PPL

Offers an attractive valuation as the era of liquidity crunch to be over soon

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We initiate our coverage on Pakistan Petroleum Ltd (PPL) with a DCF based Jun-20 TP of Rs.201 which provides an upside potential of 29%. A dividend yield of 5%, if incorporated gives a total return of 34%

In spite of a challenging macroeconomic environment, the company managed to grow its revenues and earnings at a 2-year CAGR of 25% and 63% respectively

Going forward, the company expects its revenues and earnings to grow at a 4-year CAGR of 10% as the depreciation of exchange rate, increased exploration and development activities would further enhance the profitability of the company

Furthermore, debt free structure, stable outlook for crude oil prices and reduction in terrorism has made the valuation of the company much more attractive

Sector Overview

Pakistan had paid USD 4.3 billion for the crude oil imports and over USD 2 billion for gas (LNG) during 2018 as imported crude and refined petroleum products make 82-83 percent of Pakistan's consumption. As per a statement given by the officials of Petroleum Division in the Senate Committee; Pakistan's oil and gas reserves will finish after 10 to 13 years. Pakistan has 1,197 million barrel of oil reserves with the current speed of consumption. Out of this, 865 million barrels have been extracted while 332 million barrels remain as reserves. Out of the total 57 million cubic feet of gas discovered, 36 million has been extracted. The rest 21 million remains in the reserves that will be able to satisfy the demand for the next 13 years. The current demand for gas stands at 1,000 million cubic feet per day which are expected to go up to 3,600 by 2030. As for petroleum products, domestic production only meets 15 percent of the total demand. The country used 26.4 million tons of petroleum products in 2016-17 with 85 percent of it being imported. Pakistan has a total of 8.8 million gas consumers with an annual addition of 0.5 million consumers.

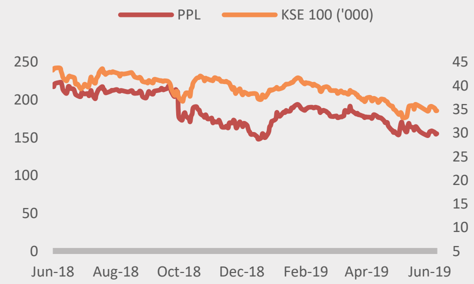
Natural gas plays a major role in the energy matrix of Pakistan. It accounts for almost 32 percent of the total primary energy supply mix in Pakistan and is 20th largest gas consumer of the word, with an established natural gas industry. Pakistan's gas consumption is nearly the same as in France, which is a developed and industrialized country. This shows how much gas Pakistan is misusing or wasting. There was a time when Pakistan was self-sufficient in gas. However, increased demand fostered by lack of alternative fuels and price subsidies coupled with diminishing production constrained by unattractive fiscal terms have resulted in systematic and power shortages.

Over the past half century, the petroleum industry has played a significant role in national development by making large indigenous gas discoveries. With looming energy crises and the ongoing growing demand for oil and gas in Pakistan, the exploration and production of oil & gas, or upstream has garnered considerable interest from investors (both local and foreign). Amid the improved security situation, Pakistan is now attracting the oil and gas exploration companies to invest in its oil and gas sector. A group of US-based oil and gas exploration companies have expressed their keen interest in investing in exploring hydrocarbon deposits in Pakistan in partnership with a state-owned domestic firm. Furthermore, a leading company of China has also expressed its readiness to invest in natural gas exploration and production sector of Pakistan.

Key Statistics

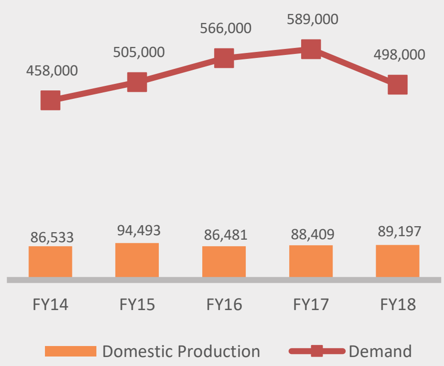
Symbol	PPL
TP - Jun 20	201.00
LDCP	155.57
Upside	29%
Free Float (Mn)	482
Market Cap. (Rs.mn)	352,677

Shareholders	Percentage
Government of Pakistan	68.00
PPL Employees Empowerment Trust	7.00
Private Investors	25.00
Total	100.00



Symbol	PE Ratio
MARI	7.37
OGDC	7.29
POL	8.39
Peer Average	**7.68**
PPL	**6.69**
Discount	**13%**

Pakistan Crude Oil Production vs Demand(bpd)



Sources: ACPL Research, Company Financials, PEB 2018, CEIC, PSX)

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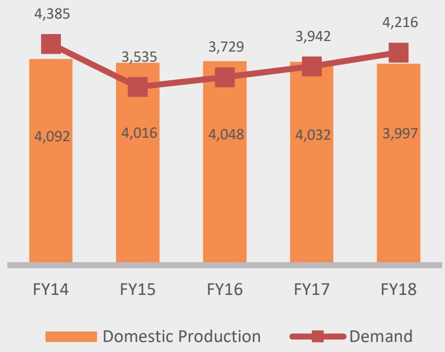
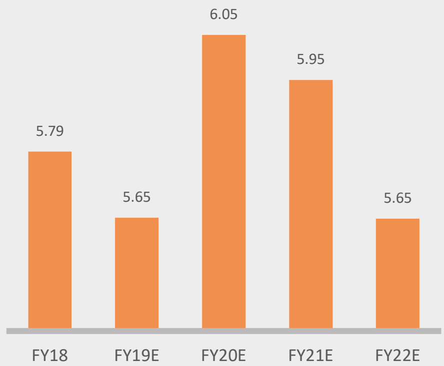
Key Statistics

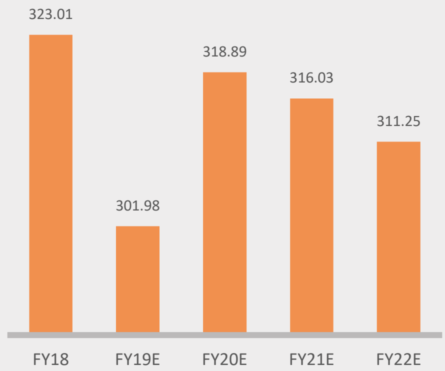
Pakistan Natural Gas Production vs Demand (mmscfd)



PPL Crude Oil Production (mn, bbl)



PPL Natural Gas Production (bcf)



Sources: ACPL Research, Company Financials, PEB 2018, CEIC, PSX)

Currently, around 17 local and foreign E&P companies are operating in Pakistan amongst which four companies are listed on Pakistan Stock Exchange. The Oil and Gas (O&G) sector operates under the Federal Ministry of Energy (Petroleum Division). Pakistan Petroleum Policy 2012 offers one of the best incentives for E&P companies. Government of Pakistan guarantees the purchase of whatever is produced by the O&G companies, at the well head. All proceeds to foreign companies are paid in USD. (Pakistan - Oil and Gas Equipment, 2018) (Oil & Gas Sector, 2017) (Mettis Global, 2019) (ProPakistani, 2019) (Pakistan Energy Book, 2018)

Company Overview

The pioneer of the natural gas industry in the country, Pakistan Petroleum Limited (PPL) has been a frontline player in the energy sector since the mid-1950s. As a major supplier of natural gas, PPL today contributes over 20 percent of the country's total natural gas supplies besides producing crude oil, Natural Gas Liquid and Liquefied Petroleum Gas. PPL has acquired 100 percent shareholding of MND E&P Limited, a company incorporated in England and Wales. The name of the subsidiary has been changed to PPL Europe E&P Limited.

The company has also established a wholly owned subsidiary, PPL Asia E&P B.V. with corporate seat in Amsterdam, Kingdom of Netherlands. The subsidiary will focus on exploration and production of oil and gas in the region. PPL has assigned its interest in Block 8, Iraq, under the Exploration, Development and Production Service Contract with Midland Oil Company, Iraq to PPL Asia E&P B.V. (Company Website, n.d.)

Operational Background & Challenges

PPL operates 10 producing fields across the country at Sui (Pakistan's largest gas field), Adhi, Kandhkot, Chachar, Mazarani, Adam, Adam West, Shadadpur, Shahdadpur West and Shahdadpur East holds working interest in 20 partner-operated producing fields, including Qadirpur the country's second largest gas field.

The average production declined slightly to 988 MMscfde in 2017-18 from 1,006 MMscfde in 2016-17 primarily due to natural decline in mature fields. The Company was able to minimize this decline through a year-on-year production increase from Gambat South, Adhi, Tal and Kirthar. In Gambat South, the overall production has increased from last year despite delay in commissioning of GPF-III. The production is expected to further increase after commissioning of GPF-III and GPF-IV. In its efforts to diversify its activities and to leverage existing portfolio, special focus was placed on the mining activities of Bolan Mining Enterprises (BME) which has achieved highest ever barytes sales of 206,921 metric tons during 2017-18.

The exploration activities resulted in a discovery in operated area in Adhi South X-1 in FY18. The company also produced for the first time from SUL west dome in Kandhkot, which has also increased the company's reserves base.

One of the biggest challenges being faced by the Company in line with the industry is the circular debt issue. As for now, the circular debt of the power sector stands at around Rs.1.6 trillion (All time high). According to the sources, the government is set to contain the power sector's circular debt to Rs.50-60 billion by July 2020. Therefore, we expect that the liquidity concerns of PPL would be resolved in the coming years.

8 New Discoveries in FY19

The company has made 8 new discoveries in FY19 namely Hub X-1, Yasar X-1, Badeel X-1, Talagang X-1, Hadaf X-1, Benari X-1, Mela-5 and Gulsher-1. According to our initial estimates, all of these discoveries cumulatively will enhance the annual gas and oil production of the company by around 13,243 MMSCF and 347,170 BBL respectively from FY20 onwards, which will have an impact of around Rs1.2/share.

Financial Performance

70% revenue of the company comes from the sale of natural gas, 25% comes from crude oil, 4% from LPG and 1% from barytes. The financial performance of oil and gas exploration companies in Pakistan are highly dependent on international crude oil prices. Therefore, the recovery in oil prices started from FY16 caused the company's revenue to grow at a 2-year CAGR of 25% to Rs126bn in FY18. Going forward, we expect the revenue to grow at a 4-year CAGR of 10% to Rs186bn by FY22 on account of stable oil prices in international market, devaluation of rupee and stable recoverable crude inventories held by the company. The calculation has been done by assuming the Arab Light crude oil price at $69 per barrel in FY19 and $60 per barrel in subsequent years.

The company posted the gross margin of 59% in FY18, higher than its 5-year average of 51%. Going forward, we expect the gross margin to remain stable at around 61% on account of reduced operating expenses.

Other income of the company constitutes around 7% of its revenue. The major portion of the other income comes from bank deposits and exchange gains. The company posted the other income of Rs9bn in FY18. Going forward, we expect the company to post other income of around Rs10bn in FY19 on account of higher interest rate and huge exchange gains.

The bottom line of the company has grown at a 2-year CAGR of 63% to Rs45bn in FY18. Currently, the net margin of the company stands at 36%. Going forward, we expect the bottom line to grow at a 4-year CAGR of 10% to Rs67bn by FY22. Whereas, the net margin is expected to remain at 38% during the same period.

Crude Oil Price Outlook

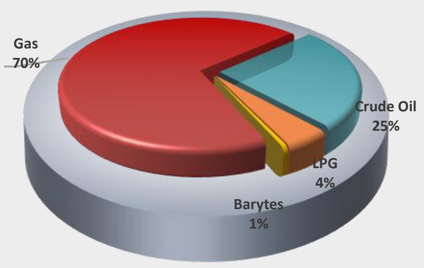
Oil price is under downward pressure on concerns that demand for it will suffer if economic growth slows as the US and China ramp up tariffs on each other's goods in a trade war that could hit worldwide economic growth. Furthermore, the IMF has also revised down its global growth outlook from 3.5% to 3.3% which will definitely hurt the crude oil demand as well.

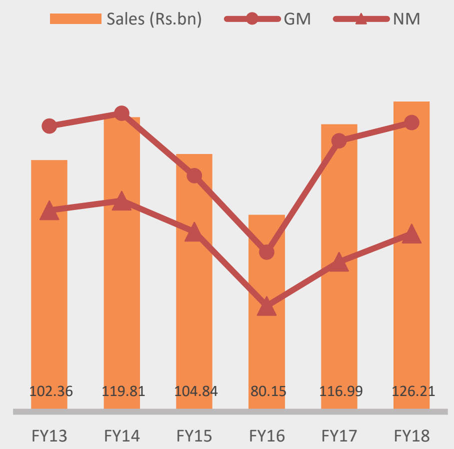
OPEC wants the crude oil prices to go higher as the economies of OPEC members are highly dependent on oil exports. For this purpose, the OPEC and its allies (Russia) decided to cut production by 1.2 million bpd in their meeting earlier in Dec-18. Sanctions on Venezuela and Iran also reduced the crude oil supply worldwide due to which a surge in oil prices was seen during last 3 to 4 months. On the other hand, USA wants the oil prices to remain lower in order to avoid inflationary pressure on US economy. Moreover, there are also some political goals behind US stance as the conflicts between some middle east countries and US are not hidden from anyone.

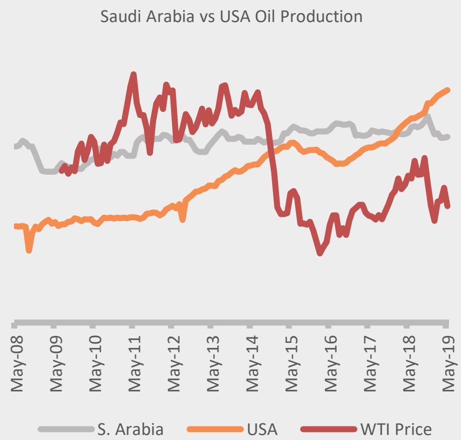
If we analyze the historical oil production of US and S. Arabia in chart, we come to know that the US oil production was far below than that of S. Arabia 5 years back. However, US has been uninterruptedly increasing its oil production and by doing so, it became the world's largest oil producer by crossing S. Arabia back in 2017. It can be clearly seen in the chart that S. Arabia has cut its production in 2019 over demand concerns due to global slowdown but, US is still increasing it production in order to fill the supply gap created by OPEC cut, sanctions on Venezuela & Iran and middle east tensions. Currently, US is the world's largest oil producer with total output of 12.4 million bpd and is solely capable of manipulating the crude oil prices. Therefore, we expect the US stance on oil prices would prevail and any upside in oil prices is not likely in near term. However, we expect the prices of WTI and Arab light to hover around $50 and $60 respectively.

Key Statistics

Components of Sales







Sources: ACPL Research, Company Financials, Macrotrends

Key Statistics

Debt Free Capital Structure

In today's high-cost money environment where the policy rate has reached 12.25% from the bottom of 5.75% within a year and expected to rise further in future as well, debt-free companies are the only suitable options for risk-averse investors. PPL is wholly equity financed company. Hence, it has a debt-free structure and free from related cash flow distress and default risks.

Investment Perspective

Sizable discoveries which can make a difference in the country's overall hydrocarbon reserves is a challenging task. PPL, being a national E&P company, is focused on this goal. However, one of the main challenges faced by the oil & gas industry is circular debt which needs to be resolved at the earliest to keep up and indeed increase the pace of E&P activities. We expect the proceeds from upcoming energy sukuk 2 would somewhat relief the liquidity crunch of the company. Furthermore, the curtailment of circular debt up to Rs50-60bn by July 2020 as stated by the energy minister Mr. Omar Ayub would pave all the ways for the company to resume its aggressive exploration activities and to continue its stable dividend paying policy.

Moreover, the company has an edge of having dollar denominated revenue in such environment where the domestic currency has been depreciated over 40% since last year. Further depreciation is still on the cards as the government has decided to keep the rupee near to its fair value. Furthermore, debt free structure, stable outlook for crude oil prices and reduction in terrorism has made the valuation of the company much more attractive.

Valuation

PPL is currently trading at FY20E PE of 5.19x. Furthermore, the script is trading at a FY20E P/B of 1.10x which offers a significant discount of 38% relative to its historical 5-year average of 1.77x. We have a **BUY** stance on the script with a DCF based Jun-20 TP of Rs.201 which provides an upside potential of 29%. Furthermore, it also offers a dividend yield of 5% which makes the total return of 34%.

Key Risks to Valuation

- Appreciation of PKR
- More than expected drop in oil prices
- More than expected accumulation of circular debt
- Deterioration of law and order situation in Sindh & Balochistan

Key Ratios

Profitability Ratios		FY14A	FY15A	FY16A	FY17A	FY18A	FY19E	FY20E	FY21E	FY22E	FY23E
GP Margin	%	60.67	48.00	32.41	55.12	58.80	61.33	61.33	61.33	61.33	61.33
NP Margin	%	42.92	36.63	21.51	30.50	36.20	38.40	38.60	37.50	35.81	35.98
ROE	%	29.54	20.40	8.95	16.51	19.01	23.28	21.24	18.52	16.52	14.53
ROA	%	22.49	15.74	6.33	11.00	12.44	14.85	13.92	12.69	11.61	10.48

Liquidity Ratios		FY14A	FY15A	FY16A	FY17A	FY18A	FY19E	FY20E	FY21E	FY22E	FY23E
Current	x	3.82	4.28	2.88	2.89	2.72	3.38	3.33	3.58	3.68	3.77
Quick	x	3.47	3.88	2.61	2.69	2.59	3.23	3.21	3.45	3.56	3.66

Activity Ratios		FY14A	FY15A	FY16A	FY17A	FY18A	FY19E	FY20E	FY21E	FY22E	FY23E
Receivables Days		163.63	229.09	276.94	318.97	417.95	384.14	383.90	383.77	383.69	383.89
Payables Days		139.76	153.44	213.39	335.35	432.09	364.85	423.84	434.52	440.77	474.71

Investment Ratios		FY14A	FY15A	FY16A	FY17A	FY18A	FY19E	FY20E	FY21E	FY22E	FY23E
DPS		12.50	8.50	5.75	9.00	5.50	7.67	8.18	15.08	14.70	14.00
Div. Yield	%	8.03	5.46	3.70	5.79	3.54	4.93	5.26	9.69	9.45	9.00
Dividend Cover	x	1.81	1.99	1.32	1.75	3.66	3.66	3.66	2.00	2.00	2.00
Retention	%	44.88	49.81	24.38	42.80	72.70	72.70	72.70	50.00	50.00	50.00
Payout	%	55.12	50.19	75.62	57.20	27.30	27.30	27.30	50.00	50.00	50.00
No. of Shares	('m)	2.27	2.27	2.27	2.27	2.27	2.27	2.27	2.27	2.27	2.27
EPS		22.68	16.93	7.60	15.73	20.15	28.09	29.97	30.16	29.40	28.00
BVPS		76.78	83.03	84.96	95.29	106.02	120.67	141.09	162.88	177.96	192.66
P/E	x	6.86	9.19	20.46	9.89	7.72	5.54	5.19	5.16	5.29	5.56
Sales per share		52.84	46.24	35.35	51.59	55.66	73.14	77.65	80.42	82.10	77.83
P/BV	x	2.03	1.87	1.83	1.63	1.47	1.29	1.10	0.96	0.87	0.81
P/S	x	2.94	3.36	4.40	3.02	2.79	2.13	2.00	1.93	1.89	2.00

Source: ACPL Research, Company Financials

Financial Projections

Rupees' millions	FY14A	FY15A	FY16A	FY17A	FY18A	FY19E	FY20E	FY21E	FY22E	FY23E
Revenue	119,811	104,838	80,151	116,986	126,210	165,844	176,079	182,351	186,168	176,476
Operating Expenses	-32,817	-42,289	-44,952	-31,247	-33,482	-39,803	-42,259	-43,764	-44,680	-42,354
Royalty	-14,301	-12,227	-9,219	-21,257	-18,512	-24,326	-25,827	-26,747	-27,307	-25,885
Gross profit	**72,694**	**50,322**	**25,980**	**64,482**	**74,215**	**101,716**	**107,993**	**111,840**	**114,181**	**108,236**
Exploration and prospecting expenditure	0	0	0	-10,788	-11,164	-16,584	-16,474	-17,142	-17,845	-16,672
General and administration expenses	0	0	0	-2,772	-2,560	-2,123	-2,254	-2,334	-2,383	-2,259
Finance Cost	-426	-554	-659	-461	-444	-665	-722	-783	-850	-921
Other Charges	-4,103	-4,063	-4,032	-7,137	-5,931	-8,126	-8,628	-8,935	-9,122	-8,647
Other income	6,381	7,611	5,418	4,804	9,319	10,698	10,698	8,534	4,918	4,918
Profit before income tax	**74,547**	**53,315**	**26,707**	**48,129**	**63,436**	**84,915**	**90,613**	**91,179**	**88,899**	**84,656**
Income tax expense	-23,129	-14,916	-9,465	-12,450	-17,749	-21,229	-22,653	-22,795	-22,225	-21,164
Profit for the year	**51,417**	**38,399**	**17,242**	**35,679**	**45,688**	**63,686**	**67,960**	**68,384**	**66,674**	**63,492**
EPS	**22.68**	**16.93**	**7.60**	**15.73**	**20.15**	**28.09**	**29.97**	**30.16**	**29.40**	**28.00**
EBITDA	**83,443**	**63,223**	**38,148**	**63,654**	**79,535**	**102,951**	**110,555**	**113,230**	**113,285**	**111,625**

Source: ACPL Research, Company Financials

Horizontal Analysis

Horizontal Analysis	FY14A	FY15A	FY16A	FY17A	FY18A	FY19E	FY20E	FY21E	FY22E	FY23E
Revenue	17.05%	-12.50%	-23.55%	45.96%	7.88%	31.40%	6.17%	3.56%	2.09%	-5.21%
Operating Expenses	7.23%	28.86%	6.30%	-30.49%	7.15%	18.88%	6.17%	3.56%	2.09%	-5.21%
Royalty	16.34%	-14.50%	-24.60%	130.58%	-12.91%	31.40%	6.17%	3.56%	2.09%	-5.21%
Gross profit	**22.25%**	**-30.78%**	**-48.37%**	**148.20%**	**15.09%**	**37.05%**	**6.17%**	**3.56%**	**2.09%**	**-5.21%**
Exploration and prospecting expenditure	0.00%	0.00%	0.00%	0.00%	3.49%	48.55%	-0.67%	4.06%	4.10%	-6.57%
General and administration expenses	0.00%	0.00%	0.00%	0.00%	-7.65%	-17.07%	6.17%	3.56%	2.09%	-5.21%
Finance Cost	7.88%	30.26%	18.89%	-30.03%	-3.80%	49.94%	8.56%	8.51%	8.49%	8.33%
Other Charges	23.11%	-0.96%	-0.76%	76.98%	-16.90%	37.02%	6.17%	3.56%	2.09%	-5.21%
Other income	-7.43%	19.27%	-28.81%	-11.33%	93.97%	14.80%	0.00%	-20.23%	-42.37%	0.00%
Profit before income tax	**19.03%**	**-28.48%**	**-49.91%**	**80.21%**	**31.81%**	**33.86%**	**6.71%**	**0.62%**	**-2.50%**	**-4.77%**
Income tax expense	11.86%	-35.51%	-36.55%	31.54%	42.56%	19.61%	6.71%	0.62%	-2.50%	-4.77%
Profit for the year	**22.56%**	**-25.32%**	**-55.10%**	**106.93%**	**28.05%**	**39.39%**	**6.71%**	**0.62%**	**-2.50%**	**-4.77%**
EPS	**22.56%**	**-25.32%**	**-55.10%**	**106.93%**	**28.05%**	**39.39%**	**6.71%**	**0.62%**	**-2.50%**	**-4.77%**
EBITDA	**17.53%**	**-24.23%**	**-39.66%**	**66.86%**	**24.95%**	**29.44%**	**7.39%**	**2.42%**	**0.05%**	**-1.47%**

Source: ACPL Research, Company Financials

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DEFINITION OF TERMS

TP	Target Price	CAGR	Compound Annual Growth Rate	FCF	Free Cash Flows
FCFE	Free Cash Flows to Equity	FCFF	Free Cash Flows to Firm	DCF	Discounted Cash Flows
PE	Price to Earnings Ratio	PB	Price to Book Ratio	BVPS	Book Value Per Share
EPS	Earnings Per Share	DPS	Dividend Per Share	ROE	Return of Equity
ROA	Return on Assets	SOTP	Sum of the Parts	LDCP	Last Day Closing Price

VALUATION METHODOLOGY

To arrive at our Target Price, Abbasi & Company (Private) Limited uses different valuation methods which include:

I. Discounted Cash Flow Model
II. Dividend Discount Model
III. Relative Valuation Model
IV. Sum of Parts Valuation

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Stock Rating	Expected Total Return
BUY	Greater than 15%
HOLD	Between -5% to 15%
SELL	Less than and equal to -5%

Sector Rating	Sector Outlook
Overweight	Positive
Market Weight	Neutral
Underweight	Negative

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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