

Bharat Petroleum

Rightly priced

- ▶ **Despite the positive news flows, BPCL has underperformed the market during the past fortnight**
- ▶ **Issue of fresh oil bonds for FY07 suggests that the government would support R&M companies even at higher crude prices**
- ▶ **We cut notional target price to INR347/share on revised assumptions. Expect limited downside to stock from current level. Upgrade to Neutral**

Earnings secured safely by oil bonds

Despite positive news flow, including the issuance of oil bonds worth INR280bn to refining and marketing (R&M) companies, BPCL has underperformed the market since 5 June 2006 (the day issuance of oil bonds was announced (Figure 1)).

Figure 1: BPCL has underperformed the market during the past fortnight

	Current 20-Jun-06	15 days 5-Jun-06	1M 22-May-06	6M 22-Dec-05	12M 20-Jun-05
BPCL stock price (INR)	331	375	391	427	372
BSE Sensex	9,823	10,213	10,482	9,372	6,985
BPCL stock price change		-11.9%	-15.5%	-22.5%	-11.1%
BSE Sensex		-3.8%	-6.3%	4.8%	40.6%
BPCL relative to Sensex		-8.3%	-9.8%	-26.0%	-36.8%

Source: Bloomberg, HSBC

Although retail price hikes approved by the Government of India were lower than expectations, the issue of oil bonds ensured that the earnings of the R&M companies should be well secured in FY07. With the issuance of oil bonds, we expect BPCL to report profits even if Brent remains as high as USD70/bbl in FY07e (see our report *Oil bonds a big help*, 6 June 2006). Issuance of oil bonds also signalled that the R&M companies would be adequately supported by the government in the event of a further surge in petro-product prices. Our comfort on government support to R&M companies stems from the turnaround in stance on issuance of oil bonds by the government. Earlier

Stock data

Current price	Reuters	Bloomberg equity	Bloomberg debt	Valuation range
INR 331	BPCL BO	BPCL IN	NA	INR318-376

Source: HSBC estimates

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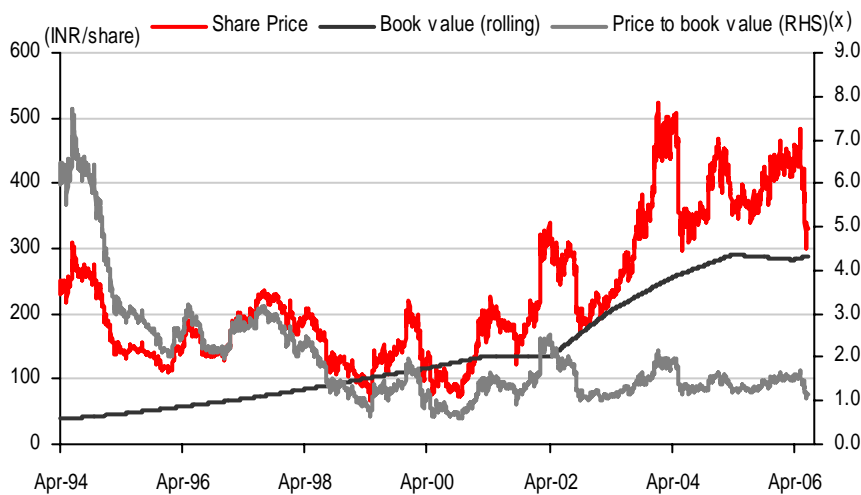
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in FY06, the Petroleum Secretary had stated that oil bonds were a one-off event and that there would be no such issuance in FY07e. But the government has finally agreed to issue oil bonds in FY07 – in fact, more than double of what they'd issued in FY06.

BPCL trading at 1.2x its FY06e book value, below historical median

Figure 2: BPCL share price performance vis-à-vis rolling book value



Source: Bloomberg, HSBC

Historically, BPCL's trailing price-to-book value has averaged 1.7x, with forward price-to-book value averaging 1.5x (Figures 2 & 3). The historical average for P/BV has been higher than the current trailing P/BV of 1.2x and a forward P/BV of 1.1x, for BPCL, implying an upside on book value based valuation.

Figure 3: Price-to-book value of BPCL during the past 10 years (since June 1996)

	Min	Avg	Max	Median
Trailing P/BV	0.64x	1.74x	3.50x	1.52x
Forward P/BV	0.55x	1.48x	2.91x	1.37x
Rolling P/BV	0.59x	1.60x	3.16x	1.42x

Source: Bloomberg, HSBC

Valuation

We expect BPCL's FY07e recurring EPS to be INR32.7/share. Our forecast is based on HSBC Brent price forecast of USD56/bbl. To value BPCL, we have considered both relative PE (relative to target Sensex PE) based valuation and price to book value approach. Figure 4 summarises our approach to valuation.

Figure 4: Fair value calculation for BPCL

BPCL's fair value calculation based on relative PE			
BSE-30 2-year target PE (x)	15.4	15.4	
	Low	High	Average
Target PER (% of BSE-30 PE)	54.3%	64.3%	
Target PE (x)	8.4	9.9	
FY08e EPS under various scenarios	INR/share	INR/share	
Scenario I	37.9	37.9	
Scenario II	25.5	25.5	
Scenario III	50.4	50.4	
2-year target price under various earnings scenarios	INR/share	INR/share	
Scenario I	318	376	347
Scenario II	214	253	
Scenario III	422	500	
Fair value	318	376	347
BPCL's fair value calculation based on Price to book value (NAV)			
FY08e NAV (INR/share)	313	313	
Historical rolling price to book ratio	Median (June 96-till date)	Median (April 02-till date)	
	1.40x	1.34x	
Fair value based on NAV (INR/share)	437	420	429

Note: Scenario I: FY08e Brent at USD50/bbl (Base case)
 Scenario II: FY08e Brent at USD60/bbl
 Scenario III: FY08e Brent at USD40/bbl
 Source: HSBC estimates

Our relative PE based valuation approach is based on relative PE of BPCL to Sensex during April 1996 to date. Our fair value range is arrived at by applying average relative PE band of 54-64% to the forward Sensex PE of 15.4x. Our estimate for forward Sensex PE is based on consensus estimates of forward Sensex PE at 13.77 (at Sensex level of 8,929, Source: Bloomberg), applied to our Sensex target of 10,000. Our price to book valuation approach is based on median of rolling price to book value of BPCL during the last 10-year and 6-year (post-Administered Price Mechanism) period.

We retain our relative PE based valuation approach to value BPCL as it is more conservative than the price to book value based valuation approach. Our fair value range for BPCL is revised downward to INR318-376 from INR356-414, with the mid-point being the notional target price (INR347). The downward revision in target price to INR347 from INR385 is because of change in relative PE range (from 60-74% earlier) and EPS scenario assumption (from varying marketing margins and change in retail prices earlier to only varying crude price level now) for FY08e. We expect limited downside from the current level and accordingly upgrade BPCL to Neutral from Underweight.

Risks to valuation

Potential re-rating triggers could be:

- ▶ Crude price and refining margin movements
- ▶ Change in petro-product pricing and stock price movement
- ▶ Change in target PE for Sensex

- ▶ Higher than expected oil prices leading to higher under-recoveries
- ▶ Failure of government to compensate R&M companies for under-recoveries

Financials & valuation

Financial statements

Year to	03/2005a	03/2006e	03/2007e	03/2008e
Profit & loss summary (INRm)				
Revenue	718,674	782,156	764,794	660,433
EBITDA	32,803	16,402	27,398	30,109
Depreciation & amortisation	-8,607	-9,076	-9,859	-10,402
Operating profit/EBIT	24,196	7,326	17,539	19,707
Net interest	-1,301	-1,189	-1,728	-1,301
PBT	30,663	11,548	21,251	24,025
HSBC PBT	30,663	11,548	21,251	24,025
Taxation	-9,595	-3,652	-7,074	-7,992
Net profit	19,216	5,446	11,838	13,716
HSBC net profit	17,684	5,446	11,838	13,716

Cash flow summary (INRm)

Cash flow from operations	16,289	14,634	23,436	24,015
Capex	-20,017	-12,700	-11,706	-11,701
Cash flow from investment	-17,977	-14,459	-11,708	-11,701
Dividends	-5,095	-165	-4,076	-4,484
Change in net debt	-10,228	1,544	-10,792	-12,408
FCF equity	-11,496	-3,478	6,289	6,695

Balance sheet summary (INRm)

Intangible fixed assets	0	0	0	0
Tangible fixed assets	120,984	124,608	126,452	127,751
Current assets	143,484	150,197	159,713	149,981
Cash & others	26,475	28,131	38,424	38,832
Total assets	271,680	283,777	295,138	286,705
Operating liabilities	110,836	113,356	116,476	109,918
Gross debt	50,300	53,500	53,001	41,000
Net debt	23,825	25,369	14,577	2,168
Shareholders funds	91,047	96,325	104,076	113,173
Invested capital	127,157	133,319	131,264	128,983

Ratio, growth and per share analysis

Year to	03/2005a	03/2006e	03/2007e	03/2008e
Y-o-y % change				
Revenue	18.6	8.8	-2.2	-13.6
EBITDA	-18.5	-50.0	67.0	9.9
Operating profit	-24.8	-69.7	139.4	12.4
PBT	-21.6	-62.3	84.0	13.1
HSBC EPS	-24.3	-69.2	117.4	15.9

Ratios (%)

Revenue/IC (x)	5.9	6.0	5.8	5.1
ROIC	13.7	3.8	8.8	10.1
ROE	22.8	5.8	11.8	12.6
ROA	9.0	3.7	5.7	6.2
EBITDA margin	4.6	2.1	3.6	4.6
Operating profit margin	3.4	0.9	2.3	3.0
EBITDA/net interest (x)	25.2	13.8	15.9	23.1
Net debt/equity	26.2	26.3	14.0	1.9
Net debt/EBITDA (x)	0.7	1.5	0.5	0.1
CF from operations/net debt	68.4	57.7	160.8	1107.5

Per share data (INR)

EPS Rep (fully diluted)	53.15	15.06	32.74	37.94
HSBC EPS	48.91	15.06	32.74	37.94
DPS	12.50	0.00	10.00	11.00
NAV	251.83	266.43	287.87	313.03

Valuation data

Year to	03/2005a	03/2006e	03/2007e	03/2008e
EV/sales	0.2	0.1	0.1	0.1
EV/EBITDA	3.5	7.1	3.8	3.1
EV/IC	0.9	0.9	0.8	0.7
PE*	6.8	22.0	10.1	8.7
P/NAV	1.3	1.2	1.2	1.1
FCF yield (%)	-12.5	-3.8	7.0	7.4
Dividend yield (%)	3.8	0.0	3.0	3.3

Note: * = Based on HSBC EPS

Issuer information

Share price (INR)	331.15	Country	India
Reuters (Equity)	BPCL.BO	Bloomberg (Equity)	BPCL IN
		Bloomberg (Debt)	BPCLIN
Market cap (INRm)	99,340	Enterprise value (INRm)	115738
No of shares (m)	300	Free float (%)	33.8
Analyst	Vishwas Katela	Contact details	91 22 2268 1236

Note: price at close of 20 Jun 2006

Disclosure appendix

Stock ratings and basis for financial analysis

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This report addresses only the long-term investment opportunities of the companies referred to in the report. As and when HSBC publishes a short-term trading idea the stocks to which these relate are identified on the website. Details of these short-term investment opportunities can be found under the Reports section of this website.

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Rating definitions for long-term investment opportunities

Stock (vs Global sector universe of companies under coverage by sector team)

- ▶ Overweight (Buy)
- ▶ Neutral (Hold)
- ▶ Underweight (Sell)

HSBC assigns ratings to its stocks in this sector on the following basis:

For companies covered on a sector basis, we apply a ratings structure which ranks the stocks according to their notional target price vs current market price and then categorises (approximately) the top 40% as Overweight, the next 40% as Neutral and the last 20% as Underweight. The performance horizon is 2 years. The notional target price is defined as the mid-point of the analysts' valuation for a stock.

Prior to 15 November 2004, HSBC's ratings system was based upon a two-stage recommendation structure: a combination of the analysts' view on the stock relative to its sector and the sector call relative to the market, together giving a view on the stock relative to the market. The sector call was the responsibility of the strategy team, set in co-operation with the analysts. For other companies, HSBC showed a recommendation relative to the market. The performance horizon was 6-12 months. The target price was the level the stock should have traded at if the market accepted the analysts' view of the stock.

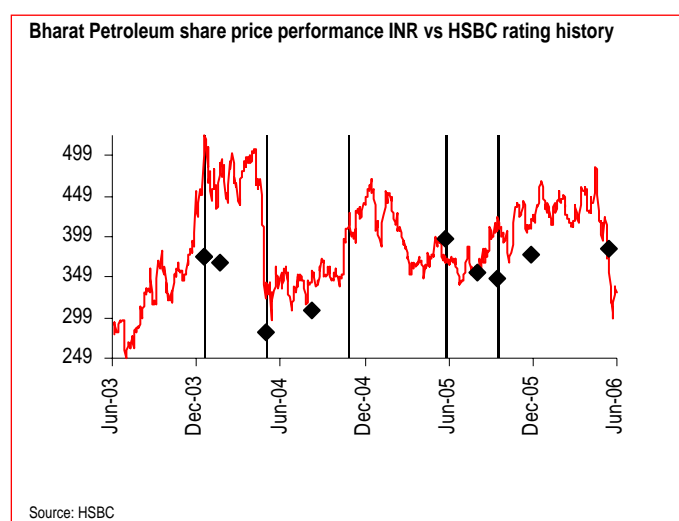
From 15 November 2004 to 7 June 2005, HSBC carried no ratings and concentrated on long-term thematic reports which identified themes and trends in industries, but did not make a conclusion as to the investment action that potential investors should take.

Rating distribution for long-term investment opportunities

As of Wednesday, June 21, 2006, the distribution of all ratings published is as follows:

Overweight/Buy	44%	(38% of these provided with Investment Banking Services)
Neutral/Hold	40%	(37% of these provided with Investment Banking Services)
Underweight/Sell	16%	(31% of these provided with Investment Banking Services)

Share price and rating changes for long-term investment opportunities



Rating & price target history		
From	To	Date
Hold	Reduce	07 January 2004
Reduce	Sell	08 January 2004
Sell	Reduce	19 May 2004
Reduce	N/R	15 November 2004
N/R	Neutral	13 June 2005
Neutral	Underweight	04 October 2005
Target price	Value	Date
Price 1	375.00	07 January 2004
Price 2	375.00	08 January 2004
Price 3	366.00	10 February 2004
Price 4	282.00	19 May 2004
Price 5	308.00	27 August 2004
Price 6	N/A	15 November 2004
Price 7	397.00	13 June 2005
Price 8	354.00	23 August 2005
Price 9	348.00	04 October 2005
Price 10	376.00	15 December 2005
Price 11	385.00	06 June 2006

Source: HSBC

Issuer & Analyst disclosures

Disclosure checklist

Company	Ticker	Recent price	Disclosure
Bharat Petroleum	BPCL.BO	331.15	3, 6, 7
Bharat Petroleum	BPCL.NS	331.15	3, 6, 7

Source: HSBC

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