Pre-Budget Expectations 2010-11

February 23, 2010

The expectations from Union Budget 2010-11 are quite low at this point. There is a consensus that there would be partial withdrawal of the stimulus package implemented in the previous years. There is also not any major expectation of fiscal consolidation or getting back to fiscal discipline. Knowing the way the Indian polity works (in a measured manner and if possible by consensus, unless the situation is catastrophic like in 1991), people on the street have little expectations from the Budget. This makes us believe that the initial market reaction to the Budget would be positive, though a few days later our markets could fall in line with the global markets in terms of direction.

Critical issues like labor reforms, pension reforms, subsidies, etc may need broader political consensus. We expect material developments on the same, if any, to be outside the budget. Any bold steps taken by the government will be welcomed by the markets as political willingness is not an issue and this is just the second budget for the UPA government.

Fiscal Deficit & Withdrawal of Stimulus

We forecast that the FY11 fiscal deficit could fall to 5.8% given strong non-tax revenue growth (incl 3G auctions), partial rollback of tax rate cuts, the lack of one-off expenditures as in FY10 and the change in GDP growth mix. The likely surge in the RBI's profit could play important role in containing the fiscal deficit. In our view, the significant reduction in deficit, if carried out, will be a positive for government bonds and for the equity market. A lower deficit will help the INR, which we expect will appreciate going forward.

The Government is faced with a double-edged sword – fiscal deficit vs growth. We expect it to try to strike a 'fine balance.' Key issues that we will be addressed during the Budget 2010-11 could be the path to fiscal consolidation and supply side measures to control food inflation (monsoon shortfall continues to have disastrous implications for India). The government's chief statistician Pronab Sen recently said the wholesale price inflation could cross 10% by end-March 2010.

The Government's FY11 government borrowing is unlikely to decline sharply from FY10 levels and hence partial withdrawal of stimulus is expected. The catch here is bringing down deficit by cutting expenditure means risk to growth & the other alternative is to increase revenues. India's stimulus package accounted for less than 1% of the GDP. India is least exposed to a stimulus roll back. There are many reasons preventing the government from aggressively withdrawing stimulus measures: India's nascent growth recovery, the recovery's reliance on government spends, and uncertainty about the global recovery.

There are clear signs that the economy is once again on a growth path (IIP, export revival, GDP etc) and hence we expect rollback of some of the measures announced by the Government last fiscal. Most likely measures include a hike in excise duties (by 200bp) as well as service tax (to FY08 levels, from the current 10% back to 12%) as the government begins withdrawal from stimulus. The withdrawal will be gradual, as highlighted time and again by the Government so as not to hurt the economic recovery. The Government could first target sectors like Auto and Cement where the recovery and offtake has been robust. Customs tariff roll backs, on the other hand, are likely to be more across-the-board. The service tax rate that was reduced from 12% to 10% is likely to be rolled back in the FY11 budget. And as a precursor to the introduction of GST (goods and services tax), we expect the service tax to be extended to most services, barring a few.

Government Spending to moderate

As fiscal consolidation takes centre-stage, we see slower growth in public expenditure (relative to FY10). However, overall, the Government will increase absolute allocation to programs like Bharat Nirman, National Rural Health Mission, National Rural Employment Guarantee Scheme, Jawaharlal Nehru National Urban Rural Mission, Integrated Child Development Scheme, Accelerated Power Development and Reform Programme etc.

Divestment
We believe the Finance Minister would place high targets from the PSU sale proceeds. This will be done in order to bring Fiscal deficit under control that would subsequently ease upward pressure on interest rates. In FY10, the Government could realize close to Rs. 200 bn from divestments (including pending issues) and in FY11, divestment proceeds could top Rs. 300 bn.

Personal Tax
For the common man, we expect that Finance Minister may raise the exemption limit in personal income tax, or the investment limit Under Sec. 80C or re-introduce standard deduction for salaried people. We believe this could be possible as rocketing prices of food articles like sugar, pulses and vegetables have been hitting the pockets of a middle class family very badly.

Rural India
It is widely believed that India was not impacted to the same extent during the financial crisis, as its rural consumption remained strong. The Government through various schemes, farm loan waiver and a rise in MSP has put a lot of money in the hand of Rural India which has gone back to fund consumption growth (2 wheelers, tractors, cement, personal care etc). We believe that while the Government will continue its emphasis on inclusive growth and social spending, it will also indirectly try and increase revenue from this segment of the population. This could be done via a rise in excise duties and service tax, which will impact Auto, Cement and FMCG companies.

Reforms
On the Reforms front, there have been a number of delays. While the Government has shown strong action on the divestments front, reforms like GST, DTC, FDI in insurance and retail, PFRDA, SBI (Amendment), LIC (Amendment), 3G auctions, consolidation of public sector banks etc are issues that yet need to be implemented.

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, the government may lay down the roadmap for implementation of the DTC.

GST - 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 organized sector, expanding the tax net over goods and services and increased consumption. 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. GST is the most ambitious indirect tax reform in India attempted ever and will create one “borderless domestic market”. It will tax “consumption” as against “production” which is the current norm. Successful pan India implementation will add ~1-1.7% to the GDP and will boost Tax/ GDP ratio. For consumers, incidence of tax will come down in case of manufactured goods. However, in case of services the incidence and coverage of tax may rise resulting in higher prices. For Industry, volume growth will accrue as incidence of taxation is minimized. Also, supply chain efficiencies will accrue as there will be no need for multiple depots and warehouses. Rollout of GST in Apr 2011 seems more likely as the current dithering owes to clarity on rate of GST: 12 or 18%?, Revenue Neutral Rate: States need to be compensated for revenues, States losing their sovereign right to tax goods despite getting the right to tax services and lack of enabling constitutional amendments and backbone IT infra for a simultaneous nation wide launch.

Given below is a summary of our sectoral expectations from the Budget.

Sector	Industry / Market - expectation / Issue	Our view	Impact on sector / Company
Auto	Rollback of stimulus package in the form of increase in excise duty by 2% for small cars, 2 wheelers and CVs	Likely	Negative for all companies, will be a larger blow for the CV segment, however excise free zones and consumer confidence could mitigate part of the impact
	Excise duty on large cars to remain the same, lower excise duty for large cars	Unlikely to lower duties	Neutral for the UV space, M&M
	Increased allocation for JNNURM scheme for public transportation	Likely	Positive for Tata Motors, Ashok Leyland
	Extend accelerated depreciation norms for CVs	Unlikely	Will benefit CV makers like Tata Motors & Ashok Leyland
	Introduce scrappage scheme for old trucks	Likely immediately or atleast a roadmap	Will benefit CV makers like Tata Motors & Ashok Leyland
Banks / Financial Services	Increase FDI in Insurance Sector from 26% to 49%	Unlikely	No impact
	Allow Banks/Power Financing companies to raise tax free Infra Bonds	Likely	Help Banks to lend for longer duration and avoid asset liability mismatch and generally improve flow of funds for the purpose.
	Recapitalization of Small PSU banks with proceeds from World Bank (USD $2 bn loan)	Likely	Enable Capital starved PSU banks to meet their growth requirements, positive for companies like IDBI, BOI, Union Bank, Dena Bank, OBC
	Reducing Government stake in PSU banks	Roadmap likely	PSU Banks could get rerated marginally
	Consolidation of PSU banks	Unlikely	If announced, will help regional banks with improved reach and economies of scale, Andhra Bank, SBI, PNB, OBC, Vijaya, Dena
	Extension of farm loan repayment period to June 2010 from Dec 2009	Likely	Poor monsoon has led to lower recovery for banks, however this will lead to under-reporting of potential NPAs. Positive for BoB and PNB as they have already provided for NPAs in Q3FY10
	Increase tax exemption provided to HFCs/ IFCs to 40% of profits from the existing 20%	Unlikely	If announced, will improve margins of these companies and support infra lending - HDFC, LIC Housing, IDFC, PFC
	Refinancing from IIFCL upto 60% of commercial bank loans for PPP projects in critical sectors is expected to continue this year as well	Likely	Positive as it helps banks manage ALM
	Bond yields to be impacted by amount of deficit to be announced	-	Positive/negative depending upon the level of fiscal deficit compared to expectations
Capital Goods	Schemes such as APDRP and RGGVY to continue	Likely	Positive for power equipment manufacturers like Crompton, Emco, ABB, BHEL, Siemens
	Excise duty rollback from 8% to 10%	Likely	Is pass through in most cases, hence neutral for companies like BHEL, Crompton, ABB, Emco, Kalpataru, Jyoti, KEC
	Levy of 14% import duty on power equipment across all capacities from the current 0-5% for different capacities	Likely to some extent	Positive for players like BHEL, L&T, Bharat Forge, Alstom as Chinese power equipment is currently cheaper by 13-14% leading to lower order inflow and lower margins for domestic players, Negative for Power generating companies in project execution stage that are dependent on imports.
	Increase in capital defence expenditure	Likely	Positive for BEL, BEML, L&T, Tata Power
	Extension of tax benefits u/s 80IA beyond Mar 11	Likely	Given the shortfall in addition to Power generating capacity, encouragement to Power equipment manufacturers to expand capacity seems natural.
	Greater thrust to railway freight corridor	Likely	Positive for BEML, Texmaco, Titagarh Wagons

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Cement	Excise duty rollback to previous levels from 8% to 10%	Likely	Negative as companies will have less scope to raise prices
	VAT rate on cement to be brought down from 12.5% to 4%, in line with Steel	Unlikely	Neutral, if implemented positive for the entire sector
	Tax incentives on housing to continue	Likely	Positive as it will support residential real estate demand
	To focus on Infra Spending	Likely	Positive
	Reduction on import duty on imported coal from the current 5%	Unlikely	Given the healthy situation of most cement companies, Govt may not act on this demand.
Construction	Higher infrastructure spending on Road, Highways, etc	Likely	Positive for the sector
	Higher budget support for Infra.Dev. Schemes	Likely	Positive
	Indirect impact of increased levies on cement and steel	Likely	Mildly negative
	Tax rates unlikey to be changed, 80-IA benefits for developers to continue	Likely	Neutral
	Grant industry status	Not likely	If implemented, could increase access of funds and lower cost of borrowings
	Relaxation of MAT provisions on Infra projects under new Direct Tax Code	Unlikely	May not be addressed in the Budget
	Further clarity on refinancing / takeout provisions for IIFCL funding	Likely	Neutral
FMCG / Consumer Goods	Roll back of stimulus - excise duty increase from 8% to 10%	Likely	Negative - HUL, Godrej, Marico, TTK Prestige, Whirlpool, Hitachi etc.
	Increase in excise duty on cigarettes	Likely	Neutral - If the hike is more than 5-8% then that could be negative for ITC.
	Increase in service tax from 10% to 12%	Likely	Negative as it will increase advertising cost which is at 13-14% of revenue for large companies
	Introduction of GST could result in lower costs and prices for end consumer	Roadmap likely	Only a roadmap/announcement of its likely implementation from Oct 2010/ Mar 2011 likely - Neutral
	Rural initiatives like NREGA to continue	Likely	Positive for FMCG companies like HUL, Godrej Consumer etc who have a large rural presence
IT Services	Extension of STPI sunset clause from FY11	Unlikely	Short term negative sentimental effect on IT stocks.
	Increased spending on education under SSA	Likely	Positive for Educomp, Everonn and NIIT. Also positive for IT companies as talent pool could increase over medium term.
	Increase in e-governance spending	Likely	Positive for all domestic focused IT companies
	Increase in service tax from 10% to 12% on domestic software companies	Likely	Neutral as this will be passed on to customers
	Substantial increase in allocation to UID project	Likely	Positive for all domestic focused IT companies
Metals & Mining	Hike in export duty on all types of iron ore forms	Unlikely	The Government has recently increased export duty on iron ore lumps to 10% from 5% and has levied fresh duty on iron ore fines at 5%. Neutral for Sesa Goa and steel companies
	Increase in import duty on steel to 20% from the current 5%	Unlikely	Neutral
	Increase in excise duties from current 8%	200 bps likely	Mildly negative for all steel companies though cost will be passed on and users will be able to offset the increase against their own excise duty liabilities
	To focus on Infra Spending	Likely	Positive for steel companies

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Oil & Gas	Partial deregulation of Petrol & Diesel Prices	Roadmap likely but details outside the Budget	Positive for OMCs and ONGC, GAIL
	Clarification on Section 80-IB deduction on Gas exploration	Likely	Upstream listed players who are engaged in exploration like RIL and ONGC could benefit
	Extension of Tax Holiday on new refineries from March 2012	Unlikely in this Budget	Neutral
	Declared goods' status to natural gas	Likely	This could end the different sales tax applicable on natural gas in various states and reset them to a uniform 4%. Users of natural gas could benefit in terms of cash flow.
Power	No change in MAT rate	Likely	Neutral
	Higher allocation in setting up renewable energy sources incl. solar power	Likely	Positive for companies like Websol Energy Systems, Moser Baer etc
	Extension of Tax holidays on power projects as the tax break under section 80-IA ends on 31 March 2011	Likely	A significant number of capacities will come up after March 2011 and thus this will be positive for the sector
	Schemes such as APDRP and RGGVY to continue	Likely	Positive for sector
	Increase in import duty on power equipment	Likely to some extent	If announced negative for companies like Indiabulls Power, Reliance Power etc that depend on Chinese / Taiwanese BTG manufacturers, else Neutral
Pharma	Increase in weighted average for R&D deduction from 150% to 200%	Unlikely	Neutral
	Extend weighted deduction provision for 5 years after 2012	Likely	Mildly positive for research based pharma companies
	Increase spending on healthcare sector	Likely	Positive for the entire sector
	Extension of EOU benefit beyond FY11	Unlikely in current form	Negative for entire sector
	Increase in excise duty	Likely	Mildly negative as a number of companies have already shifted production to excise free zones
	Concessional rates for certain categories of life saving medicines	Likely	Neutral as this forms a very small % of revenue
Real Estate	Continuation of section 80-IB of the Income Tax Act (providing tax relief to builders for construction of units less than 1000sq.ft built up area in metros)	Likely	Developers would get tax reliefs and thereby would be encouraged to construct more middle class and affordable homes. Support Govt in reducing shortage of housing units (expected to be ~22.4msf as per the 10th plan estimate).
	Increase in exemption limit under Section 24 (Interest on home loan) to increase from present Rs.0.15m to at least Rs.0.2m	Not likely	Neutral
	Allow ECB borrowings for use other than township development	Not likely due to end user restrictions	Negative for the sector
	Grant industry status	Not likely	If implemented, could increase access of funds and lower cost of borrowings
	Increase the limit for priority sector lending from Rs.20 lakhs to Rs.30 lakhs	Likely	Positive for the sector as Banks would be willing to lend higher amounts at a competitive rate to end users.
	Flat slab of 15% to be considered on rental income for NRIs	Not likely	If announced, NRI investments to increase (as a lot of NRIs lock up their apartments for fear of higher taxation and an upfront TDS of more than 30%

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Real Estate	Standard deduction of 30% towards maintenance to be increased to 40% for local residents and 50% for NRIs	Not Likely	Neutral
	Increase in allocation to the Rajiv Gandhi Awas Yojana	Likely	Companies in slum rehabilitation projects to benefit
Telecom	Estimate of 3G auctions revenue	Likely	About Rs 35,000 cr revenue indicated in earlier budget
	Increase of MAT rate from current 16.5%	Unlikely	Negative as it will hurt earnings, in line with DTC
	Increase of customs duty on telecom equipments	Likely to some extent	Negative as it will increase capex costs for the companies
	Implementation of a uniform licence fee	Unlikely	Positive if implemented for all telcos
	Increased focus on social schemes like NREGAs, etc	Likely	Increase in rural demand for mobile services
	Inclusion of tower companies into Sec 80 IA	Unlikely	Positive if implemented for all telcos
	Extension of 100% tax exemption benefits under Section 80-IA from current 5 years to 10 years (at par with other infra companies)	Unlikely	Positive if implemented for all telcos
	Increase in service tax from 10% to 12%	Likely	Marginal impact
	Extend finance under Indian Infra Fin Company to all telecom projects	Likely	If announced, will improve cheap fund access for companies in this sector
	Extend deduction u/s 35ABB to payout for 3G auction	Likely	If announced, will provide certainty about deduction availability and prevent tax disputes

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