Faysal Bank Limited

Islamic conversion adding torque to the flywheel

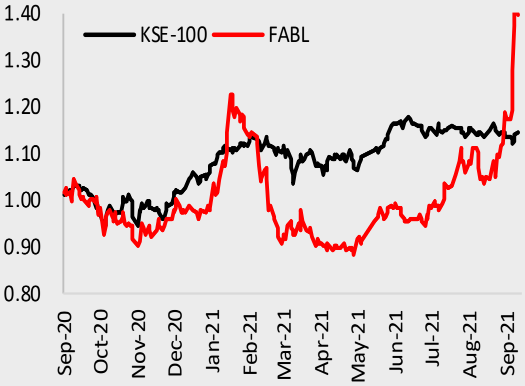
Pakistan

FABL PA		**Outperform**
Price (LDCP)	Rs	25.7
Jun-22 Target Price	Rs	36.0
Upside/Downside	%	39.9
12M Target Price	Rs	38.0
- 2-Stage Gordon growth model		
Sector		Banks
Market cap	Rs bn	39.1
30-day avg turnover	$ m	0.3
Market cap	$ m	250.4
Freet float	m	379.4
Shares issued	m	1,517.7

Investment fundamentals

Year end Dec		2020A	2021E	2022E	2023E
NII	mn	24,548	24,970	29,586	38,250
NFI	m	8,352	9,146	9,238	9,188
Fee Income	%	4,085	5,337	5,486	5,526
Total Income	m	33,056	34,116	38,824	47,438
Non. Markup Exp.	m	19,911	20,250	22,980	25,929
A.Expenses	m	19,570	19,973	22,676	25,521
Provisions		2,254	582	1,473	2,707
PBT		10,891	13,283	14,371	18,802
PAT	Rs	6,681	8,095	8,766	11,469
EPS	%	4.4	5.3	5.8	7.6
DPS	%	-	1.5	2.0	2.0
EPS Growth	x	11.3	21.2	8.3	30.8
Payout Ratio		-	28.1	34.6	26.5
DY	%	-	5.8	7.8	7.8
ADR	%	62.8	60.7	62.7	64.7
Infection Ratio	%	7.7	6.3	5.5	4.9
Coverage Ratio	x	82.2	86.5	91.2	94.0
IDR	x	51.1	50.5	21.3	20.4
Deposit Growth	x	18.1	16.1	12.6	19.3
Total CAR	x	18.8	18.6	17.3	16.9

FABL KSE 100 Relative Performance



Source: PSX, Foundation Research, Sep 2021

Analysts

Masroor Zaidi masroor@fs.com.pk
+92 21 3561 2290-94 Ext 313

Foundation Securities (Pvt) Ltd
Thursday, September 16, 2021

Event

- We start out initiation on Faysal Bank Limited (FABL) with an Outperform stance on the bank due to 1) its ongoing conversion into a full fledge Islamic bank, 2) swift transfer of asset base, 3) improving asset quality and 4) strong capital buffers which would support sustainable cash payouts. We expect earnings to grow with a 3/5yr CAGR of 10/12% even after incorporation of decent provisioning expense. Our Jun-22 TP of Rs36/sh translating into a capital upside of 40% along with a dividend yield of 6%.

Impact

- **Islamic Conversion calls for rerating:** Faysal Bank Limited (FABL) is on the track to convert its operations into full fledge Islamic bank. Conversion of advances has been taking the lead in this regard with 74% conversion rate followed by deposits (48%) and investments (21%). We expect next lag of conversion to be challenging as on the deposit front CA/SA is leading the pack with 63/52% conversion rate while conversion of fixed deposits has remained on the lower side. Conversion of term deposits depends on the maturity profile.

- **Swift conversion of asset base:** We believe that the adjustment of asset base would be swift. We have incorporated major chunk of Islamic conversion to take place by the end of CY22. On the advances front, the bank has already converted almost three quarter of its gross advances. However, conversion in the investment front remained sluggish as the bank has only been able to convert 21% of its investments. Major hurdle that has been slowing down investment conversion is the lack of availability of shariah compliant investment instruments. Issuance of GOP's Ijarah sukuk has been encouraging in recent past but still remained short of fulfilling the growing need of Islamic industry appetite. Going forward, we expect FABL's ADR to hover in the early to mid-60s whereas the bank's IDR is likely to take a dip post conversion to sync with the Islamic peers.

- **Improving asset quality:** The bank has been keenly working on cleansing of the loan book which is evident by decent reversals and write offs during past few years. This has playing its role to improve infection ratio. Our comfort on the loan book is driven by high concentration in corporate loans which would provide stability to the lending portfolio. Going forward, we expect this trend to continue and improvement in asset quality would lift provisions and keep credit concerns at bay.

- **Strong capital buffers:** Management has been holding back its cash payouts since CY15 until recently when it announced a cash dividend of Rs0.5/sh. We expect cash payouts to continue going forward as the bank currently stands at comfortable capital levels with CET-1 CAR of 16% and total CAR of 19% i.e. well above the regulatory requirements set by State Bank of Pakistan (SBP).

Price Catalyst

- June-22 TP: Rs36/sh based on blended methodology.

- Catalyst: 1) higher deposit growth, 2) timely sukuk issuance, 3) earlier increase in interest rates

- Risks: 1) lower coverage and 2) lower availability of shariah compliant investment instruments

Outlook

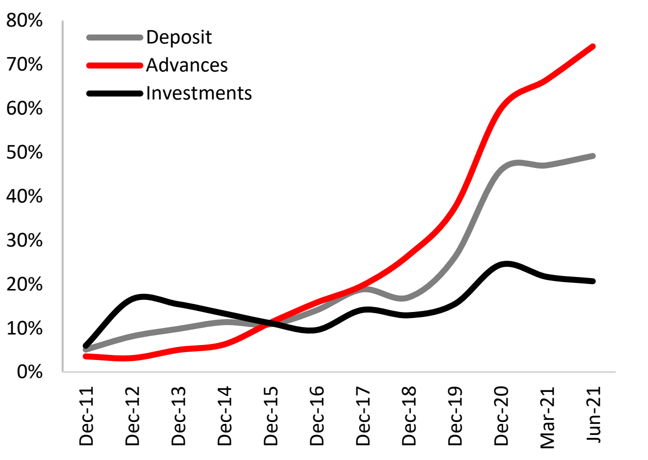
- We have an "Outperform" stance on the scrip with Jun-22 TP of Rs36/sh.

Why we have an "Outperform" stance

We expect FABL's earnings outlook to substantially improve with a 3yr earnings CAGR of 20% which would primarily be driven by the improvement in Net Interest Income (NII) which is estimated to grow with a 3yr CAGR of 17%. Further support is likely to come from recovery in fee income with a 3yr CAGR of 11%. However, upside from increase in total income is likely to be diluted by higher provision expense as the bank would improve its coverage ratio that currently stands at 85% i.e. lower compared to industry average of 98% to accommodate for the IFRS 9 implementation. However, the most crucial factor that is supposed to substantially improve the profitability outlook of the bank and make it more appealing for the investors is FABL's Islamic conversion. Management has shared their belief to achieve this monumental task by the mid of CY22 beating its previously set target of end of CY22. However, we being cautiously optimistic has assumed conversion to conclude by CY22.

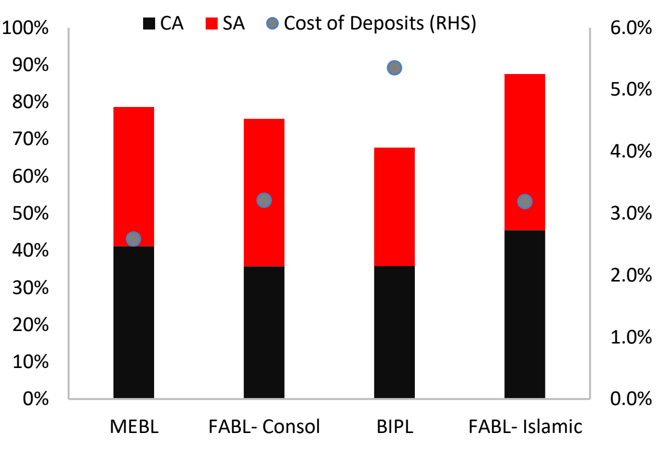
It has been more than a decade since Faysal Bank Limited (FABL) has started conversion of its conventional operations in the Islamic to achieve the target of being a Islamic bank. However, the pace of this conversion remained slow as the bank was only able to convert 17/27/13% of its deposits /advances/investments whereas conversion of asset base stood at 20% by the end of Dec'18. This conversion process picked up pace since CY19 as a result of which FABL's deposits /advances/investments have now attained the conversion ratio of 48/74/21%. With the progression of this conversion, profitability outlook of the bank is estimated to improve given the timely issuance of shariah compliant investment instrument takes place. Furthermore, FABL's CA/SA mix in the consolidated deposit stands at 36/40% taking total CASA to 76% i.e. only 3bps short of MEBL's CASA mix. This high CASA has kept its cost of deposit well contained. However, FABL's Islamic CASA mix is on the higher side at 88% with CA/SA of 45/42% due to higher CA/SA deposit conversion rate of 63/52% compared to low conversion rate of 25% for term deposits. Despite our assumption of normalizing CASA mix as conversion takes place, cost of deposits is estimated to stay on the lower side. As a result of this contained cost of deposits and better funds deployment, NII is estimated remain upbeat in next few years and grow with a CAGR of 16%.To facilitate with the Islamic conversion, FABL has restricted its payout since past 5yrs until the recently announced payout in 2QCY21. As a result of this cautious approach, the bank now possess one of the highest CET-1 (16.28%) and CAR of 18.78%, sufficient enough to absorb any potential credit related stress that may occur in the future.

Fig 01: Islamic conversion picking up pace



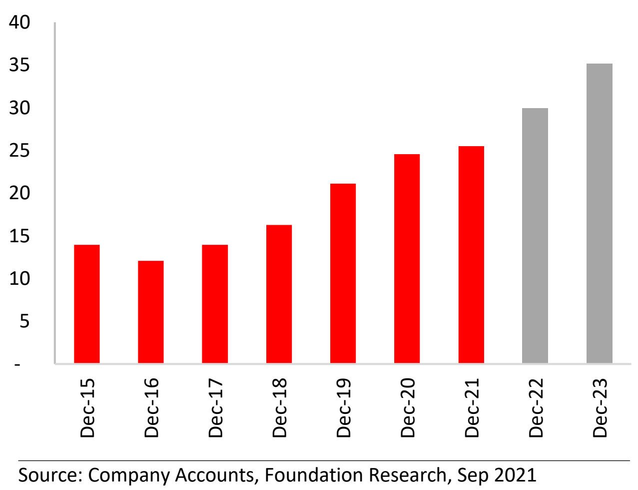
Source: Company Accounts, Foundation Research, Sep 2021

Fig 02: ..low cost of deposits



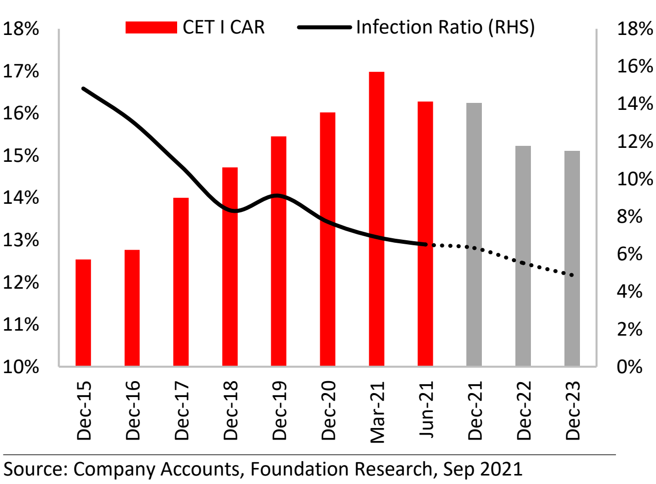
Source: Company Accounts, Foundation Research, Sep 2021

Fig 03: …NII to remain upbeat



Source: Company Accounts, Foundation Research, Sep 2021

Fig 04: Strong capital buffer and improving infection



Source: Company Accounts, Foundation Research, Sep 2021

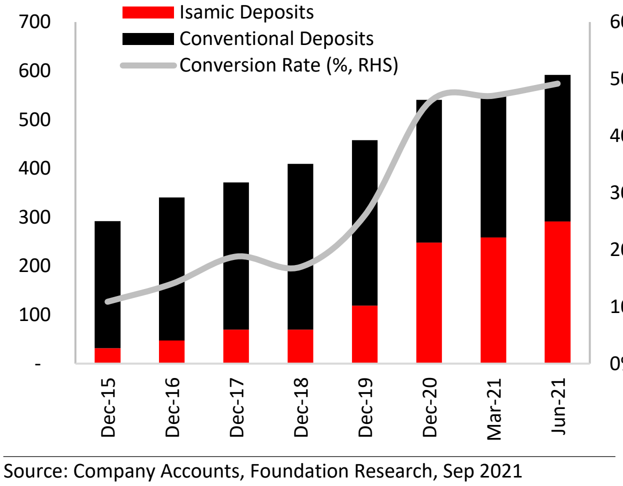
Islamic conversion calls for rerating

Lately investors have become much enthusiastic about the stock as much awaited Islamic conversion picks up pace to enter its advance stage. This excitement is primarily pinned on its comparison with the Meezan Bank Limited (superior peer) that is currently trading at a P/BV multiple of 2.79x compared to FABL's P/BV of 0.55. We believe that the Islamic conversion calls for rerating, however, we don't advocate the rerating of FABL to MEBL's multiple as we don't estimate it to achieve deposit growth or ROE generation similar to MEBL.

We would like to take a step back to first analyze the trajectory of this conversion to make our view on the future outlook of the bank. As of 2QCY21, on the deposit front, FABL has converted 48% of its deposit base into Islamic while 3yr CAGR of its overall deposit growth during this period has remained 13% vs. 15% industry deposit growth and 19% growth in Islamic industry deposits. So far, conversion of the deposit base is mainly driven by the conversion of current and saving account deposits as the bank has converted 63/52% of its current/saving deposits. However, conversion on the fixed deposits have been sluggish with a lower conversion rate of 25%. To highlight, these fixed deposits only accounts for 25% of the total deposit vs. 40/36% weight of saving/current account deposits. We opine that the conversion of all current account deposits would be swift which may boost up the overall conversion ratio to 63%. However, conversion of saving/fixed deposits might be a bit challenging task as rates offered on Islamic products are relatively lower than conventional peers. To resolve this concern, management of the bank has shared that they plan to offer slightly better rate for clients during the transition period.

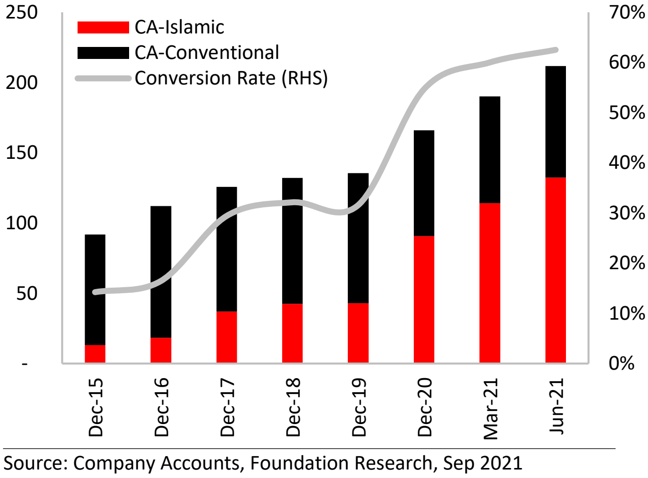
On the branches front, the bank has converted 521 (90%) of its branches into Islamic as conventional branches has now reduced to 75. Management of the bank shared that the conversion of some big conventional branches would be slow and may take time. If we highlight the clientele base, major chunk (66%) of FABL deposit base is composed of deposits from private sector which indicates relatively higher client wise deposit concentration highlighting flight risk. Whereas, MEBL's deposit base is mainly composed similar portion (65%) for retail deposits which indicate lower deposit concentration. However, management of the bank aims to expand their branch network with the addition of ~30-35 branches every year, which may increase the share of retail deposits bringing more stability in the composition mix.

Fig 5: Almost half of the deposits converted



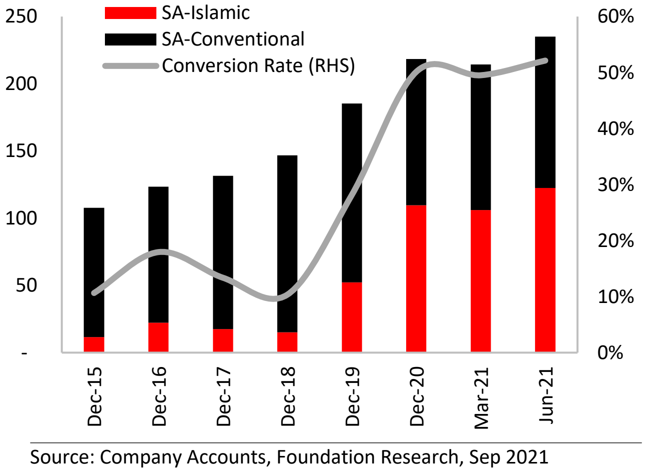
Source: Company Accounts, Foundation Research, Sep 2021

Fig 6: Conversion of CA remains impressive



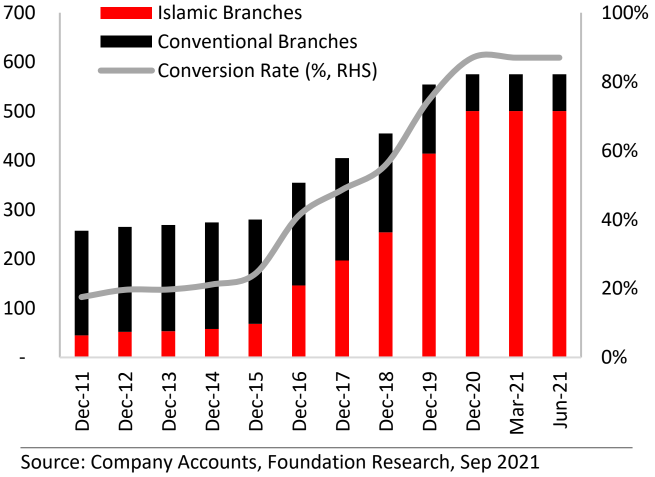
Source: Company Accounts, Foundation Research, Sep 2021

Fig 7: SA conversion stands at 52%



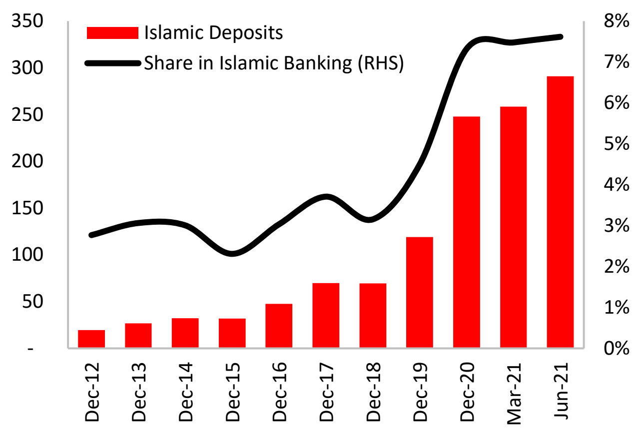
Source: Company Accounts, Foundation Research, Sep 2021

Fig 8: Major chunk (87%) of the branches converted



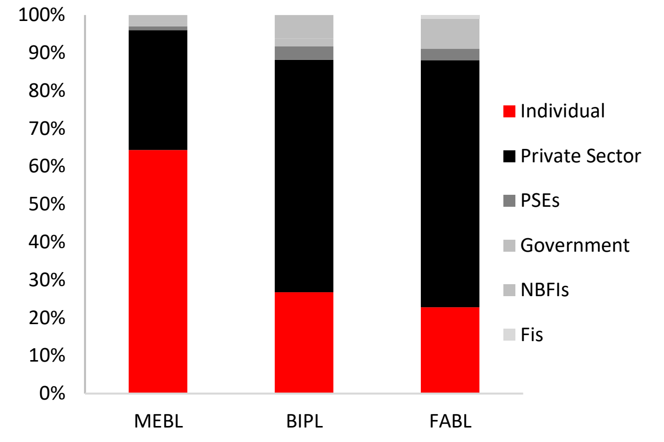
Source: Company Accounts, Foundation Research, Sep 2021

Fig 9: Share in Islamic deposit base stands at 7.6%



Source: Company Accounts, SBP, FSL Research, Sep 2021

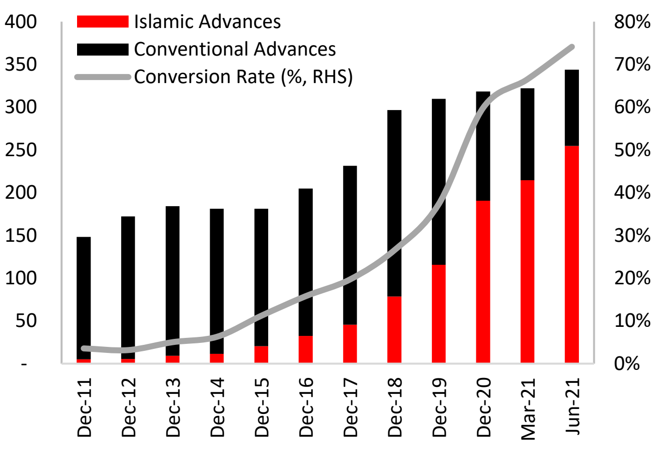
Fig 10: Deposit composition similar to BIPL



Source: Company Accounts, Foundation Research, Sep 2021

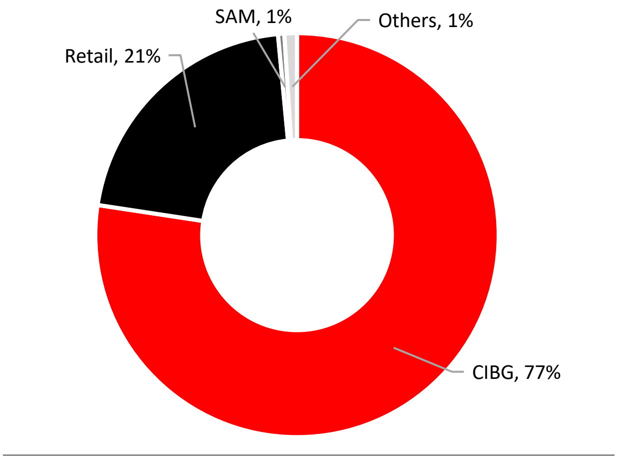
FABL's advances portfolio has been leading the conversion march as the bank has now converted 74% of its loan book into Islamic. Major portion of this conversion has been witnessed in past few years as the bank has almost doubled its conversion since Dec'19. High concentration of corporate loans gives us comfort as it would ease the process of conversion. However, investment portfolio represents almost the "inverted image" as conversion has only reached to 21% so far. Major portion of these investments (78%) are in Government Securities out of which only 11% are invested in Sukuks and Bai Muajjal. This low concentration is likely a result of lack of availability of shariah compliant investment instruments. Management is confident that they are working closely with the central bank (SBP) to resolve this problem. We do agree with the point that the stock of sukuks would improve going forward, however, its quantum and timeline may differ.

Fig 11: Three quarter of loan portfolio is now Islamic



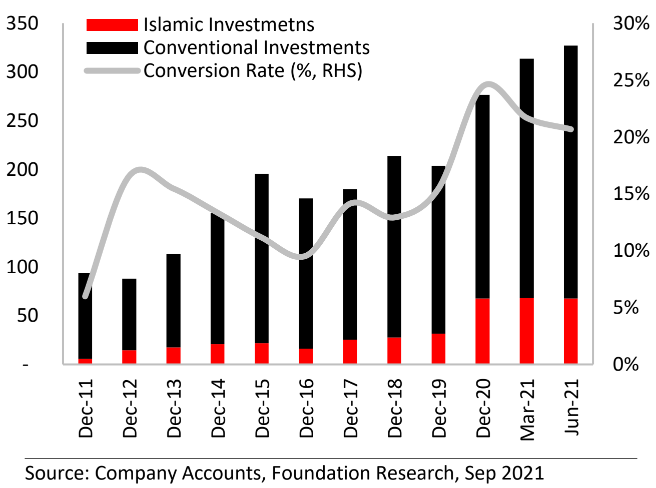
Source: Company Accounts, Foundation Research, Sep 2021

Fig 12: High concentration of corporate loans



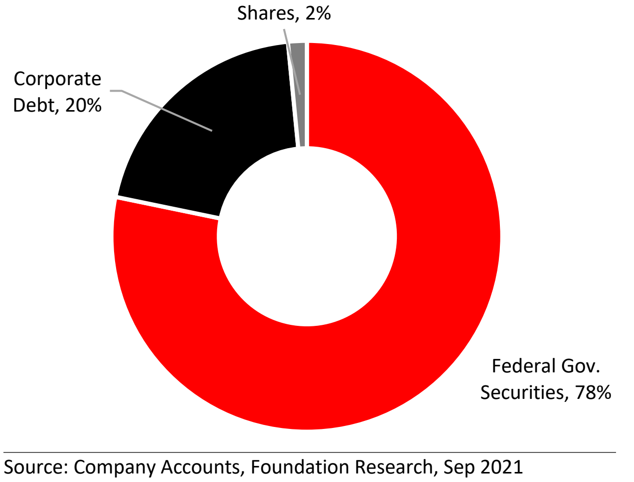
Source: Company Accounts, Foundation Research, Sep 2021

Fig 13: Investment conversion remained low



Source: Company Accounts, Foundation Research, Sep 2021

Fig 14: with higher concentration in Federal securities



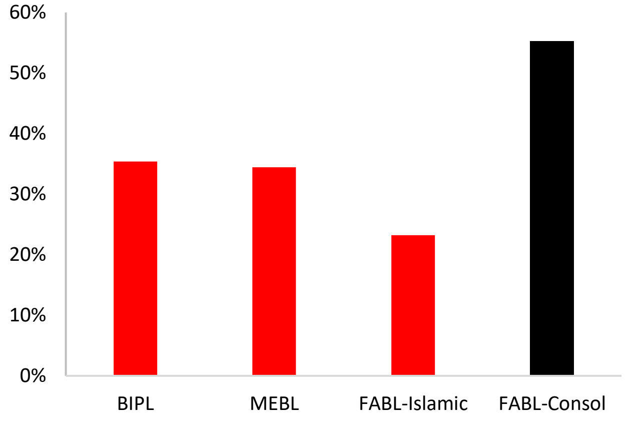
Source: Company Accounts, Foundation Research, Sep 2021

Swift adjustment of asset base

On a broader level, we believe that the adjustment of asset base would be swift, however, next lag of conversion of asset base may take time. We have incorporated major chunk of Islamic conversion to take place by the end of CY22. On the advances, the bank has already converted almost three quarter of its gross advances. Although, conversion of advances has increased the infection ratio of the conventional book to 19.25% due to conversion of cleaner loans into Islamic. The bank has made healthy recoveries worth Rs7.5bn since Dec'16 with write offs worth Rs5.4bn which has overshadowed the fresh provision charge of Rs8.9bn taken during the same period. The bank has written off loans worth of Rs5.0bn and made reversals of Rs1.5bn in CY20 alone which shows management's intent of book cleansing. Loan write offs during CY20 were primarily concentrated in few names as 6 borrowers accounted for 83% of the loans. Write offs against Japan Power/ DHA Cogen/ Al Abid Silk Mills accounts for 32/15/10% of the total write offs recorded during CY20. We believe that these write offs along with the decent recoveries are a healthy sign for asset quality. However, this may keep provision expense on the higher side at least during next few quarters. Furthermore, management has also expressed their intent to stay more focused on lending and shared their goal of keeping ADRs on the higher side (Late 60s to early 70s). This is also likely to fuel up the provisioning expense going forward, which we have incorporate in our estimates.

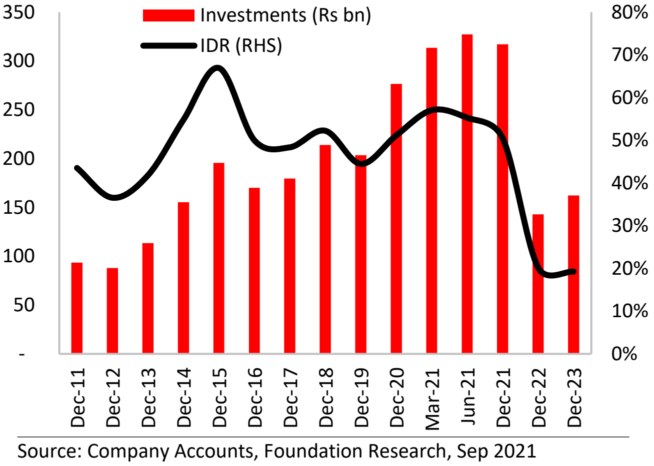
Unlike the advances, progress on conversion of investments has remained sluggish with a low conversion rate of 21%. Major hurdle which has been slowing down this conversion was the lack of availability of sukuks as the issuance of GOP's Ijarah sukuk has not been very encouraging in past few years. Nonetheless, stock of GOP's Ijarah sukuk has increased by 8.96x since March'20 to Rs636bn. On the other hand, FABL's investment in the said instrument has only increased by 5.78x. Management seems optimistic on the support provided by the SBP and expects to have a better share in the next round of Sukuk issuance. We remain cautiously optimistic on that front despite government's aggressive target of Rs1.2tn for sukuk issuance in FY22. We expect this target to partially materialize which would provide support to Islamic banks in general and FABL in particular. In addition to this, potential resumption of IMF program may pave the way for IPP payments further improving the availability of Sukuks. We expect FABL to convert its investments from T-Bills/PIBs to Islamic investments by Dec'22. As a result, the bank's IDR is likely to take a hit to eventually settle in the range similar to its Islamic peers.

Fig 15: IDR likely to settle close to peers



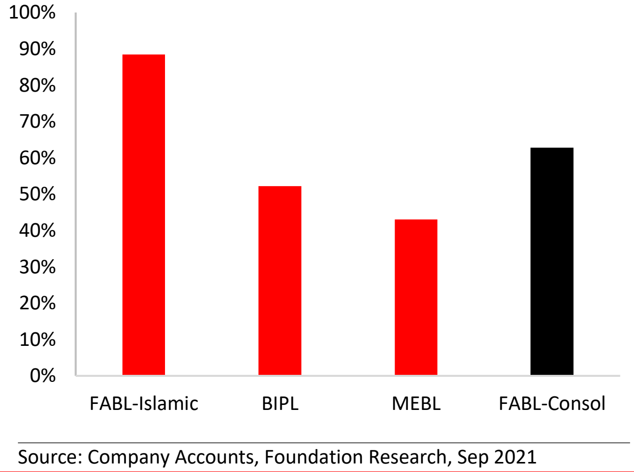
Source: Company Accounts, Foundation Research, Sep 2021

Fig 16: IDR to take a dip post conversion



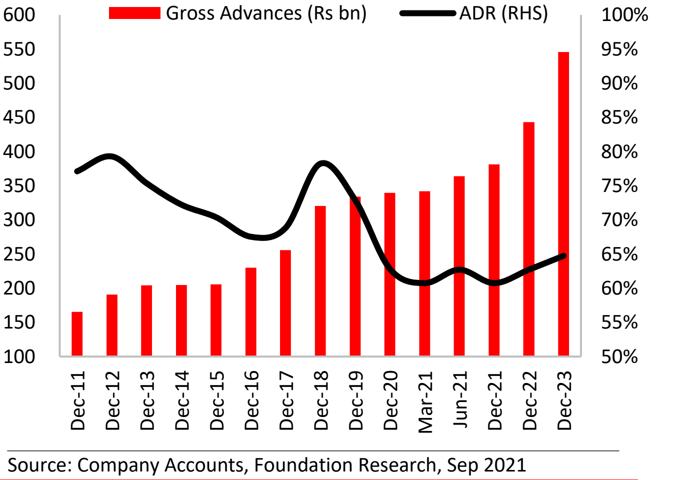
Source: Company Accounts, Foundation Research, Sep 2021

Fig 17: Operating at higher ADR compared to peers



Source: Company Accounts, Foundation Research, Sep 2021

Fig 18: ADR likely to remain higher



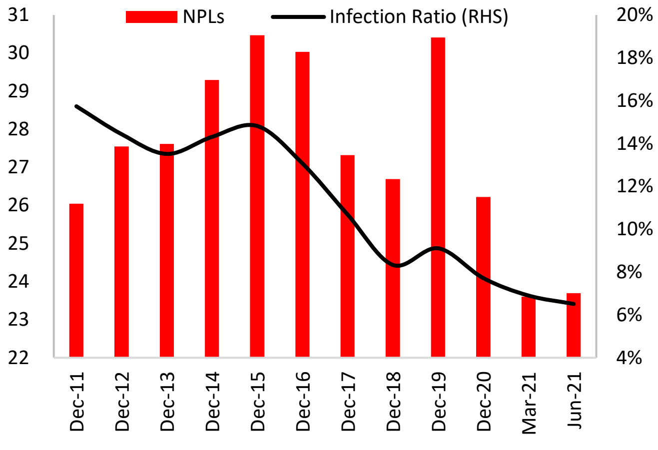
Source: Company Accounts, Foundation Research, Sep 2021

Improving asset quality with sufficient capital buffers

FABL's asset quality has been witnessing decent improvements as the infection ratio has witnessed consistent improvements. We expect this trend to continue going forward as the management seems focused on improving the asset quality. Infection ratio in FABL's Islamic loan book currently stands lower compared to peers with decent coverage. However, we believe that the last lag of conversion might include some write offs coupled with reversals as infection ratio of the conventional book currently stands at 19%. To highlight, FABL's provision coverage currently stands at 85% vs. industry average of 98% whereas the bank's general coverage for the performing loans currently stands at 0.3% vs. 1.0% of MEBL and 0.7% of BIPL. Therefore, we expect provision coverage to improve to make buffer for the IFRS9 implementation. Having said that, we believe that the bank has built up sufficient capital to absorb any potential hit that may come from increase in provision charge.

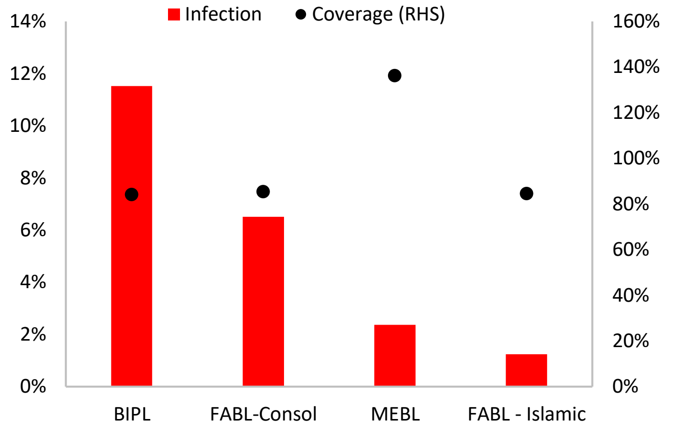
Management of the bank has been holding back its cash payouts since CY15 to build up its capital buffer. As a result, Tier 1/Total Capital now stands at Rs53/61bn translating into one of the highest CET-1 CAR of 16.28% i.e. well above the regulatory requirements. This has equipped the bank with the confidence of announcing a cash payout of Rs0.5/sh in 2QCY21. We estimate FABL's to remain comfortably above the regulatory requirements and therefore expect FABL to start decent payouts.

Fig 19: Asset quality consistently improving



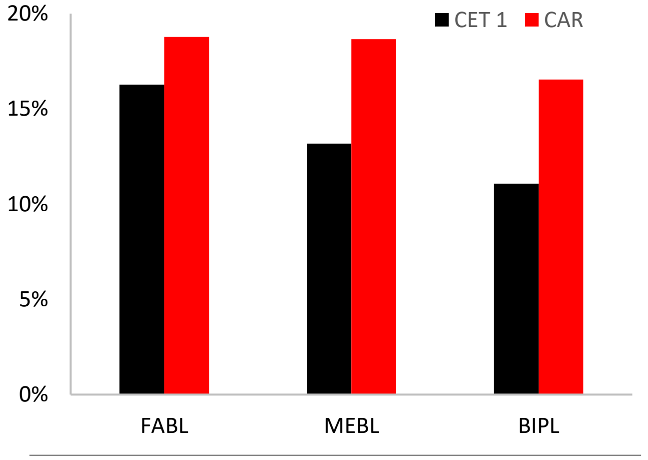
Source: Company Accounts, Foundation Research, Sep 2021

Fig 20: Converted book has even better asset quality



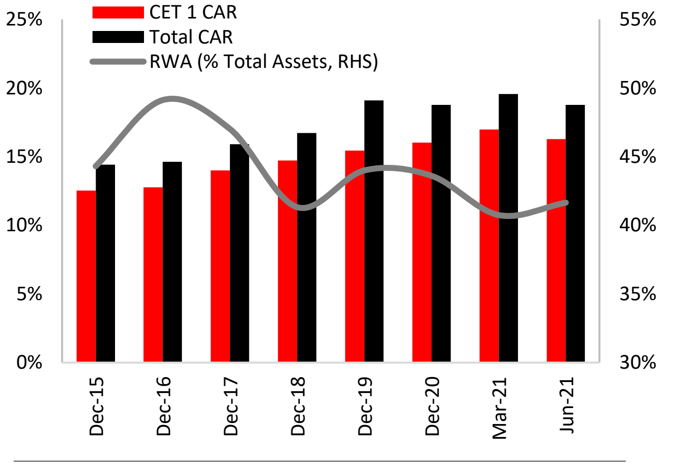
Source: Company Accounts, Foundation Research, Sep 2021

Fig 21: Sufficient capital buffers



Source: Company Accounts, Foundation Research, Sep 2021

Fig 22: CARs well above regulatory requirements



Source: Company Accounts, Foundation Research, Sep 2021

Key risks to our thesis

Lower Coverage

Mounting pressure on credit quality of the banking system has been one of the key concerns and a potent threat to the profitability outlook of the banking sector. Furthermore, however delayed but due implementation of the IFRS9 has further increased the ongoing concern. To counter this, most of the banks has increased their provision coverage as industry average is now stands at ~98%. On the other hand, FABL has not witnessed any substantial increase in the provision coverage as it current coverage stands at 85% i.e. well below the industry average. In addition to this, FABL's general coverage against the performing loans which is supposed to provide cushion in the case of the implementation of IFRS9 also stands at 0.3% vs. 0.7% of industry average. To incorporate this risk, we have taken higher provisioning expense (Rs1.5/2.7bn in CY22/23) going forward as we believe that the management would increase the provision coverage to stay prudent. This would increase FABL's coverage to over 90% by the end of CY22.

Lower Availability of Shariah Compliant Investment Instrument

Lack of the availability of shariah compliant investment instrument has been a major setback for the growth and profitability of the Islamic banks. In the uncertain economic times of COVID, conventional banks were able to channelize funds deployment towards investments in order to remain cautious with lending. As a result, IDR/ADRs for most of the banks substantially increased/decreased whereas Islamic banks were unable to do the same because there were not enough investment instruments available. This puts Islamic banks at a disadvantage compared to conventional banks. However, this has been partially compensated by the absence of MDR but the incremental risks associated with the lending overwhelms the equation. However, we expect gov't to partially meet its target of new sukuk issuance worth ~Rs1.2tn which would provide impetus to Islamic Banks. Although we remain cautious with the sukuk allocation as other Islamic banks would also be opting to get the piece of new issue.

Table 01: Faysal Bank Limited (FABL PA, Outperform, Target Price Rs36)

Balance Sheet		**CY20**	**CY21E**	**CY22E**	**CY23E**
Cash	m	59,881	62,786	70,666	84,271
Investments	m	276,470	317,086	150,233	171,800
Advances	m	318,180	360,562	420,862	520,593
Fixed Assets	m	24,102	24,078	23,992	23,957
Total Assets	m	710,064	819,500	832,417	1,044,894
Deposits	m	540,632	627,858	706,660	842,705
Borrowings	m	58,447	75,111	(2,673)	54,673
Other Liabilities	m	50,767	49,152	55,320	65,971
Total Liabilities	m	649,846	752,121	759,307	963,349
Net Assets	m	60,218	67,379	73,110	81,544
Share Capital	m	15,177	15,177	15,177	15,177
Unapp. Profits	m	24,981	32,626	38,357	46,791
Total Equity	m	60,218	67,379	73,110	81,544

Income Statement		**CY20**	**CY21E**	**CY22E**	**CY23E**
NII	m	24,548	24,970	29,586	38,250
NFI	m	8,352	9,146	9,238	9,188
Fee Income	m	4,085	5,337	5,486	5,526
Total Income	m	33,056	34,116	38,824	47,438
Op Expenses	m	19,911	20,250	22,980	25,929
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Provisions	m	2,254	582	1,473	2,707
PBT	m	10,891	13,283	14,371	18,802
PAT	m	6,681	8,095	8,766	11,469
EPS		4.4	5.3	5.8	7.6
DPS		-	1.5	2.0	2.0
EPS Growth	%	11.3	21.2	8.3	30.8
Payout	%	-	28.1	34.6	26.5

Quarterly I/S		**1QCY21**	**2QCY21**	**3QCY21**	**4QCY21**
NII	m	5,448	6,475	6,579	6,469
NFI	m	2,226	2,037	2,416	1,938
Fee Income	m	1,216	654	1,014	1,357
Total Income	m	7,674	8,511	8,994	8,407
Op Expenses	m	4,718	5,022	5,179	5,331
Admin Expenses	m	4,642	4,960	5,109	5,262
Provisions	m	(533)	521	461	133
PBT	m	3,540	2,893	2,773	1,802
PAT	m	2,115	1,953	2,049	2,046
EPS		1.39	1.29	1.35	1.35
DPS		-	0.50	-	1.00

Key Ratios		**CY20**	**CY21E**	**CY22E**	**CY23E**
NIMs	%	4.4	3.8	4.2	4.7
ADR	%	62.8	60.7	62.7	64.7
Infection	%	7.7	6.3	5.5	4.9
Coverage	%	82.2	86.5	91.2	94.0
IDR	%	51.1	50.5	21.3	20.4
Deposit growth	%	18.1	16.1	12.6	19.3
CASA	%	71.1	76.5	79.7	82.6
Cost/Income	%	59.2	58.5	58.4	53.8
CAR	%	18.8	18.6	17.3	16.9
ROE	%	12.0	13.0	12.0	15.0
BV	x	39.7	44.4	48.2	53.7

All figures are in Rs unless noted
Source: Company Accounts, Foundation Research, September 2021

About the Bank

Faysal Bank Limited was incorporated in Pakistan on October 3rd, 1994 as a Public Limited Company under the Companies Ordinance, 1984. The Bank is engaged in Commercial, Retail, Corporate and Islamic banking activities. Faysal Bank's footprint spreads over more than 200 cities with over 576 (including 521 Islamic) branches. With total assets in excess of Rs786bn, placing it amongst the significant players in Pakistan's banking industry. Faysal Bank's aim is to achieve leadership in providing shariah compliant products and services to its customers. To achieve this aim, the management is on track to convert the entire bank, including its branch network, into a full-fledged Islamic Bank. As per the latest financials, the bank has now successfully converted 90% of its branches into Islamic. Whereas conversion on the asset front is lead by advances (74%), however, conversion of the investments remained low at 21%.

Major shareholding (48%) of the bank lies with Ithmaar Bank which is a Bahrain-based Islamic retail bank that is licensed and regulated by the Central Bank of Bahrain and provides retail, commercial, treasury & financial institutions and other banking services. Ithmaar Bank is a wholly owned subsidiary of Ithmaar Holding B.S.C., which is listed on the Bahrain Bourse, and Dubai Financial Market. Other major share holding of the bank is owned by Faisal Finance (Luxembourg) S.A. (8%), MFAI (Jersey) Limited (6%) and State Life Insurance Corporation of Pakistan (5%).

Table 2: Faysal Bank Limited Limited key personnel

Key Personnel	Name	Designation
Board of Directors	Mr. Farooq Rahmatullah Khan	Chairman
	Mr. Ahmed Abdulrahim	Vice Chairman
	Mr. Yousaf Hussain	President & CEO
	Mr. Mian Muhammad Younis	Director
	Mr. Imtiaz Ahmad Pervez	Director
	Mr. Ali Munir	Director
	Mr. Juma Hasan Ali Abul	Director
	Mr. Abdulelah Ebrahim	Director
	Mr. Abdulla Abdulaziz Ali Taleb	Director
	Ms. Fatima Asad Khan	Director
	Mr. Mohsin Tariq	Director
Management	Mr. Yousaf Hussain	President & CEO
	Mr. Raheel Ijaz	Chief Operating Officer
	Mr. Syed Majid Ali	Chief Financial Officer

Source; Company Accounts, Foundation Research, September 2021

Table 3: FABL pattern of shareholding and free float as at Dec 2020

Pattern of shareholders	Holding	Shares
Ithmaar Bank B.S.C	721	48%
Faisal Finance (Luxembourg) S.A.	128	8%
MFAI (Jersey) Limited	88	6%
State Life Insurance Corporation of Pakistan	80	5%
DMI (Jersey) Limited	64	4%
Banks, DFIs, Insurance, etc.	49	3%
Mutual Funds	19	1%
General Public	222	15%
Others	145	10%

Source; Company Accounts, Foundation Research, September 2021

Abbreviations

NII	Net Interest Income
NFI	Non-Funded Income
SBP	State Bank of Pakistan
D-SIB	Domestically-Systematically Important Bank
Opex	Operating Expenses
NPL	Non-Performing Loans
MCB	MCB Bank Limited
HBL	Habib Bank Limited
UBL	United Bank Limited
ECL	Expected Credit Loss
PD	Probability of Default
LGD	Loss Given Default
ROA	Return on Asset
ROE	Return on Equity
YoY	Year-on-Year
QoQ	Quarter-on-Quarter
BS	Balance Sheet
Bn	Billion
Mn	Million
Rs	Rupee
FRB	Floating Rate Bonds

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Recommendations definitions

If

Expected return >+10%	Outperform.
Expected return from -10% to +10%	Neutral.
Expected return <-10%	Underperform.