Pakistan Strategy

31 December 2021

Mini Budget

Less negative than expected; inflationary but should help contain twin deficits

- After a few delays, the government finally presented the Mini Budget in the Parliament, the approval of which will fulfill one of the two IMF pre-conditions for resumption of the EFF Program (the other condition being amendments in the SBP Act for greater central bank autonomy). The proposed measures in the Budget will remove tax exemptions and temper hitherto concessionary rates (such as sales tax of less than the standard 17%) on various items which include imported food, plant and machinery, agricultural inputs, medical supplies and automobiles.
- Broadly the measures will be inflationary as retail prices of many consumer items will rise by at least 5%. Since many imported goods are being targeted, ultimately the measures will help contain CAD and also increase tax collection by an estimated PKR350bn (c.0.7% of GDP). The government asserts that the measures will not hurt the poor, while it has not increased tax on key farmer inputs such as fertilizers and tractors. Hence the resultant increase in public discontent for the PTI government can be moderate, in our view.
- Sectors which will be negatively affected include Automobiles and some service industries (retail in particular). There are some positive surprises too, where some negative measures anticipated by the market did not come through. Particularly, the Dairy sector remains zero-rated and GST on locally manufactured tractors remains at 5% (not increased to 17%).
- We think the initial market response to the Mini Budget will be mildly positive as its approval makes the resumption of IMF Program more likely, without much loss of political capital for the government. Apart for the Auto OEMs, it is broadly neutral for other sectors. We highlight that the market is trading close to multiyear trough levels (forward P/E of c.4.8x).

Sector	Measure	Comments
Dairy	GST raised from 10% to 17% for dairy products other than UHT and pasteurized milk GST raised on raw material for preparation of infant products	UHT/pasteurized milk has remained Zero rated which should lead to strong rebound in FCEPL stock price (having corrected on fears of zero rating reversal) - UHT segment accounts for c. 80% of its revenues. Powdered milk for tea whitener has been proposed to be moved from zero rating to 17% GST regime which will affect NESTLE, FCEPL, FFL – the impact of which is likely to be passed on to consumers. GST on other fat filled milk products (fortified milk, infant milk, yoghurt, cheese, butter, ghee) will increase from 10% to 17%, negatively affecting FCEPL, NESTLE, FFL, PREMA, and SML. However, we expect most of these names to pass on the impact. 17% GST on imported infant milk formula will prove to benefit local players such as ICI (Morinaga-Nutrico), ABOT, SEARL, IBLHL. On the flip side, GST on raw material used in infant formula at import stage will be negative. GST on import of live animals and bovine semen will negatively impact PREMA due to its substantial import volume; FCEPL, NESTLE, and FFL will be less negatively affected.
Tractor	Retention of GST at 5%	GST on tractors is maintained at 5%. This is likely to spark a rally in the sector which has underperformed recently on expectations of a hike in GST. The present demand growth momentum (up c.20% yoy in 5MFY22) is likely to sustain amid robust farmer income, in our view. We look to revisit our estimates on passage of the Bill.
Autos	FED on all cars above 1,000cc have risen by 2.5-5% Cars between 850-1,000cc are now subject to 17% GST Imported EV CBUs are now subject to 17% GST (from 5%) GST on HEVs up to 1,800cc increased to 12.5%	The measures are negative for the OEMs and contradict the recently approved Auto Policy. The increase in GST on cars between 850-1,000cc will be negative for both PSMC and LUCK (Lucky Motor Corporation), while increases in FED will lead to further price hikes and slowdown in overall demand, in our view (impact on all cars above 850cc). While an increase in FED on imported CBUs is positive for the sector, higher FED on locally manufactured double cabin pickups is negative for both INDU and GHNI.
Textile	Imposition of GST on local supplies of raw cotton	The Budget is broadly Neutral for the sector, as the cash-flow impact of higher taxes on inputs will be countered by improved refunds in the system. This, however, may encourage the industry to increase the procurement of imported cotton, in our view.
Fertilizer	GST of 2% is unchanged	The GST on all fertilizer products including Urea, DAP and others remain unchanged at 2%. An increase would have been neutral for the producers as they would have passed on the increase in prices, but it would have been negative for the farmers.

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Sector	Measure	Comments
Pharma	Increase in GST on APIs from 0% to 17% while moving from Exempt to Zero-rated status on local supplies Widespread rise in GST for pharmaceutical equipment and hospital supplies/imported equipment	Pharma companies were Exempt from GST i.e. they neither paid sales tax (0% rate) nor claimed input tax. It is proposed to raise GST to 17% on API import stage. However, Pharma companies are also moved from Exempt to Zero rated status on local supplies (following sale of final product), allowing input tax to be claimed not only on APIs but packaging and materials as well. This would result in a net positive impact for pharma companies. Import of equipment for TB, AIDS and Cancer are no longer GST exempt; this would be negative for SHFA.
IT & Telecom	17% GST on mobile phones and import of machinery Increase in taxes on phone calls, recharge and internet usage	Import of machinery for mobile-phone assembling and mobile phones (CBU) having value of US$200 and above to be imposed with 17% GST. Sale price of internet card, telephone card or phone call will increase as income tax will be raised to 15% from 8-10%. Consumption of telecom services will moderate.
Miscellaneous	Widespread increase in GST for sugar, poultry feed, seeds, lithium ion batteries, imported vegetables and several essential goods	Sugar supplied as an industrial raw material to pharmaceutical, beverage and confectionery industries will now be subject to GST Import of red chilies are no longer GST exempt which would prove beneficial for local players (NATF) Import of sunflower and canola seeds are no longer GST exempt – negative for ICI and UNITY GST raised on lithium ion phosphate batteries from 12% to 17% - negative for EXIDE, ATBA GST raised to 17% on prepared foods, sweet meats, bakeries, caterers, restaurants will prove inflationary 17% GST proposed to be imposed on several imported essential items including vegetables, poultry, eggs, contraceptives etc.

Source: IMS Research

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

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Risks:(i) These measures will be inflationary, (ii) public discontent rises ahead of elections in 2023 (iii) lower GDP growth.

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