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Stock Update

Hindustan Petroleum Corporation Limited

Robust Q2; best play among OMCs

Oil & Gas	Sharekhan code: HINDPETRO	Result Update

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

\+ Positive = Neutral - Negative

Reco/View	Change
Reco: **Buy**	↔
CMP: **Rs. 205**	
Price Target: **Rs. 260**	↔

↑ Upgrade ↔ Maintain ↓ Downgrade

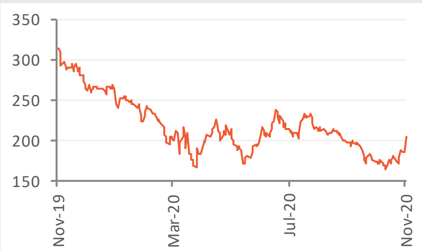
Company details

Market cap:	Rs. 31,276 cr
52-week high/low:	Rs. 317/155
NSE volume: (No of shares)	76.8 lakh
BSE code:	500104
NSE code:	HINDPETRO
Free float: (No of shares)	74.5 cr

Shareholding (%)

Promoters	51.1
FII	15.5
DII	22.3
Others	11.1

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	18	-5	1.0	-35
Relative to Sensex	14	-14	-29	-37

Sharekhan Research, Bloomberg

Summary

- Q2FY21 PAT at Rs. 2,477 crore (up 2.4x y-o-y) substantially beat street estimates led by large inventory gains of Rs. 1,780 crore and beat in core GRM at $2.7/bbl. However, earnings missed our estimate due to lower marketing margins.
- HPCL outperformed peers with strong core GRM of $2.7/bbl vs. $1.5/bbl for BPCL and negative $1/bbl for IOCL; refinery utilization of 103% (vs. 79.5%/82% for IOCL/BPCL).
- Board approved share buyback not exceeding Rs. 2,500 crore at maximum buyback price of Rs. 250/share (34% premium to closing price of Rs. 187 on November 04, 2020) from open market. Buyback and healthy dividend yield of ~8% to support stock prices.
- HPCL would report highest earnings growth among OMCs (expect PAT CAGR of 38% over FY20-FY23E versus 20% for IOCL and BPCL). Moreover, valuation is attractive at 0.8x/5.1 FY23E PBV/PE. Hence, we recommend a Buy on HPCL with PT of Rs260.

Hindustan Petroleum Corporation Limited (HPCL) Q2FY2021 operating profit at Rs. 3,342 crore (up 1.7x y-o-y) and PAT Rs. 2,477 crore (2.4x y-o-y) was substantially higher than street estimate but lower than our estimates. The beat in consensus estimates was on account of large inventory gains of Rs. 1,780 crore (versus only Rs. 53 crore in Q2FY2020), better-than-expected core GRM of $2.7/bbl (up 7.8% y-o-y and above expectation of $1-1.5/bbl) and higher other income (up 56.5% y-o-y). However, the miss versus our PAT estimate of Rs. 3,047 crore was on account of a lower blended marketing margin at Rs. 3,148/tonne (down 47.4% q-o-q). HPCL outperformed peers with strong core GRM of $2.7/bbl (versus $1.5/bbl for BPCL and negative $1/bbl for IOCL) and refinery utilisation rate of 103% (versus 79.5% for IOCL and 82% for BPCL). HPCL's board also approved share buyback not exceeding Rs. 2,500 crore at a maximum buyback price of Rs. 250/share (at a 34% premium to closing price of Rs. 187 on November 4) from open market and its promoter will not participate in buyback program. We expect HPCL to report highest earnings growth among OMCs (expect a PAT CAGR of 38% FY2020-FY2023E versus 20% for IOCL and BPCL) as HPCL has seen much faster recovery in volumes (diesel/petrol sales volume up 11.5%/4.7% y-o-y in October) and refinery utilization rate (already at 103%). HPCL's valuation of 0.8x FY2023E P/BV and 5.1x FY2023E EPS (36% discount to historical multiple and 55% to that of BPCL) is attractive given earnings visibility and a healthy RoE of 17-18%. Moreover, share buyback and healthy dividend yield of ~8% (management has indicated that HPCL would also give dividend to its shareholders apart from share buyback) lends comfort to investors. Hence, we recommend a Buy on HPCL with PT of Rs. 260.

Key positives

- Higher-than-expected core GRM at $2.7/bbl (up 7.8% y-o-y), much better when compared to $1.5/bbl for BPCL and negative $1/bbl for IOCL.
- Better-than-expected refinery throughput of 4.1 mmt (up 2.3% y-o-y) with utilization of 103% versus 79.5% for IOCL and 82% for BPCL.
- Decline in gross debt by 12.8% q-o-q to Rs. 31,963 crore as on September 2020 and robust FCF generation of Rs. 10,342 crore (3.9x y-o-y) in H1FY2021.

Key negatives

- Lower-than-expected derived marketing EBITDA margin of Rs. 3,148/tonne (down 47.4% q-o-q).

Our Call

Valuation – Recommend Buy on HPCL with PT of Rs. 260: We sharply raise our FY2021-FY2022 earnings estimate to factor in: 1) to reflect large inventory gain in Q2FY2021, 2) higher diesel and petrol volume assumption as recovery has been much ahead of expectations and 3) higher refinery utilisation. We have also introduced our FY2023 earnings estimate in this report. We expect faster earning recovery for HPCL among the OMCs as it has outperformed peers with better refinery utilization as HPCL share of marketing sales volume is higher than refinery throughput and strong volume recovery in auto fuels. Hence, we expect CAGR of 38% in PAT over FY2020-FY2023E for HPCL, which is the highest among OMCs. Moreover, HPCL trades at an attractive valuation of 5.1x FY2023EEPS (which is at discount of 36% to its historical average one year forward PE multiple and 55% to that of BPCL on FY2023E PE basis) and offers healthy dividend yield of ~8%. Hence, we recommend a Buy rating on HPCL with PT of Rs. 260.

Key risk

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	FY19	FY20	FY21E	FY22E	FY23E
Revenues	2,73,981	2,67,600	1,82,235	2,19,560	2,41,516
OPM (%)	3.7	1.5	5.7	4.8	4.6
Adjusted PAT	6,029	2,092	6,547	6,049	6,168
% y-o-y growth	-5.2	-65.3	212.9	-7.6	2.0
Adjusted EPS (Rs.)	39.6	13.7	43.0	39.7	40.5
P/E (x)	5.2	15.0	4.8	5.2	5.1
P/B (x)	1.1	1.1	1.0	0.9	0.8
EV/EBITDA (x)	5.0	16.3	6.1	5.8	5.4
RoNW (%)	23.1	7.3	21.3	17.8	16.6
RoCE (%)	21.8	6.3	15.1	13.6	13.5

Source: Company; Sharekhan estimates

Note: We now convert HPCL into a Stock Update; It was earlier a 'Viewpoint' under our coverage.

PAT substantially above estimates led by large inventory gain, better core GRM and higher other income

HPCL reported Q2FY2021 operating profit at Rs. 3,342 crore (up 65% y-o-y; down 19.1% q-o-q) was 44% above consensus estimates of Rs. 2,322 crore led by large inventory gains of Rs. 1,780 crore (versus only Rs. 53 crore in Q2FY2020) and better-than-expected core refining margin at $2.7/bbl (up 7.8% y-o-y and above expectation of $1-1.5/bbl). The miss in operating profit as compared to our estimates was due to miss in blended marketing margin at Rs. 3,148/tonne (down 47.4% q-o-q). Reported GRM at $5.1/bbl (up 80.6% y-o-y) was also above our estimate of $2.4/bbl. HPCL's core GRM of $2.7/bbl was better compared to $1.5/bbl for BPCL and negative GRM of $1/bbl for IOCL. The refinery inventory gain stood at Rs. 523 crore (versus Rs. 201 crore in Q1FY2021) and product inventory gain was at Rs. 1,257 crore (versus Rs. 432 crore in Q1FY2021). Volume performance was strong with refinery throughput of 4.1mmt (6.8% above estimate and utilization level of 103%), in-line marketing sales volume at 8.4 mmt (up 10.6% q-o-q) and higher-than-expected pipeline throughput of 4.7 mmt (up 32.8% q-o-q). PAT of Rs. 2,477 crore (up 2.4x y-o-y, down 12% q-o-q), was also significantly above street estimates of Rs. 1,485 crore led inventory gain, better core GRM, volume recovery and higher other income (up 56.5% y-o-y). Gross debt declined by 12.8% q-o-q to Rs. 31,963 crore. Cash flow from operations increased sharply by 72% y-o-y to Rs. 14,637 crore while FCF was up 3.9x y-o-y to Rs10,342 crore in H1FY2021.

Key Conference call takeaways

- **Share buyback program –** HPCL's board has approved share buyback for an aggregate amount not exceeding Rs. 2,500 crore and at a buyback price not exceeding Rs. 250/share (at a 34% premium to closing price of Rs. 187 on November 04, 2020) from the open market through stock exchange mechanism. The maximum equity shares to be bought back at a maximum buyback size and price would be 10 crore equity shares (6.6% of the outstanding equity shares). HPCL's promoters will not participate in the share buyback program. The company is looking to rewarding shareholders through a buyback, dividend and bonus issues. This is the first time that a PSU is doing buyback through open market transaction and the buyback program has to get completed in six months with a minimum acquisition of 50% if the stock price remains below Rs. 250.

- **Business update – Volume above pre-COVID levels; refinery utilization at 103%:** Diesel/petrol sales volume increased sharply by 11.5%/4.7% y-o-y in October 2020 and as compared to only 45%/38%of pre-COVID-19 level in April 2020. Overall, petroleum sales volumes stood at 98% in September and have further improved in October from 50% of pre-COVID-19 level in April 2020. In H1FY2021, HPCL fared well as compared to peers with a marketing volume degrowth at 2% lower than industry levels. Refinery utilisation rate has improved to 103% in Q2FY2021 and expected to further improve as demand for auto fuels well above pre-COVID19 level. Industrial products like bitumen, fuel oil and lubes have also witnessed sharp recovery and in fact lubes sales volume grew by 22.5% y-o-y in Q2FY2021. The total lubes sales volume was at 303 tmt in H1FY2021.

- **Capex guidance –** The management has maintained its capex guidance of Rs. 11,500 crore in FY2021E and has already spent Rs. 4,900 crore in H1FY2021.

- **Update on expansion projects –** Key expansion projects are on track to be commissioned on time. The management reiterated its guidance to complete Vizag refinery expansion project and Mumbai refinery (revamp project) in CY2021. The Resid up-gradation project at Vizag refinery is expected to get completed in CY2022E and the company aims to complete work on the Barmer refinery by CY2023. Post the relaxation of lockdown norms, most project sites have restarted with almost 40,000 workers at various sites. In terms of physical/capex progress 92%/80% of work on Mumbai refinery expansion is complete and 70%/50% for Vizag refinery expansion project.

- **Retail outlets addition and CNG stations –** The company added 895 new retail outlets in H1FY2021 and targets to add 1,800 new fuel stations in FY2021E. Currently, HPCL's total fuel station count is at 17,000 and it plans to take it to 22,000 fuel outlets in next three years. Additionally, the company has 42 mobile dispensers for diesel delivery on a door-to-door basis. The company has a total of 574 CNG stations as of September 2020 versus 499 as of June 2020. Also, 36 outlets have EV charging facility and target is to have additional model energy at every retail outlet.

- **Gas business –** The company is focused to expand gas business with setting up of 5mmt LNG terminal at Chhara and ramp-up of operations in 20 CGD areas spanning over nine states. Also, the company is planning to set up compressed bio-gas manufacturing plant with production capacity of 157,000 mtpa.
- **Crude and product inventory –** The crude and product inventory stands at 1,283 tmt and 3,000 tmt on as June 30, 2020. HPCL normal maintains crude inventory at 15 days.
- Outstanding dues from government reduced to Rs. 4,000 crore as of September 2020 as compared to Rs. 6,300 crore as on March 31, 2020.

Results Rs cr

Particulars	Q1FY21	Q1FY20	YoY (%)	Q4FY20	QoQ (%)
Particulars	Q2FY21	Q2FY20	y-o-y (%)	Q1FY21	q-o-q (%)
Net Sales	51,511	60,573	-15.0	37,498	37.4
Total Expenditure	48,169	58,548	-17.7	33,367	44.4
Reported operating profit	**3,342**	**2,025**	**65.0**	**4,131**	**-19.1**
Adjusted operating profit	3,342	2,025	65.0	4,131	-19.1
Other Income	1,079	690	56.5	785	37.4
EBITDA	4,421	2,715	62.8	4,916	-10.1
Interest	260	286	-8.8	322	-19.1
Depreciation	868	813	6.8	866	0.2
Exceptional income/(expense)	0	0	NA	0	NA
Reported PBT	**3,292**	**1,616**	**103.7**	**3,728**	**-11.7**
Adjusted PBT	3,292	1,616	103.7	3,728	-11.7
Tax	815	565	44.3	915	-10.9
Reported PAT	**2,477**	**1,052**	**135.6**	**2,814**	**-12.0**
Adjusted PAT	2,477	1,052	135.6	2,814	-12.0
Equity Cap (cr)	152	152	-	152	-
Reported EPS (Rs)	16.3	6.9	135.6	18.5	-12.0
Adjusted EPS (Rs)	16.3	6.9	***135.6***	18.5	***-12.0***
Margins (%)			**bps**		**bps**
Adjusted OPM	6.5	3.3	314.4	11.0	-452.9
Adjusted NPM	4.8	1.7	307.4	7.5	-269.4

Source: Company; Sharekhan Research

Key operating metrics

Particulars	Q2FY21	Q2FY20	YoY (%)	Q1FY21	QoQ (%)
Reported GRM ($/bbl)	5.1	2.8	80.6	0.0	NA
Refining inventory gain/(loss) ($/bbl)	2.4	0.3	NA	0.9	159.6
Core GRM ($/bbl)	2.7	2.5	7.8	-0.9	NA
Refining throughput (mmt)	4.1	4.6	-11.0	4.0	2.3
Market sales including exports (mmt)	8.4	9.4	-10.3	7.6	10.6
Pipeline throughput (mmt)	4.7	5.1	-6.9	3.5	32.8
Over/(under) recovery – Rs crore	0	0	NA	0	NA
Refinery inventory gain/(loss) – Rs crore	523	66	NA	201	160.2
Product inventory gain/(loss) – Rs crore	1,257	-13	NA	432	191.0
Forex gain/(loss) – Rs crore	524	-166	NA	49	NA

Source: Company; Sharekhan Research

Outlook and Valuation

■ Sector View – Low oil price environment and high auto fuel marketing margins bode well for OMCs

India's petrol and diesel consumption is expected to grow at 8% and 3% annually, respectively, in the medium term as penetration for two-wheelers and passenger cars improves and GDP growth recovers to normal. The sharp decline in crude oil prices would benefit OMCs in terms of lower working capital requirement and above-average auto fuel marketing margin. Although core refining margins could remain weak in the near term, gradual reduction of global petroleum product inventories (given improvement in oil demand and reduction in refinery run-rates) would improve refining margin in H2FY2021E. Moreover, Brent crude oil price at $38-40 bbl is still well below FY2020 levels of $61/bbl and would benefit refiners in terms of lower refinery fuel and loss.

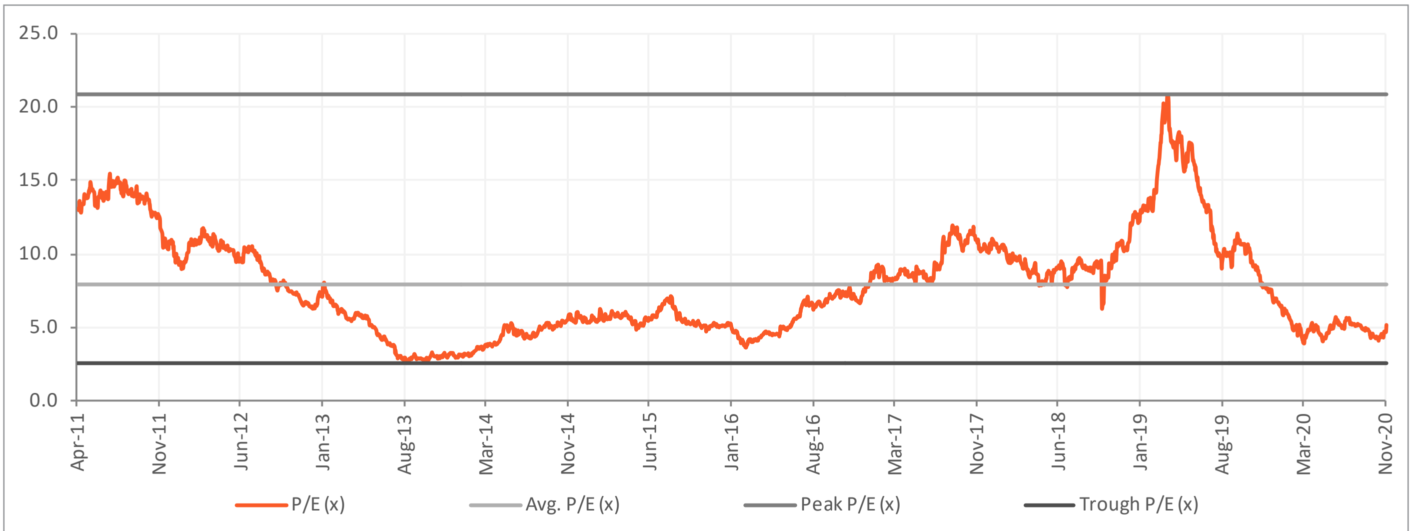
■ Company Outlook – Higher auto fuel marketing margins, volume recovery & refinery utilisation, cost to aid earnings recovery

We believe strong Q2FY2021 results were driven by inventory gains and good core GRM, which would not be sustained in H2FY2021 as crude oil prices have stabilised at $38-40/bbl, while crack spreads for petrol and diesel still remain weak. Hence, earnings momentum would be driven by volume recovery (petrol and diesel sales volume to pre-COVID-19 level in October), overall improvement in marketing margin, higher refinery utilization rate (already at 103%) and benefit of Middle East crude discounts (although core GRM is likely to remain subdued at $1.5-2/bbl). Hence, we expect a strong recovery in earnings growth at a 38% PAT CAGR over FY2020-FY2023E.

■ Valuation – Recommend Buy on HPCL with PT of Rs. 260

We sharply raise our FY2021-FY2022 earnings estimate to factor in: 1) to reflect large inventory gain in Q2FY2021, 2) higher diesel and petrol volume assumption as recovery has been much ahead of expectations and 3) higher refinery utilisation. We have also introduced our FY2023 earnings estimate in this report. We expect faster earning recovery for HPCL among the OMCs as it has outperformed peers with better refinery utilization as HPCL share of marketing sales volume is higher than refinery throughput and strong volume recovery in auto fuels. Hence, we expect CAGR of 38% in PAT over FY2020-FY2023E for HPCL, which is the highest among OMCs. Moreover, HPCL trades at an attractive valuation of 5.1x FY2023EEPS (which is at discount of 36% to its historical average one year forward PE multiple and 55% to that of BPCL on FY2023E PE basis) and offers healthy dividend yield of ~8%. Hence, we recommend a Buy rating on HPCL with PT of Rs. 260.

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 15.8mmt and retail fuel outlets of 17,000. 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 ~39mmt 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
R Kesavan	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	4.6
2	Life Insurance Corp of India	3.1
3	Reliance Capital Trustee Co Ltd	3.0
4	Mirae Asset Global Investments Co	2.1
5	Vanguard Group Inc/The	1.5
6	Franklin Resources Inc	1.4
7	Jupiter Fund Management PLC	1.3
8	BlackRock Inc	1.2
9	ICICI Prudential Life Insurance Co	1.2
10	SBI Funds Management Pvt Ltd	1.0

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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Compliance Officer: Mr. Joby John Meledan; Tel: 022-61150000; email id: compliance@sharekhan.com;

For any queries or grievances kindly email igc@sharekhan.com or contact: myaccount@sharekhan.com

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