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Refiners (Citi)
Asia Pacific | India

India Upstream & Downstream

Alert: Near-Term Relief as Government (Finally) Acts

- Industry Overview

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- **Significant steps at last** — The government''s move to hike diesel prices, tinker with excise duties on diesel and petrol, and cap the number of subsidized LPG cylinders per household (no changes in kero though), while much anticipated and much delayed, is a material positive (see Figure 1). The government estimates this to reduce gross under-recoveries by cRs203bn for the rest of FY13E (from cRs1.87tr), providing meaningful relief for government-owned upstream and downstream companies in the near term, albeit only to a limited extent.

- **Diesel prices/duties raised** — The gov't has announced a Rs5/l increase in the price of diesel, Rs1.5/l of which is on account of an increase in excise duty (from Rs2/l earlier). The price increase is expected to reduce under-recoveries for the rest of FY13E by cRs150bn. While the excise duty increase does not directly benefit the OMCs, it is a +ve (reduces the duty differential with petrol) and was largely unexpected (the gov't had, in fact, lowered the excise duty last year from Rs4.6/l to Rs2/l). These changes will increase the breakeven crude price of diesel from ~US$70 to ~US$80. The Rs5/l price hike (effectively Rs3.5/l for OMCs), nevertheless, pales in comparison to the ~Rs17.5/l loss that the OMCs have recently been incurring on the fuel.

- **Petrol duties cut, losses down to nil** — The gov't has reduced excise duty on petrol by Rs5.3/l from the earlier level of Rs14.35/l without changing its retail price, in effect bringing losses on the fuel down to zero (OMCs were recently losing ~Rs6/l). This will also lead to a narrowing in the absolute retail price differential between petrol and diesel from ~40% to ~30%, the increasing quantum of which has been one of the big drivers of the 'dieselization' trend being witnessed in India of late (growth rates of the fuel have recently risen to ~13-14% yoy levels vs. 8% in FY12; diesel cars reportedly now contribute ~16% of total diesel consumption in the country). The loss in govt's revenues from the petrol excise cut of Rs5.3/l will be more than offset by the diesel excise hike of Rs1.5/l given volumes of the former are ~1/5th of the latter.

- **LPG subsidy cap introduced** — The gov't has also announced a cap on the number of subsidized LPG cylinders per household at 6/yr. LPG losses on a cylinder that costs ~Rs400 are currently ~Rs350, implying that each cylinder beyond the specified usage cap would attract a cost of ~Rs750 based on current trends. This is expected to reduce LPG under-recoveries by ~1/3rd or cRs53bn for the rest of FY13E. A direct beneficiary of this could be GAIL, which supposedly bears subsidy only on LPG/kero, potentially leading to ~7-8% upside to earnings if the subsidy formula is maintained.

Positive for gov't-owned oil companies; prefer BPCL, ONGC — The govt's moves are definite near-term +ves for the OMCs as well as upstream companies (ONGC, OIL, GAIL). The companies are, however, not out of the woods yet given continued high losses, esp. on diesel (~Rs14/l) and kero (~Rs33/l), crude prices staying at elevated levels, the rupee weakness sustaining, gov't finances continuing to remain strained, and no clarity yet on the subsidy sharing formula for FY13. In this scenario, we continue with our preference for BPCL (an E&P portfolio that is difficult to replicate) and ONGC (on the cusp of delivering production growth) among the stocks.

Figure 1. Key CCPA* decisions and their impact

Change	Pre-CCPA	Post-CCPA	Impact
Diesel retail price	~Rs45/ltr	~Rs50/ltr	Will reduce under-recoveries on diesel by cRs150bn for the rest of FY13E; narrows gap between petrol and diesel prices to ~30% from ~40% earlier
- Excise duty on diesel	Rs2.0/ltr	Rs3.5/ltr	Would increase gov't revenues by ~Rs63bn for the rest of FY13E, more than offsetting revenue loss from the cut in excise duty on petrol
- OMC under-recovery on diesel	~Rs17.5/ltr	~Rs14/ltr	Effective price hike for OMCs is only Rs3.5/l (vs. losses of ~Rs17.5/l being incurred on the fuel) as the excise duty increase does not impact under-recoveries (is a pass-through)
Excise duty on petrol	Rs14.3/ltr	Rs9/ltr	Brings petrol losses down from ~Rs6/l to nil; reduces gov't revenues by ~Rs50bn; more than offset by hike in excise on diesel
No. of subsidised LPG cylinders per family	No cap	6 per year	Will reduce under-recoveries on LPG by cRs53bn for rest of FY13

Source: Citi Research, MOPNG. * Cabinet Committee on Political Affairs.

Bharat Petroleum

(BPCL.BO; Rs354.55; 1)

Valuation

Our Rs430 target price is based on the sum of: (i) 6x FY13E EV/EBITDA in a scenario of 40% upstream sharing and 45% government share, resulting in net industry under-recoveries of ~Rs76bn (5%), and (ii) value of its investments (Rs189/sh). The 6.0x multiple is in-line with regional peers. 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 (ex-investments) also equates to an FY13E P/B of ~1.6x. Our value of investments includes E&P value of Rs101/sh which reflects some of the potential reserves at blocks where BPCL has made discoveries.

Risks

The key downside risks to our investment thesis on BPCL are: (i) A sharp rise in crude prices which increases the overall losses for the OMCs; (ii) Any roll-backs of price hikes and/or duty cuts; (iii) Continued lack of clarity on compensation of under-recoveries and subsidy sharing mechanism; and (iv) Sharp rupee depreciation. If any of these risk factors has a greater downside impact than we anticipate, the share price will likely have difficulty attaining our target price.

Oil & Natural Gas

(ONGC.BO; Rs283.05; 1)

Valuation

Our target price of Rs317 is based on P/E of 10x Mar-13E, yielding Rs317. We expect the stock to continue trading in its historical median P/E band of 7x-12x, and accordingly assign it a 10x target multiple given imponderables on the subsidy front at high crude prices. We continue to value ONGC on traditional valuation parameters as against NAV/SOTP approach due to it being a going concern. Given that its existing fields face declining or mature production profiles, it would be incorrect to value the new discoveries (say KG gas) separately in a SOTP since new fields would anyway be required to compensate for the decline in mature fields. In terms of asset valuation, ONGC's current EV/boe of ~US$4 (on 2P reserves) appears lower than global peers due to limited leverage to crude prices.

Risks

The key downside risks to our investment thesis on ONGC are: 1) Adverse government policy which could increase the company's subsidy burden and impact net realizations; 2) Delays in new production coming on-stream; and 3) Risks of higher dry well write-offs as ONGC increases exploratory drilling, esp. in offshore deep-waters. If any of these risk factors has a greater downside impact than we anticipate, the share price will likely have difficulty attaining our target price.

Appendix A-1

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Bharat Petroleum (BPCL.BO)

Ratings and Target Price History
Fundamental Research

Analyst: Saurabh Handa

	Date	Rating	Target Price	Closing Price
1	20-Oct-10	*2L	*373.00	357.10
2	11-Nov-10	2L	*395.00	373.15
3	26-Jun-11	*1L	*392.00	317.20
4	7-Oct-11	Stock rating system changed		
5	7-Oct-11	*1	392.00	333.60
6	20-Dec-11	1	*370.00	251.85
7	14-Mar-12	1	*421.00	340.63
8	19-Jun-12	1	*430.00	375.55

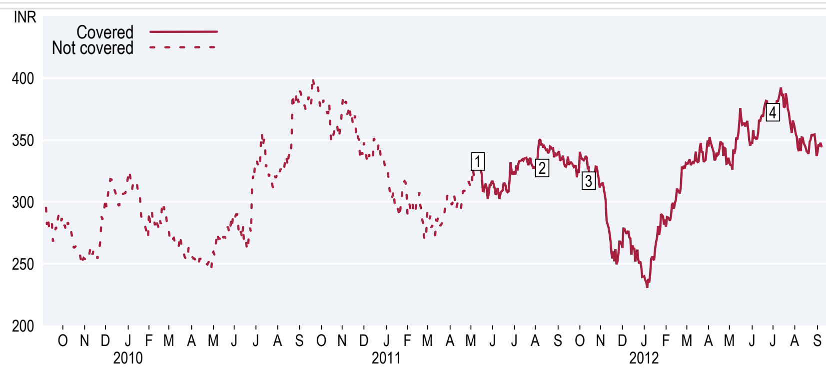
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Bharat Petroleum (BPCL.BO)

Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)

Analyst: Saurabh Handa



	Date	Rating	Target Price	Closing Price
1	11-May-11	*ADD LP	-	329.13
2	10-Aug-11	*ADD MP	-	347.03
3	14-Oct-11	*REM MP	-	327.75
4	30-Jun-12	*N	-	372.50

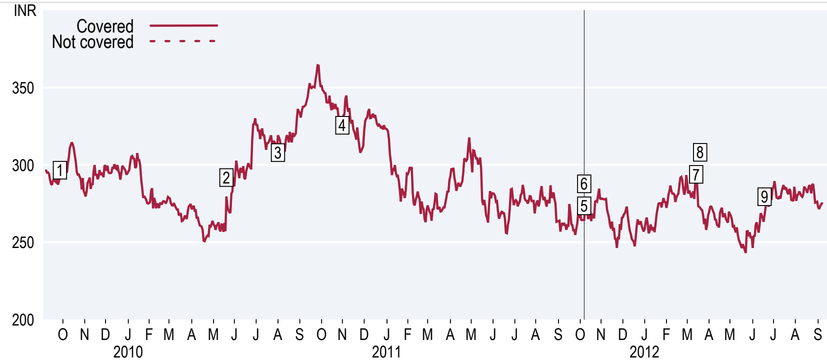
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Oil & Natural Gas (ONGC.BO)

Ratings and Target Price History
Fundamental Research

Analyst: Saurabh Handa
Covered since June 18 2010



Date	Rating	Target Price	Closing Price
1 27-Sep-09	3M	*282.50	289.33
2 20-May-10	*2L	*292.50	279.55
3 2-Aug-10	*3L	*296.25	319.13
4 1-Nov-10	*2L	*328.75	329.51
5 7-Oct-11	Stock rating system changed		
6 7-Oct-11	*1	328.75	264.45
7 14-Mar-12	1	*321.00	293.85
8 20-Mar-12	1	*313.00	272.25
9 19-Jun-12	1	*317.00	267.60

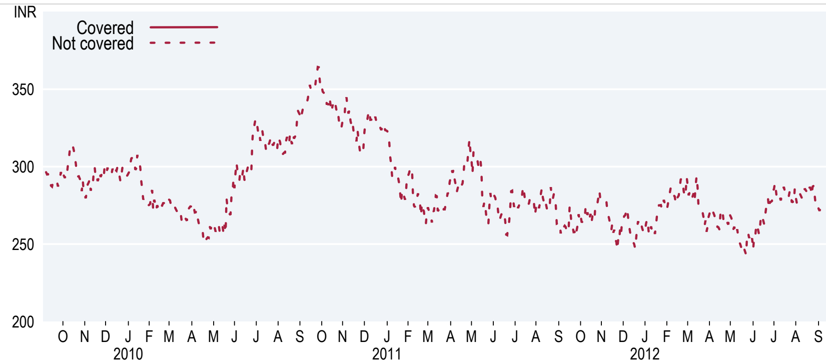
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Oil & Natural Gas (ONGC.BO)

Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)

Analyst: Saurabh Handa
Covered since June 18 2010



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