19 November 2021

Monetary Policy

Big increase in November MPS upon rising risks to stability

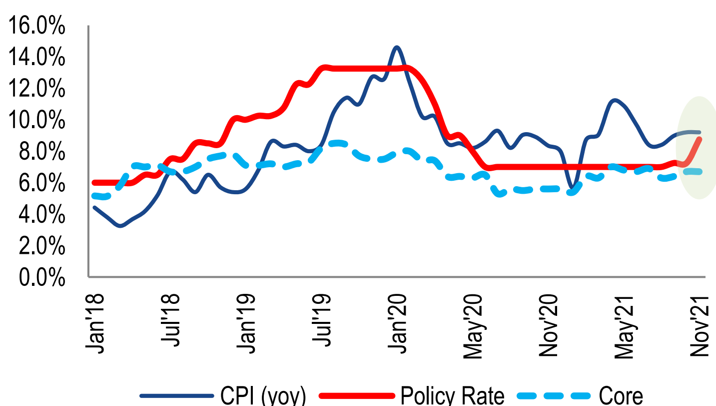
The State Bank of Pakistan (SBP) has raised the policy rate by 150bps to 8.75% – which follows the 25bps hike in September 2021. The key reason was that risks of high inflation and current account deficit have outpaced expectations, while growth outlook remains intact. The SBP decided on a large move – more than our expectation and market consensus of 100bps – as it aimed at reducing uncertainty in the markets (about future interest rates) and avoiding the need for a similarly large move in subsequent monetary policy meetings.

Reasons behind the increase in interest rates:

- The SBP sees little risk to the 4-5% GDP growth outlook for FY22. LSM is expected to slow down (from 5.2% yoy in 1QFY22) because of the tightening measures and rising input costs, but multiyear strong growth in Agriculture (record yields expected for most major crops) will make up for the lag in LSM.
- CPI has averaged 8.75% in 4MFY22, where the mom increase in CPI in Sep-Oct 2021 exceeded 2%. Higher commodity prices and domestic administered prices (of food and energy) pose risks to the SBP's projected range of 7-9%. Even core inflation (although averaging c.7% during 4MFY22) has been creeping up of late; note that most indices within core inflation are posting 8-9% yoy rise (the overall index is dragged by Education and other Covid affected segments).
- The other major driving factor behind the MPC decision is the large current account deficit of US$5.0bn in July-Oct 2021 (US$1.66bn in October) due to significantly higher imports of goods and services – led majorly by higher commodity prices (of energy and food imports). So far, the burden has fallen majorly on the exchange rate as the PKR has depreciated more than 9% FY22td. Above adjustments in the monetary policy and subsequently in the fiscal policy will play a greater role in moderating the external account imbalances.
- Fiscal deficit clocked in at a moderate c.0.8% of GDP in 1QFY22 compared to c.1% same period last year, but the SBP hinted at fiscal tightening in the near future – in our view, this will mostly entail withdrawal of tax exemptions (still in place on certain essential food and healthcare items), mandated by the IMF as a pre-condition for program resumption.

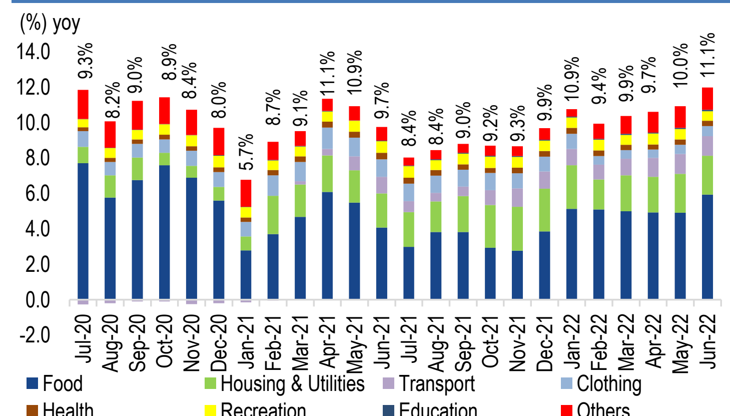
For future, the SBP guided that the end-goal of moderately positive real interest rates remains well intact but stopped short of giving a revised inflation outlook. We think there is a high probability that inflation will average above 10% in the next 12 months; and as such, the SBP would aim for double-digit policy rate by March-April 2022 from 8.75% presently. Future increases will however be smaller than the 150bps in today's MPS, unless conditions worsen. As for the markets, money market rates had already touched 9% before the MPS; and, beyond a knee-jerk initial reaction, the equity markets should not decline significantly as stock prices have already incorporated the monetary tightening (which is only brought forward in today's MPS). Refer to our sector-wise impact on the following page.

SBP raised the PR by 150bps in the Nov'21 MPS to 8.75%...



Source: SBP, PBS, IMS Research

...partly because future CPI will be higher than its projected range of 7-9%



Source: PBS, IMS Research

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Sector-wise impact of earlier than expected monetary tightening

Sector	Stance	Comments
Oil & Gas Exploration	Positive	▪ OGDC/PPL/POL were sitting on c.PKR70/91/53bn on cash and investments by Sep 2021. Every 100bps hike in interest rates raises earnings by 1%/2%/4% through other income. ▪ Some of it will however be clipped off by lower revenues, if the PKR appreciates on higher interest rates. ▪ Higher interest rates also make the opportunity cost of cash stuck in circular debt dearer.
Banks	Positive	▪ Banks that would benefit meaningfully include mid-tiers like BAFL, MEBL, BAHL, FABL (high interest rate sensitivity), where larger banks like HBL, UBL and MCB are modestly affected ▪ While a sharper than expected rise in interest rates may prompt a rise in NPLs. This is likely to be offset by well-positioned and conservatively structured loan books, coverage of +90% and sufficient capital buffers. ▪ A 3-6 month lag in asset repricing, however, may lead to a minor dip in NII in the ensuing quarter before formal lift off in CY22.
Cements	Negative	▪ DGKC and PIOC's FY22 earnings are expected to decline by 5% as we incorporate a greater increase in the PR of c.100bps in our FY22 estimates. ▪ The slide in the earnings of CHCC and MLCF is relatively lower (down 2% vs. previous estimates), majorly due to lower debt, than in the case of DGKC and PIOC. ▪ Today's event will result in a slightly neutral impact for KOHC and FCCL amid lower debt and higher cash and short term investments. ▪ LUCK's earnings will increase by PKR0.08/sh in FY22; this is despite the cash and investments being used for a new brownfield expansion in the North in the coming quarters.
Fertilizers	Neutral	▪ The increase in interest rates is neutral for the sector. Earnings of FFC, FFBL and FATIMA are estimated to decline by PKR0.13/0.15/0.02 per share in CY22; whereas, EFERT and ENGRO will likely witness a net increase of PKR0.03/0.90 in CY22.
Textiles	Neutral	▪ We expect the FY22/23f earnings of our IMS Textile Universe to be trimmed by a minor c.1% on average, which largely emanates from short-term borrowing at normal rates (long-term borrowing rates are subsidized). ▪ Short-term borrowings may increase further due to working capital constrains due to rising exports (higher imported raw material and slow refunds from the government), expansion projects and PKR slip resulting in costlier imports.
Technology & Communication	Neutral to Positive	▪ The Tech sector is a net beneficiary of rising interest rates; as majority of the companies have high cash balance and little interest bearing debt. ▪ Within our coverage, consolidated profitability of SYS/AVN will have a modestly positive impact of PKR0.18/0.03 per share in CY22.
Oil & Gas Marketing	Neutral to Negative	▪ Finance costs for PSO will rise and every 1% hike will trim earnings by 5% (PKR88bn ST borrowing by Sep'21). ▪ OMCs will reduce their L/C window on imports to 30 days, upon higher interest rates (lower days outstanding of payables), potentially straining cash-flows. ▪ At higher interest rates, we expect automobile sales to slow; which will slow the growth in petroleum consumption from double-digits of late (sales are already under pressure from record high retail prices).
Autos	Negative	▪ We expect car sales to slowdown from 2HFY22 (higher auto-finance rates and average 5% price hikes by the OEMs). Historically, auto sales recorded sharp declines in FY19-20 by an average 30%, while auto financing in FY20 declined by c.55%. ▪ In the near term, however, we estimate our IMS Autos Universe Earnings to rise an average 3% (assuming base case sales in FY22/23 remain intact) due to healthy other income amid significant customer advances. If we assume sales to decline by 10%-12% from our base case, earnings should decline by a similar magnitude. ▪ Longer lead times (presently) will lead to higher compensation payments for the OEMs, resulting in further decline in margins, in our view.

Sector	Stance	Comments
Chemicals	Neutral	▪ Other income for EPCL is estimated to increase by 7%, which should be largely offset by a 3% rise in finance cost in CY22 (vs. previous estimates). Consequently earnings are likely to remain flat due to low debt levels. ▪ LOTCHEM's other income will increase by 6% while there are no borrowings. Earnings will remain flattish on account of negligible rise in other income relative to core earnings.
Power	Neutral to Negative	▪ While HUBC is a significantly leveraged company (c. 60% total Debt to Asset), a front loaded impact of 150bps has a nominal 1-2% impact on our base case EPS and TP and does not derail the case for HUBC or its dividends at this early stage in the rate cycle. ▪ That said, if SBP sustains current momentum (above our estimates for interest rates), this could erode liquidity and give rise to a fresh round of circular debt.
Steel	Negative	▪ Long steel players, MUGHAL and ASTL, are highly leveraged with average interest-bearing D/A of c.45%. We estimate earnings impact of c.2% in FY22/23f (as we had already assumed large increase in interest rates). ▪ We estimate ISL's earnings to be impacted by a softer 0.4% in FY22/23f due to borrowings at low mark-up. ▪ Sharp PKR/USD depreciation, elevated commodity prices and upbeat demand is likely to sustain the higher borrowings and higher finance costs, in our view. ▪ Slowdown in construction projects and consumer goods is a key risk to the sector
Tractors	Neutral	▪ Compared with the Autos sector, we estimate earnings to decline by an average 0.5% from our base earnings, due to minimal short-term borrowings and ample cash. ▪ Subsidized agri-sector loans are likely to be continued; hence demand for tractors is not likely to be significantly impacted, in our view. However, a general slowdown in the economy poses a key threat to our volumetric assumptions.
Consumer / Food	Neutral	▪ While FCEPL's debt to asset ratio stands at 50%, we anticipate a minor 2% increase in its finance cost (vs. base case estimates) following today's 150bps increase in the Policy rate and no sizeable effect on EPS. This is because we have largely built the same into our estimates.
Pharmaceuticals	Neutral to Negative	▪ Pharmaceutical companies tend to maintain very low levels of debt (under 20% debt to asset), barring SEARL which recently took on PKR9.5bn LT facility to finance recent acquisitions. We anticipate a minor (1-2%) impact on earnings for AGP, but the same may be higher for SEARL.
Refineries	Neutral	▪ Refineries will embark on expensive up-gradation projects upon passing of the new Refinery Policy by the government. Higher interest rates on the related borrowing will not hurt as the interest cost will be capitalized. ▪ Borrowing for working capital remains high (to maintain furnace oil or bitumen inventory, for instance) thus finance costs will rise. NRL can mitigate this risk by utilizing the Fuel Refinery around 75% of capacity. ▪ Potential benefit from strengthening PKR due to rising interest rates - exchange gains and lower costs of plant and machinery for up-gradation projects

Source: IMS Research

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Ratings Guide*	Criteria
Buy	Total return expectation of ≥ 15% or expected to outperform the KSE-100 index
Neutral	Total return expectation of > -5% or expected to match the return of KSE-100 index
Sell	Expected downside of more than 5% or expected to underperform the KSE-100 index

*Based on 12 month horizon unless stated otherwise in the report.

Valuation Methodology: We use multiple valuation methodologies in arriving at a Target Price including, but not limited to, Discounted Cash Flow (DCF), Dividend Discount Model (DDM) and relative multiples based valuations.

Risks: (i) Significantly subdued growth because of sharp monetary tightening, (ii) inflation persists over 10%, and (iii) CAD remains high and calls for greater rate hikes

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