Company

18 February 2010 | 10 pages

Bharat Petroleum (BPCL.BO)

Equity

Alert: New E&P Discovery in Mozambique; Follows Success In Brazil

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- **Gas discovery in Mozambique announced** — A consortium in which BPCL has a 10% stake (through its wholly-owned subsidiary BPRL), has announced a gas discovery in one of its blocks in offshore Mozambique. The block in Rovuma Basin is operated by Anadarko, which is also the operator of block BM-C-30 in Campos Basin in offshore Brazil (where BPCL has a 12.5% stake and where two discoveries have been made so far). While this is just a discovery and actual appraisal/quantification of resource/reserve estimates could take some time, the newsflow is incrementally positive at the margin. We reiterate our preference for BPCL over HPCL/IOC.

- **Discovery indicates strong potential of the block** — According to a press release by the operator Anadarko, the exploration well (known as Windjammer) has encountered more than 480 net feet of natural gas in high-quality reservoir sands and is a strong indication of the potential of the basin. The discovery de-risks a substantial portion of ~50 leads and prospects that have been identified across the 2.6m acre position in the basin. Anadarko also expects to drill two to four additional exploration wells in the Rovuma Basin this year.

- **Current target price ascribes no value from E&P** — We currently ascribe no value from E&P in our target price for BPCL as formal resource estimates are not yet known. Estimates for Anadarko's Brazil resource have varied in the 150-700 mmboe range. The positive results in the Wahoo #2 appraisal well (announced in Nov-09) could indicate the resource is closer to the higher end of the band, perhaps in excess of 500 mmboe. The value accretion per share for BPCL in the 150-700 mmboe resource range, assuming a 30% recovery factor, and employing an EV/boe of US$12, could range from ~Rs10-Rs40/share. Using a higher 50% recovery and a valuation of US$15/boe could increase this to ~Rs20-Rs80/share. Today's announcement of the discovery in offshore Mozambique adds further credence to possible upside from E&P to our target price.

- **E&P newsflow incrementally positive and supports our preference for BPCL** — As highlighted in our recent note *('Indian Downstream: Game of probabilities – BPCL looks better placed'*, 1 February 2010*)*, we believe that at current levels BPCL is factoring in the lowest probability of full compensation of under-recoveries from the government vs. HPCL/IOC. While concrete reforms could be a long drawn out affair, we reiterate our preference for BPCL over HPCL/IOC. Positive newsflow on E&P lends further support to our preference for BPCL at current levels.

See Appendix A-1 for Analyst Certification and important disclosures.

- Bharat Petroleum (BPCL.BO; Rs578.50; 1H)
- Hindustan Petroleum (HPCL.BO; Rs346.60; 1H)
- Indian Oil (IOC.BO; Rs311.15; 2H)

Bharat Petroleum

Company description

BPCL is an oil refining and marketing company, with around 22% share of the Indian petro-products market. BPCL has recently merged the refining company, Kochi Refineries with itself; it also has controlling interest in another refining company, Numaligarh Refineries.

Investment strategy

We rate BPCL Buy/High Risk (1H) with a target price of Rs713. Based on the stance taken by the government at various public forums, we view there is growing confidence on the intent to completely reimburse OMCs for under-recoveries through upstream sharing/price hikes for auto fuel losses and budgetary support/oil bonds for cooking fuel losses. While absolute certainty on these issues is likely a few months away i.e. until the recently constituted committee's recommendations are finalized, we believe the stock should price in the positives, albeit with associated probabilities and appropriate valuation discounts.

Valuation

Our target price for BPCL of Rs713 is based on the sum of: (i) 6x EV/EBITDA in the scenario with Rs150bn of net under-recoveries (in-line with FY08A), (ii) 3x EV/EBITDA of incremental earnings assuming under-recovery goes to nil, and (iii) Value of its investments (Rs141/share). The 6.0x multiple is in-line with the target multiple we use for other Indian refineries. We ascribe a lower multiple for the incremental earnings from a scenario of nil net under-recoveries to factor in uncertainty associated with full implementation by the government of complete compensation to the OMCs for marketing losses. While valuing the Indian oil refining and marketing companies, we prefer to use EV/EBITDA to compare companies across the region to avoid differences in accounting policies in depreciation and taxation. Our target price also equates to an FY10E P/E of 8.7x and P/B of 1.5x, higher than for HPCL, justified in our view by BPCL's higher proportion of better quality earnings.

Risks

We assign a High Risk rating for the stock, in-line with our quantitative risk rating system. Sentiment towards the sector and BPCL is closely linked to crude price fluctuations, sector deregulation, subsidy losses, and auto fuel price hikes. Key downside risks to our target price include: (i) Rise in crude to US$80+ is an obvious risk, as the governments ability to fully compensate OMCs in such a scenario may be constrained; (ii) The government's fiscal situation continues to be a concern (total oil bonds constituted 1.3% of GDP in FY09, 0.5% in FY10E on our estimate for nil under-recovery); and (iii) The recently constituted committee's recommendations may only be finalized in the next 3-4 months.

Hindustan Petroleum

Valuation

Our target price for HPCL of Rs493 is based on the sum of: (i) 6x EV/EBITDA in the scenario with Rs150bn of net under-recoveries (in line with FY08A), (ii) 3x EV/EBITDA of incremental earnings assuming under-recovery goes to nil, and (iii) Value of its investments (Rs57/share). The 6.0x multiple is in-line with the target multiple we use for other Indian refineries. We ascribe a lower multiple for the incremental earnings from a scenario of nil net under-recoveries to factor in the uncertainty associated with full implementation by the government of complete compensation to the OMCs for marketing losses. While valuing the Indian oil refining and marketing companies, we prefer to use EV/EBITDA to compare companies across the region to avoid differences in accounting policies in depreciation and taxation. Our target price also equates to an FY10E P/E of 6.5x and P/B of 1.2x, lower than for BPCL, justified in our view by HPCL's lower proportion of better quality earnings.

Risks

We assign a High Risk rating for the stock, in-line with our quantitative risk rating system. Sentiment towards the sector and HPCL is closely linked to crude price fluctuations, sector deregulation, subsidy losses, and auto fuel price hikes. Key downside risks to our target price include: (i) Rise in crude to US$80+ is an obvious risk, as the governments ability to fully compensate OMCs in such a scenario may be constrained; (ii) The government's fiscal situation continues to be a concern (total oil bonds constituted 1.3% of GDP in FY09, 0.5% in FY10E on our estimate for nil under-recovery); and (iii) The recently constituted committee's recommendations may only be finalized in the next 3-4 months.

Indian Oil

Valuation

Our target price for IOC of Rs709 is based on the sum of: (i) 6x EV/EBITDA in the scenario with Rs150bn of net under-recoveries (in line with FY08A), (ii) 3x EV/EBITDA of incremental earnings assuming under-recovery goes to nil, and (iii) Value of its investments (Rs226/share). The 6.0x multiple is in-line with the target multiple we use for other Indian refineries. We ascribe a lower multiple for the incremental earnings from a scenario of nil net under-recoveries to factor in uncertainty associated with full implementation by the government of complete compensation to the OMCs for marketing losses. While valuing the Indian oil refining and marketing companies, we prefer to use EV/EBITDA to compare companies across the region to avoid differences in accounting policies in depreciation and taxation. Our target price also equates to an FY10E P/E of 6.2x and P/B of 1.2x, in-line with HPCL but lower than for BPCL.

Risks

We assign a High Risk rating to the stock, higher than the Medium Risk rating suggested by our quantitative risk rating system. Sentiment towards the sector and IOC is closely linked to crude price fluctuations, sector deregulation, subsidy losses, and auto fuel price hikes, thus we view a High Risk rating as more appropriate. Key downside risks to our target price include: (i) Rise in crude to US$80+ is an obvious risk, as the governments ability to fully compensate OMCs in such a scenario may be constrained; (ii) The government's fiscal situation continues to be a concern (total oil bonds constituted 1.3% of GDP in FY09, 0.5% in FY10E on our estimate for nil under-recovery); and (iii) The recently constituted committee's recommendations may only be finalized in the next 3-4 months. Key upside risks include: (i) Earlier than expected commissioning of the Panipat refinery expansion and Panipat naphtha cracker projects, and (ii) Shaper decline in crude to ~US$50/bl levels.

Appendix A-1

Analyst Certification

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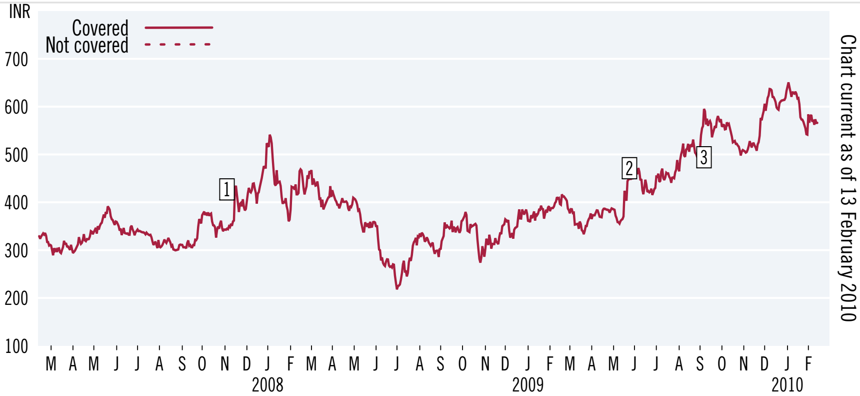
Ratings and Target Price History
Fundamental Research

Analyst: Saurabh Handa



	Date	Rating	Target Price	Closing Price
1	4-Nov-07	3M	*303.00	342.60
2	24-May-09	3M	*365.00	447.50
3	6-Sep-09	*1H	*713.00	559.55

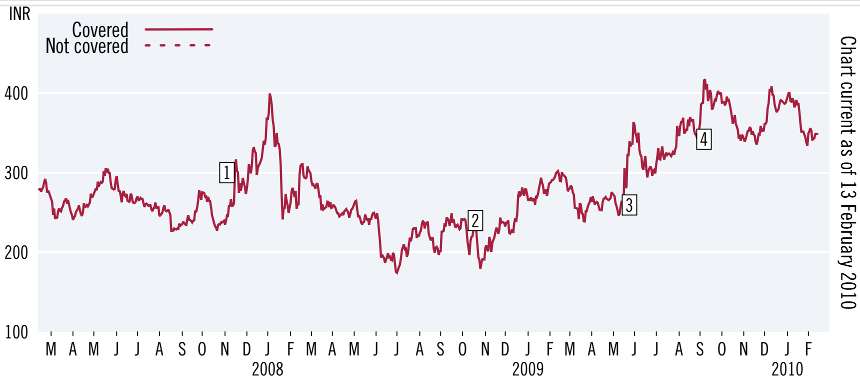
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Hindustan Petroleum (HPCL.BO)

Ratings and Target Price History
Fundamental Research

Analyst: Saurabh Handa
Covered since September 7 2009



	Date	Rating	Target Price	Closing Price
1	4-Nov-07	3M	*184.00	239.15
2	20-Oct-08	3M	*213.00	239.65
3	24-May-09	3M	*272.00	320.70
4	6-Sep-09	*1H	*493.00	387.65

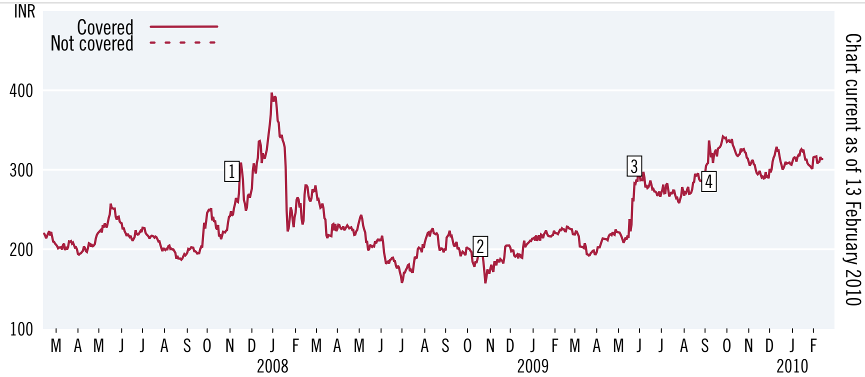
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Indian Oil (IOC.BO)

Ratings and Target Price History
Fundamental Research

Analyst: Saurabh Handa
Covered since September 7 2009



	Date	Rating	Target Price	Closing Price
1	4-Nov-07	3M	*247.00	247.85
2	20-Oct-08	*1M	*264.00	203.53
3	24-May-09	*3M	*254.00	260.25
4	6-Sep-09	*2H	*354.50	308.48

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Rating/target price changes above reflect Eastern Standard Time

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