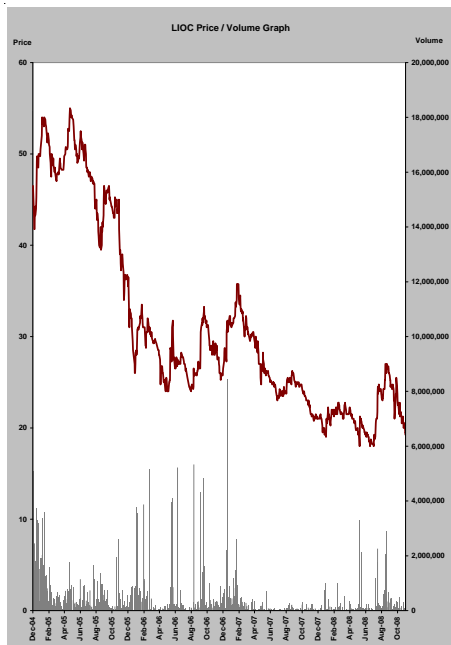


Lanka IOC (LIOC)

Rs.18.00

NEUTRAL



LIOC	
Reuters Code	LIOC.CM
Bloomberg Code	LIOC.SL
Share Price LKR	18.00
Issued Share Capital (Shares)	
*Voting	532,461,700
12 mth High/Low (Rs.)	28.00 / 18.00
Average Daily Volume	178,946
Market Capitalisation Rs. mn	9,584
Price Performance (%)	1 mth 6 mth 12mth
ASPI	-12.14 -35.75 -35.69
LIOC	-16.30 -3.75 -11.49

Fiscal year	Net Profit (Rs m)	EPS (Rs)	EPS Growth (%)	PER (x)	P/BV (x)	ROE (%)
2005	1883	3.54	275.75	5.09	0.95	18.71
2006	-1723	-3.24	-191.47	-5.56	1.15	-20.66
2007	-685	-1.29	60.21	-13.98	1.25	-8.95
2008	2340	4.40	441.41	4.10	0.96	23.41
2009E	2259	4.24	-3.47	4.24	0.78	18.43
2010E	2441	4.58	8.06	3.93	0.65	16.61

- ✓ Lanka IOC is a subsidiary of the Indian Petroleum giant Indian Oil Company which holds 75% of the Company. LIOC primarily engages in the business of sale and distribution of petroleum products. In addition the company has also diversified into the sale and distribution of lubricants and bunkering operations in FY08. LIOC also holds 33.33% of Ceylon Petroleum Storage Terminal Limited (CPSTL).
- ✓ The domestic petroleum market is a duopoly with LIOC having 23% market share. The balance is controlled by the state run CPC which effectively determines the retail selling prices of the fuel products. Volatility of Crude oil prices in the recent past have caused turmoil in most of the countries, with prices peaking at US \$ 147 per bbl in June. However prices dipped sharply reaching US \$ 48 in November.
- ✓ The Lubricant market is dominated by Chevron Lubricants with a market share of almost 75% while Lanka IOC follows with 15%. With the declining vehicle sales, growth in the lubricant market had slowed to 2% in FY08. A Lube blending plant was commissioned by the company in Trincomalee in November 2007 leading to increased margins. The company operates the oil tank farm in Trinco which consists of 99 tanks. Plans are under way to cut down prices for a short term with the intention of capturing a larger market share.
- ✓ Volatility of crude oil prices, comparative price revisions and the timing and consequently the price of the procurement of stocks are key factors affecting LIOC margins. Further the imposition of taxes and the timing of the price revisions by the government have adversely affected earnings in the previous quarters. Collectively these factors which continue to remain highly unpredictable poses a serious risk to the performance of the stock.

- ✓ LIOC recorded net earnings of Rs. 2.34bn for FY08, a growth of 441% while revenue grew by 36% to Rs. 44.76bn on the back of 6 price revisions during the year. The company is likely to maintain margins despite the new taxes imposed, due to the rapid decline in oil prices. However profits will largely depend on the timing of the purchase of oil. Lubricants revenue from the segment grew 49% contributing Rs. 180m as net profit. The revenue from the segment grew 49% to Rs. 861m.
- ✓ We expect LIOC to post an earnings decline of 3% to Rs.2.2bn with revenues expected to reach 79bn displaying a revenue growth of 75% for FY09. At Rs. 18.00, the counter trades at a PER of 4.24x FY09 earnings.

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December 2008



Profile

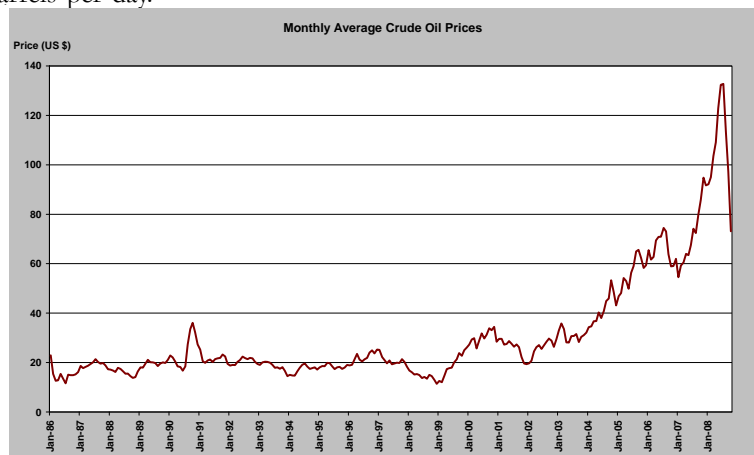
- ✓ Lanka IOC is a 75% owned subsidiary of the Fortune 500 petroleum giant, Indian Oil Company (IOC), which accounts for 60% market share of India's petroleum product market, with 80.35% of the company held by the Government of India. Lanka IOC entered the domestic petroleum market following an invitation by the government of Sri Lanka (GOSL) to commence operations as the second player in the newly liberalized petroleum market.
- ✓ Lanka IOC initiated its operations in mid 2003 following a US\$ 30m acquisition of 100 of the 359 retail fuel outlets owned by Ceypetco as well as securing a 33.33% stake in the common user facility, Ceylon Petroleum Storage Terminals Limited (CPSTL) which consists of CPC's pipeline network for an additional consideration of US\$ 45m.
- ✓ As part of the transaction, Lanka IOC also operates the Oil Tank Farm in Trincomalee consisting of 99 tanks, jetty pipelines and suction and delivery pipelines on a leasehold basis for a period of 35 years.

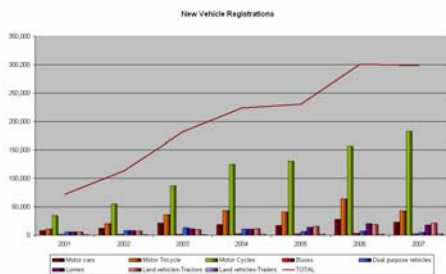
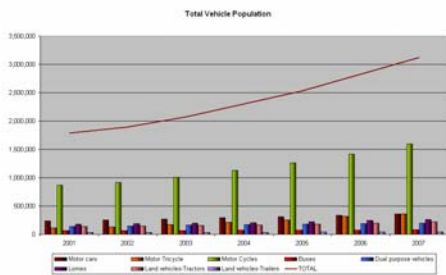
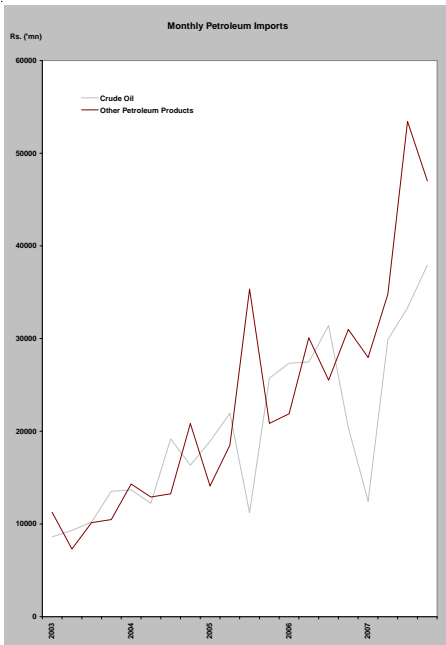
Crude Oil Outlook

- ✓ The US threats on Iran mounted early this year, initiating the rise in oil prices with prices passing the US \$ 100 mark early January. Iran is the 4th largest producer and 2nd largest exporter of oil while US is the largest consumer of oil. In addition, the rise in demand from India & China and a weaker US dollar, led to oil prices skyrocketing at a rapid pace with prices reaching US \$ 147 in June 2008. With the burst of the global commodity bubble oil prices crashed to US \$ 120 levels in August and to US \$ 48 in November.
- ✓ The slowdown in the global economies is expected to bring down crude oil consumption levels despite the demand growth in China and India, signaling a more comfortable supply and demand balance. OPEC forecasts world economic growth to slowdown to 3.8% this year and 3.3% in 2009.
- ✓ In the October monthly report the Organization of the Petroleum Exporting Countries (OPEC) expects a demand of 31.14 million barrels daily for 2009 which is a downward revision of 190,000 bpd from last month's report and 870,000 bpd less than its estimate of demand for OPEC crude in 2008. A significant cut in oil production for November and December 2008 was announced as well where the group will reduce output by 1m barrels per day.

Nation	Net exports	Production
Saudi Arabia	9.000	10.900
Russia	7.000	9.700
Norway	2.800	3.100
Iran	2.721	4.259
Nigeria	2.150	2.450
United Arab Emirates	2.400	2.800
Kuwait	2.300	2.600
Venezuela	2.100	2.855
Algeria	1.840	2.130
Mexico	1.756	3.791
Libya	1.500	1.700
Iraq	1.367	1.942
Angola	1.100	1.200
Qatar	1.000	1.100
Kazakhstan	1.000	1.200
Canada	1.100	3.300
Oman	0.679	0.743
Azerbaijan	0.460	0.600
Ecuador	0.388	0.540
Equatorial Guinea	0.340	0.356
Yemen	0.333	0.410
Argentina	0.323	0.440
Malaysia	0.300	0.800
Sudan	0.280	0.360
Colombia	0.260	0.580
Chad	0.244	0.249
Congo-Brazzaville	0.234	0.240
Denmark	0.200	0.390
Gabon	0.200	0.200
Brunei	0.231	0.237
Turkmenistan	0.170	0.260
Vietnam	0.111	0.370
Egypt	0.100	0.700
United Kingdom	0.100	2.900
Uzbekistan	0.030	0.150
Indonesia*	-0.100	1.100
Australia	-0.362	0.562
India	-1.784	0.846
China	-3.700	3.800
United States	-12.200	5.400
World	N/A	83.000

Numbers refer to millions of barrels of oil per day.
* Indonesia is not an OPEC member as of 2008





Petroleum Products

- ✓ CPC & LIOC are the only two players in the domestic petroleum industry, wherein LIOC has 23% market share, while CPC has the balance. The primary petroleum products sold are Super Petrol (95 Octane), Lanka Petrol (90 Octane), Auto Diesel (0.25% Sulphur) and Super Diesel (0.05% Sulphur) with Auto Diesel (0.25% Sulphur) contributing 60% and Lanka Petrol (90 Octane) contributing 25% of the sales volume.
- ✓ CPC has a clear advantage over LIOC as it refines more than 50% of its crude oil locally and is presently in the process of expanding its refinery capacity, while LIOC has to import 100% as refined products.
- ✓ LIOC's monthly sale of petrol and diesel amounts to 15m and 30m litres respectively, bringing in almost 85% of the petroleum revenues. CPC sells 45m litres of Petrol and 170m litres of Diesel monthly.
- ✓ LIOC currently has approximately 150 retail outlets including dealer owned retail outlets. The Company hopes to provide additional facilities in all their retail outlets. LIOC has already signed agreements to provide space with supermarket chains, banks (ATM machines) and Lanka Orix Leasing Company in order to attract a much wider customer base.
- ✓ Lanka IOC has applied to the government to set up an additional 324 retail outlets with a view to increase its spread around the country and is positive that the government would approve at least 100 out of it.
- ✓ The first price revision for FY09 was made in May 2008 when the oil prices were at US \$ 134. However with LIOC purchasing a 3 month stock at US \$ 144 a considerable loss was suffered during the 2nd quarter. Despite global prices easing off, administered prices were not reduced till November 2008. The company currently maintains stocks bought at lower prices, and if no price revisions are enacted, should maintain margins and continue to gain on fresh inventory purchases. The above average gains however will be eroded by the new tax regime on oil imports.
- ✓ As a result of highly volatile crude oil prices Lanka IOC has currently trimmed down its inventories to 30 days reducing the risk of maintaining high valued stocks for a longer period.
- ✓ Despite a duopoly, pricing is effectively determined by the Government controlled CPC. LIOC was forced to bring down prices in line with CPC when diesel prices were raised Rs.20/- above the CPC prices in May 2008, clearly demonstrating the price sensitivity of the products.
- ✓ Lanka IOC aims to minimize its dependence on petrol and diesel and augment earnings from other products. The contribution of petrol and diesel to total net profit had fallen to 31% in FY08 from 85-90% in previous years. The petroleum products market is expected to grow annually at 4% p.a. However we expect the growth in volumes to slowdown due to the drastic decline in new vehicle registrations seen in 2007 and 2008.
- ✓ LIOC could expect a more prominent growth in demand if the government moves swiftly in opening the A32 and A9 roads which will lead to additional demand in the Northern Province.

Taxes

- ✓ The Government has introduced new taxes in 2QFY08 lowering the high margins expected by the company due to the reduction in oil prices.
- ✓ A customs import duty was imposed on 25th June of Rs. 24.50 for every litre of petrol imported, thus directly affecting LIOC as it imports all its requirement through global tenders.
- ✓ On 17th September 2008 Government decided to impose an import cess tax of Rs.15/- on Petrol and Rs.10/- on diesel.
- ✓ With the new taxes the total taxes amount to 51% and 23% of retail prices of Petrol and Diesel respectively.

Lubricants

- ✓ LIOC has a 15% share of the lubricant market, long dominated by Chevron Lubricants Lanka, previously Caltex, which was a former government monopoly. LIOC's entry into the lubricant market with its SERVO brand of lubricants, distributed through its exclusive retail network has enabled the firm to capture market share rapidly.
- ✓ Chevron dominates the market, with a market share of 75%, while LIOC has 15% and the balance is split between Exxon Mobil/Esso, Valvoline, Shell, and British Petroleum/Castrol.
- ✓ The lubricant market grew at 2% last year, as against an average of 5% over the last 10 years due to sluggish vehicle sales and lower usage of thermal power plants. Currently the total local market value of lubricants and greases is around Rs. 11bn annually.
- ✓ LIOC's lubricant oil plant in the northeastern port of Trincomalee, set up a year ago, has enabled the company to increase its margins with the import duty advantage. The plant is currently producing 300,000 litres of lubricants per month as against a monthly sales volume of 400,000 litres.
- ✓ Base oil supply for the lubricant plant in Trincomalee had been bought at US \$ 750 a tonne but the price shot up to US \$ 1,800 a tonne by October and is currently expected decline with the oil prices easing. The company informs that its current base oil inventory is sufficient for a further 2 months. This would result in lubricant sector achieving higher than expected margins in the short run.
- ✓ However margins are likely to decline in the 2nd half of FY09 if price of base oil still remain above US \$ 750. LIOC is also planning on cutting down prices with the intention of gaining market share which will further reduce margins.

Bunkering

- ✓ The marine fuel bunkering industry which was dominated by Lanka Marine Services, saw a change with more players stepping into the market, following the Supreme Court decision which handed over the LMS oil storage premises to the Sri Lanka Ports Authority. Sri Lanka has issued licenses to 8 companies to supply marine fuel.

- ✓ Lanka IOC commenced marine bunkering operation by supplying diesel to ships off the eastern coast of the island. Operations commenced in May 2007. Approximately 100 ships daily pass through the Sri Lanka coast line between the Gulf region and Singapore. An aggressive marketing campaign with an enabling agent will be launched in order to enable larger volumes in the future.
- ✓ In a bid to expand its operations in the bunkering business in September the company signed an agreement with SLPA for the storage and supply of marine fuel in the Colombo port which is far more lucrative due to higher number of ship calls.

Earnings

- ✓ LIOC earned a profit of Rs.2.3Bn for FY08 achieving a growth of 442% on the back of 6 price revisions during the year. The final price revision reduced prices at the pump, diesel to Rs. 80/= and petrol to Rs. 122. Despite the introduction of 2 new taxes by the government it is likely that LIOC will maintain its profit margins with oil prices dropping to US \$ 48.
- ✓ The lubricant sector has produced a profit of Rs.180m contributing 8% to the total company earnings. Lubricant revenue grew by 49% to Rs.861m on the back of a sales volume growth of 34% from 3.64m to 4.86m in FY08. We expect the company to continue its prevailing growth in volumes in this sector with the reduction in prices and the aggressive marketing campaign.
- ✓ We expect a significant growth in the sale of bunker fuel with LIOC setting up operations in Colombo which consists of a higher number of ship calls. Further the aggressive marketing campaign for the bunker operations in Trincomalee is likely to fuel growth in the Trinco port as well.

Valuations

Scenarios	FY09E		FY10E	
	US \$/bbl	Net Profit	US \$/bbl	Net Profit
	(Avg. 12mth)	Rs. (mn)	(Avg. 12mth)	Rs. (mn)
Based on Current Assumptions	86	2,259	76	2,441
10% increase in oil prices & No change in retail price	95	(1,456)	84	(8,292)
10% increase in oil prices & 10% increase in retail price	95	482	84	(1,073)

- ✓ Earnings will vary depending on the crude oil price direction and the timing of the price revisions enacted by the government. Further, managing and procuring stocks at low prices amidst the current price volatility plays a significant role on the margins of the company.
- ✓ Current demand for petroleum products is expected stagnate with the existing macro economic conditions affecting improvements in volumes.
- ✓ In addition margins and earnings of LIOC could be maintained provided the Government holds back on any additional tax or surcharges on petroleum products.

- ✓ While we expect LIOC to register earnings of Rs. 2,259m for FY09 and Rs.2,441m for FY10 on current trends, the assumptions already stated which are highly unpredictable in nature is likely to pose a significant threat to the earnings. However at Rs. 18.00, the counter trades at a PER of 4.24x FY09 earnings and 3.93x FY10 earnings. The counter trades at 44% discount to the market.
- ✓ Given the circumstances in the retail petroleum sector where LIOC has control only relating to the purchase of stocks, any adverse situation is likely to wipe out LIOC earnings including earnings from lubricants and bunkering where earnings are not significant compared to the retail petroleum sector. As a result we are NEUTRAL despite a positive earnings outlook.

Profit & Loss Statement P/E 31 March	2004	2005	2006	2007	2008	2009E	2010E
Turnover	14533	27586	37493	32796	44760	56215	79059
Cost of sales	13478	25082	35211	31887	41085	53342	75719
Gross Profit	1055	2503	2281	909	3675	2873	3340
Other operating Income	49	59	163	343	261	287	316
Distribution cost	12	10	29	21	55	40	50
Administrative expenses	581	593	773	704	818	1004	1175
Disallowed input VAT on Subsidy	0	0	-838	215	0	0	0
Subsidy receivable written off	0	0	-2097	-303	-796	0	0
Profit from operation	511	1960	-1293	438	2266	2116	2430
Net Finance cost	0	-74	-426	-1074	251	313	195
Profit before tax	511	1885	-1719	-636	2517	2429	2625
Taxation	10	2	4	49	177	170	184
Profit after tax	501	1883	-1723	-685	2340	2259	2441

Balance Sheet As at 31 March	2004	2005	2006	2007	2008	2009E	2010E
Assets							
Non current assets							
Property plant and equipment	1809	3261	3217	3174	3234	3764	4294
Goodwill	3455	712	674	674	674	674	674
11% Interest bearing Government Bond**	0	0	0	4461	4461	4461	4461
Investment in associate	2628	4394	4394	4394	4394	4394	4394
	7892	8367	8285	12703	12763	13293	13823
Current Assets							
Inventories	2456	4649	2409	6559	8511	10689	15033
Receivables and prepayment	503	5735	5833	856	548	688	968
Cash and cash equivalents	164	1537	1021	1010	2138	3758	4221
	3123	11922	9262	8426	11197	15135	20221
Total Assets	11014	20288	17547	21128	23960	28428	34044
Equity and Liabilities							
Capital and reserves							
Ordinary shares	4000	5325	5325	5325	5325	5325	5325
Share Premium	0	2253	2252	2252	2252	2252	2252
Retained Earnings	656	2486	764	78	2419	4678	7119
	4656	10064	8340	7655	9995	12254	14695
Non - current liabilities							
Borrowings	0	1582	408	0	0	0	0
Retirement benefit obligations	18	21	23	23	46	51	56
	18	1603	431	23	46	51	56
Current liabilities							
Trade and other payables	6033	4515	4111	9270	9692	9738	10956
Current tax payable	2	1	3	0	121	177	170
Borrowings	305	4103	4661	4180	4105	6208	8166
	6340	8619	8775	13450	13918	16123	19292
Total liabilities	6358	10222	9207	13474	13965	16174	19349
Total equity & liabilities	11014	20286	17547	21128	23960	28428	34044

Cashflow Statement P/E 31 March	2004	2005	2006	2007	2008	2009E	2010E
Net profit before tax	588	1885	-1719	-636	2517	2429	2625
Depreciation & Non Cash Items	71	268	3539	768	211	63	228
Changes in Working Capital	2413	-5469	-2895	886	-1385	-2242	-3375
Income tax paid	-8	-3	-1	-63	-46	-170	-184
Net Interest	-15	-139	-308	-526	187	313	195
Subsidy Received from GOSL	0	250	1700	700	0	0	0
Gratuity paid	0	2	-1	-24	-4	4	4
Net cashflow from operating activities	3049	-3205	315	1105	1479	397	-507
Investing Activities							
Purchase of Property, Plant and Equipment	-7681	-782	-215	-227	-344	-530	-530
Net cashflow from investing activities	-7681	-782	-215	-227	-344	-530	-530
Financing Activities							
Proceeds / Repayment of borrowings	0	-51	947	341	17129	9000	9000
Repayment of borrowings	0	0	0	-1842	-15945	-7000	-7500
Dividends Payable	0	0	0	0	0	0	0
Issue of ordinary shares	3500	3578	-1	0	0	0	0
Net Cashflow from financing activities	3500	3528	946	-1501	1184	2000	1500
Net cash and cash equivalents	-1132	-459	1045	-622	2319	1867	463
Cash and cash equivalents							
At start of the year	990	-142	-853	193	-428	1891	3758
Increase / (Decrease)	-1132	-459	1045	-622	2319	1867	463
At end of period	-142	-601	192	-428	1891	3758	4221

**It is assumed that the Bonds are renewed after expiration in 2009