KSE100 Index - The Journey to 100,000 points

BMA CAPITAL

Thursday, November 28, 2024

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Pakistan Equities continued their stellar performance in 2024 as the KSE100 index broke past the symbolic 100,000 points mark. Several elements contributed to this rally, including early indications of macroeconomic stability. This report will explore the key factors that pulled Pakistan out of the default narrative and laid the groundwork for this unprecedented resurgence.

- **A successful IMF bailout:** Pakistan's entry into the IMF program under the USD 3.0bn Stand-by Arrangement (SBA) was the **prime catalyst for the rally**. Before the country's entry back in June 2023, investors had priced in default for domestic equities and international fixed-income securities. The entry into the IMF program instilled confidence in Pakistan's ability to service its external liabilities and avoid reprofiling its debt. Under the program, Pakistan introduced various monetary and fiscal reforms. Moreover, the much-needed energy sector reforms were also implemented, including adjustments in the energy pricing mechanism.
- **A larger IMF program with a longer horizon:** After the SBA's expiry, Pakistan entered a three-year USD 7.0bn EFF program, building upon the macroeconomic stability achieved during the SBA. The new IMF program targeted the country's low tax-to-GDP ratio, addressing the tax inefficiencies in Pakistan's agriculture, retail, and real estate sectors. Moreover, the program also necessitated controlled external and fiscal imbalances, building a solid foundation for sustainable long-term growth.
- **Easing inflation leading to an expedited easing cycle:** With significant structural adjustments behind us, monthly inflation figures have stabilized. Given the high inflation base, monthly CPI figures may fall below the 5% mark, a level last seen over six years ago in May 2018. This disinflationary trend allowed the State Bank of Pakistan (SBP) to aggressively reduce interest rates, cutting the policy rate by 700bps to 15%. Falling treasury yields further unlocked equity valuations and induced the flow of capital towards the Pakistan equities market.
- **External stability keeping the Pak Rupee in check:** A tight monetary and fiscal stance has kept on check on Pakistan's external account balances. Based on the available data, 6 out of the 10 months during the year have posted a current account surplus. Moreover, we estimate that **the entire calendar year will likely close in a surplus**, aided by controlled economic activity. The country, in turn, shored up its foreign exchange reserves from USD 4.4bn in June 2023 to USD 11.3bn in November 2024. External stability enabled the Pak Rupee to exhibit stability and hold its level for over a year.

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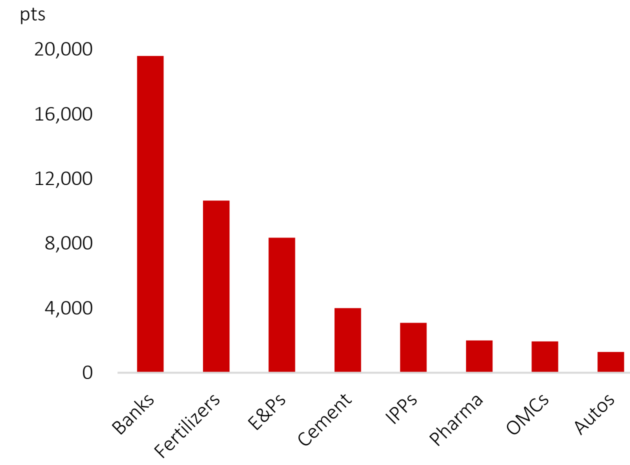
- **Market flush with liquidity:** The post-IMF increase in market participation was evident through a surge in average daily traded value (ADTV). The ADTV for 2024 has averaged around USD 70mn, 3.5x higher than the six-month average ADTV before the IMF program. Moreover, recent market activity shot up considerably, with average ADTV hovering around the **USD 120mn mark in November 2024.** This trend was most evident with the **domestic market easily absorbing Vanguard's USD 150mn liquidation** without denting the market's rising trend.
- **Energy sector reforms supporting the heavyweights:** Energy reforms under the IMF program improved the cash collection cycle for Pakistan's energy chain. Many energy companies are recording **a cash collection rate of over 100%** during their recent quarters. These reforms have assisted in unlocking the sector's depressed valuations as investors anticipate accelerated exploration activities and higher cash payouts.
- **Fiscal accounts improving:** Pakistan's fiscal accounts have improved considerably in 2024, posting a primary surplus in FY24 and a budgetary surplus in Jul-Sep 2024. Budgetary figures found support from controlled development spending and a rising share of SBP profits. Moreover, as treasury yields fall, the **government may extract savings of around PkR 1.3tn** from reduced debt servicing costs. Consequently, the **budget deficit may fall to around 5.0% of GDP against 6.8% of GDP in FY24.**
- **Budgetary measures further incentivizing equities:** Taxation measures introduced in 2024 further incentivized investments in equities through a favorable taxation regime. Most notably, the taxation levies for real estate (deemed income) and certain fixed-income investments were increased.
- **SIFC to diversify Pakistan's external funding sources:** SIFC is a venture between the government and the military establishment to promote foreign direct investment (FDI). Investment catalysts would include fostering a favorable investment climate with a long-term policy framework. The SIFC aims to attract over USD 50bn in agriculture, mining, technology, and energy. We deem the SIFC an important step in reducing Pakistan's reliance on foreign funding and ensuring long-term sustainable growth.

Dissecting the index's rally since June 2023

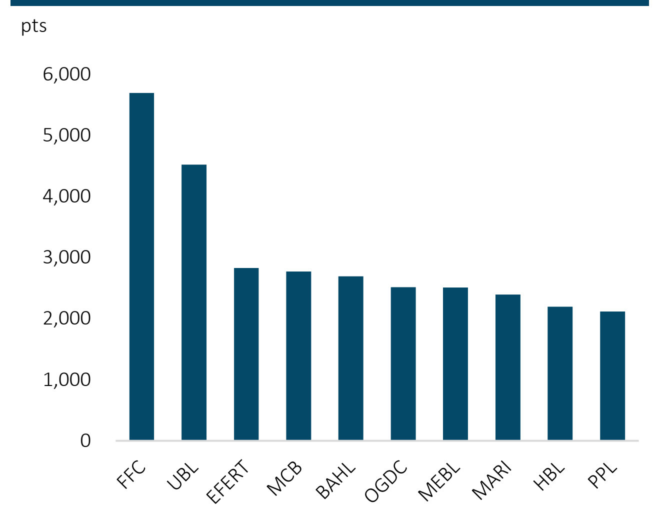
- **Banks led the rally:** The KSE100 index's performance was primarily driven by the banking sector with a **cumulative contribution of 19,592 points, or** 34% of the total rally. The industry found support from a favorable interest rate cycle, which saw the policy rate hike to a record-high level of 22%. Moreover, record profitability enhanced the balance sheets of most major banks, improving their CAR and creating room to increase their cash payouts.
- **Yield plays gaining traction:** High-yielding sectors also contributed to the index's rally. Most notably, the fertilizer industry (10,644pts), particularly Fauji Fertilizer (5,689pts) and Engro Fertilizer (2,825pts), benefitted from improved fundamentals, including a sharp improvement in pricing power. As domestic treasury yields fell, many investors felt compelled to build positions in high-yielding stocks to lock in a steady income stream.
- **Oil Exploration companies also performed:** **Pakistan's oil exploration companies (8,107pts)** also benefitted from improved sentiments, driven by developments to control the flow of the circular debt. Sharp rises in the gas tariffs ensured high cash collection from gas sales. Improved cash collection was evident in recent balance sheets of energy companies, **highlighting a cash collection rate of over 100%.** Moreover, talks of potential clearances of the circular debt arrears garnered investors' interest in anticipation of large one-off cash payouts.
- **Cement sector rallies in anticipation of improving fundamentals:** **The cement industry (4,001pts)** also benefitted from improving fundamentals amidst a sharp reduction in the policy rate and anticipation of recovering economic activity. The sector maintained its margins and profitability despite an unfavorable environment.

Top-performing Sectors



Source: PSX, BMA Research

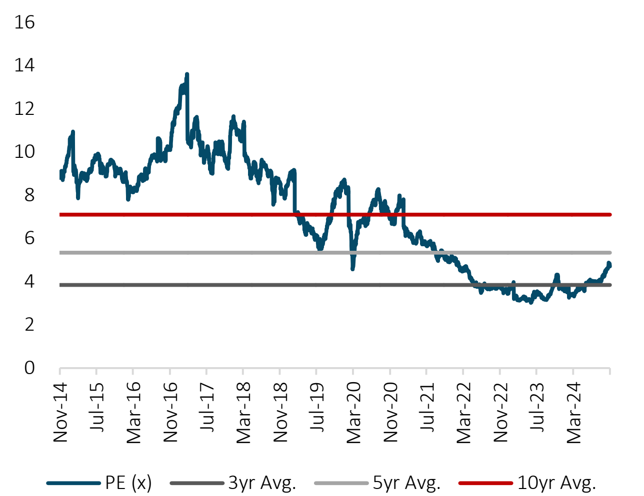
Top-performing Stocks



Source: SBP, BMA Research

Valuations are still behind historical averages

KSE100 PE Multiples Trend

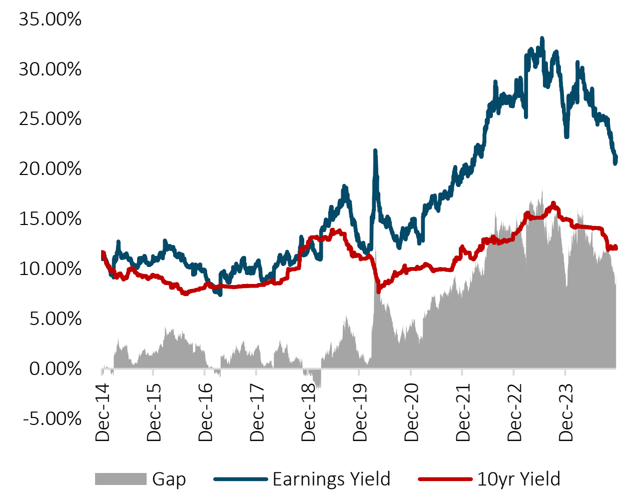


Source: Bloomberg, BMA Research

*Over the past 18 months, the KSE100 index has rerated from lows of 3.0x to **around 4.8x**. Despite the rally, the index remains 33% below its 10-year historical average of 7.1x. A potential revaluation to its historical average would imply an **index level of 151,000 points.***

*During the previous bull cycle between FY14 and FY18, the KSE100 index **averaged a PE multiple of 9.7x, implying a potential index level of 200,000 points.***

Earnings Yield vs. Treasury Yield

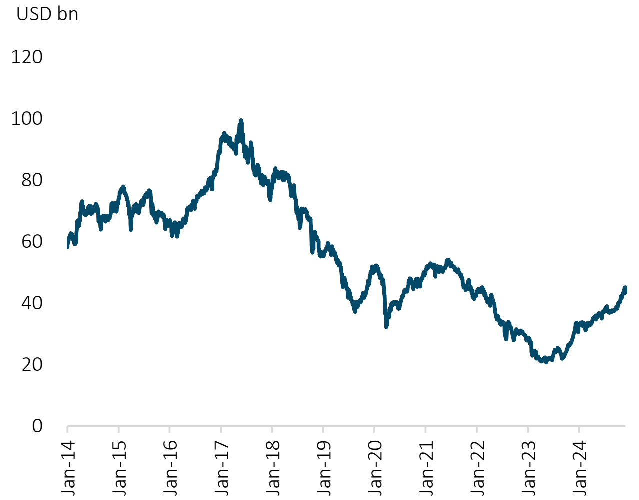


Source: PSX, Bloomberg, BMA Research

Despite the index's rally, the KSE100 index's earnings yield is at a 9.3pps premium to the 10-year treasury yield. During the index's bull cycle, the earnings yield premium averaged around 1.6pps.

*A potential re-rerating to historical averages would suggest **index levels of 156,000 points.***

PSX Market Capitalization (USD mn)



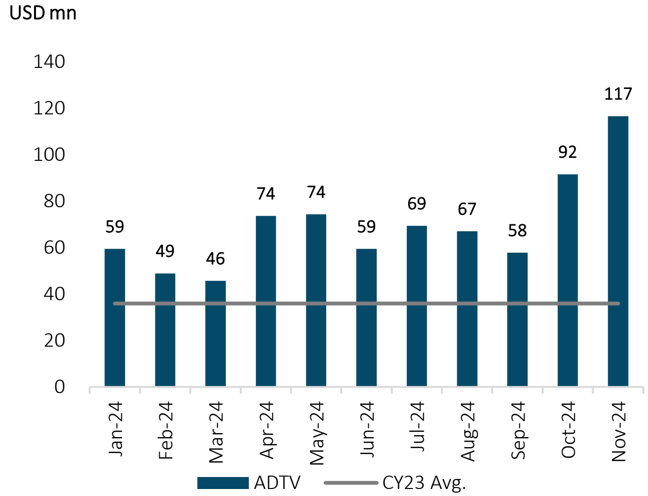
Source: PSX, Bloomberg, BMA Research

*During CY24, the PSX's market capitalization **rose 37% to USD 45.0bn** from USD 33.0bn a year prior. The capitalization, however, remains 55% below the peak level of USD 100bn back in FY17.*

*A USD 100bn market capitalization would entail index levels of **around 220,000 points**.*

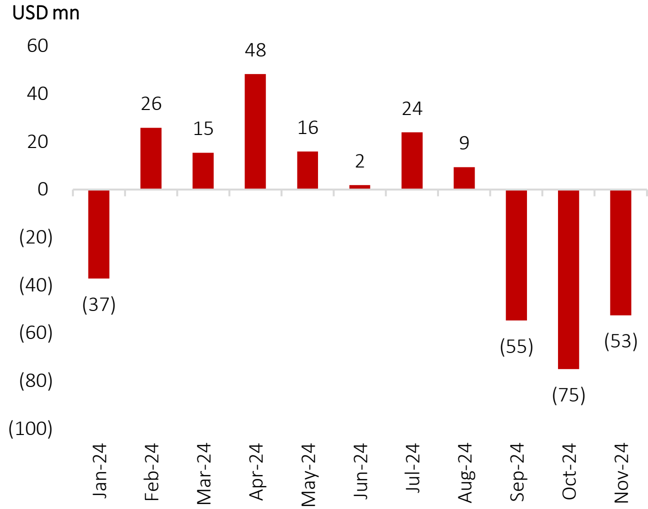
Market Participation on the Rise

Value Traded – Daily Average (USD mn)



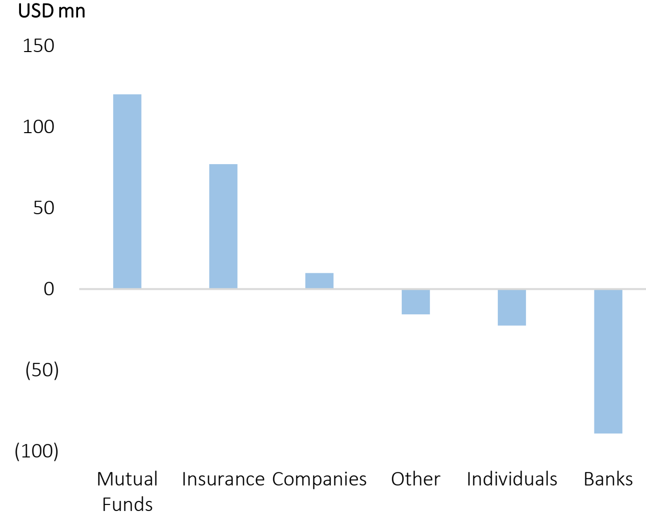
Source: PSX, Bloomberg, BMA Research

Foreign Participation (USD mn)



Source: NCCPL, BMA Research

Local Participation (USD mn)



Source: NCCPL, BMA Research

The average daily traded value (ADTV) ***surged by 93% YoY to USD 70mn*** *during CY24 against USD 36mn during CY23. Higher investor participation was witnessed on both the foreign and local front.*

Despite rising market activity, CY24's figure registered 34% below CY21's ADTV of USD 105mn and 40% below CY17's figure of USD 115mn.

Notably, November 2024's figure is approaching peak levels in the previous bull cycle.

Foreign investors turned net sellers during CY24, ***offloading positions of USD 80mn.*** *The selling, however, was instigated by the liquidation of Vanguard's Pakistan portfolio.*

Before the sell-off, foreign investors had ***built positions of USD 103mn*** *during the first eight months of the year.*

During CY24, mutual funds were the largest buyers in the domestic market, ***building positions of USD 120mn***. *We believe investors have begun switching their funds from fixed-income instruments to equities because of falling treasury yields.*

Moreover, the insurance industry continued its buying spree, building positions worth USD 77mn.

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Gulberg II, Lahore.
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Limited, Sargodha.
Tel: (048) 3767 817-18

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Plot No. 833 Liaquat Road, Faisalabad.
Tel: (041) 2612261-5.

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Trust Plaza GT road Gujranwala.
Tel: (055) 3848501-05

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Old rating system

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.)