



IMF review: Focusing on reforms

AKD Research

research@akdsecurities.net

UAN: 9221-111-253-111



AKD Securities Limited

Summary

- ❑ IMF in its latest detailed assessment on Pakistan following disbursement of US\$499mn (that took c. disbursement under the program to 32.7% of US\$6bn program), lays emphasis on fiscal and power sector reforms (release of circular debt payment under the agreed MoUs, notification of FY20 Q4 quarterly adjustment and FY21 annual rebasing).
- ❑ At the same time, the report underlined the need for calibrated approach in achieving reforms so as to keep economic recovery unperturbed. We believe the same could potentially result in revision in FBR revenue estimates (FY22: PkR5.96trn, +26.8%YoY compared to revised FY21 est. of PkR4.7trn) later during the period. Full implementation of TSA-1 by May'21 is also made part of fiscal reforms, work on which has already been initiated.
- ❑ Moreover, the staff has concurred current monetary stance, indicating interest rates may remain stable until economic recovery becomes more entrenched while any increase would be gradual as to achieve mildly positive real rates.
- ❑ The report also acknowledged Govt.'s progress for meeting compliance with FATF's remaining 3 item points (24 already complied) stating it to be in advanced stages with completion deadline before next review in Jun'21.
- ❑ The IMF authorities have also altered disbursement schedule which, dependent upon success of the sixth review, would unlock US\$1bn flows in Jun'21 and should support recent appreciation in PkR (+~9.0% from its low of ~PkR168). To highlight, IMF staff projects US\$3.4bn funding surplus in FY22.
- ❑ From market's vantage, IMF's keen interest on autonomy of regulatory bodies (SBP act, NEPRA act, OGRA act etc.) should resolve structural issues particularly in energy chain keeping power-related stocks and OMCs (PSO) in limelight whereas continued US\$ flows (SBP recently received US\$2.5bn Eurobond payment) and consequent PkR appreciation could gather interest in Cements, Steel (already reeling from stronger demand) and Autos.
- ❑ That said, potential tax measures in the upcoming budget remain a key headwind in the near term.

IMF - All focus on fiscal side

- ❑ IMF has estimated FBR revenue collection for FY22 at PkR5.96trn (+26.8%YoY against revised FY21 target of PkR4.7trn) driven by ambitious tax policy reforms planned by the Govt. of about 0.7% of GDP (or PkR364bn based on FY22 GDP).
- ❑ The tax collection target is underpinned by GST reforms, entailing elimination of exemption/preferential treatment on sales tax and increasing tax burden progressively on personal income. Regarding the former, cumulative sales tax exemptions currently stands at PkR519bn of which majority is related to, i) zero-rating on POL imports (PkR38bn), ii) exemption on pharmaceutical products, cotton and other major food items related imports (c. PkR231bn), and iii) reduced rates of tax on fertilizer and sugar (c. PkR98bn).
- ❑ The tax reforms have already been initiated with the authorities reducing income tax exemptions recently in order to generate ~PkR140bn.
- ❑ It is pertinent to highlight that the FBR revenue requirement is not part of the indicative target and provides room for the authorities to revise down projection later in the year. Floor on FBR revenues (part of indicative target) is set to increase by 17.0%YoY in 1HFY22. Moreover, primary deficit is expected at 0.4% of GDP in FY22.
- ❑ The authorities have also set timeline for full implementation of TSA-1 by May'21, on which progress has already been made with the Govt. instructing for closure of certain GoP department accounts with commercial Banks.

Sales Tax Exemptions	
Zero rating under 5th Schedule (after adjustment)	13.6
Exemption on Imports	255.8
Pharma products	65.2
Cotton	54.4
Vegetable Oil	43.2
Milk cream and butter dairies	40.4
Exemption on local supplies	54.9
Cotton	25
Reduced rates	171.3
Fertilizer	74
Sugar	24.1
Mobile phones	23.1
Total Sales Tax Exemptions	518.7

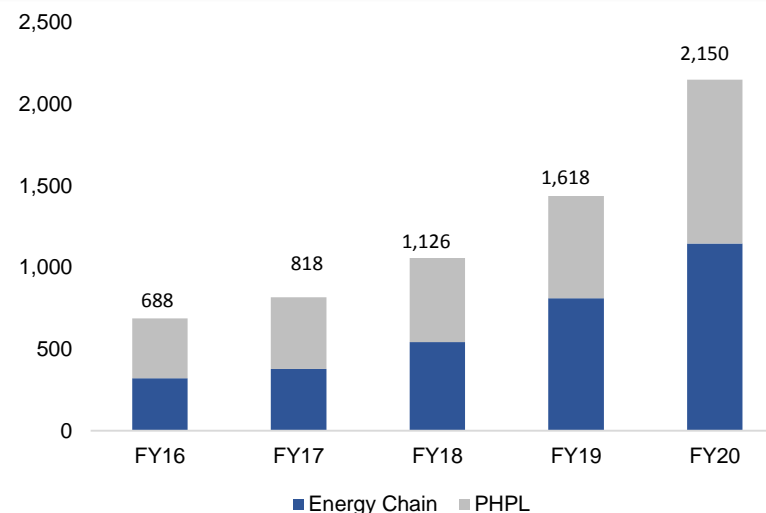
Source: AKD Research & FBR



IMF – Much focus on Power Sector reforms

- ❑ Reform discussions continue to emphasize on committing to a detailed action plan with regards to decline in circular debt accumulation in the power sector, which stood at 5.2% of GDP at end FY20. Broad policy measures in this regard include:
 - I. Agreeing to a clear timeline for outstanding power price adjustments. In this regard, base tariff was increased by PkR1.95/KWh in Jan'21, with PkR1.39/KWh hike expected in Jun'21.
 - II. Quarterly adjustments of PKR1.63/KWh for 2Q and 3Q FY20 have already been notified. The 4QFY20 and 1QFY21 adjustments are expected to fall in Sep'21 and Apr'21, respectively.
 - III. The NEPRA Act amendment ordinance issued in Mar'21 will ensure automaticity of quarterly tariff adjustments.
 - IV. The authorities are also expected to reduce power subsidies by reassessing and improving targeting of these subsidies to the most vulnerable, while improving efficiency and fairness of the system.
 - V. Authorities plan to reduce circular debt stock parked in PHPL through privatization proceeds of power sector assets, while committing to a 10 year plan to gradually absorb costly PHPL debt into cheaper central government debt.
- ❑ IMF also acknowledged government's efforts in renegotiating PPAs with 45 IPPs in efforts to reduce capacity payments in years to follow, two-fifth of the arrears or approximately PkR180bn to be paid in May'21, with the second installment to follow in Aug'21.

Circular debt (PkRbn)



Source: NEPRA & KD Research

Details of MoUs inked in Aug'20

2002

Sharing of power efficiency for oil fired plants from 30-60%

O&M savings will be shared 50:50 for oil fired plants

LPS lowered to 2% from 4.5%

ROE changed to 17% in PkR terms (USD/PKR of 145)

Take and Pay

1994

Existing capacity payments shall be reduced by 11%

Indexations w.r.t exchange rate and inflation to be discontinued for 50% of the reduced component

Possibility of termination of existing plants

Source: News Reports & AKD Research



Quantitative performance criteria

(Cumulative flow since the beginning of the year, unless otherwise indicated)	FY 2020/21						FY 2021/22	
	End-September			End-December	End-March	End-June	End-September	End-December
	Program (IT)	Adjusted Prog.	Actual	Actual Est.	Proposed (PC)	Proposed (PC)	Proposed (IT)	Proposed (IT)
	Performance Criteria							
Floor on net international reserves of the SBP (US\$m)	(8,841)	(15,047)	(10,966)	(8,528)	(10,238)	(8,676)	(8,518)	(7,677)
Ceiling on net domestic assets of the SBP (stock, PkRbn)	8,529	9,406	9,080	8,897	9,655	10,173	9,947	10,190
Ceiling on SBP's stock of net foreign currency swaps/forward position (negative, US\$m)	7,305	...	5,778	4,610	5,200	5,200	4,900	4,600
Ceiling on general government primary budget deficit (cum. Exc. grants, PkRbn)	(58)	(311)	(253)	(420)	(230)	246	(130)	(96)
Ceiling on net government budgetary borrowing from the SBP (PkRbn, stock)	7,187	...	6,089	5,885	6,908	6,618	6,333	6,049
Ceiling on the amount of government guarantees (PkRbn, stock)	1,922	...	2,843	2,826	2,715	2,715	2,735	2,765
	Continuous Performance Criteria							
Zero new flow of SBP's credit to general government	0	...	0	0	0	0	0	0
Zero ceiling on accumulation of external public payment arrears by the general government	0	...	0	0	0	0	0	0
	Indicative Targets							
Cumulative floor on Targeted Cash Transfers Spending (BISP) – PkRbn	41	...	14	67	114	199	48	102
Cumulative floor on general government budgetary health and education spending (PkRbn)	121	...	289	580	975	1,567	356	752
Floor on net tax revenues collected by the FBR (PkRbn)	1,324	...	1,011	2,210	3,394	4,691	1,181	2,585
Ceiling on net accumulation of tax refund arrears (PkRbn)	(133)	...	39	65	65	65	0	0
Ceiling on power sector payment arrears (cumulative flow, PkRbn)	27	...	102	152	319	354	(166)	(154)
The gross issuance of PIBs, Sukuks, and Eurobonds (cumulative flow, PkRbn)	n.a.	n.a.	1,268	1,986	-	-	-	-

IT= Indicative Target, PC=Performance criteria

Source: AKD Research, Pakistani authorities; and Fund staff estimates.

Structural Benchmarks

Actions		Rationale
Prior Actions		
1	Adoption by parliament of a CIT reform in consultation with IMF staff to simplify the tax system and meet program targets.	Critical to ensure achievement of program fiscal objectives.
2	Submission to parliament of the amendments to the State Bank of Pakistan Act in consultation with IMF staff.	Critical to ensure SBP independence.
3	Adoption by parliament of amendments to the NEPRA Act.	Critical to ensure tariff automacity.
4	Electricity prices: Implementation of the first-stage of the FY 2021 annual rebasing (AR) of 1.95 PRs/kWh and notification of the FY 2020 Q2 and Q3 quarterly tariff adjustments (QTAs) of 1.62 PRs/kWh; accompanied by first energy subsidy reform steps aimed at reducing the regressive nature of the tariff structure.	Critical to stem flow of power sector arrears.
5	Approval by the Cabinet of an updated Circular Debt Management Plan (CDMP) in line with international partners' advice.	Critical to bring down power sector arrears.

Structural Benchmarks	Date	Revised Date	Status	
Fiscal				
1	Commit to not grant further tax amnesties	Continuous	Not met.	
2	Avoid the practice of issuing new preferential tax treatments or exemptions.	Continuous	Not met.	
3	Presentation of the federal government mid-year budget review report to the National Assembly in line with the PFM Act.	End-Feb. 2020	Met.	
Monetary/Financial				
4	Adopt measures to strengthen the effectiveness of the AML/CFT framework to support the country's efforts to exit the Financial Action Task Force list of jurisdictions with serious deficiencies.	End-Jun. 2020	End – Jun. 2021	Not met. Advanced stage.
5	Improve towards a substantial level the effectiveness in addressing terrorism financing consistent with FATF Immediate Outcomes 9 and 10.	End-Mar. 2020		Not met. Advanced stage, to be implemented with SB #4.
6	Submit to parliament, in consultation with IMF staff, amendments to the State Bank of Pakistan Act to address all recommendations of the new 2019 Safeguards Assessment Report and the 2016 Technical Assistance Report on Central Bank Law Reform.	End-Mar. 2020		Not met. Proposed as PA #2.

Source: AKD Research, Pakistani authorities; and Fund staff estimates.

Structural Benchmarks (cont..)

		Actions		
State-Owned Enterprises		Date	Revised Date	Status
7	Submit to parliament amendments to the NEPRA Act to (i) give the regulator the power to determine and notify quarterly tariffs; (ii) ensure timely submissions of quarterly and annual petitions by the DISCOs; (iii) eliminate the gap between the regular annual tariff determination and notification by the government; and (iv) reinstate the power of the government to levy surcharges over and above the system's revenue requirements under the NEPRA Act	End-Dec. 2019		Not met. Submitted in January 2020
8	Notification of FY 2020 Q2 electricity tariff adjustment for capacity payments.	End-Jan. 2020		Not met. Proposed as PA #4.
9	Conduct and publish new audits by reputable international auditors of Pakistan International Airlines (PIA) and Pakistan Steel Mills (PSM).	End-Dec. 2019		Not met. PIA and PSM audits published in January and July 2020, respectively.
10	Conduct a triage of all SOEs, dividing them into companies to (i) maintain under state management; (ii) privatize; or (iii) liquidate.	End-Sep. 2020		Not met. Published in March 2021
11	Submit to parliament a new State-Owned Enterprise law to improve governance and transparency in line with IMF recommendations.	End-Sep. 2020		Not met. Submitted in March 2021
Social Protection and Gender				
12	Finalize the update of the BISP beneficiaries' database (National Socio-Economic Registry).	End-Jun. 2020	End-Jun. 2021	Not met. In progress.
New Structural Benchmarks				
1	Minister of Finance will establish and make functional the TSA-1.	End-May 2021		
2	Reintroduce and roll out the track-and-trace systems for tobacco products.	End-Jun. 2021		
3	Publication of awarded Covid-spending related contracts and beneficial ownership information of bidding and awarded legal persons in a centralized and publicly accessible website.	End-Apr. 2021		
4	Auditor General of Pakistan will conduct an ex-post audit of the procurement of urgently needed medical supplies related to Covid-19. Audits results will be published on the website of the Ministry of Finance.	End-Apr. 2021		
5	Reduction in CPPA-G payables to power producers through a payment up to PkR180bn with no more than 1/3 in cash and the remainder in debt instruments.	End-May 2021		
6	Completion of the FY 2021 annual rebasing (AR).	Jun. 1, 2021		
7	Finalization of the energy cross-subsidy reform for the FY 2022 budget.	End-Jun. 2021		
8	Notification of FY 2020 Q4 electricity tariff adjustment for capacity payments.	End-Sep. 2021		
9	Adoption by parliament of amendments to the OGRA Act.	End-Jun. 2021		
10	Conduct and publish external audit of the Utility Stores Corporation (USC) based on FY 2020 financials.	End-Apr. 2021		
11	Establish a robust asset declaration system with a focus on high-level public officials.	End-Jun. 2021		

Source: AKD Research, Pakistani authorities; and Fund staff estimates.

Our view - Funding flows to keep PkR strong

- ❑ IMF under the revised disbursement schedule is set to release ~US\$1bn by Jun'21 following completion of sixth review which, along with materialization of bilateral/multilateral flows (+9.7%YoY in 8MFY21, 60.3% of budgeted external flows are yet to be recorded) and continued inflows under RDA, should strengthen the case of further PkR appreciation in the near term (~9.0% appreciated from low of PkR168/USD).
- ❑ The RDA has attracted US\$800mn within six months of inception. Given ever increasing awareness of the RDA within the diaspora, we expect this number to reach an astounding US\$3bn by Dec'21.
- ❑ Total net funding surplus as per our estimates is expected at US\$2.5-3.5bn in the near term which is also consistent with IMF estimates.
- ❑ Our estimates assume current account deficit to stand at US\$1.7bn/4.7bn in FY21/22F following uptick in global commodity prices (TRJ Index +11.3% CYTD; 5% increase in key commodity prices increases full year import bill by US\$1.2bn, with oil contributing ~US\$0.5bn) and potential increase in imports particularly those related under TERF arrangements (US\$3bn).
- ❑ However, the same is expected to be balanced by workers' remittances sustaining high ground, benefiting from reopening of global economies and shift in channeling of remittances particularly by blue collar workforce to persist in the longer run.

Program timeline		
Availability Date	Amount of Purchase	
	SDRs mn	Percent of Quota
3-Jul-19	716	35
6-Dec-19	328	16
5-Mar-21	350	17
4-Jun-21	750	37
3-Sep-21	491	24
3-Dec-21	491	24
4-Mar-22	491	24
2-Sep-22	651	32
Total	4,268	210

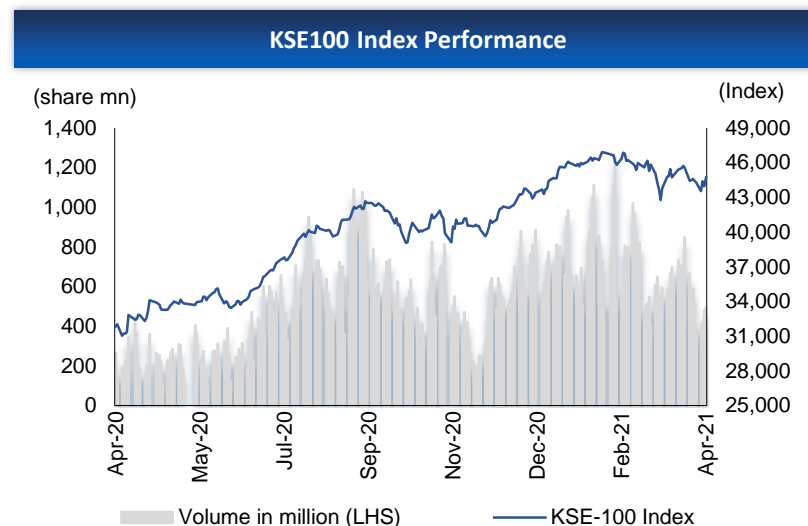
Source: IMF & AKD Research

Funding table				
(US\$m)	FY20	FY21F	FY22F	FY23F
Gross External Financing Requirements	21,879	27,013	23,643	28,016
Current account deficit	2,970	4,154	5,419	6,527
Repayment	18,164	21,819	17,156	20,370
Public Sector	12,800	17,760	14,088	15,671
IMF Repurchases	745	1,040	1,068	1,119
Available Financing	23,955	27,600	24,939	28,304
Disbursement	20,863	25,370	22,190	24,650
From private creditors	11,129	7,519	11,460	13,258
From official creditors (non-IMF)	9,734	17,850	10,730	11,392
Rollover of short-term debt	12,641	8,642	9,439	9,966
Financing surplus exc. IMF	2,076	587	1,296	288
Disbursement from IMF	2,825	1,594	2,146	954
Financing surplus	4,901	2,181	3,442	1,242

Source: IMF & AKD Research

Investment perspective

- ❑ While increase in taxes could act as a dampener, we believe structural improvements recommended are only going to improve confidence in the overall economic recovery.
- ❑ Moreover, a clear plan has been provided for resolution of current outstanding stock of circular debt which is expected to bring back the energy chain (IPPs, PSO, OGDC, PPL) into limelight, particularly after recent events clouded the outlook for disbursement of first tranche (deadline set at May'21).
- ❑ On the flip side, increase in electricity and gas tariff has been recommended which will have broader impact in the shape of inflation while energy intensive sectors like Cement, Steel will also feel significant impact. However, increase in rates is expected to be gradual and in-line with economic recovery and can potentially provide cushion to cyclicals.
- ❑ All in all, we continue to advocate for positions in Construction and Allied sectors (continuation of subsidized financing along with materialization of projects registered under amnesty scheme) and energy chain (IPPS, PSO – on resolution of circular and prospective increase in tariff).
- ❑ In terms of valuations, market continues to remain cheap with undemanding P/E and P/B of 6.5x and 0.79x, respectively which should continue enticing investors.



Source: PSX & AKD Research

Disclosure Section

Neither the information nor any opinion expressed herein constitutes an offer or a solicitation of an offer to transact in any securities or other financial instrument and is for the personal information of the recipient containing general information only. AKD Securities Limited (hereinafter referred as AKDS) is not soliciting any action based upon it. This report is not intended to provide personal investment advice nor does it provide individually tailored investment advice. This report does not take into account the specific investment objectives, financial situation/financial circumstances and the particular needs of any specific person. Investors should seek financial advice regarding the appropriateness of investing in financial instruments and implementing investment strategies discussed or recommended in this report and should understand that statements regarding future prospects may not be realized. AKDS recommends that investors independently evaluate particular investments and strategies and it encourages investors to seek the advice of a financial advisor.

The appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives. The securities or strategies discussed in this report may not be suitable for all investors, and certain investors may not be eligible to purchase or participate in some or all of them.

Reports prepared by AKDS research personnel are based on public information. AKDS makes every effort to use reliable, comprehensive information, but we make no representation that it is accurate or complete. Facts and views presented in this report have not been reviewed by and may not reflect information known to professionals in other business areas of AKDS including investment banking personnel. AKDS has established information barriers between certain business groups maintaining complete independence of this research report.

This report has been prepared independently of any issuer of securities mentioned herein and not in connection with any proposed offering of securities or as agent of any issuer of any securities. Neither AKDS, nor any of its affiliates or their research analysts have any authority whatsoever to make any representation or warranty on behalf of the issuer(s). AKDS Research Policy prohibits research personnel from disclosing a recommendation, investment rating, or investment thesis for review by an issuer prior to the publication of a research report containing such rating, recommendation or investment thesis.

We have taken all reasonable care to ensure that the information contained herein is accurate, up to date, and complies with all prevailing Pakistani legislations. However, no liability can be accepted for any errors or omissions, or for any loss resulting from the use of the information provided as any data and research material provided ahead of an investment decision are for information purposes only. We shall not be liable for any errors in the provision of this information, or for any actions taken in reliance thereon. We reserve the right to amend, alter, or withdraw any of the information contained in these pages at any time and without notice. No liability is accepted for such changes.

Stock Ratings

Investors should carefully read the definitions of all ratings used in each research report. In addition, research reports contain information carrying the analyst's view and investors should carefully read the entire research report and not infer its contents from the rating ascribed by the analyst. In any case, ratings or research should not be used or relied upon as investment advice. An investor's decision to buy, sell or hold a stock should depend on individual circumstances and other considerations. AKDS uses a three tier rating system: i) Buy, ii) Neutral and iii) Sell with total returns (capital upside + dividend yield) benchmarked against the expected one year forward floating (variable) risk free rate (10yr PIB) plus risk premium.

Valuation Methodology

To arrive at our period end target prices, AKDS uses different valuation techniques including:

- Discounted Cash Flow (DCF, DDM)
- Relative Valuation (P/E, P/B, P/S etc.)
- Equity & Asset return based methodologies (EVA, Residual Income etc.)

Analyst Certification of Independence

The analysts hereby certify that their views about the companies and their securities discussed in this report are accurately expressed and that they have not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report.

The research analysts, strategists or research associates principally having received compensation responsible for the preparation of this AKDS research report based upon various factors including quality of research, investor client feedback, stock picking, competitive factors and firm revenues.

Disclosure of Interest Area

AKDS and the authoring analyst do not have any interest in any companies recommended in this research report irrespective of the fact that AKD Securities Limited may have, within the last three years, served as manager or co-manager of a public offering of securities for, or currently may make a primary market in issues of, any or all of the entities mentioned in this report or may be providing, or have provided within the previous 12 months, significant advice or investment services in relation to the investment concerned or a related investment.

Regional Disclosures (Outside Pakistan)

The information provided in this report and the report itself is not intended for distribution to, or use by, any person or entity in any jurisdiction or country where such distribution or use would be contrary to law or regulation or which would subject AKDS or its affiliates to any registration or licensing requirements within such jurisdiction or country.

Furthermore, all copyrights, patents, intellectual and other property in the information contained in this report are held by AKDS. No rights of any kind are licensed or assigned or shall otherwise pass to persons accessing this information. You may print copies of the report or information contained within herein for your own private non-commercial use only, provided that you do not change any copyright, trade mark or other proprietary notices. All other copying, reproducing, transmitting, distributing or displaying of material in this report (by any means and in whole or in part) is prohibited.

For the United States

Compliance Notice.

This research report prepared by AKD Securities Limited is distributed in the United States to Major US Institutional Investors (as defined in Rule 15a-6 under the Securities Exchange Act of 1934, as amended) only by Decker & Co, LLC, a broker-dealer registered in the US (registered under Section 15 of Securities Exchange Act of 1934, as amended). All responsibility for the distribution of this report by Decker & Co, LLC in the US shall be borne by Decker & Co, LLC. All resulting transactions by a US person or entity should be effected through a registered broker-dealer in the US. This report is not directed at you if AKD Securities Limited or Decker & Co, LLC is prohibited or restricted by any legislation or regulation in any jurisdiction from making it available to you. You should satisfy yourself before reading it that Decker & Co, LLC and AKD Securities Limited are permitted to provide research material concerning investment to you under relevant applicable legislations and regulations.

New Rating Definitions

Buy	> 14.5% expected total return (Rf: 8.5% + Rp: 6%)
Neutral	> 8.5% to < 14.5% expected total return
Sell	< 8.5% expected total return (Rf: 8.5%)

