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Indian Downstream

Equity

Examining Earnings Potential of the OMCs

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- **Deducing normalized earnings** — We check the robustness of our earnings models for the OMCs by deducing clean, normalized earnings in an environment of nil net under-recoveries (if the EGoM decides that OMCs should bear no marketing losses, through price hikes/deregulation/upstream and gov't sharing). The results provide a fair degree of comfort to our numbers. HPCL benefits most in case of deregulation, though we continue to prefer BPCL, given better risk-reward and higher E&P potential.

- **Inherent earnings potential of OMCs** — BPCL reported a Rs43 EPS in FY10, which when adjusted for forex, inventory gains, diminution in value of investments, etc. yields a clean EPS of Rs38. In a normalized scenario, were the OMCs not to bear any net under-recoveries (as opposed to a combined total of Rs56bn borne in FY10), BPCL's normalized EPS would have been Rs60. The difference between our estimate of Rs66 is largely explained by weaker-than-expected refining in FY10 (US$3.0 GRM vs. our estimate of US$3.4). Similar analysis yields a normalized EPS of Rs53 (Rs38 reported) for HPCL and Rs40 (Rs43 reported) for IOC.

- **HPCL cheaper on normalized P/E, but BPCL offers better risk-reward** — Stripping out the value of non-income-earning investments, BPCL and HPCL are evenly valued at ~12x on trailing clean earnings. However, on normalized earnings, HPCL trades at 6.7x vs. 7.7x for BPCL, translating into higher upside in the case of deregulation, though a concurrent higher subsidy burden could also mean more earnings downside. In other words, if crude stays at ~US$70-75 (in line with FY10), HPCL could offer the highest earnings upside as the probability of Kirit Parikh recos (at least to the extent of OMCs bearing nil losses) being implemented increases. However, if crude heads back to ~US$80 and beyond, it could impact on the govt's willingness for reforms (esp. if it is considering price deregulation only within a band), negatively impacting HPCL more and making BPCL a relative pick in such a scenario. If this is also led by improving macro, better refining benefits BPCL more, with its more balanced refining/mktg mix/ commencement of Bina in FY11E. BPCL's greater exposure to E&P is an added advantage.

- **Other beneficiaries of a +ve outcome at the EGoM** — As highlighted in our note titled, "*Indian Downstream – EGoM Meeting on June 7: What to Expect?*" dated 31 May, full compensation for OMCs could lead to BPCL and HPCL trending towards our respective TPs of Rs713 and Rs493, equating to upsides of ~30% and ~40%. Complete removal of GAIL from subsidy sharing could lead to upside of ~Rs80/sh (~15%) to our TP of Rs535 and ~25% to our FY11E EPS of Rs34. Implementing crude-linked tax slabs for ONGC and OIL could result in ~30% and ~35% upside to earnings, respectively, at US$80 crude (~12% and ~20% at US$70 crude).

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

Examining Earnings Potential of the OMCs

Figure 1. OMCs' Reported, Clean, and Normalized Earnings

		BPCL	HPCL	IOC
Reported PAT	Rs bn	15.4	13.0	102.2
Reported EPS	Rs/share	43	38	43
Forex gains, inventory gains, diminution in value of invts.	Rs bn	(2.7)	(4.0)	(43.4)
Clean PAT	Rs bn	13.7	10.2	73.9
Clean EPS (adj. for exceptionals)	Rs/share	38	30	31
Normalized PAT (assuming nil net under-recoveries)	Rs bn	21.7	18.0	95.4
Normalized EPS (assuming nil net under-recoveries)	Rs/share	60	53	40
Price	Rs/share	550	354	347
Non-income earning invts.	Rs/share	90	-	30
Clean P/E	x	12.1	11.8	10.2
Normalized P/E	x	7.7	6.7	7.9

Source: Citi Investment Research and Analysis

Figure 2. Valuation Summary

			Mkt cap	Share price	Target	P/E (x)		EV/EBITDA (x)		P/BV (x)	
Company	RIC Code	Rating	(US$m)	31-May-10	price	FY11E	FY12E	FY11E	FY12E	FY11E	FY12E
ONGC	ONGC.BO	2L	56,095	1,198	1,170	10.8	10.6	4.5	4.2	2.2	1.9
Oil India	OILI.BO	2L	6,727	1,278	1,290	10.3	10.1	4.3	4.2	2.0	1.8
GAIL	GAIL.BO	1L	13,069	471	535	16.6	13.8	9.7	8.9	3.1	2.7
HPCL	HPCL.BO	1H	2,628	355	493	5.3	5.2	6.0	6.1	0.9	0.8
BPCL	BPCL.BO	1H	4,354	550	713	8.3	8.0	7.3	7.2	1.3	1.2
Indian Oil	IOC.BO	2H	18,395	346	355	8.8	8.5	6.7	6.6	1.5	1.3

Source: Citi Investment Research and Analysis estimates

Figure 3. BPCL – Valuation

	Unit		Comments
FY10E EBITDA (if Rs150bn of net under-recoveries)	Rs m	30,255	At 6.0x EV/EBITDA
FY10E EBITDA (actual; zero net under-recoveries)	Rs m	56,292	At 3.0x EV/EBITDA
EV	Rs m	259,642	
FY09 Net debt (net of oil bonds)	Rs m	52,636	
Equity value	Rs m	207,007	
No. of shares	m	362	
Value per share – (1)	Rs/share	573	
Investments – (2)	Rs/share	141	
Petronet LNG		14	At 25% discount to CMP
IGL		10	At 25% discount to CMP
BORL		38	At 1x P/B
NRL		40	At 1x P/B
Treasury stock		38	At 25% discount to CMP
Target price – (1) + (2)	**Rs/share**	**713**	

Source: Citi Investment Research and Analysis

Figure 4. HPCL – Valuation

	Unit		Comments
FY10E EBITDA (if Rs150bn of net under-recoveries)	Rs m	24,716	At 6.0x EV/EBITDA
FY10E EBITDA (actual; zero net under-recoveries)	Rs m	55,991	At 3.0x EV/EBITDA
EV	Rs m	242,122	
FY09 Net debt (net of oil bonds)	Rs m	94,485	
Equity value	Rs m	147,637	
No. of shares	m	339	
Value per share – (1)	Rs/share	436	
Investments – (2)	Rs/share	57	
MRPL		57	At 25% discount to CMP
Target price – (1) + (2)	**Rs/share**	**493**	

Source: Citi Investment Research and Analysis

Figure 5. IOC – Valuation

	Unit		Comments
FY10E EBITDA (if Rs150bn of net under-recoveries)	Rs m	94,991	At 6.0x EV/EBITDA
FY10E EBITDA (actual; zero net under-recoveries)	Rs m	187,680	At 3.0x EV/EBITDA
EV	Rs m	848,013	
FY09 Net debt (net of oil bonds)	Rs m	272,073	
Equity value	Rs m	575,940	
No. of shares	m	2,384	
Value per share – (1)	Rs/share	242	
Investments – (2)	Rs/share	113	
ONGC		59	At CMP
GAIL		3	At CMP
PLNG		2	At CMP
CPCL		5	At 1x P/B
Panipat naphtha cracker project		38	
Treasury stock		6	
Target price – (1) + (2)	**Rs/share**	**355**	

Source: Citi Investment Research and Analysis

Bharat Petroleum

(BPCL.BO; Rs550.05; 1H)

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

(HPCL.BO; Rs354.50; 1H)

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

(IOC.BO; Rs346.05; 2H)

Valuation

Our target price for IOC of Rs354.5 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 (Rs113/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

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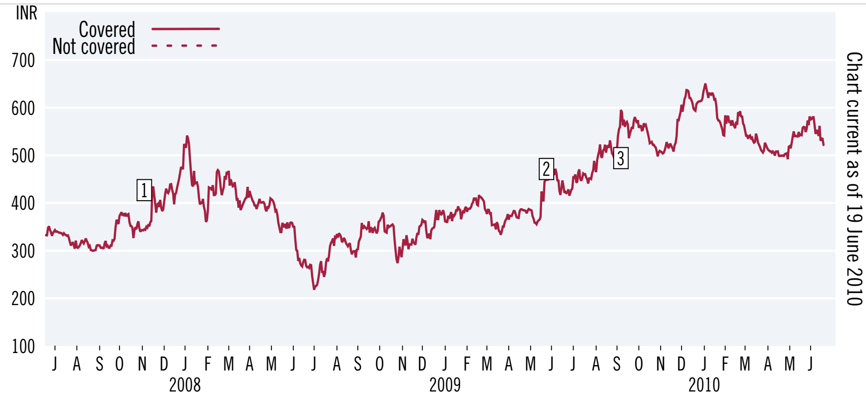
Ratings and Target Price History
Fundamental Research
Analyst: Saurabh Handa



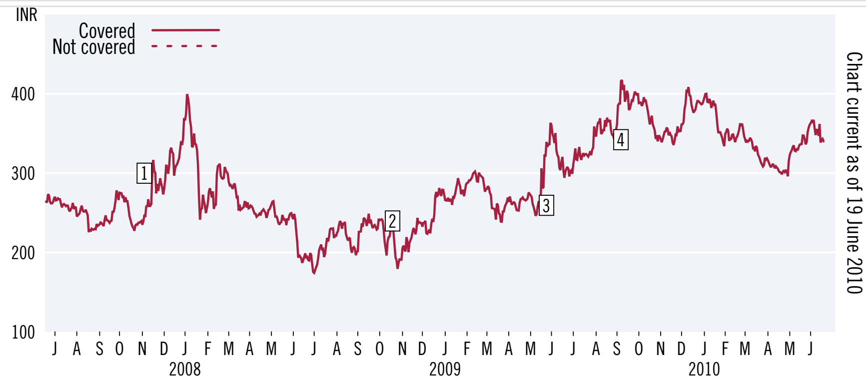
	Date	Rating	Target Price	Closing Price
1	4-Nov-07	3M	*303.00	342.60
2	24-May-09	3M	*365.00	447.50
3	6-Sep-09	*1H	*713.00	559.55

* 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	5-Nov-07	3M	*184.00	246.30
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

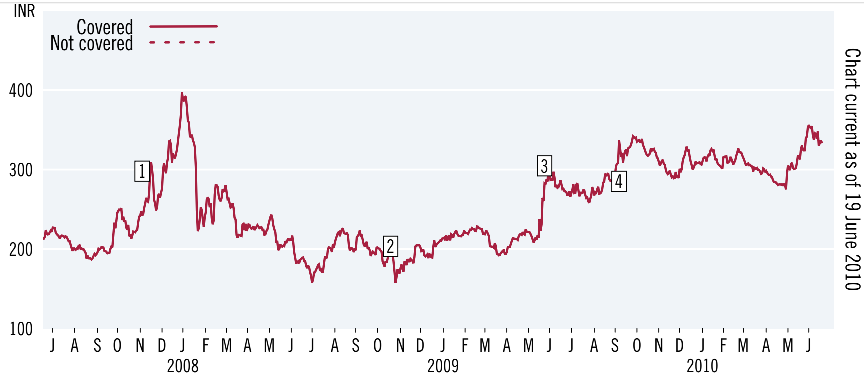
* Indicates change

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	5-Nov-07	3M	*247.00	242.25
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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