CORPORATE TAX RATE CUT: IMPACT & OUTLOOK

THE NARRATIVE HAS CHANGED FOR INDIAN EQUITY MARKETS

- *Nimesh Chandan (Head Investments – Equities)*

"Narratives are human constructs that are mixtures of fact and emotion and human interest and other extraneous detail that form an impression on the human mind." - Robert Shiller

The finance minister made some extremely important announcements today:

- Effective tax rate for domestic companies @ 22% - without exemptions/ incentives – So the effective tax rate stands at 25.1%
- 15% tax rate for companies incorporated on or after 01 oct 2019 and commences production on or before 31.03.2023 – Effective tax rate 17.01% incl all surcharge & cess. Also, no MAT to be paid.
- For Tax holiday companies/ enjoying exemptions, this will continue. They can opt for new regime once existing tax holiday gets expired
- MAT rate reduced from 18.5% to 15% for those who choose to continue under old regime
- Enhanced surcharge not applicable on capital gains arising on sale of equity shares or MF units or Business trust paying STT for Individual, HUF, AOP
- Surcharge not applicable to FPI also – for securities or derivatives
- Relief to listed companies who have already announced Buy back before 5th July 2019, tax on buy back to not be applicable

The government through these measures will forego revenues of RS. 1.45tn (0.7%) of the GDP. This is an important signal that government is using fiscal measures to boost economic growth. Accompanied with RBI which is using monetary measures to address growth issues, these measures are likely to act as a major stimulus for the Indian businesses. More importantly, this will bring back the animal spirits in the economy that we were missing in the past few months.

The post budget narrative that "the economy is undergoing a slowdown, but the government is hesitant to do anything about it"; will change to a new narrative: "the government has decided to do everything it can to revive the business cycle". Today's announcements suddenly raise the value of the all the previous announcements of the last one month too. All the changes that the finance minister has announced when taken together now are a significant push to lift the growth rates higher.

Whether these tax benefits will be passed on by corporates to end consumer to improve sales growth or invested for new ventures or stay hidden in corporate savings, only time will tell, but for the equity markets, this is an important development. India will not be immune to world wide movements in equity markets. However, India has strengthened its case to outperform other markets.

Earnings impact & Outlook:

- Nifty EPS for FY20 and FY21 will see an upgrade anywhere between 5%-10% based on assumptions whether corporates retain or pass tax benefits.
- Sectors like IT, Pharma and Utilities will be the least beneficiaries of this step. Private Banks, Auto and Consumers are biggest beneficiaries.

While there was a stronger move today in the large cap companies, we expect better days for midcap and smallcap stocks. The change in narrative on the economy will benefit the midcap and smallcap companies that had become attractive in valuation but were waiting for a trigger (or investor attention).

INTERESTING TIMES AHEAD FOR INDIAN FIXED INCOME MARKETS!

- *Avnish Jain (Head – Fixed Income)*

The announcement made by FM, are expected to have maximum impact to improve market sentiment and address concerns of slowdown in the economy. Effective tax rate reducing to 25.17% will significantly improve profitability of full tax paying companies leading to change in ROE leading to multiple re-rating. Reduction in Minimum Alternate Tax (MAT) as well as a lower rate of tax for a new company which does investment in manufacturing till 2023 should lead to higher capex. Further removal of enhanced surcharge on capital gains should be a big positive for investors.

While this move has seen positivity in the equity market participants, it has serious fiscal implications and is likely to lead to an additional borrowing in current fiscal as well fiscal challenges beyond 2020. The estimated revenue loss to the exchequer is expected to be Rs. 1,45,000 crores. This could impact the fiscal by 0.7% taking it to 4% of GDP. However, the government expects revenue buoyancy from improved economic activity.

Moreover, there was a windfall from RBI in terms of dividend given this fiscal. The additional amount given (after accounting for dividend already considered in the Budget and interim dividend taken in previous fiscal) is about 52,000cr. This should cushion the impact to 0.4%. The government has not indicated what extra borrowing may come, but it may around 75000cr. The government may further try to reduce unnecessary expenditure to reduce fiscal slippage.

Immediate Market Reaction:

- 10Y G-Sec slipped from 6.57% in the morning to 6.87% on panic selling before recovering to current level of 6.79%. There was a weekly auction scheduled for today, and the outcome for that is also suspect.
- The impact was felt throughout the yield curve, across both sovereign and corporate bond space

Fixed Income Outlook:

- We believe that the monetary policy committee (MPC) may not cut rates in October policy as they weigh the impact of fiscal stimulus on inflation. They have already cut rates by 110 bps and with a 0.7% fiscal stimulus, the MPC might adopt a wait and watch attitude.
- However, the sharp rise in yields may prompt RBI to resort to OMO purchases to support markets and in the process inject liquidity in the system
- As liquidity is expected to remain positive, the front end of the curve (especially corporate bond curve) will likely be supported.

We continue to recommend the Low Duration fund / Short Duration for Short-medium term exposure and Corporate bond fund for long term exposure.