

Pakistan Economy

FY24 Budget Preview: A fiscal conundrum

Govt. is set to announce crucial budget for FY24 on 9th June which will provide some clarity on stakeholder's plan on how to bring back the country on the right track in current uncertain times. The country has been facing multiple crises since last 12-15 months, due to devastating floods in Jul/Aug last year and deteriorating position of external accounts, which was further exacerbated by tug of war in political arena. This budget is very significant in current context, as economy is in shambles with all time high inflation and elections are scheduled in Oct'23 which might influence the govt. to announce a populist budget in order to gain public support.

News flows and commentary by finance ministry officials suggests that resumption of current IMF program seems unlikely as the program is expected to conclude in Jun'23 and three reviews are still pending with not much time in hand. Given the massive burden of external payments in next couple of years, we believe that the country will have to enter into another IMF program along with more strict policy actions on structural reforms.

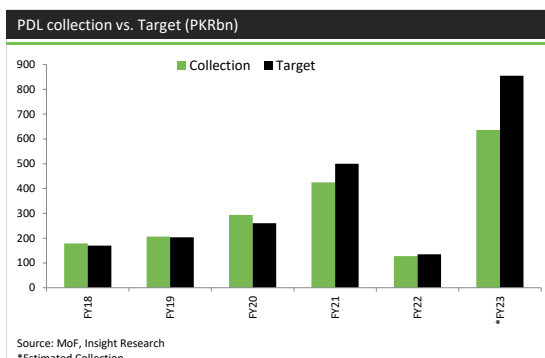
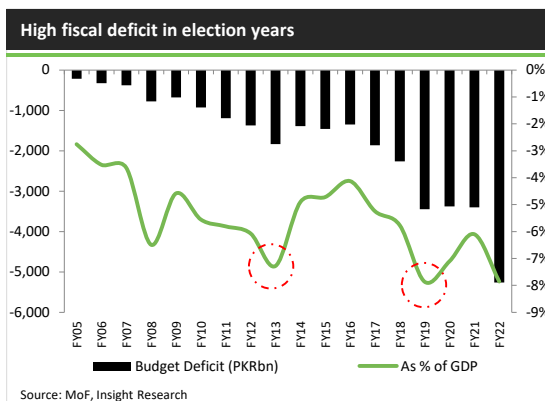
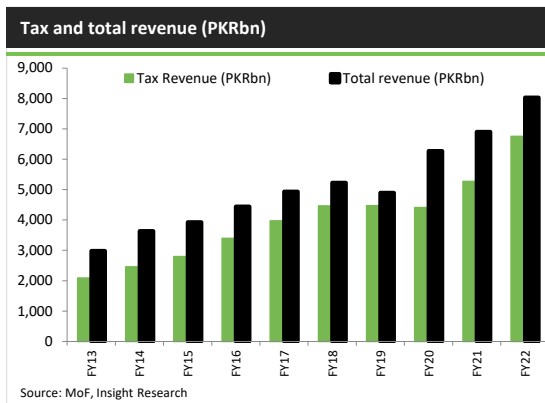
Maintaining a delicate balance between much needed reforms along with restoring economic growth and providing relief to common people in high inflationary environment will remain a key concern for stakeholders.

We expect the upcoming budget to remain neutral for capital market as investors will look forward towards Govt's efforts to address long term structural issues and generating additional revenues without burdening the already documented sector with additional tax measures.

The market is currently trading at a steep discount to its historical average and clarity on economic/political front holds the key for market performance. We continue to advocate for companies having quality earnings, dollarized revenue stream and stable cashflows, while any positive development on energy sectors reforms will catalyze stocks having exposure to circular debt. Our top picks are MARI, FFC, EFERT, LUCK, MLCF, ACPL, ILP, SYS and APL.

Optimistic tax collection target of over PKR9tr

As per news flows, Govt is expected to set a revenue collection target of PKR9.2tr in upcoming budget against the target of PKR7.5tr in FY23, up by ~23% YoY. The target seems highly optimistic as economic slowdown and restriction on imports have severely dented the collection in 11MFY23, where tax authorities have reported a shortfall of PKR430bn in 11MFY23 despite high inflationary environment; averaging at ~29% in period under review. To note, tax collection in 11MFY23 stands at ~PKR6.2tr vs. target of PKR6.6tr. We expect the govt to impose additional taxes on industries to bridge the gap between budgeted and actual tax collection. Furthermore, authorities can also enhance the tax on wealthy individuals and provide cash handouts to lower segment of the society. In addition, Govt can also restore sales tax on petroleum products, which will result in additional collection of ~PKR757bn



(assuming GST @18% and price of PKR280/ltr, incl. GST). Continuation of current PDL on petroleum products will also enhance non-tax revenue by ~PKR253bn. Having said that, we believe revenue collection target heavily relies on resumption of economic activity which is witnessing massive slowdown due to demand destruction on the back of high inflationary environment and import restrictions.

Markup payments crowding out other expenditures

The steep rise in interest rate in last 1.5 years coupled with higher borrowing needs have resulted in surge in markup expenses. To highlight, interest payment for the 9MFY23 clocked in at ~PKR3.5tr vs. PKR2.1tr in SPLY, up by 69% YoY. Markup expense for FY23 is expected to record at ~PKR5tr, while it is estimated to exceed PKR7tr in FY24, which is over 80% of tax collection target. The huge rise in interest payment will eat up significant portion of government's available resources resulting in lower allocation to essential sectors like health, education etc. As per news reports, federal PSDP target for next fiscal year is likely to set at PKR950bn, however, actual realization can be lower than the target as govt can divert these funds to other heads.

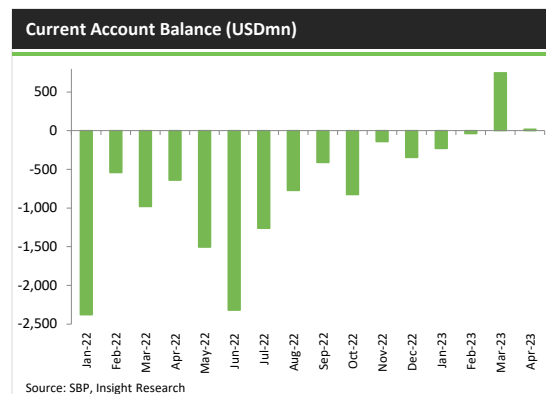
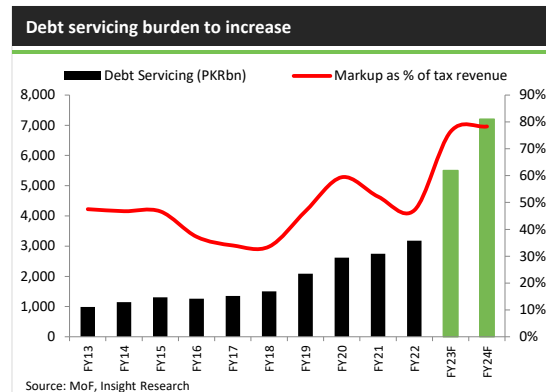
Government is likely to target fiscal deficit of ~6.5% of GDP in FY24 budget, which is driven by higher expenditures. Management of fiscal slippages in election year will remain a key concern for authorities as any unfunded expenditure will widen the financing gap and can also bring the wrath of IMF. Previously, we have seen that fiscal deficit as % to GDP has remained high in election years due to weak fiscal management, however, we believe that the current setup doesn't have that sort of luxury.

Resumption of IMF program is vital for external accounts

Given the huge debt repayment in next couple of years, bridging of external gap holds utmost importance. The current IMF program is set to expire in Jun'23 and it seems that the program will end without further disbursement. However, FY24 budget will provide more clarity on Govt's strategy on managing external crisis as strict (IMF compliant) budget will provide much needed confidence to market, however, any harsh measure to secure short term gains will spoil the party and will damage investor confidence. Current account deficit for FY23 is expected to clock at ~US\$3.5-4.0bn vs. US\$17.4bn in FY22, down by ~78%. The reduction in CAD is primarily due to restricted imports, which clocked in at ~PKR45.2bn in 10MFY23 vs. PKR58.7bn in SPLY. Given the massive slowdown in the economy and acute forex reserves, we believe that Govt. will continue to monitor imports to maintain sustainable CAD while simultaneously revive economic growth. However, fresh financing from multilateral institutions, flows from friendly countries and rollovers are essential for the country.

Inflationary pressure to ease, however upside risk looms

Headline inflation in 11MFY23 has clocked in at ~29% vs. ~11% in SPLY, the increase in inflation is primarily attributable to higher food prices, supply chain constraints, PKR devaluation and rationalization of energy tariffs. As per our estimates, CPI has peaked in May'23 where it was recorded at ~38%. We expect headline inflation to start receding from Jun'23 primarily due to high



base effect. According to news reports, Govt. is targeting inflation to average at ~21% in FY24. However, PKR devaluation and supply side challenges can result in higher inflation. As per our estimates, headline inflation is likely to average ~22.9% in FY24 vs. 29.3% in FY23.

Key taxation measures

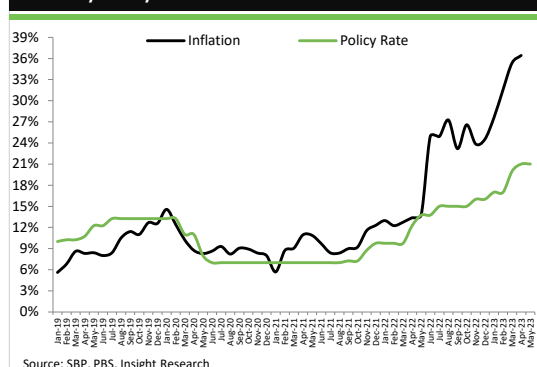
- **Tax on reserves/bonus shares:** As per media reports, FBR has recommended a 5% tax on bonus shares. If the said proposal becomes part of FY24 budget, this can induce corporates to issue healthy bonus shares in current fiscal year to avoid taxation. Earlier, RRMC proposed tax on undistributed profits of the company. However, as per news flows, the proposal is not under consideration.
- **Super tax to continue:** Given the huge tax collection target, Govt. can opt to continue levying super tax of 10% on FY24 profits.
- **Taxation of Wholesaler/Dealers/Distributors & Retailors:** RRMC has recommended taxation regime for wholesalers and distributors which will help in documentation of the economy and will have a positive impact on revenue front.
- **Imposition of wealth tax:** As per news reports, Govt. is considering imposition of wealth tax/Income support levy on all assets including agriculture. As per Govt. officials, this can fetch PKR25bn to PKR200bn.
- **GST on petroleum product:** Govt. can restore GST on petroleum products to increase revenue collection.
- **Rationalization of tax regime for commercial importers and contractors:** It is recommended to increase the rate of tax under section 148 for commercial imports from 5.5% to 8% and 3.5% to 5.5% in case of commercial importers.
- **Shifting of exporters from FTR to MTR:** FTR of exporters should also be converted into MTR. Tax credit regime may be reduced to lower tax incidence, however, abolishment of FTR is necessary to improve documentation.
- **Higher taxes on non-filers:** To increase the tax base, Govt. can enhance the rate of taxes for non-filers.

Sector wise proposals

Banks

- **Alignment of corporate tax rate:** PBA has proposed reduction in corporate tax rate to 29%, inline with other sectors. We believe that, this proposal is unlikely to go through as banks are earning healthy profits on the back of higher return on federal government securities.
- **Higher tax on income from government securities:** The steep rise in policy rate and higher borrowing by the government have resulted in lucrative profits for the banking sector. Authorities can impose tax on income from government securities to improve tax collection.

Economy: Policy rate vs. Inflation



KSE100 - Index performance pre and post budget

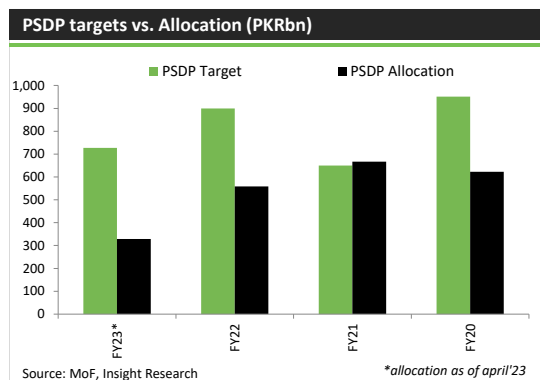
Pre - Budget			Post - Budget		
3M	1M	1W	1W	1M	3M
-3.8%	-2.0%	1.7%	Jun-22	0.3%	-0.4%
10.3%	6.9%	0.2%	Jun-21	-0.1%	-1.8%
-4.0%	2.7%	0.8%	Jun-20	-3.4%	5.8%
-11.0%	-0.2%	-2.4%	Jun-19	0.1%	-2.3%
2.2%	0.0%	0.6%	Apr-18	-2.2%	-7.5%
					-4.4%

Source: Zakheera, Insight research

- **Withholding tax on cash withdrawal:** Imposition of WHT on cash withdrawals can't be ruled out. However, this might hurt documentation drive as people will try avoid official channels.

Construction

- **Increase in PSDP:** Government likely to set PSDP target of PKR1.1tr (incl. PKR150bn under Public Private Partnership) for FY24 vs. PKR727bn in FY23. To highlight, in 10MYF23, PKR609bn has been authorized, whereas, actual expenditure clocked in at PKR374bn till Apr'23. We believe due to fiscal constraints, the actual allocation of PSDP for FY24 would be much lower.
- **FED to continue:** In mini budget of Feb'23, GoP increased the FED on cement from PKR1.5/kg to PKR2/kg. where it has been proposed to take it back to PKR1.5/kg. However, given the tight fiscal space, FED would remain unchanged.
- **Reduction of minimum tax rate:** It is proposed to abolish minimum tax or reduced it to 0.25% from 1.25% for steel manufacturers to provide some relief in time of economic turmoil.
- **Reduction in WHT:** The proposal suggests reducing the WHT tax to 0.25% on scrap supplies from non-registered scrap dealers until LC restriction is resolved.
- **Cash purchase from non-registered dealers:** It is also proposed to allow cash purchases from non-registered scrap dealers until the issue of LC is resolved.
- **Exemption for FATA/PATA:** PALSP proposed to discontinue the tax exemption for the FATA / PATA region. We believe that this proposal will likely to be passed as this will avoid tax collection losses and protect the formal steel industry which will bode well for long steel players.



E&Ps and oil marketing companies

- **Reduction in minimum tax:** OCAC has proposed a reduction in the minimum tax rate applicable to OMCs and refineries from 0.5% to 0.25%. This will allow the OMCs to maintain their profitability in fixed margins regime. However, we expect this minimum tax rate to remain same in the budget.
- **Subsidy to gas sector:** As per news flows, Government has allocated PKR76bn for gas sector subsidy against the demand of PKR230bn from Ministry of Energy. This suggests that the government is considering an increase in gas prices, as they have not allocated the necessary subsidies to meet the demand.
- **Tariff differential subsidy:** As per proposal of PPEPCA, E&P companies have sought a grant of PKR500bn for tariff differential subsidy, which would help alleviate the accumulated revenue shortfall faced by Sui gas companies. This will mainly improve the cash position of OGDC & PPL. However, chances of this proposal being approved are very thin.

Fertilizer

- **Accumulated sales tax refunds and subsidy receivables:** Fertilizer industry has been encountering a significant obstacle in the retrieval of pending subsidy and sales tax receivables from the government. As per latest available data, industry's subsidy receivable stood at ~PKR18.5bn, whereas,

	Sales tax Refunds	Gross Subsidy Receivables	Total (PKR bn)
EFERT	12.20	6.52	18.72
FFC	18.42	6.96	25.38
FFBL	16.80	3.16	19.96
FATIMA	10.48	1.84	12.32
Industry Total	57.90	18.48	76.39

Source: Company Accounts, Insight Research

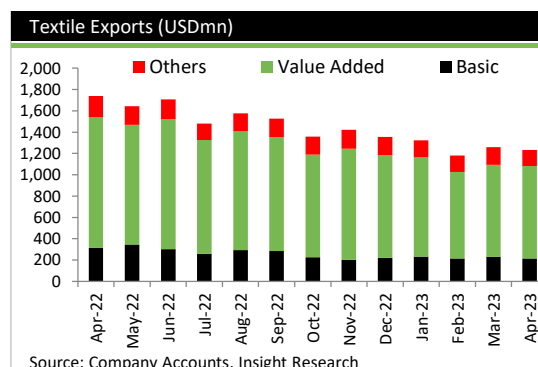
* As per latest available data

sales tax refunds worth ~PKR58bn are also unsettled. Fertilizer industry has proposed to release the said amounts to improve their cash flows.

- Anomaly in sales tax:** In federal budget 2022-23 sales tax on fertilizer was removed by government to stop piling up of sales tax refunds due to mismatch between input and output sales tax. After the decision, accumulation of sales tax stopped and input tax became part of cost for fertilizer companies. Following the cost escalation, burden was transferred to urea prices, however, DAP prices were not increased amid import parity-based pricing which created an anomaly for FFBL (local producer) and importers as sales tax was abolished from DAP imports and 5% sales tax on phosphoric acid became part of cost for FFBL. As per FFBL's management, company has proposed a level playing field in upcoming budget either by exempting FFBL from input sales tax or by imposing sales tax on imported DAP.
- Steps to support farmers:** Following Kissan package, government is likely to allocate resources for quality seeds, latest machinery and agriculture research. Similarly, allocations for complete conversion of agriculture tube wells to solar energy is also proposed. Furthermore, it is also proposed to keep lucrative support prices on key commodities and reduce cost burden by providing direct subsidies on fertilizers, seeds and necessary equipment.

Textile

- Tax on exchange gain:** RRMC has proposed to levy taxes on exchange gains for exporters who fail to repatriate proceeds within a specified period. Considering the existing ruling that pertains to imposing liens on delayed payments, the proposal by RRMC would compound the burden on export players.
- Reduction in financing rate to tackle liquidity issues:** In an effort to address the liquidity crunch faced by the textile sector, APTMA has suggested several measures. These include restoration of zero-rating status for the textile sector, refunding deferred sales tax, enhancing LTFF (Long Term Financing Facility) and EFS (Export Finance Scheme) credit limits and lowering markup rates.
- Rationalization of energy tariffs:** APTMA has also proposed for the revival of regional competitive energy tariffs in order to ensure the competitiveness of the textile sector in Punjab. Furthermore, APTMA has proposed to address the existing disparity in gas prices and availability between the export players in the north and south regions.



Refunds from GoP (PKRmn)

Companies	FY20	FY21	FY22
GATM	2,804	4,087	3,352
ILP	2,408	4,329	4,225
NML	3,490	4,617	9,298
NCL	1,436	1,525	1,328
Total	10,139	14,558	18,203

Source: Company Accounts, Insight research

Automobile assemblers

- Increase in advance income tax on non-filers:** Pakistan Business council (PBC) has proposed to increase the existing advance income tax on purchase of cars by non-filers based on different engine capacities as shown in the table.
- Imposition of tax based on value:** There are proposals to implement the advance tax and WHT based on the value of vehicles. Currently, these taxes are charged on the basis of engine capacity.

Proposed Increase in Advance income tax (PKR'000)

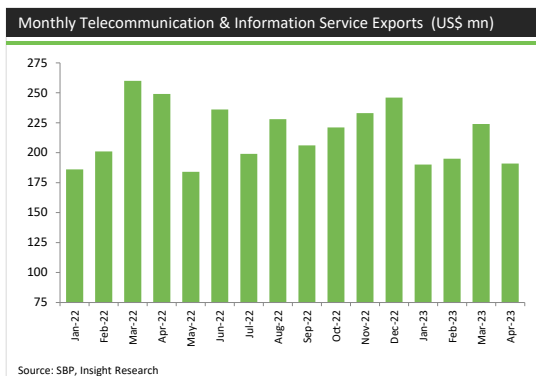
Engine Capacity	Current	Proposed	Increase
1800-2000cc	600	2,000	1,400
2001-2500cc	900	2,500	1,600
2501-3000cc	1,200	3,000	1,800
Above 3000cc	1,500	4,000	2,500

Source: PBC, Insight research

- **Reduction in FED:** OICCI has proposed to reduce the FED on locally manufactured vehicles. However, possibility of this proposal being accepted is very low.
- **Additional tax on selling before registration:** The PBC has also proposed to raise the advance income tax to PKR2.4mn (previously PKR1.2mn) for non-filers when selling vehicles (above 2,000cc engine) before registration. The objective is to discourage the prevalent "Own-money" culture by imposing a higher tax burden.

Information and Technology

- **TELCOM sector burdened with WHT:** OICCI has proposed government to abolish withholding tax on mobile services in the country. They have also proposed to abolish advance tax on auction/renewal of licenses of TELCO spectrums. Furthermore, TELCO operators also demanded 5G policy in the country which shall include free spectrum for the first five years with zero taxes on the import of equipment & 5G handsets/device and policy intervention to ban 2G/3G phones locally produced as well as imported.
- **Easing duties on mobile phones:** Mobile Phones Traders Association has given recommendations to reduce duties on mobile phones which currently ranges between 100%-150% for small and large mobiles imposed previously with an aim to generate PKR85bn. However, only PKR5-10bn were generated. The reduction in duties will significantly increase affordability of users and improve revenue generation for government.
- **Reward IT sector to improve export potential:** Pakistan Software Houses Association (PASHA) has asked government to eliminate 0.25% tax on exports earnings in upcoming budget to improve inflows of FOREX in Pakistan. The association has also proposed a 5% cash reward on IT exports to encourage reaching the \$5 billion export target by 2025. Similarly, they have also appealed gov't to revive Export Refinance Facility (ERF) for the IT sector at a 50% discount, development of special IT zones in the country and 100% forex retention permission in the banks.



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Frequently Used Acronyms

TP	Target Price	DCF	Discounted Cash Flows	FCF	Free Cash Flows
FCFE	Free Cash Flows to Equity	FCFF	Free Cash Flows to Firm	DDM	Dividend Discount Model
SOTP	Sum of the Parts	P/E	Price to Earnings ratio	P/Bv	Price to Book ratio
P/S	Price to Sales	EVA	Economic Valued Added	BVPS	Book Value per Share
EPS	Earnings per Share	DPS	Dividend per Share	DY	Dividend Yield
ROE	Return on Equity	ROA	Return on Assets	CAGR	Compounded Annual Growth Rate

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