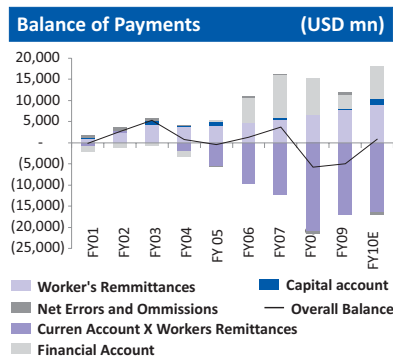
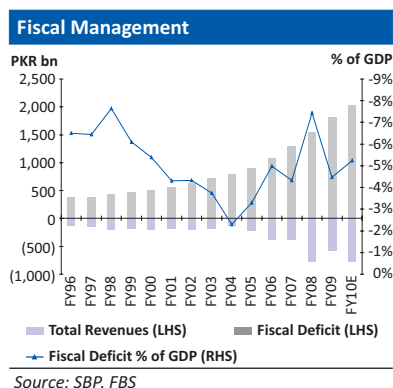


## Spring Sales!



Mar10 saw positive news on the economic front, relatively low political noise and renewed foreign investor interest in the region. Short term vitals look good and we believe the Earnings Lead Macro Lag has come into play for the KSE 100. Nevertheless, long term vulnerabilities continue to pressure market wide liquidity, particularly evident in domestic market rates which remain close to the higher end of the rate corridor, even as the SBP continues to inject liquidity on a weekly basis.



### Earnings Stimulus: index upside in the range of 10%

Balance sheet health is broadly improving for KSE 100 companies as the impact of exogenous and endogenous shocks from interest rate and commodity prices is coming off gradually. Dec10 LTM net earnings for KSE 100 companies are reflecting 32% YoY growth to PKR 222bn. The market has already taken the earnings lead, appreciating by 11% a quarter towards our Jun10 target of 11,700 points. Despite the considerable gains made in FY10 we foresee further leg room in the region of 10-20% for our top sector picks including UBL, ABL, HUBC, PPL, POL, ENGRO, LUCK and PSO.



### Macro optimism should plug confidence deficit...

Spring highlights include lower than expected inflation for Mar10 at 12.9% and a mild fiscal slippage of 1% for 1H FY10 at PKR 403bn against an IMF target of PKR 400bn. FY10 CPI inflation is likely to head south as one-off increases in power tariffs have been largely accounted for and a further 6% increase scheduled for late FY10 has been delayed. While fiscal expenditures on government salaries, security and debt servicing remain fixed, we expect cuts in PSDP and other public expenditure to rein in the deficit to the 5.5% of GDP range. Fiscal Revenues and associated liquidity drought remain a challenge, however, external financing from the IMF, some inflows from the Kerry Lugar Bill and Coalition Support Funds should sustain our deficit at that level.

### But Liquidity fundamentals still weak

Our greatest concern is a widening gap between the DTLs base and Asset base of the monetary system which could keep market rates on the uptick in 4Q FY10, especially in the case of an external financing shortfall. Despite the relative positive news on inflation and fiscal numbers, the SBP maintained a neutral stance on the discount rate for Mar10 leaving the DR at 12.5% as expected. Further clarity on fiscal operations and visibility on inflation trends in 3Q FY10 is likely to cement the SBP's decision to keep rates on the down trend by May10. Although we don't expect a significant liquidity push from the domestic market in FY10, we may face a surprise on growth fundamentals. 7mo FY10 LSM data is indicative of a healthier than expected manufacturing base, which could push output beyond the 3% FY10 target.

### Political barometer cools: Caution remains

Political triggers could sway market sentiment in both directions and we are watching political variables closely. A very positive development has been the finalization of the 18th Amendment to the Constitution of Pakistan. However, the attacks on urban civil and government infrastructure continue to be a drag on sentiment and remain a persistent threat to stability. In the case of the 18th amendment we feel the passing of the Constitutional reforms into Law will serve to strengthen the democratic framework, eliminate the systemic risks associated with the NRO and appropriately transfer vital powers to the elected Prime Minister. On the security front we do not expect slippages to unwind, however, we feel the Pakistan military and its allies are likely to sustain pressure on insurgents in the North to curtail the spread of militancy further afield.

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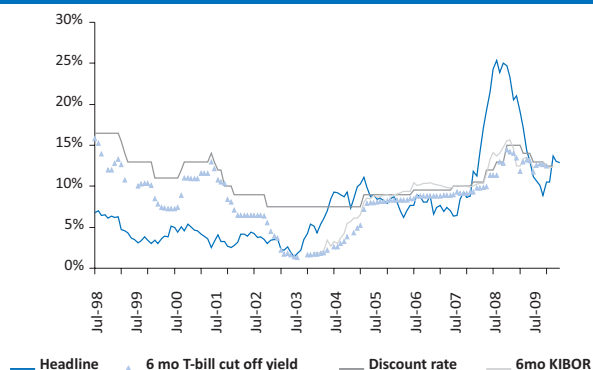
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## Going South for the Summer (of our Inflation estimate that is)

9mo FY10 CPI Headline is already a few degrees south of our FY10 estimate of 12% at 11.3% as of Mar10 and could tip closer to the 11.00% level by Jul10. MoM inflation has been averaging 1.1% since Jul09 and YoY CPI bottomed out to 8.9% earlier this quarter. However, the MoM impact was more robust in 2H FY10; as the lagged impact of costlier oil imports and other commodities as well as withdrawal of power subsidies hits home.

### YoY Headline CPI Inflation

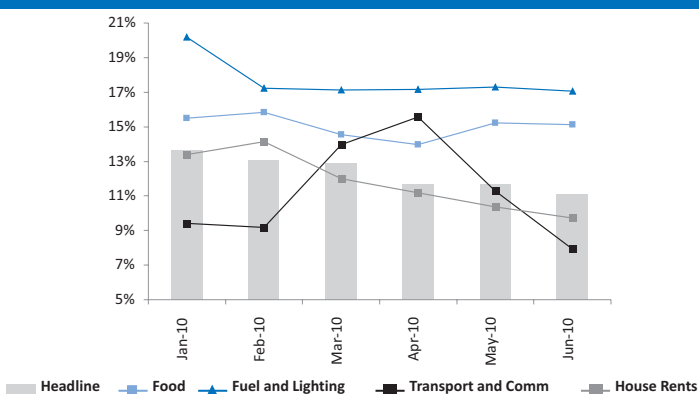


Source: SBP, Bloomberg, IGI Research

### Subsidy removal creates one off upward push

During 1Q FY10, we witnessed Transport & Communication index posting an average deflation of nearly 6%. However in 2Q FY10 the trajectory reversed, posting a 2% rise in prices YoY. As fuel price subsidies were already removed in FY09 and we expected oil to average USD 70/bbl for FY10, we did not anticipate a dramatic uptick in the Transport & Communication index. However, 2H FY10 reflects a different picture altogether with costlier oil imports reflected in 11.3% increase in the index by 3Q FY10. The impact of subsidy withdrawals on power and rising prices of gas and other fuels also pushed the Fuel & Lighting basket further by an average 18% in 3Q FY10. This is line with our expectation of an average 11% and 19% increase for the Transport & Communication and Fuel & Lighting basket respectively in 2H FY10.

### Inflation Estimates FY10



Source: SBP, Bloomberg, IGI Research

### Commodity pendulum will limit inflation downside

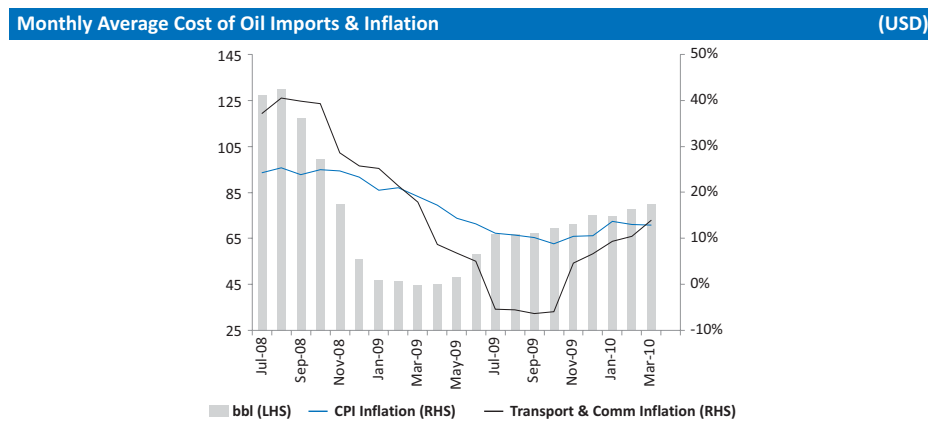
Commodity prices have been there, done that and worn the tee shirt in the last 2yrs in the wake of global rapid demand deceleration and recession expectations. Crude prices hit rock bottom in early 2009 and then began a speedy rebound resulting in Sep09 levels reflecting in excess of 40% increase over the Mar09 period. By Apr10 essential imports depicted another significant rebound in spot prices on global commodity exchanges of another 20-25% on global Crude oil prices. It is evident that the downside to inflation from the rebound in commodity prices will be mostly limited. Therefore in FY11 we are unlikely to see a significant dip below the 10% mark for CPI.

Price Changes			
	Sep09 over Mar09	Sep09 over Sep08	Apr10 over Sep09
Brent Crude	42%	-31%	25%
WTI	42%	-30%	19%
NYMEX	42%	-30%	20%
Arab Lite	41%	-30%	21%
China Domestic Steel 25mm Spot	8%	-24%	32%
Copper	52%	-3%	28%
Palm Oil	8%	-4%	27%
Wheat	-19%	-23%	21%
Coal	-2%	-58%	43%
Furnace Oil	20%	-8%	17%

Source: Bloomberg

### Delayed reaction: Import costs adjust with a lag

Our gut feel is that global liquidity conditions will not allow for another liquidity driven inflation spell. Prices of essentials are likely to stabilize in this range, give or take another 10%, as global central banks are not likely to loosen money supply further. The impact on Pakistan's domestic inflation will be negative but relatively subdued in FY10. Given the adjustment lag associated with import costs against spot prices, we expect the rebound in commodity prices to hit home within a 3mo-4mo period. Consequently the shrinkage in the trade deficit was most evident in 1Q FY10 at above 20% and has tapered off to 15% by 9mo FY10.



Source: SBP, FBS

### Despite a spike; another inflation spiral unlikely

Crude oil production from OPEC has maintained its steady pace of increase since its dramatic fall in 2008. Crude prices have rebounded to 84 USD/bbl where as supply fundamentals have remained unchanged. The spread between prices and inventories suggests that global liquidity surge associated with global 'reflation' initiated by many of the world's Central Banks triggered contango and oil prices consolidated above USD 80/bbl in 2H FY10. However, the average oil import cost for Pakistan is likely to remain in the USD 70/bbl range in FY10 and stabilize in the USD 85/bbl range in FY11. We do not expect the reflation agenda to continue as global monetary policymakers are wary of another liquidity fueled inflation spell and many have begun to tighten interest rates already, with the Australian Central Bank leading the pack.

**Pace of trade deficit shrinkage slows down**

During 1H FY10 the Trade Deficit reflected a 29% decrease to USD 6.8bn. By 9mo FY10 the pace of deficit reduction slowed to just 15% over the same period last year. This is directly related to the pick up in import costs of essentials and a mild rebound in import demand. Meanwhile, the interest rate and inflation impact on exports has been very negative; overall export receipts have also declined by 8% YoY and remain flat over the previous month's level. In FY10 we expect the trade deficit to remain in range of USD 14.5-15bn on account of the largest component of the import basket, petroleum products at 29% of the import basket, reflecting a 16% value compression.

**Inflation compression limited by wider trade deficit in 2H FY10**

Given the trajectory of import costs we were expecting a rebound in the inflation arc in 2H FY10. In line with our expectations, 3Q FY10 average inflation remained at 13.2% against the previous quarter's average of 10%. Against concerns of another inflation spiral, we anticipate inflation will slide to an average 11.5% in FY10 against our much higher forecast of 12% for the fiscal period. Moving into FY11 we expect inflation to dip below 10%, however, the downside is limited by the onslaught of further subsidy removals and a further 8-10% increase in broad based Fuel prices.

## Pulling the Fiscal socks up

The IMF recently loosened the Fiscal Deficit target to 5.1% of GDP; and we tend to agree, keeping the anticipated slippage in the range of 30-60bps for the fiscal period against an initial target of 4.6% and then 4.9%. This has been a very difficult year for Pakistan's fiscal management given (1) alignment of the regulated energy sector with market factors and associated subsidy withdrawals (2) offloading of Circular Debt to the Commercial Banking Sector effectively (3) securing external financing in a tight global liquidity environment to bridge any gaps. The Tax revenue base in Pakistan has remained notoriously narrow;

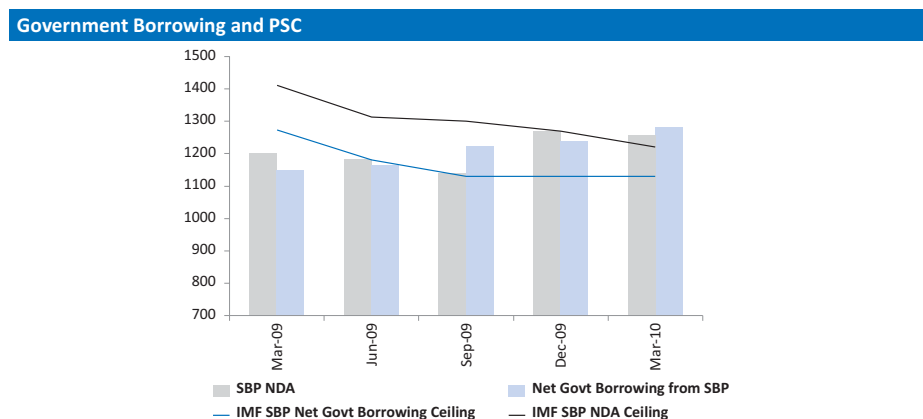
- Provincial governments providing less than 0.5% of GDP to the tax pool,
- Federal taxes pull in less than 9% of GDP or more than 300bps less compared to regional peers including Bangladesh, Sri Lanka and Nepal
- Relative to its share of GDP, Industry pays 50x more taxes than Agriculture and perhaps 4x more than Services
- In a weak economic environment, tax collection rises by a historical average of 5-10% where as the FY10 target estimated an increase close to 30%

In addition unaccounted and unforeseen pressures continue to weigh on the fiscal hand including

- Security expenditures related to insurgents in the North and Afghanistan,
- Excess burden from some protected sectors such as Water and Power which require rationalization, subsidies and financing and
- Interest payments on Circular Debt

### Government and Public Sector Borrowing stretched thin

Another indication of fiscal budgetary challenges is evident in Budgetary Borrowing trends from the SBP. Government Budgetary Borrowing from the SBP as of Apr 3'10 stands at PKR 1.278tn or over PKR 140bn beyond the IMF ceiling for the quarter ending Mar10. Evidence of crowding out is also hard to miss; while the stock of Private Sector Credit remains stagnant at PKR 2.9tn, lending to Public Sector Companies has almost doubled by 49% to an outstanding amount of PKR 432bn during the FY10 to date.



Source: SBP, IMF

### Pinching Pennies

Tokyo related funds remain mostly hard to pin down but in the range of USD 700mn against the last estimate of USD 1.1bn. CSF inflows have also been marginal when compared to the total outstanding in excess of USD 2bn, leaving the IMF the contributor of over USD 1.1bn in Budgetary Financing. Another USD 1.2bn from Kerry-Lugar due in FY10 also remains elusive.

### Commodity Operations

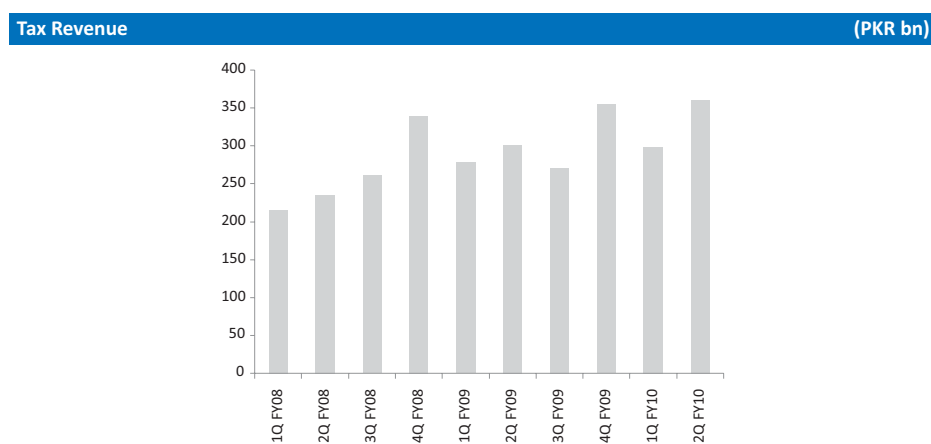
The government's outstanding Commodity Financing stands at over PKR 350bn and much remains to be done with regards to import of 1.2mn MT of Sugar via TCP and Wheat via PASSCO. In our opinion, Commodity Financing i) will exert a major pressure on liquidity moving forward and ii) may also fuel inflationary pressure if the supply chain remains bottlenecked due to regulatory lags and administrative loopholes.

### Circular Debt remains to be resolved

Delays on resolution of Circular Debt continue to plague the Energy Chain but can hardly be avoided given the excessive dependence on the Banking Sector to fund the Money Demand Gap. In FY10, the Government issued 2 TFCs worth over PKR 160bn and plans to resolve the remaining liquidity constraint with another PKR 100bn Sukuk issue before Jun10. However the modalities of the Sukuk remain to be resolved as authorities are in the process of determining the underlying asset to the issue, suggesting the process may be delayed to the latter end of CY10.

### Revenues remain sluggish

Total Revenues rose at a much slower pace of just 9% in 1H FY10 compared to the corresponding period in FY09. In the same period last year the Revenue base increased by 33% YoY reflecting the lagging impact of the inflation spiral. Although seasonal factors are at play, we expect 10-12% growth in tax receipts during FY10. Tax Revenues rose by 14% to PKR 578bn while Non-Tax receipts remained subdued at PKR 250bn for 1H FY10.



Source: Ministry of Finance, IGI Research

### Expenditure outpacing Revenue growth

During 1H FY10, overall expenditures sustained their pace rising by 24%YoY while Revenues were laggard at just 11% growth. Debt Servicing remained relatively flat at nearly PKR 300bn or 2% of GDP in 1H FY10, however, disbursement of Grants rose over 2.3x to PKR 133bn. Defense and Security related expenses also saw double digit growth while PSDP, although severely short of the initial FY10 estimate of PKR 783bn, saw its disbursement rise by 70% to PKR 224bn.

### Viva VAT

The IMF is rightfully bent on improving Pakistan's Fiscal Revenue fundamentals and it appears VAT is the only way to unclog the fiscal resource pool. The 15% VAT system is expected to replace GST at 16% with an increased threshold of PKR 7.5mn turnover with most exemptions being withdrawn, thereby bringing equity and stability to the tax revenue net. According to our estimates, VAT could generate between PKR 300-400bn in revenues for the federal coffers.

However, several implementation obstacles have plagued the proposal: amongst them documentation and acceptance by the provincial assemblies. Progress in the provincial assemblies should determine the new system's evolution; for the time being several proposals have been put forward including a National VAT, National and Provincial Mixed VAT and a National VAT ex of Sind. However, in our opinion, a simple National VAT with single Tax Management by the FBR would be in the most appropriate system. The caveat remains whether the Provinces will suffer inflation and yet fail to reap the benefits of increase tax revenues. Sind's central plea to the Federal Government is to establish Provincial VAT alongside Federal VAT.

The inflation impact will be minimized by the fact of GST already being in place for the last year, and a VAT like sales tax management system should ease the process of administration. In addition, exemptions on basic/essential items and zero-rating on other areas will effectively subsidized some low income consumers.

#### CGT to add 0.7-0.8% of GDP to the tax net

Our talks with the relevant ministries indicate the government is expecting to draw nearly PKR 100bn in revenues or 0.7% of GDP from the Capital Gains Tax implementation in FY11. The Capital Gains Tax (CGT) will be applicable on the purchase of all securities made on and after Jul 1'10. Although modalities remain to be determined, we expect the tax will be charged on two types of holdings, at the initial rates of 10%, where holding period is less than 6mo and at the rate of 7.5% where the holding period exceeds 6mo but it is less than 12mo.

Prior to FY11 all financial intermediaries, except Commercial Banks, benefited from their trading income remaining untaxed as there was no Capital Gains Tax. Commercial Banks, however, with exposure to equity from investments, are liable to pay 35% Capital Gains Tax on holdings of less than 1yr and 10% on holdings of more than 1yr.

News reports have also referred to proposals from a Tax Policy Report, to introduce CGT, adjusted for inflation, on sale of property, in addition to an annual land tax. Although we agree the incentives for under-declaration of property prices at the time of sale would be lessened and improved information management would promote a healthy property market, we feel the tax administration is unable to implement this at this time. A major drawback to this theme is the documentation of property, historical pricing to be adjusted for inflation and property rights constraints. As of 2010's Doing Business report, i) Pakistan ranks 105 out of 183 economies in capacity to deal with Construction Permits, ii) 158th in Enforcing Contracts iii) 119th in Registering Property and iv) in Paying Taxes Pakistan qualifies at number 143rd out of the 183 countries under observation; all indicative of significant implementation obstacles and administrative weakness.

CGT			
	Dividends	Short Term Gains	Long Term Gains
Brazil	15%	15%	15%
India	10%	15%	zero
Indonesia	10%	zero	zero
Korea	Ordinary income	11% for small and medium	11% for small and medium
Malaysia	Exempt	zero	zero
Philippines	11%	zero	zero
Russia	10%	13% residents, 30% non-residents	13% residents, 30% non-residents
Sri Lanka	15%	zero	zero
Thailand	10%	zero	zero
Turkey	10%	Ordinary income	zero
Vietnam	10%	zero	zero

Source: World Bank Pakistan Tax Policy Report

a/ Indonesia imposes a final withholding tax of 0.1 percent on the sale of stock market shares and 0.5 percent on the sale of new shares, whether sold or not. India also has a similar securities transaction tax.

b/ Philippines taxes only the capital gains of non-resident aliens at rates of 0.5 percent for listed shares and 5 to 10 percent on unlisted shares.

## Liquid Luck

Despite the improvement witnessed in macro-fundamentals the SBP views fiscal consolidation and its implications on the broad economy to be the most significant according to the latest MPS announcement. As expected the SBP kept its policy rate unchanged at 12.5% at the behest of fiscal deficit uncertainty and long term fragility, highlighted in our Monetary Policy Preview (*Uncertainty Rules* Mar 18'10). FY10 M2 growth as of Apr 3'10 came in less than 2%; this pales in comparison to the CY08, 5yr CAGR of above 18% suggesting the years of aggressive monetary expansion and plunging interest rates are over for now.

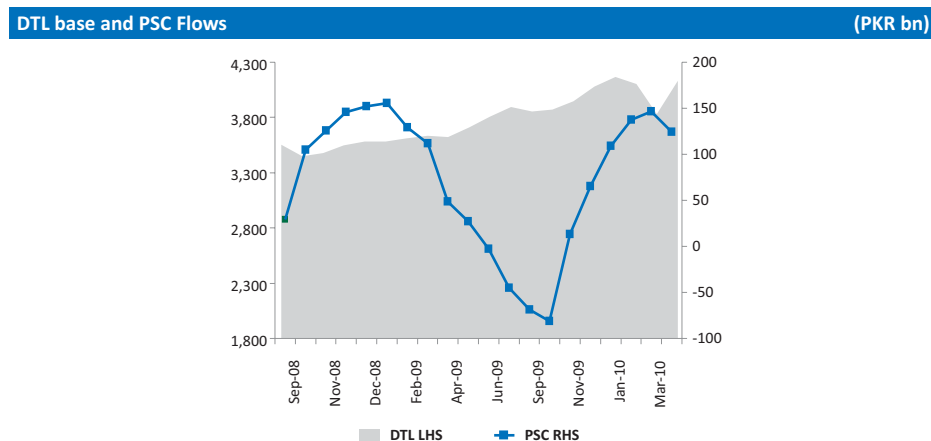
- The low Savings Base at 14% of GDP and Savings-Investment gap of more than 5%
- Federal Tax Revenues stand at a meager 9% of GDP
- Provincial Tax Revenue at only 0.4% of GDP
- Laggard Fiscal consolidation which could trigger price instability
- Unaccounted for expenses which include Circular Debt overhang across the Energy Chain and Security Expenses

### Straining Systemic Liquidity

As of Apr'10, liquidity fundamentals remain weak as Asset creation has gained momentum in 4Q FY10 at the behest of Government Money Demand. Stock of Budgetary Borrowing from the SBP is up 10% and from Commercial Banks is up 24% with demand pressure coming in from both the Central and Provincial governments. This is on the back of a 42% reduction in Stock of NFA to PKR 302bn or USD 3.5bn YoY and a flat DTL base at PKR 3.9tn.

### DTL base likely to remain stagnant in FY10

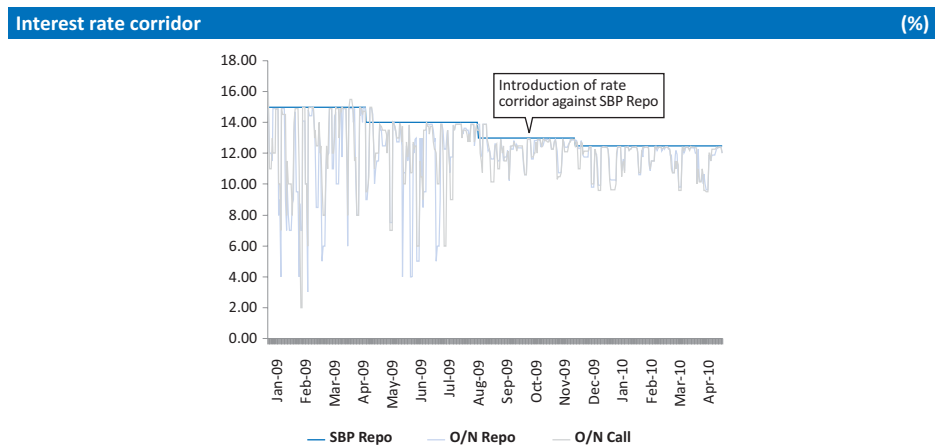
With Output growth likely to remain sluggish in the region of 3%, Monetary base encumbered by a low Savings rate and diversion of longer term deposits to National Savings Scheme, (gross mobilization during 7mo FY10 stood at PKR 346bn) the DTL base is likely to stay flat in FY10. The erosion of Net Foreign inflows in the last couple of years has also weighed on the savings base and is unlikely to recover significantly given trimmed global liquidity flows.



Source: SBP

**Market rates reflective of Money Demand Gap**

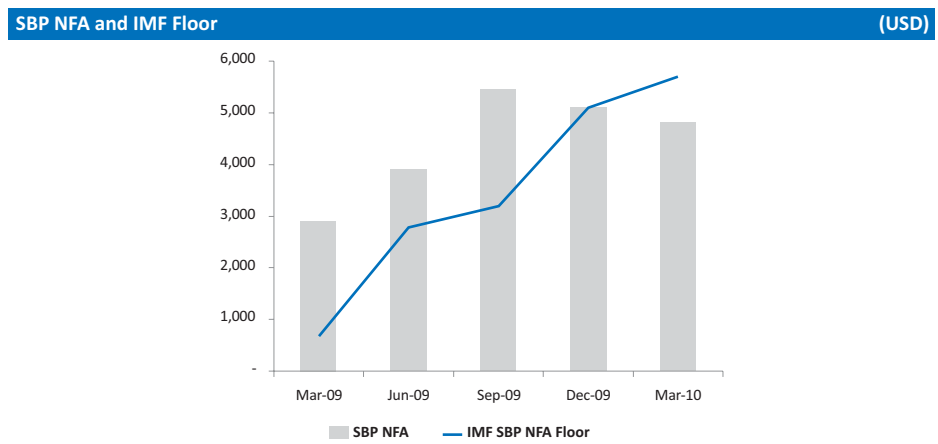
The widening gap between Assets and Resources has already tweaked market rates upward with benchmark 6mo KIBOR firm in the range of 12.35%, though it has slipped 10bps in early Apr10. KIBOR is unlikely to come off much unless domestic liquidity improves on growth fundamentals or external financing flows and consequently NFA accumulation improve significantly. O/N and Call Money rates are also indicative of market weakness as they remain at the tighter end of the rate corridor, averaging 11.7% in 3Q FY10 against 12% in the previous quarter 2Q FY10. Meanwhile the SBP has been diligently plugging liquidity gaps with frequent OMO injections in excess of PKR 100bn WoW since 2Q FY10 to keep market rates stable.



Source: SBP, IGI Research

**SBP's NFA accumulation slows down in 3Q FY10**

The pace of SBP's Net Foreign Asset accumulation has slowed considerably in Mar10, and at present appears to have dipped below the IMF Floor for Mar10 of USD 5.7bn. However this is largely due to the delay in the expected IMF tranche of USD 1.2bn and the shortfall in Tokyo related funds and CSF dues (security spending) from US allies against initial IMF estimates. In addition the payouts of the Sukuk Bond and repayment of official loans in 3Q FY10 served to deplete the NFA position. No doubt external fund disbursements remain key to recovery; any shortfall in external financing will create liquidity constraints and pressure market rates. Consequently Government Borrowing will depend more heavily on the Commercial banks crowding out the Private Sector and limited Investment Spending and Output Growth. In 3Q FY10 we have already witnessed such a pattern with cut off yields on the short end of the yield curve remaining choppy.



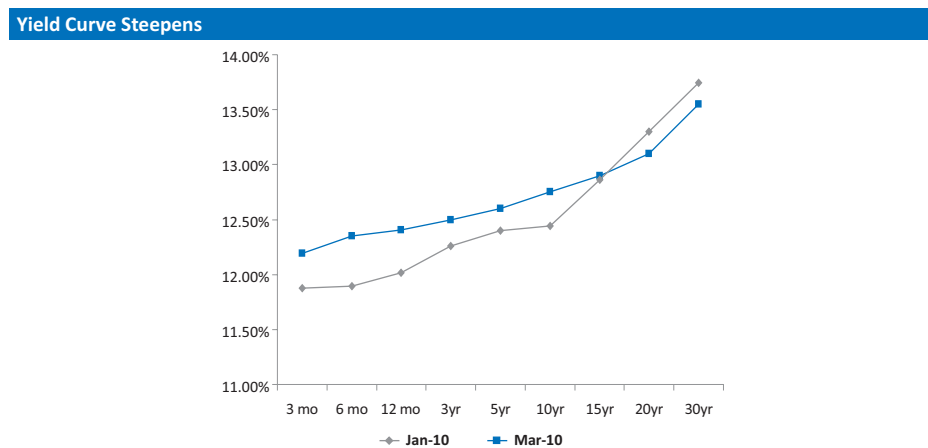
Source: SBP, IMF

### 6M KIBOR could shed some weight

With current 6M KIBOR slipping towards the 12.30% range and another rate cut of 50bps on the cards by May10, the benchmark market rate could shed some weight towards the 11.80% mark. However downward pressure may be dulled by widening capital outflows associated with i) a bloating trade deficit ii) faster short term debt payments relative to debt inflows ii) strengthening of the USD globally in line with US output and employment recovery iv) greater exchange rate pressure associated with more expensive oil import payments from the Foreign Exchange Market. We expect 6M KIBOR to shuttle between 11.80%-12.20% in 2H FY10 and present an average 12.20% for the fiscal period.

### Yield Curve steepens on short end

In 3Q FY10 we have seen the yield curve steepen considerably; this is largely due to the shortfall in external financing, increasing Budgetary Borrowing pressure and higher than expected inflation during the 3rd quarter. Moving into 4Q FY10 however we expect cut off yields to shed some bps if not remain stable, particularly if Government Money Demand loosens in lieu of expected external support.



Source: SBP, IGI Money Market Desk

### Laggard Deficit reduction poses rate risk

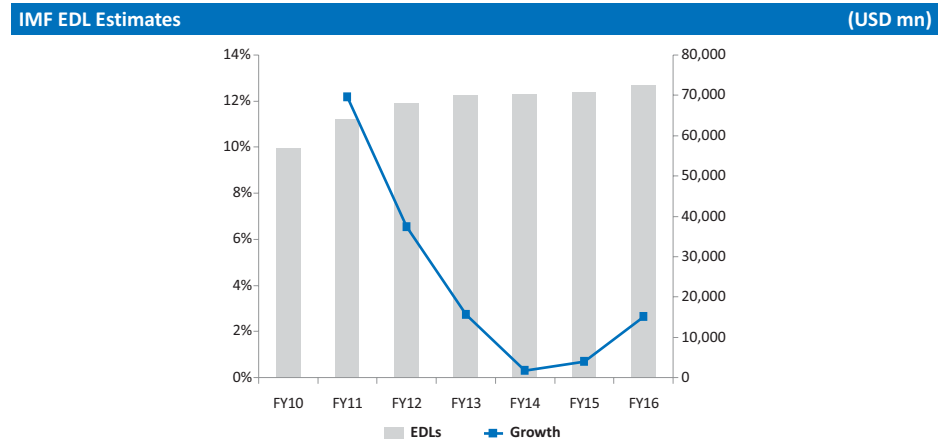
Although the monetary policy makers have achieved price stability in FY10, a key risk to the economy remains overshooting of the fiscal deficit. FY09 figures suggest the number breached IMF expectations of a deficit contraction target of 4.3% by 90bps or 5.2 % of GDP. Similarly in 1Q FY10 the deficit soared to an annualized 6% of GDP however this stabilized to within 1% of the IMF ceiling by 2Q FY10. Monetary policy makers are watching the deficit closely and are unlikely to make any aggressive easing possible unless clarity on the deficit is available.

### SBP injecting strength into the system

With maturities drying up in 2Q FY10 on account of the liquidity crunch which occurred in the same period last year, the SBP stepped up the pace of its quantitative injections via OMOs in order to ease market pressure. Accordingly, we saw the Central Bank churn over PKR 100bn in the money market on a weekly basis in conjunction with a 50bp policy rate cut announced in Nov09. In Dec10, the SBP injected a monthly average per visit of PKR 130bn via OMOs; this is tremendous compared to just PKR 20bn in previous months.

**External Debt Overhang will delay recovery in the medium term**

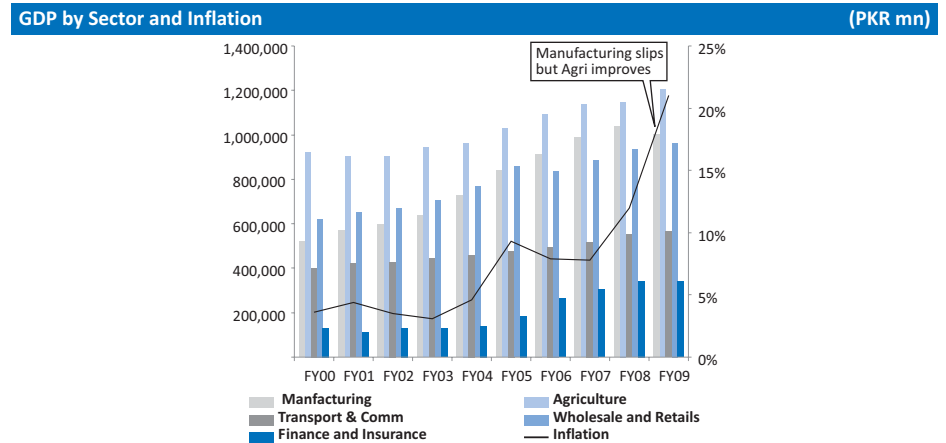
External Debt has more than doubled to reach PKR 4.6tn by 2Q FY10 over FY06. EDL Servicing also more than doubled in 3yrs, particularly in view of the excessive depreciation, to PKR 354bn by FY09. The capital outflow associated with mounting external debt will continue to have a negative impact on the exchange rate, import basket, input prices, inflation and ultimately national income. This will also leave monetary policymakers on the defensive with respect to the currency and therefore constrained to ease interest rates aggressively and kick-start investment spending. According to IMF estimates of Pakistan’s future debt accumulation, the country will acquire PKR 72.6bn in Total External Debt in the next 5yrs. However the IMF appears optimistic on the debt scenario assuming Output growth catch up will soften the impact of debt payouts on the economy.



Source: IMF 3rd Revue Jan10

## Output on the Upside

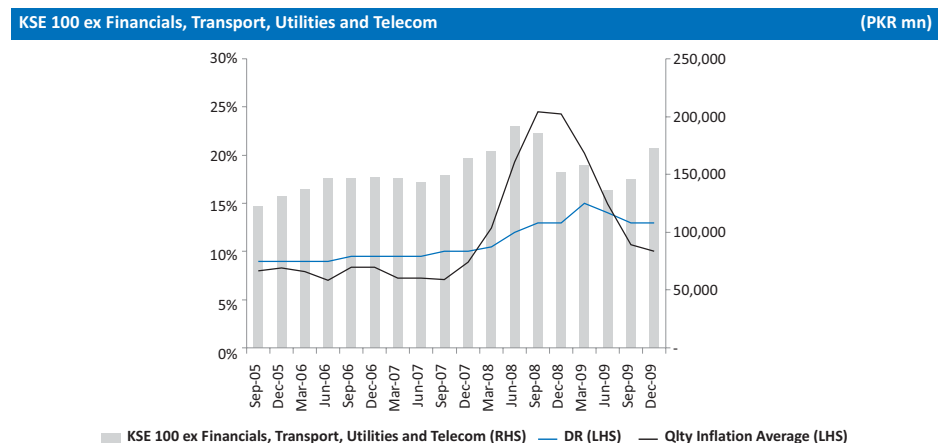
The shock associated with inflation and tightening monetary policy is most obvious in the trends of the Manufacturing base. Meanwhile Wholesale & Retail trade and even Finance & Insurance tend to fall with a lag due to their close association with the Manufacturing sector. The impact on these sectors is likely to persist with a 9mo-12mo lag well into CY11, meanwhile the impact on Agriculture is somewhat offset by the positive impact of food inflation on farmer incomes. Given the Large Scale Manufacturing base contributes over 12% of GDP, all other things being equal, we can expect a 4% improvement to push the overall GDP frontier to the 3.5-4% mark by Jun10.



Source: SBP, Ministry of Finance

### 8mo FY10 LSM Index rises by nearly 3%

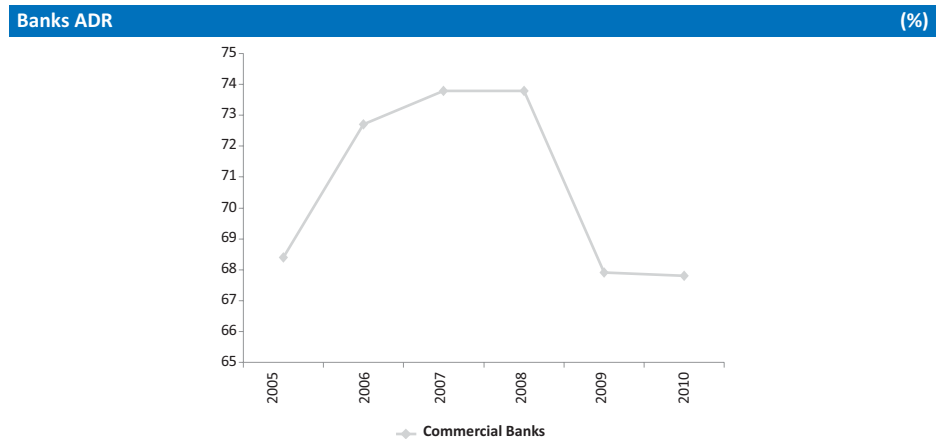
According to 8mo FY10 data OCAC (Oil Companies Advisory Committee) production indicates almost 6.6% decline over the corresponding period last year. However, these numbers are a significant improvement from 2Q FY10 which was depicting nearly double that or a 12% decline in production. The Overall Index has been buoyed by a revival in manufacturing output of Soda Ash, Fertilizers and Automobiles emerging from the slump. Broad based production showed the base remains flat YoY with regards to Steel, Iron, Jute, Sacking, Cotton Cloth and Sugar Output. However these sectors are likely to improve, once the inflation and interest impact eases off.



Source: KSE, SBP, IGI Research

**Private Sector Credit likely to remain dull in FY10**

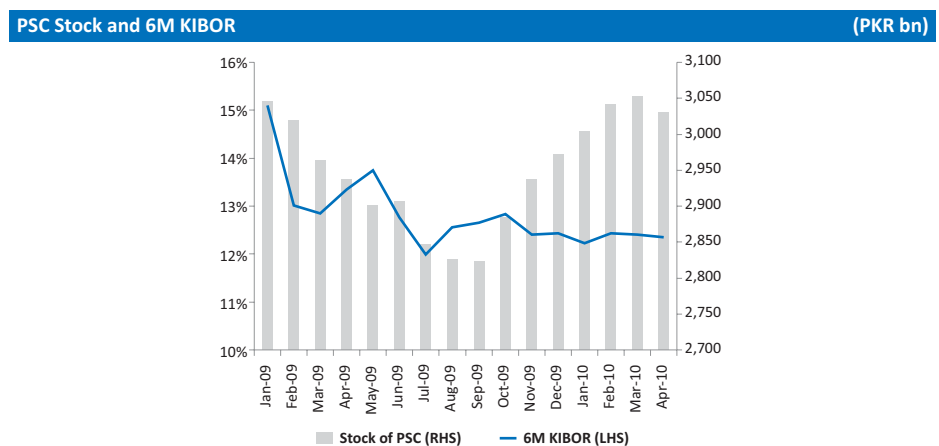
Keeping in mind the presence of the informal sector and lack of limited advances penetration in the economy, large scale investor dependence on financial intermediaries is still high. Private Sector credit has remained choked during much of FY09 and FY10 as banks still remain risk averse on account of large NPLs and default risk in the high interest rate-high inflation environment. Consequently the growth contribution from Private Sector Credit is likely to be minimal in FY10, instead the bounce back in bottom lines would be driven by easing inflation, interest rates coupled with improvement in investment income.



Source: FSR, SBP

**Financial intermediaries will restart lending as rates ease**

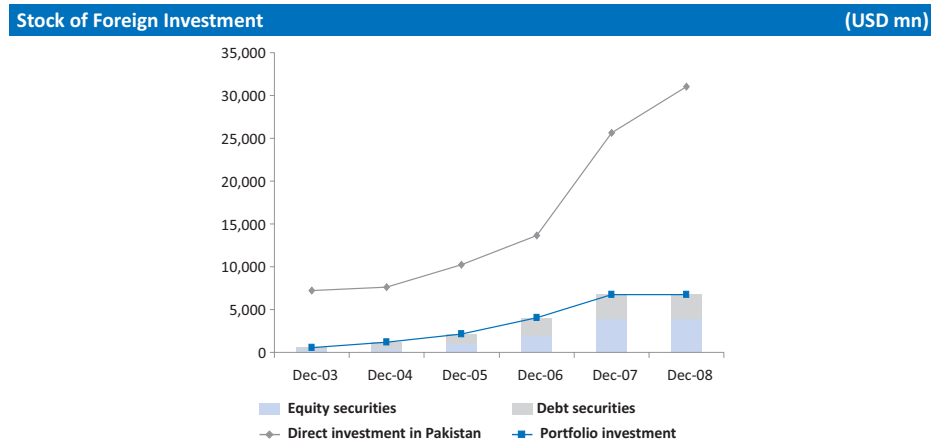
Moving into FY11 as inflation comes off towards the 9% level, we are likely to see a shift in Banks' Asset Books from Investments back to Advances. Lower yields on Government Securities are unlikely to attract the Banking system which has been faced with high costs of funding during CY09. A major constraint to the pace of this movement, however, is the persisting NPL issue. By Sep09 the ratio of NPLs to Gross Advances peaked at 12.4% compared to 8.4% in the corresponding period last year while coverage of NPLs or Provisions to NPLs stood at 70%. Although Dec09 NPL ratios are marginally lower, we believe as Advances begin to pick up we should see further improvement.



Source: SBP, Bloomberg

### Stock of Direct Investment Stable

9mo FY10 FDI inflows have remained in line with our expectations of USD 2.5bn for FY10. Flows towards key recipients in the past, Telecom and Banking, are witnessing little impetus. Meanwhile Oil & Gas has taken the lead amongst economic segments receiving the largest chunk of foreign investment during the period. Overall Investment amounted to USD 1.5bn in FY10 to date with no inflow of privatization unless the GoP initiates the OGDC International Bond Issue before Jun10, which we deem unlikely. However, the Stock of Foreign Investment rose significantly in the last decade and remains stable YoY at over USD 30bn as of FY09.



Source: SBP

### Key ratios consolidating

We expect vulnerability ratios to show some strength by Jun10 over the corresponding period last year;

- i) Current Account Deficit as % of GDP near 4% compared to 5.5% in FY09,
- ii) EDLs Servicing to Foreign Reserves at 10% compared to 11% in FY09,
- iii) Exports as % of EDLs at 34% vs 35% in FY09
- iv) EDL Servicing to Export + Remittances at 2x stable over the same period last year

5yr CAGR of GDP is at 4.3% as of FY10E while Inflation is likely to rest below our FY10 estimate of 12%. Although other indicators particularly Savings to GDP and Investment to GDP still at 15% and 18% for FY10E, we feel this is a counter cyclical result of limited global and domestic Public Investment and PSDP flows which is likely to turn around once output generation improves.

## Signed and Sealed!

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The President has signed off on the 18th Amendment on Apr 18'10, significantly reducing systemic risks to democracy in Pakistan. The Parliamentary Committee on Constitutional Reforms (PCCR) unanimously signed the draft of the 18th Amendment Bill, though earlier this month, differences between political parties arose on a number of issues including the renaming of the NWFP and nomination to the Judicial Commission. However, consensus was reached on the following i)'Khyber-Pakhtoonkhwa' to be new name of NWFP and ii) the CJP would nominate the 7th member of proposed judicial commission

### **No 18**

Via the 18th Amendment to the Constitution, the President's powers have been reduced to the right to issue warnings and be consulted by the government. Notifications proposed by the Prime Minister, be it the appointment of official functionaries, summoning the Senate and National Assembly, any potential dissolution of the lower house of Parliament and assigning of legislation, will be signed by the President of Pakistan. Any disagreement which may result in delays, such as in the notification of appointment of 7 judges of the Peshawar High Court, will pass into law if approved by Parliament within a period of 30 days, regardless. Consequently the power of the President to withhold assent on significant issues will be limited.

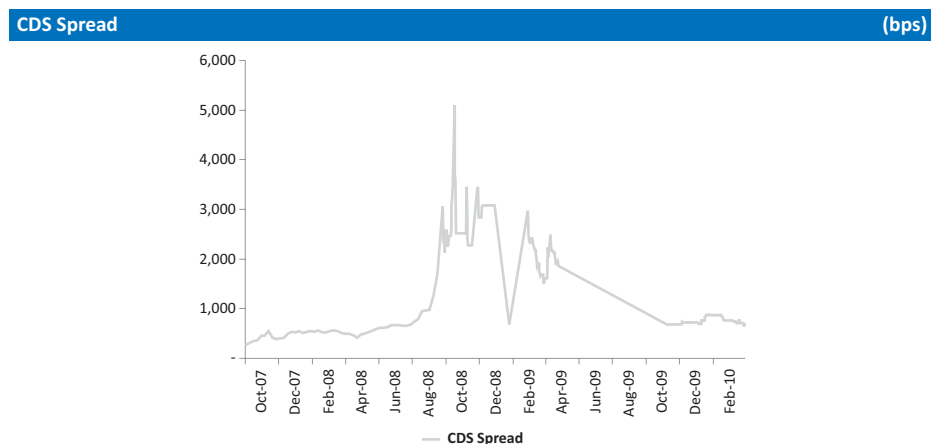
### **Judge's appointment procedure riles Lawyers**

According to the 18th Amendment, the appointment of the judges would be made through the Judicial Commission comprising 7 persons, the Chief Justice of Pakistan as Chairman, 2 senior judges of the apex court, 2 government representatives (the Law Minister and the Attorney-General), a senior advocate to be nominated by the Pakistan Bar Council and a retired Judge nominated by the CJP. The Judicial Commission, by a majority, will recommend one name for each vacancy in the Supreme Court or High courts, to form a Parliamentary Committee comprising 8 members - 4 from the Senate and 4 from the National Assembly.

However, this provision was not welcomed by the Judiciary or Lawyers. Under the Constitution, the parliamentary committee can reject any recommendation of the judicial commission with a 3/4th majority. In addition, it would not be required to declare the reasons while rejecting any such recommendation of the judicial commission. In response, the Supreme Court Bar Association, headed by Qazi Mohammad Anwar, the president of the SCBA, has decided to challenge the imposition of this clause in court. 17 out of 20 members present in the meeting supported the resolution to challenge the Judicial Commission indicating that the Lawyer's Movement and Judiciary still remain at odds with the government.

### Positive Politics cheers up market

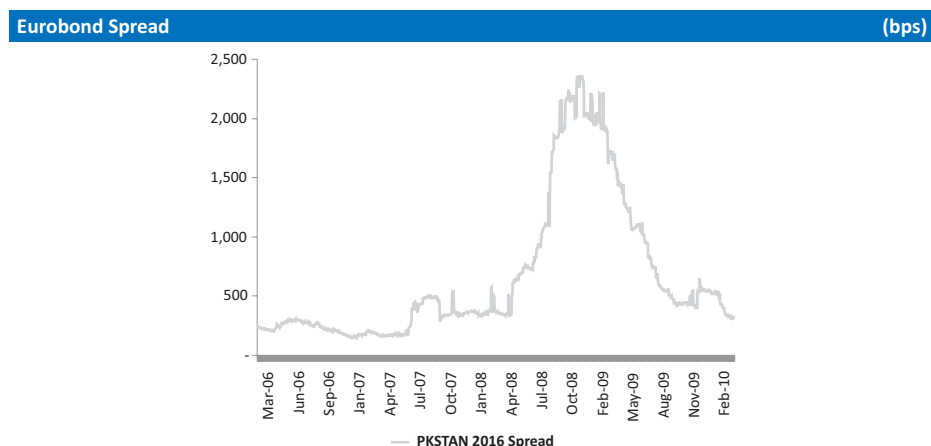
We feel the passage of the 18th Amendment into law is a very positive move for democratic institution building in Pakistan. Although we remain cautious in the short term with regards to legal challenges to the Amendment, in the medium term we feel major implementation obstacles have been overcome through an unexpectedly successful consensus building exercise. Sparring between the PML-N and PPP is also at a lower ebb if not neutralized while US support to Pakistan remains on a high note. Pakistan's political horizon looks promising; accordingly global investor sentiment also appears to have revived with the spread on Credit Default Swaps, reflecting shrinkage to under 635bps compared to a high of over 5000bps earlier.



Source: Bloomberg

### Portfolio inflows pick up pace: Eurobond shines!

In March alone, we have seen a net inflow of USD 90mn where as in FY10 to date we have observed inflows of nearly USD 1bn as per SCRA data. NCCPL data also confirms renewed interest in the region and Pakistan with a gross buy of USD 111mn in Mar10. At present Foreign Investment as % of Total Market Capitalization sits at 6.3% compared to a high of 7.5% at a market peak level of above 15,000 points in CY08. Performance of the 16yr Pakistan Eurobond was also indicative of improving investor sentiment globally. Yield spreads against the relevant UST slipped near 350bps in Apr10 from a staggering CY09 high of 2,414bps.



Source: Bloomberg

### Pak-US alliance robust

The US visit of the Pakistani authorities earlier this year, appears to have been a success with news reports suggesting accord on a number of issues including military assistance, enhanced corporation on bi-lateral trade and support on the power crisis in Pakistan. In a joint press conference, Secretary of State Hilary Clinton pledged another USD 125mn for the energy sector in Pakistan and agreed to split the remaining payments for anti-terror operations into 2 installments. Defence Minister Ahmed Mukhtar, US Defence Secretary Robert Gates, Pakistan Army chief General Ashfaq Parvez Kayani, Chairman Joint Chiefs Staff Admiral Mike Mullen, senior advisers and officials attended the dialogue.

## Lead Indicators Looking UP!

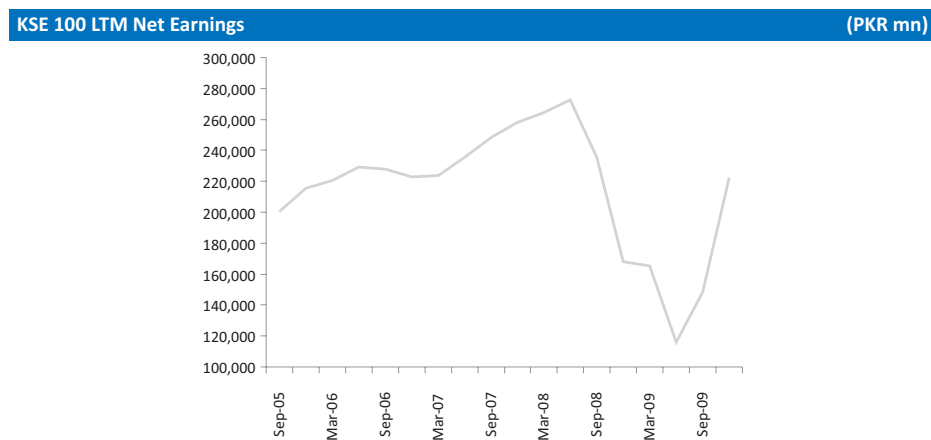
Signs of a U-Turn are filtering through to investor sentiment. Large Scale Manufacturing numbers are showing a 3% increase in 8mo FY10 from less than 1% earlier this fiscal year. Consumer capacity also seems to be improving with Cement, Fertilizer and Auto Sector offtake on the rise, growing by 13%, 28% and 34% respectively in FY10. Finally we see a marked improvement QoQ and YoY in net profits of KSE 100 companies in the range of 50% and 33% respectively as of Dec09. In lieu of the improved investment scenario, the market has seen 4 fresh equity issues compared to virtually none in the same period last year. All indications are that the market will respond to Lead Economic Indicators and has already begun to draw investors.

### KSE 100 shines!

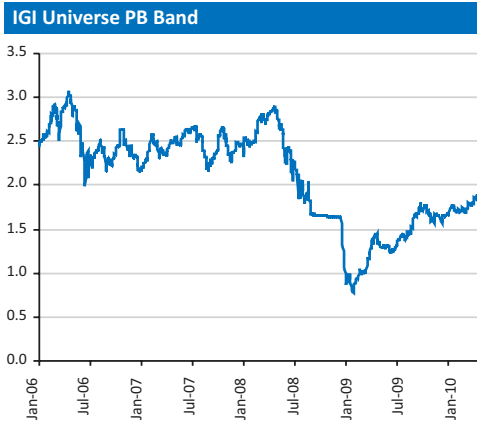
The benchmark index has performed spectacularly well in FY10, providing investors an average 11% return per quarter and shooting up by 31% in 1Q FY10 alone. Macro-optimism led frequent and sharp rallies dominated the past year, however, CY10 is likely to see earnings lead the show. In our opinion most of the blue chips in our IGI Universe have re-rated to target levels on account of improved earnings, to index levels in the range of 10,600 points. However a further boost to the 11,700 mark is entirely possible with a significant push from the remaining KSE 100 stocks in the arena.

### Broad based earnings improvement will lift index to 11,700 level

Across the listed universe, IGI Universe companies, comprising nearly 70% of the market cap, were the first to recover strength to their earnings profiles. However smaller 2nd tier scrips, ex IGI Universe, in key sectors including Banks, Insurance and other Financials, Cement, Autos, Sugar, Textiles, Power, OMCs, Fertilizer, Chemicals and Transport are still in a consolidation phase compared to their peaks in 2008.

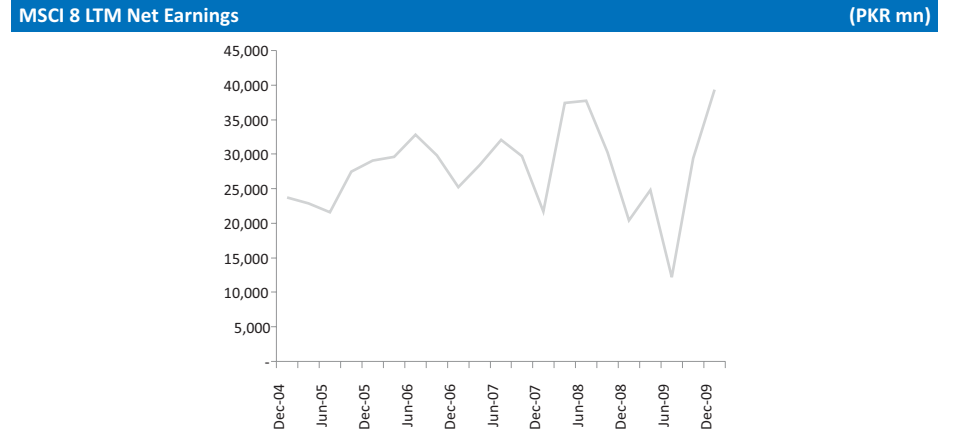


Source: KSE, IGI Research

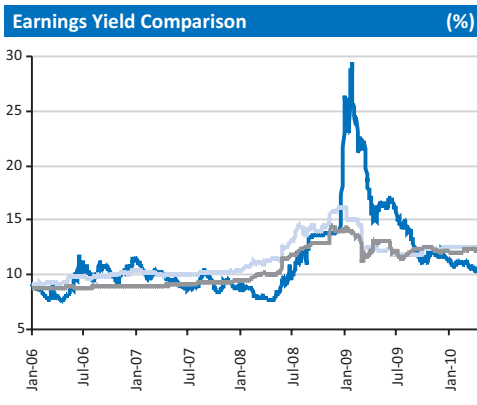


Source: KSE, IGI Research

Although we maintain a conservative stance on their earnings outlook, we believe the worst is over for many of these companies; the full scale impact of Lead Economic Indicators including lower interest rate & inflation risk, improved liquidity & consumer demand, lower impairment and reduced valuation feedback to balance sheets is likely to translate into earnings improvement by FY11. Consequently we maintain our FY10 index target at 11,700 points, assuming a 10% upside to the KSE 100 from current levels. Our index target is based on justified P/E analysis with key assumptions including payout of 50%, COE at 18%, and earnings growth at 13%. This coupled with 7% dividend yield translates into a TSR of 31% for CY10E.



Source: KSE, IGI Research



Source: KSE, IGI Research

**Longer term pressures remain**

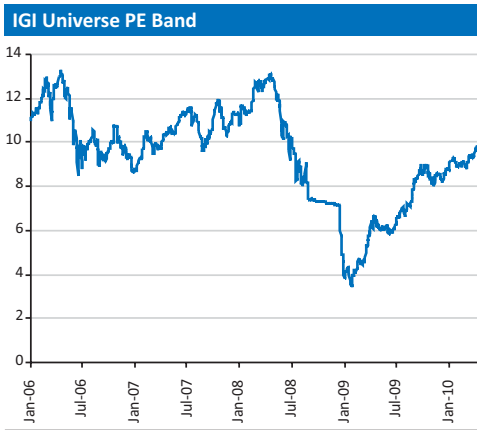
The fine print, however, tells us asset prices could remain encumbered by longer term economic fragility and a political confidence deficit. Sluggish external financing and weak export & investment receipts are also likely to amplify liquidity constraints and trigger market rate choppiness. In FY10 to date FoDP, CSF and Kerry-Lugar funds remain hard to pin down, FDI is down 50% to the range of USD 1.5bn for 9mo FY10 and Export Receipts rose by a mere 6% despite subsidized interest rates via the SBP's Export Finance Scheme and over 30% depreciation in the last 2yrs.

**Surviving the Uncertainties**

In the face of a regulatory hurdle or major political setback/event we have also ascertained the impact on the KSE 100 in terms of a bottoming out in volumes by 5-10% and an average forward P/E band dip of up to 1.5x forward earnings. Although because of the current low base of both volumes and the index, we expect the market to have a relatively muted reaction to either political or regulatory events. This should give investors flexibility when faced with uncertainties which may pop up during CY10.

**Attractive on relative valuations**

The market has reacted favorably to recent corporate results amid stabilizing macro-environment and declining interest rates. For our analysis we have used 20 IGI Universe companies which represent 67% of total market capitalization as the proxy of the sector. Our coverage cluster offers 3yr CAGR earnings growth of 13% and the market trades at attractive FY10, FY11 and FY12 PE(x) multiples of 8.8x, 7.9x and 7.0x respectively. On price-to-Growth (PEG) basis the benchmark KSE-100 index is very attractive with PEG ratios at 0.73x, 0.56x, and 0.50x. Moreover, alongside limited downside risk the market offers attractive forward dividend yields in the range of 7-8%.

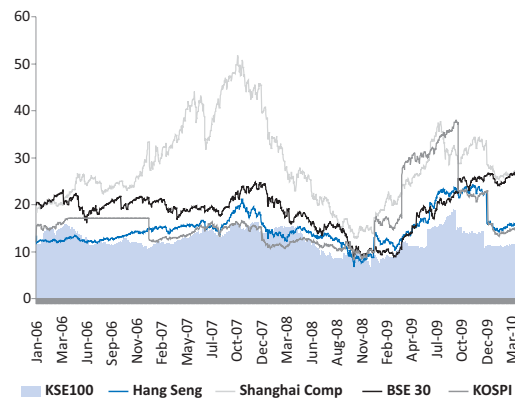


Source: KSE, IGI Research

**Deep discounts narrowing**

The FY09 crisis saw distressed foreign investors selling given weak fundamentals and political woes, which resulted in a net outflow of nearly USD 1bn. However, with stabilizing macro/political scenario coupled with an excessive discount to historical averages and regional peers, Pakistan equities once again emerged as winners; accordingly foreign funds pumped in over USD 450mn in YTD FY10. Buoyed by FII inflow, the stock market has gained over 60% in CY09, one of the best performers in the region.

**Regional PE Comparison**



Source: Bloomberg, IGI Research

**Top picks include POL, UBL, FFC, PSO and HUBC**

Our top picks in the banking sector is UBL which trades at attractive forward P/B of 1x and offers 15% upside to our target price of PKR 70 per share. The pick of E&P sector remains POL which is expected to defy the industry trend with an expected 35% EPS growth during FY10. Going forward, as the impact of higher oil/gas prices and production ramp up from TAL kicks in, we are looking at a 14% EPS growth for the sector in FY11 with POL and PPL leading the way with 21% and 25% spike in earnings YoY.

Fertilizer Sector is trading at a PE of 8.8x based on CY10 earnings, which is at a discount of 4% to its 3 year historical average PE of 9.13x. We maintain a bullish stance on the sector with FFC being our top pick, offering CY10E total stock return of 25%. Meanwhile, the cement sector has witnessed positive momentum in its price performance on the KSE off late on the back of 10% increase in cement prices. At these levels, DGKC stands out offering approximately 40% upside vis-à-vis our Jun10 PO of PKR 47 per share. HUBCO is our top pick in the power sector and offers 34% upside vis-à-vis our Jun10 PO of PKR 47 per share and presents FY10E dividend yield of 13%.

Liquidity remains the key theme in the downstream oil marketing sector. While demand for petroleum products has remained robust in 9mo FY10, we have witnessed skewed distribution preferences based on liquidity of the respective OMC's. PSO has its hand tied with the power sector maintaining a hefty share of 89% in FO and witnessing a growth of 12% YoY in black oil in 9mo FY10. We remain positive on PSO and APL with a Jun'10 target price of PKR 346 per share and PKR 396 per share, respectively.

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I, Zainab Jabbar, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject, securities and issuers. I also certify that no part of our compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this research report.

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