

# India IT Services

## Double edged Sword

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**Summary**

## IT Sector – Market Size

- CY12 global IT sector - US\$1.9trn market, growing @ 4.7%
- IT services and BPO constitute ~60%, growing 3.5%
- IT services expected to register a 4.5% CAGR – CY11-13

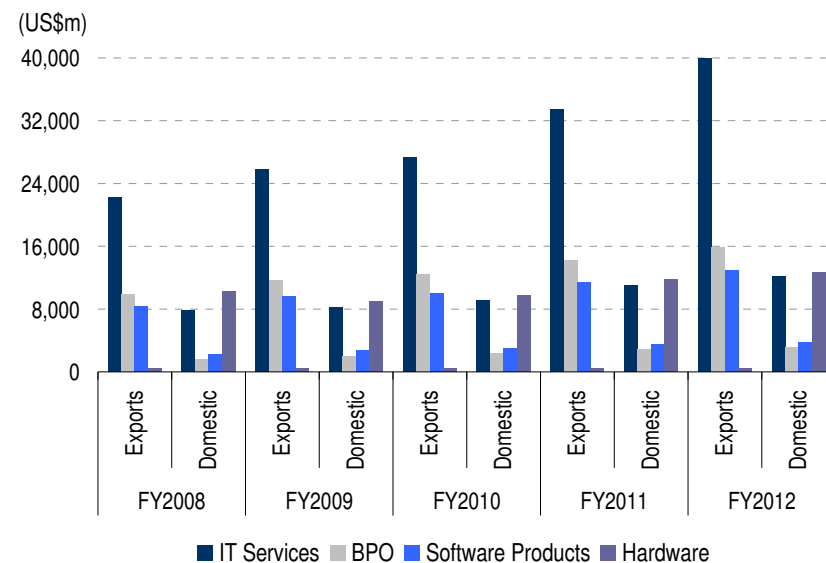
- FY13 Indian IT sector expected to grow ~11%
- FY14 NASSCOM expects the sector to grow 12-14%
- Indian IT and BPO markets expected to grow from US\$101bn (FY12) to US\$225bn (FY20), an 11% CAGR

### Revenue and growth of large companies

(US\$bn)	CY2008	CY2009	CY2010	CY2011	CY2012
Services	590	565	588	604	622
Growth (%)		(4.2)	4.1	2.7	3.0
BPO	129	151	148	154	161
Growth (%)		17.1	(2.0)	4.1	4.5
Software Products	303	271	292	310	321
Growth (%)		(10.6)	7.7	6.2	3.5
Hardware	601	562	600	748	798
Growth (%)		(6.5)	6.8	24.7	6.7
<b>Total</b>	<b>1,623</b>	<b>1,549</b>	<b>1,628</b>	<b>1,816</b>	<b>1,902</b>
Growth (%)		(4.6)	5.1	11.5	4.7

Source: IDC, Anand Rathi Research

### India – IT sector revenues



Source: NASSCOM, Anand Rathi Research

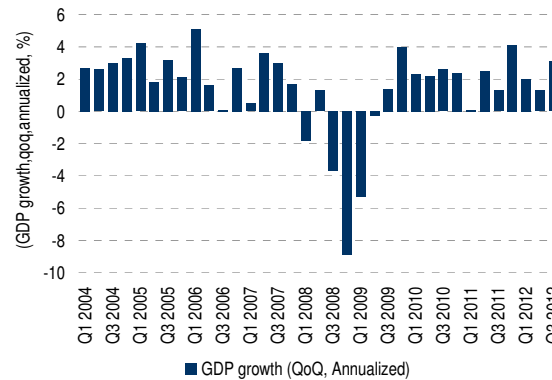
# **Mixed Macro-Economic Outlook**

## Developed markets facing growth issues

### Demand for outsourcing to rise

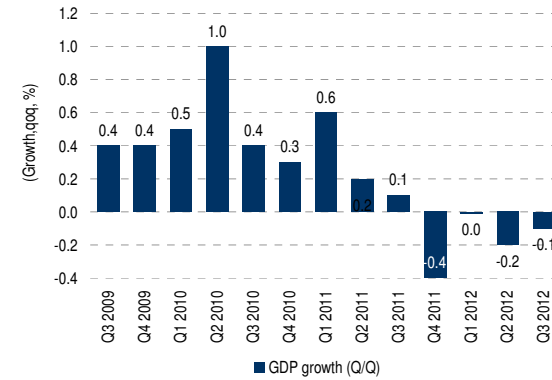
- Major developed economies under stress
- Leaves little room for high-margin discretionary spending
- Outsourcing to increase in order to rationalise cost
- Pricing to be under pressure

US: slowly Coming out of the woods



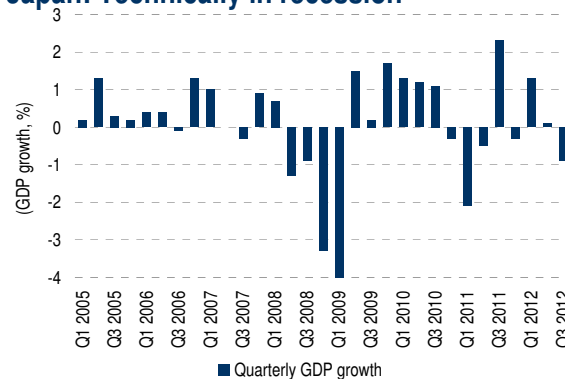
Source: BEA

Euro zone: Four quarters of negative growth



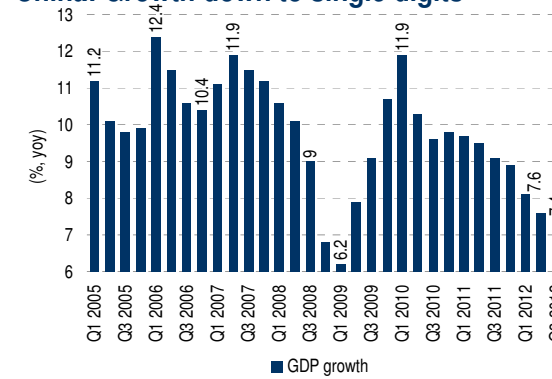
Source: Eurostat

Japan: Technically in recession



Source: National Bureau of Statistics, Japan

China: Growth down to single digits



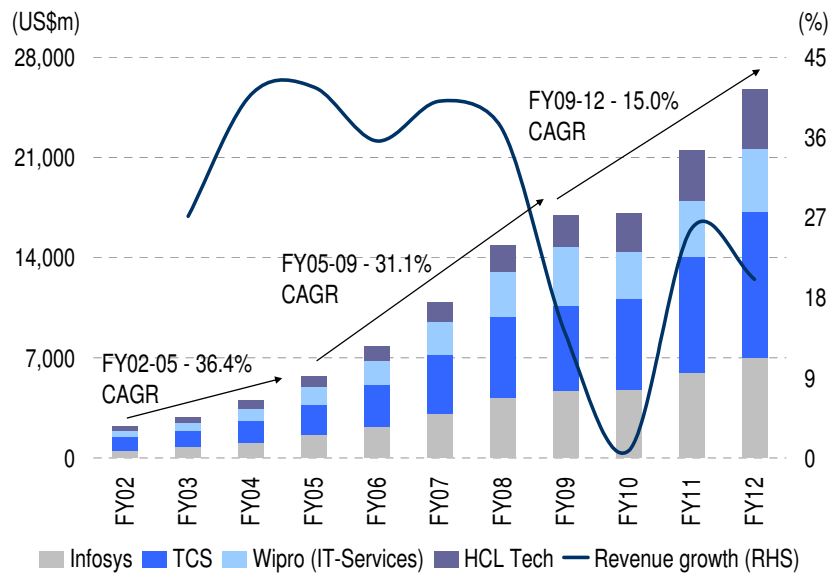
Source: National Bureau of Statistics, China

# **Position of large Indian listed companies**

# Heady growth ahead

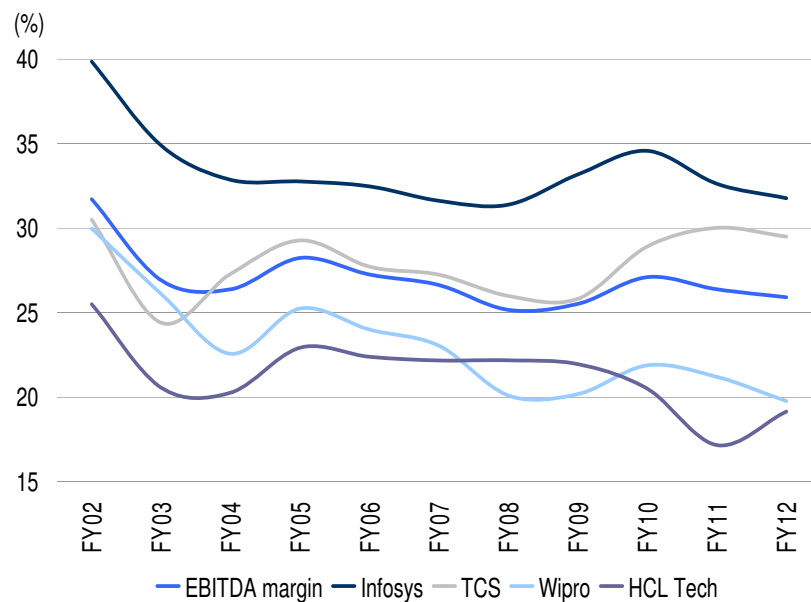
- Revenue growth rates have declined constantly
- Increasing pricing pressure pushes margin southward

Revenue and growth of large companies



Source: Companies, Anand Rathi Research

Constant pressure on margins



Source: Companies, Anand Rathi Research

## Limited margin levers...1

- Manpower costs comprise 50-55% of total cost for vendors
- Companies offering staggered wage hikes
- Companies deferring joining dates for freshers
- Slowdown seen in hiring of laterals as well

### Salary hikes

Company	FY12	FY13
Infosys	10-12% salary hike for offshore, 2-3% for onsite	6% increase in offshore wages, 2-3% onsite; onsite w.e.f. 4QFY13.
TCS	12-14% increase in offshore 2-3% onsite	8% increase in offshore wages, 2-3% onsite
Wipro	12-15% offshore salary; 3-4% onsite	6-8% wage increase in offshore, 2-3% onsite
HCL Tech	Wage hike of 12-14% for offshore; 2-4% onsite	Hike of 8% offshore and 2% onsite.

Source: Companies, Anand Rathi Research

### Employee additions

Company	FY13
Infosys	35,000 employees
TCS	50,000 employees
Wipro	IT campus hires of 11,000-12,000. IT laterals and BPO freshers and laterals would be over and above this

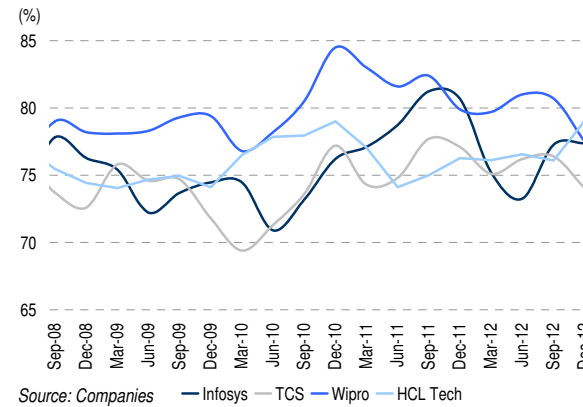
Source: Companies, Anand Rathi Research



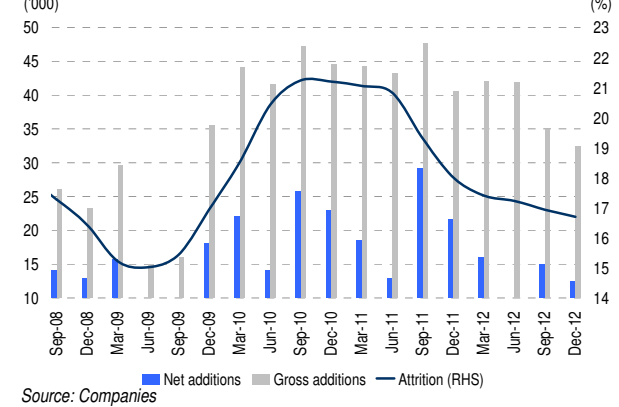
## Limited margin levers...2

- Utilization levels still below the high of ~84-85%
- Employee additions and attrition rates have tapered
- Naukri Job Index tracking demand for jobs in the IT and BPO sectors shows slow pick-up in the last quarter of FY13

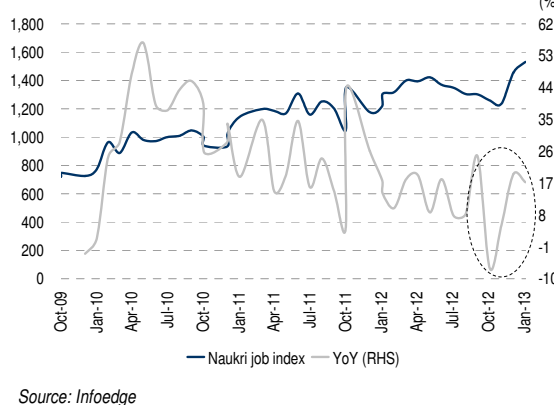
Utilisation (excl. trainees) has some room



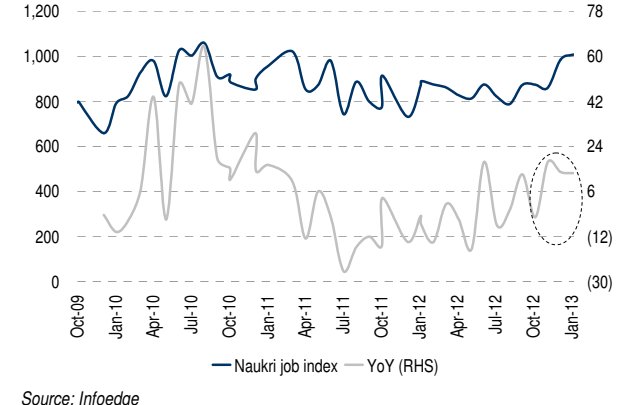
Employee additions



Naukri Job Index - IT and ITES



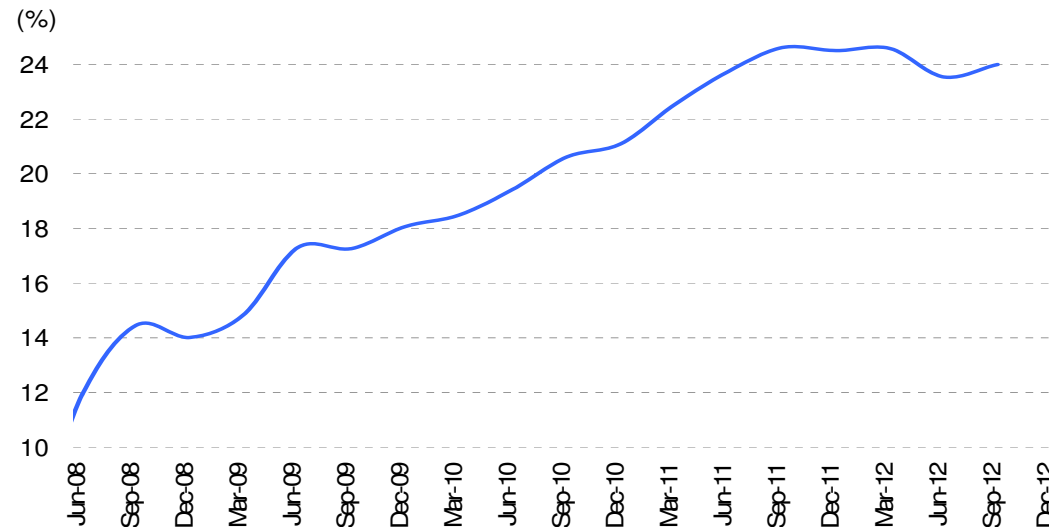
Naukri Job Index - BPO



## Limited margin levers...3

- **Visa costs** – With volumes picking up, client wins and deals being awarded, onsite employee requirements would rise. Further, our channel checks suggest that visa rejection rates have climbed manifold. Such expenses turn into sunken costs.
- **Marketing costs** - During the downturn, IT companies resorted to cutting marketing costs. This would now be reversed, leading to higher marketing spends on account of better demand visibility.
- **Limited tax holidays** – Post STPI holiday, Average tax rates for the sector have gone up from ~11-12% in FY08 to ~23% now. This has further affected the bottom line.

Average Tax Rates for Large IT companies



Source: Companies, Anand Rathi Research

## Currency – the wild card

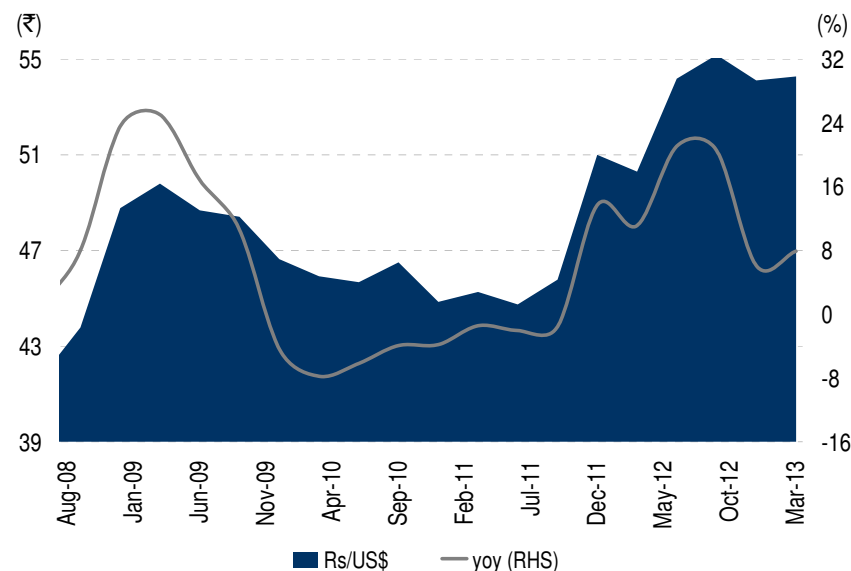
- Favorable currency movements to help domestic companies with high offshore component
- BPOs in other Asia-Pacific countries like the Philippines face the heat with the large depreciation of the rupee and appreciation of the local currency

### Quarterly average currency movements

	US\$/£	US\$/Euro	¥/US\$	US\$/AU\$
31 Dec '12	1.6	1.3	0.0	1.0
31 Sep '12	1.6	1.3	0.0	1.0
31 Dec '11	1.6	1.3	0.0	1.0
% change (qoq)	1.6	3.6	3.0	(0.1)
% change (yoy)	(0.3)	(3.8)	4.6	2.5

Source: Bloomberg, Anand Rathi Research

### Rs/US\$ over the last 10 years



Source: Bloomberg, Anand Rathi Research

# **New Business Strategies**

## Type of revenue models

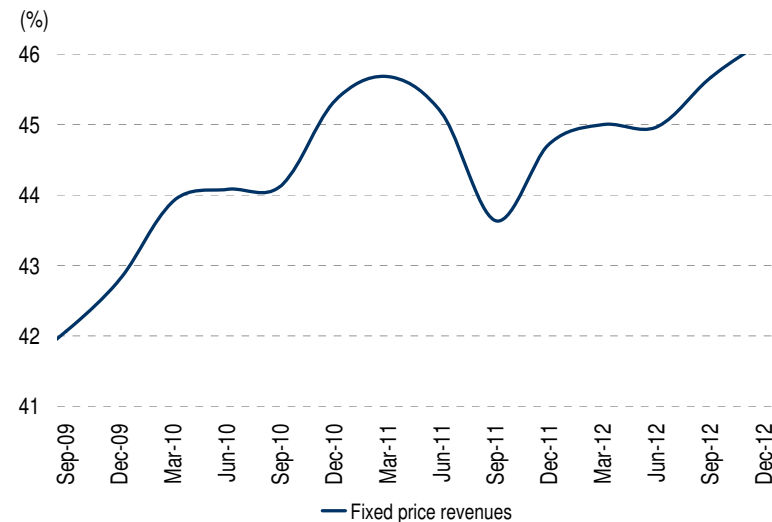
### Existing Models

- Time and Material (input-based pricing)
- Fixed-price contracts

### New Models

- Service-level agreements (SLA)
- Shared risk-reward pricing model
- Software as a service (SaaS)
- Output-based models (transaction-based pricing)

#### Fixed price contract



Source: Companies, Anand Rathi Research

## Type of Revenue Models

- Time and Material (input-based pricing)
  - Legacy model primarily used for labour arbitrage
  - Simple to understand and compare across vendors
  - No incentive for improving efficiencies
- Fixed Price contracts
  - Net outflow for clients is fixed irrespective of amount of resources put in by the service provider
  - Often used in military / government contracts to place the risk on the vendor, and control costs
  - Best when costs are known and can be kept under control
  - May fail if unforeseen costs exceed the ability of the contractor to absorb the overruns
- Service-Level Agreement (SLA)
  - Specific performance levels set to be achieved
  - Incentives, given benchmark performance levels are crossed
- Shared risk-reward pricing model
- Software as a service (SaaS)
- Output-based models (transaction-based pricing)

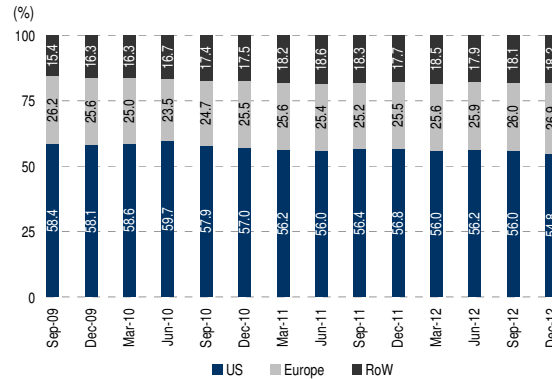
## Growth segments

■ Revenue from RoW has risen from 15.1% in Dec'07 to 18.2% in Dec'12

■ Share of IMS in revenue in the last five years rising from 10.6% to 15.8%

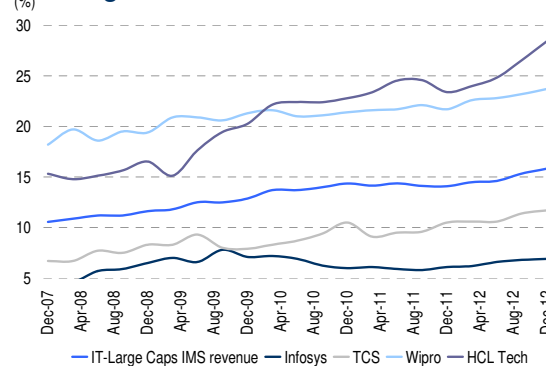
■ BPO share growing 240bps in the same period.

Share of Rest of the World increasing



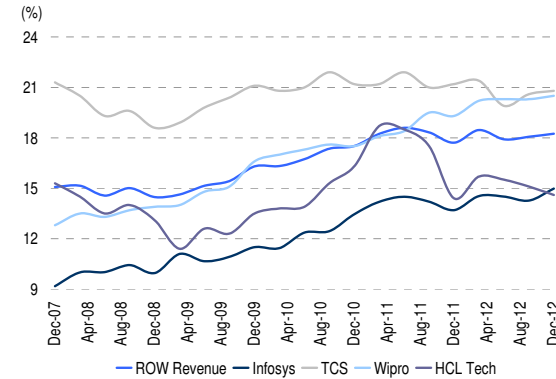
Source: Companies, Anand Rathi Research

Growing share of IMS...



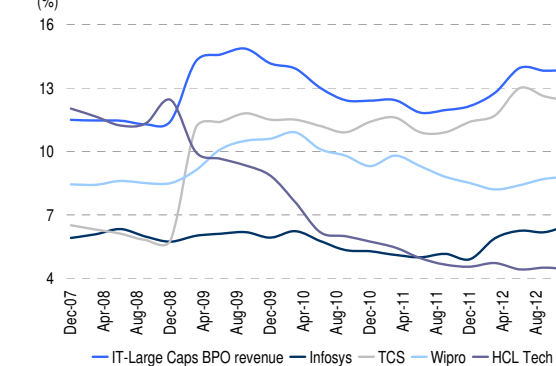
Source: Companies, Anand Rathi Research

Share of large cap companies in RoW



Source: Companies, Anand Rathi Research

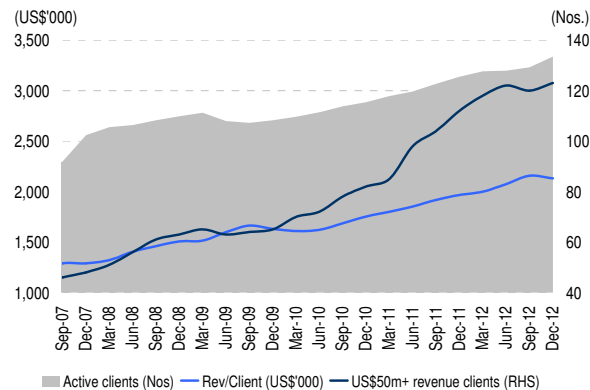
... and BPO



Source: Companies, Anand Rathi Research

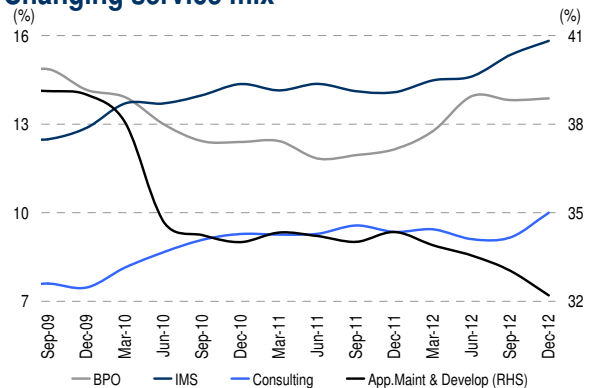
# Companies will adapt to change...1

## Client metrics improving



Source: Companies, Anand Rathi Research

## Changing service mix



Source: Companies, Anand Rathi Research

## New environment demands strategy changes

### IT service providers will be doing more of ...

- Client mining - Focusing on existing clients relationships to enhance business and cross sell products.
- Greater reach, diverse service offerings and ability to finance sales would gain importance. Mid-tier companies may lose out
- Fresh opportunities. Regulatory changes and government controls may warrant new processes and business models. Companies should react fast
- Service offerings should focus on more cost savings and predictable costs & deliverables
- Selling will begin or involve top layers (CXO); so sales profile will change

### Investors should look beyond P&L at ...

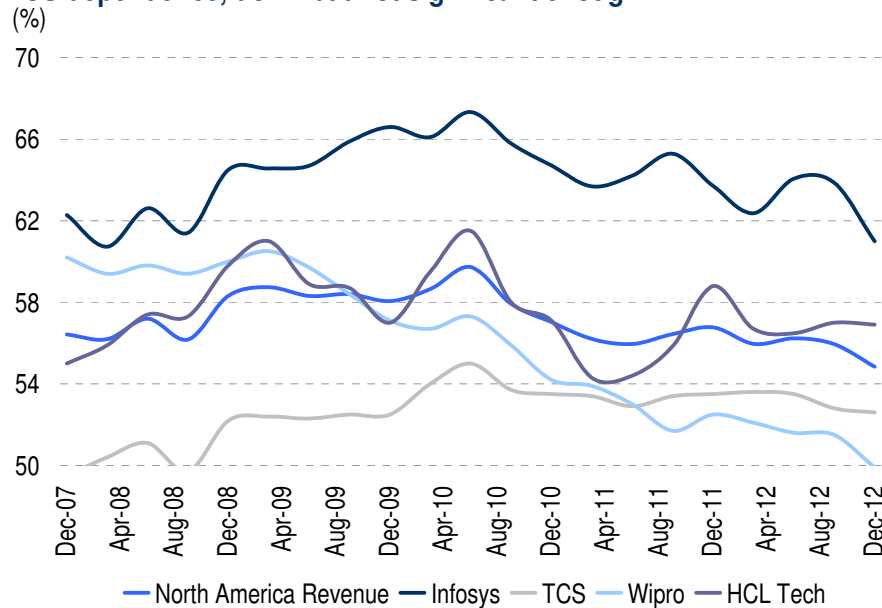
- **Efficiency.** Utilization rates, attrition, hiring, revenue productivity
- **Business mix.** Offshore and fixed-price revenue-share
- **Diversification.** Geographic, service and industry mix
- **Clients.** Reach, concentration, engagement size, large deals



## Companies will adapt to change...2

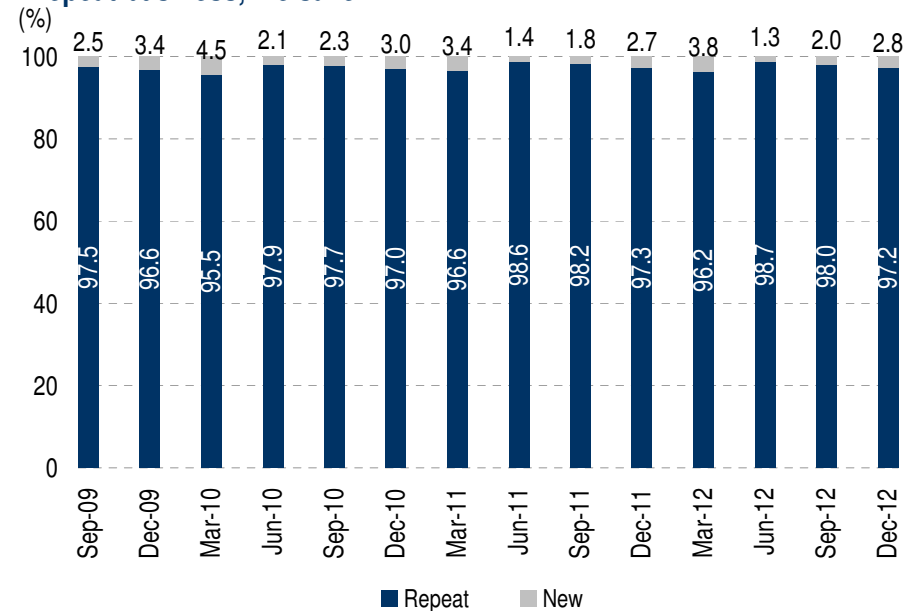
- Reducing dependence on developed market is imperative.
- Long term contracts with repeat business are tough to come. However act as a cushion in tough market conditions. Even if there is some upfront investment required to be done.

US dependence, down but not significant enough



Source: Companies, Anand Rathi Research

Repeat business, life saver



Source: Companies, Anand Rathi Research

# Valuations

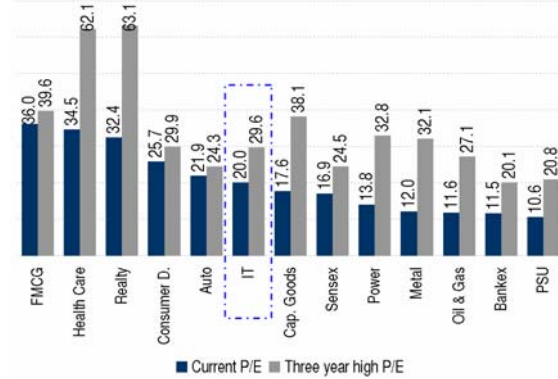
# Valuations

## IT sector returning to favour



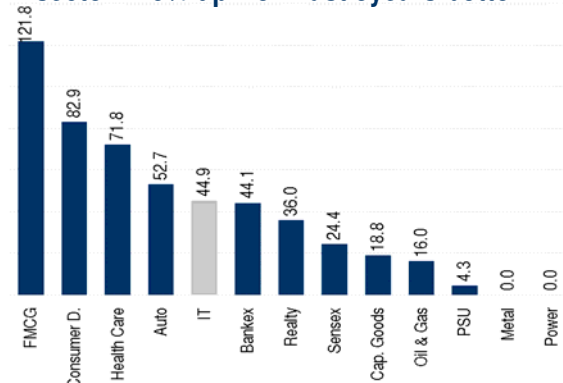
Source: Bloomberg, Anand Rathi Research

## Still room for multiples to expand



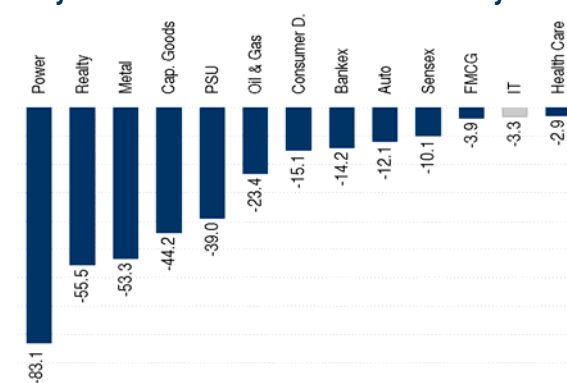
Source: Bloomberg, Anand Rathi Research

## IT sector ~45% up from last 3years bottom



Source: Bloomberg, Anand Rathi Research

## Only 3% below max valuation of last 3 years

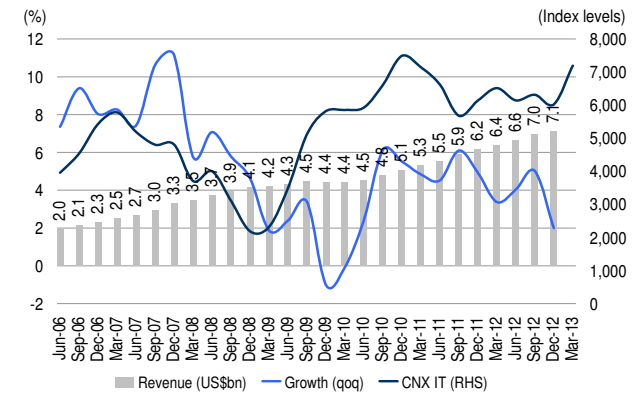


Source: Bloomberg, Anand Rathi Research

# Valuations

- CNX-IT precedes growth rates in the sector
- Valuations no longer inexpensive; limited room for upside
- Infosys and TCS have traded at above ~22x in the past
- Wipro and HCLTech normally trade at a 10-30% discount to Infosys
- Mid-cap stocks will be at a ~30-50% discount to large caps

## CNX IT, a pre-cursor of sector growth rates



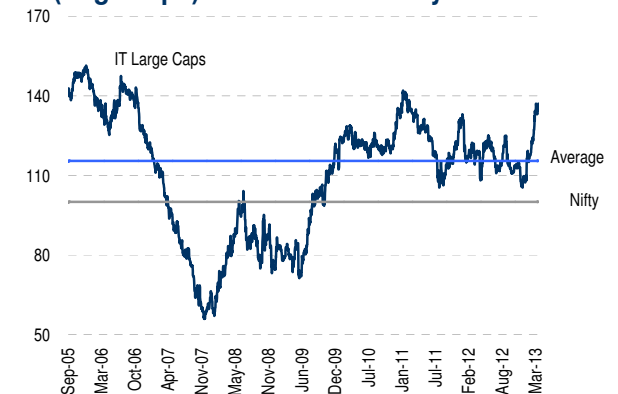
Source: Bloomberg, Companies & Anand Rathi Research

## PE band (large caps)



Source: Bloomberg, Anand Rathi Research,

## PE (large caps) relative to the Nifty



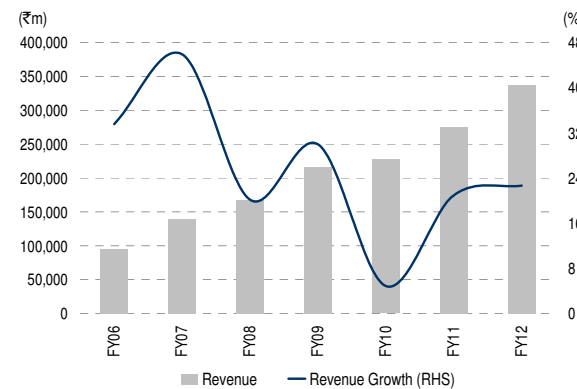
Source: Bloomberg, Anand Rathi Research,

# **Case Study**

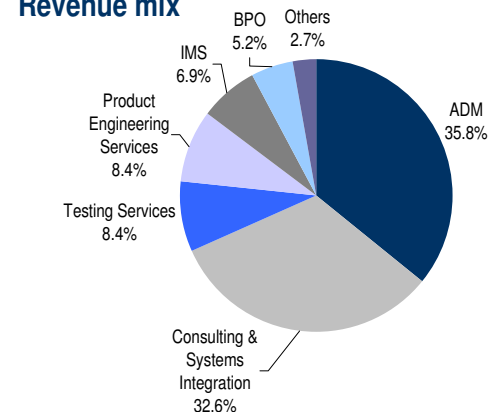
# Infosys

- Revenue growth flattened in FY11-12
- Large share of Consulting and ADM business drags down company in weak years
- Currently, the stock is at a 30% premium to the Nifty compared to its long-term 40% average
- Room for PE expansion above 18x if growth picks up

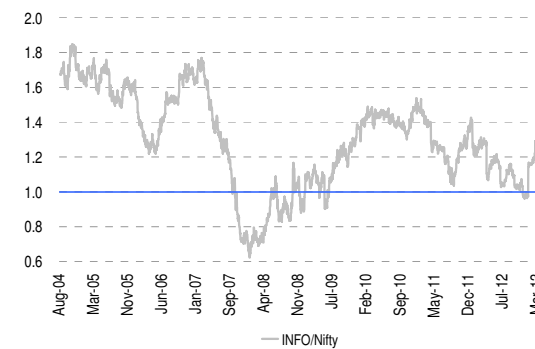
Revenue and growth



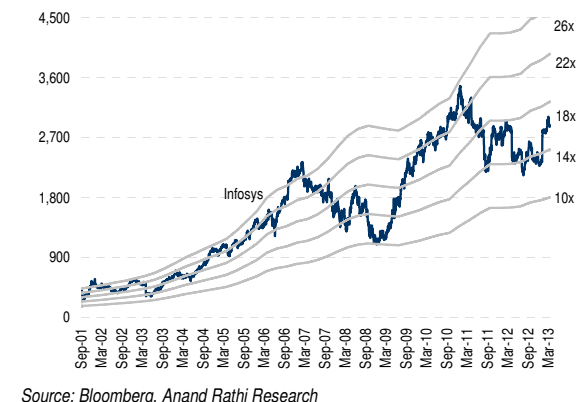
Revenue mix



Premium to the Nifty



PE band



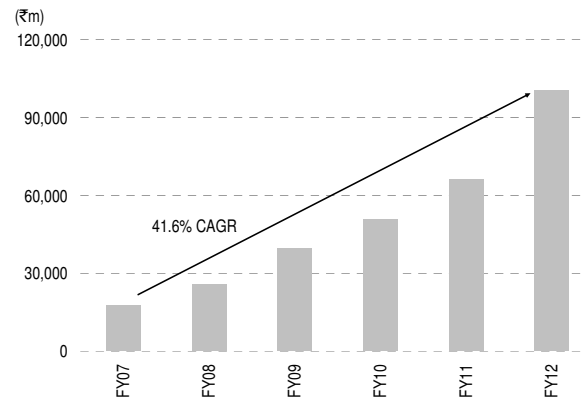
# HCL Technologies

■ Fixed Price based contracts and IMS helped company grow @ 21.9% CAGR over last four years

■ Company saw a PE expansion due to the growth in earnings

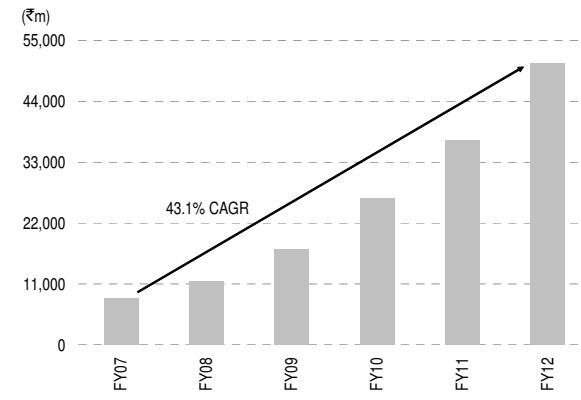
■ Discount to Infosys has reduced to 10% compared to 25-30% 2 years ago.

41.6% CAGR in Fixed price - based revenue



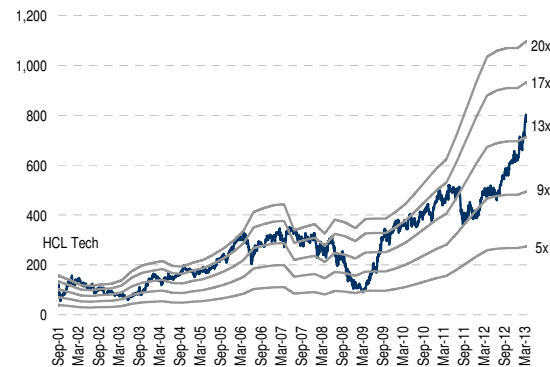
Source: Company, Anand Rathi Research

IMS at a 43.1% CAGR



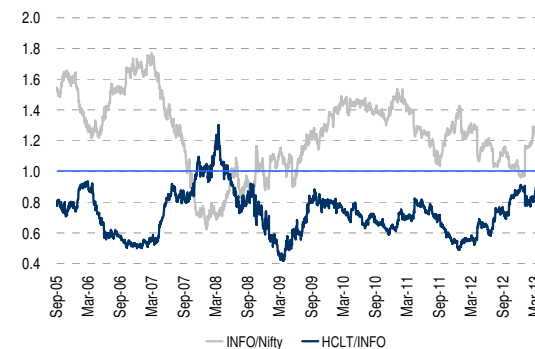
Source: Company, Anand Rathi Research

HCL Tech PE Band



Source: Bloomberg, Anand Rathi Research

HCL Tech Premium / Discount to Infosys



Source: Bloomberg, Anand Rathi Research

## Summary

- Growth rates coming down in the traditional outsourcing models
- Vendors need to adjust to new revenue models
- Very little room on the cost side
- Dependence on developed economics like the U.S. and EU needs to come down
- Vendors will grow if clients grow, not just by cost-cutting measures of clients
- Expect the Indian IT industry in the next few years to grow at low double digits
- Maintaining margins will be challenging
- PE multiples will contract with a depressing margin profile



**Thank You**

## Appendix

### Analyst Certification

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