MOTILAL OSWAL

HPCL

STOCK INFO.	BLOOMBERG
BSE Sensex: 9,920	HPCL IN
	REUTERS CODE
S&P CNX: 3,001	HPCL.BO
Equity Shares (m)	338.8
52-Week Range	380/283
1,6,12 Rel. Perf. (%)	-12/-24-66
M.Cap. (Rs b)	104.7
M.Cap. (US$ b)	2.4

31 January 2006 — **Buy**

Previous Recommendation:Buy — Rs309

YEAR END	NET SALES (RS M)	PAT (RS M)	EPS (RS)	EPS GROWTH (%)	P/E (X)	P/BV (X)	ROE (%)	ROCE (%)	EV/ SALES	EV/ EBITDA
03/05A	652,183	12,773	37.7	-32.9	8.2	1.2	15.8	16.8	0.2	5.5
03/06E	784,496	9,230	27.2	-27.7	11.3	1.2	10.7	13.7	0.2	6.1
03/07E	694,203	17,100	50.5	85.3	6.1	1.1	18.5	25.6	0.1	3.1

- Net losses of Rs10.8b as against a Rs2.4b profits last year, disappointed primarily on account of non-payment of Government share of fuel marketing losses, despite Parliament approval for the same. Mounting fuel marketing losses, lower than expected refining margins and inventory losses were the drivers of poor performance
- Fuel marketing (gross) losses at Rs20.3b were up 42.5% YoY. Net losses (post upstream share of Rs6.8b and refinery discount of Rs1b) at Rs12.4b was up 23.8% YoY. Inventory losses (on products) was Rs2.6b as against zero inventory change last year.
- Refining margin at US$0.15/bbl disappointed as Vizag recorded negative GRM at US$-2.54/bbl, on account of large inventory losses, while Mumbai recorded US$2.88/bbl. The margins are post product price discount and inventory changes.
- Crude thruput and marketing sales too were down marginally YoY. Crude thruput at 3.7m tons was down 3.7% YoY, while market sales at 5.1m tons was down 2.3% YoY.
- We believe, the below par GRM and inventory losses are temporary as both were driven by crude price decline during the quarter. Payment of Government share of fuel marketing losses (of Rs115b for the industry) in 4QFY06 would allow OMCs to report profits close to FY05 levels. Stock trades at a P/E of 5.3x (adjusted for the value of MRPL holding) and P/BV of 1.1x FY07 estimates. We maintain **Buy**.

QUARTERLY PERFORMANCE (Rs Million)

Y/E MARCH	FY05				FY06				FY05	FY06E
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4QE		
Sales	**150,238**	**150,954**	**175,812**	**175,180**	**163,621**	**178,886**	**199,306**	**242,684**	**652,183**	**784,496**
Change (%)	*9.0*	*14.1*	*23.3*	*7.9*	*8.9*	*18.5*	*13.4*	*38.5*	*13.4*	*20.3*
Raw Material Consumed	38,504	58,283	60,225	48,750	48,826	56,016	72,229	72,264	205,762	249,335
Staff Cost	1,621	1,583	1,506	2,414	1,590	1,478	1,711	2,844	7,124	7,623
Fininshed Goods Purchase	81,516	78,008	80,864	96,383	100,141	116,105	97,982	98,847	336,771	413,075
Other Exp (incl Stock Adj)	23,414	6,950	28,571	23,069	16,997	4,529	36,180	37,570	82,004	95,276
EBITDA	**5,183**	**6,129**	**4,647**	**4,564**	**-3,934**	**758**	**-8,796**	**31,158**	**20,523**	**19,187**
% of Net Sales	*3.4*	*4.1*	*2.6*	*2.6*	*-2.4*	*0.4*	*-4.4*	*12.8*	*3.1*	*-97.6*
% Change	*47.5*	*-22.5*	*-65.2*	*-47.2*	*-175.9*	*-87.6*	*-289.3*	*582.7*	*-38.6*	*-6.5*
Depreciation	1,580	1,515	1,623	1,878	1,663	1,744	1,751	1,170	6,596	6,328
Interest	117	214	319	166	142	309	559	-393	816	616
Other Income	415	700	1,012	1,169	682	789	504	-296	3,295	1,679
PBT	**3,900**	**5,100**	**3,717**	**3,689**	**-5,056**	**-505**	**-10,602**	**30,085**	**16,406**	**13,922**
Tax	1,427	2,157	1,357	-1,309	23	-284	176	4,777	3,633	4,692
Rate (%)	*36.6*	*42.3*	*36.5*	*-35.5*	*-0.4*	*56.2*	*-1.7*	*15.9*	*22.1*	*33.7*
PAT	**2,473**	**2,943**	**2,359**	**4,998**	**-5,079**	**-221**	**-10,778**	**25,308**	**12,773**	**9,230**
Change (%)	*57.2*	*-33.7*	*-69.6*	*-5.2*	*-305.4*	*-107.5*	*-556.8*	*406.4*	*-32.9*	*-27.7*

E: MOSt Estimates

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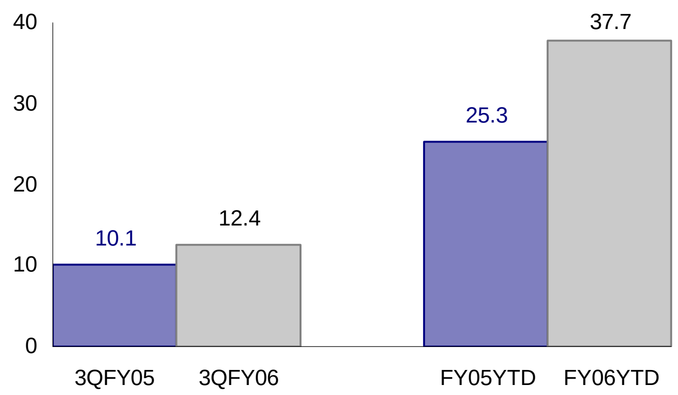
HPCL reported net losses of Rs10.8b as against a Rs2.4b profits last year. Results disappointed primarily on account of non-payment of Government share of fuel marketing losses, despite Parliament approval for the same. Mounting fuel marketing losses, lower than expected refining margins and inventory losses were the drivers of poor performance.

Fuel marketing losses continue to hurt

Fuel marketing losses were up 42.5% YoY at Rs20.3b for the quarter, thanks to higher crude prices and addition of petrol / diesel to loss making fuel list from 1QFY06. However, 1/3rd sharing by upstream players and product price discounts from standalone refiners cushioned losses. Upstream players paid Rs6.8b towards their share of losses, product price discounts from standalone (external) refiners was Rs1b. Adjusting for these contributions, HPCL's burden was Rs12.4b, up 23.8% YoY.

Going forward, we expect Government's sharing of 1/3rd losses to provide a huge relief. Crude prices continue to be a critical factor and possible weakness could turn marketing margins positive.

FUEL MARKETING LOSSES – CONTINUE TO HURT (RS B)



Source: Company/Motilal Oswal Securities

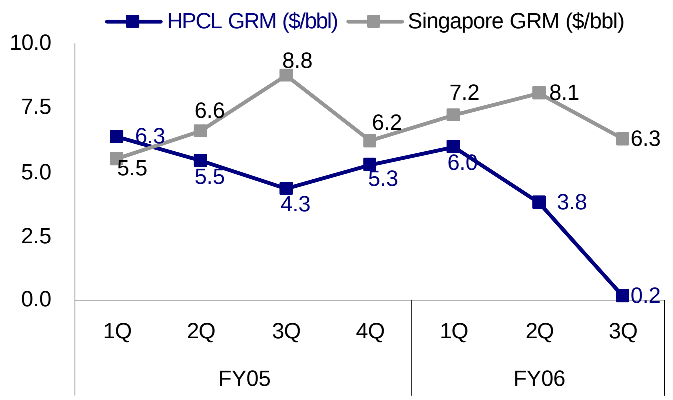
HPCL recorded an inventory loss of Rs3.2b in 2QFY05, adding to the large fuel marketing losses, thanks to a sequential decline in crude prices.

Refining margin squeezed

3QFY06 refining margins were down at just US$0.15/bbl compared to US$4.3/bbl last year, partly on account of product price discounts, fall in international refining margins and a large inventory loss impact especially at Vizag. Vizag recorded a negative refining margin of US$2.54/bbl on account of the large inventory loss, thanks to high cost crude inventory accumulated during shutdown in the previous quarter. YoY comparison with 3QFY05 would also be impacted by the tariff cuts effected over the last one year. However the impact would have been small.

We expect global refining margins to bounce back as the refining fundamentals remain unchanged. Capacity addition is limited, while demand growth continues to remain strong, maintaining high refinery operating rates. However, the delay in refinery expansion and modernization, could put HPCL at disadvantage vis-à-vis its competitors in terms of leveraging the regional refining margin strength.

QUARTERLY REFINERY-WISE MARGIN TREND (US$/BBL)

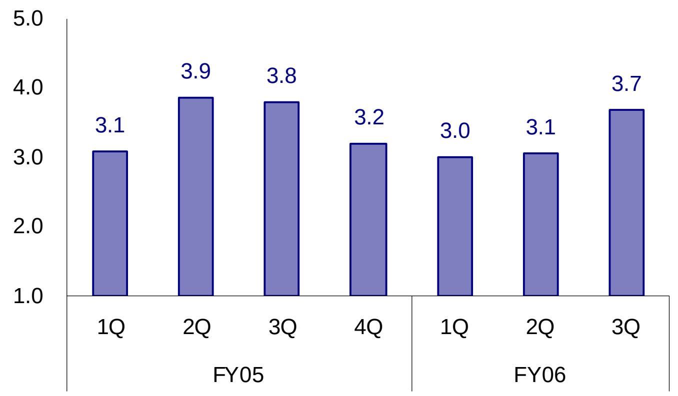


Source: Company/Motilal Oswal Securities

Refining thruput & sales down marginally

Crude thruput in 3QFY06 was down 3.7% YoY at 3.7m, while market sales at 5.1m tons was down 2.3% YoY. While countrywide demand during the quarter was weak, diesel market share loss to Reliance has further contributed to drop in market sales for state owned oil companies. Reliance has achieved a market share of 10-11%.

QUARTERLY REFINERY THRUPUT (M TON)



Source: Company/Motilal Oswal Securities

Downgrading FY06 estimate

We are downgrading FY06 estimate by 17% to reflect the poor refining performance in 3QFY06 and continuing poor marketing margins in 4QFY06.

REVISED ESTIMATES (RS M)

	FY06E			FY07E		
	OLD	NEW	% CHG.	OLD	NEW	% CHG.
EBITDA	22,124	19,187	-13.0	32,539	31,829	-2.0
Net Profit	11,187	9,230	-17.0	17,606	17,100	-3.0
Change (%)	*33.1*	*27.2*		*52.0*	*52.0*	

Source: Motilal Oswal Securities

Government sharing of losses a huge positive

Parliament approval for Rs57.5b of additional grant towards compensation for fuel marketing losses is already in place, though delay in working out the structure of the oil bonds led to non-payment of the same in 3QFY06. Oil companies expect payment of Rs115b, in 4QFY06, which would enable them to return profits close to last year reported numbers.

Policy initiatives could address fuel marketing losses

A committee headed by C.Rangarajan, is currently studying the pricing and tariff structure in the oil sector, whose recommendations are expected to address the fuel marketing loss issue comprehensively. We expect a combination of pricing and tariff restructuring initiatives would bring substantial benefit for oil marketing companies and could possibly remove fuel marketing losses from the books of oil companies, though the timing and implementation of the policies is fraught with political pitfalls.

Valuation and view

The stock is trading at 5.3x FY07E earnings (adjusted for the value of its MRPL holding) and 1.1x FY07E book value. We believe negatives are already in the price and cheap asset valuation would provide downside support. We maintain **Buy**.

HPCL: an investment profile

Company description

A fortune 500 company, HPCL is the third largest refining and marketing company in India. HPCL owns 13.5m ton of refining capacity split across two locations – Mumbai and Vizag. It sells about 20m ton of petroleum products. HPCL also holds a 17% stake in MRPL, a standalone refiner, which it jointly promoted. MRPL is now a subsidiary of ONGC.

Key investment arguments

- Government has announced that it would bear 1/3rd of fuel marketing losses along with standalone refiners. This loss sharing would enable oil marketing companies to turn profitable
- Policy risk more than priced in. Valuations continue to reflect highly pessimistic earnings expectation.

Key investment risks

- Continued increase in crude prices, along with non-revision of retail prices of controlled products.
- Loss of market share to private players.

Recent developments

- Parliament approval for Rs57.5b of additional grant towards compensation for fuel marketing losses has already been granted.
- Standalone refiners are sharing a part of the loss burden.

Valuation and view

- Valuations at 5.3x FY06E EPS, adjusted for value of investments, are moderate.
- We maintain **Buy.**

Sector view

- Refining margins are on an upswing due to improved fundamentals, globally. We expect the upcycle to continue, at least over the next 18 months.

COMPARATIVE VALUATIONS

		HPCL	BPCL	IOC
P/E (x)	FY06E	11.3	8.7	10.5
	FY07E	6.1	6.4	7.1
P/BV (x)	FY06E	1.2	1.4	1.7
	FY07E	1.1	1.3	1.4
EV/Sales (x)	FY06E	0.2	0.3	0.3
	FY07E	0.1	0.4	0.4
EV/EBITDA (x)	FY06E	6.1	4.5	6.7
	FY07E	3.1	3.3	4.5

SHAREHOLDING PATTERN (%)

	DEC.05	SEP.05	DEC.04
Promoters	51.0	51.0	51.0
Domestic Institutions	17.7	17.0	21.1
FIIs/FDIs	23.3	24.2	20.1
Others	8.0	7.8	7.8

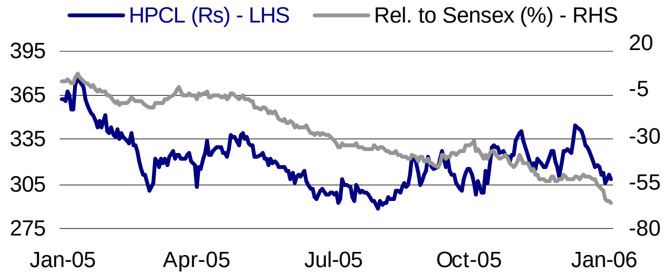
EPS: INQUIRE FORECAST VS CONSENSUS (RS)

	INQUIRE FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY06	27.2	24.2	12.6
FY07	50.5	33.0	53.2

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
309	-	-	Buy

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT					(Rs Million)
Y/E MARCH	2003	2004	2005	2006E	2007E
Net Sales	**542,595**	**575,111**	**652,183**	**784,496**	**694,203**
Finished Gds Purchase	299,363	305,839	336,771	413,075	339,375
Raw Materials Cons	143,668	150,170	205,762	249,335	225,368
Duties, Taxes, etc	58,003	63,111	54,250	56,688	50,147
Transportation	11,996	12,290	12,274	12,519	12,770
Employee Costs	5,461	5,701	7,124	7,623	8,156
Other Exp (incl Stock Ad	-3,800	5,380	15,481	26,069	26,557
EBITDA	**27,903**	**32,620**	**20,522**	**19,187**	**31,829**
% of Net Sales	*5.1*	*5.7*	*3.1*	*2.4*	*4.6*
% Growth	*56.1*	*16.9*	*-37.1*	*-6.5*	*65.9*
Depreciation	5,743	6,054	6,596	6,328	7,117
Interest	1,530	557	816	616	233
Other Income	3,487	3,794	3,295	1,679	1,314
PBT	**24,118**	**29,804**	**16,405**	**13,922**	**25,792**
Current tax	8,534	10,225	4,426	4,650	7,661
Deferred tax	211	540	-793	42	1,032
Total Rate (%)	*36.3*	*36.1*	*22.1*	*33.7*	*33.7*
PAT	15,373	19,039	12,773	9,230	17,100
Adjusted PAT	**15,373**	**19,039**	**12,773**	**9,230**	**17,100**
Change (%)	*95.1*	*23.8*	*-32.9*	*-27.7*	*85.3*

BALANCE SHEET					(Rs Million)
Y/E MARCH	2003	2004	2005	2006E	2007E
Share Capital	3,388	3,388	3,388	3,388	3,388
Reserves	63,399	74,040	81,096	84,593	93,667
Net Worth	**66,787**	**77,429**	**84,485**	**87,982**	**97,056**
Loans	13,659	17,008	20,028	16,028	9,028
Deferred Tax	14,000	14,541	13,748	13,790	14,821
Capital Employed	**94,447**	**108,977**	**118,260**	**117,799**	**120,905**
Gross Fixed Assets	107,543	113,874	117,874	125,174	159,694
Less: Depreciation	43,191	48,093	54,689	61,017	68,134
Net Fixed Assets	**64,352**	**65,781**	**63,185**	**64,157**	**91,561**
Capital WIP	3,477	4,961	16,517	27,517	1,017
Investments	7,842	8,174	8,174	8,174	8,174
Curr. Assets, L & Adv.					
Inventory	51,225	54,025	58,071	53,693	49,316
Debtors	8,624	10,003	11,581	13,830	12,225
Cash & Bank Balance	12,496	14,281	11,239	3,738	14,036
Loans & Advances	25,451	28,303	29,331	30,419	31,570
Current Liab. & Prov.					
Liabilities	69,032	64,481	68,161	72,052	73,023
Provisions	9,986	12,070	11,678	11,678	13,972
Net Current Assets	**18,777**	**30,060**	**30,382**	**17,949**	**20,152**
Application of Fund	**94,447**	**108,977**	**118,259**	**117,798**	**120,904**

E: MOSt Estimates

RATIOS					
Y/E MARCH	2003	2004	2005	2006E	2007E
Basic (Rs)					
EPS	**45.4**	**56.2**	**37.7**	**27.2**	**50.5**
Cash EPS	59.6	74.1	57.2	45.9	71.5
Book Value	197.1	228.5	249.4	259.7	286.5
DPS	20.0	22.0	15.0	15.0	21.0
Payout (incl. Div. Tax.)	44.1	39.2	39.8	55.1	41.6
Valuation (x)					
P/E		5.5	8.2	11.3	6.1
Cash P/E		4.2	5.4	6.7	4.3
EV / EBITDA		3.3	5.5	6.1	3.1
EV / Sales		0.2	0.2	0.1	0.1
Price / Book Value		1.4	1.2	1.2	1.1
Dividend Yield (%)		7.1	4.9	4.9	6.8
Profitability Ratios (%)					
RoE	23.0	26.4	15.8	10.7	18.5
RoCE	31.4	36.4	16.8	13.7	25.6
Turnover Ratios					
Debtors (No. of Days)	6.4	6.8	6.6	6.4	7.4
Asset Turnover (x)	2.9	2.8	3.1	3.6	3.1
Leverage Ratio					
Net Debt / Equity (x)	0.0	0.0	0.1	0.1	0.0

CASH FLOW STATEMENT					(Rs Million)
Y/E MARCH	2003	2004	2005	2006E	2007E
OP/(Loss) before Tax	26,965	32,620	20,522	19,187	31,829
Interest Paid	-1,530	-557	-816	-616	-233
Direct Taxes Paid	-8,744	-10,765	-3,633	-4,692	-8,692
(Inc)/Dec in Wkg. Capita	10,036	-8,972	-4,140	4,975	9,127
CF from Op. Activity	**26,727**	**12,327**	**11,933**	**18,854**	**32,030**
(Inc)/Dec in FA & CWIP	-5,678	-8,967	-15,556	-18,300	-8,020
(Pur)/Sale of Investmen	-1,318	-332	0	0	0
Inc from Invst	3,487	3,795	3,295	1,679	1,314
CF from Inv. Activit	**-3,509**	**-5,505**	**-12,261**	**-16,621**	**-6,706**
Issue of Shares	7	24	0	0	0
Inc / (Dec) in Debt	-18,056	3,349	3,020	-4,000	-7,000
Dividends Paid	-7,569	-8,409	-5,733	-5,733	-8,027
CF from Fin. Activit	**-25,618**	**-5,036**	**-2,713**	**-9,733**	**-15,027**
Inc / (Dec) in Cash	**-2,401**	**1,786**	**-3,041**	**-7,501**	**10,297**
Add: Opening Balance	14,896	12,495	14,281	11,240	3,739
Closing Balance	**12,495**	**14,281**	**11,240**	**3,739**	**14,036**

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Disclosure of Interest Statement	**HPCL**
1. Analyst ownership of the stock	No
2. Group/Directors ownership of the stock	No
3. Broking relationship with company covered	No

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