GLOBAL WARNING

How to Avoid Getting Burned in the Globalising Business Services Market

OC&C Strategy Consultants

SUMMARY

The B2B Services sector is diverse but contains some of the world's most successful businesses. Leading players are capitalising on waves of outsourcing, acquiring to accelerate their growth, and stockmarkets are increasingly recognising their attractive combination of cyclical resilience, forward visibility of earnings, and growth potential. However, beneath the sparkling track record and immense potential, there are some difficult questions that CEOs and shareholders increasingly need to address.

One of these is about how best to exploit international opportunities: which countries to target, in what order, and how? To identify the long-term success factors, OC&C has drawn on its experience of helping a range of incumbents and insurgents develop winning strategies, and created a database to examine in detail 200 of the top global firms in B2B (a group we refer to as the B2B 200). Collectively it's a powerhouse group, turning over £1.4 trillion annually, present in every continent, and including leading businesses from Construction, Engineering, HR, BPO and other B2B sectors.

The findings from analysing the data on the B2B 200 has provided several key insights:

1. STELLAR SECTOR GROWTH

The B2B 200 has been beating the market. This group of global leaders not only held up better than other sectors in recession, but has since grown revenue faster, and achieved share price growth that outstrips the major indexes.

2. TRULY INTERNATIONAL

The B2B 200 is now genuinely international, extracting more of its revenue from overseas markets than from its domestic territory. Compared to a traditional focus on dominating a home market, the opportunity for B2B majors to operate globally is now real in B2B, alongside an equally tangible threat from foreign competitors targeting their home patch.

3. AT A CROSSROADS

It's not just the European firms leading this trend. In the last 3 years it has been businesses from Asia and Latin America that have grown most outside their domestic markets.

4. SUCCESS ISN'T JUST FLAGS ON THE MAP

However, amidst all the good news there are several challenges. Not all of the B2B 200 have prospered, and the stakes are rising, so there are some large bets being placed which may not pay off. It is also apparent that scale on its own is not enough, and that some of the more focused B2B businesses have begun to outperform. Alongside investing in organic growth, M&A is a powerful weapon - the best international B2B players extract value from both – but acquisition as a way to unlock new markets needs to be handled with great care.

5. SELECTIVE INTERNATIONALISATION

There are patterns appearing about who wins, and why. In particular, those businesses that can articulate a very clear rationale for internationalising, and then execute their strategy in a focused way, are most likely to build sustainable winning positions. Recognising the specific needs of local customers, adjusting propositions to each competitive environment, and being patient in investing appropriate capital and management skills are all essential.

6. KEY LESSONS

There are evidently very large prizes to be fought for in international B2B, but pitfalls if too blunt an approach is taken. CEOs and their shareholders need to ask themselves and their teams some tough questions about why and how their businesses are going to grow, and be prepared to reject some of the internationalisation options available. One strong positive is that there is plenty to learn (and lots of profit opportunity) from evaluating carefully how B2B Services as a whole is changing.

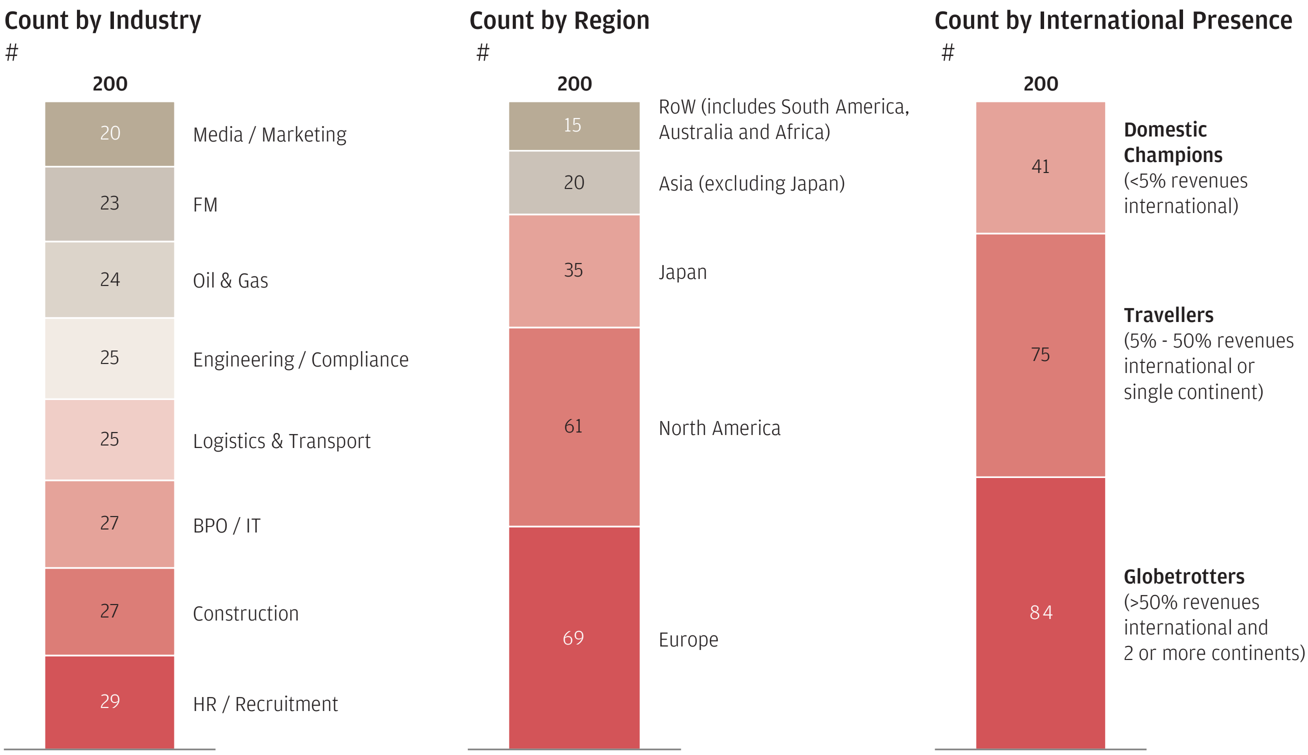
APPROACH

Through our work with B2B Services clients around the world, we've seen a range of attitudes and approaches to internationalisation, and some spectacular successes alongside examples of real struggles to move into new territories. It's been very common for Boards to see the lucrative potential of international markets and be almost overwhelmed by the options facing them. Questions about how large an international footprint to build, which countries to prioritise, and in practical terms how to do it, are obvious but not easy to answer. To help address those questions, we've constructed a bespoke database of 200 of the largest B2B Services firms in the world, analysed the data and explored case studies of success.

The B2B 200 represent a large contribution to GDP of c.£1.4 trillion revenues and range in size from £0.5bn pa to £75bn pa. The group is a cross-section of firms across industries and regions which we believe is representative of the distribution of the top global B2B services firms. Although diverse in terms of the markets they serve, they have plenty in common in terms of delivering services to other businesses and governments; as such we believe there are a host of common learnings which can be drawn.

We believe these lessons can be highly useful for B2B businesses thinking about their next chapter of international growth.

EXHIBIT 1: B2B 200 BY INDUSTRY, REGION AND INTERNATIONAL PRESENCE



We have segmented the B2B 200 into 3 different international approaches:
1. Domestic Champions – firms who are focused on home markets and less than 5% of revenues outside of home geography
2. Travellers – firms with a more balanced international profile and 5% to 50% of revenues from abroad, or only a single continent footprint
3. Globetrotter – truly international firms with +50% of revenues from abroad and, at least a 2 continent footprint

1. STELLAR SECTOR GROWTH

> "We have seen our services markets come back quicker than we anticipated after the recession"
>
> – COO, leading global services firm

REVENUE GROWTH OF 11% PA ACROSS THE B2B 200

The B2B 200 has shown excellent performance in several respects: compared to the wider market, its revenues were more resilient in the recession; since the bottom of the recession, its revenue growth (11% pa since 2009) has been at least as good as the S&P 500 or the Eurostoxx; and the quality of these leading B2B businesses is increasingly being recognised by the markets, evident in strong share price gains (22% pa).

EXHIBIT 2: B2B 200 BY INDUSTRY, REGION AND INTERNATIONAL PRESENCE

Revenue Growth: B2B 200 vs Global Indices[1], 2008-12

Indexed to 2008[2] = 1

Revenue Growth — Share Price Growth

B2B 200

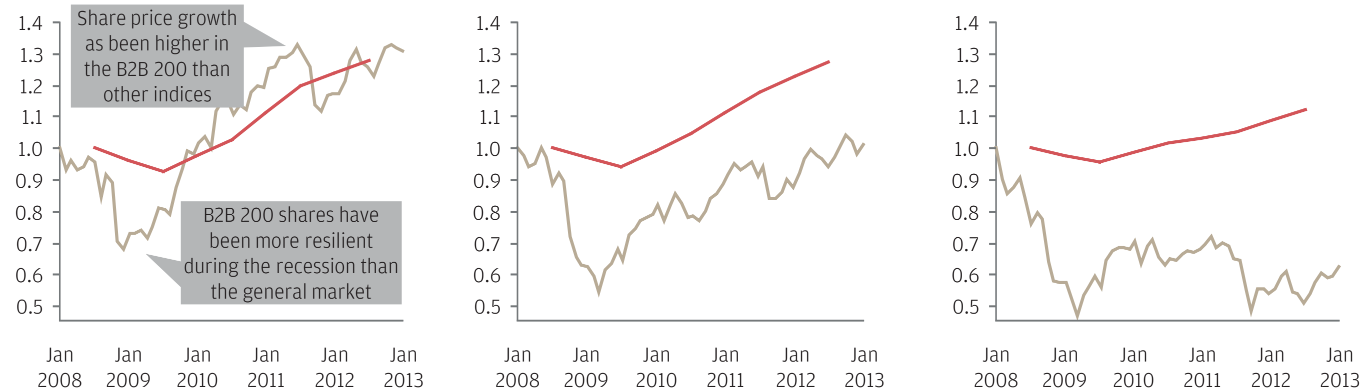
	CAGR, % 2008-09	CAGR, % 2009-12
Share Price Growth	-27%	+22%
Revenue Growth	-4%	+11%
Delta	-23%	+11%

S&P 500

	CAGR, % 2008-09	CAGR, % 2009-12
Share Price Growth	-38%	+18%
Revenue Growth	-6%	+11%
Delta	-32%	+7%

Eurostoxx 50

	CAGR, % 2008-09	CAGR, % 2009-12
Share Price Growth	-43%	+3%
Revenue Growth	-4%	+5%
Delta	-39%	-2%



1. Indices may not includes all constituents due to incomplete revenue data
2. Share Price indexed to Jan 2008, Revenue indexed to FY 2008 and shown mid-year
Source: BvD, Datastream, OC&C analysis

It is not just the traditional economic powerhouses in Europe and US that have increased revenues; growth has, in fact, been most pronounced amongst Asian and ROW headquartered companies who have seen growth of c.22% pa and c.13% pa respectively (vs c.11% pa for overall B2B 200).

European firms, on the other hand, have struggled over the last 3 years with sub-par revenue growth (c.8% pa) coupled with low and marginally contracting margins. There does not appear to be any sectoral bias driving this performance, European firms have simply under-performed.

Most sub-sectors have seen robust historic growth of between 9%pa and 13%pa with the major outliers being strong growth of the Oil and Gas majors (c.20% pa) and under-performance of the Media and Marketing sector (c.4%pa). As one would expect, margins differ significantly across sectors with FM, Construction and HR / Recruitment facing the most acute margin pressures.

2. TRULY INTERNATIONAL

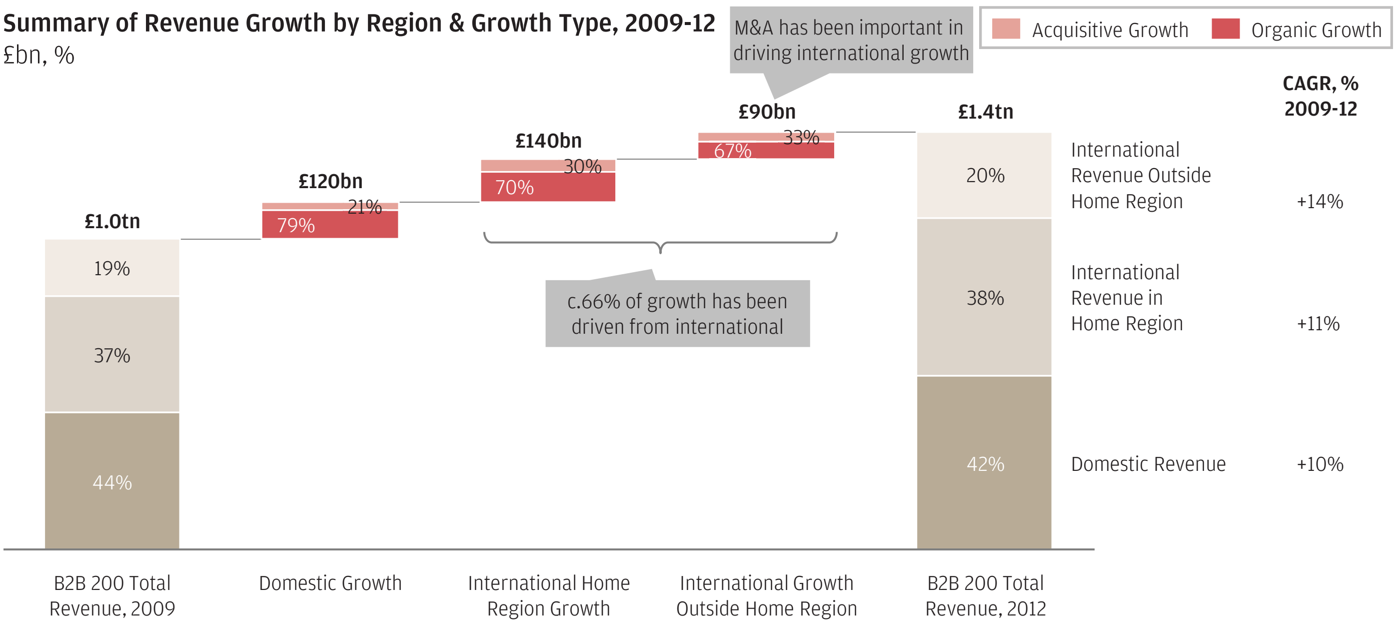
> "We have such low growth in our home markets that international represents our platform for continued growth"
>
> – Business Division MD, Global B2B Player

58% OF ALL B2B 200 REVENUES ARE NOW DERIVED FROM INTERNATIONAL OPERATIONS

International opportunities have transformed B2B Services, with each of the 8 focus sub-sectors now highly reliant on international operations and c.58% of the B2B 200 revenues coming from overseas.

International business represents c.66% of all revenue growth between 2009-12 (£230bn of £350bn revenue growth in the period); interestingly the source of revenues that has achieved the strongest growth over the last 3 years (c.14%pa) is outside of home region.

EXHIBIT 3: B2B 200 REVENUE GROWTH BY DOMESTIC AND INTERNATIONAL



Source: BvD, Datastream, OC&C analysis

M&A deal activity has been a major contributor to international growth representing almost 30% of revenue gained. Headline international deals taking place over the last few years include the acquisition of TNT Express by UPS and Smith International by Schlumberger.

The rationale behind the international transformation is clear – internationalising is both easier now than ever before and the prize is bigger:

- Provides access to higher-growth economies in more developing markets versus low growth home markets
- Gives greater scale to firms and helps to diversify portfolio risk whilst reducing exposure to any one economy
- Offers access to a wider pool of talent and innovation, plus the opportunity to pilot services in a range of markets
- Historic barriers to internationalisation, including protectionism, are being reduced (although not removed)

However, it would be overly simplistic to view the move to international as either uniform or absolute - there are a host of risks to international which ensure it is not an easy migration:

- No silver bullet to international with a variety of options in terms of country breadth, depth and operating model
- Risk of distraction from domestic market – particularly if delivering a wider set of activities
- Cost and risk of M&A to realise international success
- Risk of IP being copied or stolen in less protected developing markets

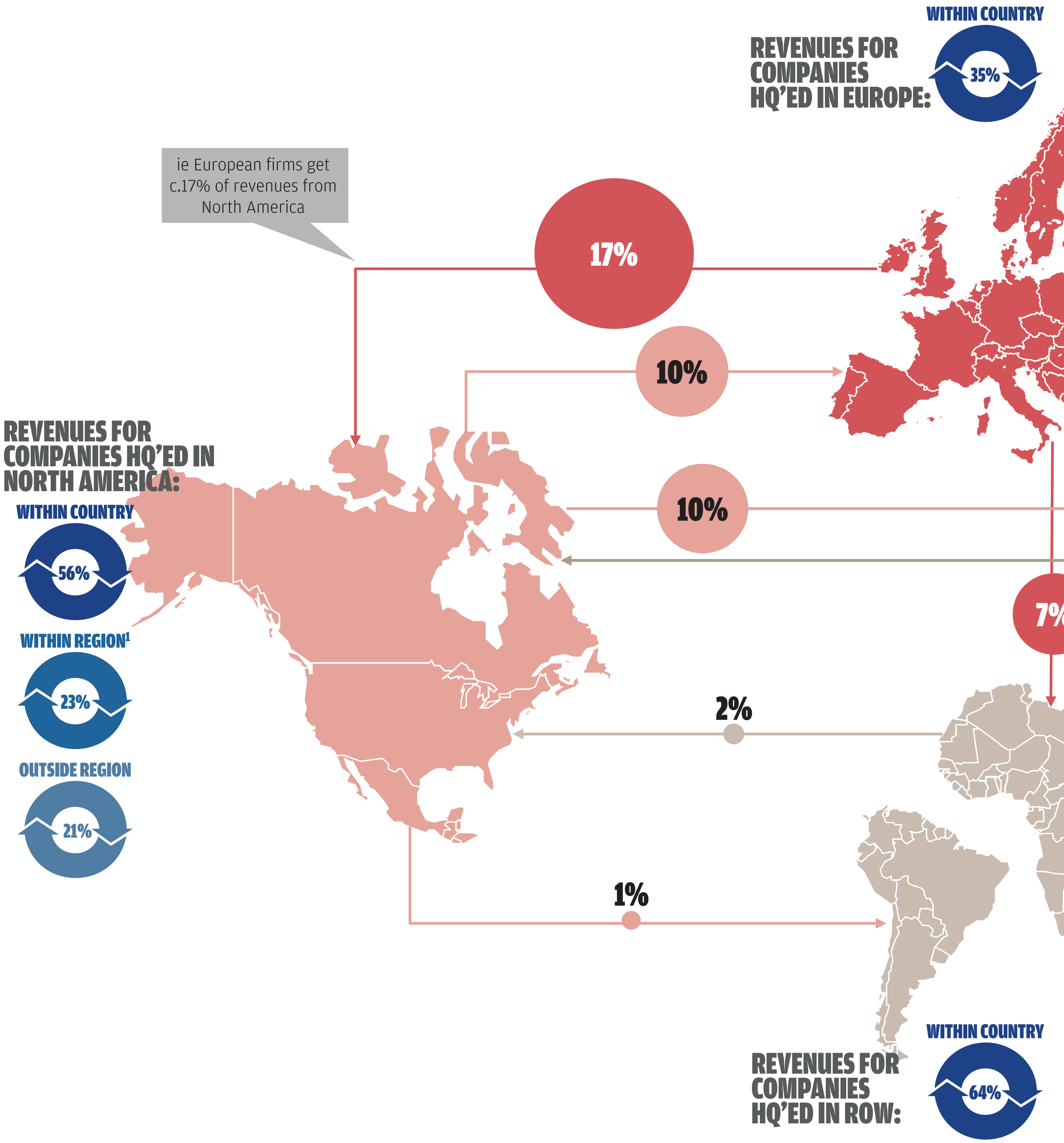
3. AT A CROSSROADS

"We have seen 70 Indian firms enter into foreign markets last year and the number is expected to double this year"

– CEO, B2B 200 Firm

INTERNATIONAL TRAFFIC IS NOW 2-WAY WITHIN THE GLOBAL B2B SERVICES INDUSTRY AND BECOMING EVER MORE SO

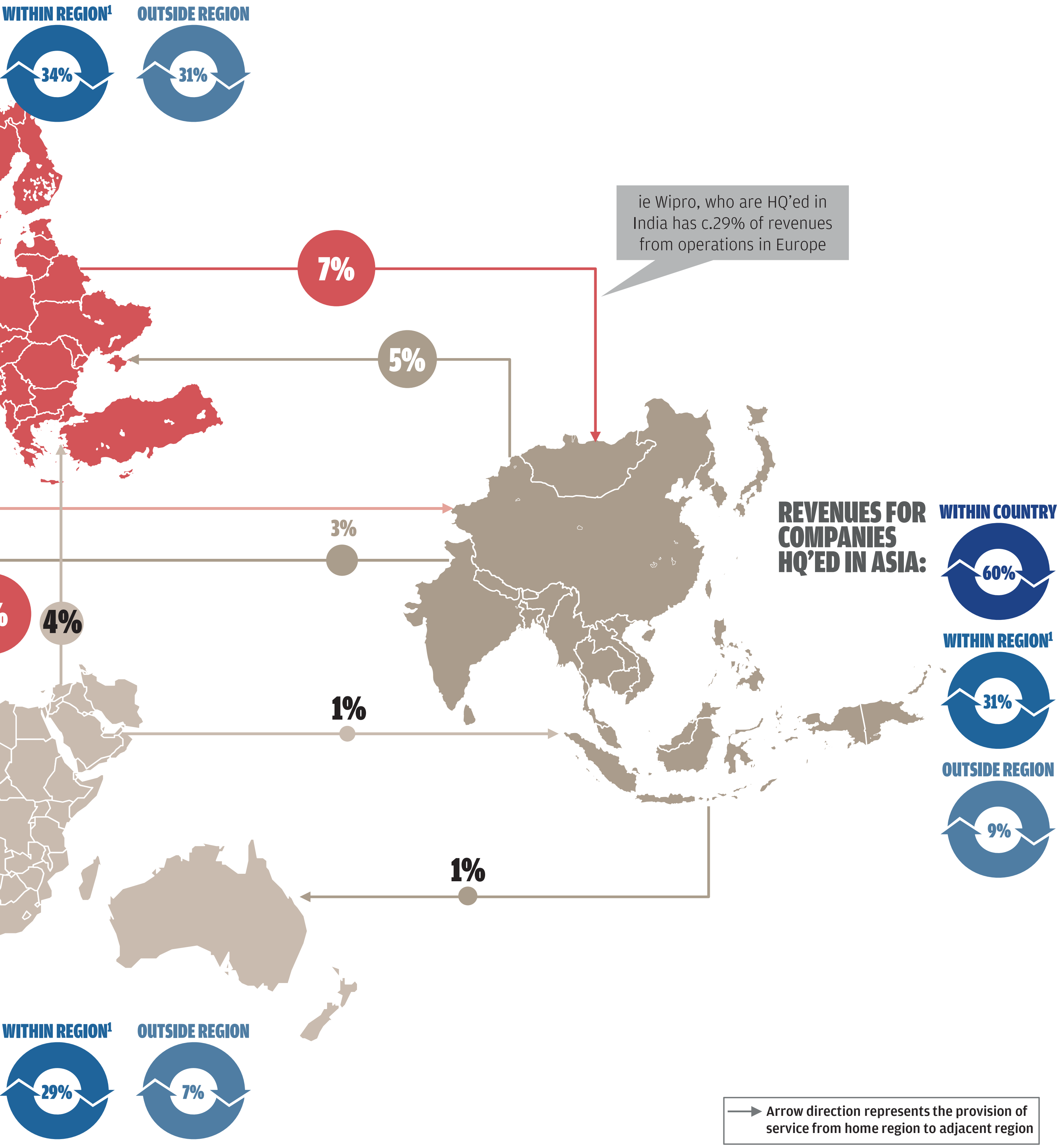
EXHIBIT 4: B2B 200 BY INTERNATIONAL TRADE FLOWS



1. Within region, but not within country
Source: BvD, Datastream, OC&C analysis

Historically European firms have been at the vanguard of international expansion with c.31% of revenues deriving from outside Europe and an additional c.34% of revenues outside of home country (but within Europe).

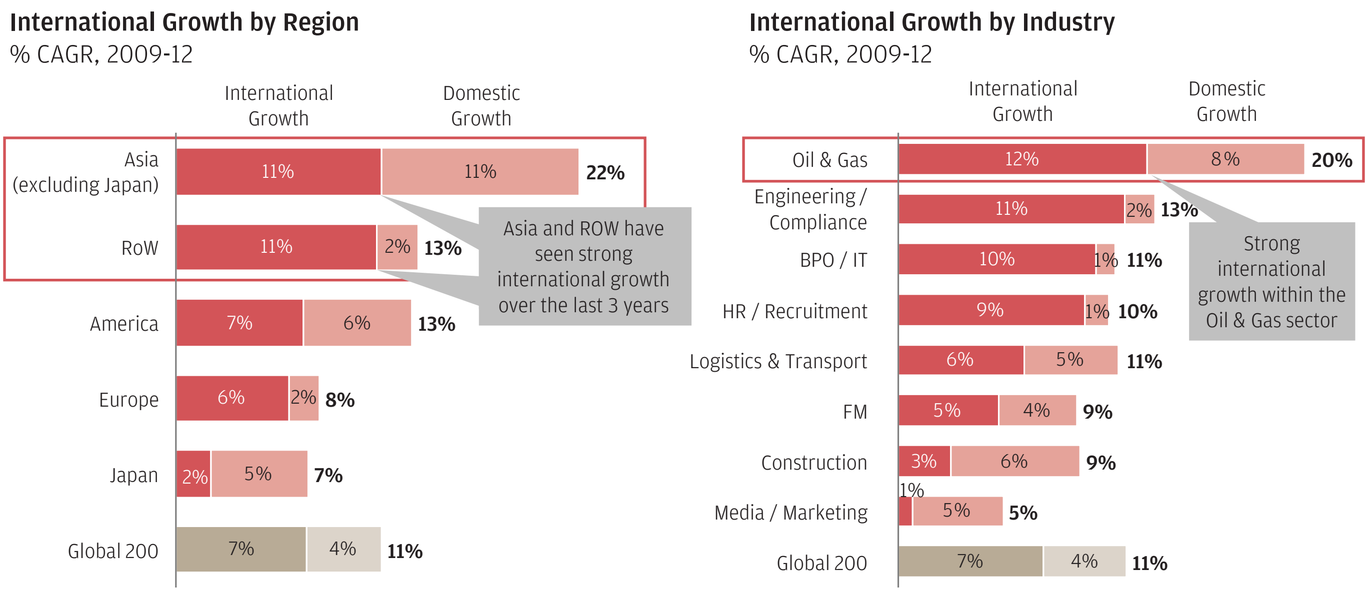
Other regions have typically been more insular in their international approach, preferring to stick to home or adjacent markets within their home region; US companies in particular are less aggressive outside their home country than one may have hypothesised with c.56% of revenues from home market (vs 35% for European firms).



However, over the last 3 years we have seen a shift in behaviour from players based in developing regions with greater international expansion- traffic is now two-way within the global B2B Services industry.

EXHIBIT 5: INTERNATIONAL GROWTH BY REGION AND INDUSTRY

International Growth by Region & Industry, 2009-12



Source: BvD, OC&C analysis

Asian firms (excluding Japan) in particular delivered impressive international growth of c.11% pa (within overall growth of c.22% pa). This demonstrates that international expansion amongst the B2B 200 is no longer purely a one-way effect from developed to developing markets.

- Example: HCL Technologies is a BPO provider based in India who has recently focused on driving overseas revenue through both acquisition (purchased UK company Axon for c.£450m in 2009) and Greenfield sites (significant investment in new American offices). As a result, revenue has grown by over 20% since 2009, with international revenue now accounting for +90% of revenues.

From a sub-sector point of view, Oil & Gas, Engineering & Compliance and BPO / IT have achieved the strongest international growth, all with growth of 10% pa plus. For these sub-sectors international operations have been crucial to delivering growth.

We believe that internationalisation has, and will continue to be, essential to sustain the high levels of growth that market participants and investors alike have come to expect from the sector – firms not developing a sophisticated international strategy risk being left behind.

4. SUCCESS ISN'T JUST "FLAGS ON THE MAP"

"It is important to have a diverse and varied international portfolio"

- CEO, B2B 200 Firm

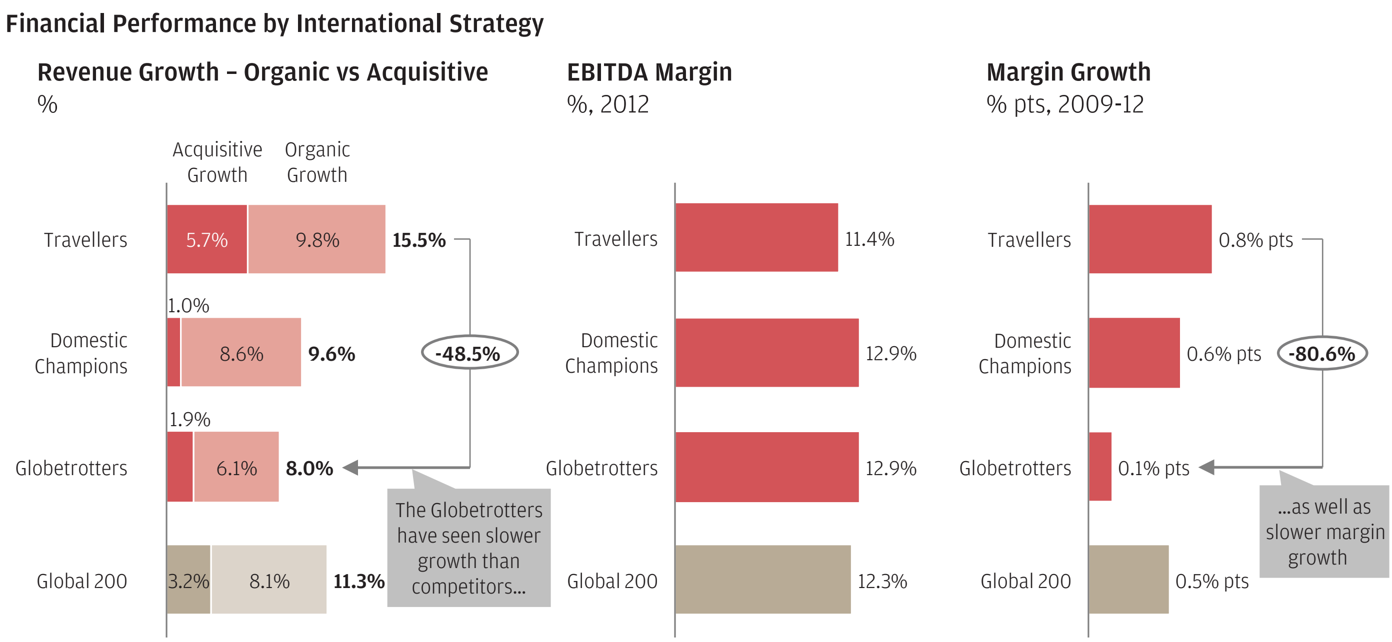
THERE IS A PRESSING NEED FOR SOME INTERNATIONALLY MATURE PLAYERS TO REFORM THEIR MODEL

There are a set of firms who historically have been international pioneers with the most mature international footprints, "The Globetrotters". This set accounts for 42% of firms within our B2B 200 and have at least 50% of their revenues outside of their home geography, as well as a presence in at least 2 continents.

Given the acceleration of international expansion, you might expect this group to be experiencing the strongest growth profile and benefiting from their early investment in international; this however is not the case and, despite robust fundamentals, the "The Globetrotters" have seen the slowest revenue growth (with particularly low organic returns) and the lowest margin growth versus B2B competitors.

Although some of the differences are quite small, "The Globetrotters" group also contains the highest proportion of firms who have experienced margin decline in the period (c.45% of all "Globetrotters") demonstrating that it is a high-risk approach, with high stakes.

EXHIBIT 6: PERFORMANCE BY LEVEL OF INTERNATIONAL DEVELOPMENT



Source: Mergermarket, BvD, OC&C analysis

These findings are consistent with our experiences with global B2B firms. Some of the international pioneers have adopted a scatter-gun international approach of generating "Flags on the Map" to maximise chances of success and drive credibility as a truly global brand. This approach, however, is missing a clear enough prioritisation of markets or selective enough deployment of resources to deliver success in many of those locations.

- Example: An IT services company, is struggling to maintain growth across its 70 geographies. Revenues have declined at c.5%pa since 2009, with international revenues down c.6% pa. It has recently divested operations in Italy, Australia and Malaysia in an attempt to consolidate its international footprint.

Although by no means uniform, some of these "Globetrotters" may need to rethink their strategies and adopt a more nuanced approach to international.

5. SELECTIVE INTERNATIONALISATION

"Time in market and local expertise is invaluable when entering a new market; we are almost blind to the risks and issues in each new market we want to operate in"

– Head of Finance, Major Global Services and Tech Firm

DEPTH IN COUNTRY, RATHER THAN BREADTH ACROSS MANY COUNTRIES, IS OFTEN PREFERABLE TO DELIVER ORGANIC SHARE GAIN

A myriad of options exist when determining international strategy from country choice, depth and breadth to the optimal operating model. All of these variables mean there is a lot of ambiguity facing CEOs and shareholders with a wealth of contradictory evidence to contend with.

The group who have most successful navigated these factors and performed best amongst our B2B 200 are "The Travellers". These are the 37% of businesses in the B2B 200 that have a strong domestic presence, but also have a meaningful international presence (>5% international revenue).

Whereas many "Globetrotters" have historically favoured breadth of countries over depth in country, "Travellers" tend to be more selective in international approach; the best firms within this group have undertaken a ruthless prioritisation to focus efforts on attractive markets.

Allied to market prioritisation is a well-considered management template to win in each country given that simple purchasing or manufacturing synergies, that may be achievable in analogous sectors, are less apparent in services markets.

Given all of the B2B 200 have significant scale, that alone is not sufficient to ensure long-term outperformance, therefore it is important for management to develop a winning formula based on intellectual property, supply chain infrastructure, customer intimacy and focused buy & build.

As a result winning in international requires time, investment and a tough skin. Based on these dynamics, depth in country is often the right trade-off vs breadth of markets to drive organic (and sustainable) share gain.

6. KEY LESSONS

"China is the scariest place on earth to try and get into. We need help on doing it"

– COO, Major US B2B Firm

IT IS INCREASINGLY IMPORTANT THAT CEOS AND SHAREHOLDERS HAVE A SHARP FOCUS ON THE ROLE OF INTERNATIONAL WITHIN WIDER CORPORATE STRATEGY

Having seen the evidence from our work on the B2B 200, we can now reflect on the Board-level questions that prompted this analysis, and suggest some possible answers.

❶ WHAT ROLE DOES INTERNATIONAL PLAY (IF AT ALL) IN MY WIDER FIRM STRATEGY?

It is first critical to **understand if international is suitable for your firm** as many firms have grown successfully without international.

- Example: Insperity operate in the relatively slow growth US Recruitment & HR market however achieved c.12%pa growth through investing resources in winning share in its home market through salesforce investment and marketing itself as the "local community champion".

If international is critical to your vision it is important to have **clarity on how it marries with the core domestic proposition**, what investment is required and what are your key strategic / financial objectives. This should be based on a long-term and value-creating strategic rationale, not escapism from domestic problems.

❷ WHAT IS THE RIGHT OVERARCHING APPROACH TO OPTIMISE VALUE?

The economic trade-offs of different international expansion routes should be top of mind when embarking on, or refining, an international strategy. It is important to be aligned to international objectives when determining the number of countries vs depth in country, expansion in home region vs new regions and the right entry model (eg. owned operations, JV etc).

Historically the "flags on the map" strategy has led to firms becoming thinly spread across a wide range of strategically and financially unimportant markets – greater focus is advised given the nuances of international markets in B2B services industries (ie, don't fly-in / fly-out, put good people on the ground, invest in relationships, accumulate local project examples etc).

- Example: Downer Group, an Australian infrastructure and mining group, have seen growth of c.26%pa through focusing on a narrow set of countries close to its home geography.

❸ WHICH COUNTRIES SHOULD I FOCUS ON GIVEN MY SUB-SECTOR AND PROPOSITION?

A ruthless prioritisation of markets with a compelling economic rationale for customers to buy is critical. Understanding which geographies are genuinely attractive in their own right, given your service type and proposition, as well as the strategic benefits of having them in your portfolio, is critical to a successful international strategy.

- Example: A prime example of selective geography choice is On Assignment. It is an HR solutions company, who has delivered c.45% revenue growth since 2009 through maintaining growth in its core US market whilst expanding in a short list of attractive Western European markets (UK, Ireland, Netherlands, Belgium, and Spain).

❹ WHAT IS THE DELIVERY MODEL AND MANAGEMENT TEMPLATE TO MAXIMISE RETURNS?

It is key to **define a management template that works in each country**; simply dragging and dropping your home proposition into new markets is unlikely to be successful. Don't be arrogant about how strong your proposition is, don't assume your experience elsewhere trumps local experience, don't assume that buyers' KPCs or market trends are universal – **adapt and refine**. Players also need to be prepared for each in-country business to evolve differently and think hard about where you will or will not allow the proposition to be adjusted.

- Example: Sodexo have adapted their western market private sector catering proposition to the Chinese market by providing workforce catering to state-owned enterprises of +5,000 people; they have also invested in a large and well trained local management team.

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