The start of the much awaited correction?

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

- Most investors are anticipating a major correction to take place soon. During the past few weeks, there were numerous developments that spooked the market but failed to trigger a correction. These include the unfavorable results of the Italian election, talks that the Fed would scale back on its bond buying program, and the US government's failure to stop the sequestration. However, just this Thursday, the PSEi fell by 1.6% after three companies namely Century Properties, Ayala Land and RCBC, announced that they sold shares to raise capital. Could this be the catalyst for the major correction?

- Share placements usually have a negative impact on share prices in the short term. Nevertheless, assuming that a major correction of the PSEi materializes because of these share placements, investors should be mentally prepared to buy this market. We are not concerned about share placements that are taking place because funds generated will be used to fund growth. As a reference, in the middle of last year, five companies namely BDO, URC, ALI, AC and PGOLD, raised a total of Php77.5 Bil in capital. All five companies also suffered a correction. However, all five companies are currently trading at much higher levels compared to their share prices during that time as earnings prospects remain attractive. Also, we do not see any reason why we should change our favorable view of the economy and the stock market. Most of the 2012 earnings results of listed companies were in line or better than expected. Meanwhile, there is speculation that the BSP would cut SDA rates again next week as inflation for the month of February (excluding the impact of sin taxes) remains benign.

- Last month, we reduced our risk free rate assumption by 150 basis points from 5.5% to 4.0%, leading to an across the board increase in the fair value estimates of stocks that we cover. Ample liquidity and low interest rates would most likely remain, especially if the BSP continues to reduce SDA rates as there is Php1.8 Tril parked in the said instrument. This would imply that stocks would most likely remain expensive. Except for EEI and Megaworld, all the other stocks in our 11 stock model portfolio can still be bought as they all continue to trade at reasonable valuations relative to our adjusted fair value estimates.

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Share placements – good or bad?

Most investors are anticipating a major correction to take place soon. This is not surprising given the steep ascent of the PSEi (up 26% since end September last year) and the overbought condition of the market.

During the past few weeks, there were numerous developments that spooked the market but failed to trigger a correction. These include the unfavorable results of the Italian election, talks that the Fed would scale back on its bond buying program, and the US government's failure to stop the sequestration.

However, just this Thursday, the PSEi fell by 1.6% after three companies namely Century Properties, Ayala Land and RCBC, announced that they sold shares to raise capital. The three companies raised a total of US$490Mil or Php20 Bil. Could this be the catalyst for the major correction?

Share placements usually have a negative impact on share prices in the short term. There are many reasons for why prices drop.

1. Shares are usually sold at a discount during share placements. CPG, ALI and RCB sold shares at a 4% to 10% discount to their market price.

2. Short term demand for shares of a stock is filled resulting to a temporary situation where the volume of sellers exceeds the volume of buyers.

3. Earnings would be diluted as the number of outstanding shares increase.

4. Market liquidity in general would be sapped.

5. A share placement could indicate that valuations are already expensive or that insiders are distributing shares in the market.

Nevertheless, assuming that a major correction of the PSEi materializes because of these share placements, investors should be mentally prepared to buy this market.

We are not concerned about share placements that are taking place because funds generated will be used to fund growth. In the case of CPG and ALI, all shares sold were primary shares, meaning that the funds raised would go to these companies to fund their growth. Fresh capital is especially important for CPG which needs funds to replenish its limited landbank. CPG's small landbank is one of its major weaknesses in our opinion. Meanwhile, although some of the shares sold by RCB were secondary shares (US$50 Mil), bulk were primary shares (US$100 Mil). The bank also needs the funds to boost its capital position in light of Basel 3.

As a reference, in the middle of last year, five companies namely BDO, URC, ALI, AC and PGOLD, raised a total of Php77.5 Bil in capital. All five companies also suffered a correction. However, all five companies are currently trading at much higher levels compared to their share prices during that time as earnings prospects remain attractive. The funds raised from the share placements also strengthened these companies' balance sheets, improving their ability to capitalize on growth opportunities (except for PGOLD which sold secondary shares).

Exhibit 1: Performance since capital raising exercise

	Date	Capital Raised	% gain since announcement
BDO	Apr 2, 2012	43.5Bil	74.1
URC	Jun 14, 2012	7.4Bil	56.1
ALI	Jul 11, 2012	13.6Bil	50.1
PGOLD	Jul 12, 2012	6.5Bil	44.4
AC	Jul 18, 2012	6.5Bil	29.2

Source: Companies, COL estimates

Also, we do not see any reason why we should change our favorable view of the economy and the stock market. Most of the 2012 earnings results of listed companies were in line or better than expected. Meanwhile, there is speculation that the BSP would cut SDA rates again next week as inflation for the month of February (excluding the impact of sin taxes) remains benign.

MSCI Index explained

In the past, we advised investors to "buy stocks that are sold down because of the rebalancing of the MSCI index." Last February, we had the privilege of attending a seminar conducted by MSCI to explain the mystery surrounding the rebalancing of the MSCI index. What we learned strengthened our conviction to buy stocks that are sold down because of the rebalancing of the index.
In MSCI's talk, they answered the 5 W's of the MSCI the index – What is the MSCI index? Who uses the index? How are companies added and removed in the index? When do they rebalance the index?

MSCI explained that the MSCI Globe Equity Indices are used by institution investors around the world for doing research, asset allocation, and performance measurement analysis. According to MSCI, around US$7 Tril worth of funds worldwide use the MSCI index as their benchmark. MSCI also said that the index is reviewed four times annually – February, May, August and November.
Since MSCI's main goal is to address the needs of large global institutional investors, its indices take into consideration the investability of stocks and the replicability of their indices in portfolios held by foreign investors. Screens that are used to determine investability include the following:

- Market capitalization
- Free float and free float market capitalization
- Liquidity (annualized traded value ratio, trading frequency)
- Size of allowable foreign ownership
- Length of trading

In short, a stock can only be included in the MSCI index if the market for that stock is big enough and liquid enough to accommodate large foreign investors.

Given the said information about the MSCI index, what does this all mean to retail investors?

Due to the large number of foreign investors that track the MSCI index, any adjustment in the index (addition and reduction in the weightings or additions and removals of certain stocks) results to significant movements in the share prices of stocks involved. In the past, stocks that were sold down because of the reduction in their weighting in the MSCI include BPI (November 2011, shares fell to a low of Php50.00), Metrobank (November 2011, shares fell to a low of Php66.00; August 2012, shares fell to a low of Php90.00), and Meralco (November 2011, shares fell to a low of Php230; August 2012, shares fell to a low of Php240).

However, the removal of a stock or the reduction of its weighting in the MSCI index does not mean that the fundamentals of the stock have turned negative. As discussed earlier, MSCI's major concern is determining whether or not a stock is investable from the perspective of foreign investors. This would explain why stocks that were sold down because of adjustments in their weight in the MSCI index eventually bounce back (BPI, Metrobank, Meralco) as these stocks remain fundamentally sound.

As retail investors, we are not confined to the limitations of large foreign institutional investors. As such, we should capitalize on opportunities resulting from sell offs caused by the rebalancing of the MSCI index.

COLing the Shots portfolio – adjusting fair value estimates to factor in higher liquidity and lower interest rates

Last month, we reduced our risk free rate assumption by 150 basis points from 5.5% to 4.0%, leading to an across the board increase in the fair value estimates of stocks that we cover. Ample liquidity and low interest rates would most likely remain, especially if the BSP continues to reduce SDA rates as there is Php1.8 Tril parked in the said instrument. This would imply that stocks would most likely remain expensive.

Except for EEI and Megaworld, all the other stocks in our 11 stock model portfolio can still be bought as they all continue to trade at reasonable valuations relative to our adjusted fair value estimates.
Exhibit X: COLing the Shots Model Portfolio

Exhibit 2: COLing the Shots Model Portfolio

	Current Price	FV	Buy Date	Buy Price	Current Return	Buy Below Price
MBT	115.00	149.00	5-Jan-12	70.70	62.70%	130.00
MPI	5.41	6.55	5-Jan-12	3.66	42.90%	5.70
EEI	12.96	14.00	30-Mar-12	6.07	115.80%	12.15
PGOLD	39.00	48.00	11-Jun-12	24.60	54.50%	41.75
SMPH	18.70	26.35	25-Jul-12	13.26	42.40%	22.90
BDO	95.75	112.00	25-Jul-12	61.25	43.40%	97.40
AGI	21.20	26.75	11-Jan-13	17.20	20.10%	23.25
MEG	3.94	4.00	11-Jan-13	3.11	21.50%	3.48
MER	322.20	380.00	11-Jan-13	275.60	10.70%	330.00
TEL	2942.00	3500.00	11-Jan-13	2636.00	8.10%	3043.00
DNL	6.96	9.75	14-Feb-13	6.00	12.70%	8.45

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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