Equity Research

December 31, 2008

INDIA

Oil&Gas and Petrochemicals

OMCs on the forefront

Top picks

Cairn India
HPCL

We expect the I-Sec oil & gas universe to post 9.9% YoY earnings growth, led by Hindustan Petroleum Corporation (HPCL) & Bharat Petroleum Corporation (BPCL) posting significant earnings growth due to impressive retail margins. Reliance Industries' (RIL) to post 14.4% YoY earnings decline due to lower refining & petchem margins and lower crude realisations. Earnings of ONGC and Cairn expected to dip on lower crude realisations and lower production. GAIL to benefit from 29.6% YoY decline in subsidy burden, leading to 18.3% YoY earnings growth. Gujarat Gas Company (GGCL) to post marginal drop in earnings due to lower gas sales volumes and higher gas costs. Indraprastha Gas (IGL) to register impressive earnings growth on higher PNG & CNG sales volumes. Gross under-recoveries expected to decrease 66% YoY, led by 37% YoY drop in crude prices.

- **Super retail margins.** With fall in crude prices and the resulting impressive retail margins, OMCs' fundamentals would improve owing to profitable retail operations. MS and HSD retail margins have averaged at Rs6.6/litre and Rs2.5/litre in Q3FY09 versus Rs4.3/litre and Rs6.1/litre losses respectively in Q3FY08.
- **GRMs, petchem margins to remain under pressure.** GRMs and petchem margins would remain subdued on account of concerns on demand as well as significant capacity additions in India, China and Saudi Arabia within a year. Q3FY09 refining margins for India are US$1.6/bl versus US$5/bl in Q3FY08.
- **Gross under-recoveries to decline, in line with crude prices.** Q3FY09 witnessed average crude prices correcting 37.5% YoY to US$55.9/bl owing to concerns on demand, given the global financial meltdown; this resulted in gross under-recoveries declining 66.2% YoY to Rs72.9bn.
- **We are positive on OMCs and prefer HPCL** on the back of the company's higher marketing leverage and cheaper valuations. HPCL is currently trading at FY10E P/E of 7.4x, which is at significant 31% discount to BPCL's FY10E P/E of 10.7x
- **Favour Cairn in upstream space.** We are positive on Cairn due to the impending production commencement from the company's oil blocks in Rajasthan and significant free cash-flow generation going forward. At present, Cairn's stock price implies long-term crude price of US$53/bl vis-à-vis US$62/bl for ONGC. ONGC would remain under pressure due to worries on subsidy sharing, falling crude prices. RIL & Reliance Petroleum would also post weak results due to fall in refining & petchem margins and lower crude prices.
- **PNGRB policy favourable for Gujarat State Petronet**, which trades at 16.5% discount to fair value of Rs40/sh. Current prices imply 30% sharing towards corporate social responsibility (CSR) and ignored upside from possible removal of CSR.
- **Uncertainties impacting gas stocks.** GAIL would remain under pressure due to uncertainties over subsidy sharing, falling crude & petchem prices and HVJ pipeline tariffs. IGL would be under pressure on regulatory concerns. Although we are positive on GGCL, the company's would witness gas supply concerns till availability of RIL's KG Basin gas.

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Table 1: Quarterly summary

Company	Sales			EBITDA			PAT		
		% Chg			% Chg			% Chg	
(Rs mn)	OND-08*	(YoY)	(QoQ)	OND-08	(YoY)	(QoQ)	OND-08	(YoY)	(QoQ)
BPCL	238,592	(11.1)	(27.8)	20,314	364.8	NM	10,317	531.4	NM
Cairn	2,167	(18.8)	(32.4)	1,230	(22.0)	(50.5)	1,169	37.2	(62.8)
GAIL	57,330	33.4	(7.1)	10,791	23.7	(26.8)	7,352	18.3	(28.2)
GGCL	3,512	1.5	8.2	584	(8.8)	(1.4)	378	(3.5)	(3.8)
HPCL	225,702	(10.5)	(27.9)	21,214	1,332.3	NM	10,908	NM	NM
IGL	2,201	20.5	2.3	924	18.4	8.6	536	19.1	6.9
ONGC	120,305	(12.0)	(18.9)	63,534	(20.9)	(25.3)	33,679	(17.1)	(30.0)
RIL	281,146	(18.7)	(37.2)	55,124	(5.5)	(14.9)	33,293	(14.4)	(19.2)
Sector aggregate	930,955	(11.7)	(28.9)	173,716	11.2	42.9	97,632	9.9	116.3

NM: not meaningful as base numbers are negative; * October-December '08
Source: I-Sec Research

Key factors to watch

- Subsidy sharing formula for FY09 among OMCs, upstream companies and the Government
- Decision of Mumbai High Court on pricing and gas supply from KG Basin
- News on oil & gas finds
- Decision of Imperial Energy shareholders, as regards the takeover bid by ONGC Videsh (OVL)
- Retail MS and HSD price cuts
- Commencement of gas production for KG Basin; details of buyers
- Decision of the Tribunal on tax benefits for gas production from NELP blocks, as per Section 80 I(b)

Table 2: Industry under-recoveries

(Rs bn)

	Q3FY09E	Q3FY08	H1FY09
Gross under-recoveries	**72.9**	**215.8**	**928.5**
Sharing of under-recoveries			
Upstream	53.5	70.9	259.3
Oil bonds issued by Govt. of India	81.6	90.8	449.7
Downstream marketing companies	(62.2)	54.1	219.6
Total	**72.9**	**215.8**	**928.5**

Source: I-Sec Research

Table 3: Margin summary

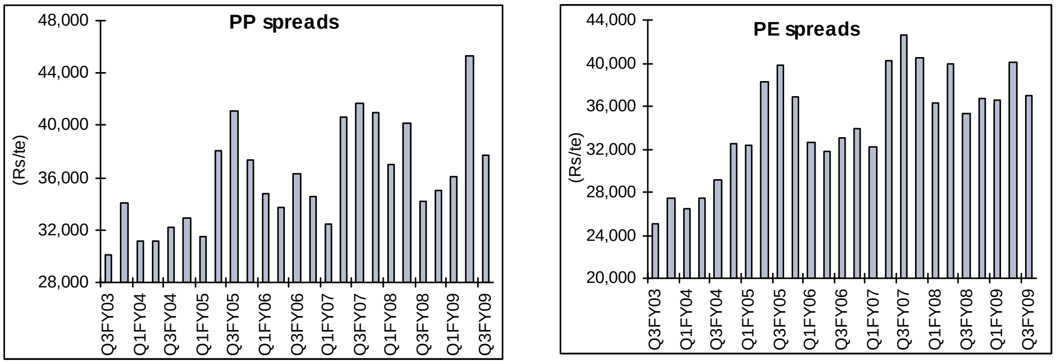
(% change)

	Q3FY09E Margin/Price	% chg (YoY)	% chg (QoQ)	Key companies
PP - Naphtha spread (Rs/te)	37,752	10.4	(16.7)	RIL
PE - Naphtha spread (Rs/te)	36,941	4.5	(7.9)	RIL
MEG - Naphtha spread (Rs/te)	11,783	(64.7)	373.0	RIL
PTA - Naphtha spread (Rs/te)	23,886	37.4	6.5	RIL
HSD retail margins (Rs/litre)	2.5	NM	NM	HPCL, BPCL, RIL
MS retail margins (Rs/litre)	6.6	NM	NM	HPCL, BPCL, RIL
Gross refining margins (US$/bl)	1.6	(67.5)	(75.0)	HPCL, BPCL, RIL
Oil price (IPE Brent) (US$/bl)	55.9	(37.5)	(51.9)	ONGC

NM – Not meaningful as the base period numbers are negative
Source: RIL, Bloomberg, I-Sec Research

PP-Naphtha spreads decline 17% QoQ, while PE-Naphtha spreads dip 8% QoQ on account of decline in demand

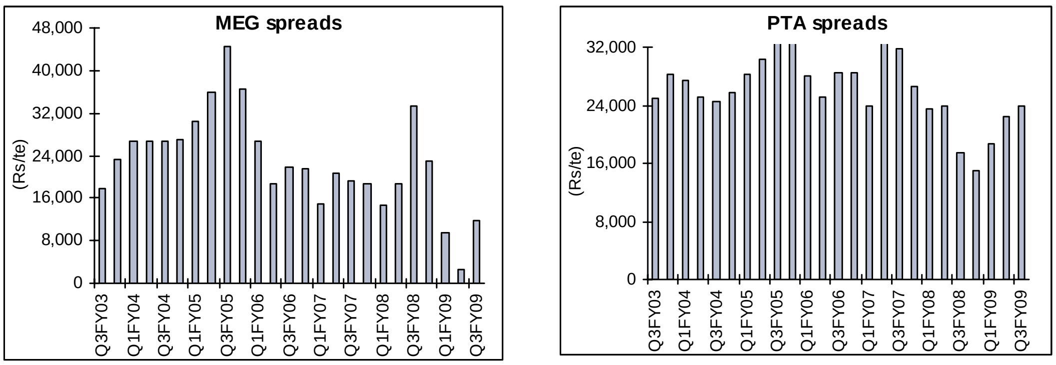
Chart 1: PP-Naphtha and PE-Naphtha spreads trend



Source: RIL, Bloomberg, I-Sec Research

MEG-Naphtha spreads significantly improve 372% QoQ due to sharp correction in naphtha prices. PTA-Naphtha spreads improve 7% QoQ

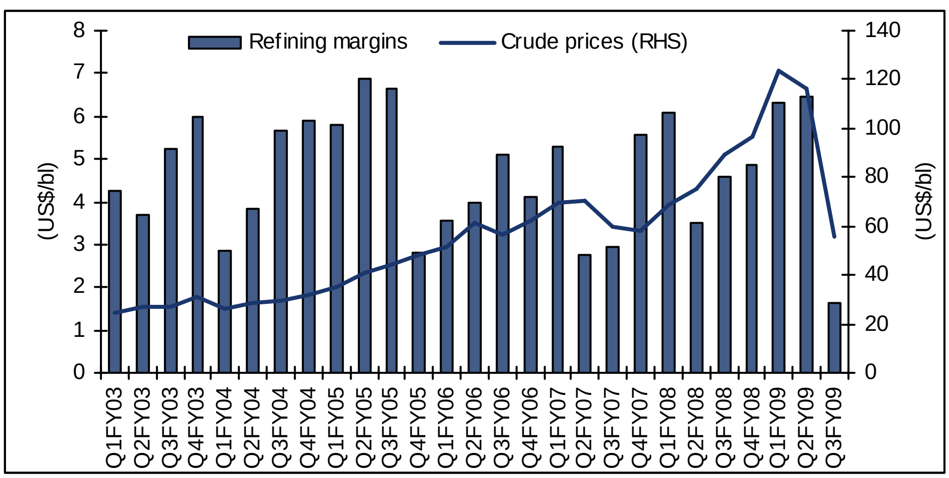
Chart 2: MEG-Naphtha and PTA-Naphtha spreads trend



Source: RIL, Bloomberg, I-Sec Research

Average Q3FY09 GRMs sharply decline 65% YoY on account of sharp correction in gasoline, diesel and SKO (superior kerosene oil) spreads with crude

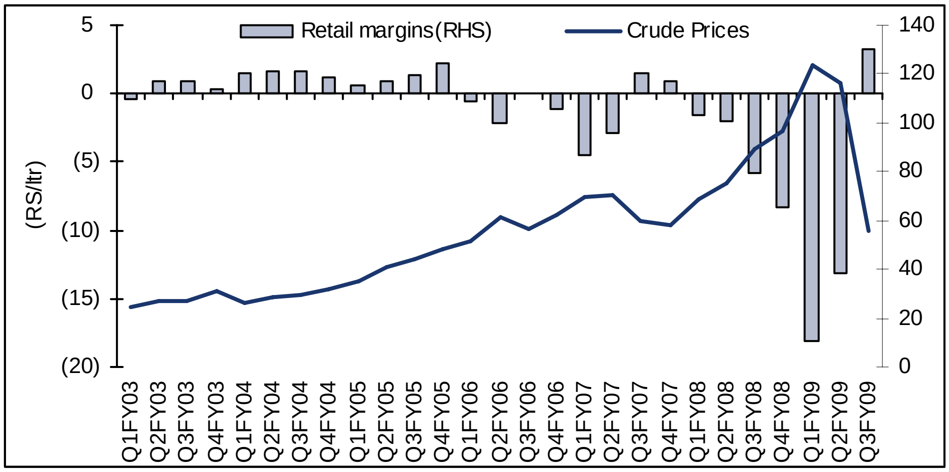
Chart 3: Refining margins, crude prices trend



Source: IEA, BPCL, Bloomberg, I-Sec Research

OMCs' retail margins have become profitable on the back of sharp correction in crude price as well as relatively stable retail prices

Chart 4: Blended auto-fuel retail margin trend



Source: I-Sec Research

Table 4: Assumptions

BPCL	Mumbai GRM – US$1.0/bl; Kochi GRM – US$2.0/bl; Throughput – Mumbai (3.2mnte), Kochi (2mnte); Inventory losses – Rs7.9bn; Oil bonds – Rs17.7bn; Upstream sharing – Rs11.6bn; Gross under-recoveries – Rs16.3bn
Cairn India	Crude oil production (net) – 1.0mmbl; Natural gas production (net) – 2.8bcf
GAIL	Subsidy – Rs2.6bn, Gas transmission volume – 86mmscmd
GGCL	Total gas volumes (inc. CNG) – 262mmscm; CNG volumes – 29mmscm
HPCL	Mumbai GRM – US$1.0/bl; Vishakhapatnam GRM – US$2.0/bl; Throughput – Mumbai (1.8mnte), Vishakhapatnam (2.4mnte); Inventory losses – Rs6.5bn; Oil bonds – Rs15.5bn; Upstream sharing – Rs10.1bn; Gross under-recoveries – Rs13.8bn
IGL	CNG volumes – 158mmscm; CNG realisations – Rs12.5/scm; PNG volumes – 12.7mmscm; PNG realisations – Rs17.6/scm
ONGC	Crude sales– 5.8mnte; Natural gas sales – 5.2bcm; Subsidy – US$22.6/bl; Net realisations – US$34.2/bl, Total Subsidy – Rs46.5bn
RIL	Refining margins – US$5.2/bl; Refining throughput – 8.2mnte

Source: I-Sec Research

BPCL (Hold)

(QoQ chg: 6.1%; YTD chg: -25.9%)

Quarterly estimates

(Rs mn, year ending March 31)

	Q3FY09E	Q3FY08	YoY (%)	QoQ (%)	YTD FY09*	YTD FY08	YoY (%)
Revenues	238,592	268,495	(11.1)	(27.8)	663,243	465,007	42.6
Bonds	17,693	20,789	(14.9)	(63.0)	105,484	25,391	315.4
EBITDA before bonds	2,621	(16,418)	NM	NM	(134,606)	(7,682)	NM
EBITDA after bonds	20,314	4,371	364.8	NM	(29,122)	17,709	NM
PBT	15,514	1,590	875.7	NM	(36,850)	15,601	NM
Recurring PAT	10,317	1,634	531.4	NM	(36,920)	10,321	NM
Reported PAT	10,317	2,913	254.2	NM	(36,920)	12,309	NM

* April-September

Source: Company data, I-Sec Research

- Revenues expected to decline 11.1% YoY to Rs239bn on account of 37% YoY decrease in global crude prices
- EBITDA, adjusted for bonds and upstream sharing, is expected to significantly improve 364.8% YoY to Rs20bn led by profitable retail operations, despite inventory losses and subdued GRMs. Q3FY09E net over-recoveries are expected to be Rs13bn compared with net under-recoveries of Rs11bn in Q3FY08
- Recurring standalone net income is expected to increase 254.2% YoY to Rs10bn due to higher EBITDA, despite 174.4% YoY increase in interest expenses
- Key swing factors are inventory gains, bonds, upstream subsidy, refining margins and international product prices (of LPG, kerosene, HSD and MS)

Cairn India (Buy)

(QoQ chg: -18.9%; YTD chg: -30.6%)

Quarterly estimates

(Rs mn, year ending December 31)

	Q4CY08E	Q4CY07	YoY (%)	QoQ (%)	YTDCY08*	YTDCY07*	YoY (%)
Revenues	2,167	2,667	(18.8)	(32.4)	10,401	7,455	39.5
EBITDA	1,230	1,577	(22.0)	(50.5)	7,465	5,094	46.5
PBT	1,771	1,196	48.1	(54.4)	8,350	4,695	77.8
Recurring PAT	1,169	852	37.2	(62.8)	6,142	3,535	73.7

*January-September

Source: Company data, I-Sec Research

- Revenues are expected to decline 18.8% YoY owing to 37% YoY decrease in crude prices and 5.4% YoY decline in crude production, despite 23.5% YoY increase in INR/USD exchange rates
- EBITDA is expected to decrease 22% YoY due to lower crude realisations, despite 14% fall in operating expenses
- Net income is expected to grow 37.2% YoY on the back of 356.9% increase in other income (Rs1.2bn) from investments and gain from foreign exchange fluctuations, despite lower EBITDA
- Key swing factors are production volumes, realisations, exploratory write-offs and exchange rates

GAIL (Buy)

(QoQ chg: -26.7%; YTD chg: -43.9%)

Quarterly estimates

(Rs mn, year ending March 31)

	Q3FY09E	Q3FY08	YoY (%)	QoQ (%)	YTD FY09*	YTD FY08	YoY (%)
Revenues before subsidy	59,915	46,658	28.4	(8.9)	126,926	93,066	36.4
Subsidy	2,586	3,675	(29.6)	(35.5)	7,893	5,320	48.4
Revenue after subsidy	57,330	42,983	33.4	(7.1)	119,033	87,746	35.7
EBITDA	10,791	8,723	23.7	(26.8)	29,612	19,170	54.5
PBT	10,796	8,988	20.1	(28.2)	29,421	18,585	58.3
PAT	7,352	6,213	18.3	(28.2)	19,783	12,578	57.3

* April-September

Source: Company data, I-Sec Research

- Revenues are expected to increase 33.4% YoY led by higher LPG revenues due to decline in subsidies, higher petchem volumes, gas transportation volumes and LNG/gas trading volumes
- EBITDA is expected to improve 23.7% YoY due to higher LPG business
- Net income likely to increase 18.3% YoY on the back of higher EBITDA
- Key swing factors are a*d hoc* surprises on subsidies and gas trading

Gujarat Gas Company (Buy)

(QoQ chg: -27.1%; YTD chg: -66.5%)

Quarterly estimates

(Rs mn, year ending December 31)

	Q4CY08E	Q4CY07	YoY (%)	QoQ (%)	YTD CY08*	YTD CY07*	YoY (%)
Revenues	3,512	3,459	1.5	8.2	9,704	8,691	11.6
EBITDA	584	641	(8.8)	(1.4)	1,882	1,575	19.4
PBT	565	589	(4.1)	(1.4)	1,781	1,417	25.7
Recurring PAT	378	392	(3.5)	(3.8)	1,215	919	32.2

* January-September

Source: Company data, I-Sec Research

- Despite 20.1% YoY decline in gas sales volumes, revenues likely to rise 1.5% YoY driven by: i) growth in the high-value retail and CNG segments, ii) 20% and 4% price hikes for domestic and industrial customers respectively, effective April ’08
- EBITDA margin to shrink ~190bps YoY to 16.6% owing to higher personnel expenses as well as higher gas cost (in rupee terms) due to weakening of the rupee against the US dollar
- Net income likely to decline a marginal 3.5% YoY due to 8.8% YoY decrease in EBITDA, despite 78% increase in other income
- Key swing factors are retail, CNG volumes, shift in gas sourcing basket, exchange rates and gas allocation policy

HPCL (Buy)

(QoQ chg: -16.1%; YTD chg: -23.9%)

Quarterly estimates

(Rs mn, year ending March 31)

	Q3FY09E	Q3FY08	YoY (%)	QoQ (%)	YTD FY09*	YTD FY08	YoY (%)
Revenues	225,702	252,180	(10.5)	(27.9)	609,354	437,611	39.2
Bonds	15,511	18,990	(18.3)	(63.3)	93,360	23,550	296.4
EBITDA before bonds	5,703	(17,509)	NM	NM	(122,908)	(11,660)	NM
EBITDA after bonds	21,214	1,481	1,332.3	NM	(29,548)	11,891	NM
PBT	16,404	(219)	NM	NM	(41,010)	11,502	NM
Recurring PAT	10,908	(157)	NM	NM	(41,070)	7,661	NM
Reported PAT	10,908	(157)	NM	NM	(41,070)	7,661	NM

* April-September
Source: Company data, I-Sec Research

- Revenues are expected to decline 10.5% YoY to Rs226bn due to 37% YoY decrease in global crude prices
- EBITDA, adjusted for bonds and upstream sharing, is expected to significantly improve 1,332.3% YoY to Rs21bn led by profitable retail operations, despite inventory losses and subdued GRMs. Q3FY09E net over-recoveries are expected to be Rs12bn compared with net under-recoveries of Rs11bn in Q3FY08
- We expect recurring net income of Rs11bn in Q3FY09 vis-à-vis Rs157mn net losses in Q3FY08 due to higher EBITDA, despite 119.1% YoY increase in interest expenses
- Key swing factors are inventory gains, bonds, upstream subsidy, refining margins and international product prices (of LPG, kerosene, diesel and gasoline)

Indraprastha Gas (Buy)

(QoQ chg: -14.4%; YTD chg: -43.4%)

Quarterly estimates

(Rs mn, year ending March 31)

	Q3FY09E	Q3FY08	YoY (%)	QoQ (%)	YTD FY09*	YTD FY08	YoY (%)
Revenues	2,201	1,827	20.5	2.3	4,059	3,358	20.9
EBITDA	924	781	18.4	8.6	1,606	1,437	11.8
PBT	814	678	20.2	8.4	1,405	1,211	16.1
PAT	536	450	19.1	6.9	939	813	15.5

* April-September
Source: Company data, I-Sec Research

- Revenues are expected to improve 20.5% YoY due to 20% & 19% increase in CNG & PNG sales volumes respectively
- EBITDA is expected to grow 18.4% YoY to Rs924mn; EBITDA margin is likely to remain flat YoY at 42%
- Net income is expected to surge 19.1% YoY to Rs536mn
- Key swing factors are CNG & PNG volumes and depreciation

ONGC (Buy)

(QoQ chg: -35.4%; YTD chg: -46.2%)

Quarterly estimates (Standalone)

(Rs mn, year ending March 31)

	Q3FY09E	Q3FY08	YoY (%)	QoQ (%)	YTD FY09*	YTD FY08	YoY (%)
Revenues before subsidies	166,826	197,470	(15.5)	(39.3)	548,352	336,790	62.8
Subsidy	46,521	60,800	(23.5)	(63.3)	224,730	74,480	201.7
Revenue after subsidy	120,305	136,670	(12.0)	(18.9)	323,622	262,310	23.4
EBITDA	63,534	80,318	(20.9)	(25.3)	202,608	163,376	24.0
PBT	53,383	66,716	(20.0)	(30.0)	176,263	146,094	20.7
PAT	33,679	40,607	(17.1)	(30.0)	114,013	96,272	18.4

* April-September
Source: Company data, I-Sec Research

- Revenues (adjusted for subsidy) are expected to decline 12% YoY due to 39% decrease in net realisations of crude and 3.5% fall in crude production, despite lower subsidy burden and 24% rise in INR/USD exchange rates
- EBITDA is expected to decrease 20.9% YoY on account of lower crude realisations, lower crude production and higher other expenses
- Net income is expected to decrease 17.1% YoY due to lower EBITDA margins, despite 70% increase in other income to Rs14.7bn
- Key swing factors are levies, subsidy, personnel expenses and recouped costs

Reliance Industries (Buy)

(QoQ chg: -34.4%; YTD chg: -56.1%)

Quarterly estimates (Standalone)

If RIL registers refining margin of US$9.5/bl (versus I-Sec estimate of US$8.5/bl), net income would increase to Rs35.8bn

(Rs mn, year ending March 31)

	Q3FY09E	Q3FY08	YoY (%)	QoQ (%)	YTD FY09*	YTD FY08	YoY (%)
Revenues	281,146	345,900	(18.7)	(37.2)	863,660	615,670	40.3
EBITDA	55,124	58,330	(5.5)	(14.9)	125,950	114,540	10.0
PBT	39,770	46,080	(13.7)	(19.2)	98,260	90,130	9.0
PAT (Recurring)	33,293	38,882	(14.4)	(19.2)	82,320	74,670	10.2
PAT (Reported)	33,293	80,790	(58.8)	(19.2)	82,320	74,670	10.2

* April-September
Source: Company data, I-Sec Research

- Revenues are expected to decline 18.7% YoY due to 37% YoY decrease in crude prices and lower petrochemical products prices
- EBITDA is expected to reduce 5.5% YoY to Rs55.1bn on account of lower GRMs, lower petchem margins and lower crude prices
- Net income is expected to decrease 14.4% YoY due to lower EBITDA and 77% increase in interest expenses
- Key swing factors are refining, petchem margins and crude prices

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