

## Editorial:

### Government's stimulating measures

December 2008 was a month of support measures for the Indian economy to counter weak macroeconomic indicators, amidst volatile capital markets and the global recession. Global agencies, the Indian Government and quasi government agencies lowered their GDP growth estimates for the next fiscal. Concerned by the situation, the RBI and the Central Government unveiled a slew of fiscal and sector specific measures to ensure credit availability, liquidity and restore confidence.

The Central Government announced stimulus packages worth around INR 5,000bn in two stages. While this is likely to distort the Government's financial discipline and will swell the fiscal budget, the measures will go a long way in addressing the funding woes and help maintain domestic demand in specific sectors.

### Organised retailers expand

Albeit being marginally affected by the recent economic slowdown the domestic consumption growth continues and many organised retailers have announced plans to continue with their previously deferred expansion plans. Falling real estate rates have eased the operating costs for the retailers. We expect the well capitalised retailers and those having presence across multiple retail formats to find the going easy in the current environment.

### Affordable housing in focus

Realty developers are shifting their focus from developing luxury/premium segment housing to affordable/low-cost housing as the demand for such housing remains resilient. This is backed by government initiatives including subsidised housing loans, refinancing packages to housing finance companies and subsequent announcements of reduction of housing loan rates by the public sector banks. Apart from the realtors being the direct beneficiaries, we see this as a significant positive for the housing finance companies and the housing construction and equipment manufacturers.

### Infrastructure remains under spotlight

Infrastructure continues to remain under the spotlight as the government announced setting up a dedicated fund of INR 500bn to provide loans to infrastructure projects and ensure availability of funds to provide impetus to current as well as planned infrastructure projects. Additionally, policy reforms were announced to improve profitability of highway projects. This is also likely to speed up implementation of the (Public Private Partnership) PPP projects.

The Government is planning changes to the coal distribution policy to ensure adequate supply of coal to the thermal power plants to ensure their uninterrupted functioning. The policy changes intend to increase the guaranteed minimum level of coal supply to the power plants.

While we expect to start seeing the lagged effects of stimulus measures in the coming months, we are long-term bullish on the Indian economy. Our investment themes of India's domestic consumption, infrastructure and outsourcing continue to be attractive with moderate valuations and significant growth opportunities.

## Theme Update

### Domestic consumption

#### **Expansion in organized retail despite slowdown...**

The current size of the Indian retail sector is estimated at \$350bn with the share of organized retail at less than 5%. However, this is expected to change with the retail market expected to grow to \$650bn by 2015 and the share of organized retail expected to reach 15-20% of total retail. While these projections were made when the Indian economy was growing at ~8%, certain questions are now being raised on the growth of the retail industry given the slowdown in the economy. The concerns have become more profound when some of the big retailers were reported to be closing outlets due to mounting losses.

A slowdown in expansion by retailers during first half of 2008 was primarily a result of the increase in real estate costs. The expectation of a boom in organised retail in India influenced many companies to foray into retailing, buying millions of sq ft of floor space at a time when the property prices were hovering at their historical highs.

The real estate rates for retail outlets saw a correction in the second half of 2008 and a further fall is expected in the coming 6-9 months. Some retailers have stated that they have seen rentals decline by 10-20% in Tier-1 cities, while Tier-2 cities have witnessed a 30-40% decline. The decline in real estate rentals has helped the cost of rent as a percentage of sales to fall from 20-25% to 10-15%.

Companies are picking up on their earlier expansion plans from where they had earlier put them on hold. Some of the existing players are restarting their deferred expansions, while the new entrants who had delayed their launch are announcing their forays. The table shows some of the expansion plans announced during the month.

Brand/Company	Segment	No. of stores	Timeframe
Big Bazaar	Hypermarket	240	2011
Reliance Retail	Multi-format	N.A. <sup>1</sup>	2010
Spencer's Retail	Hypermarket	15	Mar 2009
ColorPlus	Apparel	120	2011
Westside	Apparel	30	NA
Raymond	Apparel	50	NA

Source: Media Reports

The retail sector is attractive for both, retail companies as well as investors despite the slow down because the current level of penetration of organized retail in the country is low and the estimated opportunity for growth is high. While in the short term, retail companies will see some decline in growth due to the economic slowdown, the long term outlook remains positive. The players with a pan-India presence (economies of scale) and operational efficiencies (higher operating margins) will continue to expand while smaller regional players will face stiff competition resulting in some getting acquired.

- The companies that can benefit the most in the current scenario are the ones that have substantial financial backing of their parent/holding companies including Reliance Retail and Trent; the retail arm of the Tata Group.
- With the success of various retail formats under debate, players such as Spencer's and Future Group will find going easy in the current scenario due to their presence across multiple formats.

<sup>1</sup> The company announced it will begin expansion in 6 months time after real estate rates fall further. The company had initially planned to launch 2000 stores by 2008. It currently has 700 outlets. Expansion plans had been put on hold during the last 6-8 months.

**Realtors shifting focus to low cost housing**

The real estate industry has been among the worst hit sectors because of the fall in capital markets, monetary tightening by the Reserve Bank of India (RBI), and the overall slowdown in Indian economic growth. The real estate sector boomed during the last few years causing property prices to double across the country. However, the sector is witnessing decline in demand since the beginning of the year because of rise in interest rates for housing loans and high property prices.

During the growth phase of the last 3-4 years, most real-estate builders focused on developing high margin housing for the affluent segment. Even when the demand for such housing started showing signs of a slowdown, the developers continued to focus on the segment as they believed this was a temporary situation and that the latent demand would bring about a recovery. However, the continued sluggishness caused inventory of high end houses to pile up.

In light of this, developers have changed their strategy towards low cost housing. Demand for low cost housing remains resilient and the government has taken initiative to provide support for development of affordable housing for low income households. According to the Planning Commission of India there was a shortage of 24.7 million homes in India (April 2007), and of this more than 99% is in low income housing segment. The investment required to overcome the total shortage at the beginning of the 11th five year plan (2007-12) was estimated at INR 1,472bn. An additional INR 2,141bn would be required for the additional demand of 7.26 million units during the plan period.

The government has announced various incentives to encourage private participation in affordable housing projects. To support the measures public sector banks announced that interest rate on home loans of INR 0.5-2m will be capped at 9.25% while rates of loans of less than INR 0.5m will be 8.5% p.a. Further, National Housing Bank (NHB) mandated interest rates should be based on risk weights on loan to value ratio. This will bring down interest rate on loans of smaller amount adding to the cut in interest rates by 50 to 100 basis points.

Industry bodies and the task force appointed by the Ministry of Housing and Urban Poverty Alleviation recently made the following recommendations on measures to help develop affordable housing:

- Affordable housing to be included in the definition of Infrastructure
- Land acquisition norms to be simplified
- Changing agriculture land conversion rules for developing affordable housing
- Establish a dedicated shelter fund by introducing a 0.5% levy on all central government taxes supplemented with budgetary support of the same amount
- Fiscal measures such as reducing stamp duty, registration charges, and income tax benefits for developers involved in affordable housing projects.

The government is considering additional incentives such as increasing deduction limit for housing loans under income tax exemptions, a one-time debt restructuring option for real estate companies, and allowing 100% FDI through the automatic route for integrated township projects. Similarly, the NHB expects banks to cut interest rates on housing loans further in the coming months.

**Government and quasi-government initiatives**

- A subsidy of 5% on interest rate for housing loans of less than INR 0.1m that will help provide 0.31m homes to the low income segment.
- NHB announced it will provide funds under the INR 40bn refinance package to housing finance companies at a concessional rate of 8% for housing loans of INR 2m or less.
- Housing and Urban Development Corporation (HUDCO) announced that it will cut interest rates on project loans by 50 basis points and rates on individual home loans of less than INR 2m (HUDCO Niwas) by 100-125 basis points.

Many of the big Indian real estate developers including DLF, Unitech, Ansal Properties, and Omaxe have reacted positively to these government initiatives and we see further momentum building up in affordable housing ventures. In the coming months new projects by these players are expected to be announced. Earlier, only a handful of smaller builders developed such houses. DLF (one of India's biggest real estate developers) recently announced it will invest INR 150bn over the next three years to develop residential projects in the mid-income housing segment shifting its focus from high income housing. They are expected to now target the low income segment as well.

The possibility of further measures is high as the government could seek to leverage the resulting goodwill for the upcoming elections. The sectors that will gain from the incentives are construction material and equipment manufacturing companies, banks and non-banking finance companies (NBFCs) that are dedicated to housing finance and builders that already have or plan to launch low cost housing projects.

Despite the direct beneficiaries being the realty development companies, we would like to stay away from these stocks for the next 6-9 months. Among the housing finance companies, we have a positive view of HDFC because of its strong capitalization, prudent lending norms, high asset quality and good reach across segments.

### **Infrastructure**

#### ***Policy reform to improve profitability of projects...***

The government announced a stimulus package during the month which included providing funding support to the infrastructure sector. Private participants faced several challenges in building and operating infrastructure projects because of unavailability of funds and increase in cost of borrowing. Further, the fall in valuations of companies added to their difficulty in raising funds.

The poor response of bids for 60 highway projects highlighted this problem. Some of the factors attributed to the poor response of bids were:

- The interest rates on loans for infrastructure projects are in the range of 13%-16%. This has resulted in many projects becoming unviable.
- Traffic projections by National Highways Authority of India (NHAI) were considered to be on the higher side and slowdown in economic activity is expected to reduce traffic on these routes.
- Lastly, the estimated project costs needed revision as bids for the projects had been made based on input costs levels of 2005-06. These have increased significantly with rise in commodity prices during the last two years.

Various policy recommendations have been made to the authorities by companies to buoy the infrastructure sector in dealing with these problems. In response, the government decided to consider some of the recommendations to encourage private participation. On the finance front, the government authorised IIFCL to raise INR 100bn of tax free bonds to provide funds for lending to financial institutions, including banks. This will increase the availability of funds and at lower interest rates. Further, RBI has provided IIFCL a credit line of \$5bn to provide loans in foreign exchange.

The other changes that are being considered by the government are:

- Increasing sanctioned cost by 15%
- Increase viability gap funding to 60%-100% from the current 40%
- Increase concession period by 5-10 year from the current limit of 20 years

The implementation of these recommendations is crucial for achieving the road expansion target for the 11<sup>th</sup> plan (2007-12). The reforms need to be introduced at the soonest possible so that the current shortfall in the targeted investments in road projects is narrowed.

These government initiatives are positive for all infrastructure development companies in general and the road construction companies in particular. Some of these measures will also help speed up the PPP projects.

#### ***Inadequate supply of coal affecting power generation...***

Coal based power plants in the nation have been facing problems in electricity generation because of shortages in supply of coal. The supply of raw material to coal-based power generation facilities in India is crucial as they account for ~65 of total power generation capacity in India. Coal shortages have reduced the coal inventory in 56 plants reducing to 'critical' levels (less than seven days of stock) and 33 plants to the 'super critical' levels (less than 4 days of stock). The reason for this was the failure of the Ministry of Power in planning and executing targeted capacity additions. The mismatch between increase power generation capacity and coal supplies has resulted in the shortage.

To tackle this supply crisis, Coal India Limited (CIL) plans to make amendments in the new coal distribution policy (NCDP). Under the fuel supply agreements (FSA) norms it intends to increase the guaranteed minimum level of coal supply known as the trigger level from 60% to 75%.

The power sector accounts for ~32% of the projected investment of \$500bn during the current five year plan and 75% of the capacity addition is expected to come from thermal based plants (mostly coal based). The irregularity and shortfall in supply of coal is significantly hampering investments as the plants cannot be commissioned till supply of coal is ensured. The implementation of the NCDP will help improve the load factor of power plants and the biggest beneficiary will be NTPC, the largest thermal based power producer in India. The company has been facing shortage of coal supply causing many of its plant to operate at unviable levels. The company has to rely on import of coal to meet its requirements. The private players such as Tata Power, Reliance Power, Jindal Power and others will also benefit as their capacity utilization will improve and bidding for new power projects will become more attractive.

The FSA norms were to be agreed upon by the end of November 2008, but the disagreement between the authorities and power companies resulted in postponement of the date by two months. This has delayed the implementation of suggested norms. The sooner it is implemented the better it will be for the power sector.

## **Feature of the month**

### **Slew of stimulus measures**

Leading macroeconomic indicators are beginning to indicating economic slow down. Industrial production contracted by 0.4% YoY in October 2008, after rising by 5.5% in the previous month. Exports nosedived by 15% and 10% during October and November 2008 respectively. The fear of a liquidity crunch made FIIs pull out money from the stock markets and banks became skeptical to lend. The call rates shot up to 23% in the first week of October 2008. Also, rise in inflation to double-digit numbers in the first half of the year adversely affected domestic consumption. While the government and quasi-government agencies estimated the GDP growth at 7%, IMF and other global development bodies have predicted much lower growth estimates of ~5% for FY2009-10. Concerned by the situation, the RBI and the Central Government unveiled a slew of measures to ensure credit availability (thus boost flagging consumer demand), liquidity and restore confidence. These included:

- Stimulus package I worth ~INR 3,300bn (direct benefits).
- Stimulus package II worth INR 1,550bn (direct benefits).
- One-off measures

**Monetary and Fiscal Measures of Stimulus Package I**

Measure	Implications
4% across-the-board excise duty cut worth INR 87bn	Expected to stimulate demand across sectors linked to domestic consumption, more specifically automotives and consumer durables, which were affected the most due to the slowdown.
Refund of terminal excise duty and lower 7% interest rate for pre and post shipment credit to benefit exporters.	The export incentives of over INR 20bn are expected to stimulate exports that have seen a fall of 12% for the first time in the last five years. Sectors expected to benefit are leather, textiles, gems and jewellery, handlooms etc.
Faster clearances of infrastructure projects. Infrastructure Finance Company Limited (IIFCL) to raise INR 100bn by issuing tax free bonds.	Project worth INR 1,000bn would be cleared and commenced faster than before. The tax breaks on the new funds raised by IIFCL would be passed on to the borrowers thereby reducing the overall cost of borrowing for infrastructure projects.
Repo and reverse Repo rates reduced by 1% each from 7.5% to 6.5% and from 6% to 5% respectively. Liquidity support of INR 40bn through refinancing by National Housing Board (NHB) Banks to be more liberal when lending to the real estate sector, restructured loans will not be shown as NPAs.	Commercial banks would pass on the effect of lower Repo rates by reducing the rates of housing finance. Cheaper home loans are expected to increase the demand for homes and allied industries such as steel and cement.
Liquidity support of INR 70bn to Small Industries Development Bank of India (SIDBI) Interest rate on post-shipment rupee export credit to SMEs capped at BPLR minus 2.5%.	Will reduce the overall cost of financing for small and medium enterprises and ease the pressure on margins.

Source: Media Sources, ValueNotes Research

**Sectoral Measures of Stimulus Package II**

It was felt that the quantum of the fiscal measures announced in the first tranche was insufficient. Besides being very small in quantum (only 0.6% of the GDP), the fiscal measures were spread across too many sectors. To complement the first package and ensure higher credit flow to specific sectors, the Government announced Stimulus package II.

Sector	Measures and Implications	Beneficiaries
Infrastructure	<ul style="list-style-type: none"> <li>The cap on total borrowings allowed through external commercial borrowings (ECBs) for infrastructure companies raised from \$100mn to \$500mn</li> <li>IIFCL allowed to raise INR 400bn in tax-free bonds that can be leveraged to INR 1,000bn.</li> <li>NBFCs that provide finance to Infrastructure companies now permitted to raise funds through ECBs. Ceilings on interest rates and tenure of ECBs increased.</li> </ul> <p>All measures are expected to improve flow of funds to the sector. This will also help many projects to achieve financial closure. The projects are currently stalled due to shortage of funds.</p>	<p>Larsen &amp; Toubro Hindustan Construction Co.</p> <p>NBFCs that provide finance to Infrastructure companies such as: IDFC REC PFC</p>
Automobile (Commercial Vehicles)	<ul style="list-style-type: none"> <li>NBFCs that provide consumer loans for purchase of Commercial Vehicles (CVs) allowed to access lines of credit from Public sector banks (PSBs).</li> <li>Accelerated depreciation of 50% allowed for CVs</li> </ul>	<p>NBFCs that provide consumer loans for purchase of CVs: Sundaram Finance Shriram Transport Finance</p>

	purchased up to March 31, 2009. All measures will help in ease of availability of loans and aid to revive demand of CVs.	CV manufacturing companies: Ashok Leyland Tata Motors Escorts
	- A Stressed Asset Stabilization Fund (SASF) is set up that will acquire stressed assets of IDBI.	IDBI
Metals	- 5% import duty on zinc restored. This will help in creating a level playing field between zinc manufacturers and importers.	Hindustan Zinc
Real Estate	- Ban on raising funds through ECB route for developing townships withdrawn.	Township developers: DLF Ansal Properties & Infrastructure Parsvnath Developers

Source: Media Sources, ValueNotes Research

Besides the above-mentioned sector specific measures, the package also included monetary measures. The RBI further cut CRR to 5%, and Repo and the reverse Repo rates to 5.5% and 4% respectively. The RBI wished to disincentivise banks from re-investing funds with the RBI and instead propel them to lend more to the productive sectors of the economy. To attract more foreign investments, the Government raised the investment limits for the FIIs in corporate bonds from \$6bn to \$15 bn. The Central Government also allowed State Governments to raise funds worth ~0.5% of Gross State Domestic Product for funding various infrastructure projects to aid in generating more employment and stimulating demand.

#### One off Measures

- To attract more investment into the power sector, the Central Electricity Regulatory Commission (CERC), a quasi-government nodal agency body raised the base RoE for power utilities from the existing 14% to 15.5%. Further if the projects are commissioned on time, the companies can earn an additional RoE of 0.5%. Power companies such as NTPC, NHPC, Neyveli Lignite, PowerGrid, Tata Power, Reliance Power and Torrent Power stand to benefit from these amendments.
- The RBI reduced the standard asset provisioning requirements of urban co-operative banks (UCBs) lending to NBFCs to 0.4% from 2%. This has made it easier for the UCBs to lend to commercial real estate and NBFCs. Similarly, the central bank reduced risk provisioning of commercial banks for commercial real estate loans to 100% from 150%.
- The Government is planning to amend certain provisions of the Income Tax Act, which will benefit some entities operating in Special Economic Zones (SEZs). The SEZ Act states that entire profits earned by SEZ units from exports will be exempt from tax. The ratio of export turnover to total turnover determines the export profits. There exists an anomaly in the definition of 'total turnover'. 'Total turnover' is defined as total turnover of the company as a whole and not total turnover of the SEZ unit, as intended by the SEZ Act. This anomaly affects the ratio for computing the export profits (see table below).

The proposed amendment intends to change the definition of 'total turnover' to include the total turnover of only the SEZ unit of the company. This change is expected to significantly benefit a number of IT companies who have units registered in SEZ as well as non SEZ locations.

## Impact Analysis

### Domestic Consumption

Consumers are apprehensive of spending on new purchases either of automobiles or real estate or even consumer durables. In a weakening demand environment, companies are unlikely to be able to retain the benefits of the excise duty cuts or use it to expand their profit margins. But the reduction certainly allows elbow room for companies to cut product prices without further sacrifice on margins. Makers of consumer durables, FMCGs and automobiles may be the key beneficiaries of this cut. Measures aimed at aiding export-oriented sectors such as gems and jewellery, textiles and iron ore may help to ease their funding woes and reduce financing costs of exporters. But bleak economic data emanating from the US and much of Europe suggests that the measures may not be sufficient to offset the sheer lack of demand faced by exporters to these regions.

### Infrastructure

In the month of November 2008 the Government announced that it will set up a dedicated fund of INR 500bn to provide loans to infrastructure projects being undertaken by private companies as well as those under the PPP initiative. Measures were also targeted at ensuring availability of cheaper funds to provide impetus to current as well as planned infrastructure projects. However, the perennial problem for infrastructure projects in India has been the delay in execution. Most of the infrastructure projects have achieved just about 19% completion till date. The status demonstrates the yawning gap between allocation and fructification. Therefore, even though the approval process for infrastructure projects will be expeditious, effective spending of the targeted INR 3,000bn at the fag end of the fiscal year remains a big challenge.

### Opinion

The RBI has cut CRR by a 4% since September 2008. Following the CRR cut, the money supply in the system (M3) will expand but with a time lag of 4-6 months. The RBI has also increased the credit disbursal target of the banks to 24% from 20% as envisaged in the Annual Policy Statement. Thus the RBI has infused ~INR 4,000 bn into the economy. The central bank estimates that there will be significant expansion in credit flow from banks in next few quarters. Coupled with the sector specific measures, the central bank feels that there will be adequate liquidity in the system in the current fiscal year.

Also, according to RBI, effects of the global financial crisis are yet to be fully transmitted to the Indian economy. Hence it is prudent to reserve arsenal of monetary and fiscal policy measures for future use. The central bank and the Government therefore do not envisage any more stimulus packages in the current fiscal year.