Research

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Bulging staff cost, shrinking margins

Operating margins of IT firms to shrink yet again, as H-1B visa rules continue to curb arbitrage

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Bulging staff cost, shrinking margins

Indian information technology (IT) services companies need to write a new code to debug rising staff costs.

Traditionally, the sector has relied on labour arbitrage for maintaining margins, but that gap has been narrowing owing to various market forces - mainly changing US policy stance towards H-1B visas.

Employee expenses which account for nearly 60-65% of total operating costs and cost per employee for Tier 1 players rose faster at ~17% and ~9% on-year in fiscal 2019, respectively, compared with ~6% and ~3% a year before. For mid-tier players, the increase in employee expenses was ~13% on-year for nine months ended December of fiscal 2019 as many are yet to declare fourth quarter results.

Such an increase in employee costs can be attributed to tightening of visa norms for Indian players, resulting in higher onsite costs for them. Ever since the US government tightened its H-1B visa policy in 2017, challenges have mounted for the sector. That year, Indian-origin employees were the largest consumers of H-1B visas at 63% of initial employment, so the sudden change meant fulfilling onsite client requirements became tough.

To be sure, Indian IT players have had an offsite-onsite employee ratio of 80:20. Employees with H-1B visas have been at the core of their strategy, given that they cost ~20% cheaper than US-based employees. Further, the unemployment rate in the US technology sector was only 1.8-2.0% in calendar 2018, compared with an overall unemployment rate of 3.8-4.0%. So, the limited staff availability is expected to lead to higher employee costs associated with hiring US locals.

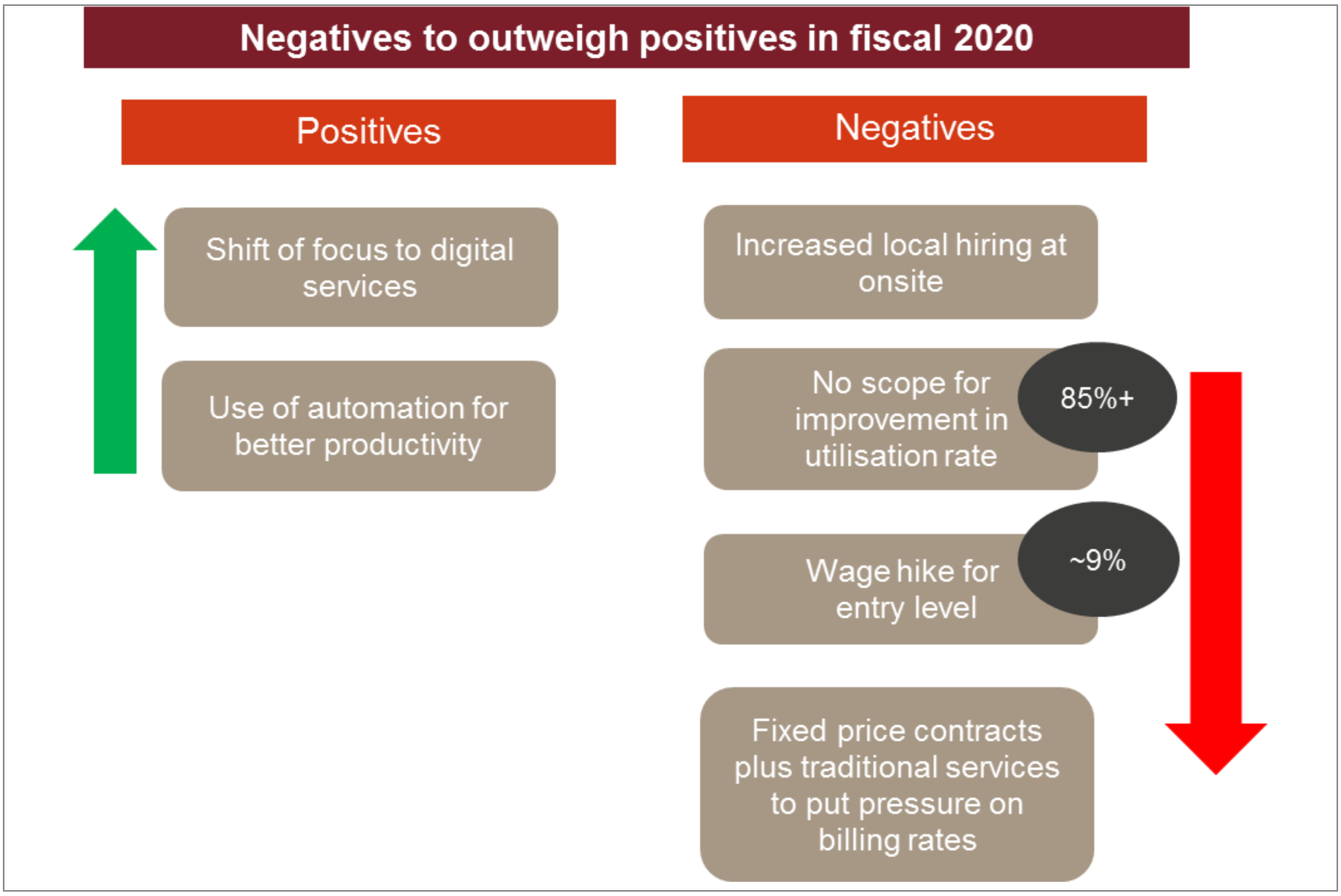
A deep dive into this issue shows the onsite costs of Indian IT companies would continue to rise and put their profit margins at risk.

Margins have been declining structurally for the past five fiscals, as billing rates and utilisation stabilise, so rising employee costs will only add to the pressure. Employee utilisation was high at ~85% in fiscal 2019, with only a marginal room for improvement in the future. Billing rates are expected to remain under pressure, as traditional services become commoditised.

CRISIL Research expects revenues to grow by 7-8% in dollar terms for the sector in fiscal 2020, helped by double-digit growth in digital services. Operating margin is forecast to decline 30-80 bps for the sector in fiscal 2020 as local hires increase for onsite job, who cost 25-30% more than their H-1B counter parts.

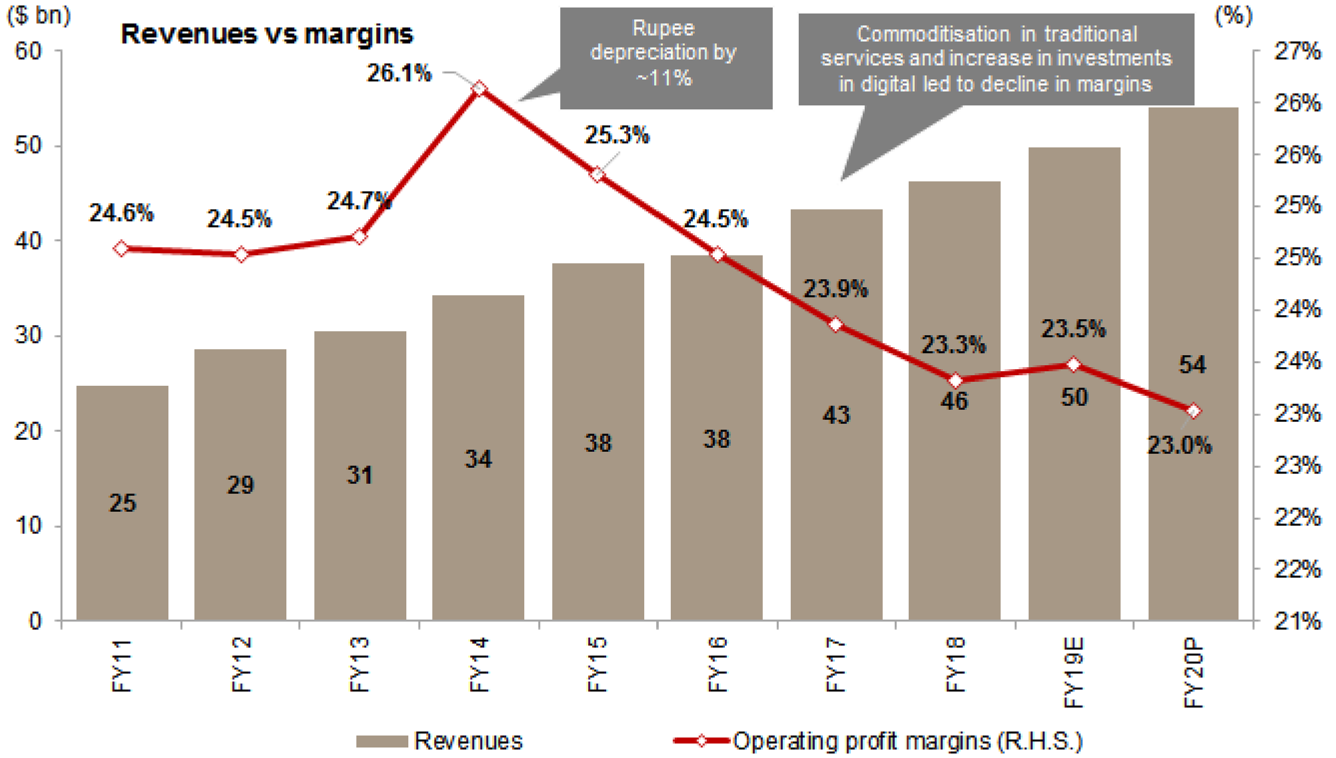
Players can try to optimise onsite costs by resorting to the pyramid model, wherein college graduates are hired at $50,000-60,000 in a higher proportion and the rest filled with a few domain experts at a higher cost, fewer onsite bench resources, and keeping variable salaries depending on the outcome of projects. Focus on moving up the value chain in digital services could also play a role to offset rising employee cost.

Margins to be negatively impacted in fiscal 2020



Source: CRISIL Research

Margins continue to shrink despite being at a decadal low



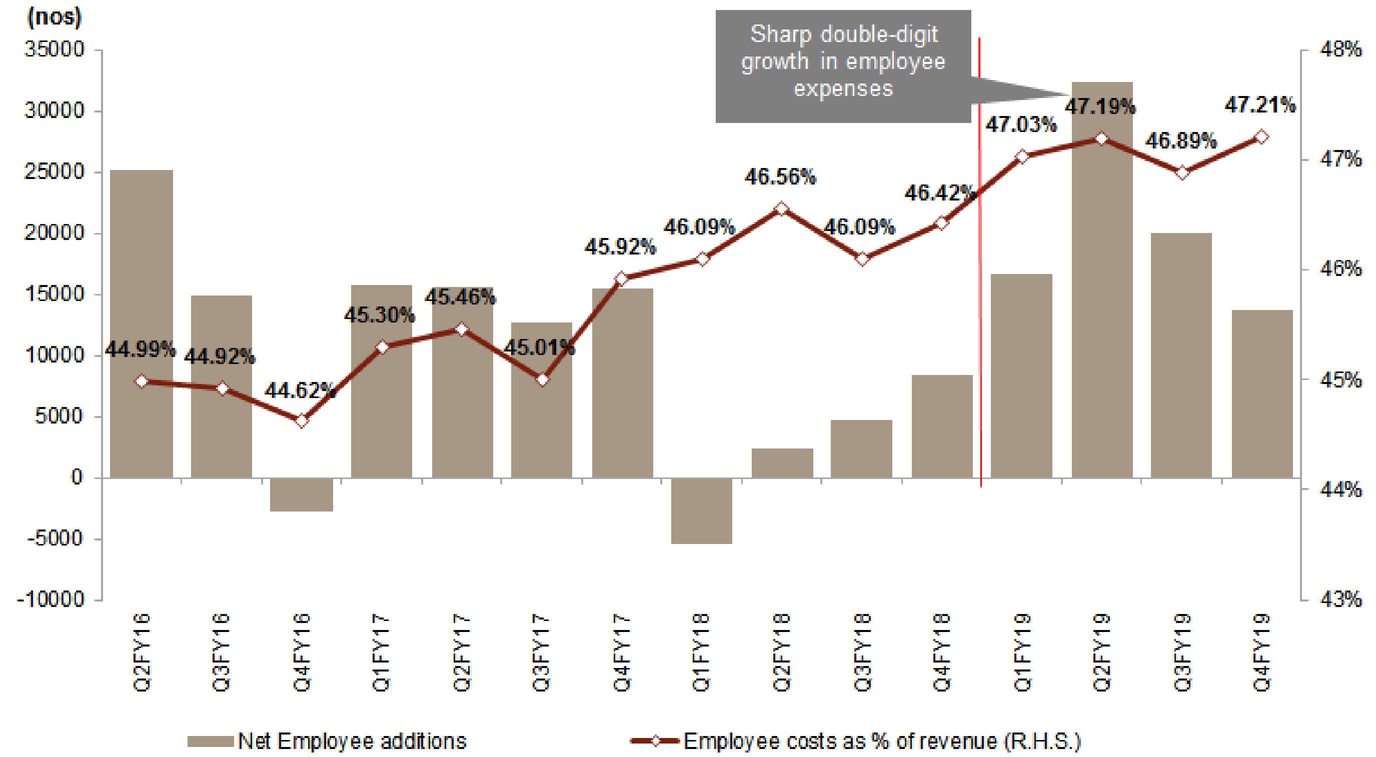
Note: Tier 1 companies, which include TCS, Infosys, HCL Technologies and Wipro, are taken into consideration

Source: CRISIL Research, Company reports

The rise in employee expenses of IT players can be attributed to higher:

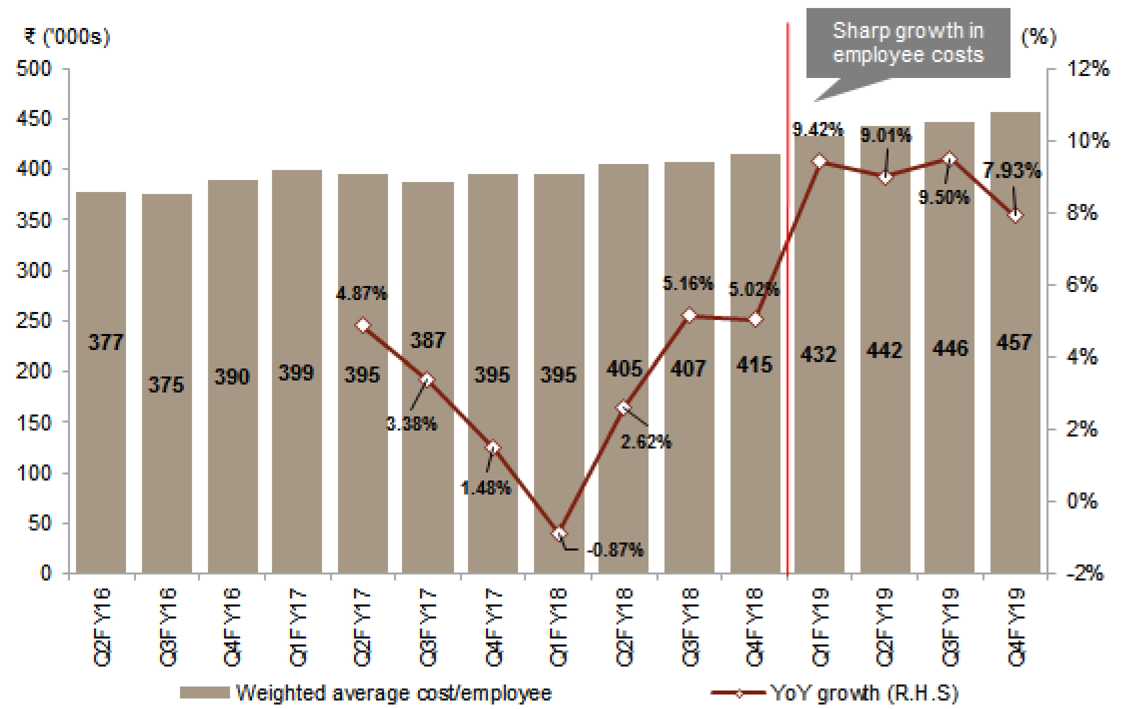
- **Employee additions:** Tier 1 players added more than 82,000 employees in fiscal 2019, compared with only 10,000 employees in entire fiscal 2018, which is the highest in past five fiscals.
- **Cost per employee:** The cost per employee for Tier 1 players rose to Rs 479,540 in the last quarter of fiscal 2019, a sharp ~9% on-year increase compared with less than 5% in the previous eight quarters. The increase in cost per employee can be attributed to the rising number of onsite local hires and higher (~2x) salaries of employees with digital skills, as the wage hike was only in the range of 6-8% for the employees for the period. Employee cost has been trending up for the past eight quarters even though employee addition was muted during fiscal 2018, which can be on account of higher onsite costs for players.

Higher employee addition shows a relationship with cost increase for Tier 1 players



Note: Tier 1 companies included are TCS, Infosys, HCL Technologies and Wipro
Source: Company reports, CRISIL Research

Cost per employee for Tier 1 players, too, is rising



Note: Tier 1 companies included are TCS, Infosys, HCL Technologies and Wipro
Source: Company reports, CRISIL Research

H-1B visa policy changes lead to more local hires at a higher cost

Even though no major policy changes have been implemented targeting Indian IT companies in terms of H-1B visa regulations, there has been a generally negative sentiment within the US administration. This is evident in the greater scrutiny of H-1B based employees through more disclosures under US President Trump's 'Buy American Hire American, 2017' executive order.

The recent policy change, effective April 1, 2019, reverses the order of selection of visas, through which the US Citizenship and Immigration Services (USCIS) selects H-1B petitions under the H-1B regular cap and the 'advanced degree' exemption. Changing the order of selection of visa will likely increase the number of petitions for beneficiaries with a master's or higher degree from a US institution of higher education; estimated to increase up to 16% (or 5,340 workers) in the total number of selected H-1B visas. This is expected to reduce the number of H-1B visas issued to IT services companies, as a bachelor's degree is the highest degree of education for most H-1B employees.

Higher scrutiny for H-1B visas in recent years

1998-2005

- **American Competitiveness and Workforce Improvement Act, 1998-** Visa cap increased from 65,000 to 115,000
- **American Competitiveness in the 21st Century Act, 2000** – Further increased to 195,000 for 2001-2003
- **Consolidated Appropriations Act, 2005 -** Reduced to 65,000 with the exemption of 20,000 for foreigners doing master's degree and above from US universities

2013-2017

- **H1B Visa Reforms Act, 2013** – More details for employers for the prevention of visa misuse
- **Consolidated Appropriations Act, 2016**- Doubled H-1B fees to $4,000 for companies having more than 50 employees in the US, with more than 50% of those employees in H-1B
- **Buy American and Hire American , 2017** -Executive order which seeks to create higher wages and employment rates for US workers, and to protect their economic interests by rigorously enforcing and administering immigration laws

2017-present

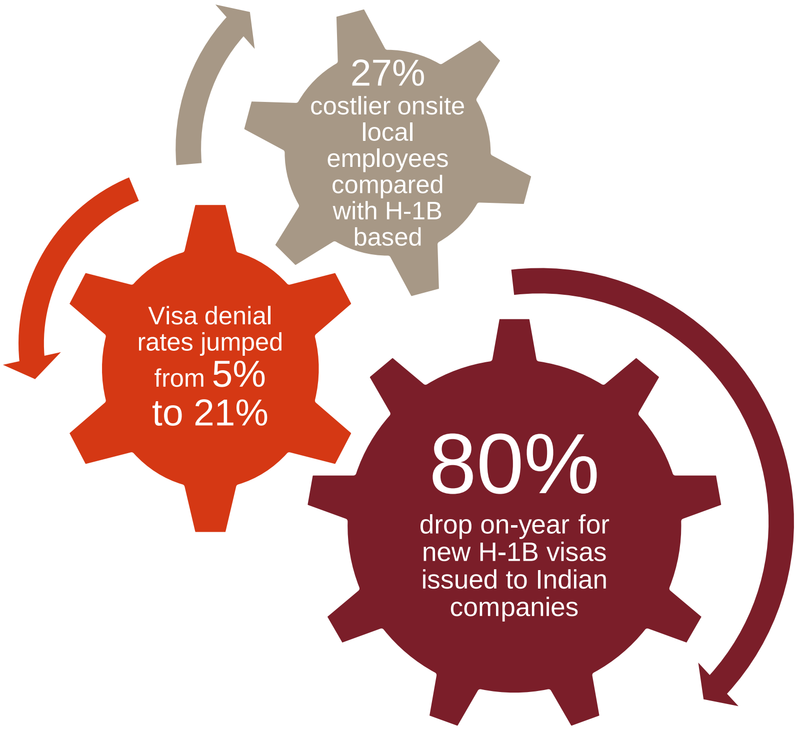
- **USCIS Policy Memorandum, 2017** – Same level of scrutiny for initial and extension requests
- **USCIS Policy Memorandum, 2018** - Policy on requirements for third party worksite H-1B petitions
- **New LCA form, 2018** – More disclosures
- **Department of Homeland Security issues Notice of Proposed Rulemaking for H-1B Visa, 2018**- Electronic registration coupled with reverse selection process

Source: USCIS, CRISIL Research

The impact on players is evident

In line with the tightening of H-1B visa norms, new H-1B petitions issued to Tier 1 Indian IT firms declined at a significant ~55% CAGR from fiscal 2015 to fiscal 2018. Also, the denial rate for H-1B petitions has been higher for Indian players than for other countries. The denial rate rose from 5% in fiscal 2017 to 21% in fiscal 2018 for India, while it marginally increased for US companies from 1% to 2% in this period.

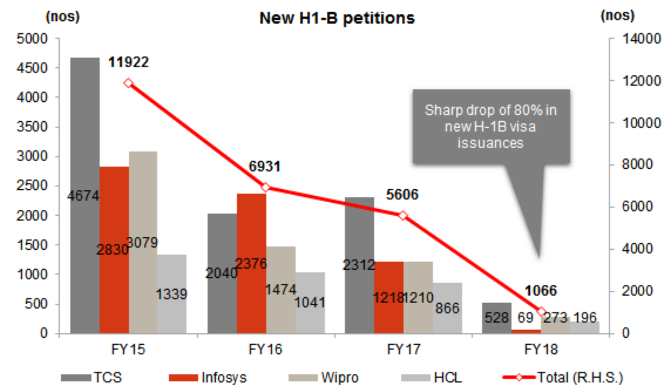
Onsite costs tightening

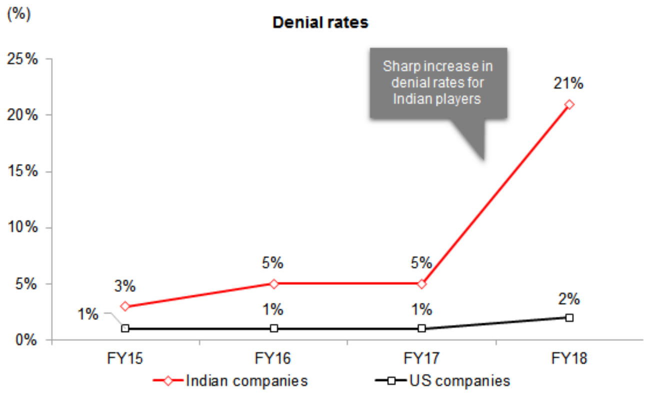


Source: USCIS, CRISIL Research

Onsite hiring, which entails taking on local employees, can result in an increase in onsite employee cost for players. An analysis of local wages for computer-based occupations, along with H-1B wage rates prevalent for the same computer-based occupations across the US (including variation in wages for individual states), indicates that the average per hour rate for an H-1B-based employee is ~$33 and that for a locally-based employee is ~$42. So, in general, local talent needs to be paid 25-30% higher wages.

New H-1B-based petitions issued to Indian companies continue to fall amid rising denial rates





Note: 1. Indian companies considered for weighted average are TCS, Infosys, HCL and Wipro

2. US companies considered for weighted average are Amazon, Google, Facebook and Microsoft

3. USCIS' fiscal year starts from October 1 and ends on September 30

Source: US Citizenship and Immigration Services; National Foundation for American Policy, CRISIL Research

Hiring sub-contractors and using onsite operating levers to meet short-term demand

Stringent regulations, especially for H-1B visas, have made it difficult for IT companies to cater to urgent onsite demand. As a result, their sub-contracting cost as a percentage of revenue rose from 8.9% in fiscal 2014 to 13.17% in fiscal 2019.

Also, with the increase in digital-transformation deals – which entail more short-term presence of employees at client locations – CRISIL Research expects sub-contracting costs to remain high for IT players in the immediate future. Onsite margin pressures can be partially offset by cost-optimisation techniques, such as the pyramid model, gradual reduction of high-cost resources, fewer onsite bench resources, and keeping variable salaries depending on the outcome of projects.

Nevertheless, margin concerns for IT players may not fade instantly.

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