Federal Budget FY23

A Robin Hood Budget

11 June 2022

Research Entity Number – REP-085

Executive Summary

In the last few weeks, the government has significantly reduced fuel subsidies, while passing legislation to reform state-owned entities and set up an Export-Import Bank to take over the SBP’s refinance facilities. Efforts to recapitalize two private sector banks have also accelerated. These measures are part of the structural benchmarks agreed upon with the IMF in February. The FY23 Budget is part of the same chain.

The tax collection target is a little short of the PKR7,250bn which was initially being reported in the press, but there is much common ground with the IMF. Taxation is more equitable, with new revenue measures targeting large landowners and the big corporates/retailers. The space this opens up, together with a sharp reduction in subsidies, allows the government to increase direct cash transfers to the most vulnerable, focus on development projects, and even reduce income tax for the middle class.

Some aspects will be challenging, for instance meeting the large target for petroleum levy will likely be politically difficult, but it is heartening to note the finance minister stated in his speech that the government is not afraid of taking tough decisions. There are also risks to headline macroeconomic targets (i.e. 5% GDP growth, 11.5% CPI, 2.2% CAD) but in its broad brushstrokes, the FY23 Budget is a responsible one and should satisfy the IMF in our view. This should help successfully complete the pending 7th review of the IMF programme.

Not unexpectedly, given the need for fiscal discipline, there are hardly any positives for listed corporates. Sectors such as Banks and Autos have been hurt but there is little to no impact for most sectors. In general, the Budget’s measures do not detract from the equity market’s cheap valuations, with market capitalization to GDP already near historical troughs. There are some misgivings regarding the elimination of tax credit on investment in mutual funds but any retail redemptions may be offset by a potential inflow from real estate into equities.

Positive Impact: Tractors, Technology, Pharmaceuticals, Entertainment, Textile

Neutral Impact: Cement, Steel, Fertilizer, Energy

Negative Impact: Banks, Autos, Insurance, Mutual Funds

Pakistan Market – Key Highlights

Budget Steps	Impact	Comments
CGT on listed stocks	**Positive**	Capital gains on disposal of listed equities will now be subject to a sliding scale depending on the holding period. Earlier, the CGT was 12.5% irrespective of holding period. Now, CGT will be 15% if securities are disposed within 1yr, but will reduce by 2.5ppt each year thereafter.
CGT on immoveable property	**Positive**	15% CGT on disposal of plots within 1yr; with the CGT rate to progressively reduce by 2.5ppt every year to reach 0% after 6yrs. Earlier, the CGT on disposal of plots was not applicable after a period of 4yrs and the applicable tax rate was 3-15% depending on the gain.
Value tax on immoveable property	**Positive**	For immoveable properties (other than home) worth more than PKR25mn, the deemed rent will be 5% of the fair value of those properties. The Budget seeks to tax this deemed rent at 20% (this equates to 1% of the fair value of the properties).
Poverty Alleviation Tax	**Negative**	Additional tax of 2% on annual income of more than PKR300mn. This will hurt corporate profitability by increasing the effective corporate income tax rate to 31% (ex-banks which see taxation rise to 47%). Most of the companies in our coverage easily meet the PKR300mn threshold.
No tax credit on multiple investment avenues	**Negative**	Tax credit on assorted investment avenues including mutual funds and life insurance has been removed. This may lead to redemptions. That said, the industry is likely to lobby for this tax credit to be reinstated.
Establishment of a federal pension fund	**Positive**	Government to set up a federal pension fund, initially with a PKR5-10bn outlay. This is a small amount but a step in the right direction. If this fund invests in equities, it may also encourage other state owned financial institutions to consider a higher allocation towards the market.

The Budget brings Pakistan closer to resuming the IMF programme, which is a key objective it sets out to achieve. Longer term investment in the stock market has been encouraged. While enhanced taxation in the real estate sector may lead to funds flow towards equities, the impact could be offset by the removal of tax credit on investing in mutual funds and life insurance. The setting up of a federal pension fund is a step in the right direction, although the initial amount is small. The additional taxation on the corporate sector is a price worth paying if it means achieving the targeted revenue and satisfying the IMF.

We believe the impact on corporate profitability is manageable (Banks most impacted), and it does not take away from the attractively valued KSE100. The move for more equitable taxation between real estate and other asset classes is positive. Given the low level of savings in the country, we believe there is a reasonable case for the tax credit on mutual funds and insurance to be reinstated. We retain our positive outlook on Pakistan equities.

The IMF is needed and the Budget brings agreement closer

Targeting more sustainable and inclusive growth

- Pakistan achieved 6% GDP growth in FY22, higher than target, but - similar to previous cycles – this contributed to an elevated current account deficit and a quick drawdown of Fx reserves.
- The FY23 Budget appears to be more disciplined, targeting more moderate GDP growth of 5% and a primary surplus. Taxation is more equitable and social protection has not been ignored.
- The focus is on economic stabilization first and then achieving more sustainable growth. Export-oriented sectors have been incentivized, while sectors with low productivity such as real estate have been penalized.

Commodity prices pose risks but IMF is nearer

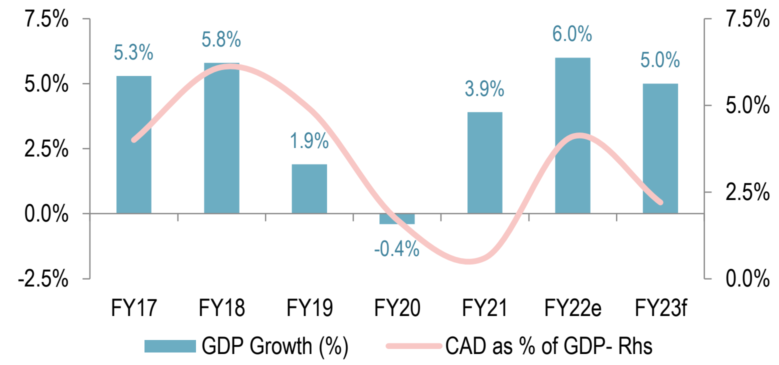
- Revenue collection is banking on higher collection from real estate, as well as a petroleum levy. The latter will be easier to implement fully if international oil prices come off (in February, a PKR30/ltr levy on fuel was agreed to but it is zero at present).
- Higher commodity prices risk FY23 headline CPI being pushed into the teens. However, with the fiscal side shouldering more of the burden, the SBP may focus on core inflation and step away from further monetary tightening (PR has nearly doubled in the last nine months to 13.75% at present).
- Risks on the external accounts highlight the need to restart the IMF programme quickly. We believe the FY23 Budget will lead to a staff-level agreement with the IMF later this month.

Key macro indicators

(%)	FY22B	FY22R	FY23B
GDP growth	5.0	6.0	5.0
- Agriculture	3.5	4.4	3.9
- Industry	6.5	7.2	7.1
- Services	4.7	6.2	5.1
CPI (YoY)	8.2	11.7	11.5
Tax to GDP	10.7	8.8	9.0
Fiscal deficit to GDP	6.3	7.1	4.9
Primary balance to GDP	-0.7	-2.4	+0.2
C/A deficit to GDP	1.7	4.1	2.2

Source: Ministry of Finance, IMS Research

High GDP growth has widened the CAD in the past



Source: MoF

Fiscal targets: From blanket subsidies to targeted relief

Tax Revenue (PKRbn)	FY22B	FY22R	FY23B	yoy	Comments
FBR Taxes (I + II)	5,829	6,000	7,004	17%	IMF reportedly wanted PKR7,250bn tax collection. Growth inline with nominal GDP
I. Direct Taxes	2,182	2,204	2,573	17%	Higher tax on real estate and large corporates/retailers, and relief to salaried class
- Income Tax	2,172	2,191	2,558	17%	Salaries up to PKR1.2mn pa are exempt, double the previous threshold.
- Others	10	13	15	17%	
II. Indirect Taxes	3,647	3,796	4,431	17%	
- Customs Duties	785	817	953	17%	Key measure is RD on imported motor spirit under China-Pakistan FTA
- Sales Tax	2,506	2,635	3,076	17%	No major new measures. Relief given to agriculture sector e.g. zero GST on tractors
- Federal Excise	356	344	402	17%	Higher FED on locally manufactured cigarettes

Non Tax Revenue (PKRbn)	FY22B	FY22R	FY23B	yoy	Comments
PTA (3G/4G Licenses)	45	100	50	-50%	
Dividends	90	70	80	14%	Potential for positive surprises from state owned entities if circular debt alleviates
SBP Profits	650	474	300	-37%	Given the higher interest rates, this number may surprise on the upside
Petroleum Levy	610	135	750	456%	Fuel subsidies are largely gone but a levy is not yet in place.
Gas Infrastructure Development Cess	130	25	210	740%	Collection was low last year due to court stay orders. This can repeat in FY23
Total	2,080	1,315	2,000	52%	Downside risks from Petroleum Levy and GIDC

Expenditure (PKRbn)	FY22B	FY22R	FY23B	yoy	Comments
Current Expenditure	7,523	8,516	8,694	2%	Higher interest payments to be offset by lower direct subsidies
- Interest Payment	3,060	3,144	3,950	26%	Impact of higher interest rates
- Pension	480	525	530	1%	
- Defence	1,370	1,480	1,523	3%	
- Grants & Transfers	1,168	1,090	1,242	14%	Higher BISP payments (direct cash handouts)
- Subsidies	682	1,515	699	-54%	Reduction driven by lower fuel subsidies and lower payments to IPPs
- Others	764	762	750	-2%	
Development Expenditure	900	550	727	32%	Lower subsidies and higher revenue targets make space for PSDP allocation
Total Expenditure	8,423	9,066	9,421	4%	Focus is on controlling current expense growth

Source: Ministry of Finance, IMS Research

Sector Impact

Sector Impact: Summary

Sectors	Impact	Top Picks
Banks	Negative	UBL, MEBL, BAFL
Autos	Negative	INDU
Information Technology	Positive	SYS
Tractors	Positive	MTL
Cement	Neutral	LUCK, MLCF
Steel	Neutral to Negative	MUGHAL
Fertilizer & Agriculture	Neutral	EFERT, FFC
Textiles & Chemicals	Neutral to Positive	ILP
Miscellaneous*	Neutral to Positive	HUMNL**, AGP

** Pharma, Packaging & Entertainment*

*** not in coverage*

Banks

Budget Impact: **Negative**

Key measures

- Tax rate on banks increased from 39% (inclusive of 4% super tax) to 47% (inclusive of 4% super tax and 2% poverty alleviation tax).
- Taxation on total income from government securities linked to ADR.
    i. if ADR < 40%, then tax rises to 55%
    ii. if ADR between 40%-50%, then tax rises to 49%
    iii. if ADR > 50%, then tax rate stays 47% as above
- Digital means required for payments made by companies amounting to more than PKR1mn. Card transactions for international payments to be subject to 1% advance tax

Analyst Comments

Banking profitability has benefited from margin expansion amidst higher interest rates. The FY23 Budget rationalizes these windfall gains. We estimate a 10-13% decline in EPS estimates and a commensurate reduction in TPs. Even so, upsides will still be 25-30%. Banks that need to increase ADR (currently c 40%) include UBL and MCB. Dividends for most banks are defendable over the medium-term, but MCB may see CAR slip below 15% after a few years if it sticks to a 70%+ payout.

Autos

Budget Impact: **Negative**

Key measures

- Advance taxes on the cars broadly increased, ramping up vehicle registration payments. Advance tax on EVs increased from 1% to 2%.
- Imposition of Capital Value Tax of 2% on vehicles over PKR5.0mn.
- Austerity measures to control the government's expenditures may result in a cut down in vehicle purchases during the year.

Analyst Comments

The budget measures impact the sector negatively. The imposition of Capital Value Tax on vehicles above PKR5.0mn is likely to be negative for INDU, HCAR, SAZEW, Hyundai and LUCK (Kia/Peugeot). Also, advance tax on cars will further slow down car purchases (largely premium segment), albeit gradually. The decline in car purchases by the government, as the finance minister alluded to in his speech, is likely to dent INDU's sales the most, in our view.

Information Technology

Budget Impact: **Positive**

Key measures

- Abolishment of 65F of income tax ordinance, to be replaced by a turnover tax of 0.25% on IT exports vs. 1.0% earlier.
- PKR17bn has been set aside to facilitate IT exports.
- FED on telecommunication services increased to 19.5% vs. 16% previously

Analyst Comments

Reduced turnover tax will increase the profitability of IT exporting companies, while the abolishment of 65F of the ITO will help companies limit their exposure to the PKR as they will be allowed to hold cash in foreign currency. Additional PKR17bn to support IT exports will help boost IT exports in FY23 and onwards. Lastly, the increased FED on telecommunication services to 19.5% in FY23 vs. 16% may hurt PTC.

Tractors

Budget Impact: **Positive**

Key measures

- Removal of sales tax on Tractors, from 5% to 0%.
- Resolution of Sales Tax refunds to the sector.
- Measures to promote agriculture production and uplift overall farmer incomes. These include exemption of sales tax on seeds, and reduction of taxes on other agricultural machinery, among others.

Analyst Comments

The removal of Sales Tax is likely to bode well for the Tractor segment, as historically, a 5-6% decline in GST led to a surge in sales by as high as c 40-60%. This will decrease tractor prices by at least c PKR60,000, and therefore boost FY23 earnings and dividend, in our view. Other measures to boost farmer income further reinforce our liking for the sector. Positive for MTL and AGTL.

Cement

Budget Impact: **Neutral**

Key measures

- National PSDP allocation is proposed to increased by c31% to PKR727bn vs. PKR555bn in FY22.
- About PKR100bn has been allocated for the construction of dams while NHA budget is also about PKR120bn.
- Increase in advance tax from 1% to 2% on purchase of immovable property.
- Tax on deemed rental income on immoveable property above PKR25mn at a rate of 1% of fair market value of said property
- WHT on REIT management services has reduced to 3% from 8% previously.
- 100% depreciation adjustment allowed on new expansion for industries

Analyst Comments

No direct incentive has been provided to the sector except for higher PSDP allocation and reduced REIT withholding taxes. This may lift cement demand, but higher taxation on real estate may have an offsetting impact. With most cement companies having already announced expansions, the 100% tax allowable depreciation expense in the first year of new expansion will provide relief to the likes of MLCF, LUCK, FCCL, KOHC and CHCC.

Steel

Budget Impact: **Neutral to Negative**

Key measures

- Federal PSDP is up c31%yoy to PKR727bn. Approximately PKR100bn will be allocated for the construction of dams and PKR118bn has been allocated to the highway authority for the construction of motorways and bridges.
- Withholding tax reduced to 0.25% in case of distributors, dealers, sub-dealers, wholesalers and retailers of cement and steel.
- Through the Bill, it is proposed to levy value addition tax @ 3% on the import of compressor scrap, motor scrap, and copper cable cutting scrap. This levy is imposable even if imported as raw material or intermediary goods by a manufacturer for in-house consumption

Analyst Comments

Increase in PSDP along with focus on construction of mega dams and infrastructure projects will help overall demand of the Steel and allied industries. However, the new taxation measures on real estate may reduce private sector construction activity. With regards to non ferrous materials, MUGHAL's copper business may be affected by the proposed VAT of 3% on compressor scrap.

Fertilizer & Agriculture

Budget Impact: **Neutral**

Key measures

- Government has allocated PKR6.0bn subsidy for imported Urea.
- PKR200bn GIDC target has been set for FY23 vs. actual payment of PKR20.0bn in FY22.
- Abolishment of CNIC/NTN condition for sale to unregistered persons.
- To ensure continuous Urea production, PKR15bn subsidy has been set a side for the fertilizer plants.
- Sales tax on seeds proposed to be abolished.
- Abolishment of Custom Duty on import of agriculture machinery.

Analyst Comments

The government has budgeted to receive about PKR200bn of outstanding GIDC. However, the sector has obtained stays from the courts and has paid nothing so far. The subsidy on imported Urea is PKR3,000/bag and the government will still sell imports on a significant premium compared to current local prices unless it subsidizes them. Abolishment of NIC/NTN requirement for the sale of fertilizer will improve the supply chain, and will help companies to claim more input tax

Textiles & Chemicals

Budget Impact: **Neutral to Positive**

Key measures

- Immediate clearance of duty drawback cliams (PKR40.5bn) and other refunds.
- Rationalization of duties on synthetic yarn and other materials
- Reduction in duties related to dyes
- Reduction of custom duty on BOPP films final products from 20%to 16% and reduction / exemption of CD & ACD on raw materials for aluminum paste and glycerol crude and glycerol

Analyst Comments

The major benefit to the Textile sector will be the clearance of DLTL to the tune of PKR40.5bn on an immediate basis. This will ease pressures on the cash flows of the sector (positive for ILP, GATM, NML). The rationalization and reduction in duties related to synthetic yarn and dyes will reduce costs. For Chemicals, the reduced CDs will help the paint industry.

Miscellaneous

Budget Impact: **Neutral to Positive**

Key measures

- To encourage local manufacturing of pharmaceuticals, customs duties have been exempted on c 30 APIs along with resolution on sales tax refunds which was made in the FY22 mini budget.
- Tax holiday for filmmakers for 10 years. Film producers and distributors get exemption of 8% withholding tax as well as import of film equipment fully exempted from custom duty & sales tax

Analyst Comments

The Pharmaceutical sector will benefit from the CD exemption on additional APIs. Additionally, the government will ensure that delayed sales tax refunds will be promptly released, which will help with the sector's liquidity.

On Entertainment, filmmakers will be gaining benefits in the form of a 10 year tax holiday and exemption of 8% withholding tax. Furthermore, production houses have the ability to import film equipment which will be fully exempted from customs duty as well as sales tax.

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Buy	Total return expectation of ≥ 15% or expected to outperform the KSE-100 index
Neutral	Total return expectation of > -5% or expected to match the return of KSE-100 index
Sell	Expected downside of more than 5% or expected to underperform the KSE-100 index

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.