OMCs – Remain focused

Executive summary

- We believe that the concern of the auto fuel burden on OMCs is over-hyped.
- The new government is focused on reducing under-recoveries, rather than doing a mere postmortem.
- We believe that government would reduce the auto fuel under-recoveries by increasing retail fuel prices.
- This would result in significantly lower under-recoveries and the burden would be easily managed by upstream.
- Even if the auto fuel burden comes on the OMCs, their core earnings would remain intact due to significant inventory gains.
- We prefer HPCL and IOCL over BPCL due to their low exposure to auto fuels. We reiterate our BUY on OMCs.

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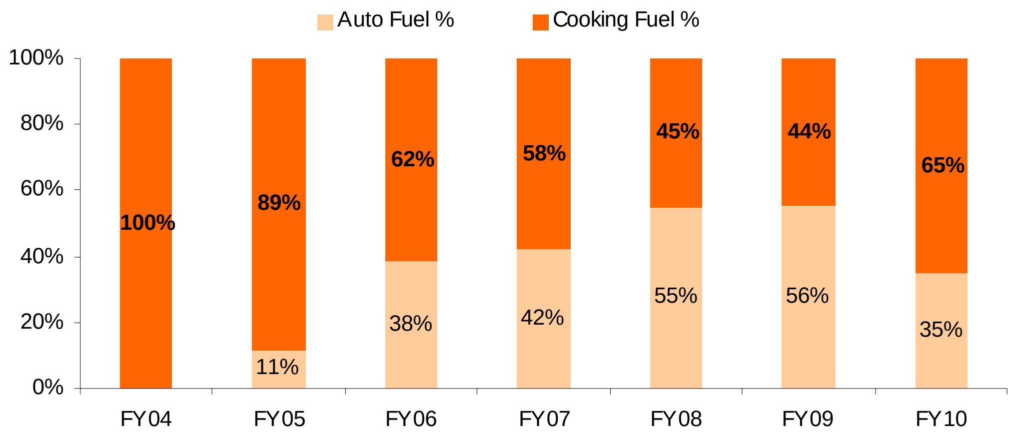
Concerns on auto fuel under-recoveries over-hyped

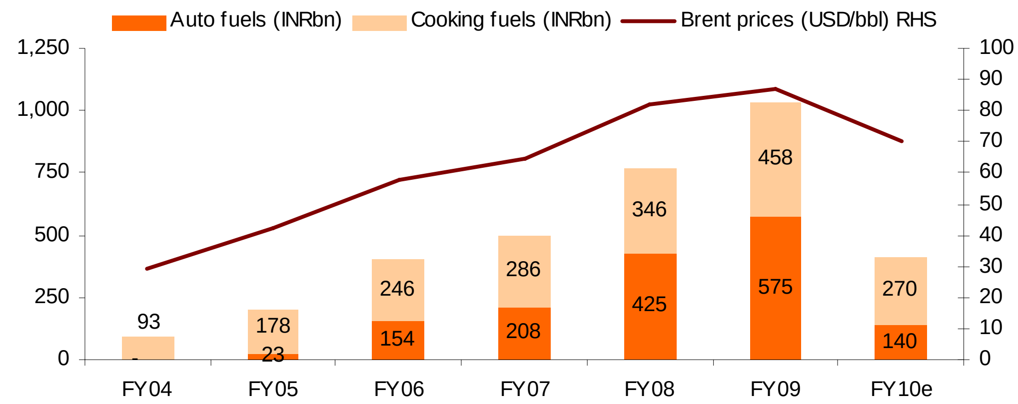
- Recently Oil Secretary mentioned that auto fuel subsidies would be shared by upstream and OMC's, and most of it would come from upstream as their capability is much higher at USD70/bbl. This raised eyebrow on subsidiary sharing for OMCs.
- We believe that concerns of auto fuel under-recoveries on OMCs were always present as government never announced formally (like cooking fuels) that burden would be entirely borne by upstream.
- However, the key for making the case of negligible under-recoveries burden on OMCs arise from the fact that government would reduce the auto fuel under-recoveries by retail fuel price hikes. This means auto fuel under-recoveries burden would be lower and be easily manageable by upstream.
- We believe that frequent price hikes by the government on auto fuels, is the most effective way to reduce under-recoveries. Till date, the new government has demonstrated this by increasing the retail fuel prices on July 2, 2009 as oil prices rise to USD70bbl. We don't rule out further price increases by the government if oil prices go up further.
- This is the reason that auto fuel under-recoveries are only 35% of the total under-recoveries in FY10e against 56% in FY09.
- Even if we assume government to increase retail fuel prices of up to last year, it implies a breakeven price of USD75/bbl which implies if crude prices increases further there would be price hikes.
- Also, considering the current growth rate in auto fuel sales (~8.5% CAGR over FY07-10e), it is necessary for government to increase domestic fuel prices to reflect international oil prices. This would reduce the diversion of auto fuels for other purposes and other uneconomical consumption.
- We also see that oil prices are expected to remain weak as US distillate fundamentals are not showing any signs of recovery.

Auto fuel under-recoveries lowest in last five years



Source: Companies, Antique

Under-recovery burden significantly lower than last years



Source: Companies, Antique

Against all speculations, auto fuel price hike came at USD70/bbl

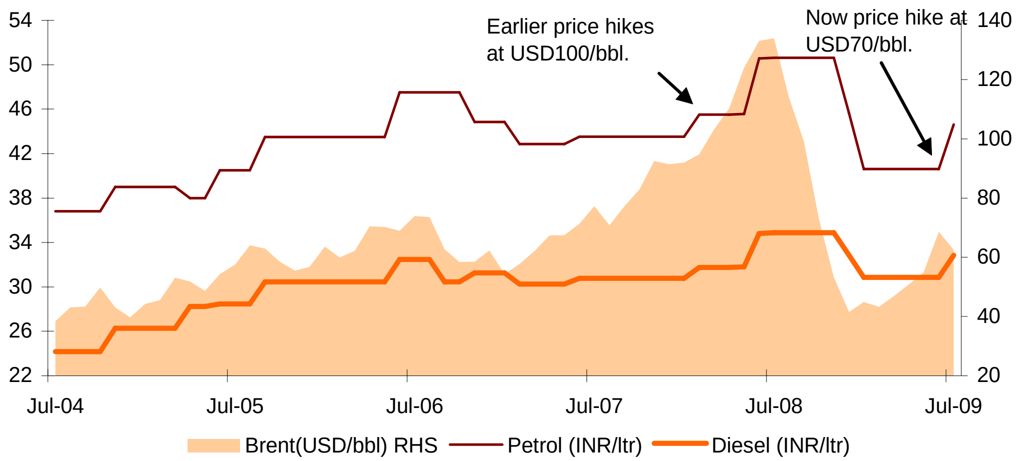


Table of price changes by UPA government during their last 5 year term

Date	Diesel	Petrol	Brent
	INR/ltr	INR/ltr	USD/bbl
15-Jun-04	22.7	35.7	35.2
31-Jul-04	24.2	36.8	38.4
4-Nov-04	26.3	39.0	43.1
1-Apr-05	28.2	38.0	51.9
5-Apr-05	26.5	38.0	51.9
20-Jun-05	28.5	40.5	54.3
6-Sep-05	30.5	43.5	63.0
5-Jun-06	32.5	47.5	68.9
% change	43%	33%	96%

After price hike on July 2, 2009 only USD4/bbl under-recovery

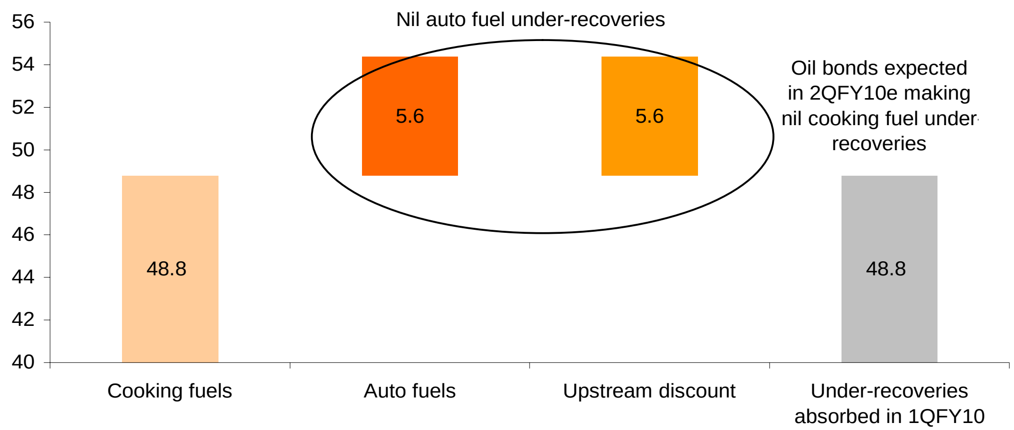
Date	Diesel	Petrol	Actual Brent	Implied Diesel prices	Implied Brent price	(Under-recovery)
	INR/ltr	INR/ltr	USD/bbl	USD/bbl	USD/bbl	USD/bbl
Feb-08	31.8	45.5	95	75	59	(36)
Jun-08	34.8	50.6	133	90	57	(76)
Dec-08	32.9	45.6	42	70	54	12
Jan-09	30.9	40.6	45	65	52	7
Jul-09	**32.9**	**44.6**	**71**	**75**	**67**	**(4)**

Marketing volumes as a % of sensitive products

%	HPCL	BPCL	IOCL
MS	16.3%	16.6%	12.0%
HSD	58.9%	62.1%	63.8%
Auto fuels	**75.2%**	**78.6%**	**75.9%**
LPG	15.6%	14.2%	11.6%
SKO	9.2%	7.2%	12.5%
Cooking fuels	**24.8%**	**21.4%**	**24.1%**

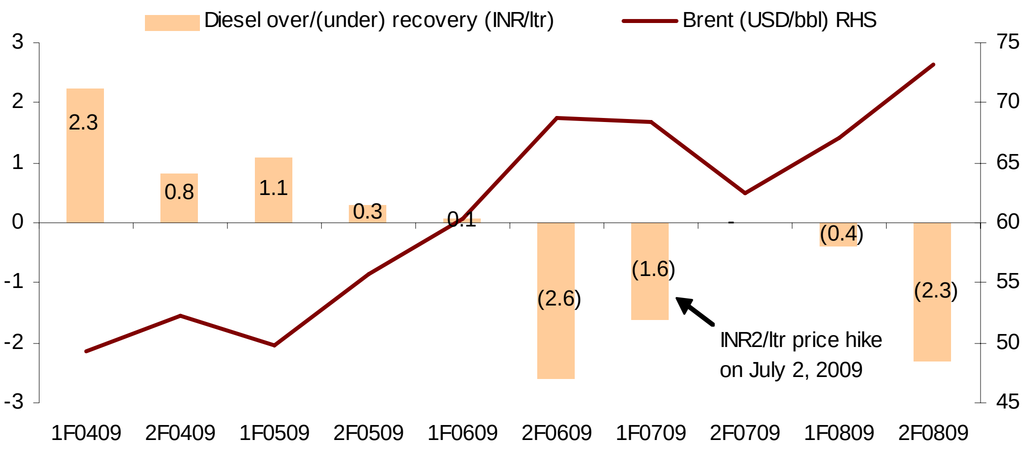
Source:MoP&NG, Antique

Nil auto fuel under-recoveries burden on OMCs for 1QFY10

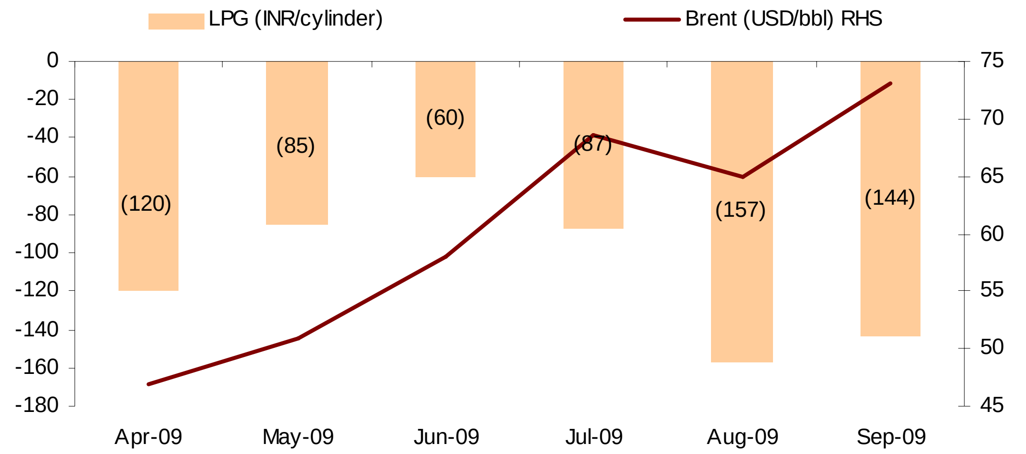


No concerns with rise in oil prices as effective burden on OMCs could fall to nil

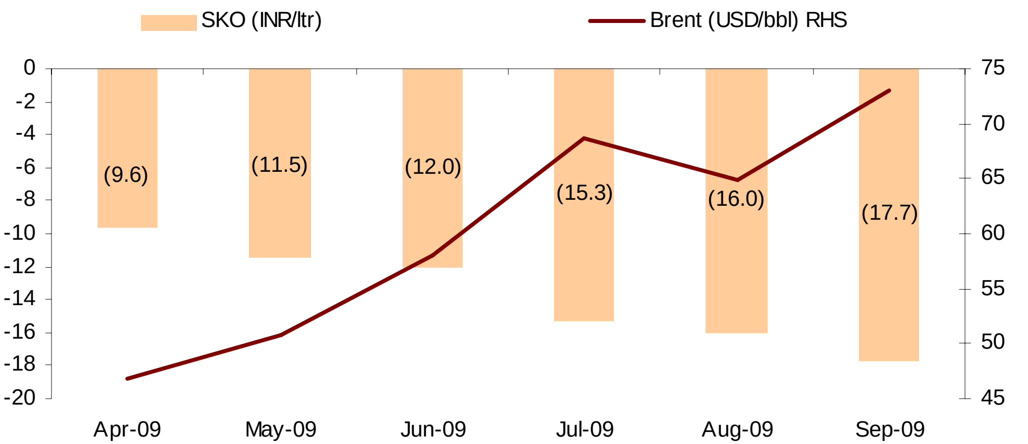
Over/ (under)-recoveries on Diesel during YTD FY10



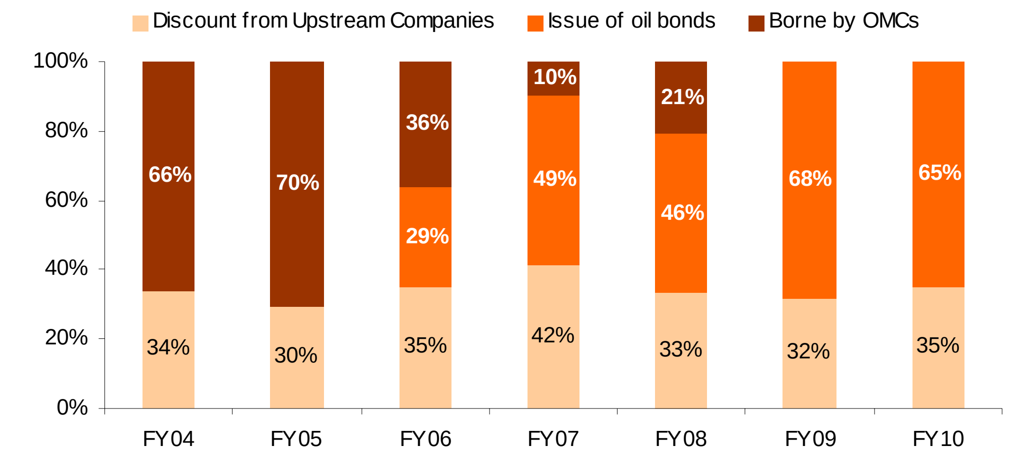
Under-recoveries on LPG (INR/cylinder) during YTD FY10



Under-recoveries on Kerosene (INR/ltr) during YTD FY10



Incidence of under-recoveries on OMCs would be reduced to nil



Taking cues from China in fuel price reforms

- China has increased both gasoline and diesel prices by CNY300/mt, representing an increase of 4-5%.
- The price hikes of gasoline and diesel dispels doubts over China's commitment to the new fuel price mechanism.
- We believe, China would adjust prices of gasoline and diesel whenever there is a 4% swing in the price of crude basket over a period of 22 working days.
- This strengthens our view that emerging markets including India would no longer bear the burden of auto fuel subsidies.
- We believe that the Indian government would increase retail prices for auto fuels if international oil prices rise significantly.

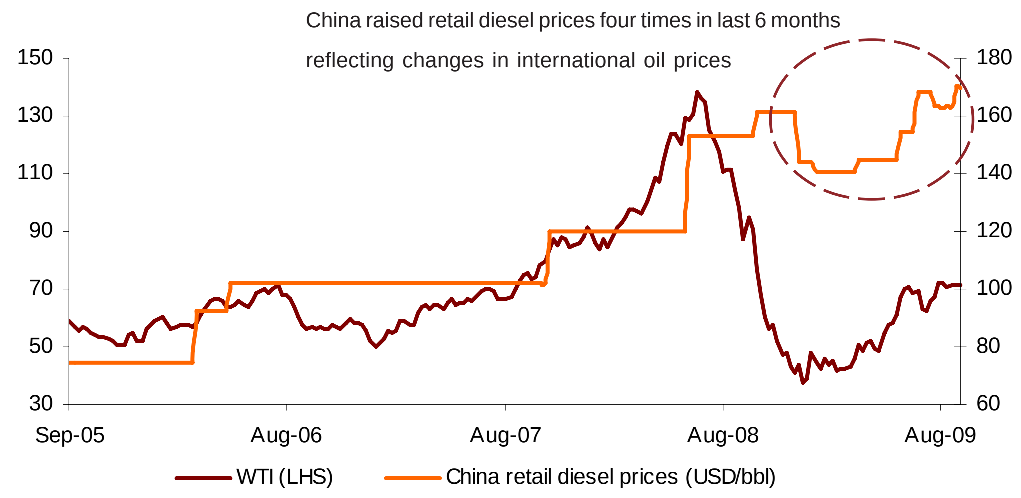
Government forms much awaited panel on fuel pricing reforms

- The government has formed a five-member committee headed by Mr. Kirit S Parikh, a former member (Energy) of the Planning Commission who was the author of Integrated Energy Policy, to suggest reforms in pricing of auto and cooking fuels.
- The panel headed by Mr. Parikh will be the third committee on the issue with recommendations of previous C Rangarajan committee and B K Chaturvedi committee not fully implemented.
- As per media reports, the panel would submit its report on oil product pricing within three months.

Key highlights of the Integrated Energy Policy (IEP)

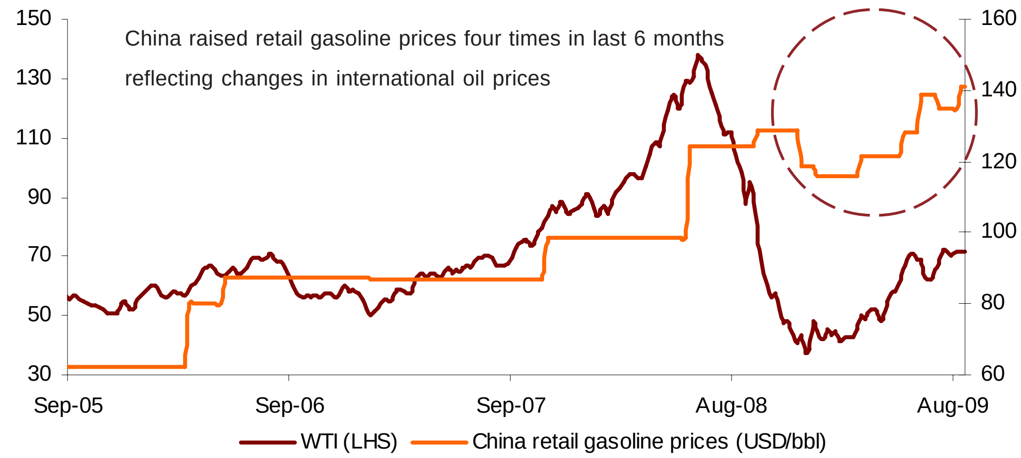
- We studied the Integrated Energy Policy (IEP), prepared by Mr. Kirit S. Parikh in August 2006 to understand his key arguments and thought process on the price reforms. The IEP was later adopted by the UPA government in December 2008 and made public by planning commission last week.
- We believe that since the new oil product pricing panel is headed by Mr. Kirit S. Parikh, we could see some of his key arguments in the fuel price reforms panel recommendations.

China retail diesel prices (USD/bbl) and WTI prices (USD/bbl)



Source: NDRC, Bloomberg and Antique

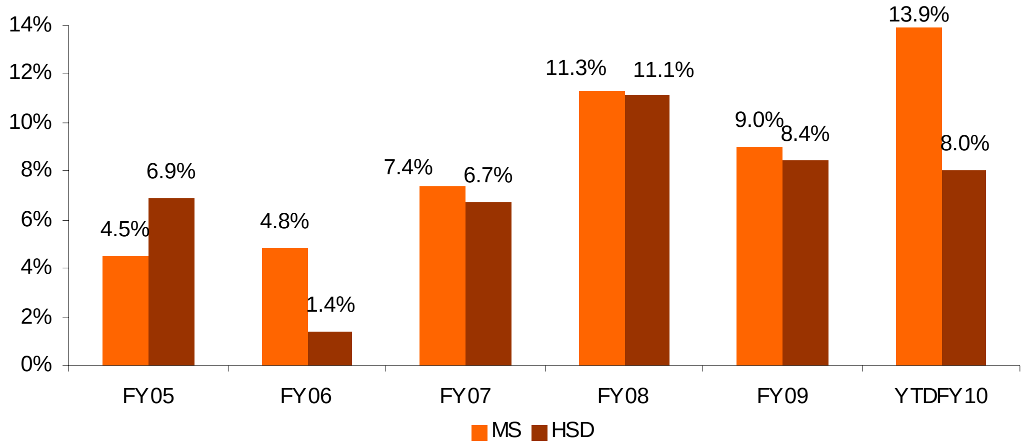
China retail gasoline prices (USD/bbl) and WTI prices (USD/bbl)



Source: NDRC, Bloomberg and Antique

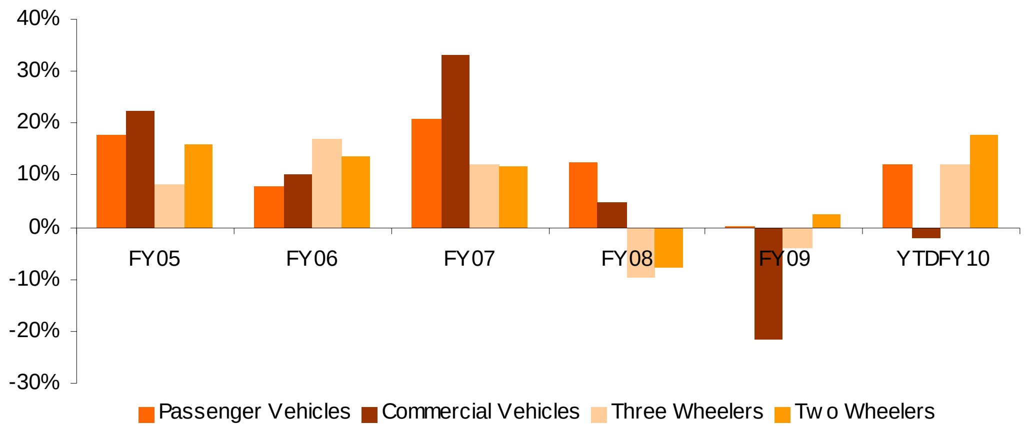
- The Integrated Energy Policy (IEP) has broadly argued the following:
  1. IEP highlighted that distortions in energy pricing in India and advocated for moving towards trade parity pricing which would reduce costs for OMCs. This is negative for standalone refiners.
  2. IEP criticized the practice of burdening oil marketing and upstream companieswith kerosene and LPG subsidies and leakages in subsidized products. This move is in line with the government's commitment of taking the entire burden of kerosene and LPG subsidies.
  3. IEP also highlighted the need to have consistency in taxes across fuels.
  4. IEP argued against multiple prices prevailing for natural gas and advocated for a single benchmark of gas prices for various sources of gas, which would be positve for ONGC and OIL.
- We remain positive on OMCs as pricing reforms unfold for auto fuels and government remains committed to provide for under-recoveries on cooking fuels.
- Also, considering the current growth rate in auto fuel sales (~8.5% CAGR over FY07-10e), it is necessary for government to increase domestic fuel prices to reflect international oil prices. This would not only reduce the diversion of auto fuels for other purposes but also reduce other uneconomical consumption.
- Even if the auto fuel burden comes on OMCs their core holdings would remain intact helped by the significant inventory gains made by them in 1QFY10.
- If auto fuel burden comes on OMCs, BPCL would bear the higher auto fuel burden comparing to HPCL as it has higher auto fuel exposure.
- We are increasing our FY10e EPS for HPCL by 11% to INR51.2/share and also increase our target price to INR504/share. We reiterate our BUY on OMCs..

Auto fuel growth (%)



Source: PPAC, Antique

Vehicle growth (%)



Source: SIAM, Antique

Valuations and key risks

Recommendation summary

Company	Recommendation	CMP	Target price	Upside	FY10e EPS	PE (x)	Valuation
HPCL	BUY	394	504	28%	51	6.9x	SOTP
IOCL	BUY	636	711	12%	64	7.7x	SOTP
BPCL	BUY	567	594	5%	63	8.6x	SOTP

Market data	HPCL	BPCL	IOCL
Market Cap (INRbn)	137	208	790
O/S Shares (m)	339	362	1214
Free Float (m)	166	129	136
Avg 6m Daily Vol ('000)	2018	1036	1022
High_52week	426	601	688
Low_52week	163	226	299

Valuations on FY10e financials	HPCL	BPCL	IOCL
Price	394	567	636
No. of shares (m)	339	328	1,185
Market cap (INRbn)	137	208	790
Gross debt (INRbn)	165	168	390
Oil Bonds / Cash (INRbn)	113	130	250
Debt net of bonds (INRbn)	52	38	140
Value of investments (INRbn)	15	8	166
Value of investments/share	44	25	140
EV (excl investments) (INRbn)	171	216	727
EPS	51	63	64
EBITDA (INRbn)	43	45	146
Book value	356	434	436
PE (excl investments)	6.9	8.6	7.7
EV/EBITDA (excl investments)	4.0	4.8	5.0
PB (excl investments)	1.0	1.2	1.1

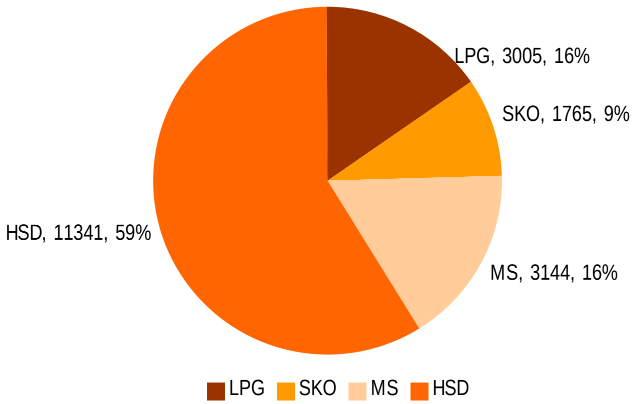
Shareholding	HPCL	BPCL	IOCL
Promoters	51.1%	54.9%	78.9%
FII	9.2%	8.3%	1.0%
Financial Institutions	12.6%	13.6%	5.5%
Goverenment Co.s/Insurance	16.1%	16.8%	8.8%
Bodies corporate	0.0%	3.0%	0.5%
Individuals	6.1%	3.4%	5.3%

The key macro risks to our earnings forecasts and ratings are as follows:

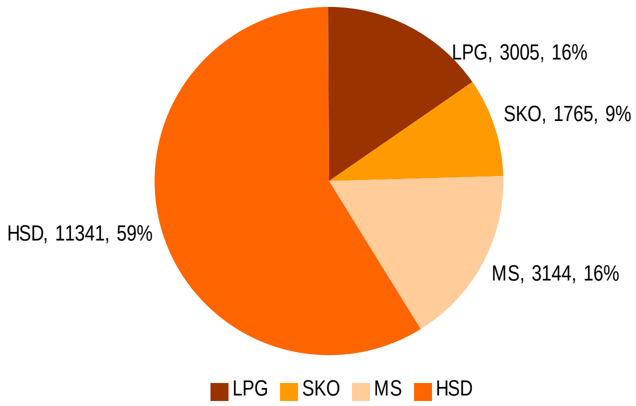
- Domestic or global economic slowdown may reduce refining and chemicals demand, affecting refining margins for OMCs.
- Oil prices higher than our estimates may affect our earnings estimates.
- Higher subsidy sharing than our estimates may affect our earnings estimates for OMCs and upstream companies.
- Non-relieving of OMCs and upstream from sharing under-recoveries on cooking fuels may affect our earnings estimates.
- Volatility in foreign exchange may increase costs of key feedstock (crude oil), which is denominated in US dollars.
- Any adverse regulatory change with respect to direct or indirect taxation may affect our earnings estimates.

OMCs % sales volume in sensitive products

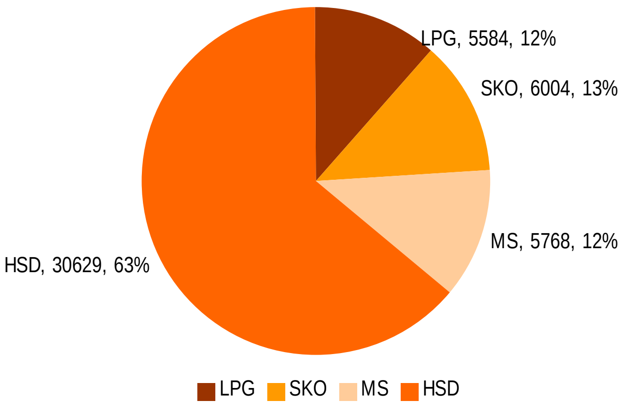
BPCL % volumes for FY10e



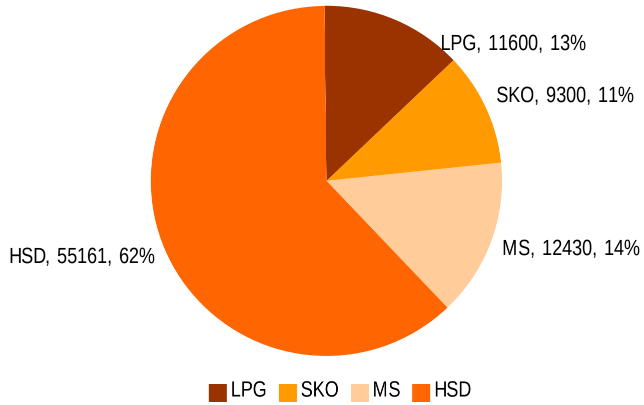
HPCL % volumes for FY10e



IOCL % volumes for FY10e

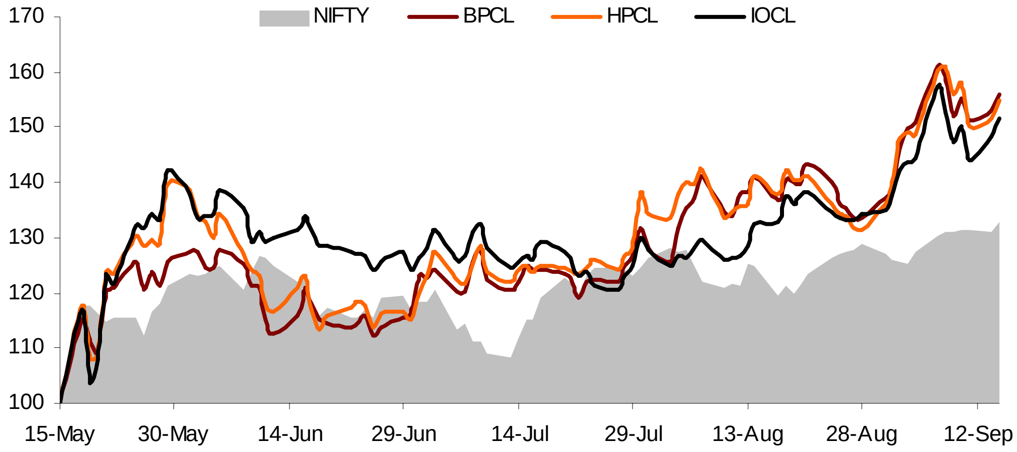


Total % volumes for FY10e

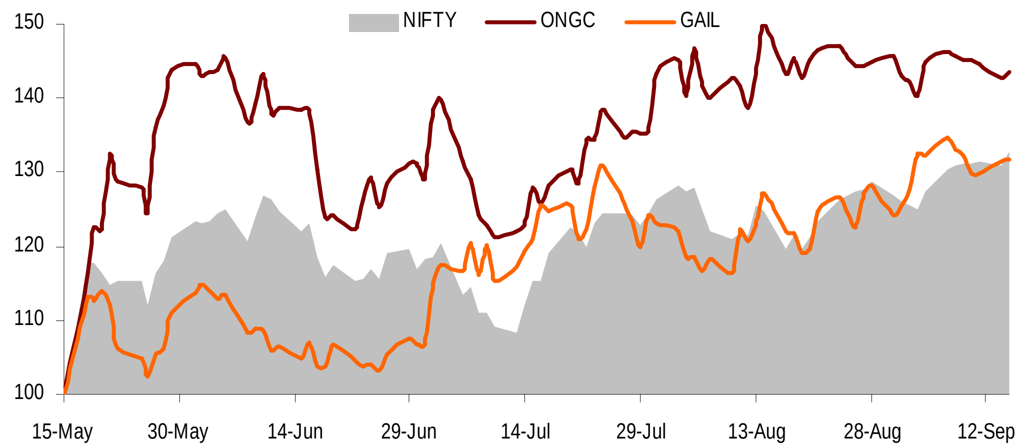


Oil marketing and PSU upstream co's outperformed NIFTY despite rising oil prices

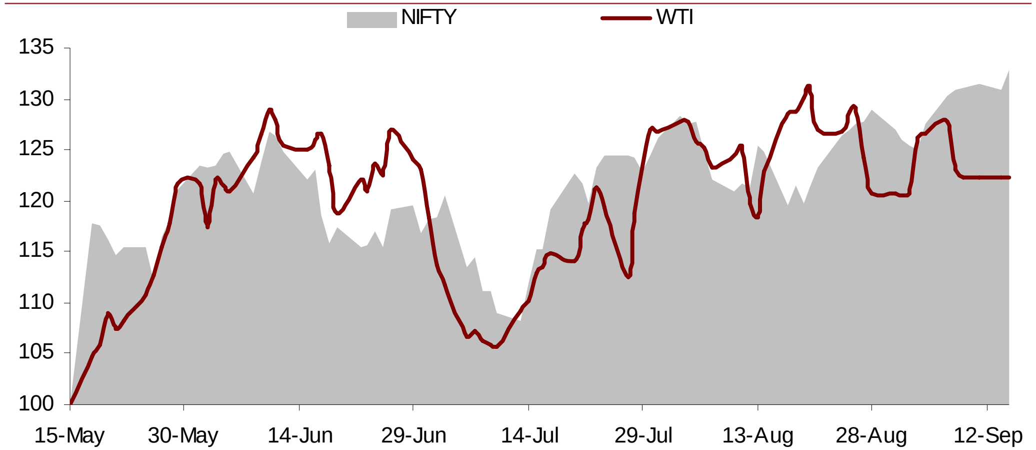
OMCs outperformed Nifty despite rising oil prices



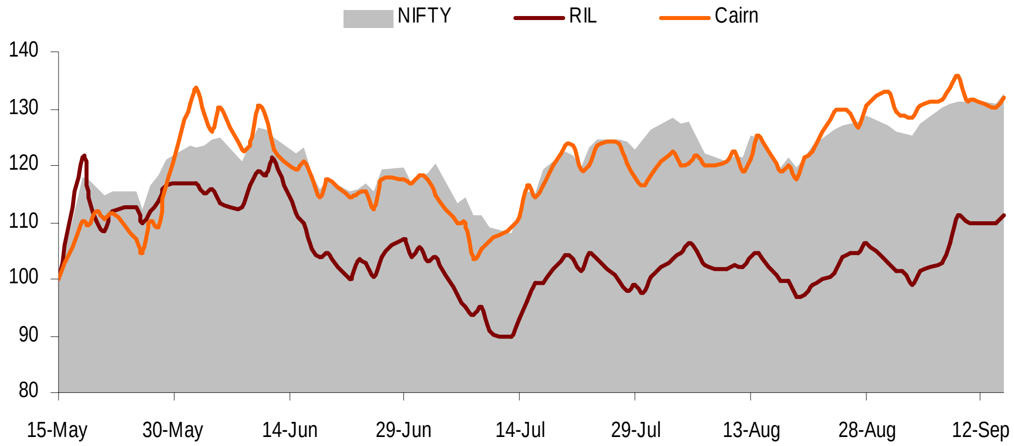
ONGC outpeformed Nifty significantly



WTI and Nifty performed in line

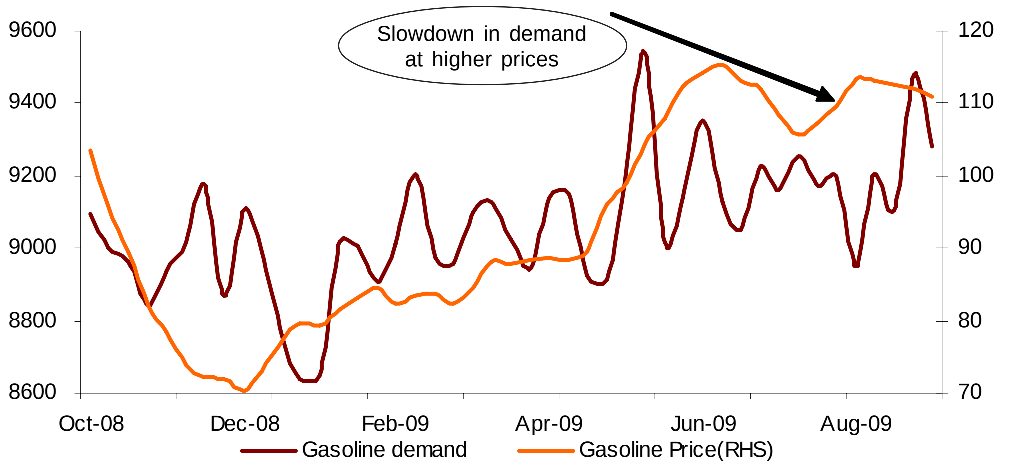


RIL underperformed Nifty significantly

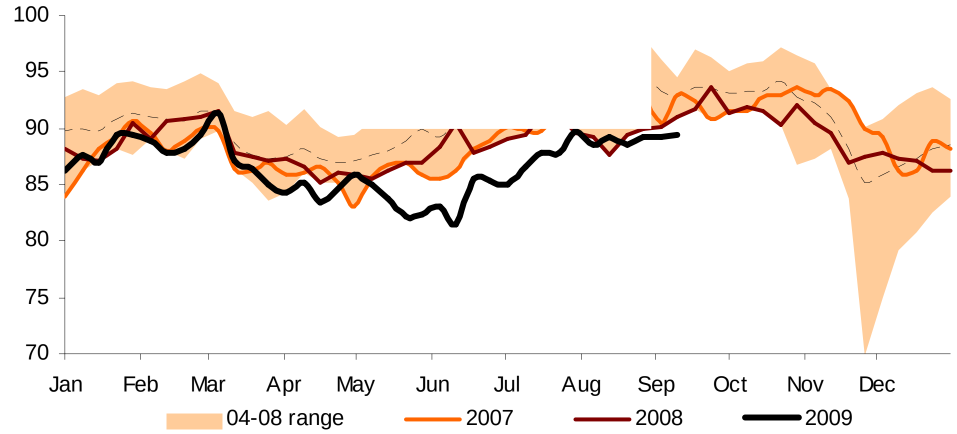


US oil products demand sensitive at higher oil prices

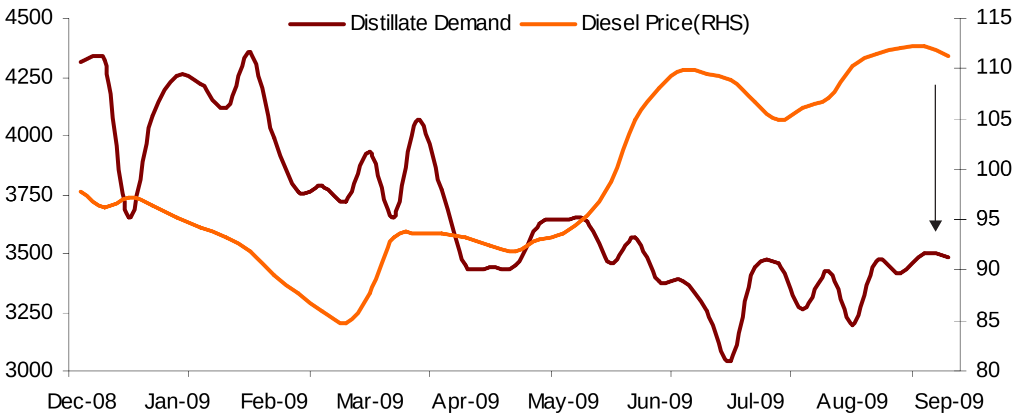
US gasoline demand price sensitive, lower demand at higher price



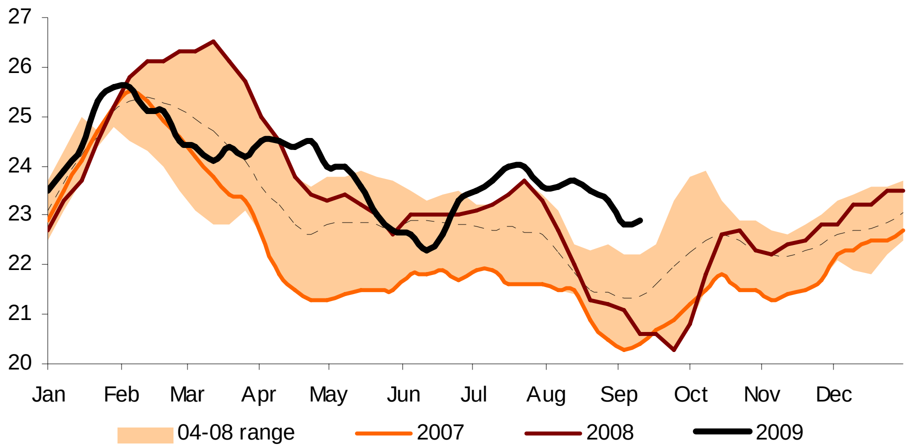
US refinery runs weak as product stocks at all-time high (%)



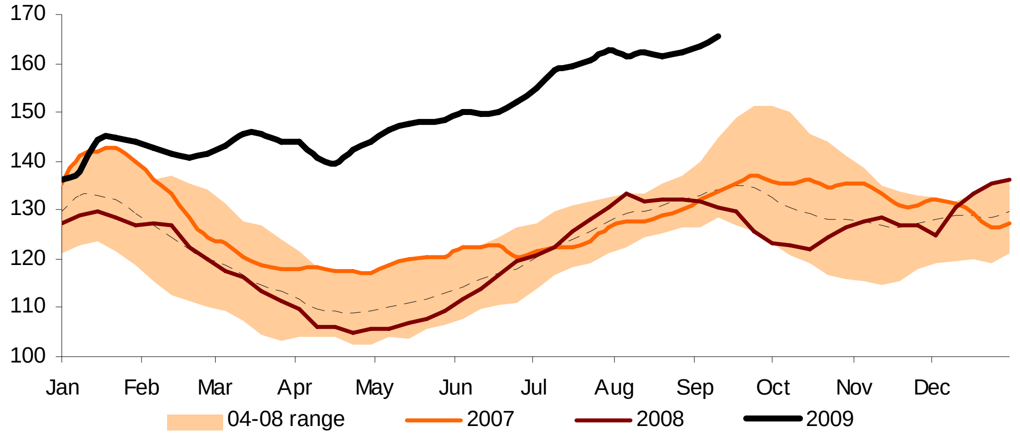
US diesel demand also showing the inverse relationship to prices



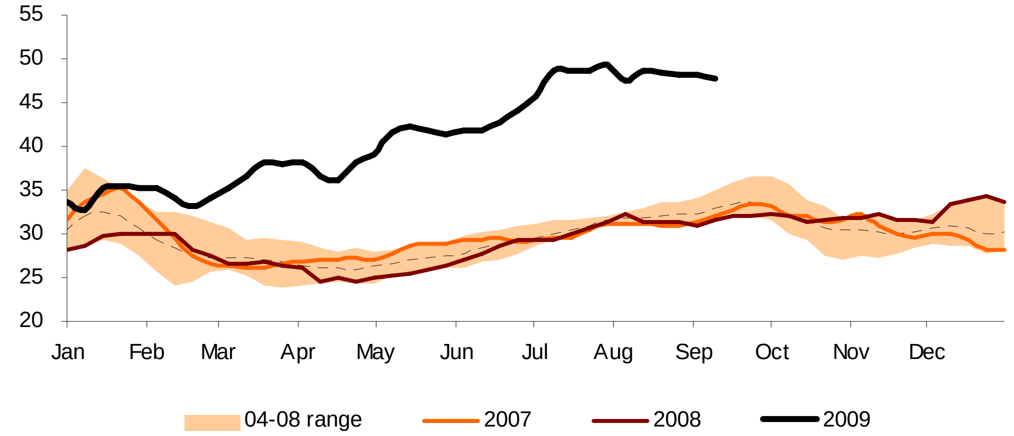
Gasoline demand cover (no. of days)



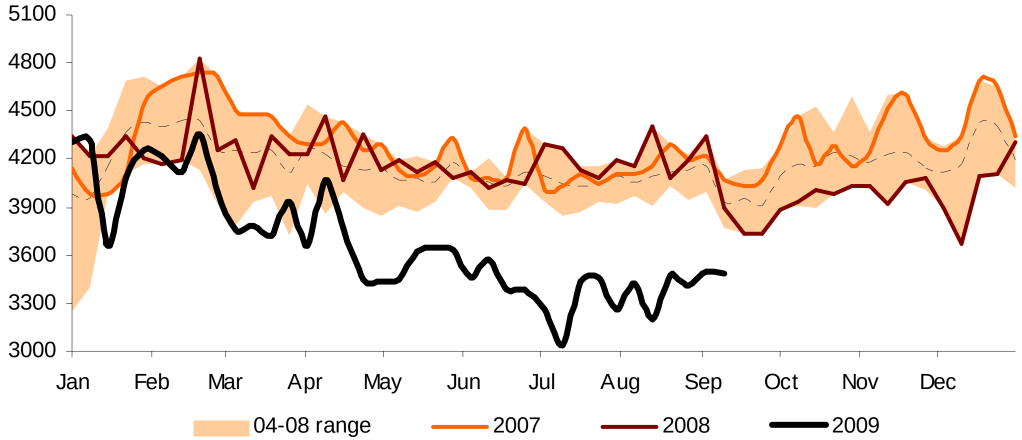
US distillate stocks at all time high (MMbbls)



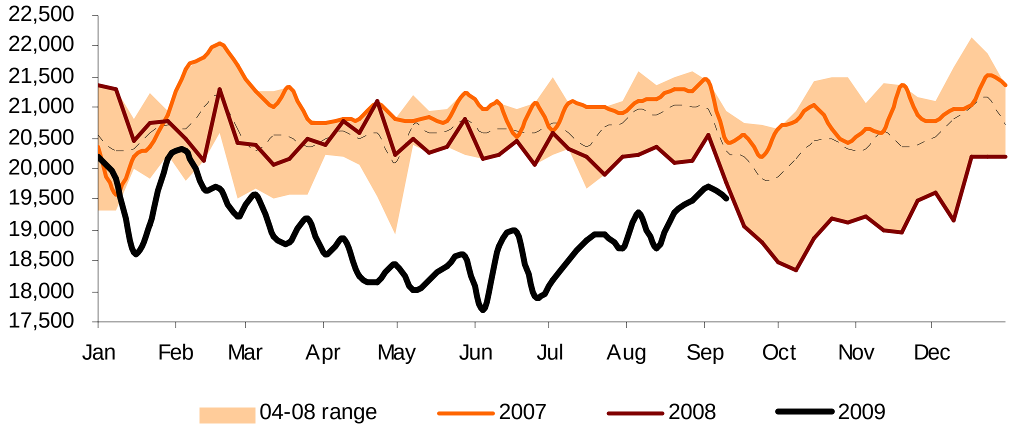
US diesel demand cover also at all time high (no. of days)



US distillate demand significantly below 5-year range (Mbbl/d)



US total oil products demand significantly below 5-year low (Mbbl/d)



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