Union Budget 2010

The Great Indian Balancing Act

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Union Budget 2010: The great Indian balancing act

- The government is currently facing the classical dilemma of choosing between supporting growth and ensuring fiscal discipline – striking the balance is the key
- We do not expect any aggressive across-the-board roll-back of the fiscal stimulus
- However, there can be selective hikes in excise duties by 2-4% for certain sectors (eg, automobiles, cement, FMCG etc)
- Social sector programmes, benefits for exporters, and support for SMEs will continue
- Amidst infra-spending by the government, roads, power and rural electrification will continue enjoying prominence
- We do not expect any major change for most taxes, especially as both Goods and Service Tax (GST) and the new Direct Tax Code (DTC) are to be implemented in the near future
- However, we do not rule out imposition of a temporary tax/cess to fund government's large and persisting social sector spending
- The current budget may announce a roadmap (timeframe, tax rates etc) for implementation of the new DTC and GST
- We expect disinvestments of ~INR 300-400 bn in FY11 – Coal India, Hindustan Copper, SAIL, BSNL etc are some of the prominent disinvestment candidates
- Despite no aggressive fiscal tightening, fiscal health is set to improve on higher tax collections and disinvestment proceeds. We project centre's gross fiscal deficit (GFD) to be ~5.8% of GDP in FY11
- Net borrowing by the Centre, in that case, will be within INR 4 tn
- Government's budget projections can be a notch more aggressive. We think, the government will set the budget estimate for GFD at ~5.5%

Macro backdrop – The dilemma of growth revival versus fiscal prudence

Macro environment demands a delicate balance

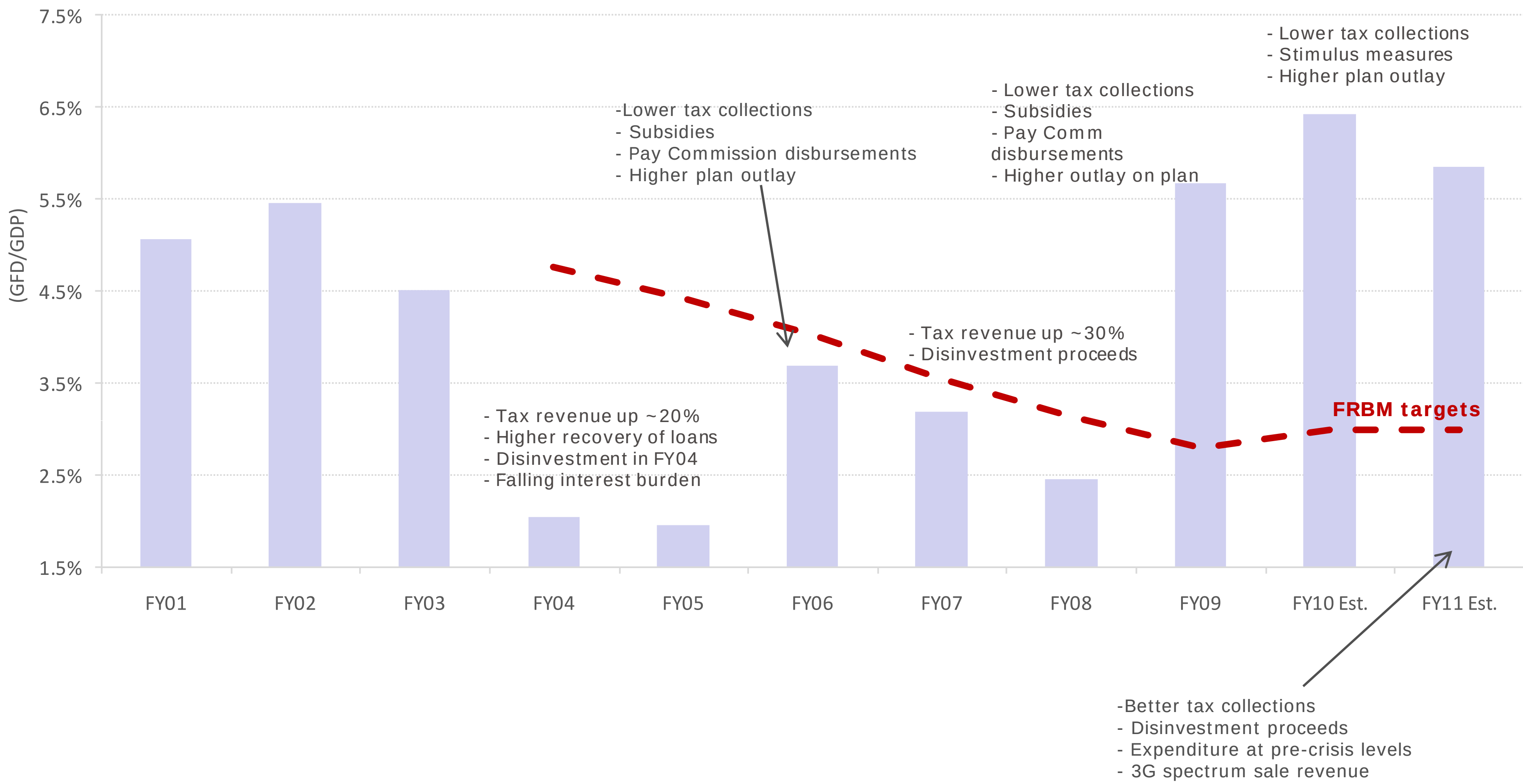
- The government, today, is facing the big dilemma – whether to keep supporting growth revival (with all the stimulus measures/sops) or to start unwinding some of them so as to bring fiscal discipline back

- We do not expect this budget to be a big-bang one in either direction:
  - The government cannot withdraw support for the economy aggressively as recovery is only at an early stage and policymakers can, by no means, afford over-tightening
  - At the same time, fiscal rectitude cannot be altogether ignored. Otherwise large deficits and government borrowings will eventually start putting pressure on interest rates – which could be counterproductive for growth over the medium-term

- The current global situation also stands at crossroads:
  - On one hand, most countries – both developed and developing – are still supporting growth revival at the cost of fiscal health. India's fiscal situation, though stretched, is relatively better compared with several countries
  - On the other hand, recent default-like situations in countries like Greece, Spain and Portugal is acting as a warning, especially for the developing economies

- Overall, we do not expect any aggressive roll-back of the stimulus measures. Nevertheless, FY11 can be the starting point of a slow but steady fiscal consolidation largely on the back of rising tax revenues and significant disinvestment proceeds

Fiscal deficit surged since FY09 ...



Source: Budget documents, CMIE, Edelweiss research

… hit by a sudden slowdown in revenue and …

(INR bn)	FY07 (A)	FY08 (A)	FY09 (RE)	FY10 (BE)
Total receipts	**5,789**	**7,398**	**8,710**	**10,240**
Gross tax revenue	**4,735**	**5,931**	**6,279**	**6,411**
Major gross tax heads				
Income tax	751	1,026	1,226	1,129
Corporate tax	1,443	1,929	2,220	2,567
Custom duties	863	1,041	1,080	980
Excise duties	1,176	1,236	1,084	1,065
Service tax receipt	376	513	650	650
Non-tax revenue	**832**	**1023**	**962**	**1403**
Major non-tax heads				
Interest receipt	225	211	190	192
Dividend and profits receipts	293	345	397	498

A: Actual; RE: Revised estimate; BE: Budget estimate

Source: Budget documents, Edelweiss research

- Revenue under income tax decelerated significantly with the slowing economy since FY09. Government's own budget estimate factored in a fall in income tax revenue in FY10. The final outcome may, however, escape a decline during the year
- Corporate tax collection decelerated to ~15% during FY09-10 from the average annual growth of over 30% during the previous six years
- Indirect tax collections had also fallen during FY09-10, reflecting sharp reduction in excise and custom duties apart from slowing economic activities

... surging expenditure

- Expenditure on central plan increased sharply in FY09 and FY10 on the back of increased spending on rural development, urban renewal programs and towards increased assistance to state and UTs to finance their plan outlays. FY09 growth at ~42% was much above the average level of ~17% seen in FY01-FY08
- Subsidies witnessed a sharp rise (over 80%) in FY09 on account of higher oil and fertiliser prices. However, it declined ~14% in FY10 on the back of lower commodity prices
- Interest payments and defence expenditure continued on their rising trajectory

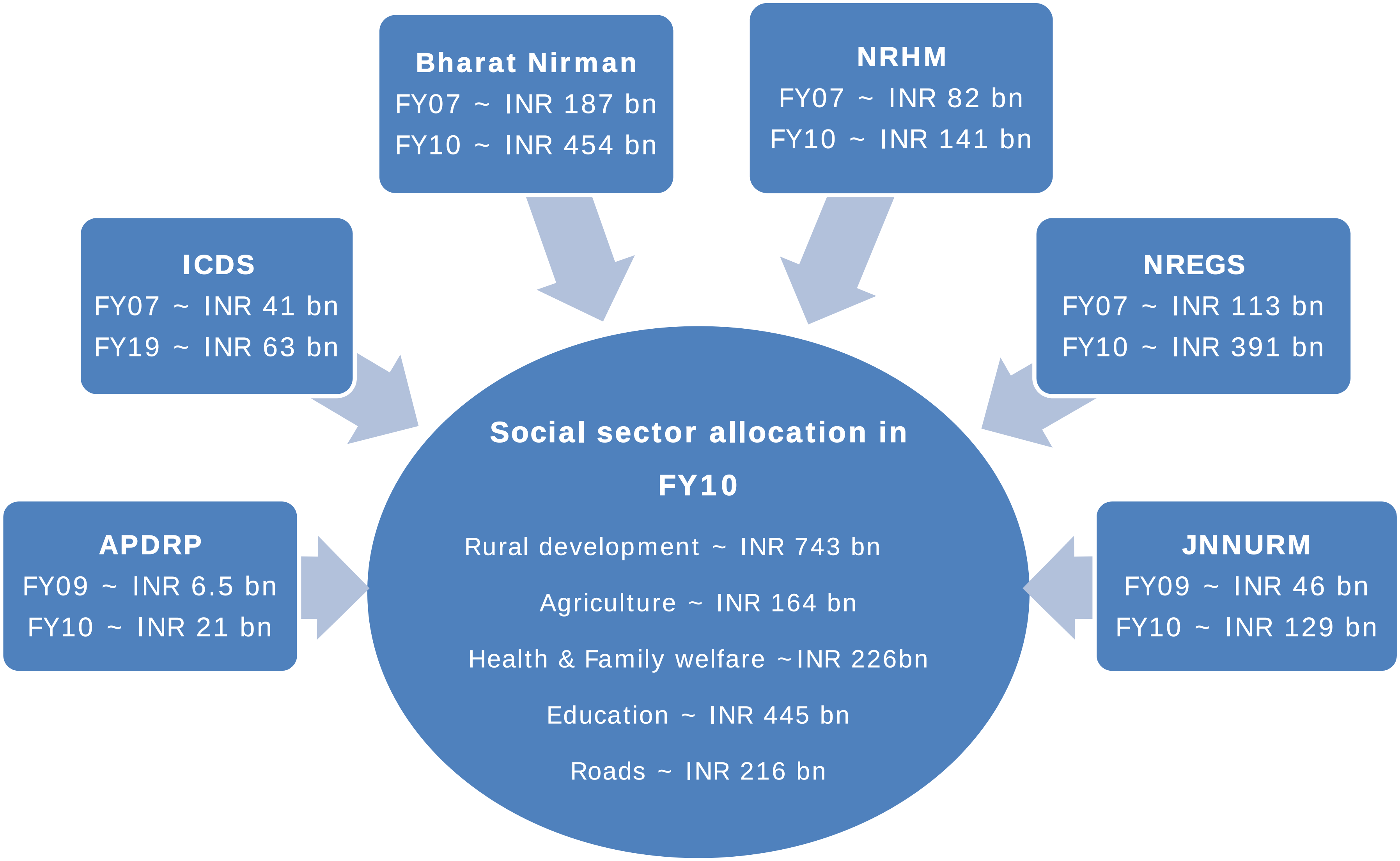
(INR bn)	FY07 (A)	FY08 (A)	FY09 (RE)	FY10 (BE)
Total expenditure	**5,834**	**7,127**	**9,010**	**10,208**
Revenue expenditure	**5,146**	**5,944**	**8,034**	**8,972**
Capital expenditure	**688**	**1,182**	**975**	**1,236**
Major expenditure heads				
Expenditure on central plan outlay*	1,243	1,435	2,041	2,398
Defence - rev and capital	855	917	1,146	1,417
Interest payments	1,503	1,710	1,927	2,255
Subsidies	571	709	1,292	1,113
Pensions	221	243	327	350
Grants to states and UTs	357	358	384	486

A: Actual; RE: Revised estimate; BE: Budget estimate

**Social services, agriculture, rural development, special area programs, energy, industry and minerals, transport, grants-in-aid to central governments.*

Source: Budget documents, Edelweiss research

Enhanced social sector spending cushioned the economy ….



NHRM: National Rural Health Mission, NREGS: National Rural Employment Guarantee Scheme, JNNURM: Jawaharlal Nehru National Urban Rural Mission, ICDS: Integrated Child Development Scheme, APDRP: Accelerated Power Development and Reform Programme

Source: Budget documents, Edelweiss research

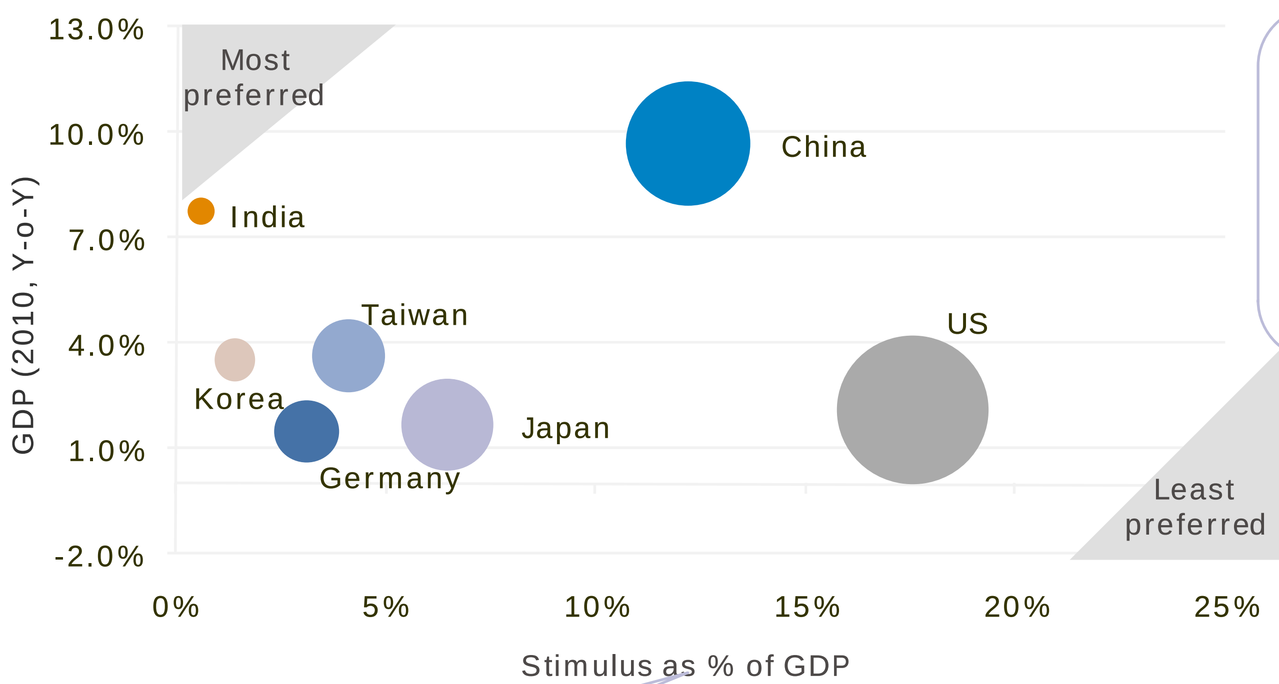
Note: All numbers for FY10 are as per Budget Estimates

.... along with several other direct or indirect stimulus measures

- Excise duty reduction from 12-14% to a mean rate of 8%
- Across the board cut of 4% in CENVAT rate (except for petro products)
- Service tax reduction from 12% to 10%
- Disbursement of 6th Pay Commission arrears
- Increase in market borrowing limits for states
- Recapitalisation of state-run banks to the tune of INR 200 bn over a period of two years to ensure that the banking system does not suffer from capital adequacy constraints
- Creation of a special financing entity to provide liquidity support against investment grade paper to NBFCs
- Authorising IIFCL to raise INR 100 bn via tax-free bonds to refinance bank lending for infra projects
- Credit cover to SMEs on loans extended to INR 10 mn with a guarantee cover of 50% and for credit facility up to INR 0.5 mn raised to 85%

Source: GoI, Edelweiss research

Still, India's stimulus was far lower than peers ....



India's stimulus package accounted for less than 1% of the GDP. Countries such as China and US announced packages worth 10% or more of their respective GDPs

India's stimulus package was broad-based, and was not spent for bail-out of any particular industry or sector

India is least exposed to a stimulus roll back. A large chunk of stimulus packages is in fact at the grass roots level of the economy—MSPs, NREGS, etc., which are in place to generate rural employment—and gels well with the government's priority of "inclusive growth"

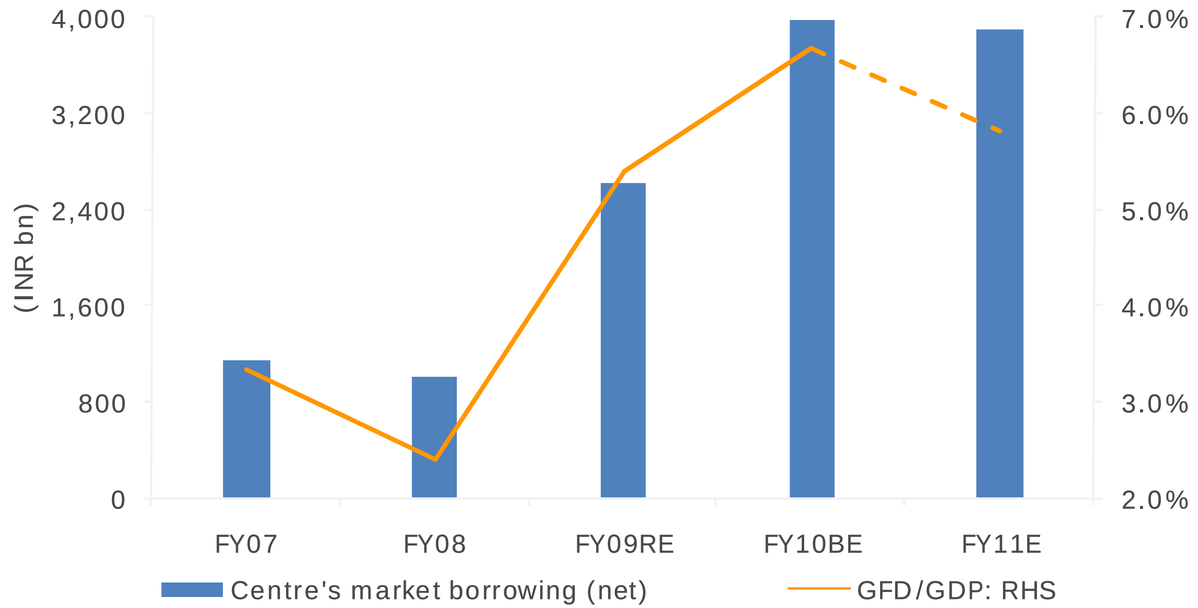
Source: Federal reserve, Bloomberg, IMF, Edelweiss research

Note: Size of bubbles indicate relative size of stimulus

… and roll-back of the same to remain selective and gradual

Stimulus measures – Direct or indirect	Likely trends in FY11
Enhanced spending on critical rural infrastructure and social security schemes – eg, NREGS, *Bharat Nirman*	Unlikely to be reduced given government's commitment towards inclusive growth
Payment of arrears under 6th Pay Commission	Irreversible measure – No scope of roll-back. However, no fresh arrear disbursement by the Central government; can be there from state and local governments
Support to promote exports and SMEs	No near-term rollback as export recovery is still in nascent stage
Enhancement of Minimum Support Prices (MSPs) of agro-products	Agro-MSPs almost never come down in India – too sensitive from a political standpoint also
Waiving agriculture loans	One-time measure – no scope of a roll-back
Excise duty reduction from 12-14% to a mean rate of 8%	Rollback possible; but, likely to be selective and gradual
Service tax reduction from 12% to 10%	Rollback not likely to be immediate and maybe linked to the implementation of GST

Fiscal health, however, set to improve in FY11 on stronger revenue



RE: Revised estimate; BE: Budget estimate

Source: GoI, CMIE, Edelweiss research

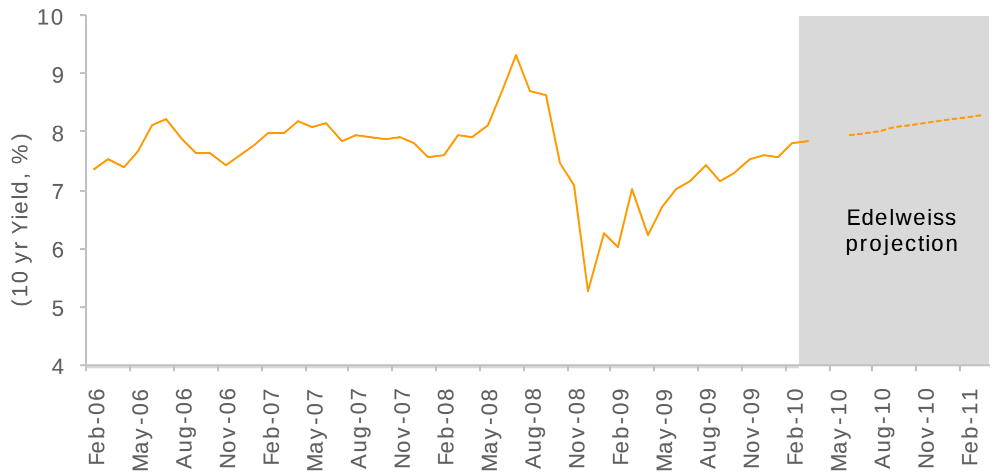
FY10 – What went by …

- Disinvestment revenue ~ INR 286 bn – much higher than budget estimates
- Direct tax revenue collection target hiked by ~INR 300 bn
- Higher outlay on social sectors, pay commission arrears and other stimulus measures, against which revenue receipts remained dampened
- Centre's borrowing (net) was at a all time high of ~INR 4 tn

FY11 – What is in store …

- Higher revenue collections resulting from strong pick-up in economic activity
- Disinvestment proceeds, at ~INR 350 bn, higher than FY10
- Additional revenue of ~INR 250 bn from 3G auction sale
- No further payout of arrears as per 6th Pay Commission recommendations
- Expenditure to remain high on social programs
- Centre's borrowing (net) to stay close to ~INR 3.9 tn

Interest rates not to go out of hand



Source: Bloomberg, Edelweiss research

- As net borrowings of the government remains at an elevated level and credit growth is set to pick up in FY11, there will be constant pressure on the overall interest rate spectrum. Having said that, we do not expect the 10 year yield to shoot up and sustain beyond the range of ~8.20-8.40%. In our view, there will be significant buying support at those levels. We also expect steady capital flows for India during the next fiscal, which will also be a cushion for domestic liquidity
- The current round of inflation has been driven by a surge in food and other primary article prices driven by supply constraints. We expect this trend to buckle down next quarter onwards and inflation (WPI) to settle at ~6% by Q2FY11
- We factor in slow but steady hike in the repo and reverse repo rates by RBI Q1FY11 onwards. However, the current 10-year yield have largely priced in such hikes. Shorter-end of the yield curve is likely to react more due to RBI tightening turning the yield curve flatter
- Interest rates on bank lending too will face upward pressures. But, we do not expect lending rates to increase by more than 50-75 bps across the spectrum during FY11, especially against the backdrop of steady capital flows and new RBI norms on base rate

Unforeseen surge in subsidies, however, remains a key risk

	(INR bn)	FY07	FY08	FY09 (RE)	FY10 (BE)
A	**Major subsidies**	**535**	**675**	**1227**	**1060**
1	Food	240	313	436	525
2	Indigenous (Urea) fertiliser	127	130	165	98
3	Imported (Urea) fertiliser	33	66	110	59
4	Sale of decontrolled fertiliser with concession	103	129	484	343
	Total fertillizer subsidy	**262**	**325**	**758**	**500**
5	Petroleum subsidy	27	28	29	31
6	Grants to NAFED for MIS/PPS	6	9	4	4
B	**Other subsidies**	**36**	**34**	**65**	**53**
7	Import/Export of sugar edible oils etc	0	0	5	2
8	Interest subsidies	28	23	41	26
9	Other subsidies	8	11	19	25
	Total subsidies	**571**	**709**	**1292**	**1113**
C	**Off-budgetary liabiliites**				
1	Securities issued to oil companies	241	206	759	103
2	Securities issued to Food Corporation of India	162	-	-	-
3	Securities issued to fertilizer companies	-	75	200	-
4	Asset management Trust for SASF of IDBI	-	-	-	-

RE: Revised estimate; BE: Budget estimate *Source: Budget documents, Edelweiss research*

- For long, subsidies have been a bane on government finances – inflating the fiscal deficit number
- Moreover, a large number of off-budget expenditure remained ‘hidden’ but continue to weigh negatively on fiscal health
- In the event of high volatility in commodity (especially crude oil and food) prices in the global markets, the government may have to shrug off a part of the gain in its fiscal health by way of such subsidies and off-balance sheet expenses

Roadmap for reforms

Direct Tax Code roadmap to receive mixed reaction

- The overhaul of the DTC is likely to be effective from FY12 onwards. Accordingly, we do not expect any major tweaking in the direct tax rates (both corporate and individual) in the current budget. However, government may lay down the roadmap for implementation of the DTC
- The DTC roadmap is likely to receive mixed reaction. While corporate tax rate will become lower, MAT paying companies will be adversely affected
- There can be a negative reaction if the long-term capital gain (LTCG) exemption is scrapped as currently proposed by the DTC
- For individuals, taxation of instruments on maturity will be viewed as negative

	Edelweiss expectation	Impact
Corporates (Corporate tax rate @ 25%) (MAT @2% of gross assets for non banks) (Capital gains tax @ 25%)	While any major tinkering is not expected, government may lay down a roadmap of implementation	The new DTC will be effective only from FY12 - so no direct impact; but, can have sentimental effect. Reduction of the corporate tax rate to 25% will be beneficial to select companies, which are currently paying higher effective tax. New MAT structure for non-banks may weigh negatively on infra companies
Individual (Proposed income slab for marginal rates to increase) (Taxation of instruments on maturity) (Removal of tax benefit on interest paid on housing loan)	Roadmap for implementation likely to be laid down	Some clauses may be viewed positively (such as increasing income slab for marginal rates). Taxation of instruments on maturity will be a negative

DTC not to offer much of a cheer for capital markets

	Edelweiss expectation	Impact
Taxation of long-term capital gains	It is possible that the roadmap for DTC implementation will mention removal of the special tax treatment for long-term capital gains (LTCG)	This will make income from LTCG also taxable at the marginal tax rate applicable for individuals/corporates. Such an announcement will, thus, weigh negatively on the markets
Securities Transaction Tax (STT)	There are two distinct camps at the moment on this issue. One group believes that the government will consider scrapping STT in order to boost the equity markets, especially given the strong primary market activity queued up in FY11. The other camp believes that when the government is already under pressure for the elevated level of deficits, it is unlikely to sacrifice the revenue of ~ INR 80-90 bn from this source	Given the pressure on government due to the high deficits, chances are less that the STT will be scrapped. However, in case of such an event, there will be a distinct boost to market sentiment
Dividend Distribution Tax (DDT)	Currently the effective DDT is ~17%. There is a possibility that this rate will be brought down to ~15%	It will be a just a marginal positive

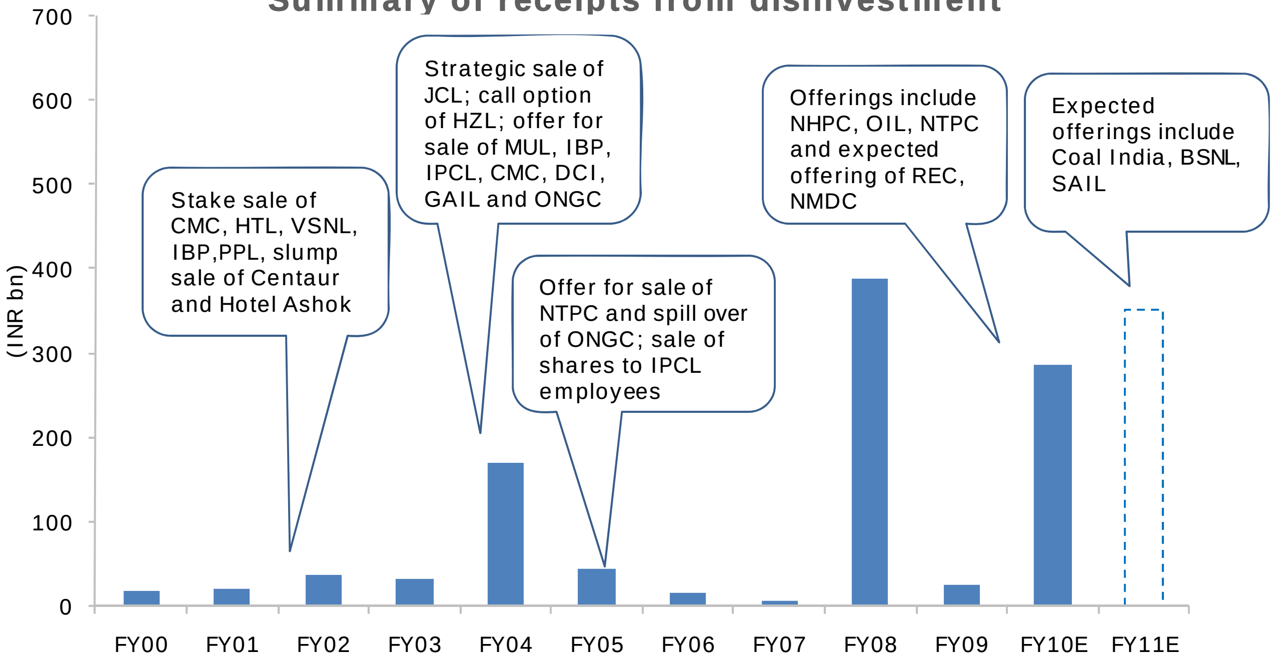
Greater clarity on GST roadmap can be a positive

- While there may not be an announcement regarding the formal introduction of GST, the government, in our view, may lay down some guidelines to effect the smooth transition to a GST regime. The positive effects of GST introduction is manifold: a likely increase in government revenues, which will be funded at the cost of the parallel economy, higher investments in the organised sector, expanding the tax nets over goods and services and increased consumption
- One such step towards implementation of GST would be through phasing out of Central Sales Tax (CST) from the indirect taxes. CST rate has been brought down from 4% to 2%. It is expected that the policy makers would consider completely phasing out CST in the before the implementation of GST
- The challenges toward a smooth transition to GST regime include agreement between states and Centre on levy and administration of duties, IT infrastructure issues and integration of indirect tax administration at Centre and state level
- There has been some tentativeness towards fixing up the specifics around GST implementation and, we believe, the market will react positively to any news of GST implementation

Disinvestments to stay strong

- For FY11, we expect disinvestments in the range of ~INR 300-400 bn. In the previous budget in July 2009, the government had announced expected proceeds from disinvestment at only INR 11 bn. Finally, the proceeds from disinvestments is expected to be ~ Rs 286 bn in FY10. Some immediate proceeds which we have factored for this fiscal include REC and NMDC
- For FY11, some of the names we have considered as probable disinvestment candidates include Coal India, SAIL and BSNL
- Although divestments have not been a major source of revenue, they are expected to gain importance in FY11

Summary of receipts from disinvestment



Source: Bloomberg, Edelweiss research

Note: For FY08, part of the receipt was due to book transfer of stake in SBI from RBI to govt

FDI in select sectors – Still non-starter

Retail

- To combat the high food prices and bring in more competition, the Prime Minister has recently pitched in for opening up retail trade to foreign companies
- Current rules do not allow any foreign participation in multi brand retail although in single brand retail, foreign companies are allowed to take 51% stake. In wholesale or cash and carry segment, the government allows 100% FDI
- Despite increasing voices of support for higher FDI in retail, we do not think that any resolution will be passed to that effect in the current budget. In our view, it is a politically charged topic and the government will be doubly careful before its introduction.

Insurance

- FDI in insurance has been a long standing demand of the insurance industry as it allows for expansion and capital raising. The current cap for FDI in insurance is 26%
- There is uncertainty from the government about opening up the sector for further FDI.

Sector-specific expectations

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Auto

Sector	Industry/Market wishlist	Edelweiss expectation	Impact on sector/company
Automobiles	No excise duty hikes for small cars/ two wheelers/ CVs	Excise duty hike of between 2%-4%	Negative
	Lower excise duties for large cars	No change in excise duties for large cars	NIL
	Increased allocation to JNNURM scheme for public transportation	Allocation likely to rise	Positive for Tata Motors, Ashok Leyland

BFSI

Sector	Industry/Market wish list	Edelweiss expectation	Impact on sector/company
BFSI	Agricultural debt waiver and debt relief scheme: Prepayment period to be extended further from December 31, 2009	Will be extended till June 2010	Recognition of agri NPLs will be lower - Positive for PSU banks (in general) and BoB and PNB (in particular) as they have already provided for the same in Q3FY10
	Interest subvention for pre-shipment credit and short term crop loan extended in last budget is expected to be rolled back	Stimulus provided last year will be rolled back	Neutral
	Refinancing from IIFCL upto 60% of commercial bank loans for PPP projects in critical sectors is expected to continue this year as well	Investment requirement in infra is huge and this facility is expected to continue	Positive for infrastructure credit book of banks to manage ALM
	Increasing tax breaks provided to Housing finance/Infrastructure lending companies which currently is allowed up to 20% of profits derived from projects may be increased back to 40%	Has been a point of discussion since last few years	To reduce effective tax rate to ~20% from 26-27% currently - Positive: HDFC, LIC Housing, IDFC, Power Finance Corporation
	To allow power financing companies to float tax free bonds	Move important to improve flow of funds to power sector and reduce cost of funds for power financing companies	Positive for PFC

Sector-specific expectations (contd.)

Cement

Sector	Industry / Market wishlist	Edelweiss expectation	Impact on sector / company
Cement	Excise duty to cut to 4%	Increase in excise duty from 8% to 10%	Marginally negative
	Reduction in import duty imposed on imported coal		

Construction

Sector	Industry / Market wishlist	Edelweiss expectation	Impact on sector / company
Construction	Relaxation of MAT provisions on infra projects under new Direct Tax code	Likely to happen as infra is Govt priority	Positive for all developers
	Relaxation of ECB norms	Unlikely to happen as there is ample liquidity in the domestic markets	Neutral
	Increase in central govt outlay for roads and urban infra	Likely to happen as infra is Govt priority	Positive
	Further clarity on refinancing/takeout provisions for IIFCL funding	Likely to happen but may not result in immediate benefits	Neutral

Sector-specific expectations (contd.)

Engineering and Capital Goods

Sector	Industry/ Market wish list	Edelweiss expectation	Impact on sector/ company
Engineering and capital goods	Increase in import duties on Chinese power equipment imports	We expect import duties to be marginally increased on certain key power sector imports	Positive
	Sustained capex in flagship programmes such as Bharat Niram, rural electrification etc	Capex in rural electrification and distribution reforms likely to continue	Neutral

FMCG

Sector	Industry/Market wishlist	Edelweiss expectation	Impact on sector/company
FMCG	Rural initiatives on income generation continue to remain a priority	We expect this to continue	This is positive for FMCG consumption as almost 40-50% of FMCG demand comes from rural areas for most of the companies
	Rollback of excise cuts	We do not expect complete rollback for FMCG as food inflation continues to remain high and will get adversely impacted. However we do not rule out partial rollback to the tune of 200-300 bps	--
	Excise duty increase for cigarettes	We expect excise to increase by 5-8% for cigarettes as there was no increase in filter cigarettes last year	Any increase beyond 10% is negative for ITC and other cigarette companies. 5-8% can be easily passed to the consumer with some margin expansion
	MAT rate can be increased	This may happen as it could be a step towards direct tax code	If this gets implemented, it will be negative for MAT paying companies like Dabur and GCPL

Sector-specific expectations (contd.)

Hotels

Sector	Industry / Market wishlist	Edelweiss expectation	Impact on sector / company
Hotels	To be included under Sec 80 IA (Infrastructure status) for all hotels across India and across all categories	Considering the demand supply mismatch and the interest of global hotel chains into India, we believe this is the right time for the acceptance of this wish.	It will have a huge positive impact on the ongoing and planned hotels as the profits will be tax exempt for consecutive 10 years out of first 15 years.

Media

Sector	Industry / Market wishlist	Edelweiss expectation	Impact on Sector / Company
Media	FDI norms get liberalised for some of the segments like radio, DTH and cable	This may happen as the recommendations have been made by the regulator TRAI	If this gets implemented, this will be a big positive for the sector
	Rationalisation and parity in the service tax paid by TV and radio broadcasters on revenues accrued by them from advertisements.	This seems unlikely to happen as this demand has been pending now for many years	If this gets implemented, it will be a positive for radio and TV companies
	Provision for doubtful debt be allowed as expense in MAT profit calculation	Looks unlikely	If this gets implemented, this will be a positive for media companies

Sector-specific expectations (contd.)

Metals and Mining

Sector	Industry / Market wishlist	Edelweiss expectation	Impact on sector / company
Metals & Mining	Retaining excise duty	Increase from 8% to 10%	Marginal negative on demand
	No change in customs duty structure	No change in customs duty structure	Neutral
	Retaining thrust on rural and infrastructure spend	Likley to continue	Positive

Pharma

Sector	Industry / Market wish list	Edelweiss expectation	Impact on sector / company
Pharma	Increase in weighted average for R&D deduction	Not expected	Positive if implemented, has been a long standing demand
	Excise duty structures to remain	Likely harmonised to other sectors	Marginally negative; most companies have shifted domestic operations to tax friendly areas
	Direct tax code changes	Not expected	Changes in MAT carry forward or tax rates could be negative
	Concessional rates for certain categories of life saving medicines	Likely to be announced	Marginal impact due to lower share in total sales
	SEZ policy	More clarity based on changes in proposed direct tax code	Proposed changes in DTC have induced some confusion, clarity would be welcome

Sector-specific expectations (contd.)

Real Estate

Sector	Industry / Market wishlist	Edelweiss expectation	Impact on sector / company
Real Estate	Increase in exemption limit for interest payment and on loan repayments	Nil	Neutral
	Infrastructure status (leading to tax benefits) on affordable housing projects		

Retail

Sector	Industry / Market wishlist	Edelweiss expectation	Impact on sector / company
Retail	FDI norms get liberalised for different retail formats	This is unlikely to happen as retail is a sensitive sector impacting the neibourhood Kirana store	If it is implemented, it will be a big positive for the sector

Oil and Gas

Sector	Industry / Market wishlist	Edelweiss expectation	Impact on Sector / Company
Oil & Gas	Clarity on tax benefits to the natural gas production from NELP/CBM blocks	None	Positive for upstream companies having NELP/CBM blocks. RIL will benefit but we and street have assumed tax benefits already.

Sector-specific expectations (concluded)

Telecom

Sector	Industry / Market wishlist	Edelweiss expectation	Impact on sector / company
Telecom	Extension of 100% tax exemption benefits under Section 80IA from current 5 years to 10 years (at par with other infrastructure sectors)	Unlikely	Positive for all telecos if implemented
	Section 80IA benefits to be made available to companies undergoing amalgamation or demerger after 31.3.2007	Unlikely; expect M&A norms to be framed in consultation with sector regulator	Positive for all telecos if implemented
	Implementation of a uniform licence fee regime	Unlikely; expect license fee norms to be framed in consultation with sector regulator	Positive for all telecos if implemented
	Indicative revenues from 3G auction	INR 350 bn revenues indicated in earlier budget	--

Information Technology

Sector	Industry / Market wishlist	Edelweiss expectation	Impact on Sector / Company
IT	Extension of tax benefits under Section 10A/10B	Already extension given for two years, may not continue. Full tax regime post FY11 for all IT companies	Negative, but market has already factored the same in stock prices and valuations
	Clarification on calculation of SEZ profits to include full exemption of profits from SEZ	Clarity to be provided on profits from SEZ	Positive - if 100% of SEZ profits are exempted, negative if based on turnover criteria

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