Pakistan Strategy

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Pakistan
Market Strategy

Budget FY20; A long shot

Revenue mobilization target seems overly ambitious

An internal resource availability target of PKR4,902bn (up 26.9% YoY), that is built on underlying expectation of a 617% YoY increase in provincial surplus and 33.8% YoY increase in FBR tax collection, seems overly ambitious. Hence, budgeted fiscal deficit target of 7.1% of GDP for FY20 looks like a long shot. Increase in taxes on sugar, edible oil, packaged food, beverages, and construction materials raise inflation concern. Overall, budgeted economic indicators post a bleak picture, specifically inflation is estimated to stay in the range of 11-13% and economic growth is projected to slow down to 2.4% in FY20. The finance bill is negative from corporate earnings standpoint, mainly due to increase in corporate/turnover tax rates and decrease in tax credit on new investments. We don't expect the budget to drive an immediate negative response from the market. That said, market momentum in general is expected to remain sluggish due to rising cost of equity. Government's inflation estimate implies that there is room for further monetary tightening.

Revenue collection target appears too good to be true

The government has envisaged a PKR8,238bn budgetary outlay for FY20, up 38.9% from FY19 revised estimate. National Public Sector Development Program has been increased by 34.4% from FY19 revised estimates to PKR1,613bn.

Funding the aforementioned outlay is an overly ambitious internal resource availability target of PKR4,902bn (up 26.9%), that is built on underlying expectation of a 617% YoY increase in provincial surplus and 33.8% YoY increase in FBR tax collections. Hence meeting budgeted fiscal deficit target of 7.1% of GDP for FY20 looks like a long shot.

Government has budgeted a 116% increase in total external resource mobilization; the increase is on account of the Saudi Arabia oil facility, commercial bank borrowings, support from friendly countries and IMF.

Economic indicators post a bleak picture

Government has estimated GDP growth rate to slide down to 2.4% vs 3.3% in FY19r. Inflation is estimated to stay in the range of 11-13%, fuelled by increase in taxes on sugar, edible oil, packaged food, beverages, and construction materials. Where there is no explicit mention of utility tariff revisions in the budget, we expect sizable increase on this front in the coming days to flare inflation.

Fiscal balance as % of GDP is expected to improve from -7.2% (FY19 revised) to -7.1% in FY20. The aforementioned looks hard to achieve given the increasing debt servicing cost and ambitious revenue targets.

Corporate earnings and market standpoint

The finance bill is negative from corporate earnings standpoint, due to increase in corporate/turnover tax rates and decrease in tax credit on new investments.

We don't expect the budget to drive an immediate negative response from the market. That said, market momentum in general is expected to remain sluggish due to rising cost of equity. Government's inflation estimate implies further room for monetary tightening.

Budgetary position	Revised FY19	Budgeted FY20
Resources	5,062	7,899
A Internal Resources	3,659	4,716
- Net revenue receipts	2,568	3,462
- Net capital receipts	1,031	831
- Estimated provincial surplus	58	422
B External resources	1,403	3,032
C Privatization proceeds	0	150
Expenditure	6,419	8,238
I-Current expenditure on revenue	5,589	7,288
II-Development Expenditure	829	949
Bank borrowing	1,356	338

Source: Ministry of finance, Alfalah Research

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Funding the aforementioned outlay is an overly ambitious internal resource availability target of PKR4,902bn (up 26.9%), that is built on underlying expectation of a 617% YoY increase in provincial surplus and 33.8% YoY increase in FBR tax collections. Note that provincial surplus in FY19 is expected to stand at PKR58.9bn against the budgeted PKR285.6bn.

Government has budgeted a 116% increase in total external resource mobilization; the increase is on account of the Saudi Arabia oil facility, commercial bank borrowings, support from friendly countries and IMF.

Resource position

	Budgeted FY19	Revised FY19	Budgeted FY20
A) Internal resources	4,042	3,864	4,902
1) Net revenue receipts (i-ii)	3,070	2,569	3,462
(i) Gross revenue receipts	5,661	5,032	6,717
(ii)Less provincial shares in taxes	2,590	2,463	3,255
2) Total capital receipts	686	1,236	1,017
3) Estimated provincial surplus	286	59	423
B) External resources	1,118	1,403	3,032
Total resources (A+B)	5,160	5,267	7,934

Source: Ministry of finance, Alfalah Research

Government has budgeted a 33.9% increase in FBR tax collections. Direct tax collection is expected to increase by 25.5% to PKR2,082bn and indirect taxes are expected to increase by 39.4% to PKR3,473bn. Note that FBR's collections are expected to clock in at around PKR4,150bn in FY19 vs budgeted amount of PKR4,435bn. Hence meeting budgeted fiscal deficit target of 7.1% of GDP for FY20 looks like a long shot.

Net revenue receipts

	Budgeted FY19	Revised FY19	Budgeted FY20
Tax revenue	**4,889**	**4,394**	**5,822**
A. FBR taxes	**4,435**	**4,150**	**5,555**
-direct taxes	1,735	1,659	2,082
-indirect taxes	2,700	2,491	3,473
B. Other taxes	**454**	**244**	**267**
Non-tax revenue	772	638	894
Gross revenue receipts	**5,661**	**5,032**	**6,717**
Provincial share in gross revenue	2,590	2,463	3,255
Net revenue receipts	**3,070**	**2,569**	**3,462**

Source: Ministry of finance, Alfalah Research

National Public Sector Development Program has been increased by 34.4% from FY19 revised estimates to PKR1,613bn.

Development expenditure

	Budgeted FY19	Revised FY19	Budgeted FY20
Federal PSDP	800	500	701
Provincial	850	700	912
Total national PSDP	**1,650**	**1,200**	**1,613**
Dev. expenditure outside PSDP	**180**	**163**	**86**

Source: Ministry of finance, Alfalah Research

Economic indicators post a bleak picture
Government has estimated GDP growth rate to slide down to 2.4% vs 3.3% in FY19r.

Fiscal balance as % of GDP is expected to improve from -7.2% (FY19 revised) to -7.1% in FY20. The aforementioned looks hard achieve given the increasing debt servicing cost and overly ambitious revenue targets.

Inflation is estimated to stay in the range of 11-13%, fuelled by increase in taxes on sugar, edible oil, packaged food, beverages, and construction materials.

Where there is no explicit mention of utility tariff revisions in the budget, we expect sizable increase on this front in days ahead to flare inflation.

Another surprise factor that can impact inflation is the rebasing of CPI from FY08 to FY16.

Overall, the aforementioned numbers suggest that there is room for further monetary tightening, in our view.

Macroeconomic indicators 2018-22

	Budget FY19	Revised FY19	Budget FY20	FY21F	FY22F
Real GDP growth	6.2	3.3	2.4	3.0	4.5
Inflation	6.0	7.2	11-13	8.3	6.0
			(as % of GDP)		
Total revenue	16.3	14.5	16.7	18.3	19.2
-tax revenue	13.9	12.6	14.4	16.0	17.0
-FBR tax revenue	11.6	10.8	12.6	14.2	15.1
-Non-tax revenue	2.4	1.9	2.3	2.3	2.2
Total expenditure	21.2	2.7	23.8	23.4	22.8
- Current	16.5	18.3	20.2	19.7	19.0
- Development	4.7	3.4	3.6	3.7	3.8
Fiscal balance	-4.9	-7.2	-7.1	-5.1	-3.6
Revenue balance	-0.2	-3.8	-3.6	-1.4	0.2
Total public debt (Gross)	68.0	77.7	77.6	75.2	70.6
Total public debt (Net)	63.6	72.0	73.0	71.3	67.3
GDP at market prices (bn)	38,388	38,559	44,003	49,568	55,380

Source: Ministry of finance, Alfalah Research

Corporate earnings and market standpoint

The finance bill is negative from corporate earnings standpoint, due to increase in corporate and turnover tax rates and decrease in tax credit on new investments.

We don't expect the budget to drive an immediate negative response from the market.

That said, market momentum in general is expected to remain sluggish due to rising cost of equity. Government's inflation estimate implies that there is room for further monetary tightening.

Sectoral view point

Sector	Impact	Details
Banks	Negative	Increase in tax on return from government bonds, TSA
Steels	Negative	Imposition of FED of 17%
Textiles	Negative	Removal of zero rated status
Autos	Negative	Imposition of FED on locally assembled cars
Chemicals	Negative	Removal of tax credit
FMCGs	Negative	Imposition/ increase in sales tax on oil/milk/ghee
OMCs	Neutral to Negative	Increase in turnover tax
Cement	Neutral to Negative	Removal of tax credit, increase in FED by 0.5 per kg
E&Ps	Neutral	No impact
Power	Neutral	Increase in taxes on dividends from 7.5% to 15%
Fertilizer	Neutral	Corporate tax rate fixed at 29%
Pharma	Positive	Reduction of duty on raw materials

Source: Alfalah Research

Capital Markets (Negative)

- In Finance Act, 2018, the tax rate for companies was intended to be gradually reduced from 30% in tax year 2018 to 25% in tax year 2023. In Finance Bill FY20, the tax rate for companies has been fixed at 29% in order to recover and maintain the tax base to ensure revenue for the government. In addition to this, the government has maintained super tax of 3% & 4% for non-banking and banking companies respectively.

- Tax credit (10% of plant & machinery) that was allowed on new investments is reduced to 5% from 10% and the exemption period is also narrowed down to Jun-19 from FY21. However, industrial undertakings which have already claimed this tax credit but could not fully adjust the credit against tax payable would still be entitled to carry forward the unabsorbed available credit of prior years.

- Presently, 25% of depreciation allowance on buildings is claimed in its first year, which is inconsistent with the total life of the building, hence this is proposed to be withdrawn.

- The present tax rate of 7.5% on dividend received on shares of a company set up for power generation or on shares of a company supplying coal exclusively to power generation projects is being increased to 15%. Furthermore, tax rate of dividend is being charged at 25% for persons receiving dividend from companies which enjoy exemption of tax on income or where no tax is payable due to availability of tax credits or due to brought forward business or depreciation losses.

- Presently the rate of tax on dividends received by a person from a mutual fund is 10% and 12.5%. Persons receiving dividend from stock fund is also taxed at 12.5%. Furthermore, dividend received by a person from a development REIT scheme is reduced by 50% of the normal rate. Now all these rates are being enhanced to 15%. Moreover, 15% of withholding tax on dividend is being applied for persons receiving income.

- Presently minimum tax on turnover is charged at the rate of 1.25% of the turnover if taxable income is less than 1.25% of turnover. Certain sectors have reduced rate of minimum tax @ 0.2%, 0.25% & 0.5% of turnover. The aforesaid rates of minimum tax are being enhanced from 1.25% to 1.5%, from 0.20% to 0.25%, from 0.25% to 0.3% and from 0.5% to 0.75% respectively.

Banks (Negative)

- Currently banks are claiming deductions on provisions classified as both “doubtful” and “loss”. As per Budget FY20, deductions of provisions only classified under the “loss” category will be allowed. We deem this to be slightly negative for the sector.

- Profit from government securities as is in excess of twenty percent of total profit before tax is being proposed to be taxed separately at the rate of 37.5%.

- Introduction of Treasury Single Account will result in outflow of deposits that the government previously held with commercial banks. This will be negative for banks particularly those that have high government deposits such as NBP.

- Exclusion of brought forward depreciation and business losses for calculation of super tax will have a mildly negative earnings impact for the sector.

Cements (Neutral to Negative)

- Tax credit (10% of plant & machinery) that was allowed on new investments is reduced to 5% from 10% and the exemption period is also narrowed down to Jun-19 from FY21. However, industrial undertakings which have already claimed this tax credit but could not fully adjust the credit against tax payable would still be entitled to carry forward the unabsorbed available credit of prior years.

- The PSDP for 2019-20 is allocated at PKR1,613bn, which is 34% higher than FY19 revised estimate, and hence positive for the sector.

- It is proposed to increase FED on cement from PKR1.5 per kg to PKR2 per kg. However, cement players might be able to pass on the impact of increase in FED (in case of restoration of marketing arrangement).

Fertilizers (Neutral)

- PKR218bn have been allocated over five years for the development of water infrastructure. In addition to this, PKR44.8bn has been assigned for increasing productivity of rice, wheat, cotton and sugarcane. Moreover, livestock initiatives of PKR5.6bn for small and medium farmers have been taken along with the crop loan insurance for small farmers allocated at PKR2.5bn.

Chemical (Negative)

- Tax credit (10% of plant & machinery) that was allowed on new investments is reduced to 5% from 10% and the exemption period is also narrowed down to Jun-19 from FY21. Since EPCL's plant is expected to come online in CY21, this measure by the government would hurt EPCL's profitability.

Autos (Negative)

- Through Finance Supplementary (Second Amendment) Act, 2019, FED on locally manufactured/ assembled cars of 1700cc and above was introduced at 10%. Now, in order to rationalize this levy, it is proposed to enlarge the scope of FED by imposing FED at 2.5% on vehicles up to 1000cc, 5% on 1001cc to 2000cc vehicles and 7.5% on above 2000cc on locally manufactured or assembled motor vehicles.

- 2% extra tax on auto parts and tyres/tubes has been withdrawn in the Budget 2019-20.

Steel (Negative)

- Special Regime of taxation for steel sector is being abolished, Sales tax on billets, ingots, bars, ship plates and other long profiles may be exempted at manufacturing and import stage, and in lieu thereof FED at 17% in sales tax mode may be imposed for the reason that there is no exemption of FED in tribal areas.

Oil and Gas (Neutral to Negative)

- 3% VAT is payable on all commercial imports. One of the exclusions from this levy is available to those petroleum products imported by oil marketing companies, whose prices are regulated. This exclusion does not cover furnace oil, which is being proposed now.

- Since the deregulation of CNG prices by OGRA, CNG prices have risen but the government has not changed tax rates for the CNG dealers which are being changed for Region 1 from PKR64.8/kg to PKR74.04/kg and for Region II from PKR57.69/kg to PKR69.57/kg.

- Presently, FED is payable at PKR17.18 per 100 cubic meters for LNG. In budget 2019-20, it is proposed to increase FED on LNG from PKR17.18 per 100 cu. m to PKR10 per MMBTU (same level as for local gas). Moreover, 5% custom duty is to be levied on LNG import which was previously exempt from such duties.

- Moreover, exemption of custom duty on import of plant and machinery has been proposed for the companies who set up hydrocracker plants for oil refining.

- Changing final tax regime into minimum tax regime for commercial importers, commercial suppliers of goods, contractors, and persons deriving brokerage or commission income and persons earnings from CNG stations. The tax collected or deducted from the aforesaid persons shall now be treated as minimum tax liability except for exporters, persons winning prizes and sellers of petroleum products. This measure is designed as a first step for gradual phasing out of the final tax regime and transition to income based taxation for all persons.

Textiles (Negative)

- Zero-rating for the textile sector has been abolished due to the fact that zero-rating has created loopholes and the benefit is being availed by unintended beneficiaries/non-exporters. In this regard, huge misuse of SRO on import of fabric and processed fabrics has been reported. To streamline and prevent revenue leakage, SRO 1125 is being withdrawn. Hence, it is proposed to restore standard rate of 17% on items covered under the said SRO. Moreover, duty on elastomeric yarn is to be exempted.

Power (Neutral)

- The present tax rate of 7.5% on dividend received on shares of a company set up for power generation or on shares of a company supplying coal exclusively to power generation projects is being increased to 15%.

Paper (Positive)

- The government has withdrawn custom duty on basic raw material for paper production (wood pulp and paper scrap) in budget 19-20. In addition to this, duty on different paper types is reduced to 16% from previous 20%.

Pharmaceutical (Positive)

- 3% custom duty slashed for 18 medical input items and on medicines for certain rare diseases.

Miscellaneous

- Presently Sugar is subject to sales tax of 8%. In Budget 19-20, it is proposed that the sales tax rate on sugar may be enhanced to 17%.

- It is proposed that the non-aerated packaged sugary drinks, such as juices, syrups and squashes may be subjected to FED at 5% of retail price.

- FED on cigarettes is levied on fixed rate basis (4,500/1,000 stick). It is now proposed to enhance the rates and redefine the thresholds by abolishing the third tier introduced earlier. Tax slabs on cigarettes have been reduced to two with upper slab taxed at PKR 5,200/1000 sticks and lower slab at PKR 1,650/1,000 sticks.

- In order to restore normal tax regime, in addition to measures included in the Finance Bill, the following notifications providing for PKR1/kg and PKR0.40 per kg rates are proposed to be withdrawn. Accordingly, it is proposed to increase rate of FED to 17% on edible oils/ghee/cooking oil.

- Presently, the sales tax regime on various forms of milk is uneven. Milk and cream, concentrated, and unsweetened/unflavoured is subject to a higher rate while sweetened milk is enjoying exemption. It is proposed to rationalize the same. Both the categories are now proposed to be taxed at 10%.

- In view of the undocumented nature of food sector (restaurant/bakeries/caterers) and very low input tax for adjustment because of exempted food related inputs such as meat, vegetables, flour etc, there is disincentive to pay sales tax at 17%. In order to encourage compliance, it is proposed to reduce the sales tax rate from 17% to 7.5% against which input tax adjustment will not be allowed.

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