



Drive Margin Improvements with Effective Contract Management

By Vikas Taneja, Vikash Jain, Amit Kumar, Hyun Kim, Nitin Chandalia, Samir Mehta, and Jim Hull

“We are seeing significantly lower margins than the range we have seen in the past. There are some salary increases planned and certainly we have to be very careful”.

– CFO, Tier-I IT player

IT Firms Witnessing a Margin Drop of up to 300 Bps Amidst Surging Wage Inflation

Rising inflation is one of the key discussion topics in the world of economics today. In the United States, inflation recently reached the highest level in 40 years with CPI rising by **9.1%** y-o-y as of June 2022 and wage inflation increasing to **4-7%**¹. Higher levels of attrition in the technology sector coupled with cost headwinds stemming from a resumption in travel, have pushed up staffing/human resource-related costs for many IT services firms.

With sectors like retail, apparel, and aerospace experiencing a complete absence of business for almost 2 months in FY21, clients are likely to lead pricing pressure on the IT companies and also delay payments.

– IT Sector Analyst

Wage inflation has been on the rise in client geographies. This will drive higher wage costs as salary hikes would have to be higher than seen earlier.

– JP Morgan Chase & Co. analyst commentary

1. ISG Index 1Q22 report

In the past, onsite wage increases for Indian firms have been in the range of **1.5-2%**², in line with local inflation levels. A recent analysis by Jefferies finds that a **1%** wage inflation leads to a **~30bps** margin drag. By combining these data points, financial analysts predict a margin drag of **~60bps** for the current fiscal year. Increased attrition levels³ (See Exhibit 1), prevalent in many sectors, in the post-COVID era, have deeply affected the technology industry and further worsened margins.

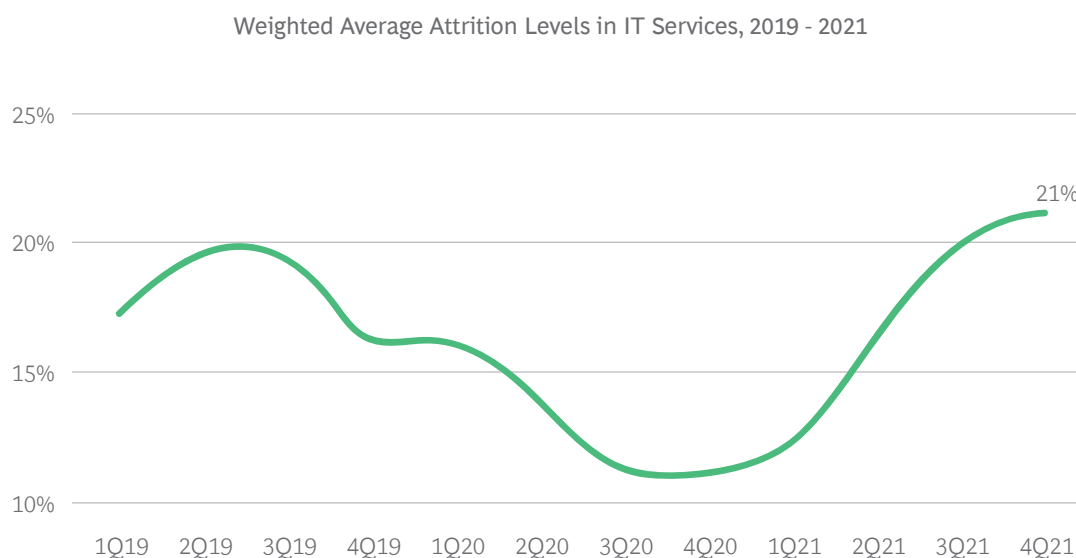
A comparison of earnings before interest and tax (EBIT) for leading global IT companies⁴ (See Exhibit 2) reveals a margin drag of up to **300 bps** from March 2021 to March 2022, which indicates that nearly **20-25%** of the drop can be attributed to wage inflation.

Robust Management of Contract Data can be a Key Lever for Arresting Margin Erosion

IT & ITeS companies are trying to re-work their pricing strategies to counter the margin pressure. However, given the time-consuming nature of such changes, commercial tightness facilitated by effective management of contract data emerges as an important avenue for protecting margins.

Contracts are an essential part of the day-to-day activities of any services firm as they comprise the crucial underlying commitments that drive business operations. A Harvard Business Review article finds that inefficient contracting causes firms to lose between **5-20% of deal-value**⁵, given that the contract clauses span almost all organizational areas such as procurement, sales, finance, human resources, legal, and service domains. Proper authoring and implementation of contractual clauses are therefore important for margin improvement in the services domain. Some areas in which contract management plays a crucial role in arresting margin drop are discussed below:

Exhibit 1 - Attrition Levels at an All-Time High in IT Services

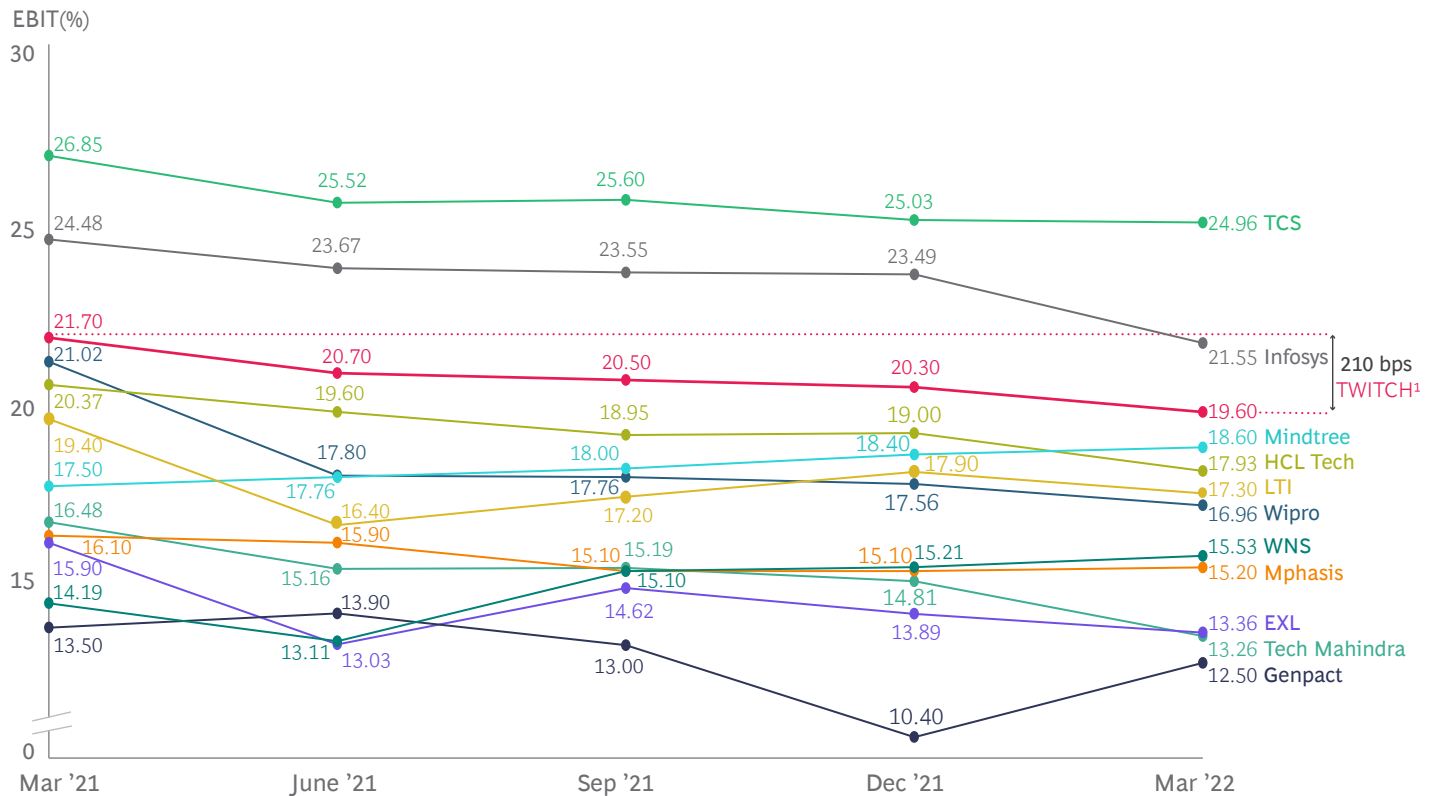


Source: ISG, 2022; Includes providers from ISG Index™ Leaderboard

2. Business standard report, 15th Mar 2022, Factiva
3. ISG Index 1Q22 report
4. Company annual reports, JPMorgan Analysis
5. <https://hbr.org/2018/02/how-ai-is-changing-contracts>

Exhibit 2 - Drop in Operating Margins for the last FY for Leading Global IT and ITeS firms

Upto 300 bps margin drop observed across companies from Mar'21 to Mar'22



Source: Company annual reports, BCG analysis

¹ TWITCH refers to average margin returns for TCS, Wipro, Infosys, Tech Mahindra, Cognizant and HCL technologies

1. Revenue Assurance



- Standardized contract templates ensuring the incorporation of revenue adjustment parameters such as COLA, ECA, payment schedules, and NRE costs help to identify and prevent revenue leakage.
- AI-enabled contract negotiation support can drive favorable pricing by leveraging information from past contracts across geographies and business divisions.
- Monitoring of delivery terms (SLA commitments, deployments milestones, etc.) and pro-active course correction can ensure cost optimization and penalty reduction.
- Tracking staffing deviations between as-sold v/s actual is critical for arresting cost leakages.

6. General Data Protection Regulation

7. California Consumer Privacy Act

2. Risk Management



- Consulting and IT services firms are particularly vulnerable to risks associated with missed obligations and regulatory concerns due to the geographically diverse nature of the industry
- With the introduction of new regulations such as GDPR⁶ and CCPA⁷, complete visibility into contracts is essential to help mitigate hidden contract risks and ensure the proper management of reputation risk.
- Clauses around liability super cap, penalties, and GDPR are key considerations for any services firm
- Pro-active prompts on regulatory penalties can help avoid penalties.

3. Operational Effectiveness



Impact Potential:

1%+

margin improvement

- In the age of ever-increasing efficiency, fast processing and quick turnaround time for contract authoring is of prime importance.
- Manually maintained and fragmented storage of contracts are **inefficient, exposed to human error, and decrease visibility**.
- Contract management solutions offer a compelling value proposition on this front through dedicated capabilities such as a **centralized searchable repository, collaboration apps, workflow builders, and AI-based digitization**, which streamline processes and free up human capital.

A powerful contract management solution accrues immense value to a customer across the authoring and execution stages, and addresses key areas of concern such as margin erosion, revenue assurance, delivery excellence, and many more. Apart from driving business agility and organizational compliance, contract management shows tangible bottom-line benefits in terms of revenue uplift and cost optimization, leading to margin improvement.

A recent interesting case study on arresting margin erosion for a global IT firm is given in the next section.

BCG and Icertis Worked Together on Plugging Revenue Leakages in the IT Industry

BCG is working with Icertis, a leading AI-driven CLM solution provider, on minimizing revenue leakage through effective end-to-end contract lifecycle management. Rated by Gartner and Forrester as an industry leader in its vertical, the Icertis Contract Intelligence (ICI) platform aims to ensure proper authoring and enforcement of key contract clauses for clients, with BCG providing consulting support for the identification of key metrics to track and generate business insights.

With elevated inflation levels in world markets, IT/ITeS players needed to identify and track inflation clauses in their existing contracts. **Given that manual review of contracts caused significant delays**, these clients required an AI-driven integrated platform to complete the contract analysis effectively and efficiently.

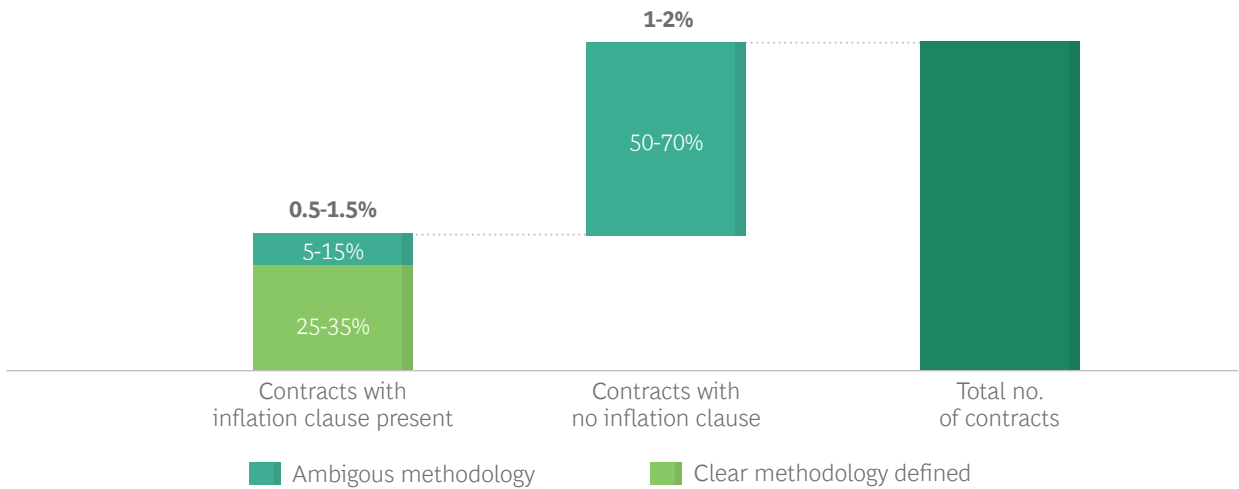
As a part of the initial assessment of client baselines in the pre-implementation phase, the ICI platform's robust algorithmic and multi-lingual capabilities provide rapid analysis of sample documents in multiple languages.

Following the algorithmic training which is used to identify **COLA, CPI, ECA, and other related clauses**, an AI-enabled meta-data extraction engine is used to segregate contracts into 3 categories: 1) Contracts with well-defined inflation clauses, 2) Contracts that refer to inflation clauses but with clear authoring gaps, and 3) Contracts with no inflation clauses. An estimated dollar value analysis further indicates the potential for value addition (**See Exhibit 3**). The platform also helps deliver the results in a customized output format, alongside interactive dashboards for easy access and monitoring of contractual data.

This joint analysis revealed that combining these measures allow IT/ITeS players to prevent revenue **leakage to the tune of 1.5-3.5%**. As part of longer-term deployment planning, several leading players in this industry are on course to leveraging the ICI platform across all inflation-related contract documents and, more broadly, on other contractual obligations to inspect and transform all their contracts.

Contract management solutions have the potential to prevent significant margin reduction. They also help improve visibility by providing a centralized digital repository of contracts for the C-suite and enable them to track their outstanding contractual obligations and manage commitments. AI-enabled solutions backed by cloud storage functionalities, hold the key to the future of arresting margin erosion and providing an efficient and transparent contract management solution.

Exhibit 3 - 1.5-3.5% Value Unlock Potential via Proper Authoring and Implementation of Inflation Clauses



Source: BCG-client joint analysis

Contract Archetype	Approach Methodology	Value Potential (% of revenue)
<ul style="list-style-type: none"> Inflation clause present, with a defined methodology 	<ul style="list-style-type: none"> Leverage price escalation clauses to implement price changes 	0.5-1.5%
<ul style="list-style-type: none"> Inflation clause present but with clear authoring gaps 	<ul style="list-style-type: none"> Amend contract to ensure clear and actionable clauses for full coverage 	
<ul style="list-style-type: none"> Inflation clause absent 	<ul style="list-style-type: none"> Amend contract to include inflation clause, and tracking systems enforcement 	1-2%

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About Icertis

With unmatched technology and category defining innovation, Icertis pushes the boundaries of what's possible with contract lifecycle management (CLM). The AI-powered, analyst validated Icertis Contract Intelligence (ICI) platform turns contracts from static documents into strategic advantage by structuring and connecting the critical contract information that defines how an organization runs.

Today, the world's most iconic brands and disruptive innovators trust Icertis to govern the rights and commitments in their 10 million+ contracts worth more than \$1 trillion, in 40+ languages and 90+ countries.

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