Company Flash

26 October 2006 | 6 pages

Chennai Petroleum (CHPC.BO)

Weak Refining, Stock Losses Drag Profits Down

- Results better than expectations — Chennai Petroleum's 2Q FY07 PAT at Rs973m was better than expected even though weak refining trends and inventory losses led to a 50% yoy decline in profits during the quarter.
- Pre-discount GRM of $4.8/bbl — Gross GRM (pre-subsidy discount on LPG/SKO) stood at US$4.8/bbl, significantly lower on a qoq basis but in line with the trend witnessed in the regional refining markets. The refining margins were also affected by the inventory losses, which were Rs670m (US$0.8/bbl) during the quarter.
- Refining discounts could reduce — If the reduction in retail losses is sustained (on account of lower crude prices), we believe that the discount requirement for the pure refiners may also be reviewed. While the implicit discount on MS/HSD is permanent in nature (as it is linked to trade parity formula), LPG/SKO discounts are fixed on a per bbl basis, which can undergo some modification.
- Maintain Buy/Low Risk (1L) — At current prices, CPCL offers a 6.6% dividend yield. Natural protection in refining margin volatility (through lower subsidy sharing) could result in relatively stable earnings visibility. Likely pick-up in the product spreads in the short term could be a driver for stock performance.

Buy/Low Risk	1L
Price (23 Oct 06)	Rs182.40
Target price	Rs257.00
Expected share price return	40.9%
Expected dividend yield	6.6%
Expected total return	**47.5%**
Market Cap	Rs27,167M
	US$600M

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/CEPS (x)	EV/EBITDA (x)	ROE (%)
2004A	4,000	26.85	32.1	6.8	5.3	6.4	27.6
2005A	5,748	38.58	43.7	4.7	3.5	4.0	31.8
2006E	5,842	39.21	1.6	4.7	3.4	4.2	25.9
2007E	6,267	42.06	7.3	4.3	3.2	3.6	22.7
2008E	6,348	42.60	1.3	4.3	3.1	2.9	19.4

Source: Company Reports and Citigroup Investment Research estimates

Rahul Singh[1]
+91-22-6631-9863
rahul.r.singh@citigroup.com

Pradeep Mirchandani, CFA[1]
+91-22-6631-9877
pradeep.mirchandani@citigroup.com

Saurabh Handa[1]
saurabh.handa@citigroup.com

See page 4 for Analyst Certification and important disclosures.

Citigroup Research is a division of Citigroup Global Markets Inc. (the "Firm"), which does and seeks to do business with companies covered in its research reports. As a result, investors should be aware that the Firm may have a conflict of interest that could affect the objectivity of this report. Investors should consider this report as only a single factor in making their investment decision. Non-US research analysts who have prepared this report, and who may be associated persons of the member or member organization, are not registered/qualified as research analysts with the NYSE and/or NASD, but instead have satisfied the registration/qualification requirements or other research-related standards of a non-US jurisdiction.

[1]Citigroup Global Market India Private Limited

Figure 1. Chennai Petroleum — 2Q FY07 Results (Rupees in Millions)

Year ending 31 Mar	2QFY06	1QFY07	2QFY07	% YoY
Net Sales	**54,586**	**64,642**	**66,069**	**21.0%**
Operating Costs	50,678	59,853	63,689	25.7%
- Material Costs	48,983	58,058	62,432	27.5%
- Personnel Costs	219	245	353	61.0%
- Other Overheads	1,475	1,550	904	-38.7%
EBITDA	**3,908**	**4,789**	**2,381**	**-39.1%**
EBITDA margin	*7.2%*	*7.4%*	*3.6%*	
Other Income	66	69	146	120.5%
PBDIT	3,975	4,857	2,527	-36.4%
Depreciation	589	586	586	-0.6%
Interest	425	426	468	10.1%
Pre-tax Profit	2,960	3,846	1,473	-50.3%
Tax	996	1,300	500	-49.8%
Profit After Tax	**1,964**	**2,546**	**973**	**-50.5%**
Operational Parameters				
Refinery Thruput (mMT)	2.67	2.62	2.50	
GRM – net of discounts (US$/bbl)	5.68	6.64	4.15	
Gross GRM ($/bbl)	7.47	8.55	4.81	
Subsidy discounts (Rs mn)	1,538	1,680	560	
Subsidy discount ($/bbl)	1.79	1.91	0.66	

Source: Company Reports and Citigroup Investment Research

Chennai Petroleum

Company Description

CPCL is a South India based refinery with 10.5mtpa capacity, manufacturing a wide variety of petroleum products, lubricants and additives. Initially set up with international participation, CPCL gradually became a public-sector undertaking and subsequently a subsidiary of IOC (51.88% stake), giving IOC a presence in the southern region.

Investment Thesis

We maintain our Buy (1L) rating on CPCL with a target price of Rs257. CPCL looks well positioned to capitalize on the sustained upturn in refining margins. In this context, CPCL's capacity expansion by 40% (up from 7.5MTPA to 10.5MTPA) and increased complexity appear timely. The company has improved its distillate yield and its heavy crude processing capacity now compares favorably with peers. Meanwhile, gross refining margins (GRMs) in the Asia-Pacific region have been on an uptrend, driven by strong demand growth from countries like China and India, and supply constraints due to years of underinvestment. Pure refiners, however, may be asked to bear the marketing losses of subsidy sharing by the pure refiners. Though subsidy sharing is likely to remain within manageable limits, especially in relation to the strong GRMs, it would cap the upside potential in the stock from present levels. IOC has also been contemplating a merger of CPCL with itself. Any move toward a merger with IOC could impact the stock performance adversely.

Valuation

Our target price of Rs257 is based on an EV/EBITDA of 4.5x FY07E, a 10-20% discount to BPCL/HPCL/IOC. The valuation discount is on account of being a pure refinery, and hence much higher cyclicality than the integrated R&M companies. It should be noted that earnings are highly sensitive to GRMs (EPS varies by Rs15 for every US$1/bbl variation in GRMs). Besides, the target EV/EBITDA multiple is also at the higher end of the company's past five-year historical trading band of 3x-4.5x (median of 3.5x). We believe CPCL deserves to trade at the higher end of the trading band on account of sustained strength in the refining margins and longer duration of the refinery cycle. While valuing the Indian refining and marketing companies, we tend to use EV/EBITDA numbers to compare companies across the regions, thereby avoiding the differences in accounting policies on depreciation and taxation. Our target price of Rs257 is also based on a dividend yield of 4.5%, higher than the post-tax returns of one-year bank deposits. The assumed dividend yield is higher than that of bank deposit returns on account of higher cyclicality of CPCL's refinery earnings.

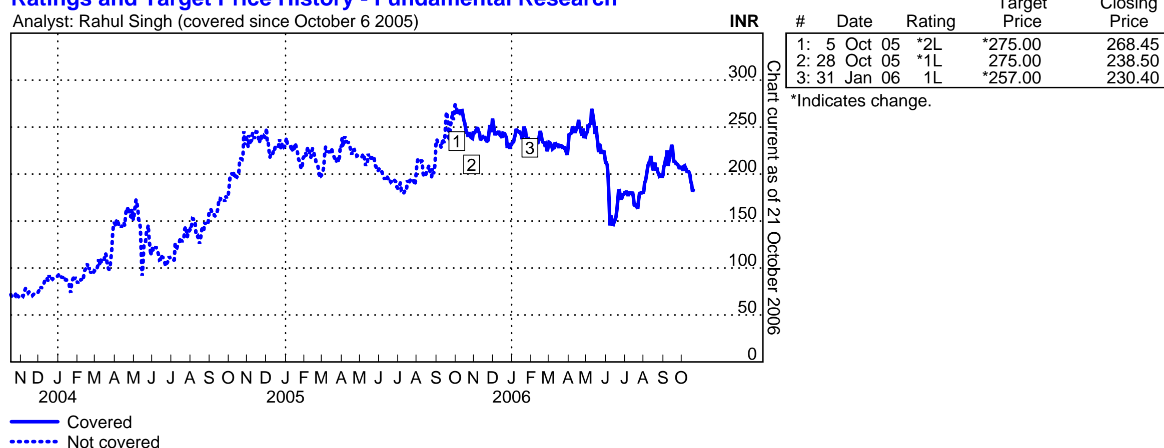
Risks

We rate CPCL as Low Risk based on our quantitative risk-rating system. Further strength in the regional refining margins could result in upside risk to our earnings estimates. Any move by the government to implement the Downstream Regulatory Bill, set up an independent regulator and free retail pricing could give a fillip to the stock. Declines in regional refining margins will have an adverse impact on our earnings estimates for CPCL. Any move to initiate merger with its parent, IOC, may be adverse for the minority shareholders of CPCL on account of the marketing losses of the former. Sentiment towards the sector and CPCL is closely linked to event risks from sector deregulation, import duty changes on petroleum products, subsidy losses and auto fuel price hikes. Any decrease in the dividend payout policy by CPCL will adversely impact the stock. If any of these risk factors has a greater impact than we expect, CPCL's share price will likely have difficulty attaining our target price

Analyst Certification Appendix A-1

We, Rahul Singh and Pradeep Mirchandani, CFA, research analysts and the authors of this report, hereby certify that all of the views expressed in this research report accurately reflect our personal views about any and all of the subject issuer(s) or securities. We also certify that no part of our compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

IMPORTANT DISCLOSURES



Citigroup Global Markets Inc. or its affiliates beneficially owns 1% or more of any class of common equity securities of Chennai Petroleum Corporation Ltd. This position reflects information available as of the prior business day.

Citigroup Global Markets Inc. or an affiliate received compensation for products and services other than investment banking services from Chennai Petroleum Corporation Ltd in the past 12 months.

Citigroup Global Markets Inc. currently has, or had within the past 12 months, the following company(ies) as clients, and the services provided were non-investment-banking, securities-related: Chennai Petroleum Corporation Ltd.

Citigroup Global Markets Inc. currently has, or had within the past 12 months, the following company(ies) as clients, and the services provided were non-investment-banking, non-securities-related: Chennai Petroleum Corporation Ltd.

Analysts' compensation is determined based upon activities and services intended to benefit the investor clients of Citigroup Global Markets Inc. and its affiliates ("the Firm"). Like all Firm employees, analysts receive compensation that is impacted by overall firm profitability, which includes revenues from, among other business units, the Private Client Division, Institutional Sales and Trading, and Investment Banking.

For important disclosures (including copies of historical disclosures) regarding the companies that are the subject of this Citigroup Investment Research product ("the Product"), please contact Citigroup Investment Research, 388 Greenwich Street, 29th Floor, New York, NY, 10013, Attention: Legal/Compliance. In addition, the same important disclosures, with the exception of the Valuation and Risk assessments and historical disclosures, are contained on the Firm's disclosure website at www.citigroupgeo.com. Private Client Division clients should refer to www.smithbarney.com/research. Valuation and Risk assessments can be found in the text of the most recent research note/report regarding the subject company. Historical disclosures (for up to the past three years) will be provided upon request.

Citigroup Investment Research Ratings Distribution

Data current as of 30 September 2006	Buy	Hold	Sell
Citigroup Investment Research Global Fundamental Coverage (2914)	46%	40%	14%
% of companies in each rating category that are investment banking clients	44%	43%	32%
India -- Asia Pacific (105)	59%	16%	25%
% of companies in each rating category that are investment banking clients	52%	65%	38%

Guide to Fundamental Research Investment Ratings:
Citigroup Investment Research's stock recommendations include a risk rating and an investment rating.
Risk ratings, which take into account both price volatility and fundamental criteria, are: Low (L), Medium (M), High (H), and Speculative (S).
Investment ratings are a function of Citigroup Investment Research's expectation of total return (forecast price appreciation and dividend yield within the next 12 months) and risk rating.
For securities in emerging markets (Asia Pacific, Emerging Europe/Middle East/Africa, and Latin America), investment ratings are: Buy (1) (expected total return of 15% or more for Low-Risk stocks, 20% or more for Medium-Risk stocks, 30% or more for High-Risk stocks, and 40% or more for Speculative stocks); Hold (2) (5%-15% for Low-Risk stocks, 10%-20% for Medium-Risk stocks, 15%-30% for High-Risk stocks, and 20%-40% for Speculative stocks); and Sell (3) (5% or less for Low-Risk stocks, 10% or less for Medium-Risk stocks, 15% or less for High-Risk stocks, and 20% or less for Speculative stocks).
Investment ratings are determined by the ranges described above at the time of initiation of coverage, a change in investment and/or risk rating, or a change in target price (subject to limited management discretion). At other times, the expected total returns may fall outside of these ranges because of market price

movements and/or other short-term volatility or trading patterns. Such interim deviations from specified ranges will be permitted but will become subject to review by Research Management. Your decision to buy or sell a security should be based upon your personal investment objectives and should be made only after evaluating the stock's expected performance and risk.

OTHER DISCLOSURES

Citigroup Global Markets Inc. or its affiliates beneficially owns 2% or more of any class of common equity securities of Chennai Petroleum Corporation Ltd.

Citigroup Global Markets Inc. or its affiliates holds a long position in any class of common equity securities of Chennai Petroleum Corporation Ltd.

For securities recommended in the Product in which the Firm is not a market maker, the Firm is a liquidity provider in the issuers' financial instruments and may act as principal in connection with such transactions. The Firm is a regular issuer of traded financial instruments linked to securities that may have been recommended in the Product. The Firm regularly trades in the securities of the subject company(ies) discussed in the Product. The Firm may engage in securities transactions in a manner inconsistent with the Product and, with respect to securities covered by the Product, will buy or sell from customers on a principal basis.

Securities recommended, offered, or sold by the Firm: (i) are not insured by the Federal Deposit Insurance Corporation; (ii) are not deposits or other obligations of any insured depository institution (including Citibank); and (iii) are subject to investment risks, including the possible loss of the principal amount invested. Although information has been obtained from and is based upon sources that the Firm believes to be reliable, we do not guarantee its accuracy and it may be incomplete and condensed. Note, however, that the Firm has taken all reasonable steps to determine the accuracy and completeness of the disclosures made in the Important Disclosures section of the Product. In producing Products, members of the Firm's research department may have received assistance from the subject company(ies) referred to in the Product. Any such assistance may have included access to sites owned, leased or otherwise operated or controlled by the issuers and meetings with management, employees or other parties associated with the subject company(ies). Firm policy prohibits research analysts from sending draft research to subject companies. However, it should be presumed that the author of the Product has had discussions with the subject company to ensure factual accuracy prior to publication. All opinions, projections and estimates constitute the judgment of the author as of the date of the Product and these, plus any other information contained in the Product, are subject to change without notice. Prices and availability of financial instruments also are subject to change without notice. Notwithstanding other departments within the Firm advising the companies discussed in this Product, information obtained in such role is not used in the preparation of the Product. Although Citigroup Investment Research does not set a predetermined frequency for publication, if the Product is a fundamental research report, it is the intention of Citigroup Investment Research to provide research coverage of the/those issuer(s) mentioned therein, including in response to news affecting this issuer, subject to applicable quiet periods and capacity constraints. The Product is for informational purposes only and is not intended as an offer or solicitation for the purchase or sale of a security. Any decision to purchase securities mentioned in the Product must take into account existing public information on such security or any registered prospectus.

Investing in non-U.S. securities, including ADRs, may entail certain risks. The securities of non-U.S. issuers may not be registered with, nor be subject to the reporting requirements of the U.S. Securities and Exchange Commission. There may be limited information available on foreign securities. Foreign companies are generally not subject to uniform audit and reporting standards, practices and requirements comparable to those in the U.S. Securities of some foreign companies may be less liquid and their prices more volatile than securities of comparable U.S. companies. In addition, exchange rate movements may have an adverse effect on the value of an investment in a foreign stock and its corresponding dividend payment for U.S. investors. Net dividends to ADR investors are estimated, using withholding tax rates conventions, deemed accurate, but investors are urged to consult their tax advisor for exact dividend computations. Investors who have received the Product from the Firm may be prohibited in certain states or other jurisdictions from purchasing securities mentioned in the Product from the Firm. Please ask your Financial Consultant for additional details. Citigroup Global Markets Inc. takes responsibility for the Product in the United States. Any orders by US investors resulting from the information contained in the Product may be placed only through Citigroup Global Markets Inc.

The Citigroup legal entity that takes responsibility for the production of the Product is the legal entity which the first named author is employed by. The Product is made available in Australia to wholesale clients through Citigroup Global Markets Australia Pty Ltd. (ABN 64 003 114 832 and AFSL No. 240992) and to retail clients through Citigroup Wealth Advisors Pty Ltd. (ABN 19 009 145 555 and AFSL No. 240813), Participants of the ASX Group and regulated by the Australian Securities & Investments Commission. Citigroup Centre, 2 Park Street, Sydney, NSW 2000. If the Product is being made available in certain provinces of Canada by Citigroup Global Markets (Canada) Inc. ("CGM Canada"), CGM Canada has approved the Product. Citigroup Place, 123 Front Street West, Suite 1100, Toronto, Ontario M5J 2M3. The Product may not be distributed to private clients in Germany. The Product is distributed in Germany by Citigroup Global Markets Deutschland AG & Co. KGaA, which is regulated by Bundesanstalt fuer Finanzdienstleistungsaufsicht (BaFin). Frankfurt am Main, Reuterweg 16, 60323 Frankfurt am Main. If the Product is made available in Hong Kong by, or on behalf of, Citigroup Global Markets Asia Ltd., it is attributable to Citigroup Global Markets Asia Ltd., Citibank Tower, Citibank Plaza, 3 Garden Road, Hong Kong. Citigroup Global Markets Asia Ltd. is regulated by Hong Kong Securities and Futures Commission. If the Product is made available in Hong Kong by The Citigroup Private Bank to its clients, it is attributable to Citibank N.A., Citibank Tower, Citibank Plaza, 3 Garden Road, Hong Kong. The Citigroup Private Bank and Citibank N.A. is regulated by the Hong Kong Monetary Authority. The Product is made available in India by Citigroup Global Markets India Private Limited, which is regulated by Securities and Exchange Board of India. Bakhtawar, Nariman Point, Mumbai 400-021. If the Product was prepared by Citigroup Investment Research and distributed in Japan by Nikko Citigroup Ltd., it is being so distributed under license. Nikko Citigroup Limited is regulated by Financial Services Agency, Securities and Exchange Surveillance Commission, Japan Securities Dealers Association, Tokyo Stock Exchange and Osaka Securities Exchange. Akasaka Park Building, 2-20, Akasaka 5-chome, Minato-ku, Tokyo 107-6122. The Product is made available in Korea by Citigroup Global Markets Korea Securities Ltd., which is regulated by Financial Supervisory Commission and the Financial Supervisory Service. Hungkuk Life Insurance Building, 226 Shinmunno 1-GA, Jongno-Gu, Seoul, 110-061. The Product is made available in Malaysia by Citigroup Global Markets Malaysia Sdn Bhd, which is regulated by Malaysia Securities Commission. Menara Citibank, 165 Jalan Ampang, Kuala Lumpur, 50450. The Product is made available in Mexico by Acciones y Valores Banamex, S.A. De C. V., Casa de Bolsa, which is regulated by Comision Nacional Bancaria y de Valores. Reforma 398, Col. Juarez, 06600 Mexico, D.F. In New Zealand the Product is made available through Citigroup Global Markets New Zealand Ltd., a Participant of the New Zealand Exchange Limited and regulated by the New Zealand Securities Commission. Level 19, Mobile on the Park, 157 lambton Quay, Wellington. The Product is made available in Poland by Dom Maklerski Banku Handlowego SA an indirect subsidiary of Citigroup Inc., which is regulated by Komisja Papierów Wartosciowych i Gield. Bank Handlowy w Warszawie S.A. ul. Senatorska 16, 00-923 Warszawa. The Product is made available in the Russian Federation through ZAO Citibank, which is licensed to carry out banking activities in the Russian Federation in accordance with the general banking license issued by the Central Bank of the Russian Federation and brokerage activities in accordance with the license issued by the Federal Service for Financial Markets. Neither the Product nor any information contained in the Product shall be considered as advertising the securities mentioned in this report within the territory of the Russian Federation or outside the Russian Federation. The Product does not constitute an appraisal within the meaning of the Federal Law of the Russian Federation of 29 July 1998 No. 135-FZ (as amended) On Appraisal Activities in the Russian Federation. 8-10 Gasheka Street, 125047 Moscow. The Product is made available in Singapore through Citigroup Global Markets Singapore Pte. Ltd.,

a Capital Markets Services Licence holder, and regulated by Monetary Authority of Singapore. 1 Temasek Avenue, #39-02 Millenia Tower, Singapore 039192. Citigroup Global Markets (Pty) Ltd. is incorporated in the Republic of South Africa (company registration number 2000/025866/07) and its registered office is at 145 West Street, Sandton, 2196, Saxonwold. Citigroup Global Markets (Pty) Ltd. is regulated by JSE Securities Exchange South Africa, South African Reserve Bank and the Financial Services Board. The investments and services contained herein are not available to private customers in South Africa. The Product is made available in Taiwan through Citigroup Global Markets Inc. (Taipei Branch), which is regulated by Securities & Futures Bureau. No portion of the report may be reproduced or quoted in Taiwan by the press or any other person. No. 8 Manhattan Building, Hsin Yi Road, Section 5, Taipei 100, Taiwan. The Product is made available in Thailand through Citicorp Securities (Thailand) Ltd., which is regulated by the Securities and Exchange Commission of Thailand. 18/F, 22/F and 29/F, 82 North Sathorn Road, Silom, Bangrak, Bangkok 10500, Thailand. The Product is made available in United Kingdom by Citigroup Global Markets Limited, which is authorised and regulated by Financial Services Authority. This material may relate to investments or services of a person outside of the UK or to other matters which are not regulated by the FSA and further details as to where this may be the case are available upon request in respect of this material. Citigroup Centre, Canada Square, Canary Wharf, London, E14 5LB. The Product is made available in United States by Citigroup Global Markets Inc, which is regulated by NASD, NYSE and the US Securities and Exchange Commission. 388 Greenwich Street, New York, NY 10013. Unless specified to the contrary, within EU Member States, the Product is made available by Citigroup Global Markets Limited, which is regulated by Financial Services Authority. Many European regulators require that a firm must establish, implement and make available a policy for managing conflicts of interest arising as a result of publication or distribution of investment research. The policy applicable to Citigroup Investment Research's Products can be found at www.citigroupgeo.com. Compensation of equity research analysts is determined by equity research management and Citigroup's senior management and is not linked to specific transactions or recommendations. The Product may have been distributed simultaneously, in multiple formats, to the Firm's worldwide institutional and retail customers. The Product is not to be construed as providing investment services in any jurisdiction where the provision of such services would be illegal. Subject to the nature and contents of the Product, the investments described therein are subject to fluctuations in price and/or value and investors may get back less than originally invested. Certain high-volatility investments can be subject to sudden and large falls in value that could equal or exceed the amount invested. Certain investments contained in the Product may have tax implications for private customers whereby levels and basis of taxation may be subject to change. If in doubt, investors should seek advice from a tax adviser. Advice in the Product has been prepared without taking account of the objectives, financial situation or needs of any particular investor. Accordingly, investors should, before acting on the advice, consider the appropriateness of the advice, having regard to their objectives, financial situation and needs.

© 2006 Citigroup Global Markets Inc. Citigroup Investment Research is a division and service mark of Citigroup Global Markets Inc. and its affiliates and is used and registered throughout the world. Citigroup and the Umbrella Device are trademarks and service marks of Citigroup or its affiliates and are used and registered throughout the world. Nikko is a registered trademark of Nikko Cordial Corporation. All rights reserved. Any unauthorized use, duplication, redistribution or disclosure is prohibited by law and will result in prosecution. The information contained in the Product is intended solely for the recipient and may not be further distributed by the recipient. The Firm accepts no liability whatsoever for the actions of third parties. The Product may provide the addresses of, or contain hyperlinks to, websites. Except to the extent to which the Product refers to website material of the Firm, the Firm has not reviewed the linked site. Equally, except to the extent to which the Product refers to website material of the Firm, the Firm takes no responsibility for, and makes no representations or warranties whatsoever as to, the data and information contained therein. Such address or hyperlink (including addresses or hyperlinks to website material of the Firm) is provided solely for your convenience and information and the content of the linked site does not in anyway form part of this document. Accessing such website or following such link through the Product or the website of the Firm shall be at your own risk and the Firm shall have no liability arising out of, or in connection with, any such referenced website.

ADDITIONAL INFORMATION IS AVAILABLE UPON REQUEST