Yahoo! Finance
The Exchange
July 24, 2013

YAHOO! FINANCE

Here's Why China Isn't Taking Over the IT World … Yet
By Marty Wolf

A July 9th article by Martin Wolf (not me), chief economics columnist for the Financial Times, London, was entitled: "Why China Will Not Buy The World." While noting that China's acquisitive ambitions often make the West nervous, Wolf concludes that the threat is overblown.

That's because the Chinese economy is built on collaborating with large global companies. So far, China has not yet scaled its own companies. As a result, China has had mixed results in participating in large international mergers and acquisitions.

While Martin Wolf of the Financial Times can write about what's happening in the world, this Martin Wolf can report on IT with first-hand knowledge. Having just returned from meetings with some of China's IT leaders – those running IT outsourcers and technology solutions providers – I can attest that China will not be buying the IT services world.

The industry is elsewhere

In layman's terms, the Chinese IT services industry is "late to the party." To achieve global leadership in IT services, Chinese companies will have to displace current leaders – companies with long head starts and deep customer relationships.

No surprise, the main players in IT services are in the United States and India. In the United States, the big firms are IBM Global Services, HP and Accenture – in India it is Tata Consultancy Services, Infosys and WiPro.

In comparison, Chinese IT service leaders are relatively small with a tiny global market share. Plus, the biggest buyers of IT services are in North America and Western Europe. Customers in these regions are predisposed to use and trust U.S. and Indian IT services providers.

Challenges for China

Still, Chinese IT companies do have opportunities, as well as hurdles. First, the hurdles.

The toughest challenge I heard over and over from Chinese IT executives was, "how can Chinese companies compete with India?" After all, India's IT sector is much, much larger than China's. Indian companies are bigger, more mature, with established customer and supplier relationships in key markets. As India's labor cost advantage has lessened over time, companies have turned to selling more sophisticated services to customers to move up the value chain. One of their key growth strategies is to make strategic cross-border acquisitions to add domain and functional expertise, and get closer to customers geographically.

Meanwhile, Chinese IT companies compete with India mostly by providing basic outsourcing services at lower cost, as labor is cheaper in China (although that advantage is eroding). However, these lower value services deliver lower margins, and companies post a fraction of the profits Indian companies do.

Up the value chain

So, just as India has had to step up and provide higher value services when its own labor costs began to rise, China is the same position now – with three big differences: trust, fewer and smaller cross-border deals, and culture.

First, Chinese IT companies face trust barriers when selling to the West that Indian companies don't. Companies offering higher value IT services need access to their customers' valuable data. Customers must be assured that this data is private and safe. Before they can effectively sell high-value services to the West, Chinese IT companies must earn their trust.

Second, Chinese IT companies thus far have been unable to pull off cross-border acquisitions of any notable size. Most successful deals have had valuations of less than USD 20 million. Yet to accelerate the global growth of the industry, they need to be in the range of USD 50-100 million.

This is not for lack of trying. Negotiating and closing cross-border acquisitions is difficult even for experienced companies. Chinese IT companies are new to the game and their inability to close deals can make potential sellers wary of offers from Chinese companies.

Third, Chinese IT companies face language and cultural barriers with the West.

Not all bad news

Now for the opportunity.

Unlike India, which has a tiny domestic market for IT services, China represents a massive opportunity for Chinese IT companies. The day is coming soon that China's home market will provide Chinese IT companies the chance to grow rapidly both in size and sophistication. That will prepare them to go global.

So what must Chinese IT companies do now to get ready for that day?

Potential Chinese IT services customers have growing needs in three areas:

Healthcare – Healthcare policy changes of a decade ago and an aging population open up new opportunities for company to provide medical services to the elderly. Examples include remote diagnostics, treatment and monitoring, and long-term care.

Financial services – Capital markets, commodities markets and investment management services in new asset classes such as hedge funds are still being developed in China. These new businesses need IT systems that meet stringent international standards for key functions such as trading, risk management and compliance.

Education – Parents all over China are keenly focused on better education for their children to ensure a competitive global workforce. Massively Open Online Courses (MOOCs) and other learning technologies could give children in rural areas improved opportunities to learn.

Chinese IT companies that purchase foreign companies with expertise in these areas have a dual opportunity: they can bring valuable IP and experience back to their home market while expanding their businesses globally.

Will it happen?

But here is a cautionary note: although I spoke to many Chinese IT companies that have cash in hand for cross-border acquisitions, cash alone is not enough. To ensure that their opportunities are not squandered, Chinese IT service companies must be very smart about the way they approach acquisitions.

First, they must choose the right companies to acquire.

Second, they must close the deals.

Third, they must make these acquisitions successful.

Fourth, they must capitalize on these acquisitions to bring new capabilities to new markets.

To find, close and successfully integrate the right acquisition, Chinese IT companies will need to rely upon smart lawyers, accountants and advisors experienced in international M&A.

To go further and take business away from U.S. and Indian IT services leaders, Chinese companies will need to develop skills that will enable them to build deep relationships, both with newly acquired talent through M&A and new customers made possible through those acquisitions. With language and culture differences, this will take awhile.

So, for now anyway, Chinese IT services companies will not buy the IT services world. That's according to Martin Wolf. You can guess which one.

Marty Wolf is president and founder of martinwolf M&A Global Advisors. Marty has been involved in more than 115 IT M&A transactions during the last 16 years.