Foundation Research
Equities

Foundation Securities

Monday, 02 January 2012

Pakistan Strategy

Pakistan Strategy (Contd)

Foundation Securities

PAKISTAN

Pakistan Politics

02 January 2012

Key players

Becoming fluid; current government has failed to implement key reforms

- **Pakistan US relationship at new lows.** As 2011 drew to a close, the uneasy ties between Pakistan and US took a turn for the worse, signaling more trouble ahead in 2012. In a span of two months, the political situation has become very fluid, first due to the Memogate scandal, allegedly involving the President, and then following the deadly NATO air strike that killed over 20 Pakistani soldiers next to the Afghan border. In reaction to the latter, Pakistan boycotted the Bonn conference on Afghanistan and had the US vacate the Shamsi airbase. It has also upgraded its air defense system along the Afghan border and cut-off supplies to NATO troops in Afghanistan. While the US response includes partly blaming Pakistani troops for the attacks and freezing of some aid to Pakistan. According to a recent New York Times report quoting unnamed US officials, US is preparing for a reduced future partnership with Pakistan involving restricted drone strikes against militants and reduced aid. However, we believe that Pakistan and US will eventually salvage their relationship in some form given their deep interdependency as 1) US needs Pakistan for its graceful exit in 2014 and to ensure a lasting peace in Afghanistan 2) Pakistan needs direct and indirect US support for its economic survival.
- **Is Memogate scandal the last straw?** The Memogate scandal refers to a secret memo delivered to Admiral Mike Mullen which asked for U.S. government help to prevent a suspected coup by the Pakistan army in the aftermath of Osama Bin Laden's killing in Abbotabad. In return, the memo offered to reorient Pakistan's foreign policy in line with U.S. interests. A US national, Mansoor Ijaz, who delivered the aforesaid memo, claims that Hussain Haqqani, the former ambassador to US, drafted it at the behest of President Zardari. At present, country's Supreme Court is hearing the Memogate scandal case in an extremely charged political environment. The government considers the memo as just a piece of paper concocted by Mansoor Ijaz. However, country's military establishment insists that the memo is a reality meant to undermine country's national security. The army chief has urged the judiciary to thoroughly investigate the issue and take it to its logical conclusion. President Zardari, who has recently returned from a sudden medical trip to Dubai, has decided not to reply in the Memo case, citing immunity he enjoys under the Constitution. However, the chief justice of the Supreme Court has observed that the president cannot avoid the case on the presumption that he enjoys immunity. In a latest development, the Supreme Court has ordered the formation of a judicial commission, comprising chief justices of three high courts, to probe the alleged memo and complete its findings within four weeks. The Memogate controversy has put the army and the government on a collision course and is bound to create a lot of noise and uncertainty as investigations and court hearings progress on in 2012.

Analyst
Syed Suleman Akhtar, CFA
92 21 5612290-94 Ext 338
sakhtar@fs.com.pk

PAKISTAN

Pakistan Politics

02 January 2012

Global Competitiveness Rankings

	2010	2011
Pakistan	101	123
India	49	51
Bangladesh	106	107
Sri Lanka	79	62
Malaysia	24	26
Thailand	36	38
Philippines	87	85

Source: The Global Competitiveness Report 2010-11

- **PTI fast emerging as an alternative political force.** With successful public gatherings in Lahore and Karachi under its belt, PTI, led by former cricketer Imran Khan, is fast emerging as an alternative political force. Riding on a growing wave of disillusionment with the current political parties, Khan promises to root out corruption, stand up to America and introduce a merit-based culture. The party, which mainly appeals to middle-class urban youth and women, has recently seen a growing number of veteran politicians from PPP, PML-N and PML-Q joining its ranks. We expect the party to pose a serious challenge to incumbent PPP and PML-N in the next general elections.
- **Political parties drawing battle lines as next elections come close.** With elections scheduled in the beginning of 2013 and early elections quite possible, political parties have started drawing their battle lines as indicated by rising political rallies and protests. We expect further pick up in political activities as election date draws closer.
- **Ruling coalition has failed to implement key reforms.** During its 4 years in office, the current coalition government has failed to implement politically tough yet urgently needed reforms to put the country on sustained high growth path. For instance, there has been no progress on key fiscal reforms to widen the tax base. Consequently, the tax-to-GDP ratio has declined to 9%, one of the lowest in the developing world and revenues are barely enough to meet government's current expenditures. The government has also failed to effectively address the energy crisis. Due to increasing reliance on expensive furnace oil based plants for electricity generation, the power mix has become extremely sensitive to global crude prices. Thus, incessant increase in global oil prices has greatly neutralized over 70% increase in electricity tariffs over the last three years, resulting in no respite in power subsidies provided by the government. Further, because of insufficient furnace oil imports, due to ever increasing circular debt, a sizable chunk of thermal power generation capacity remains idle. Moreover, the government has not come up with a medium to long-term plan for solving the energy sector issues. The government has also not made any progress in restructuring loss making public sector enterprises (PSEs). Financial condition of these PSEs has rather deteriorated due to overstaffing, corruption, politicized unions and mismanagement. Pakistan's deteriorating policy environment is also captured in its falling global competitiveness ranking. Pakistan's ranking has dropped from 101 in 2010 to 123 in 2011.

Analyst

Syed Suleman Akhtar, CFA

92 21 5612290-94 Ext 338 sakhtar@fs.com.pk

Foundation Research
Economics

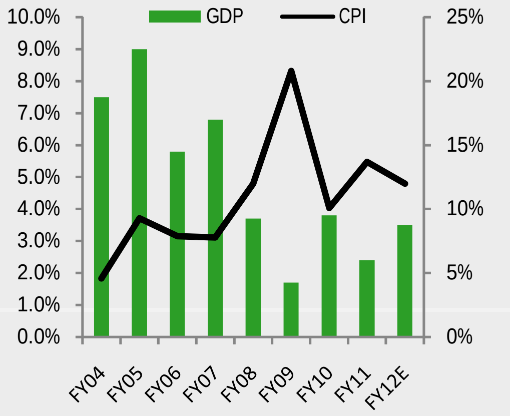
Foundation Securities

PAKISTAN

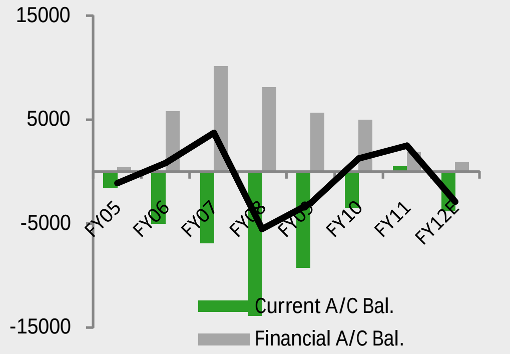
Pakistan Economy

02 January 2012

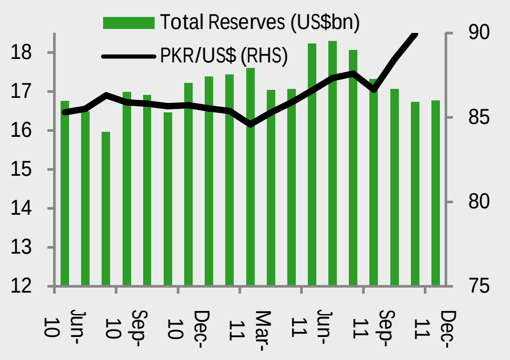
Inflation and GDP growth



External account summary (USDmn)



Reserves and PKR trend



Analyst

Syed Suleman Akhtar, CFA
92 21 5612290-94 Ext 338 sakhtar@fs.com.pk

2012: Another disappointing year in the making

In the absence of a clear-cut macroeconomic revival plan to address structural issues preventing sustained high macroeconomic growth, FY12 would be another disappointing year for the economy.

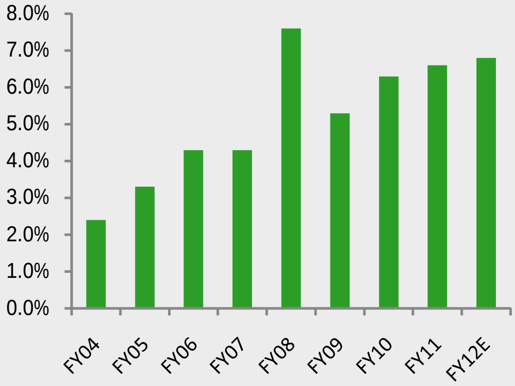
- **GDP growth to miss target again.** The government initially projected GDP growth to bounce back to 4.2% in FY12. However, we think that GDP growth is likely to remain around 3.5% as 1) lower wheat output, due to insufficient fertilizer application, would depress agriculture growth 2) continued electricity and gas shortages would keep industrial production in check and 3) lower SBP profits, weakness in transport and communication (Pakistan Railway, PIA) and absence of one-off gains in public administration and defense (50% increase in salaries of government employees last year) and community and social services (heavy flood related spending in FY11) would hit services sector growth.
- **Fiscal deficit to come well in excess of 6.0% of GDP.** Government's fiscal deficit projection of 4.0% of GDP will be breached by wide margin in our opinion as the recent conversion of Rs391bn PSE debt to PIBs/MTBs alone adds 1.8% of GDP to FY12 fiscal deficit. Other than the above, the subsidy burden would also be significantly higher than budgetary estimates. On the revenue side, we expect significant shortfall in defense receipts and privatization proceeds. SBP profits would also be lower, while we seriously doubt that auction of 3G licenses could happen in the current environment. We also find FBR tax collection target rather optimistic being significantly above nominal GDP growth and in the absence of any meaningful tax reforms. We estimate FY12 budget deficit to comfortably reach 6.8% (including PSE debt conversion) of GDP.
- **External account to exhibit considerable weakness.** For FY12, the government originally projected a small current account deficit of USD1.4bn (0.6%ofGDP) due to slight increase in imports and slower growth in remittances. However, at USD2.1bn during July-November, FY12 current account deficit has already breached government's full year estimate. We estimate a full year deficit of USD3.8bn, due to higher trade deficit and lower defense receipts. However, this would still be quite narrow at 1.6% of FY12 GDP. Our bigger concern is the dwindling surplus on the financial account. We find FY12 financial account estimates very optimistic as FDI and portfolio investments are projected to substantially increase to USD3.5bn and USD950mn, respectively. Further, the government estimates a significant jump in official loan disbursements by multilateral lenders. However, given that Pakistan is no longer in the IMF program, government's limited loan absorption capacity and dismal loan receipts in the last fiscal year, we seriously doubt government's ability to raise sufficient external loans. Heavy debt repayments starting from 2HFY12 would further compound any shortfall in projected loan receipts. In our view, funding even a very narrow current account deficit would not be easy for the government. Weakness on the external account would result in further foreign exchange reserves depletion and greater PKR depreciation against USD during 2HFY11.

Foundation Securities

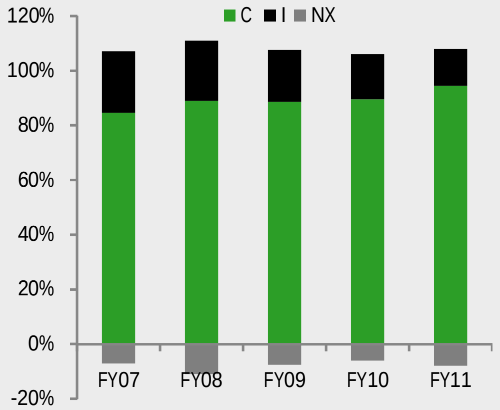
PAKISTAN

Pakistan Economy

Fiscal Deficit (as %age of GDP)



GDP composition



Analyst

Syed Suleman Akhtar, CFA
92 21 5612290-94 Ext 338 sakhtar@fs.com.pk

Inflation to remain in line with forecasts, M2 growth will be lopsided. We believe that inflation will remain within annual plan target of 12% due to recent softening of global commodity prices. However, further hike in electricity and gas tariffs, expected PKR depreciation, strong demand created by the government and lack of administrative controls over prices would keep inflationary pressures strong during the fiscal year. We expect money supply growth to remain around 12-13% in FY12, lower than 15.9% recorded in FY11, due to NFA attrition. The NDA component will again be driven by public sector borrowing. We see low probability of any further decline in interest rates due to uncertainty on the fiscal and external side.

Structural issues besetting sustained high macroeconomic growth

- **Perennial fiscal weakness:** The root cause of Pakistan's macroeconomic woes is its fiscal weakness. The main issues are 1) low tax collection (9.0 % of GDP) as most of the economy remains undocumented/under-taxed 2) public sector inefficiencies as depicted by heavy losses incurred by State enterprises.
- **GDP composition is too lopsided:** Pakistan's economy remains too lopsided with the share of private consumption expenditures in GDP coming to 86.3%, while GCFF is just 11.8%. Pakistan needs to pursue a more balanced growth (current GDP composition: C94.5%, I13.4%, NX -7.9%), with investments and exports rising at a faster pace than consumption expenditures.
- **Low savings:** Another related issue is the low savings rate (13.8% of GDP). Given that Pakistan's growth model is primarily domestic demand-led, the country needs to enhance the local savings rate to fund much needed investment expenditures.
- **Competiveness and productivity:** Weak external competitiveness, as manifested in a high structural trade deficit, due to low value addition and productivity in the agriculture and industrial sectors remains another impediment for the local economy, threatening macroeconomic stability and impeding efforts to achieve sustained higher GDP growth.

PAKISTAN

Pakistan Economy

Fig Key macroeconomic forecasts

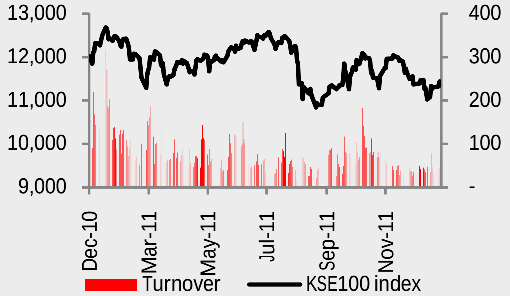
Fiscal year runs from July to June	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
Nominal GDP (Rsbn)	7,623	8,673	10,243	12,724.0	14,837	18,063	21,041
Nominal GDP (US$bn)	127	143	164	159	178	211	237
Per capita GDP (US$)	807	887	995	944	1,035	1,201	1,327
Population (mn)	158	161	165	168	172	175	179
Growth indicators (% YoY)							
Real GDP	5.8%	6.8%	3.7%	1.7%	3.8%	2.4%	3.5%
Agriculture	6.3%	4.1%	1.0%	4.0%	0.6%	1.2%	2.5%
Industry	4.1%	8.8%	1.4%	-0.1%	8.3%	-0.1%	3.0%
Services	6.5%	7.0%	6.0%	1.7%	2.9%	4.1%	4.2%
Inflation indicators (%YoY)							
CPI (average)	7.9%	7.8%	12.0%	20.8%	10.1%	13.7%	12.0%
Money and policy rates							
Money supply-M 2	15.1%	19.3%	15.3%	9.6%	12.5%	15.9%	13.0%
SBP discount rate	9.0%	9.5%	12.0%	14.0%	12.5%	14.0%	12.0%
Consolidated fiscal deficit	4.3%	4.4%	7.6%	5.3%	6.3%	6.6%	6.8%
Balance of payments (US$bn)							
Trade balance	-8.4	-9.7	-15.0	-12.6	-11.5	-10.2	-14.3
Invisible balance	3.5	2.8	1.1	3.4	7.6	10.7	10.5
Current account balance	-5.0	-6.9	-13.9	-9.3	-3.9	0.5	-3.8
as % GDP	-3.9%	-4.8%	-8.5%	-5.8%	-2.2%	0.3%	-1.6%
Financial account balance	6.3	10.6	8.4	6.2	5.2	2.0	0.9
Overall balance	1.3	3.7	-5.5	-3.1	1.3	2.5	-2.9
Foreign exchange reserves	13.1	15.6	11.4	12.4	16.7	18.2	14.4
Exchange rate PKR/USD (avg)	59.86	60.63	62.55	80.15	83.48	85.8	88.7
% YoY	0.8%	1.3%	3.2%	28.1%	4.2%	2.8%	3.4%
Exchange rate PKR/USD (end period)	60.2	60.4	68.4	81.5	85.5	86.1	91.3
% YoY	0.9%	0.3%	13.3%	19.1%	5.0%	0.7%	6.0%

PAKISTAN

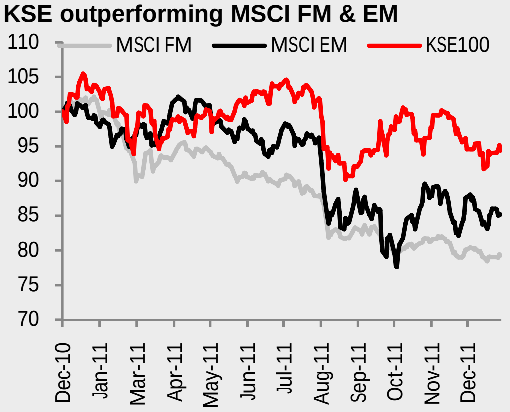
Pakistan Strategy

02 January 2012

KSE100 Index (LHS), Turnover (RHS, mn)

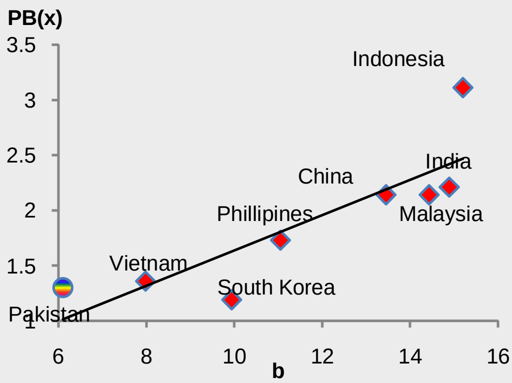


KSE outperforming MSCI FM & EM



Source: MSCI Barra, FS Research, January 2012

Attractive relative to regional markets



Source: Bloomberg, FS Research, January 2012

Analyst

Syed Suleman Akhtar, CFA
92 21 5612290-94 Ext 338 sakhtar@fs.com.pk

Lackluster CY11, current level overly incorporates negatives

- **Dull CY11 performance, though KSE still outperforms peer markets.** Despite a robust 19.0% earnings growth, the local bourse has witnessed a bearish trend during the year with the benchmark KSE-100 declining by 5.6% from 12022 to 11348. Nonetheless, the local market has reasonably outperformed other regional markets as MSCI EM and MSCI FM indexes are down by 15% and 21%, respectively during the year. However, despite their superior CY11 performance, Pakistani equity markets still trade at a sizable discount to their regional peers. At current levels, the KSE-100 Index trades at 6.1x and 1.3x next year earnings and book value respectively, which is at a 49% discount to regional market average PE of 12.0x and 30% discount to PB of 1.9x.

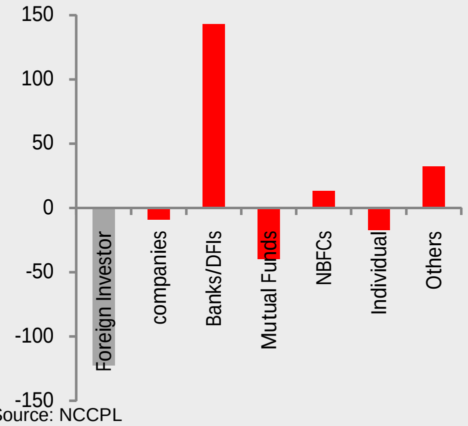
- **Foreigners become net sellers, trading activity at multiyear lows.** An investor-wise break-up of portfolio flows reveals that foreign investors sold shares worth USD123mn during the year against net purchases of USD520mn in CY11. Consequently, the share of foreigner ownership in free float has declined to around 29% from 32% at last year end. Among local players, banks/DFIs (USD143mn) remained major buyers, while mutual funds (USD40mn) and individual (USD17mn) were net sellers. Further, subdued participation by local players, on CGT fears, rising political uncertainty, low macroeconomic visibility and shortcomings in the new leverage product, has led to significant decline in average daily turnover and value traded to multiyear lows at 48.95mn shares and USD30.32mn during 2HCY11.

- **Major sectors underperform; significant appreciation in illiquid food producers.** Oil and gas and banks, the two largest listed sectors, were down by 9% and 22% respectively, the former due to circular debt and lower production additions and the latter on account of NIM shrinkage fears and low macroeconomic visibility. While the third largest chemical sector was up by 9% for the year, due to strong price performance by some fertilizer companies (FFBL, FFC and Fatima). The fourth largest sector, food producers was down by a hefty 37% on the back of significant appreciation in some illiquid names (Nestle and Unilever).

- **Current index level incorporates a lot of negatives.** Compared to yields on alternate investments (NSS and PIBs), defensive composition of local equity market and future earnings growth, the current market level overly incorporates negatives, in our opinion. We expect corporate earnings to grow by a slower 9% in 2012, due to flat bank profits, before resuming double digit growth in 2013. Thus, assuming no change in PE multiples, the index target for December 2012 comes to 12369. However, we believe the market should trade at a higher PE multiple given the current rates on alternate investments and expected average annual earnings growth of 12% over the next two years. Assigning a PE of 7.0x to 2012 earnings, we arrive at an index target of 13086 for December 2012.

Pakistan Strategy

Net portfolio flows during CY11 (USD mn)



Source: NCCPL

Positive catalysts for the market

- **Improvement in Pakistan US relations.** The above could potentially lead to release of coalition support funds and US aid, lessening the stress on the external account. Further, the US would also help in future Pakistan IMF negotiations.
- **Political clarity.** An amicable end to the hotly debated Memogate case would be a key trigger.
- **An investor friendly change in the leverage product.** According to recent media reports, SECP would allow individual financers in MTS and lower cash margin requirements.
- **Favorable amendment in the CGT regime.** According to its chairman, the SECP will propose new mechanism for filing of CGT returns and collection of the capital gains tax (CGT) on stock exchanges to address concerns of the broker's community and investors for revival of the capital market.
- **Patch-up between IMF and Pakistan leading to a new back to back program.** With FDIs dwindling and the government unable to borrow from international capital markets, Pakistan needs a back to back IMF program (IMF nod is also needed for financing from other donors) for funding its twin deficits and heavy debt repayments in the coming years. IMF program will also ensure greater discipline in government spending and force it to undertake key macroeconomic reforms.
- **Improvement in macroeconomic visibility.** Any tangible progress on key reforms would be a milestone.
- **Foreign buying.** We believe foreign participation will be muted in 1HCY12 due to high global economic risks and investors flight to safety. However, foreign investors will eventually return to EM due to their better fundamentals and higher growth prospects.

Downside risks

- Further deterioration in law and order situation and political climate. The above would adversely impact the domestic economy and equity markets.

Action and recommendation

- At current attractive levels, we have an outperform stance on all major sectors and most of our universe companies. However, given the high level of political and macroeconomic uncertainty, we have selected defensive stocks in all major sectors as our top picks. In banks, our top pick is MCB due to its de-risked and highly liquid balance sheet, superior liability franchise, decent dividend yield and robust capital position. Among E&Ps and OMCs, we recommend POL and APL which are vertically integrated at the group level, offer healthy dividend yields and are least affected by the circular debt issue. In case of fertilizers, our top pick is FFC which is little affected by gas load shedding and offers a handsome dividend yield. In cements, our top pick is Lucky which has negligible leverage and is most cost efficient among local players. Out other picks are Engro and Hubco due to their deeply discounted valuations.

PAKISTAN

Pakistan Banks

02 January 2012

NIM shrinkage to flatten CY12 earnings, attractive valuations nonetheless

Sector theme

- We expect our universe banks (Big5) to post flattish earnings growth of just 1.4% in CY12 due to 1) NIM compression following 200bp cut in SBP discount rate in 2HCY11 and 2) slower deposit growth due to lower M2 growth.
- Nonetheless, we find current valuations extremely attractive as despite an estimated 23% profitability growth (13% including NBP) in the outgoing year, our universe banks are down by 23% against 5.6% correction in the benchmark KSE-100 Index during CY11. Based on the latest closing prices, FSL bank universe trades at CY12 PE and PB of 5.2x and 0.8x, respectively.

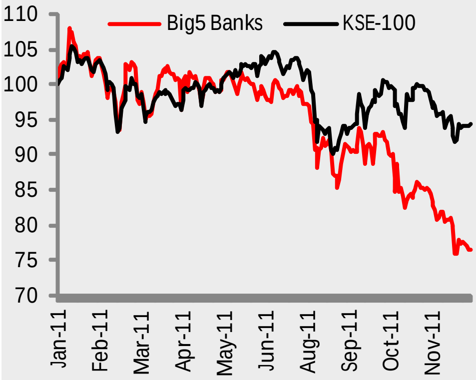
Sector outlook

- **NIM compression and slower deposit growth to hit CY12 top line.** We have built in an average 70bp NIM compression for CY12 in our financial models incorporating 1) 200bp cut in SBP discount rate 2) conversion of Rs391bn power and commodity sector debt into low yielding PIBs and T-Bills. We also expect a slowdown in deposit growth to 12% in CY12 due to weaker broad money growth. Unlike last year when M2 growth was boosted by a significant increase in NFAs on the back of a healthy overall balance of payments position, we expect some NFA attrition in CY12, due to increasing weakness on the external account, to suppress money supply growth. However, lower provisions, due to de-risked asset books, contained opex and double digit balance growth should offset the impact of NIM compression on banks' bottom lines, enabling them to post flat earnings.
- **Private sector credit to remain muted, PSE borrowing to prop up advances growth.** In view of the uncertain macroeconomic environment, the banks are likely to continue with their cautious lending approach and deploy their liquidity in government securities and public sector lending. For CY12, we are penciling in 9% advances growth due to an expected pick up in PSE borrowing (commodity, circular debt etc.) as these state-owned enterprises stand deleveraged after the recent bail-out by the government.

Action and recommendation

- **Low macroeconomic visibility affecting investor perceptions.** Since banking industry fortunes are tied to that of the overall economy, low macroeconomic visibility, together with NIM compression fears, is affecting investors' confidence in the sector. Macroeconomic visibility is low due to uncertainty on the fiscal side i.e. size of the fiscal deficit and its funding. The above makes monetary policy and external sector outlook unpredictable beyond a three month horizon, due to risks of heavy government borrowing from commercial banks/central bank and uncertainty on foreign inflows. We expect our universe banks to significantly rerate once there is an improvement in macroeconomic visibility.
- We have rolled forward our target prices from June 30, 2012 to December 31, 2012. At current levels, we have an Outperform stance on our entire universe banks, while MCB Bank (TP Rs229.1) is our top sector pick.

Banks underperforming KSE100



Source: Foundation Research, January 2012

CY12 valuation snapshot of Big5 Banks

	P/E	P/B	Div Yield
HBL	5.6	10	7.4%
MCB	5.4	11	9.4%
NBP	4.4	0.5	15.5%
UBL	5.0	0.7	8.3%
ABL	5.0	10	8.0%

Source: Foundation Research, January 2012

Analyst
Syed Suleman Akhtar, CFA
92 21561229 Ext 338 suleman.akhtar@fs.com.pk

Foundation Research
Equities

Foundation Securities

PAKISTAN

MCB Bank

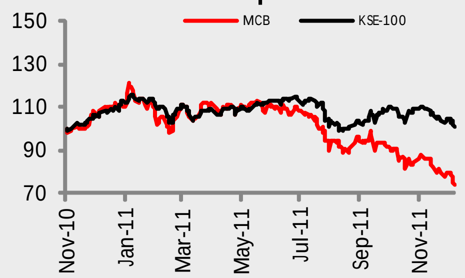
02 January 2012

MCB PA		**Outperform**
Stock price as of 30 Dec	Rs	134.6
Dec 12 target price	Rs	229.1
Upside/downside	%	70.2
Valuation	Rs	229.1
- Gordon Growth Model		
Banks		
Market cap	Rs bn	112.6
30-day avg turnover	US$m	1.6
Market cap	US$m	1,252
Number shares on issue	m	836

Investment fundamentals

Year end 31 Dec		2010A	2011E	2012E	2013E
Net interest inc	m	36,802	44,449	45,282	50,502
Non interest inc	m	6,711	7,592	8,440	9,570
Underlying profit	m	30,107	36,705	35,954	40,097
PBT	m	26,509	33,004	33,145	36,954
PBT Growth	%	13.5	24.5	0.4	11.5
Adjusted profit	m	16,872	21,073	21,400	24,314
EPS adj	Rs	20.2	25.2	25.6	29.1
EPS adj growth	%	7.7	24.9	1.6	13.6
PE adj	x	6.7	5.3	5.3	4.6
Total DPS	Rs	10.5	12.0	13.0	14.0
Total div yiel	%	7.8	8.9	9.7	10.4
ROA	%	3.1	3.4	3.0	2.9
ROE	%	21.9	24.1	21.6	21.8
Equity to assets	%	14.4	13.8	13.6	13.4
Price/book	x	1.4	1.2	1.1	1.0

MCB PA rel KSE100 performance



Source: Datastream, Foundation Research, January 2012
(all figures in PKR unless noted)

Analyst
Syed Suleman Akhtar, CFA
92 215612290 Ext 338 suleman.akhtar@fs.com.pk

Best placed in the current environment

Investment theme

- Our investment premise on MCB is based on its attractive valuation, superior ROE, strong liability franchise, de-risked balance sheet, stabilizing asset quality, robust capital position and better cost efficiency. We believe, irrespective of the economic cycle, the above should enable MCB to deliver a superior return to its shareholders. MCB is trading on an attractive valuation at CY11 PB of 1.2x and PE of 5.3x, at respective 53% and 48% discounts to 5-year historical averages.

Key thesis

- **Bank with the best banking franchise:** MCB Bank arguably has the strongest deposit franchise in the domestic banking industry as low cost current and savings account (CASA) deposits make up 79.3% of its deposit book against the industry CASA ratio of 67.3% (2QCY11 numbers). Though MCB has a 9.0% share in overall industry deposits, its share in current and savings deposits is higher at 11.0% and 10.4%, respectively. Further, the share of public/government deposits in bank's deposits is just 3.4%, making it least vulnerable to any transition to a single treasury account. A key driver of MCB's superior profitability is its exceptionally high ROA of 3%+ primarily due to a very fat NIM. The bank's NIM is, in turn, driven by its low cost of funds due to its robust liability franchise. A low funding cost also allows the bank to offer more competitive loan prices to its customers.
- **A significantly de-risked balance sheet:** In view of the consistently turbulent macroeconomic environment since 2008, MCB has adopted a very conservative lending stance, parking nearly all of its incremental funds in short-term risk-free government securities. Consequently, the share of advances in its assets has declined to 35.1% from 58.9% in CY08 while the share of investments has improved to 45.3% from 22.0%. The balance sheet remains conservative and highly liquid, positioning the bank to comfortably deal with any future economic uncertainty.
- **Strong capital position offers added buffer:** MCB is in a very robust capital position with a CAR of 22.0% (CY10 accounts) vs. the regulatory requirement of a minimum of 10.0%, while the more important tier 1 ratio stands at 20.7%. MCB's equity to assets ratio, which disregards risk weights, also stands at a comfortable 13.2%. Its strong capital position provides further cushion against any potential loan losses. Further, in case of a pick-up in private sector credit, the bank has ample room to increase its loan book without issuing any additional equity or cutting dividends.

Price catalyst

- Dec-12 price target: Rs229.1 based on Gordon Growth Model methodology.
- Catalyst: Strong earnings growth in CY11, any improvement in macroeconomic visibility.

Action and recommendation

- The scrip offers 70.2% upside to our target price. We reiterate Outperform.

PAKISTAN

Oil and Gas Exploration

02 Jan 2012

Production and prices to drive double digit earnings growth

Sector theme

- 2011 was a dull year for the E&P sector as the sector only managed to match the KSE100 return of -5.6% during the calendar year. The two heavyweights, OGDC and PPL, both underperformed the index though POL outperformed by a considerable margin. However, we expect 2012 will bring in positive production and exploratory news flow for all the listed E&Ps. Record oil output of 75kbpd coupled with strong wellhead gas prices will allow E&P companies to record double digit growth in bottom line.

Sector outlook

- **Record oil production to drive healthy earnings growth of 30.5% in the sector:** We estimate record oil production of 75,000bpd in 2012, which translates to YoY growth of 15%. This will be the highest oil output by the country in its history, driven by materialization of key projects such as Nashpa-02 (4,800bpd oil, 12mmcfd gas), Makori East-1 (5,000bpd oil, 20mmcfd gas), KPD-TAY integrated project (1,000bpd oil, 100mmcfd gas), Halini-1 (1,700bpd oil), and Sinjhoro (1,200bpd oil, 15mmcfd gas). Relatively smaller production additions from other fields such as Adhi and Domial will also add to country's oil production. The net production addition is estimated at 10,000bpd oil, taking into account natural decline from mature basins. Additional production upside is highly likely as our production estimates do not incorporate any success at Nashpa-03 (at 98% target depth) and Makori East-02 (at 93% target depth), though positive results are anticipated from the two wells by 1HCY12. The incremental oil output translates to approximately $400mn of additional oil sales by the E&P sector for 2012. This will allow the listed E&Ps to register double digit growth of 30.5% in profits in FY12

- **Positive developments on regulatory front to kick start tight gas production for the first time in country's history:** Due to Ministry of Petroleum's policy initiatives on conventional/unconventional hydrocarbon resources of the country, the E&P sector will remain in the spotlight during 2012. The 2011 Petroleum Policy already offers significantly better gas prices with reduction in windfall levy and conversion option with 100% pricing incentive on recent finds. For unconventional resources, tight gas policy and low btu gas policy have been announced, whereas shale gas policy is also under study. Apart from record oil output, we expect another milestone of first ever tight gas production to be achieved in 2012.

Action and recommendation

- Since E&P is the largest sector comprising more than one-third the market cap of KSE-100, it's a must invest sector for funds tracking market performance. Though our outlook for E&P sector's production and earnings growth remains positive, we only have 'Outperform' recommendation on POL. OGDC is 'Neutral' owing to relatively expensive valuations whereas MGCL is also 'Neutral' owing to unattractive return formula. PPL remains on our 'restricted list' but in terms of valuations, it is the cheapest E&P company trading at an extremely attractive FY12 PE of 5.3x and offering decent dividend yield of 8.3%.

Analyst
Asim wahab Khan, CFA
92 21 5612290-94 Ext 335 awkhan@fs.com.pk

PAKISTAN

Pakistan Oilfields

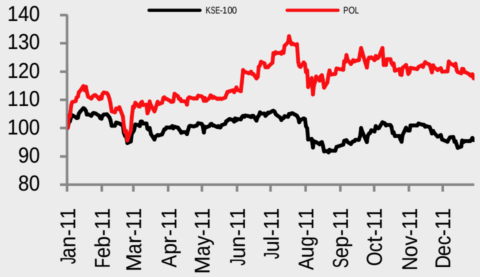
02 January 2012

POL PA		Outperform
Stock price as of Dec 30	Rs	346.5
June 12 target	Rs	421.3
Upside/downside	%	21.6
Valuation	Rs	421.3
- Reserve based DCF		
Oil and gas exploration		
Market cap	Rs bn	82.0
30-day avg turnover	US$m	2.0
Market cap	US$m	921
Number shares on issue	m	236.5

Investment fundamentals

Year end 30 Jun		2010A	2011E	2012E	2013E
Total revenue	m	17,845	24,951	30,969	32,335
EBIT	m	9,875	15,174	18,406	18,880
EBIT Growth	%	28.3	53.7	21.3	2.6
Recurring profit	m	7,437	10,951	13,680	14,205
Reported profit	m	7,437	10,815	13,680	14,205
EPS rep	Rs	31.44	45.72	57.83	60.05
EPS rep growth	%	32.4	45.4	26.5	3.8
EPS rec	Rs	31.44	46.30	57.83	60.05
EPS rec growth	%	32.4	47.3	26.5	3.8
PE rep	x	11.0	7.6	6.0	5.8
PE rec	x	11.0	7.5	6.0	5.8
Total DPS	Rs	25.50	35.00	40.00	42.00
Total div yield	%	7.4	10.1	11.5	12.1
ROA	%	18.9	23.0	27.2	25.8
ROE	%	25.5	32.4	37.6	34.8
EV/EBITDA	x	6.3	4.1	3.1	2.8
Net debt/equity	%	-52.82	-54.94	-58.69	-52.21
Price/book	x	2.8	2.5	2.3	2.0

POL PK rel KSE100 performance



Source: Bloomberg, Foundation Research, January 2012
(all figures in PKR unless noted)

Analyst

Asim wahab Khan, CFA
92 21 5612290-94 Ext 335 awkhan@fs.com.pk

Another year of outperformance in the offing

Investment theme

- POL's investment theme revolves around value that's being driven by hefty production additions from nation's most valuable hydrocarbon asset, Tal, and high oil prices. POL has comprehensively outperformed the market and peer companies in CY11 and we expect strong results on the back of enhanced flows from Tal and Ikhlas blocks and continued strength in oil prices will allow POL to maintain its strong performance in FY12. Attractive valuations, hefty payouts, near-term production additions, and exploration and development upside from Tal and Ikhlas block are but a few triggers this stock has to offer, making it our only pick in the E&P space.

Key thesis

- **Key triggers to unfold in 1HCY12:** During CY12, We expect POL to maintain the strong price performance trend it exhibited in CY11, owing to abundance of triggers which will keep investors enthusiasm alive in the stock. The key driver will remain development news flow from Tal, as significant increase of 5,000bpd oil and 20mmcfd gas from Makori East-1 in 1QCY12 and production increase of 500bpd oil and 20mmcfd gas from Manzalai-09 (to be connected to Manzalai CPF) will be the primary price drivers for POL. Domial-2 is also under completion and production from the well is expected in 1QCY12, though it will only serve to arrest the consistent decline in oil production from POL operated fields. On exploration and development front, Makori East-2, Dhulian deep-1 (both nearing target depth), and Sadrial-1 will potentially unlock significant exploration/appraisal upside for POL. Lastly, consistently high oil prices will also result in significant earnings upgrade for POL. Our base case oil price assumption of USD100/bbl for FY12 is well below the current average of USD108.7/bbl (July 01 to Dec 30). As per our calculations, if oil prices end up USD5/bbl above our assumption, POL's earnings will increase by PKR2.0/share.
- POL trades at FY12E PE, P/B, and EV/EBITDA multiples of 6.0x, 2.3x, and 3.1x, respectively, which translates to a discount of 30% to OGDC. When compared to global oil exploration pure plays for the same period, POL is even more attractive. Global oil exploration companies trade at an average EV/EBITDA of 6.0x (premium of 100% to POL), PE of 12.0x (premium of 100% to POL), and PB of 2.0x (similar to POL). Moreover, POL offers exceptional EBITDA margins of 68% (global average 50.8%) and ROE of 32.4% (global average 15.1%).

Price catalyst

- Jun-12 price target: PKR421.3 based on Reserve Based DCF methodology.
- Catalyst: Production commencement from Makori East-1/Domial-2, unlocking of exploration and production potential of Tal, Ikhlas, and Margala blocks.

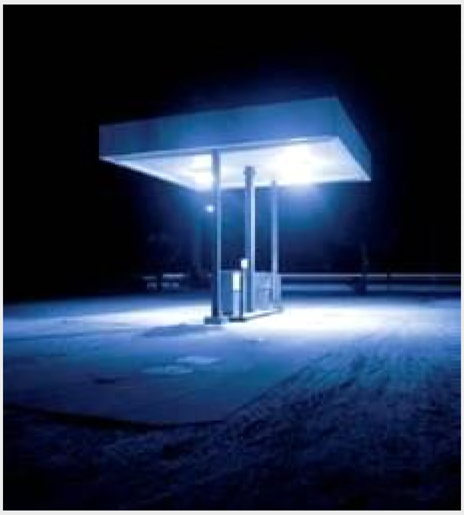
Action and recommendation

- **21.6% upside to our target price of PKR421.3:** The stock trades at attractive FY12 PE, PB, and EV/EBITDA multiples of 6.0x, 2.3x, and 3.1x, respectively. We recommend 'Outperform' on POL.

PAKISTAN

Oil Marketing

2 January 2012



Margin revision to boost profitability

Key theme

- Owing to the economic slowdown in the past few years, volumetric sales of POL products have remained stagnant, as the volumes have grown by meager 2.5% during the past 4 years. The trend is expected to persist until economic recovery picks up. But the perennially higher crude prices have boded well for the OMCs and the companies are poised to register strong earnings. Apart from high oil prices, OMCs will also benefit from the rise in margins on regulated products (Mogas and HSD), that were completely implemented since 1st Nov'11. But due to weak global economic growth together with Euro debt crisis, decline in crude oil prices cannot be ruled out, which may erode the timing gains. Depreciating Pak Rupee against USD is another threat to the profitability of marketing companies.

Sector outlook

- **Volumes to remain flat in FY12:** Despite the government's strategy to bridge the country's power deficit via fuel oil based power plants, country's FO sales have remained flat. As per PPIB, approximately 1,045MW of FO based power plants were commissioned during the past 18 months, but no significant increase has been witnessed in FO sales. Apparently the government is reluctant to operate power plants at designed capacity to avoid importing expensive FO which would eat up precious foreign reserves. Owing to continued policy of under utilization, FO volumes are expected to remain flat. Diesel, strongly correlated to economic activity, is expected to grow 2.5% to 3.0%. Although there is an uptrend in the demand for Mogas on the back of severe gas crisis in the country, it constitutes only 12% of the total POL sales in Pakistan. Therefore, it does not have significant impact on the overall volumes.
- **Margin revision to boost core earnings:** On the repeated pleas of OMCs, ECC increased the margins on HSD and Mogas by PKR0.41/l and PKR0.48/l in Aug'11, to be implemented in three phases. The complete increase has been passed on which would favorably affect the earnings of the company in the coming periods depending upon how much market share they have in each product. PSO and SHELL because of their dominance in HSD and Mogas will witness surge in earnings by PKR7.3/share and PKR6.8/share respectively in FY12, and PKR9.5/share and PKR8.8/share respectively thereafter. APL, on the other hand, will experience increase in FY12 earnings by PKR3.9/share and by PKR5.2/share thereafter.
- **Depreciating currency can hurt the sector:** Since the start of current fiscal year, Pak Rupee is under pressure. The currency has lost approximately 5.02% against USD to date and if the trend persists in future, which in our opinion is likely, OMCs especially PSO can come under pressure owing to the forex losses.

Action and recommendation

- Although PSO offers blanket exposure to the OMC sector, we prefer APL because of its growth potential, immunity to circular debt and forex losses, and healthy payout. We maintain Outperform on APL with Target Price of PKR486.3/share.

Analyst

Hasan Raza

92 215612290-94 Ext 311 hasan.raza@fs.com.pk

Foundation Securities

PAKISTAN

Attock Petroleum Limited

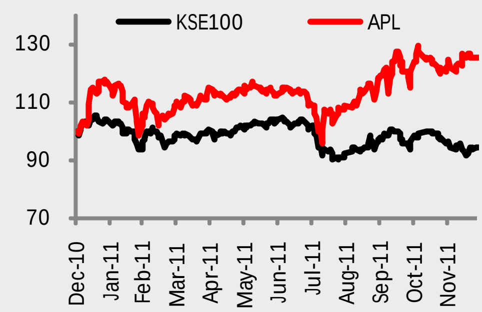
2 January 2012

APL PA		Outperform
Stock price as of 30 Dec	Rs	412.5
June 12 target	Rs	486.3
Upside/downside	%	17.9%
Valuation	Rs	486.3
- Discounted cashflow		
Oil marketing		
Market cap	Rs bn	28.5
30-day avg turnover	US$m	0.9
Market cap	US$m	332
Number shares on issue	m	69.1

Investment fundamentals

Year end 30 Jun		20010A	2011A	2012E	2013E
Total revenue	m	82,792	109,395	128,322	139,415
EBIT	m	5,166	6,700	6,536	6,955
EBIT Growth	%	20.7	29.7	(2.5)	6.4
Recurring Profi	m	3,594	4,257	4,290	4,780
Reported Profi	m	3,594	4,257	4,290	4,780
EPS rep	Rs	52.0	616	62.1	69.2
EPS rep growth	%	16.6	18.4	0.8	114
EPS rec	Rs	52.0	616	62.1	69.2
EPS rec growth	%	16.6	18.4	0.8	114
PE rep	x	7.9	6.7	6.6	6.0
PE rec	x	7.9	6.7	6.6	6.0
Total DPS	Rs	25.00	4150	40.34	44.95
Total div yiel	%	6.1	10.1	9.8	10.9
ROA	%	15.5	15.7	15.8	14.1
ROE	%	44.1	410	34.9	34.4
EV/EBITDA	x	3.5	3.3	3.1	2.7
Net debt/equity	x	(100.4)	(45.2)	(53.7)	(55.2)
Price/book	x	3.1	2.5	2.2	19

APL PK rel KSE100 performance



Source: Bloomberg, Foundation Research, January 2012
(all figures in PKR unless noted)

Analyst
Hassan Raza
92 21561 2290-94 Ext 311 hasan.raza@fs.com.pk

Robust earnings to continue

Investment theme

- Attock Petroleum Limited (APL) earnings have grown at a 4-year CAGR of 25.3% and so has the stock, which has appreciated by 27% annually since July'07. The scrip has outperformed the broader market in CY11 by handsome 31.4%. Total return (capital appreciation + Div Yield) during the outgoing year has been 37.9%. APL remains our top pick in OMC sector owing to attractive FY12 dividend yield of 9.6%, relative immunity to the vicious circular debt and sound growth prospects (earnings + volumetric).

Investment thesis

- **Volumetric growth, a key revenue driver:** Despite meager POL industry growth of 2.5% during past 4 years, volumetric sales of APL have risen by 6.6% during the same period. Hence the company was able to increase its market share from 6.7% in FY07 to 7.8% in FY11 (89bps surge took place in FY11 alone). It was due to the superior liquidity, steady increase in its retail outlets, aggressive marketing strategies and backing of the group owned refineries. Most of the growth came from rising sales of PMG, HSD and FO, which increased by 469%, 199%, and 11% during the period. On the back of aforementioned reasons, we foresee the uptrend in market share to continue in the future.

- **Impact of margin revision yet to come:** We believe that growth momentum in the earnings will continue during the time to come because, 1) steady rise in the market share will augment the bottom line of the company, and 2) the full impact of upswing in HSD and PMG margins is yet to be reflected in the earnings of the company. The company will brace part of earnings increase in 2QFY12 results with the incremental EPS of PKR1.20 due to margin revision, while complete impact, which we currently estimate at PKR1.35, shall be visible in 3QFY12 earnings.

- **Higher crude prices and some uptick in asphalt sales will further boost the earnings:** Higher crude prices bode well for OMCs, especially those which handle significant deregulated products. Margins on these products rise in tandem with prices of the products. FO comprised of approximately 38% of total volume handled by APL last year and OMCs earn margins varying from 2.7%-4.0% on FO. We have assumed crude oil prices of USD100/bbl in FY12 and USD90/bbl thereafter. In case reference crude prices remain higher than our assumptions, APL earnings shall witness positive surprise. Also, revival of bitumen sale shall also lift the earnings of the company. We have currently assumed asphalt sales of 190,000MT in FY12 and according to our estimates incremental 10,000MTs of asphalt sales shall increase the earnings by PKR0.7/share.

Price catalyst

- Jun-11 price target: PKR486.3 based on a discounted cash flow methodology.

- Catalyst: Revival of asphalt sales.

Action and recommendation

- **18% upside to our price target of PKR342.0:** APL currently trades at attractive FY11 PE, PB, and EV/EBITDA multiples of 4.7x, 1.4x, and 3.2x, respectively. We maintain our 'Outperform' rating on the stock.

PAKISTAN

Power Sector

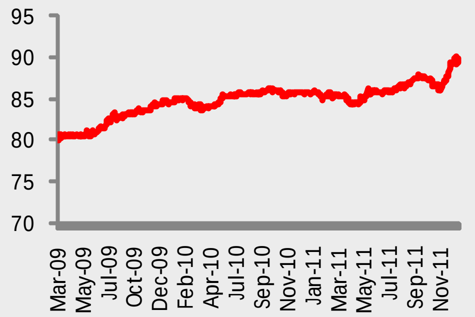
2 January 2012

Electricity generation sources

	MW	%	CAGR*
Wapda Hydel	6,555	28%	0.4%
Wapda Gencos	4,885	21%	0.3%
IPPs	9,102	39%	11.9%
KESC	2,083	9%	4.4%
Nuclear	787	3%	14.2%
Total	23,412	100%	4.4%

*4 years CACG
Source: Nepra

PKR/USD exchange rate



Source: Bloomberg, Foundation Research, January 2012
(all figures in PKR unless noted)

Analyst

Hassan Raza
92 21561 2290-94 Ext 313 hasan.raza@fs.com.pk

Circular debt: the culprit

Sector theme

- Power consumption in Pakistan has steadily increased due to significant rise in disposable incomes, increasing use of power intensive appliances, urbanization and industrialization which has resulted in power demand to outpace supply. Over the last four years power demand has risen by CAGR of 7.6%, while supply has grown by just 4.4%. Demand supply shortfall ranges from 4000-5000MW depending on peak time and season. To bridge the power shortage, around 1,122MW of IPPs (hydel + thermal) are expected to come online between 2012-2015.

Sector outlook

- At present, total electricity demand of the country stands at around 22,000MW. Although total nameplate generation capacity of 23,412MW exceeds the demand requirement, actual available capacity is around 19,669MW. This is due to low plant load factor owing to aging generators and poor maintenance of equipment at existing WAPDA & KESC plants, and losses of power due to poor-quality transmission lines and theft. Changing reservoir levels also contract the generation availability as it results in decreased hydel generation capability especially in the winter season.
- Over the past few years, the generation mix has deteriorated – tilting towards more expensive thermal power generation. Share of cheap hydel generation which, during the mid 1980s reached the peak of 67% has come down to the level of 28%. Thermal power generation now comprises approximately 69% of the power generation capacity in Pakistan. The problem has further been compounded by rising FO prices and non availability of cheap gas for thermal generation. FO prices have inflated by massive 214% during the past three years resulting in high electricity generation cost. While government on the other hand has not been able to pass on the impact of higher generation cost to public. It has incapacitated PEPCO to fully pay the IPPs for its power purchases resulting in cash flow constraints for IPPs, as well as the whole energy chain, ensuing in the infamous circular debt.
- Although government has raised power tariffs by 70% during the past 3 years to reduce tariff differential, introduced fuel price adjustments to adjust for monthly variation in fuel costs, and issued TFCs of worth PKR165bn to eliminate circular debt, the efforts have not yielded desired results. This is due to the fact that despite significant tariff increase, tariff subsidy of approximately PKR2.5/kWh-PKR3.0/kWh is still being provided to an average consumer. Secondly, lower billing recovery, power thefts and the poor infrastructure resulting in T&D losses further compound the problem.

Action and recommendation

- IPPs are contributing around 35.6% to the generation capacity, which is projected to rise with upcoming IPPs and shall result in their increased clout. Based on Friday's closing price, FSL power universe trades at an attractive FY11 P/E of 6.4x and offers a dividend yield of 15.3%. We maintain Outperform rating on both Hub Power (TP PKR47.3) and Kot Addu Power (TP PKR50.5).

PAKISTAN

Hub Power Company Ltd

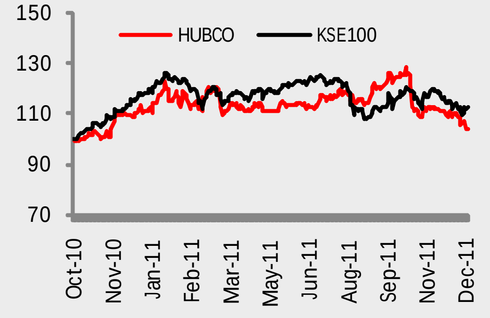
2 January 2012

HUBC PA		Outperform
Stock price as of 30 Dec	Rs	34.2
June 12 target	Rs	47.3
Upside/down side	%	38.4
Valuation	Rs	47.3
- DDM based		
Power Generation & Distribution Sector		
Market cap	Rs bn	39.6
30-day avg turnover	US$m	1.4
Market cap	US$m	454.9
Number shares on issue	m	1,157

Investment fundamentals

Year end 30 Jun		2011A	2012E	2013E	2014E
Total revenue	m	123,310	134,382	144,965	149,639
EBIT	m	8,807	10,497	10,900	10,569
EBIT Growth	%	19.8	19.2	3.8	(3.0)
Recurring profit	m	5,425	6,220	7,282	7,718
Reported profit	m	5,425	6,220	7,282	7,718
EPS rep	Rs	4.7	5.4	6.3	6.7
EPS rep growth	%	(2.36)	14.66	17.07	6.00
PE rep	x	7.3	6.4	5.4	5.1
Total DPS	Rs	5.50	5.50	6.00	6.25
Total div yield	%	16.1	16.1	17.6	18.3
ROA	%	3.7	5.0	6.1	7.1
ROE	%	18.4	20.6	23.6	24.5
EV/EBITDA	x	7.5	5.8	5.3	5.1
Net debt/equity	%	133.17	110.74	90.37	72.85
Price/book	x	13	13	13	13

HUBC PA rel KSE100 performance



Source: Bloomberg, Foundation Research, January 2012
(all figures in PKR unless noted)

Analyst

Hassan Raza
92 21 5612290-94 Ext 311 hasan.raza@fs.com.pk

Irresistible dividend yield packed with growth

Key theme

- Hub Power Company (Hubco) is Pakistan's second largest and the largest privately held IPP. At yesterday's closing price the stock provides a USD based IRR of 16.9% and PKR based IRR of 20.8%. The stock also offers handsome FY12 dividend yield of 16.1%.

Investment thesis

- **Earnings to grow on the back of higher indexation due to uptick in PPA & rupee devaluation:** After registering splendid growth in FY09 and FY10, net earnings of the company declined slightly in FY11 owing to higher financial charges and recognition of Narowal revenue on reference tariff. Bottom line of the company is expected to grow at 3-year CAGR of 12.4% in the coming years due to higher indexation factor on the back of upturn in PPA in coming periods.

- **Narowal expansion is value accretive:** The 225MW greenfield Narowal project achieved its COD in April11. The plant has net dependable capacity of 213.92MW with thermal efficiency of 45%. Hubco is still recognizing the revenues on pre-COD reference tariff after the lapse of almost 8 months. The company expects Nepra to announce post-COD revised tariff in Jan'12 which would boost the earnings of the company going forward.

- **Circular debt reaches precarious levels:** Before Narowal plant came online, circular debt was not an issue for Hubco. Infact the company used to earn a small spread on taking short term financing. But after COD of Narowal plant, circular debt can take its toll on the dividends of the company as Hubco has to make advance payments for fuel supply. Debt levels are already high and the company may have to rely on internally generated funds which could negatively impact the payout.

- **Rupee devaluation - bane for some, boon for IPPs:** As the returns of IPPs are dollar based and later converted into rupees, IPPs tend to benefit from depreciating domestic currency. Pak Rupee has depreciated by 5.02% during CY11. Upturn in PPA (real terms), coupled with depreciating Pak Rupee will improve the recurrent earnings of the company from FY12.

Target Price and Price catalyst

- June-11 price target: PKR47.3/share on account of DDM based methodology.

- Catalyst: Growth in dividend stream due to rupee devaluation and uptick in PPA. Progress on new projects & resolution of circular debt.

Action and recommendation

- We are optimistic about the earnings growth of the company from 2HFY12 due to higher indexation factor and revised Narowal Tariff. The stock offers 38.4% upside to our June'12 target price of PKR47.3/share and trades at attractive FY12 PE, PB, and EV/EBITDA of 6.4x, 1.3x and 5.8x respectively. The stock also offers an attractive dividend yield of 16.1%. We maintain our Outperform stance on the stock.

Foundation Research
Equities

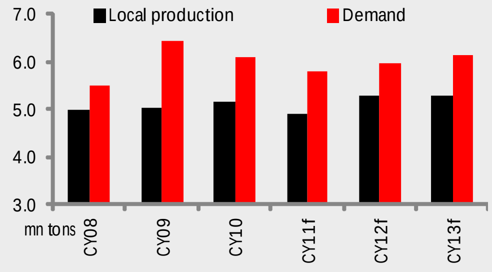
Foundation Securities

PAKISTAN

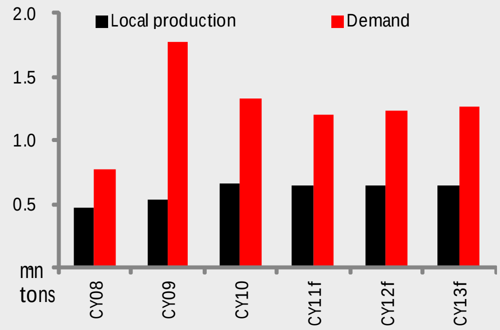
Fertilizer Sector

02 January 2012

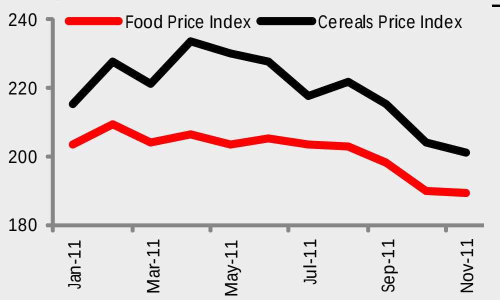
Urea suppy demand scenario



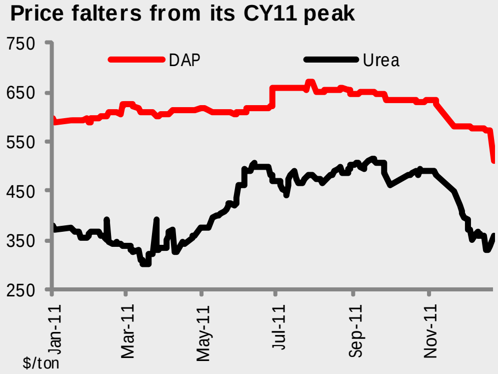
DAP suppy demand scenario



FAO price index



Price falters from its CY11 peak



Source: Bloomberg, FAO, FSL Research, Jan 2012

Analyst

Taha Khan Javed, CFA

92 215612290-94 Ext 313 taha@fs.com.pk

Response to GIDC and gas curtailment to determine sector profitability

Sector theme

- Agriculture remains the backbone of the economy with 62% of the country's population directly or indirectly generating livelihood from it, while it contributes approximately 21% to the country's GDP. Demand for urea and DAP exceeds local production, and is thus supplemented by imports. Despite the country having urea production capability of 6.8mn tpa, total country production in CY11 will remain around 5.0mn tpa. Gas curtailment to Enven will in our view continue to determine local urea price and profitability of the sector.

Sector outlook

- **International fertilizer and agri prices falling from peak:** International fertilizer price has started to decrease from its CY11 peak (witnessed in 3q) and is currently at trough level for the year. Apart from expected capacity addition in both urea and DAP, recent decline in agri prices (especially cotton and wheat) has started to put pressure fertilizer prices globally. FAO's food price index is down 10% in Nov CY11 from its peak witnessed in Feb CY11 as global production of some grains is at a multiyear high.

- Decline in agri prices has started to result in greater lobbying from local farming community against the rise in urea prices. Moreover, as political temperature in the country starts to increase (early election possibility), we expect the government to keep check on urea prices from increasing further.

- **Unprecedented increase in feedstock price:** As per OGRA's notification, the recently approved Gas Infrastructure Cess (GIDC) bill will be applicable to old plants (no impact on Enven and Fatima) from CY12 onwards, resulting in feedstock prices rising by PKR197/mmbtu. Apart from GIDC, feedstock price on old plants has been raised by 14% to PKR116/mmbtu (incorporating GIDC results in feedstock cost rising to PKR313/mmbtu). Fuel stock price has also been raised by 14% to PKR495/mmbtu. Obviously the question remains whether the government will allow the manufacturers to pass on the cost side pressure. We have incorporated the worst case condition (no urea price increase, while GIDC is implemented) in our models.

- **Pricing power of urea producers decreasing gradually:** As global prices decrease and local cost increase (GIDC and biannual gas price revision), the disparity between international and local urea price is set to decrease. It is yet to be seen how the companies will react to GIDC, but they may be able to pass it in 1QCY12. However, given the renewed commitment by the Government to provide gas to Enven, once production resumes from 2QCY12, it may lead to decrease in urea price/margin from the current level. We believe that Engro will continue as the front runner in determining urea price in CY12 as well.

Action and recommendation

- Based on Friday's closing price, FSL fertilizer universe trades at an attractive CY12 P/E of 6.3x and offers a dividend yield of 11.9%. We have incorporated the worst case condition (no urea price increase, while GIDC is implemented) in our models, and still have a Buy stance on both Engro and FFC. While we maintain our cautious stance on FFBL (due to its high correlation with international DAP prices.

PAKISTAN

Fauji Fertilizer Company

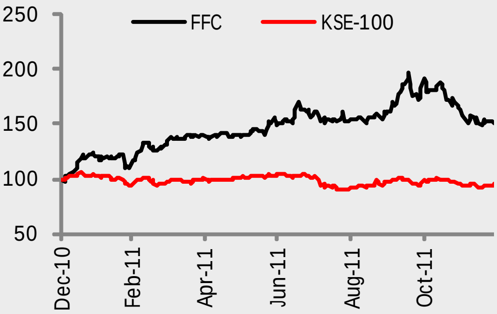
02 January 2012

FFC PA		Outperform
Stock price as of 30 Dec	Rs	149.5
Jun-12 target	Rs	182.8
Upside/downside	%	22.2
Valuation	Rs	182.8
- DCF based		
Fertilizer Sector		
Market cap	Rs bn	126.8
30-day avg turnover	US$m	3.4
Market cap	US$m	1,425
Number shares on issue	m	848

Investment fundamentals

Year end 31Dec		2010A	2011E	2012E	2013E
Total revenue	m	44,874	56,421	72,161	75,194
EBIT	m	17,397	31,753	26,826	26,614
EBIT Growth	%	24.2	82.5	(15.5)	(0.8)
Recurring profit	m	11,029	20,659	18,008	17,978
Reported profit	m	11,029	20,659	18,008	17,978
EPS rep	Rs	13.00	24.36	21.23	21.20
EPS rep growth	%	25.0	87.3	(12.8)	(0.2)
EPS rec	Rs	13.00	24.36	21.23	21.20
EPS rec growth	%	25.0	87.3	(12.8)	(0.2)
PE rep	x	11.5	6.1	7.0	7.1
PE rec	x	11.5	6.1	7.0	7.1
Total DPS	Rs	10.40	21.75	19.75	20.25
Total div yield	%	7.0	14.5	13.2	13.5
ROA	%	25.6	47.8	39.7	39.6
ROE	%	71.4	117.0	95.2	91.2
EV/EBITDA	x	7.4	4.1	4.6	4.6
Net debt/equity	%	-12.9	-22.1	-49.6	-48.6
Price/book	x	8.2	7.2	6.7	6.4

FFC PK rel KSE100 performance



Source: Bloomberg, Foundation Research, Jan 2012
(all figures in PKR unless noted)

Analyst

Taha Khan Javed, CFA
92 21 35612290-94 Ext 313 taha@fs.com.pk

GIDC may dent profitability growth in CY12 but valuations are still appealing

Key theme

- FFC's share price alone, has risen by 49% in CY11 (outperforming the KSE-100 index by 54%) due to substantial rise in profitability. We expect CY12 to be a challenging year in term of maintaining earnings growth. Nonetheless, valuations are still appealing even after incorporating the worst case condition (no urea price increase, while GIDC is implemented) in our model.

Investment thesis

- **Feedstock price increase from PKR102/mmbtu to PKR313/mmbtu will dent profitability growth:** After witnessing 217% increase in earnings during CY08-CY11, FFC's earnings, we believe, will witness a decline in CY12. Incorporating GIDC, feedstock price has risen by 207% for old plants. This will severely increase the cost of production for older plants. Engro's old plant is also impacted by this bill, but since Enven is not affected by it; the impact on Engro is relatively moderate compared to FFC and FFBL. Through this bill, the Government may well limit the unprecedented profitability increase witnessed in FFC. Being conservative we have incorporated the latest feedstock and fuel stock price in our model, without changing urea price.
- **Earnings upside possible:** We are currently assuming no increase in urea price to compensate for fuel price increase and inflationary trend since prices were raised in Dec 2011. It is yet to be seen how the fertilizer companies will react to feedstock price increase. They may increase urea price to compensate for some/all feedstock price increase, so earnings upside possibility does remain. For every PKR100/bag (net) increase in urea price, CY12 earnings will rise by PKR3.2/share (15%). Another premise for decline in FFC's profitability is stable gas supply to Enven, which if falters, will likely lead to increase in urea price.
- **FFBL provides the DAP flavor:** FFC has a 51% stake in FFBL (sole DAP producers in the country) and earns handsome dividend income from FFBL. FFBL is expected to post record earnings in CY11, however future earnings are expected to decline due to rise in global DAP capacity.
- **Progress on wind project:** EPC contract for the 50MW wind project at Jhimpir Sindh has been signed with Nordex Singapore/Descon. The license and tariff determination has been approved with NEPRA. The estimated cost is USD135mn and COD is expected in mid CY12.

Price catalyst

- Jun-12 price target: PKR182.8/share based on discounted cash flow valuation.
- Catalyst: Urea/Feedstock price change, any change in gas supply position/regulatory regime and progress on wind power project.

Action and recommendation

- Being conservative we have incorporated the worst case scenario. But despite that we maintain our Outperform rating due to considerable benefit emanating from stable urea production. The stock is trading at CY12 P/E of 7.0x and offers a dividend yield of 13.2%

PAKISTAN

Engro Corporation

02 January 2012

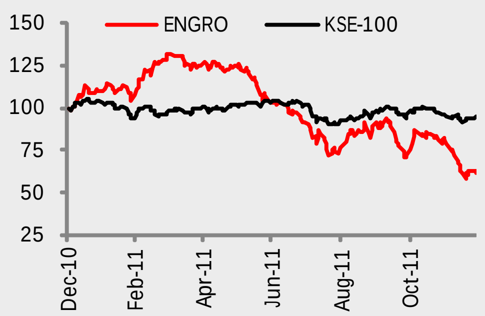
ENGRO PA **Outperform**

Stock price as of 30 Dec	Rs	92.7
Jun 12 target	Rs	190.3
Upside/dow nside	%	105.3
Valuation	Rs	190.3
- DCF based		
Fertilizer Sector		
Market cap	Rs bn	36.5
30-day avg turnover	US$m	3.0
Market cap	US$m	423.9
Number shares on issue	m	393.3

Investment fundamentals

Year end 31Dec		2010A	2011E	2012E	2013
Total revenue	m	79,976	111,892	137,695	149,467
EBIT	m	11,923	19,303	20,055	19,974
EBIT Growth	%	74.7	619	3.9	(0.4)
Recurring profit	m	6,790	7,066	8,512	10,660
Reported profit	m	6,790	7,066	8,512	10,660
EPS rep	Rs	17.26	17.97	21.64	27.11
EPS rep growth	%	78.4	4.1	20.5	25.2
EPS rec	Rs	17.26	17.97	21.64	27.11
EPS rec growth	%	78.4	4.1	20.5	25.2
PE rep	x	5.4	5.2	4.3	3.4
PE rec	x	5.4	5.2	4.3	3.4
Total DPS	Rs	5.00	6.00	6.00	8.00
Total div yield	%	5.4	6.5	6.5	8.6
ROA	%	4.9	3.6	5.2	6.6
ROE	%	219	17.3	21.1	23.4
EV/EBITDA	x	12.4	8.8	7.0	5.7
Net debt/equity	%	298.7	249.9	204.5	159.1
Price/book	x	11	10	0.8	0.7

ENGRO PK rel KSE100 performance



Source: Bloomberg, Foundation Research, Jan 2012
(all figures in PKR unless noted)

Analyst

Taha Khan Javed, CFA
92 2135612290-94 Ext 313 taha@fs.com.pk

Too cheap to ignore

Key theme

- Despite addition of 1.3mn tpa urea plant (becoming the largest urea manufacturer in the country), Engro Corporation's share piece has fallen by 43% in 2HCY11, due to increasing gas curtailment and rising fears on company's future cash flows. In our opinion, the company can easily meet its financial obligations if gas supply is even partially restored. Engro offers one of the highest return potential in our FSL universe.

Investment thesis

- **Limited impact from feedstock price increase**: Engro will be less affected by GIDC bill as Enven is exempted from it. Thus, the impact on Engro is relatively moderate. Engro's management has stated that they will pass on any cost impact since there is still room for increase in local prices, when compared to international landed cost. Assuming the worst case scenario in our model (no change in urea price to compensate for cost side increase), Engro's valuation still looks compelling. For every PKR100/bag (net) increase in urea price, CY12 earnings will rise by PKR4.6/share (21%).

- Engro has long contested that it will reduce urea price if it receives its quota of gas allocation. Engro had recently decreased urea price by PKR100//bag to PKR1,480/bag but again raised it to the previous level as Enven was shut prematurely. Going by what management is saying, Engro will raise urea price to compensate for GIDC in the first quarter. However in our view, once Enven starts production for Mar CY12 onwards, urea price decline is on the cards. However if gas supply situation remains precarious the company will persist with higher urea prices to compensate for production loss.

- **Don't forget the bouquet of investments, apart from fertilizer business:** Apart from Fertilizer (which contributes 60% to our valuation), Engro's other venture continue to show decent profits and contribute PKR76/share to our target price. Engro Energy (220MW gas based IPP) after achieving COD in CY10 continues to perform well. Engro Foods continues to gain ground, with turnover being almost equal to Fertilizer business and net margins improving gradually. Engro Vopak remains a cash cow, thought it may see some dip in profitability as contract with LOTPTA is renegotiated. Eximp is projected to maintain its market share in fertilizer imports, while loss in rice business is anticipated to decline and its volumes improve. Engro Polymer after suffering set back in CY11 from VCM plant is also projected to reduce its losses.

Price catalyst

- Jun-12 price target: PKR190.3/share based on Sum of Parts valuation.

- Catalyst: Any concrete plan on the gas supply issue, boost in DAP import margin and higher income from various ventures.

Action and recommendation

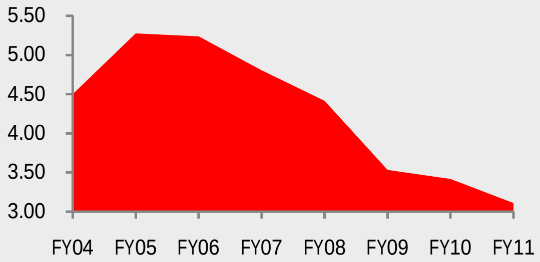
- Engro's share is trading at attractive levels, and we feel that the stock is too cheap to ignore despite its risks. We expect decent earnings to continue in CY12 and beyond despite assuming low capacity utilization. The stock is trading at an attractive CY12 P/E of 4.3x and P/B of 0.8x. We maintain our Outperform stance.

PAKISTAN

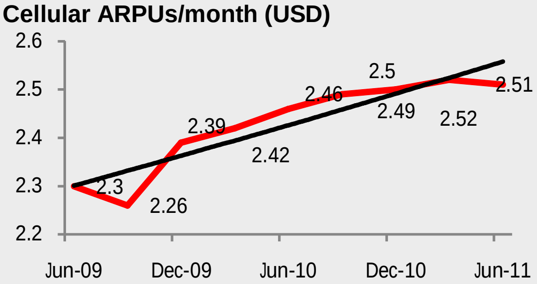
Telecommunication

02 January 2012

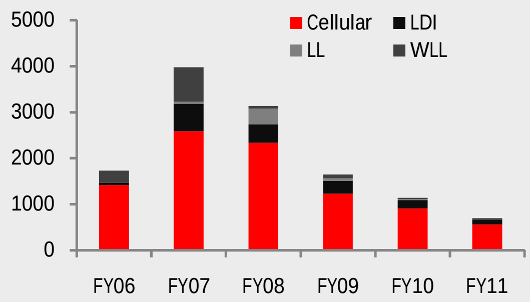
Fixed Landline Subscriber trend (mn)



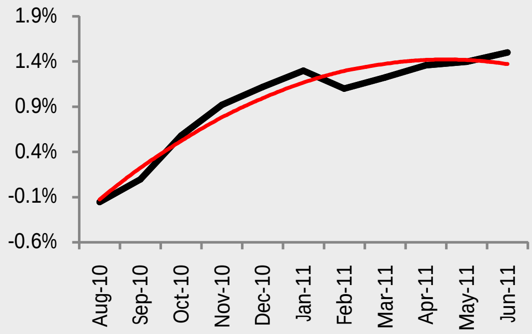
Cellular ARPUs/month (USD)



Investment in telecom sector (USD)



Cellular subscibers trend



Source: PTA, Foundation Research, January 2012

Analyst

Mansoor Khanani

92 21 561 2290-94 Ext 345 mansoor.khanani@fs.com.pk

Broadband: The growth story

Sector theme

- Our Investment theme on Pakistan's telecommunication sector is based on stabilizing cellular sector and largely untapped data services sector (Broadband). Moreover, favorable government policies, stabilizing ARPUs, attempts to improve cost efficiencies and valuation discounts as compared to regional players support our bullish stance on the sector.

Sector Outlook

- **Falling fixed line telephony:** Following the global trend, fixed telephony is in a state of constant decline post availability of cellular services at cheaper rates. Fixed line subscribers have declined to nearly 3.1mn from peak of 5.2mn in 2005 primarily owing to competition from cellular companies.
- **Cellular subscribers growth to remain steady:** With cellular subscribers touching 108mn (cellular teledensity of 60.6%), we expect sizeable growth in cellular subscribers to 145mn by the end of FY15. The above is corroborated by YoY cellular subscriber's growth, which has remained at 7.7% average during last 3 years.
- **ARPUs seem to have bottomed out:** Fierce price wars and slowdown in subscriber growth has led to declining ARPUs currently averaging at USD2.42. We think cellular ARPUs have bottomed out with some room of improvement owing to gradual increase in usage of value added services and tariff ceilings imposed by regulatory watchdog PTA. Moreover, since expansion activities undertaken by all cellular companies have slowed down (in line with FDIs in cellular segment), profitability of cellular sector is expected to increase going forward even if ARPUs remain stagnant at current levels.
- **Dull Wireless landline prospects:** Though wireless network is expected to grow at a steady pace going forward, prospects for this segment seem gloomy owing to network availability and competitive call rates being offered by cellular companies. WLL subscriber base has increased to 3.0mn subscribers with PTCL being the market leader (market share of 42%).
- **Broadband – where the growth lies!:** Of all available telecom services, we believe broadband segment will be the key growth driver in telecom industry going forward owing to recent expansion in broadband networks and competition pushing down the tariff. Moreover, Universal Support Fund, which was established to support telecom services, is also promoting broadband services in rural areas by providing broadband connections at subsidized rates. Pakistan telecommunication authority (PTA) expects broadband connections to touch 5.5mn mark by FY15E (currently 1.25mn subscribers).

Action and recommendation

- We currently holds an Outperform stance on Pakistan Telecommunication Company Limited (PTC PA) which provides investors exposure to all major segments of telecom services in the country. Other than holding Pakistan's largest fixed landline infrastructure, the company caters to the cellular segment through its wholly owned subsidiary Ufone. Moreover, PTC has the largest subscribers of data services like Broadband, IPTV and EVDO in the country. Further, the company has express its intent to compete in the upcoming license auction offer through 3G.

Foundation Research
Equities

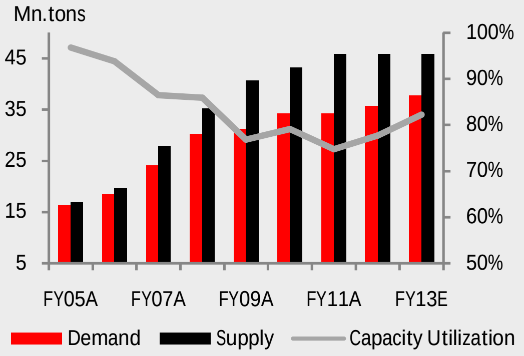
Foundation Securities

PAKISTAN

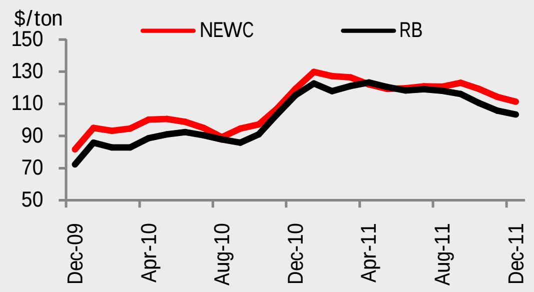
Cement Sector

02 January 2012

Demand, supply & capacity utilization



Coal Price benchmarks



Source: Bloomberg, Foundation Research, Jan 2012
(all figures in PKR unless noted)

Analyst

Mansoor Khanani
92 21 5612290-9 Ext 345 mansoor.khanani@fs.com.pk

Flat volumes, but wider margins to boost profits

Sector theme

- During FY11 the demand of cement in the local market has witnessed a drop of 6.7% YoY. Whereas, exports also showed a decline of 11.6% YoY due to regional expansions coming online. Going forward in FY12, we expect 4.5% YoY increase in local cement demand for FY12 owing to start of construction work on number of small dams and some increase in private construction. However, exports for FY12 are expected to decline by 4.2% YoY mainly due to regional expansion becoming operational.

Sector outlook

- **Domestic cement consumption to drive sales:** During 5MFY12 the demand of cement in the domestic market has witnessed an increase of 7% YoY to 8.8mn tons, primarily due to low base effect of FY11 owing to flash floods in rural areas that had devastated the rural economy. Going forward, we expect further pick up in local cement demand during the 2HFY12 due to, 1) pick up in post floods reconstruction in rural areas of Sindh 2) start of construction work on a number of small dams, to be jointly financed by the Government of Pakistan and Exim Bank of China and 3) some increase in private construction. We expect domestic cement demand to improve by 4.5% YoY to 23.2mn tons in FY12.
- **Exports projected to be decline going forward:** Pakistan's cement manufacturers were aggressively catering to export markets where there is robust construction activity such as Iraq, Afghanistan, UAE and South Africa with total exports showing massive growth of (FY05-10) CAGR 17%. However, exports during 5MFY12 has declined by 3.9% YoY to 3.8mn tons due to high base effect of 5MFY11 and, more importantly, regional expansions becoming operational. Going forward we expect total cement exports for FY12 to show a decline of 4.2% YoY to 9.0mn tons.
- **Strong domestic prices and decline in coal prices are major triggers:** Cement manufacturers have continued to maintained prices at levels as high as PKR420/bag in the North and PKR410/bag in the South. High cement prices have managed to prevail owing to pick up in private construction work and construction work on small dams. Going forward, we expect further recovery in local cement prices during 2HFY12 owing to seasonal trend of increase in cement prices due pick up post winter construction. Amidst low energy demand on the back of slowdown in manufacturing activity globally, coal prices have continued to maintain their fall. After rising to as high as US$124/ton in Jun'11, coal prices have declined by 18% to US$102/ton. We expect further pressure on coal prices in the coming months due to fears of slowing demand from China.

Action and recommendation

- We expect FY12 results for cement manufacturers to remain robust on the back of both 28% YoY increase in domestic retention prices and 18% YoY decline in international coal prices. Within our FSL universe coverage, Lucky cement and Attock are expected to achieve superior performance with the profitability expected to increase by 36% and 33% YoY in FY12. Further, due to improvement in margins, we expect profits of our Universe companies (LUCK, DGKC, and ACPL) to grow 20%YoY in FY12.

Foundation Research
Equities

Foundation Securities

PAKISTAN

Lucky Cement Ltd

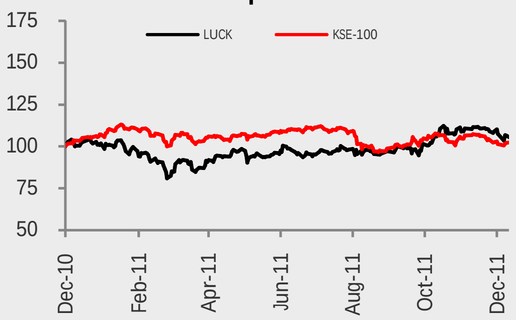
02 January 2012

LUCK PA		**Outperform**
Stock price as of 30 Dec	Rs	75.0
June 12 target	Rs	95.3
Upside/downside	%	27.0
Valuation	Rs	95.3
- DCF based		
Cement Sector		
Market cap	Rs bn	24.3
30-day avg turnover	US$m	0.9
Market cap	US$m	285
Number shares on issue	m	323

Investment fundamentals

Year end 30 Jun		2010A	2011A	2012E	2013E
Total revenue	m	24,509	26,018	33,082	36,016
EBIT	m	3,987	4,838	7,108	7,732
EBIT Growth	%	(38)	21	47	9
Recurring profit	m	3,137	3,970	5,414	5,614
Reported profit	m	3,137	3,970	5,414	5,614
EPS rep	Rs	9.70	12.28	16.74	17.36
EPS rep growth	%	(31.7)	26.5	36.4	3.7
EPS rec	Rs	9.70	12.28	16.74	17.36
EPS rec growth	%	(31.74)	26.5	36.4	3.7
PE rep	x	7.7	6.1	4.5	4.3
PE rec	x	7.7	6.1	4.5	4.3
Total DPS	Rs	4.00	4.00	4.00	4.00
Total div yield	%	5.3	5.3	5.3	5.3
ROA	%	8.2	9.6	11.8	11.9
ROE	%	12.5	14.3	16.8	15.4
EV/EBITDA	x	5.8	4.7	3.0	2.4
Net debt/equity	%	31.0	24.8	5.5	-5.3
Price/book	x	0.9	0.8	0.7	0.6

LUCK PA rel KSE100 performance



Source: Bloomberg, Foundation Research, Jan 2012
(all figures in PKR unless noted)

Analyst

Mansoor Khanani
92 21 5612290-94 Ext 345 mansoor.khanani@fs.com.pk

Maintaining the lead

Key theme

- Lucky is Pakistan's largest cement manufacturer with more than 25% market share in exports sales for FY11. Its earnings are expected to grow by 36% YoY to PKR5,414mn in FY12 due strong domestic prices and expected volumetric recovery during the next couple of month.

Investment thesis

- **Robust domestic prices combined with strong market share to boost profitability in FY12:** Lucky being the market leader for local sales (16% market share in FY11) is expected to benefit from 35% YoY higher local retention prices of PKR5,700-5,900/ton. Despite floods devastation in rural areas of Sindh, Lucky witnessed 11% YoY increase in local sales during 5MFY12. Going forward, we expect further recovery in the domestic cement consumption during 2HFY12 on the back of reconstruction work in the floods hit areas of Sindh and pick up in post winter construction activities. We expect company's earnings to increase by 36.4% YoY to 5,414mn in FY12.

- **Simultaneous presence a key advantage:** Lucky benefits from its simultaneous presence in both regions (South and North) of the country. The company's highest production capacity and dual presence benefits the company in catering large domestic market of the Northern region from factory located in the North and sea based export avenues from factory located in the south. While company's competitor DGKC has presence in Punjab only, thus it misses on sea-based exports at Karachi Sea port due to high inland freight.

- **Cost efficient strategies and supply of power to HESCO to add value:** Lucky's project of Used Tyres Derived Fuel at Karachi Plant is at final stages of completion and is expected to come online by the end of this calendar year. Whereas RDF system on Pezu plant would be operational from Sep '12. Further, work on grid station installation and inter connection with distribution network of HESCO is progressing as per schedule and electricity supply is expected to commence from Feb'12.

- **Partnering with local firm in Congo to provide geographical diversification:** The Company has recently announced its plan to set up a 1mtpa green field cement manufacturing plant in the democratic republic of Congo (DRC), by partnering with a local firm. As per management, feasibility on this plant has been completed and the same is expected to be operational by the end of Oct'13. According to our estimates Congo has an annual demand of around 8-9mtpa while its existing capacity is only 2mtpa. Besides providing huge developing market for cement, this country also provides proximity to coal reserves in Africa which should boost overall profitability of the company.

Price catalyst

- June-12 price target: PKR95.3/share based on DCF valuation.
- Catalyst: Business diversification and trend in domestic cement prices.

Action and recommendation

- Since the stock is offering 27.0% upside to our June-12 target price, we maintain our Outperform rating.

PAKISTAN

Pakistan Automobiles

02 Jan 2012

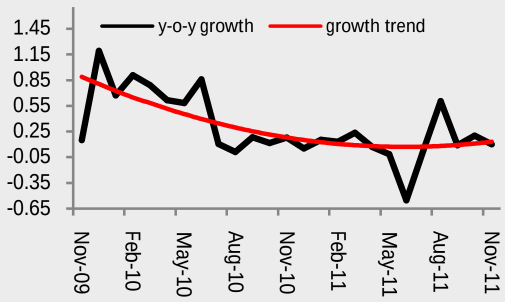
Investment fundamentals

	FY11A	FY12E	YoY
Honda	15,486	11,678	-24.6%
Indus	50,015	49,116	-1.8%
Pak Suzuki	79,941	85,684	7.2%
Dewan	203.00	-	-100.0%
Others	543	441	-18.8%
Total	146,188	146,919	0.5%

Mkt Share

	FY11A	FY12E	YoY
HCAR	10.6%	7.9%	-25.0%
IMC	34.2%	33.4%	-2.3%
PSMC	54.7%	58.3%	6.7%
DFML	0.1%	0.0%	-100.0%
Others	0.4%	0.3%	-19.2%
Total	100.0%	100.0%	0.0%

Demand, supply & capacity utilization



Source: Bloomberg, Foundation Research, Jan 2012
(all figures in PKR unless noted)

Analyst
Mansoor Khanani
92 21 5612290-94 Ext 345 mansoor.khanani@fs.com.pk

Regulatory risk and Yen appreciation remain key threats

Key theme

- FY11 proved to be an eventful year for the local auto assemblers with their sales beset by devastating floods during 1HFY11 and, when things seemed to be normalizing in 2H, by Japanese earthquake related supply shocks. Going in FY12, we expect auto sales to remain flat at 146k units owing to prevailing supply issues of some auto parts from Thailand and ban on import of factory fitted CNG kits by ECC.

Sector outlook

- **Auto sales projected to remain flat in FY12:** Despite floods damages in the rural areas of Sindh and squeezing farmers' income due to increasing cost pressure and drop in agriculture product prices, vehicle sales have increased by 17.6% YoY to 70,717 units primarily due to re-launch of Yellow cab scheme by Punjab government and low base effect of 5MFY11. Going forward, we expect 7.2% decline in auto sales during 2HFY12, as the ECC has banned import of CNG kits and cylinders and sale of cars and LCVs with factory fitted CNG kits in a bid to conserve natural gas. Following the decision, we expect vehicle sales to remain flat at 142mn for FY12.

- **Positive steel prices impact remained muted due to Yen volatility:** Steel prices have cooled down by 11% since July'11 on fears of slowdown in Chinese economy. However, positive impact of decline in steel prices remained muted due to significant appreciation of Japanese Yen against Rupee and other international currencies. Japanese Yen has climbed 8% against Rupee and 5.5% against dollar since July'11. Going forward, PKR/Yen parity would depend on 1) how the EU sovereign debt crisis unfolds 2) Pakistan's external account position during 2HFY12.

- **Regulatory risk to be a key threat:** Apart from fundamental concerns, auto assemblers are also surrounded by regulatory risks like recently relaxed used car policy and upcoming AIDP policy. Government is expected to announce a revised AIDP policy in the current fiscal with the intent to relax its policy for new entrants in the auto industry by removing the limit of minimum global annual production of 100k units and reduction in duties on CKDs. We expect these measures may dampen market share for existing auto assemblers in the long term.

Action and recommendation

- We expect FY12 results for auto assemblers to remain dull primarily due to flat volumes and weak margins. Within our FSL universe coverage, INDU and PSMC are expected to post 12% YoY and 13% YoY earnings growth in FY12

- Hence, we retain our FY12E local auto sales assumption of 146k units and downgrade INDU (PO: PKR222.50/share) and PSMC (with PO of PKR64.80/share) to Neutral due to aforementioned regulatory risks.

PAKISTAN

Pakistan Textiles

02 January 2012

Weak cotton prices to hit sector's earnings in FY12

Sector theme

- Pakistan's textile sector is one of the most important sectors of economy since it is the largest contributor to country's exports (56% in FY11). Pakistan's textile sector performed commendably in FY11 with a stellar earnings growth of more than 100% YoY in FY11. Going forward in FY12, we expect sector's profitability to decline further owing to the early procurement of cotton at higher prices combined with lower prices of yarn and value-added products in the international market.

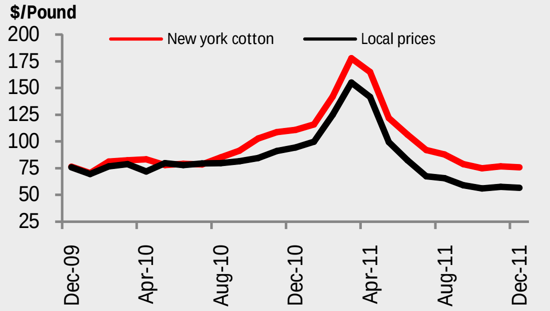
Sector outlook

- **Textile exports to drop by 5% YoY in FY12:** According to Cotton crop assessment committee (CCAC), government is likely to revise upward the recent estimates (projected by (CCAC) of cotton production from 12.2mn bales to 13.0mn bales for FY12. We expect that total cotton production for FY12 should be around 13.2mn bales. Moreover, expected shortfall of around 1.5mn bales would likely be met through imports from international market. However, we expect country total textile exports to decline by 5% YoY to US$13.1bn in FY12 primarily due to substantial drop in cotton and yarn prices in the international market.
- **Sector's profitability to face tough time:** Lower cotton prices in the local and international market resulted in the sizeable drop in sector's profitability in 1QFY12. The spinning sector was the major loser among the textile units primarily due to procurement of cotton at higher prices and exports of yarn at lower prices.
- **Cotton prices in a free fall since Mar'11:** Since Mar'11 Cotton prices have witnessed a substantial decline, both in the international and local markets. International cotton prices have dropped by around 59% to US$0.93/lbs, whereas domestic cotton prices have sunk to a record 20 month low of PKR5,300/maund from PKR13,000-13,500 in Mar'11, on account of improved global and local cotton production. In the coming months, we expect cotton prices to remain at the current levels due to above mentioned reasons. Nevertheless, lower cotton prices will fairly reduce textile manufacturers' reliance on short term borrowings which can lead to reduced financial cost.

Action and recommendation

- With the decline in cotton prices, the profitability of the stand alone spinning units will be affected the most. Spinners will not be able to make windfall gains which they had made during the last year owing to continuously rising prices and supply concerns. However, composite units like NML could fare better in the current situation as they are elastic in switching focus in-between their segments different lines. Moreover, NML's dividend income from investment portfolio has always provided a cushion against volatile margins of textile business. With recent investments in low risk high yielding IPP business (NPL and AES acquisitions) starting to bear fruit, dividend income should show strong growth from FY12. We currently hold an Outperform rating on the stock.

Cotton Prices benchmark



Source: Bloomberg, Foundation Research, Jan 2012

(all figures in PKR unless noted)

Analyst

Mansoor Khanani

92 21 5612290-94 Ext 345 mansoor.khanani@fs.com.pk

Foundation Research
Equities

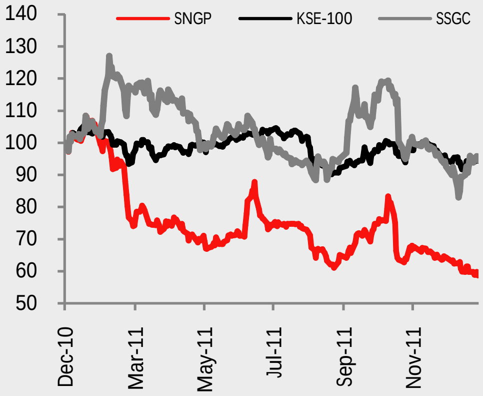
Foundation Securities

PAKISTAN

Gas Marketing

02 January 2012

Performance of Sui twins in CY11



Analyst

Asim Wahab Khan, CFA

92 21 561 2290 Ext 335 awkhan@fs.com.pk

Valuations hinge on regulations

Key theme

- 2011 proved to be a difficult year for gas marketing investors as it underperformed the KSE-100 index by 15.6pp. SNGP's performance was highly disappointing, as it yielded a negative return 41.2% (excluding dividends) as against market return of -5.6%, due to ballooning UFG losses and high interest charges on circular debt. SSGC fared relatively better as it matched the market performance, owing to support from non operating income. Oil and Gas Regulatory Authority (OGRA) had lifted the UFG benchmark from 5.0% to 7.0% for FY10 along with reclassification of non-operating income for Sui twins which boosted their bottom line significantly. Despite confusions and uncertainty, the same was implemented for FY11. We have assumed the decision to continue in FY12 though unfavorable regulatory decision will significantly erode the value of Sui twins.

Sector Outlook

- **UFG losses – Sui twins' Achilles Heel:** UFG benchmarks were introduced by OGRA in FY04 to bring down unaccounted for gas (UFG) losses of Sui twins to international level of 4.0% by 2012. Gas marketing companies have to bear the entire loss above the upper cap, along with 50% of the spread between the upper and lower cap. Due to gradual fall in benchmarks and higher cost of gas, both companies lost total PKR7,308mn during FY09 as compared to PKR3,473mn during FY08 owing to UFG losses. However, for FY10, OGRA lifted the UFG benchmark to 7.0%, resulting in shrinkage of 23.7% in combined UFG losses to PKR5,576mn, lifting the bpttom line of gas marketing companies. However, with increased gas prices and higher gas consumption from UFG prone domestic sector, the UFH losses ballooned to record level of PKR9,678mn for FY11.

- **Gas price hike to swell gas losses:** As per OGRA notification, the gas prices in the country have been raised in the range of 1.81% to 207.1% (including the gas cess). The increase for all the domestic slabs and commercial consumers is 13.98%. Though increase or decrease in gas prices does not directly affect the profits of gas distribution companies, it reflects in the UFG losses. The increase in gas prices will not only increase the rupee losses of the Sui twins, but may also encourage gas thefts.

- **High regulatory risk:** The managements of the Sui twins have been pursuing government to permanently revise the UFG benchmarks upwards. For FY11, Sui twins were required to submit a detailed UFG study before the announcement of OGRA decision. OGRA, however, provided an interim relief to both companies on 21st September on the back of Sindh High Court's decision. Though no UFG limit has been set for FY12, reversion to previous UFG regime (upper cap of 5% and floor of 4.25%) will drag the bottom line of gas marketing companies in the red zone.

Action and recommendation

Since decisions related to UFG benchmarks can significantly alter the expected earnings of Sui twins, we advise investors to remain cautious while investing in these stocks until announcement of decision for FY12 by OGRA. Moreover, since the UFG benchmark is expected to be determined every year, there is a high regulatory risk for medium to long term investors.

Foundation Research
Equities

Foundation Securities

PAKISTAN

Universe Snapshot

Company Name	Target	Upside	Recommendation	EPS (Diluted)			DPS (Diluted)			PE (x)			PBV (x)			EV/EBITDA			Dividend Yield		
				2010F/A	2011F	2012F	2010F/A	2011F	2012F	2010F/A	2011F	2012F	2010F/A	2011F	2012F	2010F/A	2011F	2012F	2010F/A	2011F	2012F
Commercial Banks			**Outperform**																		
Habib Bank	139.50	31.5%	Outperform	15.26	18.93	19.20	5.91	7.00	8.00	7.0	5.6	5.5	1.2	1.1	0.9	NA	NA	NA	5.6%	6.6%	7.5%
MCB Bank	229.10	70.2%	Outperform	20.18	25.20	25.59	10.45	12.00	13.00	6.7	5.3	5.3	1.4	1.2	1.1	NA	NA	NA	7.8%	8.9%	9.7%
National Bank	59.72	45.5%	Outperform	10.59	8.94	9.50	6.00	6.00	6.50	3.9	4.6	4.3	0.5	0.5	0.5	NA	NA	NA	14.6%	14.6%	15.8%
United Bank	78.00	48.9%	Outperform	9.01	11.22	10.86	5.00	4.00	4.50	5.8	4.7	4.8	0.9	0.8	0.7	NA	NA	NA	9.5%	7.6%	8.6%
Allied Bank	84.30	56.7%	Outperform	9.63	11.10	11.14	3.00	3.50	4.00	5.6	4.8	4.8	1.3	1.1	1.0	NA	NA	NA	6.8%	7.4%	8.4%
Cement			**Outperform**																		
Attock	77.40	51.8%	Outperform	11.74	7.90	11.65	4.17	5.00	5.00	4.3	6.5	4.4	0.8	0.8	0.7	1.9	1.7	1.5	8.2%	9.8%	9.8%
DG Khan	31.50	65.5%	Outperform	0.53	0.39	2.02	-	-	0.50	35.8	48.8	9.4	0.3	0.3	0.3	7.0	6.0	5.0	0.0%	0.0%	2.2%
Lucky	95.30	27.0%	Outperform	9.70	12.28	16.74	4.00	4.00	4.00	7.7	6.1	4.5	1.0	0.9	0.8	6.1	4.6	3.5	5.3%	5.3%	5.3%
Power Generation			**Outperform**																		
Hubco	47.32	38.4%	Outperform	4.80	4.69	5.38	5.00	5.50	5.50	7.1	7.3	6.4	1.3	1.3	1.3	7.8	7.3	5.6	14.6%	16.1%	16.1%
Kapco	50.49	22.2%	Outperform	5.78	7.41	6.39	5.00	6.50	6.00	7.1	5.6	6.5	1.6	1.5	1.5	4.0	2.9	2.8	12.1%	15.7%	14.5%
Oil & Gas Marketing			**Outperform**																		
PSO	359.00	58.0%	Outperform	(39.05)	86.17	65.17	5.00	13.00	15.00	(5.8)	2.6	3.5	1.3	0.9	0.8	2.2	4.1	5.1	2.2%	5.7%	6.6%
SSGC	30.62	58.7%	Outperform	5.24	5.22	5.40	1.20	2.50	2.50	3.7	3.7	3.6	1.0	0.9	0.8	2.2	2.3	1.9	6.2%	13.0%	13.0%
SNGPL	22.31	42.0%	Outperform	4.65	2.21	2.61	2.00	1.00	1.50	3.4	7.1	6.0	0.5	0.5	0.5	0.8	0.9	0.8	12.7%	6.4%	9.5%
APL	486.31	17.9%	Outperform	52.00	61.58	62.07	25.00	41.50	40.34	7.9	6.7	6.6	3.1	2.5	2.2	3.5	3.4	3.2	6.1%	10.1%	9.8%
Oil & Gas Exploration			**Outperform**																		
OGDCL	161.00	6.2%	Neutral	13.76	14.77	19.37	5.50	5.50	7.75	11.0	10.3	7.8	4.1	3.2	2.6	6.4	5.5	4.1	3.6%	3.6%	5.1%
Pakistan Oilfields	428.60	23.7%	Outperform	31.44	45.72	57.83	30.09	35.00	40.48	11.0	7.6	6.0	2.8	2.5	2.3	6.3	4.3	3.5	8.7%	10.1%	11.7%
Pakistan Petroleum	NA	NA	NA	17.74	23.92	31.21	6.82	9.09	14.05	9.5	7.0	5.4	2.8	2.3	1.8	5.0	3.4	2.5	4.1%	5.4%	8.3%
MGCL	89.38	10.3%	Outperform	3.67	4.14	4.95	2.48	2.77	3.71	22.1	19.5	16.4	6.8	6.1	5.6	2.2	1.5	1.1	3.1%	3.4%	4.6%
Automobile Assembler			**Underperform**																		
Indus Motor	222.50	8.5%	Neutral	43.81	34.90	39.15	12.34	12.30	12.30	4.7	5.9	5.2	1.3	1.1	1.0	0.8	0.9	(0.3)	6.0%	6.0%	6.0%
Pak Suzuki Motors	64.80	9.8%	Neutral	2.57	12.25	13.98	-	3.00	3.00	23.0	4.8	4.2	0.3	0.3	0.3	0.5	0.5	0.6	0.0%	5.1%	5.1%
Chemical			**Outperform**																		
ICI Pakistan	146.00	21.4%	Outperform	17.50	14.64	15.96	17.50	10.00	10.38	6.9	8.2	7.5	1.1	1.2	1.1	2.5	2.8	2.8	14.6%	8.3%	8.6%
Lotte Pakistan	14.85	60.2%	Outperform	2.99	3.56	1.70	0.50	1.00	1.25	3.1	2.6	5.4	1.5	1.0	0.9	1.3	0.9	1.3	5.4%	10.8%	13.5%
Paper & Board			**Neutral**																		
Packages Limited	146.90	77.6%	Neutral	(3.94)	(1.47)	5.38	-	-	-	(21.0)	(56.3)	15.4	0.3	0.3	0.3	9.6	7.4	5.9	0.0%	0.0%	0.0%
Telecom			**Outperform**																		
PTCL	23.56	126.8%	Outperform	1.82	1.26	1.55	1.75	1.50	1.50	5.7	8.3	6.7	0.5	0.5	0.5	1.6	2.2	1.4	16.8%	14.4%	14.4%
Textile																					
Nishat Mills	66.30	63.9%	Outperform	8.29	13.78	11.05	2.50	2.50	3.00	4.9	2.9	3.7	0.5	0.4	0.4	4.5	3.3	3.5	6.2%	6.2%	7.4%
Fertilizer			**Outperform**																		
Engro Corporation	190.30	105.3%	Outperform	17.26	17.97	21.64	5.00	6.00	6.00	5.4	5.2	4.3	1.1	1.0	0.8	11.4	6.6	6.1	5.4%	6.5%	6.5%
Fauji Fertilizer Bin Qasim	38.30	-9.7%	Neutral	6.97	10.77	6.08	6.55	9.50	5.50	6.1	3.9	7.0	3.2	3.0	2.8	3.0	1.9	2.8	15.4%	22.4%	13.0%
Fauji Fertilizer	182.30	21.9%	Outperform	13.00	24.36	21.23	10.40	21.75	19.75	11.5	6.1	7.0	8.2	7.2	6.7	6.7	3.8	4.2	7.0%	14.5%	13.2%

Foundation Research
Equities

Foundation Securities

Foundation Securities (Pvt) Limited

URL: www.fs.com.pk

Email: info@fs.com.pk

Office

Karachi

Ground Floor, Bahria Complex II

MT Khan Road

Karachi

UAN: 111 000 375

PABX: +9221 35612290-94

Facsimile: +9221 35612262

Foundation Research

Analyst	Sectors	PABX	Email
Syed Suleman Akhtar, CFA	Economy, Banking	+92 21 3561 2290-94 x 338	suleman.akhtar@fs.com.pk
Asim Wahab Khan, CFA	E&P, Gas Marketing	+92 21 3561 2290-94 x 335	awkhan@fs.com.pk
Taha Khan Javed, CFA	Fertilizers, Chemicals	+92 21 3561 2290-94 x 313	taha@fs.com.pk
Mansoor Khanani	Cements, Autos, Textiles	+92 21 3561 2290-94 x 345	mansoor.khanani@fs.com.pk
Hassan Raza	Oil Marketing, Power	+92 21 3561 2290-94 x 311	hasan.raza@fs.com.pk
Shahzad Usman	Database	+92 21 3561 2290-94 x 312	shahzad.usman@fs.com.pk

Foundation Sales

Trader	PABX	Email
Karachi		
Atif Muhammad Khan	+92 21 3561 2253	atif@fs.com.pk
Siraj Ebrahim Kazi	+92 21 3561 2256	siraj@fs.com.pk
Syed Rehan Ali	+92 21 3561 2259	rehan@fs.com.pk
Zubair Ghulam Hussain	+92 21 3563 5166	zubair.hussain@fs.com.pk
Imran Abdul Aziz	+92 21 3563 5013	iaziz@fs.com.pk
Faisal Khan	+92 21 3561 2258	faisal@fs.com.pk
Adnan Ahmed Usmani	+92 21 3561 0887	adnan@fs.com.pk
Muhammad Rameez	+92 21 3561 0280	mrameez@fs.com.pk