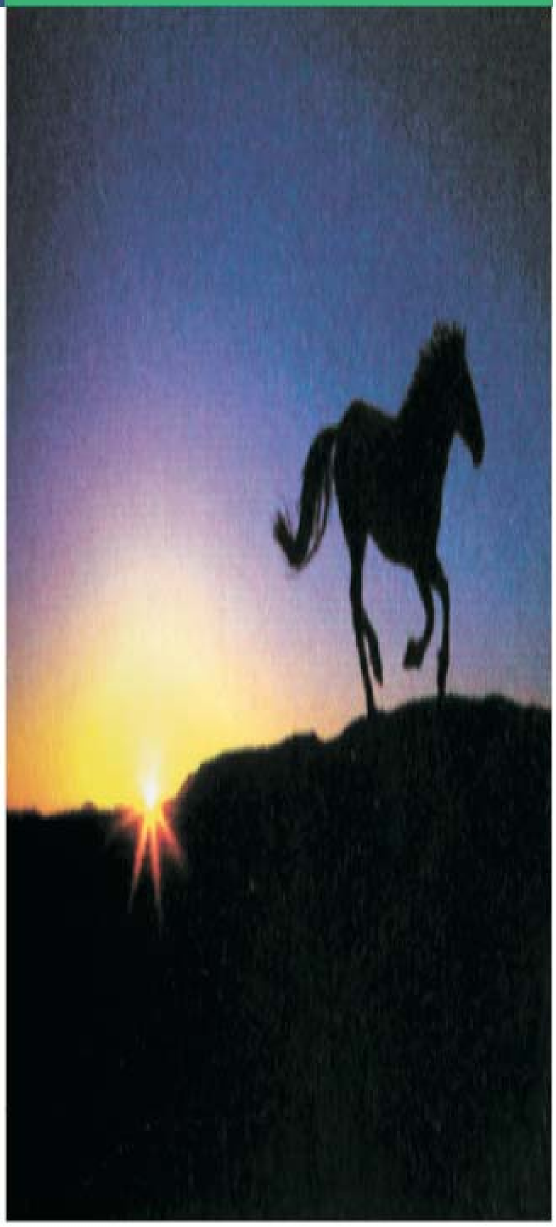
July 2007

STRATEGY
PAKISTAN

Pakistan: Expanding Growth Horizons

An Investment Consideration



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All prices are as of July 10, 2007

Introduction

Pakistan's economy has been showing rapid growth of over 7.0% CAGR in the last 4 years and the growth momentum is likely to continue at this rate going forward. **What drives this growth and how long will it last?** The answer to the former is domestic demand – a hunger that has spurred unprecedented surge in consumption expenditure. The latter question is tinged with suspicion over the sustainability of this growth were the present military rule to falter. We maintain that Pakistan's economic conditions have greatly benefited from the present government's liberal policies and it will be difficult—to say the least—for any new government to undo the momentum that the consumption cycle has heretofore picked up.

The benchmark equities index KSE-100 has witnessed impressive growth over the last few years on account of pro-investment climate in the country. The KSE-100 index has increased from 1521 points in June 2000 to 13728 in June 2007, which marks a rise of over 12000 points or an increase of 773% in all.

Factors responsible for the high index returns include:

- Speedy privatization process attracting foreign investors
- Higher industrial growth
- Increase in listed capital
- Heightened merger & acquisition activities
- Increased foreign interest
- Favorable policies allowing repatriation of funds to Pakistan
- Declining external debt

Inherent strengths of the economy convince us that the economic boom is likely to continue. We enumerate these as follows in addition to the factors that may challenge our assumptions.

Strengths

- Rising income levels and a developing middle class have spurred a consumption boom that drives economic growth
- Changing demographics to result in younger population that is also more affluent lend further credence to the consumption boom
- Increasing education levels and productivity
- Increasing business confidence manifested in exorbitant levels of Gross Fixed Capital Formation (GFCF)
- Regional comparison shows better output growth driving the economy
- Future forecasts are positive. We break GDP growth into cyclical and trend components Long term trend is expected to continue to rise while the expansionary phase in the business cycle is expected to continue till FY10
- Amicable relations with foreign countries especially neighboring India have alleviated security risks

Challenges

- High and persistent inflation that necessitate a tight monetary stance
- Twin deficit situation: a fiscal deficit of 4.2% and trade deficit of 9.0%. The trade deficit problem is compounded by inflationary concerns
- Low domestic savings mean increased foreign reliance for fueling growth

Macroeconomic Outlook

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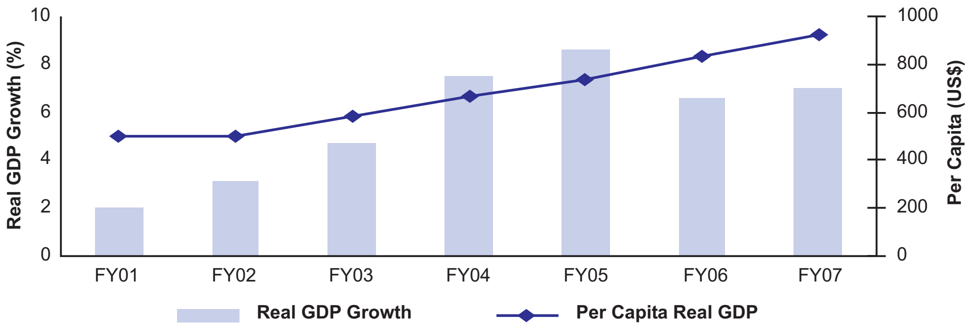
Country Profile

Income Profile

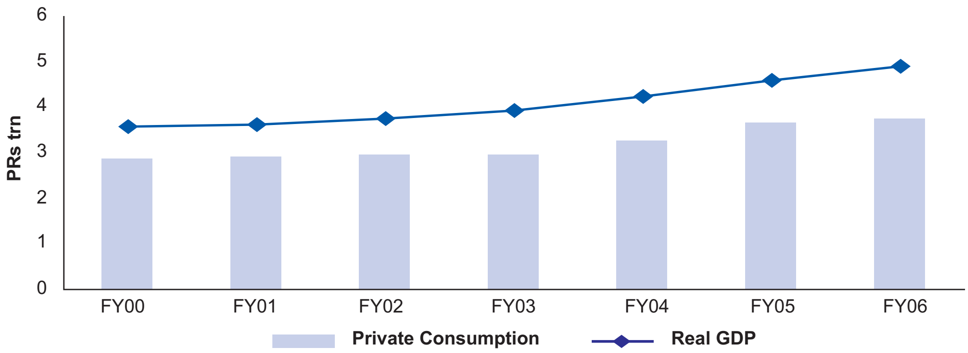
A demographic transition is in process that has enabled Pakistan to host a predominantly young population that is more affluent. Income levels have shown robust growth in the past 5 years as evidenced by the steep upturn of the country' real Gross Domestic Product (GDP). After an unprecedented growth of 8% in FY05, real output growth slowed to 6.6% in FY06. Evidence to the rising middle class is an average growth of 5.5% per annum in real per capita GDP over the last four years. In nominal terms per capita income was up by 11% to reach US$925 in FY07.

Chart 01: Real GDP Profile



Source: Economic Survey FY07 & IGI Research

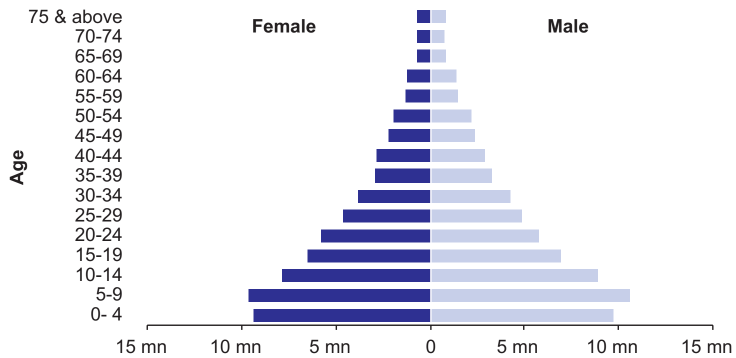
Chart 02: Private Consumption Expenditure



Source: Economic Survey FY07 & IGI Research

Higher income levels have instigated an upsurge in consumption expenditure. Growth in private consumption has been the engine behind the economic growth. Moreover, rising consumption is reassuring as it ensures that the country's economic growth is fuelled internally and the country is less susceptible to external turmoil.

Chart 03: Demographic Profile



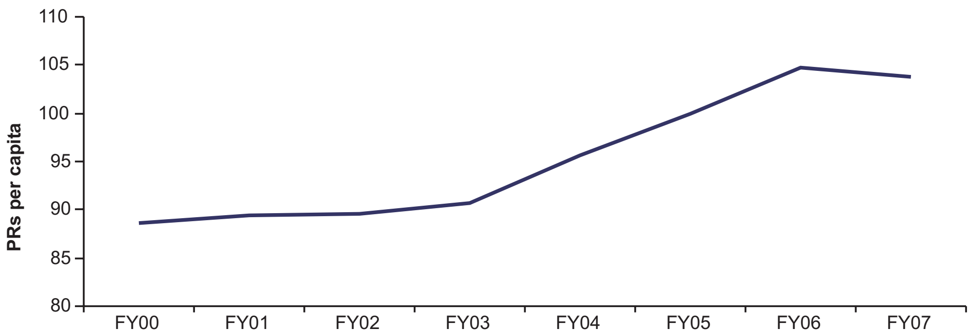
Source: Economic Survey FY07 & IGI Research

Education Trend

Productivity of the average labor force of the country is on a rise. Consistent rise in the future will depend upon investments in skill development and education of the population. Growing literacy levels and greater participation of skilled workforce warrant continued rise in productivity in the future.

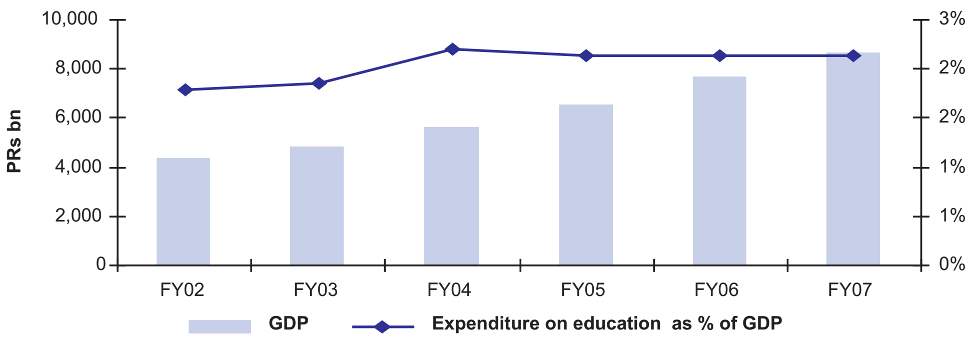
A number of initiatives that mark a transition in education levels in the country include: National Education Policy (NEP) review approved in 2005 which includes reform of the education system through free education up to Matriculation. Not only primary education, higher education spending has also been on a rise since the establishment of the Higher Education Commission (HEC) in 2002. Pakistan's higher education budget has increased sevenfold to about US$449mn which amounts to 0.5% of the GDP.

Chart 04: Labour Force Productivity



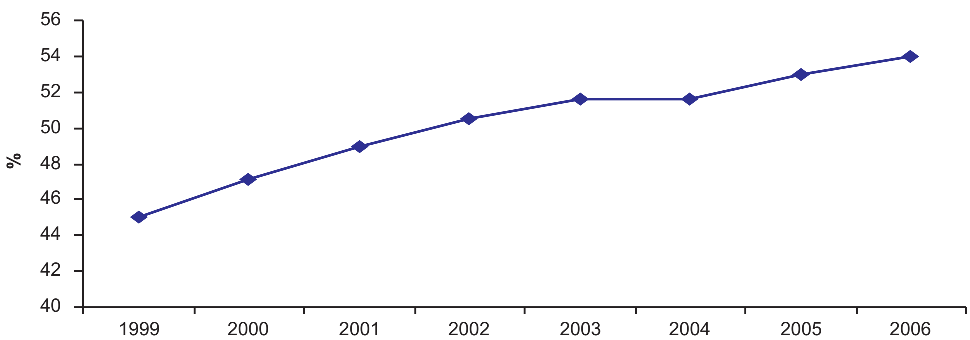
Source: Economic Survey FY07 & IGI Research

Chart 05: Actual GDP and Expenditure on Education



Source: Economic Survey FY07 & IGI Research

Chart 06: Literacy Rate



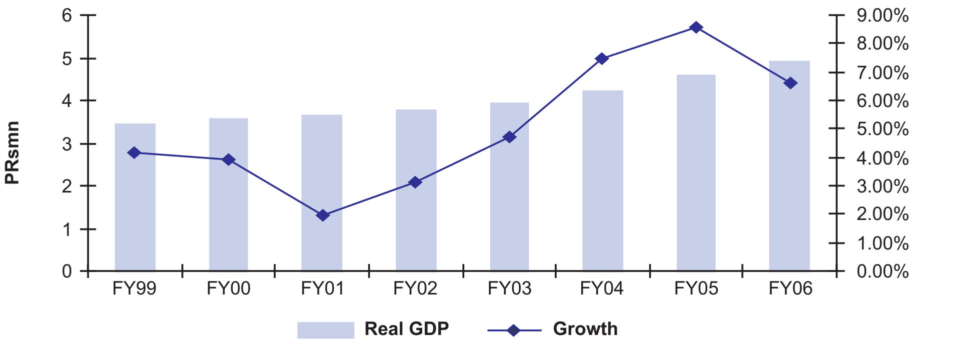
Source: Economic Survey FY07, SBP & IGI Research

Political Stability

Investor anxiety about the outcome of the upcoming elections centers on the possibility of slowdown in economic growth as a result of change in government. This fear is based on the belief that the Musharraf regime has been responsible for the recent economic upturn. While it cannot be refuted that the economy has indeed performed well in recent years, we argue that many other factors can be attributed to it. First, macroeconomic expansion is visible not only in Pakistan but in most of Developing Asia. In fact on a regional basis, Asian nations have been one of the fastest growing in recent times.

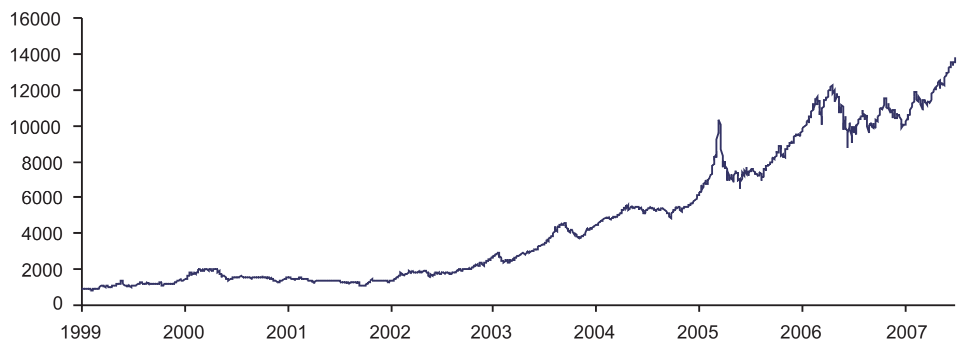
Second, the present government is the only one in the history of Pakistan that has been allowed to complete its term of 5 years. A possible explanation for successful economic reform may be the available time frame which earlier governments lacked.

Chart 07: Real GDP



Source: World Economic Outlook April '07, IMF

Chart 08: KSE - 100 Index



Source: World Economic Outlook April '07, IMF

Musharraf government took over in October 1999 and became President in 2001. Clearly, the above illustration suggests that for a good 3 years of his rule the economy showed very little improvement. The same argument applies to the stock market. The bull-run did not begin until June 2002. But from then onward we have seen consistent upward trend in the market.

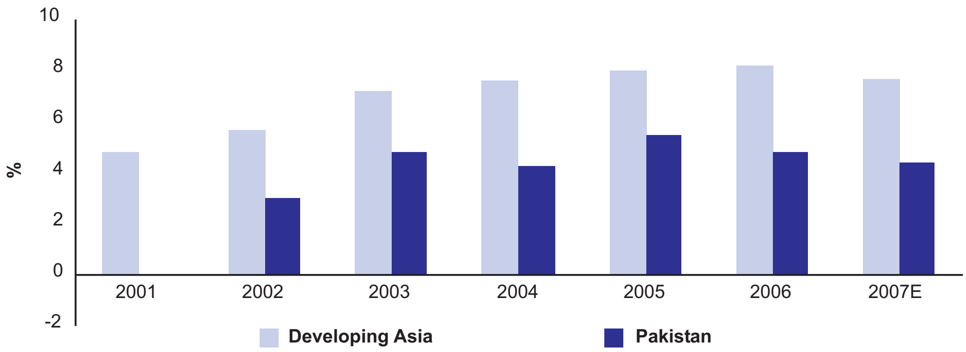
We conclude the argument with the belief that political stability and adequate time for economic reform have been the principal factors that have allowed the demand driven economic growth to prosper rather than any element of the ruling party itself. Thus, we do not foresee any alteration in government to have a detrimental impact on the country's economy.

Comparison with Other Countries - Developing Story
On a regional basis, we compare Pakistan's economic growth with that of Developing Asia* Growth in real per capita income is lower than the region due to less growth in overall real GDP.

However, such comparison is distorted by the phenomenal growth in overheated economies such as India and China. When we exclude China and India, the numbers are much more favorable and show that Pakistan's growth in real terms has been greater than the average in recent years although it was a laggard in years 2000-03.

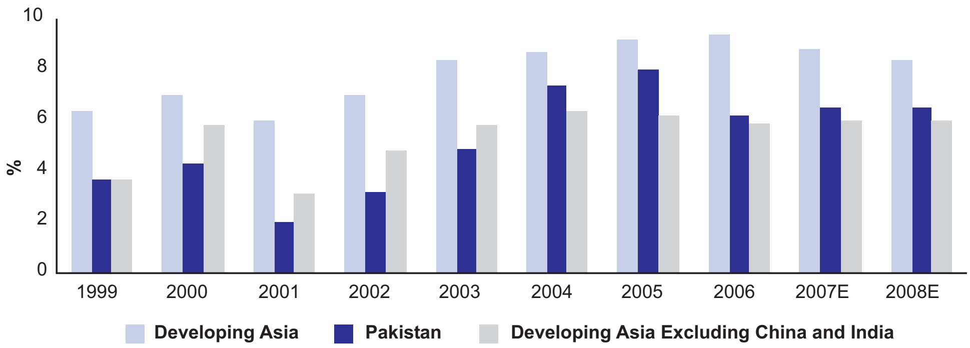
Inflation has been of mounting concern to policy makers in the rapidly growing economy. Pakistan has averaged higher inflation than Developing Asia but has fared better when we exclude China and India. A constrained monetary policy however, has left money supply in the country reduced as compared to the region.

Chart 09: Real Per Capita GDP Growth



Source: World Economic Outlook April '07, IMF

Chart 10: Real GDP Growth



Source: World Economic Outlook April '07, IMF

**Developing Asia includes: Bhutan, Cambodia, China, Fiji, Indonesia, Kiribati, Lao PDR, Malaysia, Myanmar, Papua New Guinea, Philippines, Samoa, Solomon Islands, Thailand, Tonga, Vanuatu, Vietnam, Bangladesh, India, Maldives, Nepal, Pakistan, Sri Lanka*

Chart 11: Consumer Prices

Source: World Economic Outlook April '07, IMF

Chart 12: Board Money Aggregates (% change)

Source: World Economic Outlook April '07, IMF

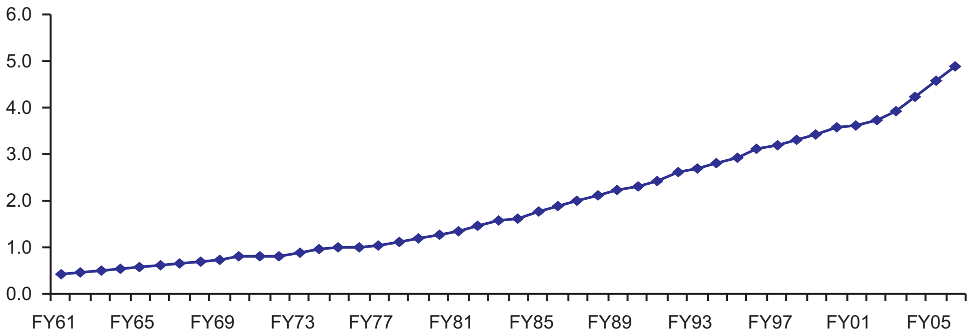
Chart 13: Central Government Fiscal Balance (% of GDP)

Source: World Economic Outlook April '07, IMF

GDP Profile

Pakistan's output has shown robust growth in the past 5 years as evidenced by the steep upturn of the country' real Gross Domestic Product (GDP). After an unprecedented growth of 8% in FY05, real output growth slowed to 6.6% in FY06.

Chart 14: Real GDP (Base 1999 - 2000=100)) **(mn)**



Source: Federal Bureau Statistics & IGI Research

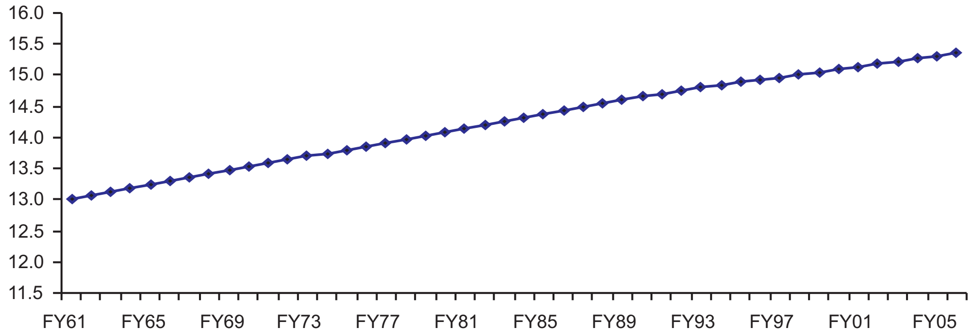
At first glance, the country's real output function appears to show exponential growth. In order to forecast the economy's true potential for growth, we separate real GDP* into three components: a long-run trend, business cycles and short-run shocks to the economy. This dissection is expected to give better insight into the changing pattern of economic growth and future prospects.

The country's real output has had a positive trend throughout the selected period (FY61-FY06). However, the increase in real GDP has depicted varying rates over the period. We attribute the change in long-run growth trend to structural changes in the economy. The highest growth in trend came in the early 60's including industrial and financial institutions development. The 1965 war pulled the trend growth down in the latter half of 1960s. Increasing public fixed investment in the 1970s again pushed up the trend growth and it touched a peak in FY83. Subsequently, the trend remained on a decline for an extended period (even though overall GDP growth in the 80s was high) and touched a trough in FY99. Since then the economy's long run-trend has been on a consistent rise.

Cyclical movements show that Pakistan has completed two business cycles since FY61; one ending with a trough in FY78 and the second one ending in FY01. Since then, the country has recovered and is currently in an expansionary phase. In FY06, the business cycle crossed the peak of the earlier business cycle. **Does this mark an inflection point in the cycle and is the economy about to recoil?** Not according to our estimates! An important distinction between FY90 and FY06 is that the long-run trend component in FY90 was declining whereas in FY06 it was on a consistent rise. Not only does this indicate that the current expansionary phase is more a result of infrastructure building and investment rather than the expansion of the '90s which was largely due to transitory factor such as inflow of remittances and foreign aid, but also that these structural changes will support long run growth.

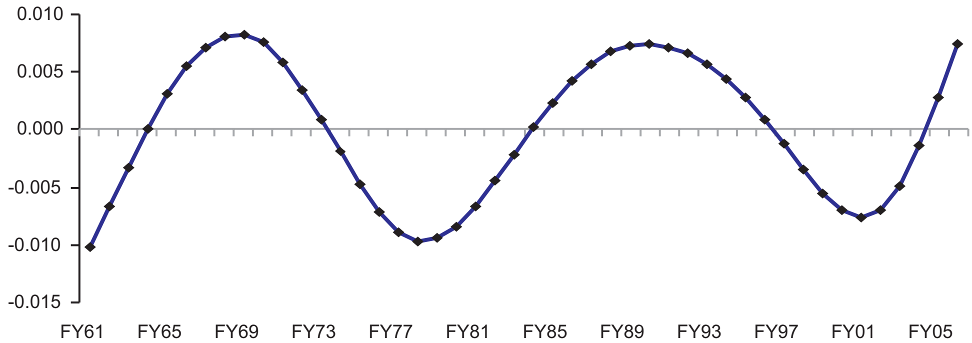
** For this we have applied the Hodrick Prescott filter in Eviews 6.0 on natural log of time series data of real GDP. The resulting components (trend, cyclical and shock) are in natual log of PRs mn.*

Chart 15: Long-run Trend Component of Real GDP (In of PRs mn)



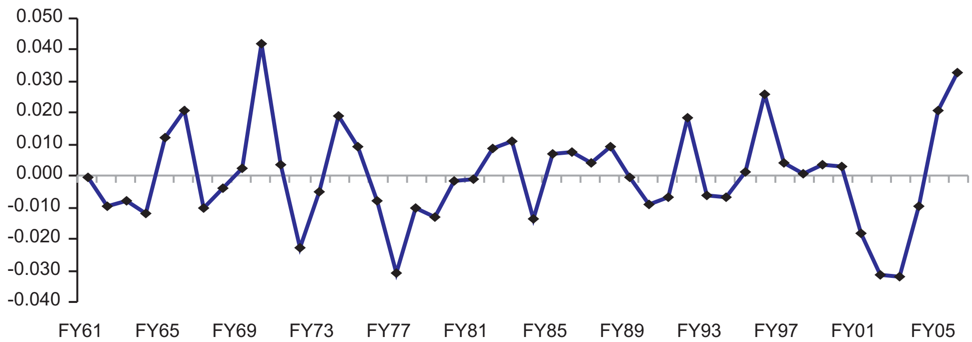
Source: IGI Research

Chart 16: Business Cycle Component of Real GDP (In of PRs mn)



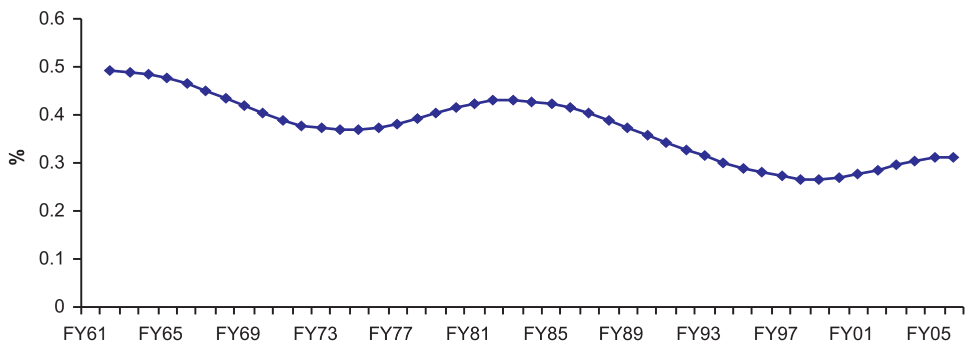
Source: IGI Research

Chart 17: Short-run Shock Component of Real GDP (In of PRs mn)



Source: IGI Research

Chart 18: Long-run Trend Component Growth Rate (In of PRs mn)

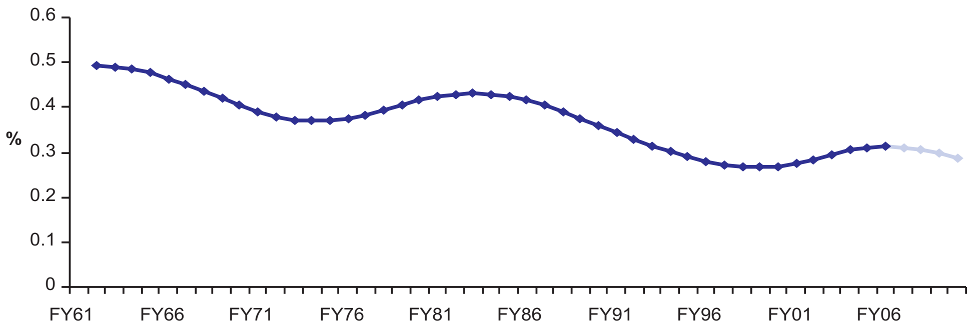


Source: IGI Research

The following graphs show our projections of the real output as well as its component. It is estimated that the trend growth will continue to rise in the coming years. The cyclical component of the GDP is projected to rise further and reach its peak in FY10. The trend and cyclical components will continue to drive the overall GDP growth upwards.

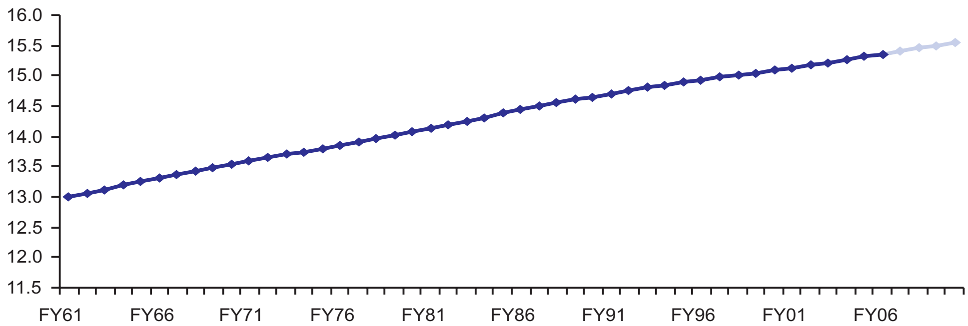
This projection is based on the assumption that the economy will not suffer from any shocks during that period.

Chart 19: Long-run Trend Component Growth Rate **(In of PRs mn)**



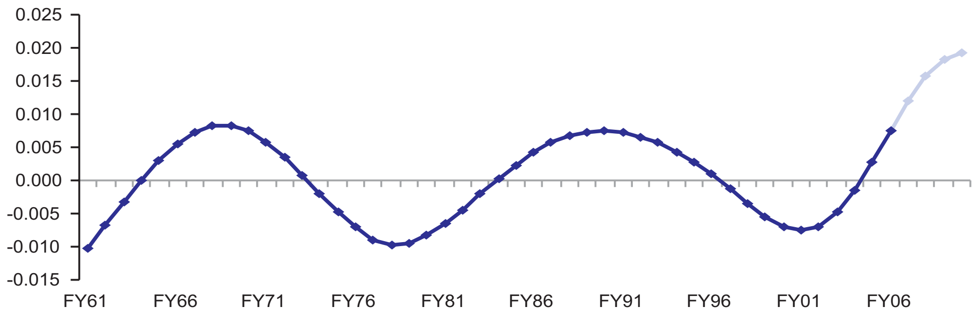
Source: IGI Research

Chart 20: Long-run Trend Component of Real GDP **(In of PRs mn)**



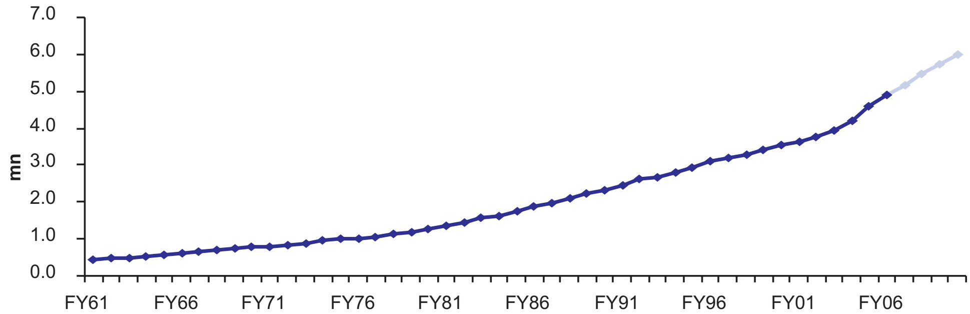
Source: IGI Research

Chart 21: Business Cycle Component of Real GDP **(In of PRs mn)**



Source: IGI Research

Chart 22: Real GDP (Base 1999-2000=100)



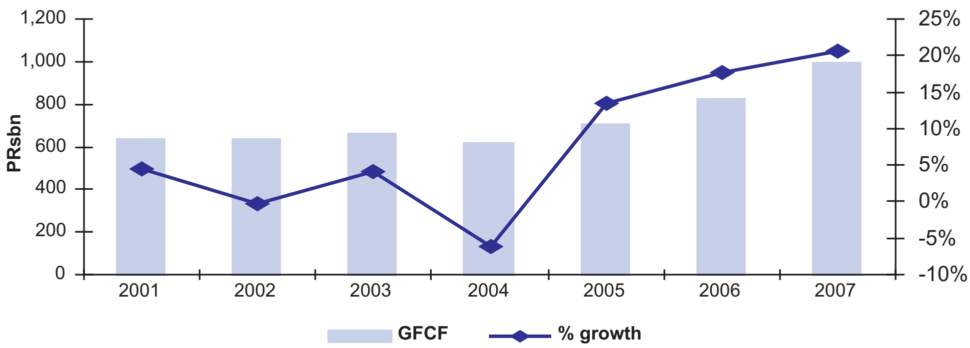
Source: IGI Research

Data points in lighter shade represent forecasts for the period FY07 to FY10.

Monetary and Fiscal Discipline

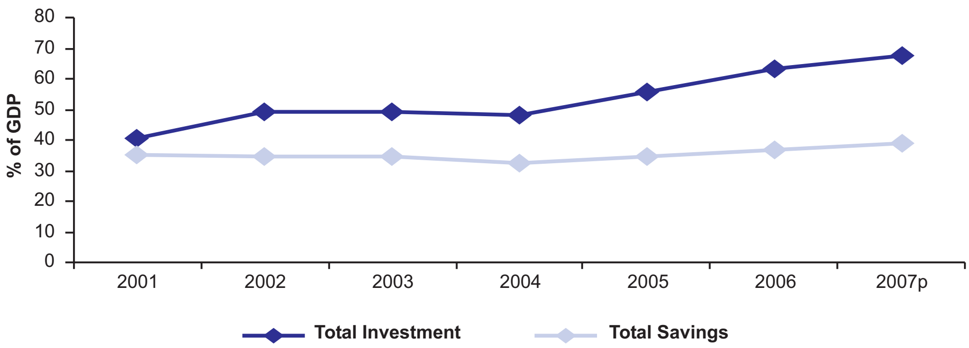
Evidence to the rising middle class is an average growth of 5.5% per annum in real per capita GDP over the last four years. In nominal terms per capita income was up by 11% to reach US$925 in 11MFY07. Rising income levels combined with a very high propensity to consume have resulted in a structural shift in consumer spending patterns. Real private consumption has grown at an average rate of 7.4% per annum during the last four years. Changes in demographic structure in the form of a rising share of working age population have also been responsible for the increasing disposable income levels and current consumption.

Chart 23: Real Gross Fixed Capital Formation



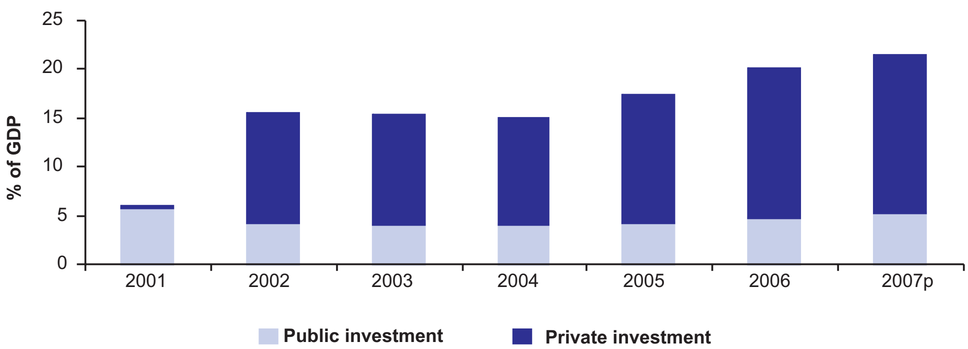
Source: IGI Research

Chart 24: Savings & Investment



Source: IGI Research

Chart 25: Gross Fixed Investment

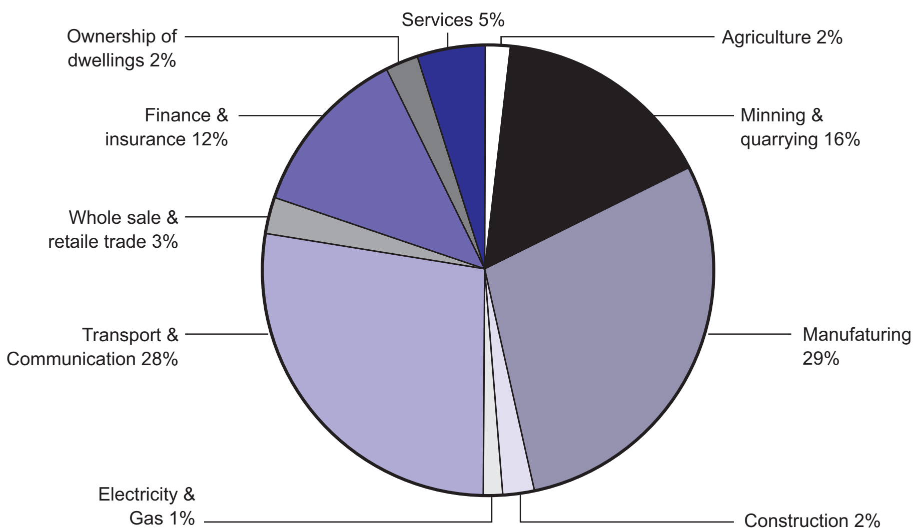


Source: IGI Research

Rising business confidence has resulted in greater investments in fixed capital. Real gross fixed capital formation i.e. real investment grew by 20.6% in FY07 and has average 17.3% over the past 3 years. This strengthens our argument of continuing prospects for growth. All 3 avenues of investment i.e. private, public and foreign, have witnessed increase in FY07 with growth in real private investment recorded at 19.6%, public sector investment at 31.7% and foreign direct investment at 37%. It is concerning, however, that the upsurge in investments has not been accompanied by a parallel rise in national savings which currently stand at 18% of GDP whereas the balance is funded by foreign savings (this simply reflects the current account deficit in the balance of payments). Total investments form 23% of GDP and National Savings finance 84% of fixed investment.

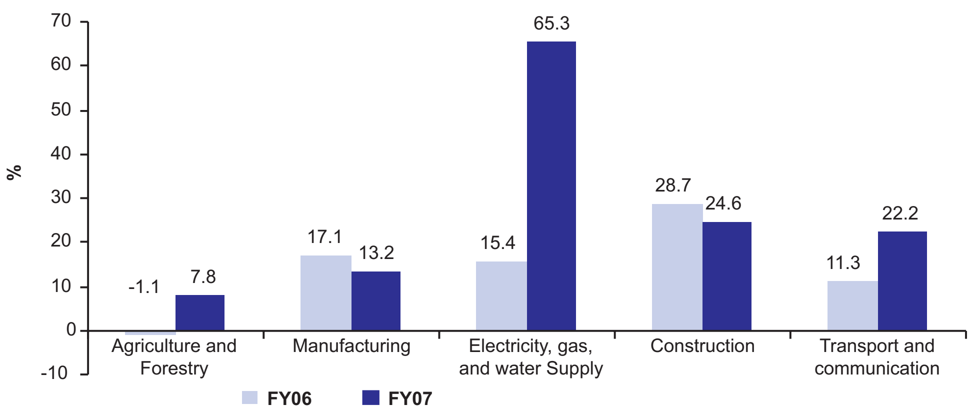
The sectors attracting the greatest private sector investment include mining and quarrying, manufacturing, construction, transport and communication, banking and finance and wholesale and retail trade. All sectors of the economy have witnessed double digit growth in investment save for agriculture (3.8%), ownership of dwellings (4.6%) and electricity & gas distribution (-49.9%). This raises questions about how far these investments can sustain the economy's growth given that such a crucial sector as electricity & gas distribution has witnessed disinvestment. Moreover, agriculture that contributes 21% to the country's GDP has received marginal investment growth. Rather than growth in investment it would be well advised to take a look at the share of each sector in total investments. However, the same perturbing situation is evident in this case too.

Chart 26: Sector Wise Share of Increase in GFCF



Source: Economic Survey FY07 & IGI Research

Chart 27: Growth in Business Sector Loans



Source: State Bank of Pakistan

It is worth mentioning here that the investment in these sectors may not be reflected accurately through GFCF since a predominant source of funding for these sectors is bank loans. We take a look at the growth in business sector loans in the first quarter of FY07. We find that the greatest growth in business loans has indeed come from the electricity, gas and water supply sector (65.3% or PRs12.3bn) and alleviates concern of low investment in this sector. Agriculture loans on the other hand registered a somewhat low growth of 7.8% or PRs10.5bn. We expect this growth to increase as sowing season approaches.

On the foreign front, Pakistan has successfully maintained a non-hostile relationship with neighbor India and significant headways in trade and commerce have been made. An example is the unique opportunity to Pakistan cement manufacturers that stand to benefit from the current excess supply situation in Pakistan versus an excess demand situation in India. Further trade opportunities are expected to arise in the future which are likely to benefit both countries' economies.

Challenges

A concern for policy makers is the twin deficit situation that the country faces. The fiscal deficit is targeted at 4.2% of GDP for FY07 which seems achievable given that during 9MFY07 the deficit had reached 3.1% of GDP. Reforms in taxation and revenue generation are underway and a shift towards broad based and transparent tax administration has been envisaged. It is encouraging to note that tax collection by Central Board of Revenue (CBR) has increased by 112.8% over the past 6 years whereas the revenue deficit (difference between total revenue and total current expenditure) has been reduced to 0.2% in FY06, and targeted to reach a revenue surplus of 0.6% in FY07. On the other hand, the current account deficit stands at US$6.2bn (4.3% of GDP) in 9MFY07. Moreover the trade deficit stands as 9.0%. This is despite the fact that import growth has slowed, as performance of exports has been lackluster.

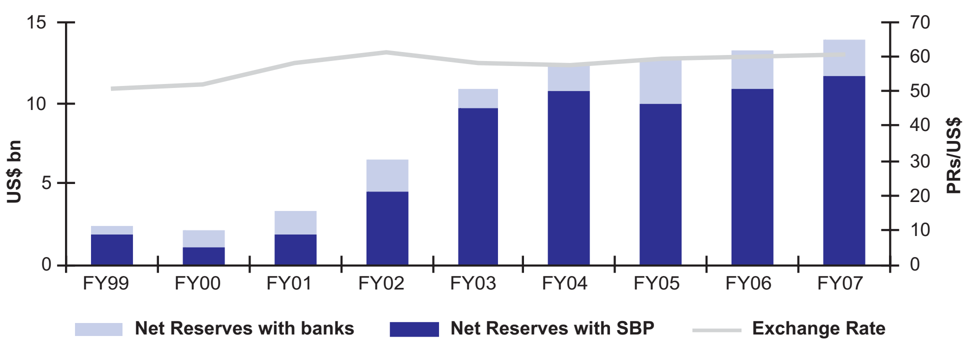
Heightened economic activity has been accompanied by rising inflation and consequently a tight monetary policy. The central bank has taken several steps to curtail inflation ranging from increased reserve requirements and frequent mopping up of liquidity in the inter-bank money market. Despite these efforts inflation has still managed to creep beyond the target for the year. CPI increase in May 2007 was recorded at 7.84% as against a target of 6.5% for the year, and the question arises as to whether the policy is tight enough.

Combating inflation however, is complicated by the parallel concern of maintaining a stable exchange rate. For the past couple of years, SBP has successfully managed to keep the exchange rate stable with minor depreciation of the Pak Rupee. A situation of possible devaluation did crop up in 2006 yet the Pak Rupee withstood it mitigating any qualms of a rotting currency akin to Brazil or Argentine.

Alongside rising foreign exchange reserves (US$13.79bn on June2, 2007), the Pak Rupee has depreciated by 0.77% against the US dollar in FY07 to date in nominal terms. However, this comparison masks the fact that the Pak Rupee depreciated much more against other currencies like GB Pound and Euro. The Pak Rupee showed cumulative depreciation of 4.04% (during Jun-Apr FY07) in the Nominal Effective Exchange Rate (NEER). The NEER shows the aggregate depreciation against a basket of currencies. The Real Effective Exchange Rate (REER) however, appreciated by 2.06% (during Jun-Apr FY07).

The difference between the real and nominal rates presents an important aspect of the domestic currency: it is appreciating in real terms against a basket of currencies; it is only due to the high domestic inflation that the Pak Rupee appears to depreciate. This fact highlights the paradox of managing domestic inflation: leave it untamed and it leads to excessive imports, combat it too well and the currency appreciates in real terms discouraging the already small exports. In any case it leaves the country's dire trade balance gasping.

Chart 28: Forex Reserves & Exchange Rate Movement



Source: State Bank of Pakistan, Bloomberg & IGI Research

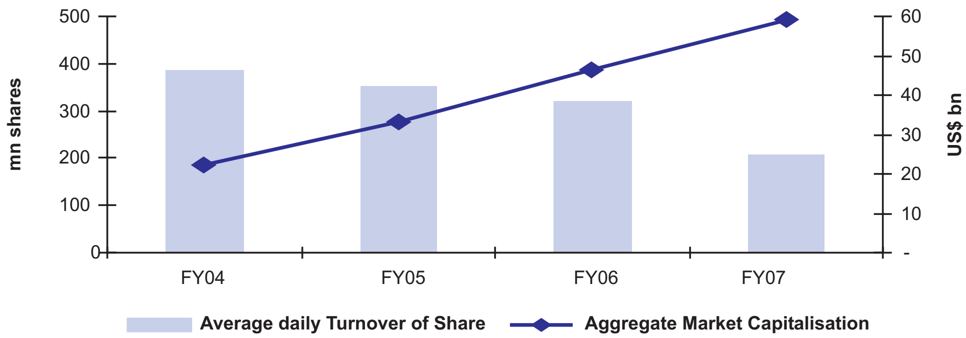
The tight monetary stance has had special consequences for the country's banking sector in particular because the accompanying rising interest rate environment triggered lending rates but deposit rates have lagged them resulting in the present favorable margins in the sector and rising profitability.

Investment Strategy

KSE - 100 Index Profile

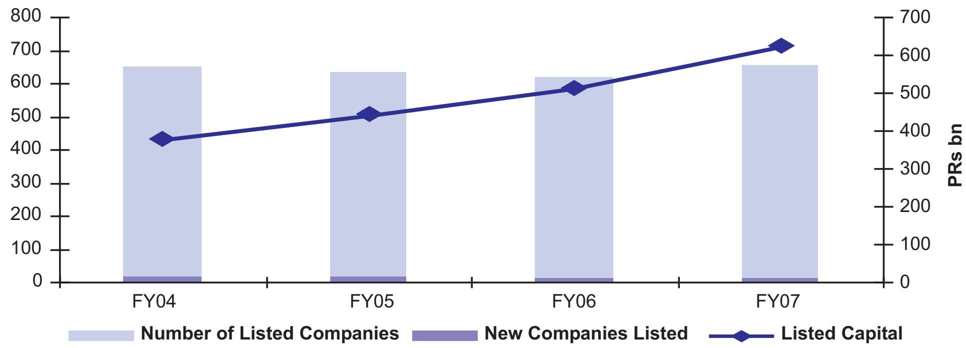
The KSE-100 index has witnessed impressive growth over the last few years on account of pro-investment climate in the country. The KSE-100 index has increased from 1521 points in June 2000 to 13728 in June 2007, which marks a rise of over 12000 points or an increase of 773% in all. On annual basis this marks an average increase of 37%.

Chart 29: KSE-100 Index Profile



Source: Economic Survey FY07 & IGI Research

Chart 30: KSE-100 Index Listing



Source: Economic Survey FY07 & IGI Research

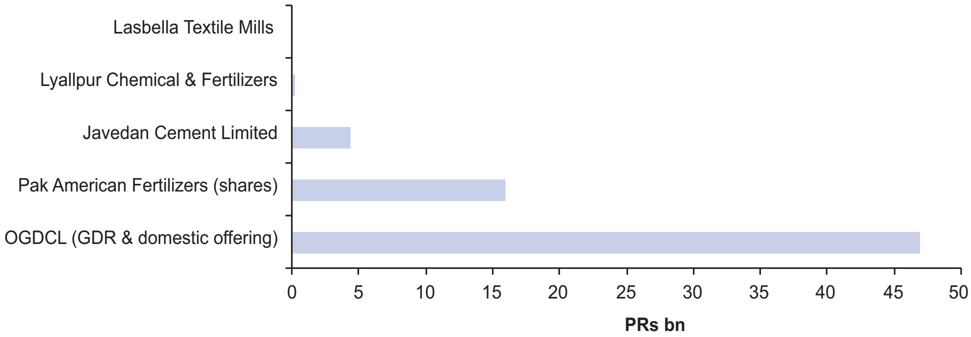
Several factors are attributed to this continuous bull-run including:

- Speedy privatization process attracting foreign investors
- Higher industrial growth
- Increase in listed capital
- Heightened merger & acquisition activities
- Increased foreign interest
- Removal of restrictions on repatriation of funds to Pakistan
- Declining external debt

Privatization of major public sector entities like KAPCO and PTCL in FY06 attracted huge investor interest. In FY07, no major privatization occurred, however, Global Depository Receipt (GDR) offering and local offering of OGDCL was successfully completed amounting to a total of PRs46.963bn. Moreover, the GDR offering of MCB Bank* was also well received by foreign investors. Recently, GDR issue of UBL raised US$650.3mn whereas privatization of PSO, NIT and PPL is in the pipeline.

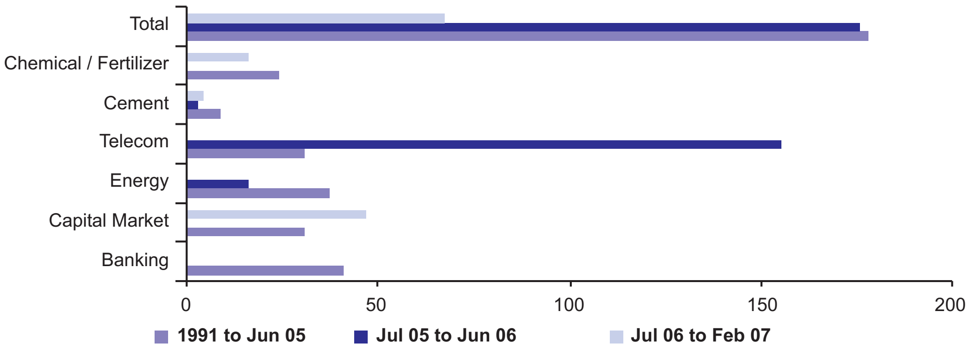
* *GDR of MCB Bank was not a privatization event as the bank is already privately owned. However, it does mark an important event of foreign interest in Pakistan.*

Chart 31: Assets Privatized During FY07



Source: Economic Survey FY07 & IGI Research

Chart 32: Amount of Privatization Transactions (PRs bn)



Source: Economic Survey FY07 & IGI Research

Among M&A activities foreign interest has been predominant. The major M&A activities in recent years include the following:

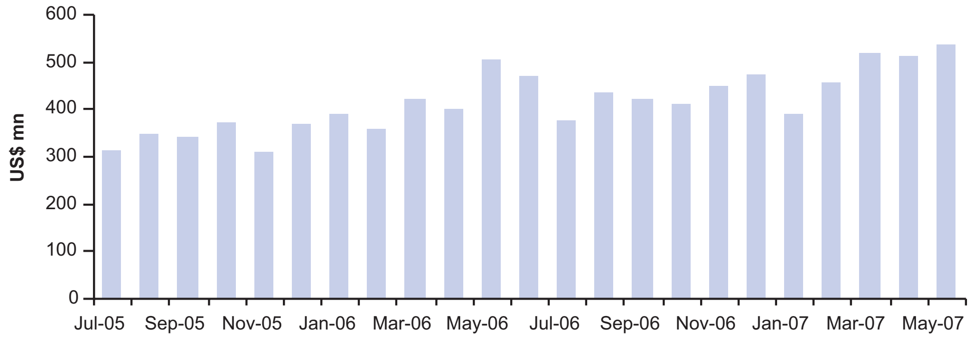
Table 01: Foreign Acquisitions in Pakistan (US$ mn)

Acquirer	Target	Size of Transaction
Etisalat	Pakistan Telecommunications Co. Ltd.	2600
Standard Chartered Bank	Union Bank	487
SAMBA	Crescent Commercial Bank	100
ABN AMRO Bank	Prime Commercial Bank	230
Tamasek Holdings Singapore	PICIC	300
China Mobile	Paktel	284
Philip Morris	Lakson Tobacco	340
Oman Telecom	Worldcall Telecom	113

Source: Economic Survey FY07 & IGI Research

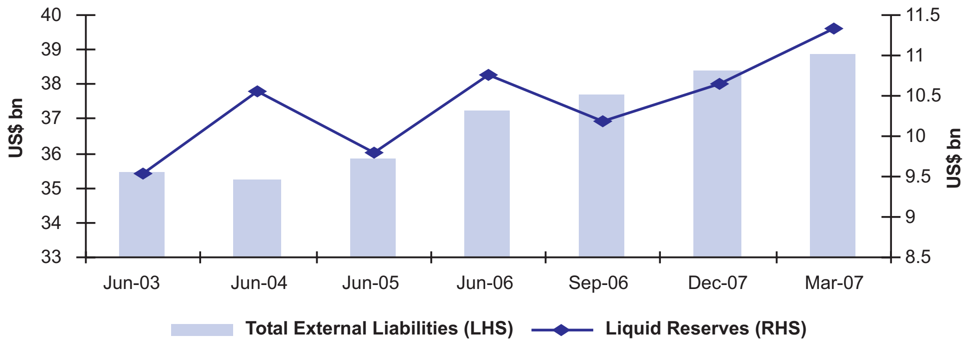
Favorable policies encouraging repatriation of funds to Pakistan have been instrumental in channeling greater funds in the form of home remittances. These have reached all time highs and crossed the US$500mn per month mark in FY07.

Chart 33: Home Remittances Per Month



Source: SBP & IGI Research

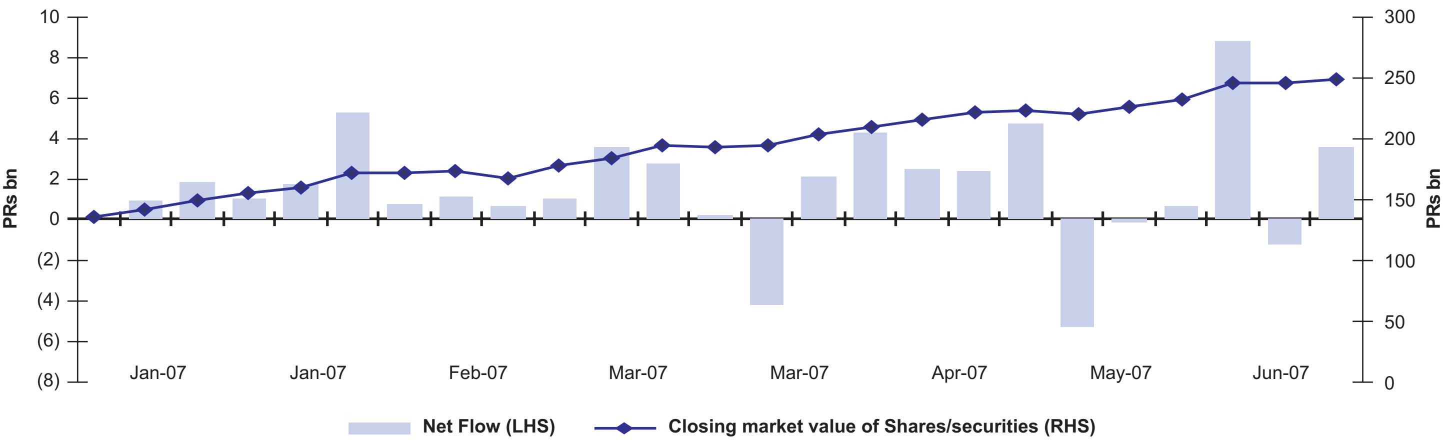
Chart 34: External Liabilties and Reserves



Source: SBP & IGI Research

Foreign investment in the country's capital markets is gauged through balances in the Special Convertible Rupee Accounts (SCRAs). The market value of securities held by foreigners in Pakistan reached PRs249bn in June, 2007. The market value of securities has been on a consistent rise during the year owing to positive inflows as well as rise in the security prices themselves.

Chart 35: Foregin Investment Through SCRAs

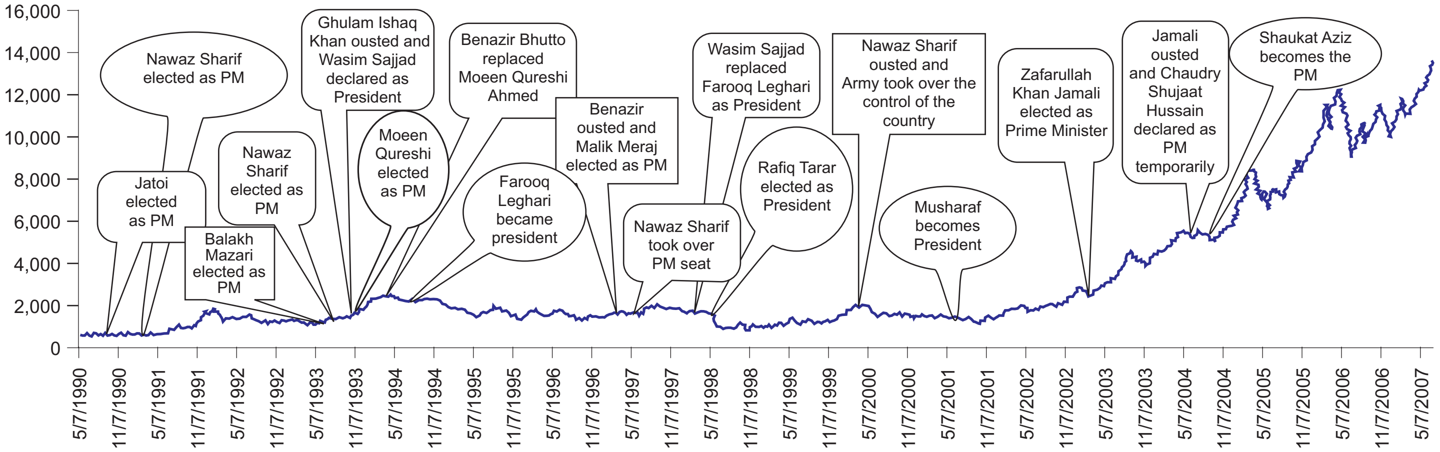


Source: SBP & IGI Research

Volatility with Respect to Political Events

The present government has spearheaded an unprecedented bull-run in the KSE-100. Musharraf became president in 2001. Since then the country has had two Prime Ministers yet the bull-run continues.

Chart 36: Political Events Impact on KSE-100



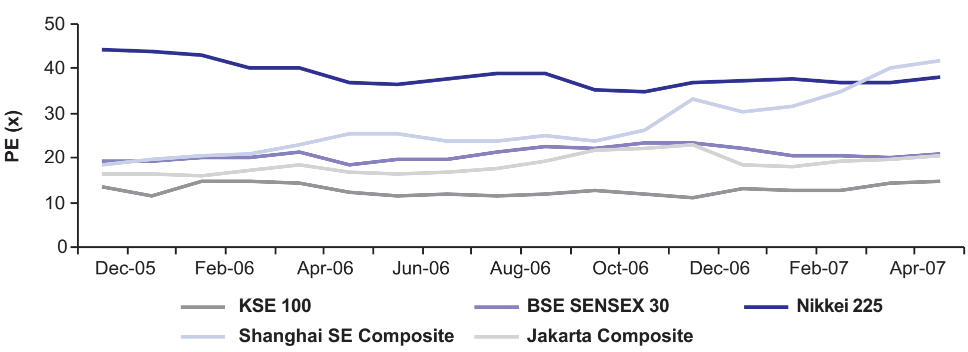
Source: Bloomberg, National Assembly website & IGI Research

With the approaching elections in FY08, there is an apprehension about a possible change in presidency. In our view even if such a change were to occur the present economic growth is likely to be sustained. This is not only due to underlying factors driving growth (as we discuss later) but the political necessities are likely to dictate continuation of the momentum whichever party is in power. Any new party will be coming in much more favorable conditions than it has ever come in before. It will also be under greater scrutiny and pressure from the public, media as well as foreigners. Under such circumstances any government is likely to continue to remain investment friendly despite pressure for populist decisions. These are the very factors responsible for the mounting equity market and continuation of these is likely to ensure continued ascent of the KSE-100.

Index Comparison with Other Indices

Among regional peers, the KSE-100 index trades at a significant discount. In May 2007 the KSE100 reached its highest Price-to-Earning (PE) multiple in two years. Even so, it remained at a fair discount to regional indices including the BSE Sensex 30 which traded at 21.1x, Nikkei 225 at 37.91x, Shaghai SE Composite at 41.84x and Jakarta Composite at 20.36x. It is worth noting that the KSE-100 has always traded at a discount to other markets. The question to be asked is whether there is a paradigm shift to suggest that such a discount is no longer warranted. As we have discussed earlier in the economic section, the country is indeed undergoing a structural as well as demographic change that justifies rise in index multiples.

Chart 37: Index PE Multiples Comparison



Source: Bloomberg

Banks

Sector Snapshot

Favorable Economic Backdrop

The economy has been showing rapid growth of over 7.0% CAGR in the last 3 years and future forecasts are positive with 7.0% GDP growth expected in FY08.

Changing Lending Mix - Consumer is the King!

Presently banks have high exposure to corporate lending with consumer lending forming only 12% of total outstanding loans of the sector. Overall, loans-to-GDP is 42% whereas consumer loans-to-GDP is less than 4%. These low levels of loan penetration, especially in the consumer segment, suggest that Pakistan is an under-banked country and potential for growth exists. Alongside, rise in per capita income from US$562 to US$925 during last 4 years also indicates increasing demand for consumer financing products. The mix of bank advances is expected to tilt in favor of consumer banking in the future because this is one of the fastest growing segments.

Consolidation - an Exciting Reality

Regulatory pressure to raise minimum capital levels of banks is providing the impetus to consolidate. We believe the low concentration levels in the industry justify mergers and acquisitions. The 4-firm concentration ratio, which is the sum of market shares of the four largest firms, is 48%. This is contrary to popular belief that the top few banks control the banking sector. The Herfindahl Index (HI) is another measure, which is the sum of squared market shares of all firms in the industry. Values of HI between 1000 and 1800 are generally considered to be moderately concentrated while values above 1800 are considered concentrated. For Pakistan the value is 808 (using market shares of deposits), which indicates low concentration. Therefore, mergers in the industry appear to be justified.

Blinking on International Radar Screen

High returns and potential acquisitions have caught the attention of international players.

Financial Performance

Pakistan banks' profits have soared in past years riding on the wave of economic growth and expansion of margins. Returns found in Pakistan banks are one of the highest in the region. The central bank's efforts in the past one and a half decade have been to foster a competitive and less segmented market. Consequently, the sector that used to be dominated by five big public sector banks in the early 1990s is now in the profit-hungry hands of the private sector. This has infused fresh competition and newer products and most importantly a profit-driven focus that was missing in the public sector dominated market of the early 1990s. Return on equity for the entire sector was recorded at an all-time high of 36% in 2006.

Table 02: Financial Performance highlights of IGI Banks universe

	2005A	2006A	2007E	2008E
Total Revenue	90,569	119,814	150,795	179,719
Profit Before Tax	51,480	70,516	87,987	106,019
Profit After Tax	34,924	47,215	59,449	71,722
Net Profit Margin (%)	41%	40%	41%	42%
Sales Growth YoY (%)	59%	33%	28%	21%
Profitability Growth YoY (%)	106%	31%	40%	23%
Return on Equity (%)	28%	26%	27%	26%

Source: Company Reports & IGI Research

This amazing performance has not gone unnoticed in the eyes of international players and the sector is ablaze with rumors of mergers and acquisitions. Standard Chartered Bank's successful acquisition of Union Bank at a price close to 5 times its book value has set off an unstoppable quest for 'Who's next?' We believe that there are fundamental grounds for buying these stocks. There is real evidence that banks are preparing for consolidation. Some are raising capital to fund growth and others are already talking to potential partners. Investors should remember that the benefit of consolidation is stability of pricing (fewer banks to drive

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pricing down) rather than cost-cutting. Banks are already exploring avenues outside traditional banking. Even the regulator is becoming more accommodative of newer products.

The strengths of this sector compared to other bank sectors in the region remain its better than average margins, strong capital position and demand. Regulatory pressures have resulted in accumulation of large capital bases as well as large loan loss reserves for most banks. Most banks in our coverage were able to meet our minimum standard of 50% prudent coverage. The economy has been undergoing a period of unprecedented growth and the rising interest rate scenario has enabled banks to enjoy very high margins. Though inflationary pressures have forced the central bank to maintain a tight monetary stance and discourage credit off take to private sector, we expect inflationary pressure to ease off in the near future. Already core inflation is down to 5.5% as of December 2006 though food inflation remains in double digits.

The increasing levels of consumer affluence have resulted in a sharp rise in consumer financing. The year 2005 saw the peak in growth in consumer financing. Tight monetary policy stance stifled growth slightly in 2006, yet prospects remain high for the future. We believe that the growing interest from foreign players is centered on the potential available in this particular segment.

Comparative Valuations

Comparing the banking sector of Pakistan with regional counterparts, it can be seen in the table below that Pakistan offers one of the highest Net Interest Margins in the region (3.54%) as well as Return on Equity (30.88%). Banking sector in Pakistan offers a reasonable dividend yield and advances growth. However, the sector is trading at a relatively high price-to-book multiple of 5.23x. We believe that the growth potential offered by this sector justifies the high multiple. Moreover our top pick BOP is trading at a discount to the domestic sector multiple. After analyzing the following table it can easily be concluded that the banking sector of Pakistan appears attractive on a regional basis.

Table 03: Regional Comparison of Banking Sector

	Price to Book	Div Yield	ROE	PER	Avg 5-day vol	30 Day vol	Net Int. Margin
NBP	2.88	1.3721	21.08	16.85	16,194,100	27.54	5.45
UBL	7.34	1.153	30.04	27.43	3,147,920	35.59	4.67
MCB	8.55	1.9844	47.13	22.05	5,587,340	33.64	N/A
BAFL	4.25	0	21	22.87	8,125,000	27.35	3.05
FABL	2.24	7.2464	25.15	10.41	1,123,820	27.56	4.2
BOP	3.05	0	21.9	17.70	12,262,940	32.12	5.35
Pakistan	5.08	2.27	30.88	30.84	1,149,701	47.90	3.54
India	3.41	3.24	16.58	10.92	183,133	34.00	NA
Indonesia	2.59	1.27	14.88	35.98	20,659,238	33.62	5.89
Hong Kong	1.83	3.78	14.12	15.70	4,888,707	20.94	1.83
Thailand	1.68	2.36	3.92	31.21	11,105,107	27.12	3.32

Source: Bloomberg

Bottomline: An Investment Perspective

Analyzing aforementioned facts and developments, we view banking sector of Pakistan as a robust growth play, offering substantial capital gain coupled with decent dividend yield. At existing price level we hold a POSITIVE stance on the sector.

Bank of Punjab **BUY**

Investment Consideration

- A public sector bank with extensive rural branch network and favorable funding mix. Low cost deposits form 60% of total deposits.

- Attractive investment in National Investment Trust (NIT) units likely to boost Non-Interest Revenue as well as possible wind fall gains.

- Established niche in SME segment due to its branch location.

- Low coverage ratio of 49% is not very prudent and creating concerns for future loan losses. However level of Non Performing Loans (NPL) has been low so far at 2.3%.

- Capital levels are low and stood at 10.09% at of December 2006 but meet the regulatory capital adequacy requirement. However the bank's paid-up capital is low and further capital rising in required to meet regulatory minimum capital requirement.

- Recent allegation of fraudulent loans have proved to be unfounded. The current low prices as a result offer an attractive opportunity to buy.

Table 04: Normalized Required Return Analysis

	Net Income	EPS	Dividend	PE Rating	NAV	Price-to book
	PRs mn	PRs	PRs	x	PRs	x
2005A	2,353	10.02	0	14.45	58.2	2.49
2006A	3,804	13.14	0	11.02	36.72	3.94
2007E	6,071	20.92	0	6.92	81.2	1.78
2008E	8,118	27.98	0	5.17	110.3	1.31

Source: Company Reports & IGI Research

Table 05: Required Return Analysis (%)

Normalised ROE	31	Normalised price/book	178
Required return	17	Misvaluation	22
Fair price/book	217	12 month return potential	22

Source: Company Reports & IGI Research

Valuation and Recommendation

The bank has shown superb growth in profits as well as book size in recent years. Going forward we expect it to continue its growth albeit at a slower rate. Its funding cost is on the higher side yet the bank compensated for it by effective pricing of loans. The risk profile of the bank is favorable in terms of low level of NPLs. However the bank does not follow a prudent practice in terms of provisioning.

Currently the bank is trading at leading price- to- book multiple of 1.78x of its 2007 expected book value. According to our estimates the bank justifies a fair price-to-book ratio of 2.46x. The bank offers significant upside potential at current prices. We make a BUY recommendation for this bank. Our target price for BOP is PRs.133 per share.

Cement

Sector Snapshot

Favorable Economic Backdrop
The correlation of per capita cement consumption to nominal GDP has stood at 0.9186 over the last couple of years, which suggests that higher economic growth translates into greater cement consumption. Cement sales are expected to grow 1.3x the nominal GDP growth in FY08.

Government's Commitment to Infrastructure Development Driving Demand
High GDP growth, accompanied by growing allocation to the Public Sector Development Program (PSDP) by the government, has translated into greater construction activity and thereby cements demand. The government has allocated PRs520bn to PSDP for FY08.

Industry Cycle Set For a Profitable Turn
The demand supply situation reverses periodically. After every three to four years a round of expansions raises the supply in excess of demand. Demand eventually rises to close the gap and a fresh round of expansions starts. Currently the capacity expansions in the industry that started in FY06 are nearing its end. This suggests that capacity will remain stagnant for the next 3 to 4 years. Given favorable economic environment backed by government's commitment on PSDP, we envisage growing demand in cement at a CAGR of 18% during next three years. Such a situation bodes well for manufacturer's profits because sales will keep rising without further investment in plants, thereby, increasing company valuations. At the end of FY07, industry capacity stood at 33mntpa. Total sales were recorded at 24mntpa. Overall industry capacity has shown a CAGR of 18% from FY02 to FY07 whereas sales have shown a CAGR of 18% from FY02 to FY07. Going forward, we expect industry demand to grow at a CAGR of 11-12% during next three years. Industry capacity at the end of FY08 is expected to be 37mntpa.

Export Market Looking Attractive
In the last few years, Pakistan exports were mainly concentrated to Afghanistan. Recently, Pakistan has started exploring its sea port for exports. Exports to neighboring countries like India, however, can be conducted through the land route and the excess demand situation in India makes this option extremely attractive. Potential export market can grow exponentially from modest 2.5mntpa to over 7.0mntpa by FY09. Target markets include neighboring countries along with Middle East, Africa and Iraq.

Leverage Affects Both Ways
Large amount of fixed operating costs due to the recent capital expenditure have raised operating leverage. As of FY06, cement industry leverage ratio stood at 58%. Moreover, long term loans acquired to finance these expansions have also introduced fixed financial costs raising the companies' financial leverage. Both these factors together contribute to a high degree of total leverage. Any change in sales has a magnified effect on the companies' bottom line due to this factor. A price war, therefore, can be detrimental to the sector's profitability.

Cartel Reformation Benefits All
The existing cartel or so-called marketing arrangement is an important element of the cement sector. The cartel ensures that prices are stable and high enough to benefit all. A breakup in the cartel, however, may hurt the sector's profitability. The cement industry is fairly fragmented with 27 players. During last sixty years various forms of cartels have been witnessed in the cement sector. However, those cartels never proved to be long lasting due to low concentration in the sector (as explained by Concentration Ratio and Herfindahl Index). Therefore, we do expect that current formation of cartel in the offering may not prove to be a long lasting one.

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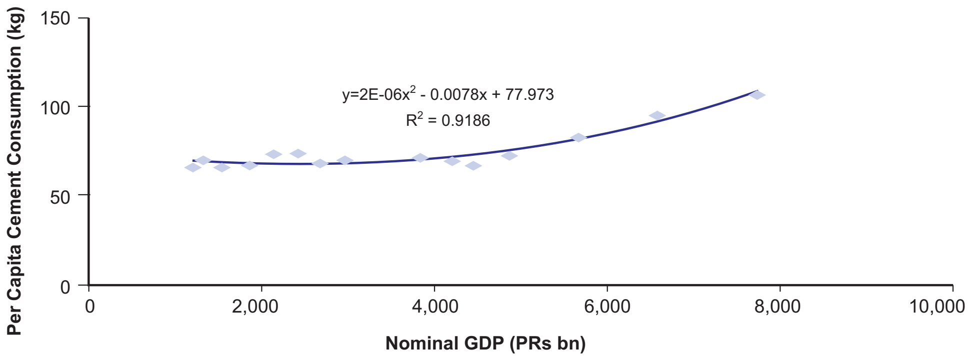
Mergers and Acquisition

The possibility of industry consolidation suggests that small cement companies may become acquisition targets by large ones. Especially those big players who missed the expansion opportunity in the South are expected to target small Southern plants. This will allow them to avail the export market through the sea route. Industry will not witness massive capacity expansions in the next three to four years and the overall industry capacity is expected to be 40mntpa in FY10, therefore, we believe that now industry will be a possible target for Mergers and Acquisitions (M&A). 4-firm Concentration of 40% and Herfindahl Index of 713 also suggests that cement industry will be M&A story in the next three years.

Chart 38: Per Capita Cement Consumption vs. Nominal GDP



Source: IGI Research

Financial Performance

During the past five years the IGI Cement Universe has shown a progress in the bottom line with a CAGR of 16%. The total sales have increased to US$479mn in FY06 which is 58% higher than the sales of FY05. Similarly the profit before tax which was US$91mn in FY05 increased to US$144mn. The net profit margin also increased by 3.84% to reach 24.65%. Return on equity was 17.41% in FY05 and 24.04% in FY06; however, in future we do not expect such high returns.

Table 06: Financial Performance Highlights of IGI Cement Universe

Income Statement	FY05A	FY06A	FY07E	FY08E	FY09E
Total Sales in (US$ mn)	304	479	556	702	795
Profit Before Taxes (in US$ mn)	91	144	48	132	180
Profit After Taxes (US$ mn)	67	120	79	107	142
Net Profit Margin (%)	20.81	24.65	13.28	14.92	17.35
Sales Growth Yoy (%)	33.51%	57.63%	16.19%	26.24%	13.19%
Profitability Growth YoY (%)	48.92%	78.82%	-34.10%	34.61%	32.56%
Return On Equity (%)	17.41	24.04	12.01	14.78	16.51

Source: IGI Research

Comparative Valuations

Comparing the cement sector of Pakistan with regional counterparts, it can be seen in the table below that the cement sector of Pakistan offers almost 26% return on equity, which is the highest in the region. In addition to this, cement sector in Pakistan offers one of the highest dividend yield and sales growth. Coupled with these, the sector is trading at earnings multiple of 12.6x which is below the regional average. Moreover, the cement sector of Pakistan offers the highest operating profit margin. After analyzing the following table it can easily be concluded that the cement sector of Pakistan appears as the most attractive sector among its regional counterparts.

Table 07: Comparative Valuation

	Price to Book	Div Yield	ROE	PER	Avg 5-day vol	30 Day vol	Sales Growth	Price to Sales	Operating Profit Margin
Pakistan	2.82	1.51	26.31	12.63	1,441,786	43.25	44.21	2.08	26.41
LUCK	4.84	0.8203	31.73	17.69	2,356,268	35.87	100.61	4.02	32.18
DGKC	1.42	1.1364	16.92	11.27	2,702,088	35.28	50.69	3.62	45.53
MLCF	1.12	0	16.09	7.52	396,760	39.73	33.07	1.20	34.70
PIOC	2.81	2.9901	26.12	12.15	77,982	37.97	50.40	1.77	34.76
FCCL	2.84	2.551	50.60	6.60	575,850	29.27	50.65	1.70	47.77
India	5.41	0.79	7.63	33.00	68,713	52.77	7.09	0.89	-0.37
Indonesia	5.22	0.64	15.03	160.64	4,775,333	40.06	9.39	2.70	12.49
Hong Kong	6.19	0.16	4.84	76.02	2,818,165	87.62	51.12	6.81	5.17
Thailand	2.54	1.92	11.82	12.28	839,954	29.24	14.89	0.95	7.66

Source: IGI Research

Bottomline: An Investment Perspective

Analyzing the aforementioned facts and developments, we view cement sector of Pakistan as a growth play, however several scrips in the sector has already reached their fair values. Therefore, we recommend NEUTRAL on the sector.

Pioneer Cement Limited — SELL

Brief Company Overview

Pioneer Cement is located near Sargodha, Punjab. About two-thirds of the company's local sales are to the Lahore area (Lahore, Sheikhupura Gujranwala), with the remainder sold to Faisalabad. The company is not well placed to target the Afghanistan market. PIOC has a free float of 38%. PIOC was one of the first ones to come up with additional capacities in the recent phase of industry wide plant expansions. In FY06 PIOC came up with additional capacity of 1.5mntpa and their overall capacity became 2.1mntpa. The first plant was setup by FL Smidth while the new one uses KHT, a German technology. PIOC has no further plans to extend their capacities in the recent future. However, they may eye a new location in the South for setting up a Greenfield plant.

Key Investment Considerations

- One of the first ones to come up with additional capacities (1.5mntpa) whereas existing capacity is 2.1mntpa.
- Highly leveraged and sensitive to change in cement prices. Likely to be severely hit by price wars.
- Factory is located near Kalabagh dam. If quota allocation does not occur it would benefited the most along with MLCF.
- Location is not favorable to export to Afghanistan yet it has a share of 5.4% in total exports, PIOC is relying on BOT terminal issue to be solved so that it could explore the sea route for exports.
- Unlike others in the industry it did not operate on more than 100% capacity in the recent past as its new plant was already underway when others were busy in expansions.

Table 08: Estimates

	FY04A	FY05A	FY06A	FY07E	FY08E	FY09E
Net income	424,265	332,089	675,982	108,927	382,607	510,207
Dividend per share	-	-	-	-	0.5	0.7
Earning per share	4.4	2.1	4.2	0.6	2.3	3.0
Book value per share	5.7	10.5	14.3	14.3	16.1	18.4
Price/Book	2.0	1.7	3.4	3.4	3.0	2.6
Price/Earning	2.6	8.3	11.5	80.3	21.0	16.1
Dividend yield	0.0%	0.0%	0.0%	0.0%	1.5%	2.2%

Source: IGI Research

Valuation & Recommendation

Currently PIOC is trading at a PE of 20.96 on FY08E earnings; we expect it to trade at a PE of 17.3 on FY08E earnings. Our fair value for PIOC based on DCF valuation is PRs39. Currently the scrip is trading at a 19.09% premium to our fair value. We suggest a 'SELL' recommendation on PIOC.

Table 09: Sensitivity analysis

		Terminal growth rate				
		3.0%	3.5%	4.0%	4.5%	5.0%
WACC	10.1%	34.23	36.65	39.38	42.50	46.08
	10.6%	34.13	36.54	39.28	42.39	45.97
	11.1%	34.02	36.44	39.17	42.28	45.87
	11.6%	33.92	36.33	39.06	42.18	45.76
	12.1%	33.81	36.23	38.96	42.08	45.66
	12.6%	33.71	36.13	38.86	41.98	45.56
	13.1%	33.61	36.03	38.76	41.88	45.46

Source: IGI Research

Exploration and Production (E&P)

Sector Snapshot

- In the past five years, Pakistan's energy consumption has grown at a CAGR of 5.4% (almost inline with the average GDP growth rate), which surged to 57.85mn TOE (tones of oil equivalent) in FY06. During the period FY01 to FY06 demand for gas, coal, electricity and LPG grew at CAGR of 10.4%, 22.8%, 6.8%, and 17.6% respectively. However, oil consumption plunged by 1.3%. The growth in the country's gas consumption during the past five years is considered to be the third highest in the Asia Pacific region, following Singapore and China.

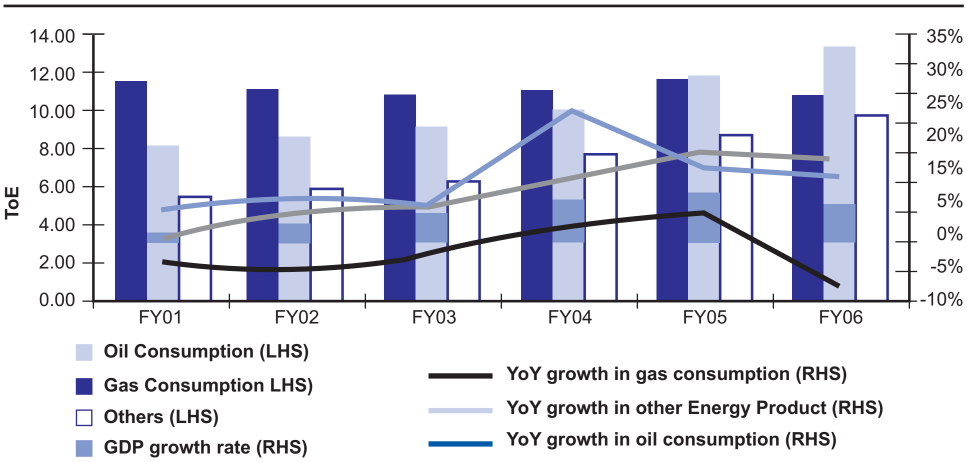
- As per government estimates, overall domestic energy requirement is expected to surge to 80mn TOE by FY10, increasing at a CAGR of 8.4%. According to the Energy Year Book 2006, Pakistan has 32.58tcf (612.4mn TOE) natural gas balance recoverable reserves and 0.53tcf (15.3mn TOE) associated gas balance recoverable reserves, which would be sufficient to satisfy the country's cumulative gas requirements for 18 years. Moreover, the country has 324.5mn barrel (43.53mn tones) of balance recoverable oil reserves, which would be sufficient to satisfy total domestic oil requirements for merely another 4 years.

- At present, Pakistan satisfies only 20% of its oil demand through domestic production. Moreover, the demand for gas is growing rapidly and going forward, the country is likely to become a net gas importer. The government is exploring all possible avenues to avoid any energy crisis, going forward and is likely to offer major incentives, to domestic as well foreign oil & gas exploration companies, in the upcoming petroleum policy to lure greater investment towards this largely untapped sector.

- On the back of favorable economic outlook, anticipated robust growth in demand for energy products and most importantly outstanding success ratio of new discoveries in the country (which currently stands at 1:4 as against the global success ratio of 1:10) some E&P companies have already undertaken massive oil and gas drilling & exploration activities. Oil and Gas Development Company Limited (OGDCL), the largest E&P Company in Pakistan, has also under taken massive exploration and drilling activities and is going to spend US$1.9bn in this respect by FY09.

- Aforementioned facts signify the country's dependence on domestically produced oil and gas would surely remain intact. Considering this fact, E&P sector is one of the least vulnerable sectors to the unanticipated economic fluctuations and in our view, prudent fund managers should give more weightage to this sector.

Chart 39: Consumption Pattern of Energy Product Relative to GDP growth during FY01 to FY06



Source: Energy Year Book 2006

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Financial Performance

During the past 5 years, the profitability of the IGI universe E&P companies has witnessed phenomenal growth. The topline of the sector grew at a 5 year CAGR of 24.81% mainly on the back of significant growth in volumetric sales. Moreover, during this period, the bottomline of the sector increased at a 5 year CAGR of 28.42%. According to our estimates, in the next 3 years, the topline of the sector is expected to grow at a CAGR of 18.22% while the profitability of the sector is likely to increase at a CAGR of 14.96%.

Table 10: Financial performance highlights of IGI E&P Universe

	2005A	2006A	2007F	2008F	2009F
Total Sales in (US$ mn)	1,598	2,117	2,623	3,081	3,498
Profit Before Taxes (in US$ mn)	1,029	1,418	1,692	1,924	2,189
Profit After Taxes (US$ mn)	685	978	1,158	1,307	1,486
Net Profit Margin (%)	42.8%	46.2%	44.2%	42.4%	42.5%
Sales Growth YoY (%)	40.6%	32.5%	23.9%	17.5%	13.5%
Profitability Growth YoY (%)	43.14%	42.9%	18.4%	12.8%	13.7%
Return on Equity (%)	44.84%	50.95%	51.02%	47.57%	43.64%

Out of 4 listed E&P companies, IGI E&P universe includes OGDC and PPL. Both these companies have cumulative market capitalization of US$ 11,672bn, index weightage of 22.5% and sector weightage of 87%.

Source: IGI Research

Comparative Valuations

Comparing the E&P sector of Pakistan with regional counterparts, it can be seen in the table below that the E&P sector of Pakistan offers almost 40% Return on Equity, which is the highest in the region. In addition to this, E&P sector in Pakistan offers the highest dividend yield and sales growth. Coupled with these, the sector is trading at earnings multiple of 10x which is the lowest. Moreover, after Thailand, the E&P sector of Pakistan offers the highest operating profit margin. After analyzing the following table it can easily be concluded that the E&P sector of Pakistan appears as the most attractive sector among its regional counterparts.

Table 11: Regional Comparison of Oil and Gas Exploration & Production Sector

	PBV	RoE	RoE/PBV	PSR	Div Yield	PCF	PER	Avg Vol. 5-day	30 days Volatility	OPM	Sales Growth
Pakistan	5.11	39.70%	8.80%	4.54	3.88%	10.99	11.32	10,180,200	26.39	47.64%	36.03%
India	4.65	18.16%	5.68%	4.81	1.10%	11.26	25.25	540,566	38.83	27.17%	23.23%
Indonesia	5.00	11.61%	2.81%	3.93	0.00%	5.19	57.67	26,643,600	40.62	18.60%	12.84%
Hong Kong	7.49	11.02%	5.46%	3.49	2.92%	63.89	20.00	205,870,176	47.61	28.85%	21.84%
Thailand	4.63	35.01%	8.86%	3.90	3.06%	7.98	15.44	12,101,840	29.35	54.15%	30.59%

Source: Bloomberg

Bottomline: An Investment Perspective

Analyzing aforementioned facts and developments, we view E&P sector of Pakistan as an attractive investment option offering substantial capital gain coupled with decent dividend yield. At existing price level, we hold POSITIVE stance on the sector.

Oil and Gas Development Company Limited (OGDCL) BUY

Brief Company Overview

Oil & Gas Development Company Ltd (OGDC) is the largest oil and gas exploration company in Pakistan. The company has the largest exploration acreage in the country covering 33% of the total acreage awarded. During the month of February 2007, the company's average per day production level was 45,748 barrels of oil, 1,155 MMcf of gas, 438 metric tons of LPG and 72 metric tons of Sulphur, which includes its shares in various joint ventures.ÊÊPresently, the company has recoverable oil and gas reserves of 130mn barrels and 9.7tcf, which are equivalent to 37% and 32% of the country's oil and gas recoverable reserves respectively. At present, 80% of the company's production is driven from gas and 18% comes from crude oil while the remaining 2% comes from LPG, Sulphur and White Oil products. However crude oil, because of relatively better margins contributes almost 44% to the company's revenues while gas adds 48% to the topline.

Key Investment Considerations

- The company's management has recently accelerated exploration and drilling activities to increase oil and gas production to 136,830bpd and 2,963MMscfd respectively by the year FY11.

- Keeping in view oil & gas discoveries success ratio in Pakistan which stands at 1:4- far better than the global success ration of 1:10- we believe that the massive drilling and exploration activities would enable the company to achieve its optimistic five year strategic targets.

- In our view, OGDCL is expected to be one of the major beneficiaries of the upcoming Petroleum Policy 2007.

- In 9MFY07, the company has posted an EPS of PRs8.05. For the entire FY07, we expect the company to post an EPS of PRs11.97 as against an EPS of PRs10.69 reported in FY06, translating into 12%YoY growth.

- According to our forecast, during FY07 to FY10 the topline of the company is expected to grow at a CAGR of 18.6% while earnings are likely to increase at a CAGR of 16.5%.

- At existing level, the stock trades at prospective earning multiple of 10.15x which is lower than that of the KSE-100 index.

- At current price level, the stock offers potential upside of 18.32% to its fair value and dividend yield of 7.5%. Coupled with this, the stock offers Return on Equity of (ROE) of 49%, which is significantly higher than that of regional counterparts and almost twice as high as the average RoE of KSE-100 index.

Table 12: Key Valuation Statistic @ 120.85

	FY05A	FY06A	FY07F	FY08F	FY09F	FY10F
Earning Per Share- diluted	7.67	10.69	11.97	13.34	15.40	19.73
Price Earning Ratio	15.77	11.31	10.15	9.45	8.23	6.74
Dividend Per Share	7.50	9.00	9.25	10.00	10.00	12.00
Dividend Yield	6.21%	7.45%	7.65%	7.65%	8.27%	8.27%
Return on Equity	41.4%	49.8%	49.5%	49.7%	49.1%	55.3%
Return on Capital Employed	49.6%	56.1%	56.8%	52.2%	50.8%	59.4%
Book Value Per Share	19.35	23.59	24.80	28.89	33.80	37.52
Price to Book Value	6.25	5.12	4.81	3.97	3.29	2.65
EV/EBITDA	8.87	6.84	6.09	5.13	4.46	3.42

PE, PBV and Div Yield are calculated on the closing market price of June 7, 2007

Source: IGI Research

Regional Comparison

In the following table it can be seen that at existing levels, OGDC appears to be one of the most attractive scrips among domestic as well as regional listed oil and gas exploration companies. The company yields highest dividend yield among its local and regional counterparts. Moreover, the company appears to be the most efficiently managed E&P Company in the region, as its operating margin is the highest among the regional oil and gas exploration companies. Nevertheless, the company appears to be most expensive one based on Price to Book Value (PBV) but this is justified by the fact that the company offers RoE of almost 48%, which is one of the highest in the region. Moreover, the stock is highly liquid with low volatility. The Government of Pakistan (GoP) recently liquidated 10% stakes in this E&P giant, through a GDR offering. Presently, GoP holds 85% stakes in the company. By virtue of GDR issue, OGDC has become a highly liquid trading stock, which facilitates easy entry and exit.

Table 13: OGDC V/S Rest of Key Regional E&P Companies

	PBV	PSR	Div Yield	PCF	RoE	PER	Avg Vol. 5-day	Volatility 30 day	OPM	Sales Growth
Pakistan										
OGDC	5.22	5.45	7.7%	10.8	47.8%	10.21	27,470,780	17.48	63.1%	30.0%
PPL	6.01	5.71	3.8%	12.5	52.1%	10.25	8,407,560	20.59	59.2%	36.7%
POL	4.46	4.44	2.1%	11.0	51.7%	8.48	4,791,660	25.52	56.0%	73.1%
MARI	2.34	2.55	1.9%	9.7	7.2%	33.11	50,800	41.96	12.2%	4.4%
INDIA										
ONGC	3.24	2.61	3.6%	8.2	28.4%	12.30	187,246	22.58	30.1%	21.5%
Thailand										
PTTEP	4.63	3.90	3.1%	8.0	35.0%	15.44	12,101,840	29.35	54.2%	30.6%
Indonesia										
MEDC	3.78	1.59	0.0%	5.2	7.1%	32.88	9,520,100	28.26	22.7%	27.8%
ENRG	6.44	6.27	0.0%	N/A	16.1%	56.08	43,767,100	52.99	14.5%	2.1%

Source: Bloomberg

Valuation & Recommendation: Buy @ 120.85

Using Discounted Cash Flow (DCF) model, at weighted average cost of capital (WACC) of 16.3% and terminal growth rate of 5%, our fair value for the scrip is PRs143 per share and US$23.54 per GDR. At present level the stock offers potential upside of 18.32% from our fair value. The stock is expected to offer a total annual return of 28% (expected capital gain of18.32% and dividend yield of 8%) and, thus we advise investors to BUY at present levels.

Table 14: Sensitivity Analysis: Fair Value per Share

Terminal Growth Rate	15.0%	16.0%	16.4%	17.0%	18.0%
2.0%	132	122	119	115	108
3.0%	140	129	126	121	113
4.0%	150	138	134	127	119
5.0%	162	147	143	135	125
6.0%	176	159	153	145	133
7.0%	194	173	166	156	143
8.0%	217	191	182	170	154

Source: IGI Research

Consumer Goods and Packaging Industry

Sustained economic growth, positive changes in consumption preferences and surge of private lending from commercial banks have resulted in incremental levels of consumer spending, providing the all important impetus for the consumer goods sector. This PRs 102bn (US$ 1.68bn) consumer goods market is growing with a momentum of 11.5% on a 5year CAGR. With GNP per capita of US$ 925 for FY08, private consumption expenditure is likely to grow 13% on average over the next 5 years; with the consumer goods market (durable and non durable) expected to grow at a stupendous 25% over the next four years. From this platform, the consumer goods companies face upbeat market condition and immense demand potential. Key beneficiaries of this economic boom are FMCG companies and related upstream packaging companies.

Key Investment Considerations

Following are the key features and developments in the consumer industry, which indicate the prospects of growth in this industry.

- **Increased aggregate demand**
  On the back of rising incomes and workers' remittances, the average household income has increased substantially to US$ 925 per person. Moreover, increased private borrowing has also increased the disposable incomes, resulting in excess private consumption expenditure on services and consumer non-durables. This shift in consumer behavior is typical of emerging countries and signals Pakistan's transition into a "mass consumption" stage.

- **State sponsored reduction in costs**
  The very recently announced FY08 budget is indicative of the government's stance on supporting the consumer. The reduction, and in some cases exemption, on key raw materials for consumer goods companies is going to have a very positive impact on the bottom line of the a ffected industries. For instance the reduction in the excise duty for paper and newsprint is going to fare very well for the paper and board companies. Similarly, the reduced and in some cases exempted sales tax for certain consumer durables will affect the top line of affected companies positively.

- **Capacity expansions in key industries**
  The best part of this consumer cycle is the multitude of upcoming capacities which can afford the increase in volumetric sales going ahead. From the massive capacity expansion on the UHT plants in various food conglomerates to the installation of a state of the art ice cream plant in Unilever, the willingness of corporations to invest in this part of central Asia is reflective of the overall positive sentiment. With most capacities coming online by the end of 2007, the Pakistani market will see a surge in consumer non-durables. With the average income at US$ 925, and consumption per capita at US$ 758, and a large youth segment, Pakistan faces sustained economic growth arising from robust aggregate demand.

Financial Performance

As mentioned above, the beneficiaries of the economic growth are the consumer goods companies, which is evident by their respective turnovers. Moreover, despite the tremendous growth figures which these companies have witnessed in the recent past, their margins seem to be impervious to rising competition. Reason being – an under explored, unsaturated market. In the future, we see Pakistan as an attractive market, with much room for consumer satisfaction.

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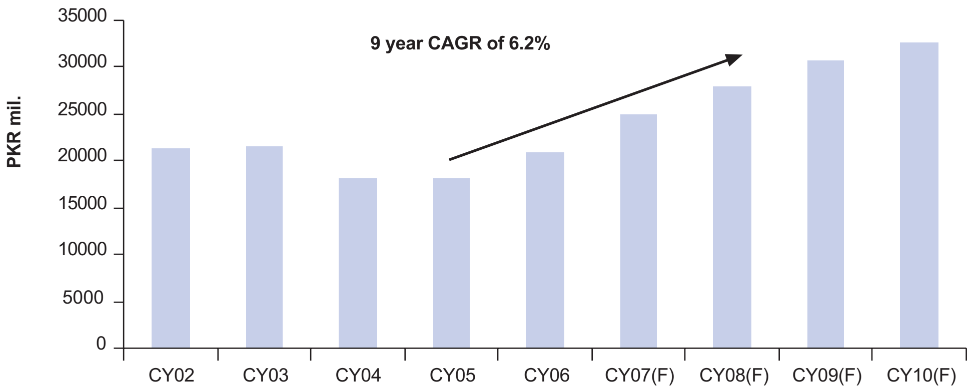
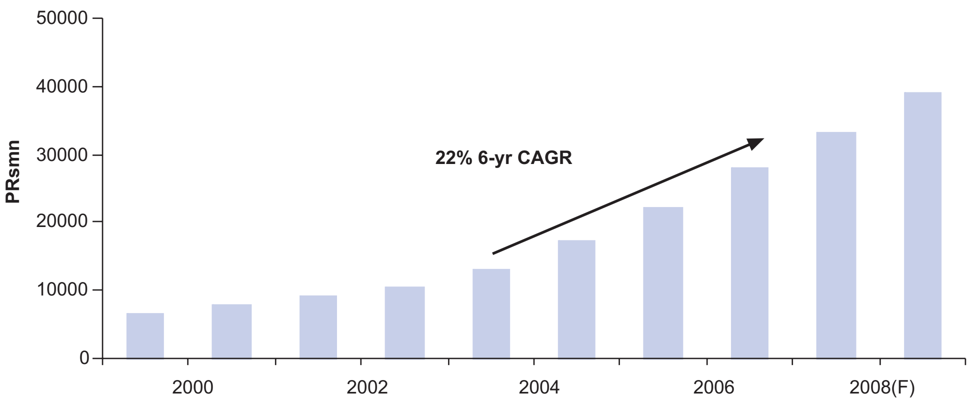
Chart 40: UNILEVER Net Sales



Source: IGI Research

Chart 41: Nestle Turnover **(PRs mn)**



Source: IGI Research

Comparative Valuations

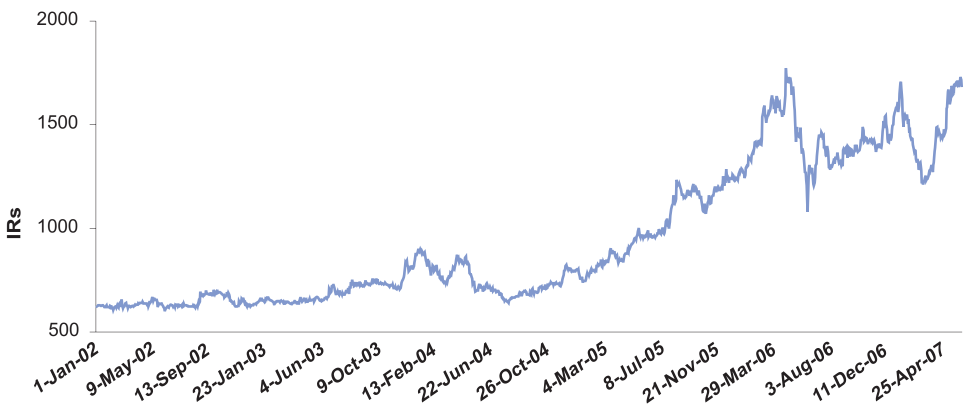
While the prosperous economic growth numbers reveal much, we resort to here to comparing the performance of some key consumer goods companies in India, some of which are counterparts to consumer goods companies in Pakistan.

Table 14: Comparative Valuations

	RoE	Net Margins
ULEVER PA	88%	8%
Hind. Lever	77%	9%
NESTLE	47%	5.30%
Nestle India	86%	11%
Packages	45%	15%
Colgate India	42%	7%
Tata Tea	32%	5%
Consumer	37%	9.33%

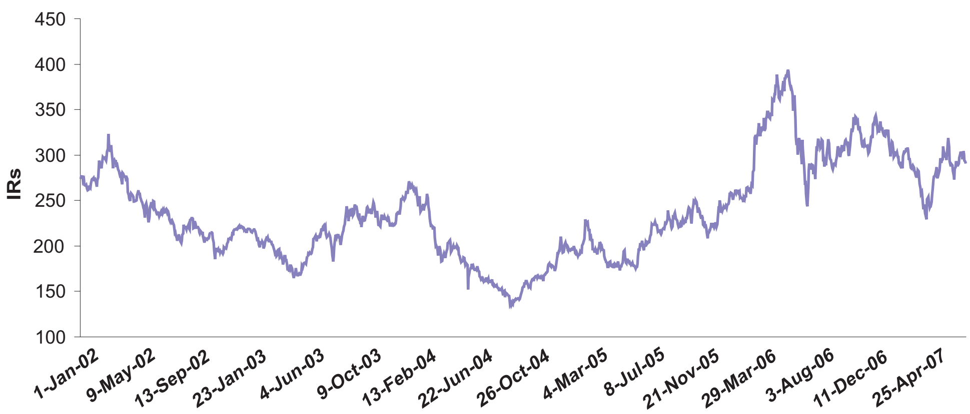
Source: IGI Research

Chart 42: Nestle India



Source: IGI Research

Chart 43: Hindustan Lever **(PRs mn)**



Source: IGI Research

Packages BUY

In light of Packages Limited's stellar performance in turnover and the current capacity expansion, we believe that Packages offers excellent investment potential for medium to long-term play. For 2007 and 2008 we anticipate dimmed profitability in light of financial costs and deprecation charges. Yet, in the long-term we believe the company's cash sources and balance sheet strength indicate sound growth potential.

The script is currently trading at PRs315.5 and offers an upside potential of 23% to our DCF based fair value of PRs388. The script is trading at a PE multiple of 13.69 times and offers a dividend of PRs6 for 2007. In light of the company's strong fundamentals as well as its potential and presence in the industry, we recommend a "buy" on the scrip!

Demand Driven Sales

Committed to providing the packaging needs of almost all major consumer goods companies as well providing paper and poster papers to different concerns, PKGS faces a demand CAGR of 18% for the past 5 years, and going ahead this number is estimated to remain at 15% for next 5 years.

Aggressive Capacity Expansion

The Bulleh Shah Paper Mills (BSPM) project is the centre of much attention and hype. The new site, sprawling 300,000 acres and in close proximity to India, is surrounded by wheat fields that source the straw – fiber that PKGS utilizes as raw material. The move to BSPM has been in the pipeline for quite some years now. A number of factors have accumulated which compel the large-scale move, from 100,000 tonnes capacity to 300,000 tonnes by 2010.

Improving Profitability

In general, the profitabilty of the company will suffer in the expanison years for a vareity of reasons. Yet, after the full operation of the BSPM, the net margin will improve substantially, from 15% in 2006 to 17% by 2010, on the back of better economies of scale as well as value addition.

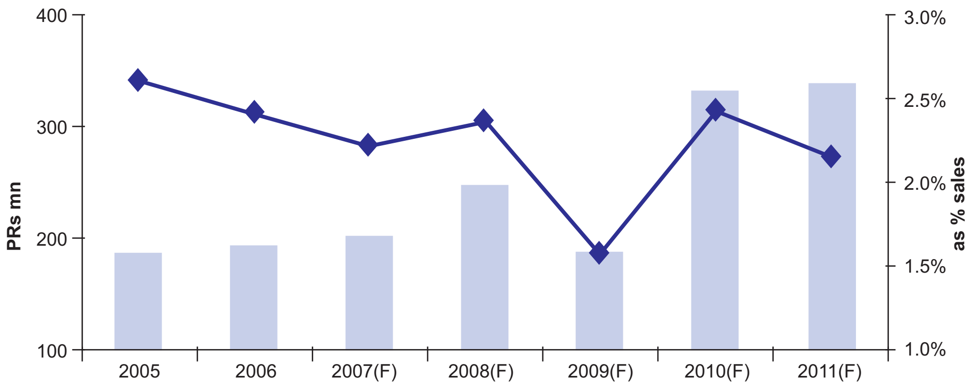
Company Investment Portfolio – The real treasure chest!

Another positive factor to be considered here is that of the investment income the company accrues by virtue of its holdings and subsidiary concens. On average, PKGS banks investment income at 10% of total sales. This number is more likely to increase than not, in light of the growth in the associated concerns.

Financial Performance

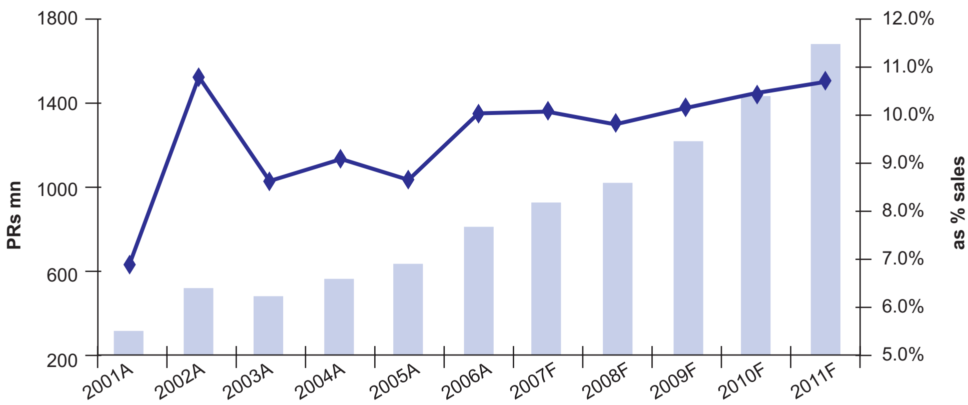
Unlike the operating margin, the net margin of the company remains less driven by the gross margins. It can be seen from the profile below that net margins will stumble in the years of expansion, mainly from the impact of rising fuel prices in (form 2006) and the increased borrowing rates. The repayment of the PRs 10.5bn loan will continue to adversely affect the net margin uptil 2014. A positive factor to be considered here is that of the investment income the company accrues by virtue of its holdings and subsidiary concens. On average, PKGS banks investment income at 10% of total sales. This number is more likely to increase than not, in light of the growth in the associated concerns.

Chart 44: PKGS - Financial Costs



Source: IGI Research

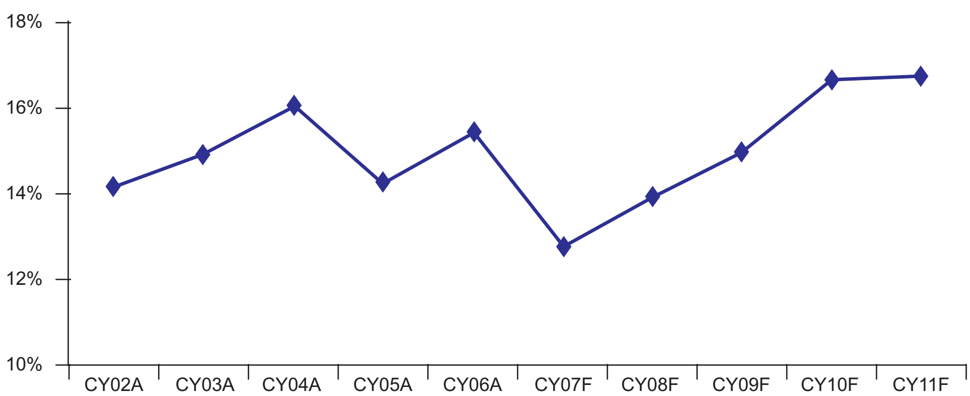
Chart 45: PKGS - Investment Income



Source: IGI Research

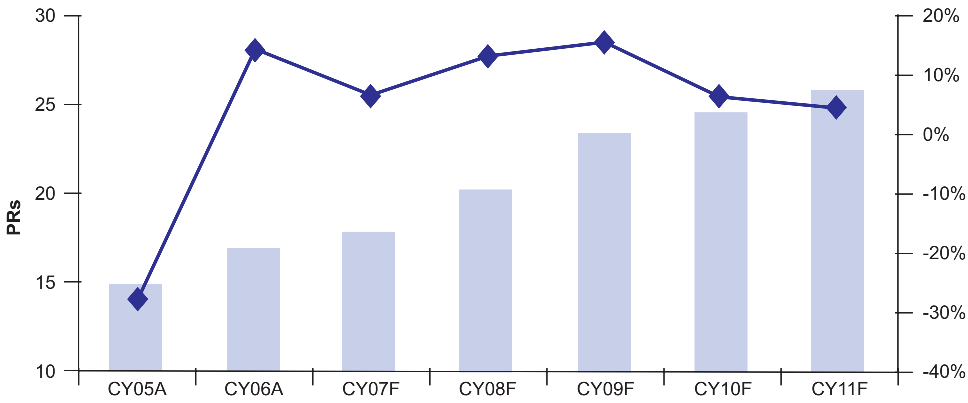
In general, the profitabilty of the company will suffer in the expanison years for a vareity of reasons, as discussed above. Yet, after the full operation of the BSPM, the net margins will improve substantially on the back of better economies of scale as well as value addition.

Chart 46: PKGS - Net Margin



Source: IGI Research

Chart 47: EPS and EPS Growth Rates



Source: IGI Research

Valuation Summary

In light of the company's strong fundamentals as well as its potential and presence in the industry, we recommend a "buy" on the script! Priced at PRs 388 as per our DCF based model, the script offers substantial upside of 23% from current trading price of PRs 315.

Table 15: Valuation Statistics

Year End Dec 31st	CY06A	CY07F	CY08F	CY09F	CY10F	CY11F
EPS (PkR)	16.60	17.64	19.95	23.04	24.49	25.58
EPS growth	14%	6.3%	13%	15%	6.3%	4.5%
DPS (PkR)	6.00	6.17	6.98	8.06	11.02	11.51
Dividend yield	2%	2%	3%	3%	4%	4%
Payout Ratio	36%	35%	35%	35%	45%	45%
PER	19.01	17.89	15.81	13.69	12.88	12.33
BVS (PkR)	195.70	236.60	188.30	161.20	181.10	210.90
P/BVS	1.61	1.33	1.68	1.96	1.74	1.50
CFS (PkR)	11.10	(7.80)	(5.10)	(8.10)	(8.10)	4.20

Source: IGI Research

Conclusion

The country is on a fast growth track and does not show signs of slowing down in the medium term. Rising income levels and changing demographics have resulted in a structural shift to a younger and more affluent population. Growing consumption is a consequence of this structural shift which augurs well for industries. Business confidence is high as the expansionary cycle is forecasted to continue. Regulatory changes have also enabled greater and easier foreign investments through capital markets.

Risks include the high and persistent inflation as well as the twin deficit situation that the country is facing. Both these factors demand a tight monetary stance. We do not foresee any ease in monetary policy however the demand driven economic growth is unlikely to be stifled by a moderate tightening. We have concluded that the impending change in political scene is unlikely to hamper the growth story.

IGI Universe Valuation Summary

Company	Recommendation	Fair Value (PRs)	EPS (PRs)			DPS (PRs)			ROE (%)			BVPS (PRs)			P/E (x)			P/B (x)		
			2006a	2007e	2008e	2006a	2007e	2008e	2006a	2007e	2008e	2006a	2007e	2008e	2006a	2007e	2008e	2006a	2007e	2008e
Banks																				
NBP	Neutral	292	24.01	29.50	33.27	3.48	3.00	3.00	18.77	19.6	18.3	115.58	166.86	197.55	13.99	13.40	14.35	2.27	1.57	1.33
UBL	Sell	146	14.62	17.99	22.79	2.40	2.50	2.50	18.37	31.3	30	46.12	65.54	86.54	11.18	6.57	6.85	4.46	3.14	2.37
MCB	Sell	248	19.33	24.69	29.07	7.50	7.50	8.50	37.61	32.13	31.15	65.01	83.06	103.63	9.31	10.90	11.24	5.39	4.22	3.38
BAFL	Neutral	55	3.86	7.02	9.00	-	1.50	1.50	20.37	27.7	28.7	24.48	27.99	34.78	2.83	2.08	2.01	2.35	2.06	1.66
BOP	Buy	133	13.14	20.92	27.98	-	-	-	43.64	29.8	29.2	36.72	81.20	110.30	2.50	3.67	3.74	2.98	1.35	0.99
FABL	Neutral	73	6.65	8.09	9.32	2.50	3.50	3.50	10.79	22.6	20.8	32.56	37.32	50.70	6.96	3.32	3.61	2.31	2.01	1.48
Cement																				
LUCK	Neutral	115	7.40	6.43	9.05	-	1.00	1.00	27.38	19.92	22.45	27.00	32.00	40.00	11.30	15.90	11.30	3.10	3.20	2.50
DGKC	Sell	100	13.10	7.11	8.90	1.50	2.40	1.50	12.55	8.08	9.34	104.00	88.00	95.00	6.10	14.30	11.40	0.80	1.20	1.10
MLCF	Neutral	28	3.60	1.02	1.60	2.40	-	1.00	14.51	3.99	6.13	24.25	25.50	26.10	9.50	18.40	11.70	1.40	0.70	0.70
PIOC	Sell	39	4.20	0.64	2.25	-	-	0.50	29.11	4.48	13.99	14.30	14.30	16.10	10.40	45.30	12.90	3.00	2.00	1.80
FCCL	Neutral	24	3.20	2.40	2.60	1.00	1.00	1.00	36.67	23.60	21.98	8.90	10.30	11.90	6.40	7.80	7.30	2.30	1.80	1.60
Consumer Goods																				
ULEVER	Neutral	2,450	123.70	134.70	146.70	122.00	129.30	140.90	89.83	65.54	65.79	137.7	183.8	188	17.00	15.60	14.30	15.30	11.40	11.20
NESTLE	Neutral	1,600	30.10	39.00	45.20	5.00	15.00	40.70	46.63	54.63	62.14	64.5	68.2	72.7	54.90	42.30	36.50	25.60	24.20	22.70
PKGS	Buy	388	16.60	18.30	20.40	6.00	6.50	9.00	44.67	11.10	13.69	195.7	183.7	165.4	16.40	13.30	12.00	1.40	1.50	1.60
Oil Marketing Companies																				
OGDC	Buy	143	10.69	11.97	13.34	9.00	9.25	10.00	49.80	49.50	49.70	23.59	24.8	28.89	11.57	10.33	9.27	5.24	4.99	4.28
PPL	Neutral	292	19.54	27.48	32.06	9.00	11.00	12.00	36.79	41.30	38.21	59.88	59.88	59.88	13.68	9.73	8.34	4.46	4.46	4.46

All prices are as of July 10, 2007

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Analyst Certification

We, Aymen Saeed, Shayan Hasan Jafry, Sobia Muhammad Din & Tahir Hussein Ali, hereby certify that the views expressed in this research report accurately reflect our personal views about the subject, securities and issuers. We 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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