Pakistan Equity Market Outlook

2017

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December 9, 2016

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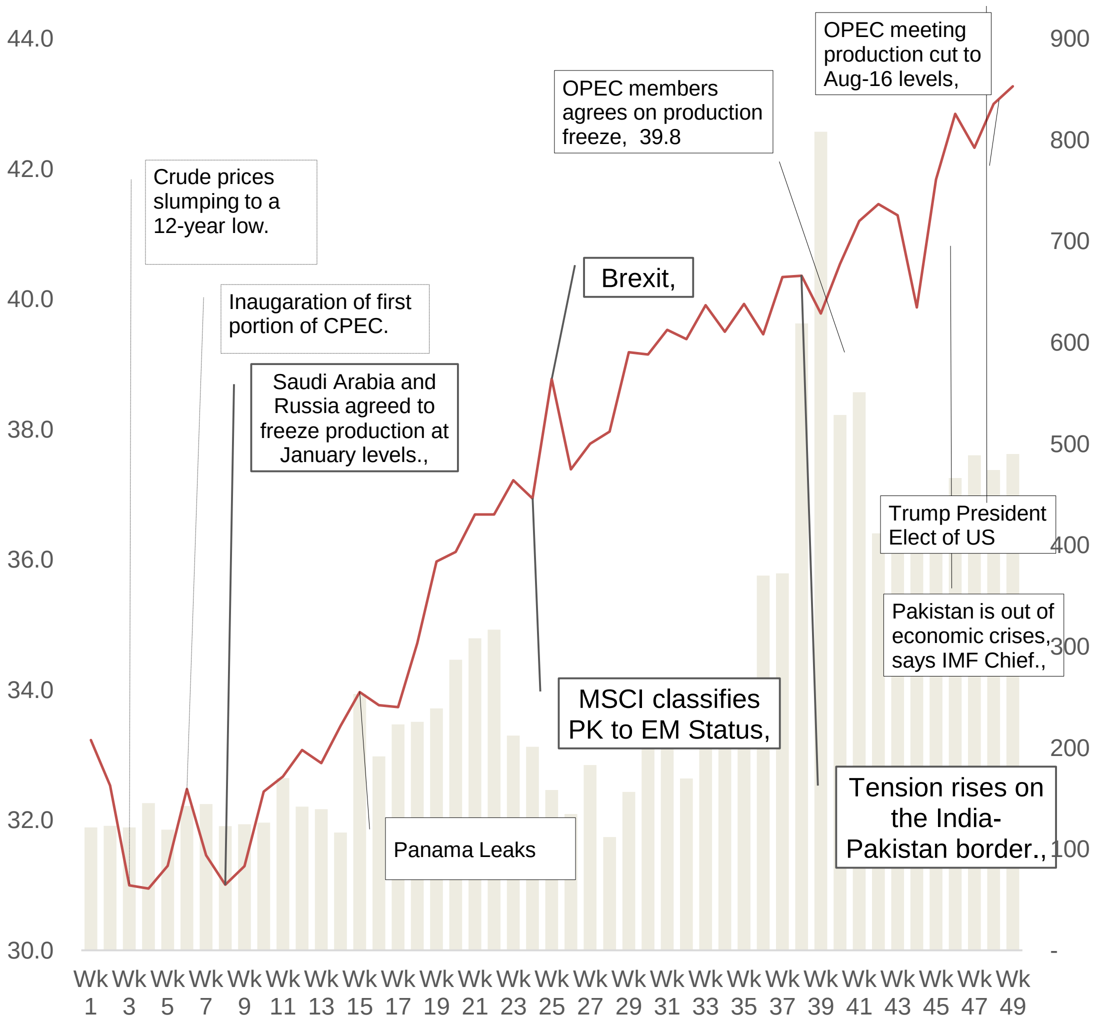
Pakistan Equity Market

- **Global Equity Markets Performance:** Amidst global worries over fading growth in China / EU and US along with sheer drop in global commodity prices, equity markets all across reacted negatively resulting in a very dull start to CY16. However, this pessimism was short-lived. Concerns of China hard landing started to fade away, subsequently leading to recovery in oil/commodity prices. On EU and US, concerns over Brexit fallout and gloomy US growth outlook, subsided and markets took off allowing to recover and eventually, 2016 turned out to be a positive year for equities.
- **KSE100:** Mooting global and positive domestic events KSE-100 also cheered along, with CY16 ending with nearly +36% (+28% USD) return, compared to 3 Yr average return of 21%. Market liquidity improved with average annual volumes standing at 3Yr high of 278mn.
- **Outlook:** Although 2017 outlook for equity market much depends on subsequent economic policy decisions and political situation, we note that a number of significant trends have emerged that could work as backdrop for market performance in 2017. Emerging trends such as higher commodity prices compared to 2014 and 2015 levels, rising domestic inflation, strengthening of USD in the wake of expected US fed rate increase and pick-up in US/ China economic growth, should prove to be a volatile environment for equities. However, we believe better corporate earnings, improved market liquidity and on-going market multiple re-rating under MSCI could easily offset potential valuation pressures from such trends.
- **Long-term case for stocks remains intact:** With stable earnings and the potential for rebounding valuations in some sectors, total-return prospects for equities remain compelling in our view. A combination of factors feed into our optimism over equity market performance in 2017, which are low interest rate environment along with improved domestic law and order situation and pick-up in economic growth.
- **Index target**: In 2017, we eye an index target in the range of 50,00-52,000, which at current closing of 44,741, offers a market return in the range of +10-16%. Our target is simply based on re-rating of market fwd P/E multiple from 9.8x to 11.0x.

Key Theme For The Year



- We updated our key theme for this year:

1# Economic Outlook: On the macroeconomic front, we expect economic fundamentals to be supportive for equity market.

2# Improving Liquidity: Liquidity has been a key driver of equity market in 2016 and 2017 would not much different, in our view. We highlight reclassification of PSX in MSCI EM and divestment of PSX to be key liquidity driver.

3# Commodity Prices and market Volatility: We see more volatility ahead as dominating sectors E&Ps and banks weighs on movement in oil prices. Moreover, along with rising commodity prices, global growth uncertainties and a renewed rise in the USD as near-term risks, would be key factors dictating overall inflation levels and currency movement.

4# Earnings Growth: We see a corporate earnings growth of ~16% (compared to +8% average in past 3Yrs) that would support equity prices in 2017. In our view E&Ps, Banks and Cements will lead the earnings recovery in 2017.

Market Snapshot

Exhibit: KSE 100 Returns (annually)

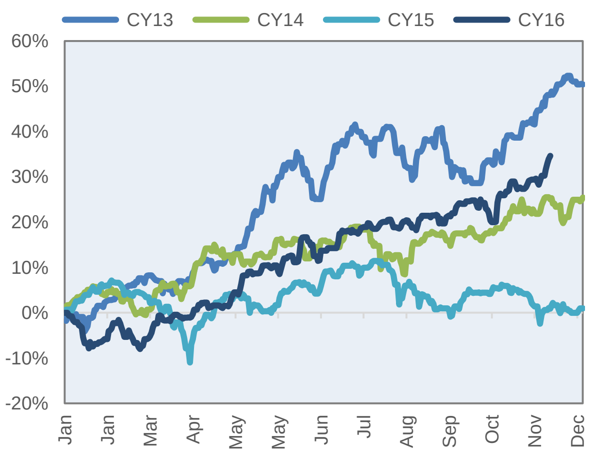


Exhibit: Sector-wise (leaders)

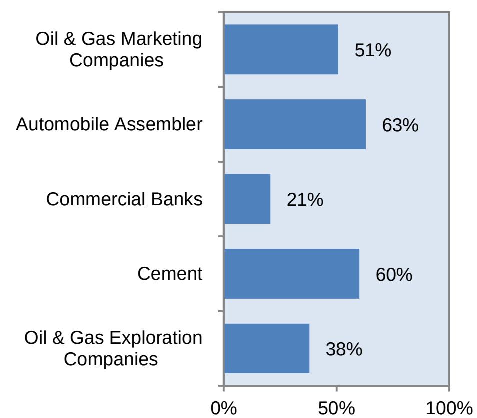


Exhibit: Sector-wise (laggards)

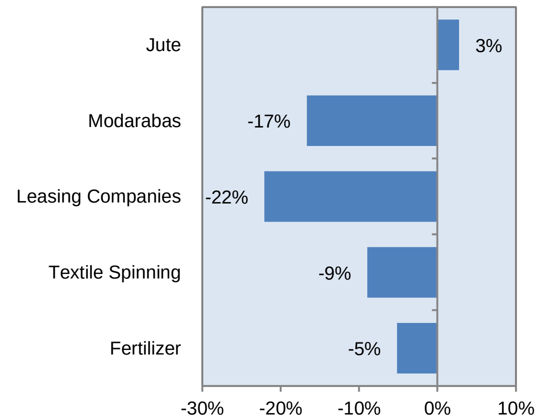
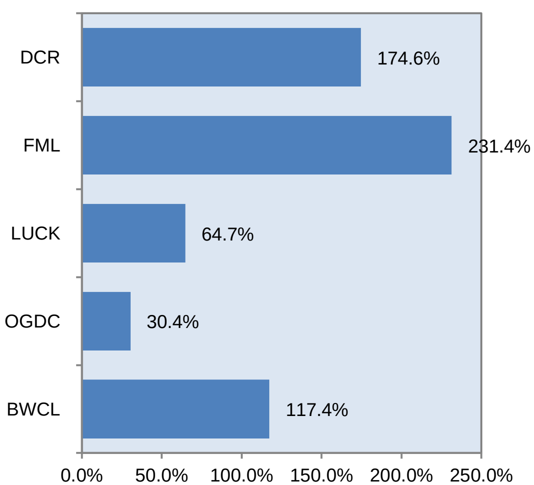


Exhibit: Company-wise (Leaders)



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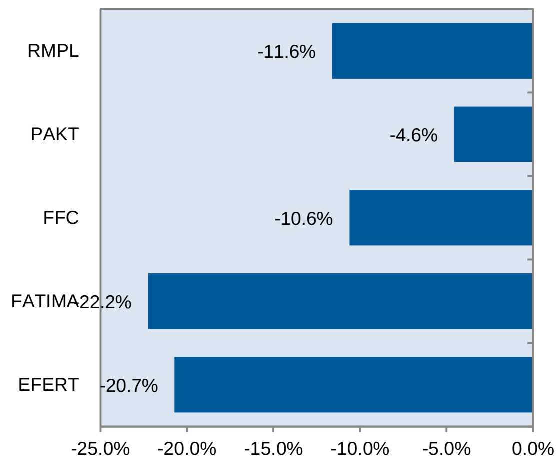
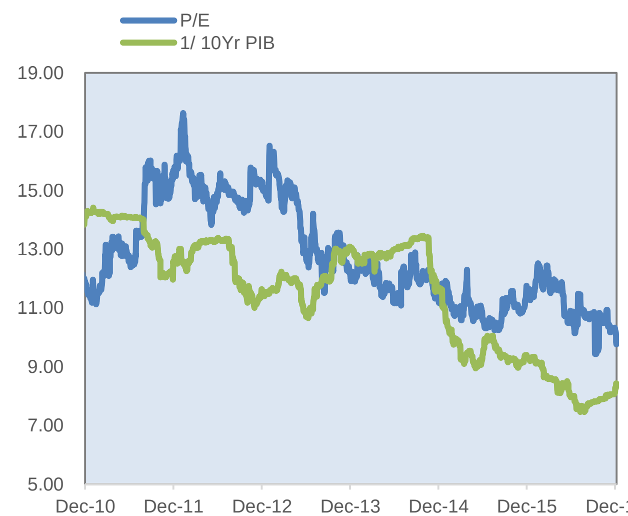


Exhibit: Market P/E and 10Yr PIB Multiple (1/Yld)



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1 Economic Outlook

On The Macroeconomic Front, We Expect Economic Fundamentals To Be Supportive For Equity Market

Economic Forecasts	2016	2017	2018	2019	2020
GDP	4.7	5.0	5.2	5.5	5.5
CPI (Per. Avg)	2.9	5.2	5.0	5.0	5.0
Invst. / GDP	15.2	15.7	16.0	16.6	17.0
C/a Bal. (USDbn)	(2.5)	(4.7)	(7.1)	(7.6)	(7.1)
FDI (USDbn)	1.3	2.6	3.3	4.4	6.0
FX Reserves	18.1	20.8	22.0	21.8	21.2
Fiscal Bal. / GDP	4.3	3.6	2.9	2.7	2.5
Development Exp. / GDP	3.7	3.8	3.8	4.0	4.3
Total Debt / GDP	66.9	64.2	61.7	59.3	56.4

Source: IMF

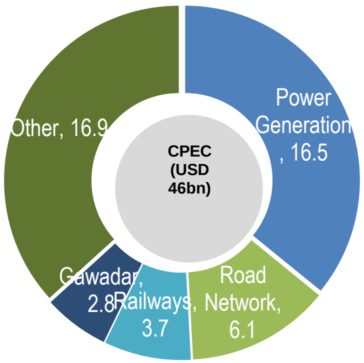
"Pakistan's Fund-supported program has helped the country restore macroeconomic stability, reduce vulnerabilities, and make progress in tackling key structural challenges"

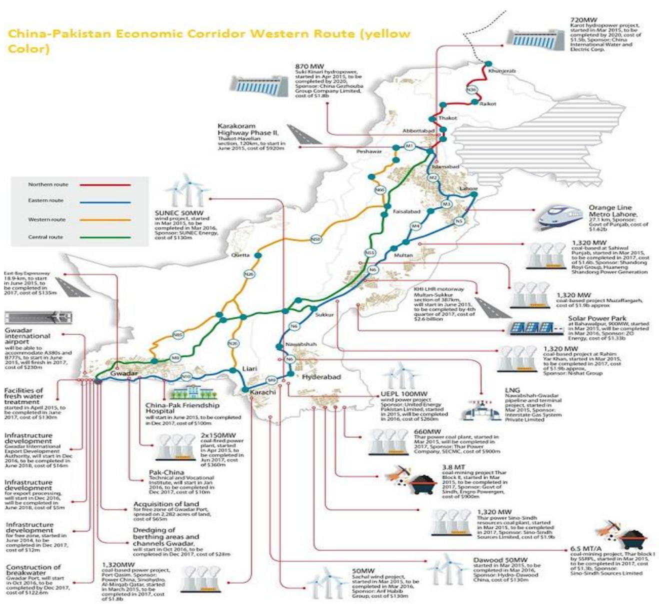
– IMF (Oct-2016)

- **Growth:** Pakistan economic growth prospects have further strengthened. In addition, we see reform agenda picking up pace in 2017, particularly as election year draws in (expected by May-18). Progress on reforms along with improved law & order situation and beginning of investment cycle under CPEC will form the key backdrop for a sustainable growth trend and therefore be supportive for equity market.
- Infrastructure spending is likely to boost construction activity, while upcoming power projects is most likely to improve energy deficiency. Recent cyclical data for cements and power generation has been encouraging. Whereas potential upward movement in inflation could improve corporate earnings for financial sector and consumer sector.
- **Inflation:** Inflation has moderated at higher level in 5MFY17 at +3.94% (5MFY16 +1.84%), led by increase in oil prices, food prices and downward sticky house rental prices. Even after excluding base effect, monthly average increase during 5MFY17 was also higher by a 10bps at 0.48%. With commodity prices stablising at higher level than 2016, inflation in 2HFY17 is likely to stay on the higher side. Having said that, average FY17 is likely to stay under SBP target inflation of 5%, which gives less reason for monetary cycle to reverse.
- **External Accounts:** Current account balance is expected to further deteriorate in 2017 owing to increasing commodity prices, subpar growth in remittances and weak exports, eventually taking toll on country's FX reserves. This along with current overvalued position of PKR (REER at 125.9) will likely take a toll on PKR. In addition, strengthening USD will add to further worries. Although this may benefit export value added chain and power sector but will also limit USD denominated market returns. However, inflows from uni/bi lateral agencies and increasing trade based collaboration with multiple countries is expected to limit overall damage to PKR against USD.

CPEC

A Corridor of Opportunity





- Earlier in 2014, China and Pakistan signed 51 MOU's under project titled "China-Pakistan Economic Corridor" dubbed CPEC worth USD 46bn, that amount has been raised to USD ~55bn. The project is expected to be completed by 2020.
- The CPEC aims to link Xinjiang to Gwadar port by a network of highways, railway and gas pipelines. To develop the road network, three routes are projected to be built namely Central, Eastern and Western routes.
- Sizeable amount of CPEC funds are dedicated for energy (~36% of total allocated amount) and infrastructure development (~21% of total allocated amount), energy bottlenecks are likely to subside over the period of CPEC, while increase infrastructure (road and rail networks) will bring about overall investment in allied sectors of the economy. We estimate, CPEC alone could bring Pakistan Investment to GDP to >29% from FY16 ~15.2%.
- As of today, major projects worth USD 18bn have already achieved financial closure.
- Moreover, Turkey, Russia, France, Iran and other regional participants have also shown interest to be part of CPEC.
- We highlight, Cements, Steel and Banks to stand key beneficiary of CPEC projects.

1 Economic Outlook

Monthly Macroeconomic Indicators

	Unit	Oct-15	Nov-15	Dec-15	Jan-16	Feb-16	Mar-16	Apr-16	May-16	Jun-16	Jul-16	Aug-16	Sep-16	Oct-16
Current Acc. Bal.	(USDmn)	(437)	(199)	(438)	(590)	128	226	100	(792)	(16)	(586)	(621)	(174)	(381)
Exports	(USDmn)	1,807	1,741	1,953	1,708	1,871	2,007	1,799	1,954	1,864	1,503	1,851	1,687	1,820
Imports	(USDmn)	3,204	3,097	3,574	3,257	3,105	3,202	3,060	3,810	3,968	3,087	3,892	3,236	3,343
Trade Balance	(USDmn)	(1,397)	(1,356)	(1,621)	(1,549)	(1,234)	(1,195)	(1,261)	(1,856)	(2,104)	(1,584)	(2,041)	(1,549)	(1,523)
Remittances	(USDmn)	1,540	1,592	1,637	1,463	1,716	2,015	1,657	1,799	2,073	1,328	1,761	1,609	1,560
Portfolio Invest.	(USDmn)	(45)	(56)	(45)	(74)	(34)	(2)	(35)	43	19	50	(8)	(14)	(96)
FDI	(USDmn)	24	(26)	84	24	103	162	24	64	342	64	(47)	137	67
LSM	(%YoY)	5.24	4.72	2.29	5.13	2.82	6.75	(3.14)	(1.05)	(0.01)	2.76	1.71	-	-
FX Reserves	(USDbn)	19.81	19.84	20.81	20.29	20.34	20.92	20.80	21.35	23.08	23.00	23.03	23.62	24.19
FX Reserves: SBP	(USDbn)	14.82	14.77	15.88	15.44	15.51	16.12	15.90	16.58	18.13	18.06	18.12	18.49	19.13
FX Reserves: Banks	(USDbn)	4.99	5.07	4.93	4.86	4.83	4.80	4.90	4.77	4.96	4.94	4.91	5.13	5.06
Import Cover	mnths	4.60	4.80	4.40	4.70	5.00	5.00	5.20	4.40	4.60	5.90	4.70	5.70	5.70
Tax Collections	(PKRbn)	224	225	327	202	215	301	243	301	468	-	-	-	-
CPI	%YoY	1.61	2.73	3.19	3.32	4.02	3.93	4.17	3.16	3.19	4.19	3.63	3.88	4.20
Food CPI	%YoY	0.50	2.16	2.66	2.52	3.71	3.71	4.73	2.07	2.28	4.70	3.39	3.99	4.37
Non-Food	%YoY	2.41	3.14	3.56	3.88	4.24	4.08	3.78	3.94	3.84	3.82	3.81	3.80	4.09
CORE (NFNE)	%YoY	3.40	4.00	4.10	4.30	4.50	4.70	4.40	4.60	4.60	4.50	4.60	4.80	5.10
M2	(PKRbn)	11,120	11,168	11,509	11,394	11,484	11,745	11,749	12,012	12,641	12,470	12,477	12,685	12,763
M2 Growth	%YoY	12.9	13.4	13.0	12.3	12.4	13.8	12.6	12.8	14.7	13.6	14.1	13.0	14.8
Credit to Govt.	(PKRbn)	7,299	7,379	7,356	7,449	7,536	7,589	7,571	7,885	8,109	8,197	8,261	8,284	7,310
Pvt. Sect Credit Growth	%YoY	4.25	5.21	8.81	9.68	10.20	32.69	33.70	33.62	13.69	11.69	10.79	11.15	24.29
SBP Reverse Repo Rate	%	6.50	6.50	6.50	6.50	6.50	6.50	6.50	6.43	6.25	6.25	6.25	6.25	6.25
6M KIBOR	%	6.35	6.23	6.30	6.19	6.15	6.14	6.14	6.09	5.70	5.80	5.79	5.82	5.84
6M T-BILL	%	6.44	6.30	6.40	6.23	6.22	6.19	6.20	6.15	5.93	5.83	5.87	5.90	5.91
5YR PIB	%	7.98	8.00	8.32	8.02	7.33	7.14	6.95	7.07	6.77	6.52	6.67	6.72	6.83
Net Inj/Mop-up	(PKRbn)	(6,627)	(5,319)	(6,059)	(4,599)	(5,254)	(6,787)	(5,992)	(5,038)	(7,497)	(6,966)	(2,535)	(5,871)	(3,865)
KSE100	Index	34,262	32,255	32,816	31,299	31,370	33,139	34,719	36,062	37,784	39,529	39,810	40,542	39,894
Market Returns	%	12.8	3.4	2.1	(9.1)	(6.7)	9.6	2.9	9.1	9.8	10.6	14.6	25.6	16.4
Monthly Market Volumes	mn	182	179	136	129	132	141	225	275	175	163	260	560	499
USD	PKR	104.48	105.37	104.66	104.84	104.62	104.65	104.67	104.68	104.59	104.74	104.62	104.54	104.60
EURO	PKR	117.33	113.21	113.75	113.84	116.09	116.17	118.58	118.32	117.29	115.71	117.16	117.08	115.24
JPY	PKR	0.87	0.86	0.86	0.89	0.91	0.93	0.96	0.96	0.99	1.00	1.03	1.03	1.01

2 Improving Liquidity

Liquidity has been a key driver of equity market in 2016 and so will be for 2017

MSCI EM Index

Comp.	Index Family	Mkt. Cap. (USDbn)	% wt.	Fwd P/Ex	D/Y%	P/Bx
OGDC	LARGE	6.32	0.03%	7.99	4.70	1.25
HBL	MID	3.21	0.03%	9.36	6.10	1.70
MCB	MID	2.34	0.03%	10.05	7.25	1.70
UBL	MID	2.54	0.03%	9.05	7.18	1.70
LUCK	MID	2.28	0.02%	13.88	1.66	2.82
ENGRO	MID	1.54	0.02%	-	-	-
FFC	MID	1.27	0.02%	11.21	8.03	4.44
HUBC	MID	1.22	0.02%	10.10	9.73	4.06
PSO	MID	1.04	0.02%	6.83	4.49	1.06
Pakistan EM			**0.21%**			
Current MSCI EM				11.99	2.60	1.52

Source: MSCI, IGI Research

Regional Market Multiples

Country	P/E x	P/B x	D/Y %
Pakistan	10.15	1.95	5.10
China	15.40	1.76	1.80
Hong Kong	12.50	1.17	3.50
Philipines	17.52	2.23	1.90
Taiwan	14.96	1.61	3.90
Vietnam	15.05	1.86	2.70
India	17.96	2.60	1.70

Source: MSCI, IGI Research

- **Will hunt for bargains be hard**? Market P/E multiple have re-rated nearly ~17% since CY16TD to stand at 10.3x. We think there are still room for further re-rating. We say this on a) inclusion of Pakistan in MSCI Emerging Market index, b) upward re-rating of Pakistan Sovereign Rating, and c) nearing completion of mega projects under CPEC arrangements. More importantly, low market P/E of 10.3x is also reflective of marred performance of the two dominating sectors E&Ps and Banks (excluding Banks and E&Ps, market fwd P/E stands at 12.0x compared 9.8x). Heading into 2017, positive outlook on E&Ps and Banks, we estimate that these two sectors alone could easily push market P/E above ~11.0x.
- **MSCI Emerging Market Status:** Pakistan will be classified into MSCI Emerging Markets (EM) index by May-17 from current MSCI Frontier Market (FM) Index. Currently MSCI EM index market capitilisation stands at USD 3.9trn representing 23 EM countries. For Pakistan MCB, HBL, OGDC, UBL, FFC and ENGRO with a total free-float market capitilisation of USD ~7.5bn would make up 0.2% of the total EM pie. Post MSCI reclassification of Pakistan, we expect PSX to potentially re-rate at higher multiple (forward P/E of MSCI EM stands at 11.9x). With reclassification of Pakistan into MSCI EM index market liquidity is likely to improve along with market re-rating. Our major marketweights are in Automobile assemblers and Power distribution companies (ex-KEL). As for Autos we view limited volumetric growth (sector expansion will be slow to catch up rising demand), tighter monetary policy and rising inflation have the potential to be a drag on absolute valuations going forward.
- **PSX Divestment:** SECP is in a process of divesting (40%+20%) 60% shares of PSX. The bidding process will be completed towards end of CY16. As per news sources, 17 (local and foreign) players have submitted bids to acquire 40% stake of PSX and its expected that further 20% of stake will be offered to general public through IPO within 6 months after bidding process. So far the price/share for PSX ranges in between PKR 25-35/share, which could in bring about additional USD 115mn to USD 160mn. Moreover, additional liquidity at local brokers would also mean increase use of leveraged products, subsequently leading to higher volumes.

Market Snapshot

Exhibit: Improving Market Volumes (KSEALL)

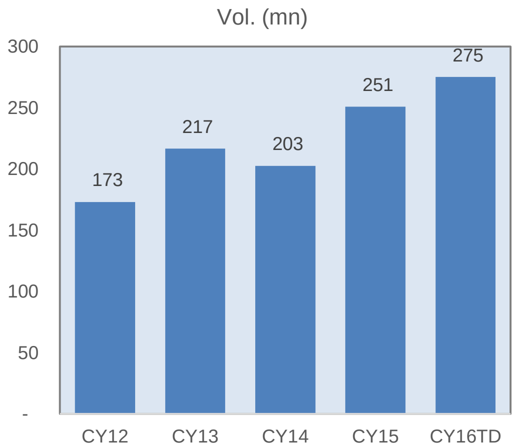


Exhibit: Monthly foreign invst. (USDmn)

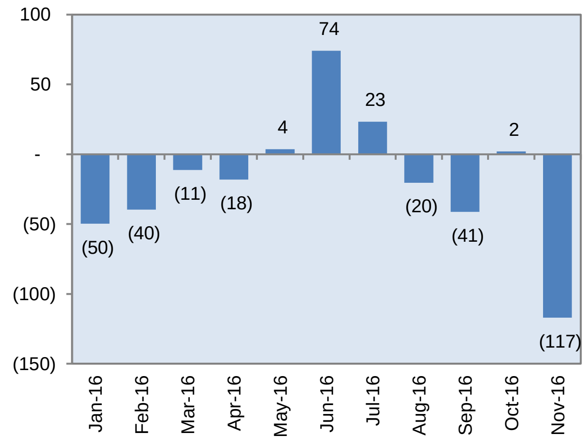


Exhibit: Sector-wise FIPI (USDmn) CY16td

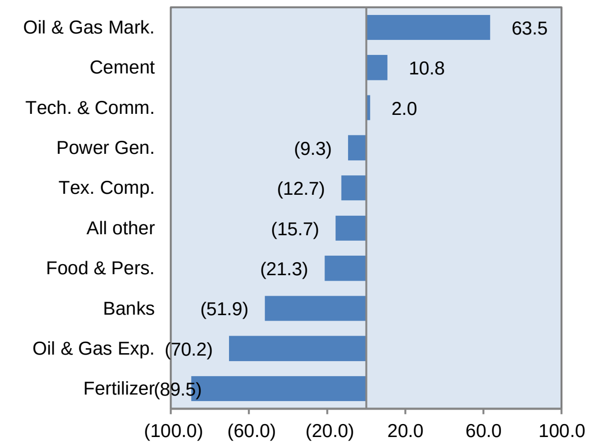


Exhibit: Pakistan versus MSCI EM index

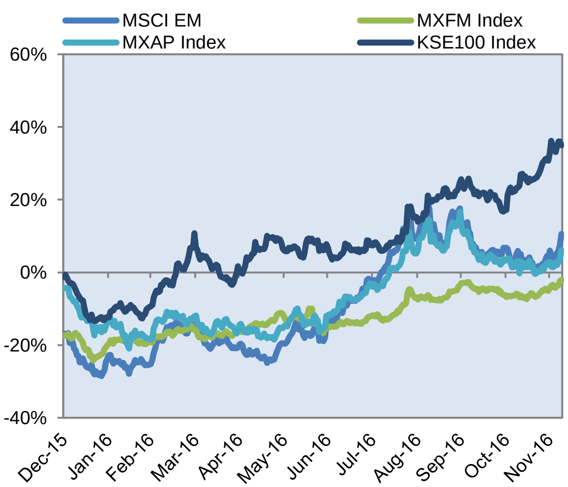


Exhibit: Sector wise volume Leaders

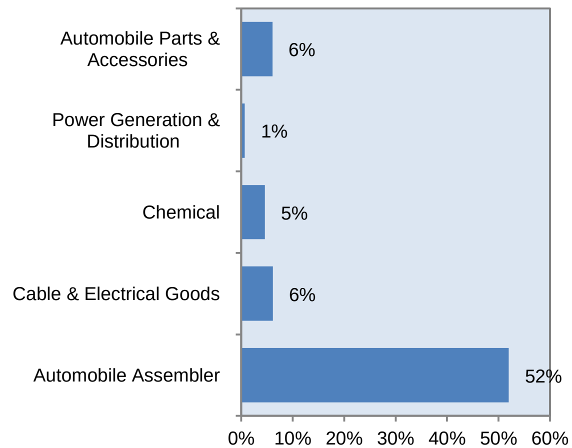
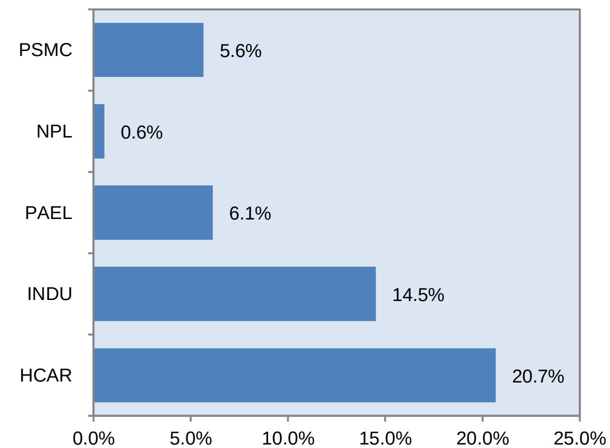


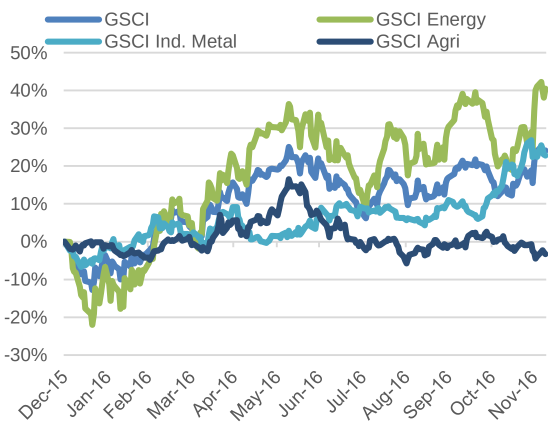
Exhibit: Company wise volume Leaders

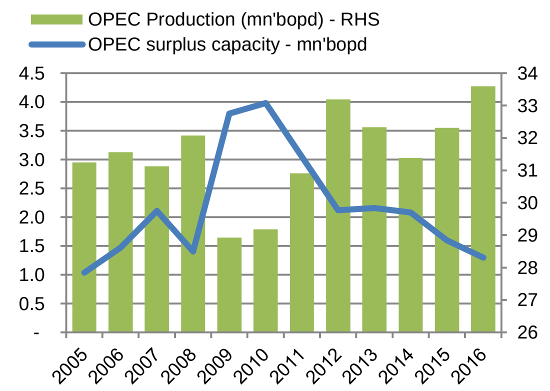


3 Commodity Prices and market Volatility

Rising commodity prices global growth uncertainties and a renewed rise in the USD as near-term risks, would be key factors keeping markets volatile

GSCI Commodity Indices





- **The Inter-Market: Commodity, Dollar and Equity:** Diffusing the effects of political events (Brexit, US Election in particular) equity markets all across globe rattled to the tune of commodity price movements, causing big swings currency markets as well. The GSCI index reached 387.01 level by Nov-16 end from a low of 271.81 level in Feb-16, marking a +24% return CY16 to date. The fading away of China economy hard landing and renewed optimism in US economic growth were all key drivers for base commodity. For oil, however, decisions to cut or expand production by OPEC committee pretty much dictated the prices all round in CY16.
- **Oil - Rebalancing Oversupply may not be as easy as it seems:** Oil price (WTI Crude) has rallied +38% in CY16TD on the back of a) OPEC members mutual agreement to curb production to 32.5mn'bopd in Nov-16, while understanding reached with Non-OPEC members to curb production by 0.6mn'bopd, and b) rise in demand from China during 2Q16. The agreement between OPEC members is effective from Jan-17 for a period of six months and could be extended for another six months thereon. However we believe, prices would remain under pressure owing to a) concerns over implementation of OPEC members arrangement to curb production, b) US shale producers to commence production (having breakeven price between USD 50-60/bbl), and c) rise in Non-OPEC production. Concerns persist whether production cut agreed by OPEC members would be enough to balance oversupplied market. Moreover, we believe OPEC members would not want prices to cross breakeven price of US shale oil producers as that would mean losing market share for OPEC members.
- **Steel & Coal:** Steel and coal prices remained volatile during 2016, ending with an increasing trend owing to less than expected deceleration in China and intact demand from emerging markets. For Coal in particularly, new mining rules in China restriction production days and string of disruptions in Australia kept prices in upward direction. Going forward, with global demand in particularly China, India, Brazil and Oceania Countries picking up, we this demand growth to continue despite the downward trend in China, owing to robust demand from India, Brazil and Oceania countries could drive overall steel prices while we expect coal to stabilize as China has already relaxed its initial measures and any upsurge will result in new supply from the producers who closed down during the depress coal price for the last few years.

Oil – Global Demand & Supply

Exhibit: Oil Demand And Supply in 2017 - (OPEC - Nov'16)

mn'bopd	1Q16	2Q16	3Q16	4Q16	2016	1Q17	2Q17	3Q17	4Q17	2017
World Demand										
OECD	46.8	46.3	47.0	46.6	46.7	46.9	46.3	47.2	46.8	46.8
Americas	24.6	24.7	25.1	24.8	24.8	24.8	24.9	25.3	25.0	25.0
Europe	13.6	13.9	14.2	13.7	13.9	13.6	13.9	14.3	13.8	13.9
Asia Pacific	8.6	7.6	7.6	8.1	8.0	8.5	7.6	7.6	8.0	7.9
DCs	30.7	31.0	31.7	31.3	31.2	31.3	31.7	32.3	32.0	31.8
FSU	4.5	4.4	4.7	5.0	4.7	4.6	4.4	4.8	5.1	4.7
Other Europe	0.7	0.6	0.7	0.8	0.7	0.7	0.7	0.7	0.8	0.7
China	10.8	11.4	11.1	11.6	11.2	11.1	11.6	11.4	11.9	11.5
Total World demand	**93.5**	**93.7**	**95.1**	**95.3**	**94.4**	**94.6**	**94.7**	**96.4**	**96.5**	**95.5**
Non-OPEC Supply										
OECD	25.4	24.3	24.5	24.7	24.7	24.7	24.5	24.3	24.7	24.6
Americas	21.1	20.1	20.5	20.5	20.5	20.4	20.3	20.3	20.5	20.4
Europe	3.9	3.7	3.6	3.8	3.7	3.9	3.7	3.5	3.8	3.7
Asisa Pacific	0.4	0.4	0.5	0.5	0.4	0.4	0.5	0.4	0.4	0.4
DCs	11.1	11.1	11.3	11.4	11.2	11.4	11.5	11.5	11.6	11.5
FSU	14.0	13.7	13.7	14.0	13.9	14.1	13.9	14.0	14.1	14.0
Other Europe	0.1	0.1	0.1	0.1	1.1	1.1	1.2	0.2	0.2	0.2
China	4.2	4.1	4.0	4.0	4.1	4.0	4.0	4.0	4.0	4.0
Processing Gains	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2
Total Non-OPEC Supply	55.5	55.8	56.5	56.2	56.2	56.7	56.2	56.1	56.8	56.4
OPEC NGLs + Non Coventionals oil	6.2	6.3	6.3	6.3	6.3	6.4	6.4	6.4	6.5	6.4
Non-OPEC Supply	**63.2**	**61.8**	**62.1**	**62.8**	**62.5**	**63.0**	**62.6**	**62.5**	**63.3**	**62.9**
OPEC Production *	32.5	32.8	33.3	-	32.5	32.5	32.5	32.5	32.5	32.5
Total Supply	**95.7**	**94.6**	**95.4**	**62.8**	**95.0**	**95.5**	**95.1**	**95.0**	**95.8**	**95.4**

Source: OPEC

** IGI Estimate for OPEC production from 4Q16 onwards*

4 Earnings Growth

Corporate Earnings are expected to show ~16% growth in 2017, led by E&Ps, Banks and Cements

Sectors	Recom.	Mkt. Cap. PKRbn
AUTO ASSEMBLERS	UW	240.06
CEMENTS	OW	537.57
BANKS	OW	1,289.37
FERTILISER	OW	434.44
FOOD	MW	115.16
OMCS	OW	259.42
E&PS	OW	1,224.75
POWER	OW	448.54
TELECOM	OW	90.17
TOTAL		**4,639.76**

Source: IGI Research

Sectors	EPS % 2017	P/E 2017	D/Y 2017
AUTO ASSEMBLERS	(14.3)	14.1	3.6
CEMENTS	8.8	19.4	2.7
BANKS	4.9	8.7	6.9
FERTILISER	(11.4)	17.8	3.6
FOOD	10.8	29.5	-
OMCS	40.2	10.5	3.5
E&PS	44.9	8.7	4.8
POWER	9.4	8.7	4.7
TELECOM	175.4	17.4	11.4
MARKET	**15.9**	**10.5**	**4.9**
MARKET (ex- Banks &EPS)	**7.7**	**13.7**	**3.7**

Source: IGI Research

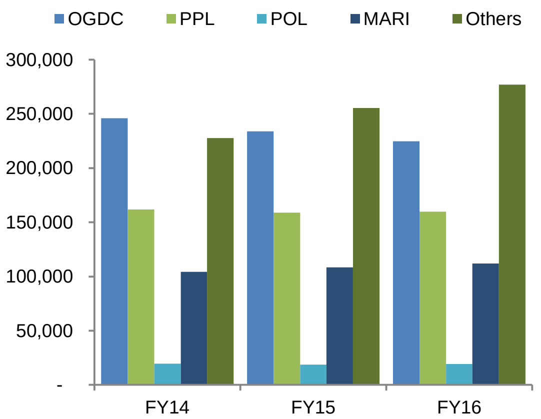
- We see a corporate earnings growth of ~16% (compared to 8% average in past 3Yrs) that would support equity prices in 2017. In our view E&Ps, Banks and Cements will lead the earnings recovery in 2017. Since 2014 onwards, Banks and E&Ps stock have been stuck in sideways range owing to drop in international oil prices and subsequent monetary easing that came along with it. With expected recovery in commodity prices in particularly oil (Arab light touched 44/bbl by Nov-16 end from a low of USD 21/bbl), corporate profit growth for these two sectors looks set to accelerate as we move into 2017. While coal prices have settled at higher levels (averaging USD 75/ton in 5MCY16 compared to USD 55/ton last year same period), this could suppress profit margins for cements stocks, however stronger domestic growth helped by projects under CPEC and Fiscal spending would likely offset negative impact on earnings. Companies currently low on utlisation and undergoing expansion will be fast to catch upon growing demand. Moreover, lower corporate tax (30% applicable from Jun-17 onwards) and non-continuation of super tax would certainly benefit bottom line.
- Our major marketweights are in Automobile Assemblers and Power Distribution Companies (ex-KEL). As for Autos, we view limited volumetric growth (sector expansion will be slower to catch up rising demand), tighter monetary policy and rising inflation have the potential to be a drag on absolute valuations going forward.
- The main downside risks to our view would be if the USD strengthening in 2017, suggesting a cautious view on overall earnings. However, for Textile and Power sector for which currency translation effect would bode rather well.

Sectors Outlook

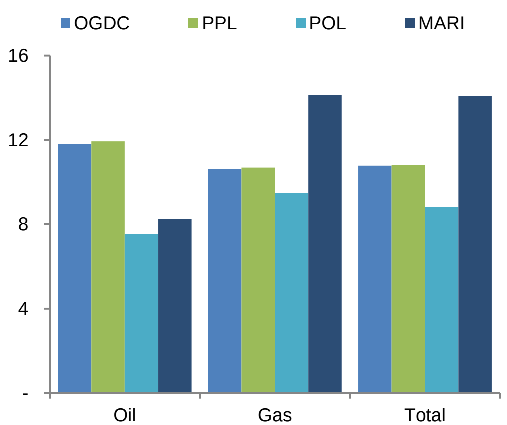
Oil & Gas Exploration Companies

Oil Supply Glut – A Fallacy or Verity

Total Production (BoE)



2P Reserve Life - Jun-16



- **Oil Outlook**: Oil price (Arab Light) has rebounded by +70% in CY16TD to stand at USD 52.5/bbl after bottoming out at USD 21/bbl in Jan-16. Oil prices have surged up by +26% to USD 52/bbl since OPEC members first agreed on a production freeze to Aug-16 level, while recent uptick in oil price emanated from successful OPEC's meeting in Vienna (Nov-16) to curb oil production to 32.5mn'bopd and allocation of cut for each member (effective from Jan-17). In addition, as per OPEC press release, an understanding has been reached where non-OPEC members will cut production by 0.6mn'bopd. This is the first production cut by OPEC members since 2008.
- As the duration of agreement is for six months we expect Arab Light to remain range bound between USD 50-55/bbl and average USD 50/bbl for FY17. However oil prices are expected to come under pressure, as crude crosses USD 50/bbl mark, making it feasible for some key Shale oil producers to operate i.e Midland Basin has breakeven price of USD 51/bbl and US oil producer Eagle Ford East has a breakeven price of USD52/bbl. Implementation of agreement to cut production by OPEC members remains a key factor as previously OPEC members have not held their end of the bargain. Moreover, once non-OPEC oil production rises, OPEC may reconsider its price management policy of production cut. Increasing US oil rig count should keep oil price ascend in check which has been on a rise since last six months. Our long-term oil price assumption stands at USD 50/bbl.

Exhibit: Pakistan Total Oil and Gas Reserves

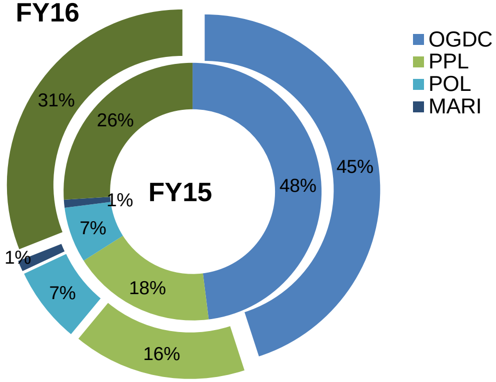
	Oil (mnbbls)	Gas (bcf)	Total (mnBoE)
OGDC	171	4,763	1,001
PPL	66	3,238	631
POL	21	246	63
MARI	2	3,482	609
Others E&Ps	91	7,429	1,035
Total Reserves	351	19,158	3,340

Source: PPIS, IGI Research

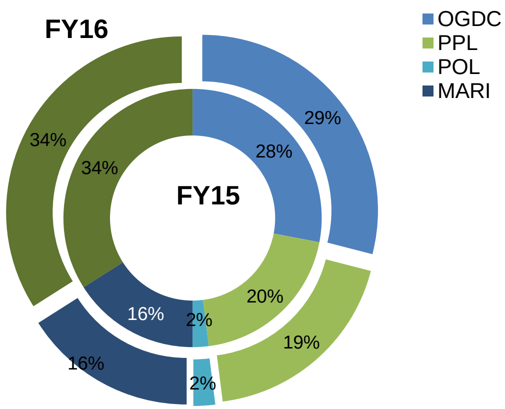
Oil & Gas Exploration Companies

Oil Supply Glut – A Fallacy or Verity

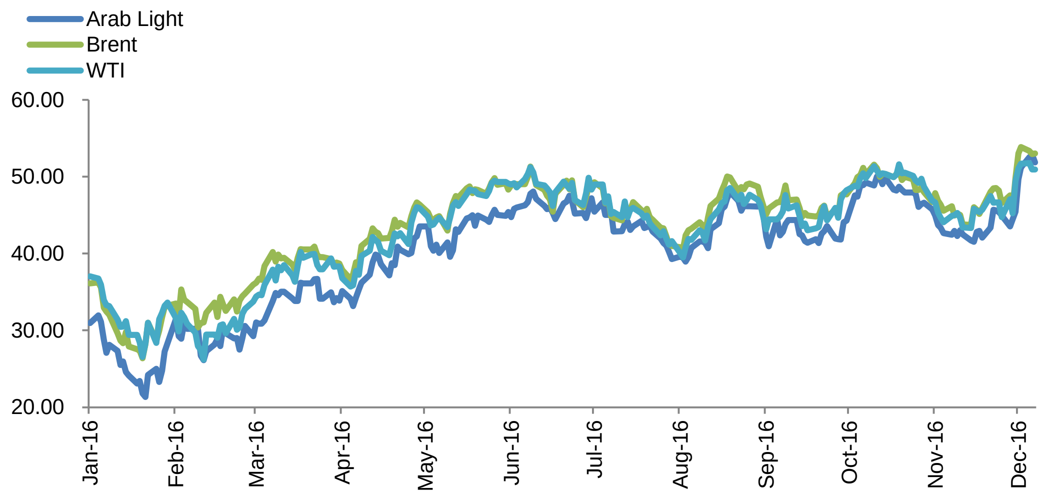
E&P Market share - Oil



E&P Market share - Gas



- **Risks and Opportunities:** Conversion of concessions to Petroleum Policy 2012 (PP12) would provide higher wellhead prices as ceiling for oil price under PP12 is USD 110/bbl. A total of 47 concessions have been granted conversion to PP12 including Tal, Gambat South and Hala block. Any new discovery from the converted blocks would be priced under PP12. Recently, drilling activity (exploratory well) in converted blocks include Surqamar-1 (Kohat Block), Miriwah East X-1 (Barkhan) and Chhutto-1 (Nim), while recent discoveries include Mithri-1 (Khewari), Gundanwari-1 (Britism), Khamiso-1 (Guddu) and Bashar X-1 (Hala). Major drilling in development/appraisal well includes Mardankhel - 2/3 (Tal block), Adhi – 26/27 (Adhi) and Sui – 95 (Sui).
- **Recommendation:** IGI E&P universe has outperformed KSE-100 index by +1.6% in CY16TD. Among E&P companies OGDC, PPL and MARI remain our top picks with Dec-17 TP of PKR 185/share, PKR 211/share and PKR 1,388/share, respectively.



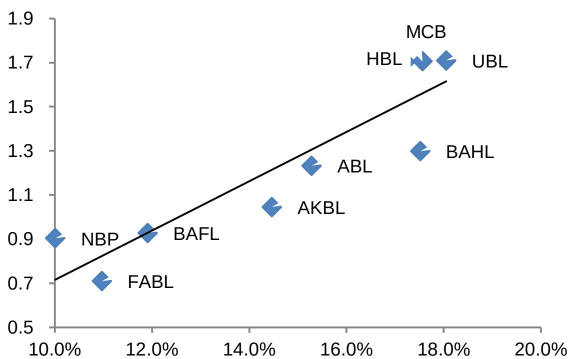
Oil & Gas Exploration Companies

Company	Recom.	Key Catalyst	Key Risks
OGDC	**Buy**	▪ Company to gain benefit from new wellhead gas prices after conversion of concessions to Petroleum Policy 2012. ▪ Gas production contributes almost around 64% of the total revenue and wellhead gas prices of most fields are capped providing shield against declining oil prices. ▪ Furthermore, other income to rise from investment in PIBs with interest rate of 11.50% (Maturity Jul-17). ▪ OGDC relies heavily on Nashpa for oil. Apart from Nashpa, major oil production is from Adhi (Adhi Block) and Makori East (Tal block). Major gas production comes from Qadirpur and Uch. ▪ Discoveries in CY16TD include Thal East-1, Thal West-1, Nashpa-6/7 and Gundanwari-1 having cumulative earnings impact of PKR 1.52/share in FY18.	▪ PIBs maturity in Jul-17 likely to be rolled over at lower mark-up ▪ Oil is expected to remain under pressure during CY17 and is expected to hover around USD 50-55/bbl.
PPL	**Buy**	▪ Extension of Sui lease for 10 years effective from Jun-15. ▪ Sui wellhead gas price linked with price under Petroleum Policy 2012 at a discount of 55%. ▪ We expect revenue contribution of Sui field to increase to 48% in FY17 from 35%. ▪ Major discoveries in CY16 include Makori Deep-1, Makor East-5, Nashpa-6 and Nashpa-7 having cumulative earnings impact of PKR 1.78/share in FY18. ▪ PPL discovered gas reserves from exploratory well Hatim-X1, located in Gambat South block in Dec-15, which is biggest gas discovery in last 10-years and expected to come online in 1QCY17, with an expected annualized earnings impact of PKR 1.4/share.	▪ Additional 10% royalty to be collected under extension agreement granted for Sui lease. ▪ Extension allowed by SECP to PPL for announcement of FY16 result by Feb-17 on account of impairment loss on its subsidiary ▪ PIBs maturity in Jul-17 likely to be rolled over at lower mark-up ▪ Oil is expected to remain under pressure during CY17 and is expected to hover around USD 50-55/bbl.
MARI	**Buy**	▪ Revision in gas price formula with discount to wellhead price to reduce to 20.1% in CY17 from 33.5% in CY16. ▪ Redemption of preference share in Jun-16 through loan of PKR 9bn leading to possible higher payout going forward ▪ Commencement of oil and gas production from Halini Deep-1 in May-16 to lift FY17 earning by PKR 6.4/share ▪ Discoveries in CY16 include Shabaz-1 and Bashar X-1 having annualized earnings impact of PKR 5.0/share and PKR 1.81/share	▪ Oil is expected to remain under pressure during CY17 and is expected to hover around USD 50-55/bbl.

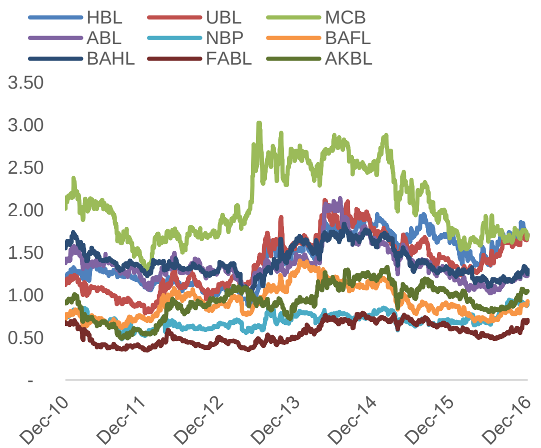
Commercial Banks

Value-based Investment

Banks P/B and ROE



Banks P/B



- **Performance:** During CY16, IGI banking sector return stood at +13.2%, underperforming the KSE 100 market return of +36%, bringing the banks to record low valuations. Profitability for the period 9MCY16 showed a muted decline of 0.1%, compared to past 3Yr CAGR of +12%. On pre-tax basis sector profitability was down by 2%YoY (3Yr CAGR of 17%). Concerns largely revolved around a) declining earning yields amid historic low discount rate, b) increased re-investment risks due to maturing PIBs (PKR 1.4trn by 1HCY16 having average weighted yields of ~11.2%), and c) below industry growth in IGI Banking stocks advances up by +7% 9MCY16(+11%YoY growth in sector). While these aforementioned factors do hold some basis for underperformance, we think these factors have overplayed and valuations are now dirt cheap with average P/B trading at a discount of ~15% to now 1.6x (for IGI banking stocks).
- **Going forward in 2017:** re-investment of govt. securities at lower yields (we expect banks to keep investment in short-term due to risks of higher inflation, that would keep overall earnings yield even low) and slowdown in government borrowing requirement, will likely herd the banks to keep expanding their loan book, as to ensure stable earning yields, if not declining. While, low cost of borrowing (lending rate on fresh disbursement down to 7.3%, a multi-year low) and public led investment projects will keep overall private sector credit demand upbeat.
- **Risk of NPLs formation** (particularly in textile) is still there but increased recoveries have increased banks appetite. As a result, sector asset quality has improved significantly as well, as NPLs to gross loans have come off substantially, standing at 10.6% in 9MCY16 compared to 12.5% in 9MCY15 and from a high of 16% in CY11.
- **On deposit side,** stable inflation and pick-up in economic growth, along with steady rise in private sector credit, broad money growth is likely to persist a ~13% growth rate. On cost side, changes in minimum deposit rates will dominate sector deposit strategy.
- **In 2017,** for banks having a) higher C/a deposit, b) adequate capital base to expand their loan sheet, c) high non-interest income, and d) have larger investment gains on their book, should be able to sustain better earnings growth. In this respect we recommend, UBL, HBL and BAHL as our top picks.

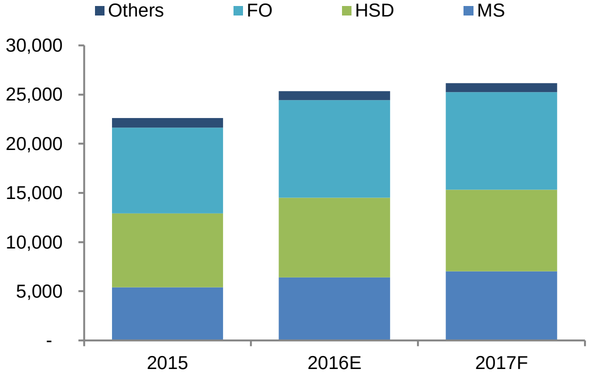
Commercial Banks

Company	Recom.	Key Catalyst	Key Risks
UBL	**Buy**	▪ 9MCY16 profitability up by +11% one of the highest in IGI banking stock despite higher tax charge and difficult operating environment for banks ▪ +11% growth in Advances, keeping NIMs above industry average at ~4.3% in 9MCY16 ▪ High proportion of Non-interest income total income ▪ Higher international asset exposure offers better diversification benefits ▪ 2017 fwdP/E: 8.1x, P/B: 1.5x, Div. Yld %: 8.0%. Earnings 3Yr CAGR: 6%	▪ Geographical risks (middle east 70% of total international loan sheet), ▪ Lack of loan diversification (~21% in energy and 12% in agri-business) ▪ Low capital base (CAR ~14%) compared to its peer makes relatively difficult for the bank to expand its credit growth aggressively.
HBL	**Buy**	▪ Backed by largest deposit size (branches: +1700) and growing, HBL is all set to benefit from Pakistan growth story. ▪ Bank enjoys a <16% CAR, with fastest current account deposit growth (+30%), ample of room to expand loan sheet (in special reference to CPEC projects) ▪ Management increasing focus bank's adoptive strategy to channelise revenue stream through alternative distributions (Fee income growth of +19% 9MCY16) ▪ ROAs have shown rise reaching 1.7% by Sep16 end, catching up with its peers UBL, MCB and ABL. ▪ P/E: 8.8x, P/B: 1.5x, Div. Yld %: 6.8%. Earnings 3Yr CAGR: 6%	▪ Slower than expected credit off-take and faster accretion in NPLs

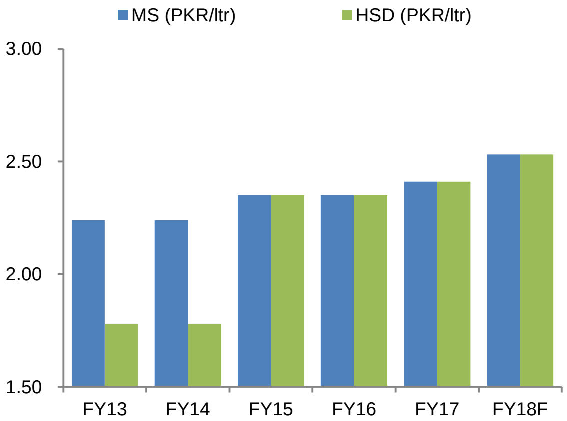
Oil Marketing Companies

Strong Volumetric Demand To Drive Sector Profitability

OMC Sales Data (000'ton)



MS and HSD Margins - PKR/ltr



- **Performance:** IGI OMC universe posted +42% return in CY16TD as compared to +36% returns by KSE-100. This stellar performance was on the back of +20%YoY growth in earnings in 9MCY16 for HASCOL and +48/+35%YoY rise in earnings in FY16/1QFY17 for PSO. Volumes for 10MCY16 leaped up by +9%/45%YoY for PSO/HASCOL. Volumes were driven by 13%/10% lower domestic prices for MS and HSD and +20% increase in passenger car sales (3% including Bolan) in CY16TD.
- **Volumetric Growth:** We expect volumes to grow by +14%YoY and +1%YoY for MS and HSD sales in FY17. MS sales are expected to rise on the back of a) increasing passenger car sales owing to lower interest rate environment and, b) local MS prices down by 15%YoY in CY16TD. HSD volumes are expected to rise on the back of increased commercial transportation on the back of initiating CPEC projects and truck/ tractor sales. We expect no further growth in FO volumes due to a) lack of new development of FO based power plants, b) government focusing on establishing coal based power projects and, c) conversion of existing plants to coal. Furthermore, expected import of LNG of 1.5mn ton for FY17 should keep a lid on FO sales. FO prices are down by 43%YoY in CY16TD, thus we expect lower contribution to gross profit from FO at 22%, 13% and 9% for PSO, HASCOL and APL, respectively.
- **Margins Linked with CPI:** In May-16, the Economic Coordination Committee (ECC) approved on recommendation of Ministry of Petroleum and Natural Resources (MPNR) annual increase of 0.06/ltr in OMCs margins for MS and HSD, along with annual revision thereon linked with CPI. Taking a 5% base case increase in CPI, we estimate MS and HSD margins to augment by 5%YoY from FY18F onwards. MS and HSD margins are expected to clock in at PKR 2.53/share/PKR 2.66/share/PKR 2.79/share for FY18/FY19/FY20, respectively.

Oil Marketing Companies

Strong Volumetric Demand To Drive Sector Profitability

Exhibit: Market Share - Company-wise

	CY16TD	CY15TD	FY17TD	FY16TD
MS				
PSO	40%	46%	41%	44%
APL	8%	6%	9%	7%
HASCOL	8%	5%	8%	6%
SHEL	18%	20%	17%	19%
Others	26%	22%	26%	23%
HSD				
PSO	48%	50%	48%	48%
APL	8%	10%	9%	10%
HASCOL	9%	6%	9%	8%
SHEL	13%	15%	12%	15%
Others	22%	20%	23%	20%
FO				
PSO	73%	69%	74%	72%
APL	6%	9%	6%	8%
HASCOL	6%	6%	6%	5%
SHEL	1%	1%	1%	1%
Others	14%	15%	13%	14%

Source: IGI Research

- **Circular Debt:** Recently circular debt has started to pile up to reach level that was last seen back in 2013 when Government settled the amount through scheme of cash payments and book adjustments. As a result, PSO's receivables stand at PKR 250bn which was PKR 220bn in 2013 when Government settled the circular debt through payment of PKR 480bn through different cash schemes. With PIBs issued to PSO in relation to accrued amount receivable about to mature in Jul-17, we believe, this should lead to rollover of existing PIBs and further payment through cash scheme for current accumulation in circular debt.
- **Oil Outlook:** Oil price (benchmark Arab Light) have rebounded by 70% in CY16TD after bottoming out in Jan-16 at USD 21/bbl. Oil price is expected to remain range bound between USD 50-55/bbl in CY17. We expect oil price to remain less volatile on the back of no major trigger leading to possible inventory gains and less likelihood of inventory losses. Key triggers remain implementation and extension of OPEC agreement to curb production at 32.5mn'bopd, non-OPEC production increase and shale oil production.
- **Recommendation:** IGI OMC universe has outperformed KSE-100 index by +3.1% in CY16TD. Among OMCs, PSO/HASCOL/APL remain our top picks with our Dec-17 TP of PKR 497/share, PKR 431/share and PKR 847/share, offering an upside of +23%/29% /25% from its last closing. HASCOL is at CY17F P/E of 19.9x, while PSO and APL are currently trading at FY17E P/E of 6.9x and 10.5x, respectively.

Oil Marketing Companies

Company	Recom.	Key Catalyst	Key Risks
PSO	**Buy**	▪ Demand for MS to remain upbeat providing 12%YoY growth amid increasing passenger car sales and lower domestic prices. ▪ HSD to post 4%YoY growth in volumes in FY17 due to increasing commercial transportation and tuck/tractor sales. ▪ We expect no major growth in FO volume as no new FO based power projects are being undertaken, however in FY17 we expect FO volumes to pick up by 1%YoY mainly from Hubco post repair work at Hub Plant ▪ Company plans to incur Capex of PKR 2-8bn in FY17/18 to increase storage capacity and retail outlets for MS and HSD to meet rising demand (target of 100 retail outlets per annum). ▪ We expect import of LNG to have an earnings impact of PKR 2.14/share in FY17 earnings (contribution of 4-5%). ▪ Annual margin accretion linked with CPI for MS and HSD to augment earnings by PKR 0.67/ share and PKR 0.75/share in FY17	▪ Oil Price volatility could result in hefty inventory losses. ▪ Recent pile up in receivables to PKR 250bn mainly on part of government owned IPPs (PKR 185bn) to hinder company's cash position and growth plans. ▪ Shift of LNG contract to Pakistan LNG by FY18 to erode earnings by PKR 3.9/share ▪ Decline in FO prices to result in lower contribution of profit from FO sales. ▪ Maturity of PIBs in Jul-17 and being rolled over at a lower mark-up rate from current 11.5%
HASCOL	**Buy**	▪ Substantial growth in MS and HSD volumes by 37%YoY and 15%YoY in CY17. ▪ The company plans to install 2 new storage facilities at Kotla Jam and Thalian by the end of CY18, while MS and HSD storage facility is expected to come online by Sep-17 at Port Qasim (JV between Vitol and Hascol for 200kTon storage facility) ▪ The company plans to increase its retail outlets to 400 by the end of CY17. ▪ Supply agreement with Vitol leading to guaranteed supply to cater the rising demand and minimum reliance on hospitality agreements with other OMCs leading to improved supply chain management. ▪ Joint venture between Hascol and Vitol to establish 200kTon storage facility at Port Qasim ▪ Immunity to circular with receivables secured through irrevocable financial instruments, act as a key catalyst leading to better cash position for the company.	▪ As number of storage facilities increase, the company gets more exposed to heavy inventory losses if oil prices drop down further and local prices are reduced accordingly. ▪ SHEL and PSO aggressively pursuing expansion in retail outlets and storage capacities to regain market share.
APL	**Buy**	▪ MS volumes to grow by 14%YoY in FY17 ▪ Asphalt sales to rise by 4%YoY in FY17 ▪ Healthy margins of 15-25% on sale of asphalt ▪ Earnings to post 18% CAGR from FY16-19F	▪ Oil Price volatility could result in hefty inventory losses.

Power Generation & Distribution

Never Ending Circular Debt Lingers Over IPPs

Key Upcoming Events

- **HUBC :** Demerger of Narowal Plant (expected in 2017), 2x660MW coal based power plant with estimated cost of USD 2.4bn (HUBC stake of 26%, USD 20mn investment in SECMC
- **KAPCO:** PPA set to expire in 2021, Feasibility assessment of setting up coal based power plant.
- **PKGP:** Coal conversion of existing plant (expected in 2019).
- **LPL:** Coal conversion in 2019

- **Performance:** IGI Power generation and distribution sector universe posted +5% return in CY16TD as compared to +36% return by KSE-100. This under-performance was on the back of repair work on boiler which concluded in 2QFY16 and repair work on Narowal plant from 1QFY17 for HUBC. KAPCO posted negative return as a result of expiration of PPA in 2021 and divestment of Government stake.
- **Sector Cash flows to take a hit as circular debt rises:** We expect cash flows constraints for IPPs as circular debt has started piling up in recent times leading to fuel supply concerns. Furthermore, FO prices have risen, increasing cost of generation on FO higher than gas. LNG supply to IPPs has also led to accumulation of PKR ~10bn in overdue receivables. Government of Pakistan's commitment to IMF to cap circular debt at PKR 303bn (not let circular debt accumulation exceed PKR 104bn) is yet to be implemented. Circular debt stands at similar level to 2013 when PML-N Government settled the amount of circular debt through different cash schemes. We believe with elections nearing another settlement of circular debt may be on the cards.
- **PKR Depreciation to Improve Profitability:** Moreover, we believe PKR depreciation in CY17 should further boost profitability for IPPs on account of USD based return. We expect profitability to rise further on the back of lower O&M costs as major maintenance and turnaround activity for most IPPs concluded. However, NCPL and NPL are relatively newer plant in the initial stage of their operations so their O&M costs are expected to be lower in the first few years of operation.
- **Dividend Yield:** IPPs are expected to remain under spotlight due to their high dividend yield among lower interest rate environment. NCPL, NPL and KAPCO have the highest dividend yield of 13.8%, 11.9% and 11.4% as compared to other IPPs.
- **Recommendation:** Among IPPs, HUBC remains our top pick with Dec-17 TP of PKR 125.5/share, offering an upside of 11% from its last closing. The scrip is currently trading at FY17E P/E of 8.8x, offering dividend yield of 9.5%.

Power Generation & Distribution

Company	Recom.	Key Catalyst	Key Risks
HUBC	**Buy**	▪ Earnings to improve going forward based on PKR depreciation ▪ Demerger of Narowal Plant to bring in excess cash which we believe could be utilized for the upcoming coal power project at Hub Site and thus reducing risk of dividend cut. ▪ PCE to increase by 5%YoY in FY17. ▪ Formation of Hub Power Services Limited (HPSL), which has taken over the management of O&M at Hub Plant resulting in synergies and will also operate the 2x660MW coal power plant. ▪ Coal Based power plant expected to come online by 2019. ▪ Dividend yield for FY17 is expected at PKR 10.5/share with a dividend yield of 9.5%	▪ PKR appreciation would further dilute the earnings for the company. ▪ Reduction of coal project to 1x660MW on the back of potential improvement in Required Commercial Operation Date (RCOD) bringing down our valuation by PKR 7.9/share for 1x660 MW plant ▪ Repairs and maintenance at Narowal Plant commencing in 1QFY17 to reduce earnings in FY17 ▪ Increase in interest rates
KAPCO	**Hold**	▪ +6% CAGR in earnings from FY16E-19F. ▪ Dividend for FY17 is expected at PKR 9.9/share with a dividend yield of 11.7%.	▪ Profitability to take a hit if circular debt quantum increases. ▪ PKR appreciation would further dilute the earnings for the company. ▪ PPA set to expire in 2021 could lead to dividend curtailment depending on the terms and conditions of new PPA. ▪ No further development on coal based power plant
NCPL	**Sell**	▪ The company has the highest dividend yield of around 13.8% compared to other IPPs. ▪ Lower O&M cost in to boost profitability in FY16, as the company incurred zero O&M cost in 1QFY16.	▪ As the plant is relatively new, O&M costs are expected to rise going forward thus reducing profitability.
NPL	**Sell**	▪ The company offers a high dividend yield of 11.4% in FY17. ▪ O&M cost to remain low in FY16 as the plant is relatively new and profitability to be high in the initial years of operations.	▪ As the plant is relatively new, O&M costs are expected to rise going forward thus reducing profitability. ▪ Extension of O&M contract with Wartsila ending in 2QFY16. Once expired and not renewed could lead to one time high costs.

Cements

Strong Domestic Demand Outlook Intact

Key planned expansions/sector events

PIOC	Initiation of 12 MW WHR in Dec-16 Grinding unit installation to complete by Mar-17
CHCC	Commercial operation of Line II to start Dec-16 Operations of 6MW WHR power plant in Jan-16
MLCF	40MW coal based CPP to start operations in FY18
LUCK	10MW WHR to be functional by 3QFY17
FCCL	Disrupted line II to get fully operational by 4QFY17

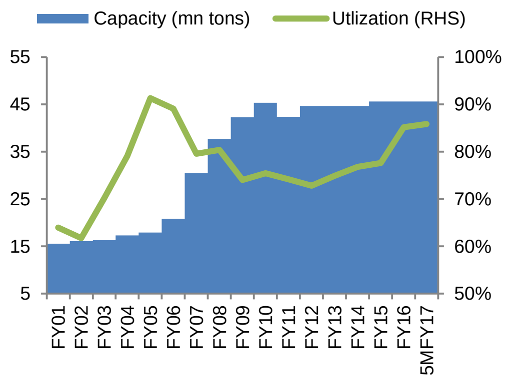
Performance: IGI cement universe posted returns of +48% in CY16 as compared to +36% by KSE-100. This performance was observed on the back of +18%YoY growth in earnings with +560bps expansion in gross margins. Despite flat cement prices, margins grew on the back of a) upbeat domestic growth of +17%YoY, b) depressed commodity prices in international market, c) higher contribution of local sales in total revenue mix resulting in higher retention price per bag, and d) lower power cost from grid. The sector achieved capacity utilization of 85% in FY16, where local dispatches augmented by +17%YoY whereas exports remained sluggish (-14%YoY). Leveraged companies i.e. MLCF and FCCL witnessed lower financial charges due to bottomed out interest rates and early debt retirement. During 5MFY17, local dispatches have gone up by +12% (+11% in North and +17% in South), whereas exports have declined by 0.79%YoY (+4% in North and -10% in South).

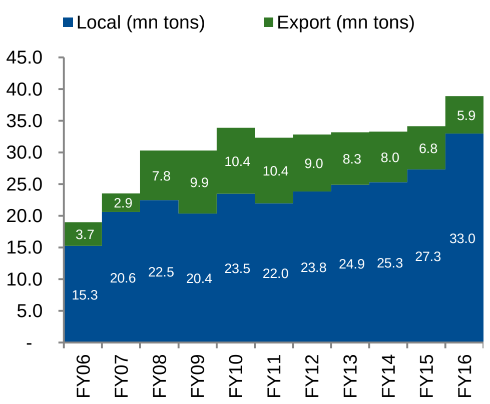
Cement industry Poised growth: In FY17, IGI Cement sector is estimated to post earnings growth of +14%YoY. The industry is expected to witness +10% - 11% growth in total dispatches, resulting in capacity utilization to reach 92%-95%, led by a) higher private sector consumption, b) elevated fiscal spending on infrastructure, and c) CPEC projects. We expect further tilt in revenue mix towards high margin domestic sales while export volumetric growth is expected to remain sluggish.

Keeping in view government’s focus on infrastructural development and approaching election year in 2018, we remain affirm over decent double digit growth in domestic demand during CY17. We expect higher allocation of PSDP in Federal budget FY18 (last budget before election) followed by higher realization of development funds as we approach election (key performance indicator for govt).

Cements

Strong Domestic Demand Outlook Intact





Existing capacities – Heating up: In order to absorb rising local demand, it has become imperative for cement industry to go for expansion which has become the need of moment before existing capacities exhaust. To recall, capacity utilization peaked 99% in Nov-16 despite off peak season. To address this expected increase in domestic demand likely to arise from CPEC, cement players have already announced capacity additions of ~22mn tpa. In our view, key beneficiary of this expansion cycle would be first movers i.e. CHCC and players with ample room for volumetric growth i.e. PIOC, leading the industry.

Recommendation

For Dec-17, our preferred plays are DGKC, FCCL, and PIOC with an upside potential of 28%, 19%, and 13% along with FY17E dividend yield of 3.0%, 5.0%,and 5.3% respectively.

Cements

Company	Recom.	Key Catalyst	Key Risks
LUCK	**BUY**	▪ 20%YoY earnings growth expected in FY17 ▪ DR Congo plant of 1.18mn tons likely to materialize in EPS impact of PKR ~4/sh in FY17 ▪ Brownfield expansion of 1.2mn tons in south to commence commercial operations from 3QFY18 ▪ ICI contributing PKR 98/sh to valuation ▪ Investments in 660MW coal based CPP to contribute PKR ~95 to valuation ▪ 10MW WHR plant expected to start operations from 3QFY17 ▪ In a recent development, Lucky has decided to 1) make investment in automobile industry worth PKR 12bn in a Joint venture with Kia Motors 2) Due diligence of DCL's north plant to evaluate potential acquisition 3) increase cement grinding capacity of Iraq unit from 0.87mn tons to 1.74mn tons (impact not included in our valuation).	▪ Further increase in coal price ▪ Price War ▪ Delay in materialization of expansion plans ▪ Slow development in Gwadar leading to idle capacity in South ▪ Lower domestic demand ▪ Increase import from Iran ▪ Margin contraction in Congo due to competition
DGKC	**Buy**	▪ 7%YoY earnings growth expected in FY17 ▪ 30MW coal based CPP to provide additional savings of PKR ~1.5/sh in FY17 ▪ Greenfield expansion of 2.7mn tpa to commence operations in 4QFY18 ▪ Brownfield expansion of 2.2mn tpa in DGK under planning phase ▪ EBITDA generation of PKR ~35bn in next 2 years ▪ Tax incentive for new industrial unit	▪ Further increase in coal price ▪ Price War ▪ Delay in expansion ▪ Increase in interest rates ▪ Slow development in Gwadar leading to idle capacity in South ▪ Increase import from Iran ▪ Lower domestic demand
PIOC	**Buy**	▪ 35%YoY earnings growth expected in FY17 ▪ 12MW WHR power plant to provide annualized additional savings of PKR ~1/share in FY17 ▪ Grinding mill facility to initiate operations from Mar-17 will add further value ▪ Low utilization (65% in FY16) provides ample room for capturing domestic demand ▪ Expected dividend yield of 5% in FY17	▪ Delay in grinding mill installation ▪ Further increase in coal price ▪ Price War ▪ Increase in interest rates ▪ Increase import from Iran ▪ Lower domestic demand

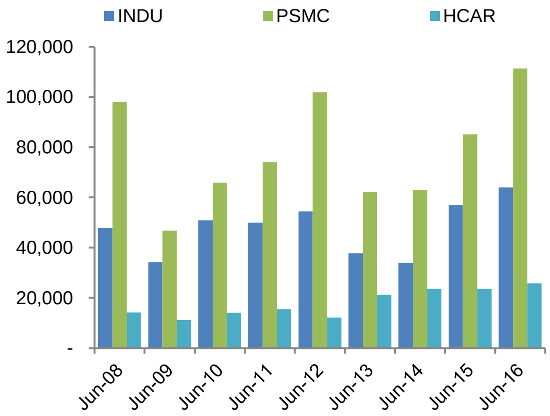
Cements

Company	Recom.	Key Catalyst	Key Risks
FCCL	**BUY**	▪ Commencement of disrupted line II in 4QFY17 to normalize earnings growth and cost efficiency ▪ Room for capacity utilization ▪ Lower oil prices to reduce power cost ▪ Availability of LNG for 6MW Gas based CPP to reduce power cost ▪ Cost rationalization initiatives under review (plans of installing WHR and CPP at line I).	▪ Delay in commissioning of line II ▪ Further increase in coal price ▪ Curtailment of dividend due to installation of CPP and WHR ▪ Price War ▪ Increase in interest rates ▪ Increase import from Iran ▪ Lower domestic demand
KOHC	**BUY**	▪ 7%YoY earnings growth expected in FY17 ▪ Lower FO prices will reduce power cost from CPP ▪ Installation of 105 tph cement mill is under way which is expected to be completed by Dec-17.	▪ Delay in commencement of cement mill ▪ Further increase in coal price ▪ Price War ▪ Increase in interest rates ▪ Increase import from Iran ▪ Lower domestic demand

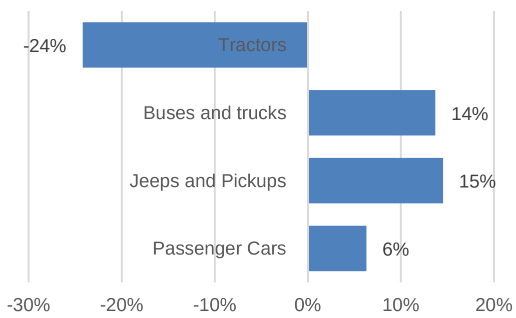
Automobile Assembler

Volumetric Slowdown – Curbing Earnings

Passenger Car Volumes - Company-wise



5Yr CAGR - Autosector



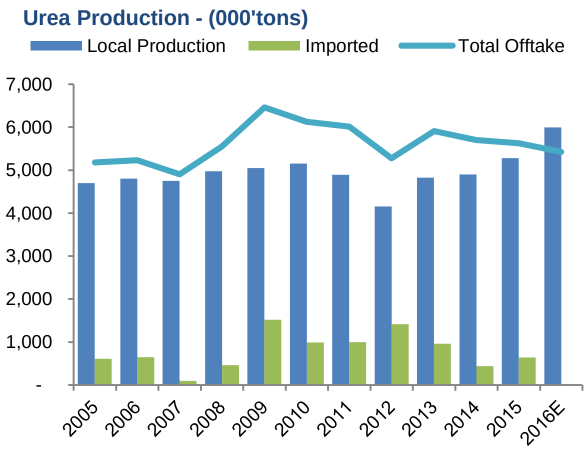
- **Slowdown in volumes**: We believe the auto demand cycle has peaked in near term with record volumes in FY16 (+20%YoY TO 181kunits) but there is still structural growth potential in automobile sector in long term. The key stimuli - potential GDP growth, low interest rates, soft inflation, low motorization levels and improving security situation all point to higher demand. However, for FY17 we believe the absolute volume will slowdown owing to company specific factors - INDU facing slowdown in Corolla sales and PSMC's Ravi and Bolan volume decrease post conclusion of 'Apna Rozgar Taxi Scheme.
- **Cost:** China curbed its steel production in order to ease out the supply glut causing steel prices to rise (bottomed out at USD 326/ton in Nov-15). In the backdrop of improving global economic growth outlook, we expect steel to continue upward price momentum, suppressing gross margins of OEMs. On forex front, given probable Fed rate hike and continued easing policy of Bank of Japan, we expect USD to appreciate against both JPY and PKR in CY17.
- **Imminent threat to pricing power:** The incentive in ADP-II for new investments and positive demand outlook has encouraged some new/reviving players to start operations in Pakistan. The entry of new/reviving players and increasing import of used cars pose an imminent threat to market share and pricing power of the incumbent players.
- **Risks:** In addition to competition from new/reviving players and used cars, the players also face the risk of uncertainly in the exchange rates and more than expected appreciation in international steel prices.
- **Recommendation:** Given the superior market performance whereby automobile assembler posted a total return +62.9%, we see valuations are overstretched, hence we are underweight on the auto sector with hold call on INDU (TP PKR 1,694/share: +7% upside) and PSMC (TP PKR 519/share: 1% downside) .

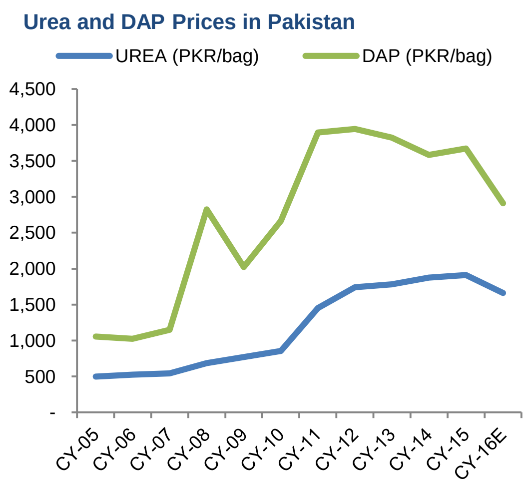
Automobile Assembler

Company	Recom.	Key Catalyst	Key Risks
INDU	**Hold**	▪ Earning attrition of 16% in FY17. ▪ Slowdown in demand of Corolla. ▪ Facelift of Corolla 11th Generation ▪ Launch of new generations of Hilux and Fortuner ▪ Dividend yield of 5.4%	▪ JPY appreciation and USD depreciation ▪ More than expected rise in steel prices ▪ New players entry ▪ Increase in used cars import
PSMC	**Hold**	▪ Earning attrition of 49% in CY16. ▪ Possible launch of Alto and Celerio replacing Mehran and Cultus ▪ Possible government scheme ▪ Turnaround in loss making motorcycle segment.	▪ JPY appreciation and USD depreciation ▪ More than expected rise in steel prices ▪ New players entry ▪ Increase in used cars import
HCAR	**Sell**	▪ Earning improvement of 49% in FY17 ▪ Civic 10th Generation to keep volumes a float ▪ Possible launch of City Model	▪ JPY appreciation and USD depreciation ▪ More than expected rise in steel prices ▪ New players entry ▪ Increase in used cars import ▪ Facelift of Corolla 11^{TH} Generation

Fertilizer

Despite Growth in Demand, Supply Glut to Persist





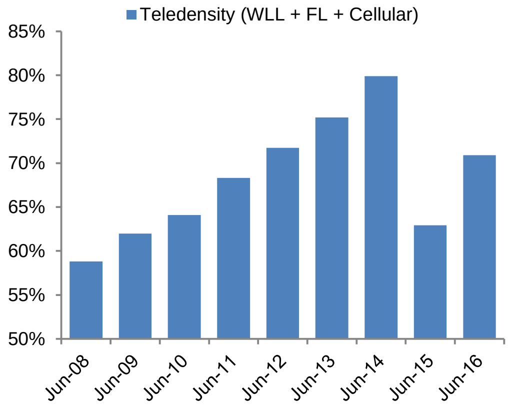
- **Performance:** For CY16TD, IGI Fertilizer sector underperformed the index KSE-100 by nearly 49%, reflecting 37% earnings decline for the sector on the account of lower offtake of urea and reduction in urea/DAP prices.
- **Higher Production, Lower Offtake led to Inventory Glut:** During the current year, urea production increased by +14%YoY during 10MCY16 due to availability of gas (including imported LNG)to the sector. However weak farm economics did effect overall urea offtake in the early part (5MCY16), but soon recovered after announcement of subsidy by PKR 156/bag, reduction in sales tax to 5% from 17% and a subsequent price cut of PKR 50/bag cut in retention prices by manufacturers, in FY17 budget. Nevertheless, higher production along with suppressed offtake growth, overall urea inventory accumulated to 1.7mnton in Oct-16. For DAP offtake surged by +25% to 1.4mn tons during 10MCY16 on the back of decline in DAP prices by 21%YoY.
- **Supply glut to persist:** We expect supply glut situation to persist in 2017, as improved gas supply will keep production at elevated levels for the industry. The prospect of exporting urea is still pending with Government of Pakistan (GOP). In the most likely scenario we expect exports are likely to reopen, easing up sectors inventory level. This is particularly true considering rising trend of international urea prices (urea prices rose to USD 240/ton by Nov-16, from a low of USD 181/ton back in Jul-16).
- **Low Pricing Power, improving demand should accrete gross margins for sector:** We believe, once the subsidy exhaust in Jun-17, manufacturers might find it difficult to raise urea prices back to pre-subsidy level. We say this primarily due to supply glut situation seen in 2017, unless exports pave it way for lower inventory levels. Further, recent reduction in fuel gas prices (GoP reduced fuel prices from PKR 600/mmbtu to PKR 400/mmbtu) gived less incentives to manufacturers to raise prices. Having said lower product prices along with expected improvement in farm economics should lead to stronger demand in 2017. For that matter we expect industry margins to improve, albeit marginally.
- **Recommendation:**
  We estimate IGI Fertiliser Sector earnings to growth of +18%YoY in CY17. Amongst our coverage companies, EFERT is our top pick with Dec-17 TP of PKR 85/share, offering an upside of +27% from its last closing. The scrip is currently trading CY17E P/E multiple of 6.5x, offering dividend yield of 7.8%.

Fertilizer

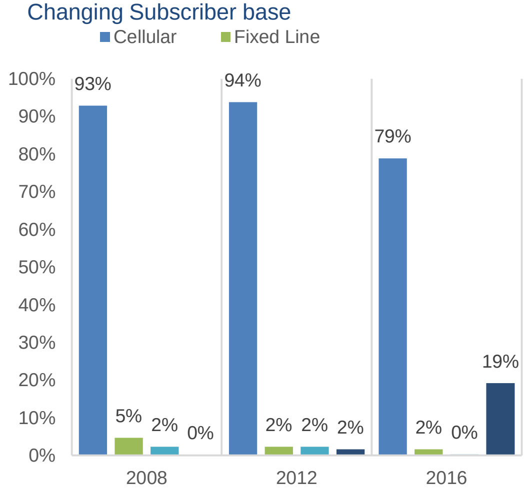
Company	Recom.	Key Catalyst	Key Risks
EFERT	**Buy**	▪ Company is estimated to post an EPS of PKR 10.1/share for CY17 from PKR 7.5/share for CY16, up by a massive +35% ▪ Availability of USD 0.70/mmbtu gas for Enven Plant, in case gas price increase ▪ Decline in company financing cost due to aggressive deleveraging and low interest rates ▪ In times of declining international DAP prices, EFERT gross margin will further improve	▪ Continued price discounts ▪ Increase in international Phos acid prices ▪ Fall in international/Local urea prices ▪ Increase in Interest rates
FFBL	**Hold**	▪ +18%YoY expected growth in earnings for CY17. ▪ Income from sale of electricity to KE ▪ Fuel cost saving as company with expected commencement of its Coal Power Plant (1QCY17), leading to gas availability at urea production line. We expect aforementioned add EPS of PKR 0.7-1.0/share ▪ Sizable dividend income from FCCL and AKBL	▪ Weakening pricing power of DAP due to international decline in commodity prices. ▪ Given weak banking sector dynamics and capital issues at AKBL, dividend stream may get effected ▪ Increase in international Phos Acid Prices ▪ Fall in urea/DAP prices
FFC	**Hold**	▪ +4%YoY growth in earnings for CY17. ▪ Other Income from FFBL, FCCL and AKBL contributing sizable amount of 13% of pre-tax income ▪ International expansion in Tanzania	▪ Inter-corporate dividend stream may get effected ▪ International/Local urea price decline

Technology and Communication

Data Led Growth Ineludible



Changing Subscriber base



- **Industry:** Introduction of NGMS in Jun-14 has changed the sector dynamics, a shift towards data communication has resulted in decline of voice communication. Moreover the cellular data has resulted in cannibalization of non cellular data too owing to the flexibility associated with cellular data usage. The growth stimuli of data communication– large and young population, increasing GDP, low broadband penetration, increasing cellular customer base and increasing mobile proliferation all point towards growth.
- **Performance:** IGI telecom and communication universe posted return of +7% during CY16TD compared to KSE-100 return of 33%.
- **Risks:** We flag aggressive price based competition and changes in technology to be key risk to the profitability of telecom sector companies wars
- **Outlook:** We foresee data led growth and ARPU enhancement in the sector owing to favorable demographics, increasing cellular customer base, low mobile and broadband penetration and increasing GDP.
- **Recommendation:** We are overweight on the telecom sector with over perform ratings on PTC with a target price of PKR 21.26, implying upside of +20%.

Technology and Communication

Company	Recom.	Key Catalyst	Key Risks
PTC	**Buy**	▪ Earning improvement of +28% in CY17 ▪ Average Revenue per user Growth ▪ Broadening PTML customers base. ▪ Price floor for telecom services	▪ Price wars ▪ Excessive cannibalization of voice based telephony ▪ Technological risk

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Hold	If target priceon aforementioned security(ies) is in between -10% and 10%, from its last closing price(s)
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