



Pakistan Outlook 2009



Slowing Down, U-Turn Ahead

January 2009

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2009: SLOWING DOWN, U-TURN AHEAD

PAKISTAN EQUITIES: WEAK START COULD MAKE FOR A STRONG FINISH

The removal of the price floor precipitated a 35% decline in the KSE100 Index from the floor level. After touching our target low, the benchmark index is now trading at a forward PER of 5.0x at an unprecedented 48.1% discount to the region. The good news is that investor sentiment is dismal, valuations are ridiculously cheap and the dividend yield sits in excess of 20% for certain stocks. Given that the KSE100 Index opened the year at a four year low, an uptick in business activity towards the end of the year on improved macro fundamentals could well see it close up YoY by December 2009.

FACTORS THAT WILL TURN THE TIDE: BOTTOM OF THE U?

Key factors will signal whether a sustained upswing is imminent. Monetary easing is one and will provide a boost to business and economic activity. Earnings have likely bottomed with FY09E expected to post a slight decline but FY10E will be decidedly better. The return of liquidity is also crucial to this cause. Domestic liquidity management is likely to remain tight with fiscal spending being reigned in for the next six months but monetary easing towards the latter half of the year will help in this regard. Stability in global markets is equally important as portfolio inflows for the domestic market are highly co-related to global equities performance.

ECONOMIC UPDATE: THE SILVER LINING BEGINS TO SHINE

Gradual improvements in macro indicators are coming through. IMF support has boosted the FX reserve position to over USD10bn, while remittance activity recorded yet another high for December 2008. The trade deficit will shrink on a YoY basis by Jun 2009 on the back of lower oil/commodity prices. Inflation remains well in the twenties, although the good news on this front is that it has been registering a month on month decline since November 2008 and we expect it to come off very rapidly over the next six months. This, combined with government efforts to limit CB borrowing, should see interest rates begin to ease as early as 2QCY09.

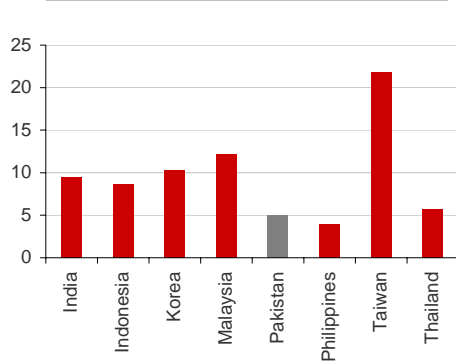
TOP TRADING IDEAS FOR 2009: DEFENSE IS THE BEST OFFENSE

Our top picks for the year include FFC, OGDC, PPL, HUBC, PTC and NBP. These represent our preference for defensive stocks which are expected to post positive earnings growth in FY09E and are cheap on a trailing and forward PER (PBR for financials) basis. Strong dividend yield has also been highly favoured as this will help boost total return in a crawling equity market. Other factors include good cash position and low debt, to minimize earnings impact from higher financial charges. Other ideas to look out for include potential merger activity especially in the listed banking and brokerage space.

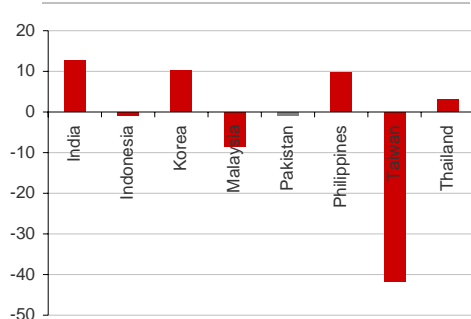
STRATEGY

Maheen Rahman
Head of Research

2009 PER (x)



2009 Earnings Growth (%)



Source: International Broker Research, BMA Research

PAK EQUITIES: WEAK START COULD MAKE FOR A STRONG FINISH

SENTIMENT DISMAL; VALUATIONS ENTICINGLY CHEAP

Prior to floor removal, we were of the opinion that the KSE 100 Index level needed to decline by approximately 35% – 40% and achieve a level of 5,500 – 6,000 before valuations were in sync with the rest of Asia and also reflective of the prevailing economic scenario. The KSE 100 Index has touched our target low before rebounding 5% and currently sits at a trailing and forward PER of 4.9x and 5.0x respectively, reflecting a 48.1% forward discount to other regional markets. The good news for Pak equities is that sentiment is dismal which usually signals the bottom of the bear market, while valuations have become enticingly cheap. The dividend yield alone is in excess of 20% for certain stocks.

OPENING THE YEAR AT A FOUR-YEAR LOW; CHANCES HIGH FOR CLOSING 2009 UP

The KSE 100 Index opened on January 1, 2009 at a four year low of 5,753. Given a gradual improvement in most macro indicators and an expected cut in interest rates by the 3Q/4Q 2009, there is reason for equities to stage a rebound towards the end of the year. On an earnings basis, we expect the overall BMA Universe (75% of market capitalization) to register a fairly flat year.

IN THE MEANTIME, IT'S A DEFENSIVE TRADING MARKET; LOOK FOR BOUNCE-BACK STOCKS AND IMPORTANT TRIGGERS

It will be a year of slow recovery and adjustment to a new operating environment. Add to that a considerable stock overhang issue, technical constraints on liquidity (CFS financing) and debate over the market support fund. While there may be a more sustained upward impetus towards the end of the year, much of 2009 will be spent trading defensive stocks and playing on the dividend yield.

We believe that a market low of 5,500 has been established and once the market enters this zone, good stocks with solid return potential should be considered. The criteria that we would use include:

Criteria to identify stocks with solid bounce-back potential

Criteria	Rationale
1. Positive earnings growth over 2009	Corporates able to post positive growth in a year where total earnings will suffer a marginal decline are better placed
2. Cheap on a trailing and forward price to earnings (for corporates) and price to book (for financials) multiple as compared to market multiple	We use cheap on a trailing basis as well to avoid the inherent bias in forward analyst forecasts
3. Part of strong corporate group/profile/sovereign backing	Reflects financial strength
4. High dividend yield in excess of 10 yr PIB	Better return potential

Source: BMA Research

Important triggers that will affect particular stocks or sectors should also be considered. Dividend dates and share bonus announcement are important as is any merger or takeover activity.

The bottom of the 'U'?; Potentially yes, but no upswing in sight for another six to eight months

It may be too early to say that we are sitting at the bottom of a U-shaped recovery; but there are certain factors that will signal if and when the market is ready for a sustained upswing. We believe it will take six to eight months for some of these to become evident.

- **Growth recovery; living with painfully high interest rates:** After suffering through an exceptionally hard landing throughout 2008, macro indicators are slowly being pulled back to more reasonable levels. The low point on GDP growth should be seen this year – in tandem with the punitive interest rate and inflation environment. Monetary easing should commence latest by 3QCY09 as inflation subsides to more palatable levels and that should correspond with an overall upswing in business and economic activity particularly on the manufacturing front.
- However, corporates will still have to deal with a weaker PKR than has been over the last few years along with restructuring and higher unemployment that will hurt overall consumption patterns. Expect GDP growth to average 3.4% in FY09 and potentially touch 5.0% by FY10. Equities will respond correspondingly.
- **Earnings bottoming:** FY09E will see a slight decline in overall corporate earnings by 0.9%, with sectors such as OMCs, Refineries and Autos likely to take the biggest hits. Fertilizers, Cements and Power should buck the norm and post earnings increases but this will not be able to offset an overall decline in earnings growth for this fiscal year. This should be followed by a modest recovery in FY10 led by the financial sector as it responds to moderate increases in growth. However, earnings visibility still remains somewhat hazy given that overall IMF assistance is so closely tied to fiscal spending and borrowing patterns.
- **Liquidity comeback; The all important factor for an equity revival:** A key factor behind the global and domestic equity bull-run was the abundant availability of liquidity both from internal and external sources. On the domestic front liquidity management is likely to remain tight as the government reigns in fiscal spend and the Central Bank keeps monetary policy restrictive until inflationary pressures begin to subside. On the external front, strong NFA flows are not likely to return to Pakistan for the moment until an overall level of global calm begins to prevail and fund managers re-look to deploy cash into cheap equities. We believe the current liquidity downswing will play out over the next six to eight months with an overall loosening of interest rates by 3QCY09 signaling the end of monetary tightening.
- One must not discount the impact from changes in the potential CFS structure and the State Enterprise Fund of PKR 20bn. These will and should push the Index from current lows to some recovery but this in itself will form the basis of a bear market rally. Given the stock overhang issue higher levels reached will prompt additional selling pressure. Until true liquidity returns to the markets this will keep overall equity performance somewhat muted.

- **Dirt Cheap Valuations:** We place the forward PE multiple of the KSE100 at 5.0x for FY09E based on flat earnings growth for FY09. This indicates that the discount to the region has widened to an unprecedented 48.1%. Also the dividend yield for certain stocks has exceeded 20%. We expect the market to continue to trade in a PE band range of 5.0x – 7.0x over the course of 2009.
- **Global growth:** In order for Pakistan to realize a comeback in portfolio flows some element of calm has to prevail in global and domestic markets. It should be noted that the highest point for portfolio inflows was in 2007, a year when equities globally outperformed and Pakistan was able to gain visibility through flotation of several international issuances on debt and equity.
- **We believe buying interest at cheap valuations will remain from the foreign side;** however instead of a longer term view on the market it is possible that foreigners may look to engage in short term profitable trades for the time being. A sustained level of foreign portfolio investment hence will not return until global economic issues begin to subside. The value of foreign portfolio holding prior to market floor removal was USD2.2bn as of 13 December. Today, a month later, the value of this holding has dropped to USD1.3bn with SCRA registering a net outflow of only USD78mn since the floor was removed. This implies that the bulk of erosion in SCRA portfolio value has been predominantly through value erosion rather than heavy foreign selling. In fact, foreigners have also displayed healthy buying activity since December 15th.

POTENTIAL RISK FACTORS

- **Regulatory and governance risk:** A key factor driving the KSE100 Index freefall was the inability of the SECP, KSE and other government bodies to beef up investor confidence at a time when economic issues were clearly coming to a head. Poorly thought out decisions regarding the imposition of the floor mechanism on stock prices plus changes in the lower lock limits, not only prompted further off market selling at ridiculous discounts, but also eventually pushed MSCI Barra to remove Pakistan from the Emerging Markets Index.
- We believe there remains a certain element of governance risk within the system. However, provided the regulators have learnt from their mistakes, such severe forms of capital control are unlikely to be imposed again. However it is imperative that stakeholders now push for demutualization and listing of the exchange to dilute the impact individual or a group of collective members can have on exchange management decisions. Such a process along with continued management of economic issues will restart the painful process of rebuilding investor confidence
- That political animal gone wild: After a difficult two years on the political front we can be forgiven for wanting to believe that political issues have been set aside for the time being. While the possibility of snap elections anytime soon is not likely over the course of 2009, there may be changes and restructuring within the existing government structure as alliances evolve. Also it is imperative to keep a close eye on Pak-US relations under the new White House administration especially in the context of souring relations with India.

TOP TRADING IDEAS FOR 2009

Stock	Trailing PER (x)	Forward PER (x)	EPS Growth FY09E (%)	Div. Yield (%)	Strengths	Potential Price Triggers
FFC*	6.2	5.0	24.8	21.9	<ul style="list-style-type: none"> Conservative business model Strong cash flow Low debt/equity for CY09E offers bottom line protection from high financial charges 	<ul style="list-style-type: none"> Quarterly dividends paid – announcement usually in early part of the quarter. (Positive) Major positive change in urea demand (Positive) Removal of gas subsidy (Negative) Announcements impacting subsidiary FFBL such as removal of DAP subsidy (Negative/Positive)
OGDC	4.6	4.3	5.9	19.6	<ul style="list-style-type: none"> Trading at deep discount to regional PER multiples Strong 9.0% 3yr production growth CAGR expected due to enhanced production from Mela and other fields Hedge against PKR depreciation 	<ul style="list-style-type: none"> Quarterly dividend announcement usually in mid quarter. (Positive) Further increase in well head gas prices (Positive) Spike in global crude prices (Positive) Finalization of potential Qadirpur selloff (Negative)
PPL	5.7	3.9	47.0	12.9	<ul style="list-style-type: none"> Increase in gas prices to yield earnings growth CAGR of 10% through FY08-11E 90% of earnings from gas production, cushioning earnings from oil price volatility PKR 22.1bn cash position with no debt on the books 	<ul style="list-style-type: none"> Dividend paid twice in second and fourth quarter, usually in beginning of quarter. (Positive) Further increase in well head gas prices (Positive)
HUBC	7.9	6.3	26.1	14.4	<ul style="list-style-type: none"> Strong growth potential given high demand (higher load factor) from sole purchaser WAPDA Further expansions with the most recent one due to come online by FY10E Hedge against PKR depreciation 	<ul style="list-style-type: none"> Second and fourth quarter dividend payment usually made in quarter end. (Positive) Significant progress on circular debt issue (Positive)

PTC	N/A	5.5	N/A	12.4	<ul style="list-style-type: none"> ▪ Earnings turnaround in FY09E post VSS ▪ PKR 18.0bn cash position ▪ Low debt/equity for CY09E offers bottom line protection from high financial charges 	<ul style="list-style-type: none"> ▪ Dividend payment in last quarter, usually by quarter end (Positive) ▪ Further attrition in subscriber base (Negative) ▪ Upward revision in calling rates (Positive) ▪ Revision in APC rates
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NBP*	3.1	3.0	3.5	8.2	<ul style="list-style-type: none"> ▪ Large and well capitalized ▪ Low ADR within SBP prescribed limits ▪ Dividend realized in 1 payment ▪ Forward PBR 0.4x vs. 0.9x for the market 	<ul style="list-style-type: none"> ▪ Once yearly dividend announcement usually made in last quarter of financial year (Positive) ▪ Higher than expected NPLs (Negative) ▪ Announcements on stock buyback (Positive)
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* = CY09E dividend yield; rest are FY09E

Economy

Mustafa Pasha
Economist

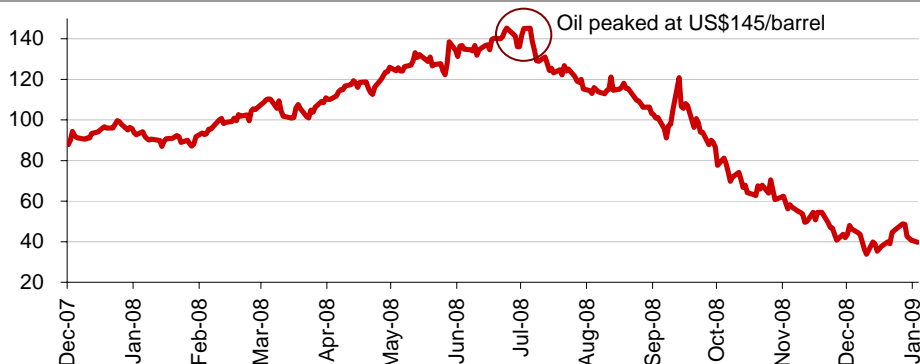
2009: THE SILVER LINING BEGINS TO SHINE

The end of 2008 marked the culmination of one of the most volatile periods in the country's history. From the ouster of a military led government to the economic upheaval and virtual meltdown of capital markets which forced the country in to yet another IMF program, Pakistan endured crisis after crisis. Perhaps the only positive to come out from this year was the sheer resilience demonstrated by the people as well as the economy. Though 2009 will remain a year of consolidation and recovery, the silver lining on the ominous cloud that hovered for most of last year has finally begun to shine.

COMMODITY PRICE MELTDOWN: A BALM FOR EXTERNAL ACCOUNT WOUNDS

While a host of factors pushed the economy to the brink, perhaps the single most important reason was the explosion in international commodity prices. The cost of importing oil, cotton, wheat and palm oil during the commodity boom pushed the FY08 trade deficit to USD15.3bn and forced an outflow of USD5.8bn on the balance of payments account. While the first quarter of FY09 saw this trend continue, the last months of 2008 displayed a marked improvement as the monthly trade deficit fell from USD1.69bn in October to USD0.67bn in November; a decrease of almost 60%. We expect this improvement to be even more marked in official December numbers as preliminary statistics indicate a 13% cut in the deficit on a mom basis. The improvement in the country's trade figures have after the requisite time lag coincided with the meltdown in prices for crude oil, wheat, cotton and palm oil.

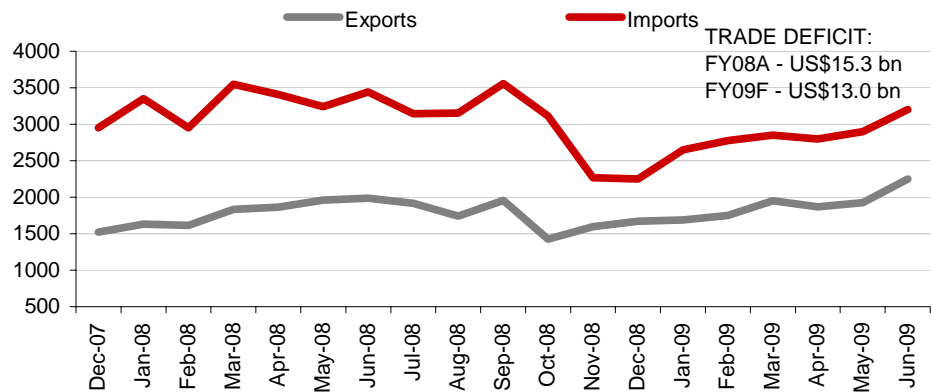
Figure 1: Nymex Dec 07 – Jan 08



Source: Bloomberg, BMA Research

In the face of a U.S recession and relative slowdowns in China and India, the outlook for international commodity prices is bleak in 2009. While a rebound from the lows seen at the end of 2008 is expected, the heady highs of July are not expected to return in the short to medium term. This bodes well for Pakistan's external account woes as going forward the pressures which forced massive dollar outflows are expected to ease and provide relief to the currency as well as the country's FOREX reserves. A continuation of the trend witnessed in the last quarter of 2008, should see the country significantly reduce its trade deficit to around USD13.0bn, a 15% improvement over FY08.

Figure 2: Trade deficit Dec 07 – Jun 09

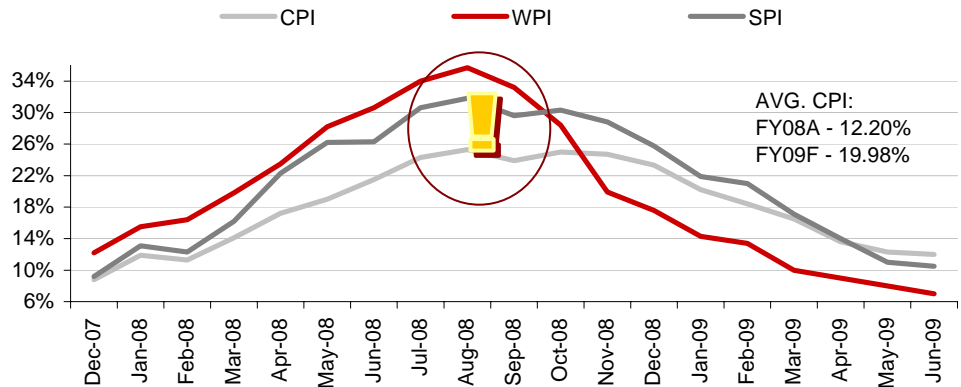


Source: SBP, BMA Research

INFLATION'S 15 MINUTES OF FAME: CONSUMER'S BREATHE A SIGH OF RELIEF

The good news is that inflation seems to have finally peaked; the bad news is that the last CPI reading came in at 23.3%. There were two distinct phases to the severe inflationary pressure we witnessed in 2008, the first one occurred in 1QCY08 as CPI started to reflect the 65% increase in wheat prices, 47% increase in palm oil and 30% increase in cotton and crude oil. The second phase started in April as the price of crude continued to climb rapidly and the newly elected government started to withdraw subsidies on petroleum products, electricity, gas and medicinal products; while increasing the wheat support price paid to farmers.

Figure 3: Trends in Inflation Dec 07 – Jun 09



Source: SBP, BMA Research

The inflection point in the graph above and the data four months forward confirms that CPI touched its peak of 25.3% in August. More importantly over the last two months the CPI index is down by 0.6%, while food and transport prices

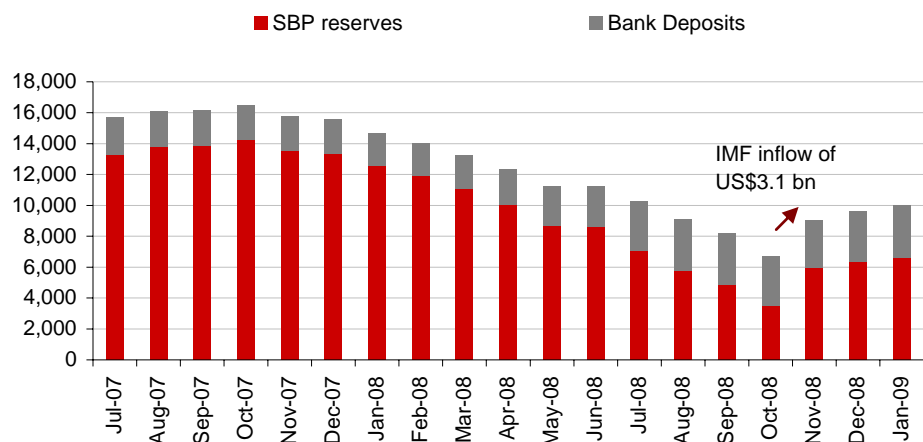
have decreased by 3.0% and 9.5% respectively. As the high base effect kicks in over 1HCY09 and the drop in petroleum and food prices starts to take effect; inflation is expected to continue its downward trend and end the fiscal year around 12%.

MONETARY HAWKS NO MORE: TIME TO REVERSE

The crisis on the external and inflationary front forced the SBP to tackle what was perceived as an output gap in an overheated economy. Between July 2007 and November 2008 the SBP raised the discount rate five times from 9.5% to 15%. Each time, the rationale of inflationary pressures and twin deficits was used to increase borrowing costs for consumers and industry alike. In effect; a demand side instrument was being used to tame a supply side problem, the result was the complete breakdown in the demand for consumer financing, rising NPLs in the banking sector and a heavy debt burden which hurt the profitability of large scale manufacturing, especially the highly leveraged textile and cement sectors.

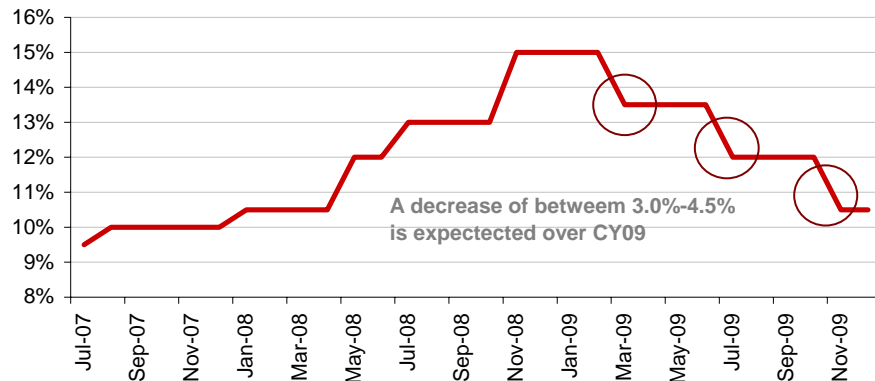
However the rationale for further monetary tightening has now faded. Inflation has started to ease on the back of falling international prices, pressure on the external account has similarly decreased, while money supply growth has been contained to just 1.25% in 1HFY09. With LSM growth negative 6.2% in 1QFY09, advances growth slowing down from an average of nearly 24% (2003-2007) to under 18.5% and auto sales down by over 40%; the output gap has narrowed. Moreover, projections for GDP growth in this fiscal year are now 3.5%; a significant fall from the 7%+ growth that the economy witnessed over the last 5 years. Lending further credence to the view that interest rate cuts may be seen as early as 2QCY09 (though more probable in 1QFY10) is the comfort that FOREX reserves of over USD10bn and a PKR that has been stable at 79 for over a month provide.

Figure 4: FOREX reserves Jul 07 – Jan 09



Source: SBP, BMA Research

With industry and the populace calling for relief from suffocating interest costs, the government will be loathed to increase rates at a time when the economy has seemingly bottomed out. The end of Ms. Shamshad Akhtar's tenure at the helm of the SBP and the induction of Mr. Salim Raza as the new Governor may be an indication that 2009 will bring about a reversal of monetary policy.

Figure 5: SBP discount rate outlook Jul 07 – Dec 09


Source: SBP, BMA Research

THE IMF: FRIEND OR FOE?

Improving macroeconomic indicators in a normal situation would probably call for a reversal of the monetary stance and the implementation of multiple rate cuts. The current scenario however is complicated by the presence of the IMF which remains hawkish on monetary policy. The conditionality attached to the IMF bail out includes several quantitative targets on minimum NFA levels, ceilings on NDAs, government borrowing and FOREX reserves.

Figure 6: IMF Targets

	Targets		
	Dec 08	Mar 09	Jun 09
Floor on SBP NFAs (USD mn)	1,165	671	2,782
Ceiling on SBP NDAs (PKR bn)	1,346	1,412	1,314
Ceiling on net government borrowing from SBP (PKR bn)	1,274	1,274	1,181
Ceiling on overall budget deficit (PKR bn)	261	405	562

Source: IMF, BMA Research

With regards to the minimum level of net foreign assets, the end December target has been comfortably met with NFA levels currently over USD2,100mn. With the dollar outflows seen in 1HFY09 slowing down, stabilization of the PKR against the USD, and expected inflows from multilateral institutions and friendly countries in excess of USD1bn the March target of USD671mn should also be satisfied.

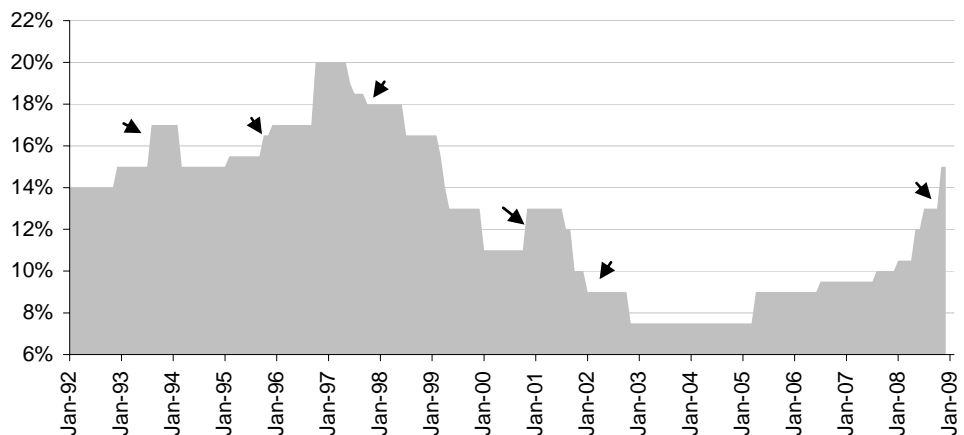
The level of net domestic assets, net government borrowing and overall budget deficit are all interrelated. The level of NDAs will ultimately be decided by whether the government is able to sustain the reforms it has implemented over the last 6 months. These reforms include reducing subsidies on petroleum products (in fact due to the commodity price melt down the government is receiving inflows from the petroleum development levy) while power and gas tariffs have been increased significantly since the budget in June 2008. Allied to a 65% cut in allocated development expenditure, the government has been able

to reduce the 1QFY09 budget deficit to just 1% of GDP. If tax revenue targets are met for the rest of the year and the remaining subsidies are successfully phased out then the government should be able to meet the IMF’s target budget deficit in December as well as in March and June. Given that government sector borrowing and operations are the overwhelming drivers of NDA expansion and contraction, a semblance of fiscal discipline in conjunction with easing inflationary pressures, should ensure that Pakistan is able to shed the unwanted label of being a single tranche country.

Arguments for keeping interest rates steady are increasing; however government borrowing trends between Nov 08 – Jan 09 will be crucial in determining which way the rate goes.

The graph below shows what happened to the policy rate every time Pakistan entered in to an agreement with the IMF and provides ample evidence that further monetary tightening is not a foregone conclusion. With the country so far on track to meet the IMF’s quantitative targets another hike in the discount rate could be avoided. The key risk factor we see in this regard is the government’s ability to limit the amount of Central Bank borrowing between Nov to the end of this fiscal. To its credit, the GOP managed to retire almost PKR 200 bn during the last 3 weeks of Dec alone but net borrowing still exceeds the limit set by the IMF by approximately PKR 70 bn. To this end January inflation and NDA expansion data is key to determining whether interest rates will increase or stay unchanged.

Figure 7: IMF and the SBP discount rate Jan 92 – Nov 08



Source: SBP, IMF, BMA Research

GOING FORWARD: IN NEED OF REAL REFORM

Since the start of the century, Pakistan has made massive strides in transforming its economy and leaving behind the lost decade of the 90s. Between 2001-2007 growth averaged over 7% while GDP almost tripled in size from USD60bn to USD170bn. A previously insulated economy went through major reforms to open itself to the world; as a result the volume of international trade increased from USD20bn to USD60bn, all while retaining relative price stability.

However despite the creation of 5mn jobs, reduction in poverty and inflow of foreign direct investment totaling billions of dollars, the last year has shown how vulnerable the economy remains to external shocks. A boom in commodity prices shook the foundations of the entire structure and brought the country to the brink of default on its debt obligations. Consequently we were forced back to the ignominy of being bailed out by the IMF and being subject to the whims and criticisms of the international community.

The policy response to the threat of inflation necessitated in the minds of the SBP, a repeated tightening on the monetary front. The persistent power shortage plagued large scale manufacturing's production capacity and the government's decision to withdraw special rates on utilities for industrial use raised costs in an already inflationary environment.

As corporate profitability shrunk, the circular debt issue remained unsolved and the financial sector suffered one of the most tumultuous years in recent memory, projections for GDP were accordingly slashed. Growth is expected to slow from 5.8% in FY08 to 3.4% in FY09 and recover to 5% in FY10. This recovery should start to become apparent by the end of the calendar year as the SBP and Ministry of Finance move aggressively to stimulate the economy.

Despite the resilience displayed by the economy, a return to US\$100 oil or an increase in the prices for palm oil and steel could derail the recovery in macroeconomic indicators very quickly. The financing from the IMF unfortunately remains little more than sticky tape over a gaping wound, which will be unable to provide long term relief unless a sustained policy to overcome the inherent infrastructural weaknesses in the economy is thoroughly implemented. To this end, Pakistan must learn to play to her strengths – investment in the workforce to raise productivity and skill levels as well as investment in agriculture, power and natural resource to expand the overall production capacity of the economic base will be crucial to avoiding such hard landings in the future.

BANKS

MARKETWEIGHT

Omar Chaghtai

Banking Sector Analyst

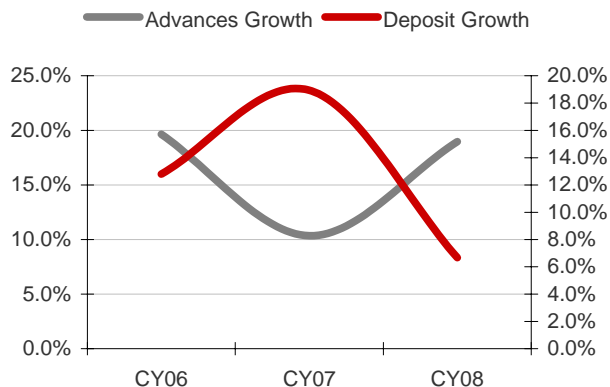
FORCED CONSOLIDATION!

ADVANCES: STANDING STRONG

- Advances growth weighed in at 19.0% for CY08 compared to 10.4% in the corresponding period of last year. High borrowing from public sector companies, especially given the circular debt issue as well as enhanced working capital requirements for the corporate sector where rising inflation has increased the cost of doing business, kept advances buoyant. Lending rates have also been trending upwards persistently through CY08 thus far with the average rate for 11MCY08 at 12.3% and a further policy rate hike will likely push them up further; we expect it will likely exceed 12.5% for CY08E.

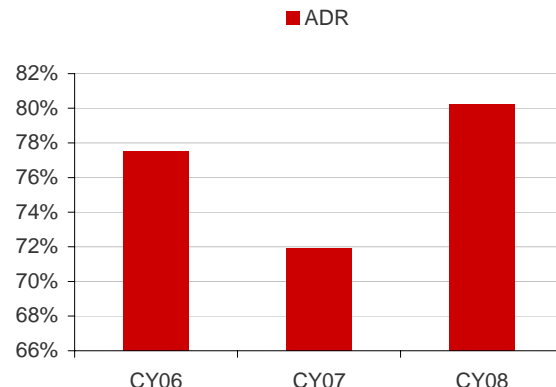
Moving forward, the government's focus on agriculture as well as meeting the power deficit will likely be key drivers for advances growth, with increased lending to related sectors, especially power where credit demand is relatively inelastic to interest rates. Furthermore advances growth should also be bolstered by the government's funding needs, given IMF conditionality of achieving zero borrowing from the SBP. Other important segments can be logistics, telecoms, transportation and port handling facilities. Other than this, SME's, microfinance and agriculture will also be important. On the consumer side, mortgage and personal loans growth looks promising, but we believe that banks will look to consolidate on their consumer portfolios given the high rate of interest and asset quality issues.

Advances and Deposit Growth



Source: BMA Research

Advance to Deposit Ratio



Source: BMA Research

DEPOSITS: COMPETITION HEATS UP

- Deposit growth clocked in at 6.7% through CY08 down significantly from 18.9% in CY07 and also dismal compared to a 5yr CAGR of 16.5%. This slowdown is attributable to several factors. The PKR has weakened by 29.0% during CY08 and tight liquidity had spawned rumors of bank defaults, which led to capital flight and consequent attrition in the deposit base. Furthermore fixed income and money market funds also competed aggressively for deposits and may have been successful to an extent, given they offer a tax benefit and are highly liquid. Also, revision in NSS rates pushed returns on pensioner and Bahbood investments as high as 16.80%

hence making them an attractive investment alternative. Finally, Eid withdrawals which normally find their way back into the system did not follow the same trend this year.

On a brighter note, as we expected, deposit growth did indeed turn positive in 4QCY08, clocking in at 0.5% compared to -1.3% in the previous quarter. Deposit rates for fresh deposits were also higher at 9.36% on average in Oct-Nov08 compared to 7.94% in 3QCY08. Improved deposit growth in 4QCY08 actually helped provide some relief to the sector ADR, causing a decline from its peak of 82.1% (Nov08) though it still sat pretty high at 80.2% by CY08 end. This is compared to 68.5% a year ago. Average cost of funds in 11MCY08 registered at 5.1%, already exceeding our expectation of over 5.0% for CY08E and 1.1% higher than it was during the same period the previous year.

PROFITABILITY: BOTTOMING OUT

- We expect the banking sector to register negative earnings growth of approximately 10.9% (BMA Universe) during CY08E after a subdued growth of 5.0% during CY07A. While the FSV provisioning was responsible for the slowdown during CY07A, higher provisioning in part due to FSV and also due to the economic slowdown along with the minimum deposit cost of 5.0% (compressing margins) will be key drivers behind the negative growth. CY09E however, should be decidedly better with earnings rebounding to post growth of approx. 20.0%.

CREDIT QUALITY: NPLS RAISING RED FLAG

- Provisioning in 11MCY08 was up significantly by 57.1% YoY. Withdrawal of the FSV benefit is a key contributor to this increase. Also responsible is a rising policy rate which has led to cash flow issues for corporates and consequently could mean trouble in terms of honoring debt servicing commitments. Provisions to Gross Loans were up at 6.3% by CY08 end compared to 4.7% a year earlier and have been increasing steadily over the past few years. While high provisioning is limited to just select banks, it is unlikely to start coming off at least until late CY09E when GDP growth also begins to pick up.
- We believe provisioning will remain high through CY09E but will be lower on YoY due to a high base during CY08E. SBP's regulation to withdrawal of forced sale value and decreasing the time period for classifying personal loans and consumer loans as "Loss" will compel banks to be careful with regard to loan extensions. Also the high interest rate scenario and the general economic slowdown has forced banks to consolidate their consumer portfolios.

MARGINS: HEADING SOUTH

- Spreads stood at 7.63% in Nov08 which represents a rise of 49bps since CY07 end. A further squeeze is likely moving forward as deposit rates continue to rise ahead of improvement in lending rates through asset re-pricing. Furthermore, we expect limited re-pricing which will help offset the rise in deposit rates only partially, given the associated risk of higher NPLs. While Pakistan currently has one of the highest NIMs in the region, we

believe NIMs will reduce and stabilize at par with regional peers over the longer term.

Factors contributing to pressure on NIMs include (a) Slowdown in M2 growth, (b) SBP's directive of an ADR of 70% by end Mar09, (c) further rise in NSS rates (as mentioned earlier).

OUTLOOK: CONSOLIDATION TO REMAIN KEY THEME

- Over CY09E, asset quality and strong capitalization will remain key issues for the sector to grapple with. Domestic consolidation will also be an important theme as smaller banks look to meet their MCR requirements through M&A activity. The country remains largely under penetrated with a credit to GDP ratio of 28% well below regional averages. Growth will be driven by an enhanced branch network with agri, consumer, SME and corporate sectors all pushing loan growth. Profit growth will be driven by volume and higher penetration of non-banked markets.

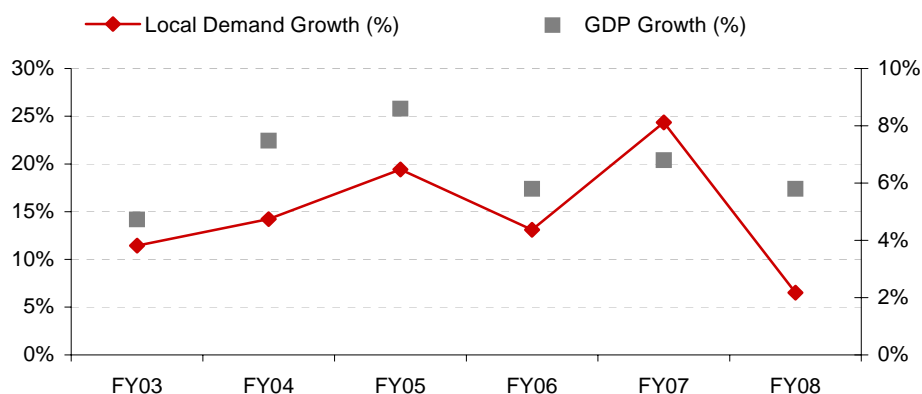
CEMENT
UNDERWEIGHT

Aisha Kirmani
Cement Analyst

OUTLOOK NEGATIVE BUT VALUE PICKS EMERGE

- Cement offtake has a high correlation with economic growth. The local demand/GDP multiplier during FY07 slowed down to 1.1 versus an average of 2.2 over FY03-08. During FY08, local cement growth registered single digits for the first time since FY02.

Figure 1: Dispatches vs. GDP Growth

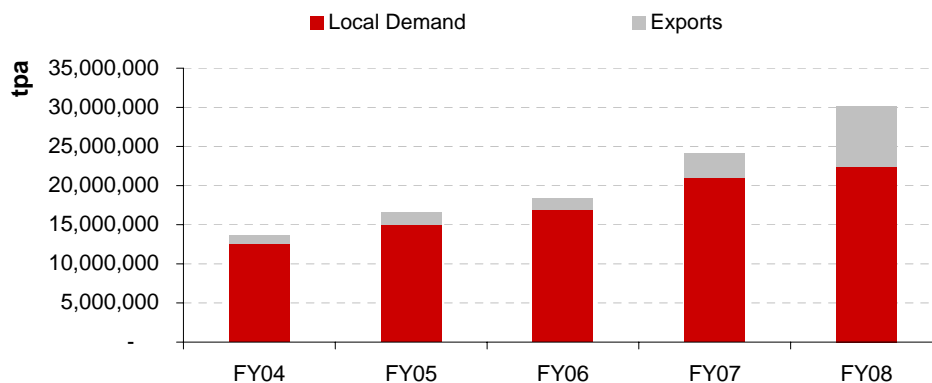


Source: BMA Research, APCMA

INDUSTRY DYNAMICS: DEMAND VS SUPPLY

- **Weak local demand:** Housing demand which typically accounts for approximately 70.0% Local demand is likely to decline as people put off housing construction in the current high interest rate and high inflation scenario. Going forward we expect the tight liquidity situation and dwindling demand to result in construction project delays push back new launches. Additionally, with the government facing pressure from the IMF to reduce fiscal deficit to 4.2% of GDP in FY09E from 7.4% in FY09 it is likely that investments towards infrastructure spend will be put on hold in the near term. Local dispatches are expected to remain in the red during FY09E.

Figure 2: Local vs. Export Sales Growth



Source: BMA Research, APCMA

- **Exports losing steam:** As the capacity expansion cycle came online in FY07, much of the surplus capacity was absorbed by strong export growth. However, export as a percentage of total sales still remains low and in FY08 accounted 13.2% of total cement industry sales. Going forward, as an economic slowdown looms in exporting nations and regional capacities come online, we expect cement growth to slow as well. For FY09E, we anticipate cement export growth of 40.0%; export sales should allow companies to maintain a capacity utilization of approximately 73.0% (versus the previous year's 83.0%).

OTHER DYNAMICS: COAL PRICES EASE BUT OTHER WOES CONTINUE

- Even though cement prices have eased to average at PKR350/bag from an all-time high level of PKR400/bag, manufacturer's gross margin are still cushioned due to a steep decline in coal prices (South African coal prices currently sitting at USD78.30/ton from an all time high of USD176.80/ton). However going forward we expect reduced manufacturer pricing power and heavy financial charges to keep bottomline growth in check.
- Although exports have grown substantially at 72.1% YoY over 5MCY08 the dispatch numbers are showing a declining trend on a MoM basis. In the face of a weak global economy we expect export growth to ease off ultimately putting pressure on overall cement dispatches.
- 2007 was a year of cement industry expansions. As a result, supply has been enhanced, but depreciation and financial charges have increased. High interest rates (we do not expect interest rates to ease off during 1HFY09E) have made the situation challenging for this highly leveraged sector.

OUTLOOK: UNDERWEIGHT

- Given the weak sector dynamics we advise investors to view the sector with caution and maintain an UNDERWEIGHT stance till industry dynamics strengthen. However we believe that select companies are emerging as long term value buys after witnessing steep corrections over the last 6 to 9 months. Our favored picks in the sector include LUCK and ACPL. LUCK and ACPL are trading on a FY09E P/E of 2.9x and 3.3x respectively.
- Potential triggers could include the takeover of an existing plant by a larger or international player. An acquisition by a player in the north of a smaller player in the south could be the start of a consolidation phase in the sector and is likely to spur interest. Subject to coal prices continuing their downward trek and inflation easing in 2HFY09E, interest in cement scrips could pick up as manufacturer margins show improvement and demand for the commodity picks up.

CHEMICALS MARKETWEIGHT

Aisha Kirmani
Chemicals Analyst

DIVERSIFICATION IS KEY

PSF: NOT MUCH ROOM FOR GROWTH

- Polyester Staple Fibre (PSF) contributes approximately 40% to ICI's top line. The segment had undergone troubled times during the last few years with low margins and capacity utilization. Problems faced by Dewan Salman Fibre (DSF) which is one of the largest PSF producers in the country, proved to be a blessing in disguise for ICI as capacity utilization improved to over 90%, hence helping it achieve highest ever sales during 1HCY08. With commodity prices (particularly crude) coming off, margins are expected to improve further. We expect strong PSF performance to continue due to a lower-than-expected cotton crop for the year and continued problems with the country's leading PSF manufacturer.

SODA ASH: CONSOLIDATING ITS SHARE

- Currently ICI holds approximately 70% of soda ash market share. With the 65ktpa expansion expected to come online during 2QCY09E, the company will likely increase its market share to over 80%. The company commands significant pricing power for soda ash and hence margins are expected to remain strong going forward as well. We expect the segment to grow at a 4yr CAGR of 7.0%.

PAINTS: AKZO IMPACT

- Paints is another segment which can be adversely impacted by economic slowdown as growth contracts in the construction and auto industries. The company however, stands to benefit from new parent Akzo Nobel whose expertise lies in decorative paints and will allow it to expand its portfolio. ICI plans to export paints to Iran and Afghanistan as well.

LIFE SCIENCES AND CHEMICALS: SMALL BUT PROFITABLE

- These two segments continued to do well, increasing their operating profits by 18.1% and 124.7%, respectively. Seeds grew by approximately 49.0%, animal health by 35.0% and pharmaceuticals by 18.0%.

OUTLOOK: STABLE GROWTH

- The diversified business portfolio of the company should help it remain stable in the current economic downturn. We expect earnings growth to occur at a 4yr CAGR of 15.6% moving forward. The scrip is currently trading at a CY09E PER of 3.8x of 10x and at current levels offers an upside potential of 107.6% to our fair value of PKR138.

Technology and Communication

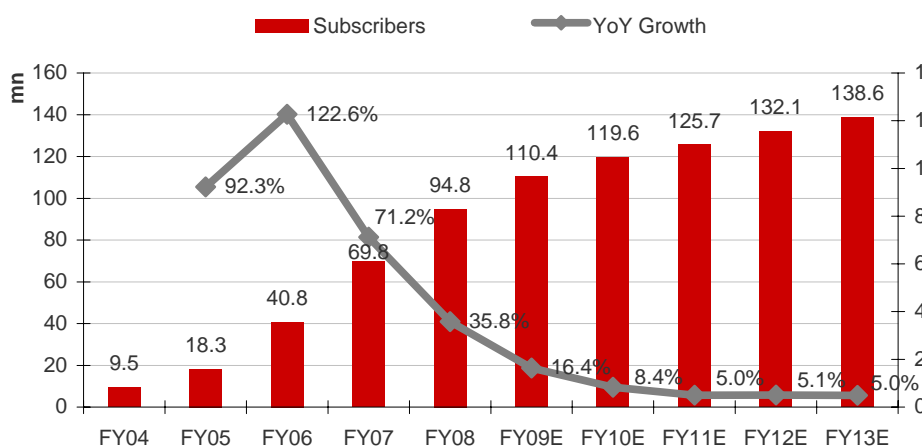
OVERWEIGHT

Omar B. Chaghtai
Analyst

COMMUNICATION: DOWN BUT NOT OUT

- The years of rapid telecom sector growth are now a thing of nostalgia. Industry subscriber growth which clocked in as high as 123% just a few years ago in FY06 had declined to 36% for FY08 and we expect it to drop to less than half that for FY09E. Cellular, which is the dominant component of 60.0% teledensity as of Sep08, will remain the primary contributor to subscriber growth moving forward and hence discounting for churn as competition between operators heats up, as well as multiple SIMs, telecom growth in real terms will likely be very subdued.

Figure 1: Total Subscriber Forecast

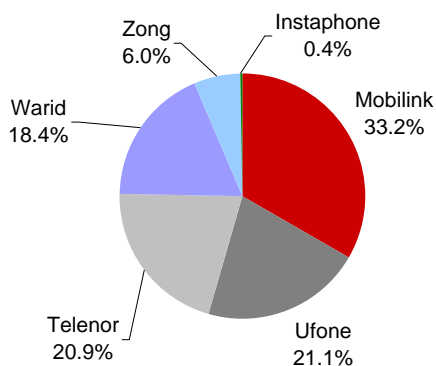


Source: PTA, BMA Research

INDUSTRY DYNAMICS: CELLULAR REMAINS DOMINANT BUT IS PEAKING

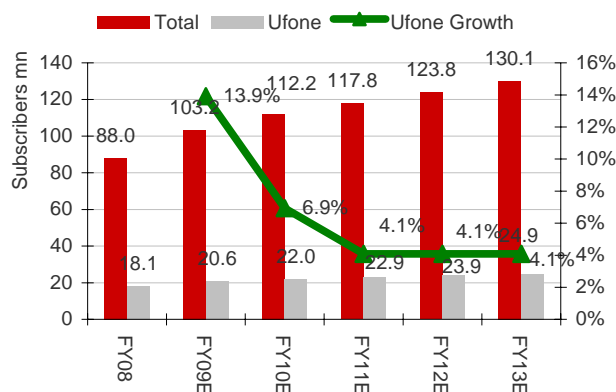
- Cellular:** Subscriber addition is now clearly staggering, dropping from an FY08 average of 2.1mn/mo to just 472k/mo for FY09YTD. On the other hand, the 90mn strong segment has provided a relatively stable revenue base for most of its operators who will now likely compete aggressively to steal away customers as teledensity peaks; cellular currently comprises 56.2% of overall teledensity. We expect cellular subscribers to reach 130.2mn by FY13E. Giant Mobilink which current comprises 33.2% market share has been recently losing ground to the other operators while PTC's wholly-owned subsidiary Ufone has held steady in its number 2 slot with about 21% market share. Going forward, we expect PTC to keep its share relatively stable, dipping only slightly to about 19%.

Market Share Nov08



Source: PTA

Subscriber Forecast

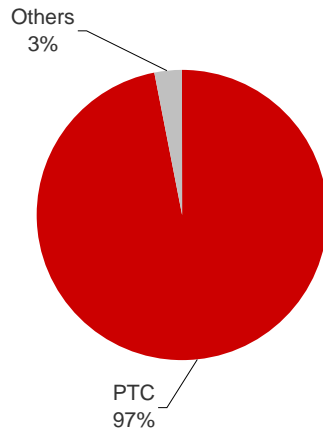


Source: PTA

Latest subscriber growth figures do give us some cause for concern. In Nov08, subscriber addition turned negative though marginally, dipping by 0.1% MoM. This was largely attributable to Mobilink which posted significant deletions to the tune of 927k subs MoM while all other operators improved their respective base. It remains to be seen whether this trend will continue in the coming months; if so, we would be compelled to revise downward our previous estimate for subs at end of FY09E.

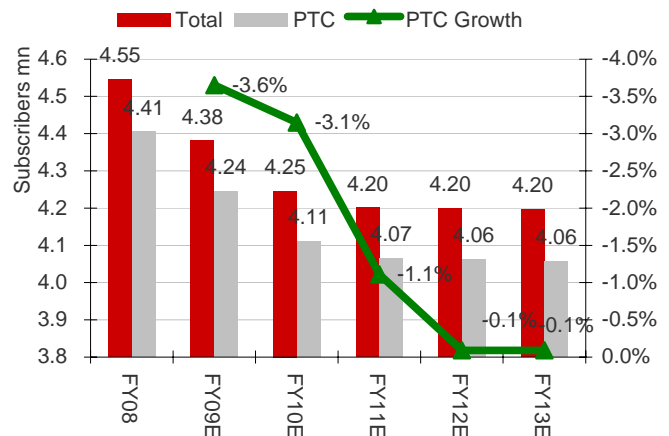
- **Fixed:** PTC remains the dominant player, commanding bulk of the subscriber base. Intense competition from the cellular segment has eroded fixed line market share over the years and subscriber attrition continues; we expect however, that fixed line subs will stabilize at about 4.20mn subs by FY13E. For FY09E, we expect subs to decline to 4.38mn or by 3.7%.

Market Share FY08



Source: PTA

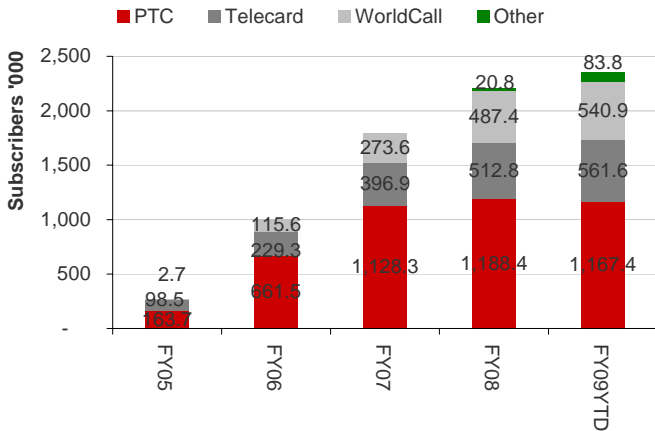
Subscriber Forecast



Source: PTA

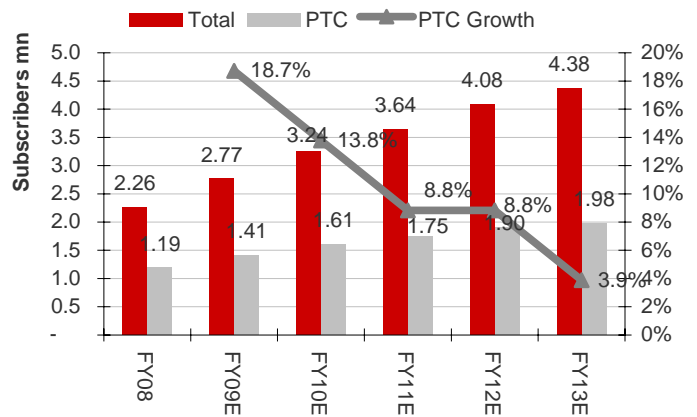
Wireless (WLL): 49.6% of WLL subs belong to PTC with Telecard and Worldcall comprising another 23.9% and 23.0%, respectively. While we expect PTC's share to dip to 45% over the next 5 years, it should remain a major player. However, the WLL segment on the whole is not expected to post spectacular growth similar to cellular, although WLL deployment is relatively cost effective. This is attributed to the fact that cellular operators are now already well rooted in rural areas and are likely to defend their market share aggressively through price competition. Furthermore, WLL operators have also had to contend with service quality issues. We estimate growth at a 5yr CAGR of 11% for WLL subs which should sit at 4.38mn by FY13E and should by then have outpaced their fixed counterparts.

Market Share



Source: PTA

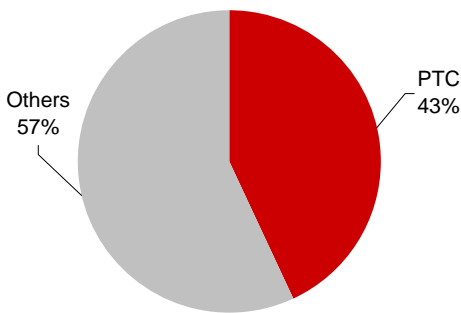
Subscriber Forecast



Source: PTA

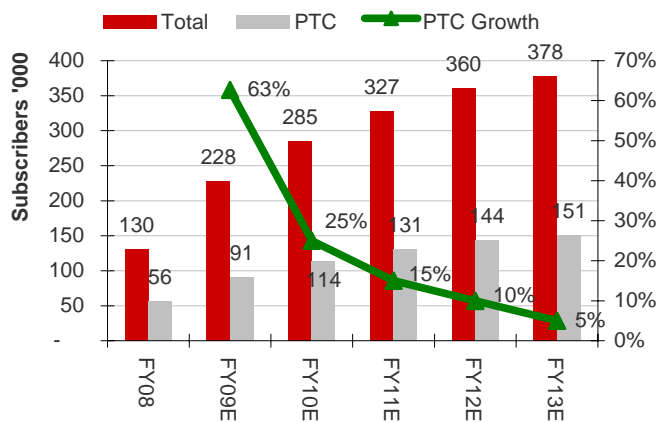
- Broadband:** Subscribers grew by 188.5% during FY08 but the base still remains quite low at 130k. PTC and Worldcall combined have about 90% of the share. Despite the fact that the segment is in its infancy, we do not expect it to grow by leaps and bounds, given a low country literacy rate and poor computer penetration. Broadband subs are likely to grow at a 5yr CAGR of 22% to reach 378k by FY13E with PTC comprising 40.0% of these. Segment revenue however, will only contribute 1.6% to PTC's top line by that period.

Market Share



Source: PTA

Subscriber Forecast



Source: PTA

OUTLOOK: PTC STILL STANDING!

- That's right. And strong at that. While faster-than-expected subscriber attrition remains a key concern, recent revision in rates/pulse timing for local loop calls should help bolster revenue from that head which we believe comprises almost 30% of total revenue. Furthermore, NWD which accounts for 11% of the top line has and will continue to benefit from the introduction of the Pakistan and Basic Plus packages. Additionally, recent significant PKR depreciation will also boost the effective average settlement rate for the LDI incoming segment which has an 8% share. These changes combined will help keep revenue and consequently

earnings stable, moving forward which we forecast will rise at a 4yr CAGR of 1.5% and 10.3% through FY13E.

- With VSS out of the way, an earnings turnaround is imminent, from an LPS of PKR0.55 in FY08 to an EPS of PKR2.91 for FY09E. PTC current price PKR16.10 translates to an FY09E PER of 5.5x while the average PER for PTC over the past two years (rolling period) has been 16.6x, implying significant discount. Also the aforementioned level implies a FY09E dividend yield of 12.4%. Given that the scrip has 3.7% weightage in the KSE100, it will likely be at the forefront of any positive moves in the market. Our fair value for PTC is PKR35 which represents 110.8% upside from current levels; we believe it provides a good investment opportunity and recommend BUY.

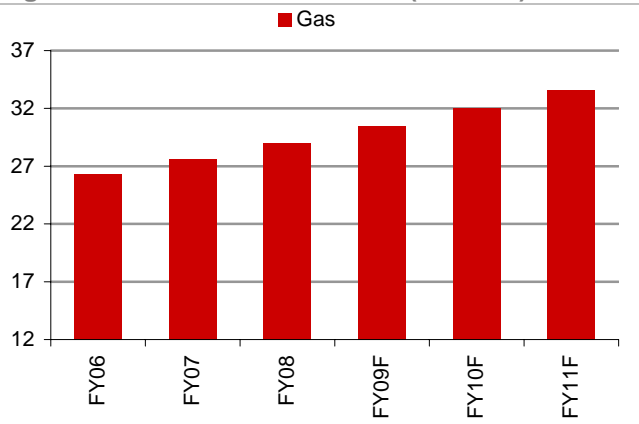
E & P OVERWEIGHT

Yasir Shafi
Energy Analyst

SOLID FUNDAMENTALS!

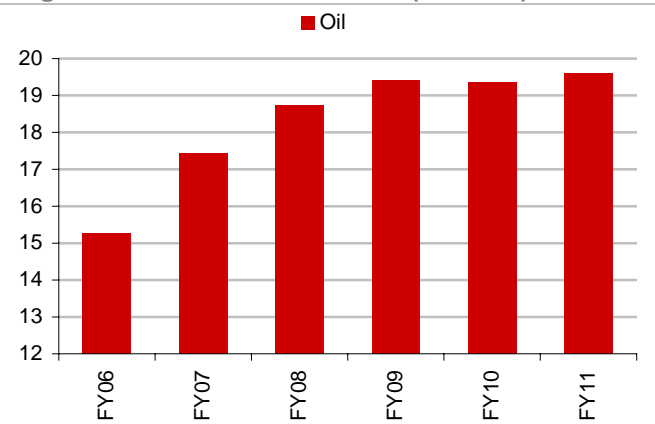
- We maintain our OVERWEIGHT stance on the E&P sector backed by expectations of steady demand, handsome production growth and protection from PKR depreciation due to dollar denominated revenues.

Figure 1: Gas Demand Forecast (mn TOE)



Source: BMA Research, Energy Yearbook 2007

Figure 2: Oil Demand Forecast (mn TOE)



Source: BMA Research, Energy Yearbook 2007

- **Drilling activity to remain healthy:** We expect aggressive drilling in the E&P sector to continue in FY09E. OGDC announced a target of 32 wells for the year with a further 20 wells if security allows. The industry as a whole plans to drill 90 wells during the year. In FY09YTD, OGDC has spudded 10 wells while the industry has drilled 27 wells. PPL plans to drill about 10 wells on average over the next few years while we expect POL to remain passive in its exploration efforts and drill close to 5 wells on average annually.
- **Petroleum Policy 2008 approved by the GoP:** The government has recently approved a new petroleum policy recently which proposes more incentives to E&P companies particularly higher gas prices. However, the benefits of this new policy will not come through in the short term as the relevant pricing and production agreements for the new policy will take time to be approved.
- **Oil prices expected to consolidate at lower levels:** International oil prices are a major driver for domestic E&P earnings since local prices of both oil and gas are benchmarked against international crude oil prices. Oil prices have corrected significantly in FY09YTD, decreasing by more than 50%. Our Arab Light oil price assumption is USD65, USD50 and USD60 for FY09E, FY10E and the long term, respectively.

The current deteriorating economic environment globally is the main reason behind such a sharp drop in oil prices. Major concern and worries for the US economy, which is still by far the largest consumer of oil, have brought down demand for the commodity and expectations are that demand will further slide if the US continues to post worsening economic numbers. Therefore, we believe that oil prices will remain on the lower side and recovery will be

observed only when the major economies enter the recovery phase of the business cycle; this is not expected to take place in the near term.

- **Stock picks:** We like all the three major E&P companies on the KSE, however our top pick is PPL due to substantial earnings jump expected over FY09E (47.0%) together with production additions from Mela, Tal and Qadirpur. The prices of four of PPL's major fields were increased by 23.4% HoH in 1HFY09E. Moreover, due to the depreciation of the PKR by 13.5% FY09YTD we expect gas prices to remain flat or decrease slightly in 2HFY09E. The company also has a considerable cash balance resulting in higher other income due to higher interest rates. Moreover, PPL trades at a 11.5% discount to the sector FY09E PER of 3.6x. Our fair value for PPL is PKR283, implying an upside of 155.1% and an FY09E dividend yield of 15.7%.

FERTILIZER OVERWEIGHT

Aisha Kirmani
Fertilizer Analyst

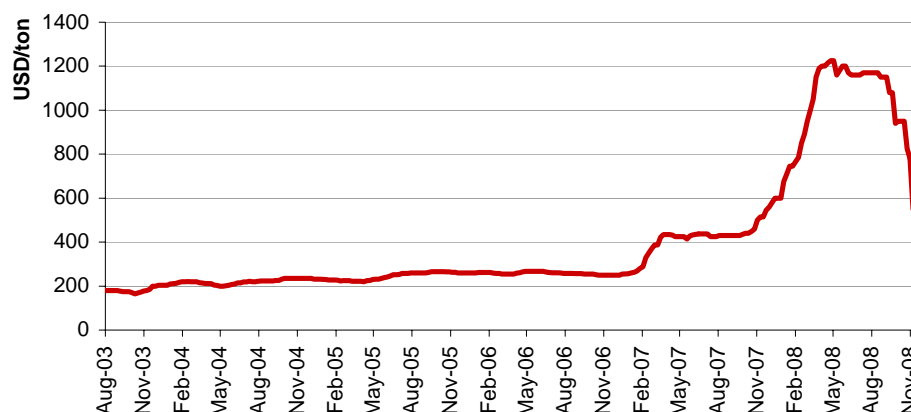
UREA IS KING

- With government focus on agriculture and budget FY09 unveiling numerous incentives, the fertilizer sector scrips, with strong earnings growth and high dividend yield remain a safe haven for investors in times of economic uncertainty.

INDUSTRY DYNAMICS: LESS DAP = MORE UREA

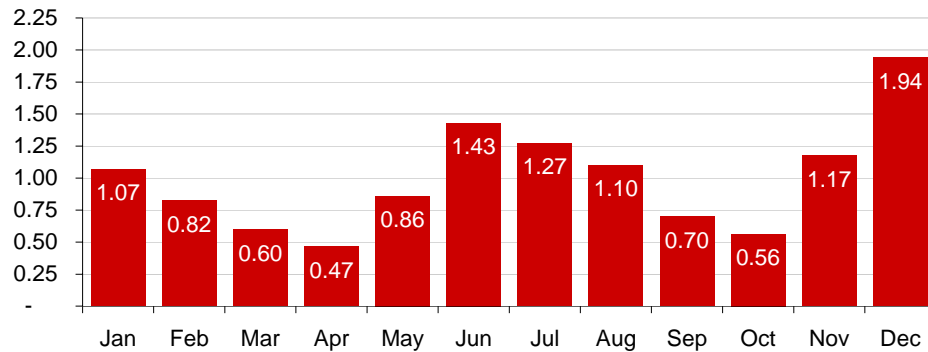
- Urea and DAP are the two main fertilizers used in Pakistan and together accounted for 84.3% of fertilizer use in CY07. Soaring DAP prices in the earlier part of the year and uncertainty surrounding the DAP subsidy have led to a drastic fall in DAP offtake numbers and a surge in urea demand. 11MCY08 numbers depict a 46.6% decline in DAP offtake with urea offtake showing a steep rise of 16.9%.

Figure 1: International DAP Price Trend



Source: BMA Research, NFDC

- As DAP demand continues to contract, urea manufacturers have witnessed strong pricing power with urea demand picking up. Urea prices averaged PKR543/bag during CY07. Historically, urea prices have been viewed as stable and have grown at a steady CY02-07 CAGR of 5.7%. However, during CY08E we expect urea prices to grow by a sharp 14.9% and average PKR624/bag.
- Fertilizer use varies in seasonality. The last quarter of every calendar year is generally a time of heavy fertilizer use as it coincides with the sowing of the wheat crop. With urea demand having remained strong during the year we expect this trend to continue through the final quarter allowing margin expansion to drive strong earnings growth for the manufacturers.

Figure 2: CY01-07 Urea Monthly Seasonality Index


Source: BMA Research, APCMA

OUTLOOK: OVERWEIGHT

- Although heavy selling pressure was witnessed across the board upon removal of the price floor. The decline in fertilizers scrip prices have ranged from 41.2% to 29.2%. Going forward we believe the fertilizer sector remains in growth mode and is relatively insulated against the economic upheaval.
- FFC with its strong dividend yield remains a safe bet within the fertilizer sector. The company is expected to deliver strong earnings growth of 15.4% and a dividend yield of 22.8% over CY09E. Urea demand is expected to remain robust and, in the unlikely event that DAP demand takes off, the company also stands to benefit from improved dividend income from its 51% stake in FFBL. Given the volatile nature of the current investment climate, FFC remains a top pick with its strong earnings growth and defensive nature.
- ENGRO is trading on CY09E P/E of 4.7x and the scrip offers a strong CY07-12E earnings CAGR of 10.0%. Although the scrip did experience some negative price action as the market overplayed concerns regarding the company's debt of USD1bn, we believe that downside is limited at current prices. We continue to like ENGRO on account of the strong growth story in its core business.
- Even though FFBL offers significant upside to our fair value of PKR27, we remain cautious as a result of the number of risk associated with it. CY08 has been disappointing with the company expected to deliver an earnings growth of just 5.1% on account of dismal DAP sales and shrinking P205/DAP margins amidst soaring raw material prices.

FMCG**MARKETWEIGHT**

Aisha Kirmani
FMCG Analyst

THE 'WHITE' REVOLUTION**INDUSTRY DYNAMICS: BOTTOMLINE SUPPORTED BY ECONOMIC GROWTH**

- Nestle and Unilever have experienced stable growth over the last few years on the back of rising per capita income and increasing urbanization. The government's agrarian focus should bode well for Nestle. Nestle and Engro Foods coupled with other players in the dairy industry have been pushing forward initiatives for the development of the dairy sector.

GOVERNMENT EFFORTS: PUSHING THE DAIRY SECTOR

- PKR1.5bn allocation from PSDP for dairy collection should help in supporting and pushing forward corporate farming initiatives which will help strengthen and develop the milk collection infrastructure.

OUTLOOK: MARKETWEIGHT

- Over CY08 Nestle's topline has grown as a result of price hikes. The company has tried to pass on inflationary cost pressures to consumers but gross margins have also shrunk. Gross margins have averaged 26% in 9MCY08 versus 29% in 9MCY07. With competition emerging from other packaged milk producers and newer concepts in fresh milk (Millac) the company has had to exercise caution when implementing price hikes. If the company loses customers to competitors in the current difficult economic scenario, it will take some time before lost ground can be reclaimed. Going forward the increase in retail price may lead to consumers curtailing their spending on non-essentials such as ice cream as inflationary pressures continue to rise for the common household.
- We have a neutral stance on the sector. In our opinion the steep rise in inflation resulting in reduced disposable income may place pressure on Unilever's and Nestle's topline and profitability. Even though inflation is expected to ease in 2HFY09 it is likely that consumers will continue to exercise caution when purchasing. The target market for FMCG products is the growing middle class and demand for its products is somewhat elastic. FMCG scrips are generally illiquid and low beta and we do not expect significant price action in them going forward.

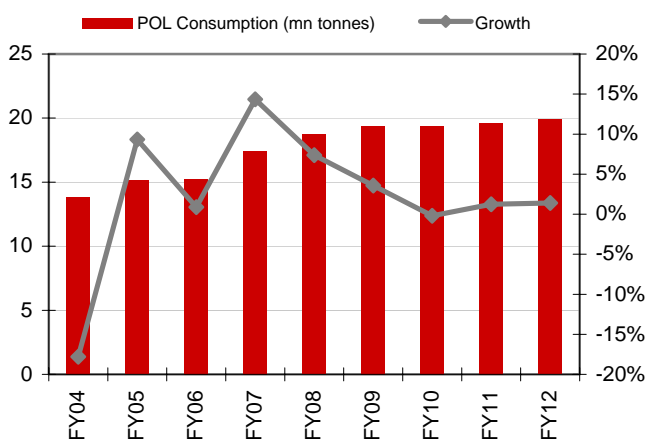
OMC MARKETWEIGHT

Yasir Shafi
Energy Analyst

SLOW DOWN

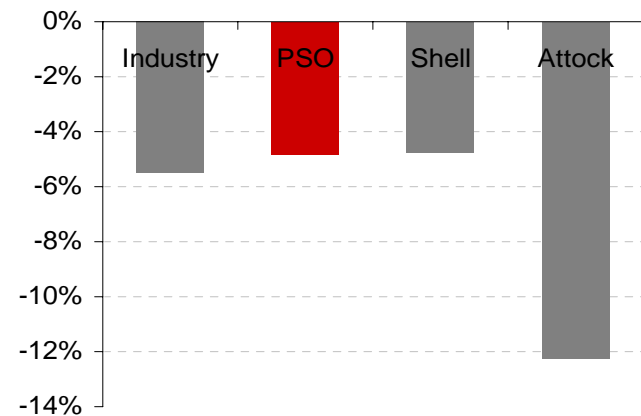
- We have a MARKETWEIGHT stance on the OMC sector backed by expectations of slowing consumption growth and inventory losses particularly in 1QFY09E from declining international product prices.
- **Lower volumetric growth:** Over the next year, we expect oil consumption growth to slow from 7.2% YoY in FY08 to 3.6% YoY in FY09E. This is mainly on account of the challenging domestic economic conditions which are expected to lead to lower GDP growth. For 4MFY09, consumption has actually declined by 5.5% YoY, however we expect a bounce back in consumption numbers due to recent decline in POL prices. Going forward, we forecast oil consumption in Pakistan to grow marginally at a 3yr CAGR of 1.5%.

Figure 1: POL Consumption Growth



Source: Pakistan Oil Market Report, BMA Research

Figure 2: Industry volume growth YoY (4MFY09)

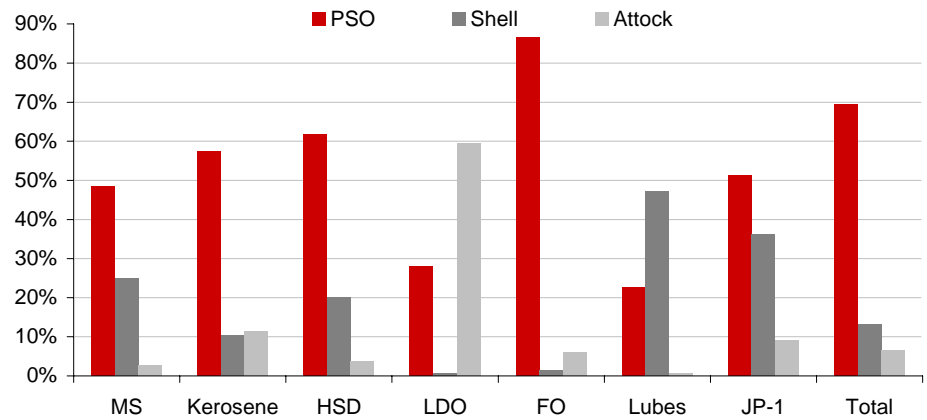


Source: BMA Research, OCAC

- **Inventory losses:** With the current oil and product price environment we expect the OMC sector, particularly PSO and Shell, to be hurt by substantial inventory losses. Ex-refinery prices of Mogas, HSD and international FO decreased by 11.9%, 18.9% and 3.9%, respectively during 1QFY09. Moreover, sector companies that import POL products also incurred exchange losses which have put further pressure on earnings in FY09E.
- **Margins Improved:** In a recent move the government has increased the margins of OMC's on Mogas and Kerosene from 3.5% to 4.0% and also increased HSD margins putting a range of PKR1.35 and 1.50 per liter derived from crude oil prices ranging from USD 45 to USD 80 per bbl. It is not yet clear if this move is only for a year or longer. If its for a year only then we do not expect this move to have a significant impact on valuations, however if these changes are for the long term then we expect valuations to rise by 11.9% on average for sector companies.
- **Stock picks:** Our top pick in the sector is APL with a fair value of PKR297 and potential upside of 106.3%. We like APL due to its low earnings volatility (little exposure to inventory gains or losses from oil prices movements),

major chunk of revenue derived from the deregulated segment and market leadership in FO sales after PSO. It is currently trading at a FY09E PER of 3.9x.

Figure 3: Market Shares for 4MFY09



Source: BMA Research

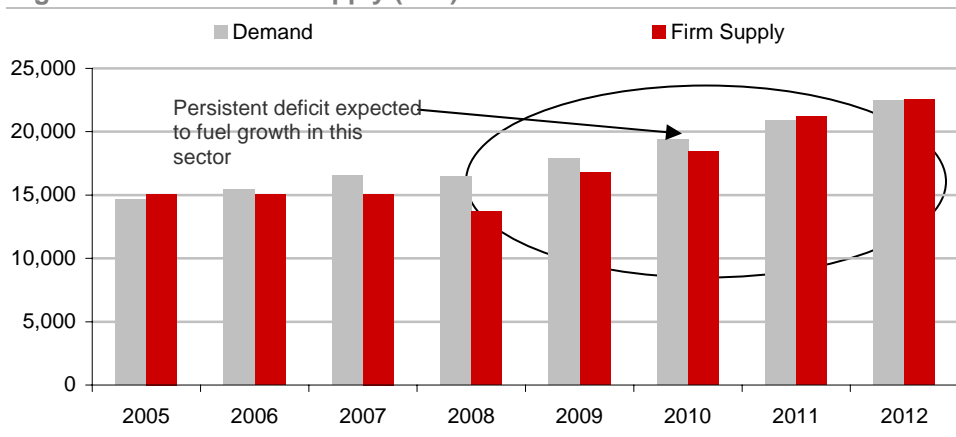
**POWER
OVERWEIGHT**

Yasir Shafi
Energy Analyst

DEVELOPMENT IN ABUNDANCE

- **Power crunch:** Electricity demand in the country has been extremely robust during the last few years, growing by 10% on average. This is attributable to increased consumption from electricity supplied areas as well as new demand coming from newly laid out power lines. As shown by the graph below the situation is expected to remain status quo until 2012. Current estimates put the power shortfall at 6,000MW.

Figure 1: Demand and Supply (MW)



Source: PPIB (Pakistan Power Infrastructure Board)

- **Expansions and new investment:** In order to bridge the shortfall, the GoP is encouraging new investment and expansions from existing IPPs. PPIB plans to add 10,453MW to total domestic capacity by 2012. Some progress has been made on this front. Implementation agreements for 2,673MW capacity have been signed while financial closure of 2,119MW capacity power plants has been achieved.
- **High and stable yields:** Due to the fixed contractual tariffs and the return on equity component embedded in tariffs, IPPs are blessed with a stable cash flow resulting in high payouts and dividend yields. Power companies are amongst the highest dividend paying KSE100 companies. However a big inhibitor of stable cash dividends and high dividend yields, going forward is the ongoing circular debt issue which has resulted in depriving these utilities of much needed cash. Therefore this liquidity crunch in the power sector may lead to lower than expected dividend yields from major IPP's like KAPCO and HUBCO.

Stock picks: Our top pick is Hubco (HUBC). The company is expected to provide strong dividend growth in the future on account of strong demand (higher load factor) from its sole power purchaser WAPDA and future expansions (with the most recent one expected to come online by FY10E). We expect dividends to jump by 29.7% in FY10E and grow at a 5yr CAGR of 18.9%. Our FY09E dividend yield for the company is 16.5%. With the current expansion plans of the company and the expected dividend growth, a re-rating of the scrip could be possible. At current levels the stock holds upside potential of 120.1% to our fair value of PKR34.

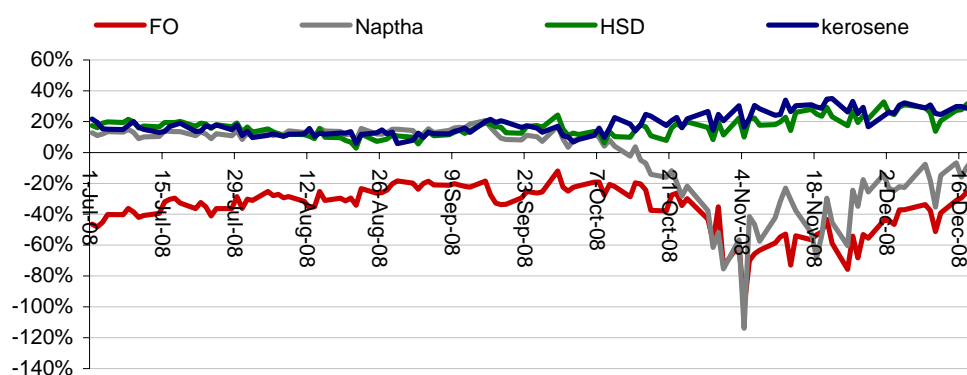
REFINERY UNDERWEIGHT

Yasir Shafi
Energy Analyst

WHEN THE GOING GETS TOUGH

- We have an UNDERWEIGHT stance on the refinery sector based on declining fundamentals due to government interventions resulting in shrinking margins, PKR depreciation causing exchange losses and expectations of an earnings decline in FY09E relative to the bumper earnings year of FY08.
- Total installed capacity of the local refinery sector is 12.87mn tons. Local refinery production stood at 9.6mn tons for FY08, up 4.2%. Refinery capacity is expected to increase to approximately 20mn tons by 2012 once Khalifa and Indus refinery start operations. Moreover, Trans Asia refinery will further add to the country's total capacity. These refineries however, are mainly export oriented and therefore are not expected to significantly affect the local sector. Hence, in the next few years Pakistan could benefit substantially through increased export of petroleum products bringing much needed foreign exchange into the country.
- For FY09YTD, refinery margins for HSD, FO, Kerosene and Naptha changed to 16.9%, -36.0%, 18.5% and -4.9% from 15.0%, -35.8%, 16.2% and 20.1% respectively. Moreover, as shown by the graph below margins have declined further given the steep fall in international oil prices. Arab Light crude prices have declined by more than 50% in FY09YTD. Naptha margins have taken a particular beating with margin declines in excess of 124.0% for FY09YTD forcing refineries to sell it at below cost similar to FO.
- Global refinery capacity is estimated to be approximately 4,000mn tons which is expected to increase to 5,000mn tons by 2012 with the majority of expansion coming online in Asia. With increased supply this is expected put further pressure on margins.

Figure 1: Gross Refinery Margins (FY09YTD)



Source: Bloomberg

- Refinery margins and profitability are heavily dependent on global petroleum product prices. Refined product prices and GRM's generally lag behind rising oil prices. We believe that refining margins will remain low as demand has been faltering in light of the global financial crisis.
- The local refinery sector's fundamentals are deteriorating as the government has cut customs duty on HSD from 10.0% to 7.5%. Furthermore, it has also changed the price mechanism for Mogas which applies to refineries,

effectively reducing their selling price. Apart from these factors, PKR depreciation has also hurt refineries in the form of exchange losses on crude imports as reflected in recent 1QFY09 results. Even though last year was a bumper year for refineries, we do not expect the sector to show similar earnings growth over FY09E.

Technology and Communication

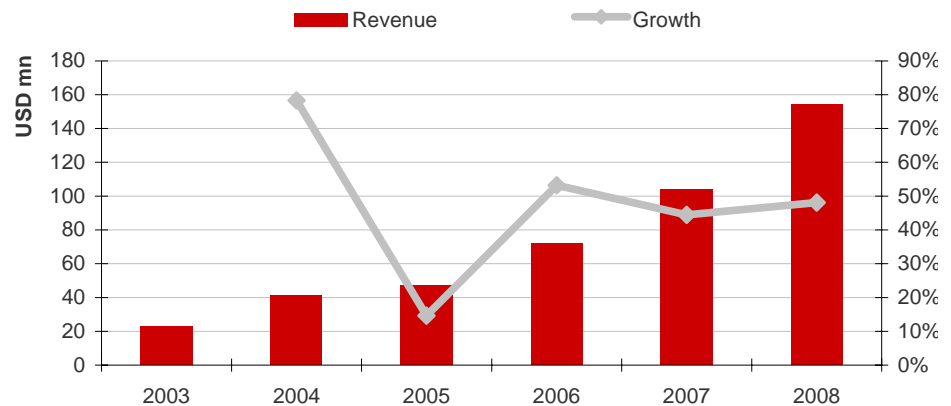
UNDERWEIGHT

Omar B. Chaghtai
Analyst

TECHNOLOGY: SOFTWARE SOFTENING

- According to the SBP figures, Pakistan's IT exports have grown at a 5yr CAGR of 46.3%. Exports though, still constitute a small chunk of the total industry size which is estimated to be USD2.8bn. This includes over 1,161 registered IT companies (including 60 foreign IT and telecommunication companies). Two companies (including NETSOL) have achieved CMMI Level 5 accreditation while 3 have reached level 3 and 15 have reached level 2. Pakistan's demographic dividend also comes into play here with an IT workforce which is 110,000 strong and growing at a phenomenal rate of 20,000 IT graduates annually.

Figure 1: IT Exports and Growth



Source: SBP

OUTLOOK: EARNINGS GROWTH TO DECELERATE

- NETSOL is the only listed IT play on the KSE100. The company derives majority of its revenue (80.7% in FY08) from license sales, services and maintenance related to its flagship LeaseSoft product, a leasing solution whose scope has now been expanded to encompass lending in general. Given the prevailing global credit crunch, license sales are expected to be depressed in FY09E YoY. While, the decline in license sales should be at least partially offset by rising services and maintenance revenue, given our expectation of negative earnings growth and lack of visibility of any positive triggers to price appreciation we remain UNDERWEIGHT on the sector.