

# Better outlook than peers but not cheap

## Budget support keeps IOC in black in 3Q; Underperform

In 3Q, the government finally confirmed budget support to compensate R&M companies for subsidy. Indian Oil (IOC) accounted only 63% of budget support, which means recurring EPS of Rs26.3 in 9M. Outlook for 4Q is weak, despite recovery in refining margins. Hence, a cut in consensus FY10E EPS of Rs35.1 appears likely. IOC's FY10E earnings outlook is better than peers but it is not cheap at 10.6x FY10E EPS. We retain our Underperform rating on IOC.

## 3Q refining margins at US\$3.7/bbl, lower than in 1H

IOC's refining margin weakened to US\$3.7/bbl in 3Q FY10, thereby pulling down the 9M average to US\$4.8/bbl from US\$5.4/bbl in 1H.

## 9M EPS Rs26; 63% of budget support accounted in 3Q

In 3Q, the government confirmed budgetary support of Rs71bn to IOC toward the FY10E subsidy hit. IOC accounted only Rs44.8bn (63%) in 3Q. IOC also got compensation from upstream companies to cover the entire auto fuel subsidy. This helped IOC remain in the black (EPS Rs10), despite weak refining margins in 3Q. 9M EPS stands at Rs26.3. IOC's 3Q EPS would have been higher, at Rs17.1, and 9M at Rs33.4, if the entire budgetary support of Rs71bn was accounted in 3Q.

## Poor 4Q outlook; downside to consensus FY10E EPS

IOC's 9M EPS is Rs26.3. The outlook for 4Q is poor, despite a likely recovery in refining margins. IOC's share of the 4Q LPG-kerosene subsidy is expected to be Rs61-69bn, while budget support would be just Rs26.2bn. Without more support, 4Q EPS is likely to be Rs2 and FY10E EPS is likely to be Rs28.2 (close to BoFAML's estimate). However, a cut in consensus FY10E EPS (Rs35.1) appears imminent.

## Estimates (Mar)

(Rs)	2008A	2009A	2010E	2011E	2012E
Net Income (Adjusted - mn)	79,526	25,994	68,174	71,214	62,398
EPS	33.18	10.71	28.08	29.33	25.70
EPS Change (YoY)	32.1%	-67.7%	162.3%	4.5%	-12.4%
Dividend / Share	2.75	3.84	10.00	10.00	9.00
Free Cash Flow / Share	5.10	13.04	66.27	36.28	6.16

## Valuation (Mar)

	2008A	2009A	2010E	2011E	2012E
P/E	9.08x	28.15x	10.73x	10.27x	11.73x
Dividend Yield	0.913%	1.27%	3.32%	3.32%	2.99%
EV / EBITDA*	7.93x	13.27x	7.71x	8.62x	9.36x
Free Cash Flow Yield*	1.66%	4.33%	21.99%	12.04%	2.04%

\* For full definitions of *iQmethod*<sup>SM</sup> measures, see page 5.

Equity | India | IOC

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## Stock Data

Price	Rs301.35
Price Objective	Rs269.00
Date Established	13-Nov-2009
Investment Opinion	C-3-7
Volatility Risk	HIGH
52-Week Range	Rs189.03-Rs395.00
Mrkt Val / Shares Out (mn)	US\$15,784 / 2,427.9
Average Daily Volume	760,066
BofAML Ticker / Exchange	IOCOF / BSE
Bloomberg / Reuters	IOCL IN / IOC.BO
ROE (2010E)	14.2%
Net Dbt to Eqty (Mar-2009A)	98.5%
Est. 5-Yr EPS / DPS Growth	10.0% / 10.0%
Free Float	28.0%

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## iQprofile<sup>SM</sup> Indian Oil Corp.

### Key Income Statement Data (Mar)

	2008A	2009A	2010E	2011E	2012E
<b>(Rs Millions)</b>					
Sales	2,279,454	2,875,281	4,346,950	5,071,213	5,390,838
Gross Profit	NA	NA	NA	NA	NA
Sell General & Admin Expense	(2,151,844)	(2,799,000)	(4,215,602)	(4,953,767)	(5,282,699)
Operating Profit	97,193	44,386	97,384	84,396	71,906
Net Interest & Other Income	28,093	(7,895)	5,725	24,029	22,620
Associates	NA	NA	NA	NA	NA
Pretax Income	125,286	36,491	103,109	108,426	94,526
Tax (expense) / Benefit	(39,382)	(12,533)	(32,680)	(34,302)	(29,704)
Net Income (Adjusted)	79,526	25,994	68,174	71,214	62,398
Average Fully Diluted Shares Outstanding	2,385	2,428	2,428	2,428	2,428

### Key Cash Flow Statement Data

Net Income	79,526	25,994	68,174	71,214	62,398
Depreciation & Amortization	30,417	31,894	33,964	33,050	36,234
Change in Working Capital	NA	NA	NA	NA	NA
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	(20,825)	111,707	65,519	(11,880)	(2,364)
Cash Flow from Operations	89,117	169,596	167,657	92,383	96,268
Capital Expenditure	(76,967)	(137,942)	(6,764)	(4,301)	(81,306)
(Acquisition) / Disposal of Investments	(14,555)	(105,337)	4,743	115,000	40,000
Other Cash Inflow / (Outflow)	0	0	0	0	0
Cash Flow from Investing	(91,522)	(243,279)	(2,021)	110,699	(41,306)
Shares Issue / (Repurchase)	0	216	11,275	0	0
Cost of Dividends Paid	(16,266)	(10,918)	(27,375)	(27,375)	(24,638)
Cash Flow from Financing	(1,410)	74,557	(127,469)	(194,375)	(24,638)
Free Cash Flow	12,150	31,654	160,894	88,082	14,962
Net Debt	377,607	463,417	313,880	138,173	107,849
Change in Net Debt	18,671	84,385	(149,537)	(175,707)	(30,324)

### Key Balance Sheet Data

Property, Plant & Equipment	469,231	576,156	548,956	520,207	565,280
Other Non-Current Assets	208,678	314,065	309,322	194,322	154,322
Trade Receivables	68,192	59,379	126,803	141,376	143,395
Cash & Equivalents	10,602	10,052	48,220	56,927	87,251
Other Current Assets	503,888	402,596	479,348	527,607	534,294
Total Assets	1,260,591	1,362,248	1,512,649	1,440,439	1,484,542
Long-Term Debt	178,636	192,514	171,000	94,000	94,000
Other Non-Current Liabilities	61,134	59,691	59,691	59,691	59,691
Short-Term Debt	209,574	280,955	191,100	101,100	101,100
Other Current Liabilities	354,139	358,654	566,094	614,136	618,055
Total Liabilities	803,482	891,814	987,885	868,927	872,846
Total Equity	457,109	470,434	524,763	571,512	611,696
Total Equity & Liabilities	1,260,591	1,362,248	1,512,649	1,440,439	1,484,542

### iQmethod<sup>SM</sup> - Bus Performance\*

Return On Capital Employed	9.7%	4.6%	8.4%	8.1%	7.1%
Return On Equity	19.9%	5.8%	14.2%	13.5%	11.0%
Operating Margin	4.3%	1.5%	2.2%	1.7%	1.3%
EBITDA Margin	5.6%	2.7%	3.0%	2.3%	2.0%

### iQmethod<sup>SM</sup> - Quality of Earnings\*

Cash Realization Ratio	1.1x	6.5x	2.5x	1.3x	1.5x
Asset Replacement Ratio	2.5x	4.3x	0.2x	0.1x	2.2x
Tax Rate (Reported)	31.4%	34.3%	31.7%	31.6%	31.4%
Net Debt-to-Equity Ratio	82.6%	98.5%	59.8%	24.2%	17.6%
Interest Cover	5.4x	1.1x	3.9x	7.6x	9.2x

### Key Metrics

\* For full definitions of iQmethod<sup>SM</sup> measures, see page 5.

### Company Description

IOC, a refining & marketing company, is India's largest company by revenue. Its seven refineries have a total capacity of 827,000bpd. It owns 52% IN CPCL refinery (210,000bpd) and 74.5% IN BRPL refinery (47,000bpd). LPG, kerosene, diesel & gasoline (the prices of which are regulated) make up 63% of its marketing volumes. Refining margins, however, track international margins. IOC is 82% owned by the government of India.

### Investment Thesis

A comprehensive solution to the subsidy problem plaguing IOC and peers appears unlikely in the foreseeable future. The subsidy regime makes earnings of IOC and its peers highly unpredictable. IOC's earnings tend to be more stable than peer. However IOC has far less leverage than peers to auto fuel marketing margins, which is one of the main earnings drivers for IOC and peers. IOC has more exposure than peers to petrochemicals and petrochemical outlook is likely to be poor for at least 2-3 years.

### Stock Data

Price to Book Value 1.4x

## 3Q FY10 result

Table 1: IOC 3Q and 9M FY10 results (standalone)

Rsmn	3Q FY10	3Q FY09	Change	9M FY10	9M FY09	Change
Net sales	704,098	703,687	0%	1,905,591	2,452,346	-22%
Total expenditure	676,393	671,510	1%	1,821,758	2,461,950	-26%
<b>EBDITA</b>	<b>27,705</b>	<b>32,177</b>	<b>-14%</b>	<b>83,832</b>	<b>(9,605)</b>	<b>-973%</b>
Interest	4,091	15,054	-73%	10,908	31,125	-65%
Depreciation	7,996	7,275	10%	23,400	20,776	13%
Other Income	6,783	19,831	-66%	30,308	32,532	-7%
PBT	22,400	29,679	-25%	79,832	(28,973)	-376%
Tax	(1,798)	93	-2037%	15,963	2,619	509%
Recurring PAT	24,198	29,586	-18%	63,870	(31,593)	-302%
Extra-ordinary items	(17,232)	0		(17,232)	(5,141)	
<b>Reported PAT</b>	<b>6,966</b>	<b>29,586</b>	<b>-76%</b>	<b>46,638</b>	<b>(36,734)</b>	<b>-227%</b>
Recurring EPS	10.0	12.4	-20%	26.3	(13.2)	-299%
Reported EPS	2.9	12.4	-77%	19.2	(15.4)	-225%

Source: Company, BofA Merrill Lynch

## Price objective basis & risk

### IOC (IOCOF)

Our PO of Rs269/share is based on PE of 7.0x on IOC's FY10E consolidated EPS (excluding dividend income from ONGC, PLNG, and GAIL) of Rs26/share. Our PO also includes market value of IOC's investments in ONGC, Petronet LNG and GAIL of Rs86/share. 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 IOC, (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) Lower than expected auto fuel marketing margins 5) Steep decline in market price of ONGC, Petronet LNG and GAIL. 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) Sharp rise in market prices of ONGC and GAIL.

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Investment rating	Company	BofAML ticker	Bloomberg symbol	Analyst
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	CNPC (Hong Kong)	CNPXF	135 HK	Vitus Leung
	COSL	CHOLF	2883 HK	Vitus Leung
	LG Chem	LGCLF	051910 KS	Kenneth Whee
	ONGC	ONGCF	ONGC IN	Vidyadhar Ginde
	Sinopec	SNPMF	386 HK	Thomas Wong
	Sinopec - A	SNP	SNP US	Thomas Wong
	SK Energy	XVERF	096770 KS	Kenneth Whee
<b>NEUTRAL</b>				
	CNOOC	CEOHF	883 HK	Thomas Wong
	CNOOC	CEO	CEO US	Thomas Wong
	Oil India Ltd	XLCRF	OINL IN	Vidyadhar Ginde
	PetroChina	PCCYF	857 HK	Thomas Wong
	PetroChina - A	PTR	PTR US	Thomas Wong
<b>UNDERPERFORM</b>				
	BPCL	XBPCF	BPCL IN	Vidyadhar Ginde
	Citic Resources	CTJHF	1205 HK	Vitus Leung
	Formosa Chemicals & Fibre	XFUMF	1326 TT	Kenneth Whee
	Formosa Petrochemical	FPTCF	6505 TT	Kenneth Whee
	Formosa Plastics	FSAPF	1301 TT	Kenneth Whee
	GS Holdings	GSHDF	078930 KS	Kenneth Whee
	Hindustan Petro.	XHTPF	HPCL IN	Vidyadhar Ginde
	IOC	IOCOF	IOCL IN	Vidyadhar Ginde
	Petronet LNG Ltd	POLNF	PLNG IN	Vidyadhar Ginde
	Reliance Inds	XRELF	RIL IN	Vidyadhar Ginde
	Reliance Inds -G	RLNIY	RIGD LI	Vidyadhar Ginde
	S-Oil	SOOCF	010950 KS	Kenneth Whee

**iQmethod<sup>SM</sup> Measures Definitions**

<b>Business Performance</b>	<b>Numerator</b>	<b>Denominator</b>
Return On Capital Employed	$\text{NOPAT} = (\text{EBIT} + \text{Interest Income}) * (1 - \text{Tax Rate}) + \text{Goodwill Amortization}$	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill
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
<b>Quality of Earnings</b>		
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
<b>Valuation Toolkit</b>		
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	$\text{EV} = \text{Current Share Price} * \text{Current Shares} + \text{Minority Equity} + \text{Net Debt} + \text{Sales} + \text{Other LT Liabilities}$	
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

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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 December 31, 2009 or such later date as indicated.

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Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	131	55.04%	Buy	84	71.19%
Neutral	58	24.37%	Neutral	29	69.05%
Sell	49	20.59%	Sell	20	44.44%

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Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1699	50.78%	Buy	904	58.82%
Neutral	841	25.13%	Neutral	491	65.03%
Sell	806	24.09%	Sell	368	49.80%

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