Sector Report | Pakistan Research

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Alpha Capital REN # REP - 004   akseer إكسير REN # REP - 400 R

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OMCs: Higher growth ahead, Still a Buy

FY24 was a tumultuous year for Oil Marketing Companies (OMCs), characterized by demand destruction, elevated fuel prices, and a resurgence of smuggling activities from across the border, all of which hurt the OMC industry. However, the start of FY25 has been promising, and the outlook for the sector is positive as we witness a significant rebound in sales volumes. The past six months have been favorable for OMCs due to high volumetric sales, primarily driven by increased demand for Motor Spirit (MS) and High-Speed Diesel (HSD).

Potential turnaround due to improving economic conditions - The growth in MS and HSD sales reflects a recovery in economic activity, particularly in the transportation and agricultural sectors, driven by falling commodity prices. We believe with the economic conditions stabilizing, further growth in MS and HSD sales volume is expected. Inflation has been steadily coming down, with the average inflation during CY24 recorded at 13.1%, compared to 30.9% last year. This is coupled with a projected GDP growth of 2.8% and a gradual recovery in large-scale manufacturing and service sectors, which will stimulate demand.

Revision in margins overdue – The government is expected to approve an increase in the OMC margins in Feb'25 following a recommendation by OGRA to increase margins from PKR 7.86/l to PKR 9.22/l. This is in line with the CPI-linked methodology of implementing margins and has been long overdue. An increase in margins will set the sector up for profitability.

Lower interest rates to ease financial strain – The OMC sector is heavily reliant on LCs for imports and credit lines for its working capital needs. With the policy rate being slashed from 22% to 13%, we expect the borrowing costs of OMCs to decline, improving their financial viability. This is particularly a plus for PSO that has the highest debt-to-asset ratio in the industry (42.40% in FY24). However, being cash-heavy, APL is likely to suffer a decline in investment income due to declining interest rates.

Circular debt growth arrested – Circular debt has been a long-standing issue for the OMC sector. However, timely gas tariff rationalization and improved cash collection have resulted in an improvement in liquidity positions of both SNGP and SSGC. This has had a positive impact on PSO, a primary creditor to both gas companies, unlocking its core valuation.

PSO is our top pick, primarily due to its significant earning potential and liquidity position, with a 100% recovery in the RLNG segment. We also recommend 'BUY' on APL due to its agile inventory management and cheaper valuation

Key Data – Pakistan State Oil

PSX Ticker	PSO
Target Price (PKR)	619
Current Price (PKR)	343
Upside/Downside (%)	+81%
Dividend Yield (%)	4.4%
Total Return (%)	85%
12-month High (PKR)	465
12-month Low (PKR)	137
Outstanding Shares (mn)	469
Market Cap (PKR mn)	160,818

Source: PSX, Akseer Research

Key Data – Attock Petroleum

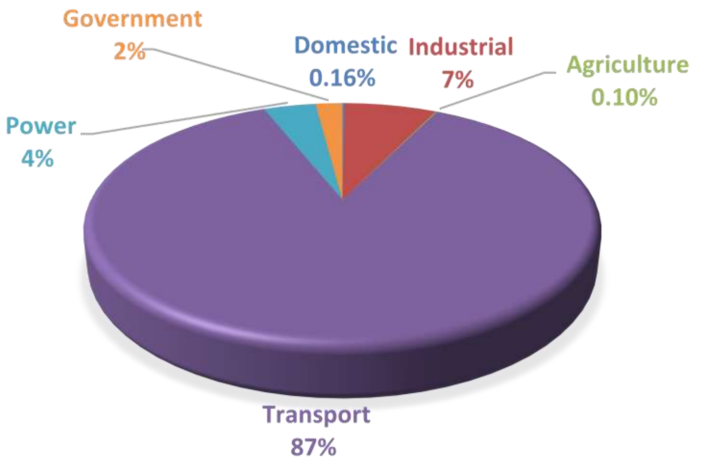
PSX Ticker	APL
Target Price (PKR)	577
Current Price (PKR)	478
Upside/(Downside) (%)	+21%
Dividend Yield (%)	4.5%
Total Return (%)	25%
12-month High (PKR)	575
12-month Low (PKR)	351
Outstanding Shares (mn)	124
Market Cap (PKR mn)	59,471

Source: PSX, Akseer Research

Industry Overview

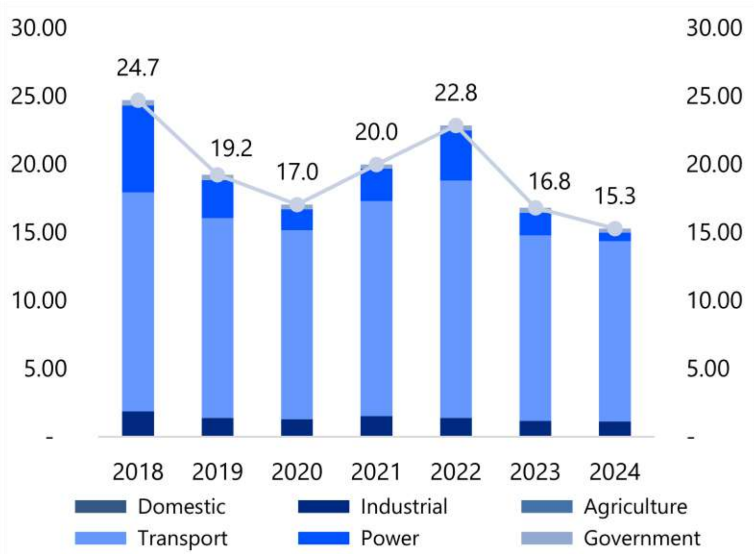
The Pakistani economy is a net energy importer that relies significantly on imports of petroleum products to meet local demand. The demand for POL products is largely driven by the transportation sector and the level of industrial activity. During FY24, the country consumed 15.7mn tons (down 9.0%) of POL products, impacted by sluggish growth and a decline in large-scale manufacturing growth.

Sectoral Consumption for FY24



Source: Akseer Research, Pakistan Energy Yearbook

Historical POL Consumption (In Mn tons)



Source: Akseer Research, Pakistan Energy Yearbook

Transportation remains the primary consumer, accounting for approximately 87% of the total demand, followed by the industrial sector representing 7% of the total demand. Owing to low local oil reserves and a lack of new discoveries, in FY24, imported POL products constituted 55% of the total supply and comprised a significant portion of the national import bill.

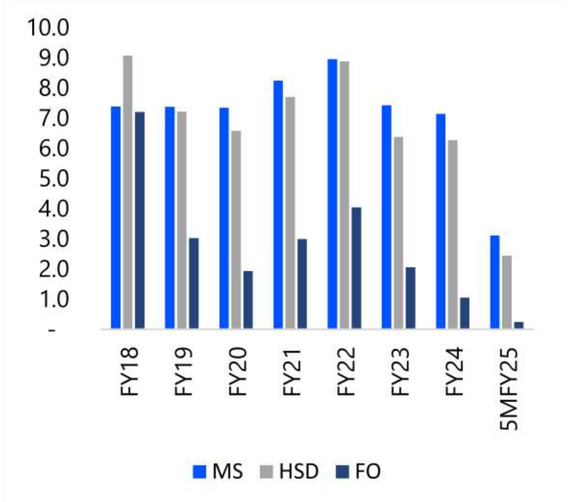
The industry structure is semi–oligopolistic, with a few large players dominating the market. Nevertheless, the market has also witnessed proliferation by an increasing number of small entrants. Currently, as updated by OGRA on September 2023, 10 OMCs possess marketing licenses; 33 OMCs have received provisional marketing licenses, and 5 OMCs have been granted licenses without marketing permissions. The barrier to entry is low, given the requirement to invest at least PKR 500 million in three years, with a minimum upfront equity of PKR 100 million.

Market Dynamics & Key Players

As of FY24, five major players accounted for 80.96% of the total industry market share. During the year, the industry experienced a decline of 2.29% in white oil demand, with volumes for MS and HSD falling by 3.79% and 1.73%, respectively, compared to last year. This decline can be attributed to several factors, including continued economic slowdown, demand destruction amid high inflation, and an influx of smuggled petroleum products from the western border. Additionally, there was a decline of 49% YoY in black oil demand on the back of decreased electricity generation from RFO-based power plants. However, the lubricant industry made modest recovery, registering an increase of 2.84% compared to last year. Overall, retail fuel volumes have decreased by 8.02%, falling to 15.2mn tons, down from 16.8mn tons in FY23. Considering that MS offtakes are a function of automobiles sales, sales have decreased by 16.09% (~ 106,460 units in FY24) compared to last year.

The industry is highly regulated by the government through OGRA, which sets the MS and HSD prices every fortnight. OMCs have established infrastructure nationwide to increase their outreach by expanding their retail networks and constructing storage depots in provinces to enhance their storage capacities. Some large players, such as Total Parco, PSO and APL, have also achieved backward integration to the midstream sector, enabling to lift POL products from local refineries and thereby strengthening their supply chain capabilities.

Historical POL Sales Volume (In Mn tons)

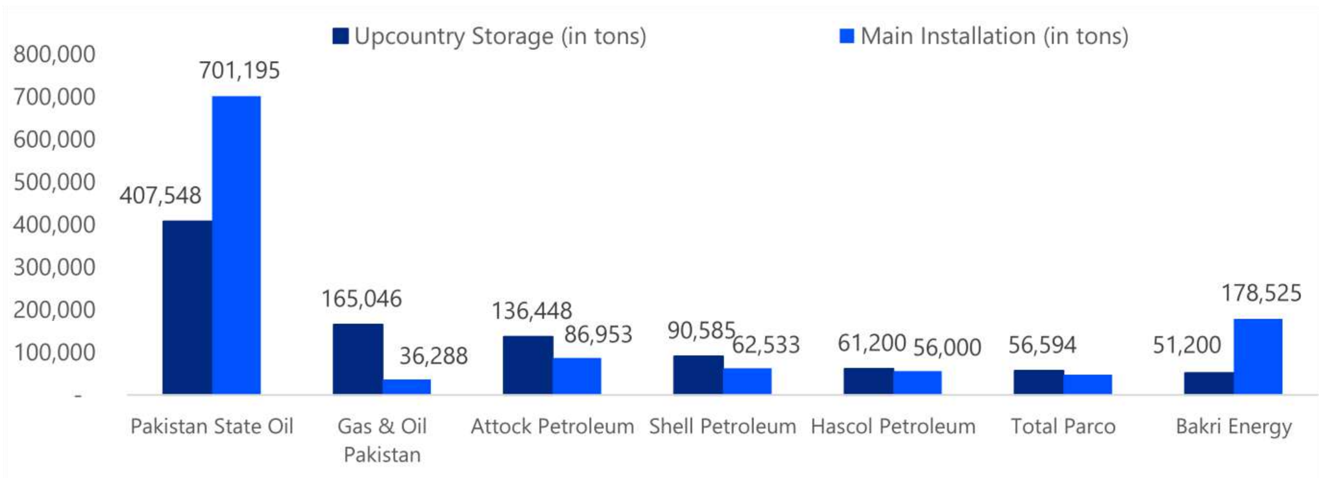


Source: Akseer Research, Pakistan Energy Yearbook

Storage Infrastructure & Retail Network

In FY23, the cumulative storage capacities for MS and HS were 0.95mn tons and 1.01mn tons, respectively.

Storage Capacity in FY23 (Upcountry and Main Installation)

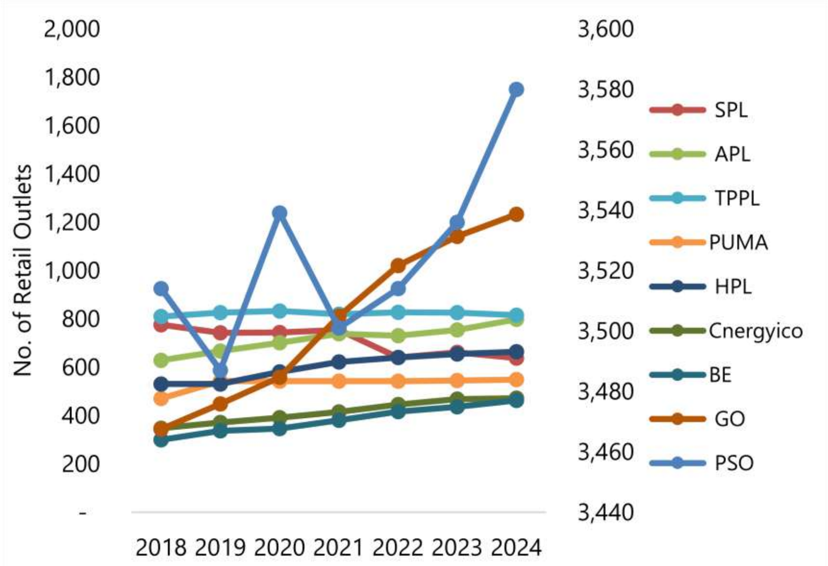


Source: Akseer Research, OCAC

In FY23, the ECC introduced the "Bonded Storage Policy" as part of its efforts to improve the oil supply chain. The new policy enables foreign suppliers to store POL products in their own dedicated warehouses (duly licensed by OGRA) near Pakistani ports without attracting foreign exchange payment until the products are sold in the local market or exported. Currently, the storage infrastructure is underutilized, with only 40% of storage capacity in use. This policy is expected to reduce the issue of premiums charged on foreign LCs and freight costs, thereby improving efficiency to the supply chain.

OMCs market POL products through their retail fuel outlets. There are an estimated 10,682 retail outlets in Pakistan, with PSO having the largest footprint representing 35% of the total country's network. It is important to note that GO has had a phenomenal retail outlet expansion in the last few years (~FY18 – 24 CAGR: 24 %).

Retail Network (No. of outlets)



Source: Akseer Research, OCAC

Key Revenue Drivers

The pricing structure of POL products (mainly MS and HSD) consists of five distinct components.

Ex-Refinery Price: This is based on PSO's cost of supply and is adjusted for any exchange rates losses incurred by PSO.

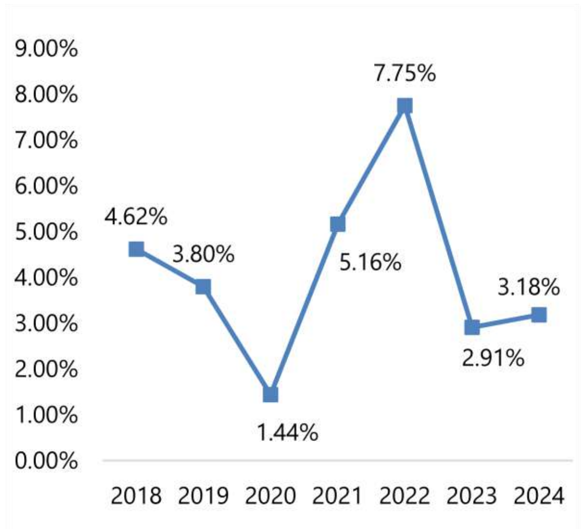
Inland Freight Equalization Margin: This ensures uniform pricing across different regions in Pakistan. It pools in costs incurred by different OMCs to transport POL products from local refineries or ports to various depots and retail outlets, which is then subsequently reimbursed through the pricing mechanism.

For example, if APL is supplying POL products all over Pakistan, a smaller OMC is restricted to selling them in Sindh only. The smaller OMC will have to pay the difference that APL has incurred in supplying POL products to the far-flung areas of Pakistan, such as KPK.

Petroleum Levy: Currently, this is charged at PKR 60/l for MS and HSD, while for Hi-Octane Blend, it stands at PKR 50/l. In the Finance Bill 2025, the petroleum levy limit was enhanced from PKR 60 to PKR 70/l; however, as of now the levy remains unchanged.

OMC and dealer margins: These are stipulated by the government, setting a fixed margin on per liter of fuel price. It is currently PKR 7.88/l on both MS and HSD, while the dealer margin is PKR 8.66/l. Companies with COCO (Company Owned, Company Operated) sites are able to retain both the OMC margin and

Sector Gross Margins



Source: Akseer Research, Pakistan Energy Yearbook the dealer margin. In contrast, most OMCs utilize a franchising model, where independent parties provide the necessary capital for these outlets.

MOGAS Price Breakdown (In PKR/ltr)

Source: Akseer Research, OGRA

Sales Tax Conundrum

With respect to sales tax, in FY22 the government had abolished sales tax on petroleum products and assigned zero-rating status. Zero rating status allowed the industry to get sales tax refunds from the government. However, in Finance Act 2024, POL products were recategorized from the zero rating to tax-exempt status which disallows refunds of input sales tax on imported machinery and is expected to increase the operating costs of OMCs and refineries.

Another important development in the making has been a proposal to impose reduced tax of 5-7% on petroleum products. The proposal aims to address revenue shortfalls for the fiscal year. It is pertinent to note that the FBR has an annual revenue target of PKR12.97tn. In 1QFY25, the FBR fetched PKR 2.56bn against the target of PKR 2.65bn, resulting in a shortfall of PKR 96bn. Therefore, any shortfalls may potentially be plugged by increased PDL or sales tax on petroleum products.

The Challenge of Smuggling: Implications for High-Speed Diesel Consumption

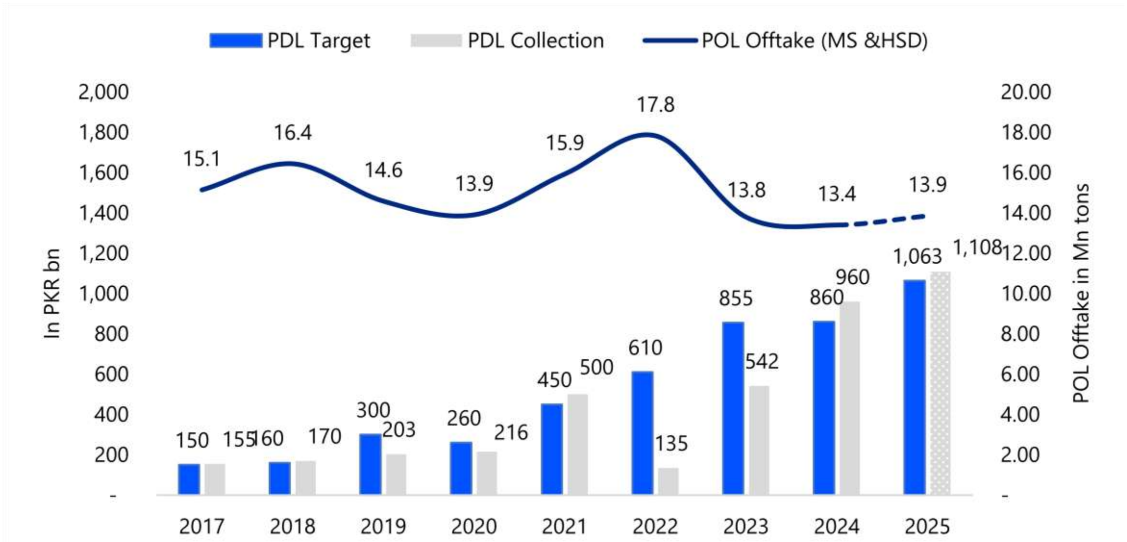
At the industry level, the 5-year CAGR (FY19-FY24) of MS and HSD sales stand at -0.65% and -2.78%, respectively. The formal sector loses considerable market share in HSD sales to the black economy via smuggling through porous borders. In FY23, when headline inflation clocked at 31.4%, there was an uptick in smuggling activities as arbitrageurs took advantage of the price distortions in the formal and informal sector. However, crackdown on smuggling in early March 2024 reduced the influx for a short term. As per news reports, nearly 2.74 mn tons of HSD was smuggled into the country in FY24, representing 30% of the market size.

As higher levies are applied to fuel retail prices, the opportunity to smuggle rises. It is pertinent to note that Iranian diesel is sold at PKR 25-30/liter discount to the official retail price; this gap is expected to widen should the government impose increased taxes or levies. The wider the price differential, the more we can expect POL products to be smuggled deeper into the country. This is already evident from 7,531mn tons being smuggled on a daily basis, as per reports. However, renewed focus on anti-smuggling operations may potentially result in improved HSD sales for FY25.

Petroleum Levy – FY25 Target Revised by the IMF

In Q1FY25, POL offtake remained muted, clocking at 15.7mn tons compared to 16.2mn tons in the same period last year. The government had initially set a PKR 1,281bn PDL collection target by 26% YoY compared to last year, raising the petroleum levy limit from PKR 60/l to PKR 70/l.

Annual PDL Collection Target and Revenue



Source: Akseer Research, Ministry of Finance, OCAC

The decreased offtake in 1QFY25 raised concerns that collections might fall short of the target considering the current run rate. Citing the shortfall, the IMF's report on Pakistan has revised its collection target downward by PKR 180bn to PKR 1,063bn, a reduction of 17%. However, in a fortunate turn of events, offtakes have improved in Q2FY25. We estimate that if the current run rate of offtakes were to continue, there would be a surplus in collection by PKR 45bn. We present sensitivities for the PDL collection outlook, if the PDL is increased to PKR 65/l in Q3FY25:

		HSD Sales Volumes Increase/Decrease						
		-5%	-3%	-1%	0%	1%	3%	5%
MS Sales Volume	-5%	1,138	1,141	1,144	1,145	1,146	1,149	1,152
	-3%	1,142	1,144	1,147	1,148	1,150	1,152	1,155
	-1%	1,145	1,148	1,150	1,152	1,153	1,156	1,158
	0%	1,147	1,149	1,152	**1,153**	1,155	1,157	1,160
	1%	1,148	1,151	1,154	1,155	1,156	1,159	1,162
	3%	1,151	1,154	1,157	1,158	1,160	1,162	1,165
	5%	1,155	1,157	1,160	1,161	1,163	1,166	1,168

The revision in the petroleum levy target has relieved some pressure; however, we cannot rule out an increase in the PDL if a black swan event occurs, where offtakes are negatively impacted or cross-border smuggling increases.

Interestingly, increasing PDL to fund the overall revenue shortfall is a double-edged sword, since higher prices not only reduce consumption but also increase the financial incentive for smuggling.

Geopolitics to Define Oil Price Direction

International crude oil price fluctuations embedded in the ex-refinery price bear a direct impact on the companies' profitability through inventory gains and losses. The price of crude oil has lately been under pressure as international markets are grappling with a series of headwinds, including slowing economic growth, increased freight rates, and US oil production at all time high levels. However, global oil inventories currently stand at 4.4bn barrels, the lowest on record since 2017.

Since the outbreak of conflict in Gaza, spikes in global oil prices have been short-lived. The primary concern remains an escalation event where Iran and Israel are involved in a direct full-scale conflict or if Israel targets the Iranian oil infrastructure in response to regular skirmishes between the two nations.

According to the International Energy Agency (IEA) estimates, Iran produces 3.2mn barrels of oil per day, while OPEC+ has estimated 5.63mn barrels per day of spare capacity. We believe that the impact of any retaliatory attack on Iran's oil assets would lead to a short-term jump in oil prices as Iran's oil production will be severely curtailed. However, supply from OPEC+ is sufficient to make up for the lost capacity.

As a base case, we have assumed limited disruption in oil supply from Iran and therefore expect oil prices to average at USD 75/bbl for the remainder FY25. Also, for the long term, we expect oil prices to average USD 80/bbl with limited upside potential due to continued global transition away from fossil fuels and the development of more new oil/gas fields worldwide.

Recent Trends and Challenges

Over the past five years, profitability growth has remained under pressure for the sector, particularly last year, as muted demand coupled with elevated finance costs and increased tax burden chipped away fuel profits.

Moreover, BEV/PHEV vehicles are expected to make an entry in Pakistan as BYD is planning to roll out its BEV models by Dec-24. Limited increase in POL volumes, coupled with the threat of substitution from the EV industry, has driven companies to diversify and strengthen their profitability profile. GO Pakistan was the first OMC to introduce an electric-charging station, while APL has widened its product offerings to include LPG, bitumen, and industrial lubricants. PSO, on the other hand, has embraced non-retail fuel revenue streams by digitizing its systems, convenience stores, and other services.

Historical Perspective

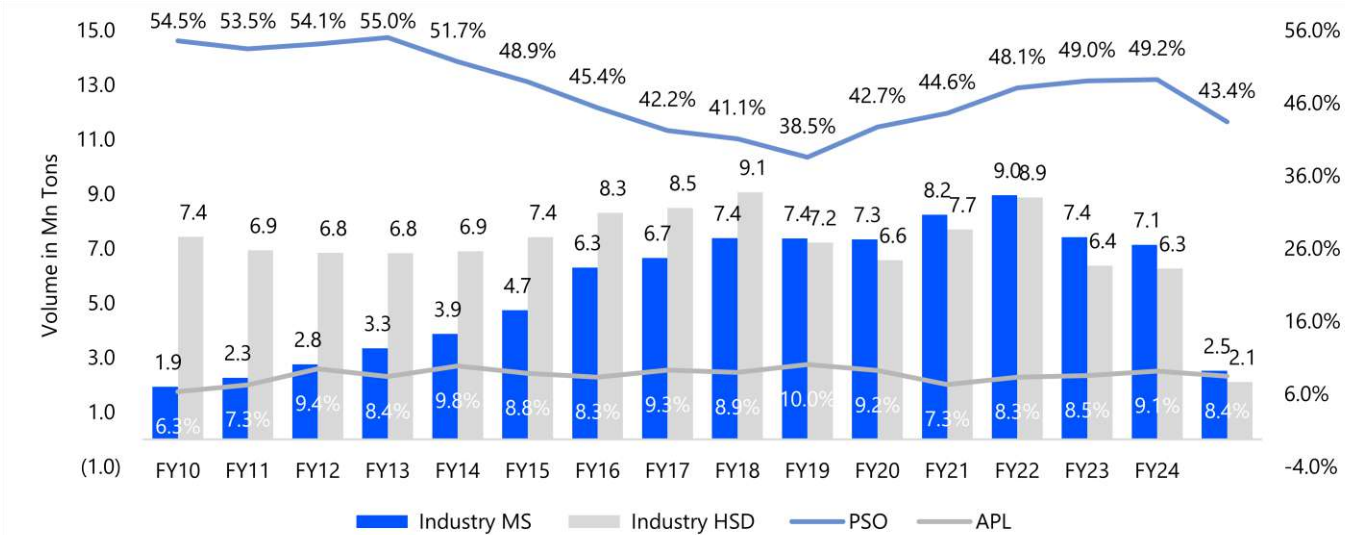
The last 14 years of the industry can be traced as three distinct phases that shaped the sector and made the market what it is today.

Phase I – Even though the circular debt issue started from 2005, FY10 to FY13 was the period when the energy giant PSO held its market leadership with its retail market share, peaking to 55.10% in FY13. This was achieved without any aggressive retail network expansion. PSO increased its retail network to 3,805 outlets by the end of FY14 (CAGR: 1.21%). Meanwhile, APL, another listed company, gained volumes by aggressively expanding its retail network which jumped from 277 outlets to 468 (CAGR: 14.1%). Its retail fuel market share increased from 6.32% to 9.83%.

Phase II – However, in FY14, established OMCs began struggling with renewed aggression as 9 new players entered the market. This was a period when macroeconomic indicators were improving and the State Bank had adopted an accommodative monetary policy stance, flushing the market with low-cost financing. The policy rate was at its lowest in Dec'17 at 6.25%.

This enabled new players to expand aggressively, biting into the market share of well-established players such as APL and PSO. PSO was facing a severe liquidity crunch due to receivables owed by the power sector, which were ballooning at an alarming rate. An important caveat of the 1994 Power Policy had been the government guaranteeing fuel supply for RFO-based plants and PSO owing to its special status of "strategic SOE" was legally bound to supply the power sector in the face of under-recovery of costs. This led to the erosion of its retail fuel market share to 42.72% in FY19.

PSO and APL Market Share from FY10 – FY24



Source: Akseer Research, Ministry of Finance, OCAC

Phase III – FY20 was marked by the Covid-19 pandemic, which disrupted many economies. Economic fundamentals started deteriorating, marked by widening Current Account Deficit (CAD) and a rapidly depreciating local currency (PKR lost 34.7% of its value in just over a year). Not only did this add pressure to the country's foreign exchange reserves, but it also increased the POL import costs for OMCs. Adding to the misery, the State Bank also unleashed successive rate hikes in an effort to contain runaway inflation and reduce aggregate demand. This caused the industry's working capital requirement to spike, and with limited credit lines, the financial viability of smaller OMCs was also jeopardized.

Restrictions were placed on imports, which severely impacted countrywide supply chains, leading to industry shutdowns and a decline in production. This ultimately resulted in a fall in the consumption of petroleum products.

During FY24, the sale of petroleum products fell to an 18-year low, which can be attributed to an exponential rise in cross-border smuggling, economic slowdown, and demand destruction caused by unprecedented inflationary pressures. During this time, both PSO and APL established their resilience through increased market share by 21 points and 63 points, respectively in FY24. Both companies have two things in common: i) ample cash flow to fund their operations and ii) backward integration of their group operations, which allows them to lower their import bill via local procurement.

Future Outlook

The State Bank has already made three consecutive cuts of 700 bps in the policy rate, bringing it to 15.00%. We expect further easing, albeit at a much slower pace, in the upcoming quarters. However, the era of a super-low interest rate (6.25%) is nowhere in sight. Inflation has fallen to 7.2% as of October 2024; however, elevated interest rates are to remain a new normal.

As of October 2024, POL offtakes have started showing signs of improvement, with HSD offtake increasing due to the agricultural season and a crackdown on cross-border smuggling. After an eventful year marked by persistent inflation, high interest rates, and dwindling foreign exchange reserves, the economy is finally on the mend and is projected to grow modestly by 3.5% in FY25, compared to 2.4% in FY24, supported by stabilization policies and a favorable economic environment.

Structural reform along with a stable currency has established grounds for large-scale manufacturing to revive during FY25. Notably, the automobile sector has been an early riser, with passenger car sales surging by 25% YoY, increasing from 16,021 units to 20,068. Improved purchasing power of consumers has also strengthened higher car penetration, as Pakistan's per capita car ownership lags significantly behind that of peers.

Lastly, the axle load regime implementation also presents an opportunity for increased fuel consumption. Currently, the regime's implementation is limited to a few major motorways and Karachi Port Trust. Widespread implementation of the policy is expected to escalate voyage costs, as the load ladened on trucks is reduced by 30%, thereby increasing the number of trucks employed and HSD consumption.

As the economy thrives, the OMC industry stands to benefit from increased sales volumes, driven by heightened demand that accompanies economic growth.

From Compliance to Consumption: The Ripple Effect of Axle Load Limits on Oil Marketing Companies

On 15 November 2023, the government implemented the axle load regime (National Highway Policy 2000), reducing the truckload capacity by almost half. The axle load regime is now being implemented on vehicles using the motorways and at Karachi Port Trust. Earlier, trucks used to be loaded beyond the recommended capacity to save on transportation costs. Now after the implementation of the regime, a 4-axle single that used to carry 60 tons is now mandated to carry 41.5 tons under new regulations.

The implementation of axle load limits in Pakistan is poised to significantly impact OMCs, as it will change fuel demand dynamics. In FY24, the transportation sector consumed 87% of the HSD sold through legal channels. The continued implementation of this regulation, along with the economic revival, is expected to increase HSD consumption, which would translate to higher sales volume for OMCs. This can be illustrated by an example: The weight of a two-axle truck is 4.6 tons, and before the

regulation, it was carrying 25 tons worth of goods, bringing the total net weight to 30 tons. The truck transports the goods from the south (Karachi)

to the north (Lahore), covering an average distance of 1214km.

As per the VOC report published by the National Transport Research Centre (NTRC), the average consumption of a two-axle truck (Hino) is 266 liters per 1000 km. When the truck is overloaded, it consumes 519 liters. Implementation of the regime will reduce this consumption to 323 liters, requiring two trips to carry the same amount of goods in 626 liters, which is 20% higher per ton. The

Axel Load Limit Implementation	Before	After	Variance
Kerb Weight (A)	4.55	4.55	
Load (B)	25.00	12.95	
Gross Weight (A+B)	**29.55**	**17.50**	**-41%**
Estimated Fuel Consumption in Liter	518.55	322.92	-38%
No. of trips	1.00	2.00	
Voyage Cost for Trip (In Rs)	95,000	75,289	-21%
Total Fuel Consumption per Ton	20.74	24.94	20%

Source: Akseer Research, National Transport Research Centre increase in voyage costs will result in higher consumption of HSD, increasing profitability of the OMC industry.

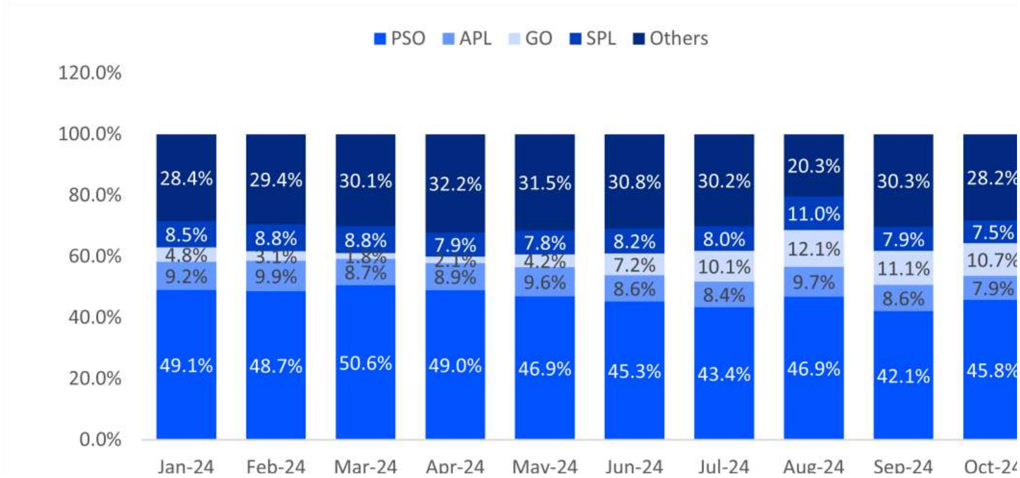
The Paradigm Shift: GO and Shell threatening to Shake the Industry

In the past years, there have been significant shifts in the sector that could challenge the status quo of a few large OMCs dominating the industry. The government has taken concrete steps to increase foreign investment in the country, particularly in the oil & gas sector. In Nov'23, Shell's parent company, Shell Petroleum Company Limited (SPCo), announced its exit from Pakistan and signed an agreement to sell off its domestic operations to Saudia Arabia's Wafi Energy LLC. The sale has now materialized with Wafi Energy, holding 87.78% of Shell Pakistan's total issued capital.

Wafi Energy is an affiliate of Asyad Holding Group in KSA, specializing in management and operation of fuel stations. While Shell has a strong lubricant market, its strength is overshadowed by its low market share in the retail fuel market (FY24: 6.38% for HSD and 9.73% for MS). However, considering the strong profile of its acquirer, there is the risk of aggressive retail expansion and ultimate encroachment of PSO's market share.

Similarly, in Dec'23 Aramco signed an agreement to acquire 40% of Gas & Oil Pakistan as part of its efforts to expand into the country's downstream operations. Over the past few months, GO has demonstrated impressive growth, biting a chunk of PSO's market share in retail fuels. Over the past 9 months, its market share in MS increased from 4.76% to 10.40%, while its market share in HSD rose from 4.76% to 12%.

Monthly Retail Fuel Market Share – CY24



Source: Akseer Research, OCAC

In May'24, the Competition Commission of Pakistan (CCP) granted a time-bound exemption for a product supply agreement between Aramco and GO, under which Aramco would meet GO's full demand for essential petroleum products in its outlets, enabling GO to capture a greater market share. However, it is important to note this one-off exemption is set to expire in June'26 and an extension will be incumbent on the prevailing demand/supply conditions. As part of its efforts to get domestic refineries to be on board with the Brownfield Refinery Policy, OGRA has been directed to prioritize upliftment of local petroleum products and fill any gaps in demand through PSO.

Electric Vehicles: A Real Threat or a Fad?

FY25 is marked by the emergence of EVs in the Pakistani market, with BYD rolling out its most sought-after models in 4QCY24. However, the question whether EVs will serve to substitute conventional cars and ultimately reduce the pie of retail fuel sales still stands. Globally, prices of energy storage solution and lithium-ion batteries are on a steep downward trajectory. However, Pakistan faces several challenges in its transition to EVs, including policy uncertainty, a lack of charging infrastructure, and the prohibitive high initial cost.

Currently, Pakistan does not have local assembly or manufacturing; it has partnerships and joint venture agreements with international manufacturers. Although EVs offer long-term savings in terms of fuel and maintenance, the total cost of ownership (TCO) is higher for EVs compared to conventional cars, largely due to increased manufacturing costs. However, as local assemblies of EVs become operational (first planned by 2026), cost and availability matrices of EV may improve compared to conventional vehicles.

Currently, HEV and PHEV models are significantly more fuel-efficient than conventional cars. In FY24, as per the Pakistan Automotive Manufacturers Association (PAMA), hybrid vehicles made up approximately 11% of the total passenger car sales in Pakistan. If the EV adoption rate is increased to 35%, then it can have a significant impact on POL offtakes.

It is interesting to note the BYD also has economy segment offerings in its global portfolio (Seagull, for example, which is estimated to be around PKR 1.69 crores). If BYD were to introduce such models in Pakistan, the EV adoption rate could jump has high as 20 – 30%, impacting overall petroleum product consumption.

Alpha Capital REN # REP-004 | akseer REN # REP-400R

Pakistan State Oil (PSO)

We maintain our 'Buy' stance on PSO with a Dec'25 TP of 619/sh. We estimate a five-year earnings CAGR of 27% on the back of improving demand conditions and economic recovery. The dividend yield takes the total return potential to 85%. Currently, the company is trading at a forward core P/E multiple of 3.91x.

Company Description

Pakistan State Oil (PSO) is a state-owned enterprise with national strategic importance; the government holds 25.5% stake in the company. Its primary functions are the procurement, storage and marketing of POL products, including import of liquified natural gas (LNG). PSO also blends industrial-grade and automotive-grade lubricating oil. The company was incorporated in Pakistan in 1976 and is based in Karachi, Pakistan. As of Sep 30, 2024, PSO had 3,602 retail fuel outlets and 19 storage depots across the country.

Investment Thesis

- The company has an enviable, enduring record as a survivor in the OMC industry with numerous peaks and troughs. Post-Covid period has been particularly challenging, marked by headwinds from inflation, economic slowdown, higher financing costs, and lower volumetric offtakes. However, despite these challenges, PSO has a robust financial position and its core earnings have held strong.

- Our investment thesis is premised on the fact that the state has undertaken significant reforms to contain circular debt in the gas sector, resulting in positive cash flows for its main debtors, SNGPL and SSGC, and unlocking value for PSO.

- As the collection of its overdue receivable improves, we expect the company to scale down the leverage on its balance sheet, bringing down operational costs and improving bottom-line growth.

- Secondly, its subsidiary, Pakistan Refinery, has signed an agreement for the upgradation and expansion of its refining capacity, which will eventually improve the agility and responsiveness of PSO's supply chain and enable to it enhance the reliability of its domestic supplies.

Key Data

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Target Price (PKR)	619
Current Price (PKR)	343
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Source: PSX, Akseer Research

Relative Share Performance

Source PSX: Akseer Research

Summary	FY22A	FY23A	FY24A	FY25F	FY26F	FY27F
EPS (PKR)	183.66	12.06	33.79	87.72	118.64	132.96
Earnings growth	196%	-93%	180%	160%	35%	12%
DPS (PKR)	10.00	7.50	10.00	15.00	15.00	18.00
BVPS (PKR)	459	461	493	574	682	800
P/Ex	1.87	28.40	10.14	3.91	2.89	2.58
Dividend yield	2.9%	2.2%	2.9%	4.4%	4.4%	5.3%
P/BVx	0.75	0.74	0.70	0.60	0.50	0.43
ROA	13.5%	0.6%	1.6%	4.2%	5.4%	6.0%
ROE	40.0%	2.6%	6.9%	15.3%	17.4%	16.6%

Source: Company Accounts, Akseer Research

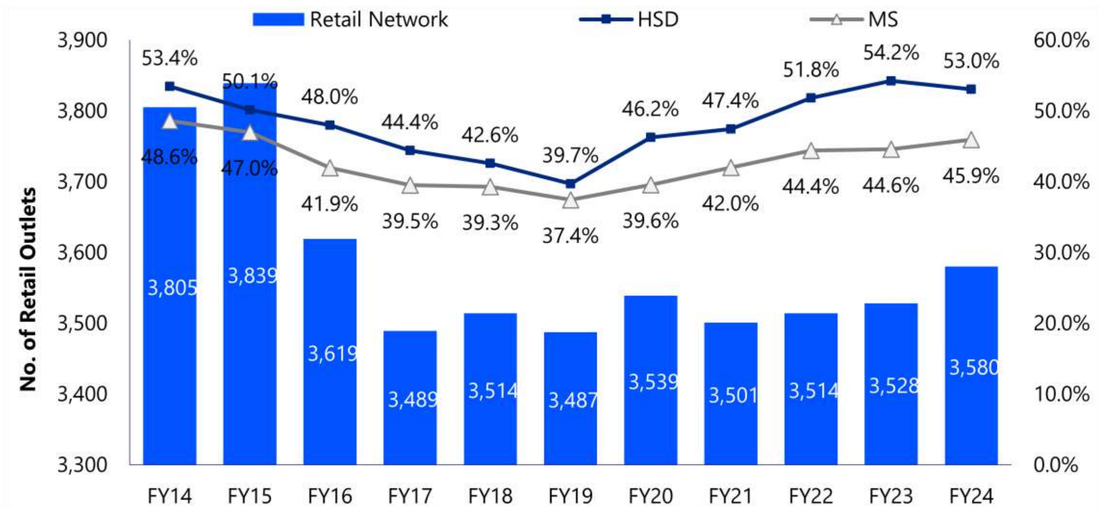
Stiff Competition to Threaten PSO's Market Leadership

Looking ahead, we believe Aramco's involvement in GO's operation will reduce its supply chain constraints and improve its working capital management, turning it into a formidable force. The company has the ability to capture a greater market share than PSO, as observed in the last couple of months.

Moreover, Aramco has opened its first retail outlet in October 2024, marking the beginning of stiff competition within the industry.

The sustained loss of PSO's market share is an integral part of our investment thesis. However, PSO's competitive moat is its massive scale, which makes it the largest player in the industry. Firstly, PSO's large storage and retail outlet network enables it to maintain a sizable stock of POL products, giving it a better brick-and-mortar presence. Secondly, PSO has always been the primary importer of HSD in the country, thanks to its G2G contracts that accounted for 90% of the imported stocks in FY24.

PSO Historical Market Share and Retail Network



Source: Akseer Research, Company Accounts

The following sensitivity table shows the impact of market share erosion on core EPS in FY25.

		MS Market Share							
		-4%	-3%	-2%	-1%	1%	2%	3%	4%
HSD Market Share	-4%	74.39	75.48	76.56	77.64	79.81	80.89	81.97	83.06
	-3%	75.26	76.34	77.42	78.51	80.67	81.75	82.84	83.92
	-2%	76.12	77.20	78.29	**79.37**	81.53	82.62	83.70	84.78
	-1%	76.98	78.07	79.15	80.23	82.40	83.48	84.56	85.65
	1%	78.71	79.79	80.87	81.96	84.12	85.21	86.29	87.37
	2%	79.57	80.65	81.74	82.82	84.99	86.07	87.15	88.23
	3%	80.44	81.52	82.60	83.68	85.85	86.93	88.01	89.10
	4%	81.30	82.38	83.46	84.55	86.71	87.79	88.88	89.96

Upgradation of PRL Expected to Strengthen Supply Chain

Another major development on the cards is that PSO's subsidiary, PRL, is embarking on a journey to upgrade and expand its refinery. This development is set to create valuable synergies within PSO's supply chain, enhancing its ability to meet growing demand by scaling up its local procurement.

For context, PSO holds a 63.56% stake in PRL, which currently operates with a refining capacity of 50,000 bpd per year, which is roughly equivalent to 2.3mn tons of petroleum products. PRL utilizes hydro skimming technology, but like many refineries its production slate cannot vary significantly, which implies that it cannot increase the production of high demand POL products such as MS and HSD. Over the past 5 years, the country's fuel consumption mix has changed, with demand for furnace oil plummeting due to lower offtakes from power generation. Furnace oil is generally a negative-margin product due to low global demand, and in some instances, the cost of transporting furnace oil also contributes to the loss.

One of the key issues facing local refineries is competition from imported POL products. OMCs frequently opt to import rather than source locally. For instance, in a bearish oil market, refineries are locked into higher POL prices for a fortnight while OMCs can procure the same product at a lower rate by importing it. Therefore, the prevailing pricing mechanism puts refineries at a considerable disadvantage.

To address the ongoing challenges and to revamp archaic refining technologies, the government introduced the Brownfield Refinery Policy in FY23 aimed at helping the existing refineries. Pakistan Refinery was the first refinery to sign the Brownfield Refinery Policy in Nov'23, underscoring its proactiveness. As part of this agreement, the company has planned to undertake substantial investments aimed at modernizing its refining operation.

Under this policy, the refinery's capacity is projected to increase from 50,000 to 100,000 bpd, and it is poised to enhance the production of MS and HSD while minimizing the negative-margin FO production (currently 30-40% of the mix), thus improving the refinery's financial viability. The expansion is expected to increase MS production from 250,000 tons to 1.5mn tons, and for HSD, it would increase from 600,000 tons to 2mn tons.

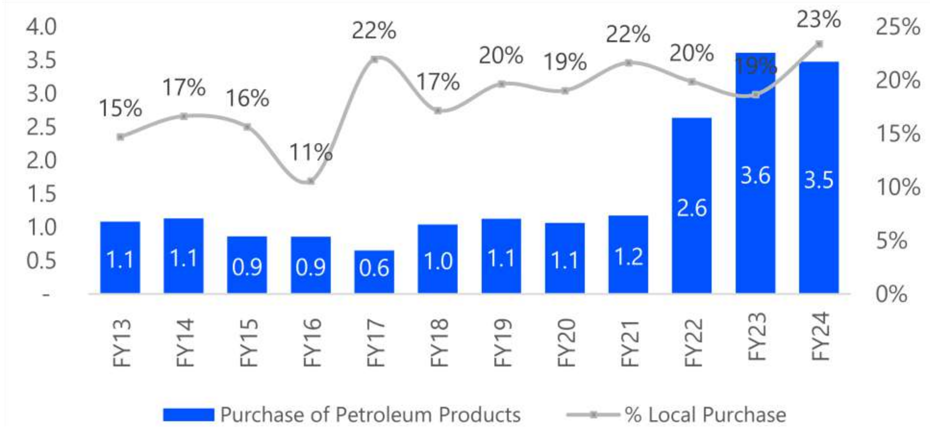
An important provision of this agreement is the financial support mechanism, provided through a 10% deemed duty on ex-refinery price of MS and HSD for a duration of 7 years, starting from the signing of the upgradation agreement. However, a portion of the deemed duty (2.5% on HSD and 10% on MS) will be deposited to an escrow account for the upgradation project.

The good news is that the 7.5% deemed duty on HSD will continue even after the expiration of the 7-year incentive period, lasting for 20 years or when deregulation is implemented, whichever comes first.

In addition, PRL will have access to withdraw up to 27.5% of the total project cost from the escrow account if it imports new plant, machinery, and equipment, which will help fund its ongoing capex expenditure.

Historically, PSO has procured ~20% of its POL products locally through its sister concern. With this agreement in place, we expect the quantum of local procurement to rise thereby bolstering the reliability of PSO's supply chain. This will also serve to mitigate earnings volatility incurred on inventory by enhancing the supply chain's responsiveness to price fluctuations.

Purchase from Local Refineries in PKR bn as % of Total Purchase



Source: Akseer Research, Company Accounts

For this ambitious project, PRL estimates that it would require an investment outlay of USD 1.5 to 2bn. To finance this endeavor, the company plans to secure a substantial portion of the capital through foreign borrowing and is actively seeking collaborative investment to mitigate project risk and reduce PSO's equity exposure. Currently, the company is in the early stages of securing investment from United Energy Ltd for the project.

Smuggling Crackdown to Bear Fruit

Smuggling has always been a pervasive issue in the OMC industry, with smuggled lubricants and HSD from Iran flooding the market. The government has recently ramped up its efforts to curb cross-border smuggling, which is expected to translate to greater legal HSD sales. Meanwhile, the MS and HSD sales for PSO are expected to grow at a 5-year CAGR of 0.89% and 2.48%, respectively. Given the government's consistently firm stance against smuggling and PSO's stable market share, a 10% reduction in smuggling activity would lead to an increase in volumetric sales of HSD, resulting in an EPS impact of PKR 5.52/sh.

Impact of Decline in Smuggling Operations

		-5%	-10%	-15%
PSO HSD Sales	M. tons	3,431,508	3,657,265	3,883,022
PSO EPS Impact	PKR	2.76	5.52	8.28

Source: Akseer Research, OGRA, OCAC

Structural Reforms in the Gas Sector: A Boon for PSO

Things have been looking up for PSO when it comes to the profitability of its LNG segment. Its primary debtor, SNGPL, has successfully brought down the unaccounted-for-gas (UFG) ratio from 8.98% in FY20 to 5.15% in FY23. Consistent efforts are being made to reduce the UFG levels, enabling SNGPL to enhance the efficiency of its operation and improve cash collection. It is important to note that any percentage of UFG above the fixed benchmark is treated as disallowances and deducted from the gross revenue.

Additionally, both gas utilities, SNGP and SSGC, are also now cash- positive due to recent gas price rationalization measures. The cash surplus provides SNGP with sufficient liquidity to meet short-term obligations, including payments to suppliers like PSO. Furthermore, PSO has been able to make 100% recoveries on RLNG, sold to SNGP, resulting in a profitable LNG segment. PSO also received a balloon payment of PKR 70bn in 4QFY24, which resulted in a reduction of overdue receivables. While gross receivables currently stand at PKR468bn (PKR997/sh), with the cash surplus and a potential further decrease in UFG, we expect further reduction in overdue receivables for PSO, thereby unlocking value and improving its cash flows.

The Plague Called Circular Debt

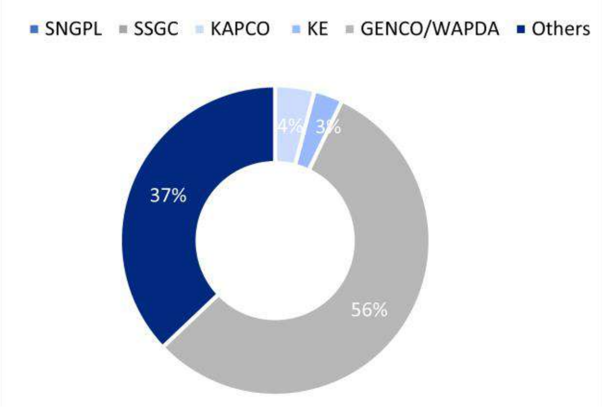
PSO has long found itself trapped in the relentless grip of circular debt. The roots of this crisis can be traced back to 2006, when a shift from a low-cost hydel power to high-cost thermal power generation began to take shape. Since the electricity tariffs were not substantially increased in line with cost recovery levels, the power sector struggled to meet its financial obligation on fuel purchases (furnace oil) dues to suppliers such as PSO. While the power sector was grappling with mounting debts, a similar crisis had emerged in the gas sector.

Since 2015, Pakistan has turned to importing RLNG due to continuous depletion of its indigenous gas reserves. However, this solution came with its own set of challenges. The government's delay in tariff revision (consumer prices had remained flat from 2015 to 2018) combined with high operational costs and collection shortfalls created an untenable situation for utility companies such SSGC and SNGP. These companies struggled to pay their dues to PSO which was and has been the primary importer of RLNG in the country. Currently, the RLNG segment contributes 29% of the total revenues while representing 69% of PSO's gross receivables, predominantly owed by SNGPL. This highlights the precarious situation PSO found itself in – caught between the realities of liquidity needs and an unyielding debt cycle.

Until recently, the RLNG segment had been unattractive, primarily due to poor economics. PSO not only bore the brunt of non-recoveries but also suffered losses due to RLNG's regulated status, with a fixed margin of 2.5% compared to HSFO (ex-inventory gain/losses), which is unregulated and has always positively contributed to the company's bottom line. This meager gross profit often proved insufficient to cover ongoing operational and financial costs, resulting in losses and negatively impacting overall profitability.

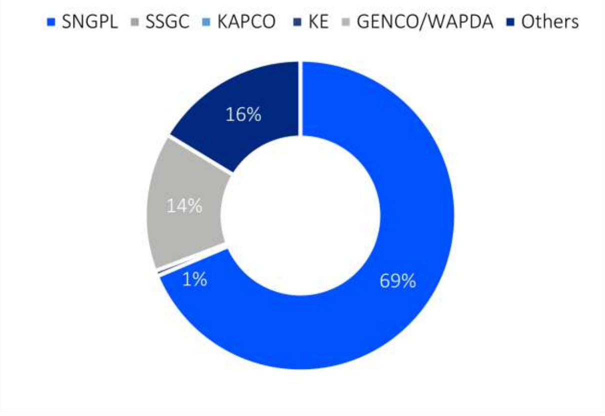
With regard to the gas crisis in Pakistan, in FY24, the country's indigenous gas reserves stood at 18.4 TCF on account of new gas field discoveries. Gas production has been steadily declining by 5% over the years to the current production level of 3,390 mmcfd. We expect the decline to continue at a rate of 5% per annum. Assuming 3% annual demand growth, RLNG requirements to cover the shortfall will jump by 19% each year between FY25 and FY29. However, the realization of these imports is incumbent on the national fiscal and external space.

Gross Receivables in FY14



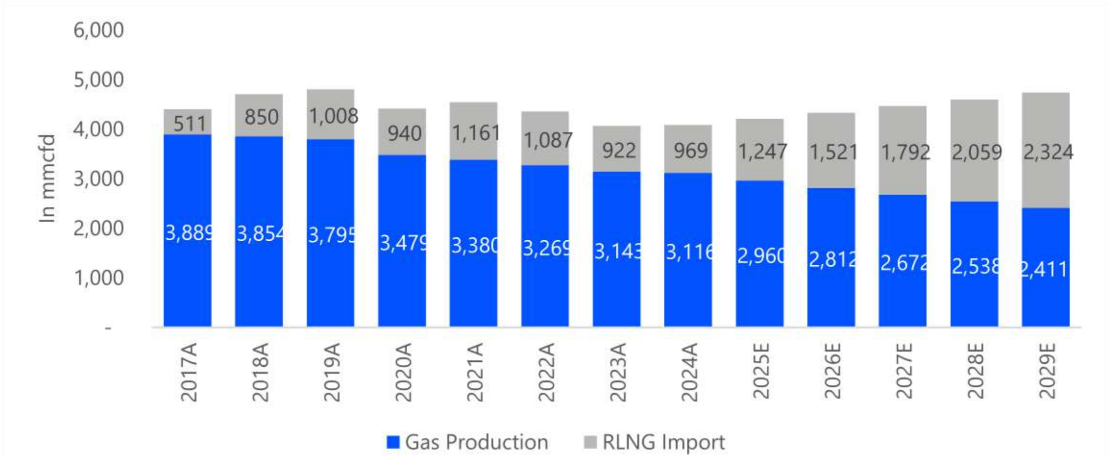
Source: Akseer Research, Company Accounts

Gross Receivables in FY24



Source: Akseer Research, Company Accounts

Gas Supply & Demand



Source: Akseer Research, Pakistan Energy Yearbook, OGRA

Its pertinent to note that, due to dwindling gas reserves, a majority of the imported RLNG has historically been diverted to the power and industrial sector. However, during periods of peak demand (winter season), it is also diverted to the domestic sector. The price of imported RLNG is considerably higher than that of locally produced gas, and during peak seasons, utility companies are forced to provide RLNG to subsidized domestic consumers, leading to greater cost inefficiencies. The diversion to the domestic sector is expected to increase as domestic production declines; consequently, the mix of RLNG in the gas system will continue to increase. In this case, simply increasing gas tariffs once is not enough and will require continuous monitoring and timely increases on a par with the dollarized weighted average cost of gas to prevent further accumulation of circular debt in the system.

A shift in policy is evident, as the government is cutting down on subsidies lent previously. For example, in 3QFY24, the government ceased funding for imported RLNG to Agritech and FatimaFert from its own budget and, instead, opted to subsidize it through charges to other consumers, resulting in the price of RLNG, increasing by approximately 8%.

Moreover, as per the IMF didact, gas prices were revised by 35% in Jan'23, with another hike by 65% in Nov '23, resulting in revenue improvement for SNGPL and, consequently, stalling the accumulation of trade debts in PSO's books. The government has committed to rebasing the gas prices on a biannual basis, which should ensure steady cash flows to SSGC and SNGPL and keep the growth of circular debt in check. Limited fiscal space and stringent conditions demanded by the IMF leaves no way out of the conundrum except gas price rationalization. Currently, there is 100% recovery on the gas being sold, and PSO has been prioritized over OGDC and PPL for the recovery of overdue receivables, in an effort to reduce PSO's leverage.

Sourcing of Diesel through Long-Term G2G Contracts

Being the country's flagship energy giant, PSO has G2G contracts for timely procurement of HSD. It has an extended credit facility from Kuwait Petroleum Corporation (KPC) for HSD procurement, which ensures a reliable and steady supply of the POL product while minimizing procurement and pricing risks. Moreover, OGRA's pricing mechanism incorporates a weighted average of the KPC premium, while the premium paid in the spot market by other OMCs is capped at USD 15/bbl. Since PSO is procuring a majority of its HSD supply from KPC at a much lower premium, this gives it a competitive advantage over other OMCs.

Country-risk premium shifts over time, based on Pakistan's ability to meet its external obligations. Therefore, the premium on spot LCs also varies. A majority of the OMCs import POL products using spot letters of credit, which exposes them to fluctuations in the risk premium, leading to higher import costs. In contrast, PSO's long-term agreement with KPC provides more stability and predictability in pricing.

The combination of low margins and disadvantageous LC premium creates significant challenges for smaller OMCs, as these companies cannot expand their operations without forming alliances with foreign fuel suppliers. This dynamic reinforces PSO's dominant position in the market.

Implications of Axle Load Implementation

Implementation of the axle load regime is expected to improve demand conditions. If regulations are strictly enforced, the implications are far-reaching. As of FY24, there were approximately 321,900 trucks on the road. With the increase in the number of trips needed to transport goods, we expect greater fuel consumption in the long run. This is advantageous for PSO due to its widespread network of storage depots and retail fuel outlets. A 15%

increase in HSD consumption would result in a positive EPS impact of PKR 9.44/sh.

Hedging against Exchange Rate Volatility

PSO imports petroleum products, making it susceptible to exchange rate fluctuations due to its exposure to foreign creditors.

Generally, when PSO imports petroleum products, it establishes a letter of credit with its bank to facilitate the transactions. The time lag between the opening of an LC with the bank and the arrival of cargo at the port leads to exchange gains and losses, where unrealized gains and losses are recorded on the company's books.

The company's exchange rate losses incurred on foreign credit facilities are hedged via OGRA's pricing mechanisms that incorporates PSO's losses within the ex-refinery prices every fortnight, while the exchange rate losses on FE-25 loans are recoverable from the government. This mechanism protects PSO from what could be catastrophic exchange rate losses in the event of steep rupee devaluation, leading to higher operational costs. Disbursement against the cumulative exchange rate losses on FE-25 borrowings is decided on every budgetary cycle.

Storage Rehabilitation and Expansion

PSO boasts an extensive storage depot network. As of FY23, the company held 31.6% of the total fuel storage capacity in the country. In FY24, the company completed the construction of 7 storage depots across Faisalabad, Mehmoodkot, and Faqirabad, adding 91,000 MT worth of capacity and bringing its total storage capacity to approximately 499,000 tons.

Moreover, under its storage rehabilitation schedule, storage depots totaling 26,600 M. tons were revitalized at Sihala, Pipri Marshalling Yard (PMY), Buffer Oil Terminal, Habibabad, and Sahiwal. Another 21,400 M.Tons of storage capacity is up for enhancement at Zulfiqarabad, Sihala and Mehmoodkot Terminals.

Aside from storage capabilities, the company has also invested in the logistical side and has a 12% stake in PAPCO, which operates a 786-km-long White Oil Pipeline. The pipeline transports imported as well locally produced petroleum products from multiple sources to different demand centers. In 2021, The White Oil Pipeline had also been upgraded to allow simultaneous transportation of motor spirit from Karachi to Machike. Recently, construction for its 477-km-long section (Machike- Thaliyan – Tarujabba) has been approved, which is a joint venture between PSO, PARCO, and Interstate Gas Systems. This development is expected to bring greater efficiency and improve the agility of its supply chain.

Timely Revision in Margins to Ensure Consistent Earnings

To recall, OMC margins had remained stagnant in FY23, a period that was marked with unprecedented inflationary pressures and record- high financing requirements. This changed back in 1QFY24, when ECC approved a 31% hike in the OMC margins for MS and HSD, increasing it from PKR 6.00/l to PKR 7.87/l each, which was implemented through four fortnightly installments.

Currently, the government is expected to approve another revision in the OMC margins following a recommendation from OGRA. The OMC margins are expected to increase by PKR 1.35 to PKR 9.22/l and the dealers' margin is set to jump by PKR 1.40 to PKR 10.04/l. This increase was proposed in light of rising operational costs, higher working capital requirements, elevated turnover tax, as well as the need to support digitization and automation of petrol pumps over the next three years.

OMCs and dealers have long been lobbying for an increase in margins due to rising operational costs. As per the proposed changes, the OMC margin is set to increase by PKR 1.35/l and the dealers' margin is set to rise by PKR 1.40/l.

Proposed margins of PKR 0.5/l and PKR 0.25/l have been allocated to the digitization of OMCs and dealers, respectively. It is expected that the digitization will help improve transparency. Once implemented, the proposal will help curb the smuggling of POL products by improving tracking and traceability through digitization.

In our base case, we have assumed a CPI-linked annual increase in margins. MS and HSD volumes for FY24 are used as benchmarks for our calculation. If the proposed increase is implemented in Q3FY25, the EPS impact of margin revision will stand at PKR 14.8/sh.

Inventory Management – The Question of Dead Stock

Thanks to its special status as a state-owned enterprise, PSO is mandated to keep five additional days of strategic POL product reserves for defense purposes.

This is in addition to the 21 days mandated by OGRA itself. PSO also faces the issue of dead stock in the 787-km-long PAPCO pipeline, which is used to transport petroleum products upcountry. This brings the total days of inventory outstanding to 45, and the sheer volume of inventory in the pipeline and in the storage, depots make PSO extremely vulnerable to commodity price fluctuations. Moreover, due to smaller OMCs skimping on maintaining the minimum inventory levels, PSO is forced to take on greater inventory to maintain adequate reserves to prevent a countrywide fuel shortage.

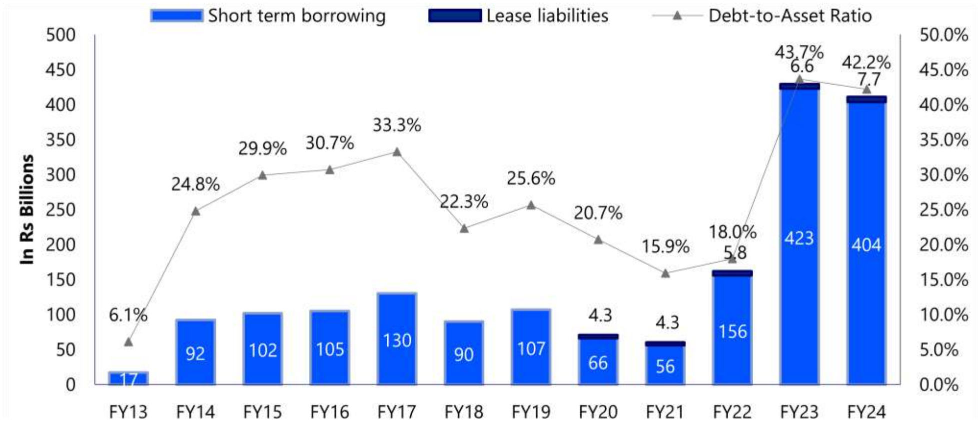
Owing to the above reasons, PSO has limited room to maneuver when dealing with short-term fluctuations in crude oil prices, making it susceptible to massive inventory gains and losses. It enjoys high inventory gains in periods of elevated oil prices and vice versa.

For every 5% change in the crude oil price, the impact of inventory gains/losses in FY26 is approximately PKR 7.97/sh, assuming other factors remain constant.

Deleveraging of Its Balance Sheet

As of FY24, the company's debt-to-asset ratio stood at 42.20%, while finance costs accounted for 54.65% of its expenses. Since the circular debt crisis for gas is now under control thanks to appropriate cost recovery and revenue generation by gas distribution companies, we expect PSO to gradually deleverage its balance sheet, giving it more room to expand its business and upgrade its infrastructure accordingly.

Debt-to-Equity Ratio vs Interest Rate



Source: Akseer Research, Company Accounts

Pivoting towards Becoming an Energy Company

With the advent of EV in Pakistan, PSO has installed charging stations in both Islamabad and Lahore. The company is in the process of installing two more charging stations on the M2 motorway.

Moreover, PSO and Hub Power Holdings Limited have signed an MoU for the establishment of a nationwide electric vehicle charging network. This is the first step towards PSO positioning itself as an essential infrastructure service provider and tapping into the growing EV market, which is currently in its infancy in Pakistan.

The company's potential revenues from this venture are directly proportional to EV penetration and will require a substantial adoption rate to make a significant impact on bottom-line growth.

Changing Tides in the Power Sector

The permeating structural issues in the power sector has given rise to several proposals to reduce the high-capacity charges owed to IPPs. One of the proposals that has taken the industry by storm is the transition from 'take or pay' agreements to 'take and pay' agreements. An underlying caveat of this transition is that fuel supply arrangements will be the responsibility of the IPPs and that government guarantees will be revoked. It is pertinent to note that, under the Power Policy 1994, PSO is legally bound to supply furnace oil (FO) to the IPPs irrespective of payment overdue status. If the responsibility of arranging fuel supply is shifted, this would improve PSO's working capital management. At the moment, RFO plants are losing favor due to their obsolete technology and inefficiencies, resulting in lower RFO offtake.

PSO is expected to receive PKR 14.8bn (~PKR 43/sh) from HUBC on account of the former's contract termination. The receipt of these funds has been incorporated in our analysis. Moreover, as more power plants are being roped in for contract renegotiation, further recovery of dues are expected.

Diversification Efforts: Breaking Away from Status Quo

To combat the constant liquidity crunch, PSO has undertaken several strategic initiatives to diversify its revenue stream and improve its cash flows. A key development on the policy front was the SOE Act, 2023, which introduced the principles of competitive neutrality, ensuring PSO operates on a level-playing field with its private competitors. This gave PSO the leeway to innovate and diversify itself to remain competitive.

On Sep 30, 2024, PSO established the PSO Venture Capital (Pvt) Ltd, earmarking PKR 415mn from its retained earnings to invest in startups and unlock new streams of revenue.

In 2019, PSO launched its own wallet, DIGICASH, allowing users to manage their wallets via the PSO Fuelink app and obtain both digital and physical DIGICASH cards to make purchases at its retail fuel stations. Building on its wallet, PSO has been gunning for an EMI (Electronic Money Institution) license for its fintech subsidiary, Cerisma Pvt Ltd, the license was granted in April 2024. The opportunity this presents is enormous, considering PSO's extensive network of retail outlets and point-of-sale functions all over the country.

For instance, in FY24, PSO recorded net sales of PKR 3,571bn and, assuming half of the sales were made through DIGICASH, then the company would have access to a monthly transaction value of PKR 105bn. With the fintech license in hand, DIGICASH card can be branded as a Visa or Mastercard which can be used for all sorts of retail operations beyond the purchase of fuel and lubricants, potentially amplifying the daily transaction volume. PSO has a head start in the space as it already had corporate users of its fuel card before it obtained its EMI license. Moreover, the company can leverage its strong retail network where the cards can be utilized.

This strategy will allow PSO to establish its own financial ecosystem and will not only save on MDR charges (this is charged between 1.5% - 2% by banks) but will turn it into a revenue stream in itself. Moreover, under the EMI license, fintech companies can invest 75% of their cash balance in treasury bills and government securities, which would be a boon for PSO. Another advantage is that its commercial partners (dealers and distributors) could function as agents, allowing withdrawal of cash from PSO's financial system (similar to how agents operate in similar EMI systems, such as Easypaisa and JazzCash) and receive fuel supplies in lieu of it. This allows PSO to essentially receive prepayments on its petroleum products, which should further improve its working capital. It is pertinent to note that an average retailer has a limit of PKR10,000 on customer withdrawals for Easypaisa and JazzCash ecosystems. But considering PSO's monthly sales of 177bn within its retail network, the opportunity presented for cash withdrawals is an estimated PKR0.16mn per day per retail outlet using FY24 sales as a benchmark.

Another interesting development is the company's collaboration with the government of Gilgit-Baltistan in launching the 'Blue LPG initiative ', which will allow the company to offer last-mile delivery of LPG in modern, lightweight composite cylinders. Customers will be able to purchase via a mobile app and web platform; currently, this initiative is in its initial phase in Central Hunza. This will allow PSO to capture untapped market in the area, thereby increasing its customer base and establishing itself as a reliable LPG supplier.

Earnings Growth Anticipated

PSO's core earnings (excluding inventory gains/losses) is expected to increase steadily. As the economy is slowly recovering on the back of improved economic fundamentals and lower commodity prices, we expect volumetric sales to increase. PSO has the infrastructure and retail network in place to capture the market share in a booming economy. Earnings growth is expected at a 5-year CAGR of 27%.

Upside Potential and Moderate Dividend Yield

PSO remains undervalued, trading at a forward core P/E multiple of 3.91x. The scrip is a great candidate for growth investors and is a strong play among oil and gas majors due to its cheap valuation and growth potential. Downside risks are expected to be mitigated by increased cash flows, which should enable it to pay consistent dividends. The dividend yield for FY25/FY26 is 4.4%.

Valuation Basis

We expect gas prices to be reviewed and rebased semi-annually, which would ensure that accumulation of circular debt is effectively halted.

This should unlock value for PSO freeing up trapped retained earnings, giving the company the flexibility to pursue strategic growth opportunities. The scrip offers an upside potential of 81% on the Dec '25 target price of PKR 619/sh.

Our PT for PSO has been computed on discounted cash flows using free cashflow-to-equity to calculate the terminal value. We have used a risk-free rate of 12%, a beta of 1.0, and a market-risk premium of 6% to arrive at a cost of equity of 18%.

Risks

Key risks to our investment thesis are:

Downside Risks: 1) A steep decline in crude oil prices will depress earnings due to inventory losses, 2) delayed margin revision, 3) a relapse of HSD smuggling,

4) intense competition in the industry, 5) exchange rate losses on foreign credit facilities, which are no longer covered by the government.

Upside Risk: 1) Bullish trend in crude oil prices, which will result in inventory gains, 2) consistent margin revision, 3) anti-smuggling operation, 4) continued market leadership, 5) timely cash flows from debtors.

Attock Petroleum

We maintain our 'Buy' stance on the scrip with a Dec-25 TP of PKR 577/sh. The company is expected to hold its ground in an increasingly competitive environment and has ample liquidity to fund future projects. Moreover. Its sister concern Attock Refinery is expected to undertake the upgradation project which will significantly improve its production slate. The scrip has an upside potential of 20% from the last close. With a dividend yield of 4.5%, the total return comes to 25%.

Company Description

Based in Rawalpindi, Pakistan, Attock Petroleum is the third largest oil marketing company in Pakistan. It deals with the procurement, transportation and marketing of POL products, including bitumen and lubricants. APL was incorporated in Pakistan as a Public Limited Company in December 1995 and began operations in 1998. As of Sep 30, 2024 APL had 809 retail fuel outlets and 9 storage depots across the country.

Investment Thesis

- APL has the strongest liquidity profile in the OMC industry. Our investment thesis is built on the caveat that as the economy revives, POL product offtake will increase. APL is strategically positioned to take advantage of this change in tide and capture market share.

- APL has lower foreign exchange exposure compared to other OMCs. During periods of steep devaluation, APL rakes in exchange gains against its exposure; however, in times of relative currency stability, it loses out on these gains.

- Among OMCs, APL has a significant advantage thanks to its vertically-integrated model (both midstream and downstream) that gives it high financial flexibility.

- Lastly, APL's sister concern, Attock Refinery (ATRL), is set to sign the Brownfield Refinery Policy 2023 for the upgradation of its facility. Although the signing of the agreement has faced setbacks with respect to the resolution of the input sales tax issue, the company strongly supports the upgradation project and is expected to be onboarded, thereby enhancing its production slate. This project is expected to be value-accretive and will reduce associated low RON penalties, thereby improving its production slate.

Key Data

PSX Ticker	APL
Target Price (PKR)	577
Current Price (PKR)	478
Upside/(Downside) (%)	+21%
Dividend Yield (%)	4.5%
Total Return (%)	25%
12-month High (PKR)	575
12-month Low (PKR)	351
Outstanding Shares (mn)	124
Market Cap (PKR mn)	59,471

Source: PSX, Akseer Research

Relative Share Performance

Source: PSX, Akseer Research

Summary	FY22A	FY23A	FY24A	FY25F	FY26F	FY27F
EPS (PKR)	148.99	100.15	111.09	70.96	88.53	91.91
Earnings growth	-33%	11%	-36%	25%	4%	18%
DPS (PKR)	45.00	27.50	27.50	21.29	30.99	36.76
BVPS (PKR)	301	365	451	497	561	620
P/Ex	3.21	4.77	4.30	6.74	5.40	5.20
D/Y	9.4%	5.8%	5.8%	4.5%	6.5%	7.7%
P/BVx	1.59	1.31	1.06	0.96	0.85	0.77
ROA	23.4%	12.2%	13.0%	8.1%	9.2%	8.7%
ROE	61.7%	30.2%	27.3%	15.0%	16.8%	15.6%

Source: Company Accounts, Akseer Research

Positioned to Hold Its Ground in Face of Growing Competition

APL is the third largest OMC in Pakistan with a market share of 8.42% for FY24, an increase of 35bps over the year. The company has a history of sustainable and strong cash flows, enabling it to expand its market share in retail fuels. This growth occurred despite reduced POL offtakes in FY24 due to slow economic activity and inflationary pressures.

As inflation recedes and the State Bank is easing its monetary policy stance, we expect financing costs to cool, with the average interest rate for FY25 estimated to be 15%. As interest rates are declining, we expect APL to face steep competition; however, we expect it to sustain its retail fuel market share without having to pursue aggressive expansion strategies. Its strong cash flows provide it leverage to expand its network and operations without jeopardizing its financial health. Over the past ten months, overall market share trends indicate that APL has mostly been resilient, with a 34bps drop in HSD market share and a 17bps increase in MS market share compared to SPLY.

APL Set to Reap Benefits amid Anti-Smuggling Crackdown

The company stands to gain significantly from the Pakistani government's recent crackdown on cross border smuggling of diesel. The influx of smuggled diesel has severely impacted refineries such as its sister concern ATRL that has been struggling with overstocked inventories and reduced operational capacity due to low domestic demand. With the enforcement of stricter measures, we project to see a positive impact of PKR 1.40/sh if the contribution of smuggled HSD were to be reduced by 15%. Moreover, APL's growth outlook remains promising with a projected 5 years CAGR of 2.50% & 0.39% (FY24-FY29) for MS sales and HSD sales respectively

Impact of Decline in Smuggling Operations

		-5%	-10%	-15%
APL HSD Sales	M. tons	579,826	617,973	656,119
APL EPS Impact	PKR	0.47	0.93	1.40

Source: Akseer Research, OGRA, OCAC

Higher Sales Volume Expected on The Back Of Retail And Storage Network Expansion

As of September 30, 2024, APL's retail network comprised 809 retail outlets, of which 42 are company-operated sites. Over the past year, the company's retail network has expanded by 58 outlets, while 3 outlets have been shut. Moreover, the company now has 9 storage depots (a combined capacity of 210,885 metric tons), including the newly constructed bulk oil terminals in Dera Ismail Khan that boasts a storage capacity of 10,945 metric tons for HSD and 7,963 metric tons for MS.

The company is currently planning to expand its Rawalpindi Bulk Oil terminal by 10,000 tons. Estimated capex lies in the range of PKR 600-800 mn. Another expansion is planned at the terminal in Port Qasim which will be increased by 18,700 tons. With regard to the terminal at KPK, the litigation against APL has been resolved and boundaries at the site have been erected.

We believe that expanding its storage infrastructure and retail outlet network will ensure that its POL products are readily available and will boost earning potential. Moreover, the company has plans to solarize its company-operated retail fuel outlets and bulk oil storage terminals.

Embracing Electrification

APL has currently established 3 Electric Vehicle (EV) Charging Stations with a capacity of 180kW in Islamabad and Rawalpindi. The company plans to add 7 more charging stations in Lahore, Islamabad, motorways, and national highways to diversify its revenue stream and cater to the increasing demand for electric vehicles in the market. The company currently holds 22 sites out of

42 designated for charging stations on the motorways. The estimated capital expenditure (CAPEX) per charging station is PKR 40mn. The demand for EV charging stations is expected to rise once the upfront cost of owning an electric vehicle decreases to a range of PKR 5 – 6mn.

Diversification into the LPG business

APL has made strategic investment in LPG sector as part of its efforts to enhance the company's long-term growth. Its LPG storage and filling facility (with a design capacity of 203 metric tons) in Rawalpindi is expected to be commissioned by early 2025. It is comprised of four storage tanks with a daily filling capacity of 50 metric tons. The expected sales volume is 120 tons/day, bringing it to 39,600 tons per annum.

The estimated margin is PKR 28,000/ton, assuming the company pockets both the OMC margin and the distribution margin. The new product will be aimed at industrial and commercial consumers. Assuming that 39,000 tons of LPG is sold in FY26 the after-tax, the EPS impact translates to PKR 3.43/sh.

Lower Exchange Losses Due to Reduced Exposure and Efficient Supply Chain

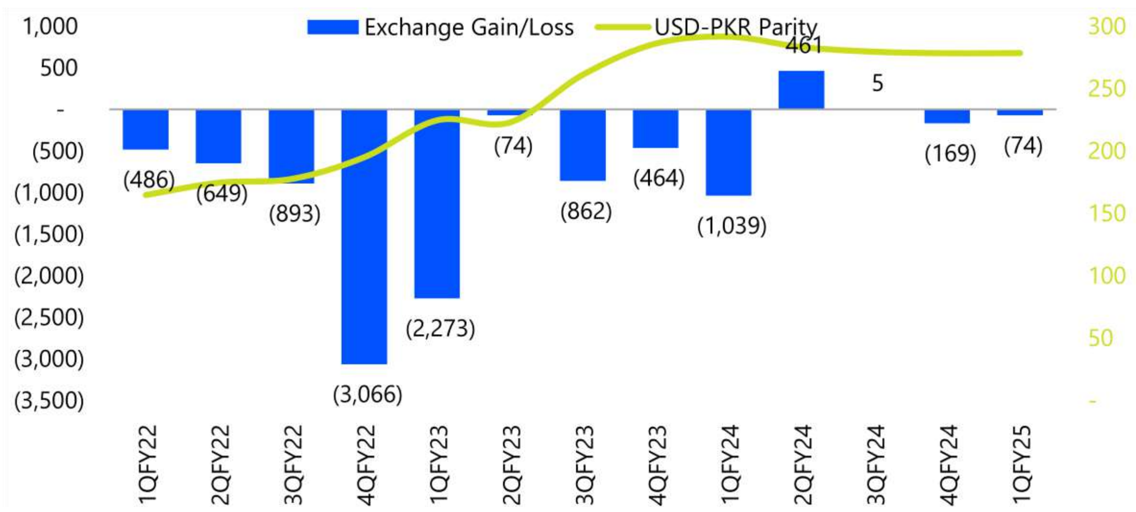
APL's exposure to foreign liabilities is much lower due to the procurement of large volumes of POL products locally. This is established by the fact that in FY24, APL recorded foreign risk exposure of PKR 3.9bn. Its stable cash flow generation mitigated its exposure to foreign currency fluctuations.

Moreover, the company also plays on the backward integration it has with its sister concerns, the National Refinery and Attock Refinery, allowing it to lean on local procurement when there is high currency rate volatility, thus mitigating its exchange rate risk.

Considering the USD/PKR parity has remained stable since Dec '23, the company has not had to face significant exchange rate losses/gains. However, historically, APL has always enjoyed low earnings volatility due to its lower exchange rate risk and efficient supply chain management, which makes it a strong pick against its peers.

For every 10% PKR depreciation (with all other variables constant), earnings would increase by PKR 5.8/sh.

Exchange Gain/Loss vs USD-PKR Parity



Source: Akseer Research, Company Accounts

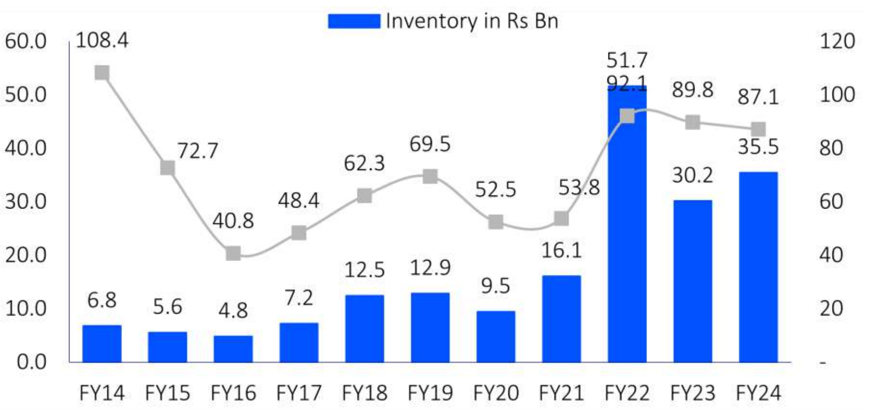
Leveraging Synergies in the supply chain to Mitigate Commodity Price Volatility

FY24 was marked by economic downturn and muted fuel demand; however, with the economy slowly recovering, we believe APL is well-positioned for a strong rebound. Its robust cash flows enable it to mitigate the impact of adverse oil price movements on the company's bottom line, allowing it to shore up the inventory in the face of demand recovery.

In a rising oil price environment, OMCs are usually forced to increase their working capital, which results in a reduction of return on invested capital. However, APL has a significant advantage over its peers, as it has ample room to raise it working capital by delaying payments to its sister concerns. This allows the company to enjoy high returns in a bullish oil market. Its winning strategy includes its efficient inventory system and lower-than-average working capital requirements.

When the oil price is set to decrease, it leads to potential inventory losses, quickly offloading its inventory levels to the minimum stock level to mitigate those losses. An example of this was observed on 11 October 2023, when the company offered petrol at a PKR 10 discount below the official retail price in a bid to reduce stock levels as petroleum prices were expected to fall by PKR 40/l. Similarly, when oil prices are set to be bullish, they increase inventory through local procurement from their sister concerns, securing easy gains.

APL Inventory Value in PKR mn vs Global Oil Prices



Source: Akseer Research, Company Accounts

Upgradation of Attock Refinery to Unlock Further Value

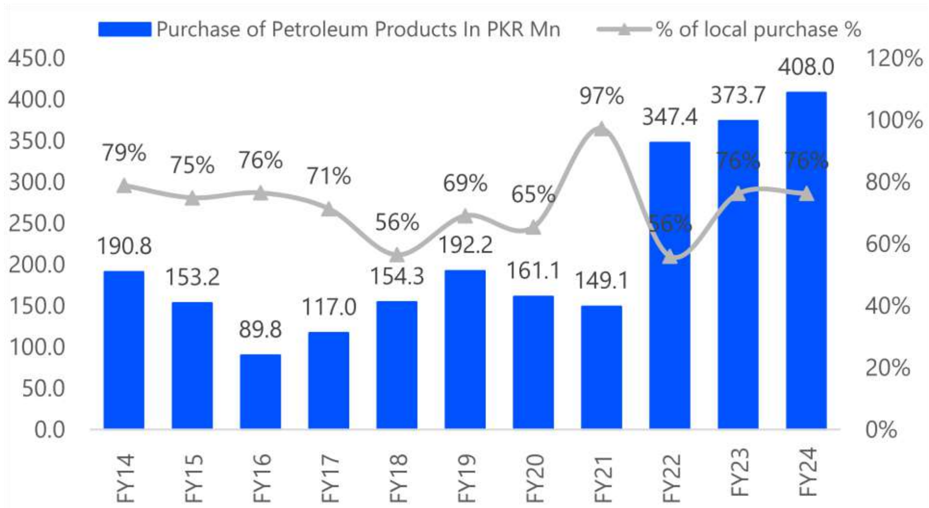
Attock Refinery (ATRL), a subsidiary of APL is poised for a significant upgrade, aimed at enhancing its production capabilities for premium products, specifically RON 95 and 10ppm gas oil. This initiative is also expected to reduce its reliance on chemical additives in POL products. The advancement of this project, however, is hindered by issues related to the Brownfield Refinery Policy 2023, particularly the classification of petroleum products under the sales tax-exempt category, which prevents a refund of input taxes, consequently increasing the refinery's operational cost.

ATRL is uniquely positioned in the industry as being the only refinery optimized for processing of heavier grades of crude oil. Despite this advantage, it has predominantly utilized lighter grades due to depleting oil reserves from indigenous sources in the Potohar and KP regions. The company is hopeful for an increase in domestic crude oil allocation from the Indus Basin region, which is pending necessary approval.

The financing plan for the upgradation project is structured with 70% debt and 30% equity. Both ATRL and APL possess substantial cash reserves and short-term investments that will enable them to meet capital expenditure requirements without compromising APL's equity position. The project is geared towards value addition and is not expected to increase the refinery's overall capacity.

APL stands to benefit from the upgradation as it would improve the reliability of its domestic supplies. Moreover, ATRL has set ambitious targets to increase exports of FO in FY25 to 100,000 tons (compared to 80,000 tons in FY24), which will generate revenue to support upgradation costs and enhance APL's overall supply chain resilience.

Purchase of Locally Refined Products



Source: Akseer Research, Company Accounts

Margin Revision to Propel Bottom-Line Growth

As highlighted earlier, Pakistan's economy is on a path to recovery; we expect margins to rebound and continue increasing during the expansion phase on the back of volumetric growth.

The government is expected to approve a revision in the OMC margins following a recommendation from OGRA. OMC margins are set to increase by PKR 1.35 to PKR 9.22/l and the dealers' margin is set to increase by PKR 1.40 to PKR 10.04/l. Assuming the proposed increase is implemented Q3FY24 onwards and FY24 volumes are used as a benchmark, we can expect the core EPS impact at PKR 10.6/sh for FY25.

Bitumen Offtake Set to Increase

Over the past year, deteriorating economic fundamentals and high interest rates have curbed economic activity. Bitumen is a crucial component used extensively in the pavement of roads. In FY24, the industry offtake dipped by 9% to 109K tons, with APL's market share plummeting from the highs of 80% to 43.81% due to an influx of large volumes of imported bitumen and reduced supply from National Refinery (NRL), a sister concern of APL. In FY24, the government allocated PKR 1.4tn for public spending and development projects (PSDP) which was subsequently slashed down to PKR 1.1tn. The government has further reduced PSDP allocations to projects, as mandated by the IMF, with allocation to the NHA decreased from PKR 180bn to PKR 161bn. It is likely that the PSDP outlay maybe reduced further by PKR 200bn to PKR400bn, depending on fiscal operations.

As of FY24, the NHA network comprised 48 national highways and motorways spanning 14,480km, with major projects in the pipeline, such as the Peshawar-Karachi motorway (PKM) and the 6-lane Hyderabad-Sukkur Motorway. We expect bitumen offtake to increase by 2% over the year as APL increases its market share in FY25. The impact of this market share increase is expected at PK0.26/sh.

It is important to note that the IMF has set the FY25 primary surplus target at 1% of the GDP, which will be gradually increased to 2% in FY26, contingent on an improvement in revenue collection. The increase in target will make it less likely for the government to scale up development spending. However, from FY27, we expect recovery in spending levels on road infrastructure.

Steady Earnings Growth

Going forward, we expect core earnings for APL (excluding exchange gains/losses and inventory gains/losses) to increase in the next five years. As the economy is recovering, we expect higher volumetric sales. Meanwhile, APL is well-positioned to absorb the demand increase due to is expansive storage infrastructure and a strong retail presence in the Punjab.

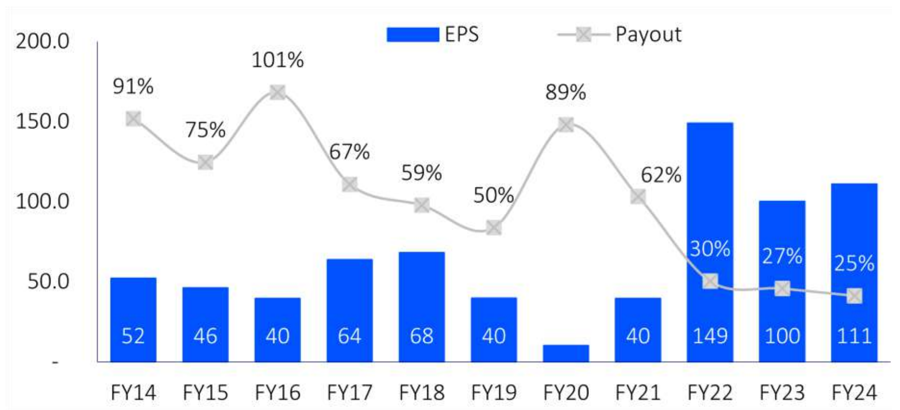
Moreover, as of Sep 2024, the company shored up short-term investments worth PKR 35bn to fund any potential need for liquidity. The company's foreign exposure is also now limited due to the rupee's relative stability. We expect operating costs to be contained on account of lower currency volatility and a declining inflation rate.

Moderate Dividend Yield and Value Potential

Currently, the company remains undervalued, trading at a forward P/E multiple of 6.74x. Its strong liquidity profile lends strength to our case of its growth potential and low earnings risk, making it an excellent value oil play for investors.

Meanwhile, the dividend yield has been low in FY24 with the company retaining profits for strategic investments. We expect the investments to pay off in the coming years, and we project the dividend yield to be 4.5% & 6.5% in FY25/FY26, respectively.

Historical Dividend Payout and EPS



Source: Akseer Research, Company Accounts

Valuation Basis

On the whole, APL makes for a compelling value proposition and offers a balanced combination of the dividend yield and upside growth. We highlight a 'Buy' call on the scrip with a target price for Dec 2025 at PKR 577/sh, offering an upside of 20% from its previous close and a dividend yield of 4.5% in FY25, bringing the expected total return to 25%.

Our PT for APL has been computed on discounted cash flows, using free cashflow to equity (FCFE) to calculate the terminal value. We have used a risk-free rate of 12%, a beta of 1.0, and a market-risk premium of 6% to arrive at a cost of equity of 18%.

Risks

Key risks to our investment thesis are: 1) Steep decline in crude oil prices, which will depress earnings due to inventory losses, 2) delayed margin revision, 3) a relapse of HSD smuggling, and 4) intense competition in in the industry.

Upside risk: 1) An increase in market shares 2) a rise in the crude oil price 3) higher-than-expected margin revision, 4) steep rupee depreciation, and 5) anti-smuggling operations.

Disclaimer

Valuation Methodology

To arrive at our 12-months Price Target, the JV uses different valuation methods which include: 1). DCF methodology, 2). Relative valuation methodology, and 3). Asset-based valuation methodology.

Ratings Criteria

JV employs a three-tier ratings system to rate a stock, as mentioned below, which is based upon the level of expected return for a specific stock. The rating is based on the following with time horizon of 12-months.

Rating	Expected Total Return
Buy	Greater than or equal to +15%
Hold	Between -5% and +15%
Sell	Less than or equal to -5%

Ratings are updated to account for any development impacting the economy/sector/company, changes in analysts' assumptions or a combination of these factors.

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Analyst Certification

The research analyst, denoted by 'AC' on the cover of this report, has also been involved in the preparation of this report, and is a member of JV's Equity Research Team. The analyst certifies that (1) the views expressed in this report accurately reflect his/her personal views and (2) no part of his/her compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this report.

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