Pakistan Petroleum Limited

Attractive on all counts

Company Update: BUY

Target Price: Rs236

Oil & Gas Producers

January 2010

JS Global Capital Limited

We rate Pakistan Petroleum Limited (PPL) as our top pick in the E&P sector on the back of stock's compelling valuations, mainly driven by new production flows from Tal, Hala, Latif and Nashpa fields. Recovery in hydro carbon prices and steep Rupee depreciation further improves E&P sectors outlook. In addition, company's balanced exploration strategy and its focus on local and international JVs offer the potential of new hydrocarbon discoveries and reserves addition going forward.

Valuation: offers an upside of 19%

Based on our reserve based fair value of Rs236 per share, PPL is set to offer 19% potential upside from the current market price. In addition, the stock also offers one of the most attractive dividend yields (FY10E 7.6%) not only amongst our JS Universe companies but also compared to its regional peers.

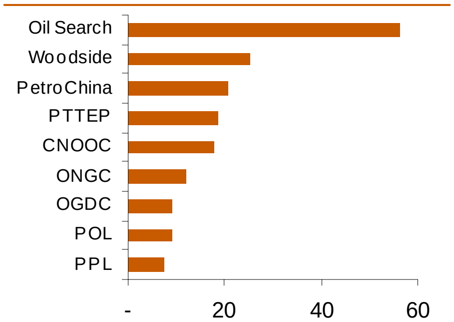
Table: PPL valuation breakup (Rupees per share)

Developed assets	202
Developing assets	20
Exploration potential	14

Source: JS Research

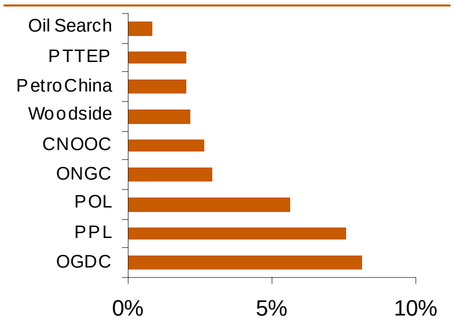
Our price target primarily comprises of valuation based on 2P reserves along with the value of exploration potential, assigned in the light of company's exploration plan. The valuation assumes PPL's 2P reserves of 926mn BOE with reserve life estimated at around 16 years. Moreover, our Arab Light oil price average for FY10, FY11 and FY12 stand at US$73, US$76 and US$77 per barrel respectively with long term oil price assumption of US$70 per barrel.

Graph: PE (x)



Source: JS Research, Reuters

Graph: Dividend yield (%)



Source: JS Research, Reuters

Production flows already materializing

Commencement of hydrocarbon production from discoveries including Latif and Gambat has already started to contribute around 50mmcfd of gas. Apart from this, oil and gas production from Adam-X well in Hala is expected to begin during 3QFY10; the initial flows are likely to remain in the vicinity of 1,200bpd oil and 15mmcfd gas. Additional 150mmcfd gas flow is likely to commence by June 2010, once the installation of interim gas compression plants at Qadirpur is accomplished.

KATS Code:
PPL

Bloomberg Code:
PPL PA

Reuters Code:
PPL.KA

Market Price:
Rs197.83

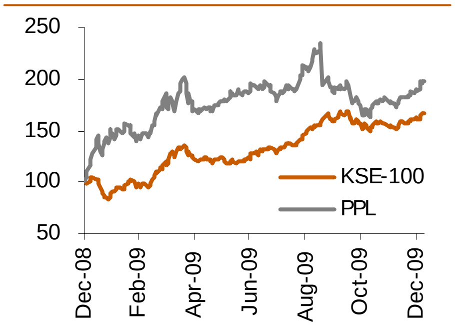
Market Cap:
Rs197.0bn
US$2.3bn

1-yr Avg. Daily Volume:
2.8mn shares
Rs524mn
US$6.2mn

1-yr High/Low:
Rs235.31/126.00

Estimated free float:
206mn shares (20.7%)

Graph: PPL vs KSE-100 Index



Source: JS Research

Umer Bin Ayaz
umer.ayaz@js.com
Senior Analyst
92 (21) 111-574-111
(ext. 3103)

More importantly, commercial production from Manzalai compression facility also began last November and has now reached the level of around 3,800bpd of oil and 208mmcfd of gas with an annualized earnings impact of Rs3.9 per share on PPL to be completely visible in FY11. Further, initial production flows from Mamikhel and Maramzai are also likely to start by April and June 2010, respectively. Moving ahead, commercial development of the two fields would be another earning trigger for PPL and other participants.

Table: Estimated Project Completion Periods & Production Enhancement

Development Projects	Operator	PPL's Stake	Expected Completion	Expected rise in production
Mamikhel	MOL	28%	3QFY10	2,880bpd and 46mmcfd
Maramzai	MOL	28%	4QFY10	1450bpd and 40mmcfd
Mela	OGDC	26%	3QFY10	2,000 bpd
Qadirpur	OGDC	7%	4QFY10	150mmcfd
Kandhkot	PPL	100%	3QFY10	30mmcfd

Source: JS Research, PPL

Wellhead prices set to rebound

After touching a trough of US$32.7 per barrel in December 2008, Arab Light crude price witnessed a rebound and are currently hovering in the range of US$81 per barrel. This recovery not only led to higher oil revenues for the E&Ps but on the back of this, wellhead gas prices are also set to rebound in the upcoming wellhead price revision likely in the end of Jan 2010. Due to limited share of oil sales in PPL's revenue pie (16%), the company remained the least beneficiary of soaring oil prices, however, we view PPL as the key beneficiary of the upcoming wellhead price revision as wellhead prices of Sui and Kandhkot (contributing 75% to PPL's gas production) would witness an increase of 23%.

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

Field	PPL Stake	Unit	1HFY10	2HFY10E	Δ%
Adhi	39%	Rs/mmbtu	119.7	123.1	3%
Sui	100%	Rs/mmbtu	115.7	142.6	23%
Kandhkot	100%	Rs/mmbtu	115.7	142.6	23%
Qadirpur	7%	Rs/mmbtu	161.0	161.0	0%
Miano	15%	US$/mmbtu	2.9	3.5	20%
Sawan	26%	US$/mmbtu	2.9	3.5	20%
Manzala-Tal	28%	US$/mmbtu	2.7	2.7	0%
Makori-Tal	28%	US$/mmbtu	2.7	2.7	0%
Mela	26%	US$/mmbtu	2.7	2.7	0%

Source: OGRA, JS Research

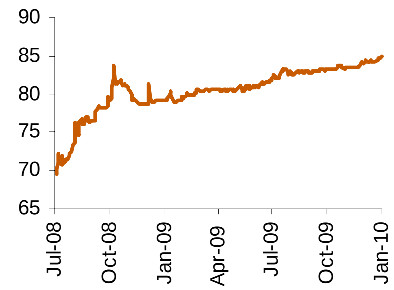
Gas yields to improve with new production coming in

With production commencements from the newer discoveries and a natural decline in production from Sui, PPL's average gas price for the company is set to improve. Currently around 75% of PPL's gas production is contributed by Sui and Kandhkot, the wellhead price of the two fields has remained in the range of US$1.4 to US$1.6 per mmbtu compared to wellhead price of around US$2.7 per mmbtu for newer discoveries under 2001 policy. With consistent improvement expected in new production flows, we believe the average gas yield for the company would improve going forward.

Dollar based returns offering hedge against currency depreciation

Pricing of crude oil produced in Pakistan is pegged with Arab Light crude prices quoted in US dollar terms. Similarly, gas wellhead prices of discoveries post 1994 are also linked with Arab Light crude price, whereas for older fields, gas prices are linked to International HSFO prices also quoted in US dollar terms. With the rising pressure on Pak Rupee against all major currencies (Rupee already depreciated by 3.6% since July 2009) the E&P sector stands as prime beneficiary of this depreciation as the sector earnings would improve by around 0.4% for every 1 Rupee rise in US$ value.

Graph: Rupee/US$ parity



Source: JS Research, SBP

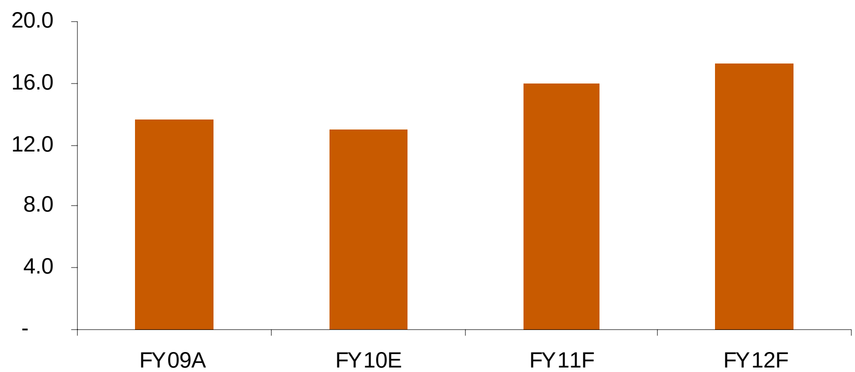
Exploring the international front

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

Gearing up the Capex

FY09 witnessed a significant jump of around 100% in PPL's Capex, primarily on the back of development projects mainly at Manzalai and Kandhkot fields. Though the management has hinted at accelerating its Capex going forward, we expect the expenditure in FY10 would stand in the vicinity of Rs13bn, witnessing a consistent rise in future.

Graph: Capex (Rs bn)



Source: JS Research & Company accounts

Key risks to our thesis

Volatility in oil prices: With rising volatility in the international oil prices, Arab Light crude prices so far in FY10 has hovered in the range of US$61.7 – US$81.6 averaging at US$72.9 per barrel. Though, our Arab Light price estimate for FY10E, FY11F, FY12F currently stands at US$73, US$76 and US$77 per barrel, respectively, any significant change in the crude 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.

Graph: Arab light price

Source: Reuters

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 guide lines of 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 by the end of FY10. This should mitigate the risk of dwindling dividends payouts.

Based on FY10E Capex of Rs13bn and no significant accumulation of circular debt, the company would manage to generate FCFE worth Rs20 per share. In addition, the company has cash and short term investments worth Rs18.9bn (Rs19 per share) on its balance sheet offering the room to support any shortfall in dividend payments arising on the back of any potential delay in resolution of circular debt.

Table: FCFE projections

	FY08A	FY09A	FY10E	FY11F	FY12F
Profit after tax	19,707	27,702	24,433	32,482	34,281
Non Cash Expense	2,114	3,355	4,969	6,176	7,448
	21,822	31,057	29,402	38,657	41,729
Working Capital	594	(13,778)	3,676	5,910	(731)
	22,416	17,279	33,078	44,568	40,998
Capital Expenditure	(5,991)	(13,603)	(13,016)	(16,027)	(17,332)
	16,425	3,677	20,062	28,540	23,666
Financing	(1)	-	-	-	-
FCFE	16,426	3,677	20,062	25,046	27,374
FCFE/Share	21.8	3.7	20.1	25.2	27.5

Source: JS Research

Pakistan Petroleum Limited – Financial Highlights

Year ended June (Rs mn)	FY08A	FY09A	FY010E	FY011F	FY012F
Balance sheet					
Share Capital & Reserve	43,654	63,058	87,263	98,631	108,916
Long Term Liabilities	3,790	5,183	5,447	6,534	7,621
Current Liabilities	13,579	14,674	16,207	17,828	19,076
Total Liabilities & Equity	**61,023**	**82,915**	**108,917**	**122,994**	**135,613**
Fixed Assets	21,368	34,971	43,018	52,870	62,753
Other Long Term Assets	1,793	2,507	2,507	2,507	2,507
Current Assets	37,862	45,438	63,393	67,617	70,353
Total Assets	**61,023**	**82,915**	**108,917**	**122,994**	**135,613**
Profit & Loss Statement					
Net Sales	45,717	61,580	61,988	79,630	86,286
Operating Expenses	6,144	6,791	9,854	11,534	13,307
Royalty	5,516	7,463	7,325	9,173	9,903
Ammortization of EDE	670	836	1,060	1,418	1,801
Exploration cost written off	3,880	5,535	6,509	7,160	7,661
Operating Profit	**29,506**	**40,955**	**37,239**	**50,345**	**53,613**
Profit before Taxes	30,447	41,908	36,831	48,963	51,675
Profit After Taxes	**19,707**	**27,702**	**24,433**	**32,482**	**34,281**
Ratios					
Profitability					
Operating Margin	65%	67%	60%	63%	62%
EBITDA Margin	71%	73%	66%	68%	67%
Pre-tax margins	67%	68%	59%	61%	60%
Net profit margin	43%	45%	39%	41%	40%
Return on Equity	45%	44%	28%	33%	31%
Return on Assets	32%	33%	22%	26%	25%
Valuation					
Earning per share (Rs)	19.8	27.8	24.5	32.6	34.4
Price to earning ratio (x)	9.2	5.3	8.1	6.1	5.7
Dividend yield (%)	7.1%	7.3%	7.6%	10.1%	11.1%
Price to book value (x)	4.1	2.3	2.3	2.0	1.8

Source: JS Research & Company accounts

Research Team

Muzzammil Aslam	Economy & Politcs	(92-21) 111574111 (ext. 3035)	muzzammil.aslam@js.com
Farhan Rizvi, CFA	Banks, Strategy & Insurance	(92-21) 111574111 (ext. 3096)	farhan.rizvi@js.com
Umer Bin Ayaz	E&P, Refinery & Power	(92-21) 111574111 (ext. 3103)	umer.ayaz@js.com
Syed Atif Zafar	OMCs, Cement, Autos & Chemicals	(92-21) 111574111 (ext. 3118)	atif.zafar@js.com
Mustufa Bilwani	Banks, Telecom & Paper&Board	(92-21) 111574111 (ext. 3100)	mustufa.bilwani@js.com
Bilal Qamar	Fertilizer & Textile	(92-21) 111574111 (ext. 3099)	bilal.qamar@js.com
Raheel Ashraf	Technical Analyst	(92-21) 111574111 (ext. 3098)	raheel.ashraf@js.com
Adeel Jafri	Database Manager	(92-21) 111574111 (ext. 3098)	adeel.jafri@js.com
Rabia Mansoor	Research Trainee	(92-21) 111574111 (ext. 3119)	rabia.tariq@js.com
Angela Yousuf	Research Trainee	(92-21) 111574111 (ext. 3097)	angela.memon@js.com
Sana Hanif	Research Trainee	(92-21) 111574111 (ext. 3102)	sana.hanif@js.com
Muhammad Furqan	Librarian	(92-21) 111574111 (ext. 3105)	muhammad.furqan@js.com

Equity Sales

Junaid Iqbal	(92-21) 32799511	junaid.iqbal@js.com
Atif Malik	(92-21) 32799513	atif.malik@js.com
Raza Abbas	(92-21) 32799563	raza.abbas@js.com
Faiza Naz	(92-21) 32799505	faiza.naz@js.com
Muzammil Mussani	(92-21) 32799508	muzammil.mussani@js.com
Sameer Danawala	(92-21) 32799569	sameer.danawala@js.com
Asim Ali	(92-21) 32799509	asim.ali@js.com
Samar Iqbal	(92-21) 32800152	samar.iqbal@js.com
Irfan Iqbal	(92-21) 32799502	irfan.iqbal@js.com
Ahmed Abdul Rauf	(92-21) 32799518	ahmed.rauf@js.com
Abdul Aziz	(92-21) 32799507	abdul.aziz@js.com
Irfan Ali	(92-21) 32462567	irfan.ali@js.com

Main Office

6th Floor, Faysal House,
Main Shahrah-e-Faisal
Karachi. Pakistan
Tele: 92-21-111-574-111
Fax: 92-21-32800163-66
Website: www.js.com

KSE Office

2nd Floor, Room No. 75,
Karachi Stock Exchange Building,
Stock Exchange Road, Karachi.
Tele: 92-21-32425692 (2427458)
Fax: 92-21-32418106

Lahore Office

307 – Upper Mall,
Lahore – 54000
Pakistan
Tele: 92-42-111-574-111
Fax: 92-42- 5789109

Islamabad Office

Chaudhary Plaza, 65 West,
Fazal-e-Haq Road, Blue Area
Islamabad, Pakistan.
Tele: 92-51-111-574-111
Fax: 92-51-2806328

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ANALYST CERTIFICATION

I, Umer Bin Ayaz, the author of this report, hereby certify that all of the views expressed in this research report accurately reflect my personal views about any and all of the subject issuer(s) or securities. I also certify that no part of my compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.