# Equirus Long Horizon Fund

## Special Investor Communiqué - Sep'19

**September 20, 2019** was a momentous day in the Indian history. With the announcement of steep cut in corporate tax rates, the government has decisively changed stance from being perceived as pro socialistic (left) to pro capitalistic (right). Along with the corporate tax rate cuts, the Finance Minister also announced cut in tax rates for new manufacturing units to 15% (~17% effective), MAT rates to 15% and rolled back surcharge on FPI's that was levied post budget. Standing true to his words during Independence day speech, Mr. Modi has provided tremendous impetus for the 'job creators' of the country by putting ~USD 20 bn in their hands.

**How does this affect us?**

In our previous communications, we highlighted that our companies are at a discount to their intrinsic value. **If that was a whisper, this is a scream.** Our portfolio companies are trading at bargain basement prices and we are on the cusp of a big wealth creation opportunity, if not the biggest.

The jury is still out on what will be the first and the higher order effects of this move by the government. The debate be best left for the economists. However, we are sticking our necks out and will deploy as much capital as we can over coming days.

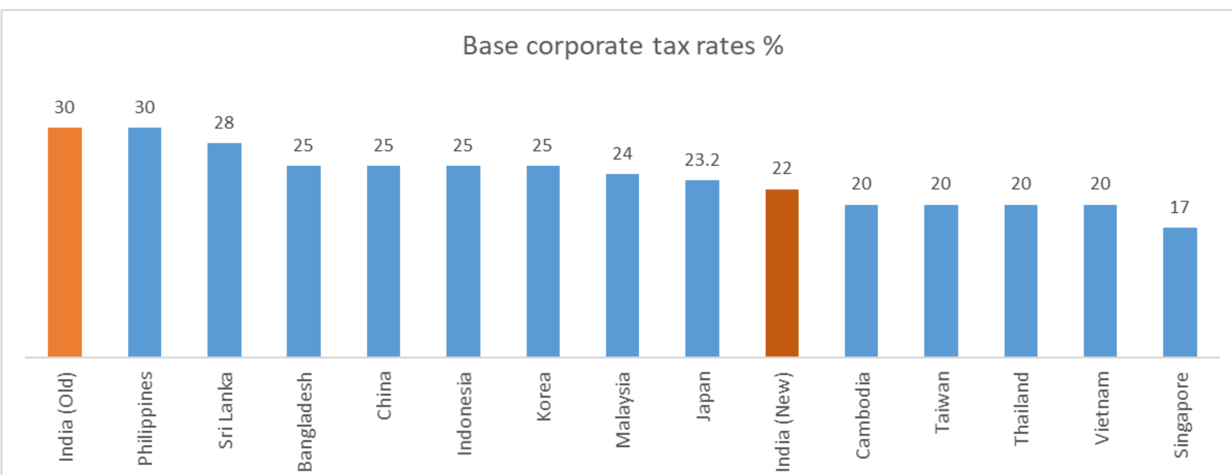
As Warren Buffett once wrote, ***"Opportunities come infrequently. When it rains gold, put out the bucket, not the thimble."***

We encourage you as well to increase your equity allotments substantially through us and/or other investment vehicles of your choice.

## How does this affect corporate India?

Higher tax implied lower reinvestment rates because of which India was starved of equity capital available for growth. This ~USD 20 bn of risk capital per annum will create a huge multiplier effect in the economy. There have been examples of tax rate cuts across many countries especially during slowing growth scenario which has led to higher growth rates in the following years. In the recent past, the corporate tax rates were lowered in US which added ~80 bps to their GDP growth. It should be noted that, at the scale of US economy, ~80 bps is a very big number.

India is now in line with its Asian peers in terms of corporate tax rates which will help it in terms of export competitiveness. With the trade war going on between US and China, lower tax rates (15% for new entities) can go a long way in attracting foreign companies set up their manufacturing bases in India.




*Source: Delloite, KPMG*

Lower taxes also mean higher fiscal deficit for the government, which should lead to strategic divestments of the government PSUs. This would again be in line with Mr. Modi's credo of "Minimum government and maximum governance". We can expect large divestments starting with Air India over coming quarters.

## Degrees of Impact

Indian corporates will feel a long-lasting impact of this move. Short to medium term effects of can be classified in following three buckets:

**Type A advantage** - Direct profitability increase:

Companies will enjoy this benefit of increased profitability which will directly add to the bottomline and RoE. Companies can use this extra buffer to increase growth by implementing price cuts, increase in marketing spends, employee incentives, etc. Or they can choose to increase shareholder distributions. All the companies will enjoy this benefit. For example, companies catering to consumer staples and its value chain will most likely be restricted to this benefit.

**Type B advantage -** Increase in demand related to credit growth:

Substantial amounts of capital will be added to the balance sheets of financial services companies. This capital buffer should increase the risk appetite and lead to growth for the credit starved economy. This will lead to a multiplier effect in the economy.

**Type C advantage -** Increase in demand for companies that are mainly driven by capital formation:

Capex demand should be stimulated at multiple levels. We believe companies where demand is driven by capex will be the biggest beneficiaries of these tax cuts. Apart from growth, which by itself can be substantial, there can be a big spike in profitability due to operating leverage. Some of the triggers are:

i. Unviable projects becoming viable: There projects which over the years become unviable because of various reasons and stuck due to lack of capital should become viable and attract funding.

ii. New private capex: Private capex has stagnated in India for past many years. The new entities setting up manufacturing units post October 1, 2019 and coming in production before March 31, 2023, will attract only 15% tax rate (~17% effective). This will give a big incentive to corporates and entrepreneurs for setting up manufacturing plants.

iii. Foreign Direct Investments (FDI): With tax rate in teens and the disruption caused by the trade war, India will become very attractive destination for US companies looking to move manufacturing away from China. This will provide them access to low cost manufacturing base as well as a substantially large Indian consumer base. Things cannot get much better than that. Of course, much awaited land and labour reforms can be the icing on this cake.

## Impact on our investments

Tax cuts will translate into i) immediate jump in bottomline and RoE and ii) lower P/E ratios. Suddenly, weighted average RoE of our portfolio jumped to 20% (an increase of 188 bps). Further portfolio FY20 PE decreased to 11.2x (from 12.5x earlier) even after factoring in the price increased on Friday. (Let's not forget, the headline indices jumped more than 5% on Friday, the 2nd biggest rise ever). Following chart shows increment in profitability and the types of benefits, we discussed earlier, that our companies will enjoy.

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| Company | Earnings jump | RoE jump (bps) | Type of benefits |
| --- | --- | --- | --- |
| Company 1 | 17% | 355.70 | A |
| Company 2 | 15% | 211.88 | A |
| Company 3 | 15% | 147.33 | A |
| Company 4 | 15% | 314.48 | A, B |
| Company 5 | 15% | 285.30 | A, C |
| Company 6 | 13% | 202.67 | A, C |
| Company 7 | 13% | 215.14 | A |
| Company 8 | 8% | 144.83 | A |
| Company 9 | 8% | 230.65 | A, C |
| Company 10 | 8% | 97.69 | A |
| Company 11 | 5% | 85.23 | A, C |
| Company 12 | 3% | 44.14 | A, C |
| Company 13 | 2% | 26.15 | A |
| Company 14 | 2% | 18.15 | A, B |

* *Excludes a special situation investment*

**Assuming ceteris paribus situation.*

For any queries related to increasing your investments with us or anything else, please feel free to get in touch with me (viraj.mehta@equirus.com) or Siddhartha (siddhartha.grover@equirus.com).

Thanking you,

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