US Economic Slowdown and its Challenges To the Indian Outsourcing Industry

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1. Introduction:

February is that time of the year when National Association of Software and Service Companies (Nasscom), India's top outsourcing body holds its annual meeting, where top industry honchos gather to show-case their past achievements as well as deliberate on the future of the IT services industry. This year, the mood of the meeting was a bit somber as it was held under the gathering cloud of a possible US economic slowdown and a progressively unfavorable foreign exchange situation.

After 5 years of sustained growth, when the industry witnessed revenue growth in excess of 30% Year-On-Year, the IT firms were the cynosure of the stock market. But in 2007, shares of Indian IT firms fell to become among the worst performers in a booming local market, hurt by concerns over the impact of a slowdown in the US, rising local wages and an appreciating currency.

The industry today faces multiple challenges -- talent, manpower and infrastructure issues -- that will need to be addressed collectively. There are worries of a technology spending slowdown in the US market which is responsible for more than 60% of its revenue. Local factors related to end of a tax holiday and rising wages and other costs are another cause of concern. Increasing availability of skilled professionals and competition from rivals like the Philippines are other factors the industry has to contend with, while trying to keep its “head above water” during the impending slowdown. The once red-hot sector that employs some two million workers is showing signs of strains.

However, the leaders in the industry are not sitting back. A series of strategies are on the anvil to minimize the impact of such challenges. In our view, this difficult period will help the industry become more mature and develop more innovative delivery & profitability models.

2. A snapshot of the Indian IT services industry

The IT sector, which accounted for a little of 1% of India’s GDP a few years back has grown rapidly, and now contributes to nearly 5 per cent of India's GDP. Despite the potentially looming US economic woes, it is expected to clock a growth rate of nearly 30% in fiscal year 2009.

According to a recent study, the Indian IT and BPO industry is expected to generate revenues of $64 billion by the end of fiscal year 2008, registering a growth of 33 per cent. Per the ‘Strategic Review 2008' prepared by IT industry body NASSCOM, the software and services exports are expected to reach $40.8 billion, while the domestic market is expected to touch $23.2 billion in FY08.

Today, the US contributes to more that 60% of the software and services export revenue, followed by Europe which accounts for around 25% of the export revenue. Per the sectoral breakup, Banking, Financial and Insurance (BFSI) sector accounts for about 50% of the services revenue. Any economic slowdown in the US and more so the specific problems in BFSI sector like the current Sub prime meltdown can have significant material effect on the prospect of the industry if it is not managed properly.

The industry, which so far has been growing at a good clip, is faced with multiple challenges, which could dampen its growth and affect its margin:

- Its largest market, US, is expected to experience an economic slowdown in 2008.

- The Sub prime problem which has affected the Mortgage industry could result in a ripple effect affecting the largest BFSI sector, the largest contributor of revenue to the industry.
- Manpower cost in the industry is growing at a rate of 12-15% per annum.
- Difficult market is resulting in higher SG&A costs
- Cost of real state and facilities are increasing at a fast rate.
- Competition from other countries like Philippines, Eastern Europe is sniping at the heels
- Certain tax benefits provided by the Indian government is due for rolling back
- Skill availability is constrained resulting in higher recruitment, retention and training costs.
- Last but not the least, the unfavorable foreign exchange fluctuation has had a direct impact in the range of 6-12% on the operating margins

3. Foreign Exchange Fluctuation - Rupee Appreciation

The majority of Indian service provider revenues are billed in US Dollars while their earnings are reported in INR. Any appreciation of the Rupee against the Dollar thus affects revenues of the industry negatively. During 2007, when the INR appreciated against US Dollar by approximately 12%, it was enough to significantly impact the revenues earned by Indian Service Providers. Volatility in the US Dollar is also an issue in terms of impacting the value of Indian Service Provider assets located at various locations worldwide, in terms of their carrying value. Moreover, current assets of these companies, especially Accounts Receivables are impacted negatively while relevant liabilities, specifically Account Payables, bulk of which are in INR stay at same levels. Another significant negative impact is on imports policy, especially covering capital items by increasing liability and cost.

Organizations have responded to this change at multiple levels with a clear focus on minimizing the negative impact of Dollar depreciation. Many organizations have renewed their commitment to business acquisition and growth in rest of the world and are also increasingly focusing on domestic business, which has been relatively immune to USD volatility. In some cases, effort has also been made to sign rupee denominated contracts, thus looking to pass-on the currency risk to clients. Organizations, with increasingly sophisticated maturity, have also resorted to hedging the balance sheet and cash flows against currency risks.

Another innovative lever that organizations are using to counter the Dollar depreciation effect is one of improving operational efficiency. The highlights of key strategies are:

- Increase in utilization levels of employees.
- Increased work hours (many organizations have moved from weekly 40 hours to about 50 working hours)
- Optimizing the onshore to offshore mix of effort and revenue to gain better operational leverage
- Flattening the delivery pyramid. Most companies now leverage a pyramid where in excess of 50% delivery staff is in the 0-2 year's bracket, thus significantly reducing cost of delivery and improving margins. Also, the average experience profile at various levels of the pyramid is being progressively reduced.
- Opening new delivery centers in Tier-2 cities, thus significantly cutting infrastructure and personnel costs
- Improving productivity in all internal shared services functions with a view of practicing what they preach to their clients - Getting more bang out of every Rupee of SG&A spend.
- Making an effort to move up the value chain in consulting services via acquiring additional consulting capabilities through acquisitions or opening newer, more value added practices. The objective is to introduce higher margin services that then complement the existing services portfolio/offerings.

4. The US Sub prime Mortgage Crisis:

Origination of the Credit Bubble

The easy credit bubble of 1990s saw the housing prices soar across wide swaths of United States. In a hurry to benefit from the easy credit and low interest rates, lenders progressively lowered lending criteria and started giving loans up to 100% of home assessed values, which were at a historically high. On top of that, lenders aggressively pursued the American consumer to open and utilize additional home equity based lines of credit, which enabled the consumers to use their houses as an ATM. In markets such as California, the median prices of homes jumped more than 30% every year with the result that an increasing majority of prospective buyers, with limited buying capability, had to resort to what is called as "Sub prime" mortgage terms. These terms essentially allowed the lenders to loan to people with less than good credit at low introductory rates that then would convert after 3 or 5 years into much higher rates.

The debt leverage did not stop there. In the way that US securities market works, all such mortgages were then chopped, repackaged as bundled securities and resold, multiple times, to investors all over the world. This essentially obliterated all ability to trace an investment to individual mortgages that it comprises.

Impact of the Credit Bubble

When the market finally started cooling off, it suffered a double whammy. When the low introductory rate time period expired, many home owners found that they could not afford the much higher rates they converted to. The rate of foreclosures, especially in red hot markets, has been inching up in an increasing sign of consumer distress. The ATM that many consumers counted on, and used to pay other debts, stopped paying out cash. At the same time, in the securities market, the demand for securities that were secured in, a significant part, by sub prime mortgages, went down. This meant the mortgage companies that had done a lot of business in sub prime or even Alt-A mortgages suddenly had commitments they could not meet. In a short period of time, Countrywide, the largest mortgage company in United States had to be sold to Bank of America and by a statistic, more than 70 mortgage companies including large names such as American Home Mortgage, New Century Mortgage, Option One, Fremont Mortgage declared bankruptcy, halted operations or had to seek buyers. This spiraled upwards into investment banks and hedge funds with the result that many of them such as Bear Stearns, Citi etc... lost such significant value that they needed outside cash infusion to keep operating.

This crisis has directly impacted the consumer confidence and spending in the United States, further slowing down the economy. There is wide spread pessimism in the US about impending recession or already being in one.

As of writing this article, the pessimism seems to be spreading to even prime loan mortgages and there is strong media debate on whether the US Government announced tax cuts & economic stimulus package will have any significant impact on this trend.

Impact on the Indian IT/ITES Industry

The Indian Tier-1 companies, with minimal exposure to the sub-prime segment, estimated as less than 1% of their revenue have been able to weather the storm quite well in the short-term, however the impact has been more significant on service providers focused on the mortgage industry. When, in the initial stages, lenders like First Magnus Financial Corp and GreenPoint Mortgage declared bankruptcy, Indian companies like WNS and EXL services who received more than 8%-9% of their revenue from mortgage services, had to tone down their 2008 revenue guidance. Companies like iGate Global, with their exposure to Green Point Mortgage saw a drop of 7%-10% in their quarterly revenue.

Some of the key third party service providers for mortgage included Equinox, WNS, EXL, Wipro BPO and Infosys BPO. Captives in the space include Bank of America, ABN Amro, Citi Group, HSBC, Countrywide Financial and Ocwen. Many of them have had to revisit their strategies to tide over the problem.

Companies caught in this have increasingly adopted cost containment strategies to maintain their margins and also looked at alternate streams of revenue from other sectors and geographies like Europe and Asia, to shore up the top-line. In a new twist, the crisis has thrown up M&A opportunities in the long term, with large Indian vendors looking for buy-out targets in US in this space.

However, with the talk about a broader economic slowdown, the real worry for companies is that the problem is no longer about sub-prime, or the mortgage industry. The contagion is now spreading to all financial markets and other segments of the financial services industry. As per the recent economic data released, the malice has already started affecting the auto loan and credit card industry. The collapse of Bear Stearns and the troubles of some of the hedge funds have clearly sent this message home. There is no doubt that this will continue to be a severe shock to the global financial sector with very significant long term repercussions. High fuel prices and negative consumer sentiment is now feared to drag down the US economy into recession. This would have a spiraling effect first with the retail industry and slowly spreading to other industries.

While immediate term demand side concerns will be clear once the IT budgets are out, most industry executives believe that the banking sector reeling under the pressure of sub-prime and mortgage crisis will see IT budgets getting tightened. IT budgets related to banking, credit card, mortgage space getting negatively impacted is a good possibility. Clients might not increase IT spends irrespective of volumes or revenues going up, but they may increase allocation for off shoring, to get more value out of curtailed IT budget. If this happened, it will directly benefit the Indian IT sector. Indian vendors, those affected by this crisis, have to respond with strategies similar to what they would do in tiding over a broader economic slowdown.

5. Is the US into recession?

There is no ambiguity about whether US is entering a recessionary phase. The debate is on the extent of slowdown and duration the recessionary phase will last? What will be the impact on IT budgets both in short and long term? Is the level of off shoring going to contract or increase during the downturn?

As per Morgan Stanley, despite the downturn in the banking sector due to mortgage problem, since mid 2007, the IT budgets of top six banks in US saw a 10% increase during Oct-Dec 2007 quarter. Such data points and indicators have led to a lot of speculation about the extent of IT budget cut that we can expect and extent of same across sectors. There could see marginal decline in IT budget and companies will hold on spends on new IT deployments in case of prolonged down turn and last into the next couple of years.

We believe that this recession, even though a cause of concern for the global economy may in the long run prove beneficial to the overall outsourcing industry, in particular, the Indian service providers.
It is expected that lower spending on IT by clients and limited volumes growth (of IT) could impact the first couple of quarters for 2008. But at the same time there are several large opportunities in the applications, development maintenance space and package implementation across all industry verticals, which are potential growth areas. The optimistic view, held by some in the industry, is that the downturn could spur more clients to increase the work they farm out to cheaper India firms even as they pare overall technology budgets

What is also important to realize is that clients will be expecting higher value for every dollar spent during this difficult period with service providers. The expectation is that IT budgets of companies will reduce marginally but decisions on discretionary spends and new system upgrades will be postponed.

6. Possible Scenarios facing Indian Outsourcing Industry

Given that there are no well formed views on the impact of possible recession on outsourcing, we believe that the industry should have a clear and differentiated strategy based on how the market develops forward in this year. The framework outlined below can serve as guidance on the approaches that can be taken, based on evolving market parameters.

Exchange Rates	Strategic Scenarios	
Negative	**Scenario-1** Strong Rupee US Recession limited and not across industries	**Scenario- 4** Strong Rupee US Recession prolonged and widespread across industries
Positive	**Scenario- 2** Strong Dollar US Recession limited and not across industries	**Scenario- 3** Strong Dollar US Recession prolonged and widespread across industries
	Limited → ***Recession*** → **Prolonged**	

Scenario-1:

Strong rupee, but the US recession is limited and contained within few sectors.

- The recession affects few sectors and is not prolonged.
- Investors continue to invest in emerging markets. The rupee continues to remain strong against the dollar owing to the strong foreign funds inflow.

Impact on outsourcing

- The strong rupee hits margins of all US-focused Indian outsourcing companies in the short run. This may continue into the medium term. To counter this, companies look to target business in other geographies, and contract in more stable currencies like the Euro and the Sterling.
- Suppliers will try and renegotiate contract with an inbuilt pricing increase clause. Also effort will be made to push rupee denominated contracts.
- The smaller IT businesses are affected by the rupee crisis and there is a consolidation phase among the industry firms
- The rupee appreciation diverts some of the business from India to other competing locations such as the Philippines, China, East Europe, as Indian companies lose competitiveness.
- Limited IT budget cuts in sectors affected. Vendors strengthen focus on other sectors to maintain growth levels

Scenario2:

Strong dollar, but the US recession is limited and contained within few sectors

- The recession affects few sectors and is not prolonged.

- However, investors choose to be cautious and become risk averse. Consequently some of the investment boom in emerging markets is curtailed, leading to a weaker rupee.

Impact on outsourcing

- The rupee depreciation benefits US-focused outsourcing companies in India. However, those with significant exposure to sectors affected by downturn, focus on improving operational efficiency.
- Aggressive pricing is offered to win new business from sectors not affected by downturn.
- Focus is on to deliver more value to customer for each dollar spent.
- Client companies restructure their business and enhance degree of outsourcing to manage costs.
- In view of the likely growth in demand after the crisis settles, the larger Indian companies may consider buying out US-based service providers, as valuations of US-based providers tumble. This acts as additional lever for winning new business.

Scenario 3:

Strong Dollar, but the economic slowdown is widespread and prolonged.

- Consumer spending on the whole decreases.
- The slowdown extends to most sectors in the economy. Global stock markets crash.
- Risk aversion sets in and investors start to pull out money from emerging markets like India.
- Markets in India also crash and the rupee starts to depreciate.
- The depreciating rupee helps exports of goods and services, however overall demand remains low due to the global slowdown.

Impact on outsourcing

- As slowdown spreads, outsourcing from most sectors decreases.
- Vendors offers attractive pricing to lure clients to offshore. SG&A expenses rise to win clients.
- Strong suppliers grow by acquiring weaker companies and gaining their customers.
- Banking and financial services currently accounts for nearly fifty percent of off shoring to India currently. As a result, many outsourcing companies go bust in the short term as this sector is likely to be impacted first.
- The more financially sound companies manage to survive, partly because of the rupee depreciation (which keeps their margins intact), and because they try to get business from other sectors such as healthcare, telecom, etc. They also try diversification into other markets such as Europe, Middle East, Asia & the domestic Indian market, etc.

Scenario 4:

Strong Rupee, but the slowdown is widespread and prolonged.

- Consumer spending on the whole decreases.
- The credit crunch spreads to other sectors .such as retail.
- Stock markets in the US crash, leading to ripple effects on financial markets and stock markets in the UK, Europe and other countries.
- Investors however, believe that the stronger economies will bounce back and therefore continue to invest in emerging economies, including India.
- A combination of the two factors above leads to the rupee remaining relatively strong despite the global slowdown.

Impact on outsourcing

- As the crisis spreads, outsourcing reduces in the short run.
- Banking and financial services currently accounts for more than fifty percent of off shoring to India currently. As a result, many outsourcing companies go bust in the short term.
- The more financially sound companies manage to survive, but struggle in the short term due to the rupee appreciation.

- There is an overall chaos in the outsourcing industry, with companies' directly affected losing business and the others with their margins hit by the stronger rupee.
- The larger IT companies try to diversify into other markets such as Europe, Middle East, Asia & the domestic Indian market, etc. However, the global crash makes the rupee stronger against other currencies such as the Euro and the Sterling too.
- Operational efficiencies are pursued aggressively.
- However, the stronger rupee leads to some business getting diverted to competing destinations such as the Philippines, China and Eastern Europe.

7. Conclusion:

Unlike the last US recession few years back, the industry today seems to be robust enough and has strong cash reserves to sail through expected turbulence. The industry today comprises of players who are multi-billion dollar organizations with presence in multiple geographies support by robust business systems, which has capability to undertake strains in the short and medium term. We will definitely witness a "tightening of the belt" to bring in further operational economics. The global delivery model that has been crafted carefully over last five years will see extension into new low cost destinations, to leverage cost arbitrage further. Europe will come into greater focus, as companies try to spread their risk by expanding into Europe and reduce dependence of the industry on US market alone. The downturn will also experience consolidation in the industry, as some of the smaller and weaker companies get acquired by larger players. The approach of the industry players will be to adopt an optimistic approach mixed with caution and put in place differentiated strategies, based on evolving market dynamics, to ride through the turbulence.