Deutsche Bank

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India Strategy: Budget expectations

Bold economic budget after a long gap?

Threads weaving strategic tapestry of the budget: 1) Subsidy rationalization (fuel & fertilizers); 2) Withdrawal of fiscal stimulus; 3) Stimulating investments; 4) Channelizing retail investments into equity markets; 5) Socialization of tax structure

Five strategic threads to weave the tapestry of FY13 budget
Budget FY13 to be woven around the following five strategic threads (1) **fiscal consolidation through subsidy rationalization** – through raising diesel, kerosene and LPG prices and partial decontrol of urea prices (these may be the UPA government's boldest economic decisions). Food subsidy however may be raised as government introduces food security bill (2) **withdrawal of fiscal stimulus** – through raising excise and service tax rates – across the board – by 200bps and widening service tax net (3) **stimulating investments and jumpstarting capital formation** (4) **accelerating retail investment in equity markets** – through lowering of short term capital gains tax on equities and increasing tax allowances for retail investment in equity mutual funds allowing channelization of personal savings from real assets to equities and (5) **socialization of personal tax structure** – through raising maximum income tax exemption limit and reintroducing personal tax surcharge on high tax bracket assesses and doubling corporate tax surcharge. This may probably be the last opportunity for Finance Minister to present an economic budget in the current term of UPA, as FY14 union budget (being last full-fledged budget before General Elections in 2014) will likely be guided by the imperatives of a popular democracy.

Priority shift - from excessive focus on Aam Admi (Common Man) to capital formation… for now
We believe that allocations to welfarist programs like National Rural Employment Guarantee Scheme (NREGS) are unlikely to rise from FY12 levels, allowing the government to keep expenditure under control. However we expect to see government increasing its focus on plan expenditure on projects aimed at reviving capital formation (pertaining particularly to roads, railways and irrigation). With the gross fixed capital formation showing compression in Jul-Sep qtr, we expect several fiscal measures (through budgetary allocations, tax exemptions/benefits, easier financing etc.) to kickstart the capex cycle. As per our infrastructure analysts, the government may adopt following key measures: **(i)** Sun-set clause on tax incentives for infra projects likely to be extended by one more year; **(ii)** We expect government to announce fiscal incentives for new capex; **(iii)** Increased focus on Accelerated Power Development and Reform Program (APDRP); **(iv)** Setup of National Electricity Fund to provide interest subsidy to SEBs for investments in T&D sector for reducing the losses.

Implications for portfolio construction
Higher taxes & reined in expenditure on populist schemes should result in curtailing domestic consumption modestly. Terms of trade may shift from rural to urban India, albeit temporarily. We cut exposure to both consumer discretionary and staples in our model portfolio. Increased focus on capital formation through incentivizing infrastructure investments will benefit infrastructure stocks. Our Top Picks are: Axis Bank, ICICI Bank, SBI, Coal India, L&T, TCS, Bharti, DLF.
(for detailed sector-wise expectations from the budget please see pages 5-8 of the note.

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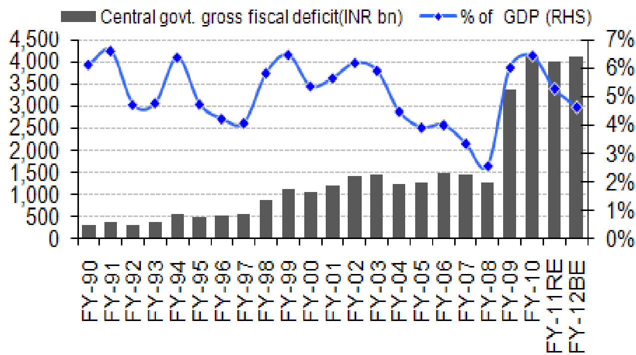
Key budget expectations

Imperatives of fiscal consolidation and capital formation to largely guide FY13 union budget

- **Nominal GDP growth of 14%-14.5%** is likely to be used for the budget arithmetic
- **Across the board hike in excise and service tax rates by 200bps**. The budget would also endeavor to bring more services into the tax net through introduction of a small and clearly defined negative list of services.
- The budget will likely layout a roadmap on subsidy rationalization through raising of diesel, LPG and kerosene prices.
- **We expect partial decontrol of urea prices** to address concerns over rising fertilizer subsidies - this will also result in increasing much needed investments into the fertilizer sector, where imports have risen sharply on domestic shortages.
- It is likely that the government may **re-introduce surcharge on personal income tax (10%),** particularly for assesses with gross taxable income in the maximum bracket. However, the FM is likely to raise the maximum exemption limit to INR250000 from INR180000, thereby providing more disposable income into the hands of lower income earning group.
- The budget may further **raise the MAT rate to 20% (from 18.5%).** We also expect finance minister to raise surcharge on corporate taxes to 10% (vs. 5% currently)
- **Disinvestments** target are likely to be lower but unlikely to be totally eliminated
- The **growth in expenditure is likely to be kept subdued** with several of the flagship social schemes (such as MGNREGS*) likely to see flat or lower allocations
- **Food subsidy** is likely to rise modestly as the government rolls out its food subsidy bill in FY13. However, only partial rollout in FY13 may keep expenditure under control
- **Interest payments** should show a relatively lower increment driven by expectation of lower interest rates. With expectation of fiscal consolidation, government borrowing could show relatively lower rise or even a decline over FY12, which should lead to lower interest expenses, aided further by an expected decline in interest rates.
- With a decline in financial savings among Indian households, we believe that the budget will contain some incentives aimed at **accelerating retail investors' participation in equity markets**. Some of the key avenues that the FM can consider tapping include: (i) lowering/eliminating of short-term capital gains tax on equities,(ii) increasing tax allowances for retail investment in equity mutual funds allowing channelization of personal savings from real assets into equities

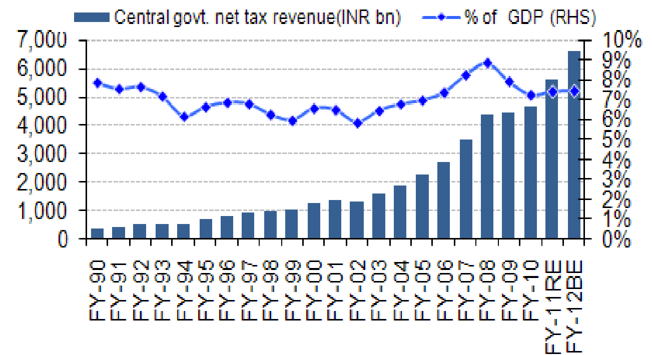
(Abhay Laijawala /Abhishek Saraf)

Figure 1: Trend in central government's fiscal deficit



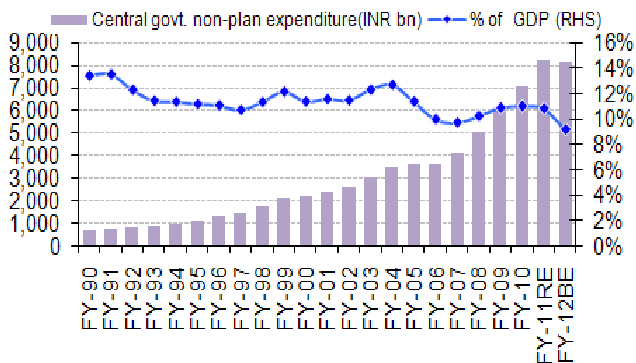
Source: Deutsche Bank; CMIE; Government of India

Figure 2: Trend in net tax revenue



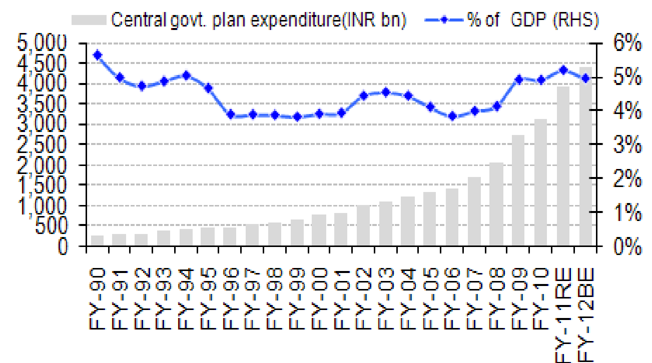
Source: Deutsche Bank; CMIE; Government of India

Figure 3: Trend in non-plan expenditure



Source: Deutsche Bank; CMIE; Government of India

Figure 4: Trend in plan expenditure



Source: Deutsche Bank; CMIE; Government of India

Figure 5: trend in key subsidies

Figures in INR bn	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11 RE	2011-12BE	2011-12E
Food Subsidies	231	240	313	438	584	606	606	750
% of GDP	***0.6%***	***0.6%***	***0.6%***	***0.8%***	***0.9%***	***0.8%***	***0.7%***	***0.8%***
Fertillizer Subsidies	185	262	325	766	613	550	500	900
% of GDP	***0.5%***	***0.6%***	***0.7%***	***1.4%***	***1.0%***	***0.7%***	***0.6%***	***1.0%***
Petroleum Subsidies	27	27	28	29	150	384	236	1,250
% of GDP	***0.1%***	***0.1%***	***0.1%***	***0.1%***	***0.2%***	***0.5%***	***0.3%***	***1.4%***
Aggregate	442	529	666	1,232	1,347	1,540	1,342	2,900
% of GDP	***1.2%***	***1.2%***	***1.3%***	***2.2%***	***2.1%***	***2.0%***	***1.5%***	***3.3%***

Source: Deutsche Bank; CMIE; Government of India

Sector wise expectations

Automotives (Srinivas Rao/Amyn Pirani)

- Excise duty rate on most automobiles (except large passenger vehicles & UVs) could be raised by 200bps to 12%. Excise duty on large cars (>1500cc) and UVs could be raised by 200bps to 24%.

- Recent news-flow indicates imposition of specific excise duty on diesel passenger vehicles. While this would be a sentiment negative for Mahindra & Mahindra (100% vehicles are diesel), the bigger impact would be on Maruti (30% diesel). Vehicle manufactured by Mahindra do not face threats from petrol substitutes, and hence impact would be short-lived. However, in the case of Maruti, demand may move towards petrol variants which are less profitable for the company.

- Allocation towards rural sector (employment and infrastructure) under various schemes like (NREGGS) is unlikely to increase. We note that successful implementation of rural employment schemes have reduced the supply of farm labor and have given an impetus to farm mechanization (tractor volume growth at 23% p.a. during FY09-12E). We believe this would lead to moderation in growth for tractors (10% in FY13E) and two-wheelers (13% in FY13E).

Cement (Chockalingam Narayanan)

- Better implementation of plan allocations could result in higher construction demand from infrastructure segments.

- Excise duty structure is likely see an upward recalibration

- Higher service tax could result in freight cost moving up

- Elimination of import duty on thermal coal is likely to provide some relief to cement sector

- Differential between MAT and Income Tax rate may come down

Consumer Staples (Gaurav Bhatia)

- We expect specific excise duty on cigarettes to be raised by 10%. However, we believe that ITC is best placed to absorb the hike in excise duties as it has a demonstrated track record of passing on excise duty hikes to the end consumer.

- Excise duty increase of 200bps, cut as part of the stimulus package, could be reinstated. While companies like Marico, Dabur etc won't be affected, as they have manufacturing facilities in excise exempt zone, Asian Paints would get impacted and would have to pass it on.

- Any increase in income tax slabs (particularly hike in the maximum exempt slab), which lowers tax outgo and increases disposable income will be positive for the consumer sector.

Financials (Manish Karwa/Manish Shukla)

- Fiscal consolidation is very crucial from a macro perspective, and the banks will like better fiscal policies and the supply of government securities should be limited
- Some clarity on the restructuring / sops for the power sector - which should aid asset quality issues at the banks.
- Some articulation of the intent to pass the insurance bill, which among other things raises the foreign limit to 49% from 26%. All insurance holding companies will in principle benefit as it will bring them closer to listing however, HDFC Ltd is the only company to have articulated its intention to list the insurance business
- Tax benefits on long-term deposits may be increased - currently it is a part of the overall deduction limit of Rs100,000 under section 80C. It could be taken out and provided with a separate limit as deposit growth has been weak; and bankers have been complaining about the differential tax treatment of bank deposits and fixed income mutual funds
- Fresh budgetary allocation for recapitalization of PSU banks especially in the light of new Basel III requirements and higher capital requirements for SBI
- Further clarity on modalities of issuing new private sector bank licenses.

Fertilizers (Harshad Katkar/Amit Murarka)

- We expect per unit subsidy to be cut under the Nutrient Based Subsidy (NBS) system for non-urea fertilizers. While this will not impact realisations of fertiliser companies (since they are free to increase the retail selling price of non-urea fertilizers under NBS), it might impact demand of these fertilizers due to higher prices.

Infrastructure (Manish Saxena/Anup Kulkarni)

- One of the biggest constraints faced by the infrastructure companies is the non-availability of banking finance as lot of banks have hit an upper exposure for infra funds. We expect finance minister to allow banks to raise tax free paper for funding infra projects similar to those given to NBFC infra companies such as L&T and IDFC.
- Sun-set clause on tax incentives for infra projects is likely to be extended by one more year
- We expect government to announce fiscal incentives for new capex.
- Differential between MAT and Income Tax rate may come down.
- Imposition of 19% import duties on power generation equipment. Any duty less than that may not benefit power equipment suppliers
- Clarity on investments in fertilizer sector to be watched for new capex to be initiated
- Allocations to NHAI, Indian Railways and DFC is likely to show flat to rising trend with much more emphasis on proper utilization of the funds

- High likelihood of revenue generation from auctioning of natural resources such as Coal/other minerals

- Dividends, divestments and implied capex from PSUs. Newflow suggests that all PSUs have planned a cumulative US$25bn+ capex for next 3 years, at a time when Government was evaluating dividend policy of the companies.

Oil & Gas (Harshad Katkar/Amit Murarka)

- We expect status quo to be maintained on customs and excise duties in the oil & gas sector in light of the sustained high losses on sales of subsidized petroleum products at current retail selling price. Note that customs duty was cut in June 2011 by 5% to nil for crude oil and to 2.5% for petrol and diesel, and excise duty on diesel was cut by INR2.6/lit to INR2/lit.

- Extension of the commissioning date of new refineries to avail the seven-year tax holiday. The exemption is currently available for only those refineries which have been/would be commissioned by March 2012. This will benefit Indian Oil Corporation (IOC) which is setting up a greenfield 15mmtpa refinery in Paradip, Orissa.

- We expect per unit subsidy to be cut under the Nutrient Based Subsidy (NBS) system for non-urea fertilizers. While this will not impact realisations of fertiliser companies (since they are free to increase the retail selling price of non-urea fertilizers under NBS), it might impact demand of these fertilizers due to higher prices.

Pharmaceuticals (Abhay Shanbhag/Mayank Kankaria)

- All round increase in taxes - indirect (excise duty is expected to be rolled back by 2.0% to pre-crisis levels) and direct (expected increase in MAT to 20% from 18.5% will aggravate some of the manufacturing units losing their tax holiday in a phased manner)

- Expected increase in healthcare budgets will almost entirely benefit smaller companies, who generally win most of these tenders

- Hence big companies are lobbying for higher weighted deduction (currently at 200%) on R&D related costs and lower taxation on R&D incomes.

Real Estate (Abhay Shanbhag/Mayank Kankaria)

- On the policy front, the liquidity starved industry is pushing for relaxation of end-use restrictions on the use of External Commercial Borrowings (ECBs). Biggest beneficiaries would be - DLF, Unitech & HDIL

- On the direct taxes front, limit of income-tax deduction for interest on housing loans may be increased to INR 300,000 (from current INR 150,000). While this will improve affordability for end-users and hence boost demand - a positive for all real estate developers, we believe that developers in tier 2/3 cities or in the affordable segment (where unit value would be <INR5m) will be major beneficiaries – HDIL, Sobha, etc

- SEZ have significantly lost their charm as direct & indirect tax exemptions have been significantly diluted. With quite a few SEZs being in different phases of

development, restoring even some of these exemptions will benefit developers in the near-term and the end-use industry (IT or manufacturing) in the long-term. Biggest beneficiaries would be - DLF & Unitech

- On the indirect taxes front, further clarifications on implementation of much awaited Goods and Services Tax (GST) and reduction in multiplicity of taxes (overlapping of central and state taxes) will be a positive for the industry

- Relaxation of FDI norms on multi-brand retail industry

Utilities (Abhishek Puri)

- Reduction/removal of duties on imported coal but no changes in cess for coal

- Increased focus on Accelerated Power Development and Reform Programme (APDRP)

- Setup of National Electricity Fund to provide interest subsidy to SEBs for investments in T&D sector for reducing the losses.

- Differential between MAT and Income Tax rate may come down

Appendix 1

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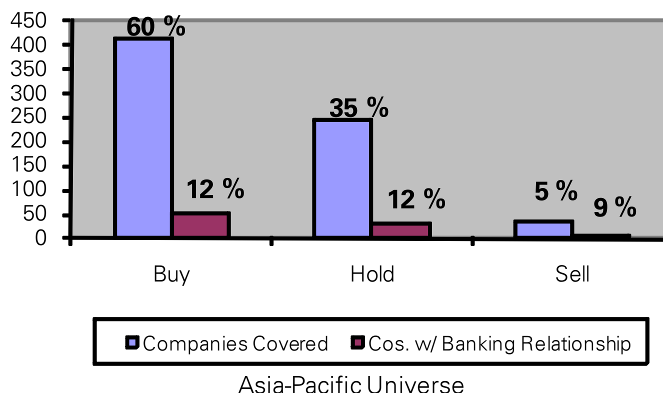

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