

INDIA

Refinery Margins

11 May 2007

RIL IN Outperform

Stock price as of 10 May 2007	Rs	1581.40
12-month target	Rs	1775.00
Upside/downside	%	+12.2
Valuation	Rs	1972.00
- Sum of parts		

GICS sector		energy
Market cap	Rs bn	2,299
Market cap	US\$m	56,494
Number shares on issue	m	1,454

HPCL IN Outperform

Stock price as of 10 May 2007	Rs	288.20
12-month target	Rs	403.00
Upside/downside	%	+39.8
Valuation	Rs	450.00
- RNAV		

GICS sector		energy
Market cap	Rs m	97,975
Market cap	US\$m	2,403
Number shares on issue	m	339

BPCL IN Outperform

Stock price as of 10 May 2007	Rs	355.10
12-month target	Rs	541.00
Upside/downside	%	+52.4
Valuation	Rs	601.00
- RNAV		

GICS sector		energy
Market cap	Rs m	106,530
Market cap	US\$m	2,618
Number shares on issue	m	300

IOCL IN Not Rated

Stock price as of 10 May 2007	Rs	457.90
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GICS sector		energy
Market cap	Rs m	534,833
Market cap	US\$m	13,141
Number shares on issue	m	1,168

Stronger for longer

Event

- Global refining margins have surged in the past month because of capacity shutdowns by large refiners. We have analysed this surge and identified Indian refiners that are likely to benefit.

Impact

- Global refining margins have increased by US\$2.3/bbl** (Singapore Dubai cracking) in the past month to near two-year highs (Figure 1) as a result of seasonal capacity shutdowns. The refineries that are not operating at 100% capacity include Petroleos de Venezuela SA (Venezuela), Chevron (South Africa), Royal Dutch Shell (Australia), OMV AG (Schwechat, Arpechim and Burghausen), Exxon Mobil (Texas) and Saras SpA (Sardinia). These shutdowns are expected to last between 10 and 40 days.
- Reliance's (RIL) refinery head recently said that the cycle downturn has been pushed out by many years.** He added that global capacity increases have been delayed. He forecasts that global CDU capacity additions of 1.0m b/d, which are much lower than demand growth, will support higher margins (Figure 2). Reliance's view is also supported by the International Energy Association (IEA), which expects capacity additions to lag demand, resulting in higher utilisation rates for the foreseeable future.
- In addition, complex margins delta are strong** compared to simple margins, which Reliance's refinery head believes could be sustained, with the complex refining margins remaining high due to a conversion capacity crunch. He believes that a continuous reduction in US product inventories, tighter product specifications, strong gas and oil margins and residual fuel oil economics will support strong complex margins (Figure 3, 4).
- Reliance Industries, HPCL, BPCL and IOCL are the main plays** on refinery margins. However, the PSU refiners are forced to sell most of their products in the domestic markets at government-determined prices. This results in negative marketing margins for HPCL, BPCL and IOCL (Figure 5). We believe that RIL, the largest refiner in India, which recently got government approval to convert its refinery into an export-oriented refinery, is the best play in the sector because it is not subject to negative marketing margins.

Outlook

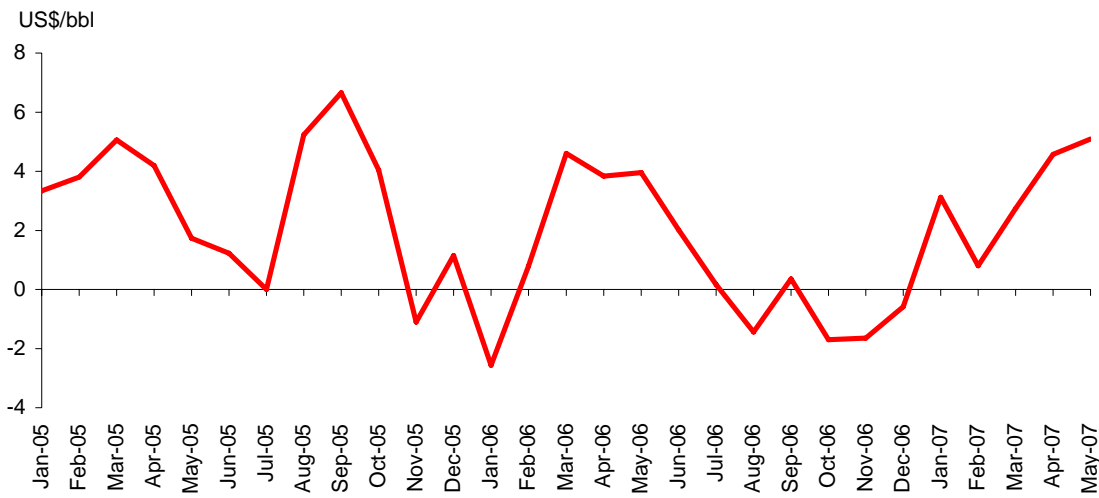
- Reliance Industries is our top sector pick.** Strong capex of US\$20bn and oil finds that are potentially as large as ONGC's (ONGC IN, Rs884, Underperform, TP: Rs695) reserves will likely triple earnings over the next five years. This should also result in a consistent rise in ROE, based on a rising contribution from high-return businesses.
- HPCL and BPCL trade at 0.8x and 0.9x FY08E book value, respectively. We believe that both are value plays and reaffirm our Outperform ratings.

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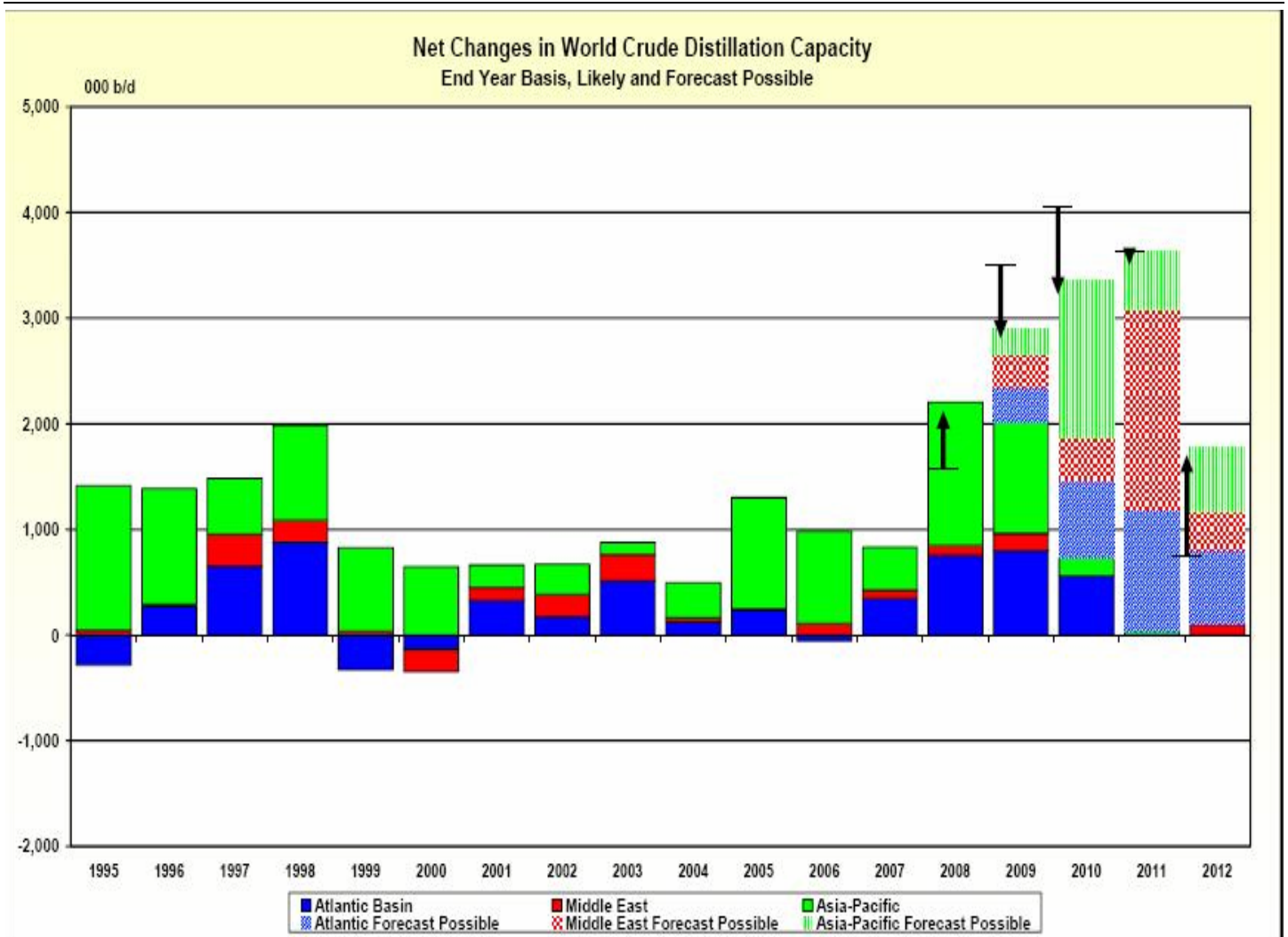
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Fig 1 Singapore Dubai Cracking Margins



Source: Bloomberg, Macquarie Research, May 2007

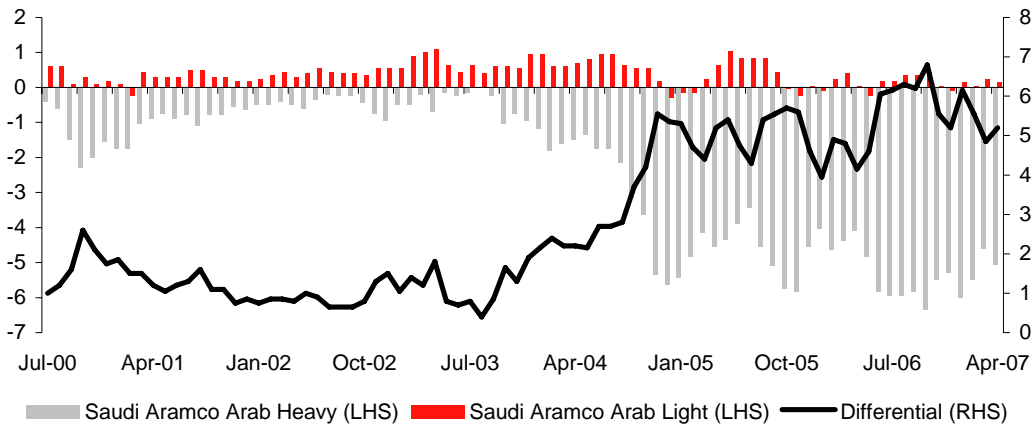
Fig 2 Delay in project implementation to push cycle downturn ahead



Source: Reliance Industries, Macquarie Research, May 2007

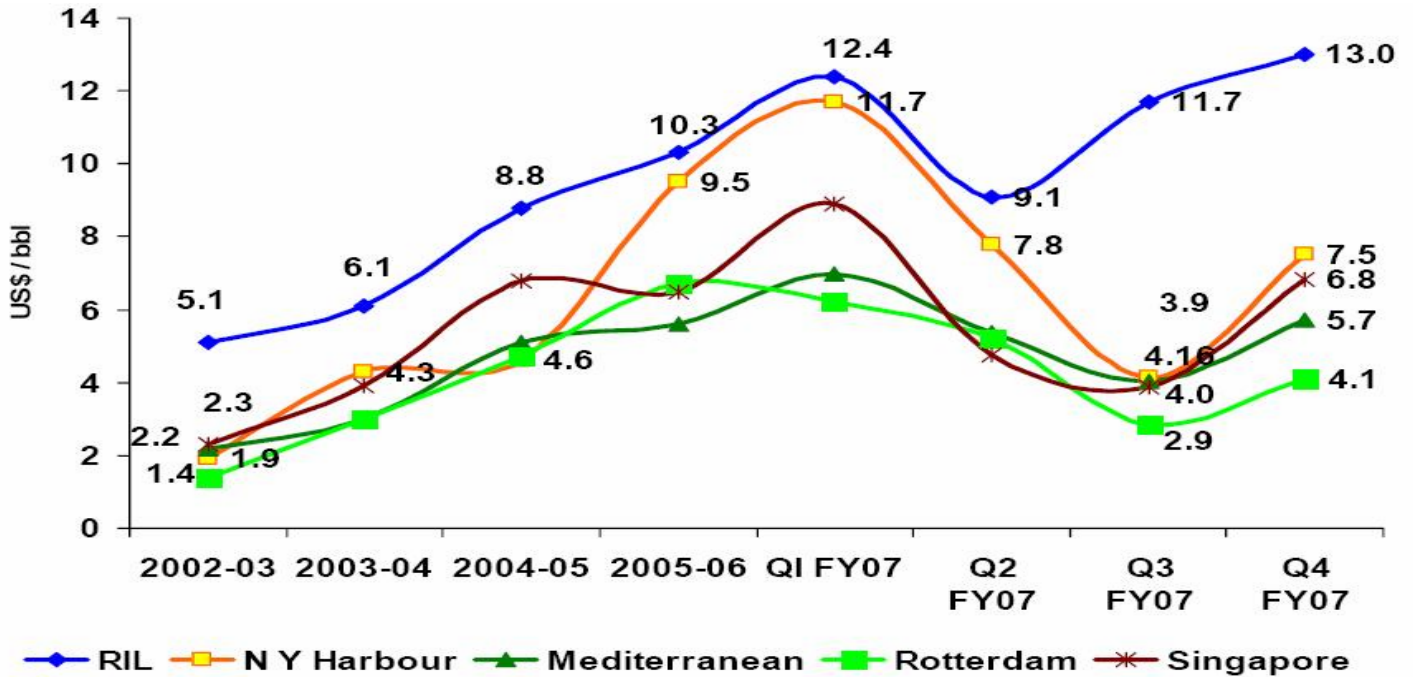
Sustained advantage for Global Complex Refiners

Fig 3 Strong-Light – Heavy Differential



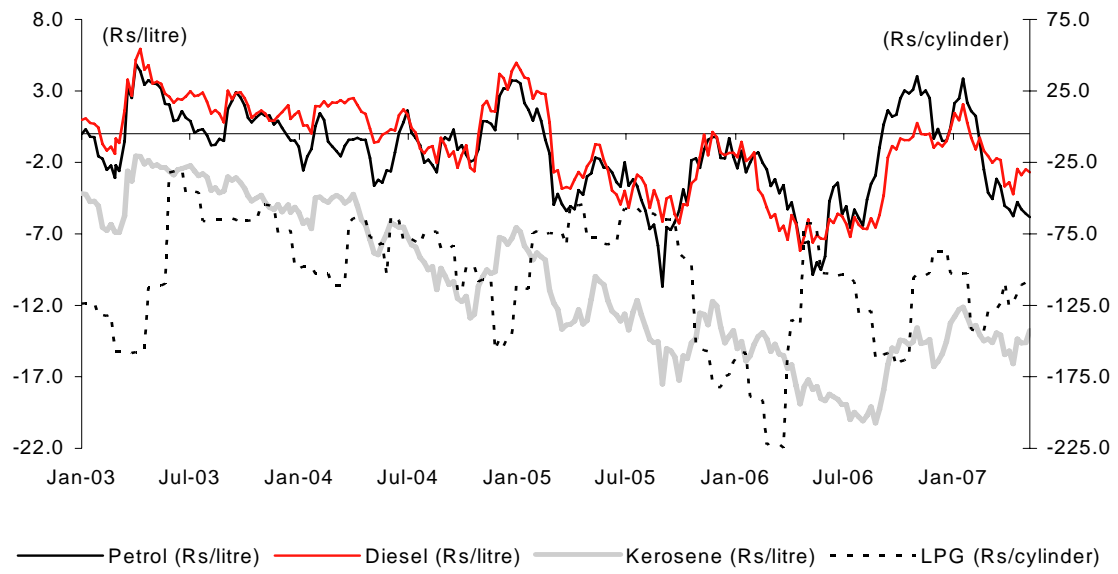
Source: Bloomberg, Macquarie Research, May 2007

Fig 4 Reliance Industries: Increasing outperformance over the global benchmarks



Source: Reliance Industries, Macquarie Research, May 2007

Fig 5 Retail fuel margins continue to be negative for the PSU refiners



Source: Macquarie Research, May 2007

Important disclosures:

Recommendation definitions

Macquarie Australia/New Zealand

Outperform – return >5% in excess of benchmark return (>2.5% in excess for listed property trusts)
 Neutral – return within 5% of benchmark return (within 2.5% for listed property trusts)
 Underperform – return >5% below benchmark return (>2.5% below for listed property trusts)

Macquarie Asia

Outperform – expected return >+10%
 Neutral – expected return from -10% to +10%
 Underperform – expected return <-10%

Macquarie First South Securities (South Africa)

Outperform – expected return >+5%
 Neutral – expected return from -5% to +5%
 Underperform – expected return <-5%

Recommendations – 12 months

Note: Quant recommendations may differ from Fundamental Analyst recommendations

Recommendation proportions

	AU/NZ	Asia	RSA
Outperform	44.37%	58.37%	42.60%
Neutral	44.01%	21.30%	46.80%
Underperform	11.62%	20.33%	10.60%

For quarter ending 31 March 2007

Volatility index definition*

This is calculated from the volatility of historic price movements.

Very high–highest risk – Stock should be expected to move up or down 60–100% in a year – investors should be aware this stock is highly speculative.

High – stock should be expected to move up or down at least 40–60% in a year – investors should be aware this stock could be speculative.

Medium – stock should be expected to move up or down at least 30–40% in a year.

Low–medium – stock should be expected to move up or down at least 25–30% in a year.

Low – stock should be expected to move up or down at least 15–25% in a year.

* Applicable to Australian/NZ stocks only

Financial definitions

All "Adjusted" data items have had the following adjustments made:
 Added back: goodwill amortisation, provision for catastrophe reserves, IFRS derivatives & hedging, IFRS impairments & IFRS interest expense
 Excluded: non recurring items, asset revals, property revals, appraisal value uplift, preference dividends & minority interests

EPS = adjusted net profit / efpowa*

ROA = adjusted ebit / average total assets

ROA Banks/Insurance = adjusted net profit / average total assets

ROE = adjusted net profit / average shareholders funds

Gross cashflow = adjusted net profit + depreciation

*equivalent fully paid ordinary weighted average number of shares

All Reported numbers for Australian/NZ listed stocks are modelled under IFRS (International Financial Reporting Standards).

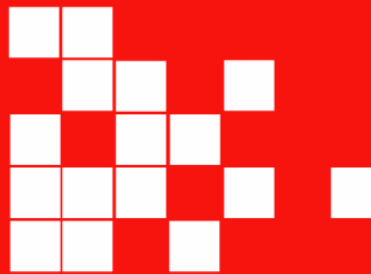
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