BMA CAPITAL

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FY11: LIQUIDITY, KEY TO THE PROMISED LAND

PAKISTAN EQUITIES: UP 36% FOR THE YEAR

KSE100 closed up 36% in FY10 on the back of low base and continued economic improvement – earmarking itself as one of the best performing equity markets. Net foreign inflows were recorded at USD567mn while OGDC, the star performer, gained 79% for the year and alone contributed ~1,125 points to the index. Trading value however remained dismal, with daily average clocking in at USD84mn for FY10.

THE ECONOMIC STORY: RECOVERY STILL FRAGILE

Despite persistent challenges, Pakistan's economic growth is expected to clock in at 4.1% in FY10 and 4.5% in FY11 compared to the previous year growth of 1.2%. LSM contributed significantly to the recent recovery however contribution from agriculture remained less than expected. Going forward, smooth transition from consolidation to recovery will require addressing key risks emanating from energy crisis, double-digit inflation and excessive government borrowing. We foresee further up tick in secondary market yields, however rule out increase in the SBP policy discount rate in the short term.

VALUATIONS: COMPELLING TO SAY THE LEAST

Due to higher bond yields, we have revised downwards BMA Universe fair values by up to 5%. However due to stable external accounts and easing inflation from Jan11 onwards, we maintain our Dec10 KSE100 target of 11,500. Trading at FY11E PER of 7.2x, Pakistan equities remain one of the most undervalued markets in the region. Achieving these targets will however require improvement on the liquidity front, whereby expected launch of Margin Finance/Trading is likely to bode well for the market.

THE UNDERLYING THEME: GETTING THE RIGHT MIX

Our High Conviction Investment ideas have yielded up to 40% outperformance during FY10 while our current list includes PPL, PSO, MCB, ACPL and LUCK – all reflecting upside potential in the north of 20% from current levels.

BMA Sector Stance

Sector	BMA Recommendation
Oil Marketing Companies	OVERWEIGHT
Cement	OVERWEIGHT
Independent Power Producers	OVERWEIGHT
Oil and Gas Exploration	MARKETWEIGHT
Commercial Banks	MARKETWEIGHT
Autos	MARKETWEIGHT
Telecom and Technology	MARKETWEIGHT
Fertilizer	MARKETWEIGHT
Textile	MARKETWEIGHT
Refineries	UNDERWEIGHT

Source: BMA Research

FY11: LIQUIDITY, KEY TO THE PROMISED LAND

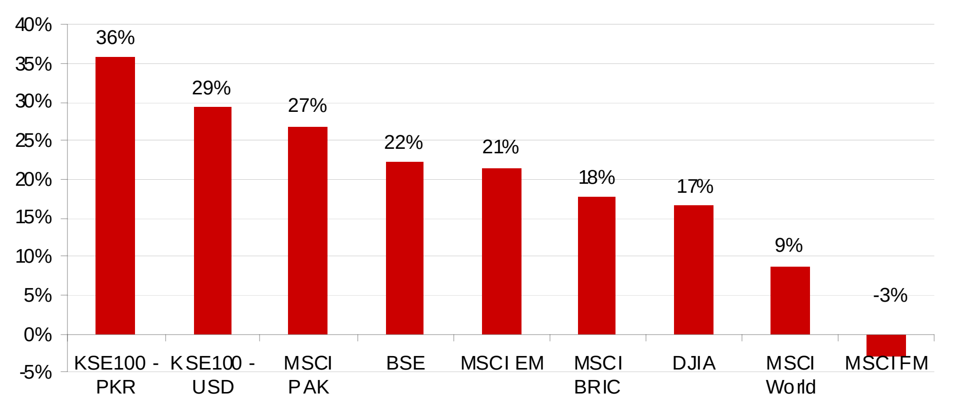
Top 10 KSE100 Best Performers		
Company	Ticker	% Change
Grays Of Cambridge	GRAYS	367%
TRG Pakistan	TRG	204%
Lotte PTA	LOTPTA	199%
Indus Motor	INDU	163%
Colgate Palmolive	COLG	149%
Millat Tractors	MTL	143%
Unilever Pakistan	ULEVER	116%
Oil & Gas Dev. Co.	OGDC	90%
Allied Bank	ABL	80%
Fauji Fertilizer B. Qasim	FFBL	72%

Top 10 KSE100 Worst Performers		
Company	Ticker	% Change
Gharibwal Cement	GWLC	-62%
KASB Bank	KASBB	-50%
Azgard Nine	ANL	-50%
Pak Reinsurance	PAKRI	-46%
Bestway Cement	BWCL	-44%
Mari Gas Company	MARI	-44%
Jahangir Siddiqui	JSCL	-44%
Engro Polymer	EPCL	-42%
Pak Elektron	PAEL	-41%
NIB Bank	NIB	-37%

An all-round better performance on economic and political front allowed Pakistan equities to post a remarkable performance as the benchmark KSE100 closed at 9,722, up 35.7% for FY10. While low base effect was also one of the factors behind the stellar performance, it would be interesting to note that FY10 was not a one-off in KSE's history as the benchmark has posted an average performance of 30% since FY02.

Comparing with global benchmarks however, Pakistan has once again been earmarked as one of the best performing equity markets during the outgoing fiscal year.

Select Equity Market Performances during FY10

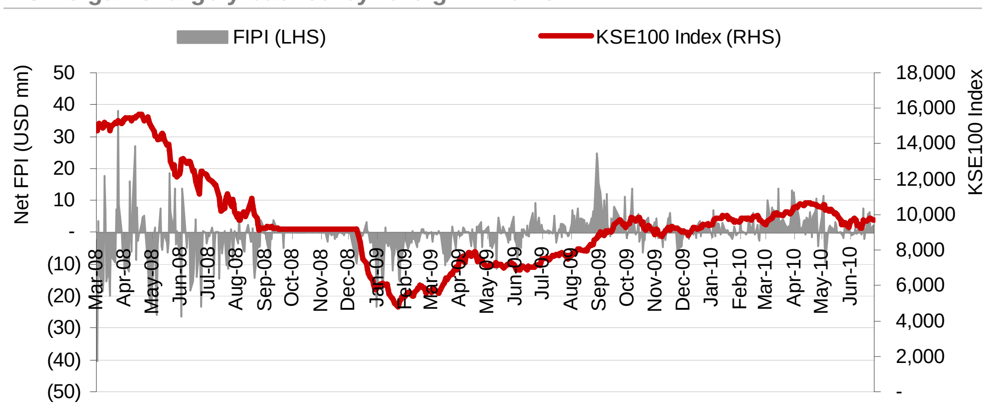


Source: BMA Research

The remarkable aspect this year around was however the return of foreign interest in the country. Governance concerns, raised by imposition of stock price floor in Aug08, were brushed aside as Pakistan equities witnessed net inflow of USD567mn for FY10 after recording net outflow of USD430mn in the previous fiscal year.

Domestic investors were consequently seen on the selling side, by virtue of which foreign investors are now estimated to account for over 28% of free float weighted market capitalization of Pakistan equities.

KSE's gains largely backed by foreign inflows



Source: BMA Research

Star performance for the year was bagged by OGDC as it gained 79% (adjusted basis) for the year, on the back of aggressive buying by select long-only foreign funds. Consequently, its weight increased from 17.7% at the beginning of FY10 to currently 24.7%. More interestingly, we estimate the stock to have contributed 1,125 points in KSE100 during the outgoing fiscal year; thus stripping out OGDC's performance, the benchmark has posted a return of merely 20% for the year.

Sector Wise Performance during FY10

Sector	Performance
Leisure Goods	367%
Support Services	204%
Automobile and Parts	89%
Industrial Engineering	88%
Electronic and Electrical Equipment	66%
Health Care Equipment and Services	57%
Oil and Gas	55%
Food Producers	55%
Tobacco	42%
Software and Computer Services	40%
Chemicals	37%
Industrial metals and Mining	33%
Media	28%
Beverages	28%
Industrial Transportation	27%
Banks	27%
Equity Investment Instruments	24%
Personal Goods	23%
Fixed Line Telecommunication	23%
Electricity	18%
Travel and Leisure	16%
Travel and Leisure	1%
Technology Hardware and Equipment	1%
Gas Water and Multiutilities	-4%
Life Insurance	-8%
Non Life Insurance	-8%
Forestry and Paper	-8%
Construction and Materials	-10%
Pharma and Bio Tech	-14%
Financial Services	-20%
Real Estate Investment and Services	-26%
Household Goods	-41%

Source: BMA Research

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BMA High Conviction Investment Ideas yielded up to 40% outperformance during FY10

Following table highlights our High Conviction Investment Calls issued during FY10. Those that were removed from the list during the year are HUBC, POL, DGKC, MCB, FFBL, OGDC and LUCK whereby they outperformed the benchmark index by 2-40%.

BMA High Conviction Investment Ideas: those removed from the list during FY10

Scrip	Current Price	Date of Inclusion	Adj Price at Inclusion	Date of Removal	Price on Date of Removal	Return	Over/Under Performance
HUBC	32.0	10-Apr-09	20	24-Jun-10	32.1	60%	27%
POL	215.9	2HFY09	134.5	15-Jan-10	238.1	77%	40%
DGKC	23.6	26-Nov-09	26.1	15-Jan-10	30.9	18%	12%
MCB	194.2	9-Dec-09	179.4	15-Jan-10	202.2	13%	2%
FFBL	26.0	13-Oct-09	21.4	9-Dec-09	22.3	4%	12%
OGDC	141.7	2HFY09	74.5	12-Nov-09	98.5	32%	8%
LUCK	62.1	2HFY09	55.7	7-Aug-09	73.1	31%	22%

Source: BMA Research

Traded value down to USD84mn for FY10

The weakest link for Pakistan equities has however been the shrinkage in traded values as the daily average was recorded at USD84mn for FY10, down from a high of USD595mn in FY06. This has largely been a factor of 1) absence of a widely accepted leverage product in the market, 2) liquidity concerns arising from energy sector circular debt and excessive government borrowing.

Average Daily Traded Value (USDmn)

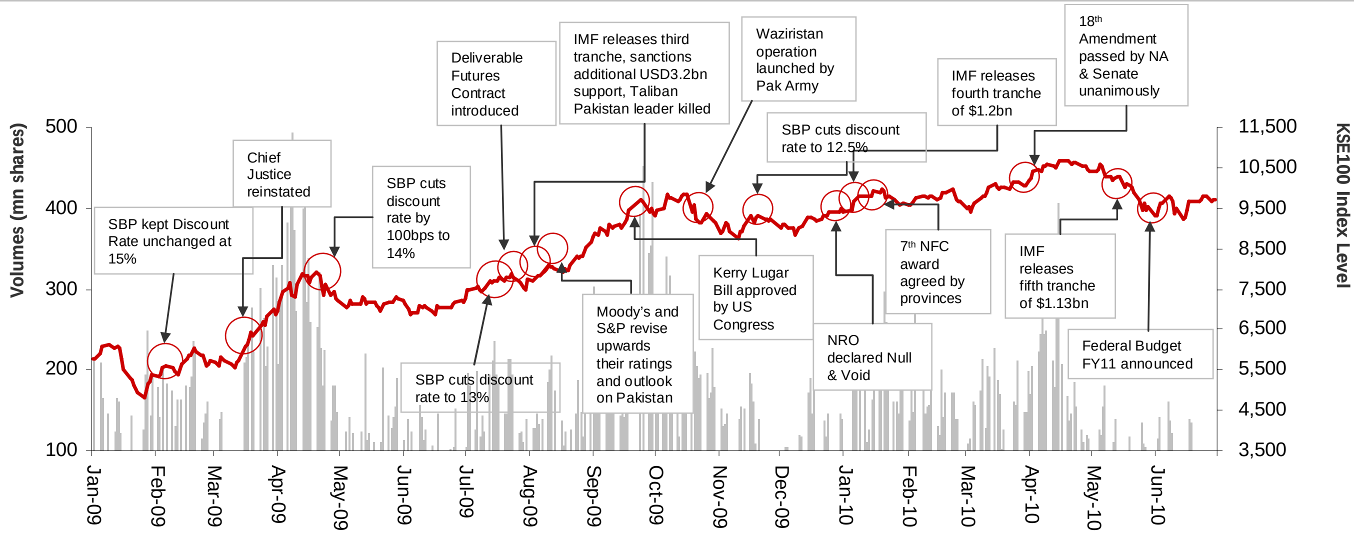
FY06	594.54
FY07	367.27
FY08	410.43
FY09	56.84
FY10	83.61

Source: BMA Research

Performance for 1HCY10 miserable though

Pakistan equities remained lackluster during 1HCY10 as the benchmark posted a meager growth of 4%, compared to the previous half growth of 31%. While domestic investors were largely seen on the selling side, net foreign inflows of USD276mn during the 1HCY10 cushioned the index. The biggest disappointment for the outgoing half has thus been the shrinkage in traded value as the daily average was recorded at USD63mn, compared to preceding half average of USD98mn.

Chain of Events



Source: BMA Research

Thursday, July 01, 2010

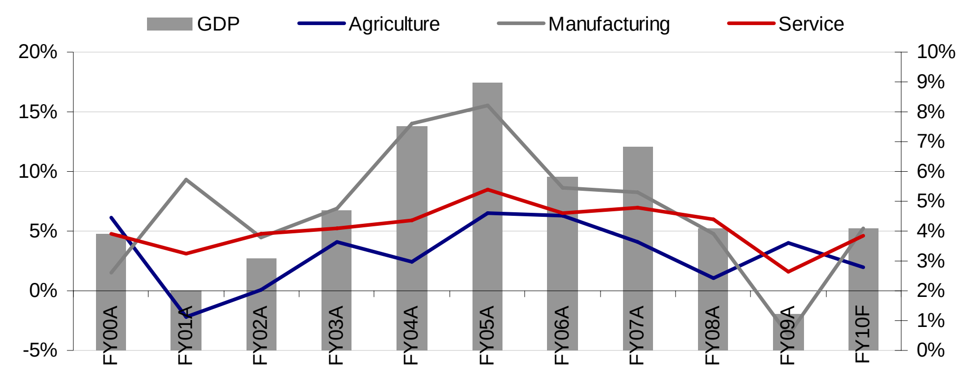
ECONOMIC RECOVERY STILL FRAGILE

Despite persistent challenges, Pakistan's economic growth is expected to clock in at 4.1% in FY10 and 4.5% in FY11 compared to the previous year's growth of 1.2%. LSM contributed significantly to the recent recovery however contribution from agriculture remained less than expected. Going forward, smooth transition from consolidation to recovery will require addressing key risks, including:

- Power crises which is severely damaging the overall economic growth particularly the industrial sector. As per MoF, this contributed to 1% decline in headline GDP growth in FY10
- Higher inflation keeping SBP cautioned towards interest rates
- Liquidity constraints due to higher government borrowing is one of the impediments to private sector credit and subsequently hinders economic activity particularly due to non availability of working capital financing to manufacturing sector.

Considering the fact that agriculture and manufacturing remain key contributing factors towards economic recovery, growth for FY11 would remain dependent on timely decision regarding support prices and resolution of circular debt.

Pakistan's sector wise Economic Performance



Source: SBP, MoF, BMA Research

Agriculture: Productivity and yields adding value

Continued support through relatively higher support prices for local grains helped achieve better crop production in year FY10. Consequently better cash flows are expected to improve fertilizer mix of which prices remained relatively stable in FY10 – prices for Urea and DAP increased by 5% and 8% YoY respectively. In addition, improving water availability and recent subsidies for potash fertilizer also imply better production during FY11. Taking into account the said factors we expect Agriculture to grow by 3.8-4%.

Manufacturing: Key determinant for economic recovery

Local manufacturing sector (LSM) growth improved on the back of industries (Cement, Fertilizer and Autos) with resilient local demand. LSM posted considerable growth of 4.52% in 10MFY10 compared to 8.2% decline in FY09. Kick start in private credit amidst relatively lower government borrowing in 2QFY10 helped resolve financing issues for working capital of manufacturing sector to some extent. In addition, the expected resolution of power crises, pick up in domestic demand and exports growth are positive triggers for the sharp recovery in LSM. On the back of improved productivity of manufacturing and construction sector, industrial sector is expected to grow by 5.6% in FY10 compared to -3.3% in FY09.

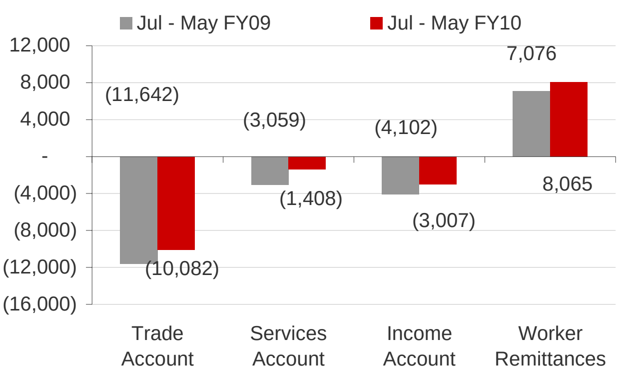
Industrial sector contributes 24% to the GDP directly and also supports the Services sector (particularly transport and communication), financial sector and whole sale and retail sector (cumulative share of these sectors stands at 34% to GDP) therefore recovery in industrial sector would play an instrumental role for overall economic growth.

Balance of payment: Depicting a promising picture

With ranged-bound oil prices and slowdown in imports on the back of regulatory amendments, the current account has moved swiftly towards more sustainable equilibrium. Current account deficit for the period Jul-May10 posted 66% YoY decline to settle at USD2.9mn.

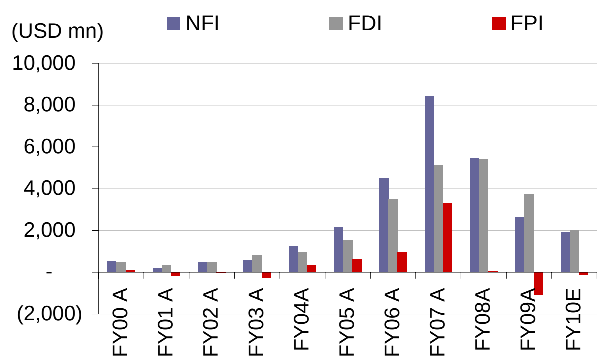
Although we expect oil prices to average out at USD70-75/bbl, RMB (Yuan) appreciation may have short term implications i.e. recovery in commodity prices and direct import from China. Currently we maintain unfavorable trade balance of USD1.7bn with China. In this case import bill is expected to exert pressure over trade balance. However, better price competitiveness would help exports (particularly textile which contribute 60% in total exports) to bode well for the same reason. In addition, due to weaker economic conditions of Pakistan's major trading partners (US and UAE account for 29% exports), elastic demand for textile exports, expected 4-5% annual PKR depreciation against green back and appreciating RMB would help gain further market share in international markets.

Current account stabilizing yet vulnerable



Source: SBP, BMA Research

Foreign investment in Pakistan



Source: SBP, BMA Research

On the other hand, despite 45% YoY decline in foreign direct investment, the financial account registered only 9% YoY decline to USD4.0bn. Due to poor law and order situation any major turnaround on this front is not expected during FY11. However, support through multilateral and IFIs funding is expected to support the overall balance of payment. BoP stands at a surplus of USD781mn in 11MFY10 compared to a deficit of USD3.8bn during 11MFY09.

Inflation: Upward bias may raise concerns in short term

Inflationary pressures continued to ease throughout 2010 as the high base affect, decline in international prices and a cautious monetary stance have arrested inflation. CPI is expected at annual avg. of 12% for FY10 compared to 20% observed in FY09. However, short term glitches including 1) Subsidy elimination, 2) +100bps hike in S.tax rates and 3) seasonal price surge in Ramadan are expected to cause loosening grip over inflation in short term.

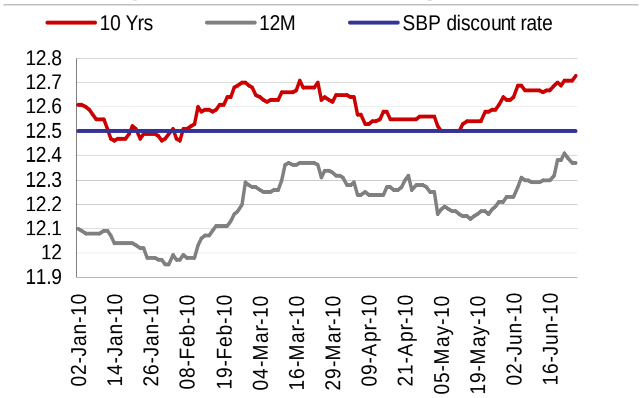
Considering these elements, we expect CPI to remain in the range of 12.6-12.8% while low base of 2QFY10 may have implications in terms of maintaining the same range till Dec10. In terms of policy stance, we expect the short term resurgence in inflation to raise concerns but the expected downward adjustments in CPI post Dec10 rules out any short term hike in the SBP policy rate

Money market yields hinged on liquidity

As mentioned earlier, the government borrowing remains a key impediment for the private sector growth. Considering non materialization of FoDP inflows, we expect the borrowing pressure on banking system to persist. Recent borrowing target for the next quarter also vouch for the same. The Govt. targets PKR535bn and PKR45bn for T-bills and PIBs respectively compared to PKR460bn and 20bn for quarter ended Mar10 (PIBs target for 1HFY11 stands at PKR85bn).

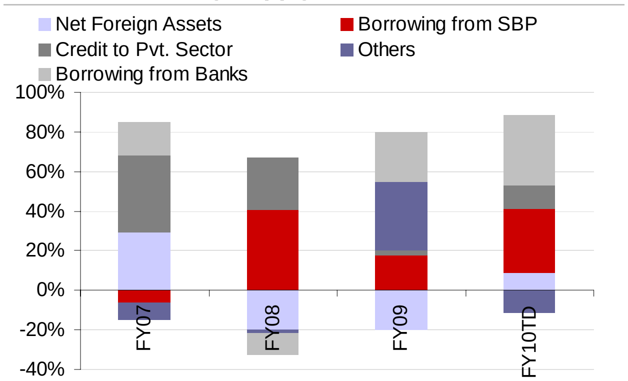
During the ongoing quarter borrowing has actually surpassed the set targets for T-bills, particularly in Jun10. This factor arrested short term slide in the secondary market yields – 1 yr. T-bills yields have increased by 23bps MoM to settle at 12.37%.

Secondary Market Yields to inch up



Source: SBP, BMA Research

Factors of money supply



Source: SBP, BMA Research

Considering the higher borrowing requirements from commercial banks, we expect T-bill yields to inch up towards 12.4-12.45%. Since yields for 3 & 6 months papers carry relatively higher potential for upside compared to 12 months, we expect participation to remain titled towards 3 and 6 months. In addition, backed by borrowing shift towards the longer term papers, 10-15bps upward revision in PIB yields can not be ruled out in the short term.

Up tick in secondary market yields; Fair values revised down by up to 5%

With excessive government borrowing and liquidity pressure now limiting the possibility of further monetary easing, the pressure on secondary market yields has already been apparent. Thus as flagged in our earlier notes, we are officially revising down our fair values for BMA Universe by up to 5%. Our house assumption for risk-free rate (10 year PIB yield) is now taken to be 12.75% which we will maintain as long as the government bond yields in the range of 12.5-13.0%.

Revised BMA Universe with 10 year PIB taken at 12.75%

Ticker	Company Name	Sector	Current Price	BMA Revised Fair Value	Upside/downside potent.	Recommend.
MCB	MCB Bank	Banks	194.2	235	21%	BUY
NBP	National Bank	Banks	64.1	64	0%	NEUTRAL
HBL	Habib Bank	Banks	97.3	100	3%	NEUTRAL
UBL	United Bank	Banks	54.2	67	24%	BUY
BAFL	Bank Alfalah	Banks	9.5	15	59%	BUY
OGDC	Oil & Gas Development	Oil and Gas	141.7	133	-6%	REDUCE
PPL	Pakistan Petroleum	Oil and Gas	184.1	224	22%	BUY
POL	Pakistan Oil Fields	Oil and Gas	215.9	275	27%	BUY
PSO	Pakistan State Oil	Oil and Gas	260.2	402	54%	BUY
APL	Attock Petroleum	Oil and Gas	289.8	540	86%	BUY
HUBC	Hub Power	Electricity	32.0	41	28%	BUY
PTC	Pakistan Telecom	Fixed Line Telecom	17.8	29	60%	BUY
FFC	Fauji Fertilizer	Chemicals	103.1	115	12%	ADD
ENGRO	Engro Chemicals	Chemicals	173.6	219	26%	BUY
FFBL	Fauji Fertilizer Bin Qasim	Chemicals	26.0	34	31%	BUY
ICI	ICI Pakistan	Chemicals	118.6	176	48%	BUY
LUCK	Lucky Cement	Construction and Materials	62.1	86	38%	BUY
DGKC	DG Khan Cement	Construction and Materials	23.6	35	48%	BUY
ACPL	Attock Cement	Construction and Materials	65.5	96	47%	BUY
INDU	Indus Motors	Automobile and Parts	262.4	280	7%	ADD
PSMC	Pak Suzuki Motor	Automobile and Parts	79.3	106	34%	BUY
NML	Nishat Mills	Personal Goods	43.1	67	55%	BUY
PKGS	Packages	General Industrials	118.5	165	40%	BUY

Source: BMA Research

VALUATIONS COMPELLING; LIQUIDITY TO REMAIN A CONCERN

While the market may still have to discount the rising pressure on secondary market yields, we would like to point out the positives in the form of rebound in LSM sector growth, continued improvement in external accounts and potential ease in inflation from Jan11. With these factors having direct implication on economic progress, our stance on Pakistan equities remains positive as we maintain our 2010 KSE100 index target of 11,500.

Moreover, valuations for most blue chip companies are as exciting as ever with overall BMA Universe reflecting FY10E and FY11E respective PERs of 8.0x and 7.2x – a discount of ~50% to the regional equity markets. We maintain an Overweight stance on OMCs, Cement and Power sectors whereby we carry forward our current High Conviction Investment Ideas (PPL, PSO, MCB, ACPL and LUCK) into FY11.

BMA Sector Stance

Sector	BMA Recommendation
Oil Marketing Companies	OVERWEIGHT
Cement	OVERWEIGHT
Independent Power Producers	OVERWEIGHT
Oil and Gas Exploration	MARKETWEIGHT
Commercial Banks	MARKETWEIGHT
Autos	MARKETWEIGHT
Telecom and Technology	MARKETWEIGHT
Fertilizer	MARKETWEIGHT
Textile	MARKETWEIGHT
Refineries	UNDERWEIGHT

High Conviction Stock Ideas

Company	Ticker	Current Price	Fair Value	Pot Upside	EPS (PKR)		PER(x)		EPS Growth		Dividend Yield	
		PKR/share	PKR/share		FY10E	FY11E	FY10E	FY11E	FY10E	FY11E	FY10E	FY11E
Pakistan Petroleum	PPL	184	224	22%	23.4	23.4	7.9	6.6	-16%	20%	5%	7%
Pakistan State Oil	PSO	260	402	54%	52.3	52.3	5.0	5.7	NM	-13%	2%	2%
MCB Bank	MCB	194	235	21%	23.0	23.0	8.5	7.8	13%	9%	7%	7%
Attock Cement	ACPL	66	96	47%	14.1	14.1	4.6	3.7	-18%	27%	4%	6%
Lucky Cement	LUCK	62	86	38%	10.8	10.8	5.8	4.0	-24%	37%	3%	4%
BMA Universe Average							**8.0**	**7.2**	**12%**	**11%**	**6%**	**7.0**

Source: BMA Research

Reintroduction of a widely accepted leverage product will however remain the key in achieving our index and stock targets. Some of the financial products recently launched include Cash Settled Futures (CSF) and relaxation on short selling while a committee has been formed to review and propose Margin Trading/Financing for the market – whereby we expect the product to be finalized during July10.

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