



The problem with Pakistan is that few internationalists take the time to understand the place. They tend to see it as some sort of evil twin to India.

Please note: This commentary drew unprecedented response in both number and length of email replies received. The views were so passionate and articulate, we decided to summarize them in an addendum to this Research Note, beginning on page 3.

Our **Research Notes** series aims to provide timely commentary on investment topics of interest to our clients and friends. As a specialized investment firm bridging Islamic and conventional markets, Codexa Capital's analytical work explores aspects of asset management relevant to global audiences with interests in niche and evolving stories.

What to Do With Pakistan?

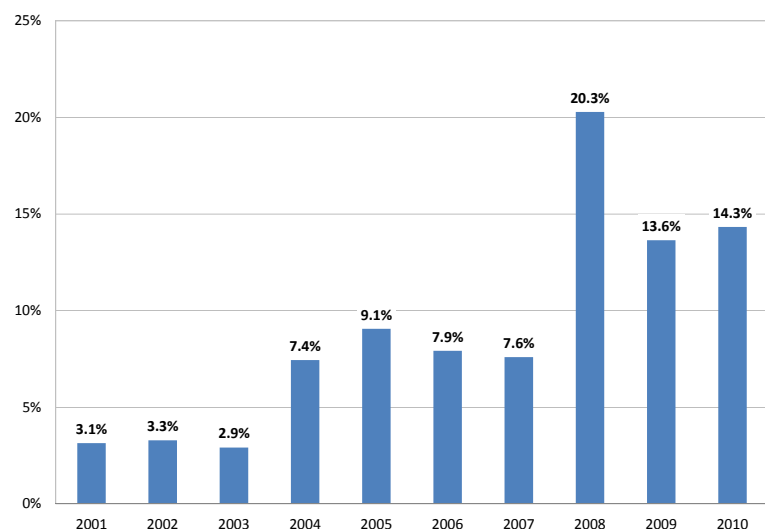
By Douglas Clark Johnson

I've been to Pakistan a dozen times over the years, most of them routine trips to speak with qualified investors and explore opportunities for inward capital. On one of those trips, I picked up a small souvenir from Sindh, a mirror-embellished elephant now sitting on my office table. It reminds me daily of the points of light this intriguing country is capable of producing, affirmed by my visit in early December.

The problem with Pakistan is that few internationalists take the time to understand the place. They tend to see it as some sort of evil twin to India. Pakistan actually constitutes a complex religious society of Sunnis and Shiites, with Ismailis and Ahmediyyas adding further dimension. Then there are myriad ethnic divisions, with the Pashtuns often being singled out in casual banter on national politics.

Despite its reputation, Pakistan may make sense now as both a direct and a portfolio investment opportunity. I consider it the definitive "information arbitrage" story among the world's frontier markets. One of my rules of thumb is that the private sector is often most energetic in countries where the public sector is most challenged. After all, any corporate management

Pakistan: Decade of Escalating Inflation (Consumer Price Index Year-on-Year Change)



Source: World Bank; 2010 estimate.

Pakistan is not for the faint-hearted. But there are material opportunities in the oil and gas, natural resources, textile, and agricultural sectors, given the decline in asset prices seen over the past two years.

capable of successfully running a commercial enterprise amid such noise is probably pretty good at what it does.

Pakistan has fit easily into this framework for some years. What makes the story timely now is the indirect stimulus impact of QE2. The headlines in a recent issue of *Pakistan & Gulf Economist*, a local newsmagazine, are worth noting:

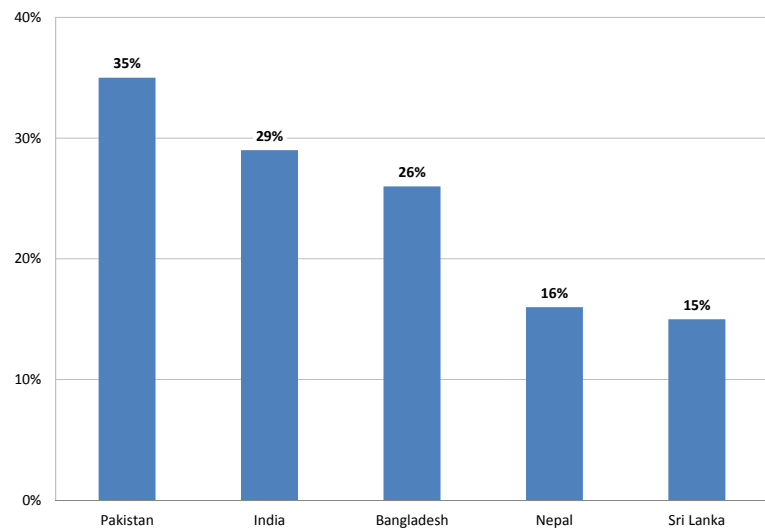
- “Corporate Invests \$135 Million at Port Qasim”
- “Reality is Not as Bleak as Being Painted”
- “Attracting Foreign Investments in Balochistan”

The magazine also featured comments by the head of one commercial bank, focusing on fierce competition and the need for change. A fair assessment of publication content also takes note of other headlines, including “Foreign Investment Hit by War on Terror.” But my read is, this is a pretty good contrarian indicator. Certainly the Pakistani executives I met before the year-end holidays seemed to be savoring the potential, while acknowledging the detrimental effects of government corruption and social turmoil.

Pakistan is not for the faint-hearted. But there are material opportunities in the oil and gas, natural resources, textile, and agricultural sectors, given the decline in asset prices seen over the past two years. Foreign direct investment totaled more than \$5 billion in 2006-07 and dropped to less than half that amount in the fiscal year ending June 2010. Yet relatively strong foreign direct inflows from the UAE (usually trailing just behind FDI numbers from the US and UK) may form a more definitive sign of expatriate confidence in the local economy. The UAE-sourced data presumably originates largely from non-resident Pakistanis or at least knowledgeable insiders. China has likewise made aggressive commitments in the past.

The US Federal Reserve Board is doing an admirable job of inflating the emerging economies of the world—rather better than the US economy itself, to date. I argue that this wall of money will soon hit dollarized frontier economies like Pakistan. The local Pakistani equity market may be ripe for further gains beyond those seen since the August floods. Given cheap valuation readings, investors may be willing to look beyond near-term concerns such as lingering high interest rates and a weak government, aiming for strong medium-to-long-term gains. The expected release of the next IMF tranche in Q1 2011 could act as a trip switch for inward flows.

Investors in Pakistani shares will likely see validation of their commitments if foreign direct inflows improve as we expect over the year ahead. Operating somewhat below the radar of Western economic analysts, both the Saudis and the Chinese are set to lead the charge in project commitments, especially if progress is made on addressing political extremism. Arab and Asian businessmen may have a somewhat different view on country risk than do global pundits.

Pakistan: Most Urbanized South Asian Country (Urban Population as Percent of Total)

Source: World Bank (most recent available data).

The response to our piece became so voluminous that we wanted to convey the full spectrum of ideas and emotions. We provide below excerpts from the many email replies received.

Addendum: Reader Comments on “What to Do With Pakistan?”

We started 2011 with a commitment to producing regular commentary on investment aspects of key markets we serve. It was a simple goal. Yet, in our beginning-of-the-year treatment on Pakistan, we stumbled into passion and conviction quite unlike anything experienced in decades of writing investment research.

The response to our piece, “What to Do With Pakistan?”, became so voluminous that we wanted to convey the full spectrum of ideas and emotions. We provide below excerpts from the many email replies received-- from Singapore, Dubai, London, New York, and seemingly everywhere in-between.

Our commentary was released just before the assassination of Salman Taseer, Governor of Punjab, by a member of his security staff. Certainly these views ring as loud now as they did before this new headline.

Despite the focus of the West on Pakistan’s nuclear capability, no voice in our audience raised the subject as a matter of material concern. Nor for that matter were ties with India. There was constructive banter, however, about associations with China and the Middle East. The 2010 flooding was generally treated as a *fait accompli*.

Excerpts from the emails we received are organized roughly by concept, with some selective editing or distilling of material for readability. While we obtained permission from the authors, we have maintained their anonymity.

We hope you find this array of perceptions to be as thought-provoking as we did.

“I totally agree that Pakistan has potential much beyond our own imaginations, but political and financial corruption is devastating. I am quite bullish myself on many sectors. Areas that are badly in need, even more so after the floods: house building finance, micro finance, and consumer finance.”

Pakistan's Future

- “I sometimes wonder what to call a person who insists on remaining sick, despite the fact that he has the best medication available to cure himself. The case of Pakistan is so intriguing that many a thesis can be written on the subject of ‘To what maximum extent a nation can go on a self-destructive path and yet unable to find the bottom.’ I had thought after losing half the country in 1971, Pakistan will re-emerge as a strong nation, but it was a mere wish.”
- “Pakistan has many issues to endure and change. The most important is our image. It’s bad because of our own actions and a myopic understanding of the outside world. We think that the rest of the world has no problems, that it’s only Pakistan that has problems, and that the whole world conspires against us. These points are the biggest hurdles in allowing business and investment to come into the country.”

Flooding

- “I think the country is facing a number of challenges. First is the recent flood damage to various sectors in the country that is estimated to be around \$10 billion. The country will have to be engaged in a medium-to-long term planning for post flood construction, recovery planning, and additional programming to cope with this disaster.”

Industry Sectors

- “Opportunities never end! Private sector profitability has been very seriously attractive compared to the environment companies operate in.”
- “I totally agree that Pakistan has potential much beyond our own imaginations, but political and financial corruption is devastating. I am quite bullish myself on many sectors. Areas that are badly in need, even more so after the floods: house building finance, micro finance, and consumer finance.”
- “Agriculture: It is so surprising to note that a good number of people in Pakistan are hungry and that the country is importing food at high cost. With the fertile land that we have, we should be able to feed 50% more population than what we have. Primitive agri-methods lead to mediocre output and lack of good storage facilities is responsible for waste of large quantities of whatever food is produced.”
- “Minerals: We believe the country has huge resources of petrol, gas, coal, metals (including gold deposits) in Baluchistan. What a pity that there is a separation movement going on there currently whereas this one province alone can earn huge income for the whole country so as to pay back all debts.”

“On the recent state visit by the Chinese premier, the Chinese were not interested in what they can do for Pakistan, but what Pakistan can do for them with reference to trade and economics. There is a famous saying here that if 1,000 containers come from China to Pakistan, only one goes back full. It is the game of trade balances and surpluses.”

International Ties

- “Pakistan is a strategic location as a regional hub. It’s a principal gateway to the Central Asia Republics. It has strong and long-standing links with the Middle East and South Asia. There are comprehensive duty-free facilities for investors.”
- “The level of violence and corruption is really alarming, and the outlook doesn’t seem positive, at least from my perspective. The Pakistan economy is linked to the neighboring countries, mainly Iran and UAE, and both economies are now facing the challenges of the UN sanctions and recession.”
- “On the recent state visit by the Chinese premier, the Chinese were not interested in what they can do for Pakistan, but what Pakistan can do for them with reference to trade and economics. There is a famous saying here that if 1,000 containers come from China to Pakistan, only one goes back full. It is the game of trade balances and surpluses.”

Leadership

- “I am not convinced that Pakistan will be able to prosper as long as this government remains in power. I say this not because of corruption, which is a way of life. My problem is that while some in other countries are also corrupt, they at least attempt to focus on issues like attracting FDI and don’t confuse military aid with inflows. I am also bearish on ability to control the violence and the extremism which will remain at the forefront of the agenda for a while, even if it doesn’t explode (not certain by any means).”
- “Given the current dismal leadership, I may not be that optimistic to start looking for silver lining in the darkening clouds on the economic horizon. I wish the political leaders could visualize the treasures the country holds compared to their peanut gains amassed through unfair means.”
- “There is no direction for the country from the top. And, while the masses don’t have the means to make a difference, many in the upper class have substantial wealth which they don’t feel comfortable in investing within the country. This is partly because of the lack of direction, but mostly because of there being uncertain about the government’s decisions, although if they are given an opportunity, they can themselves give a direction and a stimulus of the economy.”

Human Resources

- “I truly think they have many good brains there just like those in China and India. With over 180 million, Pakistan is a market to reckon with.”
- “People are willing to learn, hard working, talented and tuned to limited resources. Pakistan contains all strategic resources, like the

“The fragmentation of society is a result of poverty and lack of progress, as people have nothing else but to pick on small differences. Once the economy starts picking up, and the size of the cake starts growing, these differences will disappear as everyone will focus on making the best of the opportunities. The sound of money is the best healer in such situations.”

pieces in a jigsaw puzzle, they simply need to be put together to construct a beautiful picture.”

- “Pakistan has the demographic weight, diversity, and critical mass of well educated people to have an economy worth taking a serious look at. However, as you have mentioned, it’s not for the faint-hearted. Not only for the obvious geostrategic elements, but also because of the high level of corruption and the lack of a trusted and stable regulatory framework.”
- “I do not think I need to tell you about the quality of human resources in Pakistan. However, the fragmentation of society is a result of poverty and lack of progress, as people have nothing else but to pick on small differences. Once the economy starts picking up, and the size of the cake starts growing, these differences will disappear as everyone will focus on making the best of the opportunities. The sound of money is the best healer in such situations.”

Capital Markets

- “I have personally been a beneficiary of the capital markets growth of Pakistan and very truly understand the risks and potential of our market. At the beginning of the year 2010, I had expected the market to touch 12000-to-13000 during March-April, as valuations were cheap and investors were quite keen to get in. Similarly, there were four IPO’s in the first four months. But all the hoo-ha that is going on in the government and that the judiciary will strike caused the market to just keep on speculating.”
- “Look at the mindless issues on taxation! No one wants to pay! Anyway, in the last four months, the market went up by 26% out of the total 27% during the year. This year 2011 will hopefully be a good year. One can expect the KSE-100 to be between 14000-to-15000, Inshallah. I have been telling people that it’s actually oxymoronic to hear that people do not trust the state and government and on the other hand, 487 billion rupees went into the National Saving Scheme in last two fiscals!”

Investment Risk

- “Pakistan has long been misunderstood by the international community. However, individuals and entities that do understand the country have always been able to generate long-term returns.”
- “We just have to apply the simple rules of finance: high risk and high return. Pakistan is considered as a high risk market due to political instability, large influence of foreign forces, terrorism, high interest rates, lack of regulatory control, red tape, corruption, lack of infrastructure, et cetera.”
- “You have companies such as Unilever (who have setup a plant in Pakistan which is their largest in South Asia), Nestle, ICI, Bata, and many others who have increased their presence in the country. The reason why these

Note on Codexa Capital

Codexa Capital bridges Islamic and conventional markets. Our expertise crosses project finance, product structuring, and capital introduction activity. Our issuer audiences are global; our investor audiences spread primarily across the Muslim world.

This note's principal author, Douglas Clark Johnson, is CEO and Chief Investment Strategist of Codexa Capital. He can be reached at douglas.johnson@codexacapital.com.

Disclosures

In the United States, Codexa is not registered as a securities broker-dealer or an investment advisor either with the SEC or with any state securities regulatory agencies. The information, opinions, or recommendations in this article are submitted solely for informational purposes.

The information provided here has been obtained or compiled from sources we believe to be reliable; we cannot and do not guarantee the accuracy, validity, timeliness or completeness of any data made available.

Opinions and estimates reflect current judgment as of the date appearing on the article; they are neither all-inclusive nor can they be guaranteed to be complete or accurate. Past performance does not indicate future returns.

This material is for general information only. Every effort has been made to ensure that it is accurate; however, it is not intended to be a complete description of the matters described. It does not contain and is not to be taken as containing any securities advice or securities recommendation. Furthermore, it is not intended that it be relied on by recipients for the purpose of making investment decisions and is not a replacement of the requirement for further research and advice.

Codexa Capital LLC

80 Broad Street, 5th Floor
New York, NY 10004

+1 212.330.9155
contact@codexacapital.com
www.codexacapital.com

companies are doing so well in Pakistan is that they are efficient in terms of productivity, financial and management control, operating in an inefficient market.”

- “Though the investment amount wasn’t substantial, however, it may be worthwhile to share one of the recent strategic investments of approximately \$20 million from Lotte Confectionary, South Korea, which may be good example of investor confidence in Pakistan.”
- “Yes, there are opportunities for money to be made, but you have to understand the place. Investment in Pakistan equals all the incumbent risks of investments in India plus the risks of investing in Afghanistan! That’s why the country lies between the two!”

Random Thoughts

- “Very interesting and good insights. But do any of your Middle Eastern investors share your view?”
- “I can go on for hours expressing my views on the situation in Pakistan.”
- “Pakistan is a real economy with a substantial population which is at this juncture engaged in a critical struggle with consequences reaching far beyond its borders.”
- “If reached to any concrete plan for this country, please do share it with me.”
- “The Chinese are already investing there. I believe the country, minus the instability, can go very far.”
- “Investors are a shrewd lot and will always find opportunities among challenges.”
- “Pakistan will face many of the challenges you reference, but it has committed public servants trying to make the investment climate attractive.”