ICRA

INDIAN IT SERVICES INDUSTRY

Increase in onsite hiring compensate for currency benefits in FY2019; demand environment to remain stable

June 2019

Agenda

Executive Summary

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- During Q4FY2019, ICRA sample companies (13 companies) grew by 16.8% in INR terms while in US$ terms it grew by 6.0%. During the quarter INR depreciated by approximately 9.5%/2.7%/1.3% YoY versus US$/GBP/EUR respectively (USA and Europe collectively contribute 85% of ICRA sample set revenues) respectively leading to higher INR growth. Few companies reported higher deal wins during the quarter while net employee addition has increased during the quarter across majority of our sample companies, being signs of stable demand environment for IT Services sector. The net employee additions show positive trend with approximately 11,3787 additions during FY2019 compared to 11,600 during FY2018 and 93,500 in FY2017.
- Demand is being driven by solutions built around Digital technologies (Mobility, Social, Cloud, Analytics and Automation) while traditional outsourcing services such as Custom Application maintenance face pricing pressure and ERP (Enterprise resource planning) applications are increasingly becoming consumer oriented with application delivery mechanism shifting to cloud based environments. The earlier small-scale proof of concept digital projects has started evolving into enterprise level larger implementations coupled with improvement in discretionary spend supporting future growth. In the Infrastructure management services, rapid adoption of cloud computing (public cloud) has led to lower demand for servers, middleware, integration services & routine hosted applications as well as maintenance of such infrastructure.
- On a YoY basis the growth from America during FY2018 and FY2019 stood at 3.0% and 17.0%. During the same period Europe posted growth of 10.0% and 19.0%. The relatively better performance of Europe is on favourable demand from Europe compared to USA, improved geographical penetration by Indian IT Services outsourcing companies over the last few years as well as positive currency impact. Nevertheless, demand from UK continues to be negatively affected by uncertainty in the markets due to the result of the Brexit referendum.

Executive Summary

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- With volatile demand from developed economies, companies are increasingly focusing on RoW markets such as Asia Pacific, Middle East and Africa which are expected to generate higher growth going forward. During FY2019, RoW posted 10.0 YoY growth.
- Within traditional sourcing, IT outsourcing (ITO) rose 7 percent, to $5.6 billion, fueled by 7 percent growth in application development and maintenance (ADM) services, while business process outsourcing (BPO) declined 14 percent, to $1.4 billion. Contract volume, at 438 deals, dropped 11 percent on YoY basis. On the traditional side, ITO is being paced by ADM, as enterprises continue to spend aggressively on application and architecture modernization.
- Despite the currency benefits as well as use of operating levers, the profitability declined on account of pricing pressure, higher employee expenses especially onsite led by fresh hiring, and increase in sub-contracting cost for new contracts. The operating margin during Q4FY2019 remained at 22.7% compared to 23.1% in Q4FY2018. On an average rupee depreciated by 9.5% YoY vis-a-vis US$ during Q4FY2019.
- The share of fixed price contract stood at 55.9% Q4FY2019 compared to 54.0% in Q4FY2018 while Utilisation remained stable at 81.1% during the same period for ICRA sample companies. The net employee additions show positive trend with approximately 113,787 additions during FY2019 compared to 11,600 during FY2018 and 93,500 people added in FY2017. High-end services such as consulting, SMAC and automation also aided improvement in revenues per employee from INR 0.97 million Q4FY18 to INR 10.5 million Q4FY2019, growth rate of 8.1%. This has led to better absorption of overheads.

Executive Summary

- The cap on fresh H1B visa for the US market has remained stagnant since 2014 coupled with 10.0% lesser issuances of overall (fresh plus renewals) H-1B visa during October-September 2018 period owing to tighter scrutiny led to higher onsite hiring during FY2019. This has also added to cost for the Indian IT Services players apart from higher visa fees and compliance cost associated with enhanced scrutiny of visa applications. In the recent past there has been several proposed legislations to substantially increase the minimum wages for H1B visa holders, which will impact the margins adversely, if implemented.

- 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. With aggregate operating margins of ICRA sample set at 22.5% for FY2019 coupled with moderate capex (organic as well as inorganic) and working capital requirements, the free cash flows have remained robust historically. Despite growth and margins expected to remain under pressure over the medium term, these factors are unlikely to impact the free cash flow generation ability of Indian IT Services companies though there could be moderation in the quantum of such cash flows.

- The FY2019-2022e CAGR is expected to be around 9-11% for the Indian IT Services companies compared to CAGR of 9.7% experienced over the FY2016-2019e period.

- 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 22.5% in FY2019e to 21.5% in FY2020e and 20.5% in FY2022e.

- The credit profile is also supported by net cash position with significant liquidity in the form of surplus investments generated out of past cash flows. 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).

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Thank You!

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