



ICRA



## Indian IT Services Sector:

Pandemic struck demand will lead to -3.0%-Nil growth for FY2020 and margin contraction; shift to digital accelerated as silver lining

Subrata Ray  
+91 22 61143408  
subrata@icraindia.com

Gaurav Jain  
+91 20 66069922  
gaurav.jain@icraindia.com

Jay Sheth  
+91 22 61143419  
Jay.sheth@icraindia.com

Pawan Mundhra  
+91 20 66069999  
Pawan.mundhra@icraindia.com

Sonam Agarwal  
+91 22 61143400  
Sonam.agarwal@icraindia.com

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## Executive Summary

**Covid-19 impacts Q4FY2020 growth and business operation for Indian IT Services Industry**

- The demand prospects for the Indian IT Services companies will be adversely impacted by Outbreak of Coronavirus globally. The growth which stood at approximately 6.8% (US\$, FY2020) for our sample set will drop to -3% to Nil in FY2021e. Pandemic Covid-19 has delayed new projects off-take & deal conversion, higher price discounts and furloughs in short term and lower economic growth across the world curtailing overall IT Services spend.
- During Q4FY2020, ICRA sample companies grew by 7.6% in INR terms while in US\$ terms it grew by 4.5%. During the quarter INR depreciated by approximately 2.8%/1.0%/-0.2% versus US\$/GBP/EURO respectively (US and Europe collectively contribute 85% of ICRA sample set revenues) respectively leading to lower US\$ growth. Growth over the last 3-4 years has remained range bound with US\$ growth remaining at 6-8% incrementally impacted by Covid-19 in March 2020 quarter. Developed economies which contribute more than 90% of the IT Services exports is facing sluggish growth leading to lower demand for IT Services.
- While investments in digital technologies (Mobility, Social, Cloud, Analytics and Automation) continue to gather pace, legacy services growth remains subdued. The earlier small-scale proof of concept digital projects has started evolving into enterprise level larger implementations, modernization of core legacy systems coupled with improvement in discretionary spend supporting growth. Traditional services are increasingly adopting digital with IMS shifting to As a Service Model and Testing Services being automated. 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. Indian IT Services companies have increased investments in digital infrastructure like Center of Excellence (CoEs), labs and design centers to showcase capabilities coupled with several acquisition to augment their User/Consumer design capabilities.
- Companies in our sample continue to witness volume growth reflecting demand for IT services, albeit at lower pace. With INR movement positively impacting companies across sector, the growth rates have been divergent across companies. HCL Tech and LTI reported above average growth owing to inorganic reasons while companies like Zensar and Wipro reporting muted growth on lower new business as well business restructuring. Companies are re-orienting their business models to focus on high-end technologies such as SMAC, Automation, Design Thinking either through acquisitions or internal investments and will remain critical for the Indian IT Services going forward.

**Covid-19 Impact on various Business Parameters**

Parameter	Covid-19 impact on Industry
Supply	"90-95% achievement of work from home for majority of the IT Services Players by April with seamless integration for Application, IMS, Analytics. BFSI vertical impacted due to required modification in confidentiality agreements with clients; BP impacted due to infrastructure constraints.
Demand	Travel, hospitality, Airlines, non-essential Retail, Oil/Gas most impacted. Impact seen across sectors including BFSI, Communication, Manufacturing though Life Sciences impacted the least owing to nature of work.
New Deals and Execution	Pace of conversion of earlier deal wins into revenues have moderated. New deals focused on cost take-outs, cloud transformation, virtualization and digital customer experience though conversion time has increased due to Covid-19.

Parameter	Covid-19 impact on Industry
<b>Pricing / Payment Terms</b>	Mostly seen in legacy work during contract renegotiations. Covid-19 economic impact will be felt across the value-chain including IT Services Players specially from end user industries under pressure.
<b>Employee Utilization</b>	With lower new deals signing, ramp up in signed deals-, overall slowdown in execution; utilization will be low in H1 considering companies already hired / made offers in Q4FY2020 for H1FY2021.
<b>Opportunities</b>	Acceleration in cloud adoption/agile methods led by increasing engagements; Expect Analytics, IoT, Cybersecurity and Automation to gain ground
<b>Profitability</b>	Short term Levers: G&A, Marketing costs Medium term levers: Increased offshoring, automation, salary variablisation, productivity improvements
<b>Vendor Consolidation and Captives</b>	Small vendors unable to survive Covid-19 will lead to consolidation and market share gains for Larger Players; Captives takeovers likely if Covid-19 persist for longer tenure

#### Europe growing faster than USA; Insurance and Manufacturing vertical growing above average in FY2020, Covid-19 impact seen across sectors

- In terms of verticals, BFSI growth is slowing down over the last few quarters with Q4 and FY2020 growth of 9.2% and 6.8% respectively. Demand for the sector has been adversely impacted by current macroeconomic conditions impacting the banking industry including sustained low interest rates, continued focus on cost optimization, managing their discretionary spends as well as insourcing by few clients for want of greater control. The BFS segment growth is supported by digitization efforts, cost optimization, regulatory, compliance and security driven initiatives. Among the BFS segment, Capital markets and commercial banks saw weakness supported by Retail and Payments banks. The Insurance sector has seen good growth led by modernizing of legacy systems and is supporting the overall growth for BFSI which contributes 30% of ICRA's sample set revenues.
- The BFSI vertical (30% of sector revenues) which is already seeing weakness across US and Europe will be further impacted owing to Covid-19 induced fiscal and monetary policies leading to lower interest rates impacting margins coupled with impact of coronavirus on economic growth, lower credit offtake and other banking services. Other key sectors such as Oil and gas will be impacted because of record low crude oil prices leading to reduced discretionary spends. Manufacturing sector which has been one of the key growth drivers would be adversely hit due to lower consumption. Travel and Hospitality followed by Retail will be impacted as consumers will restrict outdoor activities to essentials in the foreseeable future. However, Life Sciences vertical is expected to see stable demand; the demand for technology vertical would be strong owing to core modernization and cloud

- On a YoY basis the growth from America during FY18, FY19 and FY20 stood at -1.1%, 19.6% and 8.9%. During the same period Europe posted growth of 6.8%, 22.0% and 8.2% while for RoW it stood at -0.4%, 10.6%, 6.2%. The relatively better performance of Europe (Ex-UK) is on favourable demand, improved geographical penetration by Indian IT Services outsourcing companies over the last few years. Demand from UK continues to be negatively affected by weakening of the GBP and uncertainties associated with Brexit.
- With slowing 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.

#### **Pace of new ITO contract awarded reflect moderate outlook for Traditional Sourcing**

- Overall demand for outsourcing during Q2CY20 remained soft on account of the economic fallout subsequent to the lockdown imposed across countries due to the pandemic. However, the pandemic led to accelerated growth of cloud-based IaaS (Infrastructure as a service) with higher focus on digital business initiatives. Growth of digital demand in traditional ADM services was led by cloud-based services and continued thrust on analytics and AI by various clients to support their business functions. There was also increased greater demand for security services due to remote working and lack of in-house security skills with various customers. Overall commercial sourcing market declined by 5.0 % YoY in Q2CY20 as traditional sourcing declined by 16% partly offset by a 7 % growth in As a Service market.
- Traditional sourcing ACV declined by 16.0 %, to \$6.0 billion, during Q2CY20 with the global sourcing market slowing down in the quarter due to the pandemic related economic fallout. The decline in traditional sourcing growth is attributable to large deals being delayed or cancelled as companies focused on conserving cash due to underlying business activity being adversely impacted. This was reflected in the contract volume declining by 11.0 % to 445 during Q2CY20. Traditional IT outsourcing (ITO) declined by 10.0 % to \$4.8 billion while Business process outsourcing (BPO) declined 34.0% in Q2CY20 culminating in a 16 % decline in traditional outsourcing. The total contract value (TCV) for traditional sourcing witnessed a decline of 27% during Q2CY2020 with ITO declining by 21 % and BPO by 41 %.
- Traditional outsourcing deal activity is expected to decline by 700-900 bps during CY2020 due to reduced discretionary spend owing to sluggish economic growth. Nevertheless, a rebound is expected H2CY2020 with increased spending on cybersecurity, cloud migration and collaborative tools.

#### **Use of operating levers compensate for profitability headwinds**

- The margin during Q4FY2020 were impacted by the lockdown during last two weeks of March 2020 and remained flattish at 22.7% supported by INR depreciation and operational efficiencies. The margins were impacted by pricing pressure on commoditised offerings and higher sub-contracting costs during the quarter led by skilled visa shortage.
- The share of fixed price contract stood at 63.2% Q4FY2020 compared to 58.6% in Q4FY2019 while Utilization remained flattish at 80% for ICRA sample companies. We estimate a single percentage point improvement in employee utilization leads to a ~40bps improvement in margin. The net employee additions stood at (5,317) and 67,358 during Q4FY2020 and FY2020 compared to addition 1,13,787 during FY2019. High-end services such as consulting, SMAC and automation also aided improvement in revenues per employee from INR 9.43 million Q4FY19 to INR 9.76 million Q4FY2020, growth rate of 3.4%. This has led to better absorption of overheads.
- On the supply side, Indian IT services will face issues such as travel restrictions to developed countries as well as closure of offices / work from home at various offshore development centers as well as onshore thereby impacting movement of labour. At the initial stages of projects, movement of labour at client's site is essential while later the same can be managed remotely. New projects to be commissioned will be delayed by minimum of 3-6 months while projects in pipeline will also face delays.

### **Covid-19 to accelerate shift to Digital technologies; Indian companies lag international peers**

- In the enterprise application space, significant spending has shifted from traditional on-premises implementation such as enterprise resource planning (ERP) to initiatives built around cloud, mobility, security and analytics. While earlier, the typical projects were in the pilot or proof of concept (POC) stage having a budget limited to a few million dollars, in the past year, size of such projects has scaled up materially. While earlier the investments in digital were restricted to front-end consumer facing applications to provide a better user experience, investments are now moving to the back-end. These are likely to be large scale digital transformation programs intending to modernise/replace their core legacy systems and size of the budgets is also expected to be more significant. This is especially true in consumer facing industries such as banking and retail verticals where the industries are going through a disruption and a legacy system may act as a hindrance for staying competitive.
- Indian IT companies in the past three years have made significant investments, organic and inorganic to reduce the gap with larger global companies such as Accenture, Capgemini and IBM resulting in their recent high growth rates in digital and increase in overall share of digital in their revenue mix. However, the global counterparts still have an edge in competency and scale because of early investments, organic and inorganic, made by them in digital technologies which is reflected in their higher proportion of revenues from digital offerings than their Indian counterparts.
- The Covid-19 pandemic is accelerating the secular trends of core modernization, usage of collaborative technologies and cloud migration as companies shift to digital business models to pursue work from home model.

### **Geo-Political issues: Temporary suspension of H1-B visa mildly negative for sector; Uncertainty prevails on proposed immigration legislations and rules tightening for US markets**

- The temporary suspension of issuance of fresh H-1B visas and L-1 visas (inter-company transfer) till December 2020 in view of the impact of Covid-19 pandemic on US economy and employment will be mildly negative for the Indian IT Services Sector considering their high dependence on such visas.
- With the visa issuance norms being tightened in USA by restricting the entry of entry-level programmers coupled with increasing compliance and evidence requirements adding to cost pressures, Indian companies have started to ramp up onshore hiring in USA. USCIS has significantly increased the Request for Evidence (RFE) before issuing H-1B visas leading to higher compliance costs. The percentage of completed case with Request for Evidence increased from 22.3% in FY2015 (Financial Year refers to October to September period) to 40.2% in FY2019. More restrictive administration policies have increased denials for H-1B petitions significantly, with denial rates rising from 6% in FY 2015 (October 2014 to September 2015 period) to 21% in FY 2019 (October 2018 to September 2019) for new H-1B petitions for initial employment (Exhibit 22). The top 7 India based companies had only 6,855 H1-B petitions for initial employment approved in FY 2019, decline of 63% (Exhibit 24).
- Apart from visa denials, companies are relying less on such visas and building up domestic workforce in the United States. Moreover, IT Services companies are using more digital services, such as cloud computing, “bots” and artificial intelligence, which require fewer workers.
- As a part of review of H1-B visa programme, the US Government is likely to replace the lottery-based system with merit-based system giving priority to highest salary applicants. There were approximately 2,25,000 applications for 85,000 H-1B visas to be issued in FY2021 (October 2020 to September 2021) making the programme intensely competitive. On an average, Indian IT Services companies pay higher than the minimum wages as per ICRA research though the proposed change will lead to higher onshore hiring for mid-level programmers who may not qualify for the visas based on new rule. Indian IT companies had already ramped up entry-level programmers in the past owing to tighter H-1B visa regime by USA, as explained above.



# OUTLOOK

### Outlook: Credit Profile to remain stable despite short term impact of Coronavirus outbreak

- The Indian IT Services industry which grew by 6.8% in FY2020 will witness muted growth in FY2021 owing to Coronavirus outbreak. The sector growth will drop to 0% to -3% in FY2021 versus ICRA's earlier expectation of 6-8%. The global spread of the coronavirus is resulting in simultaneously supply and demand shocks. ICRA expects these shocks to materially slow economic activity. US and Eurozone which generates more than 80% of IT Services export revenues will see their GDP contract in CY2020 (Source: IMF). Our IT Services growth forecast assumes gradual recovery during the second half of the year, however the evolution of the pandemic remains highly uncertain and the full extent of the economic costs remain unclear at this point of time.
- In terms of long term growth expectations, ICRA expects the sector US\$ growth to remain at 5%-8% over the FY2020-FY2025e period. While earlier, the typical projects were in the pilot or proof of concept (POC) stage having a limited budget, size of such projects has scaled up materially. Additionally, while earlier investments in digital were restricted to front-end consumer facing applications to provide a better user experience, investments are now moving to the back-end. These are likely to be large scale digital transformation programs intending to modernise/replace their core legacy systems and size of the budgets is also expected to be more significant. The growth of Indian IT Services companies will be impacted by lower demand led by uncertain macro-economic environment, cloud adoption and high competitive intensity from local as well as international players.
- The margins for the Indian IT Services companies will continue to reflect the challenging operating environment characterised by continued pressure on commoditised IT services, wage inflation, higher onsite costs necessitated by visa curbs as well as lower discretionary spend by corporate. Higher spends on emerging technologies while managing existing IT operations efficiently without significant headroom to increase budgets continues to put considerable pricing pressure on commoditised traditional IT services – legacy services are witnessing steady declines (by low single digits). The pricing pressure is usually felt when a deal comes up for renewal or during a vendor consolidation exercise. This has also led IT companies to increase efforts on automation to improve productivity and enhance the quality of work through machine learning. Nevertheless, commoditization of services is expected to be faster than the pace of automation resulting in continued pressure on revenues and profitability. Margins will be supported by factors such as ability to modify cost structure with variabilisation of salaries and gradual reduction in 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 margins from 22.3% in FY2020 to 20.0% in FY2022e.
- Nevertheless, the credit profile of Indian IT Services companies will remain stable underpinned by its ability to sustain free cash flows despite pressure on short term revenue growth and margins. With aggregate operating margins of ICRA sample set at 22.3% in FY2020 coupled with moderate capex (organic as well as inorganic) and working capital requirements, the free cash flows have remained robust historically.
- 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 (13 leading companies) reported surplus liquidity (net of debt) of approximately Rs. 1,644 billion March 2020 despite maintaining healthy dividend pay-out of approximately 60% of profits in addition to share buybacks. We expect that IT services companies will continue to maintain higher dividend payouts as well as share buybacks especially from large IT Services companies as there are limited avenues for fund deployment. The capex requirements (organic and inorganic) of Indian IT Services have been moderate relative to cash flow generation. Majority of the acquisitions done by Indian IT Services players have been to acquire competencies rather than achieve scale and size. The recent acquisitions have been to acquire digital capabilities revolving around cloud application services, user and design experience, analytics and mobility solutions. This has led to low ticket size acquisitions with average deal sizes of approximately US\$ 100 million.

## ABOUT ICRA

ICRA Limited (formerly Investment Information and Credit Rating Agency of India Limited) was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.

Today, ICRA and its subsidiaries together form the ICRA Group of Companies (Group ICRA). ICRA is a Public Limited Company, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange.

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- Assist the regulators in promoting transparency in the financial markets;
- Provide intermediaries with a tool to improve efficiency in the funds raising process.

## Business Contacts

Mr. L. Shivakumar  
E-mail: shivakumar@icraindia.com  
Tel: +91 22 6114 3406 / +91 98210 86490

Mr. Jayanta Chatterjee  
E-mail: jayantac@icraindia.com  
Tel: +91 80 4332 6401/ +91 98450 22459

## Media and Public Relations

Ms. Naznin Prodhani  
E-mail: communications@icraindia.com  
Tel: +91 124 4545 860

## Registered Office:

1105, Kailash Building, 11th Floor,  
26, Kasturba Gandhi Marg,  
New Delhi - 110 001  
Tel: + 91 11 2335 7940-45

## Corporate Office:

Building No.8, 2nd Floor,  
Tower A, DLF Cyber City Phase II,  
Gurgaon- 122 002  
Tel: +91 124 4545300

## Ahmedabad

1809-1811, Shapath V,  
Opposite Karnavati Club  
S.G. Highway, Ahmedabad - 380015  
Tel: +91 79 4027 1500/01

## Bengaluru 1

'The Millenia', Tower- B, Unit No. 1004,  
10th Floor, 1 & 2 Murphy Road,  
Bengaluru - 560 008  
Tel: +91 80 4332 6400

## Bengaluru 2

2nd Floor, Vayudooth Chamber,  
15-16, Trinity Circle, M.G. Road,  
Bengaluru - 560 001  
Tel: +91 80 4922 5500

## Chennai

5th Floor, Karumuttu Centre,  
634, Anna Salai, Nandanam  
Chennai - 600 035  
Tel: +91 44 4596 4300

## Hyderabad 1

No. 7-1-58, 301, 3rd Floor, 'CONCOURSE',  
Above SBI-HPS Branch, Ameerpet,  
Hyderabad - 500 016  
Tel: +91 40 4920 0200

## Hyderabad 2

4A, 4th Floor, SHOBHAN,  
6-3-927, A&B Somajiguda,  
Raj Bhavan Road,  
Hyderabad – 500082  
Tel: +91 40 40676500

## Kolkata

A-10 & 11, 3rd Floor,  
FMC Fortuna 234/3A,  
A.J.C. Bose Road,  
Kolkata - 700 020  
Tel: +91 33 7150 1100/01

## Mumbai

3rd Floor, Electric Mansion  
Appasaheb Marathe Marg,  
Prabhadevi,  
Mumbai - 400 025  
Tel: +91 22 6169 3300

## Pune

5A, 5th Floor, Symphony,  
S. No. 210 CTS 3202 Range Hills Road,  
Shivajinagar, Pune - 411 020  
Tel: +91 20 2556 0194, 020 6606 9999

Email: info@icraindia.com

Helpdesk: 9354738909

Website: www.icra.in/ www.icraresearch.in

