

Market Strategy

IMF Imminent - Tough Call Taken

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IMF imminent- Tough call taken

Difficult exit

What Pakistan needs right now is a short term pragmatic solution to defuse the external ticking bomb. As bitter as it may sound - more macro orthodoxy is a welcomed first step, as authorities have finally [as per media] decided to take unpopular measures including imposition of GST, flood levy and other taxes coupled with tariff hikes and revisiting FX regime to ensure IMF is through. We consider this to set the country on the path of fiscal consolidation and balance of payment stability in the long run, while in the short-run, potentially leading to immediate disbursement from the IMF followed by financing from other multilateral and bilateral international creditors.

Revisiting macroeconomic policies

The critical situation of the local currency, mixed with a soaring inflation rate, decelerating economic growth, and the lack of financing sources for the government, pushed authorities to agree to the stringent conditions laid down by the International Monetary Fund (IMF) under the Extended Fund Facility (EFF). While we believe this welcomed development will put the nation on a recovery path, it is expected to be long, tricky, and challenging. To recall, the IMF's Extended Fund Facility (EFF) program had fallen off track amid delays in acceptance of the conditions set out by the Fund and survival without IMF is not an option given the scale of the external financing needs, where the majority of the funding is linked to an IMF endorsement.

We also believe that the expected IMF assistance approval will require a much deeper fiscal consolidation, while also revisiting our other macroeconomic policies including foreign exchange policy. Taking everything into account, a host of revenue and fiscal consolidation measures are expected to be taken in the upcoming days including:

- i) Additional taxes and levy (proposed) including: the imposition of GST on petroleum products, removal of GST exemptions on certain items, flood levy on imports, and tax on FX gains of banks,
- ii) Market-based exchange rate, and
- iii) Rationalization of energy (electricity and gas) tariffs etc.

While we have discussed each of the aforementioned measures and their impact in detail in the following section of the report, we believe, these measures are likely to get the program back on track and pave the way for the release of the next tranche of ~USD 1.2bn in Feb'23. With the 10th review also due in early 2023 (1Q) - combining the two reviews remains a possibility though this may further delay the IMF disbursement. Along with the fiscal adjustments we expect monetary authorities too to maintain a tight monetary policy and raise rates by another 1% in 1QCY23.

Measures to 'fix' the economy

In its latest seventh and eighth review report, IMF stated that the government had committed to activating contingency measures as soon as monthly data show signs of underperformance against the (IMF) program revenue targets. These measures included: an immediate increase in GST on fuel as a prelude to reaching 17%; further streamlining of GST exemptions including on sugary drinks and other unwarranted exemptions, and/or increasing Federal Excise Duty on cigarettes and other RDs, if required. Hence, we believe, this calls for another mini-budget due to the emerging threat of revenue shortfall along with some other stringent measures. Here is a list of proposed measures:

Additional taxes and levy

One of the proposed measures is to resume General Sales Tax (GST) on petroleum products which was reduced to zero percent in Feb'22, through an SRO. Therefore, as a contingency measure, the Gov't is likely to immediately increase GST on fuel. This can be done in a phased-wise manner (as a prelude to reaching 17%) or in one-go, depending on what is decided between the authorities and the Fund. In addition, government is also mulling over imposing flood levy tax on imported items, with rates (as per media reports) likely to be in the range of 1% - 2%. Another tax that is being considered by the government is on the FX gains of the banking sector. Banks made exceptional FX gains in the time of volatility, up ~176% YoY in 9MCY22 compared to SPLY (listed banks).

Imposition of GST on petroleum products: FBR collection target of PKR 7.4trn seems over-optimistic. We expect a shortfall to be partially covered by imposing GST on petroleum products. We expect gov't to increase GST in a staggered manner, initially increasing it by 10% in remainder part of FY23 and eventually increasing it to 17% with the onset of new fiscal year (FY24). With this, we expect gov't to collect ~PKR 170bn in remaining 5MFY23.

Flood levy on import: The authorities are also contemplating imposing flood-levy on imports. This proposed measure is targeting not only at improving tax collection but also discouraging imports at the same time given the situation of foreign exchange reserves held by the State Bank of Pakistan (SBP). Initially the proposal was to impose it on non-essential items only, however, news is, now it is being imposed across the board. Our working suggests that every 1.5% of flood-levy on imports will help gov't generate PKR ~90bn revenue.

Tax on foreign exchange income of Banks: As per media reports, one of the measures the government is considering to bridge this revenue shortfall is through imposition of new taxes on banks' FX income. The proposal doing the rounds suggest taxing foreign income of banks which went abnormally up during 9MCY22. To recall, FX income of the listed banks for 9MCY22 stood at PKR 89bn compared to PKR 32bn recorded in SPLY, marking a mammoth jump of 176%. This growth was mainly attributable to 22.7% depreciation of PKR against USD during 9MCY22. According to media reports, it is expected that the government would charge an additional tax of around 40%, on FX income of the banks in CY22. Therefore we have run a sensitivity analysis of different possibilities of tax rates and calculated incremental tax amount that government will be able to collect. Results show that incremental tax of around PKR 48bn can be collected with this measure of the government.

A dent on banking profitability: We believe, imposing additional taxes would hurt the bank's profitability further. To note, the government already imposed hefty taxes on this sector in CY22, resulting in a decline in their profitability. The banking sector's Profit before Tax during 9MCY22 was recorded at PKR 472bn, depicting a jump of 40% YoY (PBT 9MCY21: PKR 338bn). In addition, the tax charged during 9MCY22 was PKR 263bn compared to PKR 136bn in 9MCY21, portraying a mammoth jump of 93% YoY. As a result, we saw the Profit after Tax of the industry recording a meagre growth of 4% YoY, clocking-in at PKR 209bn compared to PKR 201bn in 9MCY21. To recall, ROE of the banking sector which averaged around 20% in 2010 has gone down to avg. ~13% in 2021.

Below find table summarizing impact of tax (different tax rates assumed) on FX income of our AHL coverage on CY22E earnings.

Exhibit: Sensitivity of incremental tax on FX income

Banks	CY22E	Sensitivity of incremental tax on EPS		
		40%*	50%*	60%*
MCB	25.0	-15%	-19%	-23%
UBL	20.3	-17%	-21%	-25%
BAFL	11.0	-23%	-28%	-34%
HBL	23.5	-20%	-25%	-30%
ABL	16.0	-21%	-26%	-31%
NBP	12.2	-12%	-15%	-18%
AKBL	12.0	-16%	-20%	-24%
BOP	3.2	-9%	-11%	-13%
MEBL	22.3	-5%	-6%	-8%
FABL	7.4	-11%	-14%	-17%

Source (s): Company Financials, AHL Research, *Tax charge on FX income

Free-float is back in play

Under the EFF, Pakistan had committed to maintain a market-determined exchange rate as it remains vital to lessen the external imbalances and start rebuilding reserves. Moreover, in its seventh and eighth review, Pakistan also committed to remove the import ban and exchange restrictions conditional upon the Balance of Payment (BOP) stability. The PKR witnessed significant pressure throughout CY22 – almost 20% dip against the USD. The SBP had allowed this depreciation of the currency in order to make imports expensive and incentivize exports. As a consequence of continuous PKR depreciation and controls imposed by the Central Bank on imports, current account deficit came down significantly in 1HFY23, marking a 60% decline. However, with letting the market determine the exchange rate, pressure on the currency may mount given low reserve levels. However, the resumption of the IMF program and related multilateral flows, financial assistance from friendly countries, lower commodities prices, and lower current account deficit will relatively ease off pressure from the currency. We expect PKR to hover in the range of 263-265/USD by Dec'23 end.

Rationalization of electricity and gas tariffs

Gas Tariff increase

The IMF has repeatedly asked the authorities to embark on the rationalization of gas tariff as well as prepare a circular debt management plan, and clear gas circular debt arrears. Pertinently, the deficit on the sale of gas is increasing by approx. PKR 170bn per annum, primarily due to delay in tariff notification. The only solution is an increase in tariffs so as to counter future accumulation.

With the pressure to resume the IMF program mounting by each day, we believe the government will soon notify new electricity and gas tariffs for consumers, so as to meet pre-requisites of the multilateral financial agency.

To recall, the Economic Coordination Committee (ECC) had approved a gas tariff hike for domestic consumers and general industries during Jul'22, ranging from 8% - 235%. Albeit, latest news flow suggests a potential increase in domestic household slabs from 6 to 9, whereby the first three slabs are expected to remain shielded from any hike. While the remainder 6 slabs (high end residential gas consumers), are to bear the burden of the increase.

As per our understanding, the first three slabs (of up to 2 hm³) of residential consumers, will be cross-subsidized by the other six slabs, where the rate of the highest slab will augment from PKR 1,460/mmbtu to PKR 3,230/mmbtu, by 121%.

Having incorporated the above for household consumers, we have assumed the rate hike approved in the last ECC meeting for all other gas consumers (commercial, power sector and industries) to prevail. Consequentially, the weighted average cost of gas is expected to climb up by 50% to PKR 983/mmbtu from PKR 655/mmbtu at present.

We believe this jump in gas prices will help the government raise additional revenue of PKR 482bn, and help improve the circular debt accumulation of domestic gas utilities (SNGP, SSGC) going forward. This should also bode well for E&P companies (PPL, OGDC) whose receivables from Sui companies put pressure on their balance sheets.

We also highlight that there still remains more room to increase gas prices for the power sector, as well as other industries, however, clarity is yet to emerge on the rates of these sectors.

Sectoral impact

Exploration and Production

E&P companies have been circular debt-stricken for a long time. Pertinently, 3-year average gas revenue of OGDC and PPL has a 44% and 65% contribution to the total revenue. Thus, a hike in gas prices will be positive for these companies, as it will not only improve the cash flow position, but is likely to increase their payouts as well.

Fertilizer

Feed and fuel stock prices are expected to increase by 42% and 82% to PKR 430/mmbtu (current PKR 302/mmbtu) and PKR 1,837/mmbtu (current PKR 1,023/mmbtu), respectively. The impact of the hike would be significant as fertilizer manufacturers would have to jack up urea prices by an average of ~PKR 374/bag in order to nullify the impact. For EFERT, the impact would be slightly lower due to its partial gas dependency on PP12 policy (the company would need to augment prices

Exhibit: Proposed Gas Rates

PKR/mmbtu	Existing Rates	Proposed Rates	Change
Domestic			
Up to 0.5 hm ³ per month	121	121	0%
Up to 1 hm ³ per month	300	300	0%
Up to 2 hm ³ per month	553	553	0%
Up to 2.5 hm ³ per month	na	823	na
Up to 3.0 hm ³ per month	738	1,476	100%
Up to 3.5 hm ³ per month	na	2,952	na
Up to 4 hm ³ per month	1,107	3,230	192%
Up to 4.5 hm ³ per month	na	3,230	na
Above 5 hm ³ per month	1,460	3,230	121%
Bulk	780	928	19%
Special Commercial*	697	928	33%
Commercial	1,283	2,321	80.9%
Power	857	928	8.3%
Power - Liberty	1,181	2,406	103.7%
Fertilizer - Feed (Engro)	117	140	19.7%
Fertilizer - Feed (others)	302	430	42.4%
Fertilizer - Fuel	1,023	1,857	81.5%
Cement	1,277	2,321	81.8%
General Industry (Non-Export)	1,054	1,650	56.5%
General Industry (Export)	819	952	16.3%
Captive (Non-Export)	1,087	1,650	51.8%
Captive (Export)	852	952	11.8%
CNG			
Region-I	1,371	2,321	69.3%
Region-II	1,350	2,321	71.9%
Weighted Average	655	983	50.1%

Source (s): OGRA, News Report, AHL Research, *Roti Tandoors highlighted in red, as approved by the ECC Jul'22

by PKR 348/bag to completely pass on the impact). Meanwhile, impact on FFBL would only be on its feed gas (PKR 150/bag for urea and PKR 65/bag for DAP) amid its dependency is on coal-based power plant for power generation/fuel.

Cement

Gas tariff for cement players using captive power plants has been recommended at PKR 1,650/mmbtu from the prevailing PKR 1,087/mmbtu (+52%). We highlight that very few key players have a captive gas or dual-fired power plant (namely LUCK, DGKC, MLCF and FCCL under the AHL cement universe). Albeit, only LUCK's dependency on gas based power generation remains notable. Therefore, our workings suggest that LUCK will have to raise prices by nearly PKR 18.3/bag in order to completely pass on the impact of higher gas prices (assuming 100% usage at its South plant and 50% at its North plant). We believe LUCK will pass on the impact.

Steel

Gas tariff for industries (non-exports) is expected to be raised to PKR 1,650/mmbtu (+57%). Long steel players (manufacturers of rebars: ASTL and MUGHAL) use very limited gas during the reheating process. Amreli Steels Limited (ASTL) uses around 40 m³/ton. Whereas Mughal Iron and Steel Industries (MUGHAL) consumes 35 m³/ton for billet reheating. We believe hike in gas tariff will necessitate a PKR 1,225/ton increase in ASTL's rebar prices to completely pass on the impact. While MUGHAL is not under our formal coverage, our back of the envelope workings suggest that the impact on MUGHAL might be slightly more adverse since it has a 27MW captive gas power plant which increases the company's exposure to the gas price hike, therefore prices may have to be increased by PKR 5,650/ton.

Chemical

The expected increase in gas price will negatively impact the chemical companies under AHL coverage (EPCL) as it fulfills the energy requirements through the gas-based captive power plant. Due to the prevailing gas shortage in the country, EPCL has also been affected adversely due to gas supply constraints. To manage this issue EPCL has entered into an interim agreement with SSGC for the supply of RLNG till 28th Feb'23. Currently, EPCL is being charged PKR 1,087/mmbtu while the Jan'23 rate of RLNG notified by OGRA is PKR 3,365/mmbtu (USD 14.32/mmbu). Going forward, we have assumed the company will rely on RLNG for three (3) months.

The current gas price for captive power plants (for EPCL) is PKR 1,087/mmbtu, which is expected to increase to PKR 1,650/mmbtu (+52%). Therefore, we estimate the hike in gas price to have a negative earnings impact in CY23E on EPCL of PKR 1.84/share (24%). It is pertinent to note, that EPCL will have to increase PVC prices by USD 49/ton to fully pass on the impact.

Electricity Tariff

As agreed with the Fund under the EFF, the authorities decided on regular implementation of power tariff adjustments in line with established formulas to implement the Circular Debt Management Plan (CDMP) as stated in the latest review. In this regard, the government increased electricity prices by PKR 7.92/kWh in Jul'22. The objective of this increase in the prices of electricity was to reduce the deficit and pass on the impact of higher capacity and energy payments to end consumers. Despite a hefty increase in electricity tariff in Jul'22, since then, PKR 700bn has piled up on account of numerous factors including 1) lower than expected power generation growth, 2) PKR depreciation (NEPRA tariff was set at a parity of PKR 200/USD), 3) lower recovery ratio at 83% as compared to last year's average of 93%, and 4) higher T&D losses at 17.5% as compared to 15.0% during the last year. It is expected that the gov't will increase the tariff by another PKR 7.5/kWh in the upcoming months.

Economy

Our initial estimates suggest that hike in electricity tariff to the tune of PKR 7.5/kWh will have an impact of PKR 450bn in form of incremental revenue in next six months against the expected shortfall of PKR 700bn in the power sector during 1HFY23.

In addition, direct impact of the aforementioned CPI would be around 85bps, however, there would be second round impact in the upcoming months.

For different sectors, we have estimated the broad impact on the sector as below:

Cement

Cement prices will have to be raised up by ~PKR 40-45/bag to completely pass on the impact of electricity tariff hike. The cement manufacturers already got room with the declining coal prices (RB2) from USD 295/ton to USD 170/ton during last 3 months, however, we believe that this will be passed on to the end consumer.

Steel

Long steel: We estimate rebar costs to jump up by PKR 5,000-5,500/ton post electricity tariff hike. We do highlight that scrap prices have already undergone a correction recently while due to import restrictions and unavailability of raw material, the rebar prices have been hiked by PKR 30k – 37k/ton on average during the last 45 days. However, we believe that this impact will also be passed on to the end consumer.

Flat Steel: Given the minimum electricity requirement in the flat steel rolling process, CRC prices will have to be increased by a nominal PKR 1,000-1,200/ton to completely pass on the impact of the higher electricity tariff.

Textile

Export-oriented sectors are eligible for a special electricity tariff at PKR 20/kWh. Therefore, there will be no impact on the textile sector (export-oriented), as per our initial understanding.

Outlook

The stock market has remained under pressure since the past few months on account of the delay in IMF's ninth review. However, it is expected that the incumbent government will soon undertake a number of measures to meet the pre-requisites of the program, which will bring some much needed clarity. To begin with, the government is set to bring a mini Budget where a tax of 1-2% flood levy will be imposed on imports. Our estimates suggest that this will help generate additional revenue of PKR 90-100bn in the second half of the ongoing fiscal year. In addition, additional tax to the tune of 40% will be imposed on Commercial Banks' FX income, with collection arriving at PKR 48bn. Apart from this, we expect the government to augment the electricity and gas tariff for end consumers, as rationalization of energy tariffs has been a key demand of the IMF, which may invigorate the E&P and gas utilities sector as it will help curb the quantum of future gas circular debt. Our preferred stocks are OGDC, PPL, MARI, MCB, FABL, MEBL, BAFL, LUCK, MLCF, FCCL, ENGRO, FFC, HUBC, PSO, SNGP and HUMNL. The KSE-100 is currently trading at a PER of 3.8x (2023) compared to Asia Pac regional average of 11.7x while offering a dividend yield of ~10.5% versus ~3.0% offered by the region.

Exhibit: IMF Program resumption prerequisites matrix and impact on different sectors

	Electricity price hike impact	Gas price hike impact	Currency depreciation	Additional taxation	Comment
E&P	Neutral	Positive	Positive	Neutral	Significant positive for E&Ps with respect to cash flows and future accumulation of gas circular debt. Clearance of gas circular debt arrears would re-rate E&Ps significantly.
Banks	Neutral	Neutral	Neutral	Negative	Taxation on FX income would be negative for the sector.
Fertilizer	Neutral	Negative	Neutral	Neutral	Gas tariff hike likely to be passed on to the end consumers with an estimated increase of PKR 350/bag in urea prices.
Cement	Negative	Negative	Negative	Neutral	Manufacturers have a significant room with the declining coal prices to absorb the costs, however, it is likely to be passed on to the end consumer.
OMCs	Neutral	Neutral	Neutral	Neutral	OMCs will be a beneficiary of the potential clearance of gas circular debt arrears (including RLNG).
Gas Utilities	Neutral	Positive	Negative	Neutral	Gas tariff hike would be cash flow positive while currency depreciation would be negative as the quantum of UFG will increase.
Autos	Negative	Neutral	Negative	Neutral	Higher cost of production amid currency depreciation and electricity tariff hike, demand already appears dull, while import curbs also pose threats to the sector.
Power	Positive	Neutral	Positive	Neutral	Electricity tariff hike will have a cash flow positive impact while currency depreciation would be positive for companies operating under Power Policy 2015.
Textiles	Neutral to Negative	Neutral to Negative	Positive	Neutral	Competitive tariff for export-oriented sectors are likely to remain unchanged, whereas cost will increase for local manufacturing. Currency depreciation to be positive for exporters.
Chemicals	Neutral	Negative	Positive	Neutral	Gas tariff hike would be negative, however partial pass-on cannot be ruled out. Currency impact would be positive amid \$ based margins.
Steel	Negative	Negative	Negative	Neutral	Partial pass on expected, however, all measures appear negative for the sector which is already facing the brunt of delay in LC opening.

Source (s): AHL Research

Pakistan: Quantitative Performance Criteria and Indicative Targets

Exhibit: Pakistan: Quantitative Performance Criteria and Indicative Targets

		FY2022												FY23		
		end-December				end-March				end-June				end-Sep	end-Dec	end-Mar
		Program CR 22/27	Adjusted Program	Actual	Status	Program CR 22/27	Adjusted Program	Actual	Status	Program CR 22/27	Adjusted Program	Actual	Status	Proposed (PC)	Proposed (PC)	Proposed (PC)
Performance Criteria																
Floor on net international reserves of the SBP	\$ mn	(5,450)	(3,242)	(3,210)	Met	(6,000)	(5,481)	(7,790)	Not Met	(5,100)	(4,653)	(10,784)	Not met	(11,450)	(10,300)	(9,800)
Ceiling on net domestic assets of the SBP, Stock	PKR bn	9,850	9,704	9,158	Met	10,233	10,326	9,986	Met	10,792	10,895	10,850	Met	11,127	11,213	11,327
Ceiling on SBP's stock of net foreign currency swaps/forward position, negative	\$ mn	---	---	4,382	---	4,300	---	4,293	Met	4,000	---	3,998	Met	4,000	4,000	4,000
Ceiling on the general government primary budget deficit, cumulative	PKR bn	(300)	(239)	(281)	Met	(389)	(292)	275	Not met	25	267	1,900	Not met	(339)	(924)	(897)
Ceiling on net government budgetary borrowing from the SBP, Stock	PKR bn	6,049	6,506	5,245	Met	6,049	6,506	5,127	Met	6,049	---	5,077	Met	5,791	5,791	5,791
Ceiling on the amount of government guarantees, Stock	PKR bn	2,797	---	2,673	Met	2,954	---	2,749	Met	2,956	---	2,771	Met	2,978	3,077	3,102
Cumulative floor on targeted cash transfers spending (BISP)	PKR bn	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	70	149	232
Continuous Performance Criteria																
Zero new flow of SBP's credit to general government		-	---	-	Met	-	---	-	Met	-	---	-	Met	-	-	-
Zero ceiling on accumulation of external public payment arrears by the general government		-	---	-	Met	-	---	-	Met	-	---	-	Met	-	-	-
Indicative Targets																
Cumulative floor on targeted cash transfers spending (BISP)	PKR bn	86	---	67	Not met	199	---	177	Not met	250	---	235	Not met	n.a.	n.a.	n.a.
Cumulative floor on general government budgetary health and education spending	PKR bn	783	---	729	Not met	1,287	---	1,198	Not met	2,014	---	1,796	Not met	446	1,070	1,771
Floor on net tax revenues collected by the FBR, cumulative	PKR bn	2,852	---	2,901	Met	4,343	---	4,365	Met	6,100	---	6,126	Met	1,569	3,511	5,304
Ceiling on net accumulation of tax refund arrears, cumulative	PKR bn	11	---	51	Not met	6	---	127	Not met	-	---	147	Not met	-	-	-
Ceiling on power sector payment arrears, cumulative	PKR bn	67	---	357	Not met	184	---	456	Not met	166	---	536	Not met	(208)	(157)	30
Gross issuance of PIBs, Sukuks, and Eurobonds, cumulative	PKR bn	2,450	---	2,969	Met	3,650	---	4,818	Met	4,900	---	6,267	Met	---	---	---

Source (s): IMF, AHL Research

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BUY	Upside* of subject security(ies) is more than +15% from last closing of market price(s)
HOLD	Upside* of subject security(ies) is between -15% and +15% from last closing of market price(s)
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- **Dividend Discounted Model (DDM)**
- **Sum of the Parts (SoTP)**
- **Justified Price to Book (JPTB)**
- **Reserved Base Valuation (RBV)**

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