Cognizant

Industry Report

Cognizant mainly operates in the IT Consulting and Services Industry. Companies in this industry provide various services and consulting for firms and individuals ranging from simple outsourcing services to consulting on new technologies such as AI and cloud computing. A large majority of firms use some sort of technology or computing system and the number of firms adding technology to their businesses just keeps growing as new technologies facilitate the way we do business and improve efficiency and cost reduction. However, with the rise of technological advances, companies in this industry must remain on top of new technologies to be able to provide up-to-date service to their clients, companies who fail to keep up with the emerging technologies will experience a significant loss of market share. Overall, the industry has experienced significant growth and is expected to keep growing for the foreseeable future, but the companies still must remain largely competitive to assert their market share as there are plenty of competitors in the industry. Diversity in products and services appears to optimize the advantage of each client as firms prefer to stay with the same firms for their IT services due to high switching costs. The risk of interrupting day-to-day activities and the "Switching Cost" tend to keep firms away from switching their IT service firm.

Overall the IT Services Industry is a fragmented, mature, and international industry with first-mover advantage, as you’ll see with digital for example, however, it is a stable industry. An analysis of the market share 5-year change from 2012 to 2017 will show that the average change in market share for this industry is less then 1%. For the most part, companies in the industry use partnerships with other firms in the industry as well as suppliers, which leads to many firms using the same suppliers and high switching costs as other suppliers will not have as competitive pricing as in a partnership. One of the reasons for this could be because some suppliers such as Cisco are using forward integration to gain market share in the industry. Although suppliers have a significant bargaining power in the industry, being that a significant portion of the suppliers’ sales are from this industry prices will remain fairly competitive especially within the partnerships in the industry. There is a threat of substitutes for certain products such as AI and cloud services as companies like Microsoft and Amazon hold a large share of that industry which leads to standardization of those products reducing the need for IT Services, however, custom projects, such as Internet of Things projects, and other areas that are not dominated do not face distinct threats of substitutes. New firms, are not likely to enter the market due to the high cost of entering the market as well as the partnership supplier structure of the industry among other things, however, firms currently operating actively with the industry such as financial institutions and professional services companies, such as Deloitte, who already have a large IT department are moving into the IT Service Industry easily and fast. Companies like Deloitte and PriceWaterhouseCoopers have gained market share at much quicker rates than most firms in the industry over the last five years. Lastly, the buyers appear to have a low bargaining power in the industry because there are high switching costs, individual buyers represent a small percentage of sales, and the product or service is important to the buyers.

A large trend in the industry lately has been the rise in demand for digital services, among other new technologies. New technologies can have a significant impact on the growth of a firm, and that is currently being reflected in the demand for IT consulting services especially for digital, cloud, and mobile services, with digital being the most popular so far in 2018. Such services can vastly impact a firm from reduced costs to better customer service to more efficient internal operations. Firms are beginning to move, at a rapid rate, their application and infrastructures into the cloud to reduce costs and improve services and quality of services and products they provide to their customers. Other services that firms have been adopting to improve their customer service are chatbots and digital assistants which are powered by Artificial Intelligence (AI,) which points to a long-term need for IT services considering these systems usually take continuous maintenance and development to function properly, since most firms cannot afford full-time IT developers this can translate to increased demand in outsourcing services. To make all these additions to their services and products certain companies might even need further IT services and consulting to renew or improve their infrastructures to able to support the new technologies. As you can see, adding on new technologies or improving the ones you have to imply changes to the firms' IT infrastructure creating a positive impact for companies in the industry because all new customers have the opportunity of becoming returning long-term customers as one service leads to another and so on. Some of the companies who stand to gain the most from these services due to their experience as system integrators such as Cognizant, IBM, and Accenture.

As the demand for workers in the IT services department rises, the number of qualified candidates for those positions is not keeping up with demand making outsourcing the cheapest option. Recently, it has become more and more expensive for firms to find and retain qualified workers for these IT service positions and companies who are trying to lower costs are looking at outsourcing of IT services as a significant way to quickly reduce costs. This is especially true in Europe where even in large countries like England and France the average amount of IT service work that is outsourced falls way below that of Germany and other large nations. Where Germany outsources 60% of their IT work England and France only outsource 35% of theirs which leaves a significant gap of IT outsourcing services to be filled soon as firms look to cut costs in Europe. In England, it can be 4.2x more expensive to have a full-time IT-outsourcing employee versus what it would cost for the same employee in India, according to Everest Group. Moreover, Europe has recently experienced an increase in demand for IT services as major nations in Europe find themselves lagging in technology when compared to other companies in other nations such as the United States. As companies are noticing the gap the demand for IT services quickly increase which reflects an influx in demand for these American IT service firms who are already ahead of these technologies and can quickly and easily install and adapt these new technologies. Companies like Amazon, IBM, Microsoft, and Google have been taking advantage of this market gap to increase their IT and cloud computing services. Also, there is a shortage of IT candidates to work on emerging technologies such as AI and cloud computing which encourages firms to once again look for outside outsourcing services to adopt these new technologies. European firms had been wary of outsourcing IT services fearing political backslash, however, these recent outsourcing services don't require layoffs because they are new services, so companies have been having an easier time getting these deal acquisitions.

Moreover, firms in the industry are looking to reduce costs and the employee headcount has been reducing as a result. In 2017 firms in the industry shuffled their employees around digital areas, the most profitable area currently. Firms are slowing down their headcount growth and some firms are even reducing it and their looking to improve their utilization rates in order to remain efficient and cost-effective. In early 2018 the utilization rates for the industry were a little above 80% percent and are expected to increase to 85% or higher as firms continue to focus on productivity improvement. Also, firms are working on employee retention as they look to invest more towards education and training for their employees especially with the rise of digital and the push towards digital area employees. Some companies like Accenture are already experiencing high productivity levels, above 90% utilization rate, and competitors are noticing the difference this makes. Hiring trends towards Digital area will remain common throughout the near future as digital continuous to show the most demand.

Firms in the IT service industry can expect a recent influx of cash due to recent and proposed tax reforms and opportunities that can significantly lower tax costs and allow companies to move their cash from offshore back into the United States at a lower tax rate which in return should result in more mergers and acquisition opportunities for these firms as they look for growth. A recent tax break which will be reflected throughout the 2019 fiscal year, reduces the US federal corporate tax rate from 35% to 20% which according to Bloomberg this translates into an average of a 5% lift for 2019 EPS. Moreover, there currently is a reform in both the House and the Senate's version of the tax reform bill which proposes the idea of a one-time tax repatriation holiday which would allow firms with holdings outside of the United States to move that money back into the United States at a lower rate which would be a good opportunity for many firms to move their money back into the US to be better invested. Firms like Cognizant, who hold over 80% of their cash off-shore stand to benefit the most from these changes which should allow them to further invest into mergers and acquisitions as many firms are doing with their cash. Aside from growth opportunities in mergers in acquisitions, having their cash sitting in the United States can earn them a little more value as the Fed raises interest rates.

With an increase in cash, it's important to remain focused on what the key main use of cash should be for these firms. Merger and acquisitions should see a continued influx of cash as companies are looking to acquire more talent and expertise for their Digital areas. Acquisitions are expected to be a significant revenue growth factor for most IT service firms according to JP Morgan, where companies will try to grow their presence in the digital field through inorganically finding more acquisitions and merge opportunities and eventually agreements. Although, for those firms who are having a hard time finding the best use for their cash, bringing it back to the United States might still be the best option as the Fed raises interest rates and is expected to raise interest rates even further. Increased interest rates can hurt firms who have variable debt such as Genpact can be negatively impacted, however, firms such as Cognizant and ExlService Holdings who have higher average cash balances can result in a better short-term use of their cash in the United States. IT service firms generally run high cash balances so increase in cash yields are generally a positive factor for this industry, this is especially significant throughout the next few years as firms experience tax reductions and reforms which can allow them access to more cash with higher returns. Acquisitions remain the best investment for cash to gain market share in the digital area as well as other opportunities, however, as IT service firms regularly carry large cash balances, higher yield on cash can show a slight upside.

As new technologies are emerging companies are rapidly finding a use for these technological advances to better utilize their resources and increase efficiency which leads to new opportunities to introduce new or improved products and services, cut costs, and improve customer experience among other things. Firms have been especially demanding of RPA (Robotic process automation) and Artificial Intelligence to improve their digital areas as these new technologies are automated and intelligent allowing them to cut costs and become more efficient. The overall market for these two IT services is expected to increase to a $15 billion-dollar industry by 2021 implying a 19% increase in the market size. RPA services along with IT consulting can help firms improve their capabilities by automating whole processes or business functions which would return better results for the clients with more consistent and timely services as well as lower costs. Because of this, RPA and AI services have become more and more attractive for firms throughout the recent years and this demand growth is expected to continue for the near future along with consulting services to support these systems as firms look to cut costs and become more efficient.

Much like RPA, Artificial Intelligence has multiple uses in business and firms are beginning to explore and take advantage of these uses. More and more firms are adopting AI services to automate and improve various business functions from sales and marketing to customer service. AI can be used to improve sales and customer experience using simulations, recommendation systems, chatbots, and virtual assistants to help customers enjoy a better and more personalized experience as well with AI-marketing platforms. Firms also stand to benefit internally from the use of AI by improving operational activities and increasing efficiency and creating a more concrete analysis of their operations and business practices to improve functionality. As these services become mainstream for most firms, IT services can see a steady growth in this industry in the consulting area as firms will need outside consulting help to develop, learn, and maintain these new technologies and systems. IT services firms can see increased consulting in education and training for these new systems as well as security and risk management. Cloud computing will also remain a prominent service in demand as firms are finding it cheaper and easier to maintain their computing systems in cloud services, firms are looking for reliable and efficient system integrations to avoid conflicts or complications in order to minimize the effect on day-to-day activities.

Enterprise Internet of Things is expected to see growth in demand as project sizes for IoT are increasing. Unlike other products in the industry that are largely dominated by one or two firms like cloud computing is dominated by Amazon and Microsoft, the IoT is a largely scattered industry with a few providers in different industries such as Salesforce in software development and GE and industrial firm. This is beneficial for the IT services industry because it implies customized work needs to be done for these growing projects. Not only is attractive upfront as firms are gaining more work, but custom work can often imply further services from the same firm due to the high switching costs in this industry.

Currently, the highest demand for IT services and consulting has been the banking industry and according to a report by PricewaterhouseCoopers, the banking services and health insurance and wealth management firms will keep driving the demand for these services. More than 80% of banking service CEOs are concerned about how quickly technologies are changing in the banking services as banks are beginning to follow the sharing economy. Banking services, with the help of AI and consulting IT services, have become more decentralized as individuals are using information systems to connect people with excess capital to people who can utilize that capital without immediately going to banks as intermediaries. To keep up with this change in banking services, firms require advanced AI systems as well as blockchain, more recently, to explore and gain market share in the sharing economy of banking services. Banking services will also push a significant increase in growth through their shift into digital areas as digital is becoming more and more mainstream. Accessibility has become a growing area of competition as banking firms compete for accessibility in mobile devices paired with digital improvement especially with the use of digital wallets and such. Demand for outsourcing and consulting in the banking industry can be expected to grow consistently as the industry experiences some changes especially in England once the Brexit is complicated, new regulations could represent new opportunities to improve efficiency.

As companies begin the process of changing their infrastructure onto the cloud to optimize their use and reduce costs, this is leaving them vulnerable to cyber-attacks, the most prominent risk of the industry. As new technologies are emerging so are cyber-attacks and hacking scandals as cyber-terrorist are becoming more prominent and damaging to firms. In response, firms have been increasing their research and development in risk management and cybersecurity precautions for their systems and their clients. As cyber-attacks are becoming more common and more complex, 80% of technology executives report that their organization are ill-prepared to combat cyber-terrorist and are struggling to assemble a reasonable defense. At the same time, the number of qualified cybersecurity specialist is very limited and extremely hard to find available candidates to hire, firms are looking to outsource that service with cloud-based cyber security being the primary product of choice for these firms. McKinsey estimates that cloud-based cybersecurity products are going to make up 60% of the security products, significantly up from 10% in 2015. This is especially beneficial for the companies in the IT service industry who have been investing in cybersecurity products and cloud security products like DXC Technology and Accenture. Also, headwinds and restrictions on VISAs to bring outside employees onto the United States have been limited and reducing under the current president which can affect the way companies are hiring new employees.

Many companies have been benefitting from the current currency rates as they stand to gain from the difference of the rupee against the dollar through incrementally favorable currency hedges for next year and beyond. However, as an industry, most companies remained largely unaffected by currency fluctuations even as the British Pound and the Euro were about 1% down. Certain companies such as Globant, Virtusa, and Cognizant stand to gain the most from the current currency trends, Globant was due to their activities in South America when the Peso has depreciated almost 40%. The company is expected to operate ~20% of their operating expenses in Peso which is estimated to increase their 2018 and 2019 yearly earnings by 0.4% and 0.3% respectively. Other firms who experienced the most discomfort form the current currency fluctuations were affected either because a large part of their revenue was denominated in Indian rupee or it was because of the British Pound rate. The use of FX hedges not only benefited some companies they also helped a lot of companies avoid risk in currency exchange making the effect of the currency fluctuations a minor factor in their costs.

The uncertainty of Brexit has created a lot of volatility in the industry as firms are not sure of where the industry is going in the near future and therefore don't want to make as large investments in IT services until they see the changes that are to come, this is especially true for the banking industry in England which saw a significant decrease in growth in those services. Although the current situation surrounding Brexit cause currency volatility and uncertainty for businesses soon, IT service companies are seeing the rebuilding of a new economy to implement new advanced systems that could revolutionize how business is done in England. Brexit and the opportunity to modernize and improve the IT systems in England is a catalyst for the industry especially for firms like Cognizant and Globant who have a high exposure to the banking industry in England. Given the number of firms who are trying to expand margins in the near term, the focus will shift to generating sustainable margin expansion which creates sustainable earnings growth.