Burnt Oak Partners

Does the traditional IT company still have a future?

With the rise of commercial cloud services and the ongoing digitization, an important revolution is taking place in the IT industry. The traditional business model of IT Services companies - often created in the last decades of the last century - is increasingly under pressure. Here we see the competitive model published by the economist Porter in 1979 at work, in which substitute services ('substitutes') and new market players ('new entrants') play an important role. What does this mean for the traditional IT (outsourcing) company and what strategy can be followed to survive this competition?

Some history

Until the late 1980s, the "IT industry" was dominated by hardware companies such as IBM, Hewlett Packard, Digital Equipment Corporation and Olivetti. Due to the growing application of IT, the demand for software developers (programmers) also increased. This resulted in the rapid emergence of companies such as BSO in the Netherlands, WM-data in Sweden, CAP in France and Logica in the UK. Over the years, some of these companies have grown into internationally operating systems integrators.

At the same time, companies started to focus on the development and sales of standard software (SAP) and databases (Oracle). In the 1990s, companies emerged that specialized in outsourcing IT services, often based on their own data centres and network solutions (EDS). Large IT companies grew into one-stop-shop providers of a variety of IT services, from consultancy to workplace management.

This 'primordial soup' resulted in a reasonably well-organized supplier structure that has remained stable for the past 25 years, but which is now in danger of changing rapidly.

The existing business model

The revenue model of the traditional IT industry is still partly based on hours times rate. Investments in hardware and software are usually borne by the customer.

MARKET PLAYERS

IBM - Kyndryl

In November 2021, IBM spun off its Global Technology Services division and floated it on the stock market under the name Kyndryl.

Kyndryl employs approximately 88,000 staff worldwide and includes all of IBM's traditional IT outsourcing activities. For 2021, the company reported a 5% drop in revenue to $18.5 billion and a loss of $2.3 billion.

Kyndryl's share price has since fallen from USD 28 to USD 10 in November 2022 (minus 65%).

ATOS - Evidian

With a turnover of 11 billion euros, Atos is one of the largest European IT service providers. However, the company has been hit hard in recent times. The share price has fallen from 100 euros in 2017 to 10 euros in November 2022 (minus 90%).

Turnover in infrastructure services fell by twelve percent in 2021 to 5.4 billion euros and this business unit is suffering from loss-making contracts and declining turnover.

Last June, Atos announced it was exploring the possibility of splitting the company into two separate entities. The legacy part will continue under the Atos name and the future-oriented activities will be called Evidian.

In the meantime, the company has rejected an offer of 4.2 billion euros for the (future) Evidian part. Potential buyers were Onepoint and the British private equity fund ICG. Presumably, a buyer is being sought for the Atos part.

The outsourcing business model partly deviates from this, because the customer no longer pays for the resources deployed, but for defined services and service levels. The supplier increases its profits by reducing costs through economies of scale, efficiency improvements, offshoring and automation.

In the early years of IT outsourcing, these savings were relatively easy to achieve. Over time, however, this became increasingly difficult. The consequence of this model was a cost-saving culture and a persistent resistance to investments in renewal and innovation. Investment requests from sales teams were often answered with the statement “we are not a bank”.

Offshoring labour plays an important role in the outsourcing business model. However, this had the side effect that Indian companies seized the opportunity to penetrate the home market of the established Western IT Service companies. The success of these new players rests largely on lower labour costs, well-trained employees, and customer focus. Broadly speaking, however, these offshore companies operate in the same way as the established Western players. This means that they too must adapt their service offerings to deliver more added value, as well as increase their local presence.

Due to recent geopolitical developments, governments and companies are increasingly recognizing their dependence on the global supply-chain model. One of the questions here is to what extent this upcoming aversion to globalization will translate into new opportunities for local and regional players.

A new business model

With the rise of companies such as Amazon and Google, the position of the traditional players comes under increasing pressure. The revenue model of these companies is based on advertising (Google), online sales (Amazon), software licenses (Microsoft) and the commercialization of information (Google). These activities generate huge cash flows, which make it possible to make large investments in data centres and infrastructure. The scale at which these 'hyperscalers' operate is unprecedented. Moreover, these companies are investing massively in cloud capacity, without specific customer contracts in return. Something the traditional IT players were never capable of.

MARKET PLAYERS

DXC

Early 2017, Hewlett Packard Enterprise (HPE) spun off its Enterprise Services and merged it with Computer Sciences Corporation (CSC).

DXC also reports declining revenue. Turnover in 2019 was still USD 20.75 billion but expected to fall to 16.27 billion (-22%) in 2022. Overall DXC is still profitable. A positive operating result of 9.5% is expected for the fiscal year 2022.

The share price of the new DXC fell from USD 75 in early 2018 to USD 28 in November 2022 (minus 63%).

The company recently confirmed to be in talks with a private equity fund about a possible acquisition.

Europe

In Europe, this adverse situation is worsened by the fact that all hyperscalers operating in Europe, are US based. There is not a single European company that operates successfully in this market. Attempts in this direction have failed because the established players were stuck in the old business model, with a focus on cost savings and mutual competition. An initiative for cooperation between major European IT companies and the EU did not get off the ground, despite the fact that the EU itself is a major consumer of cloud services.

In 2020, a European initiative was launched under the name Gaia-X, in which 22 European companies work together. Gaia-X focuses on the development of a European software framework that functions on top of existing cloud platforms. This framework should, among other things, ensure that users become less dependent on one specific cloud supplier. More about this in a follow-up article.

How do IT companies respond to this development

(see some examples in the right column)

Many large and small IT companies are shifting their focus from IT outsourcing to digital transformation and cloud migration projects. In this way, they function as suppliers of the large cloud and SaaS providers and therefore lose a significant part of their recurring revenue.

In addition to the traditional IT companies, many new companies have emerged focusing on this niche. Currently, a large part of the cloud migration projects is carried out by such specialized companies.

The emergence of specialised companies in the field of digitization also leads to a loss of market share for traditional systems integrators.

It is true that the cloud migration market itself is an interesting market, but at the same time we see cloud and SaaS providers penetrating this segment.

Some believe that things will not change so quickly, and that legacy systems and traditional data centres will remain in use for a long time to come. It will certainly take years before the majority of systems are migrated to the cloud, but the trend is irrevocably in that direction. The annual growth figures of 30-40% prove this.

SaaS

Next to the traditional IT Outsourcers and the native cloud suppliers, several suppliers of large software packages play an important role on the market for cloud services.

These companies increasingly deliver their software on a SaaS basis, using their own cloud solutions or collaborating with suppliers such as Microsoft and AWS to create hybrid solutions.

In the top 3 are Salesforce, Oracle and SAP, with recent growth rates of cloud services of 22%, 45% and 34% respectively.

Mid-2022, SAP reported that cloud revenues exceeded their classic on-premise revenue for the first time.

Oracle is currently the fastest growing in this market and focuses on solutions for specific markets such as healthcare.

Oracle sees “industry-specific solutions” as the most important weapon in the battle for the cloud market.

In response to the above-mentioned market shift, we have seen major IT companies, such as IBM, divest their outsourcing activities, either by privatizing them or by putting them for sale.

For the parent company concerned, this offers an opportunity to get rid of these loss-making activities. However, the question is how viable these privatized activities are and what risk existing customers run in the event of a possible collapse of these privatized companies.

How can the traditional IT company survive?

This is the key question for the traditional IT outsourcing company.

The following solutions may be considered:

Collaboration

Many companies are forced to look for a collaboration model with the major cloud suppliers. In this way, existing customers can be offered a hybrid solution. In the long run, this route is risky because companies become dependent and lose recurring revenue. However such partnerships mean that the necessary time is gained to implement strategic changes and become less dependent on traditional IT outsourcing contracts.

Specialization

Another solution direction is offering more market-specific expertise, digital innovation, functional application management and business process outsourcing. This - combined with the management of hybrid infrastructures and cybersecurity - remains an important growth market for the time being.

It is interesting to see how specialized SaaS companies such as Oracle are developing in this area (see right column).

M&A

Regarding legacy systems, the solution in the short and medium term must be sought in economies of scale by consolidating outsourcing contracts, via strategic acquisitions or partnerships with competitors. The life of this branch of sport can be extended by merging facilities and resources and by further automation. Such a second outsourcing wave requires major efforts in several areas. Think about financing, converting customer contracts and the impact on existing staff. Private Equity funds are currently interested and active on this consolidation market.

HYPERSCALERS

The main Hyperscalers in Europe are Amazon (Amazon Web Services), Microsoft (Microsoft Azure) and Google (Google Cloud).

The global top-5 also includes Chinese players Alibaba and Huawei.

According to Gartner, these 5 players control more than 80% of the market worldwide. AWS 39%, MS Azure 21%, Alibaba 9.5%, Google 7% and Huawei 5%.

The global Infrastructure-as-a-Service (IaaS) market is growing at more than 40% annually, according to Gartner.

Migration to the cloud is considered a serious option for every major outsourcing contract currently expiring. Customers often standardize on one cloud provider.

The financial strength of these large cloud providers also creates the opportunity to finance extensive transformation projects for customers.

At the end of 2022 this development is slowing down. Due to a looming recession and declining advertising and retail revenues, the share prices of the large American Tech companies are falling. For example, the share price of Amazon, Google and Microsoft has fallen by 47%, 33% and 29% respectively in 1 year.

This – temporarily - limits the possibilities to invest for these large Tech companies.

Copy

Finally, it remains an interesting option to see whether European IT companies are able to build and successfully operate their own European Cloud data centre infrastructure – jointly or separately and if possible, with the support of Brussels. Such an infrastructure must be of sufficient scale to compete with the existing hyperscalers. Technology is not the problem here, but financing, competition between IT-suppliers, the liberalized European market, and international trade politics definitely are.

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