

Pakistan: Just push play

Market primer

- Strong performer in 2002-2005:** The benchmark Karachi Stock Exchange 100 Companies' Index (KSE-100 Index) enjoyed stellar returns from January 2002 to 2005. The significant returns were brought about by a huge influx of liquidity into the economy, post 9/11. Falling interest rates and a healthy economy helped drive up equity values nearly tenfold. However, since then, stock values have had difficulty sustaining this strong performance.
- Monetary tightening in 2005:** Ever since the central bank embarked on monetary tightening in 2005, Pakistan's stock market has been a laggard to regional emerging markets. However, we expect the KSE-100 to perform well during 2007 and catch up to at least maintain the discount at which it has historically traded to Asia Pacific ex-Japan.
- Macro themes to consider:** We expect stock prices to take their cue from a peaking monetary cycle, in which monetary easing may be possible in sometime in FY08 (Jul 07 - Jun 08). Fiscal pump-priming ahead of the 2007 presidential elections, and the high probability of policy continuity as President Musharraf is likely to remain in charge following the elections, are also positive drivers, in our view.
- Market investment themes:** Corporate earnings are expected to continue to grow at a double-digit pace (based on consensus estimates) in FY07 and FY08. Valuations also look attractive relative to global emerging markets, which is likely to act as a catalyst for foreign fund flows into the country.
- Risks to consider:** There are, however, some risks to keep in mind apart from the usual dependence on President Musharraf. There could be a delay in the easing of monetary policy, capital gains tax exemption has only been extended for a year, and regulatory issues still have the potential to upset momentum, as they have done in the past.

Table 1: Pakistan stock market returns

	KSE-100 Index	Return
2001	1273.06	-15.6%
2002	2701.41	112.2%
2003	4471.60	65.5%
2004	6218.40	39.1%
2005	9556.61	53.7%
2006	10,040.50	5.1%

Source: Karachi Stock Exchange.

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Pakistan

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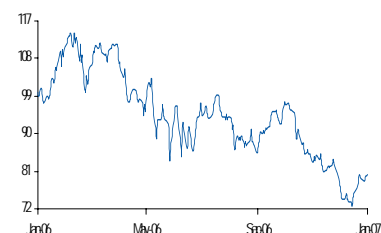
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Figure 1: Pakistan lagging behind Asia Pacific ex-Japan



Source: MSCI, Datastream.

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Economic review and outlook

Higher GDP growth, lower poverty, more FDI and lower fiscal deficit

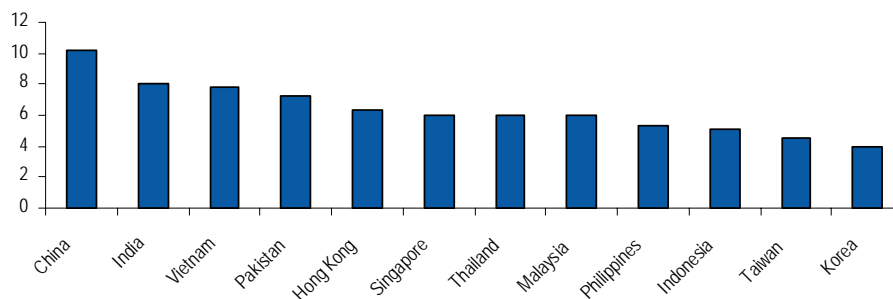
Pakistan is in the top half of Emerging Asia's fast-growing economies.

Pakistan's economic performance in the past five years has been commendable. GDP growth is higher, poverty rates are down, inflation is lower, FDI is up, and fiscal deficits are down. However, the current account balance has turned to a deficit, although overall external balances are healthy. Driving all of these improvements has been an environment of relative political stability under the pro-reform administration of President Musharraf and Prime Minister Shaukat Aziz.

Sustainability of above-average GDP growth needed

Pakistan's economy grew 6.6% during FY06 (ending on June 30) – the third consecutive year of GDP growth exceeding 6%. Compared to the rest of Emerging Asia, that recent track record puts Pakistan's GDP growth rate solidly in the top half of the region's fast-growing economies.

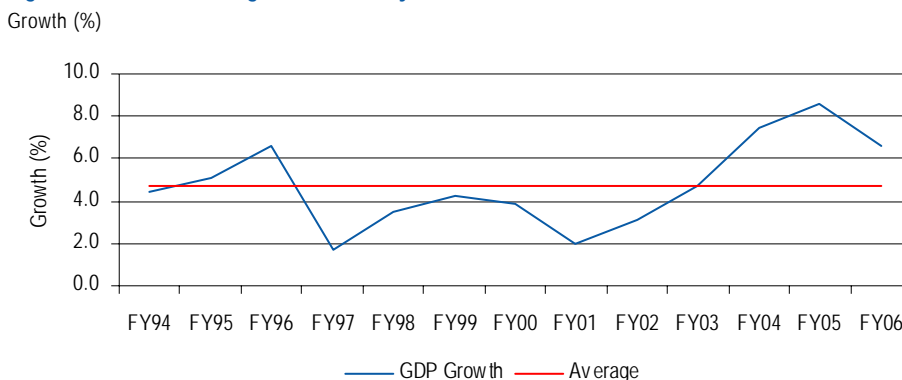
Figure 2: Regional economies' three-year average GDP growth



Source: JPMorgan Economics.

Pakistan's government is targeting a 6-7% range for real GDP growth over the medium term. Though this target may seem aggressive against a 10-year historical average of close to 5%, recent structural reforms and privatizations have improved the overall business and investment climate substantially.

Figure 3: Pakistan's GDP growth over the years



Source: Economic Survey of Pakistan

Gross fixed capital formation has risen from below 17% of GDP in FY2001/02 to over 20% last year and should continue to move higher.

Gross fixed capital formation has risen from below 17% of GDP in FY02 to over 20% last year and should continue to move higher. FDI has surged from below US\$0.5 billion in FY02 to US\$3.5 billion in FY06, of which US\$1.5 billion came from privatization receipts. In addition, the government has embarked on aggressive fiscal initiatives including the setting of a goal of doubling spending on education and health as a share of GDP within 10 years.

IMF foresees future GDP growth being sustained at 6.5-7.0%.

These favorable dynamics in the size and efficiency of both the physical and human capital stock make a 6-7% target range for medium-term growth seem very reasonable, in our view. The IMF, in its recently completed Article IV consultation, uses a baseline assumption for real GDP growth of 7%. And even in a scenario of both fiscal and monetary tightening, the Fund sees growth being sustained at 6.5-7.0%.

GDP composition

Table 2: Sectoral share in GDP

	FY70	FY06
Agriculture	38.9	21.6
Mining & Quarrying	0.5	2.6
Manufacturing	16.0	18.2
<i>Large Scale</i>	12.5	12.7
<i>Small Scale</i>	3.5	4.3
Construction	4.2	2.2
Electricity & Gas Distribution	2.0	3.0
Services Sector	38.4	52.4
Transport, Storage, & Communication	6.3	10.5
Wholesale & Retail Trade	13.8	19.2
Finance & Insurance	1.8	4.6
Ownership of Dwellings	3.4	2.8
Public Adm. & Defence	6.4	5.8
Other Services	6.7	9.5
Total GDP	100.0	100.0

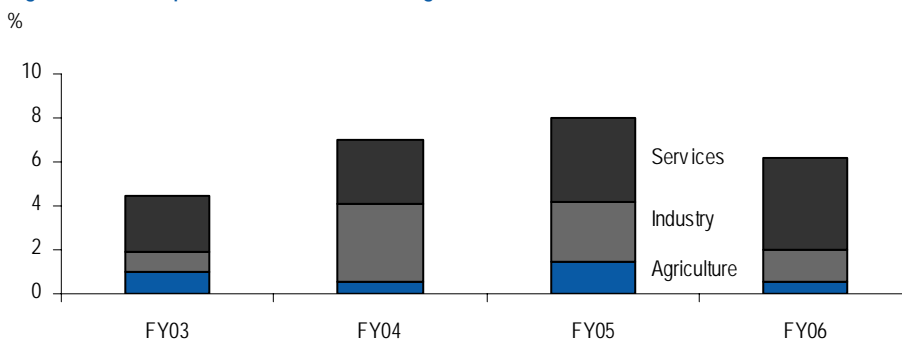
Source: Economic Survey of Pakistan

Services 52% of GDP are the largest part of the economy

Agriculture, has declined from 40% to 20% of GDP

The manufacturing sector, while growing more rapidly in recent years, is still only 18% of GDP, though overall industry (also including mining, construction, electricity and gas) raises that share to 26%

Figure 4: Real output and domestic demand growth



Source: JPMorgan Economics

The industrial sector has performed well in recent years, growing at close to a double-digit pace.

Table 3: Growth performance of industrial sector components (percent)

	1980s	1990s	FY03	FY04	FY05	FY06
Mining & Quarrying	9.5	2.7	6.6	15.6	9.6	3.8
Manufacturing	8.2	4.8	6.9	14.0	12.6	8.6
Construction	4.7	2.6	4.0	-10.7	18.6	9.2
Electricity & Gas	10.1	7.4	-11.7	56.8	3.5	-8.4

Source: Economic Survey of Pakistan

Note, however, that growth tapered off in FY06 owing to capacity constraints in a few industries, competition from imports, and a tightening of monetary conditions. Cement, automobiles, and fertilizer, for example, have suffered because of capacity constraints.

The start to FY07 has been good with Jul-Sep manufacturing growth at around 11.2%. We believe that manufacturing will continue to post double-digit growth in the medium term, as new capacity comes on line in key sectors, especially the three mentioned above.

Services sector has mainly been driven by financial and communication sectors along with wholesale and retail trade

Rivalling the strong growth in industry is the recent track record in services. This is particularly true of growth in telecoms and financials. Pakistan's financial sector has seen tremendous growth in the past few years, and has been the driving force behind sustained above-average services sector growth. Banking sector profitability has broken its own records year after year. The boom in mobile phone subscribers and the number of motor vehicles on the road have provided the impetus for value addition in the Transport, Storage, and Communications sub-sector. Driven by these two sectors, services overall is likely to continue to increase its weight in GDP in the medium term.

Table 4: Growth performance of services sector components (percent)

	1980s	1990s	FY03	FY04	FY05	FY06
Transport, Storage, & Communication	6.2	5.1	4.3	3.5	3.6	7.2
Wholesale & Retail Trade	7.2	3.7	5.9	8.4	11.1	9.9
Finance & Insurance	6.0	5.8	-1.3	9.0	29.7	23.0
Ownership of Dwellings	7.9	5.3	3.3	3.5	3.5	3.5
Public Administration & Defense	5.4	2.8	7.7	3.2	0.6	4.7
Other Services	6.5	6.5	6.1	5.6	5.9	6.5
Total Services Sector Growth	6.6	4.6	5.2	5.9	8.0	8.8

Source: Economic Survey of Pakistan

Expansionary fiscal policy

Balanced revenue deficit by 2008

Since FY03, Pakistan's fiscal deficit has been well contained below 4% of GDP (excluding earthquake-related spending in the two most recent fiscal years). Debt ratios have also come down over this period not just due to the improved budget performance but also thanks to debt forgiveness. Over the medium term, under the Fiscal Responsibility and Debt Limitation Law (FRDL) of 2005, the government is committed to balancing the revenue deficit by FY08 and reducing public debt to 60% of GDP by 2013.

Table 5: Pakistan's fiscal operations highlights (Rs bn)

	FY03	FY04	FY05	FY06
Total Revenue	720.8	805.8	900.0	1076.6
Tax Revenue	487.6	555.5	632.2	753.0
Surcharges	68.2	62.4	27.1	50.8
Non-tax Revenue	165.0	187.9	240.7	272.9
Total Expenditure	898.2	940.4	1117.0	1401.8
Current Expenditure	791.7	763.1	943.1	1121.0
Development Expenditure*	129.2	161.0	227.7	365.0
Statistical Discrepancy	3.2	0.0	78.5	-86.3
Overall Fiscal Balance	-180.6	-134.5	-217.0	-325.2

* Includes Earthquake related expenditure

Source: State Bank of Pakistan Annual Report

Development budget for FY07 is up 19% to Rs435bn over actual spending in FY06

In the immediate term, the government's FY07 budget projects a deficit of 4.2% of GDP, unchanged from last year's deficit (including earthquake-related spending). The budget includes a development expenditure plan of Rs435bn, a substantial 19% increase over actual spending in FY06, which is a central part of the government's pro-poor, pro-growth policy.

Table 6: FY07 budget highlights

	(Rs bn)	As % of GDP
Total Revenue	1188	13.5%
Tax Revenue	954	10.8%
Non-Tax Revenue	234	2.7%
Total Expenditure	1562	17.7%
Current Expenditure	1152	13.1%
Development Expenditure	435	4.9%
Overall Fiscal Balance	374	4.2%

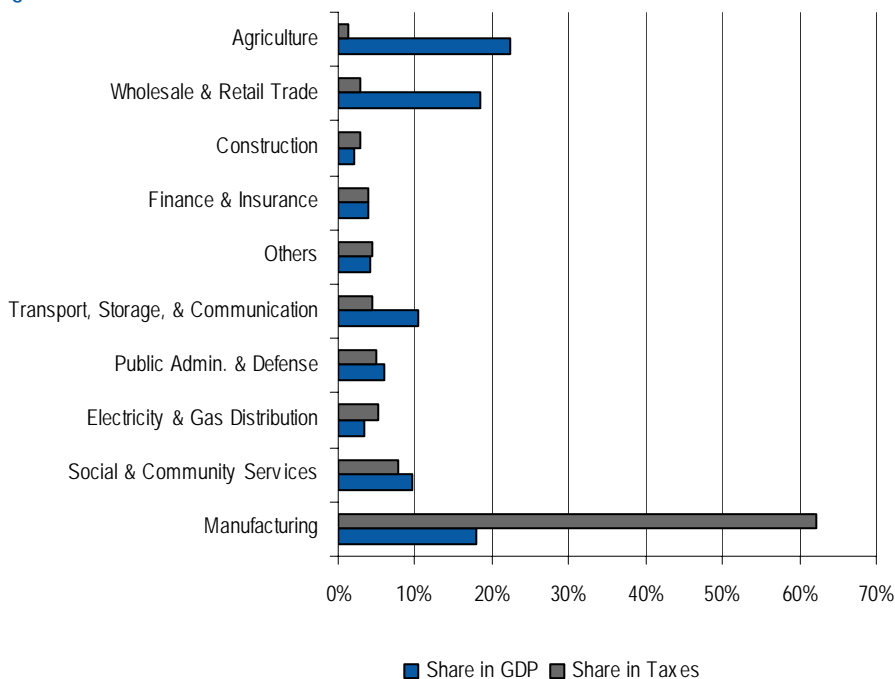
Source: State Bank of Pakistan

Tax revenue just 10% of GDP

Financing such increases in spending, which are not only projected for this year, but over the medium-term, faces certain constraints. Tax revenues as a percent of GDP have been flat at between 10-11% of GDP for the past several years. At this stage, there appears to be limited scope, given the required political costs, to increase this ratio by broadening the tax base. Indeed, looking at the tax base by sector, it is very

clear that certain sectors, especially agriculture, are making tax contributions that are far out of line with their contribution to GDP.

Figure 5: Sectoral contribution to GDP and taxes



Source: Economic Survey of Pakistan

Non-tax revenues are equivalent to about 3% of GDP and are likely to play a prominent role in Pakistan's budget in the medium term

So, instead, efforts are currently concentrated on improving the efficiency of tax collection by streamlining of income tax rates and tax administration generally. Non-tax revenues have featured privatization-related revenues and dividends from state-owned enterprises in recent years and it is necessary that such a revenue stream, equivalent to about 3% of GDP, continues to play a prominent role in Pakistan's budget in the medium-term in order for the fiscal deficit to consolidate further.

Persistent inflation pressures, but tide may be turning

Inflation 8.9% YoY

Inflation in Pakistan has stayed persistently high, with the most recent reading in December 2006 jumping to 8.9% YoY.

Surging exports, an expansionary fiscal stance, and abundant liquidity have underwritten rapid output growth over the last three years. These factors, together with a rapid rise in energy costs, have fueled the country's high inflation rate.

Monetary policy, which had been very accommodative since FY02, gradually began to tighten starting in mid-2004. In April 2005, the SBP increased the discount rate by 150bps to 9.0%.

Despite this policy rate move and an increase in market interest rates, bank lending growth continued to be brisk. In particular, consumer financing rose from being only 7.8% of total banking sector advances in June 2003 to 13.6% by June 2006. Within

consumer finance, personal loans, credit cards, auto loans, and now housing loans saw rapid growth.

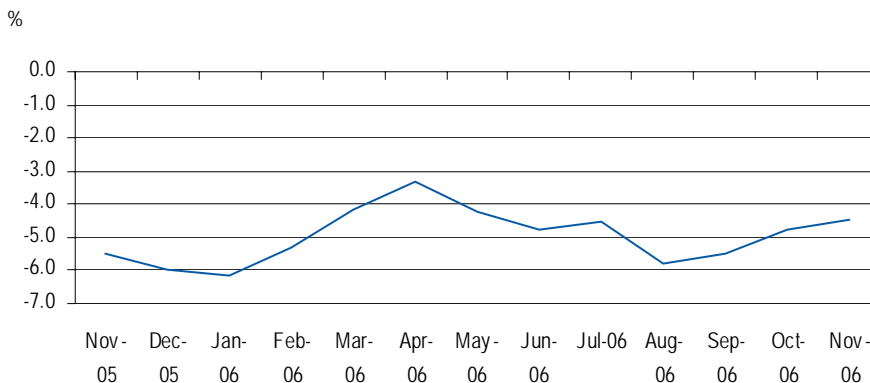
Table 7: Consumer financing in Pakistan (Rs in billions)

	Jun-03	Jun-04	Jun-05	Jun-06
Credit Cards	6.5	12.3	19.3	33.5
Auto Loans	18.7	27.8	66.0	97.8
Consumer Durables	0.3	2.2	1.6	1.5
Housing Loans	3.4	7.8	27.1	43.1
Personal Loans	48.0	72.7	92.0	120.5
Total Consumer Finance	76.9	122.8	206.0	296.4
As % of Total Banking Sector Advances	7.8%	9.5%	11.4%	13.6%

Source: State Bank of Pakistan

The installation of a new SBP Governor, Dr. Shamshad Akhtar, at the beginning of 2006, did not alter the central bank's tightening path. Indeed, the new governor has emphasized that she intends to pursue policies that would positive real returns to depositors in Pakistan.

Figure 6: Real deposit rates in Pakistan



Source: State Bank of Pakistan and Federal Bureau of Statistics

Note: Calculated using Y/Y CPI and average deposit rates of all banks

SBP further tightened monetary policy in July 2006 when it not only increased the policy discount rate by a further 50bps to 9.5%, but also increased the Statutory Liquidity (SLR) and Cash Reserve (CRR) requirements.

Table 8: Changes in CRR and SLR by SBP Since 2000

Effective From	CRR (as % of DTL)	SLR (% of DTL)
October 7, 2000	Average 7%, Minimum 6%	15%
December 16, 2000	Average 5%, Minimum 4%	15%
December 30, 2000	Average 5%, Minimum 3%	15%
January 5, 2006	Average 5%, Minimum 4%	15%
July 22, 2006	7% of Demand and 3% of Time Liabilities	18%

Source: State Bank of Pakistan

*A more detailed table since 1948 is presented in the Appendix

The recent increase in CRR is that SBP allows a lower CRR on time deposits (3%), while penalizing banks with demand deposits (CRR at 7%). The large banks have

SBP continues to focus on non-food, non-energy inflation, which has come down to 5.5% in December 2006. Therefore, SBP is satisfied that tightening measures have worked

continued to capitalize on their huge deposit base and low advances-deposits ratio to reap record profits up until now.

Note that while headline CPI remains elevated, core inflation (ex food and energy, or NFNE) has fallen to 5.5% YoY in December from 7.4% a year earlier. The higher level of CPI stems from higher food prices still prevalent in the economy. The prominence with which the SBP focused on this drop in NFNE inflation in its recent January-June Monetary Policy Statement is important as it can be read as a signal that it expects headline inflation to eventually follow.

Perhaps more importantly, the recent Monetary Policy Statement directly attributes the drop in NFNE to the SBP's tightening measures in July last year and earlier. The Statement also says, "Initial evidence for FY07 suggests that *SBP's monetary tightening undertaken so far has been successful in reducing excess demand from the economy, without hurting the growth momentum*" (original italics). In addition, the central bank notes that its Monetary Conditions Index is clearly showing the impact of these tightening moves.

The message then is that SBP is satisfied that its tightening measures have worked and will stay on hold for now while monitoring the ongoing developments of both headline and NFNE inflation. We believe that CPI inflation can move toward the target level of 6.5% for FY07, if food inflation, which has been the main driver of the recently elevated overall inflation rate, continues its incipient decline. In addition, the decline in global oil prices should help bring headline inflation down. This raises the possibility of an easing of monetary conditions in the second half of 2007.

Balance of payments challenging, but not alarming

Pakistan's external accounts have become a cause for some concern over the last couple of years. Since 2001, the current account has seen significant swings, first into large surplus and now into deficits of a similar magnitude. Looking back, post-9/11, Pakistan's balance of payments saw flows coming into the country from a variety of sources. Workers' remittances and foreign aid and grants, combined with surging exports and foreign investment inflows, all helped prop up Pakistan's external accounts to record levels.

Table 9: Current Account summary

US\$ in millions	FY01	FY02	FY03	FY04	FY05	FY06
Goods (net)	(1,269)	(294)	(359)	(1,279)	(4,514)	(8,442)
Services (net)	(981)	(298)	(2)	(1,316)	(3,293)	(4,402)
Income (net)	(2,161)	(2,319)	(2,211)	(2,207)	(2,386)	(2,671)
Current Transfers	4,737	5,744	6,642	6,613	8,659	10,516
Current A/c balance	326	2,833	4,070	1,811	(1,534)	(4,999)

Source: State Bank of Pakistan Annual Reports

Table 10: Balance of Payments at a glance (US\$ in millions)

Current Account	FY03	FY04	FY05	FY06
Trade Balance	-359	-1,279	-4,514	-8,442
Services (Net)	-2	-1,316	-3,293	-4,402
Income (Net)	-2,211	-2,207	-2,386	-2,671
Current Transfers (Net)	6,642	6,614	8,659	10,516
Current Account Balance	4,070	1,812	-1,534	-4,999
Financial Account				
Direct Investment Abroad	-27	-45	-66	-70
Direct Investment in Pakistan	798	951	1,525	3,521
Portfolio Investment	-239	314	620	985
Other Investment	-1,014	-2,555	-1,633	1,461
Financial Account Balance	-482	-1,335	446	5,897

Source: State Bank of Pakistan Annual Reports

In recent years, imports have increased sharply, propelled by Pakistan's oil import bill and rising demand for durables. Meanwhile, export growth has been sluggish owing to still-high dependence on the very competitive textile industry (60% of total exports in FY06). In FY06, current account hit a record deficit of \$5.0bn (3.9% of GDP).

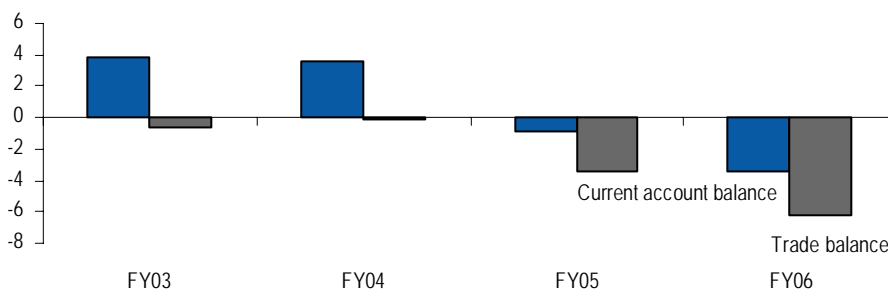
Table 11: Trade account details

(US\$ in millions)	FY01	FY02	FY03	FY04	FY05	FY06
Exports	9,201.6	9,134.6	11,160.2	12,313.3	14,391.1	16,451.2
Primary Commodities	1,199.9	1,001.7	1,263.9	1,275.0	1,674.3	1,904.2
Textile Group	5,790.9	5,810.6	7,263.1	8,073.0	8,482.8	9,891.0
Others Group	2,210.8	2,322.3	2,633.2	2,965.3	4,234.0	4,656.0
Imports	10,728.9	10,339.6	12,220.1	15,591.8	20,598.1	28,580.8
Food Group	1,131.4	823.3	978.0	1,033.3	1,408.8	2,059.1
Machinery Group	2,066.3	2,116.6	2,942.3	4,220.4	5,918.2	8,323.2
Petroleum Group	3,360.8	2,807.0	3,066.4	3,166.6	3,999.7	6,674.9
Textile Group	161.8	187.5	221.6	260.5	317.2	545.8
Agricultural & Chemicals Group	1,901.7	1,839.6	2,160.7	2,797.7	3,604.7	3,996.7
Metal Group	361.4	433.9	507.4	687.7	1,218.3	1,852.7
Miscellaneous Group	265.5	285.4	306.4	378.3	482.9	596.2
Others Group	1,480.0	1,846.3	2,037.3	3,047.3	3,648.3	4,532.2
Overall Trade Balance	-1,527.3	-1,205.0	-1,059.9	-3,278.5	-6,207.0	-12,129.6

Source: SBP Annual Reports

Figure 7: Current Account balance

US\$ in billions



Source: JPMorgan Economics

EMBI spreads suggest Eurobond issuance at favorable cost

When Pakistan last ventured into the international bond market to borrow, the government issued 10-year and 30-year Eurobonds at very attractive yields of 7.125% and 7.875%, respectively.

Pakistan’s current S&P assigned, foreign currency sovereign rating stands at B+, and can be seen in a regional context in Table 12 below.

Table 12: Sovereign ratings & spreads

	Rating	Spread (bps)
Indonesia	BB-	160
Pakistan	B+	154
Philippines	BB-	151
Malaysia	A-	66
China	A	51

Source: Standard & Poors and Datastream.

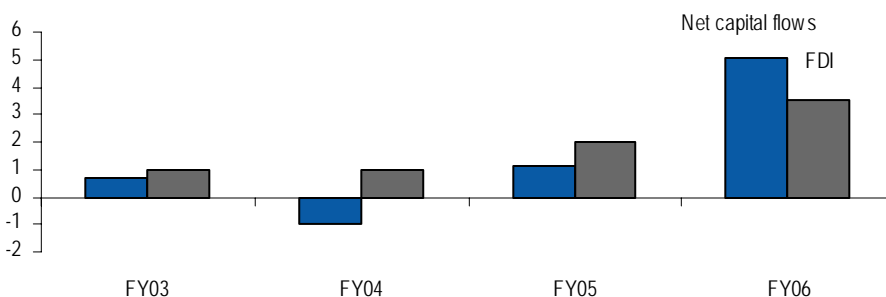
The EMBI spread against the US treasuries has sunk close to all-time lows, and Pakistan may end up getting a favorable spread yet again from the international bond market.

The large projected fiscal gap of Rs374 billion (4.2% of GDP) will have to be plugged through a combination of domestic and foreign borrowing. This is why, we believe, the Finance Ministry has reinstated the issuance of local long-term bonds (PIBs).

On the other side of the balance of payments, the surge in capital inflows has been more than sufficient to cover the elevated current account deficit, allowing foreign exchange reserves to be stable-to-higher.

Figure 8: Capital flows

US\$ in billions



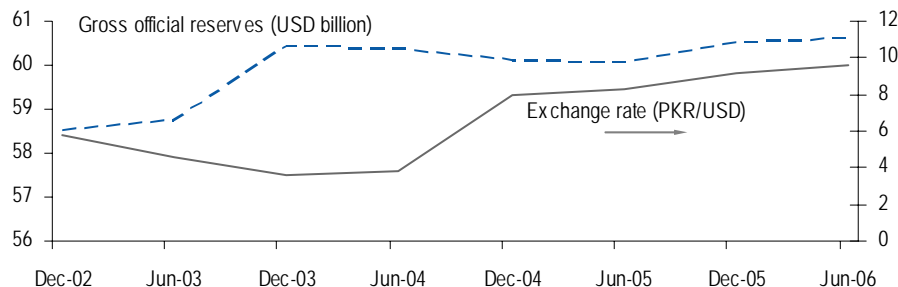
Source: IMF

Pakistan may be able to sustain current account deficits in the range of US\$5-6bn in the medium term according to the IMF

Over the medium term, financing the current account deficit will require a sustained inflow of non-debt creating capital. This means that the recent success of the privatization program must continue, as must Pakistan’s increased attractiveness to foreign investors. In addition, Pakistan has shown the ability to access international capital markets at attractive spreads over low US Treasury yields. The IMF, in its

recent assessment, has stated that it believes that Pakistan’s “external financing prospects can remain favorable for several years. During this period, Pakistan could sustain external current account deficits in the range of US\$5-6bn (consistent with a steady decline in the current account deficit-to-GDP ratio), and strengthen gradually its international reserves position.”

Figure 9: Foreign exchange reserves & exchange rate



Source: IMF

PKR to continue to be tightly managed

After the decision in May 1999 to scrap both the official exchange rate (PKR 46 to the US dollar) and the dual exchange rate system, the PKR has moved in a tight range of PKR/USD 59-61. Indeed, the movements of the currency have been so small that the IMF officially labels the currency as having a de facto peg to the dollar (a label the government rejects).

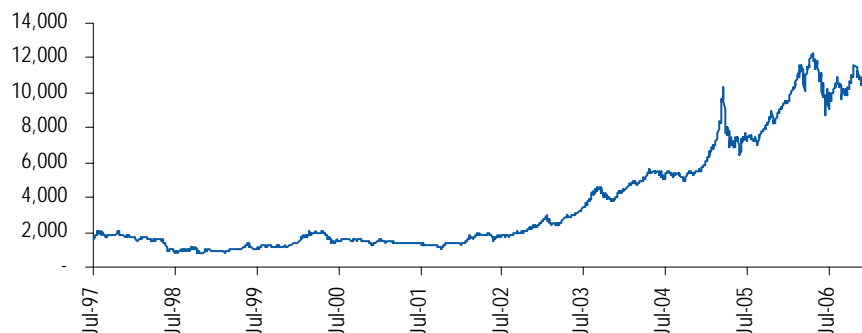
PKR depreciation of 1% expected over the course of 2007 to 61.5 PKR/US\$

Going forward, our expectation is that the balance of payments will post a small surplus in 2007. Combined with the JPMorgan forecast of general dollar weakness and strength of currencies in the rest of Emerging Asia, these dynamics point to the possibility of a slight nominal appreciation of the Rupee versus the US\$. However, given the size of the current account deficit and the lumpiness and risks around capital inflows, we would expect another slight depreciation of 1% over the course of 2007 (61.5 PKR/US\$).

Equity market overview

This section provides a historical perspective for the reader on how Pakistan's Karachi stock index (KSE) came to be one of the best performing stock markets in the region over the last few years

Figure 10: KSE-100 historical movements



Source: Karachi Stock Exchange

KSE structure and economic representation

Table 13: Sectoral share in stock market capitalization and economy

Sector	Wt. in KSE Market Cap.	Wt. in Economy
Oil & Gas Exploration & Production (Mining)	26.0%	2.6%
Banking, Finance, & Insurance	31.0%	4.6%
Transport & Communication	7.6%	10.5%
Electricity & Gas Distribution	5.1%	3.0%
Agriculture	0.0%	21.6%
Textile	3.4%	3.1%
Sugar	0.7%	0.5%
Cement	3.5%	0.5%
Fertilizer	4.7%	0.4%
Pharmaceuticals	1.6%	0.6%
Automobiles	2.6%	0.5%

Source: Economic Survey of Pakistan and Karachi Stock Exchange

Table 14: Pakistan stock market returns

	KSE-100	Return
2001	1,273.06	-15.6%
2002	2,701.41	112.2%
2003	4,471.60	65.5%
2004	6,218.40	39.1%
2005	9,556.61	53.7%
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Source: Karachi Stock Exchange

2002-2005: The locals never had it so good

During the early years depicted in Figure 10 and Table 14, Pakistan remained on most foreign funds managers' restricted lists for numerous reasons. Some of the obvious ones included the war next door in Afghanistan, souring relations with India, law-and-order concerns within the country with a spate of bomb attacks carried out on foreign targets, and the high-profile murder of US journalist Daniel Pearl. In fact foreigners were so visibly afraid to come to Pakistan that sport and cultural activities also came to a standstill in the country's commercial hub of Karachi, which is also its largest city. (For a detailed look at Pakistan's geography, please refer to the map in the Appendix to this report).

From a P/E multiple of under 5x to near double digits in a few years

Towards the end of 2001, the stock market in Pakistan seemed to be in the doldrums, with the benchmark Karachi Stock Exchange 100 Companies' Index (KSE-100) trading at a level of 1273 points. At the time, this constituted a P/E multiple of under 5x, reflecting the dearth of interest in Pakistani equities.

Table 15: Historical P/E multiples for Pakistan

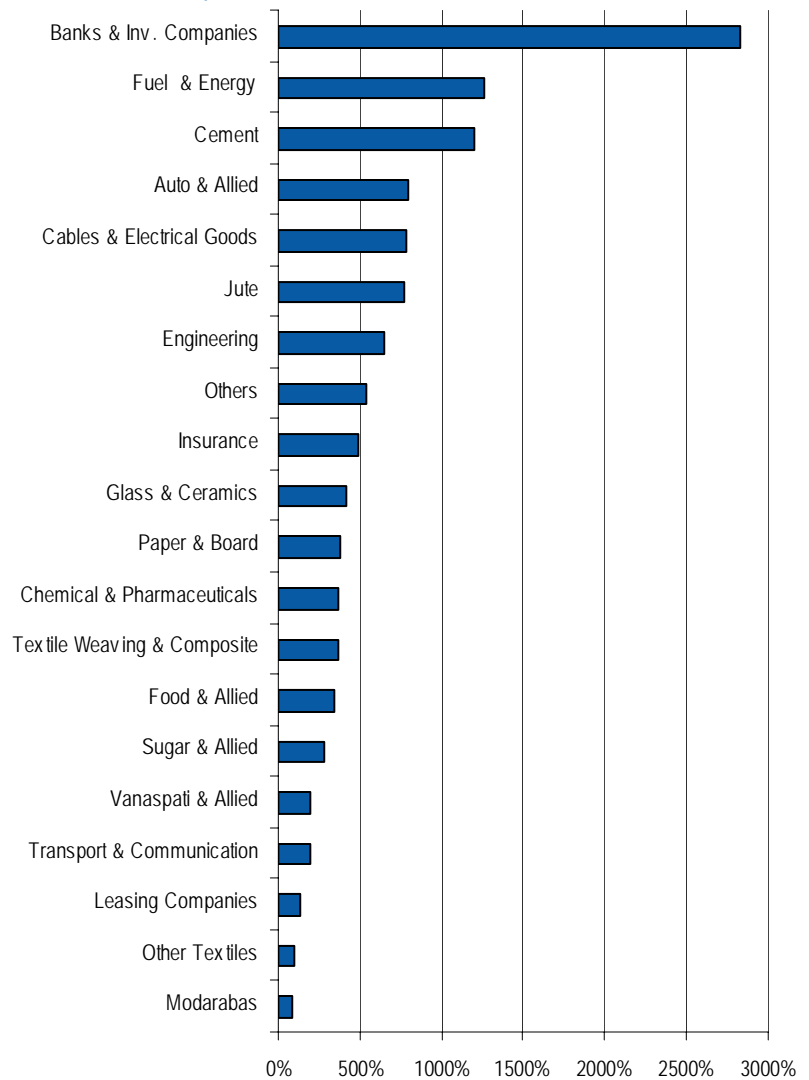
2001	2002	2003	2004	2005	2006
9.59	4.89	5.45	6.55	7.56	10.95

Source: Karachi Stock Exchange and Company Reports

*Calculated as Avg. Market Capitalization divided by Net Profit for the year

The rise in stock values was so swift, and aided by a completely bottomed-out base, that the Karachi stock market was nominated as the ‘Best Performing Stock Market in the World’ in 2002.

Figure 11: Sector-wise market capitalization increase FY02-FY06



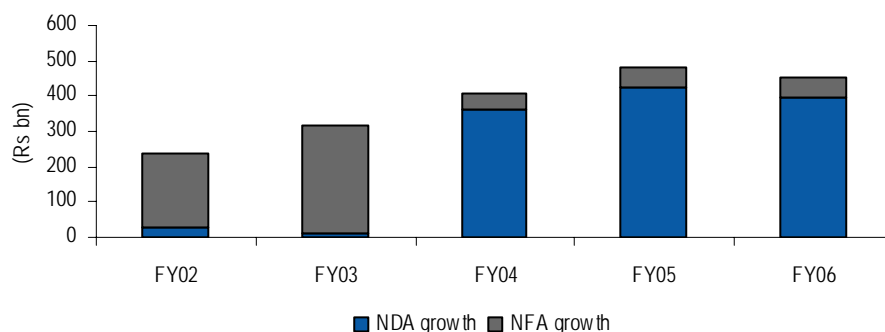
Source: State Bank of Pakistan Annual Reports

Rapid rise in money supply post 9/11

Rising money supply following 9/11 and easy monetary policy were key drivers
 Money supply post 9/11 grew rapidly primarily driven by expatriate Pakistanis; note the growth in net foreign assets (NFA) of the banking system. Post 9/11 scrutiny on foreign currency transfers through unofficial 'hundi and hawala' channels compelled expatriate Pakistanis to remit their funds through the legal channels, i.e. the banking system. As Pakistan participated in the war on terror as a leading coalition partner, funds also flowed in via grants and aid from the US and multilateral donor agencies.

Net development aid grew rapidly in FY02-FY03
 Then net foreign assets in the banking sector grew due to expatriate remittances

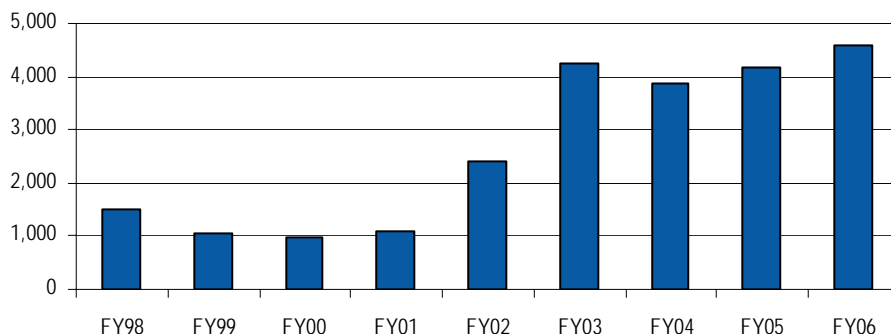
Figure 12: Contributions of NDA & NFA in M2 growth



Source: State Bank of Pakistan Annual Reports

Figure 13: Growth in workers' remittances

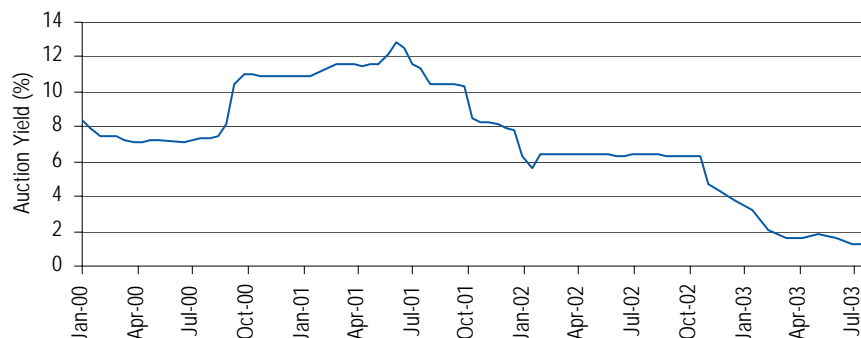
US\$ millions



Source: State Bank of Pakistan Annual Reports

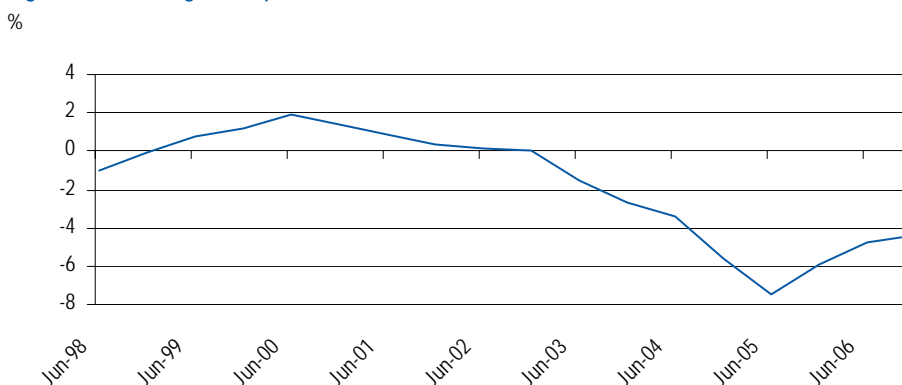
With many gulf based expatriates a higher oil price has helped boost remittances

Figure 14: Declining 6-month T-bill yields



Source: Bloomberg

Figure 15: Declining real deposit rates forced funds to be directed towards stocks



Source: State Bank of Pakistan and Economic Survey of Pakistan

Lower risk-free rate plus strong growth

With interest rates moving down, along with required rates of return for investors from the stock market, the re-rating process of local equities began with an uninterrupted bull-run lasting from 2002 to 2005.

The country's return to above-average GDP growth numbers also pushed up equity prices, as corporate profitability rose significantly in 2002-2005.

Table 16: Corporate profitability growth since 2002

2002	2003	2004	2005
74%	61%	82%	40%

Source: Karachi Stock Exchange & Company Reports

Table 17: Dividend yields at KSE

2002	2003	2004	2005	2006
14.0%	10.5%	8.1%	8.0%	5.1%^

Source: Karachi Stock Exchange & Company Reports

*Calculated as Total Dividend divided by Avg. Mkt. Cap

^Source: Bloomberg

Table 18: Funds raised through stock market: 2002-2005

Year	Rs millions
2002	1,155.9
2003	8,016.6
2004	13,835.2
2005	7,444.5
Total	30,452.2

Source: Karachi Stock Exchange

Rs286 billion (US\$4.8 billion) of privatizations since 2002

The largest privatization in Pakistan's history, that of Pakistan Telecom, took place in 2005 with 26% management stake being sold for US\$2.6 billion

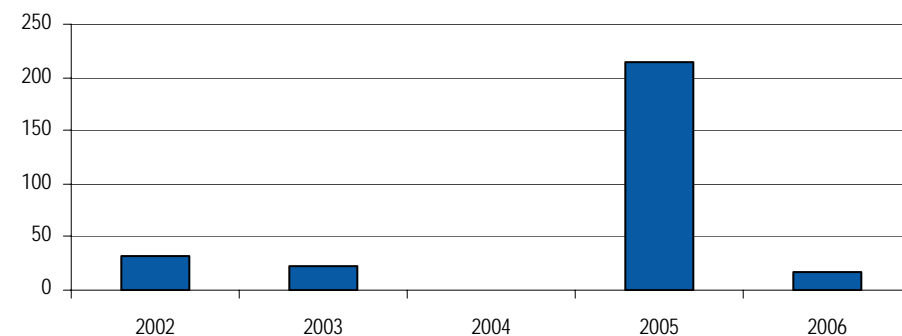
SECP has initiated a number of reforms to improve transparency of dealings at the KSE and reduce the risk on the KSE itself

Capital raising

As can be seen in Table 18 equity capital-raising increased sharply in 2004 (see Appendix for a detailed list). Out of the Rs30.5 billion raised, Rs20.6 billion was the sale of SoEs by the government of Pakistan.

Figure 16: Privatization sale proceeds

Rs in billions



Source: Privatization Commission of Pakistan

Note: Details available in Appendix

There has been good foreign interest (mainly Middle Eastern) in Pakistan's privatization transactions, particularly in the financial and telecommunications sectors. In fact, in the privatization process of Pakistan Telecommunication Company (PTCL), UAE-based Etisalat outbid its nearest competitor, China Mobile, by nearly a factor of two. The privatization transaction of PTCL was the largest ever in the country's history, with 26% shares along with management control being sold for Rs155bn (US\$2.6bn). The government even managed to privatize the loss-making Karachi Electric Supply Company (KESC). Yet again, Middle Eastern interest was at the forefront. Now, following the sale of GDRs of the country's most profitable entity, Oil & Gas Development Company (OGDC), the government has several other capital market transactions and strategic sales lined up in 2007.

Regulatory reform

The Securities & Exchange Commission of Pakistan (SECP) passed many reforms from 2002 to 2005 (See Box 1). They dealt with the shortcomings of the indigenous leveraging system called 'badla' or 'carryover transactions' (COT), which historically played a role in creating excessive market volatility (see Box 2).

Reforms on the corporate governance front were introduced, with listed companies being required to produce quarterly results, and half yearly results to be reviewed by auditors. Other corporate governance initiatives included institution of a statement from the company CEO and Chairman certifying the authenticity of accounts, as well as requiring the immediate dissemination of any 'material' information to the stock exchanges for quick communication to investors. Strict corporate governance measures resulted in numerous companies opting to de-list from the local stock exchange (see Figure 17), however, the 652 companies that are still listed, are now producing correspondence and reports that comply with much higher standards of corporate responsibility than before.

Box 1: SECP Reforms pushed through in FY02-FY05

The SECP has managed to push through some key reforms in the last few years. Some of the salient reforms are listed here (Source: SECP Annual Reports).

FY02: Key reforms pushed through in FY02 include:

- Regulations for Short Selling under Ready Market introduced
- Improvements in badla/COT regulations, e.g. minimum period of 10 days, restricted to liquid shares only, higher margins, etc.
- Investor Protection Fund and Clearing House Protection Fund set up.
- Reclassification of Board of Directors of Stock Exchanges, i.e. 4 non-member directors along with 5 member directors, position of Vice Chairman abolished, etc.
- Regulations for Futures Trading in Provisionally Listed Securities.
- Over the counter (OTC) market set up.

FY03: Key reforms pushed through in FY03 include:

- Listed Companies (Substantial Acquisition of Voting Shares and Takeovers) Ordinance, 2002 introduced.
- Development of a road map to replace COT with margin financing and stock futures.
- Order given for implementation of Unique Identification Number for clients and account holders.
- Restriction placed on physical settlement of shares. All shares to be settled through the Central Depository System.
- Managing Director of stock exchanges to be appointed by SECP.
- Restriction on brokers from holding position on boards of directors of listed companies.

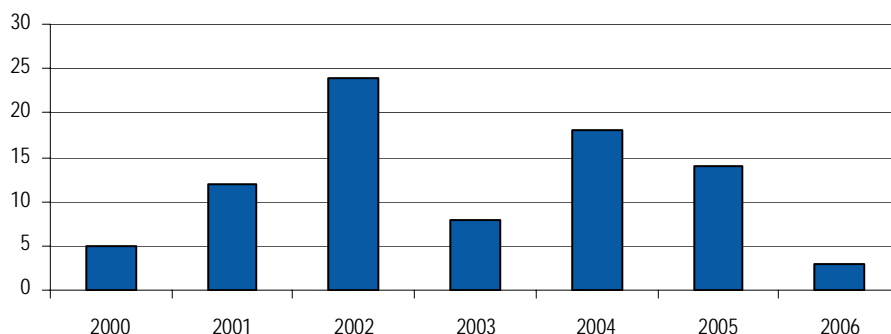
FY04: Key reforms pushed through in FY04 include:

- Notification of Margin Trading Rules, 2004.
- National Clearing and Settlement Systems Regulations, 2004.
- Selection of 29 stocks for COT eligibility.
- Selection of top 15 COT eligible stocks for futures trading.

FY05: Key reforms pushed through in FY05 include:

- Commencement of COT phase-out, which was abruptly stopped following the March 2005 crash.
- Notification of Clearing Houses (Registration and Regulation) Rules, 2005.
- Regulations for Proprietary Trading, 2004.
- Regulations for Securities Lending & Borrowing, 2004.
- Internet Trading Guidelines, 2005.
- Prohibition of Group Account Facility.
- Elimination of COT and replacement with CFS.

Figure 17: Number of delistings in recent years



Source: Karachi Stock Exchange

However, in the last couple of years, the SECP's role in stock market regulation has come under pressure. This has occurred as the result of the SECP taking the blame for a market crash in March 2005.

Solving the March 2005 crash: SECP's standing diluted

One of the darkest episodes in the history of Pakistan's stock market occurred in March 2005, when the benchmark KSE-100 Index managed to lose 26% of its value in a matter of 12 trading sessions. Four heavyweight stocks were mainly responsible for the rise and fall of the KSE-100 Index during the forlorn month of March 2005. The rise in the KSE-100 was driven mainly by 4 heavyweight stocks, namely OGDC, PPL, PTCL, Hubco, and NBP, but almost no listed stock was spared in the carnage that ensued.

The March 2005 crisis was such a serious event that the government was forced to intervene and formulate an independent task force to try and ascertain the reasons for the crash. The task force came out with its report in a few weeks' time and attributed a host of reasons for the sudden decline in stock prices. The SECP, stock brokers, leverage providers, etc. all found themselves being held accountable for part of the blame. The task force made some recommendations to try and make dealings more transparent and less risky at the stock exchanges. New risk management ideas were floated, and some have also been implemented.

However, the government's parliamentary committee on financial affairs organized yet another probe into the March 2005 crash following intense public pressure. This time, a foreign forensic investigation team was hired to try and sort out the details to arrive at a conclusion. The investigation turned out to be an anti-climax, with all suspected parties (brokers, govt. officials, stock exchange management, etc.) being absolved of any wrongdoing. The eventual blame was laid at the feet of the SECP, which apparently had inadvertently caused the crash by tinkering with the stock exchanges' risk management systems. This has effectively reduced the 'clout' of the regulator, but not before significant reforms had been achieved.

For more detail on the events leading up to this change in perception about the SECP, please read on in the next section.

Pakistan attracted concerted foreign interest in FY05 and FY06 after a 10-year hiatus

2005-2006: Enter the foreign fund managers

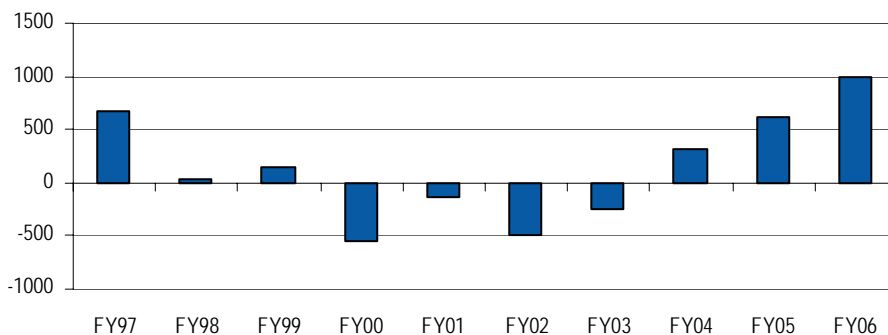
Its run of success brought Pakistan's stock onto the radar screen of foreign fund managers. Added to this, investibility improved due to the increase in market capitalization, aided by higher free float through new stock market offerings. Market capitalization surged 5.5 times from US\$7 billion to US\$46 billion over a period of four years, taking stock market capitalization to GDP from 9% at end-FY02 to around 36% at end-FY06.

FPI at its highest since 1990s

As a backdrop, Pakistan endured one of the leanest periods in terms of foreign portfolio investment (FPI) in its stock market during the latter half of the 1990s and the early part of the 2000s (Figure 18).

Figure 18: Foreign portfolio investment in Pakistan

US\$ in millions



Source: State Bank of Pakistan Annual Reports & Website

Foreign investment still a small part of stock market free float

Even though the numbers are the highest in a decade, foreign portfolio investment in Pakistan's stock market still accounts for only 17-18% of free float. Table 19 shows how foreign investors have divided their money invested in Pakistan.

Table 19: Pakistan's foreign investment position (US\$ in millions)

	Stock as on 31-12-2003	Stock as on 31-12-2004	Stock as on 31-12-2005 (P)
Direct investment in Pakistan	8,196	8,367	10,480
Equity capital and reinvested earnings	6,540	6,935	9,118
Other capital	1,656	1,432	1,362
Portfolio investment	1,182	1,662	2,423
Equity securities	217	495	946
Debt securities	965	1,167	1,477
Other investment	36,193	36,117	34,898
Trade credits	-	-	-
Loans	33,828	34,161	32,414
Currency and deposits	970	581	1,021
Other liabilities	1,395	1,375	1,463

P : Provisional

Source: State Bank of Pakistan

Contagion effect low as a result

With Pakistan's stock market having little participation from foreign investors, it has remained largely de-linked from turbulence in other regional stock markets.

Figure 19: KSE-100 vs regional indices since 2003



Source: Bloomberg

While the KSE had a significant (29%) correction in April-June 2006, this was driven largely by internal factors, such as regulatory issues and expectations of incremental tax being levied on capital market transactions in the FY07 Budget, which was to be announced in June 2006. According to the State Bank of Pakistan (SBP) data, funds flow of foreign portfolio investors to/from the Special Convertible Rupee Accounts (SCRAs) shows that there was nearly not as much foreign selling in the Pakistani stock market to cause such a huge crash of 3505 points (29%). There was an outflow of \$30mn in April 2006, while May 2006 only saw an outflow of \$1.5mn. The bottom line, however, is that June 2006 actually saw positive flow into SCRAs worth \$3.6 million.

Box 2: 'Badla' and 'CFS'

Pakistan's stock market has always contributed its fair share to controversy doing the rounds in the local media. Most of the controversy has centered on the unique, yet routinely chastised, method of financing used by leveraged investors. It was banished from the Indian stock market in 2001 to allow development of the derivatives market, and Pakistan remains the only country in the world that still practices it.

Definition: *'Badla', an Urdu term meaning 'to return', is the unique sub-continental mode of purchasing shares by leveraging oneself. It is basically a repurchase agreement, also known as Carry Over Trade (COT), between the buyer and seller. Badla is carried out on the Karachi Stock Exchange Trading System (KATS), and a bid/offer mode is used.*

Modalities: *Lenders and borrowers use KATS screens to execute all badla transactions. Previously bids and offers were placed in terms of Rupees, however, now percentages are used to eliminate the cumbersome process of calculating the 'badla rate' (cost of borrowing). Trading in the badla market used to begin right after the regular market closed. But now it's held in tandem with regular trading hours, and extended for an hour after regular trading hours. Badla has now been renamed as 'Continuous Funding System' (CFS) to address its 'continuous' nature.*

Stocks eligible for badla/CFS financing: *This list has also been shortened and extended several times. From as high as all the listed companies, to as low as less than 10 stocks, this list has been rewritten plenty of times. As of now, this list holds 71 stocks. For a list of stocks eligible for badla financing, please refer to the Appendix to this Report.*

Crises blamed for: *The foremost danger of badla remains that stock brokers continue to be badla financiers, either directly or indirectly. With most stock brokers running proprietary books, this exposes borrowers to a situation where stock brokers may be aware of the extent of their leveraged positions. May 2000 was when the dangers of badla came to the fore. The KSE-100 Index lost 26% in a matter of 6 weeks. Fingers were raised at not only suspected culprits, but also the badla mode of financing. Other crises blamed on badla include May 2002 stock market correction and the March 2005 stock market crash.*

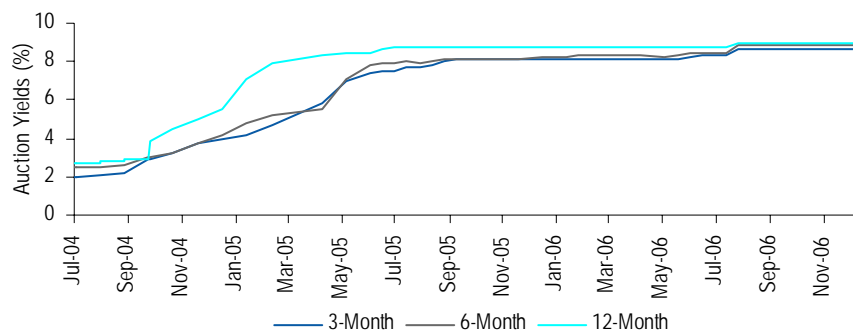
Points to Ponder: *Badla/CFS has been repeatedly blamed for non-development of a proper equity derivatives market at KSE. Margin financing has also fallen victim to its existence. We believe that in order to develop a thriving derivatives market and reduce volatility in the stock market, the SECP may have to take steps as drastic as those taken in India in 2001. Comparisons with India are made when we talk about multiples. However, a remedy for quite a few ills of the stock market may be elimination of badla/CFS.*

Tightened monetary regime during 2005-2006

After a three-year period of low interest rates and easy monetary policy, State Bank of Pakistan (SBP) was faced with the prospect of an overheating economy. Year-on-year inflation based on the Consumer Price Index (CPI) had surged to over 11% in

the early part of 2005. SBP had already begun to hint at possible rate rises since the middle of 2004 with a consistent increase in Treasury Bill auction yields.

Figure 20: Tightening monetary policy



Source: Bloomberg

A 150bp increase in the policy discount rate in April 2005 showed SBP's seriousness in warding off inflationary threats

The real indication of SBP's seriousness in terms of moving to a tightened monetary regime came through a 150 bps increase in its discount rate from 7.5% to 9% in April 2005. This 150bps increase was the first discount rate increase since June 2001, and served to prolong a decline in equity prices.

The rate hike had an immediate impact on the corporate sector, where recent investment had been financed primarily on a floating rate basis; higher policy rates raised borrowing costs as well.

Table 20: SBP discount rate changes in recent years

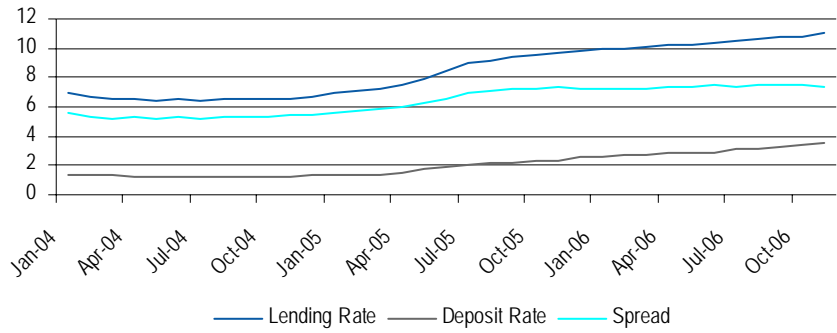
Discount Rate	Valid Till (Month)
12.00%	Oct-00
13.00%	Jun-01
14.00%	Aug-01
12.00%	Oct-01
10.00%	Jan-02
9.00%	Nov-02
7.50%	Apr-05
9.00%	Jul-06
9.50%	To-Date

Source: State Bank of Pakistan

The tight monetary regime continued onward into 2006, and another discount rate increase was announced in July 2006. Newly appointed SBP governor, Dr. Shamsah Akhtar increased her focus on maintaining a reasonable lending-deposit spread for banks, and has been pushing banks to provide positive real returns to depositors. Therefore, another tool used by SBP during 2006 to try and restrict money supply growth (and influence deposit rates) was the reserve requirement for banks. These were raised right before the half-yearly Monetary Policy Statement was released in July 2006.

Figure 21: Rising spreads of the banking sector

Auction Yields (%)



Source: State Bank of Pakistan

With benchmark interest rates on the higher side, Pakistan's stock market faced a reduction in justifiable valuation multiples. Therefore, other than the banking sector, where rising spreads more than nullified the impact of lower justifiable multiples, listed sectors were faced with reduction in valuations.

Politics: A one-man show?

President Musharraf the lynchpin of Pakistani politics

Despite international disapproval on General Pervez Musharraf's advent into Pakistan's politics in October 1999, his position has consolidated into one of strength, supported by growing local popularity. His ascent to power was welcomed locally as the public became disillusioned with the high profile corruption and policy inertia of democratically elected governments.

Parliament looks set to complete its term for the first time in country's history

Even though Pakistan and India were carved out of the same sub-continent, both countries' political fortunes couldn't have traveled a more divergent path. While Pakistan's political history has been cluttered with military interventions and the country's split-up in the 1970s, India has had a much more stable democracy to work with, with no military intervention at all.

Box 3: Pakistan's Political Chronology

Pakistan's political history has been marred by several instances of imposition of military rule, as democracy has been unable to thrive in the country. Here are some key dates in Pakistan's checkered political past.

- | | |
|-------------|-----------------------------------------------------------------------------------------------------------------------------------|
| 1947 | <i>Pakistan's independence is declared from British rule, in the form of East and West Pakistan</i> |
| 1948 | <i>Pakistan's founder, Muhammad Ali Jinnah passes away.</i> |
| 1948 | <i>First war with India over disputed territory of Kashmir.</i> |
| 1951 | <i>Liaquat Ali Khan, Pakistan's first Prime Minister is assassinated.</i> |
| 1956 | <i>Pakistan's constitution proclaims it an Islamic Republic.</i> |
| 1958 | <i>President Iskander Mirza imposes martial law and takes over country's leadership.</i> |
| 1958 | <i>President Mirza is deposed, and General Ayub Khan takes over country's reins.</i> |
| 1960 | <i>General Ayub Khan becomes president.</i> |
| 1965 | <i>Second war with India over Kashmir.</i> |
| 1969 | <i>Gen. Ayub Khan resigns, and Gen. Yahya Khan takes over as president and chief martial law administrator.</i> |
| 1970 | <i>Breakaway Awami League wins elections in East Pakistan, raising tensions with West Pakistan.</i> |
| 1971 | <i>Civil war in East Pakistan, which with the help of India, breaks away to become an independent country known as Bangladesh</i> |
| 1971 | <i>Gen. Yahya Khan resigns, and hands over power to a civilian, Zulfikar Ali Bhutto.</i> |
| 1972 | <i>Simla Peace Agreement signed with India.</i> |
| 1973 | <i>Zulfikar Ali Bhutto becomes Prime Minister and creates new constitution.</i> |
| 1977 | <i>Military removes Bhutto following allegations of vote-rigging in elections, and Gen. Zia-ul-Haq takes over.</i> |

1978	<i>Gen. Zia becomes president of Pakistan.</i>
1979	<i>Zulfiqar Ali Bhutto is hanged for alleged conspiracy to murder political opponent.</i>
1980	<i>US pledges assistance to Pakistan to thwart Soviet intervention in Afghanistan.</i>
1985	<i>Martial law lifted along with ban on political parties.</i>
1986	<i>Zulfiqar Ali Bhutto's daughter, Benazir Bhutto returns from exile to lead her Pakistan Peoples Party in elections.</i>
1988	<i>Gen. Zia is killed in a mysterious air crash along with other top officials.</i>
1988	<i>Benazir Bhutto becomes Prime Minister as her party wins elections.</i>
1990	<i>Benazir's government is removed by President Ghulam Ishaq Khan and Mian Nawaz Sharif becomes Prime Minister after elections.</i>
1993	<i>Nawaz government removed by President Ghulam Ishaq Khan.</i>
1993	<i>Benazir becomes Prime Minister again and Farooq Leghari becomes President.</i>
1996	<i>President Leghari dismisses Benazir's government on allegations of corruption.</i>
1997	<i>Nawaz Sharif becomes Prime Minister yet again and amends constitution to reduce President's powers.</i>
1998	<i>Pakistan conducts its first nuclear test in May.</i>
1999	<i>The Kargil conflict erupts with India, and US has to intervene diplomatically.</i>
1999	<i>Gen. Musharraf takes over power in a military coup and removes Nawaz Sharif.</i>
2000	<i>Nawaz Sharif goes into exile in Saudi Arabia.</i>
2001	<i>Gen. Musharraf names himself president while remaining chief of army.</i>
2001	<i>President Musharraf lends support to US-led war on terror following 9/11 attacks.</i>
2002	<i>Elections held, in which PML-Q and allies take over parliamentary majority. Mir Zafarullah Khan Jamali is elected Prime Minister.</i>
2004	<i>Jamali resigns his post, and Shaukat Aziz takes over as Prime Minister.</i>
2007	<i>General elections are planned for this year with press reports suggesting January 2008 as a possible timeframe for holding elections.</i>

After a series of hiccups, the parliament that was elected in 2002 looks set to complete its 5-year term, for the first time in the country's history. Marred by assassinations and military takeovers, Pakistan's parliament has never had a chance to complete a 5-year term since independence in 1947.

Table 21: Current political party composition in parliament

Party	Seats
PML – Q	126
PPP	71
MMA	63
MQM	17
PML – N	19
PPP Patriots	10
Others	36

Source: <http://education.yahoo.com/reference/factbook/pk/govern.html>

President Musharraf has used his uniform to let everyone know who the boss is, and to control the political scene in Pakistan

President Musharraf has created an alliance of politicians with differing ideologies

President Musharraf's adeptness in navigating the political environment has been a primary factor in maintaining stability, in our view. He has been at the forefront of almost all decisions made by Pakistan's parliament, while maintaining a finely-balanced coalition of various politicians. His assertiveness in dealing with any 'non-conforming' politicians has compelled his predecessors' (previous Prime Ministers) followers to join his ranks.

Even though the mainstream Pakistan Muslim League – Quaid-e-Azam (PML-Q) has been able to muster up enough strength to hold its own, President Musharraf has decided to work with other 'like-minded' politicians as well. The PML-Q is basically a group of politicians who have left their previous leader, former Prime Minister Mian Nawaz Sharif, to join hands with President Musharraf.

So far, Gen. Musharraf has done a commendable job of holding together a coalition of parties with such vast ideological differences. His refusal to join hands with the mainstream Pakistan Peoples Party (PPP) of Benazir Bhutto and Pakistan Muslim League – Nawaz (PML-N) of Mian Nawaz Sharif was a critical factor in breaking the stranglehold of these two parties on Pakistan's leadership.

Has used his uniform to great effect

If ever there was a way to cool down aspiring pretenders to the throne of Pakistan's Prime Ministerial role, President Musharraf seems to have used it perfectly. After having tried a candidate supplied by his PML-Q followers in Mir Zafarullah Khan Jamali for almost 2 years, President Musharraf decided to promote his own hand-picked Finance Minister to Prime Minister.

This political masterstroke not only let everyone in the political ranks know quite clearly who the boss is, but also embarked Pakistan on an image-building exercise like none before.

Even though he had made commitments to remove his military uniform earlier on during his reign, President Musharraf has probably seen through the political dangers that could emerge as a result. He has now clearly stated that the uniform will only come off when he is sure no harm can come to Pakistan when he does discard his military role.

However, it does seem very likely that President Musharraf will remain in uniform for as long as he is in charge of the country. We believe this is simply because the uniform, and the amendments he has made to the country's constitution, go so well together that a non-military ruler may not be viable for Pakistan in the medium term.

A necessary ally

Pakistan's journey during President Musharraf's tenure can be characterized as moving from a pariah state to a frontline ally of the First World, leaving the country's profile in the international political arena at its highest level in many years.

Accolades earned for being staunch ally in the ‘war on terror’

Since 9/11, Pakistan’s contribution on the global stage has increased. In a far wider role than ever before, Pakistan’s image amongst the western nations has received a significant makeover.

Box 4: Pakistan’s Contributions to the Global War on Terror

Pakistan has emerged as a key ally in the global war on terror initiated by the US. Pakistan’s contributions have been highlighted by US President Bush and other western leaders on many an occasion. Listed below are a few key contributions made by Pakistan, which have endeared President Musharraf to the west.

- *President Musharraf banned two militant groups, the Lashkar-e-Tayyabah and Jaish-e-Muhammad.*
- *Pakistan has provided basing and overflight permission for all U.S. and coalition forces.*
- *Pakistan has deployed a large number of troops along the Afghanistan border in support of OEF.*
- *Pakistan has spent a large portion of its logistical reserves to support the coalition, a very significant contribution in light of Pakistan’s economic difficulties and self-defense support requirements.*
- *Country representatives arrived at CENTCOM on March 14, 2002. There are five at CENTCOM.*
- *The Inter-Services Intelligence (ISI) has helped in various phases of operations to capture Al Qaeda operatives.*

President Musharraf is now considered one of the closest allies of US President George W. Bush. Pakistan has been singled out for praise on many an occasion by various western leaders for the country’s contribution in the US-led coalition, notably in its cooperation against Al-Qaeda.

Even though President Musharraf initially had to make a complete u-turn on Pakistan’s relations with the Taliban in Afghanistan, since then he has had to take some tough steps to ensure that there are no further policy u-turns.

Improved relations with India a key strategic positive

There was a time in the sub-continent’s history not so long ago when it was literally considered taboo to use the words ‘Kashmir’ and ‘dialogue’ in the same sentence, given that Pakistan and India have fought three wars since the split in 1947.

Relations have thawed since, and barring President Musharraf’s earlier diplomatic impasses with India, mainly due to his role in the Kargil conflict, India and Pakistan have finally managed to maintain regular, formal diplomatic ties. There are regular foreign secretary-level meetings, and foreign ministers also meet up when important issues are under consideration.

President Musharraf is likely to get re-elected

Pakistan is due to hold general elections in the last quarter of 2007. However, the caveat here is that President Musharraf will likely be elected by the already sitting

Relations have improved considerably with India, especially following the election of Congress party to power in India

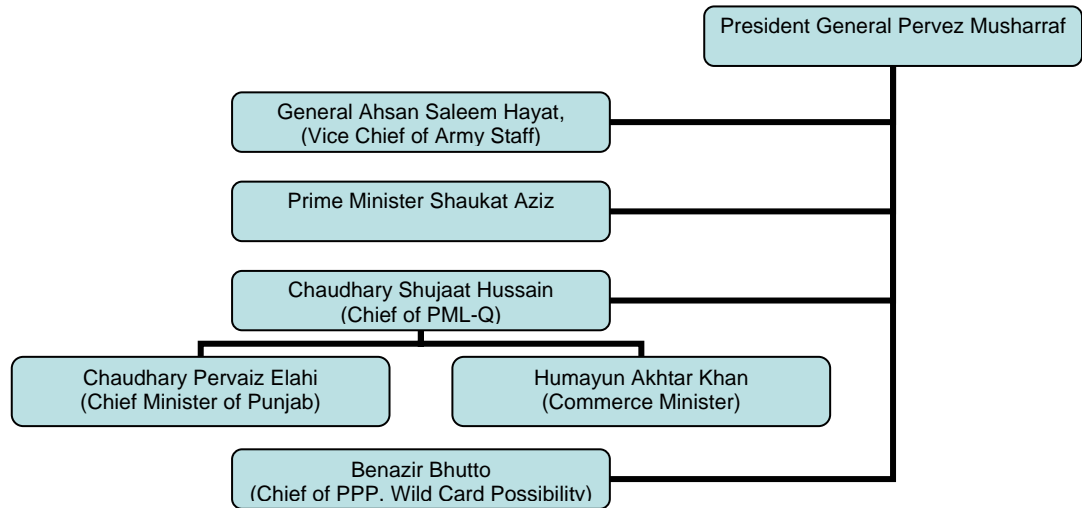
parliament of today. This is yet another political stratagem by President Musharraf to ensure a smooth path, at least with his re-election to the Presidential chair. We also believe that President Musharraf will retain his uniform following his re-election, given the necessity to maintain authority over the power centered on the armed forces.

Political allies may change, but same man to run the show

During the last couple of years, the position of the PML-Q (Pakistan Muslim League – Quaid-e-Azam) as President Musharraf’s foremost political ally has diminished slightly. Suggestions have been made that more unified, liberal political parties such as the PPP (Pakistan Peoples Party) may be invited to share in governance alongside President Musharraf.

Despite the potential broadening of political alliances, President Musharraf is likely to remain firmly in charge, with rifts amongst President Musharraf’s fiercest opponents, the MMA and PML-N, likely to be exploited to secure a stronger coalition for the next five years.

Figure 22: Possible successors of President Musharraf



Post-Musharraf future remains cloudy

Succession risk is the single-largest political risk that faces Pakistan. The centric focus of President Musharraf on himself without having apparently groomed any successor to take over in his absence is a big question mark. Currently all political influence and authority emanate from one central location, and any volatility on that front could once more render the political future of Pakistan uncertain.

The single largest risk to Pakistan’s economic turnaround and political scene is the absence of President Musharraf from the picture

While observers may conclude that economic reforms initiated by President Musharraf would continue in his absence, history suggests that political parties have a poor track record in converting strong starts given by authoritarian regimes into continued prosperity. In our view, Pakistan could see a power struggle as political parties jostle to fill the vacuum, to the detriment of the economy.

The most likely outcome of President Musharraf leaving his post now would probably be another military figure taking control at the top, given the highly divided political party environment. This would further retard the democratic process initiated by President Musharraf after he himself had ruled for three years on his own. However, constitutionally, the Senate Chairman becomes the president in the absence of the sitting president. Any new military man may opt to continue to rule on his own or conduct elections and then hand over control to a civilian government.

US elections in 2008 also important for Pakistan

The recently held congressional elections in the US have seen the balance of power shift towards the Democrats for the first time after the 1990s. Pakistan's relationship with the current Republican setup has been beneficial for both the US and Pakistan. However, we feel that a seemingly likely tilt towards the Democrats in the 2008 US presidential elections may force Pakistan towards yet another policy rethink. We feel that Pakistan may continue to be a key ally as long as the war on terror remains the main pivot of US foreign policy.

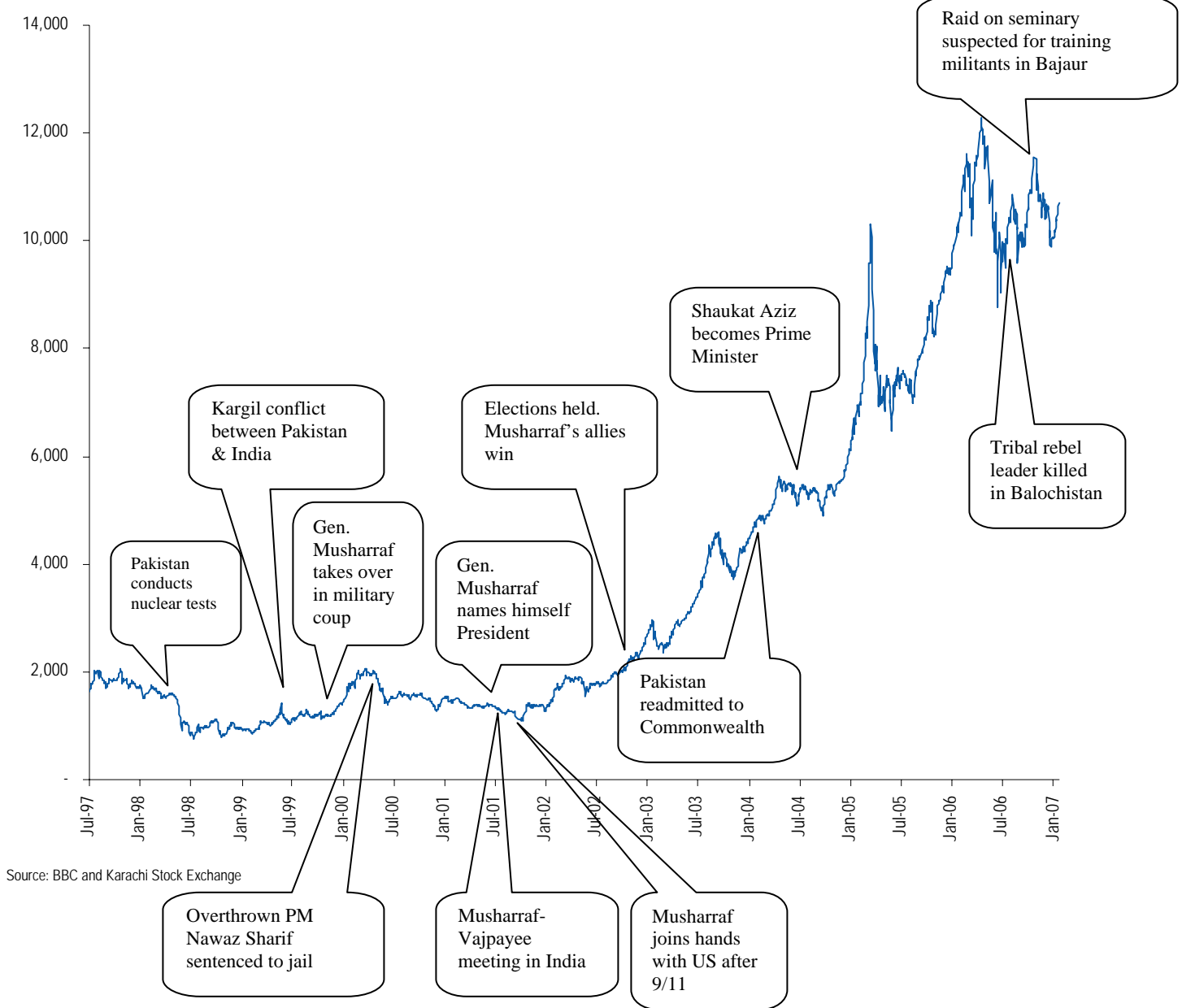
Bottom line: Continuity of policies on the cards

From an investor's point of view, the outlook for policy continuity is good, with the above succession caveats. President Musharraf is likely to secure re-election as President and remain chief of the army to further consolidate his power, in our view.

The only risk to continuity of policy may fall on the foreign policy front if the US presidential elections bring about a foreign policy shift that de-emphasizes the 'war on terror'. Otherwise, President Musharraf looks set to continue forward with his policy of developing Pakistan into a global player in terms of economic contribution.

Possible shift in US stance following 2008 presidential elections could be another risk factor for President Musharraf to cope with

Figure 23: Politics and its influence on KSE-100



Source: BBC and Karachi Stock Exchange

Market outlook: investment themes

Phenomenal returns seen in 2002-2005 may not be possible going forward, however, a more subdued, yet positive, return profile seems likely

Corporate earnings growth, increased foreign interest, increasing M&A activity, and continuity of policies following elections hold the key to the market's direction

Pakistan's stock market went through a consolidation phase in 2006, following 4 consecutive years of above-average returns, on the back of tighter monetary policy and regulatory reforms aimed at reducing speculative retail activity. Based on the investment themes identified here, we believe this sets the stage for local equities to resume their upward march. However, the phenomenal returns seen during 2002-2005 may not be available going forward, and a more subdued nominal return of close to 15-20% may be more likely.

An improving macroeconomic picture is likely to support corporate earnings growth in the medium to long term. Pakistan continues to trade at a discount to the regional and EM universes. Foreign interest in Pakistan's stock market continues to rise, and could act as a further catalyst for share price rises. Other investment drivers include possibility of progress on the privatization front, M&A activity within the corporate sector (especially the financial sector), while the outcome of 2007 elections, though fairly predictable, will hold the key to continuity of policies that have underpinned Pakistan's economic resurgence, and as such will continue to hold significance for the stock market.

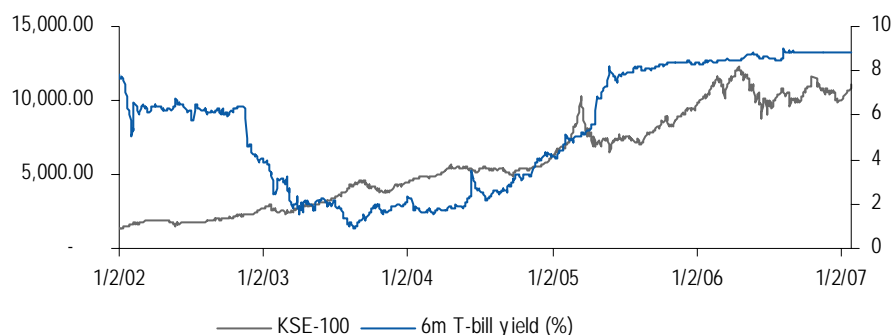
Benign macro/political outlook

Key investment drivers from a macro perspective are a peaking interest rate and monetary policy cycle, continuation of expansionary fiscal policy, and the likelihood of a second Musharraf administration that will extend pro-market policy programs over the next five years.

Easier monetary policy

While headline inflation continues to be elevated, core non-food and non-energy inflation is easing (see Economy section). The SBP appears satisfied that its tightening measures have worked and will stay on hold for now. We believe that CPI inflation can move toward the target level of 6.5% for FY07, as food inflation and energy costs fall, raising the possibility of an easing of monetary conditions in the second half of 2007. Given the historical correlation between interest rates and the KSE, and the fact that most corporates borrow on floating rates, the impact on both ratings and earnings is likely to be positive.

Figure 24: KSE-100 vs interest rate movements since 2002



Source: Karachi Stock Exchange & Bloomberg

Infrastructure spending budget of close to 2% of GDP ahead of the election suggests a positive demand impact on various sectors

Fiscal pump-priming

Combined with a potential easing of the monetary stance later in calendar year 2007 (first half FY08), a huge development spending budget of 4.9% of GDP for FY07 ahead of the election suggests a positive demand impact on various sectors.

Infrastructure spending (close to 2% of GDP) is likely to provide impetus to cement demand. In fact, cement demand is already up 26% Y/Y during 1HFY07. Other construction-related, ancillary sectors like glass, engineering, paints, etc. are also likely to see greater demand for their products. Banking stands to benefit as well in terms of additional credit demand to be generated, both from the public and private sectors. However, an issue remains with banks' balance sheets a bit stretched in terms of (Advances + Investments)/Deposits Ratio. At end-2006, this ratio stands at 106%.

Additional power demand is also likely to be generated as a result of coming on line of the new projects. Pakistan is already power deficient, and this would provide an incentive to the private sector to come forward with new power projects to try and bridge the gap.

Listed companies that could feel the benefits include the cement majors DG Khan and Lucky Cement, power generators (if they go for expansions) Hubco, KAPCO, and Karachi Electric Supply Corporation (KESC), oil & gas marketing companies like PSO, Shell, Sui North, and Sui South. Telecom giant PTCL could also benefit from any infrastructure development in the country. Banks with more room available to increase asset/deposit ratios (ADR), e.g. National Bank of Pakistan and Allied Bank Ltd, are well positioned to benefit.

Robust earnings growth outlook

Corporate earnings expected to grow at close to nominal GDP growth rate in the medium to long term

Table 22 highlights the IBES consensus earnings growth estimates for each of the major listed sectors. The estimates are based on the MSCI Pakistan Index constituents, which account for 60% of the total KSE-100 market capitalization. Overall earnings growth estimates are quite in line with nominal GDP growth estimates of around 12-13% for FY07 and FY08. GDP growth in Pakistan is expected to be driven by consumption, as the case has been during the last 3 years of above-average growth.

Another component of the return would be the dividends received. Consensus dividend yield estimates for Pakistan's stock market are in the range of 5-6% annually. Therefore, total nominal return for investors in Pakistan's stock market may be in the range of 15-20% on an average annual basis in the medium term.

Table 22: Sector-wise earnings growth contribution based on MSCI Pakistan Index stocks

	FY07E	Contribution to growth	FY08E	Contribution to growth
Oil & Gas Exploration	15.3%	6.7%	13.8%	6.0%
Telecom	1.2%	0.1%	11.4%	1.3%
Oil Marketing	-32.4%	-1.1%	18.1%	0.6%
Banks	19.2%	5.5%	5.5%	1.6%
Gas distribution	4.6%	0.1%	14.2%	0.4%
Fertilizer	6.3%	0.3%	6.4%	0.3%
Utilities	1.7%	0.0%	-0.4%	0.0%
Cement	-8.0%	-0.1%	59.9%	0.6%
Chemicals	40.2%	0.4%	34.1%	0.4%
Textiles	-5.0%	0.0%	23.6%	0.2%
Overall Market	11.9%	11.9%	11.4%	11.4%

Source: IBES estimates.

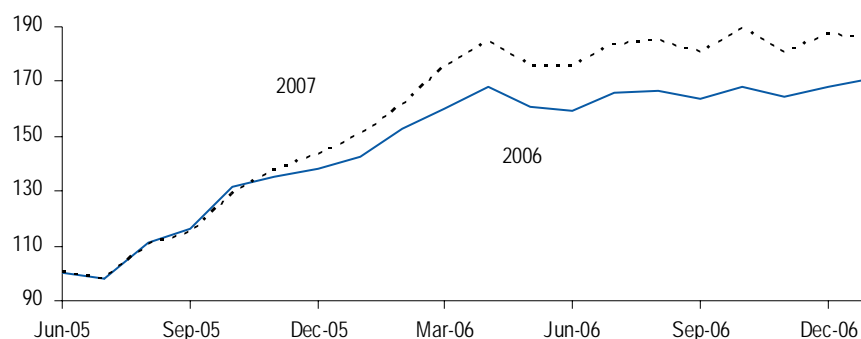
Table 23: Regional earnings growth comparisons

	2007E
Pakistan*	11.9%
Global*	9.4%
USA*	9.2%
Europe*	8.0%
Asia Pacific*	9.7%
Asia Pacific ex-Japan	9.8%
Pacific ex-Japan	5.4%
EMF Asia	14.6%
Japan*	14.3%
Australia	8.1%
China	6.6%
Hong Kong	-5.7%
India	17.5%
Indonesia	21.4%
Korea	14.1%
Malaysia	14.7%
Philippines	16.0%
Singapore	-2.3%
Taiwan	21.7%
Thailand	2.6%

Source: JPMorgan estimates. *IBES estimate using MSCI constituents.

On a regional comparison, Pakistan's earnings growth does not appear particularly exciting in 2007. However, IBES consensus forecast changes show that earnings momentum has shifted upwards over the last several months. This trend could continue in anticipation of easier monetary policy.

Figure 25: Pakistan stocks 2006 and 2007 earnings forecast trend



Source: Datastream, IBES

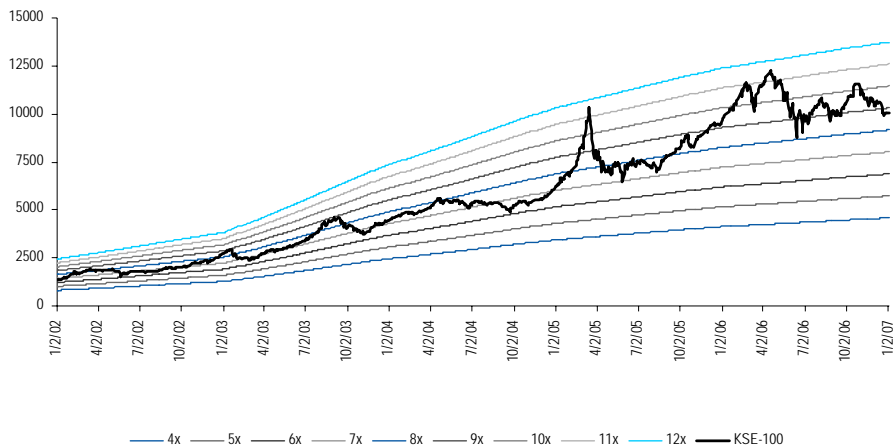
Note: All year ends are for December. EPS figures are normalized, starting at 100 on base date June 2005 for ease of comparison.

Cheaper valuations

Cheap on P/E and P/BV

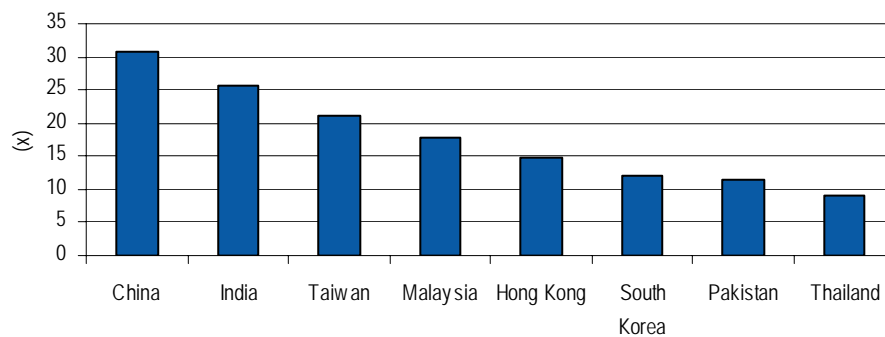
Pakistan is showing value on a historical comparison, with P/E having dipped below 11x (consensus) earnings from a 2006 peak of nearly 12x, while on a regional comparison, only Thailand is cheaper.

Figure 26: KSE-100 P/E bands



Source: Karachi Stock Exchange & Company reports

Figure 27: Pakistan's P/E multiple in a regional context

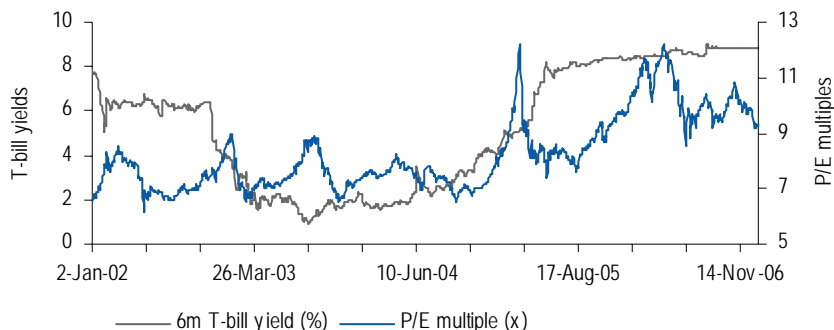


Source: Bloomberg

Note: Trailing P/E multiple used for comparison

However, part of the reason for the market's low P/E multiples lie in the connection with interest rates, which are structurally higher relative to the region.

Figure 28: Pakistan's P/E multiple in relation to interest rates



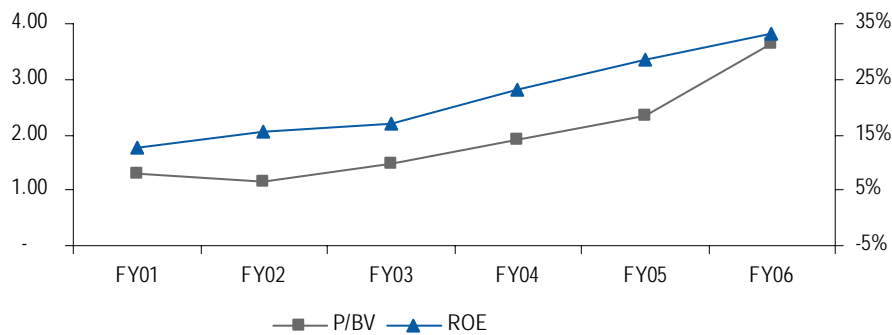
Source: Karachi Stock Exchange data & Bloomberg

Pakistan's listed companies continue to earn one of the highest ROEs in the region

P/BV and ROE comparisons – attractive relative to returns

Pakistan's listed companies have seen tremendous growth in profitability over the past four years thanks to an economic turnaround. Companies' ROEs have risen to over 30% on average. Figure 29 shows how linear KSE's P/BV to ROE relationship has been over the years as ROE has continued to increase. As a major weight in the Index is attributable to the energy sector, any decline in oil price that affects future ROE runs the risk of a downward adjustment in these ratios.

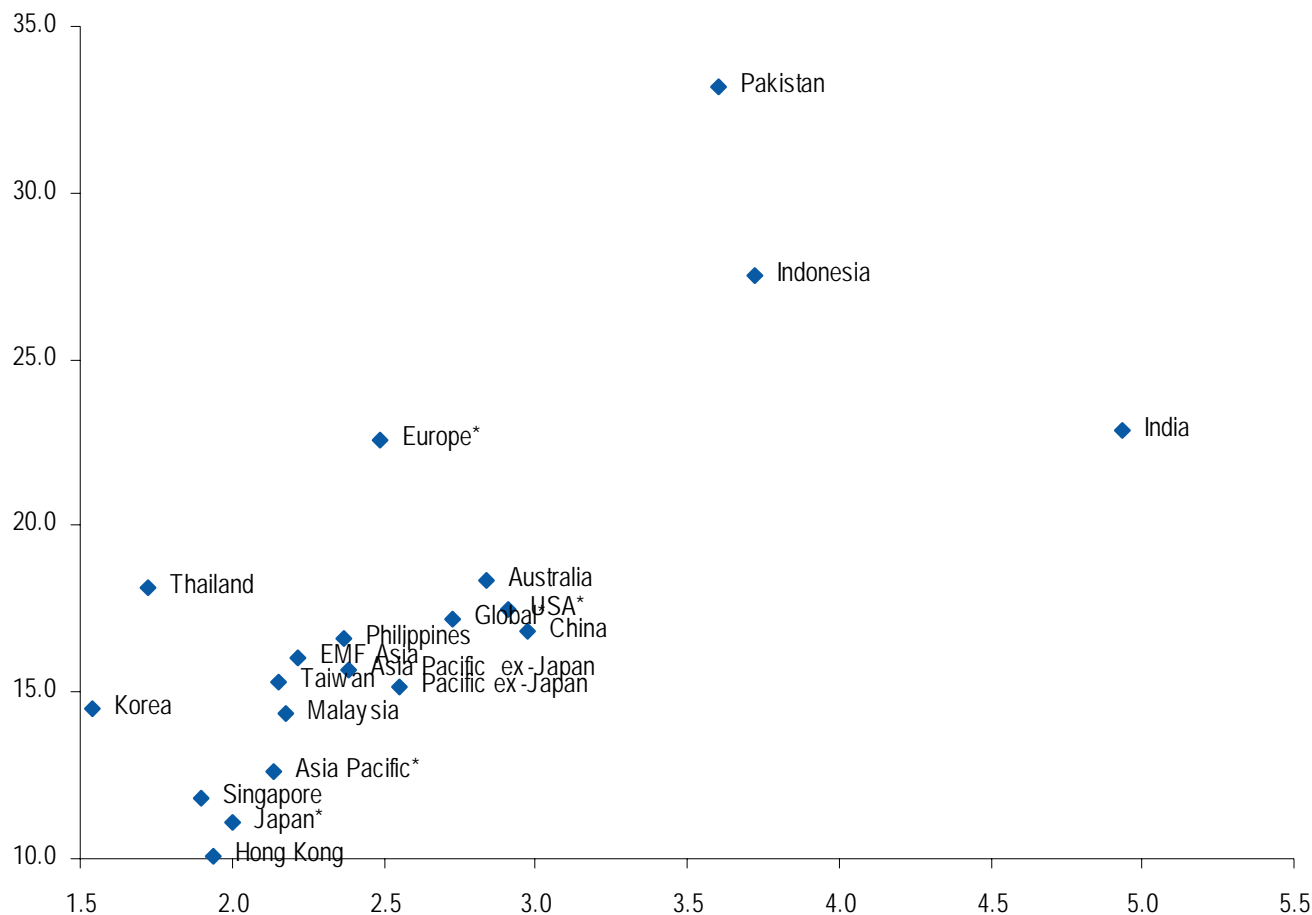
Figure 29: P/BV & ROE time series for Pakistan



Source: Company Reports & Karachi Stock Exchange.

Currently the KSE is trading at close to 3.6x on P/BV basis, while offering an ROE of 33.2%, based on IBES consensus earnings estimates. Figure 30 shows Pakistan's position with relation to other emerging markets in terms of P/BV-ROE comparisons, where it appears relatively cheap.

Figure 30: Pakistan compared regionally on a P/BV-ROE basis



Source: JPMorgan estimates; IBES estimates for Pakistan

Sustainability of returns - DuPont analysis to break down ROE

As can be seen from Table 24 and Table 25, Pakistani companies' ROEs have been a function of rising net profit margins over the last 5 years. Corporate profitability growth in Pakistan has also been consumption driven with aggregate demand enabling companies to charge higher margins for their products. But, declining oil prices could cause ROE to fall, given the high net profit margins attributable to the oil companies.

However, the following two tables also show that the extremely high ROEs for the market as whole have been driven by the banking sector. However, ROE ex-banks is still a very respectable 20%+, but due to the asset turnover rather than margins. We believe this could be because large Pakistani companies formed several years ago still have not revalued their assets to market, and may be working with a lower base value. This is especially the case in the Energy sector. Elsewhere, asset turnover still has room to rise.

A further point worth noting is that leverage has declined across the market, and with a new easing monetary cycle set to commence, rising investment financed by borrowing could drive ROEs in the next leg.

Table 24: Trend of DuPont analysis of Pakistan stocks ex-Banks

	FY01	FY02	FY03	FY04	FY05
Net Profit Margin	2.9%	4.4%	5.9%	9.5%	10.1%
Sales/Assets	0.95	0.93	1.01	0.95	0.96
Assets/Equity	4.70	3.87	2.98	2.67	2.44
ROE	12.9%	15.8%	17.5%	24.2%	23.6%

Source: Company Reports.

Table 25: DuPont analysis ex-Energy ex-Banks

	FY01	FY02	FY03	FY04	FY05
Net Profit Margin	4.2%	6.8%	7.9%	10.0%	10.5%
Sales/Assets	0.79	0.79	0.82	0.82	0.75
Assets/Equity	3.98	3.28	2.99	2.86	2.68
ROE	13.2%	17.8%	19.4%	23.4%	21.2%

Source: Company Reports

Comparison with other regional markets

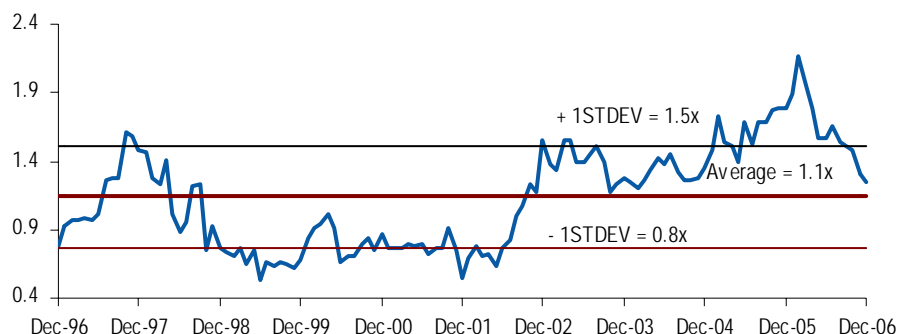
The tables below provide a quick glance at MSCI Pakistan's comparison with other regional emerging markets on the basis of ROE, P/E, P/BV, EPS growth, and dividend yield.

Table 26: Regional indices valuations

	26-Jan-07 MSCI Index	P/E (x)					Dividend yield (%)				P/BV (x)				ROE (%)		
		Current Trailing	12m Fwd	05	06E	07E	Current Trailing	05	06E	07E	Current Trailing	05	06E	07E	05	06E	07E
Global*	411	17.2	15.9	19.5	17.4	15.9	2.6	2.1	2.6	2.6	2.7	3.0	2.7	2.7	15.7	16.4	17.2
USA*	1,344	16.7	15.6	19.4	16.9	15.6	1.8	2.3	1.8	1.9	2.9	3.2	2.9	2.6	17.0	18.0	17.5
Europe*	1,512	14.2	13.3	16.1	14.3	13.3	3.0	2.6	3.0	3.2	2.5	2.5	2.5	2.3	17.2	17.5	17.9
Japan*	1,088	20.2	17.8	21.7	20.4	17.8	1.0	0.9	1.0	1.1	2.0	2.2	2.1	1.9	11.2	10.5	11.1
Asia Pacific*	137	18.0	16.6	20.3	18.2	16.6	1.8	1.6	1.8	1.9	2.2	2.4	2.2	2.0	12.6	12.7	12.6
AP ex-Japan	409	16.1	14.8	18.0	16.2	14.8	2.8	2.6	2.8	3.1	2.4	2.6	2.4	2.2	15.0	15.6	15.7
Pacific ex-Japan	390	17.3	16.5	19.4	17.4	16.5	3.4	3.3	3.4	3.6	2.6	3.3	2.6	2.4	15.8	16.7	15.2
EMF Asia	528	15.0	13.3	16.4	15.2	13.3	2.3	2.1	2.3	2.7	2.2	2.5	2.2	2.0	15.6	15.4	16.1
EMF LATAM*	5,918,870	13.7	12.1	16.1	13.9	12.1	2.2	2.2	2.5	3.2	4.3	4.5	2.8	2.4	24.8	25.2	20.6
EMF EMEA*	438	13.5	12.2	16.7	13.6	12.2	2.5	2.5	2.3	2.6	2.6	2.6	2.2	2.2	18.3	17.6	16.9
EM*	39,388	14.0	12.8	15.5	14.1	12.8	2.3	2.3	2.5	2.8	2.6	2.7	2.4	2.1	18.3	17.7	17.4
Pakistan*	380	11.6	10.1	12.7	11.8	10.1	4.6	4.6	4.5	5.4	3.8	5.4	3.9	2.9	38.8	38.6	33.5

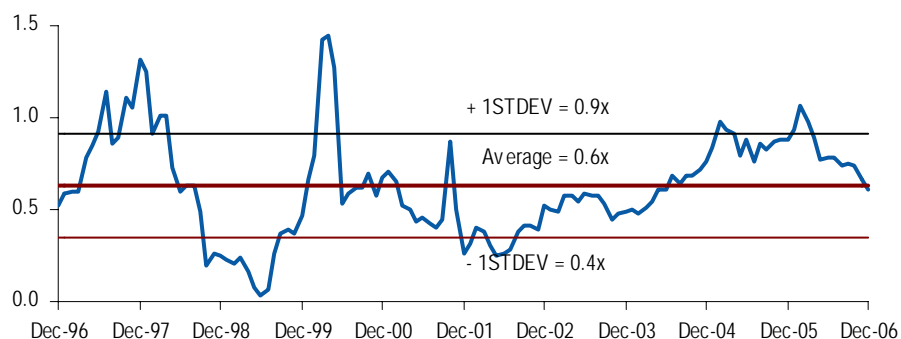
Source: I/B/E/S, MSCI, JPMorgan. * Market forecast numbers are derived from bottom-up calculations of each individual MSCI constituents using I/B/E/S estimates. For all other markets, forecast numbers are derived from bottom-up calculations of each individual MSCI constituents using JPM estimates for covered stocks and I/B/E/S estimates for the rest.

Figure 31: P/BV of MSCI Pakistan relative to MSCI Asia ex-Japan



Source: Datastream, MSCI

Figure 32: P/E of MSCI Pakistan relative to MSCI Asia ex-Japan



Source: Datastream, MSCI

Fund flows boosted by foreigners

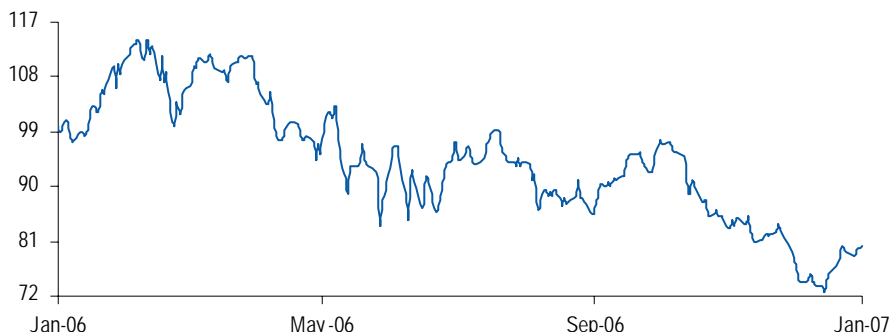
Foreign fund managers have actively started to take interest in Pakistan since FY05 and this interest has only grown over the last couple of years. New funds have flowed in from a host of countries.

Pakistan a catch-up play for 2007?

With a great number of countries still going through a tightening of money supply, Pakistan appears well placed with tight monetary policy likely to ease later this year. During the last year (2006), Pakistan's stock market consolidated and provided only a 5.1% return, while other global markets continued on the growth path. Figure 33 shows how Pakistan's stock market performed as against the broader Asia Pacific ex-Japan.

Focus shift away from tightening makes Pakistan's stock market appear well-placed in comparison with regional peers

Figure 33: MSCI Pakistan's underperformance versus MSCI Asia Pacific ex-Japan



Source: MSCI, Datastream.

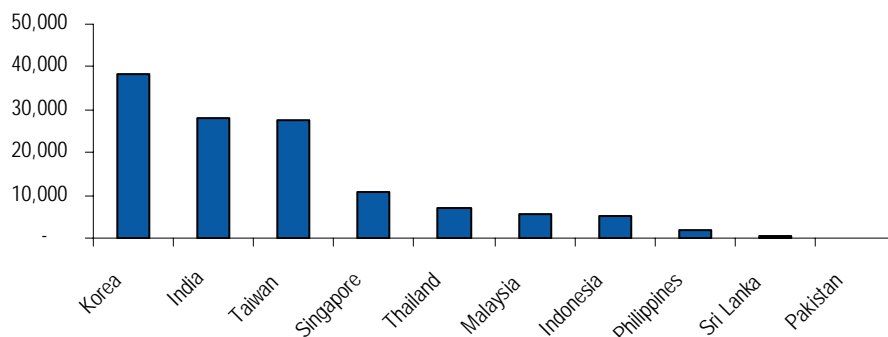
Foreign ownership continues to increase in Pakistan's stock market

Even though it still accounts for a small part of market free float, foreign ownership has seen its share swell in overall free float over the past couple of years to the highest level of the last decade. Despite this, foreign portfolios account for only 17-18% of free float.

By the end of 2006, foreign investment in equity securities in Pakistan had reached US\$2.0-2.1bn (JPMorgan estimates). This suggests further room for GEM mandates to enter the market.

Figure 34: Foreign portfolio investment of a sample of investors (as at Nov 2006)

US\$ in millions



Source: eMergingPortfolio.com

Note: eMergingPortfolio.com's Cross Border Country Flows Report measures monthly net foreign portfolio investment into and out of 51 emerging equity markets. Cross Border Country Flows (=Net Purchases (Sales)) is derived by taking the total change in market value of holdings in a particular country between the beginning and ending of the month, and adjusting the total change in value by the change due to market performance. End of month portfolio holdings data (sorted by country) is gathered for approximately 545 funds with total net assets exceeding \$220 billion (as of Jan. 31, 2004).

New equity supply could be a draw

Following a dry spell of nearly 10 years, Pakistan's stock market saw the issuance of GDRs of a local company. MCB Bank issued GDRs in 2006 via a listing in London, making it the first Pakistani bank to issue GDRs.

The government has already issued \$813 million worth of GDRs of the country's largest (by profitability) and the stock market's largest (by market capitalization) company, Oil & Gas Development Company Ltd. (OGDC). The issuance was

Several new GDRs and local listings have been planned for 2007

completed in December 2006, and although the GDR price was lower than many local consensus estimates, the government did manage to raise enough to fund its balance of payments comfortably.

Other such GDRs are also in the pipeline with National Bank of Pakistan (NBP) possibly being the next company to see its GDRs issued. This will yet again be a government offering, as NBP is a public sector bank.

Once the flow gets going, the government also plans to issue GDRs of other large cap stocks such as Pakistan Petroleum (PPL). New government offerings are also likely to make their way through local IPOs. These include Habib Bank Ltd., (the country's second-largest bank), Pakistan Steel Mills, State Life Insurance Company (the country's largest insurer), etc.

This expected further enhancement of free float is likely to provide further opportunities for foreign fund managers to access Pakistan's stock market.

High global risk appetite could support new foreign inflows

Globally, funds have been flowing into emerging markets with much more regularity and in much greater quantum than ever before. The global liquidity build-up due to good global economic growth over the last few years has allowed shrinkage in the EMBI spread.

Figure 35: Declining EMBI spreads show rising risk appetite

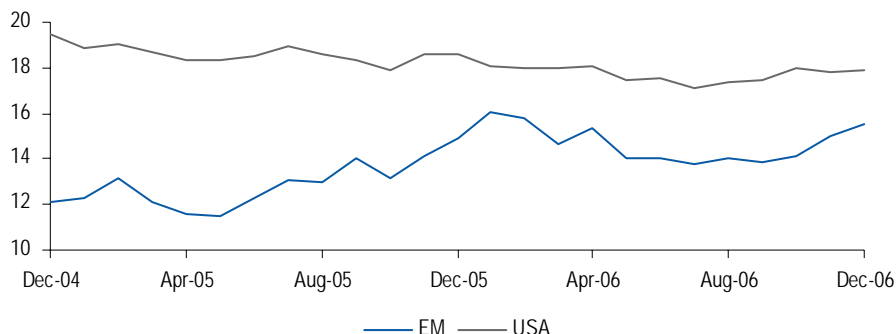
basis points



Source: Datastream

Despite this, EM equities have yet to show a similar re-rating, suggesting further inflows. Figure 36 shows the P/E multiple of MSCI Emerging Markets (EM) versus the US multiple over a period. As such, we see the possibility of Pakistan attracting new foreign inflows as the turn in the rate cycle ushers in a new earnings upcycle.

Figure 36: MSCI EM P/E multiple vs US P/E multiple



Source: MSCI, Datastream

Local investors still not as active as in 2002-2005

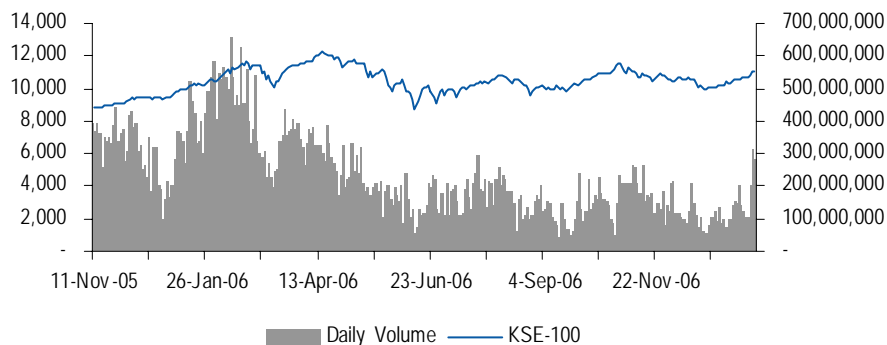
Pakistan’s stock market is primarily a retail-driven market, with most of the volumes being generated by retail investors. Institutions do actively participate, but the bulk of the trading activity emanates from individual investors.

Trading volumes in Pakistan's stock market have dipped considerably over the last couple of years, especially since the three large corrections seen in March 2005, March 2006, and June 2006

Trading volumes in Pakistan’s stock market have dipped considerably over the last couple of years, especially since the 3 large corrections seen in March 2005, March 2006, and June 2006. A number of risk management initiatives introduced by the Securities & Exchange Commission of Pakistan (SECP) have negatively affected local, retail trading activity. Stricter margin and exposure requirements seem to have taken their toll on stock trading volumes that consistently averaged over 300mn shares per day in the cash market not too long ago.

Figure 37 gives the reader a better idea of how trading volumes have dipped at KSE over the last couple of years, after going through a honeymoon period in the couple of years before then.

Figure 37: Trading volumes since crash in 2006



Source: Bloomberg

Key events to watch out for during 2007

Privatization momentum sustainability

The Musharraf government is hoping to continue the privatization momentum built up over the last few years through the sell-offs of several big-ticket items. Successful

privatizations include, Habib Bank, United Bank, Allied Bank, Pak American Fertilizer, Pakistan Telecommunication, and a host of other names.

Going forward, the government is keen on privatizing Pakistan State Oil, Pakistan Petroleum, Sui Northern Gas, Sui Southern Gas, Pakistan Steel Mills, etc. Pakistan State Oil and Pakistan Petroleum are at more advanced stages of privatization as compared to other names listed above.

Table 27: Privatizations in the pipeline

Pakistan State Oil Company
Pakistan Petroleum Ltd.
State Life Insurance (Through stock market)
United Bank Ltd. (2nd offering)
Sui Northern Gas Pipelines Ltd.
Sui Southern Gas Company Ltd.
Oil & Gas Development Company Ltd.
National Investment Trust
Habib Bank Ltd. (Through stock market)
Pakistan Steel Mills

Source: Privatization Commission of Pakistan

The government is targeting Pakistan State Oil's (PSO) privatization to be completed before the end of March 2006. 12 foreign and local parties (mostly foreign and Middle Eastern) parties have expressed their interest in participating in the privatization process of PSO. The successful culmination of yet another privatization delayed by years, as in the case of PTCL, is likely to provide a further confidence booster to stock market investors.

Increased M&A activity and further potential

A recent development in Pakistan's private sector has been the onset of mergers and acquisitions outside the ambit of the government's privatization program. The banking sector has been at the forefront of such M&A activity; however, other sectors such as power and industrials have also been in the limelight.

The largest private deal so far has been Standard Chartered's acquisition of Union Bank Ltd. at a price tag of over US\$400 million for close to 90% of the bank's shares.

Most recently, one of Pakistan's big two tobacco companies, Lakson Tobacco has been taken over by Phillip Morris, which paid US\$339million to acquire a 50% stake in the company.

The banking sector has further possibilities of M&A activity. MNCs like ABN AMRO and Temasek Holdings have shown interest in expanding their businesses in Pakistan.

The most recent acquisition pertains to the telecom sector, where Millicom has agreed to sell off its stake in a local cellular operator Paktel to China Mobile.

2007 general elections: A Musharraf and like-minded group victory expected

Even though it may be considered a forgone conclusion by many, President Musharraf's and his like-minded political allies' victory in the 2007 general elections is likely to be a sentiment booster for many investors. Not only stock market

Foreign companies are increasingly seeking to acquire strategic stakes in Pakistan, especially in the financial sector

investors would take heart from this development, but this is likely to result in further sustainability of FDI flows as well, in our view.

Risks to consider

There are a few market-specific risks to keep in mind when investing in Pakistan's stock market.

Delay in easing of monetary policy

The SBP governor has already stated her intent of trying to raise banks' deposit rates in order to provide positive real returns to depositors. Given the current situation whereby core inflation continues to decline, Pakistan may see a shift towards easier monetary policy. However, central bank priorities to achieve positive real deposit returns may delay this progression.

Capital gains tax put off, but only for a year

Capital gains earned on investments made in Pakistan's stock market are exempted from tax currently. However, the FY05 Budget had brought with it a two-year extension in capital gains tax exemption, which was due to expire in June 2007. This time, quite a while before the FY08 Budget, the Prime Minister has announced a further 1-year extension in this exemption. Now, the FY09 Budget is, therefore, expected to carry the imposition of capital gains tax.

Capital gains tax whenever it may be enforced, we believe, may not be imposed in a plain vanilla form. We expect there to be incentives for holding stocks for a longer period as compared to a short-term horizon. For example, a higher tax rate for selling off shares on the same trading day may be imposed as compared to holding the shares for as long as a month.

This could have a couple of implications. Firstly, on the negative side, retail volumes in the stock market could fall. On the positive side, capital gains taxation with holding period restrictions could reduce trading volatility.

Table 28: Capital gains taxation in various emerging markets

Stock Market	Capital Gains Tax Rate
Brazil	20%
China	33% (none on individuals)
India	10.25%
Indonesia	0.1%
Russia	23.7% (none on individuals)

Source: Respective stock exchanges.

Any tinkering with the CFS/badla mechanism

Pakistan is the only country in the world where badla financing was still being used post-2001, when India decided to scrap the controversial leveraging tool. Several schedules have been created and plans have been devised to amicably and peacefully remove badla financing from the list of available leveraging mechanisms at the stock market. However, resistance has been so strong from investors, day traders, and stock brokers that all the plans have pretty much been shot down.

A middle ground has been reached with badla having been converted to CFS. The number of stocks eligible for CFS financing has recently been increased to 71 along with the ceiling amount for financing to Rs55bn from Rs25bn earlier on. The

presence of badla/CFS has been detrimental for the fate of margin financing, and has been a huge impediment in the development of a thriving derivatives market. Pakistan needs to look no further than its neighbor, India, where badla was found to be a root cause of stock market manipulations, and was cast aside in 2001. This helped develop one of the most liquid equity derivatives markets in the region.

A risk is that if the SECP once again tries to tinker with, or phase out CFS, volumes are likely to drastically reduce. Also, stock prices may take a battering as CFS borrowers seek to square positions. Local stock brokers are also very likely to debate the merits and demerits of such a move, and are likely to offer stiff resistance to the complete elimination of CFS.

Key sectors and stocks

This section provides the reader with brief overviews of the major listed sectors in Pakistan's KSE.

Table 29: Regional P/E, EPS growth, dividend yield comparison by sector

2007E	Weight			P/E			EPS Growth			Dividend Yield		
	Pakistan	APxJ	EM	Pakistan	APxJ	EM	Pakistan	APxJ	EM	Pakistan	APxJ	EM
Market				10.1	14.3	12.9	16.9	9.8	11.6	5.4	3.2	2.7
Consumer	1.9	6.6	6.3	8.0	13.9	13.7	NA	21.4	24.0	2.2	2.8	2.3
Energy	30.6	6.0	16.4	9.5	11.4	10.0	13.8	-2.5	6.5	7.5	3.2	2.4
Financials	38.6	35.8	20.9	10.6	15.8	14.1	19.0	9.4	18.9	2.1	3.5	2.7
Materials	14.1	10.8	13.2	9.5	10.0	9.7	22.8	6.9	1.7	7.5	3.4	4.0
Telecom	7.6	6.6	10.9	12.1	14.9	14.8	2.1	6.5	11.0	7.6	4.0	3.5

Source: MSCI, IBES, Datastream, JPMorgan.

Table 30: Regional P/BV, ROE, payout ratio comparison by sector

2007E	Price to Book Value			RoE			Payout Ratio		
	Pakistan	APxJ	EM	Pakistan	APxJ	EM	Pakistan	APxJ	EM
Market	2.9	2.1	2.1	29.3	15.0	16.6	0.54	0.46	0.35
Consumer	0.7	2.2	2.2	8.4	15.8	16.1	0.18	0.38	0.32
Energy	4.1	2.3	1.8	43.1	19.8	17.8	0.71	0.36	0.24
Financials	3.0	2.0	2.2	28.4	13.0	15.9	0.23	0.56	0.38
Materials	3.6	2.2	1.9	38.0	21.8	19.2	0.71	0.34	0.39
Telecom	2.3	2.7	2.9	18.8	17.8	19.4	0.92	0.60	0.52

Source: MSCI, IBES, Datastream, JPMorgan.

Table 31: Snapshot of key stocks listed on KSE

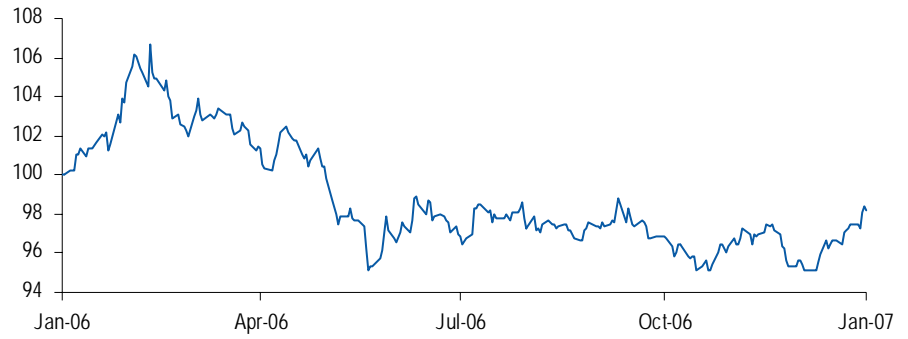
	KSE-100 Index Wt.	Earnings growth		PER		Div. Yld	
		FY07E	FY08E	FY07E	FY08E	FY07E	FY08E
OGDC PK*	19.1%	8.7%	12.4%	10.48	9.33	9.0%	10.3%
PTCL PK*	7.3%	1.2%	11.4%	12.50	11.22	10.1%	10.1%
NBP PK*	7.2%	10.9%	6.6%	10.06	9.44	1.1%	1.5%
PPL PK*	6.4%	36.0%	18.0%	9.67	8.20	5.5%	6.0%
MCB PK*	5.5%	29.5%	5.8%	10.55	9.98	2.4%	2.4%
UBL PK*	4.0%	20.5%	4.0%	8.69	8.35	2.0%	2.2%
POL PK	2.5%	27.7%	21.7%	8.79	7.22	4.8%	5.1%
PSO PK*	2.1%	-32.4%	18.1%	11.40	9.66	6.0%	8.2%
FFC PK*	2.0%	4.8%	17.2%	9.73	8.30	9.9%	10.5%
SNGP PK*	1.6%	4.6%	14.2%	11.00	9.63	5.1%	5.3%
KAPCO PK	1.5%	-16.2%	10.6%	7.96	7.20	12.0%	13.5%
HUBC PK*	1.3%	1.7%	-0.4%	12.76	12.81	10.6%	10.8%
BOP PK	1.2%	24.4%	0.5%	7.02	6.98	1.5%	2.5%
ENGRO PK*	1.1%	9.0%	-13.1%	14.61	16.82	7.0%	7.3%
FFBL PK	1.0%	-9.5%	25.0%	15.50	12.40	6.5%	12.4%
FABL PK*	1.0%	18.1%	3.1%	7.67	7.44	5.1%	5.3%
ACBL PK	0.9%	16.3%	21.4%	9.55	7.87	2.5%	3.0%
BAFL PK	0.8%	22.9%	21.5%	9.31	7.67	4.5%	5.0%
SHEL PK	0.8%	-33.3%	16.6%	10.83	9.29	4.2%	7.5%
DGKC PK	0.7%	-33.1%	44.7%	11.29	7.80	2.0%	2.5%
ICI PK*	0.6%	40.2%	34.1%	8.29	6.18	4.7%	6.3%
LUCK PK*	0.6%	-8.0%	59.9%	9.62	6.01	1.0%	3.0%
NML PK*	0.6%	-5.0%	23.6%	8.89	7.19	4.5%	4.6%

Source: IBES estimates.

Note: Bloomberg codes shown here.

* Constituents of MSCI Pakistan Index

Figure 38: MSCI Pakistan vs KSE-100 Index



Source: MSCI, Datastream.

Banking sector

Pakistan's banking sector has been the best performing sector in terms of percentage gains to investors over the last few years. There are 36 commercial banks currently operating in Pakistan. Of these, 26 are local, with the remaining 10 being foreign banks. 22 are listed.

The regulator: State Bank of Pakistan

The commercial banking sector in Pakistan is regulated by the central bank, i.e. State Bank of Pakistan (SBP). SBP's vision about the future of Pakistan's banking industry has been outlined through a series of moves encouraging few strong players, rather than a scattering of fragile institutions. SBP has asked all commercial banks operating in Pakistan to raise their paid-up capitals to Rs6bn each by the end of 2009. Banks have to increase their paid-up capitals by increments of Rs1 billion each year to finally end up at the desired level at the desired time. As a result, there have been several banks that have consolidated together to create larger financial institutions.

Deposits

Total banking sector deposits stand at Rs3,000 billion (US\$49 billion), coming up to 34% of the country's GDP. The 4-year CAGR for banking sector deposits stands at 18%, which has been a direct function of 4-year M2 growth of 16% annually.

Loans

Total banking sector loans (advances) have also risen dramatically as the economic situation has improved markedly. Total loans amount to Rs2,409 billion (US\$39.7 billion), coming up to 27% of GDP. The country's banking sector Loans to Deposits ratio has also risen each year, and now stands at 80.3%. Consumer assets account for close to 13% of total bank loans. NPLs as a percentage of total loans stand at 1.3% for commercial banks as per latest figures released by SBP (September 2006).

Profitability outlook

Profitability of the banking sector has been breaking its own record year after year during this ongoing decade. The early growth in profits came as a result of expansion in loanable funds, while the latter portion of this growth has arisen from tightening of monetary policy resulting in higher banking spreads. Going forward, profit growth may not be as high as the previous years due to a base effect. However, expected easing of monetary policy holds the potential for better growth in the loans portfolio.

Table 32: Banking sector highlights

2005	NBP	MCB	BAFL	BOP	ACBL
Net Interest Income (PKR mn)*	21,088	13,830	4,662	3,125	3,900
Net Profit (PKR mn)	12,709	8,922	1,702	2,353	2,022
Market capitalization (PKR mn)	182,922	146,336	22,500	31,028	22,750
P/E (x)	10.3	12.5	11.2	8.1	10.7
Price to book (x)	2.1	4.8	2.1	2.0	2.2
ROE	22%	40%	23%	24%	20%
Dividend Yield	1%	2%	3%	0%	1%
Earnings growth 2005	105%	138%	56%	72%	5%
Earnings growth 2-year CAGR	76%	267%	4%	85%	40%

Source: Company reports.

*Note: Provisioning against NPLs has been subtracted

Oil and gas sector

Pakistan's Oil and Gas sector is divided into four sub sectors: 1) Exploration and Production; 2) Refineries; 3) Oil marketing companies (OMC); and 4) Gas Distribution. The E&P sector is the dominant sector on the KSE 100 index with index weightage currently standing at 19%. The high weightage is attributable to OGDCL which is by far the largest market capitalization scrip in the KSE 100 index with current market capitalization standing at PKR507bn (USD8.3bn)

Upstream Oil & Gas sector

The exploration and production sector comprises four companies, namely OGDCL, PPL, POL and Mari Gas. The total market capitalization of the three major companies stands at PKR745 billion (USD12.4 billion). OGDCL is the largest E&P Company in terms of reserves while PPL is a close second in gas reserves. Pakistan Oilfields Limited is a major oil producer.

Business characteristics of the E&P Sector

Oil revenues of E&P companies are based on international crude oil prices while gas revenues are linked to international oil prices with applicable discounts according to the various petroleum policies. These companies also have dollar based returns. On most fields gas prices are capped at a certain level, e.g. in the latest petroleum policy the cap occurs at USD36/barrel of crude oil for well head gas prices. The actual price realized is much lower due to many discounts.

E&P sector outlook

Energy prices over the past four months have started to recede, which is seemingly negative for the oil and gas sector. In the case of E&P companies lower energy prices should not affect valuations as much, as both PPL and OGDCL have a reserve mix heavily tilted towards natural gas. Pakistan Oilfields could suffer as crude oil accounts for a substantial portion of its reserves. In the current environment of high energy prices, exploration activity is rising, with OGDCL and PPL both involved in offshore drilling activities.

Although enhanced production from existing facilities could prop up earnings, recent soft crude oil prices will keep earnings growth below the historical performance seen. Exploration and development activities have picked up in the sector due to high energy prices providing favorable returns. OGDCL in recent times has increased its production significantly, while both OGDCL and PPL are engaged in offshore drilling activities. Therefore, profit growth is expected to continue despite declining oil prices.

Table 33: Upstream oil & gas sector highlights

FY06	OGDCL	PPL	POL	Sector
Sales (PKR mn)	96,755	31,757	15,375	143,887
Net Profit (PKR mn)	45,968	13,401	6,126	65,494
Market capitalization (PKR mn)	507,940	169,124	68,312	745,376
P/E (x)	11.0	12.6	11.2	11.4
EV/EBITDA (x)	7.3	8.4	7.5	7.5
Price to book (x)	5.4	5.6	4.7	5.3
Dividend Yield	8%	4%	4%	6%
Earnings growth FY06	39%	55%	63%	44%
Earnings growth 2-year CAGR	43%	42%	57%	44%

Source: Company reports.

Downstream oil & gas sector

Oil marketing companies

There are three listed companies within the OMC sector of Pakistan, Pakistan State Oil (PSO), Shell Pakistan Limited (Shell), and Attock Petroleum Limited. The downstream petroleum sector of Pakistan is heavily regulated with margins and prices of white oil petroleum products determined by the governing body, Oil and Gas regulatory authority OGRA. Furnace oil prices and margins are de regulated. Currently the regulated distribution margins range between 2.8% to 2.95% on the final price.

Refinery sector

There are four companies in the sector: 1) National Refinery Limited (NRL); 2) Pakistan Refinery Limited; 3) Attock Refinery Limited; 4) Bosicor. The largest refinery in the country, Pak Arab Refinery, is unlisted. The refinery business is extremely volatile and the regulators have set the limit for maximum dividend payout at 50% of paid up capital at the end of 2002. The payout restriction is only applicable in the case of pure refinery operations, for example the payout from the income generated by National Refinery Limited's lube business is not restricted. International oil prices determine the selling price of refined products in the country. High volatility in the business along with a limited payout has implied that P/E multiples for companies in the sector are at the lower end.

Gas distribution

Sui Northern Gas Pipeline Company (SNGP) and Sui Southern Gas Company (SSGC) are the two gas distribution companies in Pakistan. Both SNGP and SSGC have a fixed return formula with operating profit calculated at 17.5% and 17% of net operating assets, respectively. The return formula is currently under consideration and it has been proposed to change the formula to a floating rate based on interest rates. The two companies are also on the privatization list of the Government.

Downstream oil and gas sector outlook

Downstream oil sector earnings are vulnerable to steep decreases in international oil prices as both the refinery sector and the OMC sector will incur inventory losses. Earnings growth on a year on year basis for the OMC sector is also going to remain under pressure due to reduced gross margins, and drop in petroleum product consumption. However, earnings growth momentum is expected to resume in FY08, as the oil price trend normalizes. PSO continues to remain on the privatization priority list.

Table 34: Downstream oil & gas sector highlights

FY06	PSO	Shell	NRL	SNGP	SSGC
Sales (PKR mn)	298,250	117,263	80,894	105,851	66,304
Net Profit (PKR mn)	7,525	3,108	3,410	3,722	892
Market capitalization (PKR mn)	53,043	21,861	17,073	38,822	16,377
P/E (x)	7.05	7.03	5.01	10.43	18.37
Price to book (x)	2.55	2.16	1.82	2.57	1.58
Dividend Yield	11%	8%	6%	4%	5%
Earnings growth FY06	33%	27%	61%	36%	-12%
Earnings growth 2-year CAGR	34%	44%	36%	27%	-5%

Source: Company reports.

Utilities

Pakistan's power sector comprises of two utilities KESC and WAPDA, with KESC supplying to the city of Karachi while WAPDA covers the rest of the country. WAPDA and KESC both have their own thermal power generation facilities; however, they also purchase power from independent power producers. From the equity market perspective the most actively traded stocks within the power sector are KESC, Hubco, and KAPCO. KESC was recently privatized, while KAPCO was listed in 2005. WAPDA isn't listed on the stock exchange.

Independent power producers

Hubco and Kapco are defined as independent power producers (IPPs), and have very similar business structures. Besides Hubco and Kapco, other IPPs are also listed, however, they have limited liquidity and low market capitalizations. The business structure for both Hubco and Kapco are based on a 30 year power purchase agreement with WAPDA. The tariff payments by WAPDA are separated in to two parts, energy payments, and capacity purchase prices. The capacity payments include an escalable (i.e. indexed to USD dollar and US inflation) implicit return and fixed operating and maintenance costs while debt repayments/finance costs are non-escalable. Energy payments are based on amount of fuel consumed and the fuel price. Essentially if every thing goes according to plan, all the cost incurred by the business will be covered by the tariff with the escalatable implicit return left over to be distributed to shareholders. Indeed the dividend payout policy of both Hubco and Kapco historically has been to distribute the entire cash generation of the business to shareholders, which has provided attractive yields to investors.

IPP sector outlook

Pakistan currently faces a power shortage and by FY10 an excess demand of 5,500 MW is anticipated. As a result the government is seeking rapid investment in the sector, providing various incentives to investors. As a result we could see both Hubco and Kapco expanding their current capacities. Future anticipated investments in the power sector along with devaluation of the rupee (which is positive for IPPs) are two things to watch out for in the sector.

Table 35: Utilities' sector highlights

FY06	Hubco	Kapco
Sales (PKR mn)	27,911	32,833
Net Profit (PKR mn)	2,768	5,317
Market capitalization (PKR mn)	31,822	35,826
P/E (x)	11.5	6.7
Price to book (x)	1.1	1.8
Dividend Yield	11%	20%
Earnings growth FY06	-49%	-34%
Earnings growth 2-year CAGR	-29%	-12%

Source: Company reports.

Telecom sector

Pakistan telecoms are in an expansion mode, led by the cellular operators. The country's wireless penetration reached 29% in November 2006 with the total cellular subscribers at 46 million. The telecom sector was deregulated in July 2004 when the Government of Pakistan opened up the fixed line segment to competition. Prior to that, Pakistan Telecommunication Company Limited (PTCL) was the only company providing fixed line services on a commercial basis. Earlier that year, two cellular licenses were auctioned for US\$291 million each.

The fixed-line market

In July 2004, 36 Local Loop (LL), 17 Wireless Local Loop-Limited Mobility (WLM) and 12 Long Distance & International (LDI) licenses were issued. So far in the fixed line segment only three new LL and five WLM operators have started their services. Among these PTCL is still in the lead with 96% share in the LL segment and 63% share in the WLL segment. The WLM operators use CDMA as their base technology and as per the policy these operators can only offer single-cell mobility.

The cellular segment

In the cellular segment, there are six operators with country-wide cellular license. Five of these use GSM as their base technology. Orascom's subsidiary company Pakistan Mobile Communications Limited (PMCL) is the largest cellular operator with 47.6% market share as of November 2006. This is followed by Pakistan Telecom Mobile Limited (PTML), PTCL's 100% owned subsidiary with 20.8% share. Warid and Telenor rank third and fourth with 15.7% and 12.6% market share.

Traffic & tariffs

Subscriber growth has been robust in the sector, where intense competition among cellular operators and cheaper tariffs on pre-paid cards has drastically reduced cost of nationwide and International Outgoing Calls (IOCs). The International Incoming/Outgoing call ratio has improved from 13x in FY04 to 7.8x at end FY07. According to PTA, cheaper IOC tariffs led to 173% YoY growth in IO minutes to 405 million in FY06. On the cellular front, total traffic more than doubled to 30 billion in FY06 against 14 billion in FY05; a growth of 109% YoY.

Outlook

Pakistan Telecommunication Company Ltd. (PTCL), the main listed telco, was recently been privatized and taken over by Etisalat of UAE. Earnings drivers include subscriber base, call tariffs, and interest rates as the new management aggressively aims to turn around the company.

Table 36: Telecom sector highlights

FY06	PTCL*	WorldCall	Telecard	Sector
Sales (PKR mn)	82,983	4,356	2,560	89,900
Net Profit (PKR mn)	22,501	948	54	23,503
Market capitalization (PKR mn)	258,570	6,769	2,880	268,219
P/E (x)	8.7	14.0	1.9	8.8
EV/EBITDA (x)	5.95	15.57	0.93	6.0
Price to book (x)	2.45	0.60	0.79	2.2
Dividend Yield	10%	0%	0%	10%
Earnings growth FY06	-22%	n/a	-78%	-19%
Earnings growth 2-year CAGR	-16%	n/a	-34%	-14%

Source: Company reports.

*Note: Consolidated results taken for PTCL

Fertilizer sector

There are about six urea manufacturers in the country of which four are listed at the local stock exchanges. These include Fauji Fertilizer Company Limited, Engro Chemical, Fauji Fertilizer Bin Qasim (FFBL) and Dawood Hercules Company Limited. Fauji Fertilizer is the largest player in the fertilizer sector with a 44% market share, while Engro, as the second largest urea manufacturer has about 17% market share. Only one fertilizer manufacturer, FFBL, produces DAP in the country, with 68% of the DAP usage imported.

Industry dynamics

The fertilizer industry is currently facing a urea supply shortfall and by end August 06, the proportion of imports in total urea offtake had increased to about 13%. Over the last 5 years, the average urea offtake growth was 5.1%. Urea manufacturers are running at 100% plus capacity utilization levels and two manufacturers are considering expanding capacity to fill-in the growing demand supply gap. For the purpose of balance fertilization, the GoP has recently announced subsidy of PkR250/ per bag on DAP. This move is likely improve DAP offtake in the country. The average growth in DAP offtake over the last 5-years has been 3.4%.

Fertilizer prices

The Government of Pakistan provides an indirect subsidy to fertilizer manufacturers by selling feedstock gas (80% of the raw material cost) at approximately 50% lower rates compared to the price for commercial users. The price of urea has grown at an average rate of 8% in the last 5 years and currently a 50kg bag of urea costs about PkR535 to the farmer. On the flip side, imported urea costs GoP at least PkR1200/bag. The heavy burden of imported urea's cost is being borne by the GoP, while its distribution is local manufacturers' responsibility on a 'zero profit' margin.

Expansion on the cards

In the face of rising urea supply shortfall, the GoP has recently awarded a 100MMCFD gas deposit to Engro Chemical. The company is in the process of arranging finances in order to start building a production facility. 100MMCFD gas would allow Engro to increase its urea production by approximately 1.1mn tons and when the facility comes online in 2010, Engro's market share on annualized basis would increase to about 35% against existing 17%. FFBL is also in the process of increasing its urea and DAP production capacity.

Table 37: Fertilizer sector highlights

2005	FFC	Engro	FFBL	DHCL	Sector
Sales (PKR mn)	25,481	18,276	14,255	3,291	61,303
Net Profit (PKR mn)	4,897	2,319	2,449	2,868	12,533
Market capitalization (PKR mn)	53,739	27,369	27,229	23,451	131,788
P/E (x)	11.0	11.8	11.1	8.2	10.5
EV/EBITDA (x)	6.9	7.6	4.5	21.2	7.2
Price to book (x)	4.32	3.71	3.52	2.51	3.6
Dividend Yield	9%	6%	9%	3%	7%
Earnings growth 2005	22%	44%	78%	157%	38%
Earnings growth 2-year CAGR	25%	22%	81%	44%	33%

Source: Company reports.

Cement sector

The last few years have been a golden period for local cement manufacturers, where improving economic fundamentals, government of Pakistan's increased spending on infrastructure development, high commercial activity and rising demand for housing on account of better liquidity, has kept cement offtake growth in double digits.

During FY06 cement sales registered a growth of 13%, while the total dispatches for 1HFY07 show YoY growth of 26%. Despite strong demand, the cement manufacturers' 'good old days' are over at least until the revival of an agreement among cement manufacturers. Reversal in interest rates, disagreement among the members of the cement manufacturers' association over capacity expansions, GoP's increased pressure to reduce prices, and surplus capacity in the absence of set quotas under the association's direction have raised serious concerns about cement manufacturers' viability.

Cement manufacturers

The cement industry comprises of about 27 players of which over 17 players are listed cement manufacturers. The industry is divided into two broad categories; the Northern Region and the Southern Region. The northern region has over 87% share in total cement dispatches while the manufacturers based in the Southern region only contribute 13% on average to the annual cement sales.

Supply chasing demand

Cement's demand side of the equation is pretty strong on the back of 1) GoP's 60% higher Public Sector Development Projects allocation target, 2) cement demand's strong correlation with the GDP growth and our expectations of 6%+ GDP growth rate in FY07, 3) an increasing number of real-estate development projects for commercial and residential use, 4) a developing export market, and 5) expected construction of mega dams. According to the All Pakistan Cement Manufacturers' Association (APCMA), the current industry's capacity for cement is 24 million tons, which is likely to rise to 37 million tons by the end of FY07 given the expansion being undertaken in the sector. On the other hand, consensus expects demand growth to settle at around 17%, which translates into 22 million tons. If the planned expansions come online according to APCMA's estimates, the industry is likely to have a production surplus of about 15mn tons.

Cement prices

After making highs of Rs430/bag at the retail level earlier last year, cement prices fell sharply during early 1QFY07. At the moment the cement prices in the retail market are in the range of Pkr210-Pkr230/bag.

Table 38: Cement sector highlights

FY06	D.G. Khan Cement	Lucky Cement	Sector
Sales (PKR mn)	7,956	7,985	15,940
Net Profit (PKR mn)	2,418	1,936	4,354
Market capitalization (PKR mn)	12,520	16,777	29,297
P/E (x)	5.18	8.67	6.7
EV/EBITDA (x)	1.2	8.4	1.6
Price to book (x)	0.6	2.4	1.1
Dividend Yield	2%	0%	1%
Earnings growth FY06	44%	134%	74%
Earnings growth 2-year CAGR	71%	68%	70%

Source: Company reports.

Appendix I:

Key Facts About Pakistan

- **Full name:** Islamic Republic of Pakistan
- **Population:** 155.4 million (Economic Survey of Pakistan FY06)
- **Area:** 796,095 sq km (BBC)
- **Languages:** Urdu, English, Punjabi, Sindhi, Balochi, and Pashto
- **Currency:** Pakistani Rupee
- **Labor Force:** 46.8 million (Economic Survey of Pakistan FY06)
- **Unemployment Rate:** 6.5% (Economic Survey of Pakistan FY06)
- **Infant Mortality:** 7.7% (Economic Survey of Pakistan FY06)
- **Government System:** Parliamentary
- **Literacy Rate:** 53% (Economic Survey of Pakistan FY06)
- **Size of GDP:** US\$145 billion (FY07 Estimate)
- **Per Capita Income:** US\$847 (Economic Survey of Pakistan FY06)
- **Installed Electricity:** 19,400 MW (Economic Survey of Pakistan FY06)
- **Key Exports:** Textile, rice, cotton, and leather goods
- **Key Imports:** Petroleum products and machinery
- **Country dialing code:** +92
- **Internet domain:** .pk
- **Total Teledensity:** 34.1% (Pakistan Telecom Authority)

Figure 39: Detailed map of Pakistan



Table 39: Funds raised through stock market: 2002-2005

2002	Funds Raised (Rs mn)
Attock Cement Pakistan Ltd.	100.0
Bosicor Pakistan Ltd.	272.5
National Bank of Pakistan (2nd offer)	783.4
Total	1155.9
2003	Funds Raised (Rs mn)
Ittehad Chemicals	71.1
The Resource Group (TRG)	200.0
Pak. International Container Terminal	160.0
National Bank of Pakistan (3rd offer)	604.0
First National Bank Modaraba	100.0
Oil & Gas Development Company	6881.5
Total	8016.6
2004	Funds Raised (Rs mn)
WorldCall Broadband	300.0
Pakistan Capital Market Fund	375.0
Sui Southern Gas (2nd offer)	1745.0
MacPac Films	150.0
Callmate Telips Telecom	150.0
Southern Networks Ltd.	150.0
Bank Al Falah Ltd.	1200.0
ABAMCO Composite Fund	1000.0
Pakistan International Airline (2nd offer)	1150.7
Pakistan Petroleum Ltd.	5658.2
Pakistan Strategic Allocation Fund	750.0
Chenab Ltd. (Preference Shares only)	160.0
First National Equities	125.0
AMZ Ventures	100.0
Atlas Fund of Funds	200.0
Network Microfinance Bank	40.0
Meezan Balanced Fund	300.0
International Housing Finance Ltd.	150.0
Jahangir Siddiqui Capital Markets Ltd.	131.3
Total	13835.2
2005	Funds Raised (Rs mn)
Attock Petroleum Ltd.	577.5
Kot Addu Power Company Ltd.	2640.8
First Dawood Mutual Fund	125.0
Dewan Farooque Spinning Mills	150.0
United Bank Ltd.	1101.2
Eye Television Network	150.0
Zephyr Textiles Ltd.	120.0
Chenab Ltd.	540.0
NetSol Technologies	250.0
WorldCall Telecom	690.0
D.S. Industries Ltd.	100.0
AKD Index Tracker Fund	250.0
Siddiqsons Tin Plate Ltd.	500.0
PICIC Energy Fund	250.0
Total	7444.5
Grand Total	30452.2

Source: Karachi Stock Exchange

*Issues highlighted are government's share offerings

Table 40: Privatization proceeds since 2002

Company	Year	Sale Proceeds (Rs mn)
United Bank Ltd. (51% stake)	2002	12,350
Bank Al Falah	2002	620
Govt. stake in Badin (II) oil field	2002	516
Govt. stake in Adhi oil field	2002	681
Govt. stake in Dhurnal field	2002	231
Govt. stake in Ratana field	2002	32
Govt. stake in Badin (I) field	2002	8,599
Govt. stake in Turkwal field	2002	120
Pak Saudi Fertilizers	2002	8,151
E&M Oil Mills	2002	94
Maqbool Oil Company Ltd.	2002	28
Habib Bank Ltd. (51% stake)	2003	22,409
Associated Cement Rohri	2003	255
Thatta Cement	2004	793
Kohinoor Oil Mills	2004	81
National Refinery Ltd. (51% stake)	2005	16,415
Karachi Electric Supply Company	2005	20,240
Pakistan Telecom (26% stake)	2005	155,000
Carrier Telephone Industries	2005	500
Mustehkam Cement (85.3% stake)	2005	3,205
Pak Arab Fertilizers (94.8% stake)	2005	14,126
United Industries	2005	8
Bolan Textile Mills	2005	128
Falletti's Hotel Lahore	2005	1,211
Javedan Cement Ltd.	2005	4,316
Pak American Fertilizers	2006	16,110
Lasbella Textile Mills	2006	156
Grand Total		286,375

Source: State Bank of Pakistan Annual Reports.

Table 41: History of CRR & SLR Changes by SBP

Effective From	CRR (as % of DTL)	SLR (% of DTL)
July 1, 1948	5% of Demand and 2% of Time Liabilities	15%
July 25, 1963	5%	15%
April 1, 1965	6.25%	15%
May 1, 1965	7.5%	15%
August 21, 1965	6.25%	15%
September 17, 1965	5%	15%
June 16, 1967	6.25%	15%
September 1, 1967	6.25%	20%
January 19, 1968	5%	20%
June 9, 1972	5%	25%
August 16, 1973	5%	30%
August 13, 1992	5%	35%
December 19, 1992	5%	40%
October 27, 1993	5%	30%
March 1, 1994	5%	25%
May 28, 1997	5%	20%
July 28, 1997	Average 5%, Minimum 4%	20%
January 2, 1998	Average 5%, Minimum 4%	18%
June 22, 1998	3.75% Rupee, 5% Foreign	15%
September 5, 1998	Average 5%, Minimum 4%	15%
May 19, 1999	Average 3.5%, Minimum 2.5%	13%
July 12, 1999	Average 5%, Minimum 4%	15%
October 7, 2000	Average 7%, Minimum 6%	15%
December 16, 2000	Average 5%, Minimum 4%	15%
December 30, 2000	Average 5%, Minimum 3%	15%
January 5, 2006	Average 5%, Minimum 4%	15%
July 22, 2006	7% of Demand and 3% of Time Liabilities	18%

Source: State Bank of Pakistan Annual Reports

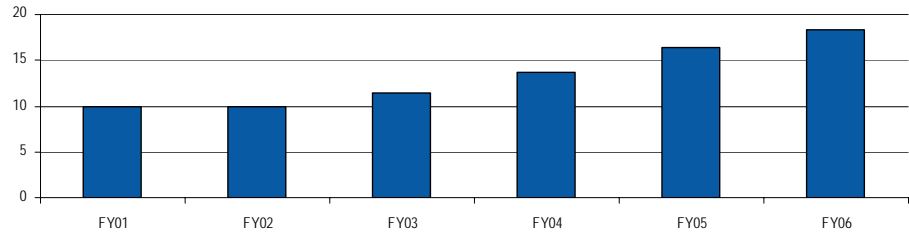
Table 42: Detailed Balance of Payments history

Current Account	FY03	FY04	FY05	FY06
Exports	10,974	12,459	14,482	16,506
Imports	11,333	13,738	18,996	24,948
Trade Balance	-359	-1,279	-4,514	-8,442
Transportation	-711	-890	-1,218	-1,790
Travel	-402	-1,034	-995	-1,185
Communication Services	230	166	272	97
Other Business Services	-42	-332	-2,217	-2,552
Government Services	1,014	905	1,041	1,359
Other	-91	-131	-176	-331
Services (Net)	-2	-1,316	-3,293	-4,402
Direct Investment	-988	-1,215	-1,622	-2,076
Portfolio Investment	-223	-201	-154	-95
Others	-1,000	-791	-610	-500
Income (Net)	-2,211	-2,207	-2,386	-2,671
Workers Remittances	4,237	3,871	4,168	4,600
FCA – Residents	-12	367	521	312
Others	1,512	1,864	3,720	4,925
<i>Private Transfers</i>	<i>5,737</i>	<i>6,102</i>	<i>8,409</i>	<i>9,837</i>
Saudi Oil Facility	637	302	0	0
Cash Grants	209	202	231	464
<i>Official Transfers</i>	<i>905</i>	<i>512</i>	<i>250</i>	<i>679</i>
Current Transfers (Net)	6,642	6,614	8,659	10,516
Current Account Balance	4,070	1,812	-1,534	-4,999
Financial Account				
Direct Investment Abroad	-27	-45	-66	-70
Direct Investment in Pakistan	798	951	1,525	3,521
of which - Equity Capital	674	763	1,208	2,925
Reinvested Earning	124	183	314	537
Portfolio Investment	-239	314	620	985
of which - Stock Markets	22	-28	151	351
Special US\$ Bonds	-228	-137	-130	-174
Eurobonds	-7	496	596	796
Other Investment	-1,014	-2,555	-1,633	1,461
Assets	438	-670	-1,352	196
Liabilities	-1,452	-1,885	-281	1,265
Financial Account Balance	-482	-1,335	446	5,897

Source: State Bank of Pakistan Annual Reports

Figure 40: Pakistan cement sales growth

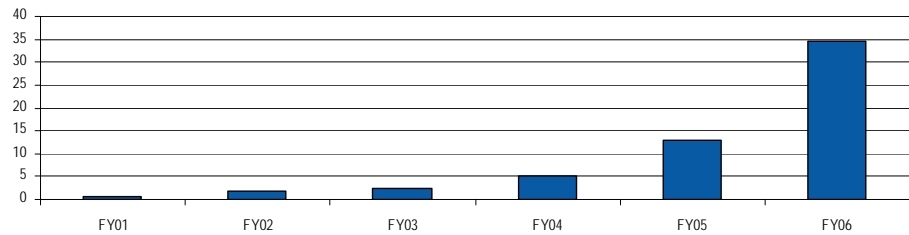
Million tons



Source: All Pakistan Cement Manufacturers' Association

Figure 41: Cellular subscribers in Pakistan

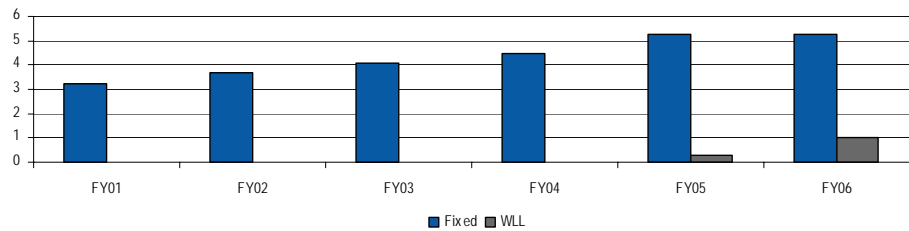
Million subscribers



Source: Pakistan Telecommunication Authority

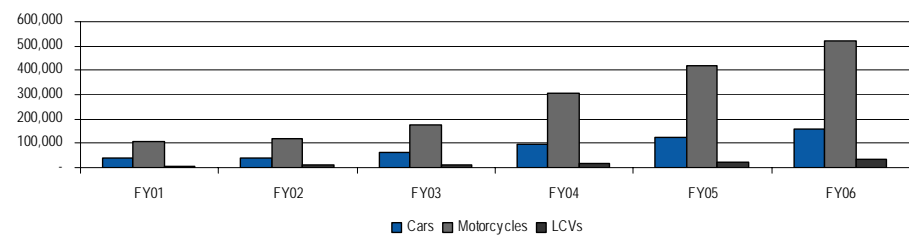
Figure 42: Fixed line and WLL subscribers in Pakistan

Million subscribers



Source: Pakistan Telecommunication Authority

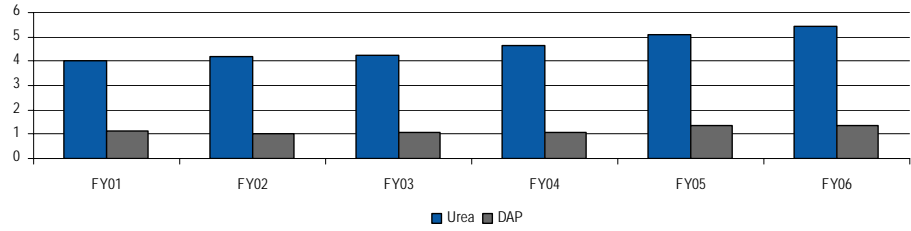
Figure 43: Automobile production in Pakistan



Source: Pakistan Automotive Manufacturers' Association

Figure 44: Urea and DAP demand in Pakistan

Million tons



Source: National Fertilizer Development Centre

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