Is the Pakistani Stock Market still attractive to buy?

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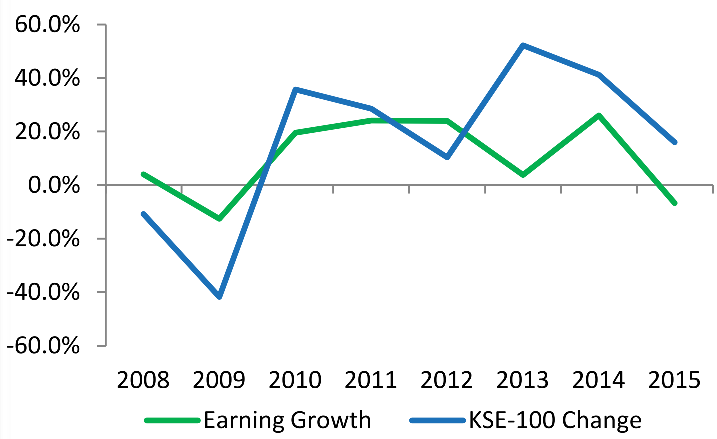
Local equity markets have delivered phenomenal returns over the last few years. The benchmark KSE 100 Index has increased by more than sevenfold to 36,000 points from the trough level of 4,815 hit in January 2009. With the KSE 100 Index hitting record highs, many investors ponder whether the stock market would continue to post handsome returns going forward.

Dissection of Historical Performance of the Stock Market

We highlight that simply looking at the Index level in isolation could be misleading without taking into account key stock market drivers such as corporate earnings growth, valuations (Price to Earning, Price to Book Value, dividend yield, etc.), key macroeconomic indicators (GDP growth trend, inflation, interest rates, external account position, etc.), and geo-political & security situation. Corporate earnings and dividends have remained robust, rising at a Compounded Annual Growth Rate (CAGR) of around 14% during the last six years.

Fig 1 KSE- 100 Index Largely Following Corporate Earnings Growth



Source: KSE, NAFA Research, July 2015

Fig 2 Corporate Earnings Growth and Dividend Yield Explain Most of Market Performance

	FY09	FY15	% Change p.a.
KSE-100 Index	7,162	34,399	30%
Earnings (PKR bn)*	207	464	
Dividends (PKR bn)*	108	234	
Breakdown:			
Earnings Growth	14.40%		
Dividend Yield	6.90%		
PE Re-rating	8.60%		
Market Performance	**30%**		

*Based on NAFA Universe of 72 Large Companies (90% of KSE-100 Market Capitalisation)
Source: KSE, NAFA Research, July 2015

As seen from Fig 1, the KSE-100 Index has largely tracked the growth in corporate earnings and dividends. Our analysis, as summarized in Fig 2, shows that almost three-fourth of the market performance during the last six years (June 2009-June 2015) is explained by corporate earnings growth and dividend yield. During this period Price to Earnings ratio of the market has rerated from 6.4 times to 9.5 times. Significant improvement in macroeconomic indicators as manifested in multi-year low inflation, rising GDP growth rate, benign balance of payments position, contained fiscal deficit, and improving political & security situation is the key reason of the market re-rating.

Fig 3 Macroeconomic Indicators have Significantly Improved

	FY2009	**FY2015**
GDP Growth	0.4%	4.2%
Foreign Exchange Reserves (USD bn)	12.4	18.7
Import Cover (number of weeks)	18.6	20.7
Current Account Deficit as % of GDP	5.5%	0.8%
Fiscal Deficit as % of GDP	5.2%	5.2%
Inflation	17	4.5%
SBP Discount rate	14	7.0%

Source: SBP & Ministry of Finance

What is the Justified PE Multiple of Our Stock Market?

We have used Justified PE framework to assess the upside in the stock market from the current levels. The justified PE methodology is a simple yet intuitive valuation technique that uses macro inputs like interest rates, corporate earnings, dividend payout and associated risks to calculate a justified PE ratio for the market. The justified PE ratio formula takes into account estimated earnings/dividends growth rate (g), cost of equity (r), and dividend policy (pay-out ratio) to get a justified PE level for the market:

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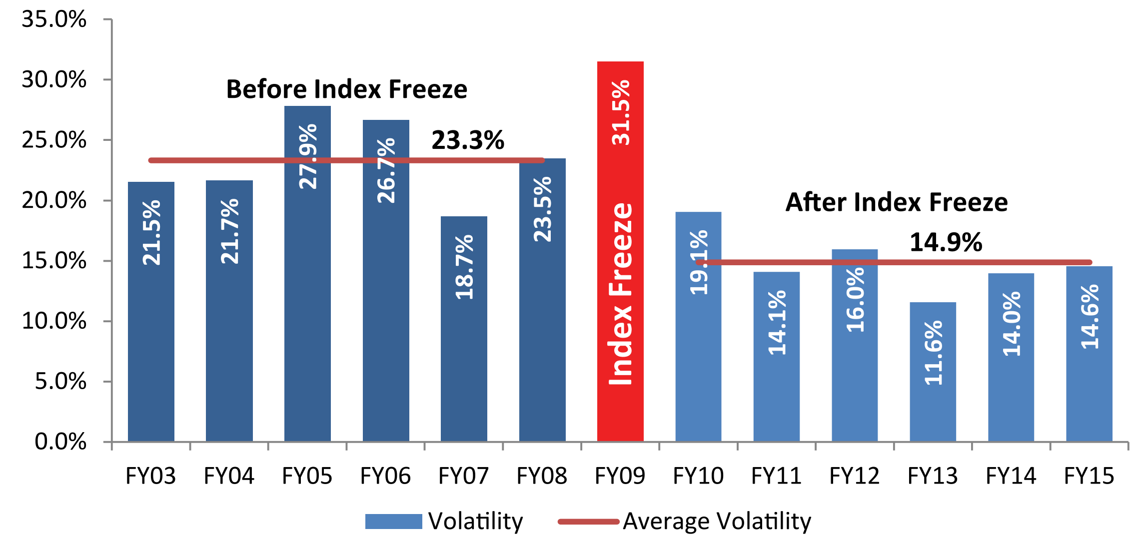
$$Justified\ PE = \left(\frac{Payout\ Ratio}{Required\ rate\ of\ Return - Growth}\right)$$

Payout ratio is the proportion of earnings that is paid out as dividends, while growth represents expected aggregate earnings growth of the companies listed on the stock market. Required Rate of Return takes into account the risk free interest rate and the equity market risk premium required by the investors to carry the equity risk. Mathematically, the justified PE multiple of the stock market depends upon; (i) the required rate of return of investors; (ii) pay-out ratio and; (iii) the expected growth in earnings.

The medium term risk free rate, based on 5-year PIB, is around 9% currently. We project subdued commodity prices, contained fiscal deficit and measured broad money growth trend to continue in the coming years as well. Based on this, we project inflation to remain at around 7% p.a. in the near future. Thus, medium-term risk free rate is expected to remain at around 9% p.a.

The risk premium is based on volatility (risk) of the stock market. A historical analysis of daily Index movements reveals that stock market volatility has notably diminished over the last few years. In order to quantify the reduced volatility, we have taken daily volatility as measured by standard deviation (σ) from FY10-FY15 (6 years after the market freeze in FY09) and compared it with daily volatility from FY03-FY08 (6 years before the market freeze in FY09). We have excluded FY09 as an outlier as the market remained frozen for a several months during the year and crashed dramatically post freeze period, resulting in the supernormal volatility during the year. The results show 840bps reduction in volatility.

Fig 4 Substantial Reduction in Market Volatility (Std Deviation)



Source: KSE, NAFA Research, July 2015

The sharp reduction in volatility as depicted in Fig 4 can be attributed to lower leverage position in the market, higher participation of more informed investors including institutional investors, attractive valuations post 2008 market crash, and improved macroeconomic indicators. The historical (last 30 years) risk premium of the stock market is 7%. This is based on an average return of 16% p.a. on the stock market and an average risk free rate of return of 9% p.a. over the last 30 years. Reduced stock market volatility, along with strengthening macroeconomic indicators and improving political and security situation warrants a lower equity risk premium going forward. However, based on prudence we continue to assume a 7% p.a. equity risk premium in the coming years. Based on the abzve analysis:

$$Required\ Rate\ of\ Return = Risk\ free\ rate + Market\ Risk\ Premium = 9\% + 7\% = 16\%$$

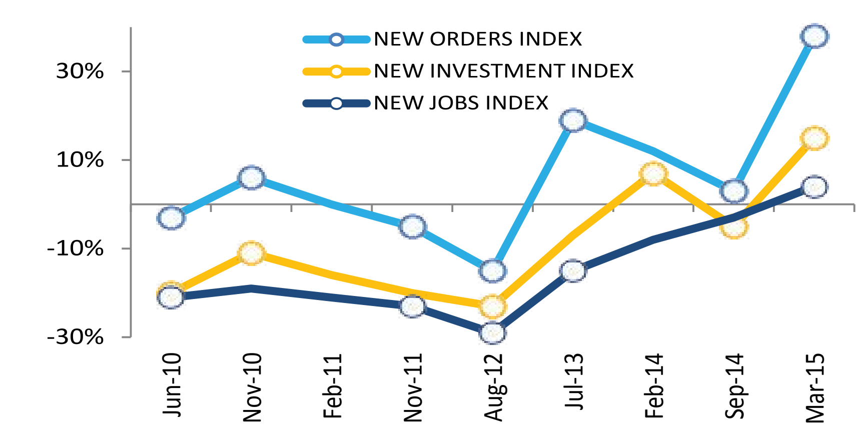
We expect corporate earnings and dividends to grow in line with nominal GDP growth (inflation + real growth) in the medium-term. Our estimate for this nominal growth rate is 12%, assuming 7% inflation and 5% real GDP growth. Real GDP growth hit an eight year high of 4.2% in FY15. Over the medium term we expect economic growth of 5% driven by greater macroeconomic stability, ameliorating security and law and order condition, improving political climate, benign interest rate environment, higher development spending, implementation of infrastructure projects under the China-Pakistan Economic Corridor (CPEC), and resolution of structural bottlenecks, especially the energy shortages.

The current dividend pay-out ratio of the market is around 50%. Going forward, we incorporate a pay-out ratio of 50% and alternatively a retention rate of 50%.

$$\textit{Corporate Earnings Growth} = \textit{Real GDP Growth} + \textit{Inflaton} = 5\% + 7\% = 12\%$$

A survey conducted by OICCI which encompasses the job market, manufacturing activities, and investments explains the improvement in business confidence as depicted in Fig 5. The results of the survey indicate considerable improvement in all the three areas. This further strengthens our belief in the economy growing by 5% p.a. or more in the coming years.

Fig 5 OICCI Survey Indicates Improvement in overall Business Activities



Source: OICCI

Incorporating a pay-out ratio of 50%, required rate of return of 16% and corporate earnings growth rate of 12% into the formula, we arrive at a justified PE of 12.5 times for the Stock Exchange:

$$\textit{Justified PE} = \frac{\textit{Payout Ratio}}{\textit{Required Return} - \textit{Growth}} = \frac{50\%}{(16\% - 12\%)} = 12.5x$$

Justified PE multiple of 12.5 times versus the prevailing forward PE multiple of 9.5 times suggests an upside potential of 32% in the stock market. Assuming that the stock market takes five years to rerate itself to our justified earnings multiple, 5% p.a. compounded return (upside potential) can be expected from rerating of the stock market every year. Adding to this the 12% p.a corporate earnings growth, and 5% p.a dividend yield, the total overall expected return of the stock market is around 22% per annum over the next 5 years.

Conclusion

The higher risk of the stock market is generally a deterrent for employee funds and individual investors. However, the current returns offered by bank deposits and T-bills of around 6%-7% may not even compensate for erosion of purchasing power by inflation in the coming years. Hence, it is not advisable to keep the entire investment in fixed income securities. The stock market is still an attractive investment avenue despite strong performance in the recent years. Our analysis shows that assuming the present macroeconomic trends continue, the expected return from the stock market is 22% p.a. Thus, investor should consider investing some portion of their assets in equities. We recommend that a portion of retirement and individual investors' funds be invested either directly in the stock market or via Capital Protected Strategy where the capital remains protected while investor also benefits from the expected upside/growth of the stock market. Such a Capital Protected Strategy is expected to provide a return somewhere between the fixed income avenues and the stock market.