

MARCH 01, 2010

UPDATE

BSE-30: 16,430

Service tax on under-construction projects creates uncertainty. The imposition of a service tax on the buying of under-construction property will likely result in an additional cost of up to 3.3%, which we believe would be shared equally by the builder and buyer. Budget documents indicate that government intends to recognize 'construction activity' as a service provided by the developer to the buyer. We believe the imposition of service tax will be debated extensively and full clarity on the proposal will likely emerge in a couple of months.

Under-construction property to attract service tax

Finance bill has inserted a clarification which makes under-construction activity of real estate projects a taxable service. The Finance Bill says that unless the entire consideration of the property is paid, after the completion of construction that is after the receipt of completion certificate from the competent authority, the "activity of construction would be deemed to be a taxable service" provided by the builder or promoter or developer to the prospective buyer and the service tax would be charged accordingly.

The service tax is applicable for (1) construction of complex service under sub clause (zzzh) and (2) construction of 'commercial or industrial construction service under sub clause (zzq). 'Construction of complex' means construction of a new residential complex (with more than 12 units) or completion and finishing services in relation to a residential complex.

Provision for abatement likely limits maximum impact to 3.3%

The government is signaling that it wants to classify 'construction of property' as a service. Though the service tax is 10.3%, we highlight the net impact will be lower as there will be likely abatement of 67% for services provided in the construction of residential complexes as per notification No. 18/2005 –ST dated 7/6/05. Abatement can be taken under the Cenvat Credit Rules, 2004, in which the service provider can take credit of excise duty paid on material cost, namely, the cost of cement, steel, fittings and fixtures, tiles etc.

What is the value of the service? This would be gross amount charged by the service provider for providing such service and the money value of any other consideration (if any) received for providing such service. Hence, we believe the service tax will be imposed on the selling price of the flat/unit.

An abatement of 67% means that service tax will be payable only on 33% of the gross amount of the sale value of the unit. A 10.3% service tax on 33% of the gross amount of the sale value would imply an additional cost of 3.3% for the unit.

Clarity to emerge post the discussion in the parliament—uncertainty may delay demand

We estimate that the maximum impact of the service tax will likely be 3.3% of the selling price, which we believe will be shared by the developer and buyer to minimize the impact borne by each entity. Such a scenario would result in NAVs getting impacted by 3-4%. However, as developers start explicitly charging service tax, we expect resistance by the buyers considering large financial quantum involved. Uncertainty with respect to service tax may delay purchase decisions impacting revival in residential demand and this will be more detrimental than imposition of service tax itself. Imposition of service tax (levied by Central govt) along with stamp duty (levied by the State government) results in multiplicity of taxes and has the possibility of increasing the cash transactions in the system to avoid the incidence of these taxes.

QUICK NUMBERS

- NAVs could be impacted by 3-4% if service tax is shared equally
- Large tax savings for personal income in Rs0.5-1 mn to increase affordability

Puneet Jain
puneet.j@kotak.com
Mumbai: +91-22-6634-1255

Sandeep Reddy
sandeep.reddy@kotak.com
Mumbai: +91-22-6634-1216

Shubham Satyarth
shubham.satyarth@kotak.com
Mumbai: +91-22-6634-1320

Kotak Institutional Equities Research
kotak.research@kotak.com
Mumbai: +91-22-6634-1100

However, we believe clarity on the subject of service tax on 'under-construction property' will emerge over a period of couple of months as the Finance Bill will have to be passed by the legislature. We also highlight that our discussions with developers indicate that there will be a strong opposition to the service tax imposition from the builders lobby and buyers as well.

Other key changes for the real estate sector

- ▶ **The Budget allowed projects started before March 31, 2008, to be completed within five years instead of four for claiming deduction of their profits.** These would be applicable for projects which have started post March 2005. This will be a positive for developers whose projects are under construction and may have got delayed by the weak economic environment in FY2009.
- ▶ **Interest rate subvention on a housing loan up to Rs1 mn** where the house price is up to Rs2 mn has been extended to March 31, 2011.
- ▶ **Increased focus on slum rehabilitation.** Increased allocation to Rajiv Awas Yojana (RAY) for slum dwellers and urban poor to provide property rights to slum dwellers. The government has proposed allocating Rs12.7 bn for this purpose in FY2011E as compared to Rs1.5 bn in FY2010. This is positive for developers since it opens up an avenue for growth as more slum rehabilitation projects will come up for bidding.
- ▶ **Service tax of 10.3% will be levied on facilities** like (1) prime/preferential location charges for allotting a flat/commercial space according to the choice of the buyer (i.e. direction- sea facing, park facing, corner flat; floor- first floor, top floor) and (2) internal or external development charges which are collected for developing/ maintaining parks, laying of sewerage and water pipelines, providing access roads and common lighting etc; (3) fire-fighting installation charges; and (4) power back up charges etc.

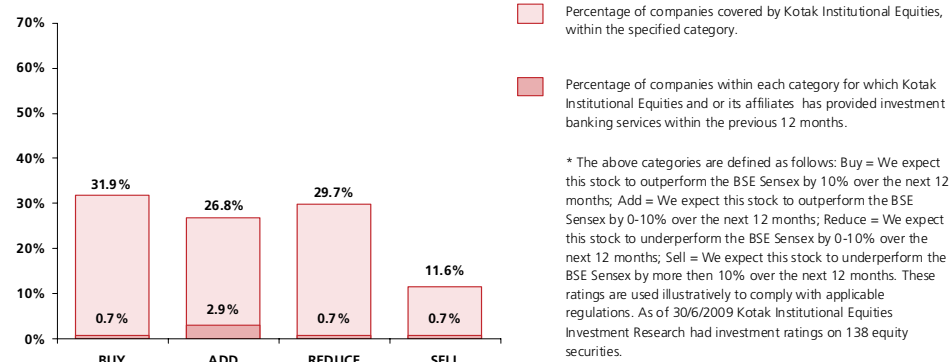
The cost of these facilities are in the range of 5-6% of the total cost of the flat/unit, which would mean an additional cost of ~0.5% due to imposition of service tax. However, we note that charges for car parking have been specifically excluded from the scope of service tax. We note that developers could avoid paying service tax by quoting a separate rate for each unit rather than charging for the above-mentioned things separately.

- ▶ **Increase in MAT to 18% from 15%.** This will be slightly negative for the developers since there will be higher incidence of tax but most developers have already completed their projects which gave them tax benefits under Sec 80IB and are moving to a full tax regime.
- ▶ **The Budget announced a tax savings of Rs20,000 for those annual incomes up to Rs0.5 mn and up to Rs50,000 for those earning up to Rs0.8 mn.** Additional resulting savings would translate to into better affordability for purchasing houses and also could partly mitigate increased costs due to service tax imposition.

"I, Puneet Jain, hereby certify that all of the views expressed in this report accurately reflect my personal views about the subject company or companies and its or their securities. I also certify that no part of my compensation was, is or will be, directly or indirectly, related to the specific recommendations or views expressed in this report."

Kotak Institutional Equities Research coverage universe

Distribution of ratings/investment banking relationships



Source: Kotak Institutional Equities

As of June 30, 2009

Ratings and other definitions/identifiers

Definitions of ratings

BUY. We expect this stock to outperform the BSE Sensex by 10% over the next 12 months.

ADD. We expect this stock to outperform the BSE Sensex by 0-10% over the next 12 months.

REDUCE. We expect this stock to underperform the BSE Sensex by 0-10% over the next 12 months.

SELL. We expect this stock to underperform the BSE Sensex by more than 10% over the next 12 months.

Our target price are also on 12-month horizon basis.

Other definitions

Coverage view. The coverage view represents each analyst's overall fundamental outlook on the Sector. The coverage view will consist of one of the following designations: **Attractive, Neutral, Cautious.**

Other ratings/identifiers

NR = Not Rated. The investment rating and target price, if any, have been suspended temporarily. Such suspension is in compliance with applicable regulation(s) and/or Kotak Securities policies in circumstances when Kotak Securities or its affiliates is acting in an advisory capacity in a merger or strategic transaction involving this company and in certain other circumstances.

CS = Coverage Suspended. Kotak Securities has suspended coverage of this company.

NC = Not Covered. Kotak Securities does not cover this company.

RS = Rating Suspended. Kotak Securities Research has suspended the investment rating and price target, if any, for this stock, because there is not a sufficient fundamental basis for determining an investment rating or target. The previous investment rating and price target, if any, are no longer in effect for this stock and should not be relied upon.

NA = Not Available or Not Applicable. The information is not available for display or is not applicable.

NM = Not Meaningful. The information is not meaningful and is therefore excluded.

Corporate Office

Kotak Securities Ltd.
Bakhtawar, 1st Floor
229, Nariman Point
Mumbai 400 021, India
Tel: +91-22-6634-1100

Overseas Offices

Kotak Mahindra (UK) Ltd
6th Floor, Portsoken House
155-157 The Minories
London EC 3N 1 LS
Tel: +44-20-7977-6900 / 6940

Kotak Mahindra Inc
50 Main Street, Suite No.310
Westchester Financial Centre
White Plains, New York 10606
Tel:+1-914-997-6120

Copyright 2010 Kotak Institutional Equities (Kotak Securities Limited). All rights reserved.

Kotak Securities Limited and its affiliates are a full-service, integrated investment banking, investment management, brokerage and financing group. We along with our affiliates are leading underwriter of securities and participants in virtually all securities trading markets in India. We and our affiliates have investment banking and other business relationships with a significant percentage of the companies covered by our Investment Research Department. Our research professionals provide important input into our investment banking and other business selection processes. Investors should assume that Kotak Securities Limited and/or its affiliates are seeking or will seek investment banking or other business from the company or companies that are the subject of this material and that the research professionals who were involved in preparing this material may participate in the solicitation of such business. Our research professionals are paid in part based on the profitability of Kotak Securities Limited, which include earnings from investment banking and other business. Kotak Securities Limited generally prohibits its analysts, persons reporting to analysts, and members of their households from maintaining a financial interest in the securities or derivatives of any companies that the analysts cover. Additionally, Kotak Securities Limited generally prohibits its analysts and persons reporting to analysts from serving as an officer, director, or advisory board member of any companies that the analysts cover. Our salespeople, traders, and other professionals may provide oral or written market commentary or trading strategies to our clients that reflect opinions that are contrary to the opinions expressed herein, and our proprietary trading and investing businesses may make investment decisions that are inconsistent with the recommendations expressed herein. In reviewing these materials, you should be aware that any or all of the foregoing, among other things, may give rise to real or potential conflicts of interest. Additionally, other important information regarding our relationships with the company or companies that are the subject of this material is provided herein.

This material should not be construed as an offer to sell or the solicitation of an offer to buy any security in any jurisdiction where such an offer or solicitation would be illegal. We are not soliciting any action based on this material. It is for the general information of clients of Kotak Securities Limited. It does not constitute a personal recommendation or take into account the particular investment objectives, financial situations, or needs of individual clients. Before acting on any advice or recommendation in this material, clients should consider whether it is suitable for their particular circumstances and, if necessary, seek professional advice. The price and value of the investments referred to in this material and the income from them may go down as well as up, and investors may realize losses on any investments. Past performance is not a guide for future performance, future returns are not guaranteed and a loss of original capital may occur. Kotak Securities Limited does not provide tax advice to its clients, and all investors are strongly advised to consult with their tax advisers regarding any potential investment.

Certain transactions -including those involving futures, options, and other derivatives as well as non-investment-grade securities - give rise to substantial risk and are not suitable for all investors. The material is based on information that we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied on as such. Opinions expressed are our current opinions as of the date appearing on this material only. We endeavor to update on a reasonable basis the information discussed in this material, but regulatory, compliance, or other reasons may prevent us from doing so. We and our affiliates, officers, directors, and employees, including persons involved in the preparation or issuance of this material, may from time to time have "long" or "short" positions in, act as principal in, and buy or sell the securities or derivatives thereof of companies mentioned herein. For the purpose of calculating whether Kotak Securities Limited and its affiliates holds beneficially owns or controls, including the right to vote for directors, 1% of more of the equity shares of the subject issuer of a research report, the holdings does not include accounts managed by Kotak Mahindra Mutual Fund. Kotak Securities Limited and its non US affiliates may, to the extent permissible under applicable laws, have acted on or used this research to the extent that it relates to non US issuers, prior to or immediately following its publication. Foreign currency denominated securities are subject to fluctuations in exchange rates that could have an adverse effect on the value or price of or income derived from the investment. In addition, investors in securities such as ADRs, the value of which are influenced by foreign currencies affectively assume currency risk. In addition options involve risks and are not suitable for all investors. Please ensure that you have read and understood the current derivatives risk disclosure document before entering into any derivative transactions.

This report has not been prepared by Kotak Mahindra Inc. (KMInc). However KMInc has reviewed the report and, in so far as it includes current or historical information, it is believed to be reliable, although its accuracy and completeness cannot be guaranteed. Any reference to Kotak Securities Limited shall also be deemed to mean and include Kotak Mahindra Inc.