

Economics & Strategy

Vital Signs

2009 depicted a rocky road for Pakistan and the world economy; it began with a big bang and has ended on a rather sober note with the country trudging towards stabilization, in the wake of the global liquidity crunch. We held hands with the IMF, marched the Long March, tried to break free of circular debt, made friends in Japan and enemies (of insurgents) in Waziristan and jettisoned the NRO. Meanwhile policymakers followed through; Structural Adjustment targets were broadly met with inflation, fiscal and current account deficits all showing improvement. However, implementation challenges deflected progress in key areas such as fiscal revenue mobilization, export growth and de-bottlenecking of supply constraints which continue to hamper macro-stability and sustain systemic risk in the medium term.

Fragile Economics

Pakistan's policy makers used a strong demand-contraction based 'disinflation' approach to stabilize the price level and its subsequent impact on the broad economy. Conversely the rest of the world's central bankers barring a few, were moving towards 'reflation', via bottomed out interest rates and monetary stimulus. By Oct09 Pakistan's CPI inflation dipped to a low of 8.9%, the Current Account Deficit shrunk by 81% to USD 1.4bn in 1H FY10 and the Trade Deficit narrowed by 29% to USD 6.8bn during the same period. The main beneficiary of the IMF payout has been the External Account which turned a surplus of nearly USD 1bn in 5mo FY10 while the PKR which has strengthened to a volatility ratio of 4% in FY10 compared to 20% in FY09 and 13% in FY08.

Liquidity bounce

Although Monetary Aggregates present a healthier picture, the M2 curve is largely presenting the positive impact of IMF funding and crucial policy moves such as money market operations reforms and aggressive central bank liquidity management. Lower Twin Deficits, tamer inflation and a deregulated market aside, interest rates have come off because capital outflows have shrunk and the budget deficit will shrink as the cost of government borrowing declines in the short term. The medium term outlook remains beleaguered due to the lack of sustainability of this cash injection. In the longer term, prudent policy making, unshackled by political variables, will have to come into play.

Underlying Depression

Key challenges to the medium term scenario are the exceptionally low savings base at 14% of GDP, dismal fiscal revenue mobilization at less than 10% of GDP, persistent supply constraints, supply-side inflation, and a volatile political landscape. Without due attention to the above factors, it will be difficult for policy makers to generate sustainable growth, increase competitiveness and reduce the impact of both exogenous and endogenous shocks, to the economic system.

Less Frisk, More Risk

While CY09 presented a tremendous rebound in both local and international markets, CY10 is likely to reflect a more restrained investor sentiment. The KSE 100 alone saw several short and frequent rallies in March, June and Sep09, motivated by liquidity normalization and stability of macro-economic indicators. During the current year we expect a less frisky equity market, unnerved by a jittery PKR, inflation risk and a fragile economy. Moving forward i) balance sheet health ii) financial sector reforms, and iii) exogenous and endogenous shocks from political and security valves will matter more.

Fundamentals are more important than ever

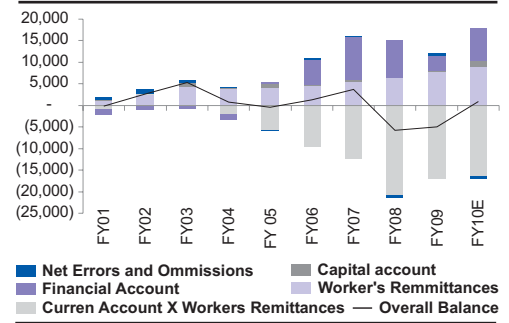
CY09 saw the most dramatic fall and subsequent rise of the KSE in recent history, with the KSE 100 index up 64%YTD and nearly 104% from trough. Going forward, the market is expected to inch towards our Jun10 target of 11,000 points with further leg room for our top sector picks including UBL, NBP, HUBC, PPL, POL, ENGRO, LUCK and PSO. If the SBP sheds another 50bps on the policy rate as expected in 2H FY10, asset prices should respond to lower inflation and interest rate risk. The benchmark index is currently trading at a P/E of 13x based on last 12mo earnings while our earnings estimates for IGI Universe indicate a forward looking P/E level of 8.7x in CY10. However, the KSE 100 top line remains generally flat YoY in FY10; bounty hunters should know that timing is essential, sectors should be chosen wisely and fundamentals are more important than ever.

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Data & Result as of January 09, 2010

Balance of Payments (USD mn)



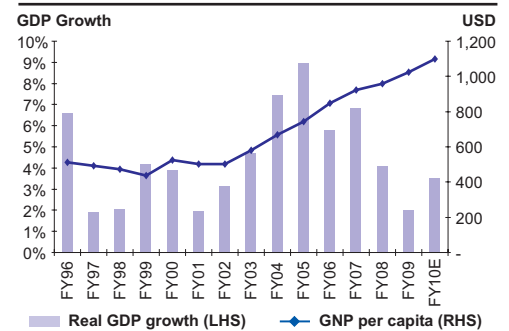
Source: SBP

Fiscal Management



Source: SBP, FBS

GDP growth and Per Capita Income



Source: SBP



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Road to Reform

There were some very significant policy benefits undertaken in the last year; integration of foreign exchange management into monetary policy, refined interest rate and liquidity management, reforms in money market operations which have smoothed market rate volatility, removal of oil import payments from central banks books and IMF ceilings on direct government borrowing from the central bank. We believe the Monetary Management has fared very well in comparison to their Fiscal peers. Implementation challenges have tilted towards the fiscal end of the policy spectrum in areas of subsidy management and tax administration reform.

The IMF agreement led to bold policy moves made by the current government including;

- i. A gradual rate hike which brought the Discount Rate to 15% from pre-crisis levels of 10%
- ii. Elimination of fuel subsidies which added nearly PKR 200bn to the fiscal burden in FY08
- iii. Electricity tariff increase of an average 18% and a phased increase of 24% expected in FY10

Improved Fiscal and Monetary Policy Coordination

In CY09 policy coordination between agents on the domestic and external front has been generally positive with most targets broadly met. Government Money Demand has remained on the higher side with total stock of direct borrowing from the SBP in the range of PKR 1.236tn, marginally over the Dec09 ceiling of PKR 1.130tn. A similar breach of PKR 100bn occurred in Sep09 as the government remains under pressure from weak fiscal resource mobilization. Nevertheless, the MoF has prudently observed T-bill auction targets during 2Q FY10 which shuttled between PKR 15-26bn at a time. Policymakers have also done well to keep the SBP's stock of NFA at USD 4.9bn well above the IMF floor of USD 3.2bn for Dec09. The SBP's stock of NDA at PKR 1.277tn is also well within the IMF target of PKR 1.340tn as of Dec 19'09.

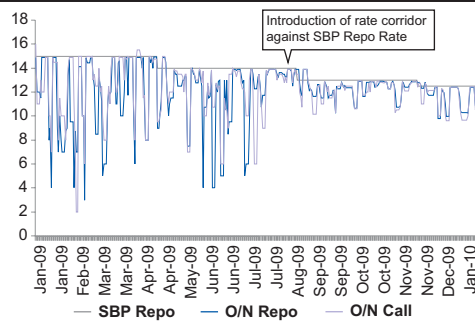
IMF 3rd Review: not as gung-ho as the last one

Although the IMF's 3rd Review highlights the achievements of policymakers in very tough circumstances, analysts point out the increasing economic and political vulnerabilities that have emerged in late CY09. These include fiscal slippage, delays in subsidy removal and restrained exchange rate flexibility as mentioned in the IMF staff appraisal.

Money Market reforms aid market rate stability

On the monetary policy front several positive developments enhanced forecasting of the government's cashflow. The announcement of a rate corridor to rationalize money market rates is one such positive. Rates using the SBP's reverse Repo rate as the ceiling and the standing Repo facility to absorb excess liquidity as the floor will stabilize market liquidity and send clear monetary policy signals. During much of CY09 O/N Repo rates tightened to within 1-2% of the DR while Call rates have also stabilized to within a corridor of 2-3%. Further measures include pre-announced treasury auction volume targets, advance notice of auctions and availability of T-bills from the Treasury to the SBP, as needed, to conduct its Open Market Operations.

Market Rates (%)



Source: Bloomberg

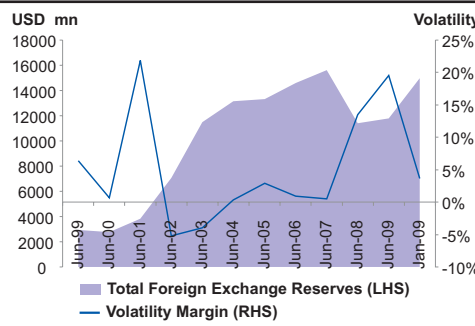
Integrating Foreign Exchange management into monetary policy

The SBP had been instructed to phase out foreign exchange financing of the following;

- (i) Furnace oil by Feb'09 (Completed)
- (ii) Diesel and other refined products by Aug 1'09 (Completed)
- (iii) Crude oil by Feb 1'10 (Completed)

Despite concerns of increasing pressure on the PKR from the movement of oil import payments to the commercial banks, the PKR has largely held its own against the USD, during 1H FY10. The local currency has depicted an exchange rate volatility of under 4%, however this has been aided by shrinking capital outflows associated with a narrowing trade deficit, reduced import values and demand and heavy external financing. The integration of foreign exchange policy into the SBP's monetary policy has allowed the exchange rate to function as it should; as a 'price' or transactional cost. The consequences of that however for a small open economy like Pakistan which is dependent on commodity imports, remain challenging to say the least.

Exrate Volatility



Source: SBP

PKR to average 6% depreciation till FY12

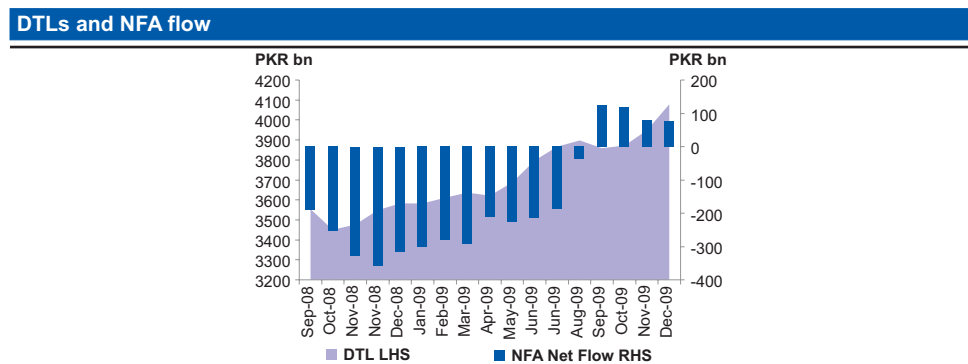
Exchange rate parity presents the greatest challenge moving forward in the wake of mounting external debt payouts, lower export receipts and limited external financing sources. By Nov10 we should expect healthy inflows from the IMF, ADB, World Bank and Tokyo related funds. However generous cash injections aside, domestic net income generation and lower net capital outflows will be the only route to PKR stability. Given the dependence on external financing is set to remain on a high note in the next few years, we believe average depreciation between FY10-12 will likely average around 6% YoY before stabilizing in line with net income growth to the 2-3% range again.

Ergo...Liquidity

Overall money supply rose by 5.2% to a stock of PKR 5.4tn by 1H FY10 compared to a marginal decline in the same period last year. This pales in comparison to the CY08 5yr CAGR of above 18%. The years of aggressive monetary expansion and plunging interest rates appear to be over for now. However, M2 growth should remain in the range of 5-7% with stable NFA accumulation and Government Borrowing, while Private Sector Credit is likely to catch up a little later.

Gap between Assets and Deposits narrowing

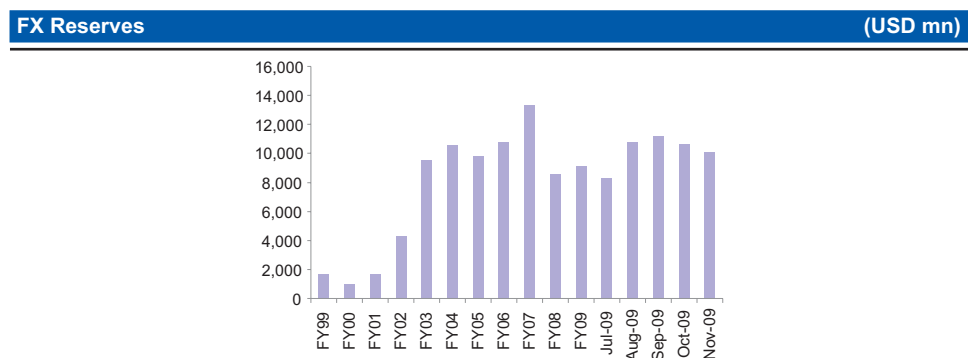
In Dec08 Net Foreign Assets (NFA) outflow amounted to PKR 317bn against a stock of PKR 517bn in Dec08. The deposit base also reflected an outflow of over PKR 125bn against a stock of DTLs amounting to PKR 3.98tn. In lieu of the recent structural adjustment, policymakers have managed to minimize capital outflows, increase the DTLs base by nearly PKR 100bn and even boost Private Sector Credit albeit marginally by 2.2%. With the gap between assets and deposits/reserves narrowing, chances of a future liquidity crunch have been largely neutralized. However, sustainability of this scenario will require robust fiscal and monetary policy coordination in the future.



Source: SBP

Foreign Reserves bump up past USD 14bn

At the same time last year SBP's Foreign Reserves stood at roughly USD 9bn already cushioned by the IMF's 1st tranche of more than USD 2bn. We do expect foreign reserve depletion in 3Q FY10 on account of a rebound in import values and scheduled debt payments. However, if all goes well in 4Q FY10, we expect further IMF tranches (remaining balance of another USD 5bn) and the reduced Tokyo related funds of USD 1.6bn to keep reserves at USD 14bn by Jun10.

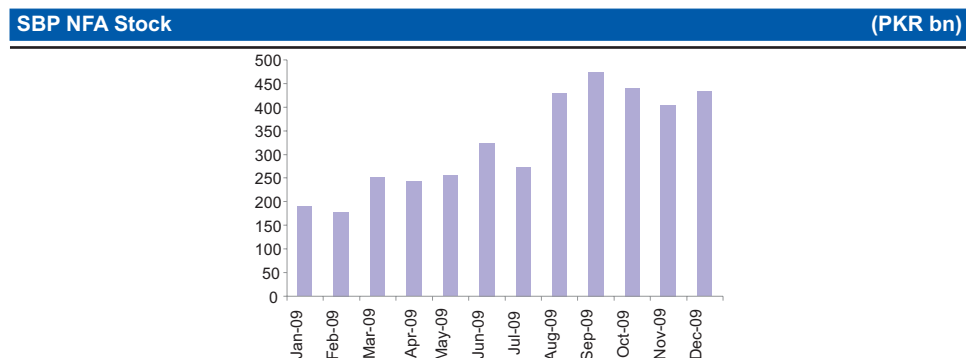


Source: SBP

Stable NFA position and a very active SBP

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 FY09 and FY10, the SBP injected PKR 136.6bn and PKR 293.8bn into the MM via OMOs; this is tremendous compared to net amounts less the PKR 20bn in previous years.

Rates also remained largely stable with benchmark 6M KIBOR averaging 12.6% during the quarter as expected. By Dec 19'09 overall monetary aggregates suggest 4.7% broad money growth largely on account of a net inflow of PKR 56.2bn versus a net outflow of PKR 331.9bn from the country's Net Foreign Assets in the corresponding period last year. Remittances, external financing and foreign investment flows have all been strong contributors to the strengthened foreign currency position.



Source: SBP

Heavy Auction target but rates should stay stable

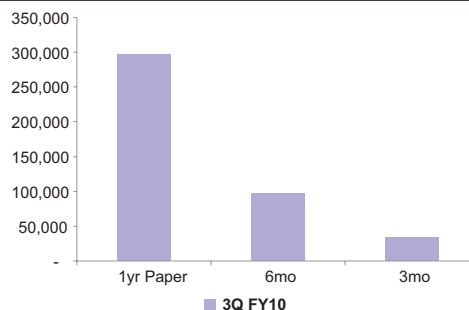
According to the preannounced auction schedule, the MoF will raise PKR 430bn in short term paper with a total of 6 auctions for 3Q FY10. Auctions are in line with maturities in the range of PKR 400bn in 3mo, 6mo and 1yr paper due for the current quarter. Although the auction target is fairly heavy, we don't expect it to rock the rate boat with respect to the SBP's M2 growth trajectory. The tight market liquidity witnessed in 2Q FY10 was largely a function of seasonal factors and weak government security maturities YoY due to limited Auction interest on the part of Commercial Banks in the same quarter last year. 3Q FY10 is likely to witness loosening of market liquidity, and nearly PKR 300bn in 1yr paper is expected to mature during that period.

6M KIBOR to average 12.20% in FY10

With current 6M KIBOR in the 12.40% range and another rate cut of 50bps on the cards by Mar10, 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) deteriorating political variables which could trigger a confidence deficit and v) 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.

T bill Maturities

(PKR mn)



Source: IGI MM Desk

Consumers and Companies are back in the ball game

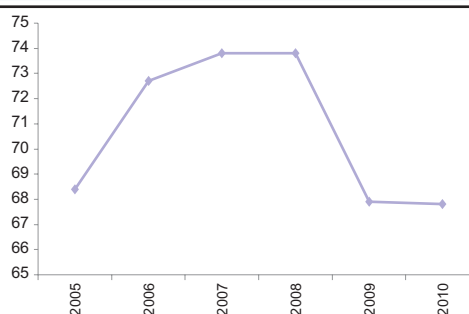
As price stability and rate easing boosts consumption and balance sheet health, we expect retail investors, institutions and corporates to churn a sustainable pool of funds through the capital market. Asset prices have rebounded significantly since Jan09 with the KSE 100 index returning investors 104% YTD from trough. At the same time last year market players were deleveraging their portfolios and conserving cash. In CY10 however they are likely to take advantage of the improving valuations on bonds and equities and buoy the KSE 100 in the 9,800 point range.

Financial Intermediaries will loosen noose on credit channel

We believe the ease off in rates will motivate financial intermediaries to loosen credit channels and shift their Asset allocation towards Advances in 2010. The high cost of funding due to rates peaking in FY09 will motivate Banks, DFIs and NBFCs to build their high yield Advances' books; especially in view of minimized default risk and improved borrower capacity. The telling ADR ratio of the banking system, currently at 64%, reflects a narrowing of the gap between assets and deposits/reserves in FY10. This is similar to the economy's monetary asset profile which reflects a stabilization of the gap between asset creation and reserve accumulation.

Commercial Banks ADR

(%)



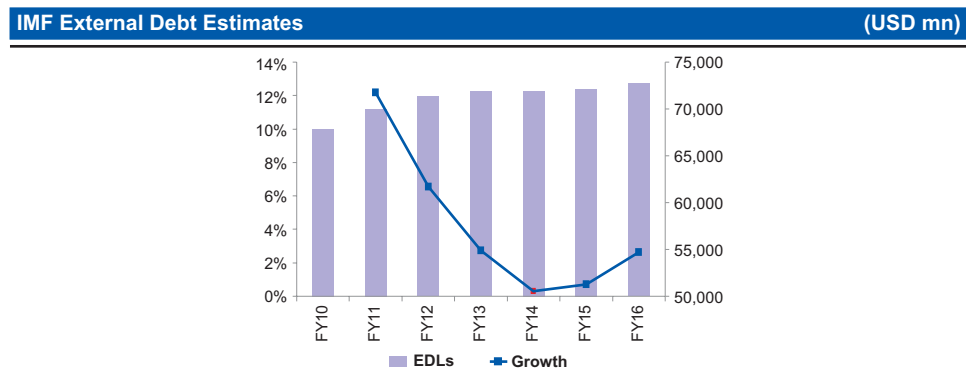
Source: Statical Bulletin Jan10

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 deficit breached IMF expectations of a deficit contraction target to 4.3% by 90bps or 5.2 % of GDP. Similarly in 1Q FY10 the deficit soared to an annualized 6% of GDP suggesting fiscal policy makers are fast running out of resources with respect to their spending needs. Monetary policy makers have lately suggested legislative action be taken to demarcate a ceiling on Government Borrowing from the SBP, via the Federal Debt Limitation Act 2005. This makes sense given the dilution of monetary policy by imprudent government budgetary financing. If fiscal policy makers continue to overshoot targets the monetary easing is likely to come to a halt. Excessive Government Borrowing could lead to a breach of the SBP's NDA ceiling prescribed by the IMF. Naturally consequences of a rate hike in this environment would be extremely negative for the broad economy and constrain the pace of recovery.

External Debt Overhang will delay recovery in the medium term

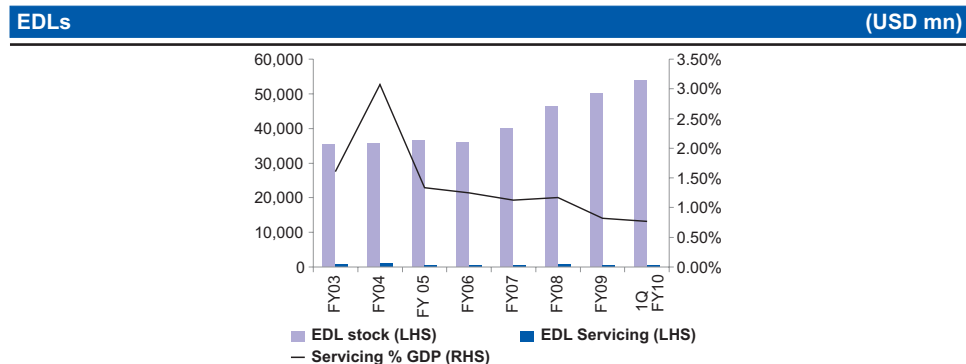
External Debt has more than doubled to reach PKR 4.6tn by 1Q FY10 over FY06. EDL Servicing also more than doubled in 3yrs, particularly in view of the excessive depreciation to PKR 354bn by FY09. The capital outflow associated with mounting external debt will continue to have a negative impact on the 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 unable 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.



Source: SBP

Higher rates expected on future debt issuance in international markets

Those Governments whose fiscal resource mobilization remains weak generally have to pay high rates on short term debt. Pakistan's is no exception, therefore we stand with significant short term debt necessitating frequent capital outflows. The maturing 5yr Sukuk Bond due for Jan10 will drain USD 600mn from our foreign reserves. However, this is being followed up by plans to issue another USD 500mn Eurobond in Mar10. Rates, however, are unlikely to replicate the very attractive yields of 6.75%-7.25% on the 10yr and 30yr Eurbonds issued in CY06.



Source: SBP

Policy makers will have to make prudent use of cash injections

A year after the financial crisis, it appears key market drivers including macro-stability, liquidity and regulatory reform are back on track. Investors who stood their ground in Jan09, were rewarded with attractive gains by Jan10. However, Pakistan's economy remains fragile, especially with respect to unrealized and tricky political variables which may ultimately affect liquidity, trigger policy errors and disturb macro-stability. In retrospect Pakistan's policymakers have acted decisively and courageously, they fought for and won much needed external financing, adopted painful economic measures and stabilized the economy. However, brave policymaking is still required to sustain this achievement.

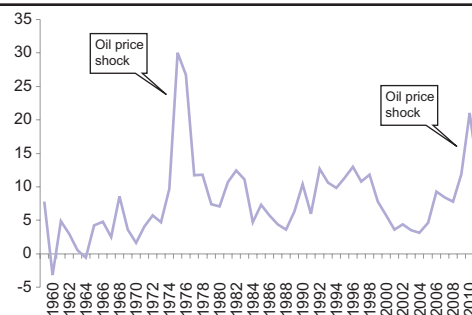
I say Contango, You say Contango

Domestic inflation appears to be cooling in line with global inflation trends and the SBP's tight monetary policy. The bottom line: its a give and take: you *need* money to *get* inflation. A combination of higher rates, inflation, unfavorable exchange rates, and thinning external receipts, all served to narrow the output gap, restrict credit channels, reduce aggregate demand and shrink overall Money Supply. Using Broad Money growth as an anchor for future price stability and reflective of monetary policy actions, we can expect inflation to remain stable in lieu of 5-7% M2 growth in FY10.

Global Financial Intermediaries will be lending again

Although the inflation risk is relatively muted in CY10, once financial intermediaries start lending again across the globe, inflation risk will reappear. Pakistan, a net importer of most essentials has always been exposed to exogenous price shocks and until policymakers devise a mechanism to minimize the impact of this systemic risk, we will continue to face the consequences of our Output Gap.

Long Term Inflation in Pakistan (%)



Source: SBP

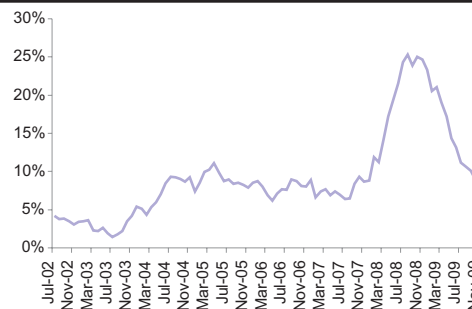
Contango Commodities

Essentially commodity prices will reflect contango, or upward sloping forward curve such as the normal yield curve. This will be derived from normalizing global liquidity and demand in the medium term. One short term exception to the global meltdown has been the Chinese Dragon and the Indian Tiger. Aggregate demand from these Goliath's may give impetus to the commodity engine sooner than expected.

Tamer Inflation in FY10

In Dec09 CPI Headline is likely to tip upward closer to the 11.55% level as the high base effect of Oct09 index levels comes off. MoM inflation has been averaging 1.2% since Jul09 and YoY CPI bottomed out to 8.9% earlier this quarter. However, the MoM impact is likely to be more robust in 2H FY10; as the lagged impact of higher oil prices and reduction in power subsidies comes into play we could see average MoM CPI inflation soar to 1.5% and YoY CPI peak at 14% in Jun10.

YoY CPI Inflation

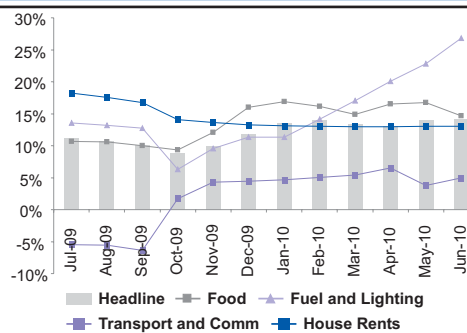


Source: SBP

Subsidy removal: relative consumer baskets will soar

YoY numbers indicate Transport & Communication index has been posting an average deflation of nearly 6% since Jul09, however in Nov09 the trajectory reversed, posting a 4% rise in prices compared to the same month last year. As fuel price subsidies were already removed in FY09 and we expect oil to average USD 75/bbl for FY10 we don't think a dramatic uptick in the Transport & Communication index is imminent. Conversely the Fuel & Lighting basket has been rising at an average 13% since Jul09 and YoY contracted to just 5% over Nov08 index levels. With the recent power price hikes, however, we expect acceleration in Dec09 to 11% and a 2H FY10 average of 19% for this component of CPI.

Inflation Estimates FY10

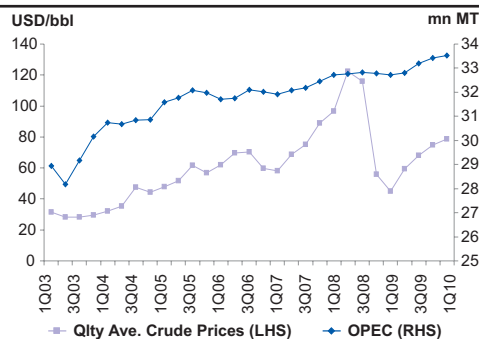


Source: IGI Research

Commodities make a strong start in 2010

Last Sep08 we saw significant pressure on global commodity prices alleviated in the wake of the rapid demand deceleration, global de-leveraging and recession expectations for the US and Eurozone. In Feb09 Crudes had hit rock bottom and begun their rebound. Fast forward Jan10 and we have seen across the board Crude Oil prices soar by nearly 20% over Sep09 levels alone.

Inventories and Crude Prices



Source: E/A US Dept. of Energy

Status Quo on Supply

Crude oil production from OPEC has maintained its steady pace of increase with OPEC even announcing a marginal decrease in production in line with the plunge in Crude prices to the USD 45/bbl level. A year later, however, Crude prices have rebounded to 81 USD/bbl where as supply fundamentals have remained unchanged. The spread between prices and inventories suggests another global liquidity surge will trigger contango and oil prices could even hover above USD 85/bbl in 1H FY11.

Oil import basket to cost USD 10-11bn

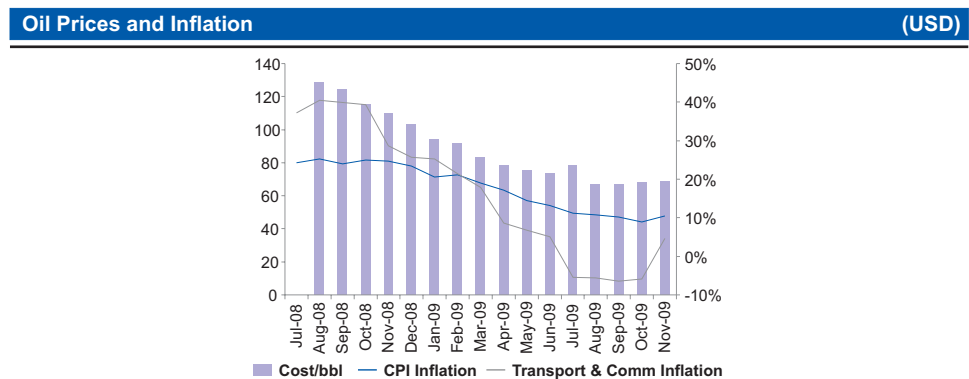
In Aug08 the country was importing oil products at an average 130/bbl; a year on FY to date average prices have stabilized to just under USD 70/bbl. Moving forward, we expect petroleum product imports to accumulate to approximately 18mn MT, with an an import value of USD 10bn. This is incorporating an increase in the FY to date average imported oil price to approximately USD 75/bbl. If oil prices continue to soar to an average USD 85/bbl in 4Q FY10, we can expect oil import values to rise to USD 11bn in FY10.

FY10 impact on inflation appears muted

We have assumed an average 6% Transport & Communication index inflation rate for FY10, given crude oil prices have averaged USD 80/bbl in the last 3yrs on QoQ basis. This incorporates the spike to above USD 120/bbl in CY08 and depression to USD 45/bbl in CY09. In terms of oil import values however the cost has only recently dipped below USD 70/bbl due to the lag between global spot prices and forward contracts. It is expected to average USD 65/bbl in 2Q FY10 and then rebound above USD 70/bbl in 3Q FY10 still providing an average cost of crude imports of USD 75/bbl.

US, War on Terror, Israel, Iraq, Iran

Volatile geopolitics is presently the only push we see for oil prices in the short term, as inventories remain stable and chances of a liquidity push towards another commodity bubble are slim. Suggestions that China, India and Australia may even tighten market rates in CY10, indicate policymakers remain wary of a liquidity bubble despite 'reflation' targets and are taking steps to avoid the same.



Source: SBP, FBS & IGI Research

Trade deficit to shrink to USD 15bn range

1H FY10 trade deficit stood at USD 6.8bn a 29% decrease from the same period last year. Detailed figures for the previous 5mo FY10 indicate 23% decline in imports which reflects lower import values and import demand. However 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 30% value compression.

Bleak House

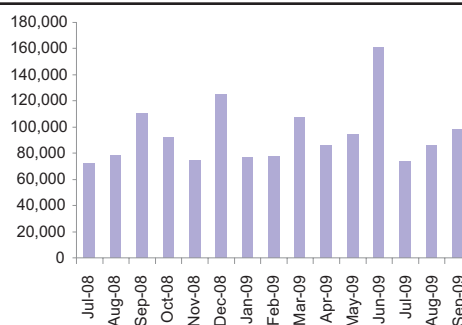
FY10 Fiscal Operations reflect a similarly worrying trend as FY09 with the Budget Deficit soaring to PKR 223bn or 1.5% of GDP in 1Q FY10. This is against an IMF ceiling of PKR 194bn for quarter ending Sep09 and reflects an annualized 6% of GDP compared to the IMF target of 4.6% (including project grants and aid). During the previous fiscal year revised Budget Deficit also overshot the IMF target of 4.3% to reach 5.2% of GDP. Key drivers of the current slippage remain the usual suspects; a surge in Development Spending and Domestic Debt Servicing. However the government has indicated seasonal factors, advances salaries on account of the Eid Holidays, extensions on advance tax payments to 2Q FY10 and higher security spending were to blame.

Revenues buoyed by Non-Tax Receipts

Total Revenues rose at a much slower pace of just 11% compared to 1Q FY09, whereas in the corresponding period last year the Revenue base increased by 23%. Although seasonal factors are at play we expect 10-12% growth in tax receipts during FY10. Tax Revenues rose by 8% to PKR 298.7bn while Non-Tax receipts surged dramatically to PKR 128.4bn for 1Q FY10 over the corresponding period last year. Although Sep09 figures are a little more encouraging at above PKR 98bn the obvious outcome of slow output recovery will be a compressed tax base.

FBR Tax Collection

(PKR mn)



Source: FBS

The key components of the Tax Base remained mostly flat with shrinkage in Direct Taxes by 6% to PKR 84bn, and a mild increase in Sales Tax and Taxes on Goods & Services by 5% and 7% to PKR 117bn and PKR 146bn respectively. Receipts from International Trade took a hit in line with import shrinkage and are likely to remain muted in FY10.

Non-Tax base cushioned by SBP profits

The largest component of the Non-Tax bracket was profits from the SBP, amounting to PKR 70bn in this quarter alone compared to just PKR 28bn in the same period last year. While the Petroleum Development Levy surged by 7x to 112bn during FY09 it was a no-show in FY10 as the government recently replaced it with the Petroleum Levy now classified as a component of 'Other Taxes'. This component alone is likely to garner PKR 120bn in support for the fiscal revenue base in FY10.

Expenditure outpacing Revenue growth

During 1Q FY10, overall expenditures rose by 24% while Revenues were laggard at just 11% growth. Higher than expected interest payments which soared by 23% to over PKR 140bn and Development Spending, which also exceeded expectations to rise by nearly 2x to PKR 115bn, were the key culprits. As interest rates come off in FY10 we should see the rate hangover on domestic debt recede somewhat, although this could be offset by the volumetric increase in government borrowing demand particularly from external sources.

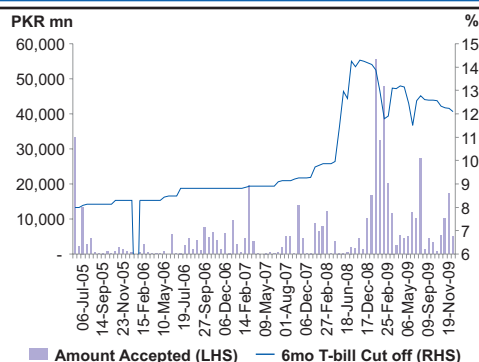
Tax to GDP ratio still in the doldrums

During FY09 Tax Revenues slid in line with GDP growth to a recent low of 9.2% of GDP, far below regional peers in the range of 13-17%. The Fiscal Deficit remains endangered by weak fiscal resource mobilization and is a major concern for the IMF. At present annualized figures suggest the Tax-GDP ratio could sink as low as 8% in FY10 which necessitates a faster pace of regulatory reform towards rejuvenation of the tax base. The introduction of VAT earmarked for Jul10 and legislative confirmation by Apr10 will be a crucial development in the tax framework and IMF Staff are likely to view this as a positive for revenue mobilization.

Financing the Fiscal Deficit

During the current quarter the Budget Deficit was largely financed via domestic resources; 34% of the deficit was financed through External Resources while 66% was financed by from the Domestic Bank and Non-Bank sources. External Financing support has increased dramatically as a proportion of total fiscal resource mobilization to over 30% compared to 19% in FY09. This is likely to provide a substantial cushion to Fiscal Operations in FY10, as the IMF has committed USD 715mn in 1Q FY10 and USD 357mn before Dec09 for Budgetary support.

6mo T-bill Cut off and Volume



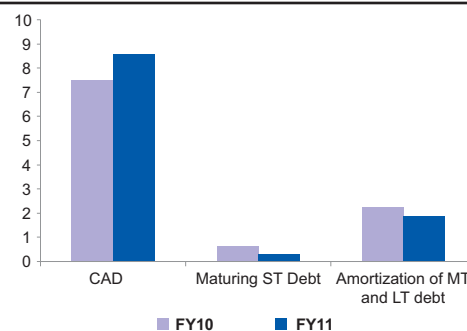
Source: SBP

External financing requirements to rise as mounting debt payments begin to pinch

Delays and downward adjustments in receivables from Tokyo pledges will be a cause for concern and increase pressure on domestic borrowing and the IMF in 4Q FY10. The Minimum External Financing Requirements range near USD 11bn a year for the next 2 fiscal periods with IMF and Friends of Pakistan presenting key support lines. Estimated receipts from Friends of Pakistan have already been knocked down to USD 1.6bn from USD 2.2bn earlier in FY10. Pakistan will also begin repaying the IMF substantial amounts which will inflate to SDR 1.46bn in 2012 and SDR 1.8bn in 2013. SDRs are the IMF currency representing a basket of major currencies and range closely with the USD.

External Financing Requirements

(USD bn)



Source: SBP, MoF

Circular Debt remains to be resolved

In FY10 the government issued a TFC worth PKR 85bn and plans to resolve the liquidity constraint with regards to the remaining stock of PKR 216bn by Mar10. Recourse to financing remains limited and with the shaving off of expected inflows from Tokyo-related donors borrowing pressure could build on domestic base very quickly. The added burden of over PKR 200bn in remaining circular debt does little to lift our sentiments regarding the governments Debt Management strategy. The lack of a legislative amendment barring an increase in government borrowing direct from the SBP, also threatens to result in a situation where the SBP's NDA ceiling may again be breached in FY10.

Betting on Tokyo

The reliance of fiscal spending on Tokyo funds and the subsequent ontake of budgetary financing from the IMF against these loans presents a major challenge in FY10. According to Jun10 IMF projections the country was to receive USD 2.2bn from Tokyo related disbursements. This does not seem to have materialized and news reports suggest the amount has been knocked down to USD 1.6bn for FY10. The subsequent spending pressure could present upward pressure on T-bill yields.

Milestones ahead

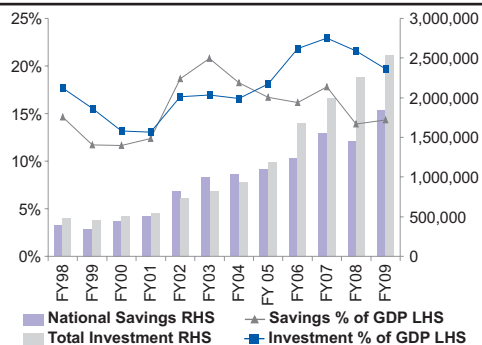
Structural conditionalities placed by the IMF on Pakistan have included removal of fuel and power subsidies and eliminating circular debt. Although the latter has been met both have faced delays which don't bode well for the IMF-Pakistan relationship. Moving forward the IMF expects Pakistan to establish an expedited tax refund system to ensure prompt procession and a full implementation of VAT. The returns from a VAT imposition would do little for the government's fiscal position in FY10, however it will lift the collection base significantly in FY11.

Output Anemia

Monetary policy transmission has effectively stabilized inflation and exchange rates, albeit the fall out on consumption and GDP has been negative. The bottom line: monetary policy has a longer term impact on price stability but a fleeting impact on output. Low rates and expansionary monetary policy of the last decade boosted consumption spending but it failed to close the Output Gap. Unless we close the Savings-Investment Gap we will unfortunately continue to be exposed to economic instability.

Savings and Investment Gap

(PKR)

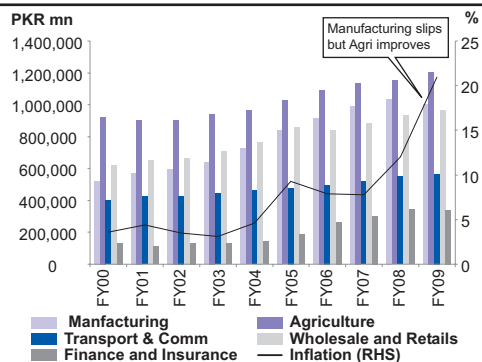


Source: SBP

Flat LSM

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.

GDP Components and Inflation

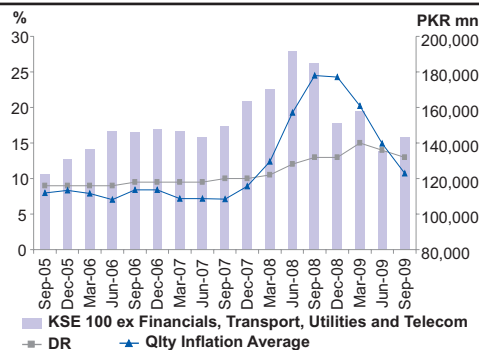


Source: Economic Survey FBS

Oct09 LSM Index numbers reflect base shrinkage

Indicators which adequately reflect a domestic product picture include Large Scale Manufacturing and Net Earnings of the Listed Universe. According to Oct09 data OCAC (Oil Companies Advisory Committee) 4mo FY10 production indicates almost 12% decline over the corresponding period last year. However Ministry of Industries which records broad based production indicates the base remains flat YoY with major declines from Steel, Iron, Auto Sector, Jute, Sacking, Cotton Cloth and Sugar Output.

Listed Manufacturing Base and input prices



Source: SBP, Company Reports & IGI Research

Private Sector Credit and Borrower activity

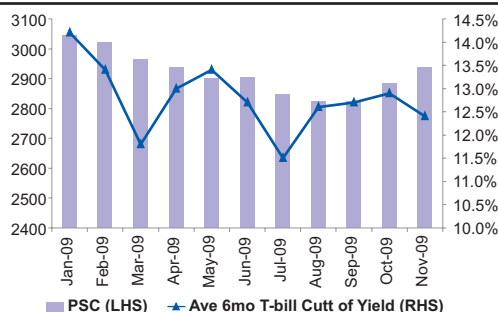
Keeping in mind the presence of the informal sector and limited advances penetration, investor dependence on financial intermediaries to grow is still high. Private Sector credit has remained choked during much of FY09 and FY10 and banks still remain risk averse on account of large NPLs and default risk in the high interest rate-high inflation environment. Despite concerns about the fragility of the recent stabilization, we expect financial intermediaries to take advantage of the lower interest rate, inflation risk and release credit channels by 3Q FY10.

NPLs could keep banks risk averse

A major reason for this would be the shift in Banks' Asset Books from Investments back to Advances as 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 11% in the corresponding period last year while coverage of NPLs or Provisions to NPLs stands at 70%

PSC & Tbill Cut offs

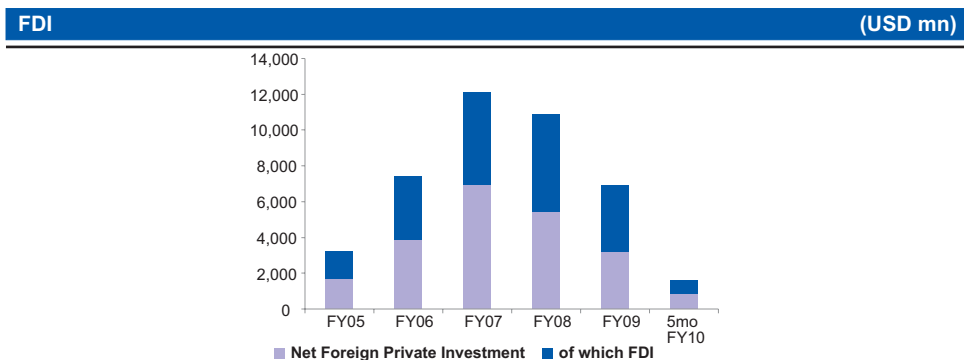
(PKR bn)



Source: SBP

Externally financed Investment spending on the decline

5mo FY10 FDI inflows have been very weak with the key recipients, Telecom and Banking, seeing little impetus. Meanwhile Oil & Gas has taken the lead amongst economic segments receiving foreign investment, with USD 207mn during the period. Overall Investment amounted to less than USD 800mn in FY10 to date with no inflow of privatization receipts suggesting the year end figure could be as low as USD 2bn.



Source: SBP

FY10 Growth to roll in at 3%

Given current trends we expect the Manufacturing base to present the greatest weight on National Income, remaining largely flat in FY10. Meanwhile Agriculture is likely to post a growth rate of 4-5% in FY10 while Services growth should sustain at 4%. The overall GDP growth rate is likely to remain at 3% in FY10 and following that 4% in FY11.

Oh (Big) Brother

In the very recent past Pakistan's prospects were looking very bright on account of its very obvious advantage as a key player in the war against terror. An alliance with the US, long-standing relationship with China and improving relations with India contributed to the image of a more credible, reliable and liberal Pakistan all of which initiated a new wave of investment and growth.

Fast forward to CY10 and the regional and domestic political landscape has altered dramatically. Friction between Pakistan's leadership and Opposition has re-emerged while the insurgency in Pakistan's Northwest rages on. This poses continuous security challenges to the country's urban infrastructure, manifested in the rapid increase in attacks on government and security services and civilian targets in the last year.

Political Fault-lines

This time last year we had termed CY09 to be *The Year of the Terror Trap (IGI Finex Securities "Economics and Strategy" It's a Wrap Dec08)* and so it became. By summer Swat was fought and won and by fall the Waziristan wildcard emerged. This posed continuous security challenges to the country's urban infrastructure, manifested in the rapid increase in attacks on government and security services and civilian targets. In the backdrop of the bigger picture, domestic politics took center stage with the Long March, restoration of the Judiciary and the key milestone of the year; the shelving of the NRO.

When push came to shove...

Foreign policy hitches are expected and opposition to Pakistan's relationship with the US from the diverse social and political fabric of the country will emerge. The fallout of the new emphasis on performance criteria will be hardest on the fledgling Pakistani democracy. Sustained opposition could exacerbate domestic instability and political infighting and consequently cracks in the coalition government. If the PPP led coalition were to fall apart and lose control of the political steering wheel, reform agendas whether in political, economic or legislative spheres, will be put on hold, endangering future stability.

Put on your party hats

In recent weeks, the Pakistani leadership has found itself cornered; on the one hand Opposition party leaders have come out with strong statements questioning the credibility of beneficiaries of the NRO including the President of Pakistan Mr. Zardari. Terming the only threat to democracy in Pakistan being the 'undemocratic' attitude of the PPP, Mr. Sharif has upped the ante by suggesting the 'vehicle of democracy could come to a halt'.

Democratic discord

These statements are not just inflammatory but reveal the underbelly of deep discord and discontent amongst political stakeholders. High on the agenda for the PML-N is calling on President Zardari to relinquish powers granted to him via the 17th amendment to the constitution, which allow the President to dissolve Parliament and dismiss the Prime Minister. However on a recent visit to the Southern Provinces Mr. Sharif adopted a more conciliatory approach while still calling for the Charter of Democracy to be implemented; going so far as to say he would not abandon Mr. Zardari even if his own party disowned him.

Where the Army stands

Pakistan's political landscape cannot be complete without its Army and it appears this arm of the Federal structure is keeping mum these days. However tensions are brewing between the democratic framework and the military, visible in its scathing condemnation of the terms and conditions of the Kerry-Lugar Bill earlier this year. Although chances of a military intervention are very slim given the recent exit of President Musharraf, the Army will remain a key source of support to any democratic regime moving forward. Therefore the PPP is unlikely to forfeit the military's support as its political future unfolds.

Political pressures have resulted in reform lags

The emerging political fracas could destabilize the economy, efforts against the insurgency and Pakistan's relationship with the US. Key to the outcome will be President Zardari's handling of the issue, as political constraints have been a largely personalized matter with the focus being on the President himself. We believe President Zardari is likely to remain calm and collected during the next few weeks as he reserves the right to immunity under Article 248(2) of the Constitution. However a key risk to this scenario is an aggressive response from the PPP to fend off mounting criticism from the Opposition. This could lead to a pre Long March style political standoff with the PML-N, however with a weakened PPP in the ring.

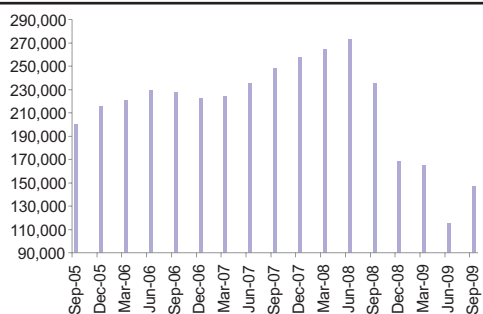
Bubble Bath

Going forward, with most macro-economic, regulatory and liquidity risks minimized in FY10, the market is expected to inch towards our Jun10 target of 11,000 points. The fine print, however, tells us asset prices could remain encumbered by economic fragility and a confidence deficit. Sluggish external financing and weak export and investment receipts are also likely to create currency jitters and therefore cautious market behavior from participants. So Yes; CY10 may prove to be the flattest year the KSE 100 has seen since CY06. QoQ Dec09 ended practically flat in terms of returns not only over the previous quarter of Sep09 at 9,700 points but also over the same period last year in mid Dec08 before the zero % lock on the KSE 100 was removed.

Will Earnings Matter?

The simple answer to this query is that a policy induced reduction in the nominal interest rate will boost both valuations and ultimately trigger an expansion of net income which will sustain consumption of these same assets. So Yes; earnings will proportionately improve as interest rates come off; providing other factors such as input prices, exchange rates and wage inflation do not negate the positives. We expect the SBP to shed a further 50bps off the policy rate by Jun10; however the impact of a rate cut on net earnings is likely to be sector and stock specific. Infact by Dec10 Net LTM earnings should remain largely flat YoY, due to a lower topline for some sectors such as E&P due to lower oil prices and a better than expected results for cyclicals such as Banks.

Net LTM Earnings KSE 100 (PKR mn)



Source: SBP

Blu-Rays

We recommend investors adopt a cautious approach to the equity market with broad spectrum stock picks, clear entry and exit points, high dividend yields and fundamentally strong earnings expectations. Our top sector picks including UBL, NBP, HUBC, PPL, ENGRO, FFC, POL, LUCK and PSO with clear price objectives that could translate into year-end Total Stock Returns (TSRs) returns of 25-30%. Based on our estimates, IGI universe companies are all set to show an earnings growth in the vicinity of 10% YoY for FY10. This comes on the back of a 7% YoY earnings decline experienced during FY09. At current levels, our coverage universe is currently yielding 5.6% taking the total return in the range of 15%.

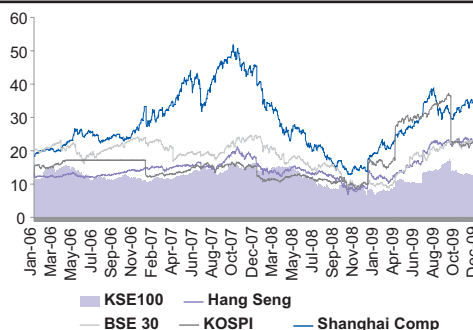
The Budget tells all

A major development in FY11's Federal Budget will be the decision on Capital Gains Tax which has been waived till 2010. This could be a major short term negative trigger for the equity market following the Mar10 earnings season as Budget speculation builds up. In the longer term however we believe CGT will add value to financial market transparency and reform while limiting index volatility. It was earlier suggested that Pakistan adopt a pattern similar to that of India which as of 2008, waived taxes on long term capital (holding period is one year or more). However short term capital gain from equities held for less than one year, is taxed at 15% plus surcharges. In this case investors may be motivated to hold on to equities for a longer period of time; consequently index stability and price discovery is more likely to be achieved as longer term investors sustain the market.

The global investor in 2010

On the back of global central bank's reflation policies, global capital markets also rebounded to safe territory. However most global economies particularly the less developed ones in Latin America, Asia, Eastern Europe and the Eurozone all remain fragile. The fear remains that equity markets may have recovered on another liquidity spiral which will lead to an unmanageable asset bubble. Most market P/E's do suggest market recoveries were rapid, however it would be safe to say that most investors remain cautious and are watching valuations closely. The KSE 100's own trailing P/E has rebounded to 13x after dipping as low as 7x in FY09, meanwhile China, India, Hong Kong and Korea have roared ahead to a range of 37-23x earnings.

Regional PEs



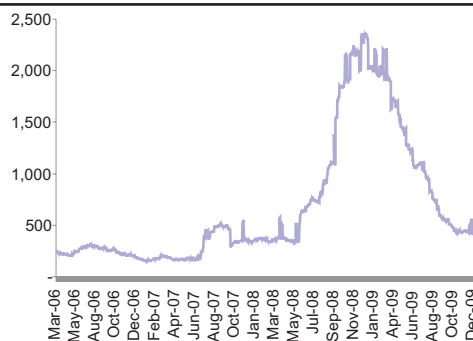
Source: Bloomberg

Plugging the investor confidence gap

In CY09 Pakistan suffered the most rapid decline in outlook in a decade; its S&P peer group changed from Indonesia to Lebanon while its ratings declined to CCC/Negative/C for both its Foreign Currency Debt and Local Currency denominated debt. With the macro stability, democracy and external financing cushion supporting the country, ratings improved dramatically in less than a year back to the B peer group and reflecting a 'Stable' outlook.

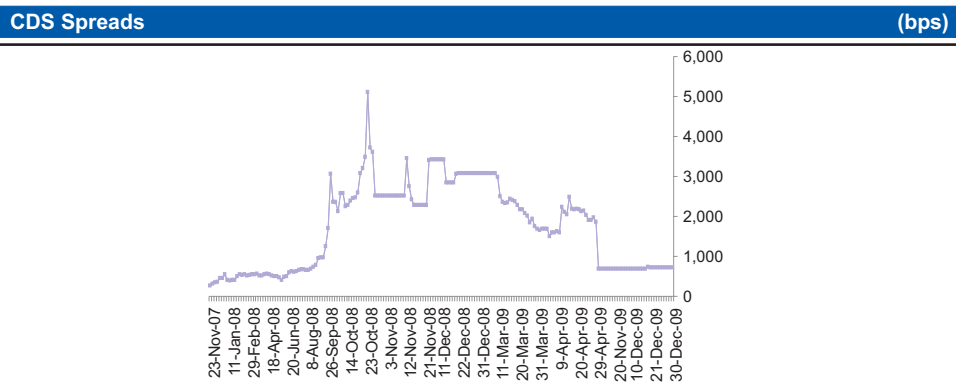
Eurobond Spread

(bps)



Source: Bloomberg

It took much less time and persuasion than expected, for Pakistan to regain its credibility in the global marketplace, although vulnerabilities remain. Improving investor confidence is evident in narrowing spreads on Eurobonds, yields on which shrunk to 11% from 24% earlier. CDS spreads also declined to under 700bps in recent days, compared to over 3,800bps in the same period last year.



Source: Bloomberg

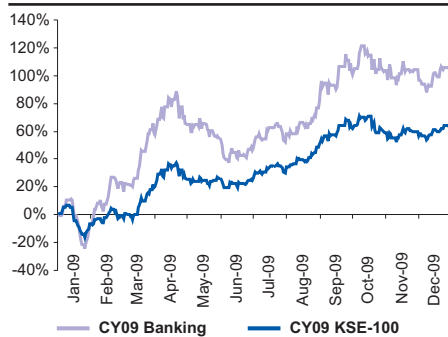
Financial Sector Regulators Dragging their feet

Moving forward we anticipate further financial market reforms to improve liquidity, introduce a leverage product, unplug investment channels and remove systemic risks from the system. Since the financial crisis of 3Q CY08, regulators have not effectively moved to derive mechanisms to improve market efficiencies and account for the costs and culprits of the crisis. Movement on an acceptable leverage instrument and demutualization of the KSE has also lagged due to inconsistencies amongst stakeholders, regulators and risk managers.

Meanwhile volumes remain sullen in the range of 80-100mn compared to CY07 when volumes averaged 350mn shares a day. Market capitalization has almost halved from the KSE Index's heyday of over USD 70bn to just USD 31bn today. Moving forward we believe prudent financial sector reforms could prove a major catalyst to market interest and activity in CY10 and assist in attaining our price objectives for our favorite picks.

Banking Sector

Relative performance: Banking Sector vs. KSE100



Source: Bloomberg & IGI Research

Recent trends support positive outlook for 2010

Pakistan banks reported in-line or above consensus 3Q CY09 earnings. For our coverage banks, in 3Q CY09 the overall profitability rebounded sharply by 26% QoQ underpinned by i) sharp drop in credit provisions 2) positive surprise in NIMs in the quarter under review 3) trading gains from strong capital markets and 4) opex growth under control +2% YoY. Consequently, the average ROE and ROA improved 181bps and 27bps to 17.6% and 1.8% respectively. Within our coverage banks, ABL led the pack with the highest ROE at 29% followed by MCB at 25%.

Asset Quality – Stress seems to be easing off

Recent quarterly data reveals sequential easing in fresh NPL accumulation as growth receded to 4.8% or PKR 9.3bn for our coverage banks compared to average quarterly buildup of 8% QoQ growth or PKR 13bn in the 1Q and 2Q CY09. However, despite slowdown in NPL buildup the NPL/Gross Advances ratio increased on account of seasonal contraction in loans during the 3rd quarter. Total provisions for our coverage banks declined by 38% QoQ while Provisions/Gross Advances ratio eased considerably by 26bps to 0.48%.

NIM surprise on the upside

Last quarter banks saw net interest margins reverse course, expanding by 5bps on average to 6.1%. NIM expansion was mainly a result of funding costs declining faster than asset yields. The drop in funding costs was mainly due to i) downward repricing of term deposits as a result of previous rate cuts and ii) shifting mix towards CASA deposits. Within our coverage banks, ABL and UBL posted the highest improvement in CASA mix at 5.2% and 6.0% respectively while NBP registered a decline of -5.8% in CASA deposits.

Loan growth to pick-up in coming quarters

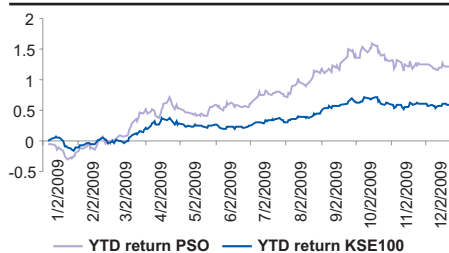
With current focus on economic stabilization rather than growth, fundamental factors are not favorable to a rapid expansion of loan books to historical levels of 20% range. However, a sequential recovery in loan growth is on the cards given i) 4-5% growth in 4Q CY09 inline with seasonal patterns ii) easing interest rates iii) demand from energy sector iv) revival in working capital loans given higher commodity prices and v) higher trade related loans amid global recovery and vi) lower NPLs increasing banks lending appetite. Going forward we expect 10-12% growth in loans in CY10-CY11E.

Sector Stance Neutral – Stock selective approach

The banking sector has more than doubled in YTD CY09 and IGI Universe has rallied 17-118% in absolute terms and has outperformed the benchmark KSE100 index by 47% on average. Our Gordon Growth valuations cost of equity is 18% while sustainable ROE ranges from 13-23%. The implied PB multiples range from 0.4-2.1x. Concerns over asset quality and slowing credit growth are now receding that were a major overhang on bank stocks are now receding as macro/NPL outlook continues to improve. At current levels, our universe trades at average forward PE and PB of 8x and 1.4x respectively and we maintain a neutral stance on the sector. We maintain a neutral stance on MCB, ABL and HBL while a Buy stance on NBP and UBL.

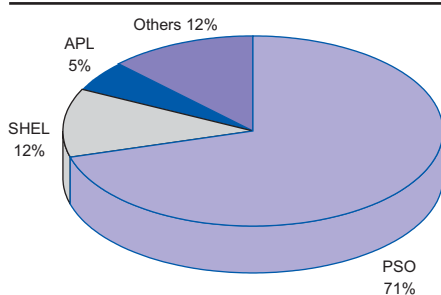
OMC Sector

Relative performance: PSO vs. KSE100



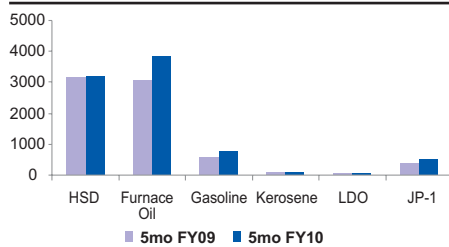
Source: Bloomberg & IGI Research

OMC Marketshare - 5mo FY10



Source: OCAC & IGI Research

5mo YoY POL Growth ('000 MT)



Source: OCAC & IGI Research

FO led volumes driving OMC sales

Furnace oil took the limelight for OMC's after demand driven growth in the power sector saw its volumes grow 25.9% YoY in 5mo FY10 compared to the corresponding period last year. Surge in the power sector demand came on two accounts i) increased load factor of FO based power plants and ii) substitution of dual turbine power plants to FO due to gas shortage. With the power supply deficit gaining much political attention, moving forward, we expect FO off-take in the industry to continue to improve with a 3yr CAGR of 11% from FY09-FY12. With a market share of 89% in FO, we believe PSO will be the prime beneficiary from the power sector's growth. It will benefit from its extensive distribution network and well-established logistics and storage ability to provide uninterrupted supply to the power sector.

HSD rebound up for grabs

After dampened demand in FY09, HSD volumes rebounded in 2Q FY10 as the country's economic recovery began to gain momentum. Continuing into 2H FY10, we expect off-take growth to remain positive yet muffled. Demand for the product, however, will gradually improve in line with the country's real GDP growth rate and we anticipate a 3yr CAGR from FY09-FY12 of 4.3%. Upon revival, HSD demand will provide an additional avenue to OMC's to generate revenue and present a broader base for cash collection. PSO will look to regain its market share in white oil which currently stands at 58.3%. Also, it has pricing power in HSD which ensures the company its due margins as opposed to its competitors which are exposed to higher procurement prices.

Range bound Oil prices to provide earnings certainty

Erratic crude oil prices in FY08 and FY09 introduced much volatility in OMC profitability. Since their stabilization in 2H FY09, crude oil prices have continued to remain range bound and are expected to continue such behavior in the near term. Previously, PSO had been most susceptible to inventory losses because of its massive share in the white oil pipeline. However, the stabilization of crude oil prices would increase certainty in the company's earnings while enabling it gradual accumulation of inventory gains.

Tariff hike to ease liquidity

PSO stood largely at the crux of the circular debt issue as it continued to supply FO to the cash starved power sector after other OMC's shied away. This resulted in piling receivables and surging financial charges for PSO in FY09; up 356% YoY. 2 TFC's later, financial charges continued to remain high at PKR 1.57bn in 1Q FY10. Moving forward, we anticipate an improvement in its liquidity position on account for the 24% power tariff hike. Although we do believe that the partial removal of subsidy will not abolish the circular debt issue completely, it will certainly retard the accumulation of accruals and introduce liquidity into the chain. Also, we believe that after the tariff hikes implementation in April, we will see a lagged impact of it on PSO towards the end of FY10. Financial charges, hence, would remain high at PKR 4.5bn with the company managing a TIE of 3.7x.

Pricing revision to create uncertainty

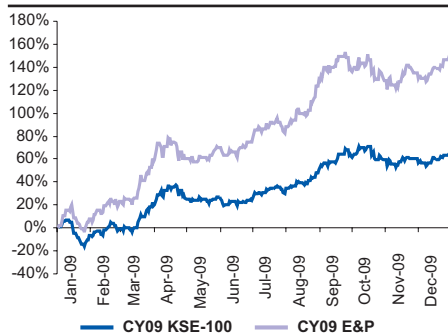
Recent reports have indicated that a revision of downstream pricing maybe on the cards. According to the proposition, distribution margins will be a fixed per liter margin capped at the current level. With crude oil prices expected to increase in the long run in line with the global economic recovery, OMC's will be forgoing possibly higher distribution margins. However, ambiguity remains over the proposed changes and its impact will become clearer after a final decision arrives from the apex court where they will be presented in the third week of Jan'10.

Outlook

Amongst the OMC sector, we like PSO because of its ability to capitalize on future demand growth in the country. At its closing price on Jan 7'10 of PKR 306.93 per share, the stock is trading at FY10 and FY11 PE of 6.73x and 5.06x which is at a significant discount to our estimates for the index at 8.7x. We maintain our BUY call on the scrip with a Jun10 target price of PKR 385 per share.

E&P Sector

Relative performance: E&P Sector vs. KSE100



Source: Bloomberg & IGI Research

Volume delivery finally underway

Volumetric surge, imminent drilling results, rebound in gas prices and the inherent defensive nature of the Exploration and Production stocks underpin our positive stance on Pakistan's E&P sector.

Production commencement from Manzalai is a significant landmark

The much anticipated Central Processing Facility at Manzalai field (TAL block) has finally commenced production from Oct09. The additional flows from the field are expected around 200mmcf of gas and 4,000 bbls of oil. The impact of production from the CPF on oil volumes for POL, PPL and OGDCL is a jump of 23%, 22% and 3% from 1Q FY10 levels. In addition, gas volumes are set to grow by 116%, 6%, and 5.5% for POL, PPL and OGDCL, respectively.

Wellhead gas prices to experience a double digit increase

The wellhead gas price for the E&P companies is revised semiannually. The pricing mechanism of most of the fields is either linked to international HSFO or Arab Light oil prices. With Arab light oil and HSFO prices rebounding by 53% and 62% HoH respectively (Jun-Nov09 period), we are expecting wellhead prices for some fields to be raised as high as 22% HoH. Capped fields' pricing will also see a 3% raise due to the PKR depreciation vis-à-vis the greenback

Debt could be another story for E&Ps during 2010

Pakistan E&P sector is completely deleveraged at the moment. All the E&Ps have been generating sufficient internal funds to cater to their operating and CAPEX requirements. The inter-corporate debt issue, however, has severely impacted the sector's dividend paying capacity and its future capital expenditure program. In particular, we see a very high possibility of OGDCL and PPL seeking external sources of financing to meet their obligations. POL, nonetheless, seems comfortably placed and would have sufficient internally generated funds for its operational and capital expenditure needs.

Drilling results imminent

A number of exploratory wells have entered the drill stem testing phase, with results expected in the imminent future. Of the 14 exploratory wells currently being drilled, 2 wells are undergoing production testing phase - normally the last phase after which the well is either declared dry or considered a discovery.

Positive sector stance; POL and PPL top picks

The Pakistan E&P sector currently trades at FY10 PE and PBV multiples of 9.1x and 2.9x respectively, implying a discount of nearly 40-50% to the regional companies. In addition, based on EV/BOE multiples the local companies are trading at steep discount of above 45% to their regional peers. With earnings and volume improvement on the horizon, we expect these discounts to narrow going forward. Our top picks in the E&P sector are POL and PPL, while we have a neutral stance on OGDCL.

E&P - Sector Snapshot

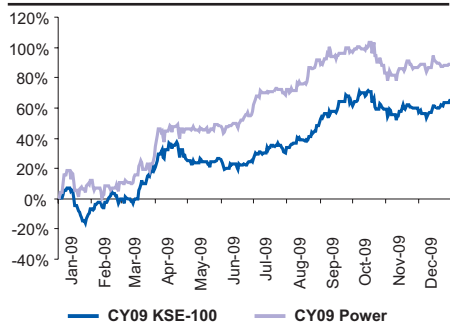
Sector	Target Price - Jun10 PKR/share	Rating	EPS - PKR			DPS - PKR			BVPS - PKR			ROE		
			FY09A	FY10E	FY11E	FY09A	FY10E	FY11E	FY09A	FY10E	FY11E	FY09A	FY10E	FY11E
OGDCL	117	Hold	16.1	15.1	18.1	9.1	7.0	9.8	39	47	55	45%	35%	35%
PPL	233	Buy	12.9	12.1	14.0	8.3	6.0	8.5	29	35	41	47%	37%	37%
POL	276	Buy	27.8	24.5	30.4	10.8	9.8	13.7	63	78	95	52%	35%	35%
			23.8	29.1	38.9	18.0	13.1	17.5	107	123	145	22%	25%	29%

Sector	Free Float	M. Cap (USD mn)	P/E (x)			Div. Yld			P/BV (x)			EV/BOE - USD		
			FY09A	FY10E	FY11E	FY09A	FY10E	FY11E	FY09A	FY10E	FY11E	FY09A	FY10E	FY11E
OGDCL	15%	6,001	8.6	9.1	7.6	6.7%	5.1%	7.2%	3.5	2.9	2.5	2.7	2.8	3.0
PPL	40%	2,352	9.1	9.7	8.4	7.0%	5.1%	7.3%	4.0	3.3	2.9	2.9	3.0	3.1
POL	20%	692	7.1	8.1	6.5	5.5%	4.9%	6.9%	3.1	2.5	2.1	2.1	2.3	2.4
			10.3	8.5	6.3	7.3%	5.3%	7.1%	2.3	2.0	1.7	4.2	4.4	4.6

Source: Company Reports & IGI Research

Power Sector

Relative performance: Power Sector vs. KSE100



Source: Bloomberg & IGI Research

High earnings certainty to provide safety

Earnings in the power sector are characteristic of a defensive investment. Their pricing models are resilient to exogenous economic volatility and provide healthy returns and high earnings certainty. Both our picks from the power sector, HUBC and KAPCO, remain immune to fluctuations in fuel cost and depreciation of PKR against the USD which underpins our liking for the two companies.

Power deficit to provide guaranteed demand

The country's power deficit slipped further in FY09 after demand soared on the back of increased domestic and industrial consumption. At current levels, we face a power shortage of 2,500 – 3,500 MW which presents a long term future for power generation companies. For power sector scrips in the IGI universe this represents guaranteed demand and an opportunity to expand as availed by HUBCO in the form of Laraib Energy, due to come online in CY12.

Sector stands out on dividend play

The power sector has historically been a strong dividend play with dividend yield averaging around 10% in the last three years. In our opinion, the sector will continue to maintain its high dividend payout and we estimate an FY10E dividend yield of 14.78% for our universe. At current levels, the expected yield offers an attractive 264bps spread over 10yr PIB bonds which have already shed nearly 300bps since Jan09 to currently stand at 12.14%. Moreover, in the declining interest rate regime, dividend yield offered by the power sectors coupled with potential capital gains pose an enticing opportunity to investors.

Electricity tariffs to improve liquidity

Liquidity remained scarce in the power sector after power distribution companies failed to pay IPP's for their power purchases. This eventually flowed through the energy chain to become known as circular debt. This resulted in a massive pile up of accruals drying up liquidity pushing financial charges for HUBC and KAPCO up 6.5% and 190% YoY in FY09. However, as per IMF stipulation the government intends to eliminate power subsidies by increasing the power tariff by 24% by April in a three tier program. Although, the hike would not eliminate circular debt completely, we believe it would impede further accumulations in the system and introduce liquidity into the chain. For FY10, we expect HUBC and KAPCO to post a TIE of 3.3x and 4.4x.

HUBCO

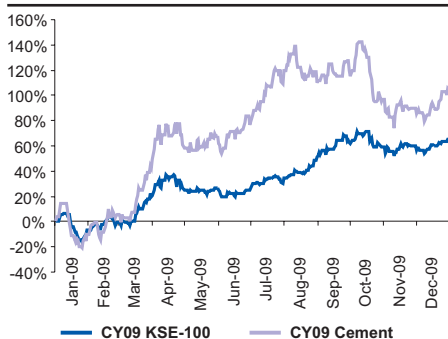
Despite having rallied 126.5% in CY09 and outperforming the benchmark KSE-100 index by 62%, at present levels, we believe there is still 34.3% upside in the scrip vis-à-vis our target price of PKR 43 per share. Further, in our opinion, the stock is trading at cheap multiple based on our forecasted FY10E PE of 7.6x and offers FY10E dividend yield of 12.2%. We re-iterate our BUY stance on the scrip.

KAPCO

We expect company's payout to post a 5yr CAGR of 12% between FY09 to FY14E. At current levels, the stock is trading at 21.6% discount to our PO of PKR 60 per share. Furthermore, the stock offers FY10E dividend yield of 16.5%. We continue to hold a BUY stance on the scrip.

Cement Sector

Relative performance: Cement Sector vs. KSE100



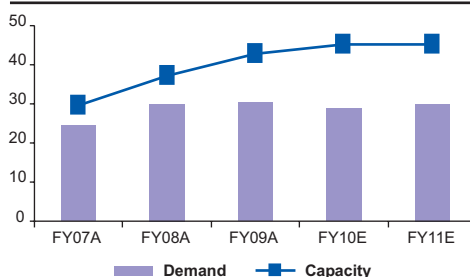
Source: Bloomberg & IGI Research

Volumes expected to decline in FY10

Cement demand witnessed a staggering growth of 24% in FY08; however the growth subsided appreciably in FY09 to 2% mainly due to a 14% decline in local cement dispatches amid severe economic downturn which has had a huge dampening effect on local cement industry. Moving forward, in FY10 we expect local cement demand to increase by 2% fuelled by i) lower cement prices and ii) marginal recovery expected in construction industry. However, during the same period, we expect export to decline by 20% on the back i) reduction in demand in Middle East amid financial crisis and ii) decline in export prices of cement to approx USD 51/tonne, which has made export through the sea an unattractive avenue for plants in the northern region with 80% of country's total capacity.

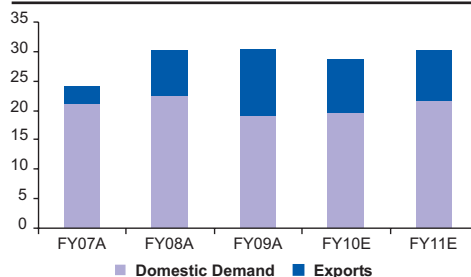
Moreover, we expect the total cement dispatches to decline to 28.66mn MT in FY10 compared 30.54mn MT in the corresponding period last year. The total capacity is expected to increase to 45.2mn MT in FY10 consequently resulting in a drop in capacity utilization to 63.4% in FY10 as against 71% in FY09.

Cement - Demand Supply (mn MT)



Source: APCMA, Company Reports & IGI Research

Cement - Demand Scenario (mn MT)



Source: APCMA, Company Reports & IGI Research

Prices to remain subdued amid failure to reach consensus price agreement

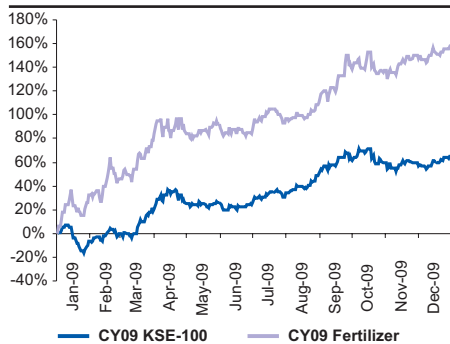
The average cement prices have come down to the level of approximately PKR 267/bag in 2Q FY10 compared PKR 320/bag in 4Q FY09: a decline of 17% resulting from failure to reach consensus price agreement between the stakeholders. The reduction in prices have compressed the margins for the industry and has led to 5 cement plants with a cumulative production capacity of 12mn MT having to suspend their production. Going forward, the prices are expected to remain subdued in 3Q FY10; however, we expect an uptick in cement prices in 4Q FY10 on the back of pick up in construction activity as winter season comes to a close.

Sector Stance - Cautious

The short-term outlook remains subdued for the cement sector owing to i) depressed domestic cement demand amid halted construction as economic downturn continues, ii) decline in regional cement demand on the back of economic meltdown mainly in the Middle East, iii) increased competition as regional capacities come online and ban on Saudi Arabian export is lifted, iv) decreased retention prices for cement; both in the domestic and export market and v) compressions in margins amid rising energy cost. All said, at current levels, we believe that negatives have already been accounted for in the share prices of LUCK and DGKC, and we maintain a BUY stance on both the scrips.

Fertilizer Sector

**Relative performance:
Fertilizer Sector vs. KSE100**



Source: Bloomberg & IGI Research

Macro dynamics – positive

The macro dynamics are playing in positive for the fertilizer sector with improving farmer liquidity amid high crop support prices. Moreover, higher urea availability driven by timely imports, and higher requirements for BT Cotton cultivation have lent further support to fertilizer offtake. Agricultural credit disbursement has registered an increase of 8.66% YoY to PKR 80.95bn in the first five months of FY10. SBP has set a full year target for FY10 at PKR 260bn. Increase in DAP offtakes in CY09 should also result in improved crop yields on the back of balanced fertilizer usage. The demand trajectory for both urea and DAP is expected to continue at 3-4% and Pakistan to remain a urea-deficit country in the long term, with the supply deficit to resurface in CY12 at approximately 480,000 tons. Furthermore, we do not see any imminent risk of gas shortage to the fertilizer sector, with 20yrs of reserve life remaining at Mari Gas Field and further reserves of 1.2tcf at the Mari Deep Field.

DAP prices to remain firm; Urea prices to increase inline with cost

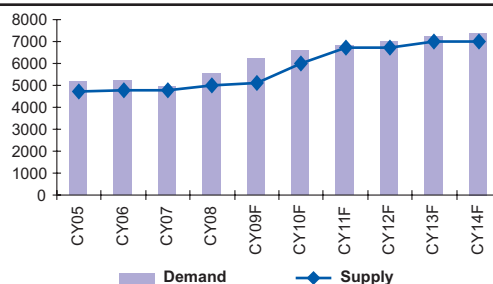
International Urea and DAP prices are likely to remain stable, with some seasonal variations in DAP prices. DAP primary margins are likely to see a slight squeeze in CY10, as raw material prices are expected to increase, while DAP prices remain firm. Local Urea prices are expected to increase in line with inflation and gas prices, as Urea producers are expected to maintain pricing power.

Urea Supply Deficit – here to stay

Indigenous urea production in CY10, expected to come in at 6mn tons, would be 17% higher YoY due to the onset of production from Fatima Fertilizer and ENGRO's new plants. The urea deficit will however persist in CY10, with consumption projected to increase by 3%YoY to 6.6mn tons. All imports (0.4mn tons) would be allocated to NFC.

Urea: Demand & Supply

('000MT)



Source: NFDC & IGI Research

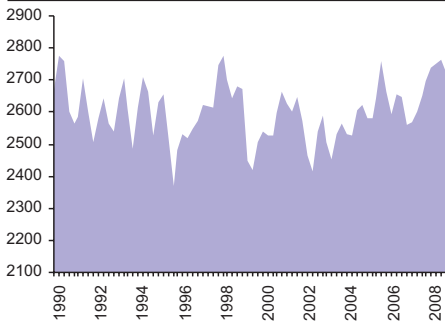
Outlook – positive on Urea producers

Being a pure urea play, FFC is well positioned to be the main beneficiary of strong urea demand through CY10 and beyond. We believe the scrip presents a perfect investment avenue offering a dividend yield of 15-16%. ENGRO has long been regarded a growth stock and we believe long-term growth prospect is intact with urea expansion plans expected to come online by 3Q CY10 and a 217MW power plant to start commercial production by 1Q CY10. The core fertilizer business will benefit from higher GMs in CY10 post-expansion and Engro Foods is expected to turn profitable in CY10, lending further support to bottomline. The momentum in DAP offtakes is expected to break off and FFBL's primary margins may come under pressure as raw material prices increase as previously mentioned. However, news on the front of its associate (PMP) may come in positive.

We remain positive on Urea producers - ENGRO and FFC and advise a cautious stance on FFBL.

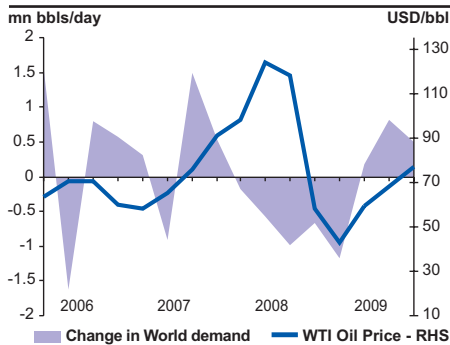
Commodity

OECD End-of-period Commercial Inventory (mn bbls)



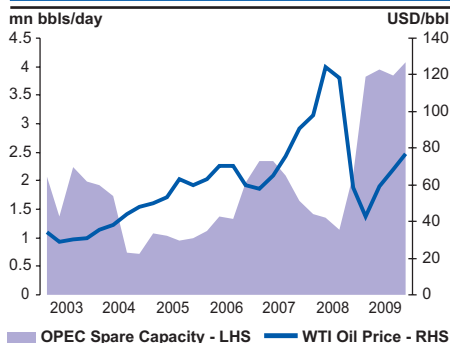
Source: Bloomberg

Change in Oil Consumption vs Oil Prices



Source: Bloomberg

Spare Capacity vs Oil Prices



Source: Bloomberg

Crude Oil price Yo-Yo!

Crude prices have crossed the USD80/bbl mark following a spike in demand for heating fuels in North America. This comes on the back of one of the best year for commodities, with crude prices surging by nearly 140% from their trough. However, the question that arises is whether the trend is sustainable and will oil prices keep climbing toward the USD100/bbl mark.

Turn around in oil consumption pushing oil prices

Oil consumption has always been strongly linked to the pace of economic growth of the developed countries. However, in recent years increase in demand from developing nations particularly China has been attributed to increase in consumption of oil. After oil price's meteoric rise and the subsequent crash in CY08, oil prices have been steadily inching higher during CY09. Oil consumption which had seen 5 successive quarters of negative growth since 1Q CY08 to 1Q CY09, finally turned positive in 2Q CY09. Since then oil demand has increased by a cumulative 1.49mn bbls/day and has taken oil prices with it. This rebound in demand has mainly been set-off by China followed by US and then the rest of the world. The strength of recovery in world's economy as well as oil consumption will continue to be rocky in our opinion.

All time high inventory levels and spare capacities

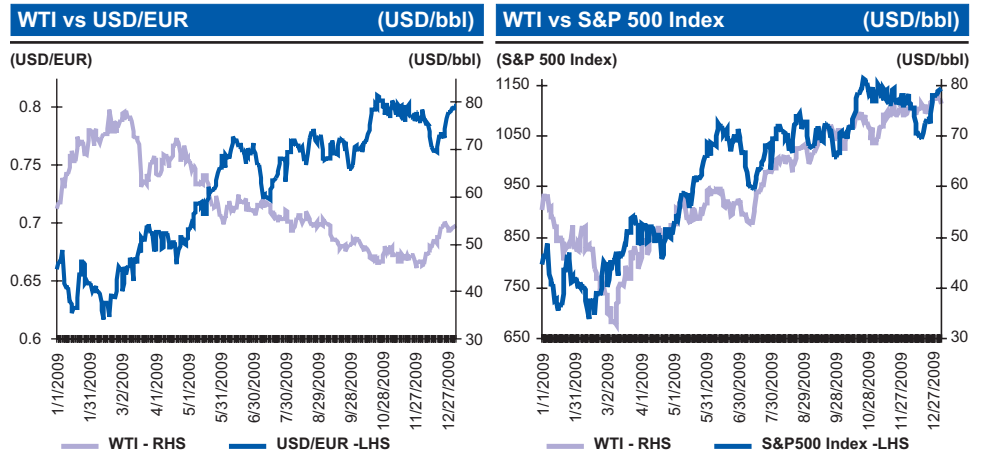
The pace of the economic recovery, however, is both a cause and effect of oil prices. Consequently, we believe that the rise in oil price will remain range-bound so that it does not derail the recovery process. Inventory levels and spare capacities -though declining a tad in the 3Q CY09- remain much higher than historic levels and are expected to continue exerting downside pressures on oil prices in the medium term. Historic data also reveals that in the past 15 years that there is a decline in oil consumption in the 2Q as demand for heating fuels declines globally. Consequently the recent spike may not be sustainable into the 2Q CY10.

Strength of the USD a strong determinant

The final straw in crude price surge remains the strength of the USD against other currencies. Weakness of the USD has had a strong role to play in the uptick in oil prices and had been one of the main driving factors behind the 2008 surge. While the repercussions of the stimulus plan unveiled by the Obama administration are expected to linger on, the USD has held its ground recently as economic numbers reveal some semblance of recovery. In the long run, question marks over the strength and stability of the USD hang in the balance and may drive prices higher.

Outlook

Taking in to account the above mentioned factors we expect oil prices may lose some steam in the short term, however, the longer term trend of rising prices is expected to persist. We expect oil prices to average USD75/bbl during 2HFY10 and USD78/bbl during FY11. We maintain our earning forecasts and target prices for the OMC and E&P sector as these are based on the above mentioned crude oil price assumptions.



Source: Bloomberg

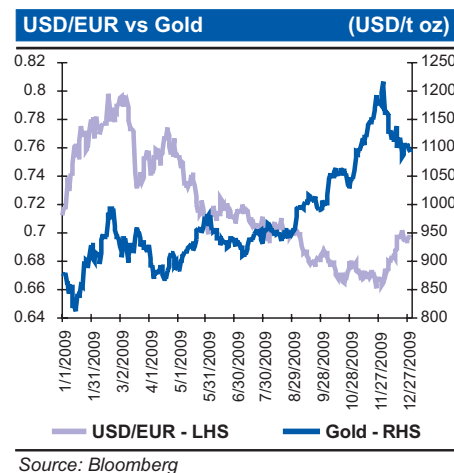
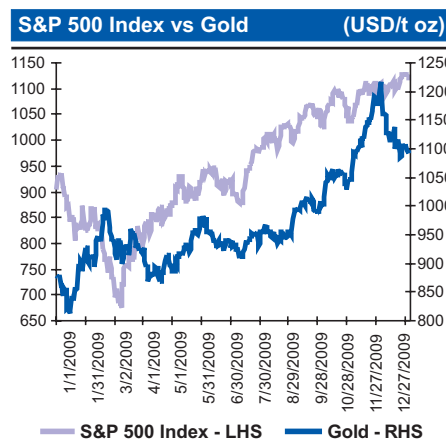
Source: Bloomberg

Commodity

Gold....

Commodities including, Gold are expected to maintain their upward momentum during 2010, hot on the heels of the remarkable run-up in most asset-classes witnessed during 2009. Gold prices in 2009 recorded their ninth consecutive annual gain after finishing 2009 with a 24% YoY gain and having risen nearly 300% since 2001. Key triggers for Gold's price movement could be demand from China and India. In addition, we may witness further efforts by both these countries to further diversify their huge USD reserves. Massive liquidity injections during 2009 have led to the USD weakening against other currencies, leading to pressures on FX reserves held by these countries.

While recessionary effects have begun reversing since 2H CY09, the overall pace of economic recovery will remain uneven in developed and emerging market economies. Emerging market economies, however, are expected to outpace the growth of the developed nations. Moreover, with massive stimulus not having generated the kind of impact that was widely expected, uncertainties will continue to surround investors and risk diversification coupled with wealth preservation may remain an underlying investment theme. Gold prices may continually stand to gain, given constrained supply, and limited projects coming on stream. The first quarter average prices may remain range bound between USD 1,100-1,160. Mid year and beyond, this trend is likely to see gold edging higher to range between USD 1,100 - 1,300/ t oz.



Technical Outlook

(Written by Wajahat Ali Khan from the Equity Sales Desk. Views may not concur with the Research Department)

Last Year Performance

After the trough of 4,781 points in Feb09, the KSE-100 index rebounded by almost 5,097 points. Monthly volumes averaged at 3.6bn shares which translates into 168mn in daily trades. The recovery was led by E&P, Banks, Fertilizer and followed closely by Cement, Insurance, Refineries and the Automobile sector.



Recent Trend & Technical Outlook for the year 2010

The market looks positive in the long term, however, we believe it would be interrupted by short term corrections. We expect the index to successfully consolidate at 9,000 and start a strong rally for the 12,200 points level. The Doji Star formation (last red candle with upper lower shadow in above graph) is already indicative of the index consolidating around the 9,000 level during the last quarter of the current year. In the same period, monthly volumes sustained at 3.6bn shares while a further increment in volumes could push the index upward. The current quarterly candlestick formations and leading indicators such as Stochastic Oscillator & RSI strengthen the positive view of the market. Also, the market may provide opportunities amidst volatility in short term for trading portfolios.

Stock Selection with the Target Price

We discuss sector wise stocks with their annual target price.

- ◆ In E&P:
 - Long term view in POL with the target of PKR 325,
 - Buy stance for PPL for PKR 224 PSO for PKR 419.
 - In case of OGDC our stance will be Neutral with a target of PKR 126.
- ◆ In Banks:
 - UBL with the target of PKR 84,
 - NBP for PKR 116,
 - MCB for PKR 282,
 - BAFL for PKR 23,
 - AKBL for PKR 36
- ◆ In cements:
 - DGKC with the annual target of PKR 42,
 - LUCK for PKR 93,
 - ACPL for PKR 76
- ◆ In Fertilizer:
 - ENGRO PKR 230,
 - FFBL PKR 34,

- Neutral stance for FFC with the target of PKR 120.
- ◆ In Power:
 - HUBC PKR 42,
 - KAPCO PKR 55,
- ◆ Miscellaneous:
 - PTC PKR 28.
 - NML PKR 96,
 - AICL for PKR 168,
 - NETSOL PKR 39

Major Supports & Resistance Levels

Strong resistance in the long term will be expected around 10,260 and 11,550 points, respectively. On the other hand, the index has ample support at 8,700 & 8,500 points.

IGI Universe - Valuation Summary

Company	Stance	Last Close - PKR/share	PT - PKR/share	M. Cap - USD mn	EPS -PKR			DPS -PKR			P/E - x			Div. Yld		
					2008a	2009e/a	2010e	2008a	2009e/a	2010e	2008a	2009e/a	2010e	2008a	2009e/a	2010e
IGI Universe				20,560	9.0	8.4	9.2	5.0	4.9	4.4	8.9	9.5	8.7	6.3%	6.2%	5.6%
Banks																
NBP	Buy	80.5	90.0	1,025	14.6	11.7	15.2	5.4	5.5	6.0	5.5	6.9	5.3	6.7%	6.8%	7.5%
UBL	Buy	62.6	65.0	825	7.5	7.4	8.8	2.3	2.5	3.0	8.3	8.5	7.1	3.7%	4.0%	4.8%
MCB	Neutral	220.4	225.0	1,802	22.2	21.2	25.2	10.5	11.0	12.0	9.9	10.4	8.7	4.8%	5.0%	5.4%
BAFL	Neutral	14.2	15.0	226	1.0	1.4	1.7	0.0	0.0	0.5	14.8	10.1	8.3	0.0%	0.0%	3.5%
HBL	Neutral	133.3	120.0	1,437	17.1	13.5	17.4	4.6	5.0	5.5	7.8	9.9	7.7	3.5%	3.8%	4.1%
ABL	Neutral	61.9	60.0	521	5.8	8.0	9.1	2.3	2.5	3.0	10.7	7.7	6.8	3.7%	4.0%	4.8%
Cement																
*LUCK	Buy	68.5	74.0	262	8.3	14.2	11.3	0.0	4.0	2.8	8.3	4.8	6.1	0.0%	5.8%	4.0%
*DGKC	Buy	32.8	41.0	118	-0.2	2.0	3.1	0.0	0.0	0.8	NA	16.7	10.5	0.0%	0.0%	2.3%
Oil & Gas																
OGDC	Neutral	116.7	117.0	5,938	10.3	12.9	12.1	11.0	8.3	6.0	11.3	9.0	9.6	9.4%	7.1%	5.1%
PPL	Buy	198.3	233.0	2,337	19.8	27.8	24.5	11.8	10.8	9.8	10.0	7.1	8.1	5.9%	5.5%	4.9%
POL	Buy	251.6	276.0	704	36.4	24.2	29.0	12.3	18.0	13.1	6.9	10.4	8.7	4.9%	7.2%	5.2%
PSO	Buy	306.9	385.0	623	81.9	-39.1	45.6	23.5	5.0	18.0	3.7	NA	6.7	7.7%	1.6%	5.9%
Fertilizer																
*FFC	Buy	105.7	113.0	849	9.6	12.6	13.2	10.6	12.2	13.2	11.0	8.4	8.0	10.0%	11.5%	12.5%
*FFBL	Neutral	26.8	27.5	296	3.1	3.2	3.5	2.8	2.9	2.8	8.6	8.4	7.6	10.3%	10.8%	10.6%
*ENGRO	Buy	191.4	225.0	675	14.2	11.6	15.4	6.0	5.4	6.3	13.5	16.4	12.4	3.1%	2.8%	3.3%
Power																
KAPCO	Buy	48.4	60.2	505	9.1	6.4	8.6	5.5	6.5	8.0	5.4	7.5	5.6	11.3%	13.3%	16.5%
HUBC	Buy	32.4	43.0	444	2.3	3.3	4.2	2.2	3.4	3.9	14.4	9.9	7.7	6.6%	10.3%	12.1%
Refinery																
*ATRL	Neutral	138.6	137.0	140	72.1	11.9	5.3	8.0	0.0	0.0	1.9	11.6	26.3	5.8%	0.0%	0.0%
*NRL	Neutral	177.1	243.0	168	75.1	19.2	27.3	20.0	12.5	11.0	2.4	9.2	6.5	11.3%	7.1%	6.2%
Telecom																
PTC	Buy	19.5	29.6	1,178	-0.4	1.8	1.9	0.0	1.5	1.5	NA	10.9	0.0	0.0%	7.7%	7.7%
Auto																
*INDU	Buy	203.1	230.0	189	29.2	17.6	27.6	10.5	5.5	15.3	7.0	11.5	7.3	5.2%	2.7%	7.6%
*PSMC	Buy	97.0	114.0	94	7.6	6.1	10.0	1.5	1.0	1.9	12.8	16.0	9.7	1.5%	1.0%	2.0%

 Source: IGI Research
 * Bloomberg consensus

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