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Engro Fertilizer

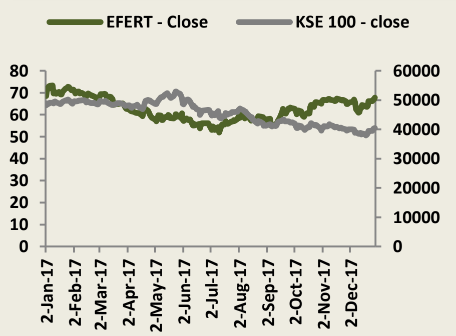
Initiating Coverage

Call		
Buy	Hold	Sell

Quick Financials

PSX Code	EFERT
Bloomberg Code	EFERT.PA
Reuters Code	EFERT.KA
Current Price (PKR/sh)	68
Year High - Low (PKR/sh)	71.04 - 51.90
Market Cap (PKR mn)	90,800
Market Cap (US$ mn)	819
P/E (ttm)	8
Free Float (%)	45%
Free Float Market Cap (PKR mn)	40,860
Target Price (PKR/sh)	79
Upside	16%

Relative Performance



Analyst - Saad Pervez
saad.pervez@darsononline.com
+92-21-32467224 Ext: 125

Information & Data Sources:
PSX, NFDC, Company Accounts, SBP, PBS and Darson Research

Every cloud has a silver lining...

Industry Overview

Pakistan is undergoing a series of positive developments with improved economic, political and law & order situations. Country's growing population, increased market liquidity and relatively low inflation & interest rates could bode well for the agriculture sector and eventually for the local fertilizer industry.

The agriculture sector of Pakistan accounts for:

- 21% of the country's GDP
- 60% of the employed labor force in rural areas whereas the total labor force of the country is around 57mn, in which 44% is involved in agriculture, 20% is in industry and 36% in other services
- 64 % of the population of Pakistan which resides in rural areas and is directly or indirectly involved in agricultural activities
- 65% of the country's total export earnings making it the largest source of Foreign Exchange earnings
- Providing raw material for industries like textile and sugar
- Forming alone the basis for over 50% of industrial population and has a growth rate of around 4% per annum

Agricultural Growth

% (Base year 2005-06)	FY13-14	FY14-15	FY15-16	FY16-17
Agriculture	2.5	2.13	0.27	3.46
Crops	2.64	0.16	-4.97	3.02
i) Important Crops	7.22	-1.62	-5.47	4.12
ii) Other Crops	-5.71	2.51	0.59	0.21
iii) Cotton Ginning	-1.33	7.24	-22.12	5.59

Sourse: PBS, Darson Research

Production of Important Crops

Thousand Tonnes	FY13-14	FY14-15	FY15-16	FY16-17
Wheat	25,979	25,086	25,633	25,750
Sugarcane	67,460	62,826	65,482	73,607
Rice	6,798	7,003	6,801	6,849
Maize	4,944	4,937	5,271	6,130
Cotton (000 bales)	12,769	13,960	9,917	10,671

Sourse: PBS, Darson Research

The problems associated with the agricultural sector are:

- Unequal distribution of landholdings
- Illiteracy in rural areas (Country's literacy rate is 55%, whereas, in urban areas it is 72% and in rural areas it is 45%)
- Traditional & old methods of production
- Disguised unemployment
- Conversion of arable land into non-agricultural uses
- Water logging & salinity related problems
- Land erosion related issues

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Did you know?
In December 2017, The World Bank approved USD 300mn to modernize agriculture in Punjab province of Pakistan to raise farmers' incomes, give consumers better quality and safer food at lower prices, create jobs on farms and agribusinesses, and improve the use of irrigation water.

Production of Important Crops

Million Acre Feet	FY13-14	FY14-15	FY15-16	FY16-17
Kharif	66.5	69.3	65.5	71.4
Rabi	32.5	33.1	32.9	29.7
Total	99	102.4	98.4	101.1

Source: PBS, Darson Research

Actual Surface Water Availability

Millimeters	Monsoon Rainfall (Jul-Sep) 2016	Post Monsoon Rainfall (Oct-Dec) 2016	Winter Rainfall (Jan-Mar) 2017
Actual	176	3	75
Shortage (-)/excess (+)	35.3	-23.4	1.2
% Shortage (-)/excess (+)	25.10%	-88.60%	1.60%

Source: Pakistan Meteorological Department
*: Area Weighted

A leap forward…

Fertilizer Sector's Critique

Fertilizer sector in Pakistan is capable of producing over 6mn tons per year (produced in 2016) which is slightly above the national demand, after being a urea deficit country for more than a decade. Fertilizer sector has also played an important role in eliminating imports to save the much needed foreign exchange and improving food quality in the country.

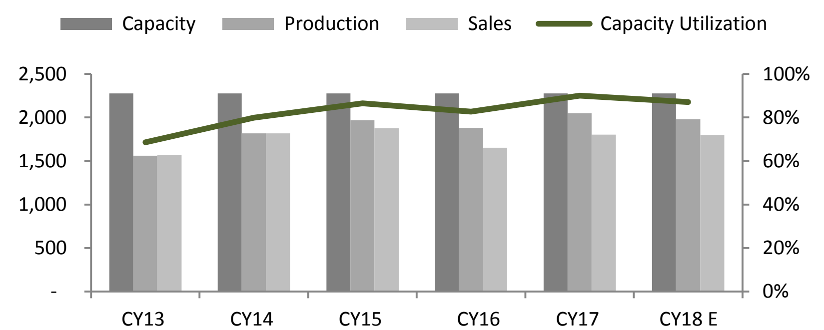
Historically, fertilizer industry has been facing several challenges which are:

- Insufficient gas supplies
- Power shortages
- High gas tariffs
- Taxation related issues
- Political factors

Positive development transpired as the government gave the permission to export 600k tons till October 2017 and Economic Co-ordination Committee (ECC) of the Cabinet in January 2018 had also allowed export of additional 35,000 Metric Tons (MT) of urea to Sri Lanka, in addition to extending the deadline for export of the remaining quantity of 41,000 MT up to February 28, 2018, despite stiff resistance from Secretary Ministry of National Food Security and Research.

Did you know?
The resources provided by the World Bank will be part of a larger program by the Government of Punjab that aims to better harness the enormous potential for farming in the province, with its fertile soils and extensive irrigation system. The program is estimated to create 350,000 jobs, to lift 1.7mn people from poverty line and to increase farmers' purchasing power.

EFERT's Urea



Source: Company Accounts, Darson Research

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We believe that any increase in crop prices while fertilizer prices remaining at constant level could also benefit farmers as well as the fertilizer sector, as farmers tend to increase crop yields in such scenarios by utilizing more fertilizer products. While PKR devaluation against USD might further provide room to increase local DAP prices.

Did you know?
Pakistan ranks eighth worldwide in farm output, according to the List of countries by GDP sector composition.

Company-wise

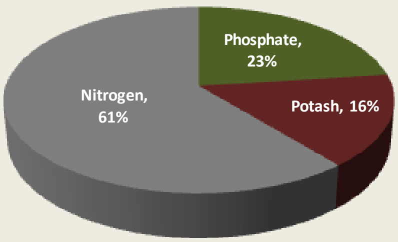
UREA	CY15		CY16		CY17		TOTAL	
'000 tons	Prod.	Off-take	Prod.	Off-take	Prod.	Off-take	Prod.	Off-tale
EFERT	1,967	1,879	1,873	1,653	1,854	1,802	9,079	8,714
FFC	2,469	2,408	2,523	2,428	2,513	2,474	12,314	12,090
FFBL	302	290	434	443	543	546	1,716	1,718
FATIMA	394	373	500	356	474	417	2,091	1,864

Source: NFDC

DAP	CY15		CY16		CY17		TOTAL	
'000 tons	Import	Off-Tk	Import	Off-Tk	Import	Off-Tk	Import	Off-Tk
EFERT	430	391	521	528	506	536	2,257	2,259
FFC	204	165	164	202	513	513	1,075	1,076
FFBL	-	748	-	791	-	831	-	3,851
FATIMA	-	-	-	24	17	45	97	150
000 tons	**Prod.**	**Off-Tk**	**Prod.**	**Off-Tk**	**Prod.**	**Off-Tk**	**Prod.**	**Off-Tk**
FFBL	768	748	791	791	809	831	3,814	3,851

Source: NFDC

Average % used annually in fertilizer



Region-wise

Urea off-takes (000 tons)	CY13	CY14	CY15	CY16	CY17	TOTAL
Punjab	4,038	3,775	3,721	3,573	3,909	19,015
Sindh	1,241	1,327	1,472	1,487	1,529	7,056
KPK	388	321	273	303	247	1,532
Baluchistan	228	209	150	133	176	895
AJK/FATA			-	-	-	-
TOTAL	**5,895**	**5,631**	**5,616**	**5,495**	**5,861**	**28,499**

Source: NFDC

Did you know?
In Pakistan, the most important crops are wheat, sugarcane, cotton, and rice, which together account for more than 75% of the value of total crop output.

Catch-22 situation…

Global Fertilizer's Market

As far as the global markets are concerned, Chinese export sets the price for the global markets as China has been the world's largest urea producer. China, together with India and the Middle East, accounts for around two-thirds of the world's production of urea. China holds 35% share in the world urea production and almost 30% in global urea exports. Today, China accounts for 30% of global fertilizer use.

However, in Pakistan, the major gas reserves are depleting rapidly, the supply-demand gap in the country is broadening and we need alternative sources of fuel to ensure the smooth functioning of our industries. For many years now, the robust fertilizer industry has been suffering due to insufficient supply of Natural Gas, which is used as an important raw material for producing fertilizer. Gas availability can affect the local fertilizer manufacturing but smooth supply of subsidized LNG gas can become a better source of production.

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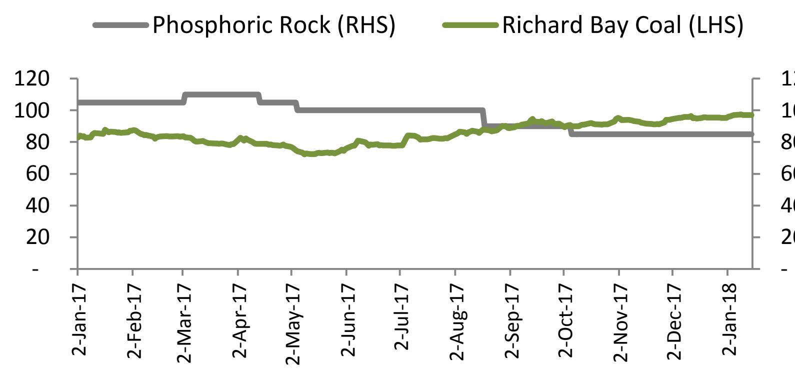
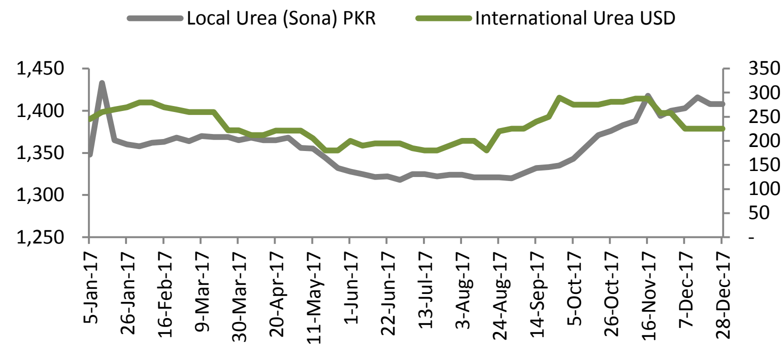
International Fertilizer Prices

Origin/Type	Price Range
China Urea	USD 300 to 320 per ton
Middle East Urea	USD 260 to 262 per ton
US Gulf DAP	USD 360 to 353 per ton
MAP	USD 375 to 405 per ton
TSP	USD 290 to 300 per ton

Source: NFDC

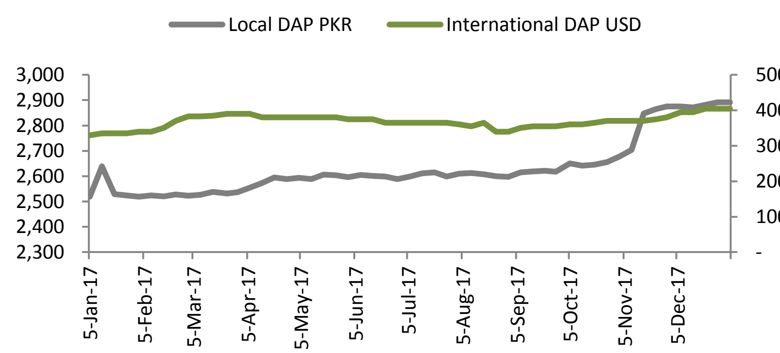




In the past, China and the Middle East showed high growth rate in urea production (China more than 70mn tons and Middle East more than 20mn tons in 2016). Especially China showed the high growth from 2000 to 2013 as urea production jumped from 30mn tons in 2000 to almost 70mn tons in 2013. However, as currently urea is over-supplied; Chinese production is slowing down or even decreasing recently.

On the other hand, production of urea in the Middle East has been growing steadily and is expected to grow more with several new urea projects. Urea production in Eastern Europe & India has increased slightly in couple of years. Interestingly, production volume in the US and Africa is growing at a notable rate since 2015.

Did you know?
Fertilizer industry in Pakistan is the second largest consumer of Pakistan's total gas availability which is consumed at an estimation of 25% for fertilizer companies and 35% for the energy usage.



In Pakistan, currently, as compared to our neighbor countries, the Urea and DAP prices are at relative levels while international prices for both Urea and DAP has been declining even though coal prices are inching up while phosphoric rock prices are crawled up.

We also expect that in the near future, the urea inventory will remain on the same level as it is now on the back of improved demand in this year as most of the inventory has been wiped out on the account of given export permission.

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Did you know?
The government is also proposing to reduce general ST on urea from 5% to 2% and to terminate the Rs100/bag cash subsidy regime which would increase the retail price for farmers.

A glimmer of hope…

Fertilizer Subsidy

Unlike developed countries, in under-developing countries, economic retrieval and supportive policies for local industries are the dominance of current policy; therefore, Pakistani government provides subsidies and incentives to farmers to amplify productivity.

Government of Pakistan strengthened the agricultural and fertilizer sectors by giving subsidies, allocating particular gas supplier to fertilizer companies/plants and also by guaranteeing uninterrupted gas supply. The government also gave immense cushion to this sector after giving small loans to the farmers, supporting farmers to expand their purchasing power and also by reducing sales tax on urea from 17% to 5% estimated at PKR 184 per bag of urea, a GST based subsidy. However, cash subsidy on urea has been revised from PKR 156 per bag to PKR 100 per bag for FY18 from Finance Ministry of Pakistan but it has been assured from the Ministry to make the disbursement process smooth.

Making headway…

Fertilizer Sector's Analytical Growth

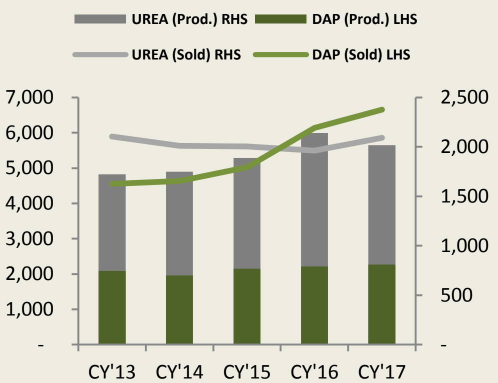
The usual decline in urea demand comes on the back of mainly decreasing:

- commodity prices
- unstable agro-economics

Although, demand showed impressive recovery because of significant reduction in urea prices, followed by the subsidy announced by the government which also turned out to be better for weak agro-economics and farmers' conditions.

Lower urea imports also give an edge to the local urea manufacturers, who are currently distressed in terms of both increased competition and a loss of purchasing power by the supply of less expensive imported urea and we expect that higher international prices may force the Government of Pakistan to reduce urea imports due to limitations on foreign exchange reserves which will eventually provide breathing space to local fertilizer manufacturers

Industry's Production and Sales (000 tons)



Source: NFDC

Total Industry's production

000 tons	CY'13	CY'14	CY'15	CY'16	CY'17	TOTAL
UREA	4,829	4,896	5,284	5,993	5,653	26,654
DAP	744	701	768	791	809	3,814
NP	423	464	682	628	651	2,848
NPK	54	68	74	70	59	325

Source: NFDC

Total Industry's off-takes

000 tons	CY13	CY14	CY15	CY16	CY17	TOTAL
UREA	5,895	5,631	5,617	5,495	5,861	28,499
DAP	1,626	1,655	1,793	2,194	2,378	9,646
NP	425	470	579	682	688	2,844
NPK	57	69	71	66	60	323

Source: NFDC

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EFERT - blowing away the cobwebs…

Company's Dynamics & Competitive Landscape

In 2010, Engro Fertilizer, with all the fertilizer business, demerged from Engro Chemicals and became a separate entity while Engro Chemicals turned into Engro Corporation Limited. Engro Fertilizer (EFERT) is a wholly owned subsidiary of Engro Corporation (ENGRO) which is a cash rich organization.

Did you know?
Engro Fertilizers Limited possesses a 24 year old fertilizers experience and 1,170 employees on average basis.

Engro Fertilizer invested USD 1.1bn, one of the largest private investments ever in the history of Pakistan on the commitment of the Government of Pakistan for guaranteed gas on an uninterrupted basis for Engro Fertilizer. The plant was established in 2010 which still is the world's largest single train urea plant with 1,300,000 metric ton capacity.

EFERT's core competencies are its unique brand image, strategic location (near agricultural belt) which supplements vast distribution network underpinned by strong brand identity & resonance with farmers and remarkable dealer's network. While on the other hand, the company is facing few challenges because of Government back off from the Gas Sales Agreement (GSA), also fewer gas reserves, inconsistent production of fertilizers, all together result in lower production which leads to lower sales and finally lower profits.

Company's BoDs

Position	Name
Chairman	Ghias Khan
Chief Executive/MD	Ruhail Muhammad
Board of Director	Javed Akbar
Board of Director	Abdul Samad Dawood
Board of Director	Asim Murtaza Khan
Board of Director	Ms. Sadia Khan
Board of Director	Ruhail Muhammad
Board of Director	Ghias Khan
Board of Director	Asad Said Jafar

Source: Company Accounts

EFERT has three urea plants. Plant-I was established in 1964 by an American Company. The annual capacity of Plant-I is 173,000 metric tons. Plant-II is made of Japanese technology. It has the annual capacity of 802,000 metric tons and Plant-III was made in 2010. It has the annual capacity of 1,300,000 metric tons. EFERT is the sole producer of NPK fertilizer in the country which is sold under the name of Zarkhez with a capacity of 100kt.

The new facility (EnVen) is not operating on full capacity due to on-going energy crises in the country. Once operational fully, it will increase Engro's production share from the current levels.

The huge urea expansion (EnVen) was undertaken to become self-sufficient in Urea production at national level primarily. But unfortunately, the strong vision was damaged as the company was supplied natural gas less frequently than promised.

The plant could save much of the country's foreign reserves which the government spends due to urea imports. The plant's production capacity of 1.3 million tons per annum enhanced Engro Fertilizer's total annual urea production capacity to 2.3 million tons.
The concessionary gas to its EnVen plant which is priced at USD 0.7/mmbtu (2013 – 2023) as compared to the industry which is priced at USD 4.2 per mmbtu also provides an edge to export even at low price. The company has also made an agreement of 16mmscfd with Mari gas at normal industry price. Major export destinations of the company are East African countries.

Did you know?
Engro Fertilizer undertook its largest urea expansion project in 2007. EFERT's urea plants in Daharki can produce up to 2,275,000 metric tons altogether, which has also made Daharki the 5th largest urea producer site in the world.

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Shareholding Pattern

Shareholders Category	No. of Shareholders	No. of Shares	Percentage
Directors, Chief Executive Officer and their spouse and minor children	8	94,825	0.01%
Associated Companies, Undertakings and related Parties	1	751,312,049	56%
Banks, Financial Institutions and Non Banking Financial Institutions	39	68,225,138	5%
Insurance Companies	25	32,448,886	2%
Modarabas and Mutual Funds	82	138,403,390	10%
Share holders holding 10%	1	751,312,049	56%
General Public :			
a. Local	25,210	174,813,050	14%
b .Foreign	0	0	0%
Others	490	170,002,037	13%

Source: Company Accounts, Darson Research

EFERT's SWOT Analysis

Operational and Financial Performance

EFERT has a highly leveraged capital structure (38% equity-financed and 62% debt-financed in 2017), while a big proportion of debt incurred on the back of EnVen 1.3 completion.

The top-line in 2017 inclined +11%YoY as compared to same period last year and only the slight increase of +3%YoY in the overall CoGS coupled with lower finance cost, resulted in +22% increase in PBT and almost +20%YoY surge in EPS which clocked in at PKR 8.4 versus PKR 6.98 in same period last year.

EFERT's EnVen plant is enjoying the leverage of being supplied with concessionary gas for 10 years since commencement and according to the company it is anticipated that the concessionary status will be given till 2023 and not till 2021 as the company wasn't provided any concessionary gas in the first two years, which will also bring positivity in the margins.

We expect that stable fertilizer off-takes in this year would also impact EFERT's profitability with some debts of EFERT which have also been restructured this year while others are on their way to the maturity date which take up a hefty proportion of PBIT in terms of finance cost. The company holds no further plan to re-profile/re-structure loans due to increase in interest rates. Other income of the company is also getting bigger and it is expected to further strengthen.

The company's payout has been growing which was evident from 112%, a notable increase in 2017 while in 2016 it was 103%. We expect the company to pay high dividend in the future as well because EFERT holds no current plan of expansion while the company has undergone slight upgradation in 2017 in the face of installing compression units which enhanced production, whereas cash flows of EFERT have also improved significantly.

Did you know?
EFERT recorded highest ever production of urea (1,968kt) as well as the highest ever sale of urea (1,878kt) in 2015, while highest ever phosphate sale of 534kt was achieved in 2016.

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EFERT's margins are improving expressively which can be attributed to the change in DAP business's accounting treatment as it is reflected in the consolidated accounts and not on standalone basis.

We expect the company to post improved profit in years to come while any reduction in subsidy income will negatively influence the other income of the company. Going forward we also expect that the coming budget will be more fertilizer's industry-friendly, nonetheless, keeping current subsidy situation in mind we have only incorporated subsidy income till June of this year.

Any change in foreign currency could have an adverse impact on the company considering that it has obtained USD denominated loans. However, this is mitigated by the company after partially hedging its exposure against FX denominated borrowings through forward contracts & FX options, EFERT's conversion of IFC loan further reducing USD dominating debt and also rupee devaluation which will also increase the landed cost of imported urea providing fertilizer manufacturers with more room for increasing prices. However, the company's loans in foreign currency have come down considerably.

Giving a heads up….
Legal Matters

- The matter related to government's imposition of GIDC cost on concessionary plants is in court and since this imposition was in conflict with the fertilizer policy (2001), which undoubtedly indicates that the concessionary gas of USD 0.7/mmbtu will remain fixed at such price till the expiry of 10 years from the date of commissioning and it is inclusive of all duties. Hence, we believe that the decision would come in favor of fertilizer companies.

- Competition Commission of Pakistan (CCP) had imposed a fine of PKR 3.1bn on EFERT in 2013 accusing it for inflating the price of fertilizer which turned the situation into something worst as the food inflation rose for the nation. Nonetheless, EFERT is contesting this order through all legal means after EFERT has filed a writ in the Sindh High Court which then granted stay against the recovery of the imposed fine. EFERT has reserved an appeal on this matter.

Did you know?
In October 2011, the Sindh High Court ordered the immediate restoration of gas to Engro Fertilizers under the contract upholding the sovereign guarantee and the GSA, but this decision was not implemented.

EFERT's Urea

Volumes in Kt	CY13	CY14	CY15	CY16	CY17
Capacity	2,275	2,275	2,275	2,275	2,275
Production	1,562	1,819	1,968	1,881	2,048
Sales	1,570	1,818	1,878	1,652	1,802
Capacity Utilization	69%	80%	86%	83%	90%

Source: NFDC, Company Accounts, Darson Research

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EFERT's Performance

PKR MN	CY15 A	CY16* A	CY17* A	CY18* E	CY19* E
Net sales	85,003	69,519	77,129	74,121	76,456
COGS	55,435	52,408	53,911	50,803	52,889
Gross Profit	29,568	17,111	23,219	23	24
Finance cost	4,588	3,136	2,648	3,059	3,253
Profit/Loss before tax	21,169	13,375	16,665	16,160	16,513
Taxation	6,141	4,351	5,509	5,171	5,284
Profit/Loss after tax	15,027	9,025	11,156	11	11
EPS/LPS - basic	11.3	6.8	8.4	8.2	8.4
*Consolidated Accounts					

Did you know?
Engro Enven only received gas for 189 days in 2011 and 45 days in 2012 even after the agreement with Government of Pakistan.

Margins

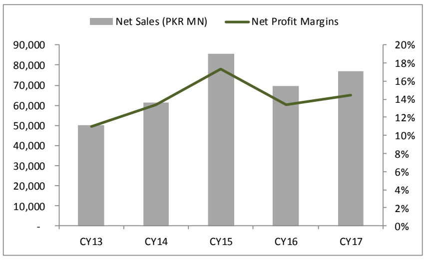
Percentages (%)	CY15 A	CY16* A	CY17* A	CY18* E	CY19* E
Gross Profit Margin	35%	25%	30%	31%	31%
Operating Profit Margin	30%	24%	25%	26%	26%
Net Profit Margin	18%	13%	14%	15%	15%
*Consolidated Accounts					

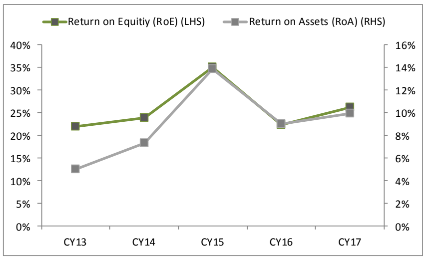
Ratios

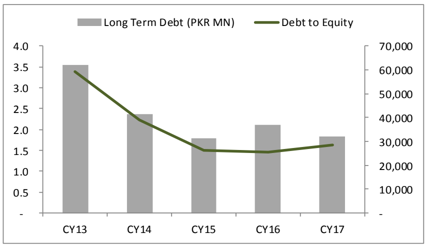
	CY15 A	CY16* A	CY17* A	CY18* E	CY19* E
Operating profit per share	19	13	14	14	15
Net profit per share	11	7	8	8	8
Return on equity	35%	22%	26%	26%	28%
Return on asset	14%	9%	10%	11%	11%
Quick ratio	0.7	0.9	0.8	0.9	1
Total assets turnover ratio	0.8	0.7	0.7	0.7	0.7
Price to earning	6	10	8	8	8
*Consolidated Accounts					

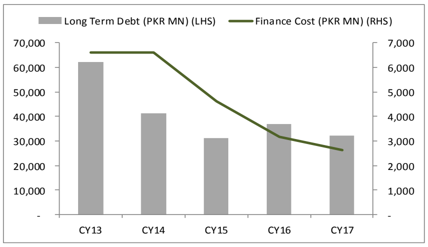
Financial Trends

Did you know?
A flood caused in Badin became the reason for the downfall of sales in the beginning of the new CY12 of Engro Fertilizers. Not only this, the flood at the end of the Fiscal Year 2012 (FY12) in the Khyber Pakhtunkhwa, Upper Sindh, Southern Punjab and Balochistan regions of Pakistan further aids in the declination of Sales in CY12.









Source: Company Accounts, Darson Research

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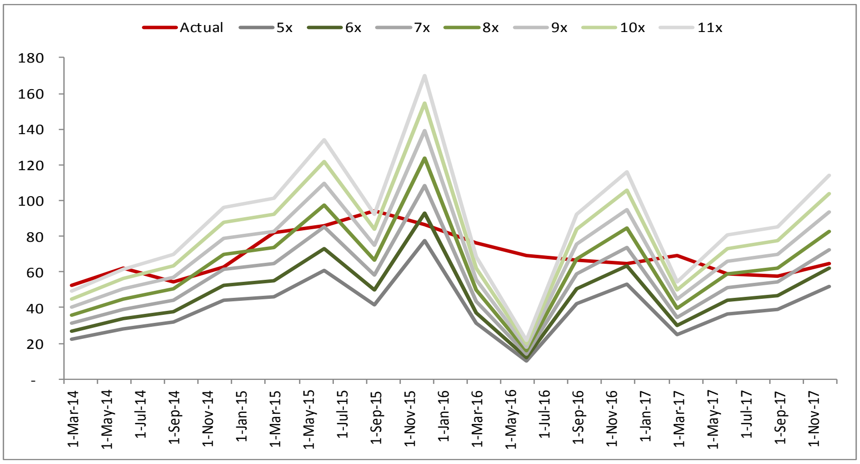
Did you know?
Engro Fertilizers had also faced major bone of contention in the past (2012 -2013) among the leadership crisis as it had made it extremely difficult for company's board member to convince their investors regarding the slow production of the urea producing plants that had dragged the overall corporation into red zone.

P/E Valuation

EFERT scrip on average basis is traded between P/E of 7x and 8x. Currently P/E hover around 8x suggesting that the scrip is fairly valued against our analyst based forecast. Hence, supporting our valuation and depicting a potential gain in coming quarters.



Future stance

Valuation methodology

Did you know?
EFERT has more than 90 to 120 warehouses across Pakistan and its products are spreading over 300 cities and towns while reaching out to more than 1.5mn farmers.

We uphold our market stance on the fertilizer sector with EFERT as our top pick given the company's low cost of producing enabled it to cater the pricing pressure better than its peers.

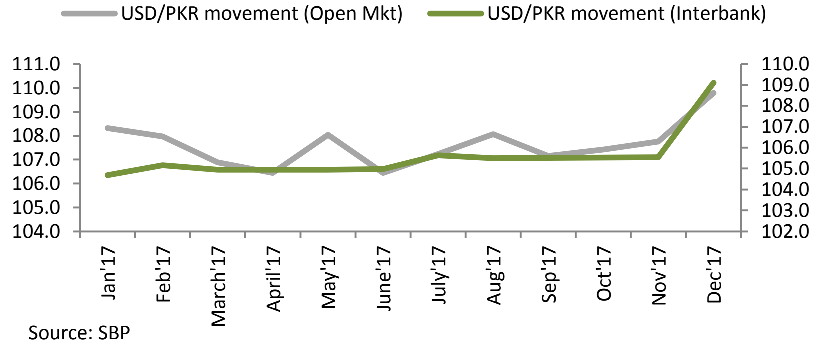
Within the Darson Fertilizer Universe, we indicate fertilizer manufacturers which have a secure supply of natural gas to be the likely beneficiary of higher fertilizer demand, which includes EFERT and FATIMA. Furthermore, considering election year politics and their outcomes, we expect that the fertilizer sector may become a victim of negligence coupled with higher fuel prices which would also influence this sector unfavorably.

Incorporating the discussed changes, our 2018 target price for EFERT based on DCF valuation is PKR 79/sh resulting in a BUY call.

Risk Associated with Target Price

The risks which are linked with our valuation are:

- Urea price regulations
- Unfavorable court decision
- Hike in gas prices
- Increased competition
- Continued unhelpful government policies
- Stagnant demand



Source: SBP

darsonResearch

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If;

- **Expected return >15%** - Buy Call
- **Expected Return is in between 0% to 15%** - Neutral/Hold Call
- **Expected Return <0%** - Sell Call

Valuation Methodology
To arrive at our period end target prices, DSL uses different valuation methodologies including:

- Discounted cash flow (DCF, DDM)
- Justified price to book (JPB)
- Relative Valuation (P/E, P/B, P/S etc.)
- Equity & Asset return based methodologies (EVA, Residual Income etc.)

SECP JamaPunji Portal link: www.JamaPunji.pk

Frequently Used Acronyms

TP - Target Price
FCF - Free Cash Flows
FCFF - Free Cash Flows to Firm
SOTP - Sum of the Parts
P/Bv - Price to Book ratio
EVA - Economic Valued Added
EPS - Earnings per Share
DY - Dividend Yield
ROA - Return on Assets
DCF - Discounted Cash Flows
FCFE - Free Cash Flows to Equity
DDM - Dividend Discount Model
P/E - Price to Earnings ratio
P/S - Price to Sales
BVPS - Book Value per Share
DPS - Dividend per Share
ROE - Return on Equity
JPB - Justified Price to Book