

Pakistan Funds

PGF & PIF; conversion scheme offers an opportunity

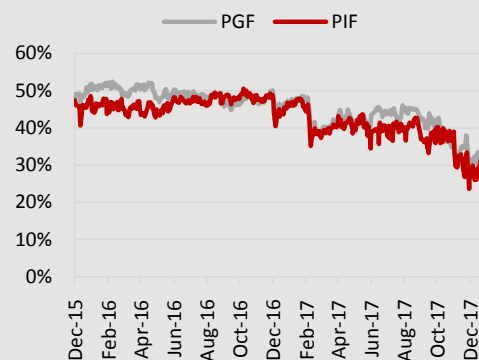
Friday, January 12, 2018

| PGF Performance | | | |
|-------------------|-----|-----|-----|
| | 3M | 6M | 12M |
| Absolute % | 17% | 9% | 9% |
| Relative to KSE % | 11% | 13% | 21% |

Source: BMA Research

| PIF Performance | | | |
|-------------------|-----|-----|-----|
| | 3M | 6M | 12M |
| Absolute % | 12% | -1% | 2% |
| Relative to KSE % | 6% | 3% | 14% |

Historical discount to NAV



Source: BMA Research

- HBL Asset Management Limited (HBLAML) has informed the exchange that the company has gained approval from the board of directors for conversion of PICIC Growth Fund (PGF) and PICIC Investment Funds (PIF) into open end schemes.
- This should pave the way for conversion of ~PKR16.8bn of closed-end scheme's assets into open-end over the next 3-6 months and represents a potential arbitrage opportunity for investors as close-end schemes tend to trade below their Net Asset Values (NAV).
- However, this conversion is not all simple and straightforward as these funds contain a 'Frozen assets' category containing ~22mn and ~12mn shares of SNGP and PSO on which govt. has imposed trading restrictions.
- To work around this problem, HBLAML would issue two categories of shares; Category 'A' & Category 'B' where Category 'A' shares would continue to be a closed end scheme for all practical purposes until lifting of restrictions by govt. on assets of 'Frozen' portfolio.
- We have carried out scenario analysis and calculated a range of values for PGF and PIF post successful conversion and estimate a potential upside in the range of 5%-13% and 12%-21%, respectively.

Potential arbitrage opportunity in the offering: As per a notice sent to the exchange by HBL Asset Management Limited (HBLAML), the company has gained approval from the Board of Directors (BoD) in last EOGM for conversion of PICIC Growth Fund (PGF) (PKR12.6bn) and PICIC Investment Funds (PIF) (PKR4.2bn) into open-end schemes from closed-end schemes. After conversion, PGF and PIF will be renamed to HBL Growth Fund (HGF) and HBL Investment Fund (HIF), respectively. This represents a potential arbitrage opportunity for investors as close-end schemes tend to trade below their Net Asset Values (NAV). To highlight, in the past two years, PGF and PIF have traded at an average discount of 45% and 43% respectively, to their NAVs. The entire process of getting approvals from investors, SECP and Pakistan Stock Exchange (PSX) is likely to take around 3-6 months. During this time period, the market price of PGF and PIF should converge to their respective NAVs, in our view. Just to highlight, both PGF and PIF are currently trading at a 30% discount to their NAVs.

Conversion to open end scheme is complicated due to govt. restrictions...: While conversion from closed-end scheme to open-end scheme should in theory be simple and straight forward, however, this particular transaction won't be simple due to a caveat. PICIC Asset Management Company, the company that used to manage these funds before HBLAML, acquired these funds from the govt. under a privatization deal under which shares of two State Owned Enterprises (SOEs), 21.8mn shares of Pakistan State Oil (PSO) and 12.4mn shares of Sui Northern Gas Pipelines Limited (SNGP), cumulatively held in PGF and PIF were placed in a 'Frozen portfolio'. The manager of these funds is forbidden by the govt. of Pakistan from selling or transferring these shares until notification from the govt.

...However, HBLAML has found a way around: In order to work around this, HBLAML has decided on issuing two separate classes of shares in the new open end schemes of HGF and HIF; Category A and Category B. Category A shares would contain the frozen assets portion of PGF and PIF, whereas, category B would contain the unfrozen assets portion of the fund. Category A shares will continue to remain to be a closed-end scheme for all practical purposes until the govt. lifts restriction on sale of shares in PSO and SNGP, while the category B shares would be an open-end scheme where investors can redeem their investment at the published NAV. New investors that wish to invest in the newly created open-end schemes would be allocated Category 'C' shares.

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Potential range of values post conversion: We have carried out scenario analysis and calculated a range of values for HGF and HIF post successful conversion. Since Category A shares of both HGF and HIF would be frozen, its value would continue to mimic that of a closed end scheme. Thus, we estimate that Category A shares of HGF and HIF would trade at a discount to their respective NAVs in the range of 51%-25% (avg. 44%). On the other hand, Category B shares would converge to their NAV. Therefore, any investor that buys one share of PGF and/or PIF today, would see his investment rise to the sum of (i) NAV of Category B shares less back-end load (10%, 5% and 0% on redemption within 6 months, 12 months and after 12 months of conversion to open end), and (ii) post conversion market price of Category A shares that would continue to trade at a discount to NAV. In the table below we have calculated a range of possible values post conversion of the funds after deducting back-end load. For Category 'A' shares of both HGF and HIF, a discount to NAV of 44% has been assumed (in-line with historical avg.), whereas for value of Category 'B' shares, three potential values have been calculated assuming timeline of cash conversion (before 6 months, before 12 months and after 12 months).

Sensitivity of Return to Back-end Load

| HGF Possible range of values | | | | HIF Possible range of values | | | |
|------------------------------|-------------|-------------|-------------|------------------------------|-------------|-------------|-------------|
| PKR/sh | 10% | 5% | 0% | PKR/sh | 10% | 5% | 0% |
| HGF 'A' (Price) | 11.2 | 11.2 | 11.2 | HIF 'A' (Price) | 3.8 | 3.8 | 3.8 |
| HGF 'B' (NAV) | 22.0 | 23.2 | 24.5 | HIF 'B' (NAV) | 11.4 | 12.0 | 12.7 |
| Total | 33.2 | 34.4 | 35.6 | Total | 15.2 | 15.8 | 16.4 |

Source: Company Reports, PSX , MUFAP, BMA Research

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| | |
|--------------|------------------------------|
| Buy | >20% expected total return |
| Neutral | 0%-20% expected total return |
| Underperform | <0% expected total return |

*Total stock return = capital gain + dividend yield

Old rating system

| | |
|--------------|--|
| Overweight | Total stock return > expected market return + 2% |
| Marketweight | Expected market return \pm 2% |
| Underweight | Total stock return < expected market return - 2% |

Valuation Methodology

To arrive at our period end target prices, BMA Capital uses different valuation methodologies including

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