DEEP VALUE PICKS

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PSU – depressed valuations an opportunity or value trap?

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PSU stocks have had a most forgettable year in 2020 with the Nifty PSE index declining ~30% since Jan'20. Average P/E for some Navratna PSUs has shrunk to <7x on FY22E despite a robust earnings outlook. The rationale for buybacks emerges from the deep discount on valuations. While the HPCL buyback sets the right tone for reviving PSUs valuations, BPCL's divestment could lend an impetus to the rerating momentum. We believe PSUs in the cyclical business – especially oil – offer attractive risk-reward.

Valuation gap with Nifty widens: The Nifty PSE index has underperformed the Nifty by a staggering 105% since Jun'14 despite many cash-rich PSUs maintaining healthy dividend payouts. The PSE index was lagging the broader market by 28% until Jan'18, but the underperformance worsened sharply from Q4FY18 triggered by the open offer exemption granted to ONGC on its deal with HPCL.

Government needs valuation trend to reverse…: The government's steep divestment target of Rs 2tn for FY21 would need most PSUs to trend much higher than current value, whether it explores strategic divestment (BPCL, Concor, Air India) or fund raising through secondary markets (ETFs, IPOs). There's some hope that the government may be able to lock in proceeds from the BPCL divestment in FY21 (quantum not yet ascertained), going by the recently concluded first stage of this process (EOI).

…while PSUs well placed to opt for buyback: For companies that have ROE/ ROCE of >10% and are trading at <1x FY20 P/BV (deep value PSUs), a buyback is clearly a preferred move to enhance shareholder value. Various large PSUs fit into this bracket and carry the flexibility to offer attractive buybacks. We note that the one announced by HPCL in Nov'20, where the promoters will not be participating, has resulted in a 25% stock rally.

Cyclicals to lead the rerating pack: We expect cyclicals to helm the rerating among PSUs. Oil entities lead the deep value pack following the attractive buyback plan by stepdown PSU HPCL (owned by ONGC). BPCL's divestment is expected to have direct implications on industry dynamics for IOCL – the latter could lead the rerating pack. SAIL and NMDC are other deep value bets among cyclicals considering positive indicators of an industry turnaround.

PSU stocks continue to underperform

The Nifty PSE index has underperformed the broader market by a staggering 105% since Jun'14. Though the continuous dilution of government stakes is commonly viewed as the culprit, we believe that a variety of factors are at play and hence trend reversal would take a lot of effort from the government.

Dilution only part of the problem

Fig 5 below debunks the common perceptions linking underperformance of PSU stocks purely to steady dilution by the government. There are several examples to disprove this belief, such as Bharat Electronics (BHE), Container Corp (CCRI) and Power Grid. Instead, some of the factors below could have affected their performance.

- **Change in business fundamentals** – e.g. commodity price movements for ONGC, IOCL, SAIL
- **Perception of a lack of consideration for minority shareholders** – e.g. the ONGC-HPCL deal wherein an open offer exemption was granted to ONGC, creating a negative perception around minority shareholders of oil PSUs. This impacted stock performance of all oil PSUs (and even GAIL)
- **Regulatory actions**, especially those that seem irrational and create the impression of company returns being diluted for political gain

FIG 1 – CHANGE IN GOVERNMENT HOLDING VS STOCK PERFORMANCE

Ticker	% change in Govt. holding since June 2014	% change in stock price since June 2014
BHE IN	**(23.9)**	**252.7**
BHEL IN	0.1	(73.1)
BPCL IN	(2.0)	221.3
COAL IN	(23.5)	(52.6)
CCRI IN	**(7.0)**	**73.2**
GAIL IN	(4.0)	(6.9)
HUDCO IN	0.0	(54.8)
ITI IN	0.3	705.9
IOCL IN	**(17.1)**	**37.1**
NHPC IN	(15.0)	12.0
NLC IN	(10.8)	(12.8)
NMDC IN	(10.4)	(32.4)
NTPC IN	(23.9)	(20.3)
NACL IN	(29.4)	10.0
ONGC IN	(8.5)	(60.2)
OINL IN	(11.0)	(58.5)
PWGR IN	**(6.6)**	**94.6**
RITE IN	**(15.4)**	**60.1**
SJVN IN	(3.2)	9.2
SAIL IN	(5.0)	(35.3)

Source: Bloomberg, BOBCAPS Research, CMIE

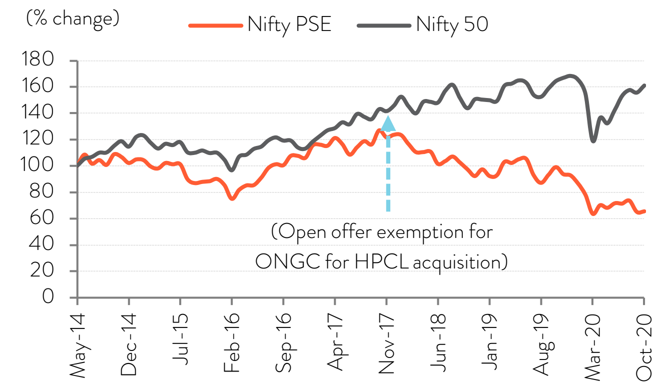
Open offer exemption for ONGC the primary trigger

Derating of PSUs worsened from Q4FY18 post open offer exemption to ONGC

We note that the PSE index was lagging the broader market by 28% until Jan'18, but the underperformance worsened sharply from Q4FY18 – seems primarily due to the open offer exemption granted to ONGC by the government after it formally approved the merger deal with HPCL.

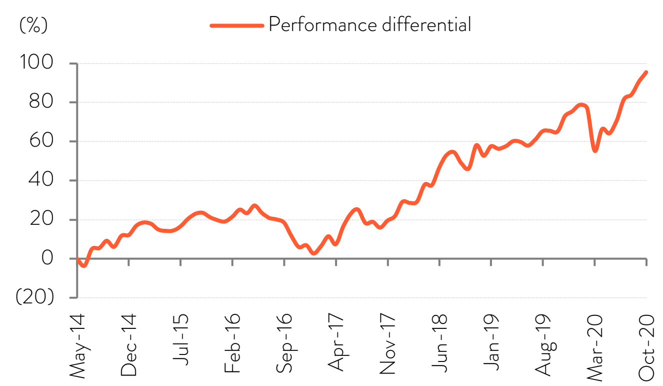
This event changed the course of the index as prices of both companies tanked ~50% in a few months following the deal announcement (ONGC and HPCL have combined weights of ~20% in the Nifty PSE). Both stocks have yet to return to price levels prevailing before the deal announcement – especially HPCL, considering oil prices are trending much lower at ~US$ 45/bbl vs. US$ 65/bbl at the time of the deal.

FIG 2 – NIFTY PSE VS. NIFTY



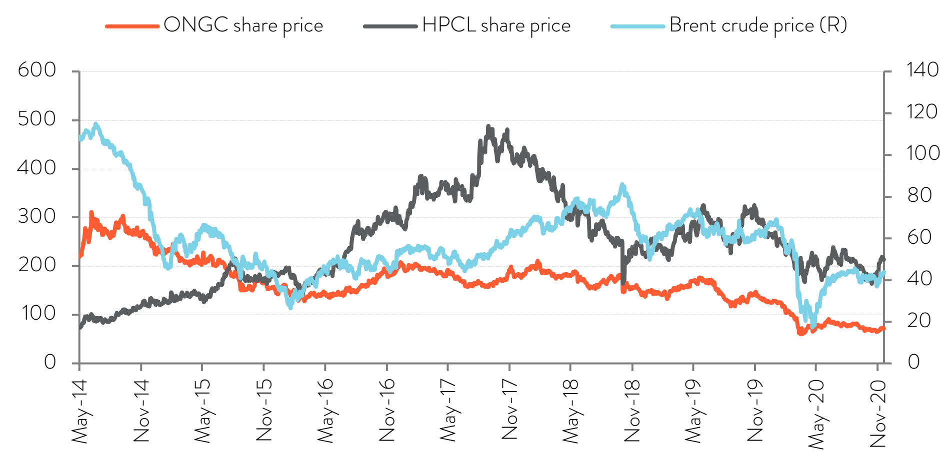
Source: Bloomberg, BOBCAPS Research

FIG 3 – NIFTY PSE UNDERPERFORMANCE



Source: Bloomberg, BOBCAPS Research

FIG 4 – ONGC VS HPCL VS OIL PRICE



Source: Bloomberg, BOBCAPS research

Steep divestment targets

The government's divestment target of Rs 2tn for FY21 would need most PSUs to trend much higher than current value, whether it explores strategic divestment (BPCL, Concor, Air India) or fund raising through secondary markets (ETFs, IPOs).

Rising divestment targets imply greater need for government to improve PSU valuations

Target increasingly difficult to achieve…

- The divestment target of Rs 2.1tn (FY21 budget estimate) looks difficult to achieve given that only ~Rs 61bn has been mopped up in FY21 YTD. The dependence on divestment to meet the fiscal deficit target remains elevated at 26%.
- There's some hope that the government may be able to lock in proceeds from the BPCL divestment in FY21 (quantum not yet ascertained), going by the recently concluded first stage of this process (EOI).
- Apart from BPCL, Air India and CCRI, the government plans to raise ~Rs 900bn by listing LIC. Most likely, there would be delays in the Air India and LIC IPOs, implying higher reliance on BPCL and other market issuances by the government.

…making sustainability of optimum PSU valuations more critical

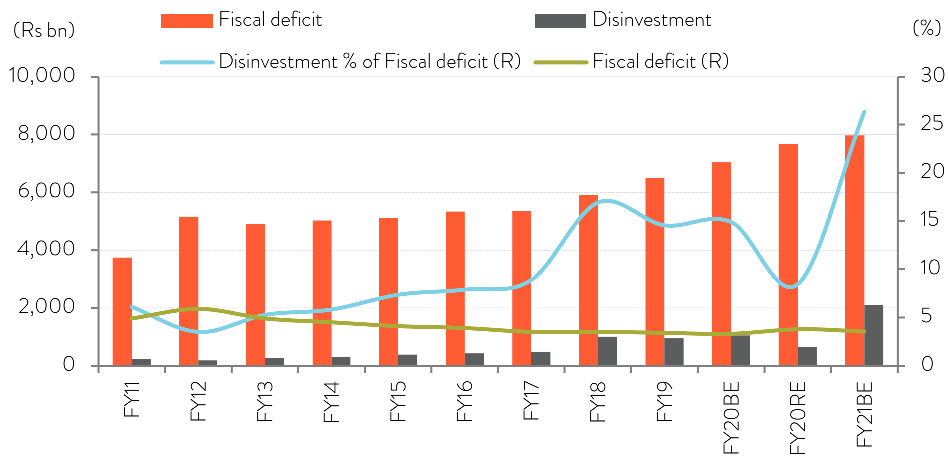
- We continue to see a strong case for the government to ensure optimum valuation for PSUs, to maximise potential for divestment.
- The government would need valuations of many cash-rich PSUs to trend much higher, mostly close to what their fundamentals justify.

FIG 5 – DIVESTMENT BREAKDOWN OVER LAST 8 YEARS

Year	ETFs	OFS & FPO	IPO	Buybacks	SUUTI	Strategic disinvestments & Others	Total
FY14	30.0	128.2	-	-	-	-	**158.2**
FY15	-	243.5	-	-	-	-	**243.5**
FY16	-	195.1	-	44.8	-	81.5	**321.5**
FY17	85.0	80.0	-	189.6	107.8	-	**462.5**
FY18	145.0	137.1	240.4	53.4	14.0	4.1	**594.0**
FY19	450.8	52.4	19.1	106.7	53.8	166.9	**849.7**
FY20	308.7	11.3	11.1	8.2	6.0	157.6	**503.0**
FY21	-	57.0	4.4	-	-	-	**61.4**
Total	**1,019.5**	**904.6**	**275.1**	**402.8**	**181.6**	**410.2**	**3,193.7**

Source: DIPAM, BOBCAPS Research

FIG 6 – DISINVESTMENT VS. FISCAL DEFICIT



Source: Company, BOBCAPS Research | Note: The divestment amount shown here differs from DIPAM data as it is taken from budgetary documents

What could reverse PSU underperformance?

Regaining confidence of minority shareholders

Government needs to do a lot more to gain confidence of minority shareholders

- **Buybacks:** The buyback announced by HPCL in Nov'20, where the promoters will not be participating, has resulted in a 25% stock rally. In contrast, we saw a relatively muted response to the one announced by NTPC, where promoters have an option to participate, with the stock moving up ~12% since the announcement. PSU management commentary (see Annexure A on Page 8) shows that HPCL endorses buybacks with promoter exemption as an effective way to reward shareholders.

- **Divestments:** The government has improved its divestment parameters after the sharp derating witnessed post the ONGC-HPCL deal, ensuring critical factors such as barring PSUs from bidding and denying open offer exemption. A successful divestment of BPCL to a private entity could therefore trigger a rerating across some PSUs (especially oil).

- **IPOs:** The IPOs of RITES and IRCTC (in FY19/FY20) garnered good interest from investors and were executed quite smoothly. The planned mega IPO of LIC most likely in FY22 could lift sentiments across financial PSUs if executed well.

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Deep value bets

We screen for PSUs that offer deep value to investors from a universe of over 70 listed central government-owned enterprises. From a valuation perspective, many of these entities look attractively priced on both P/E and P/BV parameters, while also offering attractive dividend yields. We exclude the financial sector from our analysis considering the limited scope for any corporate action (especially buybacks) in the current environment.

Cyclicals could lead rerating in the near term

We view PSU cyclicals such as IOCL, NMDC, SAIL and ONGC among others highlighted in Fig 7 as ideal picks in the near term given the rerating triggers below:

Cyclicals could lead the initial wave of rerating expected across PSUs

- prospects of a V-shaped recovery in fundamentals as the pandemic impact lessens globally and potential vaccine launch draws nearer;
- expectations of robust earnings recovery, with improved commodity prices as demand recovers;
- positive examples set by the BPCL divestment and HPCL buyback which make a strong case for other PSUs to follow suit

FIG 7 – PSUs WITH VISIBLE EARNINGS TRACTION (>RS 50BN MARKET CAP) | ■ DEEP VALUE PICKS

Ticker	Government holding (%)	Earnings CAGR FY21E-23E	P/E (x) FY22E	P/E (x) FY23E	ROCE (%)	ROE (%)	Debt/Equity (x)	Dividend yield (%) FY20	P/BV (x) FY20
BHE IN	51.1	15.9	12.0	10.5	29.9	15.7	0.0	2.9	2.36
BHEL IN	63.2	97.5	10.3	11.8	(1.6)	(1.9)	0.2	4.3	0.34
BPCL IN	53.0	20.3	9.2	8.2	10.9	17.0	1.8	4.4	2.27
COAL IN	66.1	12.6	5.5	5.0	33.7	36.3	0.2	9.5	2.45
CCRI IN	54.8	24.2	22.4	19.5	7.0	6.8	0.0	1.4	2.43
GAIL IN	**52.1**	**19.7**	**6.8**	**6.4**	**24.2**	**9.3**	**0.2**	**7.8**	**0.86**
HUDCO IN	**89.8**	**6.9**	**3.8**	**-**	**10.8**	**14.1**	**5.0**	**9.5**	**0.54**
ITI IN	90.3	-	-	-	11.5	11.7	0.5	0.0	4.80
IOCL IN	**51.5**	**18.9**	**5.4**	**4.3**	**(3.2)**	**12.1**	**1.4**	**5.0**	**0.84**
IRCTC IN	87.4	118.6	28.3	24.8	62.4	20.5	0.1	0.9	16.10
NHPC IN	71.0	7.5	6.8	6.1	9.4	9.0	0.7	5.7	0.66
NLC IN	**79.2**	**-**	**-**	**-**	**10.3**	**10.0**	**1.9**	**14.4**	**0.53**
NMDC IN	**69.7**	**0.1**	**7.3**	**7.5**	**27.1**	**13.5**	**0.0**	**5.5**	**1.06**
NTPC IN	**51.0**	**9.3**	**5.8**	**5.7**	**9.4**	**10.9**	**1.7**	**3.6**	**0.74**
NACL IN	51.5	41.4	12.3	9.1	2.2	3.1	0.0	-	3.78
ONGC IN	**60.4**	**52.6**	**5.3**	**4.2**	**10.4**	**4.3**	**0.6**	**7.0**	**0.43**
OINL IN	**56.7**	**37.5**	**6.1**	**5.4**	**22.7**	**4.4**	**0.5**	**11.5**	**0.35**
PWGR IN	51.3	10.5	8.0	7.2	12.1	16.0	2.3	5.3	1.53
RITE IN	72.0	15.1	10.4	9.0	35.1	19.7	0.0	6.3	2.40
SJVN IN	86.8	6.5	5.5	5.3	15.7	-	0.2	9.8	0.40
SAIL IN	**75.0**	**112.7**	**8.9**	**6.3**	**9.7**	**(1.5)**	**1.2**	**0.0**	**0.40**

Source: Bloomberg, BOBCAPS Research

Annexure A: Management commentary on buybacks/dividends

IOCL

- **Buyback/dividends:** IOCL has no immediate plans for a buyback. Its last buyback did not have much impact on the stock price and hence management is skeptical about whether this would reward shareholders. However, it is open to consider this route based on investor feedback.

- **Capex:** Capex will be maintained at pre-Covid levels of ~Rs 260bn (if not increased) for FY21.

HPCL (owned by ONGC)

- **Buyback/dividends:** The buyback was undertaken purely to create value for shareholders. Management believes that the intrinsic value of HPCL's stock is far more than that reflected in the CMP, well above Rs 250. Considering that the cost of borrowing is much lower than the cost of equity, this also makes a buyback more viable.

  The company will consider all the three ways to reward shareholders – dividends, buybacks and bonuses. Buybacks would most likely have no impact on dividend payouts in FY21.

- **Capex:** The company is very comfortable with its debt/equity ratio and also enjoys a good credit history, so funding its capex will not be a concern.

Coal India

- **Buyback/dividends:** Management indicated that it will be in a position to offer some more dividends despite paying out 90% of its profit toward this in H1FY21. The company is confident that Q3FY21 profitability could be higher YoY and better than H1.

  Management believes that buyback is not a favourable option for investors as it attracts a marginal tax rate for shareholders. Additionally, many subsidiaries of Coal India usually pass on cash to the company through dividends, implying that it is prudent for it to reward shareholders through dividends.

- **Capex:** The current capex trend of Rs 100bn in FY21 could be exceeded if demand picks up. Capex is linked to production levels and hence could rise to Rs 130bn-140bn if production improves over FY22-FY23.

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Recommendations and Absolute returns (%) over 12 months

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ADD – Expected return from >+5% to +15%

REDUCE – Expected return from -5% to +5%

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