

# Benefiting from stability and volume growth



## Initiating with Overweight

From a regional perspective, Pakistan's oil marketing industry offers a unique growth theme. Based on this conviction, we initiate coverage on the sector with an Overweight stance underpinned by the following factors:

**A thriving oligopoly:** With over 80% market share shared between two companies and high barriers to effective competition, existing small and potential new oil companies are unlikely to pose any threat in an industry which lacks vertical integration.

**Policy and marketing margins holding steady:** Pakistan's oil marketing industry offers lower risk in the regional context given the stability in government policy and outlook for marketing margins. Prices set by the government guarantee a 3.5% margin to OMCs on regulated products (65% of total volume) and all subsidies are borne by the government.

**Growth opportunities in downstream industry:** We regard volume growth (5% CAGR over 2007E-10E) and attractive investment opportunities in infrastructure as key earnings growth opportunities, while the non-fuel segment remains a major untapped area.

### Pakistan State Oil a competitive leader

We re-instate coverage on PSO with a Buy recommendation and 12-month price objective of PRs407/share, based on (1) its strong volume growth (5% CAGR over 2007E-10E), (2) ongoing efforts to explore opportunities in the non-fuel segment, (3) favorable operating environment (dominant 65% market share), and (4) possibility of privatization in June 2007.

### Attock Petroleum Ltd banking on synergies

We initiate coverage on APL with a Buy recommendation. Our DCF-based price objective is PRs441/share providing a 19% upside potential to the current price. Our Buy rating is underpinned by (1) the anticipated strength of APL's earnings growth, (2) its ability to capture industry growth, and (3) the possibility of further leveraging group synergies.

### Risks

The risks are (1) sustained decline in product prices in the international market, (2) higher water and gas availability leading to lower fuel consumption, (3) slowdown in economic activity, and (4) exchange rate risk.

**Mohammad Fawad Khan**

Research Analyst  
KASB Securities

**Stuart B Smith >>**

+65 6330 7212

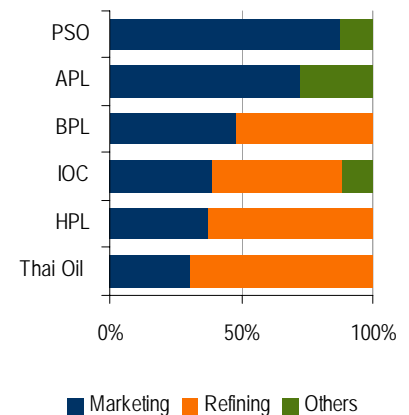
Research Analyst  
Merrill Lynch (Singapore)  
stuart\_b\_smith@ml.com

**Adrian Loh >>**

+65 6330 7220

Research Analyst  
Merrill Lynch (Singapore)  
adrian\_loh@ml.com

Chart 1: PSO and APL: High EBITDA contributions (%) from oil marketing business



Source: KASB Securities estimates

Merrill Lynch participated in the preparation of this report, in part, based on information provided by KASB Securities Ltd (KASB Securities). ^^^KASB Securities employees are not registered/qualified as research analysts under NYSE/NASD rules.

>> Employed by a non-US affiliate of MLPF&S and is not registered/qualified as a research analyst under the NYSE/NASD rules.

Merrill Lynch does and seeks to do business with companies covered in its research reports. As a result, investors should be aware that the firm may have a conflict of interest that could affect the objectivity of this report. Investors should consider this report as only a single factor in making their investment decision.

Refer to important disclosures on page 31 to 32. Analyst Certification on page 30. Price Objective Basis/Risk on page 30.

## Sector themes

From a regional perspective, Pakistan's oil marketing industry appears to offer a unique growth theme. Based on this conviction, we initiate coverage on the sector with an Overweight stance. We rate Pakistan State Oil (PSO) and Attock Petroleum Limited (APL) both Buys. However, we prefer PSO to APL.

In our view, two factors hamper a more meaningful comparison of Pakistan's oil marketing industry in the regional context. These are: (1) the industry's unique make-up which is solely based on the standalone marketing business, and (2) the downstream industry has remained exempt from government policy to subsidize end-product prices.

### Why we are Overweight on oil marketing

We are Overweight on Pakistan's oil marketing industry because we are convinced that it offers a strong investment case backed by the following factors.

#### Policy and marketing margins holding steady

Pakistan's oil marketing industry offers relatively lower risk in the regional context given the current stability in government policy and outlook for marketing margins. Prices set by the government allow a 3.5% margin to OMCs and all subsidies are borne by the government. We anticipate marketing margins (currently US\$2.07-4.48/bbl) to remain strong in the future as the prevailing pricing mechanism ensures that any volatility in oil prices is absorbed by movement in government taxes.

#### Thriving oligopolistic industry structure

With over 80% market share resting with two companies (PSO 65% and Shell 17%), high infrastructure investment requirement, retail outlet presence and strong brand recognition, we believe that existing small and potential new oil companies are unlikely to pose any meaningful competition in an industry which lacks vertical integration.

#### Growth opportunities in downstream industry

We regard volume growth (5% CAGR over 2007E-10E) and attractive investment opportunities in infrastructure as key earnings growth opportunities, while the non-fuel segment remains a major untapped area.

Among our listed sample of three downstream companies, namely, PSO, APL and Shell Pakistan Ltd (Shell), we initiate coverage on PSO and APL with Buy ratings. We believe both these companies are better placed to leverage their respective positions to outpace industry growth and capture emerging investment opportunities in the industry. Between the two, we prefer PSO in view of its size, potential to benefit from the untapped non-fuel retail sales, better dividend yield and upcoming privatization (targeted for 30 June 2007).

### PSO competitively placed in a growing industry

We re-instate coverage on PSO, Pakistan's largest oil marketing company with a market share in excess of 65%. Our Buy recommendation is premised on:

- Strong volume growth (5% CAGR over 2007E-10E)
- Ongoing efforts to explore opportunities in the non-fuel segment
- Favorable operating environment
- Investment projects; advantage of strong balance sheet
- Proposed privatization in June 2007

The stock is currently trading at P/E of 10.15x on 2008E earnings, relatively inexpensive multiple compared to its own historical average. Our 12-month, SOTP-based price objective is set at PRs407/share.

**Table 1: PSO: Valuation**

	PRsmn	PRs/share	% total
NPV of Forecasts	16,088	94	23%
NPV of Terminal Value	39,205	229	56%
Value of PSO's Future Free Cash Flows from operations	55,292	322	79%
Add: Receivables	5,685	33	8%
Receivables to government on product subsidy (80%)	7,784	45	11%
Less: Net Debt (Net Cash)	(5,750)	(34)	-8%
Add: Investments			
Pakistan Refinery Ltd	1,166	7	2%
PAPCO (1.2x of book value)	3,935	23	6%
Asia Petroleum Limited (1.2x of book value)	1,743	10	2%
Total Investments	6,844	40	10%
Total	69,870	407	

Source: KASB Securities estimates

## APL banking on synergies

A standalone oil marketing company in Pakistan, APL is ranked third with a market share of 8%. We initiate coverage on the stock with a Buy rating and 12-month price objective of PRs441/share based on DCF. Our recommendation is premised on:

- Expected strong earnings growth
- Ability to capture industry growth
- Possibility of further leveraging group synergies

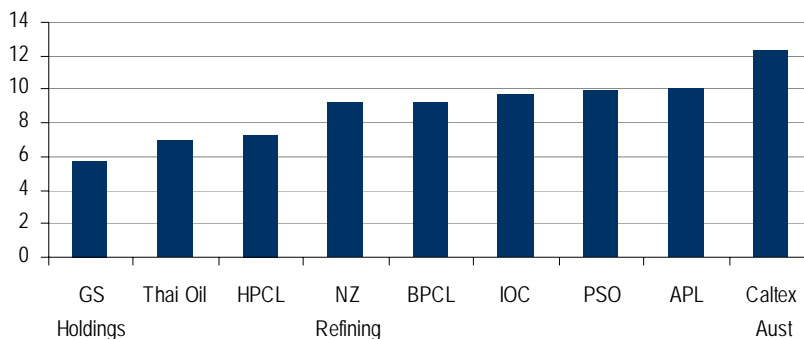
## Comparison of multiples

A comparison of earnings, EBITDA and dividend yield of downstream companies serves as a strong reference point, in our view.

### P/E – Room for expansion

This multiple is widely used in the local market. Due to the industry's unique structure, Pakistan's downstream companies currently have higher P/E's vis-à-vis their regional peers. In our view, current multiples have further room to expand in view of stable-to-rising earnings growth in future. Moreover, the impending privatization of PSO could provide further earnings upgrades and may see the stock trading above its historical multiples as the news flow on privatization continues. That said, we need to flag that this multiple is prone to distortion because of differing accounting policies.

**Chart 2: P/E: Earnings growth and policy stability justify expansion, 2008E**



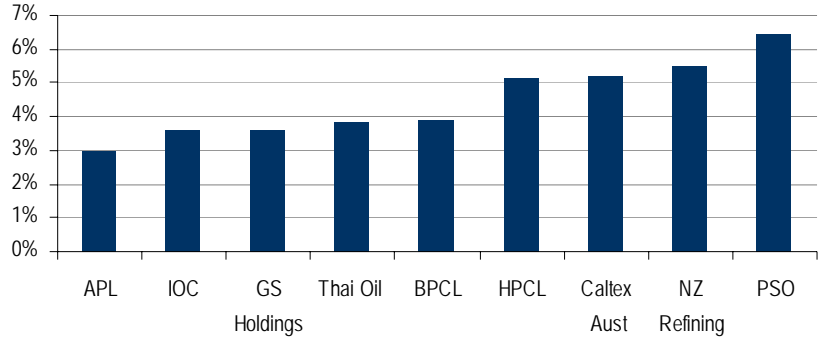
Note: APL and PSO have financial year-end in June.

Source: Merrill Lynch estimates, estimates for APL and PSO KASB Securities, estimates Thai Oil Phatra Securities

### Dividend yield – PSO stands out

A striking feature of PSO is its attractive FY07E (year-end June) dividend yield of 6%. This is 200-300bp higher than those of its regional peers. On the other hand, APL's FY07E (year-end June) dividend yield is low at 3%, however it is very much inline with regional peers. Given manageable capex requirements and expected earnings growth, we believe APL will be able to raise its dividend payouts going forward.

Chart 3: Dividend yield: Attractive for 2007E

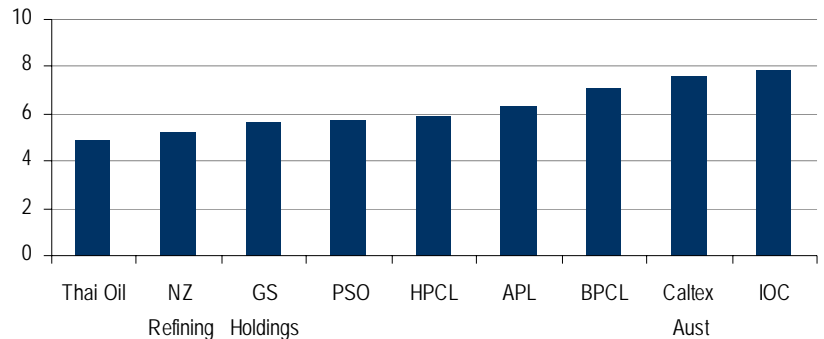


Note: APL and PSO have financial year-end in June.  
 Source: Merrill Lynch estimates, estimates for APL and PSO KASB Securities, estimates Thai Oil Phatra Securities

### EV/EBITDA – Discount to regional average

We have also compared Pakistan's downstream oil companies based on their EV/EBITDA and found that PSO and APL trade at a discount to their regional peers.

Chart 4: EV/EBITDA: PSO and APL trade at discount to peers, 2008E



Note: APL and PSO have financial year-end in June.  
 Source: Merrill Lynch Estimates, estimates for APL and PSO KASB Securities, estimates Thai Oil Phatra Securities

28 February 2007

**Table 2: Regional Comparison**

	ML ticker	QRQ	Rec	Price* (PRs)	P/E (x)			P/CF (x)			EV/EBITDA (x)			Yield		ROE
					06E	07E	08E	06E	07E	08E	06E	07E	08E	06E	07E	
SPC	SPCJF	B-1-8	Buy	4	8.0	7.9	10.1	6.7	6.3	7.7	5.6	5.2	6.4	7.9%	3.8%	19%
Reliance Inds	XRELF	B-1-7	Buy	1406	21.6	18.1	17.3	15.7	13.4	12.8	15.4	12.6	12.3	0.0	0.0	20.1%
Formosa Petro	FPTCF	C-2-7	Neutral	70	13.3	10.5	n/a	18.2	11.8	n/a	10.0	7.8	n/a	5.6%	6.4%	22%
PTT pcl	PETTF	C-1-7	Buy	212	6.8	7.3	7.0	5.2	5.8	5.5	4.9	5.3	4.9	5.2%	4.1%	38%
Thai Oil	TOJF	C-1-8	Buy	57	7.0	7.7	6.9	6.5	4.3	5.7	6.0	5.4	4.9	5.7%	5.2%	25%
Shell Refining	SRMMF	B-1-8	Buy	11	9.4	8.6	9.4	5.9	5.5	6.0	5.4	5.1	5.6	4.7%	3.4%	17%
BPCL	XBPCF	C-2-7	Neutral	336	8.3	7.8	9.2	1.7	12.0	4.6	6.3	6.1	7.1	3.6%	3.9%	4%
HPCL	XHTPF	C-1-7	Buy	292	7.9	7.0	7.3	3.1	16.9	5.4	7.4	6.3	5.9	4.4%	5.1%	5%
IOC	IOCOF	C-2-7	Neutral	435	12.8	8.9	9.7	3.9	5.6	6.8	9.3	7.7	7.8	4.7%	3.6%	16%
Sinopec	SNPMF	C-1-7	Buy	7	11.0	10.6	10.2	7.2	6.2	6.0	5.9	5.6	5.5	2.0%	2.1%	21%
Pakistan Refining	XPREF	C-1-7	Buy	208	4.8	9.4	5.5	3.0	(12.6)	4.0	1.3	3.9	1.6	0.0%	0.0%	21%
Pakistan State Oil**	PKSOF	C-1-7	Buy	358.5	8.2	12.1	10.1	39.8	14.8	12.5	3.6	5.7	4.8	9.5%	6.1%	22%
Attock Petroleum Limited**	XAKTF	C-1-7	Buy	383	11.0	9.9	8.7	8.9	11.0	9.3	7.5	7.2	6.34	2.4%	3.0%	49.3%
Average					9.4	9.5	9.4	4.4	9.2	5.5	6.4	5.7	5.8	4.4%	3.9%	23.2%

\*As of 22 Feb 07. \*\*PSO and APL have financial year-end in June.

Source: Merrill Lynch estimates, estimates for APL and PSO KASB Securities, estimates for Thai Oil and PTT Phatra Securities

**Table 3: Pakistan's downstream industry: SWOT analysis**
**Strengths**

Rising energy demand: Pakistan's energy growth estimated at 7-8% pa.

Healthy volume growth: Above-average economic growth rate and focus on transportation infrastructure plus higher consumption of transportation oil will lead to higher sales volume.

Favorable marketing margin calculation: Current marketing margin calculation mechanism (as % of end-product prices mechanism) benefits the downstream industry in view of expected recovery in government taxes and PRs depreciation against US\$.

Stable government policy: The key positive is the government's resolve not to burden the sector with any subsidy provided to end consumers.

Oligopolistic structure in the oil marketing industry: Two players dominate with 80% market share.

**Opportunities**

Benefiting from regional industry supply crunch: Firm product prices would translate into healthy marketing margins for the industry.

Possible delays in gas pipeline project: Furnace oil consumption would pick up as the power industry shifts to furnace oil from gas due to shortage of gas supply.

Strong electricity demand and higher-than-expected dependence on thermal electricity may provide opportunity for higher fuel oil growth.

Investment opportunities in storage and pipeline: Volume growth would necessitate investment in storage and pipeline.

Focus on alternative fuel: Government focus on changing the energy mix may create opportunities for the marketing players.

Source: KASB Securities

**Weaknesses**

Lack of integration: Sector-wide integration is low as the largest marketing company operates as a standalone player.

Deregulation of product prices: The government has yet to deregulate the prices on HSD and MOGAS.

Reliance on imported products: The indigenous production of petroleum products is not sufficient to meet domestic demand, thereby leading to heavy reliance on imports.

Subsidies not reflecting international prices: Since the government provides subsidy to end consumers, the retail prices of petroleum products do not necessarily reflect prices in international market.

**Threats**

Rise in exchange rate: Appreciation of the PRs against US\$ could lower earnings.

Steep decline in oil prices: A higher-than-expected decline would negatively affect earnings/valuations.

Adverse revision of existing petroleum policy: No historical precedents. Any change in policy could adversely affect realized margins prices.

Water availability: Higher water availability leading to higher hydroelectricity generation and lower demand for fuel oil.

Slowdown in economic activity: This can potentially lead to lower volume growth and can affect our earnings and valuations estimates for PSO and APL.

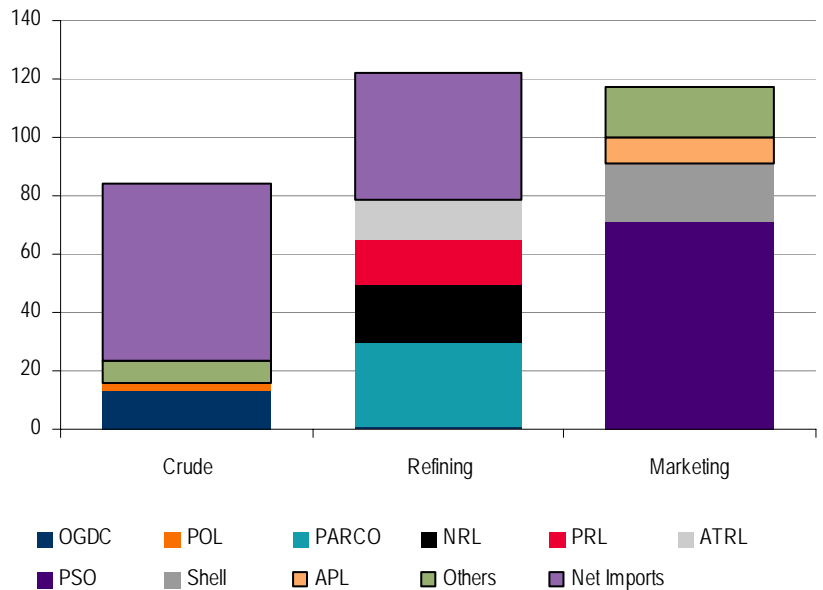
## Oligopoly to thrive

With over 80% market share resting with two companies (PSO 65% and Shell 17%), high infrastructure investment requirement and retail outlet presence, we believe the current oligopolistic industry structure will continue to thrive. While both APL and PSO are expected to gain market share in the future, we believe APL's aggressive rollout of retail outlets and infrastructure investment will enable it to outpace industry growth. For PSO, a renewed focus on high-margin products combined with its hegemony in power fuel should help to enhance its presence. We believe there is a strong possibility of integration in the industry as the push by marketing companies to differentiate their product offerings gather momentum.

## Unique industry structure

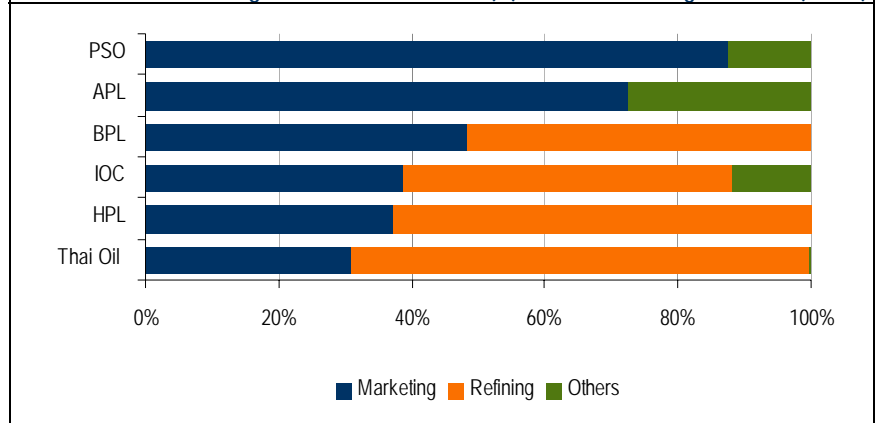
Pakistan's oil marketing sector is largely based on standalone marketing function, with small supply-side integration. The refinery coverage among oil marketing companies is low and only ~14% of total marketed products comes from refineries owned/controlled by marketers. This independent business structure makes Pakistan's oil marketing companies unique in the regional context where the norm is integrated models (refining plus marketing) providing high refinery coverage. In our view, government ownership and the ensuing separate policy formulation explain the current fragmented structure in the downstream industry.

Chart 5: Pakistan's downstream industry: Evident lack of vertical integration, 2006E (mmbbl)



Source: Pakistan Energy Year Book 2005, Oil Companies Advisory Committee

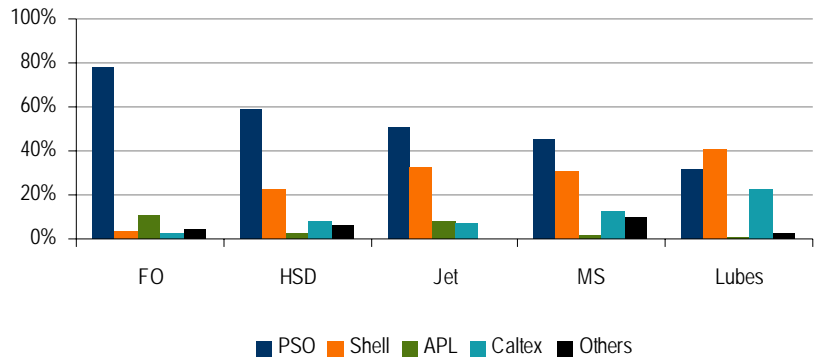
Chart 6: PSO and APL: High EBITDA contributions (%) from oil marketing business, (2006A)



Source: KASB Securities estimates

Despite the presence of 10 active companies, the industry structure is basically oligopolistic with the two major companies, PSO and Shell Pakistan, commanding a combined market share of over 80% of petroleum products. PSO is the industry leader with total market share of over 65%. APL posted a strong performance in 2006, improving its market share from 3% to 8% after the Attock Group acquired National Refinery Limited, the second-largest refinery in Pakistan.

Chart 7: Pakistan oil marketing industry: Market share, 2006A



Source: Oil Companies Advisory Committee

Given the confluence of factors from high investment requirement to retail outlet presence and brand recognition, we do not expect the current smaller companies to change the industry structure in a significant way. In short, we expect the oligopolistic structure to continue to thrive, giving the big companies the advantages of scale, cost efficiencies and flexibility in operations.

### Key emerging trends

#### Price strategy not the route to gain market share

We do not see OMCs taking the price route to secure market share in the transportation fuel segment. Our rationale is as follows:

- Prices are rarely an attraction among quality-conscious retail fuel consumers. The high market share of Shell Pakistan and Caltex in retail products, despite their relatively low number of retail outlets, fully reinforces this view.

- In the current standalone marketing model, retail products are the major earnings and revenue drivers. While a new company would want to build its financial muscles over the medium term by relying on these products, existing companies in the sector are unlikely to feel the need to lower margins to push through the products.
- Over the past few years, oil marketing companies have focused on branding transportation fuels by differentiating products based on chemicals additive. This increasing trend of differentiation leaves little room for a price war on these products. We expect OMCs to place more focus on value-added products and service. Key value-added products to be introduced are (1) ethanol blending (PSO has already embarked on a pilot project on 10% ethanol blending), and (2) blending of MOGAS and HSD with engine-cleansing chemical and/or green fuels.
- As furnace oil (FO) becomes increasingly treated like a commodity product, price cutting to gain market share will become more prevalent.

#### High barriers to entry for new entrants

While potential new entrants may focus on a particular segment, the current entrenched positions of existing companies suggest that broad-based entry into the sector would be difficult, to say the least. The possible niche segmentations are in imports of fuel oil business and marketing of lubes product.

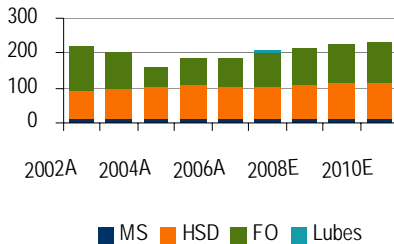
#### Integrated models to emerge

We anticipate integration in the industry as new refineries establish their marketing arm and current marketing companies eye integration over the medium-to-long term. Our arguments for the push toward industry integration are as follows.

With the commissioning of new refineries and expanded capacities, product oversupply might be inevitable and we believe this development could prompt the standalone refineries to opt for an integrated model. However, given the size of the investment required and the considerable time lag before gaining meaningful clout, we believe the existing companies will have an advantage over newer ones. Currently the government coordinates the procurement of products in the event of supply shortage, while refineries have to source customers for surplus products.

In the case of PSO, it is still without a supply source despite its substantial market share of over 65%. Following the government's rejection of its offer to acquire National Refinery in 2005, we believe PSO may now opt for equity investment in new refineries instead.

**Chart 8: PSO: Volume trend ('000bpd)**



Source: Merrill Lynch estimates, PSO

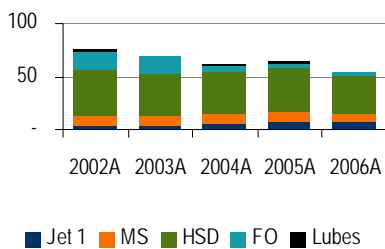
## Likely strategies of key participants

### PSO (market share 65%) – competitively placed leader

With a network of over 3,800 outlets and strong brand recognition, we believe Pakistan State Oil will emerge as an aggressive competitor in the future landscape. We expect the company to be more focused on its market share by:

- Launching marketing initiatives (quality and service plus loyalty cards) to protect its position in the retail fuel product categories. While competition from existing and new companies will heighten, we believe PSO's renewed focus on retail products and wide outlet reach will support its market share.
- Revamping existing outlets and opening new ones. In the past three years, PSO has refurbished over 700 outlets and we expect this strategy will continue to be implemented over the next 2-3 years.
- Optimizing product portfolio with greater focus on high-margin products such as auto lubricants, CNG and LPG.
- Investing further in oil movement (pipeline) and storage
- Finding a stable oil supply source (backward integration) in future. Having been denied participation in the privatization of Pakistan's second-largest refinery, we see a high possibility of PSO developing a joint venture in the refining business with any of the new companies in the industry. In our view, such a venture will create a win-win situation for both parties. While PSO will gain a supply source to support its market share, the refinery company will have the advantage of large buyers with high marketing volume (over 10mn ton volume per annum).

**Chart 9: Shell Pakistan: Volume trend ('000bpd)**



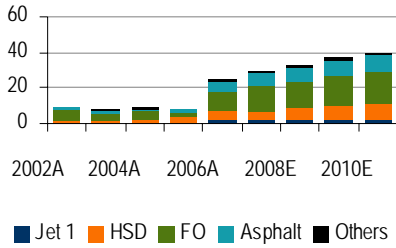
Source: Shell, Pakistan Energy Year Book 2005

### Shell Pakistan (market share 17%) – defending the trough

We do not expect any major change in Shell Pakistan's strategy to focus on high-margin retail products, such as auto lubes and CNG. Indeed, its key challenge remains the keen competition in the lubricant and CNG segments. These two segments make up the company's main business and it appears that its market share is under threat.

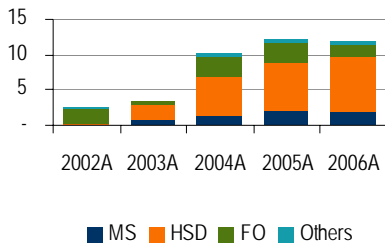
In the CNG segment, competition is also on the rise from independent CNG outlets which do not require marketing license/affiliation to operate. Currently Shell has the highest market share in the lubricant segment (~40%) despite a low presence in terms of retail outlets. This is because of consumers' perception that it offers better quality products. That said, the company is in the midst of consolidating its outlets which number over 1,200. Of these, about 800 outlets have been revamped.

Chart 10: APL: Volume trend ('000bpd)



Source: Merrill Lynch estimates, APL

Chart 11: Total-Parco: Volume trend ('000bpd)



Source: Pakistan Energy Year Book 2005, OCAC

### APL (market share 8%) – strong group synergies

We believe Attock Petroleum Limited is taking steps to sustain the growth it has achieved in the recent past by (1) improving market share in retail (gasoline, gasoil and lubricants) and industrial products, (2) investing in infrastructure (build storage facility and open new outlets), and (3) tapping the export market in Afghanistan. Overall we have conservatively assumed a 2.2% increase in market share to 10% by FY10 from 8% in FY06.

We are anticipating an expansion of APL's business model that will allow the company to fully tap its group-level synergies. The Attock Group operates two refineries which are strategically located in northern and southern Pakistan. Together, both refineries supply 30% of domestic consumption. Within just one year, APL has opened 37 pumps, taking the total to 145 commissioned pumps. It plans to add 61 pumps in 2007. We expect APL's retail network to double in size over the next four years to 300 outlets.

### Total-PARCO (market share 4%) – integration benefits

With good co-branding, procurement and supply availability through its JV partner, we believe Total-PARCO (TTPL) can garner a higher market share over the medium term, particularly in industrial products. A small but growing competitor, Total-Parco is a 50:50 joint venture between Total of France and Pak Arab Refinery Ltd, Pakistan's largest refinery with 100,000bpd capacity. With a dual focus on high-margin products and industrial fuel, TPPL has already made strong inroads with total market share of 4% in just five years. In retail fuel, the company is benefiting from the marketing resources and experience of Total of France, while enjoying strong supply backup in gasoline and power fuel (two supply deficit fuel) from Pak Arab Refinery.

## Policy stability and firm margins

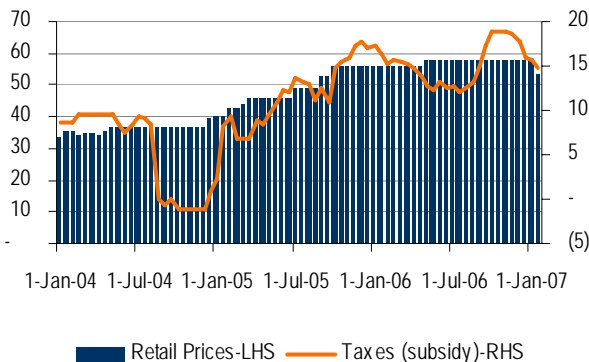
Pakistan's downstream industry has been exempt from the government's policy of subsidizing end-product prices. Given the expected recovery of government taxes lost in subsidizing end-product prices, coupled with the Pakistan rupee's depreciation against the US\$, we believe marketing margins (calculated as 3.5% of presales tax price) will continue to remain firm. Indeed, after six years of reform, the government's role in the oil marketing industry has progressively been minimized. We see improved operational and pricing freedom for OMCs as the government continues its drive to deregulate the industry.

## Oil price inflation – policy stability a positive

One of the things that helped lower the risk profile of local oil marketing companies vis-à-vis their regional peers was policy stability. The government was committed to pursuing a stable policy while curbing the impact of oil price inflation on end consumers. No downstream companies (refining and marketing) has had to bear the burden of subsidies. The government achieved these twin objectives in the following ways.

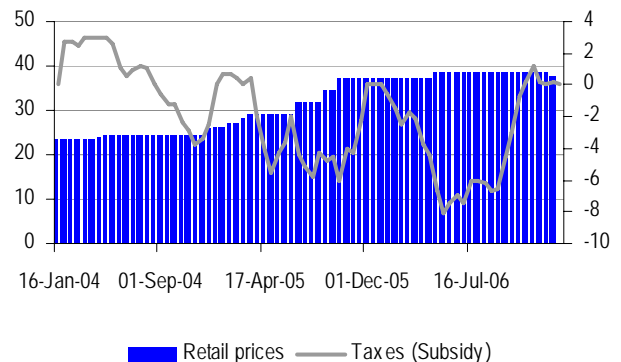
- Cutting back its own share of taxes and levies built into petroleum product prices called Petroleum Development Levy (PDL). In Pakistan, the petroleum product prices carry a volume-based development tax apart from the general sales tax and excise duty. The amount of PDL imposed on per liter of any product (generally, high speed diesel, motor gasoline and light aviation fuel) is a function of government revenue requirement and government policy of stabilizing domestic prices. As oil prices increase, the government progressively reduces the PDL on domestic products.

Chart 12: Petroleum product taxes (PRs/liter) on motor spirit



Source: Oil & GAS Regulatory Authority, OCAC, KASB Securities estimates

Chart 13: Petroleum product taxes (PRs/liter) on high speed diesel



Source: Oil & GAS Regulatory Authority, OCAC, KASB Securities estimates

- Cross-subsidizing the high-volume products consumed by the low-income group (ie, HSD) through higher taxes (PDL) on aviation fuel and MOGAS.

Should the PDL collection on MOGAS and aviation fuel be insufficient to cover the revenue loss or subsidy on HSD, the government can either pass on the cost to end consumers, or keep retail prices unchanged. For the latter option, the differential between ex-refinery prices on HSD and tax collection on other products would create net receivables of oil marketing companies to the government. These receivables, called Petroleum Development Claims, are paid from either budgetary subsidy or carried forward with the expectation that any softness in future prices will enable the government to collect taxes on MOGAS or other products.

We estimate that the government provided a net subsidy of PRs3bn in 2005 and about PRs13bn in 2006. It collected taxes of PRs11bn and PRs20bn, respectively, during 2005 and 2006 while providing subsidies on HSD to the tune of PRs14bn and PRs34bn for the corresponding periods. As of September 2006, the government has provided a subsidy of PRs7.bn. However, the recent drop in petroleum product prices and the ensuing tax collection have eliminated the effect of the subsidy, turning petroleum products into a net source of revenue (as of end-2006) to retire receivables of oil marketing carried from 2005-06. As of end-2006, the receivables totaled PRs12bn, down from PRs24bn in 4Q FY06. During 2005 and 2006, though the net subsidy was nominal, the government took a hit on revenue collection of roughly PRs40-50bn in order to limit the impact of oil price inflation on end consumers.

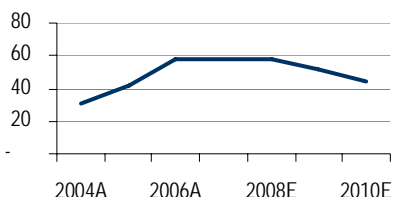
**Table 4: OMC receivables on government (PRs bn), Jan 2007**

PSO	8.0
Shell	3.2
APL	0.5
Others	0.3

Source: Merrill Lynch

This stability in policy comes against the backdrop of an oligopolistic structure in the downstream industry where over 65% of market share is in the hands of the state-owned Pakistan State Oil. The only direct impact of end-consumer subsidy on the OMCs has been the interest cost they have to bear to finance the receivables which are generally compensated by stretching their tax payments (corporate and sales tax) to the maximum allowable time period. The indirect cost has been the potential loss of marketing margins (linked with end-product prices) which did not increase in proportion to oil price inflation.

**Chart 14: Oil prices to come off (US\$/bbl)**



Source: Merrill Lynch estimates

## Stable marketing margins

In our view, Pakistan's oil marketing companies enjoy relatively low earnings volatility because their marketing margins, a key earnings driver, have been stable given that these are determined as a percentage of retail product prices while only 65% product prices are regulated.

Retail prices have been relatively stable in the past 12 months, with only two end-product price revisions in May 2006 and January 2007 despite the fact that prices are reviewed every fortnight under the pricing regulations. Clearly, the volatility in ex-refinery prices in the international market has been absorbed by changes in government taxes, making marketing margins stable in the process. In an increasing oil price scenario, the government will avoid raising end-product prices by reducing its share of taxes built into the product prices and, if necessary, providing subsidies (not borne by the oil marketing industry). Should the oil price decline, the government is expected to raise its share of taxes in product prices (see details below Table 5).

While the marketing margins for Pakistan's OMCs lack a strict comparison due to the industry's unique standalone model, we view the current margins on retail regulated products as healthy at US\$2.53-4.48/bbl. Dealer margins and freight costs are separately provided in the pricing mechanism. Relative to retail products, the margins on deregulated power fuel (furnace oil) are low at US\$1.3-2.07/bbl given the commodity-like nature of power fuel. In the event of declining oil prices, we do not expect the government to pass on the full benefit to end consumers, hence margins are likely to remain firm. The retail prices on transportation fuels (MS and HSD) in Pakistan come in at the lower end in the regional context.

Table 5: Pakistan: Product prices and marketing margins, 16 February 2007

	Product prices (PRs/liter)	Marketing margins (PRs/liter)	Marketing margins (US\$/bbl)
High Speed Diesel( Gasoil)	39	1.1	2.91
Motor Spirit (Petrol)	58	1.57	4.48
Kerosene	35	1.02	2.68
High Octane Blending Comp.	65	1.89	4.97
Light Diesel Oil	33	0.96	2.53
Furnace Oil	31.43	0.79	2.07

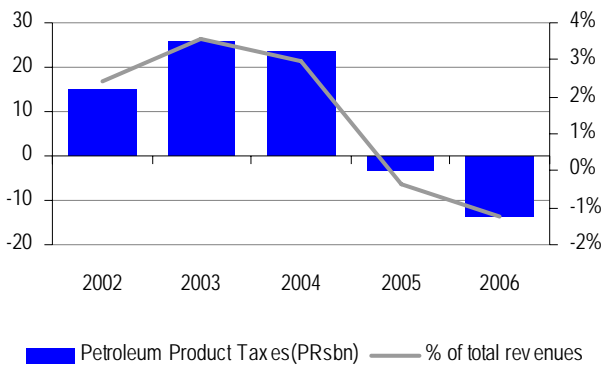
Source: Oil & Gas Regulatory Authority, KASB Securities

## Recovery of taxes

The government is expected to recover its share of taxes which was previously built into the product prices before passing on the full benefit of expected future oil price decline to end consumers.

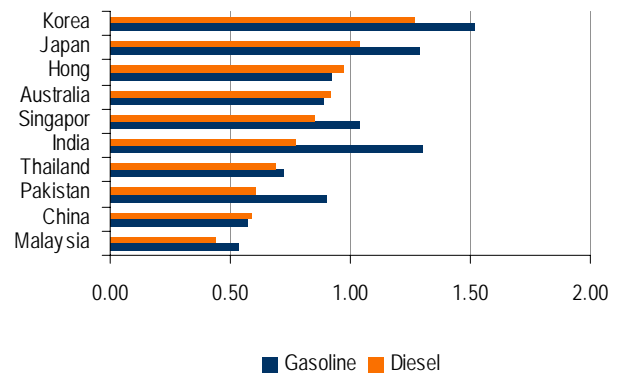
- **Significant source of government revenue:** Historically, taxes on petroleum products constitute a significant 6-7% of total government revenue. Following the fortnightly revision on 16 January 2007, the volume-based tax on HSD has reduced to PRs1.16/ liter. The total share of government taxes on HSD prices has slipped to 7-10% in 2007 from 20-25% in 2004. The government used to collect PRs3.5-4/liter on diesel before the oil price inflation in the past 3-4 years.
- **Likely increase in government fiscal deficit:** From an expected fiscal deficit of PRs396bn in FY07 (4.5% of GDP), we estimate the deficit will rise to PRs433bn in FY08.

Chart 15: Government tax collection from petroleum products turned negative due to subsidies



Source: OGRA, Pakistan Economic Survey

Chart 16: Comparison of retail prices (US\$/liter) in different countries. Pakistan comes at the lower end



Source: Merrill Lynch

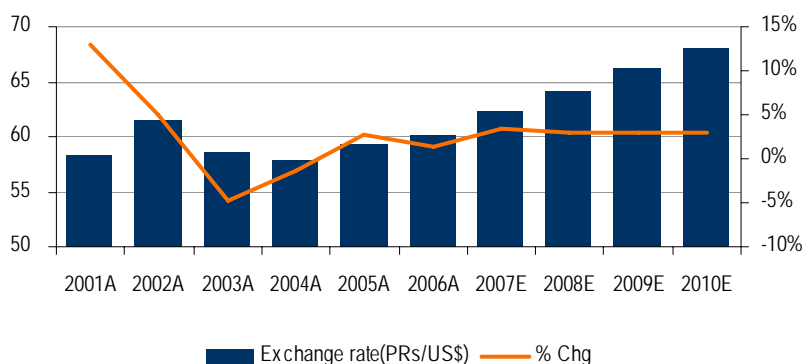
## Pakistan rupee depreciation against US\$

As ex-refinery prices are linked with import parity prices, an expected 3% depreciation in PRs against the US\$ would bolster PRs-based marketing margins for oil marketing companies. We highlight the following reasons that could trigger a rupee depreciation.

- Global withdrawal of liquidity would make attracting foreign capital difficult.

- Major central banks (eg, BoJ, ECB, RBI and PBC) are expected to tighten their monetary policy.
- Global tightening cycles are negative for high-yielding current account deficit currencies.
- Pakistan's sovereign Eurobond (US\$-denominated) yields have fallen sharply recently as country risk premiums widen in the wake of rising macro-economic imbalances.

**Chart 17: Expected currency depreciation positive for OMCs (PRs/US\$)**



Source: Merrill Lynch estimates, State Bank of Pakistan

### Enhanced pricing and operational freedom

The government's drive to deregulate and liberalize the oil marketing margins industry over the past six years seems to have paid off as its role has been progressively reduced to mere policy formulation and ensuring that its revenue targets for petroleum product sales are met. As a result, OMCs now enjoy enhanced operational and pricing freedom.

The import regime has been deregulated completely and private-sector parties are allowed to fill the supply deficit gap. An independent regulatory authority, called the Oil & Gas Regulatory Authority (OGRA), has been tasked with regulatory oversight, performing regular pricing reviews of remaining regulated products and procurement coordination of deficit products besides notifying ex-refinery prices.

**Table 6: Pakistan's oil marketing industry: Chronology of regulatory changes**

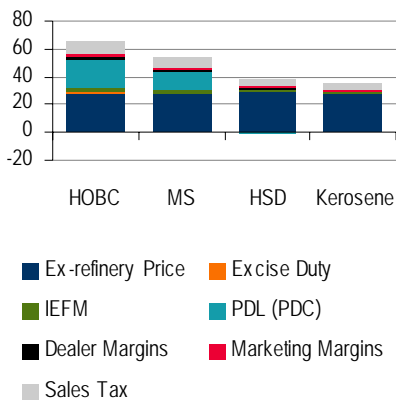
Jul-00	Fuel oil import and price deregulated
Sep-00	LPG price deregulated
Mar-07	Self management of freight pool implemented through OCAC
Jul-07	Imports of FO Deregulated
Mar-07	OGRA ordinance promulgated
Mar-07	OMC margins revised up to present levels
Sep-07	OGRA introduced rules governing marketing industry
Jan-06	Modification in OMC rules (Paid up capital requirement beefed up)
Jul-07	NRL (second largest refinery) privatized, Attock Group emerged successful bidder
Mar-07	Government adjusted the formula for calculation of marketing margins, exclude sales tax from marketing margin calculation
Apr-07	Pricing Authority transferred to Oil & gas Regulatory Authority from OCAC

Source: Merrill Lynch

### Pricing mechanism

Prices of regulated products (gasoil (HSD), gasoline, kerosene, and light diesel oil) are pegged to international prices through a formula agreed between the government and the industry players. The end-product prices are determined on a fortnightly basis. High speed diesel prices, though deregulated, are not yet completely liberalized. Under the current pricing agreement, OGRA identifies the maximum price of HSD along with the maximum marketing margin which OMCs are allowed to charge the end consumers. These marketing margins, however, are calculated using the same formula as that for regulated products.

Chart 18: Regulated product price build up (PRs/ liter)



Source: OGRA, Merrill Lynch

OMCs are allowed to give discounts from marketing margins to dealers to market the products. In the furnace oil segment, competition has kept prices of deregulated FO within a range (marketing margins on FO has remained at 2.5-3.5%). On lubes and auto fuel gases (LPG and CNG), the margins are quite high, ranging from 25% to 28%. Table 7 illustrates the general formula for calculating the marketing margins of regulated products.

Table 7: Regulated product pricing mechanism

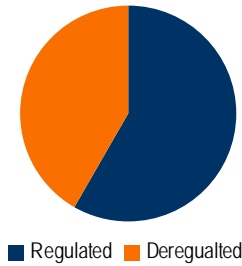
Pricing element	ML comments
Retail Prices	Uniform across Pakistan, freight equalization mechanism eliminates differences in product movement cost across region.
Sales Tax	Levied at 15%.
Dealer Margins (if applicable)	4% of sum of all items except ST and marketing margins.
Marketing Margins	3.5% of sum of all items except ST and dealer margins.
Inland Freight	Except for FO, actual freights are pooled and distributed evenly, administered by the Oil Companies Advisory Committee.
Petroleum Development Levy/(Petroleum Devt Claims)	Government taxes per liter of unit/(Claims by OMC to government).
Excise Duty (if applicable)	Flat rate of PRs0.88/liter on motor gasoline.
Ex-refinery prices	Ex-refinery prices (this along with import price make up input for retail price calculation).
Tariff (if applicable))	6% on LDO, kerosene and aviation fuel, 10% on HSD.
Import Parity Prices	Landed cost of product
Incidentals (1.09% plus wharfage)	Incidentals like LC commission, ocean losses etc.
Freight (actual)	Actual published freight.
Product Premium	Actual.
15-day average FOB price (Arab Gulf)	Published prices in Platts Report.

Source: OGRA

During 2006, the government adjusted the formula for the calculation of marketing margins and dealer margins. The adjusted formula, which has been in place since March 2006, calls for the determination of margins based on retail prices prior to sales tax. Previously, the margins were calculated based on retail prices (including sales which allowed OMCs to earn a margin on government taxes as well). Although the government's intention was to remove the anomaly in the margin calculation as the retail prices had only PRs0.15-0.3/liter impact, this modification caused the OMCs' absolute margins on regulated products to decline by 19-20%.

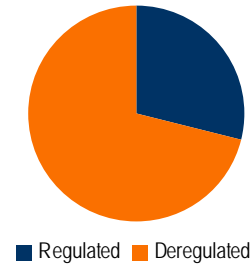
For APL, however, its gross margins are likely to be less affected compared to PSO because a major portion of its revenues comes from deregulated products and/or export sales. Charts 22-23 track the gross margins of the two companies.

Chart 19: PSO: Product mix, June 2006



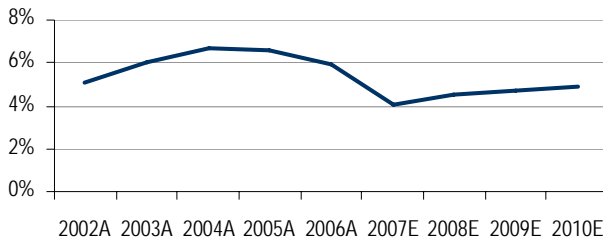
Source: PSO, Pakistan Economic Survey 2005

Chart 20: APL: Product mix, June 2006



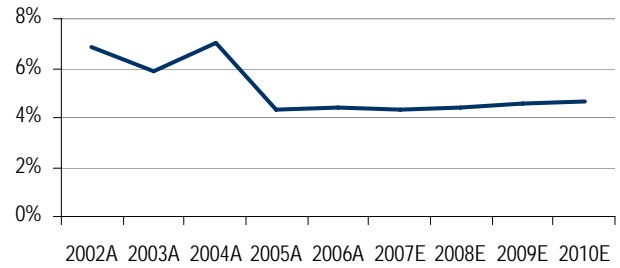
Source: APL, Pakistan Economic Survey 2005

Chart 21: PSO: Gross margins (%)



Source: PSO, KASB Securities estimates

Chart 22: APL: Gross margins (%)



Source: APL, KASB Securities estimates

## Future reforms to address remaining issues

We believe the government will continue to reduce its role in the oil and gas business and we see signs of further reforms aimed at addressing the remaining operational and deregulation aspects.

### Abolishing system of uniform prices for regulated products

This would result in different prices at different retail outlets, thereby reflecting actual freight expenses. To keep prices constant, the total freight cost from four main installations to the 29 primary depots and secondary freight pool cost (from depots to retail outlets) are pooled in respective accounts for different products. The pooled cost is averaged out and loaded on respective petroleum products. This system results in implicit subsidies to consumers staying further away from the refining and import facilities. The new system would reflect freight economics and provide freight efficiencies. The change is likely to occur in stages. The first phase will see a proposal to reduce the number of primary depots from 29 to 15. Phase 2 may result in complete liberalization of the freight element.

In our view, PSO would be the key beneficiary of such a development as the company enjoys strong infrastructure and pipeline support for product logistics. It stands to benefit from (1) pricing power over other players, (2) cost savings through its current infrastructure, and (3) hospitality charges on usage of its infrastructure by other OMCs. However, abolishing the secondary pool may prompt PSO and Shell to hasten the rationalization of their retail outlets as many

of the outlets might be rendered commercially unfeasible. We have not quantified the impact of the proposed change given the uncertainty over its timing and direction. Table 8 provides the current freight cost for the major products.

**Table 8: Freight cost of different products, as of 16 January 2007**

	Freight (PRs/liter)	US\$/bbl
Motor Spirit	1.74	4.5
High Speed Diesel	1.4	3.4
High Octane Blending Component	3.46	9.2
Kerosene	1.88	4.9
Light Diesel Oil	2.21	5.8

Source: OGRA, KASB Securities

## Price deregulation

Over the medium term, we expect the government to continue to deregulate prices. We see two prerequisites for the implementation of this change.

- Strengthening of intuitional capacity in Oil & Gas Regularity Authority (OGRA) to guard against potential abuses or collusive behavior. This is particularly important after the privatization of the largest OMC (from state-run oligopoly to private oligopoly).
- Abandoning the present system of uniform product pricing as detailed above.

The liberalization of product prices may lead to margin expansion for MOGAS and HSD as OMCs have begun differentiating these products based on different additives. However, we do not think the government will aggressively deregulate product prices yet given the upcoming general election in 2007, volatility in the crude market, high product pricing environment and cross-subsidy mechanism.

**Table 9: Pakistan downstream industry: Applicable prices and trade regulations**

Activity	HSD	HSFO	LSFO	Motor Gasoline	LDO	HOBC	Kerosene	Jet Fuel	LPG	Naphtha	Crude
Imports by private sector	Allowed: Local production lifted first	Allowed: Local production lifted first	Allowed	Surplus production; being exported	Allowed: Local production lifted first	Allowed; Local production lifted first	Allowed: Local production lifted first	Allowed: Local production lifted first	Allowed	Surplus production	Not allowed; refineries can import
Import Parity Price (IPP) / Export Price	Determined as caps by OGRA	No restrictions	No restrictions	Determined by OGRA on import parity	Determined by OGRA	Determined by OGRA	Determined by OGRA	Determined by OGRA	Saudi ARAMCO plus US\$12.5/ton for freight	Surplus product;	Determined by refinery;
Ex-Refinery (producer) price with protective duty	Determined by OGRA, with 10% protective duty on IPP	Deregulated-Refinery	Deregulated-Refinery	Determined by OGRA	Determined by OGRA, with 6% protective duty on IPP	Determined by OGRA	Determined by OGRA, with 6% protective duty on IPP	Determined by OGRA, with 6% protective duty on IPP	Determined by LPG producer Committee	N.A	N.A
Ex-29 Depot price (wholesale)	Determined by each OMC, based on its average cost of supply that is local and import, but below OGRA cap	Deregulated-OMCs	Deregulated-OMCs	Determined by OGRA	Determined by OGRA	Determined by OGRA	Determined by OGRA	Determined by OGRA	Deregulated - "Gentle" advice to keep price reasonable	N.A	N.A
Retail price	Determined by OMCs	Determined by OMCs	Determined by OMCs	Determined by OGRA	Determined by Retailers	Determined by OGRA	Determined by Retailers	Determined by OMCs	Deregulated	N.A	N.A
Marketing margins	Fixed at 3.5%	Market Driven	Market Driven	Fixed at 3.5%	Fixed at 3.5%	Fixed at 3.5%	Fixed at 3.5%	Fixed at 3.5%	Market Driven	Market Driven	Market Driven

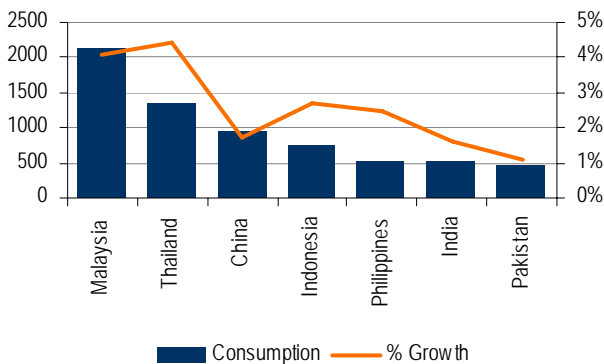
Source: OGRA

## Opportunities aplenty downstream

Volume growth and infrastructure investment are, in our view, the key earnings growth opportunities available to oil marketing companies in Pakistan. Meanwhile, the non-fuel segment remains untapped. With economic growth likely to be sustained at 6-7% and power fuel demand on the rise as opposed to low energy consumption per capita historically, we believe the downstream oil industry is poised to enjoy an uptrend in volume (four-year CAGR of 5% over 2007E-10E). This would make Pakistan one of the fastest-growing oil markets in Asia Pacific. Mass scale conversion to CNG vehicles (an estimated 70% of passenger cars converted to CNG in 2006) and unavailability of technology has reduced future substitution risk from alternative fuels, in our view.

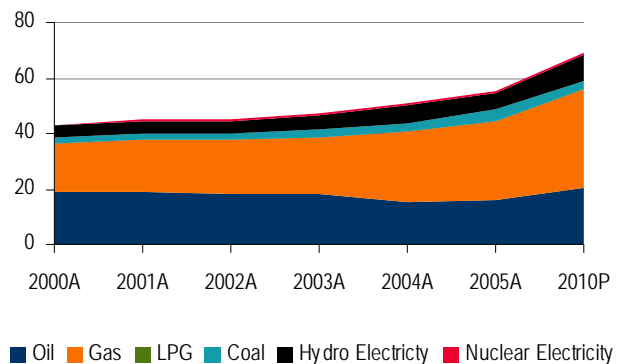
Sustained economic outlook for the medium term should set the stage for energy needs to burgeon, in our view. The government estimates that energy demand will grow at 7.5% CAGR (1.2x GDP). Future energy growth would come against the backdrop of historically low consumption of energy. Compared with the regional average of 1,036kg oil equivalent, Pakistan's per capita energy consumption has been low at 455kg oil equivalent. The higher contribution of real sector growth in the overall economic growth would help to narrow the prevailing gap in energy consumption vis-à-vis regional energy consumption.

Chart 23: Pakistan: Low per capita energy consumption (kg oil equivalent)



Source: World Economic Outlook 2006

Chart 24: Oil consumption enjoys upside to government forecasts of primary energy mix (mn tons)



Source: Pakistan Energy Year Book 2005, Sui South Gas Company

Oil and gas contributes about 84% in the primary energy mix. Over time, oil share has reduced from 50% to 38% due to the government's push to substitute fuel oil for gas. However, the government estimates that the primary energy mix would remain largely unchanged by 2010. We see risks to its projections of primary energy mix from the following sources:

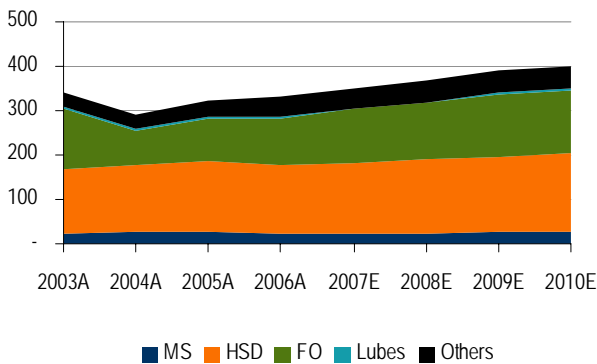
- Implementation of proposed gas import projects (LNG and gas imports from Iran)
- Hydro capacity generation in the country
- Potential delay in construction of power projects

In our view, there remains upside to petroleum share in the energy mix should any of the above-mentioned risks materialize.

## Petroleum product consumption

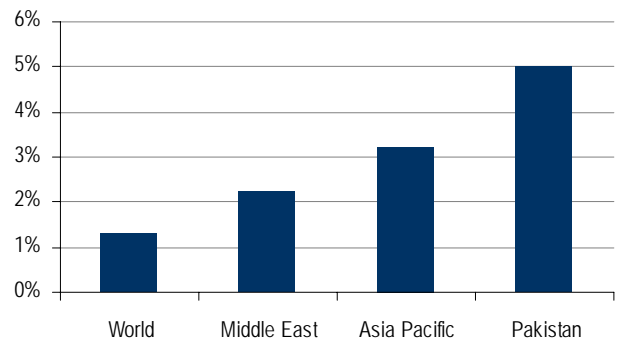
With the GDP growth rate expected to remain above-average (6-7%) over the next few years and the government's renewed focus on building transportation infrastructure, we believe overall petroleum product consumption in Pakistan should begin to look up. We estimate growth of 5% over 2007E-10E (0.76x of GDP). The anticipated growth should lift Pakistan's oil consumption to 400,000bpd (19.35 mn tons) by 2010 from 329,000bpd (15.9mn tons) in 2006. On a comparison to consumption growth in different regions, Pakistan seems poised to experience one of the highest growth in petroleum product demand.

Chart 25: Pakistan: Product consumption ('000bpd)



Source: OCAC, Merrill Lynch estimates

Chart 26: Comparison of oil consumption (2007E-2010E)

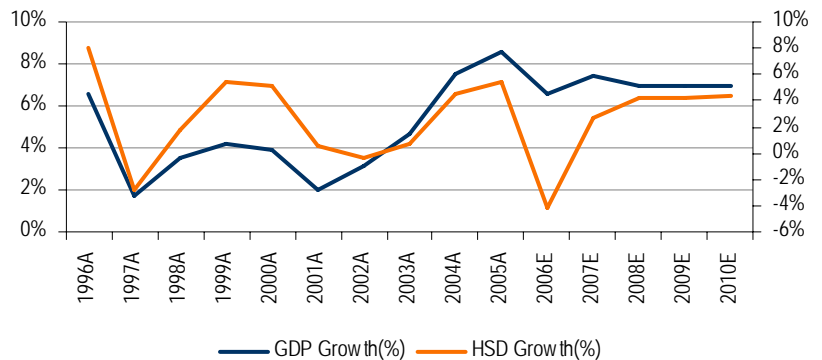


Source: Merrill Lynch Estimates

## HSD – counting on increasing transportation need

The growth in this transportation fuel consumption is largely a function of economic activity as evident in the strong correlation between the two. Historically, HSD growth was 2-3% below that of real GDP. We forecast HSD consumption to grow by 3% over the next four years based on its historical relationship with real GDP growth. We see considerably low risk of substitution for HSD. There has been a general lack of appropriate technology for the CNG fuel to make this feasible

Chart 27: HSD in Pakistan: Expected economic growth to drive consumption



Source: Pakistan Economic Survey 2006, Merrill Lynch estimates

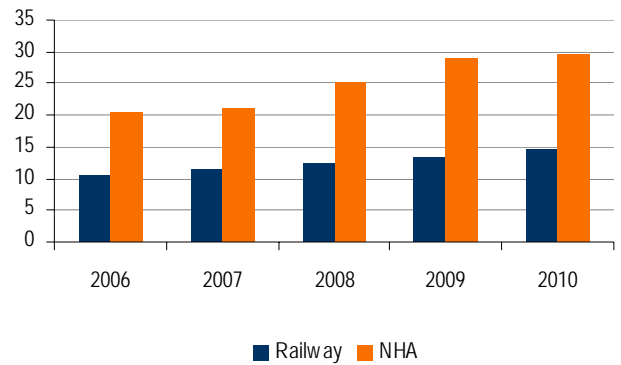
We may see potential upside in HSD consumption coming from improved transportation infrastructure. Overall, the government estimates an increase in passenger traffic by 12% for 2006-2010 while freight traffic is forecast to grow by 7% as the government steps up efforts to build roads and lay railway tracks. For this the government expects to spend on average PRs35bn (US\$580mn) pa.

Chart 28: Pakistan: Expected jump in transportation



Source: Pakistan Planning Commission

Chart 29: Pakistan: Infrastructure budget (PRs bn)



Source: Pakistan Planning Commission

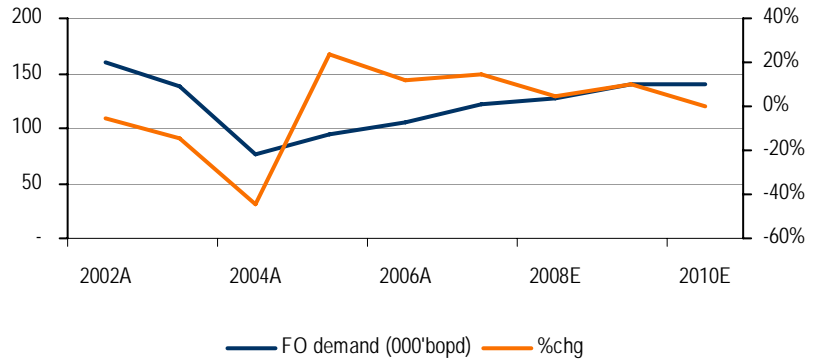
### Furnace oil – fuel-based power generation to boost demand

We believe the strong recovery of power fuel demand in the past two years will continue over the medium term. Pakistan’s power fuel demand has seen a major drop in 2001-04 as the government focused on substituting power fuel with gas for power generation. Power fuel demand plunged by 55% as a result. However, demand recovered sharply in 2005-06, recording growth of 37%.

Going forward, we believe power fuel demand would become much more stable. We estimate a four-year CAGR of 7% over 2007E-10E based on demand by existing and upcoming oil-based power plants. We have conservatively assumed a 3% increase in load factors of existing plants (from ~18% to 21%) and have taken a 60% load factor for upcoming oil-based capacities, 5% lower than government guarantees throughput at 65% for new IPPs.

We believe the government’s dependence on fuel-based IPPs have risen in recent times as these IPPs are the major source for meeting incremental electricity demand. This is evident from 1.6x jump in load factor of major IPPs in FY06. Even in 1Q FY06 which had been historically a low load factor period, the dependence was high. In the absence of any abrupt increase in hdyel power (based on higher-than-average rainfall) and large-sized gas discovery, the fuel oil-based IPPs are the only ones which currently carry idle capacity to meet the incremental demand.

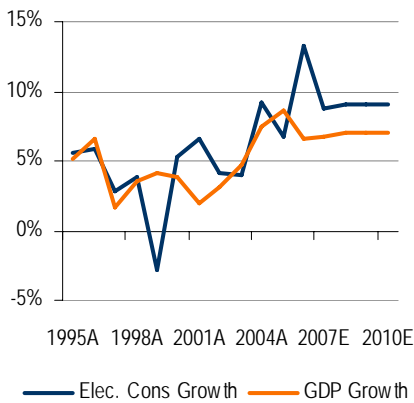
Chart 30: Pakistan: Expected uptrend in furnace oil consumption ('000bpd)



Source: Pakistan Energy Year Book 2005, KASB Securities estimates

Currently, 12.8GW of power supply is based on thermal fuel (fuel and gas) representing 66% of total installed capacity, while 13.3GW of supply has been proposed by the private sector to pre-empt supply shortage in the future. We believe the government will continue to rely on fuel oil-based power projects owing to the following factors.

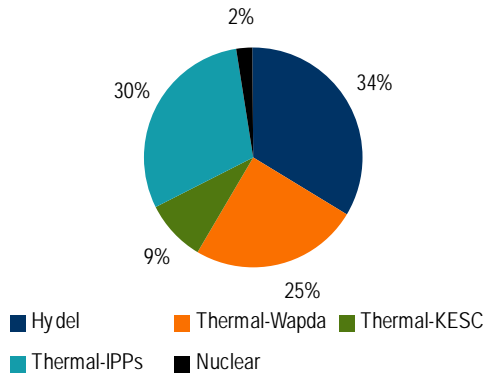
Chart 31: Strong growth in electricity consumption to continue (%)



Source: Merrill Lynch estimates

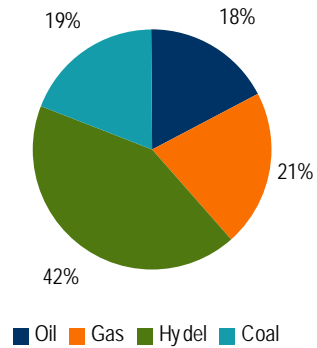
- Robust demand for electricity:** Electricity demand is expected to grow by a strong 6-7% because of high manufacturing sector growth and village electrification. Pakistan's current electricity supply requirement is 10.9GW or 94,588GWH (including line losses of ~25%). Historically, domestic electricity demand has been 1.2x of GDP which we believe will be the case in future.
- Continued low availability of hydel capacity:** Historically, hydel generation has not operated above 56% even in good years with normal monsoon rains. In the past six years, there have been only 1,669MW of installed capacity of hydel electricity generation relative to demand increase of 3,135MW. In the next few years, only 1,823MW of installed capacity addition (53% of expected addition in required electricity generation) would be made as per the government's forecast.
- Low availability of gas for power generation:** Pakistan is already facing gas shortage at 700mcfpd, or 19% of total gas supply, during winter, according to government officials. We believe future supply addition will not be enough to support the current level of gas-based thermal electricity generation. Against an expected growth in gas consumption of 7-8% (1.2x of GDP), we estimate supply additions will maintain a four-year CAGR of 5-5.5%. Based on current demand and supply addition, the government forecasts a gas supply deficit of 140-150mmcfpd by 2009-10, In our view, this is a rather conservative estimate. Pakistan's current gas demand stands at ~3800mmcfpd. To bridge the anticipated supply gap, the government is actively working on two gas import projects.

Chart 32: Pakistan: Breakdown of installed electricity generation (total 19.37GW)



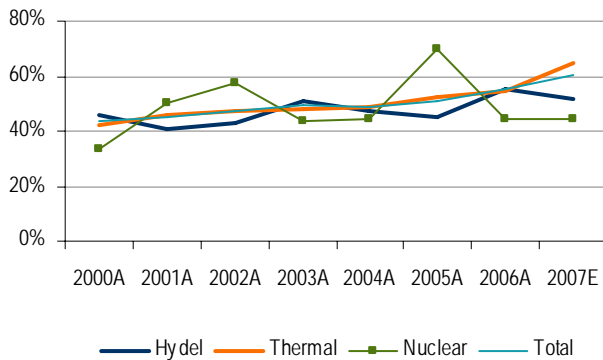
Source: Pakistan Energy Year Book 2005

Chart 33: Pakistan: Proposed electricity addition by source (total addition 13.3GW)



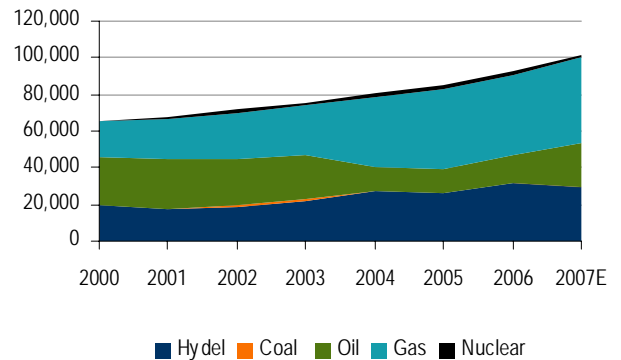
Source: Private Power Infrastructure Board

Chart 34: Load factor (%) of thermal-based projects have increased



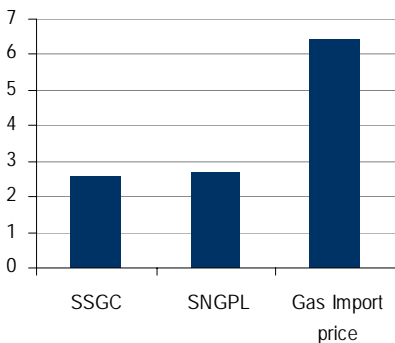
Source: Pakistan Energy Year Book 2005, KASB Securities estimates

Chart 35: Driven by fuel-based power projects (GWH)



Source: Pakistan Energy Year Book 2005, KASB Securities estimates

Chart 36: Average gas cost (US\$/mcf)



Source: Sui Southern Gas Company, Sui Northern Pipeline Company, Merrill Lynch

However, we see low risk to our forecast of FO consumption growth from future import of natural gas. We highlight the following reasons.

Compared to the government's forecast of 140mmcf/d gas shortage, we estimate gas shortage at 700-900mmcf/d because demand growth (8% CAGR over 2007E-10E) will exceed the estimated growth in supply (6% CAGR over 2007E-10E). We believe the gas imports will help the government to bridge the supply gap domestically and with little surplus gap for allocation to power projects for substitution of FO with gas. The government targets to import 1,100mmcf/d of gas from two gas import projects.

Furthermore, as the price of imported gas (quoted in different newspapers at US\$6.2/mcf) would be 1.2-1.3x higher than that of local gas (US\$2.6-2.8/mcf), there would much less benefit to switch a fuel-fired power project to gas.

### Integrated liquid natural gas project

The import project is estimated to cost US\$600-800mn and will have a total gas supply potential of 300mmcf/d. The government is currently processing Expression of Interest documents submitted by various local and international parties. The project is targeted for completion by 2010. The LNG import would be the first gas import project by Pakistan.

### Gas pipeline import project

The government is also working on importing gas through pipelines from Iran, Qatar and Turkmenistan. All three pipelines will drop in Pakistan and may be extended to neighboring India for supplies of gas. Given its relatively low cost and construction period, the government has focused more on the gas import project from Iran. The project has made important headways in terms of negotiation on gas pricing. The three parties – Pakistan, Iran and India – are believed to have agreed to benchmarked crude basket of Japan for pricing gas and a fixed portion of US\$1.2/mcf to be built into the cost. The project is expected to cost US\$7bn and will take 3-5 years to construct. The initial volume of gas supplies are expected to be 2bnccpd, of which Pakistan will take up ~800mmccpd. The project supplies are expected to plateau at 3bnccpd by 2015.

### Areas of potential upside

We see potential upside to our assumptions from

Delays in the capacity addition in non fuel based electricity generation

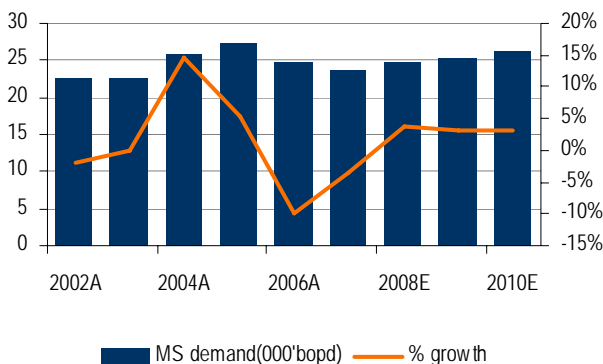
Higher gas demand leading to supply cut to existing power plants and

Higher than assumed increase in load factors of existing IPPs.

### Motor gasoline – demand increasing from motor bikes

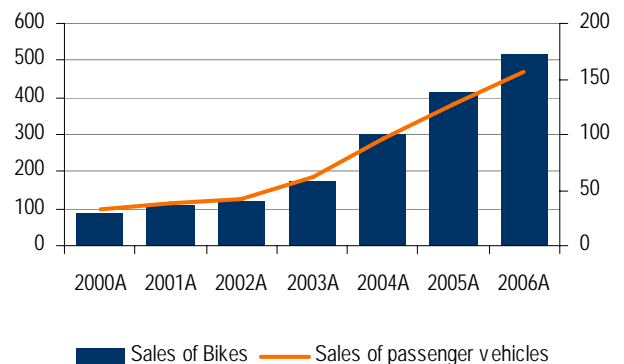
We forecast a modest recovery in motor gasoline (MS) consumption and expect growth of 1.6% over the medium term. This growth would be driven by the recovery of gasoline demand in the passenger vehicle segment, while the motor bike segment will remain the second major user. MS consumption declined by 10% in FY06 following impressive growth of 14% and 5.5% in FY04 and FY05, respectively. Owing to the government’s perception that MS is a fuel for high-income earners, MS prices have been used to cross-subsidize the prices of HSD and other fuel products, thereby triggering a mass scale conversion to CNG fuel. We believe a major phase of conversion is over which has reduced the risk of future substitution risk in the motor fuel segment. Government data show that up to 1mn passenger cars have switched to CNG fuel as of March 2006, translating into 70% of total passenger vehicles in Pakistan.

Chart 37: Modest increase in motor spirit consumption ('000bpd)



Source: KASB Securities estimates, Oil Companies Advisory Committee

Chart 38: Sales of bikes and passenger vehicles ('000 units)



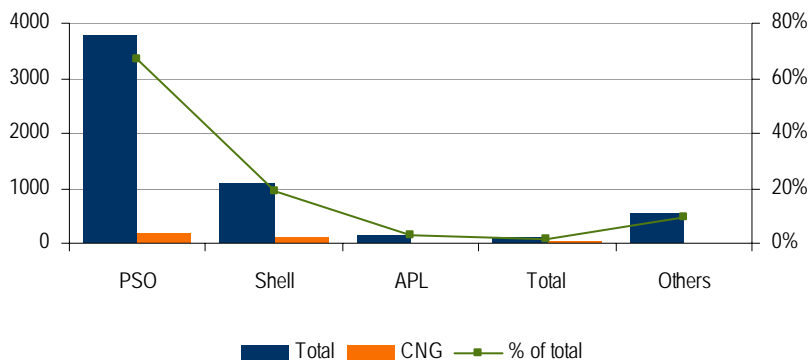
Source: Economic Survey of Pakistan 2006

### OMCs participate in CNG growth

In our view, more new outlets will be opened and the trend of equipping the current urban-centric outlets with CNG dispensers will persist. We estimate that OMCs are likely to set up 50-100 new outlets pa. PSO, APL and Total-Parco are likely to be the leaders of this trend. The expected increase in road infrastructure, as well as jump in vehicles on roads and low penetration level (one outlet per 140 sq km vs general density of one retail outlet per 20-30 sq km), underpin the need for more new outlets. Currently there are 5,600 retail outlets. As two of the largest OMCs, PSO and Shell Pakistan are in the process of rationalizing their retail outlet network, closing down 100-150 outlets pa, the addition to present number of outlets in Pakistan is likely to remain limited

OMCs have not been completely at the losing end due to the CNG conversion. By installing CNG facilities at their retail outlets, OMCs have had a part in the segment's strong growth. Currently CNG outlets are only concentrated in the urban areas owing to limited availability of piped gas. However, new technologies may throw open the opportunity to set up gas stations in rural areas as well. PSO is taking the lead in the CNG segment with its novel concept of a mother-daughter CNG station. This means that CNG stations in the rural regions where access to piped gas is limited will be supplied gas from the storage created at the site where there is access to piped gas.

Chart 39: Retail outlets: PSO and Shell dominate the landscape



Source: Oil Companies Advisory Committee

The mass scale conversion to CNG vehicles have not been matched by a proportionate addition of CNG retailers. Of the 1,089 stations offering CNG facilities, 250 are operated by OMCs and the rest by independent station owners. While OMCs and CNG station owners will focus on meeting the untapped potential (1,370 cars per station compared to 260 cars per station which were previously serving petrol-based cars), we believe OMCs have more advantages over independent station owners in the medium term owing to (1) low investment requirement as OMCs already have land and building and need only to install CNG dispensers, (2) OMCs offer a full package of service (eg, oiling and car wash convenience stores) which is unlikely to be matched by independent station owners, and (3) location advantage as high visibility locations are controlled by OMCs in the urban center.

**Table 10: 1H FY06 (Dec 06) petroleum product consumption(000' tons)**

	1H FY07A	1H FY06A	% Chg
MOGAS:	570	612	-7%
KEROSENE	108	111	-3%
HSD	3,560	3,705	-4%
FO	3408	1,937	76%
LUBES & GREASES	59	65	-8%
TOTAL:	8,722	7,345	19%

Source: Oil Companies Advisory Committee

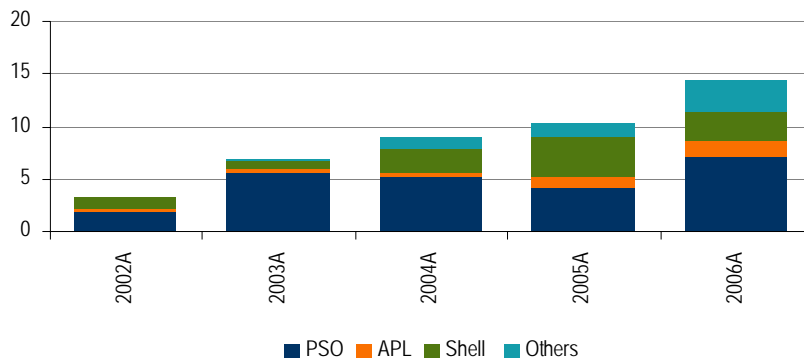
### YTD petroleum product performance – seasonality explains lower consumption

Petroleum product consumption recorded an impressive jump of 19% during July-December 2006. The YTD FY07 performance has primarily been supported by strong demand from power projects which rose by 76% during the first six months. We believe the power demand is hindered by the shortage of hydel capacity generation in the country. Newspapers reported a reduction in hydel electricity generation by 10%. We do not expect furnace oil consumption to be able to maintain such strong growth in the coming months as hydel capacity becomes available and the low base effect of last year is removed. We expect FO demand to come down to 15% by June 2007. In high speed diesel (gasoil), the delay in sugar crushing season of about two months (normally starts in November and lasts for three months) has resulted in a slowdown in HSD consumption YTD.

### Export to Afghanistan

Export to neighboring Afghanistan is proving to be a new window of growth for local marketing companies. The OMCs are better placed to meet the demand in land-locked Afghanistan, in our view, because of (1) proximity of the country, (2) refining capacity shortfall in other neighboring country (mainly Iran), (3) availability of infrastructure logistics to local OMCs for imports and onward supply, and (4) surplus production of gasoline and heating fuel domestically.

**Chart 40: Export sales to Afghanistan ('000bpd)**



Source: Oil Companies Advisory Committee

Marketing companies are currently acting as subcontracting agents for other big oil marketing names in Afghanistan. As security conditions in the country improve, OMCs may be encouraged to establish a full-fledged presence by setting up retail outlets. We understand that PSO is exploring the feasibility of having a joint-venture partnership in Afghanistan, while APL has already obtained a license to set up an outlet in the capital city of Kabul. Local OMCs have been able to export ~15,000bpd or 0.7mn tons of petroleum products to Afghanistan in 2006 (4.4% of total domestic volume).

## Investment opportunities in oil infrastructure

The key areas for future investment requirements are as follows.

### Pipeline business

The current under-investment in the oil movement infrastructure can be gauged from the fact that only 11% of total movement is done through pipeline. Future growth in consumption is likely to further reduce this share. The investment in pipeline business offers the advantages of efficient, cost-effective and reliable source of oil movement. Moreover, as an investment, the oil pipeline business offers stable returns (15-20%) which are generally linked with benchmarked throughput capacity. The industry is currently working on the following projects:

- 470km pipeline between Lahore (Punjab province) and Peshawar (the NWFP province) for white oil products.
- 50km pipeline from Hub (province of Baluchistan) to Karachi for white oil products.
- 1,000km white oil pipeline in the left Indus river basin linking southern and northern Pakistan.
- Apart from these pipelines, the industry is working to expand the capacity of Pakistan's largest pipeline from 93,000bpd (4.5mn tons) to 124,000bpd (6mn tons). An 864km pipeline will link the coastal city of Karachi to Pakistan's northern and central regions. The pipeline will hopefully meet the crude demand of a landlocked refinery and be used to move white oil product. Pak Arab Refinery (51%), PSO (12%), Shell Pakistan (26%) and Caltex Pakistan (11%) are the partners in this joint-venture project.

We expect PSO and the Attock Group to take the lead in pipeline projects. Both are already jointly working on the Lahore-to-Peshawar pipeline. PSO's position as a market leader necessitates continual investments in oil infrastructure in order to maintain operational flexibility. The Attock Group is flexing its muscles for a more active role in the downstream sector. These two companies have strong balance sheets to finance their pursuits. We see low chances of Shell Pakistan and Chevron Texaco (Caltex) to be aggressive in the pipeline business.

### Building up strategic reserves

With geopolitical risks on the rise and volatility in oil supplies unlikely to abate, the government has turned to building strategic oil reserves. The storage reserves should offer downstream companies a low risk/stable return investment opportunity. These reserves would be different from the current commercial reserves owned by OMCs and refineries. Unlike the commercial reserves that have 15-20 days of demand cover, the government's proposed strategic reserves will have 45-60 days of cover.

We believe the construction of the reserves would be gradual given the high investment requirement (total capex of PRs17-22bn or US\$276-368mn). Our estimates do not include the cost of first fill for inventories. The ultimate cost of building the strategic reserves will likely be borne by consumers as the government is considering levying a new tax on retail prices to provide for the investment returns and operating cost of reserves.

In Table 11, we have provided an estimate of the total stock to be built based on our forecasts of product demand. PSO, given its balance sheet flexibility and experience in managing Pakistan's largest commercial reserves, is the most suitable candidate among the listed peers.

Figure 1: Pakistan: Downstream infrastructure



Source: PSO

Table 11: Required investment in storage infrastructure

Number of Days	45	50	55	60
<b>Required Storage Buildup</b>				
JP (mn bbl)	0.17	0.19	0.15	0.23
MS (mn bbl)	0.16	0.17	0.19	0.21
HSD (mn bbl)	1.07	1.19	1.3	1.42
FO (mn bbl)	0.84	0.93	1.02	1.11
Total storage requirement (mn bbl)	2.39	2.65	2.92	3.18
Investment Requirement (PRs mn)	16,816	18,685	20,553	22,422
Investment Requirement (US\$m)	276	306	337	368

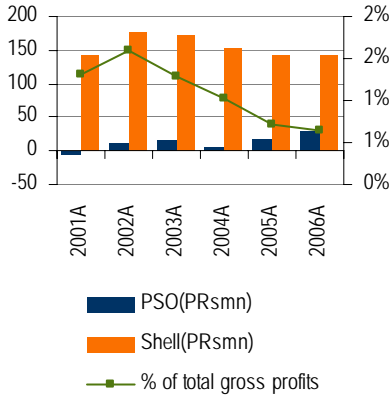
Source: KASB Securities estimates

Table 12: Downstream infrastructure by company

Categories	PSO	Shell	Caltex	APL
Total Storage Capacity in '000bbl tons	6410	1163	358	15
% share	80.7%	14.6%	4.5%	0.2%
Storage Installation	9	5	5	
% share	47.4%	26.3%	26.3%	
Depots	27	15	12	1
% share	49.1%	27.3%	21.8%	1.8%
Total Storage Capacity in 000mn tons	860	156	48	2

Source: Oil Companies Advisory Committee

Chart 41: Retail sales: Low contribution to gross profits



Source: PSO, Shell

## Untapped potential in non-fuel segment

With increasing per capita income (40% in the past three years) and changing lifestyles, the focus on the non-fuel retail segment (allied business) is a key area to tap to enjoy retail sales growth. Currently the contribution of this segment to OMCs' gross profits is quite low (1% in 2006 vs 20-40% for downstream companies in developed countries). We see two key benefits to domestic OMCs: (1) maximization of returns from outlet investment and (2) increasing non-fuel segment revenue to cushion price volatility in oil markets.

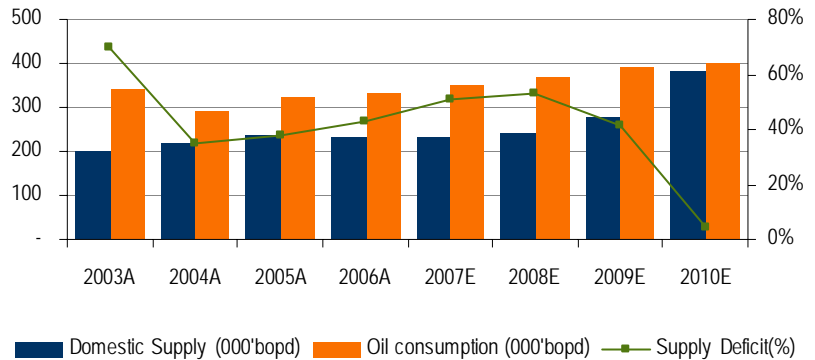
Among the key services the OMCs are likely to focus on are:

- Convenience stores:** Currently only about 250 of the total 5,800 outlets come convenience stores. A changing lifestyle will likely support OMC efforts to tap the huge growth potential though competition would come from existing undocumented stores and new branded chain outlets.
- Tie-up with service providers:** Joining hands with other service providers like banks or fast-food chains to access a wider pool of retail consumers. Key services likely to be included are ATM installations (with banks) and sale of fast food in rural and urban areas. PSO has already signed an agreement with a bank to allow it to set up ATMs at its retail outlets.
- Marketing and promotion:** Co-branding and media campaign support for other companies at retail sites are underway, albeit on a limited scale.

## Refined product supply deficit to last till FY09

Pakistan is currently running a 40% supply deficit which is likely to last till 2009. The expected commissioning of relocated refineries will probably bridge this gap by 2010. Potential export-oriented refineries, relocation of old refineries and expansion by existing refineries are likely to create supply surplus in the country.

Chart 42: Pakistan: Refining supply additions to cut reliance on imported refined products



Source: Pakistan Energy Year Book 2005, Merrill Lynch estimates

With Pakistan offering an available market for two major products (HSD and FO), low investment requirement on second-hand refineries, and short payback period of about 4-6 years, the proposal to relocate second-hand refineries seems attractive. Six old refineries have been targeted for relocation and two are currently in the implementation stage.

Of the export-oriented refineries, two projects have been proposed with a total capacity of ~285,000bpd or 13.8mn tons. While both projects are in the initial stage (one at MOU stage and the other at feasibility stage), we expect one

export-oriented refinery to materialize given the keen interest expressed by the sponsors. However, with the ongoing bottlenecks in the OEM industry (lack of human capital) and the capital-intensive, long construction period of new refining projects, we see a high risk of project implementations being delayed.

**Table 13: Pakistan: Refinery capacity additions**

	Capacity (kbpd)	Schedule	Type	Status	ML comments
Gwadar	220	2012	New	GoP assigned the project to IPIS	Likely to materialize
Pak-Kuwait	200	N/A	New	MOU signed	Low chances of materializing
Bosicor	100	N/A	Relocation	Planning	Risk of withdrawal is increasing
Coastal Refinery	45	N/A	Relocation	Planning	Likely to be dropped
Admore-Arabian Construction Company	30	2009	Relocation	MOU signed	Risk of withdrawal is high
Trans Asia Ltd	100	N/A	Relocation	Planning	Possibly conditional upon acquisition of PSO

Source: KASB Securities

Pakistan's current refining capacity of 246,000bpd (12.1mn tons) is split among six refining companies. Interestingly, all are based on simple hydro-skimming technology. Pak Arab Refining Company (PARCO), an equal joint-venture between the government of Pakistan and the International Petroleum Investment Corporation (IPIS), is the largest refiner in the industry.

**Table 14: Pakistan: Installed refining capacity, June 2006**

Player	mtpa	kbpd
Pakistan Refinery Limited	2.2	45
National Refinery Limited	2.7	55
Attock Refinery Limited	1.8	37
Pak-Arab Refinery Limited	4.5	92
Bosicor Refinery Limited	0.75	15
Dhodak Topping Refinery	0.12	2
<b>Total present capacity</b>	<b>12.1</b>	<b>246</b>
<b>Addition</b>		
Indus Refinery (June 09)	4.4	100
Bosicor Oil Company (December 09)	4.4	100
<b>Total future capacity</b>	<b>20.9</b>	<b>446</b>

Source: KASB Securities

## Price Objective Basis & Risk

Our price objective for Pakistan State Oil is PRs407/share based on the sum-of-the-parts valuation method. This represents an upside of over 17% to the current market price.

Risks: (1) Sustained decline in product prices in the international market. (2) Higher water and gas availability leading to lower fuel consumption. (3) Government intervention in the business. (4) Delays in privatization affecting investor sentiment.

Our price objective for APL is PRs441/share, based on our DCF valuation method. Key assumptions in our valuation include:

1. Long-term oil price assumption of US\$47/bbl (WTI).
2. WACC of 16.23% and terminal growth rate of 6%. We believe our long-term terminal growth assumption is realistic given expected long-term US CPI of 2%, expected long-term PRs depreciation against US\$ of 2% and APL's historical strong earnings growth.

This represents potential upside of over 19% to the current market price.

The risks associated with APL are: (1) sustained decline in product prices leading to lower absolute margins, (2) slowdown in exports to Afghanistan, (3) discontinuation of group synergies, (4) exchange rate risk, (5) management openness, and (6) group level decision making which can potentially undermine the interests of minority shareholders.

## Analyst Certification

We, Stuart B Smith and Mohammad Fawad Khan, hereby certify that the views each of us has expressed in this research report accurately reflect each of our respective personal views about the subject securities and issuers. We also certify that no part of our respective compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

## Special Disclosures

This report is issued and distributed outside Pakistan solely by Merrill Lynch. KASB Securities is not licensed to provide advisory services outside Pakistan. Investors should contact their Merrill Lynch representative if they have questions concerning this report.

## Important Disclosures

### PKSOF Price Chart



B : Buy, N : Neutral, S : Sell, PO : Price objective, NA : No longer valid

The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark Grey shading indicates the security is restricted with the opinion suspended. Light Grey shading indicates the security is under review with the opinion withdrawn. Chart current as of January 31, 2007 or such later date as indicated.

### Investment Rating Distribution: Energy Group (as of 31 Dec 2006)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	103	55.68%	Buy	44	42.72%
Neutral	73	39.46%	Neutral	21	28.77%
Sell	9	4.86%	Sell	1	11.11%

### Investment Rating Distribution: Global Group (as of 31 Dec 2006)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1306	42.74%	Buy	406	31.09%
Neutral	1509	49.38%	Neutral	446	29.56%
Sell	241	7.89%	Sell	53	21.99%

\* Companies in respect of which MLPF&S or an affiliate has received compensation for investment banking services within the past 12 months.

**FUNDAMENTAL EQUITY OPINION KEY:** Opinions include a Volatility Risk Rating, an Investment Rating and an Income Rating. VOLATILITY RISK RATINGS, indicators of potential price fluctuation, are: A - Low, B - Medium, and C - High. INVESTMENT RATINGS, indicators of expected total return (price appreciation plus yield) within the 12-month period from the date of the initial rating, are: 1 - Buy (10% or more for Low and Medium Volatility Risk Securities - 20% or more for High Volatility Risk securities); 2 - Neutral (0-10% for Low and Medium Volatility Risk securities - 0-20% for High Volatility Risk securities); 3 - Sell (negative return); and 6 - No Rating. INCOME RATINGS, indicators of potential cash dividends, are: 7 - same/higher (dividend considered to be secure); 8 - same/lower (dividend not considered to be secure); and 9 - pays no cash dividend.

In the US, retail sales and/or distribution of this report may be made only in states where these securities are exempt from registration or have been qualified for sale: Attock Petroleum, Pakistan State.

The analyst(s) responsible for covering the securities in this report receive compensation based upon, among other factors, the overall profitability of Merrill Lynch, including profits derived from investment banking revenues.

## Other Important Disclosures

UK readers: MLPF&S or an affiliate is a liquidity provider for the securities discussed in this report.

---

### Information relating to Non-U.S. affiliates of Merrill Lynch, Pierce, Fenner & Smith Incorporated (MLPF&S):

MLPF&S distributes research reports of the following non-US affiliates in the US (short name: legal name): Merrill Lynch (France): Merrill Lynch Capital Markets (France) SAS; Merrill Lynch (Frankfurt): Merrill Lynch International Bank Ltd, Frankfurt Branch; Merrill Lynch (South Africa): Merrill Lynch South Africa (Pty) Ltd; Merrill Lynch (Milan): Merrill Lynch International Bank Limited; MLPF&S (UK): Merrill Lynch, Pierce, Fenner & Smith Limited; Merrill Lynch (Australia): Merrill Lynch Equities (Australia) Limited; Merrill Lynch (Hong Kong): Merrill Lynch (Asia Pacific) Limited; Merrill Lynch (Singapore): Merrill Lynch (Singapore) Pte Ltd; Merrill Lynch (Canada): Merrill Lynch Canada Inc; Merrill Lynch (Mexico): Merrill Lynch Mexico, SA de CV, Casa de Bolsa; Merrill Lynch (Argentina): Merrill Lynch Argentina SA; Merrill Lynch (Japan): Merrill Lynch Japan Securities Co, Ltd; Merrill Lynch (Seoul): Merrill Lynch International Incorporated (Seoul Branch); Merrill Lynch (Taiwan): Merrill Lynch Global (Taiwan) Limited; DSP Merrill Lynch (India): DSP Merrill Lynch Limited; PT Merrill Lynch (Indonesia): PT Merrill Lynch Indonesia; Merrill Lynch (KL) Sdn. Bhd.: Merrill Lynch (Malaysia); Merrill Lynch (Israel): Merrill Lynch Israel Limited; Merrill Lynch (Russia): Merrill Lynch CIS Limited, Moscow.

This research report has been prepared and issued by MLPF&S and/or one or more of its non-U.S. affiliates. MLPF&S is the distributor of this research report in the U.S. and accepts full responsibility for research reports of its non-U.S. affiliates distributed in the U.S. Any U.S. person receiving this research report and wishing to effect any transaction in any security discussed in the report should do so through MLPF&S and not such foreign affiliates.

This research report has been approved for publication in the United Kingdom by Merrill Lynch, Pierce, Fenner & Smith Limited, which is authorized and regulated by the Financial Services Authority; has been considered and distributed in Japan by Merrill Lynch Japan Securities Co, Ltd, a registered securities dealer under the Securities and Exchange Law in Japan; is distributed in Hong Kong by Merrill Lynch (Asia Pacific) Limited, which is regulated by the Hong Kong SFC; is issued and distributed in Taiwan by Merrill Lynch Global (Taiwan) Ltd or Merrill Lynch, Pierce, Fenner & Smith Limited (Taiwan Branch); is issued and distributed in Malaysia by Merrill Lynch (KL) Sdn. Bhd., a licensed investment adviser regulated by the Malaysian Securities Commission; and is issued and distributed in Singapore by Merrill Lynch International Bank Limited (Merchant Bank) and Merrill Lynch (Singapore) Pte Ltd (Company Registration No.'s F 06872E and 198602883D respectively). Merrill Lynch International Bank Limited (Merchant Bank) and Merrill Lynch (Singapore) Pte Ltd. are regulated by the Monetary Authority of Singapore. Merrill Lynch Equities (Australia) Limited, (ABN 65 006 276 795), AFS License 235132, provides this report in Australia. No approval is required for publication or distribution of this report in Brazil.

Merrill Lynch (Frankfurt) is regulated by BaFin.

### Copyright, User Agreement and other general information related to this report:

Copyright 2007 Merrill Lynch, Pierce, Fenner & Smith Incorporated. All rights reserved. This research report is prepared for the use of Merrill Lynch clients and may not be redistributed, retransmitted or disclosed, in whole or in part, or in any form or manner, without the express written consent of Merrill Lynch. Merrill Lynch research reports are distributed simultaneously to internal and client websites eligible to receive such research prior to any public dissemination by Merrill Lynch of the research report or information or opinion contained therein. Any unauthorized use or disclosure is prohibited. Receipt and review of this research report constitutes your agreement not to redistribute, retransmit, or disclose to others the contents, opinions, conclusion, or information contained in this report (including any investment recommendations, estimates or price targets) prior to Merrill Lynch's public disclosure of such information. The information herein (other than disclosure information relating to Merrill Lynch and its affiliates) was obtained from various sources and we do not guarantee its accuracy. Merrill Lynch makes no representations or warranties whatsoever as to the data and information provided in any third party referenced website and shall have no liability or responsibility arising out of or in connection with any such referenced website.

This research report provides general information only. Neither the information nor any opinion expressed constitutes an offer or an invitation to make an offer, to buy or sell any securities or other investment or any options, futures or derivatives related to such securities or investments. It is not intended to provide personal investment advice and it does not take into account the specific investment objectives, financial situation and the particular needs of any specific person who may receive this report. Investors should seek financial advice regarding the appropriateness of investing in any securities, other investment or investment strategies discussed or recommended in this report and should understand that statements regarding future prospects may not be realized. Investors should note that income from such securities or other investments, if any, may fluctuate and that price or value of such securities and investments may rise or fall. Accordingly, investors may receive back less than originally invested. Past performance is not necessarily a guide to future performance. Any information relating to the tax status of financial instruments discussed herein is not intended to provide tax advice or to be used by anyone to provide tax advice. Investors are urged to seek tax advice based on their particular circumstances from an independent tax professional.

Foreign currency rates of exchange may adversely affect the value, price or income of any security or related investment mentioned in this report. In addition, investors in securities such as ADRs, whose values are influenced by the currency of the underlying security, effectively assume currency risk.

Officers of MLPF&S or one or more of its affiliates (other than research analysts) may have a financial interest in securities of the issuer(s) or in related investments.

Merrill Lynch Research policies relating to conflicts of interest are described at <http://www.ml.com/media/43347.pdf>.

Fundamental equity reports are produced on a regular basis as necessary to keep the investment recommendation current.

# Dominant position in a growing industry; Buy

## PSO - A competitive leader

Pakistan State Oil PSO is largest domestic oil marketing company with market share of over 65%. We are re-instating covering with a Buy and PO of PRs407, which provides potential total return of about 20%.

## Strong volume growth ahead

PSO looks poised to achieve a four-year volume CAGR of 5% (2006 to 2010E).

## Exploring potential in non-fuel segment

PSO plans to leverage its extensive retail outlet network (3,800 sites) to explore the large untapped potential in the segment.

## Favorable industry structure

The company derives obvious benefits from its dominant position in the industry. It also features stable marketing margins (3.5% on retail products).

## Privatization targeted for 30 June 2007

This might deliver further value from realizing the present and future potential of balance sheet strengths and a change in business focus.

## Buy; Our PO is PRs407 (potential return of 20%)

Our valuation is based on the sum-of-the-parts, which allows us to account for both – PSO's free cash flows and its investments & receivables.

## Risks

(1) Sustained decline in product prices in the international markets. (2) Low power fuel consumption. (4) Delays in privatization.

## Estimates (Jun)

(PRs)	2005A	2006A	2007E	2008E	2009E
Net Income (Adjusted - mn)	5,662	7,525	4,881	6,094	6,403
EPS	32.98	43.87	28.46	35.53	37.33
EPS Change (YoY)	34.3%	33.0%	-35.1%	24.8%	5.1%
Dividend / Share	22.00	34.00	22.00	25.00	25.00
Free Cash Flow / Share	19.31	6.30	15.86	24.66	29.69

## Valuation (Jun)

	2005A	2006A	2007E	2008E	2009E
P/E	10.88x	8.18x	12.61x	10.10x	9.61x
Dividend Yield	6.13%	9.48%	6.13%	6.97%	6.97%
EV / EBITDA*	6.23x	4.81x	7.64x	6.43x	6.29x
Free Cash Flow Yield*	5.38%	1.76%	4.42%	6.87%	8.28%

\* For full definitions of *iQmethod*<sup>SM</sup> measures, see page 25.

Equity | Pakistan | Oil Refining and Marketing  
28 February 2007



# Merrill Lynch

## Mohammad Fawad Khan

Research Analyst  
KASB Securities

## Stuart B Smith >>

+65 6330 7212

Research Analyst  
Merrill Lynch (Singapore)  
stuart\_b\_smith@ml.com

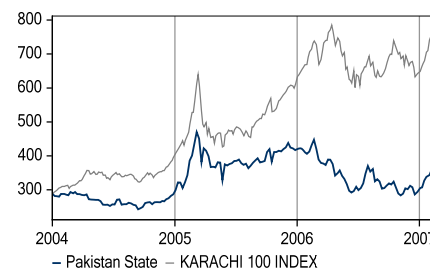
## Adrian Loh >>

+65 6330 7220

Research Analyst  
Merrill Lynch (Singapore)  
adrian\_loh@ml.com

## Stock Data

Price	PRs358.75
Price Objective	PRs407.00
Date Established	28-Feb-2007
Investment Opinion	C-1-7
Volatility Risk	HIGH
52-Week Range	PRs264.65-PRs454.00
Mrkt Val / Shares Out (mn)	US\$1,014 / 171.5
Average Daily Volume	3,929,986
ML Symbol / Exchange	PKSOF / KAR
Bloomberg / Reuters	PSO PA / PSO.KA
ROE (2007E)	22.8%
Net Dbt to Eqty (Jun-2006A)	-9.1%
Est. 5-Yr EPS / DPS Growth	10.0% / 4.3%
Free Float	48.0%



Merrill Lynch participated in the preparation of this report, in part, based on information provided by KASB Securities Ltd (KASB Securities). <sup>^^^</sup>KASB Securities employees are not registered/qualified as research analysts under NYSE/NASD rules.

>> Employed by a non-US affiliate of MLPF&S and is not registered/qualified as a research analyst under the NYSE/NASD rules.

Merrill Lynch does and seeks to do business with companies covered in its research reports. As a result, investors should be aware that the firm may have a conflict of interest that could affect the objectivity of this report. Investors should consider this report as only a single factor in making their investment decision.

Refer to important disclosures on page 26 to 27. Analyst Certification on page 25. Price Objective Basis/Risk on page 25.

# iQprofile<sup>SM</sup> Pakistan State Oil

Key Income Statement Data (Jun)	2005A	2006A	2007E	2008E	2009E
<b>(PRs Millions)</b>					
Sales	207,693	288,712	302,213	329,355	316,361
Gross Profit	13,750	17,207	11,929	14,048	14,651
Sell General & Admin Expense	NA	NA	NA	NA	NA
Operating Profit	9,823	12,897	7,757	9,387	9,525
Net Interest & Other Income	(632)	(1,243)	(247)	(11)	326
Associates	NA	NA	NA	NA	NA
Pretax Income	9,191	11,654	7,510	9,375	9,851
Tax (expense) / Benefit	(3,536)	(4,129)	(2,628)	(3,281)	(3,448)
Net Income (Adjusted)	5,662	7,525	4,881	6,094	6,403
Average Fully Diluted Shares Outstanding	172	172	172	172	172

## Key Cash Flow Statement Data

Net Income (Reported)	5,656	7,525	4,881	6,094	6,403
Depreciation & Amortization	984	1,082	1,050	1,073	1,173
Change in Working Capital	(5,837)	(12,924)	(2,083)	(2,439)	(2,047)
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	4,011	5,862	979	1,030	1,090
Cash Flow from Operations	4,814	1,545	4,827	5,759	6,619
Capital Expenditure	(1,502)	(465)	(2,107)	(1,530)	(1,526)
(Acquisition) / Disposal of Investments	244	281	0	0	0
Other Cash Inflow / (Outflow)	471	99	60	51	47
Cash Flow from Investing	(788)	(86)	(2,047)	(1,479)	(1,479)
Shares Issue / (Repurchase)	0	0	0	0	0
Cost of Dividends Paid	(3,617)	(4,389)	(3,472)	(4,082)	(4,288)
Cash Flow from Financing	(3,687)	(1,483)	(3,566)	(3,424)	(4,634)
Free Cash Flow	3,312	1,080	2,720	4,229	5,093
Net Debt	(1,922)	(1,899)	(1,112)	(1,968)	(2,474)
Change in Net Debt	(409)	2,929	692	(197)	(852)

## Key Balance Sheet Data

Property, Plant & Equipment	6,404	6,667	7,149	7,603	7,955
Other Non-Current Assets	5,169	5,383	5,922	5,892	5,867
Trade Receivables	0	0	0	0	0
Cash & Equivalents	1,922	1,899	1,112	1,968	2,474
Other Current Assets	38,812	56,220	59,832	64,583	63,724
Total Assets	52,308	70,168	74,015	80,047	80,019
Long-Term Debt	0	0	0	0	0
Other Non-Current Liabilities	1,999	2,299	2,330	2,356	2,383
Short-Term Debt	0	0	0	0	0
Other Current Liabilities	32,764	47,057	49,765	53,964	51,794
Total Liabilities	34,763	49,355	52,095	56,320	54,177
Total Equity	17,545	20,813	21,921	23,727	25,842
Total Equity & Liabilities	52,308	70,169	74,016	80,047	80,019

## iQmethod<sup>SM</sup> - Bus Performance\*

Return On Capital Employed	33.0%	39.0%	21.3%	24.2%	22.8%
Return On Equity	34.3%	39.2%	22.8%	26.7%	25.8%
Operating Margin	4.7%	4.5%	2.6%	2.9%	3.0%
EBITDA Margin	5.2%	4.8%	2.9%	3.2%	3.4%

## iQmethod<sup>SM</sup> - Quality of Earnings\*

Cash Realization Ratio	0.9x	0.2x	1.0x	0.9x	1.0x
Asset Replacement Ratio	1.5x	0.4x	2.0x	1.4x	1.3x
Tax Rate (Reported)	38.5%	35.4%	35.0%	35.0%	35.0%
Net Debt-to-Equity Ratio	-11.0%	-9.1%	-5.1%	-8.3%	-9.6%
Interest Cover	26.5x	13.0x	8.5x	11.4x	13.4x

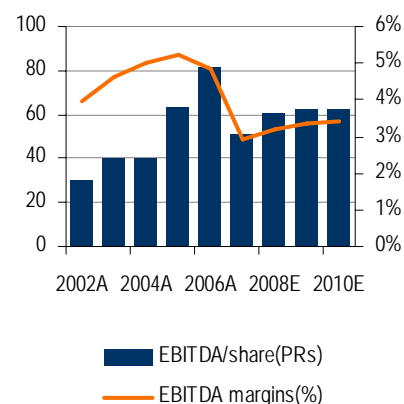
## Key Metrics

\* For full definitions of iQmethod<sup>SM</sup> measures, see page 25.

## Company Description

PSO is the largest oil and petroleum lubricant marketing play with a market share in excess of 65%. PSO enjoys extensive reach controlling over 3,800 retail outlets across the country. The government of Pakistan (GoP) maintains an effective 52% stake in the company through a 26% direct ownership and 26% ownership via 100% state-owned enterprises (National Investment Trust and Investment Corporation of Pakistan).

Chart 1: EBITDA /share (PRs) and EBTDA margins(%) trend



Source: PSO, Merrill Lynch Estimates

## Stock Data

Price to Book Value 2.8x

## Investment thesis

### Strong volume growth seen

We believe PSO is poised to achieve strong volume growth, driven by its package of initiatives: (1) Beefing up quality and focusing on convenience. (2) Investing in retail network expansion and refurbishment, and (3) Increasing focus on high-margin products. PSO is also the biggest beneficiary of the rising demand for power fuel, as it has long-term supply contracts with independent power producers (IPPs) covering 30% of the installed power capacity (50% of thermal capacity) in the country. We see volume CAGR of 5% over 2006-2010E for PSO.

### Exploring potential in the non-fuel segment

PSO plans to explore the potential in non-fuel retail sales. We believe it is poised to benefit from this untapped potential. PSO is targeting to increase the contribution from non-fuel retail sales (at the gross profit level) to PRs1bn by 2010 from PRs12mn (PRs0.7/share) in 2006. With over 3,800 retail sites (66% of the industry's retail sites), PSO certainly has the advantage of extensive reach to consumers across Pakistan. Nevertheless, we are conservatively factoring into our earnings forecasts only 30% of management targets.

### Favorable industry structure

In addition to strong volume growth, PSO has the advantages of operating in an oligopoly (it dominates with a market share of 65%) and a favorable regulatory backdrop (which allows for stable marketing margins of 3.5% on retail prices).

### Investment projects - Advantages of a strong balance sheet

Key investment projects in the oil downstream sector where PSO is likely to focus on are (1) Oil storage and oil pipeline. (2) Setting up of an oil refinery. The oil storage and pipeline business offers stable returns (15-20%) that are generally linked to benchmarked throughput capacity. There are strong benefits if PSO opts for backward integration into the refining business. As PSO has a cash-rich balance sheet, we do not expect it to face any problems in raising funds for the projects.

### Privatization to add more value

The key areas benefiting minority shareholders are the company's: (1) Aggressive focus on high-margin products. (2) Settlement of receivables issue (PRs33/share impact on cash flow). (3) Move towards an integrated model. (4) Restructuring of balance sheet.

### Earnings drop of 35% in FY07 is already priced in

We expect PSO's FY07 earnings to drop 35%, but believe the market has already incorporated the potential decline into the share price. Earnings are expected to decline as a result of an adjustment in the way marketing margins are calculated (done in April 2006), stock losses due to the oil price decline in IHFY07 and drop in other income (detailed inside).

## Valuation

Our valuation of PRs407/share is based on the sum-of-the-parts method, which allows us to account for all of the following: PSO's future free cash generation, its investments in different companies, and its long- & short-term receivables from the government.

**Table 1: PSO Valuation**

	PRsmn	PRs/share	% of total
NPV of forecasts	16,088	94	23%
NPV of Terminal Value	39,205	229	56%
Value of PSO's future free cash flows from operations	55,292	322	79%
Add: Receivables (Long aged stuck up receivables to government)	5,685	33	8%
Receivables to government on product subsidy	7,784	45	11%
Less: net debt (net cash)	(5,750)	(34)	-8%
Add: investments			
Pakistan Refinery Ltd	1,166	7	2%
PAPCO (1.2x of book value)	3,935	23	6%
Asia Petroleum Ltd (1.2x of book value)	1,743	10	2%
Total investments	6,844	40	10%
Total	69,856	407	

Source: KASB Securities Estimates

## Potential near-term drivers and risks

We see the following as key catalysts for share price performance in the short term – (1) Developments related to PSO's privatization. (2) Earnings announcements. (3) Investments in projects.

Risks perceived: (1) Sustained decline in product prices, leading to lower retail prices and decline in margins for PSO. (2) Drop in power fuel (furnace oil) consumption for electricity generation. (3) Exchange rate risk. (4) Government intervention in the business. (5) Continuation of current contracts signed with external parties. (6) Slowdown in economic activity.

**Table 2: PSO – Facts and figures**
**Highlights**

Largest OMC in Pakistan with market share of over 65%.

Over 3,800 retail outlets (1,500+ outlets refurbished)

Operations at eight airports, supplying fuel to both national and international airlines.

Will be exclusive operator at Sialkot International Airport.

**Infrastructure and supply chain**

27 depots and 9 installations

Covering over 81% of country's storage capacity

Supply chain supported by 8,500 tank lorries and 3,800 railway engines

**Strategic investments**
**Pakistan Refinery Ltd (18% stake)**

Pakistan's third-largest refinery (capacity: 4,500 bopd)

**Pak Grease Manufacturing Company (22% stake)**

Manufacturer of specialized grease.

**Asia Petroleum Ltd (49% stake)**

Power fuel movement through 82km long pipeline, capacity of 3.6mn tons.

**Pak Arab Pipeline Co (12% stake)**

Crude and product movement from Karachi to upper country, capacity of 4.5mn tons.

Source: PSO

## PSO: Company profile

PSO is involved in petroleum and oil lubricant product marketing in Pakistan. It is the largest marketing play with a market share in excess of 65%. It is a stand-alone oil marketing company in Pakistan, leading in almost all downstream segments. It has extensive reach, controlling over 3,800 retail outlets spread across the country, and owns 80% of the downstream infrastructure.

Its strategic investments include an 18% stake in Pakistan Refinery Ltd (Pakistan's third-largest hydro skimming refiner), 49% in Asia Petroleum Ltd and 12% in Pak Arab Pipeline Co, the two oil pipeline companies. The Government of Pakistan (GoP) maintains an effective 52% stake in PSO through a 26% direct ownership and another 26% via 100% state-owned enterprises (National Investment Trust and Investment Corporation of Pakistan). The GoP intends to sell 51% stake in PSO as part of its privatization program.

### The clientele

Being the largest OMC, PSO has a diversified clientele base extending to retail, industrial, and commercial clients and the government, aviation and marine. Given this breadth, reliance on any individual consumer is quite low. However, the company has a huge exposure to power industry (as a percentage of sales), in the form of IPPs and the Water & Power Development Authority (WAPDA). Major IPPs on PSO's client list include the Hub Power Company, WAPDA and Karachi Electric Supply Corp (KESC). Being a state-owned entity, PSO also delivers a big chunk of aviation fuel to the national carrier.

### The suppliers

PSO draws supplies from all the six refineries operating in Pakistan, given its presence all over the country. To meet the supply gap in gas-oil and furnace-oil products, it has to import a large portion of its needs, mostly from Middle Eastern countries. PSO has a long-term supply contract for gas-oil (or high-speed diesel; HSD) products with Kuwait's state-owned Kuwait Petroleum Co. PSO meets all of its HSD import requirement under the contract

For importing FO, the company floats open tenders. Supply of all other products is met mostly through local refining capacity. Depending upon the location of CNG outlet, natural gas is supplied by two gas distribution companies that cater to the northern and southern region of the country respectively.

## Management team bringing a successful turnaround

Given the company's restructuring efforts since 1999, the current management team and board of directors represent a balanced blend of public and private sector personnel. The team has extensive local and international exposure to the oil & gas and chemicals industries, and has brought about one of the most successful management turnaround stories in Pakistan. In preparation for PSO's privatization to achieve a better price, the government picked the current management team from the private sector in 2000. The team has focused on key business areas, including:

- Cutting employee costs (VSS introduced in 2001, leading to layoff of 750 employees, or 40% of current headcount in PSO).
- Recovering market share (motor spirit: up from 40% in 2002 to 46% in 2006; HSD: sustained at 60% despite entry of six new competitors).

- Streamlining procurement and inventory policy by introducing new technology (Enterprise Resource Planning System introduced last year).
- Closing down non-commercial retail outlets and re-profiling of human resources. PSO's extraordinary turnaround story has the Harvard Business School to select it as a case study.

**Table 3: PSO – Management profile**

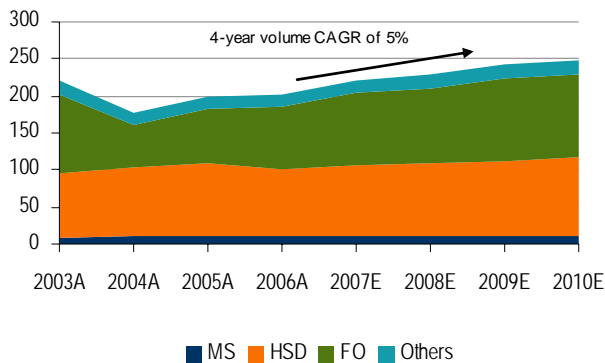
Name	Designation	Tenure at PSO	International experience
Mr. Pervaiz Kausar	Chairman BoD	3.5 years	35 years with Engro Checimals(formerly Exxon Corporation) as VP
Mr. Tariq Kirmani	Member BoD (served as MD during 2001-2005)	6 years	30 Years with different multinational at senior management position
Mr. Jalees Siddique	Managing Director & CEO, Executive Director for HR	2 years	U.S.A., Canada
Mr. Yacoob Suttar	Executive Director, Finance & IT	2 years	N/A
Mr. Kalim Siddiqui	Executive Director, Customer Services	N/A	N.A

Source: PSO

## Strong volume growth ahead

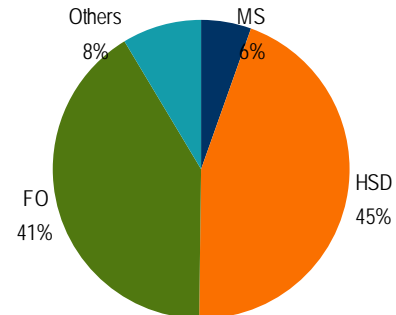
We believe PSO is poised to achieve strong volume growth, driven by its package of initiatives. We expect volume CAGR of 5% over 2006-2010, in line with expected industry growth. PSO is the biggest beneficiary of the rising demand for power fuel, as it has long-term supply contracts with major power producers. PSO's dominance in the power fuel segment (80% market share) is difficult to challenge, in our view.

Chart 2: PSO volume trend (000bopd)



Source: PSO, Merrill Lynch Estimates

Chart 3: PSO; volume breakdown



Source: PSO, Merrill Lynch

## Pakistan oil industry: Healthy volume growth

To provide a historical context, due to the government's drive to substitute fuel oil with gas, fuel consumption in the country dropped significantly in 2004, only to bounce back in subsequent years as the gas supplies fell short of demand.

Given the outlook for sustained economic growth (6-7%) here on, and increasing power fuel demand coming off a low base (historically) for energy consumption per capita, we see a volume uptrend – CAGR of 5% over 2006-2010E – in the downstream oil industry. That would make Pakistan one of the fastest growing oil markets in the Asia Pacific region. Exports to Afghanistan are also new growth avenues for Pakistan's downstream industry.

## PSO's key initiatives

### 1. Beefing up quality and convenience

To sustain its leadership in retail fuel products and develop a large base of captive customers, PSO has sharpened focus on boosting quality and providing convenience to retail/corporate customers by adding to its list of consumer cards.

**Quality:** Mobile lab tests on retail outlets monitor and address adulteration in products and improve the consumer's quality perception. Installation of modern servicing machinery, sealing the storage facilities at retail outlets and installation of tracking system on all vehicles engaged in product movement etc are additional measures to ensure quality.

**Convenience:** After the Loyalty, Fleet and Corporate cards, PSO introduced Prepaid Cards last year. It is the first OMC to launch such initiatives, which (1) provide access to captive consumers (2) customize its product offering to consumers' needs to meet increasing segmentation in the retail business and (3) help grab market share in retail products. PSO is the first OMC to launch the

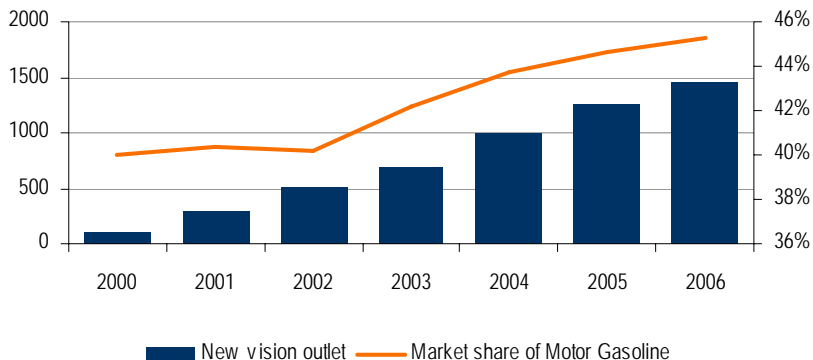
concept of 10% blended motor gasoline and gasoil, and many engine-friendly fuels. It has an extensive network of over 1,500 retail outlets that accept its cards (energized outlets).

## 2. Investing in retail network expansion and refurbishment

This is one area where PSO has shown considerable improvement through continued investments over the years, and it is likely to continue adding new refurbished outlets ( “New Vision Outlet ”) aggressively. That these investments have worked in its favor is evident from PSO’s higher market share in motor gasoline. Sustaining them should yield even more market share and improve its quality perception among retail consumers. The New Vision outlets also support PSO’s renewed focus on high-margin products, in our view.

PSO has about 1,500 sites under its New Vision network, and is expected to add 150-200 sites per annum for the next two to three years.

Chart 4: Restructuring of outlets has enabled PSO to increase market share



Source: PSO

## 3. Increasing focus on high-margin products

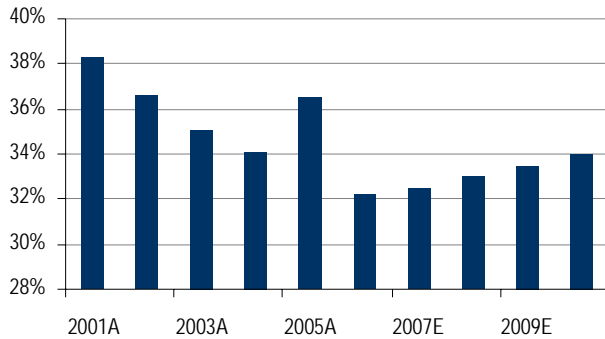
PSO is increasing focus on the growing market for liquid petroleum gas (LPG), compressed natural gas (CNG) and lubricants. All three products have registered healthy growth in the past five years. The current pricing deregulation makes these product categories very attractive for OMCs, as margins have remained above historical average (CNG: 10-12%; LPG: 25%; Auto lubricants: 28%).

### Lubes - Counting on reach and increased marketing efforts

After the recovery of market share in white oil products, PSO is all set to capture more volume in lubricants. It has a market share of 32% in this category, but can easily capitalize on its extensive and growing “New Vision” network and its franchise agreement with international brand – Castrol (of British Petroleum) – for this purpose. Moreover, to cater to the increasing segmentation in the market, PSO has also come up with its brands for automotive and industrial use.

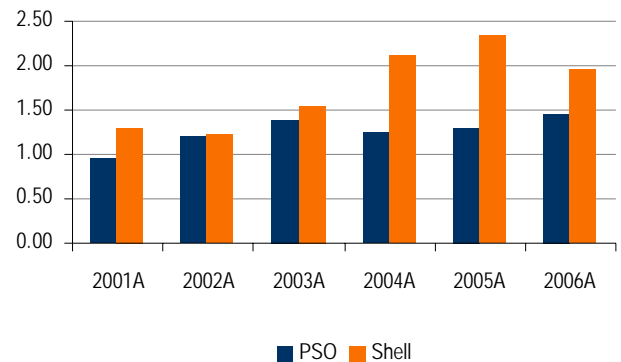
The lube market is the most quality conscious market in the POL (petroleum and oil lubricants) segment, and consumer perception plays an important role in the purchase decision. Marketing campaigns are important in shaping the purchase decision. So far, we believe PSO has been more dependent on its rising number of retail outlets, spending about 27% less on marketing than its peer, Shell Pakistan (over 2001-2006)). But now, PSO is increasingly focusing on its marketing campaign too to grab market share.

Chart 5: PSO's market share in the lube segment



Source: PSO, KASB Securities Estimates

Chart 6: PSO has spent comparatively less on marketing lubes  
Marketing expenses (PRs)/litre



Source: PSO, Shell

In 2006, a fire at PSO's newly built lubricant blending plant constrained its supply chain, resulting in market share loss of about 300bps. The plant was insured and PSO has reinitiated work to set up a new lubricant blending plant by June 2007. With expected investment of over PRs500mn (US\$9mn), the plant will have capacity of 20ktons and will come on-line by the end of this fiscal year. The new plant will also provide PSO with supply chain flexibility, in terms of introducing new variants of lubricant oil, and cover 41% of its demand for lubricants products.

We have conservatively assumed that by FY10, PSO's market share will improve by 2% (100bps lower than its share in 2005) due to its new initiatives. Lubricant sales have registered a CAGR of 7% in the past five years due to rising auto sales (five-year CAGR of 32.5%; 2002-2006).

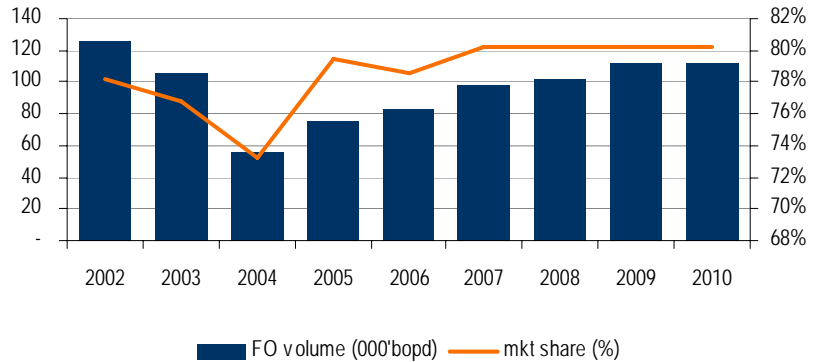
#### LPG and CNG - The fast growing segments

PSO has drawn up innovative plans to capitalize on the fast growing LPG and CNG markets. It is working in conjunction with a Middle Eastern company (on a daughter mother concept) for supplying CNG to areas not currently accessible through piped gas. An expansion project is also under way in its LPG cylinder plants. LPG and CNG have gained popularity among vehicle owners owing to their low prices (compared to motor fuel). These initiatives will help PSO mitigate the impact of gasoline substitution. As of 2005, 150 outlets were equipped with CNG facility. The 5-year consumption CAGR has been 12% for LPG and 187%. We expect the healthy growth trends to continue for at least the next three to four years. PSO handled LPG volumes of 58tpd last year.

### PSO offers a synthetic exposure to growing electricity demand

PSO is the biggest beneficiary of the rising demand for power fuel, as it has long-term supply contracts with IPPs covering 30% of the installed power capacity (50% of thermal capacity) in the country. Risk on such long-term supply contracts are low, as the government guarantees power fuel supply over the life of the power projects ranging 25-30 years. PSO has a total market share of 80% and we estimate that about 60% of its power fuel sales are made as part of its long-term agreement.

Chart 7: PSO should achieve sustainable upturn in FO volume



Source: PSO KASB Securities estimates

### IPPs are operating at high utilization rate

We believe the strong recovery seen in power fuel demand over the past two years is set to continue over the medium term. Power fuel demand plunged 55% during 2001-2004, as the government substituted power fuel with gas for power generation. However, demand bounced back – up 37% – over 2005-2006, and we think it will remain stable here on. We estimate a four-year CAGR of 7% over 2006-2010 based on power fuel demand from existing and new oil-based power plants. We have conservatively assumed a 3% increase in load factors at existing plants (from 18% to 21%) and have taken 60% load factor for new oil-based capacities, 5% lower than the government-guaranteed throughput of 65% for new IPPs.

We believe government's dependence on fuel-based IPPs has increased lately, as the IPPs have been the major source for meeting incremental electricity demand. This is evident from the 1.6x jump in load factors of major IPPs in FY06. Even in 1QFY06, the dependence was high, although historically, the first quarter is a low load factor period.

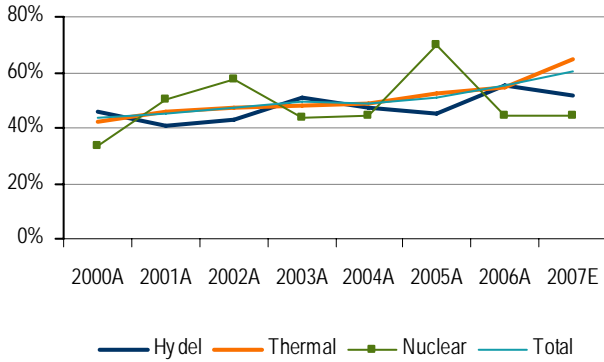
In absence of any abrupt increase in hydel power (based on higher-than-average rainfall) and big gas discoveries, fuel oil-based IPPs are the only source that have idle capacity to meet incremental demand..

#### What might yield potential upside to our assumptions

- Delays in capacity addition of non fuel-based electricity generation.
- Higher gas demand leading to supply cuts to existing power plants.
- Higher-than-expected increase in load factors of existing IPPs.

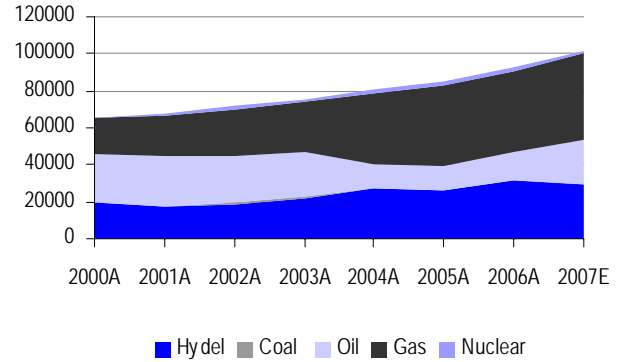
28 February 2007

**Chart 8: Load factor (%) of thermal-based projects have increased**



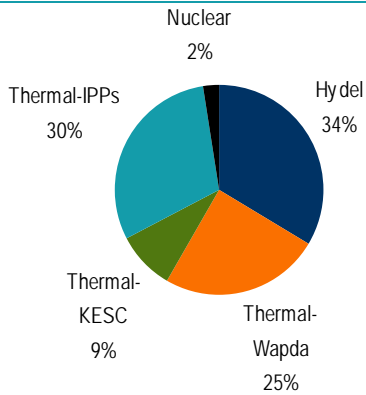
Source: Pakistan Energy Year Book 2006

**Chart 9: Driven by fuel based power projects (GWH)**



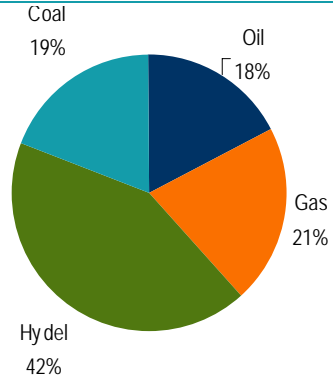
Source: Pakistan Energy Year Book 2006

**Chart 10: Pakistan – Breakdown of installed capacity of electricity generation (Total 19.37GW)**



Source: Pakistan Energy Year Book 2006

**Chart 11: Pakistan – Breakdown of expected electricity capacity addition (Total 13.3 GW)**



Source: Pakistan Private Infrastructure Board

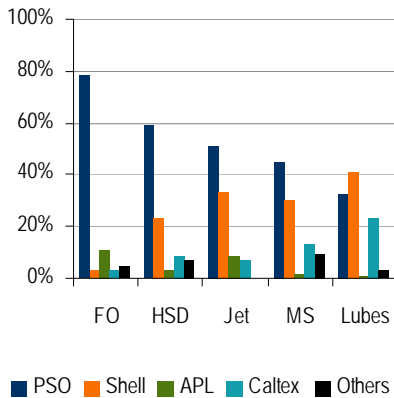
## Favorable industry structure

In addition to strong volume growth, PSO has the advantages of dominating an oligopoly (market share of 65%) and a favorable regulatory backdrop allowing for stable marketing margins of 3.5% on the retail prices to marketing companies.

### Strongly placed in downstream

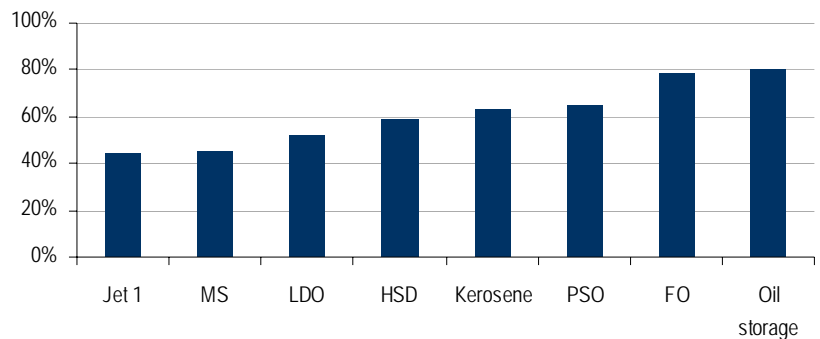
We believe PSO is strongly placed in Pakistan's downstream industry. Our belief is underpinned by the positives favoring the company: (1) Extensive reach to consumers via control over 3,800 retail outlets. (2) Strong brand recognition. (3) Hegemony in oil movement infrastructure and storage (80% storage facility). (4) Market leadership in almost all spheres of the downstream industry. These positives coupled with an almost un-leverage balance sheet and its initiatives make PSO suitably placed to leverage off its size to capitalize on the expected volume growth, in our view.

Chart 12: Market shares – PSO dominates



Source: OGRAT

Chart 13: PSO share (%) in petroleum product and oil storage



Source: PSO

### PSO's leadership set to continue

We believe PSO has all it takes to sustain dominance in Pakistan's downstream industry supported by a strong retail network, continued investments in oil movement & storage infrastructure, and experience in handling high volumes. We believe these advantages are difficult to match by existing or new companies.

Power fuel supply is an area in which PSO's near monopoly is hard to challenge, with or without its privatization. It has gained experience in international markets for local import needs. This can be gauged from the fact the PSO has, on average, imported 2-3mn tons of fuel annually to meet the country's demand. PSO owns 87% of power fuel storage facility and has pipelines to all major IPPs. The ability to handle heavy volumes and its high market share provide PSO the pricing power in this commodity-type product, potentially edging out competition.

In fuel transportation, PSO has the advantage of operating the most extensive retail network in Pakistan. With over 1,500 retail site and plans to invest on refurbishing the sites, PSO is likely to sharpen this advantage to sustain its market share in transporting fuel.

PSO's investments in storage and oil movement infrastructure not only support its logistics, but have become a source for income, as PSO offers its facilities to other players in the industry. However, contribution from such rental income is

modest at PRs500-600mn (PRs2.91-3.5/share), and we do not expect this to increase in future, as we believe PSO might require more of its existing infrastructure for its own consumption.

## Stable marketing margins

We believe PSO has relatively low earnings volatility, as it relies heavily on regulated products. Roughly 60% of its volumes are based on regulated products (only FO and auto lubes are deregulated).

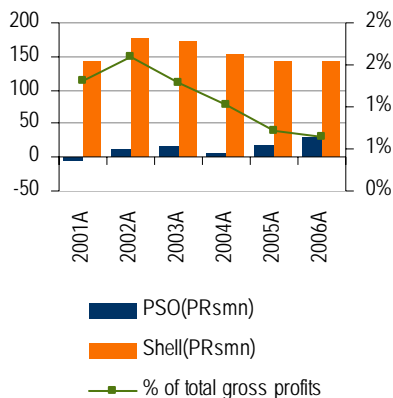
PSO's marketing margins (a key earnings driver) have been stable, primarily because they are based on a percentage of retail product prices, which have been relatively steady. In the past 12 months, end product prices have been revised only twice (May 2006 and January 2007), though prices are reviewed every fortnight as per the pricing regulations. Clearly, the volatility in ex-refinery prices in the international market has been absorbed by changes in government taxes, stabilizing marketing margins. Amid increasing oil prices, the government tries to avoid raising end-product prices by reducing its share of taxes built into the product prices and, at times, providing subsidy (not borne by the oil marketing industry). In oil prices fall, the government is expected to raise its share of taxes in product prices.

**Table 4: Product prices and marketing margins (16 February 2007)**

	Product prices (PRs/litre)	Marketing margins (PRs/litre)	Marketing margins (US\$/bbl)
High Speed Diesel( Gasoil)	39	1.1	2.91
Motor Spirit (Petrol)	58	1.57	4.48
Kerosene	35	1.02	2.68
High Octane Blending			
Comp.	65	1.89	4.97
Light Diesel Oil	33	0.96	2.53
Furnace Oil	31.43	0.79	2.07

Source: Oil & Gas Regulatory Authority, KASB Securities

Chart 14: Retail sales - Low contribution to gross profits



Source: PSO, Shell

## Eyeing potential in non-fuel segment

PSO plans to explore the potential in non-fuel retail sales, and we think it is poised to benefit from this move. With over 3,800 retail sites (66% of industry), PSO has extensive reach across Pakistan. The country has 6.8mn registered vehicles that need to refuel, and PSO also holds 60% of the market for transporting fuel to retail outlets. An increasing number of refurbished retail outlets should augment PSO's efforts to leverage its advantages in retail outlets. While non-fuel retail sales should contribute PRs12mn (PRs0.6/share) at gross profit level in 2006, PSO is looking to increase this to PRs1bn by 2010.

That said, we are conservatively factoring in only 30% of management's targets into our earnings forecasts. We would look for further concrete developments before incorporating the full potential of non-fuel retail sales into earnings.

We see two key benefits to PSO from this move – (1) Maximization of returns on investments in retail outlets. (2) Increasing non-fuel segment revenue to cushion oil price volatility. With per capita income increasing (up 40% in the past three years) and life styles changing, the focus on non-fuel retail segment (allied business) has become strategically important for future earnings.

### Areas PSO is focusing upon

- **Convenience stores:** Only 175 of the total outlets now feature convenience stores. A changing life style is likely to support PSO's efforts to tap the huge growth potential. Though competition may come from undocumented stores and new branded chain outlets, we believe PSO can face the challenge. That's because – (1) PSO has location advantages at many sites. (2) Investment requirement for PSO would be low relative to other retail chain players. (3) PSO can potentially offer package products (4) the management is already on the lookout to tie up with retail store chain of international repute.
- **Banking, food:** PSO is joining hands with other service providers like banks and fast food chains to leverage its reach. Key services likely to be included are ATMs (MCB Bank) and fast food chains in rural and urban areas. PSO has already entered an agreement with a bank allowing the setting up of ATM machines at its retail sites.
- **Advertising:** Co-branding and media campaign support for other companies at the retail sites is under way, though on a limited scale.
- **Bills and cards:** PSO is spearheading the change in distribution chain for fast-moving products like mobile cards and services like collection of utility bills. It has signed a pact with Mobilink, Pakistan's largest cellular operator with 22mn subscribers, to sell cellular cards at its outlets. PSO has also struck deals for utility bill collection with a number of companies.

## Investment projects; advantage of strong balance sheet

Key investment projects in the oil downstream sector where PSO is likely to focus on are (1) Oil storage and oil pipeline. (2) Setting up of an oil refinery. As PSO has a cash-rich balance sheet, we do not expect it to face any problems in raising funds for the projects.

### Oil storage and oil pipeline

With oil demand rising, the need to increase oil storage capacity and further investments in oil movement infrastructure is likely to arise. We expect PSO to take a lead in undertaking such projects. Its market leader position requires sustained investments in oil infrastructure to maintain flexibility. The oil storage and pipeline business offers stable returns (15-20%) that are generally linked to benchmarked throughput capacity. Returns on the pipeline and storage business are close to PSO's cost of capital of 14.6%. We believe the expected stable earnings profile lowers business risk, which, in turn, lowers hurdle rates, making the project attractive for the company.

PSO, along with Attock group, is already working to set up a 470 km pipeline between Lahore and Peshawar for white oil products. This will require an estimated investment of PRs10.37bn (US\$170mn). The joint venture partners are obtaining the approvals from the concerned regulatory authorities.

### Potential backward integration into refinery

Given that PSO handles over 10.5mn tons in marketing volumes, its backward integration into the refinery business seems a logical consequence to both the current and new management. Having denied participation in the privatization of second-largest refinery, National Refinery Ltd, the current management is likely to take alternative route of making equity investments in the refining business via a joint venture with new refineries. Post privatization, we expect the new management to opt for an integrated oil refining and marketing model. In our view, such a venture will be a win-win situation for both partners. PSO stands to gain in the form of a supply back-up to support its market share while the refinery company will have the advantage of large buyers with high marketing volumes (over 2x of future capacity).

Due to government presence in the oil refining and oil marketing segment, the business models in Pakistan are unique as large marketing companies do not have supply sources though some group level integration is evolving. While PSO is yet to unveil its plans for backward integration, we see following benefits for PSO as an integrated entity –

1. With its own supply source, PSO can free up cash from working capital. As per last published accounts, it carries inventories for 38 days.
2. It can reduce dependence on imported fuel. PSO currently imports 78kbopd, or 3.8mn tons (about 38%) of its requirement.
3. Will provide PSO flexibility on product quality sourced from local refineries.

## Privatization - Potential opportunities for value creation

The government intends to privatize PSO and plans to offer a 51% stake to a prospective buyer. We see the following areas for efficiencies, which have significant potential to benefit both majority and minority shareholders.

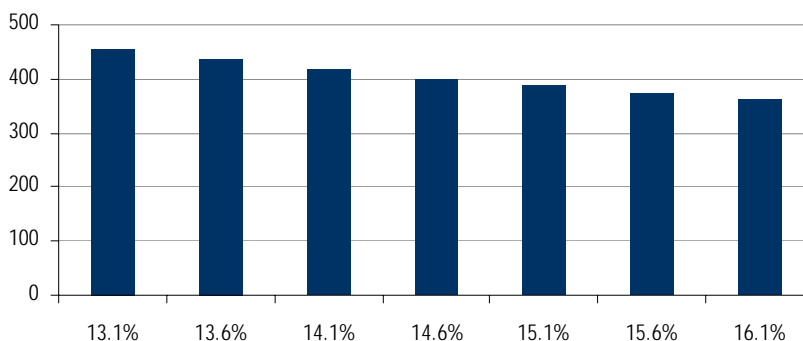
### Product portfolio optimization

Post privatization, we expect the new management to spearhead ongoing efforts to enhance market share on high-margin products like lubes and CNG.

### Restructuring of balance sheet

PSO's un-leveraged balance sheet offers option-like features to the new investors for taking up capital-intensive projects like refinery or pipeline. PSO shareholders would benefit from (1) potential value addition from projects and (2) value creation due to the lower discount rate to be applied on its cash flows. We show the sensitivity of valuation to reductions in the discount rate in the following chart.

Chart 15: Restructuring of balance sheet may increase PSO's valuation (PRs/share)



Source: KASB Securities Estimates

### Settlement of long-standing receivables

One promising area from both minority and majority shareholders' perspective is the settlement of PSO's age-old receivables with the government and state-owned enterprises. PSO carries PRs5,685mn (or PRs33/share) of such receivables on its book. These receivables are over and above subsidy receivables on petroleum products estimated at PRs8bn. The government has already recognized the liability for up to 98% of the amount, but PSO will not earn any returns on the blocked cash.

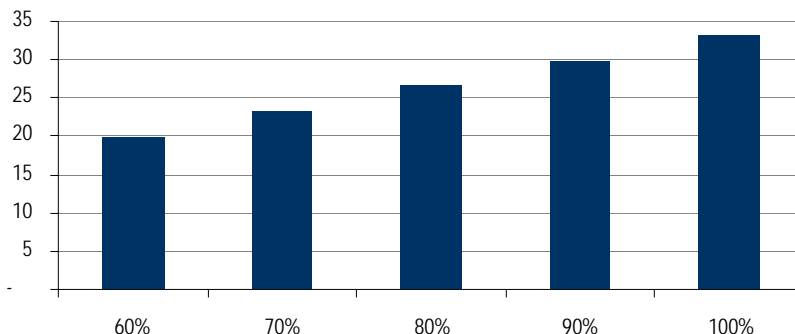
Table 5: Settlement of receivables

Long standing receivables	Provision		Status
Price differential claims on Imports	1,465	575	Settled with GoP, last payment received in 2003
Hubco First Fill	802	None	Settled with GoP, last action in 2005
			Final reconciliation prepared with Wapda and GoP submitted for GoP action in 2006
Price Differentials b/w LSFO and HSFO	3,418	None	
Total (PRsmn)	5,685	575	
PSO/share	33.14	3.35	

Source: PSO

Once the dues come in, they will provide cash to be deployed in any investment opportunity (as discussed) or reduce short-term borrowings to increase earnings and valuation. We do not expect any one-time high payout by the new/current management upon settlement of receivables. In our view, the new management is likely to be more focused on using balance sheet to take up more downstream projects that are compatible with PSO's current business. In the following chart, we have shown the impact of different levels of receivables recovery on valuation.

**Chart 16: Valuation impact from receivables (PRs/share)**



Source: PSO KASB Securities Estimates

Given the risk-free nature of these receivables, we have incorporated these receivables into our valuation. The payment/recovery of remaining payables is likely to be expedited ahead of privatization. We expect PSO to fully recover the amount before it is privatized.

### Government aiming privatization by 30 June

There have been two attempts to privatize the company. The first time, the government had to call off the process due to withdrawal of one of the three parties involved. The second time, the government invited Expression of Interest (EOI) in two phases. In the first phase, three Middle Eastern parties showed interest until the pre-bid meeting. Upon receiving requests for reopening the privatization process to accommodate interests from new parties as well as parties who had earlier withdrawn (i.e., in the first phase of EOI), the government re-invited EOI/Statement of Qualification. Resultantly there are now 11 parties in the run for the 51% stake in PSO with management rights.

The government wants to complete the transaction by 30 June 2007, three months beyond its earlier target of 31 March. The delay is because of due diligence by the new parties. We see the June deadline as achievable. As more parties are now interested, this will not only provide the government more quality parties for managing PSO, but also a better privatization price due to competition among potential bidders. The privatization does not have to be ratified by minority shareholders. The list of interested parties is given in the table on the next page.

**Table 6: Parties interested in PSO's privatization**

---

Statement of Qualification	
1	Fauji Foundation Attock Group of Companies ( upto 25.5% stake by Pakistan Oilfields, Attock Petroleum Ltd, National Refinery Ltd and Attock Refinery Ltd)
2	Abraaj Capital of Saudi Arabia
3	MCB Bank Ltd. & Vitol S.A. of Switzerland,
4	MCB Bank Ltd. & Vitol S.A. of Switzerland,
Expression of Interest (Awaiting qualification)	
5	Kohinoor Group
6	Saudi Arabian group of Bakri International Energy Systems & Dabbagh Group Holding
7	Goldman Sachs (Asia) Finance
8	Kuwait & National Industries Group,
Re-confirmation (Final parties from first phase of EOIs)	
9	Al Ghurair Inv LLC and Associate UAE
10	Abu Dhabi Group, UAE
11	Consortium of Noor Financial Services and Al Jomaih Holding Company , SA

Source: Privatization Commission of Pakistan

## Long-term supply contracts with IPPs

Post privatization, it is still undecided who will bear the risk of fuel supply contract that PSO has entered into with IPPs on behalf of the government. We see a high chance that the government will continue with the existing mechanism guaranteeing FO supply, as withdrawing the fuel supply guarantee will undermine its contracts with IPPs. However, the government may sign an indemnity agreement with PSO, whereby the new management will be asked to compensate the government for any potential payment on account of PSO's failure to supply fuel.

## Valuation: PRs407/share

Our valuation of PRs407/share is based on the sum-of-the-parts method, which allows us to account for all of the following: PSO's future free cash generation, its investments in different companies, and its long- & short-term receivables from the government.

### Our key assumptions

- Long-term oil price assumption of US\$47/bbl (WTI).
- WACC of 14.6% and terminal growth rate of 5%. We believe long-term terminal growth assumption is realistic given expected long-term US CPI of 2% and an expected 2% long-term depreciation of PRs versus US\$. The terminal growth reflects largely the expected nominal growth (ex-refinery prices linked with international prices).
- We have valued PSO's investments in Pakistan Refinery at PRs266/share of our PO (the share is at a 29% discount to our PO).
- We have used PBV of 1.2x for PSO's investments in Pak Arab Pipeline Co and Asia Petroleum Ltd. Both these companies operate in the stable business of oil pipelines where returns are fixed (15-20%) based on benchmarked capacity utilization factor.

Table 7: PSO valuation

	30-Jun-07	30-Jun-08	30-Jun-09	30-Jun-10
EBITDA less earnings from associate	9,934	11,616	11,947	12,029
Less: Cash tax payable on EBIT	-2,948	-3,568	-3,696	-3,730
Plus: Decrease in working capital	-802	-1,203	-957	-1,106
Less: Capital expenditure	-2,107	-1,530	-1,526	-1,523
Free cash flows	4,077	5,315	5,767	5,670
PV of free cash flows	3,889	4,422	4,186	3,591
	PRs mn	PRs/share	% of total	
NPV of forecasts	16,088	94	23%	
NPV of terminal value	39,205	229	56%	
Value of PSO's future free cash flows from operations	55,292	322	79%	
Long-term receivables	5,685	33	8%	
Receivables to government on product subsidy	7,784	45	11%	
Net debt	(5,750)	(34)	-8%	
Add investments				
Pakistan Refinery Ltd	1,166	7	2%	
PAPCO (1.2x of book value)	3,935	23	6%	
Asia Petroleum Ltd (1.2x of book value)	1,743	10	2%	
Total investments	6,844	40	20%	
Total	69,856	407		

Source: KASB Securities Estimates

### WACC calculation

WACC is based on actual cost of debt of 11% and cost of equity of 17.54%, calculated using the CAPM approach. For CAPM, we have used risk-free rate of 10%, 50bp higher than central bank's discount rate of 9.5% and 60bp lower than 10-year government paper yield of 10.6%. We have used beta of 1.01 based on the stock's three-year price history. Moreover, we have taken a market risk premium of 7% which, in our view, represents adequate compensation for exposure to an emerging market like Pakistan.

Table 8: PSO: WACC calculation

Risk Free Rate	10.00%
Equity Risk Premium	7.00%
Beta	1.01
Cost of Equity	17.54%
Weight age of Equity	70%
Cost of Debt	11%
Weight age of Debt	30%
WACC	14.6%

Source: Merrill Lynch Estimates

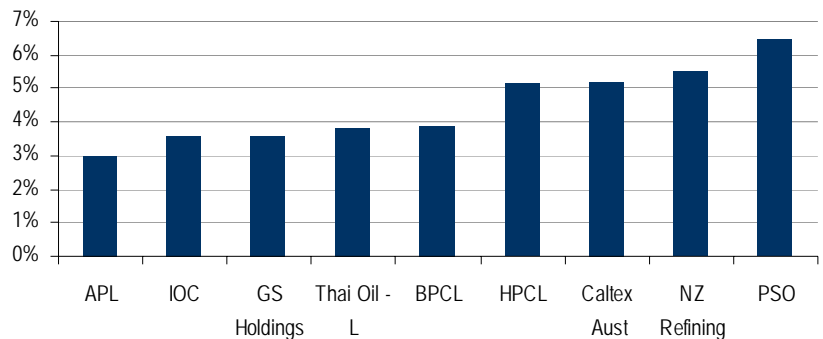
## Buy with PO of PRs407/share

We recommend a Buy on PSO with a PO of PRs407/share. Our recommendation is underpinned by (1) PSO's strong competitive position. (2) Upside potential from privatization. (3) Decent future earnings growth of 10%, and (4) Dividend yield of 6%, which looks attractive in the local and regional context.

## PSO offers attractive dividend yield

A striking feature of PSO is its attractive dividend yield of 6% (2007E), 200-300bps higher than those of its regional peers. We expect dividend payout to remain flat at 78% in 2007 (over 2006), and have assumed the payout ratio to remain at 70% over 2008-2010. However, given the strong cash flow generation, we believe PSO has the potential to increase its cash payment in the future.

Chart 17: PSO offers attractive dividend yield among peers (2007E)



Source: KASB Securities Estimates

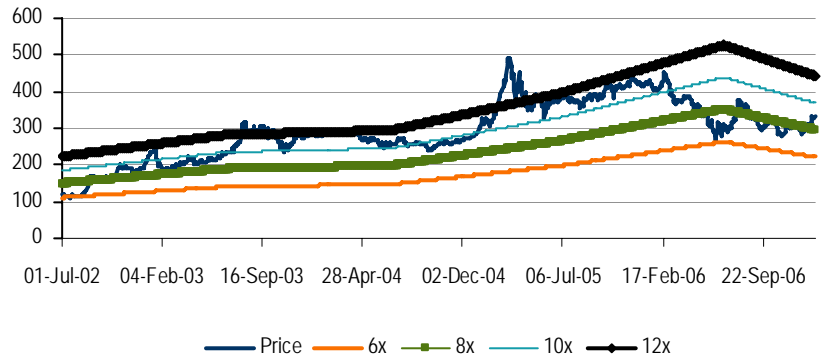
## PSO inexpensive relative to historical levels

Lacking appropriate peers in the region, we have provided a comparison of PSO's current valuation multiples vis-a-vis its own historical multiples.

### P/E may expand in the short term

The P/E enjoys widespread popularity in the local market. This is evident in relationship of PSO price and valuation multiples historically. Relative to PSO's historical P/E of 10.5x2000, it is currently available at PER of 10.1x on 2008E earnings. In our view, current multiples have room to expand further based on (1) PSO's stable/rising earnings growth outlook under our declining oil price scenario (2) pending privatization, which creates the potential for further earnings upgrade. As more news flow is expected on the privatization front in the near term, we may see this materializing soon (3-6 months).

Chart 18: P/E multiple may expand in the short term

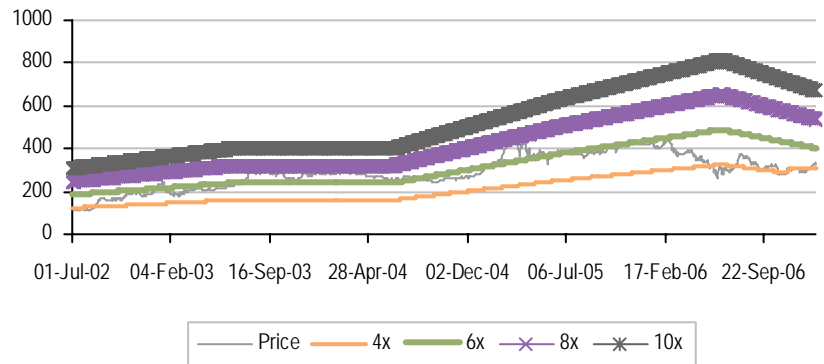


Source: PSO KASB Securities estimates

### EV/EBITDA

PSO 's historical price has also closely followed the EV/EBITDA multiple. Relative to its present EV/EBITDA of 4.8x based on 2008E earnings, PSO has historically traded at EV/EBITDA of 5.4x.

Chart 19: PSO: EV/EBITDA trend



Source: PSO KASB Securities estimates

## Potential near-term drivers and risks

### Developments related to privatization

Historically, PSO has often been considered a privatization play. With the government targeting completion of privatization by June 2007, news flow on the privatization front may lead to a decent price run-up in the local market.

### Earnings announcement

The upcoming quarterly results may provide a positive surprise for the market as PSO has the potential to reverse provisions on (1) net realizable value (potential of PRs3-PRs4/share) and (2) trade receivables (about PRs1.6bn, or PRs9.32/sh).

### Investment projects

Any development on investment projects (pipeline and storage) may result in price performance, as these projects are believed to have higher returns (15-20%) than the estimated cost of capital of 14.6% for PSO.

## Key risks

### Sustained decline in product prices

This could lead to lower retail prices and decline in margins for PSO, as marketing margins are determined as a percentage of retail prices. Moreover, inventory losses may arise due to a decline in product prices.

### Drop in FO consumption for electricity generation

Such a drop can happen if there is a sizable gas discovery (and subsequent related developments) or from higher hydel power availability. With FO being imported fuel, the government has strong reasons to prefer gas over fuel oil.

### Exchange rate risk

The PRs (local currency) depreciation benefits local marketing companies, as product prices are ultimately linked to US\$-denominated oil prices. Over the past five years, PRs has depreciated 3% (on average) versus the US\$. We expect PRs to depreciate 3% per annum over 2008-2010 too. That said, any appreciation of PRs vs the US\$ would be a risk to PRs-based earnings of local oil marketing companies.

### Government intervention in the business

While government intervention is believed to be non-existent in the past few years, a change in government may result in intervention in the future.

### Continuation of contracts with external parties

We have assumed the continuation of PSO's current agreements with IPPs for fuel oil supply and its alliance with British Petroleum for marketing different grades of Castrol lubricant in Pakistan. Any change in the agreement may affect our earnings forecasts and valuation.

### Slowdown in economic activity

This can potentially hurt sentiment on the stock, and cap price upside. However, it will not affect our price objective, as we have not assumed any upside from the potential privatization of the company.

## FY07 - Earnings drop of 35% seen

We expect PSO to earn profit after tax of PRs4,881mn (PRs28.4/share)FY07 compared to PRs7525mn (PRs43.9/share)in FY06. Due to adjustments to the marketing margins formula in March 2006, stock losses in the first two quarters and drop in other income, we expect PSO to report an earnings drop of 35% in 2007.

### Adjustments to marketing margins

In 2006, the government adjusted the formula for determination of marketing margins and dealer margins. The adjusted formula calls for determination of margins based on retail prices pre-sales tax. Earlier, margins were calculated on retail prices including sales tax, which allowed OMCs to earn margins on government taxes as well. This modification led to absolute margins for OMCs declining 19-20% on regulated products. The government intention was to remove the anomaly in margin calculation as retail prices had only PRs0.15-0.3/litre impact. The adjusted formula has been in place since March 2006, and its full-year impact will appear only in 2007.

### Stock losses

With more than 18-24% decline in petroleum product and crude prices in the first two quarters, PSO's earnings should be depressed due to stock losses.

### Drop in other income

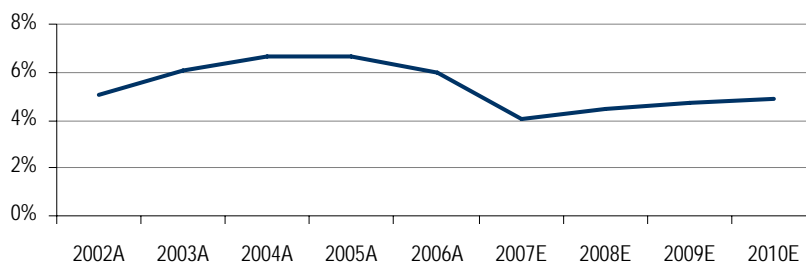
An expected 42% drop in other income of PSO in FY07 was mainly due to the absence of deferred tax asset adjustment in PSO's 49%-owned associate company, Asia Petroleum Ltd, which recorded a one-time deferred tax asset adjustment of about PRs1bn in 2006.

Table 9: PSO P&L (PRsmn)

	2006A	2007E	Chg (%)
Net Sales	288,712	302,213	5%
Cost of Sales	271,505	290,284	7%
<b>Gross Profit</b>	<b>17,207</b>	<b>11,929</b>	<b>-31%</b>
Operating Expenses	3,228	3,122	-3%
Operating Profit	13,979	8,807	-37%
Other Income	1,867	1,085	-42%
Other Expenses	573	420	-27%
Depreciation & Amortization	1,082	1,050	-3%
<b>EBIT</b>	<b>12,649</b>	<b>8,422</b>	<b>-33%</b>
Financial Charges	995	912	-8%
EBT	11,654	7,510	-36%
Taxation	4,129	2,628	-36%
<b>Net Profit (Loss)</b>	<b>7,525</b>	<b>4,881</b>	<b>-35%</b>
EPS (PRs/share)	43.9	28.5	-35%

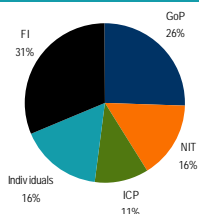
Source: PSO, KASB Securities Estimates

Chart 20: PSO gross margins(%)



Source: PSO, KASB Securities Estimates

Chart 21: Shareholding pattern



Source: PSO

### Shareholding pattern

PSO is a majority state-owned enterprise. The government maintains an effective 52% stake in the company through a 26% direct ownership and 25% via its 100% state-owned enterprises, National Investment Trust (NIT) and Investment Corp of Pakistan (ICP). PSO has a free float of 48%. Financial institutions (excluding NIT and ICP) hold 31%, while individual investors own only 16% of the company. PSO has historically enjoyed healthy liquidity. Its average daily turnover has been US\$10mn in the past six months.

28 February 2007

**Table 10: Pakistan State Oil; Income Statement (PRsmn)**

Year End June	2005A	2006A	2007E	2008E	2009E
Net Sales	207,693	288,712	302,213	329,355	316,361
Cost of sales	-193,942	-271,505	-290,284	-315,306	-301,710
Gross Profit	13,750	17,207	11,929	14,048	14,651
Operating Expenses	-2,943	-3,228	-3,122	-3,589	-3,953
Other Income	815	1,867	1,085	1,320	1,565
Other Charges	-1,076	-2,114	-420	-512	-530
EBITDA	10,546	13,731	9,472	11,268	11,733
Depreciation & Amortization	-984	-1,082	-1,050	-1,073	-1,173
EBIT	9,562	12,649	8,422	10,195	10,561
Financial Charges	-371	-995	-912	-820	-710
Earnings before tax	9,191	11,654	7,510	9,375	9,851
Taxation	-3,536	-4,129	-2,628	-3,281	-3,448
Earnings after tax	5,656	7,525	4,881	6,094	6,403
EPS(PR\$/share)	32.98	43.87	28.46	35.53	37.33
DPS(PR\$/share)	22.00	34.00	22.00	25.00	25.00

Source: PSO, KASB Securities Estimates

**Table 11: Pakistan State Oil; Balance Sheet (PRsmn)**

Year End June	2005A	2006A	2007E	2008E	2009E
Fixed Assets	8,256	7,639	8,696	9,153	9,507
Investments	2,318	3,279	3,279	3,279	3,279
Other LT assets	1,000	1,131	1,095	1,063	1,035
Current assets					
Cash & equivalents	1,922	1,899	1,112	1,968	2,474
Inventories	20,583	28,169	30,221	32,826	31,411
Accounts receivable	6,791	11,840	12,420	13,535	13,001
Other Current assets	13,360	18,110	18,304	20,190	21,786
Total assets	52,308	70,168	74,015	80,047	80,019
Current liabilities					
Accounts payable	25,470	36,269	38,777	42,120	40,303
Other Current Liabilities	7,294	10,788	10,988	11,844	11,491
LT liabilities					
LT borrowings	0	0	0	0	0
Deferred tax	1,324	1,555	1,578	1,597	1,616
Other non-current liabilities	675	744	751	759	767
Shareholders' equity					
Paid-up capital	1,715	1,715	1,715	1,715	1,715
Reserves	15,077	18,142	19,250	21,056	23,172
Net cash/(debt) (PRsm)	2,890	5,750	6,435	6,230	5,371
Book value/share (PRs)	98	116	122	133	145

Source: PSO, KASB Securities Estimates

**Table 12: Pakistan State Oil; Cash Flow ( PRsmn)**

Year End June	2005A	2006A	2007E	2008E	2009E
Profit Before Tax	9,191	11,654	7,510	9,375	9,851
Less: Cash Tax Paid	2,191	3,543	2,628	3,281	3,448
Non cash Items	222	1,039			
Add Depreciation & Ammortization	984	1,082	1,050	1,073	1,173
Sub-total	7,984	9,194	5,931	7,167	7,576
Change in Trade Debts	-850	-5,048	-580	-1,115	534
Changes in Working Capital	-2,948	-6,610	-1,104	-1,408	-957
Capex	-1,502	-465	-2,107	-1,530	-1,526
Total Investing Cash Flows	-788	-86	-2,047	-1,479	-1,479
Financing Cash Flows					
Change in Equity	0	0	0	0	0
Cash Dividends	-3,617	-4,389	-3,472	-4,082	-4,288
Total Financing Cash Flows	-3,687	-1,483	-3,566	-3,424	-4,634
Net Change in Cash	561	1,016	-786	856	506

Source: PSO, KASB Securities Estimates

**Table 13: Pakistan State Oil; Key measures**

Year End June	2005A	2006A	2007E	2008E	2009E
Total Sales Volume(000'bopd)	200	201	222	229	243
of which					
FO(000'bopd)	76	83	97	102	112
HSD(000'bopd)	96	90	96	98	101
MS(000'bopd)	12	11	11	11	12
Prices					
PRs/US\$	59	60	62	64	66
Marketing Margins (US\$/bbl)					
FO	1.4	1.9	1.5	1.4	1.3
HSD	2.5	3.3	2.8	2.8	2.7
MS	3.8	5.2	4.0	3.9	3.3
Market share					
FO	79%	79%	80%	80%	80%
HSD	60%	59%	60%	59%	59%
MS	45%	45%	46%	46%	46%
Average tax rate	38%	35%	35%	35%	35%

Source: PSO, KASB Securities Estimates

## Price Objective Basis & Risk

Our price objective for Pakistan State Oil is PRs407/share based on the sum-of-the-parts valuation method. This represents potential total return of over 17% to the current market price.

Risks: (1) Sustained decline in product prices in the international market. (2) Higher water and gas availability leading to lower fuel consumption. (3) Government intervention in the business. (4) Delays in privatization affecting investor sentiment.

## Analyst Certification

We, Stuart B Smith and Mohammad Fawad Khan, hereby certify that the views each of us has expressed in this research report accurately reflect each of our respective personal views about the subject securities and issuers. We also certify that no part of our respective compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

## Special Disclosures

This report is issued and distributed outside Pakistan solely by Merrill Lynch. KASB Securities is not licensed to provide advisory services outside Pakistan. Investors should contact their Merrill Lynch representative if they have questions concerning this report.

### *iQmethod*<sup>SM</sup> Measures Definitions

Business Performance	Numerator	Denominator
Return On Capital Employed	$\text{NOPAT} = (\text{EBIT} + \text{Interest Income}) * (1 - \text{Tax Rate}) + \text{Goodwill Amortization}$	$\text{Total Assets} - \text{Current Liabilities} + \text{ST Debt} + \text{Accumulated Goodwill}$
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
<b>Quality of Earnings</b>		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
<b>Valuation Toolkit</b>		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	$\text{EV} = \text{Current Share Price} * \text{Current Shares} + \text{Minority Equity} + \text{Net Debt} + \text{Sales Other LT Liabilities}$	
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

*iQmethod*<sup>SM</sup> is the set of Merrill Lynch standard measures that serve to maintain global consistency under three broad headings: Business Performance, Quality of Earnings, and valuations. The key features of *iQmethod* are: A consistently structured, detailed, and transparent methodology. Guidelines to maximize the effectiveness of the comparative valuation process, and to identify some common pitfalls.

*iQdatabase*<sup>®</sup> is our real-time global research database that is sourced directly from our equity analysts' earnings models and includes forecasted as well as historical data for income statements, balance sheets, and cash flow statements for companies covered by Merrill Lynch.

*iQprofile*<sup>SM</sup>, *iQmethod*<sup>SM</sup> are service marks of Merrill Lynch & Co., Inc. *iQdatabase*<sup>®</sup> is a registered service mark of Merrill Lynch & Co., Inc.

## Important Disclosures

### PKSOF Price Chart



B : Buy, N : Neutral, S : Sell, PO : Price objective, NA : No longer valid

The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark Grey shading indicates the security is restricted with the opinion suspended. Light Grey shading indicates the security is under review with the opinion withdrawn. Chart current as of January 31, 2007 or such later date as indicated.

### Investment Rating Distribution: Energy Group (as of 31 Dec 2006)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	103	55.68%	Buy	44	42.72%
Neutral	73	39.46%	Neutral	21	28.77%
Sell	9	4.86%	Sell	1	11.11%

### Investment Rating Distribution: Global Group (as of 31 Dec 2006)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1306	42.74%	Buy	406	31.09%
Neutral	1509	49.38%	Neutral	446	29.56%
Sell	241	7.89%	Sell	53	21.99%

\* Companies in respect of which MLPF&S or an affiliate has received compensation for investment banking services within the past 12 months.

**FUNDAMENTAL EQUITY OPINION KEY:** Opinions include a Volatility Risk Rating, an Investment Rating and an Income Rating. VOLATILITY RISK RATINGS, indicators of potential price fluctuation, are: A - Low, B - Medium, and C - High. INVESTMENT RATINGS, indicators of expected total return (price appreciation plus yield) within the 12-month period from the date of the initial rating, are: 1 - Buy (10% or more for Low and Medium Volatility Risk Securities - 20% or more for High Volatility Risk securities); 2 - Neutral (0-10% for Low and Medium Volatility Risk securities - 0-20% for High Volatility Risk securities); 3 - Sell (negative return); and 6 - No Rating. INCOME RATINGS, indicators of potential cash dividends, are: 7 - same/higher (dividend considered to be secure); 8 - same/lower (dividend not considered to be secure); and 9 - pays no cash dividend.

In the US, retail sales and/or distribution of this report may be made only in states where these securities are exempt from registration or have been qualified for sale: Pakistan State.

The analyst(s) responsible for covering the securities in this report receive compensation based upon, among other factors, the overall profitability of Merrill Lynch, including profits derived from investment banking revenues.

## Other Important Disclosures

UK readers: MLPF&S or an affiliate is a liquidity provider for the securities discussed in this report.

---

### Information relating to Non-U.S. affiliates of Merrill Lynch, Pierce, Fenner & Smith Incorporated (MLPF&S):

MLPF&S distributes research reports of the following non-US affiliates in the US (short name: legal name): Merrill Lynch (France): Merrill Lynch Capital Markets (France) SAS; Merrill Lynch (Frankfurt): Merrill Lynch International Bank Ltd, Frankfurt Branch; Merrill Lynch (South Africa): Merrill Lynch South Africa (Pty) Ltd; Merrill Lynch (Milan): Merrill Lynch International Bank Limited; MLPF&S (UK): Merrill Lynch, Pierce, Fenner & Smith Limited; Merrill Lynch (Australia): Merrill Lynch Equities (Australia) Limited; Merrill Lynch (Hong Kong): Merrill Lynch (Asia Pacific) Limited; Merrill Lynch (Singapore): Merrill Lynch (Singapore) Pte Ltd; Merrill Lynch (Canada): Merrill Lynch Canada Inc; Merrill Lynch (Mexico): Merrill Lynch Mexico, SA de CV, Casa de Bolsa; Merrill Lynch (Argentina): Merrill Lynch Argentina SA; Merrill Lynch (Japan): Merrill Lynch Japan Securities Co, Ltd; Merrill Lynch (Seoul): Merrill Lynch International Incorporated (Seoul Branch); Merrill Lynch (Taiwan): Merrill Lynch Global (Taiwan) Limited; DSP Merrill Lynch (India): DSP Merrill Lynch Limited; PT Merrill Lynch (Indonesia): PT Merrill Lynch Indonesia; Merrill Lynch (KL) Sdn. Bhd.; Merrill Lynch (Malaysia); Merrill Lynch (Israel): Merrill Lynch Israel Limited; Merrill Lynch (Russia): Merrill Lynch CIS Limited, Moscow.

This research report has been prepared and issued by MLPF&S and/or one or more of its non-U.S. affiliates. MLPF&S is the distributor of this research report in the U.S. and accepts full responsibility for research reports of its non-U.S. affiliates distributed in the U.S. Any U.S. person receiving this research report and wishing to effect any transaction in any security discussed in the report should do so through MLPF&S and not such foreign affiliates.

This research report has been approved for publication in the United Kingdom by Merrill Lynch, Pierce, Fenner & Smith Limited, which is authorized and regulated by the Financial Services Authority; has been considered and distributed in Japan by Merrill Lynch Japan Securities Co, Ltd, a registered securities dealer under the Securities and Exchange Law in Japan; is distributed in Hong Kong by Merrill Lynch (Asia Pacific) Limited, which is regulated by the Hong Kong SFC; is issued and distributed in Taiwan by Merrill Lynch Global (Taiwan) Ltd or Merrill Lynch, Pierce, Fenner & Smith Limited (Taiwan Branch); is issued and distributed in Malaysia by Merrill Lynch (KL) Sdn. Bhd., a licensed investment adviser regulated by the Malaysian Securities Commission; and is issued and distributed in Singapore by Merrill Lynch International Bank Limited (Merchant Bank) and Merrill Lynch (Singapore) Pte Ltd (Company Registration No.'s F 06872E and 198602883D respectively). Merrill Lynch International Bank Limited (Merchant Bank) and Merrill Lynch (Singapore) Pte Ltd. are regulated by the Monetary Authority of Singapore. Merrill Lynch Equities (Australia) Limited, (ABN 65 006 276 795), AFS License 235132, provides this report in Australia. No approval is required for publication or distribution of this report in Brazil.

Merrill Lynch (Frankfurt) is regulated by BaFin.

### Copyright, User Agreement and other general information related to this report:

Copyright 2007 Merrill Lynch, Pierce, Fenner & Smith Incorporated. All rights reserved. This research report is prepared for the use of Merrill Lynch clients and may not be redistributed, retransmitted or disclosed, in whole or in part, or in any form or manner, without the express written consent of Merrill Lynch. Merrill Lynch research reports are distributed simultaneously to internal and client websites eligible to receive such research prior to any public dissemination by Merrill Lynch of the research report or information or opinion contained therein. Any unauthorized use or disclosure is prohibited. Receipt and review of this research report constitutes your agreement not to redistribute, retransmit, or disclose to others the contents, opinions, conclusion, or information contained in this report (including any investment recommendations, estimates or price targets) prior to Merrill Lynch's public disclosure of such information. The information herein (other than disclosure information relating to Merrill Lynch and its affiliates) was obtained from various sources and we do not guarantee its accuracy. Merrill Lynch makes no representations or warranties whatsoever as to the data and information provided in any third party referenced website and shall have no liability or responsibility arising out of or in connection with any such referenced website.

This research report provides general information only. Neither the information nor any opinion expressed constitutes an offer or an invitation to make an offer, to buy or sell any securities or other investment or any options, futures or derivatives related to such securities or investments. It is not intended to provide personal investment advice and it does not take into account the specific investment objectives, financial situation and the particular needs of any specific person who may receive this report. Investors should seek financial advice regarding the appropriateness of investing in any securities, other investment or investment strategies discussed or recommended in this report and should understand that statements regarding future prospects may not be realized. Investors should note that income from such securities or other investments, if any, may fluctuate and that price or value of such securities and investments may rise or fall. Accordingly, investors may receive back less than originally invested. Past performance is not necessarily a guide to future performance. Any information relating to the tax status of financial instruments discussed herein is not intended to provide tax advice or to be used by anyone to provide tax advice. Investors are urged to seek tax advice based on their particular circumstances from an independent tax professional.

Foreign currency rates of exchange may adversely affect the value, price or income of any security or related investment mentioned in this report. In addition, investors in securities such as ADRs, whose values are influenced by the currency of the underlying security, effectively assume currency risk.

Officers of MLPF&S or one or more of its affiliates (other than research analysts) may have a financial interest in securities of the issuer(s) or in related investments.

Merrill Lynch Research policies relating to conflicts of interest are described at <http://www.ml.com/media/43347.pdf>.

iQmethod, iQmethod 2.0, iQprofile, iQtoolkit, iQworks are service marks of Merrill Lynch & Co., Inc. iQanalytics®, iQcustom®, iQdatabase® are registered service marks of Merrill Lynch & Co., Inc.

Fundamental equity reports are produced on a regular basis as necessary to keep the investment recommendation current.

# Banking on synergies; new Buy



## Initiating with a Buy rating, PO of PRs441

Attock Petroleum (APL) is a standalone oil marketing company with 8% market share of Pakistan's downstream oil industry. Our DCF-based price objective is PRs441/share, implying 19% potential total return. Our Buy rating is premised on our expectation that APL will: (1) show strong earnings growth, (2) capitalize on industry growth opportunities, and (3) benefit from group synergies.

### Strong earnings growth

We believe APL is poised to enjoy a strong double digit earnings growth (over the next four years) underpinned by a growing core business and contribution from its trading business. A strong uptrend in the bottom line last year (earnings jumped 2x in FY06 – year ending June) resulted from Attock Group's acquisition of Pakistan's second largest refinery in 2006.

### Capitalizing on industry growth opportunities

We conservatively expect APL to increase its market share by 2 percentage points to 10% via aggressive outlet rollouts (number of outlets expected to double over the next four years) and investment in infrastructure.

### Benefiting from group synergies

Being a marketing arm of two refineries controlled by Attock Group adds to the company's ability by (1) strengthening its position in the export market in Afghanistan, and (2) reducing its working capital requirement and enabling it to potentially look for higher volumes in the high margin lubricant segment.

### Risks to our PO

(1) Lower future absolute margins, (2) slowdown in exports to Afghanistan, (3) discontinuation of group synergies, and (4) management transparency.

#### Estimates (Jun)

(PRs)	2005A	2006A	2007E	2008E	2009E
Net Income (Adjusted - mn)	460	1,393	1,540	1,748	1,913
EPS	11.49	34.82	38.49	43.69	47.83
EPS Change (YoY)	2.1%	202.9%	10.6%	13.5%	9.5%
Dividend / Share	5.00	9.00	11.55	13.11	14.35
Free Cash Flow / Share	24.44	40.49	32.31	38.92	41.79

#### Valuation (Jun)

	2005A	2006A	2007E	2008E	2009E
P/E	33.28x	10.99x	9.94x	8.75x	8.00x
Dividend Yield	1.31%	2.35%	3.02%	3.43%	3.75%
EV / EBITDA*	37.08x	7.57x	7.25x	6.34x	5.77x
Free Cash Flow Yield*	5.59%	10.59%	8.45%	10.17%	10.93%

\* For full definitions of *iQmethod*<sup>SM</sup> measures, see page 17.

#### Mohammad Fawad Khan

Research Analyst  
KASB Securities

#### Stuart B Smith >>

Research Analyst  
Merrill Lynch (Singapore)  
stuart\_b\_smith@ml.com

+65 6330 7212

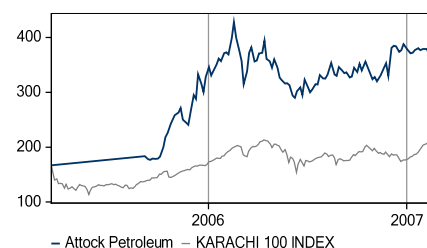
#### Adrian Loh >>

Research Analyst  
Merrill Lynch (Singapore)  
adrian\_loh@ml.com

+65 6330 7220

#### Stock Data

Price	PRs382.50
Price Objective	PRs441.56
Date Established	28-Feb-2007
Investment Opinion	C-1-7
Volatility Risk	HIGH
52-Week Range	PRs261.75-PRs404.75
Mrkt Val / Shares Out (mn)	US\$252 / 40.0
Average Daily Volume	59,966
ML Symbol / Exchange	XAKTF / KAR
Bloomberg / Reuters	APL PA / APL.KA
ROE (2007E)	59.5%
Net Dbt to Eqty (Jun-2006A)	-106.6%
Est. 5-Yr EPS / DPS Growth	10.2% / 14.4%
Free Float	28.0%



Merrill Lynch participated in the preparation of this report, in part, based on information provided by KASB Securities Ltd (KASB Securities). <sup>^^^</sup>KASB Securities employees are not registered/qualified as research analysts under NYSE/NASD rules.

>> Employed by a non-US affiliate of MLPF&S and is not registered/qualified as a research analyst under the NYSE/NASD rules.

Merrill Lynch does and seeks to do business with companies covered in its research reports. As a result, investors should be aware that the firm may have a conflict of interest that could affect the objectivity of this report. Investors should consider this report as only a single factor in making their investment decision.

Refer to important disclosures on page 18 to 19. Analyst Certification on page 16. Price Objective Basis/Risk on page 16.

28 February 2007

# iQprofile<sup>SM</sup> Attock Petroleum Ltd.

Key Income Statement Data (Jun)	2005A	2006A	2007E	2008E	2009E
<b>(PRs Millions)</b>					
Sales	9,910	40,839	44,229	50,025	53,134
Gross Profit	431	1,812	1,921	2,200	2,433
Sell General & Admin Expense	NA	NA	NA	NA	NA
Operating Profit	300	1,571	1,608	1,822	1,983
Net Interest & Other Income	259	375	530	606	674
Associates	NA	NA	NA	NA	NA
Pretax Income	559	1,946	2,138	2,427	2,657
Tax (expense) / Benefit	(99)	(553)	(599)	(680)	(744)
Net Income (Adjusted)	460	1,393	1,540	1,748	1,913
Average Fully Diluted Shares Outstanding	40	40	40	40	40

## Key Cash Flow Statement Data

Net Income (Reported)	460	1,393	1,540	1,748	1,913
Depreciation & Amortization	32	56	91	121	151
Change in Working Capital	442	413	(29)	(12)	(93)
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	0	0	0	0	0
Cash Flow from Operations	934	1,861	1,602	1,857	1,972
Capital Expenditure	(79)	(242)	(309)	(300)	(300)
(Acquisition) / Disposal of Investments	(89)	(262)	0	0	0
Other Cash Inflow / (Outflow)	24	17	40	42	37
Cash Flow from Investing	(143)	(487)	(269)	(258)	(263)
Shares Issue / (Repurchase)	0	0	0	0	0
Cost of Dividends Paid	(120)	(360)	(462)	(524)	(574)
Cash Flow from Financing	(120)	(360)	(462)	(524)	(574)
Free Cash Flow	855	1,620	1,292	1,557	1,672
Net Debt	(1,184)	(2,182)	(3,012)	(4,045)	(5,142)
Change in Net Debt	NA	NA	NA	NA	NA

## Key Balance Sheet Data

Property, Plant & Equipment	335	521	739	918	1,067
Other Non-Current Assets	91	353	353	353	353
Trade Receivables	277	2,502	2,666	3,015	3,203
Cash & Equivalents	1,268	2,282	3,153	4,228	5,362
Other Current Assets	478	927	1,016	1,280	1,498
Total Assets	2,449	6,586	7,928	9,794	11,483
Long-Term Debt	84	101	141	183	220
Other Non-Current Liabilities	14	29	25	22	19
Short-Term Debt	NA	NA	NA	NA	NA
Other Current Liabilities	1,337	4,409	4,637	5,241	5,556
Total Liabilities	1,435	4,538	4,803	5,446	5,795
Total Equity	1,014	2,047	3,125	4,348	5,687
Total Equity & Liabilities	2,449	6,585	7,927	9,794	11,482

## iQmethod<sup>SM</sup> - Bus Performance\*

Return On Capital Employed	28.5%	73.5%	46.8%	36.6%	29.6%
Return On Equity	54.4%	91.0%	59.5%	46.8%	38.1%
Operating Margin	3.0%	3.8%	3.6%	3.6%	3.7%
EBITDA Margin	3.4%	4.0%	3.8%	3.9%	4.0%

## iQmethod<sup>SM</sup> - Quality of Earnings\*

Cash Realization Ratio	2.0x	1.3x	1.0x	1.1x	1.0x
Asset Replacement Ratio	2.5x	4.3x	3.4x	2.5x	2.0x
Tax Rate (Reported)	17.8%	28.4%	28.0%	28.0%	28.0%
Net Debt-to-Equity Ratio	-116.7%	-106.6%	-96.4%	-93.0%	-90.4%
Interest Cover	NM	NA	NA	NA	NA

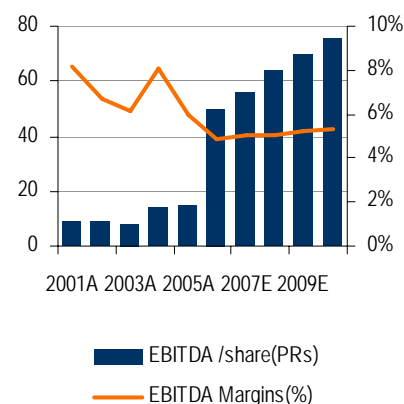
## Key Metrics

\* For full definitions of iQmethod<sup>SM</sup> measures, see page 17.

## Company Description

Attock Petroleum Ltd is an oil marketing company in Pakistan. It is the third-largest marketing play with a market share in excess of 7%. Being a part of Attock Group, APL acts as a marketing arm for two group refineries - National Refinery Ltd and Attock Refinery Ltd. APL has also a strong presence in Afghanistan. The Attock group has a 65% stake, and APL management owns 7% of the company.

## Chart 1: APL-EBITDA Trend (PRs)



Source: Merrill Lynch

## Stock Data

Price to Book Value 4.9x

## Strong earnings growth profile

We believe APL is poised to enjoy a strong double digit earnings growth (over the next four years) underpinned by growing core business and higher contribution from APL's trading business. The expected future earnings growth follows a strong uptrend in the bottom line last year (earnings jumped 2x in FY06) when APL benefited from Attock Group's acquisition of Pakistan's second largest refinery in 2006.

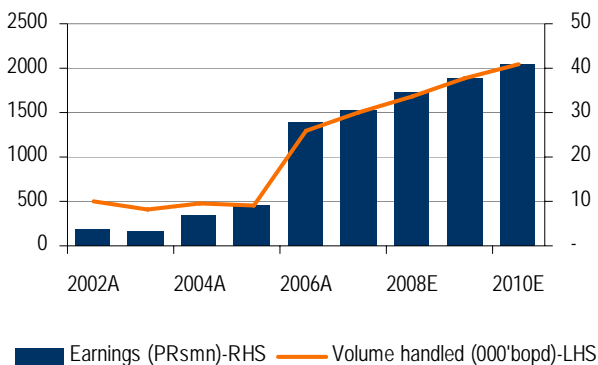
### Increasing volume...

Strong industry growth and a confluence of initiatives (detailed below) are expected to enable APL to improve its presence in Pakistan's downstream industry. We expect APL to register a four-year volume CAGR of 10%.

### ...and non-core supplementing the core...

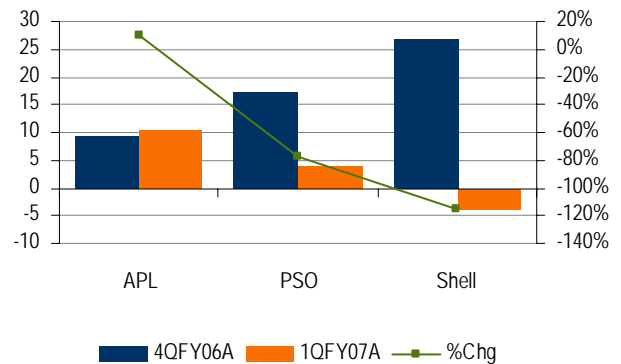
An expected investment into infrastructure and strong free cash flow generation are expected to enable the non-core business (commissioning, rental income and interest income) to support the core business.

Chart 2: We expect future volume jump to drive APL's earnings growth



Source: KASB Securities estimates, APL

Chart 3: Comparison of 1Q FY07 earnings



Source: PSO, Shell, APL

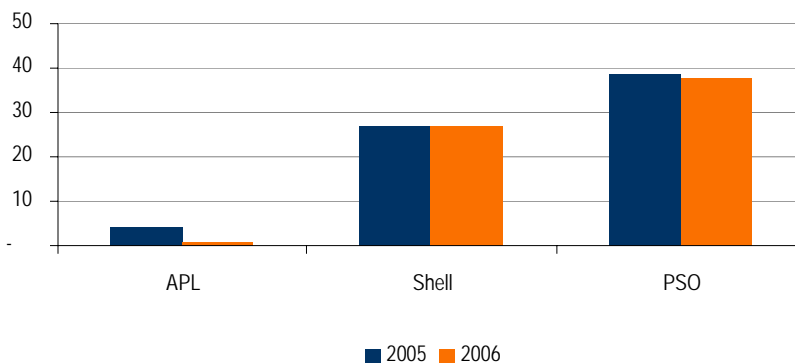
### ...with low correlation to oil market volatility

An important and attractive aspect of APL's earnings profile is its low correlation to volatility in oil prices in the backdrop of (1) its synergies with group companies (low inventory levels) and (2) strong contribution from APL's non-core and non-oil-correlated businesses. Given the volatility in oil prices in recent times, this aspect eliminates one of the risks for APL that is common in the downstream oil industry. 1Q FY07 earnings support this point strongly where APL withstood the impact of a 10-15% drop in product prices, unlike other companies.

### Low inventory levels

Indirect integration also enables APL to maintain lower inventory levels (only 4-6 days) relative to other companies (25-35 days). Low inventory levels also lower the earnings volatility from stock losses/gains emanating from volatility in oil prices. Moreover, low inventory levels reduce investment in working capital. While future business growth will require high inventory levels, we see this positive holding out largely in future too as APL continues to act as the marketing arm of two group refineries.

Chart 4: APL benefits from low inventory levels ( Inventory Days)



Source: APL, Shell, PSO

Table 1: APL trends in margins (%)

	2004A	2005A	2006A	2007E
Gross Profit Margins	7.1%	4.3%	4.4%	4.3%
EBITDA Margins	8.1%	6.0%	4.9%	5.0%
Net Profit Margins	4.9%	4.6%	3.4%	3.5%

Source: KASB Securities, APL

## Earnings jumped 2x in FY06

APL has emerged as a prime beneficiary of Attock Group's acquisition of National Refinery Limited, Pakistan's second largest refinery with a capacity of 55k bopd. The acquisition changed enabled the company to increase its market share from 2% to 8% while increasing its volumes by 1.8x to 26kbopd. Furthermore, as APL took over the exports trade of the newly acquired refinery (mainly naphtha), the fee and commission earnings also showed strong growth. While APL's gross margins improved slightly over FY05, EBITDA margins and net margins dropped as a result of a disproportionate increase in non-operating earnings.

Table 2: APL: Earnings jumped 2x in 2006

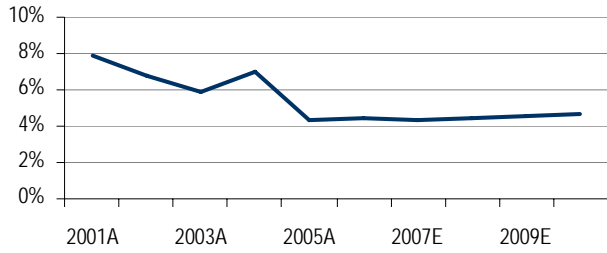
	2005A	2006A	% change
Net Sales	9,910	40,839	312%
Cost of Sales	9,479	39,027	312%
Gross Profit	431	1,812	320%
Operating Expenses	99	185	87%
Operating Profit	332	1,626	390%
Other Income	294	476	62%
Other Expenses	34	101	200%
Depreciation & Amortization	32	56	74%
EBIT	560	1,946	248%
Financial Charges	1	-	-100%
EBT	559	1,946	248%
Taxation	99	553	456%
Net Profit (Loss)	460	1,393	203%
EPS (PRs/share)	11.49	34.81	203%

Source: APL

## Low impact of adjustment in marketing margins

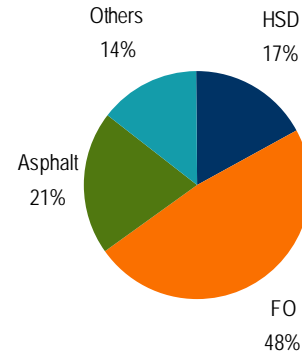
During 2006, the government had adjusted the formula for calculation of dealer margins. The adjusted formula calls for determination of margins based on retail prices pre sales tax. Earlier, the margins were calculated on retail prices (including sales tax), which allowed the Oil marketing companies to earn margin on government taxes as well. This modification had a negative impact on absolute margins for OMCs, which declined by 19-20% on regulated products. The government's intention was to remove the anomaly in the margin calculation as the retail prices had only PRs0.15-0.3/litre impact. The adjusted formula has been in place since March 2006 and full year impact of the adjustment will show up in the FY07 performance. APL's high dependence on export sales and deregulated products (asphalt, FO and specialized petroleum products) is likely to soften the impact of the drop in margins of its regulated products.

**Chart 5: APL – Gross margins (%)**



Source: KASB Securities estimates, APL

**Chart 6: APL – Product breakdown; deregulated products dominate**



Source: APL

## Earnings outlook carries upside potential

We believe the turnaround in fortunes for APL is not yet complete. The following sources can prove to be drivers for strong earnings performance in future:

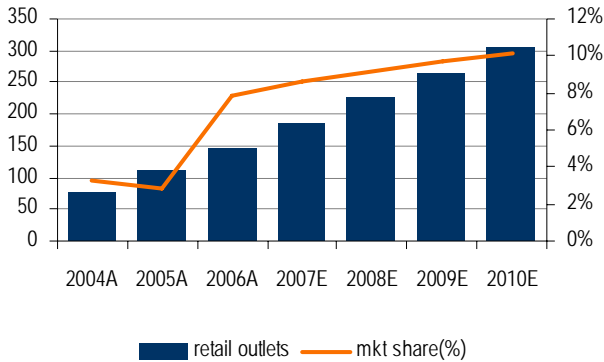
1. Higher volume in high margin lubricant lube segment.
2. Consolidation of export presence in Afghanistan.
3. Benefits of further integrative synergies with group companies.

These drivers are discussed in detail in the next two sections.

## Capturing industry growth

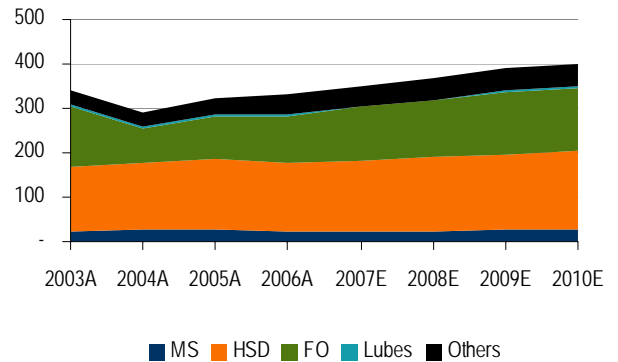
Management has embarked upon an aggressive plan to capitalize on the expected industry growth. This includes aggressive rollout of retail outlets and creating back-end support via investment in infrastructure and storages. We conservatively forecast APL to increase its market share to 10% in 2010 from 8% in 2006 on the back of higher-than-industry volume growth (CAGR of 10% vs industry CAGR of 5%).

Chart 7: We expect APL to improve its market share to 10% from 8%



Source: KASB Securities estimates, APL

Chart 8: Pakistan's product consumption is growing at a CAGR of 5% (000:bopd)



Source: KASB Securities estimates

## Industry growth - Leveraging domestic demand

With expected above average economic growth rate (6-7%) and renewed focus on transportation and oil storage and movement infrastructure, coming in the backdrop of low energy consumption per capita historically, the downstream oil industry looks set to enjoy a stable uptrend in volumes growing at an estimated CAGR of 5% over 2006-2010.

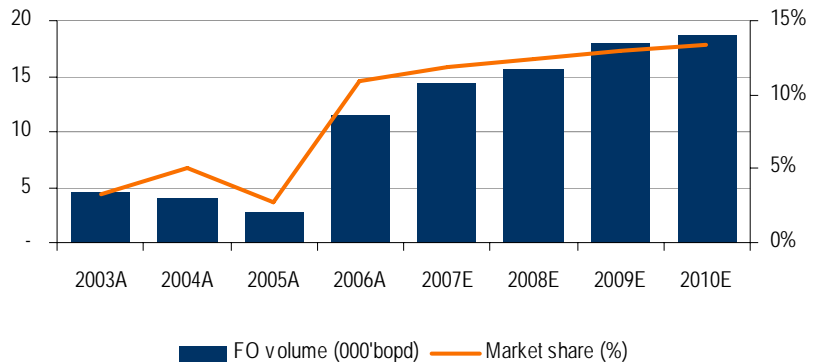
### Plans for rapid retail rollout

In order to tap the growing retail product demand and improve its presence, APL has embarked upon fast paced rollouts of retail outlets, relying heavily on dealer arrangement. In a departure from its conventional focus on areas of upper Punjab province and the North West Frontier Province (NWFP), APL is now beginning to focus more on developing its presence in the central Punjab and southern region (Sindh). In these areas, APL enjoys back-end support (one of the two group refineries is located in the southern region). In 2006, in a span of just one year, APL opened 37 new pumps, taking the number of total commissioned pumps to 145; it plans to add 61 new pumps in 2007. We expect APL's retail outlet network to grow by 2x over the next four years to 300 outlets.

### Advantage in power fuel segment

In the power fuel segment, where Pakistan faces a supply shortage (roughly 40% of demand is met through imports), we believe APL can gain further market share. APL's competitive advantages of supply back-up and future support from infrastructure are likely to enable it to drive out small companies from the segment. These two advantages also enable APL to hold its own against the strong market share and pricing power of OMC giant PSO, in our view. We expect APL to increase its market share in the power fuel segment from 11% in 2006 to 13% in 2010E.

Chart 9: Integration benefit to support market share jump in power fuel segment



Source: KASB Securities estimates, Oil Companies Advisory Committee

## Investment in infrastructure

To support expansion in retail outlets and provide further operational flexibility, APL has planned investment in requisite infrastructure for petroleum product storage. To feed the upcoming retail outlets, APL plans to set up a new bulk oil terminal facility with capacity to store 8,000 tons of petroleum products, to be completed by 2008. Moreover, the company's storage facility in the southern region is also being expanded. We estimate a total capex requirement of PRs60mn-80mn for expansion of storage facilities. Post completion of these two projects, APL's total storage capacity will increase cover to 5 days of its annual volume. In our view, more such expansions are on the cards in future once the company is firmly set up in the southern region.

Table 3: Infrastructure ownership

Categories	PSO	Shell	Caltex	APL
Total Storage Capacity in 000'bbl tons	6410	1163	358	15
% share	80.7%	14.6%	4.5%	0.2%
Storage Installation	9	5	5	
% share	47.4%	26.3%	26.3%	
Depots	27	15	12	1
% share	49.1%	27.3%	21.8%	1.8%
Total Storage Capacity in 000mn tons	860	156	48	2

Source: OCAC

## Benefiting from group synergies

APL enjoys strong advantages over others via its indirect integration with two group refineries. These advantages include the following: (1) It has a reliable supply source for two supply deficit power fuels and high speed diesel, (2) it enjoys pricing benefit over other marketing companies in tapping the export potential in Afghanistan, (3) the group synergies help in keeping working capital requirement low, and (4) enhanced utilization of APL's current infrastructure for export of surplus products of the two refineries. An aggressive entry into the lubricant oil segment remains a key future potential growth area for APL. These advantages are expected to drive future earnings growth and also offer potential upside to bottom line.

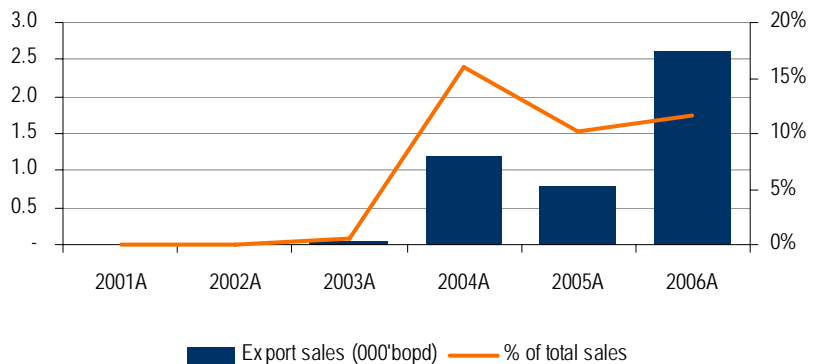
## Marketing arm for group refineries

Being a part of Attock Group, APL acts as a marketing arm for the two group refineries, ie, National Refinery Ltd and Attock Refinery Ltd. These two refineries are located strategically in the north and have total capacity of 4.9mn tons (110bopd). The strategic location supports APL's plans of grabbing high volume. Currently, the level of integration is restricted by APL's market share (APL handles only 24% of these two refineries' capacity).

## Exports to Afghanistan

In recent times, petroleum product export opportunities to land-locked Afghanistan have opened up a new avenue of earnings growth for local oil marketing companies. Given a free market mechanism for exports to Afghanistan and a supply source in the form of Attock Refinery Limited (the closest supply source for exports), APL enjoys a cost advantage over other oil marketing companies and has the potential to undercut prices to beat competition. APL has been able to capture 18% market share in Afghanistan. This represents 10% of total volume handled by APL. While management is looking for opportunities to tie up with local parties in order to open retail outlets in Afghanistan, we have assumed a constant export volume for APL in future years. APL has already received licenses for marketing of petroleum products in the country.

Chart 10: APL – Export sales have picked up strongly

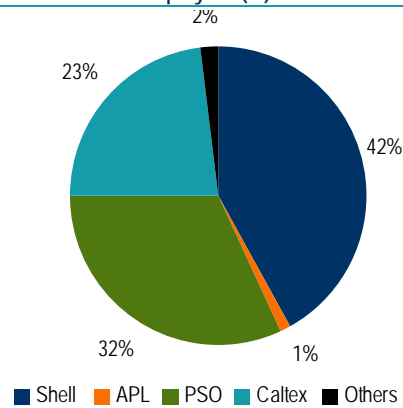


Source: APL, OCAC

## Lubes - Potential upside waiting to be tapped

One area which promises rich dividends for APL is an increased focus on the high margin, high growth lubricant segment. With the increased number of retail outlets and group ownership of the country's only lubricant producer (National Refinery Limited), APL management is likely to concentrate on raising its participation in the lubricant segment (1% market share only). APL has already launched its own lubricant brand. We see two prerequisites for high lubricant volumes: (1) further attention to quality image, and (2) strengthening the lube supply chain by investment in a lubricant oil blending plant. The total sales of lubricant oil have registered a five-year CAGR of 7% over the past five years on the back of growing auto sales (five-year CAGR of 6% over 2002-2006). We expect lube sales to grow by 4-5% pa in future.

Chart 11: Lube: Market share of different players (%)



Source: OCAC

## Valuation

Our valuation for APL is PRs441/share, based on DCF valuation. Key assumptions in our valuation include:

1. Long-term oil price assumption of US\$47/bbl (WTI).
2. WACC of 16.23% and terminal growth rate of 6%. We believe our long-term terminal growth assumption is realistic given expected long-term US CPI of 2%, expected long-term PRs depreciation against US\$ of 2% and APL's historical strong earnings growth.

Table 4: APL – Valuation

	30-Jun-07	30-Jun-08	30-Jun-09	30-Jun-10
EBITDA	2,135	2,412	2,672	2,900
Less: Cash Tax Payable on EBIT	-641	-724	-802	-870
Plus: Change in Working Capital	-25	-9	-90	-96
Less: Capital Expenditure	-309	-300	-300	-300
Free Cash Flows	1,160	1,380	1,481	1,634
PV of Free Cash Flows	1,102	1,128	1,041	988
		PRs mn	PRs/share	% of total
NPV of Forecasts		4,259	106	24%
NPV of Terminal Value		10,238	256	58%
Enterprise Value		14,497	362	82%
Less: Net Debt		-3,153	-79	-18%
Equity Value		17,650	441	100%
No. Shares (millions)		40		
Per Share Equity Value		441		

Source: KASB Securities estimates

Table 5: APL – WACC calculation

Risk Free Rate	10.00%
Equity Risk Premium	7.00%
Beta	0.9
Cost of Equity	16.23%
Weight age of Equity	100%
Cost of Debt	11%
Weight age of Debt	0%
WACC	16.23%

Source: Merrill Lynch estimates

## WACC calculation

This is based on actual cost of debt of 11% and cost of equity of 16.23%, calculated through CAPM approach. For CAPM, we have used a risk free rate of 10%, which is 50bp higher than the central bank's discount rate of 9.5% and 60bp lower than the 10-year government paper yield of ~10.6%. We have incorporated a beta of 0.89, which is slightly lower than PSO's beta of 1.01. Given APL's low earnings risk to oil prices, as explained on page 3, we believe a lower beta is justified. The limited price data (APL was listed in 2005) impedes calculation of APL's actual beta. Moreover, we have assumed a market risk premium of 7% which, in our view, represents an adequate compensation for taking exposure in an emerging market like Pakistan.

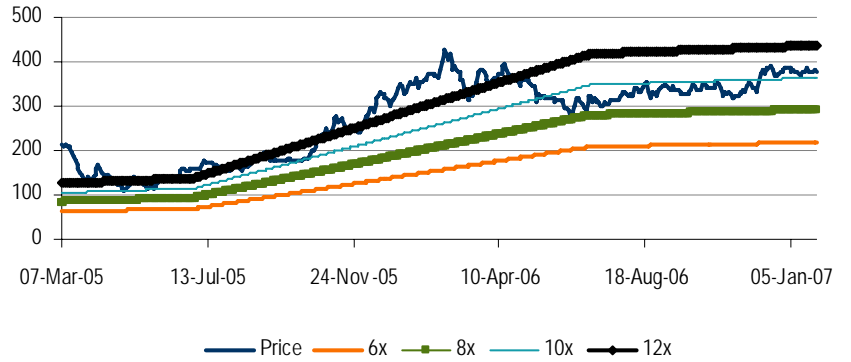
## Recommendation

We recommend a Buy on APL with a 12-month PO of PRs441/share. Our recommendation is underpinned by (1) APL's strong earnings growth outlook, (2) its potential for further leveraging group synergies, (3) its ability to capitalize on industry growth, and (4) its inexpensive valuation and strong price upside potential.

## Inexpensive on P/E...

This valuation multiple seems to enjoy widespread popularity in the local market. Relative to APL's historical P/E of 11.6x (since listing), APL is currently available at a P/E of 8.7x on 2008E earnings. Given APL's high earnings growth prospects and its low earnings sensitivity to oil price, we believe APL deserves to trade at a premium to PSO and the general market P/E of 10.6x.

Chart 12: Inexpensive on P/E multiple

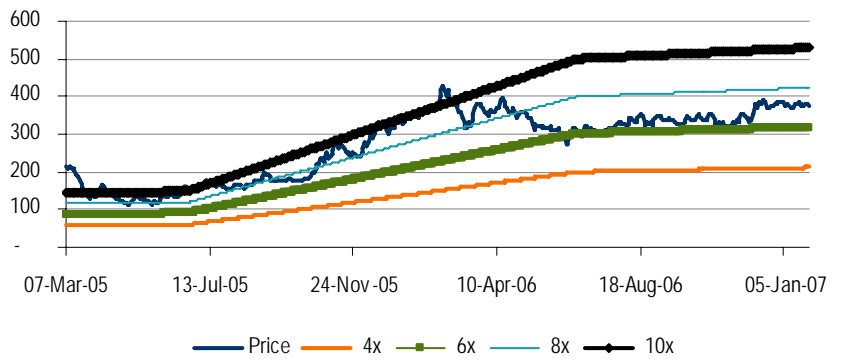


Source: KASB Securities, APL

**...and also on EV/EBITDA**

Relative to its current EV/EBITDA of 6.34x based on 2008E, APL's average EV/EBITDA since listing has been 6.8x.

Chart 13: EV/EBITDA



Source: KASB Securities

## Potential near-term drivers

### Earnings announcement

APL has frequently outperformed market expectations on earnings. Should 3Q FY07 prove to be a repeat of the past, APL's share price may fare well.

### PSO privatization

As APL is also participating in the privatization of PSO, any development on this front may prove to be a price driver for the stock. We see high likelihood of progress on PSO privatization in the next quarter as the government targets to complete the deal by June 2007.

### Investment projects by the group/company

Any development on investment projects to be undertaken by the group (pipeline, storage and setting up of power plant) may result in price performance as these projects are believed to be value accretive for the company since they yield higher returns compared to the cost of capital for the company. APL stands to benefit from either participation in the projects or being a commercial partner in them.

## Key risks

### Sustained decline in product prices

This would lead to lower absolute margins for APL and inventory losses.

### Slowdown in exports to Afghanistan

Around 10% of APL's volume is estimated to come from exports to Afghanistan. A slowdown in Afghanistan may adversely affect our earnings valuation estimates.

### Exchange rate risk

Pakistan rupee (local currency) depreciation benefits local marketing companies, as product prices are ultimately linked with dollar-denominated oil prices. In the past five years, the rupee has depreciated at an average 3% pa. Based on our forecasts, we expect rupee to depreciate by 3% pa over 2008-2010. However rupee appreciation against US\$ remains a risk to PRs-based earnings of local oil marketing companies.

### Group interests

Being a company with a small free float (28% or ~US60\$mn), value creation for APL's minority shareholders may not be of supreme interest to the company's management and decisions or projects undertaken may not represent the best interests of APL's minority shareholders.

### Discontinuation of group synergies

Among the major areas to be affected by this will be: (1) working capital requirement, and (2) commission and rental income earned from group companies (mainly two refineries).

### Management transparency and reputation

We do not find management to be open to investors for discussing the company's future strategy. Moreover, there remains management reputation risk.

## POL to bid for PSO acquisition

Attock Petroleum Limited, along with other three sister concerns of Attock Group, has expressed interest in acquiring a 51% stake in Pakistan State Oil (PSO) through privatization targeted for June 2007. APL, like other Attock Group concerns, intends to buy up to 25.5% stake in PSO.

We are inclined to believe that APL's potential acquisition of PSO is more important from a group perspective and that the acquisition might not produce big synergies to the company. The only area of synergies between PSO and APL is oil storage and movement infrastructure. PSO controls over 83% of total infrastructure in the country, while APL needs to invest in infrastructure in order to support its future growth plans. Even in this area, the potential of synergies would be limited.

The risk of Attock Group overbidding and subsequent higher cash outflow remains for APL shareholders. Given PSO's healthy dividend yield and potential of earnings growth post privatization, the risk to valuation is likely to be nominal. Moreover, as we do not expect APL to take a 25.5% stake in PSO, the potential negative impact will be diluted. APL's small balance sheet size (PRs6,584mn) as opposed to total transaction size of ~PRs27bn) and the comfortable cash rich balance sheets of other sister concerns of Attock group underpin our stance.

**Table 6: Cash available with Attock Group's sister concerns (June 2006, PRs mn)**

NRL	7,761
ATRL	8,031
POL	3,924
APL	2,280

Source: Companies Reports

The two refineries operated by Attock Group (National Refinery Ltd and Attock Refinery Ltd) will emerge as major beneficiaries of the acquisition given potential for strong synergies between refining and marketing.

## APL's clients

Being the third largest OMC, APL has a diversified clientele which comprises retail clients, industrial and aviation companies and the export market. Unlike other refineries, APL's product and revenue concentration is low. In the power fuel business, APL plans to have a meaningful share as the company has the advantage of two group refineries. The company is competing to win different fuel supply contracts with Water and Power Development Board (WAPDA) and Karachi Electric Supply Corporation. APL acts in the capacity of subcontractor mostly for oil supply to major oil companies operating in Afghanistan.

## APL's supplies

APL draws its supplies mainly from two refineries operated by Attock Group. These two refineries are strategically located in the northern and southern region of the country and enable the company to feed its outlets. APL's reliance on imported products is low. Depending upon the location of the CNG outlet, the natural gas is supplied by two gas distribution companies catering to the northern and southern region of the country, respectively.

## Management

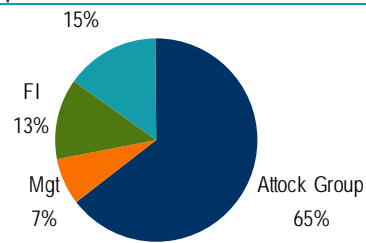
APL's management team has extensive experience in the oil and gas business in Pakistan. The management team has successfully steered the company through different phases of inception, early growth, and integration with other related business of the group. Furthermore, the management team's confidence in the company's strong fundamentals is reflected in its 7% ownership of the company (CEO, directors and others). However, we maintain our concerns on management transparency. The board of directors is represented by the company's management and representation from Attock Group's companies. The Attock

Group, which owns the majority rights in APL, is a pioneer explorer/operator, instrumental in making Pakistan's first oil discovery at Khaur. The group has over 55 years of operational experience in Pakistan.

## Shareholding pattern

APL is Attock Group's oil marketing arm in Pakistan. Attock Group maintains a 65% stake in the company. APL's management (other than the group) owns a 7% stake in the company. Excluding shares owned by the sponsors and management, APL has a free float of 28%. Financial institutions have a 13% stake while individual investors and others own a 15% share in the company. Its average daily turnover has been US\$2.8mn in the past six months. APL is a relatively fresh entrant to Pakistan's bourses as it was listed in 2005.

Chart 14: APL – Shareholding pattern



Source: APL

## APL - Financials

**Table 7: APL: Income statement (PRs mn)**

Year to June	2005A	2006A	2007E	2008E	2009E
Net Sales	9,910	40,839	44,229	50,025	53,134
Cost of sales	9,479	39,027	42,308	47,826	50,701
Gross Profit	431	1,812	1,921	2,200	2,433
Operating Expenses	99	185	221	257	299
Other Income	294	476	632	716	791
Other Charges	34	101	102	110	117
EBITDA	592	2,001	2,230	2,548	2,808
Depreciation & Amortization	32	56	91	121	151
EBIT	560	1,946	2,138	2,427	2,657
Financial Charges	1	0	0	0	0
Earnings before tax	559	1,946	2,138	2,427	2,657
Taxation	99	553	599	680	744
Earnings after tax	460	1,393	1,540	1,748	1,913
EPS(PR\$/share)	11.5	34.8	38.5	43.7	47.8
DPS(PR\$/share)	5.00	9.00	11.55	13.11	14.35

Source: KASB Securities estimates, APL

**Table 8: APL: Balance sheet (PRs mn)**

Year to June	2005A	2006A	2007E	2008E	2009E
Fixed Assets	335	521	739	918	1067
Investments	91	353	353	353	353
Other LT assets	0	0	0	0	0
Current assets					
Cash & equivalents	1268	2282	3153	4228	5362
Inventories	110	74	348	524	695
Accounts receivable	277	2502	2666	3015	3203
Other Current assets	368	852	669	756	803
Total assets					
Current liabilities					
Accounts payable	1337	4409	4637	5241	5556
Other Current Liabilities	0	0	0	0	0
LT liabilities					
LT borrowings	0	0	0	0	0
Deferred tax	14	29	25	22	19
Other non-current liabilities	84	101	141	183	220
Shareholders' equity					
Paid-up capital	400	400	400	400	400
Reserves	613	1646	2723	3947	5286
Net cash/(debt) (PRs mn)	1268	2282	3153	4228	5362
Book value/share (PRs)	25	51	78	109	142

Source: KASB Securities estimates, APL

**Table 9: APL: Cash flows**

Year to June	2005A	2006A	2007E	2008E	2009E
Profit After Tax	460	1393	1540	1748	1913
Add Deprecation & Amortization	32	56	91	121	151
Sub-total	492	1448	1631	1869	2064
Changes in Working Capital	442	413	-29	-12	-93
Operating Cash Flow	934	1861	1602	1857	1972
Investing Cash Flow					
Capex	-79	-242	-309	-300	-300
Change in Other LT Assets	-64	-246	40	42	37
Total Investing Cash Flows	-143	-487	-269	-258	-263
Financing Cash Flows					
Change in Equity	0	0	0	0	0
Cash Dividends	-120	-360	-462	-524	-574
Total Financing Cash Flows	-120	-360	-462	-524	-574
Net Change in Cash	671	1014	871	1075	1134

Source: KASB Securities estimates, APL

**Table 10: APL: Key measures**

Year to June	2005A	2006A	2007E	2008E	2009E
Sales Volume(000'bopd)	9.3	26.0	30.2	33.6	37.9
FO(000'bopd)	2.7	11.5	14.4	15.7	18.0
HSD (000'bopd)	3.3	4.6	5.2	6.6	7.7
Total (000'bopd)	0.3	0.4	0.4	0.4	0.4
Prices					
PR\$/US\$	59.3	60.2	62.3	64.2	66.1
Marketing Margins (US\$/bbl)					
FO	1.4	1.9	1.5	1.4	1.3
HSD	2.5	3.3	2.8	2.8	2.7
MS	9.3	26.0	30.2	33.6	37.9
Market share					
FO	3%	11%	12%	12%	13%
HSD	2%	3%	3%	4%	4%
Total	3%	8%	9%	9%	10%
Average tax rate	18%	28%	28%	28%	28%

Source: KASB Securities estimates, APL

## Price Objective Basis & Risk

Our price objective for APL is PRs441/share, based on our DCF valuation method. Key assumptions in our valuation include:

3. Long-term oil price assumption of US\$47/bbl (WTI).
4. WACC of 16.23% and terminal growth rate of 6%. We believe our long-term terminal growth assumption is realistic given expected long-term US CPI of 2%, expected long-term PRs depreciation against US\$ of 2% and APL's historical strong earnings growth.

This represents potential total return of over 19% to the current market price.

The risks associated with APL are: (1) sustained decline in product prices leading to lower absolute margins, (2) slowdown in exports to Afghanistan, (3) discontinuation of group synergies, (4) exchange rate risk, (5) management openness, and (6) group level decision making which can potentially undermine the interests of minority shareholders.

## Analyst Certification

We, Stuart B Smith and Mohammad Fawad Khan, hereby certify that the views each of us has expressed in this research report accurately reflect each of our respective personal views about the subject securities and issuers. We also certify that no part of our respective compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

## Special Disclosures

This report is issued and distributed outside Pakistan solely by Merrill Lynch. KASB Securities is not licensed to provide advisory services outside Pakistan. Investors should contact their Merrill Lynch representative if they have questions concerning this report.

28 February 2007

***iQmethod*<sup>SM</sup> Measures Definitions**

<b>Business Performance</b>	<b>Numerator</b>	<b>Denominator</b>
Return On Capital Employed	$\text{NOPAT} = (\text{EBIT} + \text{Interest Income}) * (1 - \text{Tax Rate}) + \text{Goodwill Amortization}$	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
<b>Quality of Earnings</b>		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
<b>Valuation Toolkit</b>		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	$\text{EV} = \text{Current Share Price} * \text{Current Shares} + \text{Minority Equity} + \text{Net Debt} + \text{Sales} + \text{Other LT Liabilities}$	
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

*iQmethod*<sup>SM</sup> is the set of Merrill Lynch standard measures that serve to maintain global consistency under three broad headings: Business Performance, Quality of Earnings, and validations. The key features of *iQmethod* are: A consistently structured, detailed, and transparent methodology. Guidelines to maximize the effectiveness of the comparative valuation process, and to identify some common pitfalls.

*iQdatabase*<sup>®</sup> is our real-time global research database that is sourced directly from our equity analysts' earnings models and includes forecasted as well as historical data for income statements, balance sheets, and cash flow statements for companies covered by Merrill Lynch.

*iQprofile*<sup>SM</sup>, *iQmethod*<sup>SM</sup> are service marks of Merrill Lynch & Co., Inc. *iQdatabase*<sup>®</sup> is a registered service mark of Merrill Lynch & Co., Inc.

## Important Disclosures

### Investment Rating Distribution: Energy Group (as of 31 Dec 2006)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	103	55.68%	Buy	44	42.72%
Neutral	73	39.46%	Neutral	21	28.77%
Sell	9	4.86%	Sell	1	11.11%

### Investment Rating Distribution: Global Group (as of 31 Dec 2006)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1306	42.74%	Buy	406	31.09%
Neutral	1509	49.38%	Neutral	446	29.56%
Sell	241	7.89%	Sell	53	21.99%

\* Companies in respect of which MLPF&S or an affiliate has received compensation for investment banking services within the past 12 months.

**FUNDAMENTAL EQUITY OPINION KEY:** Opinions include a Volatility Risk Rating, an Investment Rating and an Income Rating. **VOLATILITY RISK RATINGS**, indicators of potential price fluctuation, are: A - Low, B - Medium, and C - High. **INVESTMENT RATINGS**, indicators of expected total return (price appreciation plus yield) within the 12-month period from the date of the initial rating, are: 1 - Buy (10% or more for Low and Medium Volatility Risk Securities - 20% or more for High Volatility Risk securities); 2 - Neutral (0-10% for Low and Medium Volatility Risk securities - 0-20% for High Volatility Risk securities); 3 - Sell (negative return); and 6 - No Rating. **INCOME RATINGS**, indicators of potential cash dividends, are: 7 - same/higher (dividend considered to be secure); 8 - same/lower (dividend not considered to be secure); and 9 - pays no cash dividend.

In the US, retail sales and/or distribution of this report may be made only in states where these securities are exempt from registration or have been qualified for sale: Attock Petroleum.

The analyst(s) responsible for covering the securities in this report receive compensation based upon, among other factors, the overall profitability of Merrill Lynch, including profits derived from investment banking revenues.

## Other Important Disclosures

UK readers: MLPF&S or an affiliate is a liquidity provider for the securities discussed in this report.

---

### Information relating to Non-U.S. affiliates of Merrill Lynch, Pierce, Fenner & Smith Incorporated (MLPF&S):

MLPF&S distributes research reports of the following non-US affiliates in the US (short name: legal name): Merrill Lynch (France): Merrill Lynch Capital Markets (France) SAS; Merrill Lynch (Frankfurt): Merrill Lynch International Bank Ltd, Frankfurt Branch; Merrill Lynch (South Africa): Merrill Lynch South Africa (Pty) Ltd; Merrill Lynch (Milan): Merrill Lynch International Bank Limited; MLPF&S (UK): Merrill Lynch, Pierce, Fenner & Smith Limited; Merrill Lynch (Australia): Merrill Lynch Equities (Australia) Limited; Merrill Lynch (Hong Kong): Merrill Lynch (Asia Pacific) Limited; Merrill Lynch (Singapore): Merrill Lynch (Singapore) Pte Ltd; Merrill Lynch (Canada): Merrill Lynch Canada Inc; Merrill Lynch (Mexico): Merrill Lynch Mexico, SA de CV, Casa de Bolsa; Merrill Lynch (Argentina): Merrill Lynch Argentina SA; Merrill Lynch (Japan): Merrill Lynch Japan Securities Co, Ltd; Merrill Lynch (Seoul): Merrill Lynch International Incorporated (Seoul Branch); Merrill Lynch (Taiwan): Merrill Lynch Global (Taiwan) Limited; DSP Merrill Lynch (India): DSP Merrill Lynch Limited; PT Merrill Lynch (Indonesia): PT Merrill Lynch Indonesia; Merrill Lynch (KL) Sdn. Bhd.; Merrill Lynch (Malaysia); Merrill Lynch (Israel): Merrill Lynch Israel Limited; Merrill Lynch (Russia): Merrill Lynch CIS Limited, Moscow.

This research report has been prepared and issued by MLPF&S and/or one or more of its non-U.S. affiliates. MLPF&S is the distributor of this research report in the U.S. and accepts full responsibility for research reports of its non-U.S. affiliates distributed in the U.S. Any U.S. person receiving this research report and wishing to effect any transaction in any security discussed in the report should do so through MLPF&S and not such foreign affiliates.

This research report has been approved for publication in the United Kingdom by Merrill Lynch, Pierce, Fenner & Smith Limited, which is authorized and regulated by the Financial Services Authority; has been considered and distributed in Japan by Merrill Lynch Japan Securities Co, Ltd, a registered securities dealer under the Securities and Exchange Law in Japan; is distributed in Hong Kong by Merrill Lynch (Asia Pacific) Limited, which is regulated by the Hong Kong SFC; is issued and distributed in Taiwan by Merrill Lynch Global (Taiwan) Ltd or Merrill Lynch, Pierce, Fenner & Smith Limited (Taiwan Branch); is issued and distributed in Malaysia by Merrill Lynch (KL) Sdn. Bhd., a licensed investment adviser regulated by the Malaysian Securities Commission; and is issued and distributed in Singapore by Merrill Lynch International Bank Limited (Merchant Bank) and Merrill Lynch (Singapore) Pte Ltd (Company Registration No.'s F 06872E and 198602883D respectively). Merrill Lynch International Bank Limited (Merchant Bank) and Merrill Lynch (Singapore) Pte Ltd. are regulated by the Monetary Authority of Singapore. Merrill Lynch Equities (Australia) Limited, (ABN 65 006 276 795), AFS License 235132, provides this report in Australia. No approval is required for publication or distribution of this report in Brazil.

Merrill Lynch (Frankfurt) is regulated by BaFin.

### Copyright, User Agreement and other general information related to this report:

Copyright 2007 Merrill Lynch, Pierce, Fenner & Smith Incorporated. All rights reserved. This research report is prepared for the use of Merrill Lynch clients and may not be redistributed, retransmitted or disclosed, in whole or in part, or in any form or manner, without the express written consent of Merrill Lynch. Merrill Lynch research reports are distributed simultaneously to internal and client websites eligible to receive such research prior to any public dissemination by Merrill Lynch of the research report or information or opinion contained therein. Any unauthorized use or disclosure is prohibited. Receipt and review of this research report constitutes your agreement not to redistribute, retransmit, or disclose to others the contents, opinions, conclusion, or information contained in this report (including any investment recommendations, estimates or price targets) prior to Merrill Lynch's public disclosure of such information. The information herein (other than disclosure information relating to Merrill Lynch and its affiliates) was obtained from various sources and we do not guarantee its accuracy. Merrill Lynch makes no representations or warranties whatsoever as to the data and information provided in any third party referenced website and shall have no liability or responsibility arising out of or in connection with any such referenced website.

This research report provides general information only. Neither the information nor any opinion expressed constitutes an offer or an invitation to make an offer, to buy or sell any securities or other investment or any options, futures or derivatives related to such securities or investments. It is not intended to provide personal investment advice and it does not take into account the specific investment objectives, financial situation and the particular needs of any specific person who may receive this report. Investors should seek financial advice regarding the appropriateness of investing in any securities, other investment or investment strategies discussed or recommended in this report and should understand that statements regarding future prospects may not be realized. Investors should note that income from such securities or other investments, if any, may fluctuate and that price or value of such securities and investments may rise or fall. Accordingly, investors may receive back less than originally invested. Past performance is not necessarily a guide to future performance. Any information relating to the tax status of financial instruments discussed herein is not intended to provide tax advice or to be used by anyone to provide tax advice. Investors are urged to seek tax advice based on their particular circumstances from an independent tax professional.

Foreign currency rates of exchange may adversely affect the value, price or income of any security or related investment mentioned in this report. In addition, investors in securities such as ADRs, whose values are influenced by the currency of the underlying security, effectively assume currency risk.

Officers of MLPF&S or one or more of its affiliates (other than research analysts) may have a financial interest in securities of the issuer(s) or in related investments.

Merrill Lynch Research policies relating to conflicts of interest are described at <http://www.ml.com/media/43347.pdf>.

iQmethod, iQmethod 2.0, iQprofile, iQtoolkit, iQworks are service marks of Merrill Lynch & Co., Inc. iQanalytics®, iQcustom®, iQdatabase® are registered service marks of Merrill Lynch & Co., Inc.

Fundamental equity reports are produced on a regular basis as necessary to keep the investment recommendation current.