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PRICE POINT

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Frontier markets.

PAKISTAN: POLITICS, PROGRESSION AND POTENTIAL.

EXECUTIVE SUMMARY

Within frontier markets, Asia is offering up more and more interesting opportunities. Economic growth rates in these markets are far outstripping most emerging and developed markets. At the same time, as we continue to visit the region we are increasingly finding a greater number of quality companies to invest in.

In this Price Point, Oliver Bell, portfolio manager for T. Rowe Price's Frontier Markets Equity and Middle East & Africa Equity Strategies, highlights why he has been excited about Pakistan for some time now, and why he believes the investment backdrop continues to improve.

Contrary to the negative headlines we often see in the press, Pakistan has been slowly progressing on a much more stable path, and this has been rewarded with improving returns from equity investors. (Pakistan was the 3rd best-performing stock market in the Asia-Pacific region in 2014[1]). Much of this has been down to the real sea change we have been witnessing in the country.

Over the last few years, there has been a dramatic change in the political landscape. We have had for the first time a government completing a full term, the first time since independence 67 years ago, while the transfer of power to the opposition was also handed peacefully. Importantly, stability within the political landscape has led to a stability of economics and commitment to adhere to an IMF program[2]. This means we are dealing with a country that is lowering its budget deficit, privatising state-owned assets and starting to tackle energy shortages; all meaningful milestones for international investors.

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[1] THE Karachi 100 index returned 33.0% in U.S. dollar terms from December 31, 2013 to December 31, 2014. Source: Thomson Reuters

[2] The International Monetary Fund saved Pakistan from a possible default in 2013 by agreeing to lend US$6.8 billion over a period of three years. The cash is being distributed in increments and could stop if Pakistan fails to institute changes, such as cracking down on tax evasion and privatizing loss-making state companies.

Pakistan stands out among Asian frontier markets, with valuations low and companies benefiting from restructuring.

REAL PROGRESS BEING MADE

As part of the IMF program, they have committed to a very aggressive, almost unprecedented privatisation program. In June 2014, Pakistan experienced its first privatisation in seven years, with the sale of 19.8% of United Bank. Plans for 2015 include the sale of 41.5% of Habib Bank in a secondary public offering, tentatively planned for this month, for which the government is hoping to raise around US$1.2bn. Several electricity supply companies are also scheduled to be sold to strategic investors in 2015, which we believe should be a litmus test for reform in the sector.

While not strictly a privatisation, there are also plans to sell a 40% strategic stake in the stock exchange, and to list an additional 20% of shares on the exchange itself.

Meanwhile, they are also embarking and prioritising on a massive restructuring and privatisation of the power sector, which is much needed to unleash Pakistan's economic growth. (After slumping to less than 3% from 2007-2011, economic growth is steadily rebounding and is estimated at 5.5% this year, but this could be much higher if structural changes continue).

LOWER INFLATION PROVIDING POSITIVE DEVELOPMENTS FOR MONETARY POLICY

The fall in oil and other commodities is also providing a further tailwind to the economy. This has had a knock-on effect to inflation, with the rate dropping quite sharply in recent months, and is now at an 11-year low. (Inflation fell to 3.2% in February).

On the back of these lower inflationary pressures, Pakistan's central bank has cut its key discount rate twice so far this year (a 1% reduction in January, followed up by a further 50bps in March, taking the rate to 8.0%). Encouragingly, we are expecting more to come if inflation remains anchored at these lower levels.

POSITIVE DEMOGRAPHICS AND MOST LIQUID MARKET

Pakistan's 186mn population is the largest among frontier markets, and the sixth largest globally (after China, India, the US, Indonesia and Brazil). A 9% weight in the MSCI Frontier Markets Index ranks Pakistan third by weight (after Kuwait and Nigeria), making it the largest oil-importing country in the index. With 560 companies listed, the US$77bn market cap Karachi Stock Exchange trades US$150mn daily, giving Pakistan the most liquid equity market among countries in the MSCI Frontier Markets index. (The market's free-float is approximately 33%, with around 35% of the free-float owned by foreigners[3]).

FORMER EMERGING MARKET

The Karachi Stock Exchange also has a long history, dating back to 1947, and Pakistan will be familiar to some emerging market investors as it was considered a mainstream emerging market from 1994 until 2008 (when a margin-trading-related crash led to the market closing for several months and MSCI reclassifying the market as frontier).

The good news, in our view, is that new listings from the government's IMF-mandated privatization program should continue to broaden the market, and this will at some point be recognized by MSCI.

BEWARE OF THE PAST

Although improving, it is however important to remember that Pakistan has had a chequered past, and therefore caution is always necessary. The government of Prime Minister Nawaz Sharif, which came to power in 2013, is still under pressure to do more to revive the economy, solve crippling power shortages and create more favorable conditions for badly needed foreign investment. Pakistan also ranks last within Asia in the World Economic Forum's competitiveness scores, and in the lower half of the World Bank's Ease of Doing Business survey.

Meanwhile, despite inflation falling recently to much lower levels, it has been structurally high over the past decade, averaging nearly 11%. Food and housing are the two major components of the CPI basket – making inflation prone to supply shocks.

[3] Source: MSCI Factset.

Therefore, there is much to monitor when approaching investment, and investors need to be both active and diligent.

GREAT VALUE

However, along with Sri Lanka, Pakistan stands out among Asian frontier markets as much of the bad news is already embedded in valuations. The market traded at a low of 6-times forward earnings. Recent gains have moved that forward P/E onto 9-times[4], but this still remains very favorable versus other frontier, emerging and developed markets.

Additionally, with markets currently showing zero tolerance of negative earnings momentum, Pakistan has benefited as we have seen a strong trend of earnings upgrades. The positive backdrop is further enhanced by the potential for many companies to benefit from the more stable political environment, along with the boost that lower energy prices will bring.

FINANCIALS PROVIDING THE BEST WAY TO GAIN FROM POSITIVE ECONOMIC DRIVERS

As we have stated before, the opportunity set in Asia as with other frontier markets is majorly focused on the financials sector. Encouragingly, financials is an area where we continue to see a tangible difference between the emerging and developed world, and we are strongly playing this theme throughout the region.

The banking systems in frontier and emerging market countries have also been through a crisis in the past 20 years. Having learnt from the painful experience of excess leverage and a severe bad debt cycle, lending practices have improved in many countries, and banks therefore tend to operate on a more traditional basis. Most concentrate on taking deposits, making loans to consumers and to businesses, and processing transactions; this model is very supportive of profitability, if well-managed.

Valuations are also generally favorable. There are many banks trading at high single-digit to low double-digit levels when considering forward looking price-to-earnings ratios. Many frontier banks are also generating exciting, but also sustainable return on equity levels. 20% per-annum growth is not uncommon, especially in Pakistan and Sri Lanka.

In Pakistan, banks had been in a de-leveraging cycle for almost five years up until the summer of 2014. This has reversed sharply and loan growth has now picked up, into double-digits in some cases, as corporates have started to re-leverage. This is now coming through strongly in profits growth.

WINNERS & LOSERS: GREAT OPPORTUNITIES FOR STOCK PICKERS

With all frontier markets though there are winners and losers. Identifying a theme or a trend does not necessarily make a successful growth investment. Stock returns within the same country and industry can exhibit notable dispersion. Therefore, it is important to spend a great deal of your research figuring out who really is winning in these marketplaces. This will help to refine stock picking ideas.

Overall though, Pakistan and other markets in the Asian frontier region are becoming more important to investors. Positive demographics and low credit penetration levels provide a robust backdrop for investing.

These markets though still remain relatively high-beta areas compared to developed and some emerging markets. A prolonged period of political uncertainty would likely damage economic policy making, so you still have to incorporate some type of political risk premium when investing.

However, with a focus on the fundamentals and careful stock selection, experienced investors can help to mitigate some of the risks, and potentially reap significant long-term rewards from markets like Pakistan.

[4] As of February, 2015. Source: Renaissance Capital.

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