



Hamad Aslam, CFA
haslam@bmacapital.com

Nurali Barkatali
nurali.barkatali@bmacapital.com

Sana I. Bawani
sana.iqbal@bmacapital.com

Omar Rafiq
omar.rafiq@bmacapital.com

Muhammad Ali Taufiq
ali.taufiq@bmacapital.com

Samina Sher Ali Kanji
skanji@bmacapital.com

Naseem Akhtar Khattak
nakhtar@bmacapital.com

Budget Review 2011-12

Maneuvering through the Fiscal Challenges

June 6, 2011



- **Budget overview and economic highlights:** The government announced Federal budget FY12 envisaging outlay of PKR3.7trn and total revenues of PKR2.7trn; fiscal deficit target is set at 4% of GDP which however appears to be overtly optimistic
- Barring modest changes, the overall announcement maintained status quo on a number of sectors, reflecting the will to provide consistent government policies. Further, the budget aims to promote appropriate tax mix, documentation of economy, investment, relief measures for the masses and austerity measures in non-development expenditures
- While broad revenue measures appear to be ambitious, we expect GDP growth to achieve government set target of 4.2% for FY12. However, key risks stem from lingering circular debt in the system while any increase in government borrowing may further crowd-out the private sector and keep interest rates downward sticky
- **Sector specific news-flow:** With regulatory duties and GST trimmed on cement and automobiles, we are likely to see higher MoM offtakes in Jul11 though partially offset by an expected dip in the ongoing month. However given relative inelasticity in demand and limited expected increase in retention margins, we maintain our overall projections for both the sectors
- For banks, the corporate tax rate was maintained at 35% which is to be taken as a sigh of relief for the sector and should result in respite in stock prices following the massive underperformance off-late
- For asset management industry, increased tax incentives for individuals investing in T-bills and elongating time duration of investment to avail tax benefits in mutual funds may lead to minor outflows from money market/cash fund category
- **Capital Markets:** Contrary to pre-budget rumors circulated by certain circles, no change was announced in Capital Gains Tax (CGT) regime for equity markets – while this is likely to dampen the sentiments in the short term, we believe the growth momentum in corporate profitability should eventually allow Pakistan equities to catch up with value
- We maintain our 2011 end target of 14,000 for KSE100 along with an Overweight stance on OMCs, Electricity (IPPs) and Fertilizers. We also highlight APL and FFC as our High Conviction Investment ideas – all 17 ideas pitched since 2009 under this list have posted positive returns during their inclusion period while 14 out of them have substantially outperformed the benchmark KSE100 index

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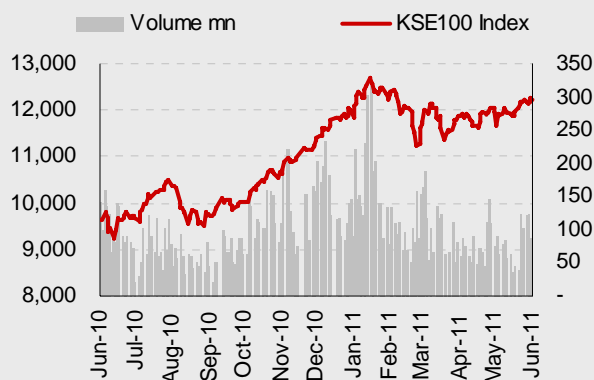
**Budget Overview and Capital Market Strategy:
Opportunity to be a contrarian**

- **Appropriate tax mix:** Share of indirect taxation is envisaged to be reduced on already burdened sectors through abolishment of Special Excise Duty (SED), reduction and removal of Federal Excise Duty (FED) for a number of sectors and reduction of General Sales Tax (GST) to 16% for the sectors charged with 17% earlier
- **Documentation of economy:** Local sales for unregistered segments within the five zero-rated sectors (including textile, leather, sports goods and surgical goods) have been levied with GST of 5% while it has been made mandatory to file income and wealth tax returns for heavy users of electricity, irrespective of their profitability/income
- **Investment:** Individuals and foreign investors are encouraged to invest in government securities with WHT of 10% now being the final tax, relieving them of the statutory requirement of filing tax returns. Incentives for investing in the private sector are however more cosmetic in nature where 100% tax credit is allowed for a period of 5 years (or commencement of COD, whichever is later) for establishing a new industrial undertaking or investing in plant & machinery for BMR activities, if financed by 100% equity
- **Relief measures:** Given the tight resources available to the government, broad based relief measures were limited to extending tax exemption to people earning PKR350,000 pa (from PKR300,000 pa earlier) and increasing government employees' salaries by 15%, in addition to the earlier mentioned cut in FED, GST and SED
- **Austerity measures:** All voluntary non-development expenditures have been kept in-line with last year's level with increase in government employees' salaries and pension being the only exception
- **The budget however lacks** clear roadmap for 1) resolution of circular debt, 2) revenue mobilization measures and 3) job creation

Sector	Budget Announcement	Impact	BMA Stance
Banks	<ul style="list-style-type: none"> ▪ Allowed banks to carry forward provisioning of up to 5% of total advances for consumer and SME segments, as tax deductible expense for succeeding years ▪ Tax on dividend income from Asset Management Companies increased to 20% (from 10% earlier) for banks 	Positive	Marketweight
Construction and Materials	<ul style="list-style-type: none"> ▪ FED reduced by PKR200/ton, SED (2.5%) abolished and GST reduced to 16% from 17% earlier ▪ Aggressive allocation for PSDP (including dams) but unlikely to be met 	Positive	Marketweight
Automobile & Parts	<ul style="list-style-type: none"> ▪ Status quo maintained on CKD kits and CBU imports ▪ GST reduced from 17% to 16% and SED (2.5%) abolished 	Positive	Underweight
Life-Insurance	<ul style="list-style-type: none"> ▪ Tax incentives announced for investing in Life Insurance products 	Positive	
General Measures	<ul style="list-style-type: none"> ▪ Tax benefit arising from minimum turnover tax allowed to be carried forward to 5 years (from 3 years earlier) – potentially benefiting companies with low net margins or losses ▪ 100% tax credit allowed for 5 years for investments in new industrial undertakings and BMR, if financed by 100% equity 	Positive	
Capital Markets	<ul style="list-style-type: none"> ▪ No change in CGT regime ▪ Aligning with equities, CVT of 0.01% withdrawn on Modarba certificates and instruments of redeemable capital (TFCs) traded on stock exchanges ▪ Tax credit enhanced from 5% to 15% for new equity listings ▪ 10% WHT on investment in govt securities made full and final liability for individuals 	Neutral	
Oil Marketing Companies	<ul style="list-style-type: none"> ▪ Tax benefit arising from minimum turnover tax allowed to be carried forward to 5 years (from 3 years earlier) 	Neutral	Overweight

Sector	Budget Announcement	Impact	BMA Stance
Electricity	<ul style="list-style-type: none"> Subsidy on account of electricity tariff differential has been reduced to PKR75bn for FY12 	Neutral	Overweight
Fertilizers	<ul style="list-style-type: none"> GST reduction from 17% earlier to 16% 	Neutral	Overweight
Oil & Gas Exploration	<ul style="list-style-type: none"> Customs duties exemption on E&P equipments 	Neutral	Marketweight
Textile	<ul style="list-style-type: none"> 5% GST imposed on the sector but likely to be limited to unregistered segments 	Neutral	Marketweight
Refineries	<ul style="list-style-type: none"> 100% tax credit offered for the next 5 years as an incentive for 100% equity investment in industrial undertaking commencing after July 2011 	Neutral	Underweight
Mutual Funds and AMCs	<ul style="list-style-type: none"> Increased tax incentives for investing in government securities may lead to risk of redemption from money market funds by individuals Tax savings on investment in mutual funds enhanced but accompanied by increased duration of required investment (36mths from 12mths earlier) 	Negative	

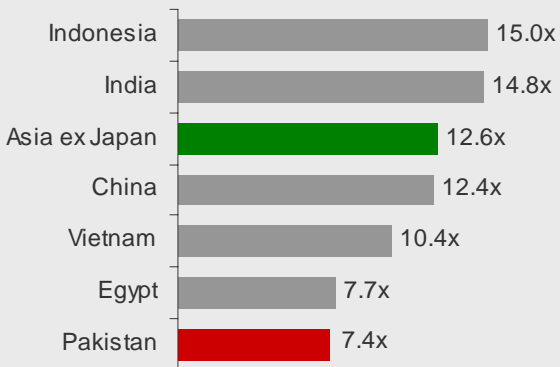
KSE100 Index: Price Volume Graph



BMA Universe Valuation Snapshot

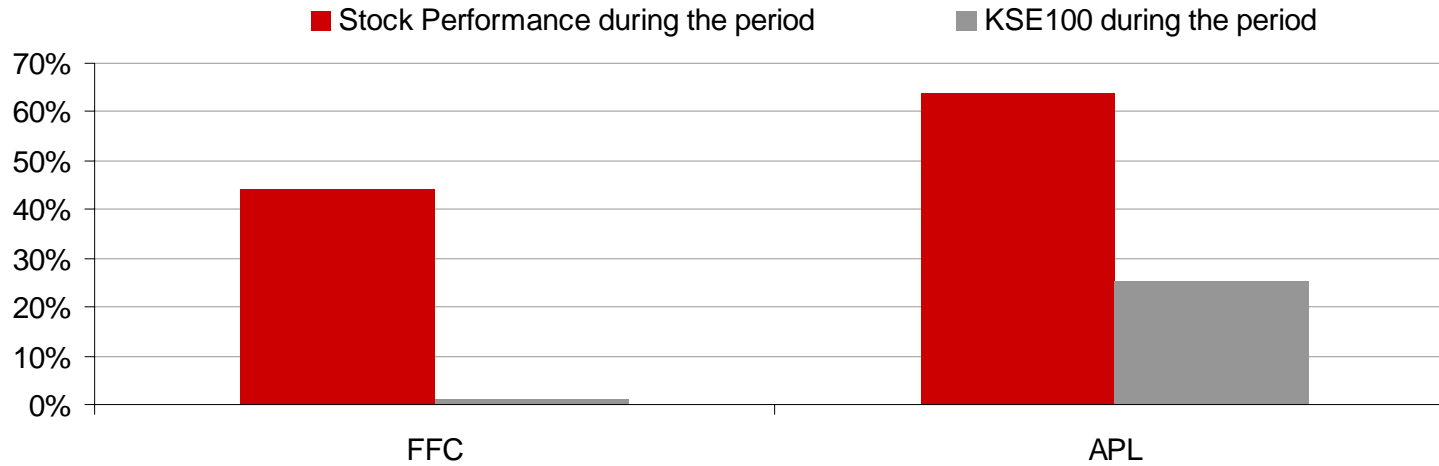
	FY10A	FY11E	FY12E
PER	9.2x	7.4x	6.7x
PBV	1.9x	1.7x	1.5x
Div. Yield	6%	7%	7%
EPS Growth	17%	24%	11%

Regional Valuations – 2011 PER

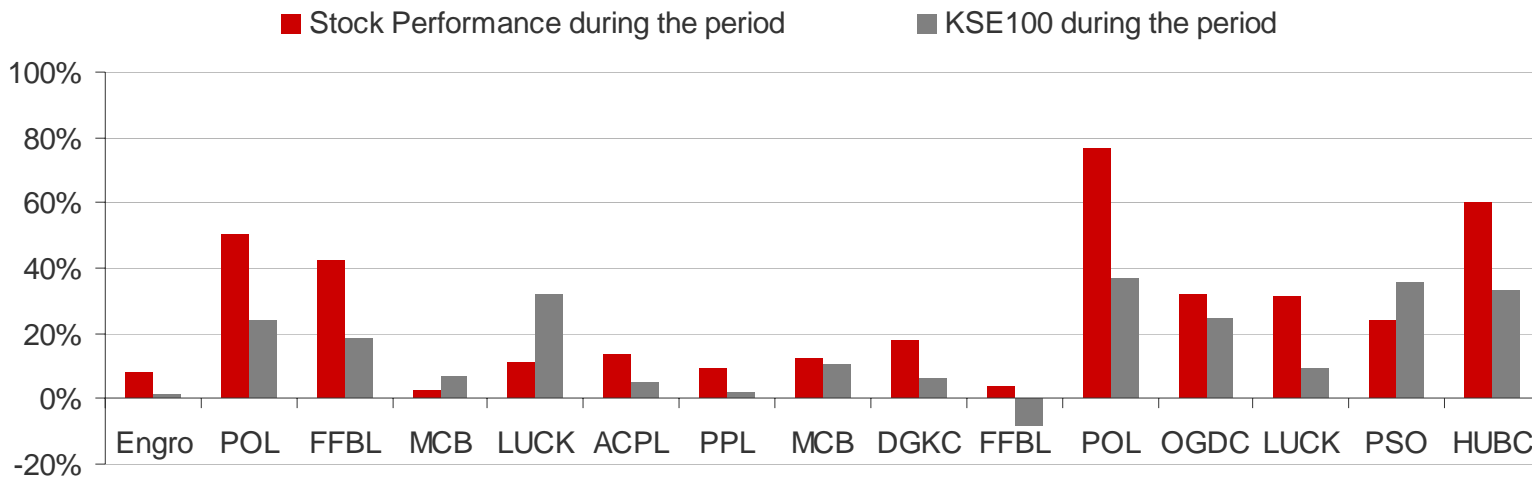


- Contrary to pre-budget rumors circulated by certain circles, no change was announced in either the prevailing regime for Capital Gains Tax (CGT) or tax collection methodology for small investors. As a result, in-line with earlier announced schedule, tax slab stands enhanced to 8% (from 7.5% in FY11) on trading of securities held for between 6-12 months (refer to the table in appendix for detailed schedule of CGT slabs)
- While this is likely to dampen sentiments in the short term, we believe the growth momentum in corporate profitability should eventually allow Pakistan equities to catch up with value
- We re-iterate our positive outlook on Pakistan equities – even without eyeing any substantial re-rating, projected EPS growth of 24% in FY11 is likely to take KSE100 to 14,000 by 2011 end. While we flag cement, autos and banking sectors to be triggered positively by the budget, we maintain OMCs, Fertilizer and Electricity (IPPs) as our Overweight sectors
- Aggressive stock-level exposure should be maintained in companies with clear pricing power and growing domestic demand. In this regard, Attock Petroleum (APL) and Fauji Fertilizer (FFC) stand out as our High Conviction Investment Ideas
- While we maintain a BUY call on Engro Corp (ENGRO), we are removing the stock from the list, owing to its lingering gas supply concerns – the stock has outperformed KSE100 by 7% since its inclusion in Feb11

Current Conviction Calls



Previous Conviction Calls



Refer: Appendix for complete history on stock prices and index levels on respective dates of inclusion and exclusion

Capital Markets

Muhammad Asad

EVP, Chief Investment Officer (CIO),
Al-Meezan Investment Management

Equity Markets

- *Contrary to widespread expectations, the budget did not announce any relaxations on CGT for small investors*
- *According to Mr. Asad, this is likely to result in disappointment and a possible short term correction in equities – however given the profitability growth and compelling valuations, Pakistan equities should continue to catch up with value in due course*
- *He emphasized that, as seen in the past, regulatory changes do impact sentiments in the short term, but eventually the fundamentals that dictate the long term direction*
- *He is however of the view that market activity and trading volumes are likely to remain on the lower side as speculators and day-traders may opt to stay on the sidelines*

Mutual Funds

- *Increased tax incentives for individuals investing in government securities may hurt the mutual fund industry, particularly the dominant money market/cash fund category*
- *Additionally, elongating the holding period for investing in mutual funds to avail tax benefits is unlikely to be compensated by the announced increase in benefit ceiling*
- *Increased tax benefits for investing in Voluntary Pension Schemes (VPS) should however attract savvy investors into pension fund categories*

Sector impact

- *The budgetary announcements have so far been sector-neutral, however positive sentiments may dictate cement and auto sectors due to cut in regulatory duties and taxes for them*
- *Budget is also likely to have a neutral to positive impact on banking sector for which investors are likely to be relieved by the fact that corporate tax rate has been maintained at 35%*



Economy: Overly ambitious

- The government envisages 4.2% GDP growth for FY12 through extending long awaited development program and inducing investments as the latter has declined to 11.8% of GDP from 13.4% last year
- Budget outlay for FY12 is estimated at PKR3.7trn – up 14% YoY, against total revenue target of PKR2.7trn – up 13% YoY with the government aiming to curtail its fiscal budget deficit to 4% of GDP (PKR850bn after adjusting PKR125bn provincial surplus)
- To address the most critical factor i.e. low tax to GDP, the government vowed to bring 0.7mn tax evaders into the tax net. These measures are expected to yield approximately PKR70bn in FY12
- No incremental direct tax is being levied on existing tax payers, while reduction in GST (100bps for a number of sectors), Federal Excise Duty (FED) and abolishment of Special Excise Duty (SED) is projected to be partially offset by the impact of withdrawal of GST exemption on unregistered segments of five zero-rated sectors. Vide these broad measures, GoP targets a 17% YoY increase in total tax collection to PKR2.1trn for FY12 together with PKR658bn from non-tax revenues (+4% YoY). To meet such an ambitious target, tax collection share from FBR is set at PKR2.0trn (+17% YoY) and proceeds from privatization are targeted at PKR70bn
- Financing the deficit however remains challenging, considering persistent reliance on uncertain gross external loans (up to the tune of PKR344bn). Further, government projects domestic financing to decline to PKR304bn compared to revised target of PKR452bn for FY11
- Once again an overly ambitious allocation for Public Sector Development Program (PSDP) of PKR730bn has been laid out in the budget, out of which PKR430bn is allocated for provinces
- With regards to GST exemption on zero-rated sectors, government has started eliminating the relaxation provided through SROs which is projected to raise PKR30bn
- Total allocation for subsidies has been set at PKR166bn (0.8% of GDP) for FY12 against revised estimate of PKR396bn for FY11. Out of this, subsidy on electricity tariff differential is estimated at PKR75bn compared to PKR284bn for FY11

PKR bn	FY11B.E	FY11 R.B.E	FY12 F.B.E
Total revenue	2,411	2,236	2,732
Tax Revenue	1,779	1,679	2,074
Direct	658	627	744
Indirect	1,121	1,052	1,331
Non tax revenue	632	557	658
FBR revenues	1,667	1,588	1,952
Total expenditures	3,263	3,386	3,707
Current	1,998	2,296	2,315
Interest	699	728	791
Defence	442	445	495
Subsidies	127	396	166
PSDP	663	462	730
Fiscal Deficit	(852)	(1,150)	(975)
Estimated provincial surplus	167	120	125
Fiscal Deficit after provincial surplus	(685)	(1,030)	(850)

Key Ratios

Tax to GDP	10.3%	9.3%	9.9%
FBR tax to GDP	9.7%	8.8%	9.3%
Development exp. To GDP	3.8%	2.6%	3.5%
Debt servicing to GDP	4.0%	4.0%	3.8%
Defence exp. To GDP	2.6%	2.5%	2.4%
Deficit to GDP	-4.0%	-5.7%	-4.0%
External financing to GDP	18.9%	18.7%	17.6%
Domestic financing to GDP	11.6%	12.7%	11.0%

Source: MoF, BMA Research

B.E: Budget Estimates

R.B.E: Revised Budget Estimates

F.B.E: Forecasted Budget Estimates

- While development spending, if disbursed in line with the targets, would help yield positive impact on macro framework, track record reveals that the first brunt of fiscal slippage is absorbed by reduction in PSDP allocation – actual historical disbursements have ranged in the vicinity of 50% of the budgeted amount
- With regards to revenue collection, we remain skeptical on the ability to achieve the targets as 1) no significant measures have been announced to increase direct taxes and 2) imposition of 5% GST on zero-rated sectors is limited to unregistered segments. Further, reduction of GST by 100bps (on a number of sectors) is projected to cost GoP about PKR35bn
- Subsidy elimination has been vowed time and again with PKR166bn being designated under this head for FY12. Though GoP plans to reduce subsidy chiefly on electricity, the current pace of elimination and high int'l crude oil prices may not allow the same
- Based on the above mentioned factors, we consider restricting deficit to GDP at 4% would remain challenging. In addition, as flows from IFIs remain pegged with IMF's endorsement on fiscal discipline, persistent pressure on domestic financing seems to be the likely scenario
- Resultant excessive borrowing from domestic institutions would not only result in crowding out effect but also keep interest rates downward sticky. On the other hand monetization can not be ruled out which may sour GoP's relations with IMF
- For overall economy, we however do eye GDP growth of 4.2% for FY12 - key risks for which stem from lingering circular debt in the system and inflation once again exacerbating beyond 12%

Economy

Dr. Ishrat Hussain

Dean and Director of the Institute of Business Administration (IBA), Karachi
Former Governor, State Bank of Pakistan

Budget direction

- *The expectations from federal budget have traditionally been quite high but we must realize that the degrees of freedom and maneuverability have shrunk substantially for the federal government*
- *Nonetheless, the budget has deviated from the recent past by announcing 1) cut in regulatory duties and indirect taxation, 2) abolishment of incoherent tax exemptions earlier available for a wide variety of activities and 3) focus on direct taxation by bringing in potential taxpayers in the tax net*
- *However, it has lacked an integrated framework where federation can not be seen in isolation with the provinces – as discussed in National Economic Council (NEC), the overall resource envelope and expenditure thrust and sectoral priorities should be determined first and then responsibilities be divided and assigned to federal and provincial governments*
- *There should also have been an explicit declaration of a comprehensive strategy about all public sector enterprises, corporations, autonomous bodies and other entities which are to be restructured, liquidated, wound up, merged, privatized, or retained*

Macro economic numbers

- *Revenue targets announced in the budget are on the ambitious side and may not be met without concrete measures on direct taxation*
- *Given inflexibility in the major expenditure heads i.e. debt servicing, defense and security, the budget deficit target of 4% of GDP is likely to be surpassed, especially if provinces are unable to meet their targeted allocations*
- *The biggest concern is the sharp decline in investment to GDP ratio and thus a resultant risk to growth estimates - the provincial governments should be bound to use the additional resources from the divisible pool towards investment in roads and highways, irrigation systems, rural infrastructure, education, health, water supply, sanitation and urban services*



Sector Outlook

Sector: Banks

Analyst: Omar Rafiq

Sector Stance: MARKETWEIGHT

Budget Impact: Positive

BMA Coverage

	T-Price	C. Price	Pot.Upside	Reco.
MCB	216	200	8%	Add
NBP	54	52	4%	Neutral
HBL	100	117	-14%	Reduce
UBL	70	63	11%	Add
BAFL	12	10	16%	Buy

Valuations

	EPS	P/E	PBV	Div. Yield
MCB	23.3	8.6x	1.9x	7%
NBP	8.9	5.9x	0.7x	11%
HBL	16.9	6.9x	1.3x	7%
UBL	12.3	5.1x	1.0x	8%
BAFL	2.4	4.2x	0.5x	10%

Key Budgetary Measures

- Finance Bill has allowed banks to carry over provisioning on NPLs of up to 1% on total advances and 5% on total advances for consumers and SMEs (Small and Medium Enterprises) to succeeding years as a tax deductible expense
- 10% WHT (Withholding Tax) for individuals investing in government securities made full and final tax liability
- Tax rate enhanced from 10% to 20% for banks on dividend income derived from Asset Management Companies (AMCs)
- GoP has projected dividends of PKR10/share from NBP, PKR4/share from ABL, PKR5/share from UBL

Impact

- Allowing carry forward of provisioning as tax expense clarifies the discrepancy created by Fiscal Budget FY10-11 where upper limit of allowable expense was enhanced on consumer and SME segments but was kept unchanged when carrying forward to succeeding years. Impact of the above measure will be Neutral for our Banking Universe, however smaller banks with high infection in consumer and SME segments are likely to see an ease in their tax expense – key beneficiaries: NIB, Summit and Silk Bank
- All of our coverage banks have investment stakes in their respective AMCs, however given their minimal contribution to consolidated profitability, increased taxation on dividend income on AMCs is unlikely to materially impact our projections
- Announced tax incentives for investment in government securities are limited to individuals and foreigners – given the size of the overall banking deposits, any shift will be minimal
- Dividend projections for NBP are unlikely to be met

Outlook

- Contrary to market fears, corporate tax rate has been maintained at 35% for the sector which should allow the key scrips to catch up to the recent underperformance; we highlight MCB and UBL as the top bets

Sector: Banks

Chief Financial Officer

Large local commercial bank

- *According to our discussions, the budget announcement has clarified disparity between total tax deductible expense allowance for provisioning expense (on NPLs) and the amount that was allowed to be carried forward to succeeding years (details on the announcement discussed in the previous slide); this is not however a surprise as proposals regarding the same were already under discussion with regulatory bodies*
- *The big 5 banks are unlikely to find any significant reprieve from the decision as their SME and Consumer infection ratios remain firmly under control*
- *Smaller banks with high infection ratios (NPL to Advances) are however expected to benefit modestly from the decision whereby their financial health and cash flow position is anticipated to improve (albeit moderately)*
- *Our discussions also confirmed that increase in dividend tax on payouts of Asset Management Companies (AMC) is not likely to have material impact on the core earnings as the head contributes only marginally to the overall profitability*
- *It was however still uncertain whether the tax covers only subsidiary/associated AMCs or the measure implies to a more general category (any listed AMC)*

Sector: Construction & Mater.

Analyst: Sana I. Bawani

Sector Stance: MARKETWEIGHT

Budget Impact: Positive

BMA Coverage

	T-Price	C. Price	Pot.Upside	Reco.
LUCK	87	75	16%	Buy
DGKC	41	25	66%	Buy
ACPL	82	55	50%	Buy

Valuations

	EPS	P/E	PBV	Div. Yield
LUCK	11.6	6.5x	0.9x	7%
DGKC	1.1	22.0x	0.4x	0%
ACPL	8.0	6.8x	0.8x	9%

Key Budgetary Measures

- FED on local cement sales has been cut by PKR200/ton (PKR10/bag) to PKR500/ton which would be gradually phased out by FY14 while FED on white cement has been completely withdrawn
- Reduction in GST by 1% and removal of SED (2.5%) combined with FED reduction should lead to a drop of approximately PKR400/ton (~PKR20/bag) in cement prices
- PSDP has been set at PKR730bn for FY12 (PKR430bn allocated for provinces with the rest for federal development initiatives). FED on services provided by property developers or promoters has been reduced to promote housing and construction

Impact

- Our earlier projections of a 10% rise in retention prices remain intact owing to the fact that cement manufacturers now have greater leeway to increase their margins while passing on some of the benefit to the end consumers. Therefore, our projections remain unchanged for BMA Cement Universe
- On the flip side, non-essential purchases of cement would likely be deferred to post Jun11 on expected lower prices leading to a drop in Jun11 sales and a pickup in Jul11
- While aggressive allocations have been made wrt PSDP, we do not pin our hopes on the same as funding is partially attached to foreign assistance which may experience volatility as witnessed in the past

Outlook

- We eye 5% YoY growth in domestic cement offtakes to 23mn tons for FY12 after an expected decline of 7% YoY to 22mn tons in FY11. Post-flood reconstruction activities would provide impetus to local demand while cost efficiencies derived from Waste Heat Recovery (WHR) and Refused Derived Fuel (RDF) would improve margins going forward.
- Our DCF based Dec11 TPs for LUCK and DGKC stand at PKR87 and PKR41 respectively. BUY!

Sector: Construction & Mater.

Mr. Irfan Amanullah

General Manager (F & C) & Company Sec.
Attock Cement Pakistan Ltd.

- *A detailed discussion with Mr. Irfan Amaullah on the budgetary measures revealed that reduction in FED and GST and abolishment of SED would likely bring down cement prices from Jul11 onwards.*
- *However, imposition of 16% GST on cement blocks and bricks (previously zero-rated) acts as a counter-productive measure for the end consumers. This is because any architecture is primarily made up of blocks and bricks while cement only forms a small portion of the total input. Therefore, imposition of GST on blocks and bricks eventually raises the cost of construction and reduction in cement prices following a reduction in taxes is not passed on in the chain.*
- *Mr. Amanullah was also concerned with the high duty on shredded rubber scrap which could be used as a cheaper fuel in place of the expensive coal. Duty on the same was proposed to be reduced in Budget FY12 by the industry players with an aim to reduce the production costs but unfortunately, it did not come through.*
- *Furthermore, he was also of the opinion that freight subsidy should have been announced for the cement sector so as to promote exports but nothing was announced in this regard.*

Sector: Automobile & Parts

Analyst: Sana I. Bawani

Sector Stance: UNDERWEIGHT

Budget Impact: Positive

BMA Coverage

	T-Price	C. Price	Pot.Upside	Reco.
INDU	212	222	-4%	Neutral
PSMC	70	67	5%	Add

Valuations

	EPS	P/E	PBV	Div. Yield
INDU	23.8	9.3x	1.3x	5%
PSMC	4.0	16.8x	0.4x	2%

Key Budgetary Measures

- Status quo was maintained on custom duties on hi-tech parts (32.5%), CKD (32.5%) and localized parts (50%) against Auto Industry Development Plan (AIDP) proposals. Similarly, existing duty structure on import of CBU's remains intact. However, zero rating of sales tax has been removed on CNG buses (CBU and CKD), trucks and dumpers (exceeding 5 tons), trailers and road tractors
- GST has been slashed by 1% and SED (2.5%) completely eliminated
- Sales tax exemption on CNG kits, cylinders and valves for CNG kits, and reclaimed lead stands removed
- Minimum tax of 0.5% on gross annual turnover allowed to be carried forward to 5 years from 3 years earlier
- PKR2bn allocated for Benazir Tractor Support Program

Impact

- Car prices would decline by 3.5% w.e.f July 01, 2011 following the reduction in GST (1%) and removal of SED (2.5%). We believe it would lead to marginally higher sales in FY12 however it would discourage car purchases in Jun11 with buyers waiting for Jul11 leading to lower level of advances and hence, other income for both INDU and PSMC for 4QFY11
- Minimum turnover tax hit Pak Suzuki (PSMC) in CY10 however our projections of rebound in its profitability reflect that extension of time period for carry forward of losses will not impact the company

Outlook

- Budget FY12 sets a positive direction for the domestic auto industry as we maintain our sales growth forecast of 5% to 154k units in FY12. Additionally, an enhanced product portfolio of INDU combined with greater demand from the rural regions following the wheat harvest season would lead to higher sales for the company in FY12.
- However given limited upside to our target prices, we maintain an Underweight stance on the sector

Sector: Oil Marketing Cos.

Analyst: Muhammad Ali Taufiq

Sector Stance: OVERWEIGHT

Budget Impact: NEUTRAL

BMA Coverage

	T-Price	C. Price	Pot.Upside	Reco.
PSO	380	290	31%	Buy
APL	460	385	19%	Buy
SHEL	213	228	-7%	Reduce

Valuations

	EPS	P/E	PBV	Div. Yield
PSO	65.8	4.4x	1.3x	3%
APL	53.8	7.2x	2.4x	6%
SHEL	28.0	8.2x	1.7x	11%

Key Budgetary Measures

- Turnover tax of 0.5% is to be allowed to be carried forward and adjusted against tax liability for 5 years compared to 3 years earlier
- Government has disclosed its FY12 dividend expectation from PSO of PKR385mn (DPS: PKR10) which is in-line with our expectations of dividend from the company over the same period
- Government has also targeted PKR120bn revenues as Petroleum Levy over FY12, which seems to be an achievable target

Impact

- Increasing time frame for carry forwarding turnover tax from 3 to 5 years will not impact OMCs in the current environment, however it will allow for tax benefits in case there is a substantial decline in earnings due to inventory losses
- There were no measures taken to address inter-corporate circular debt in the energy chain, which is likely to remain a cause of concern for OMC giant, PSO

Outlook

- We maintain our Overweight stance on the sector. OMCs are expected to benefit from rising POL sales where PSO stands out as the biggest beneficiary of increasing fuel requirement of the power sector while post flood infrastructure rebuilding activity will continue and keep demand of Asphalt on the higher side benefiting Attock Petroleum (APL) the most in this case
- However, lingering circular debt will continue to keep liquidity in the energy chain at critical levels – thus highlighting APL as the best bet from the sector

Sector: Electricity

Analyst: Nurali Barkatali

Sector Stance: OVERWEIGHT

Budget Impact: Neutral

BMA Coverage

	T-Price	C. Price	Pot.Upside	Reco.
HUBC	43	38	14%	Add
KAPCO	49	43	13%	Add

Valuations

	EPS	P/E	PBV	Div. Yield
HUBC	5.1	7.5x	1.5x	13%
KAPCO	7.4	5.9x	1.6x	14%

Key Budgetary Measures

- Subsidy on account of electricity tariff differential (ETD) is set at PKR75bn for FY12 against revised target of PKR284bn in FY11

Impact

- The budgetary announcements will have no direct impact on Independent Power Producers (IPPs) as their profitability (IRR) is assured by way sovereign guarantee
- However in the absence of announcement on any remedial measures for reducing the circular debt, the problem is to persist in the system. Further, as seen in previous years, actual subsidy on ETD is likely to be higher than the budgeted amount – which is likely to exacerbate cash flow position for the sector
- We anticipate that IPPs will be forced to rely on short-term borrowing, a measure which is likely to trim their bottom-line especially under prevailing tight monetary environment

Outlook

- The government recently injected PKR120bn to address the circular debt issue; nonetheless in the absence of structural reforms, circular debt is likely to resurge
- We have an ADD stance on both the IPP stocks under our coverage; however we prefer HUBC as it has remained immune to circular debt woes, while inherent growth story on the back of expansion through Narowal and Laraib projects keep the room open for further upside

Sector: Electricity

Ruhail Mohammed

Chief Financial Officer
Engro Corporation
(parent company of Engro Power Gen)

Circular debt

- *The federal budget did not lay out any concrete steps required to address circular debt in the energy chain*
- *As per Mr. Mohammed, the issue is not the current outstanding amount which can be resolved by one-time injection in the system but the ongoing subsidies in the power sector. He was of the opinion that if current extent of subsidies were continued, circular debt could potentially become a recurring phenomenon*
- *Another industry expert showed his disappointment on the budget as it failed to address the lingering circular debt issue, which if addressed efficiently can increase utilization of existing power projects and curtail overall energy deficit in the country*

Sector: Fertilizer

Analyst: Omar Rafiq

Sector Stance: OVERWEIGHT

Budget Impact: Neutral

BMA Coverage

	T-Price	C. Price	Pot.Upside	Reco.
FFC	164	141	16%	Buy
ENGRO	228	192	19%	Buy
FFBL	40	43	-8%	Reduce
DAWH	92	63	45%	Buy

Valuations

	EPS	P/E	PBV	Div. Yield
FFC	18.7	7.5x	6.9x	13%
ENGRO	26.6	7.2x	1.9x	3%
FFBL	6.5	6.6x	3.8x	15%
DAWH	10.9	5.8x	1.1x	2%

Key Budgetary Measures

- GST on fertilizer sales stands reduced to 16% compared to 17% earlier
- Agriculture remained the sacred cow for the government and no material change was announced in its tax regime

Impact

- Decrease in GST for the sector is likely to be a pass through to farmers; we anticipate core-profitability estimates for listed companies to remain intact
- Furthermore, no intent to reduce indirect gas subsidy was specified - which indicates that the untargeted subsidy is likely to continue for the sector
- Contrary to expectations, initial suggestions regarding 10% Levy on gas consumption was not imposed in the budget

Outlook

- We remain bullish on the sector given that fertilizer demand will out-pace supply as a result of production constraints while farm profitability is expected to remain strong
- Urea manufacturers, especially Fauji Fertilizer Company (FFC) continues to be our favored pick from the sector and continues to form part of our High Conviction ideas
- Rationalization of gas allocation to the sector however remains a key trigger for the sector

Sector: Fertilizer (& FMCG)

Ruhail Mohammed

Chief Financial Officer
Engro Corporation
(parent company of Engro Fertilizer and
Engro Foods)

- *Mr. Ruhail Mohammed expressed that reduction in GST to 16% is unlikely to cause any significant change in the fertilizer sector dynamics. The tax was already imposed in Mar11 (at 17%) which has been passed through to the farmers.*
- *Mr. Mohammed felt that the budget should have touched upon gas allocation and pricing rationalization whereby inefficient utilization of the scarce natural resource should have been addressed*
- *Fuel price disparity (between conventional fuel oils and natural gas) has consistently resulted in diversion of gas from the fertilizer sector, thereby creating economic costs far greater than direct costs for the sector*
- *He was pleased that government maintained GST exempt status for packaged milk, thereby not disturbing the dynamics of the sector (it is next to impossible to tax loose milk sales, due to lack of documentation). He was of the opinion that the government should ensure not to disturb a level playing field for near perfect substitutes*

Sector: Oil & Gas Exploration

Analyst: Muhammad Ali Taufiq

Sector Stance: MARKETWEIGHT

Budget Impact: NEUTRAL

BMA Coverage

	T-Price	C. Price	Pot.Upside	Reco.
PPL	239	214	12%	Add
POL	360	337	7%	Add

Valuations

	EPS	P/E	PBV	Div. Yield
PPL	28.7	7.5x	2.5x	5%
POL	44.0	7.7x	2.6x	8%

Key Budgetary Measures

- Government has disclosed its FY12 dividend expectations from OGDC and PPL of PKR25bn (DPS: PKR7.7) and PKR8.4bn (DPS: PKR10.1) respectively, which do not deviate much from our expectations
- Complete custom duty exemption has been granted on imports of well-head and integral components compared to an exemption of customs duty in excess of 15% ad valorem earlier

Impact

- CAPEX is usually capitalized and later depreciated over useful life of the asset. Custom duties exemption on E&P equipments will have little impact on CAPEX amounts and thus its depreciation is not likely to change our projections
- 100% tax credit offered on 100% equity financed CAPEX if applicable on E&Ps may also encourage exploration and development efforts taken by the companies

Outlook

- Upside risks related to more discoveries of additional fields in TAL and Nashpa blocks and increase in oil and gas production from Sinjoro and KPD blocks exist for the E&P sector
- PPL is expected to perform well going forward due to its guaranteed rise in well-head gas prices applicable over its 1HFY12 gas production. On the other hand, POL is to continue to benefit from double-digit volumetric growth from TAL Block

Sector: Textile

Analyst: Sana I. Bawani

Sector Stance: MARKETWEIGHT

Budget Impact: Neutral

BMA Coverage

	T-Price	C. Price	Pot.Upside	Reco.
NML	75	59	26%	Buy
NCL	28	26	8%	Add

Valuations

	EPS	P/E	PBV	Div. Yield
NML	11.9	5.0x	0.6x	4%
NCL	10.6	2.4x	0.7x	9%

Key Budgetary Measures

- GST at 5% stands imposed on the local textile sales; 6% tax on yarn and 4% on fabrics was imposed on unregistered manufacturers in Mar11 which was previously zero-rated. However, applicability of the same still remains unclear with regards to registered / unregistered entities and the segments on which it has been imposed
- Tax credit equal to 100% of tax payable on investments in new undertakings or BMR projects financed through 100% equity

Impact

- GST on unregistered textile manufacturers will not impact major leading players including Nishat Mills (NML) and Nishat Chunian (NCL) as they primarily deal with registered companies
- However, if GST at 5% on local sales of these companies is imposed it will be passed on to the end consumers and will therefore not affect their profitability. Furthermore, both NML and NCL are export-oriented and derive only 20-25% of their revenues through local sales

Outlook

- Recent recovery in cotton prices on the back of floods in the US have led to local prices also staying firm at PKR8,500/maund. Similarly, yarn prices have also followed suit and are on their way upwards, which is expected to benefit the spinners in the next quarter. Textile players are also optimistic on the export front where their end product prices have been revised upwards to match the rising cotton trend back in Mar11. However, energy shortage in the country continues to act as a hindrance to profitability and growth.
- NML and NCL are currently trading at FY12E PER of 4.7x and 5.3x respectively and we believe the companies would post strong earnings in FY12 on the back of core profitability as well as investment income

Sector: Textile

Mr. Shaukat Elahi

Managing Director
Nagina Group and member companies

- *Mr. Shaukat Elahi, Chairman, Nagina Group, considers Budget FY12 a non-event for the textile industry as it did not bring any new incentives for the sector. Furthermore, he was also of the view that the GST imposition announcement on textile and removal of zero-rating facility remains unclear with regards to its applicability.*
- *Mr. Elahi appreciated tax credit incentive on industrial undertakings and BMR projects with 100% equity financing and agreed that it should promote investment going forward. However, the budget failed to address load shedding and energy shortages prevailing in the country which hampers production efficiency of the industry and hence, its export potential.*
- *With regards to steps taken for the promotion of the capital market, Mr. Elahi valued the tax incentives given to IPOs which would encourage new listings at the bourse and bring capital flows into the country.*
- *Another leading textile industrialist also termed investment tax credit on industrial undertakings and BMR projects as a huge benefit for the sector in terms of promoting investment and expansion in the industry*

Sector: Refineries

Analyst: Muhammad Ali Taufiq

Sector Stance: UNDERWEIGHT

Budget Impact: NEUTRAL

BMA Coverage

	T-Price	C. Price	Pot.Upside	Reco.
NRL	417	378	10%	Add
ATRL	117	140	-16%	Sell

Valuations

	EPS	P/E	PBV	Div. Yield
NRL	88.2	4.3x	1.2x	9%
ATRL	31.5	4.4x	0.9x	4%

Key Budgetary Measures

- Turnover tax of 0.5% is to be allowed to be carried forward and adjusted against tax liability for 5 years compared to 3 years earlier
- Government has offered 100% tax credit for the next 5 years as an incentive for 100% equity investment in industrial undertaking commencing after July 2011. This includes new manufacturing facility and purchase and installation of machinery for the purpose of BMR (balancing, modernization and replacement) of plant and machinery already installed therein

Impact

- Increasing time frame for carry forwarding turnover tax from 3 to 5 years will not impact refineries in the current environment, however it will allow for tax benefits in case there is a substantial decline in earnings due to drop in GRMs – highlighting Attock Refinery (ATRL) as a beneficiary
- 100% tax credit offered on 100% equity financed CAPEX will encourage refineries in expanding their capacities and up-gradation of their current installation. Further, under current strong GRM scenario and cash balances, refineries may also take advantage of this opportunity to set up or expand their lube refining operations

Outlook

- Budget has been non-eventful for the sector but regulatory risks related to reduction in deemed duty on HSD still persist. Hence we continue to maintain our Underweight stance on the sector



Appendix

BUDGET REVIEW 2011-12

BMA Universe

Sector	Company Name	Ticker	TP	Price	Upside/	Rec	USD mn	P/E (x)		EPS (PKR/sh)		EPS Growth (%)		Div Yield (%)		BVPS (PKR/sh)		
			Dec-11	3-Jun	Downside			2011F	2012F	2011F	2012F	2011F	2012F	2011F	2012F	2011F	2012F	
1	Banks	MCB Bank	MCB	216	200	8%	ADD	1,947	8.6x	7.6x	23.3	26.4	16%	13%	7%	8%	105.6	117.4
2	Banks	National Bank	NBP	54	52	4%	NEUTRAL	1,023	5.9x	4.8x	8.9	10.8	-15%	22%	11%	13%	79.5	85.9
3	Banks	Habib Bank	HBL	100	117	-14%	REDUCE	1,499	6.9x	6.4x	16.9	18.3	19%	9%	7%	9%	92.2	102.3
4	Banks	United Bank	UBL	70	63	11%	ADD	897	5.1x	4.5x	12.3	13.9	35%	13%	8%	10%	64.2	73.1
5	Banks	Bank Alfalah	BAFL	12	10	16%	BUY	160	4.2x	3.6x	2.4	2.8	235%	16%	10%	11%	18.9	21.0
6	Oil and Gas	Oil & Gas Dev Co *	OGDC	147				7,707										
7	Oil and Gas	Pakistan Petroleum	PPL	239	214	12%	ADD	2,968	7.5x	6.2x	28.7	34.4	47%	20%	5.4%	7%	84.7	102.3
8	Oil and Gas	Pakistan Oil Fields	POL	360	337	7%	ADD	927	7.7x	6.5x	44.0	51.5	40%	17%	8.3%	11%	131.7	145.0
9	Oil and Gas	Pakistan State Oil	PSO	380	290	31%	BUY	579	4.4x	4.0x	65.8	72.9	25%	11%	3%	2%	228.8	291.7
10	Oil and Gas	Attock Petroleum	APL	460	385	19%	BUY	310	7.2x	6.5x	53.8	59.6	4%	11%	6%	6%	157.5	192.1
11	Oil and Gas	National Refinery	NRL	417	378	10%	ADD	351	4.3x	4.7x	88.2	80.6	115%	-9%	5.3%	9%	313.8	359.4
12	Oil and Gas	Attock Refinery	ATRL	117	140	-16%	SELL	139	4.4x	6.0x	31.5	23.5	2023%	-25%	3.6%	4%	162.9	181.4
13	Oil and Gas	Shell Pakistan	SHEL	213	228	-7%	REDUCE	182	8.2x	6.2x	28.0	36.9	79%	32%	11.0%	13%	134.3	156.2
14	Electricity	Hub Power	HUBC	43	38	14%	ADD	507	7.5x	5.9x	5.1	6.4	5%	27%	13%	14%	25.9	26.4
15	Electricity	Kot Addu Power	KAPCO	49	43	13%	ADD	445	5.9x	5.6x	7.4	7.7	28%	4%	14%	15%	27.0	27.8
16	Fixed Line Telecommunic	Pakistan Telecom	PTC	25	18	42%	BUY	770	8.7x	7.4x	2.0	2.4	-18%	16%	8%	9%	26.5	26.7
17	Chemicals	Fauji Fertilizer	FFC	164	141	16%	BUY	1,395	7.5x	7.1x	18.7	20.0	44%	7%	13%	14%	20.6	21.7
18	Chemicals	Engro Corporation	ENGRO	228	192	19%	BUY	878	7.2x	5.8x	26.6	32.9	54%	24%	3%	5%	103.2	129.6
19	Chemicals	Fauji Fert Bin Qasim	FFBL	40	43	-8%	REDUCE	471	6.6x	7.4x	6.5	5.8	-6%	-11%	15%	13%	11.3	11.4
20	Chemicals	Dawood Hercules	DAWH	92	63	45%	BUY	355	5.8x	4.5x	10.9	14.0	62%	28%	2%	2%	58.5	71.5
21	Chemicals	ICI Pakistan	ICI	175	158	11%	ADD	256	8.1x	7.3x	19.5	21.6	11%	11%	8%	8%	121.8	126.2
22	Chemicals	Lotte PTA	LOTPTA	19	15	27%	BUY	264	3.9x	4.3x	3.8	3.5	29%	-10%	4%	3%	10.2	13.7
23	Construction and Materials	Lucky Cement	LUCK	87	75	16%	BUY	281	6.5x	5.7x	11.6	13.2	19%	14%	7%	7%	84.2	92.4
24	Construction and Materials	DG Khan Cement	DGKC	41	25	66%	BUY	126	22.0x	11.7x	1.1	2.1	111%	87%	0%	0%	62.4	64.5
25	Construction and Materials	Attock Cement	ACPL	82	55	50%	BUY	55	6.8x	4.9x	8.0	11.2	-31%	40%	9%	9%	68.0	74.7
26	Automobile and Parts	Indus Motors	INDU	212	222	-4%	NEUTRAL	203	9.3x	6.8x	23.8	32.5	-46%	37%	5%	6%	168.9	191.5
27	Automobile and Parts	Pak Suzuki Motor	PSMC	70	67	5%	ADD	64	16.8x	13.2x	4.0	5.0	55%	27%	2%	1%	182.2	186.6
28	Personal Goods	Nishat Mills	NML	75	59	26%	BUY	243	5.0x	4.7x	11.9	12.8	44%	7%	4%	4%	105.7	116.0
29	Personal Goods	Nishat Chunian	NCL	28	26	8%	ADD	49	2.4x	5.3x	10.6	4.8	85%	-55%	9%	5%	36.2	38.4
30	General Industrials	Packages	PKGS	215	111	94%	BUY	109	19.8x	9.7x	5.6	11.4	NM	104%	5%	9%	281.2	292.6
31	Media	Hum TV . Network	HUMNL	27	17	61%	BUY	10	3.7x	3.3x	4.5	5.1	10%	12%	11%	12%	19.5	22.5
32	Non Life Insurance	Adamjee Insurance	AICL	87	67	30%	BUY	96	6.0x	5.8x	11.2	11.5	155%	3%	4%	4%	96.5	104.7
33	Non Life Insurance	Pak Reinsurance Ltd.	PAKRI	19	17	12%	ADD	60	5.7x	5.5x	3.0	3.1	71%	4%	12%	17%	20.3	21.4
34	Industrial Transportatio	Pakistan Int. Cont. Terminal	PICT	114	90	27%	BUY	114	7.7x	6.5x	11.6	13.8	42%	19%	2%	2%	44.1	55.9
Universe								25,440	7.4x	6.7x			24%	11%	7%	7%		

Economic indicators

GDP growth	%			
Agriculture	%			
Manufacturing (LSM)	%			
Services	%			

	FY08A	FY09A	FY10A	FY11P
	3.7	1.2	4.1	2.4
	1.0	4.0	2.0	1.2
	4.8	(3.7)	5.2	3.0
	6.0	1.6	4.6	3.5

External Account

		10MFY11	10MFY10	YoY
Trade balance	USD mn	(8,285)	(9,292)	-11%
Exports	USD mn	20,526	16,167	27%
Imports	USD mn	28,811	25,459	13%
Remittances	USD mn	9,046	7,307	24%
Current account	USD mn	748	(3,456)	
FDI	USD mn	1,232	1,775	-31%
Overall balances	USD mn	1,210	730	66%
Trade balance as % of GDP				
Current account as % of GDP				

	(14,970)	(12,627)	(11,377)	(11,171)
	20,427	19,121	19,636	23,563
	35,397	31,747	31,055	34,735
	6,451	7,811	8,906	11,043
	(13,874)	(9,261)	(3,495)	(1,040)
	5,410	3,720	2,201	1,383
	(5,290)	(3,002)	1,266	1,459
	(9.0)	(7.6)	(6.4)	(5.4)
	(8.3)	(5.6)	(2.0)	(0.5)

Fiscal Account *

		3QFY11	3QFY10	YoY
Total Revenue	PKR bn	1,495	1,402	7%
Tax Collection	PKR bn	1,118	1,015	10%
Current expenditures	PKR bn	1,910	1,660	15%
Development expenditures	PKR bn	353	364	-3%
Fiscal deficit	PKR bn	783	626	25%
Tax Collection as % of GDP		6.2	6.8	
Budget deficit as % of GDP		4.3	4.2	

	1,499	1,851	2,078	2,236
	1,051	1,312	1,473	1,588
	1,853	2,042	2,354	2,296
	452	480	653	462
	777	680	929	1,030
	10.0	10.0	9.9	8.8
	7.4	5.2	6.3	5.7

USD Reserves

		Apr-11	Mar-11	MoM
SBP reserves	USD mn	13,704	14,290	-4%
Banks' reserves	USD mn	3,342	3,311	1%
Total foreign reserves		17,045	17,601	-3%
Reserves in months of imports		4.7	5.5	
PKR/USD (Period Avg.)		84.7	85.4	-0.8%

	8,577	9,177	12,951	
	2,822	3,307	3,816	
	11,399	12,484	16,767	16,800
	3.9	4.7	6.5	5.8
	62.6	78.7	83.8	85.5

Interest Rates ~

		May-11	Apr-11	MoM bps
SBP discount rate	%	14.00	14.00	-
6M KIBOR	%	13.52	13.61	(0.09)
12M T-bills	%	13.77	13.81	(0.04)
10yr. PIB	%	14.10	14.10	-

	12.00	14.00	12.50	14.00
	14.19	12.76	12.37	13.67
	11.79	12.15	12.38	13.90
	13.42	11.99	12.84	14.10

Price Indices

		May-11	Apr-11	MoM bps
CPI	%	13.23	13.04	0.2
SPI	%	15.40	16.10	(0.7)
WPI	%	22.90	25.90	(3.0)

	12.0	20.8	11.7	14.0 - 14.3
	14.2	22.7	13.2	
	16.4	18.2	12.6	

* Budgeted expected for FY10 & 11

~ Monthly average, Jun-end for annual numbers

^ Stock at period end

Current Calls

Scripts	Inclusion		C. Price	Performance	
	Date	Price		Absolute	Relative
FFC	5-Jan-11	98.2	141.5	44%	43%
APL	3-Sep-10	235.3	385.4	64%	38%

Previous Calls

Scripts	Inclusion		Removal		Performance	
	Date	Price	Date	Price	Absolute	Relative
ENGRO	17-Feb-11	177.7	3-Jun-11	192.0	8%	7%
POL	4-Oct-10	211.3	27-Jan-11	318.2	51%	26%
FFBL	12-Jul-10	23.5	22-Dec-10	33.5	43%	24%
MCB	7-Jun-10	164.0	13-Oct-10	168.4	3%	-4%
LUCK	8-Mar-10	69.5	18-Jan-11	77.2	11%	-21%
ACPL	15-Jan-10	53.6	13-Oct-10	60.8	13%	8%
PPL	15-Jan-10	153.8	1-Oct-10	168.3	9%	7%
MCB	9-Dec-09	153.0	15-Jan-10	172.3	13%	2%
DGKC	26-Nov-09	25.5	15-Jan-10	30.1	18%	11%
FFBL	13-Oct-09	18.2	9-Dec-09	18.9	4%	12%
POL	1-Jul-09	121.1	15-Jan-10	214.3	77%	40%
OGDC	1-Jul-09	73.1	12-Nov-09	96.6	32%	8%
LUCK	1-Jul-09	52.7	7-Aug-09	69.2	31%	22%
PSO	5-May-09	183.9	27-Aug-10	228.6	24%	-11%
HUBC	10-Apr-09	17.5	24-Jun-10	28.0	61%	27%

CGT Rate Slabs	2010	2011	2012	2013	2014	2015	2016
Less than 6 months	10.0%	10.0%	12.5%	15.0%	17.5%	17.5%	17.5%
6 to 12 months	7.5%	8.0%	8.5%	9.0%	9.5%	10.0%	10.0%
Over 12 months	Nil	Nil	Nil	Nil	Nil	Nil	Nil

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ANALYST CERTIFICATION

We, Hamad Aslam, Nurali Barkatali, Sana I. Bawani, Omar Rafiq and Ali Taufiq, hereby certify that this report represents our personal opinions and analysis of information. All views are accurately expressed to the best of our knowledge. We certify that no part of our remuneration is linked either directly or indirectly to recommendations or analysis covered in this report.

	Scope	Contact No.	Email
Hamad Aslam, CFA	Group Head, Institutional Equity Sales	+9221 32464693	haslam@bmacapital.com
Research Team			
Nurali Barkatali	Economy, Electricity	+9221 111 262 111 Ext. 2056	nurali.barkatali@bmacapital.com
Sana. I. Bawani	Automobile, Textile, Cements	+9221 111 262 111 Ext. 2063	sana.iqbal@bmacapital.com
Omar Rafiq	Fertilizer, Banks	+9221 111 262 111 Ext. 2054	omar.rafiq@bmacapital.com
M. Ali Taufiq	OMC, Refinery, E&P, Insurance	+9221 111 262 111 Ext. 2064	ali.taufiq@bmacapital.com
Samina Sher Ali Kanji	Database Incharge	+9221 111 262 111 Ext. 2061	skanji@bmacapital.com
Naseem Akhtar Khattak	Layout & Product Distribution	+9221 111 262 111 Ext. 2060	nakhtar@bmacapital.com
Institutional Sales Team			
Omar Beg Chaghtai	Head of International Sales	+9221 3244465-67	omair.chaghtai@bmacapital.com
Gohar Rasool	International Sales	+9221 3244465-67	gohar.rasool@bmacapital.com
Azher Ali Shahzad	Domestic Sales	+9221 3244465-67	ashezad@bmacapital.com
Junaid Godil	Domestic Sales	+9221 3244465-67	jsgodil@bmacapital.com
Syed Imran Rizvi	Domestic Sales	+9221 3244465-67	Imran.rizvi@bmacapital.com
Usman Ali	Domestic Sales	+9221 3244465-67	usman.ali@bmacapital.com