Day Break

Thursday, 20 February 2020

IGI Securities

COMPANY UPDATE

Pakistan State Oil Company Limited

Oil & Gas Marketing Companies

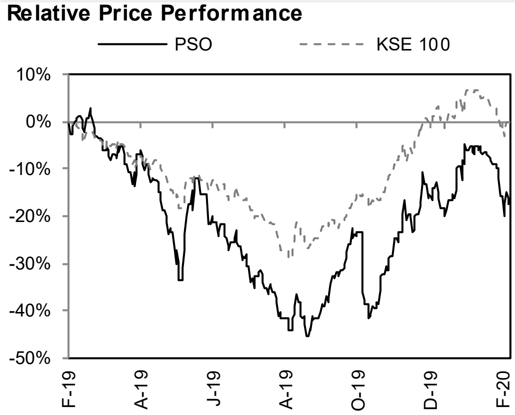
Recommendation			**BUY**
Target Price:	Dec/20		253.6
Last Closing:	19-Feb-20		183.6
Upside:			38.1
Valuation Methodology:			Discounted Cash Flow (DCF)
Time Horizon:			10M
Market Data			
Bloomberg Tkr.			PSO PA
Shares (mn)			469.5
Free Float Shares (mn)			211.3
Free Float Shares (%)			45.0%
Market Cap (PKRbn | USDmn)		86.2	558.6
Exchange			KSE 100
Price Info.	90D	06M	12M
Abs. Return	10.9	41.7	(17.4)
Lo	170.0	124.5	124.5
Hi	216.9	216.9	235.0

Key Company Financials

Period End: Jun

PKRbn	**2019e**	**2020f**	**2021f**	**2022f**
Total Revenue	1,154.3	1,217.7	900.0	959.6
Net Income	10.6	12.3	13.3	16.0
EPS (PKR)	22.5	26.1	28.2	34.1
DPS (PKR)	10.0	10.0	12.0	13.0
Total Assets	417.1	403.4	371.0	384.4
Total Equity	119.2	127.7	136.1	146.2
Key Financial Ratios				
ROE (%)	14.5	9.2	9.9	10.1
P/E (x)	8.1	7.0	6.5	5.4
P/B (x)	0.8	0.7	0.7	0.6
DY (%)	5.4	5.4	6.5	7.1

Relative Price Performance



Source: Bloomberg, PSX & IGI Research

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Oil & Gas Marketing Companies

PSO: Earnings revised post 2QFY20 result while Sukuk-II to act as a trigger; 'Buy' maintained

- ✓ We have revised our earnings estimate for Pakistan State Oil Company Limited (PSO) by an average of 6-14% for FY20-24. As a result our Dec-20 target price has been revised down marginally by 1% to PKR 253.6/share,
- ✓ PSO held its analyst briefing on 19th Feb-20 to discuss financial result for 2QFY20 and future prospects of the company. Profitability for 2QFY20 clocked in at PKR 2.91bn (EPS: PKR 6.19) up by +42.6xYoY compared to PKR 0.07bn (EPS: PKR 0.15)
- ✓ We attribute this incline in earnings during 2QFY20 to a) +9%YoY increase in total volumes led by +19/+12%YoY jump in MS/HSD sales, b) other income in the absence of exchange losses, c) higher other income likely owing to elevated Late Payment Surcharge (LPS) income and, d) lower inventory losses of nearly ~PKR 2.3bn,
- ✓ We recommend a **"BUY"** stance on PSO with our Dec-20 target price of PKR 253.6/share offering 38% upside from last close.

Earnings revised post management meeting

We have revised our earnings estimate for Pakistan State Oil Company Limited (PSO) by an average of 6-14% for FY20-24 on account of higher finance cost, lower FO prices, higher LPS income and lower other charges. As a result our Dec-20 target price has been revised down marginally by 1% to PKR 253.6/share. However, we have not incorporated Sukuk-II amount to be received by PSO.

Profitability for 2QFY20 reported at PKR 6.19/share up by +42.6xYoY

PSO held its analyst briefing on 19th Feb-20 to discuss financial result for 2QFY20 and future prospects of the company. Profitability for 2QFY20 clocked in at PKR 2.91bn (EPS: PKR 6.19) up by +42.6xYoY compared to PKR 0.07bn (EPS: PKR 0.15) in the same period last year. We attribute this incline in earnings during 2QFY20 to a) +9%YoY increase in total volumes led by +19/+12%YoY jump in MS/HSD sales, b) other income in the absence of exchange losses, c) higher other income likely owing to elevated Late Payment Surcharge (LPS) income and, d) lower inventory losses of nearly ~PKR 2.3bn compared to PKR 4.9bn in the same period last year. This brings total earnings for 1HFY20 to PKR 6.44bn (EPS PKR 13.71) compared to PKR 4.25bn (EPS PKR 9.05) in the same period last year

Exhibit: PSO Financial Highlight

PKRmn	2QFY20	2QFY19	YoY	1HFY20	1HFY19	YoY
Net Sales	312,556	291,825	7%	642,339	571,853	12%
Gross Profit	6,970	5,090	37%	17,677	15,996	11%
S&D Expense	3,198	2,360	36%	5,763	4,428	30%
Admin Expense	731	565	29%	1,455	1,286	13%
Other Charges/(Income)	(138)	1,027	n/m	151	1,819	-92%
Other Operating Income	5,395	1,680	3.2x	6,979	2,650	2.6x
EBIT	8,574	2,818	3.0x	17,286	11,114	56%
Finance Cost	3,900	2,029	92%	6,540	3,855	70%
Profit Before Taxation	4,842	604	8.0x	11,058	7,194	54%
Taxation	1,935	535	3.6x	4,623	2,944	57%
Profit After Taxation	2,906	68	42.6x	6,435	4,249	51%
EPS (PKR)	6.19	0.15		13.71	9.05	
DPS (PKR)	-	-		-	-	

Source: IGI Research, Company Financials *No of Shares: 469.47mn*

Earnings are down by 18%QoQ during 2QFY20

On a sequential basis, earnings are down by 18%QoQ on account of inventory losses of PKR 2.64bn and higher finance cost. However, earnings decline remained restricted due to PKR 5.2bn LPS income realized during the quarter and exchange gain leading to other operating income against other charge booked in the preceding quarter.

Exhibit: PSO receivables position

PKR bn	17-Feb-20	31-Dec-19	30-Sep-19	30-Jun-19	30-Jun-18
Power Sector	100.5	102.6	107.1	115.9	199.9
SNGPL (LNG)	85.1	70.4	67.1	64.7	15.9
PIA	13.6	12.9	12.9	13.3	13.0
PDC	9.6	9.6	9.6	9.6	9.6
Exchange losses on FE-25	27.8	27.8	28.0	30.2	9.7
Total	236.6	223.3	224.7	233.7	248.1
LPS	*110	*110	119.8	113.2	87.2
Total Inc. LPS	346.6	333.3	344.5	346.9	335.3

Source: PSO, IGI Research
** Estimated as per management*

Major takeaways from analyst briefing as stated by the management

Key financial highlights:

- ✓ The result included the consolidation of Pakistan Refinery Limited (PRL) in to PSO post acquisition of further stake in Dec-18 which brought total stake in PRL to 52.7%. On a consolidated basis PSO's earnings stand at PKR 1.83bn (EPS PKR 3.91) bringing total consolidated profits for IHFY20 to PKR 4.34bn (EPS PKR 11.36). Comparable last year numbers were not reported as consolidation was effective from 4QFY19;
- ✓ Effective tax rate clocked in at 40.0% during 2QFY20 compared to 88.7% (1QFY20: 43.2%) reported in the corresponding period last year, bringing total effective tax rate to 41.8% for 1HFY20 compared to 40.9% in the same period last year;
- ✓ PSO booked in inventory loss of PKR 2.64bn during the 2QFY20 which was mostly due to inventory loss of PKR 1.22bn on MS and PKR 1.21bn on HSD;
- ✓ Other income was higher due to substantial penal interest income of PKR 5.2bn realized during quarter mainly from CPPA;
- ✓ Finance cost surged by +92%YoY to PKR 3.90bn during 2QFY20 against PKR 2.03bn in the same period last year likely owing to elevated mark-up cost on short term borrowings. This is likely due to shift in ST borrowing from FE-25 (now at USD 100mn at 5% mark-up) to local which carries higher mark-up rate of nearly 14%;
- ✓ LNG receivables from SNGP have increased to PKR 85bn as at 17th Feb-20 compared to PKR 65bn as at Jun-19, however power sector receivables are down to PKR 101bn as at 17th Feb-20 compared to PKR 116bn as at Jun-19 owing to better recoveries;
- ✓ PSO's market share in white oil products has increased to 44.1% in 1HFY20 as compared to 39.1% in 1HFY19.

Exhibit: Market Share of white oil product (%)
PSO increased its market share in White Oil products to 44.1% in 1HFY20

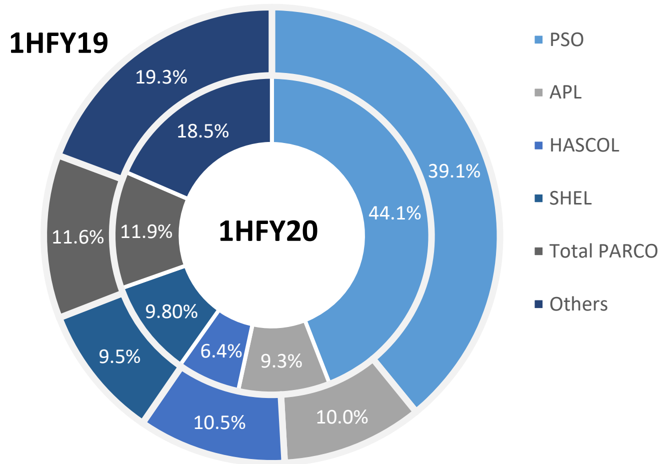
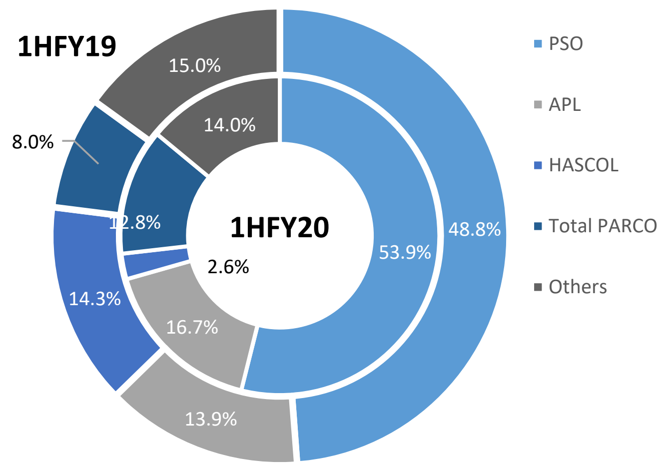


Exhibit: Market Share of black oil product (%)
PSO remains market leader in black oil with a market share of 53.9% in 1HFY20



Management's business outlook included:

- ✓ Sukuk-II is likely to come through by end of Mar-2020;
- ✓ The Company has put proposal to be allocated PKR 101bn from Sukuk-II which would completely write off over dues from power sector however this remains highly unlikely and considering power sector receivables are down to PKR 101bn (PKR 200bn at Jun-18) a smaller allocation than PKR 60 received in Sukuk-I cannot be ruled out;
- ✓ PSO recovered higher LPS income from power sector on convincing power sector that PSO is not borrowing at higher rate and needs higher LPS income. LPS overdue stands nearly at ~PKR 110bn;
- ✓ PSO expect to convert 250,000 tonnes of FO storage in to MS and HSD in the next 2.5yrs with 50,000 tonnes of FO to be converted in to MS by end of 2019, whereas total of 164,000 tonnes of storage is planned for rehabilitation;
- ✓ Dividend payout is now generally is 3Q each year as SNGP's recoveries are low in winter season and during 3Q PSO expects improved payments from SNGP;
- ✓ PSO has obtained a stay order on a case against OGRA's interpretation of law regarding installation of new retail outlets in a province depending on storage available in that particular province which after the stay order would mean that OMCs can now install retail outlets in any province against total countrywide storage, This would allow for increase retail network in Punjab especially which was being limited under this regulation;
- ✓ The Company will plan its investment post transition phase in PRL with first phase focusing on upgradation of refinery in deep conversion and then second phase focusing on capacity enhancement. However, the amount of investment will only be quantified once plan is approved by the Board of Directors. Furthermore, post transition phase PSO will likely uplift higher percentage of products from PRL however this would not have any impact on profitability. Investment in upgradation of PRL would likely be done by 2024-25 however in short term management is planning on shifting to light sweeter crude to reduce FO quantity produced and also move towards producing RON-95 petrol to avail higher margins;

- ✓ ECC approval has been granted to clear outstanding dues of PSO related to exchange losses accumulated on FE-25 borrowing. However, these would likely be clear gradually over the next few years;
- ✓ Exchange rate now used by OGRA in determining the prices for each month would be the rate prevailing in the last week of preceding month. This would reduce quantum of exchange losses for OMC's especially PSO;
- ✓ FE 25 borrowing is down to USD 100mn which will mature in the next few months and the Company does not expect to utilize the facility further owing to build up of receivables of exchange losses on these loans. Thus PSO will likely shift completely to local borrowing which will keep mark-up cost on these borrowings on higher side as the rate charged is nearly ~14% compared to 5% on FE-25 borrowings;
- ✓ PSO expects OMC's to further book inventory losses in 3QFY20 whereas in 4QFY20 management expects prices to recover and during 2HFY20 inventory losses would be normalized;
- ✓ PSO expects to retain market share despite HASCOL having availed LC to resolve supply chain issues. The Company expects smaller OMC to lose out market share while PSO is likely to retain its market share however does not foresee market share reaching 60% again.

Outlook

The Company is expected to increase it storage capacity by 250k MTons in the coming years which is expected to reduce PSO's vulnerability to heavy inventory loss/gain and ease storage concerns especially for MS. PSO is also focusing on reducing operating costs especially administrative cost. Furthermore, Sukuk-II issue likely expected by end of Mar-20. This in turn would allow PSO's working capital to ease off whereas any lower FO sales would most likely keep a lid on accumulation of circular debt. However, key concern remains, accumulation of circular debt on LNG through SNGP which by contractual agreement terms is on take or pay basis, and cash requirement for PSO in this regard is fixed. Thus PSO's working capital concerns are likely to ease but not eliminate as retail fuel segment has been on a downturn in terms of demand and to a certain extent hit by grey market. However increased storage and increasing retail presence in Punjab post stay order against OGRA's interpretation of regulation would allow PSO to recapture and sustain its market share in white oil products.

On volumes front total industry volumes dropped by 5%YoY in 1HFY20. This was reflective of 10%YoY and 19%YoY drop in HSD and FO sales in 1HFY20. Drop in HSD sales in 1HFY20 was due to high price differential between smuggled and local fuel leading to hit from grey market sales and economic slowdown which has been limited by GoP efforts however not completely stopped. HSD being directly correlated to GDP growth is likely to post 2.5%-3.0% growth post FY20 while FO is likely to maintain 2.2-2.6mn tons. MS sales are likely to post only 5-10%YoY growth in FY20 with 8-10% growth there onwards.

Recommendation

We recommend a "BUY" stance on PSO with our Dec-20 target price of PKR 253.6/share offering 38% upside from last close. The company is currently trading at FY20 P/E of 7.0x.

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Recommendation	Rating System
Buy	If target price on aforementioned security(ies) is more than 10%, from its last closing price(s)
Hold	If target price on aforementioned security(ies) is in between -10% and 10%, from its last closing price(s)
Sell	If target price on aforementioned security(ies) is less than -10%, from its last closing price(s)

Time Horizon: Dec – 2020
Valuation Methodology: The analyst(s) has used following valuation methodology to arrive at the target price of the said security (ies):
(Discounted Cash Flow)

Risk: Investment in securities are subject to economic risk, market risk, interest rate risks, currency risks, and credit risks, political and geopolitical risks. The performance of company (ies) covered herein might unfavorably be affected by multiple factors including, business, economic, and political conditions. Hence, there is no assurance or guarantee that estimates, recommendation, opinion, etc. given about the security (ies)/company (ies) in the report will be achieved.

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