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FIRST LIGHT

08 March 2022

RESEARCH

Oil & Gas

OMCs - Constructive view with a caveat

SUMMARY

Oil & Gas

- OMCs could face near-term pressure on marketing margins from the sharp rise in crude price
- We retain our constructive view on OMCs on the premise that crude price and, in turn, marketing margins will normalise over FY23
- We now rate all OMCs as BUY as we upgrade BPCL after the recent correction; prefer HPCL for its earnings growth driven by project delivery

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Daily macro indicators

Indicator	03-Mar	04-Mar	Chg (%)
US 10Y yield (%)	1.84	1.73	(11)
India 10Y yield (%)	6.83	6.81	(1)
USD/INR	75.91	76.17	(0.3)
Brent Crude (US$/bbl)	110.5	118.1	6.9
Dow	33,795	33,615	(0.5)
Hang Seng	22,467	21,905	(2.5)
Sensex	55,103	54,334	(1.4)
India FII (US$ mn)	**02-Mar**	**03-Mar**	**Chg ($ mn)**
FII-D	(194.0)	(34.2)	159.9
FII-E	(535.7)	(862.6)	(326.9)

Source: Bank of Baroda Economics Research

BOBCAPS Research
researchreport@bobcaps.in

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Kirtan Mehta, CFA
researchreport@bobcaps.in

OMCs have seen a pullback: Stock prices of BPCL, HPCL and IOCL have corrected by 15-19% since mid-Nov'21 after a pause on retail price revisions and, more recently, the sharp rise in crude prices. The correction has been relatively modest, indicating that the market is considering both events as temporary.

Stability of marketing margin in question: At current prices, marketing loss on petrol and diesel has shot up to Rs 23-27/l. While we expect price revisions to commence post March, these are likely to be staggered, leading to pressure on marketing margins for 1-2 quarters. The impact is material as Re 1/l of marketing loss on petrol and diesel for a quarter could lower FY23E EBITDA by 5-7% for OMCs.

Crude price could revert to US$ 80-90/bbl over FY23: Despite near-term uncertainty, we believe sanctions on Russia's energy flows are unlikely given the global dependence on its supplies and the fact that OPEC's entire spare capacity could be erased just to replace 4.6mbpd of Russian crude flow. If no sanctions are imposed, we believe trade flows could rebalance, allowing supply to continue. With a ramp-up of both OPEC and non-OPEC production, the market could return to surplus in CY22. Any deal with Iran could help ease supply tightness earlier.

Retain constructive views on OMCs: We expect the eventual return of crude price to US$ 75/bbl over CY23 and hence retain our constructive stance on OMCs. Factoring in faster recovery in refining margins and a one-quarter impact on marketing margins in FY23, we raise our FY23/FY24 earnings forecasts by 2%/7% across OMCs. We also roll valuations forward to FY24.

Prefer HPCL amongst OMCs: We prefer HPCL as the company is positioned to deliver profit growth over FY23-FY24, earlier than other OMCs, from the completion of capex investments worth Rs 320bn on its books and Rs 212bn by HMEL. For BPCL, though we upgrade the stock from HOLD to BUY, we lower our TP to Rs 450 (vs. Rs 460) as we no longer bake in potential acquisition value. While the government is aiming to close the privatisation transaction in FY23, the task looks increasingly difficult with two bidders unable to tie up with strategic partners.

Recommendation snapshot

Ticker	Price	Target	Rating
BPCL IN	348	450	BUY
HPCL IN	285	410	BUY
IOCL IN	113	150	BUY

Price & Target in Rupees | Price as of 4 Mar 2022

Disclaimer

Recommendation scale: Recommendations and Absolute returns (%) over 12 months

BUY – Expected return >+15%

HOLD – Expected return from -6% to +15%

SELL – Expected return <-6%

Note: Recommendation structure changed with effect from 21 June 2021

Our recommendation scale does not factor in short-term stock price volatility related to market fluctuations. Thus, our recommendations may not always be strictly in line with the recommendation scale as shown above.

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