Uncertain times ahead for Indian IT sector

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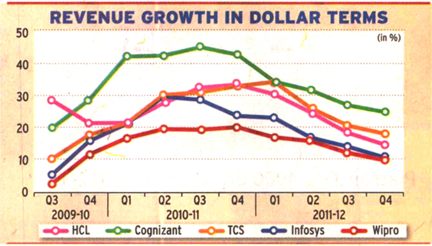
Since the global financial crisis of 2008, India's IT industry has been unable to recreate the magic of its halcyon years from 2003 to 2008, when exports grew at a phenomenal 26 per cent compounded annual growth rate (CAGR), making it the darling of equity investors and creating blue chip behemoths such as Infosys, TCS, and Wipro.

After a brief recovery following the 2008 crisis, the global economy again appears to be going into a tailspin that has adversely affected both the U.S. and Europe, the Indian IT industry's key markets. This has led to heightened client caution on IT spends.

Intensified competition within the sector is exacerbating the pressure, which has impacted growth in billing rates and, consequently, revenues.

These factors are taking a toll on the Indian IT industry's growth, and causing a shakeout at the top, if the January-March 2012 quarterly results of leading players are any indication.

For the first time in 47 quarters, Infosys, hitherto the bellwether of the sector, missed its revenue growth guidance. Its guidance for 2012-13 is just 8-10 per cent growth in U.S. dollar terms compared with the industry association National Association of Software and Service Companies' (Nasscom's) guidance of 11-14 per cent. Cognizant revised downward



its 2012 revenue growth guidance to 20 per cent from 23 per cent earlier, citing slower-than-anticipated pick-up in demand in banking and healthcare verticals. Wipro did not give full-year guidance but said that it expected flat sequential growth in the April-June 2012 quarter. TCS was the only one of the biggies which adopted a more upbeat tone, saying that its deal pipeline was good and that it hoped to beat Nasscom's revenue growth estimate.

Clearly, the concerns regarding the sector's near-term prospects are not misplaced. Although India's IT services exports grew by a robust 19 per cent year-on-year in dollar terms in 2011-12, the trends in the last two quarters are worrisome. Hit by the continued macro-economic woes in developed countries

that resulted in delays in project ramp-ups, the top four Indian IT companies grew at 17 per cent in the third quarter and 14 per cent in the fourth quarter, against a healthy 24 per cent in the first-half.

There does not appear to be any immediate respite, either. Crisil Research is of the view that the global economic uncertainty will persist in 2012-13. Consequently, IT services exports will grow at 12-14 per cent in 2012-13 in dollar terms, sharply lower than 19 per cent in 2011-12.

Why this will be so is clear from the economic situation in the developed countries, particularly in Europe. In the last few quarters, GDP (gross domestic product) growth in Europe has come down appreciably due to the austerity measures taken by several governments to combat the sovereign debt crisis. This fragile economic landscape and an unstable political environment have severely dented the business prospects of many IT sector clients in the region. Indian IT vendors generate close to 20 per cent of their revenue from the European market, primarily the U.K. In the U.S., the downturn has also made the noises against outsourcing shriller, particularly in an election year. In addition, visa norms have been tightened and local hiring by Indian IT companies in the U.S. has gone up, consequently hiking their costs and slowing the growth of offshore services.

Some of the aftershocks of this global economic downturn are already visible. In 2011, global BFSI (banking, financial services, insurance) clients, who account for more than 40 per cent of Indian IT vendors' revenues, reported a dip in profitability due to lower revenue growth and pressure on margins. Telecom clients, too, have been going through tough times. As a result, the cash flows and discretionary spending of such large clients have come down significantly in the last few quarters of 2011-12 and is expected to remain subdued in the next few quarters.

We believe that although the IT budget of clients will remain more or less stable in 2012, the extra caution that they are exercising, as part of measures to manage risk in an uncertain business environment, will continue to result in spending delays.

Yet another important factor impacting the competitive landscape and pricing is contract expiries.

According to TPI (an outsourcing advisory company that tracks contracts) estimates, the number of contract expiries is likely to rise by 20 per cent in 2012, compared with 2011. In such a scenario, compounded by a dismal economic environment, clients try to renegotiate contracts to suit their business needs, which, more often than not, results in pricing pressure on IT vendors.

If the rupee stays weak against the dollar, as at present, it will partly mitigate the cumulative adverse effects of some of the other factors. Nevertheless, to enhance long-term competitiveness, Indian IT players will have to increase client relationship mining, deepen their service offerings, expand their global delivery and marketing presence and increase focus on non-linear business (a model of de-linking revenue growth from employee growth).

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