

Castrol India

Easing pressures – ready to grow!

A 1Q07 net profit increase of 29% yoy did not fully reflect the drop in base oil prices. However, recent rupee appreciation augurs well for earnings and compensates for strength in crude oil prices. We maintain our Buy rating and Rs300 target price.

Key forecasts

	FY05A	FY06A	FY07F	FY08F	FY09F
Revenue (Rsm)	14304	17524	18354	18041	18586
EBITDA (Rsm)	2107	2201	3020	3521	4654
Reported net profit (Rsm)	1412	1546	2007	2351	3122
Normalised net profit (Rsm) ¹	1412	1392	2007	2351	3122
Normalised EPS (Rs)	11.4	11.3	16.2	19.0	25.3
Dividend per share (Rs)	8.25	9.00	11.0	14.0	16.0
Dividend yield (%)	3.15	3.43	4.20	5.34	6.10
Normalised PE (x)	22.9	23.3	16.1	13.8	10.4
EV/EBITDA (x)	14.7	13.8	9.99	8.42	6.20
Price/book value (x)	8.30	7.75	6.98	6.46	5.50
ROIC (%)	56.5	52.2	84.5	87.1	123.2

1. Post-goodwill amortisation and pre-exceptional items
Accounting Standard: Local GAAP
Source: Company data, ABN AMRO forecasts

year to Dec, fully diluted

1Q07 results slightly disappointing

Castrol reported net profit of Rs415m, an increase of 29% yoy and 9% qoq. Net sales grew 18% yoy, mainly in response to better net realisation. Profit was below our expectations, as input costs do not appear to have fully reflected the drop in base oil prices (may be an inventory issue). However, we continue to expect a further decline in base oil prices, which should be positive for earnings.

Base oil prices experiencing a decline

Base oil prices continue to decline after peaking in October 2006. Our estimates show a 24% drop from the peak and 10% from the previous quarter. The sharp rally in base oil prices in 2006 was more a function of an increase in base oil margins (base oil price less cost of crude) than an increase in crude oil prices. Despite strength in the crude oil price in 1Q07, the base oil price has weakened as base oil margins have come off their highs. A 7% appreciation in the rupee over the past month has been an additional positive factor, since input costs are also reduced to that extent (every 1% change in the exchange rate/international base oil price has a 2.5% impact on EPS, other factors remaining constant). We continue to believe the worst is over on the input cost front and that lower costs will drive margin growth going forward. The only point of debate is the speed at which this improvement materialises.

We maintain our Buy rating and target price of Rs300

We maintain our 2007 estimate of EPS growth of 40% to Rs16.2, resulting in a total return on equity of 46%. We forecast earnings will grow 64% over 2007-09 in response to lower base oil prices and volume growth. Our expectation of a decline in base oil prices is beginning to manifest itself and the stock has rallied 25% over the past month. The 2007F dividend yield at 4.2% remains attractive. The 2006 annual report talked of a possible new growth driver – Bike Zone (motor cycle servicing business) – which is still in its early stage, but which could provide an avenue for higher long-term growth in our opinion.

Priced at close of business 30 April 2007.

Mafatal Chambers – C Wing, Ground Floor, N.M. Joshi Marg, Lower Parel (E), Mumbai 400 013, India. Tel : +91 022 6754 8411 Fax : +91 022 6754 8420

Buy

Absolute performance

n/a

Short term (0-60 days)

Neutral

Market relative to region

Materials

India

Price

Rs262.15

Target price

Rs300.00

Market capitalisation

Rs32.41bn (US\$786.97m)

Avg (12mth) daily turnover

Rs15.11m (US\$0.34m)

Reuters

CAST.BO

Bloomberg

CSTR.L IN

Asset allocation

Equities Underweight

Cash Overweight

Bonds Overweight

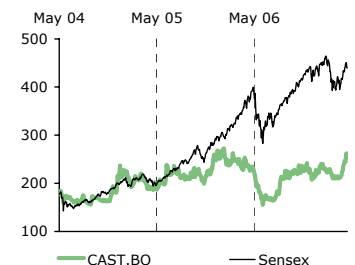
Price performance (1M) (3M) (12M)

Price (Rs) 210.9 232.0 228.1

Absolute % 24.3 13.0 14.9

Rel market % 17.1 15.8 -1.8

Rel sector % 22.4 6.1 10.0



Stock borrowing: Difficult

Volatility (30-day): 26.03%

Volatility (6-month trend): ↓

52-week range: 285.00-154.55

Sensex: 13872.37

BBG AP Chemicals: 235.66

Source: ABN AMRO, Bloomberg

Researched by

ABN AMRO Institutional
Equities Team

www.abnamrobroking.co.in

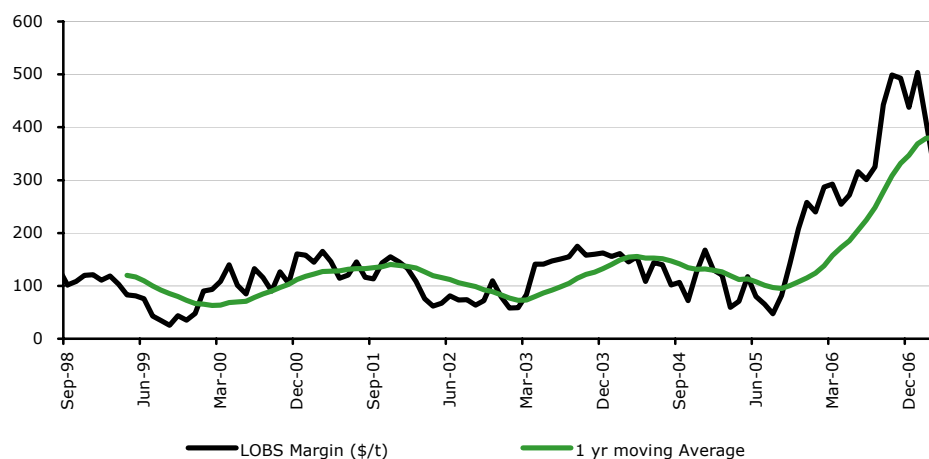
Easing pressure – ready to grow!

Table 1 : 1Q07 results summary

Rs m	Mar-06	Dec-06	Mar-07	yoy	qoq
Gross sales	4,397	5,629	5,178	18%	-8%
Less: excide duty	640	824	758		
Net sales	3,757	4,805	4,421	18%	-8%
Inc/dec in stock	-51	155	-188		
Raw material cons	2,505	2,969	2,974	19%	0%
Staff cost (excl VRS)	144	181	191		
Advertisement	121	162	167	38%	3%
Carriage, insurance, freight	151	166	163	8%	-2%
Other expenditure	387	462	474	22%	3%
Total expenditure	3,257	4,094	3,780	16%	-8%
EBIDTA	500	711	640	28%	-10%
Interest	7	22	9		
Depreciation	42	47	48		
Other income	42	48	73		
Profit before tax	494	691	657		
Current tax	172	310	242		
Net profit	321	381	415	29%	9%
EPS	2.60	3.08	3.36	29%	9%

Source: Company data

Chart 1 : LOBS margin trend (US\$/tonne)



Source: Bloomberg, ABN AMRO

Table 2 : Castrol - key assumptions

Year to 31 Dec	2005	2006	2007F	2008F	2009F
Lubes sales volume (KL)	226,471	225,840	232,072	240,122	247,382
Unit realisation (Rs./KL)	63,160	77,595	79,086	75,132	75,132
Brent oil price (US\$/bbl)	54.4	65.4	55.0	45.0	40.0
Base oil unit cost (Rs./KL)	25,651	41,500	34,850	28,989	24,638
Ad spend (Rsm)	776	648	1,122	978	825

Source: Company data, ABN AMRO forecasts

We believe the key risks to our investment case and DCF-based target price for Castrol are:

- crude oil prices remaining at current levels or reaching new highs,
- LOBS margins remaining at current levels or rising further, and
- Castrol being unable to generate more volumes and market share.

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CASTROL INDIA: KEY FINANCIAL DATA

Income statement

Rsm	FY05A	FY06A	FY07F	FY08F	FY09F
Revenue	14304	17524	18354	18041	18586
Cost of sales	-7752	-10794	-9936	-9086	-8413
Operating costs	-4445	-4529	-5397	-5433	-5519
EBITDA	2107	2201	3020	3521	4654
DDA & Impairment (ex gw)	-189.3	-180.0	-194.2	-204.3	-214.4
EBITA	1918	2021	2826	3317	4440
Goodwill (amort/impaird)	n/a	n/a	n/a	n/a	n/a
EBIT	1918	2021	2826	3317	4440
Net interest	170.6	149.0	206.2	234.3	274.6
Associates (pre-tax)	n/a	n/a	n/a	n/a	n/a
Forex gain / (loss)	n/a	n/a	n/a	n/a	n/a
Exceptionals (pre-tax)	n/a	154.0	n/a	n/a	n/a
Other pre-tax items	0.00	0.00	0.00	0.00	0.00
Reported PTP	2089	2324	3032	3551	4714
Taxation	-676.9	-778.0	-1026	-1200	-1593
Minority interests	n/a	n/a	n/a	n/a	n/a
Exceptionals (post-tax)	n/a	n/a	n/a	n/a	n/a
Other post-tax items	0.00	0.00	0.00	0.00	0.00
Reported net profit	1412	1546	2007	2351	3122
Normalised Items Excl. GW	0.00	154.0	0.00	0.00	0.00
Normalised net profit	1412	1392	2007	2351	3122

Source: Company data, ABN AMRO forecasts

year to Dec

Balance sheet

Rsm	FY05A	FY06A	FY07F	FY08F	FY09F
Cash & market secs (1)	1480	2125	2280	2800	3563
Other current assets	4421	4789	5030	4944	5093
Tangible fixed assets	1383	1343	1289	1225	1150
Intang assets (incl gw)	n/a	n/a	n/a	n/a	n/a
Oth non-curr assets	0.00	0.00	0.00	0.00	0.00
Total assets	7284	8257	8599	8969	9806
Short term debt (2)	0.00	0.00	0.00	0.00	0.00
Trade & oth current liab	2398	3278	3017	2793	2615
Long term debt (3)	27.9	27.9	27.9	27.9	27.9
Oth non-current liab	957.8	772.5	918.3	1135	1282
Total liabilities	3384	4079	3964	3955	3925
Total equity (incl min)	3900	4178	4635	5014	5882
Total liab & sh equity	7284	8257	8599	8969	9806
Net debt (2+3-1)	-1452	-2097	-2252	-2773	-3535

Source: Company data, ABN AMRO forecasts

year ended Dec

Cash flow statement

Rsm	FY05A	FY06A	FY07F	FY08F	FY09F
EBITDA	2107	2201	3020	3521	4654
Change in working capital	-455.5	316.1	-360.7	72.3	-185.5
Net interest (pd) / rec	-30.1	-41.0	-30.0	-30.0	-30.0
Taxes paid	-732.5	-758.0	-1021	-1195	-1587
Other oper cash items	200.7	190.0	236.2	264.3	304.6
Cash flow from ops (1)	1090	1908	1845	2633	3156
Capex (2)	-71.4	-140.0	-140.0	-140.0	-140.0
Disposals/(acquisitions)	0.00	154.0	0.00	0.00	0.00
Other investing cash flow	0.00	0.00	0.00	0.00	0.00
Cash flow from invest (3)	-71.4	14.0	-140.0	-140.0	-140.0
Incr / (decr) in equity	0.00	0.00	0.00	0.00	0.00
Incr / (decr) in debt	-9.30	0.00	0.00	0.00	0.00
Ordinary dividend paid	-1163	-1268	-1550	-1972	-2254
Preferred dividends (4)	n/a	n/a	n/a	n/a	n/a
Other financing cash flow	38.7	-0.12	0.00	0.00	0.00
Cash flow from fin (5)	-1134	-1268	-1550	-1972	-2254
Forex & disc ops (6)	9.10	-9.10	n/a	n/a	n/a
Incr/(decr) cash (1+3+5+6)	-106.1	644.9	155.6	520.3	762.3
Equity FCF (1+2+4)	1019	1768	1705	2493	3016

Lines in bold can be derived from the immediately preceding lines.

Source: Company data, ABN AMRO forecasts

year to Dec

CASTROL INDIA: PERFORMANCE AND VALUATION

Standard ratios	Castrol India					Asian Paints			Hindustan Lever		
Performance	FY05A	FY06A	FY07F	FY08F	FY09F	FY06F	FY07F	FY08F	FY06F	FY07F	FY08F
Sales growth (%)	9.18	22.5	4.73	-1.70	3.02	16.3	17.7	17.8	9.43	12.0	13.0
EBITDA growth (%)	1.50	4.44	37.2	16.6	32.2	20.2	20.5	19.5	14.2	24.0	18.8
EBIT growth (%)	-0.85	5.36	39.8	17.4	33.8	23.8	22.2	21.0	15.1	24.9	19.4
Normalised EPS growth (%)	-2.28	-1.40	44.2	17.2	32.8	22.6	21.3	19.6	17.5	22.9	17.4
EBITDA margin (%)	14.7	12.6	16.5	19.5	25.0	15.6	16.0	16.3	13.6	15.1	15.9
EBIT margin (%)	13.4	11.5	15.4	18.4	23.9	13.5	14.0	14.4	12.5	14.0	14.8
Net profit margin (%)	9.87	7.94	10.9	13.0	16.8	9.57	9.86	10.0	12.7	14.0	14.5
Return on avg assets (%)	18.7	16.6	22.2	25.0	31.3	18.0	20.0	21.5	23.5	26.2	28.0
Return on avg equity (%)	37.6	34.5	45.5	48.7	57.3	35.0	36.5	37.6	60.9	65.9	70.2
ROIC (%)	56.5	52.2	84.5	87.1	123.2	30.2	33.8	34.0	84.9	86.4	97.2
ROIC - WACC (%)	47.4	43.1	75.4	78.0	114.2	19.8	23.3	23.6	73.4	74.9	85.7
				<i>year to Dec</i>			<i>year to Mar</i>			<i>year to Dec</i>	
Valuation											
EV/sales (x)	2.16	1.73	1.64	1.64	1.55	3.38	2.89	2.46	3.60	3.21	2.82
EV/EBITDA (x)	14.7	13.8	9.99	8.42	6.20	21.6	18.0	15.1	26.4	21.3	17.8
EV/EBITDA @ tgt price (x)	16.9	15.9	11.5	9.75	7.21	22.0	18.4	15.4	34.0	27.4	22.9
EV/EBIT (x)	16.1	15.0	10.7	8.94	6.50	25.1	20.6	17.1	28.7	22.9	19.1
EV/invested capital (x)	12.1	13.7	11.9	12.4	11.5	10.5	8.78	7.57	19.9	18.7	17.8
Price/book value (x)	8.30	7.75	6.98	6.46	5.50	11.5	9.87	8.47	15.9	14.7	13.2
Equity FCF yield (%)	3.15	5.46	5.27	7.70	9.32	2.16	1.91	2.38	3.04	4.46	5.30
Normalised PE (x)	22.9	23.3	16.1	13.8	10.4	35.2	29.0	24.3	28.5	23.2	19.8
Norm PE @tgt price (x)	26.2	26.6	18.5	15.8	11.9	35.8	29.5	24.7	36.6	29.8	25.4
Dividend yield (%)	3.15	3.43	4.20	5.34	6.10	1.51	1.89	2.27	3.21	3.76	4.28
				<i>year to Dec</i>			<i>year to Mar</i>			<i>year to Dec</i>	
Per share data											
Tot adj dil sh, ave (m)	123.5	123.5	123.5	123.5	123.5						
Reported EPS (INR)	11.4	12.5	16.2	19.0	25.3						
Normalised EPS (INR)	11.4	11.3	16.2	19.0	25.3						
Dividend per share (INR)	8.25	9.00	11.0	14.0	16.0						
Equity FCF per share (INR)	8.25	14.3	13.8	20.2	24.4						
Book value per sh (INR)	31.6	33.8	37.5	40.6	47.6						
				<i>year to Dec</i>			<i>year to Mar</i>			<i>year to Dec</i>	
Solvency											
Net debt to equity (%)						-37.2	-50.2	-48.6	-55.3	-60.1	
Net debt to tot ass (%)						-19.9	-25.4	-26.2	-30.9	-36.0	
Net debt to EBITDA						-0.69	-0.95	-0.75	-0.79	-0.76	
Current ratio (x)						2.46	2.11	2.42	2.77	3.31	
Operating CF int cov (x)						61.5	66.0	96.5	128.6	159.1	
Dividend cover (x)						1.21	1.10	1.29	1.19	1.38	
										<i>year to Dec</i>	

Priced as follows: CAST.BO - Rs262.15; ASPN.BO - Rs793.20; HLL.BO - Rs199.40
Source: Company data, ABN AMRO forecasts

CASTROL INDIA: VALUATION METHODOLOGY

Economic Profit Valuation	INR m	%	Discounted Cash Flow Valuation	INR m	%
Adjusted Opening Invested Capital	2642.5	8	Value of Phase 1: Explicit (2007 to 2011)	10010.3	29
NPV of Economic Profit During Explicit Period	9319.2	27	Value of Phase 2: Value Driver (2012 to 2014)	4505.2	13
NPV of Econ Profit of Remaining Business (1, 2)	14494.8	41	Value of Phase 3: Fade (2015 to 2019)	6531.0	19
NPV of Econ Profit of Net Inv (Grth Business) (1, 3)	8493.5	24	Terminal Value	13667.6	39
Enterprise Value	34950.1	100	Enterprise Value	34714.1	100
Plus: Other Assets	0.0	0	FCF Grth Rate at end of Phs 1 implied by DCF Valuation		-0.8
Less: Minorities	0.0	0	FCF Grth Rate at end of Phs 1 implied by Current Price		-3.6
Less: Net Debt (as at 22 Jan 2007)	-2138.9	-6			
Equity Value	37089.0	106			
No. Shares (millions)	123.5				
Per Share Equity Value	300.32				
Current Share Price	262.15				

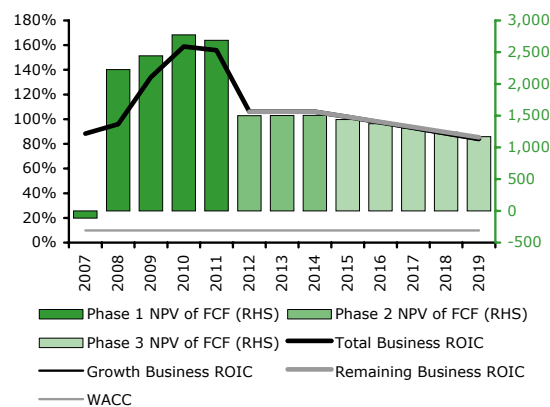
Sensitivity Table		No of Years in Fade Period				
		5	7	9	11	13
WACC	7.8%	383.81	418.34	454.29	491.63	530.50
	8.8%	337.09	364.33	392.18	420.59	449.65
	9.8%	300.32	322.10	344.00	365.95	388.01
	10.8%	270.68	288.32	305.75	322.92	339.88
	11.8%	246.36	260.78	274.80	288.37	301.56

Performance Summary	2007	2008	2009	Phase 2 Avg (2012 - 2014)
Invested Capital Growth (%)	7.5	-5.4	4.7	10.0
Operating Margin (%)	16.8	20.0	25.7	20.8
Capital Turnover (x)	7.9	7.2	7.8	7.6

Source: ABN AMRO

- In periods following the Explicit Period i.e. Phase 2 and Phase 3
- Remaining Business is defined as Capital as at the end of Phase 1 and capex = depreciation thereafter
- Net Investment is defined as capex over and above depreciation after Phase 1

Returns, WACC and NPV of Free Cash Flow

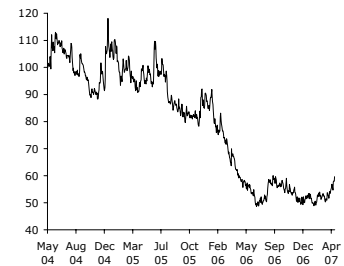


Castrol India

Company description

Castrol India is 71% owned by BP. It is one of the oldest players in the lubricants segment in India and has around 20% share of the overall lubricants market. The period from 1919 to 1991 was largely uneventful, because government restrictions prevented free market competition. After liberalisation, Castrol launched a marketing blitz that resulted in its market share increasing from 6% to around 20%. Subsequent market share growth has proved difficult as PSU competitors have become aggressive.

Buy Price relative to country



Strategic analysis

Average SWOT company score: **2**

Shareholding pattern

Strengths

Castrol's key strengths are its brand and reach. The introduction of the bazaar trade (non-fuel-pump distribution channel) has increased its reach manifold, leaving behind public sector oil companies. The addition of the BP brand enables it to compete in the mid-price segment.

4

Weaknesses

Dependence upon an external source for base oil makes Castrol vulnerable to base oil price volatility.

1

Opportunities

ABN AMRO estimates the Indian economy will grow at a rate of 6-7%. This along with ambitious road infrastructure projects offers demand growth potential for lubricant volumes. Castrol may get a new distribution channel if local private players (Reliance/Essar) ramp up their petrol station network.

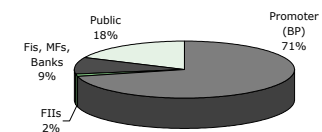
3

Threats

PSU oil companies have become very aggressive and have entered the bazaar segment. Their overall size and profitability enables them to take a hit on their lubricant operations, if required.

1

Scoring range is 1-5 (high score is good)



Source: BSE

Market data

Headquarters

Technopolis Knowledge Park, Mahakali Caves Road, Andheri (E), Mumbai 400 093, India

Website

www.castrol.co.in

Shares in issue

123.6m

Freefloat

29%

Majority shareholders

BP plc (71%)

India

Country view

Neutral

Country rel to Asia Pacific

The market looks expensive, but we believe it will remain supportive when regional funds seek a domestically driven home with continuing robust earnings growth. The ABN AMRO Indian PMI suggests the economy is still powering ahead despite the global headwinds, thanks to its domestically oriented economic structure. At the sector level, we still like autos, software and construction-related stocks.

The country view is set in consultation with the relevant company analyst but is the ultimate responsibility of the Strategy Team.



Competitive position

Average competitive score: **3-**

Broker recommendations

Supplier power

The large size of refining companies improves the company's bargaining power vis-a-vis lubricant manufacturers.

4-

Barriers to entry

Entry barriers are low, especially at the lower end. Investment requirement is minimal. The presence of a large number of unorganised players is a characteristic feature of the sector.

1-

Customer power

Customer power is limited, as opposed to organised large fleet operators in western markets. The typical Indian customer has small-scale operations and no bargaining power vis-a-vis a producer.

4+

Substitute products

While there are virtually no substitutes, in a tough economic environment consumers tend to delay purchases or downgrade into cheaper products.

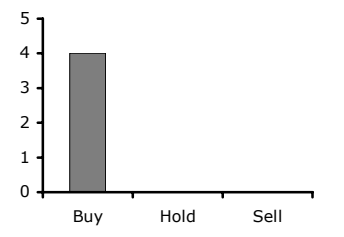
4-

Rivalry

Competition from PSUs has become intense as they have entered the bazaar trade. Virtually every global oil MNC already operates in the country, and some smaller ones may close.

2-

Scoring range 1-5 (high score is good) Plus = getting better Minus = getting worse



Source: BSE