IT Sector

UPGRADE

STPI tax sops sweeten sector prospects; upgrade to Neutral

NEUTRAL

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Recommendation snapshot

(Rs)	CMP	Earlier	Revised	Reco
Infosys	1,664	1,440	1,664	Hold
TCS	882	851	987	Hold
Wipro	458	370	432	Sell
Satyam	443	435	501	Buy
Tech Mah	814	827	952	Hold
MindTree	463	450	517	Buy

Source: Religare Research

The government has decided to extend the tax benefits available to STPI units by a year to March 2010. Had the benefits been allowed to expire in March 2009, as scheduled, IT services companies would have witnessed a significant rise in effective tax rates from FY10 onwards. The extension of tax breaks would provide a boost to earnings in FY10 and thus enhance the growth rates of companies in the sector.

We are increasing our earnings estimates for the companies under our coverage by 4–6% to factor in a lower effective tax rate regime. With the improved growth prospects, we are also raising our target P/E multiples for individual stocks. Consequently, the target prices and recommendations of our IT universe coverage also stand revised.

Over the past one month, investor sentiment towards the IT sector has witnessed a material change. In our opinion, the three concerns on the US demand environment, STPI tax expiry, and rupee appreciation fronts have been allayed to a great extent. We thus upgrade our view on the sector from Negative to Neutral.

Extension of Section 10A/10B benefits by one year

The finance minister has announced that the STPI tax benefits available to software companies will be extended by one year to March 2010. This is major sentiment booster for IT stocks as it would lower the effective tax rates in FY10. In the absence of the extension, the effective tax rates of software players were expected to rise by 5–8% from FY10.

Investor sentiment towards IT witnessing a positive shift

STPI extension cranks up investor sentiment even as other growth concerns ebb

The IT sector has witnessed a positive shift in investor sentiment over the last one month. Growth concerns, which were expected to worsen, have been allayed by various developments during this period as shown in the chart below.

Concerns	Earlier	Now
Demand concerns over US slowdown	❖ Management would be ultra-conservative while giving FY09 guidance. ❖ Repeat of 2001 was feared	❖ FY09 guidance suggests management confident of reasonable growth. ❖ However, growth to be back-ended in H2FY09
Appreciating rupee	❖ Sharp rupee appreciation was expected due to strong capital inflows	❖ Moderation of capital inflows and monetary policy measures have kept rupee stable in YTD
Rise in tax rates post-FY09	❖ Earnings growth rates were expected to slow down considerably due to expiry of STPI benefits	❖ With extension of tax benefits by a year, earnings growth visibility has improved

Positive management guidance provides vital support to sentiments

We upgrade our sector view to Neutral

Though the demand concerns arising from a slowing US economy have not died down completely, we believe that the positive management guidance provides a vital support to sentiments. Also, though we have assumed a stronger rupee in our estimates, a slower rate of appreciation would allow companies to restrict the impact on margins. With risks to growth easing off to a great extent, we upgrade our sector view from Negative to Neutral.

Earnings estimates raised 4–6% for our IT universe

Estimates for our universe coverage revised for FY10…

Post-extension of the STPI benefits, we are increasing our earnings estimates for the companies under our coverage by 4–6%.

Revised EPS estimates for FY10E

(Rs)	Earlier	Revised	Change (%)
Infosys	101.6	106.7	5.0
TCS	63.9	67.4	5.4
Wipro	28.2	29.9	6.0
Satyam	34.6	36.2	4.6
Tech Mahindra	67.9	71.0	4.6
MindTree	38.1	39.8	4.3

Source: Religare Research

Target P/E multiples raised 10–15%

…and modifying target prices and recommendations

Also, with the stronger compounded growth rates expected over FY08-FY10, we are raising our target P/E multiples for these stocks by 10–15%. With the change in target multiples and the earnings revision, our target prices for these stocks stands revised, as shown in the table below.

Revised target prices and recommendations

(Rs)	CMP	Earlier	Revised	Change (%)	Earlier	Revised	Upgrade / Downgrade
Infosys	1,664	1,440	1,664	15.5	Hold	Hold	-
TCS	882	851	987	16.0	Sell	Hold	Upgrade
Wipro	458	370	432	16.7	Sell	Sell	-
Satyam	443	435	501	15.1	Hold	Buy	Upgrade
Tech Mahindra	814	827	952	15.1	Hold	Hold	-
MindTree	463	450	517	14.8	Buy	Buy	-

Source: Religare Research

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Recommendation parameters

Large-caps*	> 10%	< - 5%	Absolute Returns
	BUY	SELL	
Mid-caps**	> 25%	< 10%	

**Market cap over US$ 1bn **Market cap less than US$ 1bn*

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Analyst’s holding in the stocks mentioned in the report: NIL.