

Research Analyst:

Sumeet Jain

sumeet.jain@icicisecurities.com
+91 22 6807 7573

Aditi Patil

aditi.patil@icicisecurities.com
+91 22 6807 7452

Technology

ISG expert webinar takeaways: Demand picking up in Jun'23; deal pipeline is still growing

We hosted IT sector experts – 1) Mr. Steven Hall President – EMEA & Partner - Digital Advisory Services, ISG and 2) Mr. Stanton Jones – Distinguished Research Analyst, ISG where we discussed key demand and tech trends playing out amidst an uncertain macro environment. Key takeaways from the call include:

Demand outlook

- **Discretionary work cancelled or delayed, while demand for cost optimisation deals remains healthy:** IT services industry is facing a slowdown in demand due to cancellations or delay in ramp-up of discretionary projects. These projects are short-term and largely relate to non-revenue generating middle office work (example: implementing new CRM cloud), whereas projects related to revenue generation and cost optimisation are moving forward. Almost every deal now has cost-saving component, as per ISG.
- **Pickup in demand in last two weeks of Jun'23; demand is likely to revive from Sep'23 quarter:** Demand didn't improve in Apr'23 and May'23 post slowdown in Mar'23 (which was impacted by banking crisis), but ISG is seeing improved decision making in last two weeks of Jun'23. Additionally, pipeline remains strong, especially at the top of the funnel. Therefore, ISG expects demand to revive from Sep'23 quarter and may retain its growth guidance of 5% YoY for managed services ACV.
- There are mega deals (>US\$100mn ACV) in the pipeline that were expected to close in Jun'23 quarter, but their closure has been delayed. However, deal flow is coming through in Jun'23 and pipeline to TCv conversion is expected to improve from Sep'23 quarter.
- Industries such as manufacturing, life sciences and public sector are growing well.

Pricing pressure more on legacy (IT infrastructure) deals; Gen AI likely to have deflationary impact on pricing

- Pricing pressure exists on legacy side (i.e. IT infrastructure management) which is ~35% of total ACV in market, while on digital services, client conversations are more around value derived by IT services provider rather than pricing. As per ISG's analysis of the deals advised by them over CY21 and 9MCY22, lowest bids won only 44% of the time.
- In the near term, impact of Generative AI on productivity improvement can be tremendous especially in software application development space, and this in turn can lead to increased competition by lowering price or delivering more value for the same price. In fact, ISG has already seen productivity improvement due to AI flowing to pricing in some proposals.
- IT companies that are slower to adopt Gen AI for improving productivity of their delivery can face margin pressures at the expense of early adopters. Strategy of maintaining lower pricing by improving employee pyramid through increased fresher intake may not help in offsetting this margin pressure.

Divergence of growth outlook and performance of tier 2 players vs tier 1 players is due to:

- IT companies are now addressing needs of not only CIOs, F&A and HR functions, but decision making has now moved to different business units at client's end increasing market opportunities.
- Deal sizes are getting smaller, allowing mid-sized IT companies to participate in these deals. For example, mega deals now make up only 20% of ACV vs 40% two years ago.
- Tier 2 IT companies have developed niche domain expertise and specialisation in new growth areas, which allows them to win mid-sized deals based on the value they provide.
- This trend of outperformance of mid-sized peers over tier 1 peers is likely to sustain, as per ISG.

BFSI vertical outlook

- Though commercial real estate market has been impacted because of work from home and high interest rate, the impact of that has not flown to tech spending for banks. Retail banking and wealth management businesses remain healthy for banks. Banks are spending on customer experience, analytics and AI. These spends are in financial operations side i.e. credit operations, consumer lending rather than IT side.

Strong demand for industry-specific BPO and engineering services

- ISG mentioned demand continues to be strong for industry-specific BPO and engineering services (product life cycle management, IoT and analytics). In insurance vertical, BPO accounted for 20% of ACV 2 years ago and now this has increased to 40%. Similar growth trends for BPO are playing out in BFS vertical now.

Impact of Generative AI

- Near-term impact of Generative AI will be tremendous improvement in productivity in software application development space and this can lead to intense pricing competition with early adopters of Gen AI benefitting at the expense of laggards. At the same time, there are concerns around organisation data privacy and safety that may impact the speed of adoption of Gen AI in certain industries.
- In the medium term, Generative AI is likely to have net positive impact on IT services industry, as per ISG.

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Name of the Compliance officer (Research Analyst): Mr. Atul Agrawal, Contact number: 022-40701000, E-mail Address : complianceofficer@icicisecurities.com

For any queries or grievances: [Mr. Prabodh Avadhoot](mailto:Mr.Prabodh.Avadhoot) Email address: headservicequality@icicidirect.com Contact Number: 18601231122
