The Pakistan Credit Rating Agency Limited

Rating Report

Pakistan Refinery Limited

Report Contents

Rating History

Dissemination Date	Long Term Rating	Short Term Rating	Outlook	Action	Rating Watch
09-Jun-2020	A-	A2	Stable	Maintain	YES
10-Dec-2019	A-	A2	Stable	Maintain	-
10-Jun-2019	A-	A2	Stable	Maintain	-
12-Dec-2018	A-	A2	Stable	Maintain	-
31-May-2018	A-	A2	Stable	Maintain	-
29-Jun-2017	A-	A2	Stable	Maintain	-
29-Jun-2016	A-	A2	Stable	Maintain	-
30-Jun-2015	A-	A2	Stable	Maintain	-
30-Jun-2014	A-	A2	Stable	Maintain	-

Rating Rationale and Key Rating Drivers

The ratings reflect the resilient business profile of Pakistan Refinery Limited (PRL) emanating from its sustainable operational history and its strategic importance in the domestic context. PRL's core business remains exposed to the vicissitudes in international crude oil and products prices, which in turn, steer the Gross Refining Margins (GRMs) of the company. PRL’s margins are also impacted on account of low HSD price, due to non-installation of DHDS Unit needed to produce Euro-II compliant Diesel. The country’s refinery sector has been going through significant challenges for an extended period, majorly pertaining to up-gradation of the refining complexes and management of furnace oil (FO) produce. The FO offtake has further obstacles on the export avenue as the IMO 2020 came into play, since Jan’20. Depressed crude and POL prices in the International market coupled with the underlying issues of the sector had hampered the performance indicators of the industry players in FY19. Adding to the woes, the global oil market was further struck by widespread uncertainty due to the outbreak of COVID-19. Inventory accumulation, NRV adjustments and POL demand slide pressurized the GRMs and profitability margins of the sector players drastically. Nonetheless, the concerns are expected to reverse, going forward, as global prices move towards a stabilized trajectory and demand takes a gradual uptick, on account of ease in lockdown. Having said this, uncertainty still prevails as to the timeliness of complete restoration and recovery of losses that the Industry has absorbed, under the current situation. Likewise, PRL’s financial risk profile exhibited a precarious position with considerable short term funding to cater working capital needs along with persistent net losses, which turned the equity negative. Pakistan State Oil (PSO) holds a majority ownership share (60.0%) in PRL, as at End-9MFY20. The purpose of the investment is backward integration which allows PSO a more assured source of supply. Strategic oversight and financial strength of the parent company and resultant benefits in value chain mechanics, is considered positive for PRL.

The ratings are dependent upon the company's aptness to arrest the adversities impacting its risk profile in a timely manner. Improved performance indicators, including reversal of equity losses and sanguine financial discipline, are imperative to the ratings. Meanwhile, the ratings are placed under “Watch” to reflect the need to oversee the risk profile of the company against unavoidable challenges, going forward.

Disclosure

Name of Rated Entity	Pakistan Refinery Limited
Type of Relationship	Solicited
Purpose of the Rating	Entity Rating
Applicable Criteria	Methodology | Corporate Ratings(Jun-19),Methodology | Correlation Between Long-Term And Short-Term Rating Scale(Jun-19),Criteria | Rating Modifier(Jun-19)
Related Research	Sector Study | Refineries(Nov-19)
Rating Analysts	Jibran Cheema | jibran.cheema@pacra.com | +92-42-35869504

Profile

Legal Structure Pakistan Refinery Limited ("PRL") is a Public Limited Company, incorporated in 1960. It is listed on the Pakistan Stock Exchange.

Background The plant came into operation, in October 1959. The designed capacity of the refinery was to process one million tons of crude oil annually. Additional capacity was added, subsequently, in October 1962. PRL, since inception, has been one of the principal producers and suppliers of petroleum products in the market.

Operations PRL, a hydroskimming refinery, is designed to process imported and local crude oil to meet the strategic and domestic fuel requirements of the country. Major products of the company comprise; LPG, Motor Gasoline, Kerosene, Jet Fuel (JP-1 & JP-8), HSD, Furnace Oil, and Naphtha. The customers of the refinery include all the major oil marketing companies, operating in the country. PRL’s refinery is situated at Korangi, while it has a tank terminal to store products, at the Keamari Terminal. In addition to these facilities, there is a network of pipelines connecting the refinery and the terminal to different supply points.

Ownership

Ownership Structure PRL is majority owned by Pakistan State Oil (PSO). PSO recently acquired further shareholding, previously held by Shell Petroleum and Chevron Global Energy, increasing its ownership share to 60.0%. Hascol Petroleum and the general public hold 14.7% and 18.3% of the ownership, respectively.

Stability The business has been governed and administered by entities, which have a distinguished name in the oil sector. Thus, the stability factor is considered strong.

Business Acumen PRL’s sponsors have strong business skills, which has helped the company to achieve sustainable success over a considerable period of time. Sponsors, particularly now with PSO on board, have industry-specific working knowledge and strategic thinking capability.

Financial Strength The company’s sponsors have the ability and willingness to support the entity on a continuing basis, and in times of crisis. The sovereign support of the government in the shape of PSO, has further enhanced this notion.

Governance

Board Structure PRL has an eleven member board, including the MD & CEO. The board comprises six non-executive, four independent, and one executive member.

Members’ Profile Mr. Syed Asad Ali Shah, a qualified chartered accountant, is the Chairman of the Board, with more than 30 years of experience in audit, assurance, consulting and governance related advisory services. PRL’s board comprises highly qualified members. It is composed of professionals with considerable foreign and local experience in the oil and gas sector. A few of the board members have an engineering background while some are qualified in the domain of finance and arts. Diversification in terms of knowledge and experience is considered good.

Board Effectiveness The BoD has constituted four committees to maintain strategic oversight, namely; i) Board Audit Committee ii) Board Human Resource and Remuneration Committee iii) Board Project Steering Committee and iv) Board Share Transfer Committee. The TORs of all the committees are formally defined. A strong control environment is maintained.

Financial Transparency PRL’s auditors, A. F. Ferguson & Co Chartered Accountants (ranked as “A” category auditor by SBP), expressed an unqualified opinion on the company’s financial statements as at End-Jun'19 and End-Dec'19. Because of its listing status, financial transparency of the company is considered strong as it has to comply with the disclosures requirements of the regulators.

Management

Organizational Structure PRL’s organizational architecture encompasses a well-built departmental structure comprising established reporting lines. The departments reporting directly to the MD comprise; a) Engineering, b) Refinery Upgrade Project, c) Technology & Inspection, d) Finance, e) Human Resources, f) Security, g) Commercial, h) Operations & HSEQ. Internal Audit Department & the Company Secretary report to the MD, indirectly.

Management Team Mr. Zahid Mir, the Managing Director and CEO of PRL since August'19, is a petroleum engineer by profession and has an MBA. He is supported by a team of qualified and competent individuals.

Effectiveness Historically, PRL’s effective management has played a major role in empowering the organization through its progressive results. Management’s effective decision-making has led to processes becoming more systematic. The robustness of control systems is considered a reflection of strong management.

MIS PRL has implemented SAP ERP, since the year 2000. The SAP software is licensed and undergoes regular up-gradation. The modules implemented at PRL comprise; Finance, Material Management, HR and Plant Maintenance. PRL’s IT infrastructure effectively manages all business operations of the company.

Control Environment The existence of the Isomerization Unit has resulted in a production increase of Motor Gasoline (MOGAS), a high margin product. The unit is responsible to convert Naphtha into MOGAS. During FY19, the installation of Diesel Hydro-Desulphurisation Unit (DHDS), to produce EURO II compliant diesel, was approved.

Business Risk

Industry Dynamics The country consumed a total of ~13.1mln metric tons (MT) of refined petroleum products in 9MFY20 (9MFY19: ~14.9mln MT), depicting a fall of ~12% compared to the corresponding period. This decrease is mainly seen due to a fall in the consumption of MOGAS and HSD as a result of a lack of growth in the transport sector. A further fall in demand because of the nationwide lockdown due to Covid-19 has added to the problems within the industry. Additionally, consumption of black oil has plunged due to declining demand of Furnace Oil (FO), as the government is gradually reducing reliance on oil-based power plants in favor of other input sources for electricity generation i.e. LNG & Coal.

Relative Position With regards to relative positioning of the players in the premium products (HSD and MOGAS); efficiency and utilization of available capacity is essential. PARCO and Byco Petroleum retain a large chunk of the market share of ~52%, while PRL, NRL, and ARL collectively contribute ~48% to the total domestic POL supply.

Revenues A declining trend in the turnover was noted, with the net revenue amounting to PKR~75,440mln in 9MFY20 (9MFY19: PKR~81,433mln), depicting a fall of 7% compared to the corresponding period. This is attributed, in part, to the decrease in offtake of Furnace Oil from Power Plants during the first two quarters of FY20, owing to the availability of alternate energy i.e. RLNG. Demand for all products was significantly hampered by the nationwide lock down, imposed in March 2020, as a result of Covid-19.

Margins During 9MFY20, the gross refining margins remained under pressure owing to volatile international prices of crude and PoL products. Resultantly, gross profit margins worsened during the period (9MFY20: -5.6%, 9MFY19: -2.3%). Petroleum prices fell due to a slump in the global petroleum demand, adversely impacting the company and the refining industry as a whole. Consequently, the company suffered an inventory loss of PKR~4,070mln, forming a substantial portion of the total net loss amounting to PKR~ 6,770mln. Following a similar trend, the net profit margins fell to -9.0% (9MFY19: -4.3%).

Sustainability The refinery sector has been going through an existential crisis, as a result of the government's demand for environment friendly fuel. The issue of low FO offtake has been compounded by the introduction of the IMO 2020, which necessitates the use of low sulphur FO by the marine sector. Due to the substantial investment needed for the required upgrades to the refineries, the developments in this regard, have reached an impasse. A slump in demand of petroleum products, due to the lockdown in light of Covid-19, has put the industry players under further pressure. Government assistance is imperative, for the sustenance of the sector.

Financial Risk

Working Capital PRL’s working capital requirement emanates from its need to finance its inventory and trade receivables. During 9MFY20, the gross working capital days stood at an average of 73 days (9MFY19: 59 days). The deterioration, in this regard, is mainly as a result of a rise in the inventory levels, due to a slump in demand. A similar trend was noted in the average net working capital days (9MFY20: 31 days, 9MFY19: 21 days).

Coverages In 9MFY20, the Free Cash Flows From Operations (FCFO) of PRL declined further i.e. PKR ~-4,467mln (9MFY19: PKR ~-1,840mln) owing to substantial losses during the period. As a result of deteriorating FCFO and rising interest expenses, the coverages remained in an uncomfortable position with the ratio FCFO-to-Finance Cost, clocking in at -2.7x (9MFY19: -2.0x).

Capitalization The leveraging of PRL has risen significantly during the period under review, clocking in at 106.4% as at End-9MFY20 (End-FY19: 84.4%), mainly as a result of equity erosion due to consistent losses. PRL's equity turned negative during 9MFY20, representing a precarious financial position.

The Pakistan Credit Rating Agency Limited

Financial Summary
PKR mln

Pakistan Refinery Limited Refineries	Mar-20 9M	Jun-19 12M	Jun-18 12M	Jun-17 12M
A BALANCE SHEET				
1 Non-Current Assets	19,793	19,022	13,500	12,306
2 Investments	-	-	-	-
3 Related Party Exposure	77	84	71	84
4 Current Assets	20,602	23,775	16,947	13,535
a Inventories	*9,395*	*9,072*	*7,478*	*6,128*
b Trade Receivables	*8,577*	*13,195*	*7,265*	*4,471*
5 Total Assets	40,472	42,881	30,518	25,925
6 Current Liabilities	21,889	19,989	16,779	14,942
a Trade Payables	*12,104*	*11,054*	*9,634*	*8,452*
7 Borrowings	19,377	19,002	9,319	7,557
8 Related Party Exposure	-	-	-	-
9 Non-Current Liabilities	367	380	357	325
10 Net Assets	(1,161)	3,509	4,063	3,101
11 Shareholders' Equity	(1,161)	3,509	4,063	3,101
B INCOME STATEMENT				
1 Sales	75,440	115,741	92,229	69,929
a Cost of Good Sold	*(79,652)*	*(118,915)*	*(91,184)*	*(67,418)*
2 Gross Profit	(4,212)	(3,174)	1,045	2,510
a Operating Expenses	(479)	(858)	(590)	(540)
3 Operating Profit	(4,691)	(4,032)	455	1,970
a Non Operating Income or (Expense)	*125*	*230*	*965*	*74*
4 Profit or (Loss) before Interest and Tax	(4,566)	(3,802)	1,420	2,045
a Total Finance Cost	*(1,632)*	*(1,443)*	*(591)*	*(604)*
b Taxation	*(572)*	*(576)*	*(325)*	*(381)*
6 Net Income Or (Loss)	(6,770)	(5,821)	504	1,060
C CASH FLOW STATEMENT				
a Free Cash Flows from Operations (FCFO)	*(4,467)*	*(3,235)*	*1,998*	*2,985*
b Net Cash from Operating Activities before Working Capital Changes	*(6,033)*	*(4,264)*	*1,490*	*2,529*
c Changes in Working Capital	*6,739*	*(4,552)*	*(1,888)*	*1,923*
1 Net Cash provided by Operating Activities	706	(8,816)	(398)	4,452
2 Net Cash (Used in) or Available From Investing Activities	(1,261)	(1,188)	(1,502)	(1,223)
3 Net Cash (Used in) or Available From Financing Activities	2,308	9,682	1,763	(3,104)
4 Net Cash generated or (Used) during the period	1,753	(321)	(138)	125
D RATIO ANALYSIS				
1 Performance				
a Sales Growth (for the period)	-13.1%	25.5%	31.9%	8.0%
b Gross Profit Margin	-5.6%	-2.7%	1.1%	3.6%
c Net Profit Margin	-9.0%	-5.0%	0.5%	1.5%
d Cash Conversion Efficiency (EBITDA/Sales)	-5.0%	-2.6%	2.4%	4.5%
e Return on Equity (ROE)	-768.7%	-153.8%	14.1%	40.2%
2 Working Capital Management				
a Gross Working Capital (Average Days)	73	58	50	60
b Net Working Capital (Average Days)	31	26	14	19
c Current Ratio (Total Current Assets/Total Current Liabilities)	0.9	1.2	1.0	0.9
3 Coverages				
a EBITDA / Finance Cost	-2.3	-2.1	3.8	5.2
b FCFO / Finance Cost+CMLTB+Excess STB	-0.3	-0.3	0.4	0.4
c Debt Payback (Total Borrowings+Excess STB) / (FCFO-Finance Cost)	-2.5	-3.3	6.5	3.8
4 Capital Structure (Total Debt/Total Debt+Equity)				
a Total Borrowings / Total Borrowings+Equity	106.4%	84.4%	69.6%	70.9%
b Interest or Markup Payable (Days)	50.7	69.8	65.3	82.2
c Average Borrowing Rate	11.3%	10.2%	7.0%	6.6%

Credit Rating Scale & Definitions

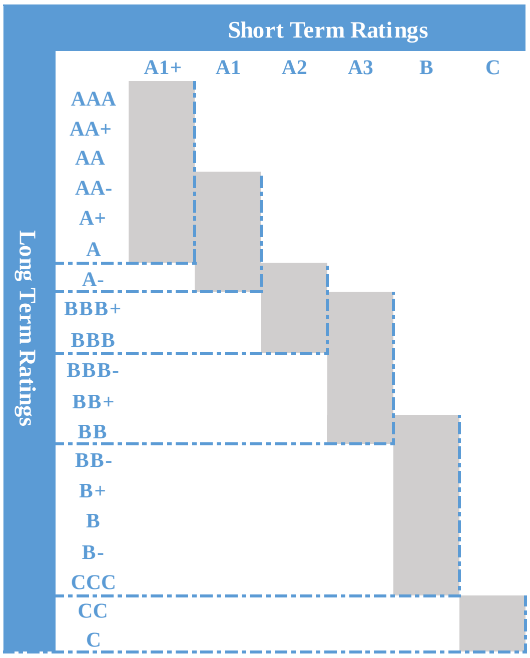
Credit rating reflects forward-looking opinion on credit worthiness of underlying entity or instrument; more specifically it covers relative ability to honor financial obligations. The primary factor being captured on the rating scale is relative likelihood of default.

Long Term Ratings

AAA	**Highest credit quality.** Lowest expectation of credit risk. Indicate exceptionally strong capacity for timely payment of financial commitments
AA+ AA AA-	**Very high credit quality.** Very low expectation of credit risk. Indicate very strong capacity for timely payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.
A+ A A-	**High credit quality.** Low expectation of credit risk. The capacity for timely payment of financial commitments is considered strong. This capacity may, nevertheless, be vulnerable to changes in circumstances or in economic conditions.
BBB+ BBB BBB-	**Good credit quality.** Currently a low expectation of credit risk. The capacity for timely payment of financial commitments is considered adequate, but adverse changes in circumstances and in economic conditions are more likely to impair this capacity.
BB+ BB BB-	**Moderate risk.** Possibility of credit risk developing. There is a possibility of credit risk developing, particularly as a result of adverse economic or business changes over time; however, business or financial alternatives may be available to allow financial commitments to be met.
B+ B B-	**High credit risk.** A limited margin of safety remains against credit risk. Financial commitments are currently being met; however, capacity for continued payment is contingent upon a sustained, favorable business and economic environment.
CCC CC C	**Very high credit risk.** Substantial credit risk “CCC” Default is a real possibility. Capacity for meeting financial commitments is solely reliant upon sustained, favorable business or economic developments. “CC” Rating indicates that default of some kind appears probable. “C” Ratings signal imminent default.
D	Obligations are currently in default.

Short Term Ratings

A1+	The highest capacity for timely repayment.
A1	A strong capacity for timely repayment.
A2	A satisfactory capacity for timely repayment. This may be susceptible to adverse changes in business, economic, or financial conditions.
A3	An adequate capacity for timely repayment. Such capacity is susceptible to adverse changes in business, economic, or financial conditions.
B	The capacity for timely repayment is more susceptible to adverse changes in business, economic, or financial conditions.
C	An inadequate capacity to ensure timely repayment.



Outlook (Stable, Positive, Negative, Developing) Indicates the potential and direction of a rating over the intermediate term in response to trends in economic and/or fundamental business/financial conditions. It is not necessarily a precursor to a rating change. ‘Stable’ outlook means a rating is not likely to change. ‘Positive’ means it may be raised. ‘Negative’ means it may be lowered. Where the trends have conflicting elements, the outlook may be described as ‘Developing’.

Rating Watch Alerts to the possibility of a rating change subsequent to, or in anticipation of, a) some material identifiable event and/or b) deviation from expected trend. But it does not mean that a rating change is inevitable. A watch should be resolved within foreseeable future, but may continue if underlying circumstances are not settled. Rating Watch may accompany Outlook of the respective opinion.

Suspension It is not possible to update an opinion due to lack of requisite information. Opinion should be resumed in foreseeable future. However, if this does not happen within six (6) months, the rating should be considered withdrawn.

Withdrawn A rating is withdrawn on a) termination of rating mandate, b) cessation of underlying entity, c) the debt instrument is redeemed, d) the rating remains suspended for six months, e) the entity/issuer defaults., or/and f) PACRA finds it impractical to surveill the opinion due to lack of requisite information.

Harmonization A change in rating due to revision in applicable methodology or underlying scale.

Regulatory and Supplementary Disclosure
(Credit Rating Companies Regulations,2016)

Rating Team Statements
(1) Rating is just an opinion about the creditworthiness of the entity and does not constitute recommendation to buy, hold or sell any security of the entity rated or to buy, hold or sell the security rated, as the case may be | Chapter III; 14-3-(x)

2) **Conflict of Interest**
i. The Rating Team or any of their family members have no interest in this rating | Chapter III; 12-2-(j)
ii. PACRA, the analysts involved in the rating process and members of its rating committee, and their family members, do not have any conflict of interest relating to the rating done by them | Chapter III; 12-2-(e) & (k)
iii. The analyst is not a substantial shareholder of the customer being rated by PACRA [Annexure F; d-(ii)] Explanation: for the purpose of above clause, the term "family members" shall include only those family members who are dependent on the analyst and members of the rating committee

Restrictions
(3) No director, officer or employee of PACRA communicates the information, acquired by him for use for rating purposes, to any other person except where required under law to do so. | Chapter III; 10-(5)
(4) PACRA does not disclose or discuss with outside parties or make improper use of the non-public information which has come to its knowledge during business relationship with the customer | Chapter III; 10-7-(d)
(5) PACRA does not make proposals or recommendations regarding the activities of rated entities that could impact a credit rating of entity subject to rating | Chapter III; 10-7-(k)

Conduct of Business
(6) PACRA fulfills its obligations in a fair, efficient, transparent and ethical manner and renders high standards of services in performing its functions and obligations; | Chapter III; 11-A-(a)
(7) PACRA uses due care in preparation of this Rating Report. Our information has been obtained from sources we consider to be reliable but its accuracy or completeness is not guaranteed. PACRA does not, in every instance, independently verifies or validates information received in the rating process or in preparing this Rating Report.
(8) PACRA prohibits its employees and analysts from soliciting money, gifts or favors from anyone with whom PACRA conducts business | Chapter III; 11-A-(q)
(9) PACRA ensures before commencement of the rating process that an analyst or employee has not had a recent employment or other significant business or personal relationship with the rated entity that may cause or may be perceived as causing a conflict of interest; | Chapter III; 11-A-(r)
(10) PACRA maintains principal of integrity in seeking rating business | Chapter III; 11-A-(u)
(11) PACRA promptly investigates, in the event of a misconduct or a breach of the policies, procedures and controls, and takes appropriate steps to rectify any weaknesses to prevent any recurrence along with suitable punitive action against the responsible employee(s) | Chapter III; 11-B-(m)

Independence & Conflict of interest
(12) PACRA receives compensation from the entity being rated or any third party for the rating services it offers. The receipt of this compensation has no influence on PACRA´s opinions or other analytical processes. In all instances, PACRA is committed to preserving the objectivity, integrity and independence of its ratings. Our relationship is governed by two distinct mandates i) rating mandate - signed with the entity being rated or issuer of the debt instrument, and fee mandate - signed with the payer, which can be different from the entity
(13) PACRA does not provide consultancy/advisory services or other services to any of its customers or to any of its customers' associated companies and associated undertakings that is being rated or has been rated by it during the preceding three years unless it has adequate mechanism in place ensuring that provision of such services does not lead to a conflict of interest situation with its rating activities; | Chapter III; 12-2-(d)
(14) PACRA discloses that no shareholder directly or indirectly holding 10% or more of the share capital of PACRA also holds directly or indirectly 10% or more of the share capital of the entity which is subject to rating or the entity which issued the instrument subject to rating by PACRA; | Reference Chapter III; 12-2-(f)
(15) PACRA ensures that the rating assigned to an entity or instrument is not be affected by the existence of a business relationship between PACRA and the entity or any other party, or the non-existence of such a relationship | Chapter III; 12-2-(i)
(16) PACRA ensures that the analysts or any of their family members shall not buy or sell or engage in any transaction in any security which falls in the analyst's area of primary analytical responsibility. This clause shall, however, not be applicable on investment in securities through collective investment schemes. | Chapter III; 12-2-(l)
(17) PACRA has established policies and procedure governing investments and trading in securities by its employees and for monitoring the same to prevent insider trading, market manipulation or any other market abuse | Chapter III; 11-B-(g)

Monitoring and review
(18) PACRA monitors all the outstanding ratings continuously and any potential change therein due to any event associated with the issuer, the security arrangement, the industry etc., is disseminated to the market, immediately and in effective manner, after appropriate consultation with the entity/issuer; | Chapter III | 18-(a)
(19) PACRA reviews all the outstanding ratings on semi-annual basis or as and when required by any creditor or upon the occurrence of such an event which requires to do so; | Chapter III | 18-(b)
(20) PACRA initiates immediate review of the outstanding rating upon becoming aware of any information that may reasonably be expected to result in downgrading of the rating; | Chapter III | 18-(c)
(21) PACRA engages with the issuer and the debt securities trustee, to remain updated on all information pertaining to the rating of the entity/instrument; | Chapter III | 18-(d)
Probability of Default
(22) PACRA´s Rating Scale reflects the expectation of credit risk. The highest rating has the lowest relative likelihood of default (i.e, probability). PACRA´s transition studies capture the historical performance behavior of a specific rating notch. Transition behavior of the assigned rating can be obtained from PACRA´s Transition Study available at our website. (www.pacra.com). However, actual transition of rating may not follow the pattern observed in the past | Chapter III | 14-(f-VII)
Proprietary Information