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CHEMICAL
PAKISTAN

IPO Briefing SITARA PEROXIDE LTD.

An Investment Perspective



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Investment Consideration

Owing to the strong repute of the Sitara Group and the demand-supply dynamics of Hydrogen Peroxide [H₂O₂], we believe that Sitara Peroxide plant presents an excellent opportunity for high growth based investment. There are a couple of key points which warrant the success of the venture. Following is a brief round up of a few salient factors which explain the highlights of investing in the Sitara Peroxide plant.

Favorable Economic Scenario

The economy has grown at an average 7% for the last 6 years, real GDP growth is expected at more than 7% for FY07, a plausible target considering the 9 months of the current year. While most of the growth has accrued from the services sector, the manufacturing sector is currently in the midst of major expansions in almost all sectors e.g. cements, E & P, automobile, dairy etc. New capacities coming online portend an increase in the economy wide business cycle, and more importantly the corresponding growth of many upstream and downstream industries. Economy wise aggregate demand is expected to increase going forward, and in this set up of growing industrialization, demand of chemicals and raw materials is expected to surge as well. In this setting, a Hydrogen Peroxide plant will be of strategic advantage.

Surging Demand - Stackelberg Advantage

Principal demand drivers in the industry for H₂O₂ are the textile and the paper and board industry. H₂O₂ is also used in the detergent industry. Since the textile and paper industry face stupendous growth ahead with several expansions coming online, the demand for H₂O₂ will increase significantly going forth. With a capacity of 30,000 tons per annum, the plant is sufficient to supply the existing local demand, estimated at 33,000 tons per annum for 2007. We estimate that the plant will be able to cater to 95% of the local demand as soon as it is installed by the end of 2007. The firm faces first mover advantage, also known as the stackelberg move, in that its early entry and high volume generation will block other entrants.

Domestic Advantage

A major portion of the raw materials cost for downstream industries using H₂O₂ as a raw material is storage and handling costs. The transportation and other arrangements of H₂O₂ present themselves as inventory lags and bottlenecks for buyers, especially since the product is usually imported and has to be transported around the country. Not to mention that the nature of the substance is highly volatile and any contaminations can ruin its usage. In being a domestic producer Sitara Peroxide can reduce the transportation costs of many of its customers as well as aligning their inventory management systems for H₂O₂. Sitara Group's knowledge and experience of local industry will provide superior sales and distribution services. This aspect of the project is a value added proposition which further substantiates the prospects of Sitara Peroxide.

Recommendation

In light of the above summary of supporting factors and our DCF based fair value of PRs 25 (assumed at 5% terminal growth and 7% premium), we recommend a strong "subscribe" to investors at the offer price of PRs10 per share.

Table 1: Valuation Statistics

	2008F	2009F	2010F	2011F	2012F
EPS	0.64	0.77	1.73	2.72	2.02
PE	15.63	12.98	5.78	3.67	4.95
BV	10.14	10.16	10.39	11.11	10.63
DBV	0.98	0.984	0.96	0.9	0.94
Div	0.5	0.75	1.5	2	2.5
Div Yield	5.0%	7.5%	15.0%	20.0%	25.0%
ROE	6.3%	7.5%	16.8%	25.3%	18.6%

Source: IGI Research

Group Introduction

The Sitara Group of Industries is one of the oldest business conglomerates in the country. The group started with textile weaving in 1956 and has since grown into a full conglomerate housing the following companies.

- Sitara Chemical Industries
- Sitara Textile Industries
- Sitara Energy Limited
- Sitara Spinning Mills Limited
- Sitara Fabrics Limited
- Sitara Hamza (Pvt.) Limited
- Sitara International (Pvt.) Limited

Sitara Peroxide Introduction

The IPO pertains to Sitara Peroxide Limited. The company is to be listed on the KSE. Sitara Peroxide is an unusual stock, capable of providing the investor with a profitable bet on sound local entrepreneurship at the back of ongoing economic boom while offering the local minority investor high quality corporate governance.

Sitara Peroxide Limited is the first H₂O₂ manufacturing plant in the country being established by the renowned Sitara Group of Companies. The existing plant capacity of 30,000 tons per annum is nearly sufficient to meet the current local demand of the chemical giving the company a first mover advantage in the shape of blocked entry for other players. This import substituting plant aims to create value primarily by reducing storage and handling costs. The blocked entry will enable the company to capture the value thus created. The timing of entry is excellent as the global peroxide industry is showing signs of a cyclical upturn. This, together with Sitara Group's excellent track record in competitively manufacturing commodity chemicals through continuous strategic up gradation of manufacturing and operations technologies makes this an excellent investment opportunity for investors.

The key risk to the company's profitability stems from the adverse movement in international H₂O₂ prices. An analysis of the historical movements of international H₂O₂ prices in conjunction with the mild protection of 5% from the government of Pakistan reveals that the company is fairly insulated from extreme scenarios.

Acquisition of Land	Completed
Start of Civil Works	April 2006
Completion of Civil Works	January 2007
Installation of Machinery	June 2007
Start trial commercial production	June 2007
Start of commercial Production	July 2007

The group plans to further the production of Hydrogen Peroxide by expanding the existing plant to 60,000 tones per annum capacity by 2011. Since the demand for H₂O₂ will continue to grow at an estimated 18% CAGR for the next 5 years (contingent on the growth of real GDP and other industry), the company plans to consolidate its position and maintain market share by expanding in the future.

Group Synergy

The cost and experience synergy that the company can gain because of the associated companies like Sitara Energy and Sitara Textile will be instrumental in expediting the learning curve of the company. Investment in the Sitara Peroxide venture is a sure shot way to explore new horizons while benefiting oneself with the support of existing market players.

Table 2: Capacity & Production

Operating Shifts per day	3
Working Hours per Shift	8
Working days per annum	300
Production Capacity (tpa):	
H2O2	30,000

Source: IGI Research

Table 3: Growth Estimates

	2008	2009	2010	2011	2012
Inflation	8%	8%	8%	8%	8%
Capacity Utilization	*80%	85%	90%	95%	95%
Increase in Price of H2O2/ton (%)	0%	5%	5%	5%	5%
Increase in all Variable and Other					
Cost (incl. Electricity)		8%	8%	8%	8%
Tax rate (%)	35%	35%	35%	35%	35%
Dividends	5.0%	7.50%	15.0%	20.0%	25.0%

Source: IGI Research

Table 4: Working Capital Consideration

Working Capital:	Initial Working Capital	First & Subsequent Years	
Finishing Goods	10	10	Days of annual production
Raw Material	30	30	Days of Consumption
Chemicals	90	90	Days of Consumption
Work in Process	1	1	
Packing Material	10	10	Days of Consumption
Accounts Payable	30	30	
Accounts Receivable	10		
Stores & Spares	150	150	Times of (Repairs & Maintenance and Stores and Spare Cost)

Source: IGI Research

Sound Corporate Governance for the Minority Shareholder:

Investors in our equity market usually shy away from stocks of companies run by most local business groups due to corporate governance problems. With a consistent track record of dividends payments, multiple winnings of the top 25 companies award, a sound second generation of entrepreneurs and professional management, Sitara Group, we believe, has a very low Corporate Governance risk. Furthermore, the Group has recently become highly committed to Islamic Modes of Financing (which includes equity financing) as is evident from their pioneering role in the development of the ‘sukuk’ market. We, therefore, believe that approaching equity market for raising funds will be a routine feature of the Group’s operations going forward, moreover reducing the cost of capital for the form as well. This repeated interaction with the stock market will make this company highly sensitive to the Corporate Governance concerns of minority investors. Thus improving minority investor confidence and reducing the company’s cost of equity capital for any given amount of risk.

Hydrogen Peroxide – Important Industrial Chemical

Hydrogen Peroxide [H2O2] is a high-purity chemical manufactured from hydrogen and air. Generally sold as a 35% or 50% aqueous solution, H2O2 is one of the key chemical compounds used in various industrial processes. More than 50% of its industrial usage is in the Paper and Board sector followed by the Textile industry. Owing to its oxidizing properties, the peroxide is used as a bleaching agent in both paper milling and textile cleansing. Water cleansing and purification also features the use of H2O2 as an organic de-odourizer.

Storage and transportation of H2O2 requires special equipment and thus its transportation costs accrue a great portion of the chemical’s cost. During transport a major concern is dilution of the chemical and contamination with water.

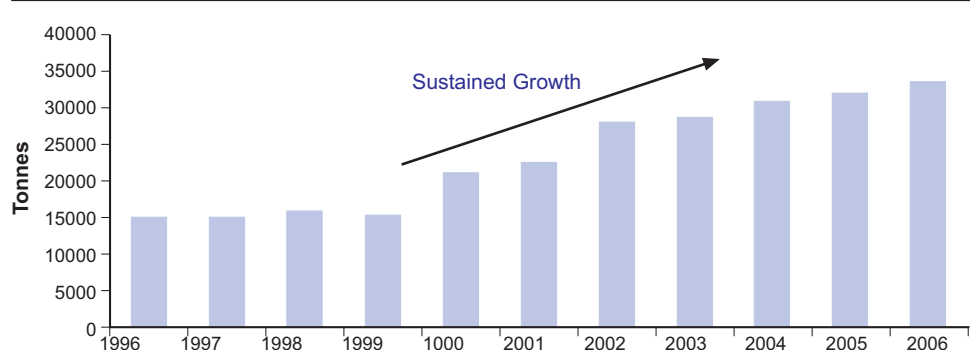
H2O2 Demand in Pakistan

While it is difficult to present a figure pertaining to the total volume or value of H2O2 imports in the country, it can be sufficiently stated that the country remains completely dependant on external producers. As a textile producing country, Pakistan is a net importer of H2O2 along with India, Bangladesh and certain African Countries. China remains more than self sufficient in the production of H2O2. Regionally, Turkey and China are net exporters of the chemical. Internationally, ‘Solvay’ is the biggest producer of H2O2 and is based in Australia.

The main two industries where H2O2 is used in Pakistan are the ‘Paper and Board Industry’ and the ‘Textile Industry’. The use of H2O2 central to the industrial production of both paper and textile and hence remains a prominent, and growing, feature of Pakistan’s import bill.

Locally, H2O2 from China is widely available and is reported to cost anywhere between PKR11 to PKR15 depending on oxidizing intensity. Usually a 35% concentration is used in the textile and paper milling industry. Most of the chemical’s application in Pakistan is based in the paper and boards segment.

Chart 1: Demand Profile - Historical Import of H2O2



Source: IGI Research

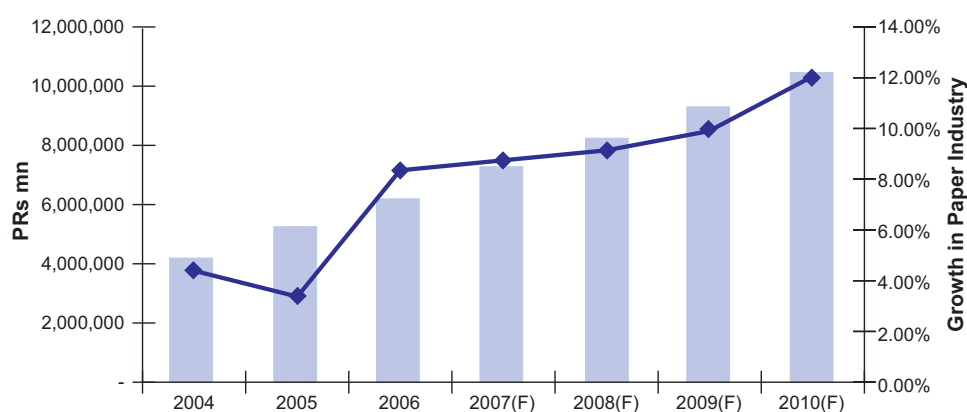
CAGR of Total Paper Industry	9.88%
CAGR of GDP/cap. growth	12%
CAGR of GNP	8.35%
CAGR of Consumption	15%

Derived Demand – Paper and Board

Riding on the back of robust GDP growth and accelerated rise in private consumer expenditures, the overall demand of consumer goods has seen an unparalleled rise in recent years. The paper and packaging solution companies are key benefactors of the recent growth in real GDP and increased household incomes.

With more than 50% of the total share in the packaging industry, Packages Limited is the industry leader. It can be thus safely assumed that in this regard, Packages remains a staple user of H₂O₂ in Pakistan. As a proxy for the stability in and potential of H₂O₂ demand in the country, one can use the production outlook of Packages Ltd.

Chart 2: GDP and Paper Industry growth



Source: IGI Research

With the optimistic figures of economy wise growth and growth in private consumption expenditure, paper and its various forms will sustain supreme growth numbers. In light of capacity to sustain the growth, as this report is being written, both Packages Ltd. and Century Paper and Board Mills are undertaking heavy expansion in their respective premises. Packages Ltd. is expected to increase its present capacity of 100,000 tonnes to 300,000 tonnes by the end of 2007, while Century is expected to bring online 50,000 tonnes capacity by the end of 2008, bringing its total capacity up to 110,000 tonnes.

Table 5: Derived Demand of H₂O₂ from Paper Industry

Growth Rate (%)	2005	2006	2007(F)	2008(F)	2009(F)	2010(F)
Real GDP (FC)	18.16%	17.59%	12.75%	12.75%	12.75%	12.75%
Population	2.67%	1.97%	1.80%	1.80%	1.80%	1.80%
GDP per Capita	15.08%	15.32%	10.76%	10.76%	10.76%	10.76%
Consumption Expenditure	22.61%	22.31%	15.00%	15.00%	12.00%	12.00%
Total Paper and Board (ton.)	439,345	476,565	518,269	563,622	612,944	666,581
Industry	3.50%	8.47%	8.75%	9.25%	10%	12%
Paper and Board Exports	14.77%	18.00%	15.00%	17.00%	20.00%	20.00%
Derived Demand of H₂O₂			13.17%	13.31%	11.74%	11.85%

Source: IGI Research

The above table illustrates convincingly the sustained demand for H₂O₂ in coming years, through paper and packaging needs alone. It is to be noted that paper pulp is the key imported substance in Pakistan's paper industry and in the processing of this pulp, H₂O₂ is used. If Packages Ltd. or Century could invest in a H₂O₂ plant, the resultant effect on their cost structures would be immense.

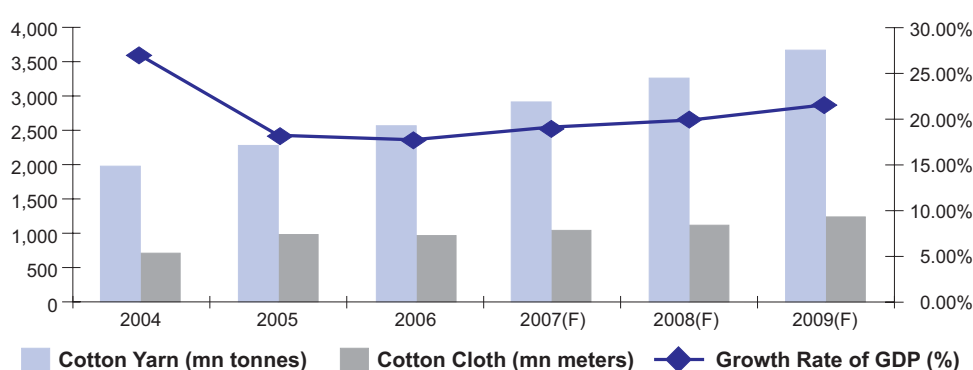
CAGR of Yarn Production	10.18%
CAGR of Cloth Production	5.76%
CAGR of GDP/cap. growth	12%
CAGR of GNP	8.35%
CAGR of Consumption	15%

Derived Demand – Textile Industry

The emphasis and international position of Pakistan's textile industry needs no introduction. Pakistan historically has been a net exporter of both finished (cloth) and intermediary (yarn) textile products. The figures for FY06 reveal that textiles present nearly half of our exports in US Dollar terms.

While it is impossible to exactly predict the textile output in a country because of the dependence on weather and other inputs, it can be safely estimated that a textile based economy like Pakistan (as share of GDP) will continue to bank on, and fully support, this sector's performance. In fact, given this year's dismal output in textile because of excess rain in Sindh and lower Punjab, the government has proposed tax reductions for the sector as a whole to boost its international competitiveness against Egyptian and Chinese competition.

Chart 3: GDP and Textile Industry growth



Source: IGI Research

An interesting feature of the sector, specifically in Pakistan remains the business plan of the larger producers. Though it is not within the scope of relevance of this report, it is necessary to mention that the industry comprises houses which are vertically integrated to provide in-house cost advantage i.e. a single house is involved in producing both finished cloth an intermediate product like yarn and other variants. In that respect, it holds special relevance in light of H₂O₂ demand that a house involved in final value added product like Nishat Lawn will also be involved in primary processes like ginning, washing and bleaching.

H₂O₂ remains a crucial chemical in the textile industry in that it is involved in the cleaning and bleaching of the yarn that further goes into ginning and designing. Other chemical substitutes to H₂O₂ are not preferred in this trade.

Table 6: Derived Demand of H₂O₂ from Textile Industry

Growth Rate (%)	2005	2006	2007(F)	2008(F)	2009(F)	2010(F)
Real GDP)	7.30%	6.20%	7.50%	7.50%	7.50%	7.50%
Population	2.67%	1.97%	1.80%	1.80%	1.80%	1.80%
GDP per Capita	5.20%	4.50%	5.30%	5.30%	5.30%	5.30%
Consumption Expenditure	22.61%	22.31%	15.00%	15.00%	12.00%	12.00%
Cotton Yarn	18.25%	11.62%	13.00%	13.00%	12.00%	10.00%
Cotton Cloth	35.43%	0.54%	7.00%	10.00%	10.00%	7.00%
Exports	9.07%	10.19%	10.00%	12.00%	12.00%	8.00%
FDI in Industry	11%	20%	10%	10%	10%	5%
Derived Demand for H₂O₂			10.75%	11.65%	10.90%	8.15%

Source: IGI Research

The conclusion in case of textile applications of H₂O₂ is that because of the dependence of the economy as a whole on Textile, and of the strain on the import bill, H₂O₂ becomes a key strategy point for the profitability of not only the sector but also for the trade deficit reduction.

Investment Risks

International H₂O₂ Price

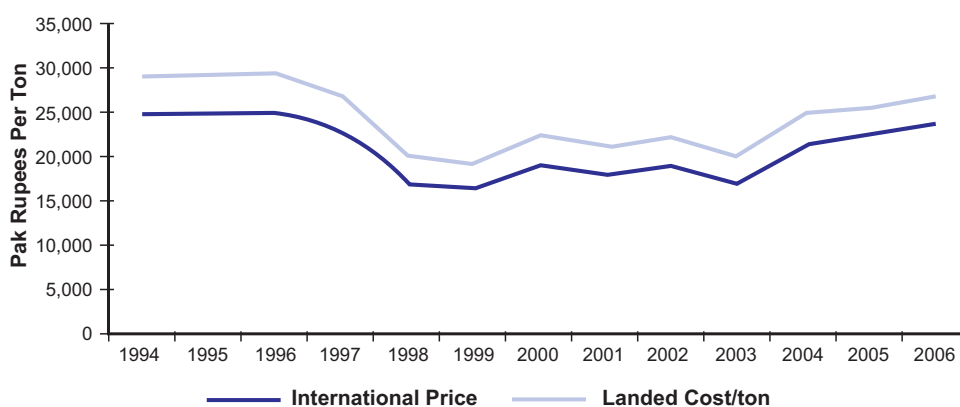
For most commodity chemicals businesses, the main risk stems from the cyclical nature in prices. As can be seen from the above plot, the international prices of H₂O₂ do exhibit the cyclical nature typical of commodity chemicals. But cyclical downturns over the last 10 year period appear to be short lived and prices move close to their long term trend. The major downturn occurred after 1995 when many large global players simultaneously increased their capacities. The global demand for the product, however, continued to grow at a constant rate hence creating a temporary oversupply position. This phenomenon occurred in many other commodity chemicals markets as well e.g. PTA, where the downturn was extreme. From the year 2003 onwards, the global industry strongly appears to be going through a phase of an upturn as no more drastic capacity additions have taken place and the demand has continued to grow steadily. At the time of writing this report, we have no information of any global supply-demand disrupting large capacity additions. We believe that large global producers are not going to commit the same error again in the near future.

Even taking the extreme scenario of a large downturn, the landed cost of imported peroxide touches PRs20,000 tpa.

We believe that the 5% cushion available to the local manufacturing is enough for the company to stay viable during worst scenarios.

Commodity chemicals businesses typically compete on cost efficiencies which in turn are generated by achieving economies of scale as well as through continuous adoption of new technologies for manufacturing and operations. Sitara Group's track record in both these areas is remarkable in their related flagship business of manufacturing caustic soda. While visiting the peroxide plant, we were also taken to their caustic soda plant and an optimal utilization of state of the art technology for manufacturing and operations was very visible.

Chart 4: International Price & Landed Cost of H₂O₂



Source: IGI Research

The Scale-Technology Tradeoff

Although the "process technology" advancement for manufacturing H₂O₂ is not fast paced, there remains a risk that the existing technology may become outdated in a few years time. A key dilemma, hence, for a new entrant is to decide on the scale of commitment to the existing technology. A careful strategic analysis may suggest a smaller than the optimal (economies of scale wise) plant size and gradual increase in scale while adopting the newer technologies. A marginal protection from imports, therefore, in the form of import duties until the plant achieves a global scale may be desirable to develop this industry in Pakistan. In view of a sound economic argument for the development of this industry locally and the associated national foreign exchange savings, we believe that the Government of Pakistan will continue to provide the minimum protection against imports in the meanwhile.

Summary and Conclusions

The demand and the supply factors of hydrogen peroxide [H₂O₂] and the strong financial prospect of the company add together to present a promising case of growth based investment. The company's added advantage of being the first mover as well as of cost-synergy between group companies renders it efficiency and greater market access.

With production initiated and capacity utilization of 100%, we further anticipate that the company will be able to fulfill its supply commitment, and fare profitable growth going forward.

We recommend a strong "subscribe" to the IPO priced at PRs 10. We expect the fair worth of the company to be PRs 25 per share, representing a 150% upside potential.

Table 7: Hydrogen Peroxide

tons	2005	2006	2007F	2008F	2009F	2010F	2011F	2012F
Demand	38,000	45,000	55,000	63,250	72,738	83,648	92,013	101,214
Supply								
Sitara Peroxide			18,000	30,000	30,000	30,000	60,000	60,000
Import Solution	36,000	43,000	37,000	33,250	42,738	53,648	32,013	41,214

Source: SBP 2006 Annual Report & IGI Research

Valuation Summary

The following pages present a snap shot of the valuation technique and the resultant numbers.

Table 8: Sensitivity Analysis Valuation

		WACC				
		13.64%	14.64%	15.64%	16.64%	17.64%
Terminal Growth Rate	0%	27	25	23	21	20
	1%	28	26	24	22	20
	2%	30	27	25	23	21
	3%	32	29	26	24	22
	4%	35	31	28	26	23

Source: IGI Research

Table 9: Sensitivity Analysis Valuation

		PE Multiple				
		7	8	9	10	11
Terminal Growth Rate	80%	27	25	23	21	20
	85%	28	26	24	22	20
	90%	30	27	25	23	21
	95%	32	29	26	24	22
	100%	35	31	28	26	23

Source: IGI Research

Projected Financials

Table 10: Projected Balance Sheet

(Rs. In '000)	2008F	2009F	2011F	2011F	2012F
CURRENT ASSETS					
Cash at bank	38,887	49,524	101,715	157,764	212,554
Accounts receivable	19,333	22,269	24,760	27,445	28,868
Inventories:					
Finished goods	15,469	16,234	17,118	18,124	18,554
Chemicals - Initial Filling	211,353	211,353	211,353	211,353	211,353
Chemicals	10,571	11,794	13,112	14,532	15,259
WIP	1,547	1,623	1,172	1,812	1,855
Packing	2,720	3,035	3,374	3,739	3,926
Stores & spares / other	11,262	12,388	13,627	14,990	16,489
Total Current Assets	311,143	328,219	386,771	449,760	508,858
FIXED ASSETS					
Fixed Assets	1,119,143	1,014,137	919,458	834,170	575,329
Unamortized preliminary					
Unamortized preliminary Expenses	13,500	12,000	10,500	9,000	7,500
Total fixed assets	1,132,759	1,026,137	929,958	843,170	764,829
CURRENT LIABILITIES					
W.P.P.F.	2,875	3,444	7,456	11,602	14,327
Current Maturity of Demand Finance	100,000	100,000	100,000	100,000	100,000
Dividends	27,550	41,325	82,650	110,200	137,750
Taxes	2,900	3,340	3,714	4,117	79,035
Short term borrowing	22,135	14,014	15,115	16,328	16,906
Short term borrowing against					
Chemicals - Initial Filling	101,449	101,449	101,449	101,449	101,449
Creditors (Salaries, Packing, Utilities)	21,595	24,262	26,742	29,411	30,841
Raw mat. (Gas)	6,290	6,683	7,076	7,469	7,469
Total Current Liabilities	285,158	294,517	344,202	380,577	487,778
LONG TERM LOANS					
Demand Finance	600,000	500,000	400,000	300,000	200,000
Total Long Term Liabilities	600,000	500,000	400,000	300,000	200,000
Total liabilities	885,158	794,517	744,202	680,577	687,778
CAPITAL AND RESERVES					
Issued Subscribed and Paid up Capital	551,000	551,000	551,000	551,000	551,000
Unappropriated profit	7,774	8,838	21,527	61,353	34,909
Total Shareholders Equity	558,774	559,838	572,527	612,353	585,909

Source: IGI Research

Table 11: Projected Profit & Loss

(Rs. In '000)	2008F	2009F	2011F	2011F	2012F
Sales	580,000	668,063	742,809	823,361	866,048
	580,000	668,063	742,809	823,361	866,048
Cost of Sales:					
Raw & Packing mat.	184,957	202,659	221,432	241,350	249,683
Salaries & Wages	9,774	10,263	10,776	11,315	11,880
Utilities	120,134	133,237	147,350	162,542	170,669
Manufacturing overhead	32,476	35,724	39,296	43,226	47,548
Depreciation	116,741	105,123	94,679	85,288	76,841
Manufacturing cost	464,082	487,005	513,533	543,720	556,622
Finishing goods					
Opening	0	15,469	16,234	17,118	18,124
Closing	(15,469)	(16,234)	(17,118)	(18,124)	(18,554)
Cost of sales	448,613	486,241	512,649	542,713	556,192
Gross Profit	131,387	181,822	230,161	280,647	309,857
Operating expenses					
Administrative	17,582	18,461	19,384	20,353	21,371
Selling	14,500	16,702	18,570	20,584	21,651
	32,082	35,163	37,954	40,937	43,022
Operating Profit	99,305	146,659	192,206	239,710	266,834
Financial charges	56,736	95,956	84,198	72,464	60,667
Net profit/(loss)	42,569	50,703	108,009	167,246	206,168
Other charges					
Preliminary expenses	1,500	1,500	1,500	1,500	1,500
W.P.P.F	2,875	3,444	7,456	11,602	14,327
	4,375	4,944	8,956	13,102	15,827
Pretax Profit/(loss)	38,194	45,759	99,053	154,143	190,341
Taxation	2,900	3,340	3,714	4,117	79,035
Profit/(loss) after tax	35,294	42,419	95,339	150,027	111,036
Dividends	27,550	41,325	82,650	110,200	137,750
Unappr. profit/(loss)	7,774	1,094	12,689	39,827	(26,444)
Balance b / d	0,	7,774	8,838	21,527	61,353
Balance c/f	7,774	8,838	21,527	61,353	34,909

Source: IGI Research

Table 12: Projected Cash Flow Statement

(Rs. In '000)	2008F	2009F	2011F	2011F	2012F
SOURCES:					
Operating Profit	99,305	146,659	192,206	239,710	266,834
Add: Depreciation	116,741	105,123	94,679	85,288	76,841
Funds generated from operations	216,046	251,782	286,885	324,998	343,676
Other sources:	-	-	-	-	-
Equity	-	-	-	-	-
Demand finance	-	-	-	-	-
Total source	216,046	251,782	286,885	324,998	343,676
USES:					
Demand Finance	-	100,000	100,000	100,000	100,000
Investing Activities:	-	-	-	-	-
Other payments:					
Financial charges	56,736	95,956	84,198	72,464	60,667
W.P.P.F	0	2,875	3,444	7,456	11,602
Dividend	0	27,550	41,325	82,650	110,220
Taxes	0	2,900	3,340	3,714	4,117
(Inc)/dec in current liabilities	72,789	5,425	(3,974)	(4,276)	(2,008)
Inc / (dec) in current assets	60,903	6,439	6,360	6,941	4,309
	190,428	241,145	234,693	268,949	288,886
Surplus / (deficit)	25,618	10,637	52,192	56,049	54,790
Opening Cash Balance	13,269	38,887	49,524	101,715	157,764
Closing Cash Balance	38,887	49,524	101,715	157,764	212,554

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I, Aymen Saeed, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject, securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this research report. Moreover, I certify that as IGI Securities is a wholly owned subsidiary of the IGI Investment Bank, which is co-lead underwriter for the IPO, my views are independent and reflect my understanding and evaluation of the investment scenario. The reader is to fully read and understand the document in light of the above mentioned facts .

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