

ASIA

# India's Budget Moving in the Right Direction

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India's Finance Minister Nirmala Sitharaman recently unveiled the country's new budget, which aims to give the economy a boost via tax cuts and other measures to stimulate foreign investment. Franklin Templeton Emerging Markets Equity Director of Portfolio Management Sukumar Rajah says the fiscal math looks credible and the targets seem achievable, with the assumption of improving Goods and Services Tax compliance. He says while there are likely to be some winners and losers from an investment standpoint, overall, the government seems to be moving in the right direction to spur economic growth.

The Indian government has delivered its final budget for fiscal year 2020, which ends in March 2020.

We believe the India Union Budget shows the government is moving in the right direction by focusing on improving the investment climate and diversifying the source of government funding, which should lower the cost of capital in the long run. As a result, we retain our positive outlook for India equities in the medium to long term.

## Balancing Growth with Fiscal Discipline

India's robust gross domestic product (GDP) growth has been slowing this year, so this budget helps outline government efforts to stimulate the economy while preserving policy continuity.

We believe the Indian government continues to balance growth priorities with fiscal discipline, while diversifying funding sources. The government has lowered its fiscal deficit target from 3.4% as announced in the February 2019 budget to 3.3% of GDP for the 2020 fiscal year.

In our opinion, the fiscal math looks credible and the targets seem achievable to us, provided the government can improve compliance with the Goods and Services Tax (GST), which would in turn boost government revenues. We're already seeing signs of increased enforcement of tax compliance following Prime Minister Narendra Modi's re-election in May. Continued disinvestment should also help boost government revenues in the medium to long term.

For businesses, a plan to cut the corporate tax rate from 30% to 25% for Indian firms with annual revenues lower than 4 billion rupees (US\$58 million) looks to benefit smaller domestic companies, which make up the bulk of the market. There are tax incentives and exemptions for larger companies as well.

## Improving Ease of Doing Business in India

There are also continuous efforts to improve the ease of doing business in India. There are direct and indirect tax incentives to attract high-tech manufacturing in products such as electronic chip manufacturing, laptops, computer servers, among others, in a move towards Digital India—the government’s initiative to improve online infrastructure and internet access across the country. The government also proposed relaxation in foreign direct investment norms for sectors such as aviation, media, and insurance to attract more overseas investment. There are also efforts to simplify labor laws, a meaningful positive as this could result in a more flexible labor market and alleviate concerns from foreign investors (labor laws have traditionally been one of the key hurdles for foreign investment in the past).

There is also continued strengthening of infrastructure and a focus on affordable housing. A railway station modernization program will be launched this year, and Indian Railways has plans to invest more in suburban rail networks and enhance metro rail networks through public-private partnerships. The Indian government is also committed to building 19.5 million houses by 2022, as well as increasing incentives on housing loans to boost low-cost housing demand. Piped water is planned to be provided for every household by 2024, thereby improving living conditions in rural areas.

Separately, there are also proposed measures to revive non-banking finance companies (NBFCs) and recapitalize state-run banks. The stress in India’s NBFCs sector has contributed to slowdown in consumption as mutual funds and the banking system have been cautious in providing liquidity to such NBFCs. To enhance liquidity access for the sector, the government will provide a guarantee on the first 10% loss to banks for purchasing consolidated high-rated pooled assets of “financially-sound” NBFCs in the next 6 months. The US\$10 billion capital infusion in respective public-sector banks is also a positive for state banks to boost lending and revive the economy, although the timing of the injection remains to be confirmed.

## Attracting Foreign Investment

The budget has a focus on attracting foreign capital and boosting investment (both equity and debt). There are several means to do so. One of these is to increase the minimum public float in listed companies to 35% from 25%, in a phased manner.

Traditionally, Indian equities have had higher private majority shareholder control, with lower free-float available to the public. Hence, raising the minimum public float threshold should ensure wider ownership through institutional investors, adding more market depth and likely leading to better corporate governance.

We also expect the proposal will help attract higher foreign capital and increase India’s weight in MSCI and FTSE emerging market indexes over the next few years. However, the higher threshold could pose a challenge to listed companies, particularly multinationals, as it could impact who has control over the companies. Some companies with low public float may consider delisting, unless they are fine with increasing the public shareholding by another 10%.

Although we think this proposal is viewed as a positive for equities in the long run, it might negatively impact the weight in global benchmark indexes in the short term due to subsequent sales from majority shareholders of some of their stakes. However, the potential impact would depend on the time allowed by the regulator to comply with the new norms.

## Potential Sector Impacts

Like nearly all government policies, there are aspects of the budget which are likely to prove more positive for certain sectors of the market than others.

- **Real Estate/Housing:** Increased tax exemption on interest on housing loans could help boost low-cost housing demand. This looks positive for property developers, housing financing, as well as housing-related goods such as cement, paints and fans.
- **Financials (Banks and non-banking finance companies [NBFCs]):** Public sector bank recapitalization should help provide some growth capital to these entities and hopefully kickstart credit flow. Apart from better liquidity access from the limited 10% credit guarantee for investment in high-rated NBFC in pooled

assets, the additional deduction of income tax on mortgages brings down effective interest rate and should benefit all housing financiers. While public sector bank recapitalization is encouraging for the public banks, we continue to prefer good quality, private retail-focused banks and corporate banks.

- **Communication Services (Telecoms):** Low interest rates should benefit sectors with traditionally higher leverage such as telecoms and metals.
- **Energy (Oil and gas):** The increase in duties on petrol and diesel increases working capital (i.e. debt) for oil marketing companies, so this isn't an area we favor at this time.
- **Consumer (Luxury goods):** The increase in customs duty on gold from 10.0% to 12.5% could impact near-term demand until consumers get used to the higher price-level. The increased income tax for higher income households could also be a potential negative for consumption of high-ticket items. Additionally, the much-anticipated boost to rural household incomes was not provided, which could be negative for sentiment towards consumer staples companies in the near term.
- **Information Technology (IT):** Buyback of shares by listed companies will now be taxed at 20% (to be paid by the company doing the buyback on the distributed income), similar to dividends. This could be relatively negative for IT companies, as Indian companies have traditionally used share buybacks to pay out shareholders with a lower tax impact. The removal of this loophole could lead to a reduction in dividend payouts from IT companies. In addition, foreign bond issuance could lead to some rupee appreciation, which would be a negative for exporters such as IT services companies. Separately on a positive note, the government has emphasized initiatives to encourage high-tech spending. It has identified IT as one of 12 "champion service sectors" and has set up a US\$745.82 million fund for realizing the potential of these champion service sectors.<sup>1</sup>
- **Financials (Insurance):** The government proposed an increase in the foreign investment limit on insurance intermediaries to 100% from 49%. This should help capital inflow for companies investing in technology solutions for the insurance sector to achieve better penetration rates.

## Outlook on India

While most aspects of the budget look encouraging, clarity is still required in some areas, such as the sources of funding for infrastructure outside of the budget, the quantum of US dollar-denominated bond issuances by the government, or the timeline for increase public float in listed equities.

But now with the elections behind us, we expect market focus to shift to the fundamentals, such as earnings growth, inflation and fiscal prudence.

We are seeing signs of a recovery in India's industrial sector and expect to see a continued increase in capacity utilization, which we think should prompt companies to start investing again. This in turn would be likely to lift profitability.

The risks we currently see are related to global factors, such as trade tensions, US Federal Reserve policy and rising oil prices. A global slowdown in growth could affect segments of the Indian economy that are more dependent on exports. That said, rising domestic consumption has tilted India's economy to be less reliant on the export sector, which makes India less vulnerable to adverse global factors, in our view.

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## **What Are the Risks?**

All investments involve risks, including the possible loss of principal. Investments in foreign securities involve special risks including currency fluctuations, economic instability and political developments. Investments in emerging markets, of which frontier markets are a subset, involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets. Because these frameworks are typically even less developed in frontier markets, as well as various factors including the increased potential for extreme price volatility, illiquidity, trade barriers and exchange controls, the risks associated with emerging markets are magnified in frontier markets. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Bond prices generally move in the opposite direction of interest rates. Thus, as the prices of bonds in an investment portfolio adjust to a rise in interest rates, the value of the portfolio may decline.

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[1](#). Source: India Brand Equity Foundation, Ministry of Commerce & Industry, Government of India, updated June 2019.