Goldman Sachs

India: Energy: Oil - Refining

OMCs to depend on bonds despite reform; govt likely benefits most

Enthusiasm on potential pricing reforms has lifted OMC stocks

The stocks of Indian oil marketing companies (OMCs) have moved up sharply in the last few weeks on media reports (e.g., Reuters) suggesting that the government could free up auto fuel pricing up to oil price of US$75/bbl, (without reforms in cooking fuels). Though the petroleum minister is yet to take office, the government has remained noncommittal on this issue; as such, we remain unconvinced about the reforms actually happening, but take a look at how the OMCs would be impacted by potential reforms.

Partial reforms may not help OMCs; gov't likely main beneficiary

We believe that deregulation of only auto fuels may not boost the earnings of OMCs, since oil bonds and upstream payments would still remain critical for them due to large losses from cooking fuel sales. We find it hard to believe that the government would issue a large quantum of oil bonds to increase OMC profits and add to the fiscal deficit in the process. Collection from any windfall tax on oil producers would also likely be less than cooking fuel losses. Hence, we believe that partial reform would improve cash flows of OMCs but may not impact earnings.

The government could be the biggest beneficiary from this, in our view, as it would likely look to reduce issuance of oil bonds and also potentially increase upstream subsidy burden. We also believe that private refiners (RIL, Essar) could be included in the subsidy scheme going forward, rather than the government initiating pricing reforms to encourage private participation in domestic petroleum retailing.

With stock prices moving on expectations of reforms and oil price rising, significant scope for disappointment going forward

With hardly any impact on earnings on OMCs likely from partial reforms and the recent run-up in these stocks, we believe there is scope of disappointment in these stocks in the near term. Moreover, rising oil prices could make partial reform itself unlikely. We believe this sentiment-driven rally in OMC stocks is unlikely to get fundamental support.

Neutral on OMCs on lack of policy direction; move out on rallies

We remain Neutral on IOC, HPCL and BPCL with P/B-based 12-m TPs of Rs415, Rs260, Rs325, respectively, as we wait for some policy direction from the gov't. We believe investors should reduce positions on any news flow-driven rally in the run-up to the Union budget in early July.

SUMMARY OF TARGET PRICES AND RATINGS

Ticker	Rating	12-month Target Price (Rs/sh)	Current Price (Rs/sh)	Potential Upside / Downside %
HPCL.BO	Neutral	260	335.35	-22%
BPCL.BO	Neutral	325	448.15	-27%
IOC.BO	Neutral	415	569.95	-27%

Downside risk: Policy disappointment on reforms, high oil price. Upside risk: Potential reforms.

Source: Goldman Sachs Research estimates

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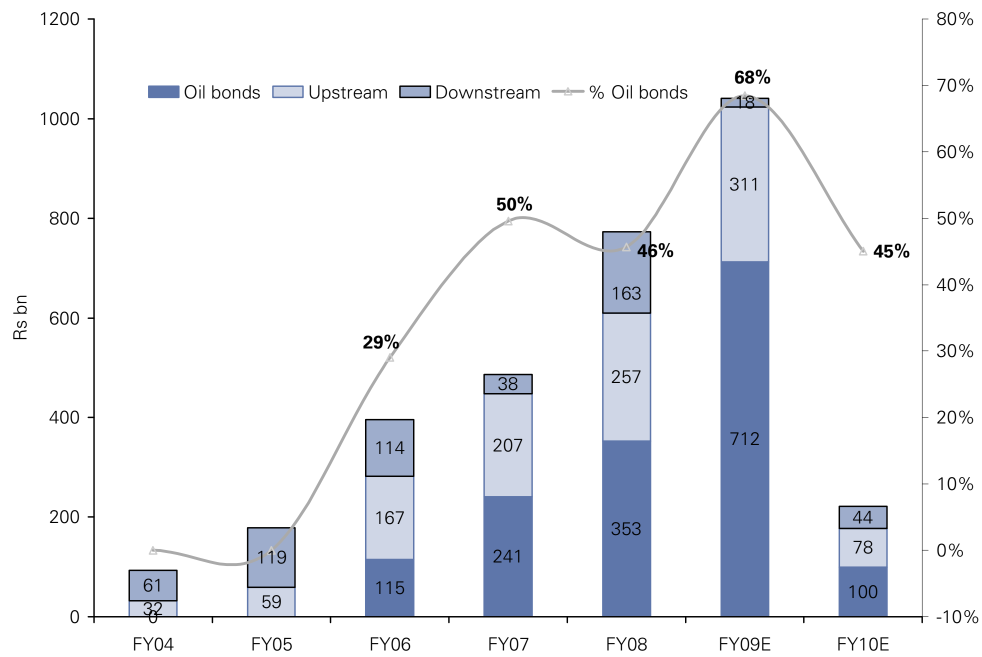
Exhibit 1: Net under-recoveries of OMCs will likely remain dependent on quantum of oil bonds given by gov't and on upstream subsidy contribution; under reforms, gov't may choose to issue fewer bonds and increase upstream burden
Analysis of net under-recovery of OMCs with and without reforms

(in Rs mn)	FY10E	FY10E-Reforms	FY11E	FY11E - Reforms	Comments
Gross under-recovery	**221,825**	**221,825**	**908,446**	**356,398**	
- Fresh oil bonds issued	99,821	99,821	545,067	196,019	Assumed 45%-55% as bonds; this could be lower due to fiscal deficit
- Lower duties					
- Fuel price changes					
- Upstream contribution (35%)	**77,639**	**77,639**	**317,956**	**124,739**	Could go up under 1) less bonds 2) private refiners start getting subsidy
- Refinery discount	-	-	-	-	
Total receipts to downstream	177,460	177,460	863,023	320,758	
Undecided portion					
Net under-recoveries for R&M cos.	**44,365**	**44,365**	**45,422**	**35,640**	Net under-recovery unlikely to change under partial reform

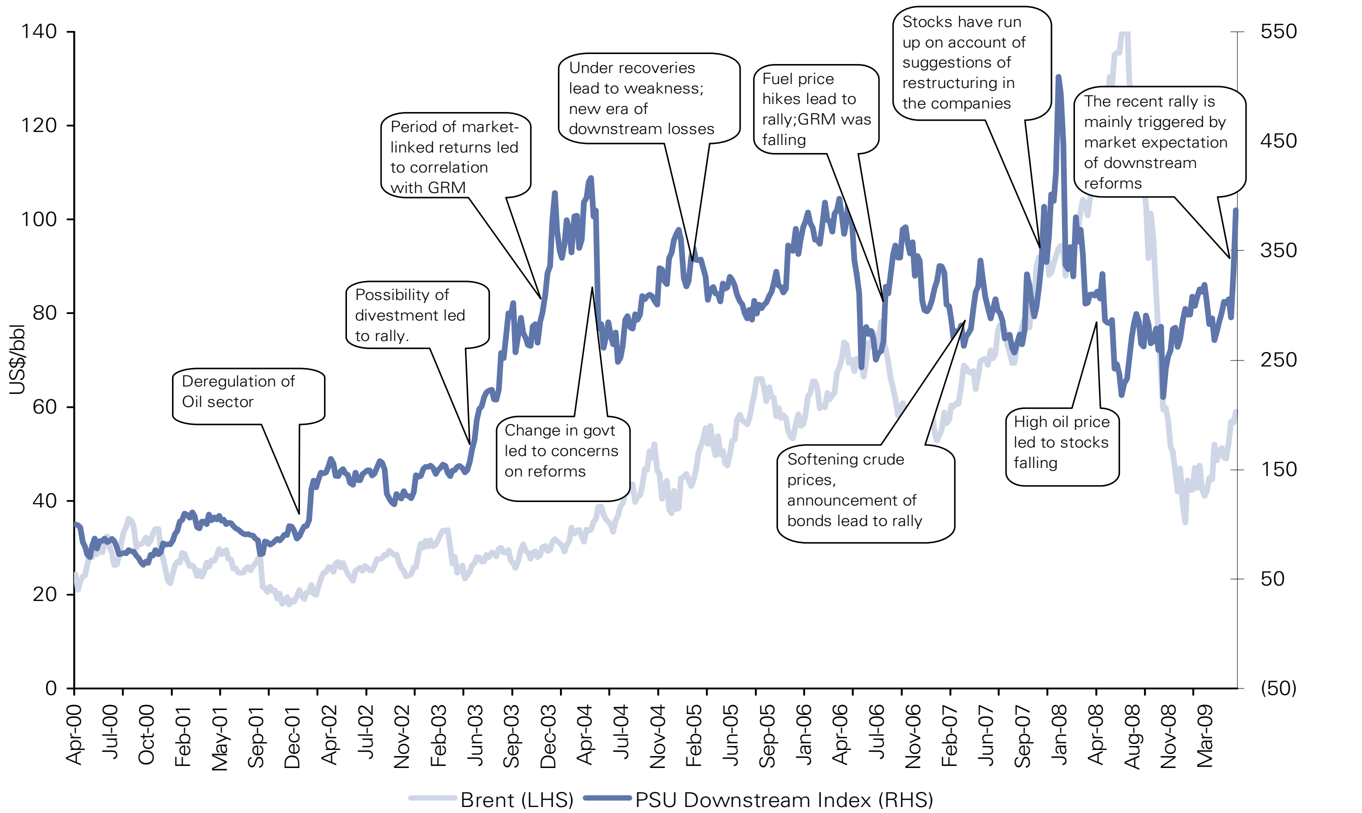
Source: Ministry of Petroleum and Natural Gas, Goldman Sachs Research estimates.

Exhibit 2: Oil bonds as a % of under-recovery have been 29%-50% (except FY09); this may go down under partial reforms, as the gov't would likely try to contain the fiscal deficit
Oil bonds and under-recoveries



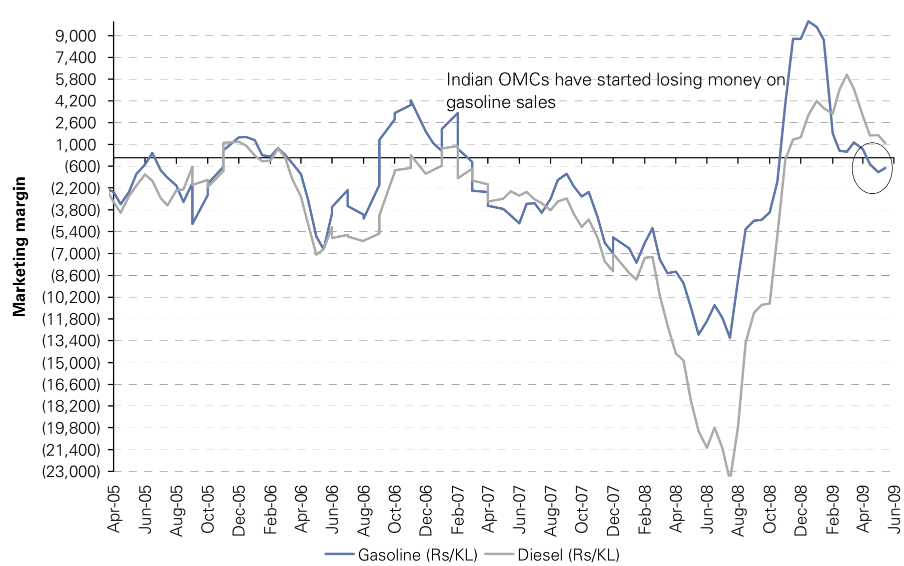
Source: Ministry of Petroleum & Natural Gas, Goldman Sachs Research estimates.

Exhibit 3: The OMC stocks have tended to react more to news flow on under-recoveries rather than refining fundamentals and give up gains quickly on disappointment, like in early 2004



Source: Bloomberg, Goldman Sachs Research

Exhibit 4: Indian state-owned oil marketing companies have already started incurring losses in gasoline sales and are close to losses on diesel



Source: Ministry of Petroleum & Natural Gas, Goldman Sachs Research

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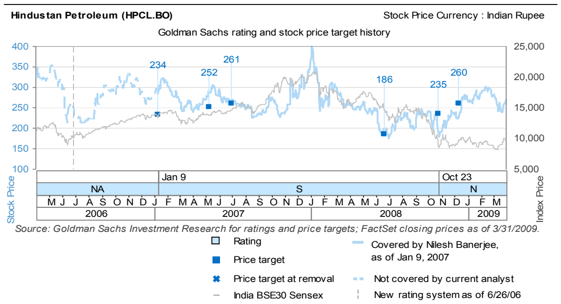

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