

Industry

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Indian Downstream

 Equity

EGoM Meeting: Big Steps Forward, But Not All The Way Yet

- OMCs benefit most, but some unanswered qns** — The announcements on partial deregulation/price hikes (Figure 1) are significantly ahead of recently tempered mkt expectations. Oil mktg cos. (BPCL/HPCL/IOC) benefit most, in our view, with improved probability of being fully compensated, given govt's stated intent of completely shielding them from losses. While upstream cos. (ONGC/OIL/GAIL) also gain through reduced subsidy burden (down from cRs770bn to cRs530bn at US\$75 crude), partial implementation of Kirit Parikh recos, esp. pertaining to subsidy sharing, increases uncertainty, leading us to prefer OMCs at this stage.
- HPCL cheapest on normalized P/E, but still prefer BPCL** — As highlighted in our note titled, "Examining Earnings Potential of the OMCs" dated 22 June 2010, HPCL looks cheapest amongst OMCs on normalized earnings (i.e., nil net under-recoveries). Even after the sharp upmove, HPCL trades at 7.6x normalized P/E vs. 8.7-8.9x for BPCL/IOC (after stripping out non-income-earning investments). Attributing a reasonable 11x multiple (in line with regional peers) and adding the value of investments could result in upside of 45% for HPCL vs. 20-25% for BPCL/IOC. However, we still favour BPCL based on: (i) government intervention if crude rises sharply (no levels specified), (ii) most downside for HPCL if spectre of under-recoveries looms again, (iii) BPCL's higher E&P potential, (iv) its more balanced refining/marketing mix, especially post-Bina, increasing refining leverage & improving marketing self-sufficiency, and (v) likely political opposition.
- Partial implementation increases upstream uncertainty** — We examine upstream sharing under 3 scenarios (Figs 4-6) and conclude that unless the Kirit Parikh formula is accepted and/or diesel is deregulated as promised, upside potential may be limited. However, this encompasses gov't share rising to ~Rs350-500bn at US\$75, depending on whether or not diesel is deregulated. We prefer GAIL over ONGC/OIL as it still retains the highest probability amongst upstream cos. of benefiting most as and when the sharing mechanism is announced by the gov't.

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Figure 1. EGoM Announcements vs. Kirit Parikh Recommendations

	Recommended by Kirit Parikh	Announced by EGoM	Comments
Petrol	Full deregulation	Full deregulation	Leads to immediate hike of Rs3.5/l; freq. of changes unknown
Diesel	Full deregulation	Price hike of Rs2/l	To be eventually deregulated, but timelines undecided
LPG	Price hike of Rs100/cyl	Price hike of Rs35/cyl	
Kerosene	Price hike of Rs6/l	Price hike of Rs3/l	First hike since 2002, a big +ve
Subsidy sharing	OMCs to be fully compensated; ONGC/OIL burden to be based on crude-linked formula; GAIL to be fully exempted; gov't share to be capped at ~Rs200bn	No announcements; subsidy sharing formula to be decided in due course	Gov't has stated intent to shield OMCs from losses and split burden between itself and upstream

Source: Citi Investment Research and Analysis

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EGoM Meeting: Big Steps Forward, But Not All The Way Yet

Impact of EGoM announcements

Figure 2. Fuel subsidies – Impact of EGoM announcements

	Pre-EGoM decision			Post-EGoM decision		
	Marketing margin (Rs/ltr, Rs/cyl)	Under-recovery (Rs bn)	% of total	Marketing margin (Rs/ltr, Rs/cyl)	Under-recovery (Rs bn)	% of total
Petrol	-4.0	75	10%	-	0	0%
Diesel	-3.5	257	33%	-1.5	150	28%
LPG	-262	239	31%	-227	210	40%
Kerosene	-16.5	199	26%	-13.5	170	32%
Total		770	100%		530	100%

Source: Citi Investment Research and Analysis

Earnings potential of the OMCs¹

Figure 3. OMCs' Reported, Clean, and Normalized Earnings

		BPCL	HPCL	IOC
Current price	Rs/share	621	402	378
Reported FY10 PAT	Rs bn	15.4	13.0	102.2
Reported FY10 EPS	Rs/share	43	38	43
Forex gains, inventory gains, diminution in value of investments	Rs bn	(2.7)	(4.0)	(43.4)
Clean FY10 PAT	Rs bn	13.7	10.2	73.9
Clean FY10 EPS	Rs/share	38	30	31
Normalized FY10 PAT	Rs bn	21.7	18.0	95.4
Normalized FY10 EPS	Rs/share	60	53	40
Non-income earning investments	Rs/share	90	-	30
Clean P/E	x	14.0	13.4	11.2
Normalized P/E	x	8.9	7.6	8.7
Price assuming 11x normalized P/E	x	750	583	470
Potential upside (assuming nil net under-recoveries)	%	21%	45%	24%

Source: Company reports, Citi Investment Research and Analysis

¹ Refer to our note titled, "Indian Downstream: Examining Earnings Potential of the OMCs" dated 22 June 2010.

Upstream sharing scenarios

Figure 4. Scenario I – Upstream share based on crude-linked formula per Kirit Parikh recos

Crude price	US\$/bbl	75	80
Gross under-recoveries (assuming no diesel deregulation)	Rs bn	530	680
Upstream sharing (based on Kirit Parikh formula)	Rs bn	34	51
Gov't share (assuming no diesel deregulation)	Rs bn	496	629
Gov't share (%)	%	94%	92%
Gross under-recoveries (assuming diesel deregulation)	Rs bn	380	425
Upstream sharing (based on Kirit Parikh formula)	Rs bn	34	51
Gov't share (assuming diesel is deregulated)	Rs bn	346	374
Gov't share (%)	%	91%	88%
ONGC			
- subsidy share	Rs bn	29	44
- net realization	US\$/bbl	71	74
- FY11E EPS (Scenario I)	Rs/share	134	143
- FY11E EPS (current)	Rs/share	111	111
% upside (downside)	%	21%	29%
OIL			
- subsidy share	Rs bn	5	7
- net realization	US\$/bbl	71	74
- FY11E EPS (Scenario I)	Rs/share	161	170
- FY11E EPS (current)	Rs/share	124	124
% upside (downside)	%	30%	38%
GAIL			
- subsidy share	Rs bn	-	-
- FY11E EPS (Scenario I)	Rs/share	36	36
- FY11E EPS (current)	Rs/share	28	28
% upside (downside)	%	29%	29%
- FY12E EPS (Scenario I)	Rs/share	43	43
- FY12E EPS (current)	Rs/share	34	34
% upside (downside)	%	26%	26%

Source: Citi Investment Research and Analysis

Figure 5. Scenario II – Diesel deregulated; upstream bears 1/3rd of total (i.e., cooking fuels only) burden

Crude price	US\$/bbl	75	80
Gross under-recoveries (assuming diesel deregulation)	Rs bn	380	425
Upstream sharing (1/3 rd of total, i.e., LPG+Kero)	Rs bn	127	142
Gov't share	Rs bn	253	283
Gov't share (%)	%	67%	67%
ONGC			
- subsidy share	Rs bn	99	113
- net realization	US\$/bbl	63	66
- FY11E EPS (Scenario II)	Rs/share	115	125
- FY11E EPS (current)	Rs/share	111	111
% upside (downside)	%	4%	13%
OIL			
- subsidy share	Rs bn	13	14
- net realization	US\$/bbl	65	69
- FY11E EPS (Scenario II)	Rs/share	143	154
- FY11E EPS (current)	Rs/share	124	124
% upside (downside)	%	16%	25%
GAIL			
- subsidy share (in line with current assumptions)	Rs bn	15	15
- FY11E EPS (current)	Rs/share	28	28
- FY12E EPS (current)	Rs/share	34	34
% upside (downside)	%	-	-

Source: Citi Investment Research and Analysis

Figure 6. Scenario III – Diesel not deregulated; upstream continues sharing auto fuel (diesel only) burden

Crude price	US\$/bbl	75	80
Gross under-recoveries	Rs bn	530	680
Upstream sharing (diesel only)	Rs bn	150	255
Gov't share	Rs bn	380	425
Gov't share (%)	%	72%	63%
ONGC			
- subsidy share	Rs bn	120	215
- net realization	US\$/bbl	60	52
- FY11E EPS (Scenario III)	Rs/share	109	97
- FY11E EPS (current)	Rs/share	111	111
% upside (downside)	%	-1%	-13%
OIL			
- subsidy share	Rs bn	15	26
- net realization	US\$/bbl	63	60
- FY11E EPS (Scenario III)	Rs/share	137	127
- FY11E EPS (current)	Rs/share	124	124
% upside (downside)	%	11%	3%
GAIL			
- subsidy share (in line with current assumptions)	Rs bn	15	15
- FY11E EPS (current)	Rs/share	28	28
- FY12E EPS (current)	Rs/share	34	34
% upside (downside)	%	-	-

Source: Citi Investment Research and Analysis

Valuation summary

Figure 7. Statistical Abstract

Company	RIC Code	Rating	Mkt cap	Share price	Target	P/E (x)		EV/EBITDA (x)		P/BV (x)	
			(US\$m)	25-Jun-10	price	FY11E	FY12E	FY11E	FY12E	FY11E	FY12E
ONGC	ONGC.BO	2L	58,677	1,264	1,170	11.4	11.2	4.8	4.5	2.3	2.0
Oil India	OILI.BO	2L	7,099	1,360	1,290	11.0	10.7	4.7	4.6	2.1	1.9
GAIL	GAIL.BO	1L	13,290	483	535	17.1	14.1	10.0	9.1	3.2	2.8
BPCL	BPCL.BO	1H	4,876	621	713	9.4	9.0	7.7	7.6	1.5	1.3
HPCL	HPCL.BO	1H	2,948	401	493	6.0	5.9	6.3	6.4	1.0	0.9
IOC	IOC.BO	2H	19,882	377	355	9.6	9.3	7.1	7.0	1.6	1.4

Source: Citi Investment Research and Analysis

Appendix A-1

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Indian Downstream

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