


OIL & GAS

21 October 2020

OMCs – Depressed valuations overlook earnings traction

The earnings outlook for oil marketing companies (OMC) remains buoyant as marketing margins are holding at elevated levels. Recovery in oil product demand, albeit a bit delayed, looks imminent in H2FY21. Benchmark GRMs have begun to revive from October. BPCL's divestment process has raised hopes for sustained and irreversible deregulation in petrol and diesel pricing. Delays in this divestment have led to a sharp share price correction in OMCs (IOCL, HPCL), making risk-reward favourable.

Rohit Ahuja | Harleen Manglani

research@bobcaps.in

Robust marketing margins to protect earnings: OMCs' stupendously high marketing margins in Q1FY21 made up for the impact of low product sales and negative benchmark GRMs during the quarter. The marketing segment could continue to anchor earnings growth through FY21-FY22, giving OMCs a near-term advantage over global peers that are exposed to the refining segment. GRMs have started to recover from Oct'20, but the outlook remains uncertain as a second wave of the pandemic hits the US and Europe. High marketing margins provide a cushion against cyclical uncertainty in OMC earnings.

Sales volume to normalise in H2FY21: Petroleum product consumption declined ~11% in H1FY21. Diesel consumption, a key barometer of economic activity, remained negative at -15.6% YoY in Sep'20 (vs. -25% in H1). Petrol demand, a barometer of personal mobility, has recovered faster to -5% YoY in Sep'20 (vs. -20% in H1). Trends for October look promising ([see Argus Media's report](#)), with diesel offtake improving 9% in the first half of the month. We could see a return to normal product consumption in India during H2FY21.

Valuations at a disconnect with fundamentals: OMCs (IOCL, HPCL) are currently trading at depressed valuations of ~3x FY22E EPS, barring BPCL (8x) due to divestment expectations. At these low valuations, the companies offer excellent dividend yields (>15%), assuming earnings remain buoyant. With completion of the BPCL divestment (in FY21E), ~40% of the fuel retailing market would be privatised. This will make free pricing for petrol/diesel an irreversible reform and hence boost valuation multiples for HPCL and IOCL.

We prefer IOCL, HPCL and BPCL in that order, based on current valuations, outlook on dividend yield, and triggers from better refining margins once oil demand normalises.

KEY RECOMMENDATIONS

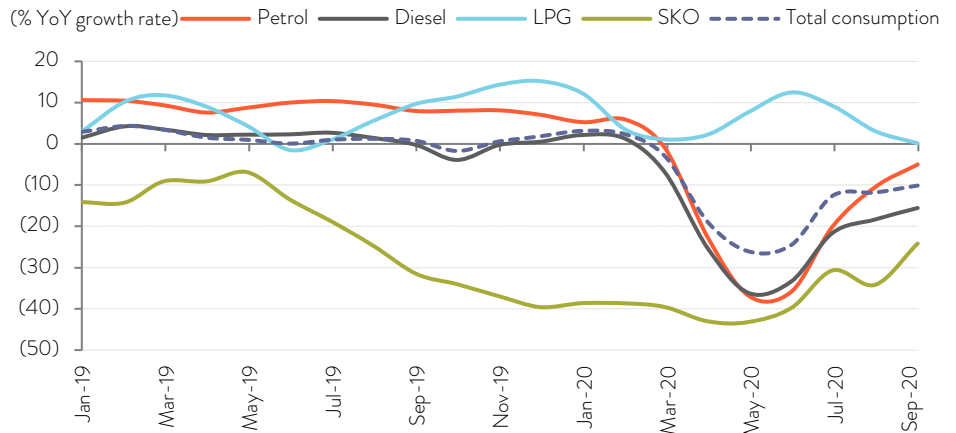
Ticker	Price	Target	Rating
IOCL IN	76	195	BUY
BPCL IN	350	480	BUY
HPCL IN	178	440	BUY

Price & Target in Rupees



Industry volumes to recover in H2

FIG 1 – DOMESTIC PRODUCT CONSUMPTION



Source: PPAC, BOBCAPS Research

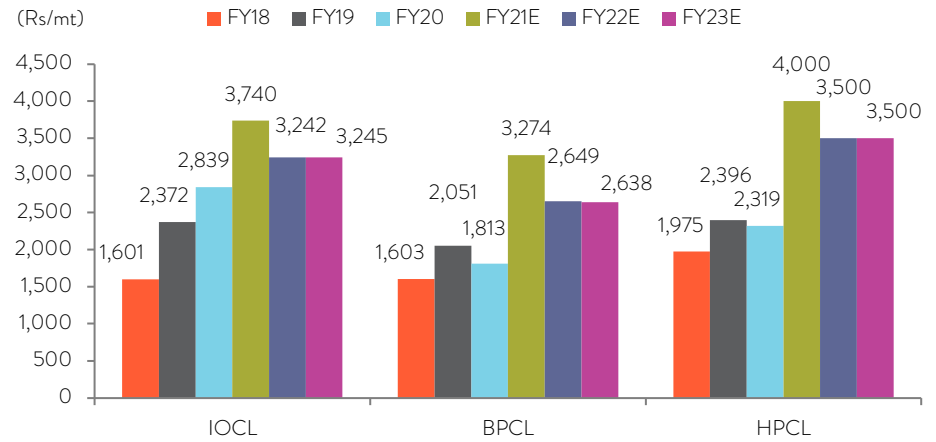
Transport fuel demand picking up; ATF still muted

- Diesel consumption has been affected the most by the Covid-19 lockdown, declining 25% in H1FY21 and 16% YoY in Sep'20. However, the first half of October has seen ~9% YoY growth, implying consumption recovery. Growing demand for diesel which is a barometer of economic activity suggests a strong case for normalisation of GDP growth by Q4FY21.
- Petrol sales have recovered relatively faster, with consumption at -5% YoY by Sep'20 vs. -20% in H1. Personal mobility is expected to pick up significantly post the pandemic as most consumers avoid public transport.
- In the near term, demand for transportation fuels would be backed by higher utilisation of the existing vehicle fleet (both commercial and passenger vehicles). Over the long term, a sustained uptrend in OEM sales (especially PVs, as seen in Aug/Sep'20) could lead to above-expected growth in fuel consumption (especially petrol).
- LPG offtake has bucked the trend, growing ~6% in H1FY21, as the lockdown raised demand for LPG cylinders from homes. This segment has been on a structural growth uptrend, also supported by increased penetration in rural areas.
- ATF and other industrial products remain the hardest hit, as air travel and industrial activity could take much longer to return to normal.

Marketing margins shoring up earnings

Marketing margins are well above the long-term average as oil prices remain benign

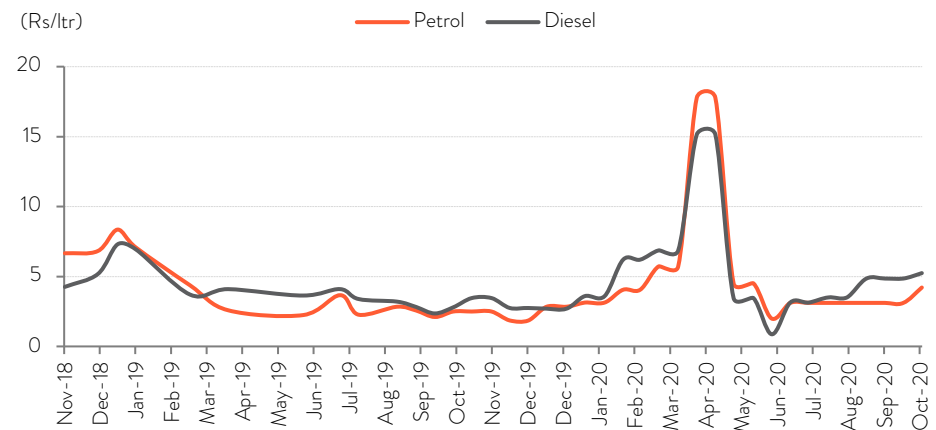
FIG 2 – OMC MARKETING MARGINS



Source: BOBCAPS Research, Company

Q1 FY21 was an exceptional quarter for margins on price freeze due to lockdown. Q2 still looks good, as margins trend above long-term average

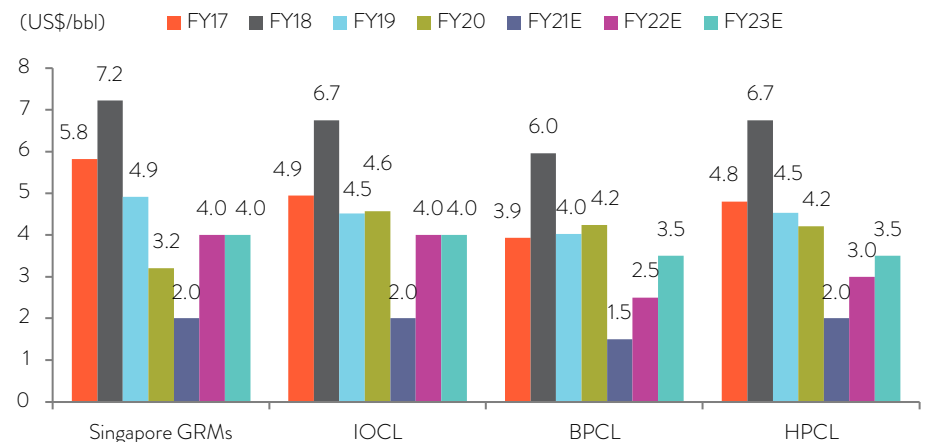
FIG 3 – PETROL AND DIESEL MARKETING MARGINS



Source: Company, PPAC, BOBCAPS Research

GRMs expected to recover from FY22, but still trend below the long-term average

FIG 4 – GRM TREND



Source: BOBCAPS Research, Company

Volume loss and low GRMs offset by high marketing margins

- OMCs' retail marketing margins on petrol and diesel have continued to trend well above long-term averages.
- Margin expansion has more than made up for loss of volumes and low GRMs in H1FY21.
- GRM recovery in Oct'20 could help normalise refining segment earnings, while sustained high marketing margins could spur overall earnings growth and ROE (>20%) for OMCs through FY21-FY23.

OMCs have lost market share to private companies since FY15, largely in low-margin bulk diesel...

...but have gained on marketing margins as their industrial volumes continue to expand

FIG 5 – OMC MARKET SHARE AND VOLUMES

(mmt)	FY15	FY16	FY17	FY18	FY19	FY20
IOCL	68.5	72.6	74.1	77.1	79.5	78.6
% of total industry	41.4	39.5	38.1	37.4	37.3	37.0
IOCL YoY % growth (R)	7.8	6.0	2.1	4.1	3.0	(1.1)
HPCL	32.0	34.2	35.2	36.9	38.7	39.6
% of total industry	19.3	18.6	18.1	17.9	18.2	18.7
HPCL YoY % growth (R)	3.2	7.0	3.0	4.7	5.0	2.4
BPCL	34.4	36.5	37.7	41.2	43.1	43.1
% of total industry	20.8	19.9	19.4	20.0	20.2	20.3
BPCL YoY % growth (R)	1.3	6.1	3.1	9.4	4.5	0.1
Total OMCs	134.9	143.3	147.0	155.2	161.2	161.3
% of total industry	81.5	78.0	75.6	75.3	75.8	75.9
OMCs total YoY % growth (R)	5.0	6.3	2.6	5.6	3.9	0.0
Others	30.7	40.5	47.6	50.9	51.6	51.1
% of total industry	18.5	22.0	24.4	24.7	24.2	24.1
Others YoY % growth	2.4	32.2	17.4	7.1	1.2	(0.8)
Total industry	165.5	183.9	194.6	206.2	212.8	212.4
Industry YoY % growth	4.5	11.1	5.8	5.9	3.2	(0.2)

Source: BOBCAPS Research, Company

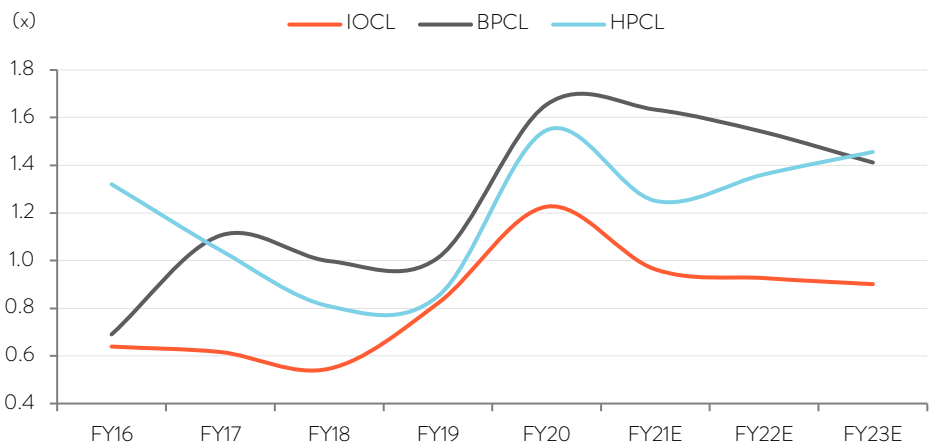
Valuations at deep discount

Prefer IOCL, HPCL and BPCL – in that order

- Low GRMs coupled with delays in BPCL's divestment has led to OMCs trading close to all-time low valuations (IOCL and HPCL at ~3x FY22E EPS). Divestment expectations have kept BPCL's multiple higher at 8x.
- At these low valuations, IOCL and HPCL offer excellent dividend yields (>15%), assuming earnings remain buoyant.
- With completion of the BPCL divestment (expected in FY21), ~40% of the fuel retailing market would be privatised. This will make free pricing for petrol and diesel an irreversible reform and hence boost valuation multiples for HPCL and IOCL.
- We prefer IOCL, HPCL and BPCL in that order, based on current valuations, outlook on dividend yield, and triggers from better refining margins once oil demand normalise.

Leverage expected to decline on better earnings traction from high marketing margins

FIG 6 – OMC LEVERAGE



Source: BOBCAPS Research, Company

IOCL

FIG 7 – IOCL: SOTP VALUATION SUMMARY

Business segments	EV (Rs bn)	Value (Rs/sh)	Comments
Refining	278	30	6x Sep'22E EBITDA
Marketing	1,342	146	6x Sep'22E EBITDA
Petrochemicals	294	32	5x Sep'22E EBITDA
Pipeline	447	49	5x Sep'22E EBITDA
Total core business EV	2,367	235	
Less: Net Debt	669	73	
Equity value of operational segments	1,698	185	
Add: Total investments	85	12	Listed holdings at 20% discount to CMP and others at investment value
IOCL Equity value	1,782	195	

Source: BOBCAPS Research

FIG 8 – IOCL: KEY ASSUMPTIONS

	FY21E	FY22E	FY23E
Oil (US\$/bbl)	35.0	40.0	45.0
GRMs (US\$/bbl)	2.0	4.0	4.0
Singapore GRMs (US\$/bbl)	2.0	4.0	4.0
Refinery throughput (mmt)	75	80	80
Pipeline throughput (mmt)	100.0	108.0	116.0
Market sales (mmt) – including exports	85	88.3	90.6
USDINR	76	78	80
Petrochemicals EBITDA (US\$/mt)	238	186	184
Marketing EBITDA (Rs/mt)	3,000	2,500	2,500

Source: BOBCAPS Research

BPCL

FIG 9 – BPCL: SOTP VALUATION SUMMARY

Business segments	EV (Rs/bn)	Value (Rs/share)	Comments
Refining			
Standalone	71	36	6x Sep'22E EBITDA
BORL refinery	182	92	6x Sep'22E EBITDA
Numaligarh	185	94	6x Sep'22E EBITDA
Marketing	666	339	5x Sep'22E EBITDA
Total core business	1,104	561	
Less: Net Debt	308	157	Adjusted for consolidation
Equity value of core business	796	405	
Total investments value	105	53	Investments in PLNG, OINL, IGL (@ 20% discount to CMP)
Total E&P	40	20	Brazil at EV/boe of US\$ 4, Mozambique at EV/boe of US\$ 1
Total equity value for BPCL	939	480	

Source: BOBCAPS Research

FIG 10 – BPCL: KEY ASSUMPTIONS

	FY21E	FY22E	FY23E
USDINR (Rs)	76.0	78.0	80
Crude price (US\$/bbl)	35.0	40.0	45.0
Mumbai & Kochi refineries			
GRM (US\$/bbl)	1.5	2.5	3.5
Crude throughput (mmt)	32.5	33.0	33.0
Bina refinery			
GRM (US\$/bbl)	10.0	10.0	10.0
Crude throughput (mmt)	9.0	9.5	9.5
Product sales (mmt)	45.3	47.8	50.5

Source: BOBCAPS Research

HPCL**FIG 11 – HPCL: SOTP VALUATION SUMMARY**

Business segments	EV (Rs bn)	Value (Rs/sh)	Comments
Refining Business	29	19	6x Sep'22E EBITDA
Marketing & others	786	516	5x Sep'22E EBITDA
Bhatinda refinery	-	-	Nil valuation on losses
Total core business	815	535	
Less: Net debt	154	101	Adjusted for Bhatinda stake
Equity Value of core businesses	661	434	
MRPL stake	8	5	20% discount to CMP
OIL stake	3	2	20% discount to CMP
HPCL's Equity Value (Rs)	672	440	

Source: Company, BOBCAPS Research

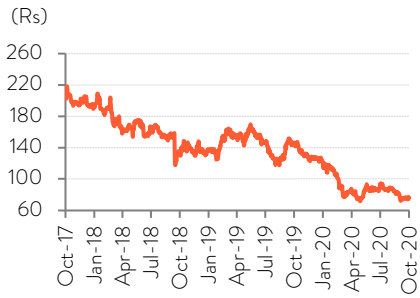
FIG 12 – HPCL: KEY ASSUMPTIONS

	FY21E	FY22E	FY23E
USDINR (Rs)	76.0	78.0	80
Crude price (US\$/bbl)	35.0	40.0	45.0
Mumbai & Vizag refineries			
GRM (US\$/bbl)	2.0	3.0	3.5
Crude throughput (mmt)	24.4	28.5	28.5
HMEL (Bhatinda)			
GRM (US\$/bbl)	7.0	8.0	10.0
Crude throughput (mmt)	12.0	12.0	12.0
Product sales (mmt)	40.7	43.4	46.4

Source: BOBCAPS Research

Stock performance

FIG 13 – IOCL



Source: NSE

FIG 14 – BPCL

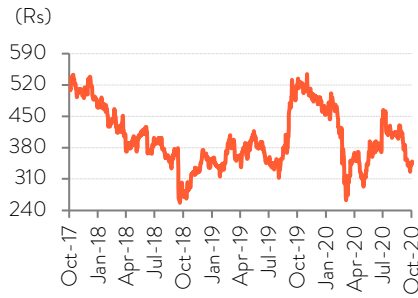
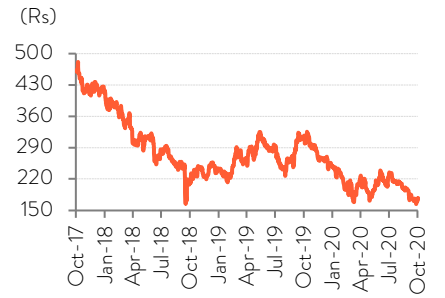


FIG 15 – HPCL



Disclaimer

Recommendations and Absolute returns (%) over 12 months

BUY – Expected return >+15%

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

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

SELL – Expected return <-5%

Note: Recommendation structure changed with effect from 1 January 2018 (Hold rating discontinued and replaced by Add / Reduce)

Rating distribution

As of 30 September 2020, out of 104 rated stocks in the BOB Capital Markets Limited (BOBCAPS) coverage universe, 54 have BUY ratings, 18 have ADD ratings, 10 are rated REDUCE and 22 are rated SELL. None of these companies have been investment banking clients in the last 12 months.

Analyst certification

The research analyst(s) authoring this report hereby certifies that (1) all of the views expressed in this research report accurately reflect his/her personal views about the subject company or companies and its or their securities, and (2) no part of his/her compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) in this report. Analysts are not registered as research analysts by FINRA and are not associated persons of BOBCAPS.

General disclaimers

BOBCAPS is engaged in the business of Institutional Stock Broking and Investment Banking. BOBCAPS is a member of the National Stock Exchange of India Limited and BSE Limited and is also a SEBI-registered Category I Merchant Banker. BOBCAPS is a wholly owned subsidiary of Bank of Baroda which has its various subsidiaries engaged in the businesses of stock broking, lending, asset management, life insurance, health insurance and wealth management, among others.

BOBCAPS's activities have neither been suspended nor has it defaulted with any stock exchange authority with whom it has been registered in the last five years. BOBCAPS has not been debarred from doing business by any stock exchange or SEBI or any other authority. No disciplinary action has been taken by any regulatory authority against BOBCAPS affecting its equity research analysis activities.

BOBCAPS has obtained registration as a Research Entity under SEBI (Research Analysts) Regulations, 2014, having registration No.: INH000000040 valid till 03 February 2020. BOBCAPS is also a SEBI-registered intermediary for the broking business having SEBI Single Registration Certificate No.: INZ000159332 dated 20 November 2017.

BOBCAPS prohibits its analysts, persons reporting to analysts, and members of their households from maintaining a financial interest in the securities or derivatives of any companies that the analysts cover. Additionally, BOBCAPS prohibits its analysts and persons reporting to analysts from serving as an officer, director, or advisory board member of any companies that the analysts cover.

Our salespeople, traders, and other professionals may provide oral or written market commentary or trading strategies to our clients that reflect opinions contrary to the opinions expressed herein, and our proprietary trading and investing businesses may make investment decisions that are inconsistent with the recommendations expressed herein. In reviewing these materials, you should be aware that any or all of the foregoing, among other things, may give rise to real or potential conflicts of interest. Additionally, other important information regarding our relationships with the company or companies that are the subject of this material is provided herein.

This material should not be construed as an offer to sell or the solicitation of an offer to buy any security in any jurisdiction where such an offer or solicitation would be illegal. We are not soliciting any action based on this material. It is for the general information of BOBCAPS's clients. It does not constitute a personal recommendation or take into account the particular investment objectives, financial situations, or needs of individual clients. Before acting on any advice or recommendation in this material, clients should consider whether it is suitable for their particular circumstances and, if necessary, seek professional advice.

The price and value of the investments referred to in this material and the income from them may go down as well as up, and investors may realize losses on any investments. Past performance is not a guide for future performance, future returns are not guaranteed and a loss of original capital may occur. BOBCAPS does not provide tax advice to its clients, and all investors are strongly advised to consult with their tax advisers regarding any potential investment in certain transactions — including those involving futures, options, and other derivatives as well as non-investment-grade securities — that give rise to substantial risk and are not suitable for all investors. The material is based on information that we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied on as such. Opinions expressed are our current opinions as of the date appearing on this material only. We endeavour to update on a reasonable basis the information discussed in this material, but regulatory, compliance, or other reasons may prevent us from doing so.

We and our affiliates, officers, directors, and employees, including persons involved in the preparation or issuance of this material, may from time to time have “long” or “short” positions in, act as principal in, and buy or sell the securities or derivatives thereof of companies mentioned herein and may from time to time add to or dispose of any such securities (or investment). We and our affiliates may act as market makers or assume an underwriting commitment in the securities of companies discussed in this document (or in related investments), may sell them to or buy them from customers on a principal basis, and may also perform or seek to perform investment banking or advisory services for or relating to these companies and may also be represented in the supervisory board or any other committee of these companies.

For the purpose of calculating whether BOBCAPS and its affiliates hold, beneficially own, or control, including the right to vote for directors, one per cent or more of the equity shares of the subject company, the holdings of the issuer of the research report is also included.

BOBCAPS and its non-US affiliates may, to the extent permissible under applicable laws, have acted on or used this research to the extent that it relates to non-US issuers, prior to or immediately following its publication. Foreign currency denominated securities are subject to fluctuations in exchange rates that could have an adverse effect on the value or price of or income derived from the investment. In addition, investors in securities such as ADRs, the value of which are influenced by foreign currencies, effectively assume currency risk. In addition, options involve risks and are not suitable for all investors. Please ensure that you have read and understood the Risk disclosure document before entering into any derivative transactions.

In the US, this material is only for Qualified Institutional Buyers as defined under rule 144(a) of the Securities Act, 1933. No part of this document may be distributed in Canada or used by private customers in the United Kingdom.

No part of this material may be (1) copied, photocopied, or duplicated in any form by any means or (2) redistributed without BOBCAPS's prior written consent.

Company-specific disclosures under SEBI (Research Analysts) Regulations, 2014

The research analyst(s) or his/her relatives do not have any material conflict of interest at the time of publication of this research report.

BOBCAPS or its research analyst(s) or his/her relatives do not have any financial interest in the subject company. BOBCAPS or its research analyst(s) or his/her relatives do not have actual/beneficial ownership of one per cent or more securities in the subject company at the end of the month immediately preceding the date of publication of this report.

The research analyst(s) has not received any compensation from the subject company in the past 12 months. Compensation of the research analyst(s) is not based on any specific merchant banking, investment banking or brokerage service transactions.

BOBCAPS or its research analyst(s) is not engaged in any market making activities for the subject company.

The research analyst(s) has not served as an officer, director or employee of the subject company.

BOBCAPS or its associates may have material conflict of interest at the time of publication of this research report.

BOBCAPS's associates may have financial interest in the subject company. BOBCAPS's associates may hold actual / beneficial ownership of one per cent or more securities in the subject company at the end of the month immediately preceding the date of publication of this report.

BOBCAPS or its associates may have managed or co-managed a public offering of securities for the subject company or may have been mandated by the subject company for any other assignment in the past 12 months.

BOBCAPS may have received compensation from the subject company in the past 12 months. BOBCAPS may from time to time solicit or perform investment banking services for the subject company. BOBCAPS or its associates may have received compensation from the subject company in the past 12 months for services in respect of managing or co-managing public offerings, corporate finance, investment banking or merchant banking, brokerage services or other advisory services in a merger or specific transaction. BOBCAPS or its associates may have received compensation for products or services other than investment banking or merchant banking or brokerage services from the subject company in the past 12 months.