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From The Desk of CIO Equities, Taher Badshah

## India Inc. Energised

On the back of what can be described as one of the most significant reform in recent decades, the Indian equity markets which had begun last week on a grim note given the sharp rise in global crude prices and amidst continuing anxiety of banking sector stress, finally ended on a positive note. Friday, the Indian government chose to cut corporate tax by moving down the base rate from 30% to 22% (though the effective benefit may vary depending on the extent of exemptions currently availed by a corporate). Additionally, the government also announced a series of measures including benign tax rates (17% all in) for new manufacturing entities commencing operations post September 2019 to encourage investments, expanding the scope of CSR activities and reversing tax surcharge on buybacks announced prior to July 2019. This move of the government comes over and above a slew of measures, long term and short-term, announced over the past 2-3 weeks.

It is a bold move, not as much on account of the quantum of the cut, but it represents a major mindset change of the Indian government in the way it thinks about growth, investments and fiscal policy. India needed a fiscally-driven stimuli given the economic slowdown of recent times which had off late begun to have its impact even on its strongest bastion, namely consumption. It utilizes the latest RBI windfall, and the new tax rate positions India better in a globally competitive environment.

An immediate fallout of this move would be to enhance EPS growth rates by between 5%-10% (depending on the deductions and pass through). It should make current multiples a lot more tolerable and may cover downside that may arise out of global uncertainties. Prior to the tax cut, Indian markets were imbedding a nearly 22% consensus EPS CAGR for FY 2019-21, which in the midst of the recent slowdown appeared way out of reach. For the market that has suffered from eight consecutive years of EPS downgrades, these extra 5-10% comes as a shot in the arm. While the tax cut is an important piece of news, it may not imply a significant incremental EPS gain v/s current inflated expectation especially for FY20. However, it does open up the possibility for growth conditions to reverse more quickly than earlier and extending itself into FY21 as well.

Even as this move may come at the cost of the fiscal (potential impact of 50-70bps of GDP) and increases risk to inflation and expected cuts in interest rates, we reckon growth to be a bigger imperative for an economy like India and with weak commodity prices and muted food inflation, some of this impact may be undermined. Besides, India is largely self-funding and does not currently face any external vulnerabilities.

While corporate tax cuts do enhance equity valuations and support asset prices, there is no evidence that they actually meaningfully spur investment or employment. This was the case with the US tax cuts as indeed it has been true with every single other tax cut move globally. There are other factors that turn tax cuts into viable stimuli, such as a well-defined investment agenda, deep structural reforms, flexibility of labor markets, elimination of trade barriers etc. There is clear evidence of slowing capital investment in the economy over the past 5-7 years which needs to be reversed for India to

recommence a more durable journey of secular growth. In this context, the PM's announcement in Aug 2019 of his plan to invest INR 100 trillion in infrastructure over the next 5 years to achieve an economic size of US\$5 trillion is critical and we keenly await the contours of the same.

Whether this move turns into a game changer and how quickly and in what manner does the tax cut feed through the economic cycle remains to be seen, there is enough done recently by the government that may change investor perspective. India's foreign equity funds flows have been deeply negative for three months in a row with ~US\$5bn leaving the market (the most negative outflow in Asia ex-Japan). This announcement may help change negative investor views while domestic liquidity still remains ample. India has meaningfully underperformed global and many Asian markets YTD and there is a clear headroom for some more catch-up notwithstanding the market rally on Friday.

To conclude, the confluence of recent economic and policy measures culminating in this tax cut does make the overall investment proposition incrementally more attractive. Risks hereon to the market in our view may now arise primarily from global market developments. With a higher probability now of a recovery in the domestic growth cycle and given the steep valuation correction of the past 12-18 months, we reiterate our preference for mid and small caps as an area of immediate opportunity even as our flagship value and growth strategies remain positioned for steady long-term capital appreciation.

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