

**Pak-Arab Refinery Limited (PARCO)****Ratings (May 2006)**

Pak-Arab Refinery Limited

	New	Previous
Entity		
Long Term	AAA	AAA
Short Term	A1+	A1+

Financial Data

PKR (mln)	30/06/05	30/06/04
Total Assets*	87,570	77,911
Equity	35,720	24,901
Operating profit	17,480	7,901
Net Income **	12,499	4,433
ROA (%)	13.4	5.4
ROE (%)	41.2	19.5
EBIDTA	20,582	11,754
Net Debt/Equity (%)	26.2	92.7

* Local currency loans secured against PARCO's foreign currency deposits & USD bonds have been offset.

** The net income for FY2004 includes subsidy of PKR 0.90bln on account of SGR on the refinery operations due from GOP.

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Rating Rationale**Assessment**

- PARCO's ratings reflect continued improvement in refinery margins along with healthy margins on pipeline operations, very strong liquidity, and the continuously improving capital structure, as a result of which the stand-alone risk absorption capacity of the company continues to strengthen. Meanwhile, up till 1HY2009, the guaranteed return on MCR provides sufficient cushion and helps in keeping the bottom line profitability intact regardless of fluctuations in the operating results of the refinery. The company's business and financial risks, therefore, remain extremely low.
- PARCO's profitability improved markedly during FY2005 on the back of substantially improved refinery margin emanating from better yields obtained from change in crude mix, as well as inventory gains owing to the upward trend in the international oil prices. Consequently, the company managed to surpass the guaranteed return benchmark for the first time since commencement of MCR operations. The continued reduction in dependence on the subsidy from GoP distinctly indicates the enhanced efficiency of the refinery operations. However, as output oil prices have failed to remain in step with the increase in input oil prices, margins have begun to decline sharply. Recognising this trend, and the costs of maintenance and targeted expansion, the management projects a profitability of around half of the FY05 level in the medium-term. Given the trend of the 1HY06 performance, the company should be comfortably able to surpass the annual target.
- The pipeline continues to be the most efficient means of transporting petroleum products upcountry affording healthy margins to PARCO. In FY2005, the operating profitability in the pipeline operations declined by around 8% over the previous year, owing mainly to the slightly reduced gross margin (FY05: 64%, FY04: 67%), and the slightly lower capacity utilization of the KMK segment (FY05: 105%; FY04: 115%). The lower capacity utilization was due to diversion of a substantial quantity of HSD to WOPP for line-fill on commencement of operations. The transportation tariff remains linked to the rate charged by Pakistan Railways.
- PARCO's revenues from the refinery operations – comprising the bulk of the company's total revenue – registered a substantial increase on account of improved yield of value added products, high petroleum prices prevalent during the year, and a sustained capacity utilization at 87%. With a less than proportionate increase in the cost of sales, the operating margin of the refinery jumped to 16.8% (FY2004: 8.8%, FY2003: 1.8%). With the introduction of Local and Murban Crude Oil from FY2005, the production slate has improved, and the white oil to black oil production ratio has improved from 60:40 to 70:30. This change has been a significant contributory factor to the improvement in profitability. Other income attributable to the refinery operations also registered a sizeable increase, primarily on the back of higher returns on investments and deposits. Substantial reduction in the financial charges as a result of effective financial management further boosted the refinery's pre-tax performance.
- The company has used its exceptional liquidity to pre-pay long-term loans in order to reduce the financial cost as well as to eliminate the foreign currency exchange risk. As a result of continued improvement in the operating cash flows, coupled with a substantial reduction in the net debt profile and decline in financial charges, the company's financial coverages improved significantly during the year. The total debt payback nearly halved for the second consecutive year, while the interest coverage improved by around 6 times, reinforcing the company's sound financial footing. Going forward, with company's planned capex requirements well covered by internal generation over the medium term, the net debt profile is expected to continue the improving trend, with consequential improvements in financial coverages.
- The White Oil Pipeline Project (WOPP), which is being implemented through PARCO's 51% owned subsidiary, PAPCO, commenced operations in March 2005. With the completion of the Korangi-Port Qasim Link Pipeline (KPLP) in March 2006 and the WOPP becoming independently operational, the transportation of HSD would now be undertaken entirely through the WOPP, while the KMK pipeline would transport only crude oil to the MCR. Meanwhile, the company is considering various initiatives to achieve further diversification in the revenue stream. These include the launch of industrial lubricants in addition to the existing automotive grades, marketing liaison for Pearl Lubricants with newly licensed OMCs, construction of a 500 tons per day asphalt production plant at the MCR to enhance throughput during the low consumption period and motor gasoline export in collaboration with OMCs.

Background

- PARCO, an unlisted public limited company, was established in 1974 as a joint venture between the Government of Pakistan (60%) and the Emirate of Abu Dhabi (40%). The company owns and operates Pakistan's longest oil pipeline network, extending from Karachi to Mehmood Kot near Multan. Forming an important link in the transport of petroleum products upcountry, the pipeline system was extended to Machhike near Lahore in 1998, and presently spans 1,228 km. PARCO's MCR, with a capacity of 4.5 mln tonnes per annum (tpa), is the largest refining complex representing around 35% of the country's aggregate refining capacity. It enjoys a GOP guaranteed 25% after-tax return on paid-up capital for the initial eight years, starting December 2000.
- PARCO markets its products through off-take agreements with Oil Marketing Companies and also through its own brand, PEARL. It also has a 40% stake in TOTAL-PARCO, a joint venture with Total Fina Elf – a French conglomerate, to market upto 25% of the MCR's production through a rapidly expanding network of TOTAL-PARCO outlets.
- The management's ability to successfully accomplish its business and financial objectives remains fully demonstrated.