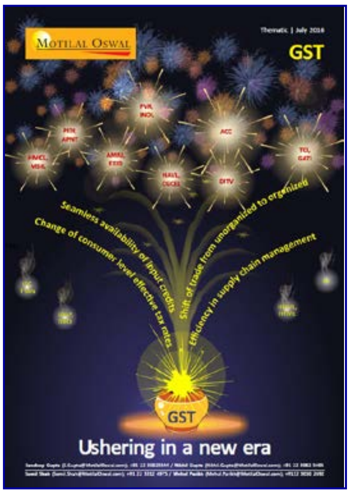
GST Council finalizes tax rates

Paves the way for July rollout



The Goods and Services Tax (GST) Council, in its crucial two-day meeting, has finalized the most-awaited tax rates for most goods and services. We believe that the government has struck a fine balance to ensure that the GST rates are non-inflationary. While there has been some divergence from rate expectations for some sectors, we do not see any rationale for near-term buoyancy in the markets as the rates are not disruptive and have been largely kept around the existing structure. We believe that the key monitorable from the market perspective will be GST implementation in the near term and gradual lowering of overall tax rates in the medium term. Also, in our view, GST will be a key catalyst for formalization of the economy over the longer term, triggering supply chain efficiency and boosting government revenues.

FMCG – a key beneficiary

- We believe that the FMCG sector stands to benefit from the reduction in tax rates for soaps, toothpastes and adhesives to 18% from 22-26% currently. Similarly, indirect tax levy on lubricants has been lowered to 18% from 27-28%. We believe that companies might either pass on the benefit of lower duties to consumers to spur demand or retain it to derive margin benefits. Indirect tax levies have been broadly maintained for cigarettes, which, in our view, could auger well for the sector. Key beneficiaries: **PIDI, ITC, CLGT, CSTRL.**

Marginally higher rates for automobiles, cement

- For automobiles, the GST rate is fixed at 28% plus cess (1% for small petrol cars, 3% for small diesel cars and 15% for others). This will lead to an increase in on-road prices of small diesel cars and mid-sized cars by ~1.6% and ~2.1%, respectively. On-road prices for large SUVs, however, will decline by ~3%. MSIL derives ~15% and ~8.5% of its volumes from small diesel cars and mid-sized cars, respectively, which may be impacted due to the change in tax rates.
- GST rate for cement has been increased to 28% from ~22-24% currently. We believe that the increase in tax rates is likely to be passed on to consumers and may not materially impact overall demand.

Limited benefits for multiplexes

- Tax rates on ticketing of multiplexes have been increased marginally from 25-27 currently to 28%. Further, tax on F&B has been hiked to a blended rate of ~ 19-21%, as against the current rate of 11-13%.
- However, the impact of higher duty is likely to be more than offset by the benefit from additional tax credits on lease rentals and annual maintenance contracts (which are currently not available). We believe the overall impact will be lower than originally expected by investors. Key impacted companies: **PVR, INOX**.

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GST meeting – agreement on tax rates for most items

- The GST Council has finalized the tax rates for various goods and services (except few items like gold, biscuits, footwear, apparel and beedi). With this, GST implementation has inched another step closer to reality, raising optimism about 1 July 2017 rollout.
- Notably, for most goods, the government has broadly kept the tax rates closest to their existing rate structure. However, for services, the Council has agreed to four tax rate slabs (from single slab currently), and the existing exemption list is largely grandfathered.
- Although the exempted list for goods is yet to be finalized, we expect it to be much leaner than the current one.
- Overall, the government has levied a lower rate of 5% on basic goods & services, 12 or 18% for general goods & services, and 28% (plus cess in some cases) for luxury goods & services.

Consumers – neutral to positive impact for many companies

- The impact of GST rates is likely to be neutral to positive for many companies in the sector. We believe that the sector will also benefit from the potential shift from unorganized to organized trade post GST implementation.
- Benefits for companies (due to lower indirect tax incidence) will either be a) retained (leading to margin gains), b) passed on entirely to customers (to spur demand) or c) spent on ads & promotion. Companies could also use a combination of these moves.
- Clear beneficiaries are toothpaste and soap players as well as cigarette companies, for whom no increase in effective rates is always good news. Alcohol players, however, will face challenges to avail input tax credit from states.
- For ITC, the effective rate of 28% plus 5% cess plus duty per stick amounts to the current rate of ~60%, meaning the impact is neutral.
- Colgate pays an effective tax of 25-26%, and thus, 18% tax on toothpastes (80% of sales) is a positive, particularly as it levels the playing field v/s Dabur and Patanjali which enjoy tax benefits.
- PIDI pays an effective tax rate of 22-23%, which will be reduced to 18%, bringing in volume/margin benefits.
- CSRTL pays an effective indirect tax rate of ~27-28%, and thus, the 18% GST rate is likely to bring some margin benefits.

Automobiles – marginal increase in tax rates

- GST rate on autos is fixed at 28% plus cess (1% for small petrol cars, 3% for small diesel cars and 15% for others).
- Except for small diesel cars (Swift, Baleno, Dzire diesel) and mid-size cars (Ertiga and Ciaz), GST rates are largely neutral from the on-road price perspective.
- For small diesel cars, the increase is ~1.6% in on-road price, while for mid-size cars, the rise is ~2.1%.
- For large SUVs (Bolero, XUV5OO), there is saving of ~3%.
- For MSIL, small diesel cars/mid-size cars contribute ~15%/ ~8.5% of volumes.
- The GST rate schedule does not specify rates for hybrid vehicles, but does talk of cess of 15%. If the base rate of 28% (+15% Cess) is applicable on hybrid vehicles,

it would result in ~11.5% increase in on-road price of such vehicles. MSIL's diesel variant of Ciaz and Ertiga would be adversely impacted by this.

Cement – rate increase will be passed to consumers

- GST rate of 28% for the sector is neutral, as the rate differential of 1-2% would be passed on to end consumers, and will thus not impact profitability.
- The bigger impact of GST on the sector would be in the form of lower freight cost due to efficient movement of fleet and ease of cross-border movement of goods.

Multiplexes – limited benefits

- Tax rates on ticketing of multiplexes have been increased marginally from 25-27% currently to 28%. Further, tax on F&B has been hiked to a blended rate of ~ 19-21%, as against the current rate of 11-13%.
- However, the increase in duties will be more than offset by additional tax credits on lease rentals and annual maintenance contracts (which are currently not available). We believe the overall impact will be lower than originally expected by investors. Key impacted companies: **PVR, INOX.**

Homebuilding – Price differential between organized and unorganized rises

- Tiles/plywood: A 28% rate (v/s current rate of 25-28%) is likely to slightly increase the product price differential between the unorganized and organized players, boosting competitiveness of unorganized players.

Metals – effective tax rate broadly unchanged

- GST rate is 18% for steel, zinc and aluminum, broadly similar to the existing all-in rate (excise 12% + VAT 5-6%). The only benefit to the sector will come from saving in entry tax/octroi.

Power – tax on coal reduced to 5%, benefits merchant power plants

- Cost of coal for the merchant power plants will reduce by 5%: benefit is ~INR100/t of coal or INR0.06-0.07/kWh (on a realization of INR 2.5-3/kWh). This is likely to be positive for **JSP, ADANI**.
- For capacities operating under PPA, the benefit is pass-through in tariffs.

Capital goods and consumer durables – mixed bag

- While the capital goods sector would benefit from a lower tax rate on contracts, there would be higher tax incidence on cables and transformers. A few segments in the consumer sector would see higher effective taxes and would need to take price hikes to offset the resultant cost pressures.
- Key changes/surprises v/s expectations were for:
  - **Fans:** Were expected to come in 18% bracket, but have been bought at 28% (currently at 24%); will need price hikes. Companies impacted: **CG Consumer**
  - **Air conditioners:** Have been put in the 28% bracket; would need 2-3% hikes. Companies impacted: **Voltas, Havells**
  - **Transformers:** In the 28% bracket (currently at 18%); would need price hikes
  - **Cables:** In the 28% bracket (currently at 18%). Companies impacted: **Havells**

- **Construction of a complex, building or civil structure:** Now in the 12% bracket (from 7-11%, depending on the VAT rate) as additional credit will be available on all inputs, which will further reduce cost
- No change in GST rates for pumps, LED bulbs, switchgear, motors and switches/switchgears

Services – increase in rates cushioned by availability of input credit

- Service tax has been increased from 15% currently to 18% in most cases – e.g. telecom, financial services. However, the impact will be offset by availability of input tax credit.

No impact on inflation; Government revenues to increase over medium term

- In our view, since the tax rates on goods (higher weightage in WPI) are broadly maintained, the impact on inflation is unlikely to be material in the near term.
- We believe that, over the medium term, government revenues are likely to increase with a higher tax base due to lower threshold limits for applicability of tax rates and the shift in trade to the formal economy.

Exhibit 1: Sector-wise impact of GST

Sector	Current Effective tax rate	GST rate	Remarks
Consumers			
Paints	25-26%	28%	**Neutral:** Companies will be able to pass price increase to consumers
Toothpaste	25-26%	18%	**Positive:** Reduction in duty rates may be passed on to generate volume benefits or may be partially retained to improve margins
Adhesive	22-23%	18%	**Positive:** Reduction in duty rates may be passed on to generate volume benefits or may be partially retained to improve margins
Soaps	25-26%	18%	**Positive:** Reduction in duty rates may be passed on to generate volume benefits or may be partially retained to improve margins
Cigarettes	28% + excise depending on length	28% + cess (as per length + ad valorem)	**Neutral:** Tax incidence is broadly maintained at current level and hence no major impact
Auto			
2 Wheelers	**30-31%**		
Motorcycles (engine>350cc)		31%	**Neutral**
Others		28%	**Marginally positive:** Entry-level two-wheelers can derive some volume benefit on reduction in tax rate by 2-3%
3 Wheelers	**30-31%**	**28%**	**Neutral:** Companies will have to pass on benefit to consumers
4 Wheelers	**31-49%**		**Neutral:** Tax rates are broadly same as current rates. Change in tax rates whatever applicable will be passed on
Small Cars (length < 4 m ; Petrol<1200 cc)		29%	
Small Cars (length < 4 m ; Diesel < 1500 cc)		31%	
Mid Segment Cars (engine < 1500 cc)		43%	
Large Cars (engine > 1500 cc)		43%	
Sports Utility Vehicles (length > 4m ; engine		43%	
1500 cc; ground clearance > 170 mm)		43%	
Mid Segment Hybrid Cars (engine < 1500 cc)		43%	
Hybrid motor vehicles > 1500 cc		43%	
Hydrogen vehicles based on fuel cell tech > 4m		43%	
CV	30-31%	28%	**Neutral:** Companies will have to pass on benefit to consumers
Batteries	29-30%	28%	**Slightly positive**: Companies may retain a portion of reduced tax rates, which may improve margins

Sector	Current Effective tax rate	GST rate	Remarks
Cement	22-24%	28%	**Neutral:** Increase in tax rates will be pass-through and is unlikely to impact volumes
Metals	19-21%	18%	**Neutral:** Reduction in duty rates will be passed on to consumers
Pharma	4-14%	5-12%	**Neutral:** Duty incidence is broadly maintained for pharmaceutical products
Capital Goods – Light electrical and aircon	22-26%	28%	**Neutral:** Marginal increase in tax rates is likely to be passed to consumers
Capital Goods – Project	22%	18%	**Neutral:** Decrease in tax rates will be passed on to customers
Information Technology	15%	18%	**Neutral**: Increase in rate will be offset by availability of input tax credit
Telecom	15%	18%	**Neutral:** Competitive intensity remains high, leaving little chance to pass on duty hike to consumers But input tax credit of ~150bp from VAT could reduce the impact
Multiplex			
Ticketing	25%-27%	28%	Limited benefit from availability of input tax credit offset by increase in duty for F&B
F&B	10.5%	20-21%	
Home Building			
Tiles / Sanitary ware	25-28%	28%	**Neutral:** Will slightly increase product price differential between unorganized and organized players, boosting competitiveness of unorganized players
Ply wood	24-25%	28%	**Neutral:** Will slightly increase product price differential between unorganized and organized players, boosting competitiveness of unorganized players

Source: GSTN, CBEC, MOSL

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