Market Strategy — Commodity

The Barrel Drop: Softening Commodity Prices a Mixed Bag For Equity Market

The Barrel Drop: Oil Prices Slip to a 4-Year Low

Oil prices have undergone a significant decline since Jul-14 West Texas Intermediate (WTI) was down by ~9% in just a month to reach USD 82/bbl (a 28 month low since Jul-12). Concurrently, Arab Light also experienced similar trends, with a price of USD 82/bbl by mid of Oct-14 (~8% decline in the month) down to an almost 4-year low.

What Has Led To Drop In Oil Prices?

Numerous reasons have piled up simultaneously triggering this sudden price drop. Filtering out short-term triggers, we believe prices will most likely stay range bound at current levels of USD 85/bbl for FY15E. Several factors have contributed to recent dip, but we view slowdown in global economies led to slowdown in oil demand along with unanticipated supply increase to be key factors responsible.

Drop In Other Commodity Prices

In addition to this, weakened economies in particularly China and over supply condition in US has led to significant decline in global commodity prices. Major commodities such as Coal, Steel, Cotton and Copper on average lost 20% of their value since Jul-13. Global commodity index (GS Commodity Index) a benchmark for commodity prices was down by 19% since Jul-13.

Positive Economic Implication

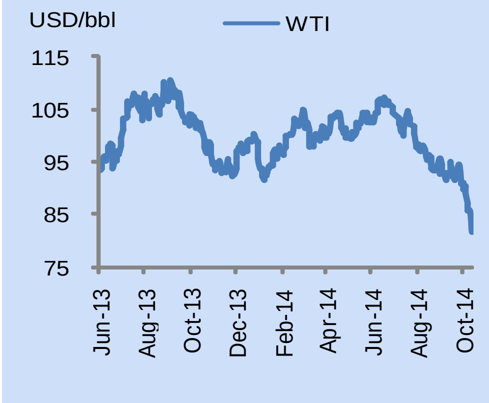
On broader scale, fall in crude oil prices means lower subsidy burden and lessening pressure on external accounts. Moreover, some benefits of this would eventually trickle down to many other manufacturing companies and to some extent, agricultural sector as well, hence growth positive. Specifically, a general trim down in key macro risks, means Pakistan could easily come in terms with quantitative targets set by IMF such that pertaining to cutbacks in power sector subsidies and maintenance of net FX reserve positions.

Capital Markets: A Mixed Bag for Equity Market

There are two ways of looking at this; firstly reduced key macro-risk could provide potential impetus for the market as whole, while sector specific impacts vary. For oil specific, in our view key beneficiaries would be chemicals and paints which could see better operating margins. E&P's may witness across-the-board margin erosion and OMC sector may register one time inventory revaluation losses. For refineries lowered oil prices could have mixed impact, including one-time inventory loss and refinery margin expansion (keeping in view final POL prices stay intact).

The KSE-100 Index has shed 1.3% in the last two trading sessions; however MTD the equity market has recorded a nominal return of 0.9%. The decline of 380points in last two trading sessions can almost entirely be attributed to Oil & Gas sector, which comprise nearly ~22% of KSE 100 capitalisation.

WTI Price Trend



Source: Bloomberg

Arablight Price Trend

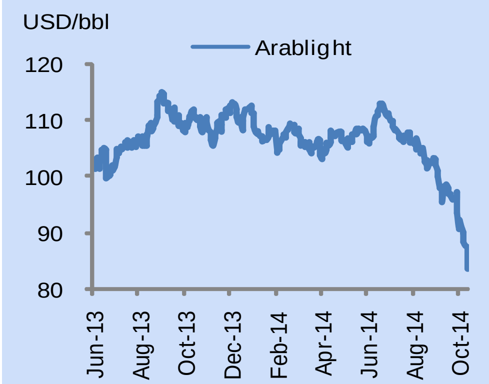


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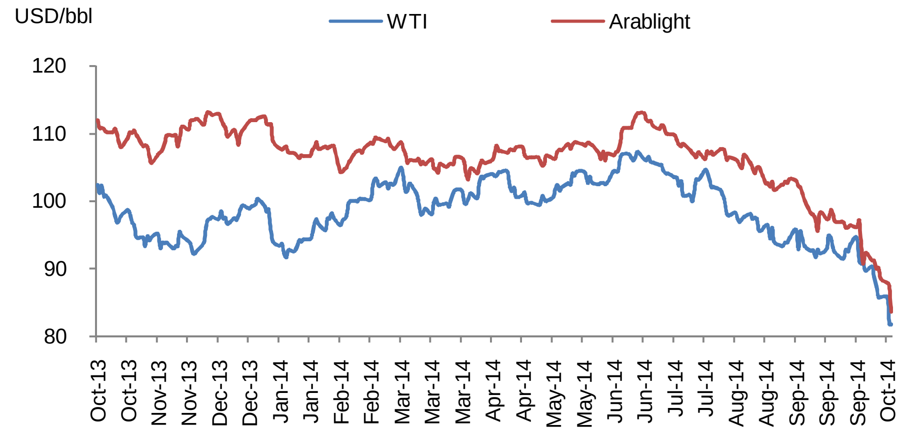
Exhibit: The Barrel Drop



Source: Bloomberg, AHL Research

What Has Led To Drop In Oil Prices?

Numerous reasons have piled up simultaneously prompting this sudden price drop. Filtering out short-term triggers, we believe prices will most likely stay range bound at current levels of USD 85/bbl for FY15E.

Slowdown in Global Economies Leading To Slowdown in Oil Demands...

On the demand front, a series of factors have contributed to gloomy oil demand. Firstly, due to a weakening global economy, with lower demand from China and Europe has caused the OPEC nations to compete over the available market share.

On the demand front, a series of factors have contributed to gloomy oil demand. IMF/ World Bank have lowered down growth projection for both EU and US. This combined with the softening demand in China (second largest oil consumer), the second largest oil consumer, has also caused prices to go into a downward spiral since the past four months.

Exhibit: World GDP Growth Projections

	2012	2013	2014	2015	2016
World	3.4	3.3	3.3	3.8	4.0
Euro area	(0.7)	(0.4)	0.8	1.3	1.7
Advanced Economies	1.4	1.5	1.7	2.3	2.3
EM & DM	5.1	4.7	4.4	5.0	5.2
ASEAN-5	6.2	5.2	4.7	5.4	5.5
LATAM	2.9	2.7	1.3	2.2	2.8
MENAP	4.8	2.5	2.7	3.9	4.5

SOURCE: IMF

And then there is OPEC nations (fulfilling nearly ~40% of global demand) in a bid to gain market share in Asia have caused downward pressures on overall crude prices, following the paths of OPEC giants, namely Saudi Arabia, Iraq and Iran.

...Along With Unanticipated Supply Increase

Compounding the impact of weakened demand, early reservation on supply side disruption particularly in the MENA (Libya in particularly) region has also dissipated. Higher output, particularly from the Libyan front is softening up demand side pressure. Together with Nigeria, these two countries averaged 1million bpd over the past 3 months, adding to overall supplies and causing prices to slide further.

And then there is this expected decline in US (largest oil consumer) oil imports due to shale gas/oil production, a substitute for petroleum. As per, back in 2006 around ~70% of US oil consumption was imported, this figure is now down to only ~30% in the 2014 YTD, with forecasts of further drops in oil imports in the coming year.

Lowering Our Base Case Oil Price Assumption by 6%

The popular hypothesis of demand-supply disequilibria and its impact on prices does somehow make the economic rationale behind the recent oil drop. However, it would be difficult to say how long this disequilibrium would exist, yet alone predict when oil prices will start to rebound and sentiments shift. But as of now we have lowered down our base case oil price assumption by almost 5.9% in FY15 to USD 95/bbl and USD 104/107.2 / bbl in FY16/17F.

Other Commodities

In addition to Oil prices drop major global commodities such as Cotton, Steel and Coal have also drop significantly.

- **Cotton Prices** – With 60% of the world's cotton being bought by China, stockpiling of the commodity from the country has witnessed a major drop in this current year (2014) - 15%YoY decline in 1QFY15, to PKR 5,200/maund. resultantly this has led to drop in global cotton prices - 17%YoY during FY15TD to rest at USd 76.3/lb. Cotton Prices Impact – Shedding 15% of its prices YoY
- **Steel Prices** – Slowdown in infrastructure led activities amid at weaker growth outlook for China and G7 countries, prices of steel came down significantly by ~10.3%YoY in FY15TD.
- **Coal Prices** – Coal prices have declined by 19% since Jul-13. Supply glut as demand continue to slowdown from China (coal imports down by 39% YoY) and Europe (as data shows German imports of the commodity at years low as well). While Shale Gas Policy in U.S. further sent Coal prices down spiral.

Commodity Prices

Exhibit: Steel Price have been on declining trend (down by ~12% since Jul-13, CY14Td

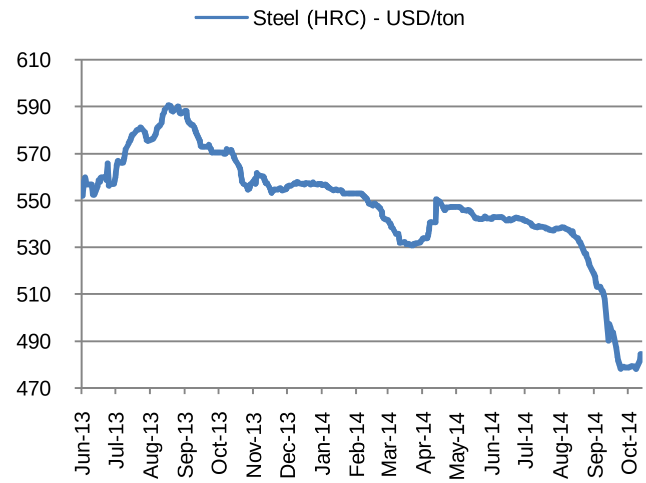


Exhibit: Since Jul-13 coal price came down by almost ~20% CY14TD

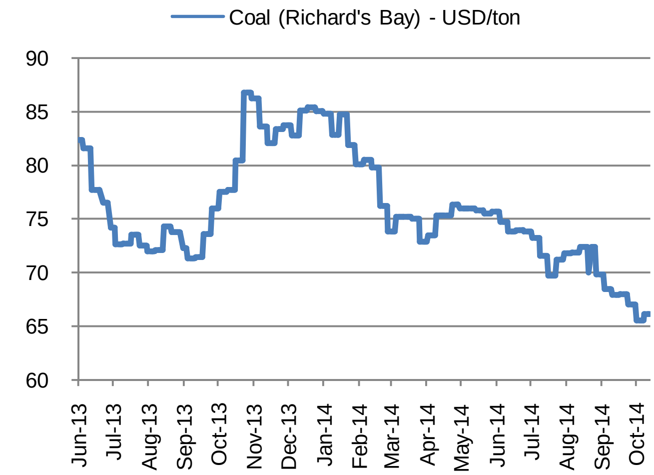
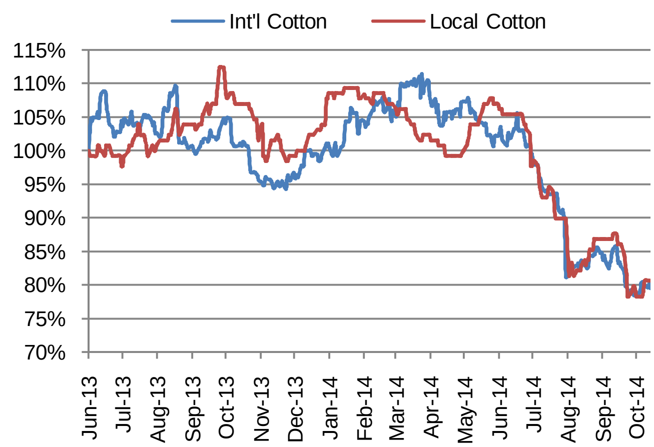


Exhibit: Cotton prices have fallen by almost ~20% since Jul-13, CY14TD, in line with international cotton prices to reach PKR 5,200/maund.



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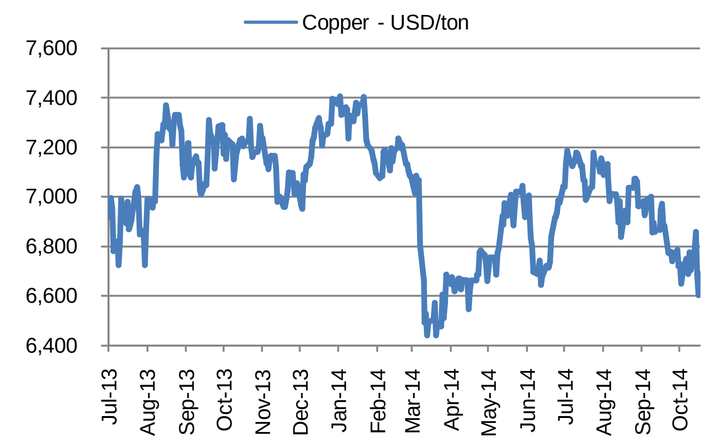


Exhibit: Global Commodity Index is down by ~12% since Jul-13

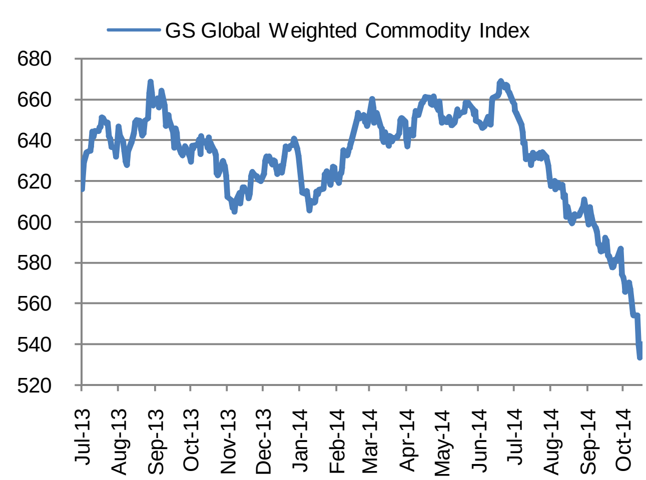
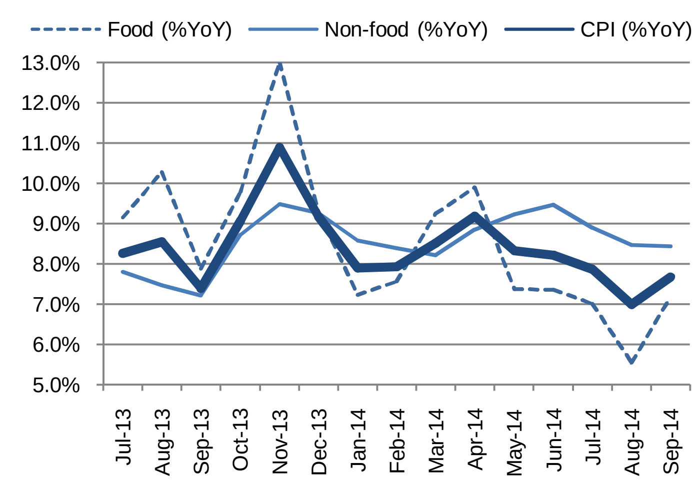


Exhibit: ...and have kept local inflation tamed



Source: Bloomberg, AHL Research

Economy

On broader scale, fall in crude oil prices means lower subsidy burden and lessening pressure on external accounts. Moreover, some benefits of this would eventually drip down to many other manufacturing companies and to some extent, agricultural sector as well, hence growth positive.

Specifically, a general trim down in key macro risks, means Pakistan could easily come in terms with quantitative targets set by IMF such that pertaining to cutbacks in power sector subsidies and maintenance of net FX reserve positions.

Downgrading Pricing Risks

Continued fall in oil prices and import price inflation could all potentially bring down domestic oil prices and other prices in the economy. Since start of FY15, aligning with international oil prices trend the government have revised down POL prices by an average 3% to date (Gasoline -4.1% to PKR 101.1/Ltr, HSD -1.8% 107.4/Ltr) and prospects of more to follow soon given the sharp decline in international oil prices wouldn't be surprising.

Henceforth a 4% decline in motor fuel would reduce index by 0.1% alone we estimate. Oil prices have a price roll-over impact, where in near we could see almost ~12% of the CPI basket could be impacted. This could easily shave of another 30-50bps of our base case inflation target for FY15 of +7.8%YoY (+8.6%YoY in FY14).

External Account and Exchange rate

On external side, starting from the lower import bill – 33% of total import bill pertains to oil – we estimate for every USD 10/bbl crude oil price reduction could save around USD ~1.4bn. On the contrary, lowering cotton prices (down by ~16%YoY to PKR 5,200/maund) could potentially hamper textile sector export growth, but we remain bullish on GSP plus outlook. Nevertheless, additional USD saving, expected disbursement of USD 1.1bn from IMF and intact foreign inflows, the subsequent build-up in FX reserves should bode well for PKR stability.

Exhibit: Current Account Balance

	FY13	FY14	FY15E	2MFY14	2MFY15
Current account balance	(2.5)	(3.0)	(1.2)	(1.4)	(0.6)
Exports	24.8	25.2	26.2	3.7	4.2
Imports	40.2	41.7	43.0	7.9	6.9
Trade Balance	(15.4)	(16.5)	(16.8)	(4.2)	(2.7)
Services Balance	(1.6)	(2.6)	(2.5)	(0.4)	(0.6)
Workers' remittances	13.9	15.8	17.4	3.0	2.6
Others	0.5	0.4	0.7	0.2	0.0
Capital Account	0.3	1.8	0.8	0.0	0.0
Net Borrowing	(2.2)	(1.1)	(0.4)	(1.4)	(0.6)

SOURCE: SBP, AHL Research

Circular Debt

The Government of Pakistan by the commencement of FY14 earmarked PKR 480bn for the resolution of circular debt. Due to one-off liquidity resolution for the energy chain, the circular debt stands manageable at 0.8% of GDP now v/s 2.1% earlier. Although energy reforms are underway, we suspect energy shortfall to fade away with time due to gradual additions. However, with the recent plunge in oil prices, we expect the intensification of circular debt to trim down as IPPs payables quantum to their fuel suppliers is expected to decrease amid lower procurement prices.

Exhibit: Lowering Power sector Subsidies...

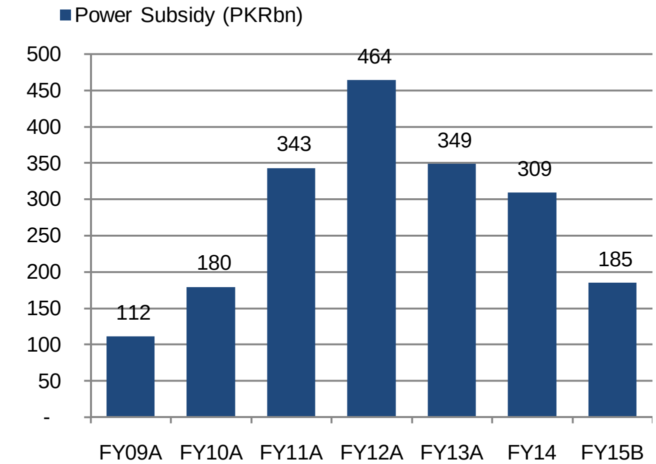
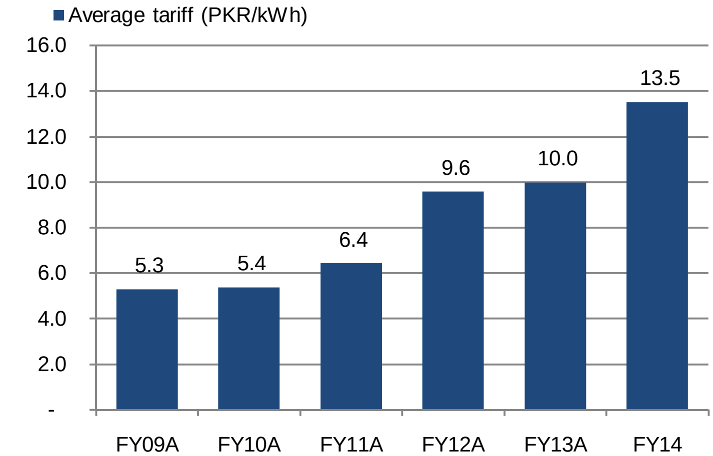


Exhibit: Rising power tariff



Source: NEPRA, AHL Research

Key Macro Indicators

	FY10	FY11	FY12	FY13	FY14	FY15F
Real						
GDP (Real Growth %)	3.1%	3.0%	3.7%	3.6%	4.1%	4.8%
Service Sector	4.6%	4.4%	4.0%	3.7%	4.3%	5.4%
Industrial Sector	4.9%	0.7%	3.1%	3.5%	5.8%	4.5%
Agricultural Sector	2.0%	2.4%	3.4%	3.3%	2.1%	3.4%
GDP (MP - PKRbn)	14,824	18,063	20,654	22,909	25,832	29,089
Prices						
CPI (YoY)	10.1%	13.7%	11.0%	7.4%	8.6%	7.8%
Policy Rate - Period end	13.9%	13.5%	12.0%	9.0%	10.0%	10.0%
External Sector (USD bn)						
Exports	19.7	25.4	24.7	24.8	25.2	26.2
Imports	31.2	35.9	40.5	40.2	41.7	43.0
Trade Terms	(11.5)	(10.5)	(15.8)	(15.4)	(16.5)	(16.8)
Remittances	8.9	11.2	13.2	14.1	15.7	17.4
FX Reserves - Period end	16.8	18.2	15.3	11.0	14.1	16.7
C/A Balance (%age of GDP)	-2.2%	-0.1%	-2.1%	-0.4%	-1.2%	-1.1%
Exchange Rate (average)	85	86	89	97	103	107
Fiscal Accounts (%age of GDP)						
Fiscal Balance	3.1%	5.7%	7.4%	8.8%	5.9%	4.9%
Public Debt	59.9%	57.2%	60.0%	63.5%	66.4%	67.5%

Source: SBP, PBS, MoF, AHL Research

Capital Market Implication

A Mixed Bag for Equities

There are two ways of looking at this; firstly, reduced key macros-risk could provide impetus for the market as whole, while on the other hand, sector specific impacts vary.

For directly oil related impact, in our view key beneficiaries would be chemicals and paints which could see better operating margins. E&P's may witness across-the-board margin erosion and OMC sector may register one time inventory revaluation losses. For refineries lowered oil prices could have mixed impact, including one-time inventory loss and refinery margin expansion (keeping in view final POL prices stay intact).

On the flip side, lowered cotton, steel, coal prices would favour general industries such as autos, cements and textiles sector in particular.

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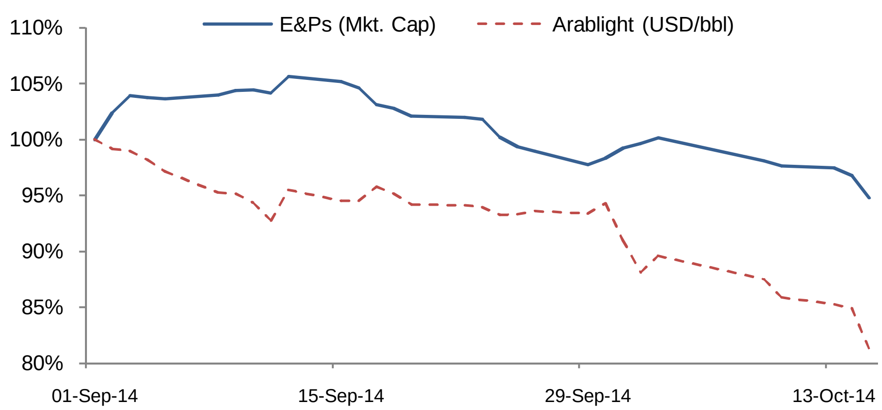
Arab Crude Oil prices are trading almost at their four year low, we believe there is lower possibility of oil prices breaching USD 77/bbl level, oil prices may stable around USD80 level, which might be sigh of relief for the investors in the market and market may start to perform backed by IMF 5th and 6th expected to be released by December coupled with lower rupee pressure.

Top picks

ENGRO, EFERT, FFBL, NCL, BAFL, HBL, KEL, DGKC, and KOHC makes to our top picks at current prices.

Exhibit: E&Ps (holding ~22% of the Mkt. Cap.) came down following the Barrel Drop



Source: Bloomberg, AHL Research

Sectors

E&Ps Sector **(Negative to Neutral)**

Since Oct-14 start, market capitalizations of major E&P companies' have shed by 5.5% (OGDC-5%, PPL-7%, POL -8%) on average. We estimate, for every USD5/bbl drop in crude oil prices our E&P sector earnings for FY15 could trim by 1.2%, 0.9% and 3.3% for OGDC, PPL and POL respectively.

Exhibit: Earnings impact on E&P for every USD 5/bbl decline in Oil Prices

EPS (PKR) - FY15	OGDC	PPL	POL
Base Case	35.2	32.2	72.4
Change in EPS	(1.2)	(0.9)	(3.3)
%age Change	-3.3%	-2.9%	-4.5%

SOURCE: AHL Research

Oil Marketing Companies Sector **(Negative to Neutral)**

PSO in particular, is likely witness one-time inventory losses in 2QFY15. We estimate based on days of inventory in hand we estimate PSO could record an inventory loss of PKR~900mn (PKR 3.3/share).

Refineries Sector **(Neutral to Positive)**

Drop in oil could be a mixed bag for refineries, the drop in oil prices would lead to inventory losses; however refineries margins may increase with a lag given crude oil prices decline more than the final product prices. We are of view; positive sentiments in refineries sector are overplayed.

Power Sector **(Neutral to Positive)**

The declining oil prices have neutral impact on the profitability of the power sector; as the fuel component is a pass-on item in an IPP tariff. However, IPPs payable amount to their fuel supplier is expected to ease off on account of lower fuel prices which would lead towards softening in the intensity of circular debt going forward.

Textile Sector **(Positive)**

Firstly, in terms of margins and secondly, lower prices could provide impetus to export sales particularly in consideration of GSP+ status advantage. For the spinning segment of the textile value chain, the impact would be neutral on account of a) yarn margins being directly proportional to cotton prices, b) subdued buying globally of yarn in restricting its price hike mainly on account of slowdown in China and c) influx of imported cheaper quality cotton &yarn from India to maintain pressure on local prices.

Auto & Auxiliary Sector **(Positive)**

We expect falling steel prices to be a very positive sign for local automobiles assemblers' margins and auto parts manufacturers as imported steel stems as a major raw material used in production. This should also benefit auto-auxiliary sector.

Petrochemicals Sector **(Positive)**

Attributable to declining oil prices, PTA and MEG prices which are raw materials (contributing almost 50%-70% in production) for PSF (Polyester Staple Fibre) reduced significantly to ~17%/ 20% FY15TD respectively. Declining PSF prices would bode well yarn producers.

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