Figure 46. Italy – Attractiveness assessment



Source: Citi Research

Eastern Europe: Next-door Delivery Center

Proximity, EU data rules and cultural fit (at least more so than with India-model companies) are important to European clients, which has led to CEE / CIS becoming emerging offshore IT Services destinations.

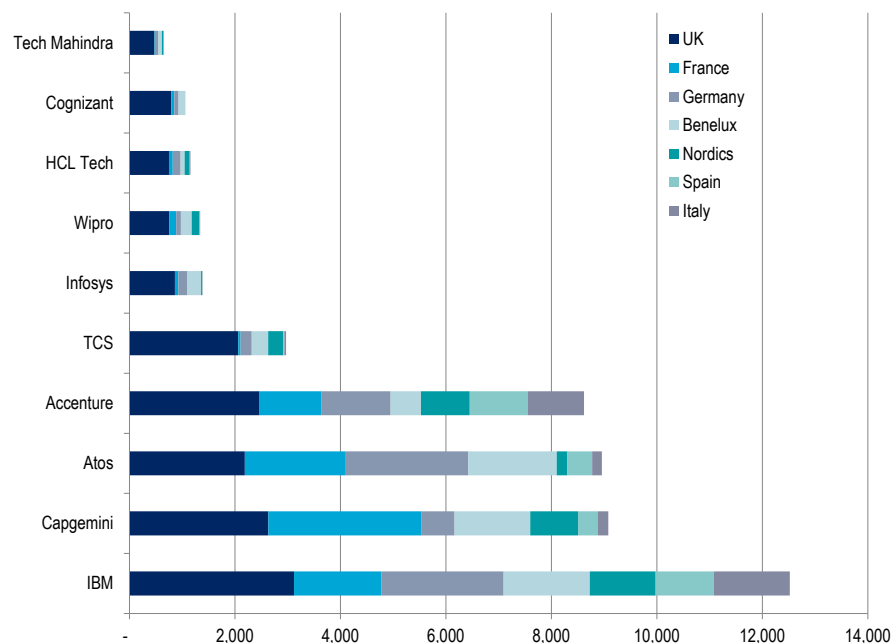
We use Buy-rated EPAM as a proxy for our analysis of this aspect of European outsourcing.

- **Near-shore delivery capability is crucial** — Many clients in Continental Europe value proximity and cultural similarity as they embark on outsourcing. EU data needs can also be a factor for some companies and applications. This drives demand for near-shore outsourcing capabilities. Costs and talent availability can vary dramatically by country and EU-based centers can be ~20- 30% more expensive than India although CIS/CEE locations can arrive at an equivalent blended rate based on a lower use of on-site talent.
- **Emerging offshore IT Services destinations** — Central and Eastern Europe is benefiting from the same characteristics that helped India become the go-to location for offshore IT outsourcing – i.e., lower cost of labor, access to talent, language skills, etc. CEE also benefits from its close proximity to Western European clients, and a desire by CIOs (Chief Information Officers) to diversify their company's offshore exposure.
 - **Lower cost of IT services labor** — Most recently, EPAM's average hourly bill rate was approximately \$35-\$40 (blended), which is in line with the Indian heritage firms like CTSH and INFY and less than half the cost of doing the same work in the U.S. or Western Europe.
 - **Diversification of offshore resources** — Our discussions with several CIOs suggest that part of their companies' IT offshoring roadmap is to send incremental work to locations other than India. Primarily it boils down to CIOs' desire to diversify their exposure to the political and economic forces that can impact the cost of doing business in any one location – whether that be changes in tax laws, wage inflation, economic cycles, conflict, or other.
 - **Geographical and Cultural advantage** — The region's close proximity to Western Europe (i.e., time-zone) gives it a competitive edge versus India, China and other Asia Pacific locations, when it comes to transferring work from Western Europe. Particularly in the CEE countries, there is also a cultural similarity (at least more so than the common alternatives) that can be helpful in terms of becoming comfortable with the vendor.
 - **Access to strong IT talent** — CEE IT vendors enjoy access to solid regional technical education centers. In 2013, based on UNCTAD Statistics data, Belarus, Hungary, Serbia, Poland, and the Ukraine had nearly 1 million graduates with technical degrees in science, IT and engineering. These are clearly broad graduate categories; however, it illustrates in our opinion that there is ample new talent each year to satisfy growing demand.
- **CEE/CIS segment should grow faster** — Based on NASSCOM estimates, the India IT-BPO segment will grow in the 13%-15% range through 2016. With total offshore IT Services spend expected to grow at approximately 12% through 2016 (per IDC), we estimate the CEE/CIS market is growing in the 20% range, especially given the lower base. IDC estimates the worldwide offshore IT market to grow to \$87 billion in 2018 (~11% CAGR 2013-2018). EPAM and Luxoft are two of the leading listed players in the CEE region.
- **EPAM is a key beneficiary** — We believe that because EPAM is more established and has relative scale it can benefit disproportionately from the trend to send incremental work to CEE/CIS, compared to other local CEE providers. We believe this helps support our 20%+ revenue growth estimate over the projection period. We do not cover Luxoft, and thus make no forecasts for the company.

Vendor Positioning

- **Implications for vendors contingent on their positioning** — Just as the shift across Europe will not be uniform, the implication for each vendor will also vary contingent upon their positioning. In our view, all vendors can be classified into three broad groups: (1) the incumbents, mostly Western European and US heritage vendors (2) the challengers, India-centric players and (3) 'The wildcards' (in our terminology), Eastern-European firms.

Figure 47. IT Services – Revenues across key regions in Europe (\$ million)



Source: Gartner, Citi Research

- **M&A will be a critical tool** — The broader macro / financial environment for M&A remains very conducive and we have explored this topic within the context of IT Services in detail in [Industry Reboot: M&A, Capital Return the Next Potential Catalysts](#). With regards to Europe, it is imperative in our view that the 'challengers' (India-centric players) in particular, place a significant emphasis on inorganic growth on the mainland in a bit to enhance their onshore footprint, and raise their profile. Meanwhile, we see the incumbents too making opportunistic moves to add scale, diversify regional footprint, and acquire new offerings.

Figure 48. Key M&A deals in Europe IT Services over the past 5 years

Acquirer	Target	Announced Date	Primary Rationale	Value	Description / Research Link
AtoS	Bull	May-14	New offering	EUR 620m	Strengthen presence in Cloud / Cybersecurity
AtoS	Siemens IT	Dec-10	Pursuit of Scale	EUR 850m	Scale in terms of offerings, regions, and verticals
Capgemini	Prosodie	Jun-11	New offering	EUR 382m	New Business model
Infosys	Lodestone	Sep-12	Geographic diversification	USD 350m	Employee base of ~850 and >200 clients. ~83% revenues from Europe
TCS	Alti	Jul-13	Geographic diversification	USD 75m	~1,200 employees; operations primarily in France, Belgium and Switzerland
Cognizant	C1 Group	Dec-12	Geographic diversification	USD 137m	~500 employees; Expanded presence in Germany and in Switzerland
Cognizant	Equinox Consulting	Oct-13	Geographic diversification	N/A	~160 employees: Expanded presence in France
Amdocs	Actix	Sep-13	New offering	USD 120m	Expand the customer experience offerings of Amdocs
Sopra	Steria	Apr-14	Pursuit of Scale	EUR 955m	Friendly merger to create a European leader in digital services

Source: Citi Research, Bloomberg

■ **'Vendor Positioning' Assessment** — With this background, combined with management commentary and steps taken so far, attractiveness of the countries / sub-regions where they have a stronger presence (as outlined in the earlier section) and ultimately our own understanding of the companies, we have assessed the positioning of each of the leading vendors.

- **4 Key Dimensions** — We have carried out the assessment along four dimensions – (1) Market penetration potential; (2) Strength of CxO relationship; (3) Offshore delivery capability; and (4) Near-shore presence.

These factors are not equally weighted and the importance of each may vary from market to market. We believe penetration potential may be an important parameter here because that (along with all initiatives) can drive revenue growth, which generally has always been the most important driver of valuations in the IT Services space.

An additional comment about Incumbency is warranted. Clearly, incumbents have a lower market penetration potential by definition – they likely have their position due to the strength of their CxO relationships. These are positives. But as we have mentioned before, incumbents also have the most to lose. A likely outcome is that they keep their existing clients and even grow volumes but they may see price degradation associated with a revenue mix shift to lower-cost resources.

- **Who is best positioned?** — Overall, we believe Accenture/Capgemini are the best placed incumbents, TCS is the lead challenger and EPAM is the best play on near shore outsourcing.

The Incumbents (European and US heritage vendors)

- The 'incumbents' benefit from well-entrenched positions and broader geographic footprint, better perception / intimacy with clients / regulators / workers, as well as potentially a slight early mover advantage when it comes to near-shoring. Some of them have significant offshoring presence as well.
- Accenture and Capgemini stand out as best positioned to protect share and grow the business. Given the penetration and size of the business, growth will obviously be slower than the challengers or wildcards though.
- One key worry for incumbents is cannibalization of existing revenues. As an example, Accenture should be in a good position to protect its relationships but if the client is reasonably penetrated, there might be limited scope for a volume-for-price growth trajectory.

The Challengers (India-centric players)

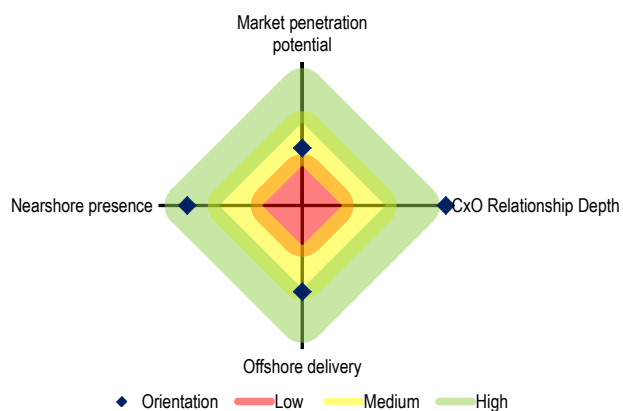
- The 'challengers' have advantages of their own too – best-in-class global delivery models and the absence of drag from legacy asset-heavy contracts. These companies have had a strategic focus on Europe for some time but have certainly benefited from their recent investments in front-office relationships through local-market acquisitions.
- Given the data we have and our discussions with industry participants, we believe TCS leads the pack followed by Infosys/CTSH within the challenger space. For example, TCS has grown its revenues from Continental Europe at ~26% CAGR over the past 3 years and now has a ~\$1.5bn practice. Most of the firms have built up local management teams and have also used M&A, where required, to scale up in the region:

- In 2008, HCL Tech acquired Axon, a focused niche vendor active in SAP consultancy and implementation work with a market leadership position in the UK. The reverse merger of HCLT SAP practice with Axon resulted in a team of ~4,500 consultants. Within SAP, Axon concentrated on a relatively defensive portfolio with majority of revenues from utilities, public sector and aerospace & defense and less exposure to BFSI and retail.
- In Sept 2012, Infosys acquired Lodestone Holding for an EV of ~US\$350mn (~1.6x trailing sales). A management consultancy firm in Zurich, it provided (1) scale in Europe – Lodestone has ~83% revenues from Europe. (2) Access to clients – Lodestone had >200 clients, with very minimal overlap with Infosys. (3) Strengthening business transformation consulting offerings – Lodestone helped Infosys increase CSI revenues by ~10%. Please refer [Lodestone Acquisition – Inorganic Strategy at Work](#) for details.
- In July 2013, TCS acquired Alti SA, a system integrator of SAP solutions in France for ~€75mn (~0.6x trailing sales). TCS had been operating in France since 1992 and had over 50 clients in the country – Alti's team of ~1,200 employees helped to further scale up its operations in France, Belgium and Switzerland.
- In Dec 2012, Cognizant announced its acquisition of six companies of the C1 Group, an independent consulting and IT services firm based in Hamburg, Germany. Further in 2013, they acquired Equinox in France.

'The Wildcards' (East European firms)

- Finally, while most of the discussion in the report so far has focused on the first two groups of vendors, we believe our so-called 'wildcards' are also increasingly emerging as a viable option for European customers looking to reap the benefits of outsourcing without using the India model.
- Amongst the Eastern EU vendors, we have evaluated EPAM and it scores high on market penetration potential as well as near-shore presence. While the company is small relative to most competitors used in this analysis, near-shore outsourcing is a strong trend and EPAM continues to deliver the best growth. Offshore delivery, where EPAM scores low, may not be a very relevant parameter when it comes to their business model – we note that EPAM delivers “offshore” rather than “near-shore” capability to its U.S. clients, so this is a pedantic assessment to some extent. EPAM is one of our top US IT Services picks. It also makes up for its lower CxO scores by actually having good breadth (e.g., CMO relationships) and a more product-oriented bent than other competitors.

Figure 49. Capgemini – Positioning assessment



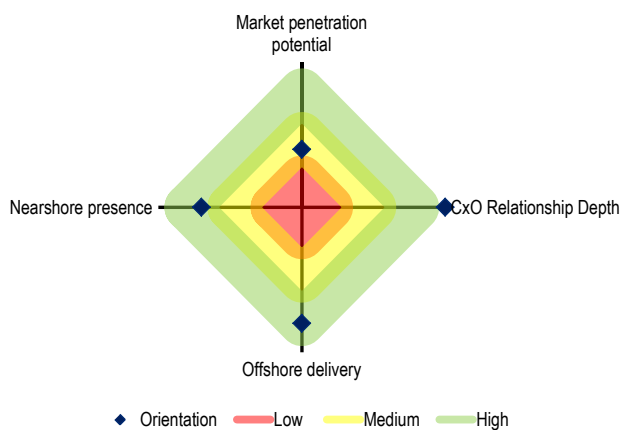
Source: Citi Research

Figure 50. AtoS – Positioning assessment



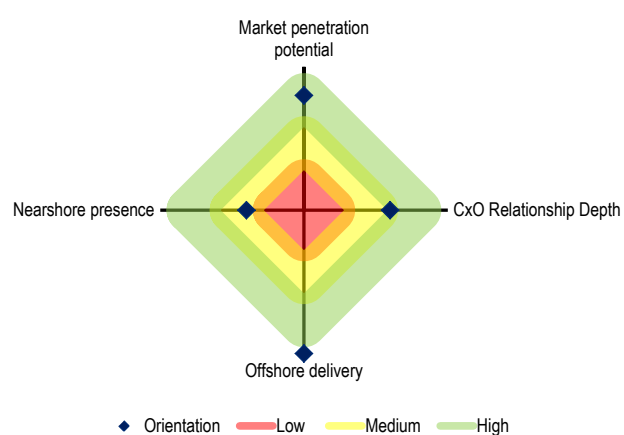
Source: Citi Research

Figure 51. Accenture – Positioning assessment



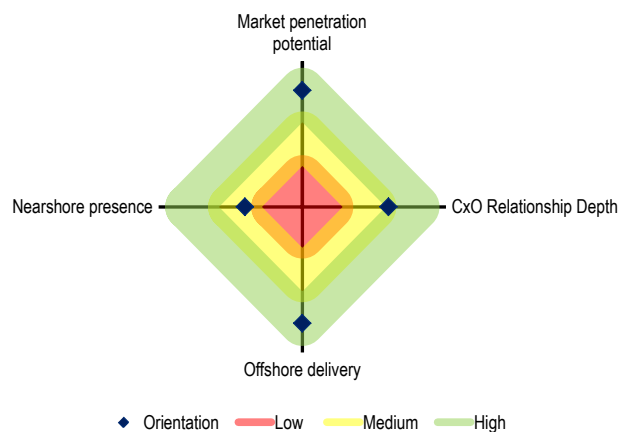
Source: Citi Research

Figure 52. TCS – Positioning assessment



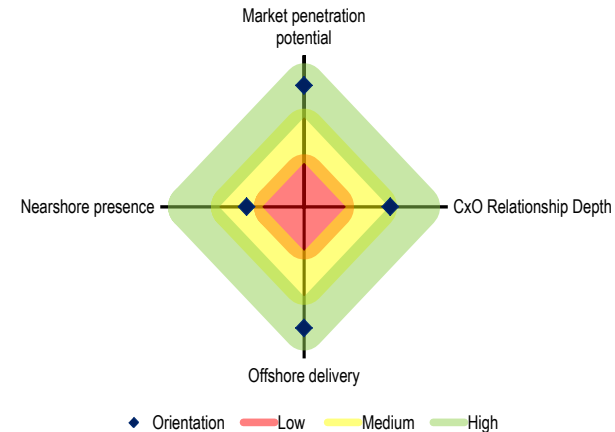
Source: Citi Research

Figure 53. Infosys – Positioning assessment



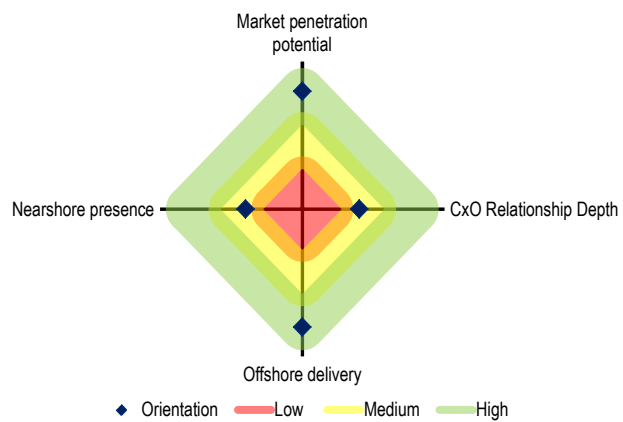
Source: Citi Research

Figure 54. Cognizant – Positioning assessment



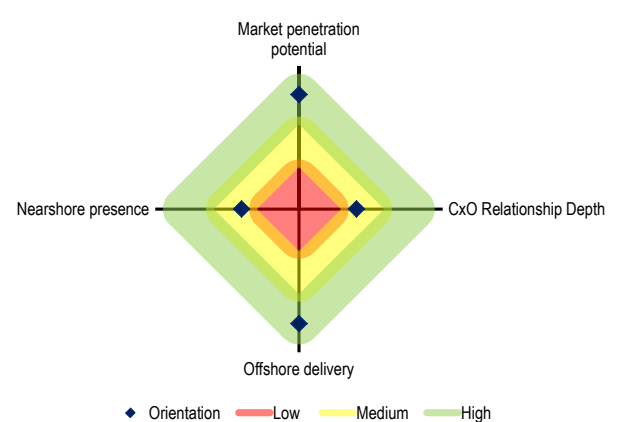
Source: Citi Research

Figure 55. Wipro – Positioning assessment



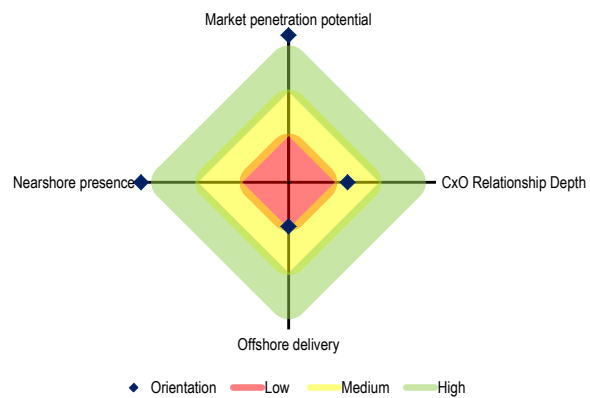
Source: Citi Research

Figure 56. HCL Tech – Positioning assessment



Source: Citi Research

Figure 57. EPAM – Positioning assessment



Source: Citi Research

Note: See our written commentary – near-shore and offshore are defined relative to European client.

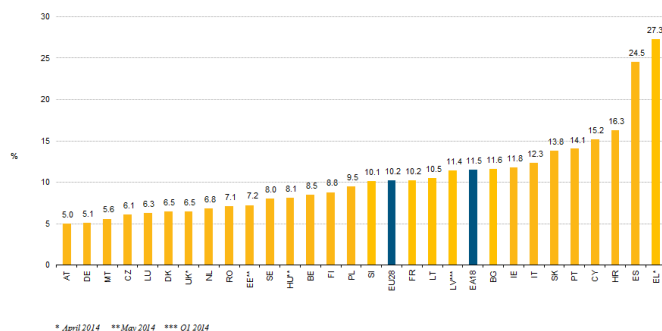
Opportunity not without its challenges / risks

The Un-word or Non-word of the year (German: Unwort des Jahres) is an annual publication that names a German word or word group that is considered to be the year's most offensive new or recently popularized term. In 1996, one of the six unwords chosen was **OUTSOURCING**.

Every opportunity comes with its fair share of challenges and risks, and below we outline some of the latter that could inhibit the pace and adoption of increased outsourcing and offshoring within Europe.

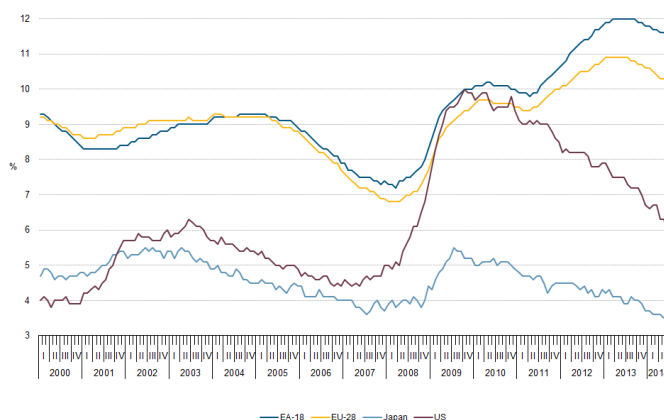
- **Legislation – some reforms but not uniform and it continues to evolve** — Although reforms appear to be lowering barriers across the continent as we highlighted earlier in the report, there exist country-wise differences in terms of implementations of relevant European Union laws – as for example in case of the Transfers of Undertakings Directive (which is quite relevant for outsourcing as it stipulates that any employee's contract of employment will be transferred automatically on the same terms as before in the event of a transfer of the undertaking). At the same time, associated legislations evolve, as for example seen with the January 2014 amendment of the 2006 TUPE regulations in the UK.
- **Elevated unemployment remains a headwind to offshoring** — Although we have talked about a shortage of STEM / IT skills, the overall unemployment levels in Europe still remain elevated – according to Eurostat estimates, ~25m men and women were unemployed in the EU-28 in June 2014, or an unemployment rate of 10.2%. And while this is down from 10.9% in June 2013, it is still higher than pre-crisis levels (low of 6.8% in 1Q08) and well above the corresponding June-2014 number for the US 6.1%. Against this backdrop, we believe the negative overall public sentiment (towards offshoring in particular) is likely to persist.

Figure 58. Unemployment rates, seasonally adjusted, June 2014



Source: Eurostat, Citi Research

Figure 59. Unemployment rates EU-28, EA-17, US and Japan, seasonally adjusted, January 2000 - June 2014



Source: Eurostat, Citi Research

- **Outsourcing vs. Shift to cloud** — Cloud computing represents an ongoing paradigm shift in the way computing resources are delivered to end-users. And while the US has been the clear leader in terms of adoption so far, we have seen signs of rising interest in Europe as well over the past 12 months. Both cloud and offshore outsourcing are means to reduce the total cost of ownership of applications and infrastructure. Sometimes both these trends compete for the same resources. And hence, in some instances, the rise of the cloud could actually negatively affect the outlook for outsourcing.

Final words ...

There is no doubt in our mind that the vendor landscape in Europe will look very different in the next decade

We are convinced that the "New Normal" in Europe, within the context of IT/BPO services, will be characterized by an increasing acceptance of outsourcing and offshoring. The pace of change may vary by geography and come with its fair share of challenges — but we believe strongly it is a structural change. Over the long run, it would be interesting to see if the "challengers" of today grow into the "incumbents" of tomorrow, and how the currently localized "wildcards" evolve in terms of market-share. Either ways, there is no doubt in our mind that the vendor landscape in Europe will be transformed over the next decade.

IT services sub-sector remains an attractive investment choice for a number of good reasons

Over and beyond the company-specific upside/downside inherent in this "New Normal" of Europe, the global IT services sub-sector remains an attractive investment choice in the medium term for a number of good reasons (i) Secular trends support top line growth — for example, the growth of BPO and still-healthy outsourcing trends in core geographies like the U.S. (ii) The growth of new markets like digitization and analytics (iii) Ability of consultants to advise on, and influence the direction of, corporate investments (iv) Attractive financial metrics, such as margins, cash flow, and healthy balance sheets (v) Relatively stable unit pricing and capable management teams round out the bullish outlook.

EPAM/Capgemini/HCL Tech are our top picks

On a 12-month view, weighting the outlook with valuation and other factors, EPAM/Capgemini/HCL Tech are our top picks in the space.

Appendix A-1

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