IDFC SSKI

INDIA RESEARCH

Interim Budget 2009-10

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No news is not always good news. As the market waited with bated breath for the Interim Budget FY10 (and announcements on the fiscal stimulus front), it has turned out to be a lukewarm affair. The government resorted to "constitutional propriety" and refrained from announcing any significant measures on the taxation front. However a higher allocation to flagship programmes, focus on social sector and a steep rise in expenditure for both FY09 and FY10 has sent alarm bells ringing on the fiscal deficit front (5.5% of GDP for FY10E). The government has adopted a counter-cyclical stance, and its productive expenditure (excluding defence, subsidies etc) is slated to rise 25% yoy over FY09 budgeted estimates and 7% yoy over revised estimates. The negative news about the government spending is that there is significant incremental expenditure on the relatively non productive areas like defence (higher wages), interest payments and subsidies- which have not fallen as much as we had expected. The government has also left room (of 0.5-1.0% of GDP) for a further push on the fiscal front with the onus of implementation on the new government. Further, FY10 budget estimates for tax revenues seem optimistic and slippage on this front would strain the fiscal position. Though the sustained momentum is a big positive, we maintain that ground level implementation of the announced spending programme remains a key monitorable.

Consequently, we see significantly diminished prospects of a bond rally to 5percent levels (on the benchmark 10 yr G-Sec) rapidly vanishing on the expectation of an outsized fiscal deficit. We have always believed that the best of the G-sec rally is behind us but did expect the falling inflation and ample liquidity to result into a trading G-Sec rally, in a high but controlled fiscal deficit environment. But that's not to be anymore and we expect bond yields to remain stable or decline marginally, at best. This changed view will have significant implications for banks (especially PSU banks, which exhibit bond proxy characteristics).

These banks will now be faced with the reality of slowing core income streams, slowing credit growth and falling margins coupled with asset quality pressures which would manifest in doubling of NPLs (to around 6-7%) over the next 12-18 months. While the unassuming valuations partly factor these events, the stream of negative newsflow lined up over the next few quarters will impinge on stock performance. We change our stance on financials to Neutral with an Underweight on PSU banks. However, as the government goes full throttle on its spending spree, both on social and physical infrastructure, we find increased comfort in the infrastructure space - levered to government spending - and remain Overweight.

On the sectoral front, the interim budget has failed to meet expectations of the steel (customs duty protection) and automobiles (removal of additional excise duty) sectors. However, increased spending allocation for JNNURM, APDRP and RGVY are sure positives for infrastructure and power equipment companies. Additionally, higher outlay for RKVY, NFSM are incrementally positive for agri-related companies while initiatives on higher education are expected to benefit education sector.

INTERIM BUDGET FY10 – THE FISCAL DEFICIT ESTIMATES HAVE SURPRISED US…

❑ FY10 fiscal deficit – ballooning…

With its hands tied being the outgoing government, the Interim Budget FY10 has turned out to be a lukewarm affair. However, what has taken us (and the market) by surprise is the fiscal deficit estimate for FY10, which the government expects at ~5.5% of the GDP. The fiscal deficit at this level points to net borrowing programme of a whopping Rs3tn for FY10. Most quarters expected FY10 fiscal deficit to be at ~Rs2.8tn (5.1% of GDP). The absolute amount of fiscal deficit is estimated to remain the same over FY09 and FY10 as the gains of a lower subsidy bill are given away for expenditures such as interest payments, defense and implementation of the Sixth Pay Commission.

❑ The room for fiscal stimulus would only add to the deficit

While announcing the budget, the government has indicated that a further rise of 0.5-1.0% in the fiscal deficit cannot be ruled out as the new government is expected to continue with the fiscal stimulus. With increased focus on government spending towards social sectors, we believe that such a move only add to the deficit and lead to a significantly high deficit at ~6.5-7.0% of the GDP.

❑ FY09 fiscal deficit – in line with estimates

FY09 fiscal deficit (Rs2.2tn, ~6% of GDP) has largely been in line with estimates. Inclusive of off-budget liabilities (Rs957bn including oil bonds and fertilizer bonds), the fiscal deficit for the Centre government stands at 8% of GDP. With state finances in trouble, the states' fiscal deficit is expected to rise to 2.6% of the GDP. On a consolidated basis, the deficit is thus estimated at 10.6% of the GDP.

Exhibit 1: Fiscal deficit

Rs bn	FY09 budget estimates	FY09 revised estimates	FY09E*	FY10 budget estimates
Market Loans	1,006	2,620	2,510	3,087
Short term borrowings	124	575	680	-
External assistance (Net)	110	96	100	160.47
Securities issued against Small Savings	99	13	0	132.55
State Provident Funds (Net)	48	48	0	50
Other Receipts (Net)	(126)	(387)	(400)	(101)
Draw-down of cash Balance	72	299.84	335	-
Total	**1,333**	**3,265**	**3,225**	**3,328**
% of GDP	***2.5***	***6.1***	***6.0***	***5.5***

** IDFC-SSKI Estimates; Source: Budget Document, IDFC-SSKI Research*

…BUT WE ENDORSE SOME OF THE REASONS

❑ Plan expenditure – higher spending support by the government

In FY09, the Central Plan outlay has increased by 13% over FY09 budgeted estimates to Rs1.7tn. A majority of this increase has been contributed by diversion of funds to rural and urban development under various government programmes (namely JNNURM and NREGS).

Of the total plan expenditure for FY09 (revised estimates), capital expenditure has increased by 23% over FY09 budgeted estimates.

Exhibit 2: Higher allocation to urban and rural development

(Rs bn)	FY09 budget estimates	FY09 revised estimates	% variation
Ministry of Rural Development	494	752	52
Department of Rural Development	385	649	68
Ministry of Urban Development	55	74	34

Source: Budget Document, IDFC-SSKI Research

Going forward in FY10, the government expects the momentum on plan expenditure to be maintained with a 3% rise over revised plan expenditure in FY09. The government has budgeted the Central Plan support to rise to Rs2tn (up 11% over FY09 budgeted estimates).

Exhibit 3: Plan expenditure

(Rs bn)	FY09 budget estimates	FY09 revised estimates	% variation	FY10 budget estimates	% growth
Revenue Expenditure	**2,098**	**2,417**	**15**	**2,483**	**3**
1. Central Plan	1,514	1,716	13	1,763	3
2. Central Assistance for State & UT Plans	584	700	20	720	3
Capital Expenditure	**336**	**413**	**23**	**368**	**(11)**
1. Central Plan	285	325	14	321	(1)
2. Central Assistance for State & UT Plans	51	88	73	47	(47)
Plan Expenditure	**2,434**	**2,830**	**16**	**2,851**	**1**
Total Budget Support for Central Plan	1,800	2,041	13	2,085	2

Source: Budget Document, IDFC-SSKI Research

❑ Higher non-plan expenditure –focus on social sectors

Non-plan expenditure for FY09 has increased by 22% over the budgeted estimates, primarily driven by higher allocations to ministries with a focus on social sectors, the fiscal stimulus as also due to implementation of the Sixth Pay Commission recommendations. Social Services (education and health) expenditure has increased by 1.7x and is slated to increase further in FY10 by 8% to Rs302bn. Non-plan allocation to various ministries/ departments, namely heavy industries and power, communications, etc – aggregated under Economic Services – has increased by 23% in FY09.

Exhibit 4: Non-plan expenditure

(Rs bn)	FY09 budget estimates	FY09 revised estimates	% variation	FY10 budget estimates	% growth
Non-plan Expenditure	**5,075**	**6,180**	**22**	**6,681**	**8**
Revenue Expenditure	**4,484**	**5,618**	**25**	**5,997**	**7**
Economic Services (Agriculture, Industry, Power, Transport, Communications, Science & Technology etc.)	180	220	23	202	(8)
Social Services (Education, Health, Broadcasting, etc)	104	281	171	303	8
Capital Expenditure	**5,915**	**562**	**(5)**	**683**	**22**
Of which: Non-plan Capital Outlay	106	137	30	129	(7)

Source: Budget Document, IDFC-SSKI Research

NOT ALL EXPENDITURE, THOUGH, IS USEFUL

❑ Interest payments and defence expenditure shoot up

Defense expenditure has increased significantly and is expected to rise further by 18% in FY10. The government has categorically clarified that the increase is mainly on the back of the implementation of the Sixth Pay Commission recommendations. However, higher interest payments in FY10 due to the inflated fiscal deficit remain an area of concern.

Exhibit 5: Higher interest payments and defense expenditure

(Rs bn)	FY09 budget estimates	FY09 revised estimates	% variation	FY10 budget estimates	% growth
Interest payments and prepayment premium	1,908	1,927	1	2,255	17
Defence	576	736	28	869	18

Source: Budget Document, IDFC-SSKI Research

❑ After a spurt in FY09, allocation for subsidies in FY10 seems to be higher – which is a negative

With significantly higher prices of agri-commodities and fertilizers in H1FY09, the subsidy bill for FY09 has increased by an astounding 81% over the budgeted estimates. While fertilizer subsidies (cash-based) have risen to Rs758bn (against budgeted estimates of Rs309bn), food subsidies are also up by 33% over the budgeted estimates to Rs436bn.

Consequently, the total subsidy bill of Rs1.29tn is significantly higher than budgeted estimates of Rs714bn.

Exhibit 6: Increased subsidies

Subsidies (Rs bn)	FY09 budget estimates	FY09 revised Estimates	FY10 budget Estimates
Major Subsidies			
Food	327	436	425
Indigenous (urea) fertilizers	129	165	86
Imported (urea) fertilizers	72	110	78
Sale of decontrolled fertilizer with concession to farmers	108	484	336
Petroleum Subsidy	29	29	31
Interest subsidies	**28**	**41**	**26**
Other subsidies	**21**	**28**	**27**

Source: Budget Document, IDFC-SSKI Research

Subsidy allocation for FY10 – at Rs1tn – seems to be on the higher side. The government expects the FY10 subsidy bill to be 22% lower than FY09 revised estimates. However, as commodity prices (read fertilizers) have declined significantly, one would have expected an even sharper decline in the allocation for subsidies in FY10.

❑ Other expenditures – seem to have derailed the fiscal restraint

The government expenditure also seems to have gone awry on a number of fronts mainly, assistances to Union Territories. Also, other expenses such as police and Pensions have increased on the back of the Sixth Pay Commission.

Exhibit 7: Higher other expenditures

(Rs bn)	FY09 budget estimates	FY09 revised estimates	FY10 budget estimates
Interest Payments	1,908	1,927	2,255
Prepayment Premium for reduction of debt	24	13	24
Pensions	251	327	350
Police	156	207	257
Defence	1,056	1,146	1,417
of which: On revenue account	*576*	*736*	*869*
On capital account	*480*	*410*	*548*

Source: Budget Document, IDFC-SSKI Research

❑ To conclude

Despite government expenditure having risen on some heads, which are not necessarily priming growth, the fact that net of subsidies, interest payments and defense, the FY10 budget estimates for expenditure are 25% higher yoy (over FY09 budget estimates) and 7% higher yoy (over FY09 revised estimates). However, we maintain that ground level implementation of the announced spending programs remains a key monitorable.

REVENUE SLIPPAGE WILL POINT TO A HIGHER DEFICIT

❑ Revenues – FY09 shortfall in line, FY10 estimates seem a tad higher

Gross tax revenues for FY09 are estimated at Rs6.2tn, a shortfall of 9% against the budgeted estimates, primarily due to significantly lower excise duty collections and a decline in personal income tax collections.

With a series of duty cuts across the board (as a measure to control inflation during H1FY09 and also as a part of the fiscal stimulus), the government expects a significant 21% shortfall in FY09 estimates for Union excise duties. The shortfall has also been exacerbated by the decline in prices of various commodities during H2FY09.

Additionally, with lower personal incomes in FY09, the government estimates an 11% shortfall in personal income tax collections.

Exhibit 8: Tax revenues

(Rs bn)	FY09 budget estimates	FY09 revised estimates	% variation	FY10 budget estimates	% growth
Gross tax revenues	**6,877**	**6,279**	**(9)**	**6,713**	**7**
Corporation tax	2,264	2,220	(2)	2,442	10
Income tax	1,383	1,226	(11)	1,354	10
Other taxes and duties	325	4	23	4	6
Customs	1,189	1,080	(9)	1,102	2
Union Excise Duties	1379	1,084	(21)	1,106	2
Service Tax	645	650	1	689	6
Taxes of the Union Territories	15	16	10	16	1
Less- NCCD transferred to the National Calamity Contingency Fund	18	18	0	25	39
Less States' Share	1,788	1,602	(10)	1,712	7
Net tax revenues	**5,072**	**4,660**	**(8)**	**4,976**	**7**

Source: Budget Document, IDFC-SSKI Research

❑ Optimistic on H2FY10 recovery

Going forward, the government expects a 7% increase in FY10 gross tax revenues, which makes us believe that government seems optimistic about an H2FY10 recovery. While the estimates assume a marginal rise of ~3% yoy (over FY09 revised estimates) in indirect tax collections for FY10, the assumption of 10%yoy growth in direct tax collections (over FY09 revised estimates) seems a tad too high due to lower corporate profits in FY10 (relative to FY09) as also significantly lower personal incomes (aggravated by increasing job losses). The lower-than-estimated tax collections in FY10 could thereby add to the already burgeoning fiscal deficit and remain the key risk to government estimates.

❑ Indications of tax cuts do no good

While the government has refrained from doling out any tax cuts in the current budget, the acting Finance Minister has indicated the UPA government, if re-elected, would look at tax cuts as a measure to stimulate demand. This measure, if implemented, clearly points to further strain on the already stretched fiscal position.

WE, THEREBY, SEE THE BOND RALLY FIZZING OUT

- With the government's fiscal deficit slated to rise (beyond the market's expectations) and with significant supply of G-Secs coming into the market, we believe the rally in government bonds is in its fag end.
- Though declining inflation (to near-zero levels) could still see a marginal decline in benchmark G-Sec yields, we believe the impending supply (with an increasing fiscal deficit) would play on the market's mind.
- While, we still see enough room for monetary easing by the RBI, and if implemented, would lead to lower G-Sec yields, we believe that incremental easing would lead to a decline in borrowing costs for corporates – through lower credit spreads – rather than for the government.

OUR VIEW

We see significantly diminished prospects of a bond rally to 5percent levels (on the benchmark 10 yr G-Sec) rapidly vanishing on the expectation of an outsized fiscal deficit. WE have always believed that the best of the G-sec rally is behind us but did expect the falling inflation, ample liquidity to result into the last leg of the rally in a controlled fiscal deficit environment. But that's not to be anymore and we expect bond yields to remain stable or decline marginally, at best. This changed view will have significant implications for banks (especially PSU banks) which were supposed to riding a trading upside on the back of the last leg of the G- sec rally.

These banks will now be faced with the reality of slowing core income streams, slowing credit growth and falling margins coupled with asset quality pressures which would manifest in doubling of NPLs (to around 6-7%) over the next 12-18 months. While the unassuming valuations partly factor these events, the stream of negative newsflow lined up over the next few quarters will impinge on stock performance. We change our stance on financials to Neutral with an underweight on PSU banks.

However, as the government goes full throttle on its spending spree, both on social and physical infrastructure, we believe the infrastructure sector stands to benefit significantly and we remain Overweight on infrastructure stocks.

FY10 INTERIM BUDGET: SECTOR IMPACT

❑ Agriculture

- Plan allocation for agriculture increased by 300% from 2003-04 to 2008-09. Rashtriya Krishi Vikas Yojna launched in 2007-08 with an outlay of Rs250bn with the objective to boost growth rate of agriculture and allied sectors to 4% per annum during the Eleventh Plan period.
- Agriculture credit disbursement increased 3x from Rs.870bn in 2003-04 to about Rs2500bn in 2007-08.
- To strengthen short-term cooperative credit structure, revival package in 25 states involving financial assistance of ~Rs135bn is being implemented.
- Interest subvention to be continued in 2009-10 to ensure that farmers get short-term crop loans up to Rs300,000 at 7% per annum.
- The Agricultural Debt Waiver and Debt Relief Scheme, 2008 was implemented by 30 June 2008 as scheduled. Debt waiver/ Debt relief amounting to Rs653bn covers 36m farmers.
- The Central Plan 2009-10 includes Rs11bn allocated for National Horticulture Mission, Rs11bn for National Food Security Mission, Rs9.5bn for Macro Management of Agriculture and Rs4bn for Micro Irrigation.
- In addition, it outlines an allocation of Rs20.21bn for Centre-sponsored schemes of Integrated Watershed Management Programme.

Our View:

- Incrementally positive for the sector, particularly Jain Irrigation, given the fund allocation towards MIS, horticulture, etc and incentives given to farmers with regards credit/financial assistance.

❑ Auto

- The interim budget has not provided any measures that would help boost sentiment in the auto sector

	Excise duty		
	Current	Expected	Actual post Interim budget
Two wheelers / Three wheelers	0.08	No change	No change
Passenger vehicles			
with engine capacity <1500cc	0.08	No change	No change
with engine capacity 1500cc - 2000cc	20% + Rs15,000	Additional Rs15,000 duty likely to be withdrawn	No change
with engine capacity >2000cc	20% + Rs20,000	Additional Rs20,000 duty likely to be withdrawn	No change
Commercial Vehicle - Goods	0.1	No change	No change
Commercial Vehicle - Passenger	0.1	No change	No change

Our view:

- The current uncertain macro-environment has inculcated a feeling of job insecurity, which in turn has led to a sharp pullback/ postponement of spending on consumer durables including cars/ two wheelers. Further, financing of auto loans is becoming increasingly stringent with banks/ NBFCs turning extremely cautious in extending credit to rate sensitive sectors and demanding higher margin contributions as also tough-to-meet documental requirements. Our ground checks reveal that interest rates on cars still hover around 15% despite the recent sharp cuts in interest rates; in cases where the manufacturer is providing subventions, rates may be lower at 12-14%. Hence, we believe that while the policy measures may provide some relief to the sector, the sooner the issue of easy availability of finance is addressed and a sense of financial / job stability returns to the customer, faster the demand would look up. However, CV demand would pick up only when the economic activity revives. For motorcycles and entry-level passenger cars, actual disbursement of cash to government employees on implementation of Sixth

Pay Commission recommendations may lead to a temporary spurt in demand given the state of STUs/ public transport and poor connectivity, especially in rural areas.

❑ Cement

- No change in indirect taxes announced. Neutral
- No changes in direct tax rates announced; deduction limit for home loan interest and principal repayments too kept unchanged. Neutral for housing, and hence cement demand.

❑ Construction / Infrastructure

- Plan outlay increased for most infrastructure sectors. Key areas include Rs350bn towards roads (+18% over 2008-09RE), Rs38bn in ports (+97% over 2008-09RE) and Rs32bn in airports (+22% over 2008-09RE). Further, budgetary allocation for the JNNURM pegged at Rs118.4bn for 2009-10.

View:

- Overall, the interim budget is positive for infrastructure and construction companies, as it carries forward the government's stated objective of focusing on infrastructure investments. Maintain IVRCL, NCC and GVK as top picks in the sector

❑ Education

- Major initiatives including a new Centre-Sponsored Scheme launched to universalize education at secondary stage in the year 2008-09.
- Outlay on Higher Education increased 9-fold in the Eleventh Five Year Plan. Ordinance promulgated for establishing 15 Central Universities. In addition to six new Indian Institutes of Technology (IITs) in Bihar, Andhra Pradesh, Rajasthan, Orissa, Punjab and Gujarat which started functioning in 2008-09, two more IITs in Madhya Pradesh and Himachal Pradesh are expected to commence their academic session in 2009-10. Five Indian Institutes of Science Education and Research (IISERs) have become functional. Two new schools of Planning and Architecture at Vijayawada and Bhopal have started functioning. Teaching is expected to commence from academic year 2009-10 in four out of the six new Indian Institutes of Management proposed for the Eleventh Plan in Haryana, Rajasthan, Jharkhand and Tamil Nadu.
- Due to revision in Educational Loan Scheme by the Government, the number of beneficiaries increased from 31.9m to 140.9m and amount of loan outstanding increased from Rs45bn as on 31 March 2004 to Rs242.6bn as on 30 September 2008.

Our View:

- Given the strong emphasis on growth in the education sector, our sense is that the environment is affirmative. We remain positive on Educomp.

❑ Financials

- The key takeaway from the interim budget for Financials is that G-Sec yields would not decline significantly from current levels of ~6%. The higher-than-expected fiscal deficit of 5.5% for FY10 (at ~6% for FY09, revised from 2.5% of GDP) announced in the interim budget implies increased government borrowing, which would in turn drive up bond supply. Consequently, the probability of a significant bond rally – induced by further rate cuts – in the near-term looks bleak. We have been consistently reiterating since December 2008 that the best period for bond gains is behind us, and thereby have advocated gradual trimming of PSU banks in the portfolio. Also, the possibility of a trading rally in PSU banks as inflation declined further has now diminished. With asset quality pressures due to manifest and significant over-holding by FIIs and domestic funds, we are cutting our sector stance to 'Neutral' from 'Overweight'.

Other key highlights:

- **Interest subvention extended:**
  - For employment-oriented sectors and SMEs extended: 2% interest rate subvention on pre- and post-shipment credit extended beyond 31 March 2009 till 30 September 2009. Subvention applicable for certain employment-oriented sectors, i.e. Textiles, Carpets, Leather, Gem & Jewellery, Marine products and SMEs. The extension implies an additional financial outlay of Rs5bn from the exchequer.
  - For farmers: Short-term crop loans of up to Rs0.3m at 7% p.a. to be continued in 2009-10
- **Re-capitalization plan for PSU banks re-affirmed:** The government had earlier earmarked Rs200bn to recapitalize PSU banks over the next two years to enable them to maintain capital adequacy ratio of 12%.
- **Agricultural Debt Waiver/ Debt Relief Scheme implemented:** The scheme has been implemented for Rs653bn as of June 2008 (as scheduled). The scheme was announced in February 2008 for waiving loans amounting to Rs600bn, which was further increased to Rs716bn in May 2008.

❑ Power Equipment

- Allocation under RGGVY upby 10% to Rs60bn, while budgetary allocation of Rs17bn made for APDRP projects including a loan of Rs14.77bn to PFC.
- Overall, allocations for the two key government schemes, RGGVY and APDRP, have been increased. Moreover, the interim budget envisages extra budgetary resources of Rs439bn to be generated by various power PSUs in FY10, which will drive order flow for power equipment companies. Positive for power equipment companies in generation as well as T&D. Maintain BHEL as top pick.

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