

Low correlation, liquid and easy to trade

Pakistan - A low correlation, domestic demand play...

Pakistan, a country of 160mn, predominantly young people, has posted an average annual real GDP growth of 7% over the past five years and we expect it to sustain this growth level going forward. With exports at just 12% of GDP, growth is driven by investment and domestic demand, making it a low correlation asset, not geared to the global economy.

... which is liquid, easy to trade and not expensive

Liquidity in the secondary market is strong (average daily turnover: US\$500mn) and regulations are accommodating for both strategic and portfolio international investors, which are reflected in a fairly active M&A/privatization spree and record portfolio inflows (around US\$1bn in FY07, up 3x YoY). Add to it valuations that are still at a discount to the region (11.8x 2007E earnings), and the case for the KSE remains strong.

How to play Pakistan? Go for direct and quasi beneficiaries

Two themes stand out in Pakistan: (1) Domestic demand where, despite a 7% real consumption CAGR over the past five years, under-penetration is evident in most sectors (financials, cement, fertilizer, autos, energy or telecom), signaling significant upside potential. Apart from banks such as MCB Bank, which offer blanket exposure to the theme courtesy growing consumer finance exposure, we continue to advocate fertilizers, namely FFBL and FFC, oil marketing giant PSO (a quasi play on power demand too) and Hubco (the most aggressively expanding IPP). Another top pick, Nishat Mills, is a textile export play, but it too has a link to domestic demand via its holding company status.

(2) The attractive oil and gas exploration theme where well density is below regional averages while success ratios are 3x higher, with POL and PPL being our preferred picks. Our choice for individual stocks are dictated by the fact that index composition does not track GDP composition and, as a result, quasi plays also need to feature on the list.

Fever pitch political noise; but market continues its march

Being an election year, combined with the Chief Justice suspension issue, 2007 has brought with it unprecedented political noise – but that seems to have had little impact on the market (up 37% YTD). We, however, do not rule out potential uneasiness in the market as the elections, the biggest risk, draw closer or the Chief Justice issue gets prolonged. Nonetheless, we remain confident of the structural story as (1) policy direction should remain intact, and (2) robust economic fundamentals should be able to override any political surprises.

Merrill Lynch participated in the preparation of this report, in part, based on information provided by KASB Securities Ltd (KASB Securities). ^{****}KASB Securities employees are not registered/qualified as research analysts under NYSE/NASD rules.

>> Employed by a non-US affiliate of MLPF&S and is not registered/qualified as a research analyst under the NYSE/NASD rules.

Refer to "Other Important Disclosures" for information on certain Merrill Lynch entities that take responsibility for this report in particular jurisdictions.

Merrill Lynch does and seeks to do business with companies covered in its research reports. As a result, investors should be aware that the firm may have a conflict of interest that could affect the objectivity of this report. Investors should consider this report as only a single factor in making their investment decision.

Refer to important disclosures on page 115 to 116. Analyst Certification on page 113. Price Objective Basis/Risk on page 110



Imtiaz Gadar, CFA ^{****}

Research Analyst
KASB Securities

Muzammil Aslam

Economist
KASB Securities

Mohammad Fawad Khan ^{****}

Research Analyst
KASB Securities

Shagufta Irshad ^{****}

Research Analyst
KASB Securities

Farrah Marwat ^{****}

Research Analyst
KASB Securities

Khurram Ghufuran ^{****}

Research Analyst
KASB Securities

Contents

Economics	7
Banks - Pakistan	13
National Bank of Pakistan	17
Pakistan Cement Sector	21
DG Khan Cement	25
Pakistan Fertilizers	29
Fauji Fertilizer Company Ltd.	33
Fauji Bin Qasim	37
Engro Chemical Pakistan Ltd.	41
Pakistan oil & gas producers	45
Oil & Gas Development Co Ltd.	49
Pakistan Oilfields Ltd.	53
Pakistan Petroleum Ltd.	57
Oil refining and marketing	61
Pakistan State Oil	65
Pakistan Independent Power Producers	69
Hub Power Company Ltd.	73
Kot Addu Power Company Ltd.	77
Telecommunications - Pakistan	81
Pakistan Textiles	85
Nishat Mills Ltd.	89
Nishat Chunian Ltd.	93
Auto - Pakistan	97
Indus Motor	101
Pak Suzuki	103
Appendix 1: Pakistan market factoid	105

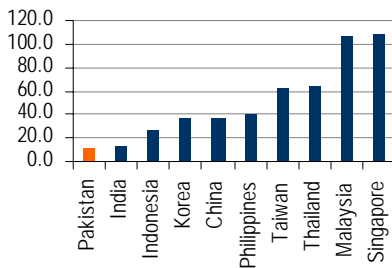
*All share prices are as at 29 June 2007 unless otherwise indicated.

Imtiaz Gadar, CFA ^^^^
 Research Analyst
 KASB Securities

Low correlation with global economy, liquid and easy to trade

Pakistan, a country of 160mn, predominantly young people, has posted an average annual real GDP growth of 7% over the past five years. We expect it to sustain this growth level going forward. With exports at just 12% of GDP, growth is driven by investment and domestic demand, making it a low correlation asset, not geared to the global economy. Liquidity in the secondary market is strong (average daily turnover: US\$500mn) and regulations are accommodating for both strategic and portfolio international investors, which are reflected in a fairly active M&A/privatization spree and record portfolio inflows (around US\$1bn in FY07, up 3x YoY). Add to it valuations that are still at a discount to the region (11.8x 2007E earnings), despite a 37% YTD rally, and the case for the KSE remains strong.

Chart 1: Exports to GDP ratio



Source: Merrill Lynch calculations, CEIC

A low correlation asset available at a discount

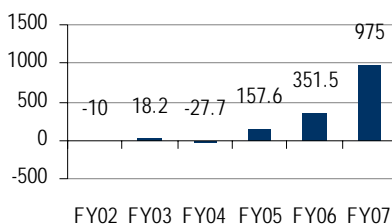
With exports just 12% of GDP, Pakistan does not drive its economic engine from international economic trends. It is an economy that has been driven by domestic consumption (posting close to 7% average annual real GDP growth for the past five years) and is expected to continue doing so, helped by increasing investments and continuation of the consumption trend. While low exports are not necessarily a good characteristic, it does set Pakistan apart from the region in terms of its sensitivity to a global slowdown. On top of that, it is not expensive even after adjusting for differing growth profiles, and its dividend yield – which is one of the highest in the region – just provides that extra sheen to the valuation argument.

Table 1: AsiaPac regional valuations

22-Jun-07	EPS Growth		Price/ Earnings		Price/ Book		Dividend Yield		EV/ EBITDA	
	2006E	2007E	2006E	2007E	2006E	2007E	2006E	2007E	2006E	2007E
Pakistan	11.6%	11.6%	13.17	11.80	3.95	3.35	4.2%	4.5%	6.74	6.35
China	1.2%	56.3%	19.33	18.81	3.48	3.04	2.1%	2.1%	7.36	7.78
Hong Kong	0.0%	46.3%	15.87	15.53	2.40	2.26	2.6%	3.0%	11.23	9.76
India	34.7%	17.9%	20.20	17.13	4.55	3.60	1.2%	1.3%	12.48	10.60
Malaysia	15.1%	13.3%	20.53	18.12	3.13	2.34	3.1%	3.6%	n.a	n.a
Philippines	18.0%	9.5%	17.85	16.30	2.76	2.46	1.8%	2.0%	7.61	7.39
Singapore	21.6%	12.3%	16.99	18.78	2.11	2.44	2.8%	2.7%	11.17	12.15
South Korea	-4.9%	6.4%	16.28	15.30	1.93	1.74	1.4%	1.5%	8.29	7.74
Taiwan	5.8%	19.7%	16.81	15.38	2.28	2.34	3.6%	3.6%	11.53	11.18
Thailand	-2.6%	-0.1%	9.57	10.76	3.11	2.76	4.7%	4.1%	6.44	6.88
Indonesia	27.4%	39.2%	23.17	16.64	6.04	4.74	1.8%	3.0%	13.72	7.74

Source: Merrill Lynch research, KASB estimates, Datastream

Chart 2: Foreign Portfolio Investments (US\$m)



Source: State Bank of Pakistan

Foreign investors are welcome

A key advantage in favor of Pakistan vis-à-vis regional peers is its policy driven welcoming attitude toward foreign investors. Foreign investors in Pakistan can and do own 100% of companies in different industries; the secondary market is no different, where foreigners are not subjected to any ownership limits or discriminatory taxes on dividends. (Capital gains are tax free for all barring banks). In addition, robust daily volumes (US\$500mn/day) ensure that there is sufficient ease of entry and exit.

The attraction and facilitative nature of the market has also come into prominence courtesy three Global Depository Receipts (GDR) offerings in the past six to eight months and the active privatization program of the Government of Pakistan. As a result, foreign interest in the market is scaling unprecedented

levels, as is evident from the chart alongside, which details net foreign portfolio flows into the country. The trend is likely to continue as the government plans to do three GDRs in FY08 (National Bank, KAPCO and Habib Bank), while a host of private entities are contemplating the same option. The reaching out of corporates to the international markets has raised the general level of awareness amongst international investors, leading to a better understanding of the risks and rewards of investments in the KSE. However, Pakistan is still far from the threat of being over-owned by foreigners as foreign ownership is still comfortably below the 10% mark.

Table 2: Pakistan: Privatization transactions

Completed Transactions				
Transaction	Date	Stake Sold	Amount (US\$mn)	Successful Bidder
Habib Bank Limited	Dec-03	51%	373	Aga Khan Fund For Economic Dev.
National Refinery	May-05	51%	274	Attock Oil Group
Pakistan Telecom	Jun-05	26%	2,600	Etisalat
Karachi Electric Supply	Nov-05	71%	340	Al Jomaih Group / Siemens
Transactions Targeted				
Transaction	Target	On Offer	Major Interested Bidders	
Pakistan State Oil	CY07	51%	BP & Kohinoor, Petronas & MCB, Vitol & Fauji (total 7 consortiums)	
Pakistan Petroleum Ltd.	1HCY08	51%	BP; OMV; MOL (Total 3 interested parties)	
National Investment Trust	2008	Mgmt rights	Major local banks and AMCs (Total 16 interested parties)	
Oil & Gas Dev. Co.	2008	51%	EOIs yet to be invited	
Sui Northern Gas Co.	NA	51%	MOL; BP; Fauji Foundation (Total 17 interested parties)	
Sui Southern Gas Co.	NA	51%	Shell; Hubco; Kogas (Total 17 interested parties)	

Source: KASB research, Privatization Commission

Table 3: Pakistan: Key sectors and themes

Sector	Theme
Telcos	Under-penetration in fixed line (4%), privatization/acquisitions, deregulation
Banks	Strong spreads, under-banked economy (4% consumer credit/ GDP)
Ferts	Demand-supply imbalance in favor of manufacturers; higher prices
OMCs	Rising volumes, especially FO; privatization of PSO
GDCs	Huge capex to fuel bottom-line growth in a fixed return formula regime
Cement	Development spending and exports to fuel growth
FMCG	Improving economic growth to increase top line
Auto	Under-penetration, pro-expansion govt. policies
Power	Expanding to fulfill rising demand; stable yield plays
E&P	High oil prices, discoveries, privatization

Source: KASB research

How to play Pakistan? Go for direct and quasi beneficiaries

As mentioned earlier, Pakistan is a predominantly domestic demand play and, therefore, population demographics are an important variable. The population is skewed toward the lower side, with more than half the population below 19 years of age, and urbanization levels are on a gradual rise. A glance across sectors indicates that most sectors are under-penetrated and offer immense upside potential. While some sectors have a case of unmet demand, others are exhibiting latent demand as per capita incomes rise.

The second theme we like is the attractive oil and gas exploration theme. While Pakistan does remain a net importer of oil and, hence, oil is not a key macro theme, it is a different story on the KSE, where the exploration sector demands a 23% weighting and its attractive landscape makes it a worthy investment avenue in our opinion. Pakistan's well density is considerably below the regional average at 1.75/1000km² while its success ratios are 3x the regional average at 30%.

GDP vs KSE 100- The disconnect

The composition of the GDP and the KSE-100 index are different in nature, which also means that some of our top picks in the market are actually quasi plays (direct plays are either not listed or are too small to be investable) on macro themes that we like in Pakistan. For a breakdown of how the Pakistan market is concentrated on a few key sectors, with other sectors either too small or too illiquid to invest, making quasi plays the best route, refer to Table 1 in Appendix 1. Appendix 1 highlights the basic factoid of the market and a brief history of how things have unfolded in the market.

Drilling down to the top picks

We have long been proponents of banks as the blanket exposure to the robust economic dynamics and consumption growth of Pakistan, led by the larger private banks like MCB Bank, but there are other avenues that we believe also offer material upside on the same themes. Our top picks (and a brief rationale) for our liking and their key valuation metrics are identified in the table below, while broader details are available in the respective sections.

Table 4: Pakistan: Top picks

Company As of 26-Jun-2007	B'berg	EPS		PE (x)		DIV YIELD		What drives our liking?
		2007	2008	2007	2008	2007	2008	
Pakistan Oilfields	POL PA	33.00	39.88	10.07	8.33	1.50	4.80	Volume growth via commercialization of recent discoveries, exploration program may provide further upside
Pakistan Petroleum	PPL PA	26.09	30.16	10.12	8.75	4.92	5.68	Rising volumes and increase in realized gas prices leading to healthy bottom-line growth.
Pakistan State Oil	PSO PA	29.09	36.70	13.44	10.65	6.14	6.91	Largest OMC in Pakistan and a quasi play on power demand. Privatization story adds further juice.
Fauji Fertilizer Co.	FFC PA	11.22	13.59	10.85	8.96	9.03	10.68	The largest urea producer offering exposure to the DAP market via 51% owned subsidiary
Fauji Bin Qasim	FFBL PA	2.02	5.13	19.32	7.59	3.85	10.27	Sole DAP producer in Pakistan should benefit from robust DAP price outlook through a timely expansion
Hub Power Co Ltd.	HUBC PA	2.42	2.62	14.91	13.74	7.72	8.30	One of the fastest expanding IPPs, tapping in the growing power demand with a fixed return business model
Nishat Mills	NML PA	11.01	13.76	11.58	9.26	1.57	1.96	A textile export play doubling up as a holding co. providing indirect exposure to domestic demand theme

Source: KASB estimates

Chart 3: KSE-100 YTD performance



Source: KSE

Table 5: Key dates on the political calendar

Events	Tentative dates
Presidential elections	15 Sep 07 - 15 Oct 07
End of term for current assembly	Nov-07
General elections	Jan/Feb- 08

Source: KASB research

High pitch political noise, but market unfazed

2007 has probably been the year with most political noise since President Pervez Musharraf assumed power in 1999. While the fact that elections are due at the end of the year was reason enough for the environment to be noisy, the suspension of the Chief Justice of Pakistan on March 9 just turned the volume a couple of notches higher. While the case is currently being contested in the Supreme Court of Pakistan, the media seems to be running a trial of its own by covering every inch of development on the issue and political parties, both for and against the issue, are participating vociferously in this trial by media. Political parties' keen interest in the issue is understandable given the elections looming over the next six to eight months. This is probably the ideal platform for both sides to gain points before the elections. The market, however, seems to have turned a blind eye and a deaf ear to the issue, as it is up 37% YTD and 20% since March 9.

All eyes on the "key man" risk

The other key variable is President Musharraf, as he has been a key man in Pakistan's turnaround and his importance from international investors' perspective cannot be downplayed. Whether he gets elected from the current or post election assemblies and with or without his position as army chief are mere details. Our base case bottom-line assumption is that Musharraf will remain in power, albeit a power-sharing agreement with any of the political parties (predominantly the Benazir Bhutto-led PPP) cannot be ruled out. In addition, we are more concerned with the policy direction of the country and do not believe that any of the opposition parties are principally opposed to the policy initiatives of the government. While opposition parties continue to make the odd noise against privatization, privatization of government-owned entities has been on everyone's wish list over the past 15 years. Therefore, we do not see any risk to policy direction.

Increased accountability would ensure policy stability

On the other hand, the increased accountability and track record will serve as a serious road block to any significant alterations in policy direction. As mentioned earlier, and as we elaborate on in the economic section of the report, the four-year report card has a great reading to boast and, therefore, follow-up performance has to match up. Pakistan has got just too much to lose and increased media accountability is likely to force the right decisions. In a nutshell, we derive comfort from our belief that, from here on, economics is likely to drive the politics rather than being the other way round.

Key risks

Apart from the generic risks of any increase in interest rates or better returns on stock market alternates, most key risks for the KSE come from its retail-centric activity (retailers and high net worth individuals control 70% of activity).

Abrupt and at times unjustified sentiment swings

The relatively retail-centric activity does make the KSE prone to abrupt mood swings. March 2005 and June 2006 were prime examples where the market lost 25% in eight trading sessions and 17% in six trading sessions, respectively, but the exuberance is not one-sided. The market had gained 36% in the one month preceding March 2005. The increased foreign and local institutional participation is gradually addressing that issue but the risk nonetheless remains.

Changes in tax structures (capital gains or transaction)

Given the high turnover, capital gains tax is a bigger cause for concern than in some other markets. In the recent budget, the exemption of capital gains tax was extended for a year, but that is widely suspected to be an election motivated step and capital gains tax could well be implemented FY08 onward. If this were to materialize, it is likely to generate some negative sentiment. Same is the case for any increase in turnover taxes (CVT), where an increase from current levels could elicit negative reactions from the broader market. The introduction of CVT in FY05 and doubling of it in CY07 did not go down well with the investors. For a full structure of commissions and trading costs, please refer to Appendix 1.

Leverage financing crunch

Leverage financing remains a key lifeline of the KSE. Currently, the official leverage financing system is completely utilized at its maximum limit of PRs55bn but system-wide influx of liquidity has not led to any signs of concern (rates on the financing are currently 7% lower than the cap rates close to 19%). However, the regulators and market participants have, on more than one occasion, crossed swords over the issue and a crunch on the liquidity side could have a ripple effect on the market.

Emerging strongly



Muzammil Aslam
Economist
KASB Securities
maslam@kasb.com

+92 21 263 5501

Pakistan's upturn is showing signs of maturity

Pakistan's GDP growth has risen well above the trend in the last five years and this has been the strongest period for its economy in nearly two decades. This explains the high capacity utilization, rise in inflation and widening current account deficit. Although risks are rising, but macro policies remain sound. We believe this should keep the economy, the balance of payments, and market on course.

Current account deficit is not a concern

We expect the current account deficit to touch 5.3% of GDP this year, driven by a slowdown in exports growth (up 3.0% YoY). However, we believe quality foreign direct investment should easily be able to finance the deficit. For FY07, we estimate foreign investments of US\$7.0bn (or 4.8% of GDP).

High foreign flows support the currency...

Robust foreign inflows over the last few months have deterred the downward revision in the exchange rate. Resultantly, the rupee has appreciated by 2.06% over July-Mar FY07 in the trade-weighted index, and export growth has reduced to meager 3% level.

...But pose a challenge for SBP

Although rising inflows do mitigate the threat of higher current account deficit to an extent, managing liquidity is a major challenge for the central bank - the State Bank of Pakistan (SBP).

Our expectations from SBP

We expect SBP to regularly monitor liquidity conditions in the US dollar and buy it from the inter-bank market to protect the rupee from appreciation. At the same time, it could raise excess money through open market operations (OMOs) and T-bill auctions to manage the rupee liquidity. We expect SBP to follow a wait-and-watch approach, rather than tighten the rates further.

Other macro indicators

Per capita income: Pakistan's per capita income has risen to US\$925 in FY07 from US\$846 last year. This bodes well for Pakistan's consumption boom theme.

Inflation: The government has missed its inflation target of 6.5% for FY07, which we estimate at 7.8% (down from 7.9% last year), driven by higher food inflation but core inflation at less than 6%.

Fiscal deficit: The FY08 federal budget has forecast fiscal deficit at 4.2% of GDP (we estimate 4.5%). This is largely driven by an increase in domestic debt servicing and development expenditure.

Pakistan - Cyclical maturity

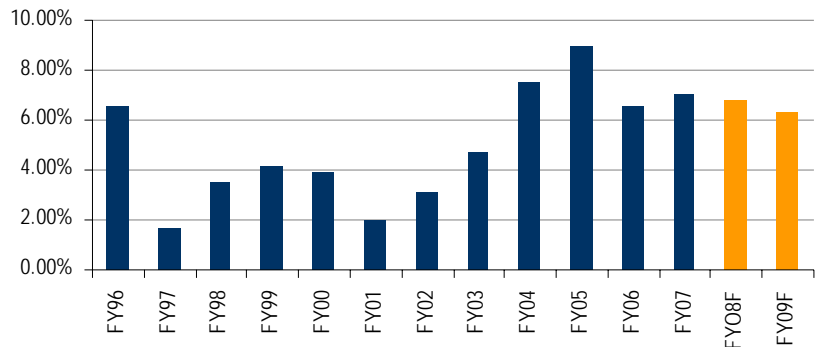
Pakistan's upturn is showing signs of maturity. Growth increased well above trend over the past five years – the strongest period for Pakistan's economy in nearly two decades. As a result, capacity utilization is high, inflation has risen and the current account deficit is widening.

The upturn is structural

In our view, Pakistan is in the midst of a structural upturn. The drivers are the economic reforms of the past few years, as well as a decline in country and equity risk premia that has lowered the cost of capital. The result is a surge in investment, which has raised the trend rate of growth to 7.0% from 4.5%. Despite higher domestic lending rates, loan growth remains strong, suggesting that the investment upturn remains on track.

Looking forward, our GDP growth estimates for FY08E (year-end June) and FY09E stand at 6.9% and 6.3%, respectively. In the near term, we expect robust consumption growth, supported by higher overseas worker remittances, massive public sector development spending and higher foreign investments.

Chart 1: Terrific run of GDP growth witnessed (since FY04)



Source: KASB Securities estimates, Economic Survey

This is likely to put pressure on the current account deficit

With the robust consumption growth (7.93% CAGR over FY03-FY07E) and investment growth (10.8% CAGR over FY03-FY07E), we expect pressure on current account deficit to continue. However, in our view, the financing of the deficits will be easily met through quality foreign inflows.

Current account deficit and its financing

Our current account deficit estimate for FY07 stands at US\$7.8bn (or 5.3% of GDP), driven by a slowdown in exports. Pakistan's exports have been badly hurt in FY07 owing to (1) high domestic inflation (7.8%), (2) an overvalued exchange rate in the trade-weighted index (2.06%), and (3) intense competition in global textile trade post quota removal (textiles account for 60%+ of the country's exports).

Our FDI estimate for FY07 stands at US\$4.5bn and our FPI estimate at US\$3.0bn. This would be enough to meet the forecast 5.3% current account deficit and protect the rupee from downward adjustment.

For FY08, we forecast a current account deficit of US\$7.67bn (4.8% of GDP). However, we expect that financing of the deficit will be easily met through higher foreign investments.

Table 1: Current account deficit breakup (in US\$bn)

	FY07F	FY08F	FY09F
Exports	17.10	18.90	21.74
Imports	26.40	29.04	30.49
Trade Balance	-9.30	-10.14	-8.76
Services balance	-4.80	-5.40	-6.00
Income balance	-3.50	-4.03	-4.63
Balance of Goods, services and income	-17.60	-19.57	-19.39
Current transfers			
Remittances	5.40	6.00	6.00
Current account deficit	7.80	7.70	7.50
Capital and financial account			
Foreign Direct Investments	4.50	3.80	4.00
Foreign Portfolio Investments	3.00	1.30	1.50
Net debt disbursement	1.30	2.50	2.50
Overall Balance	1.50	0.00	0.00

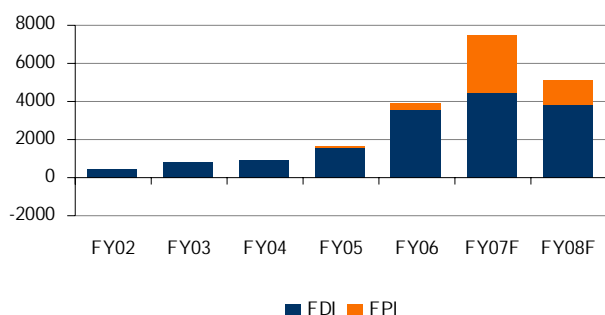
Source: KASB Securities estimates

Foreign investments gaining momentum

The political turmoil seen in the past few months has not hampered investments into the country, as reflected in the foreign inflow statistics. Foreign inflows surged 50.4% to US\$6.28bn during July-May FY07 and are expected to expand further to US\$7.0bn (or 4.5% of GDP) by the end of this fiscal year (year-end June 2007). Notable investments include the acquisition of Union Bank by Standard Chartered, the GDR of Oil and Gas Development Corporation (OGDCL) and the acquisition of Paktel Mobile by China Mobile. Transactions reportedly in the pipeline are the privatization of Pakistan State Oil (PSO), and GDRs of KAPCO and Habib Bank Limited (HBL).

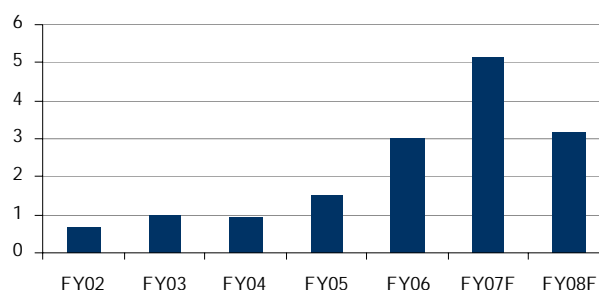
Similarly, overseas worker remittances have risen substantially, owing to (1) higher return on assets, (2) sustained economic growth and (3) a liberalized foreign exchange regime. The government has linked tax-free benefits with overseas remittances and reduced the spread between the open market and the official exchange rate. This has translated into higher worker inflows through the official channel.

Chart 2: Foreign investors buying consumption story



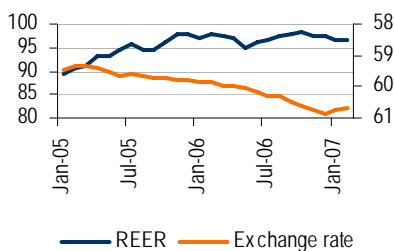
Source: KASB Securities estimates, SBP

Chart 3: Foreign investments as a % of GDP



Source: KASB Securities estimates

Chart 4: REER vs nominal exchange rate



Source: Bloomberg, SBP

Huge foreign flows support the rupee

Robust foreign inflows in the past few months have deterred the downward revision of the exchange rate. However, in the trade-weighted index, the rupee has appreciated by 2.06% over July –Mar FY07. Going forward, if foreign inflows remain robust, we do not expect the rupee to adjust downward; our rupee exchange estimate for FY08 now stands at PRs62.20/US\$, compared to our previous estimate of PRs64.40/US\$.

Monetary policy and foreign flows

Rising inflows do mitigate the threat of a higher current account deficit somewhat and pose a major challenge for the central bank, the State Bank of Pakistan (SBP), to manage liquidity. Money supply rose to 15.44% in the first 11 months of FY07 (compared to 12.90% growth during the same period in the previous year), driven by a surprise buildup of net foreign assets (NFA) in the banking sector.

We expect the SBP to continually monitor the US\$ liquidity conditions in the market and buy US\$ from the inter-bank market to protect the rupee from appreciation, while simultaneously lifting excess money through open market operations (OMOs) and T-bill auctions to manage the rupee liquidity. In our view, the existing current account deficit is driven by a slowdown in exports, which is less inflationary and requires a monetary push from the SBP. Therefore, we expect the SBP to follow a wait-and-watch approach as against further tightening.

Eurobond issue a vote of confidence on Pakistan’s economy

Pakistan successfully conducted a Eurobond issue in May 2007 – the fourth bond issue since 2004. The US\$500mn worth bond was oversubscribed by seven times, indicating overseas investors’ confidence in Pakistan’s macroeconomic fundamentals and leadership.

Standard and Poor’s has assigned a B+ unsecured foreign currency debt rating to the Islamic Republic of Pakistan’s Eurobonds. As per S&P: “Pakistan’s generally prudent economic management and strong policy environment, which over the past several years has consistently focused on structural and institutional reforms, is translating into better growth prospects.”

Additionally, S&P noted that trade liberalization and extensive privatization programs are enhancing productivity and attracting higher foreign direct investment, much of it greenfield. As a result, Pakistan is poised for a period of sustained high growth of about 7% pa, which should help alleviate poverty and make further inroads into debt reduction.

On the political front, S&P’s view is that the recent escalation of political tension and the uncertainty posed by impending presidential and parliamentary elections are unlikely to have any significant impact on credit fundamentals. S&P adds: “Yet, the longer-term challenge for the government remains, which are to expand and deepen reforms of its tax system to raise government revenues significantly from the current level and to demonstrate that the current pro-market, pro-growth set of policies will be sustained during successive administrations.”

Other macro indicators

GDP per capita: Pakistan's per capita income has increased to US\$925 in FY07, from US\$846 last year. This bodes well for Pakistan's consumption boom theme that we have long been proponents of. Banks provide blanket exposure to the theme, while the impact is expected to be seen in cement, power and consumer goods sectors.

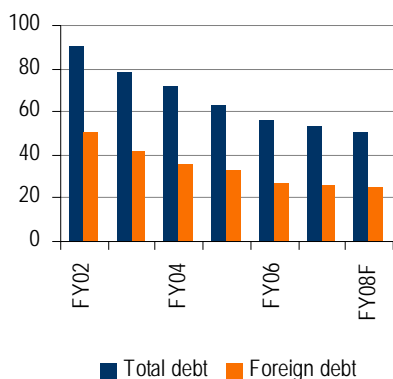
Inflation: The government has missed its FY07 full-year inflation target of 6.5%, which we expect will come in at 7.8% (down from 7.9% last year), driven by higher food inflation, while core inflation is likely to be below 6%. Food inflation (40% of the CPI basket) recorded an increase of 10.34% in the first 11 months of FY07. Looking forward, we expect a bumper wheat crop, combined with a high-base effect, to bring food inflation down in FY08. However, high oil and steel prices will remain a potential risk to inflation.

Investment to GDP: On the back of rising foreign investments, this year Pakistan has achieved a record 23% investment-to-GDP ratio (up from 21.7% last year). In FY07 alone, Pakistan has attracted foreign savings worth 5% of GDP (compared to 4.5% last year).

Fiscal deficit: The FY08 federal budget forecasts a fiscal deficit at 4.2% of GDP (our estimate: 4.5%). This is largely driven by an increase in domestic debt servicing and development expenditure. However, given the possibilities of higher development spend in 4Q FY07 and higher debt servicing; we expect the final deficit will exceed the budget estimate of 4.2%.

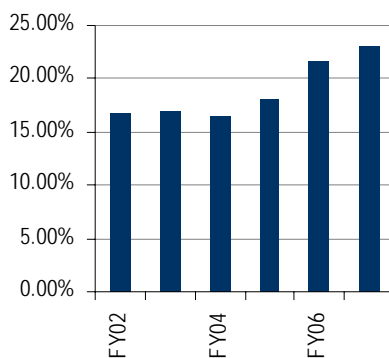
Debt to GDP: Despite the odds of higher twin deficits, Pakistan has successfully reduced its debt-to-GDP ratio to 53.4% in FY07, compared to 100.3% recorded in FY99. Interestingly, Pakistan's external debt-to-GDP ratio declined from 40.8% in FY02 to 24.6% by 3Q FY07. This signifies a higher debt repayment capacity of the country.

Chart 5: Debt as % of GDP



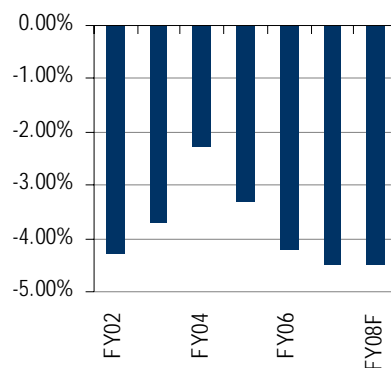
Source: Merrill Lynch estimates

Chart 6: Investment to GDP



Source: Merrill Lynch estimates, Economic Survey

Chart 7: Fiscal deficit as % of GDP



Source: Merrill Lynch estimates, Economic Survey

05 July 2007

Table 2: Pakistan – Vital statistics

	FY03A	FY04A	FY05A	FY06A	FY07	FY08F	FY09F
Real GDP growth %	4.7	7.5	9.0	6.6	7.0	6.9	6.3
Agriculture growth %	4.3	2.3	6.5	1.6	5.0	3.64	2.88
LSM growth %	7.2	18.1	19.9	10.7	8.8	8.3	7.7
Services growth %	5.2	5.9	8.5	9.6	8.0	7.5	7.0
Exports USD billion	11.16	12.3	14.4	16.5	17.1	18.9	21.7
Imports USD billion	12.22	15.6	20.6	28.6	30.4	32.5	34.5
Trade account balance USD billion	-1.06	-3.3	-6.2	-12.1	-13.3	-13.6	12.8
Remittances USD billion	4.24	3.9	4.2	4.6	5.4	6.0	6.0
Current account balance USD billion	4.07	1.8	-1.5	-5.0	-7.8	-7.7	-7.5
CPI	3.1	4.6	9.3	8.0	7.8	6.5	6.5
Money Supply (M2) growth %	18	19.6	19.2	15.2	16.0	13.5	12.8
Exchange rate PkR/USD	58.5	57.6	59.5	60.2	60.8	62.3	63.9
6m T-bill WAY%	1.66	2.1	8.0	8.5	8.9	7.5	7.5
Population (million)	146.75	149.7	152.5	155.4	158.2	161.0	163.9
Per Capita income (USD)	586	669.0	733.0	833.0	925.0	1003.0	1076.0
Development Expenditure (PkR billion)	129	160.0	202.0	306.0	435.0	520.0	
Foreign Exchange reserves (USD million)	10,600	12,500.0	12,386.0	13,128.0	15,500.0	15,500.0	15,500.0
Tax Revenues in (PkR million)	460,627	518,824.0	588,500.0	700,000.0	835,000.0	1,000,000.0	
Foreign Direct Investment (USD million)	798	950.0	1,521.0	3,500.0	4,500.0	3,800.0	4,000.00
Pakistan External Debt (USD million)	35,474	35,258.0	35,834.0	37,265.0	39,265.0	42,265.0	45,265.0
Domestic Debt (PkR million)	1,853,676	1,978,968.0	2,129,094.0	2,296,869.0	2,457,649.8	2,629,685.3	2,813,763.3
Debt Servicing as % of GDP	7.3%	6.8%	2.7%	2.2%	2.1%	1.8%	2.0%
Pakistan External Debt as % of GDP	41.7%	36.4%	32.7%	27.4%	26.8%	26.4%	25.8%
Pakistan Domestic debt as % of GDP	37.2%	35.8%	30.0%	29.1%	27.7%	26.3%	25.1%
Pakistan total debt as % of GDP	78.9%	72.2%	62.8%	56.5%	54.5%	52.7%	50.9%
Budget deficit as % of GDP	4.6%	2.5%	3.0%	4.2%	4.5%	4.5%	4.0%
Investment as % of GDP	16.7%	18.1%	18.1%	21.8%	23.0%	23.0%	23.0%
Saving as a % of GDP	20.6%	19.8%	15.6%	16.4%	18.0%	18.2%	18.7%

Source: Merrill Lynch estimates, Economic Survey

Fast growth on the frontier

Leveraged exposure to Pakistan growth

We believe the Pakistan banking sector is one of the highest growth stories across the Asia Pacific. The three key themes are:

- **Supportive macro backdrop:** Pakistan's economy should deliver 6.5-7.0% real GDP growth over the next 2-3 years, driven by high investment and domestic demand. Capacity expansions and related working capital requirements should sustain robust demand for credit.
- **Products and penetration:** Credit penetration in Pakistan is among the lowest in the Asia Pacific, with total consumer loans at 4% of GDP. We expect this to rise on increasing per capita income and consumer loan innovation. While auto loans and personal loans have led the way so far (71% of consumer finance), mortgages and credit cards could be the way forward as more banks enter the credit card space and documentary hurdles hampering housing finance are removed.
- **Regulatory environment:** The State Bank of Pakistan (SBP) has strengthened the local regulatory environment via its reform programs since 2001. Having set right the issues of NPLs, the focus is shifting to strengthening the risk management and capital adequacy of banks.

Pressure on spreads mounting but profitability still healthy

Spreads in Pakistan are at a structural peak in our opinion. The war for deposits is already on. While larger banks have managed to stay away thus far, they are likely to join sooner rather than later. This, along with SBP's active preference for longer-tenor deposits and higher deposit rates, should only add to the pressure. That would, in turn, compress spreads from the current dizzy heights of more than 7%. However, the channeling of funds to consumer finance should cushion spreads and volume growth should help maintain profitability growth.

Consolidation likely

The previous SBP governor publicly stated that the number of banks in Pakistan should be about 21. This would mean that almost 12-14 banks could be potentially merged with others or acquired. Although initially, the need to acquire or merge would depend on the relative advantage of one over the other (for instance, Standard Chartered ended up acquiring Union Bank), we expect it will gradually translate into a need to raise quick deposits and acquire growth, as evident in Temasek's (PICIC) acquisitions. However, the increased paid-up capital requirements (minimum of PRs6bn by 2009) could also force banks to sell out.



Alistair Scarff >>

+852 2536 3966

Research Analyst
Merrill Lynch (Hong Kong)
alistair_scarff@ml.com

Imtiaz Gadar, CFA ^^^^
Research Analyst
KASB Securities

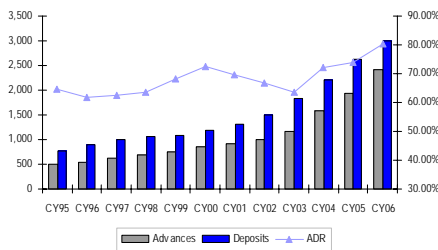
**Table 1: Consolidated balance sheet of banks
(local operations only)**

PRs mn	Dec-05	Dec-06
Cash	270,185	332,452
Balances with other banks	111,638	140,575
Lending to Financial Institutions	198,618	192,343
Investments	730,067	775,546
Gross Advances	2,043,982	2,409,478
Provisions	135,914	127,611
Net Advances	1,908,068	2,281,867
Operating Fixed assets	65,856	107,745
Deferred tax assets	8,258	7,988
Other Assets	167,386	217,731
Total Assets	3,460,076	4,056,247
Liabilities		
Bills Payable	45,404	55,177
Borrowings	336,301	420,080
Deposits and other accounts	2,661,697	2,999,895
Subordinated Loans	20,723	26,967
Liabilities against lease	619	898
Deferred tax liabilities	2,473	7,357
Other Liabilities	122,605	150,308
Total Liabilities	3,189,822	3,660,682
Net Assets	270,254	395,565
Represented by		
Paid up capital	105,789	165,479
Reserves	70,754	102,928
Un-appropriated Profits	36,397	63,520
Total	212,940	331,927
Surplus/ deficit on revaluation	57,314	63,638
	270,254	395,565

Source: SBP

The combination of banking sector reform, privatization and economic growth has led to higher consumer lending over the past few years

Chart 1: Shift towards advances visible



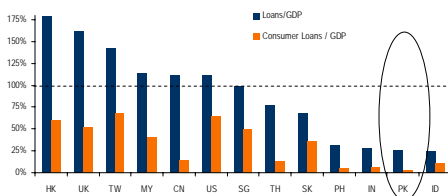
Source: SBP data

Table 2: Key macroeconomic data

	FY07A	FY08E	FY09E
GDP (%)	7.0	6.9	6.3
Agriculture (%)	5.0	3.64	2.88
Manufacturing (%)	8.8	8.3	7.7
Services (%)	8.0	7.5	7.0
Exports in US\$mn	17.1	19.3	21.7
Imports in US\$mn	30.4	32.5	34.5
Inflation (%)	7.8	6.5	6.5
6MT-bills (%)	8.9	7.5	7.5
Fiscal deficit as % of GDP	4.5	4.5	4.0
Current account bal. (US\$mn)	-7.8	-7.7	-7.5

Source: SBP, Merrill Lynch Economics Research estimates

Chart 2: Loan penetration statistics



Source: CEIC, Central Banks

Why consider Pakistan banks?

1. Supportive macro backdrop

The pickup in economic momentum and banking reforms started bearing fruit at just about the right time for Pakistan's banking sector. While banks were involved in cleaning up balance sheets, and the government busy with their privatization, higher economic growth led to consumer-driven demand, which necessitated expansion and capacity increases in many industries. Consumer lending has surged, following moves by the SBP to deregulate the consumer finance market.

In our view, Pakistan is not only going through a structural upturn due to the economic reforms of the past few years, but also experiencing a decline in country and equity risk premiums, which has lowered the cost of capital. The result is an increase in investment that, if sustained, is likely to push up growth rate. Sustained strong loan growth even in the face of recent domestic interest rate hikes suggests that the investment upturn is on track. The loan growth has slowed somewhat due to the tightening cycle but upcoming expansions in power and fertilizer, combined with the jump in consumer financing, should ensure loan growth in the high teens.

Pakistan's structural upturn should remain on track due to higher investments (from 21% to 23% of GDP in FY07). Moreover, the sources of this economic growth seem to be fairly balanced. All components of private demand – consumption, private investment and, partially, exports – are contributing to the demand-led growth. To us, this suggests the economy should prove resilient to external shocks. We believe the economy will be supported by (1) private sector demand, (2) public sector development spending, and (3) foreign investment.

We believe Pakistan's banking sector is about to enter a long-term secular growth trajectory. The jump in profitability over the past three years has seen banks invest in systems, improve infrastructure, concentrate on product development, and move out of traditional markets and cater to the consumer. Over the past five years, Pakistan banks have been mostly involved in cleaning up balance sheets. Most have spent the past two years building up loan portfolios.

We expect the next few years to be spent on product innovation and exploring new and under-explored segments of the economy. Banks have been offering simple commercial banking solutions and a limited product suite, likely due to strong credit demand. As capital requirements rise and competition heats up, we believe banks will focus on product innovation and exploit different channels to gain market share and generate incremental returns. As far as the existing consumer finance is concerned, almost all banks are focused on the top-tier consumer market. Hence, we believe there is great potential for growth.

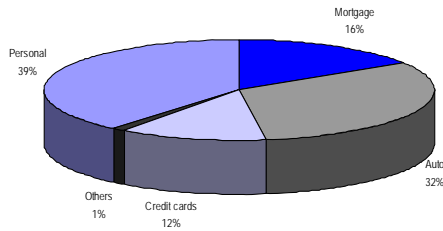
2. Consumer penetration and products

Lowest consumer loan penetration in Asia

Pakistan is one of the most under-penetrated banking markets in the Asia Pacific, with total bank sector lending at 27% of GDP as of June 2007. While this is attractive, what is particularly compelling, in our opinion, is the level of consumer lending – 4% of GDP, the lowest in Asia.

Traditionally conservative by nature, Pakistan banks made their initial foray into the consumer finance segment in 2002-03 once SBP allowed commercial banks to enter consumer financing. As benchmark interest rates fell from high double-digits to low single-digit, consumer finance became more affordable. Encouraged by the initial response and the desire to earn higher spreads, more banks entered

Chart 3: Composition of consumer loans



Source: SBP Banking Sector Statistics (April 2007)

Enhancing the SBP’s supervisory powers has been an important development

this segment. From being virtually non-existent, consumer finance now accounts for almost 14% of total banking sector advances – and it continues to grow rapidly due to increased per capita incomes and consumer loan innovations.

Auto and personal loans lead the pack

After the initial boost from auto loans (32% share in consumer finance), personal loans and residential housing loans have been the two most popular products within the consumer financing segment.

Personal loans account for 39% of total outstanding consumer loans – uses range from education and personal consumption to travel. Housing loans, meanwhile, have been relatively disappointing, with total disbursements of only PRs54bn (US\$900mn), or 16% of the outstanding consumer loans. The major stumbling block, in our opinion, has been the relatively poor status of land records leading to property title issues, creating repossession issues with respect to foreclosing on a loan in the event of default. Commercial banks have been selective in the areas (geographic) where they have extended mortgage financing – new developments and projects have been a main focus, given greater certainty of title.

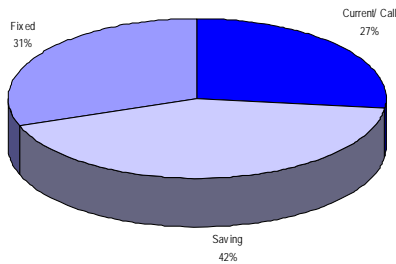
The credit card business in Pakistan was initially the forte of foreign commercial banks, but has of late seen the aggressive entry of local banks. With the yield on credit cards ranging from 28-35%, more and more banks are vying for a slice, which bodes well for the growth of a segment in its nascent stages (less than 2mn accounts).

3. Regulatory environment

One key banking sector reform (initiated in 1997) was enhancing the SBP’s regulatory supervision; case in point, non-performing loans (NPLs). In the 1990s, NPLs were increasing, some willfully, indicating collusion between bankers and borrowers. Gross NPLs were PRs282bn (US\$4.7bn) at end-2000 (principal PRs203bn, interest PRs79bn), or 25.7% of the total advances of banking sector. SBP swung into action, not only imposing stringent standards of classifications that pulled down net NPLs-to-net loans, but also pressuring banks to accelerate recoveries. About PRs10,000mn has been recovered in cash since July 2001. Cases of willful defaulters were referred to the National Accountability Bureau. The Committee on Revival of Sick Units (CRSU) was authorized to restructure NPLs and revive underlying sick units found financially and economically viable.

SBP is now focusing on improving the risk management framework of banks. It has instituted an all-embracing framework through the Institutional Risk Assessment Framework to strengthen the supervisory mechanism and mitigate the variety of risks banks are exposed to. It has also instituted a framework of stress-testing based on single-factor sensitivity and regression-based analysis. In the single-factor sensitivity analysis, exposure of banks to five major risks – interest rate, credit, real estate price, equity price and exchange rate – is assessed after subjecting the underlying risk factors to possible shocks. We expect the SBP will continue to build on the risk management framework and promote product innovation in areas such as infrastructure financing, and new liability products.

Chart 4: Deposit mix of commercial banks



Source: SBP Banking Sector Review (Dec 2006)

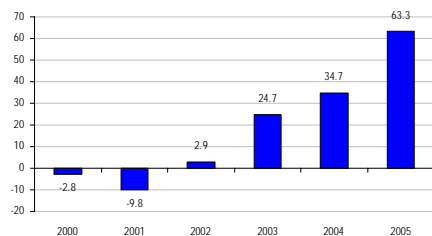
Spreads: Pressure on deposit cost to increase

Capacity expansion in key industries such as power, fertilizers and privatized entities and the related working capital requirements, combined with the increased push on consumer finance, should boost asset growth, but deposit mobilization remains one of the key challenges for the sector. While the inflow of remittances post 9/11 and channeling of funds from low-yielding investments to higher-yielding advances did provide a bonanza for the banking sector, the current sector ADR at about 74% (theoretical limit of 75%) is likely to result in a deposit war. The large banks have, so far, avoided a price war (given substantial, rate-insensitive deposit bases). But we believe they will have to enter the arena sooner rather than later, pulling down sector spreads from the current levels of over 7%.

SBP to sustain pressure

Banks are also likely to face added pressure from the SBP. Previously, they were required to maintain a flat 5% of their demand and time liabilities as cash reserve requirement (CRR). They are now required to maintain 7% (subject to a daily minimum of 6%) of demand liabilities (including time liabilities of tenor less than six months). This should discourage banks from offering higher rates on short-term deposits, as they would require higher CRR. Banks need to maintain weekly average CRR of 3% (subject to a daily minimum of 2%) of their time liabilities with tenor exceeding six months. Thus, the SBP is encouraging banks to raise time liabilities (which incurs lower CRR), but that raises the cost of deposits.

Chart 5: Profitability of banks (PRs mn)



Source: SBP Banking Sector Review (June 2006)

In addition, the SBP wants banks to increase rates offered to depositors. While the market has been speculating a direct intervention by SBP, we expect it to stick to its market-oriented stance. Our belief was confirmed in the last monetary policy statement, where the SBP tweaked the CRR requirement (technical intra-week adjustment) and reiterated its stance to stick to market-related measures.

Profitability should remain healthy

There is no denying that the year-on-year growth in profitability is likely to slow, given the increased pressure on deposits, and hence, spreads. However, channeling of funds to higher-yielding consumer assets should cushion spreads (should remain above 6% for select banks). Combined with volume growth, this should result in healthy sector profit growth (we see mid-teens for the sector and 20% for select banks).

Table 3: New capital requirements of banks

Year	Min paid-up capital (PRs mn)
Dec-05A	2,000
Dec-06E	3,000
Dec-07E	4,000
Dec-08E	5,000
Dec-09E	6,000

Source: SBP

Market forces likely to prompt sector consolidation

The previous SBP governor publicly stated that the number of banks in Pakistan should ideally be about 21. This would mean that almost 12-14 banks could be potentially merged with others or acquired. Although initially, the need to acquire or merge would depend on the relative advantage of one over the other (for instance, Standard Chartered ended up acquiring Union Bank), we expect it will gradually translate into a need to raise quick deposits and acquire growth such as Temasek's (PICIC) negotiations with local banks for a potential stake. However, the increased paid-up capital requirements (minimum of PRs6bn by 2009) could also force banks to sell out.

Equity | Pakistan | Banks-Retail (EQ)
5 July 2007

The government's treasurer

Challenges outweigh the positives - Reiterate Neutral

We reiterate our Neutral rating on National Bank of Pakistan (NBP), the largest local bank, with a Distributable Dividend Discount Model (DDDM) based fair value of PRs261/share. We are cognizant of the attraction associated with NBP due to its: (1) enviable footprint and customer base; (2) status as the government's treasurer, and (3) latent potential of new areas and legacy investments. However, in our view, addressing the following challenges will dampen its near-term share performance:

- Lack of consumer finance:** This leaves NBP vulnerable to competition from aggressive peers. While management is progressing in the right direction, the lack of requisite IT systems is likely to somewhat cripple the march forward.
- Inefficient capital structure:** While favoring the largest shareholder (GoP), we believe excess capital is dampening ROE and multiple expansion.
- Deposit market share under threat:** Nimble peers have been nibbling away at NBP's share (down 10% in the past five years) and are likely to continue to do so.
- Valuations less than compelling:** At 10x 2007E earnings and 2.0x 2007E P/BV with an expected RoE of 22%, NBP's valuations are less demanding than peers, but justified given its slower earnings growth and lower ROE.

What could make us positive on NBP?

Encouraging offtake of NBP's micro finance product, unlocking of value tied up in legacy investments (NIT and Bank Al Jazira) or a shift in strategy on the international operations side could turn us positive on the stock, while a GDR offering should help the bank gain more visibility on an international scale.

Estimates (Dec)

(PRs)	2005A	2006A	2007E	2008E	2009E
Net Income (Adjusted - mn)	12,736	17,022	19,390	19,794	21,436
EPS	21.55	24.01	23.78	24.27	26.29
EPS Change (YoY)	71.3%	11.4%	-1.0%	2.1%	8.3%
Dividend / Share	2.50	4.00	3.50	3.90	3.90
Pre-exceptional EPS	15.67	20.25	24.02	24.52	26.53
Pre-exceptional EPS Change (YoY)	97.5%	29.2%	18.7%	2.1%	8.2%
Book Value / Share	125.81	115.58	120.78	141.16	163.54

Valuation (Dec)

	2005A	2006A	2007E	2008E	2009E
P/E	11.0x	9.9x	10.0x	9.8x	9.0x
Dividend Yield	1.05%	1.69%	1.48%	1.65%	1.65%
Pre-exceptional PE	15.13x	11.71x	9.87x	9.67x	8.93x
Price / Book	2.60x	2.36x	1.96x	1.68x	1.45x
RoE / PB	8.12x	9.24x	10.95x	11.04x	11.90x
Price / Pre-Provision Profit	6.51x	5.72x	6.31x	5.85x	5.37x

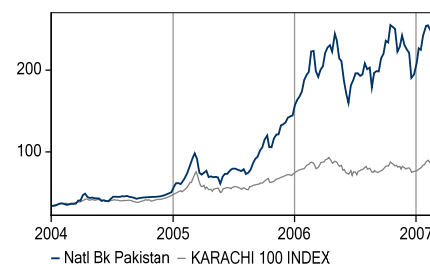


Imtiaz Gadar, CFA ^^^^ +92 21 263 5501
Research Analyst
KASB Securities
imtiaz.gadar@kasb.com

Alistair Scarff >> +852 2536 3966
Research Analyst
Merrill Lynch (Hong Kong)
alistair_scarff@ml.com

Stock Data

Price	PRs237.05
Investment Opinion	C-2-7
Volatility Risk	HIGH
52-Week Range	PRs137.78-PRs263.74
Mrkt Val / Shares Out (mn)	US\$3,184 / 815.4
Average Daily Volume	13,861,143
ML Symbol / Exchange	XJIBF / KAR
Bloomberg / Reuters	NBP PA / NBPK.KA
ROE (2007E)	21.5%
Total Dbt to Cap (Dec-2006A)	0%
Est. 5-Yr EPS / DPS Growth	8.0% / -0.8%
Free Float	24.4%



iQprofileSM National Bank of Pakistan

Key Income Statement Data (Dec)	2005A	2006A	2007E	2008E	2009E
(PRs Millions)					
Net Interest Income	23,371	30,154	33,332	35,984	38,577
Net Fee Income	4,927	6,145	7,374	8,848	10,618
Securities Gains / (Losses)	1,366	1,170	925.00	1,018	1,119
Other Income	3,100	4,849	4,022	4,014	4,024
Total Non-Interest Income	9,392	12,163	12,321	13,880	15,761
Total Operating Income	32,763	42,317	45,653	49,864	54,338
Operating Expenses	(11,234)	(12,930)	(15,025)	(16,849)	(18,319)
Pre-Provision Profit	21,529	29,386	30,627	33,015	36,019
Provisions Expense	(2,447)	(3,076)	(797.47)	(2,562)	(3,040)
Operating Profit	19,058	25,589	29,830	30,452	32,978
Non-Operating Income	NA	NA	NA	NA	NA
Pre-Tax Income	19,083	26,311	29,830	30,452	32,978
Net Income to Comm S/Hold.	12,736	17,022	19,390	19,794	21,436
Adjusted Net Income (Operating)	12,736	17,022	19,390	19,794	21,436

Key Balance Sheet Data

Total Assets	577,719	635,133	704,819	781,903	867,020
Average Interest Earning Assets	444,042	484,005	542,424	610,185	690,697
Weighted Risk Assets	353,123	394,952	420,592	483,740	547,689
Total Gross Customer Loans	299,423	348,370	397,144	455,766	514,301
Total Customer Deposits	463,427	501,872	551,938	608,945	671,951
Tier 1 Capital	36,158	53,045	69,580	86,194	104,449
Tangible Equity	36,158	53,045	69,580	86,194	104,449
Common Shareholders' Equity	74,341	81,954	98,490	115,103	133,359

Key Metrics

Net Interest Margin	5.26%	6.23%	6.14%	5.90%	5.59%
Tier 1 Ratio	10.2%	13.4%	16.5%	17.8%	19.1%
Effective Tax Rate	33.3%	35.3%	35.0%	35.0%	35.0%
Loan / Assets Ratio	51.8%	54.9%	56.3%	58.3%	59.3%
Loan / Deposit Ratio	64.6%	69.4%	72.0%	74.8%	76.5%
Oper Leverage (Inc Growth - Cost Growth)	21.9%	14.1%	-8.3%	-2.9%	0.2%
Gearing (Assets / Equity)	7.8x	7.7x	7.2x	6.8x	6.5x
Tangible Common Equity / Assets	6.3%	8.4%	9.9%	11.0%	12.0%
Tangible Common Equity / WRAs	10.2%	13.4%	16.5%	17.8%	19.1%
Revenue Growth	44.7%	29.2%	7.9%	9.2%	9.0%
Operating Expense Growth	22.7%	15.1%	16.2%	12.1%	8.7%
Provisions Expense Growth	61.5%	25.7%	-74.1%	221.3%	18.6%
Operating Revenue / Average Assets	5.8%	7.0%	6.8%	6.7%	6.6%
Operating Expenses / Average Assets	2.0%	2.1%	2.2%	2.3%	2.2%
Pre-Provision ROA	3.8%	4.8%	4.6%	4.4%	4.4%
ROA	2.3%	2.8%	2.9%	2.7%	2.6%
Pre-Provision ROE	35.7%	37.6%	33.9%	30.9%	29.0%
ROE	21.1%	21.8%	21.5%	18.5%	17.3%
RoTE	35.2%	32.1%	27.9%	23.0%	20.5%
RoWRAs	3.6%	4.3%	4.6%	4.1%	3.9%
Dividend Payout Ratio	11.6%	14.4%	14.8%	16.0%	15.0%
Efficiency Ratio (Cost / Income Ratio)	35.8%	31.4%	33.6%	34.5%	34.4%
Total Non-Interest Inc / Operating Inc	29%	29%	27%	28%	29%
Market-Related Revenue / Total Revenues	7.8%	5.9%	5.1%	5.1%	5.2%
Provisioning Burden as % of PPP	11.4%	10.5%	2.6%	7.8%	8.4%
NPLs plus Foreclosed Real Estate / Loans	11.3%	10.4%	9.5%	8.8%	8.2%
Loan Loss Reserves / NPLs	90.7%	89.0%	91.3%	92.3%	94.4%
Loan Loss Reserves / Total Loans	11.4%	10.2%	9.5%	8.8%	8.4%
Provisions Expense / Average Loans	0.9%	0.9%	0.2%	0.6%	0.6%

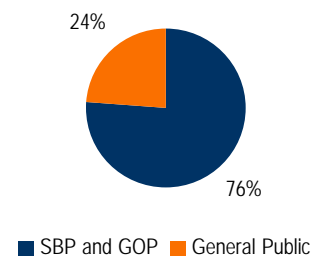
Other Metrics

Income / Employee	2.37	3.02	3.26	3.56	3.88
(Operating Expenses) / Employee	(0.813)	(0.922)	(1.07)	(1.20)	(1.31)
Pre-Provision Profit / Employee	1.56	2.10	2.18	2.35	2.57
Net Profit / Employee	0.921	1.21	1.38	1.41	1.53

Company Description

National Bank of Pakistan (NBP) is the largest commercial bank in Pakistan. The nature of responsibilities of NBP is unique from other banks/financial institutions. Besides performing normal banking activities, NBP acts as an agent of the State Bank of Pakistan for handling provincial/federal government receipts and payments on its behalf.

Chart 1: Pattern of shareholding



Source: Company Accounts

Stock Data

Price to Book Value 2.0x

We remain Neutral

In light of our positive stance on the prospects for the Pakistan banking sector as a whole, it is difficult not to have a positive bias toward the largest local bank and the government's treasurer, National Bank of Pakistan (NBP). However, while NBP has several attractive characteristics, we rate the stock as a Neutral at current levels, given the following challenges confronting the bank:

1. Consumer finance - The missing link

While the advantage enjoyed by NBP in the form of its enviable footprint and customer base is undeniable, this advantage is coming under serious threat due to NBP's shortcomings in the form of a lack of a well diversified suite of consumer finance products and services, an area where comparable peers have already channeled significant resources. While absolute numbers are impressive with NBP having the largest consumer finance portfolio (20% share), it is the lack of diversity which makes NBP lag its peers, in our view. NBP's consumer finance portfolio is concentrated primarily on one product, ie, the relatively low risk and lower return Advanced Salary Product for government employees. While the lack of diversity (no credit cards or auto loans offering as yet) compared to nimbler peers will be reflected in the bank's relative loan growth trajectory, it will predominantly be reflected in its net interest margins compared to peers.

2. Lack of IT backbone - Need time and money to address

While conservative management practices were to blame earlier, the crippling factor for NBP, in our view, which is restricting it from a major move into consumer finance is the lack of requisite IT systems and procedures. While management has the right intentions and has already contacted a short list of vendors, government due diligence and red tape mean that the full implementation will require months for completion.

3. Inefficient capital structure

NBP is over-capitalized given the bank's potential organic and inorganic growth opportunities. While maintaining a high capital base may be in the best interest of the bank's majority shareholders (the Pakistan government), we do not believe it is in the best interests of minority shareholders and excess capital should be returned to investors. The retention of excess capital has dampened RoE expansion and, thus, overall valuation multiple expansion.

4. Competition is taking its toll

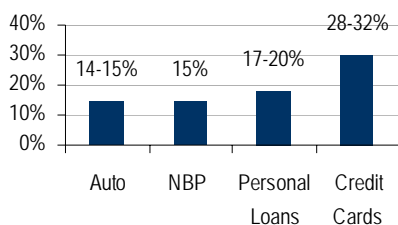
Due to the inherent shortcomings in NBP, competition is taking its toll on NBP, where the smaller banks and upgraded larger banks have been nibbling away at NBP's market share in deposits. From a market share of 26% in 2000, the current market share has fallen to 16%. However, the lagged performance on the volume side has not been reflected in the bank's margins, which have been quite robust and are among the highest in the industry. One oft flouted advantage of NBP is the optically excess liquidity, but a detailed analysis reveals that excess liquidity is mostly offshore, where local liquidity is in line with the system at 70% levels.

What would make us more positive on NBP?

As stated earlier, although not a buy, NBP is definitely a stock that needs to be on investors' radar screens given:

- Its importance as the largest local bank – size matters when it comes to cost of deposits.
- It is the government's treasurer and handles government transactions, providing a steady and relatively secure fee and commission income stream

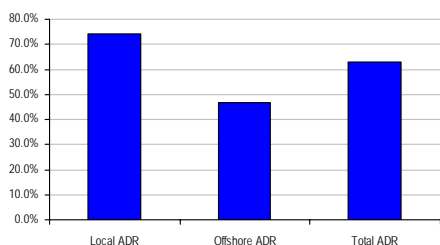
Chart 2: Yield on advance salary product compared to peers



Source: Industry estimates

NBP's approach to capital management needs to take into account the needs of all its stakeholders

Chart 3: Local vs international Adv. To deposits



Source: Company accounts

and providing captive customer base in the form of the government employees who maintain salary accounts in NBP.

- It is a liquid and investable bank stock from a secondary market perspective.

While we have highlighted our concerns about NBP upfront, we will be keeping a close watch for improvements in consumer lending products & services, IT development, and capital management among others. In addition, there are areas with considerable, but unmeasured potential, which would turn us positive on NBP.

Micro finance - Expanding the addressable banking market

The Government of Pakistan, in collaboration with NBP, has launched an initiative named Rozgar (Employment) Scheme, which is targeted at providing the unemployed youth of Pakistan with opportunities for self employment. Under the scheme, NBP would be disbursing loans to qualifying candidates for setting up utility stores, Public Call Offices (PCOs) or acquiring three wheelers for use as private taxis. The rate on these loans would be 12%, but the borrower would only have to bear 6%, with the other 6% being subsidized by the government. From NBP's vantage point, the 12% return is decent and, in addition to that, NBP will also benefit from the fee income that it will charge to vendors which supply the relevant equipment for the scheme such as three wheeler manufacturers. The risk side is also somewhat covered with the government willing to share 10% of bad loans and the amount is handed over to the vendors instead of the borrowers.

Legacy investments- Bank Al Jazira and NIT

Another important angle to the NBP story is the investments of the bank. While the bank has an active stock and bond portfolio, the stand-out investments include its 5.83% stake in Saudi-based Bank Al Jazira (BJAZ) and around 24% ownership of the largest mutual fund in Pakistan. Currently, the Bank Al Jazira investment is only contributing mark-to-market adjustments to NBP; while a decline in share price leads to a reduction in NBP's book value, it also scales up the ROE. However, NIT continues to make meaningful contribution to NBP due to its decent 9% dividend yield, which is buoyed by NIT's substantial holdings in M&A slated industries, such as banks, and NIT's willingness to participate in such transactions on the sell side.

However, a key upside to the NBP story comes from offloading of NBP's stakes in these entities where, on current market prices, the potential capital gains on the two transactions amount to PRs33.4/share of NBP. However, both these transactions carry their share of issues. Given the relatively shallow Saudi market, BJAZ can only be sold as a block deal, which would result in a discount to market price. NIT, on the other hand, can only be offloaded under a special arrangement such as privatization, as NBP is a Letter of Comfort holder in NIT. The latest is that, instead of privatization, NBP along with other key holders of NIT would be offered phased redemptions.

International operations and GDR offering

NBP has the largest overseas presence amongst local banks with a presence in 18 countries through branches, subsidiaries and rep offices. While the bank has been able to ramp up the contribution of foreign assets to around 18% of total assets, the earnings contribution lags it by a wide margin, contributing just 5.5% of total pre tax profits. With the overseas network primarily geared to trade and remittances business, a shift in focus toward commercial banking in overseas markets can reap rich dividends for NBP. NBP is also one of the companies that have been slated as GDR candidates by the government where the GoP plans to partially offload their stake. This should provide the bank with better visibility.

Innovative new product to extend reach into low socio-economic sectors

Table 1: Potential capital gains on NIT

	Per Unit Value	Gain (PRsmn)	Gain /sh (PRs)
4% discount	59.33	16,333.40	20.03
2% discount	60.56	16,791.74	20.59
Current NAV	61.80	17,250.08	21.15
2% premium	63.04	17,708.42	21.72
4% premium	64.27	18,166.76	22.28

Source: KASB estimates

Table 2: Potential capital gains on BJAZ

	Price PRs@16	Gain (PRsmn)	Gain /sh (PRs)
20% discount	637.20	7,900	9.69
10% discount	716.85	8,945	10.97
Current Price	796.50	9,991	12.25
10% premium	876.15	11,036	13.53
20% premium	955.80	12,082	14.82

Source: KASB estimates

While NBP has the largest overseas presence, it has yet to completely leverage the potential

Volumetric growth the new buzzword

Worst appears over for prices; robust outlook for volumes

With FY07 (year-end June) drawing to a close and cement prices having bottomed, we believe the worst is over for Pakistan's cement sector. We are confident that a positive surprise in the form of robust demand growth is here to stay. In our view, demand would grow at a five-year CAGR of 16% with volumes the key driver of future earnings growth.

Strong domestic demand to steer growth

At the heart of volume growth is domestic demand with a 90% share of sector sales. Pakistan has entered a period of strong domestic cement demand growth, driven by rapidly rising per capita income levels, heavy government infrastructure spending and hitherto unparalleled private sector interest in mega construction projects. We expect domestic cement demand to grow at 2.85x GDP over FY07-10E compared with 2.1x over the past four years.

Export offers a window of opportunity

Strategic location in the hub of the fastest cement-consuming area and earliest in expansion in the region have thrown open the export window. We see a clear two-year window for robust cement exports, with the Middle East and Afghanistan as the primary target markets. We expect cement exports to reach 3.06mn tons in FY07E and to grow at 20% CAGR over FY06-10E.

Expansion by industry majors to set price floor

Although cement capacity is expected to grow from 30.09mn tons (FY07) to 44.27mn tons (FY10E), we believe the worst is over for prices. Once industry majors commission their expansions over the quarter, we see limited downside to prices. While we expect capacity additions after 1Q FY08 to be staggered and unlikely to influence prices, it remains highly possible that the industry will adopt price rationalization from then. However, we do not factor the same into our assumptions.



Farrah Marwat ^^^^
Research Analyst
KASB Securities

Shagufta Irshad ^^^^
Research Analyst
KASB Securities

Table 1: Industry: Supply/demand outlook

mtpa (year-end June)	FY05	FY06	FY07E	FY08E
Cement Capacity	17.59	21.04	30.09	38.18
Capacity growth	2.0%	19.6%	43.0%	26.9%
Cement Demand	16.35	18.41	24.13	27.84
Demand growth	20%	13%	31%	15%
Domestic Consumption	14.79	16.91	21.07	24.23
Growth in domestic consumption	18%	14%	25%	15%
Exports	1.57	1.51	3.06	3.61
Exports Growth	40%	-4%	103%	18%
Exports from North (Afghanistan)	1.52	1.41	1.82	1.93
Exports from South (Middle East)	0.05	0.10	1.24	1.68
Capacity Utilization (incl. exports)	93%	88%	80%	73%
Capacity Util. (excl. exports)	84%	80%	70%	63%

Source: KASB Research

Worst appears over; play on volumes

With FY07 (year-end June) drawing to a close, we believe the worst is over for Pakistan's cement sector which seems to have witnessed the bottom of prices but has yet to fully factor in the force of demand. After peaking in 4Q FY06, cement companies lost 47% of their market cap by end-1H FY07 as a result of 7.28mn tons capacity add-ons and a 37% drop in cement prices over nine months. Year to date, the stocks have recovered 60%. The positive surprise overriding cement price volatility is robust demand growth which we believe is here to stay.

Demand will trigger upside

We highlight robust demand growth as the driving force behind Pakistan's cement sector. YTD FY07, domestic demand has risen by an unprecedented 26% YoY and export sales by 100% YoY. From PRs260/bag at the start of FY07 to PRs210-220/bag at present, we believe cement prices are already as low as they will go and expect prices to gradually inch up from 2H FY08. With relative stability on the price front, we highlight the new star of the show – volumetric growth.

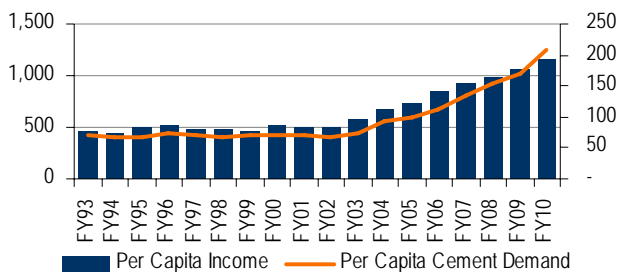
The domestic demand push

We expect domestic cement demand (90% of cement sales) to remain at the heart of the volumetric growth story, where we forecast domestic sales to grow at a five-year CAGR of 16% over FY06-11E. This would take domestic cement demand to 35.5mn tons in FY11E. Driving the pace of cement consumption are strong GDP growth, increasing income levels and a vigorous infrastructure thrust by both the public and private sectors.

Demand driver #1: Rising per capita income and GDP

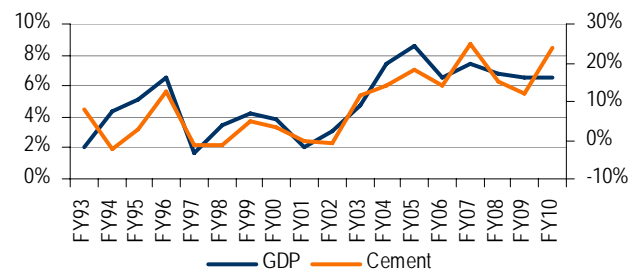
Demand for cement is being fueled by a strongly growing economy. Pakistan has sustained above-trend GDP growth in the past three years (averaging 7.6% vs the historical 10-year average of 3.9%). This has powered double-digit cement demand growth, at an average of 15.6% over FY04-06 vs the 10-year average of 2.9%. With GDP growth expected to remain north of 6.5% over the next three years, cement demand looks set to stay robust, growing at an average of 2.85x GDP over FY07-10E compared to 2.1x GDP over the previous four years and an average of just 0.9x over the decade from 1993-2003.

Chart 1: Per capita income (US\$ – LHS) vs cement demand (kg – RHS)



Source: Economic Survey of Pakistan, KASB estimates

Chart 2: GDP growth (LHS) vs cement demand growth (RHS)



Source: Economic Survey of Pakistan, KASB estimates

Demand driver #2: Geared up infrastructure spending

Adding to the vital impetus to domestic cement demand growth is a perceptible and significant shift in Pakistan's infrastructure development investment, spearheaded by stable economic policies. Indeed, in recent years, the government has significantly raised its development spending, driven by a newfound focus on building the country's physical infrastructure. The past four years of 2-3x stronger-than-real-GDP growth in cement demand is underpinned by a 28% CAGR in government development expenditure over 2002-07.

Table 2: Pakistan: Infrastructure projects

Projects	Current status
Darya Khan - D.I.Khan Bridge	Approved
Five bridges in Chitral Area	Approved
Gwadar Airport	Approved
Lining of canal projects	Approved
Ratodero-Gwadar Motorway	Approved
Qila Saifullah D.G. Khan Road	Approved
Construction of Rawalpindi bypass	Not approved
Kalat-Quetta-Chaman (N-25)	Approved
Improvement of Quetta Bypass	Approved
Lyari Express	Approved (OG)
Torkham - Jalabad Road	Approved (OG)
Lowari Tunnel & Acc. Roads project	Approved (OG)
Bridge over River Chenab at Chund	Not approved
Interchange at Kot Sarwar on M-2	Not approved
Rep. of 5 bridges on Gilgit Road	Not approved
Peshwar Northern Bypass	Approved
Indus Highway Project Phase 3	Approved (OG)
N-5 Highway Rehabilitation Project	Approved (OG)
Lakpass Tunnel Project	Not approved

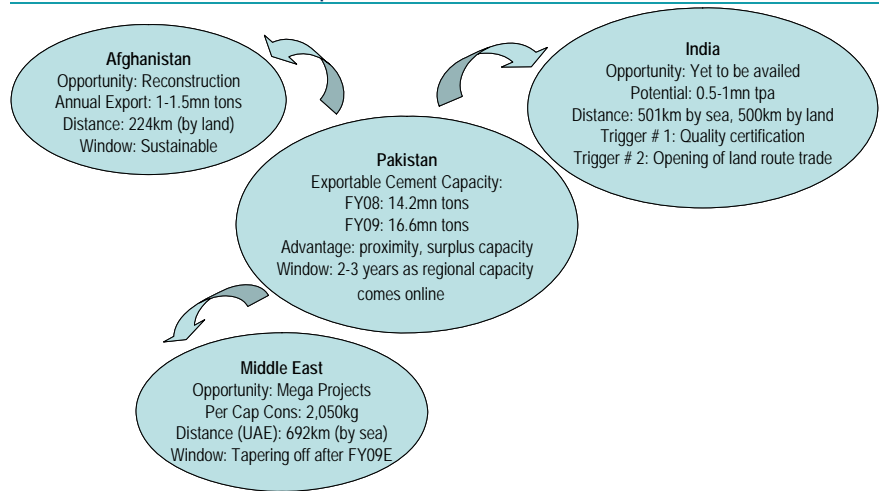
Note: OG = Ongoing. Source: KASB Research

The new factor is the private sector, which is increasingly contributing to large-scale construction. We are seeing a surge in interest, both domestic and international, in real estate investments which have drawn a number of foreign developers and construction companies to undertake mega projects in Pakistan.

Export window a vibrant opportunity

Located in the heart of one of the strongest growing cement-consuming regions in the world, Pakistan is finding that its strategic location, timely expansion and available export capacity are working in its favor. The first cement exports were recorded as recently as 2002. In the four years since, they have grown at 94% CAGR from 0.1mn tons to 1.5mn tons in FY06. We expect cement exports to top 3.06mn tons in FY07E and to grow at 20% CAGR over FY06-10E.

Chart 3: Pakistan: The cement export scenario



Source: KASB Research

Middle East

We expect the Middle East to be a strong cement export market for Pakistan over FY07-09 in view of the following: (1) per capita cement consumption of 2,050kg, 6x the global average, (2) cement shortfall, (3) tight supply curtailing hitherto key exporters (India, Iran and Saudi Arabia), and (4) high prices in the region (~US\$5/ton higher margins vs local sales). However, subsequent capacity additions across the region are likely to result in export slowdown for Pakistan.

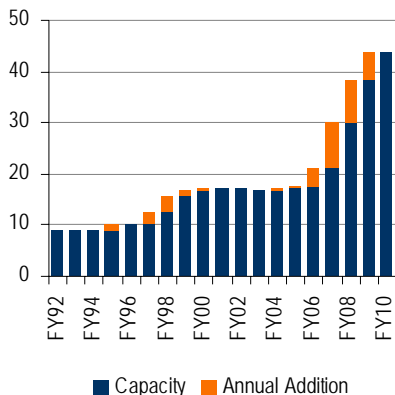
Afghanistan

Likely to remain largely dependent on Pakistan for its cement requirements, the potential for demand growth in Afghanistan remains tied to the pace of political reform and reconstruction. Hence, we take a conservative view on Afghan export potential and assume 6% pa export growth over FY08-11.

India

We have assumed no exports to India but highlight that this is a viable opportunity. With cement capacity utilization in India at 90%, Pakistan is India's cheapest and closest source of imports. Two issues remain unresolved: (1) quality certification certificates, a procedural move, and (2) opening of land route trade.

Chart 4: Cement capacity expansion (mtpa)



Source: APCMA, Companies, KASB Research

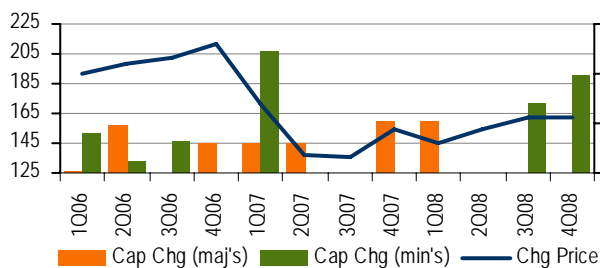
Prices to resist supply pressures

There is no doubt that cement capacity in Pakistan is going up. Industry capacity is expected to more than double from 21mn tons in FY06 to 43.5mn tons in FY10. There are, however, caveats here that are expected to keep prices stable and we believe we have already witnessed the price crunch on account of incremental capacity in FY07.

With 7.8mn tons in supply added in 1H FY07, cement prices fell from a high of PRs300/bag to as low as PRs180-190/bag in December 2006. We do not think a repeat of FY07 is in the offing. Of the 22.5mn tons additional capacity, 40% is already on stream and by the end-July 2007, that number will have scaled up to 60%. Even more relevant to prices is the fact that the “premier league” of Pakistan’s cement companies – DG Khan Cement, Lucky Cement and Maple Leaf Cement, who together control 33% of total capacity and 35% of the additions – will have no more capacity to add after July 2007.

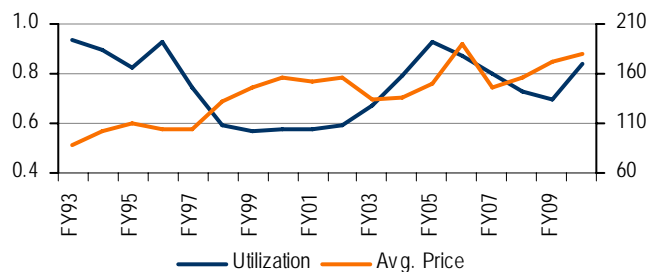
What is left will be additions by less influential companies, whom we believe will have limited ability to affect prices, let alone bear lower prices. We believe that while industry capacity expansion is substantial, the “surprise factor” could be positive and with many weaker companies expanding on low quality plants, the risk remains that when produce comes to the market, supply will fall short of targets.

Chart 5: Price (PRs/bag – LHS) vs capacity addition (mtpa – RHS)



Source: APCMA, KASB estimates

Chart 6: Low utilization levels trigger consensus pricing



Source: KASB estimates

Exports a cushion and an opportunity

Adding to our comfort on domestic prices is the availability of a strong export demand over this period, with exports expected to deliver US\$5-6 higher margins per ton and divert supply from the local market. We believe this will have dual impact: (1) help manufacturers to stomach the expected six-month softer prices, and (2) smooth out capacity impact.

Will utilization level be lower then? Naturally, but that is a short-term phenomenon that recurs cyclically. And it does not happen to all. With robust demand taking the lead, our picks in the sector are well placed with five-year utilization levels expected to remain around 90% relative to 76% for the industry.

Separately, history points out an interesting aspect – lower capacity utilization rate rather than lower prices have triggered market share allocation and consensus pricing in the industry. Our cement price and utilization forecasts are based on the assumption that the quota allocation system that brings in tow cooperation on prices is not in play. We see the potential of the industry reverting to rationalized pricing as an upside risk to our current cement price forecasts.

Buy cement growth and strong equity portfolio



Farrah Marwat ^^^^
Research Analyst
KASB Securities

Shagufta Irshad ^^^^
Research Analyst
KASB Securities

Stock attractive on core business

DG Khan Cement (DGKC) is the second largest (4.2mn tpa) lowest cost cement producer in Pakistan. It has a strong equity portfolio in associate companies (these are our top pick in Pakistan's banking and textile sectors - MCB Bank and Nishat Mills). DGKC's cement operations (9x) currently trades at a discount to market P/E of 10x FY08E earnings, which makes the stock attractive on core business.

Expansion to aid growth

We expect DGKC's core business earnings to grow at 11% CAGR (FY06-FY11E) on the back of: 1) 16% CAGR in sales volume, supported by doubling of cement capacity to 4.2mtpa in a month, enabling the company to exploit growth opportunities; and 2) improving fuel and power costs that will lead to 10% higher gross cash margins vs peers.

Strong equity portfolio

Nearly 42% of the company's assets are invested in associate companies like MCB Bank (fourth largest bank with leading deposit franchise) and Nishat Mills (largest textile exporter). With both the companies having strong earnings growth profile, we believe the equity portfolio will continue to add value for DGKC's shareholders. The portfolio value currently accounts for 46% or PRs56/sh of our SOTP value for DGKC, which we believe is not fully priced in.

Risks: 1) Longer-than-expected duration of low prices; 2) Slowdown in demand
3) Sensitivity of investments to adverse movements in the equity market.

Estimates (Jun)

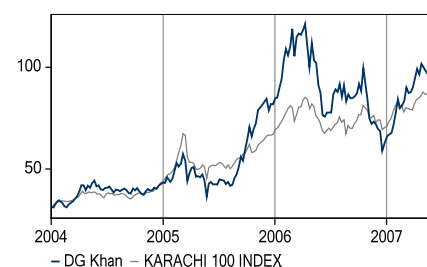
(PRs)	2005A	2006A	2007E	2008E	2009E
Net Income (Adjusted - mn)	1,682	2,418	1,710	2,048	3,039
EPS	6.63	9.54	6.74	8.08	11.99
EPS Change (YoY)	102.7%	43.8%	-29.3%	19.8%	48.4%
Dividend / Share	1.09	1.09	1.50	1.50	2.00
Free Cash Flow / Share	(2.76)	(17.99)	(19.11)	13.05	16.40

Valuation (Jun)

	2005A	2006A	2007E	2008E	2009E
P/E	17.39x	12.10x	17.11x	14.28x	9.63x
Dividend Yield	0.945%	0.945%	1.30%	1.30%	1.73%
EV / EBITDA*	21.62x	11.27x	16.66x	9.70x	8.02x
Free Cash Flow Yield*	-2.39%	-15.59%	-16.56%	11.30%	14.21%

Stock Data

Price	PRs115.40
Price Objective	PRs122.00
Date Established	27-May-2007
Investment Opinion	C-1-8
Volatility Risk	HIGH
52-Week Range	PRs57.90-PRs121.90
Mrkt Val / Shares Out (mn)	US\$483 / 253.5
Average Daily Volume	20,370,590
ML Symbol / Exchange	XDGAF / KAR
Bloomberg / Reuters	DGKC PA / DGKH.KA
ROE (2007E)	8.2%
Net Dbt to Eqty (Jun-2006A)	60.0%
Est. 5-Yr EPS / DPS Growth	12.6% / 29.7%
Free Float	65.0%



05 July 2007

iQprofileSM DG Khan Cement

Key Income Statement Data (Jun)	2005A	2006A	2007E	2008E	2009E
(PRs Millions)					
Sales	5,280	7,956	7,006	10,442	12,181
Gross Profit	2,290	4,318	3,028	5,145	6,193
Sell General & Admin Expense	(122)	(148)	(168)	(282)	(317)
Operating Profit	1,718	3,615	2,251	3,574	4,581
Net Interest & Other Income	404	(166)	28	(841)	(459)
Associates	NA	NA	NA	NA	NA
Pretax Income	2,121	3,449	2,279	2,732	4,122
Tax (expense) / Benefit	(439)	(1,030)	(569)	(684)	(1,083)
Net Income (Adjusted)	1,682	2,418	1,710	2,048	3,039
Average Fully Diluted Shares Outstanding	254	254	254	254	254

Key Cash Flow Statement Data

Net Income (Reported)	1,682	2,418	1,710	2,048	3,039
Depreciation & Amortization	357	364	438	1,046	1,001
Change in Working Capital	1,136	1,660	(3,876)	301	206
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	0	0	0	0	0
Cash Flow from Operations	3,175	4,442	(1,728)	3,396	4,246
Capital Expenditure	(3,874)	(9,003)	(3,116)	(88)	(88)
(Acquisition) / Disposal of Investments	0	0	0	0	0
Other Cash Inflow / (Outflow)	(1,275)	84	6	6	7
Cash Flow from Investing	(5,149)	(8,919)	(3,110)	(82)	(81)
Shares Issue / (Repurchase)	0	0	1,605	0	0
Cost of Dividends Paid	(251)	(277)	(277)	(380)	(380)
Cash Flow from Financing	1,984	4,460	5,229	(3,183)	(3,773)
Free Cash Flow	(699)	(4,560)	(4,844)	3,308	4,158
Net Debt	6,804	11,557	15,067	12,133	8,348
Change in Net Debt	2,226	4,753	3,510	(2,934)	(3,785)

Key Balance Sheet Data

Property, Plant & Equipment	10,938	19,576	22,255	21,296	20,383
Other Non-Current Assets	2,882	4,818	4,818	4,818	4,818
Trade Receivables	76	74	93	139	162
Cash & Equivalents	94	77	467	599	991
Other Current Assets	4,027	9,759	11,895	12,074	12,121
Total Assets	18,017	34,304	39,529	38,927	38,476
Long-Term Debt	4,899	7,372	12,228	9,339	6,550
Other Non-Current Liabilities	611	1,619	66	72	80
Short-Term Debt	1,866	4,233	3,302	3,393	2,789
Other Current Liabilities	1,190	1,783	1,622	2,148	2,424
Total Liabilities	8,699	15,036	17,222	14,952	11,842
Total Equity	9,318	19,268	22,306	23,974	26,634
Total Equity & Liabilities	18,017	34,304	39,528	38,927	38,476

iQmethodSM - Bus Performance*

Return On Capital Employed	9.7%	10.3%	4.8%	7.2%	9.3%
Return On Equity	21.5%	16.9%	8.2%	8.9%	12.0%
Operating Margin	32.5%	45.4%	32.1%	34.2%	37.6%
EBITDA Margin	39.2%	50.0%	38.4%	44.2%	45.8%

iQmethodSM - Quality of Earnings*

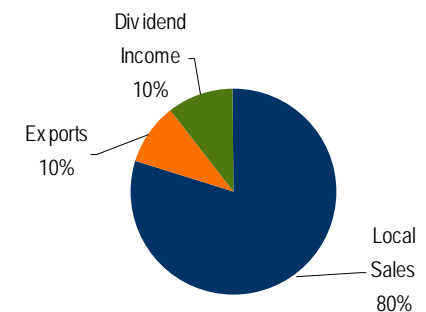
Cash Realization Ratio	1.9x	1.8x	-1.0x	1.7x	1.4x
Asset Replacement Ratio	10.8x	24.7x	7.1x	0.1x	0.1x
Tax Rate (Reported)	20.7%	29.9%	25.0%	25.0%	26.3%
Net Debt-to-Equity Ratio	73.0%	60.0%	67.5%	50.6%	31.3%
Interest Cover	5.6x	8.0x	5.1x	2.6x	4.2x

Key Metrics

Company Description

DG Khan Cement (DGKC), currently the most efficient cement producer in Pakistan, plans to expand its installed capacity of 1.957mtpa to 4.2mtpa by end-FY07. With almost 42% of its assets invested in associate companies, DGKC can also be taken as a holding company. It has an equity investment in MCB Bank, Nishat Mills and Nishat Chunian. Nishat Mills is the main sponsor of this company with 31.4%.

Chart 1: DGKC: Net Earnings Breakup (FY06)



Source: Company accounts, KASB, Merrill Lynch estimates

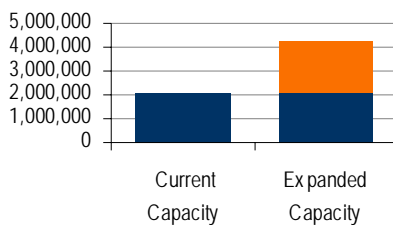
Stock Data

Price to Book Value 1.3x

Cement set for growth

DG Khan Cement (DGKC) is the second largest (4.2mn tpa) and the most efficient cement company in Pakistan with a strong equity portfolio in associated companies. We currently have a sum-of-the-parts (SOTP) value of PRs122/sh, which includes DCF-based value of PRs66/sh for core cement operations and 30% discounted portfolio investment value of PRs56/sh in associate companies. MCB Bank (86%) and Nishat Mills (13%), which represent 99% of DGKC's PRs20bn portfolio value, both are our top picks in Pakistan's banking and textile sectors, respectively, both with strong earnings growth profile. We expect DGKC to post 13% CAGR in its bottomline over FY06-FY11E on the back of: 1) doubling of plant capacity, enabling the company to capture rapidly growing domestic and export demand; 2) price rationalization expected from 3QFY08; 3) improving margins from fuel efficiency and 4) 24% growth in dividend income from associates. We have not incorporated any major exports to the Middle East and no exports to India, which could be potential triggers, going forward.

Chart 2: DGKC's capacity to double



Source: APCMA, Company

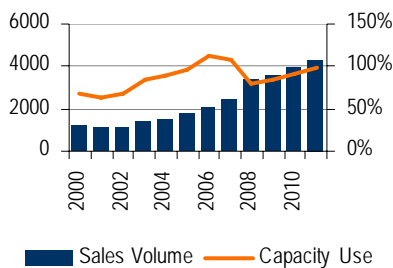
Capacity to double

DGKC's production capacity is likely to double to 4.2mn tons per annum through the commissioning of its new line in a month. The company has commenced trial production and marketing from its new plant located in Chakwal with a capacity of 6,700tpd of clinker or 2.1mn tons of cement pa. We expect the plant to become fully operational from Jun-Jul 2007 and enable the company to catch up with the rapidly growing cement demand in the country and strong exports in the regional markets.

Strong control over market share

DGKC covers the entire country (is located in the centre of Pakistan) and has its major focus on Punjab, which is the largest province and Pakistan's agricultural hub. DGKC' strong control on the market can be assessed from the fact that the company has been successful in maintaining its market share at 11%. This is despite the capacity addition of 9mn tonnes by others, at a time when DGKC was still working on completing its expansion project. DGKC could have lost at least 3% market share, but for its strong marketing efforts, considering that the company's total production capacity in the industry fell to 7% from 10

Chart 3: Sales growth

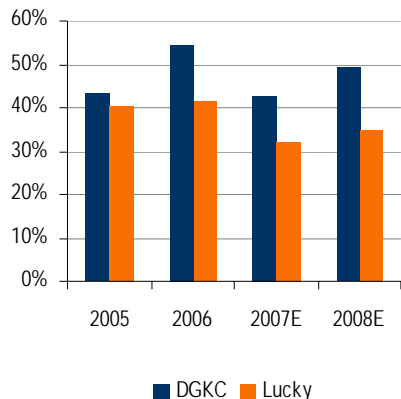


Source: Merrill Lynch estimates, KASB

Expansion to accelerate volume growth

We believe DGKC will continue to benefit from its strong marketing efforts, post commissioning of its new plant. We estimate 16% volume CAGR over FY07-FY11E, in line with industry demand CAGR. This comes on the back of rising income level, heavy government infrastructure spending and growing private sector spending on urban housing projects.

Chart 4: DGKC: Higher gross cash margins



Source: KASB estimates, Company

Price stability, cost edge to improve margins

We estimate DGKC's gross cash margins to expand by 600bp in FY08 and remain stable at these levels. This would come on the back of 6% recovery in average prices in FY08 and continuation of DGKC's edge over peers on 20% lower fuel and power cost, leading to about 10% higher gross cash margins vs peers, including Lucky Cement. We believe cement prices have touched a bottom (PRs220) and are set to rise from 3QFY08. We believe an early cooperation towards price rationalization before 3QFY08 could provide a positive trigger to the sector. DGKC would continue to be dominant in price-setting, post commissioning of its expansion plan.

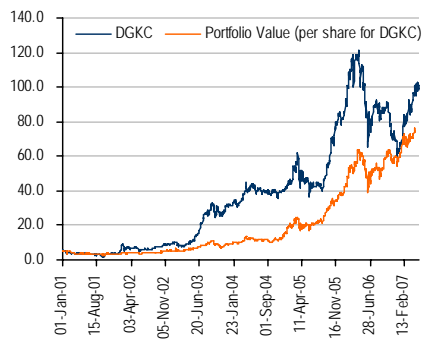
Planning a new greenfield project in south

DGKC has finally decided to set up a new greenfield project in the southern region. This is primarily to cater to the potential demand from development of a new port at Gwadar and exports via sea route to Middle East and other regional markets, after reflecting on the successful and timely strategy adopted by Lucky Cement. The company is in the process of acquiring 400 acres of land required for setting up the plant with a minimum capacity of 5,000tpd of clinker (or 1.6mn tons of cement), of which it has already bought 75 acres; it will directly negotiate for the remaining with the provincial government. The plant will be located in Hub industrial estate near the Attock Cement plant, which is also close to the Karachi port and potential Gwadar port.

We have currently not incorporated this expansion into our forecast and await the financial close. How positive this investment would be for DGKC, will depend on how attractive the Middle East market would remain after three years, once the key exporting countries to UAE, including Saudi Arabia, Iran, Egypt and India are done with their expansion projects.

However, given the price increases in the Middle East, we expect DGKC to export some bagged cement from its old plant in North, wherein the higher export price (US\$55/ton or above) should cover the inland freight cost of US\$8-10/ton. This would provide upside to our sales forecast for DGKC.

Chart 5: DGKC's stock price strongly correlates with its portfolio value



Source: KASB Research

Dividends to strengthen bottomline growth

Dividend income from MCB bank and Nishat Mills should continue to strongly support DGKC's bottomline and provide a potential cushion during volatility. MCB Bank, our top pick among Pakistan banks, is a key contributor, contributing 85% to DGKC's dividend income, which will likely witness 24% CAGR over FY06-FY11E.

MCB Bank is the fourth largest bank in Pakistan, with a leading deposit franchise (about 85% low cost deposits). Nishat Mills is the largest integrated textile company, handling 9% of national yarn and 13% of fabric sales in Pakistan.

Buy on stronger DAP, urea remains defensive

Equity | Pakistan | Fertilizers
5 July 2007



Shagufta Irshad ^^^^
Research Analyst
KASB Securities
sirshad@kasb.com

+92 21 263 5501

Fertilizer a strategic fit

The agrarian nature of Pakistan's economy makes the fertilizer sector a strategic fit. Unlike other global commodities, the fertilizer business has consistently benefited from favorable policies by successive governments. We expect this trend to continue with the government currently looking at how the agricultural sector can help sustain GDP growth momentum (agriculture constitutes 23% of total GDP in Pakistan).

Supply shortfall to persist

Crop yields in Pakistan lag those in other fertilizer-intensive countries due to sub-optimal fertilizer application rates. We expect demand to grow by 3% pa for urea and 10% pa for DAP in the long term. Urea shortage should persist until mid-2010 when Engro Chemical's 1.3mtpa plant begins operation. The issue would then be temporarily resolved until the need for a new plant re-emerges in 2014, in our view. On the DAP front, Pakistan would remain a net importer as FFBL's expansion is unlikely to lower imports to 50-60% from the current 70%.

Strong pricing power for urea

With a relatively straightforward earnings equation driven by volumetric growth and pricing power, we believe the fertilizer sector stands to gain from the non-competitiveness of imported urea (cost disparity) and insufficient indigenous supply to fulfill demand. Given the domestic shortages and Engro's heavily debt-serviced US\$0.9bn expansion, we see little risk to urea prices in the aftermath of Engro's expansion in 2010.

DAP – Buy on global outlook for bio-fuels

In our opinion, DAP prices would remain high for the next several years as there is no significant increase in capacity until 2010 at the earliest. Furthermore, we now expect global DAP prices to peak in 2010 instead of 2008 since a delay in Saudi DAP expansion has prolonged the up-cycle for DAP prices.

Sector strategy – FFBL is our top pick

FFBL is our top pick in the sector with a PO of PRs45/share. The company is ideally placed to capitalize on the DAP up-cycle with production capacities for urea and DAP expected to increase by 16% and 15% respectively by July 2007, while total DAP capacity would be raised by 51% as of January 2008. We also like FFC as a defensive play as it offers 10% 2007E dividend yield and indirect exposure to FFBL's growth through its 51% stake.

Table 1: Pakistan Fertilizers: Key statistics

'000 tons	2004	2005	2006
Urea			
Production	4,400	4,691	4,803
Imported Product	311	487	427
Sales	4,712	5,179	5,230
YoY Sales Growth	5.1%	9.9%	1.1%
DAP			
Production	574	588	451
Imported Product	633	777	1,009
Sales	1,207	1,364	1,460
YoY Sales Growth	7.7%	13.0%	10.3%

Source: NFDC

Table 2: Pakistan Fertilizers: Market structure

	Urea	DAP
Mkt Share (2006)		
FFC	49%	29%
Engro	19%	20%
FFBL	13%	27%
Others	19%	25%

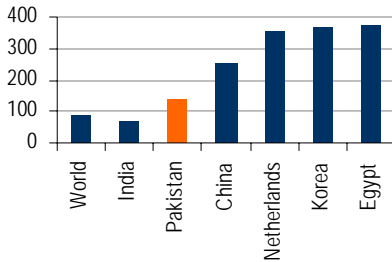
No. of Producers	6	1
Importing party	Govt	Private Importers

Source: NFDC reports

Strategic fit for Pakistan

The fertilizer business in Pakistan is stable, quite unlike other global commodities. Indeed, this sector is of strategic importance given Pakistan's agrarian economy.

Chart 1: Nutrient consumption: Breakdown by country (kg/ha)



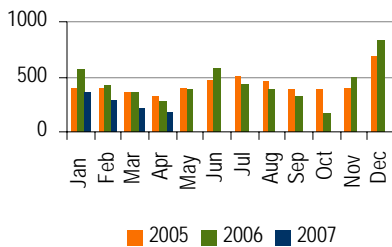
Source: NFDC, FAO

In our opinion, the government has two options: (1) to import fertilizer, which will cost precious foreign exchange, or (2) to provide rupee-based subsidy to the fertilizer sector in the form of lower gas prices. The latter has been the obvious choice. With the government currently looking at how the agricultural sector can help to sustain GDP growth momentum (agriculture contributes 23% to GDP), we believe the fertilizer sector will continue to see a favorable policy environment.

With supply shortfall becoming acute, the government has recently set up a competitive bidding process and allocated gas to Engro Chemical to set up a 1.3mtpa urea plant. We expect this project to become operational in mid-2010 which should temporarily resolve the supply-side issues for a couple of years. However, to meet domestic urea demand, we believe at least one more urea plant of similar scale would be needed by 2015-18.

With the strong outlook for DAP price, Fauji Fertilizer Bin Qasim, the only DAP producer in Pakistan, is our top pick in the sector.

Chart 2: Pakistan: Urea sales ('000 tons)



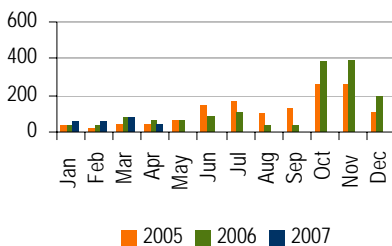
Source: NFDC

Fertilizer demand outlook

Crop yields in Pakistan lag those in other fertilizer-intensive countries due to sub-optimal fertilizer application rates. Thus, we expect to see long-term increases in fertilizer consumption in Asia as farmers gain better access to soil-nutrient analyses. This should help improve yields with balanced nutrient application rates to meet the desired level of crop output, as evidenced by the 5% improvement in nutrient consumption (five-year CAGR over FY01-06) to 156kg/ha. Add to this the fact that the 10-year CAGR of urea demand is 5%, reflecting a long-term growth pattern.

Pakistan's nutrient consumption would need to at least double to match China's consumption pattern. This should help to maintain stable growth in the agricultural sector and, eventually, the country's GDP. In the long term, we expect demand to grow by 3% pa for urea and 10% pa for DAP.

Chart 3: Pakistan: DAP sales ('000 tons)



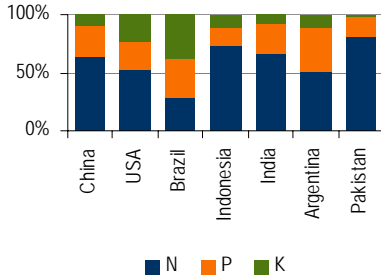
Source: NFDC

Between January and April 2007, we witnessed urea sales sliding by 35% YoY and attribute this to higher year-end inventories with dealers and the delay in cotton and rice sowing in Punjab Province (lag effect coming from delay in previous crops) which consumes more than 70% of domestic urea supply. We are not worried about the slowdown in urea sales as we expect demand to pick up when the time comes for sowing of major crops – cotton in 2Q and wheat in 4Q.

With an expected FY07 bumper wheat crop resulting in higher purchasing power for farmers, we expect farmers to apply more fertilizers to maximize crop yields. Already we are seeing a 42% YoY growth in urea consumption in Sindh province in April 2007 with farmers buying urea for rice and cotton sowing expected during May-June. We believe the same can be replicated in Punjab where crop sowing will accelerate subsequent to wheat harvesting.

DAP sales grew by 9% YoY in the first four months of 2007. Despite a 75% increase in global DAP prices YTD, we believe a PRs470/bag subsidy given on retail prices will continue to encourage greater application of DAP to maximize crop yields.

Chart 4: Nutrient consumption pattern



Source: FAO, NFDC

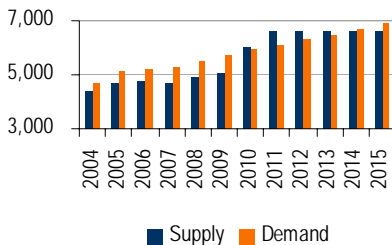
Subsidizing DAP prices to promote balanced nutrient consumption

The government has introduced a price subsidy of PRs250 per 50kg bag of DAP in October 2006 to encourage optimal nutrient consumption in a bid to raise domestic crop yields by 10-15%. The adjustment in DAP prices of these fertilizers is intended to discourage unnecessary application of urea ("N" component or nitrogen-based fertilizer) and encourage adequate use of DAP ("P" component or phosphate). With urea selling at subsidized prices (indirect subsidy by the government via subsidizing gas tariffs for fertilizer manufacturers), farmers tend to use large quantities of urea instead of a balanced mix of all nutrients, ie, N and P (3.5:1 instead of 2:1).

In April 2007, following the upsurge in global DAP prices (70% increase YTD), the government raised the subsidy to PRs400/bag in Apr-07. Therefore, from 1 July, the subsidy will be increased to PRs470/bag. This move has already borne fruit for the government as we have witnessed a bumper wheat crop (sown during 4Q). Now the government is keen to replicate the same for the cotton crop (sown in 2Q).

This development bodes well for FFBL, Pakistan's only DAP producer, and DAP importers from two perspectives: (1) higher demand and DAP application by the farmers, and (2) greater enthusiasm by dealers to pre-buy DAP in the off-season, thus reducing inventory carrying cost.

Chart 5: Supply shortfall ('000 tons) to widen



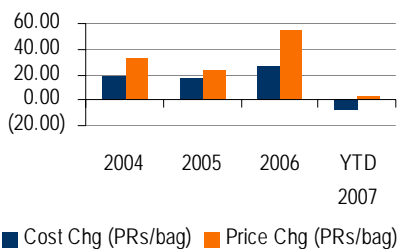
Source: NFDC, KASB estimates

Supply shortfall for urea to continue

Most fertilizer companies in Pakistan are currently operating above 100% capacity. If demand continues to grow at 3% pa in the long term, we anticipate a domestic supply shortage of 700,000 tons again by 2009 before new production capacities by Fatima Fertilizer (0.3mtpa) and Engro Chemical (1.3mtpa) would come on stream. Meanwhile, the government is putting pressure on fertilizer companies to enhance their production capacities via de-bottlenecking as it is cheaper for the government to provide gas subsidies to domestic urea manufacturers than to subsidize imported urea.

In our view, even after Engro's 1.3mtpa urea plant begins operation in mid-2010, supply shortage will re-emerge after a couple of years. With the growing needs of the agricultural sector and project completion time of 3-4years, the government will need to allocate gas for at least one more similar-size urea plant before 2010.

Chart 6: Passing on the cost increase



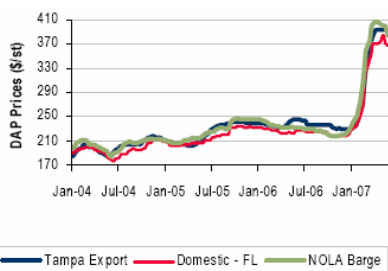
Source: Industry sources

Urea: Strong pricing power to continue

The earnings side of the equation for urea producers in Pakistan is straightforward: profits = f (volume, pricing power). While volumetric growth is expected to be low (at least for the next two years), urea manufacturers are likely to have strong pricing power during the intermediate period, enabling them to completely pass on the cost of higher gas prices (basic input) to end users. We, therefore, do not expect the increase in gas prices (in response to rising oil prices) to have an adverse impact on fertilizer companies' cash margins.

Widening demand-supply gap and a significant differential between domestic and international urea prices (almost 50%) are likely to ensure that domestic fertilizer manufacturers continue to enjoy strong pricing power. Over the medium term, we believe capacity additions by domestic fertilizer manufacturers will help narrow the gap between supply and demand to some extent.

Chart 7: DAP prices surging to record levels



Source: Green Markets

Even after Engro's expansion in 2010, we do not expect Engro to trigger a price war nor flood the market with urea to capture market share at the cost of prolonging the breakeven period for the project. Instead, Engro's new plant can simply replace the need for expensive imports, which would thereby reduce the subsidy burden on the government.

DAP: Bio-fuels strengthening price outlook

Di-ammonium phosphate (DAP) prices have surged by more than 70% in the first four months of 2007, touching record-high levels, and have remained relatively firm in the past two months at US\$425/ton (fob Tampa prices) where bio-fuels have been sustaining the strength in corn demand and, resultantly, the demand for fertilizers. The Energy Policy Act of 2005 has resulted in acceleration of demand for corn-derived ethanol and, to further support this, the US government has announced a list of incentives/subsidies to ethanol-based fuel production. As per USDA, corn used for ethanol production could approach 30mn acres by 2012, indicating around 50% increase from current levels.

In the long term, increased corn plantings augur well for fertilizer consumption, as corn accounts for 47% of the total US fertilizer consumption by all crops and also has the highest DAP application among crops. We expect DAP prices to remain high for the next 2-3 years during which global phosphoric acid capacity utilization rates are expected to hit ~90%. Besides, we do not see any significant increase in capacity until 2010 at the earliest.

We expect continued delays in the Saudi DAP expansion (3mtpa or 9% of the global capacity) to keep DAP operating rates tight through 2010. However, DAP export prices are expected to come under pressure in 2011 when the Saudi plant would become operational. To incorporate this, we have assumed a 17% YoY decline in domestic DAP prices in 2011.

Sector strategy: FFBL is our top pick

FFBL is our top pick in the sector. The company is ideally placed to capitalize on the DAP up-cycle with expected increase in production capacity for urea and DAP by 16% and 15%, respectively, in July 2007, while DAP capacity is expected to go up by a total of 51% after the company completes its planned expansion in January 2008. FFBL is trading at 7.2x 2008E earnings and a three-year CAGR of 21%. We also like FFC as a defensive play as it offers 10% 2007E dividend yield and indirect exposure to FFBL's growth through its 51% stake. We are Neutral on Engro.

Table 3: Valuation, 2008E

Stocks	Recommendation	P/E	Yield
FFBL	Buy	7.4x	10.6%
FFC	Buy	8.9x	10.7%
Engro	Neutral	16.5x	3.6%

Source: KASB estimates

A safe haven



Shagufta Irshad ^^^^
Research Analyst
KASB Securities

Dominance in urea; indirect exposure to DAP growth

With its market leadership (48% direct market share and 60% share with subsidiary FFBL), efficient operation (lowest fuel consumption among peers), and plans to enhance capacity by 16% by 2007-08E, Fauji Fertilizer Company (FFC) is a defensive investment theme on the urea business, with an added growth angle in phosphates (DAP) in its capacity as a holding company.

Investment in phosphate value chain to augment growth

A remunerative subsidiary in the form of Fauji Bin Qasim (FFBL) should supplement FFC's bottom line going forward as FFBL's expansion comes online in 2008E. Meanwhile, we expect the investment in Pak Maroc Phosphore to start paying dividends from 2010. Based on this, we expect FFC's dividend income to grow at a CAGR of 14% over 2006-2011E.

Exploring options for diversification

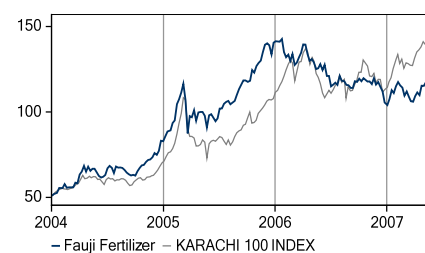
To capitalize on the strength of its strong balance sheet size with low gearing ratio and to maintain long-term earnings growth, FFC is scouting for diversification in wind power and LNG projects and is also expected to take part in the bidding for PSO along with its group companies, which is not reflected in our estimates.

A defensive name in Pakistan's fertilizer sector

FFC is currently one of the cheapest fertilizer plays in Pakistan, trading at 10.8x 2007E earnings, offering the highest dividend yield of 9% (2007E) in the sector and the second highest yield in the market.

Stock Data

Price	PRs121.75
Price Objective	PRs135.00
Date Established	25-Jun-2007
Investment Opinion	C-1-7
Volatility Risk	HIGH
52-Week Range	PRs103.00-PRs128.15
Mrkt Val / Shares Out (mn)	US\$992 / 493.5
Average Daily Volume	2,656,353
ML Symbol / Exchange	FAUJF / KAR
Bloomberg / Reuters	FFC PA / FAUF.KA
ROE (2007E)	43.1%
Net Dbt to Eqty (Dec-2006A)	39.5%
Est. 5-Yr EPS / DPS Growth	11.5% / 8.8%
Free Float	56.0%



Estimates (Dec)

(PRs)	2005A	2006A	2007E	2008E	2009E
Net Income (Adjusted - mn)	5,002	4,741	5,643	6,811	7,322
EPS	9.92	9.39	11.22	13.59	14.62
EPS Change (YoY)	22.3%	-5.3%	19.5%	21.1%	7.6%
Dividend / Share	10.09	10.00	11.00	13.00	13.50
Free Cash Flow / Share	13.48	(0.367)	10.59	15.09	16.66

Valuation (Dec)

	2005A	2006A	2007E	2008E	2009E
P/E	12.27x	12.96x	10.85x	8.96x	8.33x
Dividend Yield	8.28%	8.21%	9.03%	10.68%	11.09%
EV / EBITDA*	8.70x	8.42x	7.44x	6.44x	6.14x
Free Cash Flow Yield*	11.07%	-0.302%	8.70%	12.40%	13.68%

05 July 2007

iQprofileSM Fauji Fertilizer Company Ltd.

Key Income Statement Data (Dec)	2005A	2006A	2007E	2008E	2009E
(PRs Millions)					
Sales	25,481	29,951	35,417	31,877	32,593
Gross Profit	9,851	10,489	11,961	13,012	13,545
Sell General & Admin Expense	(2,359)	(2,734)	(3,188)	(2,869)	(2,933)
Operating Profit	6,623	6,857	7,888	9,243	9,709
Net Interest & Other Income	592	128	130	480	727
Associates	NA	NA	NA	NA	NA
Pretax Income	7,214	6,985	8,018	9,723	10,436
Tax (expense) / Benefit	(2,317)	(2,349)	(2,480)	(3,017)	(3,219)
Net Income (Adjusted)	5,002	4,741	5,643	6,811	7,322
Average Fully Diluted Shares Outstanding	493	493	493	493	493

Key Cash Flow Statement Data

Net Income (Reported)	4,897	4,636	5,538	6,706	7,217
Depreciation & Amortization	869	898	885	900	903
Change in Working Capital	(787)	2,642	2,642	(236)	133
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	2,440	(7,141)	(1,298)	177	67
Cash Flow from Operations	7,420	1,035	7,767	7,548	8,319
Capital Expenditure	(769)	(1,216)	(2,541)	(100)	(100)
(Acquisition) / Disposal of Investments	(1,922)	3,391	816	0	0
Other Cash Inflow / (Outflow)	3	(11)	(3)	(2)	(2)
Cash Flow from Investing	(2,688)	2,164	(1,728)	(102)	(102)
Shares Issue / (Repurchase)	NA	NA	NA	NA	NA
Cost of Dividends Paid	(4,751)	(4,121)	(5,256)	(6,415)	(6,785)
Cash Flow from Financing	(4,616)	(2,748)	(7,308)	(6,984)	(7,410)
Free Cash Flow	6,651	(181)	5,226	7,448	8,219
Net Debt	4,201	5,123	4,339	3,309	1,877
Change in Net Debt	20	922	(784)	(1,031)	(1,432)

Key Balance Sheet Data

Property, Plant & Equipment	9,185	9,608	11,369	10,674	9,975
Other Non-Current Assets	7,800	8,058	7,956	7,853	7,750
Trade Receivables	660	961	1,181	1,063	1,086
Cash & Equivalents	1,172	1,623	354	816	1,623
Other Current Assets	9,633	7,180	6,157	5,363	5,252
Total Assets	28,449	27,430	27,017	25,768	25,687
Long-Term Debt	981	1,194	2,125	1,500	875
Other Non-Current Liabilities	2,401	2,396	2,401	2,401	2,401
Short-Term Debt	4,392	5,552	2,569	2,625	2,625
Other Current Liabilities	8,234	5,332	6,682	5,712	5,824
Total Liabilities	16,008	14,474	13,777	12,238	11,725
Total Equity	12,441	12,957	13,239	13,530	13,962
Total Equity & Liabilities	28,449	27,430	27,016	25,768	25,687

iQmethodSM - Bus Performance*

Return On Capital Employed	24.1%	23.0%	26.3%	32.2%	34.3%
Return On Equity	40.4%	37.3%	43.1%	50.9%	53.3%
Operating Margin	26.0%	22.9%	22.3%	29.0%	29.8%
EBITDA Margin	29.4%	25.8%	24.7%	31.8%	32.6%

iQmethodSM - Quality of Earnings*

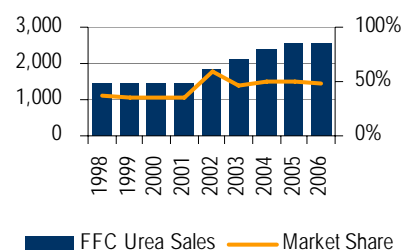
Cash Realization Ratio	1.5x	0.2x	1.4x	1.1x	1.1x
Asset Replacement Ratio	1.0x	1.5x	3.3x	0.1x	0.1x
Tax Rate (Reported)	32.1%	33.6%	30.9%	31.0%	30.8%
Net Debt-to-Equity Ratio	33.8%	39.5%	32.8%	24.5%	13.4%
Interest Cover	20.3x	13.2x	14.6x	20.5x	26.9x

Key Metrics

Company Description

FFC is the largest fertilizer (urea) manufacturing company in Pakistan, 44% owned by the Fauji Foundation group. FFC has a production capacity of 1.9mn tons. The company has a monopoly in Punjab province, which is the hub of agricultural activity in Pakistan. FFC controls 51% stake in Fauji Fertilizer Bin Qasim, the only Di-ammonium Phosphate (DAP) producer in Pakistan.

Chart 1: FFC: Urea Sales & Market Share



Source: NFDC

Stock Data

Price to Book Value 4.5x

A safer route to Pakistan fertilizers

We have a Buy rating on FFC with a PO of PRs135. In our view, FFC provides a safer route to get exposure to Pakistan's fertilizer sector for the following reasons:

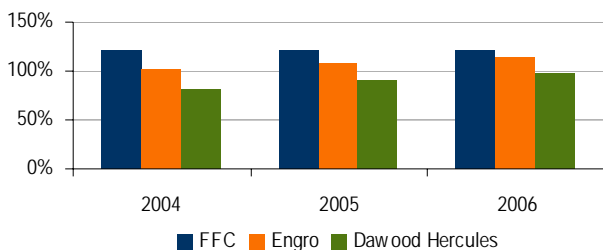
1. It is the market leader – controlling around 60% market share in urea (subsidiary FFBL has a 12% share).
2. It is the holding company for FFBL, the only DAP producer in Pakistan, and Pak Maroc Phosphore (PMP), a recently established JV producing phosphoric acid (an input for DAP) in Morocco.
3. We expect FFC's earnings to grow at a CAGR of 11.5%, fueled by (1) 16% capacity addition in urea plant during 2007-08E, and (2) DAP expansion and strong DAP price outlook, leading to higher dividends from FFBL.

Dominance in urea to continue

FFC's urea business, accounting for more than 70% of revenue, would remain its bread-and-butter business. FFC dominates the urea market by controlling 48% market share directly and around 60% share indirectly (FFC plus FFBL). We expect FFC's dominance in the urea business to continue even after the completion of Engro's urea project in 2010E, when Engro will likely become the co-leader with a 34% share. However, at that point, FFC would still dominate as a group with a forecast 44% share (34% for FFC, 10% for FFBL) compared to the Dawood group's forecast share of 42% (34% for Engro, 8% for Dawood Hercules).

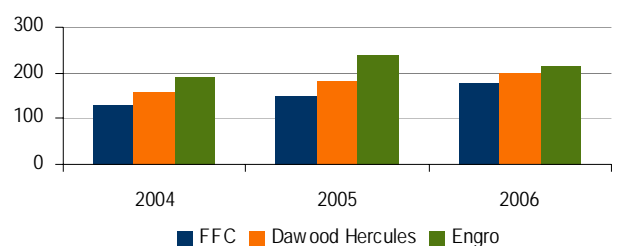
Given that urea prices of all fertilizer companies are identical, cost efficiencies arising from greater fuel efficiency and higher operating rates should enable FFC to post better margins compared to its peers. Historically, FFC has 15-20% lower fuel cost advantage and 10-15% better capacity utilization rates compared to its peers. Owing to the cost advantage, coupled with a 16% increase in urea capacity by 330,000 tons during 2007E-08E via de-bottlenecking of all three plants, we expect FFC's core business earnings to grow at a CAGR of 10% in 2006-2011E.

Chart 2: FFC: Highest urea plant operating rates
Capacity use (%)



Source: KASB estimates, company accounts

Chart 3: FFC: Most efficient urea producer
Feedstock and fuel cost (PRs per 50kg bag)

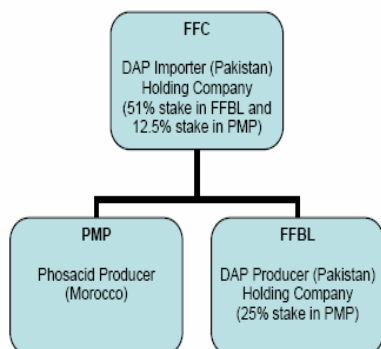


Source: KASB estimates, company accounts

Expansion at Engro unlikely to hurt margins

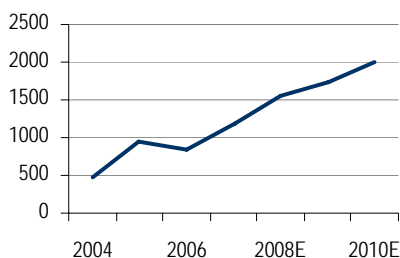
We do not foresee a direct threat to FFC's urea margins in 2010 subsequent to the completion of Engro's new urea plant. With the supply constraint likely to continue even after the completion of Engro's plant, and given that the industry representation would remain in a few hands (FFC and Engro would continue to lead the industry and enjoy bargaining power with the government on regulatory aspects), we expect the industry to maintain its strong pricing position. Meanwhile, we do not expect Engro to opt for price wars by flooding the market with new production at the cost of prolonging its breakeven point for the project; instead, it can simply replace imports and continue to charge the prevailing urea prices.

Chart 4: FFC: Investment in phosphate chain



Source: KASB Research, FFC

Chart 5: FFC: Dividend income (PRs mn)



Source: KASB, Merrill Lynch estimates

Investment in phosphate value chain

FFC has a direct (being an importer of DAP and seller of the entire DAP produce of its subsidiary) as well as indirect exposure into the phosphate business value chain (being a holding company). We expect income from investments in FFBL and PMP to grow at a CAGR of 14% (2006-2011E), with FFBL contributing a major chunk of the dividend income.

As a DAP importer

FFC controls around 40% market share in Pakistan's DAP business via imports of DAP and selling DAP produced by FFBL (on a commission basis). Since the setting up of its subsidiary, FFBL, in 2000, FFC has been marketing the latter's entire production under its own brand name, which has helped strengthen the group's market control and pricing power. While maintaining its market leadership, FFC manages DAP imports after ensuring the complete sales of FFBL's produce (FFBL is the only DAP producer in Pakistan, meeting only 35% of the country's demand). Since FFBL is planning a 170-day shutdown at its DAP plant to complete its expansion program, we believe FFC would need to import 162,000 tons of additional DAP this year, which would likely offset the impact of lower dividends from FFBL in 2007.

Holding company for Pakistan's only DAP producer

Being a holding company for FFBL (the only DAP producer in Pakistan), FFC has an indirect exposure to the rapidly growing phosphate demand, where strong global price outlook is acting as an icing on the cake. After seeing 70% YTD increase in global DAP prices, we expect DAP prices to get even stronger over the next couple of years until a major export-oriented expansion in Saudi Arabia comes on line in 2011. FFC would actually start gaining from the hike in global DAP prices from 2008 onward, when FFBL's DAP expansion would be completed and it would start paying higher dividends to FFC. Based on this, we expect dividend income from FFBL to grow at a CAGR of 25% over the next three years (2006-2009E), accounting for around 20% of FFC's bottom line.

JV partner in raw material producing company

FFC also indirectly controls around 25% stake (12.5% directly and the rest through its stake in FFBL) in Fauji Foundation's and OCP, Morocco's phosphoric acid producing venture, Pak Maroc Phosphore (PMP). PMP has a production capacity of 375,000 tons of phosphoric acid and is expected to commence production toward the end of 2007. We have conservatively assumed a 10% return in 2009 and a 15% return from 2010. Given the stronger outlook for phosphoric acid and higher global capacity use rates (above 90% till 2010), higher-than-expected return from this investment would remain an upside to our estimates for FFC.

Exploring diversification options

With no existing option available to FFC to invest in the fertilizer business in Pakistan, after having backed out of the gas bidding conducted last year, we believe FFC would be aggressively scouting for diversification options to unleash the potential from its low leverage position. We expect FFC to remain focused on agriculture-related or risk-free businesses offering guaranteed returns (like power utilities). The FFC board has highlighted three investment opportunities: (1) a 50MW wind power project costing US\$80mn-100mn (offering guaranteed return of 15% on investment); (2) a US\$500mn LNG project, and (3) interest in acquiring a 51% stake in Pakistan State Oil, the largest oil marketing company in Pakistan, along with group companies and Vitol S.A., through competitive bidding process.

The biggest beneficiary of extended DAP up-cycle

Equity | Pakistan | Fertilizers
5 July 2007



Merrill Lynch

Shagufta Irshad ^^^^
Research Analyst
KASB Securities

Buy on strong DAP outlook

We believe that FFBL is ideally placed to capitalize on the DAP up-cycle with expected increases in urea production capacity by 16% (1H07) and DAP capacity by 51% (4Q07). We have a Buy recommendation on FFBL with a DCF-based PO of PRs45/share. High demand for DAP globally (due to demand for bio-fuels), coupled with the protracted delay in Saudi DAP expansion (3mtpa or 9% of global capacity), could prolong the up-cycle for DAP prices, which should peak in 2010E.

Competitive margins vis-à-vis peers

The extension of the gas subsidy until 2008 gives FFBL an edge over its peers in terms of 15% higher cash margins on urea. While rising feedstock gas prices would enable FFBL's peers to maintain their margins, they would help FFBL to report improvement in margins. With DAP, FFBL's margin tends to be 10-15% higher than importers since it is the sole domestic DAP producer and bound to a fixed cost structure throughout the year.

Strategic investment in Morocco

A 25% equity stake in Pak Maroc Phosphore appears a profitable investment decision for FFBL, given (1) the positive outlook for the international phosphate industry, (2) captive demand for phosphoric acid from FFBL and Moroccan DAP producing centers, and (3) cheap and abundant raw material supply of phosphate rocks in Morocco. We have incorporated 10-15% return from this investment from 2009 onwards into our estimates.

Risks: (1) Longer-than-expected plant shutdown for expansion, (2) postponing DAP plant de-bottlenecking from 4Q07 to 1Q08, and (3) natural calamities.

Estimates (Dec)

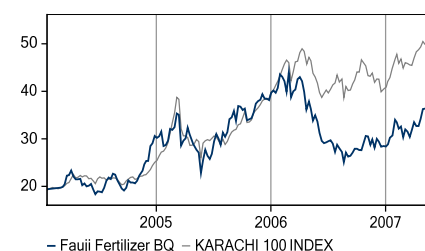
(PRs)	2005A	2006A	2007E	2008E	2009E
Net Income (Adjusted - mn)	2,448	2,445	1,884	4,794	4,312
EPS	2.62	2.62	2.02	5.13	4.62
EPS Change (YoY)	33.7%	-0.1%	-23.0%	154.5%	-10.0%
Dividend / Share	2.50	2.50	1.50	4.00	3.50
Free Cash Flow / Share	2.77	0.677	0.180	7.27	6.36

Valuation (Dec)

	2005A	2006A	2007E	2008E	2009E
P/E	14.44x	14.46x	18.77x	7.38x	8.20x
Dividend Yield	6.61%	6.61%	3.96%	10.57%	9.25%
EV / EBITDA*	10.55x	10.43x	11.87x	5.59x	5.83x
Free Cash Flow Yield*	7.32%	1.79%	0.475%	19.20%	16.82%

Stock Data

Price	PRs37.85
Price Objective	PRs45.00
Date Established	14-Jun-2007
Investment Opinion	C-1-8
Volatility Risk	HIGH
52-Week Range	PRs24.15-PRs39.05
Mrkt Val / Shares Out (mn)	US\$583 / 934.1
Average Daily Volume	15,847,100
ML Symbol / Exchange	FJDF / KAR
Bloomberg / Reuters	FFBL PA / JORD.KA
ROE (2007E)	22.7%
Net Dbt to Eqty (Dec-2006A)	77.1%
Est. 5-Yr EPS / DPS Growth	6.5% / 5.4%
Free Float	30.8%



05 July 2007

iQprofileSM Fauji Bin Qasim

Key Income Statement Data (Dec)	2005A	2006A	2007E	2008E	2009E
(PRs Millions)					
Sales	14,255	14,707	11,346	19,588	21,136
Gross Profit	5,488	5,671	5,098	10,289	9,753
Sell General & Admin Expense	(1,358)	(1,515)	(1,135)	(1,763)	(1,691)
Operating Profit	3,021	2,917	2,590	6,978	6,525
Net Interest & Other Income	(261)	(412)	(396)	(276)	(137)
Associates	NA	NA	NA	NA	NA
Pretax Income	3,214	3,057	2,298	6,775	6,580
Tax (expense) / Benefit	(1,221)	(1,067)	(804)	(2,371)	(2,268)
Net Income (Adjusted)	2,448	2,445	1,884	4,794	4,312
Average Fully Diluted Shares Outstanding	934	934	934	934	934

Key Cash Flow Statement Data

Net Income (Reported)	1,993	1,990	1,494	4,404	4,312
Depreciation & Amortization	939	995	1,235	1,250	1,255
Change in Working Capital	235	(1,982)	578	747	469
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	383	992	386	439	9
Cash Flow from Operations	3,550	1,995	3,693	6,840	6,045
Capital Expenditure	(962)	(1,363)	(3,525)	(50)	(100)
(Acquisition) / Disposal of Investments	(376)	(1,179)	0	(1,500)	0
Other Cash Inflow / (Outflow)	171	(23)	(8)	(50)	(10)
Cash Flow from Investing	(1,167)	(2,565)	(3,532)	(1,600)	(110)
Shares Issue / (Repurchase)	0	0	0	0	0
Cost of Dividends Paid	(1,868)	(1,635)	(2,335)	(3,036)	(3,269)
Cash Flow from Financing	(1,854)	(437)	(3,581)	(5,639)	(6,373)
Free Cash Flow	2,588	633	168	6,790	5,945
Net Debt	5,689	6,584	11,397	9,193	6,528
Change in Net Debt	(515)	2,205	2,175	(2,203)	(2,666)

Key Balance Sheet Data

Property, Plant & Equipment	14,563	14,930	17,220	16,020	14,865
Other Non-Current Assets	752	1,428	1,429	2,930	2,931
Trade Receivables	116	231	142	245	264
Cash & Equivalents	6,931	7,236	1,181	781	342
Other Current Assets	2,220	3,856	2,574	2,644	2,784
Total Assets	24,581	27,681	22,546	22,620	21,188
Long-Term Debt	9,181	8,077	6,974	5,870	4,767
Other Non-Current Liabilities	1,322	2,634	0	0	0
Short-Term Debt	3,439	5,743	5,604	4,104	2,104
Other Current Liabilities	2,906	2,675	1,883	2,803	3,431
Total Liabilities	16,848	19,129	14,460	12,776	10,301
Total Equity	7,728	8,538	8,086	9,844	10,887
Total Equity & Liabilities	24,575	27,667	22,546	22,620	21,188

iQmethodSM - Bus Performance*

Return On Capital Employed	11.6%	11.0%	7.8%	22.7%	23.4%
Return On Equity	32.9%	30.1%	22.7%	53.5%	41.6%
Operating Margin	21.2%	19.8%	22.8%	35.6%	30.9%
EBITDA Margin	30.8%	30.1%	34.3%	42.2%	37.6%

iQmethodSM - Quality of Earnings*

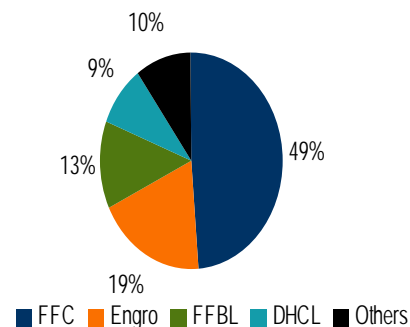
Cash Realization Ratio	1.5x	0.8x	2.0x	1.4x	1.4x
Asset Replacement Ratio	1.0x	1.4x	2.9x	0x	0.1x
Tax Rate (Reported)	38.0%	34.9%	35.0%	35.0%	34.5%
Net Debt-to-Equity Ratio	73.6%	77.1%	140.9%	93.4%	60.0%
Interest Cover	4.8x	3.6x	5.3x	20.2x	35.3x

Key Metrics

Company Description

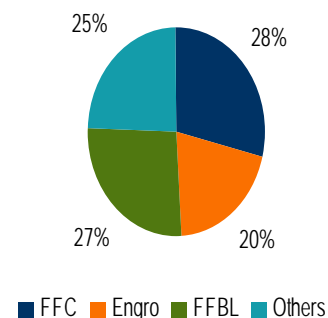
FFBL is a subsidiary of FFC, Pakistan's largest fertilizer company. FFBL has a production capacity of 551,000 tons of urea and 446,000 tons of DAP. It is the only producer of DAP in Pakistan but meets only 30% of the country's requirement. FFBL is undergoing an expansion plan (2006-07), which would increase its urea capacity by 15% and DAP capacity by 51% in 2007.

Chart 1: FFBL: Urea market share, 2006



Source: NFDC

Chart 2: FFBL: DAP market share, 2006



Source: NFDC

Stock Data

Price to Book Value

4.4x

Buy on strong DAP outlook

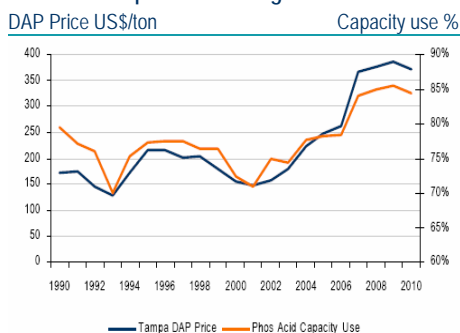
We believe that FFBL is ideally placed to capitalize on the DAP up-cycle with expected increases in urea production capacity by 16% (1H07) and DAP capacity by 51% (4Q07). We have a Buy recommendation on FFBL with a DCF-based PO of PRs45/share, offering 21% earnings growth over 2006-09E. High demand for DAP globally (due to demand for bio-fuels), coupled with the protracted delay in Saudi DAP expansion (3mtpa or 9% of global capacity), we believe could prolong the up-cycle for DAP prices, which should peak in 2010.

Bio-fuels strengthening DAP outlook

As the sole producer of DAP in Pakistan, meeting ~30% (50% after expansion) of domestic need, we believe FFBL would be the biggest beneficiary of the strong outlook for global DAP price. With ~70% of the country's demand met through imports, domestic prices are inevitably linked with global DAP export prices, which have touched a record-high of US\$425/ton (fob Tampa prices) after surging more than 70% in the first four months of 2007 on the back of strong demand for bio-fuels (ethanol) derived from corn.

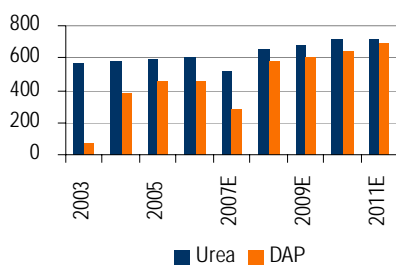
As per USDA, corn used for ethanol production in the US could approach 30mn acres by 2012E, which is about a 50% increase from the current level. Increased corn plantings in the long term are favorable for fertilizer consumption, as corn accounts for 47% of the total US fertilizer consumption by all crops. DAP price outlook becomes even stronger when we consider the high operating rates (over 90%) for phosphoric acid and protracted delays in Saudi DAP expansion (9% addition to global capacity) which could prolong the up-cycle for DAP prices. The impact of DAP price increase would become more pronounced from 2008 onwards when FFBL's expanded DAP plant would start producing.

Chart 3: DAP prices to strengthen further



Source: Green Markets, Fertecon, Merrill Lynch estimates

Chart 4: Sales to pick up after expansion ('000t)



Source: FFBL, KASB estimates

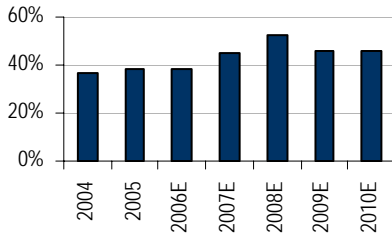
Expansion underway

With a 51% capacity addition in DAP to 0.675mtpa and 16% addition in urea production capacity to 0.637mtpa, FFBL is geared to take advantage of both domestic shortage in urea and the up-cycle of global DAP prices (2007-10). The company is currently undergoing expansion via de-bottlenecking of its existing plant in a bid to upgrade its ammonia plant (precursor to urea and DAP). This would enhance plant reliability, increase urea plant maximum capacity utilization rates to 120% for urea and 122% for DAP, improve fuel consumption and raise production capacity of both urea and DAP plants by 16% and 15%, respectively. The first phase of this process was completed through a 60-day plant shutdown in 2006 and the second phase requiring ~90-day shutdown in 2007 which ended on 24 June.

To utilize the surplus ammonia available after this phase of expansion, FFBL plans to expand its DAP plant capacity by 51% (altogether from current level) through a 90-day plant shutdown scheduled for 4Q07. We are being conservative and have assumed an extra 15-day shutdown in the first two weeks of January 2008 before the expanded plant would become fully operational.

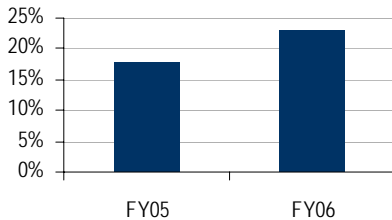
That said, we understand that FFBL is also considering postponing the 90-day shutdown required for the DAP plant revamp to 1Q08 from 4Q07 in order to capitalize on the peaking DAP prices in 4Q07. The final decision is expected in July 2007. In our view, the chances of this shift appear slim given the potential loss of surplus raw material (ammonia), which is not sellable.

Chart 5: Gross margins to peak in 2008



Source: FFBL, KASB, Merrill Lynch estimates

Chart 6: Indo Maroc Phosphore: ROE (%)



Source: Chambal Fertilizers Annual reports

Cost advantage in urea to continue until 2008

We believe that FFBL can enjoy 15% higher gross margin on urea until 2008. This cost advantage over other domestic urea producers is thanks to 10-year fixed feedstock gas price subsidy given by the government to new producers from its commencement. For its peers, the subsidy has already expired in 2003. While rising feedstock gas prices would enable peers to maintain their margins, for FFBL, it would actually be able to report improvement in margins.

When the subsidy period expires, FFBL would get feedstock gas at the prevailing price available to its peers. As a result, in 2009, we expect FFBL's gross cash margins on urea to drop by 11% pts to 58%. But the impact on its overall margins would be less pronounced (only 6% pts drop to 46%) with the upsurge in DAP prices.

Pak Maroc Phosphore offers potential upside

FFBL's 25% stake in Pak Maroc Phosphore S.A. (PMP), a JV between OCP of Morocco and Fauji group, will not only ensure availability of phosphoric acid at comparative rates but also offer promising returns (dividends) from this investment. PMP can produce 375,000 tons of phosphoric acid pa and is expected to commence production by end-2007. Of this total produce, FFBL would keep 325,000 tons for its own use post expansion and sell the rest to the Moroccan DAP production center near the PMP plant.

We have assumed a 10% return in 2009 and 15% return from 2010. Given the stronger outlook for phosphoric acid and higher global capacity use rates (above 90% till 2010), we believe we are being conservative on the return from this investment. Compared Indo Maroc Phosphore (IMACID), a similar JV formed in 1999 between OCP of Morocco and Chambal Fertilizer and Tata Chemicals of India, its ROEs of 23% in FY06 (year-end March) and 18% in FY05 cause us to believe returns would be even higher in the coming years as the phosphoric acid prices are doing exceptionally well.

Investing in power to ensure stable dividends

FFBL's board has recently approved a PRs1.5bn investment in Fauji Power Company (Dharki) Limited (FPCDL), proposed by Fauji Foundation (the group). FPCDL would be an independent power producer and is estimated to cost US\$196.72mn with Fauji Foundation and FFBL pooling resources for the required equity (25-30% of the cost). The project is expected to guarantee a ROE of 15% (CPI-adjusted). FFBL is in the process of procuring a plant and signing gas supply and power purchase agreements, all of which are expected to be completed by end-2007. The project is slated to start commercial production from mid-2009E and dividends should flow in from 2010E.

Other investment plans

Once it completes its own expansion and PMP commences operation, FFBL plans to undertake the investment projects identified by the group for 2008. These include privatization of PSO, SSGC's LNG project, investment in Fauji Cement and other power projects. We have not incorporated any of these investments in our base case.

Crucial investment decisions awaited



Shagufta Irshad ^^^^
Research Analyst
KASB Securities

We are Neutral on Engro

We reiterate Neutral on Engro and estimate 10% earnings CAGR over 2006-2011E, on the back of: 1) growth in DAP business with supportive government policies to promote higher phosphate consumption and; 2) rising dividend contribution from associate companies, currently undergoing expansions.

Funding plan for the new urea project is crucial

We have not incorporated revenues from the potential 1.3mtpa urea expansion into our base case, owing to the subjectivity factor involved in fixing the offer price and new number of shares required to meet the equity funding portion of the project. The project is expected to cost US\$750mn (US\$950mn including capitalized interest during construction period). We would await management's announcement of the funding plan and then incorporate it into our estimates.

Investments from JVs to cushion earnings growth

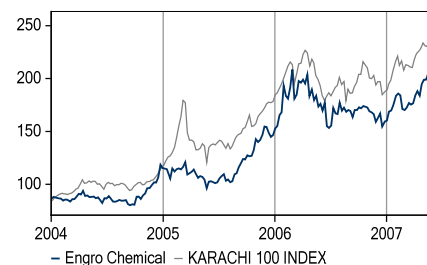
We believe dividend income from investments in JVs and subsidiaries, which currently contribute more than 40% to Engro's bottomline, would cushion Engro during adverse situations. We believe this contribution will hold importance for Engro in 2010, as it is expected to report a drop in its earnings during this period.

Potential triggers

In our view the following factors would potentially trigger an upgrade in its stock price over the next two years: 1) Announcement of funding plan for urea expansion, 2) Better-than-expected performance of Engro Foods (rising market share and early breakeven) 3) Positive surprise from trading business (phosphate).

Stock Data

Price	PRs251.45
Investment Opinion	C-2-7
Volatility Risk	HIGH
52-Week Range	PRs146.61-PRs257.00
Mrkt Val / Shares Out (mn)	US\$804 / 193.5
Average Daily Volume	4,609,482
ML Symbol / Exchange	ENGCF / KAR
Bloomberg / Reuters	ENGRO PA / EGCH.KA
ROE (2007E)	23.7%
Net Dbt to Eqty (Dec-2006A)	25.4%
Est. 5-Yr EPS / DPS Growth	9.9% / 0%
Free Float	23.7%



Estimates (Dec)

(PRs)	2005A	2006A	2007E	2008E	2009E
Net Income (Adjusted - mn)	2,319	2,547	2,718	2,945	2,968
EPS	11.99	13.17	14.05	15.22	15.34
EPS Change (YoY)	44.0%	9.8%	6.7%	8.4%	0.8%
Dividend / Share	8.70	7.83	9.00	9.00	9.00
Free Cash Flow / Share	12.78	11.25	20.38	17.86	18.23

Valuation (Dec)

	2005A	2006A	2007E	2008E	2009E
P/E	20.98x	19.10x	17.90x	16.52x	16.39x
Dividend Yield	3.46%	3.11%	3.58%	3.58%	3.58%
EV / EBITDA*	12.07x	11.51x	10.50x	9.73x	9.86x
Free Cash Flow Yield*	4.02%	4.47%	8.11%	7.10%	7.25%

05 July 2007

iQprofileSM Engro Chemical Pakistan Ltd.

Key Income Statement Data (Dec)

(PRs Millions)	2005A	2006A	2007E	2008E	2009E
Sales	18,276	17,602	18,439	19,996	20,284
Gross Profit	4,496	4,837	5,294	5,836	5,756
Sell General & Admin Expense	NA	NA	NA	NA	NA
Operating Profit	2,641	2,756	3,404	3,832	3,727
Net Interest & Other Income	(221)	(316)	(366)	(363)	(285)
Associates	NA	NA	NA	NA	NA
Pretax Income	3,220	3,445	3,693	4,057	4,066
Tax (expense) / Benefit	(900)	(897)	(975)	(1,112)	(1,098)
Net Income (Adjusted)	2,319	2,547	2,718	2,945	2,968
Average Fully Diluted Shares Outstanding	193	193	193	193	193

Key Cash Flow Statement Data

Net Income (Reported)	2,319	2,547	2,718	2,945	2,968
Depreciation & Amortization	609	623	599	604	609
Change in Working Capital	(702)	(807)	1,077	6	50
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	80	153	(350)	0	0
Cash Flow from Operations	2,307	2,516	4,043	3,555	3,627
Capital Expenditure	(353)	(340)	(100)	(100)	(100)
(Acquisition) / Disposal of Investments	(22)	(1,575)	(2,558)	(2,802)	(1,000)
Other Cash Inflow / (Outflow)	(53)	0	70	60	60
Cash Flow from Investing	(428)	(1,915)	(2,587)	(2,842)	(1,040)
Shares Issue / (Repurchase)	0	1,221	3,154	0	0
Cost of Dividends Paid	(1,494)	(1,770)	(1,748)	(1,741)	(1,741)
Cash Flow from Financing	(2,177)	62	1,317	(841)	(2,616)
Free Cash Flow	1,954	2,176	3,943	3,455	3,527
Net Debt	2,437	2,385	(478)	550	(296)
Change in Net Debt	(384)	(52)	(2,863)	1,028	(846)

Key Balance Sheet Data

Property, Plant & Equipment	6,840	6,558	6,059	5,555	5,046
Other Non-Current Assets	2,260	3,739	6,278	9,080	10,080
Trade Receivables	543	623	659	714	724
Cash & Equivalents	1,142	1,805	4,578	4,450	4,421
Other Current Assets	3,326	3,256	2,705	2,771	2,756
Total Assets	14,112	15,981	20,279	22,570	23,028
Long-Term Debt	2,888	1,800	3,100	3,125	1,825
Other Non-Current Liabilities	1,046	1,168	948	1,002	1,056
Short-Term Debt	690	2,390	1,000	1,875	2,300
Other Current Liabilities	2,110	1,253	1,654	1,787	1,839
Total Liabilities	6,736	6,611	6,702	7,789	7,020
Total Equity	7,376	9,370	13,577	14,781	16,008
Total Equity & Liabilities	14,112	15,981	20,279	22,570	23,028

iQmethodSM - Bus Performance*

Return On Capital Employed	21.1%	20.3%	18.3%	16.6%	15.4%
Return On Equity	33.2%	30.4%	23.7%	20.8%	19.3%
Operating Margin	14.5%	15.7%	18.5%	19.2%	18.4%
EBITDA Margin	22.2%	24.1%	25.3%	25.1%	24.5%

iQmethodSM - Quality of Earnings*

Cash Realization Ratio	1.0x	1.0x	1.5x	1.2x	1.2x
Asset Replacement Ratio	0.6x	0.5x	0.2x	0.2x	0.2x
Tax Rate (Reported)	28.0%	26.0%	26.4%	27.4%	27.0%
Net Debt-to-Equity Ratio	33.0%	25.4%	-3.5%	3.7%	-1.8%
Interest Cover	12.3x	10.0x	9.1x	10.1x	12.0x

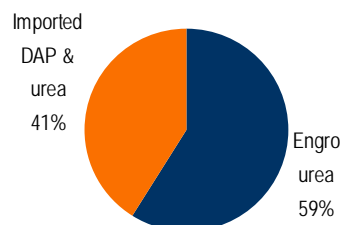
Key Metrics

Dividend Yield	3	3	4	4	4
----------------	---	---	---	---	---

Company Description

Engro is the second largest manufacturer of urea in Pakistan with a production capacity of 850,000 tons. The company is also involved in the production of boutique fertilizers (like NPK) and hybrid seeds. As a part of its diversification strategy, Engro has invested in petrochemicals, terminal handling business, industrial automated technology. The company has recently ventured into the dairy milk and power project businesses.

Chart 1: Revenue Breakup (2006)



Source: Engro

Stock Data

Price to Book Value 3.6x

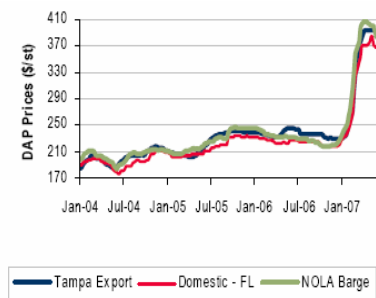
Crucial investment decisions awaited

We expect Engro to post 10% earnings CAGR over 2006-2011E, on the back of: 1) strong growth in DAP business, backed by supportive government policies and; 2) growing dividend contribution from associate companies. We reiterate our Neutral stance on Engro, although we have not incorporated revenues from its potential 1.3mtpa urea expansion into our base case, owing to subjectivity factor involved in offer price and new number of shares required to meet the funding of the equity portion of the project. We await management's decision on its funding plans and would then incorporate it into our estimates. We believe factors that could potentially trigger an upgrade are surprise from the DAP business and announcement of funding plan for expansion, which can minimize dilution and better-than-expected performance by Engro Foods.

Urea business - operating at maximum capacity

Engro is currently the second largest urea manufacturer in Pakistan after Fauji Fertilizer (FFC), with a 20% market share. Engro has recently upgraded its design capacity by 15% from 850,000 tpa to 975,000 tpa through plant de-bottlenecking. The upgrade is part of the company's new strategy to enhance capacity utilization rates through a turnaround (maintenance shut downs) every alternate year. The urea business currently contributes 60% to Engro's revenues and about 40% to the company's bottomline. With the company operating at maximum capacity utilization at the base plant, growth from the urea business until 2010E would remain restricted for Engro until its new urea project comes on-stream (expansion not incorporated in the base case).

Chart 2: DAP prices (Bulk US Gulf) – US\$/ton



Source: Green Markets

DAP - Timing crucial for imports

Engro is a major importer of DAP and with international DAP prices touching a 30-year high, we believe it would be a key beneficiary of the price increase. As such, timely order placement for imports compared to peers will help it book better trading gains versus other importers like FFC. However, its trading gains could have been higher had the company cushioned itself from last year's inventory when international DAP prices averaged US\$425/ton (US Gulf prices on fob basis) compared with the average price of US\$268/ton since beginning 2007. We do not expect Engro to replicate similar trading margins as it did in 2005 and 2006, owing to lesser low-cost inventories available since last year-end compared to previous years.

Investments to cushion earnings growth

We believe dividend income from investments in JVs and subsidiaries, which currently contribute more than 40% to Engro's bottomline, would cushion Engro during adverse situations. We believe this contribution will hold importance for Engro in 2010, as it is expected to report a drop in its earnings during this period (mainly due to immediate jump in financial charges and depreciation, once the plant comes on-stream). At this time its investment in Engro Energy would start generating cash inflows (dividend income) for Engro, which will likely provide a cushion to meet the working capital requirements for the new project. Given the scheduled expansions at associated companies (Engro Asahi, Engro Foods, Engro Innovative), we have conservatively estimated 11% CAGR in dividend income over 5 years. We have not incorporated any dividends from Engro Foods for the next five years (2007-2011E), as the management expects this company to turn profitable by 2010-2011.

Table 1: Engro: Investments

Company	Business
Engro Vopak	Terminal handling and storage
Engro Asahi Polymer	Petrochemicals - PVC resins
Engro Eximp	Trading (Imported fertilizers)
Engro Innovative	Industrial automation solutions
Engro Foods	Dairy products
Engro Energy	Independent Power Producer

Source: Engro

Table 2: Key project highlights

Project size	1.3 mtpa
Plant supplier	Snamprogetti and Haldor Topose
Project cost	US\$750mn
Cost+ Capitalized interest	US\$950mn
Signing of GSA & financial closure	6 months
Construction period	36 months
Expected commencement	Jul-2010
Target debt/equity	75/25
Equity	US\$187mn
Long-term debt	US\$563mn
Feedstock gas price	US\$0.7/mmbtu fixed until Jul 2020

Source: KASB estimates, Company

Expansions - not added to base case

Engro has signed contract deals with plant suppliers and the domestic gas suppliers, once it received gas allocation to set up 1.3mtpa urea plant in Dec 2006. The company plans to finance 75% of the project cost of US\$750mn through debt and remaining through equity. Of this, the company has arranged 58% of the required debt (US\$331mn), 28% of the equity (US\$52mn) 51% of the overall plant cost requirement. The company recently issued rights (15% at PRs125/sh) to raise this equity portion (US\$52mn). We expect the company to raise 25% of the plant cost, at about US\$187mn, from fresh equity. This would come partly from the rights (recently issued) and partly from the GDR issue to new investors (expected in 2008). It targets to complete financial closure by 30 October and hopes to come out with another equity issue in 2008.

Given the subjectivity factor involved in assuming the offer price for new shares and the number of new shares to be issued, we have still not incorporated this into our base-case forecast. We would wait for the management to announce its funding plan and then incorporate this expansion into our estimates.

Funding plan is crucial

Given further equity requirement of almost US\$135mn, the potential impact from new equity issues would be crucial in gauging the impact on expansions for shareholders, in our view. The management is currently considering various debt/equity ratios and alternate options, such as local rights issue, preference shares, borrowing from local/international bank /export credit agencies that can potentially minimize the dilution effect and financing cost of the project. Moreover, the company plans to delay the equity issue, which would be a positive from an equity dilution perspective. However, given an enterprise value of US\$785mn and a balance sheet size of US\$330mn, lending institutions may initially ask Engro to inject equity before disbursing any major debt financing to conform with the long-term debt:equity ratio of 60:40 requirement of the central bank. We expect Engro to raise equity by 2H08, at the time when it should require major payments for plant suppliers.

Strategic advantages for Engro

The key strategic reasons for Engro to expand are as follows: 1) Increase in market share to 34% from 20% currently, providing Engro a co-leadership status with FFC, 2) cost advantage from fixed feedstock gas prices until 2020 for the new plant; 3) pricing power and greater influence in policy issues; 4) synergies for imported DAP and NPK businesses and 5) larger capital base for the company.

Risks to the project

We cite the following risks to the project: 1) delay in project commencement; 2) management change (with Dawood group) with reduced control of Engro employees trust; 3) project cost over-run; 4) poor response to the equity offer; 5) an unexpected hike in interest rates and 6) natural calamities having an impact on urea demand.

Untapped value in a growing gas market



Mohammad Fawad Khan^{^^^}
Research Analyst
KASB Securities

Exploration activity on the rise

The past two years have seen a surge in exploration activity in Pakistan – exploration licenses awarded are up 28% and drilling activity, spearheaded by listed companies in particular, has risen 33%. We expect listed exploration companies to remain in the limelight on likely positive news flow on exploration and development.

Tapping Pakistan's exploration potential

The underlying reason for the heightened exploration activity is that Pakistan has extremely low exploration density (per 1,000km² density of 1.75 wells compared to the global average of 10 wells) and a significantly higher success ratio (30% compared to the global average of 10%). Overall, Pakistan has enjoyed a reserve addition of 154% in oil and 150% in gas over the past five years.

Solid development potential

The E&P operators face low risk of monetization of discovered reserves, owing to Pakistan's deficit in indigenous sources of oil and gas. About 70-75% of the country's crude oil needs are met through imports, and we expect gas supply deficit of 750mmcf/d by 2009-10, due to sustained and strong gas consumption growth of 7-8% pa.

Market-linked pricing

Hydrocarbon pricing in Pakistan is transparent. Crude prices are linked with Middle Eastern crude prices and closely track the movement in Arab Light prices. Gas prices are benchmarked to crude prices based on energy content and follow a sliding scale that makes gas prices regressive against upward/downward movement in oil prices. Heavy reliance on gas revenue goes in favor of E&Ps given the expected oil price decline over the longer term. OGDC and PPL derive 56% and 93% of their revenues from gas, respectively, while Pakistan Oilfields' (POL) expected gas revenue share by 2008 is 50%.

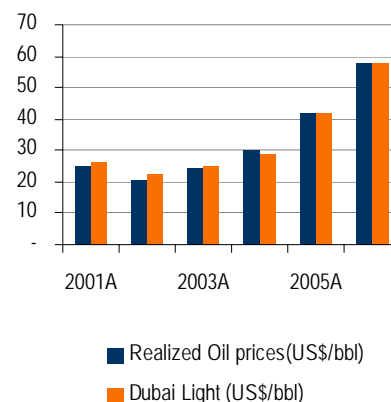
New policy provides further incentives

The proposed new policy (to be effective on new areas only) proposes uncapping gas prices and providing incentives based on cost/potential of an area. This may result in a 13-52% jump in realized gas prices against the Petroleum Policy 2001.

Sector strategy

We like themes on the development potential and exploration program. We recommend Buy on Pakistan Petroleum Ltd and Pakistan Oilfields Ltd.

Chart 1: Realized oil prices in Pakistan are comparable to Dubai Light prices



Source: POL, OGDC

Exploration activity on the rise

In the past few years, both local and foreign E&Ps in Pakistan have stepped up exploration activity, thanks to enhanced government focus and improved confidence among the companies. Both areas under exploration and exploration area have increased in the past two years. Area under exploration has jumped to 223k km² in 2006 from less than 118kkm² in the previous year, up 28%, while the number of exploration leases has risen to 110 from 83 during the period.

What is particularly interesting is the increasing participation by local E&P operator in the exploration activities in Pakistan. Local companies, with their knowledge of different basins and growing confidence, have become active in areas that were not tried before. In terms of areas, Potwar basin, Lower Indus and Middle Indus basins have been explored extensively while offshore, Baluchistan and North West Frontier Province (NWFP) are among the least explored areas.

The pick up in exploration activity is reflected in total wells drilled in FY07 (year-end June). Compared to 22 wells drilled in 2005, total drilling rose to 33 wells in 2006, and in 2007 the E&P industry plans to drill 45 wells. In terms of exploration spend, we estimate the average annual exploration budget of listed companies to rise to US\$245mn over 2006-08E from US\$88mn during 2003-05. With increasing exploration activity, the exploration-related news flow will keep the listed companies in limelight. Due to the higher area under exploration, the exploration well drilling seems poised to significantly increase in the medium term.

Table 1: Exploration statistics

Exploration wells (to date)	654
Appraisal/development wells (to date)	840
Total	1494
Sedimentary area (km ²)	827268
Drilling density (well/1,000km ²)	1.75
Total discoveries	188
Oil	51
Oil & gas/Gas/Gas condensate	137
Overall success rate	30%
Area under exploration (Km ²)	223755

Source: Pakistan Petroleum Information Service

Tapping Pakistan's exploration potential

The underlying reason for a pick-up in exploration activity is Pakistan's attractive exploration statistics: (1) Low exploration density (per 1,000km² density of 1.75 wells compared to the global average of 10 wells); and (2) a significantly higher success ratio (30% vs global average of 10%).

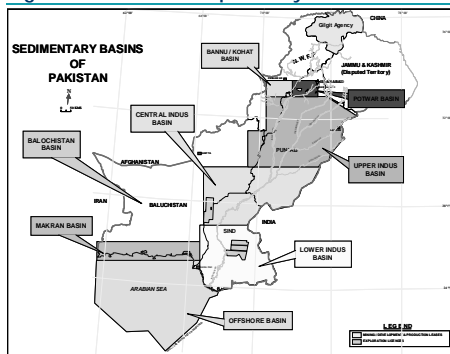
Overall, Pakistan has enjoyed a reserve addition of 154% in oil and 150% in gas over the past five years owing to healthy success ratio and findings historically. While exploration activity in untested areas may mean a lower success ratio compared to the historical ratio, we believe the success ratio will still remain better than the world average. Pakistan is largely a gas province with 32TCF of gas reserves and ranks sixth among the Asia-Pacific countries in gas reserves. Oil reserves are modest at 308mmboe.

Development potential

E&P companies carry a low risk of monetization of any discovered reserves owing to Pakistan's lack of indigenous sources of oil and gas. The country relies on imports to meet up to 70-75% of its crude oil needs. The government projects the total gas supply deficit in the country to increase to 140-150mmcfpod by 2009 as a result of strong gas demand growth of 7-8% pa (1.2x GDP growth). However, given increasing gas supply shortage in the winter season (750mmcf in the latest winter season lasting for 2-3 months compared to 150-200mmcf in the previous winter) coupled with increasing demand for electricity, the gas deficit will likely be higher.

Gas has enjoyed a status of first-choice fuel and makes up 50% of Pakistan's overall energy needs. Gas consumption carries two major sources of latent demand: (1) the power sector, and (2) gas demand in the rural areas.

Figure 1: Pakistan's exploratory basins+



Source: PPIS

Favorable regulatory regime

Market-linked hydrocarbon pricing

Crude pricing

As crude oil produced in Pakistan is comparable with Middle Eastern crude in quality, prices of Middle Eastern crude have been taken as a benchmark. The E&P companies are entitled to C&F (cost and freight) prices of Middle Eastern crude at refinery gate adjusted for minor quality premium/discount. The realized crude prices in Pakistan have closely tracked movement in Arab light prices.

Gas pricing

Gas prices are benchmarked with crude prices based on energy content and follow a sliding scale that makes gas prices regressive against upward/downward movement in oil prices. Based on the Petroleum Policy 2001, the maximum and minimum gas price a producer can realize is US\$2.82-3.08/MMBTU and US\$1.91-US\$2.21/MMBTU, respectively, due to applicability of cap and floor on benchmarked oil prices at US\$16/bbl and US\$36/bbl, respectively.

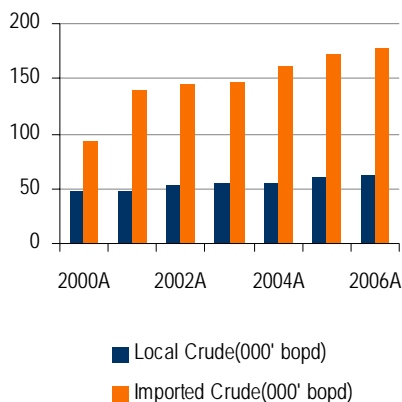
With regressive gas pricing mechanism in place and heavy reliance on gas revenue (50-56%), we believe Pakistan's E&P sector has an edge in terms of effective hedge of gas revenues against downward movement in oil prices. In our universe, OGDC carries 56% revenue share derived from gas while POL's expected gas revenue share by 2008E is 50%.

Table 2: Gas pricing mechanism in Pakistan

Oil prices (A) (US\$/bbl)	Marginal benefit (B)	Effective oil prices (US\$/bbl) (C)	Gas prices (US\$/MMBTU) (C* Zonal Disc/5.6)	% change
16	100%	16	2.06	
21	50%	18.5	2.38	16%
26	30%	20	2.57	8%
36	20%	22	2.83	10%

*Subject to Zonal Discount of 22.5%(Zone III),27.5%(Zone II) and 32.5%(Zone I)+
Source: Petroleum Policy 2001

Chart 2: Pakistan relies heavily on imported crude



Source: Pakistan Energy Year Book

Level playing field

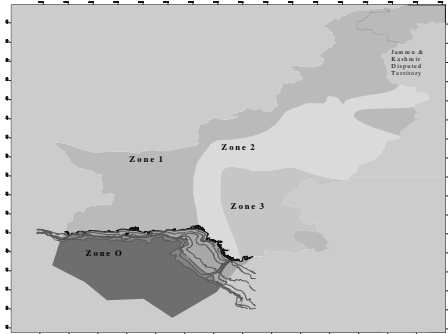
The Petroleum Policy 2001 governs the E&P sector and ensures a level playing field for both local and foreign companies. The government makes sure that there is transparency at every level, from the award of exploration lease to the grant of development lease. It arranges an open bidding for grant of exploration lease. Companies quoting the highest commitment in terms of exploration activity to be carried out in a particular area are granted the area. The sector is most deregulated with minimum government involvement. E&P activities are governed by the Petroleum Policy 2001, under which an E&P player negotiates terms and conditions relating to any area (named Petroleum Concession Agreement) with the government.

Pakistan's total exploration acreage has been divided into four zones based on prospectively, risk and cost. The onshore area comprises three zones.

Policy stability

Unlike in other developing countries, the government of Pakistan has followed the terms and conditions relating to pricing of hydrocarbons in spirit with no tweaking of pre-agreed pricing mechanism. The impact of higher oil prices was borne both by the government (reduced levies and collections) and the consumers. We see low risk of any unilateral revision/tweaking by the government in contract terms negotiated with producers in future. Our reasons are as follows:

Figure 2: Zonal Distribution



Source: Petroleum Policy 2001

1. The government's heightened focus on luring foreign investment into the country and enhancing production of indigenous sources of energy through aggressive exploration activity in the country.
2. Prices of gas in Pakistan are subsidized heavily – gas prices are 60% of Henry Hub prices in the US, which are determined on a demand-supply basis.
3. The government understands that oil inflation is an exogenous shock as imported crude meets up to 70-75% of domestic refinery requirement.
4. The philosophy adopted by the present economic team is more in line with market-based policies.

New policy providing further incentives

We view the newly unveiled draft of Petroleum Exploration and Production Policy 2007 positively since it proposes to offer better terms to E&P operators. The draft is likely to be finalized within a month after incorporating feedback from different stakeholders.

We see two clear objectives of the new policy:

- (1) To draw further investment and foreign players to the industry.
- (2) To increase exploration in areas which are relatively under-explored by differentiating pricing terms in these areas.

We believe the new policy, to be finalized shortly, has the potential to draw further investments and new foreign and local players to the E&P industry.

However, we rule out the possibility of the old pricing agreement on D&P lease being reopened for renegotiation. Exploration areas acquired in 2007 are prime candidates for conversion to the new regime, while the older exploration areas (2006 and before) are likely to be considered on a case-by-case basis for inclusion under the new regime.

An aggressive explorer

**Merrill Lynch**Mohammad Fawad Khan ^^^^
Research Analyst
KASB Securities

Exploration activity picking up

Oil & Gas Development Co (OGDC) is an aggressive exploration company, in our view. The company spud-in a total of 24 wells during FY06, compared with eight wells drilled in FY05. Going forward, exploration drilling is likely to remain high, with OGDC targeting 25 wells during 2007. We believe OGDC has a good chance of augmenting its reserve portfolio through its exploration program by extending into (1) exploration of producing areas, and (2) new areas such as offshore and relatively unexplored basins in Baluchistan.

Execution risk

Over 2006-2010E, we expect an overall 10% production volume CAGR to drive a 9% CAGR in earnings for OGDC. We expect gas to account for most of the addition in production.

Defensive exposure to oil prices

Given OGDC's heavy revenue composition in gas, we believe OGDC's earnings provide defensive exposure to oil prices. This is borne out by its earnings sensitivity to oil prices. We have estimated the impact on OGDC's total revenues, through its earnings, which show a 1.1% and 1.2% sensitivity for 2007E and 2008E on a US\$1/bbl change in oil prices (about 1.6% and 1.5% higher than our base case oil price assumption of US\$59/bbl and US\$63/bbl, respectively).

Attractive on comparables

While we currently have a Neutral rating on OGDC (since it is trading close to our SOTP valuation of PRs124/share), the stock shows a favorable comparison on both local and regional comparisons. At 2008E P/E of 8.5x and EV/EBITDA of 4.8x, OGDC trades at 20% and 16% discount, respectively, to regional peers.

Estimates (Jun)

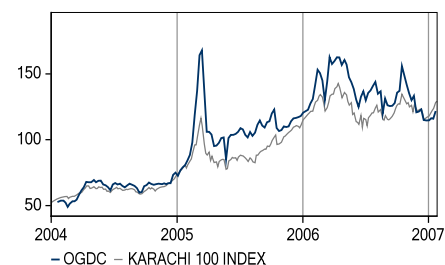
(PRs)	2005A	2006A	2007E	2008E	2009E
Net Income (Adjusted - mn)	33,004	45,803	55,230	61,733	62,926
EPS	7.67	10.65	12.84	14.35	14.63
EPS Change (YoY)	44.4%	38.8%	20.6%	11.8%	1.9%
Dividend / Share	7.50	9.00	9.00	10.00	9.00
Free Cash Flow / Share	7.61	8.47	13.66	13.84	14.46

Valuation (Jun)

	2005A	2006A	2007E	2008E	2009E
P/E	15.87x	11.44x	9.48x	8.49x	8.32x
Dividend Yield	6.16%	7.39%	7.39%	8.21%	7.39%
EV / EBITDA*	8.31x	6.34x	5.40x	4.84x	4.72x
Free Cash Flow Yield*	6.25%	6.95%	11.21%	11.36%	11.87%

Stock Data

Price	PRs121.80
Investment Opinion	C-2-7
Volatility Risk	HIGH
52-Week Range	PRs111.90-PRs170.50
Mkt Val / Shares Out (mn)	US\$8,624 / 4,300.9
Average Daily Volume	14,217,380
ML Symbol / Exchange	XOGCF / KAR
Bloomberg / Reuters	OGDC PA / OGDC.KA
ROE (2007E)	50.3%
Net Dbt to Eqty (Jun-2006A)	-37.1%
Est. 5-Yr EPS / DPS Growth	NA / NA
Free Float	5.0%



iQprofileSM Oil & Gas Development Co Ltd.

Key Income Statement Data (Jun)

(PRs Millions)	2005A	2006A	2007E	2008E	2009E
Sales	74,853	97,309	112,528	125,102	128,783
Gross Profit	67,127	86,560	101,969	112,631	114,942
Sell General & Admin Expense	(872)	(996)	(1,125)	(1,326)	(1,469)
Operating Profit	49,445	64,848	77,527	85,527	86,535
Net Interest & Other Income	(348)	909	261	1,421	2,094
Associates	NA	NA	NA	NA	NA
Pretax Income	49,097	65,757	77,788	86,948	88,628
Tax (expense) / Benefit	(16,093)	(19,954)	(22,559)	(25,215)	(25,702)
Net Income (Adjusted)	33,004	45,803	55,230	61,733	62,926
Average Fully Diluted Shares Outstanding	4,301	4,301	4,301	4,301	4,301

Key Cash Flow Statement Data

Net Income (Reported)	33,004	45,803	55,230	61,733	62,926
Depreciation & Amortization	8,555	9,771	10,960	12,040	12,796
Change in Working Capital	433	(9,444)	6,272	(1,123)	(2,285)
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	1,537	4,242	3,770	3,371	2,253
Cash Flow from Operations	43,529	50,372	76,232	76,020	75,691
Capital Expenditure	(10,808)	(13,945)	(17,500)	(16,500)	(13,500)
(Acquisition) / Disposal of Investments	(816)	251	(1,538)	(419)	(123)
Other Cash Inflow / (Outflow)	NA	NA	NA	NA	NA
Cash Flow from Investing	(11,624)	(13,694)	(19,038)	(16,919)	(13,623)
Shares Issue / (Repurchase)	NA	NA	NA	NA	NA
Cost of Dividends Paid	(18,616)	(41,445)	(31,505)	(42,149)	(39,569)
Cash Flow from Financing	(18,631)	(41,445)	(31,505)	(42,149)	(39,569)
Free Cash Flow	32,721	36,428	58,732	59,520	62,191
Net Debt	(42,380)	(37,614)	(63,302)	(80,254)	(102,754)
Change in Net Debt	(13,289)	4,766	(25,688)	(16,952)	(22,500)

Key Balance Sheet Data

Property, Plant & Equipment	45,733	45,977	53,117	58,177	58,881
Other Non-Current Assets	4,837	4,586	6,124	6,543	6,666
Trade Receivables	22,265	27,754	23,122	23,992	26,462
Cash & Equivalents	42,380	37,614	63,302	80,254	102,754
Other Current Assets	8,065	13,280	11,715	13,024	13,408
Total Assets	123,279	129,211	157,381	181,991	208,171
Long-Term Debt	0	0	0	0	0
Other Non-Current Liabilities	19,625	19,938	24,307	28,278	30,531
Short-Term Debt	0	0	0	0	0
Other Current Liabilities	13,585	7,808	15,087	17,003	16,712
Total Liabilities	33,210	27,746	39,395	45,281	47,243
Total Equity	90,069	101,465	117,986	136,710	160,928
Total Equity & Liabilities	123,279	129,211	157,381	181,991	208,171

iQmethodSM - Bus Performance*

Return On Capital Employed	32.8%	42.3%	44.1%	42.8%	37.9%
Return On Equity	38.1%	47.8%	50.3%	48.5%	42.3%
Operating Margin	66.1%	66.6%	68.9%	68.4%	67.2%
EBITDA Margin	77.0%	77.6%	78.9%	79.1%	78.8%

iQmethodSM - Quality of Earnings*

Cash Realization Ratio	1.3x	1.1x	1.4x	1.2x	1.2x
Asset Replacement Ratio	2.2x	2.3x	2.9x	2.3x	1.7x
Tax Rate (Reported)	32.8%	30.3%	29.0%	29.0%	29.0%
Net Debt-to-Equity Ratio	-47.1%	-37.1%	-53.7%	-58.7%	-63.9%
Interest Cover	NA	NA	NA	NA	NA

Key Metrics

Company Description

Oil & Gas Development Company (OGDC) is Pakistan's largest Oil & Gas producer. It has a diversified portfolio of exploration acreage that extends over 40 areas. We believe its exploration activity IN NEW areas coupled WITH its reserve potential IN the present producing areas provides further reserve potential. OGDC has assumed an aggressive production stance via a fast track development of its fields.

Table 1: OGDC-Key Statistics

Reserves (2P estimated)	
Oil (mmbbl)	161
Gas (tcf)	12
Total (mmbbl)	2094
Exploration Licenses	47
Production(FY06A)	
Oil(bpd)	39,659
Gas(mmcfd)	971
LPG (tpd)	358
Realized oil prices(US\$/bbl)	49.88
Realized Gas prices (US\$/mmbtu)	2.44

Source: OGDC, Pakistan Energy year Book, Merrill Lynch

Stock Data

Price to Book Value	4.4x
---------------------	------

An aggressive explorer

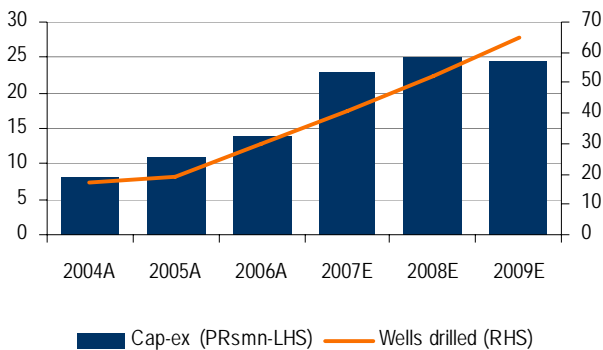
With strong cash flow generation, strength in balance sheet and widening deficit of indigenously produced oil and gas in Pakistan, we believe OGDC embarked on an aggressive exploration program in FY06 (year to June). OGDC raised its exploration drilling from eight wells in FY05 to 23 wells in FY06 and targets to drill 25 wells in FY07 (13 wells already drilled). The focus on exploration is beginning to pay off with 11 discoveries in FY07. We believe OGDC has a good chance of augmenting its reserve portfolio through its two-pronged exploration program: (1) delineating exploration potential of OGDC's current producing areas (Adhi, Qadirpur, Uch) and reserve assessment of new finds in FY07, and (2) extending its exploration program into new and untested areas, which also include Baluchistan and offshore areas.

However, we need to highlight that risk is also higher from exploration in offshore and Baluchistan areas, where both exploration potential is yet to be established and the cost of exploration would be high. With scanty information on its exploration program, the outcome of these activities remains to be seen. We estimate OGDC's annual average exploration spend to increase to US\$217mn in 2007E-2010E from US\$50mn in 2000-2005. Our estimate incorporates 88% of management's current guideline exploration budget for 2007-2009E. From its past exploration activities, OGDC has been able to maintain oil and gas reserve replacement of 105% and 330%, respectively, over the past three years.

International exploration

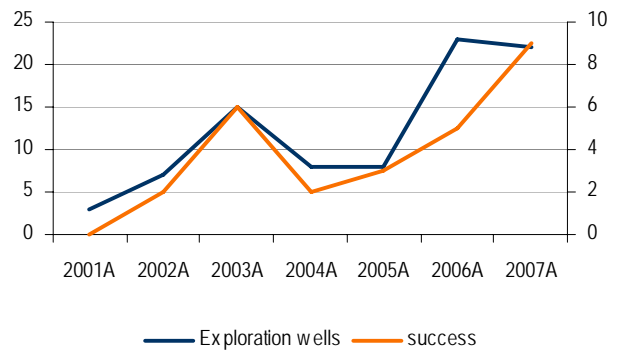
Besides efforts to tap Pakistan's exploration potential, OGDC also plans to go international. However, the company is yet to have any success on this count. OGDC has identified key prospective regions for international exploration, which include Syria, Eritrea and Sudan. Given increasing focus on international exploration by OGDC in a bid to diversify risk, we believe OGDC is likely to meet with success on this front in the near term.

Chart 1: OGDC future cap-ex and planned wells drilling



Source: KASB estimates, OGDC

Chart 2: Historical exploration drilling (x) and success hits (x)



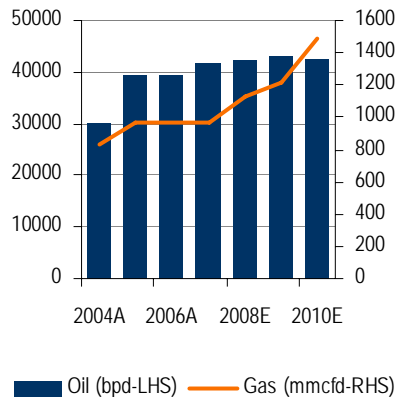
Source: OGDC, Pakistan Petroleum Information Services

Development potential - Execution risk is high

Besides an aggressive exploration program, OGDC has also undertaken a field development plan to meet its targeted production CAGR of 13% of gas and 14% of oil over 2007-2009E. OGDC targets to spend around US\$970mn over 2007E-2010E to boost its production. The development program involves:

- (1) Development of recent finds, and
- (2) Further production upgrade of key producing fields.

Chart 3: OGDC's production profile



Source: KASB estimates

We see execution risk to OGDC development plans. The risk has also transpired in FY07 fully where at least four field development projects have been delayed by 6-12 months due to litigation process while risk of delay on another project is high. However, early commencement of production from some of the recent finds has mitigated the risk to earnings from delays. Relative to management targets, we estimate OGDC's oil and gas production CAGR at 2% and 11%, respectively, over 2007-2010. In our view, most of the production growth in gas would be back-loaded (2010).

Defensive exposure to oil prices

Given the heavy composition of gas in OGDC's revenue and the change in gas pricing discount on the Qadirpur field in FY07, we expect OGDC's earnings to provide a defensive exposure to oil prices. This can be seen from OGDC's earnings sensitivity to oil prices. Our analysis shows a 1.1% and 1.2% sensitivity on OGDC's 2007E and 2008E earnings, respectively, on a US\$1/bbl change in oil prices (~1.6% and 1.5% higher than our base case oil price assumption of US\$59/bbl and US\$63/bbl, respectively). The low sensitivity to earnings arises on account of a regressive wellhead gas prices mechanism in Pakistan. Under Petroleum Policy 2001, the movement of crude prices of US\$1 above US\$25/bbl entitles producers only US\$0.024/mcf-US\$0.027 changes in gas prices.

Attractive on comparables

While we currently have a Neutral rating on OGDC (since it trades close to our SOTP valuation of PRs124/share), the stock offers a favorable comparison on both local and regional comparisons. At 2008E P/E of 8.5x and EV/EBITDA of 4.8x, OGDC trades at 20% and 16% discount, respectively, to regional peers.

Upside potential

The following areas offer potential upside to our valuation:

Further discoveries and appraisal of recent discoveries

OGDC has struck a total of 11 discoveries in the past 12 months. Given the scarce information on the structure of reserves, it is difficult to quantify the possible upside. While some of the discoveries have been brought on line, the reserve potential is yet to be assessed.

Higher production rate from some of the fields

This includes Qadirpur (75mmcf of low BTU gas for a power project), Pirkoh (12-20mmcf through development of the field) and Adhi (10-15mmcf through development of the field). Taking into account the potential production upside, our production CAGR could forecast rise to 12% from 11% and valuation could jump to PRs127/share.

Final settlement of gas price issue

We understand that the notified gas prices on the OGDC key gas field, Qadirpur, is subject to further negotiations and do not rule out future revision with an improved pricing structure (likely within six months). We believe the current gas price of PRs162.5/mmbtu has the potential to be revised up to PRs175-PRs180/mmbtu. This would raise our valuation by PRs4-PRs5/share and can prove to be a strong price trigger, in our view.

Volume growth ahead; Buy

Equity | Pakistan | Oil & Gas Producers
5 July 2007



Merrill Lynch

Mohammad Fawad Khan^{^^^}
Research Analyst
KASB Securities

Strong volume growth

Pakistan Oilfields (POL) has significant undeveloped reserves following its recent discoveries in the Tal Block at Manzalai and Makori. We expect fast-track monetization of the recent finds, coupled with the application of secondary techniques on the key producing field at Pindori (planned completion this year) to add to volume and earnings growth (estimated four-year earnings CAGR of 16% via volume growth of 19%).

High chances of further reserve additions

We see a high chance of success for POL's exploration efforts in the future, as it focuses on already tested areas with recorded prospects. POL carries additional exploration upside in some of its producing fields. Reserve delineation may provide upside to our valuation. Additionally, POL is evaluating opportunities of exploration activity in Iran, where 17 blocks have been opened up for bidding. We expect POL to be a part of 3-4 exploration drillings over 2007-2010.

Buy POL, near-term hiccups overplayed

We believe the market has overplayed near-term hiccups on M&A activity and production issues on Pindori field. Strong earnings growth, attractive valuation and potential for reserve addition underpin our Buy recommendation. We see the possibility of price performance from current levels, driven by news flow on both exploration and field development.

Key issues

Management's openness to investors with regard to future strategy and its drilling programs, low production flow from the Pindori field, delays in implementation of development plan, asset acquisition and M&A risks.

Estimates (Jun)

(PRs)	2005A	2006A	2007E	2008E	2009E
Net Income (Adjusted - mn)	3,763	6,126	6,505	7,861	9,487
EPS	19.09	31.08	33.00	39.88	48.13
EPS Change (YoY)	50.8%	62.8%	6.2%	20.8%	20.7%
Dividend / Share	8.33	13.35	5.00	15.95	19.25
Free Cash Flow / Share	18.16	21.62	29.58	30.43	46.53

Valuation (Jun)

	2005A	2006A	2007E	2008E	2009E
P/E	17.44x	10.71x	10.09x	8.35x	6.92x
Dividend Yield	2.50%	4.01%	1.50%	4.79%	5.78%
EV / EBITDA*	9.91x	5.65x	5.98x	4.83x	4.15x
Free Cash Flow Yield*	5.45%	6.49%	8.89%	9.14%	13.98%

Stock Data

Price	PRs332.95
Price Objective	PRs455.69
Date Established	15-May-2007
Investment Opinion	C-1-7
Volatility Risk	HIGH
52-Week Range	PRs291.05-PRs386.95
Mrkt Val / Shares Out (mn)	US\$1,082 / 197.1
Average Daily Volume	4,028,433
ML Symbol / Exchange	XPKOF / KAR
Bloomberg / Reuters	POL PA / PKOL.KA
ROE (2007E)	39.3%
Net Dbt to Eqty (Jun-2006A)	-8.4%
Est. 5-Yr EPS / DPS Growth	19.0% / 28.0%
Free Float	46.0%



iQprofileSM Pakistan Oilfields Ltd.

Key Income Statement Data (Jun)	2005A	2006A	2007E	2008E	2009E
(PRs Millions)					
Sales	8,998	15,376	15,690	18,775	21,780
Gross Profit	7,841	13,608	13,258	16,058	19,187
Sell General & Admin Expense	(32)	(52)	(51)	(59)	(62)
Operating Profit	4,656	8,466	8,920	10,420	12,229
Net Interest & Other Income	281	(191)	(10)	498	856
Associates	NA	NA	NA	NA	NA
Pretax Income	4,937	8,275	8,911	10,918	13,086
Tax (expense) / Benefit	(1,174)	(2,149)	(2,406)	(3,057)	(3,599)
Net Income (Adjusted)	3,763	6,126	6,505	7,861	9,487
Average Fully Diluted Shares Outstanding	197	197	197	197	197

Key Cash Flow Statement Data

Net Income (Reported)	3,763	6,126	6,505	7,861	9,487
Depreciation & Amortization	1,456	2,254	1,200	2,128	2,367
Change in Working Capital	323	(1,593)	1,054	(430)	238
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	586	874	572	539	631
Cash Flow from Operations	6,128	7,660	9,332	10,098	12,723
Capital Expenditure	(2,548)	(3,399)	(3,500)	(4,100)	(3,550)
(Acquisition) / Disposal of Investments	(1,791)	(5,779)	122	0	0
Other Cash Inflow / (Outflow)	22	39	521	56	380
Cash Flow from Investing	(4,318)	(9,139)	(2,858)	(4,044)	(3,170)
Shares Issue / (Repurchase)	NA	NA	NA	NA	NA
Cost of Dividends Paid	(1,643)	(2,529)	(2,631)	(986)	(3,144)
Cash Flow from Financing	(1,643)	171	(5,331)	(986)	(3,144)
Free Cash Flow	3,580	4,261	5,832	5,998	9,173
Net Debt	(5,232)	(1,224)	(5,067)	(10,136)	(16,545)
Change in Net Debt	(168)	4,008	(3,843)	(5,069)	(6,409)

Key Balance Sheet Data

Property, Plant & Equipment	4,941	5,987	8,260	10,343	11,708
Other Non-Current Assets	3,445	8,861	9,948	11,006	11,994
Trade Receivables	1,356	2,719	2,377	2,845	3,300
Cash & Equivalents	5,232	3,924	5,067	10,136	16,545
Other Current Assets	858	1,751	1,494	1,788	2,074
Total Assets	15,832	23,241	27,146	36,118	45,621
Long-Term Debt	0	1,620	0	0	0
Other Non-Current Liabilities	3,150	3,688	5,841	7,607	9,788
Short-Term Debt	0	1,080	0	0	0
Other Current Liabilities	1,554	2,228	2,806	3,137	4,117
Total Liabilities	4,704	8,617	8,648	10,744	13,905
Total Equity	11,128	14,624	18,498	25,373	31,716
Total Equity & Liabilities	15,832	23,241	27,146	36,117	45,621

iQmethodSM - Bus Performance*

Return On Capital Employed	27.5%	33.9%	28.1%	26.1%	23.8%
Return On Equity	37.4%	47.6%	39.3%	35.8%	33.2%
Operating Margin	51.7%	55.1%	56.9%	55.5%	56.1%
EBITDA Margin	67.9%	69.7%	64.5%	66.8%	67.0%

iQmethodSM - Quality of Earnings*

Cash Realization Ratio	1.6x	1.3x	1.4x	1.3x	1.3x
Asset Replacement Ratio	2.0x	1.6x	3.4x	2.1x	1.7x
Tax Rate (Reported)	23.8%	26.0%	27.0%	28.0%	27.5%
Net Debt-to-Equity Ratio	-47.0%	-8.4%	-27.4%	-39.9%	-52.2%
Interest Cover	-14.6x	-37.4x	-10.5x	-20.6x	-13.4x

Key Metrics

Company Description

Pakistan Oilfields (POL) is an E&P operator in Pakistan with most of its activities centered in the northern part of the country. POL is small operator and has maintained a low risk exploration activity, which involves exploration in areas with established potential. Development of recent discoveries is expected to deliver production growth.

Table 1: POL-Key Statistics

Reserves (2P estimated)	
Oil(mmbbl)	47.3
Gas (tcf)	0.7
Total (mmbob)	163.5
Exploration Licenses	5.0
Production (FY06A)	
Oil(bpd)	7827.1
Gas(mmcfd)	48.5
LPG (tpd)	209.0
Realized oil prices(US\$/bbl)	57.5
Realized Gas prices (US\$/mmbtu)	3.0

Source: POL, Pakistan Energy Year Book

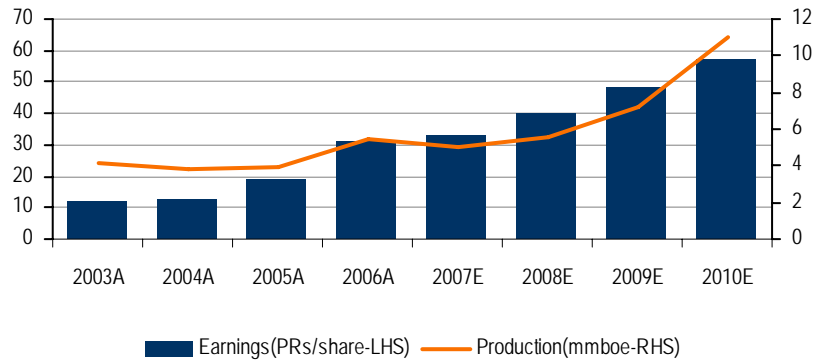
Stock Data

Price to Book Value	3.5x
---------------------	------

Strong production growth

Our bullish stance on POL is underpinned by our belief in the potential for strong volume growth in POL (19% CAGR over 2006A-2010E) from the monetization of recent finds and application of secondary recovery techniques leading to a four-year earnings CAGR of 16% over 2006-2010E. Additional gas production would remain a major driver, with 4-year volume CAGR of 29% over 2007E-2010E (gas production of 132mmcf by 2010E). Relative to gas production, growth in oil production should be modest at 5% over 2007E-2010E (oil production of 9470bpd seen by 2010E).

Chart 4: Volumes driving earnings growth



Source: POL, KASB Estimates

Exploration: International ambitions

We see a high chance of success for POL's exploration efforts in the future, as it focuses on already tested areas with recorded prospects. We expect POL to be a part of 3-4 exploration drillings over 2007-2010E. It has also expressed intention to re-enter the international exploration arena. It is evaluating prospects of exploration activity in Iran, where 17 blocks are open for bidding. After an un-successful exploration attempt in Yemen in 2002-03, Iran will mark POL's second attempt at international exploration. Though details are still unclear on the prospects of the offered blocks, we believe POL is likely to enter as a joint venture partner.

M&A risks subdued on disqualification

POL and three other Attock Group companies intend to buy up to 25.5% stake each in Pakistan State Oil (PSO), a state-owned oil marketing company, as part of its privatization. While the potential acquisition of PSO lacks synergies for POL, shareholders may benefit from the potential restructuring of the balance sheet.

The Attock Group has been disqualified from PSO's privatization, which has reduced the M&A risks associated with POL's potential acquisition for now. The underlying reason for disqualification is believed to be non-submission of documents by the Attock Group. Even if the Attock Group succeeds in its attempt eventually, we do not see significant risks to POL's valuation (1.3-3.6%).

We also do not share market concerns over the future dividend stream of POL. However, we believe POL's earnings are likely to decline as PSO's dividend yield of 7% is lower than the returns (about 11%) that POL is now earning on its surplus cash. If the PSO stake is acquired, we estimate a negative impact of PRs1.03-2.24/share to POL's earnings in FY08. The government targets to complete the transaction by end-June, which, in our view, could be delayed.

Reiterating Buy

Our PO for POL is PRs456/sh, set at an estimated NAV based on 2P reserves. We think the market is overplaying the negative production surprise (Manzalai, Pindori, Pariwali), and putting the medium-to-long term earnings potential on the backburner.

POL now has a D&P lease in place for the Manzalai field. Given the widening gas supply deficit in Pakistan, we see high chances for the timely commercialization of Manzalai field. Furthermore, higher-than-expected production from the field as part of phase II of field development plan also outweighs any potential impact.

Production recovery at the Pindori field is well under way. POL has raised production from 3,800bpd in March to 5,000bpd in June. We see further possibility of a recovery in the field's production.

Our Buy recommendation on the stock is underpinned by the following:

1. Attractive valuation providing 37% upside potential.
2. Strong earnings growth (4-year CAGR of 16% over 2007E-2010E) from monetization of Tal block reserves and normalization of production flow from the Pindori and Pariwali fields.
3. Attractive exploration appeal from low-risk exploration prospects in producing areas and areas close to producing areas.

Potential share price triggers

Early arrest of production decline in Pindori field

We believe this will boost investor confidence on management and could potentially raise production from the field. After the completion of work-over job on Pindori VA, we see good chances of further production recovery. This should be done by the end of 4QFY07 / 1QFY08, in our view.

Gas sales agreement on Manzalai field

We believe this is likely to happen by end of 4QFY07 / 1QFY08. We expect gas volume of 200mmcf to be brought online by January 2009. The potential for early commencement of production could lead to earnings and valuation upsides.

Exploration and development drilling

POL is involved in three exploration wells, which include one deep well in the Tal block to test a new structure. The drilling on well, currently close to its targeted depth, may be complete by end of 4QFY07 / 1QFY08. Any potential positive developments could lead to a strong price run-up, in our view. POL also aims to tap the additional reserve potential in three producing fields (Chak Naurang, Minwal and Ratana). The addition of reserves may trigger a share price performance.

Equity | Pakistan | Oil & Gas Producers
5 July 2007

Exploration bearing fruit; Buy



Mohammad Fawad Khan^{^^^} +
Research Analyst
KASB Securities

Focus on exploration paying off

PPL's heightened focus on exploration is bearing fruit with eight discoveries during FY07 (year-end June). The work continues to be aggressive – PPL is targeting 10-11 wells pa including one onshore well in Yemen – but balanced. We are confident that PPL's exploration program has the capacity to deliver on future reserve addition.

Price and production driving earnings growth

We expect the combined effect of modest volume growth and increase in average gas prices will help PPL deliver four-year earnings CAGR of 19%. We estimate gas prices for the company would rise by 6% on average by 2010 while production should increase by 3% CAGR over the same period.

Defensive exposure to oil prices

With gas contributing to 93% of its total revenue, we view PPL as a defensive play on oil prices given that the gas pricing mechanism in Pakistan is regressive.

Buy PPL on growth and potential reserve addition

We set our PO at PRs299.8/share, based on sum-of-the-parts valuation. We have incorporated a long-term oil price assumption of US\$60/bbl (WTI) and have used a discount rate of 16%. We recommend a Buy on PPL in view of the following: (1) attractive valuation, (2) strong earnings growth, (3) potential reserve addition, and (4) potential privatization gains.

Risks

(1) Delays in development plans, (2) exploration risk, (3) exchange rate risk, and (4) production suspension in Sui field.

Estimates (Jun)

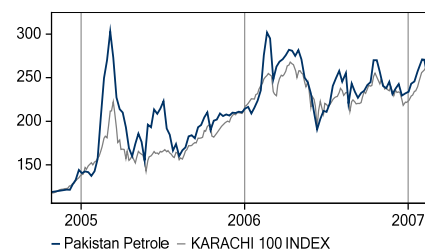
(PRs)	2005A	2006A	2007E	2008E	2009E
Net Income (Adjusted - mn)	8,623	13,401	17,892	20,688	22,908
EPS	12.57	19.54	26.09	30.16	33.40
EPS Change (YoY)	30.3%	55.4%	33.5%	15.6%	10.7%
Dividend / Share	5.56	9.00	13.00	15.00	17.00
Free Cash Flow / Share	10.49	14.94	21.12	29.49	31.02

Valuation (Jun)

	2005A	2006A	2007E	2008E	2009E
P/E	20.97x	13.50x	10.11x	8.74x	7.89x
Dividend Yield	2.11%	3.41%	4.93%	5.69%	6.45%
EV / EBITDA*	10.96x	7.76x	6.27x	5.33x	4.89x
Free Cash Flow Yield*	3.98%	5.66%	8.01%	11.18%	11.76%

Stock Data

Price	PRs263.70
Price Objective	PRs299.80
Date Established	15-May-2007
Investment Opinion	C-1-7
Volatility Risk	HIGH
52-Week Range	PRs181.50-PRs277.75
Mrkt Val / Shares Out (mn)	US\$2,985 / 685.8
Average Daily Volume	4,818,860
ML Symbol / Exchange	XKIRF / KAR
Bloomberg / Reuters	PPL PA / PPL.KA
ROE (2007E)	51.0%
Net Dbt to Eqty (Jun-2006A)	-54.6%
Est. 5-Yr EPS / DPS Growth	17.1% / 23.4%
Free Float	15.0%



05 July 2007

iQprofileSM Pakistan Petroleum Ltd.

Key Income Statement Data (Jun)	2005A	2006A	2007E	2008E	2009E
(PRs Millions)					
Sales	23,294	31,757	37,669	43,841	47,564
Gross Profit	20,323	28,525	33,531	39,271	42,500
Sell General & Admin Expense	(425)	(469)	(495)	(530)	(571)
Operating Profit	13,699	19,841	24,716	29,275	31,905
Net Interest & Other Income	(224)	349	1,214	925	1,537
Associates	NA	NA	NA	NA	NA
Pretax Income	13,475	20,190	25,930	30,201	33,442
Tax (expense) / Benefit	(4,852)	(6,789)	(8,038)	(9,513)	(10,534)
Net Income (Adjusted)	8,623	13,401	17,892	20,688	22,908
Average Fully Diluted Shares Outstanding	686	686	686	686	686

Key Cash Flow Statement Data

Net Income (Reported)	8,623	13,401	17,892	20,688	22,908
Depreciation & Amortization	1,506	1,614	1,860	1,990	2,136
Change in Working Capital	(1,880)	(1,210)	(1,920)	895	(364)
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	3,630	2,791	2,054	2,899	2,839
Cash Flow from Operations	11,879	16,596	19,885	26,471	27,520
Capital Expenditure	(4,684)	(6,352)	(5,400)	(6,248)	(6,248)
(Acquisition) / Disposal of Investments	NA	NA	NA	NA	NA
Other Cash Inflow / (Outflow)	176	950	212	0	0
Cash Flow from Investing	(4,508)	(5,402)	(5,188)	(6,248)	(6,248)
Shares Issue / (Repurchase)	NA	NA	NA	NA	NA
Cost of Dividends Paid	(3,429)	(4,462)	(8,051)	(9,309)	(10,309)
Cash Flow from Financing	(3,433)	(4,444)	(8,131)	(9,309)	(10,309)
Free Cash Flow	7,195	10,244	14,485	20,223	21,272
Net Debt	(9,772)	(16,497)	(23,601)	(34,807)	(45,770)
Change in Net Debt	(3,943)	(6,732)	(6,645)	(10,914)	(10,963)

Key Balance Sheet Data

Property, Plant & Equipment	9,670	11,695	13,299	15,328	17,238
Other Non-Current Assets	3,088	1,707	1,993	2,979	3,950
Trade Receivables	5,377	7,406	8,463	9,009	9,773
Cash & Equivalents	10,577	17,327	23,893	34,807	45,770
Other Current Assets	2,086	2,321	2,689	2,402	2,606
Total Assets	30,797	40,456	50,337	64,524	79,338
Long-Term Debt	62	79	0	0	0
Other Non-Current Liabilities	4,889	4,533	5,149	6,804	8,413
Short-Term Debt	743	751	291	0	0
Other Current Liabilities	3,858	4,904	4,868	6,313	6,919
Total Liabilities	9,552	10,267	10,308	13,117	15,332
Total Equity	21,245	30,189	40,029	51,407	64,006
Total Equity & Liabilities	30,797	40,456	50,337	64,524	79,338

iQmethodSM - Bus Performance*

Return On Capital Employed	39.0%	45.3%	46.3%	41.8%	36.7%
Return On Equity	46.2%	52.1%	51.0%	45.3%	39.7%
Operating Margin	58.8%	62.5%	65.6%	66.8%	67.1%
EBITDA Margin	65.3%	67.6%	70.6%	71.3%	71.6%

iQmethodSM - Quality of Earnings*

Cash Realization Ratio	1.4x	1.2x	1.1x	1.3x	1.2x
Asset Replacement Ratio	3.4x	4.3x	3.3x	3.5x	3.3x
Tax Rate (Reported)	36.0%	33.6%	31.0%	31.5%	31.5%
Net Debt-to-Equity Ratio	-46.0%	-54.6%	-59.0%	-67.7%	-71.5%
Interest Cover	NA	NA	NA	NA	NA

Key Metrics

Company Description

Pakistan Petroleum Ltd (PPL) is the largest gas producer (gas production of 1020mmcfpd) and second largest exploration company in Pakistan. PPL is a government-owned company with the Government of Pakistan holding a 78% stake. The International Finance Corporation (IFC) has a 6% stake in the company, acquired from PPL's former owners, Burma Oil Co. Ltd. PPL is the second largest stock by market cap in the Karachi Stock Exchange.

Table 1: PPL-Key Highlights

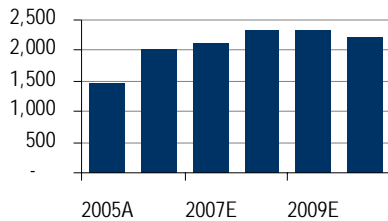
Reserves (2P estimated)	
Oil(mmbbl)	43.6
Gas (tcf)	6.7
Total (mmboe)	1116.9
Exploration Licenses	27.0
Production (FY06A)	
Oil(bpd)	1930.3
Gas(mmcf/d)	1018.1
LPG (tpd)	26.5
Realized oil prices(US\$/bbl)	46.5
Realized Gas prices (US\$/mmbtu)	1.3

Source: PPL, Pakistan Energy Year Book

Stock Data

Price to Book Value	4.5x
---------------------	------

Chart 1: PPL-Future exploration capex (PRs mn)



Source: PPL, Merrill Lynch estimates

Exploration bearing fruit

PPL's heightened focus on exploration is bearing fruit with four discoveries from eight hits, including one high-impact hit. The work continues to be aggressive (10-11 wells pa including one onshore well in Yemen) but balanced. We believe current and future exploration activities will not only target new areas, but also be geared towards exploring reserve potential in existing producing areas. We estimate PPL's exploration capex at US\$37mn, or PRs2,249mn, over 2007-10.

Moreover, to lower the risk of future exploration activities, the company has:

1. Diversified the exploration acreage among operators via share swaps in six areas with OMV, and
2. Spread out areas under exploration in terms of risk profile and across basins.

We are confident that PPL's exploration program has the capacity to deliver on future reserve addition.

Setting foot in Yemen

PPL has made a successful bid in Yemen and secured a 50% interest in onshore Block 29 along with OMV (operator). The block is located in a high-risk area and PPL will have commitment of at least one exploration well within 1-2 years. This makes PPL the first public limited company in Pakistan to embark on international exploration.

In our view, PPL's entry into Yemen will go a long way to help the company in the following ways: (1) source for reserve additions in the global arena, (2) establish a diversified exploration portfolio in different regions, (3) gain valuable international and technical experience, (4) have more meaningful participation in future international exploration efforts, (6) facilitate future strategy on asset acquisition, and (7) raise company profile. We understand that PPL has also identified Oman, Kenya, Tanzania and Mozambique as other prospective areas for exploration.

Earnings growth with defensive exposure to oil

With the current lower base of realized gas prices for PPL, this means a disconnect between the conventional volume-earnings relationship as future production would come from fields having higher gas prices relative to the current average prices. In our view, it is only a matter of time before this disconnect transpires fully as PPL's earnings growth would likely outpace volume addition.

Currently the company realizes gas prices of US\$1.44/mcf, which is a 40-50% discount to average gas prices of a normal field under the present petroleum policy. The discount is due to low realized gas prices on key producing assets of Sui and Kandkot. We estimate that gas prices for PPL would increase by 6% on average over 2006-10E through the dual impact of:

- Higher-priced production additions (Tal block, Qadirpur and Sawan, and new discoveries), and
- Uncapped gas prices on key fields (while gas prices are capped under Petroleum Policy 2001, the cap does not apply to key fields like Sui, Kandkot, Sawan and Miano).

3% production CAGR

We estimate 3.4% volume CAGR over 2007E-10E for PPL. The bulk of the increase should come from oil, which is expected to rise to 8,100bopd by 2010, ie, a four-year CAGR of 47%. In light of the current natural production in Sui, we expect net gas production to remain flat and rise by only 2.36% over 2006-10E. In our view, annual development expense is likely to average US\$59mn or PRs3,600mn.

PPL a defensive play on oil prices

With 93% revenues drive from gas, PPL is a defensive bet on oil prices as gas pricing mechanism in Pakistan is regressive. For PPL, realized gas prices increased on Sui and Kandkot changes by only US\$0.12/mcf for every US\$1/bbl movement of oil prices above US\$36/bbl (US\$0.23/mcf for some fields. On average, PPL's valuation changes by 1% for 6% change in our long term oil assumption. The low correlation coefficient of only 0.34 of PPL prices (since listing) with oil prices reinforces our point.

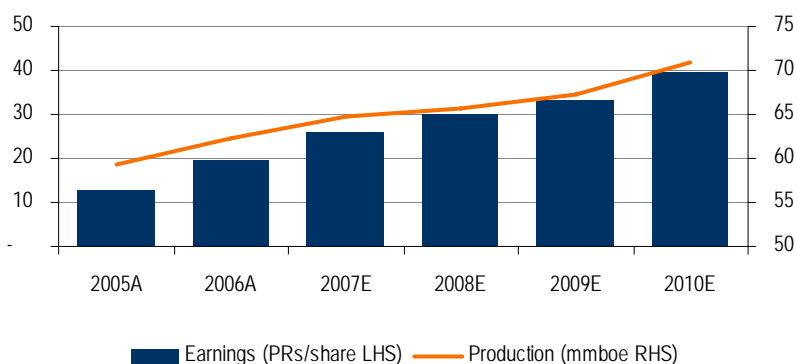
Privatization to add further value

The government intends to offer a 51% stake with management rights via privatization. Four foreign parties have indicated interest in the deal: (1) British Petroleum, (2) OMV, (3) China National Petroleum Corporation and Zhenhua Oil consortium, and (4) MOL-Kufpec consortium. We believe the privatization of PPL will offer minority shareholders the following benefits:

- Optimum recovery through application of modern techniques
- Aggressive regional exploration
- Optimum use of surplus cash
- Change in business model

While all four parties are said to have completed due diligence process, the privatization has been delayed by one provincial government's demand for a 20% stake in PPL due to potentially lower royalty from resource mining in the province.

Chart 2: PPL: Strong earnings growth



Source: PPL, Merrill Lynch estimates

Reiterate Buy

We recommend a Buy on PPL, Pakistan's largest gas producer. The stock offers 19% potential total return on its 12-month price objective of PRs299.8/share, based on sum-of-the-parts valuation.

Benefiting from stability, volume



Mohammad Fawad Khan^{^^^}
Research Analyst
KASB Securities

Overweight oil marketing industry

From a regional perspective, Pakistan's oil marketing industry offers a unique growth theme. Lacking vertical integration into the refining business, Pakistan's oil marketing industry is structured as a standalone marketing business. Our liking of the sector is underpinned by the following aspects.

A thriving oligopoly

With over 80% market share resting with two companies (PSO, 65% and Shell, 17%), high infrastructure investments and retail outlet presence, we believe the current oligopoly structure will continue to thrive.

Policy and marketing margins holding steady

Pakistan's oil marketing industry offers lower risk in the regional context given the stability in government policy and outlook for marketing margins. Prices set by the government guarantee a 3.5% margin to OMCs on regulated products (65% of total volume) and all subsidies are borne by the government.

Growth opportunities in downstream industry

In the backdrop of low per capita energy consumption, we regard volume growth (7.5% CAGR over 2007-10E) and attractive investment opportunities in infrastructure as key earnings growth opportunities, while the non-fuel segment remains a major untapped area.

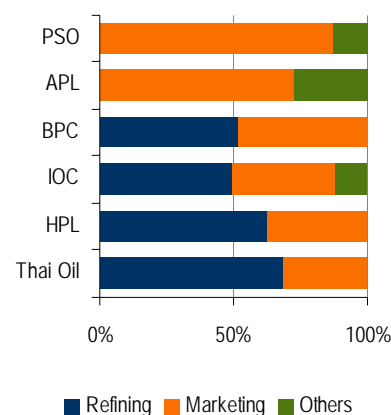
Pakistan State Oil - A competitive leader

We recommend a Buy on PSO (PKSOF. C-1-7, PRs395.45) with a PO of PRs422/share, based on (1) its strong volume growth (7.3% CAGR over 2007E-10E), (2) ongoing efforts to explore opportunities in the non-fuel segment, (3) favorable operating environment (dominant 65% market share), and (4) possibility of privatization in June 2007.

Risks

The risks are (1) sustained decline in product prices in the international market, (2) higher water and gas availability leading to lower fuel consumption, (3) slowdown in economic activity, and (4) exchange rate risks.

Chart 1: High EBITDA (%) contribution from oil marketing segment

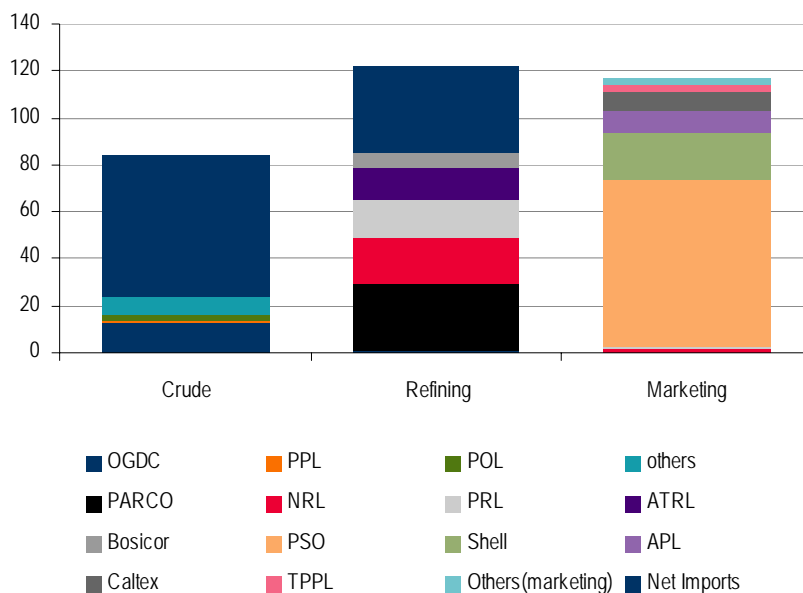


Source: Merrill Lynch Estimates

Overweight oil marketing sector

From a regional perspective, Pakistan's oil marketing industry offers a unique growth theme. It is largely based on a standalone marketing function, with a little supply-side integration. The refinery coverage among oil marketing companies is low and only about 14% of total marketed products come from refineries owned / controlled by marketers. This independent business structure makes Pakistan's oil marketing companies unique in the regional context, where the norm is integrated models (refining plus marketing) providing high refinery coverage. In our view, government ownership and the ensuing separate policy formulation explain the current fragmented structure in the downstream industry.

Chart 2: Pakistan's downstream industry: Lack of vertical integration (2006; mn bbl)



Source: Merrill Lynch Estimates

Oligopoly to thrive

With more than 80% market share resting with two players (PSO, 65% and Shell, 17%), high infrastructure investment requirement and retail outlet presence, we believe the current oligopoly structure will thrive. While both Attock Petroleum Ltd (APL) and PSO are expected to gain market share in future, we believe APL's aggressive rollout of retail outlets and infrastructure investment will enable it to outpace industry growth. For PSO, a renewed focus on high-margin products combined with its hegemony in power fuel will enhance its presence. We foresee a strong possibility of integration in the industry as the push by marketing companies to differentiate their product offerings gather momentum.

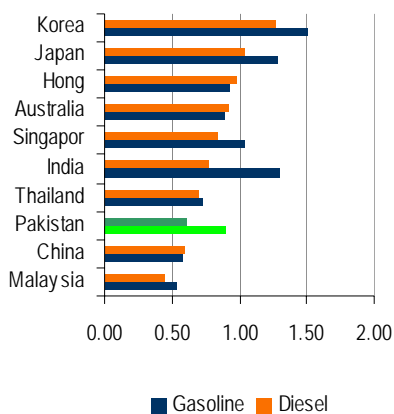
Policy stability and firm margins

Pakistan's downstream industry has been exempt from the government's policy of subsidizing end-product prices. Given the expected recovery of government taxes lost in subsidizing end-product prices, coupled with the Pakistan rupee's depreciation against the US\$, we believe marketing margins (calculated as 3.5% of presales tax price) will continue to remain firm. Indeed, after six years of reform, the government's role in the oil marketing industry has progressively declined. We see improved operational and pricing freedom for OMCs as the government continues to deregulate the industry.

Stable marketing margins

In our view, Pakistan's oil marketing companies enjoy relatively low earnings volatility because their marketing margins, a key earnings driver, have been stable given that these are determined as a percentage of retail product prices while up to 70% of product prices are regulated.

Chart 3: Comparison of MS and HSD prices (US\$/litre)



Source: Merrill Lynch

Retail prices have been relatively stable in the past 12 months, with only two end-product price revisions in May 2006 and January 2007 despite the fact that prices are reviewed every fortnight (as part of the pricing regulations). Clearly, the volatility in ex-refinery prices in the international market has been absorbed by changes in government taxes, making marketing margins stable in the process. In an increasing oil price scenario, the government will avoid raising end-product prices by reducing its share of taxes built into the product prices and, if necessary, providing subsidies (not borne by the oil marketing industry). Should the oil price decline, the government is expected to raise its share of taxes in product prices (see details in the table below).

While the marketing margins for Pakistan's OMCs lack a strict comparison due to the industry's unique model, we view the current margins on retail regulated products (30% of total volume) as healthy at US\$2.07-4.48/bbl. Dealer margins and freight costs are separately provided in the pricing mechanism. Relative to retail products, the margins on deregulated power fuel (furnace oil) are low at US\$1.3-1.5/bbl given the commodity-like nature of power fuel. In the event of declining oil prices, we do not expect the government to pass on the full benefits to end-consumers, and hence, margins are likely to remain firm. The retail prices on transportation fuels (MS and HSD) in Pakistan come in at the lower end in the regional context.

Table 1: Calculation of regulated product prices

Pricing element	ML comments
Retail Prices	Uniform across Pakistan, freight equalization mechanism eliminates differences in product movement cost across region.
Sales Tax	Levied at 15%.
Dealer Margins (if applicable)	4% of sum of all items except ST and marketing margins.
Marketing Margins	3.5% of sum of all items except ST and dealer margins.
Inland Freight	Except for FO, actual freights are pooled and distributed evenly, administered by the Oil Companies Advisory Committee.
Petroleum Development Levy/(Petroleum Devt Claims)	Government taxes per liter of unit/(Claims by OMC to government).
Excise Duty (if applicable)	Flat rate of PRs0.88/liter on motor gasoline.
Ex-refinery prices	Ex-refinery prices (this along with import price make up input for retail price calculation).
Tariff (if applicable))	6% on LDO, kerosene and aviation fuel, 10% on HSD.
Import Parity Prices	Landed cost of product
Incidentals (1.09% plus wharfage)	Incidentals like LC commission, ocean losses etc.
Freight (actual)	Actual published freight.
Product Premium	Actual.
15-day average FOB price (Arab Gulf)	Published prices in Platts Report.

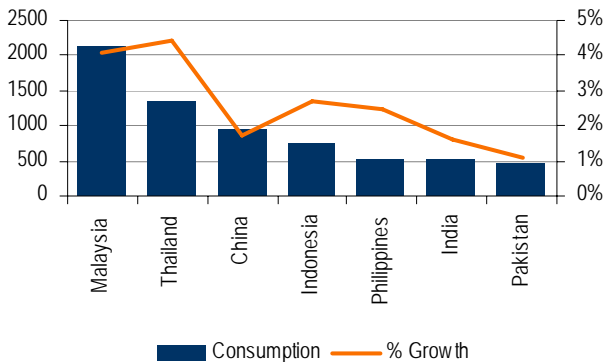
Source: Merrill Lynch

Opportunities aplenty downstream

Volume growth and infrastructure investment are, in our view, the key earnings growth opportunities available to oil marketing companies in Pakistan. Meanwhile, the non-fuel segment remains untapped. With economic growth likely to sustain at 6-7% and power fuel demand on the rise (on a low energy consumption per capita historically), we believe the downstream oil industry is poised to enjoy an uptrend in volume (four-year CAGR of 5% over 2007-10E). This would make Pakistan one of the fastest-growing oil markets in Asia Pacific. Large scale conversion to CNG vehicles (an estimated 70% of passenger cars were converted to CNG in 2006) and unavailability of technology has reduced future substitution risk from alternative fuels, in our view.

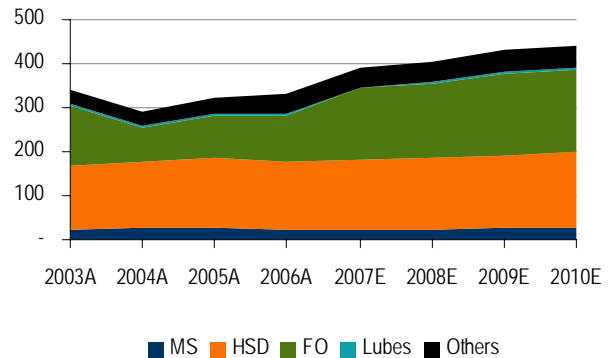
Sustained economic outlook for the medium term should lead to a surge in energy needs, in our view. The government estimates that energy demand will achieve a 7.5% CAGR (1.2x GDP). Energy growth in the future would come on a historically low base of energy consumption. Compared with the regional average of 1,036kg oil equivalent, Pakistan's per capita energy consumption has been low at 455kg oil equivalent. The higher contribution of real sector growth to overall economic growth would help narrow the prevailing gap in energy consumption vis-à-vis regional energy consumption.

Chart 4: Pakistan: Low per capita energy consumption (kg oil equivalent)



Source: World Economic Outlook 2006

Chart 5: Uptrend in Pakistan's product consumption ('000bpd)



Source: Merrill Lynch Estimates

Petroleum product consumption

With the GDP growth rate expected to remain above-average (6-7%) over the next few years and the government's renewed focus on building transportation infrastructure, we believe overall petroleum product consumption in Pakistan should begin to look up. We estimate growth of 7.5% over 2007-10E (0.76x of GDP). The anticipated growth should lift Pakistan's oil consumption to 440,000bpd (21.27 mn tons) by 2010E, from 329,000bpd (15.9mn tons) in 2006. On comparing consumption growth across regions, Pakistan seems poised to achieve one of the highest growth rates in petroleum product demand.

A dominant player in a growing industry

Equity | Pakistan | Oil Refining and Marketing
5 July 2007



Mohammad Fawad Khan^{^^^}
Research Analyst
KASB Securities

A competitive leader; valued on SOTP method

We recommend Buy on Pakistan State Oil (PSO) with a PO of PRs422/sh, which is the largest domestic oil marketing company with over 65% market share. Our PO is based on sum-of-the-parts (SOTP) valuation method, which accounts for the company's free cash flows and investments and receivables.

Strong volume growth ahead

PSO is poised to achieve strong volumes at 7.5% CAGR over 2006-2010E, driven by the following initiatives: (1) Beefing up quality and focusing on convenience (2) Investing in retail network expansion (3) Raising focus on high-margin products.

Exploring potential in the non-fuel segment

PSO plans to leverage its extensive retail outlet network (3,800 sites) to explore the large untapped potential in the non-fuel segment. It expects to increase contribution from non-fuel retail sales to PRs1bn by 2010E from PRs12mn in 2006.

Favorable industry structure

We believe the company derives obvious benefits from its dominant position in the industry. It also features stable marketing margins (3.5% on retail products).

Potential privatization may induce further efficiency

We expect potential privatization to deliver further value through realization of potential strength from its balance sheet and change in business focus .

Key risks

(1) Sustained decline in product prices in the international markets. (2) Low power fuel consumption. (4) Delays in privatization.

Estimates (Jun)

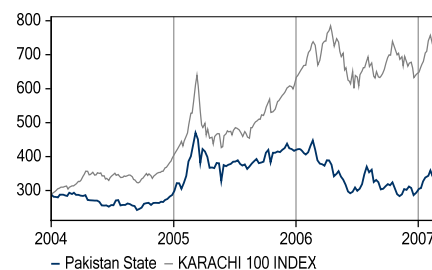
(PRs)	2005A	2006A	2007E	2008E	2009E
Net Income (Adjusted - mn)	5,656	7,525	4,989	6,295	6,716
EPS	32.98	43.87	29.09	36.70	39.16
EPS Change (YoY)	34.3%	33.0%	-33.7%	26.2%	6.7%
Dividend / Share	22.00	34.00	24.00	27.00	28.00
Free Cash Flow / Share	19.31	6.30	16.73	23.88	31.34

Valuation (Jun)

	2005A	2006A	2007E	2008E	2009E
P/E	12.00x	9.02x	13.60x	10.78x	10.10x
Dividend Yield	5.56%	8.59%	6.07%	6.83%	7.08%
EV / EBITDA*	6.81x	5.27x	8.43x	6.77x	6.57x
Free Cash Flow Yield*	4.88%	1.59%	4.23%	6.04%	7.92%

Stock Data

Price	PRs395.60
Price Objective	PRs421.60
Date Established	4-Apr-2007
Investment Opinion	C-1-7
Volatility Risk	HIGH
52-Week Range	PRs270.80-PRs425.00
Mrkt Val / Shares Out (mn)	US\$1,118 / 171.5
Average Daily Volume	2,028,363
ML Symbol / Exchange	PKSOF / KAR
Bloomberg / Reuters	PSO PA / PSO.KA
ROE (2007E)	23.5%
Net Dbt to Eqty (Dec-2006A)	-9.1%
Est. 5-Yr EPS / DPS Growth	10.0% / 4.3%
Free Float	48.0%



05 July 2007

iQprofileSM Pakistan State Oil

Key Income Statement Data (Jun)	2005A	2006A	2007E	2008E	2009E
(PRs Millions)					
Sales	207,693	288,712	298,609	353,407	342,816
Gross Profit	13,750	17,207	11,945	14,503	15,216
Sell General & Admin Expense	NA	NA	NA	NA	NA
Operating Profit	9,823	12,897	7,679	9,794	10,031
Net Interest & Other Income	(632)	(1,243)	(3)	(110)	302
Associates	NA	NA	NA	NA	NA
Pretax Income	9,191	11,654	7,676	9,685	10,333
Tax (expense) / Benefit	(3,536)	(4,129)	(2,687)	(3,390)	(3,616)
Net Income (Adjusted)	5,656	7,525	4,989	6,295	6,716
Average Fully Diluted Shares Outstanding	172	172	172	172	172

Key Cash Flow Statement Data

Net Income (Reported)	5,656	7,525	4,989	6,295	6,716
Depreciation & Amortization	984	1,082	1,050	1,073	1,173
Change in Working Capital	(5,837)	(12,924)	(2,042)	(2,773)	(2,078)
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	4,011	5,862	979	1,030	1,090
Cash Flow from Operations	4,814	1,545	4,977	5,625	6,901
Capital Expenditure	(1,502)	(465)	(2,107)	(1,530)	(1,526)
(Acquisition) / Disposal of Investments	244	281	0	0	0
Other Cash Inflow / (Outflow)	471	99	60	51	47
Cash Flow from Investing	(788)	(86)	(2,047)	(1,479)	(1,479)
Shares Issue / (Repurchase)	0	0	0	0	0
Cost of Dividends Paid	(3,617)	(4,389)	(3,678)	(4,425)	(4,734)
Cash Flow from Financing	(3,687)	(1,483)	(3,866)	(3,059)	(5,020)
Free Cash Flow	3,312	1,080	2,870	4,096	5,375
Net Debt	(1,922)	(1,899)	(962)	(2,049)	(2,450)
Change in Net Debt	(409)	2,929	749	279	(688)

Key Balance Sheet Data

Property, Plant & Equipment	6,404	6,667	7,149	7,603	7,955
Other Non-Current Assets	5,169	5,383	5,922	5,892	5,867
Trade Receivables	0	0	0	0	0
Cash & Equivalents	1,922	1,899	962	2,049	2,450
Other Current Assets	38,812	56,220	59,307	68,028	67,506
Total Assets	52,308	70,168	73,340	83,572	83,778
Long-Term Debt	0	0	0	0	0
Other Non-Current Liabilities	1,999	2,299	2,330	2,356	2,383
Short-Term Debt	0	0	0	0	0
Other Current Liabilities	32,764	47,057	49,324	57,867	56,132
Total Liabilities	34,763	49,355	51,654	60,223	58,514
Total Equity	17,545	20,813	21,686	23,350	25,264
Total Equity & Liabilities	52,308	70,169	73,340	83,573	83,778

iQmethodSM - Bus Performance*

Return On Capital Employed	33.0%	39.0%	21.2%	25.6%	24.4%
Return On Equity	34.3%	39.2%	23.5%	28.0%	27.6%
Operating Margin	4.7%	4.5%	2.6%	2.8%	2.9%
EBITDA Margin	5.2%	4.8%	2.9%	3.1%	3.3%

iQmethodSM - Quality of Earnings*

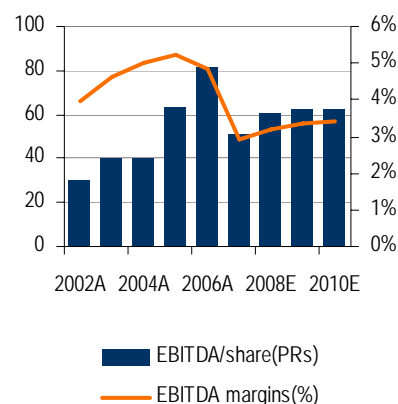
Cash Realization Ratio	0.9x	0.2x	1.0x	0.9x	1.0x
Asset Replacement Ratio	1.5x	0.4x	2.0x	1.4x	1.3x
Tax Rate (Reported)	38.5%	35.4%	35.0%	35.0%	35.0%
Net Debt-to-Equity Ratio	-11.0%	-9.1%	-4.4%	-8.8%	-9.7%
Interest Cover	26.5x	13.0x	5.5x	10.3x	13.1x

Key Metrics

Company Description

PSO is the largest oil and petroleum lubricant marketing play with a market share in excess of 65%. PSO enjoys extensive reach controlling over 3,800 retail outlets across the country. The government of Pakistan (GoP) maintains an effective 52% stake in the company through a 26% direct ownership and 26% ownership via 100% state-owned enterprises (National Investment Trust and Investment Corporation of Pakistan).

Chart 1: EBITDA /share (PRs) and EBTDA margin (%) trend



Source: PSO, Merrill Lynch Estimates

Stock Data

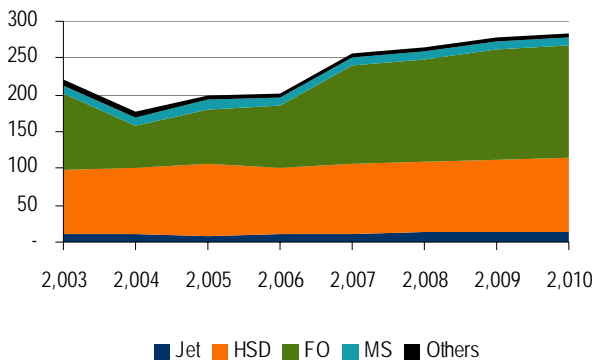
Price to Book Value 3.1x

Investment thesis

Strong volume growth forecast

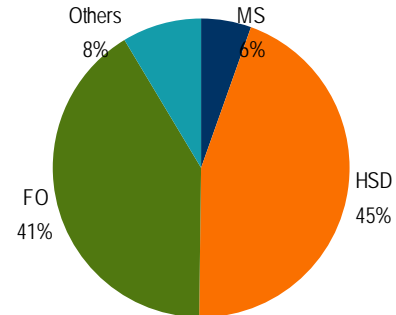
We believe PSO is poised to achieve strong volume growth, driven by its various initiatives: (1) Beefing up quality and focusing on convenience (2) Investing in retail network expansion and refurbishment, and (3) Increasing focus on high-margin products. We estimate volume CAGR of 7.5% over 2006-2010E. All these initiatives are likely to enable PSO in maintaining its current overall market share of 65%, in our view.

Chart 2: Furnance oil leading PSO volume growth ('000'bopd)



Source: PSO< Merrill Lynch Estimates

Chart 3: PSO: Volume breakdown



Source: PSO. Merrill Lynch

PSO: synthetic exposure to electricity demand

We see increased government dependence on fuel oil to meet Pakistan's growing electricity needs. This, we believe is a result of inadequate supply addition in alternate sources. Pakistan is not only undergoing a shortage in inputs from gas for electricity generation, supply addition and load factor in hydel capacity too has been inadequate in meeting the electricity demand. We see the increased dependence translating into strong volume growth in power fuel sales in future and estimate FO volume CAGR at 15% over 2006A-10E. PSO is the biggest beneficiary of the rising demand for power fuel, as it has long-term supply contracts with IPPs covering 30% of the installed power capacity (50% of thermal capacity) in the country. The risk on such long-term supply contracts is low, as the government guarantees power fuel supply over the life of the power projects ranging 25-30 years. PSO holds an 80% market share in furnace oil segment and we estimate it achieves about 60% of its power fuel sales from its long-term agreements.

Factors that can yield potential upside to our assumptions

- Delays in capacity addition of non fuel-based electricity generation.
- Higher gas demand leading to supply cuts for existing power plants.
- Higher-than-expected increase in load factor of existing IPPs.

Exploring potential in the non-fuel segment

PSO is exploring potential in non-fuel retail sales and we believe the company is poised to benefit from this untapped potential. PSO expects to increase contribution from non-fuel retail sales (at the gross profit level) to PRs1bn by 2010E from PRs12mn (PRs0.7/sh) in 2006. With over 3,800 retail sites (66% of the industry's retail sites), PSO certainly has the advantage of extensive reach to consumers across Pakistan. Nonetheless, we have conservatively factored only 30% of management target into our earnings forecasts.

Favorable industry structure

In addition to strong volume growth, we believe PSO has the advantage of operating in an oligopoly (it dominates with 65% market share) and a favorable regulatory backdrop (which allows for stable marketing margins of 3.5% on retail prices).

Investment projects - advantages of a strong balance sheet

Key investment projects in the oil downstream sector in which PSO is likely to focus on are: (1) Oil storage and oil pipeline. (2) Setting up an oil refinery. The oil storage and pipeline business offers stable returns (15-20%) that are generally linked to benchmarked throughput capacity. PSO would benefit strongly if it opts for backward integration into the refining business. As PSO has a cash-rich balance sheet, we do not expect it to face any problems in raising funds for the projects.

Potential privatization to add more value

The key areas from which the company's minority shareholders could benefit are: (1) Aggressive focus on high-margin products. (2) Settlement of receivables issue (PRs33/sh impact on cash flow). (3) Move towards an integrated model. (4) Restructuring of balance sheet.

Earnings decline of 34% in FY07E is already priced in

We expect PSO's FY07 earnings to decline by 34%, but believe the market has already incorporated the potential decline into the share price. The expected decline is due to an adjustment in the way marketing margins are calculated (done in April 2006), stock losses due to the oil price decline in IHFY07 and fall in other income.

Potential near-term drivers and risks

The key catalysts for share price performance in the short term are: (1) Developments related to PSO's potential privatization, (2) Earnings announcements, (3) Investments in projects.

Key risks: (1) Sustained decline in product prices, leading to lower retail prices and decline in margins for PSO. (2) Drop in consumption of power fuel (furnace oil) for electricity generation. (3) Exchange rate risk. (4) Government intervention in the business. (5) Continuation of current contracts signed with external parties. (6) Slowdown in economic activity (7) Delays in privatization, affecting investor sentiment.

Power deficit is key to growth



Farrah Marwat ^^^^
Research Analyst
KASB Securities

Joseph Jacobelli >>
Research Analyst
Merrill Lynch (Hong Kong)
joseph_jacobelli@ml.com

+852 2161 7381

Power deficit hits a new high...

Driven by huge power hunger and demand-supply imbalance, Pakistan's power crisis has hit a crescendo and we believe the situation will only magnify hereon. Power demand growth of 10.2% YoY was the highest ever witnessed in FY06 and is estimated to grow at 8.7% CAGR over next four years. Driving the electricity demand is high GDP growth and increasing infrastructure development in urban centers. Current power deficit of 1.1GW is expected to magnify to 2.5GW within next three months and widen further in FY09.

...and throws open growth avenues

Driven by the chronic power shortage, we eye new long-term growth avenues for Pakistan's key power players. The Pakistani government has launched an aggressive generation target, which could raise domestic capacity by 69% by 2016E. Key IPPs are well poised for expansions (announced and under consideration), in our view, benefiting from secure, rich and transparent free cash flows (FCF) plus strong, low-leveraged balance sheets.

High yield is the catch word

Structured as low risk, fixed life projects, IPPs in Pakistan have long operated on the premise of maximum payout, where companies deliver the bulk of FCF as dividends. Declining debt balances remove the restrictions on dividend payout as well as lead the upward trend of FCF.

Regulatory framework strips off risks

We believe regulatory fundamentals augment the stable, low risk environment for IPPs where long-term PPAs provide a strong safety net for FCF generation and pre-empted offtake risk. The PPAs build in a minimum US dollar-based IRR and earnings stability via insulation against demand-supply vagaries, rising fuel costs, exchange rate fluctuations and CPI inflation in the US.

Improved macro environment lends credence

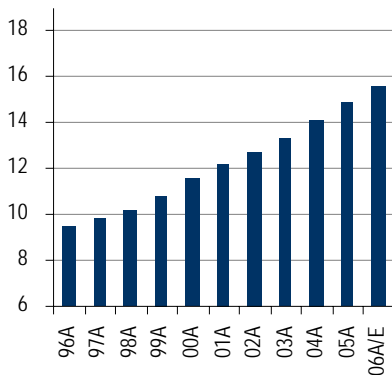
Catering to a sole state-owned customer, namely, Wapda (Water and Power Development Authority), we view the IPPs as a call on the financial health of the government. Buoyant GDP growth and high US dollar reserves suggest Pakistan is better poised for this growth wave and is far away from the troubles faced in 1990s.

Table 1: Power sector dynamics

	FY06	FY07E	FY08E
Installed capacity (MW)	19,450	19,450	19,610
Generation (TWh)	91.44	97.47	98.27
Demand (TWh)	67.60	73.52	79.77
Demand growth	10.2%	8.8%	8.5%
IPP as % of capacity	30%	30%	30%
% thermal capacity	64%	64%	64%
% hydro capacity	33%	33%	33%

Source: KASB Estimates, Energy Yearbook

Chart 1: Growth in electricity consumers (mn)



Source: Economic Survey of Pakistan

Power shortage spells growth for IPP

Pakistan is plunging into the initial stages of a massive power shortage. We forecast a 40% rise in the country's electricity demand by 2010E, propelled by an expanding economy and pent-up demand. The government has initiated an aggressive generation expansion plan to arrest the growing electricity shortage – 13.4GW (69%) by 2016 – and is committed to implementing it, both financially and in terms of policy.

Herein lies the newfound long-term earnings growth opportunity for Pakistan's Independent Power Producers (IPPs), where secure, high and transparent free cash flows, as well as strong lowly geared balance sheets support new capacity addition plans. Rich, low-risk cash flows have resulted in a dividend-heavy policy and IPPs are committed to delivering the bulk of free cash flows as dividends.

The potential growth plans coincide with a marked difference in the economic environment, lending credence to the regulatory framework - a key driver for IPP stocks. While long-term solid Power Purchase Agreements (PPAs) with government-owned transmission and distribution company, Wapda, regulate (and cap) earnings, they also proffer the "safety net" to both offtake and cash flows.

Attractive PPAs reduce risks

Large and highly stable IPP cash flows are a result of pre-determined tariff structure outlined in the PPA at the time of project inception. Investors have long bemoaned the indexed tariffs, as they cap the upside earnings potential. By virtue of the tariff, IPP cash flows come with an inbuilt earnings floor as well as indemnity to the host of variables that could endanger expected dividends.

First off, IPPs are stripped of practically all operating risks. The tariff framework ensures US dollar-denominated revenue streams (including a US dollar-based minimum IRR) where both capacity and offtake tariffs are pegged to the greenback. Hence IPP cash flows are insulated against movements in exchange rates. The PPA also ensures immunity to fuel cost, inflation and other operating expenses.

In addition, IPPs are unaffected by demand-supply dynamics in the power sector. In the current scenario in Pakistan, where there has been an explosion in electricity demand, this clause effectively neutralizes any demand-driven upside to earnings. In the longer term, however, we believe demand neutrality will play out in favor of these companies. As the government targets new and potentially cheaper sources of electricity over the next five years, IPPs are guaranteed capacity payments at a minimum capacity of 65% even at zero operation, so long as they can maintain plant availability at Wapda's required level.

Demand outstripping supply

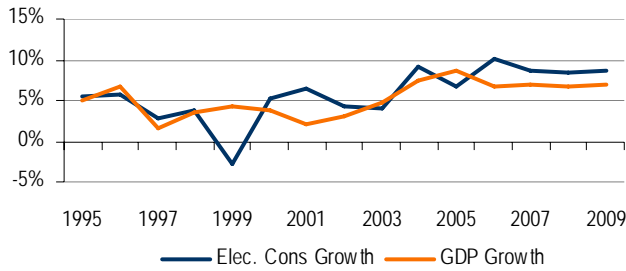
A classic case of an emerging market in the throes of unprecedented growth, Pakistan finds itself short of power. In short, the industry simply cannot generate enough electricity to meet the country's rapid growth in power demand. Driving the demand is a host of factors – high economic and industrial growth with GDP and LSM (Large Scale Manufacturing) growth expected to exceed 6% and 16%, respectively, over the next three years, current low electricity penetration, annual population growth of 1.8% with an increasing drift toward urbanization and the government's rural electrification program. We expect electricity demand to grow by at least 1.25x GDP over the next couple of years.

Table 2: Electricity demand vs GDP growth

(% growth)	GDP	Electricity	Elec/GDP (x)
1995A	5.1%	5.5%	1.1
1996A	6.6%	5.8%	0.9
1997A	1.7%	2.8%	1.7
1998A	3.5%	3.9%	1.1
1999A	4.2%	-2.9%	-0.7
2000A	3.9%	5.3%	1.4
2001A	2.0%	6.6%	3.3
2002A	3.1%	4.2%	1.4
2003A	4.7%	4.0%	0.9
2004A	7.5%	9.2%	1.2
2005A	8.6%	6.7%	0.8
2006A	6.6%	10.2%	2.0
2007E	7.0%	8.8%	1.3
2008E	6.8%	8.5%	1.3
2009E	7.0%	8.8%	1.3
2010E	7.0%	8.8%	1.3

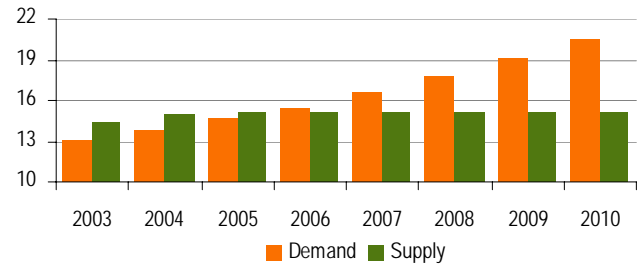
Source: KASB estimates, Economic Survey of Pakistan

Chart 2: Pakistan: Electricity consumption and GDP growth



Source: Economic Survey of Pakistan, KASB forecasts

Chart 3: Demand/supply gap widening



Source: PPIB

Current supply deficit of 1.1GW is expected to magnify to 2.5GW by 2HFY07E and likely touch 5.5GW by 2010E in a zero-supply addition scenario, potentially derailing the country's growth. Clearly, more power is needed and the government has laid out an aggressive generation plan, parking the electricity industry on the brink of mega expansion.

Table 3: Targeted capacity expansions

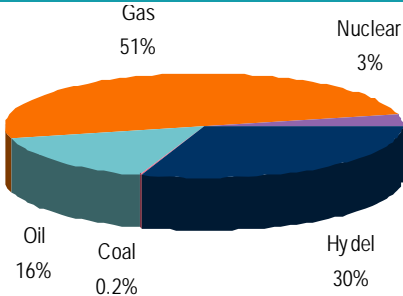
Category	No.	Cap. (GW)	Cost (US\$m)
Gas	6	1.17	881
Dual Fuel	7	1.60	1,200
Hydel	22	5.72	6,450
Coal	5	2.55	2,550
Oil	10	2.36	1,766
Total	50	13.40	12,847

Source: PPIB, COD: Commercial Operation Date

Supply lagging, but help is on the way

The Pakistani government has stepped up efforts to attract fresh investment in the sector and is in the process of setting up new tariffs for potential entrants. Meanwhile, existing IPPs have been asked to explore the possibility of further expansion, with key IPPs keen on expansion/acquisition projects. So far, a total of 50 potential projects with a combined capacity of 13.4GW have been proposed by the PPIB and are up for bidding by private sector investors.

Chart 4: Power generation by fuel source



Source: Energy Yearbook of Pakistan

Present and future fuel mix

How the supply expansion will be fueled is the big question. At present, power generation is gas heavy, as over the last 10 years, cheaper fuel has replaced furnace oil as the key generation fuel. The shortage in domestic gas has however reached a point where several industries are not provided gas during winter months and this shortage is set to magnify substantially over the years. For the upcoming expansion wave, the government has initially targeted minimal dependence on furnace oil, which has gradually been revised to incorporate more furnace oil-based expansion. If and when all of the targeted capacity comes on stream, we expect Pakistan's fuel requirements to scale up dramatically.

Not a 1990s flashback

Given the quantum of supply addition, one may be inclined to draw parallels to the late 1990s when a major destabilization of Pakistan's power sector resulted from rapid capacity addition in electricity. The supply surge led to problems at several ends. On one hand, demand did not pick up as anticipated and the result was excess generation capacity by late 1990s. Meanwhile, with the huge payments to the then cash-starved Wapda falling, it did not take long for the state-owned utility to realize that the contracts with the IPPs were unfeasible for it to service. This resulted in a bitter tariff dispute in 1998, which was resolved in 2000 and led to a reduction in tariffs for almost all IPPs. We do not expect a repeat performance this time around.

From the demand point of view

It is vital to point out that we expect more than 7% GDP growth over the next couple of years compared to 3-4% the last time electricity generation capacity expanded rapidly and demand died out.

Moving on to potential tariff revision

Given the urgency with which new sources of electricity are required by the power-starved country, we believe the government cannot afford to renegotiate IPP tariffs at this juncture. As new projects are slated to flow in at least until 2014, we believe the government will most likely have its hands tied even if it wants to reduce overzealous returns offered to bring private interest in.

Macro stability - a plus for IPPs

With Wapda as the sole customer buying power, the fate of the IPPs is irrevocably tied to the former's financial health, which may be weak but is strongly supported by the government. Given that Wapda is 100% state-owned, what we are really talking about here is the government's ability and willingness to pay for IPP power. The government's track record on financial support to Wapda is good and we believe it will come to the rescue of its distribution company, whenever it calls for in future. We view the IPPs as a proxy for government liquidity. The tide has turned on the latter, with US dollar reserves currently at US\$12.5bn compared to US\$1.75bn during the 1998 power sector crisis. We believe Wapda default is not on the cards this time.

Why the Pakistani government can afford the IPPs?

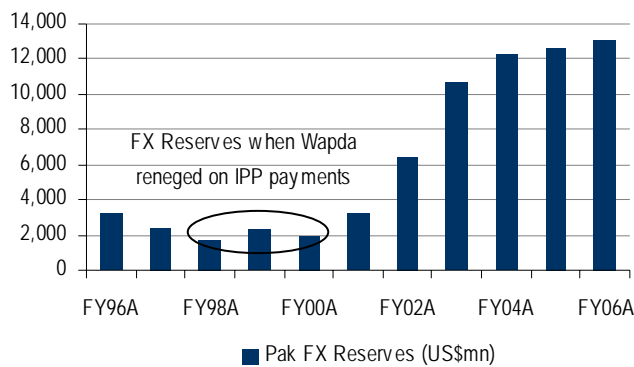
Burgeoning foreign exchange reserves are essential for the government to be able to back Wapda's payment needs. This is especially so, given that almost all IPPs are set up by foreign companies. As returns to these investors come through dividends, repatriation of US dollar-based returns has long remained the primary concern of these companies. The entire fallout in 1990s between Wapda and the IPPs was driven to its crescendo by the fact that the government simply did not have the liquidity to back up Wapda's payments. In a sea change from those days, the current economic climate suggests that the Pakistani government now has the financial muscle to support its power distribution company.

Table 4: Pak economic statistics: FY98 vs FY06

	98A	06A
GDP growth %	3.5	6.6
Forex reserves (US\$bn)	1.74	13.1
External debt/ GDP	75%	29%
Budget deficit as % of GDP	7.7%	4.2%

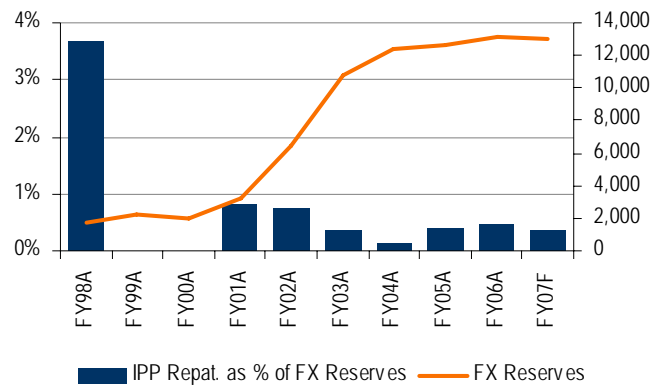
Source: KASB Research, SBP

Chart 5: FX reserves have turned the corner



Source: KASB estimates, SBP

Chart 6: IPP dividend repatriation as percentage of FX reserves



Source: KASB estimates, SBP, Companies

High yield with a growth kicker

Equity | Pakistan | Independent Power Producers
5 July 2007



Farrah Marwat ^^^^
Research Analyst
KASB Securities

The best avenue to tap power hunger

Hubco, our top pick in the Pakistan utilities space, is an ideal proxy for exposure to Pakistan's huge power hunger and demand supply imbalance. The company has gone into expansion mode, announcing a 225MW new plant. The project only adds 18% to Hubco's capacity but delivers proof of serious growth intent and could trigger re-rating of the stock from a value to growth play.

Strong balance sheet signals further growth

Hubco's profile is enhanced by its strong and largely un-leveraged balance sheet. We view the 225MW project as just the beginning of its expansion drive where 6-8 other projects are under consideration. Pay-off of senior debt (FY05) takes net debt/capital to 24:76, leaving ample room to leverage the balance sheet. Hubco can raise up to US\$580mn in debt vs. a mere US\$192mn needed for this project.

A champion yield play

Growth potential is backed by solid valuations. Structured to pay out the bulk (70% average) of free cashflows (FCFs) as dividends, Hubco has long been an attractive yield theme. Stronger FCF generation is the key behind our forecast of Hubco's five-year DPS CAGR of 12.6% over FY06-11.

Risk free operating environment

A pre-defined, indexed tariff covers fuel, operating and financial expenses, leaving the financial state of its sole customer (Wapda) as the only potential risk factor, which we believe is not significant given the government ownership of Wapda.

Estimates (Jun)

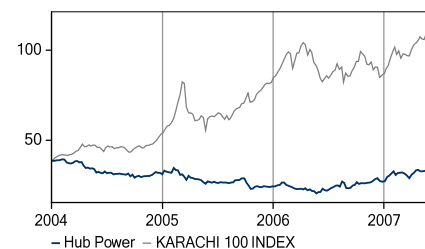
(PRs)	2005A	2006A	2007E	2008E	2009E
Net Income (Adjusted - mn)	5,385	2,768	2,795	3,042	3,497
EPS	4.65	2.39	2.42	2.63	3.02
EPS Change (YoY)	-1.4%	-48.6%	0.9%	8.8%	15.0%
Dividend / Share	1.30	3.10	2.78	3.00	3.45
Free Cash Flow / Share	3.71	3.29	4.09	0.208	(1.17)
ADR EPS (US\$)	1.96	0.999	0.997	1.08	1.25
ADR Dividend / Share (US\$)	0.548	1.29	1.15	1.24	1.42

Valuation (Jun)

	2005A	2006A	2007E	2008E	2009E
P/E	7.74x	15.05x	14.91x	13.70x	11.91x
Dividend Yield	3.61%	8.61%	7.72%	8.32%	9.57%
EV / EBITDA*	5.63x	8.46x	8.91x	8.85x	8.46x
Free Cash Flow Yield*	10.30%	9.15%	11.35%	0.577%	-3.25%

Stock Data

Price (Common / ADR)	PRs36.00 / US\$14.89
Price Objective	PRs40.15 / US\$10.78
Date Established	27-Jun-2007 / 27-Jun-2007
Investment Opinion	C-1-7 / C-1-7
Volatility Risk	HIGH / HIGH
52-Week Range	PRs21.45-PRs39.35
Market Value (mn)	US\$688
Shares Outstanding (mn)	1,157.2 / 46.3
Average Daily Volume	6,099,433
ML Symbol / Exchange	HUPWF / KAR
ML Symbol / Exchange	HUPOF / LUX
Bloomberg / Reuters	HUBC PA / HPWR.KA
ROE (2007E)	9.5%
Net Dbt to Eqty (Jun-2006A)	22.9%
Est. 5-Yr EPS / DPS Growth	18.6% / 12.6%
Free Float	45.0%



05 July 2007

iQprofileSM Hub Power Company Ltd.

Key Income Statement Data (Jun)	2005A	2006A	2007E	2008E	2009E
(PRs Millions)					
Sales	16,978	27,911	44,924	43,615	46,062
Gross Profit	8,799	6,007	5,673	5,721	5,980
Sell General & Admin Expense	(184)	(270)	(227)	(236)	(245)
Operating Profit	6,963	4,078	3,866	3,976	4,294
Net Interest & Other Income	(1,577)	(1,309)	(1,071)	(934)	(797)
Associates	0	0	0	0	0
Pretax Income	5,385	2,768	2,795	3,042	3,497
Tax (expense) / Benefit	0	0	0	0	0
Net Income (Adjusted)	5,385	2,768	2,795	3,042	3,497
Average Fully Diluted Shares Outstanding	1,157	1,157	1,157	1,157	1,157

Key Cash Flow Statement Data

Net Income (Reported)	5,385	2,768	2,795	3,042	3,497
Depreciation & Amortization	1,652	1,659	1,580	1,509	1,441
Change in Working Capital	(666)	289	(374)	(399)	17
Deferred Taxation Charge	0	0	0	0	0
Other Adjustments, Net	(1,927)	(868)	857	889	45
Cash Flow from Operations	4,444	3,848	4,857	5,042	5,000
Capital Expenditure	(155)	(38)	(127)	(4,802)	(6,354)
(Acquisition) / Disposal of Investments	1,368	151	0	0	0
Other Cash Inflow / (Outflow)	NA	NA	NA	NA	NA
Cash Flow from Investing	1,213	113	(127)	(4,802)	(6,354)
Shares Issue / (Repurchase)	NA	NA	NA	NA	NA
Cost of Dividends Paid	(1,504)	(4,454)	(3,747)	(3,341)	(3,727)
Cash Flow from Financing	(5,422)	(6,636)	(4,726)	(422)	3,090
Free Cash Flow	4,289	3,811	4,730	240	(1,354)
Net Debt	7,229	6,866	5,884	8,984	14,065
Change in Net Debt	(4,152)	493	(982)	3,100	5,081

Key Balance Sheet Data

Property, Plant & Equipment	34,940	33,325	31,872	35,164	40,077
Other Non-Current Assets	162	4	4	4	4
Trade Receivables	1,444	2,938	3,772	3,445	3,705
Cash & Equivalents	6,038	3,363	3,367	3,186	4,922
Other Current Assets	4,052	3,885	4,744	4,500	4,496
Total Assets	46,636	43,515	43,760	46,299	53,203
Long-Term Debt	10,229	9,250	8,272	11,191	17,426
Other Non-Current Liabilities	5	15	17	19	22
Short-Term Debt	3,038	979	979	979	1,561
Other Current Liabilities	1,692	3,286	5,460	5,376	5,692
Total Liabilities	14,964	13,530	14,727	17,565	24,700
Total Equity	31,672	29,985	29,032	28,733	28,503
Total Equity & Liabilities	46,636	43,515	43,760	46,299	53,203

iQmethodSM - Bus Performance*

Return On Capital Employed	14.0%	9.2%	9.4%	9.6%	9.3%
Return On Equity	18.1%	9.0%	9.5%	10.5%	12.2%
Operating Margin	41.0%	14.6%	8.6%	9.1%	9.3%
EBITDA Margin	50.7%	20.6%	12.1%	12.6%	12.5%

iQmethodSM - Quality of Earnings*

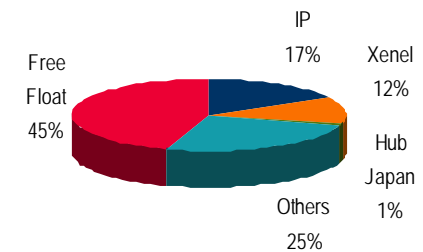
Cash Realization Ratio	0.8x	1.4x	1.7x	1.7x	1.4x
Asset Replacement Ratio	0.1x	0x	0.1x	3.2x	4.4x
Tax Rate (Reported)	NM	NM	NM	NM	NM
Net Debt-to-Equity Ratio	22.8%	22.9%	20.3%	31.3%	49.3%
Interest Cover	3.9x	2.6x	2.9x	3.3x	4.0x

Key Metrics

Company Description

The Hub Power Company (Hubco) is a 1,292MW thermal power producer and Pakistan's second-largest independent power producer. The plant operates on Residual Fuel Oil, courtesy an exclusive contract with Pakistan State Oil. Hubco supplies power primarily to state-owned Wapda under a 30-year power purchase agreement, which insulates it from most operating risks and cushions via a sovereign guarantee.

Chart 5: 1: Hubco Shareholding (FY06A)



Source: Company Accounts

Stock Data

Shares / ADR	25.00
Price to Book Value	1.4x

An avenue to tap power hunger

With the announcement of a 225MW expansion, Hubco moves up a notch in our liking. The announced expansion (1) augments the company's future growth profile; (2) allows Hubco to tap the growing national power hunger and (3) signals seriousness of management intent to become a broad based energy investment vehicle in Pakistan. We highlight that this expansion is in our view just the beginning of the company's expected growth drive and could potentially trigger re-rating of the stock from a value to growth theme.

Expansion project - 225MW by 2010

The 225MW project, based in the Punjab province, is intended to be RFO (Residual Fuel Oil) fired. Hubco will be completing the project under the government's fast track project scheme for power generation, which provides a guaranteed 15% IRR over the life of the project as compared to 12.06% IRR (US\$ based) guaranteed on Hubco's current plant at Hub, Baluchistan project. The project is expected to kick off operation in FY10 and raises our PO from PRs38.72/sh to PRs40.15/sh.

With room on the balance sheet for more

We believe the current announced expansion is not the culmination of Hubco's growth strategy. Low leverage coupled with a healthy and rising cash balance implies a number of options available to Hubco as the company has the ability to raise substantial debt to finance its future growth-oriented strategy.

With the repayment of senior debt in FY05, the company's balance sheet has been largely cleaned up. Hubco currently has a sizeable and largely un-leveraged balance sheet, where the remaining outstanding debt is scheduled to be paid off by FY16E (debt repayment is fixed in the PPA). The repayment of debt also spells out the end of debt related covenants, which include a limit on dividend payout, a minimum debt repayment reserve and a bar on any further investments.

Currently, net debt to capital has come down significantly to only 24% (net debt to equity of 23%) and we calculate that the company can raise an additional PRs34.75bn (US\$580mn) in debt on its balance sheet as per the central bank's debt limits of maximum 60:40 debt to equity financing. With the announced project expected to utilize only US\$180mn of debt raisable, we believe Hubco will continue to work on further expansion projects.

And the growth intent is visible

Apparently, a new management with a more aggressive outlook comes hand in hand with the cleared out balance sheet and excess free cash. The company's management changed last year with the appointment of a new CEO. The Board of Directors' re-election in September 2006 has brought in new faces to the board as well. And an all-new Project Management department implies that Hubco does seriously want to use its excess cash more productively.

Targeting new generation projects

Hubco, while not planning for any capacity expansion at its own site, is pre-qualified to participate in the bidding for three power projects (of ~0.45GW each) launched by the PPIB – refer to PPIB projects (Uch 2, Faisalabad, Lahore) in the table below. The company has also expressed an interest in a number of smaller power generation projects across Pakistan as well as a potential JV partnership in a coal-based power plant under consideration by the government.

Yield star - high and sustainable

Designed as a fixed life project with rich free cashflow (FCF) generation, Hubco has historically held up its commitment to distributing the bulk of FCFs as dividends, paying out on average 70% of FCFs in the past five years. We expect Hubco to maintain high FCF distribution as dividends. Meanwhile, the growth in FCFs, and hence, dividends is led by: (1) debt retirement freeing up cash flows and removing debt covenants, and (2) the expected jump in the ROE component of Hubco's tariff in FY09.

Free cash flows are the key

The expected dividend growth stems from the increasing FCFs generated by Hubco. Since FCFs are the predominant driver of the company's dividends, we are of the opinion that cash flows are more important than earnings in the case of Hubco. We expect cash flow to be on an uptrend on account of two factors:

1. Senior debt retired

Repayment of senior debt in 2005 means the debt coverage component of Hubco's tariff is now on the decline. But debt repayment also implies the freeing up of cash flows (the company was required by debt covenants to maintain 12-month interest and principal repayment in a separate account whilst debt was outstanding). We do not expect the decline in tariffs on the debt front to have a major impact on Hubco's dividend paying capability.

2. ROE component spikes up in FY09E

We also point out that the debt related reduction in tariff is expected to be offset by a sharp increase in the ROE component of Hubco's tariff come in FY09E. Hubco's tariff was cut following a two-year tariff dispute with Wapda in 2000, where the equity return component was reduced by the rupee equivalent of US\$5.25mn/month over 1996-2008 as part of the settlement agreement with Wapda. After June 30 2008, the reduction from original project company equity is the rupee equivalent of US\$5.17mn/month. The resultant upswing in project company equity in FY09 boosts the earnings growth (and FCF, and hence dividend, growth) in Hubco's otherwise capped earnings that would grow at the rate of depreciation vs the US\$ and US CPI inflation.

Top yield, growth prospects – but all priced in

Highest dividend yield in APR utilities

Kapco offers the highest dividend yield in our Asian utilities universe (10.4% FY08E vs 3x regional average). Ongoing expansion means it is well-placed to take advantage of Pakistan's massive power shortfall. But a 46% rise in the stock price since January 2007 has priced in almost all the potential upside we see, even with possible expansion. Reiterate Neutral rating. Our DDM fair valuation is PRs53/share (DCF: PRs58.6/share).

Dividends tied to rising FCFs

Kapco generates substantial free cashflows (FCFs) – FY08E FCF yield of 12.7% – which are primarily used for dividend payouts. An expected steady increase in FCF means Kapco should continue to deliver compelling dividends.

Expansion on the cards

A 0.4-0.5GW expansion being considered could reignite earnings in FY10E and boost our fair value by 14.5% to PRs61.10. With low gearing (debt-to-capital of 28%), sizeable FCF and ample liquidity, Kapco's financial strength should allow the bulk of expansion to be funded via debt, without straining dividend payouts.

In-built safety cushion

We believe tame earnings growth expected over Kapco's life is the result of a tightly woven tariff arrangement, the upshot of which is immunity to fuel price movements, depreciation of the Pakistan rupee vs the US\$ and US CPI inflation. The result is a dollar-hedged IRR of 9% (12% in terms of PRs) over the remaining project life.

ROE on an upswing

We expect Kapco to sustain ROE at a minimum of 27% over the next five years, supported by a plant efficiency that ranks highest among its peers.

Estimates (Jun)

(PRs)	2005A	2006A	2007E	2008E	2009E
Net Income (Adjusted - mn)	8,048	5,317	5,386	5,470	5,675
EPS	9.14	6.04	6.12	6.21	6.45
EPS Change (YoY)	16.0%	-33.9%	1.3%	1.6%	3.8%
Dividend / Share	8.00	8.10	6.12	6.21	6.45
Free Cash Flow / Share	9.17	10.93	7.06	7.63	7.97

Valuation (Jun)

	2005A	2006A	2007E	2008E	2009E
P/E	6.58x	9.96x	9.83x	9.68x	9.33x
Dividend Yield	13.30%	13.47%	10.17%	10.33%	10.72%
EV / EBITDA*	5.12x	5.12x	5.16x	5.09x	4.99x
Free Cash Flow Yield*	15.24%	18.18%	11.73%	12.68%	13.26%

Equity | Pakistan | Independent Power Producers
5 July 2007



Merrill Lynch

Farrah Marwat ^^^^

Research Analyst
KASB Securities

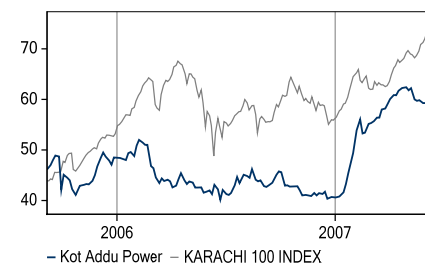
Joseph Jacobelli >>

+852 2161 7381

Research Analyst
Merrill Lynch (Hong Kong)
joseph_jacobelli@ml.com

Stock Data

Price	PRs60.15
Investment Opinion	C-2-7
Volatility Risk	HIGH
52-Week Range	PRs39.10-PRs62.75
Mrkt Val / Shares Out (mn)	US\$874 / 880.3
Average Daily Volume	1,458,416
ML Symbol / Exchange	XEQLF / KAR
Bloomberg / Reuters	KAPCO PA / KAPCO.KA
ROE (2007E)	26.8%
Net Dbt to Eqty (Jun-2006A)	22.3%
Est. 5-Yr EPS / DPS Growth	4.9% / 2.8%
Free Float	18.0%



05 July 2007

iQprofileSM Kot Addu Power Company Ltd.

Key Income Statement Data (Jun)	2005A	2006A	2007E	2008E	2009E
(PRs Millions)					
Sales	27,564	32,833	33,656	35,221	36,414
Gross Profit	11,374	11,389	11,299	11,483	11,713
Sell General & Admin Expense	(146)	(165)	(177)	(189)	(203)
Operating Profit	9,553	9,634	9,506	9,550	9,727
Net Interest & Other Income	(1,425)	(1,038)	(819)	(728)	(573)
Associates	NA	NA	NA	NA	NA
Pretax Income	8,129	8,597	8,687	8,822	9,154
Tax (expense) / Benefit	(81)	(3,279)	(3,301)	(3,352)	(3,478)
Net Income (Adjusted)	8,048	5,317	5,386	5,470	5,675
Average Fully Diluted Shares Outstanding	880	880	880	880	880

Key Cash Flow Statement Data

Net Income (Reported)	8,048	5,317	5,386	5,470	5,675
Depreciation & Amortization	1,675	1,590	1,616	1,743	1,783
Change in Working Capital	548	0	748	475	36
Deferred Taxation Charge	NA	3,163	261	265	275
Other Adjustments, Net	(1,093)	186	(1,577)	(950)	(73)
Cash Flow from Operations	9,178	10,257	6,433	7,002	7,697
Capital Expenditure	(1,108)	(631)	(222)	(289)	(677)
(Acquisition) / Disposal of Investments	NA	NA	NA	NA	NA
Other Cash Inflow / (Outflow)	41	667	(171)	(162)	(154)
Cash Flow from Investing	(1,066)	35	(393)	(452)	(831)
Shares Issue / (Repurchase)	0	0	0	0	0
Cost of Dividends Paid	(3,781)	(7,482)	(5,763)	(5,419)	(5,552)
Cash Flow from Financing	(6,039)	(9,689)	(6,771)	(6,442)	(6,453)
Free Cash Flow	8,070	9,626	6,211	6,713	7,019
Net Debt	7,194	4,488	4,211	3,080	1,767
Change in Net Debt	(4,327)	(2,706)	(276)	(1,131)	(1,313)

Key Balance Sheet Data

Property, Plant & Equipment	23,715	22,756	21,362	19,909	18,803
Other Non-Current Assets	688	18	18	18	18
Trade Receivables	2,331	3,115	2,805	2,935	3,035
Cash & Equivalents	3,762	4,366	3,635	3,744	4,156
Other Current Assets	6,234	4,023	7,626	8,239	8,363
Total Assets	36,730	34,278	35,446	34,844	34,374
Long-Term Debt	8,854	7,847	6,824	5,923	5,067
Other Non-Current Liabilities	259	3,418	3,247	3,085	2,931
Short-Term Debt	2,102	1,007	1,023	901	856
Other Current Liabilities	3,229	1,884	4,347	4,616	4,803
Total Liabilities	14,443	14,156	15,441	14,524	13,656
Total Equity	22,287	20,122	20,005	20,320	20,718
Total Equity & Liabilities	36,730	34,278	35,446	34,844	34,374

iQmethodSM - Bus Performance*

Return On Capital Employed	27.1%	18.6%	19.1%	19.8%	20.6%
Return On Equity	40.6%	25.1%	26.8%	27.1%	27.7%
Operating Margin	34.7%	29.3%	28.2%	27.1%	26.7%
EBITDA Margin	40.7%	34.2%	33.0%	32.1%	31.6%

iQmethodSM - Quality of Earnings*

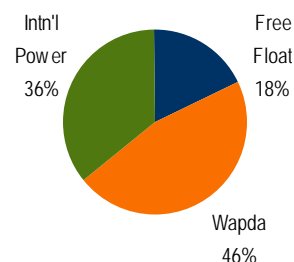
Cash Realization Ratio	1.1x	1.9x	1.2x	1.3x	1.4x
Asset Replacement Ratio	0.7x	0.4x	0.1x	0.2x	0.4x
Tax Rate (Reported)	1.0%	38.1%	38.0%	38.0%	38.0%
Net Debt-to-Equity Ratio	32.3%	22.3%	21.1%	15.2%	8.5%
Interest Cover	5.4x	6.6x	7.6x	8.7x	10.3x

Key Metrics

Company Description

With an installed capacity of 1,600MW, Kot Addu Power Company (Kapco) is the largest IPP in Pakistan. It holds the distinction of being the first multi-fuel fired power plant, having the capability of running on natural gas, furnace oil and high-speed diesel. Kapco was privatized in 1996 with International Power acquiring 36% of the government stake in Kapco. The company supplies power exclusively to state-owned Wapda.

Chart 1: Kapco shareholding pattern

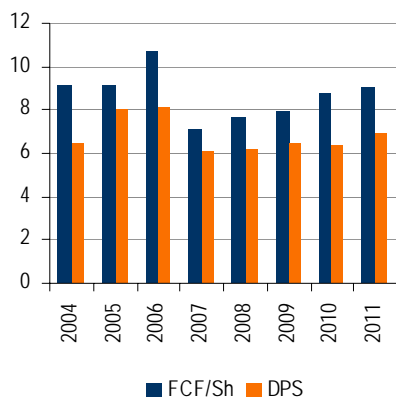


Source: Company Accounts

Stock Data

Price to Book Value 2.6x

Chart 2: Kapco pays bulk of FCF as dividends



Source: Company, KASB estimates

Dividend yield tops APR utilities

Kapco makes a compelling yield case, coming in with a dividend yield of 10.4% and FCF yield of 12.7% for FY08E. Since its inception, the company has remained committed to a maximum payout policy with the bulk of FCF distributed as dividends. Over the past five years, Kapco paid out an average 85% of FCF in dividends. This high dividend stream is also far more stable than most of its peers. In our view, Kapco will continue to deliver compelling dividend yield, coupled with high ROE and rising FCF, after a one-time dip in FY07 due to the expiry of a 10-year tax exemption.

Stability, yes...

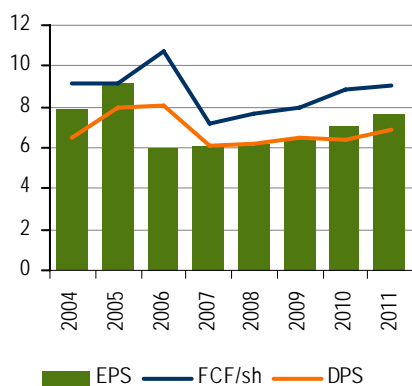
Kapco's tightly regulated tariff gives a high degree of stability to its earnings and cash flows, cushioning the company from fuel prices (and in fact, almost all relevant input prices). It also insulates Kapco from demand shocks – even if it generates zero electricity, it will continue to receive payments from Wapda based on 65% of capacity.

...but earnings growth? Not really

The flipside is that while the tariff cushions the downside it also caps earnings upside. Currently earnings growth is driven by three main factors: (1) indexation to US CPI inflation, (2) changes in PRs/US\$ exchange rate, and (3) higher thermal efficiency at Kapco's plant. That said, we highlight that Kapco's dividend payouts are linked to FCFs and not earnings.

A potential trigger for the company could be the government's announcement of a 10-15% GDR offering of the stock in FY08, thereby raising the stock's visibility.

Chart 3: FCFs, not earnings, drive DPS (PRs/sh)



Source: Company, KASB estimates

2007: First year sans tax exemption

FCF will be affected

FY06 marked the end of Kapco's 10-year exemption from corporate tax. The tax holiday, granted as an incentive at the time of its set-up, expired on 27 June 2006. From FY07 onwards, 35% corporate tax will be levied on the company. We expect Kapco's dividends for FY07 to take a sharp one-time dip due to this. However, the booking of deferred tax (PRs3.16bn) in FY06 means the decline in earnings itself will be negligible. After the dip in FY07, we expect earnings to rise steadily.

Healthy growth seen in FCF from FY08E onwards

More importantly, we see a healthy uptrend in Kapco's FCF given the gradual decline in interest payments on debt. Unlike other IPPs, Kapco does not have to maintain cash reserves to meet its debt servicing obligations because Wapda (the company's sole lender and customer) pays Kapco the net amount accruing for capacity payments after debt deduction.

FY06 payout of 130% is proof that for Kapco, cashflow, and not earnings, determines dividend payments. Hence, we believe the higher tax liability on account of deferred taxes (over FY07-09E) will not dent Kapco's dividend payments.

While we forecast higher growth in FCFs, we conservatively keep our dividend expectations on the flatter side (<100% payout).

The efficiency factor

Even with tightly regulated tariffs, Kapco squeezes in an efficiency premium. This, in our view, boosts its ROE to levels higher than those achieved by its peers.

While fuel cost is a pass-through item in the tariff, Kapco's efficient fuel consumption yields a cost-saving element for the company. As the only multi-fuel-fired plant in Pakistan, Kapco's efficiency benefits from optimal use of the fuel mix and we believe this cost advantage will continue in the future.

Table 1: Kapco: ROE higher than that for peers

	2003A	2004A	2005A	2006A	2007E	2008E	2009E	2010E
EBIT margin (%)	34%	40%	36%	31%	30%	28%	28%	28%
Asset turnover (x)	0.63	0.66	0.75	0.96	0.95	1.01	1.06	1.10
Interest burden (x)	0.06	0.06	0.05	0.04	0.04	0.03	0.03	0.02
Financial leverage (x)	2.27	1.90	1.65	1.70	1.77	1.71	1.66	1.60
Tax burden (x)	0.98	1.04	0.99	0.62	0.62	0.62	0.62	0.65
Return on equity (%)	34%	40%	36%	26%	27%	27%	27%	29%

Source: Company, KASB estimates

Power hunger = New lease on growth

With power shortage looming in Pakistan, a newfound growth angle has emerged among the major domestic power players, including Kapco. The government is looking to add to generation supply on an urgent basis. With a massive supply growth target in mind, the Private Power Infrastructure Board (PPIB) has listed 50 potential power projects that could add almost 13.4GW to the existing capacity of 19.4GW. Investment is sought from the private sector, with the government approaching existing IPPs to consider capacity expansion plans.

Potential expansion of 0.4–0.5GW

Kapco has said that it is seriously considering a 0.4-0.5GW expansion at its current plant site. The project is intended to be a dual-fuel generation plant, capable of running on both gas and furnace oil. The company has already received the PPIB's approval to go ahead with the expansion, which we believe could boost its earnings from FY10E onwards.

Kapco awaits agreement on a mutually acceptable tariff for both itself and the regulator. Should the potential expansion be finalized, the financial close of the project is likely to be December 2007, in our view. Allowing for a three-year construction period, the new plant could be operational by December 2010.

Sensitivity analysis: Potential expansion could lift fair value by 14.5% to PRs61.10

We have not factored the potential expansion into our current valuations. Our sensitivity analysis is based on a project size of 0.45GW at a cost of US\$350mn (PRs21bn at current exchange rate of PRs60/US\$).

- We assume a 25-year term for the project.
- We use management guidance that the new project is likely to be 80% debt financed with 20% equity contribution. Given Kapco's strong balance sheet (net debt-to-capital at 14%, total debt-to-capital at 28%) and good credit standing, it should be able to secure the required debt. Hence, we do not see dividend payments being adversely affected by the proposed expansion.
- As tariffs for the new project is still being determined, our calculations assume tariffs identical to those Kapco currently operates with.

Based on these assumptions, our theoretical fair value could rise about 14.5% to PRs61.10 if Kapco proceeds with its expansion plan.

Opportunities abound

Opportunities continue to exist

In the aftermath of deregulation, the telecom sector has witnessed phenomenal growth, at least in volumetric terms, with total teledensity at 42% (fixed + cellular) surpassing its emerging regional peers. The cellular side, buoyed by a growing economy and inactive SIMs, has grown exponentially (60mn subs currently from 12mn in 2005) and we think subscriber growth could start to taper off. However, abundant opportunities continue to exist in fixed line and overall revenue enhancement in the telecom space, with greater focus on value-added services.

Unique segment dynamics

While PTCL remains a major force in the sector, especially in fixed line (98% market share), other operators are giving the company a run for its money when it comes to wireless local loop (WLL), long distance and international (LDI), and cellular operations. Interestingly, all segments are at different stages of their life cycle with LDI fast headed towards becoming a commodity business and WLL still in its nascent stage. Competition-wise, price has been the preferred tool thus far, with quality and customer service taking a back seat.

Consolidation within and across segments likely

In line with other emerging markets, merger and acquisition (M&A) activity is kicking in Pakistan. Currently, it is predominantly international operators (China Mobile, SingTel, Qatar Telecom and Etisalat) interested in Pakistan that are taking the only available route of acquisition to gain exposure. Going forward, we believe consolidation is likely to span across segments, as players in maturing segments chase growth in others or look for integration with other players.

Regulatory environment pro-competition

The regulatory environment remains pro-competition. While providing an opportunity to smaller operators, the low barriers to entry, infrastructure sharing at reasonable rates, restrictions on pricing powers of Significant Market Players (SMPs) and aggressive tariff cuts pose a challenge for incumbent PTCL. However, the regulator has also come in for some criticism for rushing things too quickly, especially after the lackluster response to MNP launched earlier this year.

Lack of actionable ideas restricts choices

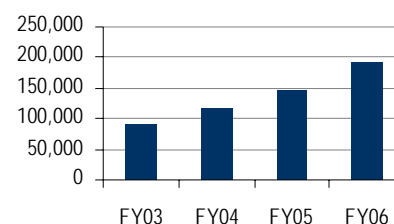
Despite the immense potential, lack of listed telecom companies restricts actionable and investable ideas. Out of 38 fixed and WLL, 12 LDIs and six cellular operators, only four companies are listed and PTCL is the only sizeable one of the lot and liquid.



Imtiaz Gadar, CFA ^^^^
Research Analyst
KASB Securities

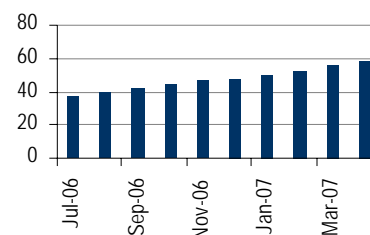
Khurram Ghufraan ^^^^
Research Analyst
KASB Securities

Chart 1: Telecom sector revenue (PRs mn)



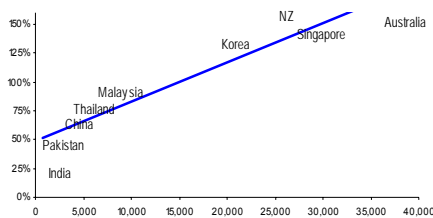
Source: PTA

Chart 2: Cellular subscribers



Source: PTA

Chart 3: GDP/capita vs teledensity



Source: Merrill Lynch estimates

Opportunities abound

In the aftermath of deregulation, the telecom sector has witnessed phenomenal growth, at least in volumetric terms, with total teledensity at 42% (fixed + cellular) in the past four years, surpassing its emerging regional peers. The cellular side, buoyed by a growing economy and inactive SIMs, has grown exponentially (60mn subs currently from 12mn in 2005) and we believe subscriber growth should start tapering off. However, abundant opportunities continue to exist in fixed line penetration and overall revenue enhancement in the telecom space, with increased focus on value-added services.

Unique segment dynamics

Having divided Pakistan's telecom sector into four segments – fixed wireline, fixed wireless, long distance and international (LDI), and cellular – we see a unique structure in each segment in terms of market share concentration. PTCL continues to dominate the fixed wireline segment, while market shares are more dispersed in the other three segments. Similarly, competitive practices also vary, but like all emerging markets, price invariably remains the preferred tool of competition.

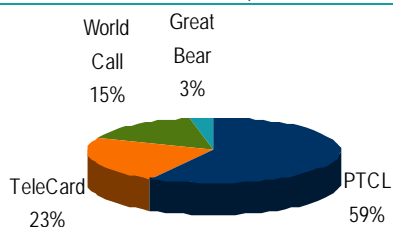
Fixed wireline – PTCL all the way

Given a 50-year head start in the segment, PTCL continues to dominate the fixed line segment, enjoying a market share of 98% with the rest lying with a cluster of area-specific operators. We do not expect the situation to change much anytime soon. As the high cost of laying copper lines poses a big barrier, the only dynamism in the sector comes from optic fiber networks targeting a triple play strategy, which will in turn slow down the growth in connections. However, given that PTCL too is exploring to aggressively enter the optic fiber domain through its Optic Fiber Access Network (OFAN) in Karachi, Lahore, Islamabad and Rawalpindi, its dominance in the segment should continue. Since optic fiber services are mostly targeted at the upper strata of the society, quality is a key competitive tool in this segment in addition to conventional price wars.

Fixed wireless – the way forward

While optic fiber would contribute a part, we believe the true growth in fixed line teledensity will come from WLL telephony given its effectiveness, in terms of cost and time, and suitability to Pakistan's geographic terrain. Not only is WLL more suitable for hilly areas as no digging is required, but it is also comparatively cheaper (US\$100-125 vs US\$250-275 per line for fixed wire line).

Chart 4: Market share in WLL, March 2007



Source: PTA

Launched in 2004, WLL has been slow to get off the ground. While growth has started picking up with a 71% increase in connections over 9MFY07, we believe it is still not substantial enough with net adds coming in at only 150,000-180,000 connections per month vis-à-vis the 2-2.5mn additions in cellular subscribers. While cellular companies continue to pose a threat, increased marketing activities by WLL operators and positioning in the right areas should bear fruit going forward, in our view.

In terms of market share, PTCL's declined from 64% to 58% over the last couple of years but still dominates the segment. Telecard, the first company in the private sector to explore the WLL segment, has a market share of 23% while Worldcall holds 15% of the market. Although competition has begun to heat up in the sector, we believe the market has enough room to accommodate existing operators.

LDI – headed towards consolidation

As expected, the segment started off with a bang in the period immediately following deregulation. However, the window of opportunity was short-lived. With all operators desiring to cash in on the opportunity, a price war ensued leading to lower tariffs and narrow margins. As a result, while international traffic continues to increase, revenue for LDI operators continues to recede. The segment, which has now reached maturity, is fast approaching consolidation with different operators being considered for acquisition. Qatar Telecom is all set to assume control of Burraq Telecom and newspaper reports said Oman Telecom is in talks to buy a majority stake in Worldcall.

Cellular –exponential growth to continue

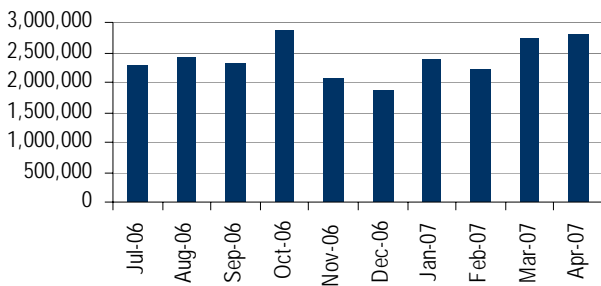
Cellular subscriber numbers continue to surpass expectations, with an average of 2.4mn net adds per month over the past nine months. The subscriber base, which stood at 8mn as of early 2005, rose to 60.9mn as of May 2007. While the growth is likely to continue over the short run, some tapering-off is expected and we forecast the cellular subscriber base to touch 100mn by 2010.

Initially the cellular segment was fueled by the introduction of Calling Party Pays regime in 2000. But the recent run-up in subscriber numbers could be attributed to (1) aggressive marketing campaigns with reduced tariffs and subsidized SIMs shaving upfront cost for subscribers, (2) falling handset rates, (3) gradual reduction in government taxes on cellular connections (from PRs2,000/SIM in 2003 to PRs1,000/SIM in 2004 and PRs500/SIM in 2005), and (4) increased coverage area (over 5,000 cities).

Market structure

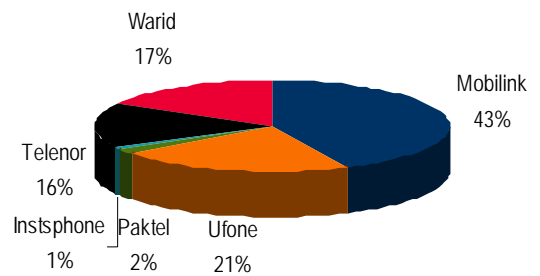
The cellular segment has long been dominated by Mobilink, the Orascom Telecom-backed brand which at one stage enjoyed a market share of around 64.5% among the four operators in the market. However, with the entry of international operators Telenor and Warid in early 2005, Mobilink’s market share has slipped to 43%. But Ufone has proved to be resilient in the face of stiff competition by maintaining a 21% market share, while Telenor and Warid each holds 16.5% of the market.

Chart 5: Monthly net additions of cellular subscribers



Source: PTA

Chart 6: Cellular market share, April 2007



Source: PTA

Rural telephony the final frontier

In a bid to capture additional market share, cellular operators have aggressively rolled out their network across the country. As a result, coverage in urban areas approaches 100% and much of the growth potential lies in rural areas. With the entry of China Mobile into Pakistan's cellular landscape, we expect competition to intensify before consolidation sets in. In addition, SingTel has recently acquired a 30% stake in Warid Telecom and this should further heighten competitive pressure in the industry.

Low ARPUs need to be seen in perspective

However, the sheen has been taken off the growth argument to some extent as current average ARPU's of US\$4 for cellular operators are among the lowest in the world and continue to decline. While growth via prepaid connections and declining tariffs has played their part, the role of inactive SIMs cannot be ignored. Inactive SIMs are assumed to have risen to 25% of outstanding SIMs and they represent not only a highly penetrated market but also a drag on ARPUs.

Mobile Number Portability no great shakes yet

More than two months into its launch, Mobile Number Portability (MNP) has been more or less a no-show. While official estimates of porting in and out of different networks are not available, a combined figure of 10,000 ports has been quoted in the press. Irrespective of the flow to and from networks, we believe the number remains largely insignificant to cause any concern to operators. With strong organic growth available in the market, cannibalization of other networks' subscribers has not appealed to cellular companies as yet.

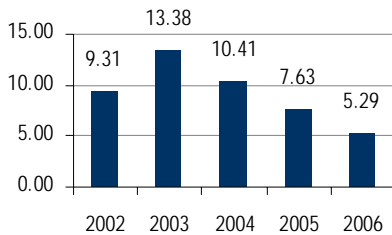
Pro-competition regulatory landscape

The regulator, Pakistan Telecommunication Authority (PTA), has adopted a pro-competition stance to date, providing smaller operators with an opportunity and PTCL a challenge. Low barriers to entry, infrastructure sharing on reasonable rates, restrictions on pricing powers of SMPs and aggressive rate cuts on international incoming have made the industry landscape tougher for PTCL. However, the regulator has also come in for some criticism of late for rushing things too quickly. After the cold response to MNP, cellular operators are convincing the regulator to delay the planned launch of 3G later this year.

Lack of actionable ideas restricts choices

Despite the immense potential, general lack of listed telecom companies and price distortion due to potential merger and acquisition stories restrict actionable ideas in the sector. None of the six cellular companies are listed and only four out of the 38 fixed line and WLL operators (operational and non operational) and 12 LDI operators are listed. The merger of four WorldCALL group companies in 2006 has shrunk the universe further and to top it all, the four too are surrounded by M&A stories. If you bring size and liquidity into the picture, we believe the incumbent PTCL remains the only liquid investable stock in the telecom space in Pakistan.

Chart 7: ARPU trend



Source: KASB estimates, PTA

Competitive pressure raise the stakes



Farrah Marwat ^^^^
Research Analyst
KASB Securities

Pakistan's textile exports waning

Two years into the post quota regime, Pakistan's textile exports have taken a sudden turn for the worse. After posting a very decent 17% YoY jump in FY06 (compared to a historical five-year average annual growth rate of 11%), textile exports have fallen on hard times, and kicked off FY07 in alarmingly poor fashion with shaky export growth that has somewhat stabilized now at 6% in 9MFY07.

The worst is over but best still some way off

We believe the industry has turned the corner since November 2006, where following a sharp 10.39% decline in 1Q FY07, exports rebounded in a big way with a 27% YoY increase in November 2006 and a 14% YoY increase in December 2006. The improvement in performance, however, in our view has been driven by the government's subsidy package to the industry and exogenous factors that imply unchanged sector fundamentals. A touch-and-go monthly export performance trend since then suggests that the industry is still not out of the woods.

Spurring the decline

We believe the interplay of factors leading to slower growth include: (1) heating up of competition from the likes of China, India, Bangladesh and Turkey; (2) higher cost of doing business owing to a 3x hike in interest rates (coming off a three-year expansion spree) as well as higher cotton and gas prices; (3) industry fragmentation and exporters' tenacity in sticking to the "bargain bin" of global textile trade, which has resulted in strong price competition and inability to pass on the higher costs.

Government steps in with a bagful of incentives

With a 60% + share of national exports, improved performance of the textile industry is crucial, forcing the government to dig deep in its bag of tricks and put on the table fresh incentives over the past nine months, including an extended R&D subsidy package and a long-term loan swap scheme spearheaded by the State Bank of Pakistan. Our concern here is timing and whether Pakistan will have lost too much market share to recover by the time the positive impact of subsidies flows through.

Table 1: Pakistan's textile industry

(Year-end June)	FY05	FY06	FY07
Exports (US\$bn)	8.56	9.93	10.64
YoY growth	10%	17%	7%

Key categories share in textile exports:

Yarn	13%	14%	13%
Fabric	22%	22%	18%
Bedwear	17%	20%	18%
Garments	13%	13%	13%
Knitwear	19%	18%	18%

Cotton Crop (mn bales)	14.60	12.37	12.38
Cotton price (PRs/kg)	58	64	68
YoY change price	-26%	10%	7%

Source: KASB estimates, FBS, KCA

Exports fall on hard times

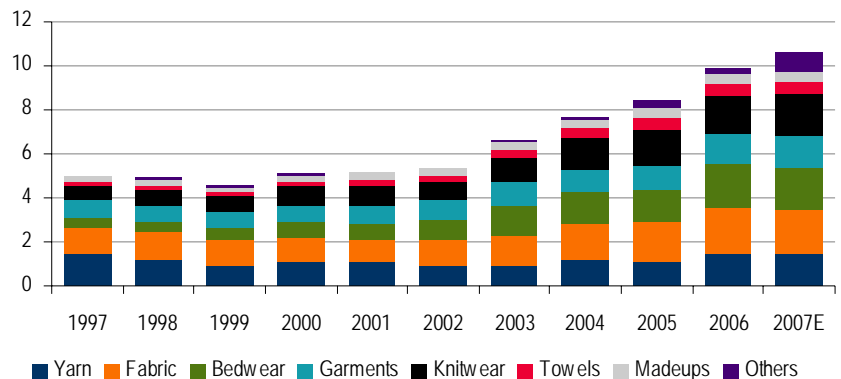
Pakistan's textile industry, primarily export-oriented, has been feeling the heat of aggressive competition in the post quota textile trade dynamics. The industry has long been the mainstay of Pakistan's exports, garnering a 60%+ share of national exports. While this share has increased to 64% of total exports YTD FY07, the textile sector's performance has been tenuous at best. The industry itself is broad-based; exports span the range of yarn, fabric, bed wear and made-ups, garments and knitwear. However, Pakistan only commands a significant share of global textile and cotton (T&C) trade in yarn and greige fabric – the two lowest value add and margin segments of the textile value chain – where margins have also been hit hardest on account of competitive pressure.

Which products work, and which don't

From our vantage point, the star of the past five years has been bed wear and home textiles, where exports have grown at a five-year CAGR of 18% over FY01-06 and Pakistan snagged the lion's share of US bed wear imports in 2006 (41% to Pakistan vs 28% to China and 10% to India).

Latest trade figures however, reveal that Pakistan is beginning to lose share in the US bed wear import market to both India and China. Rising domestic costs and resultant product price hikes are leading to lower demand. In the meantime, Pakistan's bed wear exports to the EU remain hampered by a 6.1% anti-dumping duty and non-inclusion of Pakistan in preferential access schemes. The situation has been further aggravated by capacity expansion in India. We estimate 125mn meters and 135mn meters of additional bed-wear capacity in India in FY07E and FY08E, respectively. We forecast that the dull performance YTD FY07 will result in a YoY decline in bed wear exports for the first time in 10 years.

Chart 1: Textile exports and share of key commodities (US\$bn)



Source: APTMA, FBS

We highlight however that the slowdown in bed wear exports is likely to have a greater impact on (1) smaller manufacturers (where smaller order sizes have the greatest potential of being replaced by bulk orders), and (2) new entrants to regional markets (where established customer base is easier to maintain).

FY07E - The worst is over, best still some way off

Textile exports have see-sawed wildly YTD FY07 and export growth now stands at 6% YoY – hardly a stellar performance given 17% YoY growth in FY06 and a trend growth rate of 11% over the past five years. We believe the darkest days for the industry are over, with the end of 1Q FY07 heralding a recovery of sorts.

However, we believe the situation is still far from ideal. 2Q FY07 recovery was, in our view, driven largely by subsidies to the industry and exogenous factors that do not indicate an improvement in sector fundamentals. After a broad-based 10.39% decline in 1Q FY07, exports rebounded sharply over November and December 2006, with 27% and 14% YoY growth, respectively. We trace the recovery to two factors:

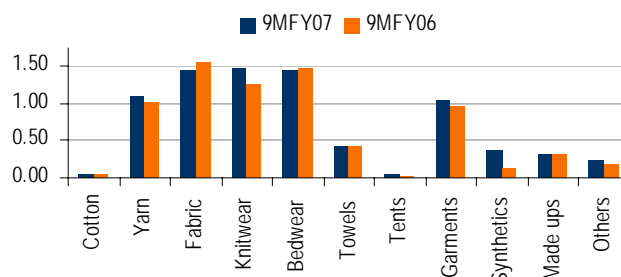
1. Base effect in 1Q FY07, owing to China's mishandling of the quota allocation in FY06. Following a surge in Chinese exports in 1H FY06, the caps were hit and China ran out of quota in the corresponding period last year. This, we believe, worked to Pakistan's benefit with a fair amount of excess demand routed to it. This explains the dip in 1Q FY07 exports as China reclaimed its rightful share of orders.
2. Political unrest in Bangladesh in the latter part of CY06 has hit both the country's productivity (via strikes) as well as order flow. The benefit to Pakistan, we believe, has been in the garments and knitwear sectors where November-December exports recorded an increase (+15% and +39%, respectively) after declining by 7% and 2%, respectively, over the first four months of the current fiscal year.

Chart 2: Monthly export growth – FY07 vs FY06



Source: FBS

Chart 3: Largely flat yearly trend across the board



Source: FBS

Since then, the touch-and-go export performance, with monthly numbers unable to report steady growth, indicates that the sector still has its work cut out for it.

What has gone wrong?

So what has put a spanner in the works for Pakistan's textile industry? Clearly, the demands of free trade markets, without the safety blanket of pre-determined market share, are playing up. We believe there is an interplay of factors at hand here including the following:

Heating up of competition

Pakistan is facing increasing competition from the likes of China, India, Bangladesh and Turkey. With stepped up competition, we identify the routes to tapping and maintaining market share, and where Pakistan lacks in this regard:

- **Economies of scale:** Large scale of production allows lower fixed costs and competitive pricing in undifferentiated products (yarn, fabric). While Pakistan's industry has invested substantially in capacity expansion (US\$6bn over the past five years), the industry remains fragmented and only a handful of manufacturers (Nishat Mills, for instance) have the requisite size to compete with Indian and Chinese manufacturers' scale of production.

- Premium products:** Pakistan's tendency to cling to the commodity end or “bargain bin” of global textile trade has resulted in exposure to strong price competition where it lacks the scale advantage. Meanwhile, fewer resources are dedicated to higher value add products which demand premium prices on account of design, etc. Note that companies with higher value add products have fared remarkably better than peers. In 9M FY07, Nishat Mills reported a 16bp rise in gross margins vs a 70-80bp decline for the industry as a whole.

Domestic costs pinch

Vocal textile bodies, meanwhile, blame the “higher cost of doing business” in Pakistan. Through the dual forces of higher inflation (8% FY06 and 7.8% FY07E) and a tight monetary policy to deal with the inflation, we have seen a 3x hike in benchmark interest rates (from 2.97% in FY04 to 10% currently) as well as higher cotton and power generation costs and a 53% hike in minimum wage rates over the past two years.

The impact of stepped up financial charges on the heavily leveraged industry coming off a three-year expansion spree have had the greatest impact, in our view, on textile sector profitability. Textile companies have been having a very difficult time reconciling hefty payments on expansion-related loans (on floating rates) with the competitive dynamics of the post quota textile export market.

Government called on for action

With a lofty export target to meet, the Government of Pakistan (GoP) has stepped in with a bagful of incentives. In order to meet the government’s export target of US\$18.6bn, we estimate textile exports would need to scale US\$11.16bn (a required growth rate of 12% YoY) vs US\$10.64bn expected (7% higher YoY).

The government has announced an R&D subsidy; akin to a rebate on value add textile export, in slabs ranging from 3-6% on printed fabric, bed wear and garments. In the recently announced federal Budget FY08, the government has also rationalized the rate of tax on textile exporters at 1% (relative to 1-1.5% earlier). In tandem, the State Bank of Pakistan (SBP) has announced a loan swap scheme – Long Term Financing for Export Oriented Projects (LTF-EOP) – expected to lower mark-up on LT loans taken after January 2005 for value added expansions by 400-500bp. In the FY08 budget, the swap facility has also been extended to the spinning sector.

Loan swap scheme kicks off

So far, the SBP has disbursed PRs43.1bn under the LTF-EOP to the textile industry. Of this, PRs34bn is the allocation for converted loans while a sum of PRs9.1bn is fresh disbursements. The impact of the loan swap is undeniably positive and should provide some respite from financial charges which have more than doubled for companies under our coverage over the past two years.

What we may also see is a rekindling of interest in further expansion and BMR. So far in FY07, textile machinery imports are down 36%, a clear indication that, at current financing rates, few are keen to expand further.

We highlight, however, that this does not give the sector indemnity to higher interest rates. A whopping 40-50% of textile companies’ borrowing is short-term finance (for WC requirements, cotton purchase and storage) where higher rates are still at play. Additionally, minimum export requirement of 50% of sales is needed for companies to avail the LTF, which means companies supplying yarn and fabric locally (~68% and 64%, respectively, are for local sale) could miss out.

Textile core leverages off equity portfolio

Equity | Pakistan | Textile Products
5 July 2007



Farrah Marwat ^^^^
Research Analyst
KASB Securities

Outperforms textile peers

Nishat Mills (NML), the largest textile company in Pakistan has been able to maintain a quality edge relative to peers in the post quota aftermath. Relative to the monthly swings in exports and collapse in profitability that the rest of the industry has been facing, NML has demonstrated relative stability in topline and margins have expanded by 16bp vs the industry-wide decline of 70-80bp.

Size and quality the key difference...

The upshot for NML has been its ability to leverage off strong international supplier relationships, global-sized facilities and a vertically integrated business model. While local peers struggle to achieve critical volume, NML already has the requisite capacity. Meanwhile, increased focus on higher value segments and expansion of dyeing and finishing capacities has helped protect margins.

...But better does not mean great

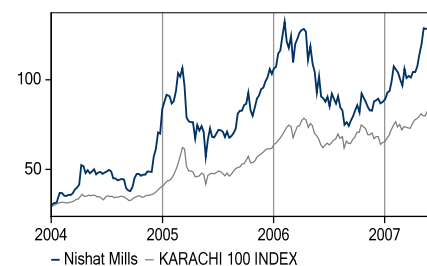
Although its textile performance has been substantially better than peers, it is at best decent. Financial charges, remain the key concern, in our view. NML cements its position as a textile plus theme, where less than dazzling textile performance is mitigated by higher other income. NML's diversification via earnings contribution from associate companies is expected to add significantly to its bottomline.

A Nishat group holding company

Doubling as a holding company for Nishat group, the market value of NML's equity portfolio (US\$358mn) is actually higher than its market cap (US\$331mn). Equity investments allow indirect exposure to some of the biggest names in Pakistan's banking and cement sectors - MCB Bank and DG Khan Cement.

Stock Data

Price	PRs124.95
Price Objective	PRs139.01
Date Established	23-May-2006
Investment Opinion	C-1-7
Volatility Risk	HIGH
52-Week Range	PRs69.64-PRs133.80
Mrkt Val / Shares Out (mn)	US\$329 / 159.8
Average Daily Volume	8,088,326
ML Symbol / Exchange	NHTXF / KAR
Bloomberg / Reuters	NML PA / NISM.KA
ROE (2007E)	8.0%
Net Dbt to Eqty (Jun-2006A)	40.8%
Est. 5-Yr EPS / DPS Growth	13.6% / 24.0%
Free Float	63.4%



Estimates (Jun)

(PRs)	2005A	2006A	2007E	2008E	2009E
Net Income (Adjusted - mn)	1,862	1,633	1,759	2,199	2,673
EPS	11.65	10.22	11.01	13.76	16.73
EPS Change (YoY)	147.9%	-12.3%	7.7%	25.0%	21.5%
Dividend / Share	2.27	1.36	2.00	2.50	2.50
Free Cash Flow / Share	5.39	(16.91)	9.11	4.78	13.41

Valuation (Jun)

	2005A	2006A	2007E	2008E	2009E
P/E	10.72x	12.23x	11.35x	9.08x	7.47x
Dividend Yield	1.82%	1.09%	1.60%	2.00%	2.00%
EV / EBITDA*	10.66x	8.43x	7.99x	7.08x	6.57x
Free Cash Flow Yield*	4.32%	-13.53%	7.29%	3.83%	10.73%

05 July 2007

iQprofileSM Nishat Mills Ltd.

Key Income Statement Data (Jun)	2005A	2006A	2007E	2008E	2009E
(PRs Millions)					
Sales	11,375	16,417	17,895	19,327	20,776
Gross Profit	2,710	3,479	3,668	4,252	4,571
Sell General & Admin Expense	(664)	(893)	(984)	(1,063)	(1,143)
Operating Profit	1,814	2,236	2,311	2,714	3,027
Net Interest & Other Income	214	(477)	(364)	(312)	(136)
Associates	441	527	571	533	585
Pretax Income	2,028	1,759	1,947	2,402	2,891
Tax (expense) / Benefit	(166)	(126)	(188)	(202)	(218)
Net Income (Adjusted)	1,862	1,633	1,759	2,199	2,673
Average Fully Diluted Shares Outstanding	160	160	160	160	160

Key Cash Flow Statement Data

Net Income (Reported)	1,862	1,633	1,759	2,199	2,673
Depreciation & Amortization	602	799	879	909	865
Change in Working Capital	(759)	158	(76)	1,290	332
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	778	(3,032)	(577)	(3,066)	(1,210)
Cash Flow from Operations	2,483	(443)	1,985	1,333	2,660
Capital Expenditure	(1,621)	(2,259)	(530)	(569)	(518)
(Acquisition) / Disposal of Investments	601	1,774	119	80	80
Other Cash Inflow / (Outflow)	0	0	(1)	(1)	(1)
Cash Flow from Investing	(1,020)	(485)	(412)	(490)	(439)
Shares Issue / (Repurchase)	0	0	0	0	0
Cost of Dividends Paid	(363)	(218)	(320)	(399)	(399)
Cash Flow from Financing	(1,557)	602	(1,594)	(566)	(2,267)
Free Cash Flow	862	(2,702)	1,455	764	2,142
Net Debt	7,333	8,624	7,224	6,781	4,959
Change in Net Debt	(1,100)	1,145	(1,254)	(444)	(1,822)

Key Balance Sheet Data

Property, Plant & Equipment	9,151	10,611	10,263	9,922	9,575
Other Non-Current Assets	5,020	10,810	11,262	11,716	12,223
Trade Receivables	877	1,027	981	1,059	1,138
Cash & Equivalents	521	50	175	451	405
Other Current Assets	6,348	8,681	8,900	10,060	10,399
Total Assets	21,918	31,179	31,580	33,208	33,740
Long-Term Debt	2,858	3,015	1,441	469	79
Other Non-Current Liabilities	0	0	0	0	0
Short-Term Debt	4,996	5,658	5,959	6,764	5,285
Other Current Liabilities	1,257	1,393	1,484	1,479	1,605
Total Liabilities	9,111	10,067	8,883	8,711	6,970
Total Equity	12,806	21,112	22,697	24,497	26,771
Total Equity & Liabilities	21,918	31,179	31,580	33,208	33,740

iQmethodSM - Bus Performance*

Return On Capital Employed	9.6%	9.3%	8.1%	9.1%	9.9%
Return On Equity	16.7%	9.6%	8.0%	9.3%	10.4%
Operating Margin	15.9%	13.6%	12.9%	14.0%	14.6%
EBITDA Margin	23.6%	20.7%	20.0%	20.9%	20.9%

iQmethodSM - Quality of Earnings*

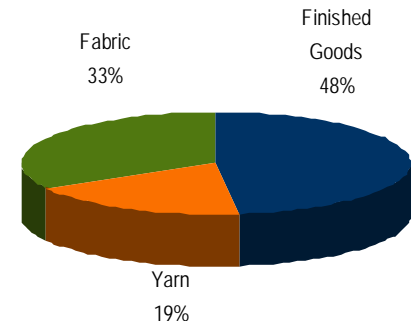
Cash Realization Ratio	1.3x	-0.3x	1.1x	0.6x	1.0x
Asset Replacement Ratio	2.7x	2.9x	0.6x	0.6x	0.6x
Tax Rate (Reported)	8.2%	7.2%	9.6%	8.4%	7.5%
Net Debt-to-Equity Ratio	57.3%	40.8%	31.8%	27.7%	18.5%
Interest Cover	5.1x	3.4x	3.9x	5.0x	7.3x

Key Metrics

Company Description

Nishat Mills is Pakistan's largest integrated textile company, with an export-oriented focus (more than 80%). Its key products include bed linens and fabric. Its holding company status as one of the country's largest business groups provides it a steady income stream through dividends and associate company's share of profits.

Chart 1: NML export sales break up



Source: Company Accounts

Stock Data

Price to Book Value 0.9x

Outperforming textile peers...

NML is the largest and amongst the most integrated textile companies in Pakistan. The company also doubles as a holding company, where the current market value (as of 18 June) of NML's equity investments (US\$358mn) is actually higher than its market cap (US\$331mn).

NML has been able to maintain a quality edge relative to peers in the post quota aftermath. The performance of the textile industry (YTD FY07) has been tenuous at best, with wildly see-sawing monthly exports and 70-80bp shrinkage in gross margins across the board on account of higher cotton prices (about 7% higher YoY) and competitive pressure.

In contrast, NML's gross margins improved 16bp in 9MFY07. We view the slowdown in sales growth from a healthy 7.5% YoY in both 1Q and 2Q to 3.3% YoY in 3Q as a one-off case, caused by the company's decision to relocate dyeing and finishing facilities from Faisalabad to Lahore. Relative to the monthly swings in exports and collapse in profitability that the rest of the industry has been facing, NML has demonstrated relative stability in its topline and margins.

Table 1: Cumulative sales growth in 9MFY07

	1QFY07	1HFY07	9MFY07
NML	7.6%	7.6%	5.4%
Industry	-10.39%	4.30%	6%

Source: KASB Estimates, Company Accounts, FBS

Size and quality the key difference...

We believe the upshot for NML has been its ability to leverage off strong international supplier relationships, global-sized facilities and a vertically integrated business model.

Higher value end provides margin protection

In recent years, the company has propelled itself up the value chain, with focus on the bed linen and home textiles segments. Over FY05-07, the share of finished products in NML's sales increased from 44% to 47%, which we believe has cushioned margins from the increase in cotton prices and increasing competition.

In July 2006, the company completed expansion of its dyeing and processing facilities by 33% from 36mn meters to 48mn meters of annual production. The expansion is directed towards NML's most profitable segment - the home textiles and apparel division - and bodes well for both future growth and margin stability, as witnessed in 2007.

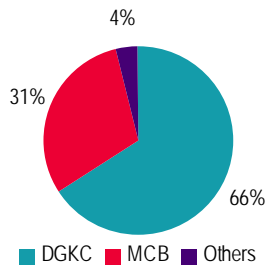
With reduced dependence on the precarious commodity yarn business (the segment is most affected by cotton prices and most exposed to price-cutting under free trade), NML should escape any price-cut, relatively unscathed. Operational diversification should also help soften the blow to NML's gross margins in times of fluctuating demand.

Too big to get squeezed out

Exporting more than 85% of its production, sheer size also propels NML to a safer ground than local industry peers. The company controls over 9% of Pakistan's total yarn exports and 11% of total fabric exports. As T&C needs are met through larger orders placed with smaller suppliers, attention is increasingly

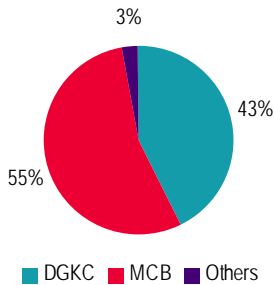
diverted to companies that are able to meet the requisite order size. While competition is in the process of achieving a critical mass, NML already has 173,000 spindles, 528 looms, 48mn meters/year processing and finishing capacity, and 500 stitching machines. Achieving economies of scale and thus benefiting through lower per unit cost of production, size is a crucial factor that will determine NML's competitiveness in future.

Chart 2: NML: portfolio income split (FY07E)



Source: KASB Estimates

Chart 3: NML: portfolio value split (18 Jun 2007)



Source: KASB estimates, KSE

...but better, not great

Although its textile performance has been substantially better than peers, it is at best decent and recent performance cements Nishat's position as a textile plus play. While sales performance has been steady so far this year, the textile side has remained depressed with only 2% YoY increase in gross profit and a 25% YoY decline in core earnings. Financial charges remain a primary concern for NML on the textile front, which has increased by 20% YoY in 9MFY07. In fact, higher financing cost has been a key detriment to the growth of the textile sector during the 20-month tightening cycle by State Bank of Pakistan (SBP). We expect the drain from financial charges to correct to some extent over the next six months, on account of the SBP loan swap scheme for the textile sector. However, we believe this will be a gradual process.

Less than dazzling textile performance is meanwhile largely mitigated by higher other income where NML's diversification via its position as holding company for Nishat group is expected to add significantly to the bottom line. Primary here is dividend income from MCB Bank and a share of profit from DG Khan Cement (NML has 31.4% stake in DGKC).

A textile plus portfolio exposure

The textile giant also doubles as a holding company. The flagship company of the Nishat Group - the textile magnate - holds a PRs21.45bn (PRs134/sh of NML) equity portfolio in listed Nishat Group companies. By virtue of investment in associate companies, NML garners (1) dividend income and share of profit from held companies, hedging cotton dependant volatility of core operations and; (2) indirect exposure to some of the biggest names in Pakistan's cement and banking sectors - MCB Bank and DG Khan Cement.

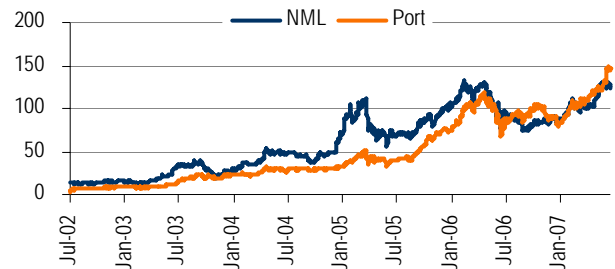
Although the textile industry is going through testing times, scale of operation, higher value-add product mix and the cushion of sustainable income from investment in group companies help NML fare far better. The stock meanwhile trades at a discount to imbedded portfolio value, an unwarranted situation in our view.

Table 2: NML: Value of portfolio

(as at 18 Jun 2007)	Shares (mn)	Current price (PRs)	Market value (PRs mn)
DGKC	79.61	114.60	9,124
NCL	10.23	41.00	420
MCB	32.13	365.85	11,754
AICL	0.53	294.90	156
Total investment			21,453
Value/NML sh			134
Value at 30% discount			15,017
Discounted value/NML sh			94

Source: KASB estimates, KSE

Chart 4: NML: stock price vs per share value of portfolio



Source: KASB estimates, KSE

Treading troubled waters



Farrah Marwat ^^^^
Research Analyst
KASB Securities

Expansion not paying off - Sell

We have a Sell on Nishat Chunian (NCL) with a fair value of PRs33.7/sh. A year into the bed wear expansion (which was delayed by six months) and profitability is floundering. With 9M FY07 bringing in losses of PRs112mn (PRs1.49/sh), we expect FY07 and FY08 to remain troubled years. More worrying yet is the increased risk to future earnings as even management targets remain flexible.

New product line rife with problems

Poor performance of the new segment has stretched longer than start-up period woes. Expansion into home textiles was expected to boost both sales volumes and margins but has resulted in the reverse on account of low capacity utilization and sub optimal product pricing.

No market share to be had

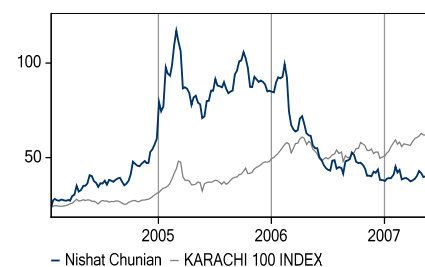
The biggest problem has been the company's inability to carve out sufficient market share to turn bed wear operations profitable. High fixed costs at the new plant and lower than feasible prices in a bid to garner market share have played havoc with gross margins, stripping off a cool 390bp YoY relative to an industry-wide decline of 70-80bp (on account of ~5% higher YoY cotton prices).

Financial charges too high to stomach

Adding to NCL's woes are financial charges that we expect will come in 26% higher YoY in FY07 after already rising by 163% in FY06. Some relief on this front is expected to flow from the government's loan swap scheme. A speedier move to high capacity utilization at the new plant and/or a greater-than-expected impact on financial charges via loan swap are key factors that could turn us positive.

Stock Data

Price	PRs41.00
Investment Opinion	C-3-8
Volatility Risk	HIGH
52-Week Range	PRs37.00-PRs55.00
Mrkt Val / Shares Out (mn)	US\$51 / 75.2
Average Daily Volume	773,333
ML Symbol / Exchange	XNCUF / KAR
Bloomberg / Reuters	NCL PA / NCHU.KA
ROE (2007E)	-6.3%
Net Dbt to Eqty (Jun-2006A)	224.4%
Est. 5-Yr EPS / DPS Growth	9.1% / NA
Free Float	56.9%



Estimates (Jun)

(PRs)	2005A	2006A	2007E	2008E	2009E
Net Income (Adjusted - mn)	722	251	(166)	56	100
EPS	9.61	3.34	(2.21)	0.746	1.33
EPS Change (YoY)	13.8%	-65.3%	NM	NM	79.0%
Dividend / Share	1.36	1.50	0	0	1.000
Free Cash Flow / Share	(33.87)	(12.68)	(6.67)	5.80	3.48

Valuation (Jun)

	2005A	2006A	2007E	2008E	2009E
P/E	4.31x	12.41x	NM	54.98x	30.72x
Dividend Yield	3.29%	3.62%	0%	0%	2.44%
EV / EBITDA*	7.79x	6.86x	8.03x	7.43x	6.84x
Free Cash Flow Yield*	-82.11%	-30.75%	-16.28%	14.14%	8.50%

iQprofileSM Nishat Chunian Ltd.

Key Income Statement Data (Jun)	2005A	2006A	2007E	2008E	2009E
(PRs Millions)					
Sales	5,454	6,551	7,075	7,499	7,949
Gross Profit	1,471	1,699	1,486	1,612	1,749
Sell General & Admin Expense	(241)	(292)	(315)	(330)	(350)
Operating Profit	975	877	525	663	776
Net Interest & Other Income	(215)	(536)	(599)	(509)	(572)
Associates	NA	NA	NA	NA	NA
Pretax Income	760	341	(75)	154	204
Tax (expense) / Benefit	(38)	(90)	(92)	(97)	(103)
Net Income (Adjusted)	722	251	(166)	56	100
Average Fully Diluted Shares Outstanding	75	75	75	75	75

Key Cash Flow Statement Data

Net Income (Reported)	722	251	(166)	56	100
Depreciation & Amortization	255	531	646	619	623
Change in Working Capital	(862)	(130)	(531)	22	(154)
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	(24)	51	15	0	0
Cash Flow from Operations	92	702	(37)	697	570
Capital Expenditure	(2,639)	(1,656)	(465)	(261)	(308)
(Acquisition) / Disposal of Investments	NA	NA	NA	NA	NA
Other Cash Inflow / (Outflow)	NA	NA	NA	NA	NA
Cash Flow from Investing	(2,639)	(1,656)	(465)	(261)	(308)
Shares Issue / (Repurchase)	0	0	0	0	0
Cost of Dividends Paid	(55)	(137)	(113)	0	0
Cash Flow from Financing	2,555	926	503	(427)	(258)
Free Cash Flow	(2,547)	(954)	(502)	436	262
Net Debt	5,169	6,258	6,873	6,437	6,175
Change in Net Debt	2,603	1,090	615	(436)	(262)

Key Balance Sheet Data

Property, Plant & Equipment	5,778	6,903	6,722	6,364	6,048
Other Non-Current Assets	2	5	5	5	5
Trade Receivables	336	543	581	514	544
Cash & Equivalents	37	11	13	21	25
Other Current Assets	2,094	2,003	2,623	2,692	2,839
Total Assets	8,248	9,465	9,944	9,595	9,461
Long-Term Debt	2,781	3,413	3,006	1,348	145
Other Non-Current Liabilities	0	0	0	0	0
Short-Term Debt	2,426	2,856	3,879	5,110	6,055
Other Current Liabilities	365	407	549	572	596
Total Liabilities	5,571	6,676	7,434	7,029	6,795
Total Equity	2,676	2,789	2,510	2,566	2,666
Total Equity & Liabilities	8,248	9,465	9,944	9,595	9,461

iQmethodSM - Bus Performance*

Return On Capital Employed	13.6%	7.3%	5.0%	3.5%	4.1%
Return On Equity	30.8%	9.2%	-6.3%	2.2%	3.8%
Operating Margin	17.9%	13.4%	7.4%	8.8%	9.8%
EBITDA Margin	22.1%	20.8%	16.4%	16.8%	17.2%

iQmethodSM - Quality of Earnings*

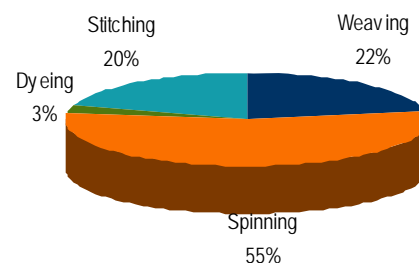
Cash Realization Ratio	0.1x	2.8x	NM	12.4x	5.7x
Asset Replacement Ratio	10.3x	3.1x	0.7x	0.4x	0.5x
Tax Rate (Reported)	4.9%	26.4%	NM	63.5%	50.7%
Net Debt-to-Equity Ratio	193.2%	224.4%	273.9%	250.9%	231.6%
Interest Cover	5.0x	1.7x	0.9x	1.3x	1.4x

Key Metrics

Company Description

Nishat Chunian, a member of the Nishat Group of companies, is an export-based textile unit. The one-time yarn and fabric producer has expanded capacity significantly in recent years to include home textiles in its manufacturing portfolio. It has been earmarked for providing the widest variety of yarn and fabric blends in Pakistan.

Chart 1: NCL Top line split 1HFY06



Source: Company Accounts, KASB Estimates

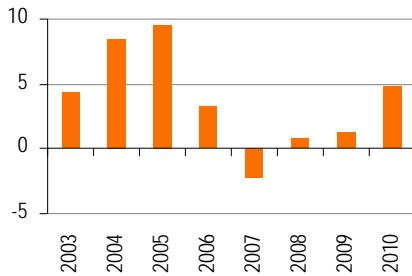
Stock Data

Price to Book Value 1.2x

Hit by expansion gone wrong

There has been a visible downswing in NCL's profitability post expansion, with the new home textiles line sending previously profitable operations into the red via drastically reduced margins and magnified financial and depreciation charges. We reiterate our Sell rating on NCL with a fair value of PR\$33.7/sh.

Chart 2: Slow EPS (PRs/sh) recovery



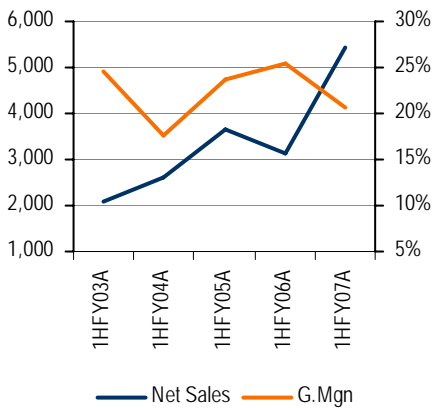
Source: Company Accounts, KASB Estimates

While we believe that FY07E is going to be the bottom for NCL, we maintain our negative stance due to the following reasons: (1) expected slow pace of recovery, and (2) increased future earnings uncertainty, where even management targets are flexible. Despite a 40% decline in stock price in the past 12 months, we believe downside risk remains and earnings volatility is too high to take exposure to the stock. NCL still trades at a premium to book value (1.2x FY07E), which appears unjustified given its FY08E ROE of 2.2% vs. Pakistan's risk-free rate of 10%.

Expansion impact not what was expected

If there was ever a problem-ridden expansion plan, it is NCL's home textiles foray. In FY05, the company embarked on an ambitious plan that entailed diversification of the existent yarn and fabric operations into home textiles. This was expected to result in an upswing in both sales volumes and pricing power (on account of higher value add products) and strengthen NCL's already above-peer gross margins. Neither has happened.

Chart 3: Sales positive but margins decline



Source: Company Accounts, KASB Estimates

Taking it from the top

Top-line growth capsized in FY06, with annualized sales dropping by 10% YoY (20% growth was recorded but on account of FY05 being a nine-month year). 9M FY07 shows no such concern, with sales up 13% YoY, largely recouping last year's sales decline, but the expected top-line surge on account of new product line commencement is yet to be seen.

More worrying, meanwhile, is the increasing share of yarn in the company's sales mix with yarn contribution swelling from 40% to 55% of top line in 9M FY07. The impact of a greater reliance on yarn is: (1) margin shrinkage, where the spinning margins come in lower than margins on other textile processes on account of lower value addition; and (2) margin volatility, where commodity-type nature of the product allows little room to maneuver around cotton prices.

Adding to NCL's risk profile is a 24% YoY increase in working capital in FY07E, driven primarily by increasing stores and inventory (+28% YoY). Our biggest concern here is the piling up of unsold and un-sellable inventory.

Margin weakness a byproduct of expansion

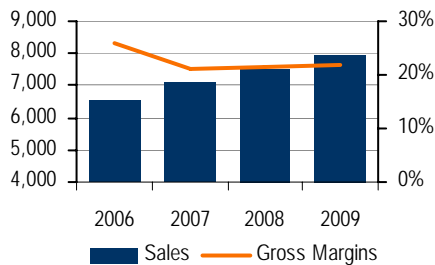
The debilitating factor for NCL has been the sharp compression in gross margins, and we expect the company to be slow to climb back up to higher pre-expansion margins. NCL's margins have dropped by 390bp in 9MFY07 as compared to peer company Nishat Mills (NHTXF), whose 9M margins have improved by 16bp, and an estimated 70-80bp decline for the industry as a whole.

The reasons for this are higher cotton prices (~7% YoY in FY07) and the leaning toward yarn sales highlighted above. The added drag for NCL is low profitability of the new home textiles line, which is causing havoc with margins on two fronts:

- Low capacity utilization.** This has kept the new bed wear plant at below breakeven levels. While capacity utilization has picked up in recent months, it remains below pre-production levels visualized and higher fixed costs continue to depress segment performance.

- **Sub optimal prices.** In a bid to carve out market share in previously untapped home textile export markets, NCL has been forced to set prices at barely breakeven levels, pushing margins for the company even lower.

Chart 4: Sales to improve but not margins



Source: KASB estimates, company accounts

Low utilization levels expected to improve ...

The capacity utilization issue, we believe, will have a quicker move to resolution than the pricing issue. As per management, home textiles capacity utilization is on a gradual uptrend, producing 200,000 meters in March 2007 (75% capacity utilization) vs capacity utilization of 40% in 4Q FY06 and 50-60% in 1H FY07.

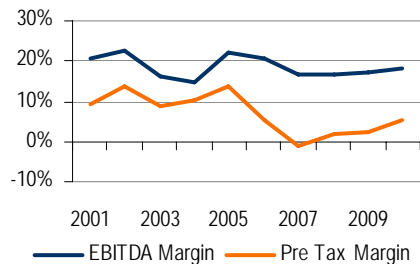
We believe that bed wear sales volumes stand to improve as the company's marketing efforts start to deliver and teething issues are put to rest. We also expect positive impact of the government's R&D subsidy scheme to kick in.

... but at the cost of margins

However, we believe that further gain of market share by NCL will be contingent upon lower prices being maintained and expect only slight recovery in gross margins over FY07-09E.

Management has maintained its strategy of first capturing market share, then attaining comfort on supply contracts, and only then reconsidering the pricing side of the equation. While the R&D subsidy should provide slight room on the pricing front, with additional capacity coming on line globally and pushing the case for economies of scale, we believe tightening competition will keep the risks to greater profitability high.

Chart 5: Wide gap b/w EBITDA & PBT margins



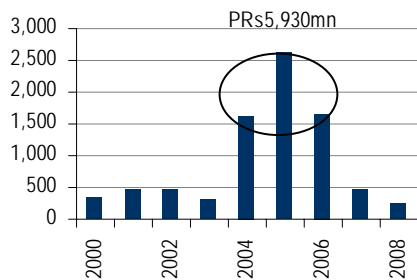
Source: KASB estimates, company accounts

The financial charges debacle

The sharp drop in pre-tax margin is dramatic relative to even the above explained decline in EBITDA margins in the kickback from NCL's expansion drive over FY04-FY06, wherein the company invested over PRs5.9bn in capex. While production capacity now stands enhanced, top line growth has not kept pace and NCL is facing financial and depreciation charges magnified several times over.

The dual impact on the financial charges front arises from (1) jacked up borrowing (PRs5.5bn additional long-term loans over 2004-07 as well as a 34% YoY jump in short-term borrowing), and (2) the close to 4x hike in benchmark lending rates, where interest payment on 95% of the company's long-term loans are linked to KIBOR (Karachi Inter bank Offer Rate) and six-month KIBOR has shot up from 2.97% in FY04 to 10% currently.

Chart 6: Hefty capex over 2004-06



Source: Company Accounts, KASB Estimates

The increase in financial burden was largely expected but the collapse of sales and margins was not. As a result, there is nothing cushioning the company from the crunch. With FY07E EBITDA of PRs1,171mn vs total FY07E debt of PRs6,885mn (ie, ~6x EBITDA), we believe NCL's financial position looks precarious, particularly given risky debt mix (44% of debt is short term) with no cash cushion. Resultantly, interest cover, which was at a comfortable 6x on average over FY01-FY05, is expected to be a mere 0.9x in FY07.

We believe some relief on the financial charges front will begin to creep in over FY08E on account of the government's debt relief package wherein the company can avail subsidized mark-up rates (300-500bp lower) for post 2003 expansion related loans.

Leaders continue to excel



Khurram Ghufra^{****}
Research Analyst
KASB Securities

Slowdown imminent in industry sales

Led by 7-7.5% GDP growth and wider accessibility to auto financing schemes, the auto sector has come a long way, achieving a sales CAGR of 32.5% in the past five years. There are four major local assemblers and aggregate industry production has risen from 48,000 units in FY01 to 192,000 in FY06. However, there has been a visible slowdown in industry sales as the period of high growth comes to an end, with sales up only 7.6% YoY in 11MFY07.

PSMC and INDU continue to register robust growth

Although industry sales have slowed, sales for Pak Suzuki and Indus Motors continue to grow at a healthy 29% and 21% YoY, respectively. The first nine months saw Pak Suzuki and Indus Motors increase their market shares to 60% (from 54% in FY06) and 25% (from 22% in FY06) respectively, whereas Honda Atlas and Dewan Farooque have been the losers.

Regulatory environment - Favorable

The government, realizing the industry's potential to provide employment, save forex, and contribute to the national kitty, recently approved a long-term vision for the sector, which provides many tariff- and non-tariff-based incentives to local assemblers. In addition, the government has recently taken steps to tighten its policy on the import of used vehicles to provide additional support.

Further expansions in the pipeline

Given the favorable emerging dynamics, Pak Suzuki and Indus Motors continue to expand existing capacity. Pak Suzuki, the industry leader with an existing capacity of 150,000 units per annum can increase production on the current plan to 170,000 units pa, and it bought land in January 2007 to set up a new plant with an expected capacity of 100,000 units pa. Similarly, Indus Motors can increase annual capacity on the current plant to 70,000 units from 53,000 units while it awaits approval from Toyota Global to set up a new plant.

Risks - Increasing pressure on margins

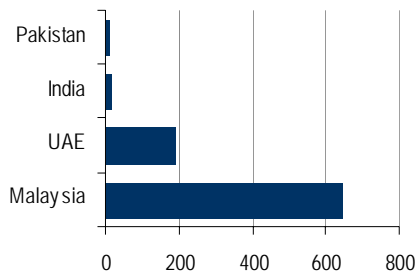
Industry margins have been under pressure due to higher distribution charges and lower other income. However, the impact on margins may be mitigated as the assemblers reap the benefits of a reduction in tariffs, as part of the AIDP.

Table 1: Industry statistics - units per annum

	FY04	FY05	FY06	11MFY07
Industry				
Production	113,357	151,580	192,111	179,522
Sales	111,553	152,365	187,436	181,098
Growth	50%	37%	23%	8%
Company sales				
Pak Suzuki	57,559	75,720	99,104	108,254
Indus Motors	29,059	34,983	40,961	43,985
Honda Atlas	13,368	24,066	28,134	16,085
Dewan Farooque	11,125	15,021	16,265	10,424
Segment sales				
800cc	33,771	39,757	43,865	45,239
1000cc	24,865	34,051	45,244	47,736
1300c+	37,984	53,501	66,405	53,809
LCV's	14,933	25,056	31,922	34,314

Source: PAMA

Chart 1: Motorization levels per 1,000 people



Source: UBL report

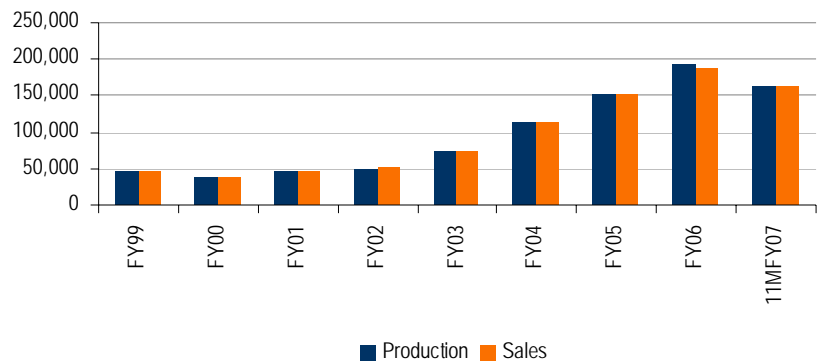
Opportunities abound for leaders

Led by robust economic growth, wider accessibility to auto financing schemes, and continuous investment in capacity enhancement, the auto sector in Pakistan has achieved a 5-year historical sales CAGR of 32.5%. As the industry emerges from an era of high growth, it is faced with increasing challenges, including a visible slowdown in industry sales, pressure on margins, and increasing auto financing rates. However, with motorization levels still as low as 10 cars per 1,000 vehicles, which lags emerging regional peers by 20-30%, there still exists great potential for local assemblers to take advantage.

Demand has outstripped supply...

In the past five years, demand for cars has more than quadrupled as car sales climbed 46% in FY06 to 231,479 against the same period last year. Sales for locally assembled cars jumped by 23% to 187,436 units while the remaining demand was filled by imported cars as local assemblers were in a race against time to fill the demand-supply gap.

Chart 2: Production & sales trends



Source: PAMA

Table 2: Current plant capacity

	units/pa
Pak Suzuki	150,000
Indus Motors	53,000
Honda Atlas	50,000
Dewan Farooque	20,000
Total capacity	273,000

Source:

...but supply side catching up fast

However, the supply side seems fast catching up to demand, as capacity expansions come online and delivery periods drop. Industry production capacity stood at approximately 147,000 units in 2005. However, by the end of FY06, capacity had already crossed 220,000 units, 51% higher YoY. The current aggregate production capacity stands at 273,000 units/pa and is set to increase further as leading local assemblers continue to have aggressive expansion plans.

Pak Suzuki. With an installed capacity of 150,000 units, it is the largest local assembler in Pakistan. Annual capacity on the current plant can be increased to 170,000 units and a new plant is slated to come up, which could effectively double production capacity by 2012.

Indus Motors. Has a current production capacity of 53,000 units pa. The capacity on the current plant can be increased to 70,000 units by undertaking efficiency measures while the company awaits the go-ahead from Toyota Global to set up a new plant.

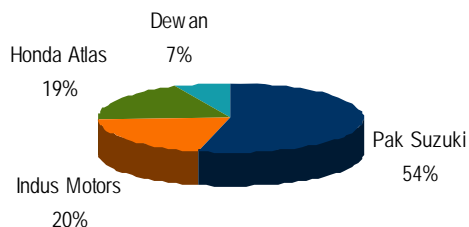
Honda Atlas. Honda Atlas completed its capacity enhancement from 32,000 units pa to 50,000 units pa in September 2006 after which demand for the company's vehicles dropped significantly due to intense competition. The company is going through a difficult period and has no plans for further expansions.

Dewan Farooque. Dewan Farooque currently has a production capacity of 20,000 units pa. With plenty of idle capacity and the company struggling to maintain market share, there are no plans for expansion in the near future.

Pak Suzuki and Indus Motors lead the pack

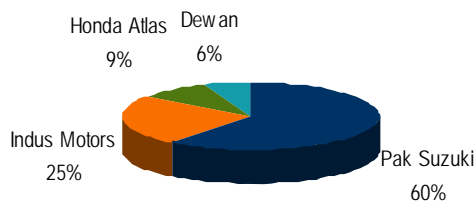
The auto industry in Pakistan is dominated by four assemblers: Pak Suzuki, Indus Motors, Honda Atlas, and Dewan Farooque. Pak Suzuki is the clear market leader, holding more than double the market share (60% in 11MFY07) vs its closest competitor. Indus Motors, is the second largest player with a 25% share. Even though industry sales have slowed to 7.6% YoY in 11MFY07, sales growth for Pak Suzuki and Indus Motors remain healthy at 23% and 19%, respectively.

Chart 3: Market share in FY06



Source: PAMA

Chart 4: Market share 11MFY07



Source: PAMA

Snapshot - Intra-segment competition

Pakistan’s auto industry is divided into four major segments in accordance with the different tariff rates applicable.

Table 3: Segment-wise sales breakdown

	FY05	FY06	11MFY07
Pak Suzuki	31,165	35,982	33,753
Indus Motors	8,592	7,883	11,486
TOTAL 800cc	39,757	43,865	45,239
Pak Suzuki	27,042	38,213	44,490
Dewan Farooque	7009	7031	3246
TOTAL 1000cc	34,051	45,244	47,736
Pak Suzuki	5,879	7,744	5,277
Indus Motors	23,002	30,527	32,447
Honda Atlas	24,066	28,134	16,085
Others	554	0	0
TOTAL 1300cc	53,501	66,405	53,809
Pak Suzuki	11,634	17,165	24,734
Indus Motors	3,389	2,551	52
Dewan Farooque	8,012	9,234	7,178
Others	2021	2972	2350
TOTAL LCV's	25,056	31,922	34,314

Source: PAMA

Pak Suzuki, the largest local assembler, has a leading 74% market share in the 800cc category with the Mehran. Indus Motors has the remaining 26% share with the Cuore. However, while sales for the Mehran have remained flat YoY, sales for the Cuore are up 69.5% YoY in 11MFY07, which has seen Cuore’s market share increase from 18% in FY06 to 26% currently.

Pak Suzuki has a commanding 94% market share in the 1000cc category with the Cultus and Alto. Sales for Dewan Farooque’s Santro have been on a downtrend ever since the heavy import of used vehicles due to which the Santro holds a relatively small 6% market share.

The 1300cc category is the most competitive segment where Indus Motors has seen its market share improve from 46% to 60% currently with sales of its flagship Corolla up 17.6% YoY in 11MFY07. Honda Atlas has seen its market share drop from 45% to 30% over the past two years as the City and Civic face stiff price competition.

Pak Suzuki has a commanding 71% market share in LCVs with Dewan Farooque a distant second with 21% of the market.

Regulatory environment improving

Unlike the 1990s, when the industry was afflicted by slow economic growth and constant policy changes, the government and the local assemblers are finally working together to address each other's concerns.

Auto Industry Development Plan finalized - Re-rating under way

The much-awaited finalization of the Auto Industry Development Plan (AIDP) makes it one of the few sectors for which the government has a documented vision. While the official policy document is yet to be unveiled, the AIDP includes many non-tariff incentives (PRs6bn fund for R&D, two auto clusters, and HR initiatives, etc) and also outlines the tariff structure, where CKD and CBU rates will be cut by 5% over the next five years. This bodes well for an industry that has historically traded at a steep 30% discount to market multiples.

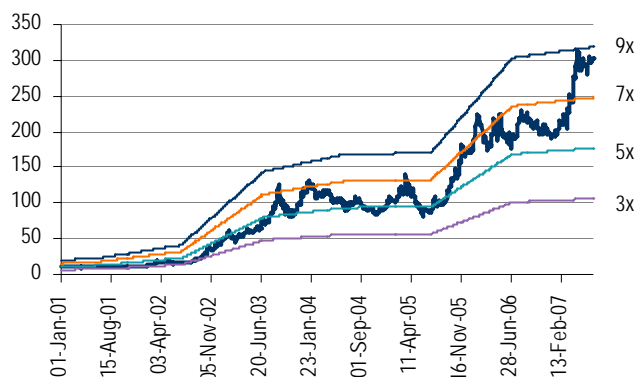
There has already been a visible re-rating for local assemblers, which should allow them to trade closer to their intrinsic values, in our view.

Table 4: Proposed tariff structure

	FY07	FY08	FY09	FY10	FY11	FY12
CKD						
Localized	50%	50%	47.5%	47.5%	45%	45%
Non-Localized	35%	35%	32.5%	32.5%	30%	30%
CBU						
below 1500cc	50%	50%	50%	45%	45%	45%
1500cc-1800cc	65%	65%	65%	60%	60%	60%
above 1800cc	75%	75%	75%	70%	70%	70%

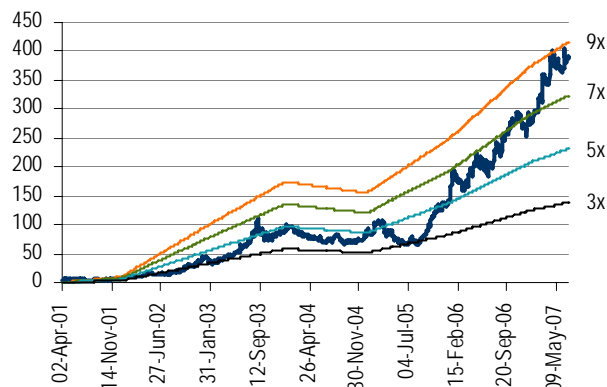
Source: Engineering and Development Board (EDB)

Chart 5: Re-rating under way – Indus Motors PE band



Source: Company Accounts

Chart 6: Re-rating under way – Pak Suzuki PE band



Source: Company Accounts

Tightening of used car import policy

In view of the adverse affect the import of used cars was having on the local industry, the government has tightened its liberal policy on imported cars by making procedures for importing used cars more stringent and imposing a three-year cap on the import of used cars.

2.5% withholding tax on local assemblers

The government has recently levied a 2.5% withholding tax (WHT) on local assemblers in the budget. Car assemblers are sure to face demand pressures due to the inevitable increase in car prices.

Risks

Given the relatively low levels of localization, local assemblers are highly sensitive to changes in Yen/PRs exchange rate. There has also been pressure on margins for local assemblers due to lower other income and higher selling expenses, even though this pressure is likely to recede as tariff rates are lowered.

The reliable brand

We visited Indus **Motor** over this month and present our impressions. **We are not commenting on the investment merit of any securities of the subject company.**

25% market share... and growing

Indus Motor Company is the second-largest automobile assembler in Pakistan with a current market share of 25%, up from 22% in FY06. Sales for the company have been on the rise, increasing at 27% five-year historical CAGR. In 11M FY07 (year-end June), the Cuore's penetration has increased to 26% in the 800cc segment from 18% in FY06, while Corolla's penetration in the 1300cc has risen to 60% from 46% in FY06. Indus Motor's also has a significant trading portfolio in which the penetration of the Camry has increased to 30% in 11M FY07 in the imported luxury car segment vs 15% in FY06.

Cashing in on the boom

The top-line growth in sales for the company has filtered through to the bottom-line, with earnings increasing at five-year historical CAGR of 67%. Indus Motor posted earnings of PRs33.7/share in FY06, up 78% YoY. However, earnings for the current fiscal year are expected to slow down with 9M earnings up only 8.2% YoY to PRs24.53/share. Historically, the company has maintained a high payout, with a dividend yield of 5%, one of the highest in the industry.

New models, expansions, plant upgrades in the pipeline

Indus Motor has lined up various initiatives over the next few years and aims to be the leading local assembler by 2015. It is looking at introducing new models, expanding capacity and upgrading its plant. The company plans to launch a new model of the Hilux in Pakistan in October 2007, with the new model for the Corolla to be unveiled in October in 2009. Production capacity, which has recently been raised to 53,000 units pa, could go up to 70,000 units pa on the current plant and plans are underway to set up a new plant with a total capacity of 100,000 units pa.

Financial Summary (FYE - June)

(PRs mn)	2004A	2005A	2006A
Net Profit	360	1,258	1,473
EBITDA Margin (%)	9.07%	13.17%	11.33%
Pre-tax Profit	528	1,933	2,266
EPS	4.59	16.00	18.74
Dividend Yield (%)	0.66%	2.31%	2.98%
ROE (%)	20.7%	57.2%	46.6%
Debt / Capital (%)	-103.8%	-291.8%	-183.6%

Source: Company Accounts

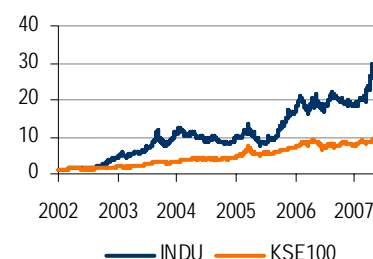


Khurram Ghufra^{****}
Research Analyst
KASB Securities

Stock Data

Price	305.5
52-Week Price Range	315/190.2
Market Val / Shares Outstanding (mn)	US\$397 / 78.6
Average Daily Volume	405,378
ML Ticker / Exchange	XIDMF
Bloomberg / Reuters	INDM.KA
Date of Visit	June-2007

Chart 1: Stock price performance



Source: KSE

Company description

Indus Motor, a joint venture between Toyota Motor Company (12.5% stake), Toyota Tsusho Corporation (12.5% stake) and the House of Habib, is renowned for the quality and reliability of its vehicles. The company's product lineup includes its flagship Corolla and the 800cc Daihatsu Cuore, of which it is the sole distributor in Pakistan. The company also has a well-diversified CBU portfolio, which includes the Camry, Land Cruiser, Prado and Hilux.

Indus Motor's production facilities are located at Port Bin Qasim Industrial Zone near Karachi with a current plant capacity of 53,000 units pa. According to management, the capacity on the current plant can be increased to 70,000 units pa and plans are already underway to set up a new plant.

Business risks

The new plant Indus Motor is planning is contingent upon approval from Toyota Global. Should there be any delay, the potential growth upside in the short-to-medium term may be capped.

Other risks are: (1) the inherent sensitivity of all local assemblers to exchange rate fluctuations due to low levels of localization, (2) monetary tightening leading to higher auto-financing rates, and (3) a slowdown in economic growth.

Financials

Table 1: Summary income statement, balance sheet and cash flow

PRs mn	2004	2005	2006
COGS	(7,140)	(13,296)	(19,591)
Gross Profit	971	2,339	2,931
SG&A	(235)	(280)	(378)
Operating Profit	526	1,827	2,279
Pretax Profit	528	1,933	2,266
Net Profit	360	1,258	1,473
Total Assets	6,238	11,069	11,556
Current Assets	5,103	10,069	10,683
Fixed Assets	1,135	1,000	874
Total Liabilities	4,384	8,524	7,785
Current Liabilities	4,130	8,170	7,237
Fixed Liabilities	254	354	548
Shareholder	NA	NA	NA
Shareholder's Equity	1,854	2,545	3,772
Operating Cash Flow	2,641	5,911	394
Investing Cash Flow	(163)	(97)	(147)
Free Cash Flow	2,478	5,814	254
Financing Cash Flow	(645)	(316)	(709)

Source: Company

Size matters

We visited Pak **Suzuki** over the past week and present our impressions. **We are not commenting on the investment merit of any securities of the subject company.**

Way ahead of the pack

Pak Suzuki has successfully tapped the growing demand for automobiles by pursuing a policy of aggressive capacity enhancements, which has grown from 10,000 units pa to 150,000 units pa currently. As a result, the company has seen its market share rising from 46% in FY01 to 60% in 11M FY07. Even though industry sales have shown signs of a slowdown in the current fiscal year, Pak Suzuki's sales remain healthy, growing at 23% YoY in 11M FY07.

Volumetric growth translates to bottom-line profitability

The volumetric growth in sales has translated into phenomenal five-year earnings CAGR of 107.5%, with the company posting earnings of PRs41.33/share in CY06. EBITDA margins, too, have gradually increased by 880bp over the past five years to 13.8% in CY06. Pak Suzuki's margins continue to be the highest in the industry due to penetration in the lower-end segments with high levels of deletion (localization of parts). The high level of deletion also shields the company from exchange rate volatility, giving it a significant advantage over competitors.

Further expansion on the cards

With expansion plans on the cards, Pak Suzuki is set to maintain its position as the leading local assembler. Capacity on the current plant can be increased to 170,000 units pa and the company has finalized plans to set up a new plant with a capacity of 100,000 units pa by CY11.

Financial Summary (FYE – December)

(PRs mn)	2004A	2005A	2006A
Net Profit	1,396	2,237	3,350
EBITDA Margin (%)	10.76%	11.99%	13.80%
Pre-tax Profit	2,126	3,520	5,139
EPS	17.22	27.59	41.33
Dividend Yield (%)	0.25%	0.84%	0.00%
ROE (%)	28.5%	33.4%	35.7%
Debt / Capital (%)	-120.0%	-123.3%	-73.7%

Source: Company Accounts

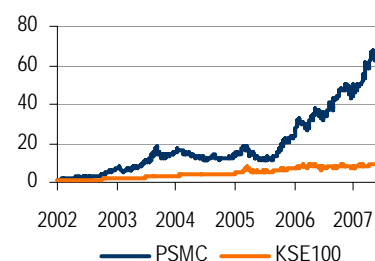


Khurram Ghufra^{****}
Research Analyst
KASB Securities

Stock Data

Price	392.00
52-Week Price Range	405.00 / 196.47
Market Val / Shares Outstanding (mn)	US\$525 / 81.07
Average Daily Volume	146,077
ML Ticker / Exchange	PKSMF
Bloomberg / Reuters	PSMC PA
Date of Visit	June-2007

Chart 1: Stock price performance



Source: KSE

Company description

Pak Suzuki is a joint venture between Suzuki Motor Corporation of Japan (73% stake) and Pakistan Automobile Corporation. Incorporated as a public limited company in August 1983, it has consolidated its position over the years and has emerged as the largest automobile assembler in Pakistan. The company offers a diversified product portfolio including passenger cars, pickups, vans and 4x4's, and has recently merged with Suzuki Motorcycles to expand its product offering.

Pak Suzuki's production plant is located in Port bin Qasim near Karachi, and has a current capacity of 150,000 units pa. This can be enhanced further to 170,000 units pa. In line with its aggressive expansion strategy, the company has bought 120 acres of land in January 2007. Plans are underway to build a new plant on this site with an expected capacity of 100,000 units pa by CY11.

Business risks

Quality remains one of the biggest concerns for Pak Suzuki. The company has fared well with the domestic auto industry in its nascent stage and a dearth of options for consumers. However, as the industry matures and competition intensifies, Pak Suzuki will have to invest in improving the quality of its vehicles.

Other risks are (1) the inherent sensitivity of all local assemblers to exchange rate fluctuations due to low levels of localization, (2) monetary tightening leading to higher auto-financing rates, and (3) a slowdown in economic growth.

Financials

Table 1: Pak Suzuki: Summary income statement, balance sheet and cash flow

(PRs mn)	2004	2004	2005
COGS	(21,577)	(31,189)	(40,501)
Gross Profit	2,885	4,185	6,687
SG&A	(253)	(412)	(821)
Operating Profit	2,162	3,156	4,713
Pretax Profit	2,126	3,520	5,139
Net Profit	1,396	2,237	3,350
Total Assets	2,751	4,691	22
Current Assets	(1,642)	(1,889)	(1,286)
Fixed Assets	1,099	2,813	(1,263)
Total Liabilities	(147)	151	(352)
Current Liabilities			
Fixed Liabilities	13,550	18,748	22,050
Shareholder	11,034	15,127	18,096
Shareholder's Equity	2,516	3,621	3,954
	7,973	10,922	11,131
Operating Cash Flow	7,973	10,771	11,062
Investing Cash Flow	0	151	69
Free Cash Flow	NA	NA	NA
Financing Cash Flow	5,577	7,826	10,919

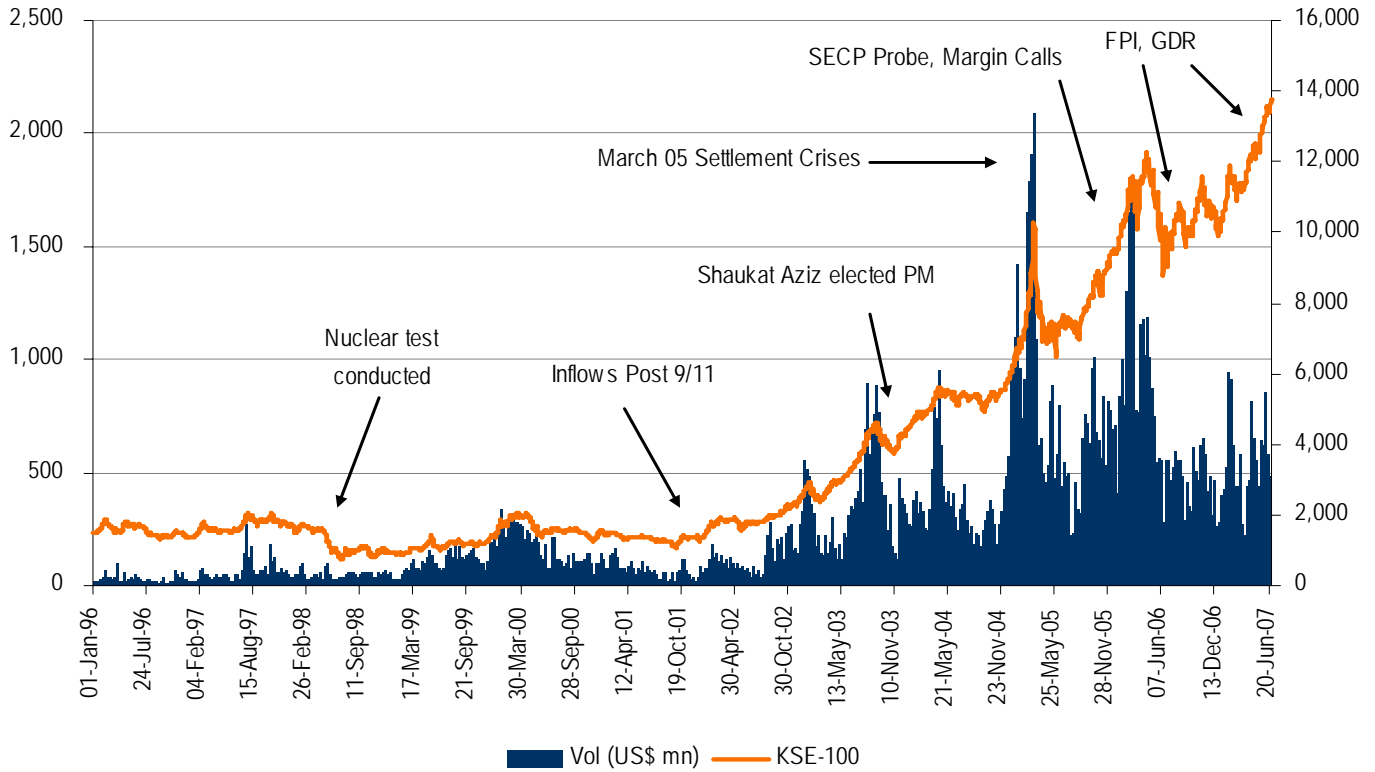
Source: Company

Appendix 1

Pakistan market factoid

KSE-100 Index- A snapshot of history

Chart 4: KSE-100: A historical snapshot



Source: KSE, KASB Research

KSE-100 Index - Composition and liquidity

Table 6: KSE-100 Composition

Sector	Weight	ADTO (US\$mn)
COMMERCIAL BANKS	29.07%	133.56
OIL & GAS EXPLORATION COMPANIES	23.12%	104.43
TECHNOLOGY & COMMUNICATION	6.62%	11.56
OIL & GAS MARKETING COMPANIES	4.95%	14.20
FERTILIZER	4.84%	13.63
CEMENT	4.15%	36.32
FOOD & PERSONAL CARE-PRUDUCTS	3.58%	0.38
POWER GENERATION & DISTRIBUTION	3.46%	3.53
INSURANCE	3.21%	6.68
INVESTMENT BANKS/COS./SECURITIES	2.61%	14.35
AUTOMOBILE ASSEMBLER	2.55%	1.34
TOBACCO	2.16%	0.07
PHARMACEUTICALS	1.30%	0.17
CHEMICALS	1.24%	0.74
REFINERY	1.16%	1.79
TEXTILE COMPOSITE	0.98%	7.68
TRANSPORT	0.97%	0.22
PAPER & BOARD	0.71%	0.90
SYNTHETIC & RAYON	0.71%	0.29
CABLE & ELECTRICAL GOODS	0.58%	0.19
MISCELLANEOUS	0.56%	0.24
CLOSED-END-MUTUAL FUNDS	0.42%	0.64
ENGINEERING	0.25%	0.17
JUTE	0.20%	0.10
GLASS & CERAMICS	0.17%	0.07
LEATHER & TANNERIES	0.08%	0.01
AUTOMOBILE PARTS & ACCESSORIES	0.07%	0.04
SUGAR & ALLIED INDUSTRIES	0.06%	0.18
LEASING COMPANIES	0.06%	0.03
TEXTILE SPINNING	0.06%	0.08
MODARABAS	0.04%	0.05
TEXTILE WEAVING	0.02%	0.06
WOOLEN	0.01%	0.00

Source: KASB research, KSE

Trading and transaction details for investors

Specific to local investors

- Capital gains on sale of listed securities are exempt from income tax up to FY08 (year-end June 2008). This exemption has been in place since 1974.
- Dividends are subject to withholding tax at 10%, to be deducted at source as a separate source of income for individuals and corporates.
- A turnover tax of 0.02% is charged on all buy transactions and 0.01% on all sell transactions.

Specific to foreign investors

- Foreign investors are allowed to operate freely in the capital market without any minimum retention period.
- Funds invested in the capital market are freely transferable, along with dividend income.
- Foreign investors are treated on par with local investors in tax treatment.

Foreign ownership structure

There is no restriction on the extent of foreign ownership in any business sector. However, any investor – foreign or local – acquiring a 10% stake or in multiples thereof, in any listed company through the stock exchanges, has to inform the exchange and the Securities and Exchange Commission, which is then communicated to the members through an announcement. For commercial banks, investors acquiring 5% stake or more have to seek prior approval from the central bank. Acquisition stake of 25% or above for any company is considered under takeover laws. The acquirer has to make a tender offer.

Portfolio flows only restricted once in past 15 years

Restriction on foreign portfolio flows has only been imposed once in the past 15 years. Post nuclear tests in May 1998, all foreign currency accounts were frozen and no foreign currency outflows were allowed. However, this restriction was partially lifted in December 1998, when the government allowed foreign currency outflows after verification by the State Bank of Pakistan. Controls on foreign currency outflows were completely lifted in February 1999. The freeze on portfolio inflows was primarily driven by the deterioration in foreign exchange balance, which dwindled to US\$30mn (import cover of less than two weeks).

The government has, on various occasions, accepted that freezing foreign currency outflows was one of the worst decisions taken in the economic history of Pakistan. Given this feeling, and the strong forex reserves position (US\$14bn+; almost seven months' import cover) we think it is unlikely to be repeated.

Market trading specifics

Table 7: Market trading specifics

Primary Exchange	KSE 100 Index			
Trading Hours	Monday-Thursday	9:45-14:15		
	Friday	9:30-12:00		
		14:30-16:00		
Trading System	Order driven system called Karachi Automated Trading System			
Settlement	T+3 (T+2 to be effective from 7th August 2007)			
Daily Price Change Limits	5% for stock above Rs.20			
	Rs.1 for stocks below Rs.20			
Short Selling	Short sales are not permitted unless one can show documentary evidence that shares are available.			
Spreads	Rs.0.05			
Board Lots	Minimum lot size is 500 shares			
	In a few shares the minimum lot is 100 shares			
Odd Lots	Odd lots can be sold			
Main Indices	KSE-100	Reuters .KSE	Bloomberg KSE<INDEX>	No. of Constituents 100

Source: KASB research, KSE

Trading operations

Table 8: Operations

Settlement Date	T+3 (T+2 to be effective from 7th August 2007)
Scrip less Environment	Lots of 100 or 500
Fees	Transaction Fee: PKR4900
Withholding Tax	10% (Cash Dividend & Profit)

Source: KASB research, KSE

Price objective basis & risk

DG Khan

Our sum-of-parts Price Objective is PRs122/share. Our SOTP based valuations include 1) a PRs66/share for DGKC's Core cement operations valued on DCF and 2) a portfolio value of PRs14bn or PRs56/sh discounted at 30%. Excluding the discounted portfolio value, DGKC's core operations is currently trading at 7.2x FY08E core EPS of PRs6.04/sh.

The risk to our price objective are 1) prolonged period for low cement prices; 2) slow down in construction activity domestically post elections; 3) with 46% of the PO coming from portfolio value, our PO for DGKC is sensitive to an extended bear market.

Fauji Fertilizer

We are reiterating Buy on FFC with a revised DCF-based PO of PRs135/share. At our price objective, we have valued FFC at a WACC of 13% and a terminal growth rate of 2%. FFC is currently the cheapest fertilizer stock in Pakistan, trading at 8.8x 2008E earnings and offering the highest dividend yield of 10% in the sector and second-highest in the stock market. At the current price, the stock offers a potential total return of 21% including upside of 12% to our DCF-based PO of PRs135/share and a dividend yield of 9%.

Risks: (1) Higher year-end urea inventory in 2007, (2) delay to FFBL's expansion plan, (2) natural hazards affecting domestic fertilizer demand, and (3) unexpected competitive pressure from Engro and Fatima Fertilizer.

Fauji Bin

Our PO of PRs45 for FBBL (price: PRs37.10; C-1-8) is based on DCF-based valuations, assuming a WACC of 12% and terminal growth of 4%. The stock currently trades at an attractive P/E of 7.6x 2008E EPS.

Risks: (1) Longer-than-expected plant shutdown for expansion, (2) shift in DAP plant de-bottlenecking from 4Q07 to 1Q08, (3) higher-than-expected decline in international DAP prices in the event of fresh expansions, and (4) natural calamities, such as drought, which may temporarily impact demand growth.

Pakistan Oilfield

Our price objective for POL at PRs456/share is based on sum-of-the-parts valuation method. Key assumptions: (1) Long-term oil price of US\$60/bbl (WTI brand), (2) cost of equity of 16.3%, (3) A 25-year production profile for POL's present reserves, and (4) we have valued POL's investment in APL at our PO of PRs441/share. Moreover, we have valued POL's investment at PRs233/share by applying P/BV of 1.66x, which is at 20% discount to NRL's historical average of 2x. We have used the DCF to value POL's present-producing and to-be-commercialized reserves. This represents upside potential of over 33% to the current market price.

Key risks associated with POL are (1) delays in implementation of development plans, (2) steep decline in oil prices, (3) exchange rate risk, (4) normal E&P risk, and (5) higher cost of future diversification strategy.

Pakistan Petroleum

Our price objective of PRs300/share is based on the sum-of-the-parts valuation method. Our estimates incorporate 2P reserves of oil and gas. Our PO represents potential upside of over 15% to the current market price.

Key risks associated with PPL: (1) delays in implementation of development plans, (2) steep decline in oil prices, (3) exchange rate risk, (4) normal E&P risk, and (5) law and order situation in the Province of Baluchistan, where the Sui field is located.

Pakistan State Oil

Our price objective for Pakistan State Oil is PRs422/share based on sum-of-the-parts valuation. This represents potential upside of over 19% to the current market price.

Risks: (1) Sustained decline in product prices in the international market. (2) Higher-than-expected inventory losses in 1HFY07. (3) Higher water and gas availability leading to lower fuel consumption. (4) Government intervention in the business. (5) Delays in privatization affecting investor sentiment.

Hub Power

We reiterate our Buy rating on Hubco with a dividend discount model (DDM) based PO of PRs40.15, 3.7% higher than our previous PO of PRs38.72/sh. At current prices, our PO implies 12% potential upside. We like the stock on account of its dividend yield, stable earnings pattern, low risk and unexplored growth potential. Hubco's 8.4% dividend yield is the second highest among Asia-Pacific utilities (average yield of 3.1%). For Hubco, we use the DDM given the project's fixed life of 30 years. Our cost of equity is 14.6%. In calculating Hubco's cost of equity, we have used a risk free rate of 10%, in line with yields on government bonds, an equity beta of 0.66 and a 7% equity risk premium, which we believe covers the risk of an emerging equity market like Pakistan. In the calculation of tariff indexation factors, we have assumed long-term US CPI inflation of 2% (Merrill Lynch estimates) and an annual devaluation of 3% of PRs vs the US\$.

Risk factors

The risk factors we highlight for Hubco are:

Wapda cannot pay

As the sole customer, Wapda's timely payments to Hubco are essential for smooth operations and Wapda's financial state is none too healthy. Risk cover in this case, we believe, is the government, whose aggressive generation expansion plans would be derailed if Wapda proves unreliable. As Wapda is state owned, we believe it will find financial support from the government.

International Power sell-off?

At present, International Power (IP), the O&M operator of Hubco, holds 16.58% of the company's shares. IP recently announced the dematerialization of its stake in Hubco, triggering IP sell off rumors.

Operational issues

In case of generator closure owing to operational issues at the plant, Hubco runs the risk of making less than required capacity available to Wapda and would be liable to pay liquidated damages.

Nishat Mills

As a textile cum holding company, we have valued Nishat Mills (NML) using sum-of-the-parts. While the textile operations of the company are valued using DCF valuation, we have attach a 30% discount to the market value of its equity portfolio to arrive at our PO of PRs139. We maintain Buy on NML.

To arrive at the DCF for its textile operations, we have applied a terminal growth rate of 4% and an equity beta of 1.14. To reach the appropriate discount rate (WACC) of 14.15%, we have taken the secondary market yield on the 10-year Pakistan Investment Bond as a proxy for the risk-free rate and an equity risk premium of 7%, adequate compensation for the risk of an emerging market such as Pakistan. We have arrived at a PO of PRs78.58 (57% of our PO) for NML's core operations, which is 12.5x FY07E core earnings of PRs6.31/share.

The equity portfolio has been valued on NAV, applying a 30% discount to market value. The discount we apply is somewhat higher than that applied to closed-end funds and is used to discount for (1) the increased volatility implicit in an emerging market like Pakistan, and (2) the portfolio is not recomposed regularly as the company is not likely to offload strategic holdings of group companies so quickly. While current market value of the portfolio is PRs17.35bn (PRs108.57/share), we incorporate PRs60.43/share as portfolio value (43% of our PO).

The risks to our PO are: 1) poor cotton crop in FY08, driven by environmental events, which could negatively impact gross margins, 2) increased competition in the bed wear market, particularly from India and China and 3) stock market movement, where an extended decline would weaken both portfolio value and premium attached to equity portfolio. On the upside, the government has disclosed that it will be announcing a textile relief package in 2-4 weeks, which could have incentives in the form of tax and/or utility rate subsidies.

Analyst Certification

We, Shagufta Irshad, Farrah Marwat, Imtiaz Gadar, CFA, Mohammad Fawad Khan, Alistair Scarff and Khurram Ghufraan, hereby certify that the views each of us has expressed in this research report accurately reflect each of our respective personal views about the subject securities and issuers. We also certify that no part of our respective compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

Special Disclosures

This report is issued and distributed outside Pakistan solely by Merrill Lynch. KASB Securities is not licensed to provide advisory services outside Pakistan. Investors should contact their Merrill Lynch representative if they have questions concerning this report.

Important Disclosures

Investment Rating Distribution: Autos Group (as of 01 Jul 2007)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	39	40.63%	Buy	6	18.18%
Neutral	45	46.88%	Neutral	5	13.51%
Sell	12	12.50%	Sell	1	9.09%

Investment Rating Distribution: Banks Group (as of 01 Jul 2007)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	120	46.51%	Buy	52	55.32%
Neutral	111	43.02%	Neutral	54	55.10%
Sell	27	10.47%	Sell	15	62.50%

Investment Rating Distribution: Building Group (as of 01 Jul 2007)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	57	52.78%	Buy	11	21.15%
Neutral	46	42.59%	Neutral	8	18.60%
Sell	5	4.63%	Sell	0	0.00%

Investment Rating Distribution: Chemicals Group (as of 01 Jul 2007)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	46	55.42%	Buy	6	15.00%
Neutral	32	38.55%	Neutral	10	35.71%
Sell	5	6.02%	Sell	0	0.00%

Investment Rating Distribution: Energy Group (as of 01 Jul 2007)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	147	58.80%	Buy	49	38.89%
Neutral	91	36.40%	Neutral	18	22.78%
Sell	12	4.80%	Sell	4	36.36%

Investment Rating Distribution: Textiles/Apparel Group (as of 01 Jul 2007)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	12	52.17%	Buy	3	25.00%
Neutral	7	30.43%	Neutral	2	28.57%
Sell	4	17.39%	Sell	1	25.00%

Investment Rating Distribution: Utilities Group (as of 01 Jul 2007)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	61	38.13%	Buy	18	35.29%
Neutral	84	52.50%	Neutral	32	43.84%
Sell	15	9.38%	Sell	3	21.43%

Investment Rating Distribution: Global Group (as of 01 Jul 2007)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1675	47.16%	Buy	435	29.21%
Neutral	1633	45.97%	Neutral	438	29.67%
Sell	244	6.87%	Sell	47	21.66%

* Companies in respect of which MLPF&S or an affiliate has received compensation for investment banking services within the past 12 months.

In the US, retail sales and/or distribution of this report may be made only in states where these securities are exempt from registration or have been qualified for sale: DG Khan, Engro Chemical, Fauji Fertilizer, Fauji Fertilizer BQ, Hub Power, Indus Motor, Kot Addu Power, Natl Bk Pakistan, Nishat Chunian, Nishat Mills, OGD, Pak Suzuki, Pakistan Oilfie, Pakistan Petrole, Pakistan State.

MLPF&S together with its affiliates beneficially owns one percent or more of the common stock of this company. If this report was issued on or after the 10th day of the month, it reflects the ownership position on the last day of the previous month. Reports issued before the 10th day of a month reflect the ownership position at the end of the second month preceding the date of the report: Nishat Mills, Pakistan Oilfie.

The analyst(s) responsible for covering the securities in this report receive compensation based upon, among other factors, the overall profitability of Merrill Lynch, including profits derived from investment banking revenues.

Other Important Disclosures

UK readers: MLPF&S or an affiliate is a liquidity provider for the securities discussed in this report.

Information relating to Non-U.S. affiliates of Merrill Lynch, Pierce, Fenner & Smith Incorporated (MLPF&S):

MLPF&S distributes research reports of the following non-US affiliates in the US (short name: legal name): Merrill Lynch (France): Merrill Lynch Capital Markets (France) SAS; Merrill Lynch (Frankfurt): Merrill Lynch International Bank Ltd, Frankfurt Branch; Merrill Lynch (South Africa): Merrill Lynch South Africa (Pty) Ltd; Merrill Lynch (Milan): Merrill Lynch International Bank Limited; MLPF&S (UK): Merrill Lynch, Pierce, Fenner & Smith Limited; Merrill Lynch (Australia): Merrill Lynch Equities (Australia) Limited; Merrill Lynch (Hong Kong): Merrill Lynch (Asia Pacific) Limited; Merrill Lynch (Singapore): Merrill Lynch (Singapore) Pte Ltd; Merrill Lynch (Canada): Merrill Lynch Canada Inc; Merrill Lynch (Mexico): Merrill Lynch Mexico, SA de CV, Casa de Bolsa; Merrill Lynch (Argentina): Merrill Lynch Argentina SA; Merrill Lynch (Japan): Merrill Lynch Japan Securities Co, Ltd; Merrill Lynch (Seoul): Merrill Lynch International Incorporated (Seoul Branch); Merrill Lynch (Taiwan): Merrill Lynch Global (Taiwan) Limited; DSP Merrill Lynch (India): DSP Merrill Lynch Limited; PT Merrill Lynch (Indonesia): PT Merrill Lynch Indonesia; Merrill Lynch (KL) Sdn. Bhd.: Merrill Lynch (Malaysia); Merrill Lynch (Israel): Merrill Lynch Israel Limited; Merrill Lynch (Russia): Merrill Lynch CIS Limited, Moscow.

This research report has been prepared and issued by MLPF&S and/or one or more of its non-U.S. affiliates. MLPF&S is the distributor of this research report in the U.S. and accepts full responsibility for research reports of its non-U.S. affiliates distributed in the U.S. Any U.S. person receiving this research report and wishing to effect any transaction in any security discussed in the report should do so through MLPF&S and not such foreign affiliates.

This research report has been approved for publication in the United Kingdom by Merrill Lynch, Pierce, Fenner & Smith Limited, which is authorized and regulated by the Financial Services Authority; has been considered and distributed in Japan by Merrill Lynch Japan Securities Co, Ltd, a registered securities dealer under the Securities and Exchange Law in Japan; is distributed in Hong Kong by Merrill Lynch (Asia Pacific) Limited, which is regulated by the Hong Kong SFC; is issued and distributed in Taiwan by Merrill Lynch Global (Taiwan) Ltd or Merrill Lynch, Pierce, Fenner & Smith Limited (Taiwan Branch); is issued and distributed in Malaysia by Merrill Lynch (KL) Sdn. Bhd., a licensed investment adviser regulated by the Malaysian Securities Commission; and is issued and distributed in Singapore by Merrill Lynch International Bank Limited (Merchant Bank) and Merrill Lynch (Singapore) Pte Ltd (Company Registration No.'s F 06872E and 198602883D respectively). Merrill Lynch International Bank Limited (Merchant Bank) and Merrill Lynch (Singapore) Pte Ltd. are regulated by the Monetary Authority of Singapore. Merrill Lynch Equities (Australia) Limited, (ABN 65 006 276 795), AFS License 235132, provides this report in Australia. No approval is required for publication or distribution of this report in Brazil.

Merrill Lynch (Frankfurt) distributes this report in Germany. Merrill Lynch (Frankfurt) is regulated by BaFin.

Copyright, User Agreement and other general information related to this report:

Copyright 2007 Merrill Lynch, Pierce, Fenner & Smith Incorporated. All rights reserved. This research report is prepared for the use of Merrill Lynch clients and may not be redistributed, retransmitted or disclosed, in whole or in part, or in any form or manner, without the express written consent of Merrill Lynch. Merrill Lynch research reports are distributed simultaneously to internal and client websites eligible to receive such research prior to any public dissemination by Merrill Lynch of the research report or information or opinion contained therein. Any unauthorized use or disclosure is prohibited. Receipt and review of this research report constitutes your agreement not to redistribute, retransmit, or disclose to others the contents, opinions, conclusion, or information contained in this report (including any investment recommendations, estimates or price targets) prior to Merrill Lynch's public disclosure of such information. The information herein (other than disclosure information relating to Merrill Lynch and its affiliates) was obtained from various sources and we do not guarantee its accuracy. Merrill Lynch makes no representations or warranties whatsoever as to the data and information provided in any third party referenced website and shall have no liability or responsibility arising out of or in connection with any such referenced website.

This research report provides general information only. Neither the information nor any opinion expressed constitutes an offer or an invitation to make an offer, to buy or sell any securities or other investment or any options, futures or derivatives related to such securities or investments. It is not intended to provide personal investment advice and it does not take into account the specific investment objectives, financial situation and the particular needs of any specific person who may receive this report. Investors should seek financial advice regarding the appropriateness of investing in any securities, other investment or investment strategies discussed or recommended in this report and should understand that statements regarding future prospects may not be realized. Investors should note that income from such securities or other investments, if any, may fluctuate and that price or value of such securities and investments may rise or fall. Accordingly, investors may receive back less than originally invested. Past performance is not necessarily a guide to future performance. Any information relating to the tax status of financial instruments discussed herein is not intended to provide tax advice or to be used by anyone to provide tax advice. Investors are urged to seek tax advice based on their particular circumstances from an independent tax professional.

Foreign currency rates of exchange may adversely affect the value, price or income of any security or related investment mentioned in this report. In addition, investors in securities such as ADRs, whose values are influenced by the currency of the underlying security, effectively assume currency risk.

Officers of MLPF&S or one or more of its affiliates (other than research analysts) may have a financial interest in securities of the issuer(s) or in related investments.

Merrill Lynch Research policies relating to conflicts of interest are described at <http://www.ml.com/media/43347.pdf>.

Fundamental equity reports are produced on a regular basis as necessary to keep the investment recommendation current.