Resilience in the technology industry

Transcript

JEREMY LEONARD: Hello, I'm Jeremy Leonard, managing director of global Industry Services at Oxford Economics, and I'm very pleased to be here with Steve Perkins from Grant Thornton to talk a little bit about resiliency in the technology industry. I think maybe a good way to kick this off is just looking at the big changes of fortune in the sector since the pandemic. We all remember back to the pandemic, way back when, we saw tech companies just going gangbusters and we've come to a point right now in the cycle where things have gotten decidedly dark, related to rising interest rates and tightening policy, or is it a signal that pandemic shifts in demand are more short-lived than we thought and that maybe all of this hype about everybody being online and gobbling up IT services was just a myth?

Maybe the answer is somewhere in the middle, but I'm sure Steve, you have some views on that that can maybe kick us off.

STEVEN PERKINS: Yeah. Thank you, Jeremy, and I'd prefer to think about it as dim as opposed to dark. You know, my personal sense is you know we're in a relatively short period. If I knew exactly how long, I'd probably be doing something different for a living, but let's call it the next 18 months, where we're having a contraction in the revenues of these tech companies, you know, based on buyers' demand. That differs depending on the markets they're in, the segments they address, what the revenue models are. So you know, tech is not one thing, as you know, it's really a broad range of sectors. For most part, they're all experiencing this bit of dimness.

What is absolutely true is, you know, after let's call it a decade and a half of hyper-growth, and that clearly accelerated in during the pandemic when it was a significant pull through of revenue for certain sectors of the tech industry, all of those that were supporting remote work, digital experiences, they all saw revenue pull forward, we have definitely slowed.

For me this feels like a cycle, and I've been doing this in the tech industry for 40 plus years. This happens. Every couple of decades, there's a shock to the system which slows buying. The last one was I think much more acute, which was the early 2000s dot com bubble burst where the fundamental models for many of the tech companies proved not to be viable. I don't think that's the case here. Perhaps the tech industry coming through this period of slow growth feels a little bit like the banking industry that went through significant restructuring during the financial crisis and you know is much, much stronger for that now as it goes through this period of high inflation and slow growth around the world. So it feels like a cycle to me. If you're a younger tech worker, and that's most of them, this is the first time they've been through it probably feels a little bit more dramatic. The other thing I'd say Jeremy is you know, I looked at some of the results from the Oxford Economics Survey Global Survey and the US survey and I'm actually struck by how shallow this depression is, if you will, in buying. It's only down since what I would kind of point to the height of the pandemic, kind of mid 2001, by three or four points in terms of commitment to technology acquisitions and buying. So you know it felt dramatic in these tech companies. It certainly, in their valuations, probably you know the smaller you are, the more dramatically that affects you, particularly you know the challenge in fundraising and the cost of money. But can I expect they'll all come out of the back end of this and spend as I see it today is about where it was pre-pandemic levels. So we haven't retrenched dramatically. We just kind of you know normalize through the tech bubble.

JEREMY LEONARD: Yeah, I think that's right. And just for context, if we look at the growth in gross value added in the tech sector, which of course is going to include much more than the fangs because I think it is quite important to emphasize, you know we talk a lot about the Facebooks and the Amazons, et cetera, and clearly they're being hit and we read about that in the papers every day. If you take the sector as a whole, we're looking at kind of eight, 9% growth over the past six to seven years. And even at Oxford Economics, in our forecast, we're projecting for this year growth of about 1%.

OK. Which is, you know, it's better than the economy as a whole and certainly when you're looking at the historical track record, it feels like a depression. But we're talking, we're still talking about growth in the market. So I think that is something that's important to bear in mind. I think the other thing is that because, as you mentioned, the tech sector is very large, it's very diverse. It's serving B to B customers in terms of both the hardware, the software and the services. It's also serving B to C and that's sort of more of the kind of Facebook, the kind of things we read about in the papers, it would be interesting to hear a little bit about the differences in terms of how those companies are going to be affected. I mean, certainly in our group of clients who are a lot of industrial corporates, we're seeing the feed-through of high interest rates to cuts in CapEx budgets and of course that's going to have both a direct impact on tech services. But it's also going to have the indirect effect to the extent that so much IT hardware goes into machinery so that when you have a pullback in CapEx spending, you actually see it through the supply chain. So certainly on the B to B, we're seeing a big impact but I'm interested in your take on kind of how you see this kind of this high inflation, high interest rate environment, how is it affecting sort of B to B versus B to C type firms?

STEVEN PERKINS: You know it's interesting. Jeremy, as you rightly point out, tech isn't one monolithic industry. I kind of, I might add a third category, it’s B to B, there's B to C, and then there's all of the ad-spend-based search Internet businesses, right. That's certainly a version of of B to C but they clearly as companies have dramatically slowed their ad spend they've been acutely affected. Maybe on the other end of the spectrum, you have semiconductors and at least for the US semiconductor business, you've got the CHIPS Act and some significant reassuring stimulation going on in that market. So you know different set of dynamics there. At least for the moment, it appears that the consumer is continuing to spend and that I think continues to prop up you know the B to C companies that are in the device business and others. We'll see if that you know if that's the next shoe to fall. If inflation rates stay high and the central banks are forced to continue higher rates for longer periods of time and the consumer rolls over. I think you'll see a natural slowdown in those spends.

You know, for the for the enterprise customers or the B to B side of it, I contrast this to the last time I went through this and I was actually the general manager at a Fortune 10 software company in the early 2000s when we went through this and I think there are some things that are fundamentally different, which may prop up the spend and the fortune of these companies a little more than historically the case. One of those just is how ubiquitous technology is in the operations of kind of all companies, as you said underpinning society and governments as well. You know that was true in the past, but it's even more true today. And as we mentioned, the pandemic really accelerated that as well. So it's hard for any company to operate, without technology and the continuing investment in technology. I do think we'll see you know deferral of, large technology transformation projects that have deferred return on investment, those large ERP implementations that may take a couple of years to be deployed and longer for the returns to be realized, will probably go on the shelf. But I think you'll see lots of digital transformation in the middle of that to drive it.

The other thing I'd say is that, again it's tough to generalize in the industry, but know two things are true additionally since 2000s: One, it's the era of software and the virtualization of hardware and networks to software. So you'll see this migration to software and, at the same time, you've seen a migration in the consumption model, and the revenue model, associated with it to go from a perpetual license model to an as-a-service model. So, the capital expense for a company to change technology, acquire technology, whether that's a large company or small, technology exchange from a capital expense to an operating expense.

It's also placed a significant burden on the tech companies to resell that license. I grew up with a perpetual license. You sell it once, you have maintenance forever, highest margin part of the business. So I think those two things certainly at the enterprise level, Jeremy, are very different this go round than the last. They'll impact spend patterns by the consumers. They’ll also impact how the tech companies have to behave during this period of dimness, if you will.

JEREMY LEONARD: Yeah, I think that's a great point about this. This move from CapEx to OpEx because that could potentially influence this, this kind of feed through as I was mentioning before you know, typically in past cycles, we've seen when there's rising interest rates, shrinking margins, then you see a pullback in CapEx and that has impacts on the IT sector. But it is more the hardware sector. So it may well be the case that as we move forward that software and as-services model will actually mean that sort of administratively it means that those expenses may be less at risk as we go through downturns, that will remain to be seen, but it's quite an interesting point. Thanks for raising that.

I do want to talk a little bit about the workforce because interestingly, you know in most in many sectors of the economy, the issue is that it's hard to find workers, but the tech sector is one sector that seems to be losing workers. Again, I don't want to pay too dark of a picture because of course, if we look at employment for the sector as a whole, for 23, for instance, we see a modest employment growth in the IT services and tech sector generally. It's not as strong as in the past of course.

But still it doesn't hide the fact that we are seeing, a fair number of thousands of layoffs. And I'm just wondering what your thoughts are in terms of, clearly those workers are going to want to find other employment. Is there a danger that we might see a sort of exodus of talent from the sector and that when the rebound comes, it'll be harder to bring talent back? I'm just interested in your thoughts on the labor market, angle of things.

STEVEN PERKINS: Yeah, that's a terrific question. And then couple of ways that a couple of ways I think about a Jeremy: One is, in the US there remains a significant, hundreds and hundreds of thousands of unfilled technology jobs in this market today.

So it's a tight labor market for technology. Again to contrast it to a couple of decades ago, the last time the industry went through a major restructuring like it's going through now the opportunity for those tech workers extends significantly beyond government. So, I jokingly refer to every company being a tech company, but that really is true as companies not only have tech workers in financial services or manufacturing, healthcare, tech workers to run their internal IT operations, they're also building their products, their customer engagement models, their services around technology. So there there's a tremendous amount of competition for that labor, for talented software to developers, service people, whole variety of job categories and technology outside of the tech industry. So while we've seen some layoffs announced and you know lots of high profile companies have announced layoffs, two things I'd say: One, on a percentage basis of their overall headcount, those layoffs are de minimis. They're hugely impactful to anybody who's been laid off, but on an overall basis, that's not true. And those people are clearly finding opportunities readily with other tech companies or other places in the market. And maybe, over the last 20 years, Salesforce has been a real bellwether at the enterprise level, the high growth we say in the high flyer, this move to an as a service model, lots of very admirable traits in the technology industry, but you know pre-pandemic they had about 48,000 employees. Last October, they had 80,000 employees and many other technology companies resemble that profile where you know, either through acquisition, which you know M&A was really hot during that period of time. But through hiring to keep up with the pace of growth they really added a tremendous amount of headcount and I think this is just a natural rationalization of their operations, their infrastructure and their head count. And I think, again, for any individual affected a pretty dramatic, but a healthy thing for these companies.

JEREMY LEONARD: Yeah, I think that's right. It comes back to kind of this cyclical versus structural and we see that in the data that we track in terms of, you know ecommerce and the use of remote technologies: Big, big pickup in the pandemic, there's been a pullback in most of the indicators but at a level that's significantly higher than before the pandemic. So I think you're right that there's always a period of adjustment when you when you have these big, big shifts, you kind of don't know what's coming.

I'd like to hear what you know cause the theme of this talk is resilience, and clearly the tech sector is up against some things perhaps it hadn't bargained for. So I'm just wondering what your thoughts are in terms of what are the most important things in terms of tech companies to build their resilience in this environment?

STEVEN PERKINS: Yeah, I'd say a couple of things, Jeremy. So you know to kind of time when the tech company entered this, probably was early last summer you saw CFOs and CEOs and the whole C-Suite husband their cash, make sure they were doing all the things they could to make sure they were financially stable. They were kind of, we're kind of through that part of it. What I see now are maybe three things:

One, they are taking the opportunity, if you will, of this slowdown to rationalize operations like we see that in the head count but you know as tech companies grow and expand new product areas, new customer sets, new markets internationally, they have a tendency to favor growth over profitability perhaps, and certainly efficiency of those operations, they add headcount to make sure they can flood the markets. They add third-party relationships. They add infrastructure internally, they make acquisitions and it's difficult to pause in the middle of that as you're laying track in front of the train, to straighten that track out. And so that's what they're doing now. They're rationalizing those operations. We see it manifested in head count, but we see it in other places as well, and anywhere you're going to see, is improved profitability albeit slower growth, but improve profitability and again if I use Salesforce as an example, if you look at their just released fourth quarter results, they had the highest profitability ever in the company's history. Again, they began to take some of these efforts to rationalize operations. They're taking more with some of the headcount reductions they've announced to go forward. So that's one, you know this natural pause to rationalize.

The other is really need to invest in their customer experience, customer engagement side of things. We discussed a little bit this change in revenue model and business model from perpetual license sell at once, that's a customer for life, to now it's a temporal relationship. So I have to go back and resell that relationship with that customer all the time depending on whatever the period of the contract is but certainly inside a couple-year window. So it is absolutely essential that you know where to hold their position with these customers. They continue to invest in that customer experience, those technologies, those people, those customer journeys. So that's an area of significant spend and they run a real risk to performance if they don't continue to invest in those areas.

The other area I'd say it and this is again a bit of a difference in the market today to where it was maybe 10 or 20 years ago, is just the need to continue to invest for compliance, so that might be to meet the security standards in the cyberspace, that might be for privacy. That might be kind of all sorts of regulatory regimes that you see for these technology companies.

These regulatory schemes differ by market. Most technology companies are international from almost day one, and there are different standards country by country, in the US there are different standards on the privacy side, state by state. So there's a real kind of overhang on the regulatory side for technology companies to continue to invest in their operations to make sure they comply, to build into their products the kind of security and privacy that they're gonna require. And again the industry has a heavy reliance on third parties in the software and a little less on the supply side that you see in the manufacturing world, but a heavy dependence on the go to market side for third parties in their ability to extend the privacy and security assurances through that network is hugely important, so there there's really a requirement for them to continue to invest there. And this is certainly an issue that boards are paying a significant amount of attention to. Twenty years ago you might you might see the industry taking a different approach to some of this regulation, kind of "I'll worry about it later." That's clearly not the world they exist in today. So, you know, customer engagement, rationalizing operations to drive efficiency and effectiveness, and profitability and just continue to build around their security into their operations and compliance is something natural I guess maybe the last one I'd add there is focus. So again it's easy to chase lots of shiny objects when you're growing like a weed. I think there's a real strategy opportunity now for these tech companies, to think "What products really have the growth potential? Where does the profitability align by customer? What markets do they want to be in?" And think about how they've expanded, how they've grown.

JEREMY LEONARD: Yeah, I think that's a great point. And I I would consider that sort of a tangent or corollary of rationalization. I think that's a good point. And I think you've actually succeeded in showing there's a silver lining to every slow-down, to every dim period. As you say, if you're a tech company and you can start boosting your profits, that's a good thing in the grand scheme of things. And I think it does demonstrate resilience.

This is great. It's been a pleasure talking to you, Steve. I think we're gonna leave it there. And I've learned a lot on this chat and I hope our listeners have as well. So I really appreciate the participation. Thank you so much.

STEVEN PERKINS:
Terrific, Jeremy. Thank you. And as I said, I’m a long-time tech guy. So I'm an optimist. I think we'll be beyond this before too long.