IBM and globalisation

Hungry tiger, dancing elephant

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How India is changing IBM's world

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LAST June IBM held its annual investors' day in the grounds of the Bangalore Palace, a'fake Windsor Castle in India's equivalent of Silicon Valley. Big Blue pulled out all the stops to impress the 50 or so investors and Wall Street analysts who turned up, gathering 10,000 employees to hear speeches by the president of India, the 'country's leading telecoms entrepreneur and IBM's own boss, Sam Palmisano, all hosted by a Bollywood babe in a red sari.

The annual investors' day is usually held in New York, though it once took place in faraway Boston. By going to Bangalore, the technology giant was sending a strong message. With 53,000 employees, India is now at the core of IBM's strategy. With other big developing countries, including China, Brazil and Russia, it is fast becoming the firm's centre of gravity.

Just three decades earlier, IBM had quit India, which was in the grip of corporatist and nationalistic industrial policies. Only in the early 1990s did it gradually start to return, as the government began to deregulate and reconnect with the world economy. Now, as Mr Palmisano pointed out to his investors .in Bangalore, the domestic Indian market has become one of the fastest-growing in the world for IBM, with revenues rising by 40-50% a year, albeit from a very small base. The firm now has more employees in India than in any other country except America.

Mr Palmisano announced that IBM would invest a further $6 billion in India over the coming three years, up from $2 billion in the previous three. That sum does not include any acquisitions of Indian companies. (It has already struck some big deals, notably buying Daksh, an Indian outsourcing company, in 2004.) Some locals wondered how IBM would manage to spend all that money. But booming demand is pulling wages higher in India and costly training is now needed to lure workers being courted by other companies.

Rethinking the multinational

IBM's Indian adventure highlights three overlapping themes. Emerging economies increasingly count as a threat to established global firms, as well as an opportunity. Indian services firms such as Infosys and Wipro are starting to give IBM-and its old rivals, Accenture, EDS and Hewlett-Packard-a run for their money. As globalisation accelerates, this is forging a new vision of what it is to be a successful multinational company. Last, regardless of how well Big Blue fares, its strategy for growth has suffered because of those first two. The big, career-threatening question facing Mr Palmisano-and the reason other multinational companies will want to study IBM closely-is whether he can find a new way to realise the growth that his shareholders demand.

In a speech last year at INSEAD business school in France, Mr Palmisano set IBM's Indian move in the context of the modern multinational company. This, he said, had passed through three phases. First was the 19^{th}-century "international model", whereby firms were based in their home country, but sold goods through overseas sales offices. Then came the classic multinational firm, in which the parent company created smaller versions of itself in countries around the world. This was how Mr Palmisano found IBM when he joined it in 1973.

The third model, argues Mr Palmisano, the IBM he is now building, is the "globally integrated enterprise". Rather than have a parent with lots of Mini-Mes around the world, such a firm shapes its strategy, management and operations as a single global entity. It puts people and jobs anywhere in the world "based on the right cost, the right skills and the right business environment. And it integrates those operations horizontally and globally." In this approach, "work flows to the places where it will be done best", that is, most efficiently and to the highest quality. The forces behind this "are irresistible", he says. "The genie's out of the bottle and there's no stopping it."

IBM's big investment in India is not just about getting cheaper workers. If it were, IBM might have been in and out of India almost as fast as Apple, which closed its Bangalore offshoring centre last year after about three months, apparently because rising labour costs meant that the expected savings failed to materialise. IBM is doing cutting-edge research and development in India and writing valuable software, as well as running low-cost call centres. One reason for holding the investors' day in Bangalore, says Mr Palmisano, was to show Wall Street analysts that "places like India do not simply mean 'cheap labour'."

Places like India: the other message that Mr Palmisano was keen to get across was the part other emerging economies are playing in remaking IBM-which he admits will take many years. Thus, IBM's financing back office is in Rio De Janeiro. It has call centres round the world. Last April, when Bangalore was paralysed by rioting over the death of Rajkumar, a movie star, IBM shifted data-centre operations to its facilities in Brazil and Colorado.

IBM used to have separate supply chains in different markets, now it has one for the whole company. Reflecting the growing importance of China, John Paterson, IBM's chief procurement officer, moved to Shenzen in October. He is the first head of a company-wide function to base himself outside America, though other top IBM executives may soon follow. Asia already accounts for one-third of IBM's $40 billion purchasing budget. Mr Paterson felt he needed to raise the quality of IBM's purchasing staff in the region and to develop its base of suppliers.

Another case of the Big Blues

Yet when history judges Mr Palmisano's time at the helm, IBM's Indian strategy may prove far more important than what the firm does elsewhere in the developing world. Becoming a globally integrated enterprise is necessary for its success, but not sufficient. Cutting costs is crucial-and globalising the supply chain has saved IBM about $8 billion a year. But to grow in the newly integrated world, as Mr Palmisano puts it, the burning question becomes "what will cause work to move to me? On what basis will I differentiate and compete?"

So as well as realising "global integration"-no easy task in a mature company with 330,000 staff in 170 countries-IBM will also need the right products. It is here that India poses a special threat, not least because of its prowling, hungry home-grown tiger companies.

When Mr Palmisano became IBM's boss in 2002, the firm seemed to have a perfectly good strategy. It was the legacy of the famous turnaround of IBM engineered by the previous boss, Lou Gerstner, and described in his book, "Who Says Elephants Can't Dance?".

When Mr Gerstner took the helm in 1993, IBM was in deep trouble, on the verge of selling itself off in pieces. In particular, the legendary mainframe business was perceived to be in terminal decline, while the firm's hardware (personal computers and the like) were rapidly becoming commodities. Mr Gerstner stabilised the mainframe business, which today is expected to see modest growth thanks to greater openness to independent software vendors, clever pricing and demand from emerging economies, including India. More fundamentally, he shifted IBM's focus from selling hardware to the fast-growing IT-services market, including outsourcing. In 1992 hardware generated around 55% of IBM's revenues, and services 25%. By 2001 hardware was down to about 30% and services up to 42%.

Meanwhile, IBM's share price rose from $11 in March 1993 to $125 in December 2001-a price it has never since matched. Last July it fell below $74, although it rallied after that-perhaps as the message that the firm is taking India seriously started to get through. Having briefly touched $100, it slipped back to $93 during the recent market wobbles. That is not the sort of performance to make a boss feel secure in his job, especially in this era of trigger-happy boards. (Though, if rumours are to be believed, a record-breaking bid from private equity may yet rescue Mr Palmisano's reputation.)

When IBM bought the consulting arm of PricewaterhouseCoopers in 2002, it seemed like the final piece of the jigsaw needed to complete the services strategy. The consultants' industrial expertise and their relationships at the top of all manner of industries would help IBM move upmarket and lead to the more lucrative work of solving complex business problems. Rapid growth seemingly beckoned. In fact, IBM's services business suffered at the lower end of the market, owing not least to unexpectedly strong competition from Indian IT firms, many of which first got started in the IT business thanks to the vacuum created when IBM quit the country.

Even now, the Indian firms are a limited form of competition. The biggest, Infosys, has a stockmarket value of only $28 billion, compared with IBM's $144 billion. IBM also has lucrative businesses the Indian firms can only dream of. These include the lease-like revenues from licences relating to its mainframe computers and its pioneering "multi-core" semiconductors, which feature in (among other things) the three leading video-games consoles.

Yet corporate IT departments are continually being pressed to cut costs. The Indian suppliers' credibility with international firms was boosted by their sterling work in inoculating networks against the Y2K computer bug. Indian firms have started to win big outsourcing contracts, some of which IBM had counted on as its own. Just as troubling for IBM has been the effect on contracts that the company managed to win, many of which were at far lower prices than they would have been without an Indian alternative. The prospect of falling margins on services contracts prompted IBM-and the other big multinational suppliers-to pledge a large amount of money to India.

Even IBM's Indian rivals concede that so far, despite teething troubles, the American giant has done well-certainly better than Accenture and EDS. If nothing else, the company has proved that you do not have to be Indian to manage a low-cost outsourcing business in India. Under IBM's ownership, the Indian workforce of Daksh, which runs call centres and does other basic "business process outsourcing", has grown from 6,000 in April 2004 to over 20,000.

Cheap and cheerful

According to Pavan Vaish, its boss, IBM has largely allowed Daksh to carryon as it was, rather than imposing on it the IBM way, as might have happened in the past. "They studied the way we did business and said we don't have to do everything here the way we run our other businesses. Certain core functions were added, such as finance, but the rest was left alone." Indeed, IBM is now trying to export the Daksh way to other parts of the empire, such as its call centre in Okinawa.

At first IBM paid too much for Indian workers, adding heat to an already sizzling labour market. Now it is trying to attract and retain talent by offering training and a career path that leads up the corporate ladder. (IBM's Indian rivals counter by telling potential recruits that they offer better training and quicker career progression than an American company run out of Armonk, New York.)

This is paying off. According to Sanford Bernstein, a research firm, IBM has already increased profit margins from its services business, thanks to the cost reductions it has made in India.

Yet these are early days in the evolution of the Indian outsourcing industry. IBM will probably have to cope with two other new trends. The first is the decline in “mega deals”, outsourcing contracts that are worth more than $1 billion over several years. These were common in the first wave of outsourcing a few years ago, but many are now due for renewal. Some companies are said to feel they ceded too much control to the outsourcing firms last time and now plan to manage the work more carefully, not least by parcelling business out to several firms. Contracts that would have gone to IBM alone may now be shared by IBM and, say, Infosys.

Nobody is really sure how significant this shift will be. After a slow year for mega deals, IBM signed three in the final quarter of last year-with the German army, Vodafone and the state of Indiana. But the consensus in the industry is that deals will be split, which is bad for IBM and good for its rivals.

The second big change is that Indian firms are rapidly moving upmarket. IBM’s great strength is in offering total outsourcing. This includes everything from simple call centres to remote infrastructure management (over 40,000 servers outside India are managed from IBM’s Bangalore operations) to “business transformation”, in which IBM re-engineers and manages a company’s entire operation, including its staff. The company has made much of one such deal, to run the back end of Bharti AirTel, India’s leading mobile phone firm, whose boss spoke at IBM’s investors’ day.

But the Indian firms are rapidly acquiring the skills and connections they need to compete for these deals. Infosys now has a consulting operation. Its smoothly effective boss, Nandan Nilekani, spends time building the sort of friendships with other chief executives that IBM bosses have had for decades and regard as crucial in winning contracts.

IBM and the other multinationals are becoming increasingly nervous about the fifth-biggest Indian outsourcer, HCl Technologies. It is leaving the world’s 200 biggest firms to the likes of IBM, and instead going after the next 800, which HCl’s boss, Vineet Nayar, says tend to feel a bit neglected by the big traditional outsourcers. largely unnoticed, HCl has won several contracts worth $300m-700m for infrastructure management and business transformation. In a recent deal with Cisco, HCl will take on risk from the American hardware company, using a contract that forsakes a fixed fee in favour of sharing revenue. According to IDC, a technology-research firm, HCl “may very well be one of the contenders to lead the IT services world of the very near future”.

As the Indian tigers improve, the pressure on IBM to innovate is bound to grow. That may get harder, which is why there is speculation that it will buy one of those Indian tigers. So far, adding jobs in India has not meant shedding many jobs in costlier places, such as America. And innovating may be harder when the corporate headquarters is in cosy New York rather than in the heat of the action in India. IBM’s chief procurement officer may be in China, but no one who reports directly to Mr Palmisano is based outside America. Yet.

Play it again, Sam

Hoping to get IBM's share price up, Mr Palmisano has promised double-digit growth in earnings per share over the long term. That is a tall order, and feasible thanks only to IBM's progress in other businesses, which has partly offset the difficulties in services. Huge savings have come as the company has broken down the barriers between its various operations. It has bought vast quantities of its own shares. It has continued to sell low-margin commodity businesses, such as hardware. In these businesses, IBM does not feel threatened by the rise of domestic competitors in countries such as China. On the contrary, it was delighted to sell one of them to Lenovo, which bought IBM's personal computer business in 2005.

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But the future gains from selling low-margin hardware businesses may be limited. That puts a greater burden on IBM's high-margin software business. In the past four years it has spent about $16 billion on over 50 acquisitions, mostly small software firms that have thrived after having been stitched into the company. It has done this so well that (the growth story in services having become a little hollow) IBM is now claiming to be the next great software company. In 2006 software accounted for 20% of its revenue and for 40% of profits, up from 35% two years earlier. Much of the growth is in "middleware", software that helps all a firm's different software to run together.

But the strategy on which IBM is pinning its hopes is more complex than just software or services. The company is betting that it can produce synergies from the three business lines-hardware, services, software-in which, unlike any of its competitors, IBM is a global leader. That means prising the firm's employees out of their traditional product-driven business "silos" and getting them to work together. This strategy is articulated in the IBM way, ie, using plenty of jargon: "service oriented architecture", "solutions" and so on. Rather than simply push products at customers, the new approach means sorting out customers' difficulties using whatever mix of services, software and hardware leads to the best outcome.

One important part of this is especially relevant to the threat posed by India. IBM is trying to write software that automates many of the activities companies now outsource. It has picked 17 industries, two of which, health care and insurance, are being primarily addressed by software engineers in India. Examples include software developed in IBM's research lab in Bangalore that tests the language skills of applicants for call-centre jobs, greatly reducing recruitment costs; and a mortgage-origination business, launched last week, which is designed to automate lending by building on technology and software from two recent acquisitions, Filenet and Palisades Technology

Partners. When processes are automated in software, they become an “asset”, the firm says, in the sense that programs generate licence fees and can be reused with other customers. This solves at a stroke the difficulty matching the Indians in labour-intensive outsourcing.

Analysts are divided about how successful IBM’s overall strategy will be. An IBM executive complains that most of the analysts who follow the company are “legacy hardware guys who don’t get software”. One who does is Barry Rubinstein of IDe. He suspects that the Indian firms are too focused on short-term profits to make the best long-term bets, which may well include automation. “Things may look very different in five to seven years’ time, and much better for IBM,” he says.

In the meantime, the big Indian IT firms are delighted that IBM is taking them seriously. “Palmisano has authenticated our model,” says the boss of one of them. “We have convinced the global investment community that our model is the future,” he says. That keeps his share price rising and raises questions about IBM’s value. Automation, among other things, may be a good long-run strategy, but in the short term IBM has to keep growing and get its share price up. “Palmisano’s problem is timing,” he concludes, with a smile. And to dance well, you have to get the timing right, as every elephant knows.

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