Sharekhan by BNP PARIBAS

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Hindustan Petroleum Corporation Ltd

Q2 miss on weak GRM; project completion to drive growth

Oil & Gas	Sharekhan code: HINDPETRO
Reco/View: Buy ↔	CMP: **Rs. 314**	Price Target: **Rs. 360** ↑

↑ Upgrade ↔ Maintain ↓ Downgrade

3R MATRIX	+	=	-
Right Sector (RS)	✓		
Right Quality (RQ)	✓		
Right Valuation (RV)	✓		

\+ Positive = Neutral – Negative

What has changed in 3R MATRIX

	Old		New
RS		↔	
RQ		↔	
RV		↔	

ESG Disclosure Score NEW

ESG RISK RATING 39.49

Updated Oct 08, 2021

High Risk

NEGL	LOW	MED	HIGH	SEVERE
0-10	10-20	20-30	30-40	40+

Source: Morningstar

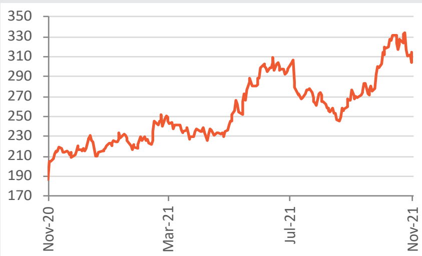
Company details

Market cap:	Rs. 44,585 cr
52-week high/low:	Rs. 340 / 181
NSE volume: (No of shares)	50.1 lakh
BSE code:	500104
NSE code:	HINDPETRO
Free float: (No of shares)	64.0 cr

Shareholding (%)

Promoters	54.9
FII	18.3
DII	15.9
Others	10.9

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	4	16	30	68
Relative to Sensex	3	6	6	21

Sharekhan Research, Bloomberg

Summary

- Q2FY22 operating profit of Rs. 2,724 crore (down 6.6% q-o-q) missed our estimate due to sharp miss in GRM and a slightly lower-than-expected marketing margin. In-line PAT at Rs. 1,924 crore (up 7.2% q-o-q) as miss in operating profit gets offset by lower interest costs and higher other income.
- HPCL's GRMs declined by 26.3% q-o-q to 2.4/bbl due to higher F&L and impact of refinery shutdowns. Implied gross marketing margins grew slightly by 2.1% q-o-q. Volumes were decent with a 0.8%/9.4%/3.1% q-o-q rise in refinery throughput/pipeline throughput/marketing sales volume at 2.5 mmt/4.8 mmt/9.1 mmt.
- Earnings outlook for OMCs has improved considerably, led by the recent sharp improvement in refining margins and likely inventory gains given rally in crude oil prices. Commissioning of Mumbai/ Vizag refinery in FY22E would drive refinery throughput and improve FCF.
- Valuation of 4.9x/1x FY23E EPS/BV is attractive considering a recovery in core earnings, RoE of 21% and dividend yield of ~7%. BPCL's privatisation could re-rate OMCs. We maintain a Buy on HPCL with a revised PT of Rs. 360.

Hindustan Petroleum Corporation Limited's (HPCL) Q2FY22 standalone operating profit of Rs. 2,724 crore, down 6.6% q-o-q was 18%/11% below ours and the consensus' estimate due to a sharp miss in GRM at $2.4/bbl (down 26.3% q-o-q and below our estimate of $3.6/bbl) and slightly lower-than-expected implied gross marketing margin of Rs. 6,889/tonne (up only 2.1% q-o-q). The sequential contraction in GRMs was due to an increase in fuel & loss and impact of shutdown in Mumbai/Vizag refineries. Volume performance was better than expectations with a 1%/3%/4% beat in refinery throughput/pipeline throughput/marketing sales volume that stood at 2.5 mmt/4.8 mmt/9.1 mmt, up 0.8%/9.4%/3.1% q-o-q, respectively. However, HPCL's GRMs at $2.4/bbl underperformed that of IOCL ($6.6/bbl) and BPCL ($6/bbl), while petrol/diesel sales volume growth of 12.9%/9.1% y-o-y as compared to the industry growth rate of 12%/9% y-o-y in Q2FY22. Reported PAT at Rs. 1,924 crore (up 7.2% q-o-q) was in line with our estimate but 5% above street estimates due to higher other income and lower interest costs.

Key positives

- Better-than-expected domestic marketing sales growth of 8.5% y-o-y versus 7% y-o-y growth for industry.

Key negatives

- GRMs sharply missed estimates at $2.4/bbl (vs. estimate of $3.6/bbl) and underperformed versus IOCL's/BPCL's GRM of $6.6/$6 per bbl.
- Gross debt increased by 7% q-o-q to Rs. 37,724 crore as of September 2021.

Management Commentary

- **Mumbai/Vizag refinery update –** Mumbai refinery is operating at ~80% utilisation currently and expected to reach 100% utilisation by Q4FY22 and witnessed testing of new CDU-VDU for commissioning. The Vizag refinery has recovered from a fire incident in Q1 and is operating at a 100% plus utilisation. The Vizag refinery's expansion is on schedule to get completed in end-FY2022 while bottom upgradation project expected to get completed by December 2022. Full benefit of capacity expansion and bottom upgradation on GRM would be visible by Q4FY23.
- **Auto fuel demand –** Management indicated that petrol demand is above pre-COVID level and diesel demand has recovered to pre-pandemic levels in October 2021.
- **Capex guidance -** The company maintained its FY22 capex guidance of Rs. 14,500 crore and expects similar capex run rate for FY23. Capex spending for H1FY22 was at ~Rs. 6,400 crore.
- **Other updates –** 1) HPCL has plans to set-up a green hydrogen plant, 2) EV charging/CNG station target of 5,000/5,300 by FY25 as compared to 327/809 currently, 3) Chhara LNG terminal is expected to get commissioned by end of FY23, 4) Have launched non-fuel retail store "Happy Shop".

Revision in estimates – We increased our FY22-24 earnings growth to factor in higher GRM assumptions.

Our Call

Valuation – Maintain Buy on HPCL with a revised PT of Rs. 360: HPCL's valuation of 4.9x its FY2023E EPS and 1x its FY2023E P/BV is attractive and does not factor in potential improvement in core earnings over FY2022-FY2023. Moreover, we expect that a healthy dividend yield of ~7% on account of sustained strong earnings and completion of the capex cycle (refinery expansion at Mumbai and Vizag refinery in FY2022) would improve FCF generation from FY2023. Attractive valuation across parameters and a potential re-rating of marketing business (if BPCL is successfully privatised) makes us constructive on HPCL. We see a favourable risk-reward, given earnings visibility, attractive valuations and a healthy dividend yield. Hence, we maintain a Buy on HPCL with a revised PT of Rs. 360.

Key Risks

Prolonged weakness in refining margin and lower-than-expected marketing sales volume amid the COVID-19 economic slowdown could impact earnings outlook and valuation.

Valuation (Standalone) Rs cr

Particulars	FY21	FY22E	FY23E	FY24E
Revenue	2,31,913	2,63,472	2,85,428	2,98,602
OPM (%)	6.4	4.6	5.0	5.4
Adjusted PAT	10,664	7,847	9,192	10,379
% y-o-y growth	*409.7*	*-26.4*	*17.1*	*12.9*
Adjusted EPS (Rs.)	75.2	55.3	64.8	73.2
P/E (x)	4.2	5.7	4.9	4.3
P/B (x)	1.2	1.1	1.0	0.9
EV/EBITDA (x)	5.5	6.1	4.9	4.1
RoNW (%)	32.7	20.4	21.1	21.1
RoCE (%)	21.7	15.5	17.2	18.8

Source: Company; Sharekhan estimates

Operating profit missed estimate on lower-than-expected GRM; PAT was in-line

Q2FY22 standalone operating profit of Rs. 2,724 crore, down 6.6% q-o-q was 18%/11% below ours and the consensus' estimate due to a sharp miss in GRM at $2.4/bbl (down 26.3% q-o-q and below our estimate of $3.6/bbl) and slightly lower-than-expected implied gross marketing margin of Rs. 6,889/tonne (up only 2.1% q-o-q). The sequential contraction in GRMs was due to an increase in fuel & loss and impact of shutdown in Mumbai/Vizag refineries. Volume performance was better than expectations with a 1%/3%/4% beat in refinery throughput/pipeline throughput/marketing sales volume that stood at 2.5 mmt/4.8 mmt/9.1 mmt, up 0.8%/9.4%/3.1% q-o-q, respectively. However, HPCL's GRMs at $2.4/bbl underperformed that of IOCL ($6.6/bbl) and BPCL ($6/bbl), while petrol/diesel sales volume growth of 12.9%/9.1% y-o-y as compared to the industry growth rate of 12%/9% y-o-y in Q2FY22. Reported PAT at Rs. 1,924 crore (up 7.2% q-o-q) was in line with our estimate but 5% above street estimates due to higher other income and lower interest costs.

Results (Standalone) Rs cr

Particulars	Q2FY22	Q2FY21	Y-o-Y %	Q1FY22	Q-o-Q %
Revenue	**82,775**	**51,511**	**60.7**	**72,166**	**14.7**
Total Expenditure	80,051	48,169	66.2	69,250	15.6
Operating profit	**2,724**	**3,342**	**-18.5**	**2,916**	**-6.6**
Other Income	739	1,079	-31.5	649	13.9
Interest	154	260	-40.7	254	-39.2
Depreciation	947	868	9.1	914	3.6
Exceptional income/(expense)	0	0	NA	0	NA
PBT	**2,361**	**3,292**	**-28.3**	**2,397**	**-1.5**
Tax	438	815	-46.3	602	-27.3
Reported PAT	**1,924**	**2,477**	**-22.4**	**1,795**	**7.2**
Equity Cap (cr)	142	142	0.0	142	0.0
Reported EPS (Rs.)	13.6	17.5	-22.4	12.7	7.2
Margins (%)			**BPS**		**BPS**
OPM	3.3	6.5	-319.7	4.0	-75.0
NPM	2.3	4.8	-248.6	2.5	-16.4
Tax rate	18.5	24.7	-620.5	25.1	-657.2

Source: Company; Sharekhan Research

Key operating metrics

Particulars	Q2FY22	Q2FY21	Y-o-Y %	Q1FY22	Q-o-Q %
Reported GRM ($/bbl)	2.4	5.1	-52.3	3.3	-26.3
Refining throughput (mmt)	2.5	4.1	-37.7	2.5	0.8
Market sales including exports (mmt)	9.1	8.4	7.9	8.8	3.1
Pipeline throughput (mmt)	4.8	4.7	1.1	4.3	9.4

Source: Company; Sharekhan Research

Outlook and Valuation

■ Sector view – Recovery in GRM to mid-cycle level, decent volume growth, and better auto fuel marketing margins bode well for earnings of OMCs

India's consumption of petrol and diesel is expected to grow at decent rate annually in the medium term, as penetration for two-wheelers and passenger cars improves and GDP growth normalises. We believe that OMCs' auto fuel marketing margins would soon normalise to historical levels as they have started daily auto fuel price revisions. Moreover, gradual reduction of global petroleum product inventories (given an improvement in oil demand and a reduction in refinery run-rates) could improve core refining margin to mid-cycle level of $3-4/bbl over CY2021E-CY2022E. Privatisation of BPCL (is successful) could play a crucial role in aligning marketing margins on petrol to global standards. All the above factors bode well for sharp earnings growth for Indian OMCs.

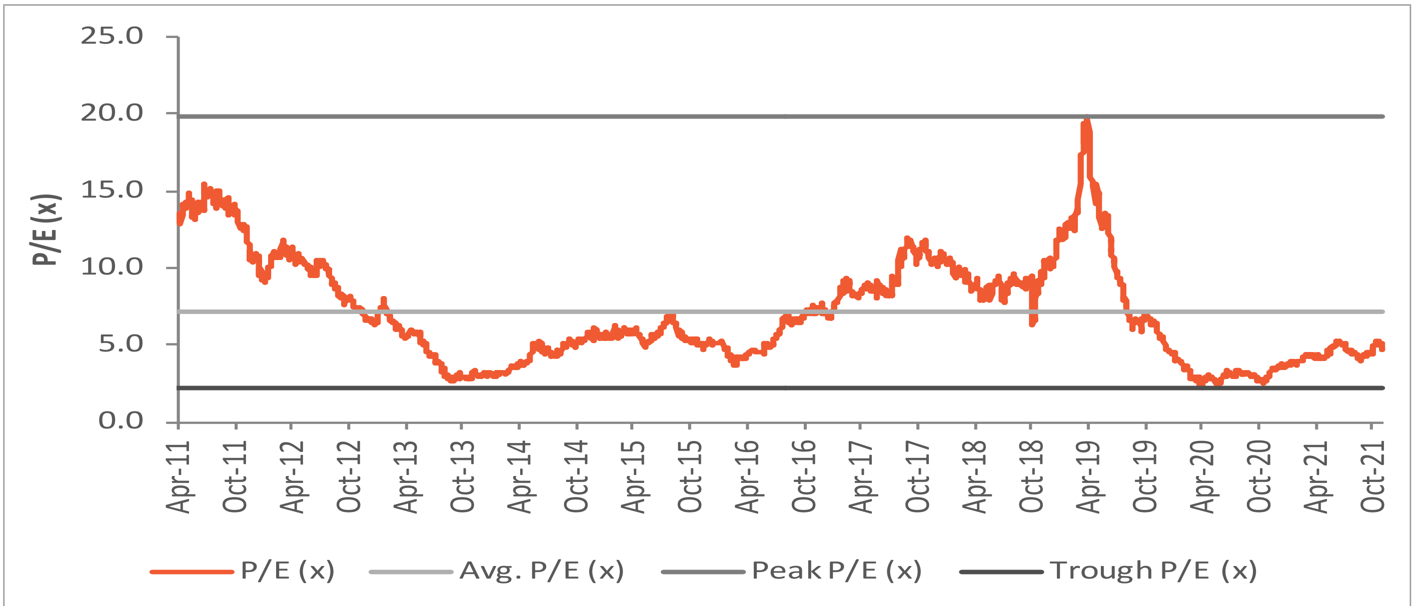
■ Company outlook – Earnings to recover led by cyclical recovery in GRM & volume and higher marketing margins

We expect HPCL's earnings to recover in the coming quarters, supported by multiple drivers such as volume recovery, higher refinery throughput (as utilisation rate improves with pre-commissioning activities at Mumbai Refinery is going on), sustained improvement in auto fuel marketing margin led by price hike, cyclical recovery in refining margin over CY2021E-CY2022E as petroleum product cracks would improve with decline in the global petroleum inventories amid a pick-up in global demand, and likely inventory gain in Q3FY2022 as spot crude oil price of $83/bbl (versus $72.8/bbl in Q1FY2022).

■ Valuation – Maintain Buy on HPCL with a revised PT of Rs. 360

HPCL's valuation of 4.9x its FY2023E EPS and 1x its FY2023E P/BV is attractive and does not factor in potential improvement in core earnings over FY2022-FY2023. Moreover, we expect that a healthy dividend yield of ~7% on account of sustained strong earnings and completion of the capex cycle (refinery expansion at Mumbai and Vizag refinery in FY2022) would improve FCF generation from FY2023. Attractive valuation across parameters and a potential re-rating of marketing business (if BPCL is successfully privatised) makes us constructive on HPCL. We see a favourable risk-reward, given earnings visibility, attractive valuations and a healthy dividend yield. Hence, we maintain a Buy on HPCL with a revised PT of Rs. 360.

One-year forward P/E (x) band



Source: Sharekhan Research

About company

HPCL is engaged into the business of crude oil refining and marketing of petroleum products. The company has a standalone refining capacity of 15.8 mmt and retail fuel outlets of 19,216. HPCL also operates petroleum product pipeline network of 3,370 km with mainline capacity of 24.9mtpa and branch line capacity of 11.1mtpa and markets ~39 mmt of petroleum products.

Investment theme

HPCL is best placed among the OMCs given higher gearing toward marketing margins and lower impact on refinery throughput as it sources ~58% of petrol and diesel marketing sales volume from other refiners. Moreover, higher auto fuel marketing margin and sharp recovery in marketing sales volume bodes well for earnings recovery for OMCs. Moreover, HPCL's valuation is also attractive with steep discount to that of BPCL.

Key Risks

- Lower-than-expected refining and marketing margins could affect earnings outlook.
- Lower-than-expected volume in case of prolonged economic slowdown amid COVID-19.
- Volatility in quarterly earnings in case of fluctuations in oil prices and Re-USD rate.

Additional Data

Key management personnel

Mukesh Kumar Surana	Chairman & Managing Director
Rajneesh Narang	Director - Finance
Vinod S Shenoy	Director – Refineries
Rakesh Misri	Director - Marketing

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	HDFC Asset Management Co. Ltd	4.7
2	Life Insurance Corp. of India	2.3
3	Vanguard Group Inc	1.8
4	BlackRock Inc	1.4
5	Franklin Resources Inc.	1.2
6	Franklin Enterprises, Inc.	1.2
7	Mirae Asset Global Investments Co. Ltd	1.1
8	SBI Funds Management Pvt. Ltd	0.9
9	UTI Asset Management Co. Ltd	0.7
10	ICICI Prudential Life Insurance Co. Ltd	0.7

Source: Bloomberg

Understanding the Sharekhan 3R Matrix

Right Sector	
Positive	Strong industry fundamentals (favorable demand-supply scenario, consistent industry growth), increasing investments, higher entry barrier, and favorable government policies
Neutral	Stagnancy in the industry growth due to macro factors and lower incremental investments by Government/private companies
Negative	Unable to recover from low in the stable economic environment, adverse government policies affecting the business fundamentals and global challenges (currency headwinds and unfavorable policies implemented by global industrial institutions) and any significant increase in commodity prices affecting profitability.
Right Quality	
Positive	Sector leader, Strong management bandwidth, Strong financial track-record, Healthy Balance sheet/cash flows, differentiated product/service portfolio and Good corporate governance.
Neutral	Macro slowdown affecting near term growth profile, Untoward events such as natural calamities resulting in near term uncertainty, Company specific events such as factory shutdown, lack of positive triggers/events in near term, raw material price movement turning unfavourable
Negative	Weakening growth trend led by led by external/internal factors, reshuffling of key management personal, questionable corporate governance, high commodity prices/weak realisation environment resulting in margin pressure and detoriating balance sheet
Right Valuation	
Positive	Strong earnings growth expectation and improving return ratios but valuations are trading at discount to industry leaders/historical average multiples, Expansion in valuation multiple due to expected outperformance amongst its peers and Industry up-cycle with conducive business environment.
Neutral	Trading at par to historical valuations and having limited scope of expansion in valuation multiples.
Negative	Trading at premium valuations but earnings outlook are weak; Emergence of roadblocks such as corporate governance issue, adverse government policies and bleak global macro environment etc warranting for lower than historical valuation multiple.

Source: Sharekhan Research

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