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## Information Technology: A Shining Star

Since the onset of the pandemic, the one sector which has been under the spotlight throughout is Information Technology (IT). As globally as well as domestically people started working from home, the need for robust IT infrastructure by companies saw a sharp uptick. This resulted in companies across sectors adopting newer IT solutions while some other decided to upgrade the existing systems.

### Indian IT Turf

The IT industry is a major force to reckon with as it contributes to over half of services' exports and accounts for 8 per cent of India's GDP. With its robust 45 lakh IT professionals, India emerges as a large base for qualified IT talent globally. Additionally, deep expertise, presence across technologies like cloud and digital with multiple domains coupled with best-in-class execution makes India IT companies well-suited to enable holistic digital transformation. In terms of clients, the BFSI sector is the largest customer, followed by manufacturing and retail.

The IT sector based on the services offered can be divided into four broad groups – IT services and engineering, research and design, business processing and outsourcing and hardware. The sector is poised to grow for the following reasons:

### Demand Environment

Companies today have realised the critical role of technology in building resiliency, improving experience and building new revenue streams. Hence, many clients are undertaking a core transformation, which is a multi-year journey. The recent quarters have seen very positive demand-driven growth owing to digital transformation and cloud migration, a trend which is likely to continue. As a result, the demand environment remains optimistic. The sector has seen larger deals come

through especially for cloud-based services, the penetration of which is expected to reach ~50 per cent over the next couple of years from the current 25 per cent.

Clients are still in the early phase of cloud migration with only a minor portion of workloads on the cloud and these enterprise clients have accelerated their cloud adoption journeys catalyzed by the pandemic. Their transformation journeys include: (1) infrastructure migration to the cloud, (2) adoption of cloud native technology stack and (3) new ways of collaboration among organisations, resulting in a strong multi-year increase in technology spending across industries. This digital transformation and cloud migration is likely to be a 3-5-year journey for organisations which improves the outlook for the sector in general.

### Margin Expansion

There was widespread expectation of slowdown in margins' growth which did not materialize due to operating leverage as well as higher offshoring. The pandemic gave legroom for margin expansion due to cost reductions as expenses related to travel were reduced. While travel may resume, there is a consensus that it won't be like before. Also, the shift towards work from home is an important lever for improving margins as it reduces expense related to facilities. While this may sound trivial, the numbers tend to be significant when considered that the sector employs nearly 45 lakh people. This expense is likely to normalise over time. Recent quarters have highlighted that the offshore mix for the companies has been changing, with larger set of employees opting to work from India rather than being physically present on-site. This is a structural lever for the margins and has thus far led to higher market share gains for Indian companies.

### Challenge Area

The attrition rate for large IT services companies in the recent quarters had touched a high of 30 per cent which resulted in increased personnel costs, putting a damper on margins. In the meanwhile, companies combated the situation by increase in hiring of fresh graduates and subcontractors for specific projects in an attempt to reduce long-term labour costs.

### Valuations

Over the last 18 months, the sector has undergone a re-rating. Valuations are no longer cheap and price-to-earnings ratio of the sector has gone up from 20-25 times to 25-40 times range. Some of the biggest gainers here are names from the mid-cap space and investors are increasingly getting sceptical of its sustainability. However, with the 3-4 year demand cycle intact, there is a possibility that this trend could sustain. Going forward, earnings growth is likely to be in line with revenue growth, with select companies in mid-cap space expected to outpace the industry growth on revenues. So, if you are an investor with a five-year view, IT space could be a good sector to invest into.