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REN # REP-004

AKSEER RESEARCH
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Economy: What to expect post resumption of the IMF program?

November 11, 2021

Akseer Research
info@akseerresearch.com

Executive Summary

- **IMF – EFF resumption around the corner**
  - The Sixth review of the IMF' Extended Funding Facility (EFF) is ongoing, and the recent news flow indicates that the government has agreed with the IMF on some fiscal measures including:
    - Increasing power tariff to help contain the circular debt
    - Ending of some of sales tax exemptions to keep the revenue collection target intact for FY22.
    - Giving full autonomy to the SBP.
  - It appears that the finer details on structural adjustments are still being ironed out (Primarily new draft of SBP autonomy bill). IMF completed combined 2nd through 5th reviews in Feb-21 with disbursement of only USD 500mn due to govt's failure to meet the quantitative and some of structural benchmarks.
  - The resumption of the IMF program would likely be paralleled by unwinding of the fiscal and monetary stimulus post COVID-19. Amid rising inflation, policy rate is likely to increase in order to achieve positive interest rates. The government will likely have to reverse part of its expansionary fiscal stance and aim for a more sustainable growth plan alongside increased focus on structural reforms, which have been on the backburner since the onset of COVID-19.
- **GDP growth rebounded in FY21, but there are question marks on future sustainability**
  - FY21 GDP growth of 3.9% was broad based; driven by a combination of low base effect, and Govt stimulus led rise in local consumption. With falling investment during the last two decades, ICOR implied GDP growth potential has fallen by 70bps from 5.1% in 2000s to 4.4% in 2010s.
  - During the last two decades; surge in GDP growth beyond ICOR implied GDP growth potential have led to substantial weaknesses in external account; requiring painful adjustments and sharp decline in growth. GoP's target of 4.8% GDP growth looks aggressive.

Executive Summary

- **Current Account Deficit will likely rise to 3.5% of GDP or USD 11.2bn in FY22; a sub 100 REER is likely to persist**
  - We expect CAD to rise to 3.5% of GDP in FY22 versus 0.6% in FY21, as imports growth is outpacing exports growth.
  - Imports are likely to grow 30% in FY22, exports are expected to increase by 20% and remittance by 9% YoY.
  - For the SBP to continue to build reserve buffer, the current BoP situation needs to be managed urgently. This would require a sub 100 REER. For FY22, we estimate PKR/USD to depreciate by 7%-13% and expect it to move in the range of 168.2-177.0 assuming a REER of 100-95.
- **CPI likely to surpass SBP's targeted range (7-9%); Policy rate to rise until mildly positive interest rates are achieved**
  - We expect FY22 CPI inflation to average 9.3%, surpassing SBP's targeted range of 7-9% (GoP forecast of 8.2%). There are substantial upside risks from 1) Global commodity price surge, especially food. 2) Domestic demand revival, 3) Weakness in PKR.
  - We believe the era of accommodative monetary policy is behind us. We expect the central bank to undertake cumulative hikes of 225 bps, taking policy rate to 8.5% by May-22 and 9.5% by Nov-22. IMF may require a more aggressive rate hike.
- **Fiscal policy is expansionary; needs to be reigned in**
  - GoP announced an expansionary FY22 budget with targeted net federal development spending up 36% YoY and subsidies up 59% YoY in FY22. ~44% of budgeted PSDP has already been released in 2MFY22. Continuation of this momentum will likely be inflationary.
  - There are risks to nontax revenue collection target; especially Petroleum Levy (PKR 610bn). 4MFY22 collection is likely to have been 4% of annual target. Nov-21 collection (net of subsidy) would likely be negative.

Macroeconomic Indicators

Macroeconomic Indicators	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21P	FY22E
GDP	4.1%	4.1%	4.6%	5.2%	5.5%	2.1%	-0.5%	3.9%	4.8%
Current Account Deficit	1.3%	1.0%	1.8%	4.0%	6.1%	4.8%	1.7%	0.6%	3.5%
Total Investment	14.6%	15.7%	15.7%	16.2%	17.3%	15.6%	15.3%	15.2%	17.0%
National Savings	13.4%	14.7%	13.9%	12.0%	11.3%	10.8%	13.6%	15.3%	13.0%
Fiscal Deficit	5.5%	5.3%	4.6%	5.8%	6.5%	9.0%	8.1%	7.1%	6.3%
Tax to GDP	10.2%	11.0%	12.6%	12.4%	12.9%	11.7%	11.4%	7.9%	10.8%
Inflation	8.6%	4.5%	2.9%	4.8%	4.70%	6.8%	10.8%	8.9%	9.3%
Interest Rate - Average	9.8%	8.8%	6.0%	5.8%	5.9%	9.4%	11.8%	7.0%	7.7%
Interest Rate – Year End	10.0%	6.5%	5.75%	5.75%	6.5%	12.25%	7.0%	7.0%	8.5%
PKR/USD Parity – Average	102.9	101.3	104.2	104.8	110.0	136.4	158.3	160.2	168.2-177.0
PKR/USD Parity – Year End	98.7	101.8	104.8	104.8	121.6	159.5	167.9	157.7	168.2-177.0

ECONOMY

Real Sector

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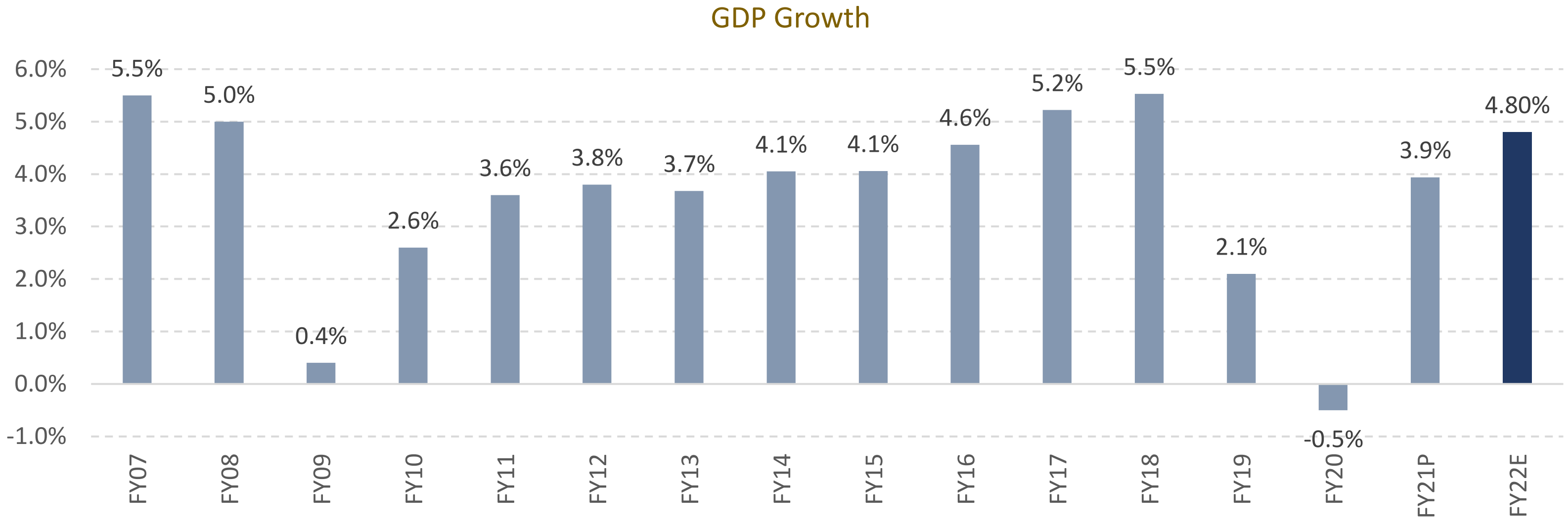
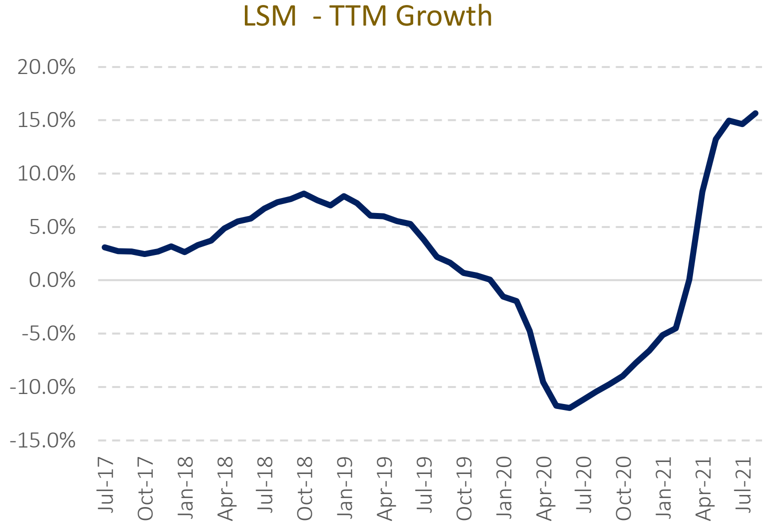
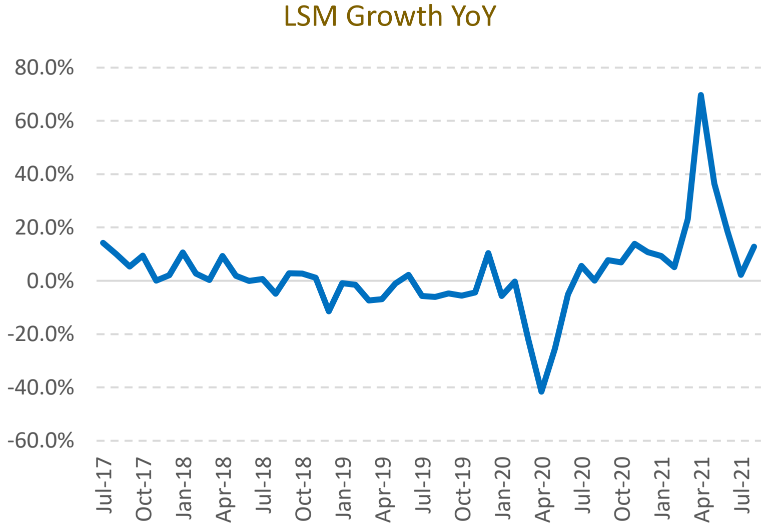
GDP growth rebounded to 3.9% YoY in FY21, but there are question marks on future sustainability

- FY21 GDP growth of 3.9% was somewhat broad based – with all sectors having positive contribution, with highest growth coming from LSM.
- Low base effect, coupled with rise in local consumption led by Govt stimulus package resulted in a rebound in the manufacturing and the services sector.
- Agri sector growth was supplemented by record crops output. Improved economics due to supply shocks led high commodity prices is like to support agri growth in the near term.

Sector-wise GDP growth	FY17	FY18	FY19	FY20R	FY21P
Agriculture	2.2%	4.0%	0.6%	3.3%	2.8%
Manufacturing	5.8%	5.4%	-0.7%	-7.4%	8.7%
Commodity Producing Sector	3.4%	4.3%	-0.5%	-0.3%	3.2%
Services	6.5%	6.4%	3.8%	-0.6%	4.4%







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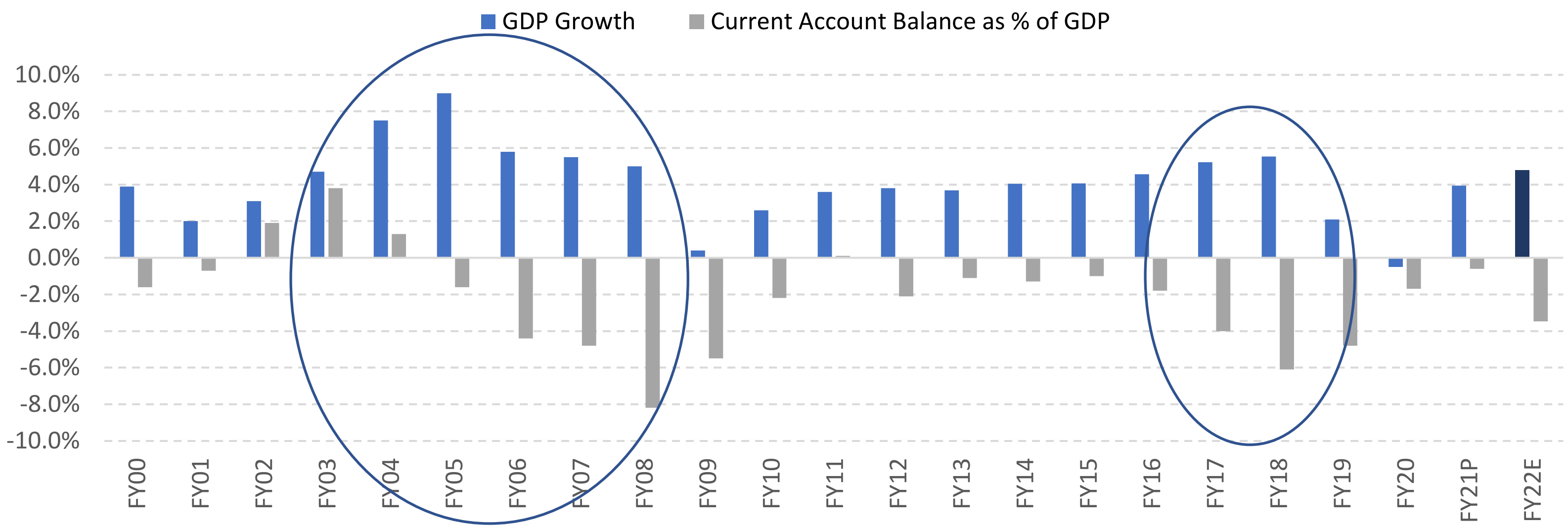
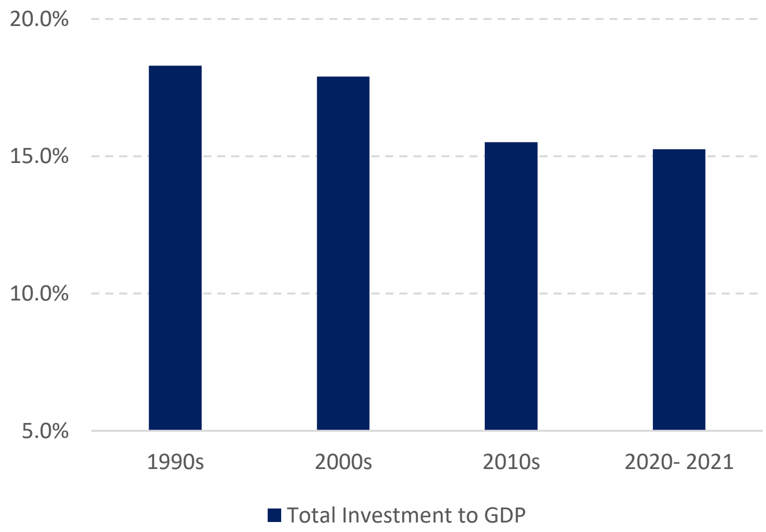
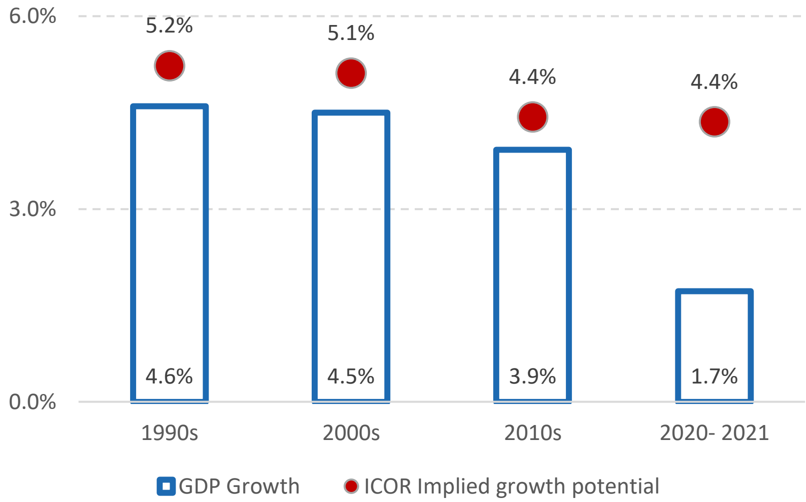
GDP growth rebounded to 3.9% YoY in FY21, but there are question marks on future sustainability

- During the last two decades; surge in GDP growth beyond ICOR (Invested Capital to Output Ratio) implied GDP growth potential have led to substantial weaknesses in external account; requiring painful adjustments and sharp decline in growth.
- With falling investment levels, ICOR implied GDP growth potential has fallen by 70bps from 5.1% in 2000s to 4.4% in 2010s.
- While low cumulative growth during 2020-21 would have allowed some slack, GoPs targeted growth of 4.8% in FY22 would likely be challenging to achieve, especially considering the likely pull back of the existing expansionary stance post resumption of the IMF program.







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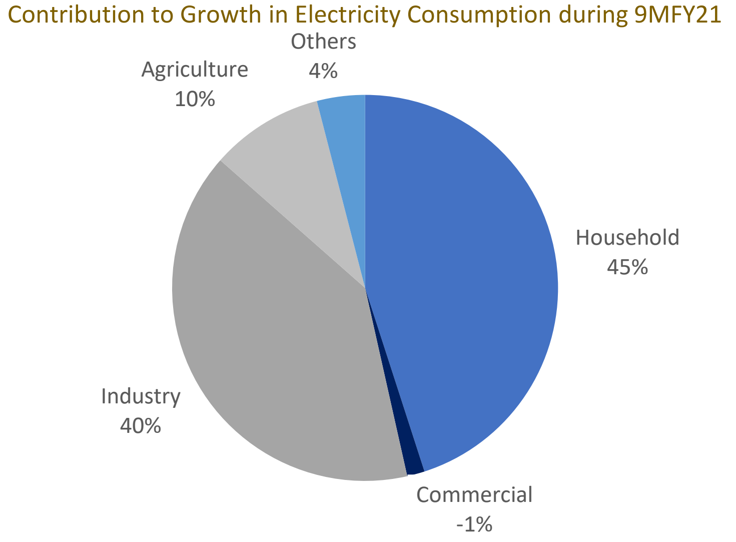
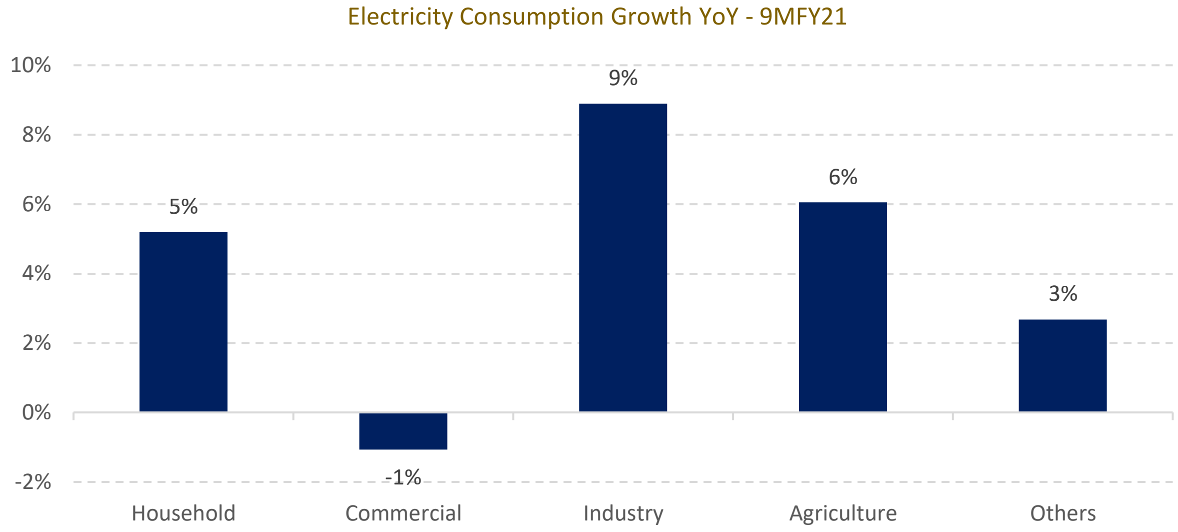
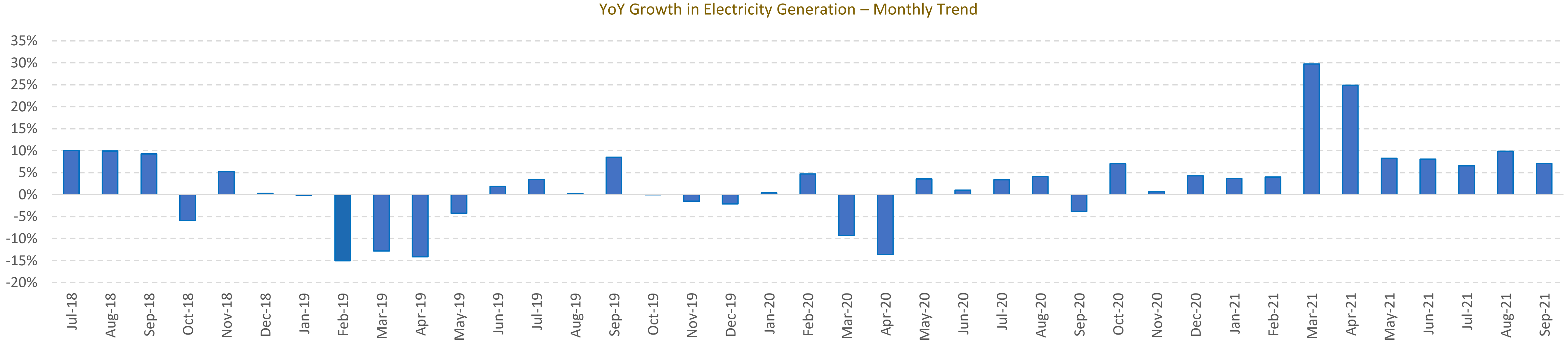




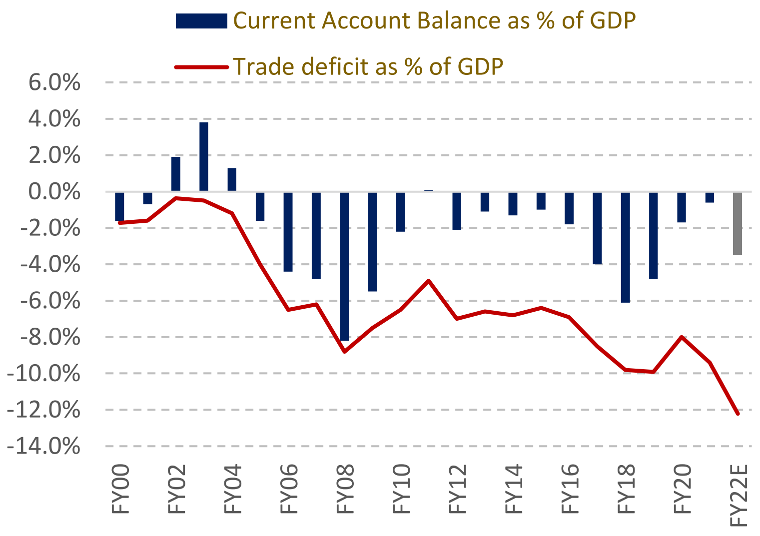


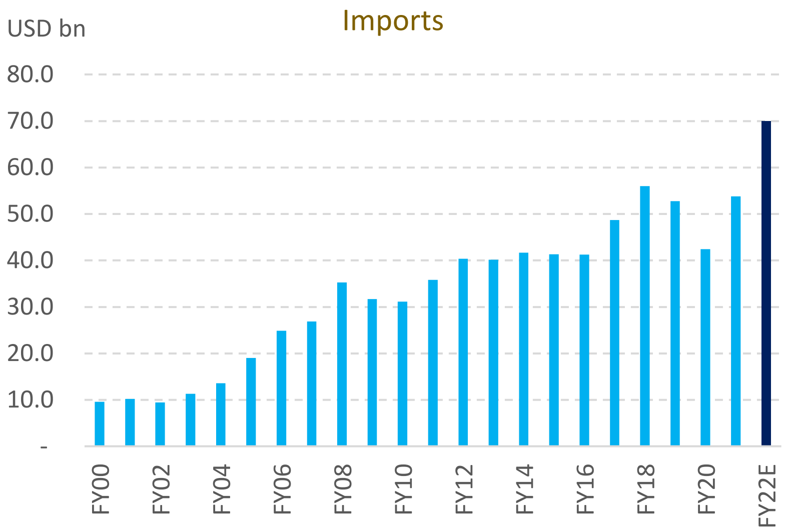
ECONOMY

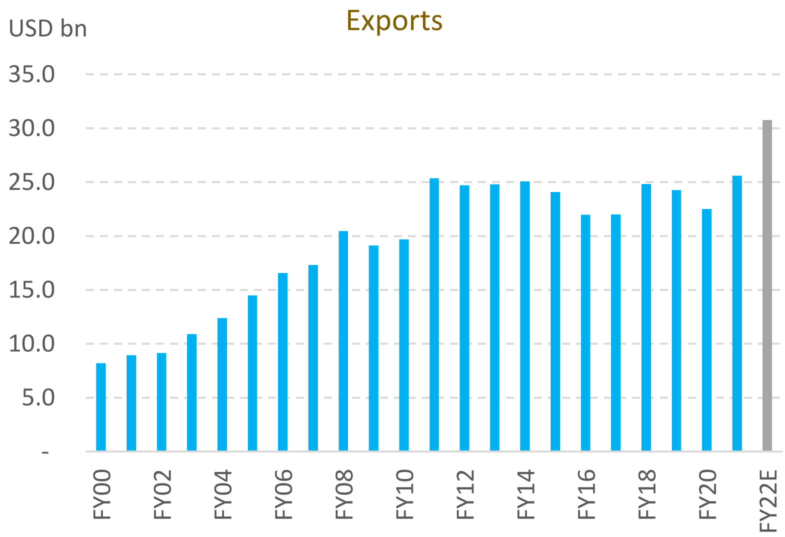
External Sector & Exchange Rate

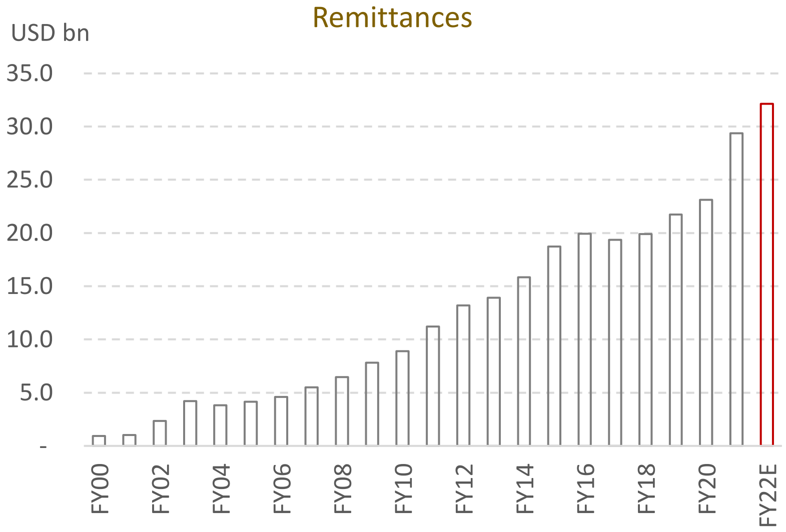
Current Account Deficit will likely rise to 3.5% of GDP or USD 11.2bn in FY22

- Current Account Deficit (CAD) is likely to widen substantially in FY22 due to surge in the trade deficit, as imports growth is outpacing exports growth. We expect CAD to rise to 3.5% of the GDP in FY22 versus 0.6% in FY21.
- Imports rose by 23% (USD 10.2bn) in FY21, driven by recovery in domestic demand post COVID-19 lockdowns and a broad-based surge in global commodity prices. Imports are likely to grow 30% in FY22.
- Exports grew by 14% (USD 3.1bn) in FY21, helped by quicker, post-COVID - lockdowns normalization of business activities. Exports are likely to grow 20% in FY22.
- Remittances grew by 27% in FY21 and will likely continue to sustain last year's levels and help in containing the CAD. Remittance flows are expected to be ~USD 32bn, up 9% YoY.



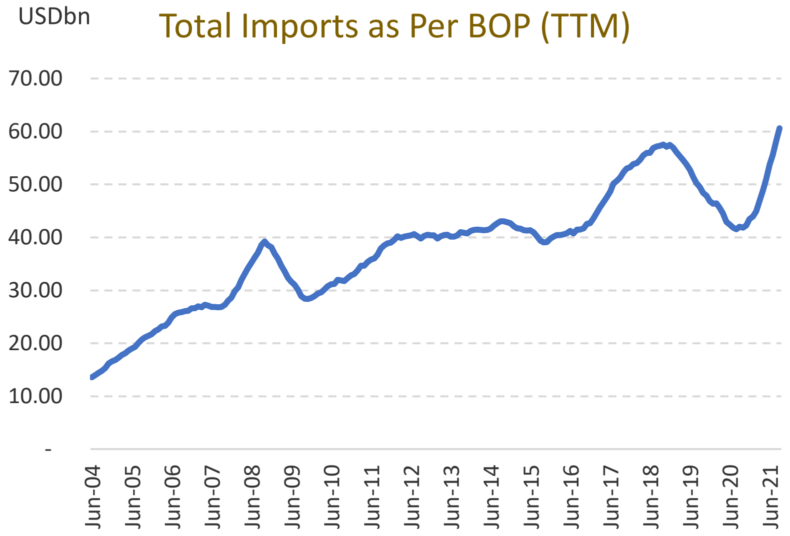


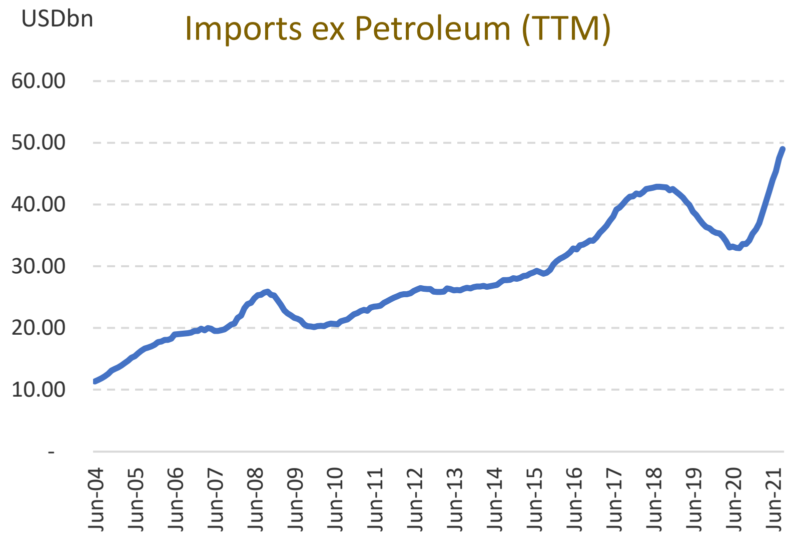


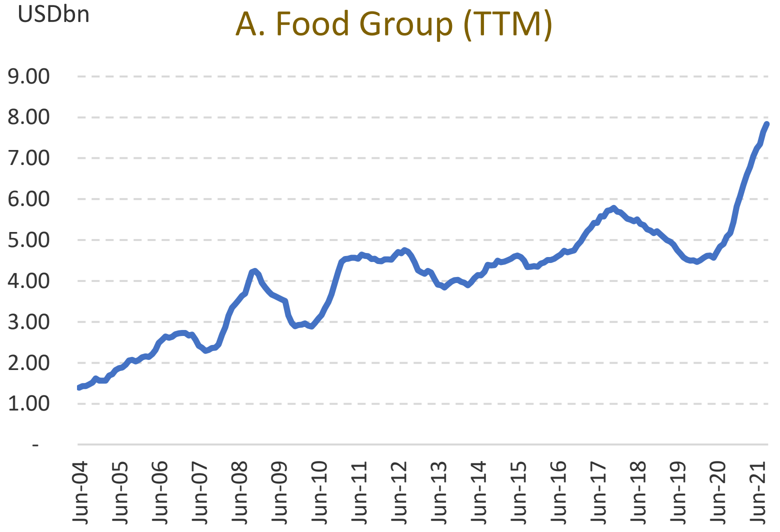


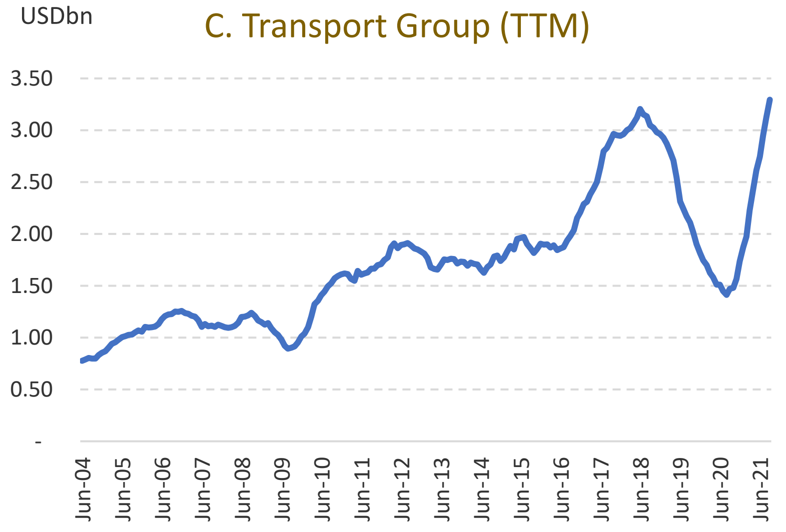
What is behind worsening trade Balance? Rising import demand and international prices

- On a trailing 12-month basis, imports are approaching their recent peak touched in FY18. This is mainly driven by non-petroleum imports, which have exceeded their recent peak.
- Growth in non-petroleum imports is driven mainly by food imports, which have increased sharply as a combined result of high international commodity prices and weak domestic agriculture growth.
- Transport imports are also up substantially; driven by low interest rates and flexible financing schemes by the banks. The central bank, in order to curtail import bill, recently revised auto financing regulations, whose impact is yet to be visible.









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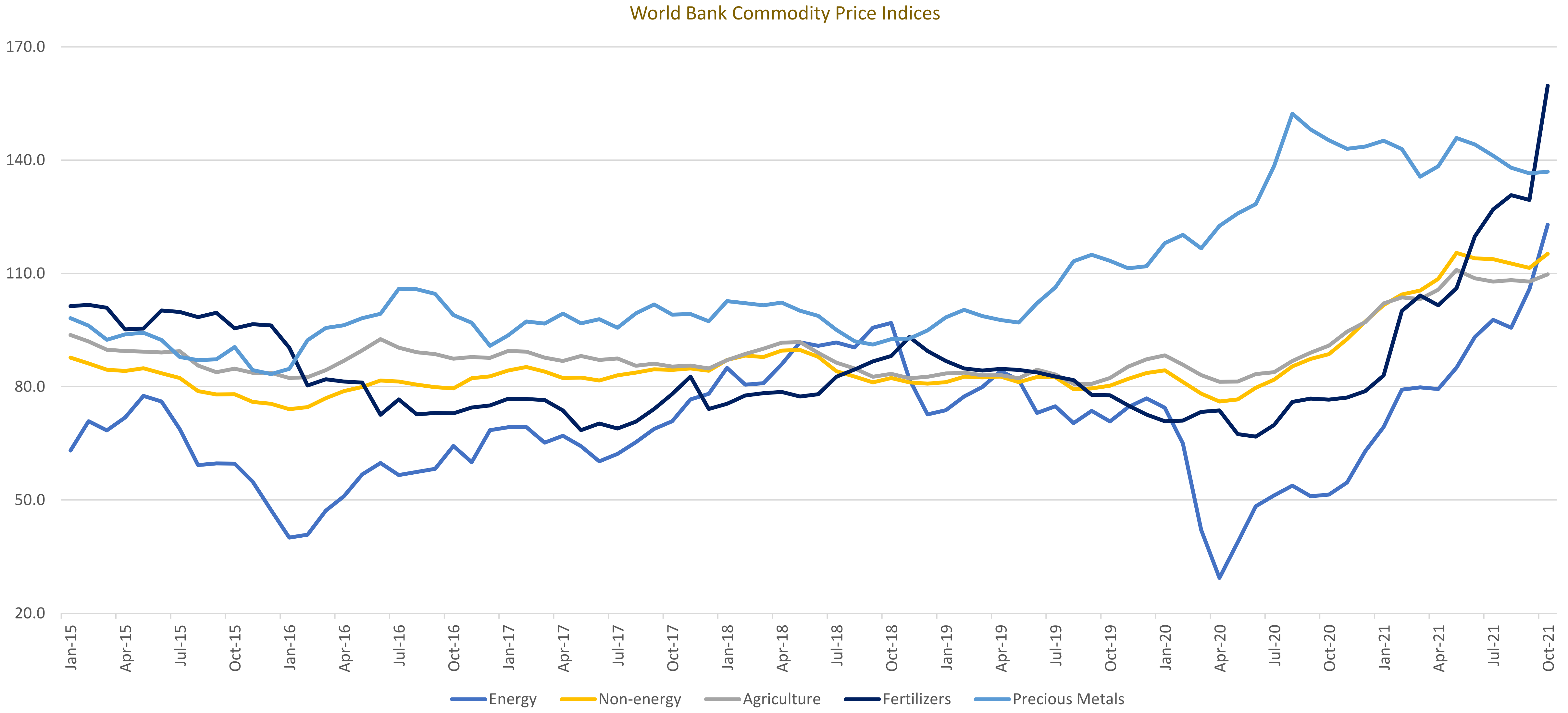
World Bank Commodity Price Indices indicate a sharp uptrend in prices post COVID led 4QFY20 declines



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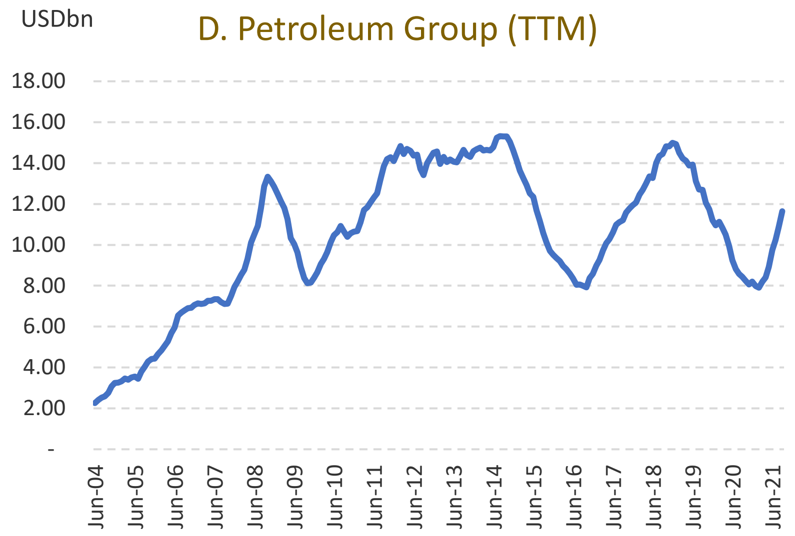
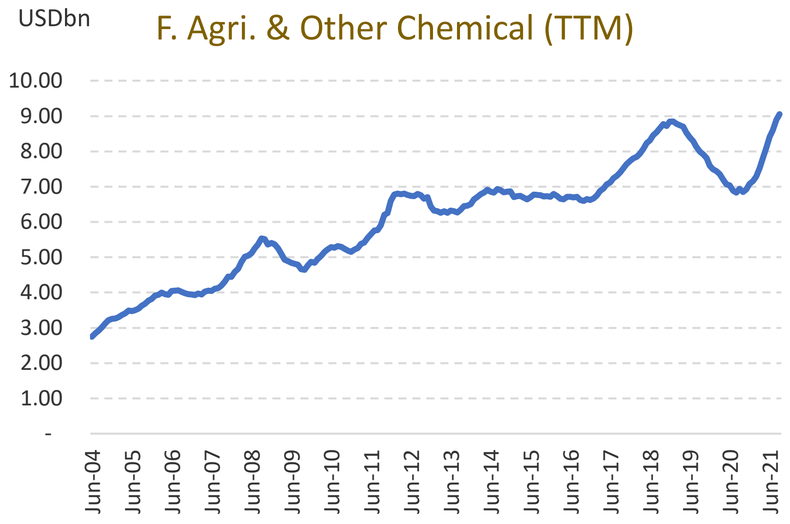
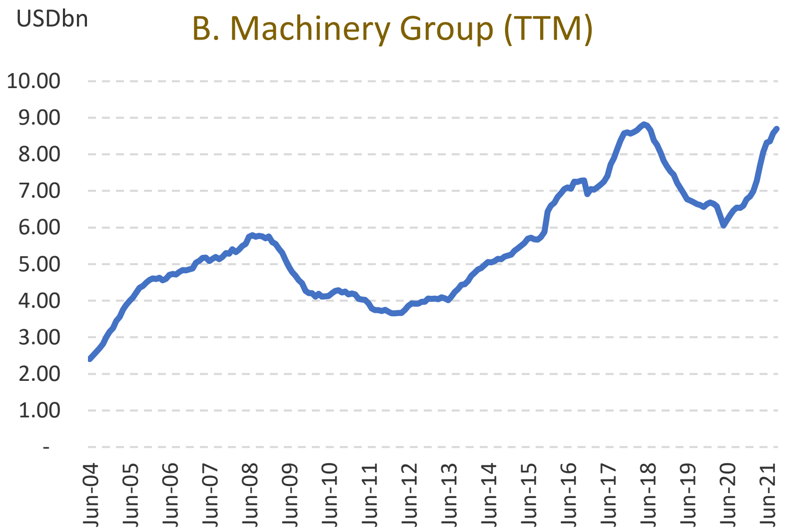
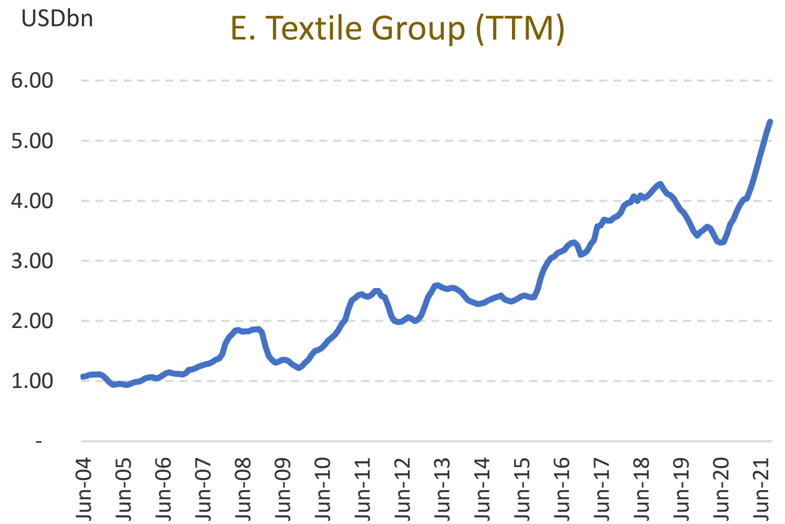
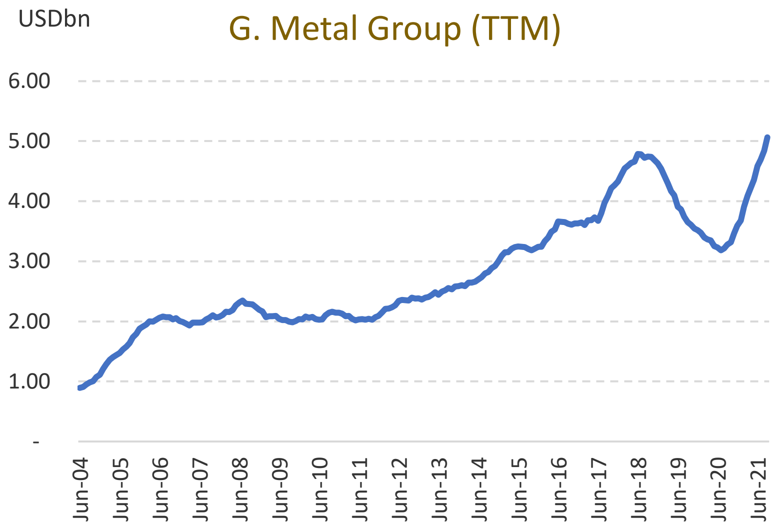
Petroleum imports are still below their recent peak indicating room for further upside

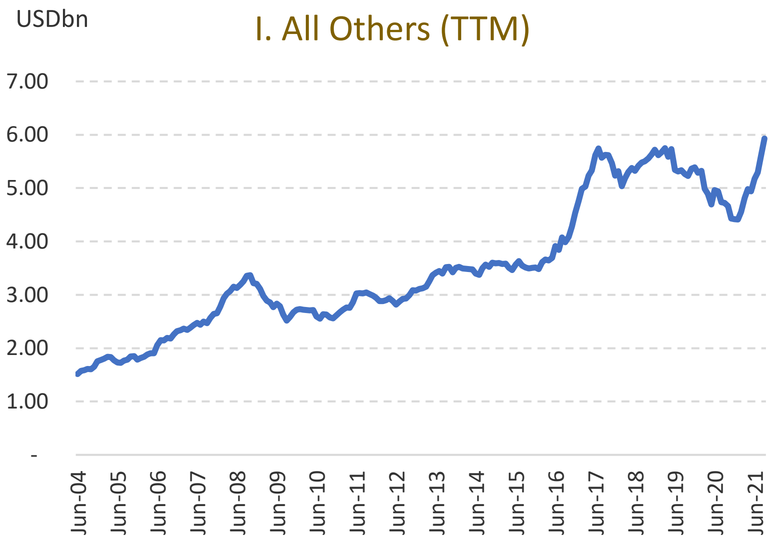












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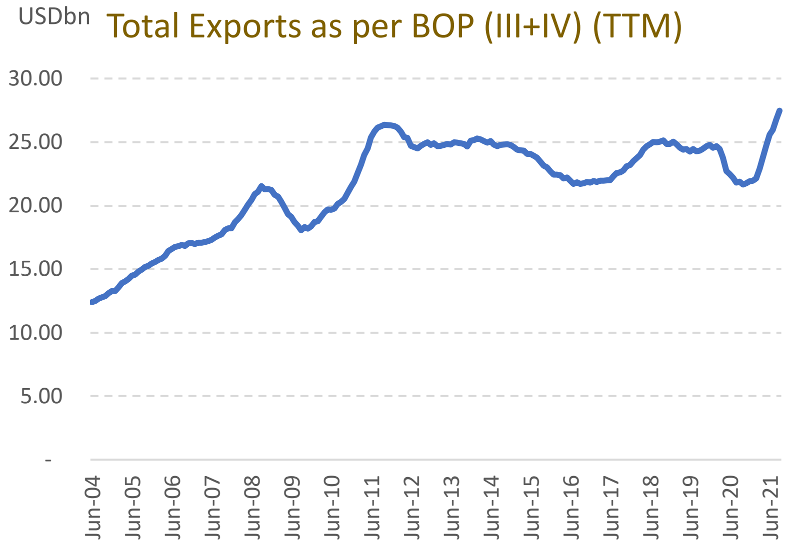
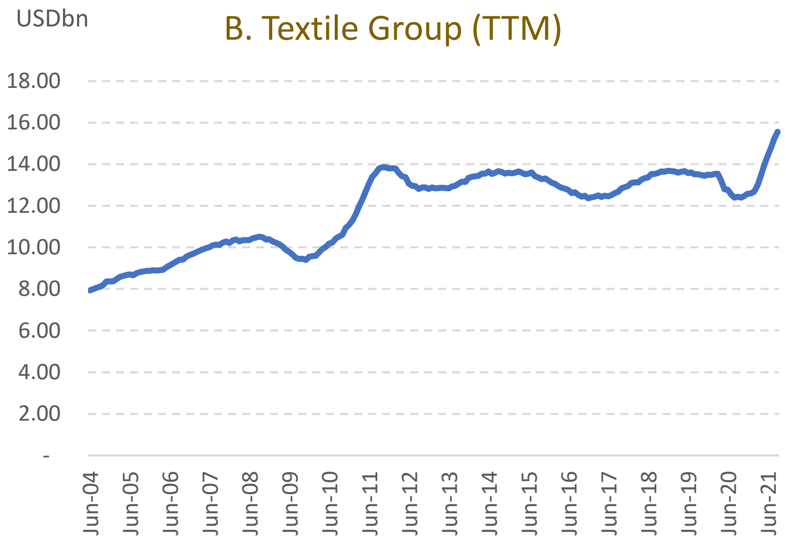
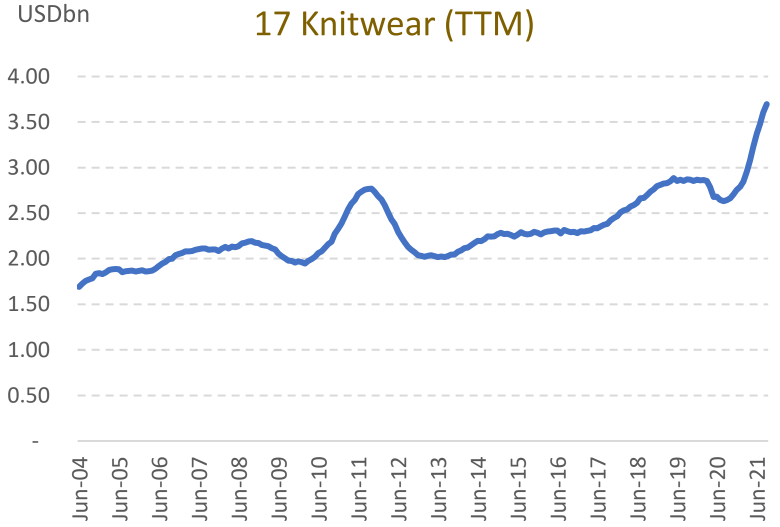
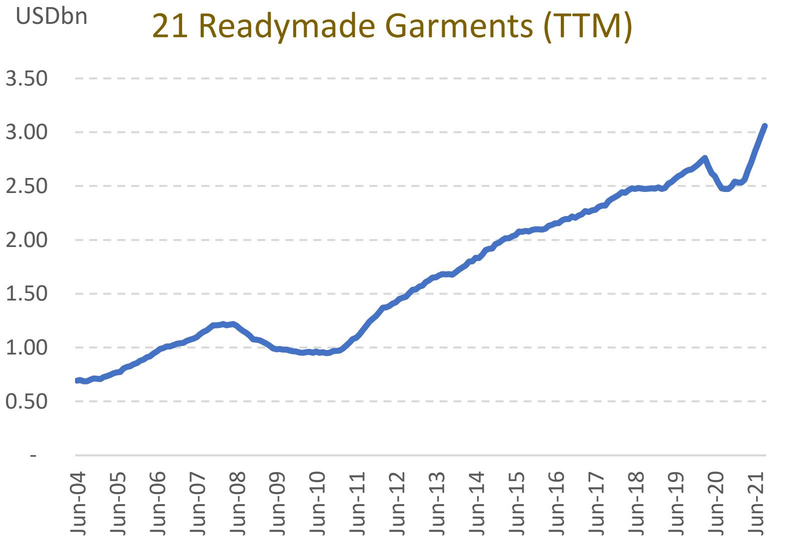
Exports' growth has been led by value added textiles; trend to continue in FY22

- 14% YoY growth in Pakistan's FY21 exports was led by the textile sector, up +13% YoY. Key impetus came from the value-added segment including Knitwear (+26%), Readymade Garments (+9%) and Bed wear (+21%).
- Textile sector exports growth will likely continue in FY22:
  - FY21 growth was partly driven by rerouted orders as regional competitors experienced much stricter lockdowns. However, a weaker PKR, which has made Pakistan more competitive may cause these buyers to stick.
  - Textile sector is operating near its capacity. However, several TERF led expansions are in pipeline. Textile machinery imports rose 45% in FY21 & 155% YoY in 1QFY22.
  - FY22 cotton output was estimated at ~8.5mn bales versus demand of 14-15mn bales. However, cotton arrivals data is promising, with 6.23mn bales arrival by the start of Nov-21 (+81% YoY), which may augment exports.









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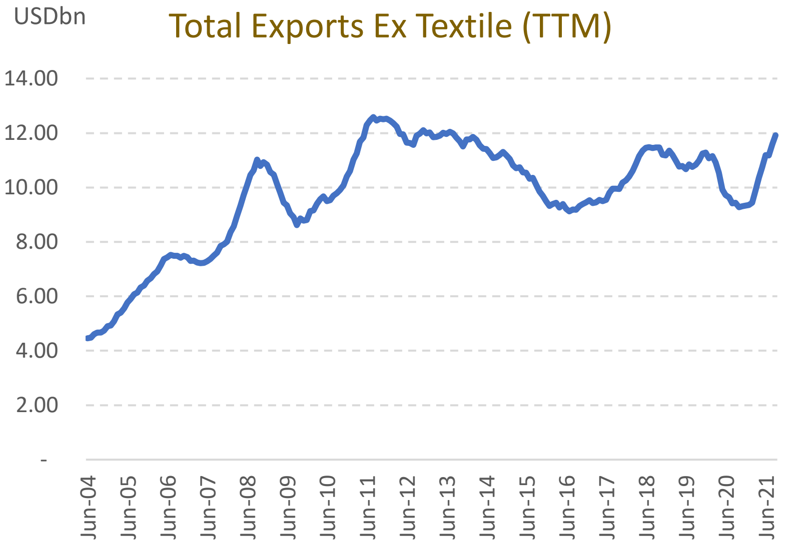
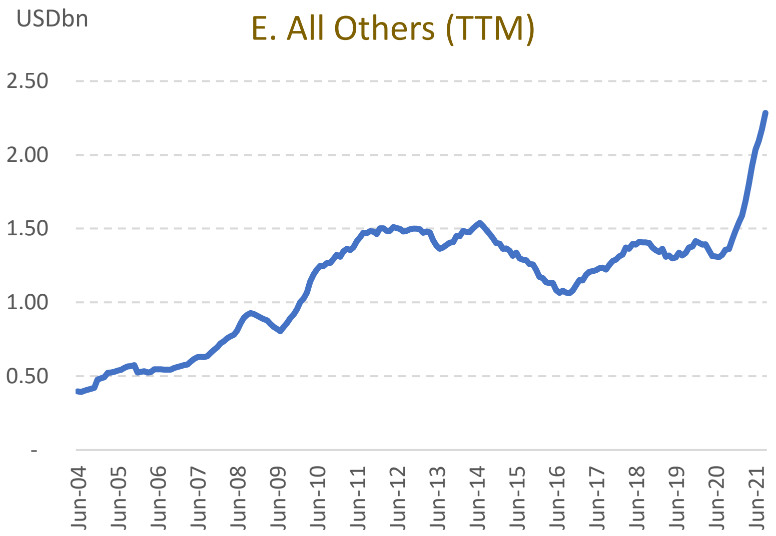
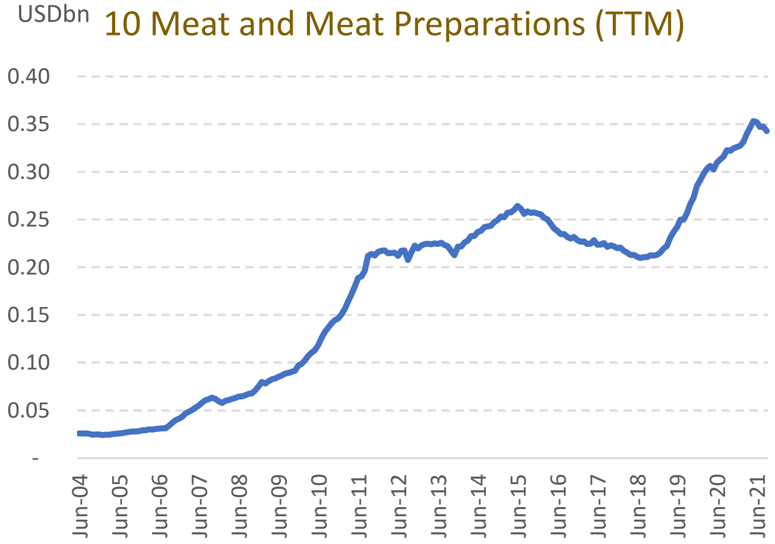
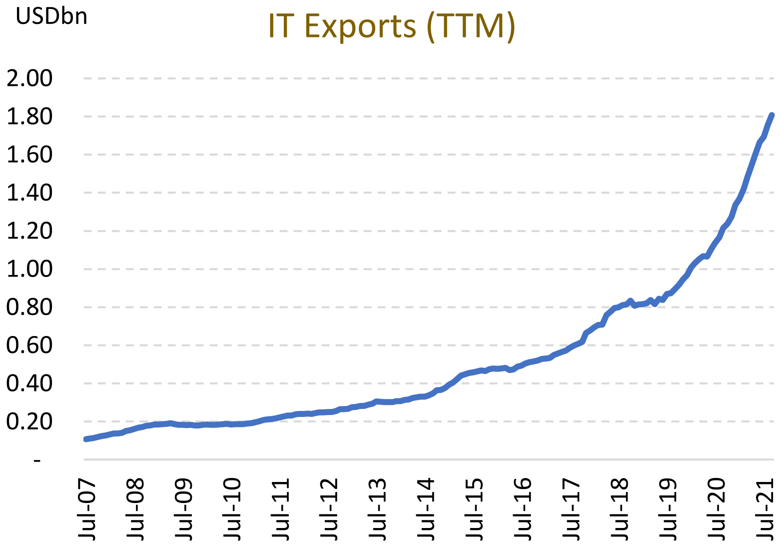
There are more bright spots in the export data

- With 56% share in exports, Textile sector will remain the key driver for exports growth in FY22. However, there are more bright spots within the exports data….
- There has been a sharp growth in the “All Others” segment of exports which is now at its all time high.
- Post PKR devaluation, meat exports have also done well.
- IT exports have also grown substantially of late.
- …However, the existing base of these growing export sectors is so small that the rapid growth is not contributing much in absolute terms to the overall exports / trade numbers.



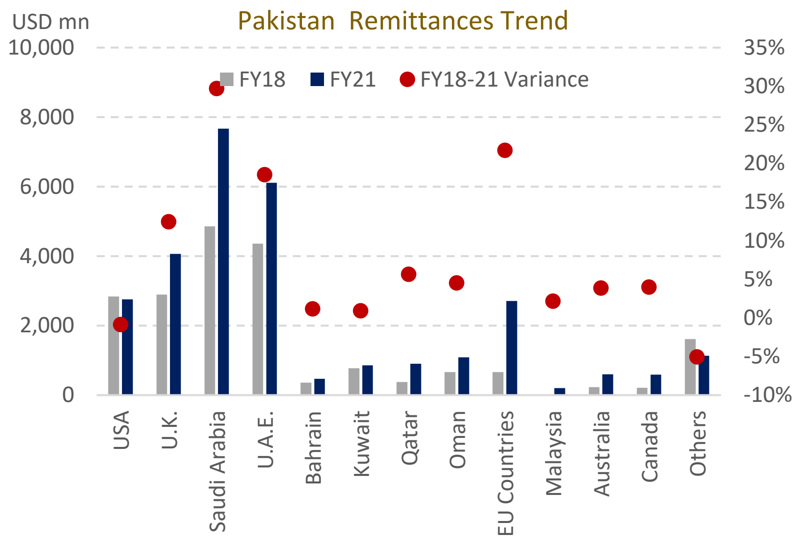


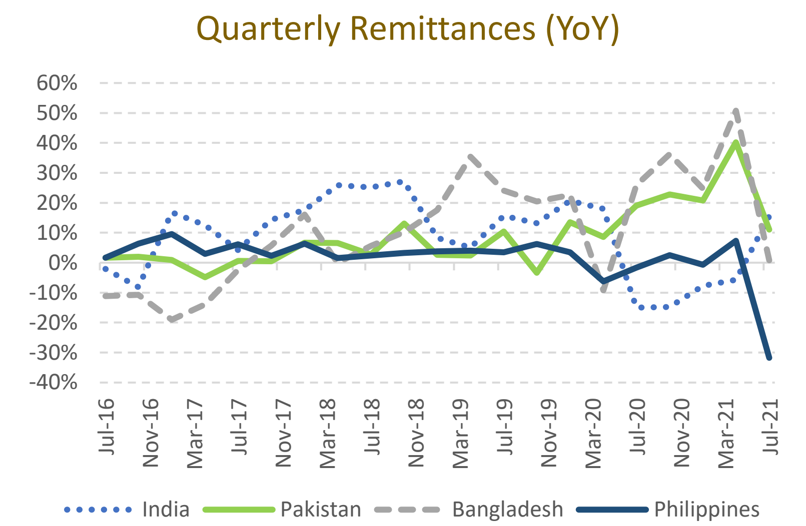


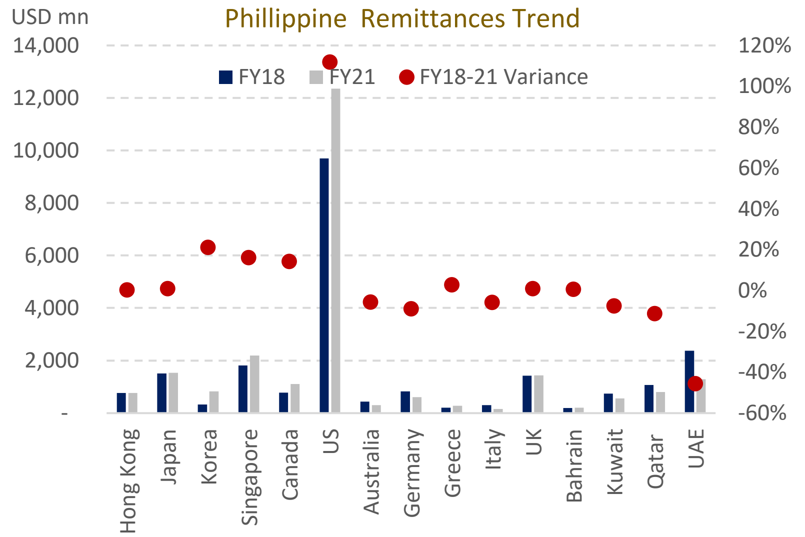


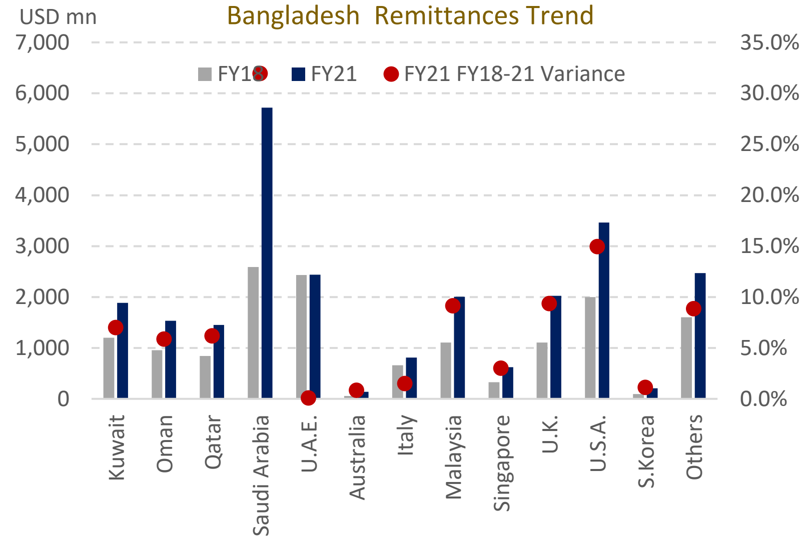
Remittance growth lent support to FY21 CAB; growth to moderate in FY22

- Remittances grew by USD 6.2bn / +27% YoY in FY21 and lent crucial support to FY21 CAB.
- Growth in remittances was a common phenomenon across all remittance receiving regional countries.
- Key driver behind FY21 remittance growth was:
  - COVID-19 related travel restrictions suspended informal remittance transfers which shifted to formal channels.
  - Expats enhanced remittance quantum to offset COVID related unemployment in Pakistan and absence of spending needs for leisure or religious family visitors / travel.
- Considering high base effect coupled with partial travel normalization post vaccinations, we expect remittance growth to slowdown to 9%.



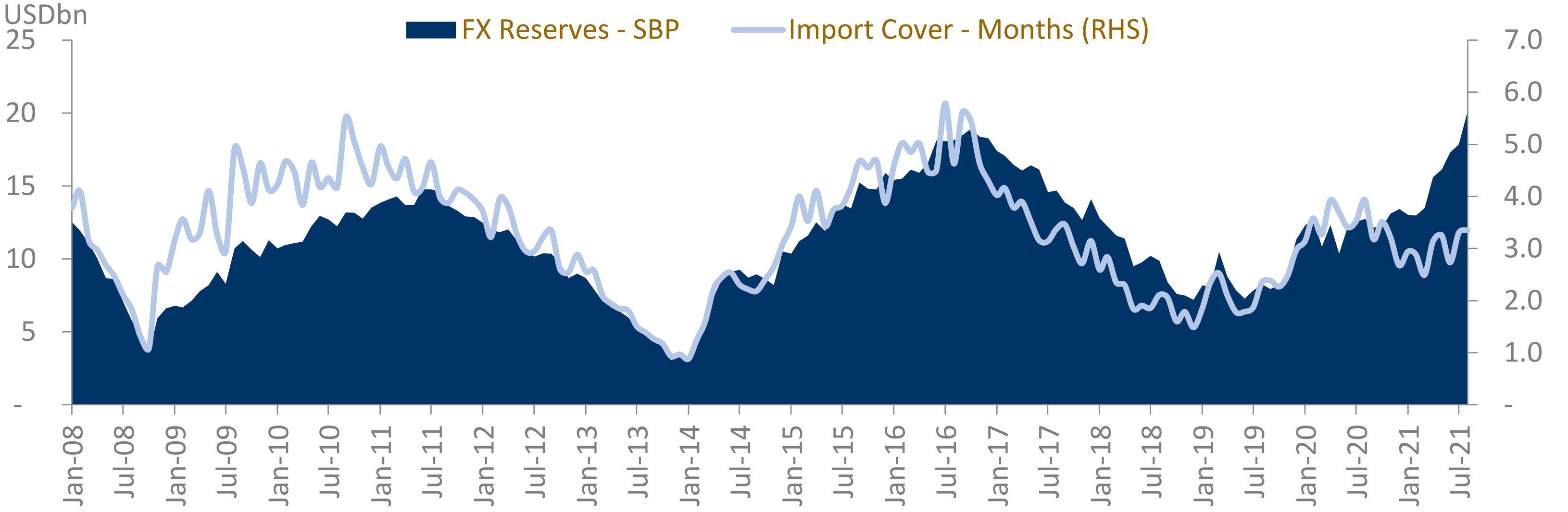


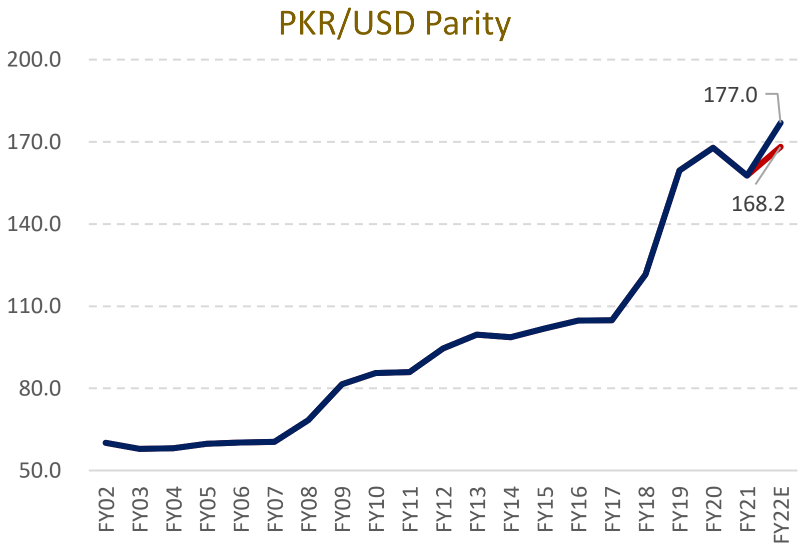


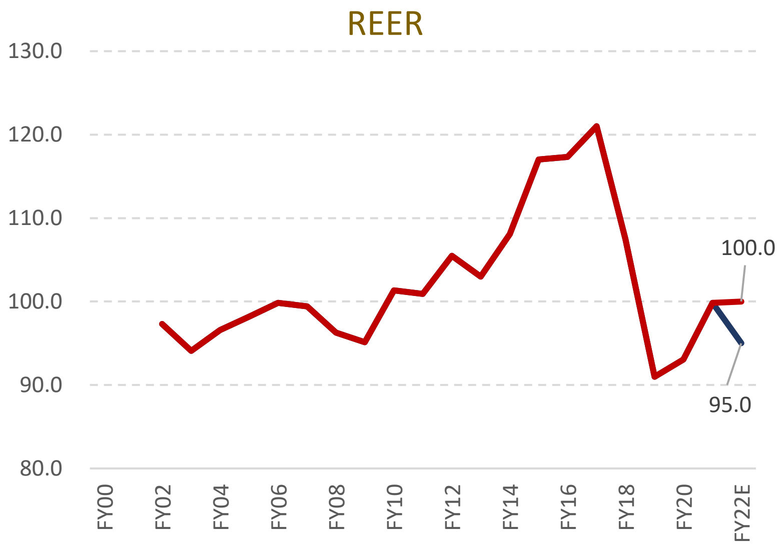


Reserves buffer is building gradually; flexible exchange rate will also help

- As of October 29, 2021, Pakistan's FX reserves stood at USD 24bn; with SBP's reserves at USD 17bn equal to ~3 months of imports.
- However, the recent rise in CAD has put pressure on PKR which has depreciated by 8% FY22 to date. For FY22, we estimate PKR/USD to depreciate by 7%-13% on closing basis and expect it to move in the range of 168.2-177.0 assuming a REER of 100-95.
- For the SBP to continue to build reserve buffer, the current BoP situation needs to be managed urgently. This would require a sub 100 REER.
- With the small quantum of FDI, CAD will have to be funded through external borrowing which will further push up Foreign Debt.

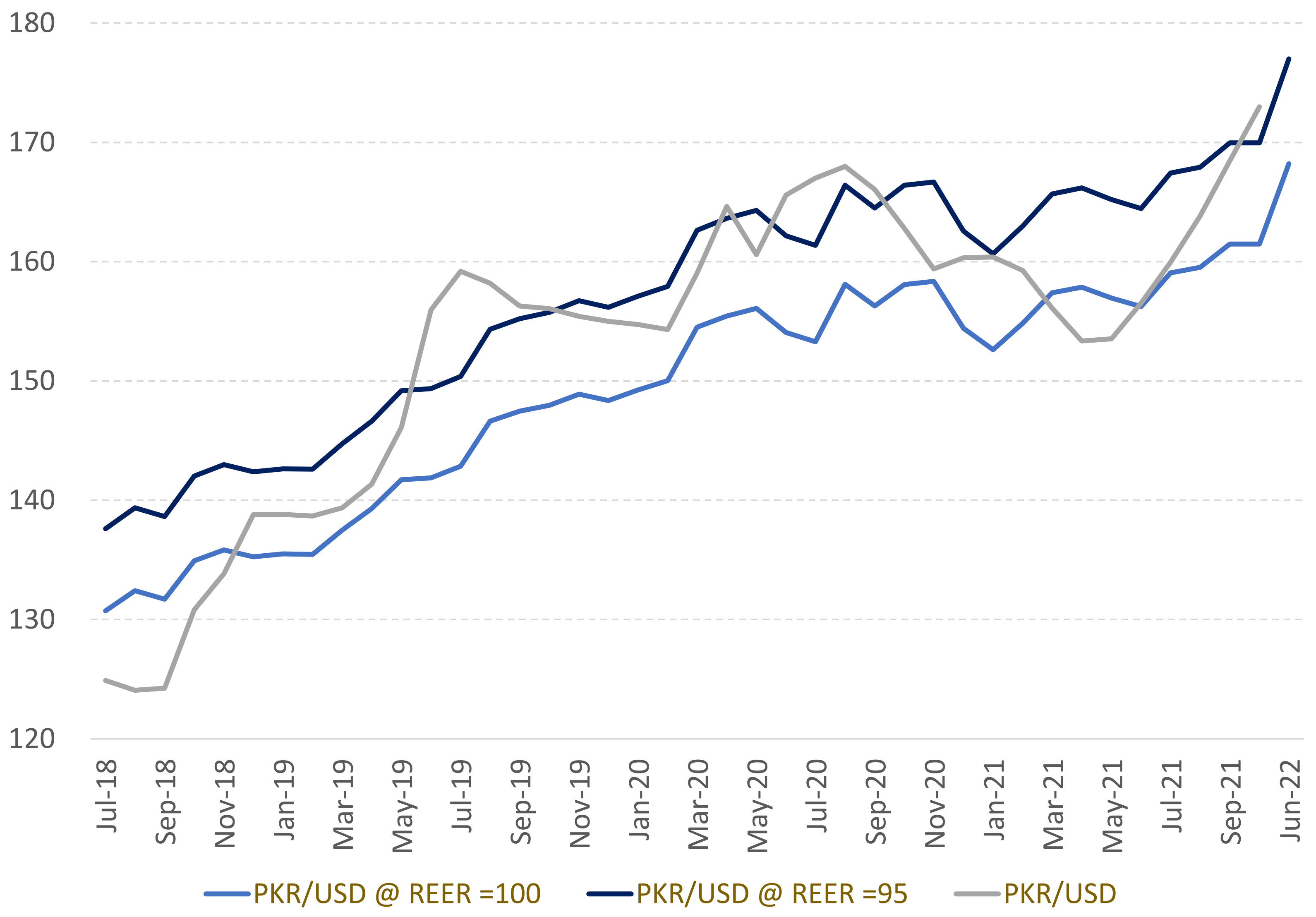






Time to go long PKR, Sell USD

- Since Jun-18, PKR/USD has traded in a narrow band, with the upper limit defined by REER of 95 and the lower limit defined by REER of 100. Breakouts from this band have proved to be short lived.
- At yesterday's rates (PKR/USD @172.9) exchange rate has breached the upper limit defined by REER of 95. This weakness is driven by recent rise in current account deficit and uncertainties surrounding the IMF program and the pace and subsequent impact of IMF mandated adjustments. They are likely to be addressed soon.
- We expect exchange rate to approach PKR/USD of 170 in the short term and expect FY22 trading range to be in the band of 168-177



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Inflation & Interest Rate

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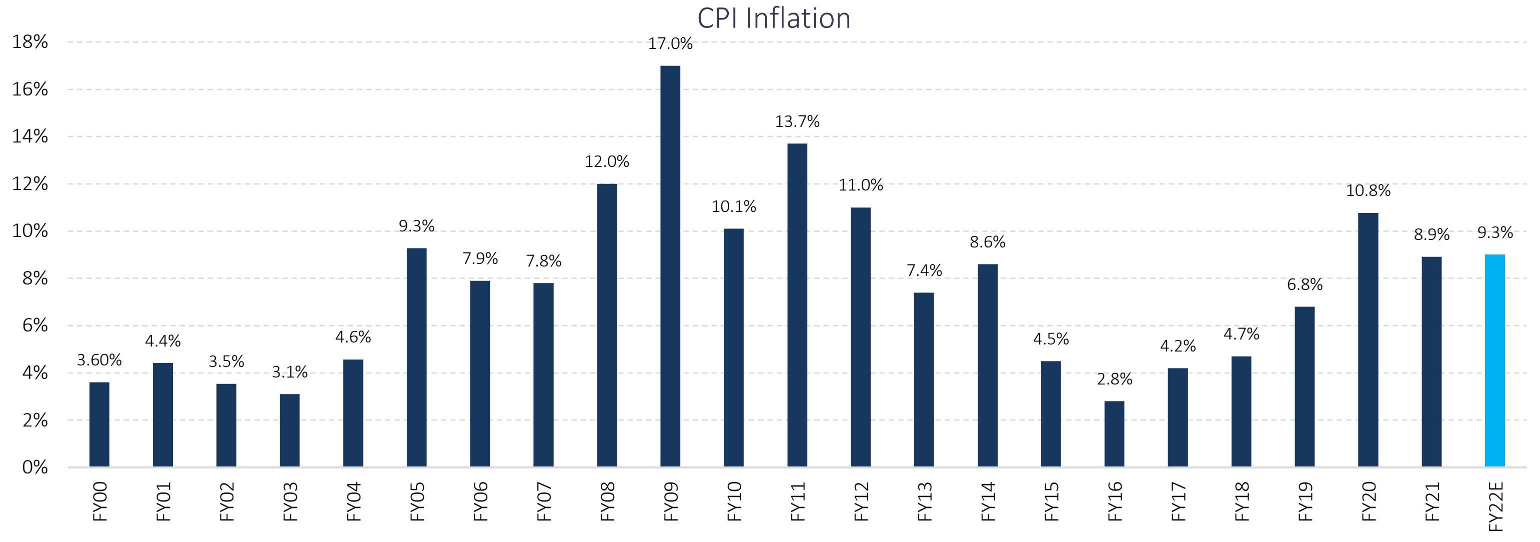
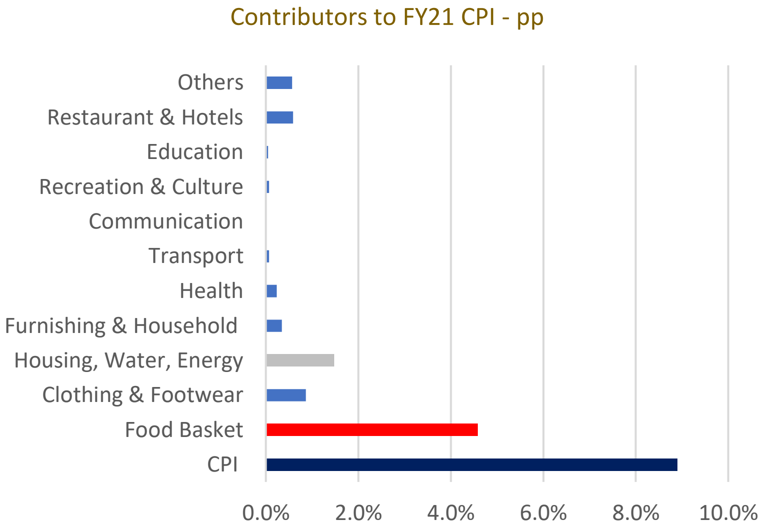
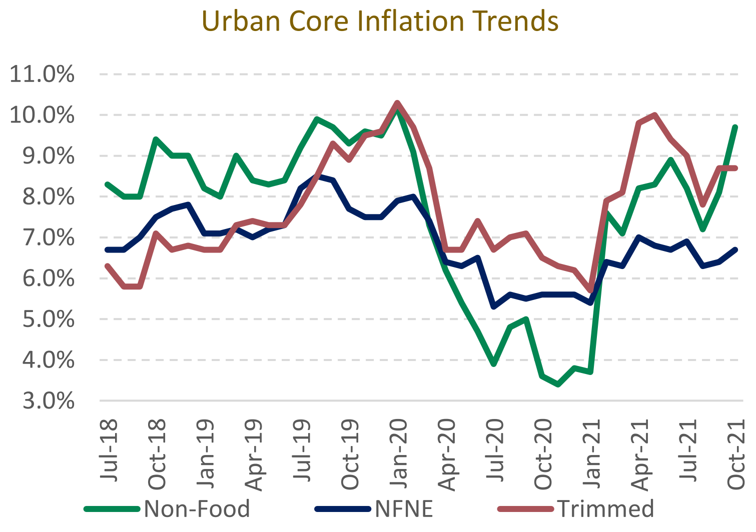
Inflationary pressures to persist amidst pandemic led demand-supply gap

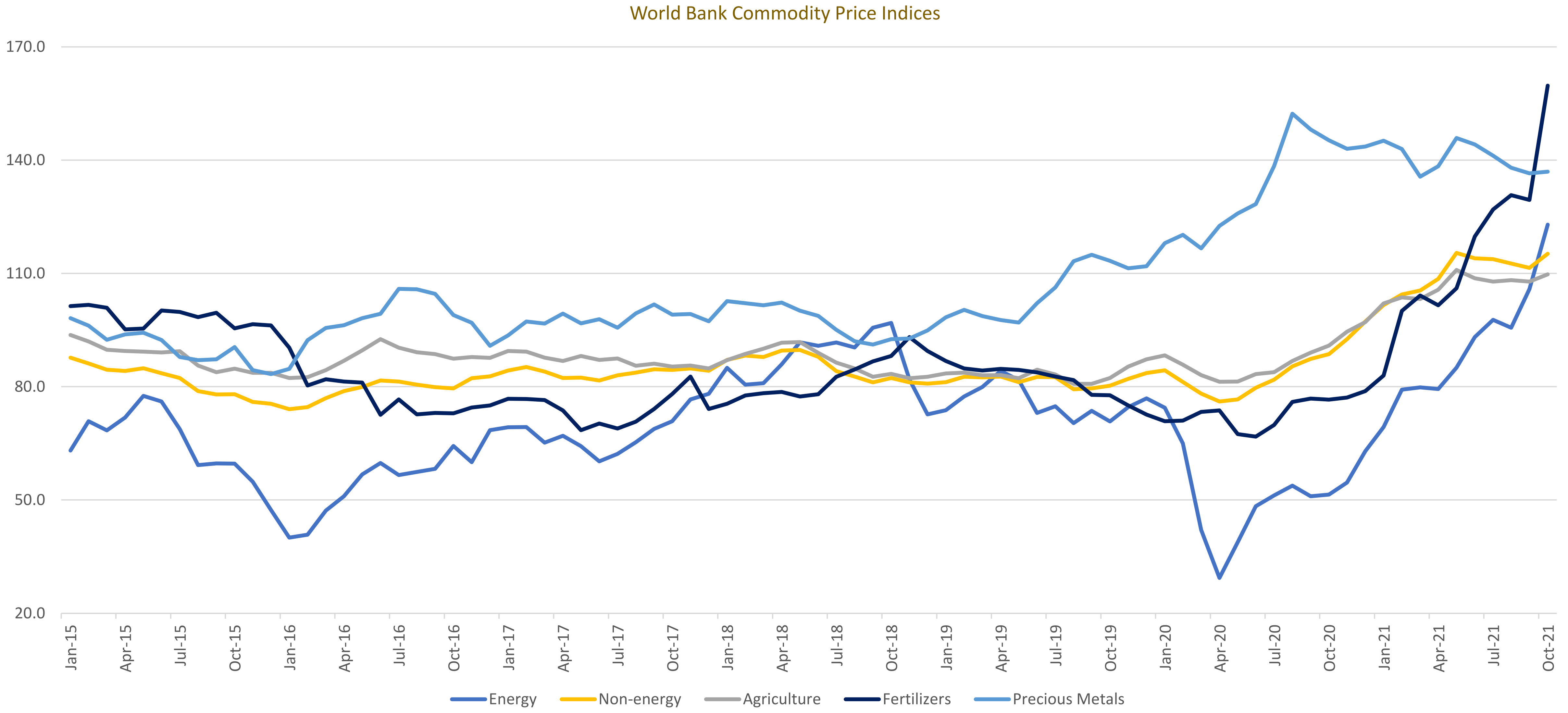
- The headline CPI inflation averaged 8.9% in FY21 versus 10.74% in FY20. Significant drop in oil prices and high base effect helped in containing inflation during FY21. Jun-21 CPI (index) was up 9.6% from its Jun-20 level.
- Food inflation contributed 4.6pp (52%) and housing & energy contributed 1.5pp (17%) to the FY21 headline CPI inflation of 8.9%.
- Core inflation remained relatively more contained as Urban NFNE averaged 6.0% in FY21 (FY20: 7.5%) and Urban Trimmed Core inflation averaged 7.6% in FY21 (FY20: 8.6%).
- We expect FY22 CPI inflation to average 9.3%, surpassing the SBP's targeted range of 7-9% (GoP forecast of 8.2%).
- There are substantial upside risks from
  - Global commodity price surge, especially food.
  - Domestic demand revival
  - Weakness in PKR







World Bank Commodity Price Indices indicate a sharp uptrend in prices post COVID led 4QFY20 declines



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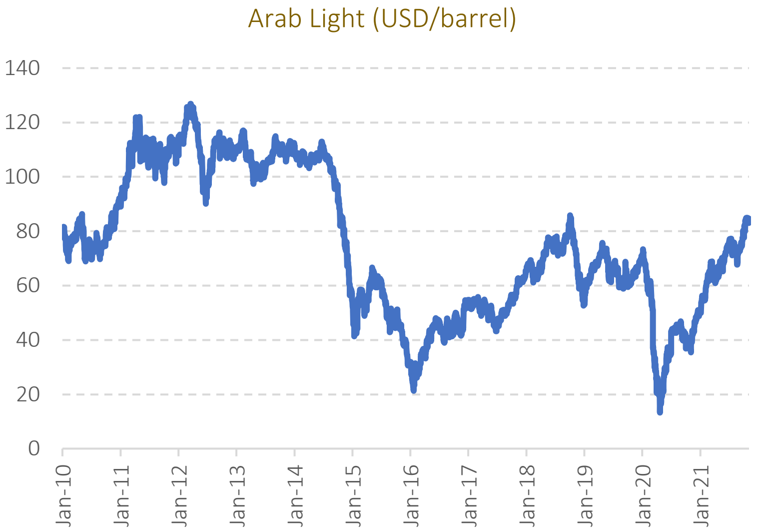
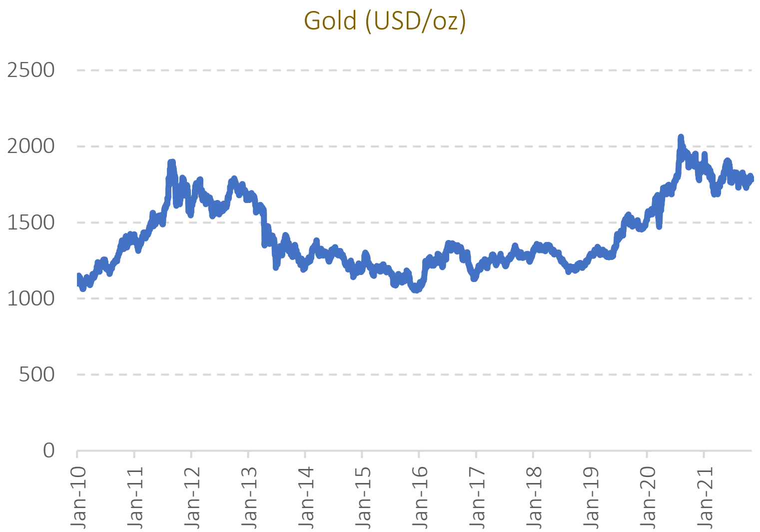
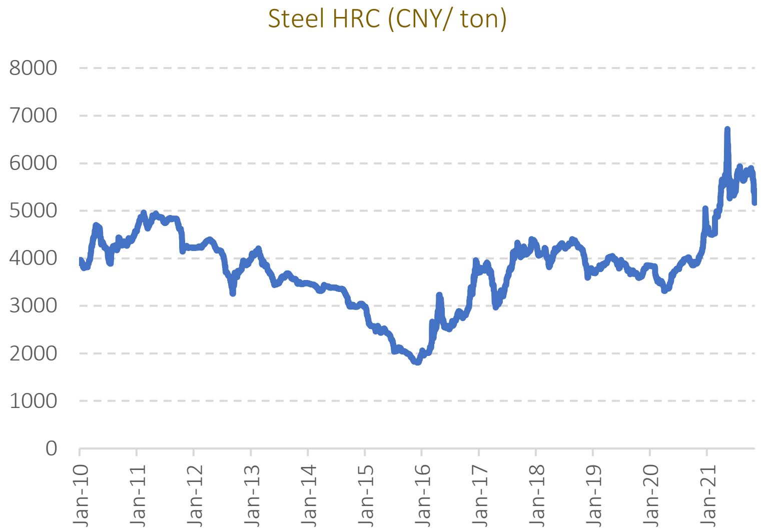
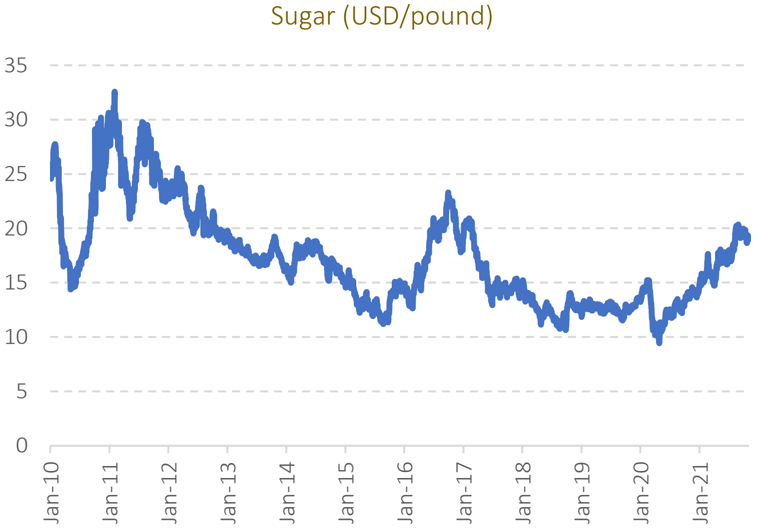
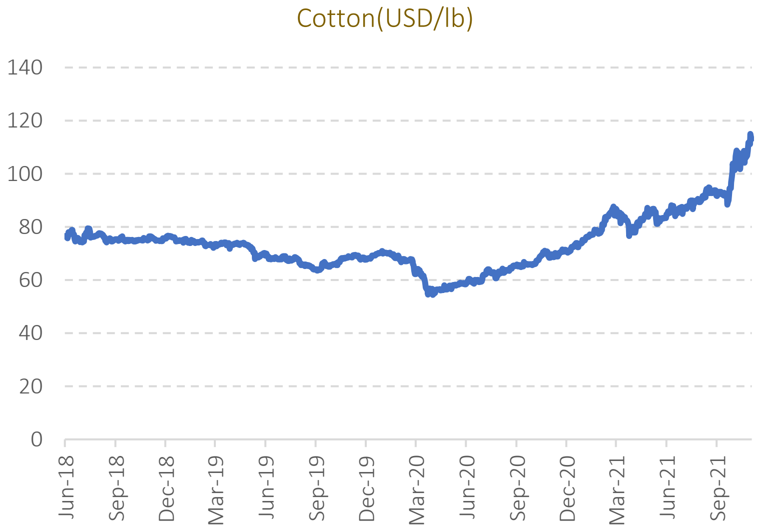
Commodities prices up due to supply disruptions amidst pandemic spread

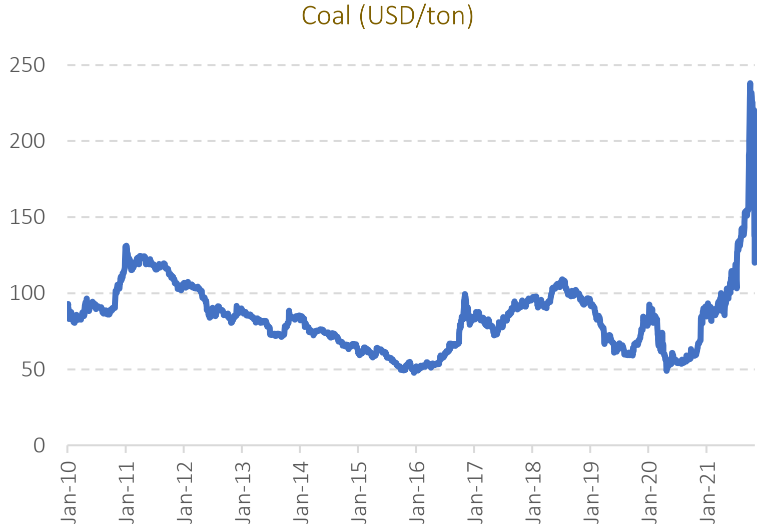












International freight costs have become highly volatile since the onset of COVID -19; we expect the freight costs to remain high in near term

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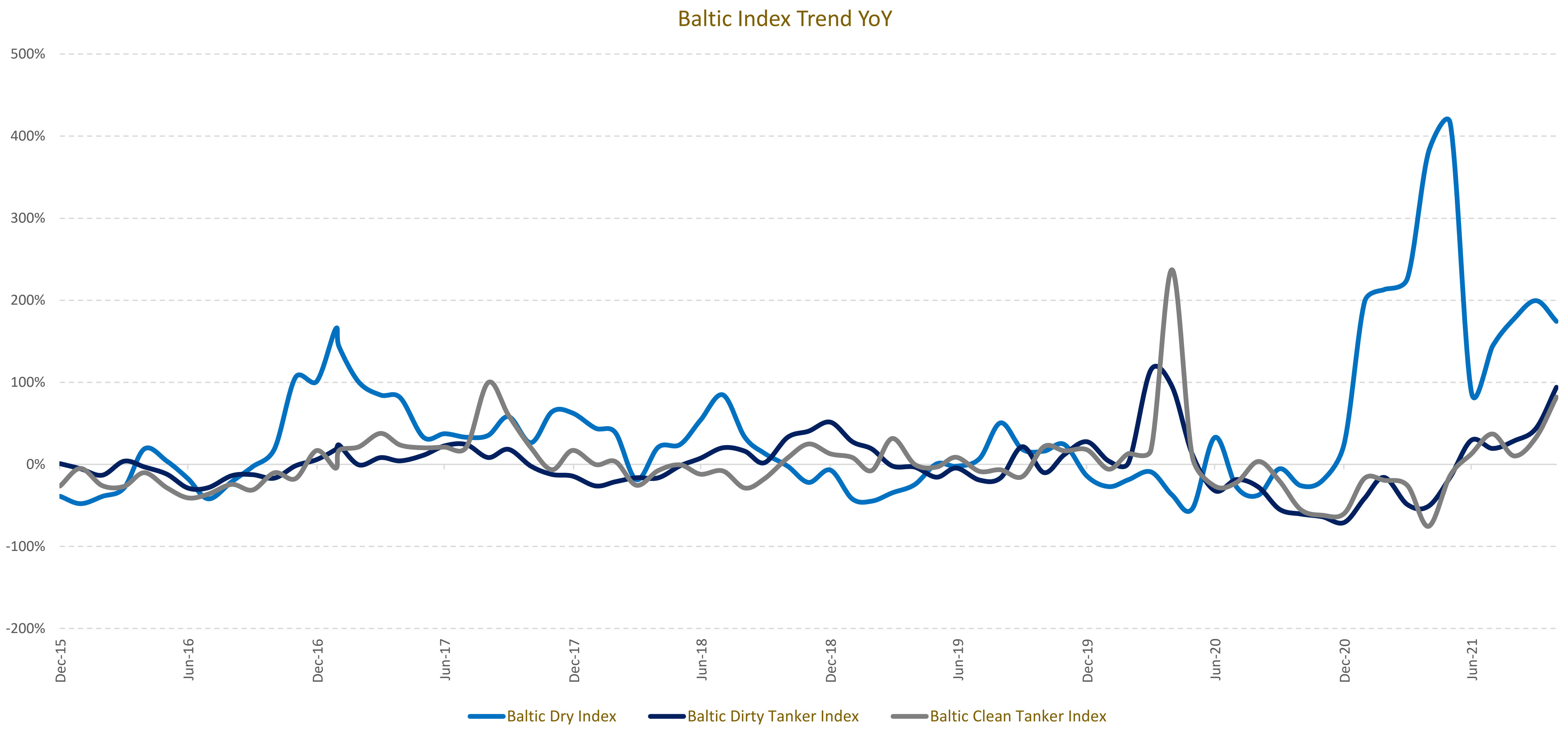
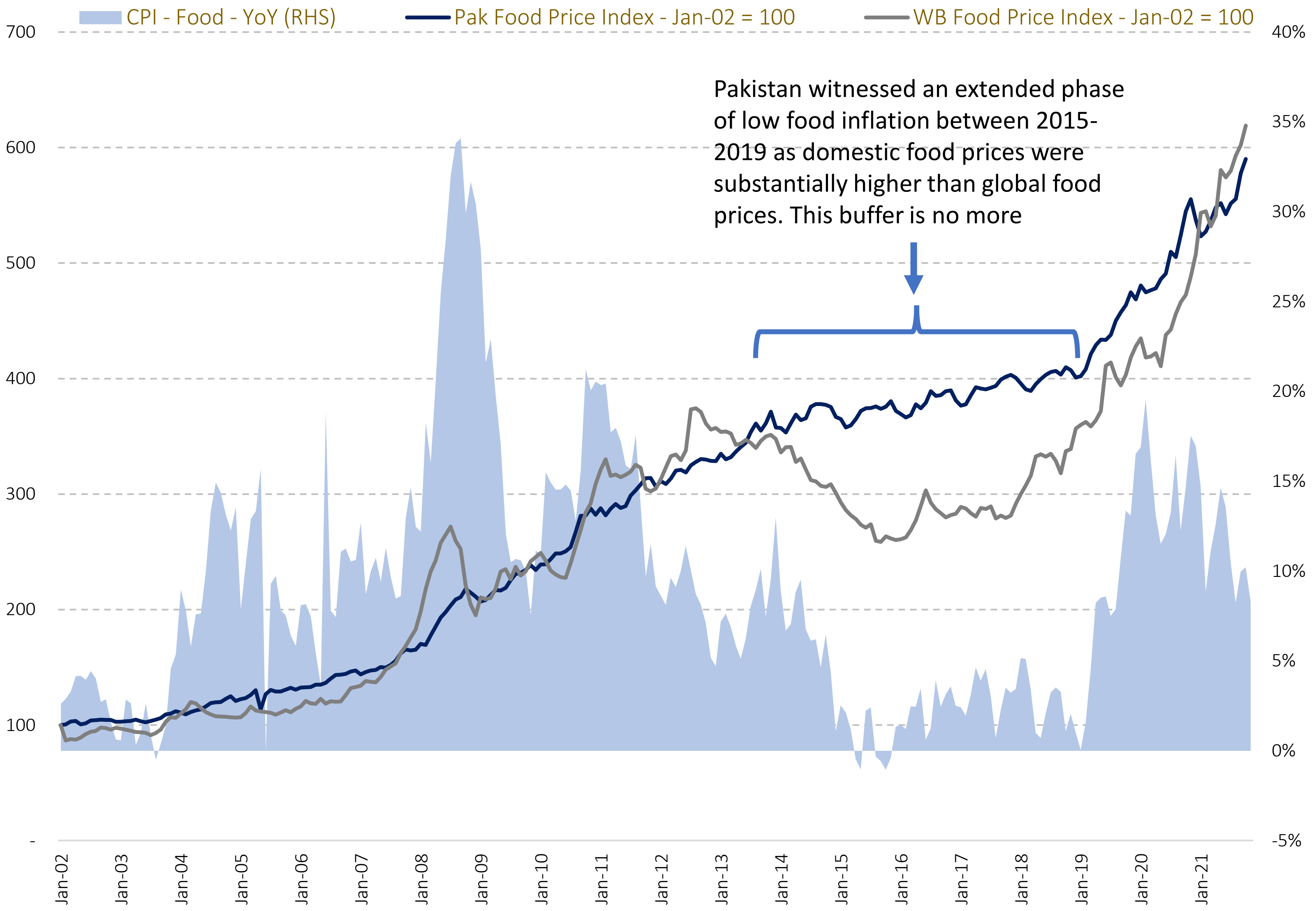


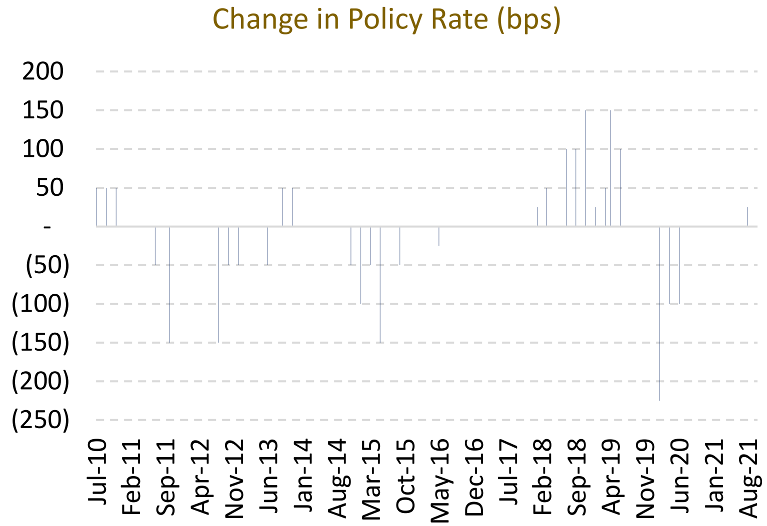
World food prices at a multi-year high. Domestic food inflation to follow the suit

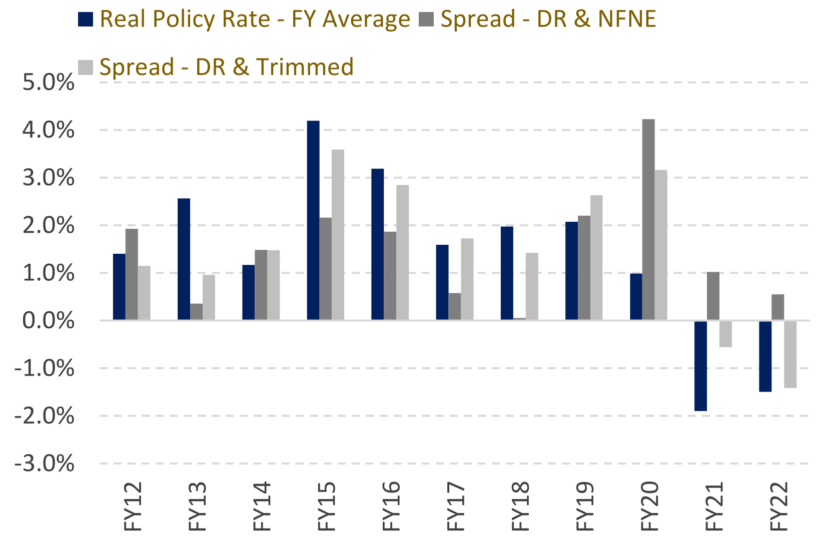
- With convergence of Pakistan and World Food Price Indices, local food prices have become more sensitive to the international price movement as well as PKR devaluation. This sensitivity will become more pronounced if domestic supply shortages require food imports.
- World Bank's Food Price Index is currently hovering near its peak (+31% YoY) driven by:
  - Rise in trade activity on the back of strong demand as economies open post vaccination.
  - Supply constraints due to logistics issue.
- PKR has depreciated by 12% from its peak in May-21 and 8% FY22TD.
- International food prices are likely to remain elevated, which, coupled with recent round of PKR deval can spiral up the domestic food inflation. Food basket has the highest weight of 35% in the CPI.

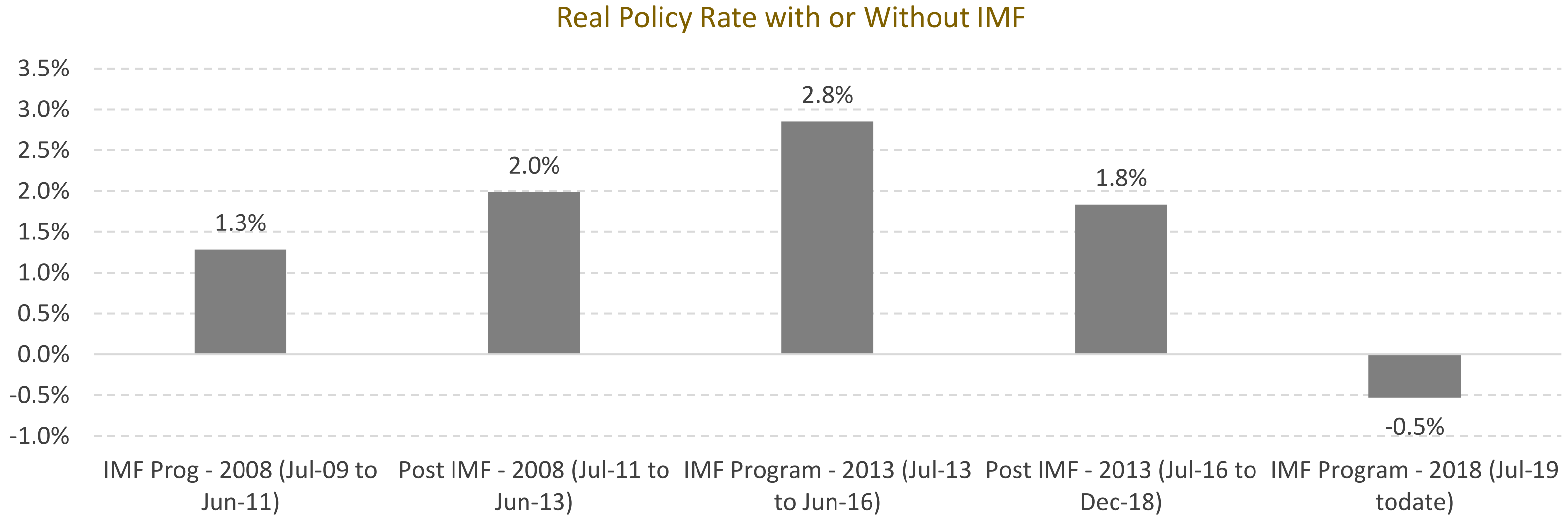


Policy rate hikes likely to continue until SBP achieves mildly positive interest rates

- The era of accommodative monetary policy to stimulate growth during the pandemic has ended as the SBP hiked policy rate by 25 bps to 7.25% in Sept-21.
- Strong economic growth, rising domestic demand and resultantly burgeoning CAD led to the reversal of monetary policy stance, and indicates that price stability and medium-term preservation of revived growth momentum is now going to be the central banks key focus, as opposed demand stimulation.
- We expect the central bank to continue raising policy rate until mildly positive interest rates are achieved,
- With our expected CPI inflation likely crossing the SBP's expected range, we expect the central bank to undertake cumulative hikes of 225 bps in the next 12 months, taking policy rate to 8.5% by May-22 and 9.5% by Nov-22. IMF may require a more aggressive rate hike.







ECONOMY

Fiscal Sector

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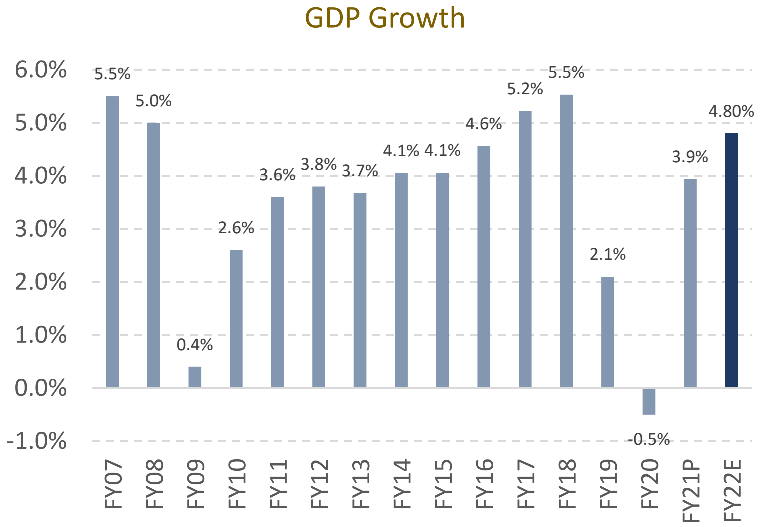
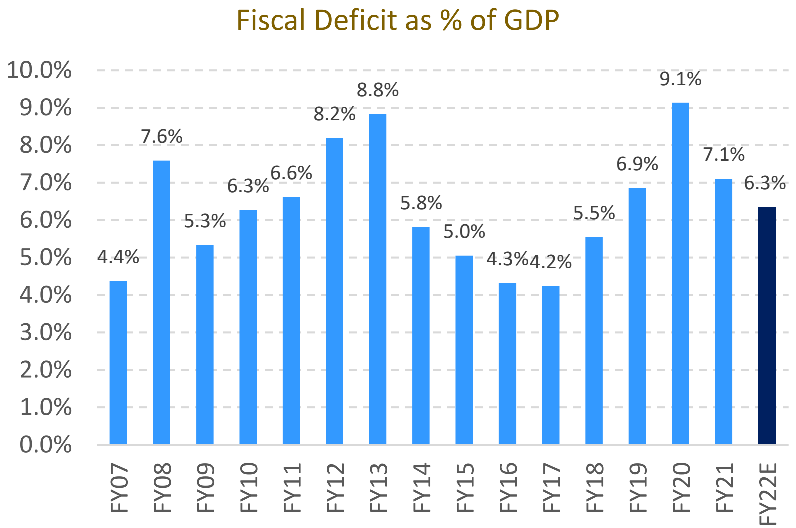
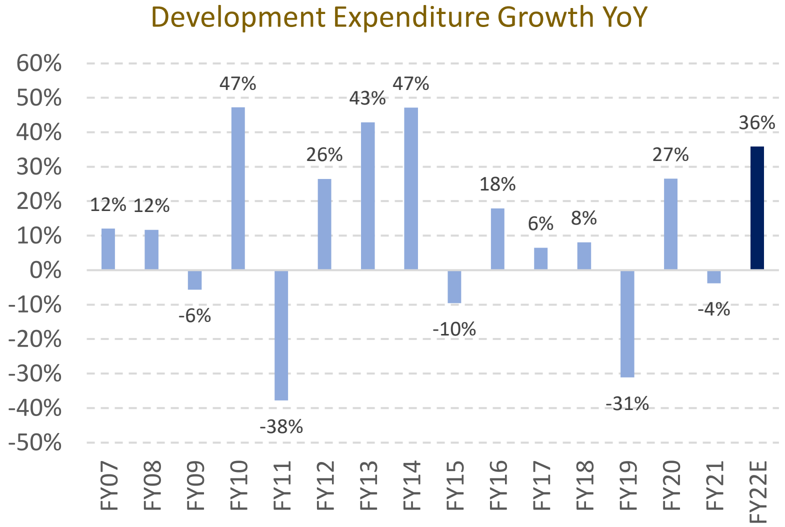
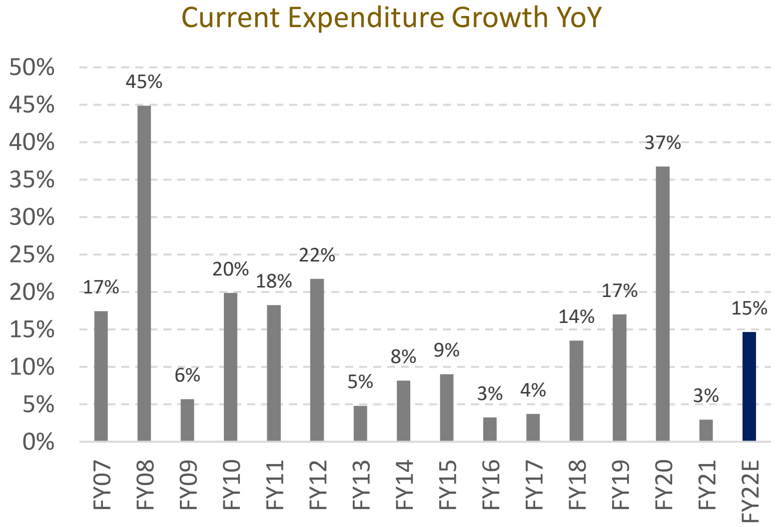
Fiscal policy is expansionary; needs to be reigned in

- Pakistan witnessed a strong post lockdown economic recovery and achieved GDP growth of 3.9% YoY in FY21 versus a contraction of 0.5% in FY20.
- GoP has envisaged an expansionary FY22 budget with net federal development spending target of PKR 900bn (+36%) YoY and subsidies worth PKR 682bn (+59% YoY) in FY22.
- ~44% of budgeted PSDP has already been released in first two months of FY22, and if the momentum continues, it will fuel the inflation.
- However, in the past PSDP allocation has been revised downwards as part efforts to contain the fiscal deficit as and when revenues fall short of target.









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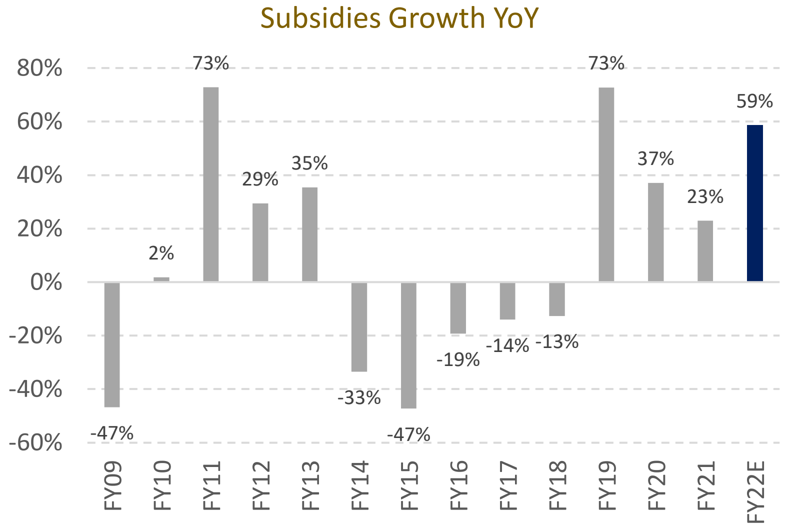
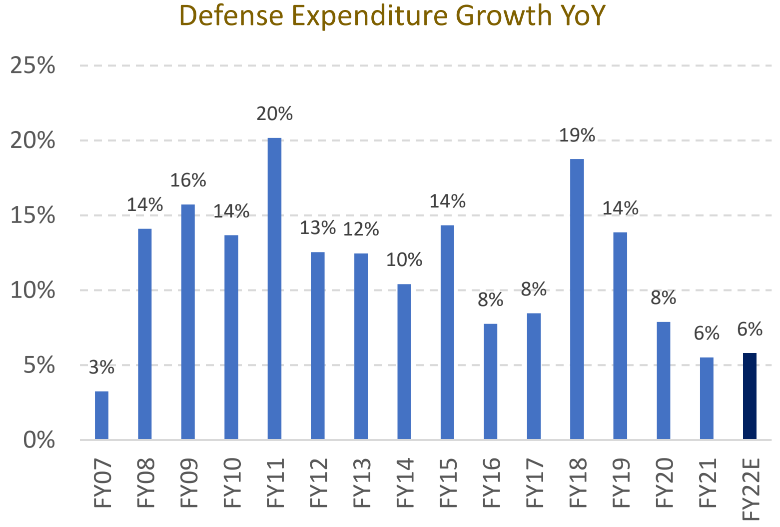
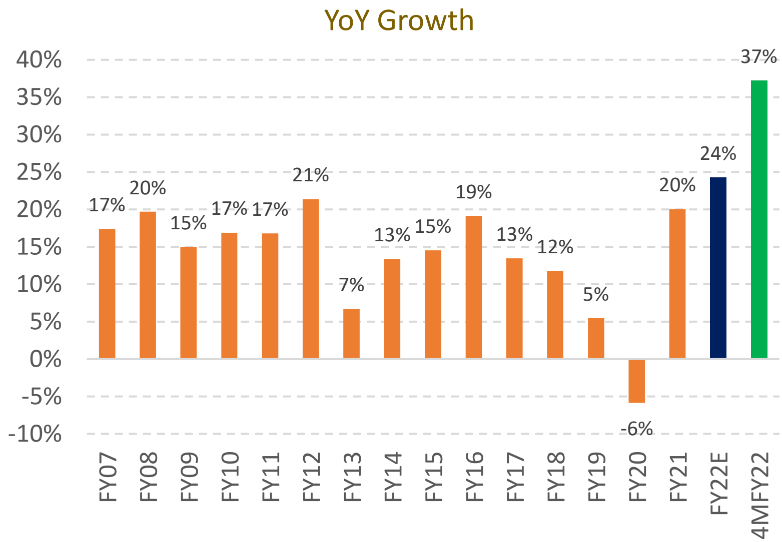
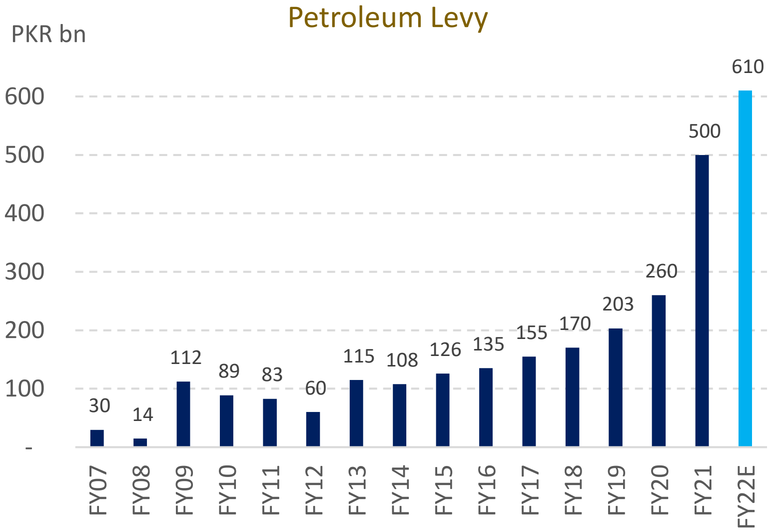
Fiscal slippage risks emanate from non-tax revenue

- FBR tax collection target is set at PKR 5.8tn, up by 24% YoY from revised PKR 4.7tn while overall tax revenue is targeted at 10.8% of GDP. With nominal GDP expected to grow by 13% in FY22, revenue targets are optimistic.
- However, growth in FBR tax collection has been a phenomenal 37% during 4MFY22 where revenues exceeded targets by 14%.
- A key challenge would be the ambitious petroleum levy (PL) target of PKR 610bn which requires levy of around PKR 35/ litre on Petrol and Diesel. However, in order to offset the impact of rising oil prices, the government has reduced the PL to ~PKR 5/litre and have also introduced PDC (subsidy). If oil prices remain high, during FY22, PL collection target would not be achieved. PL collection during 4MFY22 has only been PKR 24bn vs a target of PKR203bn target.









ECONOMY

The IMF Program

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IMF – EFF Program to achieve fiscal discipline

- Pakistan availed IMF's Extended Fund Facility (EFF) in July-19. The program resumed in Feb-21 after COVID-19 led lapse of one year and the IMF completed combined 2nd through 5th reviews with disbursement of only USD 500mn.
- Sixth Review, earlier scheduled for June-21, was delayed until Sept-21 due to disagreement between IMF and the Government over some fiscal and structural reforms under Memorandum of Economic and Financial Policies (MEFP). The recent news flow indicate the government has agreed to implement the fiscal/ monetary measures including:
  - Giving full autonomy to the SBP with zero interference from fiscal authorities. The flexible exchange rate system and recent PKR devaluation / interest rates decisions indicate the central bank's autonomy to manage monetary activities.
  - Elimination of sales tax credits and exemptions in order to make tax collection more stable. (*This will also provide buffer against missing PL target of PKR 610bn for FY22).*
  - Electricity tariff hike of PKR 1.39/ unit. This will support in containing further pileup of the power sector circular debt.
  - No new gas connections.
- The successful completion of the review will also pave way for release of approx. USD 1.0bn IMF installment.
- It will also facilitate USD 5-6bn external financing, which is contingent upon IMF's approval.

IMF –EFF Quantitative Targets

- Floor on net international reserves of the SBP
- Ceiling on net domestic assets of the SBP
- Ceiling on SBP's stock of net foreign currency swaps/forward position
- Ceiling on general government primary budget deficit
- Ceiling on net government budgetary borrowing from the SBP
- Ceiling on the amount of government guarantees
- Zero new flow of SBP's credit to general government
- Zero ceiling on accumulation of external public payment arrears by the general government
- Cumulative floor on Targeted Cash Transfers Spending (BISP)
- Cumulative floor on general government budgetary health and education spending
- Floor on net tax revenues collected by the FBR
- Ceiling on net accumulation of tax refund arrears
- Ceiling on power sector payment arrears

Structural Benchmarks

- **12 Structural Benchmarks under MEFP of which only one has been fully met, while some of them are in advance stages**

Fiscal

- Commit to not grant further tax amnesties.
- Avoid the practice of issuing new preferential tax treatments or exemptions.
- ***Presentation of the federal government mid-year budget review report to the National Assembly in line with the PFM***

Monetary

- Adopt measures to strengthen the effectiveness of the AML/CFT framework to exit the FATF grey list.
- Improve towards a substantial level the effectiveness in addressing terrorism financing consistent with FATF Immediate
- Submit to parliament, in consultation with IMF staff, amendments to the State Bank of Pakistan Act to address all recommendations of the new 2019 Safeguards Assessment Report and the 2016 Technical Assistance Report on Central Bank Law Reform

State Owned Enterprises

- Submit to parliament amendments to the NEPRA Act to (i) give the regulator the power to determine and notify quarterly tariffs; (ii) ensure timely submissions of quarterly and annual petitions by the DISCOs; (iii) eliminate the gap between the regular annual tariff determination and notification by the government; and (iv) reinstate the power of the government to levy surcharges over and above the system's revenue requirements under the NEPRA Act.
- Notification of FY 2020 Q2 electricity tariff adjustment for capacity payments.
- Conduct and publish new audits by reputable international auditors of Pakistan International Airlines (PIA) and Pakistan Steel Mills (PSM).
- Conduct a triage of all SOEs, dividing them into companies to (i) maintain under state management; (ii) privatize; or (iii) liquidate.

Structural Benchmarks

Social Protection and Gender

- Submit to parliament a new State-Owned Enterprise law to improve governance and transparency in line with IMF recommendations
- Finalize the update of the BISP beneficiaries' database (National Socio-Economic Registry)

11 New Structural Benchmarks added by the IMF in the last review

- Minister of Finance will establish and make functional the TSA-1.
- Reintroduce and roll out the track-and-trace systems for tobacco products.
- Publication of awarded Covid-spending related contracts and beneficial ownership information of bidding and awarded legal persons in a centralized and publicly accessible website.
- Auditor General of Pakistan will conduct an ex-post audit of the procurement of urgently needed medical supplies related to Covid-19. Audits results will be published on the website of the Ministry of Finance.
- Reduction in CPPA-G payables to power producers through a payment up to PKR 180bn with no more than 1/3 in cash and the remainder in debt instruments.
- Completion of the FY21 annual rebasing (AR).
- Finalization of the energy cross-subsidy reform for the FY22 budget.
- Notification of FY20 Q4 electricity tariff adjustment for capacity payments.
- Adoption by parliament of amendments to the OGRA Act.
- Conduct and publish external audit of the Utility Stores Corporation (USC) based on FY20 financials.
- Establish a robust asset declaration system with a focus on high-level public officials

IMF- EFF Program Timeline

May 2019
- IMF Reaches Staff-Level Agreement on Economic Policies with Pakistan for a Three-Year Extended Fund Facility (EFF)

July 2019
- IMF Executive Board Approves USD 6bn 39-Month EFF Arrangement for Pakistan

Nov 2019
- IMF Reaches Staff-Level Agreement on the First Review under the EFF
- IMF approves USD 450mn installment

Dec 2019
- IMF Executive Board completes the First Review of the EFF

Feb 2020
- IMF Reaches Staff-Level Agreement on the Second Review under the EFF

April 2020
- IMF Executive Board Approves a USD 1.386bn Disbursement to Pakistan to address the COVID-19 Pandemic under Rapid Installment Fund (RIF)

Feb 2021
- IMF Staff and Pakistan reached Staff-Level Agreement on the Pending Reviews under the EFF

April 2021
- The IMF Executive Board completed combined 2nd through 5th reviews of the EFF, and disbursed USD 500mn for budget support

Sept 2021
- IMF reached staff level agreement for the Sixth Review under EFF

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Team

	Designation	Email
Azfer Naseem	Chief Executive Officer, Alfa Adhi Securities	azfer.naseem@akseerresearch.com
Research		
Hifza Zia	Director Research, Akseer Research	hifza.zia@akseerresearch.com
Saad Nandia	Senior Research Analyst, Akseer Research	saad.nandia@akseerresearch.com
Aftab Awan, ACCA	Senior Research Analyst, Akseer Research	aftab.awan@akseerresearch.com
Saqib Hussain	Senior Research Analyst, Akseer Research	saqib.hussain@akseerresearch.com
Arshad Mansoor	Research Analyst, Akseer Research	arshad.mansoor@akseerresearch.com
Mohammad Raza	Research Analyst, Akseer Research	mohammad.raza@akseerresearch.com
Mohammad Atif	Research Trainee, Akseer Research	muhammad.atif@akseerresearch.com
Sales		
Bilal Ahmed Ghaffar	Advisor, Institutional & HNWI Sales, Alfa Adhi Securities	Bilal.ghaffar@alfaadhi.pk
Ubaidur Rehman Hashmi	Assistant Sales Manager, Alfa Adhi Securities	ubaid.hashmi@alfaadhi.pk

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Contact Details

Akseer Research (Pvt) Limited
1st Floor, Shaheen Chambers, KCHS block 7 & 8, off. Shahrah-e-Faisal
T: +92-21-34320359-60
E: info@akseerresearch.com

Alfa Adhi Securities (Pvt) Limited
3rd Floor, Shaheen Chambers, A-4 Central Commercial Area, KCH Society,
Block 7 & 8, Near Virtual University, Karachi
T: +92-21-38694242
E: info@alfaadhi.net