Scale Matters in IT Services: Higher Gross Margins, and Diversified Geographic Footprint

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Global enterprises have always enjoyed the benefits of scale. And technology industry is no exception. Indian information technology biggies have secured places in the global list of most-valued IT services brands frequently. The latest report by Brand Finance placed Tata Consultancy Services as the third most-valued IT services brand globally. Infosys, HCL, and Wipro also secured spots in the top-10 global tally. The scale of these IT biggies put them in good stead with regard to their global and Indian peers. Higher gross margin is the immediate outcome of the scale as large IT services companies have many levers to control cost. Moreover, higher surplus cash and sound cash reserve enable big IT companies to spread their global footprints. This not only diversifies their revenue source but also acts as a hedge against a downturn.

Mid-sized IT companies, in turn, have lower elbow room in terms of geographical expansion owing to cost considerations. Their dependence on the North American market, therefore, is high. This leads to concentration risks and makes the business model less resilient during a downturn. Typically, the cost of operations is also high for mid-sized IT firms due to a lack of economies of scale, higher usage of subcontractors, and wage cost. In turn, gross margin ratios are lower for mid-sized software services companies as compared to their global peers.

Exhibit 1: FY21 Revenue Breakup of Tier-1 Indian Service Providers

Service Provider	SG&A	Revenue % From North America	Revenue % Outside North America	Gross Margin
TCS	15%	50%	50%	41%
Infosys	10.5%	61%	39%	35%
HCL	12.5%	56.5%	43.5%	41%
Wipro	13%	59%	41%	32%
Tech Mahindra	13.6%	47.5%	52.5%	32%

Source: Company Financials, EIIRTrend

Numbers rounded up to the nearest digit or decimal point.

Exhibit 2: FY21 Revenue Breakup of Mid-Tier Indian Service Providers

Service Provider	SG&A	Revenue % From North America	Revenue % Outside North America	Gross Margin
LTTS	11.5%	61%	39%	30%
Mindtree	12.75%	77.5%	22.5%	30.5%
LTI	11.5%	68%	32%	33.5%
Mphasis	12.5%	77%	23%	28.5%
Persistent Systems	18%	81%	19%	34%
Coforge	14%	48%	52%	32%

Source: Company Financials, EIIRTrend

Numbers rounded up to the nearest digit or decimal point.

Gross margin moves in sync with scale:

- Economies of scale play a vital role for technology firms, leading to cost savings for large IT firms.
- In the fiscal year FY21, the top five Indian IT firms had an average gross margin of around 36 percent within a broader range of 32-41 percent.
- Market leader TCS with annual revenue of $22.17 billion in FY21, had a gross margin of 41 percent. India's second-largest IT services company Infosys with annual revenue of $13.56 billion, reported a gross margin of 35 percent.
- In FY21, HCL Technologies, with annual revenue of $10.17 billion, reported a gross margin of 41 percent, while both Wipro ($8.5 billion of annual revenue) and Tech Mahindra ($5.1 billion) had gross margins of 32 percent each.
- In comparison to their larger peers, leading mid-tier IT services companies reported an average gross margin of around 31 percent, with the range varying 28.5 to 34 percent.
- Among the six leading mid-sized firms, Mphasis had the lowest gross margin of 28.5 percent, while Persistent Systems had the highest gross margin of 34 percent.
- Other leading mid-tier IT firms like LTTS had a gross margin of 30 percent, while LTI had 33.5 percent of gross margin. Mindtree's gross margin was at 30.5 percent in FY21.
- The difference in gross margins indicates that scale clearly supports the cost structure through lower variable costs. Therefore, as the mid-sized IT firms grow larger with higher revenues, the difference in the gross margin as compared to larger peers is likely to shrink in the coming years.
- However, despite revenue differentials, it is seen that the SG&A expenses with regard to their total revenues remain almost at a similar range for both mid-sized and large IT companies. This reflects the aggressive spending of Indian IT firms on sales and marketing to win more clients irrespective of their top lines.

Scale leads to a healthy mix of revenue contribution:

- Diversification of revenue sources creates effective hedging against any downturn. Technology firms, therefore, are assiduously pursuing geographical diversification as a strategy.
- In this perspective, scale plays a key role in such geographical diversification. All large players have a significant share of their revenues coming from regions outside of North America. The European region, Asia Pacific, and other parts of the world contributed on an average about 45 percent of the total revenues to the top five large IT firms in FY21. In comparison, the leading six mid-tier companies drew about 31 percent of their top line from outside of North America.
- Among the top IT firms, Tech Mahindra drew the highest 52.5 percent of its revenues from outside of North America, followed by TCS at 50 percent.
- Regions outside of North America contributed 39 percent of Infosys' top line, whereas HCL Technologies drew 43.5 percent and Wipro at 41 percent during FY21.

- Among the mid-tier IT firms, Coforge has the highest contribution of 52 percent, coming beyond the North American region. But all other companies witnessed a far less contribution from this region. L&T Technologies saw a revenue contribution of 39 percent from regions outside of North America, while it was 32 percent for L&T Infotech. Mphasis & Mindtree had a contribution of 23 & 22.5 percent revenue shares in FY21 from this region.
- Higher dependence on North America, especially the US, for revenues indicates that mid-tier firms face geographical concentration risks to their top lines.
- As entering into new territories and setting up centers is a costly affair, large IT firms have the balance sheet strength to pursue such investment. So, the scale gives a distinct advantage in terms of geographical expansion. In contrast, mid-tier IT firms have to be selective in their geographical expansion plans due to cost considerations. Also, a large cash reserve provides a cushion if the investment goes wrong.

Road to top league goes through 'rest of world':

- As scale plays a critical role in spreading the revenue sources, mid-sized IT firms have to spread their wings beyond North America to boost their earnings. This will also protect their top line against a downturn and provide predictability in revenues.
- However, entering into new geographies is fraught with risks. Therefore, such investment should be carefully evaluated before taking the plunge. Partnership with local partners or startups operating in those geographies can be a great way to expand overseas before setting up full-fledged centers.
- Moreover, mid-tier firms have to provide specialized services in niche domains to win new clients in Europe and APAC regions. As competition is intense in large deal space, mid-sized companies can participate in small contracts initially and grow those deals into larger ones through client mining.
- The world is moving towards digital, with cloud-based SaaS products witnessing faster adoption. In this perspective, mid-sized companies can develop specialized SaaS products in emerging areas to get faster customer acceptance in the competitive market.

Bottom line: Scale puts IT firms in a more favorable position

Though mid-sized companies have advantages like agility and pricing flexibility, scale puts IT firms in a more favorable position. The pandemic has accelerated the pace of digital transformation, and this demand cycle is likely to continue for many years. It provides mid-sized companies a good chance to ride the new demand wave and join the league of large IT firms. If mid-sized companies can expand their wings beyond North America, retain agility in delivery with a nimble approach towards innovation, India may see more companies joining the global pecking order in coming years.

About the Author

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Pareekh Jain is CEO and Lead Analyst of EIIRTrend and Pareekh Consulting.

EIIRTrend is an information platform for discovering engineering, IoT, Industry 4.0 and R&D (EIIR) trends, information, insights, best practices, across 12 industry segments, 24 service segments, 50+ countries and 2500+ providers and buyers. Pareekh Consulting is a focused analyst and advisory firm for EIIR.

A seasoned EIIR professional, Pareekh has seen the EIIR industry from four perspectives: service provider, sourcing advisor, enterprise buyer, and industry analyst.

He is regularly quoted in media on EIIR trends. Some of the media publications he is quoted in include Harvard Business Review (HBR), NDTV, Times of India, Economic Times, Business Standard, Hindu, Business Line, Livemint, Indian Express, Financial Express, Deccan Herald, Bizzbuzz, Rediff, Voice of America, Moneycontrol, Quartz, and Business Insider.

Pareekh is a thought leader, having authored various publications on topics related to EIIR outsourcing. He loves business fiction writing in his free time, and has authored a novel, Who Is That Lady?

Pareekh received his MBA from the Indian Institute of Management (IIM), Bangalore and his Bachelor of Technology degree from the Indian Institute of Technology (IIT) Delhi.

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