September 2016

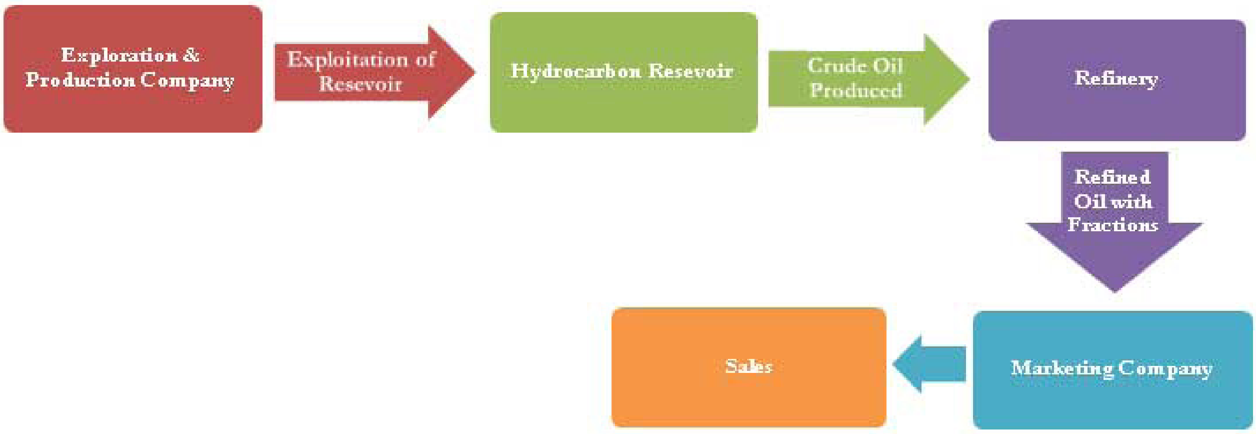
JCR-VIS
SECTOR UPDATE

Oil Marketing Companies

Complexity in supply chain management and high capex requirement has kept the local industry structure at a semi-oligopolistic level...

The Oil and Gas industry is divided into two major sectors, namely, upstream and downstream. The upstream oil sector is also known as the 'Exploration and Production' (E&P) sector. Main operations of the sector include searching for potential crude oil and natural gas fields and subsequently drilling and operating these sites for exploration of these resources. The downstream sector includes 'Refining and Marketing' sector which involves refining of petroleum crude oil and the processing and purifying of raw natural gas as well as the marketing and distribution of the final products.

Figure 1: Oil & Gas Sector Structure



While Oil & Gas sector in Pakistan comprises the entire chain with Oil and Gas Exploration companies, Oil Refineries as well as Oil and Gas Marketing companies, our focus in this review is on the Oil Marketing Companies sector (OMC). Major companies in the country within each sub-sector are as follows:

Table 1: Oil & Gas Sector Structure and Major Players	
Oil & Gas Exploration Companies	Pakistan Oilfields Limited
	Pakistan Petroleum Limited
	Oil & Gas Development Company Ltd.
	Mari Petroleum Company Limited
	Sui Southern Gas Company(SSGC)
	Sui Northern Gas Pipelines(SNGPL)
Oil Refineries	Attock Refinery Limited
	Byco Petroleum Limited
	Pak Arab Refinery Limited
	Pakistan Refinery Limited
	National Refinery Limited

Oil Marketing Companies	Pakistan State Oil (PSO)
	Attock Petroleum Limited
	Shell Pakistan Limited
	Hascol Petroleum Limited

OMC Sector

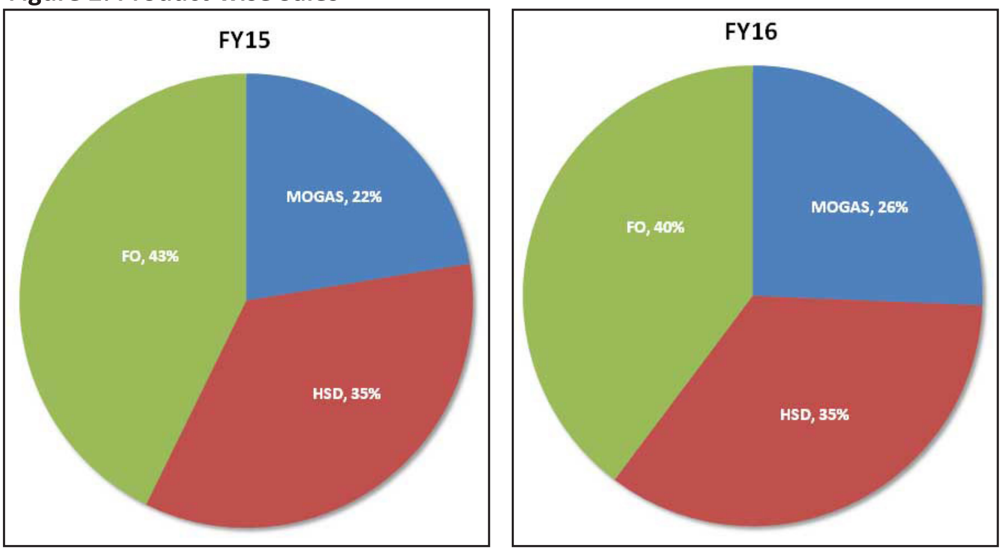
Industry Structure

The local OMC sector has 12 licensed operators with the largest player being the government owned entity, Pakistan State Oil (PSO) with a market share of 55% during 2016. Shell Pakistan Limited (Shell), Attock Petroleum Limited (APL), Total Parco Pakistan Limited/Total Parco Marketing Limited (Total) and Hascol Petroleum Limited (Hascol) are other major oil marketing companies in Pakistan. The top 5 players represent almost nine-tenth of industry sales. Complexity in supply chain management along with high capex required for volumetric growth has kept the industry structure at a semi-oligopolistic level, with fewer players dominating the market. Oil and gas regulatory authority (OGRA) has issued licenses to a number of new players while additional new licenses are expected to be issued on account of which competition in the industry is expected to increase.

Volumetric Sales (Industry)

In the Energy mix of Pakistan, petroleum accounts for approximately one third of its total value. Petroleum consumption grew at a Compound Annual Growth Rate (CAGR) of 2% over the last 20 years (1995-2015).Petroleum sales witnessed a growth of 4.7% during FY16 and amounted to 22.4mtons (FY15: 21.4mtons). High Speed Diesel (HSD), Motor Gasoline (MOGAS) and Furnace oil (FO) contribute nearly 95% to total petroleum sales. Product-wise volumetric growth was observed in the retail fuel segment (MOGAS and HSD) while FO off-take remained stagnant with the availability of Liquefied National Gas (LNG). However, proportion of FO in total petroleum sales remained the highest at around 40%. In percentage terms, sales of MOGAS and HSD increased by 18% and 3%, respectively. Higher increase in sales of MOGAS was due to lower prices (higher purchasing power for the population) and non-availability of CNG. Increase in HSD sales was primarily due to increased infrastructure development spending by the government and lower prices.

Figure 2: Product-wise Sales



As per Oil Companies Advisory Limited (OCAC), volumetric sales of petroleum products is estimated to reach 26.9m tons by 2020. OCAC has projected volumes of MOGAS and HSD to grow at a CAGR of 10% and 2%, respectively over the next five years while the demand of FO is estimated to stay at current levels. While strong demand in retail products driven by lower oil prices and increasing car sales is expected to drive oil sales going forward, government's plan to ramp up LNG imports to 2.4bcfd over the next two years and import of 1.3bcfd of gas through Turkmenistan Afghanistan Pakistan India Pipeline (TAPI) might limit MOGAS and HSD sales. Moreover, given the circular debt, LNG imports and commissioning of coal based power generation capacities, FO volumes are expected to remain under pressure. Around 6,900 MW of coal/RLNG based power generation is scheduled to come online by 2018.

Table 2: OCAC Forecast of Petroleum products (Million Tons)	**MOGAS**	**HSD**	**FO**
2014-15	4.7	7.4	9.2
2015-16	6.0	7.5	9.0
2016-17	6.6	7.6	9.0
2017-18	7.2	7.8	9.0
2018-19	**7.9**	**7.9**	**9.0**
2019-20	**8.7**	**8.1**	**9.0**

Declining Oil Prices: Challenges and Opportunities

The decline in oil prices since June'2014 and subsequent volatility has posed a challenge for industry players with effective inventory management and hedging becoming increasingly important to manage inventory losses. In FY16, Pakistan saved up-to $4.5 billion on oil imports due to a steep fall in oil prices. During the year import oil bill amounted to $7.66b as compared to $12.16b in FY15. Declining oil prices has also resulted in slower build-up in receivables for OMCs with sizeable FO sales. Going forward, oil prices are forecasted to remain relatively stable (within the $40-$50 band) during FY17 which will limit any significant inventory losses and build up in circular debt for OMCs. Price trend from mid-2014 until September 2016 is depicted in the graph below:

Figure 3: Oil Price Trends

Regulations and Pricing mechanism

The oil industry operates under the regulations framed by the Government of Pakistan (GoP) through Ministry of Petroleum and Natural Resources (MP&NR) and Oil & Gas Regulatory Authority (OGRA). Prices of some of the petroleum products are regulated by OGRA whereas prices of other products are not regulated. Given the capacity constraints of local refineries, OMC sector is heavily reliant on imports in order to meet domestic demand. Currently, around two-third of the local demand is catered through imports, in which Mogas and HSD have a significant share.

Ex-refinery price of product, government levies, inland freight, distributor & deal margins and sales tax are components which make up the final product price. Ex-refinery price in case of local production is the amount paid to the local refineries while in the case of imports; it's the import parity price. Distributor and dealer margins are fixed by the government in percentage terms in the case of FO while in Rupees/Liter terms in case of MOGAS and HSD.

Table 3: **Price Buildup for Sep-16**	**HSD**	**MS**
Sales Tax Rate	*35.5%*	*20%*
Ex-Refinery	39.09	34.97
Petroleum Levy	8.00	9.89
Inland Freight Equalization Margin	1.30	3.13
Distributor Margin	2.46	2.41
Ex-Depot Price	**50.85**	**50.40**
Sales Tax	19.00	10.71
Product Price	**69.85**	**61.11**
Dealer's Commission	2.67	3.16
Net Price	**72.52**	**64.27**
Withholding tax	0.32	0.38

Effective July'2016, OMC margins for retail fuels have been linked to the Consumer Price Index (CPI) which bodes well for the profitability of the OMC sector. Revision in distribution margins would not only improve sector's profitability but also create opportunities for investments in quality improvement and capacity up gradation. Current distribution margins are given in the table below:

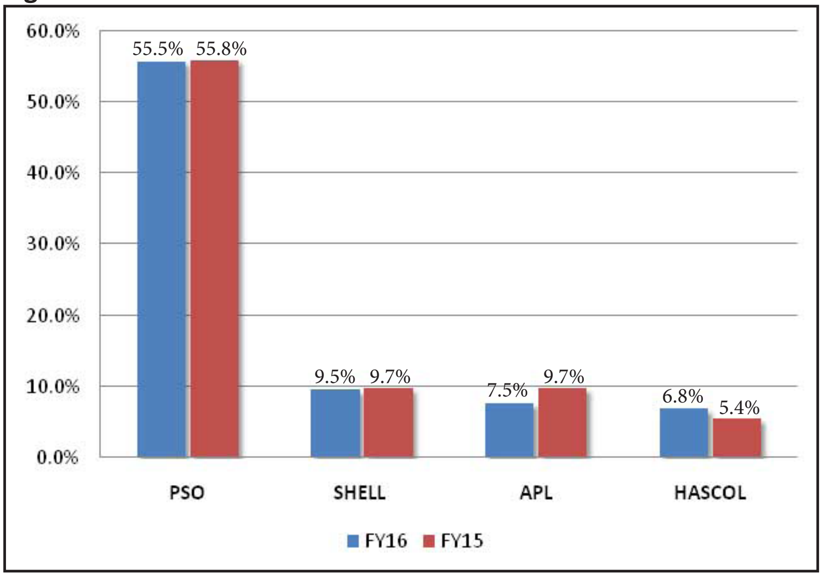
Table 4: **Distribution Margins (Per Liter)**	**Sep' 16**
PMG	2.41
HSD	2.41
FO	3% (may vary)
Lubricants	Unregulated

Higher incentive for selling retail fuels

Average selling prices of FO have declined by 27% during FY16 resulting in significantly lower margins for the segment. Margins for FO business have declined from Rs. 1,432/ton in July'2015 to around Rs. 800/ton currently. However, margins for retail fuels have increased on account of upward revisions and with linkage to CPI. Given that margins of retail fuels currently compare favorably vis-à-vis FO, maintaining/increasing market share in the retail fuels segment is considered important.

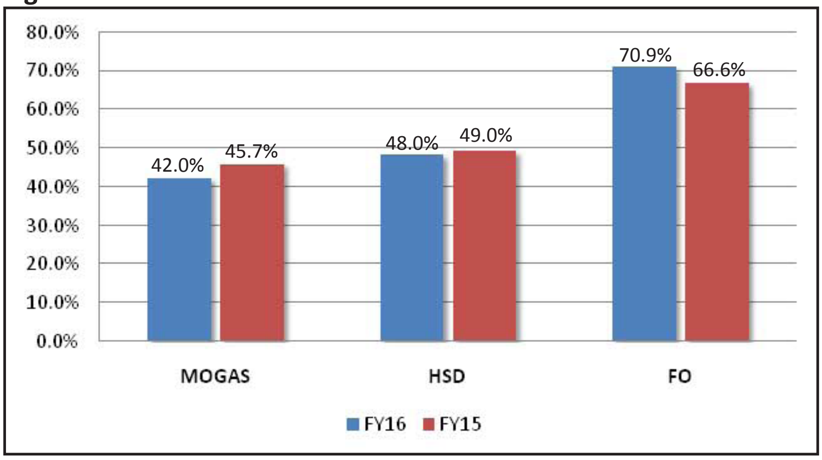
Volumetric Sales (Player-wise)

Figure 4: Market Share



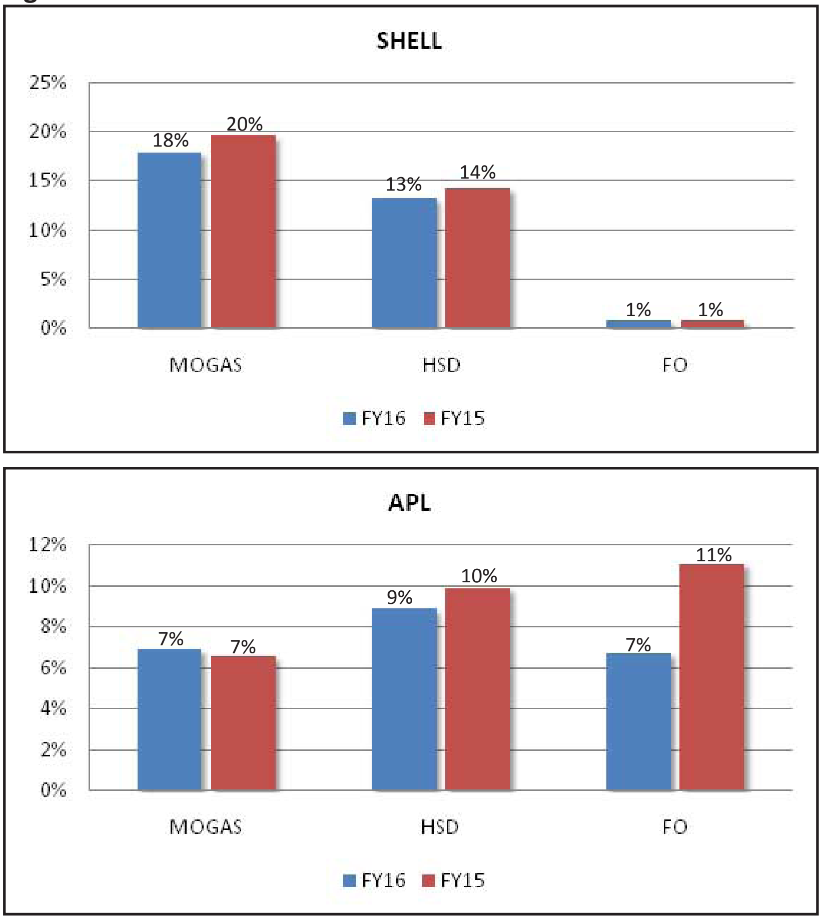
Over the last five years, the two large OMCs (Shell and PSO) have lost significant market share to smaller OMCs, indicating increasing competition from smaller players. Apart from Hascol, market share of other leading players witnessed a slight decline during FY16 vis-à-vis FY15. Given the sizeable storage capacity and retail presence, PSO continues to dominate the industry with over half of industry volumes. Market share of PSO somewhat stabilized in FY16to 55.5% after witnessing decline over the last three years from a high of 65.2% in FY13. However, market share in retail fuel segment continued to decline with overall share being supported by increase in sales in the FO segment. PSO's market share in the FO segment was sizeable at around 71%.

Figure 5: PSO Product wise Sales



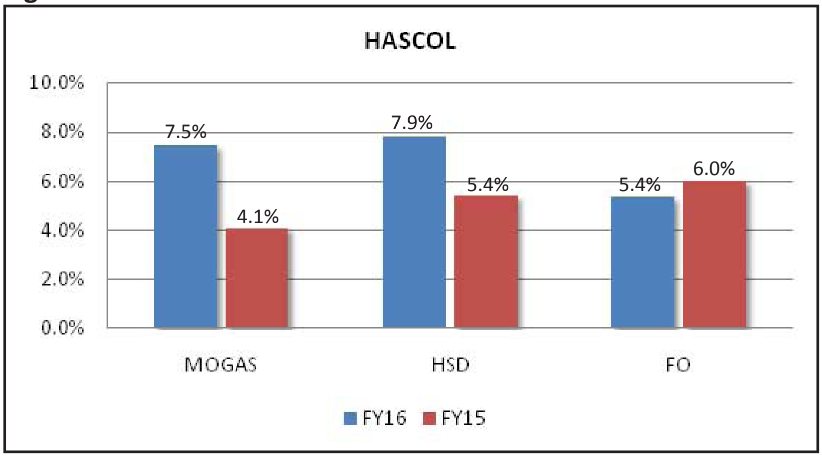
Shell's presence is primarily in the retail fuel segment with the company being the second largest player in the market. Market share in the FO segment is limited at around 1%. APL's market share witnessed a decline on account of company's strategy to change its sales mix towards retail fuels. Resultantly, market share in FO segment witnessed a significant decline during FY16.

Figure 6: Shell & APL Product wise Sales



Market share of Total remained around 9% with company being the third largest player in the retail fuel segment after PSO and Shell. Market share in MOGAS and HSD stood at 7.5% (FY15: 4.1%) and 7.9% (FY15: 5.4%), respectively.

Figure 7: Hascol Product wise Sales

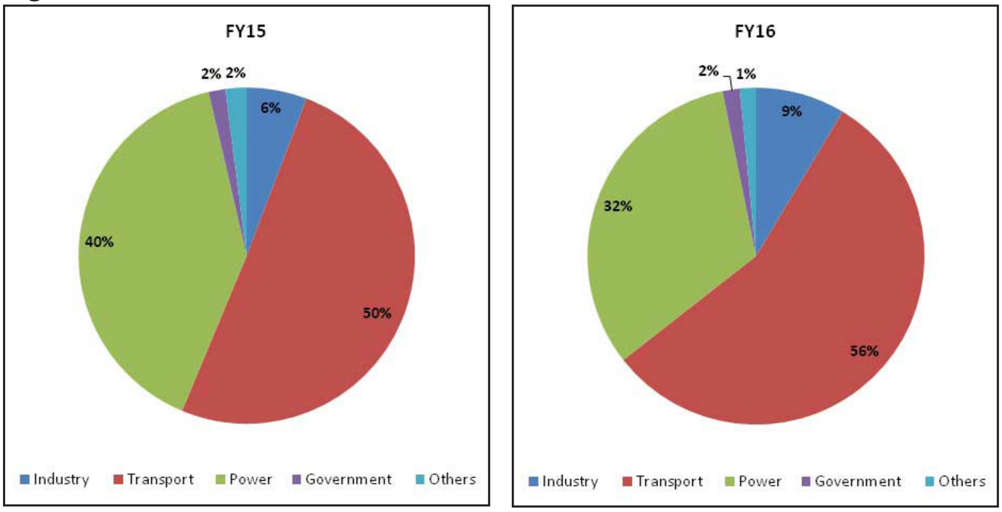


Hascol continued its growth momentum during 2016 and continued to outperform the industry with significant increase in overall and retail market share. Market share in MOGAS and HSD increased to 7.5% (FY15: 4.1%) and 7.9% (FY15: 5.4%), respectively. With margins in the FO segment being comparatively lower, market share in the FO segment witnessed a decline to 5.4% (FY15: 6%).

Sectoral Consumption

Transportation sector is the largest consumer of petroleum products at around 56% (FY15: 51%) followed by the power sector at around 32% (FY15: 40%). Lower consumption by the power sector is attributable to decline in FO utilized by PEPCO and Independent Power Producers to better gas and LNG availability.

Figure 8: Sectoral Sales



Infrastructure

Table 5: Storage Capacities as at end-FY15	Metric Tons	Percentage
Pakistan State Oil Company Limited (PSO)	303,426	64%
Shell Pakistan Limited (Shell)	69,422	15%
Attock Petroleum Limited (APL)	35,950	8%
Hascol Petroleum Limited (Hascol)	14,700	3%
Total Parco Marketing Limited (TPML)	14,073	3%
Admore Gas Private Limited (AGPL)	8,945	2%
Total Parco Pakistan Limited (TPPL)	8,300	2%
Overseas Oil Trading Company Limited (OOTCL)	6,255	1%
Bakri Trading Company Limited (BTCPL)	6,100	1%
Gas & Oil Pakistan Private Limited (GO)	3,735	1%
Askari Oil Services Limited (AOSPL)	1,580	0%
Zoom Petroleum Limited (ZOOM)	684	0%
Total	**473,170**	**100%**

PSO has a competitive edge over remaining players given its sizeable storage capacity and retail footprint. PSO accounts for almost two-third of the country's storage capacity and half of retail outlets in the country. Shell has the second largest presence in terms of storage capacities followed by Total and APL. Given the importance of storage capacities in increasing market share almost all players are focusing on enhancing storage capacities. Hascol has a number of storage capacities coming online over the next two years. JCR-VIS believes that storage capacities will be a key factor for maintaining/increasing market share, going forward.

Table 6: Retail Outlets as at end-FY15	No. of Outlets
PSO	3,839
Shell	774
TPML	522
APL	516
AGPL	387
AOSPL	372
TPPL	287
Hascol	280
Byco Petroleum Pakistan Ltd.	261
OOTCL	145
BTCPL	94
GO	71
ZOOM	12
Total	**7,560**

Financial Performance

Overall profitability of the sector witnessed healthy increase during FY16 on account of volumetric growth in sales, lower inventory losses vis-à-vis last year and decline in finance cost. While volumetric sales increased, net revenues for all players were significantly lower on account of decline in oil prices. Decline in sales was lowest for Hascol during 2015 given the significant increase in quantity sold. Besides HSD, MOGAS & FO sales, Shell benefits from strong revenues in lubricant business while APL benefits from recent uptick in Asphalt sales. Asphalt sales increased by 43% during 9MFY16 and were the highest since 2010 due to restoration of existing highways and commencement of work on multiple expressways and motorways. PSO has also added a new revenue stream with the company undertaking LNG procurement on behalf of government with a margin of 2.5%.Moreover, Hascol also intends to add LNG and bitumen to its product portfolio.

Table 7: Financial Analysis	PSO		Shell		APL		HASCOL	
(PKR million)	FY16	FY15	FY16	FY15	FY16	FY15	FY16	FY15
Net Sales	677,967	913,094	176,546	231,686	109,234	171,730	83,679	85,714
Gross Profit	22,863	22,921	11,352	8,336	5,749	4,927	3,616	2,423
Gross Margin	3.4%	2.5%	6.4%	3.6%	5.3%	2.9%	4.3%	2.8%
Operating Profit	22,826	22,671	3,462	-28	4,985	3,886	1,977	2,067
Profit Before Tax	16,289	12,033	3,807	188	5,633	4,538	1,495	1,098

Gross margins of the industry are a function of sales mix and quantum of inventory gains/losses. Hascol stands out vis-à-vis peers with most noticeable increase in retail sales while the company has also historically managed to maintain inventory losses at a lower level vis-à-vis peers. However, Shell's gross margins are highest amongst peers due to its presence in the retail fuel segment (very low FO sales) and sizeable lubricant sales (margins are deregulated) where benefit of low oil prices has not been largely passed on to consumers.

Apart from PSO which witnessed a slight decline in gross profits, remaining listed players witnessed an increase in gross profits. Despite lower inventory losses during FY16, slight decline in gross profits for PSO was due to lower gross margins in the FO segment where sales witnessed increase. APL's gross margins witnessed an increase due to higher retail sales and lower inventory losses in FY16 despite volumetric decline in sales.

Apart from increase in gross profits, profitability of the sector was also supported by lower finance cost. Decline in finance cost was due to a lower LC charges, slower build-up in receivables and 275bps dip in average KIBOR.

Table 8: Financial Analysis	**PSO**		**Shell**		**APL**		**HASCOL**	
(PKR million)	**Mar'16**	**FY15**	**Mar'16**	**FY15**	**FY16**	**FY15**	**FY16**	**FY15**
Total Debt	100,190	102,076	2,972	5,218	1,625	1,553	6,339	3,821
Total Equity	84,305	82,310	6,002	5,573	14,317	13,560	4,630	4,599
Gearing	1.19	1.24	0.50	0.94	0.11	0.11	1.37	0.83
FFO	93	-1,523	722	-491	3,700	4,735	2,993	-353
FFO/Total Debt	0.1%	-1%	32%	-9%	228%	305%	47%	-9%

The OMC sector generally enjoys favorable working capital cycle whereby the sector enjoys extended time period for payment to refineries/imports while sales are on cash basis. Overall leverage indicators of the sector have been maintained within manageable levels with most players having gearing below 1x. PSO has the highest gearing amongst listed OMCs while APL stands out in terms of balance sheet strength with limited debt on books and sizeable liquid assets (Cash & bank balances and short term investment of Rs. 11b at end-June'2016). Cash flows for most players remain healthy in relation to outstanding debt obligations.

Conclusion

- Volumetric sales of petroleum products in future are expected to emanate strong demand in retail products driven by lower oil prices and increasing car sales. However, increase in LNG imports as planned by the government, commissioning of coal based power generation capacities and import of gas through TAPI may pose challenges to volumetric growth.
- Over the last five years, the two large OMCs (PSO and Shell) have lost significant market share to smaller OMCs indicating increasing competition from smaller players. This along with expected entry of a number of new players will result in increasing competition. Hascol continued its growth momentum during 2016 and continued to outperform the industry with significant increase in overall and retail market share. JCR-VIS believes that storage capacities would be a key factor for maintaining/increasing market share, going forward.
- In a low oil price environment, margins on retail fuel compares favorably to margins on FO. This along with linkage of margin on retail fuels to CPI has resulted in higher incentive for selling retail fuels. Players with increasing proportion of retail sales are likely to post greater profitability growth, going forward.
- The decline in oil prices since June'2014 and subsequent volatility has posed a challenge for industry players with effective inventory management and hedging becoming increasingly important to manage inventory losses. Going forward, oil prices are forecasted to remain relatively stable (within the $40-$50 band) during FY17 which may limit any significant inventory losses and build up in circular debt for OMCs.
- Financial profile of the sector is satisfactory with manageable leverage indicators and adequate cash flows. Profitability of the sector is expected to improve with volumetric growth in retail sales, improving gross margins (margins linked to CPI and change in sales mix) and lower inventory losses.

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