Hindustan Petro.

Rating Change UNDERPERFORM

Equity | India | Oil Refining & Marketing
01 June 2009

Bank of America Merrill Lynch

RESEARCH

PO implies 19% potential downside

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PO implies 19% potential downside; cut to Underperform

HPCL's share price is up 40% since the election results on 16 May on hopes that auto fuel pricing may be freed up. Even as investors turn bullish, the FY10E earnings outlook has deteriorated, in our view. Auto fuel marketing margins were at supernormal levels until March 2009, but have collapsed and turned negative. Even if auto fuel prices are freed up, only a normal auto fuel margin is likely in FY10E. In this scenario, we only expect a healthy FY10E EPS if oil bonds are issued. HPCL's new PO of Rs291.4, based on base-case FY10E EPS, implies 19% potential downside. Thus we downgrade HPCL from Buy to Underperform.

Cut FY10E EPS 20% on drop in auto fuel marketing margins

We already assumed weak refining margins and significant LPG and kerosene subsidies in FY10E. We were earlier assuming a supernormal auto fuel margin of Rs2/l (US$7/bbl) in FY10E. Auto fuel margins have collapsed since March 2009 and are now negative. Margins to date in 1Q FY10 are Rs0.7/l. Assuming auto fuel pricing is freed up, FY10E margins would be Rs1.1/l. A lower auto fuel margin would have meant EPS of just Rs1.3. Assuming Rs13.6bn of oil bonds limits our FY10E EPS cut to 20% to Rs29.

Base- and worst-case PO implies 19-81% potential downside

We calculate HPCL's PO on three FY10E EPS scenarios. PO based on base- and worst-case EPS implies 19-81% potential downside. PO based on best-case EPS implies 18% potential upside. However, the best-case EPS, which assumes a supernormal auto fuel margin of Rs2/l and Brent at US$50/bbl, is improbable, in our view.

HPCL to be in red in FY09E

In 9M FY09, HPCL booked a pretax loss of Rs133/share. Although we expect a 4Q pretax profit of Rs114/share, this still means red for HPCL in FY09E

Estimates (Mar)

(Rs)	2007A	2008A	2009E	2010E	2011E
Net Income (Adjusted - mn)	15,712	11,349	(4,500)	9,832	14,667
EPS	46.35	33.48	(13.27)	29.01	43.27
EPS Change (YoY)	287.4%	-27.8%	NM	NM	49.2%
Dividend / Share	18.02	3.00	0	11.00	16.00
Free Cash Flow / Share	58.25	(5.12)	(116.96)	60.93	71.79

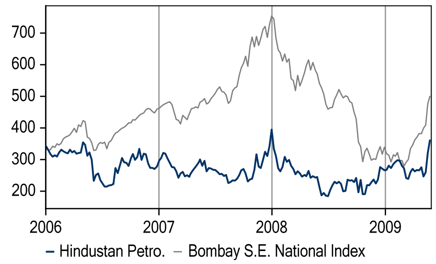
Valuation (Mar)

	2007A	2008A	2009E	2010E	2011E
P/E	7.83x	10.84x	NM	12.51x	8.39x
Dividend Yield	4.96%	0.826%	0%	3.03%	4.41%
EV / EBITDA*	9.43x	14.63x	13.82x	8.89x	7.80x
Free Cash Flow Yield*	16.05%	-1.41%	-32.23%	16.79%	19.78%

* For full definitions of *iQmethod* SM measures, see page 8.

Stock Data

Price	Rs360.00
Price Objective	Rs304.99 to Rs291.40
Date Established	1-Jun-2009
Investment Opinion	C-1-7 to C-3-7
Volatility Risk	HIGH
52-Week Range	Rs163.25-Rs398.00
Mrkt Val / Shares Out (mn)	US$2,590 / 339.0
Average Daily Volume	1,765,946
ML Symbol / Exchange	XHTPF / BSE
Bloomberg / Reuters	HPCL IN / HPCL.BO
ROE (2009E)	-4.4%
Net Dbt to Eqty (Mar-2008A)	156.1%
Est. 5-Yr EPS / DPS Growth	NA / NA
Free Float	49.0%



Refer to important disclosures on page 9 to 11. Analyst Certification on Page 7. Price Objective Basis/Risk on page 7.

iQprofile SM Hindustan Petro.

Key Income Statement Data (Mar)	2007A	2008A	2009E	2010E	2011E
(Rs Millions)					
Sales	890,413	1,047,038	1,348,520	852,691	1,051,280
Gross Profit	25,147	16,659	18,546	26,850	39,792
Sell General & Admin Expense	(1,051)	(1,119)	(2,095)	(1,268)	(10,629)
Operating Profit	17,056	7,032	6,483	15,303	18,334
Net Interest & Other Income	2,615	4,055	(13,100)	(844)	3,235
Associates	NA	NA	NA	NA	NA
Pretax Income	19,672	11,087	(6,617)	14,459	21,569
Tax (expense) / Benefit	(3,960)	262	2,117	(4,627)	(6,902)
Net Income (Adjusted)	15,712	11,349	(4,500)	9,832	14,667
Average Fully Diluted Shares Outstanding	339	339	339	339	339
Key Cash Flow Statement Data					
Net Income	15,712	11,349	(4,500)	9,832	14,667
Depreciation & Amortization	7,040	8,508	9,968	10,280	10,828
Change in Working Capital	NA	NA	NA	NA	NA
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	37,663	8,724	(44,608)	10,543	8,838
Cash Flow from Operations	60,415	28,581	(39,139)	30,655	34,334
Capital Expenditure	(40,671)	(30,316)	(505)	(10,001)	(10,000)
(Acquisition) / Disposal of Investments	(30,998)	2,904	(27,730)	59,600	(45,000)
Other Cash Inflow / (Outflow)	0	0	0	0	NA
Cash Flow from Investing	(71,670)	(27,412)	(28,234)	49,599	(55,000)
Shares Issue / (Repurchase)	5	21	0	0	NA
Cost of Dividends Paid	(3,916)	(4,312)	(1,064)	0	(6,115)
Cash Flow from Financing	24,199	(11,062)	69,500	(75,000)	(55,115)
Free Cash Flow	19,743	(1,735)	(39,644)	20,654	24,334
Net Debt	104,307	164,927	212,934	74,308	28,766
Change in Net Debt	15,166	3,122	68,438	(80,254)	26,781
Key Balance Sheet Data					
Property, Plant & Equipment	130,644	152,452	112,989	112,710	111,882
Other Non-Current Assets	71,275	68,371	126,100	66,500	21,500
Trade Receivables	15,778	17,107	22,408	14,217	17,549
Cash & Equivalents	868	2,940	5,066	5,692	2,234
Other Current Assets	98,001	172,927	205,902	109,758	132,736
Total Assets	316,566	413,796	472,466	308,878	285,902
Long-Term Debt	26,707	32,436	103,000	28,000	6,000
Other Non-Current Liabilities	15,933	17,871	15,653	15,653	15,653
Short-Term Debt	78,469	135,431	115,000	52,000	25,000
Other Current Liabilities	99,471	122,426	137,680	106,465	123,936
Total Liabilities	220,579	308,164	371,333	202,118	170,589
Total Equity	95,987	105,632	101,133	106,760	115,313
Total Equity & Liabilities	316,566	413,796	472,466	308,878	285,902
iQmethod* SM - Bus Performance					
Return On Capital Employed	8.9%	4.2%	2.3%	5.3%	7.5%
Return On Equity	17.1%	11.3%	-4.4%	9.5%	13.2%
Operating Margin	1.9%	0.7%	0.5%	1.8%	1.7%
EBITDA Margin	2.7%	1.5%	1.2%	3.0%	2.8%
iQmethod* SM - Quality of Earnings					
Cash Realization Ratio	3.8x	2.5x	NM	3.1x	2.3x
Asset Replacement Ratio	5.8x	3.6x	0.1x	1.0x	0.9x
Tax Rate (Reported)	20.1%	NM	32.0%	32.0%	32.0%
Net Debt-to-Equity Ratio	108.7%	156.1%	210.5%	69.6%	24.9%
Interest Cover	4.0x	0.9x	0.3x	1.5x	6.0x
Key Metrics					

* For full definitions of *iQmethod* SM measures, see page 8.

Company Description

HPCL is a refining & marketing company and has two refineries with a total capacity of 270kbpd. It also has a 17% stake in MRPL refinery (180kbpd). LPG, kerosene, diesel and gasoline prices (71% of marketing volumes) are regulated, which impacts HPCL's earnings as international oil prices fluctuate. Refining margins, however, track international margins. Govt owns 51% of HPCL.

Investment Thesis

A comprehensive solution to the subsidy problem plaguing HPCL and peers appears unlikely in the foreseeable future. HPCL has reported lower earnings than its peers since FY06. Its average refining margin in the last seven years is also lower than peers. HPCL has similar number of petrol stations as BPCL but its auto fuel sales volume are 15% lower than that of BPCL. Peer BPCL is a better play on rise in auto fuels than HPCL. Earnings of peer IOC are more stable than that of HPCL.

Stock Data

Price to Book Value	1.2x

HPCL to be in red in FY09E

Loss of Rs133/share in 9M FY09

Hit by large subsidies, high inventory loss and weak refining margin

HPCL was deeply in the red in 9M FY09 due to large subsidies, a high inventory loss and weak refining margins (crude inventory loss). HPCL's 9M FY09 loss was Rs133/share.

Table 1: HPCL FY09E earnings outlook

	HPCL	
	Rs-m	Rs/share
9M FY09 pre-tax loss	(45,191)	-133.3
Oil bonds in 4Q FY09	20,390	60.2
Upstream contribution in 4Q FY09	5,600	16.5
Profit from operations in 4Q FY09E	12,584	37.1
4Q FY09 pre-tax profit	38,574	113.8
Pre-tax profit/loss	(6,617)	-19.5
Tax	(2,117)	-6.2
Standalone profit/(loss)	(4,500)	-13.3
No. of shares (m)	339	

Source: Companies, Banc of America Securities - Merrill Lynch

4Q profit of Rs114/share still not enough to cover 9M loss

Strong operating profit; also large oil bonds and upstream contribution

Even as oil and product prices declined steeply, the domestic auto fuel price was cut after a delay. Consequently there was supernormal margin on auto fuels of Rs4/l (normal level is Rs1.2/l) in 4Q FY09. We thus expect Rs37.1/share pretax profit from operations in 4Q FY09E. Oil bonds and upstream contributions of Rs76.7/share will likely further boost 4Q earnings. We expect 4Q pretax profit of Rs113.8/share. 4Q EPS may not be enough to cover the 9M loss and thus HPCL would be in the red in FY09E.

FY10E earnings outlook

Cut EPS by 20% to Rs29.0 as auto fuel margins cut

Auto fuel margin assumed at Rs1.1/l; Rs13.6bn oil bonds assumed

We already assumed weak refining margins and significant LPG and kerosene subsidies in FY10E. However, we were earlier assuming FY10E auto fuel margin at a supernormal Rs2/l (US$7/bbl).

Auto fuel margins have collapsed since March 2009 and are now negative. Margins to date in 1Q FY10 are Rs0.7/l. If auto fuel pricing is freed up, FY10E margins would be Rs1.1/l, still lower than the Rs2/l previously assumed. A cut in the auto fuel margin would have meant EPS of just Rs1.3. We assumed HPCL will get Rs13.6bn of oil bonds, equivalent to one-third of its LPG and kerosene subsidy hit. Assuming oil bonds, we have limited our FY10E EPS cut to 20% at Rs29.

FY10E EPS also calculated in worst and best case scenarios

Supernormal auto fuel margin and Brent at US$50/bbl in best case

We also calculate HPCL's FY10E EPS in the best case of Rs40.8. The main assumptions of best case EPS are:

- Auto fuel margin of Rs2/litre vis-à-vis Rs1.1/l in base case
- FY10E average Brent price at US$50/bbl vis-à-vis US$56/bbl in base case

Table 2: HPCL's FY09-FY10E EPS and PE

Rs/share	
FY09E EPS	-13.3
FY10E EPS	
Base case	29.0
Best case	40.8
Worst case	1.3
Share price	360
P/E	
FY09E	NA
FY10E base case	12.4
FY10E best case	8.8
FY10E worst case	287.3

Source: Bloomberg, Banc of America Securities - Merrill Lynch

Worst case EPS based on assumption no oil bonds in FY10E

HPCL's EPS in worst case is Rs1.3. It is based on the same assumptions as the base case except for the fact that no oil bonds are assumed.

HPCL's price objective

HPCL's PO cut 4% to Rs291

HPCL's PO is based on FY10E EPS and includes the value of HPCL's investments. Our cut in HPCL's FY10E EPS of 20% has led to a 4% cut in its PO to Rs291. The decline in PO is more modest than the EPS cut as a higher P/E of 8x as against 7x earlier is assumed. The value of HPCL's investment is also up 84% to Rs66/share.

PO also calculated based on best and worst case FY10E EPS

PO on best case EPS at Rs426; worst case EPS Rs69

We have also calculated HPCL's PO based on FY10E best and worst case EPS. PO based on best case EPS is Rs426 and that on worst case EPS is just Rs69.

Table 3: HPCL's Potential upside or downside based on PO in three scenarios

Rs/share	
Price objective in	
Base case	291
Best case	426
Worst case	69
Current share price	360
Potential upside/downside in	
Base case	-19%
Best case	18%
Worst case	-81%

Source: Banc of America Securities - Merrill Lynch

Lower HPCL from Buy to Underperform

Base and worst case PO imply 19-81% potential downside

We have calculated HPCL's PO based on three FY10E EPS scenarios. PO based on base and worst case EPS implies 19-81% potential downside.

PO based on best case FY10E EPS at Rs426 implies 18% potential upside. However, best case EPS, which assumes a supernormal auto fuel margin of Rs2/l and Brent at US$50/bbl, is improbable, in our view. We downgrade HPCL from Buy to Underperform.

Appendix

HPCL's income statement comparison

Income statement in FY03-FY05 and in FY10E

No auto fuel subsidy in FY03-FY05 and FY10E

Table 4 gives HPCL's income statement in FY03-FY05 and FY10E in two scenarios. In FY03-FY05 there were healthy marketing margins on auto fuels and no oil bonds were needed to achieve healthy earnings.

Oil bonds needed in FY10E; Rs13.6bn of oil bonds assumed in base case

In FY10E, marketing margins on auto fuels are healthy but still HPCL will likely be barely in the black if no oil bonds are issued. In base case we have assumed Rs13.6bn of oil bonds for HPCL. This would boost EPS to Rs29.

Table 4: HPCL's income statement

Rs-m	FY03	FY04	FY05	FY10E	
				Base case	Worst case
Refining	12,558	15,353	19,174	11,495	11,495
Inventory loss/gain	9,000	-643	5,500	4,463	4,463
Subsidy hit	-11,750	-13,968	-25,300	-13,623	-27,247
Lubes	3,490	2,500	3,000	3,850	3,850
Pipelines	1,200	1,200	1,250	2,400	2,400
Arrears	0	1,160	0	0	0
Marketing	14,021	26,257	16,887	16,996	16,996
EBITDA	28,518	31,858	20,511	25,582	11,958
Depreciation	-5,719	-6,054	-6,584	-10,280	-10,280
Interest	-1,530	-557	-816	-10,430	-10,640
Other income	2,859	3,794	3,295	9,586	9,586
Extraordinary items	-10	762			0
Pre-tax profit	24,118	29,804	16,406	14,458	625
Tax	-8,744	-10,765	-3,633	-4,627	-200
Net profit	15,374	19,039	12,773	9,831	425
Shares outstanding	339	339	339	339	339
EPS (Rs/share)	45.4	56.2	37.7	29.0	1.3
Assumptions					
Brent price (US$/bbl)	27.5	29.0	42.2	56.0	56.0
Refining margin (US$/bbl)	3.7	4.5	5.3	3.0	3.0
Crude throughput (mmt)	12.9	13.7	13.9	17.0	17.0
Auto fuel marketing margin	0.7	1.8	0.9	1.1	1.1
Oil bonds (Rs-bn)	0.0	0.0	0.0	13.6	0.0
Exchange rate	48.4	45.9	44.9	46.0	46.0

Source: Company, Banc of America Securities - Merrill Lynch

Why FY10E EPS without oil bonds lower than FY03-FY05?

Lower than FY03 due to higher subsidy, DD&A & lower inventory gain

A comparison of HPCL's FY10E earnings in the worst case with FY03-05 reveals what hurts FY10E earnings. FY10E worst case EPS is lower than FY03 due to:

- Rs15.5bn higher subsidy in FY10E than in FY03 as oil price is much higher (US$56/bbl assumed in FY10E as against US$27.5/bbl in FY03)
- FY10E inventory gains are lower than those in FY03 by Rs4.5bn
- FY10E refining margins are lower than in FY03, which means HPCL's FY10E refining EBITDA is lower by Rs1.1bn

- FY10E depreciation is higher than in FY03 by Rs4.6bn
- FY10E interest cost is higher than that in FY03 by Rs9.1bn. FY10E other income is however higher than FY03 other income by Rs6.7bn mainly due to higher interest income on oil bonds. Thus net interest cost is also higher by Rs2.4bn

Lower than FY04 due to higher subsidies, DD&A & lower auto fuel margin

HPCL's FY10E worst case EPS is lower than FY04 EPS due to:

- Rs13.3bn higher subsidy in FY10E than in FY04 as oil price is much higher (US$56/bbl assumed in FY10E as against US$29/bbl in FY04)
- Auto fuel marketing margin of Rs1.1/l is lower than the supernormal of Rs1.8/l attained in FY04. This meant Rs9.3bn marketing EBITDA
- FY10E refining margins are lower than in FY04, which means HPCL's FY10E refining EBITDA is lower by Rs3.9bn
- FY10E depreciation is higher than in FY04 by Rs4.3bn
- FY10E interest cost is higher than that in FY04 by Rs10bn. FY10E other income is higher however than FY04 other income by Rs5.8bn mainly due to higher interest income on oil bonds. Thus net interest cost is also higher by Rs4.3bn

Lower than FY05 due to lower refining margin, higher DD&A & interest

HPCL's FY10E worst case EPS is lower than FY05 EPS due to:

- FY10E refining margins are sharply lower than that in FY05, which means HPCL's FY10E refining EBITDA is lower by Rs7.7bn
- Higher subsidy (Rs2bn) in FY10E than in FY05 as oil price is assumed higher at US$56/bbl in FY10E as against US$42/bbl in FY05
- FY10E depreciation is higher than in FY05 by Rs3.7bn
- FY10E interest cost is higher than that in FY05 by Rs9.8bn. FY10E other income is higher than FY04 other income by Rs6.3bn mainly due to higher interest income on oil bonds. Thus net interest cost is also higher by Rs3.5bn

Price objective basis & risk
Hindustan Petro. (XHTPF)

Our PO of Rs291 is based on a PE of 8.0x on FY10E EPS (excluding dividend income from MRPL) of Rs28.1. It also includes the market value of 17pct stake in refiner MRPL (ONGC's subsidiary) of Rs66. 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 in FY09E, (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.

Analyst Certification

I, Vidyadhar Ginde, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

Special Disclosures

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APR - Energy Coverage Cluster

Investment rating	Company	ML ticker	Bloomberg symbol	Analyst
BUY				
	Cairn India	XCANF	CAIR IN	Vidyadhar Ginde
	ONGC	ONGCF	ONGC IN	Vidyadhar Ginde
	Reliance Inds	XRELF	RIL IN	Vidyadhar Ginde
	Reliance Inds -G	RLNIY	RIGD LI	Vidyadhar Ginde
NEUTRAL				
	Aban Offshore L	XBWTF	ABAN IN	Vidyadhar Ginde
UNDERPERFORM				
	BPCL	XBPCF	BPCL IN	Vidyadhar Ginde
	Hindustan Petro.	XHTPF	HPCL IN	Vidyadhar Ginde
	IOC	IOCOF	IOCL IN	Vidyadhar Ginde
	Petronet LNG Ltd	POLNF	PLNG IN	Vidyadhar Ginde
RSTR				
	RPL	RPLUF	RPET IN	Vidyadhar Ginde

iQmethod SM Measures Definitions

Business Performance	Numerator	Denominator
Return On Capital Employed	NOPAT = (EBIT + Interest Income) * (1 - Tax Rate) + Goodwill Amortization	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill Amortization
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
Quality of Earnings		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
Valuation Toolkit		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	EV = Current Share Price * Current Shares + Minority Equity + Net Debt + Other LT Liabilities	Sales
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

iQmethod SM is the set of Banc of America Securities-Merrill Lynch standard measures that serve to maintain global consistency under three broad headings: Business Performance, Quality of Earnings, and validations. The key features of iQmethod are: A consistently structured, detailed, and transparent methodology. Guidelines to maximize the effectiveness of the comparative valuation process, and to identify some common pitfalls.

iQdatabase ® is our real-time global research database that is sourced directly from our equity analysts' earnings models and includes forecasted as well as historical data for income statements, balance sheets, and cash flow statements for companies covered by Banc of America Securities-Merrill Lynch.

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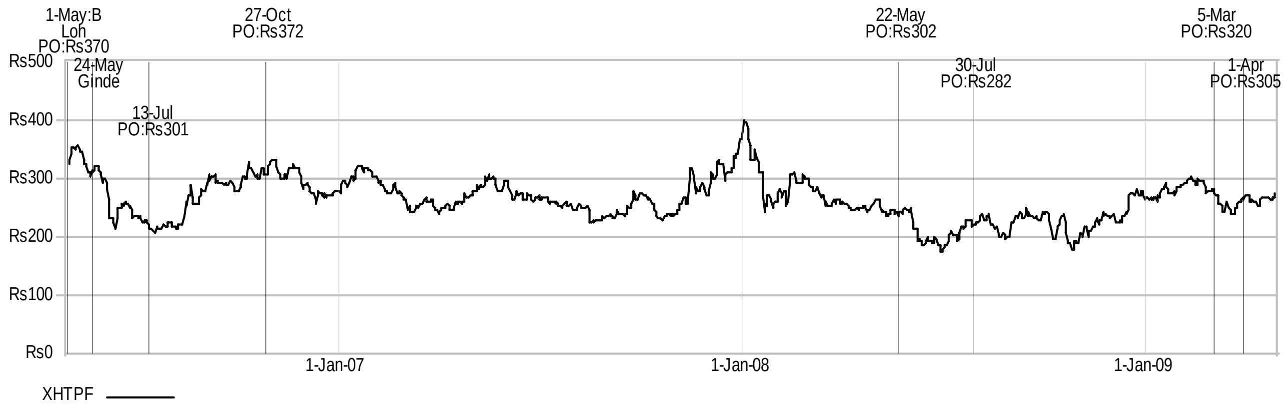
Important Disclosures

XHTPF Price Chart



B : Buy, N : Neutral, S : Sell, U : Underperform, PO : Price objective, NA : No longer valid

"Prior to May 31, 2008, the investment opinion system included Buy, Neutral and Sell. As of May 31, 2008, the investment opinion system includes Buy, Neutral and Underperform. Dark Grey shading indicates that a security is restricted with the opinion suspended. Light grey shading indicates that a security is under review with the opinion withdrawn. The current investment opinion key is contained at the end of the report. Chart is current as of April 30, 2009 or such later date as indicated. BAS-ML price charts do not reflect analysts' coverage of the stock at prior firms. Historical price charts relating to companies covered as of April 30, 2009 by former Banc of America Securities LLC (BAS) analysts are available to BAS clients on the BAS website."

Investment Rating Distribution: Energy Group (as of 01 Apr 2009)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	107	41.80%	Buy	57	59.38%
Neutral	68	26.56%	Neutral	29	50.00%
Sell	81	31.64%	Sell	26	37.68%

Investment Rating Distribution: Global Group (as of 01 Apr 2009)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1243	38.21%	Buy	520	46.39%
Neutral	841	25.85%	Neutral	349	47.04%
Sell	1169	35.94%	Sell	388	36.30%

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster*
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

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