Indiabulls

Indian Oil Corporation Limited
RESEARCH

EQUITY RESEARCH **Jun 30, 2007**

INITIATING COVERAGE

Indian Oil Corporation Ltd. — Hold

Share Data

Market Cap	Rs. 528.47 bn
Price	Rs 443.2
BSE Sensex	14650.5
Reuters	IOC.BO
Bloomberg	IOC IN
Avg. Volume (52 Week)	0.07 mn
52-Week High/Low	Rs. 972.8/685.55
Shares Outstanding	1192.4 mn

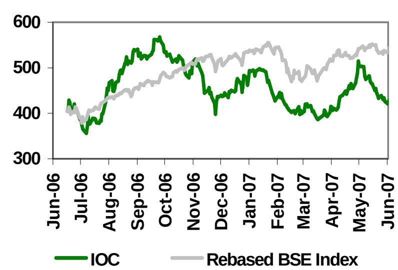
Valuation Ratios

Year to 31 March	2008E	2009E
EPS (Rs.)	100.3	128.0
+/- (%)	14.9%	27.6%
PER (x)	4.4x	3.5x
EV/ Sales (x)	0.3x	0.3x
EV/ EBITDA (x)	3.0x	2.3x

Shareholding Pattern (%)

Promoters	82
FIIs	2
Institutions	4
Public & Others	12

Relative Performance



Downstream giant held down by price control

A public sector Oil Marketing Company like Indian Oil Corporation Ltd (IOC) is heavily subsidized by the government and upstream public sector oil companies. This subsidy allows IOC to cover losses arising from sale of Motor Spirit (MS), Superior Kerosene Oil (SKO), High Speed Diesel (HSD) and LPG at restricted prices. Hence, IOC is unable to take advantage of increase in crude oil prices or increase in demand for its products.

However, with a 45% oil pipeline capacity and 47% share of oil marketing business, IOC is well positioned for competition when the government unshackles the oil industry. Based on the uncertainty in price restrictions and constraint on profits in the short term, we initiate coverage with a hold.

Year to March	FY05	FY06	FY07	FY08E	FY09E	CAGR (%)
(Figures in Rs mn, except per share data)						(FY07E-09E)
Net Sales	1,316,955	1,538,136	1,859,876	2,458,226	3,136,790	29.9%
EBITDA	97,816	106,387	223,424	276,550	352,889	25.7%
Net Profit	54,692	49,324	78,675	116,005	148,027	37.2%
Margins(%)						
EBITDA	7.4%	6.9%	12.0%	11.3%	11.3%	
NPM	4.2%	3.2%	4.2%	4.7%	4.7%	
Per Share Data (Rs.)						
Normalised EPS	50.5	43.8	87.3	100.3	128.0	21.1%
PER (x)	8.8x	10.1x	5.1x	4.4x	3.5x	

- IOC owns 41% of refining market, 51% of the pipelines and 47% of the petroleum products market.
- We expect sales to grow at 24.1% for FY08E based on continued demand for petroleum products. However, we do not expect the margins to grow.
- Higher under-recovery has resulted in increased short-term borrowing leading to higher borrowing cost (7% to 8%) and higher interest expense.
- Given the impending union election next year, we don't expect price restriction to be eliminated in the near term.
- IOC is currently trading at a P/E of 5.1x and with a forward P/E of 4.4x for FY08E and we feel that there is not much potential for upside in the short run. Hence we initiate our coverage with a Hold

Rationale

Government regulation constraining Petroleum and Diesel prices

Increase in prices of Indian crude basket has caused the government to reverse increases of gasoline and diesel prices made during June 06. As a result IOC is losing significant amount of revenue every day. The company has requested the government to hike petrol and diesel prices by Rs 5- Rs 8 per litre. Any hike in prices in the short-term seems unlikely. However, the government has compensated IOC by providing special oil bonds.

Valuable investments

IOC has significant stake in Chennai Petroleum Corporation Ltd., Bongaigaon Refineries & Petrochemicals Ltd., IBP Company Ltd., and Lanka IOC Ltd. The company has also entered into joint venture with Petronet LNG Ltd. and owns minority stake in ONGC and GAIL. As demand for petroleum products increase, value of investments in subsidiaries, joint venture and security held in ONGC & GAIL increases. IOC was able to offset some of the losses suffered by selling off some of its stake in ONGC.

Upgrading existing facilities and expanding in new areas

IOC is developing a 15MMTPA refinery-cum-petrochemicals at Paradip and a Naphtha cracker at Panipat. Other upgrades include increasing output from 6 MMTPA to 7.5 MMTPA at Haldia, adding a delayed coker unit of about 2.2MMPTA and increasing capacity by 50 TMTPA at the Manali refinery. Additions and upgrades will provide a steady source of revenue.

In an attempt to integrate backwards into upstream activities and diversify, IOC has bid for and acquired interests in Assam and Arunachal Pradesh region. The company has also entered into ventures overseas in Sirte Basin of Libya, Farsi Exploration block in Iran, onshore farm-in arrangements in Gabon, an onland block in Nigeria and two on-shore blocks in Yemen. These reserves provide IOC with an optional value. The company reports that it is also aggressively pursuing acquisition opportunities in suitable mid-sized E&P companies.

IOC is also exploring possibilities of creating clean energy via investment in Windmill power project with a capacity of 17MW. As oil reserves deplete and energy demands increase, investment in alternative energy source will create value.

XTRACARE petrol and diesel stations offer a range of value-added services to enhance customer delight and loyalty. SWAGAT brand outlets provide highway motorists with a variety of services deriving additional revenue.

Leadership position in Refining, Pipelines and Marketing

IOC owns 55% of the refineries, 45% of the pipeline infrastructure and 47% of the market share. Establishing refineries and pipelines require substantial investment which could deter smaller entrants. In the event of government deregulation of the pricing mechanism of petroleum, diesel, kerosene and LPG, IOC will have an advantage over competition in the short term.

Largest market share in aviation fuel business

IOC's aviation service controls 63% of the market share in aviation fuel business supplying fuel to Indian Defence Services, domestic and international flag carriers and private airlines. In addition, the company services bulk consumers, railways, state transport undertakings, and industrial, agricultural & marine sectors. With the government holding a major stake, IOC has the benefit of obtaining lucrative government contracts.

Risks

Further increase in oil prices will increase under-recovery

Increase in price of Indian crude basket coupled with lowering of selling price has hurt OMC like IOC. The company is incurring a loss to the tune of Rs 100 crore per day at current price level of crude oil. Any further increase in international market price will reduce IOC's revenue.

Dismantling of price controls will increase competition

Current price controls deters private and international marketing companies from entering the market. Allowing prices of petrol and diesel to adjust to market prices will invite competition affecting IOC's revenue prospect.

Depreciation of rupee against dollar

India imports over 70% of its crude oil needs. Since IOC is the largest refiner and marketer of petroleum products, depreciation of rupee will hurt the company's bottom line.

Outlook

Although the company's sales grew by 20.6% for FY07 and oil prices in international markets inched higher, IOC was not able to take full advantage of the opportunity. Burdened by price restriction imposed by the government and need to bridge the demand gap by importing crude oil, IOC's financial situation came under significant pressure. The government restructured the burden by directing upstream companies to share some of the burden and issuing special oil bonds.

Price control is keeping the margins low. We expect the price of crude oil to increase in the short term (1 year) and remain at a high level before reverting to a lower mean. Increase in crude prices will only increase the burden leading to lower profits.

In our opinion, the pricing scheme will not change in the short-term due to political and social reasons. As long as the current pricing control does not change, we do not expect significant change in the company's outlook.

Company Background

Indian Oil Corporation Ltd. is a downstream major engaged in refining of crude oil and marketing of petroleum products. The company operates the largest network of petrol and diesel stations in the country along with the distribution of Indane cooking gas.

IOC provides fuel to Indian defense services, private airlines, international and domestic airlines. It also services bulk consumer business, railways, state transport undertakings, industrial, agricultural and marine sectors.

IndianOil Technologies Limited (ITL), a wholly owned subsidiary of Indian Oil Corporation Limited is the technology-marketing arm for the entire range of technologies developed at IOC's R&D Centre. It has developed several technologies and technical expertise both in refining and lubricant sector.

IOC conducts refinery and marketing activities overseas via Lanka IOC Ltd., IndianOil Mauritius Ltd. and IOC Middle East FZE while its domestic operations are conducted via Chennai Petroleum Corporation Ltd., Bongaigaon Refineries and Petrochemicals Ltd. and IBP Company Ltd.

With a strategy to integrate backwards, IOC is entering into joint ventures with international and domestic E&P firms, acquiring oil and gas reserves and actively looking to acquire suitable medium sized E&P companies. The company's forward expansion strategy has resulted in upgrading and expanding existing facilities.

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