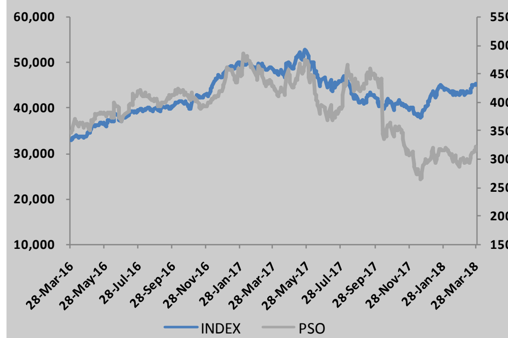
REP-091
April 2,2018

Pakistan State Oil (PSO)

- ***We re-visit our investment rationale and revise our target price from Rs340/share to Rs375/share for Dec'18, and subsequently revise our investment stance from 'BUY' to 'HOLD'***
- ***1HFY18 results indicate higher margins in Furnace Oil (FO) and Motor Spirit (MS) along with strong volumetric growth in MS and HSD has offset decline in Furnace Oil (FO) sales***
- ***Dependency on Furnace Oil (FO) business to continue to decline in future which will limit further cash being blocked in circular debt; moreover possible recovery of existing cash strapped in circular debt to reduce current operating cash cycle of 65 days (FY17) by ~10%***
- ***High Speed Diesel (HSD) margins deregulation still to go through, however we have assumed CPI linked margins for both MS and HSD in our calculation***
- ***With a CAPEX of ~Rs40Bn, PSO is focusing on expanding its storage and pipeline infrastructure to regain its lost market share***
- ***As per Government's decision to transfer LNG business to Pakistan LNG Limited (PLL) from next financial year will shave off around Rs5.3/share from PSO's bottom line***

KATS Symbol	**PSO**
Reuters Symbol	PSO.KA
Target Price	**Rs375**
LDCP	Rs321.49
Outstanding Shares (mn)	326.02
Free Float (mn)	146.71
Market Cap (mn Rs)	104,812

Price Performance Against KSE100 Index



Source: PSX

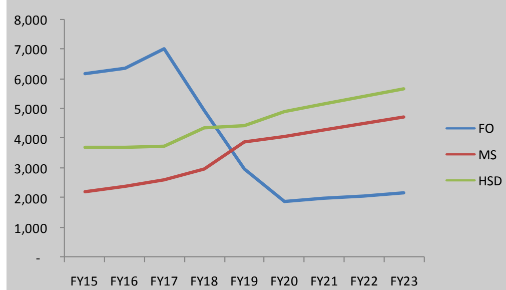
1HFY18 highlights

- PSO continued to lead the liquid fuel market with an overall market share of 54.6% (1HFY17 56.4%). MOGAS and HSD volumes grew by 17.6% and 8.8% respectively, while FO sales declined by 13% during this time
- EPS declined by 15% to Rs26.14 (Previously: Rs30.72/share) primarily due to i) Inventory losses of ~ Rs1.4Bn (per share Rs3.01/share post tax) ii) FO volumes declined impact of which was broadly offset by increase in margins of MS and FO and volumetric growth in both HSD and MS (which contributed RS 4.29/share) iii) Decline in other income by 53% due to maturity of PIBs worth of Rs43bn in 1QFY18 and lower penal income due to reduced FO sales in 2QFY18

Furnace oil volumes reductions may provide relief to lock in cash

- Pakistan's power generation mix is transitioning towards lower dependency on furnace oil, with coal and LNG based power plants expected to add ~5,200 MW which will replace current expensive power generation of around 3500 MW - 4,000 MW from Furnace Oil within the next 1-2 years
- We estimate recurring FO demand for the country to hover around 3-3.5 Mn tons from previous high of 9.5 Mn tons in FY16-17. This demand will be sufficient enough to cover local refineries production of ~3.1Mn tons
- Current contribution of FO business is around Rs7.8/share, in our calculation we have lowered FO volumes by 30%/39%/37% in FY18/FY19/FY20 (as shown in figure 1). Our sensitivity analysis suggests that every 1 Mn ton decline in FO sales would trim PSO's EPS by Rs1.57/share
- PSO's current receivables as of Feb-18 stand around Rs205.5Bn (Rs630/share). We expect changing power generation mix to increase liquidity position of PSO increasing likelihood of higher dividend payout in the future

PSO Volumes estimates (fig. 1)

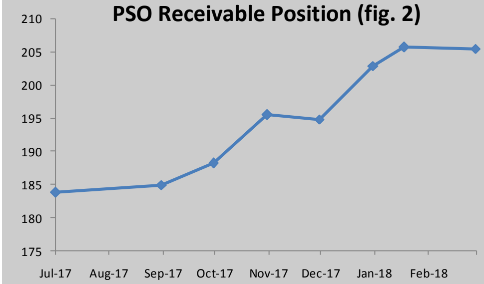


Source: Co Financials, AS Research

HSD deregulation is another growth element

- Post previous deadline for de-regulation of Nov-2017, we expect HSD margins to deregulate from FY19. Our estimate suggests that for every Rs0.1/liter increase in HSD margins Rs 1.23/share will be added to PSO's bottom line.

PSO Receivable Position (fig. 2)



Source: Co Financials, AS Research

LNG business is likely go away

- Transfer of LNG business from FY19 onwards will take away PKR 5.3/share contribution of LNG business from PSO's bottom line; however we expect this to be a positive development as it will protect PSO from any possible exposure to circular debt buildup through the LNG business in the future. Based on this rationale we have not taken LNG business in our earnings estimates beyond FY18.

Valuation

- PSO is currently trading at FY18E and FY19E P/E of 6.39x and 6.48x respectively. We have Hold stance with DCF based target price of Rs375/- (Dec-18), providing 16.7% upside from LDCP and a dividend yield of around 5.2%.

	FY17A	FY18F	FY19F	FY20F
EPS (Rs)	55.90	50.31	49.63	53.36
P/E (x)	5.75	6.39	6.48	6.02

Source: Co Financials, AS Research

Key Risks:

- Decline in petroleum demand due to higher prices
- Delay in increase in petroleum margins
- Further increase in circular debt
- Higher inventory losses

Research Department
021-111-555-275 Ext # 104
research@abbasisecurities.com

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Valuation Methodology

To arrive at period end target price, Abbasi Securities uses different valuation methodologies:

· Comparable Method (P/E, P/B etc.)

· Discounted Cash flow Method

·Equity and Asset based valuation

Rating

BUY	Total return more than 20% from last closing of market price
HOLD	Total return is in between 10% and 20% from last closing of market price
REDUCE	Total return is less than 10% from last closing market price

ABBASI SECURITIES

Contact us:
Email: research@abbasisecurities.com
Website: www.abbasisecurities.com
Telephone: 111-555-275

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