Pre-budget Outlook 2007

Edelweiss Research

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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.

- Budget 2007 is of particular significance as it is the first budget in the new five year plan and also the penultimate budget before the next round of central election. Also, uniquely, the finance minister faces the task of managing expectations across all time horizons: short term (inflation, UP, and other state elections), medium term (central elections in two years), and long term.

- The FM will maintain a bullish economic outlook for the next year. Fiscal targets are likely to get stringent, considering that the government will likely meet FY07 target by a margin. Inflation and rising economic inequity are likely to be flagged as concerns.

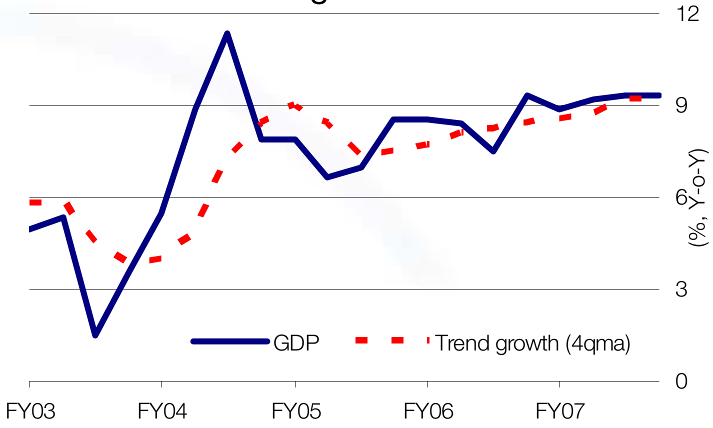
- We expect the focus to be on agriculture, infrastructure, and indirect taxes. Education and health will also be highlighted and some progress on capital market reforms is expected.

- Despite the fact that a number of government actions take place outside of the budget now, it is still an ‘event’ for equity markets. We expect the budget to be mildly positive. Two of the three UPA government budgets have been associated with positive returns, both pre- and post-budget.

Macro economic backdrop: Strong growth, flows, and markets

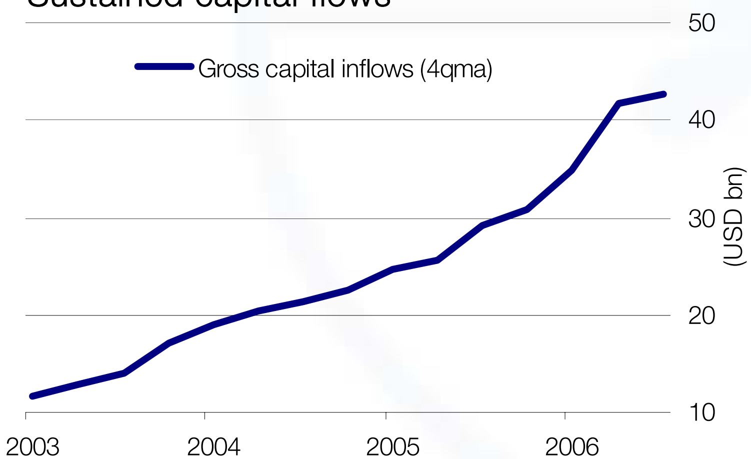
- Growth has been strong since FY05, when the UPA government came into power. An expected growth of 9% plus in FY07 is clearly above trend.
- Capital flows have also been strong since 2003—average quarterly capital flows have been over USD 40 bn, up from just over USD 10 bn in 2003.
- Strong growth as well as capital flows have kept equity markets buoyant, which has witnessed a bull run for over four years now.

Above trend GDP growth



Source: CMIE, Edelweiss research

Sustained capital flows



Source: CMIE, Edelweiss research

Buoyant capital markets

Source: CMIE

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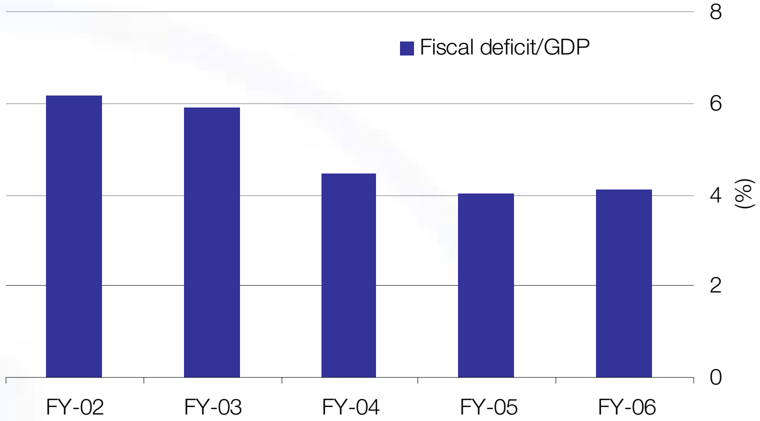
Macro economic backdrop: Fiscal situation in check

- The government's fiscal position looks comfortable. Our estimates suggest that it will more than meet the Fiscal Responsibility and Budget Management (FRBM) target that mandates a fiscal deficit to GDP ratio of 3.8% for FY07. It is likely to be closer to 3.4%.

- Three factors have contributed to the current contained fiscal situation: (i) strong receipts (69.6% of budget estimates, in comparison to 61.7% up to December 2005) as tax collections have been buoyant; (ii) total expenditure in check (at 68% of budget estimate, in comparison to 64.6% up to December 2005); and (iii) higher-than-initially expected GDP growth.

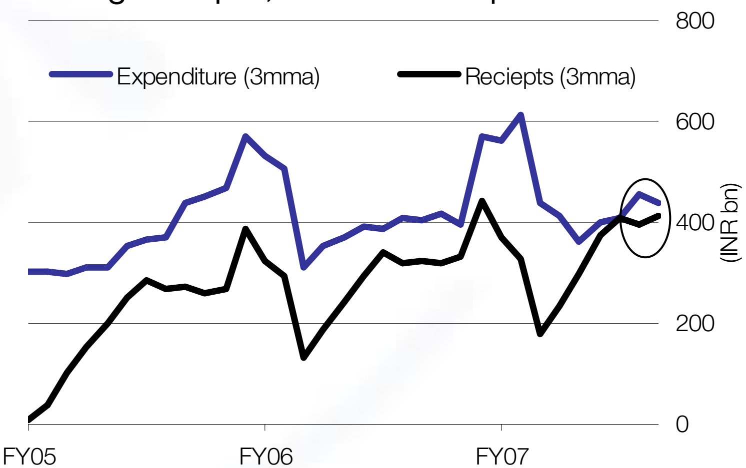
- Quarterly average fiscal deficit is down to a low of INR 27 bn for December 2006, compared to an average of INR 122 bn for the past two years.

Contained fiscal deficit



Source: CSO, Bloomberg, Edelweiss research

Strong receipts, contained expenditure



Source: CSO, Bloomberg, Edelweiss research

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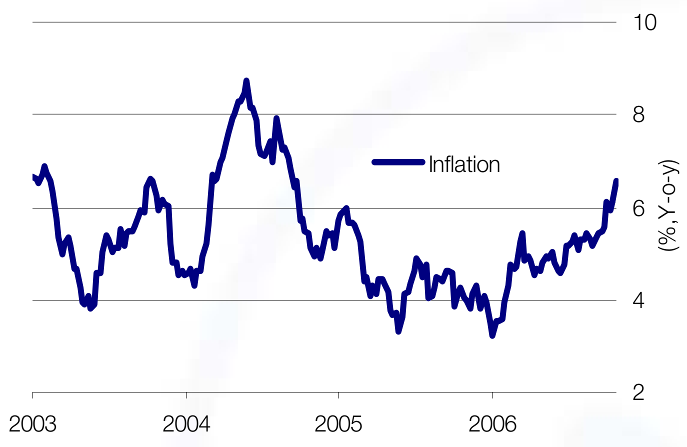
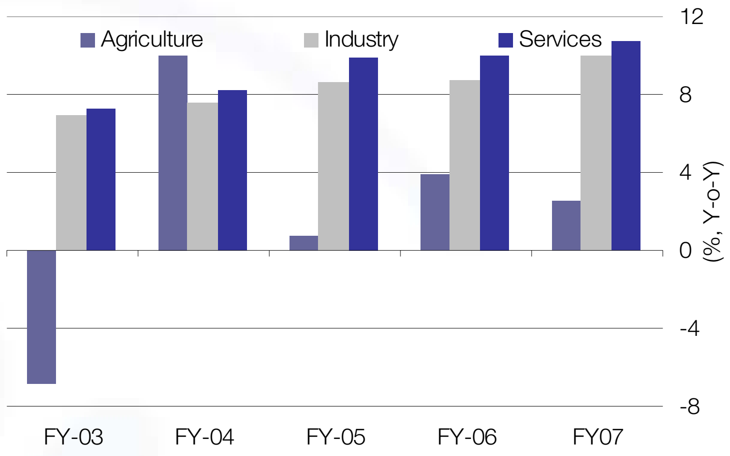
Macro economic backdrop: Inflation, agriculture of concern

Rising inflation, rising concerns



Source: Bloomberg, Office of Economic Advisor, Edelweiss research

Agriculture lags behind



Source: Bloomberg, CSO, Edelweiss research

- Inflation, at 6.73% Y-o-Y, is much above the RBI comfort range of 5-5.5%. While monetary tightening has been underway, fiscal policy has also aggressively swung into action. The government taken steps like putting restrictions on trade, cutting duties and reducing oil prices in a bid to curb inflation. While we believe that inflation is likely to come off by the end of Q1FY08, for now at least it is a worry factor.

- Agriculture growth has consistently lagged behind industry and services since FY05. It has grown at a low of 2.5% for H1FY07, in comparison with industry and services, which have grown at 10% plus rates. Considering that it hires about 60% of Indian workforce, low growth in this sector suggests rising income disparity.

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Outlook: Overall focus

Macro outlook:

The FM is likely to touch upon:

- Commitment to sustained economic growth.
- Concerns on inflation.
- Increasing economic inequity.
- More stringent fiscal targets may be set.

Focus areas

- Agriculture: is likely to acquire renewed focus, since it addresses the questions of: (i) sustaining economic growth; and (ii) rising economic inequity.
- Infrastructure: The government will continue to focus on infrastructure creation, in line with the commitment to support growth. In particular, we are likely to hear some announcements on ports, railways, and airports.
- Indirect taxes: The government slashed customs duties on a number of products in January to control rising inflationary pressures. We expect more such measures in the budget as well, though some punch may be lost since a number of measures have been undertaken already.

Sector specific expectations: Auto Components

Expectations	Impact
Excise duties on cars greater than 4mt in length are expected to be reduced from 24% to 16%	Maruti will benefit from this cut, and hence Amtek, a major supplier will also reap the benefits
Reduction in custom duties on some auto components	Mild negative for auto component manufacturers
We do not expect any further reduction in custom duties on metals, and non-ferrous alloys, which has already been reduced from 7.5% to 5%	Neutral on auto components. If duties on steel are reduced, then forging companies like Amtek and Bharat Forge will benefit, whereas, if duties on aluminium were cut then Rico and Sundaram Clayton will benefit

Sector specific expectations : Automobile

Expectations	Impact
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.
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.
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.
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.
Tax incentives for renewal of transport and private vehicle fleet.	This will benefit all players particularly Tata Motors and Ashok Leyland.

Sector specific expectations : 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 their 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/ taking planes on lease
Measures for further improvements in airport infrastructure, more airport modernization initiatives	Positive, enormous long-term benefits for the sector

Sector specific expectations: 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.

Sector specific expectations : Banking (contd.)

Expectations	Impact
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 expectations : Cement

Expectations	Impact
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 be passed on
Excise duty exemption on slag	Positive for ACC, Mysore, and Birla Corp
Abolish import duty on pet coke	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 expectations : 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 expectations : 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 expectations : FMCG

Expectations	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 expectations : Information Technology

Expectations	Impact
Extension of section 10A/10B beyond FY10	The popular and effective sections 10A/10B of the Indian Income Tax Act that were used largely by the Indian IT industry have a sunset clause and are due for a phase out by FY10. The industry has demanded that these provisions be continued. The 10A/10B facilities are to be replaced with SEZ schemes. The SEZ schemes are, however, unsuitable for small and medium sized IT companies. In case sections 10A/10B are extended beyond FY10, it will be a positive
SEZ scheme	The SEZ scheme provides for 100% tax exemption for the first five years of commencement of operations, followed by a further 50% exemption for another five years. This scheme aims at furthering India’s export advantage in many sectors including IT. This scheme has been recently enacted and we do not anticipate any changes
FBT	Dilution in FBT of some sort that will exempt genuine business expenditure from being taxed

Sector specific expectations : 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 opportunities 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 service providers
Announcement of funding mechanism and execution timeline for dedicated freight corridor	This is expected to be a big boost to growth in doemstic container movement and 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 expectations : 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 expectations : Media

Expectations	Impact
The industry expects the FDI limit in DTH business to be raised to 49% from existing 20%, at par with the cable industry. However, the possibility of it happening is low	Positive
Similarly, the FM radio sector expects the FDI limit to be raised to 26% from the existing 20%. But the probability of this happening is also low	Positive
Advertising in broadcasting media attracts service tax of 12.24% compared to nil for the print media. Broadcasters expect similar treatment as print media	Positive
There are talks of service tax being levied on fees paid to actors in films/television serials. This will push up cost of production	Negative
There were rumors of service tax being imposed on tickets sold in multiplexes. The industry, however, does not expect this to happen	Negative
Rationalization of Fringe Benefit Tax (FBT)	Positive

Sector specific expectations : Mining equipment

Expectations	Impact
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 expectations : 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

Sector specific expectations: Oil and Gas (contd.)

Expectations	Impact
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 expectations: Pharmaceuticals

Expectations	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 spending on healthcare	Marginally positive for the sector

Sector specific expectations: Real Estate

Expectations	Impact
Rationalisation of stamp duty	This may result in lower prices and will also help the government bring in more transactions in the official economy. Impact–Positive for companies
Reduction in excise duty on raw materials	Impact–Positive for companies
Restriction on SEZ	Impact–Negative for companies having large SEZ plans as certain value may erode. Also, there may be delays in land acquisition which may impact valuations
Import duty reduction on construction equipment	This will not directly benefit developers but will help in increased volumes

Sector specific expectations: 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 expectations: Telecom

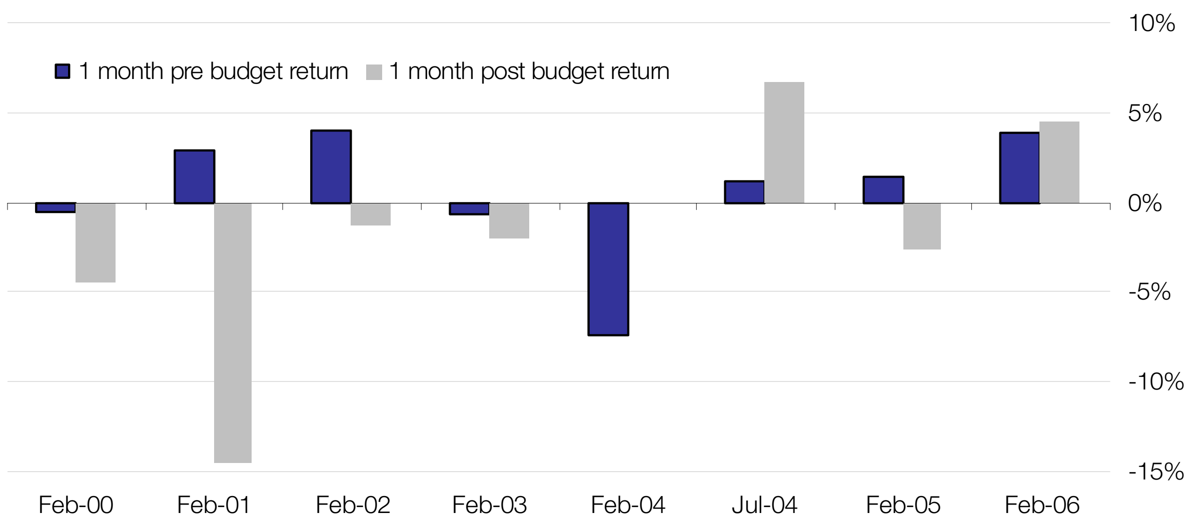
Expectations	Impact
Extension of tax benefits under section 80IA from 5 years currently to 10 years (at par with other infrastructure sectors)	Positive for telecos who get to continue with lower taxation levels, likely to free up cash flows for reinvestment into the business
Reduction in/Credit against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

Sector specific expectations: Textile

Expectations	Impact
Reduction in excise duty on man-made fibres and yarns from 8% to 4%	Synthetic yarn manufacturers will benefit as they will get parity with cotton yarn spinners. Rajasthan Spinning/ Indo Rama Synthetics will be the biggest beneficiaries
Reduction in excise duty on PTA from 8% to 4%, MEG from 12% to 8%	Reduction in duties may trigger reduction in yarn prices which will benefit synthetic fabric manufacturers
Capital subsidy on textile processing machinery to continue at 10%	Fabric manufacturers still likely to procure machinery 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% interest 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 may announce fresh capex plans
Labour reforms—more flexibility in labour laws even outside SEZ	To impact garment manufacturers positively by allowing them to plan their staffing and production requirements with gerater flexibility

Market performance around 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 have been the Jul 2004 and Feb 2006 budgets, two of three budgets under the UPA government, where both the pre and post budget returns have been strong.

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