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The Indian software meltdown

By Indrajit Basu

KOLKATA - What goes up must come down. This basic law of motion appears to be finally catching up with the Indian IT industry, particularly its famed software development sector.

For over two years, while the global IT sector was sliding under the onslaught of dotcom bursts and a general spending slowdown, most of the top Indian software companies (which account for over 50 percent of the industry's over $10 billion annual revenues) seemed to stand proof against recession. True, while many Indian companies were not hiring in the same numbers as before and their margins too were sliding in line with the global trend, their revenues and net profit growth rates seemed to be comfortably above average.

To an ordinary mortal, they seemed to have somehow derisked their growth models. But suddenly, around a month back, the illusion of everything going just fine was shattered.

April 10 dawned like any other day in mid-summer India. It ended very differently though, for scores of investors who had pumped their savings into the stock market, particularly those who had opted for IT stocks such as Infosys, India's top software company, which announced its financial results and guidance for the coming year. It isn't that Infosys' performance was dismal. It was quite the opposite. Revenues at US$216 million were up by 54 percent over the same period of the previous year and net income at $53.1 million rose by almost 26 percent, while earnings per American Depository Receipts, which represent half an underlying share, were up by 8 cents to 40 cents.

But what really pulled the battered software shares is Infosys' future earnings guidance that projected just 3 percent revenue growth for the next fiscal - ending April 2003 - and flat earnings per American Depository Receipts.

"Infosys' guidance reveals that the days of above average margins for Indian software companies are over," said R Sukumar, vice president and portfolio manager for Templeton Asset Management India, adding, "We had expected bottom-line growth projections in the region of 17-18 percent. The decline in growth was expected. However, it has happened much earlier than expected."

It got worse when, subsequently, a slew of other top Indian software companies like Wipro, HCL Technologies, Hughes Software and Satyam Software started announcing their dismal Q4 results, reinforcing analysts' worst fears. Wipro said its profit for 2002-03 had fallen by 8.5 percent and Satyam declared a huge fourth quarter loss of $7.7 million. The battering continued for two weeks thereafter in what the stock market fraternity called "easily the worst period for IT stocks" - the market valuation of top software stocks fell by a huge $53 billion.

But the travails of the country's software sector lies not in the dismal fourth-quarter performance, or for that matter, even falling margins: it lies somewhere else. Experts say that the Indian software story now stands at a critical moment of evolution and the business model of the Indian software companies, which had until now powered the exceptional growth, may well have begun to run out of steam.

"What I see happening is arithmetical progression, hiring more people to generate proportionately more revenue", said a director of a global IT consultancy giant, which like its global giants peers has adopted the Indian model and now poses as a serious threat to Indian software companies. "There is no addition to the value of the business model. The period of growth came mainly from dollar arbitrage and skills shortages in the US. Now that model is ending."

Despite the depressed economic environment, most Indian software companies always managed to grow faster than global companies because of killer advantages: their lower costs and reputation for quality. But now, say analysts, this advantage has started to get squeezed. "Foreign clients are getting smarter," says Mahesh Vaze, a Mumbai-based analyst of a US-based broking firm Refco Sify Securities. "Most of offshore clients know how much margin an Indian IT company makes and how to negotiate prices downward. And given depressed global tech spends, billing rates are slated to go even lower."

Thus, for the Indian software sector, it is not business as usual. The big picture that is emerging is that domestic software companies have to quickly address three key issues. The first is the cost advantage. Is it something they can really count on? For many years the significant challenge before Indian IT giants was to build a presence in the global (mainly US) market. But now domestic companies find their bases under attack from multinational giants such as IBM Global, EDS and Accenture, who are rapidly expanding in India. The fundamental labor cost advantage that Indian IT holds over the rest of the world and which has powered its growth still remains. But local companies now have to start preparing for the day when multinational rivals may fully avail of the same opportunity. And it has already started to happen.

The second issue is below expected growth rate of IT-enabled, or back office services, which many, including foreign experts, had touted to be the manna in terms derisking revenues for the Indian IT sector.

Indian IT has grown on the back of two waves. From 1995 to 1999 there was Y2K. In 2000 and 2001 e-commerce ruled the roost. IT enabled services (ITES) were supposed to be the third growth opportunity. Companies such as Infosys, HCL and Satyam implied that their existing relationships with clients would be important for leveraging orders in ITES. So far, the action on the ground suggests that the IT services companies have been less than successful in getting their act right in ITES.

"It is an issue of cross selling which typically represents a real challenge, a mirage, for most organizations," said Peter Schumacher, CEO of Germany-based consultancy firm Value Leadership that helps US and European companies enhance their competitive advantage by leveraging the Indian advantage.

According to Schumacher, "in large organizations it [back office services] requires consulting, process redesign and a well-orchestrated cross-functional approach for getting executive and organizational buy-in and commitment. In European organizations union representatives will have to be involved, especially with large-

scale engagements. These prerequisites mandate a much longer and more complex sales cycle. Indian companies will require management consulting resources and a better understanding of the local market intricacies to address their target market. This will represent a real challenge for most firms. Bringing these capabilities on board will take time and cost money, which in turn will cut into margins and valuations. Clearly, the Big Five consultancies have a head start in this domain. Will they [Indian companies] be able to leverage their advantage?"

Finally and perhaps most significantly, there's a fundamental shift taking place in valuation of Indian software stocks. Software services companies that held their valuations despite the global downturn that began two years ago are facing a major downward re-rating, which threatens to bring their stock valuation down to the levels of old economy companies. The present reality is: it does not matter if you are an Infosys doing a project for a Fortune 500 company; you cannot simply charge a premium. "Clearly there is now less of product and more of commodity in software services, " says Ramdeo Agarwal of Mumbai-based brokerage firm Motilal Oswal.

However, some still feel that while Indian companies struggle to adjust to new realities, the promise of India's IT sector still remains. For instance, according to Singapore-based Samir Arora, the celebrated fund manager of Alliance Capital: "Our basic advantages remain. We still possess cost competitiveness and, when all is said and done, there are not too many countries that can offer the same opportunities for global outsourcers as India."

Despite the optimism, however, the general feeling is, to come out of the rut, Indian software companies will have to start offering specialized services. **"Today, most [Indian] firms are very opportunistic," said Schumacher. "They take whatever they can get or comes across their way. Companies with $10 million in revenue serve clients in six verticals. This is a huge contrast to most European and US firms. Except for the very big ones, European and US firms are very focused on specific industries or solutions. Many Indian firms, in contrast, seem to be real industry generalists. As companies continue to grow and mature, industry specialization and domain expertise will be increasingly important," added Schumacher.**