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Global

IT Services

US Immigration Bill – What Does It Mean for Offshore IT?

- Industry Overview

- **Overhang on the sector; may continue in near term** — In this note, we deliberate on the impact of the US Immigration Reforms Bill on offshore IT. Although the Bill could be subject to multiple changes, key provisions in the current draft appear negative for offshore IT. Since this is part of a larger, comprehensive bill, timing/implementation could be protracted. Our demand thesis on the sector is positive (Muted 4Q, but Improving Demand and Inexpensive Valuations). However, near-term uncertainty may continue, benefiting global (MNC) vendors in the interim; likely to be a sector overhang.

- **First shot at scenario analysis** — There are many grey areas and also chances that the Bill may be changed/not passed – we consider some possible scenarios. If all the provisions (except "Outplacement", as interpreted currently) go through, the impact is largely economic (costs), i.e., longer-term growth rates (and multiples) should be largely unchanged. If "Outplacement" goes through, it implies business model changes, i.e., it's a challenge to growth, given limited ability to ramp projects.

- **For detailed analysis, a lot of further clarity is needed** — (a) What does Outplacement mean exactly? (b) How will clients react – could mean risk of disruption and meaningful cost escalations – onsite costs for tech employees (vendor + own) likely to go up; (c) Reaction of Indian government – significant part of GDP (direct + multiplier effect); (d) Will it go through the Senate and House – in what form and when?

- **Longer-term repercussions for the sector** — While exact outcomes depend on what form the Bill finally takes, it could imply: (a) Cost increases for onsite tech resources (for offshore, MNC and clients tech departments) – already a tight market; (b) Risk of disruption – clients may look at in-sourcing some work (using H1B workers); (c) Outplacement (if it impacts ability to work onsite) will benefit MNCs; (d) More offshore – clients comfortable with the model will increase offshore significantly, in our view. (e) Higher focus on growth drivers - Europe/BPO/ITO/Platform-based offerings etc.

- **Basic thoughts on bill content / legislative process** — Senate Committee will discuss the Bill in May/June and vote on it after that. The language in the bill typically changes as multiple legislators provide their viewpoints. The House could put forth its own version of Immigration Reform. Overall passage could be this year but is obviously not guaranteed. There will likely be a lot of discussion in Congress of the above-mentioned points on which more details are needed. Path to Citizenship/green cards a big focus, regardless.

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US Immigration Bill - Key Provisions

We discussed our initial thoughts and some of the key provisions of the bipartisan immigration reform bill in our note: US Immigration Reforms Draft Bill - Key Implications. Here, we deliberate on the subject in greater detail following our interactions with subject-matter experts and other industry participants.

Restrictions on "outplacement" is the key negative for Indian IT services – although interpretation is still not clear

- **Outplacement** — The Bill proposes restrictions on H1B dependent employers (>15% of US employees on H1B visas) from placing, outsourcing, leasing or contracting services of H-1B employees.

- **New visa application requirements** — Companies will be banned from bringing in additional workers if H1B or L1 visa holders for >75% of US workforce in FY14, >65% in FY15 and >50% in FY16.

- **Higher visa costs** — The Bill proposes higher fees for companies with greater dependence on H-1B/L1 visas: (a) $5,000 per additional worker for companies with 30%-50% employees on H-1B/L1 visas (b) $10,000 per additional worker for companies with >50% employees on H-1B/L1 visas.

- **Significant procedural changes** — The Bill also talks about a few procedural changes:

  – It requires employers to pay significantly higher wages for H1B workers than the current law - the procedure for “computation of prevailing wage level” has been changed.

  – Employers are required to first post the job openings for American workers for at least 30 days at this higher wage before hiring an H1B applicant.

  – Annual compliance audits for employers with >15% employees working in the US on H1B visas – report of the general findings of the audit to be made available to the public.

Implications for Indian IT Services

All the major IT Services companies have a significant base of operations in lower-cost locations, including India. Most of these companies also use work visas to staff on-site projects to varying degrees. However, it is only the India-model companies that have the use of work visas as an important part of their tactical approach to serve their clients – it provides labor flexibility, i.e., the ability to maintain high onsite utilization rates as well as a source of highly-trained labor/talent in a market where this kind of talent is not always readily available.

Longer-term Repercussions

In this section, we examine the key changes that may be expected in the offshore IT services market if the bill were to be passed in its current form. We had highlighted the advent of newer engagement models in Changing Face of IT Services - Industry Reboot – The Potential and the Perils; this could accelerate given the provisions in the bill.

MNC vendors could gain competitive advantage

MNC vendors could gain market share

- *Why?* — MNC vendors (like ACN/IBM) are less reliant on H1B workers. A company like IBM benefits from having a large number of non-services employees and both IBM and ACN have a significant focus on end services, like consulting. Finally, both these companies also have established public sector practices, which tend to not use people on work visas.

  One point to understand here is that there is no theoretical basis for the current offshore/onsite demographic split. There are offshore IT companies that use a much lower onsite ratio just because they got into the offshore market later and could better exploit newer communications technologies.

- *Impact* — If the clause on "outplacement" were to go through, it is likely to benefit MNC vendors. Even in the run-up to the passage of the bill, clients who are looking to award contracts of longer durations could play it safe and award them to the MNC vendors for an arguably smoother transition.

  Note — We are not saying this is "game over" for offshore companies, by any means. They have a pool of existing US citizens and green-card holders as the major ones have been ramping this headcount for a few years. They have a pool of employees with already-awarded visas, which they might have access to. They have a fast growing non-US business, which can provide some measure of growth. And we can see some offset from more offshoring (next point).

More Offshoring?

Mature clients could do more offshoring – helps costs as well as works with new regulations

- *Why?* — (a) Easier to work given the restrictions – mature clients could step up offshoring on existing projects. (b) Onsite resource cost will likely go up given supply challenges – higher offshore will help keep overall budget in control.

- *Impact* — This should be positive for offshore players and should help them mitigate some of the cost pressures that they are likely to face – however, will come at the cost of some revenue cannibalization.

"Time & material" structure could gradually go out of vogue for the onsite components of the contract

"Time & material" structure to go out of vogue and “Fixed Price” contracts may find favor?

- *Why?* — With proposed restrictions on placing, outsourcing, leasing or contracting services of H-1B employees, the traditional "time & material" structure could gradually go out of vogue for the onsite components of the contract. However, this will depend on the interpretation of “Outplacement” by the authorities.

- *Impact* — Migration to fixed price contracts would help retain H1B workers on some projects given their services are not contracted/leased. Indian IT companies would still need to step up local hiring. Given restrictions on "placement" of H1B visa holders, local hires would have to be used on the client's site.

Impact to be felt more by select service lines

BPO, ITO may be better off – relative lower onsite component

- *Why?* — Different service lines could have a different proportion of revenues from onsite work, which is more likely to be impacted with the proposed bill.

- *Impact* — Among service lines, the impact could be lesser for services like BPO and infrastructure management which have very few people onsite and there is employee re-badging in a lot of these contracts. In fact, we believe that investors who want to continue to benefit from the faster growth rate of offshore services are better off considering pure-play offshore BPO stocks.

Is reverse re-badging a possibility?

Clients may not want to risk an abrupt disruption of mission-critical services

- *Why?* — Clients may not want to risk an abrupt disruption of service with the "outplacement" clause particularly for mission critical services currently performed onsite (parts of infrastructure management contracts, for example).

- *Impact* — Clients may look at insourcing and absorb key H1B workers on their payrolls from that of the vendor. This possibility cannot be ruled out given that US clients may not have ~15% of their workforce on H1B visas currently and vendors might prefer letting their employees join the client (and help maintain the relationship) rather than moving onsite employees offshore (which could impact morale).

Acceleration in M&A to quickly build scale

- *Why?* — Indian IT companies would need to hire locally in big numbers, and quickly. They could look at M&A as an option to build scale quickly and protect their existing contracts (especially if the "outplacement" clause were to be implemented), given their healthy cash piles.

- *Impact* — Anticipation of M&A activity could drive up valuations of small and mid-sized tech companies in the US. However, such acquisitions are likely to be margin dilutive but may not necessarily be EPS dilutive given that most companies are sitting on a lot of cash, which earns low returns.

Higher wage inflation onsite

Margin headwinds due to high wage inflation onsite likely

- *Why?* — With relatively low IT unemployment in the US and offshore companies scrambling to ramp-up their onsite teams with local hires, onsite wages could see significant inflation over the next few years. The “computation of prevailing wage level” is also likely to result in higher onsite wages.

- *Impact* — Larger MNC peers (like ACN and IBM) could also get impacted with higher attrition and onsite wage inflation as their US-based employees could be targeted by offshore firms seeking to lower their percentage of employees on work visas. In the medium term, increase in onsite wages could also act as a support to onsite pricing – clients would also see the impact of high wage inflation among their own tech employees.

Sub-contracting could see an overhaul

- *Why?* — Sub-contracting firms are also likely to be impacted by the provisions on the bill. In the smaller cases, we could also see fragmentation coming in as "outplacement" restrictions are applicable for employers with >7 H1B visas (for employers that have 25 of fewer full-time employees in the US). For employers with at least 26 but not more than 50 employees in the US, the threshold level for H1B visas is 12.

- *Impact* — Finally, a higher degree of the work may have to be done in-house or offshore as subcontracting comes down. This could impact the flexibility that vendors/corporates enjoyed to use sub-contracting for specific modules of a project on a need-basis.

Increased focus on other growth drivers

Focus is likely to go up on Europe, RoW, non-linearity etc.

- *Why?* — With the US market getting more competitive, offshore providers are likely to step up their focus on other segments which are relatively less affected by implementation of the provisions outlined in the Bill.

- *Impact* — From a geography perspective, we could see increased focus on Europe. Among service lines, companies might step up efforts in non linear platform-based offerings. We recently published a report on industry growth drivers called Changing Face of IT Services which delves into some of the growth dynamics and drivers for IT Services companies, which may be worth a look at on this point.

Overhang may continue near term

Overhang on the sector; may continue in near term — Our demand thesis on the sector is positive (Muted 4Q, but Improving Demand and Inexpensive Valuations) – however, the immigration bill is an overhang on the sector. Given that this is part of a comprehensive reform bill and may take a long time to get sorted out, the uncertainty may continue in the near term and could benefit MNC vendors in the interim.

Figure 1. IT Services – Valuations

Company Name	RIC Code	Year end	Citi Rating	MCap $ m	CMP (Rs)	Target price	P/E (x) CY13E	P/E (x) CY14E	EV/EBITDA (x) CY13E	EV/EBITDA (x) CY14E	ROE CY12E
Accenture	ACN.N	31-Aug	1	56,523	$ 81	$ 83	18.5	16.8	10.3	9.7	65%
Cognizant	CTSH.O	31-Dec	1	19,601	$ 65	$ 90	15.9	13.4	9.1	7.2	23%
TCS	TCS.BO	31-Mar	2	50,175	1,376	1,625	17.7	15.7	12.9	11.4	35%
Infosys	INFY.BO	31-Mar	1	23,783	2,234	2,695	13.1	12.2	8.0	7.0	23%
Wipro	WIPR.BO	31-Mar	1	15,961	348	420	12.1	11.1	8.4	7.5	23%
HCL Tech	HCLT.BO	30-Jun	1	9,350	721	895	12.9	11.6	7.9	6.9	28%

Source: Datacentral, Citi Research estimates; Wipro has recently undergone a demerger, so metrics may not be comparable

Incremental Topics Investors Care About

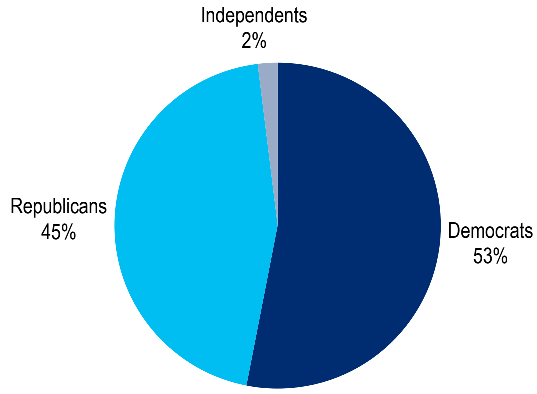
Overall, it would seem that there are multiple viewpoints in Congress about whether there is an IT talent shortage in the US

- **Why is offshoring being targeted when IT unemployment in US is low?** —
  - There are actually conflicting reports on this topic.
  - One school of thought uses the government's own BLS data which shows a relatively low 3.6% unemployment for technical professionals. Also, according to tech job board Dice, the unemployment rate among U.S. IT workers was 3.3% in 4Q2012, significantly lower than overall unemployment rate of ~8%.
  - However, based on the extensive media coverage of a recently published think-tank report on the use of work visas in technology fields, not everyone recognizes that there is an IT talent shortage in the US. This school of thought cites a recent report by the Economic Policy Institute (Guestworkers in The High-Skill U.S. Labor Market) which analyzes the STEM (science, technology, engineering, and mathematics) labor market and concludes that the US has sufficient supply of workers available in STEM occupations. For example, as per the report for every two students that U.S. colleges graduate with STEM degrees, only one is hired into a STEM job. One point to note is that this study uses older data (including from the depth of the economic downturn).
- **Will the bill be passed in the current form?** — This is a serious piece of legislation that was proposed by a bipartisan group of Senators. Given the work that has already gone into it, it is quite possible that a similar, not necessarily identical, bill could pass. With significant stakeholders involved, changes could be expected on costs/language – we cite a few of our beliefs below.
  - **Bill to be evaluated by CBO** — The draft bill has not been evaluated for financial impact by Congressional Budget Office (CBO). There could be changes in the exact quantum of fees post this evaluation.
  - **Increased cap in H-1B visas** — The bill proposes to raise the base cap for H1B visas from 65,000 to 110,000 (the cap could go as high as 180,000 in future years). However, these provisions are not as aggressive as the tech community had hoped for – there may be a move to increase this from 180,000.

It is quite possible that a similar, not necessarily identical, bill could pass

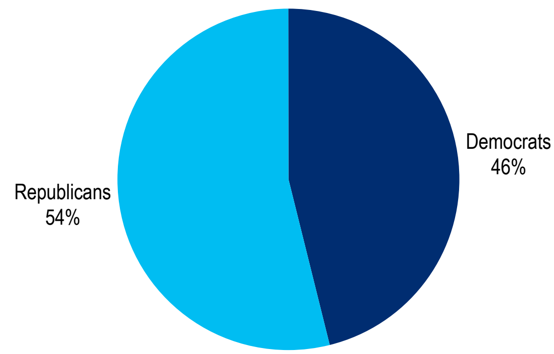
  - **Effective dates/transition** — The bill currently does not have an effective date for implementation of the "outplacement" provision, but as it goes ahead towards passage, effective dates and transition provisions are expected to be clarified, or enforcement agencies are likely to be given discretionary powers.
  - **Will Lobbying Matter to Opponents?** — This is likely to impact only at the margin as adverse fallout for a narrow constituency of technology companies is not necessarily among the top 3 priorities of industry groups. With other considerations taking precedence, lobbying for a revision is likely to take a back seat. Moreover, as prior instances have shown, if consensus were to emerge across both parties on various clauses of the bill, other considerations are not likely to deter the passing of the bill.
- **What are the odds of the bill being passed?** — Both Democrats and Republicans agree on the need for broader Immigration Reform, but there have been disagreements in the past about specific provisions. So, it is clearly not guaranteed that the bill will actually result in a law. Also, it is a wide-ranging 844-page bill and so it is highly likely that changes will be made to the initial version.

Figure 2. US Senate — Composition (2013-2015)



Source: United States Senate, Citi Research

Figure 3. US House of Representatives — Composition (2013-2015)



Source: United States House of Representatives, Citi Research

- **Provisions on green cards** — Providing a path to citizenship is a big focus and this is manifested in the significant attention given to "green card application" in the bill.
  - The process is being rewritten substantially and there is a move to increase overall no of green cards from ~1mn per year to ~2.5mn under this bill to clear the backlog of applicants.
  - Special systems are being put in place for exempting people from the overall green card limits including ~25k/year who got American degrees, ~25k/year for people with extraordinary ability, and ~70k for family members. There is also a move to recapture green card slots available in prior years that haven't been used. Put together, ~200-300k of the backlog is likely to be covered.
  - Going forward, the system is likely to translate into a merit based points system – with factors including education, familial relationships, unemployment conditions, language skills and others.
  - Another important point is the differentiation between "non-immigrants" and "intending immigrants". H1B visa holders, who have filed for green cards a particular period of time back are not considered "non-immigrants".
- **Why have new wage levels been discussed?** — The draft bill calls for a change in the procedure for "computation of prevailing wage level". This includes transitioning from a four point scale to the top 3 (and doing away with the lowest level). Rather than leaving it to the companies, the bill is also looking to include provisions for additional oversight by the labor department.

XYZ Tech Ltd - A Scenario Analysis

While there is a lot of ambiguity and the possibility that the Bill may be changed/not passed, we look at some possible scenarios. We introduce XYZ Tech Ltd, a hypothetical IT services company with ~100,000 employees and revenues of ~$4.7bn, for this purpose. Note that outcomes can vary widely for any specific company, based on their revenue mix, their employee distribution, their strategic response and focus, their track-record of adapting to past changes, the reaction of their specific client base, etc.

Three Possible Scenarios

Looking at two scenarios – (a) all other clauses ex "outplacement", and (b) all clauses. There are a lot of assumptions, given the lack of clarity at this point

- Our present scenario assumes that the Bill is not passed. XYZ Tech grows at a rate of ~10% for the next three years with PAT margins staying flattish at ~16% (some EBITDA margin declines offset by higher other income).
- In our base-case Scenario 2, we assume that all other provisions go through (without "Outplacement" as interpreted currently). In this event, we believe the impact will largely be on costs in the medium term – longer-term growth rates (and multiples) should be largely unchanged.
- In our bear-case Scenario 3, we assume that the "Outplacement" clause goes through unchanged. This would lead to a significant challenge to growth, given limited ability to ramp-up projects. However, one should keep in mind that this will apply to the US business (50-80% of total for most companies) and some service lines like ITO/BPO may be less impacted. The following are our assumptions:

Figure 4. XYZ Tech Ltd – Scenario Analysis

	FY13	FY14E	FY15E	FY16E
Present scenario - Bill is not Passed				
Revenues ($ mn)	4,703	5,174	5,693	6,265
Growth		10.0%	10.0%	10.0%
EBITDA	59,492	63,312	67,811	72,066
EBITDA Margin (%)	23.2%	22.7%	22.4%	21.7%
PAT	40,951	44,406	48,653	52,689
PAT Margin (%)	16.0%	15.9%	16.1%	15.9%
Base Case - Bill passed with moderated provisions				
Revenues ($ mn)	4,703	5,174	5,637	6,149
Growth		10.0%	8.9%	9.1%
EBITDA	59,492	63,312	64,645	66,378
EBITDA Margin (%)	23.2%	22.7%	21.5%	20.4%
PAT	40,951	44,406	46,687	49,191
PAT Margin (%)	16.0%	15.9%	15.6%	15.1%
Bear Case - bill passed as is				
Revenues ($ mn)	4,703	5,174	5,417	5,687
Growth		10.0%	4.7%	5.0%
EBITDA	59,492	63,312	60,251	57,481
EBITDA Margin (%)	23.2%	22.7%	20.9%	19.1%
PAT	40,951	44,406	43,960	43,517
PAT Margin (%)	16.0%	15.9%	15.2%	14.4%

Source: Citi Research estimates

Figure 5. XYZ Tech - Margin Decline

Margin decline in FY15	Base Case	Bear Case
Onsite Pricing	20 bp	-20 bp
Lower Offshore Pricing	0 bp	-40 bp
Lower onsite manpower ratio	20 bp	50 bp
Higher onsite wage increase	-105 bp	-130 bp
G&A savings	na	30 bp
Lower onsite utilization	na	-20 bp
Lower offshore wage increase	na	25 bp
Tax rate adjustment	10 bp	20 bp
Overall	**-50 bp**	**-80 bp**

Source: Citi Research

How are margins impacted?

- **Onsite wage inflation to be biggest headwind** — Understandably so, we expect onsite wage increases to have the maximum impact on margins. This would be the first direct follow through if the Bill were to be implemented. For every ~1% increase in onsite wages, XYZ Ltd would see its PAT margins impacted by ~20-25bp.
- **How will onsite pricing behave?** — Onsite pricing is a lot harder to call. In our base case, we expect some marginal onsite pricing increase with vendors/clients across the board facing inflation and some amount of that being passed through. Our bear-case scenario assumes that Indian companies keep pricing flat – this should be seen in context of likelihood of MNC vendors being able to take increases given lack of options for clients. Besides, clients are likely to see wage inflation in their own tech employees as well.
- **Would in turn have an impact on offshore mix** — If onsite wages/pricing were to go up, it should lead to a lot more work getting moved offshore – particularly in an environment where budgets are flat. This should have a positive impact on margins – both directly, and by lieu of tax benefits if some of the work were to be done out of SEZ locations. For every ~1% shift offshore (in employee mix), XYZ Ltd would see a positive impact on its margins by ~50-60bp.

Detailed analysis would require further clarity

Carrying out a more exhaustive and detailed analysis would require further clarity on a number of aspects:

- What does "Outplacement" mean exactly, and what timelines are we looking at to ensure a smooth transition? Does it include existing contracts?

As per media reports, India's ambassador to the US, Ms. Nirupama Rao, has recently flagged the concerns in her meeting with a top American senator.

- How would the Indian government react? — The IT Services sector accounts for a significant part of GDP – directly and with its multiplier effect (on other sectors like consumption, auto, real estate etc). Passing the Bill in the current form would significantly diminish the competitive positioning of the Indian IT companies. In this context, would the Indian government take up the issue seriously and negotiate more favorable terms? And if so, how would this be viewed by the Senate and the House?
- How will corporates react? — For companies which resort to significant outsourcing, this could mean a risk of disruption and meaningful cost escalations – onsite costs for tech employees (vendor + own) are likely to go up.
- Will it go through Senate and House, and in what form and when? Given that these provisions are part of a larger, more comprehensive, immigration reform Bill, deliberations and differences of opinion are likely. It needs to be seen how the Bill shapes up as all suggestions are incorporated.

Appendix A-1

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% of companies in each rating category that are investment banking clients	53%	49%	43%	65%	49%	51%

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