OIL & GAS

Refining – expect a super June quarter

Refining margins have increased to ever highest levels in the first week of May surpassing levels reached last may. Though we believe that the refining margins will moderate once the refineries globally come out of teething problems, Q1FY08 earnings are expected to be high, which offers trading opportunities.

We prefer standalone refiners like CPCL, RIL, and MRPL to play the high GRMs. CPCL seems to be the best bet as an increase in USD 1.0/bbl implies increase in EPS by 47% in FY08. Though oil marketing companies will also benefit from the high refining margins, investors may be exposed to risks of changing government support by oil bonds and upstream subsidies.

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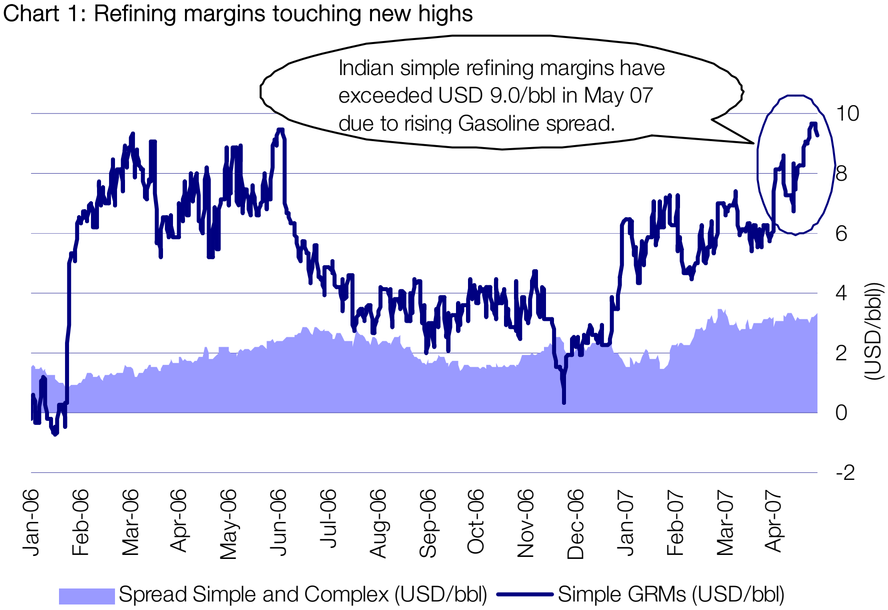
* Refining margins: Touching new highs in May

Indian simple refining margins have increased to USD 9.3/bbl as on May 2008 with complex margins exceeding USD 12.5/bbl. The sudden sprut in refining margins have been due to increasing Gasoline–WTI spread which have increased to USD 23.0/bbl compared to USD 11.9/bbl in 4QFY07. The increasing spread has been due to falling gasoline inventories, and expected tightness in gasoline supplies throughout the summer season due to expectations of longer leads by refiners in increasing their runs (post shutdowns).

Chart 1: Refining margins touching new highs

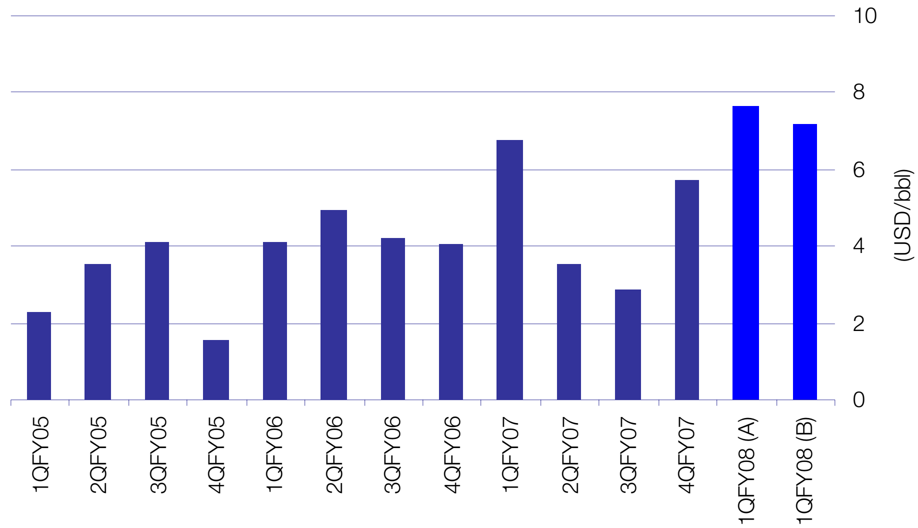


Source: Edelweiss research

* Refining margins for June quarter (Q1FY08) are headed for record numbers

We believe that June quarter (Q1FY08) GRMs for Indian refiners could touch record highs. We estimate Q1FY08 GRMs using two scenarios – (A) assuming Q1FY08 GRMs same as Q1FY08 YTD GRM run rate resulting in GRMs of USD 7.65/bbl, and (B) assuming Indian simple refining margins to moderate to USD 4.5/bbl by June end resulting in Q1FY08 refining margins estimates at USD 7.2/bbl. Both the scenarios result in higher Q1FY08 refining margins, compared to the historical margins (see figure below).

Chart 2: Q1FY08 Indian refining margins



Source: Edelweiss research *Note: (A) Assumes QTD average to sustain for Q1FY08*
(B) Assumes refinery margins to reduce to USD 4.5/bbl (our full year FY08 estimate)

Expect record GRMs from Indian refiners:

We expect an increase of USD 0.8-1.5/bbl in refining margins for Indian players after factoring in expected increase of USD 2.0/bbl in regional margins in Q1FY08 mitigated to some extent by inventory losses estimated of USD 1.1/bbl for Q1FY08.

Table 1: Expected refining margins for Domestic refiners (USD/bbl)

Company	Q1FY07	Q2FY07	Q3FY07	Q4FY07	Q1FY08
CPCL	6.6	4.2	2.7	5.1	5.9
HPCL	7.6	2.1	2.5	4.7	5.5
BPCL	5.0	0.5	2.9	4.7	5.5
IOCL	6.7	(0.3)	4.5	5.5	6.3
RIL	12.4	9.1	11.7	13.0	14.5

Source: Edelweiss research

Standalone refiners are best bets to play the current increase in refining margins

Though we believe that the refining margins will moderate once the refineries globally come out of teething problems, Q1FY08 earnings are expected to be high, which offers trading opportunities.

Our best pick to play the high GRMs are standalone refiners like CPCL, RIL, and MRPL. CPCL seems to be the best bet as an increase in USD 1.0/bbl implies increase in EPS by 47%.

Table 2: Sensitivity of EPS increase to USD 1.0/bbl increase in GRMs

	Capacity (MMT)	Yrly PAT increase (INR mn)	EPS increase (INR)	FY08E EPS	% increase
MRPL	12.0	2,381	1.4	6.2*	21.9
CPCL	10.5	2,083	14.0	29.8	46.9
RIL	33.0	8,132	5.8	73.3	8.0

Source: Edelweiss research **Bloomberg consensus*

Though even oil marketing companies will benefit from the high refining margins, investors may be exposed to risks of changing government support by oil bonds and upstream subsidies.

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RATING INTERPRETATION

Buy	Expected to appreciate more than 20% over a 12-month period	Reduce	Expected to depreciate up to 10% over a 12-month period
Accumulate	Expected to appreciate up to 20% over a 12-month period	Sell	Expected to depreciate more than 10% over a 12-month period
Trading Buy	Expected to appreciate more than 10% over a 45-day period	Trading Sell	Expected to depreciate more than 10% over a 45-day period