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EXECUTIVE SUMMARY

HiSoft Technology International Limited is a leading China-based provider of outsourced information technology (IT), research and development services, and business process outsourcing services. It is particularly focused on the Software, Hardware, Telecom, Financial Services, Pharmaceutical and Manufacturing industries. The company’s dual-shore delivery model has enabled it to serve both domestic clients and international clients in North America, Europe, and Asia.

While the Chinese IT outsourcing industry is at its infant stage and faces intense competition from the Indian IT industry, the Chinese government has taken constructive steps to support the growth and consolidation of this sector as a source of “Green GDP”. HiSoft is well positioned to emerge as a market leader through mergers and acquisitions and continue its high growth. The company faces the challenge of strong buyer power in the market and must establish a diversified, long-term client base in order to continue its success into the future.
PART I
INTRODUCTION
COMPANY OVERVIEW

Company History

HiSoft was founded in November 1996 as Haihui Dalian. In August 2002, Haihui Dalian established Haihui Sci-Tech Japan Co., Ltd., which was later renamed HiSoft Japan, in Tokyo, Japan as a wholly owned subsidiary by HiSoft. In September 2003, Haihui Dalian established DMK International, in Delaware as a wholly owned subsidiary. In an effort to raise equity capital from investors outside of China, HiSoft Technology International Limited was established as a Cayman Islands holding company in May 2004.


In December 2007, HiSoft acquired Test Pte Ltd, or Test, a Singapore-based research and development services provider. In December 2007, HiSoft acquired Daemoyrod, an Oracle application software implementation and support specialist with operations in the United States and Mexico.

In January 2009, HiSoft established Wuxi HiSoft, and, in December 2009, it established Wuxi Training Centre through Wuxi HiSoft. Also in August 2009, HiSoft acquired a business process support team from AIA.

In February 2010, HiSoft acquired Horizon Information, an IT testing company based in China. In April 2010, HiSoft acquired Echo Lane, a consulting services firm in the U.S. with expertise in cloud computing. In July 2010, HiSoft acquired Insurance Systems Laboratory CO., a Japan-based IT consulting firm specializing in IT systems for insurance companies. This is an aggressive push into the Japan insurance market for a major China-based IT outsourcing company.

In October 2010, HiSoft acquired Besure, a China-based IT services firm specializing in SAP consulting and implementation services. The acquisition allows HiSoft to expand its delivery capabilities and capture opportunities in China's growing enterprise application market. In December 2010, HiSoft formed a strategic partnership with Open Text Corporation ("Open Text"), a global leader in Enterprise Content Management (ECM), to support Web Content Management (WCM) global customers. Not only is merger and acquisition a quick way to gain market share, it also allows HiSoft to expand its service line and become more competitive in the global market.

**Business Model**

As one of the top five IT service providers in China, HiSoft has more than 5,000 employees and is managed by a professional management team with 20-year experiences in global IT companies. HiSoft provides two service lines: the first one is IT services that include application development, testing, and maintenance services for custom applications, as well as implementation and support services for packaged software. The second one is research and development services, which comprise software and hardware testing, as well as software globalization services. HiSoft provides its services to leading global companies through a combination of onshore and offshore delivery capabilities. It has eight delivery centers among which
seven are in China, located in the cities of Beijing, Chengdu, Dalian, Guangzhou, Shanghai, Shenzhen and Wuxi, and one in Singapore.

HiSoft’s business model is about acquiring foreign and domestic businesses, establishing local divisions in geographic locations where client sites are located, and combining these with its delivery capability in China. Its global coverage in China, Japan, and the United States allows it to gain international experience and stride upstream of the industry value chain quickly.

**Market Overview And Trends**

The Chinese IT outsourcing industry experienced significant growth in the past decade. This is mainly driven by three factors: strong government support with favorable policies and stimulus packages, increasing global demand and rising demand from domestic companies. Even during the global financial downturn, the industry still saw a growth rate of more than 20%. Nevertheless, IT exporting only accounted for about 3% of China’s total export revenue in 2008. China’s IT outsourcing industry is still at its infancy, with roughly 8000 small to middle sized players taking up over 60% of the total market, and the bigger players having market share of about 5% each. The industry is expected to continue its rapid growth over the next few years, and its market leaders have attracted a lot of investors.

As one of the market leaders in the industry with a market share of about 6%, HiSoft went public on June 30, 2010, initial price was $10, which increased over time and stands around $20 now. HiSoft is traded on the NASDAQ global market with Ticker HSFT, with a market cap of 837.90M.

Historically, due to their limited capacity and experience, Chinese IT outsourcing companies mainly provided low value added services such as localization and software testing. Moreover, due to the cultural and language barriers, most IT outsourcing companies relied on domestic demand or nearby oversea markets such as Japan and Korea for their growth. As the industry grows and the companies gain more experience, some of the major firms in the industries have started to move up the value chain and offer more critical services such as research and development. HiSoft is one of the leaders among this group.
With intensified competition, smaller players in the market are being absorbed by larger ones through a series of acquisitions. More consolidations are expected over the next few years. Under this trend, HiSoft has adopted an aggressive expansion strategy to acquire other companies, both domestically and internationally.
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COMPETITIVE ANALYSIS

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<td>Supplier Power</td>
<td>Medium</td>
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<tr>
<td>Substitutes and Complements</td>
<td>Low</td>
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**Internal Rivalry**

HiSoft faces intense competition from both domestic and international providers of outsourced technology services. Internationally, HiSoft generates over 80% of its revenue from clients abroad, which are mostly multi-national corporations. It is directly competing with other international IT service providers, especially those from India. As companies tap into China’s rapid growth through new product introductions or by directly building a China-based ecosystem, local IT providers are the natural choice. The low labor cost and extensive experience of doing business in China make HiSoft appealing to many international companies interested in the Chinese market. However, HiSoft lacks the scale to take over large projects with higher margins. Scale is very important in the IT outsourcing business, because many projects are very labor-intensive. In this sense, although HiSoft has been expanding rapidly through acquisitions, it is still disadvantaged against its Indian counterparts, who benefit from large economies of scale. Luckily for HiSoft, there has been a trend of rising wage in Indian, leading many multi-national corporations to turn to China for IT service providers. Moreover, some international companies pursue diversification of IT service providers as a strategy to maintain buyer power. Therefore, the demand for Chinese IT outsourcing service is expected to rise in the next five to ten years, creating ample opportunities for HiSoft.

Domestically, HiSoft’s main competitors are other large domestic IT providers such as Neusoft, Insigma, Vanceinfo. HiSoft competes with them for both domestic clients and international clients. Complex tax and investment incentive systems across different provinces have encouraged
companies to establish separate entities in each location. Highly controlled financial systems and regulation of ownership structures discouraging industry consolidation has resulted in a highly fragmented industry base. Under this condition, none of the bigger firms have an advantage in market share at this stage. Moreover, due to their small scale, it is not uncommon to see a multinational firm hiring more than one local IT service provider at the same time. For example, Microsoft hired VanceInfo for its online products and HiSoft for its mobile products. Although this trend reduces the degree of competition among domestic IT providers, it also makes it hard for companies like hiSoft to take on higher-margin projects. Therefore, the domestic competition is about cutting cost and expanding capacity. The company that gains enough scale first will have tremendous advantage over the others.

**Barriers To Entry/Exit**

The barriers to entry/exit are moderate in this industry. Firms wishing to enter this market have to overcome the technical, legal, regulatory, economic, and culture barriers. The labor-intensive nature of this industry determined that the small companies will not be capable of taking up multi-billion contracts, and those contracts are typically more profitable. Sometimes it takes a joint project of several Chinese companies to compete with one Indian company. Therefore, it is hard for small companies to enter and compete with larger ones.

Given the nature of the business, client interaction and accurate communication is essential. Although more Chinese people are learning English now, companies like hiSoft still find it hard to find qualified English speakers. Language barrier needs to be removed before the Chinese IT service providers and effectively compete in the international market.

Learning by doing is another barrier. When deciding where to outsource to, decision makers take a long list of criteria into consideration. These include language, the labor pool, infrastructure, education and training facilities, cost, and political and economic environment, government support, cultural compatibility, global and legal maturity, and data and intellectual property security and privacy. Among those factors, business domain
knowledge is becoming more important because large enterprises increasing look to outsourcing vendors as valuable partners who understand their market.

As the incumbents gain more experience and build relationships with the major clients and established their brand name. It is hard for new comers to catch up in a short period of time.

Buyer Power

Given the uncertainty nature of the business, buyers usually prefer flexible contract terms, which put them in better positions to handle unexpected changes in business needs in the current economic climate. According to a report by KPMG, approximately 76% of outsourcing contracts in 2008 represented new deals, with the remainder comprised of contract renewals, extensions, and expansions. Moreover, the large number of outsourcing IT service providers give the buyers considerable room to shop around and pick the best deal. Therefore, buyers (usually multinational corporations) have strong buyer power in the market. It is important for IT companies to maintain good and durable relationships with their clients.

HiSoft relies heavily on its major customers. This had led its stock price to plunge because investors are concerned about this fact. HiSoft had to cut its 2010 earnings forecast by 17 to 19 percent because it discovered that one of its major clients is facing cash flow issues and decided to provide a 3.5 million dollar bad debt provision because it was not sure if or when the customer would pay the money it owes. This shows how dependent HiSoft is on its major clients. A lot of the contracts HiSoft signed with its clients are short term and are not subject to automatic renewal. Those contracts are also subject to termination without prior notice or penalty to the clients. Therefore, the success of HiSoft’s business is heavily dependent on its client’s success.

Supplier Power

The supplier power in this industry is moderate. The most important input for HiSoft is highly educated labor. The success of HiSoft’s business is significantly dependent on its ability to attract and retain highly skilled
professionals. Although China produces numerous graduates every year (according to data from Ministry of Labor and Social Security, the number of college graduates was more than 4.9 million in 2007) and has achieved progress in reforming its higher education sector, problems still remain, especially in its curriculum design and teaching methodology. A gap exists between what is taught in universities and what the market requires. In the Chinese labor market, there is significant competition for professionals who are qualified to act as senior engineers or managers for IT research and development projects.

This burdens employers with extra training costs. A survey done by Accenture showed that employee training absorbs from 5 percent to 20 percent of their total operating costs.

Moreover, the Chinese IT outsourcing industry has experienced significant levels of employee attrition. The attrition rate among hiSoft’s employees who have worked for at least six months were 18.4%, 18.8% and 13.8% for 2007, 2008 and 2009, respectively. Due to the cost of hiring and training new professionals, high attrition rates can negatively affect hiSoft’s cost of revenues and net income.

As one of the top ten players in the Chinese IT outsourcing industry, HiSoft takes advantage of its presence in the second tier countries in China and recruits highly educated computer science engineers at a relatively low wage. However, hiSoft may face increasing supplier power in the form of higher wages and lower supply. It may also have difficulties recruiting the talent for its outsourcing facilities in less developed cities in China with lower average wages and living standards.

Substitutes And Complements

The IT outsourcing industry was born as a substitute for the traditional in-house IT service. The process started with the increasingly high Internet speed and available technology that made it cheaper to do some of the work offshore. Therefore, the substitute power for this industry is low. As more global corporations seek to cut costs under the economic pressure, the demand for IT service outsourcing is expected to rise. Companies are even expected to outsource more value-added work to China and India. On the
other hand, increasing technology level will serve as a complement for IT outsourcing. The continuing development of technology is expected to aggravate the demand of IT offshoring.

**FINANCIAL ANALYSIS**

*Overview*

On June 30, 2010, hiSoft went public on NASDAQ, raising $66.4 million USD. In their first year as a publicly traded company, HiSoft exhibited impressive growth in net revenues and gross profit, as would be expected of a firm in this early a stage of their development, net revenue for FY 2010 grew 60.3% year-over-year to $146.6 million. This number was roughly inline with 2Q and 3Q estimates. The firm predicts that net revenue will grow by 35% to $198 million USD for FY 2011.

The vast majority of the firm’s revenue comes from foreign-based firms, specifically US, European, and Japanese firms. However, much of the growth in revenue came from very rapid expansion of the number of Chinese firms who were hiring HiSoft. Fifty-seven percent of HiSoft’s outstanding shares are held by institutional investors. This includes an almost 10% stake held by Fidelity Management and Research Co.

As can be seen below, revenues grew YoY in all of the geographical regions, but the growth in the US/Europe and Japanese markets paled in comparison to that of the domestic market.
This trend continued into the 4Q of 2010, with the share of revenues coming from the US/Europe falling to 59.3% of net revenues and the share of revenues coming from the Greater China region growing to 12.8%. Further, if one looks at the percentage of company’s revenue based on the geographic location of the contract signing entity, the Greater China region made up 35.1% of the companies 4Q2010 net revenues. This shows that while many of their clients have headquarters based in US/Europe or Japan, they also have a physical presence in China.

### Percentage of Revenue Contribution by Client

<table>
<thead>
<tr>
<th></th>
<th>2Q09</th>
<th>3Q09</th>
<th>4Q09</th>
<th>2Q10</th>
<th>3Q10</th>
<th>4Q10</th>
</tr>
</thead>
<tbody>
<tr>
<td>Top Client</td>
<td>15.30%</td>
<td>13.70%</td>
<td>12.60%</td>
<td>13.90%</td>
<td>12.40%</td>
<td>10.90%</td>
</tr>
<tr>
<td>Top 5 Clients</td>
<td>44.50%</td>
<td>45.30%</td>
<td>44.60%</td>
<td>44.80%</td>
<td>39.80%</td>
<td>38.20%</td>
</tr>
</tbody>
</table>

HiSoft’s relatively small client base presents potential risks for the company. In 2010, the number of clients that HiSoft had who contributed more than $1 million USD grew from 21 to 27. Further, 12 of these clients paid more than $3 million USD to HiSoft in 2010. As HiSoft attracts more clients, the share of revenue accounted for by the top client and top 5 clients has fallen.
consistently. If they can continue this trend of having a growing client base, they will reduce the amount of buyer power their larger clients have.

HiSoft’s 4Q 2010 financial results were marred by a bad debt provision for a single client. The client in question experienced cash flow issues, creating a credit risk for HiSoft. Given the uncertainty of the collection of this debt, HiSoft provided a bad debt provision of $3.5 million USD, which translates to approximately $0.15 USD per ADS. As a result, the company had to adjust its 2010 diluted earnings per ADS from $0.82 USD to $0.67 USD, a substantial downgrade. The company announced this provision on February 23, 2011, a week before they released their full year 2010 financial results. This news had significant impact on the stock price, which was at $32.80 on February 18th, near their 52-week high of $34 that it had reached on Feb 8th, and fell to $19.76 on Mar 3rd. In addition, the company’s 4Q10 financial metrics were depressed by this one time provision. Most notably, 4Q operating income fell 86.8% compared to 4Q 2009.

The company had an average of 90 days between when a sale was made, and when the payment was received. This is a pretty standard time period in the industry.

**Profitability And Growth**

As shown in Figure 1, HiSoft generates its revenue mainly through its two service lines. Revenue has been increasing steadily since 2007. The share of revenue from IT service in the total revenue has dropped over time, while

<table>
<thead>
<tr>
<th>Figure 1</th>
<th>Historical Profitability Figures</th>
</tr>
</thead>
<tbody>
<tr>
<td>(dollars in thousands)</td>
<td>2007</td>
</tr>
<tr>
<td>Net Revenue USD</td>
<td>63,051</td>
</tr>
<tr>
<td>IT Service</td>
<td>40682</td>
</tr>
<tr>
<td>Research and Development Service</td>
<td>22369</td>
</tr>
<tr>
<td>Gross Profit</td>
<td>15616</td>
</tr>
<tr>
<td>Operating Income</td>
<td>626</td>
</tr>
<tr>
<td>Net Income</td>
<td>-920</td>
</tr>
<tr>
<td>Operating Cash Flow</td>
<td>-4148</td>
</tr>
</tbody>
</table>

**Source:** HiSoft Annual Report, MorningStar

As shown in figure 1, HiSoft generates its revenue mainly through its two service lines. Revenue has been increasing steadily since 2007. The share of revenue from IT service in the total revenue has dropped over time, while
the percentage revenue from research and development service increased. This shows that hiSoft has been moving up the value chain, shifting away from the lower end IT service to R&D service, which has a higher profit margin. The impact of the financial crisis can be shown in the drop in net revenue in 2009. But since demand from clients from non-financial sectors did not drop, hiSoft’s gross profit continued its growth through the financial crisis.

Figure 2 above shows HiSoft’s profitability relative to its competitors. HiSoft currently has the lowest gross profit margin, lowest return on asset, and lowest net profit margin among its key competitors. However, its net profit margin is above industry average. This is mainly because it is a very young firm at high growth stage. If HiSoft’s profit can continue its growth, it will reach the level of its competitors soon.

Solvency And Liquidity

At the end of FY 2010, HiSoft had cash and cash equivalents equal to $170 million USD. They had a short-term bank loan of $40 million, which was fully repaid by January 2011. Therefore, at the end of 2010, HiSoft held no debt. Interestingly, this seems pretty standard for companies in this industry, as the main asset in this industry is human capital. Companies in
the industry might have avoided debt in fear of cost of financial distress. HiSoft’s current ratio is lower than those of competitors listed, but higher than industry average. HiSoft has a quick ratio of 3.2, lower than all of the direct competitors listed above, this means that HiSoft will have a harder time meeting its short-term debt obligations than its competitors.

**Tax Considerations**

Under the Chinese tax system, companies that make enterprise software (software used by organizations such as businesses or governments, as opposed to retail software for individuals) are eligible for preferential tax treatment. Specifically, the company is exempted from the corporate income tax for two years, and then pays 50% of the regular corporate income tax for the subsequent three years. In 2009, one of the companies divisions obtained software enterprise status. The company believes that this division will qualify for the tax exemption beginning in 2010. Local PRC authorities must first approve this preferential tax treatment.

**Operational Efficiency**

As is shown in the key operational ratios table, HiSoft’s days of sales outstanding ratio of 90.99, higher than Cognizant and Infosys, but lower than VanceInfo. This shows that Cognizant and Infosys are taking a shorter period of time to collect money from their clients than HiSoft does. HiSoft’s asset turnover ratio is higher than VanceInfo, showing that it is more efficient at generating revenue through asset. The fact that it’s asset turnover ratio is still below industry average may the result of HiSoft’s aggressive expansion.

### Table: Key Operational Ratios 2010

<table>
<thead>
<tr>
<th></th>
<th>HIsoft</th>
<th>Cognizant</th>
<th>Infosys</th>
<th>VanceInfo</th>
<th>Industry</th>
<th>Market Median</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Days of sales outstanding</strong></td>
<td>90.99</td>
<td>68.49</td>
<td>53.87</td>
<td>119.99</td>
<td>63</td>
<td>43.2</td>
</tr>
<tr>
<td><strong>Days COGS inventory</strong></td>
<td>/</td>
<td>/</td>
<td>/</td>
<td>/</td>
<td>11.76</td>
<td>47.87</td>
</tr>
<tr>
<td><strong>Asset Turnover</strong></td>
<td>0.96</td>
<td>1.16</td>
<td>0.95</td>
<td>0.82</td>
<td>1.05</td>
<td>0.27</td>
</tr>
<tr>
<td><strong>Net Receivables Turnover Flow</strong></td>
<td>4.01</td>
<td>5.33</td>
<td>6.78</td>
<td>3.04</td>
<td>5.79</td>
<td>8.45</td>
</tr>
<tr>
<td><strong>Effective Tax Rate</strong></td>
<td>12.60%</td>
<td>16.51%</td>
<td>25.27%</td>
<td>8.88%</td>
<td>/</td>
<td>/</td>
</tr>
</tbody>
</table>

*Source: Hoovers*
Market Valuation

The chart above shows the performance of HiSoft’s stock relative to comparable companies in the industry as well as the NASDAQ Index, since the company went public in June 2010. Until the stock price drop in March, off news of their bad debt provision, HiSoft had significantly outperformed both the NASDAQ Index and the other companies in the industry. Much of this is simply that HiSoft is a much younger and smaller company with strong growth potential.

<table>
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<th>Figure 5</th>
<th>Market Valuation</th>
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<tr>
<td></td>
<td>HiSoft</td>
</tr>
<tr>
<td>Current Price ($)</td>
<td>19.53</td>
</tr>
<tr>
<td>Market Capitalization (Billion)</td>
<td>595.51M</td>
</tr>
<tr>
<td>Price/Earnings(ttm)</td>
<td>51.39</td>
</tr>
<tr>
<td>PEG ratio</td>
<td>0.93</td>
</tr>
<tr>
<td>Employees:</td>
<td>4097</td>
</tr>
<tr>
<td>Price/Sales(TTM)</td>
<td>4.15</td>
</tr>
</tbody>
</table>

Source: Yahoo Finance

As reflected in the market valuation table above, HiSoft is significantly smaller than its competitors. It’s P/E ratio is higher than its competitors, showing that investors expect higher earnings growth in the future for HiSoft than for its competitors. The PEG ratio of HiSoft is also the lowest for HiSoft, showing that it may be undervalued compared to its rivals. Overall, the data above shows that HiSoft is likely to be growing at a rate higher than its competitors.
SWOT ANALYSIS

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<td>Concentrated Client Base</td>
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<tr>
<td>Strong Human Capital Management</td>
<td>High Capital Cost</td>
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<tr>
<td>Global Perspective</td>
<td>Exchange Rate Risk</td>
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<td>Growing Demand</td>
<td>Diminishing Cost Advantage</td>
</tr>
<tr>
<td>Strong Government Support</td>
<td>Rapid Development in the IT industry</td>
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</table>

**Strengths**

**Dual-Shore Business Model**

HiSoft offers a dual-shore delivery model, which delivers its services globally through a combination of onshore and offshore capabilities. It has seven international offices, including four in North America and one in each of Japan, Hong Kong and Singapore. HiSoft also has eight offshore delivery centers of which seven are in China and one is in Singapore. The dual-shore delivery model gives HiSoft great flexibility in meeting clients’ needs.

HiSoft’s onshore personnel consist mainly of technology specialists with the industry-specific knowledge and experience required to work directly with its existing and potential clients. At the same time, HiSoft boasts its offshore delivery capabilities to provide high quality services and lower costs for the clients.

HiSoft has invested heavily in its onshore delivery model so as to differentiate itself from its competitors. The significant onshore presence allows HiSoft to integrate its services more fully with its clients’ teams and to closely interact with the senior decision-makers within the clients'
organizations. This tighter relationship drives repeat business and deepens client relationships. In terms of net revenues, 22.9% and 17.7% of HiSoft’s work was delivered onshore in 2009 and the nine months ended September 30, 2010, respectively. This number is higher than industrial average, a good indication of HiSoft’s strength.

**Strong Human Capital Management**

Human capital is the most important asset for a company like HiSoft. HiSoft mainly relies on graduate recruitment to grow its employee base and therefore maintains close relationships with over 30 colleges and universities for recruitment purpose. HiSoft adopts a multi-step entry-level recruiting system which, over the course of three to six months, allows it to identify talented college graduates, place them in a training program, evaluate them based on multiple assessment parameters. In addition, HiSoft maintains relationships with a large number of external recruiting firms and has established its own database of candidates that includes their specific skills that we can call upon on short notice when it wins engagements requiring such skills. This allows it to be able to hire significantly closer to the time of actual need for employees.

In order to train its own management level staff, HiSoft launched an eight-month weekend program through its Project Management Academy to train and develop its project managers. The Project Management Academy provides classroom training designed specifically for project specialists, program leaders, program managers and senior project managers. HiSoft also has another program for middle and senior managers, which is referred to as the "HiSoft Mini-MBA Program". It is a six-month classroom-based weekend program focused on providing them with additional skills to help them manage its business. Over 300 selected employees have completed this program since its launch in May 2008.

**Global Perspective**

IDC estimates that by 2014, China-based offshore software development revenues from Europe and North America and from Japan and Korea will reach $4.6 billion and $2.4 billion, respectively. IDC estimates that the total market of China’s outsourcing services and software deployment and
support will reach $6.0 billion by 2014. Unlike many other China-based providers that have succeeded primarily in only one geographical location, HiSoft was ranked by IDC in 2009 as a top three China-based provider of outsourced software development services by revenue for the North American and European markets.

HiSoft’s success in those markets also gives them the opportunity to leverage the skills and experience acquired from working with global clients to penetrate the domestic Chinese market. In the early years of HiSoft’s operation, it benefited from partnering with the Japan-based subsidiary of a multinational computer, technology and IT consulting company, and from establishing a global delivery center for General Electric in 2002 that was subject to General Electric’s global standards for process quality and security. In 2003, HiSoft became one of the first China-based companies to achieve the Software Engineering Institute's CMM Level 5 certification, due largely to the maturity of its software processes on a company-wide basis.

**Weaknesses**

**Concentrated Client Base**

As of December 31, 2010, HiSoft has 27 clients that contributed at least $1 million to revenues each. HiSoft’s clients are comprised of many well-known multinational companies, such as General Electric, Microsoft and UBS. One common method that is adopted by many multinational corporations when they look for potential IT service provider is to look at the company’s current client base and client reviews. In the long run, a good and reputable client base will help HiSoft establish its credible brand name and attract more clients in the future. On the other hand, having one of the major players in a specific industry as a client may cause other potential clients from this industry to hesitate when they choose HiSoft for fear of leaking their business information to their clients. It is critical for HiSoft to maintain a confidential agreement with different clients and balance the relationship between clients who might be competitors of each other. Having different service centers for different clients and carefully managing the information transaction between different teams can be a way to solve this problem.
While a small client base allows HiSoft to focus its limited resource on major clients and ensure high quality service. On the flip side, relying on a relatively small client base to generate the majority of its revenues makes HiSoft vulnerable to the business risks those clients have and gives those major clients a lot of bargaining power in contract negotiations. HiSoft’s projects come in by contracts. Due to the strong buyer power in the market, a lot of the contracts are short terms and are subject to termination without prior notice or compensation. Those short-term contracts are not automatically renewable. This puts a lot of pressure on HiSoft to deliver high quality service and actively seek to renew contracts and secure new contracts.

**High Capital Cost**

HiSoft’s onshore and offshore service model requires considerable initial investment to start a project. Its capital expenditures are incurred primarily in connection with purchases of equipment, leasehold improvements and investment in equipment, technology and operating systems. Its capital expenditures were $7.8 million, $2.0 million and $3.9 million in 2007, 2008 and 2009, respectively. Its capital expenditures for 2007 were primarily related to the opening of two new delivery centers in Chengdu and Shenzhen and its new offices in Hong Kong, moving into its new headquarters in Beijing and purchasing equipment for new employees. HiSoft is in the process of expanding its capacity. This includes the establishment of a new campus containing administrative, sales, delivery center and other functions. It is crucial for HiSoft to determine a feasible financing plan for such expansions, which is estimated to cost around $ 25 million in the next few years.

**Exchange Rate Risk**

The nature of HiSoft’s international business model makes it vulnerable to the fluctuation of exchange rates. The majority of HiSoft’s net revenues are generated in Japanese yen or U.S. dollars, while most of its costs are denominated in Chinese Yuan. In order for the company to effectively utilize its revenues, HiSoft needs to conduct currency exchanges between Chinese Yuan and other currencies frequently. Although the Chinese Yuan has been fully convertible for current account transactions since 1996, it is
uncertain that the Chinese government authorities will not limit or eliminate local corporations’ ability to exchange and retain foreign currencies in the future. Conversion of Chinese Yuan into foreign currencies generally requires the approval of SAFE and other relevant PRC governmental authorities. Moreover, Chinese Yuan is expected to appreciate in the future, and this may increase HiSoft’s cost and squeeze its profit margin.

**Opportunities**

**Early Stage of the Chinese Market**

The Chinese IT outsourcing market is at its early stage with strong growth potential. The market is highly fragmented with market leaders taking up only about five percent market share each. As one of the domestic market leaders, HiSoft only has several domestic competitors that are of comparable size. The fastest way to grow is through merger and acquisition, with the larger size of the firms, it will also be easier for the firms to move up the value chain and take up more lucrative contracts. Under the global economic downturn, it is especially hard for the 8000 smaller firms to survive. Therefore, it is a great chance for the market leaders to acquire smaller firms and expand their product line.

**Growing Demand**

According to a report by KPMG, over 70 percent of the multinational companies outsourced IT-related work offshore. By 2012, the worldwide IT, the largest segment within the outsourcing industry as a whole, is expected to reach $1 trillion. Although global economic downturn has reduced demand from companies in the financial industry, demands from other industries were almost uninfluenced. Moreover, the financial crisis caused a lot of the firms to turn to IT outsourcing so as to cut spending. This has boosted demand for the IT outsourcing.

Furthermore, China’s appeal will intensify as salary inflation drives cost up in India, the current dominant offshoring destination. India’s IT industry, blessed by high demands but beset by lagging human resources, experienced a 14% salary inflation in 2003. The trend is set to continue,
which means that, based on a 13% compound annual growth rate, Indian programmers’ pay will nearly double by 2010. Already, according to JP Morgan, some Indian companies have put in place offshore floor rates of $23 to $24 an hour.

Domestic Chinese IT companies have also started to gradually lean toward IT outsourcing. The domestic market holds great potential for outsourcing providers. Traditionally, the domestic demand was driven by smaller enterprises seeking to customize their software to their needs. Outsourcing is a relatively new idea for China’s large companies and financial institutions, which have a much lower rate of outsourcing than their U.S. counterparts. Recently there has been a trend for bigger domestic corporations to use IT outsourcing service as a measure to increase efficiency and cut cost. This trend is expected to continue to boost up demand of IT outsourcing companies.

The increase in demand coming from both domestic and foreign markets serves as a great opportunity for companies like hiSoft.

In addition, hiSoft is a leader in providing outsourced IT services to global BFSI clients from China. Its BFSI clients represented 23.7% of its net revenues in 2009. As BFSI clients have a substantial track record of outsourcing their IT services, and therefore tend to be highly experienced users of outsourcing services, HiSoft’s leadership in this sector puts it in a better position to win new business from other BFSI clients considering outsourcing in China.

**Strong Government Support**

In the past years, the Chinese GDP growth has been heavily dependent on the export manufacturing industries, which caused a lot of pollution. One of the primary goal of the Chinese government’s 12th five-year-plan is to promote “sustainable economic growth” and boost “green GDP.” As part of this program, the government is providing strong financial support to the high technology industry, which produces less pollution than conventional manufacturing industry. Chinese government supports the development of the offshoring sector via various programs. The 1000-100-10 project is a good example. This project is crafted the Ministry of Commerce. With total
funding of more than USD 1Billion, aims at doubling Chinese service exports by establishing 10 Chinese cities as outsourcing bases, and assisting in developing 1000 outsourcing vendors that can meet the global demand. As a market leader, hiSoft has been receiving government subsidies in support of its expansion domestically and globally. The government support is likely to continue into the future, making hiSoft stronger financially for its growth plans.

Threats

Intellectual Property Concerns

As companies move up the value chain and start to be more involved in the critical process of the client’s business, they will inevitably get exposed to the client’s intellectual properties. Those could be anything from an algorithm to the whole business model. Quality and security of the services have always been the two primary considerations for the clients.

HiSoft maintains information and intellectual property security through a combination of physical security, IT security, and business continuity procedures and people management. Its security system framework is based on ISO 27001, a widely accepted standard for information security management. The Chinese government has also been taking measures to strengthen its legal system so as to give multinational corporations more assurance over the safety of their key business information.

Diminishing Cost Advantage

Chinese IT service providers have always enjoyed a cost advantage over its oversea competitors thanks to the large, low-cost, highly educated labor force in China. However, in the long run, this advantage is expected to diminish due to three reasons: 1. wage inflation in China, 2. appreciation of the Chinese Yuan, 3. intensified competition for qualified management-level staff. At present, the services provided by China’s outsourcing vendors remain geared largely to low-profit-margin services. They have not yet reached the levels of sophistication and complexity seen in the United States. China’s ITO providers should realize that they couldn’t solely rely on the cost advantage in the long run. They should develop more long-
term-sustainable advantages in quality while cost advantage lasts.

**Rapid development in the IT industry**

IT service providers today face a challenging environment with rapid changes in business and economic conditions of their clients. The growth of the Internet as a corporate communications and collaboration medium, coupled with the proliferation of new software platforms and tools, has resulted in a greater level of technological complexity for the clients. Specifically, the evaluation, deployment and maintenance of the clients’ technologies each require considerable expenditure of resources and, in many cases, the development of new skills.

Faced with the competing demands of upgrading and expanding technology platforms and systems while keeping fixed costs low and preserving flexibility, more and more multi-national corporations are requiring their IT service providers to understand their business imperatives while providing scalable, reliable, high quality technology solutions at competitive prices. On top of that, those multi-national firms want their IT providers to be able to innovate and keep up with the pace of technology development. If hiSoft fails to keep up with the pace of development of the industry, it will not be able to remain competitive.
PART III

RECOMMENDATIONS
STRATEGIC RECOMMENDATIONS

Short Run Solution

Expand Capacity

In the short run, hiSoft can improve the quality of its service solutions by expanding its technical span of resources, through cooperation and acquisitions with other suppliers, expand scale of resources available and gain specific industry experience. HiSoft needs to increase the speed that it responds to service requests. If it keeps providing the same set of service, then it can only bid for projects of the same nature. In order to move up the value chain, the service requests will become more diversified, which requires a stronger capacity, quick response, and constant technology updates. HiSoft has to innovate and develop the right kind of technology. It should focus on the BFSI, telecom and Internet sectors, and become the leader in those sectors in technology and experience. A stronger capacity will also allow the company to adapt proposals to meet customers concerns, allowing hiSoft to understand and respond to its customers’ business priorities.

Building Culture and Brand Name

HiSoft should also take care to nurture a strong firm culture that brings all the newly acquired firms together. A bonding culture is crucial for an IT service company like HiSoft, because the nature of its business frequently require its employees to work with clients’ employees. A good IT service provider has to demonstrate to its customers that it is trustworthy. It should be consistent in treating different customers. They should avoid changing key contract support staff frequently, so as to maintain the level and quality of staff working on the contracts. Therefore, it is very important for HiSoft to establish a culture that both sparks employee loyalty and fits well with the culture of client firms. Since the staff can vote with their feet and leave and cause serious trouble for on-going projects. Moreover, hiSoft should have strong ethical standards of behavior and codes of practice in the company. Without strong ethical standards and confidential agreements, it is hard to establish a trustworthy brand name that will pay off in the long run.
Client Mining and Diversification

In 2010, HiSoft’s strategic clients increased from 21 to 27. Future growth potential comes from both revenue from new clients and growing penetration among existing clients. HiSoft should also take care to manage and expand its client base. The management team should take care in picking reliable clients and try to establish long-term strategic partnerships with them. When seeking new clients, hiSoft should continue its current strategy of diversify client base geographically so as to reduce risk. HiSoft may add value for its existing MNC clients by supporting their other Asia Pacific operations. The Asia Pacific markets are expected to continue to demonstrate the fastest ITO and BPO growth of any region, and hiSoft already enjoys geographic, cultural and linguistic advantages in serving the Japanese market. It may use these advantages to secure further contracts with existing clients in those markets.

Long Run Solution

Maintain Financial Stability

In the long run, HiSoft should make sure to maintain its financial stability. A sound financial structure will allow hiSoft to provide the clients with solution plans that are financially feasible and cost-efficient. Payment methods are also important. Since there is no way to accurately predict the cost associated with the project, hiSoft should gain the trust of the client and try its best to work at the most cost-efficient way.

Work undertaken with current customers may affect hiSoft’s ability to take on new and more profitable projects. HiSoft should seek a balance between less profitable short-run projects with more profitable bigger long-run projects to maintain a sustainable cash flow. More profitable projects are also more risky. Therefore, hiSoft should have the foresight to see the risk and allow extra time and money in preparation for the risk.

Leverage the Growth of the Chinese Market

Revenue from China is expected to count for 20% of the total revenue by the end of 2011. The domestic Chinese market is expected to continue its strong growth into the future. HiSoft should take initiatives to expand and
deepen its domestic business. It can do so by serving domestic companies that conduct business abroad. Just as MNCs seek new opportunities in China, many leading Chinese companies are entering overseas markets. The Fortune Global 500 list contained 46 Chinese companies in 2010, up from 16 in 2005. HiSoft has a golden opportunity to leverage its existing relationships overseas, local experience and resources to partner with these Chinese companies and serve overseas markets from their base at home. It can provide bundled services and end-to-end process management offerings that are tailored to the breadth and sophistication of its clients’ operations, in areas such as application management, customer relationship management, finance and accounting, HR management, and procurement.

Be Innovative and Adaptable

In the long run, hiSoft needs to be adaptable. A good service provider should have the capability and technical ability to deliver the services required, adapt to changes quickly and offer innovations. HiSoft should be flexible and accommodating as the bigger projects they get and the longer they last, the more likely the service requirement will change along the way. Meanwhile, hiSoft has to balance the needs of current service delivery against the need to innovate and introduce service improvements. The IT industry is developing quickly. Failing to innovate means the company is falling behind. The company should at least constantly catch up with newly developed technology and seek to innovate. It should also try to serve the client’s needs by going beyond clients’ expectations.
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APPENDICES

Appendix 1

HiSoft International Corporate Structure