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Investment outlook 2014

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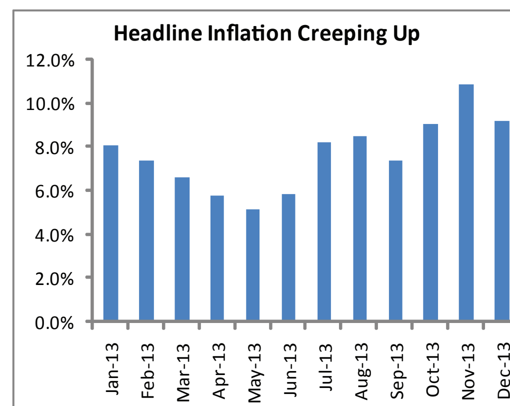
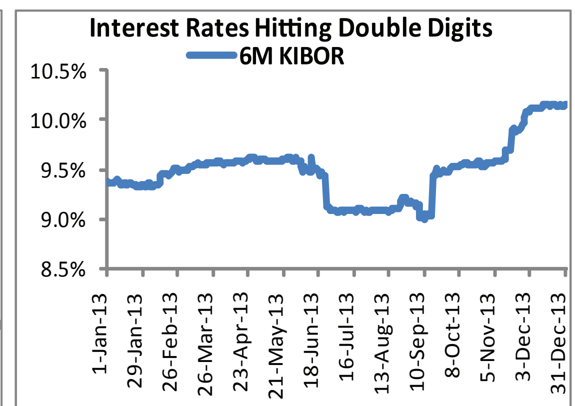
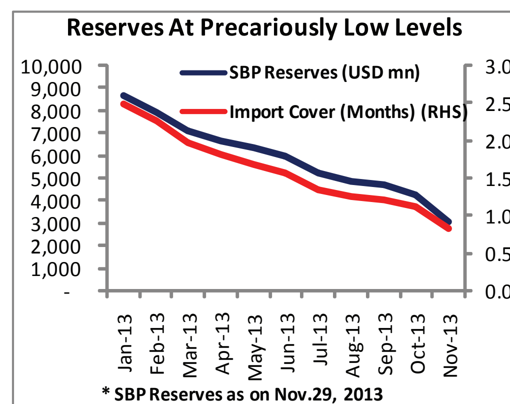
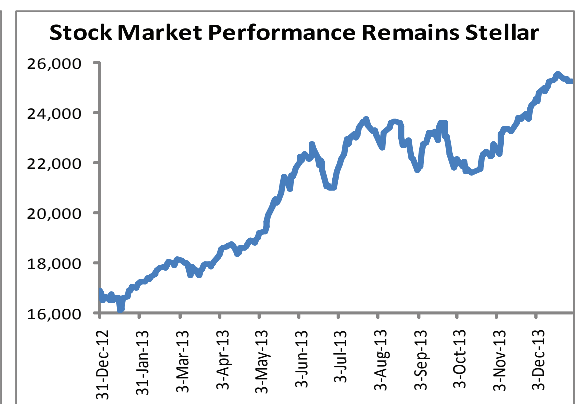
The year 2013 has ended on a mixed note for the Pakistan economy. Some of the negatives of 2013 include: Headline inflation notably picking up, foreign exchange reserves dwindling to precariously low levels exerting pressure on the rupee, and interest rates rising to double digits following an increase in policy rate and tighter liquidity conditions. On a positive note, post-resolution of power sector circular debt, industrial activity has picked up that has given a boost to the GDP growth rate; and government has demonstrated greater commitment to fiscal discipline by entering into a new IMF program.









But the stock market has continued to hit new highs with the benchmark KSE-100 Index rising by 5,345 points or 27% to 25,261 level since May 2013 general elections.

However, completely defying the earlier said negatives and to some extent, economic fundamentals, the stock market extended the earlier gains and hit new highs with the benchmark KSE-100 Index rising by 5,345 points or 27% to 25,261 level since May 2013 general elections.

We attribute this robust performance to continuous foreign buying and a sharp upswing in the local business sentiments as captured in the latest OICCI Business

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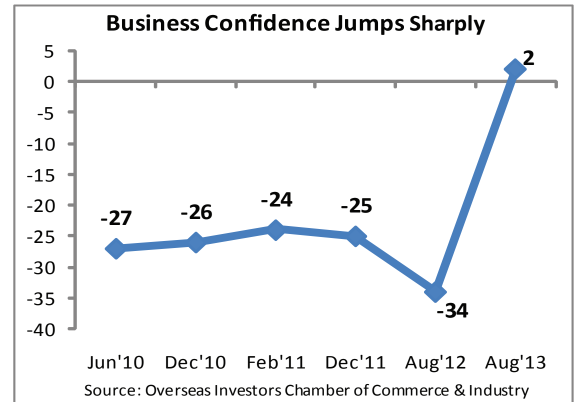
Confidence Index (BCI) Survey. According to the Survey, business sentiments have improved dramatically from negative 34% in August 2012 to positive 2% in July 2013. The positive sentiments are fueled by the perception that the new political setup will take appropriate measures to address load shedding, effectively tackle the law and order situation and generally improve governance. We feel that positive sentiments may have subsided since then on account of slow progress on the economic and governance fronts.



We expect macroeconomic challenges to continue during CY14. However, overall, CY14 is expected to be a better year than CY13.

With 2013 coming to an end, the million dollar question is how the domestic financial markets will perform in 2014. On the macroeconomic front, we expect the challenges to continue at least during 1HCY14. For instance, inflation is likely to remain at elevated levels due to further increase in administered prices notably energy, and their trickledown effect, and impact of currency weakness. Despite expected improvement in foreign exchange reserves, exchange rate would remain under pressure due to an aggressive reserves accumulation target set by the IMF. Interest rates would also remain on the higher side due to incessant government borrowing needs amid increasingly stringent quarterly government borrowing targets from SBP and higher private sector credit demand. On the flip side, driven by an upsurge in the industrial sector, FY14 GDP growth is likely to remain decent at around 4.0%. Budget deficit for the current fiscal year is also expected to come around 6-6.5% of GDP on account of certain expenditure rationalization and revenue enhancement measures, which though still quite high, would be below 8.0% registered last year.

We expect a steady improvement in macroeconomic indicators in 2HCY14 and beyond.

We expect a steady improvement in macroeconomic indicators in 2HCY14 and beyond. For instance, in the latter half of the year, inflationary pressures are likely to subside due to continued soft global commodity prices amid anemic demand, a more stable exchange rate and normalization of base effect of inflation. Further, despite a wider current account deficit, reserves position is likely to improve, driven by net disbursements from IMF and higher equity (FDIs/FPIs/privatization) and debt flows (multilateral lending, sovereign bond issues). GDP growth is expected to accelerate on improved energy supply and higher private sector investment in the aftermath of further structural reforms with a focus on fiscal policy, financial sector and trade policy; improved governance; greater political stability; and more conducive security situation.

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One frequently debated issue is government's heavy and increasingly unsustainable debt burden which currently stands at USD147bn or 63% of GDP. Debt servicing currently stands at Rs1.15tn, devouring 44% of tax revenues and leaving very little for development and other government expenditures. However, the argument on government indebtedness or creditworthiness ignores the assets owned by the federal government. According to our ballpark estimates, the government owns real estate and infrastructure assets well in excess of its total debt. It just needs to show the will and competency to gradually dispose off these assets to pay down liabilities the Pakistan government owns:

- Millions of acres of potential industrial, commercial, residential and agriculture land.
- Thousands of underutilized buildings at prime locations
- Mineral rights (coal, copper, oil, gas etc.) on millions of acres of land.
- Vast infrastructure assets including transportation assets (roads, bridges, railways, airports, seaports etc.), utility assets (electricity and gas networks, water treatment and distribution) and energy assets (extraction, power generation and transmission, pipelines etc.).
- Huge real estate owned by Government organizations and institutions such as the Military, PIA, Railways, Pakistan Steel Mills, etc.

The government owns real estate and infrastructure assets well in excess of its total debt. The government could easily generate billions of dollars just through sale of its stake in listed companies through the local and international stock exchanges.

A small proportion of the government owned assets are listed on the stock exchanges in the form of public sector (some now privatized) corporations. At current market capitalization, the value of government stake in these companies amounts to around USD15.5bn as depicted in the following table. This is substantially higher than the current EFF IMF loan facility of USD6.6bn. In our opinion, the government could easily generate billions of dollars just through sale of additional stake in these listed companies through the local and international stock exchanges. Further, the government could raise significantly higher amounts through new listings of erstwhile unlisted public sector organizations (e.g. PARCO, GHPL, State Life etc.) and strategic sale of its assets to local and international investors. The proceeds could be utilized to pay down public debt and build foreign exchange reserves as well as to invest in major infrastructure projects.

Govt. Stake in Listed Companies

Company	M. Cap (USD mn)	Value of Govt. Stake (USD mn)
OGDC	11,285	8,532
PPL	4,005	2,846
HBL	2,110	876
UBL	1,541	362
KESC	1,481	363
NBP	1,173	887
PTC	1,019	634
ABL	890	90
PSO	779	175
KAPCO	516	237
PIAA	229	194
SSGC	201	131
MARI	186	34
SNGP	128	41
PNSC	105	86
Total	**25,648**	**15,486**

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We expect the stock market to perform in line with corporate earnings growth of 20% in CY14.

During the last calendar year (CY13), the stock market has risen by a robust 49%. Subsequent to the above, the market is currently valued at a forward Price to Earnings ratio of 8.7 times. As per our estimates, corporate earnings are expected to grow at around 20% in CY14. We hold a positive outlook on foreign portfolio inflows as 1) despite expected Quantitative Easing (QE) tapering in US, global liquidity conditions are likely to remain easy due to a flagging economic recovery and persisting fears of deflation 2) Pakistan's weight in the benchmark MSCI Frontier Market Index will rise from 3.9% at present to 5.5% in May 2014 attracting additional foreign flows. We remain optimistic that the government is serious about undertaking key structural reforms this time around. Nonetheless, we do not expect the market to replicate the last year's performance due to relatively rich valuations and higher yield on fixed investments amid tighter liquidity conditions. However, we expect the stock market to rise in line with corporate earnings growth in CY14.

We expect yield on debt instruments to significantly improve in CY14 driven by higher interest rates, tighter liquidity conditions due to retirement of government borrowing from SBP and a strong credit demand from both public and private sector.

The yield on fixed income securities has remained quite subdued in CY13 due to lower interest rates, very loose liquidity conditions and dearth of private sector issuance and hunt for yield by the investors. We expect the yield on the debt instruments to improve in CY14 driven by higher interest rates, tighter liquidity conditions due to retirement of government borrowing from SBP and a strong credit demand from both public and private sector.

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