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INDIAN IT SERVICES INDUSTRY

Reversal of Selection Process for H-1B Visa Programme, Favouring Advanced Degree Holders, to Hurt Indian IT Services Companies Margins; Credit Outlook Remains Stable

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Overview

The recent proposal (Dec-18) by USCIS (United States Citizenship and Immigration Services) reversing the process for H1-B selection favouring advance degree holders will have an adverse financial impact on the Indian IT Services Companies. As per ICRA research, this will culminate into approximately 10.0% reduction in H1-B visa approvals for regular applicants (Applicant without advance degree - master's or higher from US universities) which form major part of the H1-B visa requirements of Indian IT Services Companies (Exhibit 1). This will lead to higher onsite hiring which is associated with higher wage bills and lower margins. ICRA in its earlier note dated June 2018 predicted USCIS would promote granting visa to highly skilled applicants (Link).

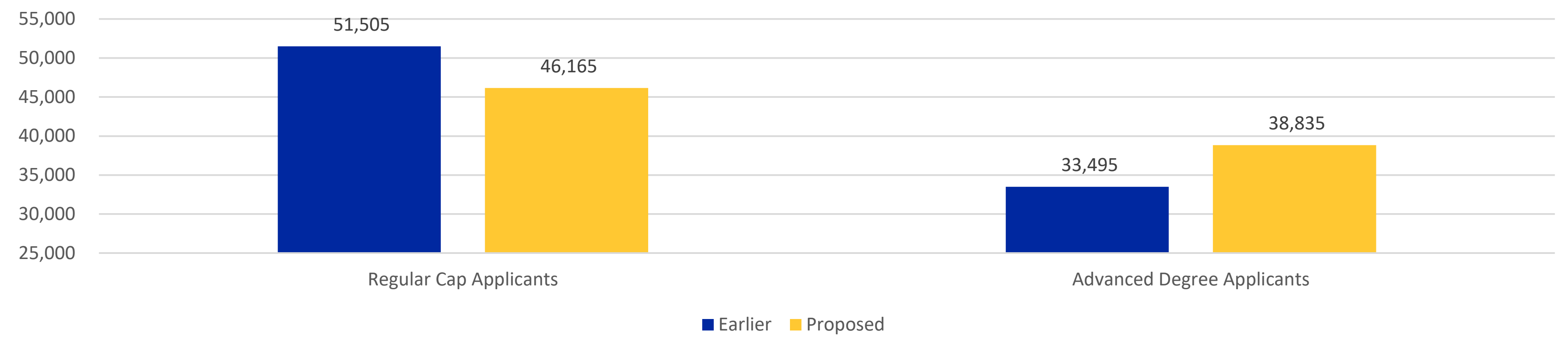
Indian Companies are the largest consumers of H1-B visas with approximately 62.7% share (Exhibit 2) with majority of such companies being in IT/ITES domain. Currently, there is a yearly cap of 65,000 on new H1-B visas issuance with additional 20,000 visas for highly-skilled labour with a master's or a higher degree from a US university. Currently when sufficient number of petition needed to reach the regular cap or advanced degree exemption are received, USCIS selects qualifying position towards the H1-B advance degree exemption first through lottery and the unselected advance degree applications are merged with the pool of regular applicants for selection process towards cap of 65,000. Under the proposed amendments, starting April 2019, USCIS would first select the 65,000 visas from the cumulative pool of regular as well as advance degree holder applicants. The 20,000 highly skilled H1-B visas would then be allotted among the remaining pool of unselected advance degree holder applicants. This will work against the Indian IT services sector (H-1B dependent employers) as their share of master's degree or equivalent for H-1B visas approved was 27% compared to 55% for non-H-1B dependent employers (Exhibit 3). An entity is defined as H-1B dependent if more than 15% of its employees are on an H-1B visa.

With the visa issuance norms being tightened by restricting the entry of entry-level programmers coupled with increasing compliance requirements adding to cost pressures, Indian companies have started to ramp up onshore hiring. USCIS has significantly increased the Request for Evidence (RFE) before issuing H1-B visas leading to higher compliance costs. During the three-month period July-September 2017 period, USCIS issued 63,184 RFEs (68.9% of H1-B cases processed) compared to 63,599 RFEs (17.8% of H1-B cases processed) issued during the entire nine-month period of October 2016-June 2017 (Exhibit 4). Leading companies such as TCS and Infosys have shared plans to hire US graduates to combat challenges in securing H-1B visas. For example, TCS hired approximately 25% of gross hiring overseas in FY2018. Infosys has announced its plans of hiring of over 10,000 by March 2020 across four technology hubs in USA. Leading companies are also increasing the proportion of offshore work to reduce dependence on such visas, though the magnitude of such shifts is expected to be marginal as only certain services are amenable to higher offshoring (Testing, IMS) compared to others. The share of offshore revenues which reduced from 43.2% FY2016 to 40.3% in FY2018 has subsequently increased to 42.2% in H1FY2019 for ICRA sample companies. The reduction in share of offshore revenues FY2016-18 period was primarily because of large number of digital technologies projects which have higher onshore components at the start of project. Overall, ICRA expects a ramp up in onshore hiring particularly for entry-level programmers to maintain a competitive cost structure while reducing dependence on H-1B visas for such low-cost skilled labour.

INDIAN IT SERVICES INDUSTRY: IMPACT OF H1-B VISA REFORMS

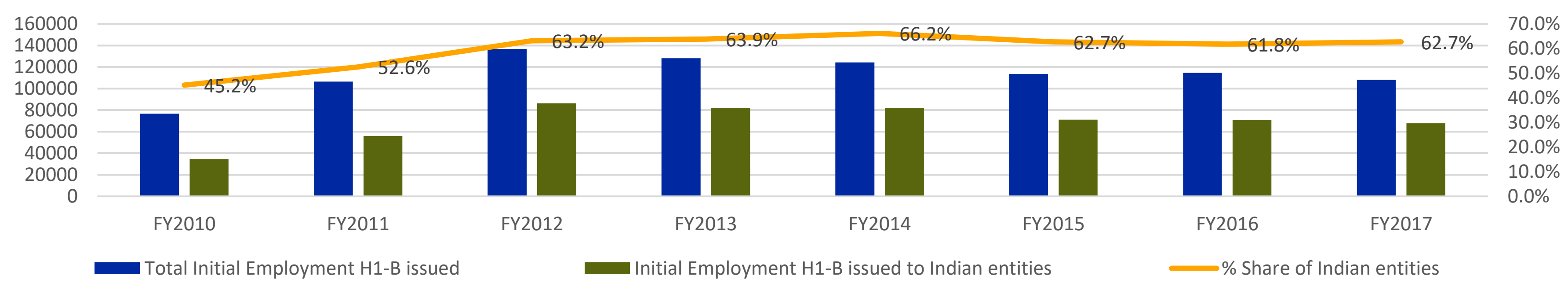
As per ICRA, increased onshore hiring associated with higher wage bill (Exhibit 5) along with factors such as pricing pressure on commoditised services, wage inflation and lower revenue growth will negatively impact the margins going forward. The FY2018-2021e revenue CAGR is expected to be around 9-12% for the Indian IT Services companies compared to CAGR of 17.1% experienced over the FY2013-2017 period with FY2018 growth of 4.2% for our sample set of 13 leading companies. Margins will be supported by factors such as ability to modify cost structure with variablisation of salaries & gradual reduction of high cost resources; deployment of operating levers such as higher share of fixed price contracts, lesser idle resources & automation benefits. However, these factors will provide limited cushion leading to overall decline in operating margins from 22.1% in FY2018 to 20.8% in FY2021e. However, the credit profile of Indian IT Services companies remains stable underpinned by its ability to sustain free cash flows despite pressure on revenue growth and margins as well as significant liquidity in the form of surplus investments generated out of past cash flows (Exhibit 6-8). Our sample set reported surplus liquidity (net of debt) of approximately Rs. 1,600 billion March 2018 despite healthy dividend pay-out of approximately 30% (Rs. 206 billion) in addition to share buybacks (Rs. 73 billion).

Exhibit 1: Share of H1-B Visa Issued Under Existing and Proposed Selection Method



Source: USCIS, ICRA Research, FY refers to October to September period

Exhibit 2: Share of Indian Companies in Initial H1-B Visa Issued

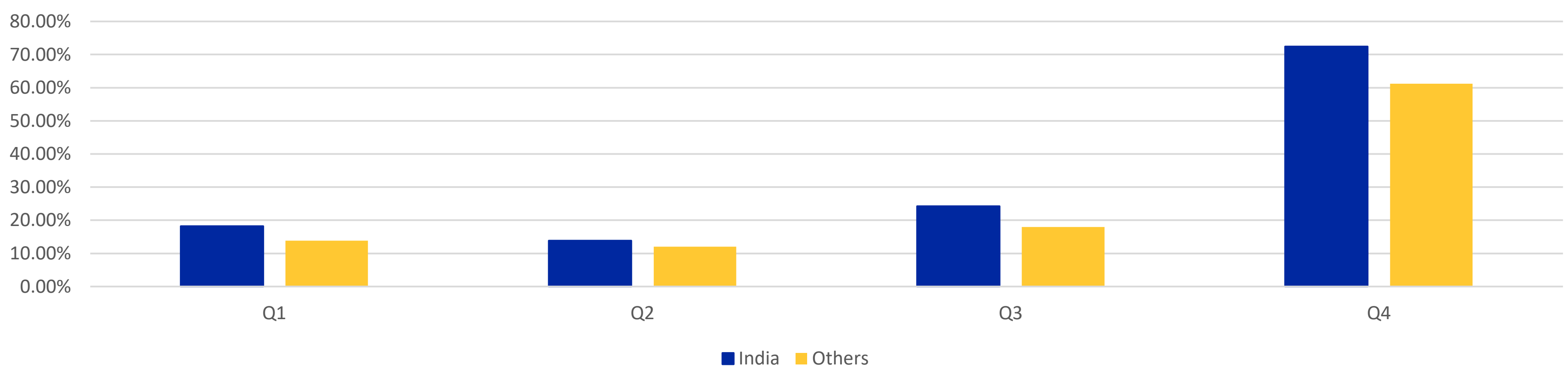


Source: USCIS, ICRA Research.

Exhibit 3: Share of Master's Degree for H-1B Dependent and Non-Dependent Companies, FY2017

Source: USCIS, Migration Policy Institute, ICRA Research, FY refers to October to September period

Exhibit 4: Quarterly Request for Evidence (RFE) issued in FY2017



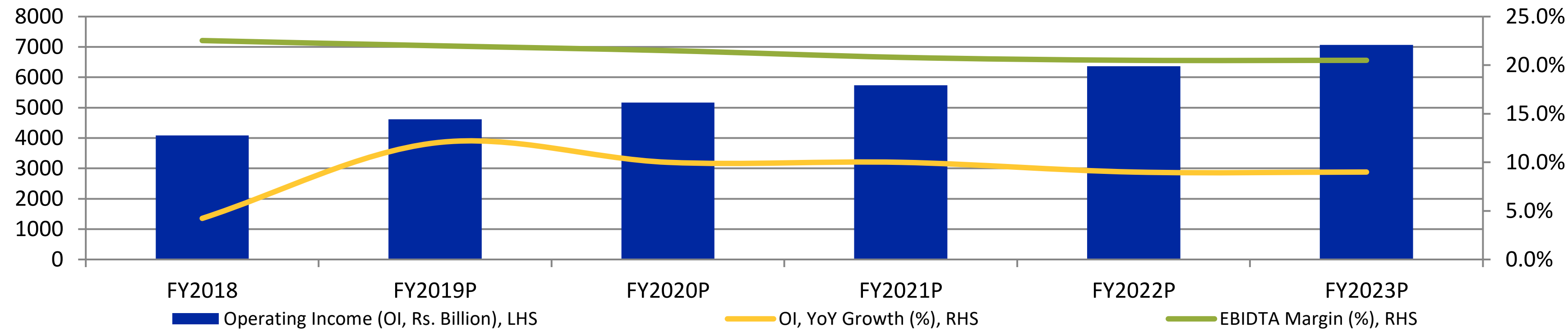
Source: USCIS, NFAP, ICRA Research, FY refers to October to September period

Exhibit 5: Sample Key Financial Statistics for Large Size Indian IT Services Company

	Onshore	Offshore	Total
Revenues	55.0%	45.0%	100.0%
Employee cost	38.6%	17.4%	56.0%
Contribution Margin	16.4%	27.6%	44.0%
Headcount Break-up	30.0%	70.0%	100.0%
Average Annual Salary (INR)	5,655,951	1,038,028	2,377,337
Billing Rate/Hour (US$)	81.3	21.7	42.8
Source: ICRA research			

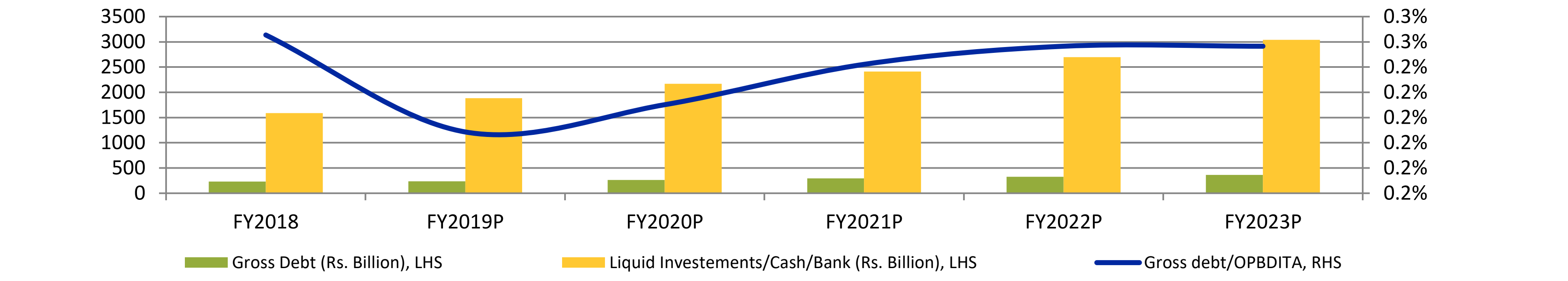
Source: ICRA Research.

Exhibit 6: Trend in Growth and Profitability Indicators for ICRA Sample Companies



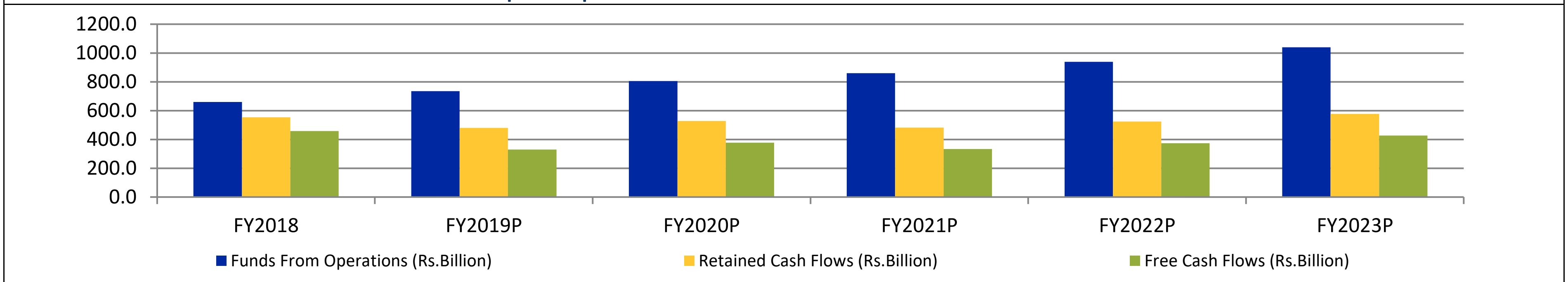
Source: ICRA Research. ICRA Sample includes 13 leading India IT Services Companies

Exhibit 7: Trends in Capital Structure and Leverage Indicators for ICRA Sample Companies



Source: ICRA Research. ICRA Sample includes 13 leading India IT Services Companies

Exhibit 8: Trends in Cash Flow Indicators for ICRA Sample Companies



Source: ICRA Research. ICRA Sample includes 13 leading India IT Services Companies

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