

BSE SENSEX

32,383

S&P CNX

10,021

CMP: INR374
TP: INR427 (+14%)
Buy

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Stock Info

Bloomberg	HPCL IN
Equity Shares (m)	1,524
52-Week Range (INR)	393/254
1, 6, 12 Rel. Per (%)	7/-11/23
M.Cap. (INR b)	559.3
M.Cap. (USD b)	8.7
Avg Val, INRm	1893.0
Free float (%)	48.9

Financials Snapshot (INR m)

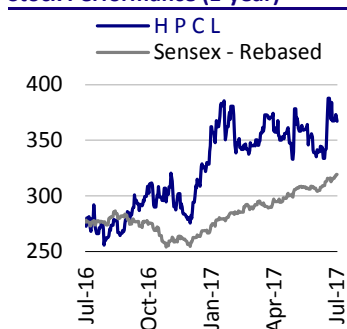
Y/E Mar	2017	2018E	2019E
Net Sales	1,870	1,855	2,085
EBITDA	105.8	91.4	100.6
PAT	62.1	45.0	49.7
EPS (INR)	40.7	29.5	32.6
Gr. (%)	66.6	(27.5)	10.4
BV/Sh (INR)	133.4	152.5	173.6
RoE (%)	32.4	20.6	20.0
RoCE (%)	18.8	12.3	12.0
P/E (x)	9.2	12.7	11.5
P/BV (x)	2.8	2.5	2.2

Shareholding pattern (%)

As On	Jun-17	Mar-17	Jun-16
Promoter	51.1	51.1	51.1
DII	10.1	9.6	14.5
FII	16.9	16.9	19.4
Others	21.9	22.4	15.0

FII Includes depository receipts

Stock Performance (1-year)



ONGC-HPCL merger

Finding the right value for HPCL

The Department of Investment and Public Asset Management (DIPAM) has invited bids for appointing an advisor for strategic sale of the government's 51.11% stake in HPCL to ONGC. The bid document mentions the following methodologies for achieving the best valuation for HPCL: (1) discounted cash flow, (2) relative valuation, (3) asset-based valuation, and (4) market valuation. We study the four possibilities to estimate what the reserve price could be. We also take a look at the possibility of a control premium. However, for this report, we leave aside the issue of open offer. While theoretically, an open offer is likely, legal interpretations may be complex and contradictory.

Discounted cash flow method

Using a GRM of USD5.1/bbl, net marketing margin of INR1.1/liter, stretched till 2038, but taking nil terminal value, we arrive at a DCF valuation of INR470/share for HPCL. Our valuation uses a WACC of 11%. Nil terminal growth beyond 2038 suggests the possibility of disruptive technologies like electric vehicles having an adverse impact on refineries. We have only taken imminent capex like expansion of Vizag refinery, and ignored larger ones like petrochemicals complex in Andhra Pradesh and participation in 60mmtpa West Coast refinery.

Relative valuation

Global peers are trading at 6.9x FY19E EV/EBITDA and 10x FY19E P/E. Indian peers are also trading at 6.9x FY19E EV/EBITDA and a little lower 9.5x FY19E P/E. Though there aren't many comparables for pure marketing plays, Caltex Australia, Z Energy, New Zealand and Petron Corp are trading at an average 7.5x FY19E EV/EBITDA and 12.3x FY19E PE. Our SOTP valuation of HPCL implies 7.8x FY19E EV/EBITDA and 11.5x FY19E EPS.

Asset valuation models

HPCL's consolidated FY18E book value is INR164. It is not correct to look at long-term average P/BV due to regulations prior to deregulation of diesel in 2014. Since 2015, the stock has traded at average P/BV of 1.7x. For the last one year, due to better GRMs, the stock has traded at 2.2x. At 2.2x, the stock is valued at INR361. We also use replacement method (Exhibit 4) to value the assets. Our replacement cost methodology suggests a value of INR350/share.

Market valuation

The stock declined 10% after 4QFY17 results, partly on account of cloud over merger, and partly on account of expected inventory losses in 1QFY18 and expected market share loss to private players. However, with expected premium valuation for sale to ONGC, it has appreciated. Using the last 60 days' average, the valuation of the company stands at INR356/share.

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Investors are advised to refer through important disclosures made at the last page of the Research Report.

Motilal Oswal research is available on www.motilaloswal.com/Institutional-Equities, Bloomberg, Thomson Reuters, Factset and S&P Capital.

Valuation of HPCL

- Our base case valuation using SOTP and EV/EBITDA for segments stands at INR427/share.
- The four methodologies mentioned in DIPAM's bid result in a minimum valuation of INR350 and a maximum valuation of INR470.
- Control premium could add to the confusion; theory suggests no control premium.

Valuation methodologies suggest INR350-470/share

The stock declined 10% after 4QFY17 results, partly on account of cloud over merger, and partly on account of expected inventory losses in 1QFY18 and expected market share loss to private players. Then vibes on higher valuation for sale to ONGC lifted the stock to INR370, almost where it was three months ago. Our DCF calculations (Exhibit 1) suggest a valuation of INR470/share, using a GRM of USD5.1/bbl. However, average GRM (including inventory gain/loss) was USD4/bbl, using which the valuation works out to INR417/share. Our DCF valuation is till 2038. We assume nil terminal growth due to the threat of disruptive technologies like electric vehicles in the long run.

Exhibit 1: DCF valuation of HPCL

	FY18E	FY19E	FY20E	FY21E	FY22E	FY23E	FY24E	FY25E
Exchange rate (INR/USD)	65.6	67.0	67.0	67.0	67.0	67.0	67.0	67.0
Refining-standalone								
Throughput (mmt)	17.8	17.8	18.8	20.1	25.7	27.5	27.5	27.5
GRM (USD/bbl)	5.0	5.1	5.1	5.1	5.1	5.1	5.1	5.1
Refining EBITDA (INRm)	28,277	29,755	31,425	33,487	42,972	45,977	45,977	45,977
Marketing								
Direct sales (mmt)	36.5	37.9	39.4	41.0	42.6	44.3	46.1	48.0
Net marketing margin (INR/lit)	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Marketing EBITDA (INRm)	42,484	44,183	45,950	47,788	49,700	51,688	53,755	55,906
Pipeline								
Throughput (mmt)	17.9	17.9	17.9	17.9	17.9	17.9	17.9	17.9
EBITDA (INR/mt)	757	772	787	803	819	836	852	869
EBITDA (INRm)	13,547	13,818	14,095	14,377	14,664	14,957	15,257	15,562
Core EBITDA (INRm)	84,308	87,757	91,470	95,652	107,336	112,623	114,989	117,445
Other operating income (INRm)	3,047	3,169	3,296	3,427	3,565	3,707	3,855	4,010
Total standalone EBITDA (INRm)	87,355	90,926	94,766	99,080	110,900	116,330	118,845	121,454
MRPL								
Throughput (mmt)	16.3	16.3	16.3	16.3	16.3	16.3	16.3	16.3
GRM (USD/bbl)	6.6	6.5	6.5	6.5	6.5	6.5	6.5	6.5
Refining EBITDA (INRm)	35,675	35,557	35,557	35,557	35,557	35,557	35,557	35,557
HMEL								
Throughput (mmt)	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0
GRM (USD/bbl)	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0
Refining EBITDA (INRm)	33,659	34,378	34,378	34,378	34,378	34,378	34,378	34,378
Conso EBITDA (INRm)	121,329	125,194	129,034	133,348	145,168	150,598	153,113	155,722
Depreciation	29,764	31,970	33,321	33,845	34,352	34,137	33,222	32,336
WC Changes	34,282	1,368	2,169	9,899	9,899	9,899	9,899	9,899
Capex	(100,000)	(100,000)	(50,000)	(50,000)	(50,000)	(5,000)	(5,000)	(5,000)
FCFF	25,395	(4,202)	49,618	60,410	68,498	117,064	118,447	119,903
WACC (%)	11.1%							
NPV (INRm)	733,886							
Terminal growth rate (%)	0							
NPV of Terminal growth (INRm)	161,544							
EV (INRm)	895,430							
Net debt (INRm)	178,047							
Market cap target (INRm)	717,383							
Target price (INR/share)	470							

Source: Company, MOSL

Exhibit 2: Peer valuation

	RoE (%)		EV/EBITDA		PBV (x)		PE (x)	
	FY18/ CY17	FY19/ CY18	FY18/ CY17	FY19/ CY18	FY18/ CY17	FY19/ CY18	FY18/ CY17	FY19/ CY18
Caltex Australia Ltd	18.5	16.9	7.8	7.5	2.4	2.2	13.9	13.3
Petron Corp	12.7	8.4	6.3	6.4	1.2	0.8	9.0	10.3
Showa Shell Sekiyu KK	13.2	13.5	7.4	7.3	1.7	1.6	11.9	11.6
Esso Thailand PCL	20.0	17.0	6.3	6.6	1.2	1.1	6.2	6.6
JXTG Holdings Inc	9.9	9.6	8.0	7.6	0.7	0.7	7.8	7.3
Thai Oil PCL	13.9	13.4	6.2	6.2	1.4	1.3	10.4	10.2
S-Oil Corp	18.5	19.4	8.1	7.0	1.8	1.7	10.3	9.0
Idemitsu Kosan Co Ltd	12.6	11.5	9.3	8.7	0.7	0.6	5.1	4.9
SK Innovation Co Ltd	10.9	10.8	4.6	4.5	0.8	0.8	7.8	7.4
Phillips 66	12.9	13.3	8.5	8.2	2.0	1.7	14.9	13.1
Marathon Petroleum Corp	9.7	7.7	7.9	8.1	1.9	1.3	16.6	14.6
Valero Energy Corp	11.6	10.8	5.8	5.8	1.5	1.5	12.1	11.3
Tesoro Corp	23.0	64.8	6.3	6.0	1.9	1.5	14.0	11.0
Indian Oil Corp	18.5	17.5	6.4	6.0	1.8	1.6	9.4	9.0
Bharat Petroleum Corp	22.7	22.7	9.9	8.7	2.7	2.3	12.4	10.9
Hindustan Petroleum Corp	21.8	21.0	6.9	6.7	2.3	2.1	10.5	10.3
Reliance Industries	10.8	10.9	10.9	9.6	1.6	1.5	15.7	13.9
Mangalore Refinery & Petrochemicals	24.4	22.3	5.5	5.2	1.8	1.5	8.3	7.5
Chennai Petroleum Corp Ltd	23.1	24.4	5.8	5.1	1.2	1.0	6.4	5.4
Average excluding Indian companies	14.4	16.7	7.1	6.9	1.5	1.3	10.8	10.0

Exhibit 3: Pure marketing plays

	ROE (%)		EV/EBITDA		PBV (x)		PE (x)	
	FY18/CY17	FY19/CY18	FY18/CY17	FY19/CY18	FY18/CY17	FY19/CY18	FY18/CY17	FY19/CY18
Caltex Australia Ltd	18.5	16.9	7.8	7.5	2.4	2.2	13.9	13.3
Z Energy Ltd	28.8	27.9	8.9	8.7	4.3	4.0	14.2	13.4
Petron Corp	12.7	8.4	6.3	6.4	1.2	0.8	9.0	10.3

Source: Bloomberg, MOSL

Exhibit 4: Replacement cost valuation

Asset	Capacity/ number	Valuation metric	Valuation (INR b)	Rationale
Refineries	14.8mmtpa	INR20b/mt	166	❖ Recent capacities at Bina, Bhatinda, Paradip came at ~INR20b/mmt Discount of 20% for lower complexity 30% discount for the lower useful life left
Marketing terminals- large formats	12	INR5b/unit	42	❖ 30% discount for the lower useful life left
Marketing terminals- depots	70	INR1.5b/unit	74	❖ 30% discount for the lower useful life left
Retail outlets	14412	INR10m/unit	144	❖ 3,000-4,000 have owned land, rest are mostly on long term lease Recent acquisition suggests a cost of INR20m for each unit
Pipelines	15510km-mmtpa	INR3.2/km-mmtpa	35	❖ Using the cost of Paradip-Raipur-Ranchi pipeline Using 30% discount due to lower useful life left
LPG bottling plants	47	INR250m/unit	8	❖ Using 30% discount due to lower useful life left
LPG unloading facility at Mangalore	1	INR10b	7	❖ Using 30% discount due to lower useful life left
Stake in Bhatinda	49% of 9mmtpa	INR20b/mt	88	❖ No discount as this is a new plant
Stake in MRPL	17% of 15mmtpa	INR20b/mt	41	❖ Using 20% discount due to lower useful life left
Others			100	❖ Stake in SAGPL, Hindustan Colas, land bank etc
Total valuation (INRb)			704	
Current net debt (INRb)			170	
Equity valuation (INRb)			534	
Value per share (INR)			350	

Source: Industry, MOSL

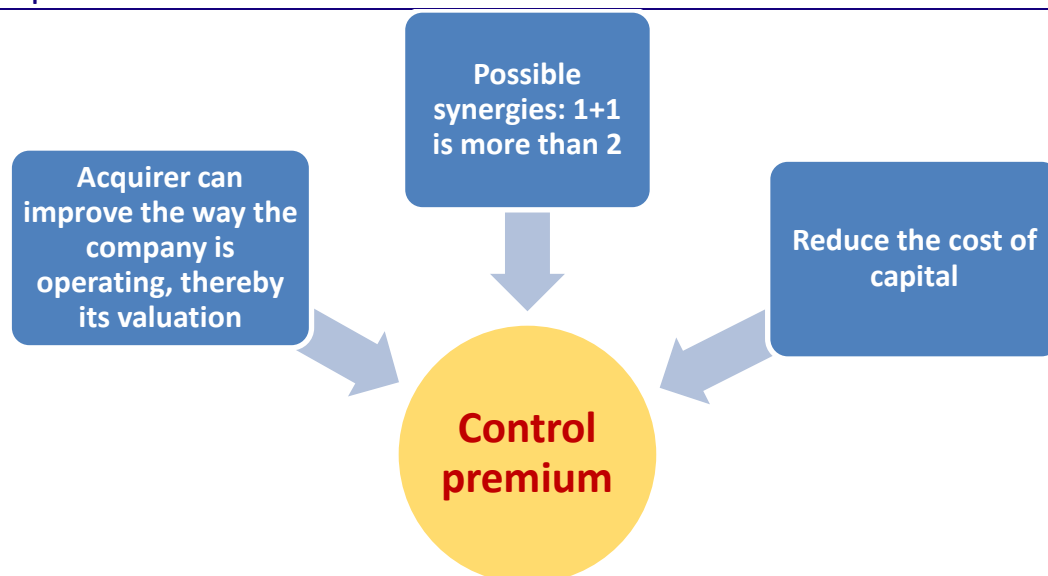
Exhibit 5: Valuation methodologies

Valuation methodology	Key assumptions	Valuation	Remarks
DCF	<ul style="list-style-type: none"> ■ GRM of USD5.1/bbl for HPCL, 6.5/bbl for MRPL, 10/bbl for HMEL ■ Net marketing margin of INR1.1/lit ■ WACC of 11% ■ Nil terminal growth 	470	<ul style="list-style-type: none"> ■ Refining is a cyclical industry and avg GRM during last 10yrs stood at USD4/bbl, which results in valuation of INR420/share ■ WACC of 12% results in valuation of INR412/share ■ Methodology is very subjective and is open to challenge
Relative valuation	<ul style="list-style-type: none"> ■ Refining at 5.5x ■ Marketing at 8x ■ Implied valuation of 7x FY19 EV/EBITDA & 11x FY19 PE (conso) 	427	<ul style="list-style-type: none"> ■ This is our base case and is least debatable
Asset valuation	<ul style="list-style-type: none"> ■ 2.2x PBV 	361	<ul style="list-style-type: none"> ■ Doesn't provide for possible ROE expansion in the future which could increase target PBV
Replacement cost valuation	<ul style="list-style-type: none"> ■ Refer to exhibit 4 for details 	350	<ul style="list-style-type: none"> ■ Hugely debatable method. Calculation of useful life, valuation of land etc might add to confusion.

Source: MOSL

Control premium – no case theoretically

Theoretically, a control premium is applied only when the acquirer (1) can change the way the company operates, thereby improving the profitability of the existing assets, (2) could benefit from the synergies that the acquisition throws, and (3) reduce the cost of capital, thereby improving interest cost and return ratios of the future capex. In the acquisition of HPCL by ONGC, the first scenario is completely ruled out, since ONGC has no better experience in running a refinery and no experience at all in marketing of petroleum products. Yet, the acquisition does provide some cushion to volatility in oil prices. Moody's rating for ONGC is Baa1 and that for HPCL is Baa3. There might be some improvement in cost of capital for HPCL due to stronger balance sheet. However, ONGC's credit rating itself may change due to the debt it would take to fund the acquisition. In a nutshell, we do not see a reason for ONGC to pay a control premium.

Exhibit 6: Control premium scenarios

Source: MOSL

What else could affect valuation?

HPCL presents an opportunity to acquire ~23% of domestic market share of petroleum products. India is one of the fastest growing countries in terms of petroleum consumption growth. This provides an immense opportunity for larger players like British Petroleum, Shell or Reliance Industries that have a large refining presence and are looking for markets for their products. Replicating this kind of presence in India would take years of efforts and investments. If a bid were invited from such private parties, they may also bring operational efficiencies both in marketing and in refining assets of HPCL, justifying higher valuation.

Confusion could keep stock price under pressure

The best way forward for the government would be to invite bids for partial sell-off and then ask ONGC to match the valuation. This would be least controversial and would not attract undue attention/dissent. However, till the time there is clarity on the way forward, we believe the stock price would remain hostage to news flows rather than fundamentals.

Financials and Valuations

Standalone - Income Statement

(INR Million)

Y/E March	FY13	FY14	FY15	FY16	FY17	FY18E	FY19E	FY20E
Net Sales	2,065,293	2,231,454	2,063,804	1,777,006	1,870,237	1,854,501	2,084,728	2,115,704
Change (%)	15.9	8.0	-7.5	-13.9	5.2	-0.8	12.4	1.5
Finished Goods	1,281,786	1,451,380	1,292,784	1,159,484	1,227,317	1,218,694	1,383,491	1,406,670
Raw Materials Cons	639,921	613,881	599,079	409,025	406,836	415,409	466,948	466,948
Other Exp	104,163	114,112	117,765	129,104	130,313	129,034	133,685	138,219
Total Expenditure	2,025,869	2,179,372	2,009,627	1,697,613	1,764,467	1,763,137	1,984,124	2,011,837
% of Sales	98.1	97.7	97.4	95.5	94.3	95.1	95.2	95.1
EBITDA	39,424	52,081	54,176	79,393	105,771	91,364	100,604	103,866
Margin (%)	1.9	2.3	2.6	4.5	5.7	4.9	4.8	4.9
Depreciation	19,315	21,884	19,712	26,532	25,353	29,087	31,087	33,087
EBIT	20,109	30,197	34,465	52,861	80,418	62,276	69,517	70,779
Int. and Finance Charges	18,377	15,046	7,066	6,536	5,357	5,276	5,925	7,500
Other Income	12,300	11,004	14,142	11,442	15,147	10,518	10,974	11,475
PBT bef. EO Exp.	14,032	26,155	41,541	57,766	90,208	67,518	74,566	74,754
EO Items	714	0	0	0	0	0	0	0
PBT after EO Exp.	14,746	26,155	41,541	57,766	90,208	67,518	74,566	74,754
Total Tax	5,699	8,817	14,209	20,505	28,120	22,504	24,853	24,916
Tax Rate (%)	38.6	33.7	34.2	35.5	31.2	33.3	33.3	33.3
Reported PAT	9,047	17,338	27,333	37,262	62,088	45,015	49,713	49,839
Adjusted PAT	8,334	17,338	27,333	37,262	62,088	45,015	49,713	49,839
Change (%)	-8.6	108.0	57.6	36.3	66.6	-27.5	10.4	0.3
Margin (%)	0.4	0.8	1.3	2.1	3.3	2.4	2.4	2.4

Standalone - Balance Sheet

(INR Million)

Y/E March	FY13	FY14	FY15	FY16	FY17	FY18E	FY19E	FY20E
Equity Share Capital	3,390	3,390	3,390	3,390	10,170	15,255	15,255	15,255
Total Reserves	133,874	146,732	156,831	176,308	193,311	217,408	249,635	281,944
Net Worth	137,264	150,122	160,221	179,698	203,482	232,663	264,891	297,199
Total Loans	324,583	319,301	170,556	143,950	171,706	180,000	215,000	285,000
Deferred Tax Liabilities	35,984	39,084	41,036	52,814	59,682	59,682	59,682	59,682
Capital Employed	497,830	508,506	371,813	376,461	434,869	472,345	539,573	641,881
Gross Block	370,062	424,668	481,749	547,104	604,615	601,749	641,749	681,749
Less: Accum. Deprn.	144,575	165,545	191,121	216,028	243,296	272,383	303,471	336,558
Net Fixed Assets	225,487	259,122	290,628	331,076	361,319	329,366	338,278	345,191
Capital WIP	51,729	45,856	34,744	18,528	18,105	120,970	180,970	190,970
Total Investments	106,269	108,599	112,415	105,786	109,186	109,186	109,186	109,186
Curr. Assets, Loans&Adv.	378,962	362,204	237,719	240,404	296,037	221,678	257,270	348,221
Inventory	164,387	187,754	129,723	132,114	185,763	106,271	130,463	132,285
Account Receivables	49,350	54,660	36,031	37,580	40,642	20,323	22,846	23,186
Cash and Bank Balance	1,471	347	171	238	337	1,182	865	88,431
Loans and Advances	163,754	119,444	71,796	70,472	69,296	93,901	103,096	104,319
Curr. Liability & Prov.	264,617	267,275	303,693	319,332	349,777	308,855	346,132	351,687
Account Payables	241,622	243,978	273,903	301,228	323,869	289,831	326,157	330,713
Provisions	22,995	23,296	29,790	18,104	25,908	19,024	19,975	20,974
Net Current Assets	114,345	94,930	-65,974	-78,928	-53,740	-87,177	-88,862	-3,466
Appl. of Funds	497,830	508,506	371,813	376,461	434,869	472,345	539,573	641,881

E: MOSL Estimates

Financials and Valuations

Ratios

Y/E March	FY13	FY14	FY15	FY16	FY17	FY18E	FY19E	FY20E
Basic (INR)								
EPS	5.5	11.4	17.9	24.4	40.7	29.5	32.6	32.7
Cash EPS	18.1	25.7	30.8	41.8	57.3	48.6	53.0	54.4
BV/Share	90.0	98.4	105.0	117.8	133.4	152.5	173.6	194.8
DPS	1.9	3.4	5.4	7.7	20.0	8.9	9.8	9.8
Payout (%)	37.2	35.4	36.5	37.7	57.5	35.2	35.2	35.2
Valuation (x)								
P/E				15.3	9.2	12.7	11.5	11.5
Cash P/E				9.0	6.5	7.7	7.1	6.9
P/BV				3.2	2.8	2.5	2.2	1.9
EV/Sales				0.4	0.4	0.4	0.4	0.4
EV/EBITDA				9.0	7.0	8.2	7.8	7.4
Dividend Yield (%)				2.0	5.3	2.4	2.6	2.6
FCF per share				24.8	9.2	5.5	-11.7	23.0
Return Ratios (%)								
RoE	6.2	12.1	17.6	21.9	32.4	20.6	20.0	17.7
RoCE	4.6	5.9	8.0	12.7	18.8	12.3	12.0	10.3
RoIC	3.9	5.8	7.8	14.3	19.8	15.1	18.9	18.8
Working Capital Ratios								
Asset Turnover (x)	4.1	4.4	5.6	4.7	4.3	3.9	3.9	3.3
Debtor (Days)	9	9	6	8	8	4	4	4
Leverage Ratio (x)								
Net Debt/Equity	1.6	1.4	0.4	0.2	0.3	0.3	0.4	0.3

Standalone - Cash Flow Statement

(INR Million)

Y/E March	FY13	FY14	FY15	FY16	FY17	FY18E	FY19E	FY20E
OP/(Loss) before Tax	14,746	26,155	39,921	57,766	90,208	67,518	74,566	74,754
Depreciation	19,344	21,884	19,712	26,532	25,353	29,087	31,087	33,087
Direct Taxes Paid	-5,699	-8,817	-14,209	-20,505	-28,120	-22,504	-24,853	-24,916
(Inc)/Dec in WC	-34,913	18,291	160,727	13,021	-25,088	34,282	1,368	2,169
CF from Operations	-6,522	57,513	206,151	76,815	62,352	108,384	82,168	85,095
Others	5,131	3,101	1,952	11,778	6,868	0	0	0
CF from Operating incl EO	-1,391	60,614	208,103	88,592	69,221	108,384	82,168	85,095
(Inc)/Dec in FA	-43,619	-49,647	-40,106	-50,763	-55,173	-100,000	-100,000	-50,000
Free Cash Flow	-45,010	10,968	167,997	37,829	14,048	8,384	-17,832	35,095
(Pur)/Sale of Investments	-2,564	-2,329	-3,816	6,629	-3,400	0	0	0
CF from Investments	-46,183	-51,976	-43,922	-44,134	-58,573	-100,000	-100,000	-50,000
Inc/(Dec) in Debt	49,790	-5,282	-148,744	-26,607	27,756	8,294	35,000	70,000
Dividend Paid	-3,368	-6,141	-9,985	-14,061	-35,702	-15,833	-17,486	-17,530
Others	359	1,661	-5,628	-3,724	-2,602	0	0	0
CF from Fin. Activity	46,782	-9,762	-164,357	-44,391	-10,548	-7,539	17,514	52,470
Inc/Dec of Cash	-792	-1,124	-176	67	99	846	-317	87,565
Opening Balance	2,264	1,471	347	171	238	337	1,182	865
Closing Balance	1,471	347	171	238	337	1,182	865	88,431

NOTES

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