Substitution of it services and products economics essay

Economics

Sector overviewDespite cutting on discretionary IT budgets globally, Indian IT industry managed to weather the storm to some extent on the back of superior quality, cost and execution efficiencies and between FY2008 and FY2012, the industry grew from Rs 2, 534 bn to Rs 4639 bn, registering a CAGR of 16%. Export revenues primarily on project based IT Services continue to drive growth with IT Services accounting for 59% of total revenues followed by BPO and Engineering services at 22% and Software Products at 19%. Labour arbitrage has been the competitive edge of the Indian software sector over the last few years. However, this seems to be threatened now by MNCs' who are replicating the Indian outsourcing model and setting up bases in the country. Domestic IT market increased revenues from Rs 886 bn in FY2008 to Rs 1, 475 bn in FY2012 registering a CAGR of 14%, with Software and Services contributing to 60% of domestic revenue and Hardware contributing to the balance 40% as the government emphasized on better technology for government projects.

Supply

Abundant supply across segments, mainly lower-end, such as ADM. Lower supply in higher-end areas like IT/Business Consulting, but competition is very tough.

Demand

Due to the ongoing global downturn, the global IT spending is expected to continue to face pressure. Emerging economies such as India and China have also slowed down.

Barriers to entry

Low, particularly in the ADM segment as this is prone to relatively easy commoditization. High in value-added services like IT/Business Consulting where-in domain expertise creates a barrier. The size of a particular company/scalability and brand-image also creates barriers to entry; as such firms have built up long-term relationships with major clients.

Competition

Competition is global in nature and stretches across boundaries and geographies. It is expected to intensify due to the attempted replication of the Indian offshoring model by MNC IT majors as well as small startups.

Substitution of IT services and products

IT continues to be a driving force towards all aspects connected with our lives. While a particular technology may become obsolete and a particular company specializing in it may suffer, the obsolete technology can only get substituted by a newer technology offered by the same/different player in the IT/ITES industry. Intense competition has impacted growth in billing rates thereby affecting revenues. For the first time in 47 quarters, Infosys missed quarter’s expectations. The major IT firms have reduced their growth expectations for the year 2012-13. The top 4 Indian IT companies grew at 17% in the 3rd quarter and at 14% in the fourth quarter as opposed to 24% in the first quarter in the last financial year and this is a cause of worry.

FINANCIAL YEAR 2012

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The Indian IT/ITES industry earned revenue of around US$ 89 bn during FY12. Out of this, exports accounted for 68% of the industry’s revenue.

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In terms of industry, BFSI contributed to 41. 2% of the IT/ITES sector's export revenues followed by Telecom, which contributed roughly 19%. All other industries taken together contributed to 39. 8% of the IT/ITES sector’s revenue.

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The USA still accounts for roughly 60% of the export revenue followed by the UK and Continental Europe, which together contributes roughly 29%. Other regions such as Asia Pacific is catching up, registering a growth of roughly 18% for exports made to this region.

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At the end of FY12, total outstanding capex in the IT/ITES industry stood at more than Rs 1765 bn spread over 437 projects.

Challenges faced by Indian IT:

1. Uncertain global economy: The Indian IT outsourcing industry gets about 75% of its revenues from US and Europe. The renewed concern regarding the European sovereign debt has led to companies slowing down their IT spending. BFSI segment has been the biggest contributor to Indian IT revenues. As shown in the figure below, the recent turmoil in Europe & US has resulted in slowing demand in BFSI segment2. Protectionist measures:

There have been periodic threats of the US stopping all outsourcing work. Rising US rhetoric against shipping of jobs to low cost locations ahead of US presidential elections in November might result in lower market shares for Indian IT companies. The US Senate will be looking into a bill backed by the Democratic party popularly known as the ‘ Bring Jobs Home Act’. If the bill is passed, tax benefits will be extended to companies that shift their work back to the US & will end tax incentives for those who send work offshore. On the other hand, Europe has quietly enforced visa restrictions making people difficult to travel onsite for work. 3. Tough competition from MNCs: Increasing competition from MNCs like IBM, Accenture who have set up bases in several of the IT zones earlier dominated by Indian IT firms. Also, US wages have been decreasing and are on par with Indian wages for some of the sectors. Outsourcing will be less attractive to American employers. 4. Pressure on billing rates: Discounts from key financial sector clients is pinching IT firms. On 12th July, Infosys claimed that pricing has fallen by 3. 7% in the June quarter from the previous quarter. As the growth in demand has fallen, firms are vying for the small pie by opting for price cuts. 5. Low employee utilization: Increasing bench size has been reported across various IT firms. Employee utilization has fallen down to 67% for lot of Indian companies. Companies have to reserve certain human capital so as to accommodate them in case of future demand. 6. Volatility of Indian rupee against the dollar: Depreciating rupee helps the IT industry. Increase its revenues as most of the companies earn in US dollars. However, as the companies would have already hedged against rupee appreciation in advance, the currency volatility wouldn't affect much. Planning for the future becomes a problem. FUTURE PROSPECTS

As per NASSCOM, the Indian IT/ITES industry is expected to grow by 11-14% in FY2013. NASSCOM has also envisaged the Indian IT/ITES industry to achieve a revenue target of USD 225 bn by 2020 for which the industry needs to grow by 13% on a y/y basis in the next eight years. NASSCOM further added that globally IT services spending are expected to grow by 4. 7% in 2013. Currently India accounts for less than 5% of the global technology spending and this provides huge opportunities for the growth of the Indian IT-BPO industry. However, Indian IT companies are expected to face competition from emerging outsourcing destinations like Philippines, Poland, Hungary, Romania, etc

ADM services, which used to provide major chunk of revenues to the domestic IT players, are getting affected due to the falling billing rates. Hence, the companies are now venturing into new high value services such as IT Consulting, Product Development, and end-to-end turnkey solutions.

With backing of BPO services, Indian IT companies are able to straddle across the entire value chain which is expected to make them more competitive as compared to other outsourced destinations. Billing rates will remain stressed in the short term; companies are expected to preserve their margins through effective cost containment. Lessons learnt during the crisis can benefit in the long run.