HPCL

BUY

INDUSTRY	OIL & GAS
CMP *(as on 7 Sep 2018)*	Rs 253
Target Price	Rs 476
Nifty	11,589
Sensex	38,390
KEY STOCK DATA	
Bloomberg	HPCL IN
No. of Shares (mn)	1,524
MCap (Rs bn) / ($ mn)	386/5,349
6m avg traded value (Rs mn)	1,802

STOCK PERFORMANCE (%)

52 Week high / low	Rs 485/245		
	3M	6M	12M
Absolute (%)	(18.7)	(29.1)	(45.2)
Relative (%)	(27.0)	(44.4)	(66.4)

SHAREHOLDING PATTERN (%)	
Promoters	0.0
FIs & Local MFs	15.37
FPIs	21.22
Public & Others	63.41

Source : BSE

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At compelling valuation

HPCL's 1.34% YoY growth in EBITDA and 2.7% growth in PAT in FY18 was misleading as the FY17 base was formed due to high inventory gains and one-off costs. However, FY18 performance reflects strong operational performance in both refining and marketing businesses. Core EBITDA (net of inventory gains/losses, forex gains/losses, one-off costs, and other operating income) and PAT were thus up 34.5% and 49.2% YoY.

Conscious efforts over the last six years to improve distillate yields has resulted in 630bps and 230bps increase in HSD and total distillate yield despite increase in the proportion of sour and heavy crude over FY13-18.

Since peaking in Aug-17, HPCL has fallen ~48%, while the Nifty is up by ~16%. This was mainly due to 1) The inadequate and untimely Petrol and Diesel retail price hikes, as oil prices surged, and 2) Expected subsidy burden. Although, the current gross margins are lower compared to normalised margins, we believe that OMCs will be allowed to make normative margins and recoup margins as they have in the past.

The potential acquisition of ONGC's stake in MRPL by HPCL could reduce the susceptibility of the company's earnings, bring economies of scale, and reduce operating costs besides expanding its product mix. There is still no clarity on the structure and timeline of this deal. However, if a cash deal were undertaken, then it would be EPS accretive and improve return ratios but leverage the balance sheet of HPCL further. Net debt to equity ratio will go up from 1.64 to 1.96.

Currently, the stock is trading at 6.1x FY21E EV/EBITDA and 7.0x FY21E P/E. Hence, we believe that the stock is currently undervalued. Maintain BUY with target price of Rs 476/share.

Key highlights of the Annual Report

- **Increase in the core GRM more than the benchmark GRM:** The benchmark GRM was up by 25% YoY, which excludes fuel and losses (F&L), but HPCL's core GRM (net of inventory gains/losses but including F&L) was up 39% YoY. This achievement is commendable as crude oil prices were up 17% during this period.
- **Subsidiaries and JVs:** The poor performance of HMEL and MRPL led to a decline in the contribution of subsidiaries and JVs in consolidated profits from 24.6% in FY17 to 16.5% in FY18.
- **Expected increase in debt:** The total debt has gone up by Rs 24.22bn to Rs 195.93bn. We expect the total loan to go further up as the company has the shareholders nod to raise Rs 120bn through NCDs/bonds to fund its capex.

Financial Summary (Standalone)

(Rs bn)	FY17	FY18	FY19E	FY20E	FY21E
Revenues	1,870.24	2,193.33	2,619.03	2,727.41	2,883.67
EBITDA	105.77	107.38	98.36	103.93	124.20
APAT	61.91	63.57	49.83	48.35	55.20
EPS (Rs/sh)	40.6	41.7	32.7	31.7	36.2
P/E (x)	6.2	6.1	7.7	8.0	7.0
EV/EBITDA(x)	4.6	4.4	6.5	7.3	6.1
RoE (%)	32.3	28.7	19.5	16.8	17.2

Source: Company, HDFC sec Inst Research

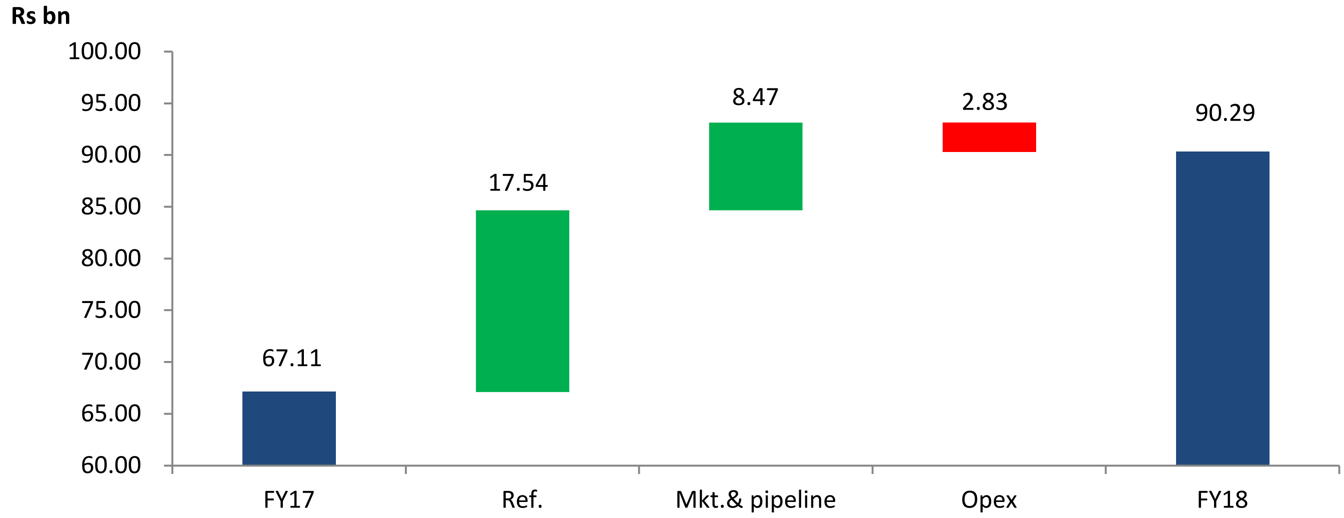
Core EBITDA was up 34.5% YoY to Rs 90.29bn from Rs 67.11bn in FY18.

While the marketing and pipeline business contributed 36.5%, the refining business contributed 75% to the overall increase in EBITDA.

The company gained market share of MS and LPG where as it lost some market share of HSD and Kerosene

Strong Operational Performance

Core EBITDA Built Up



Source: Company, HDFC sec Inst Research

- The reported EBITDA for FY18 was up 1.36% YoY from Rs 105.95bn in FY17 to Rs 107.39bn. This included refinery and marketing inventory gains and Other Operating Income. FY17 performance was boosted by Rs 38.83bn due to inventory gains and other operating income.
- Adjusting for the inventory gains/(losses) and other operating income, the core EBITDA of HPCL was up 34.5% YoY to Rs 90.29bn in FY18, mainly driven by a strong performance in the refining business. Refinery gross profit was up 40.4% YoY to Rs 60.94bn owing to strong product cracks.
- Marketing business gross profit was up 13.4% YoY to Rs 63.72bn in FY18. Total sales volumes were up 4.7% YoY to 36.87mmt while gross marketing margin was up 9.1% YoY to USD 3.46/bbl.
- During the year, the company lost market share of HSD and PDS Kerosene and gained it for MS, LPG in the domestic market. Overall, the domestic sales volumes were up 3.3% YoY, but below the country's consumption growth of 5.3%.
- Pipeline throughput increased due to augmentation in the Ramanmandi-Bhatinda pipeline capacity, direct pumping facility at the Bahadurgarh-Trikrikalan pipeline and an increase in the marketing volumes.

The company's core GRM was up 39% YoY while benchmark Singapore GRM was up 25% YoY. Better product slate and an improvement in distillate yield has resulted in better GRM than the benchmark GRM

Total sales volumes were up 4.7% YoY whereas domestic sales were up 3.3% YoY, led by 7.6% jump in MS and 8.2% increase in LPG volumes. The company gained market share for MS and LPG

Marketing and pipeline business reported gross profit of Rs 75.11bn, up 12.7% YoY. Marketing sales volumes grew by 4.7% YoY, below India's consumption growth of 5.3%. Nevertheless, the company was able to gain market share of MS and LPG. Pipeline throughput was up 12.5% YoY to 20.14mmt owing to an augmentation in the Ramanmandi-Bhatinda pipeline capacity and increase in sales volumes.

Businesswise Gross Margin Break Up

Particulars	Unit	FY17	FY18	Change	% ch.	Remarks
Refining business						
Crude throughput	mmt	17.74	18.21	*0.47*	*2.6%*	Increase in throughput at both the refineries
GRM	USD/bbl	4.86	6.76	*1.90*	*39.0%*	Benchmark Singapore GRM was up 25% YoY while HPCL's GRM was up 39% YoY.
Exchange rate	Rs/USD	67.08	66.00	*(1.08)*	*-1.6%*	The exchange rate was unfavourable in FY18
Refinery division gross margin	**Rs mn**	**43,403**	**60,940**	***17,537***	***40.4%***	**Largely driven by favourable product cracks**
Marketing business						
Sales volume	mmt	35.23	36.87	*1.64*	*4.7%*	The company lost market share for HSD and PDS Kerosene while gain market share in MS and LPG. Domestic marketing volumes were up 3.3% YoY to 35.8mmt below all India petroleum consumption growth of 5.3%.
Gross marketing margin	USD/bbl	3.17	3.46	*0.29*	*9.1%*	
Exchange rate	Rs/USD	67.08	66.00	*(1.08)*	*-1.6%*	The exchange rate was unfavourable in FY18
Marketing division gross margin	**Rs mn**	**56,179**	**63,138**	***6,959***	***12.4%***	
Pipeline business				-		
Pipeline throughput	mmt	17.91	20.14	*2.23*	*12.5%*	With an augmentation in the Ramanmandi-Bhatinda pipeline capacity and increase in sales volumes, pipeline throughput increased by 2.23% to 20.14mmt
Pipeline tariff	(Rs/tonne)	584.10	594.26	*10.16*	*1.7%*	
Pipeline division gross margin	**Rs mn**	**10,461**	**11,968**	***1,507***	***14.4%***	**An increase in throughput led to a jump in margins**
Operating expenses#	Rs mn	(42,929)	(45,756)	*(2,827)*	*6.6%*	
Core EBITDA*	**Rs mn**	**67,114**	**90,290**	***23,176***	***34.5%***	**Jump in EBITDA, largely due to the refining business.**

Source: Company, HDFC sec Inst Research; # Expenses related to business operations only, *Core EBITDA net of inventory gains/losses, forex gains/losses, other operating income

Total inventory gain and other operating income were Rs 17bn in FY18 compared to Rs 38.8bn in FY17.

In FY18, one off costs and inventory gains has resulted in an increase of 16.7% in EPS. Whereas, in FY17 it had resulted in a 42% increase in EPS.

Adjusting for one-off costs and gains, EPS was up 49.2% YoY from Rs 23.3/share to Rs 34.7/share. This indicates a strong growth in the company's core earnings.

49% YoY Growth In The Company's Earnings In FY18

Impact Of One-offs On Company's Earnings

	Unit	FY17	FY18
Reported EPS (A)	**Rs/share**	**40.7**	**41.7**
EPS growth	**%**		**2.5**
One off costs booked			
Loss on sale of Current investments	Rs mn	-	(602)
Impairment/(Reversal of Impairment) of Non - Current Investments	Rs mn	(84)	161
Provision for Doubtful Receivables	Rs mn	(7)	(829)
Provision for Doubtful Debts	Rs mn	(13)	316
Bad debt written off	Rs mn	(53)	(499)
Loss on disposal/write off on Non-Current Investment	Rs mn	-	(161)
Total costs (B)	**Rs mn**	**(156)**	**(1,614)**
Inventory gains and other operating income (C)	**Rs mn**	**38,830**	**17,095**
Total (B)+(C)	**Rs mn**	**38,674**	**15,481**
EPS impact due to one-off costs and inventory gains (D)	**Rs/share**	**17.4**	**7.0**
Core EPS* (A)-(D)	**Rs/share**	**23.3**	**34.7**
Core EPS change YoY	**Rs/share**		**11.4**
Core EPS growth YoY	**%**		**49.2**

Source: Company, HDFC sec Inst Research, * Net off one-of costs, inventory gains and other operating income

- One-off costs like loss on sale of current investments, impairment of non-current investments, provision for doubtful receivables, debts, bad debts written off, loss on disposal of non-current investments, and refinery and marketing inventory gains resulted in an increase in EPS by 16.7% or by Rs 7/share.
- EPS was merely up by 2.5% YoY from Rs 40.7/share to Rs 41.7/share. However, adjusting for one-off costs and gains, EPS was up 49.2% YoY from Rs 23.3/share to Rs 34.7/share. This implies a strong growth in the company's core earnings.

The company has made conscious efforts over the last six years, e.g. replacement of FCCU/CCU catalysts, replacement of trays with high efficient packed trays in CDU, installation of Diesel Hydro Treater (DHT) and Debutaniser, modification in FCCU raw material feeding technique. These have resulted in an improvement in the overall distillate yields by 260bps, largely led by 630bps improvement in the HSD yields alone.

Refining Business Performance

260 bps Improvement In Distillate Yield Over FY13-18

Refinery slate	FY13	FY14	FY15	FY16	FY17	FY18
Light Distillates (LD)						
Naphtha	4.5%	5.0%	6.8%	4.5%	3.9%	3.7%
LPG	7.7%	7.7%	7.3%	7.1%	7.0%	6.8%
MS	18.1%	18.8%	19.0%	19.2%	20.3%	20.1%
Hexane	0.1%	0.2%	0.1%	0.1%	0.1%	0.1%
Propylene	0.3%	0.1%	0.1%	0.3%	0.3%	0.3%
Total LD	**30.8%**	**31.8%**	**33.3%**	**31.1%**	**31.5%**	**31.1%**
Middle Distillates (MD)						
ATF	4.3%	4.0%	3.4%	3.6%	3.4%	3.7%
SKO	5.9%	5.8%	5.0%	4.6%	3.0%	2.2%
HSD	32.1%	32.2%	35.8%	35.8%	37.5%	38.4%
LDO	1.0%	1.1%	0.9%	1.1%	1.0%	1.2%
MTO	0.2%	0.3%	0.2%	0.2%	0.2%	0.3%
LOBS	2.1%	2.2%	1.6%	2.2%	2.2%	2.2%
Total MD	**45.6%**	**45.6%**	**47.0%**	**47.4%**	**47.4%**	**47.9%**
Heavy ends (HE)						
FO	10.1%	8.9%	7.2%	7.8%	8.0%	8.3%
LSHS	1.0%	0.9%	1.0%	0.0%	0.1%	0.0%
Bitumen	5.5%	5.2%	4.7%	5.9%	5.9%	5.6%
Others	0.2%	0.5%	0.5%	1.2%	0.4%	0.3%
Total HE	**16.8%**	**15.6%**	**13.5%**	**14.9%**	**14.4%**	**14.2%**
Total (before FL)	**93.2%**	**93.0%**	**93.7%**	**93.4%**	**93.3%**	**93.2%**
Fuel loss (FL)	6.8%	7.0%	6.3%	6.6%	6.7%	6.8%
Total	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**

Source: Company, HDFC sec Inst Research

- The distillate yield (light and middle distillates as a % of total production) improved by 260bps over last six years from 76.4% in FY13 to 79% in FY18. During the same period, the weightage of high sulfur crude increased from 55.9% to 60%.
- The deliberate efforts like installation of Diesel Hydro Treater unit at Visakh, replacement of catalyst in FCCU unit at both the refineries and various such measures over the last six years have resulted in a significant jump in the production of Diesel. The Diesel slate has gone up 6% over last six years from 32% in FY13 to 38% in FY18.

In FY18, the company gained market share for MS and LPG, while it lost market share for HSD and Kerosene.

The market share of MS and LPG went up by 100bps and 128bps respectively. However, it was down by 173bps and 436bps for HSD and Kerosene.

Marketing Business Performance

Market Share Of OMCs For Important Products (%)

	HPCL		BPCL		IOCL		Others	
	FY17	FY18	FY17	FY18	FY17	FY18	FY17	FY18
MS	25.2	26.2	27.0	26.7	42.7	41.5	5.1	5.6
HSD	22.4	20.6	23.6	24.8	46.6	45.0	7.5	9.6
LPG	26.1	27.4	22.4	25.0	47.0	46.4	4.5	1.1
Kero	16.5	12.1	14.9	16.9	66.7	67.4	2.0	3.7

Source: Company, PPAC, HDFC sec Inst Research

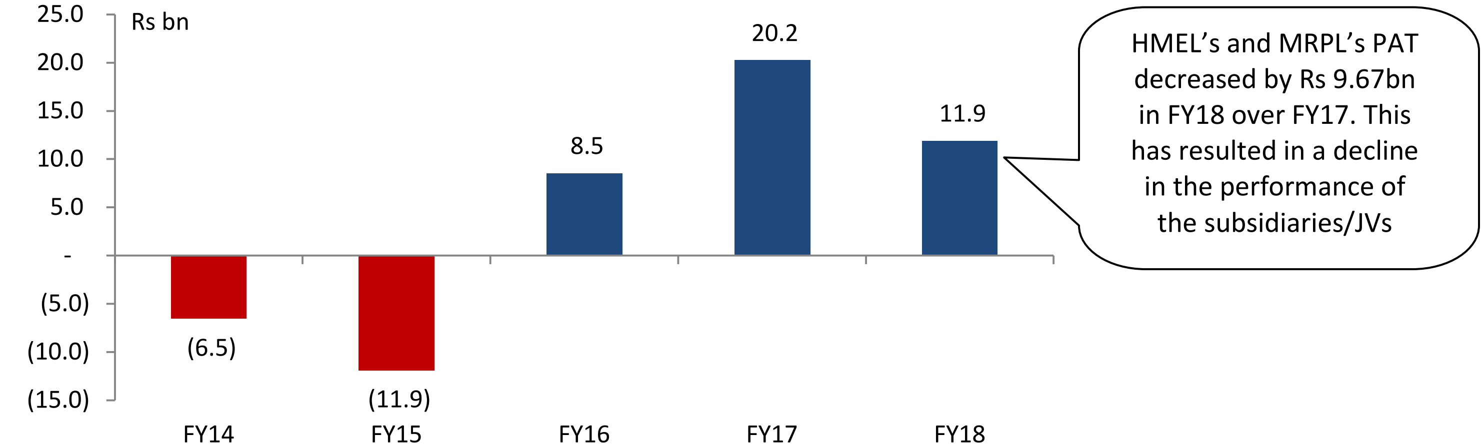
- In FY18, Oil Marketing Companies (OMCs) were able to maintain their market share in the domestic market (considering all petroleum products), despite stiff competition from the private players. If we consider the product-wise market shares, OMCs lost market share for major products like MS and HSD while gaining it for LPG and Kerosene.
- For MS, HPCL was able to gain market share (+100bps to 26.2%), while BPCL and IOCL lost market share by 30bps and 114bps respectively. Private players gained 47bps in market share.
- Private players market share increased by 204bps for HSD. HPCL lost market share by 173bps, the highest among the OMCs.
- The company’s market share for LPG has increased by 128bps in FY18. This increase could be attributable to the increase in the domestic connections under the ‘Pradhan Mantri Ujjavala Yojana’. 53% new customers enrolled under this scheme in FY18.

The subsidiaries' and JVs' performance was subdued in FY18 mainly due to a poor show by HMEL.

HMEL's performance was low due to a planned shutdown of the refinery for capacity expansion (from 9mmtpa to 11.3mmtpa). This has resulted in a 32% YoY reduction in crude throughput and higher operating expenses. We expect the capacity expansion benefits to materialise in FY19.

Subsidiary And JVs Performance

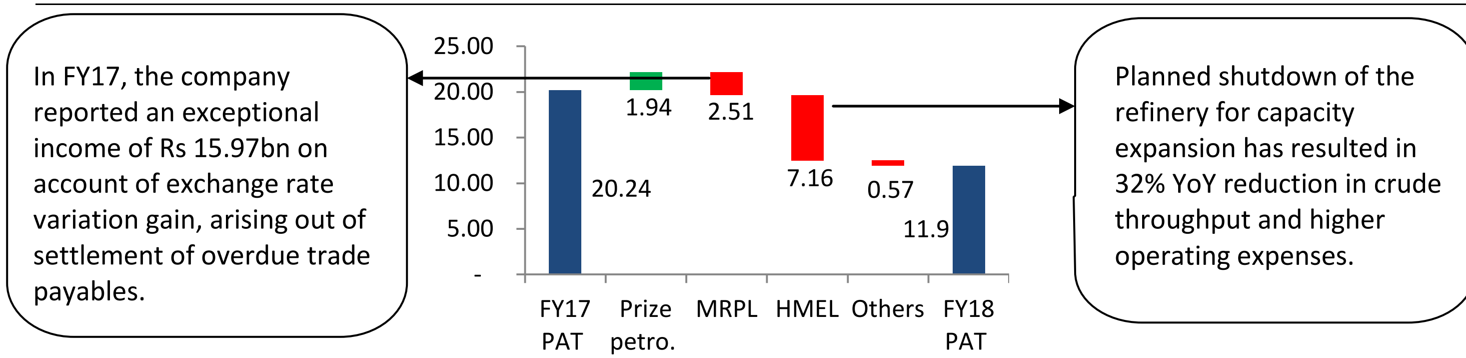
Subsidiaries And JVs Net Profit Trend



Source: Company, PPAC, HDFC sec Inst Research

- In FY18, subsidiaries and JVs, which account for ~28% of the consolidated assets, contributed 16.5% to the consolidated profits, down from 24.6% in FY17.
- After a strong performance in FY17, HPCL's subsidiaries and JVs showed subdued performance in FY18. Their profits fell by Rs 8.37bn from Rs 20.2bn in FY17 to Rs 11.9bn in FY18.
- This fall in subsidiaries and JVs profit was mainly due to Rs 9.67bn decline in profits of HPCL Mittal Energy Limited (HMEL) and Mangalore Refinery and Petrochemical Ltd (MRPL). This decline in profit was partially offset by the reduction in losses of Prize Petroleum Company Ltd, an upstream arm of HPCL.
- We expect an improvement in the profitability of HMEL in FY19, post its expansion in FY18.

Company-wise Profit Break Up (Rs bn)



Source: Company, PPAC, HDFC sec Inst Research

The total debt has gone up by Rs 24.22bn to Rs 195.93bn. We expect the total loan to go further up as the company has the shareholders nod to raise Rs 120bn through NCDs/bonds to fund its capex

Balance Sheet Analysis

Rs bn	FY17	FY18	Comments
Sources of Funds			
Share capital	10.16	15.24	During the year, the company issued 507.94mn bonus shares in the ratio of 1:2.
Reserves and Surplus	193.31	224.24	
Total Shareholder's fund	**203.47**	**239.48**	
LT borrowings	62.79	88.31	Issued FCB of USD 500mn at an interest rate of 4% p.a, which is payable at half-yearly intervals. We expect the total loan to go up as the company has the shareholders nod to raise Rs 120bn through NCDs/bonds to fund its capex.
DTL	58.96	65.69	
Other LT liabilities	0.08	0.04	
LT Provisions	1.82	0.77	
Total non-current liabilities	**123.64**	**154.82**	
ST Borrowings	108.92	107.62	
Trade Payables	126.65	157.04	Trade payables other than Micro, Small and Medium Enterprises increased by Rs 28.92bn to Rs 155.33bn
Other current liabilities	197.93	184.03	Reduction due to decrease in current maturities of long term loans
ST Provisions	24.09	25.08	
Total current liabilities	**457.58**	**473.77**	
Total Liabilities	**784.70**	**868.07**	
Application of funds			
Fixed assets			
Tangible assets	357.11	375.19	
Intangible assets	4.21	4.53	
CWIP	18.10	39.85	Mainly due to Visakh refinery expansion project
Non-current investments	58.10	61.06	Increased investment in Bhygaynagar gas by Rs1bn and in HPCL Rajasthan refinery by Rs 1.147bn
LT Loans & Advances	4.56	4.62	This includes Rs 3bn towards employee loans and advances and interest thereon.
Other non-current assets	13.39	14.09	
Total non-current assets	**455.48**	**499.33**	

Rs bn	FY17	FY18	Comments
Current investments	51.09	49.99	Decrease in government bonds
Inventories	185.76	184.20	Inventories were written down by Rs 1.12 bn to their net realisable value.
Trade receivables	40.64	55.73	
Cash and cash eq.	0.34	11.94	
ST Loans and advances	1.63	0.89	
Other current assets	49.76	65.98	Receivables from Govt. of India towards Direct Benefit Transfer of LPG (DBTL) have gone up by Rs 19.44bn to Rs 31.88bn. The amount recoverable under this subsidy scheme has gone down by Rs 6.87bn to Rs 5.24bn.
Total current liabilities	**329.22**	**368.74**	
Total Assets	**784.70**	**868.07**	

Source: Company, PPAC, HDFC sec Inst Research

Key Updates

- **Re-classification of deposits received from customers:** Earlier, the deposits received towards cylinders were presented under the head **Non-current financial liabilities**. However, on the direction of The Comptroller and Auditor General (C&AG), the said deposits have been re-classified under **Current Financial Liabilities**.
- Prime Minister Ujjavala Yojana provides a financial support of Rs 1,600 for each LPG connection. During the year, the company supplied LPG cylinders to 4.125mn families. This deposit amount of Rs 6.6bn has been sourced from its Corporate Social Responsibility fund.

MRPL acquisition would 1) Reduce the susceptibility of HPCL's earnings to marketing margin (since the sales to refining ratio would come down from 2x to 1.2x), 2) Bring economies of scale, 3) Help avoid penalties from SEBI for not meeting public float requirements in case for MRPL,

4) Reduce overall operating costs for HPCL (MRPL has lower operating costs), 5) Provide HPCL with an opportunity to increase its product portfolio with MRPL and OMPL's petchem business.

MRPL Acquisition

- HPCL has begun discussions with ONGC to acquire MRPL, in which ONGC and HPCL own 71.63% and 16.96% respectively. Post acquisition HPCL's stake will be 88.59%.
- ONGC's board has already given its in-principle approval for evaluating potential restructuring of its group companies in its meeting held on 29th June, 2018.
- We believe that HPCL will buy ONGC's stake in MRPL. The deal could be by way of making cash payment or a share swap.
- We have carried out a scenario analysis with the two extreme possibilities 1) Cash payment 2) Share swap.

CASE I: Acquisition Of Stake By Paying Cash Alone (Most Likely)

	Unit	HPCL	HPCL+MRPL (Consol)
Impact on EPS			
Payment made to ONGC for its stake (Rs mn)	Rs mn		99,173
Interest rate (%)	%		10
Standalone EBIT (Rs mn)	Rs mn	68,123	98,493
Interest (Rs mn)	Rs mn	9,706	24,028
Other income (Rs mn)	Rs mn	14,472	11,315
Standalone PBT (including other income) (Rs mn)	Rs mn	72,889	85,780
Tax rate (%)	%	33.7	33.7
Standalone PAT (Rs mn)	Rs mn	48,354	56,906
Minority interest (Rs mn)	Rs mn		6,497
Standalone PAT (Rs mn)	Rs mn	48,354	50,409
EPS (Rs/share)	Rs/share	31.7	33.1
Change in EPS (Rs/share)	**Rs/share**	**1.3**	
Change in EPS (%)	**%**	**4.3**	
Impact on the Debt to Equity ratio			
Total debt (Rs mn)	Rs mn	498,224	597,397
Equity (Rs mn)	Rs mn	303,302	305,357
Debt: Equity	X	1.64	1.96
Impact on return ratios			
RoE			
Networth (Rs mn)	Rs mn	287,587	288,614
Net Profit (Rs mn)	Rs mn	48,354	50,409
RoE (%)	**%**	**16.81**	**19.72**
RoCE			
EBIT (Rs mn)	Rs mn	68,123	98,493
Capital Employed (Rs mn)	Rs mn	574,692	761,386
RoCE (%)	**%**	**11.9**	**12.9**

Source: Company, HDFC sec Inst Research

- HPCL will buy out 71.63% from ONGC. However, as both HPCL and MRPL are subsidiaries of ONGC, there would be no change in control. Hence, we do not foresee HPCL to explore an "open-offer", like in the acquisition of HPCL by ONGC.
- At CMP, the acquisition would not be EPS/RoE/RoCE dilutive for HPCL. However, it would increase the debt by Rs 99.17bn and debt-equity ratio for the company from 1.64x to 1.96x.
- HPCL's FY20E EPS would increase by 4.3% to Rs 33.1/share while RoE and RoCE would go up by 291bps and 100bps to 19.72% and 12.9% respectively.
- We believe that this would put an additional stress on the balance sheet of an already leveraged HPCL.
- We believe, GoI will force HPCL to buy stake by raising loans from banks. In addition, government might ask ONGC to declare a special dividend and tap the proceeds from the sale of stake in MRPL.
- GoI will mop up Rs 66.89bn as a special dividend from ONGC for its 67.45% stake in the company and further Rs 20.23bn through dividend distribution taxes.
- Disinvestment target for FY19 is set at Rs 800bn. By tapping the proceeds from this transaction, GoI could achieve 8% of its target.

Disinvestment observations

Particulars	Unit	
Government stake in ONGC	%	67.45
Total credit extended to HPCL by banks	Rs mn	99,173
Fund flowing to government,		
As a Special Dividend from ONGC (A)	Rs mn	66,892
Dividend Distribution Tax (DDT) collected on Special Dividend @20.4% (B)	Rs mn	20,231
Fund flowing to government ('C)=(A)+(B)	**Rs mn**	**87,123**
GoI's disinvestment target for FY19	Rs mn	800,000
Corporation tax target for FY19	Rs mn	6,210,000
Special dividend as % of disinvestment target for FY19	%	8.36
DDT as a % of total corporate tax target	%	0.33
Leak out to minority shareholders of ONGC	Rs mn	32,281

Source: Union Budget 2018-19, HDFC sec Inst Research,

CASE: II Acquisition of stake through a swap deal (Unlikely)

	HPCL	MRPL	(HPCL+MRPL) (Consol)
SWAP ratio calculation			
EV (Rs mn)	800,038	197,104	997,143
Net Debt (Rs mn)	316,815	57,178	373,993
Equity Value (Rs mn)	483,223	139,927	623,150
Share (%)	77.5	22.5	100.0
Existing no. of shares (mn)	1,524	1,753	1,524
New no. of shares (mn)	1,182	342	1,524
SWAP ratio	**0.78**	**0.20**	
ONGC's stake in HPCL post merger			
Total no of shares (mn)	1,524	1,753	1,524*
ONGC's existing stake in (%)	51.1	71.6	
Current no of shares in (mn) (A)	779	1,255	
SWAP ratio (B)	0.78	0.20	
No of shares to ONGC post merger (mn) (A)*(B)	**604**	**245**	**849**
ONGC's stake in (%)			**55.7**

*We have assumed that the number of shares of the merged entity equals HPCL’s current number of shares

Treasury shares with HPCL

Total no of shares of MRPL (mn)	1,752.6
HPCL's stake in MRPL (%)	17.0
No of shares of MRPL with HPCL (mn) (A)	297.2
SWAP ratio (B)	0.2
No of shares treasury shares (mn) (A)*(B)	**58.0**
Value of treasury shares (Rs mn)	23,719

Post merger value of refining business will increase by ~94% to Rs 405bn. Net debt will increase by Rs 58bn.

Post-Merger Valuation (Based On Sep 20E)

Business	EBIDTA (Rs bn)	Multiple	Value (Rs bn)	Value (Rs/sh)*	Valuation basis
No of shares (net of treasury shares)				**1,466**	
Standalone					
Refining	81.0	5.0	405.1	276.3	EV/EBIDTA on Sep 20E
Marketing	60.1	8.0	481.2	328.2	EV/EBIDTA on Sep 20E
Pipeline	12.3	9.0	110.9	75.6	EV/EBIDTA on Sep 20E
Standalone net Debt			(374.0)	-255.1	As on Sep 19E
Standalone Equity Value			**623.1**	**425.0**	
Investments					
HMEL Investment	65.3	7.0	457.2	311.8	EV/EBIDTA on Sep 20E
HMEL net debt	-	-	(53.9)	(36.7)	As on Sep 19E
HMEL Equity value	-	-	403.4	134.8	HPCL's stake is 48.9%
Traded investments	**No of shares**	**CMP**			
Oil India	17.8	213.0	2.7	1.8	30% disc. on CMP
Other non traded investments			25.3	17.2	0.5x BV
Investments Equity Value				**153.8**	
Value per share				**579**	
Change over earlier TP				**103**	

Source: Company, HDFC sec Inst Research

- We have assumed that the number of shares post-merger would remain constant. Accordingly, an investor in HPCL would get 0.78 shares for every share held and an investor in MRPL would get 0.2 share for every share held.
- ONGC's stake in HPCL would increase by 4.59% to 55.7%.
- This deal would make complete sense as it would, 1) Reduce the susceptibility of HPCL's earnings to marketing margin (since the sales to refining ratio would come down from 2.1x to 1.2x), 2) Bring economies of scale, 3) Help avoid penalties from SEBI for not meeting public float requirements in case for MRPL, 4) Reduce overall operating costs for HPCL (MRPL has lower operating costs), 5) Provide HPCL with an opportunity to increase its product portfolio with MRPL and OMPL's petchem business.
- In share swap, the government will not get the proceeds from the sale in stake immediately. Thus, GoI may not go for this route of transfer of stake.

The HMEL's refinery crude throughput is expected to increase in FY19 as the company completed the expansion in FY18.
Post the Visakh refinery expansion by FY21, the crude throughput for HPCL is expected to go up.

Overall sales volumes to grow by 6% over FY18-FY21

Assumptions

	FY17	FY18	FY19E	FY20E	FY21E
Refining					
HPCL Throughput (mnT)	17.7	18.2	17.7	17.9	22.8
HMEL Throughput (mnT)	10.5	8.8	12.5	12.5	12.5
GRM Standalone(USD/bbl)	6.2	7.4	7.0	7.0	7.2
HMEL GRM (USD/bbl)	11.3	13.2	12.9	12.9	12.9
Marketing					
Volumes (mnT)	35.2	36.9	38.8	40.8	44.0
YoY Gr (%)	*3.0*	*4.7*	*5.3*	*5.0*	*7.9*
Diesel Volume (mn T)	*17.0*	*17.7*	*18.6*	*19.6*	*20.2*
Diesel Volume Gr (%)	*0.8*	*4.4*	*5.0*	*5.0*	*3.5*
Diesel's Margin (Rs/l)	2.6	2.6	2.6	2.7	2.9
Pipeline					
Volumes (mnT)	17.9	20.9	22.0	23.0	23.0
Macro					
Crude Price (USD/bbl)	50.0	57.5	70.0	70.0	70.0

Valuation (Based On Sep-20E)

Business	EBIDTA (Rs bn)	Multiple	Value (Rs bn)	Value (Rs/sh)*	Valuation basis
Standalone					
Refining	41.6	5.0	208.0	136	EV/EBIDTA on Sep 20E
Marketing	60.1	8.0	481.2	316	EV/EBIDTA on Sep 20E
Pipeline	12.3	9.0	110.9	73	EV/EBIDTA on Sep 20E
Standalone net Debt			(316.8)	-208	As on Sep 19E
Standalone Equity Value			**483.2**	**317**	
Investments					
HMEL Investment	65.3	7.0	457.2	300	HMEL Investment
HMEL net debt			(53.9)	-35	HMEL net debt
HMEL Equity value			403.4	130	HMEL Equity value
Traded investments	**No of shares**	**CMP**			**Traded investments**
Oil India	17.8	213.0	2.7	2	Oil India
MRPL	297.2	81.0	16.8	11	MRPL
Other non traded investments			25.3	17	**Other non traded investments**
Investments Equity Value			**448.2**	**159.0**	**Investments Equity Value**
Value per share			**931**	**476**	**Value per share**

Source: Company, HDFC sec Inst Research Assumptions, We have not factored in HPCL-MRPL merger in our estimates

Income Statement

(Rs bn)	FY17	FY18	FY19E	FY20E	FY21E
Revenues	**1,870.24**	**2,193.33**	**2,619.03**	**2,727.41**	**2,883.67**
Growth (%)	***4.2***	***17.3***	***19.4***	***4.1***	***5.7***
Material Expenses	1,634.15	1,944.47	2,370.71	2,467.27	2,593.84
Employee Expenses	29.46	28.59	32.02	32.98	34.62
Other Operating Expenses	100.85	112.89	117.95	123.24	131.00
EBIDTA	**105.77**	**107.38**	**98.36**	**103.93**	**124.20**
EBIDTA Margin (%)	***5.7***	***4.9***	***3.8***	***3.8***	***4.3***
EBITDA Growth (%)	***24.8***	***1.5***	***(8.4)***	***5.7***	***19.5***
Core EBITDA	**67.11**	**90.29**	**98.36**	**103.93**	**124.20**
Core EBITDA margin (%)	***3.59***	***4.12***	***3.76***	***3.81***	***4.31***
Core EBITDA growth (%)	***(29.13)***	***34.53***	***8.94***	***5.66***	***19.51***
Depreciation	25.35	27.53	29.24	35.81	44.32
EBIT	**80.42**	**79.86**	**69.12**	**68.12**	**79.89**
Other Income Incl EO	15.15	18.49	14.12	14.47	14.76
Interest	5.36	5.67	8.13	9.71	11.44
PBT	**90.21**	**92.68**	**75.11**	**72.89**	**83.21**
Tax	28.12	28.45	25.28	24.53	28.01
RPAT	**62.09**	**64.24**	**49.83**	**48.35**	**55.20**
EO (Loss) / Profit (Net Of Tax)	0.17	0.67	-	-	-
APAT	**61.91**	**63.57**	**49.83**	**48.35**	**55.20**
APAT Growth (%)	***60.3***	***2.7***	***(21.6)***	***(3.0)***	***14.2***
AEPS	**40.6**	**41.7**	**32.7**	**31.7**	**36.2**
EPS Growth (%)	***60.3***	***2.8***	***(21.6)***	***(3.0)***	***14.2***

Source: Company, HDFC sec Inst Research

Balance Sheet

(Rs bn)	FY17	FY18	FY19E	FY20E	FY21E
SOURCES OF FUNDS					
Share Capital	10.16	15.24	15.24	15.24	15.24
Reserves	193.31	224.24	256.63	288.06	323.94
Total Shareholders Funds	**203.47**	**239.48**	**271.87**	**303.30**	**339.18**
Long-term Debt	62.79	88.31	148.60	292.60	292.60
Short-term Debt	108.92	107.62	205.62	205.62	205.62
Total Debt	**171.71**	**195.93**	**354.22**	**498.22**	**498.22**
Deferred Taxes	58.96	65.69	65.69	65.69	65.69
Long Term Provisions & Others	1.90	0.81	0.81	0.81	0.81
TOTAL SOURCES OF FUNDS	**436.04**	**501.92**	**692.60**	**868.03**	**903.91**
APPLICATION OF FUNDS					
Net Block	361.32	379.72	395.48	644.67	645.36
CWIP	76.20	100.91	177.10	84.29	106.01
Investments	51.09	49.99	49.99	49.99	49.99
LT Loans & Advances	4.56	4.62	10.38	3.16	4.74
Other Non-current Assets	13.39	14.09	14.09	14.09	14.09
Total Non-current Assets	**506.56**	**549.33**	**647.05**	**796.21**	**820.19**
Inventories	185.76	184.20	225.53	234.72	246.76
Debtors	40.64	55.73	57.54	59.92	63.35
Cash & Equivalents	0.34	11.94	8.52	36.31	34.83
Other Current Assets	51.39	66.87	145.94	149.76	161.91
Total Current Assets	**278.13**	**318.74**	**437.53**	**480.71**	**506.85**
Creditors	126.65	157.04	172.93	185.55	195.07
Other Current Liabilities	222.01	209.11	219.05	223.34	228.06
Total Current Liabilities	**348.66**	**366.15**	**391.98**	**408.89**	**423.13**
Net Current Assets	**(70.52)**	**(47.41)**	**45.55**	**71.82**	**83.72**
TOTAL APPLICATION OF FUNDS	**436.04**	**501.92**	**692.60**	**868.03**	**903.91**

Source: Company, HDFC sec Inst Research

Cash Flow Statement

Rs bn	FY17	FY18	FY19E	FY20E	FY21E
Reported PBT	90.03	92.02	75.11	72.89	83.21
Non-operating & EO Items	(15.15)	(18.49)	(14.12)	(14.47)	(14.76)
Interest Expenses	5.36	5.67	8.13	9.71	11.44
Depreciation	25.35	27.53	29.24	35.81	44.32
Working Capital Change	69.51	(12.61)	(102.15)	8.74	(14.95)
Tax Paid	(18.36)	(21.71)	(25.28)	(24.53)	(28.01)
OPERATING CASH FLOW (a)	**156.74**	**72.39**	**(29.07)**	**88.13**	**81.24**
Capex	(57.40)	(70.63)	(121.19)	(192.19)	(66.72)
Free Cash Flow (FCF)	***99.34***	***1.76***	***(150.26)***	***(104.05)***	***14.52***
Investments	10.39	18.89	14.12	14.47	14.76
INVESTING CASH FLOW (b)	**(47.01)**	**(51.75)**	**(107.07)**	**(177.72)**	**(51.96)**
Debt Issuance/(Repaid)	(66.14)	24.19	158.29	144.00	-
Interest Expenses	(5.36)	(5.67)	(8.13)	(9.71)	(11.44)
FCFE	***27.84***	***20.28***	***(0.10)***	***30.24***	***3.08***
Share Capital Issuance	6.77	5.08	-	-	-
Dividend	(36.72)	(31.19)	(16.31)	(15.82)	(18.06)
Others	(8.19)	(1.46)	(1.13)	(1.10)	(1.25)
FINANCING CASH FLOW (c)	**(109.64)**	**(9.04)**	**132.72**	**117.37**	**(30.76)**
NET CASH FLOW (a+b+c)	**0.10**	**11.60**	**(3.42)**	**27.79**	**(1.48)**
Closing Cash & Equivalents	0.34	11.94	8.52	36.31	34.83

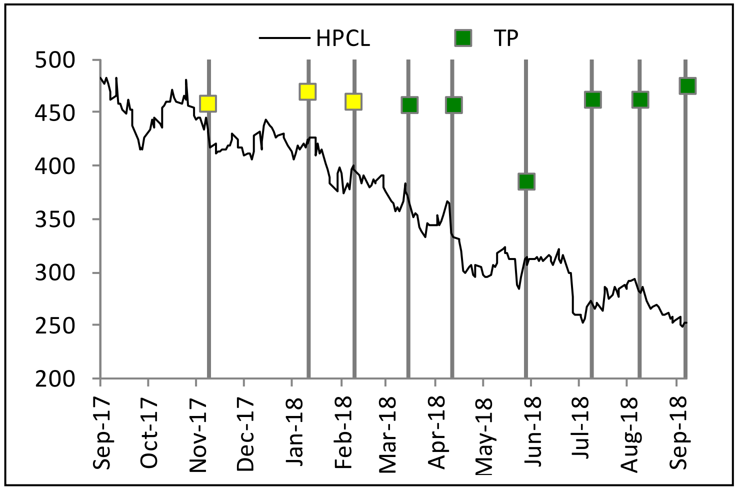
Source: Company, HDFC sec Inst Research

Key Ratios

	FY17	FY18	FY19E	FY20E	FY21E
PROFITABILITY %					
EBITDA Margin	5.7	4.9	3.8	3.8	4.3
EBIT Margin	5.1	4.5	3.2	3.0	3.3
APAT Margin	3.3	2.9	1.9	1.8	1.9
RoE	32.3	28.7	19.5	16.8	17.2
Core RoCE	21.8	24.7	18.2	11.5	9.9
RoCE	17.3	18.7	12.5	9.5	9.2
EFFICIENCY					
Tax Rate %	31.2	30.9	33.7	33.7	33.7
Asset turnover (x)	2.5	2.7	2.7	2.3	2.2
Inventory (days)	36	31	31	31	31
Debtor (days)	8	9	8	8	8
Other Current Assets (days)	10	11	20	20	20
Payables (days)	26	27	25	26	26
Other Curr Liab & Prov (days)	26	27	25	26	26
Cash conversion cycle (days)	2	(4)	10	8	8
Net Debt/EBITDA (x)	1.1	1.2	3.0	4.0	3.3
Net D/E	0.6	0.6	1.1	1.4	1.2
Interest Coverage	17.8	17.4	10.2	8.5	8.3
PER SHARE DATA					
EPS (Rs)	40.6	41.7	32.7	31.7	36.2
CEPS (Rs)	57.2	59.8	51.9	55.2	65.3
DPS (Rs)	20.0	17.0	8.9	8.6	9.8
BV (Rs)	133.4	157.1	178.4	199.0	222.5
VALUATION					
P/E (x)	6.2	6.1	7.7	8.0	7.0
P/Cash EPS (x)	4.4	4.2	4.9	4.6	3.9
P/BV (x)	1.9	1.6	1.4	1.3	1.1
EV/EBITDA (x)	4.7	4.5	6.5	7.3	6.1
EV/Revenue (x)	0.3	0.2	0.2	0.3	0.3
OCF/EV (%)	31.7	15.0	(4.5)	11.6	10.6
FCFF/EV (%)	20.1	0.4	(23.4)	(13.7)	1.9
FCFE/M CAP (%)	7.2	5.3	(0.0)	7.8	0.8
Dividend Yield (%)	7.9	6.7	3.5	3.4	3.9

Source: Company, HDFC sec Inst Research

RECOMMENDATION HISTORY



Date	CMP	Reco	Target
9-Nov-17	431	NEU	458
11-Jan-18	431	NEU	469
11-Feb-18	395	NEU	460
15-Mar-18	376	BUY	458
12-Apr-18	338	BUY	458
29-May-18	313	BUY	386
9-Jul-18	271	BUY	463
8-Aug-18	282	BUY	463
10-Sep-18	253	BUY	476

Rating Definitions

BUY : Where the stock is expected to deliver more than 10% returns over the next 12 month period
NEUTRAL : Where the stock is expected to deliver (-)10% to 10% returns over the next 12 month period
SELL : Where the stock is expected to deliver less than (-)10% returns over the next 12 month period

Disclosure:

We, **Nilesh Ghuge, MMS & Divya Singhal, CA**, authors and the names subscribed to this report, hereby certify that all of the views expressed in this research report accurately reflect our views about the subject issuer(s) or securities. HSL has no material adverse disciplinary history as on the date of publication of this report. We also certify that no part of our compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

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Any holding in stock –No

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