BMA CAPITAL

Pakistan Textile Sector

Challenging year ahead

Tuesday, June 21, 2022

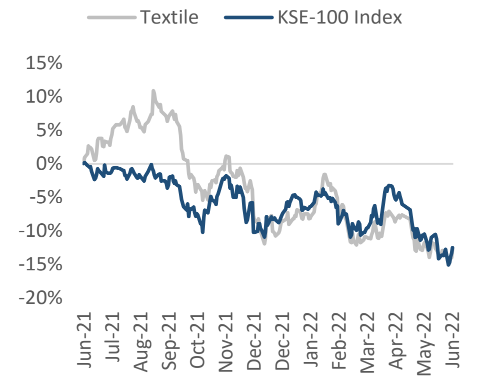
The textile space has enjoyed a fruitful fiscal year thus far where textile exports have surged to USD 17.6Bn (↑28.1% YoY in 11MFY22) on the back of rising global demand, competitive energy tariffs, inexpensive labor and conducive government policies. However, we opine that amid increasing risks of global economic slowdown, demand is expected to take a hit. The slowdown is expected on the back of i) monetary tightening that will reduce disposable incomes globally, ii) global energy commodities (crude oil, coal, RLNG) maintaining their multi-decade highs, iii) increase in global cotton prices to wipe off inventory gains and iv) slowdown in expansion activities on the back of rising project costs. Moreover, major textile exporting destinations such as USA and EU are already battling high inflation and a monetary tightening cycle is well and truly in play that has resulted in reduced purchasing power, leading to a decline in international orders. As a result, we believe that the upcoming fiscal year is going to be challenging for the sector to sustain its growth momentum.

Amid fiscal consolidation, textile sector is poised to take a hit: In the federal budget announced for FY23, govt. has emphasized on fiscal consolidation through increased tax collection and a reduction in overall govt. spending. This is on the back of IMF's demands in order to unlock the 7th tranche from the Fund which is crucial for the country, given its delicate fiscal position and weak forex reserves. Currently, the govt. is providing RLNG and electricity at subsidized rates to the sector. However, we opine that rising energy prices will lead to some sort of revision in these rates for a few quarters. This, in turn, will increase input costs for the sector, due to which margins can be affected. Furthermore, gas/electricity shortage in the country will also lead to closure/ slowdown in operations which will result in cancellation of orders, resulting in a decline in exports.

High cotton prices to wipe off inventory gains: Cotton prices in the country have soared past PKR 22k/maund during the past month, mainly due to declining cotton production in the country and high international cotton prices. To note, cotton imports have increased by ~25% YoY during 11MFY22 to clock-in at USD 1.7Bn, the impact of which is seen in the gross margins of the listed space, which have declined by ~200pp YoY during 9MFY22. To note, multiple companies had already procured cotton at an average rate of ~PKR 16k/maund however, the inventory was only sufficient for FY22. Hence, any further procurement will be at higher prices, which will result in higher input costs and might further dent gross margins.

Super commodity cycle and global inflation has further dampened outlook: Since the resumption of global economic activity amid slowdown in Covid cases, aggregate global demand outpaced aggregate supply, resulting in demand-led inflationary pressures. As a counter move, countries all over the world have increased policy rates to negate the impact and slow down demand. To recall, FED and Bank of England raised policy rates by 75/25bps, respectively, in the past week to combat rising inflation due to which consumer's purchasing power is expected to decline as monetary tightening

Textiles vs. KSE-100 Index



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

Source: PSX, BMA Research

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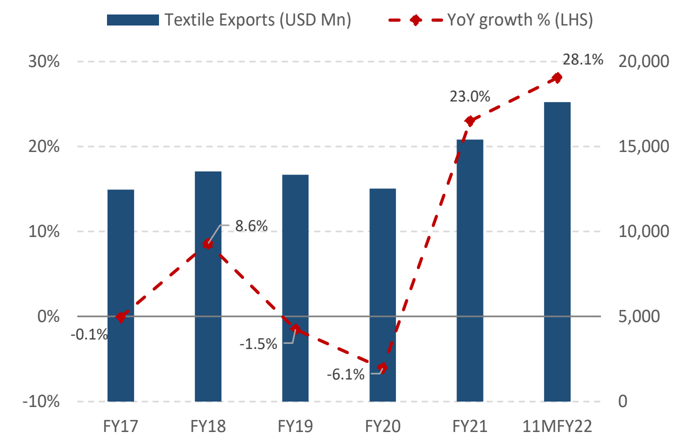
continues. In our view, demand for textile products will taper off as disposable incomes are affected. This is also evident from the ~6% MoM decline in textile exports noted in May-22. As per industry sources, multiple orders have been cancelled from US and Europe due to significant inventory pileup and slower demand which is likely to sustain in the coming months.

With IMF in the fold, exchange gains are likely to stay muted: In the ongoing fiscal year, PKR has depreciated by ~32% against the greenback, leading to robust exchange gains for the textile sector, as revenues are primarily driven by exports. While the USD is currently trading at ~PKR 210, we opine that recent steps taken by the govt. will lead to resumption of the IMF program and unlock the 7th tranche of ~USD 1.0Bn. This, in turn, will result in further flows from bilateral and multilateral sources, that can reduce the pressure on PKR and broader panic in the currency market. Hence, we expect USD to stabilize around PKR 190-195 in the upcoming months, which will result in muted exchange gains for textile exporting companies.

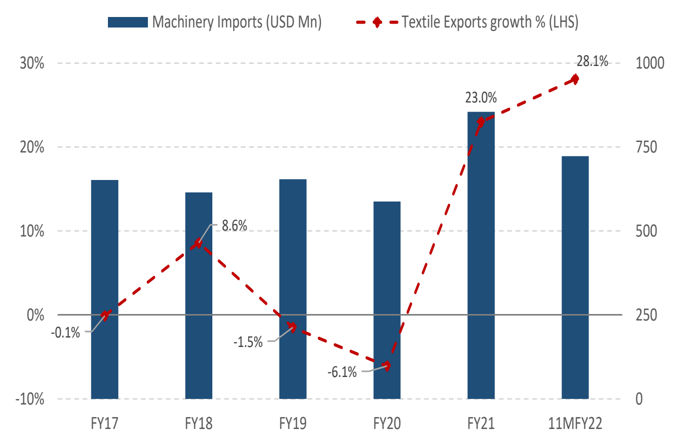
Investment thesis: In the listed textile space, ILP/GATM/NML are poised to face the brunt of this slowdown as exports account for ~90/65/60% of overall revenue mix respectively. Furthermore, high cotton prices and rising energy tariffs will result in inflated input costs for these companies, which will lead to a reduction in earnings in the upcoming fiscal year. Hence, we downgrade to a 'Hold' stance on the textile sector until further clarity.

Chart 1: Textile exports continue growth momentum for now



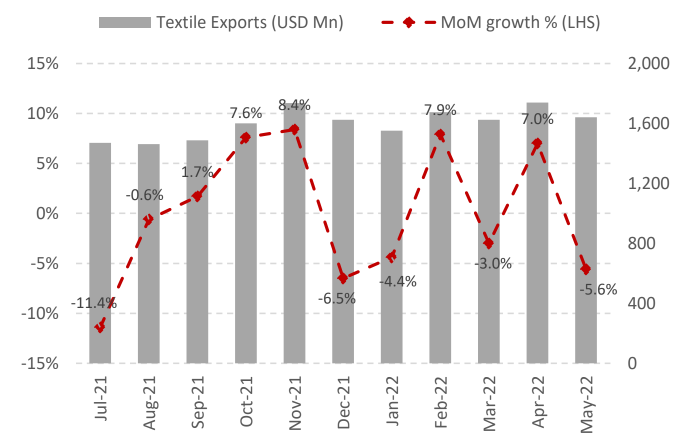
Source: PBS, SBP, BMA Research

Chart 2: Machinery imports to slowdown in the coming year



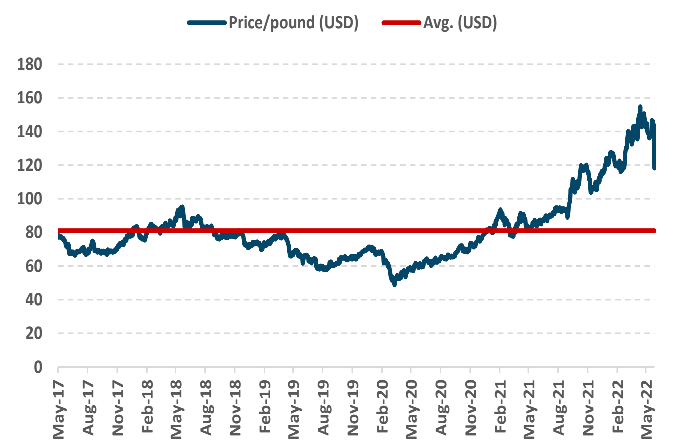
Source: PBS, SBP, BMA Research

Chart 3: Growth momentum losing steam



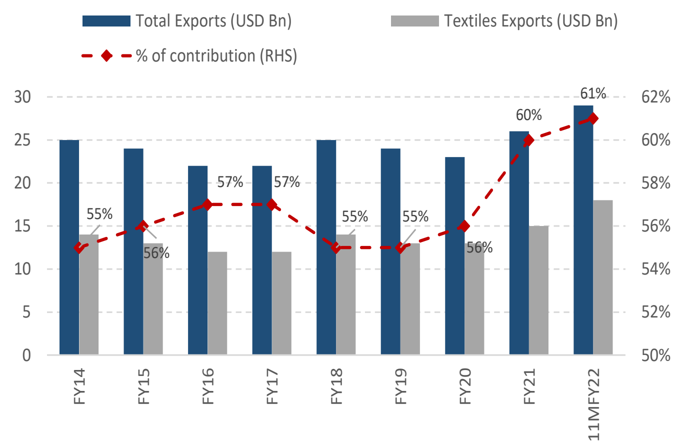
Source: PBS, SBP, BMA Research

Chart 4: International cotton prices remain elevated



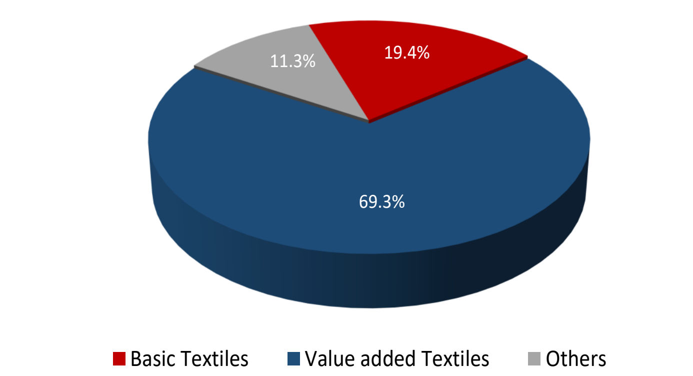
Source: Investing.com, BMA Research

Chart 5: Textiles continue to drive exports based growth



Source: PBS, SBP, BMA Research

Chart 6: Value-added textiles continue to dominate (11MFY22)



Source: PBS, SBP, BMA Research

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Buy	>15% expected total return
Hold	10%-15% expected total return
Underperform	<10% expected total return
*Total stock return = capital gain + dividend yield	

Old rating system

Overweight	Total sector return > expected market return
Marketweight	Expected market return
Underweight	Total stock return < expected market return

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.)