2 November 2011

2QFY12 Results Update | Sector: Oil & Gas

HPCL

BSE SENSEX	S&P CNX
17,481	5,258
Bloomberg	HPCL IN
Equity Shares (m)	339.0
52-Week Range (INR)	550/307
1,6,12 Rel. Perf. (%)	-14/-4/-18
M.Cap. (INR b)	114.2
M.Cap. (USD b)	2.3

CMP: INR337 — Buy

YEAR END	SALES (INR M)	ADJ. PAT (INR M)	ADJ. EPS (INR)	EPS GR. (%)	P/E (X)	P/BV (X)	ROE (%)	ROCE (%)	EV/ SALES	EV/ EBITDA
03/10A	1,092,084	13,014	38.4	198.8	-	-	11.7	8.7	-	-
03/11A	1,309,342	15,390	45.4	18.3	7.4	0.9	12.8	8.6	0.2	8.5
03/12E	1,674,436	10,383	30.6	-32.5	11.0	0.9	8.1	6.2	0.2	9.4
03/13E	1,626,294	13,268	39.1	27.8	8.6	0.8	9.7	7.6	0.1	5.3

HPCL reported EBITDA loss of INR29.4b for 2QFY12 v/s our expectation of an EBITDA of INR12.6b, primarily due to (1) nil government compensation v/s our estimate of INR32b, (2) GRM of USD1.9/bbl, much lower than our estimate of USD6.8/bbl, led by the June 2011 duty cut impact on crude inventory, and (3) forex loss of INR10b. The company reported a net loss of INR33.6b v/s a net profit of INR21b in 2QFY11 and loss of INR30.8b in 1QFY12.

Net under-recovery sharing at 67% in 2QFY12, 44% in 1HFY12; model 4% in FY12

- Of the gross under-recovery of INR47b in 2QFY12, HPCL received INR15.6b from upstream as discounts on crude purchases. However, the government did not pay any compensation during the quarter. The net subsidy burden was INR31.2b in 2QFY12.
- For FY12, we model upstream share at 38.7%, government share at ~57% and OMCs' share at 4%. For FY13, we model OMCs' share at 13%.

June 2011 duty cuts impact GRM

- GRM for the quarter was USD1.9/bbl (v/s our estimate of USD6.8/bbl) as against USD2.7/bbl in 2QFY11 and USD1.1/bbl in 1QFY12. The lower than expected GRM was led by duty cuts effected by the government in June 2011, which impacted HPCL's crude inventory.
- We estimate the impact of duty cut on the 2QFY12 reported GRM at ~USD1.2/bbl. Further, the large underperformance v/s the regional benchmark Reuters Singapore GRM in recent quarters is due to the difference in product slate - HPCL is a diesel-heavy refiner and cracks of diesel were down QoQ in 2QFY12.

Valuation and view

- We model Brent oil price of USD110/95/90/85/bbl in FY12/FY13/FY14/long-term in our estimates. Similar to earlier years, government subsidy sharing is likely to be finalized towards the end of the year. In view of the likely ONGC FPO, we expect the government to spell out a sustainable subsidy-sharing formula.
- To account for lower GRM performance in 2QFY12, we cut our FY12E EPS by 19% to INR30.6. The stock trades at 10.9x FY12E EPS of INR30.6 and 0.9x FY12E BV. Key things to watch (apart from subsidy sharing) are the start of commercial production at Bhatinda Refinery at full utilization and GRM performance. Valuations are reasonable. Maintain **Buy**.

Quarterly Performance (INR Million)

Y/E March	FY11				FY12				FY11	FY12E
	1Q	2Q	3Q	4Q	1Q	2Q	3QE	4QE		
Net Sales	**292,264**	**281,385**	**339,025**	**396,668**	**407,980**	**370,302**	**427,199**	**470,548**	**1,309,342**	**1,676,029**
Change (%)	20.8	15.1	16.0	26.6	39.6	31.6	26.0	18.6	19.9	28.0
EBITDA	**-16,155**	**23,224**	**6,267**	**19,751**	**-26,873**	**-29,437**	**15,114**	**72,777**	**33,088**	**31,581**
% of Net Sales	-5.5	8.3	1.8	5.0	-6.6	-7.9	3.5	15.5	2.5	4.5
Change (%)	-248.5	nm	340.9	50.3	66.3	nm	141.2	268.5	30.1	-4.6
Depreciation	3,174	3,234	3,647	4,015	3,886	4,150	4,200	3,949	14,070	16,184
Interest	1,968	2,200	2,417	2,255	2,641	3,028	2,925	2,810	8,840	11,405
OI (incl. Oper. other inc)	2,469	3,817	2,984	4,165	2,585	2,971	2,918	2,809	13,434	11,283
Exceptional Item	-14	-2		-137	12	0		0	-152	12
PBT	**-18,843**	**21,608**	**3,188**	**17,509**	**-30,803**	**-33,644**	**10,907**	**68,827**	**23,461**	**15,287**
Tax	0	712	1,078	6,282	0	0	1,812	3,097	8,071	4,909
Rate (%)	0.0	3.3	33.8	35.9	0.0	0.0	16.6	4.5	34.4	32.1
PAT	**-18,843**	**20,896**	**2,110**	**11,227**	**-30,803**	**-33,644**	**9,096**	**65,730**	**15,390**	**10,378**
Change (%)	nm	nm	571.2	48.9	63.5	nm	331.1	485.5	18.6	-32.6

E: MOSL Estimates

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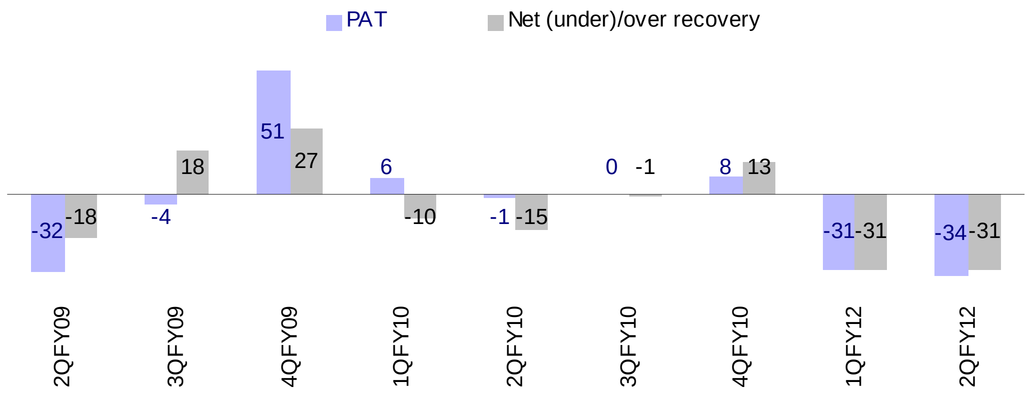
Reports loss due to nil government sharing, forex loss and lower GRM

- HPCL reported EBITDA loss of INR29.4b for 2QFY12 v/s our expectation of an EBITDA of INR12.6b, primarily due to (1) nil government compensation v/s our estimate of INR32b, (2) GRM of USD1.9/bbl, much lower than our estimate of USD6.8/bbl, led by the June 2011 duty cut impact on crude inventory, and (3) forex loss of INR10b.
- The company reported a net loss of INR33.6b v/s a net profit of INR21b in 2QFY11 and loss of INR30.8b in 1QFY12.
- Given the ad-hoc subsidy sharing, we believe quarterly financials are not indicative of the likely full-year performance. We now model OMCs' subsidy sharing at 4% in FY12 (v/s 8.8% in FY11) and upstream sharing at ~39%. The rest would be borne by the government.

Other key highlights

- Product inventory adventitious gain in the quarter was INR8.7b v/s gain of INR3b in 2QFY11 and INR2.2b in 1QFY12.
- Refinery throughput stood at 4.2mmt (v/s our estimate of 4.3mmt), up 38% YoY and 5% QoQ. Marketing volumes were 5% lower QoQ at 6.9mmt, led by seasonal factors.
- Gross debt stood at INR312b as at September 2011 v/s INR250b as at March 2011. Despite sharp rise in debt levels, HPCL's interest cost was largely contained (INR3b v/s INR2.6b in 1QFY12) due to lower interest rate at ~4.5%.
- HPCL is in the process of commissioning the CDU at its new Bhatinda Refinery and expects to start commercial production by 4QFY12.

Ad hoc subsidy sharing results in volatile quarterly profits (INR b)



Source: Company/MOSL

HPCL's subsidy sharing: Net sharing at 44% in 1HFY12, we model 4% in FY12 (INR b)

	FY10				FY11				FY12		2QFY12 (%)		FY11	1H
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	YoY	QoQ		FY12
Gross Under recovery	**11.6**	**22.2**	**29.4**	**37.2**	**44.1**	**24.2**	**34.3**	**68.6**	**95.0**	**46.9**	**93**	**-51**	**171.2**	**141.9**
Less: Sharing														
Upstream Sharing	1.7	7.6	9.6	13.5	14.7	8.1	11.4	32.1	31.7	15.6	93	-51	66.3	47.3
Oil Bonds/Cash	0.0	0.0	19.0	36.7	0.0	28.3	17.5	44.0	32.7	0.0	-100	-100	89.8	32.7
Net Under/(over) recovery	**9.9**	**14.6**	**0.8**	**(13.0)**	**29.4**	**(12.2)**	**5.4**	**(7.5)**	**30.6**	**31.2**	**-357**	**2**	**15.1**	**61.9**
As a % of Gross	**85.1**	**65.7**	**2.8**	**nm**	**66.7**	**nm**	**15.7**	**nm**	**32.2**	**66.7**			**8.8**	**43.6**

Source: Company/MOSL

HPCL's subsidy sharing: Net sharing at 32.2% in 1QFY12, we model 6% in FY12

	FY10				FY11				FY12		2QFY12 (%)	
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	YoY	QoQ
Marketing Volumes (mmt)	**6.8**	**6.3**	**6.7**	**6.5**	**6.7**	**6.0**	**7.1**	**7.2**	**7.3**	**6.9**	**15**	**-5**
Throughput (mmt)												
Mumbai	1.8	1.8	1.5	1.8	1.2	1.5	1.8	2.0	1.8	1.9	21	5
Visakh	2.3	2.2	2.2	2.1	2.1	1.5	2.3	2.4	2.2	2.3	54	6
Total	**4.1**	**4.0**	**3.7**	**3.9**	**3.3**	**3.0**	**4.1**	**4.3**	**4.0**	**4.2**	**38**	**5**
Blended GRM (USD/bbl)	**5.7**	**1.8**	**(0.3)**	**3.2**	**3.7**	**2.7**	**5.1**	**8.6**	**1.1**	**1.9**	**-27**	**77**

Source: Company/MOSL

We model OMC sharing at 6% in FY12, 13% in FY13 (INR b)

	FY08	FY09	FY10	FY11	FY12E	FY13E
Fx Rate (INR/USD)	**40.3**	**46.0**	**47.5**	**45.6**	**47.0**	**46.0**
Brent (USD/bbl)	**82.3**	**84.8**	**69.6**	**86.3**	**110.0**	**95.0**
Gross Under recoveries (INR b)						
Auto Fuels	426	575	144	375	696	256
Domestic Fuels	347	458	316	405	536	420
Total	**773**	**1,033**	**461**	**780**	**1,232**	**676**
Sharing (INR b)						
Oil Bonds/Cash	353	713	260	410	697	326
Upstream	257	329	145	303	486	262
OMC's sharing	163	-9	56	67	49	88
Total	**773**	**1,033**	**461**	**780**	**1,232**	**676**
Sharing (%)						
Government	46	69	56	53	57	48
Upstream	33	32	31	39	39	39
OMC's sharing	21	-1	12	9	4	13
Total	**100**	**100**	**100**	**100**	**100**	**100**

Source: Company/MOSL

Valuation and view

- We model Brent oil price of USD110/95/90/85/bbl in FY12/FY13/FY14/long-term in our estimates. Similar to earlier years, government subsidy sharing is likely to be finalized towards the end of the year. Led by delay in government compensation, we continue to model higher debt levels (leading to higher interest costs) for the next two quarters and expect bulk of the government compensation to come in 4QFY12. In view of the likely ONGC FPO, we expect the government to spell out a sustainable subsidy-sharing formula.
- To account for lower GRM performance in 2QFY12, we cut our FY12E EPS by 19% to INR30.6. The stock trades at 10.9x FY12E EPS of INR30.6 and 0.9x FY12E BV. Key things to watch (apart from subsidy sharing) are the start of commercial production at Bhatinda Refinery at full utilization and GRM performance. Valuations are reasonable. Maintain **Buy**.

HPCL: an investment profile

Company description

A Fortune-500 company, HPCL is a refining and marketing company in India and also has interests in upstream. It owns 13.5mmt of refining capacity, split across Mumbai (6.5mmt) and Vishakapatnam (7.5mmt). It has a crude and product pipeline network of ~2,100km and sells ~26mmt of petroleum products. HPCL also holds a 16.9% stake in MRPL, a standalone refiner, which it jointly promoted. MRPL is now a subsidiary of ONGC. HPCL is a state-owned company, with 51.11% Government of India (GoI) stake.

Key investment arguments

- HPCL's profitability continues to be determined by the quantum of under-recoveries and sharing mechanism, rather than fundamentals.
- Medium to long-term growth would come from its 9mmtpa grassroots refinery being set up in JV (~50% stake) with Mittal Energy Investments, with an estimated capex of INR172b.
- Post deregulation and subsidy rationalization, HPCL's valuations should benefit due to improvements in (1) earnings quality, (2) RoCE and RoE, (3) cash cycle, and (4) debt levels.

Key investment risks

- Delays in diesel deregulation and ad-hoc subsidy sharing.
- Non-commensurate increase in retail fuel prices. Oil price rise leads to under-recoveries for the company, and ad-hoc nature of subsidy sharing impacts profits.

Recent developments

- The government initiated the process of decontrol of retail fuel prices, starting with petrol prices. The FPO of IOCL and ONGC could be key triggers to start the decontrol process for LPG, kerosene and diesel.

Valuation and view

- The stock trades at 10.9x FY12E EPS of INR30.6 and 0.9x FY12E BV.
- Valuations are reasonable. Maintain Buy.

Sector view

- We expect refining margins to remain range-bound amidst mixed trends in the global economy and the supply-side situation. However, the ceiling will be capped in the near term, due to new capacities coming online in FY12 and FY13. We expect the demand-supply gap to correct only through refinery closure of simple refiners and continuous pick-up in global demand.

Target price and recommendation

Current Price (INR)	Target Price (INR)	Upside (%)	Reco.
337	-	-	Buy

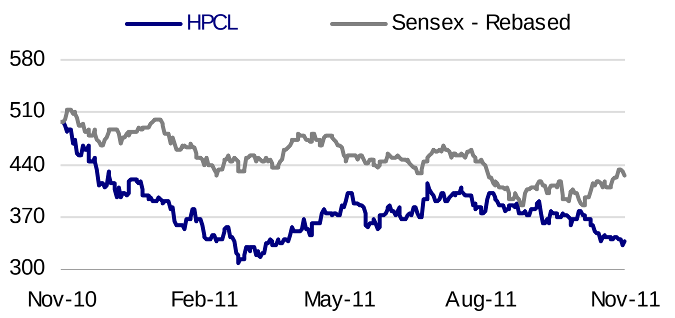
EPS: MOSL forecast v/s consensus (INR)

	MOSL Forecast	Consensus Forecast	Variation (%)
FY12	30.6	43.7	-30.1
FY13	39.1	49.5	-20.9

Shareholding pattern (%)

	Sep-11	Jun-11	Sep-10
Promoter	51.1	51.1	51.1
Domestic Inst	28.6	29.1	27.9
Foreign	9.5	9.6	9.0
Others	10.8	10.2	12.1

Stock performance (1 year)



Financials and Valuation

Income Statement (INR Million)

Y/E March	2010	2011	2012E	2013E
Net Sales	**1,092,084**	**1,309,342**	**1,674,436**	**1,626,294**
Change (%)	-12.8	19.9	27.9	-2.9
Finished Gds Purchase	642,488	843,135	1,021,598	889,707
Raw Materials Cons	344,776	366,443	558,382	649,671
Employee Costs	16,173	20,172	18,896	19,274
Other Exp	63,215	46,505	43,973	22,593
EBITDA	**25,432**	**33,088**	**31,587**	**45,050**
% of Net Sales	2.3	2.5	1.9	2.8
% Growth	-12.1	30.1	-4.5	42.6
Depreciation	11,644	14,070	16,184	23,050
Interest	9,038	8,840	11,405	12,250
Other Income	16,462	13,435	11,284	9,793
Extraordinary Items (net)	38	-152	12	
PBT	**21,250**	**23,461**	**15,294**	**19,544**
Tax	8,237	8,071	4,911	6,276
Total Rate (%)	38.8	34.4	32.1	32.1
PAT	13,014	15,390	10,383	13,268
Adjusted PAT	**13,014**	**15,390**	**10,383**	**13,268**
Change (%)	198.8	18.3	-32.5	27.8

Balance Sheet (INR Million)

Y/E March	2010	2011	2012E	2013E
Share Capital	3,390	3,390	3,390	3,390
Reserves	112,190	122,068	128,882	137,390
Net Worth	**115,580**	**125,458**	**132,272**	**140,780**
Loans	213,024	250,212	285,000	205,000
Deferred Tax	18,080	31,956	33,486	35,440
Capital Employed	**346,683**	**407,626**	**450,758**	**381,221**
Gross Fixed Assets	249,884	296,484	344,471	379,471
Less: Depreciation	96,817	110,039	126,223	149,272
Net Fixed Assets	**153,067**	**186,445**	**218,248**	**230,199**
Capital WIP	38,876	37,987	20,000	15,000
Investments	113,873	113,350	113,350	113,350
Curr. Assets, L & Adv.	**206,419**	**265,910**	**312,329**	**238,198**
Inventory	125,792	166,223	182,792	173,381
Debtors	24,373	26,544	34,003	33,025
Cash & Bank Balance	2,431	800	23,192	4,048
Loans & Advances	52,585	71,358	71,358	26,759
Other Current Assets	1,237	985	985	985
Current Liab. & Prov.	**165,552**	**196,066**	**213,170**	**215,526**
Liabilities	144,499	178,018	195,307	195,394
Provisions	21,053	18,048	17,862	20,132
Net Current Assets	**40,867**	**69,844**	**99,159**	**22,672**
Application of Funds	**346,683**	**407,626**	**450,758**	**381,221**

E: MOSL Estimates

Ratios

Y/E March	2010	2011	2012E	2013E
Basic (INR)				
EPS	**38.4**	**45.4**	**30.6**	**39.1**
Cash EPS	113.4	143.0	123.8	172.0
Book Value	340.9	370.1	390.2	415.3
DPS	12.0	14.0	9.0	12.0
Payout (incl. Div. Tax.)	16.1	30.7	34.4	35.9
Valuation (x)				
P/E	8.8	7.4	11.0	8.6
Cash P/E	3.0	2.4	2.7	2.0
EV / EBITDA	9.0	8.5	9.4	5.3
EV / Sales	0.2	0.2	0.2	0.1
Price / Book Value	1.0	0.9	0.9	0.8
Dividend Yield (%)	3.6	4.2	2.7	3.6
Profitability Ratios (%)				
RoE	11.7	12.8	8.1	9.7
RoCE	8.7	8.6	6.2	7.6
Turnover Ratios				
Debtors (No. of Days)	7.8	7.1	6.6	7.5
Asset Turnover (x)	4.8	4.8	5.2	4.5
Leverage Ratio				
Debt / Equity (x)	1.8	2.0	2.2	1.5

Cash Flow Statement (INR Million)

Y/E March	2010	2011	2012E	2013E
OP/(Loss) before Tax	21,250	23,461	15,294	19,544
Depreciation	11,679	14,082	16,184	23,050
Other op	-5,715	-2,456	0	0
Interest Paid	16,075	6,457	11,405	12,250
Direct Taxes Paid	-3,946	-5,645	-3,382	-4,321
(Inc)/Dec in Wkg. Capital	-6,530	-25,876	-6,924	57,344
CF from Op. Activity	**32,814**	**10,024**	**32,578**	**107,866**
(Inc)/Dec in FA & CWIP	-36,180	-46,101	-30,000	-30,000
(Pur)/Sale of Investments	16,601	5,371	0	0
Inc from Invst	8,037	6,919	0	0
CF from Inv. Activity	**-11,542**	**-33,810**	**-30,000**	**-30,000**
Issue of Shares	0	0	0	0
Inc / (Dec) in Debt	-9,781	30,408	34,788	-80,000
Interest paid & other Inv	-11,224	-8,933	-11,405	-12,250
Dividends Paid	-2,093	-4,731	-3,570	-4,759
CF from Fin. Activity	**-23,097**	**16,744**	**19,814**	**-97,009**
Inc / (Dec) in Cash	**-1,825**	**-7,042**	**22,392**	**-19,143**
Add: Op. Balance	6,083	2,431	800	23,192
Bank Balance Adj.	-1,826	5,410	0	0
Closing Balance	**2,431**	**800**	**23,192**	**4,048**

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3. Broking relationship with company covered	No
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