Indian Downstream

Equity

Gov't Compensation Wanting: Examining Scenarios

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- **1Q marred by losses; gov't compensation wanting** — As expected, OMCs reported heavy losses for 1Q given: (i) heavy under-recoveries on all fuels (deregulation of petrol/price hikes announced Jun-end) and (ii) no compensation from the gov't. With the OMCs yet to receive Rs140bn of cash compensation for under-recoveries in FY10 (Finance ministry has reportedly sought parliamentary approval for this), uncertainty for FY11 compensation remains. In 1Q, after accounting for 1/3 upstream share, the OMCs have suffered net under-recoveries of Rs134bn, which are expected to rise to cRs380bn for the full year. Govt's intent on compensating OMCs through cash/price hikes/further deregulation would be key determinants of stock performance, and we analyze likely scenarios, concluding that BPCL looks relatively better placed on a risk-adjusted basis.

- **Scenario I: Nil net under-recoveries – potential upside of 20-30%, but premature to price in** — We deduce normalized EBITDA for the OMCs by stripping of one-off staff costs, inventory gains/losses, etc. and taking normalized (US$4-4.5) GRMs. After assuming full compensation of under-recoveries (on a consistent and sustainable basis), according a 6x EV/EBITDA multiple, and adding value of investments, we arrive at potential upsides of 28/31/18% and normalized clean P/Es of 7.4/6.8/8.6x for BPCL/HPCL/IOC (see Figure 2). While valuations could appear attractive, it should be borne in mind that, last year, despite the govt's promise of full compensation, OMCs ultimately had to bear Rs56bn of losses, which is what we assume in Scenario II. Also, according a 6x EV/EBITDA multiple to potentially best-case earnings may be too aggressive and premature to price in, and we adopt a probability-based approach in Scenario III.

- **Scenario II: Net under-recoveries in line with FY10 – limited upside** — Given that there exists a distinct possibility of OMCs continuing to share losses in FY11, we analyze a scenario with the OMCs bearing Rs56bn of net under-recoveries (in line with FY10). Using a slightly higher 7x EV/EBITDA multiple, we arrive at more modest upsides of 13/3/12% for BPCL/HPCL/IOC, showing HPCL's relatively higher sensitivity and therefore vulnerability to gov't compensation. If we assume that the OMCs bear Rs86bn, i.e., 15% of FY11E losses of cRs570bn (upstream share 1/3, gov't share capped at 50%), we see downside of 1-6% to stock prices (see Figure 3 and Figure 4).

- **Scenario III: 50% probability of full compensation – BPCL better placed on risk-adjusted basis —** In this scenario (see Figure 5), we accord a 50% probability of full compensation and 50% of bearing Rs56bn of net under-recoveries (in line with FY10). This yields upsides of 12/6/7% for BPCL/HPCL/IOC, implying BPCL is relatively better placed at current levels from a probability/risk-adjusted basis.

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

Compensation Key; Examining Scenarios

Figure 1. OMCs – Calculation of normalized EBITDA

	BPCL	HPCL	IOC
FY10 reported EBITDA	24,007	25,432	122,166
Adjust for: one-off write-offs[1]	5,942	(1,920)	(7,327)
Add back: net under-recoveries	12,374	12,266	31,588
Clean EBITDA	**42,323**	**35,778**	**146,427**
Reported GRM ($/bbl)	3.0	2.6	4.5
FY10 throughput (MMT)	20.4	15.8	50.7
FY11E throughput (MMT)	22.0	16.0	53.0
Normalized GRM ($/bbl)	4.0	4.0	4.5
Normalized EBITDA	**51,312**	**43,509**	**167,802**[2]
FY10 net debt[3]	80,750	88,000	182,500
No. of shares	362	339	2,384

Source: Citi Investment Research and Analysis. [1]Inventory gains/losses, one-off oil bond provisions, estimated staff cost arrears. [2]Includes estimated contribution from Panipat naphtha cracker. [3]Net debt less cash receivable from gov't for FY10 compensation less oil bonds on books.

Figure 2. Scenario I – Nil net-under-recoveries (Rs/share)

	BPCL	HPCL	IOC
Core value if nil net under-recoveries (based on 6x EV/EBITDA) – (i)	627	510	311
Value of investments – (ii)	208	69	84
Fair value – (i) + (ii)	**835**	**579**	**430**
CMP	655	443	363
% upside/(downside)	***28%***	***31%***	***18%***
EPS under the scenario	72	65	42
Non-income earning investments	121	-	3
P/E on CMP (x)	7.4	6.8	8.6

Source: Citi Investment Research and Analysis

Figure 3. Scenario II (a) – Net under-recoveries in line with FY10 (Rs/share)

	BPCL	HPCL	IOC
Core value if net under-recoveries in line with FY10 (based on 7x EV/EBITDA) – (i)	530	386	323
Value of investments – (ii)	208	69	84
Fair value – (i) + (ii)	**738**	**454**	**408**
CMP	655	443	363
% upside/(downside)	***13%***	***3%***	***12%***
EPS under the scenario	49	41	33
P/E on CMP (x)	10.9	10.9	10.9

Source: Citi Investment Research and Analysis

Figure 4. Scenario II (b) – Net under-recoveries at 15% of total (Rs/share)

	BPCL	HPCL	IOC
Core value if net under-recoveries at Rs86bn, i.e., 15% of total (based on 7x EV/EBITDA) – (i)	405	254	275
Value of investments – (ii)	208	69	84
Fair value – (i) + (ii)	**613**	**322**	**359**
CMP	655	443	363
% upside/(downside)	***-6%***	***-27%***	***-1%***
EPS under the scenario	37	28	28
P/E on CMP (x)	14.4	15.8	12.7

Source: Citi Investment Research and Analysis

Figure 5. Scenario III – 50% probability of full compensation (Rs/share)

	BPCL	HPCL	IOC
Core value – (i)	525	402	306
Value of investments – (ii)	208	69	84
Fair value – (i) + (ii)	**733**	**471**	**390**
CMP	655	443	363
% upside/(downside)	***12%***	***6%***	***7%***

Source: Citi Investment Research and Analysis

OMCs – 1QFY11 performance

Figure 6. 1QFY11 Subsidy Sharing Mechanism

Rs bn	HPCL	BPCL	IOC	Total (1QFY11)	FY10	FY09
Gross under-recovery	44	46	110	201	461	1,037
Oil bonds/cash	-	-	-	-	260*	713
Upstream	15	15	37	67	144	324
Net under-recovery	**29**	**31**	**73**	**134**	**56**	-

Source: Citi Investment Research and Analysis *Rs140bn yet to be received by OMCs

Figure 7. 1QFY11 – Operational performance

	HPCL	BPCL	IOC
GRM (US$/bbl)	3.7	3.6	3.0
Inventory gains (Rsbn)	3.2	4.7	5.2

Source: Citi Investment Research and Analysis

Figure 8. Historical industry under-recoveries (Rs bn)

Year to 31-Mar	FY07	FY08	FY09	FY10
Petrol	20	73	52	52
Diesel	188	352	523	93
LPG	107	155	176	143
Kerosene	179	191	282	174
Total gross under-recoveries	**488**	**772**	**1,033**	**461**
Less: Upstream sharing	241	353	713	260
Less: Oil bonds/cash from gov't	205	257	324	144
Total net under-recoveries	**40**	**163**	**(4)**	**56**
Total Inventory gains/(losses)	**(13)**	**31**	**(86)**	**45**

Source: PPAC, Company Reports

Bharat Petroleum

Valuation

Our target price for BPCL of Rs713 is based on the sum of: (i) 6x EV/EBITDA in the scenario with Rs150bn of net under-recoveries (in-line with FY08A), (ii) 3x EV/EBITDA of incremental earnings assuming under-recovery goes to nil, and (iii) Value of its investments (Rs141/share). The 6.0x multiple is in-line with the target multiple we use for other Indian refineries. We ascribe a lower multiple for the incremental earnings from a scenario of nil net under-recoveries to factor in uncertainty associated with full implementation by the government of complete compensation to the OMCs for marketing losses. While valuing the Indian oil refining and marketing companies, we prefer to use EV/EBITDA to compare companies across the region to avoid differences in accounting policies in depreciation and taxation. Our target price also equates to an FY10E P/E of 8.7x and P/B of 1.5x, higher than for HPCL, justified in our view by BPCL's higher proportion of better quality earnings.

Risks

We assign a High Risk rating for the stock, in-line with our quantitative risk rating system. Sentiment towards the sector and BPCL is closely linked to crude price fluctuations, sector deregulation, subsidy losses, and auto fuel price hikes. Key downside risks to our target price include: (i) Rise in crude to US$80+ is an obvious risk, as the governments ability to fully compensate OMCs in such a scenario may be constrained; (ii) The government's fiscal situation continues to be a concern (total oil bonds constituted 1.3% of GDP in FY09, 0.5% in FY10E on our estimate for nil under-recovery); and (iii) The recently constituted committee's recommendations may only be finalized in the next 3-4 months.

Hindustan Petroleum

Valuation

Our target price for HPCL of Rs493 is based on the sum of: (i) 6x EV/EBITDA in the scenario with Rs150bn of net under-recoveries (in line with FY08A), (ii) 3x EV/EBITDA of incremental earnings assuming under-recovery goes to nil, and (iii) Value of its investments (Rs57/share). The 6.0x multiple is in-line with the target multiple we use for other Indian refineries. We ascribe a lower multiple for the incremental earnings from a scenario of nil net under-recoveries to factor in the uncertainty associated with full implementation by the government of complete compensation to the OMCs for marketing losses. While valuing the Indian oil refining and marketing companies, we prefer to use EV/EBITDA to compare companies across the region to avoid differences in accounting policies in depreciation and taxation. Our target price also equates to an FY10E P/E of 6.5x and P/B of 1.2x, lower than for BPCL, justified in our view by HPCL's lower proportion of better quality earnings.

Risks

We assign a High Risk rating for the stock, in-line with our quantitative risk rating system. Sentiment towards the sector and HPCL is closely linked to crude price fluctuations, sector deregulation, subsidy losses, and auto fuel price hikes. Key downside risks to our target price include: (i) Rise in crude to US$80+ is an obvious risk, as the governments ability to fully compensate OMCs in such a scenario may be constrained; (ii) The government's fiscal situation continues to be a concern (total oil bonds constituted 1.3% of GDP in FY09, 0.5% in FY10E on our estimate for nil under-recovery); and (iii) The recently constituted committee's recommendations may only be finalized in the next 3-4 months.

Indian Oil

Valuation

Our target price for IOC of Rs354.5 is based on the sum of: (i) 6x EV/EBITDA in the scenario with Rs150bn of net under-recoveries (in line with FY08A), (ii) 3x EV/EBITDA of incremental earnings assuming under-recovery goes to nil, and (iii) Value of its investments (Rs113/share). The 6.0x multiple is in-line with the target multiple we use for other Indian refineries. We ascribe a lower multiple for the incremental earnings from a scenario of nil net under-recoveries to factor in uncertainty associated with full implementation by the government of complete compensation to the OMCs for marketing losses. While valuing the Indian oil refining and marketing companies, we prefer to use EV/EBITDA to compare companies across the region to avoid differences in accounting policies in depreciation and taxation. Our target price also equates to an FY10E P/E of 6.2x and P/B of 1.2x, in-line with HPCL but lower than for BPCL.

Risks

We assign a High Risk rating to the stock, higher than the Medium Risk rating suggested by our quantitative risk rating system. Sentiment towards the sector and IOC is closely linked to crude price fluctuations, sector deregulation, subsidy losses, and auto fuel price hikes, thus we view a High Risk rating as more appropriate. Key downside risks to our target price include: (i) Rise in crude to US$80+ is an obvious risk, as the governments ability to fully compensate OMCs in such a scenario may be constrained; (ii) The government's fiscal situation continues to be a concern (total oil bonds constituted 1.3% of GDP in FY09, 0.5% in FY10E on our estimate for nil under-recovery); and (iii) The recently constituted committee's recommendations may only be finalized in the next 3-4 months. Key upside risks include: (i) Earlier than expected commissioning of the Panipat refinery expansion and Panipat naphtha cracker projects, and (ii) Shaper decline in crude to ~US$50/bl levels.

Appendix A-1

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Fundamental Research

Analyst: Saurabh Handa

	Date	Rating	Target Price	Closing Price
1	4-Nov-07	3M	*303.00	342.60
2	24-May-09	3M	*365.00	447.50
3	6-Sep-09	*1H	*713.00	559.55

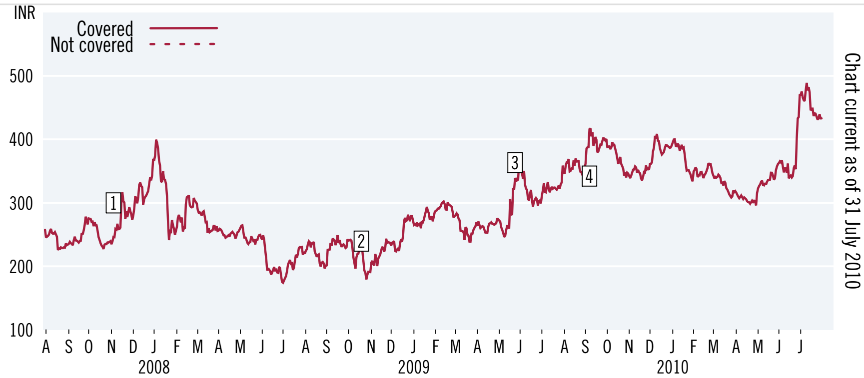
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Hindustan Petroleum (HPCL.BO)

Ratings and Target Price History
Fundamental Research

Analyst: Saurabh Handa
Covered since September 7 2009



	Date	Rating	Target Price	Closing Price
1	5-Nov-07	3M	*184.00	246.30
2	20-Oct-08	3M	*213.00	239.65
3	24-May-09	3M	*272.00	320.70
4	6-Sep-09	*1H	*493.00	387.65

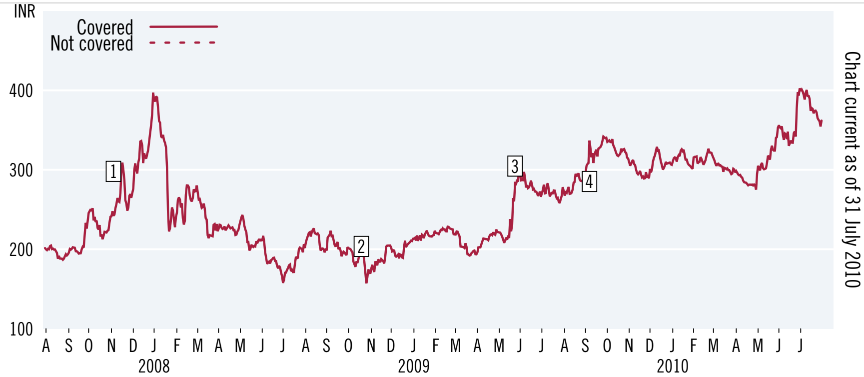
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Indian Oil (IOC.BO)

Ratings and Target Price History
Fundamental Research

Analyst: Saurabh Handa
Covered since September 7 2009



	Date	Rating	Target Price	Closing Price
1	5-Nov-07	3M	*247.00	242.25
2	20-Oct-08	*1M	*264.00	203.53
3	24-May-09	*3M	*254.00	260.25
4	6-Sep-09	*2H	*354.50	308.48

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