

Rupee depreciation: A mixed bag for IT sector

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Abstract: The depreciating rupee against the U.S. dollar is something less to cheer and more to worry for the Indian IT (information technology) industry. Its impact over a period, particularly in the backdrop of an anticipated inflationary cost pressure, is likely to cloud the short-term gains.

“What’s happening now on the rupee front will actually be a double whammy for the IT industry in the medium-term,” says Sujit Sircar, CFO, iGATE.

The inflationary conditions, he explains, will result in cost pressure for the IT companies. “Costs like travel and power will go up. Also, all import costs will impact our capital expenditure.” On the revenue front, there could be pricing pressure from clients if the depreciation of the rupee continues.

If there is something heartening, it is on the immediate front, as every percentage dollar gain, according to Mr. Sircar, “results in a 25-30 basis points increase in our margins.”

Cognizant’s CFO Karen Mc Loughlin told a global conference organized last week by Jeffries that the company had an aggressive hedging programme.

“We have about \$3.7 billion in outstanding hedges of our rupee expenses which will mature each month through 2015 at an average rate of about 51.9,” she added. Therefore, the “swings in the rupee actually don’t give us either as much benefit or pain, depending which way it’s going,” she said.

Keywords: Indian IT industry, rupee value, rupee vs dollar

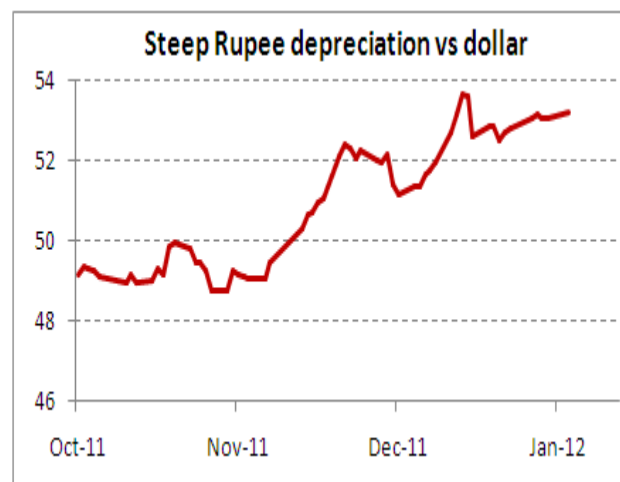
I. INTRODUCTION

Business environment has not been conducive for quite some time. Factors such as prevailing uncertainty in global economic environment, stubborn inflation, high crude prices, high interest rates and declining rupee have affected more or less every business in some way or the other. Most businesses are complaining about the sharp rupee depreciation in the past few months as their import bills are ballooning. In turn, it is adversely affecting their margins. However, there is one sector which has got good reasons to feel happy about the rupee situation.

At present, Indian Software companies facing a tough time due to economic problems in the developed economies. More companies are now openly talking about the delay in project starts. Also, pricing has been under

pressure. At best, it has remained stable only. Hence, there were almost no positives on the pricing front. In addition, they are facing a tough time in getting visa permits to send their employees to work overseas. This would curtail their off shoring advantages. The software sector has already lost its tax advantage at the beginning of the current financial year. In a situation, when most of the things were coming as headwinds, Indian IT (Information Technology) companies found respite in the rupee depreciation. How?

Indian software companies such as Infosys, Tata Consultancy Services (TCS) and Wipro get most of their business from the developed economies. A significant part of their revenues are in US dollars. Hence, depreciating rupee would definitely be boosting their sales growth as well as margins. In the past three months, rupee has depreciated by almost 8%. The positive effect of this would be revealed in the coming result announcements by these companies. However, all positives at operating levels would not trickle down to the net level. IT companies are in the practice of hedging their currency risks. As a result, the forex loss on account of hedging would be taking some of sheen out of the reported results.



Source: Trend

Well, no doubts that the rupee would help the Indian IT companies by bailing out of the current tough business environment. Now the question arises. Would this advantage continue?

There could be many possibilities. One, rupee starts appreciating. In this case, the advantage would automatically start waning. But what if the rupee remains at the present high levels or depreciates further? The first thought that may cross your mind that it would be a dream

situation for the Indian IT industry. But hold your thought for a moment. There is a flip side.

There are many big companies such as HCL Technologies out there in the software sector which believe in an aggressive growth strategy, at the expense of margins. Then, there are companies who invest the extra earned margins into business growth. The margin gains due to the rupee depreciation may set a stage for price war in the whole sector. Also, there might be pressure from the clients' side to pass some of the benefits to them. All this would finally, erode the pricing dynamics in the sector which is already under pressure at the present moment. Hence, gradually the benefits would go away.

Hence, we believe that stable rupee is the best possibility for the software companies. After all, these companies are in the business of IT services. Not in the business of managing currencies.

II. CURRENCY VOLATILITY

For National Association of Software and Service Companies, more than depreciation, the volatility of currency movement is a concern that needs to be tackled since it hinders the planning process for the Indian IT-BPO industry.

According to Shiva Ramani, CEO of iOpex Technologies, the steep depreciation “provides consolation in margins in the next couple of quarters post the extinguishment of current hedges. It is also likely that IFRS accounting may actually require provision of mark-to-market losses on booked forwards against present rates at quarter-end dates and could increase provisions.”

More than the rupee slide, the broader fear for him is the loss of momentum in spend in the U.S. BFSI sector and also the turmoil in Europe. “We may not see volume growth for couple of quarters, but can see margin improvements. So, to some extent, the wage pressure that service providers feel can be managed without compromising the margins.”

III. FALL IN RUPEE HAS MINIMAL EFFECT ON IT STOCKS

A fall in the value of the rupee should, in most conditions, be a positive for the Indian information technology industry, which gets most of its revenue from overseas, especially the United States. The recent slide of the rupee, which has lost 5 per cent of its value since the start of the fiscal year, should have been good news for the Indian IT industry. Instead, IT stocks have fallen, with the IT index losing over 6 per cent since April. Here are 5 facts on why this is happening.

A) INR v/s IT index trend:

The INR has depreciated around 5 per cent in CY 2012 so far. However, both the BSE IT and CNX IT index have fallen around 2 per cent for the same period. This shows that near-term movements in the rupee have little demonstrable effect on fundamental stock valuations. “With Indian IT expected to grow at not more than 10-12 per cent for FY13 in US\$ terms, we do not believe the

recent rupee appreciation alone gives cause for much cheer,” a report by Spark Capital said on Wednesday.

B) International demand v/s rupee:

Indian IT is geared to international rather than domestic demand. Hence, the market reacts negatively to any concerns in world economy because this offsets any gains from forex fluctuation. U.S. and Europe are two of the largest markets for the Indian IT sector, both of which are currently seeing a slowdown in growth and labor market. This is likely to affect demand for Indian IT services in the near-term and drive down revenues, which could render forex gains irrelevant, depending on relative value. “In the long run, nearly all of IT spend is discretionary; and a mere depreciation in the rupee does not alleviate market concerns on underlying demand,” the Spark Capital report explained.

C) Historical trends:

The trend was the same in 2008-09, when the US was hit with a financial crisis and slipped into recession, the Spark Capital report points out. The US dollar was around Rs 45-46 levels just prior to Lehman Brothers' bankruptcy in September 2008. But, by the end of March 2009, the US\$ had appreciated around 11 per cent against the Indian rupee. However, the CNX IT index did not mirror this positive development; in fact, it reflected just the opposite movement and declined over 40 per cent during this period. The broader Indian equity market, in comparison, only fell around 30 per cent.

D) Cash generation from forex fluctuations:

IT companies generate cash as they get more rupees for every dollar they receive. The impact is seen across the income statement – in revenue, operating profit and net profit. The key variable here is the percentage of revenue from offshore. As this percentage increases, leverage from INR depreciation increases. Percentage of cash generation due to forex fluctuation to the revenue is limited and varies for different companies. If one assumes Rs 52 per dollar as the exchange rate, cash generation could increase by as much as 25 per cent over the next two years for companies like Persistent Systems and HCL Tech.

E) Hedging:

Company's hedge against potential fall or rise in currency values. This is done by taking a contrarian position in currency markets. So, if a company that exports, fears that its revenue or profit could be affected by a sharp surge in the rupee, it could make up for those losses by hedging.

Cash flows arising from realized hedging losses/gains too differ for different companies in the IT sphere. According to the report, Indian IT firms tend to vary widely in their use of currency hedges. “At one end of the spectrum are companies like eClerx, while on the other hand we see companies like Infosys which has very limited hedge coverage for FY13,” the report said. Also, some companies like Infosys have had more or less

consistent hedging policies from quarter to quarter, while others might pare their hedge books in the wake of recent INR weakness. Hence, it is difficult to generalize the positive impact of rupee depreciation for the sector as a whole.

IV. RUPEE DEPRECIATION POSITIVE FOR IT SECTOR

The depreciating rupee to the US dollar will have a positive impact of at least three per cent on Indian revenue for the top four Indian information technology (IT) Services Company, said analyst.

Every one per cent change in rupee-dollar has a 40 basis points impact on the margins and, at least, 2 to 3.5 per cent on the net profit numbers of IT services firm.

In terms of cross-currency movements, the dollar has appreciated across the euro, pound and Australian dollar in the second quarter of FY12. Keeping this in perspective and assuming the currency positions at the end of September remains the same, the IT firms might see a marginally negative impact on the topline in the US revenue.

“In the second quarter of FY12, cross-currency impact on US dollar revenues is likely to be marginally negative (0.3-0.4 per cent), while significant gains (3.7-4.1 per cent) in other income on translation of monetary assets and liabilities to closing rates is possible, in our view, if the current currency rates were to continue,” said Ashwin Mehta and Pinku Pappan, research analyst from Nomura Equity Research.

Rostow Ramanan, chief financial officer, MindTree, believes the real benefit of the depreciating rupee will only come if it remains at this level in the third quarter (ending December 31) as well.

"From a pure Indian revenue point of view, depreciating rupee is good news for the industry. The real benefit will be visible only in the third quarter. That, too, if the rupee holds at this level. The bottom line, too, would be positive. Only in case where a company has hedged substantial amount of its revenue, will there be a negative impact. But I think the real picture would be the cross currency movement," said he.

A CLSA report said: “About 7.8 per cent depreciation in INR against US\$ in the last 45 days and expectation of further depreciation in light of continued global risk aversion have raised hopes of earnings upgrades.

While a weaker currency is a positive for earnings, we believe that improvement in core business outlook needs to precede any out performance going ahead.

Business fundamentals have progressively worsened over the last few months with select vendors indicating delays in project starts and closure of deals.”

The impact of the depreciating rupee on the bottom line will vary for each company as it would largely also depend on the hedging positions taken by these firms. Analysts were of the opinion that companies like HCL Technologies and Infosys that hedge for a shorter duration

and also have lesser hedged amount will see substantial gains. Whereas,

Tata Consultancy Services and Wipro, which do that for a longer duration and have over \$1 billion in hedges, might see a marginal negative impact. Though unlike 2008, IT firms might not see any forex losses this time.

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