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COLing the Shots

The Philippines will not be found naked

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 past month has been very challenging, with the PSEi down by as much as 24%, causing much fear and doubt among investors. Although it will most likely take a while for the market to recover given the damage on investor confidence and risk appetite, we are confident that we will eventually see the PSEi hitting new record highs before this bull market ends. Our confidence hinges on the fact that nothing has changed as far as the country's fundamentals are concerned. The main reason for the market's decline is the tapering of the US Fed's bond buying program. Markets fell in response to the said announcement due to the fact that the rally which started in the middle of 2012 was driven by liquidity and not the improvement in the outlook of the global economy. Concerns that the liquidity driven rally would not be sustainable fueled the outflow of foreign funds from the Philippines.

- The most relevant question for investors today is whether the Philippine stock market can continue to rise even without liquidity. With the strength of the country's fundamentals, we believe that the answer is "YES." The Philippines boasts of numerous long term economic growth drivers which include the country's favorable demographics, resilient OFW remittance and BPO sector, massive opportunity for investment spending, a liquid and highly capitalized banking sector and strong government finances. In BSP Governor Tetangco's speech for The Asset Forum last month, he also highlighted several strong points of the Philippine economy. He also implied that the BSP does not need to intervene in the market for both interest rates and the peso to return to levels that remain accommodative to growth.

- Notwithstanding the attractive outlook of the Philippine economy, we do not think that the market will recover right away as investor confidence and risk appetite were negatively affected by the steep drop of the market. As such, there is no need to aggressively buy this market. Consequently, a better strategy would be to stagger buying over a few months to increase the likelihood of getting a lower average purchase price.

- Stocks in our "COLing the Shots" portfolio were not spared from the market's recent drop, with prices of some stocks falling by more than 10% compared to their previous month's close. We also took out MWC, MPI and MER from our portfolio due to heightened regulatory risk. Nevertheless, we remain very bullish with the stocks that remain in the list and advise investors to take advantage of the ongoing correction to increase their position in the said stocks. Inside this report, we will discuss why the volatility of the financial markets will not eliminate trading gains of BDO and MBT, why we continue to like AGI despite the opening of Solaire, and why DNL will not be affected by the depreciation of the peso. We will also give updates on MEG and TEL to discuss how the earnings outlook of the two companies has improved recently.

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"It's only when the tide goes out that you learn who's been swimming naked."

- Warren Buffett

The tide goes out due to prospects of tighter liquidity conditions

The past month has been very challenging, with the PSEi down by as much as 24%, causing much fear and doubt among investors.

Although it will most likely take a while for the market to recover given the damage on investor confidence and risk appetite, we are confident that this too will pass and that we will once again see PSEi hitting new record highs. Our confidence hinges on the fact that nothing has changed as far as the country's fundamentals are concerned.

The main reason for the market's decline is the tapering of the US Fed's bond buying program. Due to the improving economic outlook of the US economy, the Fed last June admitted that it might reduce the size of its US$85 Bil bond buying program as early as the fourth quarter of this year.

The reason why the market fell in response to the said announcement was the fact that the rally which started in the middle of 2012 was driven by liquidity. This was something that we discussed in our first half market briefing last February. The rally in equity markets that lasted from June of 2012 to April of this year was not driven by improvement in the outlook of the global economy. In fact, in April this year, the IMF even reduced its global economic growth forecast from 3.5% to 3.3% (it has reduced its growth forecast further to 3.1% as of July). Consequently, the Fed's announcement created doubts regarding the sustainability of the market's strong performance in light of the increasing likelihood that liquidity would be reduced.

Concerns that the liquidity driven rally would not be sustainable fueled the outflow of foreign funds from the Philippines. Since the start of 2012 up to May of 2013, foreigners were net buyers in the PSE, with total net buying amounting to Php169 Bil. This trend reversed in June, with foreigners turning into net sellers, amounting to Php17 Bil.

Other markets also suffered the same fate as the Philippines. Compared to their peak, the stock market in Thailand and Indonesia, which are considered to be our closest comparisons, fell by 16.1% and 15.2% respectively. In fact, net foreign selling in the two markets has been more significant. In the two countries, foreigners have turned into net sellers for the year to date period.

The speed by which foreign investors exited the markets caused the steep drop of the PSEi in a short amount of time. While the drop in the market caused by tapering off of liquidity was a risk that we already anticipated, the speed and the magnitude by which it took place also caught us by surprise.

Nevertheless, we believe that the most relevant question for investors today is whether the stock market can continue to rise even without liquidity. Are the country's fundamentals strong enough to warrant the eventual return of foreign investors even if liquidity conditions won't be as attractive as they were last year?

Last week, I attended CFA Philippines and CFA Institute's Junior Finance and Investment Summit where BSP Deputy Government Diwa Guinigundo highlighted Warren Buffett's quote that "Only when the tide goes out do you discover who's been swimming naked." With confidence, the deputy government said that even when the tide goes out, the Philippines is sure to be found with clothes on. I completely agree with his statement.

In the past, I have repeatedly cited the drivers of the Philippines long term economic growth. These include the country's favorable demographics, resilient OFW remittance and BPO sector, massive opportunity for investment spending, a liquid and highly capitalized banking sector and strong government finances.

Even with the slight increase in interest rates and the weaker peso, I remain confident that economic growth will remain strong.

Last week, we emailed clients a copy of BSP Governor Amando Tetangco Jr's speech for The Asset Forum on June 26 where he highlighted several strong points of the Philippine economy. These include 1.) the strong growth of the Philippine economy as evidenced by the 7.8% GDP growth during 1Q13, driven by capital formation and public spending on infrastructure; 2.) the country's sound banking system comprised of well capitalized banks with low non-performing asset levels; 3.) the country's robust external position as evidenced by its GIR of US$82 Bil which is enough to cover close to 12 months worth of imports; and 4.) the country's adequate liquidity condition and robust credit growth.

I believe that the point which our BSP governor would like to stress is that because of these qualities, the BSP does not need to intervene for both interest rates and the peso to return to levels that remain accommodative to growth. Even with the sell-off in the bond market caused by the exit of foreign investors, there is no reason to believe that the 10-year bond rate will return above 10%. Moreover, despite the peso's weakness, it is not expected to return to the Php50 level. As such, conditions will remain accommodative to growth as investors continue to have access to cheap credit and as inflation remains benign.

Recently released economic indicators also paint a positive picture of the Philippines in the short-term. Money supply growth accelerated to 16.3% in May from 13.3% in April, implying the availability of funds to support the country's robust economic growth. Meanwhile, government expenditures jumped 12.4% to Php751.2 Bil during the first five months of the year, supported by a 9.7% growth in revenues to Php708.4 Bil. Infrastructure spending grew by an even faster pace of 35.2% to Php105 Bil during the same period. Continuous growth in government spending should ensure the sustainability of the country's strong economic growth.

In summary, we are confident that investors (both local and foreign) will have reason to come back to the Philippine stock market, even if liquidity conditions are less attractive. Consequently, we should take advantage of the weakness that we are seeing today to accumulate stocks ahead of their eventual recovery.

Staggered buying recommended

Notwithstanding the attractive outlook of the Philippine economy, we do not think that the market will recover right away. One of the most important lessons that I have learned from investing in the stock market for more than 15 years is to respect market action. With the significant decline of the market recently, it will take a while for the stock market to reach new highs as a lot of investors were hurt and will most likely use any rally to sell their position. Investor confidence and risk appetite were also negatively affected by the steep drop of the market causing a lot of hesitation among new investors. As such, there is no need to aggressively buy this market. A better strategy would be to stagger buying over a few months to increase the likelihood of getting a lower average purchase price.

With the volatility of the market today, risk management becomes more critical. As such, we would like to take this opportunity to remind investors of some simple but very important portfolio management rules.

1. **Diversify –** While stocks should form part of every investor's portfolio, it should not be the only instrument in one's portfolio. In our seminars, we usually advise investors to allocate 10-20% of income for investment in stocks. With proper diversification, your whole portfolio should be less vulnerable to market swings such as the one that we are seeing today.

   Your equity portfolio should also contain more than one stock and those stocks should come from different industries. That way, you are protected from any significant downturns caused by unforeseen circumstances that could affect one stock (ex., increasing regulatory risk affecting MWC, MPI and MER).

2. **Think Long Term –** Stock investments should be long term in nature. While volatile in nature, studies have shown that stocks beat returns of other popular investment instruments over time. Having a short term perspective only puts one at risk for losses as there is a greater risk of selling at a loss.

3. **Discipline –** Stick to the discipline of consistently buying stocks of good quality companies to guarantee positive returns overtime. Don't let the fearful condition of the market affect you as now is the best time to accumulate stocks with more attractive valuations.

COLing the Shots Portfolio – weakness not reflective of fundamentals

Stocks in our "COLing the Shots" portfolio were not spared from the market's drop, with prices of some stocks falling by more than 10% compared to their previous month's close. Last week, we also took out several stocks in our portfolio due to heightened regulatory risk namely Manila Water, Metro Pacific Inc., and Meralco. Nevertheless, Metro Pacific and Meralco were still trading at much higher levels compared to the price at which we first recommended them. Meanwhile, the prices of other stocks that remain in our list are also still higher compared to the price when they were first added. We also reiterate our positive view on the said stocks and advise investors to take advantage of the ongoing correction to increase their position. During the past few weeks, we have been busy talking to the management of these companies to determine whether or not the recent developments will affect them fundamentally.

BDO and MBT: Volatility will not eliminate trading gains

Sentiment for banking stocks is currently very negative due to concerns that banks would book significant trading losses due to the volatility of financial markets. Although both BDO and MBT admitted that trading gains will be hurt by the volatility of financial markets, both said that they still expect to book trading gains for the first half of the year. Recall that banks have sold a significant part of their trading portfolio during the first quarter, explaining the large trading income booked during the period. Since banks were able to lock in some of the gains, a complete wipeout of 1Q13 gains is unlikely. Also, BDO and MBT still have huge unrealized trading income totaling Php16.6Bil and Php16.0Bil as of end 1Q13 respectively resulting from the continuous decline of bond rates over the past five years. While bond rates have gone up recently, they have not increased enough to eliminate the gains accumulated over the past five years.

Valuations have also become very attractive. At their current prices, BDO is trading at 1.8X 13E P/BV while MBT is trading at 1.7X 13E P/BV, already at par with their historical average P/BV multiples. This is despite the fact that profitability of both banks as measured by ROE will continue to exceed their historical averages, even with more subdued trading gains, as loan growth remains robust and as net interest margins bottom.

AGI: Gaming revenues not affected by opening of Solaire, scrutiny of Chinese government

During our recent visit with AGI, management confirmed that the performance of Travellers' Resorts World Manila (RWM) remains good. Despite the opening of Solaire in March, RWM was only negatively affected during the first few days following the opening of its competitor. This development reinforces our view that the gaming market in the Philippines is still in the infancy stage and can accommodate more than one player.

AGI also said that it was not affected by the Chinese government's move to closely scrutinize casino operators which are being used by mainland Chinese officials to launder state funds. According to AGI, RWM's growth is not driven by these premier VIP players from China. Rather, it caters to lower-end high rollers which would not be considered as VIP players in China. Management added that Chinese VIP players constitute only a small portion of its revenues.

MEG: Consolidation of affiliates to improve LT outlook; major beneficiary of large scale property transactions in Fort Bonifacio

One of the biggest losers in our portfolio during the past month was MEG. Although shares already fell significantly in May after it was removed from the MSCI index, it fell even more, by another 10% during the month of June. Nevertheless, we continue to like MEG. In fact, fundamentals have improved further after the company took steps to consolidate its share in GERI and ELI. Recall that MEG recently acquired 2.5 Bil newly issued shares of GERI, providing it with a 22.75% stake in the company. Meanwhile, it bought another 1.2 Bil shares of ELI, increasing its stake in the subsidiary to 80.5% from 78.9%. The said developments should allow MEG to better capitalize on opportunities in the property sector, especially in the tourism sub-segment which is expected to be one of the major growth areas of the country going forward. Recall that GERI has a 3,200 hectare land bank which includes 1,146 hectares in Laurel Batangas (Twin Lakes Development) and 69 hectares in Boracay (Boracay Newcoast Development), two very popular tourist destinations.

MEG should also benefit from two upcoming developments in the Fort Bonifacio area – the planned auction of four parcels of land with an aggregate area of 8,300 sqm by the SSS and the acquisition of five office buildings of the Net group with a total leasable area of 147,000sqm by Fort Bonifacio Development Corp. (FBDC).

According to newspaper reports, SSS set a minimum bid price of Php2.24 Bil or Php270,00/sqm for its Fort Bonifacio properties. The winning bidder will be announced on October 2 this year. A successful sale at a price above the minimum bid price should benefit MEG given that it owns around 40 hectares of landbank in the periphery of the Fort Bonifacio area. In our fair value estimate, we valued MEG's property in the area at only Php120,000/sqm.

Meanwhile, there are talks that the acquisition price of the Net group office buildings is close to Php20 Bil. Assuming that the transaction closes at the said value, the implied EBITDA cap rate is between 4.1% and 6.4%. Once confirmed, the transaction is expected to create a benchmark in valuing office buildings and should reinforce our current cap rate assumption of 6.25% for office buildings (which is in fact on the conservative side assuming that the recent transaction closes at Php20 Bil). MEG should be a major beneficiary given that 35% of its NAV comes from office buildings.

PLDT: Profits looking up

Telcos are among the major beneficiaries of the weaker peso since international long distance (ILD) revenues are denominated in US dollars. As far as PLDT is concerned, ILD revenues accounted for around 19% of revenues during 1Q13. According to the company, every Php1.00 movement of the peso will boost its after-tax core income by around Php320Mil. PLDT should also benefit from the continuous improvement in the competitive environment as average revenues per user or ARPUs stabilize. In fact, PLDT already said that it expects 2Q13 results to be better than that of the previous quarter in terms of both topline and bottomline. At its current price, PLDT provides a dividend yield of 6.0%, a premium relative to the 10-year bond yield, making it an attractive alternative to fixed income investors looking for higher yields. Capital appreciation potential is also substantial relative to our fair value estimate of Php3,500/sh.

DNL: Weak peso not a concern

The weakness of the peso raised concerns regarding DNL's profitability given that around 60% of DNL's raw materials are imported. However, DNL said that it expects margins to remain stable given that it can re-price its contracts with clients ahead of time before it needs to replenish its inventory. DNL's average length of contract with clients is around 45 days. Meanwhile, it has 60 to 90 days worth of inventory. The said mismatch in length of contract and inventory days protects DNL from rising costs resulting from the depreciation of the peso or rising commodity prices. DNL also reiterated its FY13E earnings guidance of Php1.38Bil, a 34% improvement over its Php1.03Bil core earnings in 2012. At Php6.40/sh, DNL is also attractively valued, trading at 17.7X 13E P/E, a discount relative to the 24.3X average 13E P/E of the consumer sector.

We have yet to talk to the management of PGOLD and EEI. However, we think the fundamentals of the two companies remain intact. In fact, the weakness of the peso and the drop in commodity prices should event benefit PGOLD by boosting consumer spending (by increasing the value of OFW remittances) and increasing margins. Meanwhile, the continuous growth in infrastructure spending in the country should benefit EEI.

Exhibit 1: COLing the Shots Model Portfolio

	Current Price	FV	Buy Date	Buy Price	Current Return	Buy Below Price
MBT	108	149	5-Jan-12	70.7	52.80%	130
EEI	12.86	16.5	30-Mar-12	6.07	111.90%	14.35
PGOLD	35.15	48	11-Jun-12	24.6	42.90%	41.75
BDO	84.8	112	25-Jul-12	61.25	38.40%	97.4
AGI	24.3	26.75	11-Jan-13	17.2	41.30%	23.25
MEG	3.27	4.78	11-Jan-13	3.11	5.10%	4.16
TEL	2,828.00	3,500.00	11-Jan-13	2,636.00	7.30%	3,043.00
DNL	6.7	10	14-Feb-13	6	11.70%	8.7

**SMPH fair value under review following recent asset injections*

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.

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