



All You
Need to
Know



Union Budget 2016 -2017
Fiscal consolidation over Growth

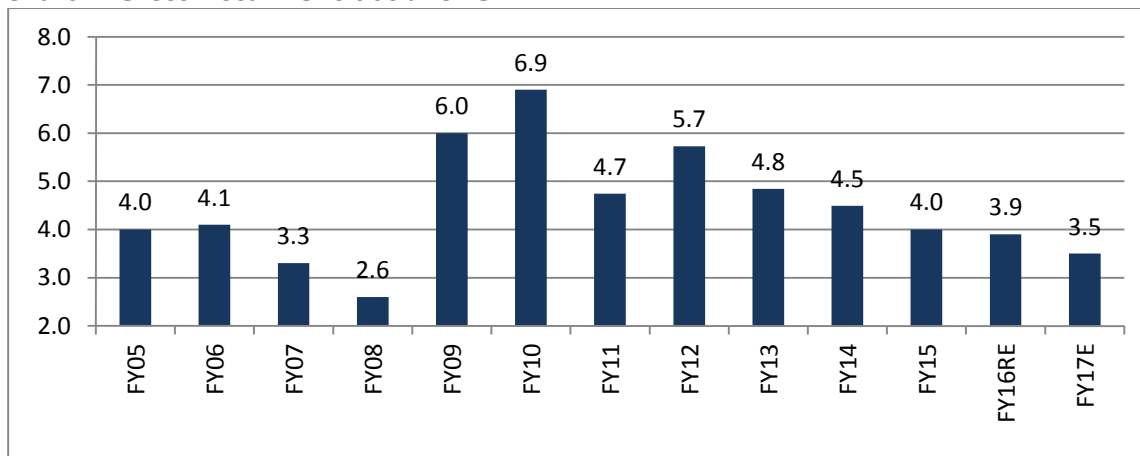
- Focus on fiscal discipline --- will RBI governor oblige by rate cut?
- No change in LTCG but taxing the super rich, fortune at the bottom of the pyramid
- Several initiatives to revive rural economy and to boost investment in infra
- IDS announcement has gone unnoticed but it could be source of revenue
- Overall, it has been pragmatic budget with no bells and whistles!!!
- Market correction provides opportunities to invest in Quality stocks. Stay Invested.

Sticking to Fiscal Consolidation despite global growth scare

The Finance Minister (FM) had two options while preparing the budget – (1) fiscal consolidation and stability or (2) a less aggressive consolidation for boosting growth. He selected option 1. Consequently, the gross fiscal deficit (GFD) in 2015-16 and 2016-17 has been retained at 3.9% and 3.5% of GDP, respectively. Accordingly, the net (gross) market borrowing for FY17 has been restrained at INR 4.3 tn (INR 6 tn) in the Union Budget FY16-17 as compared with INR 4.4 tn (INR 5.9 tn) of previous year. Notably this was the third successive year of decline in net market borrowing while gross market borrowing too has essentially remained flat for around five consecutive years. The FM stuck to fiscal discipline without compromising on public spending on infrastructure and rural economy, which is critical at this juncture to revive investment / capex cycle in the country. The increase in Plan expenditure is in the order of 15.3% over current year’s budget estimate. Plan Allocations have given special emphasis to sectors like agriculture, irrigation, social sector including health, women and child development, welfare of Scheduled Castes and Scheduled Tribes, minorities, infrastructure, etc.

With FM sticking to fiscal consolidation path and hence control over the market borrowings, it could create a possibility of interest rate cut from RBI to revive the growth.

Chart 1: Gross Fiscal Deficit as % of GDP



Achievable estimated tax revenue and expenditure numbers in the Budget

As far as the credibility of the numbers is concerned, the government’s gross tax revenue projections appear to be realistic. However, the revenue from telecom auctions (INR 990 bn against INR 560 bn in FY16) and disinvestment (including strategic sales) of INR 560 bn look somewhat stretched. Any shortfall on these may be offset by cut in development spending.

The government has estimated 10% increase in service tax on top of 25% increase in service tax in FY2016. The government has introduced a 0.5% Krishi Kalyan Cess on service tax on all services from June 1, 2016 which takes effective service tax rate to 15%. However, market was expecting increase in service tax by 150-200 bps to bring the rate near expected GST rates, which we believe is somewhat of a relief for the market.

The total expenditure is budgeted to rise at a faster pace of 10.8% YoY in FY17 v/s 7.3% in FY16 mainly due to higher spending on rural, infrastructure and social spending. However, the key focus of area of spending is rural especially irrigation, rural development (roads, housing, NREGA) as well as agriculture. Note that a lot of increase in rural spending is coming due to irrigation and PMGSY (rural roads), both of which should be productive spending.

The outlay towards subsidy remained stagnant at INR 2.5 tn since FY2014, thanks to lower oil prices and direct benefit transfer.

Table 1: Major Revenue and Expenditure Trend

IN Rs bn	FY10	FY11	FY12	FY13	FY14	FY15	FY16 Revised	FY17 Budgeted
Total revenue receipts	5,728	7,885	7,514	8,792	10,147	11,015	12,061	13,770
% YoY growth	6.0%	37.6%	-4.7%	17.0%	15.4%	8.5%	9.5%	14.2%
Non-tax revenue	1,163	2,186	1,217	1,374	1,989	1,979	2,586	3,229
% YoY growth	19.9%	88.0%	-44.3%	12.9%	44.8%	-0.5%	30.7%	24.9%
Net-tax revenue	4,565	5,699	6,298	7,419	8,159	9,036	9,475	10,541
% YoY growth	3.0%	24.8%	10.5%	17.8%	10.0%	10.8%	4.9%	11.2%
Corporation tax	2,447	2,987	3,228	3,563	3,947	4,289	4,530	4,939
% YoY growth	14.7%	22.1%	8.1%	10.4%	10.8%	8.7%	5.6%	9.0%
Income tax other than corporation tax	1,225	1,391	1,645	1,965	2,378	2,668	2,991	3,532
% YoY growth	15.5%	13.5%	18.3%	19.5%	21.0%	12.2%	12.1%	18.1%
customs duty	833	1,358	1,493	1,653	1,721	1,880	2,095	2,300
% YoY growth	-16.6%	63.0%	10.0%	10.7%	4.1%	9.3%	11.4%	9.8%
excise duty	1,030	1,377	1,449	1,758	1,695	1,900	2,841	3,187
% YoY growth	-5.2%	33.7%	5.2%	21.4%	-3.6%	12.1%	49.6%	12.2%
service tax	584	710	975	1,326	1,548	1,680	2,100	2,310
% YoY growth	-4.1%	21.6%	37.3%	36.0%	16.7%	8.5%	25.0%	10.0%
Total expenditure		11,973	13,044	14,103	15,635	16,637	17,854	19,781
% YoY growth			8.9%	8.1%	10.9%	6.4%	7.3%	10.8%
---Plan expenditure		3,790	4,124	4,136	4,531	4,626	4,772	5,500
% YoY growth			8.8%	0.3%	9.6%	2.1%	3.1%	15.3%
---Non-plan expenditure		8,183	8,920	9,967	11,104	12,010	13,082	14,280
% YoY growth			9.0%	11.7%	11.4%	8.2%	8.9%	9.2%
-----Subsidies (part of non-plan exp)		1,734	2,179	2,571	2,562	2,583	2,578	2,504
% YoY growth			25.7%	18.0%	-0.4%	0.8%	-0.2%	-2.9%

Infrastructure boosting measures

The budget provided impetus to the infrastructure sector via several measures ---

(1) Higher planned outlay for railways and roads sectors --- railways at INR 1.2 tn (up 24% yoy) and roads at INR 789 bn (up 38% yoy);

(2) Higher cess to support renewable and infrastructure investments -- higher 'Clean Energy Cess' on coal, lignite and peat to INR 400 per ton from INR 200 per ton, and introduction of infrastructure cess of 1-4% on passenger vehicles;

(3) Supporting the 'Make in India' and 'Start-up India' programs -- new manufacturing companies, engaged solely in the business of manufacture or production of articles or things, incorporated on or after March 2016, will be given an option to be taxed at 25% (plus surcharge and cess) provided they do not claim profit-linked or investment-linked deductions and do not avail of investment allowance and accelerated depreciation, units established in special economic zones (SEZ) until FY2020 will be able to avail profit-linked deductions (for export of articles or things or services), and startups to get 100% deduction of profits for three out of five if they set up during April 2016 to March 2019; they will have to pay tax under MAT mechanism though;

(4) Lower excise duty for certain capital goods segments; and

(5) Steps to revitalize the Public Private Partnership (PPP) mode through formal dispute resolution mechanisms and new specific credit rating systems.

There may be minor near-term negative impacts on removal of Section 80IA benefits for infrastructure projects and gradual lowering of R&D incentives, starting FY2018. Tax break will be available on infrastructure development projects commissioned until FY2017. The budget elucidated that no deduction will be available for projects commissioned post FY2017 for development, operation and maintenance of an infrastructure facility (Section 80-IA) and development of SEZ (Section 80-IAB). Benefit of deductions for R&D investment will be limited to 150% from FY2018 and 100% from FY2021.

Income declaration scheme

The government has announced that it will launch an Income Disclosure Scheme (IDS) where tax payers can declare unaccounted income by paying 45% of the amount (30% tax, 7.5% surcharge and 7.5% penalty). It is difficult to estimate the amount that could be raised under this scheme. The government has not built in the estimate and that could be potential upside.

GAAR is on schedule, as of now

As mentioned by the FM in the last year's budget speech that the GAAR would be implemented from April 2017, in line with that, FM mentioned that the GAAR implementation will be on schedule.

Sector Impact

Following is a quick summary of the sector-wise impact of the announcement of the budget.

Automobiles –

Union budget had three major announcements which will have a direct impact on the auto sector.

1. 1% additional luxury tax on vehicles priced above INR 1 mn (ex-factory price). Retail price of these vehicles will be above INR 1.5 mn. It will not have material impact on listed companies like Maruti, M& M and Tata Motor.
2. Imposition of infrastructure cess of 1% on small petrol/CNG/LPG vehicles, 2.5% on small diesel vehicles and 4% on large cars and SUVs (both petrol and diesel). This would lead to increase in prices of passenger vehicles but will not have any impact on two-wheelers, three-wheelers, commercial vehicle and tractor segment. In terms of listed OEMs, Maruti would be the most impacted with ~1.8% effective tax increase on its product portfolio. We believe companies will pass on the cost increase to consumers but volumes of especially large cars, SUVs and small diesel cars may go down.
3. The tax benefit of R&D spend would be reduced from 200% currently to 150% from FY2018 and 100% from FY2021. This would lead to increase in tax rate of OEMs from FY2018 onwards. M&M will be the most impacted as R&D spends of M&M is higher at around 3.5% of sales. The decline in corporate tax rate will partially offset the impact due to cut in R&D incentives in future.

Aviation – Excise duty rate on aviation turbine fuel has been increased to 14%, from 8% currently. We note that fuel cost forms ~30% of revenues for the major airlines, implying that the industry will need to take ~2% price hike to completely pass on the resultant increase in fuel cost due to excise duty hike.

PSU Bank - Re-capitalisation of INR 250 bn for FY17, if additional capital required then other means would be finalized, however this amount is lower than expected. Government is targeting to strengthen various recovery mechanisms & comprehensive bankruptcy code will be implemented by FY17. We think PSU banks are challenged with low capital position, high and rising NPLs and weakening PPOP; a higher capitalization would have helped reduce stress.

Pharma – Maximum R&D allowance for tax purposes to be restricted to 150% by 1 April, 2017 and 100% by 1 April, 2020. Negative in the long term for all Indian Pharma companies as R&D expense is 5-12% of revenue. 3000 new generic drug stores to be opened in FY17 with an aim of providing quality medicines at affordable prices - clear negative for Indian generic as well as MNCs operating in Indian formulation market as it will bring down the branded drugs growth.

Tobacco - Government has hiked excise in cigarettes by 10-11% across segments as it happens every year. We expect ITC to take 8-10% price hike to pass on the same; assuming flattish volumes which would drive cigarette EBIT growth for ITC back to low double-digits in FY2017E.

Excise duty on other tobacco products including cigars, cheerots, cigarillos and other forms of tobacco substitutes has been hiked by ~11%, excise duty on gutkha, chewing tobacco and jarda scented tobacco has been increased from 70% to 81%, excise duty on unmanufactured tobacco is hiked from 55% to 64%. The most surprising thing is that the effective excise rate on bidis remains unchanged.

Power / Cement / Aluminium - The increase in Clean Energy Cess would be passed on to end consumers and could mean an increase of INR 0.14 / unit tariff for end consumers. IPP players such as JSPL and Vedanta should be able to pass it on the extent of the capacity locked through PPAs.

In cement production, coal usage is ~13% per tonne i.e. an impact of just INR 26 / t (INR 0.5 per bag) assuming 100% usage of coal. Further, the clean energy cess is not applicable on pet coke. As majority of companies have increased their pet coke consumption (ACC 27% , Ambuja ~50%, UltraTech 74%, Shree Cement 100% and JK Cement 75%), the impact will be very negligible.

Also, it is negative for Aluminium players such as Hindalco (Power cost up INR 2.8 bn) and Vedanta (Power cost up INR 48 bn) having captive power plant based on coal.

Branded retail companies - FM has imposed excise duty on branded retail garments, currently nil. Excise on readymade garments with retail price of INR 1000 or more has been raised to 2% without input tax credit or 12.5% with input tax credit. However we feel this is likely to be passed on to the consumers.

Oil & Gas Sector - The FY17 budget proposed the change in Oil Industries Development Cess (Oil Cess) levied on domestically produced crude oil under the Oil Industry (Development) Act, 1974, to an ad-valorem duty of 20%, in place of fixed INR 4500 / mt being charged currently. As a result of proposed change while the Cess reduces to INR 3500 / mt (from INR 4500 / mt) at current crude oil prices (USD 35/bbl), the math becomes counterproductive if crude oil price increases beyond USD 45/bbl.

Investment Outlook

The FM has stuck to fiscal prudence over growth under the current challenging environment, domestically as well as global, which is commendable. At the same time the budget also provided growth triggers by providing more fillip to consumption and within that, rural consumption. This budget is dominated by investment / capex narrative coupled with boost to rural economy recognizing that India has passed through two consecutive years of draught significantly hurting rural populace. The budget has not announced any big bang reforms but it has removed the market apprehension about the possibility of Long Term Capital Gain Tax. It has not provided any incentives to rich and urban population. We feel the FM is now relying on RBI governor to ease out liquidity in the system and to cut interest rate to revive growth in economy. The main theme of the budget is the focus on kick starting public investment in infra, both on and off the balance sheet and revival of consumer sentiment especially in the rural India but maintaining fiscal prudence.

With the budget out of the way, the market will be back to the fundamental and future outlook of the economy. We believe that the implementation of several proposals announced in this budget is very critical to keep the investment momentum. We do see the macro parameters like inflation, interest rate and twin deficits remaining under acceptable level, thanks to a low price of crude oil and other commodities globally. The market has corrected sharply especially in the last two months on the back of strong FII selling in the market. The corporate India's performance remained lackluster due to slower consumer demand and limited benefits of various reforms. Although India Inc.'s margin is expanding, it is on the back of fall in revenue growth. With implementation of seventh pay commission, One Rank One Pension (OROP) and rural thrust given by the FM in the budget, consumer sentiment should see a revival. India has gone through two consecutive draughts and hence normal monsoon this year is the most critical factor for the rural sentiment. With market correction in last few months, the stock prices of many large cap and mid cap stocks have turned attractive. We recommend investing in Quality stocks.

Happy Investing!

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