Risk management practices at Wipro Limited

AV Vedpuriswar

Risk management is an essential function at Wipro. This article highlights the important risks that the company faces and the measures that it is taking to mitigate these risks.

Wipro, one of the most admired IT companies in India was founded in the year 1945 by Mohamed Hussain Hasham Premji. Under the leadership of Azim Premji leadership, the fledgling Rs. 70 mn company in hydrogenated cooking fats has grown to $736 mn (FY 2002) diversified, integrated corporation in services, technology products and consumer products. Ranked 7th among the software services companies in the world by *BusinessWeek* (Infotech 100, November 2002), it serves over 300 global leaders including Boeing, Nationwide, Ericsson, Toshiba, Cisco, Seagate, Putnam Investments, United Technologies, Best Buy, Digital, Friends Provident, IBM, Microsoft, NCR, Thames Water, Transco and Sony. Wipro currently has 17 software development centers in India, one each in the US & UK and 9 manufacturing facilities for IT and non-IT products. It has 15 marketing offices in six countries for Global IT business.

Business risks

Overview

Wipro feels the following factors can affect its business:

- the size, timing and profitability of significant projects or product orders;
- the proportion of services performed at clients' sites as opposed to offshore facilities;
- seasonal changes that affect the change in the mix of services provided to clients or in the relative proportion of services and products;
- seasonal changes that affect purchasing patterns among consumers of computer peripherals, personal computers, consumer care and other products;
- the effect of seasonal hiring patterns and the time required to train and productively utilize new employees; and
- exchange rate fluctuations.

The market for IT Services is highly competitive. Wipro's competitors include software companies, large international accounting firms and their consulting affiliates, systems consulting and integration firms, other technology companies and in-house information services departments of clients. Many of Wipro's competitors are much bigger and have significantly greater financial, technical and marketing resources compared to Wipro. Wipro's ability to compete depends on the price at which competitors offer comparable services, and the extent of the competitors' responsiveness to their clients' needs.

Approximately 59% of Wipro's total operating expenses in the Global IT Services and Products business, particularly personnel and facilities, are fixed in advance, for any given quarter. As a result, unanticipated variations in the number and timing of projects or employee utilization rates may cause significant variations in operating results in any particular quarter. Wipro believes that period-to-period comparisons of results of operations are not necessarily meaningful and should not be relied upon as indications of future performance. This is a good practice from which other companies can learn.

Growth-related risks

Wipro's Global IT Services and Products business has been growing rapidly. This growth will place significant demands on management and other resources. This will necessitate development and improvement of operational, financial and other internal controls, both in India and elsewhere. Wipro's continued growth will increase the challenges involved in:

Wipro's Global IT Services and Products business has been growing rapidly. This growth will place significant demands on management and other resources

- recruiting and retaining sufficiently skilled technical, marketing and management personnel;
- providing adequate training and supervision to maintain high quality standards; and
- preserving the company's unique culture, values and entrepreneurial environment.

If Wipro is unable to manage its growth effectively, the quality of its services and products may decline. Then its ability to attract clients and skilled personnel may be negatively affected. These factors in turn could slow down the growth of the business.

Concentration risks

Geographic concentration

Approximately 57% of Wipro's Global IT Services and Products revenues are from the US. During an economic slowdown, Wipro's clients may delay or reduce their IT spending significantly. This may in turn lower the demand for Wipro's services. Terrorist attacks in the US in September 2001, disrupted normal business practices and reduced business confidence. This has put US companies under tremendous pressure. Several clients have delayed purchase orders. Continued, terrorist attacks in the United States could cause clients in the US to further delay their decisions on IT spending. Approximately 50% of Wipro's Global IT Services and Products business is derived from clients in high growth industries who use Wipro's IT Services for networking and communications equipment. The recent rapid economic slowdown in US may adversely affect the growth prospects of these companies and decrease the demand for Wipro's services.

Client concentration

Wipro currently derives a significant portion of its revenues from a limited number of corporate clients. The loss of a major client or a significant reduction in the service performed for a major client could affect Wipro's businesses. General Electric, Wipro's largest client for the year ended March 31, 2001 and Lattice group Wipro's largest client in the year ended March 31, 2002, accounted for 8% and 7% of Wipro's Global IT Services and Products revenues, respectively. For the same periods, Wipro's 10 largest clients accounted for 45% and 42% of revenues.

Operations risks

Wipro offers a portion of its services on a fixed-price, fixed-time frame basis, rather than on a time-and-materials basis. Wipro uses specified software engineering processes and its past project experience to reduce the risks associated with estimating, planning and performing fixed-price, fixed-time frame projects. But Wipro still bears the risk of cost overruns, completion delays and wage inflation. If Wipro fails to estimate accurately the various components associated with the project, or if it fails to complete its contractual obligations within the contracted time frame, its profitability may suffer.

A significant element of Wipro's business strategy is to spread its software development activities across its centers in Bangalore, Chennai, Gurgaon, Hyderabad and Pune, and various overseas locations. Wipro believes this will provide it with cost advantages, the ability to attract highly skilled personnel in various regions of the country and the world, the ability to service clients on a regional and global basis, and the ability to provide services to its clients round the clock. Wipro maintains active voice and data communications between its main offices in Bangalore, its clients' offices, and its other software development and support facilities. Although Wipro maintains redundancy facilities and satellite communications links, any significant loss in its ability to transmit voice and data through satellite and telephone communications would result in reduction of revenues.

Wipro uses specified software engineering processes and its past project experience to reduce the risks associated with estimating, planning and performing fixed-price, fixed-time frame projects

The success of Wipro's strategy is based on comparative advantage. Wage costs in India have so far been significantly lower than wage costs in US and Europe. However, sharp wage increases in India may erode this competitive advantage. This may negatively affect its profit margins. Wipro may need to increase its employee compensation more rapidly than in the past to remain competitive. Wipro is focusing increasing on the efficiency and productivity of its employees to counter rising wages.

Risks related to mergers, acquisitions and strategic alliances

Wipro may acquire or make investments in complementary businesses, technologies, services or products, or enter into strategic partnerships with parties who can provide access to those assets. The possibility of choosing wrong acquisition, investment or strategic partnership candidates cannot be ruled out. Wipro may also not complete those transactions on terms commercially acceptable to it. If Wipro acquires another company, it could have difficulty in assimilating that company's personnel, operations, technology and software. In addition, the key personnel of the acquired company may leave. Difficulties may also arise in integrating the acquired products, services or technologies into existing operations. These difficulties could disrupt Wipro's ongoing business, distract its management and employees and increase its expenses.

Political risks

US immigration laws may change and make it more difficult for Wipro to obtain H-1B and L-1 visas for its employees. Then, Wipro's ability to compete for and provide services to clients in the US could be impaired. In response to the September 2001 terrorist attacks in the United States, the US Immigration and Naturalization Service (INS) increased the level of scrutiny in granting visas to people of South-East Asian origin. This restriction and other related changes could hamper Wipro's growth.

As of March 31, 2002, the majority of Wipro's personnel in the United States held H-1B visas (721 persons) or L-1 visas (510 persons). (An H-1B visa is a temporary work visa, which allows the employee to remain in the US while he or she remains an employee of the sponsoring firm. The L-1 visa is an intra-company transfer visa, which only allows the employee to remain in the United States temporarily). Although there is no limit to new L-1 petitions, there is a limit to the aggregate number of new H-1B petitions that the INS may approve in any fiscal year. Wipro may not be able to obtain the H-1B visas necessary to bring critical Indian professionals to the United States on an extended basis during years in which this limit is reached. This limit was reached in March 2000 for the US Government's fiscal year ended September 30, 2000.

A significant change in India's economic liberalization and deregulation policies could adversely affect business and economic conditions in India

South Asia has from time to time seen civil unrest and hostilities among neighboring countries. For example, tensions between India and Pakistan continue in Kashmir. The potential for such hostilities has recently increased as a result of terrorist attacks in the US. The attack on the Indian Parliament in late 2001 is a good example. Events of this nature in the future could not only influence the Indian economy but also have a negative impact on the market for securities of Indian companies, including Wipro's ADSs.

Since 1991, successive Indian Governments have pursued economic liberalization policies. Several restrictions on the private sector have been relaxed. Nevertheless, the involvement of the Indian Central and State Governments in the Indian economy has remained significant. The current government, formed in October 1999, has announced policies and taken initiatives that support economic liberalization. These liberalization policies may or may not continue in the future. The rate of economic liberalization could change. Specific laws and policies affecting technology companies, foreign investment, currency exchange and other matters affecting investment in Wipro's securities could change as well. A significant change in India's economic liberalization and deregulation policies could adversely affect business and economic conditions in India.

Regulatory risks

Most of Wipro's software development facilities are located in India and in US. Wipro intends to establish new development facilities in Southeast Asia and Europe. Because of Wipro's limited experience outside India, Wipro is subject to additional risks including, among other things, difficulties in regulating its business globally, export requirements and restrictions, and multiple tax structures. Any of these events could harm its future performance.

Currently, Wipro benefits from certain tax incentives under Indian tax laws. These tax incentives include a 10-year income tax holiday for business operated from specially designated "Software Technology Parks" in India. There is also a 100% income tax deduction for profits derived from exporting information technology services. As a result, Wipro's tax liability has been minimal in recent years. For the years ended March 31, 2001 and 2002, without accounting for double taxation treaty set-offs, Wipro's tax benefits were Rs. 2,389 mn, and Rs. 2,862 mn, from such tax incentives.

Wipro is also eligible for exemptions from other taxes, including customs duties. The Finance Act, 2000 has phased out the 10 year tax holiday over a 10 year period from the financial year 1999-2000 to financial year 2008-2009. Wipro's current tax holidays expire in stages by 2009. Finance Act, 2002 subjects 10% of all income derived from services located in "Software Technology Parks" to income tax for the year ending March 31, 2003. When tax holiday and income tax deduction exemptions expire or terminate, Wipro's costs will increase. The Government of India may also enact similar laws in the future, which could further impair other tax incentives.

Indian laws impose various restrictions on raising capital outside India through the issuance of equity or convertible debt securities. Generally, any foreign investment in, or an acquisition of, an Indian company requires approval from relevant government authorities in India including the Reserve Bank of India. However, the government currently does not require prior approvals for IT companies, subject to certain exceptions. Under any such exception, if the government does not approve the investment or imposes a limit on the foreign equity ownership of IT companies, Wipro will find it difficult to obtain additional equity investment by foreign investors. Failure to obtain approval from the Government of India for acquisitions of companies incorporated outside India may restrict Wipro's international growth.

Many of Wipro's contracts involve projects that are mission critical to its clients. Any failure in a client's system could result in a claim for substantial damages

The Government of India has recently issued a policy statement permitting acquisitions of companies organized outside India with a transaction value:

- If in cash, effective April 28, 2001 up to 100% of the proceeds from an ADS offering;
- If in stock, the greater of $100 mn or 10 times the acquiring company's previous fiscal year's export earnings; and
- In addition, up to US $100 mn can be invested under the automatic approval route.

These amounts are quite small in a global context and major investments will continue to be subject to discretionary approvals.

Indian law imposes foreign investment restrictions that limit a holder's ability to convert equity shares into ADSs. This may cause equity shares to trade at a discount or premium to the market price of Wipro's ADSs. Recently, however, the government has permitted two-way fungibility of ADRs, subject however to sectoral caps and certain conditions.

Legal and contractual risks

Many of Wipro's contracts involve projects that are mission critical to its clients. Any failure in a client's system could result in a claim for substantial damages, regardless of Wipro's responsibility for such failure. Wipro attempts to limit its contractual liability for damages resulting from negligent acts, errors, mistakes or omissions in rendering its services. But the company cannot always be sure that the limitations on liability it provides for in its service contracts will be enforceable in all cases, or will protect it adequately from liability for damages.

Intellectual property risk

Intellectual property rights are important to Wipro's business. Wipro relies on a combination of copyright and trademark laws, trade secrets, confidentiality procedures and contractual provisions to protect its intellectual property. However, the laws of India do not protect proprietary rights to the same extent as laws in the US. Therefore, unauthorized parties may infringe upon or misappropriate Wipro's products, services or proprietary information.

The misappropriation or duplication of Wipro's intellectual property could disrupt Wipro's ongoing business, distract management and employees, reduce revenues and increase expenses. Wipro may need to litigate to enforce its intellectual property rights or to determine the validity and scope of the proprietary rights of others. If Wipro becomes liable to third parties for infringing their intellectual property rights, it may have to pay substantial damages and may be forced to develop non-infringing technology, obtain a license or cease selling the applications or products that contain the infringing technology. Wipro may be unable to develop non-infringing technology or to obtain a license on commercially reasonable terms.

Human resources risks

Senior members of Wipro's management team, play an important role in managing Wipro's growth. Wipro's ability to execute projects and to attract new clients depends critically on its ability to attract, train, motivate and retain highly skilled professionals, especially project managers, software engineers and other senior technical personnel. If Wipro cannot hire and retain additional qualified personnel, its ability to obtain new business and expand its existing business will be impaired. Wipro faces the risk of not being able to hire and retain enough skilled and experienced employees to replace those who leave. In the face of continuing changes in technology, evolving standards and changing client preferences, redeployment and retraining of employees, may not be adequate to overcome manpower shortages.

Wipro defines market risk as the risk of loss of future earnings, or a decline in fair values or future cash flows that may result from a change in the price of a financial instrument

Financial risks

Wipro defines market risk as the risk of loss of future earnings, or a decline in fair values or future cash flows that may result from a change in the price of a financial instrument. The value of a financial instrument may change as a result of changes in the interest rates, foreign currency exchange rates, commodity prices, equity prices and other market changes. Such market risk sensitive financial instruments include foreign currency receivables and payables and long-term debt.

Wipro's exposure to market risk is a function of its investment and borrowing activities and its revenue generating activities in foreign currency. Most of Wipro's exposure to market risk arises out of its foreign currency denominated accounts receivables and investments in foreign currency denominated securities. The two main components of market risk for Wipro are interest rate risk and exchange rate risk.

Wipro manages market risk through a corporate treasury department, which evaluates and exercises independent control over the entire process of market risk management. The department recommends risk management objectives and policies which are approved by the senior management and the audit committee. The activities of the department include management of cash resources, implementing hedging strategies for foreign currency exposures, borrowing strategies, and ensuring daily compliance with market risk limits and policies.

Exchange rate risk

Exchange rate risk primarily arises from its foreign exchange revenues, receivables and payables, investments in foreign currency denominated securities and foreign currency debt. Wipro evaluates its exchange rate exposure and enters into foreign currency forward contracts to mitigate such exposure. Wipro has approved risk management policies that require it to hedge a significant portion of its exposure. Current Indian regulations do not permit Wipro to hedge the exposure on foreign currency denominated securities. Wipro's net exchange rate exposure for the years ended March 31, 2001 and 2002, was $37.5 mn and $15.5 mn, respectively.

Credit risk

In forward contracts which typically mature between one and six months, credit risk is involved. The counter parties for Wipro's exchange contracts are banks. Wipro considers the risk of non-performance by the counter parties as non-material. These forward contracts are effective hedges from an economic perspective. Wipro feels that changes in exchange rates will not have a material impact on its operating results or cash flows.

As of March 31, 2001, and 2002, Wipro had interest rate swap agreements outstanding in the notional principal amount of $3.3 mn and $Nil. The counter parties for Wipro's interest rate swaps are banks. Wipro considers the risk of non-performance by the counter parties as non-material.

Interest rate risk

Wipro's interest rate risk primarily arises from its long-term debt. Wipro adopts appropriate borrowing strategies to manage interest rate risk. Wipro also enters into interest rate swap agreements to hedge interest rate risk. The maturity profile of Wipro's debt as on March 31, 2002 is given below:

Maturing in year ending March 31:	**Total** (Rs. in millions)
2003	79
2004	28
2005	1
2006	–
Thereafter	–
Total	Rs. 108

Based on the maturity profile and composition of its debt portfolio, Wipro estimates that changes in interest rates will not have a material impact on its operating results or cash flows. Surplus cash is generally invested in short-term investments. Generally this does not expose Wipro to significant interest rate risk.

Consulting Editor, Global CEO,
Dean, ICFAI Knowledge Center.
e-mail: ved@icfai.org

Reference # 15-03-03-04