

Market Commentary

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The budget for the next decade

The Union Budget for the fiscal year ending 31 March, 2011 was presented in the Parliament on Friday. The Finance Minister has indeed walked a tightrope while attempting an improvement in the state of public finances on one hand, and the need for growth catalysts on the other. Perhaps no other country in the world pays as much attention to the annual budget as India does. This has its roots in the overwhelmingly large role that Government played in the pre-liberalization era. In the changed milieu however, Union Budget has taken the shape of a statement of intent that provides a sense of direction to all the stakeholders in the economy.

And if that is what it is, the Budget points at a young and open, consuming and growing society. The Government is playing to a large and diverse gallery, with its audience ranging from illiterate to sophisticated, from downtrodden to uber-rich, from rural aging farmers to urban yuppies. And pleasing every group to the same extent without being imprudent would be an impossible task. So some groups and sectors are crying foul, some are busy counting gains, and the rest indifferent. But the important thing to appreciate is that it is not a zero-sum game and looking at the trees too closely and for too long may make us miss the woods. In our opinion, focusing on the overall economic implication may be a far more worthwhile exercise for our readers.

A booster shot to consumption

The budget has left a vast sum of disposable income in the hands of individual tax payers by reducing effective tax rates. A typical urban individual tax payer will save anywhere between Rs.22,000/- and Rs.56,000/- per annum in tax expenses (\$500-\$1500). At a macro level, an additional Rs.25,000 Cr (\$5.5 billion) will be available for consumption with the urban population. Over the last two years rural incomes have risen sharply due to NREGA allocations and farm loan waivers, thereby building a momentum in rural consumption. We believe that consumption will now get a boost in urban parts of the country as well. Approximately 7% of Indians earn wages above Rs 1.5 lakhs (\$3,000), but they contribute 30% of GDP. Given the multiplier effect on consumption, this proposal alone can raise aggregate consumption by 5% and savings by 6%.

Commitment towards fiscal consolidation

Despite the largesse on the individual taxes front, the projected fiscal deficit has been contained to about 5.5% of GDP. This has been achieved by the following measures

- Increase in the non-tax revenues (PSU disinvestment and 3G auction)
- Raising excise duty on petrol and diesel
- A partial rollback of fiscal stimulus, and
- Taming the non-plan expenditure in the budget.

With a debt to GDP ratio of 78%, there is no option but to manage the fiscal deficit in as constructive a way as possible. The Government has laid out a roadmap for fiscal consolidation over the next few years. While execution needs to be seen, the sense of urgency assigned to this aspect is heartening.

The thrust on infrastructure unabated

Another important feature of the increased plan allocation is that nearly 46% of the allocation has been made for infrastructure development (Rs.1,735 bn ~\$40bn). Also, re-financing ability of IIFCL is estimated to have doubled to Rs.200bn (\$4.5bn) for FY11. However, efficacy of implementation in such programs is questionable, given the unconvincing track record. Budget lacks clarity on drawing a clear road map for land acquisition issues, which has been one of the major hurdles causing delays in projects.

But important economic reforms still some distance away

The general expectations of strong policy reforms did not fructify in the budget document. The Government reiterated its resolve to implement important economic reforms (such as GST and DTC) but maintained silence on many others (like subsidies and FDI). The Finance Minister particularly mentioned timelines for implementation of GST and DTC, an indication of changes to unfold. The budget also took incremental steps to narrow a huge gap between peak tax rate and MAT rate.

The list of desirables in the budget is long, but in our opinion FDI policy in retail and insurance sectors needs a review. Similarly, the vulnerability of India's public finances today is an opportunity to reform the oil sector in line with recommendations of the Kirit Parikh Committee. The budget *in toto* looks pragmatic, pro-consumption and a good point to start the next decade of change in India, warts and all.

On the portfolios:

Growth

The discretionary consumption sectors of the economy will directly benefit from the rising disposable incomes in the hands of the household sector. Consumption has always been at the centre stage of India's growth story and the new proposals underline the same. Kindly refer the table below where we have attempted to tabulate the broad impact of the budget across various sectors.

Positive	Neutral	Negative
Automobile	Auto Ancillary	Aviation
Banks	Capital Goods	Cement
Medical devices	Sugar	Oil & Gas
Construction	Media	Power
Pharmaceuticals		Real Estate
Retail		Telecom
FMCG		

The net effect of the changes in corporate tax rates on the earnings for FY11 is not expected to be material. Markets have applauded the budget broadly and gained over 3% in two trading sessions after the budget. As mentioned in our previous commentary, we believe that the markets are trading in a fairly valued territory (16x FY11E) and an elevated risk strategy may not be justified.

In line with the above mentioned outlook, we have made certain changes in the portfolio. During February, we have reduced exposure to high-beta sectors such as real estate, metals etc. We have also moved out of the businesses where the balance sheet appears stretched and near term cash flows are relatively uncertain. Hence, we have completely sold the positions in **DLF Ltd** (real estate sector) and **Suzlon Energy** (stretched balance sheet), but trimmed our exposure to **Sterlite Industries Ltd** (non-ferrous metals). We have also booked profits in **Reliance Industries Ltd** and **Opto Circuits** simply to bring their weightages down.

Going forward, we continue to maintain our cautious outlook due to the current valuations, which in our opinion look wholesome. More so, when the flow of external

capital has been volatile and a function of the news flow from the west. The worst may be behind us, but the dust there has not yet completely settled.

Lighthouse Infrastructure

The markets remained range bound during the month with the benchmark delivering returns of 0.6% for the month. The Economic Survey released during the month pegged the growth rate at 7.2% for FY10, acceleration from 6.7% growth in FY09. The union budget presented by the finance minister aimed at accelerating the growth rate further to 9% and double digit growth thereafter. The budget saw increased allocation to infrastructure development with 46% of the planned expenditure being allocated for infrastructure development. This is an increase of 22% over FY09. Significant positive measures are being announced on the rural infrastructure, power, coal and renewable front.

On the portfolio front, we marginally increased our weightage in Torrent Power and Adani Enterprises.

Eagle

February month was a volatile period for Indian equity markets, where budget considerations, fear of withdrawal of stimulus package both in India and globally, inflations fears, Greece debt fiasco and others ruled the roost. We have used this month to solidify our portfolio. While the portfolio is still in state of transition, the major moves initiated during this month were – complete exit out of Genus Power, pruning to stakes in JBF and Anant Raj, addition of Adani Enterprises and Motherson Sumi to the portfolio. As a result of these moves, our liquidity which was 9.3% odd has moved down to 4.8%. By the time all the actions have been executed our liquidity would have moved back to 10% levels, which we are comfortable with for the time being.

Annexure 1 - Numbers at a glance

Item (Figures in \$ bn)	FY09	FY10 RE*	FY11 BE#	Remarks
Revenues				
Gross Tax Revenues	132	138	162	
Corporation Tax	46	55	66	Maintain 18% rate of growth
Income Tax	26	29	28	Down 3%, as Individual tax rates are rationalized, 30% growth due to partial withdrawal of fiscal stimulus
Excise Duty	24	22	29	
Customs	22	18	25	
Other tax Revenues	14	13	15	
NCCF Expenditure	0.39	0.70	0.78	
State share of taxes	35	36	45	Increased allocations to states, a positive
Net Tax Revenues	96	101	116	
Non tax Revenues	21	24	32	
Net Revenue Receipts	117	126	148	
Capital Receipts	1.45	7	10	
Loan recovery	1.33	0.94	1.11	
Disinvestments	0.13	5.65	9	Disinvestment target raised for FY11
TOTAL RECEIPTS	119	132	158	
Expenditure				
Improved quality of expenditure				
Revenue Expenditure	173	197	208	
Interest	42	48	54	At 65% of fiscal deficit, interest burden at high levels
Defense	16	19	19	
Subsidies	28	28	25	The most vulnerable figure in the document.
Plan Expenditure	60	69	81	18% increase in Plan expenditure, positive
Admin & Social	27	33	29	
Capital Expenditure	20	25	33	
Defense	9	10	13	
Other non-plan exp	2	3	7	
Plan Expenditure	9	11	13	
TOTAL EXPENDITURE	192	222	241	
FISCAL DEFICIT				
	73	90	83	Overall impact, a lower fiscal deficit.
% of GDP	6.0%	6.7%	5.5%	

- Revised estimates # Budget estimates

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