The effect of the international financial and economic crisis on the IT sector in developing countries

Summary

Consequences for the Export Business

Almost half of the exporters from partner countries expect their exports to decrease in 2009 as compared to 2008. A quarter is banking on modest to strong export growth this year. Maintaining current turnover levels with steady customers will be difficult. European businesses are deploying fewer external IT workers, with new projects preferably being executed with internal resources. An additional reason for this is that IT outsourcing projects require considerable investments and a restructuring of business processes.

For a long time it was assumed that IT service providers by and large would benefit from the crisis. However, many EU players are currently discontinuing projects involving external IT professionals in order to cut costs and keep their own staff employed. This development has stirred up competition for the remaining IT projects. Because of this, one third of the exporters in this survey forecast slight price pressure this year. The implications for employment will be limited, as most exporters target niche markets and medium-sized customers.

IT services exporters believe the credit crisis will have the following effects, in order of importance:

- Declining demand / smaller outsourcing budgets with (potential) buyers
- Postponement of IT projects / longer decision-making processes
- Limited access to credit / financial resources (locally)
- Price pressure / smaller margins
- Fear among (potential) customers to outsource
- Declining currencies
- Customers facing financial problems or bankruptcy
- Increased protectionism in developed countries
- Fiercer competition on international markets
- Destabilised domestic markets

Credit

Over half of the exporters in this survey say the crisis is (severely) obstructing access to export credit. Lenders are more exacting than ever in their consideration of export projects and selected target markets. Investment credit is even harder to obtain. The crisis is heavily influencing the need for working capital. Exporters in partner countries say many of their European customers are stretching payment periods. This means the exporters are in greater need of working capital, which, however, is difficult to access.

Opportunities

Exporters and BSOs in the partner countries are optimistic about the opportunities arising from the crisis. The general feeling among them is that more than ever customers will now go in search of IT solutions to cut costs, improve business processes and refocus on their core activities. Companies in developing countries can benefit from this in the long and medium term. Even exporters formerly operating in the hardest hit markets, such as banking and insurance, see opportunities. They aim to shift their attention to sectors in which investment levels, for the time being at least, are not likely to drop, such as defence and government.

Experts agree that the crisis will create new opportunities for IT service providers in the long and medium term. If and when the crisis has passed and European companies revert to outsourcing, they will do it with greater intensity than before. This trend will be augmented by rising demand for high-grade IT solutions and by SMEs finally taking the plunge. Experts also predict that Europe's shortage of IT professionals will have worsened by the time the crisis is over, so that external parties will be in high demand.

Introduction

Primary Research

1. Online questionnaires
For the purpose of this survey the following parties were requested to fill out a sector-specific online questionnaire: BSOs (business support organisations), exporters from developing countries, European buyers importing from these countries, European associations.

The online questionnaire was held between February 23 and March 2, 2009. The response was as follows:

Table I Response to online questionnaire, IT sector

	IT
Exporters	67
*From partner countries**	40 (8*)
From other CBI client countries	27
BSOs	12
*From partner countries**	7 (6*)
From other CBI client countries	5
EU importers and associations	25
Total	**104**

* Number of partner countries represented

2. Interviews
Following up on the online questionnaires a number of quantitative interviews were held with:

- IT exporter, Sri Lanka
- Proexport, Colombia
- 2 IT consultants, Germany

Colombia and Sri Lanka are both priority countries from the group of partner countries determined beforehand on the basis of desk research and in consultation with CBI experts.

Secondary Research

The secondary research included material issued by Deutsche Bank Research, KPMG's 'Exploring Global Frontiers' report and EuroITX articles.

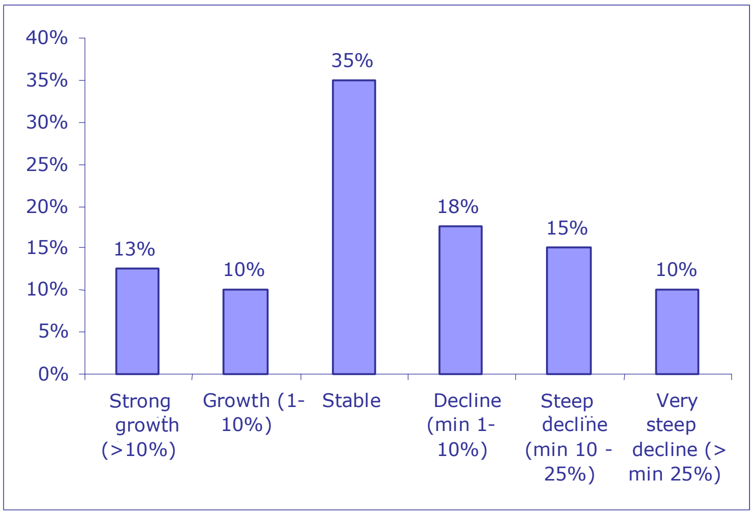
1 Consequences for export companies

2009 Forecast

Export

17 of the 37 (46%) respondents from the partner countries expect their exports to decline this year. 25% of all respondents even anticipate a drop of more than 10% (Figure 1.1). A similar percentage of respondents believe their exports will show modest to strong growth. The largest group of respondents assume exports will remain stable throughout 2009.

Figure 1.1 IT services export development in partner countries, 2008-2009 (n=40 exporters)



Source: online questionnaire (Feb 2009)

The BSOs and experts interviewed confirm this view, although they do not expect any companies to be faced with a very steep decline in exports. The experts point out that maintaining turnover levels with the current steady customers will be tough, as companies already outsourcing will only leave what is absolutely necessary to their external suppliers. Also, potential buyers are not likely to risk outsourcing at this time, as it involves considerable investments and restructuring of business processes. These activities are not usually given top priority in times of crisis and are therefore not likely to receive much support.

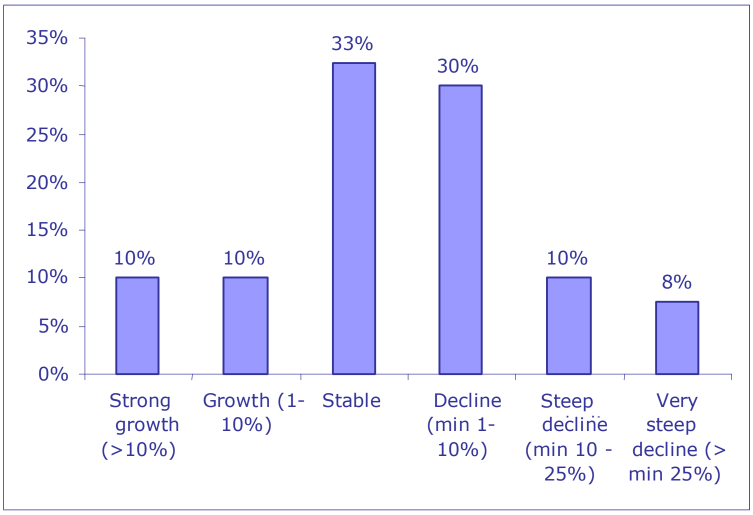
European clients approached for this survey confirm that the crisis is negatively impacting their involvement of IT suppliers from developing countries. Investments in the IT sector are generally made with great caution. Projects are diminishing both in number and in scale. More importantly, projects that do get the go-ahead are likely to be executed with internal resources.

According to a survey by Deutsche Bank Research, the effect of the crisis on IT service providers (especially in Europe and India) is becoming more and more obvious. In the first six months of 2008 it was assumed the crisis would positively affect IT service providers, as more and more customers would be forced to reduce costs. As a result of this view, the stocks of most large IT providers continued to thrive. In the third and fourth quarters, as the economic slump worsened, this changed. The value of outsourcing contracts had dropped by no less than 25% in the second six months of 2008 as compared to the same period in 2007. Financial service providers, in particular, cut back on outsourcing activities, slashing the value of outsourcing contracts by more than €6 billion. Virtually all other sectors followed suit, causing an overall negative impact on IT outsourcing. Besides the financial service providers, the transport sector and media and entertainment businesses signed far fewer outsourcing contracts.

Export Margins

The questionnaire shows that 30% of the exporters in partner countries expect a slight decline (1-10%) in export margins (Figure 1.2). The increasing price pressure is possibly a result of increased competition in the IT outsourcing sector now that European firms are reluctant to spend money.

Figure 1.2 Development of export margins in the IT services sector from partner countries, 2008-2009 (n=40 exporters)



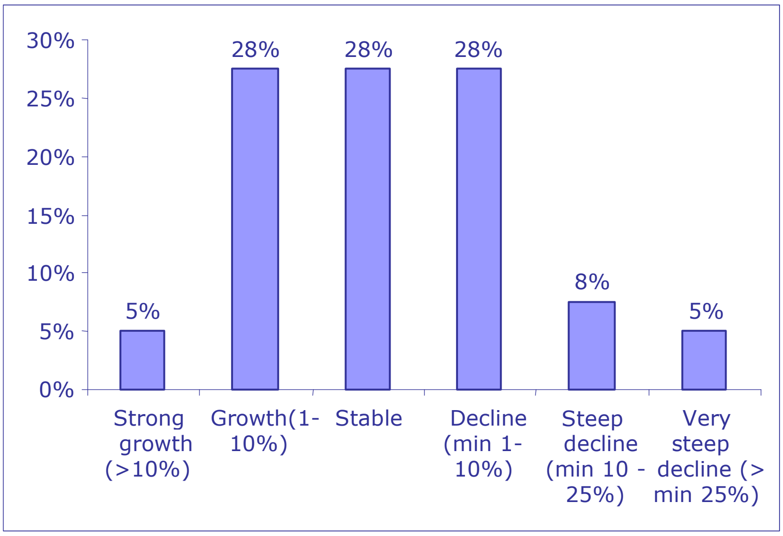
Source: online questionnaire (Feb 2009)

The BSOs are somewhat more optimistic: most of them expect stable margins. The experts admit that the IT budgets of European companies are currently under pressure, but they also point out that a buyers' market is evolving. Economic conditions are forcing companies to postpone projects, which is encouraging service providers to offer significant discounts to customers who still have enough resources and are able to make quick decisions.

Employment Levels

Exporters disagree about the effect of the crisis on employment levels (Figure 1.3). Generally speaking, the crisis is not likely to cause severe pressure on jobs among IT service providers in partner countries. 33% of the exporters even expect employment levels to rise. The reason for this is that they expect to be able to acquire sufficient numbers of new projects by focusing on niche markets, their own local markets and medium-sized buyers in search of cost reduction. The companies that anticipate job losses say they will be forced to cut costs and that in such situations laying off workers tends to be the first option.
In some partner countries, such as Colombia and Sri Lanka, there have already been layoffs.

Figure 1.3 Development of employment levels among IT service providers in partner countries (n=40 exporters)



Source: online questionnaire (Feb 2009)

The BSOs believe employment levels need not necessarily suffer from the crisis. A small majority of BSO respondents even anticipate modest employment growth.

Impact

The Biggest Problems

Exporters of IT services put forward the following major effects of the credit crisis:

- Declining demand / smaller outsourcing budgets with (potential) buyers (mentioned 14x)
- Postponement of IT projects / longer decision-making processes (10x)
- Limited access to credit / financial resources (locally) (7x)
- Price pressure / smaller margins (4x)
- Fear among (potential) customers to outsource (4x)
- Declining currencies (2x)
- Customers facing financial problems or bankruptcy (2x)
- Increased protectionism in developed countries
- Fiercer competition on international markets
- Destabilised domestic markets

One exporter also mentioned the problem of confusion as to which market segments currently offer the best opportunities. He said it is difficult to tell whether the crisis has shaken up the market and if so, to what extent.

The BSOs in partner countries agree with the exporters. Most of them also agree that there will be little or no bankruptcies (1-10%) among IT service providers in developing countries. The only respondent who fears a higher bankruptcy percentage (11 to 40%) is from India. Experts suggest this is because of the fact that in India the effects of the credit crisis have been intensified by the Satyam scandal. Satyam is India's fourth largest software supplier. The scandal, involving the biggest corporate fraud in the country's history, has severely damaged customer confidence in external service providers – and not just in India, as many customers hardly distinguish between different outsourcing locations or small and large providers.

Experts point out that companies nowadays screen their IT projects to determine whether they can be postponed or not. Projects given the go-ahead are implemented with minimal external IT expertise to keep the cost as low as possible. The outsourcing wave of recent years resulted largely from under-capacity; now that the crisis has cut back the number of IT projects, internal staff are put to work first. If the economy lifts, the opposite is likely to happen and the market for IT services is expected to take off.

European buyers say they are struggling particularly with obtaining financial resources. Also, they say the devaluation of the pound sterling and the euro has had a very negative effect on demand for IT outsourcing.

Developments in the Demand for IT Services

The wide variety of services available in the IT sector makes it difficult to see clearly which services are suffering most. The BSOs in partner countries say demand for standard software development has dropped particularly. They also observe a decline in demand for high-grade services such as system development, consultancy and services geared to the financial sector. This view is confirmed by European buyers, who admit to cutting back system development projects by as much as 50%. Demand for the development of entirely new software and systems, particularly, has taken a plunge, with many companies putting off decisions about such projects for at least six months.

The BSOs also have difficulty identifying which services stand to benefit from the crisis. Their general assumption is that IT service providers in developing countries will benefit from low (labour) costs, as cost benefits remain important to European customers. European experts and associations expect demand for high-grade services to offer good opportunities in the long run, once investments are being made again. This trend was already visible before the crisis and will regain momentum as markets recover. Customers, after all, want the best software package there is and want it tailored to their specific wishes.

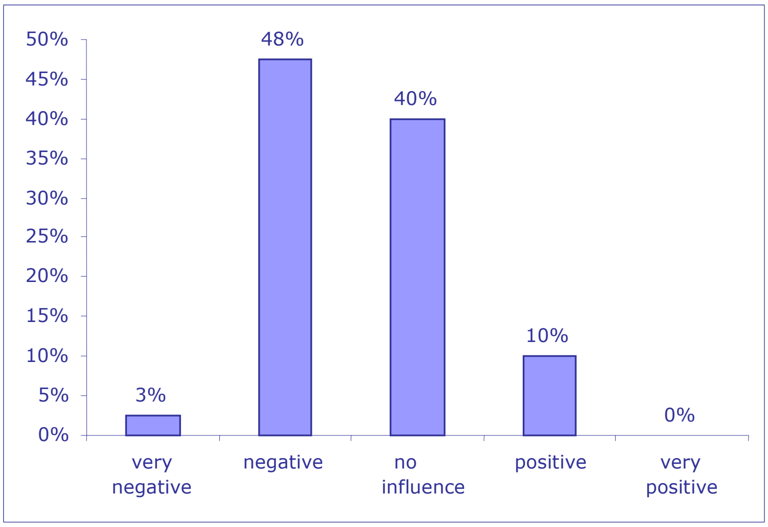
Corporate Social Responsibility

Two buzz words often heard in corporate Europe before the crisis appear to have temporarily faded into the background: 'Corporate Social Responsibility' (CSR) and 'sustainable production'. According to the experts approached for this survey, most companies will not drastically change their CSR policies as a result of the crisis. What will happen is that companies who have laid off personnel or are planning to do so will feel a strong obligation to avoid sourcing projects to external (e.g. foreign) workers.
As for sustainable production, as far as it is an issue in this sector, it is currently not considered a priority. Investments in this area simply cannot be justified.

2 Credit

More than half (51%) of the exporters in partner countries say the crisis has had a (very) negative impact on their access to export credit (Figure 1.4). A fairly large group of exporters (40%) say they do not see any problems in this area. According to the experts, lenders today will examine every export project under a microscope before putting up credit. Solidly prepared business cases do stand a good chance of obtaining credit, particularly if conditions in the target market are (relatively) favourable. An inexperienced exporter seeking to offer his services in a severely hit market, like the United Kingdom, will have a hard time getting credit. In some countries, such as Colombia, obtaining credit was already difficult before the crisis began.

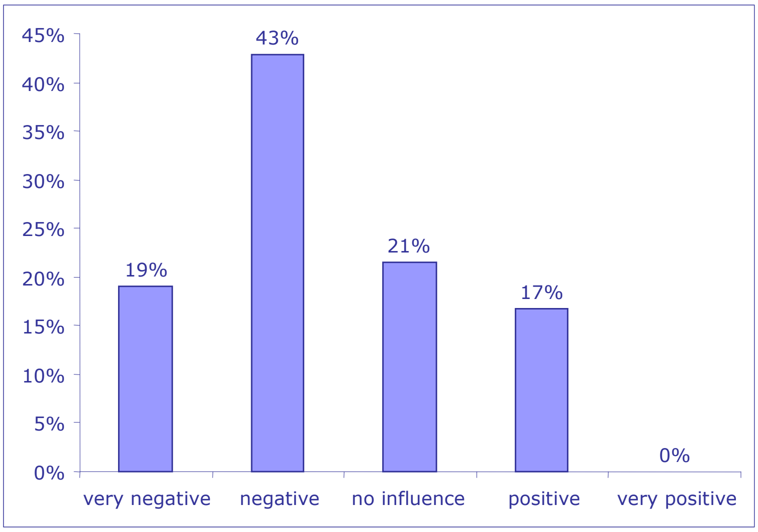
Figure 1.4 Consequences for access to export credit (n=40 exporters)



Source: online questionnaire (Feb 2009)

Conditions for obtaining investment capital are less favourable (Figure 1.5) because of the longer term involved. No less than 62% of the exporters say the crisis has made it more difficult for them to obtain investment credit.

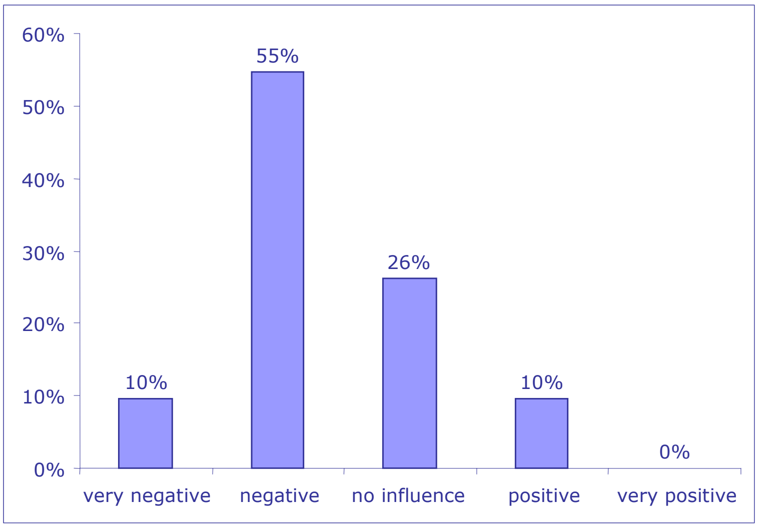
Figure 1.5 Consequences for access to investment credit (n=40 exporters)



Source: online questionnaire (Feb '09)

The crisis has had a significant impact on the need for working capital. Exporters in partner countries say many of their European buyers are stretching payment periods. This means the exporters are in greater need of working capital, which, however, is becoming more and more difficult to obtain (Figure 1.6).

Figure 1.6 Consequences for access to working capital (n=40 exporters)



Source: online questionnaire (Feb '09)

3. Opportunities

No less than 88% of the respondents from the partner countries see opportunities arising from the crisis. Exporters believe customers are more interested than ever in IT solutions that may help them reduce costs, improve business processes and refocus on core activities. Besides, some traditional IT service providers are unable to reduce their own costs to a level considered acceptable by their customers. Companies in developing countries can take advantage of this. IT service providers operating in the hardest hit segments (e.g. banking and insurance) are turning their attention to segments in which investments are likely to remain unaltered, such as defence and government.

The BSOs see opportunities for the same reasons. Moreover, a recent survey by KPMG (February 2009) confirms that it is vital for companies to find new and suitable outsourcing locations. Companies will continue to be on the lookout for cost reduction opportunities both in the short and the long term.

The experts approached in this survey also believe there will be new opportunities for IT service providers, but only in the medium and long term. In addition to the factors mentioned by other respondents, they say there will be more opportunities for IT service exporters in the years following the crisis. With European firms under pressure to lay off staff for the sake of cost reduction, the shortage of qualified personnel will only increase in the time ahead and IT buyers will increasingly look for off-shore solutions. Finally, the experts forecast an increased interest in IT solutions among European SMEs. Traditionally reluctant in most EU countries, SMEs are now gradually becoming convinced of the advantages of outsourcing. When the crisis is over, they will no longer hesitate to allocate IT projects to low-cost third parties. By the time the crisis is over, IT contracts may be going for as much as 30 to 50% less money than they are now.

In order to capitalise on these opportunities, however, exporters will have to meet certain requirements. These needs will be dealt with in the following chapter.

4 Needs

This chapter deals with the needs that will have to be met among exporters and BSOs in order for them to overcome the problems described in Chapter 1. Topping the exporters' list are the following needs:

- Improved marketing and sales capacity, such as PR, tele-sales and stronger sales teams (mentioned 14x);
- Facilitation and financing with regard to trade fair participation, matchmaking events and conferences (7x);
- Improved cash-flow and financing options as well as quicker payments by customers (6x);
- Optimised processes and increased quality, productivity and technological know-how (5x);
- Acquisition of new customers to compensate for shrinking turnover with current customers (3x);
- Better training for personnel (3x);
- Better (online) possibilities for targeted approach of customers and/or prospects (3x);
- Access to adequate market information (2x).

The above view of the needs of IT service exporters is confirmed by the BSOs in the partner countries. They, too, recognise the tremendous importance of adequate sales and marketing and the facilitation and financing of networking and matchmaking events and trade fair participation. The underlying ambition is the identification and acquisition of new customers and markets. Financing is classified as a less urgent need. In most cases, access to financial resources is considered essential for investing in marketing, technological know-how and quality and productivity improvement. In some cases, improved access to credit is even considered vital for surviving the crisis.

This survey was compiled for CBI by Facts Figures Future

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