

India's Software Services: Growth Momentum Continues

- Export revenues for the Indian Information Technology - Business Process Outsourcing industry expected to reach ~\$47 billion in FY08-09 with an annual growth of 16%-17%
- Software and services revenues aggregated to \$60 billion in FY08-09 (including domestic revenues, but excluding hardware)
- Domestic IT-BPO market in India expected to cross Rs.1,110 billion (\$23 billion) in FY2009, with about 20% annual growth rate
- Export revenues for the Indian IT-BPO industry expected to reach about \$60 billion-\$62 billion in FY10-11 with a compound annual growth rate (CAGR) of 15%

No industry can escape the impact of the global recession, and the Indian Software Services & Business Process Outsourcing (BPO) sector is no exception to that. The challenging global environment has forced National Association of Software and Services Companies (NASSCOM), the apex organisation of India's IT & BPO companies with more than 1,200 members, to scale down its projections of revenues and exports. Yet, the fresh growth estimates for the industry can be termed as quite healthy considering the current global situation.

Export Target of \$60 Billion Pushed Down By One Year

NASSCOM had earlier predicted India's IT Software Services & BPO exports (excluding hardware export) to reach \$60 billion by the financial year 2009-10. Now, the trade organization expects the target to be achieved by 2010-11. For the current financial year 2008-09, it expects the exports to grow at 16%-17% to \$47 billion, against its earlier estimates of \$50 billion. A year ago, the industry had registered 29% growth in exports to touch \$40.4 billion in 2007-08. The total revenue from IT software and services, including domestic revenue, is expected to grow by about 15% in 2008-09 to \$60 billion against the previous estimate of 21%-24% growth. The total turnover of the IT-BPO industry including hardware is pegged to be \$71.7 billion in 2008-09.

Incidentally, the Indian IT-BPO industry has been badly impacted by the extreme fluctuations in the currency market also. Not only has the rupee depreciated 22% against the dollar during the year so far, the other currencies such as Pound and Euro have also depreciated heavily. Following a strategy to reduce its dependency on the U.S. market, the industry is trying to diversify geographically. As a result, the export to Continental Europe has registered the highest growth rate in the recent years, although the U.S. remains the dominant market for the industry. During the four year period (FY04-FY08), exports to Continental Europe are estimated to grow 51.4% as against the overall industry growth rate of 33.3%. During the same period, share of the U.S. market has come down from 68% to 60% of the total industry revenues.

Best Placed To Help In Cost-Cutting

At a time when protectionist sentiments are raising high in a number of overseas markets, the Indian IT-BPO industry is trying to convey the message that they are best placed to help the customers in cost savings and efficiency. In a sense, the Indian IT-BPO industry has the

potential to utilize the current crisis as an opportunity. The industry has been successful in its attempt up to an extent, which is visible in the number of new clients won by the bigger companies. Considering the current environment, one could have expected a grinding halt in client additions, but all the four large Indian IT companies - Tata consultancy Services Ltd (TCS), Infosys Technologies Ltd, Wipro Ltd and HCL Technologies Ltd have added about 25-40 new clients during the quarter of October-December 2008.

Weak Market Sentiments Bring Take Valuations To Rock Bottom:

Although the quarterly performance of most of the listed Indian IT-BPO companies were in-line or better than expected, the overall market sentiments have become quite weak due to unfavorable economic trends and lack of investment flow. An analysis of 9 listed Indian IT companies suggests that their revenue grew by an average of 4% quarter-on-quarter (QoQ) and 28.3% year-on-year (YoY).

(% growth)	TCS		Infosys		Wipro		HCL Tech	
	QoQ	YoY	QoQ	YoY	QoQ	YoY	QoQ	YoY
Revenue	4.7	22.8	6.8	35.5	2.0	24.9	5.1	37.1
Net Profit	7.2	1.6	14.6	33.3	9.2	8.7	5.1	14.2
EBIDTA	7.0	23.3	13.2	45.9	-1.4	19.4	5.5	44.2

It's important to note that even in the challenging quarter of October-December 2008, three out of the top four companies have either improved their Earnings before Interest, Taxes, Depreciation and Amortization (EBIDTA) margin or at least maintained at the previous levels. The EBIDTA margin of TCS, India's largest IT services company stood at 27% in Q3FY09, which is 60 basis points (bps) higher than Q2FY09 and 10 bps higher than Q3FY08. Similarly Infosys, the second largest IT services firm improved its EBIDTA margin by 200 bps QoQ and 250 bps YoY at 35% in Q3FY09. The EBIDTA margin of HCL Technologies was almost flat with an improvement of 10 bps both QoQ and YoY at 22.5%. Wipro faced a decline of 60 bps QoQ and 90 bps YoY in the EBIDTA margin at 19%.

Despite registering a decent growth in revenues and net profits and maintaining a healthy margin, the companies are languishing at very dismal valuations in line with the general market sentiments. As per estimates, TCS is quoting at a price/earning (P/E) multiple of 9.2 on the estimated earnings of FY09. The P/E multiples of Infosys, Wipro and HCL Tech are estimated at 12.6, 9.1 and 5.3 respectively, based on FY09 earnings. Most of the tier-2 IT companies are at less than 5 P/E multiple. The market capitalization of a number of companies has gone below even their annual revenue. Most of the brokerage firms, both domestic and foreign, are skeptical about the earnings visibility for the next fiscal year 2009-10, hence keeping a very conservative estimate for earnings per share (EPS) of these companies in FY10. The situation, however, might change and the market will have a more

clear view of the FY10 earnings once the managements of many of these companies would come up with their respective annual guidance for FY10 at the time of announcing their fourth quarter results in July 2009.

The Challenges Are Severe:

As the global economy has slipped in to a recessionary phase, the Indian IT companies are bound to face pressure on volumes and pricing both. The customers are delaying the decisions on new projects and putting discretionary expenses on hold, resulting in to a reduction of volumes. The top four companies of the sector have already registered very low growth in volume during the recent quarters. The customers are also negotiating higher value for the money they spend, which is in other words asking for a price reduction.

Wild fluctuation in the currency market remains another risk for them. During the fiscal year so far, the rupee has depreciated by 22% against dollar. Particularly the last quarter of October-December 2008 was more challenging as rupee fell by 11% against the U.S. currency. Many analysts, however, believe that rupee will appreciate again in future to find its appropriate level. The reverse journey of rupee might again prove to be challenging for a number of Indian IT companies, because as a simple rule any appreciation in the local currency hits an exporter.