The Perfect Storm Hits Philippine Equities

COLing the Shots is a monthly publication by COL which provides insights on investment opportunities based on global and local developments that could affect the market. COLing the Shots aims to provide timely and relevant information and analysis as well as a model portfolio for successful investing.

Key Highlights

- The PSEi has lost a total of 5.3% during the past five trading days as investor sentiment once again turned for the worst due to the abundance of negative developments recently.

- Last November 8, the Philippines was badly hit by super typhoon Yolanda. Because of the destruction brought about by the typhoon, NEDA estimates that GDP growth could drop by 0.3% to 0.8% this year while the BSP said that inflation might reach 3.2% for the whole of 2013 and 4.5% in 2014.

- Moreover, since the start of September, around Php100 Bil in fresh equity was raised by companies either through share placements or IPOs. Despite this, there are still talks of numerous capital raising activities. Aside from siphoning off liquidity, capital raising activities are viewed negatively because of the potential dilution that they could cause. Moreover, companies usually price the shares being sold at a discount to their market price.

- The recently concluded third quarter earnings season was also generally unexciting. Only a handful of companies delivered better than expected results. Moreover, SM and PGOLD, which are part of the more resilient consumer sector, reported disappointing third quarter earnings results.

- Finally, foreign investors continue to sell the Philippine market as emerging market Asia remains out of favor while developed markets remain in vogue. Starting June of this year, foreign investors have been net sellers in the Philippines except for the month of July. Foreign sell-off has intensified recently as a result of the negative developments discussed earlier and as concerns of US Fed tapering once again returned to the fore.

- Given all the negative developments, it is difficult to justify a strong performance for the Philippines equities market in the short term. However, we remain convinced that a bear market will not happen anytime soon as the country's favorable long term economic growth outlook remains intact.

- The economic impact of typhoon Yolanda over the long term should be minimal given that Eastern Visayas, which was the hardest hit by the typhoon, accounts for only 4.5% of GDP. Moreover, reconstruction spending which is estimated at Php250 Bil to be spent over three years should act as an 'offset'. Meanwhile, although inflation will go up as a result of the typhoon, interest rates should not go up as the Central Bank normally increases interest rates only if inflation is driven by strong demand. Finally, among the listed companies that we cover, only EDC, FPH and FGEN, were severely affected by the storm.

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- As far as share offerings are concerned, the impact should be favorable over the long term despite the reduction of liquidity in the short term. Funds that were raised by companies can be used to finance investments that will fuel long term earnings growth. Liquidity, market capitalization and number of investible stocks of the Philippine stock market should also grow as a result of the share offerings, allowing our stock market to become bigger and more attractive to foreign investors.

- As far as the lackluster earnings season is concerned, the causes for below expected results of listed companies are generally soft patches that are not expected to last.

- While the Philippines is suffering from contagion as Thailand and Indonesia continue to announce disappointing economic growth and external account numbers, the same numbers coming out of the Philippines remain very strong. Recently announced economic statistics such as GDP growth, OFW remittances, BPO revenues, exports, foreign direct investments and the country's competitiveness ranking are all highly favorable.

- As far as the US Fed tapering is concerned, while this is the greatest risk facing the Philippine stock market today, we believe that the worst is already priced in. Assuming that the US 10-year bond rate stabilizes at 3.5%, while the Philippines' 10-year T-bond rate climbs to 5.5% in response to the Fed tapering, our end June 2014 target for the PSEi would be 6,450. The said level is still a premium relative to where the market is today. Consequently, assuming that the PSEi continues to drop, we should not be afraid to buy this market given that the country's long term fundamentals remain intact. We believe that 5,600 would be a good level to start bargain hunting. At the said level, the PSEi would also be trading at 14.4X 2014E P/E which is slightly below its 10-year historical average P/E.

- In my January "COLing the Shots" report, I already highlighted the risk of something like this happening and I recommended setting aside some cash to capitalize on opportunities such as these. While I believe that the sell-off that we are seeing today is an opportunity to deploy cash, we should understand that 1.) It might take a while for the market to recover as sentiment is hurt and as earnings surprises and more compelling valuations are needed to convince foreign investors to return; 2.) With the negative sentiment prevailing and concerns that interest rates would go up, there could be an opportunity for us to buy stocks even more cheaply. As such, we recommend the adoption of a peso cost averaging strategy in the deployment of cash. We also think it would be appropriate to increase our required capital appreciation potential for stocks to 25% from 15%. The use of borrowed money or margin is also not appropriate in this type of market.

- As a reflection of our more cautious view of the stock market in the short term, we are adjusting the "Buy Below Price" of stocks in our "COLing the Shots Model Portfolio" to reflect the increase in our required capital appreciation potential. We are also removing AGI from our portfolio. After AGI listed both its liquor subsidiary Emperador and gaming subsidiary Travellers in the PSE, there is no compelling reason for investors to own AGI as all three major earnings contributors (MEG, EMP and RWM) are already listed in the PSE. Meanwhile, despite PGOLD below expected earnings results, we are still maintaining it in our portfolio as we believe that it is too soon to turn bearish on the stock.

Typhoon also hits Philippine equities

It has been a while since my last "COLing the Shots." Although the PSEi is only down by 3.1% compared to its October 1 close of 6,194.56, it has actually lost a total of 5.3% during the past five trading days as investor sentiment once again turned for the worst due to the abundance of negative developments recently.

Last November 8, the Philippines was badly hit by super typhoon Yolanda. Because of the destruction brought about by the said typhoon, NEDA estimates that GDP growth could slow to 4.1% in the fourth quarter from 7.6% during the first half of the year, while full year GDP growth could drop by 0.3% to 0.8%. Meanwhile, the BSP said that inflation might reach 3.2% for the whole of 2013 from 2.8% during the first ten months of the year. It also said that inflation could climb to 4.5% in 2014.

Moreover, a lot of share offerings took place during the past two months, siphoning off liquidity. Since the start of September, around Php100 Bil in fresh equity was raised by companies either through share placements or IPOs. Despite this, there are still talks of numerous stock rights offerings or capital raising activities. After BPI, PNB and RCB announced plans to conduct a rights offering to raise a total of Php45.2 Bil, the market became concerned that other banks would follow suit. There is also speculation that JGS will raise capital after it bought San Miguel's stake in Meralco valued at Php72 Bil and that SMPH would raise capital after it announced a large capital expenditure plan. Aside from siphoning off liquidity, capital raising activities are viewed negatively because of the potential dilution that they could cause. Moreover, companies usually price the shares that they sell at a discount to their market price.

The recently concluded third quarter earnings season was also generally unexciting. Only a handful of companies delivered better than expected results. Moreover, SM and PGOLD, which are part of the more resilient consumer sector, reported disappointing third quarter earnings results as SM's retail business suffered from weak margins while PGOLD reported disappointing revenue growth.

Finally, foreign investors continue to sell the Philippine market as emerging market Asia (Thailand, Indonesia and Philippines) remains out of favor while developed markets (US and Europe) remain in vogue. Starting June of this year, foreign investors have been net sellers in the Philippines except for the month of July. Moreover, Philippines together with Thailand and Indonesia have underperformed the US and European markets during the past few months starting June this year. Foreign sell-off has intensified recently as a result of the negative developments discussed earlier and as concerns of US Fed tapering once again returned to the fore.

Headwinds to most likely lead to lackluster performance in the short term, but long term uptrend remains intact

Given all the negative developments, it is clearly difficult to justify a strong performance for the equities market in the short term. Most investors are probably wondering if the weakness we are seeing today is just a phase or is it the beginning of a bear market.

Despite all the bad news and the fearful condition of the stock market, we remain convinced that a bear market will not happen anytime soon as the country's favorable long term economic growth outlook remains intact.

Let's analyze all the negative developments that are taking place, starting with typhoon Yolanda.

The economic impact of typhoon Yolanda over the long term should be minimal. Although the whole of Visayas accounts for 12.5% of GDP, Eastern Visayas, which was the hardest hit by the typhoon, accounts for only 4.5% of GDP. Moreover, reconstruction efforts should act as an 'offset'. A few days ago, NEDA director-general Arsenio Balisacan estimated the cost of rebuilding typhoon-struck areas in the Visayas region at Php250Bil. This is equivalent to approximately 2% of the projected 2013 nominal GDP. Funding should also not be an issue given the government's strong finances, low interest rates, and willingness of development agencies to extend cheap loans. Although inflation will go up as a result of the typhoon, interest rates should not go up as the Central Bank normally increases interest rates only if inflation is driven by strong demand and not shortage of supply. Finally, only a few listed companies in our coverage list, namely EDC, FPH and FGEN, were severely affected by the storm. Most said that the typhoon would have little or no impact at all on their operations.

As far as share offerings are concerned, the impact should be favorable over the long term despite the reduction of liquidity in the short term. Note that bulk of the shares that were sold during the recently concluded share offerings were primary shares. This means that funds will be used by companies to finance investments that will fuel long term earnings growth.

Liquidity, market capitalization and number of investible stocks of the Philippine stock market should also grow as a result of the share offerings. Note that the Philippine market is very small, even compared to Indonesia and Thailand. (See Exhibit1) The improvement that will result from the numerous share offerings should in turn should help the Philippine stock market attract more foreign investors.

Exhibit 1: Comparison of Different Equity Markets in Asia

	No. of Listed Cos.	Total Mkt Cap (US$ Bil)	Ave. Daily Value T/O (US$ Mil)
Thailand	515	356	1,644
Indonesia	481	340	626
Philippines	260	267	240

Source: Bloomberg

As far as the lackluster earnings season is concerned, the causes for below expected results of listed companies are generally soft patches that are not expected to last. Admittedly, disappointing earnings results are strong catalysts for sell-offs. However, assuming that the reasons for disappointing earnings results are only short term in nature, investors would still consider buying stocks of companies with disappointing earnings assuming that selloffs become overblown.

While the Philippines is suffering from contagion as Thailand and Indonesia continue to announce disappointing economic growth and external account numbers, the same numbers coming out of the Philippines remain very strong. Recall that Philippine GDP growth reached 7.5% during 2Q13, exceeding economists' estimates. Not surprisingly, while the World Bank downgraded its GDP growth forecast of Thailand and Indonesia, it raised its GDP growth forecast for the Philippines from 6.2% to 7.0% this year. Moreover, growth of OFW remittances remains strong, accelerating to 6.8% in August. The BPO industry is also well on its way to meet its full year revenue target of US$16 Bil and end 2013 employment target of 960,000 jobs according to the IT and Business Process Association of the Philippines. This implies a growth of 21% in terms of revenues and 23.5% in terms of employment. Exports, which dropped by an average of 6.0% during the first five months of the year, are also showing signs of recovery. In September, exports increased by 4.9%. This was the fourth month that exports grew on a year-on-year basis. Finally, investment spending is picking up as net FDI inflows jumped by 123% in August bringing the eight-month tally to US$2.8 Bil, up by 25.4% year-on-year. The recent upgrade of the Philippines to investment grade rating and the significant improvement in the country's competitiveness ranking by 30 points to 108th should also ensure the sustainability of investment spending growth.

As far as the US Fed tapering is concerned, I would like to reiterate what I said during last month's "COLing the Shots." While this is the greatest risk facing the Philippine stock market today, we believe that the worst is already priced in. Assuming that the US 10-year bond rate stabilizes at 3.5% (at par with its average during the past 10 years), while the Philippines' 10-year T-bond rate climbs to 5.5% in response to the Fed tapering, our end June 2014 target for the PSEi would be 6,450. The said level is still a premium relative to where the market is today. Admittedly, the PSEi's upside compared to the said level is not that substantial. However, assuming that the PSEi continues to drop, we should not be afraid to buy this market given that the country's long term fundamentals remain intact. 5,600 would be a good level to start bargain hunting based on the requirement of a minimum capital appreciation potential of 15%. At the said level, the PSEi would also be trading at 14.4X 2014E P/E which is slightly below its 10-year historical average P/E.

In summary, given all the negative developments affecting the Philippine market today, it would be difficult to expect a strong performance in the short term. However, neither do we expect a bear market to take place given the country's attractive long term fundamentals.

Recommending cautious deployment of cash

In January, I came out with my first "COLing the Shots" report for the year entitled "Sunny with a Chance of Rain Storms" discussing the outlook for 2013. In my report, I already highlighted the risk of something like this happening. I also recommended setting aside some cash to capitalize on opportunities. (See a portion of the report below)

> *"Although we expect the market to go up (in 2013), we believe that it will be very volatile. . . There is speculation that the Fed could start phasing out QE3 by as early as end 2013. This would negatively affect the sustainability of the prevailing liquidity driven market rally. There is also a risk that conditions in developed countries improve significantly as governments succeed in addressing their economic problems. If this happens, the Philippine stock market could suffer from foreign fund outflows as foreign investors switch back to developed economies where stocks are much cheaper compared to the Philippines. Negative surprises could have a magnified impact on share prices since investors already have very high expectations.*
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> *Given our expectation that the market will be volatile, investors should keep a part of their portfolio in cash. This would allow investors to capitalize on opportunities to buy stocks cheaply assuming that the market is sold off due to external developments . . . or if the market goes through a correction due to profit taking activities."*

I believe that the sell-off that we are seeing today is the opportunity that we've been waiting for to deploy cash. However, there are a few caveats.

It might take a while for the market to recover. Given the volatility that we are seeing, it will take a while for investor sentiment to recover. As far as catalysts are concerned, we might need to see a few quarters of positive earnings surprises locally. Valuations of developed markets also have to adjust for foreign investor interest to return to the Philippine market (in other words, our relative valuation has to become more attractive). As such, peso cost averaging is still the preferred method to deploy cash to improve the average cost of stock purchases. It is also not wise to use margin in this type of market.

Room to be more conservative. With the negative sentiment prevailing and with concerns that interest rates would go up, there is an opportunity for us to buy stocks even more cheaply. As such, we think it would be appropriate to increase our required capital appreciation potential to 25% from 15%.

COLing the Shots Portfolio – Removing AGI, adjusting "BUY below" prices

As a reflection of our more cautious view of the stock market in the short term, we are adjusting our "Buy Below Price" to reflect the increase in our required capital appreciation potential to 25% from 15%.

We are also removing AGI from our "COLing the Shots Model Portfolio." Just recently, AGI listed both its liquor subsidiary Emperador and gaming subsidiary Travellers in the PSE. As a result, there is no compelling reason for investors to own AGI as all three major earnings contributors (MEG, EMP and RWM) can be bought separately. Given the 44.8% increase in the share price of AGI since it was added it in our "COLing the Shots Model Portfolio" in January of this year, we think now is a good time to lock in gains.

Meanwhile, despite PGOLD below expected earnings results, we are still maintaining it in our portfolio as we believe that it is too soon to turn bearish on the stock. According to PGOLD, revenues during 9M13 were negatively affected by the bad weather in August. Moreover, despite PGOLD's below expected 9M13 earnings results, profits for the period still increased by 46.6%, the fastest pace among listed consumer companies.

Exhibit 2: COLing the Shots Model Portfolio

	Current Price	FV	Buy Date	Buy Price	Current Return	Buy Below Price
EEI	9.88	13.00	30-Mar-12	6.07	62.8%	10.40
PGOLD	40.95	51.00	11-Jun-12	24.60	66.5%	40.80
MEG	3.30	4.78	11-Jan-13	3.11	6.1%	3.82
TEL	2,630.00	3,560.00	11-Jan-13	2,636.00	-0.2%	2,848.00
DNL	6.33	10.50	14-Feb-13	6.00	5.5%	8.40
RLC	21.00	30.00	5-Aug-13	22.70	-7.5%	24.00
AC	565.00	753.00	5-Aug-13	600.00	-5.8%	602.40

Investment Rating Definitions

BUY	HOLD	SELL
Stocks that have a **BUY** rating have attractive fundamentals and valuations, based on our analysis. We expect the share price to outperform the market in the next six to twelve months.	Stocks that have a **HOLD** rating have either 1.) attractive fundamentals but expensive valuations; 2.) attractive valuations but near term earnings outlook might be poor or vulnerable to numerous risks. Given the said factors, the share price of the stock may perform merely inline or underperform the market in the next six to twelve months.	We dislike both the valuations and fundamentals of stocks with a **SELL** rating. We expect the share price to underperform in the next six to twelve months.

Important Disclaimers

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