

In Focus

Capital Markets

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Strategy: The thirst for liquidity

- KSE100 closed the year at 7162 points, marking 42% decline for FY09 on the back unprecedented global challenges, domestic macro environment instability, fragile political environment and regulatory interventions
- Nonetheless, while current share prices appear to have discounted in the negatives, we believe the market is yet to price in recent developments such as display of political maturity by the democratic setup and decisive military action in the Northern region
- Based on long term sustainable ROE of 18.5%, equity risk premium of 6% and Jun10 PIB yield target of 9.5%, we project FY10-end Gordon Growth KSE100 to be at 9500; representing 33% upside from current levels
- However our hypothesis for re-rating will largely be dependent on expected triggers such as introduction of leverage tools, continued monetary easing and progress on security situation
- We expect the SBP to cut the discount rate by 350 bps to 10.5% by the end of FY10; downside risk to our discount rate projections will be stability in the price for crude oil at around USD65/barrel and materialization of external assistance
- At current levels we stay **OVERWEIGHT** on Oil & Gas Exploration, IPPs, OMCs and Cement sectors with our top picks are OGDC, PSO, HUBC, LUCK and DGKC

Fiscal Year 2008-09 can easily be regarded as one of the most challenging years that Pakistan has ever witnessed. Exogenous shocks such as commodity price escalation and the global financial crisis, coupled with domestic political and economic challenges, led Pakistan to the verge of default on its foreign debt obligations. Moreover, parched foreign investment, falling reserves, depreciating local currency and burgeoning external deficits forced the government to seek IMF economic assistance. As part of conditionalities imposed by the IMF, the State Bank was forced to increase the benchmark Discount Rate by 200bps to 15%.

LSM sector woes were exacerbated by a worsening energy crisis and rising cost of production (energy and imported raw material). For equity markets, the most significant blow came in the form of regulatory intervention such as imposition of floor on stock prices on Aug 27, 2008 for a period of 100 days – leading to a major deterioration in investor confidence and raising question marks on the integrity of Pakistan's capital markets.

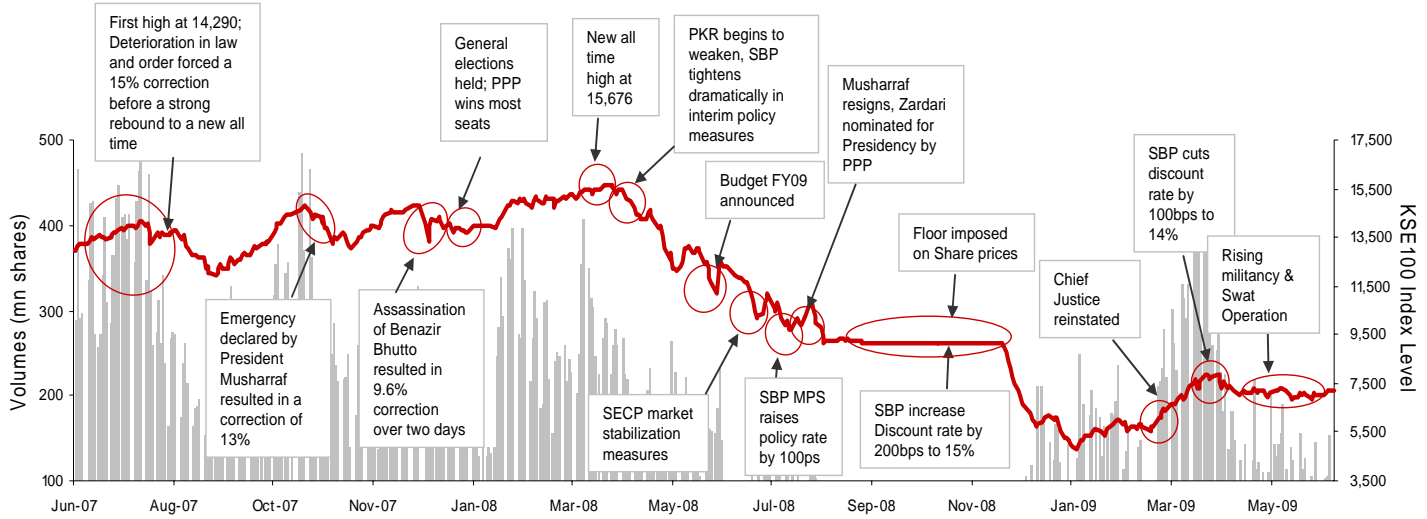
Resultantly, the KSE100 which had already fallen by a massive 25% (3,078 points) underwent massive selling pressure as the floor was lifted in December, 2008. While fresh investment and enticing dividend yields did result in a significant re-tracement of prices in most of the blue chip companies – the index finally closed the year at 7162 points, down 42%!

However, it would be unfair not to highlight some of the major developments/milestones achieved over the outgoing fiscal year – the most notable being the narrowing of differences between Pakistan's largest two political parties. As a result, the coalition government strengthened and showed commendable maturity in resolving long standing issues such as the restoration of deposed judiciary. Moreover,

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the democratic setup also allowed the government to take decisive action against growing militancy in the country and initiated a large scale operation in the Northern region. This strategy has not only drawn mass public (and media) support but is also deeply appreciated by US and other Western allies. As a result, Pakistan has received commitments of over USD5.3bn in support by Friends of Democratic Pakistan (FODP) to be disbursed over the next 2 years and USD 1.5bn per year assistance by the US over the next 5 years.

KSE100 and Key Events



Source: BMA Research

The Worst is behind us: Re-rating on the Cards

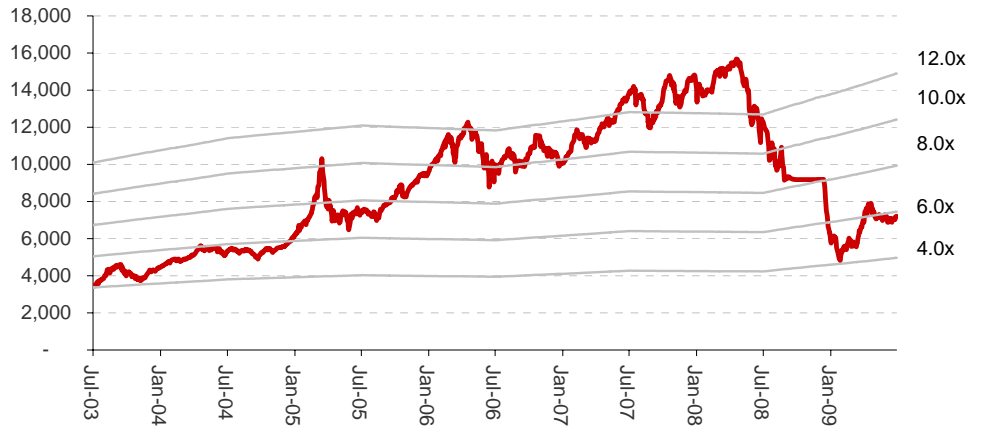
With FY08 having presented the country with more than its fair share of challenges, the consensus is that the worst of political and economic turmoil is over. We nonetheless remain cautiously optimistic and continue to follow the news-flow in the Northern region. Encouragingly, security forces have been achieving significant success against the militants with the government claiming the operation to be in its final stages. We see a resolution of the crisis to be a major signal for the return of foreign investment and improvement in local sentiment.

Nevertheless with the current valuations still near their historic troughs, we believe that the security situation has been more than discounted in the share prices. Moreover, the recent equity market rally abroad has pushed Pakistan's regional valuation discount to over 55% (from an historic average of 35%)!

Hence with dividend yields and multiples being too enticing to overlook, we expect the market to re-rate to reflect the recent positive developments. The magnitude and timeline for the re-rating will however be largely dependent on 1) extent of monetary easing, 2) inter-bank market liquidity and 3) re-introduction of effective leverage tools.

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KSE100 12-month Forward PER Bands



Source: BMA Research

Monetary easing: Targeting Discount Rate at 13.0% in Jul09 and 10.5% by Jun10

After the first discount rate cut in Apr09, the tight monetary stance has well and truly come to an end. However expectations of a single digit policy rate by the end of FY10 are premature and optimistic to say the least. Though inflation is expected to come down to single digits by the end of 1QFY10 (courtesy the high base effect); the sustainability of these numbers is open to debate. With an increase in petrol prices imminent (PKR5.0 increase equals a direct 1.3% increase in CPI) and the IMF calling for an increase in the power tariff through elimination of tariff differential subsidy, inflationary pressures are expected to re-emerge during 2QFY10.

The government has targeted average CPI for FY10E at 9.5% and international crude oil prices will be instrumental in determining whether this target is achievable. While current prices of around USD70/barrel will enable continued macroeconomic stability, a rally towards USD90/barrel will re-ignite the inflationary and balance of payments problems that plagued the country in FY08.

Hence while we project continued monetary easing, the main risk to further discount rate cuts is the re-emergence of inflationary pressures, while the absence or presence of inter-bank liquidity will determine how effective the accommodative monetary stance will be in generating economic growth. We believe that under the auspices of the IMF and continued structural vulnerabilities to international price movements, the SBP will remain cautious with regards to the discount rate and make a maximum cut of 100bps in Jul09. Given the general slowdown, especially in the industrial sector, we expect the SBP to cut the discount rate by 350 bps to 10.5% by the end of FY10. Downside risk to our discount rate projections will be stability in the price for crude oil at around USD65/barrel and materialization of external assistance.

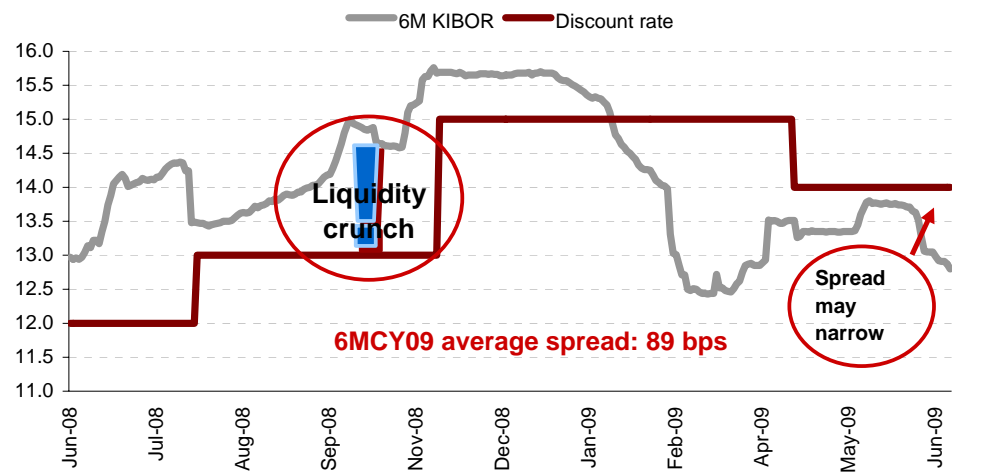
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Liquidity: Key to the Promised Land

If slippages on the fiscal front force extraordinary public sector borrowing (FY10E NSS Target: PKR241bn) and foreign assistance from the FODP does not materialize; then the demand for dollars (payment for diesel and refined products to be handed over to inter-bank market by Aug09) and deteriorating liquidity profile of banks (current ADR: 78.2%) will keep upward pressure on inter-bank and auction rates. Already the government has announced a PKR325.0bn T-bill auction target against maturities of PKR180.8bn and the resultant liquidity drain of PKR144.2bn may likely make KIBOR downward sticky during 1QFY10.

In this scenario the importance of the policy rate will be diminished as the spread between market and official rates narrows towards insignificance. As long as liquidity remains constrained, lending rates will not come off in line with the SBP's accommodative stance. The inflow of dollars and budgetary discipline will be the necessary pre-requisites for a successful monetary and fiscal stimulus.

Spread between inter-bank and policy rate FY09



Source: BMA Research

Leverage: The much awaited

The panic that gripped the market in 1HFY09 resulted in numerous actions by the regulatory bodies. By virtue of off-market transactions and government support funds, leveraged players were bailed out at discounted prices while existing products (CFS and future contracts) were withdrawn.

However with the KSE100 bottoming at 4,815 in Jan09, large scale investment was witnessed in fundamentally sound companies as fresh funds flew into the capital markets. This resulted in a sharp recovery of 64% off the index lows up to CY09 high of 7,902 in April, 2009. However absence of leverage in the market and continued reluctance of the banking sector to provide margin financing, has largely capped the upside. Trading volumes which averaged over 240mn shares in FY08 shrunk to 119mn shares during May09-June09.

Needless to say that with most institutions and long-term investors largely invested, restoration of leveraging tools will be imperative for the market to re-rate to higher

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multiples. Current discussions amongst the stakeholders (SECP, KSE and broker community) indicate the likelihood of introduction of Deliverable Future Contracts by the end of Jul09.

Way Forward: Targeting KSE100 at 9500 by Jun10

While KSE100 closed shy of our earlier stated FY09 end target of 8000-8400, the index did manage to touch these levels on intra-day basis. With economic cycle targeting benchmark Discount Rate at 10.5% and 10-year PIB to be at 9.5% by June end, we project our FY10 end Gordon Growth KSE100 target at 9500 – employing long term ROE at 18.5%, corporate retention rate at 40% and equity risk premium at 6%.

All the Same: Cherry Picking is the Key!

With the macro situation, energy deficit and consumer sentiment still far from comfortable levels; we highlight the increasing need to focus on fundamentally sound sectors and limit exposure to companies with pricing power, low leverage, sustainable cash flows, bottom line growth and quality corporate governance. As such, we stay OVERWEIGHT on Oil & Gas Exploration, Oil Marketing, IPPs and Cement sectors while we maintain UNDERWEIGHT on Banking, Insurance and Autos. At current prices, we have a MARKETWEIGHT stance on Fertilizer, Telecom & Technology and Refinery sectors. Our top picks from BMA Universe are OGDC, PSO, HUBC, LUCK and DGKC.