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**FOR PRIVATE CIRCULATION**

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# Budget FY07-08

## Focus on long-term growth amid short-term challenges

**Since the last Budget, stock markets have moved up significantly (35% gain) in the backdrop of a fast-growing economy and the consequent strong growth in corporate earnings. It is expected that 2006-07 will be the second straight year of greater than 9% GDP growth. There is a sense of optimism across industries. In this scenario, the Budget has to facilitate continued long-term growth through a balanced approach, in our view. We also believe, it is important to guard against over-optimism and rising inflation.**

Momentum has been created in the economy over the past four years (average GDP growth of more than 8%). This has to be channeled into the right areas and this can lead to sustained growth in future years. Thus, we expect the Government to continue to address key areas like infrastructure and agriculture in addition to several social initiatives.

A balanced growth approach will be maintained, in our opinion, through continued focus on social initiatives like education and public health. Inflation control also helps restrict the gap between haves and have-nots.

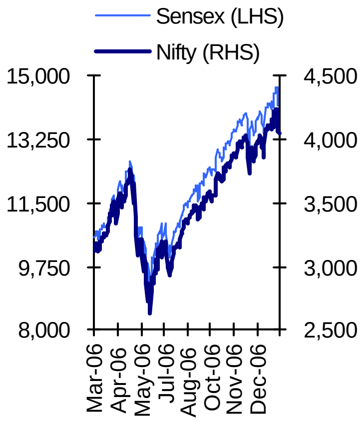
The strong growth has indeed resulted in optimism and in inflation spiraling to above 6.5%. There has also been a significant rise in prices of several asset classes. The recent up-trend in crude prices poses an additional challenge. We expect the Budget to spell out initiatives addressing supply side bottlenecks and facilitating higher supplies, especially in commodities.

We expect the Finance Minister to exercise fiscal discipline by adhering to the targets set by the Fiscal Responsibility and Budget Management Act (FRBM). While buoyant tax receipts have helped in FY07 and may continue to help in FY08, a strict check on non-plan expenditure can release funds for investments and social initiatives.

We also believe tax simplification initiatives will continue to form a part of this policy document. Initiatives like reducing multiple exemptions in direct taxes and bringing down the number of tax rate slabs in indirect taxes will continue, in our opinion. Reduction in import duty rates for commodities can help contain inflation.

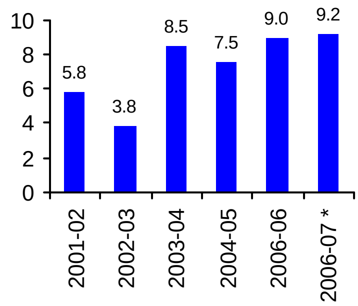
Subsidies have been a contentious issue for the government and restricting the growing subsity burden will remain a challenge. Another challenge, we believe, will be to raise resources through measures like divestments.

**Sensex performance**



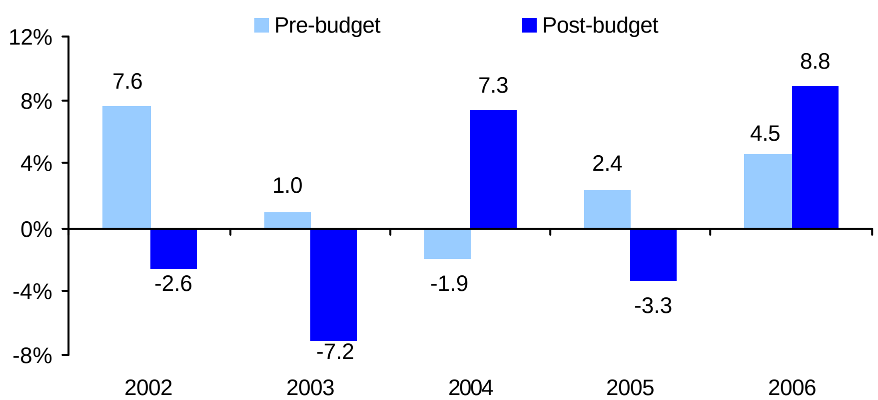

*Source : Bloomberg*

**GDP growth (%)**




*Source : CSO*
** CSO advance estimates*

**Sensex performance - one month before and after budget**




*Source: Bloomberg*

## MARKET IMPACT

*Focus to be on sectors, which are positively impacted*

We expect the Budget to be a facilitator of long-term growth, which the markets are already anticipating. Thus, we believe the focus of the markets will be more on sectors, which are positively impacted by the Budget proposals and these may out-perform others.

*The buoyant markets may have to shoulder additional burden*

However, we believe that the buoyant markets may have to shoulder additional burden. Voices have been raised against the alleged misuse of the lower tax rates on short term capital gains. Changes in tax rates for short term capital gains, if any, may impact markets negatively.

## FOCUS ON LONG-TERM GROWTH

*Budget to address issues relating to investments in infrastructure and agriculture*

The average growth in GDP of more than 8% over the past four years has provided the necessary momentum and platform for a sustained high growth over the next Five-year plan. In our opinion, India is still an investment-led economy and the Budget is expected to address issues, which can facilitate investments in areas like infrastructure and agriculture. Agricultural growth has once again dipped to about 2.7% in FY07 according to the advance estimates of Central Statistical Organisation (CSO). We expect proposals to increase this rate.

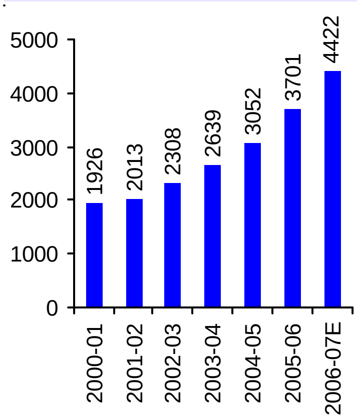
*Agricultural growth has once again dipped to about 2.7% in FY07, according to CSO*

**Real GDP growth break up (%)**

| | 2005-06 | 2006-07E |
|---|---|---|
| **Agriculture** | **6.0** | **2.7** |
| **Industry** | **8.0** | **10.0** |
| Mining | 3.6 | 4.5 |
| Manufacturing | 9.1 | 11.3 |
| Electricity | 5.3 | 7.7 |
| **Services** | **10.3** | **10.9** |
| Construction | 14.2 | 9.4 |
| Trade, Hotels, Transport, Communication | 10.4 | 13.0 |
| Finance, Real Estate, Other Businesses | 10.9 | 11.1 |
| Community & Social Services | 7.7 | 7.8 |
| **Total** | **9.0** | **9.2** |

*Source: CSO*

**Revenue receipts (Rs bn)**




*Source: Economic Survey*

The Government has announced several investments in areas like power, airports, ports, roads, etc. During the last fiscal, for instance, the government promoted the India Infrastructure Finance Company with a view to provide funding for infrastructure projects. The firm has the mandate to back projects by providing guarantees totaling over $2 bn annually.

During FY07, the Government has awarded two ultra-mega power projects (UMPPs) with total investments of about Rs.300 bn. Recently, the Government declared its intention to invite private equity companies to set up a $7-bn PE fund for UMPPs. We believe the Budget will lay down more proposals and more concrete guidelines regarding implementation of existing proposals.

Capital creation is an important facilitator of growth especially when India Inc is experiencing high capacity utilization levels of about 90% (industry estimates). Ensuring adequate liquidity for capital creation will also be high on the Government's agenda.

The approach paper for the Eleventh plan period has hinted at a need for another Green Revolution for sprucing up agricultural growth and a restructuring of agricultural policies is required to make another Green Revolution possible. We expect the Government to spell out plans for improving the agricultural growth rate.

## BALANCED GROWTH APPROACH

*we expect increased allocations to social issues like education and public health*

Long-term growth of any economy can be sustained only if it is balanced growth. With a view to bridge the urban-rural divide and the chasm between the haves and have-nots, we expect increased allocations to social issues like education, public health and other basic amenities like drinking water, etc.

In the previous Budget, the Finance Minister had laid down targets under the Sarva Shiksha Abhiyan, Jawahar Rozgar Yojana and related schemes. We expect proposals that relate to a more effective implementation of these initiatives.

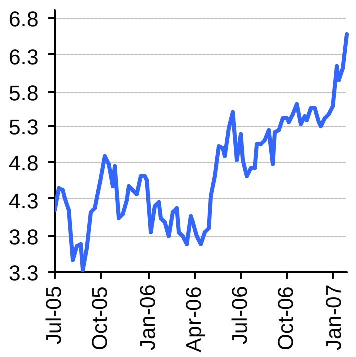
*Demographic advantage needs to be converted into skill and knowledge advantage*

India has a significant demographic advantage and this needs to be converted into skill and knowledge advantage to extend leadership in several areas including outsourcing (IT, auto, textiles, etc). We expect the Budget to further this cause by making provisions for expanding basic and technical education.

## INFLATION CONTROL MEASURES TO GET PROMINENCE

The Government has already taken steps like cutting import duties on some commodities and raising interest rates with a view to curbing inflation.

**Inflation (%)**




*Source: Bloomberg*

However, with inflation touching 6.5% in January 2007, the RBI has raised the cash reserve ratio (CRR) by 50 bps from 5.5% to 6.0%, which will come into effect in two phases of 25 bps each from Feb 17, 2007 and March 3, 2007, respectively. This is the second instance in the last three months that the apex bank has hiked the CRR, with an aim to suck out excess liquidity from the system and contain inflationary expectations. Continued inflow of foreign capital has forced the RBI to intervene in the forex market, which has in turn raised rupee liquidity in the banking system. The move by RBI is expected to suck out about Rs.140 bn of excess liquidity from the system.

Infact, food articles were the primary reason for high inflation. Inflation in this category was at 9.97%. We believe that this is more because of supply side constraint than the prevailing monetary situation, and we also believe that in the coming Budget the Government will further spell out proposals to ease infrastructural bottlenecks and facililate higher supplies, especially for commodities to curb inflationary pressures.

In terms of easing infrastructure bottlenecks, we expect more measures like reducing power deficits, reducing logistical delays in transportation of goods, etc.

With a view to increasing supplies, agricultural measures to increase production and yields are expected to find a mention. On the other hand, reduction in import duties should help in higher imports at lower prices.

## TAX REFORMS TO CONTINUE

We expect the Budget to continue with the process of tax reforms.

**Tax Collections**

| (Rs bns) | Apr 06-Jan 07 | Apr 05-Jan 06 | Growth (%) |
|---|---|---|---|
| **Direct Tax** | | | |
| Corporate Tax | 978 | 658 | 48.6 |
| Income Tax | 542 | 425 | 27.5 |
| STT | 38 | 20 | 90.2 |
| BCTT | 4 | 2 | 72.0 |
| **Indirect Taxes** | | | |
| Custom | 709 | 528 | 34.3 |
| Excise | 907 | 856 | 6.0 |
| Service Tax * | 257 | 156 | 64.7 |

*Source : Ministry of Finance * April - December 2006*

## Indirect taxes

*We expect moderation in import duties with continued protection to few sectors*

In the previous Budget, the peak import duty was brought down to 12.5% but a countervailing duty of 4% was imposed across the board except for a few sectors.

The Government is committed to bringing down import duties to Asean levels. In addition to this, currently there is an overriding concern of rising inflation. On the other hand, adequate protection is needed for several emerging/weaker sectors. Taking into account these factors, we expect moderation in import duties with continued protection to few sectors.

The Finance Minister has already indicated that diverse rates of excise duty on various goods are expected to converge at the Cenvat rate of 16%. We expect further steps in this direction. Growth in excise duty collections in the first nine months of FY07 has been at about 6%, which is in line with the target growth of about 6.25% for the fiscal.

The contribution of service tax to overall tax revenues of the Government is lower when compared to the fact that services account for more than 50% of the GDP. For 9MFY07, collections from service tax were up about 65% YoY v/s a targeted rise of 50% for FY07.

*We expect more services to come under the service tax net*

We believe the Finance Minister will bring in more services under the tax net to raise the contribution of services to tax revenues. The Government has set a deadline of April 1, 2010 to usher in a consolidated goods and services tax (GST) at the Cenvat rate of 16%. In line with this, we believe service tax rate will be gradually raised from the current 12%.

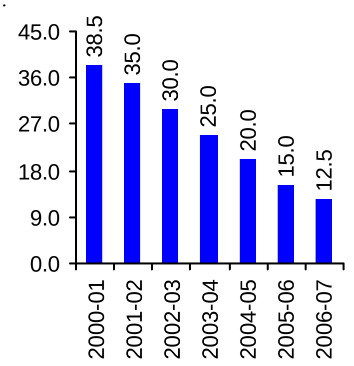
## Direct taxes

Direct taxes have been the high point of FY07, with collections having grown by 41% in the first 10 months against the fiscal target growth of 27.5%. The Government's initiatives, to bring in more people under the tax net, have paid dividends with the number of taxpayers expected to cross the 40-mn mark. Rising income levels of the Indians have also resulted in more taxpayers.

*We expect reduction in the multiple exemptions available to tax payers*

In the backdrop of a strong economy and the revenue loss due to multiple exemptions the Finance Minister has already indicated that exemptions may be pruned down. We expect the Budget to reduce the multiple exemptions available to taxpayers. However, investments in long-term savings instruments may be continued/encouraged with specifically directed tax exemptions. The Finance Minister may try to compensate for these reduced exemptions through some adjustments in the corporate surcharge.

**Peak cutoms duty (%)**




*Source: Budget Documents*

There have been representations from the industry about fringe benefit tax (FBT). We believe the Budget will continue with the FBT while making an attempt to further exempt genuine business expenditure from the tax net.

The previous budget had increased the security transaction tax (STT). We think that the buoyant stock markets may have to shoulder additional burden.

# CONSTRAINTS

We believe that the finance minister will face constraints on the following issues:

- Disinvestment
- Increasing FDI in select sectors
- Reducing subsidies
- Getting higher revenues from the agriculture sector

# SECTORAL IMPLICATIONS

*We expect positive impact on Automobiles, Capital Goods, Logistics, Food Processing, Power, Retailing, Insurance and Telecom sectors*

We expect the Budget's focus to be on sustained balanced growth, while addressing the short-term challenges of inflation and asset price rises. We also believe tax reforms, fiscal discipline and social initiatives will continue to be addressed.

We expect the following sectors to be positively impacted by the Budget: Automobiles, Capital Goods, Logistics, Food Processing, Power, Retailing and Telecom sectors. The following sectors may have marginally negative or neutral impact: Information Technology, Sugar, Media and Cement.

# Sectorwise expectation

## AUTOMOBILES

*EXPECTED BUDGET IMPACT: Positive*

*SECTOR OUTLOOK: Positive*

### Current view

- We continue to remain bullish on the entire automotive sector. This is largely on the back of demand growth being driven by higher consumer spending, changing demographic distribution and availability of financing options both in the rural and urban markets led by increased infrastructure growth and continued strong growth seen in GDP and IIP. Volume growth is likely to be sustained although companies would continue to face the challenge of higher input costs. It is expected that the passenger car market, which was 1 mn in 2003-2004, will cross the 3-mn mark by 2015.

### Key budget expectation

| Issues | Current status | Wish-list | Impact | Rationale |
|---|---|---|---|---|
| **Passenger vehicles duty structure(Cars & UVs)** | ■ Basic Excise Duty of 24% (Excluding small cars Up to 4000 mm length and engine size of 1200 cc for petrol and 1500cc for diesel)<br>■ SED of 8%<br>■ Calamity Tax of 1% | ■ Basic Excise Duty to be reduced to 16% | ■ Positive for Passenger car industry<br>■ Players like Maruti Udyog, Tata Motors and M&M may benefit | ■ To make India a hub for small cars and also make cars more affordable |
| **Two & Three Wheelers** | ■ Basic Excise Duty of 16% | ■ Basic Excise Duty to be reduced from 16% to 8% | ■ Positive for Players like Bajaj Auto, Hero Honda | ■ These are vehicles for the mobility of people who can't afford cars and have limited access to public transport facilities |
| **Utility Vehicles with seating capacity 12+1 registered as Taxis** | ■ Basic Excise Duty of 24% | ■ Reduction in basic Excise Duty to 16% | ■ Positive for cos like M&M, Tata Motors | ■ Vehicles with a seating capacity of 6 +1 registered as taxi are entitled for refund of 8% |
| **Deduction for car loans under Income Tax** | ■ No Specific Benefit | ■ Deduction similar to Housing Loan should be granted | ■ Positive for Passenger car industry | ■ This will lead to a growth in the passenger car segment and will generate higher revenue to the government in terms of Excise duty and sales tax. |
| **Motor Vehicle Depreciation rate** | ■ Currently allowed at 15% | ■ Rate should be increased to 25% | ■ Positive | ■ Depreciation should also be based on real useful life of cars, which is on average not more than 10 years. |

*Source: Kotak Securities - Private Client Research, SIAM*

### Top picks

| Company | Price | EPS (Rs) | | PE (x) | | Recommendation |
|---|---|---|---|---|---|---|
| | (Rs) | FY07E | FY08E | FY07E | FY08E | |
| Maruti | 858 | 53.0 | 61.0 | 16.1 | 14.0 | BUY |
| Bajaj Auto | 3,016 | 119.0 | 145.0 | 25.3 | 20.8 | BUY |
| M&M | 866 | 35.0 | 41.0 | 24.7 | 21.2 | BUY |

*Source: Kotak Securities - Private Client Research*

# AUTO ANCILLARIES

*EXPECTED BUDGET IMPACT: Positive*

*SECTOR OUTLOOK: Positive*

## Current view

- India is emerging as a key hub for auto component manufacture in Asia. It is well poised to play a significant role in the global automotive supply chain in the near future. Exports growth during 2005-06 was 35%. This high exports growth rate can be attributed to the improvement in the industry's export capabilities and the greater global recognition of this capability. This, coupled with high domestic demand, will lead to increased revenue visibility to Indian ancillary companies. Indian auto component manufacturing is also expanding capacities and automation levels to deal with the increased variety being offered by OEMs.

### Key budget expectation

| Issues | Current status | Wish-list | Impact | Rationale |
|---|---|---|---|---|
| **Peak Import Duty** | ■ Charged at 12.5% | ■ Maintain at the current levels | ■ Positive for the cost competitiveness of the sector | ■ Already the rate is one of the lowest in the emerging countries. |
| **Custom duty on raw materials** | ■ Customs duty on some of the steel inputs for auto components at 10% | ■ Import duty on all the raw materials, used specifically for producing auto components falling in the Early Harvest Scheme of FTA with Thailand, should be reduced to 5%. | ■ Positive | ■ It will safeguard the interest of indigenous auto component industry and make them more competitive against product imports |
| **Parts, components under RSP based assessment** | ■ Abatement of 33.5% | ■ Revision of Abatement at higher levels | ■ Positive | ■ The abatement percentage is low keeping in view that there is 16% central excise and 12.5% VAT on auto components apart from other post manufacturing expenses and traders margin. |
| **Kits for CNG/ LPG driven vehicles** | ■ Import duty for kits at 5% | ■ This concession should be extended to raw material required for manufacture of CNG kits and its parts. | ■ Positive | ■ Raw Materials currently attract duty of 7.5-12% |

*Source: Kotak Securities - Private Client Research, CII*

### Top picks

| Company | Price (Rs) | EPS (Rs) FY07E | EPS (Rs) FY08E | PE (x) FY07E | PE (x) FY08E | Recommendation |
|---|---|---|---|---|---|---|
| Subros | 236 | 24.0 | 30.0 | 9.8 | 7.8 | BUY |
| Amtek India | 157 | 9.2 | 15.9 | 17.0 | 9.8 | BUY |
| Tube Investments | 64 | 4.4 | 5.9 | 14.5 | 10.8 | BUY |

*Source: Kotak Securities - Private Client Research*

# BANKING

***EXPECTED BUDGET IMPACT: Positive***

***SECTOR OUTLOOK: Positive***

## Current view

- Rapid credit growth and rising consumerism in the economy has brought the banking sector to the forefront. The robust credit growth (31%) continues to outpace the deposit growth (23%). However, the incremental deposit mobilization, in absolute terms, is more than the incremental credit disbursements in FY07E so far. We believe the Government may adopt some measures to facilitate the banks in raising more deposits.
- Steps like exemption of interest income coming from saving deposits, or restoration of tax exemption on interest income up to Rs.15,000 under section 80L, or reduction in the lock-in period for savings under section 80C from current stipulated five years would increase the attractiveness of term deposits and bring it at par with other investment instruments.
- The tight liquidity scenario in recent times has resulted due to a hike in the repo rate by the RBI. Advance tax outflow from the system, has been a concern for the banking sector. However, it has started easing out, which is evident from the call money rate, which is hovering below the levels of 7%.
- Spurt in asset growth coupled with the expected introduction of Basel-II norms is squeezing capital for the industry. There is also a growing asset-liability mismatch in the industry as banks are focusing on short-term demand deposits to meet their long-term asset growth creation.
- In a competitive scenario, PSU banks are facing problem of trained specialists. On the other hand, automation has made many jobs quite redundant. It would be beneficial if the Government allowed another round of VRS and permitted banks to recruit specialists.
- There is a great appetite for bank stocks in the system, but FII/FDI limit is acting against it. We would love to see a relaxation in this, but do not expect FII/FDI limit in PSU banks to be hiked in this Budget from the current cap of 20%. We also do not expect any relaxation in voting rights (Cap 10%) in the private banks.
- Last but not the least, consolidation in the industry has so far only been restricted to roundtables. Now is the time to act on it, as duplication of IT infrastructure, manpower and capital is becoming prohibitively costly.

### Key budget expectation

| Issues | Current status | Wish-list | Impact | Rationale |
|---|---|---|---|---|
| **To raise capital by issue of preference shares** | Not Included | Perpetual non-cumulative preference shares to be included in Tier-I capital and redeemable cumulative preference shares to be included in Tier-II capital | Improve the Capital Adequacy Ratio (CAR) of Banks. | Provide additional source for augmenting their capital base ahead of implementation of Basel II. |
| **Relaxation in the lock-in period for savings to qualify for tax benefits (Under section 80C)** | Five years lock-in period. | Reduce it to three years. | Increase the attractiveness of term deposits and make it at par with other investment instruments | Important to correct the asset-liability mismatch developed due to high focus on term loans |
| **Increase in ceiling for TDS on fixed deposits** | Current ceiling is Rs.5,000 | Increase it to Rs.10,000 | Increase the relative attractiveness of deposits. | Important to facilitate the growth of deposits |

## Banking (contd...)

### Key budget expectation

| Issues | Current status | Wish-list | Impact | Rationale |
|---|---|---|---|---|
| **Increase in FII/ FDI limit in PSU Banks** | ■ Limit at 20% | ■ Increase it to 49% | ■ Will attract higher FII/ FDI in PSU banks which are starving for quality capital | ■ Will solve not only the problem of capital but also getting it at competitive prices |
| **Rightsizing ofManpower** | ■ Very limited scope to the Management | ■ Allowing another round of VRS and more powers to attract suitable talent | ■ In a competitive arena the need of specialists to be fulfilled. | ■ Will help getting world class product and services at competitive rates |

*Source: Kotak Securities - Private Client Research, Indian Banking Association*

### Top picks

| Company | Price | EPS (Rs) | | ABVPS (x) | | Recommendation |
|---|---|---|---|---|---|---|
| | (Rs) | FY07E | FY08E | FY07E | FY08E | |
| HDFC Bank | 1,017 | 37.1 | 48.2 | 200.7 | 241.5 | HOLD |
| ICICI Bank | 914 | 36.5 | 46.9 | 267.5 | 296.1 | BUY |
| J&K Bank | 654 | 62.9 | 79.0 | 403.3 | 465.8 | BUY |
| UTI Bank | 521 | 22.8 | 31.3 | 113.3 | 138.1 | BUY |

*Source: Kotak Securities - Private Client Research*

# CAPITAL GOODS

**EXPECTED BUDGET IMPACT: Positive**

**SECTOR OUTLOOK: Positive**

## Current view

- On the back of a healthy order backlog, electrical equipment makers should continue to report strong earnings numbers over the next few quarters. The macro indicators continue to be favorable. The Government has also shown urgency in accelerating power generation in India through the award of two ultra mega power projects. There are also plans of ultra mega transmission projects. These initiatives augur well for power equipment makers.
- The Government has already cut customs duty on copper, aluminum and alloy from 7.5% to 5%. This was expected, given the steep rise in global copper prices in FY07. The move should benefit equipment producers in terms of bringing down overall cost of inputs.
- Duties on project imports have been reduced to 7.5% from 12.5% and on specified capital goods and their parts to 7.5% from 12.5%.
- It is expected that the government's power sector reforms and other programs for rural electrification will be provided higher funding through budgetary provision to help maintain its current momentum and its implementation in the planned time frame, enabling "Electricity for all" by 2012.
- We expect continued thrust on facilitating timely implementation of awarding ultra mega power projects.
- We feel that the APDRP scheme should be continued and the Ministry of Finance should provide adequate budgetary support to the scheme
- Tax exemptions available to infrastructure development in rural areas should be extended to "Rajiv Gandhi Vidyutikaran Yojana".
- With spiraling of fuel prices, there is an urgent need to support and incentivize energy production through non-conventional sources of energy like biomass, rice husk and wind power.
- Key beneficiaries include ABB, Siemens, Areva T&D, Easun Reyrolle, IndoTech Transformers, Emco, Bharat Bijlee, Crompton Greaves, Bhel and Suzlon.

### Key budget expectation

| Issues | Current status | Wish-list | Impact | Rationale |
|---|---|---|---|---|
| **Reduction in excise duty on electrical equipment** | 16% | To be reduced to 14% | Duty likely to be passed to the customer | Reduction in product cost |
| **Reduction in customs duty on copper** | 5% | Demand already met | Neutral | Reduction in product cost |
| **Extension of special CVD to all project imports** | 4% for certain projects | Extend this benefit to all project import | Level-playing field for domestic mfrs | To neutralize state-level taxes |
| **Import duty on Capital goods under EPGC scheme** | 5% | 0% | Positive | To facilitate capacity addition |

*Source: Kotak Securities - Private Client Research, CII, IEEMA*

### Top picks

| Company | Price (Rs) | EPS (Rs) FY07E | EPS (Rs) FY08E | PE (x) FY07E | PE (x) FY08E | Recommendation |
|---|---|---|---|---|---|---|
| Siemens | 1,115 | 36.7 | 52.6 | 30.4 | 21.2 | HOLD |
| BHEL | 2,325 | 95.5 | 114 | 24.3 | 20.4 | HOLD |
| Crompton Greaves | 199 | 7.7 | 10.7 | 25.8 | 18.6 | HOLD |
| Easun Reyrolle | 705 | 45 | 57 | 15.7 | 12.4 | BUY |
| KOEL | 250 | 15.1 | 19 | 16.6 | 13.2 | BUY |
| Thermax | 392 | 16.5 | 21.3 | 23.8 | 18.4 | HOLD |
| L&T | 1,615 | 52.7 | 66.1 | 30.6 | 24.4 | BUY |
| M&P Pumps (CY06 & CY07) | 219 | 10.2 | 19.1 | 21.5 | 11.5 | BUY |

*Source: Kotak Securities - Private Client Research*

# CEMENT

***EXPECTED BUDGET IMPACT: Neutral***

***SECTOR OUTLOOK: Positive***

## Current view

- The Union Budget 2007-08 is expected to be neutral for the cement sector. The Government is continuously watching the price rises in different regional markets and is keen on controlling the price hikes to control inflation. The recent move by the Government to cut the import duty on portland cement was aimed at capping the upside in the cement prices. Logistically, however, imports are not possible in huge quantities.
- The demand-supply situation is still in favor of the producers and we expect prices to rise from the current levels on account of double-digit growth in demand and very few capacities getting operational in the near term with existing capacities already operating at almost full capacity utilizations.
- We are positive on the sector on account of a demand-supply mismatch, which will continue for another one to one and a half years till the time new announced capacities become fully operational. Sentiments are currently negative on the cement sector with the Government acting as a watchdog for rising cement prices and may keep share prices depressed in the immediate term. However, the landed cost of imports is still higher than prevailing average cement prices in other regions except Mumbai. Due to this, prices have a scope to rise even further.
- The cement industry is highly taxed and companies are expecting a cut in the excise duty and other taxes in the Union Budget 2007-08. If this happens, it would be positive for all players.

### Key budget expectation

| Issues | Current status | Wish-list | Impact | Rationale |
|---|---|---|---|---|
| **Excise duty cut** | Rs 408 per tonne is levied currently which is higher than the other commodities | Reduction in the excise duty from current levels | Positive for cement manufacturers. | Benefits can be passed on the end-uers |
| **Import duty on pet coke** | Customs duty on pet coke is at 10% currently | Abolish import duty on pet coke | Result in saving the power costs for the companies | Enhance the efficiencies of the cement companies |
| **Reduction in royalty on limestone** | Rs 45 per tonne is levied currently which is higher than that charged on high value minerals | Reduction in the limestone royalty in line with other commodities | Rationalisation of cost structure | Enhance the efficiencies of the cement companies |
| **Other Expectations** | No duty benefits for cement supplied to SEZs | Removal of excise duty for cement supplied to SEZ's<br>No levies/duties on captive power generation | Positive for companies supplying to SEZs and using captive power | Result in saving costs and benefit can be passed on to the end users |

*Source: Kotak Securities - Private Client Research, Companies, CMA, FICCI*

### Top picks

| Company | Price (Rs) | EPS (Rs) FY07E | EPS (Rs) FY08E | PE (x) FY07E | PE (x) FY08E | Recommendation |
|---|---|---|---|---|---|---|
| Shree cements | 1301 | 94 | 133 | 13.8 | 9.8 | BUY |
| India Cements | 191 | 18 | 24 | 10.6 | 8.0 | BUY |

*Source: Kotak Securities - Private Client Research*

# CONSTRUCTION

*EXPECTED BUDGET IMPACT: Positive*

*SECTOR OUTLOOK: Positive*

## Current view

- The Union budget 2007-08 is expected to be positive for the construction sector on account of an increased thrust towards infrastructure development. The Government, in the Infrastructure Summit, has envisaged an investment of $320 bn during the Eleventh Five Year Plan period. This broadly covers investment in various sectors such as road, rail, air and water transport, electric power, telecommunications, water supply and irrigation. We expect that to achieve the sustained growth rate of 9%, the Government would continue to stay focused on infrastructure development.
- We are positive on the construction sector on account of robust order backlogs, excellent revenue growth and improvement in margins. The companies in this sector have gone through another round of fund raising to remain well equipped to bid for larger sized projects. Simplification of policies and norms should result in speedy order inflows, which are expected to be positive for companies that are well equipped and have relevant experience in execution.
- Key beneficiaries would be Nagarjuna Constructions, Gammon, Hindustan Construction, Patel Engineering, GMR Infrastructure and Unity Infrastructure.

### Key budget expectation

| Issues | Current status | Wish-list | Impact | Rationale |
|---|---|---|---|---|
| **Roads** | Implementation running behind schedule;Model Concession agreement standardised;Viability gap funding upto 40% of the project cost based on competitive bidding | Simplification of policy and regulatory framework for enhanced public-private partnership; Increasing VGF cap for supporting non-viable projects | Positive for players having adequate experience and networth to bid for large size projects | Increased order flows and private participation will enhance modernisation and upgrading of highways |
| **Airports** | Slow pace of airport privatization; Investment of Rs400bn envisaged in the sector by 2012 | Upgrading and modernisation to be announced for other non-metro airports; Strengthening and construction of runaways to be identified at other airports. | Positive for players having adequate experience in airport modernisation | Facilitate private sector participation and enhance quality of infrastructure |
| **Power** | Partial fulfilment of targets in Xth Plan - in both thermal and hydro power projects | Simplified norms for environmental clearances; Increased private participation; Increased order inflows | Positive for construction companies having expertise in EPC contracts of power projects | Huge potential in hydro power still remains untapped; Fulfillment of plan targets will result in catching up with the demand supply equilibrium |
| **Irrigation** | Slow pace of implementation of major irrigation projects | Higher fund allocation through Accelerated Irrigation Benefit Programme;Support of state governments; Faster environmental clearances | Positive for players which have the best qualifications for irrigation and water projects | Result in increasing levels of urbanization |
| **Tax benefits under section 80IA** | Tax benefits available to few projects - BOT and power projects | Extension of tax holiday and benefits of 80IA on other projects | Positive for all construction companies | Result in encouraging PPP and making projects more profitable |

*Source: Kotak Securities - Private Client Research, Companies, Plan documents*

### Top picks

| Company | Price (Rs) | EPS (Rs) FY07E | EPS (Rs) FY08E | PE (x) FY07E | PE (x) FY08E | Recommendation |
|---|---|---|---|---|---|---|
| Nagarjuna Constructions | 189 | 8.5 | 12.0 | 22.2 | 15.8 | BUY |
| Patel engineering | 399 | 17.0 | 24.0 | 23.5 | 16.6 | BUY |
| Era constructions | 404 | 38.0 | 46.0 | 10.6 | 8.8 | BUY |
| Madhucon Projects | 270 | 12.0 | 19.0 | 22.5 | 14.2 | HOLD |

*Source: Kotak Securities - Private Client Research*

# FOOD PROCESSING

***EXPECTED BUDGET IMPACT: Positive***

***SECTOR OUTLOOK: Positive***

## Current view

- In India there is tremendous potential for the development of the food processing industry. This is well supported by the fact that it is the world's largest producer of milk; the second largest producer of fruits and vegetables; the largest producer of spices and groundnut; and the fourth largest producer of wheat. Despite all these advantages, India's food processing industry is very small in terms of volume and exports when compared with other countries.
- In India, less than 2% of the fruits and vegetables are processed and a larger percentage of the balance quantity is wasted or inefficiently used. We feel there is huge untapped potential in the food processing industry led by the growing Indian economy and the rising middle income working class.

### Key budget expectation

| Issues | Current status | Wish-list | Impact | Rationale |
|---|---|---|---|---|
| **Excise duty** | ■ Excise duty varies from Nil to 16% for the different products | ■ Reduce the excise duty on more processed food products | ■ Positive | ■ Reduction in excise duty could lead to growth in consumption of processed and packaged foods. |
| **Customs duty on high technology food processing machinery** | ■ Peak customs duty payable | ■ Reduce customs duty to 5% for the sophisticated food processing machinery not manufactured in India. | ■ Positive | ■ Reduction in customs duty would lead to import of high tech food processing machinery, which would lead to growth of the overall food processing industry. |
| **DEPB export benefits** | ■ Valid upto 31/3/2007 | ■ Extend upto 31/3/2012 | ■ Positive | ■ Extension of benefits would maintain the profit margins of the companies |
| **EOU export benefits** | ■ Pay duty and then claim refund | ■ Eliminate the payment of duty like in case of SEZs | ■ Positive | ■ Exemption from payment of customs duty, excise and sales tax would lead to reduction in the working capital requirements of the companies. |

*Source: Kotak Securities - Private Client Research, CII*

### Top picks

| Company | Price (Rs) | EPS (Rs) FY07E | EPS (Rs) FY08E | PE (x) FY07E | PE (x) FY08E | Recommendation |
|---|---|---|---|---|---|---|
| Gujarat Ambuja Exports | 29 | 3.4 | 5.2 | 8.6 | 5.6 | BUY |
| Riddhi Siddhi Bio | 247 | 24.4 | 36.9 | 10.1 | 6.7 | BUY |
| REI Agro | 195 | 17.4 | 22.5 | 11.2 | 8.6 | BUY |

*Source: Kotak Securities - Private Client Research*

# HOTELS

***EXPECTED BUDGET IMPACT: Positive***

***SECTOR OUTLOOK: Positive***

## Current view

- We expect companies in the hotel sector, which has a huge asset base and big expansion plans over the next few years, to benefit from the Budget proposals. The industry has demanded infrastructure status for hotel industry and increase in depreciation rates.

- **Outlook remains positive from long-term perspective:** The hotel industry in India is on a dream run with steadily rising occupancy rates and average room rates (ARRs) due to the increased inflow of tourists and business travellers witnessed over the past few years. This has resulted in demand for rooms outstripping supply. This scenario is likely to continue for the next couple of years benefiting the overall hotel industry in India.

  Factors like increasing awareness of attractive tourist destinations, increased business activity due to robust economic growth, overall rise in income levels of Indians and support provided by the government by adopting various measures are all contributing to the growth of the hotel industry.

**Key budget expectation**

| Issues | Current status | Wish-list | Impact | Rationale |
|---|---|---|---|---|
| **Infrastructure status for Hotel Industry u/s 80 IA of Income Tax Act** | ■ Limited recognition given u/s 10(23)(g) of the I.T. Act | ■ Hotel industry should be made eligible on par with the other infrastructure industries. | ■ Lower tax outgo and increased competitive-ness | ■ India is vastly under-roomed in hotel accomodation. To accelerate the pace of construction of hotel rooms, it is essential to grant full infrastructure status to hotels. |
| **Depreciation as per Income Tax Act on Hotel Buildings** | ■ 10% depreciation on hotel buildings | ■ 20% rate of depreciation | ■ Positive, lower tax outgo | ■ Hotel buildings constitute a significant part of assets for the hotel indsutry and it has to make heavy investments in renovation, upgradation and upkeep of hotel buildings. |
| **Hotels are required to pay service tax on services received outside India, especially commission paid to Foreign Travel Agents** | ■ Taxable | ■ Hotels should be expempted from paying service tax on services received from Foreign Tour Operators | ■ Positive | ■ Hotel Industry is one of the prime foreign exchange earners and is recognised as a service export industry. |

*Source: Kotak Securities - Private Client Research, HAI*

# INFORMATION TECHNOLOGY

***EXPECTED BUDGET IMPACT: Neutral***

***SECTOR OUTLOOK: Positive***

## Current view

### Software services/products and BPO

- We believe the Budget will focus on maintaining an environment conducive to the future growth of this largely export-oriented industry. The IT services industry is expected to achieve 31% growth in FY07 to $39.7 bn. Of this, exports are expected to grow by more than 33% to $31 bn.
- We expect the sector to be largely neutral to the Budget provisions. We expect the focus to be on enabling issues like promoting higher technical education (so as to meet the potential demand for employees from the sector), promoting better infrastructure facilities in Tier-II cities and other related issues.
- While the industry has asked for extension of tax benefits under section 10A/10B of the Income Tax Act, 1961, we believe the same may not be allowed.
- With a longer-term perspective, we continue to remain bullish on the sector due to expectations of continued high volume growth aided by a higher number of large deals, improving billing rates and effective handle on margins (especially for large companies).
- We believe the outsourcing and offshoring story will gather further steam in the future and this will see an increased flow of larger contracts to Indian vendors. Also, focused smaller companies with expertise on select verticals will be able to move up the value chain and attract larger clients, thereby improving their longer-term prospects.

**Key budget expectation**

| Issues | Current status | Wish-list | Impact | Rationale |
|---|---|---|---|---|
| **Tax exemption U/S 10A / 10B** | ■ Tax exemption available to units for 10 years or till FY10, whichever is earlier | ■ Extension of tax exemptions beyond FY10 | ■ Positive | ■ Maintain competitiveness of smaller players<br>■ Exports are a thrust area |
| **SEZ - tax exemptions** | Deduction for export income:<br>■ 100% for 1st five years<br>■ 50% for next five years | ■ Status quo maintained | ■ No direct impact | ■ Recently enacted; may not be tempered with |
| **Fringe benefit tax** | ■ Specified % of each of the deemed fringe benefit taxed in hands of the employer | ■ Genuine business expenditure be made exempt | ■ Marginally positive impact | ■ Unduly taxing genuine business expenditure, currently |

*Source: Kotak Securities - Private Client Research, Industry*

**Top picks**

| Company | Price (Rs) | EPS (Rs) FY07E | EPS (Rs) FY08E | PE (x) FY07E | PE (x) FY08E | Recommendation |
|---|---|---|---|---|---|---|
| Infosys | 2,284 | 67.4 | 87.9 | 33.9 | 26.0 | BUY |
| TCS | 1,260 | 42.1 | 54.6 | 29.9 | 23.1 | BUY |
| HCL Tech | 662 | 33.7 | 38.3 | 19.6 | 17.3 | BUY |
| NIIT Ltd | 583 | 27.9 | 49.5 | 20.9 | 11.8 | BUY |
| Megasoft * | 129 | 10.9 | 14.8 | 11.8 | 8.7 | HOLD |
| Allsec | 299 | 18.1 | 23.4 | 16.5 | 12.8 | HOLD |

*Source: Kotak Securities - Private Client Research; * Financials of Megasoft are for CY06 and CY07 - on a pre-merger basis (with VisualSoft)*

# LOGISTICS

***EXPECTED BUDGET IMPACT: Positive***

***SECTOR OUTLOOK: Positive***

## Current view

- India spends approximately 13% of its GDP on logistics, which is higher when compared to a global average of 10%. This is primarily due to higher transportation costs, low level of investments in technology, warehouse management, track and trace systems etc. The Indian logistics industry is dominated by a large number of unorganized players with little or no value addition and lot of intermediaries in the total supply chain. This signifies the huge growth potential that the organised and integrated Indian logistics providers have on their hands.
- We believe India is fast emerging as global manufacturing hub with strong growth in infrastructure coupled with retailing boom and we feel logistics will be one of the fastest growing businesses, going forward.

### Key budget expectation

| Issues | Current status | Wish-list | Impact | Rationale |
|---|---|---|---|---|
| **Privatization of airports** | Only metro airports are being privatized | Non-metro airports should also be privatized | Positive | Privatization of non metro airports would lead to faster growth in aviation for both passenger and cargo traffic |
| **Sales Tax on ATF** | As high as 30% in some states | Treat jet fuel as deemed export and charge sales tax at flat 4%. | Positive | Any relief in sales tax will reduce the operational cost of airlines considerably and can lead to reduction in airfares and thus increased air traffic. |
| **Airport infrastructure** | High charges for airport infrastructure | Lower airport charges and improvement in efficiency quotient | Positive | Compared to other airports in the world, Indian airports are more expensive for the level of service and efficiency standards. Due to heavy congestion each minute of additional flying can cost upwards of Rs. 2000 for an airbus 320 plane. |
| **Rationalisation of taxes** | Various taxes from state to state | Replace the multiple taxes with common tax across the country | Positive | Various taxes lead to lot of documentation thereby resulting in slower transportation of goods across the country. |
| **Infrastructure related to roads and ports** | Slower then expected implementation | Some more initiatives to be taken for faster development of the roads and ports | Positive | Efficient infrastructure is the key to the growth of the logistics industry as it facilitates faster and smoother transportation of goods across the country. |
| **Tax on shipping industry** | Twelve kind of taxes on the shipping industry | Restructuring and simplification of tax structure | Positive | Restructuring and simplification of tax structure would lead to lesser paper work and hence ensure smooth flow of goods |
| **Special Economic Zones (SEZ)** | Lots of procedures to be followed for setting up SEZ | Simplification of rules and regulations and faster approval for setting up SEZ | Positive | Thrust and simplification of rules and regulations regarding SEZ can significantly improve the import and export activities of the country, which will lead to more business for port and related logistics service providers. |
| **Dedicated rail freight corridor** | No fixed schedule as yet | Fixed schedule for implementation to set up rail freight corridor | Positive | The new freight corridor can have speed that is at-least double then the current average goods train speed, which would reduce the overall requirement of wagons and locomotives thereby resulting in minimizing logistics and transportation costs. A dedicated rail freight corridor can boost the trade activities as the transit time will come down considerably between two cities and thus will lead more transportation of goods and services giving additional business to the logistics service providers. |

# Logistics (contd...)

**Key budget expectation**

| Issues | Current status | Wish-list | Impact | Rationale |
|---|---|---|---|---|
| **Multi-modal logistics park** | ■ No announcement as yet | ■ Public private partnership in setting up Multi-modal logistics parks | ■ Positive | ■ A logistics park can provide multi-modal solution for transportation of goods and will require an investment of over Rs. 250 crores. They can also provide facilities such as warehousing and cold storage, which is logical extension of the dedicated freight corridor. |

*Source: Kotak Securities - Private Client Research*

**Top picks**

| Company | Price | EPS (Rs) | | PE (x) | | Recommendation |
|---|---|---|---|---|---|---|
| | (Rs) | FY07E | FY08E | FY07E | FY08E | |
| Gateway Distriparks | 166 | 9.3 | 12.1 | 17.9 | 13.7 | BUY |
| Concor | 1,902 | 108.4 | 126.7 | 17.5 | 15.0 | BUY |
| Gati | 96 | 4.1 | 6 | 23.5 | 16.0 | HOLD |
| Allcargo Global | 1,114 | 56.5 | 70.8 | 19.7 | 15.7 | BUY |

*Source: Kotak Securities - Private Client Research*

# MEDIA

*EXPECTED BUDGET IMPACT: Neutral*

*SECTOR OUTLOOK: Positive*

## Current view

- We expect the Budget to have a neutral impact on the prospects of the media sector, as a whole, and companies operating within it. On the other hand, we believe a thrust on promoting domestic production of set top boxes, which will aid the acceptance of distribution platforms like DTH/CAS could be expected from the Budget. These, in our opinion, will eventually lead to greater transparency in subscriber reporting and possibly higher entertainment tax revenues for the Government.
- From a longer-term perspective, we believe that on the back of greater spending power, growing consumerism and India's evolving demographics consumer discretionary sectors like media and entertainment will continue to enjoy healthy growth prospects. Our top picks within the sector would be Entertainment Network India Ltd (ENIL), UTV Software and HT Media.

### Key budget expectation

| Issues | Current status | Wish-list | Impact | Rationale |
|---|---|---|---|---|
| **Service Tax** | ■ Broadcasters are subject to levy of service tax @ 12.24% unlike the print media that is exempt from the levy of service tax. | ■ Broadcasters expect parity to be drawn between the print and electronic medium. | ■ Positive for broadcasters if there is any downward revision.<br>■ It could be negative for print media companies if the Govt. brings both the electronic and print media under ambit of service tax to draw parity. | ■ To bring about parity between the print media and the electronic media i.e. broadcasters. Such a move would help in increasing the ad spends actually accruing to the broadcaster and boost their revenues. |
| **Excise Duty** | ■ 16% levied on equipment like set top boxes | ■ To be made 'nil' duty items. | ■ Positive | ■ To bring broadcasting equipment like set top boxes on par with rates applicable on telecom equipment and provide a fillip to platforms like DTH that use set top boxes.<br>■ To encourage domestic production of set top boxes. |
| **Customs duty** | ■ Normal rates of customs duty levied on digital exhibition equipment. | ■ To be made 'nil' duty items. | ■ Positive | ■ To act as a facilitator in growth of digital exhibition segment.<br>■ Growth of this format could reduce revenue losses incurred due to piracy and boost Government's tax collections. |

## Media (contd...)

### Key budget expectation

| Issues | Current status | Wish-list | Impact | Rationale |
|---|---|---|---|---|
| | ■ Nil rate of customs duty levied on set-top boxes. | ■ Increase the customs duty on set top boxes to 5%. | ■ Neutral/Positive | ■ Excise duty on set-top boxes was exempted in FY04 to facilitate introduction of CAS. In the last budget, the exemption of excise duty was withdrawn but customs duty was reduced from 15% to NIL. However, there was no corresponding reduction of customs duty on inputs used in the manufacture of set-top box. This has resulted in a case of inverted customs duty structure.Can be rectified by a reduction of customs duty on inputs required for the manufacture of set-top box to NIL or increasing customs duty on set-top box from NIL to 5% and also allowing import of inputs at 5% duty. |

*Source: Kotak Securities - Private Client Research, Industry*

### Top picks

| Company | Price | EPS (Rs) | | PE (x) | | Recommendation |
|---|---|---|---|---|---|---|
| | (Rs) | FY07E | FY08E | FY07E | FY08E | |
| ENIL | 308 | 7.2 | 11.2 | 42.8 | 27.5 | BUY |
| UTV Software | 285 | 6.6 | 13.6 | 43.1 | 20.9 | BUY |
| HT Media | 170 | 5.6 | 8.2 | 30.3 | 20.7 | HOLD |
| TV18 | 565 | 10.5 | 14.4 | 53.8 | 39.2 | HOLD |

*Source: Kotak Securities - Private Client Research*

# OIL & GAS

***EXPECTED BUDGET IMPACT: Positive***

***SECTOR OUTLOOK: Positive***

## Current view

- India's oil ministry is seeking a series of tax and duty changes related to petroleum product retailing and energy exploration in a bid to reduce prices, subsidies and attract greater investment. It is also expected that infrastructure status would be granted to gas pipelines and E&P activities in order to facilitate growth through higher investments. Hence, overall see the budget to have positive impact on the sector.
- **Oil** - Financial year 2007 has been a mixed bag for the Indian oil industry. With rising crude prices, the industry did quite well at the upstream front. However, downstream sector problems regarding subsidies, taxes and pricing continue to persist. Hence, OMCs continue to remain dependent on oil bonds. The practice of issuing oil bonds does not resolve the problem. It only defers the resolution while compounding economic and financial costs.
- International prices are unlikely to soften in the medium term. Hence, an immediate adjustment of prices and subsidies is an urgent necessity. So, we do expect some action on the taxation structure of petroleum products in the budget.
- **Gas** -The country's natural gas supply by FY09-10 is likely to more than double from current levels due to recent KG basin discoveries. Currently, almost the entire gas consumption in India is industrial, with city gas distribution (CNG and PNG) accounting for only 4% of the consumption. We believe that with easing supply side constraint the lower share of city gas distribution is all set to change and gas distribution and transmission could turn out to be one of the fastest growing sectors.
- To facilitate sectoral growth, the industry has asked for infrastructure status to gas pipelines. This would result in benefits like tax holidays and lower cost of funds to gas transmission and distribution companies.

## Key budget expectation

| Issues | Current status | Wish-list | Impact | Rationale |
|---|---|---|---|---|
| **Excise duty cut in Diesel** | 8.16% of ex-refinery gate price + Rs 3.32/ liter (Rs 4.98/liter at current price) | Reduction in the duty by Rs 1/liter | Positive for OMCs and consumers. | Diesel remains highest contributor to total excise revenues, The contribution. has increased to 22% from 16% last year. |
| **Declared goods' status to Diesel** | Sales tax up to 29% | Uniform sales tax rate of 4% like LPG and SKO | Positive for OMCs and consumers. | To remove the inter-state difference on sales tax, OMCs making heavy losses, would also help in containing inflation |
| **Specific excise duties on Petrol and Diesel** | Petrol - 8.16% + Rs13.26/litre, Diesel - 8.16%+ Rs 3.32/litre | Specific duty of Rs 15.92 for petrol and Rs 6.08 per liter for diesel | Positive for OMCs. IOC, HPCL, BPCL, RIL | OMCs also suffer because of higher duties when crude rises |
| **Sales tax cut in gas** | Up to 20% ST in most states. | Sales tax cut to 4% and declared good status | Positive for gas dist. Companies. GGCL, IGL, GSPL | It will facilitate development of a national gas grid and ensure that the cost of gas to end customers is kept low |
| **Infrastructure status to gas pipelines and LNG import** | No major tax incentives | Upto 10 years of tax holiday under section 81-A of income tax | Positive for gas transmission companies. GSPL, GAIL, RIL | Huge investment in gas pipelines is needed to develop the gas market |
| **Infrastructure status to E&P business** | 12.5% service tax on companies offering drilling, surveying and offshore vessels for logistics | Concession on the service tax; Extending tax holiday from 7 to 10 for oil & gas discoveries | Positive for upstream companies, ONGC, RIL, Cairn. | E&P investments need to be encouraged to secure energy |

# Oil & Gas (contd...)

## Key budget expectation

| Issues | Current status | Wish-list | Impact | Rationale |
|---|---|---|---|---|
| **Differential import duty structure on crude and petroleum products** | ■ The import duty on crude at 5% while petroleum products at 7.5% | ■ Equalizing the duty on crude as well as petroleum products at 5% | ■ Negative for standalone refineries. CPCL, MRPL, RIL Neutral for OMCs | ■ This differential duty structure provides high effective protection, around 20% to the refineries, Equalizing the duty at 5% will reduce refining prices and under recovery claims |
| **Central sales tax (CST)** | ■ Current rate of 4% | ■ Zero CST on HSD, MS, SKO, LPG | ■ Positive for OMCs. HP, BP, IOC | ■ Unrecoverable levy; Prone to dual taxation |
| **Reduction in project import duty structure for infrastructure projects in petroleum sector** | ■ 5% basic customs duty + 16% CVD + 2% education cess. | ■ Nil customs duty on capital goods imported for new refineries, and pipeline projects | ■ Positive for refiners. RIL, Essar Oil, HPCL, BPCL, IOC | ■ Refineries need to be cost effective to compete globally, it is essential that the project cost be not inflated due to taxation on project imports; Exports of petroleum products are the largest commodity exports of the country |

*Source: Kotak Securities - Private Client Research, Industry*

## Top picks

| Company | Price (Rs) | EPS (Rs) FY07E | EPS (Rs) FY08E | PE (x) FY07E | PE (x) FY08E | Recommendation |
|---|---|---|---|---|---|---|
| ONGC | 900 | 86 | 97 | 10.5 | 9.3 | BUY |
| GSPL | 46 | 1.8 | 2.2 | 25.7 | 21.0 | BUY |
| HPCL | 279 | 28.2 | 35.8 | 9.9 | 7.8 | BUY |
| BPCL | 324 | 26.3 | 33.4 | 12.3 | 9.7 | BUY |
| Great Offshore | 642 | 35 | 59 | 18.3 | 10.9 | BUY |

*Source: Kotak Securities - Private Client Research*

# PHARMACEUTICALS

***EXPECTED BUDGET IMPACT: Positive***

***SECTOR OUTLOOK: Positive***

## Current view

- We expect that the pharma companies, which are well diversified into formulations and NCE/NDDS research and development will benefit from the Budget proposals. Given the huge potential of the Indian pharma sector, the Finance Minister may give a boost to the sector's prospects by qualitative measures like, extension of time limit for R&D benefit, tax exemption on milestone payments from NCE out-licensing, reduction in excise duty rate and encouragement to firms engaged in the high potential biotech area.
- **Outlook remains positive from long-term perspective:** We believe companies that are well diversified are likely to post stronger sales and have better operating margins. CRAMS would be a huge opportunity for low cost manufacturers like Indian companies. MNCs would concentrate more on their Indian subsidiaries and make India a global manufacturing hub. Major players would invest more in R&D to boost their dry product pipeline. Thus, companies with a thrust on acquisition and alliances, low cost structure, backward/forward integration, scalability and good products pipeline, would be able to sustain themselves in this highly competitive environment.

### Key budget expectation

| Issues | Current status | Wish-list | Impact | Rationale |
|---|---|---|---|---|
| **MRP based excise duty on formulations** | 16% excise duty is charged on 60% of MRP | Reduce it to 12% | Positive for most pharma companies | Maintain competitiveness and to generate cash flow for R&D spending |
| **Tax benefits on expenditure incurred on R&D and related activities** | 150% weighted average deduction available till 31st March 2007 | Extend the tax benefit by another 5 to 10 years | Positive for companies which incurres high R&D expenditures | To encourage companies to focus on NCE/NDDS research and R&D related activities |
| **Exhaustive definition of R&D for availing tax benefits by including clinical trials and patent filing spend.** | Expenditure on clinical trials and patent filings not eligible for tax benefits | To widen R&D definition to cover these expenses | Positive for companies with higher spending on IND, ANDA and DMF filings | These activities are integral part of NCE/ NDDS research |
| **Custom duty on life saving vaccines** | 15% custom duty | Exemption from custom duty | Positive for vaccine manufacturer | All types of bulk vaccines procured should be exempt |
| **Infrastructure status to hospitals** | Not available | To provide infrastructure status | Lower tax outgo | Huge spending planned on new hospitals & research centres |
| **Custom duty on import of raw materials for molecule for ANDA** | 12.5% custom duty | To reduced to 5% | Positive for R&D oriented companies | To facilitate filings of ANDA in regulated markets like USA, UK, as this is a cost incentive activity. |
| **Milestone payment received on NCE out-licensing** | All receipts are taxable | To exempt from tax | Positive for R&D oriented companies | Due to nature of capital receipt |
| **Seprate IPR savvy arbitration council or quasi-judicial body to deal with IPR related disputes in product patent regime.** | No such body exist. | Announcement for such body | No direct impact | With large number of patent application filings with DCGI, we expect lot of pre/post grant oppositions |

*Source: Kotak Securities - Private Client Research, CII*

### Top picks

| Company | Price (Rs) | EPS (Rs) FY07E | EPS (Rs) FY08E | PE (x) FY07E | PE (x) FY08E | Recommendation |
|---|---|---|---|---|---|---|
| Alembic Ltd | 66 | 6.2 | 8.4 | 10.6 | 7.8 | BUY |
| Aventis Ltd* | 1,317 | 80.3 | 91.4 | 16.4 | 14.4 | BUY |
| Cipla Ltd | 244 | 9.1 | 11.1 | 26.9 | 22.0 | BUY |
| Jubilant Organosys | 248 | 15.1 | 18.0 | 16.4 | 13.8 | BUY |
| Panacea Biotec | 451 | 21.4 | 30.2 | 21.1 | 14.9 | BUY |

*Source: Kotak Securities - Private Client Research; * Read as CY06E and CY07E*

# POWER

***EXPECTED BUDGET IMPACT: Positive***

***SECTOR OUTLOOK: Positive***

## Current view

- Despite the increase in pace of capacity addition in recent years, the power supply deficit in India continues to cripple various parts of India.Peak power deficit for the country stood at 10.5% in 2005-06. The government has set a target of 67 GW for the XIth plan as compared to a likely capacity addition of 24 GW in the Xth plan. Capacities of 12 GW is under execution. With a view of accelerate the pace of capacity addition, the government has initiated nine ultramega power projects. Out of these, two have been already awarded to successful bidders.
- Further reforms and ironing out of issues relating to open access of power would be welcome.
- Continued thrust on loss reduction at distribution level intended to improve the financials of state-level utilities is also expected
- Industry expects that the Government will exempt infrastructure companies from the purview of minimum alternate tax (MAT) to give a boost to infrastructure spending in the forthcoming Union Budget. Though infrastructure companies are exempted from payment of any tax for a period of 10 years, the imposition of MAT resulted in fiscal incentives being taken away in another form.
- Continuation of 80IA benefits for power sector beyond 2010.

**Key budget expectation**

| Issues | Current status | Wish-list | Impact | Rationale |
|---|---|---|---|---|
| **Complete IT exemption** | MAT applicable | Exemption under MAT | Saving in tax outgo | Incentivise investment in power sector |
| **Continuation of 80IA** | Benefit beyond 2010 | Maintain status quo | IT exemption | Incentivise investment in power sector |

*Source: Kotak Securities - Private Client Research, CII*

# SUGAR

*EXPECTED BUDGET IMPACT: Neutral*

*SECTOR OUTLOOK: Negative*

## Current view

- The sugar industry has witnessed a dramatic change in its fortunes in the last six months. Sugar prices have corrected sharply both domestically and in the global markets. The industry is expecting to produce surplus sugar in the region of 23 MT (consumption of 20 MT) while global markets too are expecting bumper crops from Brazil and Thailand. Although sugar prices are expected to recover from their current lows once the crushing season is over by March 2007, we expect sugar prices to remain muted, going forward.
- This is not only due to higher production but also given the government's concerns on curbing inflation. We have a negative view on the sector in the near future as earnings would come under pressure from lower sugar realizations as well as higher interest and depreciation costs due to the ongoing capex program. Currently, we have a **SELL** rating on Bajaj Hindusthan, Balrampur Chini and Dwarikesh Sugar.

### Key budget expectation

| Issues | Current status | Wish-list | Impact | Rationale |
|---|---|---|---|---|
| **Excise Duty on Molasses** | Taxed at Rs750/- per ton | Levy excise duty of eight per cent ad-valorem or at Rs 170 a tonne | Positive | The present rate of excise duty is excessively high when related to the current price of molasses as also the general rate of excise levied at eight per cent on various industrial inputs. |
| **Tax on Cash withdrawal** | Subject to tax on cash withdrawal | Exempt sugar factories | Neutral | Since most of the farmers are illiterate, they are not adept to maintaining bank accounts. |
| **Amendment of Section 32 relating to Depreciation** | Subject to 50% depreciation where an asset is acquired and put to use for the purpose of business or profession for less than 180 days | Modify the provision for seasonal industries like sugar | Positive | Sugar factories generally operate for 5 to 6 months in the season, commencing from November. Hence in the very first year of installation; they will be forced to forego part depreciation allowance |
| **Promotion of Ethanol as bio-fuel** | No specific benefits for ethanol production | Tax holiday on production of ethanol by bringing it under section 80-IA. | Positive for companies undertaking ethanol expansion | To accelerate its adoption as a bio-fuel |

*Source: Kotak Securities - Private Client Research, ISMA*

# TEXTILES

*EXPECTED BUDGET IMPACT: Positive*

*SECTOR OUTLOOK: Positive*

## Current view

- The global home textiles market is estimated at $70 bn. As per McKinsey estimates, growth in demand for home textiles is likely to be the fastest among all textile segments. According to KSA Technopac estimates, India's home textile exports may reach $8 bn by 2010 compared to $2 bn now. There exists a huge export opportunity in the home textiles segment primarily because of the separation of the consumption and production functions due to cost-driven outsourcing from India. India is fast emerging as a low-cost hub for home textiles manufacturing due to availability of raw material, low labour cost and growing market for home textile products.
- With high growth in the consumption of textile products, the incremental demand of man-made fiber is expected to grow at a much faster pace as against cotton yarn. Going forward, we see strong demand for man-made fibers leading to more demand for POY.

### Key budget expectation

| Issues | Current status | Wish-list | Impact | Rationale |
|---|---|---|---|---|
| **Concessions under TUF** | Valid till 31/3/2007 | To be extended upto 31/3/2012 | Positive | Extension of TUF scheme would lead to large inflow of investment in the textile industry thereby improving the productivity and efficiency. |
| **Customs duty on inputs for manufacture of textile machines** | 5-15% customs duty | 5% customs duty on all inputs for manufacturing textile machines | Positive | Customs duty of 5% on inputs for manufacture of textile machines and spare parts for maintenance of such machines would solve the problem of low availability and high prices of textile machinery and its spares and thus increase investments in the textile sector. |
| **Excise duty on man made yarn i.e. POY** | 8% excise duty | 4% excise duty | Positive | The duty anomaly in the textile sector would be corrected as while cotton yarn attracts 8% excise duty man made yarn i.e. POY attract 8% excise duty. |
| **Excise duty on MEG (key input for POY)** | 12% excise duty | 8% excise duty | Positive | The duty anomaly in the textile sector would be corrected as while PTA attracts 8% excise duty MEG attracts 12% excise duty. |
| **Labour reforms** | Rigid labour laws | To allow contract labour | Positive | Rigid labour laws have led to operational inflexibility. Contract labour norms should be liberalized for textiles and garments so that units can hire laborers for a few months without the compulsion of having to absorb them permanently. This would boost the productivity and investments in the textile sector |
| **FDI** | | Policies to attract FDI | Positive | If domestic reforms take place, textile exports have the potential to explode from $13 bn in 04 to $50bn by 2010 and to $70 bn by 2014. The domestic textile industry as such would require US$ 15 billion of new capital investment by 2010. |

*Source: Kotak Securities - Private Client Research, CII*

### Top picks

| Company | Price | EPS (Rs) | | PE (x) | | Recommendation |
|---|---|---|---|---|---|---|
| | (Rs) | FY07E | FY08E | FY07E | FY08E | |
| GHCL | 167 | 12.4 | 22.1 | 13.5 | 7.6 | BUY |
| JBF Industries | 108 | 12.9 | 17.1 | 8.3 | 6.3 | BUY |
| Vardhman Polytex | 108 | 14 | 16.4 | 7.7 | 6.6 | BUY |

*Source: Kotak Securities - Private Client Research*

## Research Team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