

Table: Upcoming Power Plants

RPPs	Location	MW	COD
Karkey Power	Karachi	249	Nov-09
Walter Power	Karachi	230	Dec-09
Reshma Power	Lahore	220	Dec-09
Ruba Energy	Lahore	170	Dec-09
Premier Energy	Lahore	64	Jan-10
Gulf	Gujranwala	81	Feb-10
Ind. Power	Faisalabad	221	Feb-10
Sialkot Power	Sialkot	85	Feb-10
Tapal Power	Gujranwala	74	Feb-10

IPPs (Oil)

Atlas Power	Shiekhpura	225	Jul-09
Nishat power	Lahore	200	Sep-09
Hubco	Narowal	200	Mar-10
Nishat Chunian	Lahore	200	Mar-10
Liberty Power	Faisalabad	200	Dec-10
Reshma Power	Gujranwala	172	Mar-10
Gulistan	Gujranwala	200	Jun-11
Leading Power	Faisalabad	200	Dec-11
Engro Power	Bhikki	627	Mar-12
Saba Power	Jhang	171	Mar-12
Shahpur Power	Sargodha	150	Dec-12

IPPs (Dual-Fuel)

Orient Power	Balloki	229	Jul-09
Sapphire Power	Muridke	225	Oct-09
Saif Power	Sahiwal	231	Dec-09
Halmore Power	Bhikki	225	Oct-10

Source: PPIB

FO demand to increase by 5-6mn tons in 4 years

Currently, the country generates 32% of electricity through furnace oil and 34% from gas. During the last 4-years, FO demand grew by an average of 15% annually due to higher consumption from thermal power plants. We expect 13% annualized FO sales growth during next 5 years following the commissioning of power plants. During next 2 years, we expect oil contribution in overall electricity generation to reach at 48%.

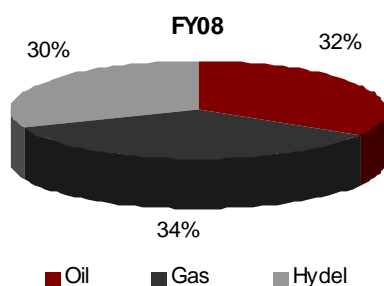
- 2250MW Rental power plants (RPPs):** To meet power crisis in the short term, government has approved 2250MW rental power plants which require additional 5-7k tons per day (1.8-2.6mntons per annum) of FO versus existing demand of 22k tons per day (8.0mn tons per annum). These power plants are expected to come online in the next 3-8 months. Though details of these power plants have not yet been released, names of few rental power plants are available on PPIB's website. PSO, the major FO supplier is expected to capitalize this opportunity since it has a vast storage and infrastructure backup. We might see news flows related to the long-term fuel supply agreements within next few months.
- 3400MW new IPPs:** Apart from rental power plants, the government has planned to bring 910MW dual fired (oil + gas) IPPs and 2545MW of oil based IPPs during next 2-22 months According to our discussion with PPIB (Private Power Infrastructure Board), Orient Power (229MW), Sapphire Power project (225MW), Saif Power (231MW) and Halmore Power (225MW) would come online within next 3-months.

Out of 2500MW oil based IPPs, Atlas power plant (225MW) is already commissioned (PSO is the fuel supplier) while Nishat power plant is expected to come online in the next few days (Shell is the fuel supplier). Nishat Chunian (200MW), Hubco Narowal project (220MW) are the other few projects which are expected to startup in the next 2-6 months.

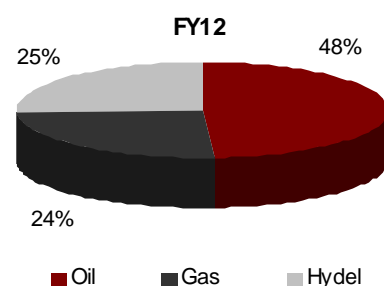
- Demand from existing power plants** To improve electricity generation through existing power plants, a Committee was constituted on July 21 2009 which instructed PSO to supply 35k tons of FO to Wapda generation companies and IPPs. In FY09, FO sales stood at 8mn tons (22k tons per day). We believe following factors will drive demand from existing power plants.

Due to disagreement amongst provinces, there is a low probability of a new dam in near future. Hydel energy is available from Mangla (1000MW), Tarbela (3478MW), Ghazi Barotha dam (1450MW) and other various smaller dams. Hydel generation contributes 30% in electricity generation.

Gas availability for power generation is diminishing. During the last 4 years, gas supply to thermal power plants declined by an average 3% annually. This trend is likely to continue due to the lack of major gas discoveries. Currently, gas contributes 34% of country's total electricity generation.

Graph: Power Generation Mix

Source: Energy Year book 2008

Graph: Power Generation Mix

Source: JS Research

PSO: Well positioned to meet additional demand

Since the entire additional demand of 5-6mn tons will be met through imports (due to refinery constraints), PSO will remain the major beneficiary as it 1) handles more than 90% of the country's oil products imports 2) has vast storage network and 3) has largest distribution network. PSO accounts for 86% market share in FO business and carries the following strengths;

- Handles more than 90% of the country's oil import. During FY09, total FO imports stood at 5mn tons. Thus, PSO's share would be in the range of 4.2-4.5mn tons.
- Vast storage network. PSO has capacity of storing 546ktons of FO, enough for 18-20 days.
- Capability to move 13mn tons of FO per annum (enough for next 4-5 years) due to its large distribution network. It can supply 35000 tons per day of FO based on 25 working days. However, according to the management, the company could even supply up to 39k tons per day.

Thus, given its capacity edge over other OMCs, we might expect bulk supply agreements with these power plants in the coming months.

Sales revenue to reach Rs1 trillion

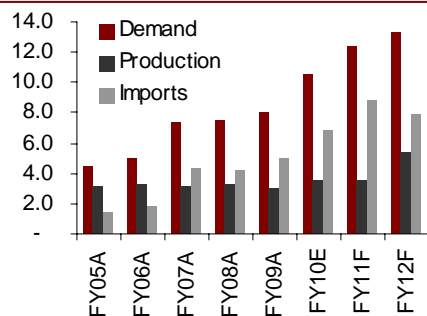
We expect PSO's gross sales to reach ~Rs1trillion mark by FY12, compared to Rs719bn in FY09 (FO contribution in revenue would be 53% against current share of 38%). Thus, we expect FO sales revenue to reach at Rs530bn in FY12 almost double than FY09 estimate of 270-300bn. This is based on 1) 11mn tons of volumetric sales projection in FY12 and 2) oil price assumption of US\$80 per barrel for FY12 which is inline with Reuters oil poll estimates.

Presently PSO, as per the GOP's approved formula (which was effective prior to deregulation of FO business), is charging 3.5% gross margin on FO cost. Thus, we expect the incremental FO demand to jack up annualized earnings by Rs28-30/share in FY12, provided that the entire circular debt is resolved and the company gets timely payments from thermal power plants.

Circular debt resolution to boost EPS by Rs16-18

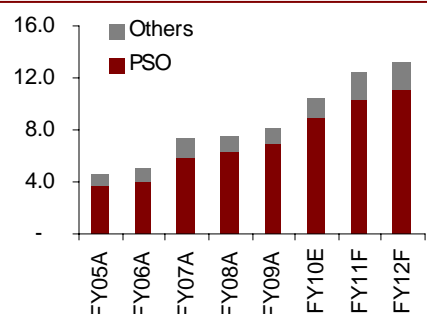
PSO's financial charges during FY09 increased by 6 fold to Rs6.2bn mainly due to heavy bank borrowing to address liquidity crunch resulting from circular debt. The government has already assured that the circular debt would be resolved in few days. GoP and the major stake holders are already on board to finalize the TFCs worth Rs90-100n. According to our calculation, if this issue is resolved, company's annualized earnings would improve by Rs16-18 per share. This would be a major trigger for PSO.

Graph: FO Demand (mn tons)



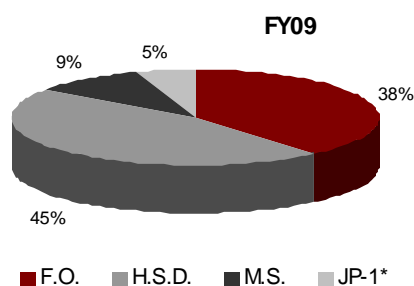
Source: OCAC, JS Research

Graph: PSO's FO sales (mn tons)



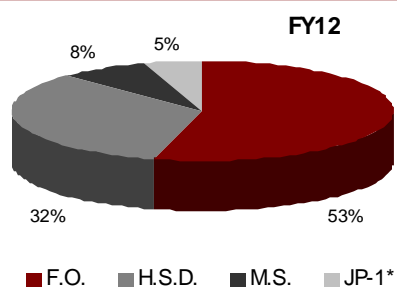
Source: OCAC, JS Research

Graph: Sales Revenue breakup



Source: JS Research

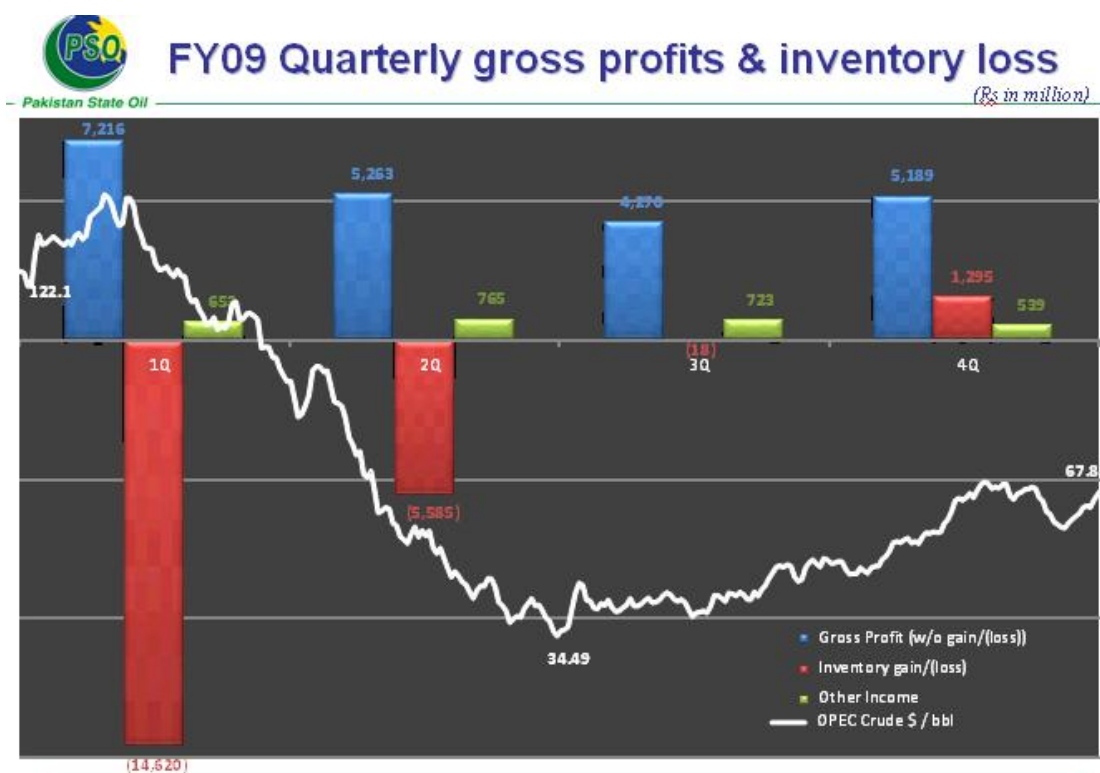
Graph: Sales Revenue breakup



Source: JS Research

Risks

Oil price - a major risk: OMCs incur inventory gains/losses when oil prices increase or decrease. Given the fact that PSO has the largest storage network, the fluctuation in oil prices has a major impact on the company's profitability. In FY09, we saw sharp fluctuation in international oil prices which touched the highest level of US\$147 per barrel and lowest level of US\$33 per barrel. As a result, the company registered Rs18.9bn loss (per share impact of Rs71.6) on account of inventory losses in FY09 (see graph).



Source: PSO

We do not expect a sharp decline in oil prices as prices are currently hovering in the band of US\$68-75 per barrel. Our oil price projection for FY10 is US\$60 per barrel followed by US\$70 per barrel in FY11 and US\$80 in FY12 and onwards. Thus, we expect the inventory losses in FY10 would amount to Rs2.5bn (per share impact of Rs10) where as we expect inventory gains of Rs2.7bn each in FY11 and FY12. In worst case (assuming oil prices of US\$45 per barrel during next 5 years), our target price for PSO would be Rs320.

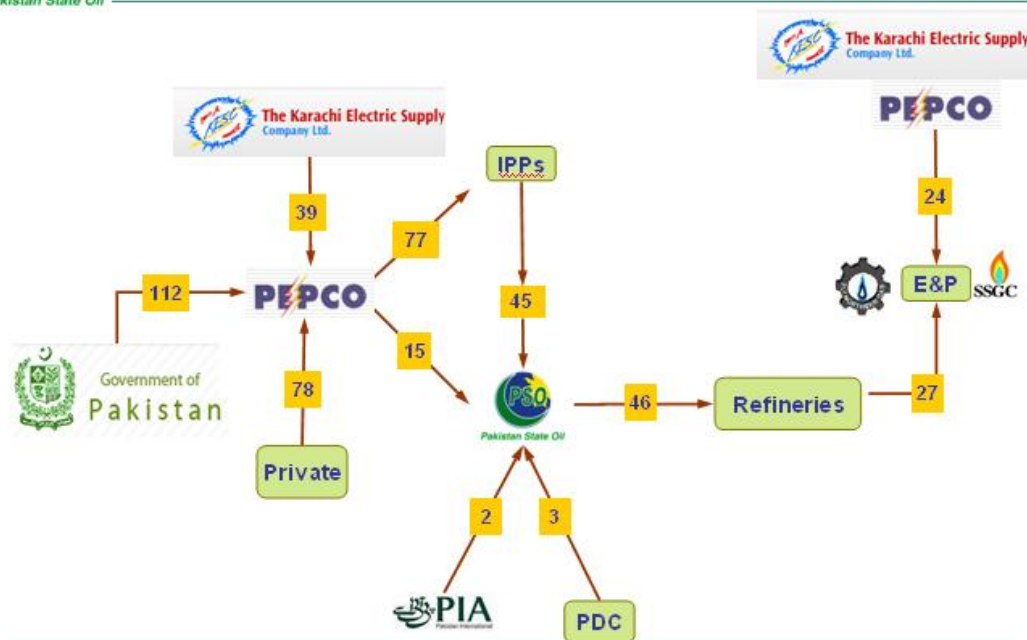
Circular debt: The resolution of circular debt is very important in the sense that the fate of upcoming power plants is attached to this issue. According to our estimates, if oil prices remain at current levels, Rs175-200bn would be required to purchase additional 5-6mn tons of FO. Thus, the prevailing Rs100-110bn circular debt needs to be resolved so that the OMCs have enough liquidity to meet the additional requirement. We expect this issue to be resolved in next few days as the govt. is in final stages to float second tranche of TFCs worth Rs90-100bn.

Due to this circular debt problem, company relied heavily on short-term borrowing which resulted in higher financial charges. Currently the process is under way to increase gross margins on FO from 3.5% to 5%.



— Pakistan State Oil —

Circular Debt: August 5, 2009 Rs 'billion



Source: PSO

According to the company, out of 3.5% gross margin, 1.9% is used for 45 days financing. Moreover, the company is required to keep 30 days inventory because of the import process. This again requires net financing cost for maintaining inventory which is 0.5%. Hence, out of 3.5% gross margins, company ends up spending 2.4% of its margins on arranging the supplies. Out of the remaining 1.1%, PSO has to bear the operation, administration and marketing costs. If payments are delayed beyond the credit period, then it is a loss proposition to carry FO business, which is the reason that dissuades the multinationals as well as other OMCs from doing FO business. We believe, if the circular debt persists in the longer term, the government could raise FO margins to 5%.

Timely payments: Even if the entire circular debt is resolved, there is a risk of smooth payments by Wapda to its supplier. However, we believe once the government eliminates power subsidies and bring additional power plants, we might see sequential power tariff rate hikes going forward. This will ensure timely payment by power plants to PSO.

Port constraints: FO is imported only at FOTO jetty at Port Qasim due to infrastructure built and GOP guarantee. Besides FO, diesel (HSD) and crude oil are also imported at the same jetty. According to the company's plan, higher demand needs at least 11-14 cargoes of 65,000 tons each per month during next 3 years. Currently, the jetty is handling 19 cargoes (10 FO cargoes, 7 diesel and 2 crude oil) against maximum cargo handling capacity of 15 vessels per month. Thus higher cargo handling will result in port congestion and increase chances of supplies disruption. Since Karachi Port is underutilized, it has been conceived that Karachi Port & Port Qasim should be connected through pipeline to divert HSD vessels from Port Qasim to Karachi Port. This will make room for accommodating desired FO cargoes at FOTCO. The project cost is Rs4bn.

Given the risk return profile of PSO, we believe the stock is available at cheap price in the JS Universe.

Pakistan State Oil

(Rs mn)	FY08A	FY09A/E	FY10E	FY11F	FY12F	FY13F
Balance Sheet						
Paid up capital	1,715	1,715	1,715	1,715	1,715	1,715
Shareholders' equity	30,965	23,409	26,725	33,994	43,299	52,668
Current Liabilities	93,736	111,901	67,269	71,777	78,729	81,592
Total Liabilities & equity	127,110	137,815	96,599	108,480	124,846	137,191
Total Current Assets	115,879	120,720	78,203	88,595	103,260	113,661
Total assets	127,110	137,815	96,599	108,480	124,846	137,191
Income statement						
Gross sales	583,214	719,282	726,195	859,515	958,950	998,029
Net Sales	495,279	612,696	612,540	723,777	806,474	839,256
Gross profit	30,024	3,010	20,521	29,731	33,563	33,824
EBITDA	23,864	(3,891)	16,443	25,251	29,078	29,520
Financial Charges	1,368	6,232	2,325	1,350	1,300	1,300
PAT	14,054	(6,698)	8,289	14,539	16,918	17,035
Ratio Analysis						
Momentum						
Sales growth	41.6%	23.7%	0.0%	18.2%	11.4%	4.1%
Net profit growth	199.8%	NM	NM	75.4%	16.4%	0.7%
Profitability						
EBITDA margin	4.8%	NM	2.7%	3.5%	3.6%	3.5%
Net margin	2.8%	NM	1.4%	2.0%	2.1%	2.0%
Return on assets	11.1%	NM	8.6%	13.4%	13.6%	12.4%
Return on equity	45.4%	NM	31.0%	42.8%	39.1%	32.3%
Valuation						
Earning per share	81.9	(39.1)	48.3	84.8	98.6	99.3
Dividend per share	23.5	5.0	29.0	42.4	44.4	44.7
Book value per share	180.5	136.5	155.8	198.2	252.4	307.1
Price to earning ratio (x)	5.2	NM	5.9	3.4	2.9	2.9
Dividend yield	5.5%	2.2%	10.2%	14.9%	15.6%	15.7%
Price to book value (x)	2.4	1.7	1.8	1.4	1.1	0.9
EV/EBITDA (x)	3.4	NM	3.6	2.2	1.8	1.6

Source: Company Accounts, JS Research

About the Company

PSO is the market leader in Pakistan's energy sector. The company has the largest network of retail outlets to serve the automotive sector and is the major fuel supplier to aviation, railways, power projects, armed forces and agriculture sector.

Pakistan State Oil, the largest oil marketing company in the country, is currently engaged in storage, distribution and marketing of various POL products. The company has 86% market share in the black oil products and 59% share in the white oil products.

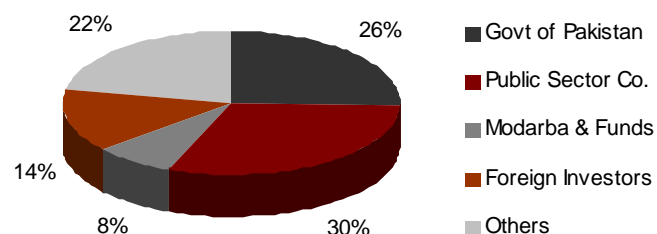
PSO has the widest strategic oil distribution network. This network comprises of 29 storage depots and 9 installations, 860,000 MTs of capacity i.e. almost 81% of the total national storage, numerous pipe lines network and equity partnership in White Oil Pipeline Project (WOPP) from Karachi to Mehmood Kot.

With its 3612 distribution outlets, PSO has the largest network in the country. Out of these, 1,610 outlets have been upgraded as per the New Vision Retail Program, with most modern facilities like electronic dispensing units, convenience stores, business centers, easy payment centers and customer friendly staff to provide unmatched and diverse services to its customers, all of which are comparable to international practices. PSO has 240+ CNG stations operational in more than 30 cities and was the first company to commission a CNG retail outlet in Jan 1996.

The company has a vast retail customer base (~2.8mn). Moreover, the company has also been meeting the fuel needs of various government entities, armed forces, railways, agriculture sector, IPPs and industrial units. PSO also provides Jet Fuel to refueling facilities at 9 airports in Pakistan and ship fuel at 3 ports.

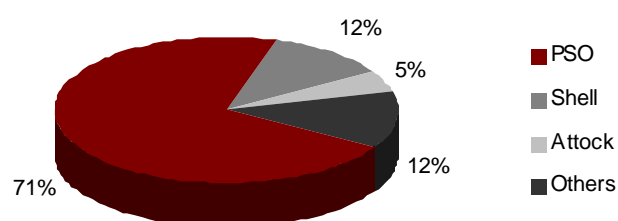
PSO is also playing its due role in meeting the energy demand of the country. In this regard, agreements have been signed for the supply of fuel with Atlas Power Limited (213 MW), Kot Addu Power Company (400 MW expansion project) and Halmore Power company (209MW).

Graph: Share holding pattern



Source: Company accounts, As of June 2008

Graph: OMCs market share FY09



Source: OCAC

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