Update on IT services and hardware industry

May 5, 2021 I Industry Research

FY21 was an unprecedented year by all yardsticks. The multiple lockdowns and social distancing restrictions on account of the covid-19 pandemic significantly impacted the economic activities across all nations globally and caused demand compression in the initial quarter of FY21. However, as travel restrictions eased in the subsequent months, the global economy recovered faster than anticipated. In H2-FY21, most developed as well as developing nations received approvals for vaccines which strengthened the hope for turnaround despite the pandemic. All such global developments saw an impact on the IT-BPM industry. Due to the essential nature of services provided, this industry was initially in a dilemma as to how their employees could work from home and not pose any security issues while dealing with the clients' sensitive data. However, this industry showed its resilience and by the end of April 2020, nearly 90% of the total workforce began working remotely, while only those performing critical functions travelled to their offices.

According to NASSCOM, the revenues of the IT-BPM industry declined 6% Q-o-Q in the first quarter of FY21, due to a demand compression, which quickly recovered in the second quarter and grew 6% Q-o-Q clocking the highest sequential growth since Q1-FY17. Revenues further rose in the third quarter by 4.1% Q-o-Q. As H2-FY21 progressed, the industry witnessed a buoyancy in technology spends by corporates, supported by growth in enterprise software and IT services. NASSCOM expects the industry to grow 2.3% YoY in FY21 to touch USD 194 bn (excluding Ecommerce). Exports expected at USD 150 bn is likely to see a modest growth of 1.9% YoY, however domestic technology sector is likely to perform better by growing 3.4% YoY to reach USD 45 bn.

The pandemic accelerated the adoption of new digital technologies and created a hybrid work model in many companies. The digital revenues of this industry maintained an uptrend and the share of digital in overall income reached nearly 50%. H2-FY21 onwards nearly all geographical regions started registering growth sequentially as well as annually. Similar was the case for various industry verticals. The client metrics improved in line with the demand recovery and the industry ended its hiring freeze, while attrition rates moderated.

According to DPIIT, the computer software and hardware sector attracted the highest FDI equity inflows in 9M-FY21 when compared with any other sector. This is equivalent to USD 24.4 billion and is nearly four-times higher when compared with 9M-FY20. The following sections are an analysis of the various industry players' operating dynamics like client metrics, performance of various industry verticals and geographical regions, growth in employee strength in FY21, etc.

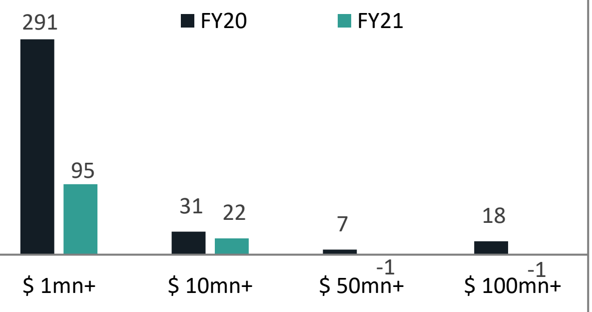
Client metrics

(Includes analysis of top 4 players: TCS, Infosys, Wipro and HCL Tech)

Analysis of chart 1 shows that the new client additions fell by half in FY21, when compared with FY20. This can largely be attributed to the significant fall in the $1 mn+ band, where client additions declined from 291 in FY20 to 95 in FY21.

A total of 117 new clients were added in the four bands of $1 mn+, $10 mn+, $50 mn+ and $100 mn+ in FY21, compared with 347 clients in FY20. Most new clients were added in the lowest band of $1 mn+ band, while the higher bands of $ 50mn+ and $100 mn+ saw a fall in even existing number of clients.

Chart 1: New client additions (YoY)



Source: Company presentations, CARE Ratings
Note: Includes data for TCS, Infosys, Wipro, HCL Tech

The order book comprised of deals related to digital transformation where a large part of these focused on cloud migration, cyber security and data analytics. Other deals related to increasing cost efficiency by implementation of automation, making better use of the existing IT infrastructure and further modernizing it.

Industry verticals and geographical markets

(Includes analysis of top 4 players: TCS, Infosys, Wipro and HCL Tech)

Most industry verticals suffered in H1-FY21 due to covid-19 induced sudden disruptions. The manufacturing industry was affected by decline in production activities. The automotive and aerospace sectors suffered due to factory closures and delays / cancellations in aircraft purchases. The energy, utility and resources vertical were under pressure due to constrained spending in the oil and gas sector. The communications vertical was lagging due to delays in 5G rollouts, while the media & entertainment industry witnessed cancellation of big sporting and entertainment events and weak advertising. The retail segment was under pressure as clients in the non-grocery, apparels, lifestyle & fashion, restaurants, logistics segments witnessed demand contraction and supply chain disruptions, while the transportation and hospitality segment was impacted by travel restrictions.

However, performance was better in H2-FY21. The retail cluster saw some recovery despite the seasonal softness of the holiday season, but there was continued weakness in discretionary retail, travel and hospitality sub verticals. The retailers continued to spend on initiatives to enhance customer experience and finding newer ways to leverage the physical store to provide value added services and experiences. The telecom segment began witnessing more traction, but softness in media and entertainment industry persisted. Segments like oil and gas, education, publishing, travel and hospitality remained under stress, while the utilities industry showed some degree of stability. The technology spends in manufacturing industry grew in the newer areas of digital, data, cloud and security and the industry vertical contributed terms of new deal signings.

The BFSI vertical, after an initial drop in early part of Q1-FY21 witnessed a quick recovery in business volumes and deals especially in US and APAC, where areas of spend included adoption of open banking, payments, insights-driven customer experience, automation, front to back digitization, mortgages transformation, robo-advisory systems, etc. The good performance continued in following quarters of FY21, with increased traction in mortgage servicing, call centre technology and operations, etc. The life sciences and healthcare vertical saw superior performance during the year and outshone all other industries.

Performance of most geographical markets declined in Q1-FY21, while Europe showed some resilience. In the following quarters, North America and India gained pace. Continental Europe continued performing well. However, the performance of various industries differed in various markets during the year. In H1-FY21, BFSI was better in US, while in other industries Europe performed better. In H2-FY21, there was broad-based momentum across multiple geographies with sizable deals. Alongside, Indian IT services players introduced new services to cater to the varying demands of clients.

Employee strength

(Includes analysis of top 4 players: TCS, Infosys, Wipro and HCL Tech)

The total headcount at the end of FY21 stood at 11.15 lakhs, a healthy growth of 8.9% YoY. The net new additions during this year were 90,813 employees, 46% higher than FY20. Usually, the first half of every financial year exhibits higher attrition as junior level employees quit jobs to pursue further studies. However, in H1-FY21, as the macro environment was grappling with multiple uncertainties, the attrition rates stood much lower than normal. With extended WFH models becoming a new norm at many large enterprises, hiring gradually shifted to non-metro regions. Employees who could work on new-age technologies like machine learning, blockchain, IoT, 5G, etc. were in higher demand. FY21 also witnessed the Indian IT companies expanding their presence globally, primarily in Canada and the US by setting up new delivery centers and hiring local employees to serve customers better.

Analysis of chart 2 shows that in FY21 employee costs as a proportion of total revenues rose in the first quarter to 50.9%, but declined in every successive quarter and reached 48.3% in the last quarter. When compared with FY20, this ratio was higher in initial two quarters and declined to 48.6% in H2-FY20.

Chart 2 also depicts the employee costs as a proportion of total costs, which grew to 70.5% in Q1-FY21 and further rose to 71.8% in Q2-FY21, but the following two quarters of H2-FY21 witnessed a decline. In FY20, this ratio was lower in the range of 66.8% to 67.7%.

Further analysis shows that the total employee base in FY21 grew by 90,813 employees, which is much higher than 62,346 employees growth witnessed in FY20. However, the employee costs in FY21 grew by Rs. 2,362 crore, compared with Rs. 2,984 crore in FY20. This shows that the incremental employee costs were lower in FY21, even though net employee base grew at a much higher pace and even after rolling out promotions and salary revisions during FY21. Most of the delivery centres of IT services players located across the globe remained closed in H1-FY21 and hence, a vast majority of the employees delivered their work from home. Due to the imposition of travel restrictions, a favourable onsite and offshore mix helped lower overall employee cost.

Chart 3 depicts revenue generated per employee and costs incurred per employee - where both the ratios remained stable during the year. In H1-FY21, cost avoidance measures like hiring freeze, reskilling bench talent to improve utilization etc. were implemented to reduce margin suppression. Additionally, temporary workforce was downsized and replaced with the existing slack in the system, which led to improvement in utilization levels.

Chart 2: Employee costs as a proportion of revenue and total costs

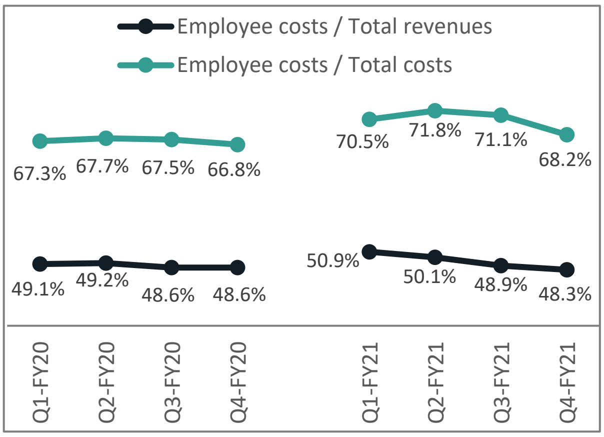
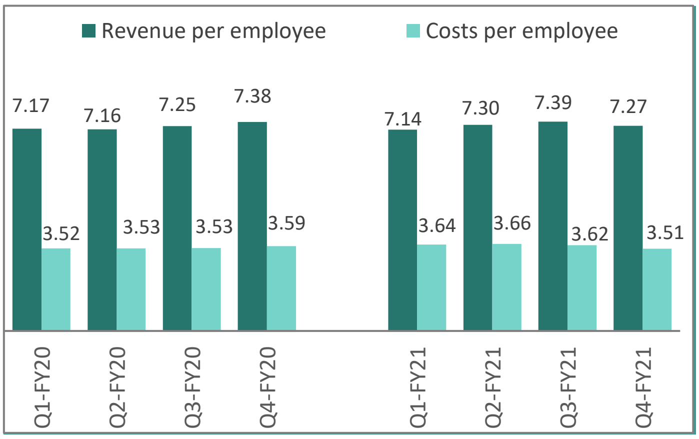


Chart 3: Revenue and costs per employee (Rs. Lakhs)



Source: Company presentations, CARE Ratings, Ace equity

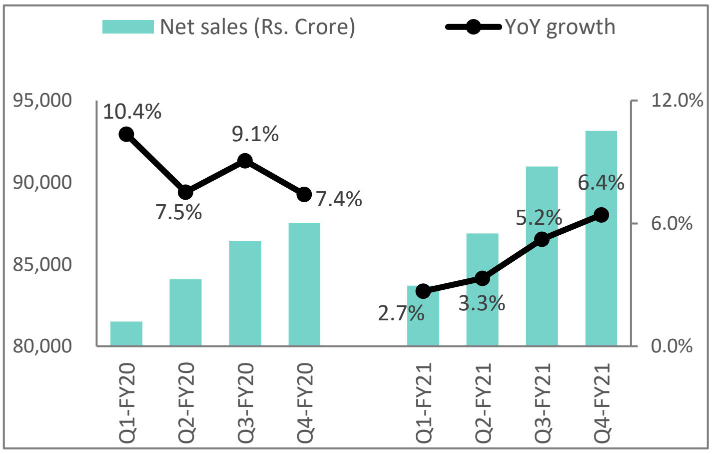
Note: Includes data for TCS, Infosys, Wipro, HCL Tech

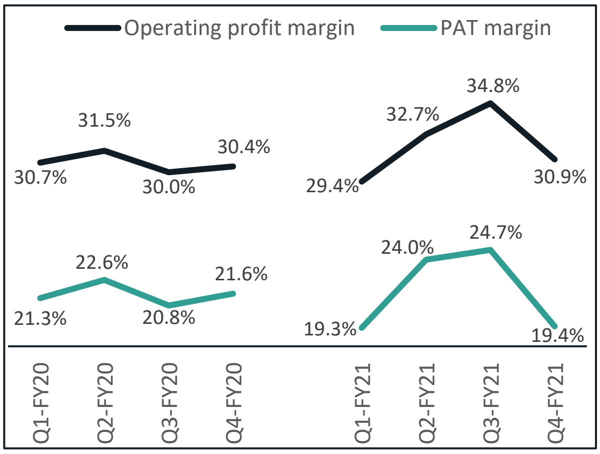
Financial performance

While the industry lagged in the first quarter of FY21, it demonstrated a strong rebound in the second quarter across all parameters, backed by growth across key verticals and geographies. The charts 4 (a) and (b) depict quarterly financials of FY20 and FY20 for 21 companies.

The first quarter of FY21 witnessed a demand contraction which got reflected in the net sales as well as margins. To control further fall in margins, IT services players indulged in short term discretionary cost reductions, some of which were enforced by covid-19 like travel and visa costs, lower selling, general and administrative expenses, rate negotiation with vendors, etc. A recovery was seen in Q2-FY21. A higher offshore mix, improved utilization levels, lower employee attrition and the benefits of moderate subcontracting aided the improvements in margins, while the adverse movement of Rupee created pressures. The free cash flows grew supported by robust collections, despite some client extension requests. Additionally, the stimulus provided by various governments to companies operating in those regions helped in improving cash collections. As the year progressed, clients accelerated their technology investments and IT services players expanded their products and service offerings to cater to new demands of an expanding set of clients. A broad-based growth across most markets and industry verticals helped this industry clock positive growth in FY21.

Charts 4 a & b: Financials of IT software industry (21 companies)





Source: Ace equity, CARE Ratings

Non-immigrant visas

The IT services industry requires free movement of people across nations and imposition of any restrictions in key markets could potentially delay project executions and rise in costs. The US is one of the largest markets for Indian IT services industry. Since nearly 5 years now, the US government administration, was seen introducing restrictive policies for the grant and approvals of non-immigrant visas. H-1B is one such non-immigrant visa, which the Indian IT services industry is the biggest beneficiary of. The frequent changes in policies have acted as deterrents to the growth of this visa dependent technology outsourcing industry. Such initiatives by the US government are an attempt to control rising unemployment rates in their country and encourage local hiring. In its response, the Indian IT services players have increased their localization efforts by hiring from American universities, setting up new delivery centres in US and made use of subcontractors.

Any decisions on immigration and work visas are crucial, as the Indian IT services industry is dependent on these short-term visas given the type of business model they operate in. It is crucial not only for the Indian IT services players, but also for US headquartered tech giants like Amazon, Google, Microsoft, Facebook, IBM, etc. who are helmed by employees of Indian origin.

In CY2020, few days prior to the US Elections, the US administration proposed not to issue temporary business visas for H-1B speciality occupations. This proposal follows a series of initiatives that the US government had taken earlier, like hiking the minimum wages for non-immigrant visa holders (for transfers and extensions) and increasing the premium processing fee. However, CY2020 and CY2021 may not see much impact of such visa restrictions, as global travel is anyways on a decline. Also, the ongoing pandemic witnessed migration to a remote working model, which helped mitigate the risks associated with approval of such visas.

Since nearly 6 months, a new government led by Mr. Biden, has taken the front seat. As of now, not much can be accurately anticipated about the future policy directions by the newly elected President. However, it can be assumed that it may not be as aggressive as the former government. In December 2020, a US court blocked the H-1B visa rule changes that made it tough to recruit H-1B workers, bringing relief to Indian technology workforce and IT industry. These rules included increasing the scope of site visits by the US Citizenship Immigration Services, limiting the qualification criteria for H-1B visa workers and reducing the validity of H-1B visa at a third party site to one year.

The following are some of the announcements made in past 4 months of CY2021:

- In February 2021, a final rule calling for higher wage levels was published. This rule was frozen for 60 days until March 2021 as per a White House memo, putting any rules that have been issued, but not implemented, on hold. This rule if implemented makes it harder for small companies and start-ups to hire H-1B workers.

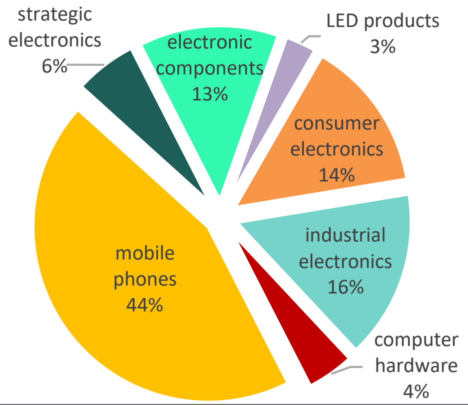
- In March 2021, the US Citizenship & Immigration Services rescinded its earlier guidance memo, which held that computer programmers are not entitled to H-1B speciality occupation visas. The US government said that H-1B visa applications can no longer be denied on the sole ground that the applicant is a computer programmer.

- In April 2021, the US Department of Labor delayed the H-1B minimum wage hike rule brought during the administration of former US President Donald Trump, with a likely implementation in Nov’22.

Electronics industry

With per capita disposable income and private consumption having doubled in the past decade, India has emerged as one of the largest markets for electronic products in the world. According to Ministry of Electronics and Information Technology, the electronics market is segmented as mobile phones, computer hardware, consumer electronics, electric components, strategic electronics, LEDs and industrial electronics comprising of auto, medical and other industrial electronic products.

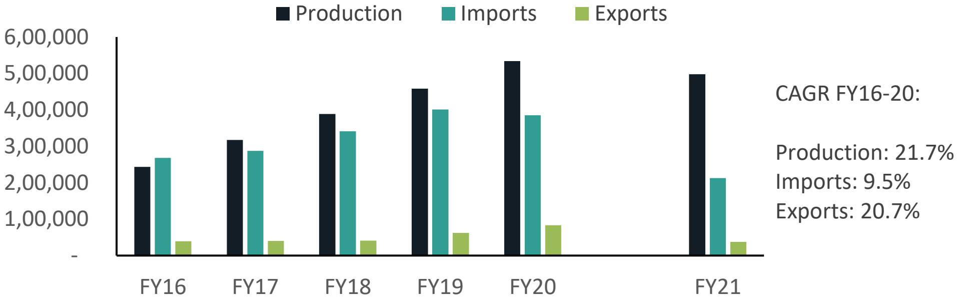
Chart 5: Estimated production share of electronics in FY21



Source: Ministry of Electronics and Information Technology

Indian electronics industry has undergone major transformation in last few years with a host of initiatives and reforms undertaken by the Government of India. There have been several initiatives to promote electronics manufacturing and as a result, domestic electronics manufacturing is on a growth trajectory. India's share in global electronics manufacturing is estimated to have grown nearly three times from 1.3% in 2012 to 3.6% in 2019. The domestic production of electronic items has more than doubled in past 5 years from Rs. 2.4 lakh crore in FY16 to Rs. 5.3 lakh crore in FY20, growing at a CAGR of 21.7%. The availability of a large domestic market, strong consumerism and skilled talent at low cost have contributed to the growth over the past few years. In FY21, the production was estimated to have fallen to Rs. 4.9 lakh crore due to the ongoing pandemic.

Chart 6: Production, imports and exports of electronics in India (Rs crore)



Source: Ministry of Electronics and Information Technology
Note: FY21 production is estimated
Note: FY21 exports and imports is April to October

India's electronics export in FY20 was 3.7% of India's total export. As per DGCI&S data, export of electronic goods exhibited a growth of 34% YoY to reach nearly Rs.0.83 lakh crore in FY20. However, in FY21 (April-October) exports stood at Rs. 0.38 lakh crore, exhibiting de-growth of 19% for the same period, due to the COVID-19 pandemic. The import of electronic goods stood at Rs. 3.8 lakh crore in FY20, exhibiting decline of 4% over previous year. In FY21, (April-October) imports declined 13% YoY to Rs.2.1 lakh crore. Over the past few years, the imports of finished goods have declined and that of electronic components have increased, indicating setting-up of manufacturing units of electronic products in the country. This is due to the rising demand of electronic components in computer hardware, strategic electronics and lighting industry sector. Production of mobile phones and industrial electronics (due to the advent of electric vehicles) are also expected to rise in near future.

IT-Hardware

Information and Communication Technology (ICT) hardware in the context of the hardware industry encompasses computers, storage, datacom, office automation hardware and operating systems. It involves the design of the semiconductors, the design of products, the manufacturing of hardware and the development of their operating systems. Emerging domains like Artificial Intelligence and Internet of Things, among others, are now the new driving forces for the growth of ICT hardware segment. Another emerging domain in ICT hardware is the large scale data centers. India with its technical prowess, cheap labour, large pool of manpower, English as the working language, has the opportunity to lead the world in all these domains.

FY21 has seen a rise in demand for ICT hardware arising out of work from home and the need to be connected remotely. Individual consumers have bought computers and tablets, enterprises have invested in their data centre infrastructure (to service the work from home, online B2B dealings) and the telecom service providers have been upgrading their infrastructure to cater to the increased broadband demand.

Production Linked Incentive (PLI) scheme for IT Hardware

The vision of National Policy on Electronics notified in February 2019 is to position India as a global hub for Electronics System Design and Manufacturing (ESDM) by encouraging and driving capabilities in the country for developing core components, including chipsets and creating an enabling environment for the industry to compete globally.

Currently, the laptop and tablet demand in India is largely met through imports valued at USD 4.2 billion and USD 0.41 billion respectively in FY20. The market for IT Hardware is dominated by 6-7 companies globally which account for about 70% of the world's market share. It is imperative that these companies expand their operations in India and make it a destination for manufacturing of IT Hardware. After the global outbreak of covid-19 in CY2020, many manufacturing companies across the globe have started looking at diversifying their production plants to mitigate the risk involved in depending on a single market.

The PLI scheme for IT Hardware notified in March 2021, proposes production linked incentive to boost domestic manufacturing and attract large investments in the value chain of IT Hardware. The target segments under the proposed scheme includes laptops, tablets, all-in-one personal computers and servers. This is an important segment to promote manufacturing under AtmaNirbhar Bharat as there is huge import reliance for these items at present. The scheme shall extend an incentive of 4% to 2% / 1% on net incremental sales (over base year of FY20) of goods manufactured in India and covered under the target segment, to eligible companies, for a period of 4 years (FY22 – 25).

According to a press release by Ministry of Electronics and IT on 4th May 2021, this scheme is expected to lead to a total production of Rs. 1.6 lakh crore in the next 4 years. Out of the total production, IT Hardware companies have proposed a production of over Rs.1.35 lakh crore and domestic companies have proposed a production of over Rs. 25,000 crore. Out of the total production of Rs. 1.6 lakh crore in the next 4 years, more than 37% will be contributed by exports of the order of Rs. 60,000 crore. The scheme is expected to bring additional investment in electronics manufacturing to the tune of Rs. 2,350 crore and generate about 37,500 direct employment opportunities along with creation of additional indirect employment of nearly 1 lakh. Domestic value addition is expected to grow from the current 5-12% to 16-35%.

A total of 19 companies have filed their application, which are Dell, ICT (Wistron), Flextronics, Rising Stars Hi-Tech (Foxconn), Lava, Dixon, Infopower (JV of Sahasra and MiTAC), Bhagwati (Micromax), Syrma, Orbic, Neolync, Optiemus, Netweb, VVDN, Smile Electronics, Panache Digilife, HLBS, RDP Workstations and Coconics.

Concluding remarks and outlook

- The digital transformation initiatives grew manifold during the pandemic, with much greater realization of the need for digitization. The industry witnessed superior operating margins in FY21 supported by improvement in several cost levers and also due to cost avoidance and deferment. With normalcy returning gradually across the world, we anticipate some of those costs to return and hence operating margins may witness some moderation in H2-FY22 and FY23.
- Global technology spends are expected to continue being upbeat in FY22. Robotics, artificial intelligence, cybersecurity, IoT, among others are expected to be the key technology focus areas in FY22. In FY22, the IT-BPM industry expected to grow by upto 5% YoY to touch USD 205 bn, where domestic market may grow at a higher pace of 6-7% YoY to USD 48 bn and exports may grow by 4-5% YoY to USD 157 bn.
- For FY22, hiring is expected to be upbeat, as most players of the Indian IT services industry are expecting a strong deal pipeline despite pressure on discretionary budgets in some of the impacted customer industries. Attrition rates are expected to grow to normal levels after a moderation in FY21, as demand starts improving due to more deal wins which creates a demand for skills in emerging areas.

Contact:

Madan Sabnavis	Chief Economist	madan.sabnavis@careratings.com	+91-22-6837 4433
Author: Vahishta Unwalla	Research Analyst	vahishta.unwalla@careratings.com	+91-22-6837 4408
Mradul Mishra	Media Contact	mradul.mishra@careratings.com	+91-22-6754 3573

CARE Ratings Limited
Corporate Office: 4th Floor, Godrej Coliseum, Somaiya Hospital Road, Off Eastern Express Highway, Sion (East), Mumbai - 400 022
Tel. : +91-22-6754 3456 I CIN: L67190MH1993PLC071691

Connect :