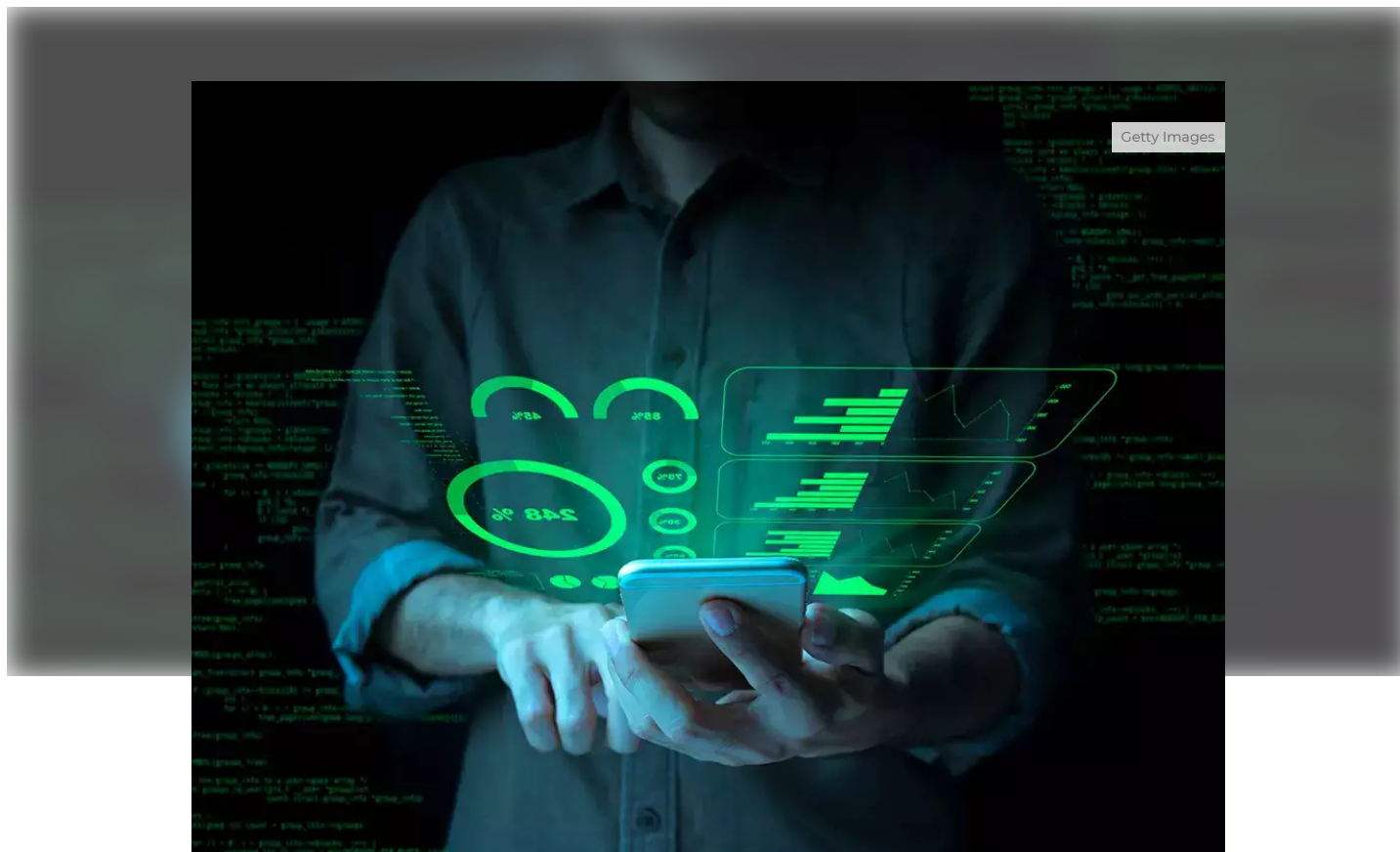


MARKETS

Focus on automation, digitisation keep IT spends high despite a slowdown

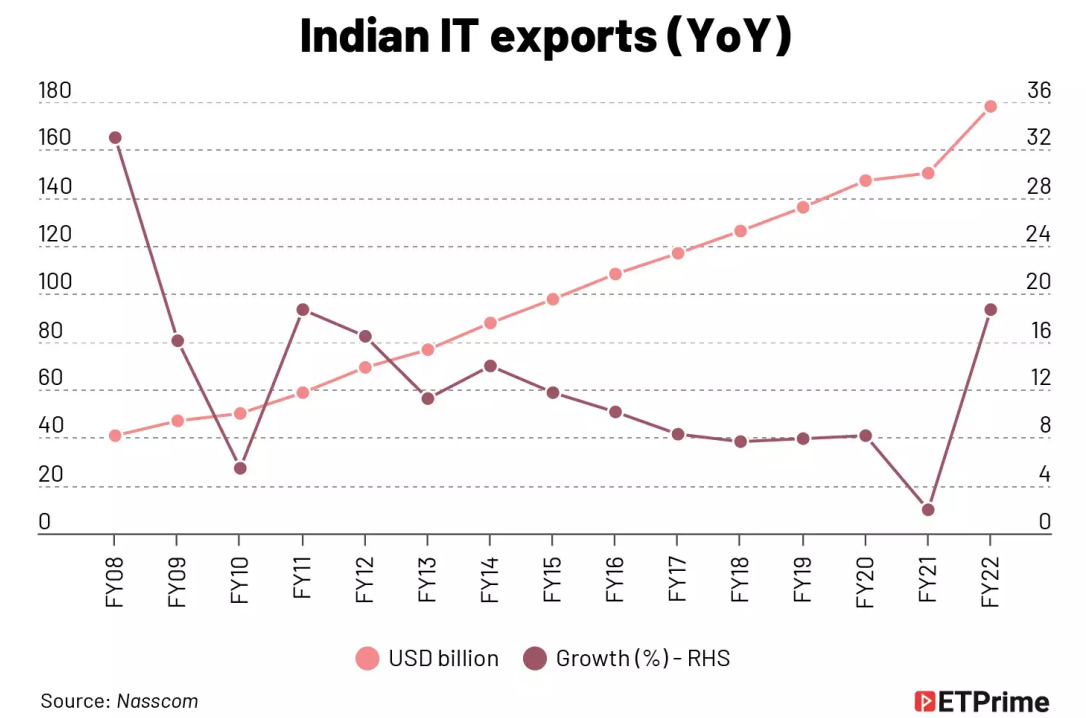


Synopsis

Indian IT companies, which have been reeling under high attrition and sharp cost increases are starting to see an easing of supply-side issues. On valuations too, the sector has undergone a sharp correction. Both cost benefits as well as valuations might come to the rescue for investors in the near-term before the growth catches up again.

Over the past two years, the global IT services sector saw a sharp surge in **IT spends**, driven by the need to catch-up on under-investment in digitisation. A large part of these investments went into Cloud, as it became even more critical enabler during the Covid-19. It gave enterprises the agility on scale, resilience, quick deployment as well as the benefit of low upfront capex. Companies across verticals and geographies underwent a rapid enterprise-wide transformation. This led to higher-than-trend spends on technology and in turn benefiting the Indian IT services industry.

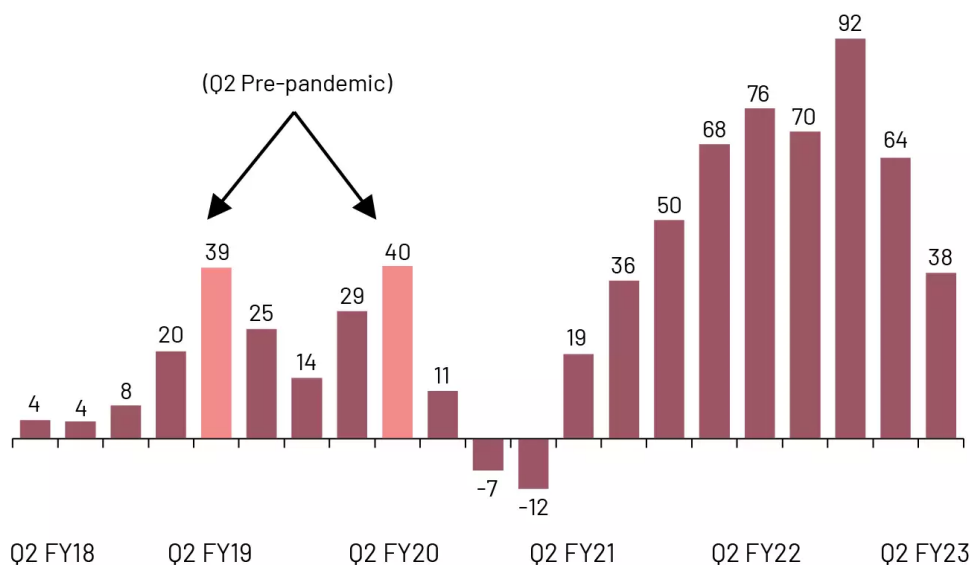
[BACK TO TOP](#)



The growth rates for the Indian **IT industry**, which were in high single digits in pre-Covid-19 years, saw a sharp jump of over 2x in the past two years. Technology modernisation became a key priority across enterprises and was viewed as necessary and strategic. This led to an enormous amount of demand uptick in a very short time. Most spends were on areas like Cloud migration, digital transformation, analytics, data, and customer experience.

The Indian **IT companies** not only had the deep domain knowledge and strong partnership credentials, but also had the ability to sharply ramp up the execution, which helped them capture this opportunity well. The rapid surge of projects and the ask of quick execution from clients led to an immense need of talent, leading to over 2x jump in the hiring intensity for the Indian IT industry.

IT services: aggregate employee net hiring



Figures in thousand

Source: Company data, Jefferies estimates

ETPrime

The hiring spree

IT services players hired aggressively to capture the surge in demand. Scarce digitally skilled talent also led to increased attrition for most companies.

Going ahead too, the growth rates for the IT services industry is likely to remain elevated compared to pre-Covid-19 years driven by companies continuing to focus on the core transformation journey. The expectations of the industry bodies as well as market research organisations like Nasscom, **Gartner**, etc, also remain optimistic as they see this accelerated tech spend to continue for the next couple of years.

Worldwide IT spending forecast

	CY19	CY20	CY21	CY22E	CY23E	CY24E	CY25E	CY26E
Data centre systems	191	180	191	212	222	234	247	258
Software	485	641	736	807	902	1,020	1,153	1,293
Devices	708	697	809	768	791	825	866	894
IT services	1,053	1,071	1,208	1,283	1,389	1,528	1,681	1,834
Communications services	1,418	1,405	1,459	1,465	1,506	1,555	1,595	1,628
Overall IT	3,855	3,994	4,403	4,535	4,810	5,162	5,542	5,907
Global IT services spend growth	3.4%	3.6%	6.8%	5.9%	6.1%	7.3%	7.4%	6.6%

Figures in USD billion unless specified

Source: Gartner Market Databook, July 2022

ETPrime

BACK TO TOP

However, the likely impact of global macro slowdown and continued high inflation on tech budgets cannot be ruled out as the tech budgets are highly linked to revenue growth of enterprises.

Tech spends

To get some more insights, one can look at the hyperscalers revenues, as it can be a lead indicator of revenue growth for Indian IT services companies. As per industry standards, every dollar spent by a customer on hyperscaler, IT services provider revenue for Cloud migration is between 0.2 cents and 0.3 cents. Additionally, the IT services companies aim to maximise their Cloud wallet share to 1.5x-2x with a broad-based Cloud revenue multiplier strategy. This involves providing data modernisation, application transformation, digital commerce, and platforms. The recent growth of hyperscalers is seeing some growth slowdown but does not raise any concerns yet as the incremental dollar addition is holding well.

Even if one were to look at the revenue visibility from a slightly different lens, the key verticals too are not flagging any concerns. The Indian IT services industry revenue is highly skewed towards BFSI, manufacturing and retail vertical, wherein the impact can be more pronounced in segments like interest rate-sensitive sectors like mortgage, capital markets in the BFSI vertical, discretionary retail, and pockets of manufacturing verticals.

Although so far, we have not seen any signs of broad weakness in the key vertical. The tech spending, especially, by the large US banks remained solid with technology spend seeing an increase of 8%-16%. Most US banks also believe that technology investments are core to growing business and indicate that tech spend is among the fastest-growing areas for the firm, along with controls and compliances. Despite a tougher macro than the US, most European BFS firms too, have not indicated a cut in technology spending. The retail and manufacturing vertical are seeing client-specific issues though for IT companies.

Spends vs. slowdown

While one cannot ignore the current macro challenges, the reason for the tech spends still holding up well for Indian IT companies could be more granular. One of the reasons could be more focus on automation technologies that can deliver near-term benefits versus artificial intelligence projects that are in the R&D phase and more long term in nature. The enterprises could be deferring these projects or delay the decision-making cycle in near term. On the other hand, digitisation programs, which provide cost savings such as automation, are prioritised. Indian IT services companies are more aligned to BAU and automations around these areas, hence the impact is not visible.

Another, and more important, reason could be the increasing intensity of outsourcing. As enterprises intent to keep their tech intensity high, incremental cost pressures lead them to countries like India. In the past too, recessions were followed by a period of high growth for Indian IT outsourcing businesses. For instance, during 2008's global financial meltdown.

[BACK TO TOP](#)

IT sector: one-year forward PE valuation



Source: Bloomberg; Jefferies estimates

ETPrime

The outlook

As we look ahead, we see the world getting more digitised over the coming years and in turn giving growth opportunities to the Indian IT sector. However, we remain cognizant of global macro's which may lead to some deferment of projects or delay in the decision-making cycle even for automation-led projects. Hence, we won't be surprised to see a slowdown in the next 12 months, compared to the past two years of strong spends, before bouncing back to a reasonable level. Levers like Cloud adoption (as per Nasscom, the Cloud spending is expected to grow ~25% for the next five years), the need to keep improving on customer experience, increasing need of cyber security, data, and analytics, should ensure a higher growth for the industry against the pre-pandemic years.

While the near-term growth on revenue might look tepid, on the flip side, the cost pressures seem to be abating. Indian IT companies, which have been reeling under high attrition and sharp cost increases, especially, the employee cost, are starting to see easing supply-side issues like softening of attrition and are likely to lower the back-filling cost of employees. This is also visible in the recent hiring slowdown seen across Indian IT companies.

Improving utilisation, as the recently hired employees are trained and deployed, would be another tailwind for cost. On valuations too, the sector has seen a sharp correction from its peak in April 2022. Both cost benefits as well as valuations might come to the rescue for investors in the near-term before growth catches up again.

(The author is fund manager at Tata Mutual Fund. Views expressed are personal and should not be construed as any investment, legal or taxation advice.)

[BACK TO TOP](#)

(Graphics by Mohammad Arshad)

(Originally published on Feb 2, 2023, 04:45 AM IST)

Don't miss out on ET Prime stories! Get your daily dose of business updates on WhatsApp. [click here!](#)