

# PAKISTAN Strategy

# MARKET VISTA

REP-019

## Pak-India ties – When one door closes, another opens

- Drastic and abrupt, developments on our Eastern front appear to be of increased pertinence, due in part to timing (Indian national polls in April-May'19), as negotiations for a US pullout from Afghanistan are gaining steam, while regional geopolitical alliances adjust to a multi-polar world
- Taking cues from past actions while commenting on possible developments across the border and at home, we highlight possible repercussions on polymer, packaging product and cotton imports, while delving into roadblocks placed on the Cement space from trade altercations (rising cost of polypropylene, Western Indian cement expansions)
- Underlining our analysis with recorded cease-fire violations and contrasting these events with KSE-100 index performance, we highlight the non-event nature of low-intensity border conflicts. That said, the current spate of terrorist actions have a greater chance of escalating due to political motives (Indian elections), possibly deviating from 'run-of-the-mill' political rhetoric
- The conclusion of Saudi Crown Prince's visit to Islamabad, accompanied by developments in the Afghan sphere and strengthening ties with China make for an increasingly tough defensive stance to Delhi's calls for 'isolating Pakistan', while long term developments towards sustainable peace in Afghanistan, (with the Taliban at the helm) could have positive spillovers for exports at home.

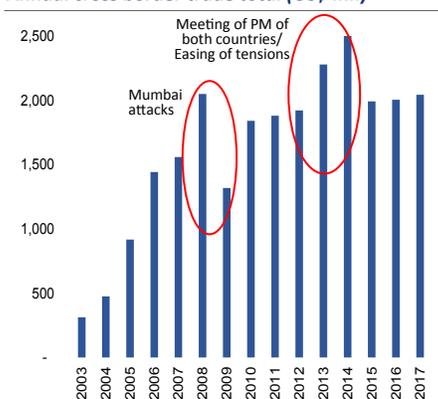
**Cross border trade is among the casualties:** In recent developments, PM Modi led cabinet gave approval to revoke the Most Favored Nation (MFN) status, granted in 1996, for Pakistan, effectively leaving room for harsh tariff imposition on imports. Poignantly, total trade between the two countries stood at US\$2.12bn for FY18 (Exports/imports from India at US\$339mn/1.78bn). Trade volumes between the neighbors have largely been reflective of political narratives of the respective Governments and regimes; evident from total trade dropping by 35.7%YoY in the aftermath of the Mumbai attacks (Nov'08) and improved ties seen in the beginning of the last PML-N era (FY13-14, trade volumes improved at a 2y CAGR of 14.2%).

**But this is not the first time:** Even so, major import groups in times of worsening ties stood rather resilient where cotton imports from India persisted through the flashpoint, whereas importers of paraxylene and polypropylene switched to Middle-Eastern countries for their supplies. Exports of Pakistan such as cements were largely unaffected due to abundant demand in western India. However, exports are likely to take contract this time around where our neighboring country has strategically raised tariffs on imports, signaling deep political motives at play in the lead-up to India's national polls. That said, exports of Cement (second largest export item to India) were expected to recede in any case, given expected capacity additions of ~10-11mn tons during the next three years in Western India.

**Chemicals and Cements will have to re-adjust:** Importers of paraxylene (used in the manufacturing of PTA) eg. LOTCHEM, are likely to incur higher freight charges as the previous pressure on imports of PX from India (share in total PX imports dropped from 89.2% in FY08 to 50.4% in FY10, going as low as ~20% afterwards but currently constitute 35% of total imports) were substituted from Middle Eastern countries like Kuwait. This could exert pressure on already depressed margins with PTA-PX margin standing at US\$58.8/t in 4QCY18 vs. US\$123.4/t in 2HCY18. Importers of Polypropylene (particularly for cement bag manufacturing) such as CPPL could witness rising input cost inflation in its cement bag business already reeling from a shortage of Kraft paper globally (raw material), with weakening cement demand depleting pricing discipline. To this end, significant impact can be witnessed on cement sector where the sector exported 1.2mn tons of cement to India which, after the duties being increased to 200%, will have to be diverted to local market in the wake of limited export options, further strengthening the pressure on local prices in North. We highlight Punjab based players, particularly MLCF & DGKC from our universe, as the most affected from incremental duties and trade frictions.

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Annual cross border trade total (US\$ mn)



Source: PBS & AKD Research

Ceasefire Violations of impact on KSE100

Years	Ceasefire Violations (CFV)	Total performance on CFV events	Average performance on CFV events	KSE-100 Annual Return
CY02	95.00	11.2%	0.1%	104.3%
CY03	31.00	8.3%	0.3%	67.7%
CY04	-	-	-	39.1%
CY05	3.00	0.9%	0.3%	53.7%
CY06	2.00	-4.6%	-2.3%	5.1%
CY07	2.00	0.9%	0.5%	40.2%
CY08	10.00	-6.3%	-0.6%	-57.1%
CY09	12.00	-5.1%	-0.4%	63.2%
CY10	23.00	-0.8%	0.0%	28.1%
CY11	17.00	1.2%	0.1%	-5.6%
CY12	24.00	2.4%	0.1%	49.0%
CY13	44.00	-5.0%	-0.1%	50.4%
CY14	50.00	0.3%	0.0%	25.5%
CY15	80.00	6.0%	0.1%	1.0%
CY16	106.00	3.2%	0.0%	43.9%
CY17	181.00	-5.5%	0.0%	-15.3%
CY18	169.00	27.6%	0.2%	-9.0%

Source: PSX & AKD Research



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**Investment perspective:** Matching market performance with historical records of reported cease-fire violations, including unprovoked, cover fire and retaliatory incidents recorded by the non-profit Indo-Pak Conflict Monitor, we arrive at a largely inconclusive trend. Since 2002, 849 cease-fire violations have been recorded on our Eastern front, with recorded violations peaking in CY17 (181 violations). We contrast these violations with KSE-100 index performance on the days coinciding with the cease-fire violations, where cumulative annual returns for the market were squarely in the green (5/10/15YR average return of 6.3/2.4/1.1%), while average daily returns over 16yrs and 849 events stood at -0.1%, a clear indicator of the market remaining unfazed by developments on the border. Moreover, during the period of heightened political tensions following the Uri attack of 18th Sept'16, the average daily KSE-100 move for the 91 cease fire violation events recorded following the incident till Dec'16 was 0.01%, during which the KSE-100 rebounded strongly (4QCY16 return of 17.9%), confirming grounded investor sentiments over perceived security risk from developments on the eastern corridor.

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Buy	> 19% expected total return (Rf: 13% + Rp: 6%)
Neutral	> 13% to < 19% expected total return
Sell	< 13% expected total return (Rf: 13%)

### Old Rating Definitions (Discontinued)

Buy	> 20% upside potential
Accumulate	> 5% to < 20% upside potential
Neutral	< 5% to > -5% potential
Reduce	< -5% to > -20% downside potential
Sell	< -20% downside potential
Not Rated	No investment opinion or recommendation

## Valuation Methodology

To arrive at our period end target prices, AKDS uses different valuation techniques including:

- Discounted Cash Flow (DCF, DDM)
- Relative Valuation (P/E, P/B, P/S etc.)
- Equity & Asset return based methodologies (EVA, Residual Income etc.)

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