CAN HPE + CSC DOMINATE THE DIGITAL UNDERBELLY, OR HAS THAT SHIP SAILED?

An industry in transition may play-out well for this mega-merger, but significant challenges remain

Authors:

Phil Fersht, Chief Analyst & CEO, HfS Research
Jamie Snowdon, EVP Data Solutions, HfS Research
Melissa O'Brien, Research Director, HfS Research

June 2016

Introduction

On 24th May 2016 HPE and CSC announced the merger of HPE's Enterprise Services Division and CSC, or at least the remaining commercial part of the organization. The merger is expected to happen before the end of March 2017. CSC and HPE shareholders will each own 50 percent of the shares in the new company. The new company will have revenues of approx. $26 Billion and around 160,000 staff.

We heard CEO Meg Whitman excitedly address the firm's key clients and industry analysts at HP's Discover event in Las Vegas, last week, with her obsessive focus on "digital transformation" and the impact of "digital disruption", however, the real opportunity for HP isn't really in the design of digital business models for clients, it's the *enablement* of them – it's the provision of the agile "digital underbelly" to make digital change happen for enterprises.

Digesting the merger of these two struggling services giants has resulted in more rumination than most, considering the timing, sheer scale, transitional uncertain market and motivation. This is not a time when most traditional service providers are looking to add more global delivery scale to already large foundations – most are trying to slim down their delivery armies and sales forces, choosing to focus on new and emerging areas for growth and getting more services delivered for less FTEs by taking better advantage of automation technologies.

However, when you consider only $15 Billion is being spent on public cloud services (IaaS) this year and one $ Trillion being spent services tied to traditional IT delivery, there is a huge amount of traditional IT and BPO business in play

- for another decade and beyond - to enable the enterprise digital experience. Hence, the opportunity HfS sees for Newco, is to attack the IT and operations plumbing necessary to enable the fast-emerging Digital enterprise, and take on the likes of IBM, NTT/Dell, Atos, Capgemini and the Indian-heritage majors.

Why the Digital underbelly poses a massive opportunity for cost-effective agile IT infrastructure providers

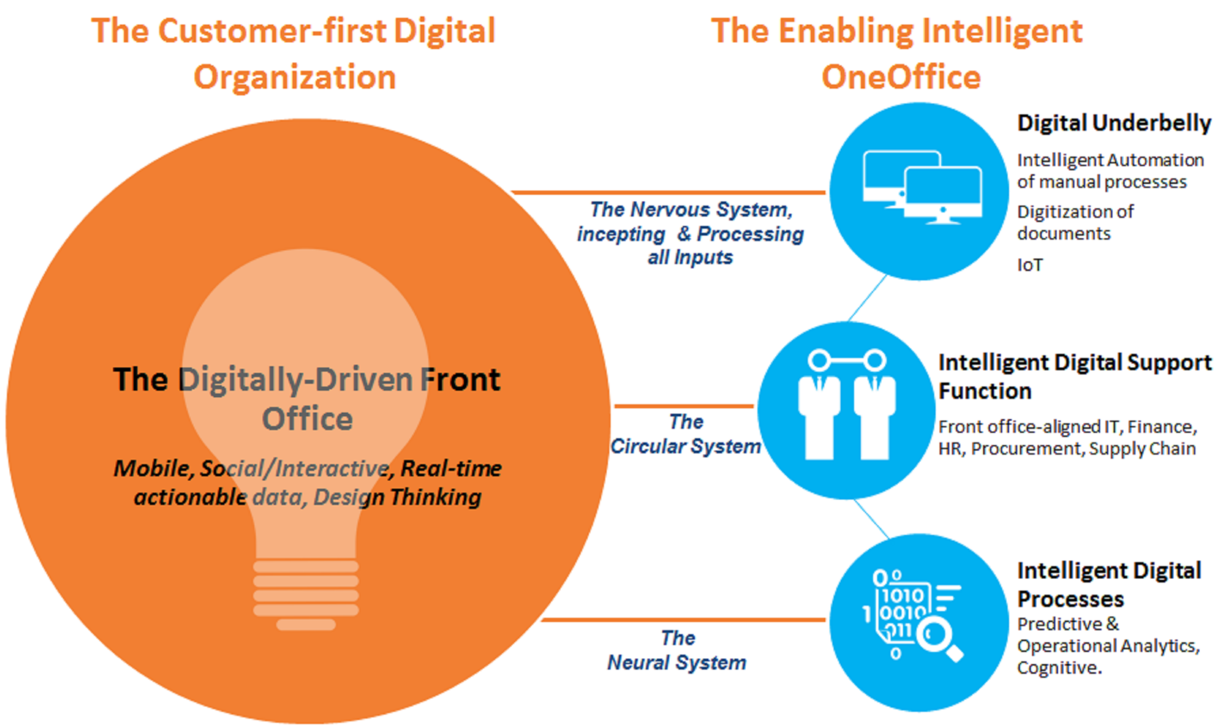
The onset of digital and emerging automation solutions, coupled with the dire need to access meaningful data in real-time, is forcing the back and middle to support the customer experience needs of the front. Our new study on achieving Intelligent Operations (see link), which canvassed 371 major buyside enterprises, reveals two key dynamics that are unifying the front, middle and back offices:

- **A "customer first mindset" is the leading business driver driving operations strategies.** Over half of upper management (51%) view their customers' experiences as impacting sourcing model change and strategy, which is placing the relevance and value of the back office in the spotlight.

- **Three quarters of enterprises (75%) claim digital is having a radical impact.** We can debate the meaning and relevance of digital forever, but the bottom line is that enterprise leaders need to (be seen) to have a digital strategy – and a support function that can facilitate these digital interactions and data needs. The old barriers, where staff in the back office don't need to think and merely oversee operational process delivery, and those in the middle, which only venture a part of the way to aligning processes to customer needs, are fading away.

Consequently, we're evolving to an era where there is only "OneOffice" that matters anymore, creating the digital customer experience and an intelligent, single office to enable and support it:

Exhibit 1: The "Intelligent OneOffice" will emerge from Digital + Automation



Source: HfS Research 2016

The Digitally-driven Front Office drives the Digital Transformation

Digital, in its purest form, is all about transforming the business to create, support and sustain the digital customer experience. It's about leveraging the omnichannel (mobile, social and interactive technology) and accessing meaningful analytics to make it happen. Digital enterprises need a support function to service those customers, get their products/services to market when they want them, manage the financial metrics, understand their needs and future demands and make sure they have got the talent which truly understand the outcomes of their work.

In their current forms, HPE-plus-CSC has some real capabilities in industries like travel and insurance to lead the market here, but is its stated digital focus is going to be in the operations and infrastructure rather than on design and industry expertise; it will struggle in markets against service providers with very strong digital design practices, such as Accenture Digital and Deloitte Digiday. In fact, Newco would be smart to partner with these firms to provide the digital underbelly capabilities at scale.

The Digital Underbelly creates the building blocks

Digitally-driven enterprises must create a Digital Underbelly to support the front office by automating manual processes, digitizing manual documents and leveraging smart devices and Internet of Things, where they are present in the value chain. Smart enterprises have realized they simply can't be effective with a digital transformation without automating processes and fixing manual interventions and breakages in their process flows. Service providers can get ahead by working with their clients to make their processes run digitally so they can grow successfully their digital businesses and create new growth for themselves. Think about a central nervous system that incepts and processes all the elements necessary to make the enterprise function.

This is where HfS views the sweet spot for Newco, provided is can really optimize the economies of scale with the merger to be price competitive with the Indian heritage majors, such as TCS, Wipro, HCL, Infosys and Cognizant. It also needs to convince clients it brings world class engineering talent, security and automation expertise to the table.

Intelligent Digital Support breaks down the legacy functional silos

Enterprises need their support functions (like an enterprise circular system), such as IT, finance, HR and supply chain, to be aligned with supporting the customer experience, as opposed to operating in some sort of vacuum, hence, we are terming this "Intelligent Digital Support", where broader roles can be created. HPE and CSC together have tremendous depth in areas like finance and accounting, contact center and HR from HPE's traditional services business, while CSC brings it's newly acquired procurement capabilities from its Xchanging acquisition.

Newco's focus needs to shift towards creating a work culture where its delivery staff are encouraged to spend more time interpreting data, understanding their clients' needs at the front end of their businesses, and ensuring the support functions keep pace with the front office. This is especially the case in industries that are more dependent than ever on real time data, using multiple channels to reach their customers and being able to think out-of-the-box with disruptive business models.

Intelligent Digital Processes can help enterprises predict, as opposed to react

Newco much focus on enabling business processes that align with their clients' desired digital customer experiences. It's not about throwing off historical data just to discover what went wrong, it's about being able to predict when things will go wrong and finding clever ways to get ahead of them. It's about embedding smart cognitive applications into process chains, about learning from mistakes and new experiences along the way. This is the enterprise neural system. Several of HPE's IT service competitors have already made strides here with autonomics platforms, such as IBM's Watson, TCS with its Ignio , Wipro with Holmes, Infosys with Mana and Accenture's evolving partnership with IPSoft's Amelia. Without a genuine story in service orchestration and autonomics, Newco could quickly fall behind, as their customers become increasingly eager to embed cognitive and self-learning elements into their business and IT processes.

However, one key service orchestration platform where we see some real growth potential for Newco is with CSC's industry-leading ServiceNow practice, which has enjoyed continued growth, especially following its 2015 acquisition of Fruition Partners. Newco should be able to divert many existing HPE clients onto its newly-acquired managed service. It just needs to figure out how to grow that competency as two forces coming together, as opposed to ending up with competing P&Ls.

Why this merger - and why now?

The reasons for the merger given by both companies' management focus on the scale of the new service provider and the ability to drive down delivery costs of cloud computing services with smart rationalization of clients and services resources. The firm's official stance is that Newco will offer:

- World-class strength in customer service and IT operations – among the safest pair of hands in the industry, deploying a broader set of resources and expertise to benefit clients;
- Market-leading industry and technology expertise – industry leading experience and IP in areas such as financial services, healthcare and life sciences, transportation, consumer products, and insurance, helping customers transform faster;
- Global scale – operating 85 delivery centers and 95 data centers across 70 countries, providing access to the most efficient IT services in the world;
- Technology independence and best-in-class capabilities in next-generation cloud, security, application development and modernization, big data and analytics, mobility, workplace, and sophisticated business process and IT services;
- Combined leadership bringing deep turnaround experience and transformation capabilities, customer relationships, sales/GTM, industry and functional expertise;
- Expanded best-of-breed technology partnerships that provide greater choice of solutions; and
- Enhanced innovation, R&D, and investment opportunities for new services and solutions.

Given the deal seems largely motivated by scale, we can look at how it will change the position of the firms in the market. Exhibit 2 shows HfS High Value IT Professional Services & Managed Services, if we add HP and CSC's IT services revenues together.

Exhibit 2: The HfS IT Services Top 10 High Value IT Professional Services & Managed Services Providers, 2015

Rank 2015	Service Provider	Estimated IT Professional Services & Managed Services Revenue 2015 ($Bn)	Market Share (%)
1	IBM	41.6	7.8%
2	Accenture	27.2	5.1%
3	HP/CSC	26.0	4.9%
4	Fujitsu	22.1	4.1%
~~4~~	~~HP~~	~~20.9~~	~~3.9%~~
5	TCS	13.2	2.5%
6	CapGemini	12.6	2.4%
7	NTT	12.2	2.3%
8	Cognizant	10.8	2.0%
9	Atos	10.6	2.0%
	~~CSC~~	~~9.6~~	~~1.8%~~
10	CGI	9.4	1.8%
11	AWS	7.9	1.5%
	Top 10	185.7	34.7%

Source: HfS Research, 2016, estimated from services provider financials. Revenues are fitted to nearest calendar year. We attempt to make the IT services numbers as close to HfS definition as possible—as part of this exercise we exclude revenues from subcontracting, we don't include BPO or business services revenues in this definition and some product services revenues were classified out of scope if the equipment serviced is not IT—for example, telephony related equipment. These numbers do not include software as a service, unless included within a broader managed services agreement. For HP/CSC we used the figure used in the merger press release.

The new firm would retake its position as a top 3 provider in high value IT professional services & managed services provider list. Interestingly AWS would move into the number 11, tantalizingly close to a spot in the top 10. The $26 Billion revenue figure takes $8 Billion as CSC, without the hived off public sector business, and $18 Billion from HPE Enterprise Services division, much of which was the acquired EDS business unit. Ironically, this deal brings together two of the original outsourcing behemoths EDS and old rivals CSC.

Certainly scale was an important requirement for IT outsourcing providers in the past as it gave flexibility and economies to these asset and labor intensive businesses. Scale only becomes a criteria for some of the very biggest of outsourcing agreements. However, in asset light world of modern IT managed services and the every increasing focus on the use of automation in these deals – scale has become a secondary consideration in many deals. We would argue that HPE, and depending on location, CSC, would have been able to handle even the very largest of deals.

What we have is two large services businesses that have spent the last three years hemorrhaging revenues, because they weren't offering what many enterprise clients wanted or there was another provider able to do the same task cheaper and more nimbly. This issue is not going to be resolved by this merger. The two firms have to reinvent themselves as a modern services firm where contracts are more open ended, value is counted in revenue growth not just cost savings and scale is replaced by other features such as agility and innovation as the key differentiators.

One of HPE's most important assets going forward will be its Helion cloud platform. This appears to be remaining within HPE and not going to the new entity. This is a big deal as it potentially weakens Helion cloud – by removing some of the private and managed private cloud expertise. Although, it also frees up HPE to use other providers.

What to Watch: Cloud service delivery expected to dominate. Leaving BPO to stagnate would be a mistake

HfS continues to see three likely scenarios for the enterprise infrastructure IT and IT services market over the next 5 years. The success of any strategy in this market will depend on which is successful. The scenarios:

- **Scenario one, rapid public cloud dominance.** This is an option that in some ways seems the least likely, this would mean 40-50% of enterprise organizations, by 2020, taking a cloud first option for new initiatives and replace/repair to the public cloud approach to existing infrastructure, the "all-in" approach to public cloud that supports digital business transformations. Whether Newco can really provide a differentiated offering against the likes of AWS in the short term is highly doubtful.

- **Scenario two, eventual public cloud dominance.** The dominance of public cloud takes much longer, it will take until 2025 to reach the same level of acceptance. With private and hybrid cloud taking up the slack, this gives hybrid a chance to properly establish itself and lengthens timeframe private/hybrid cloud is relevant. Hybrid is where Newco could have more likely success by moving existing legacy clients into hybrid public-private cloud, based on trusted relationships, geographic scale and trusted security capabilities.

- **Scenario three, hybrid cloud dominance.** Public cloud will be successful, but most enterprise organizations will adopt a hybrid approach for their core IT infrastructure, at least until 2025. The longer it takes major enterprises to make the shift to the the public cloud, the more opportunity Newco will have to position itself and a trusted IT infrastructure provider of choice to enable that digital underbelly. The challenge for Newco here will be convincing clients to avoid low cost offerings from the Indian-heritage majors. If HPE's leadership believes clients will go with them because of its traditional trusted brand, it will surely fail, as so many clients have as much (or more) trust with several of the Indian majors in today's market. Newco will have to work hard to prove it has superior cloud delivery, talent, digital understanding and digital enablement in the wake of very aggressive Indian competition.

The closer we get to 2020 the more it becomes clear that scenario one seems too rapid – as enterprise purchasing cycles dominate the time frame and general reluctance to take a big bang approach to public cloud adoption, sees scenario two as the most likely of the scenarios. This is good news for all the traditional services firms as it allows for a longer run off of legacy business and a longer time for hybrid platforms to establish and be the primary route for enterprise organizations to adopt public cloud. This was apparent in examples at the Discover event of HPE helping clients find the right hybrid balance, including in the one case of Dropbox, a shift off of AWS to a hybrid platform.

In terms of BPO, Newco has real potential to make its mark, with deep experience and footprints in finance and accounting, contact center/omnichannel, HR and procurement (via CSC's recent Xchanging acquisition). However, with the laser focus on the cloud and the need to support digital initiatives, HfS fears its BPO offerings may get neglected, or even sold off. For years, HPE's BPO business has managed to sustain a $2 billion BPO business, despite limited focus from various leaderships (now $2.6 billion with CSC) and HfS doubts new CEO Mike Lawry (coming over from CSC) has an appetite to take the firm down a BPO path.

However, with the increased focus on the omnichannel and the need to manage business process delivery, it would be a smart move, in HfS' view, to invest in smarter BPO delivery with further investments in analytics, cognitive tools and automation. Maintaining a relationship with the remaining parts of HPE will allow the BPO business to continue using certain analytics and automation tools as well as remain a channel for those businesses. HP is one of the few major IT/BPO service providers to have retained its contact center business, which could be a major facilitator of digital-led initiatives but without focus and investment in design of front end processes, risks going down the path of many large contact center players, of huge FTE and voice focused commoditized services with little differentiation or ability to service the digital customer. Developing a capability or partnership to address omnichannel and the digital customer will be critical for success; CX/ contact center leadership seem to have this clear focus, the question remains whether the new CSC-HP giant will have the appetite to support it.

The Bottom-line: The industry is in transition and the winners are those which can pivot and focus fast

Let's cut to the chase here - we're operating in a services world obsessed with preserving the past and ignoring the new. The past was all about predictable revenue and highly-visible cost reduction opportunity - there was a method to the madness. But this was because the true value was about doing things slightly better, but at much cheaper costs. The future is not so predictable - it is about being smarter, more business aware, and technically superior to piece it all together for clients. Oh, and without increased investments. It's hard, and requires a very different focus, which is one of developing talent to learn on the job, one of evaluating experiences professionals to assess their ability to change, of being able to learn new tools and platforms, which require a mixture of process and business understanding to align with real business outcomes.

The Newco that is HPE+CSC has as good a shot as most to survive the impending service industry carnage, as growth flattens and prices hit the floor for anything that is a mainstream service. It's sheer size and client portfolio should help it absorb the blows as the market shakes out and the need for increasingly complex "digital underbelly" services proliferates. As we evolve the levers for the survivors to pull are the right combination of labor arbitrage, automation enablement, cognitive understanding and digital enablement. But spending years constantly reorganizing internally to create the beast to deliver all of this with the speed, affordability and agility needed will not work. These two firms need to be slammed together with an urgency and focus not yet seen in our industry. This won't be pretty and needs to be like a very sticky BandAid being ripped off very, very quickly...because their biggest threat is within themselves.

About the Authors

Phil Fersht, Chief Analyst and CEO

Phil Fersht is Chief Analyst and Chief Executive Officer of leading global analyst authority for the services industry, HfS Research. He is an acclaimed author, analyst and visionary in Global Business Services and Outsourcing, the Digital Transformation of enterprise operations and talent strategies. Fersht coined the term "The As-a-Service Economy" which is HfS Research's vision for the future of the global services and outsourcing industry and has become widely adopted by the global services industry.

Fersht founded HfS Research in 2010 and has masterminded the development of the HfS organization as a leading analyst for the provider, in addition to steering the business operations. He is also author and creator of the most widely-read and acclaimed blog in the global services industry, entitled "Horses for Sources" and now entering its ninth year, attracting over a million visits per year across the globe. At HfS, he directs the provider's research, advisory and global knowledge community, which today totals over 100,000 professionals and is served by a respected global analyst team.

Under Fersht's stewardship, HfS Research has become the leading industry analyst provider for growing influence and value, based on the results of 1093 industry participants in the 2014 Analyst Value Survey. He was named "Analyst of the Year 2011" by the Institute of Industry Analyst Relations (IIAR), winning the premier analyst award for a second successive year - the most coveted global award for industry analysts in technology and services industry. In 2012, the International Institute of Analyst Relations (IIAR) awarded HfS research as Most Innovative Analyst Provider.

Over the past 20 years, Fersht has lived and worked in Europe, North America and Asia, where he has advised on hundreds of operations strategy, outsourcing, and global business services engagements. During his career, Phil Fersht has worked at Gartner Inc. (AMR Research), directing the provider's BPO and IT Services practices and served as market leader for Deloitte Consulting's BPO Advisory Services, where he led numerous outsourcing and offshoring advisory engagements with Fortune 500 enterprises. He began his career with IT analyst IDC.

Fersht contributes regularly to media such as Wall St Journal, Business Week, Economist, The Times of India and CIO Magazine and is a regular keynote speaker at major industry events, such as NASSCOM, Sourcing Interests Group and the HfS Blueprint Sessions.

He received a Bachelor of Science, with Honors, in European Business & Technology from Coventry University, United Kingdom and a Diplôme Universitaire de Technologie in Business & Technology from the University of Grenoble, France. He also has a diploma from the Market Research Society in the United Kingdom.

Phil can be reached at Phil.Fersht@HfSresearch.com and followed on Twitter @pfersht

Jamie Snowdon, EVP Research Operations

Jamie Snowdon has primary responsibility for overseeing the development of HfS' quarterly demand tracker, in addition to managing and developing the provider's data-centric products and services. He works across the HfS analyst teams to define evolving services markets and create market size estimates and forecasts. He also manages HfS' quantitative survey and benchmark data. Jamie has over 18 years' experience in the IT and business services industry. In that time he has worked in a variety of roles, including sales, marketing, consulting and as an industry analyst. Jamie's analyst career has largely been spent conducting data analysis including market size/forecast models, quantitative/qualitative survey analysis and competitive analysis.

Prior to HfS, Jamie has worked for a number of analyst providers including IDC and Nelson-Hall. He worked as a Research Director for Nelson-Hall, where he conducting vendor and market analysis examining the IT and Business Services community. Additionally, Jamie has spent several years at IDC, most recently as the head of European infrastructure services research. Prior to that he was the European consulting director for IDC's services group, managing all of their bespoke research. Jamie specialized in delivering custom market forecast models and forecasting tools tailored to his client's individual needs. In addition, Jamie ran IDC's European outsourcing research, covering both IT and business process outsourcing. Jamie has wide industry knowledge covering IT consulting, enterprise applications, IT & business process outsourcing, desktop & network services, equipment maintenance, and business continuity.

Earlier in his analyst career, Jamie spent four and a half years at the IT services research specialist INPUT in a mixture of marketing and analysis roles. He left as the UK operations manager having spent two years as a customer services industry analyst. Jamie completed his graduate training at one of the UK's leading electronic and IT distribution companies. Jamie's passion is learning; he holds university degrees in general science (computing), law and has a postgraduate diploma in legal practice. He lives in Twickenham, London with his wife, and two daughters. His other loves include cycling, reading trashy sci-fi, cool technology and the perfect pint.

You can find him on Twitter @TheWizeOne and via email at Jamie.Snowdon@HfSresearch.com.

Melissa O'Brien, Research Director, Omni-Channel & Contact Center Strategies

Melissa O'Brien is Research Director, Contact Center and Omni-Channel Operations and BPO at HfS Research. Her research coverage includes customer experience management services, exploring ties with marketing operations and developing thought leadership around intelligent automation for contact center and vertical specific customer engagement business processes.

Prior to HfS, Melissa spent four and a half years at IDC as Research Analyst managing the Worldwide Customer Experience Management Services program. Her role at IDC included analysis of evolving contact center business process and consumer communication trends and delivering reports, presentations and custom consulting projects including market forecasts and in depth competitive assessments.

Melissa previously worked within the BPO industry as Client Services Manager at PSG Global Solutions, an outsourced recruiting services business. Melissa held various roles at PSG Global, including new client implementation, program design, and training, including development and delivery of the original training program in their Manila and Cebu, Philippines offices.

Melissa graduated with honors from the University of New Hampshire with a BA in English and Communication, and is a member of the Phi Beta Kappa honor society.

Melissa is a Boston area native and lives just outside the city with her husband and adorably mischievous Bluetick Coonhound. She enjoys various outdoor activities, traveling, and has recently become a kickboxing fanatic.

Melissa can be reached at melissa.obrien@hfsresearch.com and followed on Twitter at @melissajaneob

About HfS Research

HfS Research serves the research, governance, and services strategy needs of business operations and IT leaders across finance, supply chain, human resources, marketing, and core industry functions. The provider provides insightful and meaningful analyst coverage of best business practices and innovations that impact successful business outcomes, such as the Digital Transformation of operations, cloud-based business platforms, services talent development strategies, process automation and outsourcing, mobility, analytics, and social collaboration. HfS applies its acclaimed Blueprint Methodology to evaluate the performance of service and technology in terms of innovating and executing against those business outcomes.

HfS educates and facilitates discussions among the world's largest knowledge community of enterprise services professionals, currently comprised of 150,000 subscribers and members. HfS Research facilitates the HfS Sourcing Executive Council, an acclaimed elite group of sourcing practitioners from leading organizations that meets bi-annually to discuss the future direction of the global services industry and the future enterprise operations framework. HfS provides Sourcing Executive Council members with the HfS Governance Academy and Certification Program to help its clients improve the governance of their global business services and vendor relationships.

In 2010 and 2011, HfS Research's founder and CEO, Phil Fersht, was named “Analyst of the Year” by the International Institute of Analyst Relations (IIAR), the premier body of analyst-facing professionals, and achieved the distinction of being voted the research analyst industry's Most Innovative Analyst Provider in 2012.

In 2013, HfS was named first in increasing influence among leading analyst providers according to the 2013 Analyst Value Survey and second out of the 44 leading industry analyst providers in the 2013 Analyst Value Index.

Now in its seventh year of publication, HfS Research’s acclaimed blog “Horses for Sources” is widely recognized as the most widely-read and revered destination for unfettered collective insight, research, and open debate about sourcing industry issues and developments. Horses for Sources now receives over a million web visits a year.

To learn more about HfS Research, please email research@HfSResearch.com.