Oil Refining & Marketing

Price Objective Change

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RESEARCH

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Improved fundamentals but uncertainties remain

R&M companies' fundamentals better; uncertainties remain

R&M companies have made large loss in 1H FY09, which looks set to rise in 9M. Steep decline in oil prices has, however, now meant no subsidy on auto fuels and even steep fall in LPG and kerosene subsidy. The improved fundamentals should be first visible in 4Q FY09E. However large losses in 9M will mean more oil bonds will be required even in 2H for R&M companies to remain in the black in FY09E. R&M companies look well-placed to report reasonable earnings in FY10E without any oil bonds. Their FY10E earnings being as good as their best ever earnings in FY04 appears unlikely but cannot be completely ruled out. BPCL's PO is raised by 12% to Rs382 but its rating remains Neutral. We retain Buy on HPCL and IOC.

Oil bonds required in 2H FY09 to make up for large 1H loss

R&M companies have made a loss of Rs144bn in 1H FY09. We expect their loss to rise to Rs231bn in 9M if no oil bonds are accounted in 3Q. Profit is likely in 4Q but not enough to wipe out 9M losses. We estimate at least Rs300bn of oil bonds would have to be issued in 2H (Rs450bn promised in 1H) if R&M companies' FY09E earnings are to be reasonable. We expect government to issue adequate oil bonds in 2H.

FY09 EPS difficult to forecast; government policy influence

We are reasonably confident adequate oil bonds will be issued to R&M companies even in 2H to ensure reasonable FY09E earnings. However, forecasting FY09E earnings of individual R&M companies is difficult. Factors driving earnings like amount of oil bonds in 2H, companies' share in oil bonds and whether auto fuel over-recovery will be allowed in 4Q are difficult to predict.

Reasonable earnings in FY10E without oil bonds

R&M companies are likely to achieve reasonable earnings in FY10E without any oil bonds for the first time since FY05. At our Brent forecast of US$50/bbl there will be no subsidy on auto fuel but LPG and kerosene subsidy will be Rs135bn.

FY10E earnings unlikely to be as high as in FY04

R&M companies' FY10E earnings being as high as their best ever earnings of Rs51.7-61.1/share in FY04 appears unlikely. They may be able to charge higher marketing margins on auto fuel than desired like in FY04 and that too on higher volumes. However FY10E refining margin is likely to be lower than in FY04. Even interest and depreciation cost in FY10E is likely to be higher than in FY04.

BPCL's PO raised by 12% to Rs382/share but retain Neutral

We have raised BPCL's PO by 12% to Rs382/share. The rise in PO is mainly due to our valuing its core business at 8x FY09E as against 7x earlier. The higher multiple is to reflect BPCL being most leveraged to various potential upsides.

Table 1: R&M companies' per share loss in 1H FY09 and 9M FY09E

Rs/share	1H FY09	9M FY09E
Loss of		
IOC	-56	-94
HPCL	-121	-178
BPCL	-102	-159

Source: Company data, DSP Merrill Lynch

Table 2: FY09E EPS in various scenarios of oil bond sharing

Rs/share	HPCL	BPCL	IOC
FY09E EPS if oil bond sharing			
Same as in 1H FY09	9.1	28.9	41.5
Same as in FY08	25.2	42.2	32.8
So as to have less variance in earnings	25.2	33.3	35.5
Share price (Rs/share)	269	373	435
PE if oil bond sharing			
Same as in 1H FY09	29.6	12.9	10.5
Same as in FY08	10.7	8.8	13.2
So as to have less variance in earnings	10.7	11.2	12.2

Source: DSP Merrill Lynch

Refer to important disclosures on page 17 to 20. Analyst Certification on Page 15. Price Objective Basis/Risk on page 14.

R&M companies outlook

FY09E earnings outlook

Rs144bn loss for R&M companies in 1H FY09

R&M companies have made a loss of Rs144bn in 1H FY09. Loss of R&M companies was so large in 1H FY09 due to the following reasons

- Not enough oil bonds were accounted by R&M companies in 1H FY09
- Large crude and product inventory loss in 2Q FY09 due to steep decline in oil prices

Table 3: 1H FY09 losses of R&M companies

Company	Loss in 1H FY09	
	Rs-m	Rs/share
IOC	-66,320	-55.6
HPCL	-41,070	-121.2
BPCL	-36,920	-102.1
Loss of R&M companies	-144,310	

Source: Company data, DSP Merrill Lynch

Large 1H loss indicates adequate oil bonds not given

R&M companies made loss of Rs144bn in 1H FY09 despite accounting Rs450bn of oil bonds. Upstream oil companies also contributed Rs259bn to subsidy in 1H. R&M companies still had to bear Rs220bn of subsidy in 1H, which is more than Rs161bn borne by them in FY08. Rs220bn is far too high subsidy to bear for R&M companies, which explains the unprecedented high loss in 1H despite accounting of oil bonds. R&M companies clearly needed more oil bonds in 1H FY09 for them to be in the black.

Table 4: Subsidy sharing in 1H FY09 and FY08

Rs.bn	FY08	1H FY09
Subsidy	771	929
Shared by		
Upstream companies	257	259
Government (ie oil bonds)	353	450
R&M companies	161	220
Total	771	929
Share in subsidy of		
Upstream companies	33%	28%
Government (ie oil bonds)	46%	48%
R&M companies	21%	24%
Total	100%	100%

Source: MoPNG, DSP Merrill Lynch

R&M companies hit by large inventory loss in 2Q FY09

R&M companies were also hit by large crude and product inventory loss in 2Q FY09. Oil (ie Brent) prices collapsed from US$140/bbl at the beginning of 2Q FY09 to US$97/bbl at the end of 2Q. This meant large inventory loss of Rs70.4bn for R&M in 2Q. 2Q inventory losses made up for hefty gains in 1Q and meant a loss of Rs43.2bn even in 1H. R&M companies' 2Q refining margins, too, were badly hit by crude inventory loss.

Table 5: 1H FY09 inventory loss of R&M companies

Rs-bn	1H FY09
1H FY09 inventory loss of	
IOC	-39.2
HPCL	-2.0
BPCL	-2.0
Total	-43.2

Source: Company data, DSP Merrill Lynch

Loss likely even in 3Q FY09E unless oil bonds accounted

Loss if no oil bonds hit by large inventory loss & weak refining margins

We expect R&M companies to be in the red even in 3Q FY09E. Loss is likely in 3Q despite a steep decline in subsidy due to

- Subsidy is likely to be significant in 3Q at Rs110bn of which R&M companies would have to bear Rs74bn if no oil bonds can be accounted
- Large inventory loss is likely in 3Q
- Refining margins are likely to be both YoY and QoQ weaker in 3Q FY09

The large inventory loss, weak refining margins and subsidy of Rs74bn will mean R&M companies will be in the red even in 3Q.

Table 6: 1H FY09 and 9M FY09E losses of R&M companies

Rs.bn	Loss in			9M FY09E loss
Company	1H FY09	3Q FY09E	9M FY09E	Rs/share
IOC	-66.3	-46.5	-112.8	-94.6
HPCL	-41.1	-19.3	-60.4	-178.2
BPCL	-36.9	-20.7	-57.7	-159.5
Loss of R&M companies	-144.3	-86.6	-230.9	

Source: Company data, DSP Merrill Lynch

R&M companies' subsidy to be Rs74bn in 3Q unless they get oil bonds

We expect the total subsidy hit to be Rs110bn in 3Q FY09E. We expect upstream companies to bear 33% of subsidy. If no oil bonds can be accounted by R&M companies in 3Q, they will have to bear the balance subsidy of Rs74bn.

Table 7: Subsidy sharing assumed in 3Q FY09E and 9M FY09E

Rs.bn	3Q FY09E	9M FY09E
Subsidy	110	1,039
Shared by		
Upstream companies	37	296
Government (ie oil bonds)	0	450
R&M companies	74	293
Total	110	1,039
Share in subsidy of		
Upstream companies	33%	28%
Government (ie oil bonds)	0%	43%
R&M companies	67%	28%
	100%	100%

Note: No oil bonds assumed in 3Q FY09

Source: MoPNG, DSP Merrill Lynch

Rs37bn hit from inventory loss in 3Q as oil prices declined sharply

Oil prices declined further from US$95/bbl at the beginning of 3Q FY09 to US$42/bbl at the end of 3Q. The decline in oil price in 3Q at US$53/bbl is steeper than US$43/bbl in 2Q. We therefore expect large inventory loss even in 3Q for R&M companies. We estimate 3Q inventory loss of R&M companies at Rs37bn. R&M companies are believed to have in 2Q FY09 accounted inventory losses up to end October 2008, when Brent was at US$64/bbl.

Profit likely in 4Q FY09E but not enough to cover 9M losses

Sharply lower subsidy and no significant inventory loss

We expect R&M companies to be in the black in 4Q even if no oil bonds are issued. We expect subsidy to be sharply lower in 4Q FY09E on a YoY basis as well as on a QoQ basis as oil and product prices are likely to be lower.

Subsidy expected to be Rs31bn in 4Q assuming Brent at US$43/bbl

We expect subsidy on LPG and kerosene at Rs31bn in 4Q FY09 assuming Brent price to be US$43/bbl. Thus 4Q LPG and kerosene subsidy is likely to be 66% QoQ and 77% YoY lower. There is unlikely to be any subsidy on auto fuels in 4Q vis-à-vis Rs160bn in 4Q FY08 and Rs19bn in 3Q FY09E.

Subsidy may be lower in 4Q if auto fuel over-recovery continues

There has been large over-recovery on gasoline and diesel since November 2008, which helped to reduce auto fuel subsidy in 3Q FY09E to Rs19.2bn. If the over-recovery continues in 4Q FY09E, it will help make up for LPG and kerosene subsidy, which we expect to be Rs31bn in 4Q FY09E. Thus we estimate the net subsidy in 4Q FY09E after accounting over-recovery on auto fuels could be less than Rs31bn.

Marketing margins on gasoline and diesel are estimated by us at Rs9.6/litre and Rs5.4/litre in the first fortnight of January 2009. Marketing margins are thus far higher than Rs1.3/litre, which we believe is the desirable level of margins. A domestic price cut in auto fuels is soon expected, which should reduce the marketing margins. However, some over-recovery on auto fuels is likely in 4Q FY09E.

Table 8: Marketing margins on petrol and diesel price during January 1-15 2009

	Gasoline Jan 1 - 15 Rs/Kl	Diesel Jan 1 - 15 Rs/Kl
Ex-refinery price	12,210	17,709
Marketing margin	9,654	5,434
Transportation and other costs/overheads	1,328	1,209
Ex-storage price	23,192	24,353
State levies fixed	1,064	457
Excise duty	90	285
Additional excise duty	6,120	3,315
Additional excise duty (specific)	7,140	
Transportation from dealer to pump	44	44
State surcharge and sales tax	11,542	7,967
Dealer commission	848	509
Final retail price	50,040	36,930
Final retail price (INR/litre)	50.04	36.93
	Dec 16 -31	Dec 16 -31
Average petrol price (fob) -USD	39.8	54.9
Exchange rate	48.1	48.1
bbl/tonne	8.53	7.46
Tonnes to Kl	1.411	1.21
Export benefit (INR/tonne)	1,099	889
Export parity price (INR/tonne)	17,438	20,577
Export parity price (INR/kl)	12,359	17,006
Import duty	2.6%	2.6%
Import parity price (Rs/tonne)	12,146	20,722
Import parity price (Rs/kl)		17,125
Premium for 0.05% sulphur diesel		608
Trade parity price (Rs/kl)	12,210	17,709

Source: Argus, Bloomberg, DSP Merrill Lynch

Profit in 4Q not enough to make up for loss of Rs231bn in 9M FY09E

We expect R&M companies' profit in 4Q FY09E to be Rs20.8bn. We expect 9M FY09E loss of R&M companies to be Rs231bn. Thus we estimate 4Q profit will be far too low to make up for loss in 9M FY09E, which we estimate at Rs231bn.

Rs300bn or more of oil bonds needed in 2H FY09E

Loss in FY09E of Rs210bn if no oil bonds issued in 2H

R&M companies have made loss of Rs144.3bn in 1HFY09 and we estimate loss to be Rs86.6bn in 3Q FY09E. Thus loss in 9M is likely to be Rs231bn. Even a profit of Rs20.8bn would mean a loss of Rs210bn in FY09E if no more oil bonds are issued in 2H FY09E. Thus Rs300bn or more of oil bonds will have to be issued to R&M companies in 2H FY09E if their FY09E earnings are to be at reasonable level.

Indications that at least Rs300bn of oil bonds may be issued in 2H

There are some indications that enough oil bonds will be issued in 2H FY09E. However, it is not clear whether R&M companies will be allowed to account any oil bonds in 3Q.

Table 9: FY09E earnings outlook

Rs-m	HPCL	BPCL	IOC	Total
Reported loss in 1H FY09	-41,070	-36,920	-66,320	-144,310
Expected loss in 3Q FY09E	-19,352	-20,757	-46,515	-86,624
Expected profit in 4Q FY09E	2,521	2,200	16,126	20,847
FY09E loss before oil bonds	-57,901	-55,477	-96,709	-210,087
Oil bonds expected in 2H	70,102	72,692	157,206	300,000
FY09E pre-tax profit	12,201	17,215	60,497	89,913
Income tax	3,660	5,165	18,149	26,974
FY09E profit	8,541	12,051	42,348	62,939
FY09E EPS	25.2	33.3	35.5	
No. of shares	339.0	361.5	1192.4	
Share price (Rs/share)	269	373	435	
PE	10.7	11.2	12.2	

Source: DSP Merrill Lynch

Ratio of oil bonds sharing to influence R&M FY09E EPS

HPCL and BPCL's share in oil bonds assumed to be higher in 2H

Rs450bn of oil bonds were accounted by R&M companies in 1H FY09. Table 10 gives the ratio in which oil bonds were accounted by them in 1H. It also gives our assumption of the ratio in which oil bonds will be shared by R&M companies in 2H. We have assumed HPCL and BPCL to get a higher share of oil bonds in 2H than in 1H. HPCL's share in oil bonds is assumed to be 23.4% in 2H vis-à-vis 20.8% in 1H. BPCL's share in oil bonds is assumed to be 24.4% in 2H vis-à-vis 23.5% in 1H. IOC's share in oil bonds is assumed at 52.4% in 2H vis-à-vis 55.8% in 1H.

Table 10: Oil bonds accounted in 1H and assumed in FY09E

Rs.bn	HPCL	BPCL	IOC	Total
Oil bonds				
Accounted in 1H	93	105	251	450
Assumed in 2H	70	73	157	300
Oil bonds in FY09E	163	178	408	750
Share in oil bonds				
1H FY09	20.8%	23.5%	55.8%	100%
2H FY09E	23.4%	24.2%	52.4%	100%
FY09E	21.8%	23.8%	54.4%	100%
Share in oil bonds in FY08	21.8%	24.4%	53.8%	100%

Source: Companies, DSP Merrill Lynch

HPCL assumed to have same share in oil bonds in FY09E as in FY08
We have assumed that HPCL will have the same share in oil bonds in FY09E as in FY08 (ie 21.8%). HPCL had a share of only 20.8% in oil bonds accounted in 1H. We have therefore assumed it will have a much higher share of 23.4% in oil bonds in 2H so that share in FY09E is 21.8%.

IOC cheapest on FY09E PE if 2H oil bond sharing same as in 1H
Earnings of R&M companies will vary significantly depending on how oil bonds are shared in 2H. IOC will be the cheapest on FY09E PE if oil bonds sharing in 2H FY09E is the same as in 1H. IOC had a share of 55.8% in oil bonds accounted in 1H. If it has the same share in oil bonds issued in 2H as in 1H, its FY09E EPS will be Rs41.5/share and PE on FY09E EPS will be 10.5x.

Table 11: R&M companies' FY09E earnings in varying scenarios of oil bonds sharing

Rs/share	HPCL	BPCL	IOC
Scenario I			
Share in oil bonds in FY09E same as in 1H	20.8%	23.5%	55.8%
FY09E EPS	9.1	28.9	41.5
Share price (Rs/share)	269	373	435
PE	29.6	12.9	10.5
Scenario II			
Share in oil bonds in FY09E same as in FY08	21.8%	24.4%	53.8%
Share in oil bonds in 2H FY09E	23.4%	25.8%	50.9%
FY09E EPS	25.2	42.2	32.8
Share price (Rs/share)	269	373	435
PE	10.7	8.8	13.2

Source: DSP Merrill Lynch

BPCL cheapest on FY09E PE if FY09E oil bond sharing same as in FY08
BPCL will be the cheapest on FY09E PE if oil bonds sharing in FY09E is the same as in FY08. BPCL had a share of 23.5% in oil bonds accounted in 1H. Its share in oil bonds was 24.4% in FY08. Thus BPCL will have 25.8% share in oil bonds accounted in 2H if it is to have the same share in oil bonds in FY09E as in FY08. In such a scenario its FY09E EPS would be Rs42.2/share and PE on FY09E EPS will be 8.8x.

Other factors influencing FY09E earnings
Over recovery on auto fuels in 4Q and profit on sale of oil bonds
There are a few factors other than amount of oil bonds issued in 2H and sharing thereof that will also influence earnings outlook of R&M companies. They are

- Whether R&M companies will be allowed significant over-recovery on auto fuels in 4Q FY09E
- Profit R&M companies are likely to make on sale of oil bonds with high coupon rates issued in November 2008
- Refining margins R&M companies achieve in 2H FY09E

Rs1/litre over-recovery on auto fuels in 4Q to boost profit by Rs13bn
We believe that a desirable level of marketing margin on gasoline and diesel is Rs1.2/litre. As is apparent from Table 8 we estimate current marketing margins on gasoline at Rs9.65/litre and diesel at Rs5.4/litre. A price cut, which is soon expected, would reduce margins. However, some over-recovery continuing cannot be ruled out. Every Rs1/litre of over-recovery in 4Q would boost R&M companies' pre-tax profit by Rs18.75bn and net profit by Rs13bn.

BPCL most leveraged to auto fuel over-recovery; IOC least leveraged

BPCL's EPS will rise the most among R&M companies if there is over-recovery on auto fuels. We estimate its gain at Rs34.1/share in a full year if there is over-recovery of Rs1/litre on auto fuels. BPCL is thus the most leveraged to gain from over-recovery in auto fuels among R&M companies.

IOC is the least leveraged to improvement in auto fuel marketing margin with its gain in a full year from Rs1/litre over-recovery being Rs22.3/share. IOC's auto fuels sales volumes are 2.2x those of BPCL and 2.5x those of HPCL. However its equity is 3.3x that of BPCL and 3.5x of HPCL. The impact of auto fuel over-recovery on its EPS therefore is lower than that in the case of BPCL and HPCL.

Table 12: Gain of R&M companies from over-recovery in auto fuel marketing margins

	BPCL	HPCL	IOC
Auto fuel sales volumes in FY09E (m KL)	18.7	16.0	40.4
Gain from Rs1/litre rise in marketing margin			
Pre-tax gain (Rs-bn)	18.7	16.0	40.4
Post-tax gain (Rs-bn)	12.3	10.6	26.6
EPS gain (Rs/share)	34.1	31.1	22.3
EPS gain in 4Q FY09E (Rs/share)	8.5	7.8	5.6

Source: DSP Merrill Lynch

8.2% 15 years Rs220bn oil bonds issued in November 2008 now up 18%

R&M companies were issued Rs220bn of 15-year maturity oil bonds with a coupon rate of 8.2%. With yields having declined steeply, these bonds are now trading at a premium of 18% to their face value. R&M companies would thus make large gains from sale of these oil bonds at a premium to face value. R&M companies have already sold some of these bonds at lower premiums. Thus we estimate gains of R&M companies will be lower than Rs11.9-17.5/share (Table 13), which are worked out assuming all bonds are sold at 18% premium to face value.

Table 13: Gain of R&M companies if all oil bonds issued in November 2008 sold at 18% premium to face value

	BPCL	HPCL	IOC
8.2% oil bonds received in November 2008 (Rs-bn)	53.3	46.9	119.8
Gain if all bonds sold at 18% premium to face value			
Pre-tax gain (Rs-bn)	9.6	8.4	21.6
Post-tax gain (Rs-bn)	6.3	5.6	14.2
EPS gain (Rs/share)	17.5	16.5	11.9

Note: Some oil bonds have already been sold at lower premium by the R&M companies; gains will therefore be lower

Source: DSP Merrill Lynch

BPCL the most leveraged to gains from sale of high coupon rate oil bonds

BPCL's EPS gain from sale of oil bonds received in November 2008 is likely to be more than that of its peers. Its EPS gain if all these bonds are sold at 18% premium to face value would be Rs17.5/share as against Rs16.5/share in case of HPCL and Rs11.9/share in case of IOC.

Refining margins may be sharply lower in 2H FY09E

ML calculated Singapore complex refining margin averaged US$11.2/bbl in 1H FY09. Refining margins of R&M companies averaged US$4.8-7.8/bbl in 1H FY09. Singapore complex refining margin is down sharply to US$5.9/bbl in 3Q FY09 while currently Singapore margins are at US$6.1/bbl. R&M companies' refining margins are thus likely to be sharply lower in 2H than in 1H.

Table 14: Refining margins in 1H FY09 and 2H forecast

US$/bbl	1H FY09	2H FY09E
Singapore complex margin	11.2	5.0
Refining margin of		
IOC	6.4	3.0
HPCL	4.8	2.5
BPCL	7.8	2.5

Source: Companies

BPCL the most leveraged to refining margin decline, too

BPCL will be the worst hit by decline in refining margins among R&M companies. Based on expected 2H throughput, BPCL's hit from US$1/bbl decline in refining margin would be Rs6.8/share vis-à-vis Rs5.8/share for HPCL and IOC.

Table 15: Hit to R&M companies of decline in refining margins in 2H

	BPCL	HPCL	IOC
Crude throughput in 2H FY09E (mmt)	10.6	8.4	29.5
Hit from US$1/bbl decline in refining margin			
Pre-tax hit (Rs-bn)	3.7	3.0	10.4
Post-tax hit (Rs-bn)	2.5	2.0	6.9
EPS hit (Rs/share)	6.8	5.8	5.8

Source: DSP Merrill Lynch

Reasonable earnings likely for R&M companies in FY09E

Several uncertainties make forecasting FY09E earnings difficult

To conclude, we expect government to issue adequate oil bonds to R&M companies in 2H FY09E. Thus we expect them to be in the black and also to report a reasonable level of earnings in FY09E.

However, as discussed, there are several factors that will influence FY09E earnings of R&M companies. Several of these factors, like amount of oil bonds in 2H, share in oil bonds and when auto fuel over-recovery, will be allowed in 4Q are government policy. These factors are therefore difficult to predict.

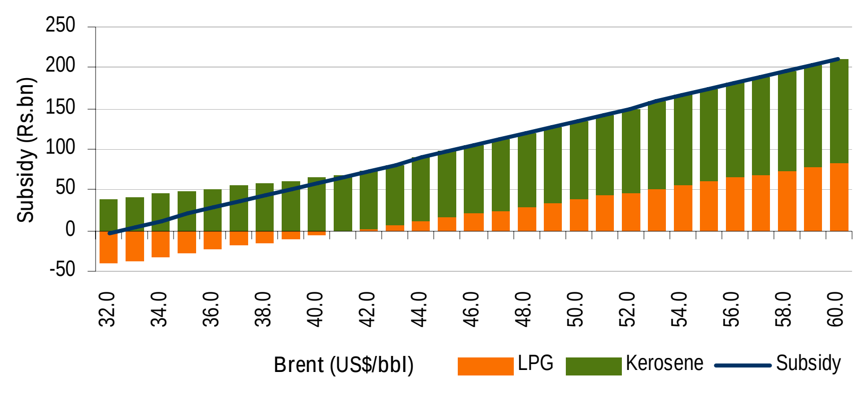
FY10E earnings outlook

Reasonable level of earnings likely without oil bonds

LPG and kerosene subsidy likely even in FY10E

R&M companies were in the black without oil bonds in FY03-FY05 after the oil sector was deregulated in April 2002. Since FY06 for four years even auto fuels were subsidized and therefore subsidy was very high. R&M companies therefore had to be issued oil bonds in FY06-FY09E to keep them in the black. In FY10E at our oil price forecast of US$50/bbl, we think there is unlikely to be any subsidy on auto fuels but subsidy on LPG and kerosene is likely to continue. We expect a reasonable level of earnings for R&M companies without oil bonds in FY10E.

Chart 1: FY10E LPG and kerosene subsidy estimates at Brent price of US$32-60/bbl



Source: DSP Merrill Lynch

LPG and kerosene subsidy Rs135bn at US$50/bbl

No LPG and kerosene subsidy if Brent price below US$33/bbl

We estimate LPG and kerosene subsidy to be Rs135bn in FY10E at our Brent price forecast of US$50/bbl. We estimate that there will be no LPG and kerosene subsidy if Brent price is below US$33/bbl. In fact there should be no LPG subsidy if Brent is below US$42/bbl. Brent will, however, have to decline to US$20/bbl for there to be no subsidy on kerosene. Our calculations assume the exchange rate to be Rs46 vis-à-vis US dollar, kerosene price to be 1.2x Brent price and LPG price to be 1.05x Brent price.

Main factors influencing R&M companies' FY10E earnings

We believe that the following factors will determine R&M companies' FY10E earnings

- Average international price of oil and the subsidized products. As discussed, if oil price is below US$32/bbl there is likely to be no LPG and kerosene subsidy.
- Whether R&M companies will be allowed some over-recovery on auto fuels in FY10E
- Refining margins of R&M companies in FY10E

Weak oil price & over-recovery being allowed positive for FY10E outlook

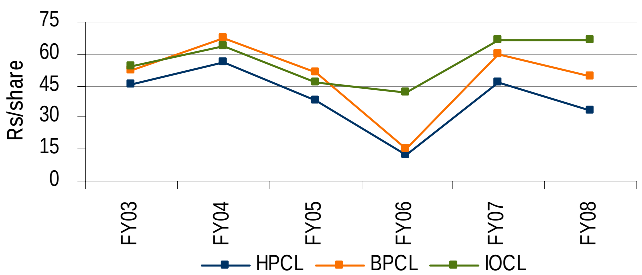
Oil price being significantly lower than US$50/bbl would be positive for R&M companies. This is because it would mean lower LPG and kerosene subsidy. Over-recovery being allowed on auto fuels would also be positive for R&M companies. If oil prices are low then it would be easier to allow over-recovery on auto fuels.

Competition from RIL and other private players to limit over-recovery

R&M companies were able to enjoy over-recovery on auto fuels in FY04. However, at that time there was no real competition from RIL and other private players like Essar Oil. RIL and Essar Oil have thereafter created network of over 1,000 petrol stations each. These private players at one stage in FY06 had managed to get market share of close to 15% in auto fuels.

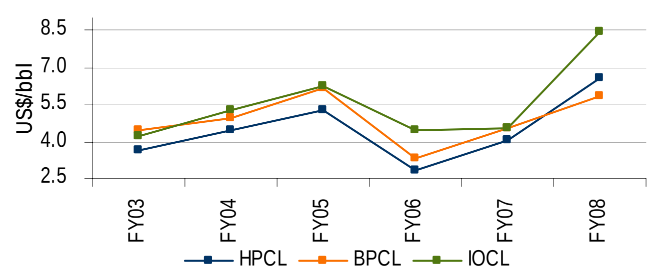
These players stopped retailing after subsidies surged in FY08. We think they are likely to re-enter auto fuel retailing. Competition from private players is likely to limit over-recovery on auto fuels.

Chart 2: Earnings trend of HPCL, BPCL and IOCL



Source: Company data and DSP Merrill Lynch

Chart 3: Refining margins trend of HPCL, BPCL and IOCL



Source: Company data and DSP Merrill Lynch

Refining margins likely to be weak in FY10E

Duty protection far lower than in FY01-FY03 when margins last weak

We expect Singapore complex refining margins to be US$4.2/bbl in FY10E. R&M companies' refining margins could be lower than at any time since deregulation in FY03. Regional refining margins were weak even until FY03. However, at that time there was significant import duty protection, which boosted refining margins. There is hardly any import duty protection now. R&M companies have upgraded their refineries over the last 3-4 years but still 30-50% of the crude used by them is light crude like Mumbai High or Bonny Light.

Other factors influencing R&M companies' share price

There are other factors that are also likely to influence share price performance of R&M companies. These are

- Whether pricing freedom is given, at least in case of auto fuels
- Whether a road map is put in place and implementation started for elimination or better targeting of LPG and kerosene subsidy

Expected auto fuel price cut has to be accompanied by pricing freedom

Domestic prices of auto fuels are soon likely to be cut. There is also expectation that price cuts will be accompanied by freedom to R&M companies to price auto fuels in future. We believe that pricing freedom being given is crucial for investor sentiment in R&M companies remaining favorable. Pricing freedom is also key to ensure subsidy situation does not worsen when oil prices rise again like it did since FY06.

Road map & steps to eliminate LPG & kerosene subsidy will be a positive

The government approving a road map for elimination or better targeting of LPG and kerosene subsidy and implementing it would be a big positive. Any such development is likely to improve investor sentiment in R&M companies and could even boost FY10E earnings.

Road map & steps to eliminate subsidy likely only after 2009 elections

Approval of any road map to eliminate or better target subsidy is only likely after the parliamentary elections due in mid-2009, in our view. Any such road map is likely only if a strong and reform oriented government confident of lasting for five years comes to power after the elections.

FY10E earnings likely to be similar to FY09E

FY10E earnings quality better than FY09E as without oil bonds

Low oil prices, which we expect in FY10E, suggest FY10E earnings of R&M companies are likely to be similar to those in FY09E. However FY10E earnings quality is likely to be better as it is likely to be achieved without any oil bonds.

FY10E earnings unlikely to be as high as in FY04

R&M companies reported their highest earnings without the aid of oil bonds in FY04. R&M companies may be able to achieve similar marketing margins (Rs1.5-2/litre) on auto fuels in FY10E as in FY04. Auto fuel sales volumes would be higher due to volume growth since then. However, we think FY10E earnings of R&M companies are not likely to be as high as in FY04 due to the following reasons

- FY10E refining margins of R&M companies are likely to be significantly lower than US$4.5-5.2/bbl achieved by them in FY04. Our Singapore complex refining margin forecast for FY10E is just US$4.2/bbl. R&M companies' margins are likely to be lower than Singapore margins due to substantial light crude they still use
- R&M companies' interest and depreciation cost in FY10E is likely to be significantly higher than in FY04. Substantial capex incurred since then will mean higher depreciation cost. R&M companies' net debt, which was Rs15-132bn in March 2004, is now up to Rs102-235bn in December 2008 net of oil bonds.

Table 16: R&M companies' recurring EPS and refining margin in FY04

	FY04	
	EPS	Refining margins
	Rs/share	US$/bbl
HPCL	51.7	4.5
BPCL	55.4	4.9
IOCL	61.1	5.2

Source: Companies, DSP Merrill Lynch

Table 17: Net Debt of R&M companies

	Net debt as of		
Rs-bn	Mar-04	Dec-08	Dec-08 (adjusted for oil bonds)
HPCL	15	260	133
BPCL	37	250	102
IOCL	132	550	235
	184	1,060	470

Source: DSP Merrill Lynch

Upgrade BPCL PO by 12% to Rs382/share

BPCL valued on 8x FY09E EPS as against 7x FY09E earlier

We have upgraded BPCL's (BPCL, C-2-7, Rs373.45) PO by 12% to Rs382/share from Rs342/share earlier. The upgrade is mainly due to BPCL's core business now being valued at 8x FY09E EPS as against 7x FY09E EPS earlier. Its core business is now valued at Rs362/share. Value of BPCL's investments is now down to Rs21/share from Rs26/share earlier.

Table 18: Upgrade in BPCL's PO

Rs/share	New	Old	Change
FY09E EPS	45.2	45.2	0%
PER (x)	8.0	7.0	
Core business value	362	316	14%
Add: value of investments	21	26	-20%
Price objective	382	342	12%

Source: DSP Merrill Lynch

Upgrade done as BPCL most leveraged to likely upsides

The main reason for using a higher multiple to value BPCL now is the fact that BPCL is the most leveraged to various possible earnings upsides. The likely upsides to FY09E earnings are over-recovery on auto fuels and profit on sale of 8.2% oil bonds received in November 2008.

Retain Buy on HPCL, IOC and Neutral on BPCL

FY09E earnings outlook

The key points we would like to make on FY09E earnings outlook are

- R&M companies have Rs144bn of loss in 1H FY09E, which we expect may rise to Rs231bn in 9M FY09E if no additional oil bonds are accounted in 3Q
- HPCL has the highest loss on Rs/share basis, while IOC's loss is the least on Rs/share basis in 1H FY09. We expect this to be the case even in 9M FY09E
- R&M companies are likely to be in the black without oil bonds in 4Q
- 4Q profit will not be adequate to make up for large loss in 9M FY09E. Thus additional oil bonds of Rs300bn or more have to be issued in 2H if R&M companies are to report reasonable earnings in FY09E
- We expect adequate oil bonds to be issued in 2H FY09E so that R&M companies have reasonable earnings in FY09E
- FY09E earnings outlook of the three R&M companies will be determined by several factors on which adequate clarity is not available.
- How much oil bonds are issued in 2H and how oil bonds will be shared among R&M companies in 2H FY09E are two such factors.

- Whether significant over-recovery is allowed on auto fuels in 4Q and profit made on sale of oil bonds with high coupon rates will also influence FY09E earnings.
- Refining margins R&M companies earn in 2H will also influence their FY09E earnings

FY10E earnings outlook

The key points we would like to make on FY10E earnings outlook are

- Marketing margins on auto fuels in FY10E could be similar to Rs1.5-2/litre achieved by the R&M companies in FY04. Auto fuel volumes will be far higher due to volume growth since then
- FY10E refining margins of R&M companies are likely to be lower than US$4.5-5.2/bbl achieved by them in FY04. We expect Singapore complex margins to be US$4.2/bbl in FY10E. R&M companies' margins are likely to be lower due to more expensive light crude still being 40-50% of their crude mix and steep decline in import duty protection
- FY10E earnings are likely to be similar to FY09E but the quality of earnings should be better as these earnings are likely without oil bonds
- FY10E earnings of R&M companies are likely to be lower than Rs51.7-61.1/share attained by them in FY04 due to lower refining margins, higher interest and depreciation cost
- FY10E earnings of R&M companies being similar to FY04 or even higher cannot be completely ruled out. This is possible if over-recovery on auto fuels in FY10E is at least similar to that in FY04, FY10E refining margins are not significantly lower than in FY04 and subsidies are significantly lower than in FY04. LPG and kerosene subsidies could be lower in FY10E than in FY04 either because oil prices are lower or because domestic price are raised. It is also possible that R&M companies have to bear no, or much lower, LPG and kerosene subsidy.

FY09-FY10E earnings kept unchanged

We are keeping FY09-FY10E earnings forecast unchanged. Table 19 gives our FY09-FY10E EPS forecast of the R&M companies.

Table 19: R&M companies' FY09E and FY10E EPS

Rs/share	FY09E	FY10E
IOC	57.2	61.6
HPCL	37.3	36.8
BPCL	45.2	34.6

Source: DSP Merrill Lynch

Retain Buy on HPCL and IOC; Neutral on BPCL

We retain our Buy rating on HPCL (HPCL, C-1-7, Rs267.75). HPCL is the cheapest among R&M companies on Price/Book value at 0.83x.

We also retain our Buy on IOC (IOCOF, C-1-7, Rs434.75). IOC's PO offers the most potential upside among R&M companies, at 17%. IOC also has rebounded the least (38%) among R&M companies from its July 2008 low of Rs315/share. BPCL and HPCL have rebounded by 56-74% from their lows in July 2008.

We retain our Neutral rating on BPCL. BPCL's PO offers the least potential upside among R&M companies, at 2%. The stock has also been the best performer among R&M companies in the last six months.

RC

Table 20: Stock performance of R&M companies

Rs/share	HPCL	BPCL	IOCL
Closing price on			
1-Jan-08	367	520	777
1-Jul-08	175	216	315
Stock price fall	-52%	-58%	-60%
1-Jul-08	175	216	315
6-Jan-08	269	373	435
Stock bounce back	54%	73%	38%

Source: Bloomberg, DSP Merrill Lynch

Price objective basis & risk

BPCL (XBPCF)

Our PO of Rs382/share is based on P/E of 8.0x on BPCL's FY09E consolidated EPS of Rs45.2/share. It also includes the market value of investments in Indraprastha Gas (IGL) and Petronet LNG (PLNG) of Rs21/share. Our FY09E earnings for BPCL are marginally higher than FY08 but lower than FY07 earnings. The P/E multiple we use to value BPCL is below the average FY09E/2008E P/E for Asian refiners. At our PO BPCL's FY09E EV/EBITDA is below average EV/EBITDA for Asian refiners universe. We have not used DCF based valuation as given the huge uncertainties it is very difficult to forecast earnings reasonably accurately beyond a 1 year timeframe. Hence we have based our PO on P/E basis. Upside risks: (1) The amount of oil bonds issued by the government is higher than our expectations, (2) Government eliminates subsidies on all products, (3) Refining margins are higher than forecast by us, (4) Rise in market prices of IGL and PLNG. Downside risks: (1) Government fails to issue enough oil bonds to keep BPCL in the black, (2) government reverts to a cost-plus-based regulated pricing mechanism, (3) steep decline in regional and hence BPCL's refining margins to levels below assumed by us, and (4) steep decline in market prices of IGL and PLNG.

Hindustan Petro. (XHTPF)

Our PO of Rs282 is based on a modest PE of 6.0x on FY09E EPS of Rs37. It also includes the market value of 17pct stake in refiner MRPL (ONGC's subsidiary) of Rs58. The PE multiple we use to value HPCL is lower than the average 2008E PE for Asian refiners. At our PO HPCL's FY09E EV/ EBITDA is below average EV/EBITDA for Asian refiners universe. We have not used DCF based valuation because uncertainties make it very difficult to forecast earnings reasonably accurately beyond a one-year timeframe. Hence we based our PO on P/E. Upside risks: (1) PO does not include any value for its E&P assets. Its service contract to produce 180mn bbls of oil from ONGC's cluster-7 marginal field may be worth Rs32/share. Downside risks: (1) Government does not issue enough oil bonds to keep HPCL in the black, (2) government reverts to a cost-plus-based regulated pricing mechanism, (3) steep decline in regional and hence HPCL's refining margins, and (4) steep decline in the market price of MRPL.

IOC (IOCOF)

Our PO of Rs507/share is based on PE of 7.0x on IOC's FY09E consolidated EPS of Rs57/share. Our PO also includes market value of IOC's investments in ONGC, Petronet LNG and GAIL of Rs142/share. The PE multiple used by us to value IOC is lower than average Asian refiners FY09E/2008E PE. At our PO, IOC's FY09E EV/EBITDA is below average EV/EBITDA for the Asian refiners universe. We have not used DCF based valuation as the huge uncertainties make it very difficult to forecast earnings reasonably accurately beyond a one-year timeframe. Hence we based our PO on a P/E basis. Downside risks:
(1) Government fails to issue enough oil bonds to keep IOC in the black,
(2) government reverts to a cost-plus-based regulated pricing mechanism,
(3) steep decline in regional and hence IOC's refining margins to levels below assumed by us, and 4) Steep decline in market price of ONGC, Petronet LNG and GAIL.

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	China BlueChem	CBLUF	3983 HK	Timothy Bush
	Hindustan Petro.	XHTPF	HPCL IN	Vidyadhar Ginde
	IOC	IOCOF	IOCL IN	Vidyadhar Ginde
	ONGC	ONGCF	ONGC IN	Vidyadhar Ginde
	Reliance Inds	XRELF	RIL IN	Vidyadhar Ginde
	Reliance Inds -G	RLNIY	RIGD LI	Vidyadhar Ginde
	Sinofert HLDG	SNFRF	297 HK	Timothy Bush
	SK Holdings	SKCXF	003600 KS	Sonia Song
NEUTRAL				
	Aban Offshore L	XBWTF	ABAN IN	Vidyadhar Ginde
	BPCL	XBPCF	BPCL IN	Vidyadhar Ginde
	Shell Refining	SRMMF	SHELL MK	Sonia Song
UNDERPERFORM				
	Formosa Chems	XFUMF	1326 TT	Sonia Song
	Formosa Petro	FPTCF	6505 TT	Sonia Song
	Formosa Plastics	FSAPF	1301 TT	Sonia Song
	GS Holdings Corp	GSHDF	078930 KS	Duke Suttikulpanich
	Hanwha Chem Corp	HAYCF	009830 KS	Stephan Han
	Honam Petrochem	HBBHF	011170 KS	Stephan Han
	LG Chem Ltd	LGCLF	051910 KS	Stephan Han
	Nan Ya Plastics	NNYPF	1303 TT	Sonia Song
	Petronet LNG Ltd	POLNF	PLNG IN	Vidyadhar Ginde
	RPL	RPLUF	RPET IN	Vidyadhar Ginde

APR - Energy Coverage Cluster

Investment rating	Company	ML ticker	Bloomberg symbol	Analyst
	SK Energy Co Ltd	XVERF	096770 KS	Sonia Song
	S-Oil Corp	SOOCF	010950 KS	Duke Suttikulpanich
	SPC	SPCJF	SPC SP	Duke Suttikulpanich
REVIEW				
	CNOOC Ltd.	CEO	CEO US	Bin Guan
	CNOOC Ltd.	CEOHF	883 HK	Bin Guan
	COS Limited	CHOLF	2883 HK	Bin Guan
	Gushan Environmental Energy	GU	GU US	Bin Guan
	Petrochina	PCCYF	857 HK	Bin Guan
	Petrochina - A	PTR	PTR US	Bin Guan
	Sinopec	SNPMF	386 HK	Bin Guan
	Sinopec - A	SNP	SNP US	Bin Guan

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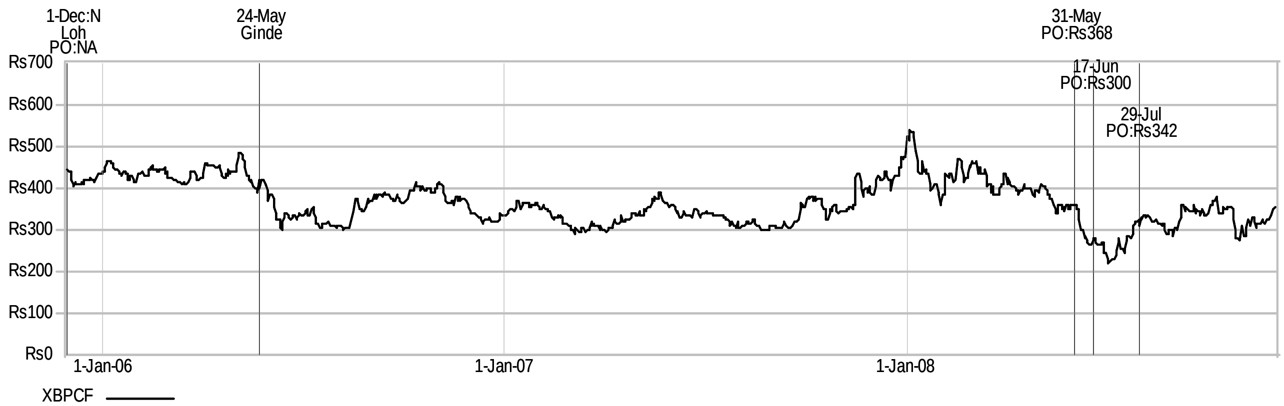
XBPCF Price Chart



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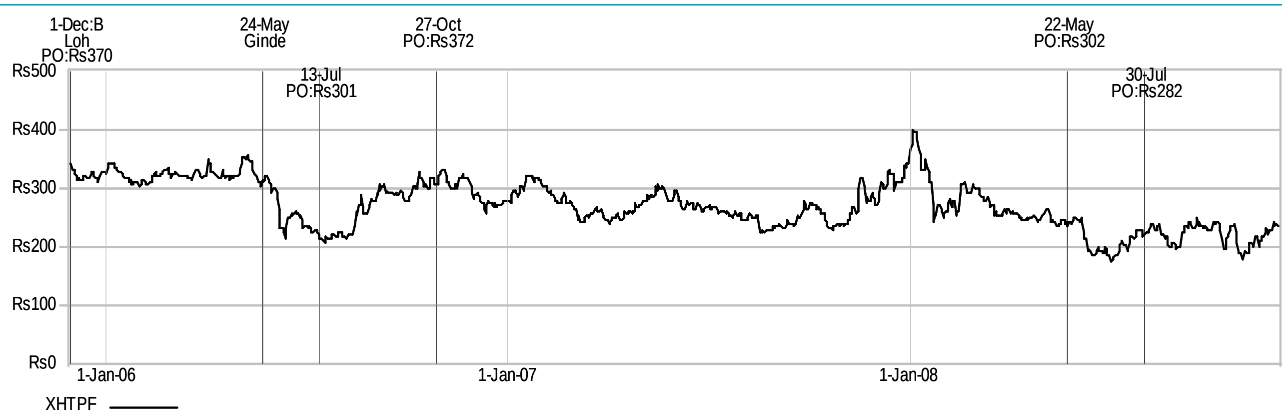
XHTPF Price Chart



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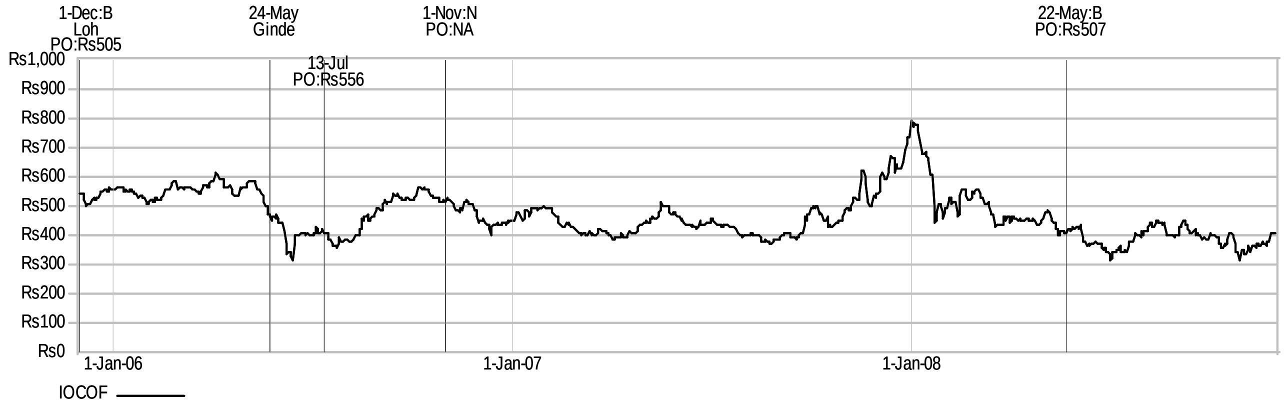
IOCOF Price Chart



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Buy	115	43.89%	Buy	37	36.63%
Neutral	60	22.90%	Neutral	19	36.54%
Sell	87	33.21%	Sell	12	15.79%

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Neutral	859	25.47%	Neutral	210	28.23%
Sell	1216	36.06%	Sell	229	20.71%

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