Pre-Budget 2007-08

Hoping for no negatives

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Summary

- **The importance of budgets has been waning over the years thanks to a sharp fall in peak duty and the government's penchant for 'reform by stealth' on key contentious issues**

- **However, FY08 being the first year of XIth Plan and with general elections slated for 2009, the markets would be wary of any negative surprises**

- **The time for fiscal consolidation is ripe NOW, expect reforms to continue**
  - Rationalization in taxes & tariffs will have an anti-inflationary thrust, given rapid growth momentum and runaway inflation, widening of tax base to continue
  - With buoyant revenue collections, fiscal deficit could be brought down significantly below targetted 3.8% in FY07 and eventually closer to 3% by 2008 instead of 2009 as per FRBM final target
  - **Positive Potential:** Reduced fiscal deficit could boost savings and investment
  - **Negative Surprise:** Big-ticket populist expenditure schemes, new tax levies, restriction on housing loan deduction
  - **Main sectoral possibilities:** Excise cut on large cars, boost to agriculture and infra i.e. power and construction

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Budget overview

Macro backdrop remains encouraging

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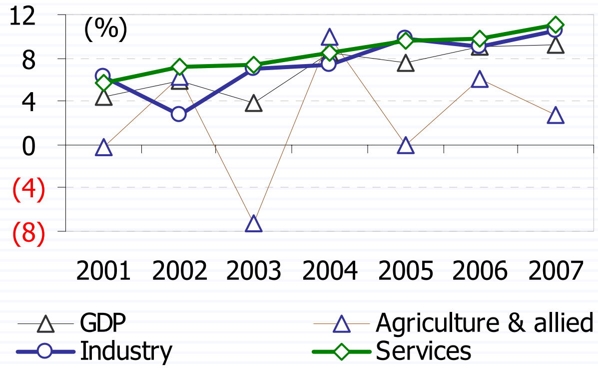
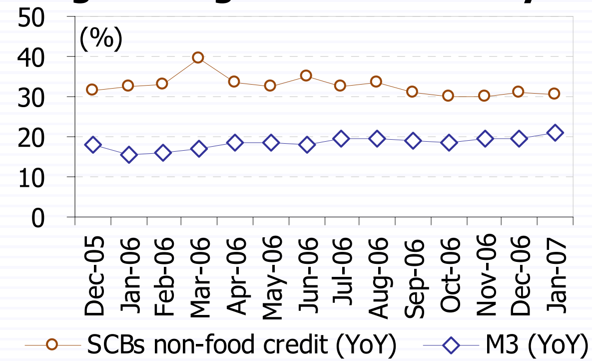
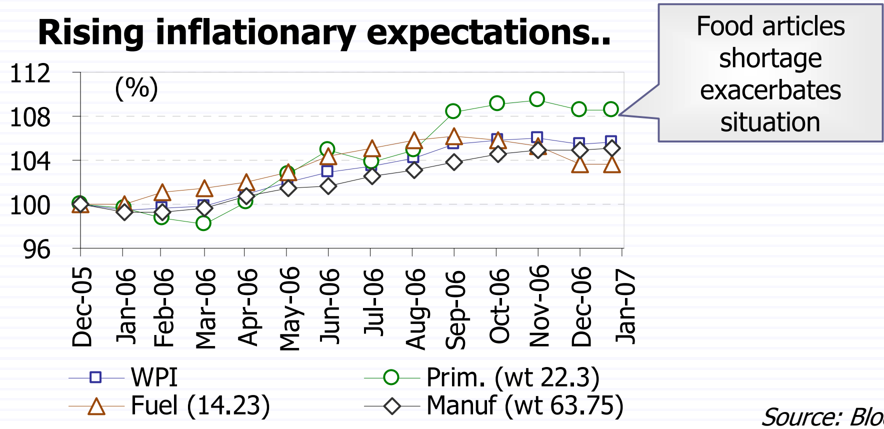
GDP led by strong non-agri growth..



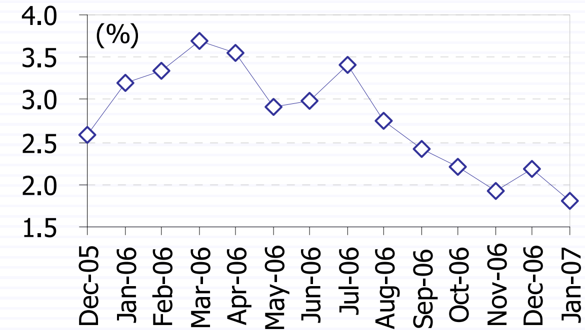
..fuelling credit growth and money supply ...



Rising inflationary expectations..



.. have led to a rise in interest rates, but low real rates leave room for further hikes



Source: Bloomberg

- GDP growth rate of 8-9% sustainable, given current rates of capital formation at ~35-36%, savings rate of 32-33%, capital flows of ~2-3% and ICOR of 4
- Average inflation likely to remain at ~ 5.5% for FY07, as primary articles supply gets augmented thru duty cuts, export-bans & seasonal supplies
- Interest rates likely to move up by further 25 bps in repo/ CRR shortly; however, lagged result of previous hikes on demand-side & liquidity cushion thru SLR cuts provide some cap
- INR appreciation likely to continue through FY08

Enough fiscal room for maneuvering

Strong GDP growth and tax revenue buoyancy…

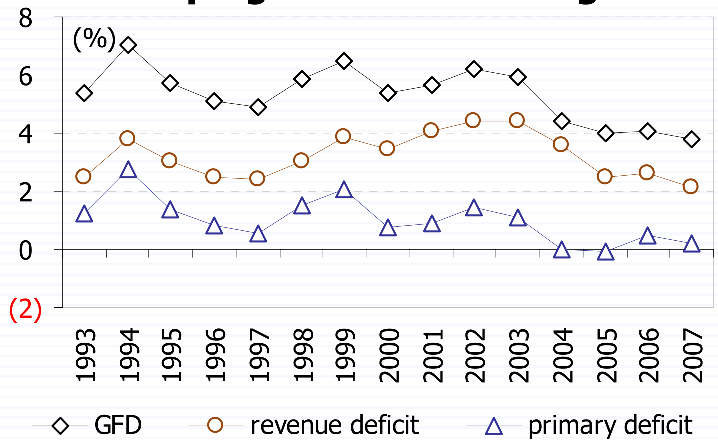
(Rs bn)	2005 Actuals	2006 Actuals	2007 BE	budgeted YoY grwth	Actual gwth Apr-Dec
Gross tax revenue	3,050	3,701	4,422	19	**32**
Income tax	493	662	774	17	**27**
Corporate tax	827	1,036	1,330	28	**55**
Custom	576	642	771	20	**33**
Excise	991	1,120	1,190	6	**6.6**

… has boosted tax/ GDP ratio…

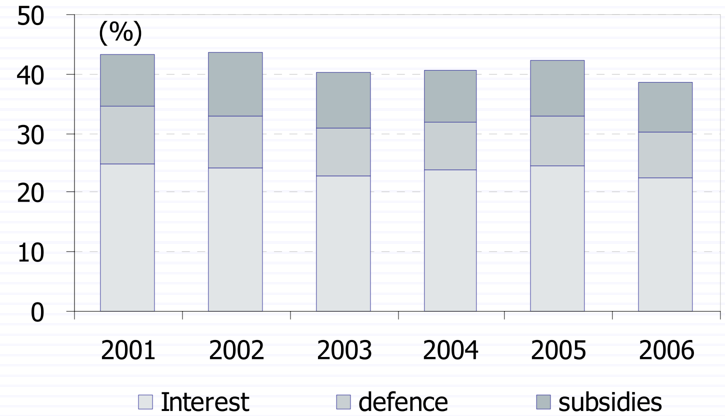
Country	Tax/GDP %
India *	17
China	18
Brazil	34
USA	27
UK	37
Korea	26

*Source: OECD, * total (incl centre + states)*

… helping achieve FRBM* goals..



..But interest & subsidies still worrisome



Fiscal deficit could fall to 3.5% vs targeted 3.8% in 2006/07, FRBM mileposts could be achieved sooner than 2009

** FRBM = Fiscal Responsibility & Budget Management: stipulates **min reduction in Revenue/ Fiscal deficit of 0.5%/ 0.3% p.a. and terminal values of Nil/ 3% by FY09***

Q3 Corporate performance: Remains upbeat

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Sector Name	Q3 Sales Gwth		Q3 EBIDTA Gwth		9M Sales Gwth		9M EBIDTA Gwth		EBIDTA Abs margin			
(%)	Q-o-Q	Y-o-Y	Q-o-Q	Y-o-Y	9M FY06/ 9M FY 05	9M FY07/ 9M FY 06	9M FY06/ 9M FY 05	9M FY07/ 9M FY 06	9M FY05	9M FY06	9M FY07	Comments
Auto	8	26	8	9	15	27	18	20	13.5	13.9	13.2	Volume remains key driver, with realizations having increased for 4-Wheelers. Margins impacted primarily on account of rising input costs.
Banking	27	34	24	31	28	26	20	25				Robust credit growth supported by stable NIMs and improving asset quality.
Cement	20	52	32	144	27	41	15	110	22.6	20.4	30.3	Margin expansion on the back of high cement realizations YoY. Volume growth will be a key driver going forward.
Energy	18	23	16	3	16	20	13	11	27.5	26.7	24.8	Strong operating performance and higher treasury income boosts PAT
Engineering	19	20	85	51	27	20	69	49	7.4	9.9	12.2	Strong growth continues. Margins helped by raw material fall. However, interest costs up.
FMCG	7	15	17	19	20	17	16	18	25.1	24.3	24.5	Despite inflationary cost environment, operating margins have been maintained. Thus reflecting volume backed pricing power.
IT Services	8	44	10	36	30	45	31	37	26.3	26.7	25.3	Volume remains key driver, with pricing uptrend observed. Margins impacted by currency appreciation, though partially offset by scale benefits.
Metals	3	39	5	43	9	39	2	28	35.7	33.5	30.9	Lower margins YoY due to decline in steel margins & higher base effect of Tata Steel vis a vis Hindalco. Strong rebound in prices to lift margins.
Petro, Oil & Gas	(1)	37	13	34	18	33	13	24	34.9	33.3	31.1	Higher net realization for crude oil & robust refining performance.
Pharmaceuticals	(7)	49	(21)	106	9	55	(21)	124	18.1	13.2	19.0	YoY spike in sales and EBIDTA due to acquisitions of Terapia & Betapharm by Ranbaxy & Dr. Reddy's respectively. Recovery in EBIDTA margins in 9MFY07 due to 180-day exclusivity on Zocor.
Telecom	7	26	13	80		43		106			39.3	Subscriber growth. Increase in long distance traffic and economies of scale led to robust performance at operating profit level.
Overall Sensex	**7**	**33**	**17**	**35**	**24**	**32**	**22**	**32**	**34.3**	**33.8**	**33.7**	

Source: Company, ENAM Research

For Banking: *Net Sales= Net Interest Income, EBIDTA= Net Income*

- **Lower RM costs in Q3 helped margins. However going forward, effect of higher interest costs to kick-in in Q4. No signs of slowing volume growth anywhere yet**

Long term measures, albeit with anti-inflationary thrust in the short run

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- **Anti-inflationary thrust, given rapid growth momentum and runaway inflation**
  - Containing expenditure and deficits
  - Reduction in Customs & Excise duties
- **FY08 will be the 1st year of the 11th Five Year Plan and a road map facilitating higher spending on infra and social sectors is expected to be laid out**
- **Centre's XI Plan Gross Budgetary Support to rise by 2.5% of GDP esp in:**
  - **Agriculture & Rural:** With XI plan calling for another "Green Revolution", major boost to Agriculture expected:
    - **Increased funding** for **Irrigation** and enhancing agricultural productivity
    - **Tax concessions** for **private investment** in Agriculture and in Agri-logistics chain
    - Announcements in **Integrated Food law, Warehouse Receipt Act** and **Essential Commodities Act**
    - **Increased outlay** for rural development: 27% increase in Gross Budgetary Support for 2007/08
  - **Social spending:** Boost to social spending i.e. Public Health, Education
  - **Infrastructure**
    - Outlays to be raised significantly to meet investment requirement of **USD 320bn** during the XI plan
    - **Infrastructure status** to sectors such as **Oil & Gas pipelines, LNG terminals** etc.
    - **Tax breaks** for **infrastructure** and **logistics** investments

Strong growth affords opportunity to rationalize tax rates & widen base

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- **Direct taxes:**
  - Reduction/ removal of 10% surcharge on Income/ Corporate tax
  - Reduction in corporate tax for foreign cos from 40% to 35% in India, changes in non-resident taxation on the anvil
  - Imposition of sunset clauses for select tax holidays i.e. on EOUs unlikely to be extended
  - Tax on savings instruments: Announcement likely on shift towards EET (Exempt, Exempt, Tax) regime

- **Indirect taxes:**
  - **Customs**: Peak rates may be aligned to Asean levels at one go i.e. at ~7-8% from the existing 12.5%
    - Duty on petrol and diesel to be reduced from 7.5% to 5%
    - Further cuts in basic metals, chemicals and machinery sectors
  - **Excise**: Peak duty could be gradually pushed to a single rate of 16%: main beneficiary large cars/ CVs currently 24%
    - Ad valorem excise duty expected to be reduced from 8% to 6%
    - Selective cuts in consumer goods
  - **Focus areas**: Specific duty cuts and concessions aimed at **agri-imports, processed foods and consumer goods**.
  - **Service tax**: Rate could be pushed up from 12% to 14%
    - 44 new items to be included ie. lending services, sports,amusement parks, health, hotel and lodging, electricity distribution etc.
  - **Goods and Services Tax (GST)**: A clear blue print to be unveiled
    - Service tax and CENVAT could be unified to 14% as a beginning
    - If done right, GST will be accompanied by the removal of all other taxes, thus leaving only Income tax, GST and Property tax

- **Removing various exemptions:**
  - Revenues foregone due to various exemptions in FY 05 stood at ~Rs 1,760bn= 1.2x Fiscal Deficit, major heads of which are as follows. Hence, many of these may be removed

Item head	Amt (Rs bn)
Corporate Tax	578
Customs	570
Excise	300
Income Tax (u/s 10A/B alone)	11

Further improvement in investment climate

- **Investment norms:**
  - To be simplified for foreign investors
  - To be relaxed further for Banking, Retail, Real Estate & Insurance
  - Agri, Power, Urban Infrastructure, Financial sector & Water privatization high on agenda
  - Media, Coal and Mining sectors to be liberalized further
- **Capital market:**
  - Section 80C deduction may be raised by Rs 50,000 to Rs 1,50,000
    - This could be a positive for ELSS and other such market instruments/ MFs
  - Further measures to channelize pension fund and long term money into the markets
  - Facilitate increased access to foreign debt
  - FBT & STT: Expected to continue
- **Banking:** Tax-break on interest earned on deposits expected
- Disinvestment of PSUs such as Power Grid Corporation etc. on the anvil. However, no major headway expected on disinvestment and labor reform

Sectoral Expectations

Auto

Sector	Item	Companies Impacted	Current status	Possible changes in Budget	Impact
Auto	**Excise Duty- Medium cars**	Maruti (MUL) and Tata Motors (TAMO)	• 16% - Small cars • 24% others	• Uniform duty at 16%	**Marginal (positive)** • Volume growth, in non core category, not to impact earnings substantially
	Commercial Vehicles	Ashok Leyland, Tata Motors (TAMO)	• 24% - M&HCV	• 16% for M&HCV	**Positive** • Will boost CV volume growth • Possibly offset any adverse interest rate hike
	2 wheelers	Bajaj, Hero Honda, TVS	• 16% excise duty	• 8% excise duty (low probability of cut)	**Positive** • Greater volumes and possibility of higher realizations

Banking

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Sector	Item	Companies Impacted	Current status	Possible changes in Budget	Impact
Banking	**Tax breaks**	All Banks	Interest earned on Bank deposits < 5 yrs are taxed	Interest earned on bank deposits across maturities likely to get a tax break	**Positive** Banks can effectively compete with small savings - can offer more competitive rates
		All Banks	Rebate on housing loans	Could be restricted to only 1 house	**Negative**
	FII Limit*	All Public Sector Banks	FII investments currently restricted to 20%	Limit can be raised to 24%	**Positive** Will lead to higher valuations

Commodities

Sector	Item	Current status	Possible changes in Budget	Impact
Cement	**Import duty**	0%	None	**No Impact**
	Excise duty	Rs 400/ tonne	Reduction by Rs 50 to Rs 350/ tonne	**Neutral** Reduction would be passed through to customers
Metals	**Import duty Non Ferrous**	Product - 5% Raw material (Copper concentrate –2%)	Reduction to 2.5% Reduction to 0%	**Marginally negative** Upswing in international prices to offset duty cut
	Import duty Ferrous	5%	Reduction to 2.5%	**Marginally negative** Upswing in international prices to offset duty cut
	Excise duty	16%	Reduction to 12%	**Neutral** Reduction to be a pass through to customers
Ferrous	**Tax Concession for mega projects**	No special income tax benefits	Income tax benefits for mega steel projects	**Positive**
Paper	**Import duty**	12.5%	Reduction to 10%	**Negative**

Commodities

Sector	Item	Current status	Possible changes in Budget	Impact
Viscose Staple Fibre	**Import duty**	Product - 10% Raw material (Pulp) – 5%	Reduction to 7.5% Reduction to 2.5%	**Marginally negative**
	Excise duty	8%	No change	**Neutral**

Engineering, Infrastructure

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Item	Current status	Possible changes in budget	Impact
Custom duty	▸ 12.5% duty on general machinery/capital goods ▸ 10% duty on captive power (>5MW), power transmission projects ▸ 7.5% duty on key raw materials	▸ Recently reduced to 7.5% ▸ Recently reduced to 7.5% ▸ Recently reduced to 5%	**Neutral** ▸ Reduction in duties on key inputs – copper, stainless steel etc. to negate impact
Excise duty	▸ 16% duty on power related capital goods ▸ 16% excise duty on non-power related	▸ Reduction to 8% ▸ Reduction to 8%	**Positive** ▸ For power related engineering cos **Neutral** ▸ Domestic consumers (mfrs.) under excise net get credit
Income tax	▸ 80IA benefit for power plant and infrastructure projects expires in 2009 ▸ Exemption on interest, dividend & capital gains tax for infrastructure cos	▸ Benefit to be extended beyond 2009 till 2012 ▸ Exempt for power and infra sector developers	**Positive** ▸ For power generators and infra developers **Positive** ▸ For infrastructure developers
APDRP scheme	▸ APDRP scheme expires in March 2007 ▸ Grants given by centre via state government	▸ Extend beyond 2007 till 2012 ▸ Bypass state gov.and disburse benefits directly to utilities	**Positive** ▸ For power related engineering companies

FMCG

Item	Categories	Current status	Possible changes in Budget	Impact
Excise	All categories	Currently at 16%	Reduced to 14%	**Positive: All companies** Reduction to offset cost inflation
	Cigarettes	Not under the VAT regime. Attracts only AED.	AED on cigarettes will be transferred to the states to impose VAT at 4% or 12.5%	**Negative for ITC:** A 5% increase in excise will not impact volumes significantly However, a potential ~10% rise in prices due to VAT introduction @ 12.5% will impact volumes negatively
Customs	Personal care and Home care products	Peak custom duty range from 13%-15%	No further reduction expected	**Neutral**

IT Services

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Item	Current status	Possible changes in Budget	Impact
Section 10A/ 10B benefits	▸ Exports are exempt for 10 years from inception of facility, with FY09 being last year to claim tax benefits	▸ Expect status quo on current act	**Negative** ▸ Early removal of this benefit would impact earnings negatively. Current effective tax rate ranges between 8-23% ▸ Small and mid-sized companies will be affected if exemption is not extended
Education Thrust	▸ Union Budget 2006 saw substantial increase in K-12 related programs like Sarva Siksha Abhiyan	▸ Higher Allocation to K-12 oriented education programs ▸ FDI in education sector	**Positive** ▸ Key beneficiaries: Educomp, NIIT Ltd

Other positives include higher budgetary allocation on rapid computerisation of Govt departments, infrastructure upgrades to IITs/ educational institutes. These measures would be positive for IT education and domestically focused IT services firms

Oil & Gas, Petchem

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Item	Companies Impacted	Possible changes in Budget	Impact
Changes in duty structure for petro products	‣ HPCL, BPCL, IOCL, CPCL, MRPL	‣ Reduction in customs duty on MS and HSD (down to 5% from 7.5%) ‣ Reduction in excise duty to 6% from 8%	‣ Reduction in excise and customs duty may partially compensate for marketing losses ‣ Reduction in import duties to impact the refinery GRMs by ~USD 0.5/bbl
Reduction in the import duty on petchem products (PTA, MEG, Polymers etc)	‣ RIL, IPCL, GAIL, IOCL	‣ Import duty on PTA, MEG to be reduced to 5% from 8% ‣ Polymers import duty to be reduced to 0% from 5% ‣ Excise duty on polyesters to be reduced further	‣ Reduction in PTA, MEG duties to improve the polyester "value add". Neutral for integrated players like RIL ‣ Polymer import duty reduction to have a marginal negative impact ‣ Polyester to be competitive v/s cotton. Positive for RIL
Infra status for pipeline companies	‣ GAIL, GSPL, Gujarat Gas, IGL	‣ May get the tax holiday 80 IA benefit for new pipelines	‣ Tax is a pass through. Lower tax rate to make tariffs competitive

Pharmaceuticals

Item	Current status	Possible changes in Budget	Impact
MRP* based excise	42.5% Abatement	50% Abatement	**Positive** For large Pharma cos, mainly MNCs. impact will be reduced if benefit is passed on to consumers
FBT	5% of the expenditure incurred on conveyance, tour and travel, use of hotels, boarding etc. Currently this matter is pending with the Supreme Court	Abolish or ambit restricted to cases where Employee-Employer relationship can be established eg.(free samples)	**Positive** For all Pharma cos. Even removal of expenses such as free samples and seminar expenses will give some relief to the industry
R&D expense tax deduction	150% weighted-average tax deduction for R&D expenses for a year	Likely to continue but to be extended for a longer time	**Positive** Long term clarity of deduction under 35(2)(a)(b) is essential as R&D is a long gestation activity
Excise **Customs Duty**	16% on formulations 12.5% on imports (mainly API imports)	8% on formulations 10% on imports or even to ASEAN rates of 5%	**Positive** For all companies who do not have manufacturing facilities in excise exempt areas, largely MNCs. Reduction in customs duty will be a minor positive for companies who import APIs

The New Pharmaceutical Policy has been under consideration for quite some time. The Government should announce it soon, to remove uncertainty surrounding its implementation

*Note: * - MRP = Maximum Retail Price,*

Real Estate

Item	Current status	Possible changes in Budget	Impact
Section 80 IB:	• 100% tax deduction of profits from housing projects approved before March 31, 2007 in the 1,000 sq. ft. (Delhi & Mumbai) and 1,500 sq. ft. (rest of India) category	• Withdrawal of section 80 IB • Extension of last date of project approvals but with additional riders	**Negative:** • Withdrawal of tax free status on a significant portion of project portfolio of developers **Positive:** • Majority of real estate players cater to this segment of home buyers
Tax Benefits Sec 24(I)(vi) **Sec 80 C**	• Sec 24(I)(vi): Deduction of interest on home loans up to Rs 150,000 p.a. for self occupied houses • Sec 80 C: Deduction of principal repayment of a home loan up to Rs 100,000 for a self occupied house	• Although there has been contemplation of a reduction/withdrawal, tax benefits on housing loans to continue unchanged	**Neutral:** • Continued tax exemptions under Sec 24(I)(vi) and Sec 80C to help maintain property off take, esp to those catering to the middle class
FDI regulations	• FDI allowed only in under construction projects with a lock in period of 3 years for repatriation	• Restrictions to continue on completed projects • Repatriation lock in for initial 3 years also to be maintained	**Neutral**

Telecom

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Item	Current status	Possible changes in Budget	Impact
Broadband Thrust	• Current subscriber base low at sub 2mn.	• Fiscal incentives on PC and broadband associated accessories	**Positive** • For all listed telecom service providers. Other players that stand to gain include HCL Infosystems, Redington
Spectrum Allocation	• Currently allotted 6.2 MHz – 10 MHz of spectrum depending on subscriber base • Spectrum charges range between 2-6% of Adjusted Gross Revenues (AGR) depending on allotted Spectrum	• Additional award of spectrum from defense department to telecom sector • Reduction in spectrum charges	**Positive :** • Additional award of spectrum would be beneficial • Would aid further reduction in tariffs and raise wireless penetration
Reduction in license fees	• Currently service providers pay 6% to 10% AGR in different circles as license fees. Part of this is apportioned towards USO fund	• Likely reduction in license fees	**Positive :** Would further reduce tariffs and increase wireless penetration
80 IA benefit	• 100% tax benefits for profits in the first 5 years and thereafter 30% per cent of profits for 5 out of the remaining 10 years	• Bring telecom at par with other infrastructure providers with tax exemption at 100% for 10 years • Extension of tax period from 15 to 20 years • Extend tax holiday to 1/4/2008	**Positive** For private sector operators – Bharti, RCOM and Idea Cellular

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