India Market Strategy

Markets complacent about any potential change in India's policy framework

Equity Strategy

India

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Investors unaware of or ignoring risks from potential change in policy stance

Slower growth recovery may prompt a potential rethink of Govt's policy stance away from fiscal consolidation towards reflating aggregate demand (link). The 7th Central Pay Commission (CPC) is implicit to this – an increase in Govt support for consumption at the expense of planned fiscal consolidation and, by extension, private capital outlays. Our recent discussions with investors indicate some complacency, evident in: 1) Investors who look at only Indian equities are presuming immediate CPC implementation as a given and looking at such a policy shift positively, ignoring risks to macro stability; 2) Investors looking at APAC/GEMs are largely unaware of any such policy shift or haven't realised the full impact as they are looking at the CPC narrowly from Central Govt's fiscal perspective. The latter investors were nearly unanimously worried in terms of potential impact on macro stability parameters when we laid out the full scale of the potential change.

Ignoring states' fiscal constraints flawed; spending mix quality reversal?

Impact of CPC on Central Govt's fiscal is likely 0.4% of GDP, which many investors viewed as not a big deal. The impact is however much bigger on states (over 1.1% of GDP) and combined with Railways implies c1.7% of GDP fiscal impact. Macro stability and India's consolidated fiscal management lies arguably with Central Govt – states' fiscal deficit is capped at 3% of GDP. 20 states accounting for 70% of India's GDP and c75% of states' spend on pay are running a fiscal deficit of more than 2.75% of GDP. They clearly cannot follow CPC without busting their fiscal limits unless they fund it by spending cuts or higher taxes (dilutes impact on aggregate demand). Implementation of CPC will more than reverse the recent improvement in spending quality towards capital spending – for both states and centre. 5 big states have reportedly called for a delayed implementation of the 7th CPC recommendations and the Railway Minister has also expressed inability to absorb the same.

Why 2016 is different vs 2008 for macro? Delay/dilution of CPC is our baseline

The macro backdrop is very different now vs 2008, the last time India adopted CPC and expanded fiscally: 1) Central/combined fiscal deficit was 2.6%/4.1% vs 4%/6.3% now; 2) Current account deficit widening was financed easily then given improving global liquidity/risk appetite – current environment may not be as conducive; 3) International investors in Indian Govt bonds were 1/10th of the US$30bn now – they arguably care more for macro stability vs near-term growth; 4) GDP growth was slowing, below trend vs a recovering (albeit slower than expected) economy now; 5) Politically, national election was in 2009, next one due in 2019. RBI Governor Rajan continues to advocate sustainable fiscal consolidation while expanding Govt capex. Our baseline scenario is of a staggered/delayed/diluted implementation and 75bps rate cuts by RBI in 2016.

Near-term consumption boost being built in, not risks or delay/dilution

If we look at earnings estimates and relative performance of sectors/stocks (details inside) benefiting from CPC, it appears markets may be expecting this change in fiscal stance (incl. CPC) to happen. Consumption boost is not a given even with CPC, neither is it surely sustainable beyond 2-3 quarters. Markets may be ignoring this and also risks to currency / inflation (scenario inside). Any delay/dilution to CPC, as per our baseline scenario, would be a negative surprise for specific sectors/stocks. Earnings downgrades in India are not done, should be sharp in 2016 and be a negative surprise to markets (Outlook 2016). Our end-2016 Nifty target of 8,200 does offer better risk-reward post recent correction. Our downside scenario implies end-2016 Nifty of 7,000.

Near-term consumption boost being built in, not risks including sustainability

Figure 1: Sectors / stocks which may be beneficiaries of CPC

	Sales growth			Earnings growth			Price Performance		P/E - 1yr fwd	
Company Name	FY16	FY17	FY18	FY16	FY17	FY18	3m	6m	Current	3yr avg
Autos 2W										
Eicher Motors	44.2%	29.2%	22.7%	92.4%	42.2%	28.7%	-14.5%	-27.1%	28.3	26.1
Hero MotoCorp	4.6%	9.8%	9.5%	25.1%	8.9%	11.7%	-5.6%	-7.9%	14.3	15.8
Autos 4W										
Maruti Suzuki India	20.2%	23.8%	15.3%	53.3%	27.9%	14.4%	-13.0%	-6.4%	17.3	18.1
Mahindra & Mahindra	5.6%	15.0%	12.3%	22.8%	30.0%	15.0%	-9.4%	-12.1%	16.3	16.8
Consumer Discretionary										
Asian Paints Ltd.	7.6%	14.7%	15.7%	23.3%	15.6%	16.5%	-1.4%	3.3%	38.3	35.4
Bajaj Electricals	17.4%	16.0%	14.3%	886.3%	66.2%	37.0%	-29.9%	-34.8%	12.8	15.2
Havells	10.7%	11.4%	11.1%	35.2%	33.5%	15.8%	12.7%	-2.7%	28.2	22.2
Jubilant FoodWorks	26.9%	25.9%	25.5%	15.9%	50.7%	39.0%	-23.0%	-37.7%	39.7	44.2
Page Industries	19.5%	22.2%	22.5%	26.2%	27.5%	23.8%	-15.8%	-16.9%	45.1	39.8
Pidilite Industries	9.1%	18.2%	20.1%	35.3%	15.3%	16.1%	-7.7%	-2.9%	35.6	31.5
Titan Company	7.5%	16.2%	13.9%	-13.1%	38.9%	18.7%	-1.4%	1.0%	30.4	28.4
TTK Prestige	10.9%	18.8%	19.6%	29.1%	28.2%	30.2%	2.2%	-1.9%	33.0	27.1
Voltas Ltd	6.2%	12.9%	13.4%	9.7%	24.4%	12.4%	-4.3%	-11.1%	21.4	18.2
United Breweries	5.3%	13.4%	14.5%	41.7%	25.0%	22.6%	-16.7%	-20.4%	59.1	61.2
United Spirits	-15.5%	10.5%	13.9%	152.9%	36.9%	30.0%	-14.8%	-24.1%	56.4	59.0
Consumer Staples										
Britannia Industries	14.7%	18.0%	17.5%	50.5%	21.5%	21.0%	-20.1%	-8.8%	32.1	30.3
Colgate Palmolive	4.4%	12.9%	12.0%	12.9%	10.3%	16.9%	-3.8%	-11.5%	35.6	34.8
Dabur	8.8%	17.6%	18.2%	19.6%	17.8%	18.3%	-10.7%	-20.3%	29.0	30.9
Emami	32.0%	26.2%	22.6%	17.9%	41.3%	27.6%	-11.1%	-13.5%	36.9	30.7
GCPL	12.0%	15.7%	14.5%	27.2%	23.0%	15.5%	-8.9%	-7.1%	28.8	31.0
Hindustan Unilever	5.4%	13.3%	13.1%	19.6%	11.3%	14.3%	-1.8%	-12.9%	35.6	35.0
ITC	10.9%	16.1%	16.2%	8.1%	16.8%	14.7%	-12.0%	-2.3%	21.7	25.8
Marico	8.0%	14.7%	14.1%	22.4%	19.4%	16.6%	11.8%	2.5%	34.8	29.7
Nestle India Ltd.	-10.7%	28.0%	15.3%	-7.1%	17.5%	20.8%	-15.7%	-10.3%	39.4	38.6
Nifty	0.9%	11.0%	13.0%	7.4%	17.2%	17.8%	-11.8%	-14.7%	14.5	14.6

Source: UBS estimates

Figure 2: Sectors impacted by risks from CPC implementations

	Sales growth			Earnings growth			Price Performance		P/E - 1yr fwd	
Company Name	FY16	FY17	FY18	FY16	FY17	FY18	3m	6m	Current	3yr avg
Beneficiaries of any currency depreciation										
Pharma	14.6%	16.4%	13.2%	20.1%	28.3%	19.3%	-21.9%	-17.0%	24.5	23.8
IT	13.8%	9.9%	8.3%	12.1%	9.0%	8.1%	-9.9%	-13.1%	16.0	17.4
Higher interest rates a negative										
Non-Bank Financials	14.2%	13.7%	15.8%	2.9%	23.3%	15.4%	-20.1%	-25.2%	10.3	11.5
Nifty	0.9%	11.0%	13.0%	7.4%	17.2%	17.8%	-11.8%	-14.7%	14.5	14.6

Source: UBS estimates

Mid-year economic analysis suggests potential relook at policy stance; RBI stance same

From the recent Mid-year economic analysis (link):

- "*If the government sticks to the path for fiscal consolidation, that would further detract from demand.*"

- "*Data uncertainty and the mixed signals sent by the economy suggest that more attention should be paid to the demand side of the economy.*"

- "*…government's commitment to further fiscal consolidation of 0.4% of GDP needs to be re-assessed.*"

- "*changing macro-economic situation, especially the fall in nominal GDP growth, requires a review of the medium term fiscal framework. What is the appropriateness of pro-cyclical fiscal policy? How should fiscal strategy take account of credibility issues that might arise from a recalibration of fiscal targets?*"

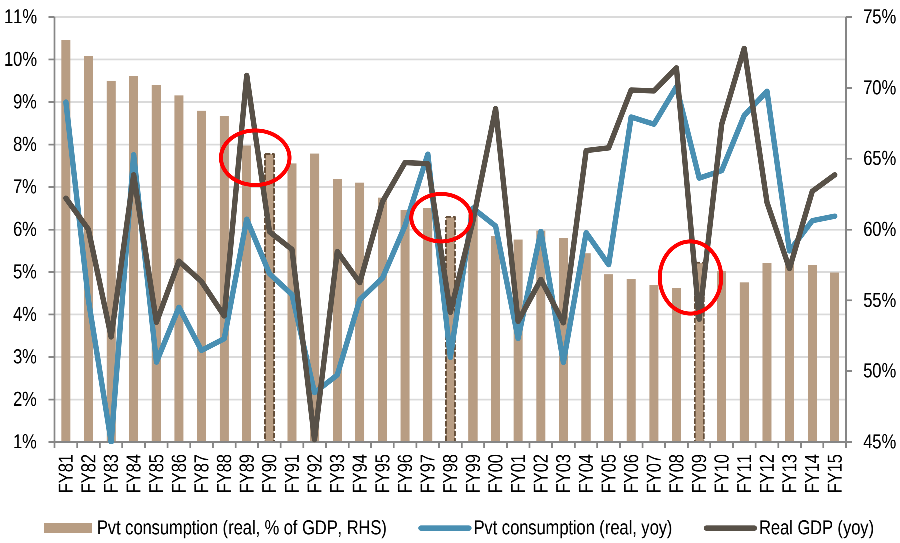
- "*On aggregate demand, both fiscal and monetary policy stances will need to be carefully re-assessed, to ensure they strike the appropriate balance between the short-term need to spur demand, especially private investment and exports, and the longer-term needs of preserving fundamental macroeconomic stability.*"

RBI Governor Rajan continues to advocate sustainable fiscal consolidation while expanding government capex.

- "*implementation of the Pay Commission proposals, and its effect on wages and rents, will also be a factor in the Reserve Bank's future deliberations, though its direct effect on aggregate demand is likely to be offset by appropriate budgetary tightening as the Government stays on the fiscal consolidation path.*"

Boost to consumption, as presumed widely, not necessary

Figure 3: Pay revision impact on private consumption

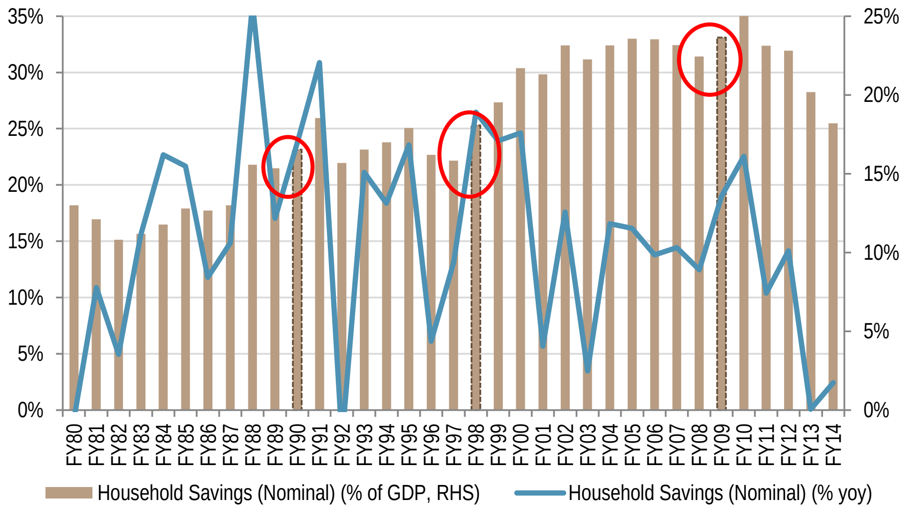


Source: CEIC, UBS

Private consumption in early 90s (post 4th CPC) and late 90s (post 5th CPC) didn't get a boost

In FY09, private consumption growth got a boost, also helped by arrear payments and other government stimulus schemes directed towards the rural economy

Figure 4: Pay revision impact on household savings



Source: CEIC, UBS

Bigger impact seems to have been on household's savings, with an improvement in growth in FY98-99 and FY09-10 leading to an increase in household savings as a % of GDP in both these periods

This could arguably also be reflecting the arrear payments but more so the high inflation seen then

Don't ignore states while looking at CPC impact

Figure 5: Statewise fiscal situation and spend on salaries and pensions

	Fiscal deficit (% of GDP)			Salaries and pensions (% of GDP)	
States	FY14	FY15 (RE)	FY16(BE)	FY14 (RE)	FY15 (BE)
Asked for delay					
Odisha	1.7	2.9	3.0	6.4	8.0
Punjab	2.8	3.0	3.0	6.6	7.6
Tamil Nadu	2.6	2.9	2.9	5.6	5.4
Uttar Pradesh	2.7	2.9	3.0	8.8	8.7
West Bengal	3.6	3.0	1.7	6.0	5.9
At risk of busting deficit targets					
Andhra Pradesh	2.1	3.9	3.0	5.5	6.9
Bihar	2.4	3.0	3.0	7.4	7.8
Chattisgarh	2.7	2.9	3.0	6.3	6.3
Haryana	2.1	3.5	3.1	4.1	4.4
Karnataka	2.8	2.8	2.8	4.0	4.7
Kerala	3.9	3.2	3.1	7.4	7.7
Madhya Pradesh	2.2	3.0	3.0	5.9	6.1
Rajasthan	2.9	4.0	3.0	5.5	6.1
Uttaranchal	2.5	3.0	2.6	8.2	8.8

Note: Some states have a different pay cycle vs the rest, for e.g. Andhra Pradesh's next revision is due only in 2019; Source: RBI, CAG, Budget documents

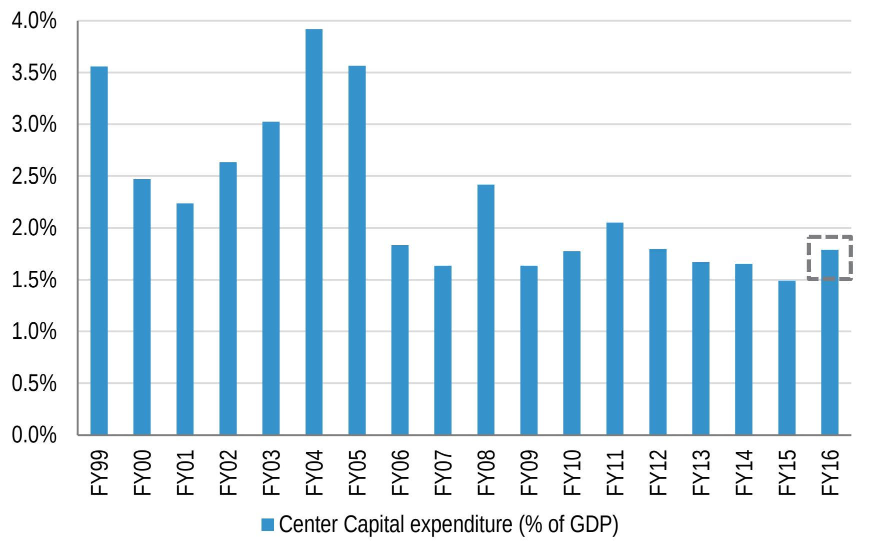
5 states have reportedly called for a delayed implementation of the 7th CPC recommendations – they have limited fiscal space

Many other states too do not have the fiscal space and risk busting their fiscal limits in case of implementation of CPC

20 states accounting for 70% of India's GDP and >75% of states' spend on pay are running a fiscal deficit of >2.75% of GDP

Worsening of fiscal quality surely in case CPC implemented

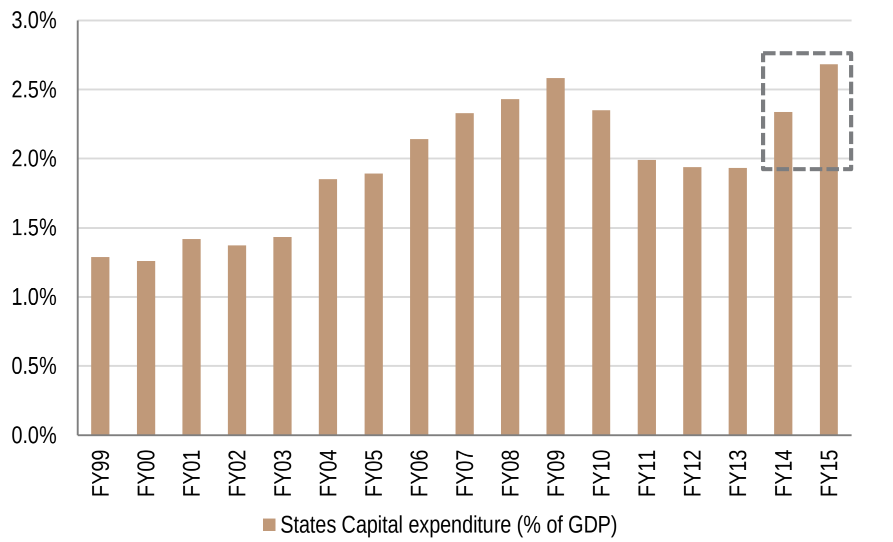
Figure 6: Centre's capital expenditure as a % of GDP – budgeted to increase. CPC implementation may imply reversal in spending quality improvement



Note: FY16 is Budget Estimates; Capital expenditure excluding loans and advances related heads; Source: CEIC, Budget documents, UBS

With the Centre improving its spending mix, capital expenditure as a % of GDP is budgeted to increase by 30bps in FY16. 40bps incremental spending on wages and pensions in FY17 could mean worsening of spending quality again

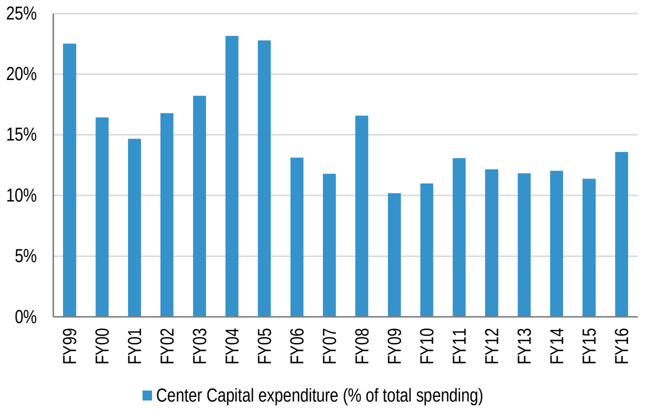
Figure 7: States capital expenditure as a % of GDP – budgeted to increase. CPC implementation may imply reversal in spending quality improvement



Note: FY14 is Revised Estimates, FY15 is Budget Estimates; Capital expenditure excluding loans and advances related heads; Source: CEIC, Budget documents, UBS

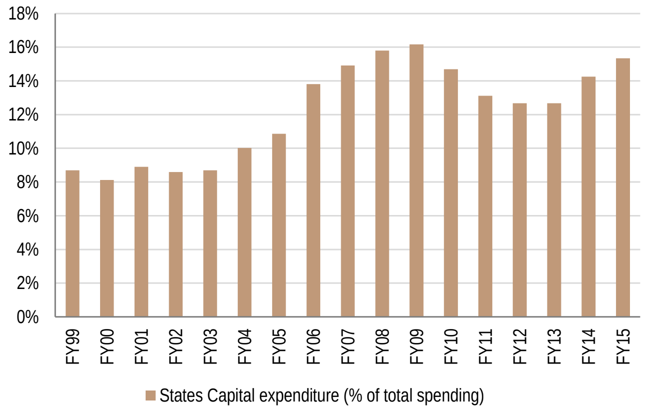
States' (combined) spending mix has also been improving, with FY15 budget estimates implying a 35bps (% of GDP) improvement in capital expenditure, after 40bps in FY14. 115bps incremental spending on wages and pensions in FY17 could mean an even bigger negative impact for states

Figure 8: Centre's spending mix budgeted to improve – capex as a % of total spending budgeted to increase



Note: FY16 is Budget Estimates; Capital expenditure excluding loans and advances related heads; Source: CEIC, Budget documents, UBS

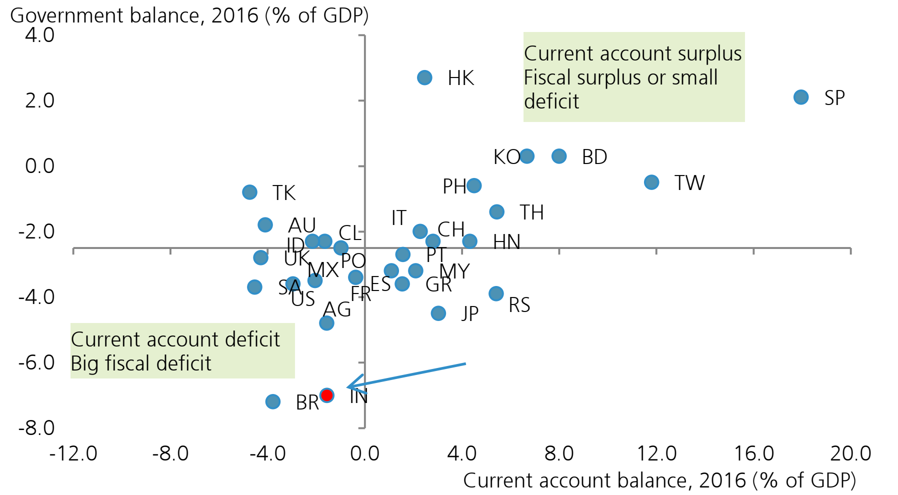
Figure 9: States' spending mix improving – capex as a % of total spending budgeted to increase



Note: FY14 is Revised Estimates, FY15 is Budget Estimates; Capital expenditure excluding loans and advances related heads; Source: CEIC, Budget documents, UBS

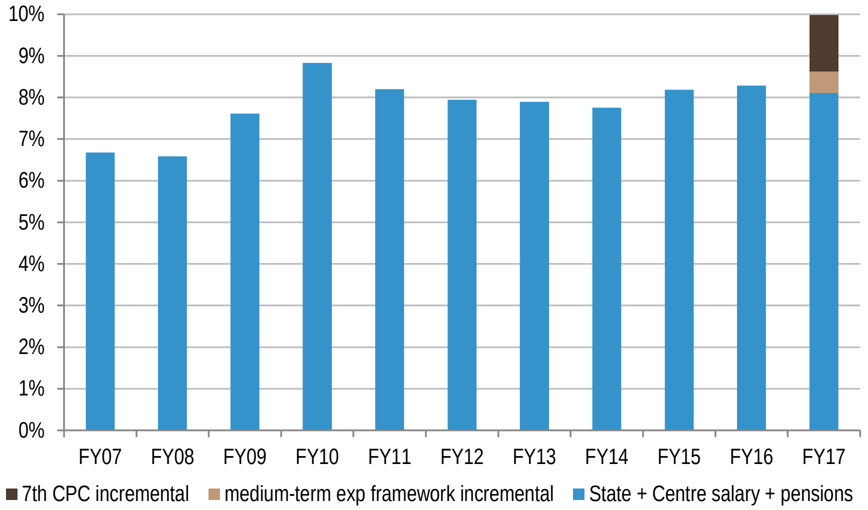
Macro parameters imply risks to currency/inflation from CPC / fiscal loosening

Figure 10: India's current account and fiscal deficits increase the risk of crowding out from domestic borrowing to fund public sector pay



Source: UBS, IMF Estimates

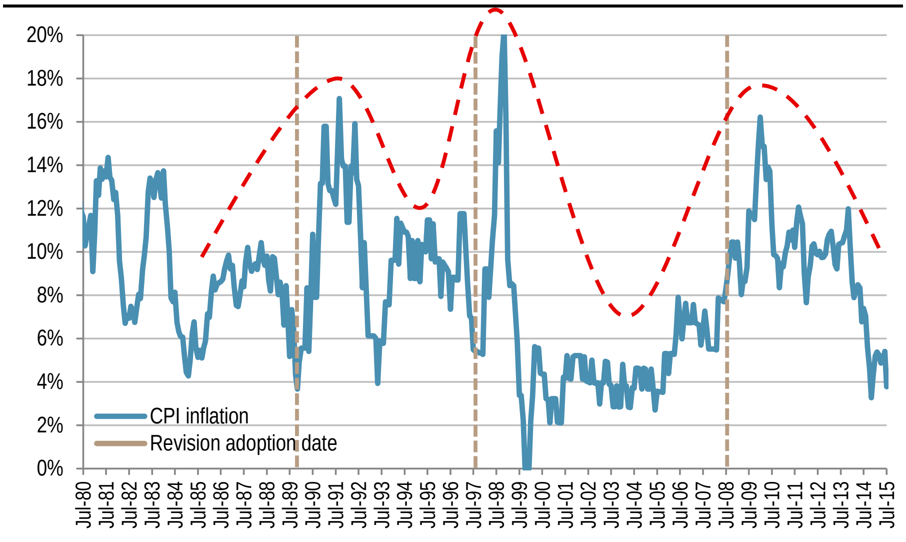
Figure 11: Wage bill trend of Centre + states and impact of 7th CPC



Source: 7th Central Pay Commission, Union Budget, RBI

Fiscal impact of CPC implementation is very significant – nearly 1.7% of GDP

Figure 12: CPI inflation vs government wage revision cycle



Source: CEIC, GoI

CPC has the potential to impact price inflation generally if it induces an increase in domestic demand verses supply – most likely by inducing money or credit creation

RBI seems willing to look through any isolated short-lived technical impact of higher house rent allowance (HRA) on CPI inflation print

Figure 13: Impact of funding decisions for pay commission

	Impact on fiscal balance	Impact on inflation / current account balance	Impact on GDP growth	Impact on potential economic volatility
Funded within budget	Neutral	Neutral	Neutral to negative	Neutral
Domestic borrowing (no monetisation)	Larger deficit	Neutral	Neutral to negative	Neutral or modest increase
Foreign borrowing	Larger deficit	Higher inflation, reduced current account balance	Short term positive, long term negative	Increased
Domestic borrowing (monetisation)	Larger deficit	Higher inflation, reduced current account balance	Short term positive, long term negative	Increased

Source: UBS

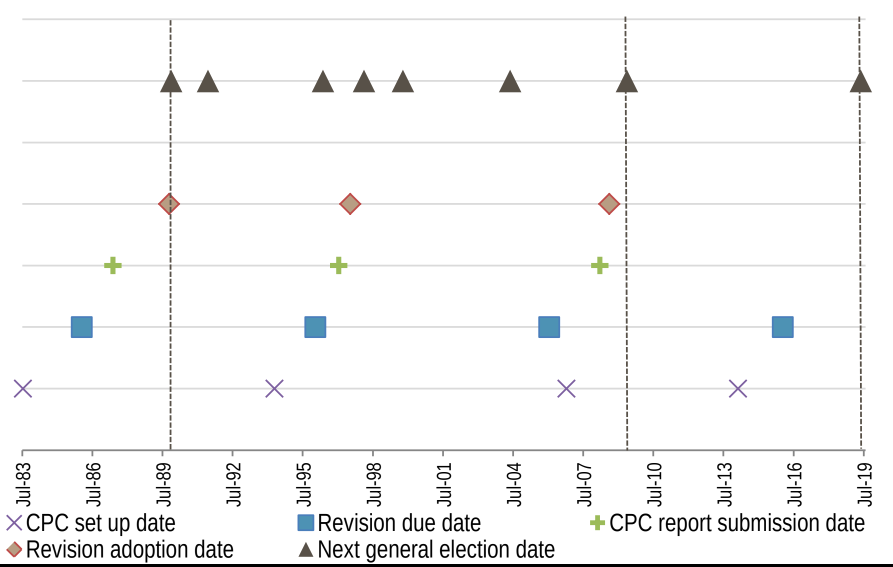
Figure 14: Scenarios by the numbers**

	UBS baseline forecast	Scenario 1: Prudence / UBS baseline forecast		Scenario 2: Fiscal shock		Scenario 3: Modest slippage but foreign investors step up	
	FY16	FY 17	FY 18	FY 17	FY 18	FY 17	FY 18
Real GDP	7.1	7.6	7.8	7.9	7.5	7.9	7.8
CPI inflation	5.0	4.6	4.0	5.5	5.0	5.0	4.5
Central govt fiscal balance	3.9	3.5	3.0	4.0	3.5	3.7	3.2
Current account balance	-0.1	-0.4	-1.1	-1.4	-1.6	-0.9	-1.4
RBI repo rate	6.5	6.00	6.00	7.25	6.75	6.75	6.75
USDINR*	66	70	73	75	77	70	77

Source: UBS Estimates * Exchange rate projections are end year.
** In these scenarios we ignore the technical rise in CPI inflation due to the potential change in the HRA in the sense that it impacts the CPI via the imputed rent on government provided accommodation. We do this because we believe the RBI and markets will look through this technical effect – although there may be an impact on inflation expectations.

Our baseline scenario remains likely delay/dilution of CPC

Figure 15: CPC timelines – delay not unprecedented



Source: GoI, Election Commissiom

There are past examples of delays in pay hikes for government employees – last three decadal revisions were delayed, including almost 30 months delay in implementation in '80s

Figure 16: Pay increases built in by medium-term expenditure framework

% yoy	FY16E	FY17E	FY18E
Salary	9.3%	15.9%	10.0%
Pensions	8.3%	15.9%	10.0%
Total	**9.0%**	**15.9%**	**10.0%**

Source: Union Budget website

Govt fiscal framework has not incorporated CPC increase

We would like to thank Santosh Kumar, an employee of Evalueserve, for his assistance in preparing this research report. Evalueserve staff provides research support services to UBS.

Valuation Method and Risk Statement

We believe the risks to our long-term estimates (for example, for corporate earnings) and macroeconomic variables (such as GDP growth rates and inflation) are an economic slowdown, a weakening currency, global economic events, and government policy changes.

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Buy	FSR is > 6% above the MRA.	48%	36%
Neutral	FSR is between -6% and 6% of the MRA.	39%	28%
Sell	FSR is > 6% below the MRA.	12%	22%
Short-Term Rating	**Definition**	**Coverage[3]**	**IB Services[4]**
Buy	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	<1%	<1%
Sell	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	<1%	<1%

Source: UBS. Rating allocations are as of 31 December 2015.
1:Percentage of companies under coverage globally within the 12-month rating category.
2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.
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