KSE100 Closing 9,575 (-62 points)

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Pakistan Research
Market| Strategy

Pakistan market fault lines

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Synopsis – see original readings of the market

Pakistan's benchmark KSE – 100 did gain 33.7% during concluded FY10 but what market analysts failed to identify was actual gains from blue chip laden KSE – 30 which increased by 24% of which Oil and Gas Develop. Corp. (OGDC) increased uncharacteristically by 80% (remember top 10 scripts that gained in relation to KSE – 100 were either third tier or illiquid stocks except OGDC & FFBL, the only main board items).

The point is that index gain was minimal and why not, if let us say, heavy weighted scripts such as OGDC, stated to be cornered or driven by one foreign fund, is set aside then gains of the market wouldn't actually be there or truly non-meaningful (for arguments sake index level could have been hovering somewhere around 7500 – 7800).

According to all consensus estimates of the market, OGDC yielded FY10PE multiple of 10x – 10.5x (10.5x is as per our ***scstrade*** stock screening search engine) and hence cannot be described as a top pick or driver of equities from investors perspective even for FY11 earnings growth and it is being wrongly perceived by any brand of foreign investor who gives sugar coated sentiment of foreign inflow. Imagine OGDC's 3 – year median PE incl. of FY10 is 9.1x, as against small but attractive peer Pakistan Oilfield's (POL) 3 – year median PE of 6.7x.

www.scstrade.com *Index vs Stocks*

FY10 outperformers vs KSE 100		*FY10 underperformers vs KSE 100*	
KSE gained	*33.7%*		
TRG Pakistan	198%	KASB Bank	59%
Lotte Pakistan Ltd	193%	Pak Reinsurance	52%
Indus Motors	143%	Azgard9	52%
Colgate Palmolive	109%	Pak Elektron	51%
Unilever	99%	Engro Polymer	48%
Oil and Gas Develop.	80%	Jahangir Siddiqui & Co	46%
Millat Tractors	72%	EFU General Insurance	45.5%
Pakistan Cables	54.5%	Attock Refinery	38.5%
Allied Bank	48%	NIB Bank	37.4%
Fauji Fertilizer Bin Qasim	45%	Pace Pakistan	36.4%

Perhaps, foreign investors are more engrossed with OGDC's EV/EBITDA of 3.5x which does not represent complete picture given host of issues that envelopes that government managed company dogged with controversies and mismanagement.

KSE Stats (scstrade search engine)

Market Cap USD	31.60 bn
KSE - 100	
FY10E P/E	9.7x
FY09A P/E	12.2x
Avg. Vol 52 week	1.35 mn
KSE - 30	
FY10E P/E	8.2x
FY09A P/E	10.3x
Avg. Vol 52 week	3.0 mn

Source: SCS Trade website

Market lacks genuine triggers

Couple of years ago, banks too became one of the largest capitalized among Pakistani scripts (around 32% of market capitalization against OGDC's 23%) and thus one of the drivers of the benchmark index due to better economic indicators 'painted' by former technocrat 'spin' doctors. But they are no more drivers due to economic downturn (or perhaps weak bases of real economy) and *International Monetary Fund* (IMF) dictated financial system where prospect of growth is not forthcoming given host of anomalies such as weak administrative controls yielding hyper-inflation, soaring interest rates (lending rates as high as 15%), regressive tax system, unprofitable public sector entities and above all awful law & order. Therefore, banks are thus laggards in terms of advances (negative growth in big banks) or let us say earnings growth and hence their market prices also aptly show underperformance.

In all honesty, Pakistan market is devoid of 'great' triggers where local funds are gasping to either liquidate equity holdings or continue loosing NAVs (most of the closed-ended funds yield lowly PE multiple of 1x as per ***scstrade*** stock screening search, yet not performing vis-à-vis market indices). The strategy of following a big foreign fund amid not following country's inherent realities seemed flawed (remember foreign investors were on a losing side in late nineties and also during market suspension days of 2008).

Few achievements with long term connotations: existence of fault lines

It is indeed agreed that military victory against terrorist in North Waziristan and Swat by Pakistan Army has given a new lease of life to the nation which is so very important for statehood. However, civil administration is taking a lot more time to convert this victory into economic gains. Pakistan is still dogged with terror strife and hence civil administration is focused towards law & order and not economic indicators. This indeed is the reason behind poor capital flows or pace of liberalization. This also adds to peoples vow because lack of avenues for future growth. Moreover, despite commissioning rental power as stop gap arrangement, rampant power shortages eating away true growth and would continue to do so in next 2 years.

Government is stated to have done few good things for long term, for instance, rationalizing foreign inward remittances system i.e. PRAL to attain USD 8 bn mark for FY10. Secondly, reported accords on nuclear power stations with China mainly on Chashma which could be diverted to attain cheap energy. Some progress is finally being made on Thar Coal gasification project, accord on Iran gas pipeline to fulfill gas shortfalls, acceptance of sales tax proceeds for Sindh province under National Finance Commission (NFC) to name a few.

Nevertheless, for short term at least, the approval ratings have been marred by chronic mis-governance, unchecked non – development expenditure, non – implementation of judicial verdicts etc. From equity market perspective, the complexity in collecting Capital Gains Tax (CGT) is certainly giving bad name to government in Islamabad; even though a committee of tax men and market participants is formed relating to payment of CGT as per the time frame specified under new finance act.

Any increase in discount rate may affect indices by 3% - 4% only

If actual outgoing CPI pertaining to FY10 remains 12% (seeing monthly trends) then it can easily be said that there may be slight increase in benchmark discount rates from the present levels of 12.5%.

Hypothetically speaking, if that materializes then Pakistan equities could depreciate vaguely by 3% - 4% taking a FY11 earnings growth median of 15% and a dividend yield of 6% (level of index can sneak 8900).

Weak confidence levels may support our view of existing fault lines

At present we see only few conglomerates contemplating either expansion or diversification in their business models. However, opportunities still exist in areas such as micro finance, revival of small medium industries, alternate energy, live stock and agriculture. Most disturbing, however, is reversal of business deals or restricting businesses pursued by conglomerates. Pulling out of few conglomerates from Pakistan to other destinations may not sound good at this juncture. This indeed highlights trust deficit between current policy makers and business professionals.

Investment strategy

Despite trumpeting 'fault line theory' of Pakistan market, we see few good stories as well that are related to FY11 earnings growth. Here we advise investors to direct investments towards growing blue chip fertilizer, oil & gas exploration, few designated banks and other growing / revitalized business models. We like FFBL, ENGRO, POL, DGKC, PKGS, UBL, NBP and LOTPTA.

Few good EV/EBITDA stocks	x
Pakistan Refinery Ltd.	0.3
Berger Paints Pakistan Ltd.	0.7
Lotte Pak PTA Ltd.	0.9
National Refinery Ltd.	1.2
Attock Refinery Ltd.	1.4
Attock Cem.Pak.Ltd	1.6
AL-Ghazi Tractors Ltd.	1.6

Source: scstrade search engine

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