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Professional Risk Opinion

IT-BPM Industry Update

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Overview

- Global economic growth in FY20 was affected by multiple macro-economic challenges such as subdued consumer demand leading to dip in manufacturing activity, unresolved trade tensions between world's two largest economies, uncertainty around Brexit issues, volatility in oil prices and the latest being the wide spread of covid-19 that put most nations globally under a lockdown. With this, the Indian economy witnessed consistent fall in GDP growth in past three quarters, starting June 2019.

- Despite these challenges, technology spends across industries remained intact. Strong deal wins and broad-based growth across verticals and geographies helped drive positive growth during the year. The industry size grew 7.7% to USD 191 bn in FY20 (estimated by NASSCOM).

- Major proportion (51%) of the industry's revenues were generated from IT services, followed by Business Process Management (20%), engineering R&D (16%), hardware (8%) and products (5%).

- Indian IT-BPM industry continues to be one of the largest employers in the country with over 4 mn people involved directly or indirectly. The industry also attracts large number of start-ups.

- Digital has emerged as one of the biggest growth drivers for companies, contributing as much as 40% to total revenues.

- Largest industry verticals by revenue generation have been life sciences and healthcare, communication, media and tech. Softness in growth was witnessed in verticals such as BFSI, manufacturing, retail and consumer business

- The computer software and hardware sector attracted 10% of the total FDI equity inflows in the country in 9M-FY20, equivalent to USD 6.3 bn.

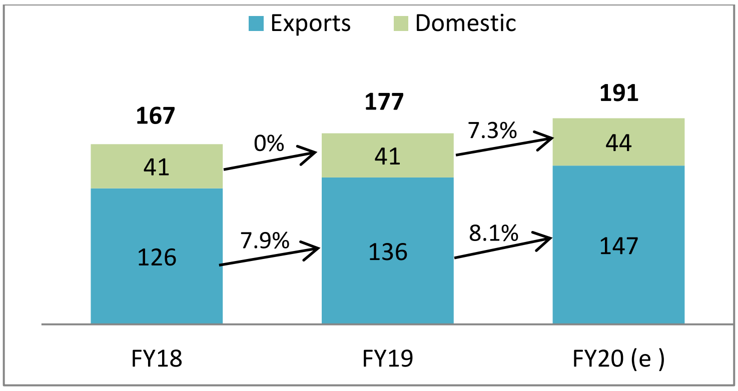
- Five Indian IT majors witnessed 28% rise in the non-immigrant H-1B visa denials in FY19 (1st October 2018 to 30th September 2019).

Industry size and structure

The Indian IT-BPM industry has a significant contribution to the Indian economy with about 40% share in total services exports from India. Despite a challenging global environment, the IT-BPM industry projected robust growth of 7.7% YoY in FY20, compared with 6.1% YoY in FY19. The industry size grew to USD 191 bn in FY20, with 77% generated from exports. A large portion of revenues for companies comes from the digital segment, which now comprises almost 40% of total revenues. Strong deal wins, broad-based growth across verticals and various geographies helped drive the positive momentum in FY20. However, the industry faced headwinds from currency volatility in H1-FY20.

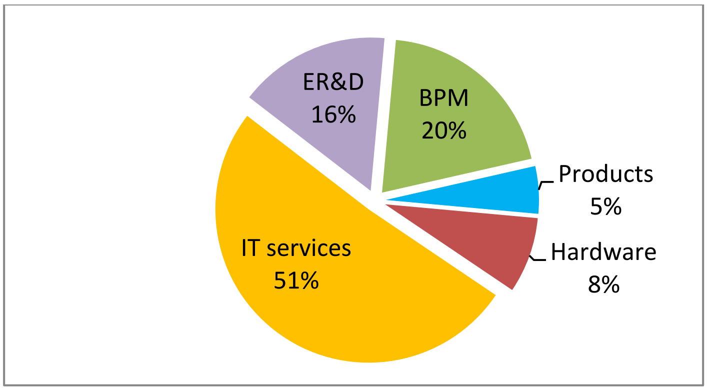
There has been a visible shift in recent years on source of revenue for IT payers, where overall spending on traditional services is tending to stagnate, with growing demand for newer technologies like cloud computing, analytics, blockchain, robotics, Internet of Things (IoT), etc. As viewed in chart 2, non-IT services segments such as Engineering service Research & Development (ER&D), Business Process Management (BPM), products and hardware now form almost 50% of the industry's revenues.

Chart 1: Indian IT-BPM industry size (USD bn)



Source: NASSCOM; e – estimated

Chart 2: Industry segments

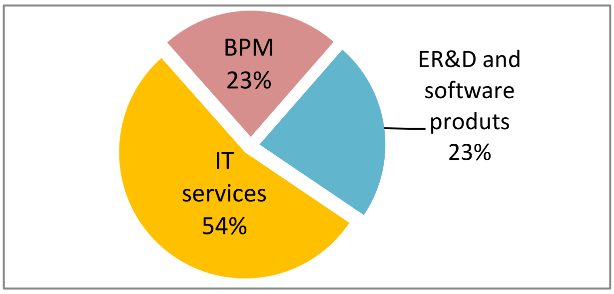


Source: NASSCOM

India's highly qualified talent pool of technical graduates is one of the largest in the world and the industry is one of the largest employers in the country with over 4 mn people. India has an advantage of low-cost human resources compared with large markets like USA. The computer software and hardware sector attracted FDI inflows worth ~USD 43.6 bn between April 2000 and December 2019 (2nd highest FDI equity inflows to India by any industry). In initial nine months of FY20, the industry witnessed FDI equity inflows of USD 6.3 bn, robust growth of 27% compared with similar period last year.

IT-BPM exports

Chart 3: Breakup of IT-BPM exports



Source: IBEF

As viewed in chart 3, IT services contribute the largest share (~54%) to the total IT-BPM exports, due to significant growth in demand for software testing and ISO (hosted applications).

BPM and ER&D and software products equally contribute 23% share each to total IT-BPM exports from India. ER&D continues to be the fastest growing segment led by demand for AECS - Autonomous, Electrification, Connectivity and Shared mobility.

Diversification

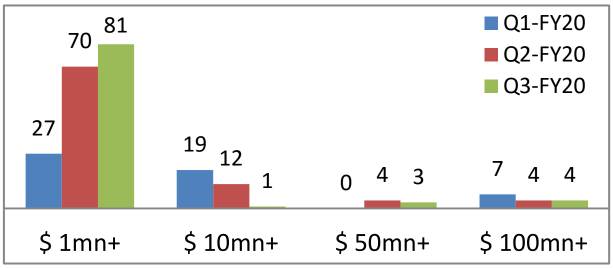
{Analysis is based on data of 4 Indian IT majors namely, TCS, Infosys, HCL Tech and Wipro; Note: All growth rates are in Constant Currency (CC) and Year on Year (YoY)}

For companies operating in this industry, diversification can be in the form of client mix, geographical markets, industry verticals, services offered, etc. Geographical diversification helps when a client suffers loss of business due to temporary disruptions in the market it operates in. Diversification in terms of industry verticals and number of clients is critical, as high dependence on limited number of clients in a particular industry could be detrimental. Similarly, a high proportion of government clients may lead to high receivables for the firm.

a) Diversification in client mix

Chart 4 depicts steady growth in new client additions across all revenue bands for four Indian IT majors. Totally, 232 new clients were added in initial 3 quarters of FY20. This includes 178 new clients in 1mn+ band, 32 new clients in 10mn+ band, 7 new clients in 50mn+ band and 15 new clients in 100 mn+ band. Such client additions have been across various industry verticals and priority for most, have been accelerated spending towards digital and simplification of IT operations.

Chart 4: New client additions

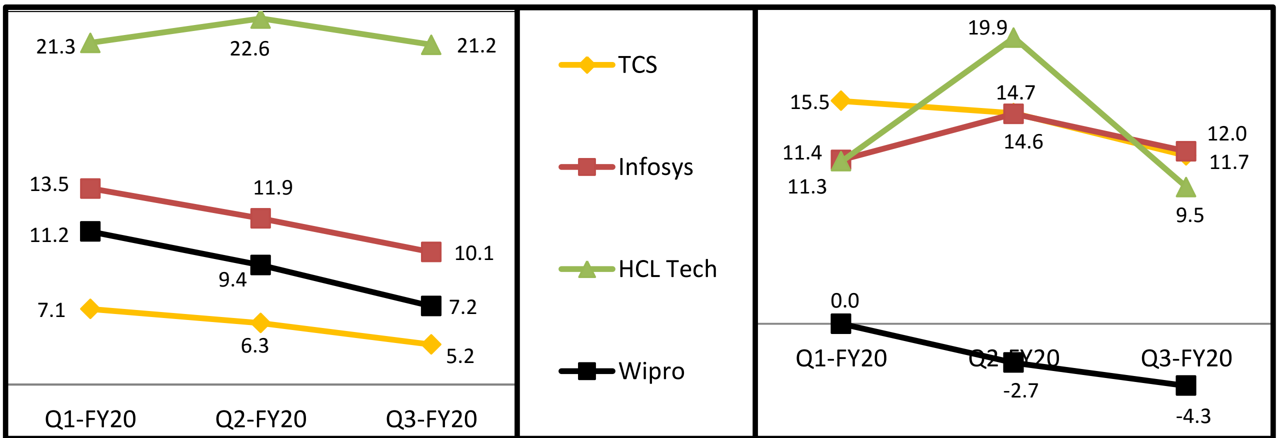


Source: Company presentations, CARE Ratings
Note: Includes data for TCS, Infosys, Wipro, HCL Tech

b) Diversification in geography and industry verticals

Americas is the largest market for Indian IT majors contributing about 50% or more of their revenues, followed by Europe with 20-30% share in company's revenues. While the IT majors posted stable growth in these two geographical markets, challenges in the macro-environment restricted the momentum in various industry verticals operating in such markets. Charts 5 and 6 depict growth in revenue in the two largest geographical markets for Indian IT majors. Due to holiday season in European and western countries during Q3 of every financial year, an IT firm may witness seasonality with lower revenue booking during the quarter. This is reflected in dip in Q3 growth rates in below charts.

Chart 5: Growth in Americas in CC (% YoY) **Chart 6: Growth in Europe in CC (% YoY)**



Note:
For TCS, data is an average of growth in North America and Latin America,
For Infosys data refers to North America,
For HCL Tech and Wipro data refers to Americas

Note:
For TCS, data is an average of UK and continental Europe

Industry verticals:

- **Banking, Financial Services and Insurance (BFSI):** BFSI is one the largest industry verticals of the industry, with about 50% share in revenues. While the insurance sub-vertical posted strong and stable growth, softness in banking and capital markets business was much pronounced in initial three quarters of the year. With some large banks in USA undergoing merger and acquisitions in start of the year, deal signings with IT services players were pushed to following quarters, affecting revenue growth. Also, continued weakness in capital markets business in both markets, especially UK due to Brexit related issues, did not provide much solace to clients for incurring IT spends. However, there were growth opportunities in consumer, corporate and commercial banking, cards and payments and wealth management driven by digital transformation and technology modernization.

- **Retail:** Retail includes sub-verticals like consumer packaged goods, travel, transportation, hospitality etc. Companies in this space considered migration to a B2C model and modernizing their supply chains. With retail being one of those industries that has strong correlation with global macro indicators, it gets impacted by consumer sentiments. Slowdown in consumption in UK and North America led to muted performance of this vertical which was reflective in customer spends.

- **Communication:** Communication industry vertical includes segments such as media, information providers, telecom, etc. Growth momentum in this industry was strengthened with large deal wins by IT players. Companies in this industry prioritized funding towards their customer reach and transformation initiatives through digital channels, self-services, Omni-channel, AI and Chatbots. Further, there were increased spending towards product innovations in 5G, IoT Solutions, cyber security, network virtualization, etc. However, the traditional business models of communication players are being challenged by digital native and OTT players. Overall performance in communications vertical was better in UK and Europe, rather than North America.

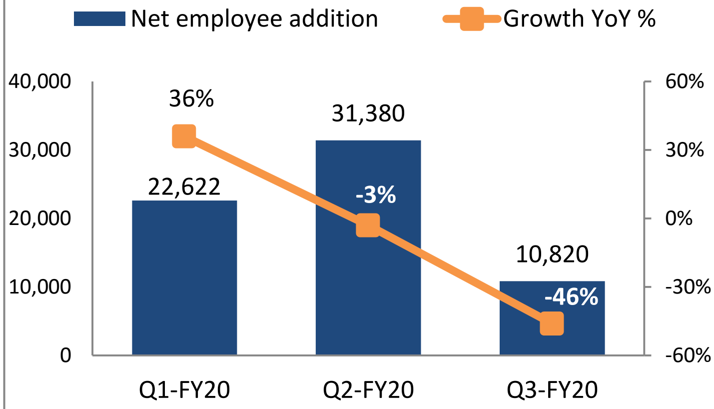
- **Life Sciences and Healthcare:** This industry projected strong double-digit growth in the initial three quarters of FY20 and was among the fastest growing verticals for Indian IT majors. Large numbers of new deals were signed with players operating in this industry, making Indian IT majors an integral part of the drug development value chain of large pharmaceutical companies globally. Deals involved providing global infrastructure management (including data centres) and platform services across the enterprise, including leveraging automation to improve efficiency and customer service.

- **Manufacturing:** Manufacturing industry vertical witnessed modest performance with continued momentum from existing clients, but weakening outlook for global environment led to increased pressures on spending plans of new clients. Manufacturing industry projected strong growth in US, but witnessed great stress in the European market as supply chains of automobile segment were negatively hit with escalating effects of trade war. Challenges in the Chinese Electric Vehicle (EV) market also posed challenges. Due to this, IT majors witnessed cost cutting initiatives, implemented by multiple clients.

- **Energy, Utilities and Resources:** Momentum in this vertical remained healthy in H1, but was soft in Q3-FY20 due to furloughs. However, strong deal wins were witnessed during the year. Customers in this industry continued their IT spends on automation, Robotic Process Automation (RPA), improving service reliability, cyber security, compliance and safety.

Growth in employee base

Chart 7: Net employee addition



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

Employees account for the largest proportion of expenses for every firm operating in this industry. Total number of employees grew to 10.26 lakh cumulatively for four Indian IT majors as on 31st December 2019. This includes about 65,000 net employee additions in initial three quarters of FY20. However, this rise in FY20 was restricted to only first quarter, which posted healthy growth of 36% YoY. Q2-FY20 witnessed a marginal fall of 3% YoY, while Q3-FY20 declined sharply by 46% YoY.

Along with the growth in employee base, employee costs and attrition rates have remained high. Therefore, companies need to make consistent efforts to improve their revenue per employee ratio. Multiple training programmes for improving technical skills are regularly held across the employee pyramid.

In recent quarters, IT services companies are increasingly winning new work contracts worth billions of Dollars that require employees to work on new-age digital technologies such as data science, analytics, blockchain, cyber security, cloud computing, etc. To support this, companies are making continuous investments on upgrading skills of their employees. These are the skills IT services firms seek in their employees and a willing to pay a premium for.

Hiring process is also being modified from physically visiting hundreds of college campuses to hiring individuals through gamified programming contests, hackathons, National Qualifier Test, etc. These processes are held at national level and attract a far larger pool of prospective employees. In terms of training, companies are also looking at backward integration as an option, which means to provide the required training in colleges itself, which makes the new joinees job ready and therefore can be deployed on projects immediately.

Concerns regarding non-immigrant visas

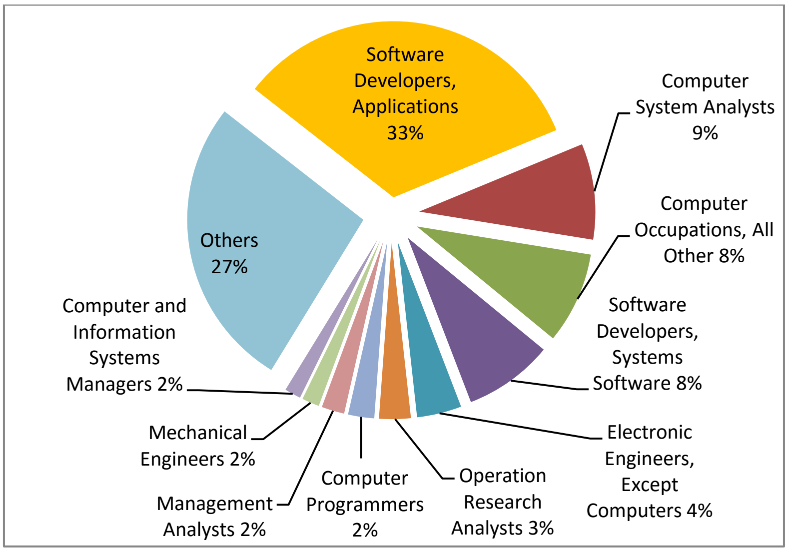
(Note: In this section, FY refers to 1st October to 30th September)

The H-1B visa is a non-immigrant visa that allows US companies to employ foreign workers in speciality occupations that require theoretical or technical expertise. As an H-1B non-immigrant, the applicant may be admitted for a period of up to 3 years, which may be extended, but not beyond a total of 6 years. This visa has an annual numerical limit cap of 65,000 each fiscal year, referred to as 'H-1B regular cap'. In addition to this, US master's degree holders have a cap of 20,000 visas.

According to US Citizenship and Immigration Services (USCIS), 4,21,276 H-1B petitions were received during FY19, of which 74.5% were from India, followed by China with 11.8% share.

Consulting, audit and tax advisory, IT services and computer manufacturing firms have topped the list of those applying for such visas in FY19. Chart 8 depicts the top 10 occupations for which maximum positions were certified in FY19, which include software developers, computer system analysts, electronic engineers, operation systems analyst, computer programmers, mechanical engineers, etc.

Chart 8: Top 10 occupations for which positions were certified in FY19



Note: Occupations based on Standard Occupational Classification (SOC) codes; FY19 refers to 1st October 2018 to 30th September 2019.
Data includes H-1B, H-1B1 and E-3 Specialty Occupations Labor Condition Programs
Source: Office of Foreign Labor Certification

Total H-1B visa petitions: received, processed and approved

USCIS starts accepting new H-1B petitions from 1st April in every fiscal. As depicted in chart 9, the total number of petitions for H-1B visa has risen in the past 5 years, however FY19 did not witness much growth. Further, in Q1-FY20, USCIS received 78,000 H-1B visa petitions, the highest in 1st quarter of any year, in past 5 years. As viewed in chart 10, along with the rise in number of 'total competitions' over the years, approval rates have continuously dropped from 95.7% in FY15 to 84.8% in FY19. In Q1-FY20, the approval rate further declined to 83.4%.

Chart 9: Total number of petitions received for H-1B visa ('000s)

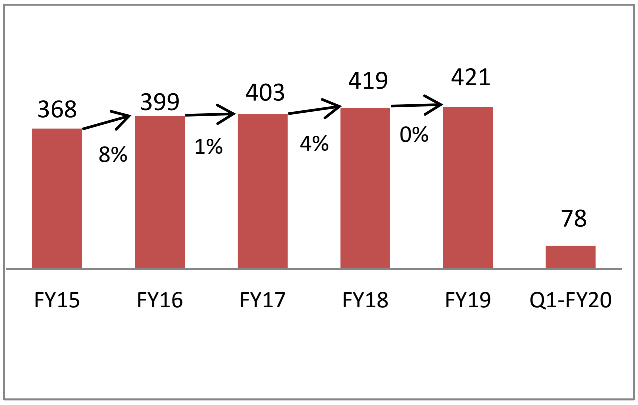
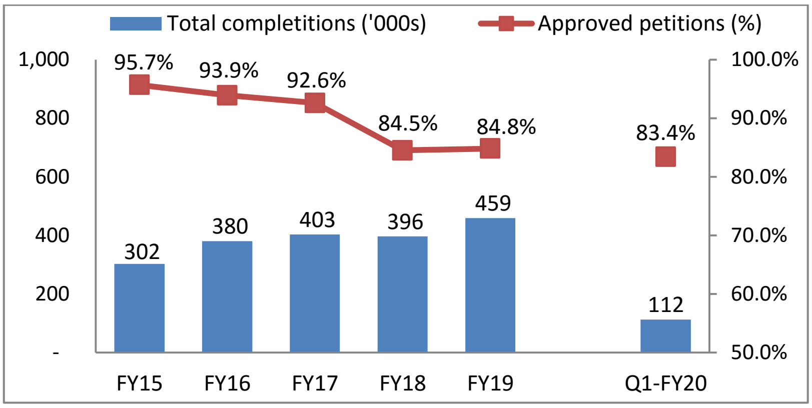


Chart 10: Total number of petitions processed and approved for H-1B visa



Source: USCIS
Note: FY refers to 1st October to 30th September
Note: 'Petitions received' refers to the number of new petitions received and entered into a case-tracking system during the reporting period.
Note: 'Total competitions' refers to the number of petitions approved and denied during the reporting period. It includes petitions received during the current year and previous years as well, which is why 'total completions' can exceed number of 'petitions received' during a FY.
Note: 'Approved petitions' refers to the number of petitions approved during the reporting period. Only initial decisions are considered. Subsequent decisions are excluded like Revocation, Remands, etc.
Note: 'Approved petitions (%)' refers to the percentage of petitions approved out of total processed

H-1B visa statistics of five Indian IT majors

Approvals: Chart 11 depicts H-1B visa approvals of past five years for five Indian IT majors. FY15-17 witnessed a steady growth in H-1B visa approvals, however, dropped sharply by 50% in FY18. It further declined by 5% in FY19. FY19 also witnessed the lowest number of visa approvals in past 5 years for five Indian IT majors.

Denials: Chart 12 depicts nearly 7 times growth in H-1B visa denials of five Indian majors in past five years. In past recent year FY19, visa denials rose 28%.

The sharp surge in denials and fall in approval rates FY18 onwards, is a result of the stringent restrictions imposed by US administration to support the economic interests of their country. In April 2017, President Trump signed the Buy American and Hire American Executive Order, which seeks to create higher wages and employment rates for US workers. US is believed to have taken this step with the goal of protecting the wages and job opportunities of US workers, along with ensuring that H-1B visas are awarded to the most skilled or highest paid. To support this, the US administration has implemented stringent regulations and made changes to their immigration policies. These measures adversely impacted IT players taking a hit on margins and increase in sub-contracting costs.

Chart 11: Number of H-1B visa petitions approved of five Indian IT majors

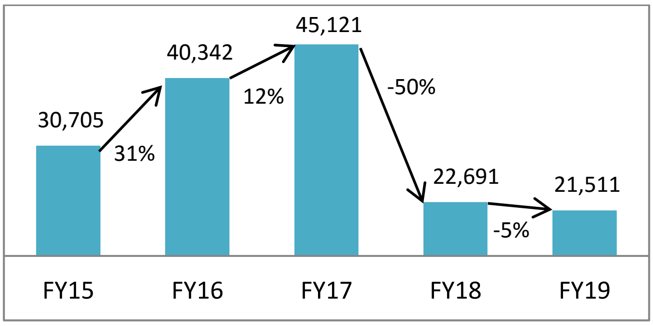
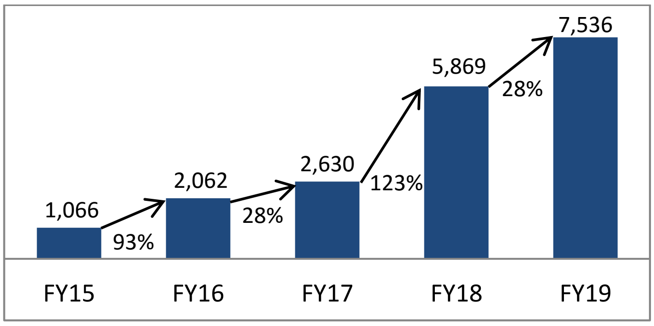
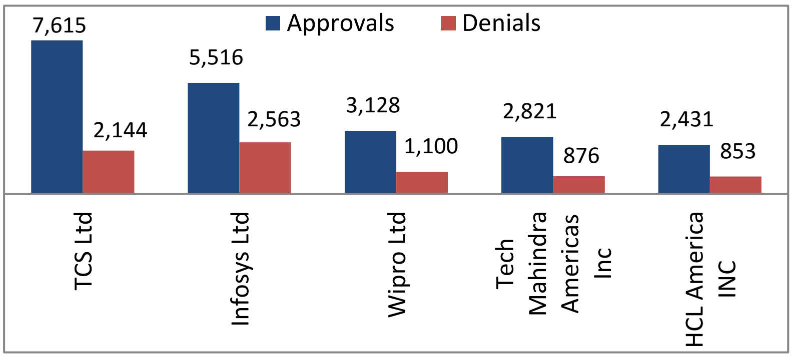


Chart 12: Number of H-1B visa petitions denied of five Indian IT majors



Source: USCIS, CARE Ratings;
Note: Data refers to TCS, Infosys, Wipro, HCL America, Tech Mahindra Americas;
Note: FY refers to 1st Oct to 30th Sept

Chart 13: Number of approved and denied H-1B visa petitions of five Indian IT majors in FY19



Source: USCIS, CARE Ratings
Note: FY refers to 1st Oct to 30th Sept

As depicted in chart 13, out of the five Indian IT majors, TCS had the maximum number of H-1B visa approvals of 7,615 visas in FY19. This was followed by Infosys, Wipro, Tech Mahindra Americas and HCL America.

In terms of number of H-1B visa denials, Infosys was leading with 2,563 petitions denials in FY19, followed by TCS.

Expected impact of Covid-19 and outlook for IT-BPM industry

- With increasing focus on deploying digital technology across all industries, the Indian IT industry has positive prospects in the long term, however performance in the short term (next 1 year) is expected to be dampened by the widespread effects of Covid-19. With restrictions on movement of people, global value chains shall be temporarily disrupted and IT services firms being a part of this value chain are sure to take a hit on their growth in the current year.

- More than 75% of the industry's revenues are sourced from exports to large markets like North America and Europe. The widespread of the coronavirus in these two markets will create ripple effects for the IT industry, as receivables from clients in those two large markets are expected to get delayed taking a hit on revenue generation for Indian IT players. In addition to this, as spending on technology is a discretionary expense, most clients are expected to lower their technology budgetary allocations for the current year. However, a depreciating Rupee, could offer some solace to industry players.

- Halt in global travel due to covid-19, will delay executing existing projects. With limited budget spends of clients, Total Contract Value (TCV) shall shrink and deal pipelines could remain weak for the year. Pressures on pricing could also be expected as large industry verticals such as BFSI, retail and manufacturing are already on a downward trend.

- The industry was already grappling with increased protectionist measures imposed by US administration on granting H-1B visas. Large costs were being incurred and processes became slow and cumbersome. To add to this, USCIS temporarily suspended services from 18th March to 4th May (tentative), which will further delay the entire process of granting such essential visas to Indian IT players. We can also expect further tightening of immigration policies by US administration, with an intent to protect jobs of US workers and reduce unemployment rates in their country.

- Impact of Covid-19 will be even more apparent for the IT industry, as growth usually takes place in H1 of every fiscal. H1 is usually a stronger for this industry as many large deals are signed during this period, while H2 witnesses large furloughs due to the holiday season. With disruption taking place in Q1 of FY20 and no definite signs of improvement in the myopic future, IT industry could witness minimal growth of 3-5% in FY21, compared with robust 7.7% in FY20.

- As per RBI data, software services exports in FY19 stood at USD 77.7 bn, which is equivalent to about USD 6.5 bn monthly (on an average). With lingering implications of covid-19, potential loss of software services exports could be in the range of USD 2-3 bn per month in the current year.

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