Global Equity Research - India

Pre - Budget Note

23 February 2007

KARVY STOCK BROKING LIMITED

Budget Expectations

from the Research Desk

The United Progressive Alliance (UPA) government will present the FY2008 Union Budget on 28th February. Strong economic growth, surge in tax collections, an improved fiscal deficit and robust corporate profitability provides the government with more leeway to increase social welfare, agriculture and infrastructure expenditure. Inflation remains a key concern which the government is likely to address especially when the Uttar Pradesh state elections are expected in FY2008.

To tackle the rising inflation we expect peak customs duty to be reduced to 10% from 12.5%. Tax surcharge on corporate and income tax is expected to be removed. To widen the tax net and capture the growing contribution of the services sector in the economy we expect the service tax to be increased to 14% from 12% and more services to be included. To increase outlays on health and education, the government may introduce a health cess and increase education cess to 4% from 2%.

(Rsbn)	SDDS Data Category and Component	Previous data April-Dec 2005	Latest Data April-Dec 2006	% change from previous to latest period
1	Revenue Receipts (2+3)	2,167	2,809	29.6
2	Tax Revenue (Net)	1,687	2,322	37.6
3	Non-Tax Revenue	480	487	1.5
4	Non-Debt Capital Receipts	74.2	79.5	7.2
5	TOTAL RECEIPTS(1+4)	2,242	2,889	28.9
6	Non-Plan Expenditure	2,379	2,722	14.4
7	Plan Expenditure(8+9)	946	1,115	17.9
8	On Revenue Account	749	939	25.4
9	On Capital Account	197	176	(10.7)
10	TOTAL EXPENDITURE (6+7)	3,325	3,837	15.4
11	Balance, deficit(+)/surplus(-) Fiscal Deficit (10-5)	1,083	949	(12.4)
12	Primary Deficit	274	22.2	(91.9)
13	Financing (14+15)	1,083	949	(12.4)
14	Domestic	1,040	898	(13.7)
15	External	43.5	50.7	16.5

Source: Controller General of Accounts

Fiscal deficit for FY2007 maybe lower than budgeted target of 3.8% and the government should be on track to achieve the 3% target for FY2009. In achieving this target we hope that the government does not continue to reduce capital expenditure as it is required especially in the infrastructure sectors.

The government's expenditure management remains a concern as the improvement in the fiscal deficit is attributed to the buoyancy in the economy rather than reducing expenditure. Any slowdown in the economy would therefore increase the fiscal deficit.

We remain positive on the **IT**, **banking** and **cement** sectors.

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Sector

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KARVY STOCK BROKING LIMITED

Banking

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Our wish list from Fiscal Budget 2007-08

Permission to banks to raise capital through perpetual non-cumulative preference shares eligible for inclusion as Tier I capital and redeemable cumulative preference shares eligible for inclusion as Tier II capital: Due to consistent high growth in credit and relatively lesser growth in deposit there are liquidity concerns in the system, therefore banks are in urgent need of other avenues to raise capital. We expect the Finance Minister to make the necessary amendments in the Banking Regulation Act to allow banks to raise capital as suggested in RBI's guidelines.

Facilitating banks' deposit growth: We expect the FM to take decisions which could facilitate deposit growth to succor banks in funding their advances.

- Relaxation in the lock in period for savings under Section 80C from present time of 5 years
- Increase in ceiling for TDS on fixed deposits from Rs.5,000
- Restoration of tax exemption on interest income under section 80L

Increase in foreign ownership limit (from present 20%) in public sector banks: We expect the Finance Minister to bring necessary amendments in the Banking Regulation Act so that FII ownership limit in public sector banks can be increased.

The government may announce measures to promote consolidation in the government so as to meet the challenge of foreign banks post FY2009.

We are **Positive** on Indian banking sector, and remain bullish on **Bank of India** , **Dena Bank** and **Union Bank of India**.

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Cement

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Reduction of import duty on petcoke from 5% to Nil: We expect the import duty on petcoke would be brought down from 5% to Nil. The reduction of import duty would reduce the power and fuel cost which would enhance the operational efficiency for the companies like Shree Cement and JK Cement. But this move has neutral impact for those companies which do not use petcoke as a fuel like ACC & GACL.

Proposal from Cement Manufacturing Association: Reduction in excise duty from Rs. 408/tones to Rs. 350/tones: We do not expect any kind of reduction on account of super normal profit and improving margins enjoyed by the cement industry.

Sector View: We are **Positive** on cement industry as we expect cement prices to remain firm in FY2008 on account of robust demand and supply constraints. The government's thrust on infrastructure and tax incentive for housing sector will boost the demand growth. The rising interest rates may be a concern for housing sector but it will be compensated by the softening real estate prices. As a result we expect the stellar performance by the cement industry to be maintained in FY08.

Our top picks include **India Cements** and **ACC**.

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Defence

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Budget allocations towards defence have witnessed a steady rise over the last few years bearing in mind India's ambitions of becoming a regional power. There have been ample provisions made for India's internal and external security. Defence expenditure has grown at CAGR of 10% over the last five years with emphasis on defence capital expenditure which has grown at 18% CAGR in the same period. Budgetary allocations towards total defence expenditure stood at Rs890bn in 2007 of which Rs374.6bn was allocated towards defence capex.

To achieve India's military ambitions of being the dominant regional power, the government is expected to steadily increase defence expenditure over the next few years. In the immediate future, the biggest deal will be the purchase of 126 multi-role fighters for the Indian Air Force (IAF) which has been pending for some time.

The government has also introduced the offset clause in the Defence Procurement Policy, 2006 to benefit Indian private and public sector companies. The clause is applicable for all defence purchases where the value of the tender exceeds Rs3bn. The clause requires foreign vendors to provide orders to Indian companies to the equivalent of 30% of the contract value.

We expect budgetary allocations towards defence to grow by 9-10% in the upcoming budget representing close to 2.3% of GDP. Around 43% of the defence expenditure is expected to be allocated towards defence capex. Allocation towards defence R&D is expected to grow by 5-6% to approximately Rs32bn. We expect the budget to be **Positive** for the sector.

Our top pick is **Astra Microwave**.

Expenditure Statistics

	FY01	FY02	FY03	FY04	FY05	FY06RE	FY07BE
Total Defence Expenditure (Rsbn)	496.2	542.7	650.0	603.0	770.0	817.0	890.0
Defence Capex (Rsbn)	123.8	162.1	149.5	169.1	334.8	330.8	374.6
Defence Revenue Expenditure (Rsbn)	372.4	380.6	500.5	433.9	435.2	486.2	515.4
Total Defence expenditure as % of GDP	2.4	2.4	2.6	2.2	2.5	2.3	2.2
Defence Capex as % of GDP	0.6	0.7	0.6	0.6	1.1	0.9	0.9
Defence R&D Expenditure (Rsbn)	NA	NA	NA	27.1	23.4	28.0	30.1

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IT Services

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The budgets never had any significant impact on the earnings' of the IT companies. There is a possibility that the budget can give some thrust to promote higher technical education, which would erase the supply related concerns. Besides the budget can give some direction in promoting tier-II and III cities which would benefit most the technology services companies, as most of the tier-1 cities are reaching saturation.

On Excise Duty – For the past 3 years, the Finance Minister has not tinkered with the excise duties on computer accessories, integrated circuits, micro assemblies and other parts like DVD, CDR, modems and routers. We expect there could be a minor lowering of excise duties – to narrow the price of branded computers with unbranded ones. MAIT has been seeking to reduce the excise duties for some time and with the Government keen to push e-governance there is an outside possibility the FY08 Budget may lower the excise duties from the current 16% to 12%. Besides, the Budget may increase the excise duty on application and system software from the current 8% (which was levied from FY07) to 12%.

On Customs Duty – The import duty on computer components like microprocessors, storage devices, monitors, computers and peripherals were done in the FY02 budget itself and in the subsequent budgets most of the items with the exception of speakers have been brought down to 0%. The speakers are currently carrying a customs duty of 15.3% (including the countervailing duty), may be the countervailing duty can be removed. In FY06 budget most of the items have been brought down to 0%, nevertheless on some of the items there are countervailing duties, which could be brought down to 0% levels.

The budget is not likely to tinker the section with 10A/B of the IT Act (taxing of export profits), as these are sun-set clauses and it will expire by FY09. If the budget can extend the concessions of SEZ to STPs, it can play a vital role in the future capital expenditure planning of many tier-2 and tier-3 companies, since STP scheme is coming close in FY09 - 10. There is lucidity required to the definition of export revenues, since export turnover to include the earlier exclusions of freight, telecommunications charges and insurance attributable to the delivery of articles or service rendered outside India. The most important notification one can expect is the withdrawal of the service tax on the maintenance software which would positively impact on margins and reduce procedural issues.

Conclusion: Infosys and TCS would continue to be our best pick, because they would continue to grow earnings by 40 – 42% as both companies have a critical size and would be participating in all the large offshore deals. For the next two years, regardless of rupee appreciating by 3 – 4% from the current levels we are positive on all the companies in the sector with the exception of TECH MAHINDRA and IFLEX SOLUTIONS as both the companies'are trading at stretched valuations, though fundamentally both the companies would be growing at around 50%.

As the budget is not likely to tinker Section 10A/B as it will expire over the next two years wouldn't mean that post FY09, the effective tax rate would hit the marginal rate. We believe till FY14, the tax is not likely hamper growth, and by that time, the companies would triple the revenue size from the current levels. Many large (tier-1) IT services companies have bid for SEZ's and the profits are not likely to come under any significant levels of taxation even beyond FY14. Most companies would follow the organic growth route and would do selective and niche acquisition to bolster the "domain". Wipro would be the company that would do maximum number of acquisitions in FY08, provided the acquisition targets fits into the company's overall strategy.

We expect the budget to be **Neutral** for the sector.

Metal

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Customs duties on many items were reduced on January 23, 2007. Therefore, going forward, we do not expect any further reduction in duties. The list of items on which duties were reduced are as follows:

Ferro alloys, stainless steel and other alloy steel to 5% from 7.5%

Calcined alumina to 5% from 7.5%

Pipes of aluminium, copper and zinc to 7.5% from 12.5%

Refractories to 5% from 7.5%

Specified raw materials of refractories to 5% from 10.75%

Primary and semi-finished forms of copper, aluminium, zinc, tin, other base metals to 5% from 7.5%.

Customs duties on steel currently stand at 5%. We expect no change in the present duty structure.

No changes in excise duties are expected from the current level of 16% for aluminium, copper and steel.

We expect the budget to be **Neutral** for the sector.

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Oil & Gas

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Push for a unified market - A major recommendation of the Rangarajan committee is the proposal to integrate the domestic oil and gas market into a single unified national market with uniformity in rates of taxes through an all encompassing VAT covering both imports and local levies such as octroi.

Implementation of the Rangarajan Committee recommendations should be done in toto. A 10-year tax holiday should be granted to pipelines, storage terminals and other related facilities for transportation and storage of petroleum products.

Industry is hoping for a reduction in excise duty on petro products in the Budget.

Oil & gas exploration and production industry should be given infrastructure status. Similarly, cross-country pipelines should be treated as infrastructure. Crude oil product and gas pipelines, storage terminals and other related facilities for transportation and storage should be classified as infrastructure facility.

Undertakings engaged in the commercial production or refining of oil should be given the option of claiming tax holiday.

We expect the budget to be **Positive** for the sector.

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Pharmaceutical

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We expect excise duty reduction from 16 % to 12 %. The industry is however pushing for reduction of excise duty to 8 %. This would benefit Ranbaxy, Dr Reddys, Sun Pharma, Cadila,Unichem Labs, Ipca Labs, Lupin and other Indian companies.

Reduction in peak customs duty from 12.5 % to 10 %. This would benefit MNCs in particular as they import large amount of raw materials.

R & D: The weighted tax deduction of 150 % on R & D expenditure is expected to end by March 2007 would get a further extension of 5 years. The industry's demand to increase the same to 200 % is unlikely to be met. This will benefit companies engaged in R & D work. This would be positive for Ranbaxy, Dr Reddys, Sun Pharma, Biocon, Cadila and other Indian companies.

Customs duty on raw materials for ANDA is expected to be reduced from 12.5 % to 5 %. Further some laxity may be allowed so as to enable companies to claim exemption on R & D expenses incurred on approved outside facilities for ANDA filing. This would benefit Ranbaxy, Dr Reddys, Sun Pharma, Cadila, Ipca Labs and Unichem Labs.

MAT rate increase expected from current 10 %. This would impact companies in MAT regime which would primarily include Sun Pharma.

We expect the budget to be **Positive** for the sector.

Our top picks include **Cadila**, **Unichem**, **Ipca**, **Divi's Laboratories, Sun Pharma** and **Indoco Remedies**

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Real Estate

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Our wish list from Fiscal Budget 2007-08

The government has been concerned with the high rate of credit penetration leading to speculative demand being created for real estate. The so-called real estate bubble has made the banks and other financial institutions more cautious in lending to this sector. The cautiousness along with the recent hike in cash reserve ratio (CRR) has led to a hike in the home loan rates, thereby suppressing the demand. However, we expect the government to announce some tax benefits and policy guidelines for the builders as well as the consumers (especially in case of residential constructions) that will make the houses more affordable for the ever rising middle class in the country.

Section 80IB: This section gives tax relief to the builders for construction of units, which are less than 1000 square feet built up in metros. A lot of builders have created houses under this scheme and consumers are benefited through the mass construction. The exemption under this section is due to end this year. We expect the government to continue giving this subsidy to the builders as this will encourage them to make more middle class and affordable homes.

Tax on Rental Income from new residential constructions: Currently a deduction of 30% is allowed on the rental income of the builders from the new residential constructions. We expect the finance minister to increase this deduction to 50%. This will spur the real estate developers to continue making the residential constructions keeping in mind the acute shortage of approximately 22.4 mn sq ft of residential area, in the 10th plan estimate by the government.

Section 24: This section gives exemption on interest payable for home loan buyers. Currently the exemption goes to Rs 1.5 lakh. We expect the government to increase this exemption limit keeping in mind the surge in real estate prices. This will help the middle class as far as the affordability of the new residential dwellings is concerned amidst the recent increase in home loan rates. Also, it will help in keeping the demand intact.

Stamp Duty: Stamp duty rates are still one of the highest in India, with as high as 15% in some of the states. Comparing this with 1-2% in countries like Singapore, we believe that there is a vast scope of relaxation of stamp duty rates in India so that it does not adversely affect the housing sector.

REITs, SEZs: The government should put things into perspective as far as the regulations related to Real Estate Investment Trusts (REITs) are concerned. This will bring in structured lender who lease their property and at the same time bring in structured investors, which are waiting to invest in the market. Also, more clarity is required in the SEZ policy of the government so that the development of the plethora of SEZs coming up can be better structured.

Overall, we believe the budget would be **Positive** for the real estate sector with the government being pro-development and willing to reduce the high rate of taxes on the sector and more clarity on policies regarding REITs and SEZs to spur growth in the sector.

Shipping

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We do not expect any specific announcement for shipping sector. However, any announcement on Fringe Benefit Tax (FBT), service tax and Minimum Alternate Tax (Mat) announcements are likely to marginally impact the shipping sector. (The shipping companies avail the ship management services from brokers and the profit of sale of ship comes under the MAT provision)

Indian shipping companies are paying around twelve different taxes like - Seafarers taxation, withholding tax on charter charges paid to foreign ship owner, interest paid to foreign players and service tax etc. The cumulative effective of these taxes lead to cost disadvantage of 4 to 5% as compared to foreign ship-owners. The restructuring of these taxes is expected to have positive impact on the industry.

The ship building industry should be given an infrastructure status or extension of 30% subsidy scheme which is ending on July 2007.

We expect the budget to be **Neutral** for the sector.

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Soda Ash

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Indian Soda Ash Industry has been negatively impacted by reduction in customs duty, abolition of anti-dumping duty. It is expected that the custom duty on soda Ash would be reduced from 10% currently. As per the international agreements, custom duty is required to be brought down to zero. The reduction in Customs duty on soda ash will have limited impact on Indian players due to significant logistic costs involved in importing the same.

Issue	Current status	Likely changes	Impact
Custom duty on soda ash	10%	Expected to be reduced.	**Mild Negative**

Top Pick: Tata Chemicals, GHCL

The expected reduction in Customs duty on soda ash will be limited for **Tata Chemical** and **GHCL** with the recent overseas acquisitions, planned capacity additions and increasing demand.

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Sugar

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Custom duty on sugar may remain at current level of 60%. (Duty free import of raw sugar is allowed under the advance licensing scheme with an obligation to export within 24 months.)

Excise duty is also expected to remain at current levels for Levy and Free sale sugar. (Note: Current Levy Sugar percentage is 10%)

Rs Per MT	Basic	Additional	Cess	Total
Levy Sugar	380	0	140	520
Free sale	710	0	140	850

To lower excise duty on Molasses from Rs 750 per MT to Rs 500 per MT or may be levied at 8% 'ad valorem'.

Exemption from the tax on cash withdrawal. (Sugar mills deal with farmers and transporters and most of these dealings are in cash.)

Exemption from service tax on sugarcane transport to avoid lots of paper work.

Incentives and tax holidays on cost (i.e Weighted deduction of 150%t) incurred by sugar factories on constructing roads in rural areas.

In view of multiple benefits of ethanol blending, the reduction of excise duty on ethanol doped petrol is expected to promote ethanol blending. Reintroduction of concessional duty of 75paise per liter on ethanol doped fuel that was allowed in the Union Budget for 2002-03, but was subsequently withdrawn.

Expectation of 80% depreciation benefit on plant and machinery for ethanol manufacturing on par with other renewable energy equipments.

Sector View

We believe the sugar stocks will underperform in short term (6 to 9 months) considering surplus scenario in domestic and international market. However, considering significant fall in sugar stocks risk return is favorable in long term on back of structural changes happening in the sugar industry with removal of the European Union (EU) subsidy and diversion of cane for ethanol blending. Again the sector is highly regulated and any significant announcement in terms of subsidy for export or re-imbursement of transportation cost will have positive impact.

We expect the budget to be **Neutral** for the sector.

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Stock Ratings		Absolute Returns	Stock Ratings		Absolute Returns
Buy	:	> 25%	Market Performer	:	0 - 15%
Out Performer	:	16 - 25%	Under Performer	:	< 0%