

RATINGS (NOVEMBER 2010)
PAK-ARAB REFINERY LIMITED (PARCO)

ENTITY	NEW	PREVIOUS
Long Term	AAA	AAA
Short Term	A1+	A1+

LT RATING HISTORY

	May 2006	Apr 2007	Jun 2008	Oct 2009	Nov 2010
AA					
A					
AA+					
AA					

FINANCIAL DATA

PKR (mln)

	FY10	FY09
Total Assets	141,030	131,060
Equity	49,075	44,107
Turnover	193,315	173,798
Net Income	7,968	5,360
Gross Margin (%)	9.4	5.6
ROE (%)	16.2	12.2
EBIDTA	19,852	11,236
Net Debt/Net Debt plus Equity (%)	31.2	43.3

ANALYSTS

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RATING RATIONALE AND KEY DRIVERS

- The ratings reflect PARCO's sovereign ownership structure – jointly owned by the Government of Pakistan (GoP) (60%) and the Emirate of Abu Dhabi (EAD) (40%) – and its strategic importance to the GoP, in terms of its socio-economic policies and its quest of lessening the import bill. The company's low business risk emanates from its leading market position, relatively high margins and diversified revenue stream. The ratings recognize the company's ability to manage its financial profile, which has lately been stretched by higher short-term borrowings, but is supplemented by strong cash flows.
- An amicable resolution of the circular debt issue, the management's ability to maintain a strong financial profile and a favourable regulatory regime remain critical for the ratings. The ratings could be negatively impacted by excessive leveraging and/or curtailment of PARCO's operations below break-even point due to circular debt.

ASSESSMENT

- The refining industry in Pakistan, with a total capacity of 13mln tpa, has come under pressure lately due to thin refining margins and volatility in international oil prices. The problem has been further aggravated by the ongoing circular debt issue, which has constrained the sector's liquidity. Meanwhile, the prices of fuel products are determined monthly, based on import parity pricing, which equates the price to the landed cost of the product if it were to be imported. In the case of HSD, refineries are allowed a deemed duty, which was reduced by the government from 10% to 7.5% in August 2008, resulting in a detrimental impact on profitability. Recently, the Economic Coordination Committee has proposed the deregulation of prices, which would introduce a free market mechanism in the industry.

- PARCO, the largest oil refinery in Pakistan, contributes about thirty-five percent to Pakistan's refining capacity and enjoys competitive advantage and strategic importance in the country's oil chain. Meanwhile, owing to its diversified operations – integrated pipeline, refining, and marketing of petroleum products – the company's revenue stream remains stable. PARCO's refining operations continue to be the largest contributor towards sales revenue. The refinery is governed under the 1994 Petroleum Policy and was guaranteed a minimum after-tax return of 25% on the paid-up capital attributable to the refinery for the initial eight years of operations, which expired in December 2008.

- During FY09, refining margins came under stress. Moreover, the throughput of the refinery declined, impacting turnover growth, as output was lowered in order to stem the accumulation of overdue receivables. The company also suffered significant net exchange loss (PKR 5,086mln) due to rupee devaluation and incurred substantial interest expense due to higher short-term borrowings to meet working capital requirements. These factors impacted the profitability negatively, causing the 25% guaranteed return to be utilized during 1HFY09 (PKR 6,632mln).

- During FY10, while the inter-corporate debt issue caused capacity utilization to decline further, improved product prices resulted in turnover growth. The gross margins also improved on the back of favourable crude oil and product price movements. Moreover, exchange losses against crude oil imports were minimized due to the relative stabilization of the local currency against the US Dollar. At the same time, the stable product demand resulted in steady capacity utilization of KMK pipeline operations, which stood at 79% in FY10 (FY09: 82%; FY08: 86%), while the capacity utilization of the Mahmood Kot-Faisalabad-Machhike (MFM) segment, which had been impacted during FY09, was restored to 82% during FY10. Going forward, the capacity utilization of both the refinery and the KMK segment remains contingent upon the resolution of circular debt. Meanwhile, PARCO continued to market some products through TPPL.

- Going forward, the company is planning to produce high quality asphalt for local consumption, which would enhance the capacity utilization and is expected to increase margins. A new Diesel Hydro-Desulphurization project has also been completed to comply with Euro II specifications. While the sale of the Euro II compliant diesel is expected to commence soon, additional revenues would only accrue to the company once the GoP approves higher prices for the product. Meanwhile, the company embarked on implementing the Enterprise Resource Planning solution, SAP, during FY09 to streamline planning and coordination across business lines, thereby increasing overall efficiency.

- PARCO maintained a low leveraged capital structure in the past. However, as a result of delayed payments by OMCs, the cash flows have recently come under stress. As a result, the company had to resort to short-term borrowings to manage its working capital needs, which caused leveraging to increase and, subsequently, diluted coverages on the back of higher financial charges. This situation improved slightly in FY10 due to better profitability and effective working capital management. The overall leveraging of the company still remains moderate, signifying financial flexibility.

PROFILE

- PARCO, an unlisted public limited company, was established in 1974. It owns and operates Pakistan's longest oil pipeline network, extending from Karachi to Mehmood Kot (KMK) near Multan and onward to Machhike near Lahore, spanning 1,228 km. PARCO's mid-country refinery (MCR) has a capacity of 4.5mln tonnes per annum (tpa).

- PARCO markets its products through off-take agreements with Oil Marketing Companies (OMCs) and lubricants through its own brand, PEARL. It has a 40% stake in TOTAL PARCO Pakistan Limited – an OMC with 5% market share – (TPPL), a joint venture with Total Fina Elf – a French conglomerate. PARCO has a 51% stake in the Pak Arab Pipeline Company (PAPCO), which has established a white oil pipeline system to transport refined products from Port Qasim to Mahmood Kot. PARCO, in a joint venture with IPIC, will be an equity partner (26% stake) in the Khalifa Coastal Refinery, which would have a refining capacity of around 250,000 barrels per day and is still in the initial stages of company formation.

- The company's ten-member Board of Directors includes six nominees of the GoP, including the Chairman and the Managing Director, while the remaining four are ADPI nominees.