

**Equity Research Pakistan**

**In Focus Strategy**

**Hamad Aslam, CFA**  
haslam@bmacapital.com

**Economy Numbers**

CPI Inflation	Aug10 YoY	13.2%
SPI Inflation	Aug10 YoY	16.2%
NFNE Inflation	Aug10 YoY	9.8%
Reserves	As 10-Sep-10	USD16.1bn
Remittances	FY10	USD8.9bn
Trade Balance	FY10	USD(11.2bn)
Current A/c deficit	FY10	USD(3.5bn)
6 Month KIBOR	21-Sep-10	12.8%
10 Year PIB	21-Sep -10	13.4%
Discount Rate		13.0%

**Leverage, the Solution to all Problems - Really?**

- (Re)introduction of leverage in the form of upcoming MTS product should improve market participation and price discovery
- However price performance may still remain capped due to 1) lenders' reluctance to finance leverage tools and 2) Pakistan equities currently face crisis of confidence rather than liquidity
- As shown by numbers, lenders of previous leverage product (CFS) no longer appear to have the willingness or ability to finance the upcoming MTS
- Moreover, PKR55bn of domestic investors' net outflow since Jul09 and a whopping increase in investment in government papers, NSS and money market funds show that liquidity is not the primary concern facing the equity markets
- Thus given the current environment of political instability, increasing interest rates, rising inflation and energy crisis, (re)introduction of leverage should not alone be construed upon as a reason enough to build aggressive equity position

Much to the joy of Pakistan equity market participants, SECP recently approved the long awaited concept of Margin Trading System (MTS). While it may take over a month before the product is launched, it is envisaged that the revised version will have enhanced risk management guidelines.

Given the lackluster local investor interest in the market, leverage tools should undoubtedly increase trading activity at the bourse and aid in 1) price discovery and 2) implementation of an entry/exit plan – the two key ingredients used in formulating an effective investment strategy.

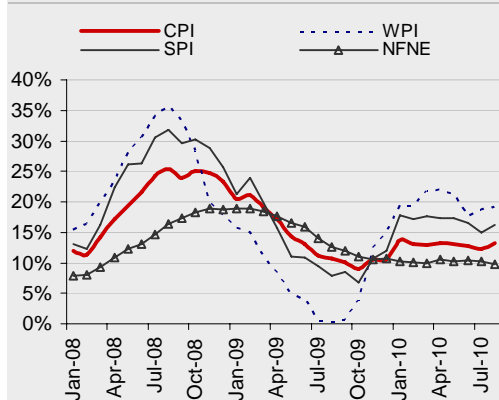
However we base our flip side of the argument on 1) lenders' reluctance to finance leverage tools and 2) Pakistan equities currently face crisis of confidence rather than liquidity.

**Who's going to lend? CFS lenders don't appear to be too interested**

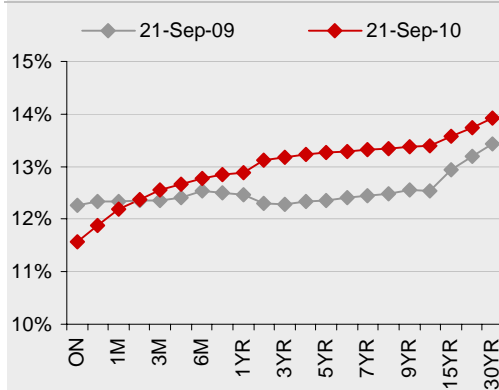
Tackling the former issue first, it should be noted that the last effective leverage tool at KSE i.e. Continuous Funding System (CFS) was largely financed by commercial banks, fixed income mutual funds, brokers and high net worth individuals. Given the equity market sentiments and performance back then, outstanding amount in CFS stayed near its upper limit of PKR55bn during 2HFY08 (Jan-Jun08) while other leverage tools (futures counter and bank overdrafts) were estimated to be of similar significance.

Current situation however paints a different picture. Commercial banks have been shying away from all sorts of risky lending and have been consistently parking their liquidity in government papers. As a result, IDR (Investment to Deposit Ratio) for the sector has risen to 38% in Jun10 from 33% in Jun09 while ADR (Advance to Deposit Ratio) has declined from 71% to 63% during the same period.

**Inflation**



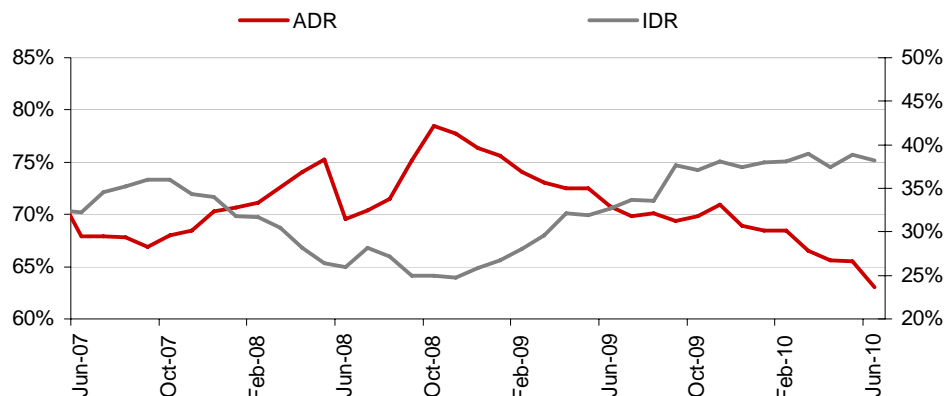
**Yield Curve**



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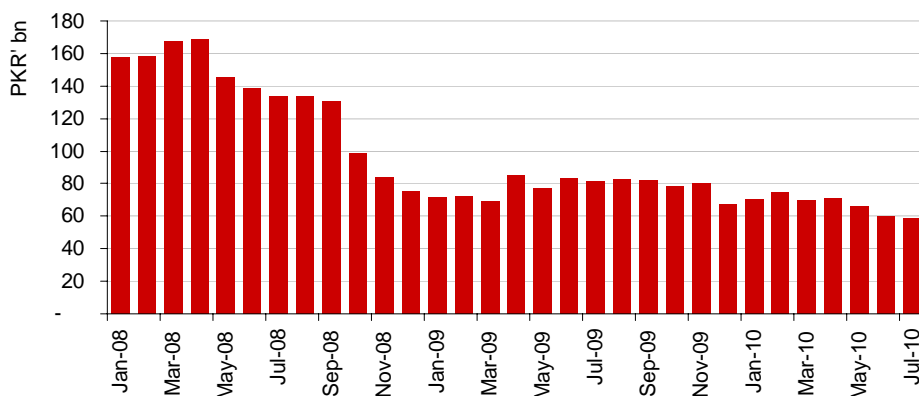
**Increasing IDR and declining ADR showing banks' reluctance to lend**



Source: SBP, BMA Research

A look at the next most popular supplier of funding to CFS i.e. fixed income mutual fund industry reveals an even more disappointing picture. Rising interest rates and economic slowdown led to severe loss of confidence (and defaults) in the corporate debt market (TFCs), resulting in unprecedented redemptions from income funds. The industry size for this segment currently stands at PKR59bn, down from its peak of PKR169bn touched in Apr08!

**Open-end Income Fund AUMs**



Source: Sixthsense, BMA Research

Thus while proposed rate of KIBOR + 8% for upcoming MTS may look attractive at first sight, it may not be enticing enough to generate enough funding to gear up the equity markets.

**The second argument: Who says liquidity is a concern?**

CY10TD has proved to be dull for Pakistan equities. Led by foreign investment in the heavy weight OGDC, KSE100 is up 6% for the period while most other blue chips have shown negative performance. Market activity and trading volumes present no different story where local investors have been seen to be consistently offloading their equity positions. On the flip side, foreign participation has been

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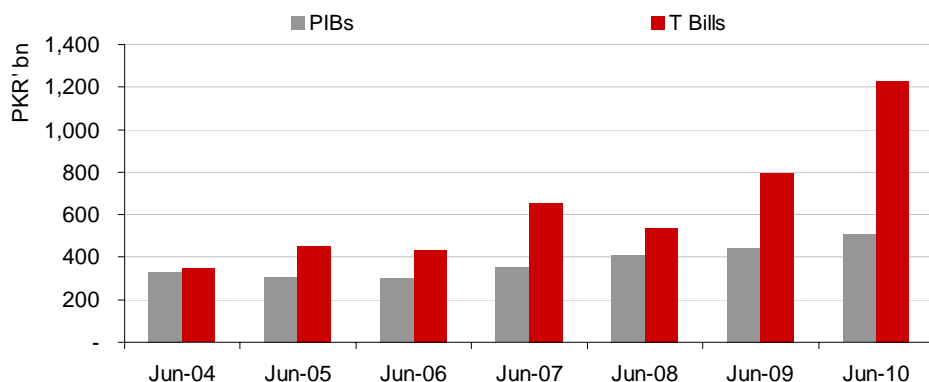
healthier than anticipated – net FIPI inflows have been recorded at USD658mn (PKR55bn) since Jul09 and USD371mn (PKR31bn) since Jan10.

The aforementioned flows however also represent net outflows recorded by the domestic investors during the same period and thus help gauge the amount of capital sitting on the sidelines and not being committed to equities.

Similarly, an analysis of the closely tied mutual fund industry reveals that open-end money market mutual funds have grown to PKR47bn (by Jul10) compared to a mere amount of PKR4bn in Jun09. While a portion of these inflows represent a switch from fixed income funds (that hold corporate bonds), it nonetheless signifies the kind of liquidity available with domestic institutions and individuals.

Investment in government papers and National Saving Scheme (NSS) represents no different story! Outstanding stock of T-Bills, PIBs and NSS has increased by a whopping PKR431bn, PKR64bn and PKR186bn during the outgoing fiscal year alone while banking deposits during the same period have registered a growth of PKR655bn.

**Outstanding Stock of Government Papers**



Source: SBP, BMA Research

Summing up the above in terms of money supply, it is interesting to note that even M2 supply has stayed in double digits during FY09 (10%) and FY10 (11%) thus substantiating our argument that domestic investors have the resources and liquidity to recommit to the market; what is lacking however is confidence and willingness.

**MTS likely to revive market participation; but price performance may remain capped**

Introduction of MTS should nonetheless increase short term investors' activity which is vital for any market to operate efficiently. However price performance and appreciation should remain capped in the current environment of political instability, increasing interest rates, rising inflation and energy crisis.

We thus believe that the return of leverage should not be construed upon as a reason alone to build aggressive equity positions. Portfolios should remain restricted to companies with healthy cash flows and business models adequate enough to sustain higher inflation and interest rates. Keeping this in mind, we reiterate our Overweight stance on Electricity (IPPs) and OMCs while our High Conviction Investment Ideas are maintained as PPL, MCB, APL, ACPL, LUCK and FFBL.