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India needs Allowance for Equity and Compulsory dividends to woo back retail investors

" Once the facts are clear, the decision jumps at you."
Peter F. Drucker

" You pay the same price for doing something halfway as for doing it completely. So you might as well do it completely."
Richard Nixon

The Indian Equity market is plagued with low interest by retail investors and it is good to take a note that government is clearly concerned about their apathy towards equity markets; the measure taken by Union budget 2012 to channelize savings in financial assets is a testimony to this. Currently, there are approx. 20 mn demat account and 38.5 mn folio of Mutual funds, suggesting 5% equities penetration in Indian households. With one of the largest pool of domestic savings, the equity penetration is abysmally low. Retirement money and pension money has not found its place in equity markets. I am a firm believer that equity markets provides unparallel opportunity to create wide spread prosperity in the country. However, the current measures by the government are insufficient looks *like a baby step* and do not appreciate the problem faced by retail investor while investing in equities. The key reason for Indian equity to remain underappreciated by domestic investors are : 1) Asset classes of choice ; Gold and Real estate has given superlative returns with much lower volatility in comparison to Equity markets over the last few years. 2) Retail investor has to rely on the kindness of the strangers (brokers, advisors) to scan profitable investing opportunity/stock while in case of the other two asset classes it can be evaluated by themselves. 3. Corporate governance issues in corporate India have been overweighing in minds of retail investor while investing in the domestic equities. This concentrated controlling shareholders coalition creates agency issues such as – reluctance to distribute cash flows, excessive investing in growth projects to have a larger empire, complex structures /tunneling, and voluminous yet opaque information – while other minority shareholders or independent board members are disinclined or unable to challenge them.

If we intend to foster equity culture in India, the above mentioned problems require a **radical solution**; providing an incentive to equity shareholders in form of **Allowance of Corporate Equity (ACE), a form of allowing nominal interest on equity capital tax deductible. This should be coupled with a compulsory dividends pay out policy, around 25% or more by corporate. ACE, allows deduction on shareholder funds (long term bond rates of Govt. Securities) from corporate taxability.** The compulsory payout of the profits will ensure that accounting profits are aligned with the cash generated by the company. To me, this is the best way to separate *the wheat from the chaff* in corporate India, encouraging long term investment in Indian equities and channelizing domestic saving in the productive financial assets.

From the above mentioned factors, government has taken measure to discourage the flow of money in real estate and gold, by introducing taxes at various points.

Table 1 : Returns of Asset Classes (%)				
	1y	**3y**	**5y**	**10y**
Gold	7%	86%	145%	435%
Real Estate*	20%	125%	275%	900%
BSE-500	-7%	19%	21%	468%

*Vallum Capital Estimate

A closer look at the constituents of BSE 500 Index past fiscal results (excluding 59 government companies and smoothing of special dividends to get factual picture), throws an interesting fact about dividend policy of India. We have not included government owned companies as the government is a policy maker on taxation related to dividends as well as majority shareholder, a conflict of interest for dual role it plays. The study throws interesting fact that average pay out is around 25% but this data is skewed by few companies having very high dividend pay outs. On an aggregate, companies accounting for 50% of the total profit, of above mentioned universe, pay just around 10% of its profit as dividends while keeping balance 90% at disposal of controlling shareholders. Investors have witnessed huge volatility in the profitability of the company over a business cycle, partially explained by the cycle itself and partly due to corporate mis-governance.

Table 2 : Companies from BSE 500 Index (440 companies, excluding Govt. companies)				
Quartile (Rs Crs)	**Market Cap**	**Net Profit**	**Dividends**	**Dividend Payout**
Q1	17,76,535	65,340	30,679	47.0%
Q2	9,63,462	55,340	11,675	21.1%
Q3	8,66,525	63,028	6,853	10.9%
Q4	6,07,288	33,599	963	2.9%

*Excluding Government Companies

In a lay man's term, there is a possibility of an overstatement and understatement of the profit by the corporate which has suited their business and capital structure need. Minority Investor has to steer through the layers of financial statement which usually results in voluminous annual report, meager pay outs and in few cases nothings. Last but not the least; in absence of compulsory dividend and allowance policy, investor is subjected to vagaries of the capital markets and price action as a sole measure of wealth creation. This may not be the best possible solution for the long term investing. ACE coupled with compulsory dividend is a strong self fulfilling mechanism which combines strong enforcement and incentivize the corporate towards fair accounting and eliminate debt bias thereby also progressing towards much safer banking system in the country.

Table 3: Financial Statements		
Balance Sheet (Rs.Cr.)	**Current**	**ACE**
Equity or Shareholder funds	12,93,664	12,93,664
Charge on Allowance for Equity	-	5.50%
Allowance on Equity	-	70,531
Total Equity	12,93,664	12,23,133

Interest on Equity is deducted directly from Shareholder funds & not routed through P&L

Income Statement (Rs.Cr.)	Current	ACE
Profit Before Tax	**2,86,212**	**2,86,212**
Effective Tax Rate	23.9%	23.9%
ACE Tax allowance to corporate (a)	-	16,857
Effective Corporate Tax	68,542	68,542
Total Tax Expense	**68,542**	**51,685**
Profit After Tax (b)	**2,17,670**	**2,34,527**
Dividend Payout	**23.1%**	**30.1%**
Dividends Proposed	**50,214**	**70,531**
Allowance on Equity (c)	-	70,531
Dividends	-	0
Retained Earnings (d)	**1,67,456**	**1,63,996**

*Excluding Government Companies.

a) ACE of 5.5% (Assumed G sec Yield) of total Net worth applied.

b) ACE impact does not flow through PAT (except tax shield) to avoid reduction of PAT thereby PE multiple & Market Cap.

c) Dividends would be classified as Allowance on Equity to gain tax advantage as Allowance on Equity is Tax Deductible, however, the % Charged on equity, as Allowance on Equity, would be capped at the long term G-Sec rate (as decided by authorities).

d) The reduction in Retained Earnings is due to the difference between the Increase in PAT & Dividends Paid Out from Current to ACE.

The international experience of ACE or its variant has been very encouraging. The countries like Belgium, Chile, Greece, Columbia, Venezuela and Latvia has some variant of ACE or compulsory dividend system working while Austria and Italy adopted it for some time ago but abandoned in favor of broader corporate tax reforms. Brazil has successfully implemented ACE coupled with compulsory dividend since 1996, a model that should inspire India. Each country has drawn its inspiration from the uniqueness of the problem it has faced and has adopted system which has suited it best. Recently, Chinese Security Regulatory commission (CSRC) has expressed strong opinion about low dividend payout by the listed entities and framed rules for dividend payout for listed companies as well as IPOs. In one its recent working paper, IMF has indicated that various government across the Europe are having discussion to adopt some form of ACE in order to reduce the debt bias that has led to meltdown of the global financial markets.

Table 4: Cash to Shareholders (Rs.Cr.)	Current	ACE	Inc/(Dec)
Dividends Proposed	50,214	70,531	
Dividend Tax at 15%	8,135	0	
Allowance on Equity : Tax @ 15%	-	11,426	
Net Cash to shareholders	**42,079**	**59,105**	**17,026**

*Excluding Government Companies.

Table 5: Cash to Government (Rs.Cr.)

	Current	ACE	Inc/(Dec)
Corporate tax	68,542	51,685	
^DDT/Interest on Equity: @15%	8,135	10,580	
Net Cash to Govt.	**76,677**	**62,265**	**-14,412**

*Excluding Government Companies.^ Dividend Distribution Tax

Table 6: Cash to Corporate (Rs.Cr.)

	Current	ACE	Inc/(Dec)
Retained Earnings	1,67,456	1,63,996	
Net Cash to Corp.	**1,67,456**	**1,63,996**	**-3,460**

Let me preempt some potentials issues which may follow on issue of compulsory dividends and mitigates ; First, it reduces the ability to reinvest specially of Indian mid and small size firms where the cost of raising equity is quite high. Study in Brazil, where compulsory dividend policy is in place, has suggested that this had no impact on long term reinvestment capabilities of the firm. Moreover, cost of equity improves dramatically, as inflows from institutional investors spreads across market capitalization thereby increasing the investible universe, which is usually quite concentrated in large cap stocks. Secondly, this would result in lower tax collections. Over the last few years, the government has raised effective tax rate by atleast 10% point, by reducing the tax sops available under various schemes, increasing Minimum Alternative Tax (MAT) and improving tax compliances. A strong incentive system in form of allowance for equity is a credit due to the corporate India and to shareholders. Statistics of BSE 500 companies (excluding 59 government owned companies) suggests that the total Profit after tax of around US$ 43.5 bn, tax collection of US$ 15 bn and dividends payment of US$ 8.5 bn for FY2011.

A back of envelop calculation would suggest that cost of implementing ACE with compulsory dividends, to public revenue, in terms of lower tax collection can be close to US $3 bn p.a, a small number, considering the economic benefit of superior corporate governance can bring for all the stakeholders. In short run, this can be reduced further, by granting allowance to new or incremental equity investments, only. This implementation will bring economic benefits, increased investments, higher wages and higher economic growth, which are urgently needed. Indian authorities have to wake up before the competition among nations intensifies to attract global long term capital for financing the country's need. As well said, India responds during crises, only; then let's not waste this opportunity in implementing ACE with compulsory dividends.

I would be available for any further discussion on this subject. Let me know your views at manish.bhandari@vallum.in

References & Endnotes

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