Company Focus

8 January 2009 | 8 pages

Hindustan Petroleum (HPCL.BO)

Sell: More Leveraged to Recovery, but Imponderables Remain

- **Downstream R&M in a different world** — Notwithstanding price cuts on auto fuels in Dec (and another likely in 1QCY09), Sing GRM of US$3/bbl and crude at ~US$50 could have a significant positive impact on profitability of R&M companies going into FY10E through: 1) higher absolute marketing EBITDA; 2) better quality of and control over earnings, which offsets 3) impact of weak refining.
- **Rs45-100bn EBITDA swing implies US$4.5-10bn EV upside** — Based on our analysis, at US$50 crude, the FY10E R&M industry EBITDA could rise by ~Rs45-100bn YoY depending on the extent of further price cuts. This is even with no oil bonds in FY10E and industry GRMs dropping to US$2.5/bbl. At 5x EV/EBITDA, this could translate to EV upside of US$4.5-10bn. Despite price cuts, blended MS and HSD margins are now ~$25-30/bbl (on last month's prices, with crude averaging US$41/bbl).
- **HPCL could benefit disproportionately** — The swing in industry EBITDA would benefit HPCL most, given its low refining/sales ratio of 0.7x vs. peers. However, we maintain our preference for IOC given uncertainty surrounding government policy on price cuts and also as the oil futures curve is in contango, suggesting the market expects crude to follow an upward trajectory.
- **Key risks** — Government policy and a sharp increase in crude prices remain the key risks to the company. However, there is some cushion if crude was to rise again; at US$50/bbl crude, blended auto fuel margin would still be ~Rs2/l.

Sell/Medium Risk	3M
Price (07 Jan 09)	Rs264.40
Target price	Rs213.00
Expected share price return	-19.4%
Expected dividend yield	3.0%
Expected total return	**-16.4%**
Market Cap	Rs89,533M US$1,848M

Price Performance (RIC: HPCL.BO, BB: HPCL IN)

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2007A	16,602	48.98	254.3	5.4	0.9	18.1	6.8
2008A	13,505	39.84	-18.7	6.6	0.8	13.4	3.9
2009E	11,769	34.72	-12.9	7.6	0.8	10.8	3.1
2010E	10,936	32.26	-7.1	8.2	0.8	9.5	3.0
2011E	9,623	28.39	-12.0	9.3	0.7	8.0	2.7

Source: Powered by dataCentral

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See Appendix A-1 for Analyst Certification and important disclosures.

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Fiscal year end 31-Mar	2007	2008	2009E	2010E	2011E
Valuation Ratios					
P/E adjusted (x)	5.4	6.6	7.6	8.2	9.3
EV/EBITDA adjusted (x)	5.3	10.4	7.2	6.4	7.4
P/BV (x)	0.9	0.8	0.8	0.8	0.7
Dividend yield (%)	6.8	3.9	3.1	3.0	2.7
Per Share Data (Rs)					
EPS adjusted	48.98	39.84	34.72	32.26	28.39
EPS reported	48.98	39.84	34.72	32.26	28.39
BVPS	283.19	311.60	329.67	347.66	363.35
DPS	18.02	10.23	8.09	8.06	7.02
Profit & Loss (RsM)					
Net sales	889,959	1,043,130	1,553,053	1,433,419	1,410,673
Operating expenses	-872,963	-1,035,882	-1,539,216	-1,422,176	-1,405,040
EBIT	**16,996**	**7,248**	**13,837**	**11,243**	**5,633**
Net interest expense	-4,230	-7,925	-15,163	-19,562	-17,705
Non-operating/exceptionals	7,736	14,136	15,380	21,531	23,680
Pre-tax profit	**20,502**	**13,460**	**14,055**	**13,212**	**11,607**
Tax	-3,960	262	-2,285	-2,276	-1,984
Extraord./Min.Int./Pref.div.	61	-217	0	0	0
Reported net income	**16,602**	**13,505**	**11,769**	**10,936**	**9,623**
Adjusted earnings	16,602	13,505	11,769	10,936	9,623
Adjusted EBITDA	24,036	15,757	23,462	21,529	16,389
Growth Rates (%)					
Sales	25.8	17.2	48.9	-7.7	-1.6
EBIT adjusted	nm	-57.4	90.9	-18.8	-49.9
EBITDA adjusted	199.8	-34.4	48.9	-8.2	-23.9
EPS adjusted	254.3	-18.7	-12.9	-7.1	-12.0
Cash Flow (RsM)					
Operating cash flow	**38,494**	**-26,292**	**57,447**	**30,247**	**29,141**
Depreciation/amortization	7,040	8,508	9,625	10,286	10,756
Net working capital	14,851	-48,306	36,053	9,025	8,762
Investing cash flow	**-71,670**	**-27,412**	**-152,343**	**-53,498**	**-27,488**
Capital expenditure	-40,671	-30,316	-5,000	-10,000	-10,000
Acquisitions/disposals	-30,998	2,904	-147,343	-43,498	-17,488
Financing cash flow	**36,342**	**59,513**	**95,105**	**25,845**	**1,058**
Borrowings	38,537	62,692	97,484	28,213	3,039
Dividends paid	-7,086	-3,817	-3,017	-3,005	-2,619
Change in cash	**3,166**	**5,809**	**209**	**2,595**	**2,711**
Balance Sheet (RsM)					
Total assets	**316,566**	**413,796**	**581,787**	**613,669**	**628,696**
Cash & cash equivalent	868	2,940	1,885	2,000	2,000
Accounts receivable	15,778	17,107	25,416	23,643	23,379
Net fixed assets	130,644	152,452	147,828	147,541	146,785
Total liabilities	**220,579**	**308,164**	**470,029**	**495,811**	**505,520**
Accounts payable	43,764	68,975	121,364	111,706	110,077
Total Debt	105,175	167,867	265,351	293,563	296,602
Shareholders' funds	**95,987**	**105,633**	**111,758**	**117,858**	**123,176**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	2.7	1.5	1.5	1.5	1.2
ROE adjusted	18.1	13.4	10.8	9.5	8.0
ROIC adjusted	9.0	4.0	5.7	5.0	2.2
Net debt to equity	108.7	156.1	235.7	247.4	239.2
Total debt to capital	52.3	61.4	70.4	71.4	70.7

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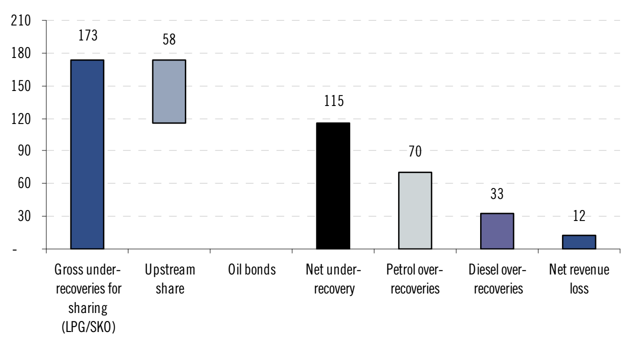
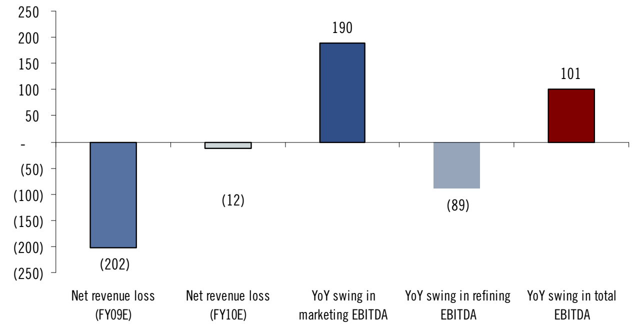
Figure 1. Build-up of FY10E net revenue loss for the industry assuming US$50 crude (Rs bn)



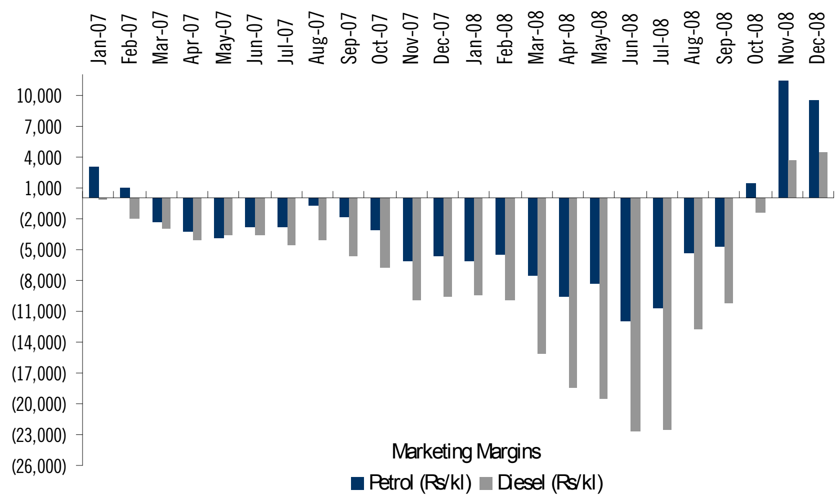
Source: Citi Investment Research

Figure 2. FY10E vs. FY09E aggregate EBITDA swing if crude stays at US$50 (Rs bn)



Source: Citi Investment Research

Figure 3. Marketing Margins on Auto Fuels



Source: Citi Investment Research estimates, Bloomberg

Hindustan Petroleum

Company description

HPCL is an oil refining and marketing company with around 20% of the Indian petro-product market. The company has two refineries in Mumbai and Vizag, and has more than 7,500 retail outlets selling automotive fuels.

Investment strategy

We rate HPCL as Sell / Medium Risk (3M) with a target price of Rs213. The stock has been driven mainly by news flow and softening of crude prices. Deregulation, clarity on subsidy-sharing, and reduced government interference in fuel pricing are key to any re-rating of downstream oil companies. Even though the government has hiked retail prices and has stuck to the subsidy sharing formula for FY09 till date, future policy especially regarding the level of "allowable" net under-recoveries remains unclear. Though the decline in crude prices and near-breakeven margins on petrol/diesel is a positive, HPCL's leverage to marketing losses and higher gearing (Net debt/EBITDA of 2.7x), makes it relatively unsafe to play this stage of recovery especially in the face of various imponderables i.e. retail price cut, elections, etc.

Valuation

Our target price for HPCL of Rs213 is based on FY10E EV/EBITDA of 6.0x for core earnings and 5.0x to contribution from oil bonds. The 6.0x multiple is a moderate discount to the approximately 6.5~7.0x target multiple we use for other Indian refineries, given the lower complexity of HPCL's refineries and also the policy indifference of the government. We use FY10E as a base considering a normalized earnings scenario based on 1/3rd subsidy sharing by upstream amid continued policy ambiguity. While valuing the Indian oil refining and marketing companies, we prefer to use EV/EBIDTA 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/BV of 0.6x, at a discount to the target imputed P/BV multiple for IOC. We believe this is justified given the poorer capital efficiency ratios of HPCL as a result of a higher proportion of lower-yielding marketing assets vs. refining assets.

Risks

We assign a Medium Risk rating to the stock, as we believe volatility in international oil prices will continue to impact earnings given the linkage to marketing margins. Sentiment toward the sector and HPCL is closely linked to event risks from sector deregulation, subsidy losses and auto fuel price hikes. Removal of the subsidy-sharing mechanism with upstream companies and/or fuel price cuts could significantly impact HPCL's earnings. The advent of private-sector competition in any significant way could exert pressure on marketing margins. Upside risks to our target price include a sharp decline in crude prices and the resultant recovery in the company's marketing profitability could lead to higher-than-estimated returns. If the government took concrete pricing action on retail products to bring them in line with international prices it would put our earnings forecasts at risk.

Appendix A-1

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Hindustan Petroleum (HPCL.BO)

Ratings and Target Price History
Fundamental Research

Analyst: Rahul Singh

	Date	Rating	Target Price	Closing Price
1	15-Jun-06	2M	*260.00	248.40
2	8-Nov-06	*3M	*299.00	309.15
3	5-Nov-07	3M	*184.00	246.30
4	20-Oct-08	3M	*213.00	239.65

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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