

Information and Communications Technology update Spring 2022



Sector overview

2021 has been labelled a “golden year” for the ICT industry. Covid-19 fast-tracked the digital transformation for many organisations with working environments changing almost overnight. Hybrid working suddenly became commonplace, with a need for remote access via hardware enablement and supporting software solutions such as cyber, cloud and networking.

The pandemic-hit supply chains within this sector, and all supporting verticals, have struggled to meet high levels of demand which is creating inflationary cost pressures and an increase in manufacturing/distribution lead times.

The challenges in semi-conductor procurement show no sign of easing at this stage either. Whilst countries such as the USA, India, Japan, China, South Korea, and the EU have all announced significant investment policies to increase capacity, the impact will not be immediate. As such,

disruption to the semi-conductor supply chain is forecast to run into 2023, and demand for raw materials is expected to rise by more than a third over the next four years.

Despite increased investment strategies, semi-conductor production remains vulnerable to raw material shortages. One of the major input costs of semi-conductors is neon gas, of which c.50% of the world’s supply is processed in Ukraine; two leading suppliers have had to halt current production because Russia’s invasion has driven costs up by ca 500%.

The aforementioned challenges, coupled with pandemic related shortages in shipping containers and manufacturing delays, is creating inflationary pressures in ICT hardware that both business and consumers are having to absorb. A combination of inflation and increased borrowing costs could see a cooling demand on non-essential products but it is unlikely to impact critical hardware and enterprise.

The increase in commodity, wages, energy, and support servicing input is driving costs up further with vendors now weighing up the value of low margin entry level products.

With this sector experiencing strong growth levels in 2021, and an upward trajectory in 2022, the increased M&A activity over the last two years seems astute.

With the emergence of new, critical technologies, value added distributors and resellers have been particularly busy acquiring businesses to complement their existing portfolio and enhance their service offering. We can expect to see more of this in 2022 and beyond.

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Strengths

- > **Global demand for ICT continues to be high with significant back orders reported:** This is expected to continue into 2023.
- > **The digital transformation has been fast-tracked and will create re-occurring income now businesses are “locked-in” to the infrastructure spend:** ICT is critical to all commercial businesses. Emerging technologies and a system refresh will be required every couple of years to ensure technology is fit for purpose and secure.
- > **Cyber, cloud and connectivity:** Software services such as these are expected to create an increasingly service driven industry, providing better margins and improved financial planning.

Challenges

- > **Effectively sourcing raw materials:** a key challenge expected for all verticals of ICT manufacturing processes to enable price volatility management through 2022 and beyond.
- > **Availability and cost of freight:** Remains challenging due to heightened demand and the ongoing lockdowns in China.
- > **Energy and employment costs:** Hyperinflation is expected to remain for the foreseeable across both key inputs. Many vendors put through price increases on the 1st of April to protect margins.
- > **Traditional distributors:** Those that have failed to move away from the traditional stationery and office supply markets may find their stock levels high and offering obsolete.
- > **ICT remains a working capital-intensive industry:** Inflation and interest rate increases will put pressure on bank facilities as well as increasing receivable balances for suppliers.
- > **Delays to the manufacturing process:** Delays for key components in system builds is causing liquidity pressures. Resellers and distributors need to ensure they have excellent procurement capabilities and the support of the vendors/original equipment manufacturers.
- > **ESG standards are gradually being imbedded in all businesses:** They are a key part of investors non-financial considerations and serve as vital criteria for lending suitability. ICT manufacturing has often struggled with the Environmental and Social factors due to the nature of the materials required and working conditions.

Notable Insolvencies

Insolvencies have remained very low in recent years. This is partly driven by fiscal support and the Corporate Insolvency & Governance Act (2020) implemented by the UK Government, but also the sector remaining buoyant in the face of the pandemic. Despite this, we are seeing an increase in the number of disputes and overdue notifications reported in this sector, driven by supply chain difficulties and slow payments from end users.

Economic Data

- > **UK Consumer Price Index rose 7% in March 2022, up from 6.2% in February 2022:** The highest contributing factor to these inflationary pressures are from housing and housing services; principally electricity, gas, and transport costs. On a monthly basis the UK saw CPI increase 1.1% in March 2022, compared to a 0.3% increase in March 2021. UK Central Bank attempted to control inflation with a further base rate increase of 0.25% in March 2022 to 0.75%.
- > **Freight rates have cooled somewhat in 2022 following the exceptional price increases in H2 2021:** 2021 saw increased demand for consumer goods following the pandemic. 60% of global goods are shipped by container, and any delays to this mode of transportation, such as lockdowns, staff and container shortages, or instances such as the blocking of the Suez Canal, have major price consequences on spot rates.
- > **Gartner anticipate ICT services spending is set to grow between 8% and 9% in the next 2 years, compared to pre-covid growth of 4-6%:** This will be driven by digital services such as AI, cloud, and security, though all verticals are expected to perform strongly.
- > **ICT spend was reported to have grown 10% in 2021 and forecast to grow 6% in 2022:** This remains ahead of global GDP growth forecasts of 4.3%. Growth is anticipated to move towards cloud services and enterprise spending.

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Underwriting Approach

QBE is underwriting on a positive basis and looking to support clients with high demand and increasing credit lines. Management information is always key, in particular cash flow forecasts to ascertain how a business is managing inflationary pressures and/or delays in procurement.

The ICT industry utilises supply chain finance and invoice discounting to fund the intense working capital churn. With increasing prices, facility headroom will start to tighten without the support of the banks and is an area we pay close attention to.

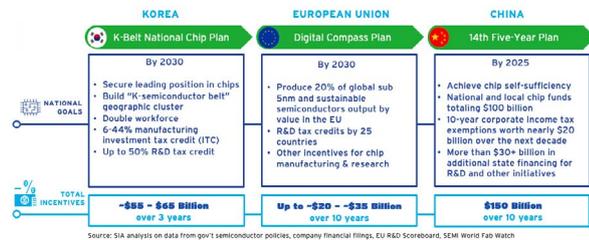
Figure 1: Annual CPIH inflation rate highest since March 1992

CPIH, OOH component and CPI 12-month inflation rates for the last 10 years, UK, February 2012 to February 2022



SOURCE - <https://www.ons.gov.uk/economy/inflationandpriceindices/bulletins/consumerpriceinflation/february2022>

Key Governmental Semiconductor Policy



SOURCE - <https://www.semiconductors.org/global-governments-ramp-up-pace-of-chip-investments/>

Global IT Growth Forecasts

	2020	2021e	2022e
Macro			
Global GDP Growth	(3.3%)	5.7%	4.2%
--U.S. GDP Growth	(3.4%)	5.5%	3.9%
--Eurozone GDP Growth	(6.5%)	5.1%	4.4%
--China GDP Growth	2.3%	8.0%	4.9%
Global IT Spending	3.0%	10.5%	6.3%
Revenues			
IT Services	2%	8%	7%
Software	9%	13%	11%
Semiconductors	7%	26%	9%
Network Equipment	(3%)	2%	5%
Mobile Telecom Equip	5%	12%	3%
External Storage	(4%)	6%	5%
Shipments			
PC	13%	15%	2%
Smartphone	(7%)	4%	1%
Server	3%	6%	5%
Printer	0%	(5%)	3%

e - Estimate. Source - S&P Global Ratings.

Contacts

Karl McKiernan
 Senior Underwriter: UK and Middle Eastern Markets
 Credit & Surety Europe
 QBE European Operations
 Direct: +44 (0)20 7105 4227
 Mobile: +44 (0)7557 316 546
 Email: karl.mckiernan@uk.qbe.com

QBE European Operations

30 Fenchurch Street
 London EC3M 3BD
 tel +44 (0)20 7105 4000
QBEurope.com



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