Pakistan – The investment opportunity

By David Graham
Partner, Dalton Strategic Partnership LLP, London

A leading Asia strategist recently described the Pakistan market as offering "… the greatest information arbitrage in Asia – the place where perception and reality are most mismatched".

Herein lies the investment opportunity for this largely misunderstood country, best known in the media and public mindset for its political uncertainty, occasional bomb blasts and militant insurgency on its borders.

To the informed investor, however, Pakistan is now beginning to be recognized as a potentially rewarding long-term opportunity. The «Melchior Selected Trust Pakistan Opportunities Fund», managed by Dalton Strategic Partnership LLP in London and advised by KASB Funds in Karachi, was recently launched to harness increasing investor interest in this interesting "new frontier" market.

Pakistan warrants particular attention given its sustainable economic growth rate of 7% annually. The country's strategic geographic position, which has enabled it to become a significant beneficiary of the wealth creation in the Middle East, the continued industrialization of its economy and a boom in domestic demand have fuelled this growth. Importantly, Pakistan is also poised to become a key global food producer and far less dependent upon oil imports due to its fast developing oil exploration programme.

Trade corridor

Pakistan's geographic position as a trade corridor between the Middle East, Central Asia, China and India has resulted in the development of a series of oil pipelines in this country, linking the oil-rich Middle East with the energy-hungry countries of India and China. China has also financed the development of a warm-water port at Gwador to facilitate Chinese exports to the West, and this is now being operated by the Singapore Port Authority.

Energy production

As well as acting as a conduit of oil from the Middle East, Pakistan is fast developing its own energy production capabilities. Whilst producing over 30% of its energy consumption requirements today, the country's exploration activity is meeting with considerable success, attracting investment by a number of the world's major oil companies.

Pakistan's government has also committed to significant investment in energy and other infrastructure, with over US$ 4 billion earmarked for expenditure on power plants and other infrastructure over the year to June 2009 with a similar amount expected to be spent by the private sector.

Middle East remittances

As an Islamic country, Pakistan has always had strong cultural ties and an affinity with the Middle East. The explosion in the oil price and the resulting growth in the Middle East has resulted in a dramatic increase in the demand for workers from Pakistan. Three million Pakistanis currently work in the Gulf States and Saudi Arabia and their growing remittances (up from US$ 2.4 billion in 2002 to over US$ 5.5 billion in 2007) are providing a significant boost to the domestic economy.

Foreign direct investment

Foreign direct investment into Pakistan has increased dramatically in recent years and currently stands at over US$ 5 billion p.a., with much of this originating from cash-rich Middle Eastern companies, such as Etisalat, Emaar, Al Warid Telecom and Orascom. In addition to Middle Eastern investment, some of the world's leading banks and telecommunications companies, such as Singapore Telecom, China Telecom, Standard Chartered Bank, ABN Amro and MayBank, have identified Pakistan's growth potential and made significant investments into the country.

Domestic demand

Historically, economic growth in Pakistan has been largely fuelled by growth in the services sector. In the future, domestic demand and the industrialization of the economy is likely to further stimulate growth. With a population of 160 million people and an average age of 23, Pakistan is experiencing a rapid broadening of its middle class. Middle class aspirations are influenced by the large number of Pakistani professionals returning from the United States and Europe, as well as by the liberation of the Pakistan media and an increase in the number of television channels (from 2 to 50) over the past few years.

An example of changing attitudes is the willingness of consumers to take on debt to fuel their consumption. Although household debt currently represents less than 4% of GDP, banks are seeing an increase in personal leverage and anticipate a surge in home and general consumer loans, not dissimilar to India's 20% compound loan growth over the past five years. Growing consumer demand is also manifested in the tremendous growth in demand for mobile phones and cars.

The agricultural sector

Despite being chronically inefficient in so many ways, Pakistan is close to self sufficiency in staple foods and is already the fifth largest milk producer, ninth largest wheat producer and fourth largest sugar cane producer in the world. The agricultural wealth of Pakistan has been identified by corporate and government organizations in the Middle East, who are planning corporate farming initiatives in the agriculturally rich Punjab region. Simultaneously, the Pakistan government is encouraging greater mechanization in agriculture and use of fertilizers to enable Pakistan to become a net exporter of agricultural produce.

The stock market

Unlike many "new frontier" stock markets, which are small and underdeveloped, the Pakistan stock market has solid credentials, a long history and over 600 listed companies, enabling investors to take advantage of the range of growth opportunities in the economy. The overall market capitalization of the Pakistan market is over US$ 70 billion, with foreign participation still relatively small. Following the correction in the market in May and early June, the Pakistan equity market is currently relatively inexpensive, with an average price/earnings multiple of 8 times, corporate earnings growth of over 20% (for the year to June 2009) and a dividend yield of close to 5%. Dominating the stock market are oil production and exploration companies, banks as well as chemical, fertilizer and cement companies, enabling investors to take advantage of a wide range of the growth opportunities.

Whilst the free float of the Pakistan stock market is currently relatively low at US$ 20 billion, it is anticipated that this will increase. Government-owned companies are expected to sell further shares to the public, and the private sector is expected to continue to raise capital from the stock market. The growing number of private-equity funds over the past two years is also a natural source of new issuance as the exit strategy for many of these is likely to be a listing on the Karachi Stock Exchange.

Inflation and currency

Similar to other Asian countries, inflation rates have been increasing in Pakistan largely due to the impact of energy and food price rises. However the overall impact of food inflation is mitigated by the fact that 60% of the population of Pakistan derives its livelihood from the agricultural sector and so will see some benefit from higher food prices.

The country's current account has deteriorated, particularly as a result of the rise in the oil price, and this has had a negative impact on the country's currency. Potential investors need to factor in the likelihood of a 5% p.a. depreciation in the value of the currency for the foreseeable future.

Conclusion

Whilst the outlook for equity markets worldwide is uncertain and there is generally a reduced appetite for risk, investor enthusiasm for interesting new growth opportunities is likely to continue. Pakistan is not only an economic growth story in itself, but represents a way of investing in Middle Eastern growth. Furthermore, the country's stock market is likely to broaden and deepen with new issuance and greater foreign participation, fuelled by reasonable company valuations and the strong corporate governance demonstrated by Pakistan company management.

Finally, whilst politics are likely to dominate newspaper headlines about Pakistan, there are encouraging signs that the present administration will continue with the reform programmes started prior to the Musharraf regime. Informed investors are likely to look past the headlines and investigate the true potential of this often misunderstood country.

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David Graham is a partner at Dalton Strategic Partnership LLP in London, responsible for the company's business in Asia. The «Melchior Selected Trust Pakistan Opportunities Fund» is a Luxembourg Sicav. Whilst managed by Dalton Strategic Partnership in London, it is advised by KASB Funds in Karachi, part of the KASB Group, one of the leading financial services companies in Pakistan. Naz Khan is CEO of KASB Funds whilst Faisal Potrik is CIO and the lead equity portfolio manager. The KASB Group has been affiliated with Merrill Lynch since 1993. KASB Funds was established in 2005, with Merrill Lynch Investment Managers (now BlackRock) purchasing a 5% equity interest in 2006.

Naz Khan
CEO KASB Funds