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Pakistan Seeks a Return to Glory

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Research Report by
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Plagued in the recent past with rampant political corruption, an intensifying border conflict, and frequent terrorist activity, the headlines would suggest now is not a good time to invest in, let alone visit, Pakistan. However, the outcome of the country's most recent national election has dramatically shifted sentiment, attracting investor interest and funding from both neighbors and the IMF.

Still Batting for Pakistan

A recent trip into Pakistan provided a sensory immersion: Karachi's hectic traffic mixed with the smell of fresh Roti (bread) cooked in clay tandoor ovens and sold by the city's street vendors. The depth and beauty of Lahore's culture against a backdrop of minarets rising above centuries-old mosques. The visit proved equally information rich, aiding our understanding of the economic and market forces at work and leading to our discovery of interesting investing opportunities.

This diverse 200-million-person economy presents attractive demographics, underpenetration across many sectors, strong management teams, an inexpensive and liquid stock market, and a strategic geographic position that offers many positives. The investment potential for Pakistan is once again being evaluated as its popular new and untested political leadership comes into force.

From pitch to politics, Imran Khan shoulders the burdens and carries the hopes of Pakistan

All eyes are on newly elected Prime Minister and Hall-of-Fame cricket star Imran Khan to see if he will be the all-rounder in politics that he was on the pitch. As corrupt as his predecessor's government proved to be, former Prime Minister Nawaz Sharif's tenure in office clamped down on terrorism and was good for business, fostering an economic boom and consumer-driven recovery through political stability and the funding of large-scale projects to repair and replace decaying infrastructure in transportation and electric power.

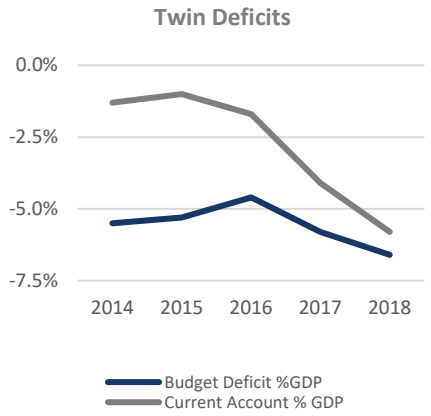
There are positive forces fueling good will for Pakistan under Khan's new government. First among those is IMF support in the form of a $6 billion loan, albeit with the bitter pill of a mandatory currency devaluation. Second is China's continued commitment to the $62 billion collection of infrastructure projects contained in the China-Pakistan Economic Corridor (CPEC) project.

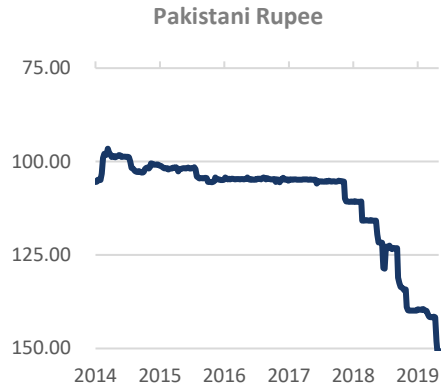
The 2013 election initially gave Sharif and his Pakistan Muslim League (PMLN) party political momentum that they were able to channel into a formidable economic expansion. Pakistan quickly assumed the position of safe haven for frontier market investors. Unfortunately, that role came undone in 2017 as a result of three key and coincident developments: a downturn in the commodities cycle, the country's elevation from frontier to emerging markets status (where it was ignored by EM investors), and the release of the Panama Papers, which explicitly implicated Sharif in high level corruption. The Supreme Court of Pakistan reacted by disqualifying Sharif from holding office based on the disclosures, creating a turbulent environment locally, and left international investors perplexed as to how the situation would play out.

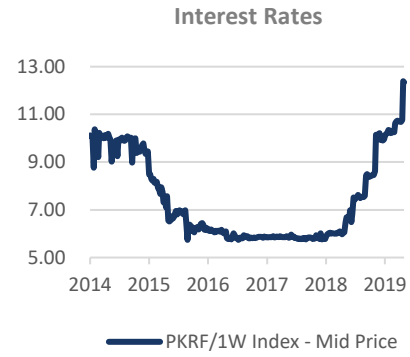
After nearly two years of significant market underperformance and rupee depreciations, the 2018 election of cricket star Khan and his Pakistan Tehreek-e-Insaf (PTI) party provided a beacon of hope for the scandal-weary populace. PTI pledged to stabilize the economy by managing the fiscal deficit, increasing exports, creating better hospitals and schools, and supporting institutions for training skilled labor. The transfer of power occurred just as the country was reaching a near breaking point from macroeconomic pressures.

Despite multiple rounds of currency devaluation, the rupee remained overvalued, inflation was rising rapidly and low real interest rates weighed on financial sector companies' strategies to deliver strong performance. Since 2018, the currency has dropped more than 40%, and interest rates have increased nearly by 700bps. On top of that, the economy shoulders the burden of twin deficits: trade and fiscal. The import-export imbalance is exacerbated by the country's status as a net importer of petroleum products, with domestic sources of oil production covering only about 20% of consumption. Fiscally, the country has been unsuccessful in efforts to persuade Pakistanis to pay income taxes. Only about 1% of the population is currently counted among tax filers, although interestingly a much larger percentage of the populace donates to specific government campaigns, such as "Imran Khan's Education Fund," because they want to contribute to their country while having greater transparency and control over where their money goes due to the widespread corruption.

These conditions have required considerable creativity in fiscal management. To build up reserves, pay off debt, and buy time to negotiate terms on the IMF deal, the government successfully sought financing from strategic allies, including Gulf Cooperation Council (GCC) countries like Saudi Arabia and its primary infrastructure development partner, China. The China connection is advantageous for both countries. Pakistan offers one of the most direct and least politically complicated routes to a seaport for companies in Western China. In exchange, Pakistan enjoys an enviable economic development package, including construction jobs and spending at the front-end and a significant import-export industry upon completion.







Source: Bloomberg

Changes have been slow under Khan and his anti-corruption PTI party. One of the biggest challenges is that they are not politicians or public administrators. With an administration that is learning on the job, the business community remains hopeful and confident that the country is on the right track but at a much slower pace than they would have hoped.

Our meetings in Pakistan explored the nature and effects of the political and macroeconomic situation as well as the idiosyncratic challenges and opportunities for Pakistani companies. We met with CEOs, CFOs, analysts and line managers. In the complex and rapidly changing business environment of Pakistan today, we see significant divergence in the prospective outcomes for leading Pakistani Industries:

Strategic Location

Positioned between the industrializing West of China and the Arabian Sea, Pakistan offers a relatively direct overland route to ports and important sea lanes.

Banking

The banking system is uniquely split between Islamic, traditional, and hybrid banks. Islamic banks tend to be more intriguing as they are growing nearly twice as fast as traditional banks due to strong demand for easily accessible Shariah-compliant banking products and services. Islamic banking accounts for about 14% of the total banking system and is expected to increase to 20-30% within five years. Islamic banks have an advantage on the deposit side as there is no defined formula for a minimum deposit rate they need to pay, unlike traditional banks which are required by the central bank to pay at least 2.5% below the discount rate. While this provides room for Islamic banks to undercut traditional competitors, the competitive nature of the Islamic banking industry keeps rates reasonable (albeit at lower levels). It's important to note that bank customers typically don't switch to Islamic Banking from just a religious perspective. Some of the Islamic banks also offer a superior suite of banking products. That is why people are willing to receive less interest on their deposits.

On the lending side, according to Shariah, Islamic banks are unable to invest in traditional government securities (Pakistan Investment Bonds, PIBs, or T-Bills), requiring them to focus more on corporate and retail asset lending. Islamic banks have commented that they can increase deposits significantly but have limits on lending due to a limited number of compliant channels. Instruments such as Sukuks, which are government bonds compliant with Shariah law, have been increasingly introduced to allow the Islamic banks to participate in government debt vehicles.

Among traditional banks, a duration mismatch recently caused profits to increase significantly when in 2019 the central bank raised interest rates by over 4% in reaction to the PKR devaluation and rising inflation. However, the business model of traditional banks is now coming under question. They have historically lent to the government and thus may be poised for a shakeup in the future as the government pushes for banks to lend more to smaller enterprises in hopes of stimulating the economy. As in many other developing markets, Pakistan's banking sector is marked by severe underpenetration. There are only 50mn deposit accounts in this country of 200mn people, with total deposits measuring only about 35% of GDP. This opportunity has prompted banks to begin moving into digital banking, a development that holds considerable potential for the industry.

Lahore

Constructed in 1673, The Badshahi Mosque is one of Pakistan's most revered sights. Located in the Punjab region bordering India, Lahore is considered the cultural capital of Pakistan. Its fertile land provides cotton for the textile industry and many other agricultural products.

Photo Andres Martinez

Automobiles

A large middle class, increasing disposable income and low car penetration contribute to strong innate fundamentals for the Pakistani auto industry, which is organized through partnerships between local manufacturers and brand name international car makers. The industry has been hampered of late by unpredictable regulatory decisions (such as permitting only tax filers to buy cars), rising import costs due to PKR depreciation, rising interest rates and government incentives provided to new competitors.

Government and regulatory actions reflect three objectives: introduce more quality international manufacturers to the market, limit the importation of used cars and use auto sales as a mechanism to increase tax collections.

Karachi

Considered Pakistan's business capital, Karachi houses many large industries and is home to the country's main port.

Photo Andres Martinez

The investable space consists of local joint ventures with quality international players: Indus Motors (Toyota), Honda Atlas and Pak Suzuki. Pak Suzuki operates in the economy segment, while the others operate in the premium segment. Within the next year, two new international competitors, Kia and Hyundai, will enter the space with most of their capacity coming online in 2020. Renault is expected to enter the market within two years. While car penetration remains low, the influx of new manufacturers will likely erode market share from existing companies and deteriorate pricing power across the board. At the same time, profit margins will likely be pressured by currency weakness. Auto makers import roughly 50-70% of their materials. This means that if there is a 10% depreciation in the currency, the companies will need to pass on a 5-7% price increase onto buyers to maintain margins. As a result, we believe the outlook is troubled at least for the next few years.

Pharmaceuticals

The primary players in the pharma sector work under an import model, where 90% of products sold are imported. Operational locations in Pakistan are for marketing headquarters, packaging products, and distribution hubs. There is a large counterfeit drug market which roughly accounts for 45% of the total market share. Of the formal market, multinationals have been losing market share over time due to local efficiencies from significant M&A between the local players that account for 55% of the formal market. Ten years ago, locals comprised only 35% of the formal market. Local companies benefit from a lax regulatory environment, scant policy restraints, fewer checks and balances and the ability to compromise on drug mix. In 2015, the Drug Regulatory Authority of Pakistan (DRAP) was formed to, at minimum, set drug pricing. Branded (post-patent) generic drugs account for 80% of the total market revenue for Pakistani pharmaceutical companies and there is limited R&D, which dampens innovation. In the past, innovative brands have tended to die out due to too much R&D expense and a quick deterioration of revenue once patents have expired.

A key healthcare initiative of Khan's administration is the Sehat Insaf Card, a state financed insurance program designed to cover a range of critical medical treatments for poor and working-class Pakistanis. The program will cover some 80mn Pakistanis from roughly 10mn families and holds potential to boost the fortunes of the pharma industry over the next several years.

Conclusion

Between the severe twin deficit, low reserves, tax collection issues, and circular debt problem in the power sector, there are many who doubt whether the new PTI government has the experience to properly address and politically navigate the issues. Those doubts must be balanced, however, against strong public support for an anti-corruption regime, the sense of urgency and purpose Khan brings as leader of the insurgent party and the inherent strength of the Pakistan, its economy and its important role in the world and region.

With the political, economic, and market movements in Pakistan over the last two years, we have found the market today intriguing. From a high-level view, the government has a long way to go in properly supporting the economy through essential structural changes. These changes will likely impact shorter term dynamics like inflation and the currency. However, with the alignment of the current government, business community, and Pakistani people, success in Imran Khan's ambitious reform plans would lay the groundwork for a potential economic boom. With the market trading at nearly 6x earnings at multi-year lows, we are looking at investments in quality businesses with a long-term time horizon.

About Frontier Global Partners

Frontier Global Partners manages a focused set of investment solutions covering international, global and frontier market equities, asset allocation and alternative investments. The firm's investment strategies reflect a shared commitment to investing in high-quality securities at prices that represent good value and to managing portfolios that exhibit low turnover. Born of twin organizations that covered separate and distinct global market segments with common approaches rooted in behavioral finance, the firm manages concentrated equity portfolios drawn from the breadth of the world's markets. Frontier Global Partners is an independent, employee-owned organization headquartered in La Jolla, California with the majority of the firm owned by its minority partners.

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