

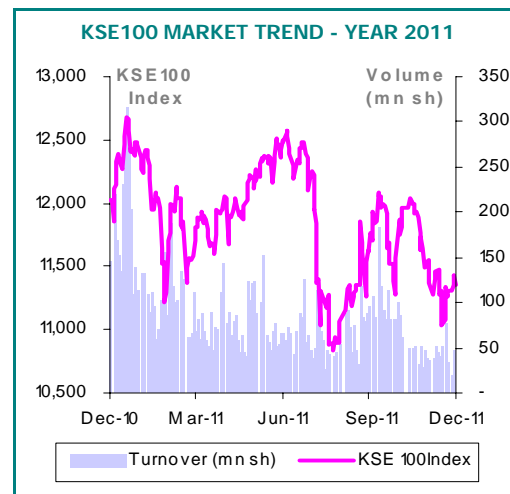


January 02, 2012

## Attractive valuations with IFs & BUTs!!

We recommend a cherry picking strategy in Pakistan on strong fundamentals and immunity to economic fluctuations. The market continues to trade at attractive multiples (PE: 6.0x for 2012) and is expected to give a total return of 18.6 % inclusive of 8.0% in terms of cash dividends. Key reasons for our above view are as follows:

- The KSE-100 index closed at 11,347 points depicting a drop of 5.61% (USD: 9.7%) in 2011. The volumes at KSE mostly remained dried up taking average daily volume to 78.75 mn shares, down 35% as compared to last year. The market activity dropped significantly during the last quarter of CY11 taking the average daily volume to 59.39 mn shares.
- In 2012, macro economic situation continues to remain bleak especially on currency and interest rates. The inflation is also expected to hover between 13.0 to 13.5% and consequently the policy makers would resort to raising the discount rate to 13.5%. The rising interest rates would lower equity valuations and we may see some market correction. We expect the currency to depreciate by 8% in 2012.
- The flight of foreign capital would also exert pressure on the stock market on the back of exacerbated Euro debt crisis and a weak currency expectation. Another wave of global recession is expected in 2012 which may bring some downturns in the local stock index arising due to global economic slump. The foreign investment recorded to be PKR 207 bn which is 7.7% of the total market capitalization of KSE 100 index and 22% of the free float.
- The inefficiencies of the PPP led government paved way for Imran Khan's party Tehrik-e-Insaf to gain popularity among the masses. Early elections in 2012 (if happens) rather than in 2013, would turn out to be a big positive trigger for stock market as the new govt. is expected to focus on improving the economic situation and raise governance standards.
- Sectors having strong business models and offering attractive dividend yields like Exploration, Power and Fertilizer form very good basis of investment. Buy POL, FFC, and LUCK.



KSE PERFORMANCE 2011	
Avg. Market Cap. (PkRmn)	3,149,119
Avg. Market Cap. (USDmn)	35,383
2011 Index High	12,681.94
2011 Index Low	10,842.26
Highest Volume (mn sh)	316.81
Lowest Volume (mn sh)	14.94
Index Return (%)	- 5.61%

Top Performers 2011	
Company	Change
FATIMA	103.10%
ULEVER	31.41%
APL	25.06%
FFBL	23.68%
FFC	20.42%
POL	18.58%
BATA	16.70%
MEBL	6.51%
AHCL	6.47%
LUCK	1.21%

Top Picks				
Company	P/E (x)	EPS: CY12E/ FY12E	Div. Yield (%)	Target Price (PKR)
LUCK	4.89	15.34	6.0%	106.00
FFC	5.55	26.96	16.2%	227.43
POL	5.55	62.42	11.0%	440.89

Source: KSE Website, Alfalah Securities Research

## Stock Market faced a slump with dried volumes in 2011

The year 2011 remained a very eventful year but not very positive for the equity markets where the KSE-100 index closed at 11,347 points depicting a drop of 5.61% and 9.7% in dollar terms. Nikkei, HangSeng and BSE SENSEX index registered a drop of 18.3%, 20.0% and 24.6% respectively in CY11 thus; KSE-100 index remained more resilient to global recessionary shocks as compared to other indices in the region.

The volumes at KSE mostly remained dried up taking average daily volume to 78.75 mn shares, down 35% as compared to last year. The market activity dropped significantly during the last quarter of CY11 taking the average daily volume to 59.39 mn shares. The fall in market is mainly attributed to:

- 1) Worsening Pak-US ties,
- 2) Deterioration in macro economic scenario,
- 3) FBR's probe of stock market investors as a result of imposition of CGT, and
- 4) Foreign selling as a result of Euro Crisis and anticipated weak economic outlook.

### Macro Economic Outlook:

The macroeconomic situation of the country remained depressing throughout the year 2011 mainly due to severe calamities and destruction caused by floods which resulted in lowered output and a slowdown in GDP growth. The government's extensive spending on flood rehabilitation projects burdened fiscal expenditures and widened fiscal deficit. Overall, the macroeconomic factors in 2011 remained mostly negative where deteriorating balance of payment, high trade and current account deficit, ever rising inflation and steep devaluation of Pak Rupee against US dollar posed an alarming situation to the economy whereas, a significant increase in workers and home remittances was witnessed in the outgoing year.

Key factors relating to the macroeconomic situation that are likely to affect 2012 are discussed as under:

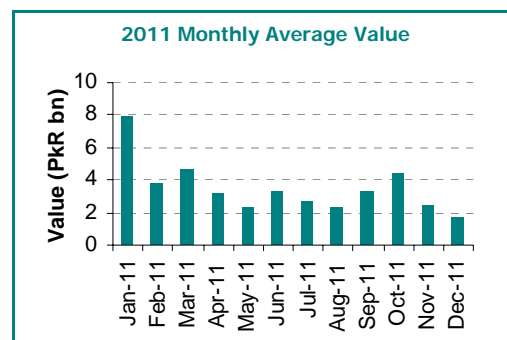
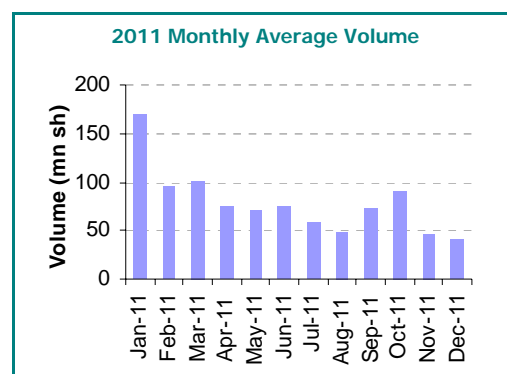
#### I. Shocks on the external front:

The balance of payment situation had started to deteriorate in the 4QCY11 and is likely to worsen further primarily due to a rising trend in the current account deficit of the country. Increase in current account deficit has also led foreign exchange reserves to erode significantly to USD 16.77 bn (as of Dec 29, 2011) which at one point had touched to USD 18.4 bn level. The exports of the country have also failed to pick up despite persistent devaluation of Pak Rupee against Dollar resulting in a higher trade deficit.

We expect the situation on the external side poses a major threat to economic sustainability and the government is likely to be driven into seeking further foreign loans to do away with the payment crises that are expected to erupt in 2012.

#### II. Steeper currency devaluation ahead likely:

The value of Pak Rupee has declined significantly against US Dollar mainly due to payment of high import bills and repayment of foreign



Volume leaders (KSE100)	
Company	Avg. Daily Volume (mn sh)
LOTPTA	15.78
FFBL	6.79
NBP	3.50
AHCL	3.25
JSCL	3.16
DGKC	3.12
NCL	2.75
ENGRO	2.73
NML	2.59
FFC	2.55

Source: KSE Website, Alfalah Securities Research

obligations. The value of Pak Rupee against US Dollar stood at PkR 85.13 at the beginning of 2011 which depreciated by 5% to PkR 89.43 on 29th Dec, 2011 after touching a low of PkR 83.29 during the year.

The currency is expected to devalue at a higher pace due to rising trade deficit and repayment of foreign debt, mainly the IMF loan of which USD 1.9 bn is due to be paid during 2012 which is expected to exert further pressure on foreign exchange reserves. We expect the currency to devalue by 8% in the next calendar year.

### **III. Inflation easing seems short-lived:**

The Consumer Price Index (CPI), a key measure of inflation, registered some respite during 2H CY11 primarily due to changes in calculation methodology rather than a genuine ease off. Base year was changed by the government from FY01 to FY08 and also made changes in the income brackets. The total number of products in the CPI basket was increased to 487 items from earlier 374. The changes in method of calculating CPI has enabled inflation to accomplish the target of 12% as per the IMF's policy.

However, it seems to be short-lived on the back of rising taxes, removal of subsidies, higher fuel and transportation cost, and gas and electricity outages would heat up inflation accompanied by currency devaluation which would bring in inflation through costlier imports.

### **IV. Erosion of purchasing power as input cost rises:**

The masses would have to bear the brunt of economic inefficiencies in 2012. Prices of several commodities are due to increase from the beginning of 2012. The government has decided to raise gas prices by 14% to 207% under the Petroleum Levy (PL) and Gas Infrastructure Development Cess (GIDC) regime from January 1st 2012, which would increase the input cost of industries, transporters and fertilizers. The fertilizer sector would pass on the incremental cost impact to farmers in order to keep their margins intact which would increase the cost of all sorts of agri-products from essential food items to cotton.

Similarly an increase in transportation cost accompanied with rising electricity cost would have a dire inflationary impact across the board. It would also result in erosion of purchasing power of the masses, making local products uncompetitive for the export market consequently deteriorating trade deficit. Moreover, we expect the crude oil prices to remain firm and hover near USD 100/bbl in the year 2012.

### **V. Interest rates likely to inch up again:**

The interest rate trend of the country registered a downward trajectory in 2011 influenced by a decline in CPI inflation during the year which gave room to the policy makers to cut the discount rate by 50bps in July and a massive rate cut of 150 bps in September 2011.

As inflation starts to peak out, the policy makers would eventually resort to raising the discount rate to keep real rates positive and to tame money supply in the system. The rising interest rates would lower equity valuations and we may see some market correction on the back of interest rate hikes.

### **VI. Circular debt issue to carry over in 2012:**

The circular debt issue still remains unresolved and is expected to deteriorate further in 2012. Theft and non-payment of dues by the government are the two major causes of circular debt therefore, we believe that as inflation would erode purchasing power of the public, more and more people would seek illegal means of using electricity and theft would tend to rise.

The rising fiscal deficit and low tax-to-GDP ratio has already crippled the government for funds and high inflation would also aggravate liquidity crunch for the government. Therefore, the entire chain associated with the circular debt would face cash crunch where E&P companies would not go for aggressive exploration and drilling, refineries' output would be kept low and oil & gas marketing and distribution companies would also restrict expansion and extend supplies only through cash sales thus, limiting their profitability and growth.

### **VII. Power outages and gas shortfall to hamper economic growth:**

The prevailing gas shortfall in Pakistan would add fuel to fire by aggravating the woes of the economy and the demand-supply gap is likely to widen as demand grows. The LNG import plan and Iran-Pakistan gas pipeline and TAPI (Turkmenistan, Afghanistan, Pakistan and India) gas pipeline would provide partial relief to fill the huge gap however all these plans are beyond FY13. Therefore, the country would face even more difficulty in managing gas load in the upcoming year and we expect the fertilizer sector may face more gas outages likewise the textile sector would also be deprived of the committed gas supply.

## Capital Market Issues

The political uncertainties overshadowed the equity performance where rifts between US, Political government and Military forces kept the sentiments dampened and market reacted intensely to various rumors regarding continuity of present political setup. One of the major issues which kept volume low was the imposition of capital gain tax and FBR's probe on filing returns and disclosing source of income of the investors. The slackness in shares turnover led to inefficiencies in price discovery due to which several fundamentally strong scrips failed to perform despite being at attractive relative multiples.

### I. Capital gain tax issue hits hard on market volumes:

FBR imposed capital gain tax (CGT) on shares trading in order to broaden tax net and track the source of investments in the capital markets to minimize tax evasion. However, this measure was resisted by the members of the exchange since the imposition of CGT has significantly reduced the flow of investments towards the stock exchanges thereby, not contributing much to revenue collection. We believe CGT would remain in place which would restrain volumes in the market in 2012.

### II. Flight of foreign capital:

During 2011, the foreign investors fled their capital out of the stock markets on the back of Euro debt crises caused by global recession and deteriorating macro economic situation of the country accompanied by expectation of steeper devaluation of Pak Rupee against dollar going forward which would lower their return on investment.

The market value of foreign investment in securities under SCRA scheme dropped to PkR 207.07 bn as on 23rd Dec, 2011 as compared to 31st Dec, 2010 position of PkR 253.75bn lower by 18.4% where the KSE-100 index slipped by 8% in the same period. The foreign investment contribution dropped to 7.7% of the total market capitalization of KSE 100 index on 16th Dec, 2011 which was 8.5% in the beginning of the year.

### III. Global recession and debt crises tumbled world indices:

Jitters of the global recession were also felt in Pakistani stock market though not very intense. Pakistan's stock market was seen to respond in tandem when World's stock markets tumbled as Euro zone and US Crises situation intensified for instance when Italy struggled to avoid being sucked into the escalating European debt crisis, and Greece moved closer to default. However, equities recovered when the global economic risks subsided.

IMF estimated 2011 global growth of only 4%, with strong ripple-effects to the global economy if Euro zone nations do not strengthen their banking system and the U.S. fails to put its fiscal policy on a balanced-budget track. IMF expected the growth of developed world at 1.6% in 2011 and emerging markets growing at a 6.4% pace. IMF has also warned of an expected global recession in 2012 citing a possibility that economic activity will turn downwards. To avert recessionary shocks, United States would need to curtail debt and in case of Euro zone, it would mean a resolution of the sovereign debt crisis. Therefore, 2012 may be seen to bring some downturns in the local stock index arising due to aggravation of global recession.

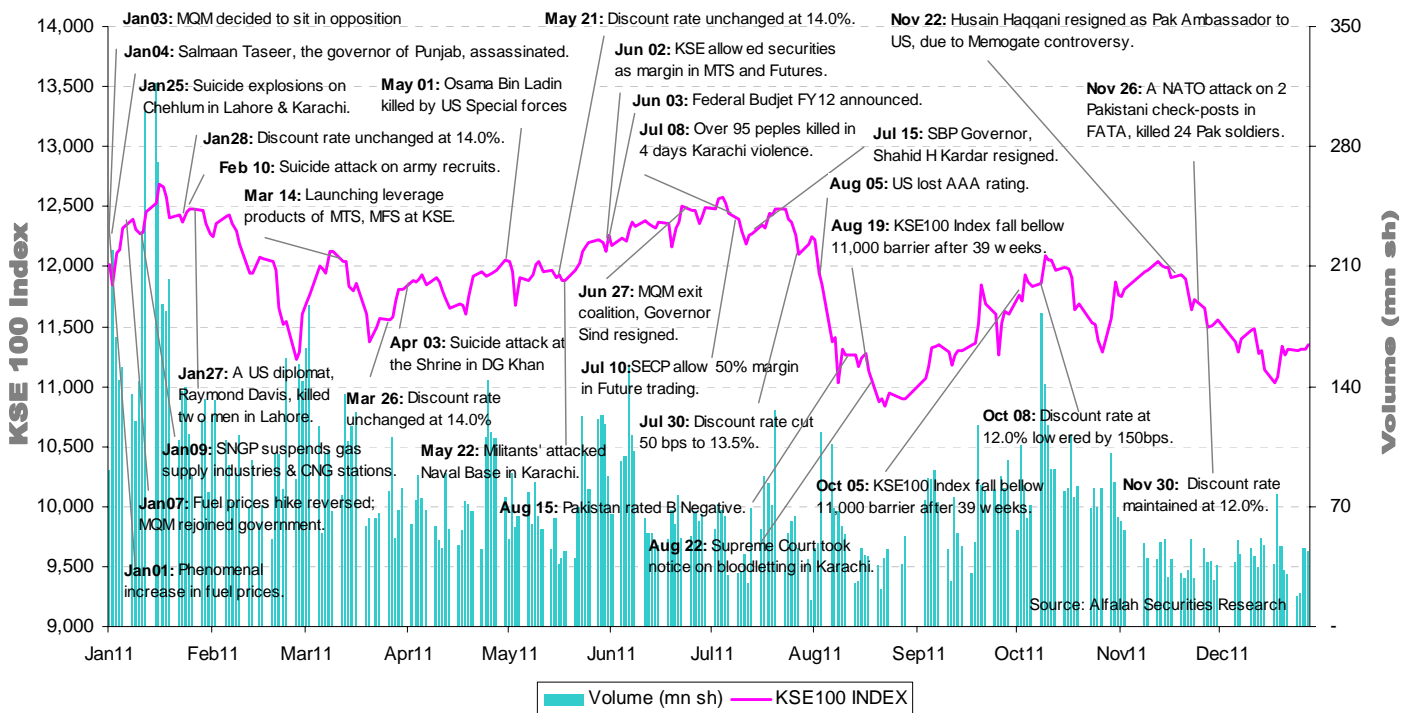
## Political tug of war continues

The politics factors remained a major factor affecting the sentiments of the market. The PPP led government seemed to remain preoccupied in several administrative and economic problems. It tried a great deal to tackle different crises like energy and gas shortfall, circular debt and floods but was not much successful due to political and administrative loopholes and inefficiencies. The PPP led government was accused of mishandling foreign policy also which led to stressful relationship with US Government despite facing immense loss of lives and property in the name of war on terror.

After seeking refuge in the IMF program, the political government took many unpopular decisions of increasing taxes and levies on petroleum products, raising electricity tariffs and curtailing subsidies which added to the miseries of the public. The inefficiencies of the PPP led government paved way for Imran Khan's party Tehrik-e-Insaf to gain popularity among the masses and the political setup took a dramatic turn.

Going forward, we believe that this interesting political development has raised hopes of some positive change in the political setup. If there are early elections held between May to September 2012 or earlier, Tehrik-e-Insaf is expected to give tough time to other political parties. In case Tehrik-e-Insaf is able to form government with big majority, we would see a revival of investors' confidence and economic activity would pick up. At that time, the stock market is also expected to sky-rocket on the back of positive economic outlook, stable government accompanied with good governance and attractive valuations of fundamentally strong scrips.

## Journey through a turbulent year: 2011



## TOP PICKS

### Lucky Cement:

Lucky Cement would continue to remain in the limelight in the cement industry with strong financial results going forward. The company would reap the benefits of rising cement prices while, its strategies for achieving cost effectiveness from Waste Heat Reduction System and cement production from Tyre Derived Fuel (TDF) instead of coal would further boost their gross margins. The company has also successfully qualified for the Clean Development Mechanism (CDM) under Kyoto Protocol of United Nations through which it would earn Carbon Emission Reduction (CER) Credits.

Moreover, the company is working on building a distribution network to supply electricity to HESCO which would result in earning income other than its core operations. Hence, based on our projections we recommend a "Buy" stance on the scrip which trades at an attractive FY12E P/E of 4.89x and offers an upside of 41.3% to our target price of PKR 106 per share.

VALUATION	FY11A	FY12E	FY13F	FY14F
Net Sales (PKR mn)	26,018	30,493	34,644	39,044
Profit/loss After Tax (PkR mn)	3,970	4,962	5,977	8,141
Earning Per Share (PKR)	12.28	15.34	18.48	25.17
EPS Growth (%)	26.6%	25.0%	20.5%	36.2%
Dividend per Share (PkR)	4.00	4.50	5.50	6.00
Dividend Yield (%)	5.3%	6.0%	7.3%	8.0%
P/E (x)	6.1	4.9	4.1	3.0

Source: Company Accounts, Alfalah Securities Research

### Fauji Fertilizer Company:

Fauji Fertilizer Company (FFC) offers an attractive CY12 dividend yield of 16%, relative to 8% of the KSE-100 index. Fauji Fertilizer continues to reap the benefits of increasing fertilizer prices which has resulted in improvement in gross margins to 58.9% in CY11F and are expected to remain intact going forward. The company faces no significant gas curtailment issues being on the Mari Gas network and would pass on the additional cost occurring due to the imposition of Gas Infrastructure Development Cess (GIDC) to end consumers. Moreover, high dividend income from Fauji Fertilizer Bin Qasim Limited (51% owned subsidiary of FFC) is expected to contribute 23.64% of earnings in CY11. We expect the bottom-line of the company to grow at a CAGR of 18% from CY10-15 and trades at a lucrative CY12F P/E of 5.55x. We recommend a "Buy" stance on FFC as the scrip offers an upside of 52.10% to our target price of PkR 227.43 per share.

VALUATION	CY10A	CY11E	CY12F	CY13F
Net Sales (PkR mn)	44,874	53,890	61,438	65,486
Profit/loss After Tax (PkR mn)	11,029	20,106	22,864	23,713
Earning Per Share (PkR)	13.0	23.7	27.0	28.0
EPS Growth (%)	15.6%	82.3%	13.7%	3.7%
Dividend per Share (PkR)	13.0	21.3	24.3	25.2
Dividend Yield (%)	8.7%	14.3%	16.2%	16.8%
P/E (x)	11.5	6.3	5.6	5.3

Source: Company Accounts, Alfalah Securities Research

### Pakistan Oilfields:

POL's earnings are expected to project strong growth potential arising out of added production and higher crude oil and gas wellhead prices. The earnings have remained robust due to contribution of Manzalai CPF, Makori East and Domial fields. Further additions from Domial and Makori East are also expected to enhance production which remains a major trigger for growth in the company. Moreover higher oil prices are likely to keep the attractiveness of this company intact added by rising gas wellhead prices. Dividend income from NRL will further jack up earnings. The stock trades at prospective FY12E earnings multiple of 5.55 and offers an upside potential of 27.26% to our DCF based target price of PkR 440.89. The stock also offers FY12E dividend yield of 11.0% and we recommend a BUY on it.

VALUATION	FY11A	FY12E	FY13F	FY14F
Net Sales (PkR mn)	24,951	32,461	33,643	35,305
PAT (PkR mn)	10,815	14,766	15,371	16,231
EPS (PkR)	45.7	62.4	65.0	68.6
EPS Growth %	45.4%	36.5%	4.1%	5.6%
DPS (PkR mn)	35.0	38.0	39.0	40.0
Dividend Yield %	10.1%	11.0%	11.3%	11.5%
P/E (x)	7.6	5.6	5.3	5.1

Source: Company Accounts, Alfalah Securities Research

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