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IT firms stare at revenue, margin blows of the decade

Healthy liquidity and low debt stock to help IT firms steer through the challenges

Revenue pressures in the ~USD 97 billion Indian information technology (IT) service industry, will intensify in fiscal 2021, due to the impact of the Covid-19 pandemic world-wide, crimping growth to a decadal low of 0-2%, surpassing even the earlier low of ~4% registered in fiscal 2018. This is as per an analysis by CRISIL Ratings of 15 large IT firms, accounting for almost 70% of the IT service sector's revenues.

The IT firms also face the spectre of price renegotiations by clients, which would add to the cost pressure emanating from investments in digital capabilities and limited incremental cost-saving avenues. Consequently, operating profitability could also moderate ~200-250 basis points to a decadal low of ~20% this fiscal.

Says Anuj Sethi, Senior Director, CRISIL Ratings, "Typically, new deals get finalised between March and May, but this time around, most clients will focus on mitigating emerging business risks and defer discretionary IT spend, while letting existing contracts continue. The current restrictions on people mobility will also delay consummation of new deals."

That said, revenue growth across business verticals will vary. For instance, the banking, financial services and insurance (BFSI, accounting for 28% of IT service revenues) will continue to grow at ~8% because of rising share of digital transactions and presence of larger and longer-term maintenance contracts that are critical to operations. Healthcare verticals (8% of IT services revenue) would also see similar growth because of rising digital transactions from hospitals.

On the other hand, large verticals such as manufacturing, travel and tourism, oil and energy, and retail (32% of IT service revenues), and communication, aerospace, defence and transportation (22% of IT service revenues) will see steep and immediate impact on revenues considering sluggish demand in these sectors.

Says Rajeswari Karthigeyan, Associate Director, CRISIL Ratings, "The impact of slowing revenues will, in turn, affect operating profitability despite gains from a depreciating rupee. That is because IT firms will have to continue investing in new-age technologies to show-case their ability to service complex digital projects. That may not lead to immediate gains. To be sure, despite the share of high-value digital revenues quadrupling to ~40% between fiscals 2016-20, IT firms saw an almost 100-150 bps decline in operating profitability to 22.7% in fiscal 2020."

As things stand, the opportunity for optimising employee and outsourcing costs (~70% of revenues), despite potential curb on recruitments and wage hikes, appears to be limited. IT firms have already streamlined costs and raised utilisation rates to peak levels of 85-90% in recent years by increasing the share of fixed-price contracts.

That said, CRISIL Ratings does not expect any material impact on the credit quality of most IT firms, given their healthy financial risk profiles supported by low debt levels and large, liquid surplus. The sample set of 15 IT firms has an average gearing of ~0.12 time and cash balances adequate to cover 4-5 months of employee costs.

A few other firms with high revenue concentration in business verticals where the demand outlook is weak could, however, face some challenges.

The extent of the Covid-19 pandemic and its impact on global economy, will remain a key monitorable.

For further information contact

Media relations	Analytical contacts	Customer service helpdesk
Saman Khan Media Relations **CRISIL Limited** D: +91 22 3342 3895 M: +91 95 940 60612 B: +91 22 3342 3000 saman.khan@crisil.com **Naireen Ahmed** Media Relations **CRISIL Limited** D: +91 22 3342 1818 M: +91 90 040 84769 B: +91 22 3342 3000 naireen.ahmed@crisil.com	**Anuj Sethi** Senior Director - CRISIL Ratings **CRISIL Limited** B:+91 44 6656 3100 anuj.sethi@crisil.com **Sameer Charania** Director - CRISIL Ratings **CRISIL Limited** D: +91 22 4097 8025 sameer.charania@crisil.com	Timings: 10.00 am to 7.00 pm Toll free Number:1800 267 1301 For a copy of Rationales / Rating Reports: CRISILratingdesk@crisil.com For Analytical queries: ratingsinvestordesk@crisil.com

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