MARKET NOTE

HCL Investing in Software to Achieve Non-Linear Growth

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EXECUTIVE SNAPSHOT

FIGURE 1

Executive Snapshot: HCL Acquires Software from IBM to Achieve Non-Linear Growth

HCL is acquiring seven software products from IBM for about $1.8 billion — Lotus Notes and Domino, Unica, Connections, Commerce, Portal, and security products AppScan and BigFix — that have approximately 5,000 long-time customers. Also, a number of IBM's software engineers as well as sales and marketing people related to the acquisition will join HCL. The latter expects direct revenue of $650 million per year from year 2, and it also expects to grow service delivery around the software. This acquisition fits into the company's "mode 3" element of the strategy, which aims to create a business based on IP, software, and ecosystem. This business was started three years ago and already has yearly revenue of $1 billion.

Key Takeaways

- This acquisition of well-established products, some of which are considered legacy, makes sense only because of their large and loyal customer base. For many, these products would be difficult to replace, and with launches of new releases from HCL, customers are likely to remain loyal. This is an interesting opportunity for HCL to provide good support and upgrade services around the software.
- The large customer base is equally interesting in creating up- and cross-sell opportunities for HCL, which has strong capabilities in automation, infrastructure, and application modernization and cloud. As an incumbent, it is much easier for HCL to target these clients with new offerings.
- The software clearly needs modernizing. HCL has already acquired some of the skills, and it has acquired R&D skills from software vendors. It has already launched new releases of Lotus and Unica. However, it will require continued investments to succeed, and despite having the resources, HCL's experience as a software provider in a highly competitive market is limited — it will meet new and fierce competitors even if it largely focuses on the existing customer base as a start .
- The success of this acquisition relies on convincing the relevant IBM people to join HCL and stay. HCL is making this a key priority and will go far to make the IBMers feel welcome and at ease in HCL. Its "employee first" culture may help it here — it has experience in integrating transferred staff from outsourcing contracts, but these are new people with different aspirations and expectations.
- Execution is critical — this acquisition could be a game-changer for HCL, propelling it to the software world with high margins (which is the purpose of the deal), but it also has big risks. Given the size of the deal with cash spending close to 20% of the company's annual revenue, it must keep the eye on the ball and work hard to keep both staff and clients happy. It will also have to set aside resources to continue investing in its traditional business.

Source: IDC, 2018

IN THIS MARKET NOTE

This IDC Market Note examines HCL's $1,775 million software acquisitions from IBM announced in early December 2018.

The acquisition includes seven software packages:

- **AppScan**, a security-focused application for identifying and managing vulnerabilities in mission-critical applications
- **BigFix**, an endpoint management and security software
- **Notes and Domino** collaborative client/server software platforms
- **Unica**, a cloud-based enterprise marketing automation software
- **WebSphere Commerce**, an omni-channel commerce platform for business-to-consumer (B2C) and business-to-business (B2B) organizations
- **WebSphere Portal**, a platform for developing enterprise web portals to help businesses deliver highly personalized social experience to clients
- **Connections**, a platform for integrating email, activity and task management, instant messaging, and file and document sharing

The acquisition is expected to be completed mid-2019 and is subject to regulatory approval. The acquisition is financed by cash accrued in HCL – 48% at the signing of the contract, the remaining one year after the contract, and HCL expects to finance $300 million through debt.

These acquisitions are expected to generate additional $625 million revenue the first year and $650 million in the following years. Together, the packages have 5,000 unique clients across the globe. HCL says "five of the packages" address double-digit growth markets and the total addressable market is $50 billion.

The deal includes transfer of product engineers, product managers, as well as sales and marketing staff from IBM. The extent of this transfer, which will be critical to success will be revealed when the acquisition is completed.

The announcement has had a mixed, mainly negative reception, primarily because of a perceived mismatch between the revenue expectation and the price. While HCL's share price declined by just over 7% in the first 24 hours after the announcement, it has since gone up again somewhat. IBM's share price was also negatively affected but to a much lower extent. However, we believe that if it is well-executed, the deal has strong potential for HCL.

IDC'S POINT OF VIEW

IDC believes this deal has several severe risk factors but also has the potential to be a game changer for HCL.

HCL Strategy: Background

HCL describes its strategy in three modes:

- **Mode 1**. Legacy services and legacy modernization, including large-scale outsourcing, application modernization, and automation.
- **Mode 2**. Services related to new platforms such as cloud, artificial intelligence, Internet of Things (IoT), and customer experience (CX). Project-oriented services are the largest part of mode 2, but digital managed services are included.

- **Mode 3**. New business models based on partnerships and IP.

The software acquisitions fit into mode 3 but will also impact growth on modes 1 and 2 as HCL's purpose is to also use the software together with modes 1 and 2 services.

Since this strategy was launched three years ago, HCL has already invested $1.2 billion in IP partnerships with CSC/DXC and IBM. The partnership with DXC involved HCL taking over its banking software and modernizing it, while DXC kept the main sales responsibility.

The IP partnership with IBM started in the autumn of 2016 around WebSphere, and certain security elements and was extended in 2017 to include Notes and Domino, so HCL already has detailed operational experience for five of the seven applications involved in this deal.

CEO C. Vijayakumar said in interviews related to the acquisition that mode 3 generates revenue at an annual run rate of $1 billion before this acquisition. HCL says the packages fit nicely into HCL's strategic focus on security, collaboration, and CX.

The Software Packages

From an analyst perspective, this deal has the feel of a "fire sale" of various aging software products that IBM no longer believes are core to its business. Notes and Domino are legacy email and collaboration applications, even if Domino's low-code/no-code capabilities is in the "new" space and IBM Connections is an enterprise social networks (ESN) solution. These are both in the collaborative applications category as far as IDC's software taxonomy is concerned. WebSphere Portal is a content management product, Unica is a marketing application, WebSphere Commerce is a digital commerce product, and so on.

Many of these products are part of the Smarter Commerce software suite that at its height (in 2012) comprised 51 "integrated" products with an annual software revenue of $20 billion. Ironically, Smarter Commerce was the brainchild of current IBM CEO Ginni Rometty, who must have sanctioned its final demise.

Unica was the central hub of the Smarter Commerce marketing proposition and enjoyed a strong position in large banks and telcos as a secure, on-premise scalable marketing campaign management engine. A cloud version was added in 2016, but by then, Unica had already lost much of its competitive edge. From a marketing applications perspective, IBM appears to have retained Silverpop (now branded Watson Marketing) as its preferred marketing cloud solution and dispensed with Unica, which was mainly on-premise.

There is nothing much wrong with the software products that IBM is divesting — nevertheless, a key question for IDC is why HCL has an interest in acquiring these products. In an acquisition briefing, HCL explained that the products are mostly positioned in fast-growing markets, and IBM has a reputation for well-built robust products. With a little polishing as well as improved marketing and positioning (as Lenovo did with IBM's PC division), it could prove to be much more than a legacy client base purchase.

HCL's mode 3 software strategy includes both stable and tested and therefore low-risk products and digital, "sexy," exciting products such as its homegrown DRYiCE enterprise integration and automation platform. HCL finds that a balanced approach of not going for high-risk start-up acquisitions is best aligned with its strategy. These solid well-established products with loyal customers provide an interesting growth market opportunity when the products are innovated.

Through the two-year IP-partnerships with IBM, HCL has gained experience with the software and has, for instance, issued new releases of both Notes (the first release for five years) and Unica (the first release for three years) to the great joy of the customers, according to HCL. Thus, the company has a clear understanding of what it will take to modernize the software packages to make them even more attractive and competitive in the market. HCL is aware this is not a one-off investment, and it is already launching road maps that it discusses with customers.

Is HCL Ready to Be a Software Provider?

Changing from being a services provider to a software provider is not a small step. HCL already has software experience, but this acquisition roughly doubles its software revenue (there are non-software parts in the $1 billion mode 3 revenue). HCL also has deep product engineering and R&D services expertise, creating its own revenue of over $1 billion. This includes developing and maintaining consumer-grade applications on behalf of global software firms.

Even though its product capabilities and willingness to invest in innovation is there, managing software products is a different story from having assets as a service provider, even if these assets are industrialized and standardized.

It is obvious that HCL's business case largely builds on an integrated software and service proposition and by HCL taking it to market by itself. The transfer of sales and marketing people will help it do so – we understand that some have transferred already together with the IP partnership. However, HCL must ensure IBM's staff are interested in this transition – HCL says it will go a long way to accommodate their wishes and will make the division a software company operating like a software company, not a services company with software incentives. IDC will be very interested to see how IBMers adapt to the culture at HCL embodied in its "employee first" management approach (Harvard Business School wrote a case about this in 2007). Suffice to say the culture will feel very different, and while it may not be a good fit for everyone, IDC predicts the majority of IBMers who transition to HCL will stay.

Next, some of these packages need – like most software – a channel, and IBM has sold it through channel partners. HCL plans to simply take over IBM's distribution network and resign deals with IBM's partners. However, maintaining a channel relationship is not just about a contract – it takes a lot more "love" and investment. We wonder – will HCL be able to and want to assign sufficient resources for that? HCL says it is used to working in partnerships and has it as a priority, but HCL's experience with partnerships from a systems integrator perspective is quite different.

Furthermore, with Unica, HCL enters into direct competition with other key partners such as Salesforce and Oracle. Is it prepared for that? For most products, HCL will target the existing client base and only look to win new logos in selected areas, for instance the AppScan security-as-a-service solution. Going for broader competition will mainly be considered when the products have been modernized and the existing client relationships satisfied. HCL claims there is a lot of opportunity for growth there. It is not looking to challenge Salesforce and Oracle – it will stay in its well-established niche at least for a while, and it claims that large vendors have so many different activities that they compete in some and collaborate in others, so potential software competition will not impact collaboration in other business units in HCL.

Will HCL be able to pull it off? It is definitely not starting from scratch, and its product knowledge is a key risk-mitigating factor, as is the staff takeover from IBM and the already established client relationships, and on top of that is HCL's software engineering services experience. This at least creates the basis for a stable business.

Getting Access to New Clients

However, there is a different and very interesting element to this acquisition – the client base. HCL has a limited number of clients. Its strategy has been based on winning large deals, such as Volvo IT and with Barclays last month, and it has been good at it. Still, that leaves HCL with relatively few customers.

This is interesting because HCL may be able to justify the business of writing tactical tuck-ins for these newly acquired software assets in a way IBM could not, thus delighting its customers.

For instance, Unica gives it access to 600 large clients, and the total deal brings 5,000 potentially attractive client relationships. There will be some overlaps, but HCL doesn't have 5,000 clients. Providing these clients with good service for their now HCL-owned software provides a tremendous up- and cross-sell opportunity for HCL. This could bring value in the form of mode 1 and mode 2 services with the same value as the services directly related to the software or even more.

While difficult to quantify in a business case, we expect that a lot of the success of the acquisition hangs on this – even if the software business taken over will see slow or no growth, the role as incumbent for critical applications in large enterprises is worth paying for. Automation, modernization, and digital transformation are key activities that HCL has been good at selling to existing clients, so even if this was just about buying the customer base – which it isn't – it could be worthwhile.

Conclusion

In summary, this looks like a good (and compared with other software deals, cheap) deal for HCL considering the depth and quality of the assets it acquires. The deal gives it an immediate large enterprise software presence, which is very hard to acquire organically. Services and maintenance cashflow revenues will be welcome, and add-on and upgrade services opportunities should be plentiful in the short to medium term. Whether HCL can hang onto these customers in the longer term is open to conjecture due to the highly competitive nature of the software market with which it is about to become acquainted. But there is hope if you consider the longevity of some software and the customers that use it – Notes was created by Lotus Development Corporation in 1989.

However, creating success will not be easy. This will require very strong execution skills, there will be no room for failure and no patience from clients while HCL is learning, even if the clients are happy that innovation is coming to well-established products. It is a very big acquisition for HCL, and it will tie up its resources both in terms of strategy, management power, people, and finances for years to come while adapting to the new reality and continuing to renew its "traditional" mode 1 and 2 business to keep it growing. This is bread and butter, but not a business that runs itself. HCL has a tradition of taking big bites, making it work by throwing resources at any problem and then gradually standardizing and industrializing the approach. This will not work in software. It's a big and bold move, and the future of HCL will be made by how this plays out. It will be very interesting to follow the development.

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Synopsis

This IDC Market Note analyzes HCL's acquisition of seven software packages from IBM. While this $1.8 billion deal carries big risk for HCL, it also has strong potential to take the company to a whole new level. This document examines the deal's risk and potential.

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