

India: Energy

Equity Research

Meaningful fuel price hikes, duty cuts; domestic theme playing out

News

The Empowered Group of ministers (EGoM) took some meaningful steps towards addressing high under-recoveries of oil marketing companies (OMCs) with a combination of retail price hikes and duty cuts. Apart from a 8% increase in retail price of diesel, 16% for kerosene and 15% for LPG, the government has abolished the 5% customs duty on crude oil and reduced that on refined products by 5%. Moreover, excise duty on diesel has been cut by Rs2.6/litre, which represents another 7% of the retail price. The duty cuts represent additional relief for the OMCs since these are not going to be passed on to the retail consumers. The total reduction in diesel losses would be more than Rs7/litre, down 50% from Rs14/litre earlier.

Analysis

We believe that these steps indicate the Indian government's willingness to take politically unpopular decisions at a point of crisis in the sector, although inflation remains high. This is in line with the RBI governor's recent comments that fuel price increases are needed for controlling the fiscal deficit and have a moderating trend on long term oil demand. The price increases would add about 70 bps to headline inflation in near term, in our view. Overall, the FY12 under-recoveries of the OMCs are likely to fall by Rs570bn (Rs210bn from price increases, Rs230bn from excise cuts and Rs130bn from customs duty cuts) to Rs 1,280bn, in our view. The FY12 subsidy-sharing formula is not finalised yet and we expect more clarity to emerge in the near term. Moreover, we note that recent correction in oil prices would add more near term relief to the state-owned oil companies.

HPCL and ONGC are our top picks for this; also like IOC, GAIL

We believe HPCL (Buy, on CL) is the largest beneficiary of regulatory action on fuel prices, with the highest sales/refining volume ratio (FY12E:1.6x) among the OMCs. Our 12-m EV/EBITDA-based TP of Rs450 implies 15% upside. We also like ONGC (Buy, on CL) owing to stable-to-improving oil realization, improving volume growth and attractive valuation. ONGC's share in under-recoveries for FY12 would now fall by anywhere between Rs125bn-Rs150bn depending on its share ranging anywhere between 33% to 38.7%. Our 12-m Director's Cut-based TP of Rs340 implies 25% upside. For GAIL, our 12-m DCF based TP of Rs 549 implies a potential upside of 22%. IOC's 12-m EV/EBITDA-based TP of Rs388 implies 15% upside. Risks: oil price spike, rise in inflation, delay in further reforms.

SUMMARY OF RATINGS AND PRICE TARGETS

Ticker	24-Jun-11 Price	Rating	Target Price	Dividend yield %	Potential TSR
ONGC.BO	272.80	Buy*	340	3.2%	28%
HPCL.BO	392.50	Buy*	450	3.3%	18%
GAIL.BO	448.70	Buy	549	2.6%	25%
IOC.BO	337.10	Buy	388	3.6%	19%
BPCL.BO	634.40	Neutral	636	2.9%	3%

*Denotes the stock is on our regional Conviction list.
All price targets are 12 months.

Source: Goldman Sachs Research estimates.

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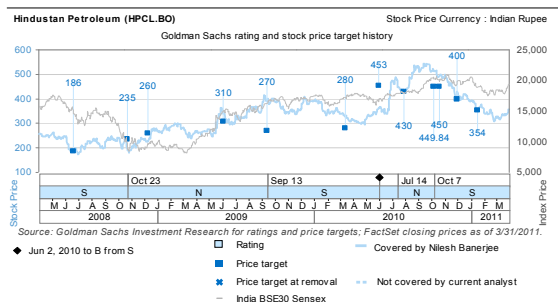
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