

Oil & Gas Sector

22 December 2020

Concerns on OMC earnings may be short-lived

We remain positive on OMCs and advise investors to buy HPCL for one year and IOC as a long-term holding, based on healthy outlook for fundamentals. We see tactical upside in BPCL as the stake sale moves to the stage of financial bidding and eventual closure of the deal. The sharp 6-7% sell-off on Monday is due to two potential worries: (a) the collapse in retail petrol and diesel margins as OMCs have not raised prices for more than two weeks despite the recent spurt in global fuel prices, which have also got added tailwind from rising spreads and (b) the media news quoting unnamed government sources regarding stiff performance targets for PSUs identified for stake sale to be laid down by "DIPAM" – the official group that oversees divestments. This news refers to PSU names ostensibly identified immediately after the NDA assumed its second term in office last year, which reportedly includes IOC, ONGC (not rated) and several other PSUs outside the Oil & Gas sector. In our view the reference in the news to increase in dividends as a one of the performance targets, among others, and potential increase in supply of paper in these PSUs, could also have added to the selling pressure triggered by the sell-off in Indian equities. The decline in OMC stocks is also in part due to the recent rally in the trio – BPCL, HPCL and IOC, which are up 2.7%/4.9%/10.8% in the last 1 month.

Potential inventory losses: Oil demand could again decline if the current second wave of the Covid-19 pandemic intensifies, resulting in fresh lockdowns. This could put pressure on oil prices and lead to inventory losses, which could squeeze 4QY21 earnings, unless OMCs raise pump prices to restore retail margins in line with YTD trends. However, we see a likely revival in oil demand and prices in 1HCY21, as the COVID vaccine administration gathers momentum globally. Also, a dip in oil prices could improve retail margins and relatively reduce the required increase in pump prices to offset the hit from inventory losses.

Retail margins: Our analysis reveals that blended retail margins (indicative) have crashed to less than Rs1/litre as of the second fortnight Dec'20. This compares with margins in excess of Rs3.5/lit in Oct-Nov'20 and the first fortnight of Dec'20. The industry has stopped daily revision of pump prices for MS/HSD, which are calibrated based on aggregate refining and marketing chain margins, as per management statements during concalls with OMCs.

Risks: (i) falling crude price could result in inventory losses (ii) OMCs may find it tough to pass on further increase in oil prices past US\$55-60/bbl, as the high excise duty threatens to push pump prices for MS/HSD past sticker shock levels (iii) higher crude and product prices could increase the need for working capital finance to fund the increase in inventory values of crude/products.

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Stock	CMP (Rs)	Sep 22E PE	TP (Rs)	Rating
BPCL	367	6.3	446	Buy
HPCL	209.5	3.9	354	Buy
IOC	87	4.2	146	Buy

Source: Bloomberg, Nirmal Bang Institutional Equities Research

Exhibit 1: Potential impact of fuel price change on retail margins

	Dec 1 2020	Base case Dec 15 2020	Dec 15 2020	Dec 15 2020
*Fuel price hike/(cut) Rs/lit	0	0	1	2
Crude price US\$/bbl RHS	43.0	48.5	48.5	48.5
MS margin Rs/lit	2.24	-1.10	-0.10	0.90
HSD Margin Rs/lit	4.49	1.27	2.27	3.27
Blended margin Rs/lit	3.93	0.68	1.68	2.68

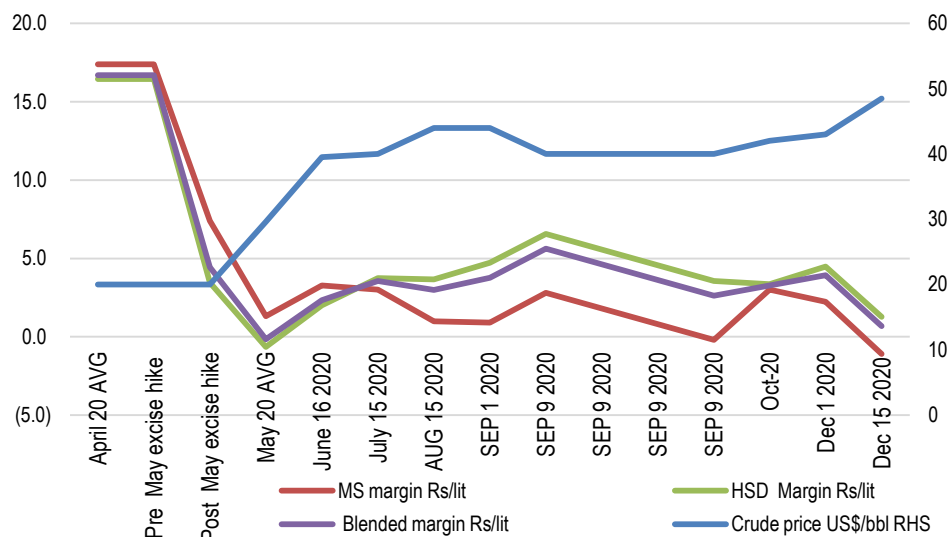
Source: Nirmal Bang Institutional Equities Research; Bloomberg; note: *price change before VAT impact

Exhibit 2: Impact of change in oil price on retail fuel margins

change on oil pr US\$/bbl	0	1	-1	5	-5
Crude price US\$/bbl RHS	48.5	49.5	47.5	53.5	43.5
MS margin Rs/lit	-1.10	-1.58	-0.63	-3.46	1.25
HSD Margin Rs/lit	1.27	0.82	1.72	-0.99	3.53
Blended margin Rs/lit	0.68	0.22	1.13	-1.61	2.96

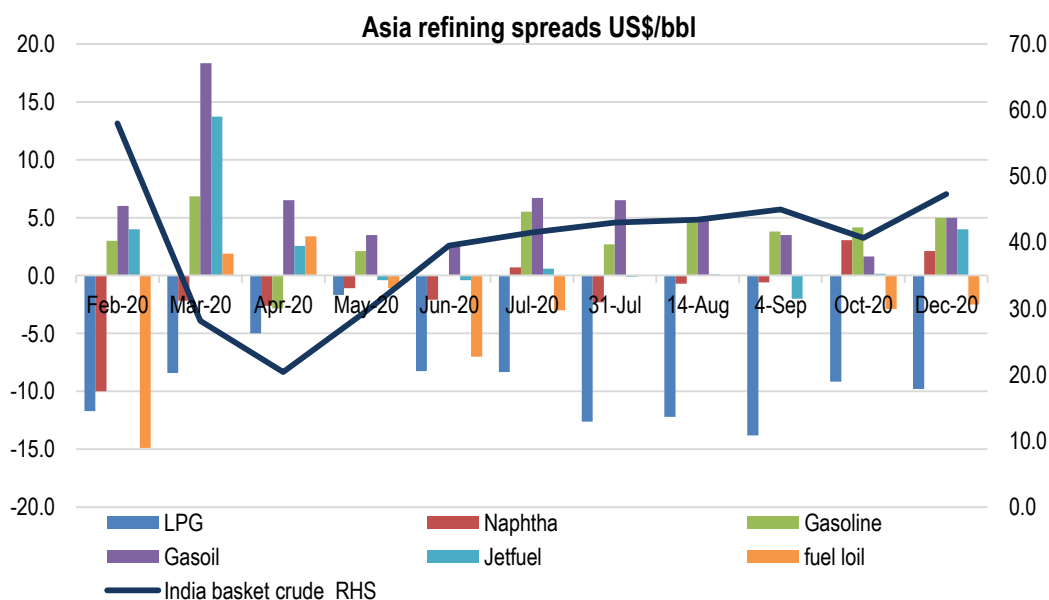
Source: Nirmal Bang Institutional Equities Research; Bloomberg

Exhibit 3: Indian OMCs retain margin trend



Source: Nirmal Bang Institutional Equities Research; Bloomberg

Exhibit 4: Asia refining spreads vs. Indian crude basket



Source: Nirmal Bang Institutional Equities Research; Bloomberg

Sensitivity of OMC earnings and valuations to GRMs and retail margins
Exhibit 5: Impact of GRM and retail margin on HPCL EPS and valuation

Variable	Chg vs base case	Sept 22E EPS Rs	Valuation Rs	Downside vs TP %
Retail margin	down Rs 1/litre	51.31	336	-5.04
GRM	down US\$1/bbl	46.46	304	-14.01
Base case		Sept 22E EPS Rs	TP Rs	-
GRM US/bbl	5.03	54.03	354	NA
Retail margin Rs/lit	3.25			

Source: Nirmal Bang Institutional Equities Research

Exhibit 6: Impact of GRM and retail margin on BPCL EPS and valuation

Variable	Chg vs base case	Sep 22E EPS Rs	Valuation Rs	Downside vs TP %
Retail margin	down Rs 1/litre	46.10	355	-20.4
GRM	down US\$1/bbl	52.8	407	-8.7
Base case		Sep 22E EPS Rs	TP Rs	-
GRM US/bbl	3.73	57.9	446	-
Retail margin Rs/lit	3.25			

Source: Nirmal Bang Institutional Equities Research

Exhibit 7: Impact of GRM and retail margin on IOC EPS and valuation

	Sept 22E	TP	Downside vs TP %
Base case	20.89	146	-
GRM down US\$1/bbl	18.08	124	-15.1
Retail Margin down Rs1/lit	18.63	128	-12.6

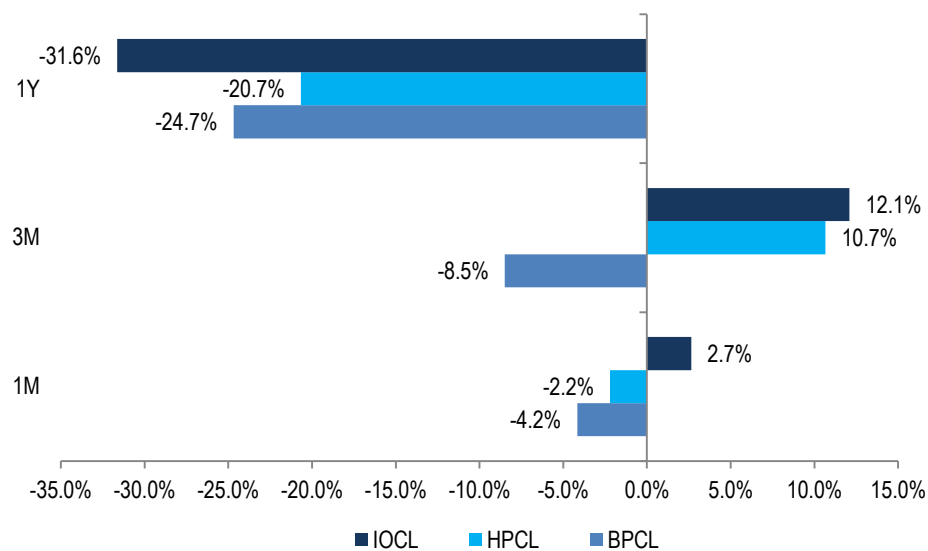
Source: Nirmal Bang Institutional Equities Research; IOC TP based on EV/E

Exhibit 8: India petroleum demand

000' Tonnes	April - Jun 20	July -Sep 20	Nov- 20	Nov 20 Ch MoM %	Nov 20 Ch YoY %	Oct - Nov 20	Oct-Nov 20 ch YoY%	1H FY21	1HFY21 ch YoY%	YTD FY21	YTD FY21 ch YoY%
LPG	6472	6803	2353	-2.9	4.1	4775	3.6	4775	-32.2	15698	-8.4
Naphtha	3075	3501	1345	3.3	7.7	2646	11.4	2646	-30.1	7878	-12.9
MS	5026	7093	2665	0.4	5.1	5319	4.8	5319	-31.5	14773	-27.5
ATF	387	803	372	4.8	-47.5	727	-48.3	727	-30.1	1546	-71.2
SKO	472	457	155	11.4	-17.8	293	-18.1	293	-36.2	1068	-38.8
HSD	15044	15833	7042	0.7	-6.9	14038	-0.3	14038	-28.1	37873	-31.7
LDO	159	184	67	-1.8	33.3	136	37.6	136	-32.4	412	-2.2
Lubricants & Greases	574	999	315	-0.3	-6.0	631	-4.6	631	-35.4	1888	-26.1
FO & LSHS	1284	1507	502	-5.6	8.9	1033	10.6	1033	-32.2	3323	-17.1
Bitumen	1528	1155	692	4.5	18.4	1355	31.5	1355	-24.7	3345	-15.4
Petroleum coke	4691	4372	1402	0.6	-16.2	2795	-16.2	2795	-32.5	10457	-28.7
Others	2153	2779	924	0.6	2.5	1843	-2.7	1843	-34.0	5852	-24.0
TOTAL	40866	45488	17834	0.4	-3.7	35593	-0.7	35593	-30.3	104113	-26.9

Source: Nirmal Bang Institutional Equities Research, PPAC

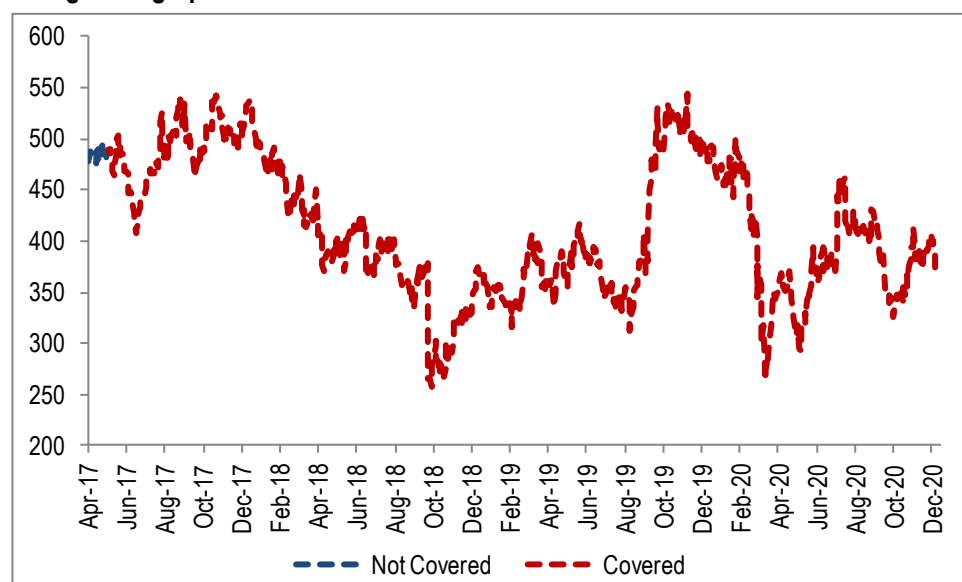
Exhibit 9: Price performance



Source: Nirmal Bang Institutional Equities Research, Bloomberg

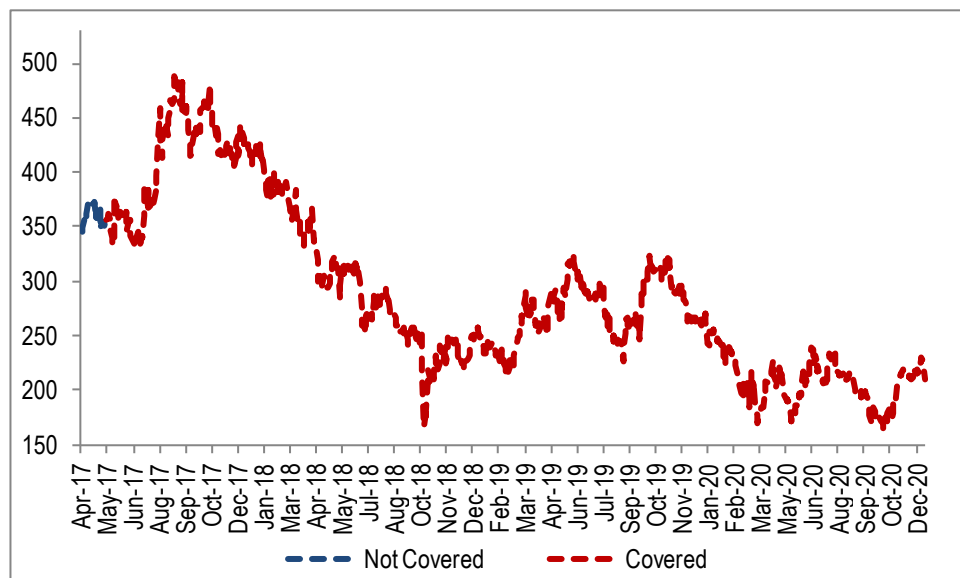
BPCL
Rating track

Date	Rating	Market price	Target price (Rs)
12 May 2017	Accumulate	738	717
16 August 2017	Accumulate	479	478
15 November 2017	Accumulate	493	489
12 February 2018	Accumulate	475	513
31 May 2018	Accumulate	400	436
9 August 2018	Accumulate	389	436
30 October 2018	Under Review	277	-
11 February 2019	Sell	338	300
21 May 2019	Sell	393	300
14 August 2019	Accumulate	343	343
11 November 2019	Accumulate	501	512
14 February 2020	Accumulate	477	534
7 April 2020	Buy	351	414
7 May 2020	Buy	344	414
5 June 2020	Buy	357	417
17 Aug 2020	Accumulate	413	417
23 September 2020	Accumulate	392	446
2 November 2020	Buy	354	446
21 December 2020	Buy	367	446

Rating track graph


HPCL
Rating track

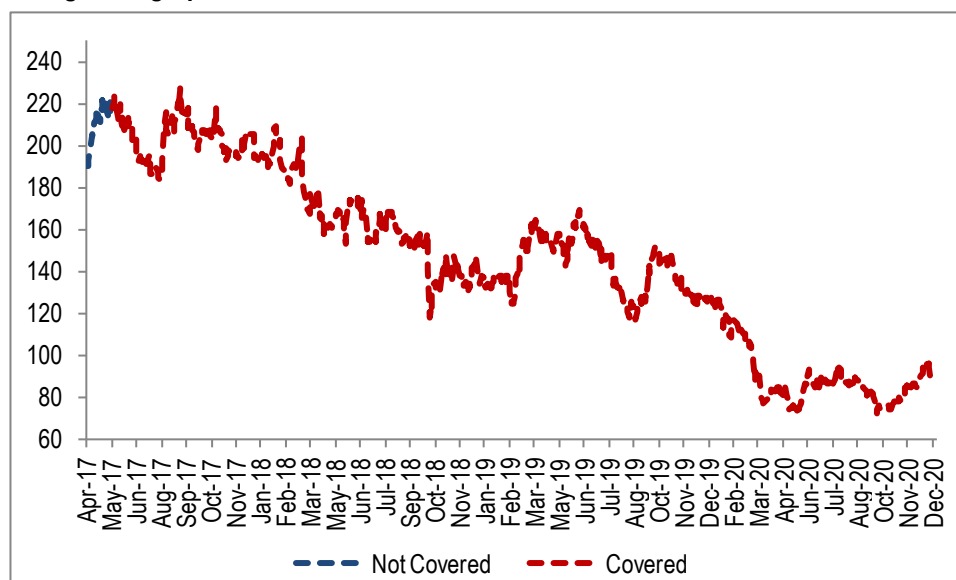
Date	Rating	Market price	Target price (Rs)
12 May 2017	Sell	567	482
29 May 2017	Sell	567	482
7 August 2017	Sell	432	321
10 November 2017	Sell	431	321
12 February 2018	Sell	393	358
23 May 2018	Sell	312	272
9 August 2018	Sell	282	249
2 November 2018	Under Review	229	-
6 February 2019	Sell	225	208
21 May 2019	Sell	294	208
8 August 2019	Sell	244	195
8 November 2019	Sell	310	245
6 February 2020	Accumulate	237	245
7 April 2020	Buy	200	353
7 May 2020	Buy	203	353
18 June 2020	Buy	214	343
8 August 2020	Buy	214	343
23 September 2020	Buy	180	343
6 November 2020	Buy	205	354
21 December 2020	Buy	209	354

Rating track graph


IOC
Rating track

Date	Rating	Market price	Target price (Rs)
12 May 2017	Sell	425	396
29 May 2017	Sell	425	396
4 August 2017	Sell	388	357
31 October 2017	Sell	414	357
1 February 2018	Accumulate	418	414
24 May 2018*	Sell	154	137
13 August 2018	Sell	161	137
5 November 2018	Under Review	148	-
31 January 2019	Sell	135	112
21 May 2019	Sell	158	112
2 August 2019	Sell	137	112
4 November 2019	Accumulate	143	147
3 February 2020	Buy	109	136
7 April 2020	Buy	80	137
7 May 2020	Buy	77	137
26 June 2020	Buy	85	148
5 August 2020	Buy	87	146
23 September 2020	Buy	76	145
3 November 2020	Buy	78	146
21 December 2020	Buy	87	146

*Price after 1:1 bonus issue

Rating track graph


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BUY > 15%

ACCUMULATE -5% to 15%

SELL < -5%

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