Company In-Depth

19 October 2006 | 10 pages

Indian Petrochemicals (IPCL.BO)

Extended Cycle, Merger Boost Earnings; Raising Target Price

Rating change ☐
Target price change ☑
Estimate change ☑

- Extended cycle, merger positive for earnings — We are adjusting our earnings estimates for IPCL to account for 1) merger of the 6 polyester entities and 2) our view that the strong petrochem cycle will now extend over the medium term. Our EPS numbers are 32-38% higher over FY07E-08E.
- Raising target price to Rs325 — Based on our revised earnings, we are raising our target price to Rs325/share (Rs270 earlier) based on 4.5x FY08E EV/EBITDA (4x FY07E EV/EBITDA earlier). A higher target multiple is justified in our view, due to greater confidence on the extension of the petrochem cycle and the more diversified earnings streams consequent to consolidation of the polyester entities.
- 2QFY07 – robust quarter — 2Q net earnings of Rs3.5bn (+75% YoY, pre-exceptional) highlights the robust operating environment for IPCL in 2QFY07. Polymer prices were up 25-27% YoY which helped offset the rise in the price of gas input costs and led to a 38% increase in operating profits.
- Synergistic merger, but awaiting more disclosures — The 2QFY07 release had some disclosures on the financials of the merged entity which point to the synergies inherent in the merger (FY06 EBITDA for the consolidated entity is higher than stand-alone EBITDAs by Rs1.2bn, current taxes were lower by Rs2.23bn). However, we are awaiting further financial details on the merged entity.
- Maintain Hold/Low Risk (2L) — IPCL stock price has outperformed on expectations of the strong quarter and likely benefits of the merger. We believe there is moderate upside from current levels and retain our Hold rating on the stock.

Hold/Low Risk	**2L**
Price (18 Oct 06)	Rs303.85
Target price	Rs325.00
from Rs270.00	
Expected share price return	7.0%
Expected dividend yield	2.0%
Expected total return	**8.9%**
Market Cap	Rs75,423M
	US$1,665M

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

See page for Analyst Certification and important disclosures.

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/CEPS (x)	EV/EBITDA (x)	ROE (%)
2004A	2,736	10.98	34.0	27.7	10.2	10.8	12.1
2005A	7,857	31.55	187.2	9.6	5.9	6.2	30.3
2006E	10,440	34.62	9.7	8.8	5.3	3.8	30.4
2007E	12,103	40.14	15.9	7.6	5.2	3.2	27.2
2008E	10,979	36.41	-9.3	8.3	5.5	3.0	20.3
2009E	9,920	32.90	-9.6	9.2	5.8	2.8	15.9

Source: Company Reports and Citigroup Investment Research

Pradeep Mirchandani, CFA[1]
+91-22-6631-9877
pradeep.mirchandani@citigroup.com

Rahul Singh[1]
+91-22-6631-9863
rahul.r.singh@citigroup.com

Saurabh Handa[1]
saurabh.handa@citigroup.com

[1]Citigroup Global Market India Private Limited

Fiscal year end 31-Mar	2004	2005	2006E	2007E	2008E
Valuation Ratios					
P/E adjusted (x)	27.7	9.6	8.8	7.6	8.3
EV/EBITDA adjusted (x)	10.2	5.6	3.8	3.0	2.8
P/BV (x)	3.3	2.6	2.3	1.8	1.6
Dividend yield (%)	0.9	1.7	1.8	2.0	2.0
Per Share Data (Rs)					
EPS (adjusted)	10.98	31.55	34.62	40.14	36.41
EPS (reported)	10.98	31.55	38.60	40.14	36.41
BVPS	91.23	117.29	131.06	164.48	194.17
DPS	2.81	5.12	5.50	6.00	6.00
Profit & Loss (RsM)					
Net sales	80,978	81,991	109,220	121,857	116,365
Operating expenses	-75,633	-71,433	-94,590	-104,131	-100,953
EBIT	**5,345**	**10,558**	**14,630**	**17,726**	**15,412**
Net interest expense	-2,992	-1,623	-1,350	-1,406	-1,012
Non-operating/exceptionals	1,013	1,322	1,470	2,300	2,490
Pre-tax profit	**3,366**	**10,257**	**14,750**	**18,620**	**16,890**
Tax	-630	-2,399	-4,310	-6,517	-5,912
Extraord./Min.Int./Pref.div.	0	0	1,200	0	0
Reported net income	**2,736**	**7,857**	**11,640**	**12,103**	**10,979**
Adjusted earnings	2,736	7,857	10,440	12,103	10,979
Adjusted EBIT	5,345	10,558	14,630	17,726	15,412
Growth Rates (%)					
EPS (adjusted)	34.0	187.2	9.7	15.9	-9.3
EBIT (adjusted)	-8.4	97.5	38.6	21.2	-13.1
Sales	61.0	1.3	33.2	11.6	-4.5
Cash Flow (RsM)					
Operating cash flow	**13,463**	**22,163**	**18,009**	**16,218**	**14,198**
Depreciation/amortization	4,716	5,057	5,610	5,535	5,735
Net working capital	6,012	9,249	759	-1,419	-2,515
Investing cash flow	**1,023**	**-1,170**	**-14,500**	**-3,500**	**-2,000**
Capital expenditure	0	-1,029	-14,500	-3,500	-2,000
Acquisitions/disposals	-627	-141	0	0	0
Financing cash flow	**-14,192**	**-14,851**	**-1,240**	**-4,387**	**-5,198**
Borrowings	-11,612	-14,058	93	-2,361	-3,172
Dividends paid	-700	-1,275	-1,857	-2,026	-2,026
Change in cash	**295**	**6,142**	**2,270**	**8,331**	**7,000**
Balance Sheet (RsM)					
Total assets	**72,289**	**76,747**	**97,337**	**108,807**	**113,282**
Cash & cash equivalent	506	6,648	9,500	18,000	25,000
Net fixed assets	54,666	50,638	59,528	57,493	53,758
Total liabilities	**49,568**	**47,537**	**57,819**	**59,213**	**54,735**
Debt	21,661	7,603	7,696	5,335	2,163
Shareholders' funds	**22,721**	**29,211**	**39,518**	**49,595**	**58,547**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	12.4	19.0	18.5	19.1	18.2
ROE adjusted	12.1	30.3	30.4	27.2	20.3
ROIC adjusted	7.9	16.8	21.4	21.4	18.5
Net debt to equity	93.1	3.3	-4.6	-25.5	-39.0
Total debt to capital	48.8	20.7	16.3	9.7	3.6

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Chemical cycle, merger positive for earnings

We are raising our earnings for IPCL based on the strong merger synergies arising out of the consolidation of 6 polyester entities into IPCL and our view that the strong petrochem cycle will extend through CY2008.

2QFY07 results release of IPCL provided us some details on the consolidated earnings for the merged entity. The consolidated EBITDA for the merged entity is Rs1.2bn higher than the stand-alone operating profits of IPCL and the six polyester entities. We believe the higher operating profit is due to synergies arising out of tax savings on materials purchased by the polyester companies from IPCL. IPCL also booked a one-time cash tax benefit of Rs2.2bn on account of accumulated losses of the polyester entities.

Figure 1. IPCL – FY06 Standalone and Merged Income statement (Rupees in Millions)

Year to 31 Mar	FY06 standalone	FY06 Merged	Difference	Comment
Gross Sales	95,970	123,620	27,650	
Excise Duty	11,280	14,400	3,120	
Net Sales	**84,690**	**109,220**	**24,530**	
Raw Material Consumed	42,310	58,090	15,780	
Stock Adjustment	(2,410)	(2,330)	80	
RM Cost of sales	39,900	55,760	15,860	
Gross Margin	**44,790**	**53,460**	**8,670**	
Employee Expenses	3,690	4,550	860	
Other Expenses	23,580	28,670	5,090	
Total Expenditure	67,170	88,980	21,810	
EBITDA	**17,520**	**20,240**	**2,720**	FY06 combined EBITDA of polyester companies was Rs1.54bn
EBITDA margin	*20.7%*	*18.5%*	*11.1%*	
Depreciation	4,800	5,610	810	
PBIT	12,720	14,630	1,910	
Interest	1,180	1,350	170	
Other Income	1,360	1,470	110	
PBT	**12,900**	**14,750**	**1,850**	
Current Tax	5,320	3,090	(2,230)	Cash tax outflow was lower in FY06

Source: Company Reports and Citigroup Investment Research

While the 2Q results have provided some details on the merged entity, the legal procedures around the merger have delayed IPCL's annual balance sheet disclosures. We expect greater clarity on the financial implications later this quarter when IPCL releases its annual report.

25-27% higher YoY polymer prices aided topline and operating growth, and helped offset rise in the price of gas input costs

Figure 2. IPCL 2QFY07 Results (Restated post-merger) – Rupees in Millions

Year to 31 Mar	Q2FY06	Q1FY07	Q2FY07	% yoy
Gross Sales	29,460	33,710	34,770	18.0%
Excise Duty	3,580	3,530	4,290	19.8%
Net Sales	**25,880**	**30,180**	**30,480**	**17.8%**
Raw Material Consumed	14,320	14,960	17,290	20.7%
Stock Adjustment	(1,200)	1,750	(1,360)	13.3%
RM Cost of sales	13,120	16,710	15,930	21.4%
Gross Margin	12,760	13,470	14,550	14.0%
Employee Expenses	1,140	1,390	1,210	6.1%
Other Expenses	7,010	6,490	6,970	-0.6%
Total Expenditure	21,270	24,590	24,110	13.4%
EBITDA	**4,610**	**5,590**	**6,370**	**38.2%**
EBITDA margin	*17.8%*	*18.5%*	*20.9%*	
Depreciation	1,400	1,320	1,350	-3.6%
PBIT	3,210	4,270	5,020	56.4%
Interest	390	510	370	-5.1%
Other Income	340	620	1,180	247.1%
PBT	3,160	4,380	5,830	84.5%
Tax	840	1,580	2,100	150.0%
Deferred Tax	310	220	220	-29.0%
Tax rate	*36.4%*	*41.1%*	*39.8%*	
Net profit before extraordinaries	2,010	2,580	3,510	74.6%
Extraordinary items	1,200			
Reported Net Income	**3,210**	**2,580**	**3,510**	**9.3%**

Source: Company Reports and Citigroup Investment Research

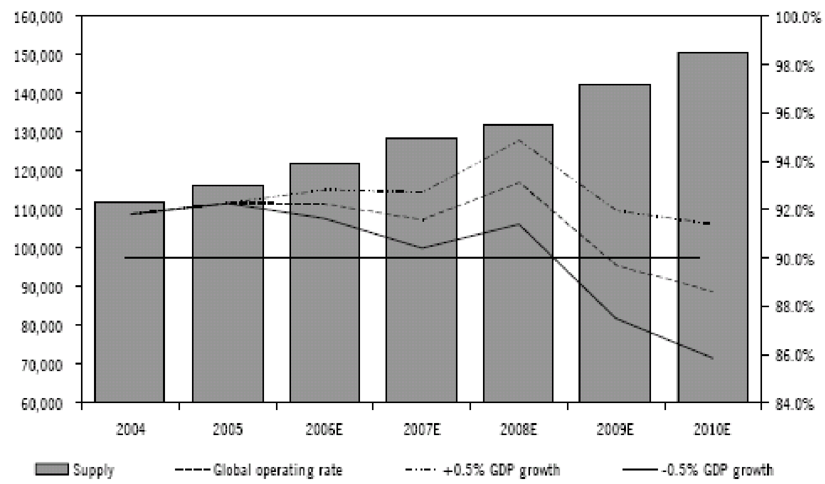
We are also adjusting our earnings for our view that the strength in the petrochem cycle will extend through to CY08 driven by the robust global economic environment. Our global petrochemical cycle view is summarized below:

- CMAI believes the petrochemical cycle peaked in 2004/05, but that a robust GDP environment is supportive of above average earnings levels until 2009 when the deluge of new capacity from the Middle East is so large that cyclical downturn conditions seem inevitable.

- Despite the continued rising oil price, economic growth has surprised on the upside in 2006. Citigroup's GDP forecasts for 2006E and 2007E stand at 3.8% and 3.5%, respectively.

- These stronger GDP projections have been reflected in our ethylene supply/demand model (Figure 3), which now suggests operating rates should remain relatively strong through 2008. The key risk to this more positive outlook is that demand fails to live up to expectations given inflationary pressures in the sector and broader economy.

Figure 3. Ethylene Supply, Demand and Utilization Rate History and Outlook, 2004-10E (tonnes in Thousands and Percent)



Source: CMAI and Citigroup Investment Research

- Increasing domestic GDP and government focus on job creation has propelled the development of the Middle Eastern Petrochemical industry away from just the ethylene chain where they have the greatest cost advantage. The region now plans substantial investments in the propylene and styrene chains (currently the Middle East has a c. $500/T cost advantage over Western producers for ethylene vs. a c.$100/T cost advantage for propylene; the cost advantage for styrene comes through the lower cost of ethylene, a key raw material).

- Over the next five years, the CAGRs for Middle Eastern capacity in ethylene, propylene and styrene are 20%, 29% and 22%, respectively. This means that by 2010 the region will account for 20% of global ethylene production and 10% of each propylene and styrene capacity.

- Propylene in particular has been seen as stronger for longer commodity given the majority of new Middle Eastern crackers use ethane as a feedstock which produces roughly ten times less propylene than naphtha-based crackers. However, the rise in propylene prices and the strong outlook has attracted new propylene production technologies such as Propane Dehydrogenation and Metathesis.

- The new investments mean that CMAI now forecast similar global capacity growth for propylene as for ethylene. One year ago forecasts for average annual propylene capacity growth were around 50bps lower than for ethylene.

Adjusting for the merger and the strength in global petrochem cycle, we are raising our EPS estimates for IPCL by 32-38% for FY07-08 (Figure 4). We introduce FY09 estimates. We have built in a decline in petrochem prices over the next two years.

Figure 4. IPCL – Earnings Revisions

Year to	Net Profit (Rs Mils.)		Diluted EPS (Rs)			Dividend Per Share (Rs)	
31-Mar	Old	New	Old	New	% Chg	Old	New
2007E	7,240	12,103	29.07	40.14	38.1%	5.12	6.00
2008E	6,864	10,979	27.56	36.41	32.1%	5.12	6.00
2009E	NA	9,920	NA	32.90	NA	NA	6.00

Source: Citigroup Investment Research

Raising Target Price to Rs325

We have raised our target price for IPCL to Rs325 (Rs270 earlier) based on 4.5x FY08E EV/EBITDA. Our earlier target was based on a mid-cycle valuation multiple of 4x FY07E EV/EBITDA. A higher target multiple is justified in our view, due to greater confidence on the extension of the petrochem cycle and the more diversified earnings streams consequent to consolidation of the polyester entities.

Indian Petrochemicals

Company Description

IPCL is the second-largest petrochemicals company in India with 26% of India's polymer capacity. Its main presence is in the ethylene chain. It was set up by the government of India, and the company built India's first large-scale naphtha cracker at Baroda (Western India). It has two gas-based crackers at Gandhar and Nagothane (both in Western India). The company is now part of the Reliance Industries Group.

Investment Thesis

We rate IPCL Hold/Low Risk (2L) with a target price of Rs325. IPCL is the second-largest petrochemical company in India, and it is highly leveraged to the ethylene chain. We expect the strength in petrochem margins to extend through until CY09 when capacity additions in the Middle East begin to come on line. We however expect IPCL's earnings to decline over FY08-09 due to our assumption of lower petrochemical prices. The government has raised the administered gas price (used as raw material) in April 2006 from US$3.86/mmbtu to US$4.75/mmbtu. While this has removed a potential overhang on the company, this is likely to adversely impact earnings in times of lower global commodity prices. IPCL stock price has outperformed on expectations of the strong earnings and likely benefits of the merger. We see marginal upside for the stock from current levels.

Valuation

Our target price for IPCL is Rs325 based on 4.5x FY08E EV/EBITDA. This is marginally higher than the mid-cycle valuation multiple of 4x in 1997 as IPCL now has a more diversified earnings stream and we believe that the petrochem cycle will now extend until 2009. When valuing Indian petrochemical companies, we tend to use EV/EBITDA numbers to compare companies across the regions, thereby avoiding regional differences in accounting policies on depreciation and taxation. Our target price is also based on a mid-cycle P/E of c.9x.

Risks

We rate IPCL Low Risk based on our quantitative risk-rating system. The main risks that could impede the stock from reaching our target price are as follows: (1) IPCL's margins are exposed to the international cycle, and thus tend to be volatile; (2) IPCL is highly exposed to the ethylene chain (largely polymers), and is less exposed to the polyester chain. Thus, it is vulnerable to a downturn in the ethylene chain; and (3) Any further hikes in the government-controlled price of gas feedstock would impact earnings. The upside risks to our target price and investment view include: (1) A stronger-than-expected petrochemical cycle over our forecast horizon; and (2) Greater-than-expected synergy benefits.

Analyst Certification Appendix A-1

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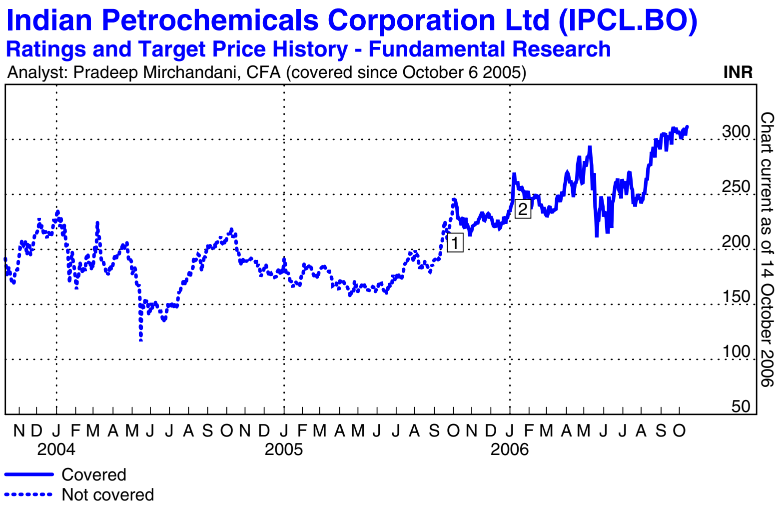

#	Date	Rating	Target Price	Closing Price
1:	5 Oct 05	2L	253.00	244.90
2:	23 Jan 06	2L	*270.00	253.00

*Indicates change.

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