IDFC INSTITUTIONAL SECURITIES

India Research

Essar Oil

OUTPERFORMER

RESULT NOTE

Mkt Cap: Rs172bn; US$3.8bn

Analyst: **Probal Sen (91-22-6622 2569; probal.sen@idfc.com)**

Result: **Q3FY11**

Comment: **Results better than estimates on higher GRMs and volumes**

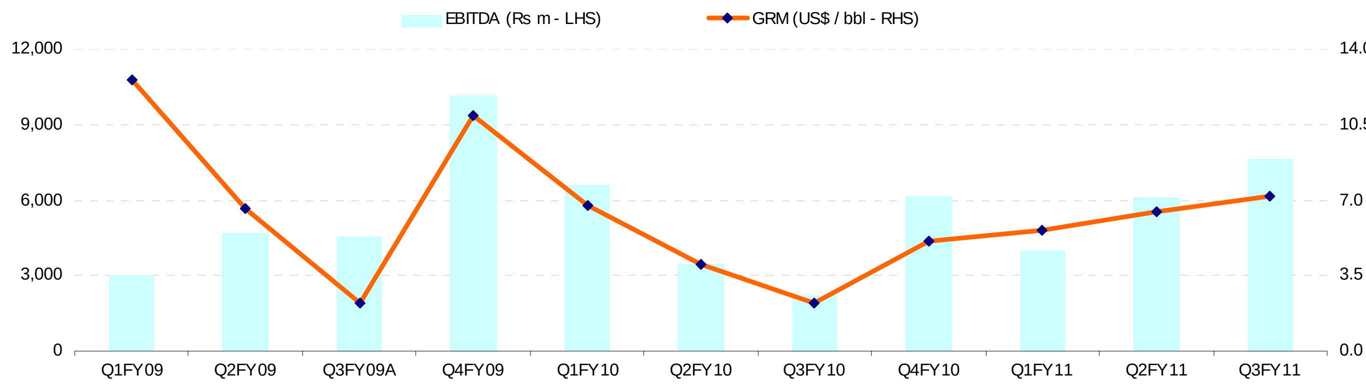
Key valuation metrics

Year to Mar 31 (Rs m)	Net sales	yoy chg (%)	Net profit	EPS (Rs)	yoy chg (%)	PER (x)	EV/E (x)
FY08	5,623	18.6	(412.1)	(0.3)	NM	n/a	(528.2)
FY09	378,867	NM	(4,227.5)	(3.1)	NM	n/a	20.4
FY10	367,150	(3.1)	290.1	0.2	NM	592.6	18.6
FY11E	406,127	10.6	5,073.9	3.7	1,648.8	33.9	10.8
FY12E	486,695	19.8	7,221.4	5.3	42.3	23.8	7.7

Highlights of Q3FY11 results

- Revenues increased 24% yoy to Rs123bn, higher than our estimates of Rs110bn, due to higher realizations and higher volumes.
- Total volumes sold during the quarter were 3.73mt, as against estimates of 3.6mt.
- Capacity utilization remained on an upward trajectory, with Essar Oil (EOL) achieving 140% capacity utilization in Q3FY11, compared to 130% in Q2FY11, 140% in Q1FY11, 135% in Q2FY10, 134% for Q3FY10 and 137% for Q4FY10.
- GRMs for the quarter were at US$7.21/bbl, compared to US$2.2/bbl for Q3FY10 and US$6.5/bbl in Q2FY11. The sequential improvement is driven by the improved refining environment, improving heavy light spreads and the usage of Mangala crude up to 45kb/d in the quarter. Going forward, the improvement in GRMs are expected to pick up steam, as EOL hope to be able to off take up to 50 kb/d of Mangala crude from Cairn by the year end, while natural gas up to 1.2 mmscmd is also expected by Q1FY12.
- Supply of Mangala crude started to EOL's refinery, supplying ~45 kb/d during the quarter, constituting ~15% of sourcing slate.
- Test production of gas started from Raniganj CBM field, with commercial production expected by Q1FY12E
- EBITDA margins were at 6% (+400 bps yoy) during the quarter, to reach Rs7.6bn. This was in line with our estimates of Rs7.7bn
- Lower depreciation and interest cost, due to lower than anticipated capex and debt and a one time arbitration award of Rs0.5bn included in other income led to PAT being higher than estimates at Rs2.7bn (our estimates of Rs1.9bn).
- Retail fuel business expanding post petrol deregulation. The number of outlets has also increased to 1385, up from 1200 outlets at the beginning of the year. Essar is targeting 1700 outlets by the end of FY11E.

Essar Oil EBITDA and GRMs

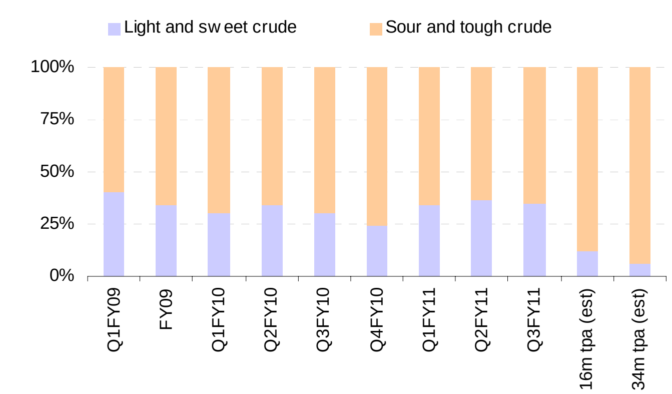


Source: IDFC Securities Research, Company

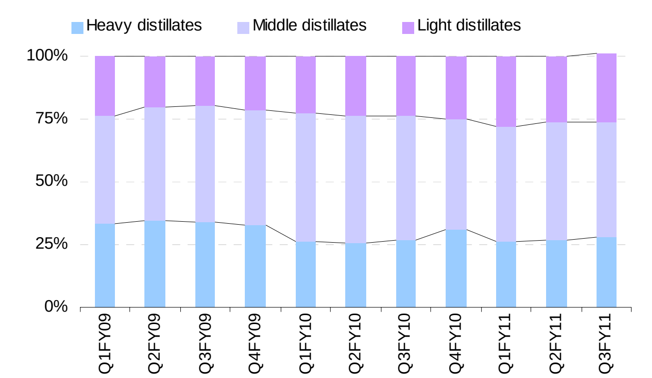
❑ Product slate veering towards middle distillates

The company is managing to deliver on its intention to increase the proportion of more profitable light and middle distillates in its product slate, thereby reducing the proportion of heavy distillates and providing support to GRMs going forward. It is also continuing to improve the proportion of heavier and sour crudes in its sourcing portfolio, which should result in higher GRMs inline with the continuing improvement in heavy light spreads.

Essar Oil crude sourcing slate



Essar Oil product slate



Source: IDFC Securities Research, Company

❑ Refinery expansion: on track for commissioning by Q2FY12E

Essar Oil remains on track to finish Phase I of its refinery expansion (10.5m tpa to 18m tpa) by Q1FY12E, with commercial production expected in Q2FY12E. The company has tied up all the financing needed for the US$1.7bn project, with ~US$500mn of equity coming into EOL's books post the successful US$1.95bn listing of the promoter company Essar Energy on the London Bourses. The company has reported 78% completion of the project, with al the new units progressing on schedule and within budget, except for two units that are lagging by a quarter.

Additionally, the company has now decided to further optimize the existing refinery unit to add another 2mtpa of CDU (crude distillation unit) capacity, thereby taking the overall nameplate capacity to 20 mtpa. The total investment required for this optimization exercise is ~Rs17bn, which the company intends to fund through a mixture of debt and equity. The company intends to complete this process by September 2012.

Essar Oil refinery configuration post expansion

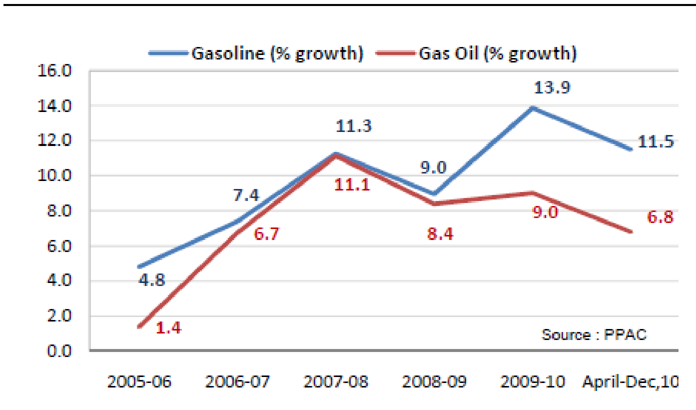
	Unit	Current 10.5 mtpa	New 20 mtpa
CDU	mtpa	10.5	20
VDU	mtpa	7.2	10.9
VBU	mtpa	1.9	0
NHT	mtpa	1.6	1.8
CCR	mtpa	0.9	1.1
FCC	mtpa	2.9	3.9
DHDS	mtpa	3.7	5.3
SRU	t/d	440	1115
ARU	mtpa		11.9
SWSU	mtpa		3.5
DHDT	mtpa		4
VGOHT	mtpa		6.5
DCU	mtpa		7.5
ISOM	mtpa		0.7
HMU,	Nm3/hr		155,000

Source: IDFC Securities Research, Company

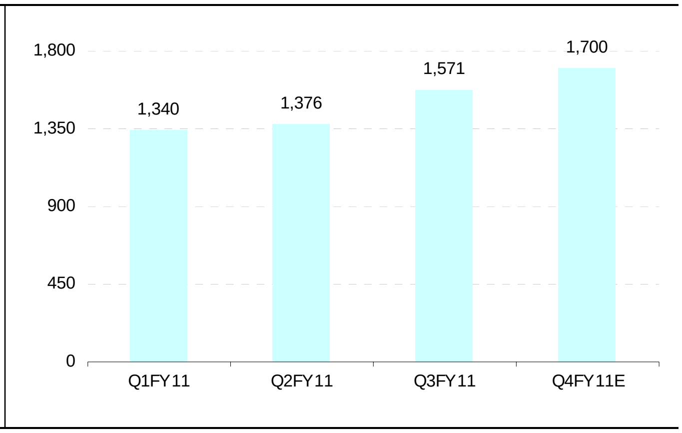
❑ Retail business gaining momentum

Essar has ramped up its retail business significantly since the beginning of FY11, and the decision to free petrol prices in June of this year has helped Gasoline (MS) sales for Essar grow at a rapid pace. At the same time however, the diesel prices have not kept pace with market prices, and this has meant that HSD sales have been muted in Q3. With domestic demand for fuels continuing to be strong, we expect further momentum in retail sales for Essar, with a potential 3mt pa of product capable of being sold from 1700 operational outlets, provided there is free pricing for both MS and HSD.

Domestic product demand



Essar fuel outlets



Source: IDFC Securities Research, Company

❑ E&P continues to progress

We had mentioned in our management meeting note of December 2009 that the E&P business of EOL is not really valued by the street, and we saw significant value in the Ratna series field (2P reserves of 80mmbbl net to Essar) and Raniganj CBM (potential resources of 3 tcf). The company has moved ahead materially on realizing some of this potential, with test production from Raniganj already commenced, and recoverable reserves being pegged at 1 tcf. Peak production of 3.5 mmscmd is expected to be reached in year 3 of operations, and remain at a plateau of at least 15-16 years. The company has also allayed concerns around being able to place this gas in the market by signing a long term gas contract with Matix Fertilizers which is setting up a 1.3mtpa Ammonia plant in Panagarh for 2.8 mmscmd. The contract runs for twenty years, with first gas supply expected FY13 onwards. Further, the company has also managed to bag four more CBM assets in the CBM IV round of auctions. As a result, total prospective resources of EOL have increased to 2100 mmboe from earlier estimates of 1400 mmboe.

Domestic demand remains strong

In a scenario of global demand being extremely weak, Essar is reaping the benefits of focusing on the domestic market, which is still growing robustly. Estimates of domestic demand for most refined fuels point to moderate to strong growth over the next five years, indicating good volume support for Essar.

Essar market mix | Domestic product demand

Source: Company, IDFC Securities Research, Crisil Research, Company

Valuations & View

The successful listing of Essar Energy in London, followed by the infusion of US$500mn as Equity in to Essar Oil has allayed a lot of concerns investors had around funding for Essar Oil's refinery expansion. With Phase I 78% complete and set to be commissioned by Q2FY12E, and an additional 2 mtpa of capacity coming on-stream September 2012 via optimization of the VBU unit, Essar's prospects going forward remain robust. The emerging E&P business is set to add another leg of growth to the company over FY10-14E. We see the timing of commissioning of Phase I coinciding nicely with the expected revival in the global economy, providing a boost to valuations over the long term. Further, the incremental improvement in refining margins worldwide due to the e4(s-6.4(oneg1mE. o0.028.29elyaffpec GRMsd for)TJ-28.7p5E

Analyst	Sector/Industry/Coverage	E-mail	Tel. +91-22-6622 2600
Pathik Gandotra	Head of Research; Financials, Strategy	pathik.gandotra@idfc.com	91-22-662 22525
Shirish Rane	Construction, Power, Cement	shirish.rane@idfc.com	91-22-662 22575
Nikhil Vora	FMCG, Media, Mid Caps, Education, Exchanges	nikhil.vora@idfc.com	91-22-662 22567
Nitin Agarwal	Pharmaceuticals, Real Estate	nitin.agarwal@idfc.com	91-22-662 22568
Chirag Shah	Metals & Mining,Telecom, Pipes, Textiles	chirag.shah@idfc.com	91-22-662 22564
Bhoomika Nair	Logistics, Engineering	bhoomika.nair@idfc.com	91-22-662 22561
Hitesh Shah, CFA	IT Services	hitesh.shah@idfc.com	91-22-662 22565
Bhushan Gajaria	Automobiles, Auto ancillaries, Retailing	bhushan.gajaria@idfc.com	91-22-662 22562
Salil Desai	Construction, Power, Cement	salil.desai@idfc.com	91-22-662 22573
Ashish Shah	Construction, Power, Cement	ashish.shah@idfc.com	91-22-662 22560
Probal Sen	Oil & Gas	probal.sen@idfc.com	91-22-662 22569
Chinmaya Garg	Financials	chinmaya.garg@idfc.com	91-22-662 22563
Abhishek Gupta	Telecom, Metals & Mining	abhishek.gupta@idfc.com	91-22-662 22661
Ritesh Shah	Pharmaceuticals	ritesh.shah@idfc.com	91-22-662 22571
Saumil Mehta	Metals, Pipes	saumil.mehta@idfc.com	91-22-662 22578
Vineet Chandak	Real Estate	vineet.chandak@idfc.com	91-22-662 22579
Kavita Kejriwal	Strategy, Financials	kavita.kejriwal@idfc.com	91-22-662 22558
Anamika Sharma	IT Services	anamika.sharma@idfc.com	91-22-662 22680
Varun Kejriwal	FMCG, Mid Caps	varun.kejriwal@idfc.com	91-22-662 22685
Swati Nangalia	Media, Education, Exchanges, Midcaps	swati.nangalia@idfc.com	91-22-662 22576
Nikhil Salvi	Construction, Power, Cement	nikhil.salvi@idfc.com	91-22-662 22566
Dharmendra Sahu	Database Analyst	dharmendra.sahu@idfc.com	91-22-662 22580
Rupesh Sonawale	Database Analyst	rupesh.sonawale@idfc.com	91-22-662 22572
Dharmesh R Bhatt, CMT	Technical Analyst	dharmesh.bhatt@idfc.com	91-22-662 22534

Equity Sales/Dealing	Designation	E-mail	Tel. +91-22-6622 2500
Naishadh Paleja	MD, CEO	naishadh.paleja@idfc.com	91-22-6622 2522
Paresh Shah	MD, Dealing	paresh.shah@idfc.com	91-22-6622 2508
Vishal Purohit	MD, Sales	vishal.purohit@idfc.com	91-22-6622 2533
Nikhil Gholani	MD, Sales	nikhil.gholani@idfc.com	91-22-6622 2529
Sanjay Panicker	Director, Sales	sanjay.panicker@idfc.com	91-22-6622 2530
Rajesh Makharia	Director, Sales	rajesh.makharia@idfc.com	91-22-6622 2528
Nirbhay Singh	SVP, Sales	nirbhay.singh@idfc.com	91-22-6622 2595
Suchit Sehgal	AVP, Sales	suchit.sehgal@idfc.com	91-22-6622 2532
Pawan Sharma	MD, Derivatives	pawan.sharma@idfc.com	91-22-6622 2539
Jignesh Shah	AVP, Derivatives	jignesh.shah@idfc.com	91-22-6622 2536
Suniil Pandit	Director, Sales trading	suniil.pandit@idfc.com	91-22-6622 2524
Mukesh Chaturvedi	SVP, Sales trading	mukesh.chaturvedi@idfc.com	91-22-6622 2512
Viren Sompura	SVP, Sales trading	viren.sompura@idfc.com	91-22-6622 2527
Rajashekhar Hiremath	VP, Sales trading	rajashekhar.hiremath@idfc.com	91-22-6622 2516

Explanation of Ratings:

1. Outperformer: More than 5% to Index
2. Neutral: Within 0-5% to Index (upside or downside)
3. Underperformer: Less than 5% to Index

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