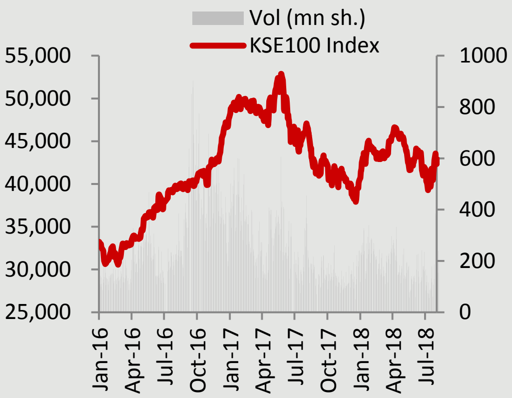
Pakistan Strategy

Pakistan back on investors' radar; concerns remain

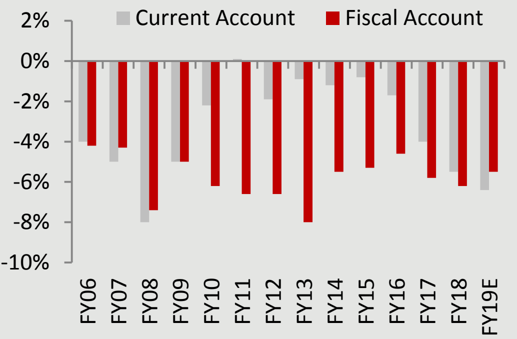
Thursday, August 09, 2018

KSE100 Index vs Volumes



Source: PSX, BMA Research

Worsening twin deficits



Source: SBP, BMA Research

- **We conducted a road show in major financial centers last week and present key takeaways from our meetings. Pakistan's investment case has clearly started attracting attention post the major political event in the form of elections and a much-needed policy action over the past six months.**
- **However, investors believe political stability may continue to face challenges from joint opposition and coalition partners, particularly small regional parties. Possibility of a change in Pakistan's foreign policy and the influence of the US over Pakistan's likely re-entry into the IMF program were also at the top of investors' mind.**
- **A key surprise for us is investors' apparent focus on possibility of populist measures and likely dent to corporate earnings. We see little room for adventurism by the new government.**
- **Expectedly, timing and size of IMF program and potential pre-conditions/conditions were also discussed at length. Investors believe Pakistan may not be able to enter an IMF program before Dec'18. We see the govt. adopting a multi-prong strategy and expect entry into the program by end-Sep/early-Oct'18.**
- **Banks are a clear favorite though disappointment in 2Q18 earnings of big banks has definitely added to investors' frustration.**

What are investors thinking? We interacted with fifteen foreign clients last week in major financial centers with a major objective to gauge investors view on Pakistan following elections. We clearly see increased investors interest in Pakistan post the major political event in the form of elections and policy action by authorities (17% devaluation, 175bps rate hike). However, investors clearly view Pakistan as a market where more policy action is required and the challenges to political stability in the aftermath of election results remain. We present below major discussion points from our meetings.

Political stability: Investors believe political stability following better-than expected results in elections may continue to face challenges from a joint opposition and coalition partners, particularly small regional parties. While we consent with the investors view, we believe the bargaining power of small parties is relatively limited at individual level and may not tantamount to significant challenge to stability of the future government.

Foreign policy: Possibility of a change in Pakistan's foreign policy and the influence of the US for Pakistan's likely re-entry into the IMF program were also at the top of investors' mind. We believe recent visit of the US ambassador to nominated Prime Minister, Chairman of PTI- Mr. Imran Khan, should serve to dilute the impact of recent statement from the US officials. All in all, we believe sharing of relevant details on repayment of loans from China will not be a sticking point.

A key surprise: Surprisingly, investors' apparent focus is on possibility of populist measures and likely dent to corporate earnings. Pricing for cement, fertz, directed lending for banks, re-opening of tariff for IPPs came under discussion. We see little room for adventurism by the new government in terms of re-opening of agreement signed with IPPs. Normalization of margin in cement (down from 45% in FY16 to 32% in FY19E) already addresses a key concern associated with disciplined pricing in cement, in our view. In fact cement nominal prices have jumped 57% since Jul'08 but are down 8% in USD terms. For fertz, we believe the government is likely to exercise control where recent price increase in urea has created room for intervention by the government.

IMF program: Expectedly, timing and size of IMF program and potential pre-conditions/conditions were also discussed at length. Investors believe Pakistan may not be

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BMA Top Ten Picks

CY19/FY19E	P/E	P/BV	D/Y
MCB	9.54	1.49	8%
UBL	8.14	1.13	9%
PPL	7.63	1.62	7%
MARI	7.27	1.91	0%
HUBC	8.43	2.68	8%
NCL	10.74	0.96	4%
EFERT	9.12	2.45	11%
FATIMA	6.56	0.97	9%
DGKC	6.37	0.63	5%
ASTL	8.65	2.01	5%

Source: BMA Research

able to enter an IMF program before Dec'18. We see the govt. adopting a multi-prong strategy and expect entry into the program by end-Sep/early-Oct'18. Key conditions for an IMF program may include: (i) increase in gas price (we expect 25% over 12-mths), (ii) Rupee devaluation (7-10% in 12mths), and (iii) policy rate hike (another 100bps), and measures to address twin-deficit (for complete details, see our report titled Watch out for three E's; Elections, Economy and Earnings). Deceleration in demand momentum for cyclicals appears to be on the cards, however we highlight valuation/stock prices reaction in select stocks is overdone.

What explains subdued interest among active funds? Drop in Pakistan's weight in MSCI EM index (to merely 0.07% from initial 0.14%, making it the smallest market) and expectation of further devaluation are believed to be major reasons for relatively subdued interest in Pakistan by EM active funds. Smooth formation of the governments at both in the center and the Punjab, and entry into the IMF program are two major events that may increase comfort for the investors. Current valuation of the market is not seen as rich and investors' interest in select sectors/stocks remain. Banks are clear favorite though frustration among investors on 2QCY18 earnings miss is palpable. We continue to favor defensive, high D/Y and devaluation friendly stocks along with select cyclicals. We reiterate our top ten picks: PPL, MARI, UBL, MCB, ASTL, NCL, DGKC, EFERT, FATIMA, and HUBC.

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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 ± 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.)