Mangalore Refinery & Petrochemicals Ltd (MRPL)

Mangalore Refinery & Petrochemicals Ltd (MRPL), in which ONGC holds 71.62% stake, operates a 11.82 MMTPA refinery in Mangalore on the west coast of India. The company produces the whole range of refined products which it supplies to both the domestic and export markets. The company aims to expand the refinery capacity to 15 MMTPA by end-FY12. The expansion will also witness the refinery complexity rising from 5.5 to 9. The higher complexity gives the refinery a higher secondary conversion capacity which will be helpful for maximizing GRM. The expanded refinery will also consist of a 2.2 MMTPA PFCCU which will mark the entry of the company into the petrochemical space. The company is also setting up Single Point Mooring (SPM) system which will reduce crude transportation costs and would contribute to higher GRM.

Investment Argument

The refining industry has bounced back strongly from the lows it hit during Q3FY10 when refining margins had entered into negative territory. Currently, Singapore simple GRMs are quoting at ~$ 6/bbl which is representative of mid-cycle levels. The jump in refining margins is largely due to very strong diesel cracks which have of late crossed $ 18/bbl. MRPL is poised to take advantage of this trend as diesel accounts for ~40% of the product slate. Excellent product slate of the expanded refinery, due to reduction in fuel oil and introduction of polypropylene, is expected to result in GRM jumping by ~$ 4/bbl during FY12-13. The company is also incurring capex towards construction of SPM which is expected to result in lower transportation costs and corresponding increase in GRM.

We expect MRPL to report GRM of $ 6.6/bbl in FY12. Post expansion in FY13, we expect the company to report GRM of $ 10.4/bbl as a result of the improved product slate. This expansion in GRM is expected to result in EBITDA doubling from ₹21,965.6 mn in FY10 to ₹41,974.6 mn in FY13. We forecast sales & net profit CAGR of 8.7% and 15.1% during FY10-13.

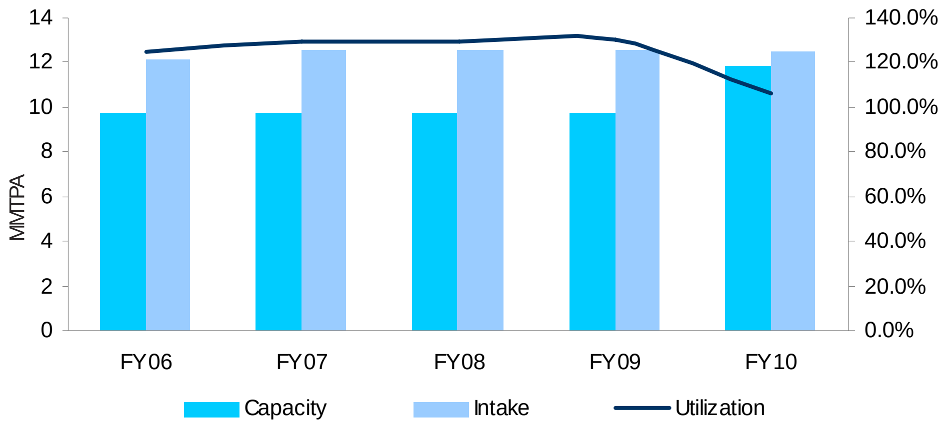
Valuation

We value MRPL using EV/EBITDA multiple of 6.25x and arrive at our FY12E price target of ₹91 per share and initiate coverage with a BUY rating. Triggers for the stock are updates regarding the progress of its refinery. The expansion project has achieved physical progress of 72.9% as of Jan 2011.

About the company

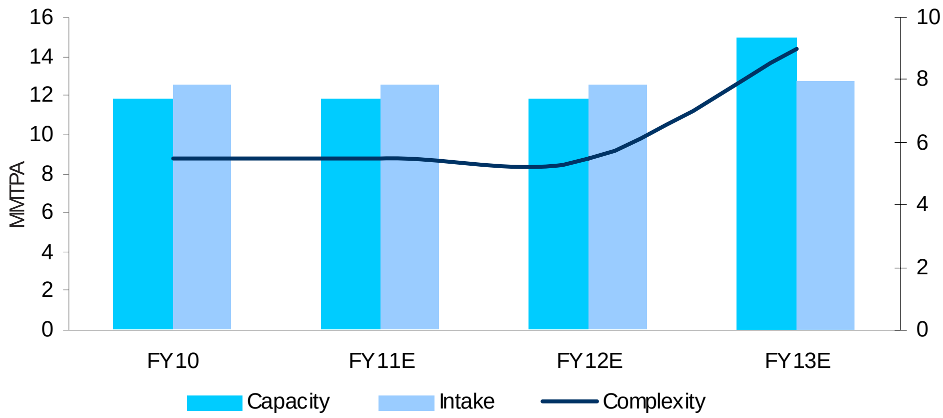
MRPL is a state-of-the-art grassroot refinery located in Mangalore and is a 71.62% subsidiary of ONGC. The refinery has Nelson complexity index of 5.5 with high flexibility to process crudes of various API and operates with a high degree of automation. MRPL has upgraded its refinery capacity to 11.82 MMTPA in FY10 and is the only refinery in India to have 2 hydrocrackers producing Premium Diesel (High Cetane). It is also the only Refinery in India to have 2 CCRs producing Unleaded Petrol (High Octane). The company earns ~65% of its revenues from the domestic market. The company is expanding its refinery capacity to 15 MMTPA by end-FY12. It is also setting up a 2.2 MMTPA PFCCU and SPM which are targeted to be commissioned by Apr-May 2012.

Historical Performance



Source: Company , LKP Research

Expected Performance



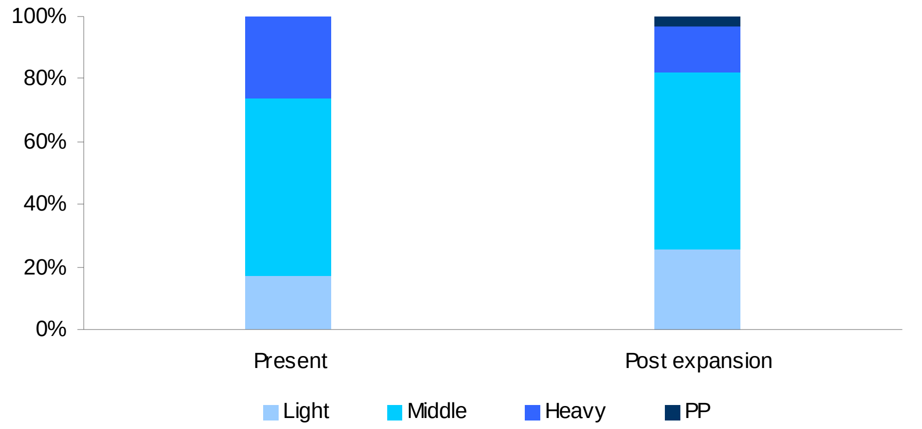
Source: Company , LKP Research

Investment Argument
Excellent product mix to improve blended realization

The capacity expansion will see the product composition of light, medium and heavy distillates witness a major change. While the proportion of light and middle distillates would increase, composition of heavy distillates will witness a major transformation. Fuel oil will be subjected to further processing in order to produce bitumen and to introduce pet coke into the product portfolio. Higher proportion of lighter products and lower proportion of heavy products will be beneficial for blended realization.

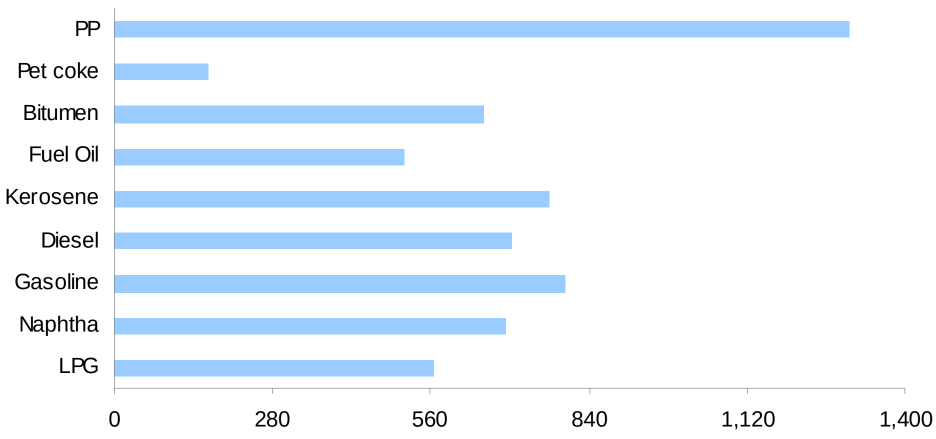
The capacity expansion programme also envisages the construction of 2.2 MMTPA PFCCU which is expected to produce 440,000 tpa of polypropylene (PP). PP belongs to the family of petrochemicals and hence, the expansion marks the entry of MRPL into the petrochemical space. Realization for PP is currently ~$ 1500/ton, which is much higher than that for ordinary refined products. Hence, blended realization will get another boost from sales of PP.

Product Slate



Source: Company , LKP Research

FY13E FOB Realization ($/ton)



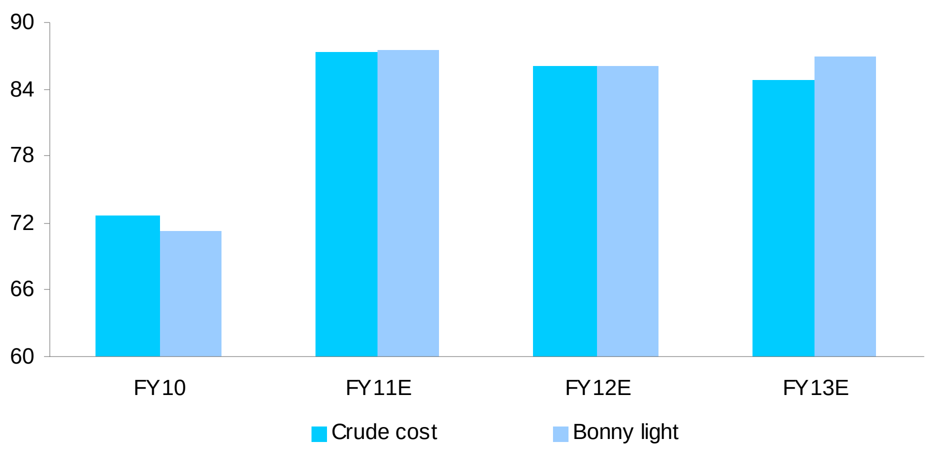
Source: Company , LKP Research

Increased use of heavier crudes to bring down crude cost

Along with capacity expansion to 15 MMTPA, the complexity of the refinery will increase to 9 from 5.5 currently. This will enable the refinery to process an increased proportion of heavy and tough crudes in its crude diet. The light-heavy spread which had shrunk to ~$ 2/bbl in Q4FY10 has since then expanded to ~$ 6/bbl which is beneficial for complex refiners. Increased use of heavy varieties of crude is estimated to result in reduction of effective crude cost by ~$ 1.3/bbl during FY12-13. We assume light sweet crude prices to average at $ 86/bbl and $ 87/bbl during FY12 & FY13 respectively.

Currently, MRPL sources ~15% of its crude intake domestically; from ONGC and Cairn India. The company sources 0.4 MMT from Cairn India currently. With the ramp up of production from Cairn India's Rajasthan field, we expect the company to source 0.6 MMT and 0.8 MMT from Cairn India in FY12 and FY13 respectively. We note that Mangala crude is attractively priced at 12.5% discount to Brent. Further, the company has to pay only FOB price, thus saving on freight and insurance costs associated with imported crude. We assume no change in quantity of crude sourced from ONGC going forward. The company has indicated that it is getting crude supply from Iran. Efforts are being made to arrive at a working solution.

Crude Intake cost ($/bbl)



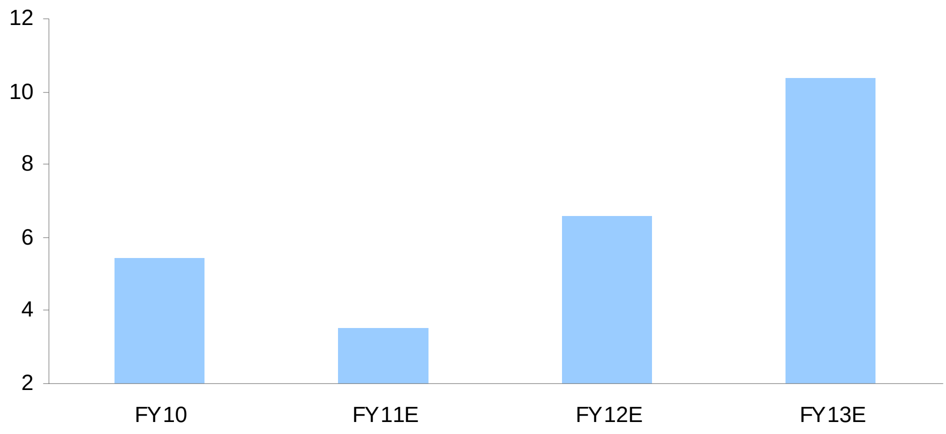
Source: Company , LKP Research

Resulting in upward spike in GRM (FY13E)

As a result of the improved product mix and increased use of heavier crudes, we forecast GRM to spike upwards to $ 10.4/bbl in FY13 from $ 6.6/bbl in FY12. GRM for FY11 would be adversely affected due to unusual heavy losses in Q1FY11 owing to exchange variation and inventory valuation. We estimate FY11 GRM at $ 3.5/bbl, with Q4FY11 GRM estimated at $ 6.8/bbl.

The jump in FY13E GRM is mainly a result of PP which commands very high realizations as compared to other refined products. Other factors contributing to the jump in GRM post expansion are increased proportion of light products and diesel and reduced production of low margin fuel oil.

GRM ($/bbl)



Source: Company , LKP Research

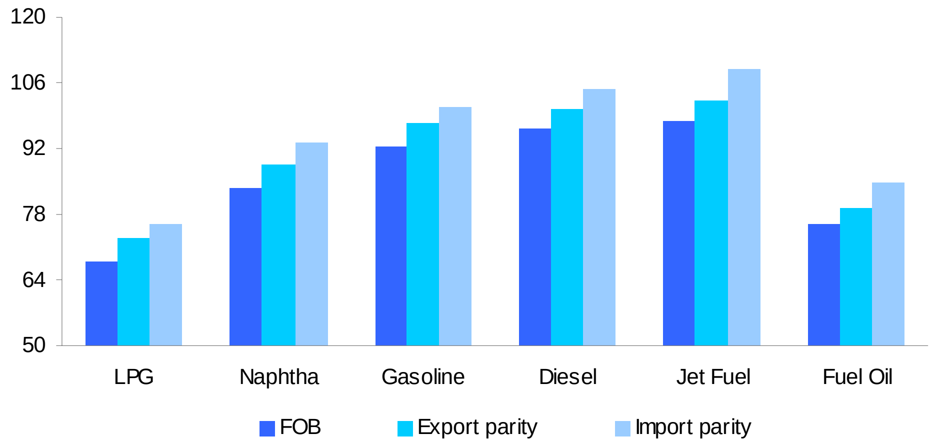
Product off-take strategy

MRPL's product marketing strategy consists of deeper penetration of the domestic market where the margins are higher than the export markets. The domestic market currently accounts for ~65% of the company's revenues. Pricing for the domestic market is done using the import parity price, which includes freight, insurance, customs duty and ocean loss. Even though export parity pricing includes customs duty drawback along with FOB price, the positive freight rate & customs duty differentials between products and crude oil results in import parity price being higher than export parity price. Sales of petrol and diesel to refineries are done at the refinery transport price, which is an 80/20 weighted average of the import and export parity prices respectively. Sales of all other products to refineries are done at import parity prices. The company also sold 808 tons of ATF and furnace oil in FY10 (FY09 sales qty: 775.4 tons) via direct marketing sales, which is the highest so far. Direct sales of bitumen for FY10 grew by 5.1% from 328.5 tons in FY09 to 345.2 tons in FY10. The company has successfully entered into the neighboring states of AP, TN, Kerala and Maharashtra for direct sales. The company is proceeding cautiously with regard to retail sales of petrol and diesel in view of regulated pricing prevalent in the country. It plans to enter into retail sales when pricing for these fuels are deregulated.

The company has entered into JV with Shell BV (Netherlands) for marketing of ATF to domestic & international airlines at Indian airports. The JV, Shell MRPL Aviation Fuels & Services Pvt. Ltd, sold 412,060 KL of ATF in FY10 and subsequently turned profitable. It fuelled 11,106 flights at the Bangalore and Hyderabad airports in FY10. The company has obtained permission from AAI for Mobile Refueling at Mangalore, Goa, Calicut etc.

The company has renewed its export contract with State Trading Corporation, Mauritius for supply of 1.1 MMTPA (+/- 10%) of petroleum products upto 31st Jul, 2013. The company effectively enjoys monopoly status in Mauritius as it supplies the entire requirement of that country. The total value of this contract at current market prices exceeds $ 2 bn.

FY12E Product prices ($/bbl)



Source: Company , LKP Research

Capex Plan and Sources of Funding

MRPL is carrying out 3 major projects currently: expansion of refinery to 15 MMTPA, polypropylene unit and SPM facility. The capex outlay for these projects is estimated to be ₹121.6 bn, ₹18 bn and ₹11.7 bn respectively. This translates into total capex of ₹151.3 bn which will be carried out during FY11-13. The capacity expansion project is progressing ahead of schedule with physical progress of 72.9% as on Jan 2011 as against the target of 71.4%. Orders for all the units like PFCC, SRU & PPU, Captive Power Plant, DHDT etc have been placed. Physical progress for the polypropylene project is 44.2% as on Jan 2011. The commitment made against the project so far stands at ₹113.8 bn. The expansion project is expected to achieve mechanical completion by Oct 2011 and is expected to be commissioned in phases by end-FY12. The polypropylene project is expected to achieve mechanical completion by Apr 2012. The company is also setting up SPM facility in Mangalore port area to receive crude in VLCC tankers. This will reduce freight costs and also enable the company to source crude from Venezuela and West Africa. The SPM facility is also proposed to be used by Indian Strategic Petroleum Reserves for setting up crude oil storage cavern of 1.5 MMT. This project is expected to be completed by May 2012.

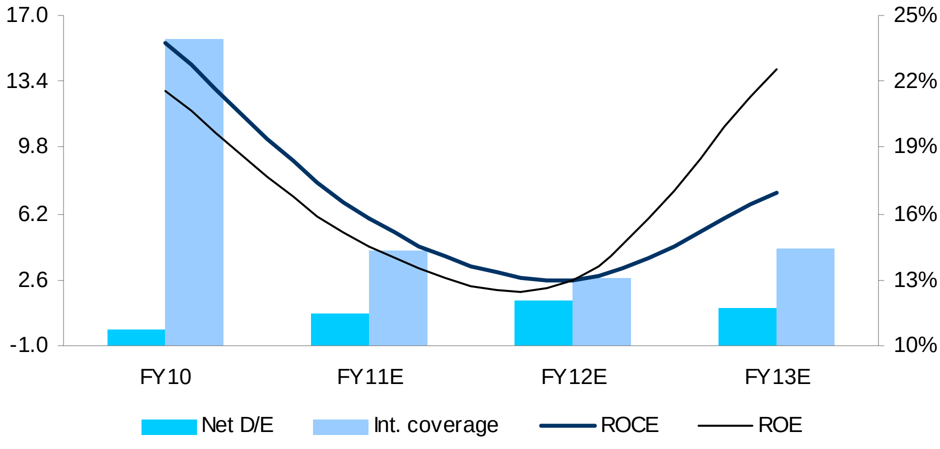
The D/E ratio for funding the expansion project would be 2:1, with the equity contribution to be met from internal accruals. ONGC has sanctioned term loan of ₹50,000 mn for the expansion project at interest rate of SBI PLR – 3.85%. OIDB has also sanctioned a medium term loan of ₹2,000 mn. The company will tie up the remaining debt requirement in due course of time.

Return ratios to improve post expansion

We forecast total debt to rise from ₹16,964 mn in FY10 to ₹53,970.7 mn in FY11 and ₹ 111,970.7 mn in FY12 & FY13 due to the capex involved for the projects being undertaken by the company. We see net debt/equity rising from (0.1) in FY10 to 0.8 and 1.5 in FY11E and FY12E before falling to 1.1 in FY13E. Interest expense is forecasted to jump from ₹1,155 mn in FY10 to ₹3,758.1 mn in FY11 and ₹7,528.1 mn in FY12 & FY13. However, interest coverage ratio looks comfortable at 4.2x, 2.7x and 4.4x for FY11E, FY12E and FY13E respectively.

We expect all the projects to be completed by Q1FY13 and we expect the same to be reflected fully in FY13 financials. Gross block is expected to jump from ₹74,351.7 mn in FY10 to ₹205,851.7 mn in FY13. We see ROCE and ROE falling from 23.7% and 21.6% in FY10 to 13% in FY12 as a result of the capex and increased interest expenses during this period of time. However, ROCE and ROE are expected to bounce to 16.9% and 22.6% in FY13 respectively.

Performance Parameters

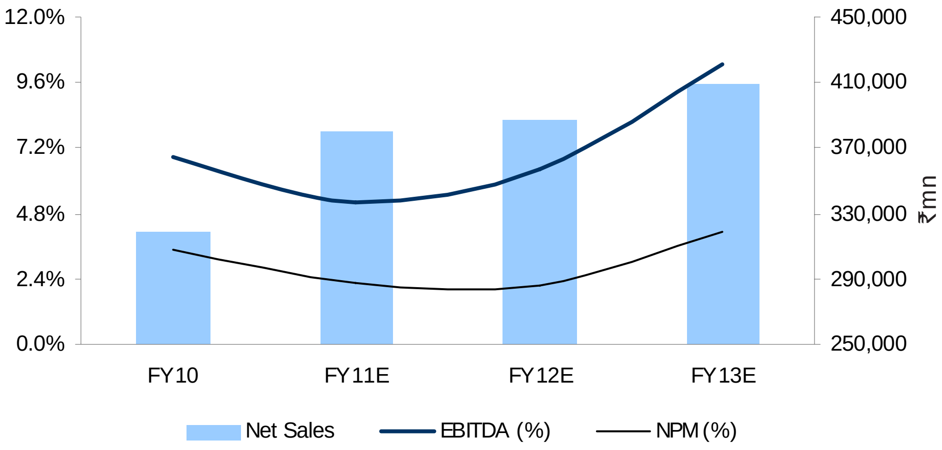


Source: Company , LKP Research

FY13E EBITDA to double from FY10 levels

We forecast net sales of ₹379,702.6 mn, ₹387,071.4 mn and ₹409,555.7 mn in FY11, FY12 and FY13 respectively. We assume 85% capacity utilization in FY13 as it is the first year of operations for the 15 MMTPA refinery. Commencement of operations from the expanded refinery is expected to result in a jump in profitability parameters owing to higher GRM. We forecast EBITDA to double from ₹21,965.6 mn in FY10 to ₹41,974.6 mn in FY13, translating into CAGR of 24.1%. Correspondingly, EBITDA margins are expected to jump from 6.9% to 10.2% during the same period. Net profit CAGR is lower at 15.1% due to the increased interest expenses associated with the expansion project. We forecast net profit of ₹8,535.9 mn, ₹8,420.4 mn and ₹16,952.5 mn in FY11, FY12 and FY13 respectively.

Financial Performance



Source: Company , LKP Research

Key Risks

- Recurrence of recession in the global or the domestic economy would depress commodity prices and would have an adverse effect on the company.
- Delays in expanding refinery capacity and/or cost overruns will adversely affect performance.
- Upward spike in interest rates will increase cost of debt.
- Volatility in commodity prices and exchange rates might result in hedging losses.

Outlook and Valuation

We estimate revenue CAGR at ~8.7%**,** EBITDA CAGR at ~24.1% and PAT CAGR at ~15.1% during FY10-FY13. GRM is expected to rise from $ 3.5/bbl in FY11 to $ 10.4/bbl in FY13E owing to increased complexity and improved product mix. Free cash flows are estimated to be ₹(59,805.6) mn in FY11 and ₹(44,914.5) mn in FY12 due to capex incurred for refinery expansion, installation of PFCCU and SPM. Free cash flow is expected to turn positive to ₹22,083.7 mn in FY13 as major portion of the capex is expected to be incurred by FY12.

We have valued MRPL using EV/EBITDA valuation and initiate coverage with a FY12E target price of ₹91, which translates to upside of 47.5%. Generally, complex refineries are valued at one year forward multiple of 7x. Since sales from the expanded refinery occur in FY13 which is 2 years away, we have adjusted the multiple of 7x for time value and use EV/EBITDA multiple of 6.25x on FY13E EBITDA to arrive at our price target. Triggers for the stock are progress reports on the status of completion of the expanded refinery.

Sensitivity Analysis

We perform a sensitivity analysis to estimate the target price at different levels of crude prices and ₹/$ exchange rate.

	$ 75/bbl	$ 80/bbl	$ 86/bbl	$ 90/bbl	$ 95/bbl
43	83.9	86.7	90	92.8	95.9
44	84.3	87.1	90.6	93.5	96.6
45	84.7	87.6	**91.1**	94.1	97.3
46	85.1	88.1	91.7	94.7	98
47	85.5	88.5	92.2	95.3	98.7

Financial Summary (MRPL)

Income statement

YE Mar (₹mn)	FY10	FY11E	FY12E	FY13E
Revenue	**318,702**	**379,703**	**387,071**	**409,556**
Raw materials	302,184	364,904	359,455	364,976
Staff expenses	959	1,637	1,719	1,805
Other Exp	402	(3,430)	2,111	2,210
Operating Profit	**15,156**	**16,591**	**23,786**	**40,565**
Operating Margin(%)	4.8%	4.4%	6.1%	9.9%
Other Income	6,809	3,227	1,086	1,410
Depreciation	3,893	3,866	4,776	9,144
EBIT	**18,072**	**15,952**	**20,096**	**32,830**
EBIT Margin(%)	5.7%	4.2%	5.2%	8.0%
Interest	1,155	3,758	7,528	7,528
PBT	**16,917**	**12,194**	**12,568**	**25,302**
PBT Margin(%)	5.3%	3.2%	3.2%	6.2%
Tax	5,795	3,658	4,147	8,350
Consolidated PAT	**11,124**	**8,536**	**8,420**	**16,952**
PAT Margins (%)	3.5%	2.2%	2.2%	4.1%

Key Ratios

YE Mar	FY10	FY11E	FY12E	FY13E
Per Share Data (₹)				
Basic EPS	6.3	4.9	4.8	9.7
Diluted EPS	5.9	4.5	4.4	8.9
CEPS	8.6	7.1	7.5	14.9
BVPS	31.9	35.3	38.7	47.0
DPS	1.2	1.2	1.2	1.2
Growth Ratios(%)				
Revenue	-16.7	19.1	1.9	5.8
EBITDA	-6.0	-9.8	25.5	68.8
PAT	-6.7	-23.3	-1.4	101.3
Cash PAT	-9.0	-17.4	6.4	97.8
Valuation Ratios (X)				
P/E	9.7	12.7	12.9	6.4
P/CEPS	7.2	8.7	8.2	4.2
P/BV	1.9	1.7	1.6	1.3
EV/Sales	(0.0)	0.1	0.3	0.2
EV/EBITDA	4.6	7.9	8.5	4.7
Turnover Ratios (Days)				
Recievable	16.9	22.0	22.0	22.0
Payable	57.0	60.0	60.0	60.0
Profitability Ratios (%)				
ROCE	23.7	15.8	13.0	16.9
ROE	21.6	14.5	13.0	22.6
Dividend payout	18.9	24.6	25.0	12.4
Dividend yield	1.9	1.9	1.9	1.9

Source: Company , LKP Research

Balance sheet

YE Mar (₹mn)	FY10	FY11E	FY12E	FY13E
SOURCES OF FUNDS				
Equity Share Capital	17,527	17,527	17,527	17,527
Reserves & Surplus	38,347	44,422	50,382	64,874
Total Networth	55,874	61,949	67,908	82,400
Total debt	16,964	53,971	111,971	111,971
Preferred Capital	92	46	46	-
Deferred tax liability	6,602	6,602	6,602	6,602
Total Liabilities	**79,532**	**122,568**	**186,527**	**200,973**
APPLICATION OF FUNDS				
Gross block	74,352	91,852	175,852	205,852
Accumulated Depreciation	41,428	45,294	50,071	59,215
Net block	32,924	46,557	125,781	146,637
Capital WIP	18,603	68,603	48,603	28,603
Investments	16,237	5,423	5,423	5,150
Current Assets				
Cash and Bank	24,500	6,250	9,347	21,668
Inventories	31,144	30,183	30,483	31,576
Sundry Debtors	16,572	22,886	23,330	24,686
Loan, Advances & others	5,850	5,850	5,850	5,850
Current Liab & Prov				
Current liabilities	63,099	59,984	59,089	59,996
Provisions	3,198	3,200	3,200	3,200
Net Current Assets	**11,769**	**1,985**	**6,721**	**20,584**
Total Assets	**79,532**	**122,568**	**186,527**	**200,973**

Cash Flow

YE Mar (₹mn)	FY10	FY11E	FY12E	FY13E
Consolidated PAT	11,124	8,536	8,420	16,952
Depreciation	3,893	3,866	4,776	9,144
Interest	1,155	3,758	7,528	7,528
Chng in working capital	(15,597)	8,466	1,639	1,541
Other operating activities	(917)	0	0	0
CF from operations (a)	**31,530**	**3,936**	**11,557**	**24,556**
Capital expenditure	14,691	67,500	64,000	10,000
Chng in investments	4,908	(10,814)	0	(273)
CF from investing (b)	**(19,599)**	**(56,686)**	**(64,000)**	**(9,727)**
Free cash flow	17,994	(59,806)	(44,915)	22,084
Equity raised/(repaid)	0	0	0	0
Inc/dec in borrowings	(2,904)	37,007	58,000	0
Dividend paid (incl. tax)	2,452	2,461	2,461	2,461
Change in preferred capital	0	(46)	0	(46)
Adj in R&S	0	0	0	0
CF from financing (c)	**(5,356)**	**34,500**	**55,539**	**(2,507)**
Net chng in cash (a+b+c)	**6,575**	**(18,250)**	**3,097**	**12,322**
Closing cash & cash equiv	**24,500**	**6,250**	**9,347**	**21,668**

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