EDS: Exit or Turnaround?

Project paper

Economics of Competitive Strategy

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Executive summary

The objective of this report is to analyze the competitive strategy and positioning of Electronic Data Systems (EDS) in the IT services industry especially with respect to its fiercest competitor International Business Machines (IBM).

The IT services industry landscape is undergoing dramatic changes. The economic downturn has kicked off massive cost cutting initiatives across all industries. While IT outsourcing has been a recommended strategy during such times, the shrinking of overall IT spending has made the IT services industry extremely rivalrous. The competitive landscape is further threatened by the entry of new low cost off shore players. Given the relatively higher supply of service providers, buyer bargaining power has increased. The input supply providers do not have much bargaining power as they rely on the IT services providers to pass their products to the consuming organizations. While in-house IT is a substitute, it does not pose an immediate challenge. There are several complements that add value to IT services.

Our analysis of EDS's troubles show that not all of it can be attributed to the economic down turn. Key findings – EDS attempted to change too many things at the same time. Internally, EDS struggled to integrate AT Kearney even six years after the acquisition, and continued to suffer from organizational bureaucracy. Externally, EDS adopted an aggressive growth strategy chasing risky mega deals with thin margins. EDS's inability to transition from a legacy behemoth to a nimble and lean organization hurt it when recession and customer woes struck. While EDS floundered in its attempt to transition from legacy to client-server systems, and web based applications, IBM strengthened its position by rapidly establishing itself as an e-business solutions provider.

We present two options to the new CEO Michael Jordan: 1) Turn around via organizational transformation 2) Exit via sale to a strategic buyer.

We recommend that EDS should negotiate a sale with a strategic buyer.

Introduction

EDS is the second largest computer services and consulting company in the world after IBM. It has a strong reputation for managing complex technology and large projects. In recent years, EDS has performed poorly relative to its peers in the IT services market. This performance cannot be attributed to the weak economy alone; its choice of competitive strategy and certain critical business decisions have an important role to play. We examine EDS's business model in light of changes in the industry and in the competitive landscape. We conclude with specific recommendations on the product mix and competitive position that would enable EDS to mitigate existing problems and take the crown of "IT services leader" from IBM Global Services (IBM GS).

Market Definitions and Trends

Market Definition: Given the wide variety of activities clubbed under the "IT services" label, it is useful to clarify basic market definitions. For the purpose of this report we have used Gartner's Worldwide IT services market definitions. The following table summarizes the market segments and major players in the market. Indian companies are increasingly active in the professional services segment.

Table 1: IT Services Market Segmentation

Service Level 1	Service Level 2	Major players
Product Support	Hardware maintenance and support Software maintenance and support	IBM, Dell Services, HP, Sun IBM, Oracle, Sybase, Microsoft, all ERP / CRM / SCM vendors
Professional Services	Consulting	Deloitte, KPMG, Accenture, CG E&Y, EDS, IBM GS, Accenture, CSC
	Development and Integration	EDS, IBM, Accenture, CSC
	IT Management (includes Outsourcing)	EDS, IBM, Accenture
	Process management	EDS, IBM, Accenture

Trends: The IT services industry landscape has undergone a dramatic change in recent years.

> ➢ As corporations scaled back IT budgets, it became increasingly important for a firm to add business consulting capabilities to its portfolio. Business consulting

became practically essential as a preface to the design of IT solutions, to convince the client of the positive return on an investment in IT services. Thus, IBM has acquired PWC, and HP has acquired Compaq (the strongest player in NT and SQL servers), effectively adding the natural complement of consulting to the other IT services business.

➢ The economic slowdown has affected the mix of IT services clients demand. The demand for outsourcing has increased and the demand for new development and systems integration has declined. This trend is expected to last in the medium term (next five years). Also outsourcing contracts are expected to be longer, which will continue to result in back loading of payments, or discounts in the earlier years, while new development and systems integration contracts will be shorter and ROI based

➢ With increased client emphasis on cost reduction, price competition is fierce. An increasingly higher percentage of outsourcing contracts are being handled offshore. This is reflected in the spectacular results of Indian IT services companies (Wipro, Infosys, Tata Consultancy Services). e.g. Infosys posted Q4 2002 revenue increase of 45% with net margins of 26%, versus EDS (net margins of 6.5% on revenues down 5.1%)

➢ The client-server architecture gained acceptance as a cost effective alternate to legacy systems during the late 1980s, resulting in a decline of new development on legacy platforms.

➢ The emergence of the Internet has allowed firms to lower transaction costs by conducting a significant share of their business online. Developing / implementing e-business solutions is now a critical part of the IT services market

Six forces analysis

Input supply

Inputs for IT Services are hardware, software and human resources. The major hardware vendors are IBM, Sun and HP. Software vendors are Oracle, SAP, IBM and Microsoft. Employees of the firm comprise the human resources input. The bargaining power of vendors is low simply because IT service providers act as value added resellers (VARs) for input supplies. The VAR relationship is typically cemented with a formal pact, e.g.

EDS has agreements with Dell, Oracle and Microsoft among others. These agreements are not exclusive in nature. The fact that IBM is a hardware and software vendor does not impact its relationships with other IT services providers (who are competitors of IBM GS), since both parties gain by cooperating.

Customer bargaining power

Customer bargaining power is high, especially in the downturn when growth in new applications and projects is low. As a rule, significant exposure to a client due to large contracts lowers the service provider's bargaining power. To mitigate customer power, IT service providers typically rely on building close relationships and establishing a foothold. This often ensures that the incumbent provider helps frame the terms of the request for proposal for the subsequent phase, practically guaranteeing that it wins the contract and further cements the relationship.

Existing competition/ Rivalry

Despite high switching costs, this is a very rivalrous industry. Even more so now during the economic downturn, because outsourcing is generally considered a favored means to cut costs.

Substitutes

There are two alternatives to hiring an IT services firm:

1. Developing in house expertise, and
2. following an Application Service Provider (ASP) model

Developing in house expertise raises typical 'buy vs. build' trade offs. While the downturn in the economy favors out sourcing models, organizations that rely on IT to provide competitive advantage e.g. Dell and Citibank continue to retain the core information technology in house.

The ASP model has not proven robust and sustainable and can be discounted as a substitute.

Threat of new entrants

Since the US industry is suffering from low profitability and is undergoing consolidation, the threat of domestic new entrants is low. However, niche firms will make inroads in the small business market, remaining under the radar screen of large players. Given the success of offshore vendors and the inroads they are making in the US market, there is a

credible threat of new lower cost entrants who can chip away at the established base of US major providers.

<u>Complements</u>

IT services firms have witnessed a great amount of consolidation and the need to expand their product offering from niche areas to the entire spectrum of IT and business consulting services. In such an environment, any service that enhances the value of the core IT service will be considered a complement.

1) The addition of management consulting improves the value proposition for the client, who is willing to share his cost savings, resulting in higher profitability than for a stand-alone unit

2) Infrastructure for hosting capabilities: Since the ASP model is a substitute to IT outsourcing, a number of IT service providers are developing capabilities that will allow them to capture a share of the ASP market as well. These capabilities will allow IT service providers to promote the concept of 'one stop shop' for IT services.

3) Alliances with off shore companies or setting up offshore facilities provide the low cost advantage.

4) Preferred vendor and VAR agreements with ERP, SCM and CRM vendors serve as valuable complements.

Overall, the industry is not very attractive for a new entrant but well-positioned incumbents can earn reasonable profits, especially if they manage to use complements effectively.

EDS – Company Overview

EDS was founded in 1962 as a data processing and data management service provider. After a steady and successful run, EDS was acquired by GM in 1984. While this proposition provided EDS with steady streams of revenue, it did not last very long. In 1996 EDS was spun off as an independent publicly traded entity. However, GM retains a special client status with EDS under a formal agreement, and accounts for over 10% of EDS's revenues since 1996. This agreement ends in 2006.

Sensing the need for value-added services, EDS launched its management consulting practice in 1993. In 1995 it acquired A.T Kearney to boost its consulting expertise. EDS

also undertook major restructuring efforts in 1996 and 1999 in response to the changing business environment. The "elephant" reorganized its product offerings (lines of businesses) and its organization structure, transforming itself from an industry specific Strategic Business Unit structure to a matrix structure more in line with a traditional consulting organization.

EDS is currently organized into four divisions:

- ➢ Operations Solutions
- ➢ Solutions consulting
- ➢ Product Lifecycle Management
- ➢ Management Consulting (A.T. Kearney)

These address the entire spectrum of IT services. Traditionally, a big portion of EDS's revenues have come from large multi year, multi billion dollar 'outsourcing' contracts e.g the $17 Billion dollar deal with MCI-Worldcom signed in 1999 and the $7 Billion dollar, five year, contract with the US Navy signed in 2000.

Table 2 below shows three year revenues and operating income from each of these divisions. AT Kearney is included in "Other", and outsourcing operations are included in "Operations Solutions".

Table 2: EDS Financial Performance

Revenues	% of total	2002 $ mn		2001 $ mn		2000 $ mn
Operations Solutions	67	14,372	66%	13,962	64%	12,037
Solutions Consulting	27	5,817	28%	6,015	27%	5,185
Product lifecycle management	4	879	4%	759	3%	524
Other	2	434	2%	405	6%	1,110
Total	100	21,502		21,141		18,856
Operating Income	Margins	2002 $ mn	Margins	2001 $ mn	Margins	2000 $ mn
Operations Solutions	11.57%	1,663	14.75%	2,059	15.64%	1,882
Solutions Consulting	18.24%	1,061	20.27%	1,219	19.52%	1,012
Product lifecycle management	15.70%	138	13.70%	104	15.27%	80
Other	-228.80%	-993	-298.02%	-1,207	-106.58%	-1,183
Total	8.69%	1,869	10.29%	2,175	9.50%	1,791

Despite the importance of outsourcing to EDS, operating margins of this segment have been declining. This may at least partially be attributed to key contracts that ran into problems (WorldCom, US Navy). However, there are other factors that contribute to EDS's current problems.

Weaknesses

> EDS's cost-structure has become uncompetitive in the face of new competition in outsourcing, its largest revenue segment, leading to lack of new wins.

> EDS is exposed to client concentration risk, since the three top customers -GM, WorldCom and the US Navy - alone accounted for over 25% of revenues.

> EDS has also been unsuccessful in integrating AT Kearney into its operations. The stated goal was that each dollar of consulting revenue would bring in five dollars of outsourcing and systems integration revenue. This has not been realized. To complicate matters further, there are organization design and incentive structure problems with AT Kearney. AT Kearney has a very different culture from the rest of the company, it also did not co-operate fully with other divisions to realize operating synergies

Competitive Landscape

IBM GS, Accenture and Computer Sciences Corporation comprise the direct competitive set of EDS.

Table 3: Competitive Set Performance 2002

Key Numbers				
	EDS	**Accenture**	**Computer Sciences**	**IBM Global Services1**
Annual Sales ($mil.)	21,502.0	13,105.0	11,426.0	36,360.0
Gross Profit Margin	24.19%	36.46%	19.91%	26.3%
Net Profit Margin	5.19%	3.07%	3.69%	n/a

IBM GS is the closest and fiercest competitor of EDS. IBM GS is composed of the following divisions:

- Strategic Outsourcing Services (SO).

- Business Consulting Services (BCS)
- Integrated Technology Services (ITS)

The following table summarizes how these divisions map into EDS's divisions:

Table 4: EDS vs. IBM

EDS	IBM
Operations solutions ➤ IT outsourcing ➤ Systems management	SO ITS
Solutions Consulting ➤ BPO ➤ Information Solutions ➤ E-solutions ➤ Systems integration	BCS
PLM	(not significant)
ATK	BCS

While EDS's revenues increased only marginally in 2002, IBM GS experienced a 4% increase in revenues, driven by the acquisition of PwC on October 1, 2002 and growth in the SO business.
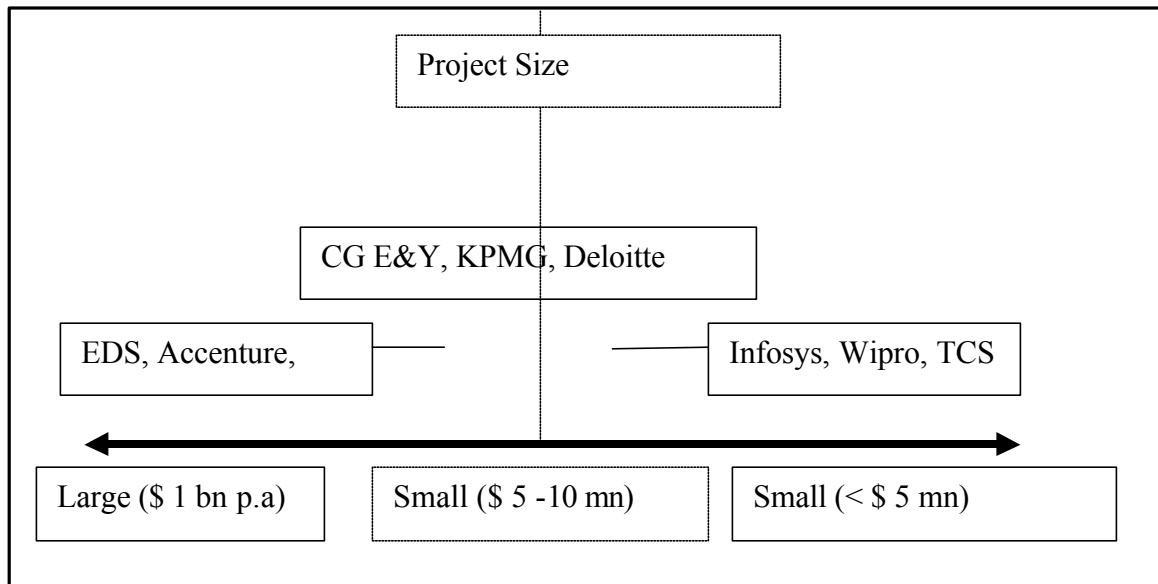
Differentiation

In addition to IBM GS, the Big Four firms also compete in the same space but on mid-size projects. Indian IT firms are making their presence felt in smaller projects and pose a very real threat to EDS since clients rate them as providing the highest value. There are two primary means of differentiation:

> Range of services offered (applications development, systems integration, business process outsourcing)
> Verticals addressed (i.e. industry expertise offered)

In theory, all players offer the full spectrum of services. Therefore there is little differentiation between the service providers in terms of range of services. In practice, however, project size serves as a differentiation variable, since few firms have the resources to handle mega deals.

The hoteling line diagram below represents the differentiation with respect to project size.
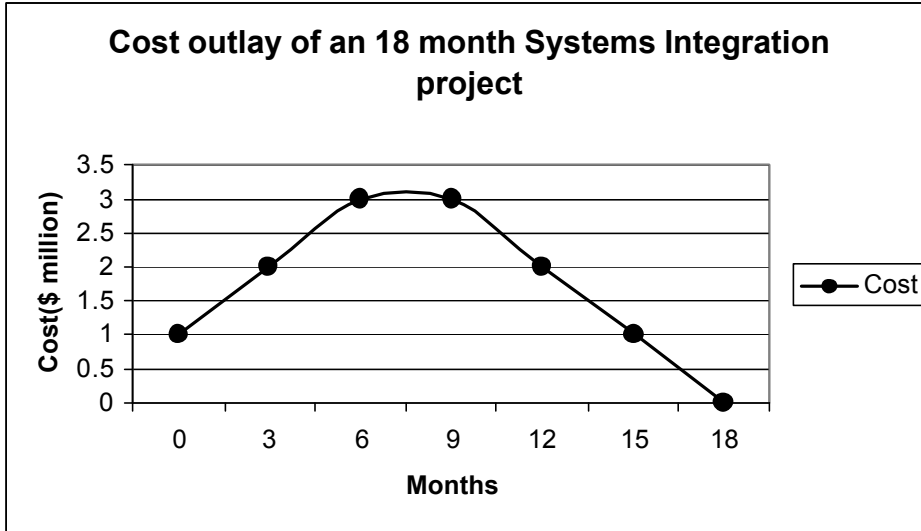
Exhibit 1: Hoteling line

Project Life Cycle

Different service offerings have different fixed and variable cost structures, impacting contribution margins and profitability.
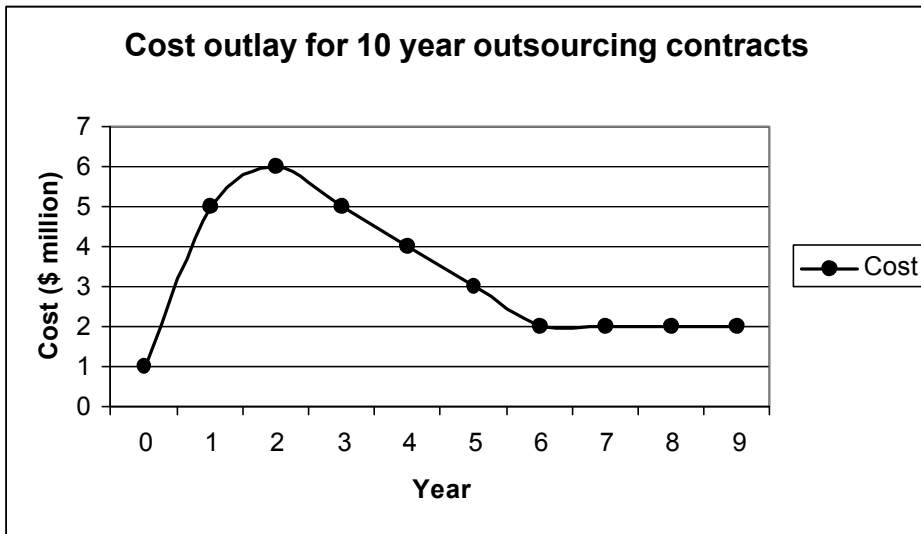
Service providers incur high upfront costs in long term outsourcing deals, thus they need to have deep pockets to handle these cash outflows. A continuous inflow of such contracts smoothens the cash requirements and earnings on a long term basis. The upside of these large contracts is the long-term lock-ins. The down side is that a few large customers are responsible for majority of the revenue stream – exposing the service provider to risks of the client's industry and competitive environment. In contrast, systems integration projects have shorter life cycles and lower upfront costs. (Exhibit 2)

Exhibit 2: Project Life Cycle

1) Time vs. costs of integration/ implementation projects (average duration 18 months)

Cost outlay of an 18 month Systems Integration project

2) Time vs. cost of outsourcing projects (average duration, 10 years)

Cost outlay for 10 year outsourcing contracts

Issues

The preceding analysis has determined that EDS needs to effectively address the following issues if it hopes to be a market leader:

1) Delay in responding to the demand for e-business solutions.
2) Problems with integrating A.T Kearney even eight years after the acquisition
3) Continued reliance on mega deals that aggravates its cash flow problems.

4) High fixed costs that do not allow it to undertake smaller projects.

5) Lack of success at exploiting it's off shore facilities in India.

6) Customer concentration risk

Options and Implications

EDS's current problems combined with the strength of its customer portfolio and the talent pool it employs, make it a prime acquisition candidate for a firm that is able to derive synergies. EDS management has two options at this stage:

➢ **Sell to a strategic buyer**. Microsoft has been mentioned as a potential acquirer since it has the financial muscle and is looking to grow beyond the Windows / Office franchise, which is forecast to have stagnant revenues. Acquiring EDS provides Microsoft with the enterprise –level consulting and services capability that it needs in order to compete with IBM. Microsoft's aggressive marketing and excellent project management skills will boost both revenues and margins for EDS. Being an outsider, Microsoft might be better able to implement the cost rationalization initiatives necessary to make EDS competitive. Also, Microsoft has developed a high degree of skill in attacking and dominating a category that might have initially escaped its attention (witness the outcome of the browser wars with Netscape), which will ensure that EDS does not pass up an opportunity like e-business solutions in future. Given the dynamics of the industry, a war of attrition is unlikely to occur if Microsoft acquires EDS

➢ **Implement changes that enable EDS to respond to its current challenges**.
   - ○ **Integrate A.T. Kearney**. We recommend that AT Kearney should be disbanded and its consultants be reassigned to industry verticals. This will improve internal communication and provide incentives for cooperation that are lacking now. EDS needs strong management consulting skills to compete with the new IBM and HP.
   - ○ **Add quick cash flow projects** – To reduce customer concentration risk, EDS first needs to lower costs (personnel and other administrative) so that it is able to handle smaller projects cost-effectively. It can then target smaller deals ($ 10 mn size) that will help diversify its portfolio and add quick cash flows

- o **Off-source (offshore outsourcing)** - Increase emphasis on offshore development by ramping up facilities in India, and other lower-cost geographical locations.

Conclusion

Since EDS is fundamentally still a profitable company, the choice between the two options boils down to a judgment of whether an outsider will be better able than incumbent management to implement cost-reductions and re-orient the company to scan opportunities.

Given EDS's lack of success in implementing major changes in the recent past, we believe there is value in negotiating a strategic sale. The new leadership will be unencumbered by EDS's past and will be able to take the steps necessary to revitalize the company.

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