TUNDRA
FONDER

PAKISTAN EQUITY MARKET

WHERE DO WE GO FROM HERE?

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PAKISTAN EQUITY MARKET – WHERE DO WE GO FROM HERE?

After being one of the world's best performing equity markets over the last 2 decades Pakistan was hit hard in 2017. Since the market all-time-high in May 2017, the Blue-Chip Index MSCI Pakistan Net TR has fallen by ~25% in USD (~30% in SEK), whereas the broader KSE 100 Index has fallen ~20% in USD (~25% in SEK). The question is, why did this happen and how do we see the market moving forward?

HOW PAKISTANI POLITICS PLAYED A TRICK ON INVESTORS…

As with any large market correction, it is always a combination of both psychology and fundamentals. The year 2017 had a jubilant start over the expected re-inclusion of Pakistan into MSCI Emerging Market Index on June 1st after a period of ~9 years. Contrary to expectations, the market witnessed net foreign outflows worth USD 82mn on the day of re-entry, as against expectations of foreign inflows to the tune of USD 300-500mn.

This created some initial nervousness prompting local investors to re-visit their expectations. The government, democratically elected in 2013, has been on a pro-growth crusade. Economic growth was approaching the strongest in a decade at 5.3% in FY17 (July 1st 2016 - June 30th 2017) owing to large scale investments under China Pakistan Economic Corridor (CPEC). Despite the fact that the usually moderate 1-2% Current Account Deficit (CAD) was creeping up and the Pak Rupee (PKR) had been stable for 3 years versus the USD, the investors remained unmoved. A growing CAD is seldom worrying when the economy is in an expansionary phase and anyone visiting Pakistan could sense the influx of Chinese investment.

For comparison, let us consider Kenya, which has been running twin deficits - both Current Account and Fiscal Budget - of 6% to 10% over the last 5 years or so. There the investors have remained calm due to a perceived stability in policy making and a belief that international bilateral investments will continue to pour in. Pakistan, therefore, would require a bigger change, something chronic even, for the growing CAD to become an issue.

Coincidently, as is not unusual in Frontier Markets, a year before the elections, political scuffles in the election run began to play a role in increasing investor uncertainty. What started as an investigation in early 2016 - post the "Panama Papers" - which had early-on indicted the Prime Minister's family, unsettled investors. Over the course of the summer, investors grew increasingly concerned that the result of the case would not be a slap on the wrist but something more serious.

Despite pre-existing familiarity with unceremonious government upheavals, a gradual discomfort permeated among investors who started contemplating what the political landscape would look like until elections in 2018 (likely to be held anywhere between late July to early August). This discomfort became pronounced when the Prime Minister, Nawaz Sharif, and his family, were heavily scrutinised by the Supreme Court after startling revelations of the Joint Investigation Team (JIT) on charges of misdeclaration of wealth and accumulation of assets beyond declared income sources. At the end of July, the Prime Minster was disqualified by the Supreme Court and the case was referred to the National Accountability Bureau (NAB).

At this point, we saw the first chance for a market turnaround. The Prime Minister declared that he was willingly stepping down and announced that his, arguably, more popular and capable, brother Shahbaz Sharif, would assume the Prime Minister post. A few days later, the market was further confused when it was announced that Shahbaz Sharif would not take-over before elections. Political analysts speculated that this move was to ensure the former Prime Minister and his party's (PML-N) grip on Pakistan's largest state of Punjab where Shahbaz Sharif is the Chief Minister. Suddenly we ended up with a not-so usual game of thrones.

..AND LED TO CONCERNS IN OTHER AREAS

This perceived lack of leadership has refocused attention on economic pitfalls, which previously did not raise alarm. The discussion on the trade deficit has spilled over to the biggest fear of any foreign investor: abrupt devaluation.

Alongside the bullish theme of CPEC, under which investments of USD 50-100bn in infrastructure and energy will be made over the course of 15-20 years, there have also been discussions about the negative side-effects of these investments. Of late, many eyes have been on the current account deficit (CAD), which has risen to 4% of GDP, and is likely to increase further. For those who are unfamiliar with the term, CAD is the net balance of exports (of goods and services) minus imports plus current transfers (mainly remittances from Pakistani workers abroad). Thus, a rising CAD can be the effect of an overvalued currency i.e. exports are not competitive but it can also be the result of increased economic activity leading to a sudden jump in the

demand for imported goods that cannot be immediately satisfied by local manufacturers. Increase in CAD can also be the result of a change in the current transfers. In Pakistan's case, it was a combination of all three.

EXPORTS, IMPORTS AND REMITTANCES

Although Pakistan's textiles tycoons have been religiously lobbying to let the currency depreciate 10%-15%, the fact remains that Pakistan has primarily been a consumption-led economy (80% of the GDP) and not a trade-driven economy as exports account for ~7% of GDP and imports worth 16% of GDP. The trade deficit has largely been financed by increased foreign remittances amounting to 6-7% of GDP. Total Trade (23% of GDP) can be compared to, on average, nearly 30% globally, and 160% in Vietnam. Pakistan is not a trade-driven market, and certainly not an export-driven economy (chart 1 below). This is not to say, that Pakistan cannot become one in the future but that would require a substantial increase in investments, foreign as well as local, and improving product quality along with world-class training for human capital. It would also require an improved perception of Pakistan as a reliable and safe supplier of goods.

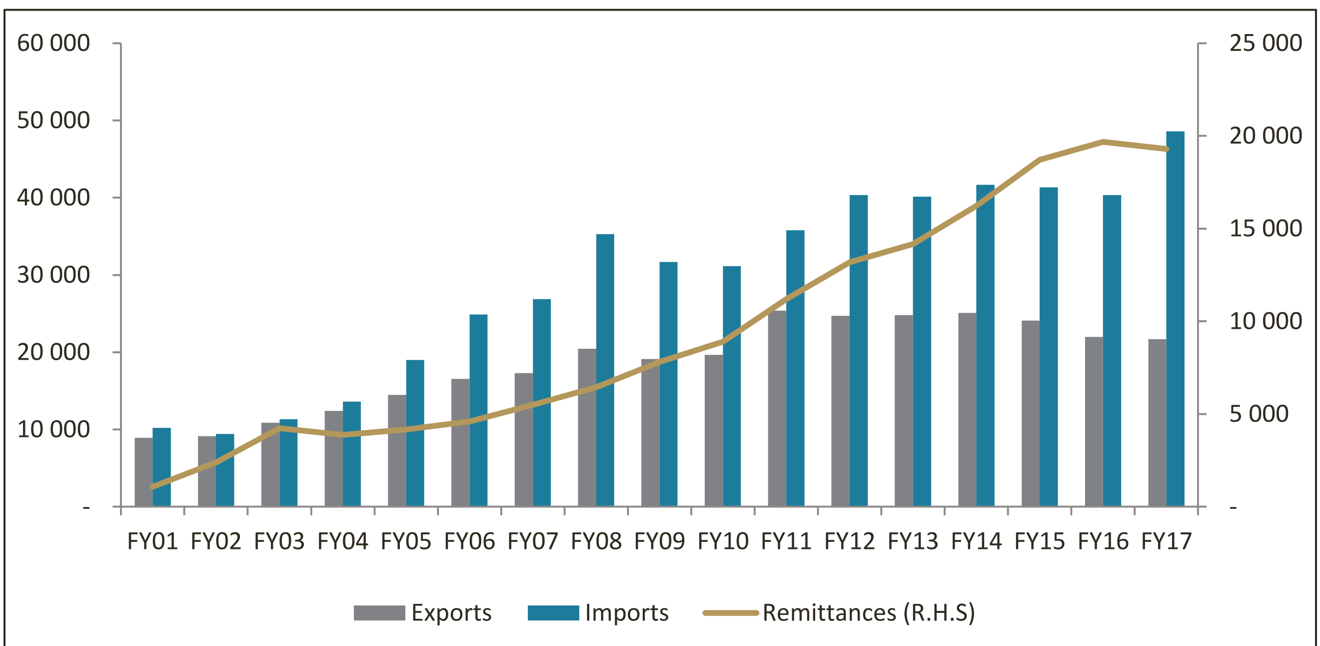
For example, during a visit to Gul Ahmed Textiles Pakistan (GATM PA) Tundra's CIO examined a variety of export quality ready-to-wear garments. Gul Ahmed is already supplying IKEA and a number of other foreign textile chains. The chinos, shown top right, at the time -

Visiting Gul Ahmed Textiles. ***Photo:*** *Tundra*

1.5 years ago – had an ex-factory price of USD 6 per pair. Their retail price in Sweden would have been approximately USD 100-150.

Looking at Gul Ahmed's P&L, even if all costs would be rupee based and we assume that the Pakistani rupee devalues by 15%, how much cheaper could those chinos become? Even a sharp 15% depreciation would mean the ex-factory price in USD is unlikely to come down by more than USD 1/pair (probably less given that electricity costs, transportation costs and parts of the raw material costs must be considered at least partially FX-linked). Nevertheless - Is that the deciding factor or is the perceived safety of the Head of Procurement and/or guaranteed access to electricity, efficient transport etc. more important factors? Pakistan has every opportunity to become an important global manufacturing hub. However, this will take time and require a lot more than a short-term 15% devaluation.

Chart 1: *Exports, imports, remittances (USDmn)*



Source: *State Bank of Pakistan*

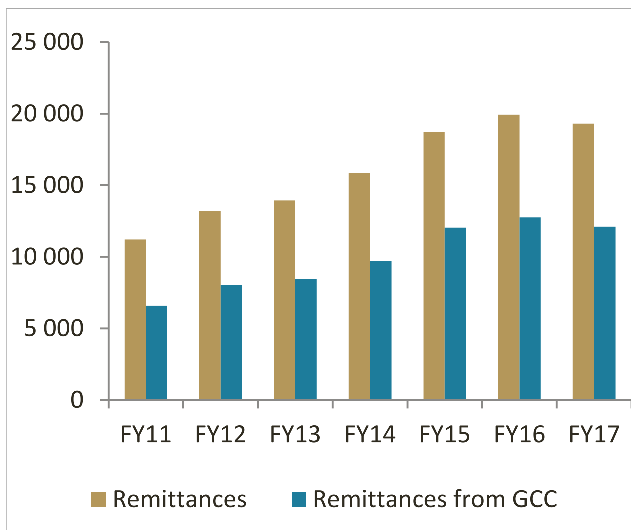
What about imports then? Pakistan showed an exceptional bounce back in economic growth in the last few years. In FY17, the GDP grew by 5.3%, which is the highest growth rate in a decade. However, growth comes at a price. As a result, we saw increased economic activity reflected in a sharply higher CAD, 4% of the GDP, up 2.5x year on year. The main reason for the rising CAD was a year on year USD 7bn increase in imports. A breakdown of the underlying components shows that more than 30% of this increase was attributed to oil and minerals. The increase in the import of oil and minerals can to a large extent be attributed to Pakistan's reliance on imported Liquefied Natural Gas (LNG) to meet growing needs of industries and gas-fired power plants. Another 24% of the increased imports was machinery (12%) and vehicles/vessels (12%). Although parts of these imports, for instance used cars, could be considered unnecessary luxury items, most economists view the majority of the increase in imports as a result of the economic expansion. Resolving energy bottlenecks through imported LNG and imported power generating machinery will keep the CAD high in the short-term. A further expansion of LNG imports by another 600mmcfd in FY2018 (July 1st 2017-June 30th 2018) will add USD 1.3bn to imports (0.4% of GDP) next year at current oil prices, as will the trains imported for the Orange Line Metro Project (approximately USD 600-850m). Avoiding such imports would obviously not be good for the economy though. For the last 15 years, remittances have been Pakistan's saviour. It can be said that human capital is Pakistan's most important export. Foreign remittances end up in current transfers. Their steady growth has made up reasonably well for a gradually increasing trade deficit. However, in the last few months we have seen a slight decline in remittances (chart 2 below).

The Middle East, which accounts for nearly 60% of the remittances, has witnessed a decline over the last year. Lower oil prices have had an impact on economic growth in the Middle East consequently fewer Pakistani workers have been sending money home. Part of this reduced flow can however be attributed to political uncertainty, and with Nawaz Sharif's disqualification, affluent Pakistani ex-patriates may be further limiting transfers. In the future, we anticipate that falling oil prices may prompt oil-rich middle eastern countries to recruit more nationals, thereby reducing the demand for labour from Pakistan. This may exacerbate the decline in remittances or force them to stagnate. Even though it would most likely be too pessimistic to call the end of "labour exports," in the short term remittances are unlikely to be able to plug the trade deficit. As we can see this has resulted in the FX reserves starting to decline (chart 3 below). In all fairness, it should be noted that this is from a historically very high level. However, with increasing imports State Bank reserves are now touching 3 months of imports which is considered a minimum benchmark level.

POSSIBLE ACTIONS

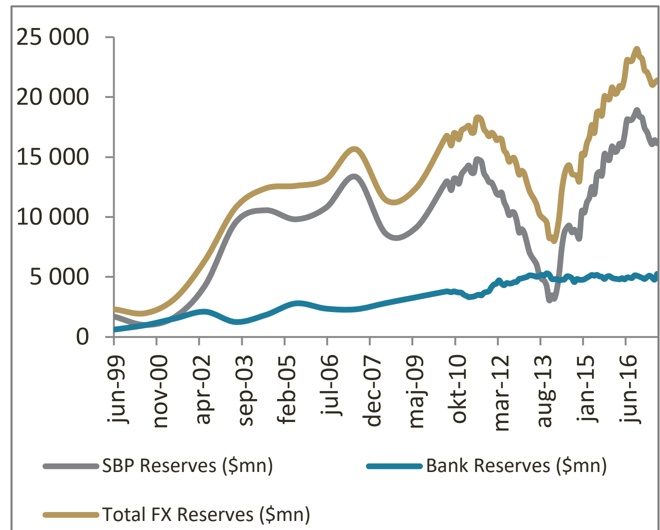
Given the situation, what can or should be done? Of course reserves can be propped up by loans but once financial markets have put their finger on a "problem" it is difficult to resolve/overlook it without directly addressing underlying causes. In the near future, we are likely to see an upward revision in custom duties, especially on finished goods. A rupee devaluation of 10%-15% might also dampen the enthusiasm for luxury imports geared towards private consumption.

***Chart 2:** Remittances – Total remittances and GCC separated (USDmn)*



***Source:** State Bank of Pakistan*

***Chart 3:** FX reserves (USDmn)*



***Source:** State Bank of Pakistan*

WHY NOT JUST DEVALUE THEN?

Devaluation is an alarming word for many foreign investors who are impacted by fluctuating currencies in smaller markets. Should we be concerned by a PKR devaluation? According to the Prime Minister, Khaqan Abbasi, devaluation will not have the intended effect. What he means by this is that Pakistan is not a trade driven economy as we discussed earlier. The primary reason fuelling the devaluation discussion is that Pakistan is operating in a vacuum of political leadership and policy guidance. We agree with the Prime Minister that while devaluing the Pakistani rupee will not have any long lasting positive effects on the economy, a moderate, controlled devaluation will in all likelihood calm investors who have already priced in the impact of an abrupt devaluation in the market. It can be argued that it is pointless to devalue in an economy where trade only equals 23% of GDP. This is true to an extent. However, if all foreign investors can discuss is "the impending devaluation" then it may as well occur while it can be done in a planned fashion. For Pakistan this is entirely possible given the amount of FX reserves and foreign lending available. We do not anticipate a significantly negative immediate impact on Pakistan's economy because:

- Less than 1/3 of Government debt is foreign currency denominated, therefore the direct effect on the balance sheet will not be very severe.
- There is in principle zero foreign currency lending among Pakistani corporates and debt levels in general are very low .
- A 10% depreciation would, in our analysis, lead to a 1.1% rise in inflation. This is an uncertain assumption given the dynamics of inflation expectations but in light of the isolated nature of Pakistan's economy the effect will be less pronounced than in a more trade oriented economy.

THE EFFECT OF DEVALUATION ON THE EQUITY MARKET

For the equity market, we have estimated the effects of devaluation on approximately 77% the broader market (KSE 100) (table 1 below). This suggests that the overall impact of devaluation will be marginally positive for the KSE 100 index as index heavy weights have a positive profitability correlation with the USD. These calculations are calculated as "on day 1", I e they are not taking into account any potential counter actions taken by companies, such as raising prices. It can be argued this a very conservative approach.

- Positive: Energy, financials, utilities
- Negative: Consumer staples, health care, materials, consumer discretionary

Table 1: *Analysis of devaluation impact on sectors*

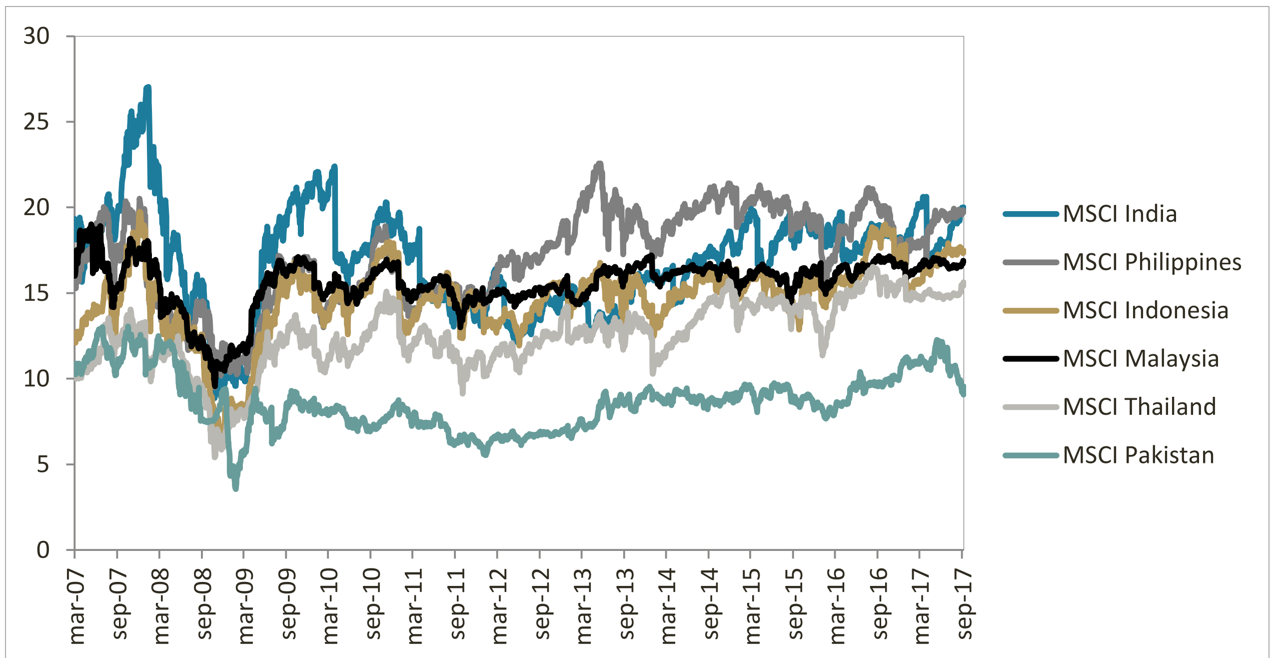
Sectors	Weights	Impact	Avg. EPS impact "day 1"	Description	Action
Financial	23.5%	Positive	5%-18%	•Increase in inflation to increase interest rates •FCY assets	•Lower lending
E&P	12.4%	Positive	6%-19%	•Pricing in USD •FCY deposits,	
Materials	11.5%	Negative	5%-14%	•Imported raw materials (coal, steel) •FCY payables	•Cost pass-through •FX hedging •Inventory gains (steel)
Fertilizer	9.1%	Neutral	1%-3%	•Import price parity (DAP) •Increased gas	•Partial cost pass-through •FX hedging
Power	5.9%	Positive	5%-14%	•USD indexed tariff	
Auto	3.2%	Negative	14%-49%	•Imported raw materials (CKD kits) •FCY payables	•Costs pass-through however affecting demand •Increase reliance on local material
Utilities	3.6%	Negative	3%-9%	•Higher UFG losses due to higher gas prices	•Reduction in UFG losses
Health Care	2.5%	Negative	7%-28%	•Imported raw materials (APIs) •FCY payables	•Cost pass-through •FX hedging
Textile	2.5%	Positive	13%-38%	•Revenue in USD on exports	•Reduce price to gain volumes
OMC	2.5%	Negative	12%-37%	•FCY payables	•Lower
Food & Personal Care	0.3%	Negative	35%-104%	•Imported raw materials (Milk powder) •FCY payables	•Partial cost pass-through •FX hedging
Total KSE100	**77% of index estimated**	**Positive**	**1-3%**	**Neutral effect before any counter effects ("Action") from companies**	**Companies have a history of successfully passing on a weaker currency and import substitution remains low**

Source: *Tundra Research*

One also have to take into consideration how higher interest rates will effect valuations and thus multiples, such as, Price to Earnings (P/E). The Weighted Average Cost of Capital (WACC) would increase in line with the rise in bond yield. The current 10-year PKR bonds in Pakistan, maturing April 2026, yield approximately 8%. Assuming a company is debt free, as many Pakistani companies are, and using a 6% risk premium, we have a WACC of 14%. We expect that incremental "10%" devaluation will lead to 1.1% higher inflation rate, which we assume can be translated to an equivalent rise in long-term bond yields. This would, in theory, cause a 6-7% lower P/E multiple.

However, putting things in perspective, with a 20-25% fall (USD) in the index levels from the peak, and companies' de-rating from a P/E of 11x to an attractive P/E of 8x (see chart 4 below) due to looming currency depreciation, we would say that removal of this uncertainty, in the form of actual depreciation, is likely to cause a certain upwards re-rating in the equity market that might very well counter any theoretical effects derived from valuation models.

Chart 4: *Pakistan's P/E versus Asian peers' P/E*



Source: Bloomberg

SO - WHEN WILL THE MARKET IMPROVE?

The events of 2017 have, once again, highlighted the fragility of any equity market. It shows how sentiment can tilt based on changing interpretations of information that is already available. A year ago, everyone expected that the CAD would jump, at least initially, as the CPEC projects started kicking in, and now it is a concern. In our discussions with investors we have routinely given a "10%-15%" depreciation of the rupee versus the USD as the base case. We have maintained this assessment for the past 1.5 years. On the political front, we have been tracking the investigations into Nawaz Sharif since early 2016. Far from everyone expected him to be excused. However, disqualification was a potential outcome and should have impacted the market long before it actually did. Not to mention, political turbulence in Pakistan one year from elections is a familiar norm. It may seem odd that currently these are hot topics but this is how equity markets work: shifting attentions and continually assessing and re-assessing a company or a market as a glass of water, either "half full" or "half empty." That said, markets are always fair. As can be seen from our assessment, we are not dismissing investor concerns. They are absolutely valid. Investors should keep in mind however that they are largely the result of a change in perception as opposed to a change in the underlying fundamentals of the market. And thereby investors should be aware that the perception might turn positive again without much change to fundamentals.

Given the fact that we believe this is a case of changed perceptions rather than changed fundamentals we believe the turning point for investors, who have been selling the market for the last two years, may be any one or a combination of the following events:

1. When investors start discussing who will win the 2018 general elections. First "polls" will be in and newspaper headlines will hint towards one camp or the other. This could be as early as November, but somewhere January-February, is more likely and it could of course drag on to just before elections. The ability to take the long view -- five years ahead until elections in 2023 -- will be the strongest and most cogent turning point.
2. Pakistan gives investors their "10-15% PKR depreciation." The shift will not be abrupt but rather as was the case in June-December 2013 when the currency moved closer to 10% over a period of six months (at that time only to regain everything in the following two months). The selection of a new Finance Minister and official statements will signal this shift. Investors understand that when it comes to devaluations most gains are to be had getting in just before it happens or very early in the process. Nigeria is a recent example proving this analysis. Market expectations on this move vary. Consensus is for it to happen at the earliest during the caretaker government (late Spring/early Summer) but in light of recent government statements it could happen anytime from here.

THE BLACK SWANS THEN?

Unexpected very negative events are of course manifold. In this report we have honed our discussion down to the context of trading related and perception oriented issues: something additional, while not fundamentally motivated, that will give the market a new hit?

1. Redemption pressures among local Mutual Funds is one such technical factor, although it is likely to be very short term in nature. In the last 24 months, Mutual Funds have had a net inflow of close to USD 600mn. If concerns of political uncertainty remain unresolved and twin deficits appear to bloat this may prompt local investors to unwind their positions and cut losses. We have not seen the local investors panic yet but we sense their nervousness.
2. The US' stern statements on Pakistan i.e. discussions of sanctions might seem ridiculous but US leadership at this point might, by some, be called mercurial.

We do not envisage the rest of the world supporting Mr. Trump's recent statements regarding Pakistan, and China has already strongly opposed him. However, it has to be listed as a potential additional hit.

FINAL THOUGHTS

In this report we have simplified the discussion down to what we believe have been the main drivers of this year's weak performance and tried to provide clarity on these drivers. The degree of alarm over these concerns is debatable. We can conclude that the fundamentals do not warrant such a deep contraction and we have tried to explain why. For investors looking for a decent long term entry point we believe we are already there. Investors should however at the same time recognise that fundamentals have been put aside for some time now and might continue to be ignored until answers to the main uncertainties have been given. Until such time these uncertainties might continue to pressure the market. For investors sensitive to short term volatility this needs to be taken into consideration.

This said, valuations provide a certain cushion though. At current levels of 43,000 of KSE 100 the broader equity market is now trading at a P/E of 8x, compared to around 6.5x when we launched Tundra Pakistan Fund in October 2011. It means we have another 20% down to the valuation multiples we were at 6 months after Osama Bin Laden was found on Pakistani soil, when volumes were at 12 year lows. Before elections in 2013; before the oil prices crashed from >USD100/barrel down to current levels; and before CPEC etc.

This has not been a standard strategy report explaining the long term investment case for Pakistan. All our unitholders have heard us explaining this story many times and we look forward to return to this subject in our future reports. The objective of this particular report however has been to try to make sense of the recent months' of weak markets and on those occasions it is unfortunately seldom about fundamentals. That said, we would however like to end this rather tactical discussion with a reminder to the reader that at all times have one eye on the longer term investment case for Pakistan. Here we remain very bullish: CPEC led infrastructure investments, low international oil prices, a young and growing (200mn) population coupled with a well developed private sector, are all present to take advantage of the growth ahead. Pakistan has been one of the world's best equity markets over the last 20 years, in USD. We believe the circumstances for another good 20 years are significantly better today than they were in 1997.

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