OMC
Sector Update

Investment Consideration

Furnace Oil demand to improve

Furnace Oil demand will largely improve on the back of an expanding power sector. Currently, the country faces a power shortfall of 2,500 – 3,000 MW and intends to bridge the gap with the addition of ~5,000 MW by CY13. These reforms will create guaranteed demand for FO and provide oil marketing companies the opportunity to cash in on the power sectors growth. We expect FO off-take in the industry to grow at a CAGR of 9% from FY09-12.

Bottomed out HSD to rebound

HSD volumes declined in FY09, with industry off-take slipping 7% YoY amidst a slower economy. We believe that the economy had bottomed out in FY09 with a real GDP growth rate of 2% and is on its way to a recovery. Data on large scale manufacturing released by the Federal Bureau of Statistics for Jul-Aug09 has already shown positive growth compared to the corresponding period last year. A recovering HSD demand will reflect in higher total off-take for OMC's boosting their topline.

Oil prices to remain uptick in FY10

International crude oil prices remained volatile in FY08-09 reaching a high of USD 145/bbl before plunging to USD 32/bbl in Dec08. Since then the commodity has gained 76.4% YTD producing healthy inventory gains for the sector in 4Q FY09 and 1QFY10. Moving forward, we believe that average oil prices will rise with a CAGR of 3% from FY10-15 on the back of improving global economic outlook resulting in continuous inventory gains for OMC's looking to offset their losses from 1H FY09.

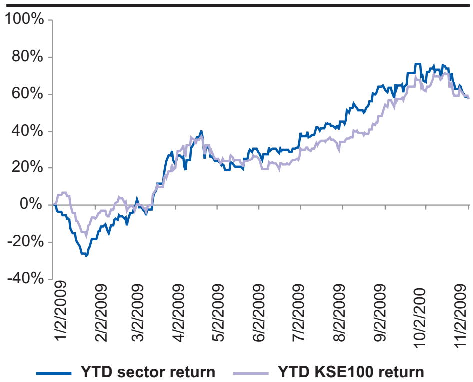
Circular debt resolution to relieve liquidity

Liquidity remained constrained in the passing fiscal year after the energy chain suffered from the circular debt issue. As the government moves towards a resolution to the issue, we believe that the OMC sector will stand as a beneficiary. Increased liquidity would deter dependence on financial borrowing for their working capital and subsequently show in their reduced financial charges which would stretch bottomline margins.

Pakistan State Oil: Unrealized upside

PSO will be the main beneficiary from the demand boost that is expected to come on the back of power reforms. The company's high market share in FO and mature supply chain and capacity will give it an edge in tackling the increased off-take. Also, the company will look to supplement its FO growth with HSD as its demand recovers in line with the economy. With an FY10E PE of 6.34x, we believe that the stock offers an unrealized upside of 30% from its current price. We have valued PSO at PKR 385 per share and maintain a BUY stance on the scrip.

Sector Price Performance



Source: Bloomberg & IGI Research

Industry off-take 1Q FY10 (000'MT)

	Industry	PSO	SHEL	APL
HSD	1,757	982	344	98
Furnace Oil	2,421	2,156	29	65
Gasoline	472	207	122	27
Kerosene	33	21	2	4
LDO	17	5	-	9
JP-1	300	130	93	15
Total	4,999	3,501	591	219
Market Share		70%	12%	4%

Source: OCAC & IGI Research

Ahmed Mumtaz
ahmed.mumtaz@igi.com.pk
111-234-234 Ext. 808

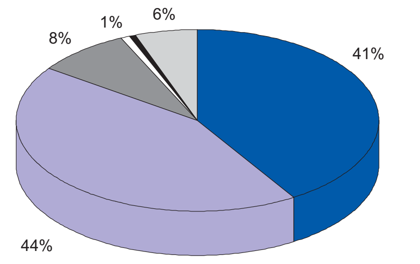
Research Department
igi.research@igi.com.pk

IGI Securities

Table of Contents

Turn up the volume

POL share - Total off-take



Source: OCAC & IGI Research

Volumes in the industry have historically been dominated by HSD and FO which have averaged 43% and 42% of total off-take in the last 2 years. Meanwhile, Mogas has held a share of 8% in the volumes pie. As far as consumption is concerned, over 90% of HSD's utilization lies in the transport sector which includes trucks, buses and agricultural tractors and crushers while the power sector stands as the main consumer of FO.

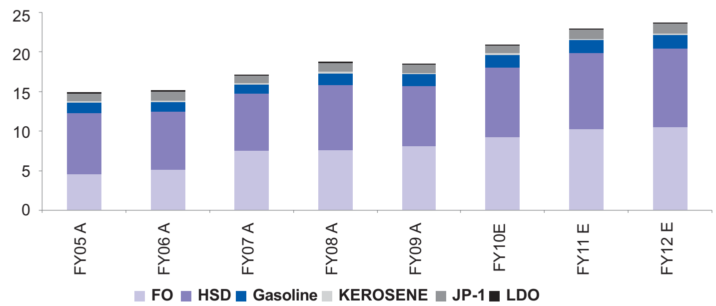
Petroleum off-take falls on economic slowdown

In the year that ended on Jun09, total off-take in the industry declined by a slim 1% to 18.53mn MT compared to 18.77mn MT in FY08. The decline largely came on the back of lower HSD sales which slipped 8% YoY from 7.61mn MT in FY09 compared to 8.25mn MT in FY08. Demand remained constrained due to a slower economy with real GDP growth rate dropping to 2% in FY09 from 4.1% in the previous fiscal year. Total petroleum product volumes, however, saw support from FO and Mogas which improved 7% and 4% YoY in FY09. Renewed efforts by the government to solve the energy shortfall led to the power sector consuming 8.1mn MT of FO in FY09 compared to 7.58mn MT is the previous fiscal year. Mogas demand also picked up late in FY09 after its ex-depot prices eased 35% making it a convenient substitute to CNG for motorist. Also, smaller OMC's pursued aggressive expansion of their retail outlets which improved accessibility and subsequently Mogas sales.

1Q FY10 volumes improve on rebound

Total off-take in the industry improved 12% YoY moving into FY10, with sales holding steady at 5mn MT at the end of 1Q FY09 compared to 4.47mn MT in the corresponding period last year. HSD continued to weigh down volumes declining 7% YoY in the quarter with volumes at 1.76mn MT. FO and Mogas, again, continued their rising trend from the year's close improving by 25% and 38% YoY in the quarter that ended Sept09.

Total Industry Offtake **(mn MT)**



Source: OCAC & IGI Research

Moving forward we expect the sectors petroleum off-take to improve in FY09-12 with a 3yr CAGR of 8.47% on two accounts. i) expansion in the power sector will provide guaranteed demand for FO and ii) HSD demand will catch up on a back of a rebounding economy.

Power sector to spur FO off-take

In FY09, the country faced a power deficit of 2,500-3,000 MW which resulted in increased power outages and social unrest bringing the issue to political forefront. The shortfall is scheduled to be leveled off by the addition of 2,084 MW in CY09 and another 1,309 MW in CY10. In total, thermal capacity of ~5,000 MW is due to come online by CY13. Hence, guaranteed demand of FO in the power sector will look to boost its off-take moving into FY10.

Bottomed out HSD to rebound

With the agricultural season approaching in October and November, we expect volumes for HSD to improve in 2Q FY10 on a QoQ basis. More importantly, in the long term we believe that the economy has bottomed out in FY09 with a real GDP growth of 2% and is rebounding into safe territory. With a 100bps policy rate cut on the cards, liquidity is expected to return to the market translating directly into improved large scale manufacturing and increased agricultural activity. Consequently, we expect HSD sales to gain momentum towards the end of FY10.

The price fix

In the week that ended Oct25'09, we saw WTI break above the USD 80/bbl to set consecutive YTD highs after it had been trading in the USD 65-75/bbl range for the whole of 3Q CY09. We believe the hike is a permanent shift in oil's trading range and comes on the back of strong economic and fundamental data. Therefore, it becomes pertinent to discuss the implications of a sustainable rise in crude oil prices on the OMC sectors financial performance.

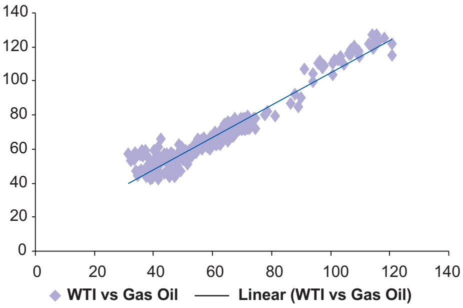
Although, OMC's do not directly procure and distribute crude oil, movements in the price of the various POL products are highly correlated with it. In our analysis, we ran a regression for over 250 observations of FOB prices of HSFO, Kerosene, Gas Oil and Gasoline 95 ron with WTI crude oil prices and found the correlation to be significant.

Regression result

	R^2	p-val of ind. var
HSFO	0.90	3.6×10^{-139}
Kerosene	0.93	2.4×10^{-162}
Gas Oil	0.94	4.5×10^{-175}
Gasoline 95 ron	0.85	2.3×10^{-118}

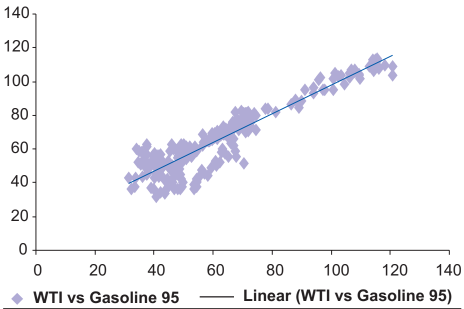
Source: IGI Research

WTI vs Gas Oil



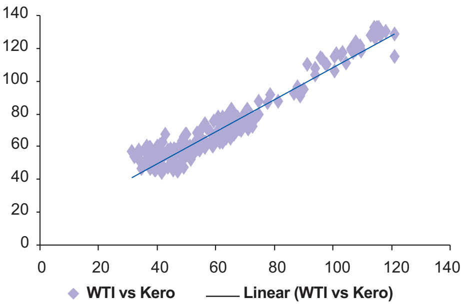
Source: OGRA & IGI Research

WTI vs Gasoline 95 ron



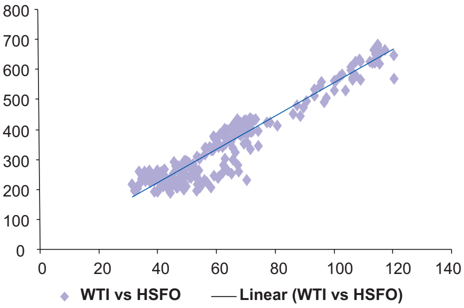
Source: OGRA & IGI Research

WTI vs Kerosene



Source: OGRA & IGI Research

WTI vs HSFO



Source: OGRA & IGI Research

Topline to inflate on oil hike

For regulated products, OMC's will sell their produce (net of GST and IFEM) at "ex-refinery prices + petroleum development levy + OMC margin". Petroleum development levy (PDL) is a pass through item and does not affect the profitability of the company. Ex-refinery price, however, is mean of the average daily international FOB price of 4 core products in the previous month and will move in line with international crude oil prices. Hence, a continuous rise in oil price would drag with it, with a month's lag, the ex-refinery prices and consequently the respective marketing margins. Similarly for unregulated products and HSD, higher input costs in line with international FOB prices would contribute to higher net sales resulting in an inflated topline.

FO, Mogas margins to boost profitability

Profitability, however, will depend more on the rising marketing margins of petroleum products. Although margins for HSD are fixed at PKR 1.35 per liter, improved marketing margins in Mogas and FO will boost OMC profitability with the rise in ex-refinery prices. Profitability will further be aided by inventory gains that the company will accumulate in the wake of continually rising crude oil prices.

Year of the circular debt issue

The year that ended on Jun09 would be remembered by most market commentators as year of the circular debt issue. The circular debt arose after the government was unable to pay the various energy sectors their share to the power differential claims and subsidies. As a consequence a domino effect of receivables and payables ran through the entire energy value chain drying it up of liquidity resulting in constrained production and increased borrowing which resulted in soaring financial charges.

Government provides temporary relief

To ease the energy chain of its liquidity woes the government has already issued a TFC of PKR 80bn in Apr09 and another of PKR 82.4bn in Sep09. This provided temporary relief to the energy chain whose cumulative receivables had risen to PKR 477bn against payables of PKR 273bn in Aug09. Key commercial banks participated in the instrument after much hue and cry over its offered rate.

Power subsidy withdrawal

Even after liquidity inflows by the government, the energy chain continued to accumulate receivables as the key issue of subsidies and government claims remained unmoved. In the recent Federal Budget, however, the government decided to remove the PKR 65bn power subsidy making a tariff hike eminent. In accordance with the federal decision and under the IMF's stipulation, the government announced a formal plan to raise power tariffs by 24% in three phases. A 6% increase has already been put into effect from Oct 01'09 while another 12% and 6% increase is expected to follow in Jan10 and Apr10 respectively. The increased tariffs will result in higher tariff collection by power distribution companies which is expected to flow through to power generating companies and consequently to oil marketing companies. Thus, it stands as a sustainable resolution to the circular debt issue.

Key risks to resolution

However, some key risks still remain in the resolution of the circular debt issue. They are i) inadequate tariff hike and ii) delay in the implementation of the tariff plan.

In our opinion, the 24% power tariff hike which is currently on the cards is inadequate and an increase of 43% would have to be necessitated to completely remove the power subsidy. Hence, we expect that the scheduled tariff hike would loosen some liquidity in the power chain but not completely abolish the circular debt issue. Also, the government is facing stiff resistance from the business community against the change. Subsequent delays of its implementation would lead to a continual receivables pileup in the OMC sector.

Stock Summary

Recommendation **BUY**

Fair Value **PKR 385**

Pakistan State Oil

Company Update

Ahmed Mumtaz
ahmed.mumtaz@igi.com.pk
111-234-234 Ext. 808

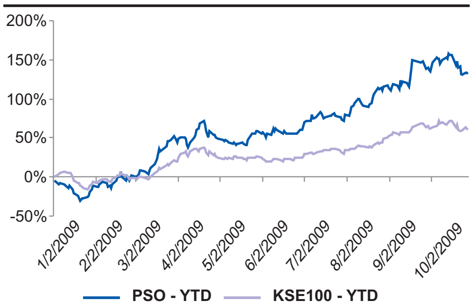
Research Department
igi.research@igi.com.pk

IGI Securities

PSO: Unrealized upside

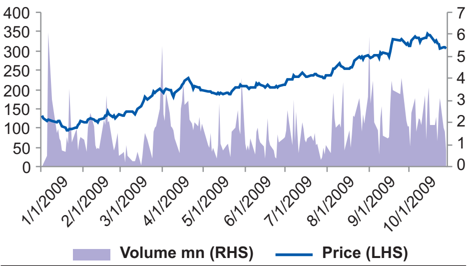
Bloomberg code	*PSO PA*
Current Price (PKR)	*295.33*
YTD Average Daily Volume (mn shares)	*1.66*
Market Capitalization (PKR mn)	*50,655*
Paid-up Capital (PKR mn)	*1,715.2*
Shares Outstanding (mn)	*171.52*
Index Weightage (%)	*2.15*
YTD Average Price (PKR)	*215*
Free Float (%)	*43*

Relative Performance: KSE100 vs PSO



Source: Bloomberg & IGI Research

PSO: Price & Volume



Source: Bloomberg & IGI Research

PSO began its rally from PKR 133 per share at the start of the calendar year and has gone on to gain 122% YTD outperforming the bench mark KSE100 index by 67%. Also, the company stands out in the region with FY10E multiples lower than the average multiples of its peers. Both PE and EV/EBITDA lie in a significantly lower band of 6.34x and 2.7x as opposed to the regions average of 25.41x and 5.8x. With a fair value of PKR 385 per share, we believe that PSO carries a 30% upside and maintain a BUY stance on the scrip.

Improved demand

The company enjoys a handsome market share in both FO and HSD; 86% and 61% at the end of FY09. With a boost in demand expected for both products, PSO will look forward to use its impressive supply chain, distribution channels and capacity to cater to its consumers. We expect FO off-take for the company to improve immediately while HSD volumes will begin to bloat towards the end of FY10 as the economy consolidates.

Consolidating margins

The company saw large variations in its margins owing to volatility in international crude oil prices in FY08-09. Gross margin shrunk to 0.49% in FY09 compared to 6.06% in FY08 after oil prices fell 51% through the fiscal year. Moving forward, we expect crude oil prices to remain uptick and rise with a CAGR of 3% from FY10-15 in line with the global economic recovery. Subsequently, PSO's profitability will improve as its recurring margins consolidate in addition to notional inventory gains that it will collect in the wake a stabilizing price environment.

Circular debt threatens liquidity

Higher accruals in FY09 constrained the company's liquidity which reflected in its financial charges; up 356% YoY. Recently, however, the government implemented a 6% hike in power tariffs in accordance with IMF stipulations and two more increases are expected to come in Jan10 and Apr10. These measures will relieve liquidity in the energy chain but we expect to see a lagged impact on PSO's earnings in FY11. For FY10, we maintain that financial charges will remain high with a FY10E TIE of 3.7x which continues to be the primary risk to our recommendation.

PSO: Financial Highlights

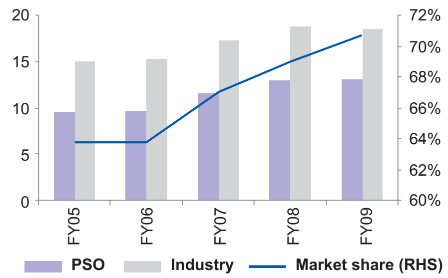
	FY08 A	FY09 A	FY10 E	FY11 E	FY12 E
EPS	81.94	(39.05)	46.59	62.51	69.68
P/E (x)	3.6	na	6.34	4.72	4.24
DPS	23.5	5.0	20.0	25.0	28.0
Dividend yield	8%	1.7%	6.8%	8.5%	9.5%
EV/EBITDA (x)	2.1	na	2.7	2.4	2.2
BVPS	180.5	121.7	160.9	202.1	247.6
P/B (x)	1.6	2.4	1.8	1.5	1.2
TIE (x)	16.4	(0.9)	3.7	6.9	9.4
RoE	54.2%	-25.8%	33.0%	34.4%	31.0%
RoA	13.9%	-4.8%	5.7%	8.6%	9.4%

Source: Company Reports & IGI Research

More pie for PSO in FY09

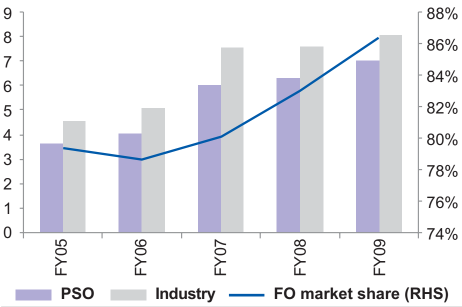
PSO improved its market share in the energy products segment to 71% at the end of FY09. Contrary to the industry, its volumes at 13.1mn MT in FY09 were 1% higher YoY compared to 12.9mn MT in FY08. The company continued its momentum going into FY10 with sales of 3.5mn MT in 1Q compared to 3.14mn MT in the corresponding period last year; a jump of 11% YoY.

Total Offtake: Industry vs. PSO (mn MT)



Source: OCAC & IGI Research

FO Offtake: Industry vs. PSO (mn MT)



Source: OCAC & IGI Research

PSO gains on FO shortfall

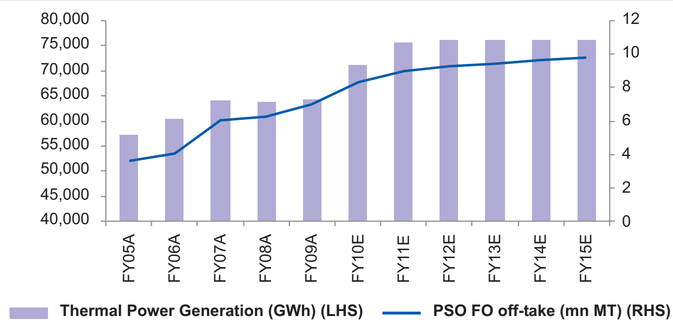
In FY09, the industry saw FO off-takes soar on the back of increased consumption in the power sector. PSO came out as the prime beneficiary improving its market share in FO to 86% at the end of FY09 after other OMC's remained hesitant to deal with the cash-starved power sector in the wake of the circular debt issue. It supplied 7mn MT of FO in FY09 and stood responsible for 90% of all FO imports. Continuing into 1Q FY10, PSO's FO volumes grew 30% YoY compared to the industry's 25% improving its market share in the product to 89%. The lacy statistics, however, came at the price of soaring receivables and tightened liquidity which is reflected in its financial charges in FY09; up 356% YoY.

FO to remain key growth driver

Going into FY10, we expect FO demand to soar as the country attempts to bridge its power deficit. The 2,500 MW power shortfall is scheduled to be leveled off by the addition of 2,084 MW in CY09 and another 1,309 MW in CY10. In total, thermal capacity of ~5,000 MW is due to come online by CY13. Only recently, PSO has signed an FSA with Northern Power Generation Company to supply FO to all its power stations which will look to consolidate its FO sales.

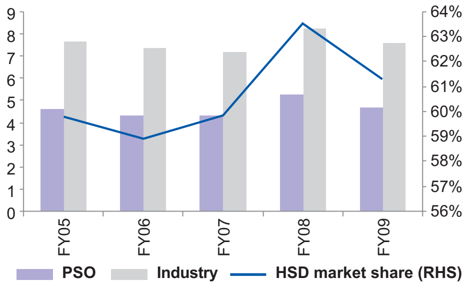
Moving forward, PSO's further contribution to the growing FO supply will depend on the acceptability of its tightened credit terms and liquidity constraints. Still, we believe, the company will capitalize on a fair share of the power sectors expansion with its FO off-take expected to go up to 9.4mn MT in FY12 from 6.9mn MT in FY09; a 3yr CAGR of 10%.

FO Off-take vs Thermal Power Generation



Source: Economic Survey & IGI Research

HSD Offtake: Industry vs. PSO (mn MT)

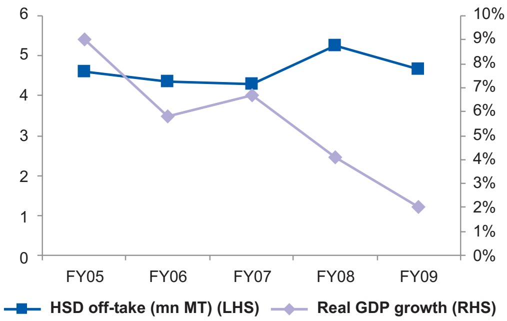


Source: OCAC & IGI Research

HSD weighs heavy on off-take

PSO's HSD sales declined in line with the industry by 11% YoY to 4.67mn MT in FY09 slightly losing its market share by 3%. The slump in sales continued into 1Q FY10 with a 16% YoY decline to 0.98mn MT in the period Jul-Sept09 compared to 1.17mn MT in the corresponding period last year.

HSD off-take vs. Real GDP growth



Source: OCAC & IGI Research

HSD to broaden revenue base

HSD demand in the industry is expected to improve as the economy rebounds moving into FY10. Data on large scale manufacturing released by the Federal Bureau of Statistics has already shown positive growth in Jul-Aug09 compared to the corresponding period last year. Also, as liquidity eases we expect that the company will have greater resources to supply HSD and look to recapture its market share to 62%. Hence, we expect HSD volumes to takeoff in FY11 and record sales of 6.15mn MT at the end of FY12; a 3-yr CAGR of 10%. Normalization of HSD off-take will supplement the company's FO sales and broaden its core revenue stream.

Lubes market holds potential growth

The lubricants market is one area where PSO has failed to dominate since its separation with the Castrol brand. Its market share at the end of FY09 stood at a dreary 23.3% as opposed to Chevron's 26.7% and Shell's 47.3%. The management, for sometime now, has emphasized their renewed efforts in the product which has margins upward of 30%. Also, the company recently confirmed an ongoing effort to collaborate with a foreign entity for higher-end synthetic lubes which is expected to materialize by Nov09.

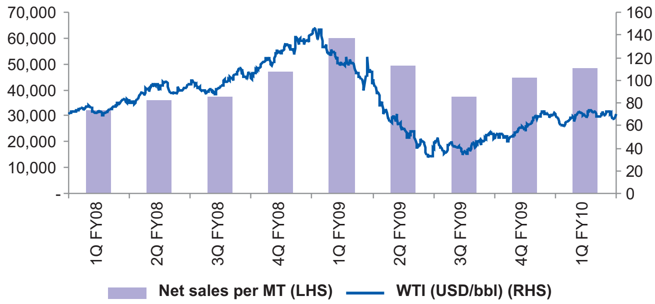
The lubricants market provides an excellent opportunity for the company to diversify its operations and we anticipate an improved market share on the back of its extensive distribution network. However, the company would have to invest significantly in its marketing campaign to establish brand recognition which it currently lacks in comparison to its competitors.

Margins recover on crude oil rebound

Lower ex-refinery prices depress sales

Moving into FY10 international crude oil prices seemed to have consolidated around the USD 65-75/bbl range. However, the turbulent consequence of its volatility becomes apparent in a YoY analysis of 1Q FY10 against 1Q FY09. Net sales per MT for the company in 1Q FY09 stood at PKR 48,347; 20% lower YoY compared to net sales per MT of PKR 60,129 in the corresponding period last year. The decline comes on the back of lower POL ex-refinery prices after they eased off by 8%-34% YoY on various products. In 1Q FY09, ex-refinery prices of POL products had peaked in line with crude oil prices which topped USD 145/bbl in July08.

WTI vs. net sales

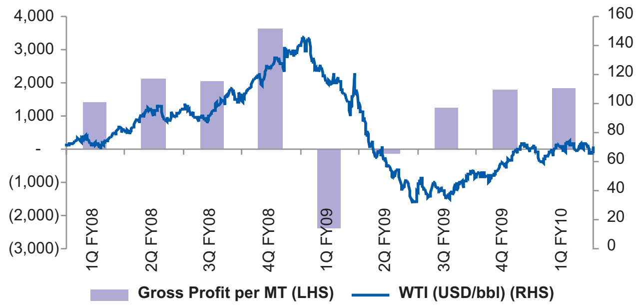


Source: Company Reports & IGI Research

Margins normalize

Although marketing margins were higher in 1Q FY09 owing to inflated ex-refinery prices, inventory played a more significant role in shaping profitability. An inventory loss of PKR 14.6bn in 1Q FY09 annihilated earnings producing a gross loss per MT of PKR 2,356 which was in line with a 28.6% decline in crude oil price in the same period. In comparison, the company posted modest inventory gains of PKR 950mn while prices remained uptick in 1Q FY10 producing a gross profit per MT of PKR 1,826.

WTI vs. gross profits



Source: Company Reports & IGI Research

Crude oil to remain stable

Hence, a change in the direction of international crude oil prices can produce volatile earnings which are in contrast to the company's actual financial position. Such externalities stand as a key risk in our investment consideration for PSO. However, the volatility appearing in FY08–09 was extraordinary and moving forward, we expect international crude oil prices to grow with a CAGR of 3% from FY10-15 in line with the global economic recovery helping PSO to make notional inventory gains in the long run. Also we expect recurring gross margins to sustain at an average of 3% in the same period.

1mo pricing to dampen gains

Furthermore, two considerations will dampen the build up of inventory gains in comparison to previous years. Firstly, HSD – which was responsible for 52% of all inventory gains in 1Q FY10 – is now priced monthly rather than fortnightly. Now, the entire 1 month's inventory will be assigned a single price for the month rather than a newer price for the last 15 days. Gains/losses, however, will still be made if the inventory exceeds or falls short of the month's sales mark. Secondly, inventory gains and losses are only incurred on products purchased from local refineries. With local refinery production in the doldrums because of the circular debt issue, PSO has been forced to divert its resources towards importing petroleum products. In any given month, ex-refinery prices are the average of the previous month's spot prices which will also be PSO's cost of importing its inventory for that month, hence, completely offsetting any difference in cost.

Crude oil sensitivity analysis

Percentage deviation from projected net sales

USD/bbl	FY10E	FY11 E	FY12 E	FY13 E	FY14 E	FY15 E
75	-	-2.6%	-5.1%	-7.6%	-10.0%	-12.4%
77	2.7%	-	-2.6%	-5.1%	-7.6%	-10.0%
80	5.4%	2.7%	-	-2.6%	-5.2%	-7.6%
82	8.3%	5.4%	2.7%	-	-2.6%	-5.2%
84	11.2%	8.3%	5.5%	2.7%	-	-2.6%
87	14.2%	11.2%	8.3%	5.5%	2.7%	-

Source: IGI Research

Percentage deviation from projected gross profit

USD/bbl	FY10E	FY11 E	FY12 E	FY13 E	FY14 E	FY15 E
75	-	-1.9%	-3.8%	-5.6%	-7.4%	-9.2%
77	1.9%	-	-1.9%	-3.8%	-5.6%	-7.5%
80	5.4%	2.7%	-	-2.6%	-5.2%	-7.6%
82	6.0%	4.0%	2.0%	-	-1.9%	-3.8%
84	8.1%	6.0%	4.0%	2.0%	-	-1.9%
87	10.3%	8.2%	6.1%	4.0%	2.0%	-

Source: IGI Research

EPS sensitivity analysis

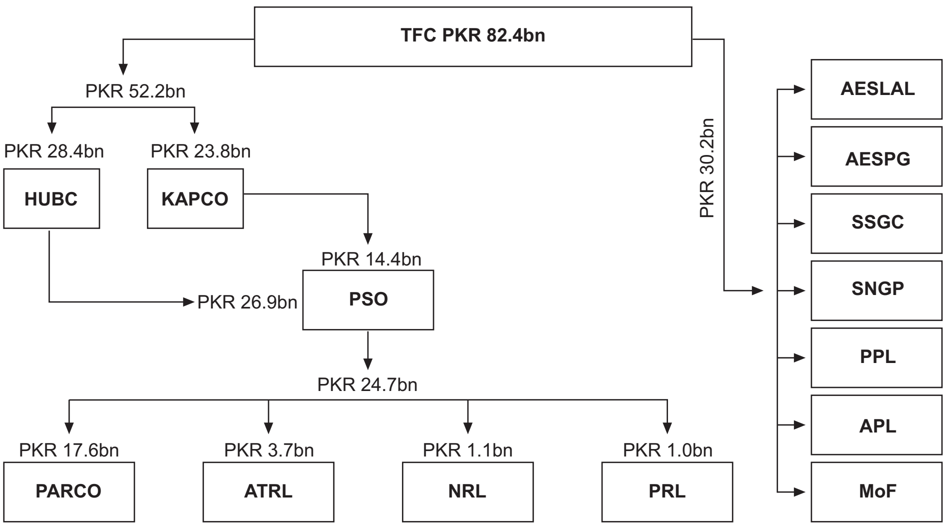
USD/bbl	FY10	FY11	FY12	FY13	FY14	FY15
75	**46.59**	61.10	66.50	68.71	71.04	72.83
77	47.65	**62.51**	68.06	70.34	72.73	74.59
80	48.75	63.95	**69.68**	72.02	74.47	76.40
82	49.87	65.45	71.34	**73.75**	76.26	78.26
84	51.03	66.98	73.04	75.53	**78.11**	80.17
87	52.23	68.57	74.80	77.36	80.01	**82.15**

Source: IGI Research

PSO: The circular debt piñata

With the issue of PKR 82.4bn TFC in Sept09, PSO's receivables have declined to PKR 65.3bn at the end of 1Q FY10 compared to PKR 80.5bn in FY09 after it accepted payments of PKR 26.9bn from Hubco and PKR 18.9bn from Kapco. Subsequently, it paid PKR 24.7bn to local refineries and the remaining portion was exhausted in paying off its import LC's. Cumulatively, its payables stood at PKR 108.8bn at the end on 1Q FY10 compared to PKR 110bn at the end of FY09. According to management, the liquidity relief lasted 10 days and the company continues to accumulate receivables at ~PKR 1-2bn per day. Consequently, financial charges continued to remain high in 1Q FY10 at PKR 1.6bn.

Circular debt TFC distribution Sep10



Source: PSO & IGI Research

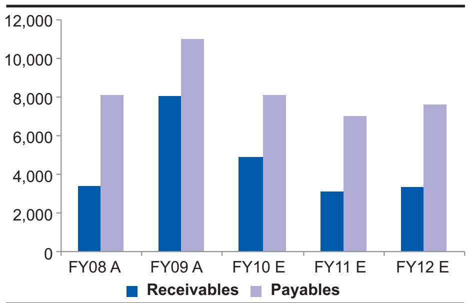
Possible liquidity relief

Although TFC's issued by the government have provided temporary relief to PSO, a more sustainable resolution of the issue will come after the completion of the proposed power tariff hike. The government under the IMF's stipulation has already put a 6% hike in place with effect from Oct1'09 while two more for 12% and 6% are expected to follow in Jan10 and Apr10 respectively. We expect that the 24% higher tariffs will improve collection and trickle down to PSO as receivables settled from power generating companies. However, its effect would produce lagged relief for PSO in FY11. In FY10, we expect financial charges to remain high at PKR 4.5bn.

Net margins to improve on resolution

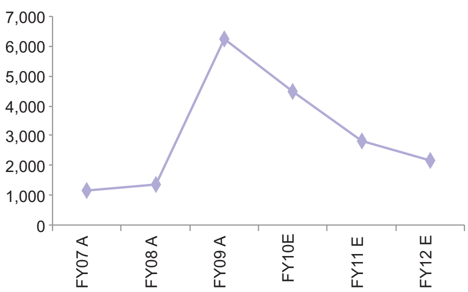
Resolution of the circular debt issue will have a positive impact on the company's net margins as financial costs normalize. Thereon, we expect TIE to move up to 10x in FY12 while the company will maintain a volumetric payables turnover of 11 per fiscal year as opposed to a volumetric receivables turnover of 25 per fiscal year. On the flip side, further delays could force PSO to provision some of its receivables which would depress its earnings as evidenced recently. In 1Q FY10, the company expensed PIA's receivables worth PKR 644mn which had an after-tax impact of PKR (2.44) on EPS.

Receivables & Payables (PKR mn)



Source: Company Reports & IGI Research

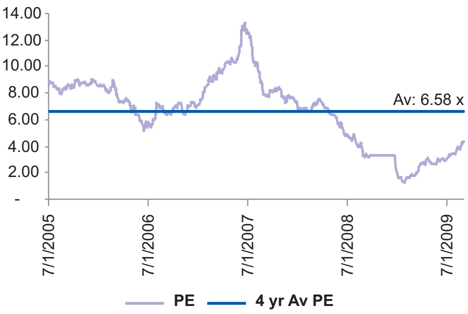
Financial charges (PKR mn)



Source: Company Reports & IGI Research

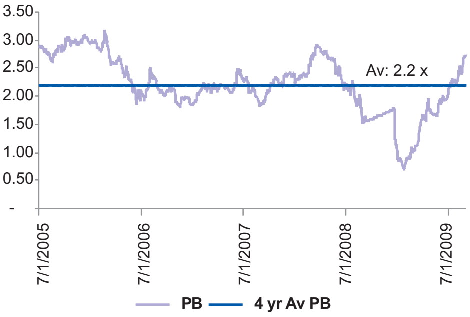
Recommendation

PE band



Source: Company Reports & IGI Research

PB band



Source: Company Reports & IGI Research

Price performance

The stock peaked at a YTD high of PKR 342.95 per share before heading south to its current price in line with the markets correction. In CY09, PSO bounced back from rock bottom prices to rally 122% YTD outperforming the bench mark KSE100 index by 67%. The stock is currently trading at an FY10E PE of 6.34x which is below its 4yr average PE of 6.58x. Hence, we believe that the stock is trading at a discount to its fair value and holds upside potential based on its future growth.

Regional comparison

Compared in the region, PSO stands out with FY10E multiples lower than the average multiples of its peers. Both PE and EV/EBITDA lie in a significantly lower band of 6.34x and 2.7x as opposed to the regions average of 25.41x and 5.8x. Also, the company's FY10E ROE and ROA stand markedly higher at 33% and 5.7% as compared to regional averages. Hence, PSO appears as an attractive offer amongst its regional comparisons listed below.

Regional Comparison

	Bloomberg code	P/E	P/B	P/S	EV/EBITDA	ROE	ROA	Sales chg.	EPS chg.
Reliance Ind	RIL IN	20.40	2.57	1.81	12.70	14.7%	7.7%	6.3%	-27.9%
Formosa Petro	6505 TT	50.24	3.93	0.87	na	6.7%	3.3%	25.2%	-78.2%
PTT pcl	PTT TB	29.98	1.80	0.43	8.20	13.9%	5.8%	32.7%	-47.4%
Esso	ESSO TB	na	1.19	0.14	5.60	-30.7%	-10.9%	11.2%	na
PSO*	PSO PA	6.34	1.80	0.06	2.70	33.0%	5.7%	29.7%	-219.3%
Bharat Pet	BPCL IN	25.00	1.52	0.13	9.00	6.2%	1.6%	22.3%	-53.4%
Hindustan Pet	HPCL IN	20.52	1.10	0.10	8.20	5.4%	1.3%	13.4%	-49.3%
Chennai Pet	MRL IN	na	1.06	0.10	na	-12.2%	-4.7%	14.1%	na
Average		**25.41**	**1.87**	**0.46**	**5.80**	**4.6%**	**1.2%**	**19.4%**	**-79.3%**

** based on FY10E*

Source: Bloomberg & IGI Research

Valuation

We have conducted our valuation using Discounted Cash Flow (DCF) model. At a WACC of 18.42% and terminal growth rate of 5%, we value the stock at PKR 385 per share. We believe that despite a 122% surge in price in CY09, the stock has an upside potential of 30% and maintain a BUY stance on the scrip.

Valuation snapshot

Rf	12%
Market risk premium	6%
Beta	1.07
Re	18%
Terminal growth rate	5%
Discounted FCFE	30,000
Discounted terminal value	35,605
Equity value	65,605
Value of investment	461
Total no. of shares outstanding	171.52
Fair value	**385.18**

Source: IGI Research

Sensitivity Analysis **(PKR/Share)**

		Discount rates				
		16%	**17%**	**18.42%**	**19%**	**20%**
Growth rates	3%	427.11	394.18	354.82	340.76	318.81
	4%	449.29	412.45	368.95	353.56	329.66
	5%	475.50	433.76	**385.18**	368.18	341.97
	6%	506.96	458.94	404.03	385.06	356.03
	7%	545.40	489.16	426.18	404.74	372.26

Source: IGI Research

IGI Securities

Financial Statements

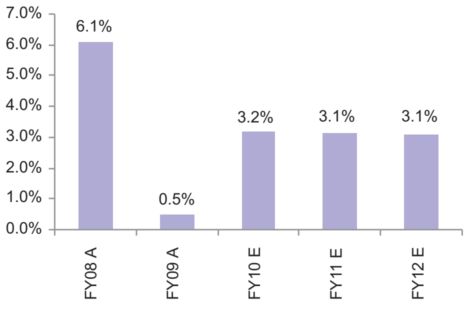
PSO: Financial Statements

Income statement (PKR mn)	FY08 A	FY09 A	FY10 E	FY11 E	FY12 E
Net sales	495,27	612,696	794,753	911,950	984,824
Cost of product sold	465,255	609,685	769,566	883,387	954,265
Gross profit	30,024	3,010	25,187	28,562	30,559
Transportation costs	338	514	379	415	436
Distribution and marketing expenses	3,278	3,961	3,811	4,196	4,627
Administrative expenses	1,147	1,152	1,231	1,310	1,395
Depreciation	1,119	1,142	1,055	1,044	1,068
Ammortization	48	53	17	17	18
Other operating expenses	3,353	3,994	4,371	5,016	5,417
Oher operating income	1,397	1,452	1,587	1,740	1,882
Other income	314	777	874	1,003	1,083
Profit from operations	22,451	(5,577)	16,783	19,308	20,564
Finance costs	1,368	6,232	4,489	2,814	2,178
PBT	21,377	(11,357)	12,294	16,494	18,386
Taxation	7,324	(4,658)	4,303	5,773	6,435
PAT	14,054	(6,699)	7,991	10,721	11,951
Balance Sheet (PKR mn)					
Current assets	115,879	138,690	118,335	110,422	124,402
Non current assets	11,231	14,732	10,018	10,006	10,467
Total assets	127,110	153,422	128,352	120,427	134,868
Current liabilities	93,736	130,023	98,077	82,924	89,394
Long term liabilities	2,409	2,528	2,679	2,840	3,011
Shareholder's equity	30,965	20,871	27,596	34,664	42,464
Total equity and liability	127,110	153,422	128,352	120,427	134,868
Cashflow Statement (PKR mn)					
Cashflow from Operating Activities	5,569	2,940	2,829	6,656	11,314
Cashflow from Investing Activities	(131)	(18)	(1,072)	(1,303)	(1,521)
Cashflow from Financing Activities	(3,942)	(3,057)	(1,506)	(3,734)	(4,139)
Beginning cash balance	1,522	3,019	2,883	3,133	4,753
Net change in cash	1,496	(136)	250	1,619	5,654
Ending cash balance	3,019	2,883	3,133	4,753	10,407
Ratios					
Net sales growth	41.6%	23.7%	29.7%	14.7%	8.0%
EPS growth	199.7%	-147.7%	-219.3%	34.2%	11.5%
Gross margin	6.1%	0.5%	3.2%	3.1%	3.1%
EBITDA margin	4.8%	-0.7%	2.2%	2.2%	2.2%
Net profit margin	2.8%	-1.1%	1.0%	1.2%	1.2%
Current ratio	1.2	1.1	1.2	1.3	1.4
Quick ratio	0.6	0.8	0.7	0.6	0.7
TIE (x)	16.4	(0.9)	3.7	6.9	9.4
Asset turnover	4.9	4.4	5.6	7.3	7.7
Equity multipler	3.9	5.4	5.8	4.0	3.3
RoE	54.2%	-25.8%	33.0%	34.4%	31.0%
RoA	13.9%	-4.8%	5.7%	8.6%	9.4%
Invertory turnver	7.5	15.0	14.9	14.9	14.8
Recievable turnover	14.6	7.6	16.2	29.5	29.4
Payables turnover	5.7	5.5	9.5	12.6	12.5
EPS	81.94	(39.05)	46.59	62.51	69.68
P/E (x)	3.60	na	6.34	4.72	4.24
DPS	23.5	5.0	20.0	25.0	28.0
Dividend yield	8.0%	1.7%	6.8%	8.5%	9.5%
EV/EBITDA (x)	2.1	na	2.7	2.4	2.2
BVPS	180.5	121.7	160.9	202.1	247.6
P/B (x)	1.6	2.4	1.8	1.5	1.2

Source: Company Reports & IGI Research

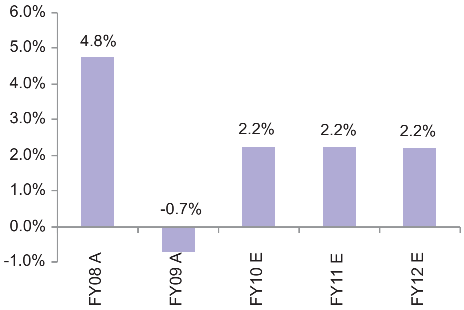
Highlights

Gross margin



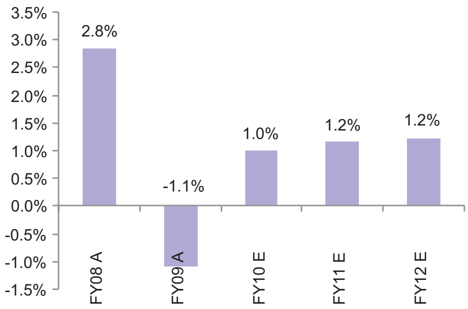
Source: *IGI Research*

EBITDA margin



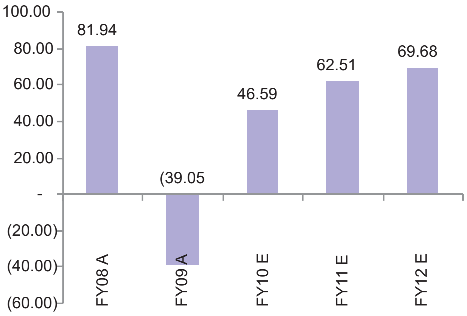
Source: *IGI Research*

Net profit margin



Source: *IGI Research*

EPS

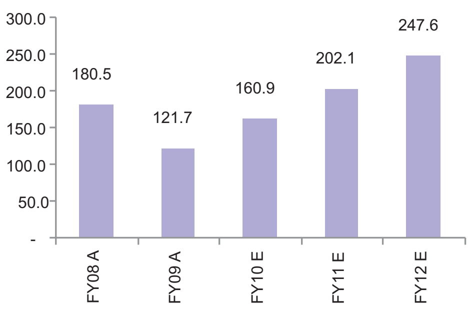


Source: *IGI Research*

DPS

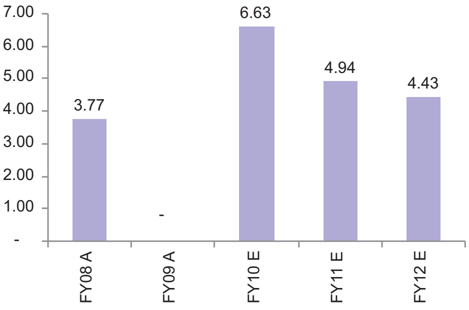
Source: *IGI Research*

BVPS



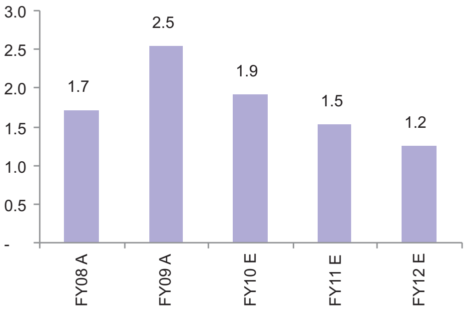
Source: *IGI Research*

P/E



Source: *IGI Research*

P/B

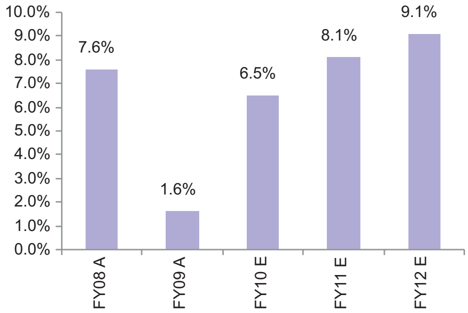


Source: *IGI Research*

EV/EBITDA

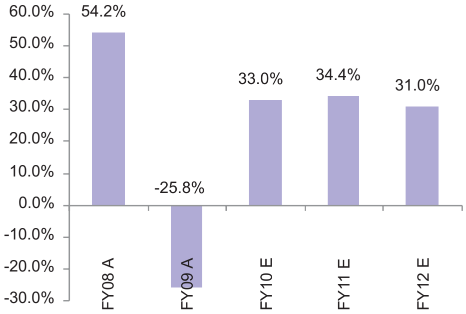
Source: *IGI Research*

Dividend yield



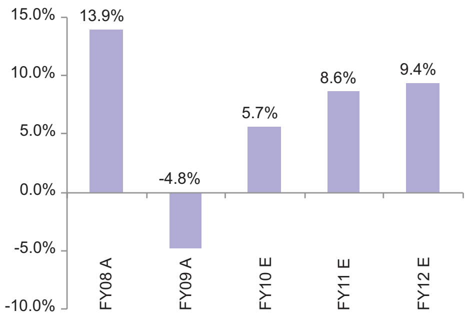
Source: *IGI Research*

RoE



Source: *IGI Research*

RoA



Source: *IGI Research*

Research Team

Zainab Jabbar	Investment Strategy, Economy	Tel: (92-21) 111-234-234 Ext.:810	zainab.jabbar@igi.com.pk
Ahmed Raza Khan	Banks, Telecom	Tel: (92-21) 111-234-234 Ext.:804	ahmed.khan@igi.com.pk
Ahmed Rajani	Power, Cement	Tel: (92-21) 111-234-234 Ext.:835	ahmed.rajani@igi.com.pk
Ahmed Mumtaz	OMC	Tel: (92-21) 111-234-234 Ext.:808	ahmed.mumtaz@igi.com.pk
Sarah Afridi	Fertilizer	Tel: (92-21) 111-234-234 Ext.:826	sarah.afridi@igi.com.pk
Abdul Sajid	Database	Tel: (92-21) 111-234-234 Ext.:813	abdul.sajid@igi.com.pk
Mansoor Ahmed	Design, Layout	Tel: (92-21) 111-234-234 Ext.:812	mansoor.ahmed@igi.com.pk

Equity Sales

Nazia Enam (Karachi)	Tel: (92-21) 530-1711	nazia.enam@igi.com.pk
Samira Omer (Karachi)	Tel: (92-21) 536-8845	samira.omer@igi.com.pk
Wajahat Ali Khan (Karachi)	Tel: (92-21) 530-1402	wajahat.khan@igi.com.pk
Abrar Raza (LHR)	Tel: (92-42) 570-7415	abrar.raza@igi.com.pk
Shafqat Ali Shah (ISL)	Tel: (92-51) 280-2243	shafqat.ali@igi.com.pk
Chaudhry Usman Javed (SKT)	Tel: (92-52) 3242689	usman.javed@igi.com.pk
Muhammad Ejaz Rana (FSD)	Tel: (92-41) 254-0854	ejaz.rana@igi.com.pk
Riaz Naseeb Khan (Multan)	Tel: (92-61) 450-0183	riaz.naseeb@igi.com.pk
Asim Irfan (Peshawar)	Tel: (92-91) 525-3980	asim.irfan@igi.com.pk
M. Mujahid Yasin (Gujranwala)	Tel: (92-55) 429-4264	mujahid.yasin@igi.com.pk

Analyst Certification

I, Ahmed Mumtaz, 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 our compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this research report.

Head Office

Suite 701-713, 7th floor, The Forum, G-20, Khayaban-e-Jami, Block-9, Clifton, Karachi
Phone: 92-21-111-234-234, 35301721-40 Fax: 92-21-111-567-567, 35301780

Branch Offices

Karachi (Clifton)
Bunglow No. F-5, Block 9, Clifton, Karachi.
Phone: 92-21-35309256-60 Fax: 92-21-35309168

Karachi - KSE
Room No. 70, 1st Floor, KSE Bldg. Stock Exchange Road, Karachi
Phone: 92-21-32429601-06 Fax: 92-21-32429607

Lahore
75-T, Phase 2, DHA, Near Lalak Chowk, Lahore
Phone: 92-42-35707411-33 Fax: 92-42-35748935

Islamabad
Mezzanine Floor, Razia Sharif Plaza, 90 - Blue Area, G-7, Islamabad
Phone: 92-51-111-234-234, 2802241-43 Fax: 92-51-2802244

Faisalabad
9th Floor, State Life Building, 2 - Liaqat Road, Faisalabad
Phone: 92-41-2540845-43 Fax: 92-41-2540815

Sialkot
Room No. 206, 2nd Floor, Cantonment Plaza, Sialkot Cantt.
Phone: 92-52-4566032-33 Fax: 92-52-4566035

Multan
1st Floor, Abdali Tower, Abdali Road, Multan Cantt.
Tel: 92-61-4500182-83, Fax: 92-61-4784403

Gujranwala
Anwar Industry Complex, Block-B-1, G.T. Road, Gujranwala
Phone: 92-55-4294264-67 Fax: 92-55-3257453

IGI
Securities