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IMF Program

Potential removal of sales tax exemptions

- The government has reportedly committed to the IMF to remove almost all sales tax exemptions, worth c.PKR350bn, as a precondition for resumption of the stalled EFF program. Broadly, this will affect petroleum, pharmaceuticals, food and other agriculture related items which had hitherto enjoyed 5-10% GST on inputs or final products, compared with the normal rate of 17%. These items are listed in the Sixth, Eighth and Ninth Schedules of the Sales Tax Act 1990.
- The major implications of the removal of exemptions will be higher inflation in the coming months, on top of the impact of recent PKR depreciation and higher petrol prices. Note that we already assume the headline CPI to average 10% in the next 12 months, without incorporating the impact of the removal of tax exemptions. Lower demand of non-essential items, as a result of higher prices, could result in moderating the current account deficit on top raising additional taxes, in our view.
- Below is a table of sectors that can be targets for a raise in GST to 17%. We present potential tax collection by the increase and the impact of industry profitability – in some cases, through lower volumes because of high price elasticity in some products (tractors, for example). Therefore, the measure will be negative for Tractor, Pharmaceutical, Dairy and Auto sectors.
- While much of farmers' input cost will be affected, we highlight that farmer income is presently at the strongest level in many years; hence, it may not be very difficult for the government to push some of these measures, in our view.

Sector	Measure	Increase in taxation	Comments
Dairy	Removal of zero rating and increase in GST	Over PKR 5bn annually	Powdered milk was moved from 10% GST to zero rating regime in the FY22 Budget while UHT/pasteurized milk went from Exempt status to Zero rated. Both of these segments will no longer be able to claim sales tax refunds if zero rating is removed. Fat filled milk products (Tea whitener, fortified milk, yoghurt, cheese and butter) can see an increase in GST (from 10% GST currently), in our view. This will negatively affect FCEPL, NESTLE, FFL, PREMA, ABOT, ICI. However, we expect most of these names to pass on the impact.
Tractor	Increase of GST to 17%	PKR 7bn	GST on tractors was last hiked by 5% and 6% in FY12 and FY14, respectively, which had led to an average 30% yoy decline in tractor volumes (GST hike of 12% proposed to 17%). However, healthy farmer income may moderate the decline in volumes to some extent, in our view. It will be Negative for MTL and AGTL.
Fertilizer	Increase GST to 17% on all fertilizers	PKR 55-60bn	Presently, the GST of all fertilizer products is 2% and an increase to 17% will lead Urea and DAP prices to rise by PKR250-260/bag and PKR1,200-1,300/bag (likely to be passed on, in our view). Neutral
Cement	Possible increase in FED by PKR25/bag	PKR 24bn	FED on cement was reduced to PKR75/bag in FY21 Budget from PKR100/bag. We have assumed local sales of c.50mn tons and higher FED by PKR25/bag. Passing it on amid slowing demand will be difficult and trim retention prices, in our view. As per news flow, the government is likely to revise GST only, which is already at 17% on cement bag; but if it plans to raise more taxes then increase in FED is a likely scenario.
Pharma	Increase GST to 17% from 0% presently	Indeterminable	Pharma companies are exempt from GST i.e. they neither claim input tax nor pay sales tax (0% rate). However, APIs are charged CD of 0-25% (additional sales tax levied on CD of 25%). A 17% GST on API imports will lead to sharp rise in costs with no pass through mechanism in place. This would ultimately squeeze margins for all companies who rely on imports (90% of the industry). We think an increase in sales tax if at all may be introduced on a limited set of surgical goods and not APIs.
Autos	GST raised to 17% from 12.5% on below 1000cc cars	PKR 8bn	GST on cars up to 1,000cc was reduced in the FY22 Budget to 12.5% from 17%, reversing – which would lead to a further increase in Economy segment cars (majorly sold by PSMC, followed by Lucky Motors with Picanto). This will potentially lead to a decline in sales growth for both companies, as prices would increase by c.4% on average for the segment. Negative for PSMC.
Petroleum	PL raised to PKR30/liter GST goes back to 17%	PKR 200bn PKR 150-160bn	Impact estimated for 2HFY22. Petroleum Levy presently at c.PKR10/liter and can increase by another PKR20/liter. GST presently 1.4%/6.7% on Mogas/HSD which will increase prices by another PKR20/liter. Volumes of HSD will slow down considerably because of higher prices. Petrol consumption is less price elastic as nearly half of it comes from motorcycles. Ultimately negative for OMC sales.
Agriculture	Increase in GST on other inputs from 5-7% to 17%	Indeterminable	These include seeds, pesticides and machineries.

Source: IMS Research

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*Based on 12 month horizon unless stated otherwise in the report.

Valuation Methodology: We use multiple valuation methodologies in arriving at a Target Price including, but not limited to, Discounted Cash Flow (DCF), Dividend Discount Model (DDM) and relative multiples based valuations.

Risks:(i) These measures will be inflationary, (ii) it can affect farmer income negatively and undermine GDP growth in FY23f, and (iii) lower tax revenue collection because of lower volumes.

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