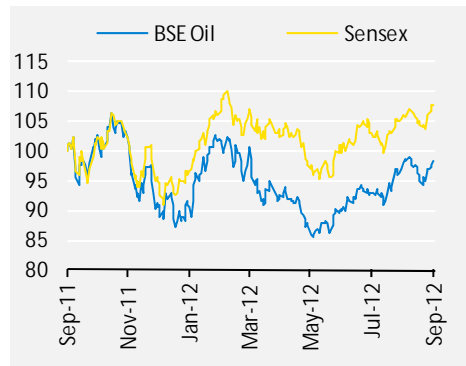


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Sensex v/s BSE Oil & Gas



Source: Bloomberg

Stock Performance

(%)	1M	6M	12M
Sensex	1.7	0.6	7.8
BSE Oil	0.0	(2.4)	(1.8)
Cairn India	3.3	(8.7)	18.4
GAIL	(1.6)	(1.3)	(11.2)
GSPL	8.4	(0.4)	(27.4)
Guj. Gas	(3.5)	(29.6)	(30.6)
IGL	(3.3)	(29.4)	(39.8)
Oil India	(0.8)	(5.1)	(8.6)
ONGC	(1.0)	(3.7)	8.6
Petronet LNG	9.4	3.3	(4.8)
Reliance Ind.	(0.1)	(2.0)	(3.3)

■ Acting on ballooning under-recoveries estimates, government has finally bit the bullet by increasing diesel prices (Rs3.5/litre), excise duty on diesel (1.5/litre), resultant increase in diesel prices being Rs5/litre (52bps hike in inflation). Government has also capped the number of subsidy LPG cylinders to 6/household per annum. Capping of LNG cylinders is the structural reform undertaken which should aid in capping LPG under recoveries in the coming years, however we remain sceptical over benefits of the same in the near term. To act on the trend of 'Dieselization' of the economy, the government has reduced excise duty on petrol by Rs5.3/litre. Increase in prices by Rs3.5/litre is likely to result in saving of Rs240bn on full year basis. Notwithstanding implementation issues, LPG capping of cylinders to ~6 per annum should reduce LPG subsidies by ~Rs113bn (assuming nil leakages in the system). Thus, the cumulative impact of the move stands at Rs355bn. For the first fortnight of September losses on diesel had mounted to Rs 17/litre and consequent under recoveries in the system had mounted to Rs2020bn. Post this action on duty tinkering and price increase effected by the government, the scenario, although improving at the margin, remains grim considering the under recovery for FY13 at current prices is Rs1,809bn, an increase of ~34% on a YoY basis.

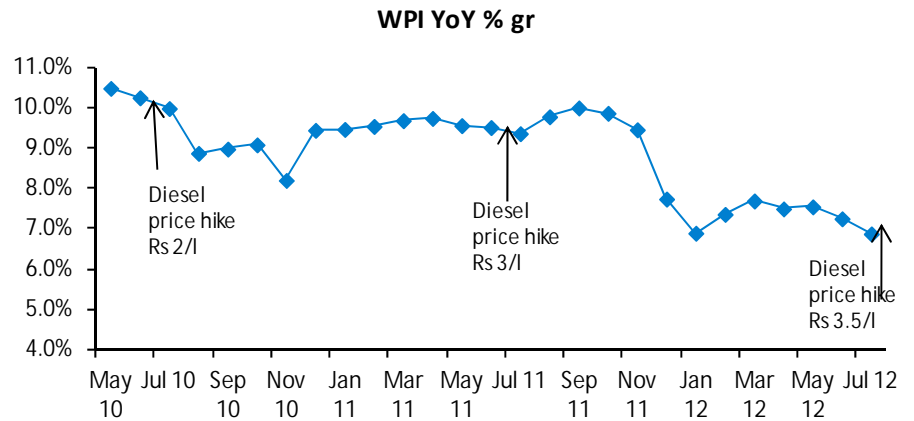
■ We would like to highlight here that every dollar increase in the crude oil prices increases the under-recoveries by ~Rs44bn (FY14). Ad-hoc increase of Rs3.5/litre in diesel prices, coupled with capping of subsidised cylinder at six per household, could result in reduction in under-recoveries by ~Rs350bn (negated by appreciation of ~US\$8/bbls in crude oil prices). Thus, there might be a scope of disappointment if the crude oil prices were to remain strong in Rupee terms in the absence of meaningful reforms. We maintain that the subsidy sharing mechanism is the key event to watch going ahead. While on the prima-facie GAIL stands to benefit on account of lower LPG under-recoveries, however we expect government to retain large part of benefit by change in subsidy sharing mechanism.

■ We continue to maintain our estimates and Target price for ONGC (Rs301/share), OINL (Rs508/share) and GAIL (Rs355/share) respectively pending clarity over the subsidy sharing mechanism.

Exhibit 1: Valuation and Recommendation

Company	Reco	CMP (Rs)	TP (Rs)	Upside (%)	P/E (x)		P/BV(x)		EV/EBITDA (x)	
					FY13	FY14	FY13	FY14	FY13	FY14
GAIL	Reduce	370	345	(6.5)	12.7	11.7	2.1	1.9	9.3	8.4
ONGC	Accumulate	283	301	6.5	10.4	8.5	1.7	1.5	4.2	3.5
Cairn India	Accumulate	341	403	18.3	6.6	7.0	1.2	1.0	4.3	3.6
Oil India	Accumulate	481	518	7.6	8.4	7.8	1.4	1.3	2.9	2.5

Source: Company Data, PL Research

Exhibit 2: Diesel price Hike and inflation


Source: Company Data, PL Research

Exhibit 3: LPG subsidy savings

No. of cylinder usage per annum	<=4	5	6	8	10	12	14	>=15
% of customers	20%	9%	12%	21%	20%	12%	5%	2%
LPG consumption as % of total LPG demand	5%	6%	9%	23%	26%	19%	8%	3%
LPG cylinders usage over 6 per annum	-	-	-	2.0	4.0	6.0	8.0	9.0
Savings (%)	-	-	-	6%	10%	10%	5%	2%
Cumulative LPG subsidy saving	0%	0%	0%	6%	16%	26%	30%	33%

Source: Company Data, PL Research, UID report

Exhibit 4: Effective Saving on LPG cylinder capping

Cap on number of cylinders	6.0	6.0	6.0	6.0
Total under-recoveries on LPG	35,000	35,000	35,000	35,000
Savings on account of cap on LPG subsidised	33%	33%	33%	33%
Less: Likely leakage in the system	0%	5%	10%	15%
Effective savings	33%	28%	23%	18%
Subsidy saved	11,375	9,625	7,875	6,125

Source: Company Data, PL Research, UID report

Crude no more an only factor to watch in case of OMCs

While crude oil prices continue to be the biggest variable impacting the overall subsidy estimates for a fiscal, the profitability of the downstream Oil marketing companies is no merely a factor of increasing or decreasing crude oil prices. We believe, government has been milking OMCs via alternative methods to lower its subsidy share and as well as to prevent passing of higher crude and product prices to end users. Following alternative mechanism has in fact led to decline in profitability to the tune of Rs80bn on consolidated basis for three OMCs combined over the last 3-4 years and has led to continuous de-rating in the OMCs stocks. We believe, building an investment case for OMCs will be a challenging task for the investors and OMCs at best continues to be a trading bet for the portfolio hedging in event of global economic slowdown. While the increase or decrease in crude oil as well as product prices does provide a favourable/adverse swing on count of these variables, we believe till a structural solution is evolved, building an investment case in OMCs will continue to lack.

(a) Effective domestic protection to the refineries: There has been a constant decline in the effective protection to domestic refineries as the government has been cutting down the import duties on the petroleum products, which in turn adversely impacts the GRMs of OMCs, in turn adversely impacting the profitability. Effective protection to refineries has been reducing from 10% in FY2004 to 2.5% in FY2013E.

(b) Interest burden on the short term loans: One of the noticeable phenomenon's for the OMCs is the mismatch between the announcement of the subsidy burden and actual disbursal of the same. Increasing under-recoveries leads to cash drain, which in turn leads to higher borrowing by these companies. To put the recent example in perspective, OMCs lost around Rs 48bn in FY12 on account of interest payout due to mismatch between the announcement and disbursal of the cash support to OMCs.

(c) Lack of revision in marketing margins and costs embedded in subsidy calculation: Marketing margins and costs involved in subsidy calculation of the regulated products were fixed in 2004 and the same has not been reviewed over the period. Comprehensive marketing margin revision of LPG / kerosene and diesel has not been carried out for the last nine and five years respectively. In the interim, the cost increase has significantly outpaced volume growth, while the ad hoc margin adjustments significantly lag the actual cost increase in our view.

Under APM (Administered Pricing Mechanism) that was in vogue officially till FY02, marketing margin for regulated products – LPG, kerosene, diesel and petrol (the last one now deregulated) – was fixed on the basis of a periodic comprehensive review of cost base (normally once in three years). Some ad hoc periodic increase was permitted till the subsequent review. While a comprehensive review for petrol (now deregulated) and diesel was carried out and margins revised in FY06 (and due for another revision now), a similar exercise for LPG / kerosene has not been carried out for the last nine years.

(d) Categorization of petrol as deregulated petroleum product: In June 2010 government deregulated the prices of petrol, wherein OMCs were allowed to increase the prices in event of increased subsidy on the same. However, we are still witnessing clutches of regulation in terms of pricing from the government. Three OMCs combined lost around Rs48.9bn in FY2012 itself on account of lack of pricing freedom. Recognizing the fact that categorization of the petrol as deregulated petroleum product leads to OMCs effectively shouldering subsidy burden on the same, there has been a voices raised by BPCL,HPCL and IOCL to treat Petrol as regulated product.

Exhibit 5: Total Under-recovery- Crude & Exchange rate (FY13)

		Brent Oil Prices (For Balance Period)				
		95.0	100.0	105.0	110.0	115.0
Exchange Rate	51.0	999,458	1,097,406	1,195,355	1,293,302	1,391,251
	52.0	1,044,939	1,144,808	1,244,677	1,344,545	1,444,414
	53.0	1,090,420	1,192,210	1,293,999	1,395,788	1,497,577
	54.0	1,135,902	1,239,612	1,343,321	1,447,031	1,550,741
	55.0	1,181,383	1,287,013	1,392,643	1,498,274	1,603,904
	56.0	1,226,864	1,334,415	1,441,966	1,549,517	1,657,068

Source: Bloomberg, PL Research

Exhibit 7: Diesel Under-recovery- Crude & Exchange rate (FY13)

		Brent Oil Prices (For Balance Period)				
		95.0	100.0	105.0	110.0	115.0
Exchange Rate	51.0	552,392	624,252	696,111	767,971	839,830
	52.0	583,296	656,564	729,833	803,101	876,370
	53.0	614,200	688,877	763,554	838,232	912,909
	54.0	645,103	721,190	797,276	873,362	949,449
	55.0	676,007	753,502	830,997	908,493	985,988
	56.0	706,910	785,815	864,719	943,624	1,022,528

Source: Bloomberg, PL Research

Exhibit 9: SKO Under-recovery- Crude & Exchange rate (FY13)

		Brent Oil Prices (For Balance Period)				
		95.0	100.0	105.0	110.0	115.0
Exchange Rate	51.0	254,535	262,239	269,943	277,646	285,350
	52.0	257,861	265,715	273,570	281,425	289,279
	53.0	261,186	269,192	277,197	285,203	293,209
	54.0	264,511	272,668	280,825	288,982	297,138
	55.0	267,836	276,144	284,452	292,760	301,068
	56.0	271,162	279,621	288,079	296,538	304,997

Source: Bloomberg, PL Research

Exhibit 11: LPG Under-recovery- Crude & Exchange rate (FY13)

		Brent Oil Prices (For Balance Period)				
		95.0	100.0	105.0	110.0	115.0
Exchange Rate	51.0	224,335	224,335	224,335	224,335	224,335
	52.0	228,121	228,121	228,121	228,121	228,121
	53.0	231,908	231,908	231,908	231,908	231,908
	54.0	235,694	235,694	235,694	235,694	235,694
	55.0	239,480	239,480	239,480	239,480	239,480
	56.0	243,266	243,266	243,266	243,266	243,266

Source: Bloomberg, PL Research

Exhibit 6: Total Under-recovery- Crude & Exchange rate (FY14)

		Brent Oil Prices				
		95.0	100.0	105.0	110.0	115.0
Exchange Rate	49.0	383,638	589,386	795,134	1,000,883	1,206,631
	50.0	469,459	679,406	889,353	1,099,300	1,309,248
	51.0	555,280	769,426	983,573	1,197,718	1,411,865
	52.0	641,101	859,446	1,077,791	1,296,136	1,514,482
	53.0	726,922	949,466	1,172,010	1,394,554	1,617,098
	54.0	812,743	1,039,486	1,266,229	1,492,972	1,719,715

Source: Bloomberg, PL Research

Exhibit 8: Diesel Under-recovery- Crude & Exchange rate (FY14)

		Brent Oil Prices				
		95.0	100.0	105.0	110.0	115.0
Exchange Rate	49.0	110,042	240,743	371,443	502,144	632,844
	50.0	168,545	301,912	435,281	568,648	702,016
	51.0	227,047	363,083	499,118	635,153	771,189
	52.0	285,550	424,253	562,955	701,658	840,361
	53.0	344,053	485,423	626,793	768,163	909,533
	54.0	402,556	546,594	690,631	834,668	978,705

Source: Bloomberg, PL Research

Exhibit 10: SKO Under-recovery- Crude & Exchange rate (FY14)

		Brent Oil Prices				
		95.0	100.0	105.0	110.0	115.0
Exchange Rate	49.0	200,347	213,374	226,401	239,428	252,455
	50.0	206,200	219,493	232,785	246,078	259,370
	51.0	212,052	225,611	239,169	252,728	266,286
	52.0	217,905	231,729	245,554	259,378	273,202
	53.0	223,757	237,848	251,938	266,028	280,118
	54.0	229,610	243,966	258,322	272,678	287,034

Source: Bloomberg, PL Research

Exhibit 12: LPG Under-recovery- Crude & Exchange rate (FY14)

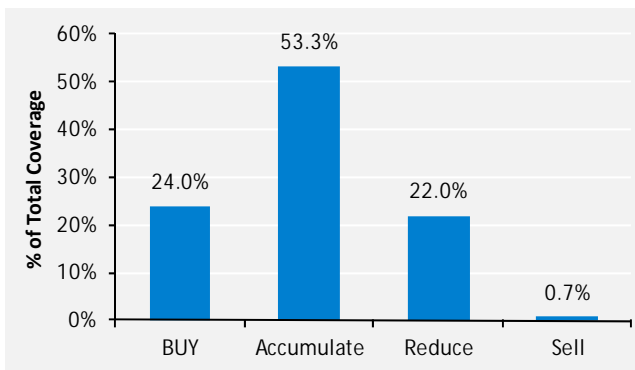
		Brent Oil Prices				
		95.0	100.0	105.0	110.0	115.0
Exchange Rate	49.0	179,383	208,903	238,422	267,941	297,460
	50.0	187,111	217,233	247,355	277,476	307,598
	51.0	194,840	225,563	256,287	287,011	317,735
	52.0	202,568	233,894	265,220	296,547	327,873
	53.0	210,296	242,224	274,153	306,082	338,011
	54.0	218,024	250,555	283,086	315,617	348,149

Source: Bloomberg, PL Research



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