RATING REPORT

Pakistan State Oil Company Limited (PSO)

REPORT DATE:
May 04, 2020

RATING ANALYSTS:

Talha Iqbal
talha.iqbal@vis.com.pk

Asfia Aziz
asfia.aziz@vis.com.pk

RATING DETAILS

Rating Category	Current Rating		Previous Rating	
	Long-term	**Short-term**	**Long-term**	**Short-term**
Entity	AA+	A-1+	AA+	A-1+
Rating Outlook	Rating Watch-Developing		Stable	
Rating Date	*May 04,'20*		*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): **Government of Pakistan – 51%**	**Managing Director & Chief Executive Officer:** Syed Muhammad Taha

APPLICABLE METHODOLOGY(IES)

Oil & Gas Industry (June 2019) https://s3-us-west-2.amazonaws.com/backupsqlvis/docs/Meth-OilGas201906.pdf
Industrial Corporates (April 2019) https://s3-us-west-2.amazonaws.com/backupsqlvis/docs/Corporate-Methodology-201904.pdf

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 34 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 Managing Director & CEO

Syed Muhammad Taha has been appointed as the CEO and MD in February 2020 replacing Mr. Jehangir Ali Shah. Syed Taha possesses 19 years of executive-level

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 (~44% in 9MFY20); it also has the largest liquid fuel storage (~55% of the country's total working storage capacity as at end-FY19) and most extensive retail network. The company's distribution and storage facilities showcase extensive geographic diversification and presence across the country supporting 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 (~3,500) 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) (ownership increased to 60%), and Pak - Arab Pipeline Company Limited (PAPCO) (12%). Accordingly, the company's vertically integrated supply chain infrastructure supports business and market risk profile.

POL products are segregated into the following three 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 possesses market dominance in other segments. Furthermore, the company is also 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. Going forward, PSO plans to continue to undergo an extensive overhaul of its existing storage and marketing infrastructure including replacement of select FO storages. Moreover, addition of new storages will also continue at strategic locations. In line with strategic objectives, PSO continues to diversify its businesses further in the mid-stream oil industry. PSO presently maintains integration into refining business through stakes in PRL which were enhanced to 60% from 52.7% previously. Improving customers' experience and loyalty also remain key focus areas.

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.

management experience. Previously, he worked as an executive director at Oasis Energy whereby he headed the Program Management Office of Port Harcourt Electricity Distribution Company, Nigeria. Prior to Oasis Energy, he worked at K-Electric Limited as Chief Operating Officer (Distribution) and a member of the Senior Leadership Team. Mr. Taha has also worked for over 9 years at PSO, where he held several senior positions including Head of Corporate Affairs, Retail Fuel, Cards Business and Corporate Planning and worked directly under CEOs. Other corporates where he worked include Shell Pakistan, Caltex Pakistan (A Chevron Company) and Pakistan Steel Mills. Mr. Taha holds an Engineering degree, with an MBA in Finance from the Institute of Business Administration Karachi.

Sizeable decline witnessed in industry volumes in FY19 and in the ongoing year. Lockdowns due to coronavirus are expected to result in a sharp decline in industry volumes (particularly for white oil business) over the near term.

Industry sales volumes decreased by 22% in FY19 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 9.1%, 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 in FY20. Pressure in industry off-take along with existing players competing for market share is expected to result in increased competitive intensity in the OMC sector. Other factors that may impact industry performance over the medium term includes enhanced technological advancements towards introduction of electric vehicles impacting fuel consumption, and higher utilization of indigenous coal from the Thar region replacing LNG off-takes.

Industry Sales (MT)			
	FY18	**FY19**	**1HFY20**
Furnace Oil (FO)	7,394,000	3,536,100	1,349,100
High Speed Diesel (HSD)	9,043,900	7,359,200	3,383,900
Motor Spirit (MS)	7,510,556	7,685,100	3,948,600
Total	**23,948,456**	**18,580,400**	**8,681,600**

PSO continued to maintain leading market position in liquid fuels with some recovery in market share in the ongoing year. Ratings derive strength from 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 ~44% market share in liquid fuels during 9MFY20 (FY19: 42%) with an established brand name in the business. Market share declined during FY19 on account of expanding competitive landscape through influx of new players, increasing competition from existing players, and phasing out of FO off-takes where the company possessed a higher market share. However, despite challenging operating environment, the company was able to re-coup its market share during 9MFY20 with the same being reported at 44% led by MS and HSD segment. Improvement in market presence during 9MFY20 was achieved through enhancement of consumer experience and forecourt improvements. Strategic initiatives over the medium term include undertaking significant investment in storage, marketing and refining infrastructure in order to retain market share given the increasingly competitive landscape.

Industry (PMG, HSD and FO)	**FY18**		**FY19**		**1HFY20**	
(in Metric Tons)	**Volumes**	**Share (%)**	**Volumes**	**Share (%)**	**Volumes**	**Share (%)**
PSO	11,934,000	49%	7,522,400	40%	3,791,500	44%
Others	12,215,000	51%	11,058,000	60%	4,890,100	56%
Industry Volumes	**24,149,000**	**100%**	**18,580,400**	**100%**	**8,681,600**	**100%**

Retail fuel (MS & HSD)

PSO's market share in retail fuels (MS & HSD) has decreased during FY19; however the company was able to recoup the same during 9MFY20. Decline in market share during FY19 is attributed to stiff competition and challenges from new entrants, substantial discounts offered by competitors, influx of smuggled products, and decline in overall fuel consumption. Nevertheless, the company continues to maintain market leadership in retail business. In order to retain its market share, initiatives envisaged marketing activities including addition of retail outlets, innovative offering- "DigiCash", 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 witnessed a declining trend since FY18. Accordingly, FO volumes of PSO have decreased significantly. 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's market share for JP-1 increased to 94% (FY18: 79.2%) in FY19. JP-1 sales volumes were reported at the highest levels since inception at 618k MT. 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. Sales to foreign carriers increased during FY19 owing to addition of seven new foreign customers; however performance of local carriers slightly deteriorated due to closure of an airlines operation. PSO achieved a market share of 100% in JP-8 exports to Afghanistan being the only OMC to export JP-8.

Gaseous fuels (LNG, CNG & LPG)

Liquefied Natural Gas

PSO imported 74 (FY18: 72) LNG vessels (6 cargos on monthly basis) with total of 236,496,743 (FY18: 233,585,797) MMBTUs in FY19. 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". LPG industry sales volume declined by 10.3% during FY19 with PSO volumes diminishing by 6.1% slightly increasing market share to 2.8% (FY18: 2.7%) during FY19. Critical challenges faced in the LPG industry included disparity in local and imported prices, and shift of imports from sea to land (Taftan Border). 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 (out of 184) in the industry.

Lubricants

PSO's lubricants business holds a market share of 8.8% (FY18: 8.7%) during FY19. Growth in this segment was subdued on account of overall decline in the industry. Sales focus remains on industrial, retail and high street segments. 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; 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. Since FY18, 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.

The company has 450 cartage contractors with a fleet of approximately 5,000 tank lorries out of which around 1500 are NHA/OGRA compliant. In terms of marketing infrastructure, PSO operates ~3,500 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 70 (FY18: 78) outlets in FY19.

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 risk of exchange losses due to rupee devaluation remains. Given the 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 increased in FY19 and in the ongoing year due to higher average selling prices and increasing LNG sales. Overall profitability is expected to remain tied to quantum of inventory gain/loss and exchange gain/loss and markup income on delayed payments.

Net sales have increased at a compound annual growth rate (CAGR) (FY15-19) of 6%. 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). In FY19, gross margins were lower due to higher average selling price, reduction in industry volumes and higher inventory losses. During 1HFY20, gross margins further declined. 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.

Despite mounting inflation, the company managed to control its operating cost the same level. PSO underwent an austerity drive during FY19 which resulted in a reduction of 17% over budgeted Administration and Marketing expenses. Moreover, demurrage expenses were also reduced by 73%

over corresponding period last year through better planning and monitoring by the management.

In FY19, the company reported a sizeable dip in overall profitability due to higher exchange losses on account of PKR devaluation, higher finance costs led by increasing interest rates and average borrowing levels. Nevertheless, profit after tax improved during 1HFY20 being a function of higher other income (receipt of late payment surcharge income from power sector) which helped the company to absorb the brunt of higher finance cost. Fluctuation in net profitability of the company has primarily been a function of inventory exchange gain/loss on delayed payments.

Albeit declining cash coverage ratios, liquidity profile is considered adequate in view of sufficient 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 owing to receipt from issuance of Pakistan Energy Sukuk.

Liquidity profile of the Company draws support from adequate cash flow from operations and sizeable proportion of retail sales in overall revenues. At end-June 2019, receivables from the Power Sector stood at Rs. 115.9b (FY18: Rs. 199.9b) reflecting a substantial reduction over the corresponding period last year owing to receipt from issuance of Pakistan Energy Sukuk. Further, during 1HFY20, receivables from the power sector further diminished by Rs. 13.4b. Improvement in power sector receivables has been off-set by the mounting dues from Sui North Gas Pipelines Limited (SNGPL) due to lower off-takes in winters. The company is actively engaged with the ministries to devise strategies for recovery of these rising receivables from SNGPL. The liquidity 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. 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 increased on a timeline basis; however the same remain within manageable levels.

Total equity has grown on timeline basis (Dec'19- Rs. 125.1b; FY19: Rs. 119.2b; FY18: Rs. 110.4b; FY17: Rs. 102.8b) on account of internal capital generation. Dividend payout ratio (including bonus shares) was reported at 44.4% (FY18: 43.0%) during FY19. Total debt comprises short term borrowings only and amounted to Rs. 110.8b (FY19: Rs. 106.9b; FY18: Rs. 89.8b; FY17: Rs. 130.5b) at end-Dec'19. Ongoing and future capex is planned to be funded by internal cash generation. Gearing and leverage ratios were reported at 0.92x (FY19: 0.90x; FY18: 0.81x; FY17: 1.27x) and 2.15x (FY19: 2.50x; FY18: 2.64x; FY17: 2.82x) respectively at end-Dec'19.

Pakistan State Oil Company Limited (PSO) Appendix I

FINANCIAL SUMMARY- Unconsolidated (Rs. in m)					
BALANCE SHEET	**FY16**	**FY17**	**FY18**	**FY19**	**1HFY20***
Fixed Assets	6,607	6,945	7,327	8,187	12,498
Long term Investments	50,133	4,388	4,784	11,440	13,538
Stock-in-Trade	50,834	66,333	81,615	89,665	85,064
Trade Debts	178,271	212,619	245,577	219,586	204,949
Cash & Bank Balances	5,736	4,131	4,637	4,593	2,614
Total Assets	342,316	392,443	402,562	417,080	394,262
Trade and Other Payables	137,877	146,270	192,146	180,043	145,535
Long Term Debt	-	-	-	-	3,796
Short Term Debt	105,113	130,499	89,847	106,977	110,857
Total Debt	105,113	130,499	89,847	106,977	114,653
Paid Up Capital	2,717	2,717	3,260	3,912	4,695
Total Equity	91,581	102,850	110,452	119,181	125,057
INCOME STATEMENT	**FY16**	**FY17**	**FY18**	**FY19**	**1HFY20***
Net Sales	677,940	878,147	1,063,744	1,154,298	642,339
Gross Profit	22,525	37,136	39,636	36,017	17,677
Profit Before Tax	16,289	29,347	27,160	17,477	11,058
Profit After Tax	10,273	18,226	15,461	10,587	6,435
RATIO ANALYSIS	**FY16**	**FY17**	**FY18**	**FY19**	**1HFY20***
Gross Margin (%)	3.3%	4.2%	3.8%	3.1%	2.8%
Net Margin (%)	1.5%	2.1%	1.5%	0.9%	1.0%
Net Working Capital	29,673	87,056	91,159	93,854	96,144
Funds from Operations	6,991	12,353	12,544	8,988	5,782
FFO to Total Debt (%)	7%	9%	14%	8%	10%
FFO to Long Term Debt (%)	NA	NA	NA	NA	304.6%
Debt Servicing Coverage Ratio (x)	2.29	3.39	3.43	2.07	2.11
Gearing (x)	1.15	1.27	0.81	0.90	0.92
Leverage (x)	2.74	2.82	2.64	2.50	2.15
Current Ratio (x)	1.12	1.31	1.32	1.32	1.37
Short term debt Coverage	218%	214%	364%	289%	262%
ROAA (%)	3%	5%	4%	3%	3%
ROAE (%)	12%	19%	14%	9%	11%

**Ratios Annualized*

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 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.
Disclaimer	Information herein was obtained from sources believed to be accurate and reliable; however, VIS does not guarantee the accuracy, adequacy or completeness of any information and is not responsible for any errors or omissions or for the results obtained from the use of such information. VIS is not an NRSRO and its ratings are not NRSRO credit ratings. For conducting this assignment, analyst did not deem necessary to contact external auditors or creditors given the unqualified nature of audited accounts and diversified creditor profile.
Due Diligence Meetings Conducted	(see below)

Rating History

Rating Date	Medium to Long Term	Short Term	Rating Outlook	Rating Action
RATING TYPE: ENTITY				
May-04-20	AA+	A-1+	Rating Watch-Developing	Maintained
Jun-19-19	AA+	A-1+	Stable	Initial

Due Diligence Meetings Conducted

	Name	Designation	Date
1	Mr. Zubair Ahmed Qureshi	Deputy GM Financial Reporting & Taxation	24-February-2020
2	Mr. Imtiaz Jaleel	CFO	24-February-2020
3	Mr. Shehryar Omar	Senior GM Marketing	24-February-2020