

Pakistan Petroleum Limited

Ready to ride on strong valuations

Company Update: **BUY**

Target Price: **Rs240**

Oil & Gas

July 2010



JS Global Capital Limited

After an impressive price performance by OGDC (now trading at FY11F PE of 9.96x), the market is now curious whether its peers, especially Pakistan Petroleum Limited (PPL) could also offer similar returns in coming months given its relatively stronger fundamentals and highly attractive valuations. We view PPL as one of our preferred plays in the E&P sector and our liking for the stock is backed by sizable hydrocarbon discoveries and new production flows that commenced in recent months. The earning outlook further improves with recovery in gas wellhead prices and new production flows expected to materialize in coming months. We further see company's accelerated CAPEX plans, diversification into the power sector and focus on the international front as key long term triggers. Trading at FY11F PE of 6.4x and 18% discount to the target price of Rs240, we reiterate our 'Buy' call on PPL and flag it as a potential out-performer in the coming months. Lastly, given the recent market performance by OGDC, PPL is now trading at 36% discount to the former in terms of PE compared to its average historical discount of 8%. This hints towards a possible shift in the investor interest towards PPL, given its deeply discounted valuations compared to OGDC.

KATS Code:
PPL

Bloomberg Code:
PPL PA

Reuters Code:
PPL.KA

Market Price:
Rs203.47

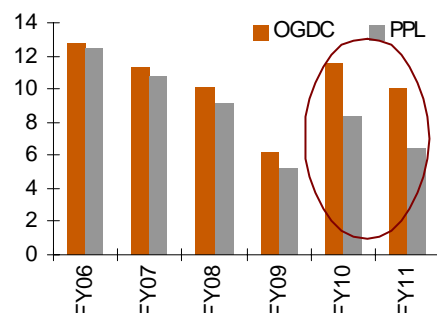
Market Cap:
Rs202.6bn
US\$2.4bn

1-yr Avg. Daily Volume:
1.9mn shares
Rs369.9mn
US\$4.3mn

1-yr High/Low:
Rs235.31/164.19

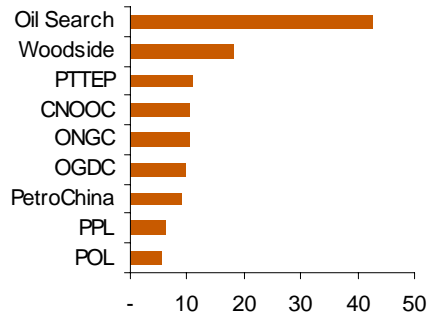
Estimated free float:
206.2mn shares (20.7%)

OGDC & PPL PE multiples (x)



Source: JS Research

Regional PE (x)



Source: JS Research & Bloomberg

Exploration efforts yielding consistent returns

Apart from new hydrocarbon flows from Manzalai that commenced in 1HFY10, new production flows from Mamikhel and Maramzai are also expected to initiate during 1HFY11. We expect combined production flows from the two fields to stand around 4,300bpd of oil and 85mmcf of gas. Based on our estimates, this would improve PPL's annualized earnings by Rs2.4 per share. Production flows from Latif and Gambat have already lifted PPL's production by around 15mmcf of gas (stake adjusted). Moreover, the company management expects to achieve production flows of around 1,200bpd oil and 15mmcf of gas from Hala in FY11. Going forward, we foresee further production flows once the Qadirpur compression project is completed (expected Sep 2010) and new gas flow from recent discovery of Latif North begins. As per initial tests, gas flow from the said field stood at 44.7mmcf.

Key statistics

	FY10	FY11	FY12
EPS (Rs)	24.6	32.1	36.0
Div. yield (%)	6.4%	10.3%	12.3%
PE (x)	8.3	6.4	5.7
PBV (x)	2.3	2.0	1.8

Source: JS Research

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Estimated Project Completion Periods & Production Enhancement

Development Projects	Operator	PPL's Stake	Expected Completion	Expected rise in production
Mamikhel	MOL	28%	2QFY11	2,880bpd and 46mmcf
Maramzai	MOL	28%	2QFY11	1450bpd and 40mmcf
Mela	OGDC	26%	1QFY11	2,000 bpd
Qadirpur	OGDC	7%	1QFY11	150mmcf
Latif North	PPL	33%	3QFY11	45mmcf

Source: JS Research, PPL

Wellhead gas prices set to rise further

Post a strong recovery in 1HFY10, we now expect another round of upward revision in gas wellhead prices due to 9% rise in crude oil and furnace oil prices during the benchmark period. With a contribution of over 70% in PPL's production, wellhead prices of Sui and Kandhkot fields are expected to rise by 6%HoH, improving PPL's earnings by ~Rs1.2 per share on annualized basis. Further, the wellhead price of Sawan (3rd biggest contributor to PPL's gas production) is also likely to rise by 4% in the upcoming revision.

Expected Revision In Gas Well Head Prices (US\$ per mmbtu)

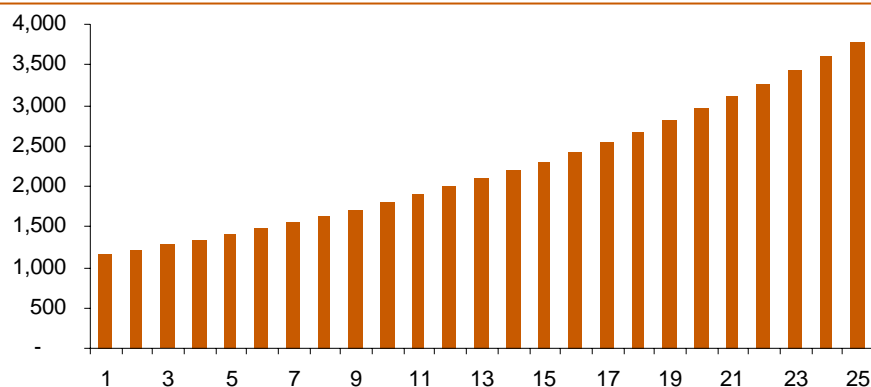
Field	PPL Stake	Unit	1HFY10A	2HFY10A	1HFY11E	Δ%
Adhi	39%	Rs/mmbtu	119.65	124.03	126.90	2%
Sui	100%	Rs/mmbtu	115.74	143.87	151.80	6%
Kandhkot	100%	Rs/mmbtu	115.74	143.87	151.80	6%
Qadirpur	7%	Rs/mmbtu	161.00	227.68	232.92	2%
Miano	15%	US\$/mmbtu	2.93	3.50	3.64	4%
Sawan	26%	US\$/mmbtu	2.93	3.50	3.64	4%
Manzalai	28%	US\$/mmbtu	2.73	2.73	2.73	0%
Makori	28%	US\$/mmbtu	2.73	2.73	2.73	0%
Mela	26%	US\$/mmbtu	2.66	2.66	2.66	0%

Source: OGRA, JS Research

Diversifying into the power sector

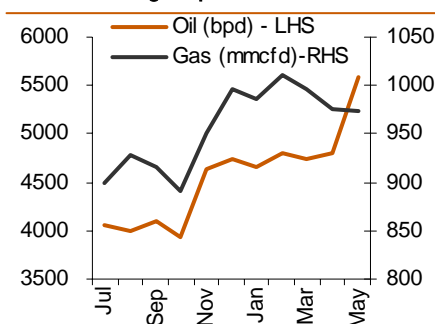
Apart from its core exploration business, PPL has plans to diversify into the power sector for which the company has already submitted an EOI (Expression of Interest) to the PPIB for setting up a 225MW Thermal Power Plant. The development is in initial stages and we believe the company may not proceed on this front till the circular debt issue is resolved in order to avoid any potential cash flow constraints while progressing on the project.

Project Estimated Cash Flows (Rs mn)



Source: JS Research

PPL's oil & gas production in FY10



Source: JS Research & PPIS

However, a critical analysis of the company's balance sheet reveals that PPL has sufficient cash to fund the expected equity injection of ~US\$86mn (assuming 30% equity stake) in the project. If this materializes, we expect a temporary dividend reduction and decline in other income of the company. In our opinion the incremental cash flows from the new power project would more than offset any negative impact on PPL's valuation.

Exploring the international front

As part of its strategy to expand its activities outside Pakistan, PPL has been actively pursuing opportunities across the globe to form joint ventures with global exploration giants namely OMV and MOL. At present, the company is at different stages of evaluating and bidding for exploration blocks in Yemen, Iran, Senegal, Algeria, Iraq, Indonesia, Armenia and Vietnam.

Investment Perspective

Given the higher certainty of development plans, improving production profile and recovery in hydrocarbon prices, we foresee PPL to depict a strong earning recovery, going forward. With 31% earnings growth likely in FY11, PPL is currently trading at an FY11F PE and dividend yield of 6.4x and 10.3%, respectively offering 18% upside to our target price of Rs240.

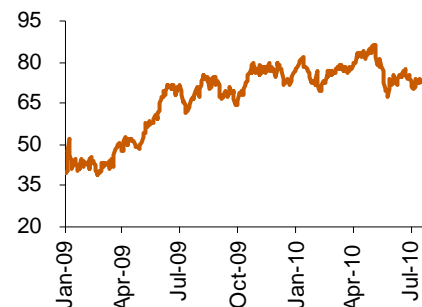
The stock is at a deep 57% discount in terms of PE multiple (historical average discount of 28%) not just only to its regional peers, but is also trading at a steep discount of 36% to its local peer (OGDC) signifying a massive room for price performance in the coming months.

Key risks to our thesis

Volatility in oil prices: Post the emergence of Euro debt crisis, international oil prices have remained volatile moving in a wide range of US\$67 to US\$86 per barrel during last 3 months. Though, our Arab Light price estimate for FY11F and FY12F currently stand at US\$76 and US\$77 per barrel, respectively, any significant change in the crude oil price movement could compel us to revise our forecasts. As per our analysis, a US\$1 per barrel change in oil price forecast would impact PPL's earnings estimate by 0.2% versus 0.5% for the E&P sector.

Circular Debt: With the accumulation of inter corporate debt in the country there are concerns regarding the liquidity situation and payouts from energy companies including the E&Ps. We believe, with the persistent rise in power and gas tariffs, removal of subsidies under the guidelines of the IMF program and lending for budgetary support from IMF, the government is in a relatively better position to resolve the issue. Hence, we could see some improvement in the liquidity situation of energy companies going forward. This should mitigate the risk of dwindling dividend payouts to the investors.

Arab light price (US\$/barrel)



Source: Reuters

Pakistan Petroleum – Financial Highlights

Year ended June (Rs mn)	FY08A	FY09A	FY010E	FY011F	FY012F
Balance sheet					
Share Capital & Reserve	43,654	63,058	88,495	99,668	110,432
Long Term Liabilities	3,790	5,183	5,447	6,534	7,621
Current Liabilities	13,579	14,674	21,218	21,681	23,022
Total Liabilities & Equity	61,023	82,915	115,159	127,882	141,076
Fixed Assets	21,368	34,971	43,419	53,680	63,968
Other Long Term Assets	1,793	2,507	2,661	2,661	2,661
Current Assets	37,862	45,438	69,079	71,541	74,446
Total Assets	61,023	82,915	115,159	127,882	141,076
Profit & Loss Statement					
Net Sales	45,717	61,580	59,838	76,562	86,640
Operating Expenses	6,144	6,791	9,663	11,454	13,211
Royalty	5,516	7,463	7,017	8,910	9,937
Ammortization of EDE	670	836	1,093	1,487	1,908
Exploration cost w ritten off	3,880	5,535	6,075	6,683	7,151
Operating Profit	29,506	40,955	35,990	48,029	54,434
Profit before Taxes	30,447	41,908	36,501	47,646	53,556
Profit After Taxes	19,707	27,702	24,456	31,923	35,883
Ratios					
Profitability					
Operating Margin	65%	67%	60%	63%	63%
EBITDA Margin	71%	73%	71%	73%	72%
Pre-tax margins	67%	68%	61%	62%	62%
Net profit margin	43%	45%	41%	42%	41%
Return on Equity	45%	44%	28%	32%	32%
Return on Assets	32%	33%	21%	25%	25%
Valuation					
Earning per share (Rs)	19.8	27.8	24.6	32.1	36.0
Price to earning ratio (x)	9.2	5.3	8.3	6.4	5.7
Dividend yield (%)	7.1%	7.3%	6.4%	10.3%	12.3%
Price to book value (x)	4.1	2.3	2.3	2.0	1.8

Source: JS Research & Company accounts

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