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Pre-Budget Report

Union Budget 2016-17

25th February, 2016

Outlook

The Finance Minister (FM) will present the Union Budget 2016-17 on February 29, 2016 which will be the third budget from the NDA-led government in its current term. **All eyes are set on whether he will be able to increase investment spendin**g, while adhering to the path of fiscal consolidation. With the budget for FY17 (12-months ending March 2017) around the corner (to be announced on February 29th), it is interesting to analyze how the FY16 budget targets are likely to be met and also discuss our expectations for the upcoming budget. While this is a key economic event followed by investors, we must highlight that the budget is merely a statement of accounts while undertaking of reforms is a continuous progress and not limited to just one day of public announcement.

The Indian market tend to look at the budget as a signal on government's stance on growth weather it is taking measures to stimulate the economy or not and on sector specific implications of policy changes.

While India remains amongst the fastest growing economies globally, growth rates are still meager and anticipated acceleration in trend is still to be firmly established. The external environment is weak and corporate earnings growth is muted. There is therefore some heightened anticipation for the FY17 budget – with hopes whether the government efforts will be able to drive economic growth over the next few quarters.

However in our view, the budget for 2016 is unlikely to be a meaningful mechanism for the market.

1. There might be a chance to increase expenditure by government this year.

   - Nominal tax collection growth is slowing,
   - Implementation of the pay commission recommendations would require large fund allocation
   - The desire to cut fiscal deficit will constrain government spending and budgetary spending will be hostage to oil price assumptions

While the central government spends to gain an additional Rs 600 bn YoY from oil exercise duties in FY17, there is a risk that higher oil prices might force tax cut subsequently.

Justification from government officials suggests that budget will likely focus on social spending /support for the downside. While one may debate the social/political implications of such a choice, such a drive will create few catalysts for the market, which looks for government spending.

2. The minister of state for finance has suggested that the budget will focus on

   - Agriculture
   - Job creation through focus on skill India, Make in India and start-up India
   - Expansion of universal social security
   - Simplifying the tax structure

We expect greater focus on capital expenditure in the budget. The private sector is burdened with high debt levels and is also operating at lower capacity utilization levels. It is imperative for the government to support via infrastructure spends.

We expect the FM to budget for a 30% increase in plan capital expenditure.

3. Allocations towards important infrastructure sectors like

   - Power
   - Railways
   - Roads
   - Ports
   - Rivers etc.

Above sectors are likely be enhanced, in line with the PM's goals. The focus will be on stricter and time-bound implementation of these budgets. Also, in line with the recent indications, we expect allocations for defense to be higher.

Subsidies account for about 15% of the Government's total expenditure. The sharp fall in crude- prices, de-control of fuel prices and better targeting of subsidies will allow the government to provide a lower amount towards fuel subsidies in FY17. As per reports, Direct Benefit Transfer (DBT) for LPG had resulted in savings of about Rs.140bn in FY15.

Apart from the above, we expect the FM to provide benefits / support to the export sector, which has been reeling under a sustained global slowdown and higher exports from China. Tax benefits in the form of MAT removal for SEZs, are likely to be announced in the budget.

On the other hand, we also expect support to the Start-Up India program of the Government, in the form of tax benefits to start-ups. The FM may look at beneficial tax treatment to their brand building expenses in the forth-coming Budget. Start-ups and e-commerce companies will likely be allowed to appropriate initial brand building expenses over several years for taxation benefits.

Overview of the Indian Economy

Indian economy has weathered many challenges successfully in recent times and is currently placed on a cyclical upturn, on the back of strong policies and a whiff of new optimism. In the recent past, the economy faced testing times with issues like

- lower growth
- high levels of inflation
- widening current account deficit

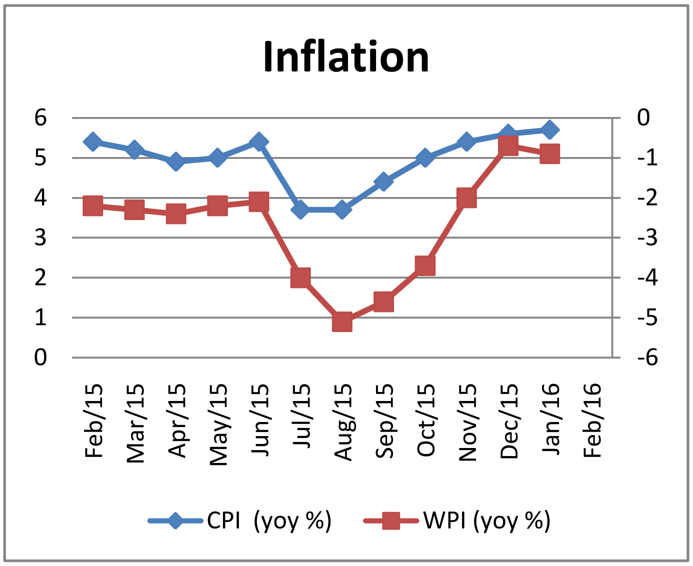
These issues are escalated by an unsupportive external environment. Growth is back, with its desirable concomitants of mild inflation and manageable current account balance with stable rupee and rising foreign exchange reserves, signaling improvements in macro-economic stability. **The growth rate of the economy, measured by the growth in GDP at constant (2011-12) market prices, improved from 6.9 per cent in 2013-14 to 7.3 per cent in 2014-15, and is projected to 7.6 per cent in 2015-16, according to the Advance Estimates released by the Central Statistics Office.** The ongoing revival is remarkable against the fact that it happened despite a highly tentative global economic conditions and a below-par domestic agricultural season.

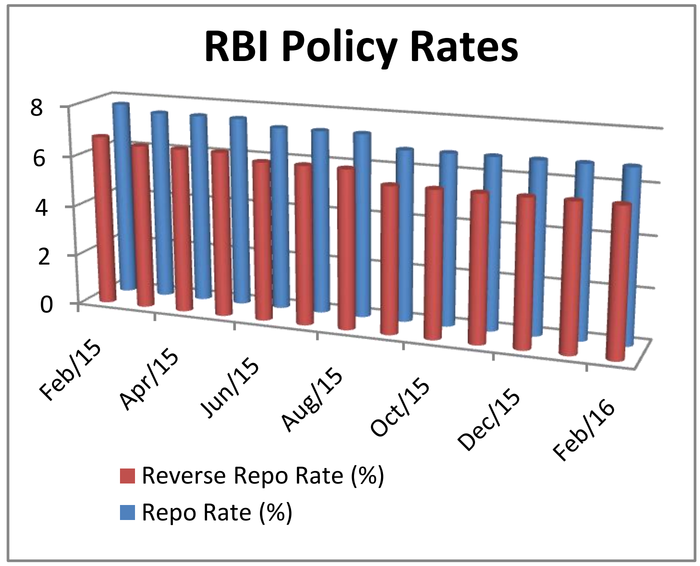
The year 2015-16 has witnessed key policy reforms, aimed at aiding growth revival and surmounting the structural constraints in the economy. The policy action has combined the needs of short term economic management with focus on taming inflation and external sector imbalances with a medium to long-term vision for transformation and development, manifested in significant reforms aimed at rationalizing administered pricing policies in petroleum and natural gas, stirring infrastructure development and de-bottlenecking the economy with initiatives to unshackle land acquisition for development (along with rehabilitation requirements therein) and to ensure adequate availability of key inputs like coal and power. The growth agenda of the Government has been tethered to the revival of manufacturing, unleashed in the **"Make in India"**, initiative, accompanied by liberalization of foreign direct investment, a large array of investment facilitation measures and steps to improve saving.

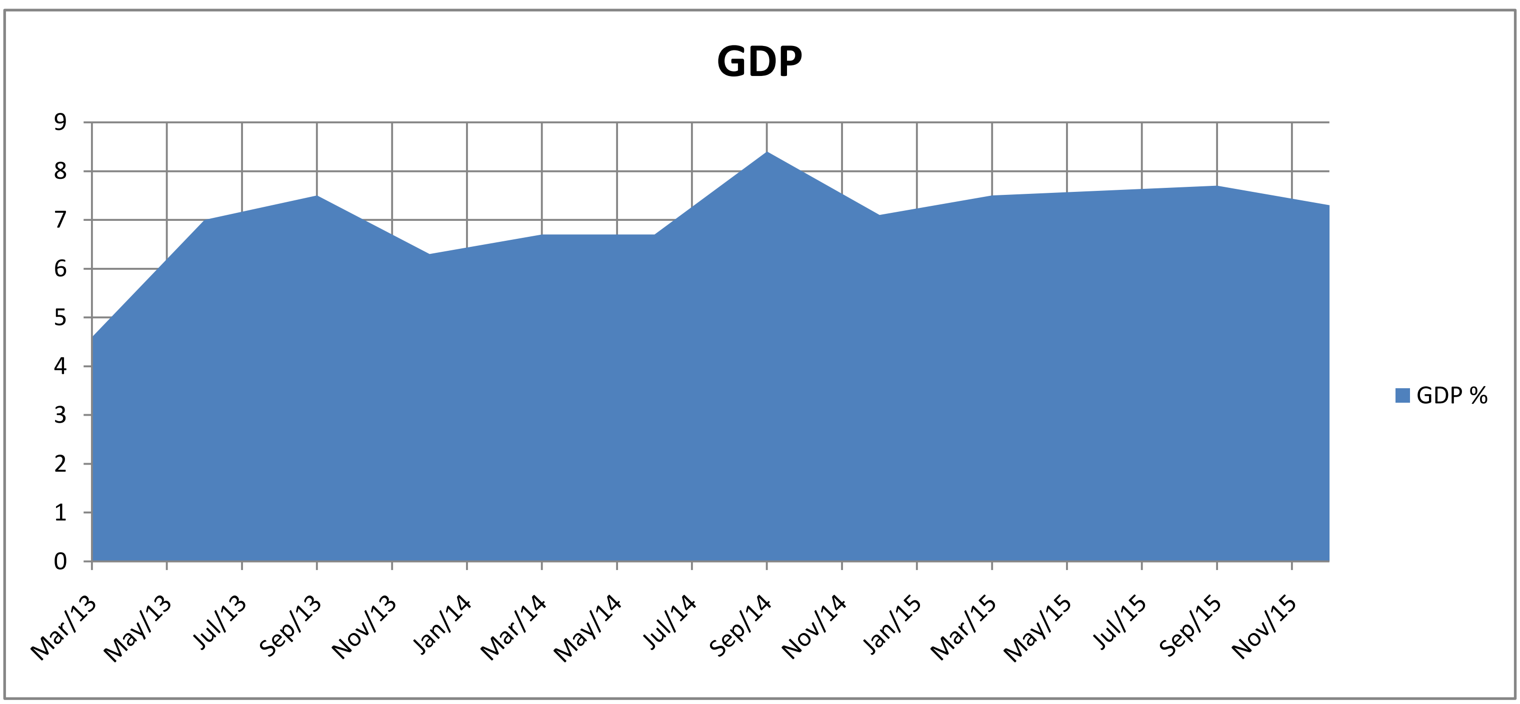
While Budget 2015-16 expounded the economic policy of the Government in a large measure, subsequent policy and legislative initiatives have been wedded to its development agenda. The **Pradhan Mantri Jan Dhan Yojana**, a landmark initiative combining opening of bank accounts with facilities of credit and insurance to those who stood excluded from the ambit of financial services so far.

The **Direct Benefit Transfer**, linked to **Aadhar**, has progressed well with greater efficiency in the delivery of subsidies. The much-awaited **Goods and Services Tax Constitutional Amendment Bill** was introduced in the Parliament, and, in order to build trust between Union and States, the first tranche of **Central Sales Tax (CST)** compensation to be given during current financial year has been announced. The Expenditure Management Commission is looking into the requirements of expenditure reforms and will suggest ways to improve allocative efficiency. The Government has also launched an effective program for **divestment** of Public Sector Undertakings. The government appears to be on track to achieve the targeted fiscal deficit to GDP ratio in 2015-16.

The steep decline of international crude oil prices, combined with the monetary policy of the Reserve Bank of India (RBI) and the Government's commitment towards fiscal prudence may have helped both WPI & CPI to remain in the target range. The current scenario of price stability and related expectations seems to have convinced the RBI, focused on a glide disinflationary path, on gradual monetary easing to support growth. **The RBI has, in two successive announcements, reduced the repo rate by 125 basis points (to 6.75 per cent) and SLR by 50 basis points (to 21.5 per cent). Rupee has again shown the level of 68 which was earlier seen in August 2013.** The current account deficit almost having been wiped out, while the government has continues to stay on the path of fiscal consolidation. **CPI inflation has fallen within the 6% RBI target as against 10%+ in the years preceding this government.**







GDP Growth

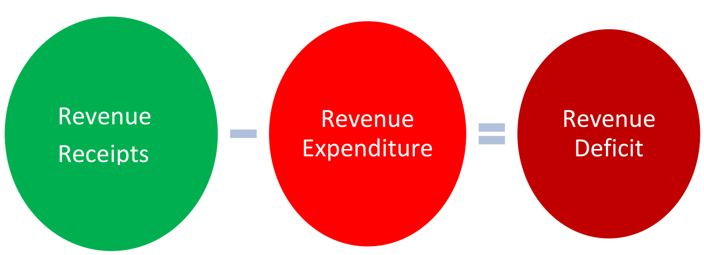
As per the Advance Estimates released by the Central Statistics Office, the Indian economy is estimated to register a growth rate of 7.6 per cent in 2015-16, as compared to a growth of 7.3 in 2014-15 and 5.1 per cent and 6.9 per cent in 2012-13 and 2013-14 respectively. While the growth in industrial and services sectors improved significantly, growth in the agricultural sector, affected by a sub-optimal monsoon, declined in 2015-16.

The sectors that are estimated to record higher growth in 2015-16 include

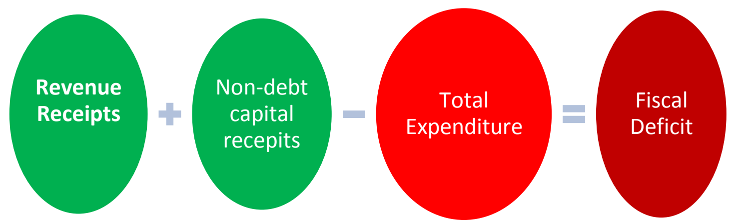
- Manufacturing
- Construction
- Electricity
- Gas
- Water supply and other utility services
- Financial
- Real estate and professional services
- Public administration
- Defence and other services.

Growth rate of GDP in the first three quarters (April-December 2015) of 2015-16 works out to 7.5 per cent, as against 7.4 per cent in the first three quarters of 2014-15. Quarter-wise, the numbers for Q1, Q2 and Q3 of 2015-16 are 7.6 per cent, 7.7 per cent and 7.3 per cent respectively. While Import to Export ratio has inclined from 1.42x in 2013-14 to 1.44x in 2014-15 and is expected at 1.52x for 2015-16.

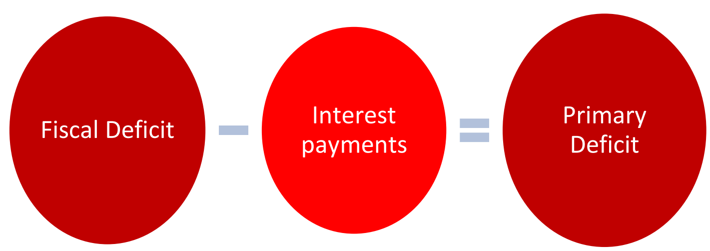
Budget Analysis



Revenue deficit refers to the excess of revenue expenditure over revenue receipts. Effective revenue deficit is the difference between revenue deficit and grants for creation of capital assets. **We foresee the revenue deficit turning into positive signs to decline to 2.8 in 2015-16 from 3.1 in 2013-14.**



Fiscal deficit is the difference between the revenue receipts plus non-debt capital receipts and the total expenditure including loans, net of repayments. This indicates the total borrowing requirements of Government from all sources. **We expect the fiscal deficit turning into positive signs declining to 3.9 in 2015-16 from 4.4 in 2013-14.**



Primary deficit is measured by fiscal deficit less interest payments. The total Plan Outlay for 2015-16 is 465277 crore. Despite a higher devolution, the Plan Outlay has been kept nearly at the level of revised estimate of 2014-15.

We expect income to increase in line with nominal GDP. Savings on crude and higher ambit of service tax will improve the indirect taxes also allocation to states expected to remain high.

			2013-2014	2014-2015	2014-2015	2015-2016
Budget at a Glance						
			Actuals @	Budget	Revised Estimates	Budget
1	**Revenue Receipts**		**1014724**	**1189763**	**1126294**	**1141575**
	2	Tax Revenue (net to centre)	815854	977258	908463	919842
	3	Non-Tax Revenue	198870	212505	217831	221733
4	**Capital Receipts (5+6+7)$**		**544723**	**605129**	**554864**	**635902**
	5	Recoveries of Loans	12497	10527	10886	10753
	6	Other Receipts	29368	63425	31350	69500
	7	Borrowings and other liabilities *	502858	531177	512628	555649
8	**Total Receipts (1+4)$**		**1559447**	**1794892**	**1681158**	**1777477**
9	**Non-Plan Expenditure**		**1106120**	**1219892**	**1213224**	**1312200**
	10	On Revenue Account	1019040	1114609	1121897	1206027
		of which,				
	11	Interest Payments	374254	427011	411354	456145
	12	On Capital Account	87080	105283	91327	106173
13	**Plan Expenditure**		**453327**	**575000**	**467934**	**465277**
	14	On Revenue Account	352732	453503	366883	330020
	15	On Capital Account	100595	121497	101051	135257
16	**Total Expenditure (9+13)**		**1559447**	**1794892**	**1681158**	**1777477**
	17	Revenue Expenditure (10+14)	1371772	1568111	1488780	1536047
	18	Of Which, Grants for creation of Capital Assets	129418	168104	131898	110551
	19	Capital Expenditure (12+15)	187675	226781	192378	241430
20	**Revenue Deficit (17-1)**		**357048**	**378348**	**362486**	**394472**
			(3.1)	**(2.9)**	**(2.9)**	**(2.8)**
21	**Effective Revenue Deficit (20-18)#**		**227630**	**210244**	**230588**	**283921**
			(2.0)	**(1.6)**	**(1.8)**	**(2.0)**
22	**Fiscal Deficit {16-(1+5+6)}**		**502858**	**531177**	**512628**	**555649**
			(4.4)	**(4.1)**	**(4.1)**	**(3.9)**
23	**Primary Deficit (22-11)**		**128604**	**104166**	**101274**	**99504**
			(1.1)	**(0.8)**	**(0.8)**	**(0.7)**

Sector Wise Expectation

Auto

Auto sector performance in FY16 has been mixed. Medium and heavy commercial vehicle (MHCV) segment grew at robust pace on the back of replacement demand and lower base. Passenger car sales growth was slow and driven mainly by the new launches. In the two wheeler segment, scooters continued to grow - though at a slower pace as compared with FY15. Motorcycle demand was tepid due to weak demand in rural areas. Back-to-back poor monsoons led to additional pressure on tractor sales.

Expectations:

- Our view for Auto is **Positive**.
- Government to announce an incentive scheme to replace 15-years old vehicles to encourage new sales
- Tax breaks to encourage investment in electric vehicles and to clarity the implementation timeline for the goods & services Tax.
- GST implementation should reduce prices for vehicles

Information Technology

According to a recent report released by Nasscom, Indian IT's (US$132bn) share in the country's total service exports is estimated at over 45% and the industry's contribution relative to India's GDP is over 9.3%. Overall, the industry is estimated to employ nearly 3.7mn people going forward, implying an addition of ~200,000 people from the current numbers. Its share in the global sourcing arena was ~56% in 2015. In 2015, a turbulent economic environment, volatility in currency, and technological shifts impacted global IT spend, which grew by a meager 0.4% to US$1.2trn. Unlike global spending, global sourcing continued its growth journey, posting an 8.5% growth in 2015 to an estimated US$162-166bn.

Expectations:

- We have a **Neutral** view for IT.
- Not expecting any material changes to the tax incentives for the companies in the sector under SEZ's policy.
- Any measure by the government that directly or indirectly supports weak domestic currency (INR) should be positive for the sector.

Banking

The credit growth for the banking system has witnessed moderate growth at 10.9% YoY (as on January 22, 2016) while deposit mobilization has grown at slightly muted pace (10.3% YoY), which has led to improvement in the C/D ratio to 76.5% as on January 22, 2016 vs. 74-75% levels seen during a quarter back. We are of the view that this could be due to few opportunistic lending towards PSU undertakings rather than any sustained revival in capex cycle. For the government to maintain a strong and competitive economy at the global scale the banking sector needs much attention and reforms.

However, looking at the drastic deterioration in the Indian banking sector's asset quality in the last few years, we expect the upcoming budget to bring in long-pending financial sector reforms, which will have a lasting impact on the overall economy.

Addressing the underlying problem of the industry which is creating stressed assets, higher capital allocation to clean up balance sheets and bringing in more efficiency and accountability by strengthening of the Bank Board Bureau are the key measures expected from the upcoming budget.

The asset quality of the banking sector has deteriorated sharply over the past few years. Compounding problems in the commodity sector can be held accountable for the same to a significant extent. The fact that ~70-75% of the total NPAs are accounted by the Metals, Infrastructure & Power sectors; Textiles are another significant contributor to stressed assets. Similarly, an equal amount of restructured was also contributed by the aforementioned sectors. Thus, resolving the concerns plaguing the underlying sectors would be the key focus of the government, going forward.

Nearly 25% of the restructured loan books seem to be risky and corrective steps to improve the utilization levels of the concerned sectors are likely to be a priority for the government in the upcoming budget.

As per RBI's Asset Quality Review measures, banks across the board have been recognizing all the troubled accounts as NPA. The Govt might consider setting up a separate entity like Asset Reconstruction Company to take over all the toxic assets of the PSU banks. A separate entity to handle all the stressed assets can result in much efficient recovery of bad debts and banks can also there by focus on their core area of focus.

Cement

Cement industry is linked with the growth in infrastructure sector and the budget is expected to be positive for the sector. The year saw healthy activity in the road sector coupled with government coming up with varied initiatives like Smart city development, Housing for all. However, pickup in the infrastructure projects lagged leading to slower cement demand growth.

Expectations:

- Our view on Cement stays **Positive**
- Implementation of GST is expected to reduce the overall taxes.
- Improved focus on affordable housing
- Higher focus on infrastructure with improved spending for roads, urban infra and smart city development.

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Metals

We expect the union budget to have a positive impact on the prospects of Metals & Mining Industry and companies operating within it. The sector has witnessed rough time due to the rising imports and low demand. The government has already taken steps to protect the domestic steel industry from the pressure of cheap imports. Also minimum import price was announced earlier this month to protect the steel industry.

Expectations:

- View for Metals is **Positive**
- With a lot of measures taken up for steel industry we don't expect major announcement in this budget.
- Increase in import duty for aluminum to combat the competition.
- Thrust on infrastructure would be also an additional advantage for this sector.

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