Oil & Gas

Switch from Indian Oil Corporation to Oil India

Key points

- **IOC - tough conditions result in record losses and stress on balance sheet:** Given the strength in crude oil prices and lack of political will to increase prices of most petroleum products (diesel, LPG, kerosene), the under recoveries in the oil sector have shot up significantly. Media reports suggest that under recoveries in the first eight months have risen to Rs80,000 crore which is more than the full year budgeted figure for FY2011. The cash-strapped government is unable to timely compensate oil marketing companies (OMCs) for under recoveries which has stressed the latter's balance sheets and has considerably increased their interest burden. Apart from this, the profitability of the refining business of Indian Oil Corporation (IOC) is likely to come under severe pressure due to a sharp decline in gross refining margins (GRMs) in the past few weeks.

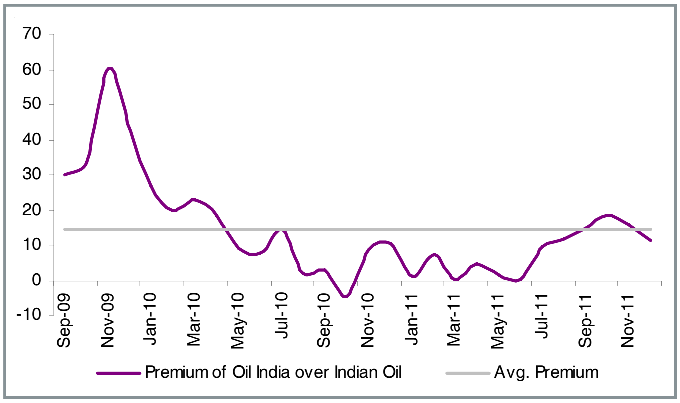
- **Oil India - strong balance sheet and business fundamentals:** On the other hand, Oil India Ltd (OIL) is the second largest exploration and production (E&P) company in India and benefits from strong crude oil prices in terms of higher realisation. The Street expects the company to maintain a steady growth of 2-4% in production of crude oil and the management has guided for an around 10-12% growth in its gas production for FY2012. The oil reserves of 505 million barrel of oil equivalent (boe) and an average reserve replacement ratio of 1.5-1.7x its annual production provide strong growth visibility. Moreover, the company has seen strong cash inflows and was sitting on cash & cash equivalents of Rs11,769 crore as on March 2011 (which works out to 43% of its market capitalisation or Rs490 per share).

- **Prefer OIL over IOC**: OIL has a much better growth outlook and a comfortable balance sheet position. Moreover, it is trading at a steep discount of 23% to its historic average multiple of 10x as compared to around 11% discount in case of IOC in spite of serious concerns.

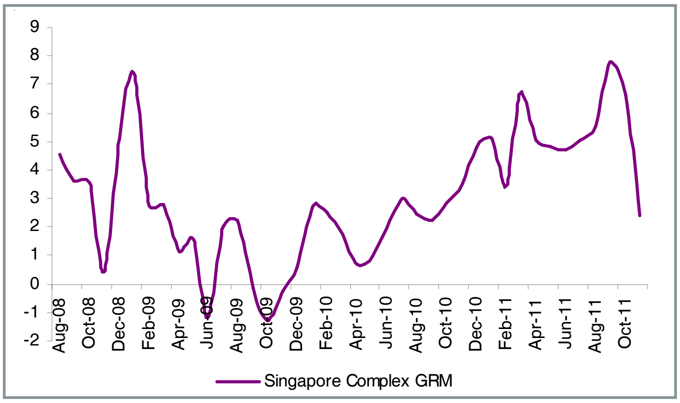
  In terms of relative valuation, OIL used to trade at a 15% premium to IOC. The premium has now narrowed down to around 11%. Given the much higher margin of safety in case of OIL, we believe that the premium would widen going ahead.

- **Risk:** A higher than expected subsidy burden on upstream companies could be a key risk to our call of switching from IOC to OIL. Secondly, the stock price of OMCs could for a temporary period, react positively when the government even partially compensates for the under recoveries due but unpaid.

Premium of OIL over IOC chart



Singapore Complex GRM trend (Monthly avg)



OIL to outperform on strong balance sheet and business fundamentals

- **Net realisation healthy with strong crude price:** The price of crude remains strong at $108/bbl (increased by 13% on a year-on-year [Y-o-Y] basis) owing to the strong demand from the non- OPEC region. Due to an increase in crude price the net realisation (after subsidy burden) of OIL in Q2FY2012 stood healthy at $86/bbl (increased by 36% YoY and 45% quarter on quarter [QoQ]). The net realisation would remain healthy in Q3 also.

- **Better growth in production volumes:** OIL has ramped up its production volumes by using better exploration and production techniques in its legacy fields located in the north east region. During FY2007-2011 the gas production has grown at a compounded annual growth rate (CAGR) of just 1% whereas in FY2012 the Street expects the company to maintain a steady growth of 2-4% in production of crude oil. Further, the management has guided for around 10-12% growth in its gas production. The reserve replacement ratio (RRR) also stood healthy at 1.5-1.7x in FY2011 and with a robust 1P reserve of 505mnbbl the company provides strong revenue visibility in the coming years.

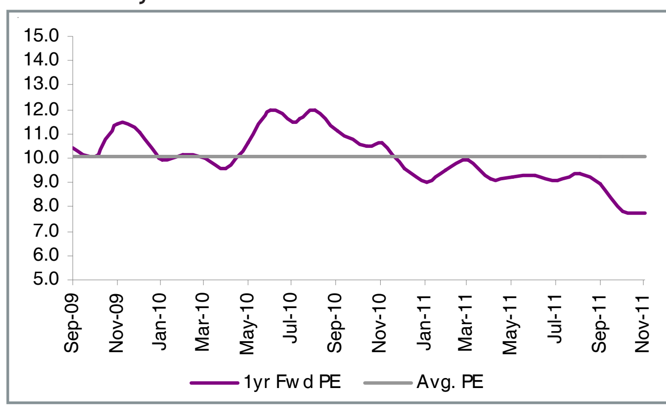
- **Strong balance sheet augurs well for a potential new acquisition in the overseas markets:** The company has a strong balance sheet with a huge cash of Rs11,769 crore with negligible debt on the books. The net cash and investment works out to around Rs490 per share. With the huge cash and healthy internal accruals the company is well placed to fund its capital expenditure (capex) and to acquire oil and gas assets in the overseas markets. Further the return ratios in terms of return on equity (RoE) and return on capital employed (RoCE) are healthy and stood at 19.6% and 28.3% respectively in FY2011. Hence we except OIL to outperform compared to IOC. In terms of valuation the stock is trading at a price earning (PE) of 7.7x discounting its FY2013E earning per share (EPS) which is at a steep discount of 23% to its historic average multiple of 10x.

- **Concern in terms of higher than expected subsidy burden and utilisation of huge cash:** Higher than expected subsidy burden due to an increase in under recoveries could affect profitability and earnings of the company. Further proper and timely utilisation of the huge cash is a key challenge for the management.

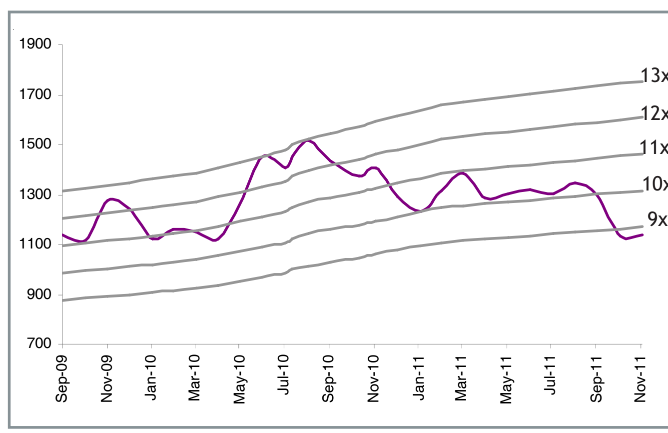
Valuation (standalone basis)

Particulars	FY09	FY10	FY11	FY12E	FY13E
Net sales (Rs cr)	7241.5	7922.6	8364.1	10579.5	10987.0
Adj. net profit (Rs cr)	2161.6	2610.4	2887.6	3445.0	3694.0
No of shares (cr)	24.0	24.0	24.0	24.0	24.0
EPS (Rs)	89.9	108.6	120.1	143.3	153.6
% Y-o-Y growth	*19.8*	*20.8*	*10.6*	*19.3*	*7.2*
PER (x)	13.1	10.8	9.8	8.2	7.7
Price/BV (x)	2.7	2.1	1.8	1.5	1.4
EV/EBITDA (x)	6.1	5.5	4.6	3.8	3.3
RoCE (%)	38.8	33.7	28.3	29.2	27.3
RoNW (%)	25.0	22.6	19.6	20.3	19.1

PE chart - 1 year forward



PE band



IOC - to underperform on mounting under recoveries and fall in GRM

- **Refining capacity to increase to 98mtpa:** IOC has a total consolidated installed refining capacity of 65.7mtpa as of end FY2011 and plans to increase the capacity to 98mtpa by the end of FY2014. IOC's marketing volumes are largely at par with its consolidated refining capacity, making it the most leveraged compared to its other OMC peers. In terms of pipeline, the company has set up pipeline across 10,899km (for oil & gas) as of end FY2011.

- **Correction in GRM affects earnings of the company:** Recently the Singapore GRM has corrected to $3.5/bbl as compared to $7.5/bbl in H1FY2012 due to contraction in the gasoline crack. IOC's GRM in Q2FY2012 has corrected sharply to $2.7/bbl from $4.7/bbl in Q1FY2012. The contraction was on account of a decline in spread between some of the light and middle distillate segments.

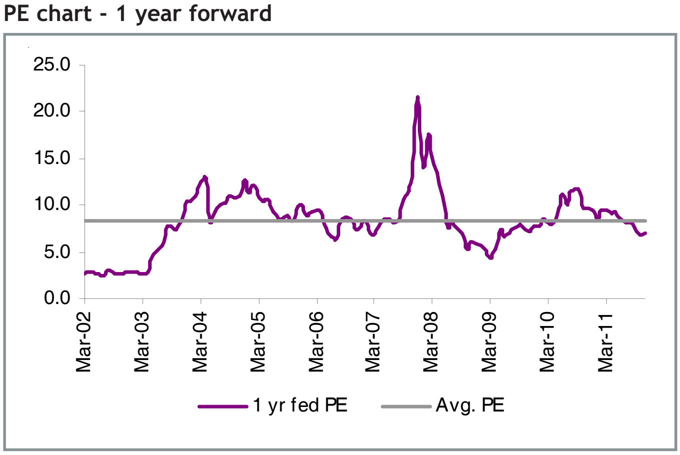
- **Increase in under recoveries; no clarity on subsidy sharing mechanism:** In addition to the decline in the GRM, the price of crude oil has remained strong to $108/bbl (increased by 13% on a Y-o-Y basis). Due to an increase in the price of crude oil the under recoveries for the company have increased significantly. The gross under recoveries for the company in H1FY2012 stood at Rs355.6 billion, of which the company has received upstream discount of 33.2%. Hence, sharing on the balance under recoveries during H1FY2012 and further increase in the under recoveries due to strong crude price will remain an overhang on the company.

- **Huge debt, poor return ratio and massive loss in H1FY2012:** The company has a huge debt of Rs52,734 crore on its books as of end FY2011 and the debt equity ratio stood at a little over 1x. Hence the interest burden continues to dent earnings of the company. The return ratios are also poor with the RoE and RoCE standing at 14% and 11.6% respectively in FY2011. During H1FY2012 the company has posted a loss to the tune of Rs11,204 crore as compared to a profit of Rs1,905 crore in H1FY2011. Hence we expect IOC to underperform compared to OIL. In terms of valuation the stock is trading at a PE of 7.5x discounting its FY2013E EPS (as against its historical average PE of 8.3x).

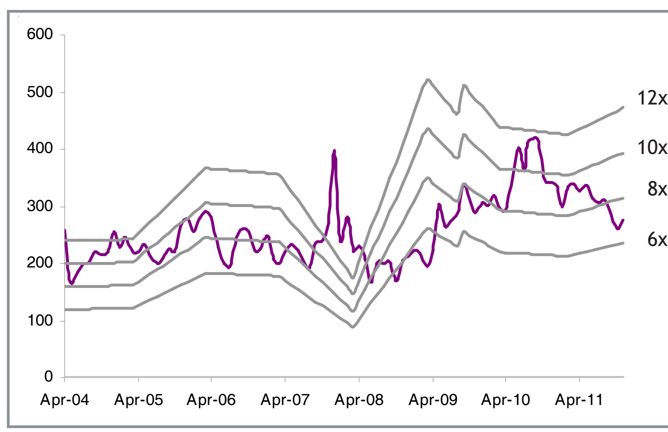
Valuation (standalone basis)

Particulars	FY09	FY10	FY11	FY12E	FY13E
Net sales (Rs cr)	307019	269366	331038	390159	386462
Adj. net profit (Rs cr)	3555	10572	7674	7381	8672
No of shares (cr)	242.8	242.8	242.8	242.8	242.8
EPS (Rs)	14.6	43.5	31.6	30.4	35.7
% Y-o-Y growth	*-50.6*	*197.4*	*-27.4*	*-3.8*	*17.5*
PER (x)	18.3	6.2	8.5	8.8	7.5
Price/BV (x)	1.5	1.3	1.2	1.0	0.9
EV/EBITDA (x)	9.7	5.7	7.1	7.3	6.8
RoCE (%)	11.2	17.0	11.6	12.1	12.3
RoNW (%)	8.4	21.6	14.1	12.7	13.3

PE chart - 1 year forward



PE band



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