10 February 2012 | 8 pages

Bharat Petroleum (BPCL.BO)

■ Company Update

Alert: Gov't & Upstream Support Drives 3Q Surprise

- **Surprise gov't compensation boosts 3Q** — Yesterday the gov't announced an additional Rs150bn as its 3Q share towards the compensation of OMCs for under-recoveries incurred on diesel, kerosene, and LPG sales. This takes the total gov't compensation to Rs450bn for 9M (Rs150bn each in 1Q and 2Q). The gov't subsidy comes as a surprise and did not figure in our estimates. In the absence of this gov't support and a greater-than-expected upstream share (38% for 9M, 47% for 3Q), BPCL would most likely have posted a loss for 3Q. However, given the govt's tight fiscal situation, it is difficult to predict the extent to which this benefit will continue in 4Q.

- **Refining performance remains subdued** — BPCL reported 3Q blended GRM of US$3.48/bbl, which takes the GRM for 9MFY12 to US$2.78. While an improvement over the average US$2.3 levels in 1H, this remains well below regional benchmarks as well the US$4.5 level achieved in FY11.

- **3Q subsidy share at 38% a -ve surprise for upstream** — In keeping with the tradition of ad-hocism, the gov't increased upstream subsidy share to 37.9% in 9M (3Q share stood at 47.1% vs. 1/3rd in 1H – see Figure 2). This, however, does not guarantee a similar share for 4Q, which we believe has the potential to be even higher. In our view, the gov't + upstream combine will need to fully make up for the OMCs' under-recoveries in FY12 (i.e., OMCs' net under-recoveries will need to be nil) to enable them to make nominal profits. This is largely on the back of the high forex losses incurred by the OMCs during the year (BPCL's 9M forex losses stand at Rs22bn) as well as the dismal refining performance (9M GRMs of US$2.6-2.8/bbl for the two OMCs that have reported so far).

- **4Q upstream share could be even higher —** Assuming the gov't maintains its 9M run-rate and shares another Rs150bn in 4Q (i.e., full-year share of Rs600bn or ~0.7% of GDP), then even a 50% upstream share for the full year may not suffice for the OMCs. Conversely, in order for the upstream share to remain at the 9M rate of 38%, the gov't compensation in 4Q will need to be in excess of ~Rs350bn, (i.e., a full-year compensation of ~Rs800bn or ~0.9% of GDP). While the gov't does have the option of delaying some of the actual disbursal to FY13 in order to reduce the impact on its FY12 fiscal calculations (having so far disbursed cRs230bn or ~0.3% of GDP), the situation nonetheless does not augur well for upstream companies.

- **BPCL our preferred OMC** — As explained above and given the govt's tight fiscal situation, we maintain our view that there exists a risk of the upstream companies once again being made the "fall guys" in FY12 by a further increase in their subsidy share in 4Q (as also highlighted in our 21-Dec reported entitled, *Indian Downstream: Rising Risks for Upstream as FY-End Approaches*. BPCL remains our preferred pick amongst the OMCs given momentum in its E&P business.

Buy	**1**
Price (10 Feb 12)	Rs598.40
Target price	Rs740.00
Expected share price return	23.7%
Expected dividend yield	1.4%
Expected total return	**25.0%**
Market Cap	Rs216,347M
	US$4,376M

Price Performance
(RIC: BPCL.BO, BB: BPCL IN)

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

Figure 1. BPCL – 3QFY12 Results

	Q3FY11	Q2FY12	Q3FY12	%yoy	%qoq	Comments
Net sales	**366,859**	**423,019**	**588,468**	**60.4%**	**39.1%**	
Total expenditure	359,371	449,967	551,371	53.4%	22.5%	
Inventory	8,362	(5,367)	2,164	-74.1%	-140.3%	
Raw material consumption	147,450	204,005	224,132	52.0%	9.9%	
Staff cost	5,696	4,381	4,892	-14.1%	11.7%	
Purchase of products for resale	178,431	219,959	288,574	61.7%	31.2%	
Other expenditure	19,433	26,990	31,610	62.7%	17.1%	Includes Rs12.67bn losses for forex fluctuations (Rs21.7bn for 9MFY12)
Operating profit	**7,488**	**(26,948)**	**37,097**	**395.4%**	**-237.7%**	
Other income	3,103	3,787	4,166	34.3%	10.0%	
Interest	2,747	4,532	5,174	88.3%	14.2%	
Depreciation	3,700	4,600	4,667	26.1%	1.4%	
PBT	4,144	(32,293)	31,422	658.3%	-197.3%	
Tax rate (%)	*54.8*	*0.0*	*0.1*			
Tax	2,270	0	26			
Net profit	**1,874**	**(32,293)**	**31,396**	**nm**	**-197.2%**	
Operational Parameters						
Blended GRM (US$/bbl)	4.61	1.65	3.48	-24.5%	111.1%	Improved over 1H, but still below regional benchmarks & FY11 levels of US$4.5/bbl
Crude Throughput (MMT)	5.03	5.58	6.13	21.9%	9.9%	
- Mumbai	3.00	3.12	3.45	15.0%	10.6%	
- Kochi	2.03	2.46	2.68	32.0%	8.9%	
Inventory gain (Rs m)	3,190	(240)	3,000	-6.0%	-1350.0%	
Forex loss/(gain) (Rs m)	181	8,071	12,673	nm	57.0%	
Gross under-recovery (Rs m)	35,118	49,255	76,343	117.4%	55.0%	
Less: upstream contribution (Rs m)	11,706	16,418	35,727	205.2%	117.6%	
Less: gov't compensation (Rs m)	18,099	0	69,937	286.4%		Gov't announced Rs150bn of compensation for overall industry 2Q losses which has been accounted for in 3Q. Another Rs150bn announced for 3QFY12.
Net under-recovery (Rs m)	5,313	32,837	0	-100.0%	-100.0%	

Source: Company, Citi Investment Research and Analysis

Figure 2. 9MFY12 Gross & Net Under-Recoveries for OMCs (Rs bn)

	1QFY12	2QFY12	3QFY12	9MFY12
Gross under-recovery	435	214	324	973
Upstream Share	145	71	153	369
as a %	33.3%	33.3%	47.1%	37.9%
Gov't share	150	0	300*	450
Net under-recoveries	**140**	**142**	**(128)**	**154**

Source: Citi Investment Research and Analysis. *Rs 150bn was announced for 2Q losses but accounted for in 3Q.

Bharat Petroleum

Valuation

Our Rs740 target price is based on the sum of: (i) 6x FY13E EV/EBITDA in a scenario of 45% upstream sharing and 50% government share, resulting in net industry under-recoveries of ~Rs80bn (5%), and (ii) value of its investments (Rs293/sh). The 6.0x multiple is in-line with regional peers. 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 (ex-investments) also equates to an FY12E P/B of 1.1x. Our value of investments includes E&P value of Rs109/sh which reflects some of the potential reserves at blocks where BPCL has made discoveries.

Risks

The key downside risks to our investment thesis on BPCL are: (i) A sharp rise in crude prices which increases the overall losses for the OMCs; (ii) Any roll-backs of price hikes and/or duty cuts; (iii) Continued lack of clarity on compensation of under-recoveries and subsidy sharing mechanism; and (iv) Sharp rupee depreciation. If any of these risk factors has a greater downside impact than we anticipate, the share price will likely have difficulty attaining our target price.

Appendix A-1

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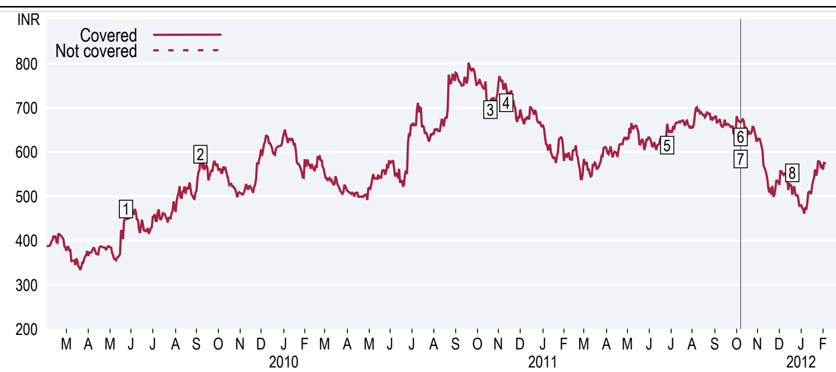
Fundamental Research
Analyst: Saurabh Handa



	Date	Rating	Target Price	Closing Price
1	24-May-09	3M	*365.00	447.50
2	6-Sep-09	*1H	*713.00	559.55
3	20-Oct-10	*2L	*746.00	714.20
4	11-Nov-10	2L	*790.00	746.30
5	26-Jun-11	*1L	*784.00	634.40
6	7-Oct-11	Stock rating system changed		
7	7-Oct-11	*1	784.00	667.20
8	20-Dec-11	1	*740.00	503.70

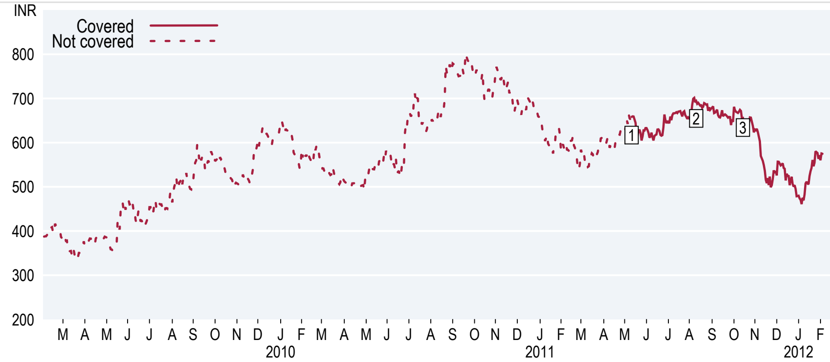
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Bharat Petroleum (BPCL.BO)

Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)

Analyst: Saurabh Handa



Date	Rating	Target Price	Closing Price
1 11-May-11	*ADD LP	-	658.25
2 10-Aug-11	*ADD MP	-	694.05
3 14-Oct-11	*REM MP	-	655.50

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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