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PAKISTAN – TURNING THE TIDE

IMPRESSIONS FROM OUR TRAVELS

PAKISTAN - TURNING THE TIDE

We recently spent a week in Pakistan with meetings in Islamabad, Lahore and Karachi.

We had the opportunity to meet key persons behind the ongoing economic reforms as well as 20 companies, representing most sectors of the market. Among the meetings were the Central Bank Governor, Minister for Economic Affairs (responsible for FATF negotiations) and the FBR Chairman. The most important takeaways are summarised below:

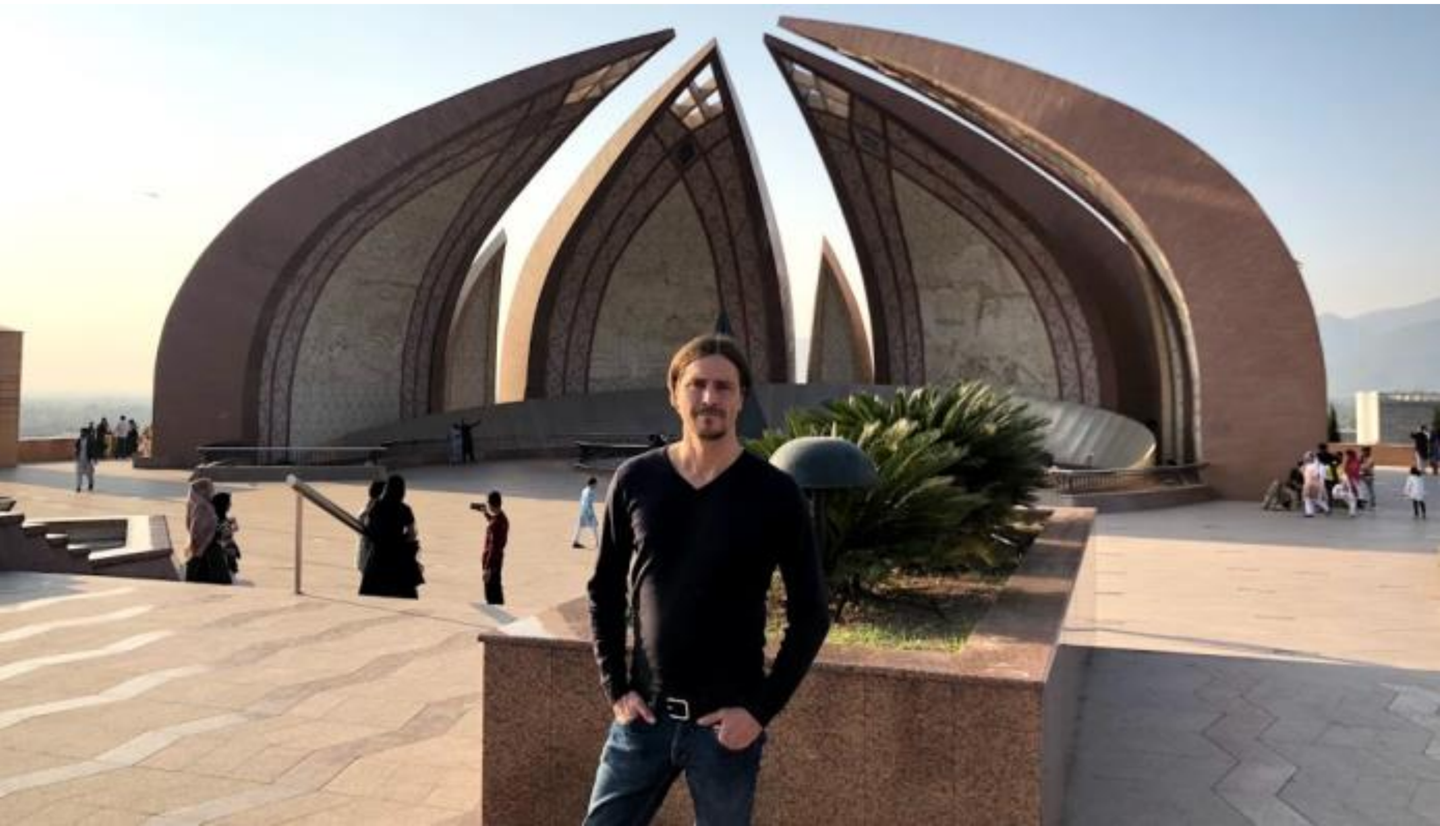
- The corporate sector has bottomed out. Demand has seen a slight improvement in September, and October and we expect a slight improvement in quarter-on-quarter performance going forward. The recovery will however be slower this time as compared with previous cycles where most corporates expect 1-1.5 years until normal business conditions. The sector that has taken the hardest hit has been the auto assemblers with both GST and new identification requirements denting demand. With new players entering the market, conditions are likely to be tough for slightly longer. Still, we expect several of them to make profits despite demand falling close to 50%.
- There is no evidence of a massive build-up in non-performing loans in the banking sector. The banks we met saw marginal increases in NPLs but they now see improvements across all sectors, including geared sectors like cements and steel. The problems in their portfolio are mainly from the overseas exposure, a widely discussed subject.
- The reforms which were lauded by the World Bank and helped Pakistan jump 28 places in the ease of doing business ranking for 2020 are actually happening. Based on our conversations with companies throughout all sectors, everyone is impacted and the adjustment is hard. Criticism is mainly focused on the pace of implementation rather than the measures per se. There seems to be a consensus that the chosen path is the right one.
- The Central Bank will not be lenient. We believe the first rate cut is likely to happen only March (base case) or January (earliest). The mantra we hear from the government and its representatives is about setting the stage for sustainable growth rather than a quick fix.
- Although a potentially unpleasant black swan risk we don't believe a blacklisting by FATF can be assigned a relevant probability. Pakistan targets to be off the grey list in the second half of 2020 which, based on how we see the progress, is reasonable to expect. We heard very little "blame game" as to why Pakistan is the country at scrutiny, however. Just a very clear focus on achieving the tasks set. The new government has accepted the current perception of the country and seems focused on improving it.

- The security situation continues to improve. It can be seen in the statistics: Total civilian fatalities in terrorist attacks peaked at 3001 persons in 2013. In 2018 this number had dropped to 369 *(source: SATP).* To put these numbers in perspective: Last year 325 people died in traffic incidents in Sweden. For me, as a regular visitor, I conclude that the atmosphere is very different than in earlier years. It is significantly more relaxed now and foreign tourists are a less uncommon sight these days.

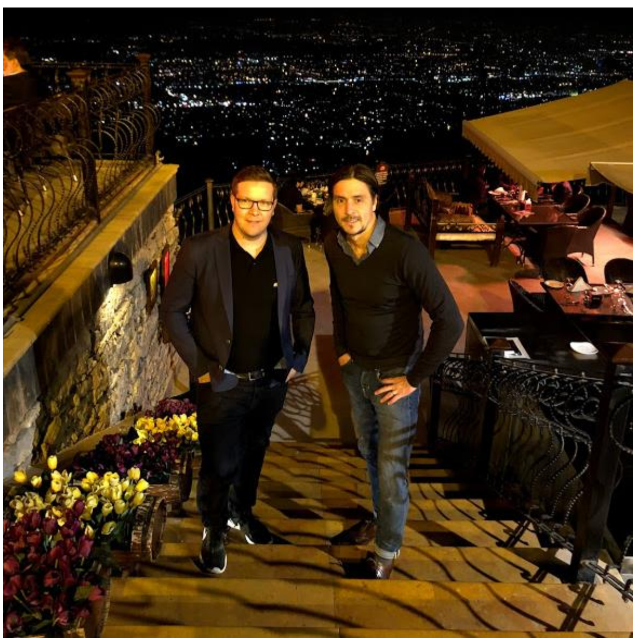
A common and strong denominator on the ground is the existence of … hope. Hope that despite the short term pain the country is experiencing, Pakistan is finally starting to build a foundation for what could become a sustainable growth path. It will not be a journey without challenges, however. Kashmir remains a black swan risk, as is anything happening to Imran Khan (he is more important than any politician ever was). Should the current work be allowed to continue however Pakistan has the chance to become the next big EM story. With the market trading at 30% discount to its 10-year average P/BV multiple the risk-reward remains favourable.

Stockholm December 2019

Mattias Martinsson
Founding Partner / Chief Investment Officer



Lunch at Tuscany Courtyard. It could just as well have been in Como or somewhere in Provence.



Dinner at Monal – a hillside pearl that is a must to visit when in Islamabad. The best kebab I’ve ever had. Below: Green Islamabad, beautifully located next to the mountains.

The ongoing protests were not visible except for a large number of containers blocking certain roads. We travelled freely but sometimes had to take detours.

Pakistan’s busiest man? Chairman of the FBR, Shabbar Zaidi. The person responsible for documenting Pakistan’s economy. One of the top three tax advisors of the country suddenly switched sides. As one of the CFOs said: ”He knows ALL the tricks. There is no escape”.

Meeting with the Minister for Economic Affairs, and also in charge of the FATF negotiations, Mr. Hammad Azhar. Very impressed.

Visiting Board of Investment, key task in the second phase of CPEC will be the Special Economic Zones.

We decided to go by road to Lahore from Islamabad. 300 km on excellent highways and the usual amenities alongside the road.

Leading private hospital provider Shifa. To the far right one of the original founders Mr. Zahid. Despite numerous administrative challenges Shifa still plans to double the number of beds in the coming 5 years.

Most subsidies are gone but the petrol price remains way below market price. 114 rupees = 70 cents, 30% lower than India. It will eventually have to rise and it will be painful for the consumer.

Arriving at the hotel in Lahore. Jokes aside, a pleasant surprise was that what used to be a well-kept secret – the hotel bar, is now openly stated among the restaurants. If you are a foreign tourist you can have your beer in the bar at Pearl Continental.

Good morning Lahore.

Morning meeting with Packages. Their main factory used to be in Lahore's poshest area, so they moved it and built a mall instead. 50 000 m2 of leasable space.

More local brands than what you normally find in posh malls like this one (3 listed above: Bata, Servis, and Nishat), and more locals shopping as opposed to just hanging around.

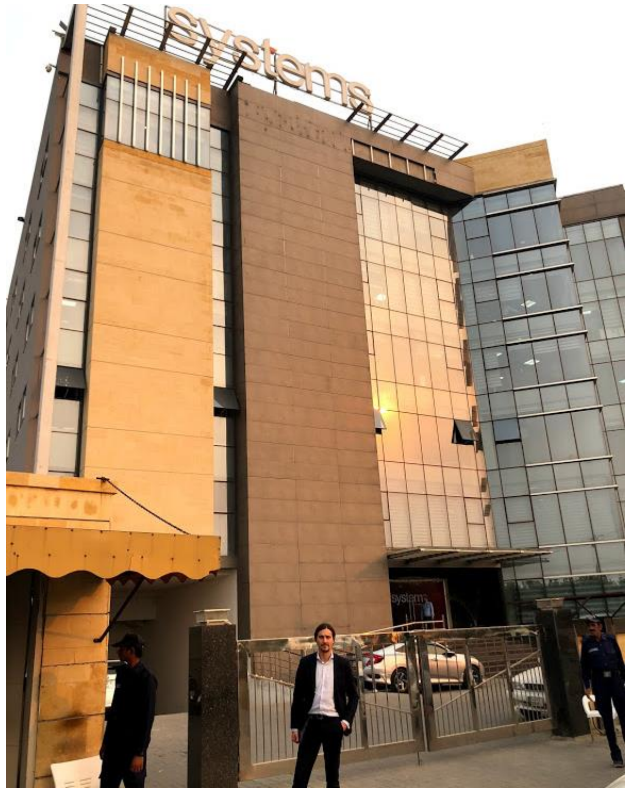
Streets of Lahore - Home to 11 million people. On our way between meetings.

Next to Andaaz, one of our favorite restaurants in Lahore is ”Food street”. A few years ago it was a wore down, dark alley which you would likely avoid (I used to). Now it is renovated, clean and safe. A place where families have dinner. Heartening to see.

Meeting with Honda Cars, one of the car assemblers. One of the absolutely hardest hit sectors. Car sales during the last 12 months have fallen by half due to several reasons: 1) All buyers of vehicles now need to be registered with their national identity card 2) More than 50% of components are imported which has led to significant price hikes. Still, it is encouraging to see that despite these short term shocks and volumes at half historic levels, a company like Honda Cars will still be able to make money going forward. The current sales volume in Pakistan (>200m people) is currently half of Sweden's and the pent up demand will eventually lead to a strong pick-up. Honda expects at least another 12 months with stagnant sales and meanwhile focuses on cost control. They are a typical example of the resilience we see in Pakistani companies. Been through these times before.

Meeting two of the leading cement companies of the north – Maple Leaf (top) and DG Khan. Conclusion was that we've seen the worst and both surprisingly hopeful on dams construction with the low cost housing project (5 million houses) an upside risk. No happy days until GDP growth is back above 4% though. Normal growth for cement demand in Pakistan is 1.5-2x GDP growth. Renewable energy projects and energy savings investments were among the topics of discussion.

Meeting with leading bank MCB. Known to be the most conservative among the larger banks. Expect inflation to remain at 11% throughout 2020 and no rate cut until earliest March 2020. Only a marginal increase in NPLs is expected.

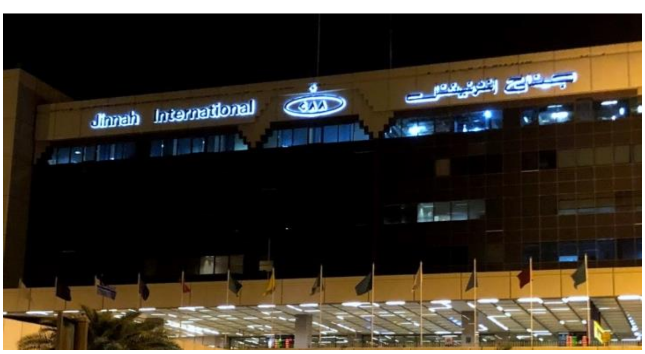


Outside Systems' headquarters in the outskirts of Lahore.

Asif Peer is a committed CEO. While we were in Lahore he was in Karachi, but connected via video conference to present his company where he is one of the larger shareholders. Very appreciated.

Domestic airport in Lahore. Normally much less hectic than the international terminals. This time also.

Landed in Karachi after 1 hour and 45-minute flight.



Jinnah International Airport

Travelling in Karachi. Even though the locals complain about the traffic we would say it is nothing versus cities like Dhaka or Lagos. In a day of meetings, you can easily take 5 meetings. Anyone who is used to travel in our countries understands the relief.

Imran and I meeting with one of the leading steel producers, Amreli Steels who produce mainly long steel (for construction). Expanded just before the crisis which means they have been hit hard through their relatively high gearing and higher import costs. Volumes continue to grow however which means they are hopeful to reach 85% capacity utilization within 3 years.

Meeting one of the leading commercial banks, UBL. Discussing the remaining issues in their international operations (GCC countries). Very transparent and one of the leaders in online banking.

Outside one of Amreli Steels' main warehouses.

Mid-sized bank Bank Alfalah. More active in consumer financing where auto loans is the main segment. Thus seen a sharp drop in business and there is risk of a higher rise in the NPLs than in the larger banks. In a low rate environment, its consumer financing business should probably excel again. A name worth watching.

Meeting Friesland Campina-Engro Foods, one of the largest packaged milk producers in Pakistan. New health regulations are discussed which could potentially grow the packaged milk market 3x over the next 10 years. It is still only 8% of total consumption. The company expects it to reach 20% over the next 10 years.

Meeting Pakistan's leading private IT-company, Systems. >80% owned by employees and former employees. 80% exports which mean they have enjoyed the last 2 years of devaluations. Have grown their topline by more than 30% per year over the last 3 years. Target to continue growing at 25% a year. In the picture CFO Roohi Khan.

CB Governor Dr. Reza Baqir on video link between meetings with IMF in Islamabad. An effort from the State Bank of Pakistan we really appreciated.

Three quarters of our local team (only Imran missing) with CEO of AGP Ms. Nusrat Munshi in the middle. A good discussion on the future expansion of one of the leading pharmaceutical producers.

FINAL WORDS

In our LinkedIn article from July 31st (link: http://bit.ly/38avOud) we talked about the asymmetric risk-reward scenario of the equity market where a too deep correction coincided with what is one of the most aggressive reform agendas ever undertaken in a country of significance. Our impression after our recent trip is that the optimism expressed is warranted. We believe the market has turned the corner and if none of the black swan risks materialize we will see conditions gradually improve from here. The much-discussed reforms, which made Pakistan jump 28 places in World Bank's latest ease of doing business index, are happening. This is confirmed by the corporates we're talking with. The pain is felt throughout the corporate sector but there is at the same time broad support for the moves taken. The current account deficit has come down to manageable levels, for October Pakistan even produced a surplus, and Pakistan has crossed USD 1bn of carry trades which signals foreign investors' confidence in the currency. Stabilization is reached. Now starts the second phase of reforms which will determine whether this is a traditional boom cycle (which will eventually be followed by a bust) or whether Pakistan will be able to build a more long-lasting recovery and avoid a new severe crisis in 3-4 years. This will be hinged on what we would describe as the most important reforms yet to bear fruit – Industrialization, and specifically improving the balance of trade. A range of measures have been introduced, including the second phase of FTAs with China, alignment of tariffs set by industrialization targets rather than as a revenue tool, simplifying license requirements for the oil & gas sector, setting up Special economic Zones (Bidding deadline for the first in Dhabeji Jan 21st), simplifying visa requirement to stimulate tourism (primarily religious tourism is a low hanging fruit) and increased efforts on skill enhancement of labour. Expectations need to be sober, however. Building a strong export base will take many years. The key question from sceptical foreign investors is whether exports and local production can keep up with import requirements in a faster growing economy. We are encouraged to see that the government now understands that this is the key challenge and that the reforms from here are targeting this challenge. Should they fail short term the new Central bank's monetary policy will allow for the rupee to gradually depreciate to avoid the sudden bust we saw early 2018 to mid-2019. For investors that is what you want to see. A proper plan AND a back-up plan should result of the reforms take longer than expected.

This cycle will be different but not only in a good way for equity market investors. The improvements will take longer given the ongoing documentation reforms and increasing tax base. Some of the traditional froth, like subsidized energy prices, an overpriced currency and tax avoidance, will not be there to support margins. Companies need to stand on their own feet from here on. Provided the reforms are allowed to continue however we believe the improved transparency and the disciplined fiscal approach will result in downward pressure on the risk premium investors require for their investments in the country. This should, in turn, allow for lower long term interest rates and higher multiples in the equity market.

The Pakistan story used to be about "the perception arbitrage" - good financial infrastructure and well-run family-owned companies navigating through very unfavourable circumstances while still outgrowing their Indian peers. A boom and bust market where the return over a full cycle was as attractive as in India. The currently ongoing reforms will be painful but what could come out at the end is a much more stable investment environment than we ever expected. This could transform Pakistan into a more traditional Asian growth story which will attract a new set of larger foreign investors that have so far avoided the market. With the market trading at a third to half the multiples of other Asian equity markets, the market is yet far from pricing in such a probability.

The hope we notice on the ground might actually be warranted.

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