2QFY07 Results Update
SECTOR: OIL & GAS

IPCL

STOCK INFO.	BLOOMBERG
BSE Sensex: 12,858	IPCL IN
	REUTERS CODE
S&P CNX: 3,711	IPCL.BO

Equity Shares (m)	* 249.1
52-Week Range (Rs)	321/185
1,6,12 Rel. Perf. (%)	7/8/-25
M.Cap. (Rs b)	78.9
M.Cap. (US$ b)	1.7

*Standalone**

18 October 2006

Sell

Previous Recommendation: Buy

Rs304

YEAR END	NET SALES (RS M)	PAT (RS M)	EPS (RS)	EPS GROWTH (%)	P/E (X)	P/BV (X)	ROE (%)	ROCE (%)	EV/ SALES	EV/ EBITDA
03/06A	84,690	9,195	36.9	17.0	8.6	2.1	27.7	33.3	0.9	4.4
03/07E	92,364	11,512	46.2	25.2	6.9	1.7	27.2	38.5	0.7	2.9
03/08E	80,371	10,585	42.5	-8.1	7.5	1.4	20.3	28.6	0.6	2.9

Standalone

- IPCL has reported merged earnings and has restated previous quarter earnings, following the court approval of the merger of six polyester companies. Net profit at Rs3.5b, was up 9.4% YoY (below our standalone estimate), while EBITDA at Rs6.4b was up 38.2% YoY (same as our standalone estimates)
- We believe, profit growth was primarily driven by margin improvement, while volumes would have suffered on account of floods and poor offtake on account of historic high product prices.
- Key product margins were at a historic high. Polymer and MEG spreads over all three feedstocks were up between 20-30% YoY, while PVC and LAB prices were up between 8-12% YoY. However, polyester margins were down between 7-30%, setting off part of the gains.
- We are downgrading the stock to **Sell** on the back poor polyester business profits and outlook and higher than expected equity dilution of 21.1% and consequent EPS dilution
- Stock trades at a P/E of 9.3x FY08E on merged entity basis. Downgrade to **Sell**. We would look to review our recommendation if additional domestic gas supply is secured, to replace imported propane and / or if the large cash in balance sheet is put to productive use.

QUARTERLY PERFORMANCE (MERGED) (Rs Million)

Y/E MARCH	FY06			FY07			FY06	FY07E
	1Q	2Q	2HE	1Q	2Q	2HE		
Net Sales	**26,210**	**25,880**	**57,130**	**30,180**	**30,480**	**52,299**	**109,220**	**112,959**
Change (%)			*196.5*	*15.1*	*17.8*	*-8.5*		*3.4*
Change in Stocks	-210	-1,200	-920	1,750	-1,360		-2,330	
Raw Material Consumed	13,580	14,320	30,190	14,960	17,290		58,090	
Staff Cost	1,120	1,140	2,290	1,390	1,210		4,550	
Other Expenses	7,050	7,010	14,610	6,490	6,970	41,779	28,670	90,479
EBITDA	**4,670**	**4,610**	**10,960**	**5,590**	**6,370**	**10,520**	**20,240**	**22,480**
% of Net Sales	*17.8*	*17.8*	*19.2*	*18.5*	*20.9*	*20.1*		*19.9*
Depreciation	1,430	1,400	2,780	1,320	1,350	3,029	5,610	5,699
Interest	370	390	590	510	370	795	1,350	1,675
Other Income	400	340	730	620	1,180	2,000	1,470	3,800
PBT	**3,270**	**3,160**	**8,320**	**4,380**	**5,830**	**8,697**	**14,750**	**18,907**
Tax	940	806	2,220	1,800	2,320	2,814	3,966	6,934
Rate (%)	*28.7*	*25.5*	*26.7*	*41.1*	*39.8*	*32.4*		*36.7*
Adjusted PAT	**2,330**	**2,354**	**6,100**	**2,580**	**3,510**	**5,883**	**10,784**	**11,973**
Change (%)				*10.7*	*49.1*	*-3.5*		*11.0*
Reported PAT	**2,330**	**3,210**	**6,100**	**2,580**	**3,510**	**5,883**	**11,640**	**11,973**

E: MOSt Estimates

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Results below expectation

IPCL has reported merged earnings and has restated previous quarter earnings, following the court approval of the merger of six polyester companies. Net profit at Rs3.5b, was up 9.4% YoY, below our standalone estimate. EBITDA at Rs6.4b was up 38.2% YoY, same as our standalone estimates. We estimate that polyester companies would have contributed about Rs0.3b to EBITDA in 2QFY07.

Margin expansion was the key driver

We believe, profit growth was primarily driven by margin improvement. Barring polyester, margins for all products was at a high, thanks to historic high domestic product prices. PE and PP spread over imported propane were up 23% and 18% YoY, while spread over gas was up 23% and 19.1% YoY. Spreads over naphtha too were up 33% and 27% YoY respectively. MEG spreads over propane, gas and naphtha were up 18.9, 7.2% and 12.7% respectively.

PVC and LAB prices were up 8.3% and 12.5% YoY respectively.

However, feedstock mix in the quarter would have been slightly skewed towards imported propane, given the gas supply disruption, which would have hurt the profits.

Volumes likely to have been subdued

We believe, sales volume would have been subdued during the quarter on account of floods as well as historic high prices, leading to postponement of purchase by buyers.

Downgrading stock to Sell

We are downgrading the stock from **Buy** to **Sell** on account of the following factors.

1. Poor polyester business profits and outlook,
2. Higher than expected equity and EPS dilution
3. Risk to earnings estimate, as sustaining 1HFY07 earnings would be challenging
4. Stock is close to our target price of Rs312/share

Polyester business contribution lower than expected, outlook weak

We estimate contribution of polyester business to EBITDA in 1QFY07 at Rs410m, PBT contribution at Rs170m and PAT contribution a negative Rs330m. We believe, 2QFY07 performance would have been worse, given the fall in polyester margins sequentially.

Outlook for polyester margins remains weak given the large capacity overhang in China. Polyester operating rates in China are reported to be between 60-63%, which has kept margins at close to cash cost levels. However, Indian polyester margins were better off, as players occasionally were taking advantage of antidumping duties on the products, thus delivering better margin performance.

We believe, significant global polyester margin improvement is still some time away, while domestic margins could get worse in the near term, given the large new capacity addition of 850ktpa by Reliance and Indorama over the last 3 months.

Equity and EPS dilution higher than expected

IPCL is set to issue additional 5.25m shares on account of the merger, leading to 21% dilution in equity. While, we believe the swap ratio and dilution would have been based on long term average product and profit margins, the medium term weakness in polyester margins would lead to large EPS dilution of 28% and 26% respectively for FY07 and FY08.

Repeat of 1HFY07 earnings would be challenging

2QFY07 witnesses historic high margins in key products, while 1QFY07 profits were boosted by strong margin and higher volume driven by inventory de-stocking. We believe, a repeat of 1HFY07 earnings would be difficult to achieve, as product prices and margins have already started falling on the back of lower crude price. For IPCL, product prices are significant given its fixed price gas feedstock (currently at US$4.75/mmbtu), which forms about 40-45% of the total feedstock by volume.

MERGED ENTITY: EARNINGS ESTIMATE (RS M)

	FY06A	FY07F	FY08F	FY09F
Net Sales	109,220	112,959	100,966	98,842
EBITDA	20,240	22,480	18,115	16,409
PBT	14,750	18,907	16,195	15,092
Net profit	11,640	11,973	9,858	9,219
FDEPS (Rs)	38.6	39.7	32.7	30.6
P/E (x)	7.9	7.7	9.3	9.9

Source: Motilal Oswal Securities

Key upside risks

Feedstock cost savings from PMT gas

IPCL could contract additional volume of domestic gas from PMT (Panna, Mukta and Tapti). PMT is expected to increase production 5MMSCMD in 4QFY08. This would replace high cost propane imports (currently supplementing domestic gas feed on account of short supply of domestic gas) to Gandhar. Similar substitution could also be expected at Nagothane on completion of Dahej-Uran pipeline, currently scheduled for February 2007 completion. The benefit from the substitution is expected to be between Rs3.3 - 5b per annum.

However, petrochemical down cycle could set in by FY09 and hence the feedstock savings is unlikely to improve profits significantly. Our current FY09 estimates do not factor in this scenario.

Large value accretive acquisition or merger

IPCL has large cash on the balance sheet, which could be used to fund large value accretive acquisition.

We would look to review our recommendation in case of a positive surprise with regard to the two possible upside risks.

Valuation is stretched; downgrade to Sell

The stock trades at a P/E of 9.7x FY08E merged entity earnings. We believe, potential upside to earnings is limited and valuation is stretched. We are downgrading the stock to a **Sell** with a target price of Rs270 (@8.25x FY08E).

IPCL: an investment profile

Company description

IPCL is the second largest player in the petrochemicals industry in India after Reliance. It is the largest integrated PVC player, largest PE producer and second largest MEG producer. It also has the largest ethylene capacity. Low operating rates and high cost borrowings affected performance under the previous management. However, currently operating rates are considerably higher than nameplate capacity, propane imports supplement gas, and total debt as well as cost of debt has fallen significantly.

Key investment arguments

- Pure petrochemical cycle play
- Petrochemical prices and margins are buoyant
- But, merger pulls down EPS

Key investment risks

- Weaker-than-expected global demand growth leading to a muted petrochemical cycle improvement.
- Sharp fall in crude prices, leading to lower product prices, impacting margins for IPCL.

Recent developments

- IPCL has merged six polyester companies with itself leading to dilution of 21% in equity.

Valuation and view

- The stock trades at a P/E of 9.7x FY08E (merged entity).
- We believe the valuation valuation is stretched and earnings upside is limited.
- Downgrade from **Buy** to **Sell** with a target price of Rs270/share (based on 8.25x FY08E EPS).

Sector view

- Petrochemical upcycle expected to continue over the next 18 months, as demand growth outpaces capacity addition.

COMPARATIVE VALUATIONS

		IPCL	RELIANCE
P/E (x)	FY07E	6.9	16.8
	FY08E	7.5	16.4
P/BV (x)	FY07E	1.7	4.4
	FY08E	1.4	3.6
EV/Sales (x)	FY07E	0.7	1.9
	FY08E	0.6	2.0
EV/EBITDA (x)	FY07E	2.9	11.1
	FY08E	2.9	10.5

SHAREHOLDING PATTERN (%)

	SEP.06	JUN.06	SEP.05
Promoter	46.5	46.0	46.0
Domestic Inst	15.0	15.8	15.8
Foreign	16.1	13.8	11.8
Others	22.4	24.4	26.4

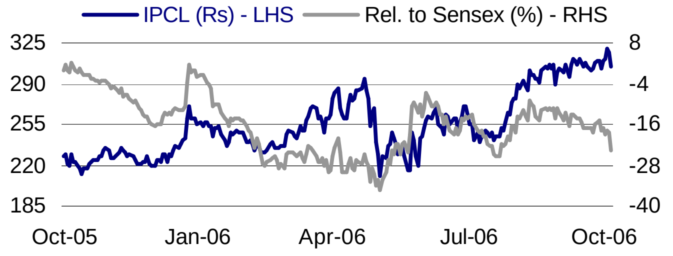
EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	39.7	28.8	37.8
FY08	32.7	25.4	28.7

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
304	270	-11.2	Sell

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT					(Rs Million)
Y/E MARCH	**2005**	**2006***	**2007E**	**2008E**	**2009E**
Net Sales	**81,991**	**84,690**	**92,364**	**80,371**	**78,247**
Change (%)	*13*	*3.3*	*9.1*	*-13.0*	*-2.6*
Raw Materials Cons	36,839	39,121	43,176	35,404	34,254
Stores and Spares, Purchases	6,138	5,673	5,829	5,134	4,967
Sales and Distribution Exp	3,053	3,022	2,992	3,052	3,113
Employee Costs	5,224	4,701	4,350	4,698	5,074
Other Expenditure	15,153	14,652	15,337	15,969	16,630
EBITDA	**15,615**	**17,520**	**20,680**	**16,115**	**14,209**
% of Net Sales	*19.0*	*20.7*	*22.4*	*20.1*	*18.2*
Depreciation	5,057	4,800	4,799	5,121	5,217
Interest	1,620	1,180	1,075	0	0
Other Income	1,322	1,361	1,638	4,126	5,584
PBT	**10,259**	**12,901**	**16,445**	**15,121**	**14,577**
Tax	2,400	3,706	4,934	4,536	4,373
Rate (%)	*23.4*	*28.7*	*30.0*	*30.0*	*30.0*
PAT	**7,859**	**9,195**	**11,512**	**10,585**	**10,204**
Change (%)	*187.3*	*17.0*	*25.2*	*-8.1*	*-3.6*

** FY06 PAT net of extraordinary*

BALANCE SHEET					(Rs Million)
Y/E MARCH	**2005**	**2006**	**2007E**	**2008E**	**2009E**
Share Capital	2,491	2,491	2,491	2,491	2,491
Reserves	26,720	34,651	44,898	54,219	63,158
Net Worth	**29,211**	**37,141**	**47,389**	**56,709**	**65,649**
Long Term Loans	11,801	5,750	750	750	0
Short Term Loans	736	0	0	0	0
Deferred Tax	11,012	12,947	15,414	17,682	19,869
Capital Employed	**52,759**	**55,839**	**63,553**	**75,141**	**85,518**
Gross Fixed Assets	97,858	100,241	102,531	104,826	106,127
Less: Depreciation	47,809	52,609	57,408	62,529	67,745
Net Fixed Assets	**50,049**	**47,632**	**45,124**	**42,298**	**38,381**
Capital WIP	588	500	500	500	500
Investments	1,653	1,653	1,653	1,653	1,653
Curr. Assets, L & Adv.					
Inventory	6,231	6,101	6,707	5,704	5,517
Debtors	7,011	7,912	8,629	7,509	7,310
Cash & Bank Balance	6,649	8,243	19,119	32,403	46,759
Loans & Adv. and Other Assets	4,566	4,292	4,292	4,292	4,292
Current Liab. & Prov.					
Liabilities	19,995	18,456	20,187	16,707	16,166
Provisions	3,994	2,037	2,284	2,511	2,729
Net Current Assets	**468**	**6,054**	**16,276**	**30,690**	**44,983**
Misc. Expenses	0	0	0	0	0
Application of Funds	**52,758**	**55,839**	**63,553**	**75,141**	**85,518**

E: MOSt Estimates

RATIOS					
Y/E MARCH	**2005**	**2006**	**2007E**	**2008E**	**2009E**
Basic (Rs)					
EPS	**31.6**	**36.9**	**46.2**	**42.5**	**41.0**
Cash EPS	51.9	56.2	65.5	63.1	61.9
Book Value	117.3	149.1	190.3	227.7	263.6
Gross DPS	4.5	4.5	4.5	4.5	4.5
Payout	14.2	12.2	9.7	10.6	11.0
Valuation (x)					
P/E	10.0	8.6	6.9	7.5	7.7
Cash P/E	6.1	5.6	4.8	5.0	5.1
EV / EBITDA	5.4	4.4	2.9	2.9	2.3
EV / Sales	1.0	0.9	0.7	0.6	0.4
Price / Book Value	2.7	2.1	1.7	1.4	1.2
Dividend Yield (%)	1.4	1.4	1.4	1.4	1.4
Profitability Ratios (%)					
RoE	30.3	27.7	27.2	20.3	16.7
RoCE	26.0	33.3	38.5	28.6	23.7
Turnover Ratios					
Debtors (No. of Days)					
Fixed Asset Turnover (x)	1.6	1.8	2.0	1.9	2.0
Leverage Ratio					
Net Debt / Equity (x)	0.1	-0.1	-0.3	-0.5	0.0

CASH FLOW STATEMENT					(Rs Million)
Y/E MARCH	**2005**	**2006**	**2007E**	**2008E**	**2009E**
OP/(Loss) before Tax	15,615	17,520	20,680	16,115	14,209
Interest Paid	-1,620	-1,180	-1,075	0	0
Direct Taxes Paid	-1,060	-1,771	-2,467	-2,268	-2,187
(Inc)/Dec in Wkg. Capital	8,830	-3,992	654	-1,130	64
CF from Op. Activity	**21,764**	**10,577**	**17,792**	**12,717**	**12,086**
Others	-254	-143	-143	-143	-143
(Inc)/Dec in FA & CWIP	-1,029	-2,295	-2,290	-2,295	-1,300
(Pur)/Sale of Investments	-141	0	0	0	0
Inc from Invst	1,322	1,361	1,638	4,126	5,584
CF from Inv. Activity	**151**	**-934**	**-652**	**1,831**	**4,284**
Issue of Shares	0	0	0	0	0
Inc / (Dec) in Debt	-14,404	-6,786	-5,000	0	-750
Dividends Paid (incl.tax)	-1,117	-1,121	-1,121	-1,121	-1,121
CF from Fin. Activity	**-15,521**	**-7,907**	**-6,121**	**-1,121**	**-1,871**
Inc / (Dec) in Cash	**6,141**	**1,593**	**10,876**	**13,284**	**14,356**
Add: Opening Balance	507	6,648	8,243	19,119	32,403
Closing Balance	**6,648**	**8,242**	**19,119**	**32,403**	**46,759**

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Disclosure of Interest Statement	IPCL
1. Analyst ownership of the stock	No
2. Group/Directors ownership of the stock	No
3. Broking relationship with company covered	No
4. Investment Banking relationship with company covered	No