ICRA

INDIAN IT SERVICES INDUSTRY

Demand environment remains stable; Increase in onsite hiring lead to margin pressure

September 2019

Agenda

01

EXECUTIVE SUMMARY

02

GLOBAL TRENDS IN IT OUTSOURCING

03

TRENDS IN FINANCIAL & OPERATING PERFORMANCE

04

OUTLOOK

05

COMPANY SECTION

Executive Summary

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- During Q1FY2020, ICRA sample companies (13 companies) grew by 10.3% in INR terms while in US$ terms it grew by 7.4%. During the quarter INR depreciated by 3.7% YoY versus US$ and appreciated 1.9% and 2.1% versus GBP/EUR respectively (USA and Europe collectively contribute 85% of ICRA sample set revenues). Few companies reported higher deal wins during the quarter while net employee addition has remained sable 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 29,305 additions during Q1FY2020 compared to 22,245 in Q4FY2019 and 26,782 in Q1FY2019.
- 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 Q1FY2020 stood at 11.6%. During the same period Europe posted growth of 9.2% though demand from UK continues to be negatively affected by uncertainty in the markets due to the result of the Brexit referendum. The relatively better performance of Rest of Europe is on account of improved geographical penetration by Indian IT Services outsourcing companies over the last few years.

Executive Summary

- 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 Q1FY2020 and FY2019, RoW posted growth of 6.7% and 10.0 respectively.
- During H1 CY2019, IT Sourcing ACV remained flat at $10.9 billion on a high base, as Q2 CY2018 was an exceptional quarter. During Q2 CY2019, IT outsourcing, declined by 7.0 percent. The growth was also impacted by continuing shift of data center infrastructure to the cloud. On the traditional side, ITO is being paced by ADM, as enterprises continue to spend aggressively on application and architecture modernization. The traditional sourcing market is expected to grow at 3.0-4.0% for CY2019.
- Despite use of operating levers, the profitability declined on account higher employee expenses especially onsite led by fresh hiring, sub-contracting cost and cross currency movements. Employee expense increased to 61.7% in Q1FY2020 to 59.8% in Q1 FY2019. The operating margin during Q1FY2020 remained lower at 22.6% versus Q1FY2018 23.3% and Q4FY2019 22.7%.
- The share of fixed price contract stood at 58.5% in Q1FY2020 compared to 58.6% Q4FY2019 and 57.5% in Q1FY2019 while Utilisation remained stable at 79.8% during the same period for ICRA sample companies. The net employee additions show stability with approximately 29,305 additions during Q1FY2020 compared to 22,245 during Q4FY2019 and 26,782 Q1FY2019. High-end services such as consulting, SMAC and automation also aided improvement in revenues per employee from INR 10.24 million Q1FY19 to INR 10.47 million Q1FY2020, growth rate of 2.2%. 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 22.4% 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% (US$ 6-8%) for the Indian IT Services companies compared to CAGR of 12.6% experienced over the FY2016-2019 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 22.4% in FY2019 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. 1,580 billion March 2019 despite healthy dividend pay-out of approximately 34% (Rs. 298 billion) in addition to share buybacks (approximately Rs. 250 billion) in FY2019.

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Thank You!

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