Manulife Investment Management

Investment Note

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On 20 September 2019, the Indian government announced a reduction in the base corporate tax rate from 30% to 22%, including a preferential tax rate of 15% for newly incorporated manufacturing companies[1]. Indian equity markets rose significantly on the news[2]. These reforms represent a significant change in policymaker's economic approach: Previously, the government favored monetary policy to boost growth; however, with this move fiscal policy also joins in. In this investment note, Rana Gupta, India Equity Specialist, examines how the reforms may boost corporate earnings, revive demand and reinvigorate investment, thus driving an investment-led economic rejuvenation.

India's corporate tax cuts – boosting investment-led growth and equity prospects

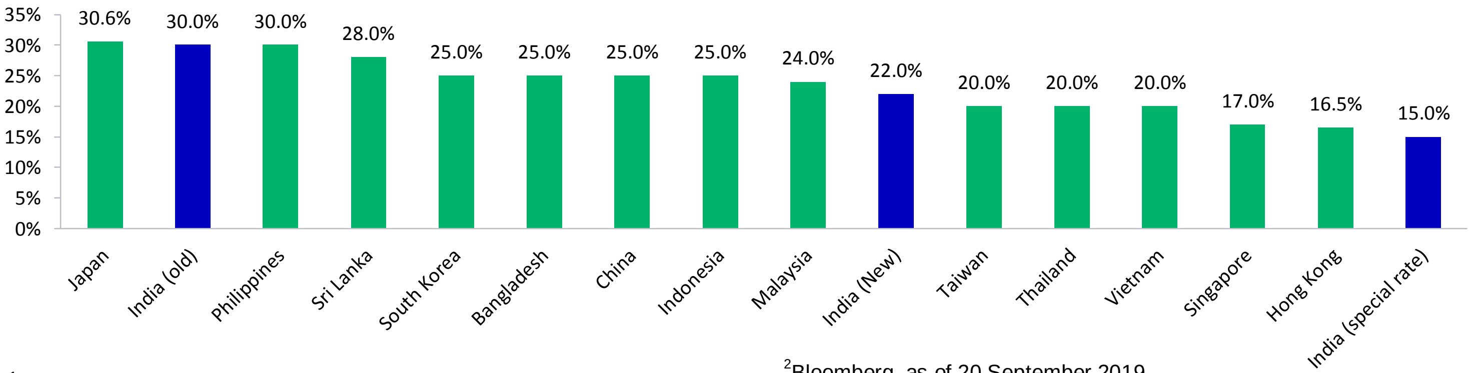
Our view: These bold reforms mark a decisive shift in the government's approach towards managing growth. We believe they will uplift income and savings for corporates, accelerate investment (domestic and FDI), increase economic formalisation, and, if coupled with other key reforms (e.g. recycling of state-owned assets and labour reforms), will transform India's investment environment.

Previously, the government primarily focused on monetary policy and the Reserve Bank of India's (RBI) tools to boost growth, while maintaining fiscal discipline. However, monetary policy has not been as effective, as the transmission of interest rates and credit has lagged policy decisions. This has contributed to the decelerating GDP growth print over the past few quarters.

We believe slower growth might have tilted the balance in favour of the government using fiscal policy. We estimate the tax cuts should translate to an economic stimulus of roughly US $20 billion, or about 0.7% of GDP (FY 2020)[3]. Moreover, India's new corporate tax rate should be competitive with most major Asian economies, and the preferential rate for new manufacturing firms will be one of the lowest in the region (see Chart 1[4]). This policy move decisively raises India's global competitiveness to attract manufacturing investment (FDI), which is also consistent with the government's preference of driving growth through investment rather than consumption.

Overall, we believe these reforms should incentivise greater domestic private capex, attract global manufacturing investment (FDI) to India, create new jobs and catalyse an investment-led economic rejuvenation.

Chart 1: Base corporate tax rate across major Asian economies



[1]Bloomberg, "India surprises with $20 billion tax cut stimulus; stocks soar." 20 September 2019. The preferential rate is for manufacturing firms incorporated after 1 October 2019 and starting production before 31 March 2023.

[2]Bloomberg, as of 20 September 2019.
[3]Manulife Investment Management estimates, 25 September 2019.
[4]Source: Bloomberg, KPMG, 24 September 2019.

Implications of tax reforms

We envisage the following possible outcomes from the reforms:

- **Boost earnings:** Our estimates suggest the tax cuts should translate to an 8-10% earnings upgrade for the listed equity universe[5] in India. We believe that corporates will use tax savings in myriad ways, such as catalysing consumer demand through price cuts and/or promotions and investing in additional capacity to take advantage of the lower investment-linked tax rates.

- **Revival in the capex cycle:** The reduced base income tax rate of 15% for new manufacturing investment does not have an expiry date as long as production starts by March 2023. Since this can translate into significant tax savings of seven percentage points lower than the new standard corporate rate, corporates could likely bring forward their capex decisions.

  We also note that because of continuing US–China trade tensions, many MNCs are looking to diversify their regional supply chains. MNCs could move part of their regional production to India to take advantage of the lower rates. We also believe the lower tax rate is an opening salvo in a package of polices to promote a more competitive investment environment that may include further reforms on factors of production (e.g. land, labour) and the expansion of end markets through trade agreements (FTAs).

- **Continued economic formalisation:** We expect the tax cuts should continue the ongoing process of economic formalisation by further levelling the playing field through a lower tax burden on formal, tax-compliant companies. The organised sector can pass on some of the benefits to consumers and accelerate market share gains
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[5]Nifty 50 stock index.

- **Higher fiscal deficit:** As a result of the tax cuts, we estimate that the central government's fiscal deficit in FY 2020 should increase from 3.3% of GDP to roughly 3.7%[6].

  Despite an increasing deficit, we expect only mild pressure on both interest rates and the Rupee for a number of reasons: (1) Global central banks easing leading to benign liquidity conditions; (2) Moderate inflation locally gives the RBI room to cut interest rates further; (3) Real rates for the Rupee remain high; (4) Global investors could be attracted to Indian equities as growth prospects revive; (5) FDI in manufacturing could increase as a result of the tax cuts; (6) Domestic tax buoyancy may improve with higher growth and last but not least (7) The government can pursue privatisation of state-owned enterprises (SOEs).

  Overall, we believe there will be adequate capital to fund the deficit without putting much upward pressure on interest rates. If the government chooses to privatise state-owned assets, we view this as another big positive for the economy and markets.

Investment outlook

In our past notes, we have argued that the re-elected administration had the unique opportunity to lift India's growth rate through the "Three R's"[7]. With the current reforms, we see that the government is moving closer to this framework, which should boost the growth rate.

[6] This estimate includes the assumption that some offsets will be available from the higher than budgeted dividend from the RBI.
[7] Manulife Investment Management: "India's incumbent government wins second election mandate." 24 May 2019. The "Three R's" are: 1) Recycle- Growth could be lifted through selling state-owned enterprise (SOE) assets to fund government spending. 2) Rebuild- Building domestic income and savings that could support investment. 3) Reinvest- Providing incentives to manufacturing firms to make investments to substitute imports and increase the global market share of exports.

India needs higher investment rates to achieve its ambitious growth targets, and we believe the bold tax reforms are a step in the right direction – if they are followed up with the right land and labour reforms. As global companies look to diversify their manufacturing base, India presents an attractive destination for investment in areas such as chemicals, engineering and electronics with a large domestic market, large pool of knowledge workers in engineering and chemistry, as well as a surplus labour pool.

We remain positive on the prospects for an investment-led economic rejuvenation on the back of the tax reforms. India has seen growth moderate over the last few quarters. We believe the large tax stimulus can break this cycle of slower growth by providing a near-term boost to demand and a medium-term boost to the investment cycle leading to a more durable and higher-quality growth.

We are currently constructive on companies that have one or more of the following attributes:

- **Businesses with a high current tax rate**, as they will now receive large tax savings to reinvest in the business.
- **Businesses with significant competition from informal sector,** as the latest tax reforms accelerate the formalisation process.
- **Businesses with the opportunity to deploy cash** to add to their capital expenditure plans in pursuit of growth.
- **Domestic manufacturing related plays** as the capex cycle revives.

At the sector level, we are constructive on organised retail, building materials (paints, tiles etc.), private-sector banks and capital goods companies.

Conclusion

We believe the latest reforms are an important first salvo in a package of reforms that can lead to an investment-led economic rejuvenation in India, boosting private savings, incentivising greater capex, accelerating the formalisation of the economy, creating jobs, and potentially leading to future privatisation of SOEs. As envisaged in our last note on the “Three R’s”, through these policy steps, a lift in India’s growth rate through country-specific reforms in an uncertain world moves another step close to reality.

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Manulife Investment Management

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