

## Indian Oil Corporation

STOCK INFO.	BLOOMBERG
BSE Sensex: 9,871	IOC IN
	REUTERS CODE
S&P CNX: 2,983	IOC.BO

27 January 2006

**Buy**
*Previous Recommendation: Buy*
**Rs530**

Equity Shares (m)	1,168.0
52-Week Range (Rs)	570/390
1,6,12 Rel. Perf. (%)	-11/1/-34
M.Cap. (Rs b)	618.8
M.Cap. (US\$ b)	9.4

YEAR	NET SALES	PAT	EPS	EPS	P/E	P/BV	ROE	ROCE	EV/	EV/
END	(RS M)	(RS M)	(RS)	GROWTH (%)	(X)	(X)	(%)	(%)	SALES	EBITDA
03/05A	1,334,072	54,692	46.8	-27.0	11.3	2.1	20.5	18.4	0.5	7.7
03/06E	2,000,345	53,529	45.8	-2.1	11.6	1.8	16.7	18.3	0.4	7.6
03/07E	1,649,710	85,076	72.8	58.9	7.3	1.4	21.8	23.7	0.4	4.8

- IOC's reported 3QFY06 net loss of Rs58m compared with profit of Rs12.9b last year despite the Rs1.2b increase in reported profit is on account of change in inventory valuation methodology. Reported profits were disappointing, as consensus' expectation of government's one-thirds loss sharing, did not come through in the current quarter.
- Poor performance was primarily driven by fuel marketing losses, which were up 28.2% YoY at Rs47.3b. Upstream contribution of Rs17.2b and standalone (external) refinery discount of Rs1.5b cushioned the losses.
- Refining margin at US\$3.4/bbl was down in line with the global trend and after adjusting for product price discount. Crude throughput at 9.9m tons was up 11.9% YoY.
- We expect the government's share of losses to be paid in 4QFY06, thus allowing IOC to record profits for the fiscal. Stock is trading at 5.1x FY07E earnings (adjusted for investments) and 1.4x FY07E book value. Foray into petrochemicals and E & P would be the key growth drivers over the next 2-3 years. We believe negatives are already in the price and asset valuation is likely to provide downside support. We maintain **Buy**.

**QUARTERLY PERFORMANCE (STANDALONE)**

(Rs Million)

Y/E MARCH	FY05				FY06				FY05	FY06E
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4QE		
<b>Net Sales</b>	<b>359,845</b>	<b>354,846</b>	<b>398,767</b>	<b>409,303</b>	<b>386,235</b>	<b>400,452</b>	<b>442,936</b>	<b>462,901</b>	<b>1,522,760</b>	<b>1,692,524</b>
Change (%)	13.2	16.8	12.8	14.5	7.3	12.9	11.1	13.1	14.3	11.1
Raw Material Consumed	123,849	112,832	129,029	128,976	138,141	159,771	182,479	213,138	494,685	1,188,213
Staff Cost	4,047	3,876	4,412	6,506	4,355	4,335	4,368	6,840	18,841	38,739
Finished Goods Purchase	144,524	170,127	190,929	221,123	221,652	222,421	219,312	161,697	726,702	1,551,785
Other Exp (incl Stock Adj)	60,784	49,394	62,351	38,082	17,427	-919	35,169	29,150	210,611	291,438
<b>EBITDA</b>	<b>26,641</b>	<b>18,616</b>	<b>12,047</b>	<b>14,616</b>	<b>4,661</b>	<b>14,844</b>	<b>1,608</b>	<b>52,076</b>	<b>71,921</b>	<b>73,189</b>
% of Net Sales	7.4	5.2	3.0	3.6	1.2	3.7	0.4	11.2	4.7	4.3
% Change	58.6	-21.1	-67.0	-43.2	-82.5	-20.3	-86.6	256.3	-29.9	1.8
Depreciation	4,826	6,164	5,178	5,666	5,439	5,215	5,549	5,258	21,834	21,461
Interest	1,266	1,281	1,526	1,759	1,684	2,497	3,225	3,177	5,831	10,582
Other Income	1,295	4,552	6,544	2,905	2,115	6,021	5,796	2,285	15,296	16,217
<b>PBT</b>	<b>21,846</b>	<b>15,723</b>	<b>11,887</b>	<b>10,097</b>	<b>-347</b>	<b>13,153</b>	<b>-1,369</b>	<b>45,926</b>	<b>59,552</b>	<b>57,363</b>
Tax	7,124	3,328	-981	1,167	196	3,657	-1,310	9,056	10,638	11,598
Rate (%)	32.6	21.2	-8.3	11.6	-56.5	27.8	95.7	19.7	17.9	20.2
<b>PAT</b>	<b>14,722</b>	<b>12,395</b>	<b>12,868</b>	<b>8,929</b>	<b>-542</b>	<b>9,496</b>	<b>-58</b>	<b>36,870</b>	<b>48,914</b>	<b>45,765</b>
Change (%)	55.8	-31.4	-46.5	-51.7	-103.7	-23.4	-100.5	312.9	-30.2	-6.4

E: MOST Estimates

IOC's reported 3QFY06 net loss of Rs58m compared with a profit of Rs12.9b last year, despite a Rs1.2b increase in reported profit owing to a change in inventory valuation methodology. Reported profits disappointed as consensus' expectation of government's one-thirds loss sharing, did not come through in the current quarter, despite Parliament's approval.

### Fuel marketing losses continue to hurt

Fuel marketing (gross) losses were up 28.2% YoY at Rs47.3b for the quarter, owing to higher crude prices and unchanged petrol/diesel prices. However, one-thirds sharing by upstream players and product price discounts from standalone refiners cushioned the losses.

Upstream players paid Rs17.2b as their share of losses, product price discounts from standalone (external) refiners was Rs1.5b.

We expect the government's share of one-thirds losses to be paid in 4QFY06. Crude prices continue to be a critical factor and possible weakness could turn marketing margins positive.

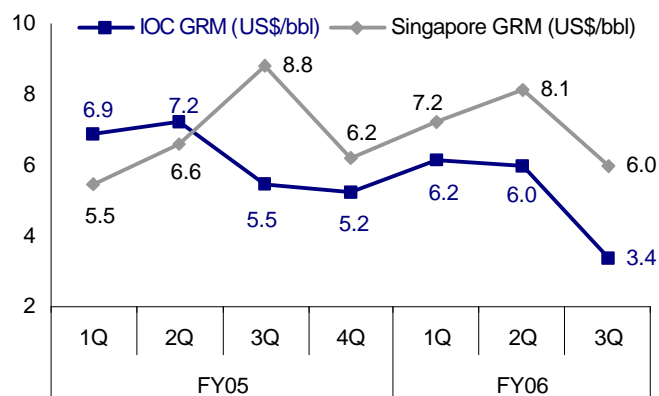
Marketing volumes at 12m tons was down marginally by 1.6% YoY.

IOC recorded an inventory loss of merely Rs50m, owing to a change in the method of valuing inventory from FIFO to moving average, which led profits to be higher by Rs1.2b.

### Refining margin stumbles

3QFY06 refining margins were down YoY at US\$3.4/bbl compared with US\$5.5/bbl last year, on account of product price discounts as well as weak international margin trend. YoY comparison with 3QFY05 would also be impacted by the tariff cuts effected over the last one year.

QUARTERLY REFINERY-WISE MARGIN TREND (US\$/BBL)



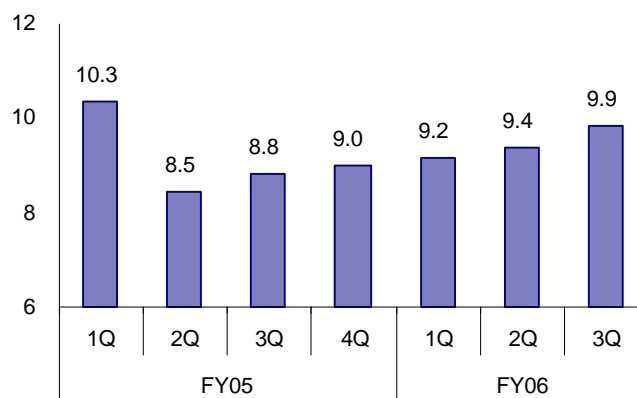
Source: Company/Motilal Oswal Securities

We believe refining margins are set to bounce back, given that the fundamentals continue to remain strong. Asian refining capacity utilization is set to remain strong due to lack of significant capacity addition in the face of growing demand.

### Refining throughput too improves

Crude throughput was up 11.9% YoY at 9.9m tons as versus 8.8m tons in 3QFY05, on account of upgradation and expansion of some of its refineries. Stabilization of the Gujarat refinery post the accident last year too would have contributed to the increase in throughput. Throughput is set to improve further as 6m tons of Panipat gets commissioned over the next few months.

QUARTERLY REFINERY THRUPTUT (M TON)



Source: Company/Motilal Oswal Securities

### **Pipelines limit earnings downside**

IOC's pipeline EBITDA was up 5.1% YoY at Rs7b, driven by higher pipeline throughput of 11.8m tons, up 14.3% YoY. Higher crude transportation (on account of refining capacity expansion) would have been the driver of higher pipeline throughput.

### **Government's loss sharing likely to come in 4QFY06**

Government announced that it would bear one-thirds the fuel marketing losses along with standalone refiners for FY06. Accordingly standalone refiners have already started providing discounts on products. However, payment has been delayed despite obtaining Parliament's approval for Rs57.5b, as the details of the instrument (oil bonds) are being worked out. Disbursal of Rs115b is expected in 4QFY06 (quantum could vary depending on actual losses in 4QFY06).

This loss sharing would enable oil marketing companies to turn profitable. We expect FY06 profits to be close to FY05 profits.

### **Petrochemical and E & P are key growth drivers**

Commissioning of PX / PTA project over the next few months and naphtha cracker over the next three years are set to drive volume and earnings growth. IOC in a joint venture (JV) with Oil India Limited (OIL) is currently in negotiations with a French E & P company for a possible acquisition. The JV has also bid for overseas blocks and the JV is being built along the lines of ONGC Videsh, with similar privileges. The E & P foray is the next big growth driver for IOC.

### **Valuation and view**

The stock is trading at 5.1x FY07E earnings (adjusted for investments) and 1.4x FY07E book value. We believe negatives are already in the price, while cheap asset valuation would provide downside support. Earnings growth would also be aided by petrochemical project implementation, while E & P foray would be a key growth driver. We maintain **Buy**.

## Indian Oil Corporation: an investment profile

### Company description

A Fortune-500 company, IOC is the largest refining and marketing company in India, with capacity and market share of 50%-54%.

### Key investment arguments

- ✍ The government has announced it would bear one-thirds the fuel marketing losses along with standalone refiners. This loss sharing would enable oil-marketing companies to turn profitable.
- ✍ Policy risk more than priced in. Valuations continue to reflect the highly pessimistic earnings expectation.

### Key investment risks

- ✍ Continued increase in crude prices, along with non-revision of retail prices of controlled products.
- ✍ Loss of market share to private players.

### Recent developments

- ✍ Parliament has approved Rs57.5b of oil bonds as part of government's loss sharing.
- ✍ Standalone refiners are sharing a part of the loss burden.

### Valuation and view

- ✍ Valuations at 5.1x FY07E EPS, adjusted for value of investments, are moderate.
- ✍ We maintain **Buy**.

### Sector view

- ✍ Refining margins are on an upswing due to improved fundamentals, globally. We expect the upcycle to continue, at least over the next 18 months.
- ✍ Proposals on retail price increase of LPG and dual pricing for kerosene could remove fuel marketing losses from the books of oil marketing companies, providing large earnings upside.

#### COMPARATIVE VALUATIONS

		IOC	BPCL	HPCL
P/E (x)	FY06E	11.6	8.2	9.3
	FY07E	7.3	6.6	5.9
P/BV (x)	FY06E	1.8	1.5	1.2
	FY07E	1.4	1.3	1.1
Div. Yield (%)	FY06E	2.8	3.3	4.9
	FY07E	4.2	5.1	6.8
EV/EBITDA (x)	FY06E	7.6	4.4	5.2
	FY07E	4.8	3.3	3.0

#### SHAREHOLDING PATTERN (%)

	DEC.05	SEP05	DEC.04
Promoters	91.3	91.3	91.3
Domestic Institutions	3.7	3.4	3.9
FII's/FDIs	1.9	2.0	1.4
Others	3.1	3.3	3.4

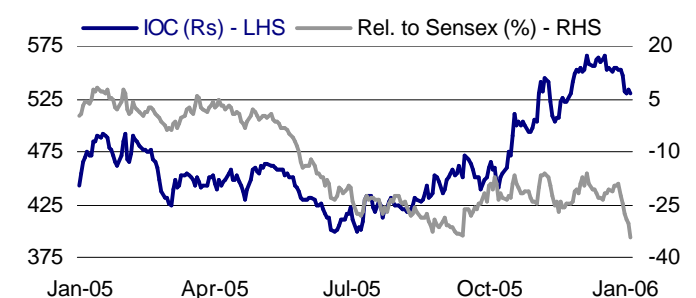
#### EPS: INQUIRE FORECAST VS CONSENSUS (RS)

	INQUIRE FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY06	45.8	40.7	12.4
FY07	72.8	52.6	38.5

#### TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
530	-	-	Buy

#### STOCK PERFORMANCE (1 YEAR)



**INCOME STATEMENT** (Rs Million)

Y/E MARCH	2005	2006E	2007E	2008E
<b>Net Sales</b>	<b>1,334,072</b>	<b>2,000,345</b>	<b>1,649,710</b>	<b>1,631,817</b>
<b>Total Income</b>	<b>1,334,072</b>	<b>2,000,345</b>	<b>1,649,710</b>	<b>1,631,817</b>
Finished Gds Purchase	572,158	828,788	568,928	527,001
Raw Materials Cons	567,197	953,549	825,513	840,786
Duties, Taxes, etc	140,227	160,640	117,134	117,134
Transportation	40,188	41,796	41,796	41,796
Employee Costs	119,494	144,452	139,661	142,264
<b>EBITDA</b>	<b>94,065</b>	<b>93,454</b>	<b>136,064</b>	<b>142,805</b>
% of Net Sales	7.1	4.7	8.2	8.8
Depreciation	25,246	24,805	25,284	25,876
Interest	7,681	11,923	4,454	3,874
Other Income	14,219	21,138	15,634	14,483
<b>PBT</b>	<b>75,357</b>	<b>77,865</b>	<b>121,959</b>	<b>127,538</b>
Tax	16,348	18,833	31,264	36,463
Rate (%)	21.7	24.2	25.6	28.6
PAT	59,009	59,032	90,695	91,075
<b>Group net profit</b>	<b>59,009</b>	<b>59,032</b>	<b>90,695</b>	<b>91,075</b>
Minority interest	-4,317	-5,503	-5,619	-5,012
<b>Net profit</b>	<b>54,692</b>	<b>53,529</b>	<b>85,076</b>	<b>86,063</b>
Change (%)	-27.0	-2.1	58.9	12

**BALANCE SHEET** (Rs Million)

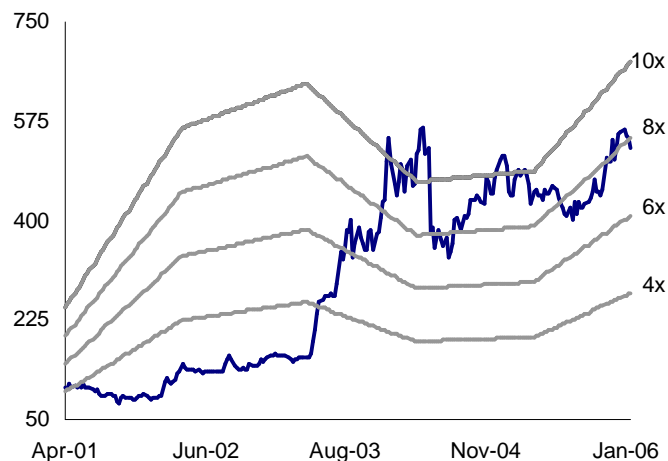
Y/E MARCH	2005	2006E	2007E	2008E
Share Capital	11,680	11,680	11,681	11,682
Reserves	282,528	336,057	421,133	507,196
<b>Net Worth</b>	<b>294,208</b>	<b>347,737</b>	<b>432,814</b>	<b>518,878</b>
Minority interest	15,935	19,875	23,952	27,608
Loans	124,937	110,514	63,562	-1,168
Deferred Tax	50,665	57,452	67,946	82,331
<b>Capital Employed</b>	<b>485,745</b>	<b>535,578</b>	<b>588,274</b>	<b>627,648</b>
Gross Fixed Assets	512,341	605,521	649,920	693,298
Less: Depreciation	188,256	212,159	236,390	261,064
<b>Net Fixed Assets</b>	<b>324,085</b>	<b>393,363</b>	<b>413,530</b>	<b>432,234</b>
Capital WIP	62,259	31,965	12,548	-9,511
Investments	49,653	71,841	10,551	124,605
Goodwill	13,667	13,299	13,594	13,933
Cash & Bank Balance	17,641	23,173	34,645	42,846
Inventory	134,325	133,913	133,150	134,169
Debtors	46,746	57,143	48,010	50,722
Loans & Advances	66,976	68,662	70,407	72,341
Other assets	627	30	31	32
Liabilities	208,509	235,427	207,582	208,702
Provisions	21,724	22,384	31,609	25,021
<b>Net Current Assets</b>	<b>36,081</b>	<b>25,110</b>	<b>47,052</b>	<b>66,387</b>
<b>Application of Funds</b>	<b>485,745</b>	<b>535,578</b>	<b>588,274</b>	<b>627,648</b>

E: MOSI Estimates; Consolidated before merger

**RATIOS**

Y/E MARCH	2005	2006E	2007E	2008E
<b>Basic (Rs)</b>				
<b>FDEPS</b>	<b>46.8</b>	<b>45.8</b>	<b>72.8</b>	<b>73.7</b>
Cash EPS	65.3	71.4	100.2	104.9
Book Value	251.9	297.7	370.5	444.2
Dividend	14.5	15.0	22.0	17.0
<b>Valuation (x)</b>				
P/E	11.3	11.6	7.3	7.2
Cash P/E	8.1	7.4	5.3	5.1
EV / EBITDA	7.7	7.6	4.8	4.0
EV / Sales	0.5	0.4	0.4	0.4
Price / Book Value	2.1	1.8	1.4	1.2
Dividend Yield (%)	2.7	2.8	4.2	3.2
<b>Profitability Ratios (%)</b>				
RoE	20.5	16.7	21.8	18.1
RoCE	18.4	18.3	23.7	23.1
<b>Leverage Ratio</b>				
Debt / Equity (x)	0.4	0.3	0.1	0.0

#Adjusted for value of investments

**PER BAND**



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**Indian Oil Corporation**

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|--|-----|
| 1. Analyst ownership of the stock            | No  |
| 2. Group/Directors ownership of the stock    | Yes |
| 3. Broking relationship with company covered | No  |

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