What Happened to the IT Services Sector?

Pre-GFC, IT services was a sector on the rise. Three companies, **SMS** (ASX:SMX), Oakton and UXC were valued by the market at more than half a billion dollars each, while new IPOs such as **DWS** (ASX:DWS) and **CSG** (ASX:CSV) traded at a significant premium to their listing price. With the wind at their backs, these companies had work thrown at them from all directions and couldn't hire new staff quickly enough.

The post-GFC years haven't been so kind. SMS is trading at a fraction of its all-time highs, following three changes of CEO in the last 18 months and several recent downgrades. In 2014 Oakton was taken over by multinational giant Dimension Data for a fraction of what it used to be worth. Earlier this year, UXC was taken over by U.S. behemoth CSC for less than its pre-GFC high. **ASG** (ASX:ASZ), DWS, and CSG are also trading well below 2007 levels.

So what went wrong? Was the pre-GFC period a peak in the cycle? Has the industry structurally changed? Or was there mismanagement across the board?

Certainly cyclical and structural changes have moved in tandem. When the business cycle turned up in 2003, IT services companies also benefited from the structural shift to outsourcing. It is no coincidence that most of them share Melbourne as their headquarters with Telstra, ANZ and Nab.

While lots of work is still outsourced, many clients have turned to large multinationals that can manage an entire project rather than several niche providers. Those multinationals have also become cheaper, thanks to the use of Indian IT companies with cheaper labour.

With structural change impacting the industry, some management and board vision would have come in handy. An industry-wide consolidation to create a major domestic force in IT services would have been able to compete with those multinationals. Most of these businesses, however, had one or two founding shareholders who didn't want to let go of their babies.

So there have been missteps, and tailwinds have become headwinds. But the much larger issue is that these weren't great businesses to begin with.

An observer in 2007 could be forgiven for thinking otherwise. Based on the pure financials, IT services companies looked like wonderful businesses. Their low capital requirements lead to balance sheets with little or no debt, high returns on capital and healthy cashflow generation. But those tailwinds mentioned previously were masking significant fragility.

Firstly, while these businesses might not require much financial capital, they are completely dependent on human capital that is not reflected on their balance sheets. And human capital can be fleeting. A further aspect of being a people business is that margins don't benefit materially from getting bigger – if management wants to grow earnings, they need to grow staff numbers, which gives them little ability to increase margins. It could be argued that they suffer from cultural diseconomies of scale, due to higher administration costs associated with managing more staff and difficulties maintaining utilisation rates as they grow.

Secondly, there was nothing to stop competition increasing once the trend to outsourcing emerged. While IT services companies initially carved successful niches in the domestic market, these businesses proved to be little more than ‘body shops’. They have no IP and no sustainable competitive advantages. There was little to stop Indian companies tendering for work here or staff leaving to form their own small firms (and take clients with them).

Finally, earnings were very predictable on the way up, but highly unpredictable on the way down. Forecasting earnings was relatively straight forward when the businesses were growing – management would guide to increases in staff numbers with percentage increases in staff generally having a proportional impact on earnings increases. However, in recent years earnings have been very difficult to predict. Management teams have cut staff numbers in response to falling demand but this has not fixed poor utilisation as demand has fallen faster than expected, leading to earnings spiralling downward.

So where does this leave the listed IT services companies? Many have tried bolt-on acquisitions, share buy-backs and management changes to restore shareholder value. While these may stem the bleeding, the grand vision of industry-wide consolidation to create a tier one domestic IT services player remains elusive. Absent more takeovers by the global companies, the Aussie players seem destined to remain small with few competitive advantages.