Pre-budget Outlook 2007

Edelweiss Research

research@edelcap.com

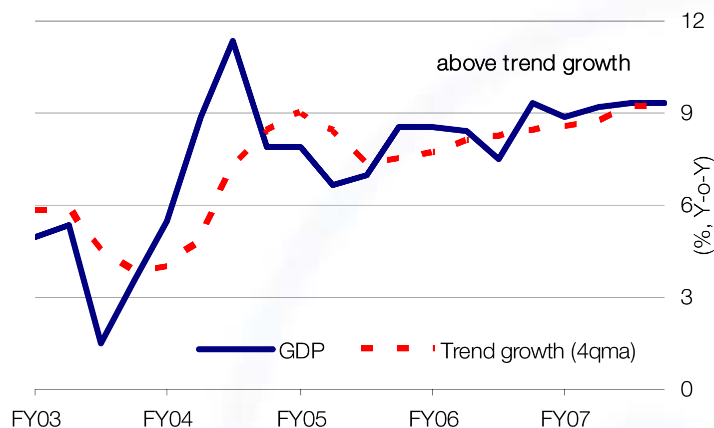
February 21, 2007

Edelweiss
Ideas create, values protect

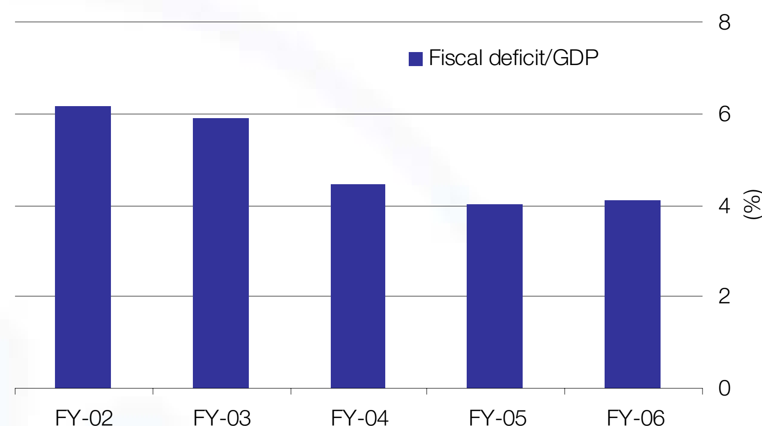
Budget significance and key takeaways

- The budget has evolved to become more than just a narrow tax and spend plan – it is now a work plan for the government for the coming year enabling structured monitoring
- This budget has particular significance as it is the first budget in the new 5 year plan and also the penultimate budget before the next round of central elections
- Also uniquely, the finance minister is faced with the task of managing expectations across all time horizons: short term, medium term and long term
- Industry expectations include reduction in direct and indirect taxes further so as to move towards the GST target; investment in physical and social infrastructure; capital market reforms
- We believe the overall focus will be on maintaining strong and sustainable GDP growth while ensuring the benefits are spread wider
- Key budget items will include infrastructure investments to make the growth sustainable; addressing issues relating to inequity and growth in the agriculture sector; taking measures to counter near-term issues such as inflation; increasing spend on health and education

Strong growth; contained fiscal situation



Source: CSO, Bloomberg, Edelweiss research

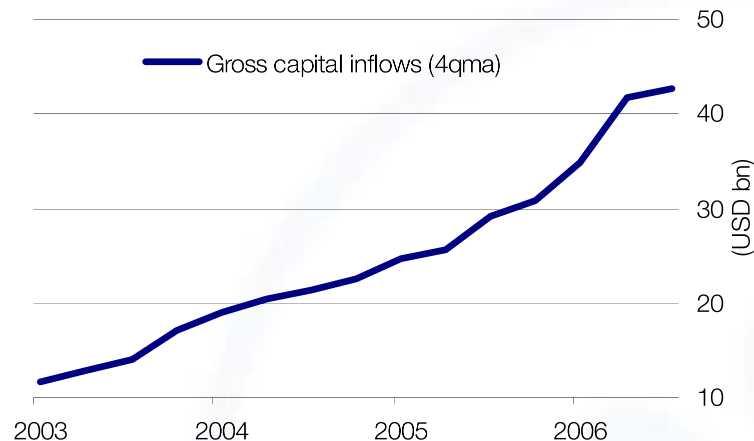


Source: CMIE, Edelweiss research

- **Growth has been trending upwards since FY05; and is clearly above trend at present. Strong industry and services growth continue to support the growth momentum.**
- **Fiscal deficit as a proportion of the GDP has been on the decline. It is expected to be lower than the 3.8% level targeted in the FY07 budget.**

Continued capital flows; bullish markets

Sustained capital flows…



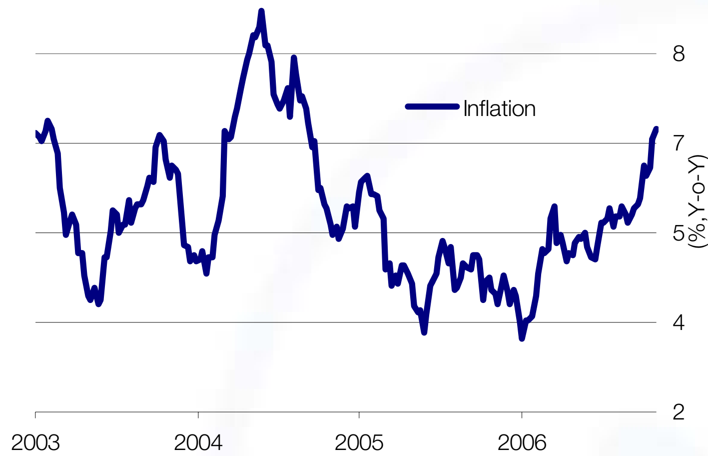
Source: CMIE, Edelweiss research

Support capital markets

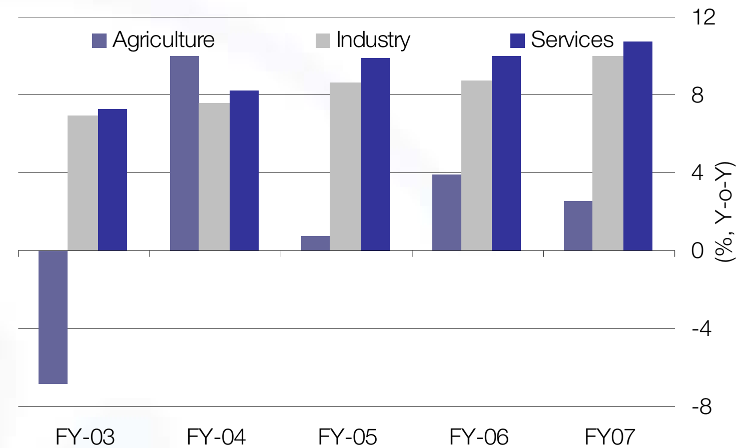
Source: CMIE

- **Continued optimism about India's economic performance has sustained capital flows into the country. The**
- **Strong corporate sector growth as well as sustained capital flows have ensured continuously rising markets.**

But.. Rising inflationary concerns and slow agricultural growth



Source: Bloomberg, Office of Economic Advisor, Edelweiss research



Source: Bloomberg, CSO, Edelweiss research

- **Inflation currently at 6.73% Y-o-Y is a source of concern. The government has taken consistent fiscal steps to bring it down in the current financial year like putting restrictions on trade, cutting duties and reducing oil prices. So far, the impact has been short-term in nature.**

- **Agriculture growth has been low at 2.5% for H1FY07; in comparison with industry and services.**

Edelweiss
Ideas create, values protect

Macro focus areas for the government

Macro outlook

- Commitment to sustained economic growth likely on government agenda
- Inflationary concerns to be highlighted
- Centre to be more optimistic on fiscal outlook

Focus areas

- The two focus areas of the UPA government: Agriculture and Infrastructure will remain so
- Agriculture may acquire renewed in light of (i) continued slow growth (ii) rising economic inequality and (iii) rising food inflation
- Industry associations also expect some progress on the central sales tax and the proposed goods and services tax. Customs and excise duty cuts are also expected.

Sector specific recommendations: Automobile

Expectations	Impact
1) Reduction in excise duty on cars larger than 4m from 24% at present to 16%. In case of continuation of current differential excise duty on small and large cars, the industry recommends doing away with the engine based distinction	The key beneficiaries of this move will be Maruti's Swift petrol (1.3L engine), Esteem, Tata Motors' Indigo and Marina and Hyundai Getz.
2) Extension of weighted deduction of 150% on R&D for income tax for another 10 years	This will benefit Tata Motors, M&M, Bajaj Auto and TVS Motors.
3) Reduction of customs duty on certain components from 12.5% to 5%.	The reduction in peak duty rate will benefit all manufacturers particularly Maruti Udyog which imports more than 10% of its input components from Suzuki and its affiliates.
4) The import duty on commercial vehicles (new and used) to be increased from the current 12.5% to 40%.	This will provide protection from emerging competition to Tata Motors and Ashok Leyland.
5) Tax incentives for renewal of transport and private vehicle fleet.	This will benefit all players particularly Tata Motors and Ashok Leyland.

Sector specific recommendations: Aviation

Expectation	Impact
Reduction in excise duty on ATF from 8% to 4%	Positive
Classify ATF as "declared goods" to charge sales tax at a flat 4%	Highly posiitve, as airlines pay an average of ~20-25% sales tax on thir ATF purchases
Exemption on withholding tax on leased aircraft to be withdrawn (withholding tax is 3% of leased aircraft cost)	Negative as most airlines are operating/ adding planes on leases
Measures for further improvements in airport infrastructure, more airport modernization initiatives	Positive, enormous long-term benefits for the sector

Sector specific recommendations: Banking

Expectations	Impact
To ease some pressure on the banks to effectively mobilize deposits in rising deposit rates environment and efficiently fund the strong credit offtake in the economy, the tax sops in this respect are expected in the following form: * We expect deduction under section 80C in respect of investments in fixed deposit for the tenure of 5 years or more to be extended even to deposits of lower maturities. * Interest earned on bank deposits is likely to get some kind of a tax break through reintroduction of section 80L of Income Tax Act that allowed tax deduction on interest income on deposits parked with banks. Or deduction may be clubbed under section 80C, though by doing so the purpose of this tax break will be diluted. * The limit of INR 5,000 for deduction of TDS on interest income on deposits is expected to be raised further to INR 10,000.	*This would turn out to be positive for the banking sector as a whole and in particular for ICICI Bank, HDFC Bank, SBI, Punjab National Bank and UTI Bank.
The budget that is likely to be more focused on infrastructure sector is expected to provide some kind of tax relief to the banks and financial institutions that finance these infrastructure projects.	Financial Institutions namely IDFC, SREI, PFC and leading banks namely SBI, PNB that are more focused on infrastructure financing will stand to benefit
The re-rating of banks largely depends on the asset quality reflected in their NPA levels. The budget is expected to lay down certain measures to aid faster NPA recovery and to encourage adequate provisioning in the form of following tax incentives: Allow deduction under Income Tax Act on provisions made for substandard, loss and doubtful assets. Currently, only NPAs that have been actually written offs are deductible. Tax exemption would be provided to the ARCs (to whom NPAs are sold under the trust route) on the profits made by them from recovery and it would be taxed at the level of the originating bank.	Banks with higher NPA accretion are likely to benefit from these incentives particularly Dena Bank, IDBI, Union Bank and Syndicate Bank.
The budget may also provide a tip-off on the following few proposals that are being talked off lately and not directly passed under the Finance Bill as they have be approved and passed under different laws: * Positive expected in terms of an increase in FDI limit in insurance industry from the present 26% to 49%. Though there are relatively lower chances of FII/FDI investment limits in public sector banks to be raised from currently restricted 20%, to provide some leverage it may be proposed that ADRs/GDRs may not be counted under the specified FII limits.	Major beneficiaries would be the insurance companies and banks that increasing resort to raising money from the international markets through ADRs/GDRs.

Sector specific recommendations: Cement

Expectations	Impact
Cement	Neutral
Enhanced spends on infrastructure and housing	Positive for the sector
Excise duty hike from INR 408/tonne	Marginally negative for large cement plants; but likely to get passed on
Excise duty exemption on slag	Positive for ACC, Mysore and Birla Corp
Abolish import duty on petcoke	Positive for Shree Cements and Madras Cements
Permitting import of chipped tyres	Positive for Grasim
Reducing royalty on limestone	Positive for the sector
Increasing duty free allowance on coal to 50% from 22%	Positive for exporters (Gujarat Ambuja, UltraTech, Sanghi and Saurashtra Cements)

Sector specific recommendations: Construction

Expectations	Impact
Extension of the benefits under 80IA likely to be spread beyond BOOT projects in the road and power sector to include other projects likely in the water and urban infrastructure segment.	With larger number of projects getting eligible for lower tax rates (MAT) the reduction in the overall tax burden is likely to lead to an improvement in margins
Increased thrust on the road sector with particular focus on the north east region. Estimated spend of ~INR 500bn during the 11th five year plan	With the new model concession agreement in place, the increased focus on the road segment is likely to lead to an acceleration in the pace of road projects being awarded
Greater focus on railway modernisation programs.	We are likely to see larger number of projects coming on stream particularly metro rail projects and dedicated freight corridors on other legs along the quadrilateral besides the Howrah-Delhi and Mumbai-Delhi routes through public private partnerships
Increased focus on airport mordernisation programs. Estimated spend of ~INR 400bn upto FY12E	With major airport modernization projects in the metros going on stream we are likely to see acceleration in the pace of non metro airport projects being awarded

Sector specific recommendations: Engineering & Capital Goods

Expectations	Impact
Customs duty on imported capital goods We expect customs duty on imported capital goods to remain unchanged at 7.5%, given that government reduced it to 12.5% in last budget from 15% and further to 7.5% in January, 2007	Neutral on power equipment players like ABB, BHEL, Crompton Greaves, Siemens. However, any further reduction is likely to lead to further competition from low cost Chinese players
Customs duty on raw materials We don't expect further reduction in customs duty on input prices (copper, zinc, alloy steel and aluminum) given that it has already been reduced to 5% from 7.5% earlier.	Neutral on power equipment players like ABB, BHEL, Crompton Greaves, Siemens.
Extension of benefit of concessional customs duty We expect the concessional zero customs duty structure to be extended to transmission projects associated with mega power projects. Power ministry have already put forward proposal to finance ministry to rationalize the duty structure.	Positive for companies asociated with power transmission projects, given that currently existing structure attracts 0% customs and CVD for mega power projects while associated transmission projects are levied a 10% customs duty and a 16% CVD
Excise duty We expect excise duty on raw materials and machinery to remain at 16%, given that excise duty collections in FY06-07 are likely to be below the budgeted collections.	Neutral for equipment manufacturers
Corporate tax and 80IA tax benefit We expect removal of/reduction in surcharge on corporate tax. Further, we expect the tax holiday u/s 80IA for UMPP's to be extended to associated power equipment suppliers.	Positive for companies paying marginal tax rate

Sector specific recommendations: FMCG

Expectation	Direction of impact
Fringe Benefit Tax may be lowered	Can mitigate the increase in advertising rates of media
new VAT rate and excise tax hike	If MRP hike is less than 8%, our call is that volume growth will be sustained at 7%
Peak import duty on chemicals (raw naterial and finished goods) for paints may be reduced	Positive given that gross margins in next few quarters are expected to be strong
No change in customs duty, excise duty and service tax rates	

Sector specific recommendations: Infrastructure & Miscellaneous

Expectations	Impact
Focus on infrastructure creation such as increasing port capacity and creating opportunities for dredging	Increased port capacities directly benefit CFS and ICD players and container train operators. It also creates opportunity for Dredging Corporation of India
Allotment of port projects on a competitive bidding mechanism as against current basis of revenue sharing or royalty/TEU and their evaluation on viability gap funding mechanism. .	Increased private sector participation is expected to aid big ticket investment in the sector, thus creating opportunities for the service providers.
Announcement for funding mechanism and execution timeline for Dedicated Freight Corridor.	This is expected to give big boost to growth in doemstic container movement and the service providers like Concor, Gateway Distriparks and SICAL. It also is postive for wagon manufacturers like Texmaco and equipment providers to Indian Railways like Kernex and Stone India

Sector specific recommendations: Logistics

Expectations	Impact
Phasing out of CST as per the original schedule by 2007-08 and immediate reduction of CST to 2%	Provides big boost to organized warehousing industry subsequently leading to incraesed outsourcing of transportation services as against in-house transportation. Positive for Gati, SICAL and Transport Corporation of India (TCI)
Blue print for substituting the complex web of central and state taxes on manufacturing and services with a single goods and services tax (GST) and maintaining the time frame for introduction of GST by 2010.	Significantly reduces the costs involved in transportation and leads to seamless transportation for goods. This in turn is expected to boost higher demand for road transportation. Positive for Gati, TCI and SICAL
Grant of Infrastructure status to warehousing industry.	This will enable companies in getting access to preferential loans and grants. Postive for Gati, TCI and SICAL
Freeing up of excess land and warehouses under Indian railways to private sector players, thus giving way for Public-Private Partnership	Positive for Concor, Gateway Distriparks and SICAL

Sector specific recommendations: Mining and Equipment

Expectation	Impact
Mining equipment 1.Higher depreciation allowance of 40% against the current 20-25%has been lobbied by the mining equipment players.	Positive for Elecon, TRF, TIL and Mcnally

Sector specific recommendations: Oil and Gas

Expectations	Impact
Rationalisation of excise duty from a combination of specific and advalorem excise duty on Petrol and Diesel to Specific excise duty. Cut in Ad Valorem rates from 8% to 6%	Possibly tax neutral at current crude prices (dependent on the specifc excise duty), but positive from a long-term perspective (reduce the volatility of consumer retail fuel prices as it would delink taxation from crude prices) Positive for IOCL. BPCL. HPCL
Reduction in import duty in ATF /Fuel Oil /Bitumen/... from 10.0% to 7.5%. For Crude, Petrol and Diesel we expect the import duty to be cut to 4%,5% and 5% respectively.	Reduction in duty protection for refineries Big negative for standalone refiners like CPCL, MRPL.Negative for IOCL, BPCL, HPCL & RIL
Import duty on naptha for petrochemicals to continue at 0.0%. Expect Import duty reduction on various petrochemical products like VSF/VFY/PSF/POY/Caprolactum/PTA/DMT/PTA by 2.5% (in line with reduction of peak tariffs)	Mild negative for polyester manufacturing firms
Further measures towards dual pricing for LPG/SKO targeted seperately towards BPL and non-BPL families Expect some announcements of direct budgetary allocation for LPG/SKO under-recoveries Rollout of the SKO “Jan Kerosene Pariyojana” to all over the country	Positive for OMC's (BPCL, HPCL and IOC) as LPG/SKO subsidy under-recoveries may ease
Infrastructure status for Pipeline and LNG projects	Tax benefits to pipeline projects increasing the return ratios - Positive for gas infrastructure companies like GAIL, PLNG & GSPL Increase in the domestic pipeline capex - Positive for pipeline companies like PSL Ltd., Man Industries, Welspun Gujarat, Jindal Saw
Import duty cut on capital goods for Pipeline companies	Positive for Gas Infrastructure companies like GAIL, PLNG & GSPL

Sector specific recommendations: Pharmaceuticals

Pharmaceuticals	Impact
Further extension on R&D abatement of 150% (Currently till March 2007)	Positive for most Pharma companies
Reduction in excise duty from 16% to 8%	Positive for Domestic players
Zero excise duty on life saving drugs	Positive for most Pharma companies
Increase in healthcare spending	Marginally positive for the sector

Sector specific recommendations: Sugar

Expectations	Impact
Excise duty	
The current excise duty on molasses is INR 750/tonne. The levied excise duty is high as the molasses realisations have corrected by ~ 35% in last six months to INR 2,000/tonne.	Positive for sugar sector
Extension of 80IA benefit	
Given that cabinet has made nationwide 5% ethanol blending mandatory from November, 2006 we expect the government to extend the 80IA tax benefit to ethanol production to encourage sugar mills for expanding ethanol capacities	Positive for sugar mills which are integrated in terms of cogeneration and distillation capacities

Sector specific recommendations: Telecom

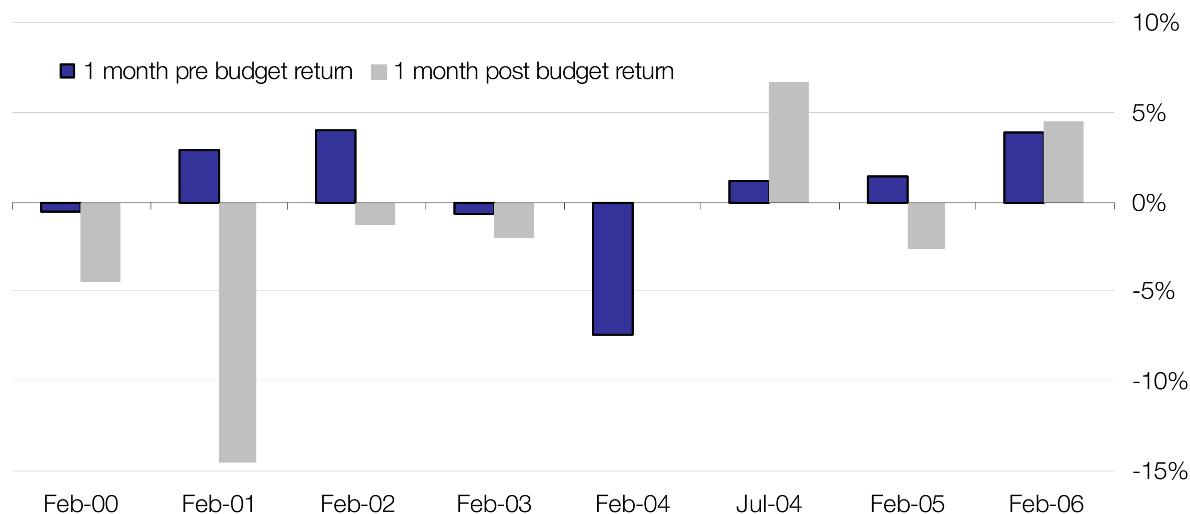
Expectations	Impact
Extension of tax benefits under section 80IA from 5 years currently to 10 years (at par with other infrastructure sectors)	Likely positive for service providers who get to continue with lower taxation levels, likely to free up cash flows for reinvestment into the business
Reduction in/Credit against 4% additional customs duty (ACD) on telecom network equipment and mobile handsets (besides other ITA bound items)	Benficial for telecos as this will lead to lower capex costs, lower handset costs likely to improve affordability of mobile services for the end customer

Sector specific recommendations: Textiles

Budget expectations	Impact
Reduction in excise duty on man-made fibres and yarns from 8% to 4%	Synthetic yarn manufacturers would benefit as they will get parity with cotton yarn spinners. Rajasthan Spinning/ Indo Rama Synthetics would be the biggest beneficiaries.
Reduction in excise duty on PTA from 8% to 4%, MEG from 12% to 8%	Reduction in duties might trigger reduction in yarn prices which will benefit the synthetic fabric manufacturers.
Capital Subsidy on textile processing machinery to continue at 10%	Fabric manufacturers still likely to procure machinery, like Alok and Mahavir, who are putting up new lines for fabric processing will continue to benefit.
Customs duty on man-made fibres, yarns and its raw materials DTA, PTA and MEG have been reduced from 15% to 10%	PSF and PFY prices like to come down -positive for the sector.
Technology Upgradation Fund (TUF) scheme, giving 5% inteerst rate subsidy on capital expenditure, to be extended for one year	Neutral to marginal positive, as most companies are covered as far as TUF funding is concerned. Some companies might announce fresh cap-ex plans.
Labour reforms- more flexibility in labour laws even outside SEZs	To impact garment manufacturers positively by allowing them to plan their staffing and production requirements with gerater flexibility

Impact of the budget

Sensex returns



Source: Bloomberg, Edelweiss research

- **Historically markets have remained fairly firm prior to the budget. Sensex returns pre budget stand at 1.75% (leaving aside Feb 2004). On the other hand, the pre budget euphoria does not seem to be long lived with the average one month Sensex returns of 1.72%. The exception to this trend has been the Jul 2004 and Feb 2006 budgets, 2 off 3 budgets under the UPA government, where both the pre and post budget returns have been strong.**

Disclaimer

This Information Package is distributed by Edelweiss on a strictly confidential basis. This Information Package and the information and projections contained herein may not be disclosed, reproduced or used in whole or in part for any purpose or furnished to any other persons without the express prior written permission of Edelweiss.

This Information Package is distributed by Edelweiss upon the express understanding that no information herein contained has been independently verified. Further, no representation or warranty expressed or implied is made nor is any responsibility of any kind accepted with respect to the completeness or accuracy of any information. Also no representation or warranty expressed or implied is made that such information remains unchanged in any respect as of any date or dates after those stated herein with respect to any matter concerning any statement made in this Information Package. Edelweiss and its directors, employees, agents and consultants shall have no liability (including liability to any person by reason of negligence or negligent misstatement) for any statements, opinions, information or matters (express or implied) arising out of, contained in or derived from, or for any omissions from the Information Package. All recipients of the Information Package should make their own independent evaluations and should conduct their own investigation and analysis and should check the accuracy, reliability and completeness of the Information and obtain independent and specific advice from appropriate professional advisers, as they deem necessary.

Where this Information Package summarizes the provisions of any other document, that summary should not be relied upon and the relevant documentation must be referred to for its full effect.