Budget FY20 – A Disciplinary Budget

July 5, 2019

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Budget with a long-term view and commendable Fiscal Discipline

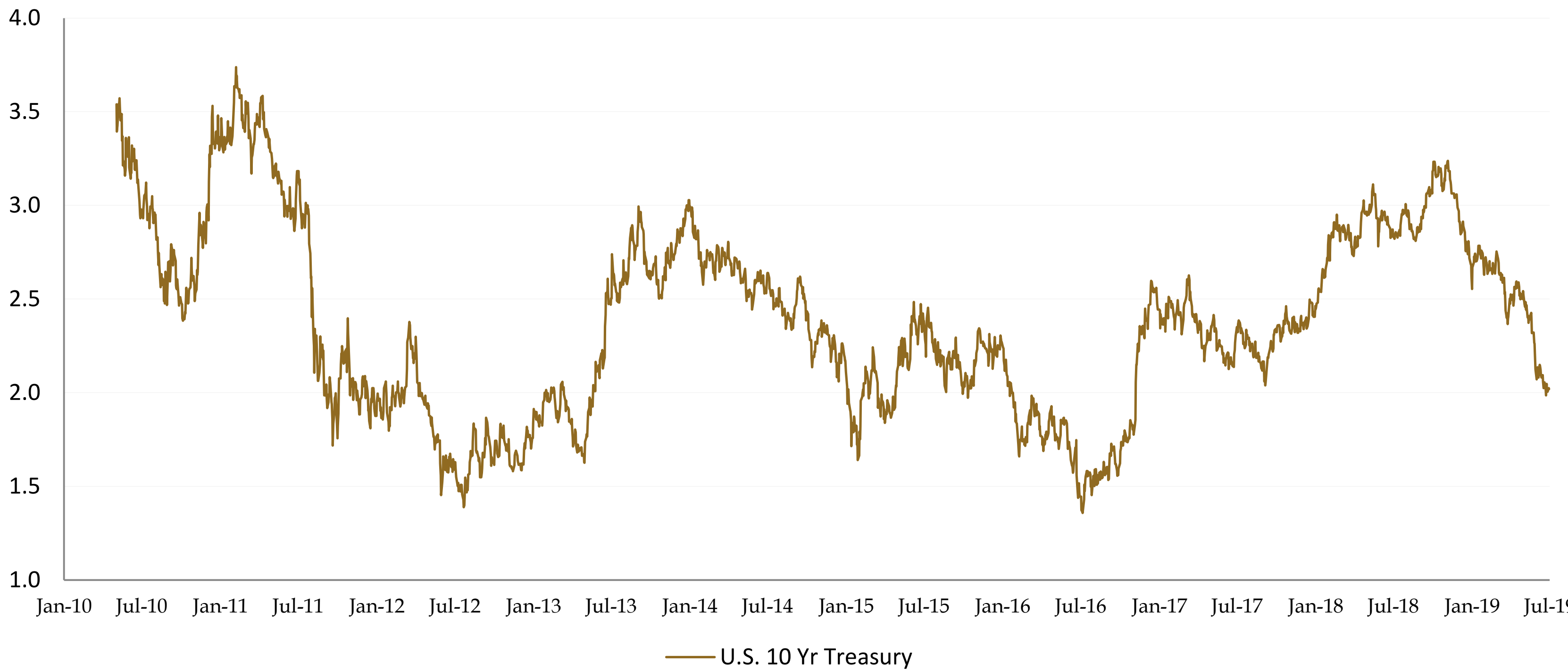
- **Sharper focus on fiscal prudence than on growth stimulus:** Fiscal deficit target for FY20 has been brought down from 3.4% of GDP to 3.3%.
- **Linking growth, skill, employment, export, capital flow:** The approach has been to create a virtuous cycle involving acceleration in production, more exports, higher capital inflows, improvement in skills, high real growth.
- **Improving the rural economy:** Improving facilities relating to housing, cooking fuel, roads, electricity, drinking water and sanitation in Rural India.
- **Public-private ventures:** Proposed measures to attract public-private participation to a large range of activities including infrastructure and housing.
- **Measures to attract foreign capital**: Clear objective of the government is to integrate India into the global supply chain and make the country a hub for a large range of global manufacturing and services.
- **Youth-centric projects:** Facilities are being put in place to improve research capabilities, facilitate sports and encourage start-ups.
- **Incremental reforms:** Has hinted at steps in areas including agriculture, education, environment, financial sector, foreign investment, technology and transportation.
- **Change in taxes:** The threshold for a 25% corporate tax has been raised for companies with up to a Rs4b turnover, from Rs2.5b earlier.

Economic Macro Background

Macro Background: Global

- Budget presented in a difficult global environment
  - Global growth has weakened starting in the second half of 2018 with growth estimated at 3.6% in 2018 and is projected to move down to 3.3% in 2019.
  - The weaker growth partly reflects the negative effects of tariff increases in the US and China and other sovereign and financial risks that have weighed on demand
  - Global financial conditions have also been tight with potential triggers that could spark further deterioration including a no-deal Brexit and further slowdown in the Chinese economy.
- Risks to global economy tilted to downside.
  - Stretched equity valuations in various markets and have been cut back with lowered expectations about earning prospects amid escalating trade tensions.
  - In the U.S as various risks to growth are emerging the FED has signaled pause on rate hikes and possibly rate cuts depending on the data
  - The ECB has ended its asset purchase program in December but has signaled monetary policy will remain accommodative in 2019
  - With investors lowering exposure to riskier assets, EM financial conditions have tightened with large differentiation based on country specific factors
  - Along with the global economy India's growth has also slowed down but is somewhat mitigated by lower oil prices and monetary easing by the RBI.

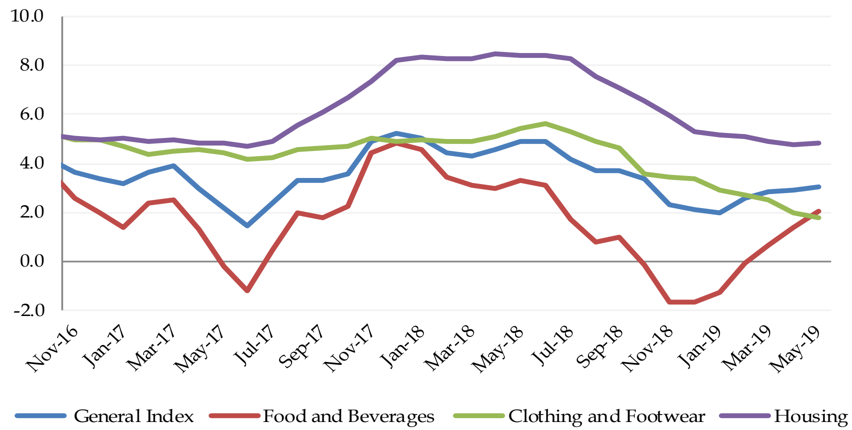
US Bond yields have moved down after reaching recent peak late last year



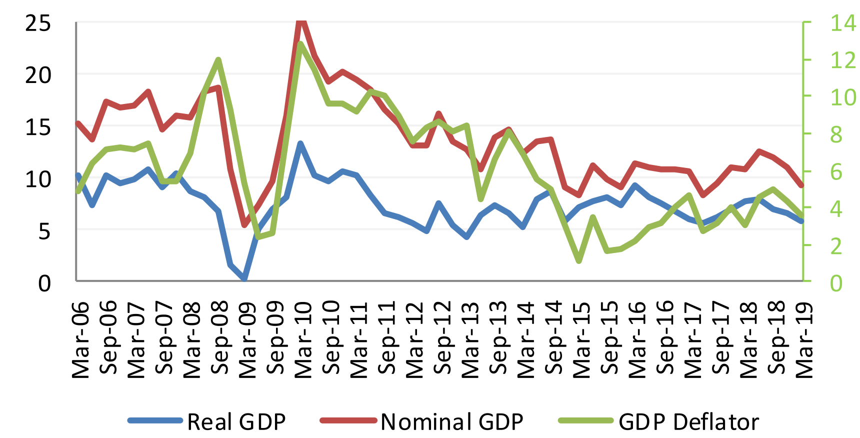
In its latest policy meeting the FED voted to hold policy rates while emphasizing caution on the rate trajectory and efforts to reduce its balance sheet. The Fed has faced increasing calls for lower rates from President Trump and indeed the latest policy forecasts has emphasized ongoing crosscurrents including trade developments and concerns about global growth with Fed policy makers open to rates cuts if the outlook worsens.

Domestic economy facing some challenges

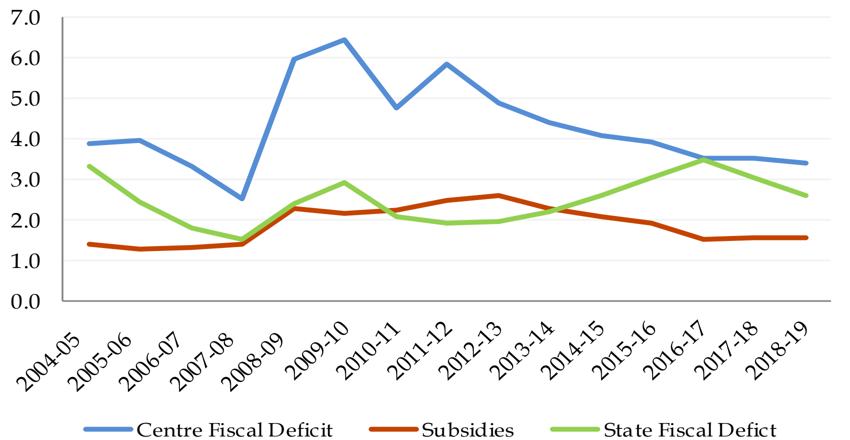
India CPI



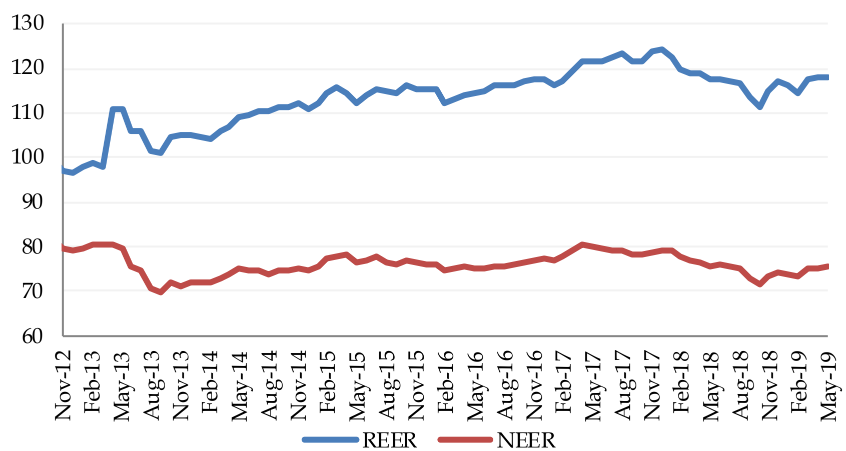
GDP Growth (2011-12 series)



Fiscal Deficit (% of GDP)



Real and Nominal Effective Exchange Rate



Budget framework

Budget Framework

	Actuals 2017-2018	Revised Estimates for 2018-19	Estimates for 2019-20	Gr % FY19RE/ FY18A	Gr % FY20BE/ FY19RE	Comments
Revenue Receipts	14,352	17,297	19,628	20.5%	13.5%	
Tax Revenue (Net)	12,427	14,844	16,496	19.5%	11.1%	
of which GST	4,426	6,439	6,633	45.5%	3.0%	
of which Excise	2,588	2,596	2,614	0.3%	0.7%	
of which Customs	1,290	1,300	1,559	0.8%	19.9%	Challenging
of which Taxes in Income	4,308	5,290	5,690	22.8%	7.6%	
Non-Tax Revenue	1,925	2,453	3,132	27.4%	27.7%	
Non-Debt Capital Receipts	1,158	932	1,198	-19.6%	28.6%	
Recovery of Loans	156	132	148	-15.8%	12.7%	
Misc Receipts (Disinvestments)	1,002	800	1,050	-20.2%	31.3%	Challenging task
Debt Receipts	5,870	5,932	6,527	1.1%	10.0%	
Draw-Down of Cash Balance	41	412	511	906.8%	23.9%	Expecting significant income from RBI
Total Receipts	**21,380**	**24,161**	**27,353**	13.0%	13.2%	
Revenue Expenditure	18,790	21,406	24,478	13.9%	14.3%	
(i) of which Interest Payments	5,292	5,876	6,605	11.0%	12.4%	
Capital Expenditure	2,637	3,166	3,386	20.1%	6.9%	
Grants in aid for capital asset creation	1,910	2,003	2,073	4.9%	3.5%	
Total Expenditure	**21,427**	**24,572**	**27,863**	14.7%	13.4%	
Fiscal Deficit	5,911	6,344	7,038	7.3%	10.9%	
Revenue Deficit	4,436	4,109	4,850	-7.4%	18.0%	
Effective Revenue Deficit	2,526	2,106	2,777	-16.6%	31.8%	Revenue Deficit as a % of GDP is going up
% of GDP	1.5%	1.1%	1.3%			
Primary Deficit	621	468	433	-24.6%	-7.6%	
Nominal GDP	**1,67,847**	**1,88,407**	**2,11,016**	12.2%	12.0%	Challenging task as inflation is lower
FD as % of GDP	**3.5%**	**3.4%**	**3.3%**			

Market Environment

Macro Market Environment

Indian financial markets have performed strongly since September 2013. However the market environment has shifted since the bull market began with important implications

2013-2018	Current
CPI was running as high as 10.5% in Sept 2013 and has steadily declined over time	After reaching its high of 5.2% in Dec 2017, CPI remains muted at 3% in May 2019.
Reflecting the high inflation environment policy rates peaked out at 8% in 2014 but have been brought down steadily over time to 6.5%	The RBI has adopted an accomodative stance and has been bringing down rates given the muted inflation and slowdown in growth.
Liqudity conditions were very tight and have improved over time with RBI's change in liqudiy management approach	The liquidity squeeze in the NBFC sector triggered by IL&FS continues to have significant market implications on the corporate bond market including higher corporate spreads, subdued primary issuances and reduced secondary volumes.
Commodity prices fell signficantly benefiting the fiscal and current account deficits. Oil prices moved from $110 in Sept 2013 to $30/bbl by January 2016	Crude prices have been volatile reflecting supply considerations including US policy on Iranian exports as well as fears of softening Chinese and broader global demand
FII holdings espeially in debt markets were very low providing room for signficant inflows	FII inflows are helped by stability in government but rising trade tensions are a hinderance

Debt Capital market takeaways

- Gross market borrowings has increased significantly from 5.71 to 7.1 lac crore. However the debt market will be pleased that the borrowing number has not increased significantly.
- Debt market is concerned with the ability of the market to absorb the increased supply from the central and state government as well as funds raised by PSUs that are used as extra budgetary resources. This increased supply is putting upward pressure on yields across the curve and crowding out private sector borrowing.
- Debt market will closely be following the GoI's decision to start borrowing in external currencies. We believe this move is mildly positive as it diversifies the governments sources of financing and will reduce the crowding out of domestic private borrowers.
- Inflation has been coming down but it may have hit its bottom and budget measures likely are to provide upside pressure to inflation.
- Furthermore the average maturity profile of Govt. debt has been improving over the years however that itself is putting pressure on long end because proportion of gross borrowings on the long end is greater.
- With liquidity conditions challenging and the significant widening of credit spreads observed over the last several months makes accommodation from the RBI imperative.

Equity Capital market takeaways

- It has been estimated that ~Rs3.75 lakh crores are blocked due to litigations under the erstwhile excise and service tax laws. A dispute resolution cum amnesty scheme called the “Sabka Vishwas Legacy Dispute Resolution Scheme” is being introduced for resolution and settlement of legacy cases of Central Excise and Service Tax.
- Proposal of restricting promoter holding to 65% may lead to increase in float of quality paper up to Rs 4 lac crore. Our analysis indicates ~1,430 companies having promoter share holding more than 65% are in listed space.
- Increased public shareholding will suck out money out of secondary markets which may keep valuations to remain in check. There may be diversion in ownership and newer IPOs might reduce due to higher percentage of public holding.
- Buyback tax proposed at 20% may dampen valuation of IT sector (see Slide 15).
- Rs700b infusion into PSU Banks, important that the money is given to stronger banks to allow for credit growth.
- Transfer of regulation of HFCs to RBI is positive, if it leads to RBI undertaking a stress testing of HFCs on the asset side, to restore confidence in HFC asset quality.

Support for NBFC sector via partial credit guarantee

- Government to take first loss up to 10% for Rs1t of “highly rate” pools bought by PSU Banks from “financially sound” NBFCs.
- However, clarity is still awaited, if the guarantee is for 6 months, the impact would be minimal. If the pools are to be purchased within 6 months, PSU Banks are unlikely to buy Rs1tn of pool assets.
- Also, as this relates to only highly rated pools from strong NBFCs, demand would already be healthy so additional benefit would be limited.
- There would be subjectivity on definition of “financially sound” NBFCs and whether it includes HFCs as well.
- The decline in yields is positive for NBFCs and wholesale funded entities.
- Overall positive for PSUs as well as NBFCs & HFCs.
- Life insurance and AMCs growth could be impacted, as HNI surplus may reduce led by higher surcharge.
- Increase in minimum public shareholding from 25% to 35% would be negative for life insurance companies.

Buyback taxed at 20% - analysis on IT sector

- Taxing buybacks at 20% will close a loophole to avoid DDT; as is the case currently for unlisted companies
- Companies may not be willing to share a bigger portion of their distributable surplus with their shareholders.
- Dividend distribution will now be on par with buybacks.
- Minority shareholders will be happier to receive dividends rather than buybacks due to STCG/LTCG.
- Infosys (~Rs.210bn), TCS (~Rs.320bn), Wipro (~Rs.240bn), Tech Mahindra (~Rs.20bn), HCL (~Rs.75bn), Mphasis (~Rs.21bn). – Total Buyback payout of ~Rs.886bn over last 2 years.
- IT companies which were earlier looked at from PER perspective, started getting better valuation after slew of buybacks – valuing companies at perpetual buyback mode/cash outflow yield.
- This would dampen valuations as now the cash payout through Buybacks would shrink by ~20%.

Impact on Consumer sector

- The import duty on Palm Fatty Acid Distillate and other fatty acids increased from 0% to 7.5%. This is the key raw material for soaps – mild negative for FMCG companies viz. HUVR, ITC, GCPL.
- Import duty on gold hiked from 10% to 12.5%. This 2.5% increase in gold prices will be a marginal tailwind for Titan as making charges are a % of gold price.
- Import duty on indoor and outdoor units of ACs increased from 10% to 20%. Will impact till the new capacity comes on stream next year – negative for Havells.
- Cigarette excise duty was re-introduced on a technical ground. However the impact is a negligible ~0.2% hike in the current cigarette tax. Also despite fiscal needs, the government desisted from hiking the overall cigarette taxes. This can be seen as a positive on intent of keeping taxes rational. – positive for ITC.
- Housing – increased tax exemption on interest on housing loans of up to Rs3.5m. This could help Tier 2/3 end housing demand – positive for Asian Paints and durables.

Vision for USD 5 trillion Indian economy remains in tact

- The 10 dimensional mission statement for USD 5 trillion Indian economy in 2024 remains with focus on inclusive growth.
- Incremental infrastructure rollout is challenged today, however digital infrastructure rollout is happening at a rapid pace.
- Terminal values of companies across sectors aided by vision statement will have an meaningful positive impact.
  - ✓ To build physical and social infrastructure and provide ease of living for all
  - ✓ Thrust on digitization across every sector and reaching every corner of country
  - ✓ To make India green, pollution free – thrust on electric vehicles
  - ✓ Thrust on rural industrialization to aid employment
  - ✓ To provide safer drinking water for all by cleaning all rivers in India
  - ✓ Develop inland waterways using India's long coastline
  - ✓ Significant efforts to make India launch-pad of satellites for the world
  - ✓ Integrated approach towards agro, food processing & preservation to make India self sufficient in food
  - ✓ To provide distress free health care and comprehensive wellness system
  - ✓ Thrust on governance to provide proactive and responsible bureaucracy

Missed Opportunity Budget With Commendable Fiscal Discipline

- Post a decisive mandate it was expected dramatic reforms to boost economy.
- Lot of committee formation announced to boost growth and promote ease of living however immediate action may take some time.
- Strong focus on infrastructure with USD1.5 trillion investment over next five years; additional tax deductions announced to promote electric vehicles.
- Support via partial credit guarantee for purchase of high rated pooled assets would improve liquidity and would be positive for PSU banks and NBFCs .
- Fiscal discipline is commendable with an aid of fuel price hikes and surcharge on super-rich community but growth orientation is submissive.
- Global financial conditions have been tight with potential triggers that could spark further deterioration including a no-deal Brexit, trade war with USA and slowdown in the Chinese economy.
- Along with the global economy India's growth has also slowed down but is somewhat mitigated by lower oil prices and monetary easing by the RBI.

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Thank You

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