RATING REPORT

Pakistan State Oil Company Limited (PSO)

REPORT DATE:
June 19, 2019

RATING ANALYSTS:

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RATING DETAILS		
Rating Category	**Initial Rating**	
	Long-term	**Short-term**
Entity	AA+	A-1+
Rating Outlook	Stable	
Rating Date	*June 19, '19*	

COMPANY INFORMATION	
Incorporated in 1976	External auditors: **A.F. Ferguson & Co. Chartered Accountants and EY Ford Rhodes Chartered Accountants**
Listed Public Limited Company	Chairman of the Board: **Zafar Ul Islam Usmani**
Key Shareholders (with stake 5% or more):	Chief Executive Officer: **Syed Jehangir Ali Shah**
Government of Pakistan – 51%	

APPLICABLE METHODOLOGY(IES)
Applicable Rating Criteria:
Oil & Gas Industry (November 2016) https://www.vis.com.pk/kc-meth.aspx
Industrial Corporates (May 2016) https://www.vis.com.pk/kc-meth.aspx

Pakistan State Oil Company Limited (PSO)

OVERVIEW OF THE INSTITUTION

Pakistan State Oil Company Limited (PSO) is a public company incorporated in Pakistan in 1976 and is listed on the Pakistan Stock Exchange Limited. Registered office of the company is located at in Karachi. Principal activities of the company are procurement, storage and marketing of petroleum and related products. It also blends and markets various kinds of lubricating oils.

Profile of Chairman

Zafar Ul Islam Usmani has held multiple C-level positions with multinational and national companies. He has worked as Chief Operating Officer in Cable & Wireless JV, Paktel; Chief Executive Officer in ExxonMobil JV in Pakistan; Senior Vice President Commercial in Pakistan International Airlines Corporation; Senior Executive Vice President in Pakistan Telecommunication Company Limited and Chief Operating Officer in CM Pak Ltd (Zong). He has overall 33 years of experience with 17 years in C-level positions, with exposure in the area of management, strategy, planning, marketing, sales, distribution, customer services and finance.

Profile of Acting Managing Director

Jehangir Ali Shah is a seasoned veteran of the oil industry. He has been appointed as Acting Managing Director of PSO on September 06, 2018. This position was also held by him previously in 2013. He joined PSO in 1984 and had worked in various management positions. His forte however, remained sales and marketing as he has led almost all marketing departments in PSO.

RATING RATIONALE

Pakistan State Oil Company Limited (PSO) is the country's largest oil marketing company (OMC) in terms of petroleum, oil and lubricant (POL) sales market share (~41% in 9MFY19); it also has the largest liquid fuel storage (~51% of the country's total working storage capacity as at end-FY18) and most extensive retail network (~40% of total retail outlets). The company's distribution and storage facilities showcase extensive geographic diversification which supports its competitive profile.

The company is engaged in storage, distribution and marketing of POL products. While being among the country's largest corporate entities, PSO offers its products through a vast network of retail outlets (~3,514) across the country, including sizeable number of 'New Vision Retail' outlets. Government of Pakistan (GoP) holds ~51% stake and management control in PSO through direct and indirect holdings. GoP has complete authority in terms of appointment of the Board of Management and Managing Director. PSO holds strategic investments in Asia Petroleum Limited (49%), Pak Grease Manufacturing Company Limited (22%), Pakistan Refinery Limited (PRL) (52.7%), Pak - Arab Pipeline Company Limited (PAPCO) (12%) and New Islamabad Airport Fuel Farm (50%). Accordingly, the company's vertically integrated supply chain infrastructure supports business and market risk profile.

POL products are segregated into three broad categories (a) white oils – comprising high speed diesel (HSD), motor gasoline (MS), jet petroleum (JP-1), and kerosene oil (SKO), (b) black oils – comprising furnace oil (FO), and light speed diesel (LDO), and (c) lubricants and chemicals. Barring lubricants, PSO is the market leader in all POL segments. Alongside, the company is engaged in supply of gaseous fuels including liquefied natural gas (LNG), liquefied petroleum gas (LPG) and franchising of compressed natural gas (CNG). The company is also establishing presence in the non-fuel retail segment with a wide network of convenience stores and other associated services.

Future Plans

- PSO is currently undergoing an extensive overhaul of its storage and marketing infrastructure.
- PAPCO is pursuing conversion of its HSD pipeline (PSO has 12% stake in the project) to multi-grade pipeline by June'2019 which will strengthen PSO's transportation infrastructure.
- The company aims to diversify its businesses further in the mid-stream oil industry. PSO presently maintains integration into refining business through stakes in PRL.
- Accordingly, some of the key areas of focus are increase in POL storages across the country, expanding lubricant availability, improving customers' experience at retail outlets and upgrading retail infrastructure.

Key Rating Drivers

Sovereign ownership and strategic national importance in the domestic energy sector.

The assigned ratings reflect sovereign ownership structure of the company with GoP being the largest shareholder, having a controlling stake. Ratings also incorporate PSO's strategic national importance in the domestic energy sector given its sizeable oil storage capacity (around half of country's total storage) and extensive footprint across the country. Thus, unhindered supply of petroleum products in the domestic market and to strategic customers is contingent on smooth operations of PSO. VIS believes PSO will continue to be of strategic importance to the country and GoP over the rating horizon.

Sharp decline witnessed in industry volumes in 9MFY19. Decrease was more pronounced in furnace oil segment, followed by high speed diesel.

Industry sales volumes decreased by 22.2% in 9MFY19 primarily on account of decrease in sales of FO. Availability of cheaper substitutes such as re-gasified LNG (RLNG) and coal has contributed to reduction in sales of FO. Excluding FO, volumes witnessed a reduction of 9.2%, with second largest decline observed in HSD. HSD sales declined on account of slowdown in economy particularly in transport & large scale manufacturing activities and increased availability of smuggled products from a neighboring country. Going forward, industry sales are expected to remain under pressure due to further reduction expected in FO off-take in FY20. Pressure in industry off-take along with existing players competing for market share is expected to result in higher competitive intensity in the OMC sector. Government regulations requiring higher minimum capital investment by new OMCs and well-established storage infrastructure of large OMCs can dilute threat of increasing competition from new entrants.

Industry Sales (000 tons)		
	9MFY19	**YoY change**
Furnace Oil (FO)	2,521.3	-53.6%
High Speed Diesel (HSD)	5,500.2	-18.9%
Motor Spirit (MS)	5,722.0	3.0%
Others	595.4	-12.1%
Total	**14,338.9**	**-22.2%**

Leading market position with ~41% market share and established brand name in the oil marketing business. Diversified product portfolio projected to support revenues; LNG sales are expected to partly offset lower furnace oil volumes.

PSO is the largest OMC in Pakistan with ~41% market share during 9MFY19 with an established brand name in the business. However, overall market share of the company has witnessed decline on a timeline basis on account of increasing competition from new & existing players (9MFY19: 41%; FY18: 50%; FY17: 55%) and decline in FO sales where PSO has a higher relative market share. Going forward, PSO has embarked on undertaking significant investment in storage, marketing and refining infrastructure in order to retain market share given the increasingly competitive landscape.

Industry	FY17		FY18		9MFY19	
(in Metric Tons)	Volumes	Share (%)	Volumes	Share (%)	Volumes	Share (%)
PSO	14,086.5	54.8	12,412.1	50.0	5,844.2	40.8
Others	11,527.5	45.2	12,425.4	50.0	8,494.7	59.2
Industry Volumes	**25,714.0**	**100**	**24,837.5**	**100.0**	**14,338.9**	**100.0**

<u>Retail fuel (MS & HSD)</u>

PSO's market share in retail fuels (MS & HSD) has decreased. Decline in market share 9MFY19 is attributed to stiff competition and challenges from new entrants, substantial discounts offered by competitors, influx of smuggled products, decline in automobile sales and lower contribution from agriculture and large scale manufacturing sector towards GDP. Nevertheless, the company continues to maintain market leadership in retail business. In a bid to retain market share, PSO has undertaken a number of marketing activities like new outlet addition, introduction of new fuel variants, revamping of C-stores and other promotional activities. Over the long-term, PSO expects to recapture retail market share through ongoing upgrade of storage and marketing infrastructure.

Furnace oil

Owing to availability of RLNG/coal and GoP's strategy of switching priority (merit order) of existing power plants to RLNG/coal, FO demand has decreased significantly during FY18 and the ongoing year. Accordingly, FO volumes of PSO have declined significantly, particularly in 9MFY19. Moreover, market share in FO has reduced on a timeline basis. In line with industry trends, management does not foresee any significant growth in this avenue and plans to focus on substitutes like LNG. As a result, build up circular debt from FO is projected to slow down although receivables from LNG business are expected to partly offset the same.

Jet fuel

PSO is engaged in business of supplying jet fuel to aviation sector. The company sells two key products namely JP-1 and JP-8. In FY18, PSO established refueling facility at the New Islamabad International Airport in collaboration with Attock Petroleum Limited with a 50% shareholding. The company maintained the largest market share for JP-1 at 79.2% (FY17: 73.5%) in FY18. The growth in volumes and increase in market share is associated with acquisition of business of both local and foreign scheduled airlines, start of operations at New Islamabad International Airport and an increase in volumes from Defense customers. Apart from this, PSO maintained the market share at 100% in JP-8 exports to Afghanistan with volume growth of 135.7% in FY18.

Gaseous fuels (LNG, CNG & LPG)

Liquefied Natural Gas

PSO imported 72 LNG vessels (6 cargos on monthly basis) with total 233,585,797 MMBTUs in FY18. On an average, 600 MMCFD of RLNG was supplied to SNGPL during FY18. Despite very thin regulated margin (due to high effective tax rate) and significant delays in receipts against LNG supplies, management plans to increase its share in the LNG business in order to offset revenue loss from FO business.

Compressed Natural Gas and Liquefied Petroleum Gas

In terms of market participation of CNG facilities under the PSO Franchise model, PSO has maintained its position in the industry. Improvement in availability of RLNG at CNG stations in Punjab contributed to the sustainability of this industry. PSO is in LPG business since 1981. It supplies LPG through a network of distributors under the brand name "Pak Gas". In FY18, the company reported volume growth of 26.3% vis-à-vis industry growth of 5.1%. Pak Gas has further strengthened its presence in the market with increased penetration in sub-urban and rural areas and is now amongst the top 6 LPG Marketing Companies in the industry.

Lubricants

PSO's lubricants business holds a market share of 8.9% and recorded volumetric growth of 4.4% in FY18. While focus remains on industrial, retail and high street segments, majority growth in the outgoing year emanated from retail and industrial channels of 5.7% and 18.9% respectively. The company blended more than 46,000 MTs in FY18 through its production facility. In line with industry trend, management plans to focus on higher end products with better margins although overall volumes may be lower.

Largest storage and marketing infrastructure in the country with ~51% of the country's total working storage capacity; storage conversion, rehabilitation and new development project along with retail outlet enhancement to strengthen infrastructure over the next two years.

PSO operates under the largest storage and marketing infrastructure in the country with ~51% of the country's total working storage capacity (~794 KMTs) as at end-FY18. Currently, the company is undergoing overhaul of its storage infrastructure through conversion of existing tanks (from products like LDO, SKO and FO) to more frequently used products like MS and HSD. Alongside, the company will install new tanks and rehabilitate existing tanks. As a result, storage capacity will increase to over 1m MT by end-FY21. As per management, rationale for this project is achieving better inventory management and volumetric growth in sales.

The company has 450 cartage contractors with a fleet of 7,940 tank lorries out of which 190 are NHA/OGRA compliant. In terms of marketing infrastructure, PSO operates ~3,514 retail branches across the country. The company plans to revamp old outlets under PSO's new branding regime. Under this scheme, the company has renovated sizeable number of 'New Vision Retail' outlets over the years with addition of 78 outlets in FY18.

While share of refinery upliftment has been increasing on a timeline basis, reliance on import remains a key risk to profitability given the country's macro-economic indicators.
PSO has sizeable reliance on imports, whereby on average two-third of fuel is imported. Resultantly, depending on timing of cargo imported, the company will have to bear a sizeable exchange loss in case of rupee devaluation. Given the sizeable current account deficit and significant external debt servicing requirements over the next three years, VIS expects the same to remain a key risk area to profitability, going forward.

Topline continues to witness growth in FY18 and the ongoing year due to higher average selling prices and increasing LNG sales.
Net sales have increased at a compound annual growth rate (CAGR) (FY15-18) of 5%. In 9MFY19, net sales increased to Rs. 819.2b (9MFY18: Rs. 749.5b; FY18: 1,056.9b; FY17: Rs. 878.1b). Sales to four major customers of the company are ~34% (FY17: 36%) for FY18. On a timeline basis, revenue from FO has witnessed a decline. This has been offset by rising sales of LNG. Overall, growth in topline was a function of both increase in average selling prices and volumes (for LNG and retail fuels). Going forward, increasing LNG sales along with recovery in MS and HSD volumes are expected to support topline of the company.

Margins to be supported by CPI linkage to retail fuels. Overall profitability is expected to remain tied to quantum of inventory gain/loss and exchange gain/loss and markup income on delayed payments.
In FY18, gross margins were lower due to increase in sales price. During 9MFY19, gross margins further declined due to lower sales volumes of black and white oil with reduction in industry volumes and inventory losses. While gross margins are expected to vary in accordance with sales volumes, inventory gains/losses and selling prices, CPI linkage of margins on retail fuels is expected to support margins. Fluctuation in net profitability of the company has primarily been a function of inventory exchange gain/loss and mark-up income on delayed payments and PIBs.

In 9MFY19, the company reported a sizeable dip in overall profitability due to lower markup income on delayed payments, exchange & inventory loss and higher finance cost on account of sharp rise in interest rates and higher average borrowing levels. Despite mounting inflation, the company managed to control its operating cost the same level. Nevertheless, profit after tax declined significantly to Rs. 5.9b (9MFY18: Rs. 13.2b) in 9MFY19.

Liquidity profile draws support from adequate cash flow from operations and sizeable cash based sales. While circular debt continues to be a liquidity constraint, sizeable decline in quantum of trade debts has been noted due to lower FO volumes and due to circular debt

payment.

Liquidity profile of the Company draws support from adequate cash flow from operations and sizeable proportion of retail sales in overall revenues. However, liquidity profile is constrained by mounting receivables (circular debt) which have accounted for at-least 50% of asset base over the past half-decade. Trade debts of the company increased to Rs. 245.6b (FY17: Rs. 212.6b) as at end-FY18. Of these, ~60% of receivables (at end-FY18) are due from government and autonomous bodies while remaining pertain to general customers. The gap is bridged through reliance on short term borrowing from banks. Buildup of circular debt has been arrested by declining FO volumes although this has been partly offset by higher LNG business receivables. In March 2019, GoP partially settled the mounting circular debt through payment of Rs. 60b; however this was offset by delayed payment on LNG supplies by an additional Rs. 40b. The persistence of circular debt and the associated liquidity constraints remain an area of concern with respect to working capital management.

Gearing and leverage indicators have decreased on timeline basis and remain within manageable levels.

Total equity has grown on timeline basis (9MFY19: Rs. 114.7b; FY18: Rs. 110.4b; FY17: Rs. 102.8b) on account of internal capital generation. Dividend payout ratio was reported at 35.9% (2017: 48.3%; 2016: 39.7%) in 2018.Total debt comprises short term borrowings only and amounted to Rs. 102.0b (FY18: Rs. 89.8b; FY17: Rs. 130.5b) at end-9MFY19. Ongoing and future capex is planned to be funded by internal cash generation. Gearing and leverage ratios were reported at 0.89x (FY18: 0.81x; FY17: 1.27x) and 2.17x (FY18: 2.64x; FY17: 2.82x) respectively at end-9MFY19.

Pakistan State Oil Company Limited (PSO) Appendix I

FINANCIAL SUMMARY *(amounts in PKR millions)*

BALANCE SHEET	FY17	FY18	9MFY19
Fixed Assets	6,945	7,327	7,518
Stock-in-Trade	66,333	81,615	77,874
Trade Debts	212,619	245,577	200,126
Cash & Bank Balances	4,131	4,637	5,508
Total Assets	392,443	402,562	364,207
Trade and Other Payables	146,270	192,146	138,650
Long Term Debt	-	-	-
Short Term Debt	130,499	89,847	101,990
Total Equity	102,850	110,452	114,742
INCOME STATEMENT	**FY17**	**FY18**	**9MFY19**
Sales-Net of Sales Tax	878,147	1,056,901	819,199
Gross Profit	37,136	39,636	23,884
Operating Profit	34,662	31,870	17,387
Profit Before Tax	29,347	27,160	10,693
Profit After Tax	18,226	15,461	5,926
RATIO ANALYSIS	**FY17**	**FY18**	**9MFY19**
Gross Margin (%)	4.2%	3.8%	2.9%
Net Working Capital	87,056	91,159	92,141
FFO	12,353	12,544	4,833
FFO to Total Debt	9.5%	14.0%	6.3%
Gearing (x)	1.27	0.81	0.89
Leverage (x)	2.82	2.64	2.17
Debt Servicing Coverage Ratio (x)	3.39	3.43	1.81
ROAA (%)	5%	4%	2%
ROAE (%)	19%	14%	7%

ISSUE/ISSUER RATING SCALE & DEFINITIONS — Appendix II

Medium to Long-Term

AAA
Highest credit quality; the risk factors are negligible, being only slightly more than for risk-free Government of Pakistan's debt.

AA+, AA, AA-
High credit quality; Protection factors are strong. Risk is modest but may vary slightly from time to time because of economic conditions.

A+, A, A-
Good credit quality; Protection factors are adequate. Risk factors may vary with possible changes in the economy.

BBB+, BBB, BBB-
Adequate credit quality; Protection factors are reasonable and sufficient. Risk factors are considered variable if changes occur in the economy.

BB+, BB, BB-
Obligations deemed likely to be met. Protection factors are capable of weakening if changes occur in the economy. Overall quality may move up or down frequently within this category.

B+, B, B-
Obligations deemed less likely to be met. Protection factors are capable of fluctuating widely if changes occur in the economy. Overall quality may move up or down frequently within this category or into higher or lower rating grade.

CCC
Considerable uncertainty exists towards meeting the obligations. Protection factors are scarce and risk may be substantial.

CC
A high default risk

C
A very high default risk

D
Defaulted obligations

Short-Term

A-1+
Highest certainty of timely payment; Short-term liquidity, including internal operating factors and /or access to alternative sources of funds, is outstanding and safety is just below risk free Government of Pakistan's short-term obligations.

A-1
High certainty of timely payment; Liquidity factors are excellent and supported by good fundamental protection factors. Risk factors are minor.

A-2
Good certainty of timely payment. Liquidity factors and company fundamentals are sound. Access to capital markets is good. Risk factors are small.

A-3
Satisfactory liquidity and other protection factors qualify entities / issues as to investment grade. Risk factors are larger and subject to more variation. Nevertheless, timely payment is expected.

B
Speculative investment characteristics; Liquidity may not be sufficient to ensure timely payment of obligations.

C
Capacity for timely payment of obligations is doubtful.

Rating Watch: VIS places entities and issues on 'Rating Watch' when it deems that there are conditions present that necessitate re-evaluation of the assigned rating(s). Refer to our 'Criteria for Rating Watch' for details. www.vis.com.pk/images/criteria_watch.pdf

Rating Outlooks: The three outlooks 'Positive', 'Stable' and 'Negative' qualify the potential direction of the assigned rating(s). An outlook is not necessarily a precursor of a rating change. Refer to our 'Criteria for Rating Outlook' for details.www.vis.com.pk/images/criteria_outlook.pdf

(SO) Rating: A suffix (SO) is added to the ratings of 'structured' securities where the servicing of debt and related obligations is backed by some sort of financial assets and/or credit support from a third party to the transaction. The suffix (SO), abbreviated for 'structured obligation', denotes that the rating has been achieved on grounds of the structure backing the transaction that enhanced the credit quality of the securities and not on the basis of the credit quality of the issuing entity alone.

(blr) Rating: A suffix (blr) is added to the ratings of a particular banking facility obtained by the borrower from a financial institution. The suffix (blr), abbreviated for 'bank loan rating' denotes that the rating is based on the credit quality of the entity and security structure of the facility.

'p' Rating: A 'p' rating is assigned to entities, where the management has not requested a rating, however, agrees to provide informational support. A 'p' rating is shown with a 'p' subscript and is publicly disclosed. It is not modified by a plus (+) or a minus (-) sign which indicates relative standing within a rating category. Outlook is not assigned to these ratings. Refer to our 'Policy for Private Ratings' for details. www.vis.com.pk/images/policy_ratings.pdf

'SD' Rating: An 'SD' rating is assigned when VIS believes that the ratee has selectively defaulted on a specific issue or obligation but it will continue to meet its payment obligations on other issues or obligations in a timely manner.

REGULATORY DISCLOSURES — Appendix III

Name of Rated Entity	Pakistan State Oil Company Limited
Sector	Oil & Gas
Type of Relationship	Solicited
Purpose of Rating	Entity Rating
Rating History	see table below
Instrument Structure	n/a
Statement by the Rating Team	VIS, the analysts involved in the rating process and members of its rating committee do not have any conflict of interest relating to the credit rating(s) mentioned herein. This rating is an opinion on credit quality only and is not a recommendation to buy or sell any securities.
Probability of Default	VIS' ratings opinions express ordinal ranking of risk, from strongest to weakest, within a universe of credit risk. Ratings are not intended as guarantees of credit quality or as exact measures of the probability that a particular issuer or particular debt issue will default.
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Rating History

Rating Date	Medium to Long Term	Short Term	Rating Outlook	Rating Action
		RATING TYPE: ENTITY		
Jun-19-19	AA+	A-1+	Stable	Initial