

In Focus Strategy

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The 'What If' of Dubai Crisis for Pakistan

- Dubai has accounted for 12% of remittances into Pakistan during the last ten years; weak outlook on Dubai's real estate market may however result in reverse capital flight
- UAE accounts for merely 6% of total exports and 7% of total investment flows for Pakistan
- Exposure of Pakistan's financial sector to Middle East assets is limited with UBL being the only major exception; likely surge in M&A activity expected for the sector
- Pakistan's cement exports to UAE stand at 2% of total offtakes; slowdown in ME construction activities had already been accounted for
- Correlation of KSE100 with MSCI EM and DJIA stand at 0.9 and 0.8 respectively while foreign holding in domestic equities is estimated to be over 24% of Pakistan's free-float weighted market capitalization
- Increase in risk premium assigned to Emerging Markets may result in foreign outflows and a setback for local equity markets; however potential decline in intl oil prices will be the key blessing out of this crisis

The recent news flow emanating from financially distressed Dubai World has led to serious concerns on other asset classes within Dubai while it has raised fingers on the recent revival of risk appetite for emerging market assets.

The Crisis: The real concern is uncertainty!

Dubai World, the state owned corporation, recently disclosed its plans to seek delay in payments for USD26bn out of its USD59bn of outstanding loans. Considering the announcement as default, both Moody's and S&P later cut their ratings on Dubai state companies which altogether account for USD80bn of liabilities.

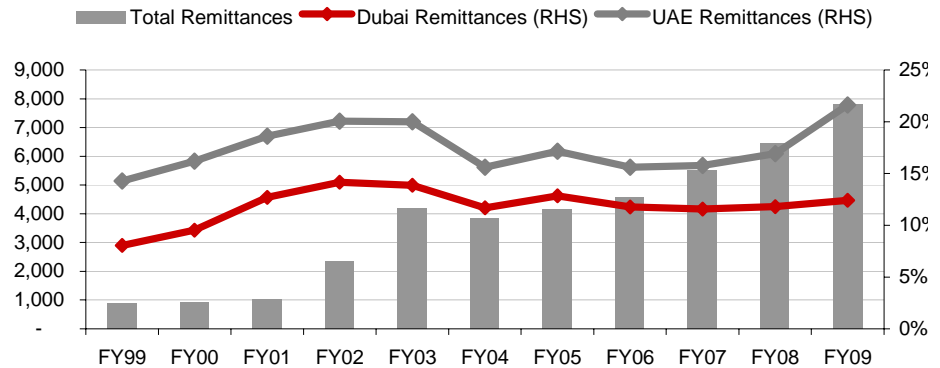
With the crisis having its direct implications on Dubai's real estate market (Dubai World owns the two real estate giants Nakheel and Limitless World), the eventual impact on the housing market remains to be seen. Real estate prices in Dubai have already fallen by ~50% from 2008 peak and any further downslide will undoubtedly be a blow to the state's financial and corporate sector.

Pakistan Economics: Remittances from Dubai may actually see a short-term spike as reverse capital flight kicks in

The United Arab Emirates has been an important source of remittances for Pakistan. Over the last ten years the U.A.E has contributed almost 17.5% of all remittance flows, with that percentage increasing to 21.6% and 22.0% in FY09 and 4MFY10 respectively. In fact over the last five years remittances from the UAE have grown at a CAGR of 23.1% as compared to the compounded growth rate of 15.3% in overall remittances. Dubai has played a leading role in remittances from the region and contributed 12.4% or USD970.4mn during FY09. Moreover, Dubai has provided almost 11.9% of all remittances during the last ten years and has consistently been amongst the top 4 sources (along with Saudi Arabia, the U.S and U.K) of worker remittances for Pakistan.

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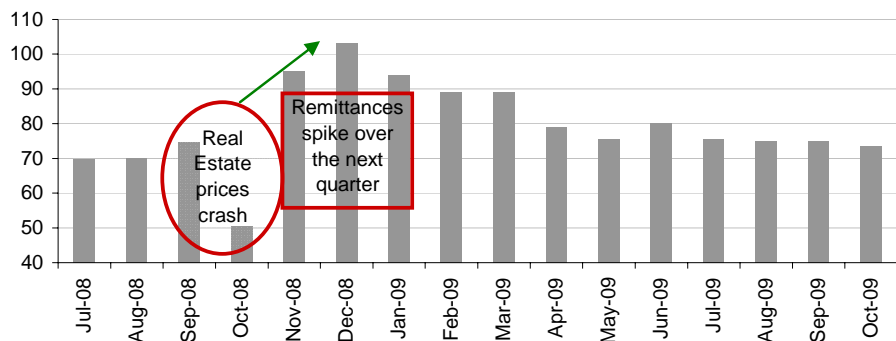
Remittances to Pakistan



Source: SBP, MoF, BMA Research

Following the sub prime crisis and the global recession that followed, analysts feared that remittances to Pakistan would dry up, as the contagion spread to the Middle East. Despite the fall in oil prices, loss of migrant labor and general economic slowdown, Pakistan has continued to witness very strong remittance flows through FY09 and 4MFY10. In fact following the real estate crash in Dubai, remittance flows have increased significantly into Pakistan. From averaging USD63.4mn per month in FY08, they jumped to USD80.9mn in FY09, an increase of 27.6%. This phenomenon can be explained by the USD12bn+ investment that has been made by Pakistanis in Dubai's real estate and equity markets. As valuations there started to drop in line with global trends, real estate and equity investments were liquidated and the proceeds were remitted back to Pakistan. Following the announcement by Dubai World, we expect further downward pressure on real estate prices and equity valuations and believe that it will provide another spike in remittance flows as Pakistani investors exit from the Dubai market. The medium term outlook will be determined by the ability of Dubai World and its associated companies to successfully meet its rescheduled debt payments (USD9.2 billion in 2010, USD19.8 billion in 2011, and USD17.3 billion in 2012). We expect that after the short term spike in remittances, monthly flows will settle down to average around USD75mn per month.

Monthly Remittances from Dubai to Pakistan (USD mn)



Source: SBP, MoF, BMA Research

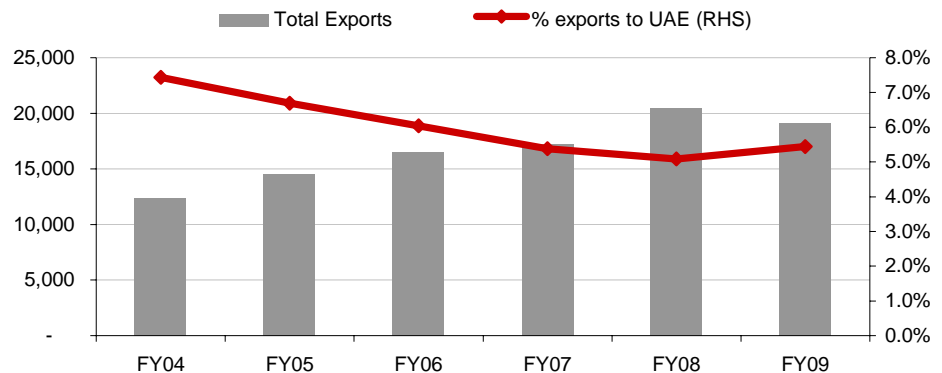
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However a more extreme outcome and a serious continued turmoil in Middle East may result in wide scale downsizing which may trickle down to substantially lower remittances into Pakistan from the region.

Pakistan Economics: Exports to UAE account for 6% of total and are expected to remain unchanged

The other major implication for Pakistan would be on the exports front, where a protracted slow down in Dubai and the U.A.E could further erode the country's FOREX earnings from exports. Fortunately, data from the last five years shows that Pakistani exports to the U.A.E have accounted on average for only 6.0% of the total. More importantly, while total exports have grown at a CAGR of 9.1% between FY04 and FY09, those to the UAE have remained fairly stagnant with a CAGR of 2.5%. In fact during this period the dollar amount of exports to the UAE has remained stable at around USD1.0bn which shows that this market has exhibited neither growth nor retrenchment. Thus going forward we do not expect the fall out from the Dubai World debt stand still to significantly affect Pakistan's export earnings.

Pakistan Exports Snapshot (USD mn)



Source: SBP, MoF, BMA Research

Pakistan Economics: UAE accounted for 7% of net investment flows in FY09

The story is similar with regards to investment flows. The U.A.E accounted for 38.4% of net investment in Pakistan in FY06; however since then the flows from this region have fallen sharply both in quantum and as a percentage of the total. In FY09 the U.A.E accounted for only 7.1% of net investment flows, while its contribution to foreign direct investment had dropped from 40.5% (FY06) to merely 4.8%. While this reduced reliance on the U.A.E for investment flows is encouraging it is also indicative of the fact that Pakistan has become a less desirable destination for foreign capital, even from longtime allies such as the U.A.E. Going forward we don't expect capital flows from the U.A.E to significantly change.

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Net Investment Flows into Pakistan

Net Investment	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09
Total	474.7	816.3	921.7	1676.6	3872.5	6959.9	5429.1	3209.4
U.A.E	17.3	120.0	146.5	417.3	1487.8	677.0	592.8	228.0
Percentage	3.7%	14.7%	15.9%	24.9%	38.4%	9.7%	10.9%	7.1%

Source: SBP, MoF, BMA Research

Domestic Financials: Exposure to ME asset class is limited; UBL the only major exception

Pakistan's financial sector (brokerage houses, investment banks and commercial banks) extensively owes its recent expansion to foreign investment from Middle East based groups. However the only significant link between domestic financials and Middle East based groups is the ownership stake while exposure to Middle East or Dubai's asset classes is limited for most; with United Bank Limited (UBL) being the only major exception.

According to UBL's latest financial results, the bank's offshore advances stand at PKR90bn, accounting for 25% of its total loan book. With most of these international loans directed towards the Middle East, UBL issued a press release revealing its direct exposure to Dubai World at USD20mn (PKR1.7bn) which accounts for 2% of its UAE book and under 0.3% of its total book.

However with the possible spillover of Dubai World's crisis into the rest of Dubai's economy, the issue indirectly heightens concerns relating to asset quality of the international book. In 3QCY09 alone, foreign NPLs climbed to PKR ~4bn up from PKR 3.1bn in 1HCY09. In contrast to the local trend, foreign NPL accumulation has been growing on a quarterly basis. On top of this, the Dubai debt worries will continue to be a significant risk factor in the bank's future performance via possibly higher foreign NPLs and provisions. Thus, we advise caution till more is known on that front.

For the rest of Pakistan's financial sector, shortfall in minimum Capital Adequacy and Paid-up Capital may bolster Merger and Acquisition activity in the event of continued liquidity constraints in the Middle East.

Pakistan Cements: Exports to ME already projected to be at 6% of total exports and 2% of total offtakes

Recent construction boom in the Middle East bolstered dispatches for Pakistan's cement industry as it was able to tap new export markets while domestic markets suffered from a severe supply glut. However against broad perceptions, exports to UAE stood at a mere 0.8mn tons for FY09 (1.0mn tons in FY08), accounting for 7% of total cement exports and 3% of total cement dispatches.

Going forward, we had already taken into account the widespread slowdown in Middle East construction activities and project exports to UAE to clock in at 0.65mn tons for FY10 and 0.6mn tons for FY11. Hence given minimal reliance on exports to UAE, local cement industry is not expected to be seriously threatened by any further fall out of Dubai. We however remain Underweight on the sector on the back domestic concerns such as lower retention prices, cut-throat competition and breakup of cartel. Having said that, any further correction in cement stock prices is likely to present an attractive opportunity to accumulate companies positioned to do well in the given environment – particularly DG Khan Cement (DGKC) which is currently trading at ~55% of the market value of its investment holdings.

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Pakistan Cement Industry Snapshot and Export Assumptions

mn tons	FY07A	FY08A	FY09A	FY10E	FY11E	FY12E
Industry Capacity	28.2	34.3	44.1	44.1	46.3	46.3
Local Dispatches	19.7	20.7	18.3	18.6	19.6	20.9
Export Dispatches	3.1	7.1	10.7	10.2	9.2	9
Exports to UAE *	0.5	1	0.8	0.7	0.6	0.6
Total Dispatches	22.8	27.7	29	28.8	28.7	29.9
<i>Total Exports as % of total offtakes</i>	<i>14%</i>	<i>25%</i>	<i>37%</i>	<i>35%</i>	<i>32%</i>	<i>30%</i>
<i>Exports to UAE as % of total exports</i>	<i>15%</i>	<i>14%</i>	<i>7%</i>	<i>6%</i>	<i>7%</i>	<i>7%</i>
<i>Exports to UAE as % of total offtakes</i>	<i>2%</i>	<i>3%</i>	<i>3%</i>	<i>2%</i>	<i>2%</i>	<i>2%</i>

* Estimated from export value comparisons

Source: BMA Research, APCMA, Pakistan Economic Survey

Equity Markets: Is Pakistan really Decoupled?

While general perception on Pakistan claims the country's equity markets to be largely decoupled with the rest of the global markets, historical correlation analysis points towards a completely different picture. KSE100 has shown a correlation of ~0.9 with both India (BSE Sensex 30) and Emerging Markets (MSCI EM) since 1990. More importantly, in-line with the rest of the global markets, Pakistan equities correlation has significantly increased (particularly with the West) post 2003 as it stands at 0.8 and 0.9 with US (Dow Jones Industrial Average) and UK (FTSE), respectively.

Correlation of KSE100 with Select Global Indices

	BSE Sensex 30	MSCI EM	Dow Jones	FTSE
1991 to date	0.94	0.91	0.64	0.47
2003 to date	0.88	0.94	0.81	0.89

Source: BMA Research

Hence while the crisis emanating from Dubai may not have a very significant impact on the country's macro environment, any meltdown in global financial markets is likely to have its toll on domestic equities.

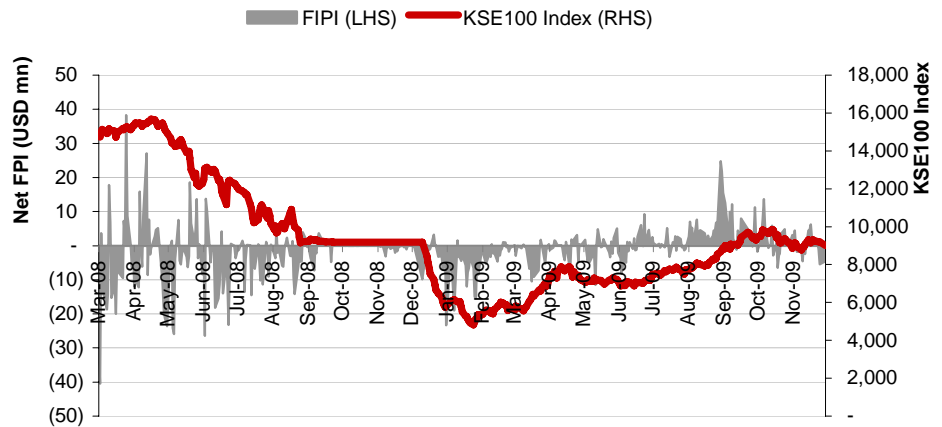
Foreign Investors: Key to Increasing Correlation

After 14 months of continuous outflow of foreign portfolio investment, FPI turned positive for the first time in Jun09. KSE has since then recorded net inflow of USD294mn. According to our estimates, foreign investor holdings right now stand at over USD2.0bn, accounting for 24% of free-float weighted market capitalization for KSE.

Given such high dominance and a visible impact of foreign investors' activity on KSE (refer to chart below), key risk to KSE index levels remain the direction and momentum of foreign funds. Of particular significance, in this context, could be the recent net portfolio outflow of USD11mn recorded in the last three trading sessions which could be a key indicator for the short term direction of foreign investors.

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Net Foreign Portfolio Investment (FPI) and KSE100 Index



Source: BMA Research, NCCPL

Risk Premium to Pakistan Equities: Dubai crisis is likely to have its toll

Backed by sustained improvement in macroeconomic balances, entry into IMF program and revival of risk appetite for emerging markets, Pakistan witnessed a significant ease in risk premium assigned to its asset classes. While the country's Eurobonds are largely illiquid, yields on them nonetheless reflect a reasonable estimate of foreign sentiments on domestic capital markets – yield on Eurobonds (maturing in 2016) have eased from a high of 29% touched in Oct08 to 9.4% as of yesterday.

Yield on Pakistan Eurobonds maturing in 2016

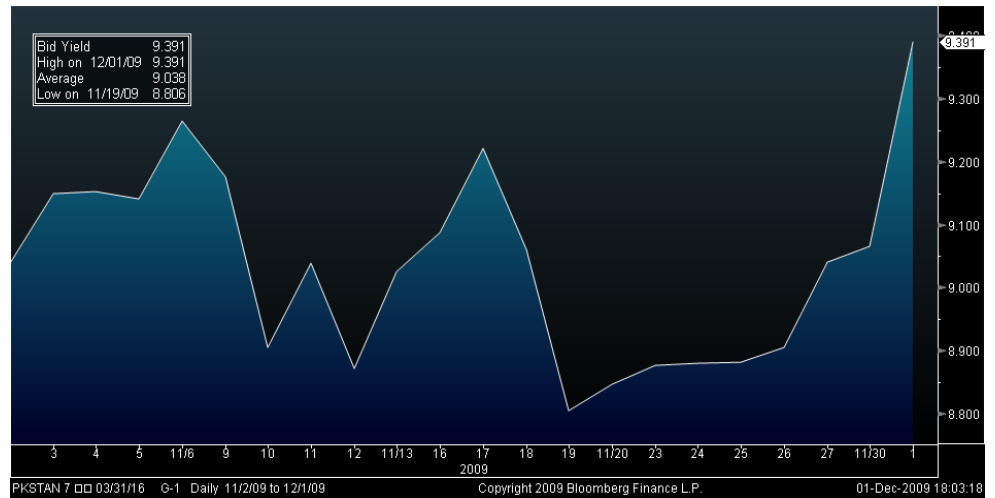


Source: Bloomberg

In-line with the trend witnessed in equity markets, a shorter term snapshot of the Eurobond yields however show that its yield spiked by ~50bps since November 26, 2009.

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Yield on Pakistan Eurobonds maturing in 2016 – Short Term Snapshot



Source: Bloomberg

To Sum It All Up: Keep a close eye on Global Markets!

Momentum for Pakistan equities has been recently restrained by uncertain domestic political and security situation. While our medium term outlook on both accounts is positive, we have been advising a cautious stance on equity markets as potentially volatile news flow can result in a severe setback for KSE.

Given the domestic environment, Dubai crisis came as a negative surprise despite its minimal impact on macroeconomic fundamentals for the country. With increasing correlation of Pakistan with other global markets, heavy dominance of foreign holding in local bourses and potential for higher risk premium assigned to emerging markets; one needs to be ever more watchful of global liquidity flows. Unwinding of carry over trades can hence have a serious impact on local index levels. Having said that, any correction in global equity markets is likely to be followed by a meltdown in commodity markets, particularly oil – which will nonetheless be a key blessing for Pakistan’s macro balances.