

FY2022 OUTLOOK FOR IT SERVICES SECTOR

Minimal disruptions owing to Covid-19 pandemic; outlook Stable

January 2021

Outlook for FY2022 - key metrics



Revenues

With 90-95% achievement of work from home and recovery in demand for IT services led by acceleration in adoption of digital demand, the revenue growth for IT services in US\$ terms is expected to be flattish in FY2021 and US\$5%-8% in FY2022.



Profitability

Profitability during H1 FY2021 has improved owing to lesser overheads during the lockdown period – primarily travel & general administrative expenditure. The trend is expected to reverse once the pandemic situation resolves; FY2022 margins will remain in line with pre-Covid levels.



Debt Levels

IT services sector companies have largely remained in net cash position owing to healthy margins, moderate working capital and capex requirements. The trend is expected to continue in FY2022 with little impact of Covid-19 on growth and profitability.

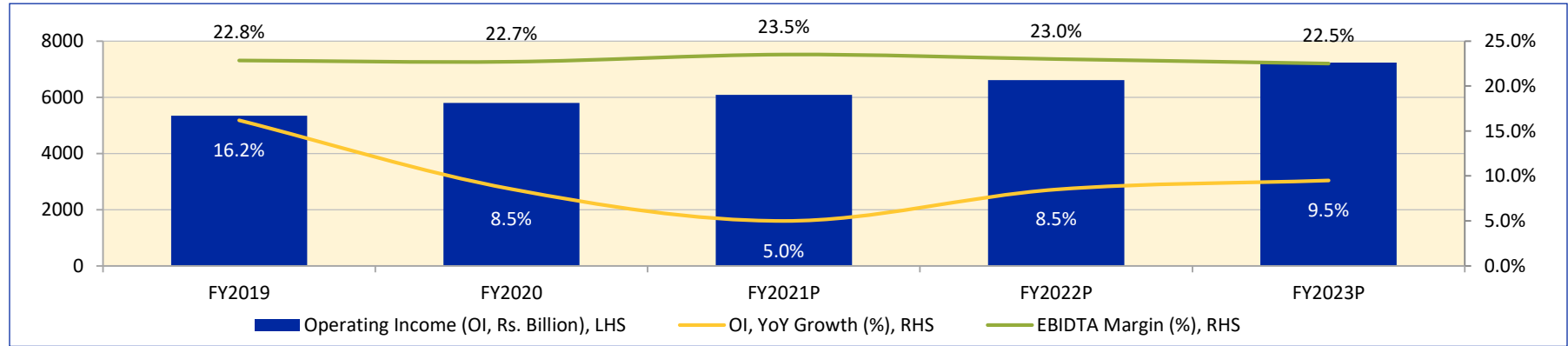


Regulatory Uncertainties

Key risk remains increase in minimum wages, changes to eligible occupations, frequency and restrictions in issuance for H-1B visa.

Growth and profitability to remain healthy

Exhibit: Movement of industry operating income and profits



Source: ICRA research, Sample includes 13 leading companies

- Demand for IT services has been mildly impacted during the current course of the Covid-19 pandemic. While all end user industries have been impacted by Covid-19, certain sectors such as travel/hospitality, retail, oil/gas has been impacted more severely. However, higher adoption of digital services has mitigated the impact to a large extent.
- 90-95% achievement of work from home for majority of the IT services players by April 2020 with seamless integration for Application, IMS, Analytics. BFSI vertical impacted initially due to required modification in confidentiality agreements with clients; BPO impacted due to infrastructure constraints.
- Pace of conversion of earlier deal wins into revenues moderated during Q1 FY2021 though has subsequently picked up pace. New deals focused on cost take-outs, cloud transformation, virtualisation and digital customer experience though conversion time has increased due to Covid-19.
- Pricing pressure mostly seen in legacy work during contract renegotiations though compensated by new digital transformation deals.

Comfortable capital structure and coverage indicators

Exhibit: Movement of industry debt levels

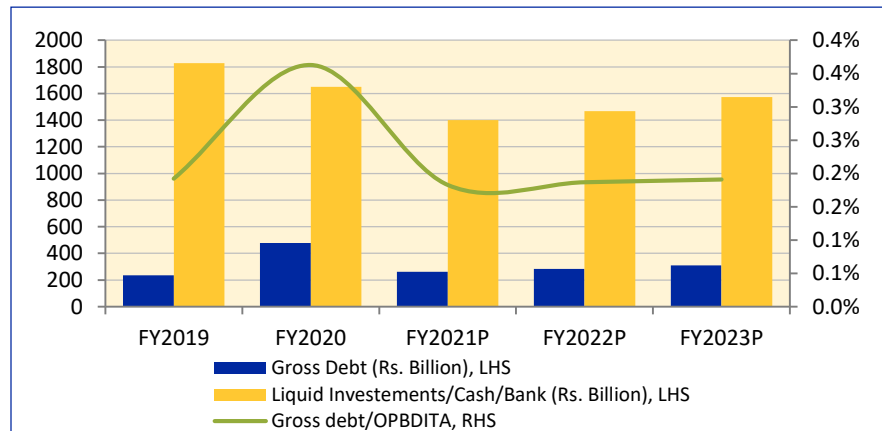
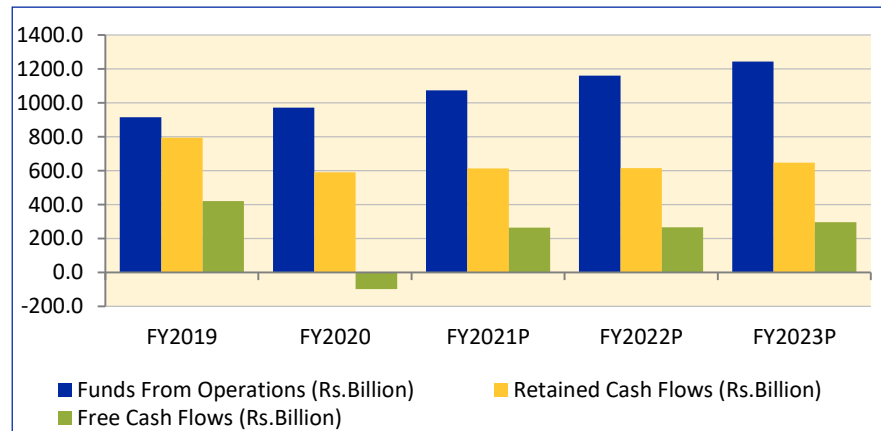


Exhibit: Liquidity position remains comfortable



Source: ICRA research, Sample includes 13 leading companies

- The gross debt levels remain modest for the industry backed by healthy profitability and cash accruals with moderate working capital intensity and capex requirements with majority of the companies in net cash position.
- The liquidity position also remains comfortable with sizeable build-up of cash/bank balances and liquid investments. Companies may opt for inorganic acquisition to utilise surplus liquidity, though the debt protection metrics will remain largely stable.

Summary



FY2022 Outlook

VOLUME	OPM	ROCE	DEBT/EBIDTA	INTEREST COVER
7%-9% (INR) 5%-8% (US\$)	23.0%	30%-32%	0.19x (NET CASH POSITION)	65.2x
<p>Minimal supply disruptions, demand for digital technologies and resumption of normal economic activity will lead to healthy growth for the sector</p>	<p>Margins will remain healthy and similar to pre-Covid levels</p>	<p>Strong RoCE for the sector with moderate working capital intensity and capex requirements</p>	<p>Debt protection metrics remain strong with recurring free cash flows</p>	<p>Strong interest coverage for leading IT-services players</p>

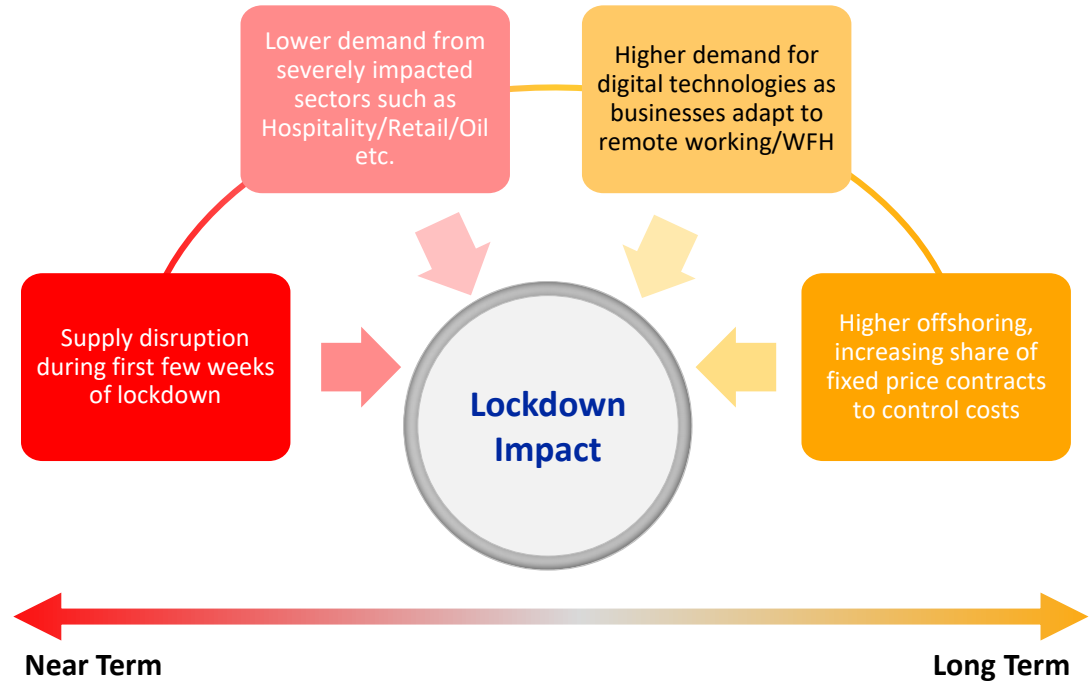


RECENT TRENDS

**Minimal impact of Covid-19 on growth and margins for
Indian IT services sector**

Minimal impact of Covid-19 on Indian IT services

- During H1 FY2021, the ICRA sample companies (13 companies) grew by 4.8% in INR terms while in US\$ terms it grew by -2.3%, impacted by the Covid-19 pandemic though supported by the rupee depreciation. In US\$ terms, the growth has sequentially improved with US\$ growth of -0.8% in Q2 FY2021 compared to -3.9% in Q1 FY2021. During H1 FY2021, the rupee depreciated by approximately 7.4%/8.0 YoY vis a vis US\$/GBP which supported its growth (the US and Europe collectively contribute 85% of ICRA sample set revenues).
- Deal wins as well as net employee additions also show improvement in Q2 FY2021 compared to Q1 FY2021. The net employee additions show a positive trend with approximately 11,859 additions during Q2 FY2021 compared to -21,130 in Q1 FY2021 and -5,379 in Q4 FY2020 for our sample set of companies.



Minimal impact of Covid-19 on Indian IT services



- On a YoY basis the growth from America during H1 FY2021 stood at 4.0%. During the same period Europe posted a growth of 6.2% though demand from the UK continues to be negatively affected by uncertainty in the markets due to the result of the Brexit referendum. The relatively better performance of the Rest of Europe is on account of the improved geographical penetration by Indian IT services outsourcing companies over the last few years. US and Europe contribute more than 80% of IT services exports



- In terms of verticals, BFSI (30% of revenues) growth is slowing down over the last few quarters with FY2020 and H1 FY2021 growth of 6.8% and 6.2% respectively though remains healthy. The BFSI vertical will be impacted owing to Covid-19 induced fiscal and monetary policies leading to lower interest rates impacting margins, coupled with the impact of the coronavirus on economic growth, lower credit offtake and other banking services. The BFSI segment growth is supported by digitisation efforts, cost optimisation, regulatory, compliance and security-driven initiatives.



- Manufacturing sector, which has been one of the key growth drivers, would be adversely hit due to lower consumption with decline of -15.1% seen in H1 FY2021. Travel and hospitality followed by discretionary retail are impacted as consumers will restrict outdoor activities to essentials in the foreseeable future. However, the life sciences vertical is expected to see stable demand; the demand for technology vertical would be strong, owing to core modernisation and cloud adoption as companies shift to digital models led by compulsory work-from-home options.



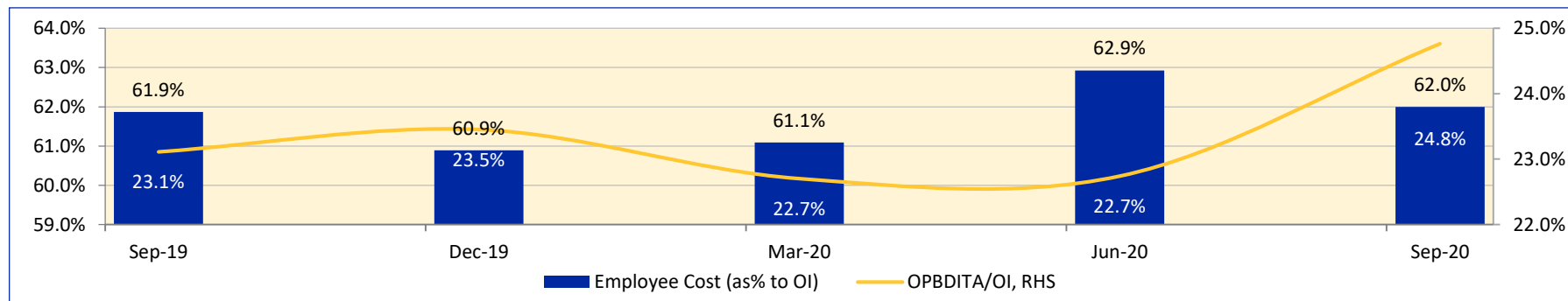
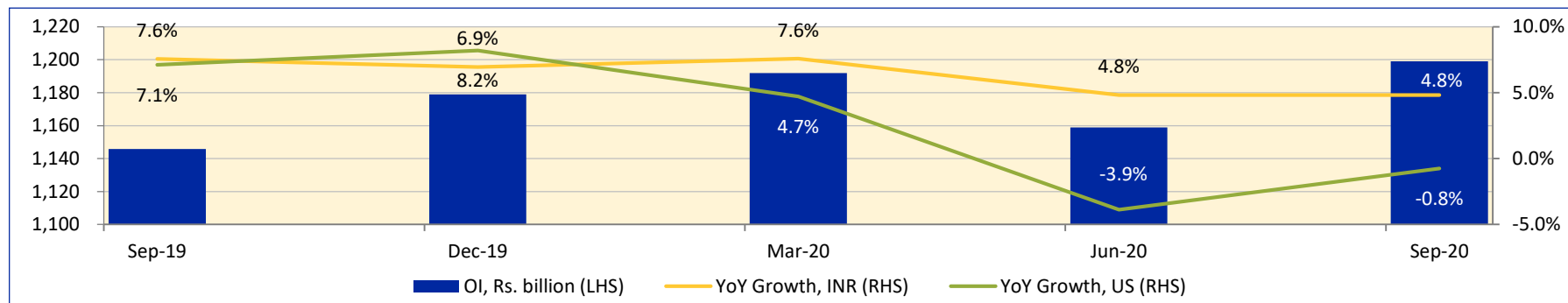
- During H1 FY2021, operating margins improved to 23.8% from 22.7% in H1 FY2020 led by multiple factors for ICRA sample companies. Lower overhead cost (travel, administrative), improved employee utilisation, higher share of fixed price contracts and INR depreciation primarily contributed to margin improvement. While margins have improved, they are unlikely to sustain beyond the pandemic situation and will revert to pre-Covid levels.



- Uncertainty prevails over proposed changes (issued October 2020) including revising definition of occupations and positions qualifying for H-1B visa, increasing minimum wage level and reducing tenure for onsite third-party employee H-1B visa categories from 3 years to 1 year as the same have been currently put on hold as per the court order.

Minimal impact of Covid-19 on growth and margins for IPM

Exhibit: Growth and Margin trend for IPM



Source: ICRA research, sample includes 13 leading companies, US\$ growth based on average USD/INR rates



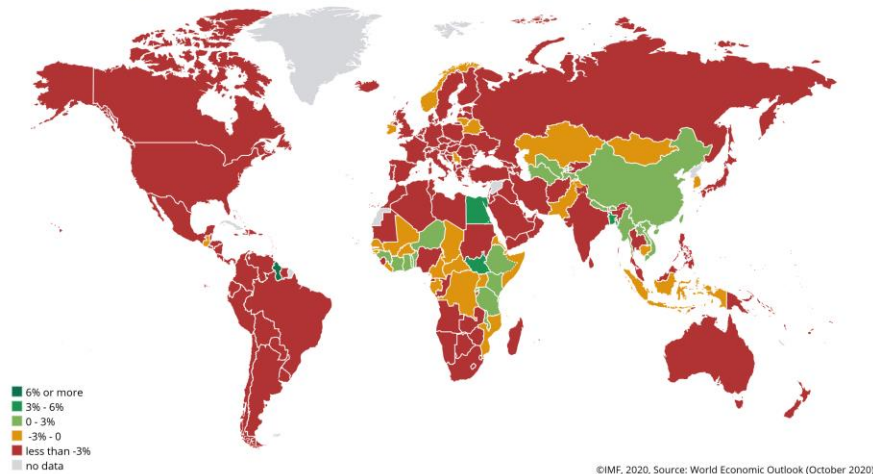
DRIVERS OF GROWTH IN 2021

Improvement in worldwide economic outlook and resumption of normal activities will spur higher discretionary spend on IT services

Improvement in economic activity in CY2021 vs CY2020

IMF DataMapper

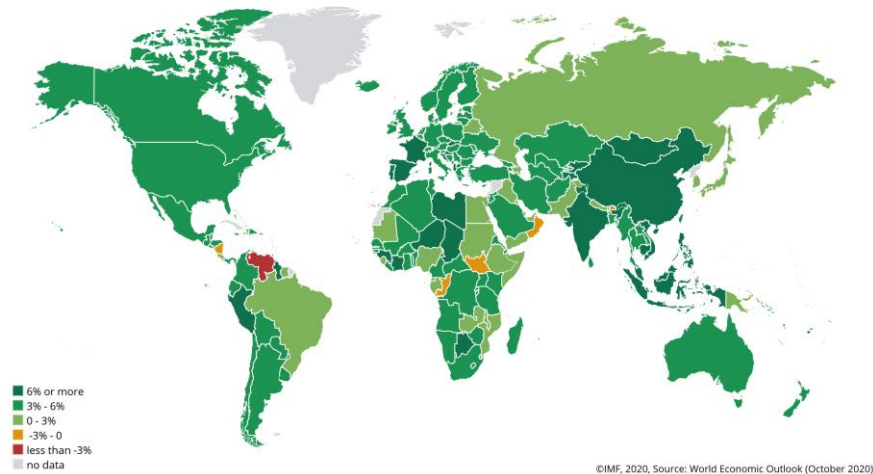
Real GDP growth (Annual percent change, 2020)



Source: IMF, October 2020

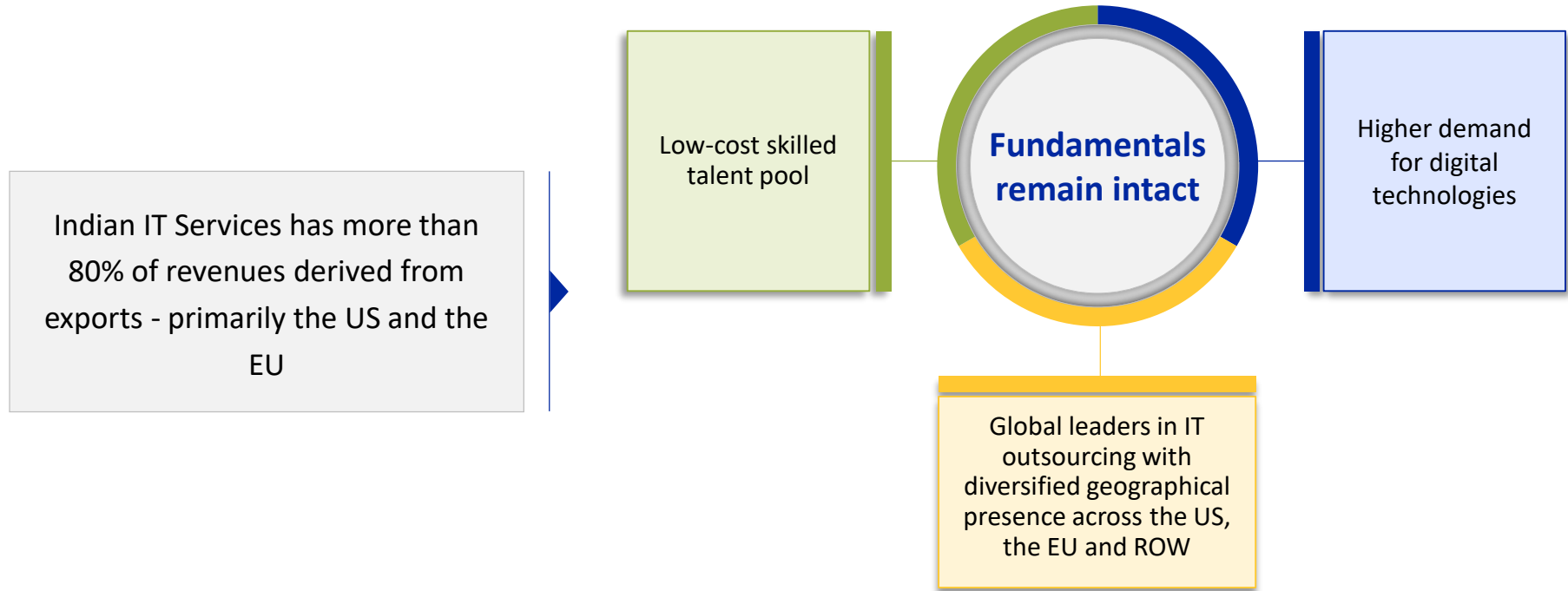
IMF DataMapper

Real GDP growth (Annual percent change, 2021)



Improved economic outlook and resumption of normal activities will support higher discretionary spend on IT services

Fundamental growth drivers remain intact

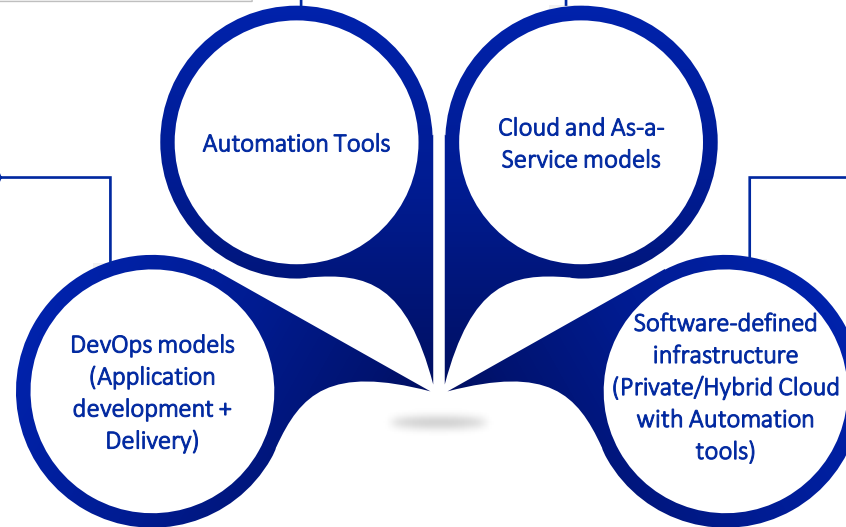


Key trends driving digital absorption

- Automation cutting across infrastructure provisioning and management, IT security, and workplace services.
- Enterprises investments driven to eliminate manual intervention through use of machine learning/artificial intelligence (AI). The self-learning and self-correcting mechanism of AI reduces outage and associated business risks and costs. It has become a key tool to save costs on legacy technologies and drive digital spends in the current pandemic environment.

- Cloud becoming an integral part of the enterprise IT infrastructure services strategy. The pandemic has accelerated on-premise to cloud movement as businesses focus on capex savings and move to an opex model.
- As-a-service models enhance service agility, provide scalability and flexibility. The pandemic has threatened business survival - forcing enterprises to adapt to modern As-a-service applications over current legacy on-premise software to make themselves competitive.

- DevOps model enables collaboration between discrete business functions for managing rapid application delivery and operations at scale. It has become even more relevant in the current distributed remote work environment.
- DevOps model continues to boost demand for containerised and cloud-based infrastructure services



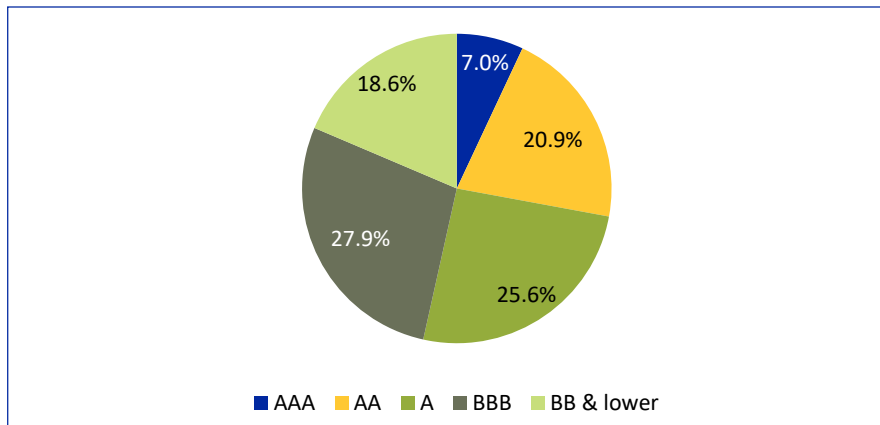
- Will transform datacenter operations as it enables tighter coupling and interlinkage among infrastructure technology stacks.
- Will enable customers to focus on their core application delivery rather than the underlying infrastructure.
- Will reduce human intervention, thus improving overall efficiency of operations



RATING ACTIONS

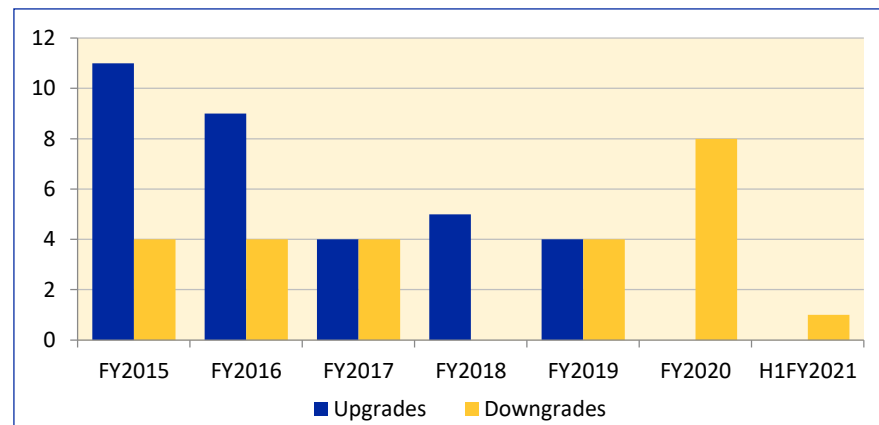
Rating actions in the recent past in pharmaceutical sector

Exhibit: Rating distribution of ICRA rated universe of 34 companies (LT Rating)



Source: ICRA research

Exhibit: Count of upgrades and downgrades (ICRA rated universe)



- ICRA has a total of 52 entities rated under IT and BPO sector distributed across IT Services (83%), IT Hardware (13%) and IT BPO (4%). Approximately 82% of the rated entities are in Investment grade category for IT services sector. This is a reflection of healthy operating healthy cash flow generation led by higher margins and low working capital requirements. Further with low capex requirements, entities in the sector have been generating free cash flows leading to net cash position and liquid investments.
- The downgrades have been primarily for entities which derive a large portion of their revenues from domestic segment with elongated payment cycles.
- During H1 FY2021, ICRA has downgraded only 1 entity which was already on Negative outlook prior to onset of Covid-19 pandemic. ICRA has also not downgraded or revised any rating outlook to Negative for IT Services sector owing to Covid-19 pandemic.



ICRA

Analytical Contact Details



Subrata Ray

Senior Group Vice President

Gaurav Jain

Vice President

Jay Sheth

Vice President



Subrata@icraindia.com

gaurav.jain@icraindia.com

Jay@icraindia.com



022-61143408

020-66069922

022-61143400



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