Federal Budget Preview FY09

2009 Federal Budget impact on Economic Growth: Neutral

We do not expect the Federal Budget 2009 to reflect fiscal space in order to kickstart economic growth in the short term. Budgetary measures are likely to focus on salvaging the extraordinary fiscal spending gap expected in the range of 7.5% of GDP via extensive debt mobilization. Investment spending and output growth is likely to take a backseat to poverty alleviation and plugging the twin deficits. Consumption is likely to slow on contracting disposable incomes while Savings will remain under 20% of GDP. Given the Federal liquidity crunch GDP growth expectations for FY09 will reflect a downside to 5% and will have a proportionate impact on private sector earnings growth.

Fiscal Outlook: Negative

We have witnessed a very disappointing loosening of fiscal management in FY08. Key milestones including reduction of public debt below 60% of GDP and increased Development spending are likely to see their last days for the short to medium term as fiscal space constricts and the debt burden rises. Tax revenues will likely remain stagnant in the 10% of GDP range while total expenditures FY09 will outpace gross revenue receipts on account of higher debt servicing costs and a mismanaged subsidy package; albeit compounded by global commodity price pressures and higher interest rates.

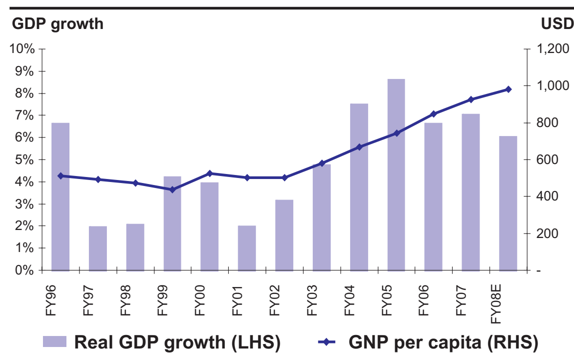
KSE Outlook: Opportunist stance

We recommend investors maintain a cautious stance for the short term on account of unstable economic indicators, political instability, scarce external and domestic liquidity flows and feeble pace of regulatory reform. Full blown exchange rate, inflation and interest rate risks are likely to have a negative impact on corporate sector earnings growth. Regulatory risks and state intervention possibilities also remain given the vulnerable economic scenario. However scrips representing dynamic demand pulls, effective commodity price and currency hedges present attractive gains in the medium term.

Regulatory Wildcard

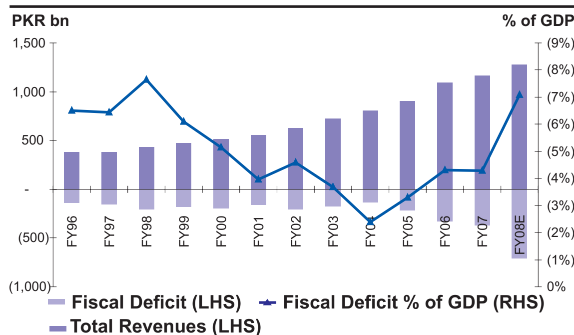
Economic vulnerabilities suggest the government may resort to inconsistent knee-jerk regulatory changes in order to prevent a liquidity crisis. Such measures include taxation of sectors which are gaining windfall profits such as Oil & Gas, direct market intervention such as the introduction of the 5% deposit rate floor and luxury goods taxes to the tune of 15-20% on imports of non-essential items. However we believe policy actions will remain fragmented until political clarity on the future of the Federal coalition is achieved.

GDP growth and Per Capita Income



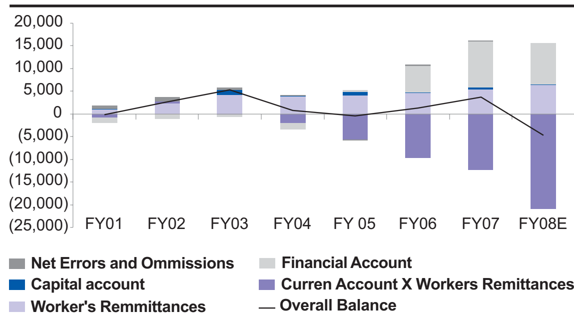
Source: Economic Survey, IGI Research

Fiscal Management



Source: MOF, Economic Survey & IGI Research

Balance of Payments (USD mn)



Source: SBP, IGI Research

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IGI Securities

Looking back …Menacing Macro Trends

During the last year Pakistan's economy has been faced with mounting challenges in the midst of a political transition from military intervention towards democratic governance. The fiscal year began on a high note but ended sourly with the demise of the leading democratic candidate of the PPP, former PM Benazir Bhutto. The PPP in tandem with the PML N nevertheless assumed a shaky coalition government in Mar08. The change of guard exposed the cracks and crevices of the previous fiscal managers with the deficit touted to be in the range of 9.5% of GDP by Finance Minister Ishaq Dar. A breakdown in the political partnership resulted in Dar's resignation and the reins of the Finance Ministry were assumed by Naveed Qamar. The external account meanwhile deteriorated with the trade deficit already exceeding USD 16bn in 10mo FY08, the Current Account Deficit reaching USD 12bn or 8% of GDP, the currency depreciating by a massive 15% in May and a drawdown by over USD 5bn to USD 11bn in foreign reserves bringing total import capacity to just 3mo worth by Jun 1'08. Inflation rates soared to 16% for 4Q FY08 brining average CPI inflation for the fiscal year to 12% and triggering an interim policy rate hike of 150bps to 12% in tow of other orthodox monetary policy measures.

360 days later and we're at the threshold of a new Federal Budget 2009. Not only will we address the strains and pressures that destabilized 2008 Federal Budget targets but we will examine key headwinds facing the future Budget. These include the twin deficits, exogenous price and domestic supply shocks, weak policy responses and a laggard tax to GDP ratio. In terms of investment strategy we believe 2009 will be a difficult year for key economic indicators, political variables, regulatory reforms and liquidity which will have a negative impact on capital markets in the short to medium term.

Fiscal Dysfunction

Annual Budget statements published last year projected an outlay of PKR 1,599bn including current expenses of PKR 1,056bn and Development expenses worth PKR 520bn. Revenues were projected at over PKR 1,368.1bn including tax revenues of PKR 1,030bn. Against this backdrop the Finance Division estimated Capital Receipts of PKR 1,411.5bn in domestic and PKR 258.5bn from external source coupled with PKR 75bn in Privatization Proceeds.

3Q FY08 Fiscal Operations released in late May08 are indicative of the gloomy trends likely to materialize by year end; current expenses rose by 24% to PKR 1,142.7bn over the same period last year while revenues lagged at a meager pace of 9% to just under a trillion rupees against an annual target of PKR 1,368.1bn. This led to an increase in the Fiscal Deficit by 81% to PKR 494bn, already at 4.6% of GDP against a full year target of 4% and expected to fall in the range of 7-7.5%.

Current expenditures have already surpassed the FY08 target. These have been driven primarily by General Public Services segment comprising Servicing of Domestic Debt up by 45% to PKR 312.8bn in just 3Q FY08 against a target of PKR 318.1bn. In addition Servicing of Foreign Debt also rose to 73% of the full year target reaching PKR 41.4bn. Other sub-segments of Current Expenditure which reflected a rapid increase were Economic Affairs; rising by 118% to PKR 76.3bn already at 97% of the FY08 Budget estimate. Defense Affairs remained in line with fiscal targets of PKR 275bn for the year despite security slippages and anti-terrorism activity in the northern areas, particularly Swat.

Federal spending on PSDP remained at just 52% of the FY08 target by 3Q FY08 or PKR 191bn. This indicates critical spending cuts which could translate into a decline of 31% in Federal PSDP spending to the range of 255bn against the PKR 370bn full year target. Nevertheless both Federal and Provincial development spending rose by 34% and 28% over 9mo FY07 largely allocated to water management, infrastructure and power. Growth of 24% and 9% in spending on Health and Education Affairs appears positive at first however it still remains at a dismal 0.003% and 0.015% of Current Expenditures during the period under review.

On the revenue front as expected the phasing out of wealth taxes in 2000; reductions in import tariffs on luxury goods including automobiles; zero rating of crude oil; ferrous waste and scrap and machinery imports; gradual decline in Development Surcharges on Petroleum are all manifested in the lackluster tax-GDP ratio of just 7.1% during 3Q FY08. Tax Revenues reached 69% of the fiscal target of PKR 1,030bn or PKR 711bn and are likely to crawl behind rapidly rising expenditures. Taxes on international trade rose by just 9% and Excise duties by just 13% during 9mo FY08 fiscal operations. Amongst revenue spinners of the Excise duty component Cement and POL sectors reflected declines in 1H FY08 over the corresponding period last year.

FBR data for 1H FY08 suggests Cement sector depicted the strongest decline amongst revenue spinners of Sales Tax by 31% on account of input adjustment claims despite massive expansion activity. This dragged down overall Sales Tax collection growth to just 6.3%. Meanwhile Telecom and POL products witnessed double digit growth in Sales Taxes however the advantage from POL sales is likely to be nullified on account of pending refunds. An important area worth exploring is the low contribution of Services sector to Sales tax component at just 3.3%. There is room for this sub segment to expand beyond hotels and travel related services which may garner a further PKR 10-15bn in revenues.

Given the expected jump in Current expense, it would have been practical for the government to take a stringent tax policy stance to contain inflationary pressures and meet fiscal targets. However a weak policy standpoint coupled with political considerations resulted in a damaging lag in response times and consequently a huge fiscal spending gap.

Federal Foils and Foibles: Budget 2008

The current year's budget was based on a number of assumptions:

- Tax Revenue would rise by 23% to PKR 1,030bn over FY07 levels
- Non-Tax Revenue would rise by 40% to PKR 337.6bn against initial FY07 estimates but was unchanged against revised FY07 figures of PKR 374bn
- Resource availability would increase to PKR 1,394bn
- The share of Current Expenditure would be limited to 66% of total budgetary outlay of PKR 1,599bn
- The size of the PSDP would rise by 32% over revised estimates for Federal Budget 2007 to PKR 520bn
- Privatization proceeds would reach PKR 75bn

Against the backdrop of Budget Highlights 2008, we have seen a discrepancy in practically every segment with our estimates suggesting a Fiscal Deficit in the range of 7.5% of FY08 GDP against a contraction target of 4%. The deteriorating Federal Budget position could be supported by what appears to be a Provincial Government Fiscal Operations surplus of upto PKR 13bn in 3Q FY08. Tax revenues are likely to remain close to the PKR 940bn range or under 10% of GDP, while Current Expenditures are expected to reach 95% of total budgetary outlay of PKR 1,599bn. Domestic Debt Servicing is likely to cross PKR 450bn against the estimated PKR 382bn range just on account of a 20% increase in the cost of short term debt; the largest proportion of the debt base. PSDP spending is also expected to crunch by 25% to the PKR 400bn range against FY08 Budget targets. Privatization proceeds meanwhile are negligible with planned GDR and exchangeable bond issues on the shelf. The 40% increase in Non-Tax revenues also remains unlikely with 9mo FY08 figures indicating negligible growth on account of dismal profits from PTA of just 15mn against a PKR 9.6bn target and dividends from Public Sector Enterprises at just 54% of expected revenues of PKR 78bn during the year to date. Development Surcharge on Petroleum has also achieved only half of the 2008 Budget target at PKR 23bn while interest from Public Sector Companies sits at just 45% of the year end target of PKR 37.5bn.

We did not expect fiscal policy managers to meet the fiscal deficit contraction target of 4% of GDP, given rising pressure from cost of debt servicing and development expenditure. However neither did we not expect fiscal mileage achieved in the last 5yrs to unravel so fast. The key highlight of fiscal management since 2002 has been containment of Public Debt to within 60% of GDP from almost double that in the 1990s. Given the grave circumstances of fiscal mismanagement, we fear this milestone of the Fiscal Responsibility and Debt Limitation Act 2005 is likely to be violated.

Federal Budget at a Glance

Chart 1: GDP growth and Per Capita Income

	PKR bn	FY07 Budget	FY07 Revised	FY08 Budget	IGI Estimates FY08	Shortfall
	Resources					
	Tax Revenue	**840.9**	**839.6**	**1,030.5**	**920.0**	**110.50**
	Non Tax revenue	241.9	374.4	337.5	360.0	(22.50)
	Gross Revenue Receipts	1,082.8	1,214.0	1,368.0	1,280.0	88.00
	Less Provincial Share	378.2	390.9	465.9	396.0	69.90
1	Net Revenue Receipts	704.6	823.1	902.7	884.0	18.70
2	Net Domestic Capital Receipts	16.4	80.5	58.5	520.0	(461.50)
3	External Receipts	239.3	276.6	258.5	294.0	76.50
4	Self Financing of PSDP by provinces	85.6	96.0	122.7	182.0	(59.30)
5	Change in Provincial Cash Balances	53.8	22.2	51.8	16.0	35.80
6	Privatization Proceeds	75.0	75.0	75.0	1.7	73.35
7	Bank Borrowing	140.0	55.3	130.9	130.9	-
	Total Resources 1-7	**1,314.7**	**1,428.7**	**1,600.1**	**2,028.6**	**(428.45)**
	Expenditures					
	Current Expenditure Revenue Account	**879.6**	**1,033.3**	**1,056.0**	**1,523.6**	**(467.62)**
	General Public Service	504.3	634.7	641.8	705.0	(63.20)
	Defense Affairs and Services	250.1	252.6	275.0	261.0	14.00
	Public Order and Safety Affairs	22.4	22.9	24.5	25.0	(0.50)
	Economic Affairs	74.7	91.2	78.9	102.0	(23.10)
	Environment Protection	0.2	0.2	0.2	0.2	0.03
	Housing and Community	1.0	1.1	1.0	0.7	0.34
	Health Affairs and Services	4.7	4.7	5.2	5.6	(0.43)
	Recreational and Culture	2.7	2.9	2.9	3.5	(0.56)
	Education Affairs and Services	18.8	21.9	24.1	23.0	1.10
	Social Protection	0.7	1.1	2.4	3.4	(1.00)
	Current expenditure Capital Account	24.6	31.9	32.1	42.0	(9.88)
8	**Total Current Expenditure**	**904.2**	**1,065.2**	**1,088.1**	**1,565.6**	**(477.50)**
9	**PSDP**	**435.0**	**394.5**	**520.0**	**440.0**	**80.00**
	Federal	320.0	279.5	370.0	255.0	115.00
	Provincial	115.0	115.0	150.0	181.0	(31.00)
	Other Development Expenditure	-	-	23.2	23.2	-
	Total Expenditure 8+9	**1,314.6**	**1,427.8**	**1,599.2**	**1,986.8**	**(387.62)**
	Federal Fiscal Deficit	**(231.77)**	**(213.82)**	**(231.18)**	**(706.80)**	**475.62**
	Federal Fiscal Deficit % of FY08 GDP					**(7.1%)**

Source: MOF, IGI Research

Mind the (Policy) Gap

Factors triggering the enormous fiscal slippages in FY08 include the fiscal management's weak policy responses to a number of unanticipated and anticipated economic events.

- Yield curve risk; the central bank's monetary tightening strategy resulted in the bumping up of the short term yield curve by over 120bps over Jun07 and increasing the cost of debt by a significant margin in FY08. The impact of a shift in the yield curve was evident in the revised estimates of the Federal Budget 2007 which suggested Servicing of Domestic Debt had exceeded initial estimates by 51% to reach PKR 287bn. With inflation on the uptick the Federal government should have anticipated further monetary tightening in 2008 and consequently strived to tighten its belt rather than indulge in fiscal loosening.

- Oil price risk; the power shortage had resulted in the 116% increase in demand for furnace oil to 4.1mn MT by Jun07 while the PPIB had issued 28 licenses for Power Projects of which the majority were thermal fuel based. The government should have pre-empted the fiscal risk and reduced oil price subsidies earlier in FY08. In the Federal Budget 2007's subsidy package the allocation for the Price Differential Claim was a meager PKR 10bn. This was later revised to PKR 25bn in light of soaring global energy prices. Despite this the Federal Budget 2008 allocation for PDC was15bn or 40% less than the previous year's revised budget expenditure! The government planned to use the declining Petroleum Development Levy estimated at PKR 25bn to subsidize POL products. It is worth mentioning that based on an annual consumption of 9.6bn liters of HSD and Light Diesel Oil and a current retail price subsidy of PKR 30 and PKR 24 respectively on these POL products, the estimated subsidy bill for just these 2 products has risen to nearly PKR 290bn before taxes. The enormous variation between PDC estimates of PKR 15bn and a current estimated oil price subsidy bill of above PKR 300bn suggest gross misconduct on the part of fiscal managers.

- The Federal Budget 2008 accounted for a subsidy package of PKR 114bn with the largest proportion allocated to WAPDA. Of this PKR 25bn was allocated towards Inter Disco Tariff Differential payments, however this amount is likely to have been overstepped on account of the revised power tariff approved by National Electric Power Regulatory Authority (NEPRA). Over PKR 35bn in financing had been arranged in the 1H FY08 while the government had earlier released PKR 20bn in advance to WAPDA. Anecdotal evidence suggests WAPDA was on the threshold of default on account of its dues to OMCs and IPPs. Meanwhile dues to WAPDA from FATA and KESC have also been on the lag, resulting in WAPDAs failure to make its due payments or carry out its planned expansion of power generation and transmission. According to news reports FATA is to pay PKR 77bn while KESC owed over PKR 30bn in Feb08. The government's role in this issue has been to negotiate between payees and recipients but without much success. It is estimated that the subsidy due to WAPDA for both GST and tariff differential will rise to PKR 150bn by Jun08 against the initial PKR 54bn.

- The Federal Public Accounts Receipts indicated Deferred Liabilities of PKR 300bn against Deposits and Reserves of PKR 320bn. Of this the Reserve Fund for Exchange Risk on Foreign Loans balance stood at just PKR 944mn against PKR 18.7bn the previous year. By May FY08 the PKR had depreciated by over 14% against the USD increasing the external debt burden of the country and suggesting the financial managers of the country were completely unprepared for any possibility of currency risk to the external debt burden of USD 42bn.

- The Federal Privatization Fund utilized to settle the country's foreign debt was budgeted at nil against the previous year's revised estimate balance of PKR 165bn, reducing the country's capacity to settle its debt burden as needed. With expectations of domestic political turbulence, inflation risk, currency risk, commodity price risk and destabilization of international financial markets on

the horizon the government should have mobilized privatization efforts before Dec07 rather than allowed themselves to be dominated by political considerations. With the arrival of the new government and deterioration of economic variables by mid 2008 it became impractical for the new government to carry through plans to issue exchangeable bonds or GDR issues of NBP, KAPCO and HBL in International Capital Markets. With the Privatization Fund coffers already empty at the beginning of the fiscal year, the shelving of these issues has limited the capacity of the country to settle its foreign debt significantly.

- In light of supply side constraints and cross-border leakages the government should have raised the minimum support price on average quality wheat flour from the PKR 14-16/kg in order to maintain import parity (PKR 38/kg as per imported wheat 10mo FY08). Instead of protecting its stocks in view of a tight global exportable surplus the government of Pakistan exported 225,000MT in FY07. This back fired with a draw down on domestic stocks which were initially estimated at 23mn MT and were revised downward below 22mn MT. Raising the Minimum Support Price on wheat would have prevented cross border leakages, supply side constraints and provided incentives to the agriculture sector to reinvest gains in production efficiencies. The government's lack of strategy constrained wheat stocks and dented the food import bill by another USD 3bn in FY08. Snowballing into 2009 domestic wheat shortages will be compounded by a downward revision in wheat output to 22mn MT against 24mn MT target for FY08 and the rising need for imports. However this will be partially offset by expectations of easing global wheat prices and an improving global exportable surplus.

- Lack of foresight also prompted the government to not account for a wheat import subsidy. With the ensuing shortage of wheat in global markets Pakistan instead tried to export a quarter of a million MT in FY07 to take advantage of global prices. By FY08 a domestic shortage necessitated an estimated 3mn MT of imports and based on domestic prices of PKR 19/kg an import subsidy of atleast PKR 54bn based on an estimated import quantity of 3mn MT by year end.

- In the last 5yrs as asset prices rose the government failed to utilize both the capital markets and the real estate base as an effective source of tax revenue. Direct Revenue receipts as a proportion of total tax revenues have risen gradually and have achieved 63% of the FY08 Budget target of PKR 408.3bn in 9mo FY08. Although this is a positive sign, it reflects a key policy gap in the capacity of the revenue agencies to effectively tap the non agricultural tax base estimated at over PKR 7,800bn in FY08. According to our estimates an effective direct tax rate of just 25% across the board should translate into revenues of nearly PKR 2,000bn from the manufacturing and services segment and yet has failed to do so.

- In our estimation the exemption of Capital Gains Tax now in place till 2010 represents a key flaw of the revenue structure of the economy. The administration must effectively document and gauge the actual transaction values of both capital markets and real estate sector to ascertain the true wealth of the economy. This will not only promote transparency and information efficiencies but boost investor confidence in our domestic assets. We expect the Capital Gains Exemption to provide a temporary boost to the equity market however the medium term negative impact on the revenue base does not inspire confidence in the government's policy mandate.

Great Expectations…soured

According to the Annual Plan 2008 GDP growth for the fiscal year was projected at 7.2% spurred by agriculture sector growth target of 4.5% and wheat yielding 24mn MT; Rice 5.7mn MT, Cotton 14.4mn bales, Sugar 55.9mn MT and Maize at 3.2mn MT. Two key crops have exhibited a shortfall in output due to pest attacks and lower fertilizer utilization on account of rising prices. Being major crops they will present a significant drag on agro output which could decline towards 3% level. Wheat yields are expected at 22mn MT and Cotton at 11mn bales while Rice exports have witnessed roadblocks suggesting there may be ambiguity regarding the actual value of the surplus yield available for export. Livestock is likely to support the overall agro picture substantially with additional capacities while a subsidy of PKR 15bn to the dairy sector in Federal Budget FY08 should also boost output.

On the industrial front we are likely to see some compression; 9mo FY08 Large Scale Manufacturing figures suggest laggard growth of under 5% against an FY08 target of 12.5%. Anecdotal evidence suggests the slowdown is evident in large scale consumer sectors particularly autos, textiles and cement. However LSM production data from FBS suggests a slowdown in vegetable oil, wheat milling, soap and detergent, cotton ginning and electronics segments. The full impact of currency depreciation risk, commodity price inflation risk, interest rate risk and ultimately liquidity risk is expected to take its toll on the manufacturing base at large. Mining and Quarrying should remain in line with initial estimates of 4.5% based on stable oil, gas and coal fuel extraction, which has received over USD 500mn in foreign investment flows in 10mo FY08.

Although the services sector was assumed to grow by 7.1% on account of continuing strength of Finance and Insurance, Wholesale & Retail trade and Transport, Storage & Communication, we expect moderation of this segment in FY08. The Transportation, Storage and Communication segment drew USD 1.2bn of foreign investment in 10mo FY08 consequently growth should remain in line with expectations of 6% for this sub-segment. However other segments including Finance and Wholesale & Retail Trade could drag Services growth below the 7% target due to a number of reasons;

- A 250bp hike in the SBP's policy rate during FY08 coupled with a 5% deposit rate floor is likely to compress already narrowing lending spreads of the banking sector affecting Finance and Insurance segment worth over 4% of PKR 9,970bn economy. Coupled with higher provisioning costs effective Jan08, slower loan growth and limited space to adjust asset yields upwards, banking profitability is likely to stabilize to the single digits for the next couple of quarters.

- During FY08 however Wholesale & Retail trade segment will receive a boost from spiraling commodity prices and burgeoning import activity and trade liberalization. However revenue gains may be affected by the economy's inability to effectively tap its agri-commodity potential due to structural inefficiencies, supply bottlenecks, inefficient fertilizer, chemical and water management. Although imports of commodities could provide a boost the wide differentials between global and domestic prices on some of these commodities and currency depreciation of upto 14% by May08 are likely to create pressure on trader margins and profitability.

Inflation targets of 6.5% were grossly underestimated in light of a 12% average CPI inflation expectation by Jun08 and a 16% average for 4Q FY08. Albeit unanticipated increases in global food and fuel prices and Pakistan's increased openness to exogenous shocks magnified the impact of the commodity price super cycle on our economy. On the fiscal front laggard policy responses and administrative weakness led to hoarding and regional leakages which also exacerbated the inflation impact. Monetary policy transmission with regards to inflation has also been negatively

impacted with record rates of debt monetization by the Finance Ministry contributing to excess liquidity in the system and Net Domestic Asset (NDA) growth of 23.4% as of May 24'08 and fiscal borrowing direct from the SBP of PKR 539bn. The monetary overhang is likely to carry over to 2009 resulting in higher than expected inflation rates for the next few quarters.

On the Balance of Payments end, prospects also look dismal. Initial forecasts of a USD 10.6bn trade deficit appears incredible against the current expectation of USD 19bn. The trade deficit already at 11% of GDP in 10mo FY08 was driven primarily by unanticipated global price increases and supply shortages of Wheat, Palm Oil, Raw Cotton and Fertilizer while the value of Petroleum imports crossed the USD 8.6bn mark. It is worth mentioning however that imports ex food and fuel rose by nearly 20% in 10mo FY08 suggesting initial estimates of a 9% import growth rate were unjustified.

Against the widening Current Account Deficit forecasted at USD 8bn and already at USD 12bn in 10mo FY08, the Capital and Financial Accounts also remain lackluster. Expectations of FDI in the range of USD 6.3bn and Portfolio investment in debt and equities to the extent of USD 2bn were soured with barely half that number materializing by Apr08. Gross disbursements from multi-lateral lending agencies to the tune of USD 3.2bn are likely to exceed expectations as the balance of payments deteriorates further and the economy increases its debt burden. Bold estimates of USD 17.7bn in foreign reserves were overturned with a balance of payments deficit of above USD 5bn and a simultaneous drawn down on the country's foreign reserves to below USD 11bn from a high of above USD 16bn earlier this year.

Fiscal Management: the Achilles Heel

We expect the Federal Budget 2009 to be announced on Jun 11'08 to lack regulatory punch. Already delayed from the earlier date of Jun 7'08, shifted to Jun 10'08, than rumoured to be further delayed to Jun 14'08 and now expected on Jun 11'08 the Budget is already riddled with management woes. The confusion over dates, retractions of announcements particularly regarding the oil price subsidy and CGT are redolent of instability within the political and fiscal framework. In contrast we believe the Monetary Policy makers stand as an excellent example of regulatory strength and present a model to be adopted by fiscal managers.

We were very hopeful that a dynamic and experienced group of bankers, industrialists and economists including Mr. Shaukat Tareen and Economist Saquib Shirani were recruited to lead the Economic Advisory Council (EAC) and advise the Finance Ministry on Budget Planning. A positive move was a phased increase of between 17-30% on retail prices of POL products particularly Diesel and LDO which dominate the POL consumption pool since Feb08.

However following the changes in retail oil prices, political noise seems to have overshadowed major policy decisions. All indications are that political considerations will dominate fiscal policy making for 2009. This makes the current macro-framework of the Federal Budget 2009 all the less credible. News reports suggest the following:

- Federal Budgetary Outlay should increase to the PKR 1,900bn range.
- Tax Revenue is targeted to rise by 38% to PKR 1,250bn. The increase is based on our expectations of FBR revenues in the range of PKR 920bn.
- The share of Current Expenditure will be targeted below 70% of total Federal Budgetary Outlay but is likely to exceed that level on account of increasing debt servicing, subsidy and development spending pressures.
- The size of the PSDP has been set at PKR 541bn; 35% increase over our revised estimates in the PKR 400bn range for FY08.
- Privatization proceeds would again be targeted at PKR 75bn however are unlikely to garner much attention in the face of loosening investor confidence.

Fiscal adjustments for 2009 are unlikely to include any major policy shift. As expected during a liquidity crunch the federal government is likely to depend on temporary solutions such as the Deferred Oil Payments Facility from the Saudi government and an exponential increase in its multi-lateral debt burden. We also expect an increase in debt financing from PIBs and a rise in NSS rates proportionate to the rise in the SBP policy rate. News of the introduction of short term NSS instruments of 3mo, 6mo and 1yr tenures suggests an increase in the debt burden and adds little value to the growth agenda of the fiscal plan.

The fiscal management's response to the CGT issue is a clear indication that policy makers are unable to take aggressive steps to rein in the teetering economy. However this might change once political clarity is achieved regarding the future of the Federal Coalition Government. The key policy options to reduce the fiscal deficit should ideally include bold measures such as;

- A phased reduction in the oil price subsidy on Diesel and LDO by 15% a year over the next 2yrs. Which suggests an estimated retail price above PKR 80/ltr and PKR 70/ltr respectively but lifts an approximate subsidy burden of PKR 250bn from the fiscal account while providing between PKR 80-90bn in tax revenues as well.

- CGT in the range of 25-35% on both capital markets and real estate markets, both considered tax havens due to lack of transparency. CGT on trading of shares was wavied till 2010 in the first week of Jun08, reflecting the incapacity of the government to bring this very important market segment into the tax net. Although the market may see a temporary blip in the wake of this development we think shelving of this regulatory reform will have a long term negative impact on capital markets' transparency, volatility and stability.

- A curious compensatory measure by the Finance Ministry was the suggestion that Public Sector Enterprises including EOBI, OGDC and PIA would be asked to invest upto 25% of their retirement and long term funds in the equity markets in a phased manner. Not only does this have implications for risk management of the investment books of these corporations but smacks of an attempt to divert attention from the core issue of necessary structural changes in the tax base.

- Reduction on duties of imported essential food items including Wheat and Palm oil which will not only benefit the domestic industry but reduce the burden on the urban poor. The negative revenue impact would be offset by domestic price and supply stability of these essential items.

- Taxes on real estate transactions. Property taxes from Provincial Government Fiscal Operations are expected at a meager PKR 3bn in FY08 of which agriculture taxes amount to just 20%. Agriculture sector contributes 23% to Pakistan's expected FY08 GDP of PKR 9,970bn, or nearly PKR 2,300bn. Total arable land under utilization as of 2006 is estimated at 34mn hectares while total cropped area is 23mn hectares. Clearly potential of this segment is grossly underutilized for taxation purposes on both its transaction and output values.

- Additional flat rate luxury goods import taxes in the range of 10% particularly automobiles and mobile phones comprising more than USD 2bn of imports in FY08.

- Phase out of Minimum Support Price regime on key crops including wheat and rice in order to prevent regional leakages, protect stocks and reduce cost of subsidized imports in case of shortages.

Macro Map 2009

The Planning Commission in coordination with the National Economic Council will be introducing its macro economic framework in due course. However we feel estimates and forecasts are likely to be unrealistic in light of grave concerns facing the domestic and international economies in FY08 and beyond. Growth is likely to be targeted at 5.5% whereas inflation is expected to remain in the 10% range resulting in an effective nominal GDP target of above PKR 11tn or USD 166bn for FY09.

Although agriculture sector growth expectations should improve on easing global exportable surpluses in wheat and rice, commodity price pressures, water and weather variables cloud the horizon.

Manufacturing sector will remain burdened with commodity price risk, currency risk and now interest rate risks into FY09 in addition to a slowdown in consumption levels which should affect cyclical sectors including cement and associated segments, autos, paper and board and electronics.

Services sector could also see a slump in the event of trade controls on luxury goods, necessary if imports are to be kept at current levels. FY09 imports are expected in the range of nearly USD 40bn while export growth lags under 10% and below USD 20bn.

National Savings could see a boost to PKR 2,000bn under 20% of GDP on account of the SBP's intervention and stipulation of a deposit rate floor of 5% on PLS accounts, however this will be partially offset by currency depreciation and liquidity risks which could perpetuate capital flight. Total investment as a % of GDP including Gross Fixed Capital Formation was expected at 24% of GDP; however we expect a slide in this figure on account of mounting economic challenges which compressed FDI to USD 3.5bn, limited fiscal space for investment spending, and raised the cost of financing investments.

Populist Agenda

In the midst of the economic vulnerabilities, political instability, a liquidity crunch and regulatory stagnation, the impact on poverty levels comes to mind. The impact of inflation on the lowest income segment is likely to be the hardest. In this situation there are several measures the federal government could take and which have caught the headlines in recent days. Without them we foresee very difficult times ahead for 35% of Pakistan's urban population which lives below the poverty line.

At present the Federal Budget's allocation for poverty alleviation programs such as Bait-ul Maal disburse barely 0.5% of GDP in funds to the poor for food subsidies, financial assistance, vocational training and rehabilitation. Food subsidies through the Utility Store Corporation of Pakistan provides food essentials at controlled rates however its coverage is limited in rural areas and annually the amount of relief received through this channel is less than PKR 500mn. Social Protection programs received just PKR 1.2bn in FY07 and were targeted at PKR 2.4bn this year; less than 0.0015% of total budgetary outlay.

Given fiscal space is limited and a liquidity crunch is expected on the Federal front, poverty alleviation programs are unlikely to be aggressive. We do foresee some feeble attempts to provide social safety nets however these are unlikely to resolve the glaring gap in social protection required. What is likely to materialize in the upcoming budget are the following:

- Low income segment support scheme, which will reportedly disburse PKR 1000 per month to 4.5mn low income families while news reports suggest the Budget allocation for this scheme could reach PKR 55bn which seems far –fetched in the current circumstances.

- Continuation of the vocational assistance program which has simply been re-labelled 'Awami Rozgar Scheme' from the earlier 'Rozgar Scheme' by the new Federal Government. The value of this scheme is likely between PKR 12-15bn and covers financing through Public sector banks such as NBP for buying public transport vehicles and opening shops.

- News reports also suggest that Pakistan will received USD 450-500mn in food crisis relief from the World Bank's Food Crisis Response Fund.

KSE Bites the Dust…is the best over?

During Apr08, the KSE 100 maintained an upward momentum, soaring to an all time high of 15,739 points on Apr 21'08. As of Apr 30'08 the index still held its own at 15,122 points, 3,416 points up from its 52-week low and 7% up from its Dec07 closing level. This was all in the face of deteriorating economic variables, political fragility, inflation, credit and currency risk. However by May08 the equity market began to lose momentum as the draw down on foreign reserves reached alarming levels of USD 5bn, currency depreciation reached 15% on May 21'08 and inflation for Apr08 soared to an all time high of 17%.

The SBP reacted aggressively with the introduction of several interim monetary policy measures including a 150bp rate hike, 100bp increase in both CRR and SLR requirements and a deposit rate floor of 5% to boost National Savings. To address rapid exchange rate depreciation numerous exchange controls were introduced including bans on export of EUR, GBP and UAE Dirham via foreign exchange companies, closure of their Nostro accounts, reduction of advance payment against L/Cs to 50% from 100% earlier and 35% L/C margin requirement for import of non food and fuel items. The fiscal management was noticeably absent during this period of extreme volatility. In line with our expectations, the KSE 100 plunged by more than 22% within a month. We feel the key trigger was market participant's anticipation of further regulatory risks. However given the mounting threats facing corporate profitability from all other avenues, we feel the market decoupled from ground realities during 2Q FY08.

Proof of the pudding

According to our analysis of the KSE 100 net earnings estimates, the KSE 100 was significantly over valued at the 15,000 level and trading at a P/E multiple of 17x trailing Last Twelve Months earnings Dec08. This was highly unusual against a historical average of 11-14x earnings during periods of normalcy and 8x-10x earnings during period of domestic distress. By domestic distress we are referring to the dismal status of all 4 key market drivers; political variables, economic indicators, regulatory reform and both external and domestic liquidity. The fragile coalition of the PPP and PML-N began to show cracks well into Mar08 while economic indicators began to deteriorate rapidly after Feb08. After an initial burst of energy from fiscal managers with the 17-30% increase in POL prices between Feb-May08, the Finance Ministry fell into disarray with the resignation of Ishaq Dar and consequently regulatory responses to economic emergencies became all the more feeble. Net Foreign Investment declined by nearly half to just USD 3.4bn in 10mo FY08 while exchange rate risks also materialized. A Federal liquidity crunch was on the cards due to fiscal mismanagement while corporate earnings also appear to have slowed. Contributing factors are a record 16% average CPI inflation for 4Q FY08, 12% average CPI inflation for FY08 and 17-30% increase in fuel prices which would have a significant impact on disposable incomes, rates of return and corporate margins.

The KSE 100 declined to a P/E multiple of 12.8x trailing Last Twelve Months earnings (Dec08) in the Post Interim Monetary Policy scenario by May 28'08. However we felt the index was still over valued in view of a forward earnings multiple of just 12x. A rudimentary analysis of KSE 100 earnings estimates for 2008 Pre the Interim Monetary Policy Measures in May08 suggests net earnings were tabled to rise by a marginal 4% in Dec08 over the corresponding period last year. Given the compounding risks associated with inflation, tighter interest rates, currency depreciation, and a slowing economy it would be appropriate to reduce growth expectations by atleast half.

With earnings remaining stable in the PKR 250bn range for the KSE 100 we felt a rational price range for the benchmark index at 10x net earnings would result in a market capitalization of PKR 2,540bn, a drop by nearly 76% since its peak in Apr08. A simple index conversion mechanism translates this into a bottom index level range

of between 9,300 and 10,200 points at which level we feel the KSE 100 would be oversold.

Seeking Alpha

In the wake of the central bank's wake up call the index had bottomed out close to the 11,000 point level and has now stabilized towards 13,000 mark. Nevertheless we feel the KSE 100 still has some roughing out to do in the coming months with economic data from fiscal and monetary policy managers on the horizon. Economic indictors, political variables and liquidity concerns are predominant along with inflation, interest rate and exchange rate risks. Although we feel the KSE still holds substantial value for long term holders of equity, we recommend investors maintain a cautious stance in the short term. Key sectors still representing attractive valuations include Oil & Gas, Power and Fertilizer which represent strong demand dynamics, effective currency hedges on account of USD linked tariff structures and incorporate a pass-through effect on commodity price increases.

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From the Equity Desk

Budgetary Impact on the Stock Market – Positive

The FY09 budget contains no surprise for Pakistan's stock market. Following the recent turmoil, wherein the KSE-100 crashed approx. 25% to the 11700 points intra-day low, the Government has announced the following broad measures prior to the budget:

1. Exemption from capital gains tax extended till June 2010.
2. The current tax regime for capital markets to remain unchanged for the 2008-09 fiscal. This includes CVT and other presumptive taxes currently applicable.
3. Demutualization of the stock exchanges to be implemented this year through Finance Bill 2008.
4. Incentives for new listings to be included in Finance Bill 2008.
5. A committee of capital markets and government representatives to develop a 3-year Capital Markets Policy over the next three months.
6. Government controlled corporations, companies and entities will invest 25% of their retirement and long-term funds in the equity markets in a phased manner.

Thus there remains no significant mystery for the capital markets in the budget. In fact with the above measures being highly pro-investment and pro-stock market in nature, we assume that the overall tone of the Federal Budget 2008-09 will be positive. There is little likelihood of any direct measures that will adversely affect any particular sector. On the other hand, there can be consequential repercussions of certain moves, such as the expected increase in NSS rates. The usual incentives for the capital markets are likely such as the increase in the IPO tax credit limit and depreciation/ taxation allowance for expansions and mergers and acquisitions.

Corporate tax rate to remain unchanged

In the FY09 budget the corporate tax rate is expected to remain at the 35% level. There are possibilities that there is an upward revision in the tax rate for unlisted companies. This could be done in order to provide an incentive for listing and boost tax revenues. We also believe that the banks' tax rate is to also remain intact at 35%.

Increase in National Saving Schemes rates and tax credit for IPOs

The upcoming budget can announce an across-the-board increase in rates of National Saving Schemes (NSS). This could be in the range of 100-200bps considering the increase in the discount rate and PIB yields. In this respect, new NSS products could also be launched to meet the government's burgeoning borrowing requirements. While NSS rates may divert funds from the banking sector and raise their aggregate borrowing costs. Nonetheless, no major impact is expected as the tremors of higher interest rates have already been felt in the economy and stock market.

Like every year, the government is expected to further enhance the tax credit for investment in IPOs / open-end mutual funds. Currently this limit is Rs300,000. This move is to arouse greater investment in new public offerings and also support the growth of open-end mutual funds, especially the fixed-income or debt funds.

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Banks - NEUTRAL

Pakistan banking sector is faced with myriad of strategic challenges going forward in the medium term. The rapidly deteriorating economic variables coupled with rising costs of funds pose risks to margins and asset quality. Moreover, amidst inflationary pressures operational expenses are on the rise and the withdrawal of FSV benefit is likely to compound pressure of increased provisioning on sector's net earnings. Against this backdrop, bottom-line growth is expected to slowdown and the sector ROE is likely to decline to 20% in CY08 as compared to 25% earlier.

During CY08 advance growth has been upbeat averaging 5% in 1Q CY08 as a result of low real lending rate and rising demand for working capital loans. In the upcoming budget we expect government to announce incentives for the agricultural and SME sectors. During 10mo FY08 credit disbursement to the agri sector has shown impressive growth of 35% yoy reaching PKR 158bn. The outstanding loans to SME sector, which contribute estimated one-third to overall GDP, amounted to PKR 410bn in FY08. The government's incentives to the afore-mentioned segments in an effort to stimulate overall growth and employment generation are likely to result in increased credit offtake to these sectors.

In previous budgets, government has reduced the tax rate applicable to banks in a phased manner from 41% in FY05 to 35% in FY08. In the upcoming budget we don't expect any change in the tax rate. Moreover, any change in withholding tax on cash withdrawals (0.2% on PKR 25K or more) will not have much of an impact as these costs are eventually passed on to the customer.

Government Borrowing creates pressure

In FY08, government set a budgetary borrowing target of PKR 130bn 7% lower than previous year's target of PKR 140bn. The unprecedented rise in commodity prices leading to fiscal imbalances coupled with slowdown in foreign inflows has led the government to exceed the target and borrowing stood at PKR 334.8bn as at May-08, as compared to PKR 171bn earlier. Going forward, borrowing target is expected to be revised upwards.

Furthermore, government's plan to float short-term bonds amounting PKR 300bn during FY09 for budgetary support and the upward revision in NSS rates to bring them in line with PIB yield is expected to have an adverse impact on the banking sector. This is likely to put pressure on deposit costs and margins due to liquidity shortage from the system.

Sector Outlook - NEUTRAL

The budget is expected to have a neutral impact on the banking sector. The incentives provided to under-penetrated sectors are likely to increase advances growth. However, the overall economic slowdown and recent policy measures announced by the SBP is likely to have an adverse impact on the banking sector. Amongst other policy measures the central bank introduced a floor rate of 5% on PLS saving deposits for the banking sector. With an average cost of PLS deposits in the 2% range for the sector, this move will significantly increase cost of deposits, squeeze net interest margins and profitability. We expect most adverse impact on Tier-I banks with the largest CASA deposit base.

The 1% hike in SLR (Statutory Reserve Requirement) is likely to increase the banking sector's capacity for low yielding treasury instruments and push scheduled banks to pick up government paper. Moreover, the rise in the SBP's policy rate is likely to push KIBOR up allowing banks to re-price loans; however this will impact growth in the long run and could trigger a deterioration of asset quality. We expect significant pressure on banking sector stocks and maintain a 'Neutral' recommendation on the sector.

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Cement - NEUTRAL to POSITIVE

PSDP Allocation

The PSDP (Public Sector Development Program) allocation for this year is expected to be around PKR 490bn, falling short by 5.8% as compared to PSDP allocation of PKR 520bn in the budget for FY08. With infrastructure development expenditure historically receiving the largest chunk of the PSDP, the decline in the amount allocated could cause a minor slowdown in the construction activities. However, with the construction of 4 big dams pending, cement demand will increase dependant upon the approval of dam construction and PSDP funding allocated towards it.

Sales Tax, CED and Export Rebate

Currently, sales are taxed a rate of 15%, which are expected to remain intact in the upcoming budget. Since the slashing of Central Excise Duty (CED) by PKR 250/MT in FY04 budget, the CED has remained unchanged at PKR 750/MT and is likely to remain PKR 750/MT for FY09 as well. The token rebate of PKR 25.08/MT is also expected to remain as an export incentive in the light of cement shortage in the region and record high export dispatches of 5.95mn MT in 10mo FY08 alone.

Estimated Impact - NEUTRAL

The impact remains NEUTRAL on the cement sector as export rebate, CED and tax are expected to remain constant in the upcoming budget. The PSDP decline holds a slight disadvantage, however with increased private construction activities coupled with substantial export demand, it is unlikely that the lower PSDP allocation will cause a negative impact on the sector's volumetric growth.

Sector Outlook – NEUTRAL to POSITIVE

Although the sector's profitability has declined by 58% on average during FY08 attributable to rising interest rates and coal prices, demand is robust. Local demand is expected to grow by 30%YoY during FY08, to reach 30.6mn MT, as infrastructure development programs including housing and dam constructions boost cement dispatches. Following that, forecasted cement demand for FY09 rests at 34mn MT, recording an increase of 12%YoY. Export growth is also expected to grow as 10mo FY8 alone has seen export dispatches increasing by a massive 142% as compared to the corresponding period last year. The export rebate is also expected to foster well for manufacturers as inclination towards higher margin exports is likely to rise till FY10-FY11.

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Refinery - NEUTRAL to NEGATIVE

Oil Pricing Formula: Removal of 10% deemed duty on diesel

The refinery sector's rising profitability on the back of rising crude prices, and consumers' woes due to increasing petroleum prices have given rise to concerns regarding the removal of the 10% deemed duty on HSD, creating uncertainty regarding the refineries' profitability prospects. The government is contemplating complete removal of the 10% duty, however we expect the oil pricing system to remain intact. The removal of deemed duty on HSD seems unlikely; however the prospect of a reduction in the duty is a more viable option for a revision in the current oil pricing system.

Estimated Impact – NEGATIVE

On average, 29% of the total production of the refineries in Pakistan is HSD. In order to improve refining margins, the tariff protection formula has earlier included a 6% import duty on LDO and kerosene and a 10% deemed duty on HSD. Import duties on LDO and kerosene were abolished in 2007, which were easily absorbed by the refineries due to miniscule production of the mentioned products. However, with HSD comprising of the majority of the product mix, the removal of duty can cause a drastic decline in refinery's profitability. Additionally, the impact of the duty removal is likely to be absorbed by the government, to reduce the fiscal deficit.

Sector Outlook – NEUTRAL

Our estimates suggest that the impact of duty removal on retail prices of HSD would be a meager deduction of PKR 6.30/litre, whereas for BOSI, duty removal will translate into a 23% decline in their bottom line. However, improving refining margins will continue to benefit the local refineries as long the lag between crude prices and petroleum prices remains minimal in the international market. However, the duty removal could erode profitability, limiting cash reserve build-up for plant up gradations, which have already surpassed initial planning stages in most refineries. PARCO and PRL's expansions, costing PKR 9bn and PKR 21bn are already under implementation, while NRL, ATRL and BOSI's projects will shortly be finalized with a combined estimated cost of PKR 20bn. Keeping in view the pros and the cons of the current pricing system and the 10% deemed duty on diesel, a gradual phase out of the duty over the upcoming years is likely.

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IPPs - NEUTRAL to POSITIVE

Liquidity Crunch

The IPP sector is currently faced with severe liquidity challenges because of the inability of major distribution companies, WAPDA and KESC, to meet their tariff payments. Due to increasing shortage of electricity in Pakistan, power distribution companies (DISCOs) have to heavily utilize all power generation sources including thermal generators, which are a relatively expensive means of electricity production amid the soaring crude oil prices. Most tariff structures of power generators allow passing the increased cost of fuel over to the DISCOs, yet, the domestic and commercial tariff is regulated by the National Electric Power Regulatory Authority (NEPRA) of Pakistan and has not been revised at pace with the electricity production costs borne by the DISCOs. As a result, the DISCOs are unable to meet their liabilities against the power producers.

WAPDA's liabilities to IPPs are, however, secured through a guarantee by the Government of Pakistan, so it's secured. Additionally, delayed payments from WAPDA bear a late-payment markup that positively contributes to the operating income of these IPPs. Nonetheless, the threat lies at the upstream of the industry; due to WAPDA's inability to meet its payments the IPPs are unable to bear their running fuel expenses and often face threat from fuel suppliers, mainly PSO, of their fuel supply to be cut off in case of any further delay in payments.

Rise in Electricity Tariff Could Benefit IPPs

The government is considering raising the domestic and commercial electricity tariff to enable the DISCOs to meet their payment liabilities so that the IPP industry as a whole can crawl out of one of the worst liquidity crises faced by the energy sector of the country due to the soaring international crude oil prices.

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Autos - NEUTRAL to POSITIVE

Key Issues

- Increased competition from imports, especially used cars, is threatening domestic sales.

- Increasing motor oil prices, deteriorating law & order situation, and slow-down of economy are crunching down passenger cars' demand in the country.

- Rapidly depreciating PKR against other major currencies has squeezed the industry's gross margins due to increased cost of imports.

- Globally rising steel prices are inflating the production cost of automobiles. Most of the cost-of-production increase is not being passed over to the consumer to support the already falling automobile sales; hence, the sector's gross margins and earnings are being adversely impacted.

Budgetary Expectations; Impact: Positive

- A temporary exemption of 2.5% withholding tax (WHT) on imported parts was granted to the industry in Feb08 to bring domestic car prices down and facilitate sales growth. The exemption was later extended until the budget announcement for FY09. We anticipate that the WHT exemption would continue to be further extended till the end of FY09.

- The government had narrowed the age limit on import of used passenger cars from 5 years to 3 years. However, enough cars were brought inside the country during the economic boom which continued till 2006, while the industry was left unregulated for a short period, so the age-limit restriction hasn't actually come-into-play to reduce competition as yet. The automobile manufacturers are requesting the government to consider further tightening of the age-limit restriction and we believe there is a strong likelihood that the government might heed to their request to support the local industry.

- Although automobile production figures have not been consistent with the projections of the Automobile Industry Development Plan (AIDP), we expect that the government would continue to cut down the custom duties on CKDs as per the plan. According to the AIDP, the local industry had a target of producing more than 200,000 passenger cars in FY09, which is likely to be missed because of declining demand. Nonetheless, the custom duties are expected to be slashed to 32.5% from 35% in the FY09 budget as per AIDP.

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Food Marketing Consumer Goods - NEUTRAL

In recent years, consumer spending has remained consistently upbeat with fmcg sector riding on the wave of economic upturn. Favorable demand drivers include rising disposable incomes, rapid urbanization and deepening penetration of organized retail. Moreover, encouraging demographics and untapped rural potential has led Pakistan to emerge on the radar screens of international retailers. However, going forward we expect the growth to moderate as a result of economic slowdown and double whammy effect of inflation. The unprecedented surge in inflation is likely to slow sales growth as a result of declining consumer purchasing power, while pushing raw materials costs north.

Duty cuts could benefit sector

In the upcoming budget we do not expect fmcg sector to receive any surprises in terms of tax levy, though there might be some rationalization of customs and excise duties. At present, market players pay 1% special excise duty (SED), 15% sales tax (GST) and 2% value added tax (VAT). The custom duty on import of finished products averages 20-25%, while duty on the import of raw materials for local production varies item wise. Palm oil and tea imports constitute major chunk of raw material imports with annual demand estimated at 1.3mn MT and 170mn kg respectively. The current tariff on palm oil imports is around PKR 8000 per ton plus with 2% withholding tax, whereas the import duty on tea is 10%. In the FY09 budget, we do not any major changes in this tax structure; however, there is a possibility of additional levy on luxury items like shampoos etc.

Declining GDP Growth unfavourable

In terms of indirect impact, the curtailment of PSDP spend will have an overall adverse impact on GDP growth, urbanization, and employment. Consequently, this will lead to a slowdown in retail and wholesale trade. On the flip side, the expected incentives to promote agricultural growth bode well for the sector. The under penetrated rural market offers tremendous potential as rural population constitutes 60% of total population. Favorable structural changes including rising rural incomes and changing lifestyles has resulted in increased demand for fmcg products.

Inflation, currency and interest rate risk to comprese margins

Despite the current macroeconomic challenges faced in the country, we expect fmcg sector to post moderate revenue growth. However, we expect profitability to remain subdued and margins under pressure as companies continue to battle surging input costs and struggle to safeguard market share amidst intense competition from both organized and un-organized players. Ever rising inflation has heightened the risk of losing market share to under-invoiced smuggled and counterfeit products.

Going forward, we expect Unilever to post top-line growth of 12% and profit margin of 7%-7.5% in CY08-CY12E. The HPC segment is expected to drive overall growth momentum. The high margin segment constitutes over 50% of the top-line and is the key focus of company’s growth strategy. At current levels, the scrip is trading at 10% premium to our PO at 2008E PE multiple of 16.2x. We maintain a ‘Neutral’ recommendation on Unilever.

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Analyst Certification

We, Zainab Jabbar, Tanvir Abid, Ahmed Raza Khan, Sarah Junejo & Muhammad Ashar Khaliq hereby certify that the views expressed in this research report accurately reflect my personal views about the subject, securities and issuers. We also certify that no part of our compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this research report.

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