SLA reached on USD3bn SBA with IMF - A Critical Development

Strategy

July 3, 2023

Pakistan Equities
Strategy

Key Points

- During the Eid holidays the local authorities and the IMF staff managed to reach a Staff Level Agreement (SLA) on a new 9-month ~USD3bn Stand-By Arrangement (SBA) avoiding the imminent risk of default, subject to the approval of the IMF's Executive Board by mid-Jul'23.
- This SBA would cover the last months of the current government, the interim setup, elections, and setting up and takeover by the new elected government.
- Response of foreign investors have been positive as yield on Pakistan's Eurobond maturing in Apr'24 has dropped from 97.8% to 66.2%. We expect that the domestic capital and currency markets are also likely to react positively in the near term as the imminent risk of default is avoided in the near term with expected support from the multilateral and bilateral sources.
- We recommend cautious optimism as we expect a decent performance in energy sector stocks exposed to the circular debt, along with cyclical sectors with expected ease of imports of raw material that led to plant shutdowns during the past few months including autos, cements and steels.
- However, a long-term sustainable rerating of multiples is dependent on reduction in political uncertainties, implementation of structural reforms and their results getting visible, and lowering of interest rates not expected before 1QCY24.

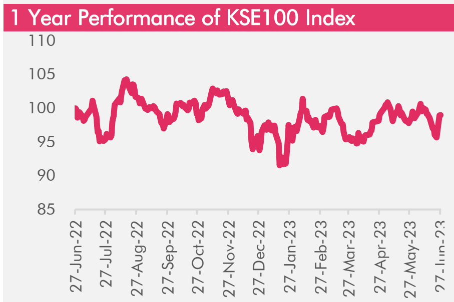
Key Data	
KSE100 Index	41,453
KSE-All Share Value (PKRmn)	7,477
KSE-All Share Value (USDmn)	26.1
KSE-All Share Volume (Shmn)	234.7
Market Capitalization (PKRtn)	6.4
Market Capitalization (USDbn)	22.3
1Year High	43,888
1 Year Low	38,136

Source: PSX, Next Research

USD3bn SBA comes as a positive surprise from the IMF

As the 2019 EFF of the IMF for Pakistan expired on Jun. 30, 2023, Pakistani authorities and the IMF staff managed to seal another 9-month SDR2.25bn (~USD3bn) Stand-By Agreement for the period Jul'23 to Mar'24. It would cover the last months of the current government, the interim setup, elections, and setting up and takeover by the new elected government. The new agreement is subject to the approval of the IMF's Executive Board in a meeting expected in mid-Jul'23, which would also give clarity on the break-up of amounts and timelines of reviews for the receipt of USD3bn. Under the 9th, 10th, and 11th reviews of the EFF just expired, Pakistan was expected to receive a sum of SDR1.95bn (~USD2.5bn) by May'23 if the reviews had concluded on time. This SBA will be taken as a positive surprise by the markets as only the conclusion of the 9th review was expected during the Eid holidays paving the way for the receipt of USD1.1bn only, with the remaining USD1.4bn wasted.

1 Year Performance of KSE100 Index



Source: PSX, Next Research

Pakistan's last-ditch efforts to resume the IMF program paid-off

During the last couple of days Pakistan's desperate efforts to secure an IMF program paid-off which included a couple of major actions apart of multiple dialogues of Pakistan's PM with MD IMF and utilizing other diplomatic platforms. The key actions by Pakistani authorities included: 1) revision in the Federal budget for FY24 in order to bring it in-line with the objectives and guidelines of the IMF while introducing revenue measures amounting to PKR215bn (FBR target increased from PKR9.2tn to PKR9.415tn), and curtailing expenditure by PKR85bn with increased BISP allocations, 2) SBP's withdrawal of its guidelines for the prioritization of imports amid critically low foreign exchange reserves (less than a month of import cover that too based on restricted imports), 3) commitment to a market-oriented foreign exchange market, and 4) another hike of 100bps in interest rates.

Start of new beginning

The statement of the IMF's staff includes the following:

- The new SBA will support the authorities' immediate efforts to stabilize the economy from recent external shocks, preserve macroeconomic stability and provide a framework for financing from multilateral institutions and bilateral partners.
- The new SBA will also create space for social and development spending through improved domestic revenue mobilization and careful spending execution to help address the needs of the Pakistani people.
- Steadfast policy implementation is key for Pakistan to overcome its current challenges, including through greater fiscal discipline, a market determined exchange rate to absorb external pressures, and further progress on reforms, particularly in the energy sector, to promote climate resilience, and to help improve the business climate.

We foresee the new SBA as a step towards achieving fiscal discipline and developing a framework for macroeconomic stability primarily to tackle the imminent external account challenges and to control inflation, until the new government takes over aiming a new longer-term program for implementation of the much-needed structural reforms for achieving a long-term all-inclusive sustainable growth.

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Markets to react positively in the near term - Medium-long term rerating of multiples is not in sight in the near term

Response of foreign investors have been positive as yield on Pakistan's Eurobond maturing in Apr'24 has dropped from 97.8% to 66.2% on June 30, 2023 (price increased from 62.2 to 71.5 cents). In response to this positive development, we believe that the capital and currency markets are also likely to react positively in the near term as the imminent risk of default is avoided in the near term with expected full support from the multilateral and bilateral sources. We expect some appreciation in the domestic currency against the USD where the REER is hovering between 85 and 87 since Feb'23. The stock market is also likely to post a healthy rally in continuation to the pre-Eid holiday momentum with this arrangement subsiding the risk of immediate default. We expect a decent performance in energy sector stocks exposed to the circular debt, along with cyclical sectors with expected ease of imports of raw material that led to plant shutdowns during the past few months including autos and cements. However, a long-term sustainable rerating of multiples is dependent on reduction in political uncertainties, implementation of structural reforms and their results getting visible, and lowering of interest rates not expected before 1QCY24. We recommend cautious optimism on the stock market in the near term with sectors highlighted above.

Market Response to SLAs with IMF

Date	Event	Before				After			
		12-month	6-month	3-month	1-month	12-month	6-month	3-month	1-month
29-Jun-23	SLA for USD3bn SBA	0.4%	4.3%	3.9%	0.3%	N/A	N/A	N/A	N/A
13-Jul-22	SLA for 7th & 8th reviews of 2019 EFF	-12.9%	-9.7%	-10.4%	1.1%	0.3%	-2.5%	1.8%	3.7%
16-Feb-21	SLA for 2nd, 3rd, 4th & 5th reviews of 2019 EFF	15.2%	15.1%	14.5%	1.0%	-1.5%	1.2%	-2.6%	-3.3%
27-Feb-20	SLA for 2nd review of 2019 EFF	-0.9%	25.4%	0.6%	-9.9%	19.6%	7.2%	-11.7%	-26.7%
8-Nov-19	SLA for 1st review of 2019 EFF	-13.6%	2.1%	20.2%	6.8%	13.9%	-7.0%	12.3%	13.9%
12-May-19	SLA for 39-month USD6bn EFF	-20.4%	-15.5%	-14.5%	-7.0%	-3.2%	5.9%	-15.2%	0.6%
4-Aug-16	SLA for 12th and final review of 2013 EFF	10.3%	22.0%	12.2%	4.3%	18.3%	25.1%	5.6%	-0.4%
12-May-16	SLA 11th review of 2013 EFF	9.8%	5.8%	15.3%	7.9%	42.7%	18.2%	10.0%	1.9%
4-Feb-16	SLA for 10th review of 2013 EFF	-7.5%	-10.7%	-7.1%	-2.8%	54.5%	22.9%	10.1%	1.1%
5-Nov-15	SLA for 9th review of 2013 EFF	12.8%	3.0%	-4.5%	5.3%	21.2%	4.1%	-5.9%	-5.3%
7-Aug-15	SLA for 8th review of 2013 EFF	22.7%	4.5%	7.4%	1.9%	8.7%	-10.4%	-5.0%	-9.1%
11-May-15	SLA for 7th review of 2013 EFF	17.7%	7.1%	-2.0%	3.6%	8.2%	1.2%	8.0%	3.2%
5-Feb-15	SLA for 6th review of 2013 EFF	29.6%	16.8%	13.3%	5.8%	-6.3%	4.3%	-3.3%	-3.8%
8-Nov-14	SLA for 4th & 5th reviews of 2013 EFF	32.4%	8.5%	5.3%	2.7%	11.3%	8.4%	12.0%	3.5%
10-May-14	SLA for 3rd review of 2013 EFF	43.1%	21.9%	8.5%	-2.6%	17.7%	9.8%	3.1%	3.7%
9-Feb-14	SLA for 2nd review of 2013 EFF	52.7%	14.8%	14.2%	1.2%	29.6%	10.1%	6.8%	0.8%
8-Nov-13	SLA for 1st review of 2013 EFF	43.0%	19.2%	-0.1%	5.2%	33.2%	22.8%	14.9%	7.1%
4-Jul-13	SLA for 3-year USD6.64bn EFF	53.8%	31.0%	17.1%	-2.1%	35.9%	19.5%	1.3%	5.9%

Source: IMF, PSX, Next Research

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R = Expected Dividend Yield + Expected Capital Gain
R' is before tax
Investment horizon is between six months to twelve months

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