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Pakistan Market

MORNING BRIEFING

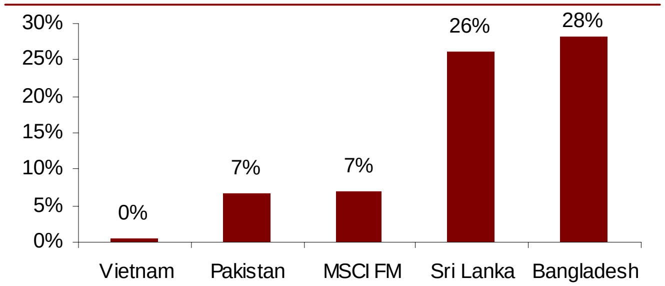
JS

Is Pakistan dirt cheap?

KSE100 Index: Closing 10033.76 ↓ (-237.95)

With markets worldwide, feeling the heat of the European debt crisis, global investment banks row and China's monetary tightening, frontier markets have continued to remain an attractive investment destination with investment flows continuing to pour in, as opposed to the huge outflows witnessed by emerging peers. A closer look at the top frontier markets reveals that Bangladesh & Sri Lanka remain major outliers in terms of market performance, posting a YTD return of 28% and 26% respectively, in 2010, as against the returns of -4% and -1% of MSCI World and EM Asia indices. In order to determine the reasons for this impressive performance, we conducted an in depth study on these countries' macro fundamentals and market valuations to pit them up against Pakistan. We observed that Sri Lanka (SL) fared poorly on both macros and market valuations. Further, though Bangladesh (BD) seemed to have a stronger footing from a macro perspective, it remains massively overvalued on all key valuation parameters (trading at a 29x PE & 5x PBV).

MSCI Frontier Asia Markets YTD Performance



Source: Reuters, MSCI & JS Research

The key triggers behind the above par performance of these two markets appears to be the return to a democratic set up & entry into the frontier markets in case of Bangladesh, and improved security situation post defeat of the Tamil Tigers for Sri Lanka. This entails that Pakistan has a re-rating potential given improved macros, deep discount on valuations, relative political stability and important gains in the war on terror. We, therefore, reiterate our liking for the local equity market with a year end 2010 index target of 11,800 points. Our top picks include POL, PPL, HUBCO, ENGRO, PTC, PSO and NML.

Pak macros: Better than SL but slightly behind BD

The massive structural adjustment undergone by Pakistan since entering the IMF program (Nov 2008) has allowed the country to appear stronger when compared to Sri Lanka in terms of macro statistics, with a more disciplined fiscal situation and a total debt to GDP ratio (see table). Moreover, despite hefty energy price pass through to eliminate/reduce subsidies, inflation remains within manageable limits and is likely to approach single digits once the last round of tariff pass through concludes. Though the country lags behind Bangladesh on key economic parameters, the gap does not seem to be substantial, with similar levels of fiscal deficit and a far better import cover.

Macro comparison (FY10E)

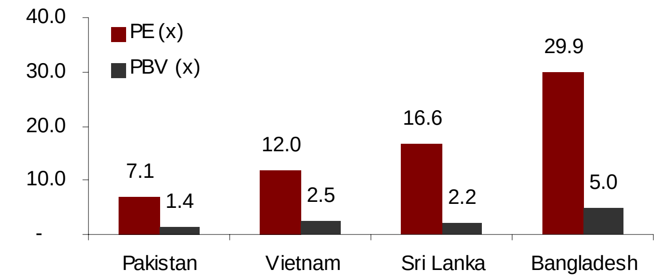
	Sri Lanka	Pakistan	Bangladesh
Real GDP (%)	5.8	3.5	5.5
CPI (%)	10.0	11.0	6.5
C/A. Bal (% of GDP)	(1.9)	(3.8)	0.2
Fiscal Deficit (% of GDP)	8.1	5.5	5.0
Total Debt-to-GDP (%)	90.2	56.7	40.6
Forex Reserves (US$bn)	7.1	16.5	8.1
Ext. Debt (US$bn)	25.1	55.5	23.0
Import Cover (months)	8.1	5.5	3.2

Source: JS Research, Central banks of Sri Lanka & Bangladesh & IMF

Is there a case for excessive premiums of SL & BD?

Our macro economic analysis gives rise to two fundamental questions: (1) What justifies the Sri Lankan market trading at a one year forward PE of 16.6x & PBV of 2.2x (130% premium to Pakistan) when its macros are weak on a relative basis? & (2) If our economic numbers revert closer to Bangladesh in the next fiscal, would there be a case for Bangladesh market to fall drastically or Pakistan's market to re-rate itself?

MSCI Frontier Markets one year forward multiples



*Source: JS Research, Reuters, *Trailing PE & PBV for Bangladesh*

Our answers to the above questions are (1) There is seemingly no justification for the KSE to trade at a 57% discount on PE and 36% on PBV to Sri Lanka, hence there lies a clear case for re-rating & (2) Bangladesh market is due for a correction as there is no rationale for the market to trade at a 28x PE and 5x PBV.

Outlook: Dec 2010 Index target of 11,800 intact

While regional markets have seen a massive exodus of portfolio flows in recent weeks, KSE continues to witness net inflows with US$20mn received month to date - a clear indication of the confidence of foreign investors in the Pakistan market. Trading at an attractive 2010E PE of 7.4x, a deep discount of 42% to regional markets PE of 12.8x, we reiterate our liking for the KSE with Dec 2010 index target of 11,800 intact. Remaining upbeat on the Oil, Power, Telecom & Fertilizer sectors, we flag PPL, POL PSO, HUBCO, PTC, ENGRO and NML as potential outperformers.

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