Altair Asset Management

Pakistan Overview and Investment Opportunities

December 1, 2009

Rooman Burana
Roselle Calvo
Arvindh Rao
Meghana Reddy
Josh Shvartsman
Ran Sun

Eagle by Gina Mikel @ www.scientificillustrator.com

We, at Altair Asset Management, seek opportunities that are often left unrecognized. We believe that in identifying these left behind fortunes, we can help our investors gain as they diversify their portfolios further into the world of emerging markets.

We at Altair Asset Management believe that Pakistan holds strong potential that has yet to be realized. While we recognize the political turmoil and macroeconomic distress, we believe that the nation is capable of emerging from the rubble as a strong nation and one that will succeed by many means. Thus, we urge our clients to invest in Pakistan now and take advantage of its potential.

Within Pakistan, we have our sights set on three stocks in particular: Hubco, FFC, and Pakistan PTA. Each of these stocks is a leader in their respective industry and we believe that each will continue to growth at a rewarding pace over the next 3-5 years. This report provides further insight into our investment rationale.

Table of Contents

Country Overview

Geographical

The Islamic Republic of Pakistan is located in South Asia. Pakistan is bordered by India in the east, China in the North, and Iran and Afghanistan in the west. The capital city, Islamabad, is located in the northern region.

Religious

The official religion is Islam, however there do exist Christian, Hindu and Sikh minorities.

Historical

Pakistan was founded in 1947. After expelling the British from the region, it was decided that the Indian subcontinent would be divided into two countries; Pakistan, a state for the Muslims, and India, a state for Hindus. Thus on 14th August, 1947, Muslims were awarded their own state called Pakistan.

Political

Pakistan was founded as a democratic country; however, for nearly half its existence it has been ruled by military dictators. The remainder of its existence, corrupt democratic leaders controlled the country. Since its formation, Pakistan faced the threat of an attack by India. Thus, national security is a primary concern, as is maintaining the strength of the armed forces. The armed forces have grown essential to the government's decision-making process, and they are also involved in foreign policy. In fact, the armed forces have gained power over time, and there have been quite a few military dictatorships in Pakistan.

In the past, military rule represented stability for several reasons: the support of the American Government, and the betterment of the economic conditions using foreign aid and the influx of foreign investments. A heavier emphasis of course lies with support of the American government who extended its full support to General Zia-ul-Haq during the Soviet War, and again to General Pervez Musharraf earlier this century.

Pakistan recently came out of a military dictatorship in 2007, when the president of the country was no longer the army chief. As of now, there are two big parties in the political arena, Pakistan Muslim League (PML) and Pakistan People's Party (PPP). In 2008, a general democratic election was held and PPP came into power and formed the federal government. The President Asif Zardari, the widower of the assassinated ex-Prime Minister Benazir Bhutto, and the Prime Minister Yusuf Raza Gilani are both from Pakistan People's Party. Since the return of democracy, Pakistan seems to be on the road to political stability. The level of uncertainty in the country decreased, which certainly is a positive sign.

Potential problems & Country risks

Pakistan faces not only external threats, but also internal threats.

In 1980's, Pakistan had to decide whether to side with socialists (Russia), or capitalists (America), and Pakistan clearly indicated its preference for the latter in the Soviet War. Pakistan struggles with its neighbor, India. The two have fought three wars and they continue to fight in Kashmir. While there seems no near term solution, politicians are in talks and tensions are beginning to ease.

Another threat which Pakistan faces is from terrorism. This is an internal as well as an external threat. Terrorism has resulted in increasing tensions within the tribal areas of Pakistan and in Afghanistan. Since the US-led war in Afghanistan began, there has also been an influx of refugees in Pakistan from across the border, as many fled their homes in Afghanistan. This has caused instability and uncertainty in the country; however with the ongoing military operations; this problem will be resolved in the near term.

Potential advantages

Despite all the risks discussed above, Pakistan still continues to be a potentially rewarding emerging market.

Pakistan is a country rich in natural resources, with huge oil, natural gas and coal reserves. Its extremely fertile soil makes it ideal for agriculture. The weather conditions, the fertility of the land and many other factors have allowed Pakistan to achieve competitive advantage over its neighboring countries in the textile business. Cotton has become one of the most widely cultivated crops in Pakistan, helping Pakistan expand its export base. The textile industry is one of the largest exporters of the country rich in natural resources.

Pakistan's geo-strategic location and its proximity to two of the world's fastest growing economies, India and China, make it a very attractive place to invest. Pakistan, as a developing country, offers cheap and skilled labor as an attraction for investors.

Presently, Pakistan is passing through a very crucial stage in its history. However, it is definitely on the road to recovery, and given its potential—which outweigh the risks of investing in Pakistan—we find a large unexploited investment opportunity in Pakistan.

Economic Overview

Historical Resilience

Over the last decade, the Pakistani economy has proved unexpectedly resilient in the face of multiple adverse events concentrated into a four-year (1998-2002) period:

- the Asian financial crisis;

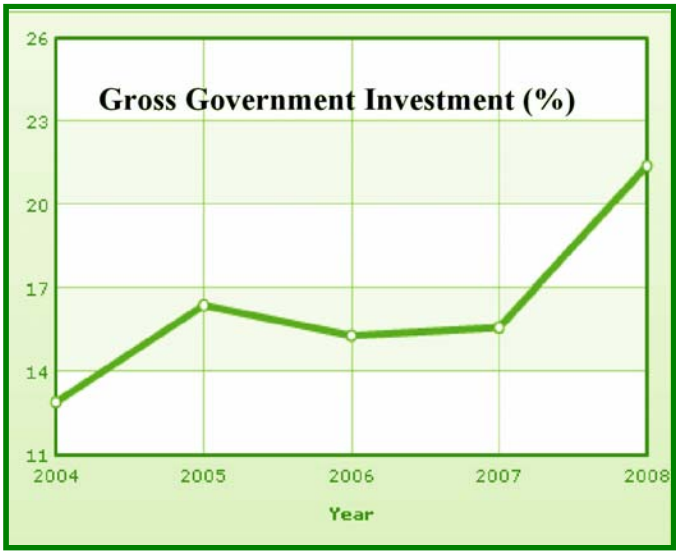
- economic sanctions
- the global recession of 2001-2002;
- a severe draught — the worst in Pakistan's history, lasting about four years;
- heightened perceptions of risk as a result of military tensions with India
- the war in Afghanistan, with a massive influx of refugees from that country

Despite these adverse events, Pakistan's economy continued to grow. This resilience has led to a change in perceptions of the economy, with leading international institutions such as the IMF praising Pakistan's performance in the face of adversity. By October 2007, Pakistan was able to raise its foreign reserves back to $16.4 billion after they had fallen during difficult times. Exceptional policies kept Pakistan's trade deficit controlled at $13 billion, exports boomed to $18 billion, revenue generation increased to become $13 billion and attracted foreign investment of $8.4 billion.

Working though the Temporary Struggles

Pakistan's uncertain role in the ongoing war on terror has had adverse effects on the economy in recent years, causing a fall in foreign investments from $8 Billion to $3.5 Billion. Combined with high global commodity prices, the dual impact has shocked Pakistan's economy, with large trade deficits, high inflation and a fall of the Pakistani Rupee. The Rupee has fallen dramatically from 60-1 USD to over 80-1 USD in the time period of mere months (83.68-1 exactly). For the first time in years, Pakistan may have to seek external funding as Balance of Payments support. Consequently, Moody's cut its outlook on Pakistan's debt from stable to negative due to political uncertainty, though it maintained the country's rating at B2. However, given Pakistan's growing foreign exchange reserves and the recovery of crude oil prices to over $70 a barrel balanced against global macroeconomic uncertainty and the potential for flights to quality, we believe the Pakistan Rupee will trade flat to the US dollar on the one-year horizon.

Nonetheless, the new government has been trying to create stability and perhaps this is the rationale behind Moody's maintained rating. While we cannot be sure, we do know that that the new policies do provide some added comfort. In fact, the willingness between both the Indian



leaders and the Pakistani leaders to resume bilateral dialogue is a phenomenal political achievement and helped rebuild investors' confidence. More importantly, the government recognizes investors' concern over the safety of their investments through the current times. As such, it is working to put together an investors' protection bill that will ensure continuity so that investors feel safe regarding their investment and know that any change in government through democratic means could not halt the continuity of their projects. Furthermore, the government itself has been aggressively investing in domestic projects in an effort to further stimulate growth as seen in the graph.

Additionally, the ministry of investment has taken several measures to enhance the flow of FDI in Pakistan which had fallen and currently stands at $4.3 billion. It looked into new tax relaxation policies on transfer of technology, liberalization, deregulation and attractive incentives to investors as salient features of its new investment policy. Market indicators suggest that the new efforts are being received positively around the world and we are confident that Pakistan will survive the current turbulence to become a strong player in the global economy soon.

Economic Changes

Between 2008 and 2009 economic activity slowed down significantly. The current account deficit narrowed to 5.1% of GDP. Financial inflows (such as FDI) fell dramatically – by over 37%— due to macroeconomic instability, the deteriorating security situation and of course the global recession. Additionally, revenues fell substantially short of the target mostly because of a drop in tax revenues as the economic slowdown reduced Pakistan's two main tax bases-manufacturing and imports. Fortunately, with the help from the IMF, SBP foreign exchange reserves rebounded to about $9.1 billion (2.9 months of imports) by the end of this past June.

In the future, there should be less turbulence, depending on the political environment. Currently the GDP (PPP) stands at $375.4 billion and has grown at a slight lower rate than usual due to the recent global recession and turmoil. This leaves Pakistan at 6.0% 5-year compound annual growth versus the 5% growth predicted by the EIU by the year 2011. We believe that there is added pessimism around Pakistan that will be proven wrong as we move forward and out of the global recession and political turmoil.

Additionally, the IMF expects the GDP growth of Pakistan, a nuclear ally of the United States, to remain unchanged at 2 percent this fiscal year and to rise to 3 percent in the 2010/11 fiscal year. Through the crisis Pakistan was kept afloat by a $7.6 billion IMF emergency loan in November, 2008. The loan was further increased to $11.3 billion in July. President and Chairman Ali Raza commented, "With the level of committed funds ... we will be able to meet our balance quite comfortably." He does not believe that Pakistan will need further help. In fact, he believes that the growth rate should recover to around 3 percent this fiscal year to June 30 and keep accelerating in coming years as the government's fiscal position improves and efforts to clamp down on Islamist Taliban insurgents pay off. We agree that there will be high payoffs for Pakistan as that political turmoil winds down.

Financial Market Overview

The Stock Exchanges

The Pakistani capital markets consist of three main stock exchanges-the Islamabad Stock Exchange (ISE), the Karachi Stock Exchange (KSE), and the Lahore Stock Exchange (LSE).

Karachi Stock Exchange

The Karachi Stock Exchange is Pakistan's oldest stock exchange. Founded in 1947, the KSE now has a listing of about 650 companies with a market capitalization of $33.81 billion USD. Compared to the other two exchanges, the KSE is largest and most liquid. In 2002, it was regarded as Business Week's "Best Performing World Stock Market."

Foreigners are allowed to become full members of the KSE, with the exception that the company representative be a Pakistani resident. Moreover, companies on the KSE can be listed in the OTC market or the ready market. The ready market requires higher capital requirements than OTC market.

Lahore Stock Exchange

The second largest stock exchange in Pakistan is the Lahore Stock Exchange with a listing of 519 companies. The LSE is the leader in technology, being the first to launch automated systems and the first to allow for internet-based trading for its customers. In an effort to compete with the KSE, it is involved in a joint effort with the Islamabad Stock Exchange to create a United Trading Platform. The goal of the platform is "to bring increased liquidity in the market, improve price discovery, maximize transparency, increase turnover, broaden investor base, curtail risks and distortions in trade, provide cost effective service to the investing public and enhance the image of both the Exchanges."

Islamabad Stock Exchange

The Islamabad Stock Exchange is the smallest and youngest of the three. Currently, there are only around 240 companies listed on the ISE. Nonetheless, the exchange is working to catch up with its competitors by investing in technology and partnering with the LSE. Its small size is understandable given its founding purpose, which was “to cater to the needs of less developed areas of the northern part of Pakistan.”

Because of Pakistan’s proximity to the war on terror, the exchanges have sometimes become victims to the rollover effects caused by attacks. Attacks have been known to shock the market and sometimes close the market for days to mitigate the effects. In 2007, a terror attack that involved the death of Pakistani leader Benazir Bhutto, led to the 3-day close of the KSE. Such events are indicative of the risks investors take when investing in Pakistani capital markets.

In the third quarter of this year, the KSE outperformed the rest of Asia. Its October 2009 gains were attributed to “15 straight weeks of net inflows that brought $240 million of capital from foreign investors into the market.” Investor confidence has also been increased by positive reports from Credit Suisse and an increased rating on the country’s sovereign debt.

Capital Markets

In the global scope, Pakistan is ranked 49th on the World Economic Forum’s Financial Index of global economies. “This Report ranks 55 of the world's leading financial systems and capital markets. It analyses the drivers of financial system development and economic growth in developed and developing countries to serve as a tool for countries to benchmark themselves and establish priorities for reform.” Given its low ranking, Pakistani capital markets have a lot of room for improvement going forward.

The capital markets are governed by the Securities and Exchange Commission of Pakistan which was created in 1997. The SECP is charged with similar responsibilities as the US SEC and is working toward its goal of improving the market efficiency of the country's capital markets. It is under the Ministry of Finance which handles all financial matters of the country.

The July-September 2009 economic update release Ministry of Finance highlighted positive events happening in the market, fueled by the improved credit ratings and other developments. According to the report, the increase in the credit rating from CCC to B- contributed to the KSE's rally of 31 percent in June 2009. Moreover, 5-year credit default swaps improved similarly falling from 3,000 basis points to 800 basis points, and "the prices of the country's outstanding dollar-denominated sovereign Eurobonds have rallied strongly."

"After witnessing momentous growth over a couple of years, the financial derivative business of the banks declined by 3 per cent during the second quarter (April-June) of current calendar year, 2009 amid contraction in foreign currency option and cross currency swap portfolio…This sector posted 11 percent and 17 percent decrease in Mar-09 and Dec-08 quarters respectively, giving a 31 percent decline since corresponding quarter of last year…The leading factor behind the popularity of Cross Currency Swaps has been the high gap between domestic and international interest rates. The high interest rate differentials have induced the local corporate, particularly those with sufficient export volumes, to swap their local currency exposures with EURIBOR or LIBOR."

Investors can seek protection from fraud and other kinds of schemes commonly experienced in developing markets by going to the SECP. The SECP monitors registered companies and their compliance with the regulations. According to their website, the SECP engages in both on-site and off-site monitoring. Moreover, many other regulations in place mirror those of the US SEC. Thus, investors can feel protected to a certain extent, the exception being from the uncontrollable effects of the war on terror.

Investment: Hubco

Pakistan's Electricity Sector

Pakistan's electricity sector is defined by its need for reform. Since the 1990s, consumer and

industry-driven demand for electricity has led to significant and persistent supply/demand gaps, leading to power outages and load shedding. Recognizing public sector inefficiencies, the government began setting up Independent power plants in the 90s. In fact, Pakistan's power laws allow for up to 100% foreign ownership in critical infrastructure such as power plants, leading many foreign companies and governments to get involved. According to research done by university students in Pakistan, as well as the Business Monitor reports on Pakistan, most of the future power plants will have significant foreign participation, be it in construction, maintenance or ownership, and significant investments are expected by transnational agencies, foreign governments, banks and private investors.

Steam Power Generation

In a modern steam turbine, fuel heats water up until it evaporates and becomes steam. The steam is forced through rotor blades, rotating a dynamo that generates electricity.

Hydroelectric Power Generation

Hydroelectric power generation depends on the mechanical force that moving water exerts on a turbine. Considered to be a "green" source of electricity, Hydro power provided about 10% of

Pakistan's electricity-- though this number is artificially low due to droughts that have hurt Pakistan.

Investment Thesis

The Hub Power Company is Pakistan's first, and largest, private utility company, and currently operates a 1200MW power plant. Hubco's asset quality, experience in managing a power plant for over 2000+ fault free days, and successful execution of its project pipeline will add shareholder value via EPS expansion, as well as P/E expansion going into 2012.

Investment Analysis

Hubco's current plant – The Hub Thermal Power Plant

Commissioned in 1997, the Hub river plant is Hubco's first and largest power plant. Representing 6% of the entire country's effective capacity, the operation of this power plant has established Hubco's reputation both domestically and internationally.

Power is generated by burning oil, acquired from Pakistan State Oil, and is sold to the Water and Power Development Authority (WAPDA), a government agency. Although the Federal Government regulates the amount that Hubco can charge for electricity, it also absorbs any wild swings in the price of oil, Hubco's primary operating cost, leading to very stable revenue streams. With about a decade of useful life left, the Hub Power Plant will continue to be a source of profits to Hubco for years to come. Although the Hub plant generates steady profits, as a going concern, Hubco has to build and run additional plants in order to maintain its market share in a growing market and add value to shareholders.

Project Pipeline

Phase 1: Narowal Thermal Plant

Hubco is in the final stages of completing a 213 MW capacity thermal power plant in Narowal, an agrarian district in the Punjab Province, on schedule and within budget. The power plant operates on the same principles as the Hub plant. The superb engineering, along with Hubco's relationship with WAPDA as the first IPP will help it strike a favorable contract that will increase top line and bottom line growth for 25-30 years.

Phase 2: Laraib Energy New Bong Escape Hydel Plant

Although thermal power plants are Hubco's bread and butter, the prospect for spectacular growth is in hydroelectricity. The government has already set a target of 1 GW of additional hydel capacity on the Jhelum River, and Laraib Energy's New Bong Escape project is one of the projects that will help the country meet its power needs. Located 5 miles downstream of the Mangla River Dam, Laraib Energy Limited, Hubco's subsidiary, is building Pakistan's first private hydel power plant marking another distinction for Hubco. Along with increased revenue and profits, the project will give management the experience needed to exploit a critical part of Pakistan's future power supply.

Stock Performance

Since December 2007, when former Prime Minister Bhutto was assassinated and the Taliban insurgency raged, Hubco has done very well against the major Index, the Karachi Stock Exchange 100. As the insurgency in Pakistan grew in 2008 and as Pakistani finances became more dire, the stock fell along with the broad index. In early 2009, however, the Federal Government guaranteed the payments by WAPDA to Hubco, causing a very sharp rally in the stock price, relative to the Index. Hubco's progress with the Narowal and Laraib projects, combined with its consistent performance, has played a huge role in the relative outperformance to the Pakistani benchmark. It is also a testament to Hubco's ability to remain strong though the remaining turbulent times and come out stronger yet.

Risks

Although Hubco's assets are undeniably good and the valuation is attractive, several factors could impede the company's growth vision. These include:

Liquidity Risk - the company may not be able to renew its substantial revolver facility

Counterparty Risk - the company has one customer which is already under strain

Counterparty Risk - the company depends on one supplier for oil

Political Risk - Pakistan has significant security and geopolitical risks

Operational Risk -the project pipeline may fail to yield sufficient revenues/experience

Operational Risk - rapid privatization efforts may hamper Hubco's negotiating power

Operational Risk - droughts may cause hydel plant to underutilize capacity

Valuation

Going back to 2005, the company has traded above a 6 P/E, going as high as 16 in 2007. As fears about the company drove the price down in 2008 and sharp swings in oil prices caused some hit to both revenue and EPS, the P/E contracted all the way back to 6 in December 2008. Since then, the stock has settled around 8 P/E, which represents the 1^{st} quartile of P/E over this period.

Trade Volume

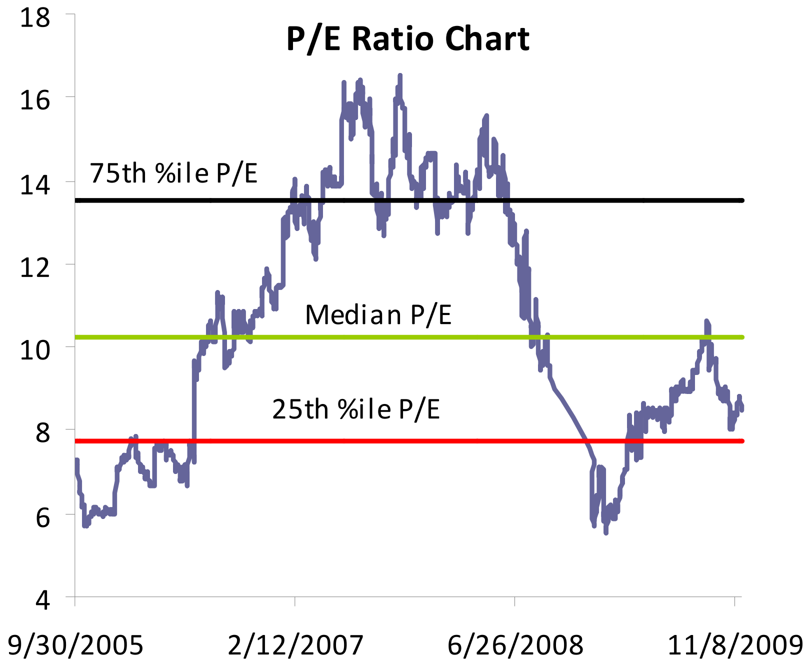
The stock trades an average daily volume of $900,000, allowing trading beyond the spare change level, with expected positions executed in one trading week.

Baseline Scenario

As the Narowal power plant comes online in 2010, and the Laraib plant comes online in 2012 we expect the P/E to retest the median P/E of 10.2 given the strong cash flows that the projects are expected to give. At the same time, EPS should also expand to PKR 4.5 from an LTM EPS of PKR 3.56. The price target for the investment horizon ending in 2012 is 45, which represents approximately 50% upside. Including the dividend, which is assumed to be 2 PKR / share per year, which is the 5 year average, the trade will lead to a total return of 66%.

Optimistic Scenario

If conditions markedly improve in the Pakistani finances, or the military operations against the Taliban go unexpectedly well, the stock could retest the 3^{rd} Quartile P/E of 13.5, along with an EPS expansion, which represents an upside well over 100% which is unlikely.



Pessimistic Scenario

Conversely, if the company's growth is slower than expected, or if Pakistani finances worsen, the stock could retest the 6 P/E bottom, along with an EPS stagnation at around 3.5, and possibly face cancellation of dividends, which represents a 30% downside, at which point the trade would be liquidated.

Ultimately, this trade has a 2:1 gain/loss ratio, which is good for a defensive utilities sector, and for a trade in general.

Conclusion

Hubco is a company with a solid management and project pipeline that can take advantage of a fundamentally hopeful power sector in Pakistan. The stock itself has performed well relative to the benchmark index, offers a depth in volume traded and a good gain/loss ratio from a trade perspective.

Investment: FFC

Urea industry: Fundamentals always pay

Agriculture remains a core pillar of Pakistan's economy: Pakistan is predominantly an agrarian economy with agriculture contributing approximately 21% (approximately PKR2.6 trillion) to the country's GDP. 65% of Pakistan's population directly or indirectly generates livelihood from the agriculture sector, while approximately 42% of the country's workforce is employed within the sector.

Growing population to fuel demand: Pakistan's population has been growing at an average rate of 2% over the last five years. Rate of population growth is expected to remain at 2% in the foreseeable future. With more mouths to feed, this rising population would fuel demand for agricultural products. This as a result will keep fertilizer demand buoyant.

Government focus towards agriculture to continue: Due to heavy reliance on the agriculture sector and strong presence of agriculturists lobby in upper echelon of power, throughout Pakistan's history government has ensured its full support to the industry. Recent measures announced in FY10 budget confirm government's commitment towards the agriculture sector, as several agriculture friendly policies have been announced for the year.

For the urea market specifically: We anticipate recent strength to continue driven by a combination of the following factors, including:

- The Pakistani government has imported over 1mn tons of urea Jan-to-date and the TCP has planned tenders for another 600k tons over the next 6M, which both will contribute to the drive-up of the urea market

- Enhanced farmer purchasing power post bumper 09 wheat crop & higher support prices
- Farmer preference for cotton over rice due to superior price returns where cotton used ~3x the fertilizer/acre that rice does. According to the research analysts, the 2009E urea offtake at 5.93mn tons (+8% YoY) and peg long term urea demand at +3% p.a.

The management of different fertilizer companies have all confirmed an increase in urea prices by PkR30 per bag. The latest increase in prices takes urea price to PkR730 per bag (ex – factory), which bodes well for fertilizer companies. Given upwards revision in earnings estimates, fertilizer companies are likely to perform well in the medium term. FFC currently controls 50% of domestic production. Strong urea demand will still continue to deliver pricing power to FFC. At the same time, FFC is significantly undervalued than its peers.

	Engro	FFC	FFBL*
EPS - new	9.2	12.8	2.1
EPS - previous	8.7	12.4	2.0

*estimates for FFBL are tentative and will be revised upwards shortly. Source: AKD Research

Company Overview

FFC is the largest fertilizer (urea) manufacturing company in Pakistan, with a 2008 market share of 56%. Apart from its core urea manufacturing business, FFC is leveraged to phosphate fertilizers through its 50.88% stake in the country's sole DAP manufacturer FFBL, where it has a market share of 15% as of 2007. The company's other investments include a 12.5% direct stake in the Pakistan Maroc Phosphore project and a proposed Rs1.5bn investment in Fauji Cement Company Limited (FCCL), equivalent to 14% of FCCL's revised share capital.

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, which is the only di-ammonium phosphate producer in Pakistan, and 12.5% stake in Pak Maroc Phosphore, which is phosphoric acid producer in Morocco. It is 44% owned by the Fauji Foundation group. FFC's headquarters are in Rawalpindi. The company has three manufacturing plants – two are in Goth Machhi in Sadiqabad and represent 70% of its total capacity, and one is in Mirpur Mathelo in District Ghotki near Sukkur.

Investment Thesis

FFC is a domestic consumption play and the market leader in urea sales and production, *with a 2008 market share of 56%.* We believe future earnings will be driven by margin improvements due to rising prices and the full impact of 3% capacity enhancement. Therefore, we think FFC is a great buy, with a target price of 117, offering 12% potential upside and an attractive CY10E dividend yield of 12.7%.

Investment Analysis

FFC is Pakistan's largest pure urea fertilizer producer. Given guaranteed urea offtake amid government's agricultural focus and limited exposure to other fertilizers except urea, FFC is a safe play for risk-averse investors. The urea demand in Pakistan rose up 15% in 9M2009 amid better crop economics. In September of 2009 , according to its reports, the company's urea revenues are up 27%, gross margins have expanded by 225bp YoY and earnings are up a sharp 25% YoY. FFC continues to remain one of the top plays in the Fertilizer sector and the stronger than anticipated urea demand in Pakistan will continue to deliver pricing power to FFC.

The company has been a major beneficiary of higher urea offtake which has been achieved, despite a 23%YoY increase in urea prices. FFC being the largest urea player benefited from these changing dynamics as it posted a 3% growth in urea offtake to 1.86mn tons during 9M2009. Due to strong demand in the Rabi sowing season, many research analysts estimate FFC's urea offtake for 2009 to stand at around 2.4mn tons, an increase of 4%YoY. The estimate is based on an expected offtake of 560ktons in 4Q2009. The growth in urea offtake coupled with higher urea prices (currently Rs730/bag, up 12%YoY), will help FFC post an increase in revenues of 14%YoY. Moreover, higher prices will help gross margins improve to 44% in the current calendar year.

Meanwhile, sharp rebound in Pakistan's DAP demand and inventory de-stocking at FFBL are also expected to play out positively for FFC via higher dividend income in the near term.

Risks

The following industry factors may impede the stock from achieving our target price:

- Crop prices influence farm plantings. Should crop prices decline for an extended period of time due to moderating consumption or rising crop stockpiles, fertilizer demand is also likely to decline with farm revenues;
- Anomalies in weather patterns can have a significant impact on fertilizer demand;
- FFC's primary production cost is natural gas. A higher than expected increase in natural gas cost without a concurrent increase in urea price could erode FFC's margins.

However, overall, we would still apply a Low Risk rating based on the following industry and company-specific risk factors:

- FFC's exposure to stable urea business which reduces earnings volatility
- relatively low financial leverage (net debt to equity of 61% as of CY'08)

Valuation

Our valuation approach is P/E and EPS as we believe they capture the near-term operating performance. We now value stock at a target 2009E P/E of 11.1x (Mean of 7.5x + 1 std of 3.6x). Historically, FFC has traded at either +1 std dev (11.1x) or -1std dev (3.9x) of mean. With our positive outlook for the company, we believe the stock deserves to trade at 1 std dev above mean(7.5x). Compared to other major players in the same industry, FFC is trading at a significant discount with EPS of 12.8x, compared to Engro and FFBL, which are 9.2 and 2.1 respectively. We think there is significant upside potential in this stock in the short term with the growing demand in the urea market and FFC's expanding facilities.

Conclusion

FFC is a domestic consumption play and the market leader in urea sales and production, with a 2008 market share of 56%. We believe future earnings will be driven by margin improvements due to rising prices, completion of the business modernization, revamping and expansion (BMRE) program, and the initiation of dividends from its investment in phosphoric acid and cement projects.

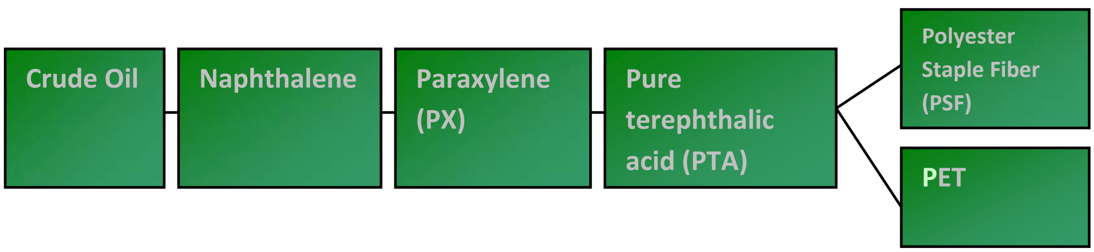
FFC is a defensive stock in terms of strong cash flow, low leverage, exchange rate risk, stable earnings and a high dividend payout. It remains as one of the cheapest urea manufacturers, trading at ~56% discount to peer group average on 2010E P/E. FFC currently trades at a 23% discount to 3-yr avg P/E of 10.1x where our target corresponds to Dec-10 target P/E of 8.4x (still a conservative 18% discount to 3- yr historical P/E) and 11.3% target D/Y. FFC 09E dividend yield seems attractive in a declining interest rate scenario. FFC is a pure urea play that should continue to benefit from strong demand growth, domestic shortages and a gap between domestic and int'l prices. Strong cash flow from the urea business protects FFC from possible lower income at its subsidiary FFBL.

Due to the well supported urea demand, we would raise earnings by 3-5% for 2009-11E with a revised target of PRs117/sh.

Investment: Pakistan PTA

PTA Industry Overview

Pakistan PTA (PPTA) produces pure terephthalic acid (PTA), a petrochemical product. The below figure illustrates PPTA's supply chain and end customer market segments.

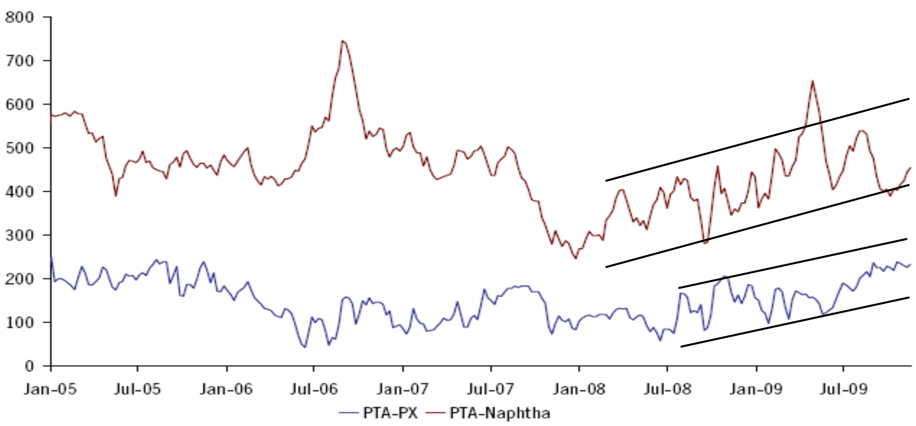


International PTA producers are generally split into the two categories of vertically integrated petroleum companies and diversified chemicals firms. Petroleum companies in the PTA market include BP and Sinopec and diversified chemicals include Reliance in India, SK-Chemicals, Mitsui and Eastman Chemicals. International PTA capacity was over 30 million tons on an annualized basis in 2004.

An important element of the PTA market in Pakistan is the constantly changing tariff landscape. Previously, there was a 15% import tariff on PTA – this has been temporarily lowered to 7.5% since Q3 2008 until the issue of domestic tariff refunds is resolved, subject to government financial issues.

A promising development for PTA producers, however, is the increasing price of PTA on the spot market. First, Asian PTA prices have recovered over 36% from the Q4 2008 lows. However, more importantly, they have not recovered to FY 2007-2008 levels, suggesting potential average selling price increases for PPTA.

In addition, PTA margins are increasing, as shown in the below graph, leading to gross margin expansion for pure-play PTA producers, reducing the effects of margin stacking. As these trends continue, pure-play PTA producers, such as PPTA, will be well-poised to capture ASP and margin expansion.



Source: Citi Investment Research, 11/23/2009 (annotated)

Company Overview and Analysis

Qualitative Analysis

Pakistan PTA (PPTA) was founded in 1996 with the construction of its plant at Port Qasim in Karachi and was subsequently partially divested from ICI Pakistan in 2000. In January 2008, Azko Nobel acquired ICI Plc, the ultimate parent of PPTA. Subsequently, Azko Nobel sold its 75% interest in PPTA in September 2009 to KP Chemical, a subsidiary of the Lotte Group in South Korea

Pakistan PTA, being the only domestic producer of PTA, has a very large share of the domestic market. PPTA's domestic customers are primarily textile mills and as such produce polyester (PSF) rather than PET. On the other hand, international customers, primarily in Europe and Asia, primarily produce PET. According to PPTA's materials, domestic demand in Pakistan exceeds 600,000 metric tons of PTA annually, while PPTA's capacity is just over 475,000 tons per year. While PPTA lacks the scale of BP, Sinopec, or Reliance, it has local advantages that will become more pronounced with the resolution of the current tariff issue. As soon as the domestic tariff refund issue is resolved, there is immediate upside for PPTA as it benefits from increased demand and reduced competition.

Other advantages include strong local textile mills and a low-cost workforce. Furthermore, compliance with environmental regulation may be less costly in Pakistan than in certain developed markets.

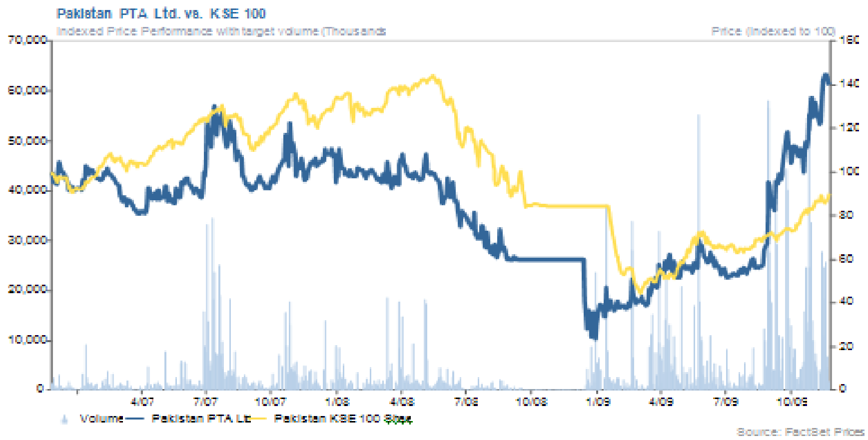
Shareholding structure

Pakistan PTA has a floated market cap of 11,356MM Rs (approximately $136MM) with an average daily volume of 3.5MM shares.. The remaining 24.99% of PPTA equity not owned by KP Chemical is traded on all three major Pakistani exchanges; Karachi, Lahore and Islamabad. As such, PPTA's total equity value is approximately $544MM (as of 11/25/2009). KP Chemical, in September 2009, initiated a tender offer to purchase up to 15% of PPTA at 3Rs/share, but received very few shares – understandable, given that the stock currently trades at 7.50Rs. There is relatively diverse shareholding in PPTA, as there are over 22,000 shareholders; this ensures that we will be able to procure the shares over a reasonable span of time.

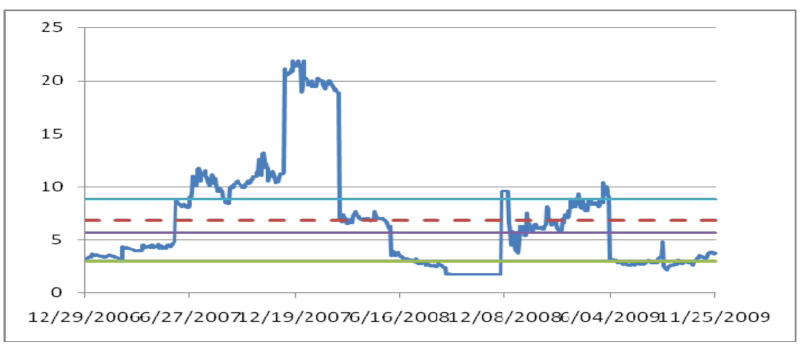
Investment Thesis

We believe PPTA to be an excellent investment due to several factors including a historically low valuation, an improving macroeconomic environment both domestically and abroad, new corporate ownership that can provide additional capital for growth, and a strong rebound from the lows of Q4 2008 triggered by financial and energy shocks.

Investment Analysis



After losing nearly 70% of its value between January 2007 and January 2009 through the financial crisis and energy spike of 2008, PPTA has strongly outperformed the KSE 100 year-to-date and risen approximately 40% from January 2007 and approximately 370% year-to-date.



Price/Free Cash Flow 2007-YTD (Average and quartiles shown)
Source: Reuters Global Fundamentals via FactSet

The important takeaways from the above graph include how PPTA's valuation was severely impacted during the oil spike and financial crisis of 2008 and how it has only recently recovered to over 3x free cash flow, the historical 2nd quartile multiple. Currently, PPTA trades at 3.7x LTM FCF. As such, as PPTA recovers to its historical median valuation of 5.7x FCF, there is approximately 52% upside. If it recovers to the historical average, there is 83% upside; however, the average is skewed by a rich valuation period of late 2007 to early 2008. As such, we believe the 52% upside case more likely. Potential drivers to a return to the historical average 7x FCF include a stronger tariff, stronger-than-expected demand for PTA, and lower crude oil prices that do not filter into PX prices, increasing the spread for PPTA. Likewise, adverse macroeconomic conditions or unfavorable actions by KP Chemical as the new corporate parent of PPTA could prompt a return to the 2x FCF levels of Q4 2008, prompting us to reevaluate the investment accordingly.

Qtr. End.:	3/31/07	6/30/07	9/30/07	12/31/07	3/31/08	6/30/08	9/30/08	12/31/08
EBITDA	448.3	584.3	824.8	550.8	748.8	1222.8	-694.7	-734.4
YoY Growth	-39.10%	-36.63%	-20.45%	63.51%	67.02%	109.26%	NM	NM
QoQ Growth	NA	30.33%	41.15%	-33.22%	35.96%	63.29%	NM	NM
Qtr. Ending:	3/31/09	6/30/09	9/30/09					
EBITDA	891.6	1298.6	1301.1					
YoY Growth	19.07%	6.20%	NM					
QoQ Growth	NM	45.65%	0.19%					

As demonstrated above, PPTA experienced financial difficulty in the twin shocks of the energy and financial crisis but has recovered to above pre-2007 levels with regard to EBITDA. Furthermore, PPTA does not have any long-term debt obligations and through its new parent, will be able to pursue additional capital expenditure projects to fuel growth and savings. For instance, PPTA has recently announced plans to build a gas-powered power plant near its Port Qasim facility for $40MM US and to install a new catalyst recovery unit for $5MM, lowering production cost with both projects while ensuring a stable electricity supply with the power plant.

Risks

- Political risk: The continuing wars in both Afghanistan and Pakistan present significant macroeconomic risks to Pakistani firms. A significant deterioration of the Pakistani political situation or the war in Afghanistan could negatively impact PPTA.

- Crude oil risk: PPTA's only product, PTA, is a product of crude oil. If crude oil prices, or more specifically, PX prices, increase faster than PTA prices, PPTA could be adversely affected.
- Scale and competition risk: If BP, Sinopec, or another large competitor sets up operations in Pakistan or lands a long-term supply contract with a large textile mill, such as Nishat Mills, PPTA's operations could be adversely affected due to the economies of scale inherent in large capital expenditure manufacturing businesses.
- Currency risk: While the Pakistani rupee has declined against the US dollar year-to-date, a significant monetary shock or political event could further depreciate the currency, adversely affecting the value of your investment in PPTA.

Valuation

Given that there are no ADRs for PPTA, we see a price target of 11Rs given the reversion to a median price/FCF valuation discussed earlier combined with continuing rationalization of the political and economic environment in Pakistan.

Conclusion

In summary, our price target of 11Rs for PPTA is based on several factors, including a rationalization in Pakistani markets as well as a global economic recovery resulting in increased indirect demand from a resurgent international consumer via its domestic polyester factory customers. Further, a restoration of the PTA tariff in Pakistan would only provide additional upside, prompting a reevaluation of our price target and potential increased allocation. While the risks to PPTA are nontrivial, given its currently depressed valuation, the risk-reward profile of this investment is very attractive.

Works Cited

Balfour, Frederik. "Guess Who Has the Hottest Stock Market." Business Week 23 Sept. 2002. Print.

Benson, Andrew, Sophie Jourdier, Vidya Anant, P. J. Juvekar, and Anthony Pettinari. Global Chemicals Cracker. Publication. Citi, 20 Nov. 2009. Web. 24 Nov. 2009.

"Capital Market Economic Survey." Ministry of Finance. June 2009. Web. 22 Nov. 2009. <http://www.finance.gov.pk/finance_survery_chapter.aspx?id=21>.

"Crisis Investing: Pakistan closes the Karachi Stock Exchange for 3 days." Today's Financial News. 28 Dec. 2007. Web. 22 Nov. 2009. <http://www.todaysfinancialnews.com/international-investing/pakistan-markets-remain-closed-201.html>.

Cunningham, Graham. Weekly Asia Petrolizer - Citi's Weekly Pan-Asia O&G Newsletter. Publication. Citi, 23 Nov. 2009. Web.

FFC. AKD Securities Limited, KASB Research, October 23, 2009

First Capital Equities. "Pakistan PTA Limited." Daily Times. 6 Sept. 2009. Web. <http://www.dailytimes.com.pk/default.asp?page=200996story_6-9-2009_pg15_4>.

"Historical financials for PPTA." Reuters Global Fundamentals. FactSet. Web.

The Hub Power Company. Reuters Knowledge. Web. 20 Nov. 2009. <http://www.knowledge.reuters.com/Views/Company/Default.aspx?issuers=100017835&countries=PK@ISO3166A2&SearchText=hub>.

HUBCO. Web. 20 Nov. 2009. <http://hubpower.com/>.

Islamabad Stock Exchange. Web. 24 Nov. 2009. <http://www.ise.com.pk/About_ISE/AboutISE.asp>.

Karachi Stock Exchange. Web. 24 Nov. 2009. <http://www.kse.com.pk/>.

""KSE 100-Index crosses 9700 level"" Regional Times. Web. 24 Nov. 2009. <http://www.regionaltimes.com/25sep2009/moneynews/kse100.htm>.

Lahore Stock Exchange. Web. 24 Nov. 2009. <http://www.lahorestockexchange.com/About/>.

Mangi, Mohsin. FFC: High payout highlights strong defensive play. Credit Suisse, October 26, 2009

Marwat, Farrah. FFC: Estimates raised on strong urea pricing power. BofA ML, October 29 2009

"Pakistan -." Wikipedia, the free encyclopedia. Web. 30 Nov. 2009. <http://en.wikipedia.org/wiki/Pakistan>.

"Pakistan - Investment (gross fixed) - Historical Data Graphs per Year." Index Mundi - Country Facts. Web. 23 Nov. 2009. <http://www.indexmundi.com/g/g.aspx?v=142&c=pk&l=en>.

Pakistan News Service - PakTribune. Web. 23 Nov. 2009. <http://www.paktribune.com/news/index.shtml?217482>.

Pakistan Power Report Q4 2009. Business Monitor Online. Web. 20 Nov. 2009. <http://www.businessmonitor.com/cgi-bin/request.pl?view=publicationsearch&file=SSPK18_20091001.pdf&SessionID=743399543545336>

Pakistan PTA Limited. Web. 25 Nov. 2009. <http://www.pakistanpta.com/>.

"Pakistan ranked 49th in WEF Financial Index." Aaj TV Online. 10 Oct. 2009. Web. 21 Nov. 2009. <http://www.aaj.tv/news/Business/149161_1detail.html>.

"Paper: Pakistan and the World Economy." Peter G. Peterson Institute for International Economics. Web. 22 Nov. 2009. <http://www.iie.com/publications/papers/paper.cfm?ResearchID=333>.

Private Power and Infrastructure Board. Web. 20 Nov. 2009. <http://www.ppib.gov.pk/>.

"Research Report on Electricity Shortage in Pakistan (Research Methodology)." Scribd. Web. 20 Nov. 2009. <http://www.scribd.com/doc/18746388/Research-Report-on-Electricity-Shortage-in-Pakistan-Research-Methodology>.

Satti, Waqas. FFC: Sept 2009 Results Update. Citigroup Global Markets, October 26, 2009

Securities & Exchange Commission of Pakistan. Web. 22 Nov. 2009. <http://www.secp.gov.pk/>.

"Soviet war in Afghanistan -." Wikipedia, the free encyclopedia. Web. 30 Nov. 2009. <http://en.wikipedia.org/wiki/Soviet_war_in_Afghanistan>.

Zaidi, Erum. The Nation. 29 Oct. 2009. Web. 22 Nov. 2009. <http://www.nation.com.pk/pakistan-news-newspaper-daily-english-online/Business/29-Oct-2009/Banks-financial-derivative-business-down>.