Faysal AssetManagement

# Pakistan Equities Rallying near 51k…. Alarm Bells Ring!

Giving a substantial return of 46% last year-the highest among Asian peers and the fifth best among global markets investors with savings have nowhere to go but the capital market.

The Chinese consortium`s entry as the buyers of a 40% strategic equity stake, signed and sealed a fortnight ago, has acted as a sweetener.

The consortium won by placing the highest bid of PKR 28 per share for 320m shares at the total price consideration of PKR 8.96bn, when the stake was put on the table in winter last year. It comprises the Chinese Financial Futures Exchange Company Ltd (lead bidders), Shanghai Stock Exchange, Shenzhen Stock Exchange, and two local partners: Pak-China Investment Company and Habib Bank Ltd.

But the PSX 100 index, now at the dizzy height above 50,000 points, having recovered from an eight year old shock that had sent it spiraling downwards to under 5,000 points, is something to reckon with.

The apex regulator, the Securities and Exchange Commission of Pakistan (SECP), has rushed onto the deck to tighten the ropes. SECP directed AMC's to maintain minimum 5% cash in their equity funds.

Chairman SECP held out an assurance that there was no likelihood of a market crash as the SECP`s Systemic Risk Department was active in market surveillance and monitoring; though he warned individual investors of blindly grabbing stocks in a quest for quick profits and released guidelines for them to trade with caution.

Last week also, the SECP also directed `existing companies other than public sector companies and multinational companies` to enhance their `free float` to 25% of the total issued shares and 5m shares in free float by Jan 03, 2018, where the companies fell short of that minimum limit.

Equity boom up until last year owed itself to corporate earnings, while the market is now liquidity driven. Market analysts have been feverishly estimating the cash that is waiting to enter the market espousing an optimistic outlook for liquidity. The continuation of the current low interest rate environment will benefit local equities where we see flows from Mutual Funds and Non-Banking Financial Companies continue this year as well. Further, there is now a strong likelihood of an amnesty scheme in 2017, which would be along the lines of the one implemented in Indonesia in July 2016 that fetched around $10bn in the Indonesian economy.

Given that Pakistan`s economy is 1/3rd the size of Indonesia, possible inflows of $2-3bn can potentially be realized by such an amnesty scheme. There are more inflows that most market gurus are looking for. The PSX can expect foreign buying of $100-200m worth stocks, following the market`s reclassification to MSCI Emerging Markets in May this year, regardless of the huge outflow of $339m in 2016. Analysts add to that the $100m stockbrokers would receive against sale of 40% PSX shares to strategic investors and 20% stock to the public in an upcoming initial public offering (IPO).

As long as the market stays flush with liquidity, there is low probability of any serious downfall. There is no foreseeable threat either to the underlying companies' growth and earnings. The Chinese consortium is expected to bring in investment, experience, technological assistance, new products and cross listings, adding that it would enhance the PSX brand profile and give it an international image.

With just around 2,50,000 account holders and only 558 listed companies was too small a base for the PSX, when compared to 50m investors and 5,900 companies on roll on the market on Dalal Street in Mumbai.

**By: Sania Awan -Sr. Research Analyst (FAML Research)** **January 30, 2017**

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The proactive role of the SECP and the PSX in speeding up the process of market reforms along with member co-operation in understanding that much of what is happening is a `win-win` situation for all.

Confidence is the name of the game; and liquidity is the trigger. The momentum right now is with the bulls in PSX, there is no stopping for the index, which is flirting with the psychological barrier of 50k. Is this a creation of an asset bubble? Are the companies experiencing exceptional growth, or is the market rerating itself to come at par with regional peers? Whatever it is those in stock brokerage business or heavily invested in the market are on adrenaline.

| Emerging Markets | P/E | Dividend Yield |
|---|---|---|
| Russia | 9.2 | 4.20% |
| Turkey | 9.6 | 2.70% |
| Czech Republic | 11.7 | 4.90% |
| UAE | 12.4 | 3.60% |
| **Pakistan** | **13** | **4.40%** |
| Brazil | 15 | 2.60% |
| Qatar | 15.1 | 3.70% |
| Malaysia | 16.9 | 3.10% |
| Thailand | 16.9 | 3.10% |
| China | 18 | 1.80% |
| Phillippines | 20 | 1.80% |
| India | 20.6 | 1.60% |
| Mexico | 22.7 | 1.90% |
| Indonesia | 23.9 | 1.60% |
| Egypt | 24.8 | 1.20% |
| Peru | 26.7 | 1.80% |
| South Africa | 30.2 | 2.80% |

One of the prime factors of high index growth is that the liquidity in the market is at unprecedented levels; and the leverage too is less than what it used to be in previous bull runs. The interest rates are low and equity markets are darlings of investors in such times. The real estate market was climbing even higher than stocks a while back; but its momentum was broken by imposition of taxes and introduction of new valuation tables in FY17 budget.

Since then, there has been no stopping to the shift of money to stock market. Investors, both directly or through mutual funds, have been continuously pouring money into the PSX. Lately, it's getting hard for domestic money to parked abroad; and that makes stock market even more lucrative. Even lately, SECP has directed mutual funds to keep at least 5% cash to cater to sudden redemptions; but the fresh flows are coming at a rate higher than what is invested by funds to keep their liquid cash intact.

Fundamentally, PSX can largely be divided into two chunks. In capital goods sectors including auto, cement, steel, chemicals and pharmaceuticals, the growth in companies' earnings is high; and the stocks' prices performance is even better. On the flipside, the valuation in sectors like banks, fertilizers and energy are saner. However, the margins in the latter sectors are compressed, and multiples are even more suppressed.

The market is behaving strangely; in sectors where margins are on the rise, price to earnings multiples are getting higher, while it's the other way round where the margins are cyclically downward. This is an absurd trend as its undermining the growth in volumes.

In auto sector, the EBITDA margins more than doubled in FY15; and within the sector, a lion's share is that of higher margins, while the volumetric growth (a barometer for real growth) is relatively much less. Margins have skyrocketed due to sharp appreciation against Pak rupee against many currencies (overvaluation of PKR is no secret), and low input prices (steel and rubber). Thanks to low competition and protectionist policies, the benefit did not get passed to the consumers, and hence companies' profitability soared.

High margins era continued in FY16 as well. Valuations of auto companies based on price to earnings or price to EBITDA multiples increased; and stock prices started moving up. Now, in FY17 with more liquidity coming in, the market is revising up price multiple ratios in the sector.

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Similarly, in the cement sector, low input prices amid import protection in an export competitive industry did wonders. The industry is now going through an expansionary phase; and market valuation of the sector is based on current margins and future volumes. Lately, steel is an emerging sector where capacity expansions are hinged upon government protection, and valuations are simply insane.

This is a dangerous trend as excessive liquidity is making investors blind. What would happen when the commodity cycle reverses? What if the government stops protecting these sectors? Early warning signs of commodity prices reversal are already here. This would be inflationary; and pressure on external account can force authorities to depreciate currency eventually. All this can bring imported inflation; needless to say that interest rates would start climbing.

The point here is that the margins of the capital goods sectors are mean reverting. In years to come, the margins will normalize and what would matter more is the volumetric growth for valuation. Nonetheless, once the global cycle reverses, banking and energy stocks will become precious for the investors; this trend is already in the making.

Since these sectors are index heavy; and a few stocks have ample float to become part of MSCI emerging market index. PSX will be part of MSCI emerging market index in May this year constituting of nine scrips. Eight of the nine stocks are in banking, fertilizer and energy businesses with only one cement company in it. This will open conduit for many global funds.

The price multiples at PSX are still much cheaper than many emerging market indices; and this fact pumps up the bulls even more. Hence, these stocks may rally once foreign investors come in the market as commodity price reversal takes place. It implies that index may not go down once margins in capital goods reverse as the index heavy stocks start moving up. However, any rising trend in the interest rates will shrink the liquidity in the market, which could hurt upward moving index.

Till that time, the ongoing momentum can make the market valuation in capital goods sectors more insane. There are other reasons for stocks in sectors like steel, to surge; their free-float is less, and it's easy to drive the prices upwards when the liquidity is pouring in. This is particularly a dangerous sign; in the recent book building of Roshan Packages, the strike price came at PKR 86.2 per share against the base price of PKR 35 per share. The blind investor seeing nothing but returns in the past year, and all mutual fund selling has been the glory of 2016.

It's virtually impossible to pin point a level that depicts index correction; however, signs are there that irrational exuberance is driving the market.

Thus, the benchmark PSX 100 Index is contained within the boundaries of a rising channel. At this point, RSI and stochastic are pointing down suggesting that the bearish pressure could trigger further decline towards the negative territory.

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