Value proposition beyond cost; transformation by shifting to non-linear model is the key challenge

Cost arbitrage, which has been the model on which the Indian IT companies traditionally built their businesses, is fast diminishing as an USP for the sector. The existing business model for the majority of the companies in Indian IT sector, leaning heavily towards providing application development and maintenance services with a focus on cost saving and labour arbitrage has failed to remain a sustainable long-term plan. Global consulting companies like IBM, HP and Accenture have set up 'offshore' centres in India, leading to the business becoming commoditised. Competition from other low cost destinations has also been increasing. Apart from the competition, there is a demand from the customers for a wider array of services at the same cost. In order to protect the margins, the Indian IT companies will have to provide the entire suite of services and increase the productivity through creation of intellectual property or differentiated skills.

The next stage of growth for Indian IT players will be driven by acquisition of market share from global players in existing contracts coming up for renewal. Out of the total deals coming up for renewal, majority are for IT and Infrastructure outsourcing agreements and only a small portion relate to application development and maintenance. Whereas the Indian IT players are dependant mainly on application development related deals and have a very small presence in IT and Infrastructure outsourcing deals. In order to increase the penetration in infrastructure and total outsourcing deals, the Indian IT companies will have to become competitive by shifting to non-linear models, which are expected to drive the industry going forward. (In a non-linear model, business and headcount growth are delinked, unlike in a traditional effort based business model). This will ensure that the companies are paid more with increase in productivity, irrespective of the employee strength. The top IT companies in India have already started taking initiatives to move towards non-linear models. At present, it is estimated that around 8-10% of the revenue comes from non-linear models and efforts are on to increase this to around 25% in the next two to three years. Recruiting the right kind of talent will be a major challenge for these companies in moving towards non-linearity.

In order to move away from the traditional pricing models, the companies will have to broaden their product offerings and one way to do this is by investing in development of products and platforms. This can be achieved either by organic or inorganic growth and the product offerings will also require the companies to invest in sales and marketing.

Outlook- Muted revenue growth coupled with pressure on margins

On the back of new technology initiatives like cloud computing and platform BPOs, mandatory regulatory spend as well as higher offshoring (to reduce cost and improve productivity), Indian IT companies are expected to register modest growth in revenue in the coming quarters. Decline in growth from FY12 levels (of around 15%) is expected mainly due to uncertain economic environment with delayed client decision-making on IT spends. BFSI, which is the highest spending sector on technology, has witnessed slowdown during the recent quarters. Due to this, more and more IT companies are focusing on increasing their business from emerging verticals like retail, healthcare, media, manufacturing and utilities.

The recent considerable weakening of the Indian rupee against major currencies like the US dollar, Euro and GBP will provide an additional boost to the revenues of IT companies. Though rupee depreciation may augur well on the margins of the IT companies, margins may be under pressure in the next few quarters on account of lower utilizations post aggressive hiring in FY12 as well as companies having to pass on some benefit of rupee depreciation through price negotiations.

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