# Indian Oil Corporation

24 May 2018

**Reuters: IOC.BO; Bloomberg: IOCL IN**

4QFY18 Result Update

## Subdued Earnings Because Of Lower GRM and Higher Expenses

**Indian Oil Corporation (IOCL) reported earnings of Rs52bn for 4QFY18, down 34% QoQ, primarily because of: 1) Lower gross refining margin or GRM of US$9.2/bbl in 4QFY18 versus US$12.32/bbl in 3QFY18, mainly on account of lower inventory gains of Rs24bn in 4QFY18 versus Rs53bn in 3QFY18. 2) Decline in refinery throughput from 18.2mmt in 3QFY18 to 17.2mmt in 4QFY18. However, earnings grew 40% YoY on account of: 1) Higher expenses in 4QFY17 relating to pay and allowances as per the Third Pay Committee's recommendations and revision of existing liabilities relating to entry tax totaling Rs 66bn. 2) Higher GRM of US$9.2/bbl in 4QFY18 versus US$8.9/bbl in 4QFY17. 3) Rise in product sales from 21.1mmt in 4QFY17 to 22.6mmt in 4QFY18, up 7% YoY.**

**Recent inability of oil marketing companies or OMCs to increase product prices amid a rising crude oil price environment has raised concerns about their ability to hike prices to compensate for the rise in crude oil prices. This also raises concerns on the pricing freedom of OMCs to set prices based on the given formula. Inability to increase prices is expected to negatively impacting their marketing margins. We have revised our SOTP-based valuation of IOCL and retained Sell rating on it with a revised target price of Rs137 (from Rs207 earlier – target price adjusted for bonus issue of 1:1 – ex-date 15th March 2018).**

**Revenues increase on account of higher crude oil prices and product sales:** IOCL's net sales at Rs1,367bn in 4QFY18 increased 4.5% QoQ and 11.8% YoY. Revenues increased because of: 1) Sharp rise in crude oil price from US$53/bbl in 4QFY17 and US$59/bbl in 3QFY18 to US$64/bbl in 4QFY18. 2) Higher product sales at 22.6mmt in 4QFY18 versus 21.1mmt in 4QFY18, up 7%YoY.

**Lower inventory gain and higher expenses lead to weak EBITDA performance:** EBITDA stood at Rs110bn, up 150% YoY and down 16.9% QoQ. Weak EBITDA performance on QoQ basis was on account of: 1) Lower GRM at US$9.2/bbl in 4QFY18 versus US$12.32/bbl in 3QFY18. IOCL reported inventory gain of Rs24bn in 4QFY18 which was significantly lower than Rs53bn in 3QFY18. 2) Other expenses at Rs86.5bn and employee benefit expenses at Rs29.4bn increased 12.7% QoQ and 24.7% QoQ, respectively. However, EBITDA increased 150% YoY on account of:1) Higher expenses in 4QFY17 relating to pay and allowances as per the Third Pay Committee's recommendations and revision of existing liabilities relating to entry tax totaling Rs66bn.

**EBIT impacted by higher depreciation:** Depreciation in 4QFY18 stood at Rs19bn, up 11.8% YoY and 12.7% QoQ.

**Decline in other income and higher finance costs impact earnings negatively**: IOCL reported other income of Rs2.4bn in 4QFY18 versus Rs13.5bn in 3QFY18, down 82% QoQ, and Rs 20.6bn in 4QFY17, down 88% YoY. Finance costs at Rs13bn in 4QFY18 increased 98.9% QoQ and 12.9% YoY. Debt increased from Rs548bn in 4QFY17 to Rs580bn in 4QFY18.

**Retain Sell rating with a revised target price of Rs137 (details on page 3):** Given our concerns on the likely decline in GRM, increase in capex over the next five years, rise in interest costs and concerns over product pricing freedom, we expect the upside in earnings to be capped. We believe that with likely low earnings growth and a decline in RoE and RoCE, the stock will get de-rated. We have retained Sell rating on IOCL with a revised target price of Rs137 (target price adjusted for bonus issue of 1:1 – ex-date 15th March 2018).

## SELL

**Sector:** Oil & Gas

**CMP:** Rs154

**Target Price:** Rs137

**Downside:** 11%

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**Key Data**

| | |
|---|---|
| Current Shares O/S (mn) | 339.6 |
| Mkt Cap (Rsbn/US$bn) | 179/2.8 |
| 52 Wk H / L (Rs) | 562/304 |
| Daily Vol. (3M NSE Avg.) | 337,318 |

**Price Performance (%)**

| | 1 M | 6 M | 1 Yr |
|---|---|---|---|
| IOCL | (5.0) | (18.0) | (28.3) |
| Nifty Index | (1.7) | 0.4 | 11.4 |

*Source: Bloomberg*

| Y/E March (Rsmn) | 4QFY18 | 3QFY18 | QoQ (%) | 4QFY17 | YoY (%) | 4QFY18E | Var. (%) |
|---|---|---|---|---|---|---|---|
| **Net sales** | **1,367,326** | **1,308,651** | *4.5* | **1,222,853** | *11.8* | **1,389,974** | *(1.6)* |
| Cost of goods | (1,141,125) | (1,075,523) | *6.1* | (1,016,207) | *12.3* | (1,184,332) | *(3.6)* |
| Employee benefits expenses | (29,419) | (23,595) | *24.7* | (42,020) | *(30.0)* | (24,067) | *22.2* |
| Other expenses | (86,570) | (76,846) | *12.7* | (120,540) | *(28.2)* | (78,383) | *10.4* |
| **EBITDA** | **110,213** | **132,687** | *(16.9)* | **44,086** | *150.0* | **103,192** | *6.8* |
| ***EBITDAM (%)*** | ***8.1*** | ***10.1*** | - | ***3.6*** | - | ***7.4*** | - |
| Depreciation and amortisation | (19,336) | (17,151) | *12.7* | (17,290) | *11.8* | (17,837) | *8.4* |
| **EBIT** | **90,876** | **115,537** | *(21.3)* | **26,796** | *239.1* | **85,355** | *6.5* |
| ***EBITM (%)*** | ***6.6*** | ***8.8*** | - | ***2.2*** | - | ***6.1*** | - |
| Other income | 2,481 | 13,534 | *(81.7)* | 20,593 | *(88.0)* | 13,070 | *(81.0)* |
| Interest expenses | (13,029) | (6,549) | *98.9* | (11,541) | *12.9* | (7,859) | *65.8* |
| Extraordinary/exceptional items | | | - | | - | | - |
| **Profit before tax** | **80,329** | **122,522** | *(34.4)* | **35,849** | *124.1* | **90,566** | *(11.3)* |
| Tax expenses | (28,148) | (43,690) | | 1,358 | | (29,887) | - |
| *Effective tax rate (%)* | *0.35* | *0.36* | - | *(0.04)* | - | *0.33* | - |
| **PAT** | **52,181** | **78,832** | *(33.8)* | **37,206** | *40.2* | **60,679** | *(14.0)* |

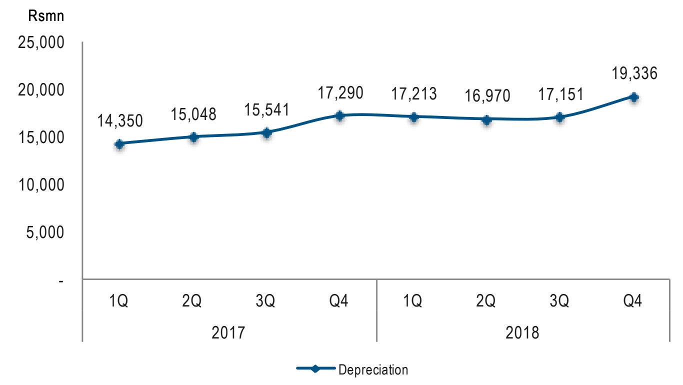
*Source: Company, Nirmal Bang Institutional Equities Research*

### Exhibit 1: Key financials

| Y/E March (Rsmn) | FY16 | FY17 | FY18E | FY19E | FY20E |
|---|---|---|---|---|---|
| Revenues | 3,460,447 | 3,553,101 | 4,480,501 | 4,985,437 | 5,329,306 |
| *YoY (%)* | *( 22.1)* | *2.7* | *26.1* | *11.3* | *6.9* |
| EBITDA | 234,429 | 340,132 | 320,926 | 344,134 | 352,377 |
| *YoY (%)* | *136.5* | *45.1* | *(5.6)* | *7.2* | *2.4* |
| PAT | 120,225 | 198,495 | 179,763 | 191,164 | 195,047 |
| *YoY (%)* | *144.8* | *65.1* | *(9.4)* | *6.3* | *2.0* |
| *EPS (Rs)* | 12.4 | 20.4 | 18.5 | 20 | 20.1 |
| *RoE (%)* | *13.8* | *20.0* | *21.0* | *21.1* | *20.2* |
| EV/EBITDA (x) | 9.3 | 6.9 | 6.7 | 6.6 | 6.8 |
| P/E (x) | 12.1 | 7.4 | 8.2 | 7.7 | 7.6 |

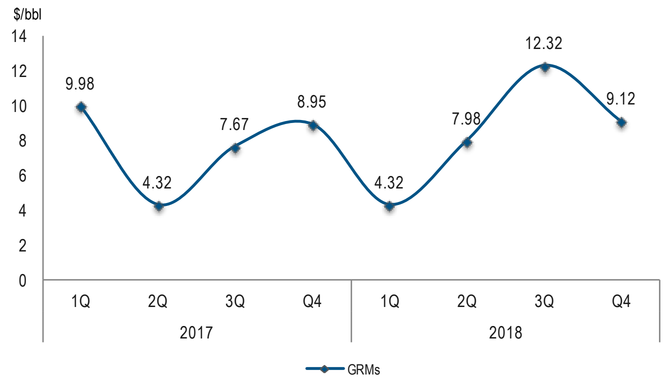
*Source: Company, Nirmal Bang Institutional Equities Research*

### Exhibit 2: Depreciation




*Source: Company, Nirmal Bang Institutional Equities Research*

### Exhibit 3: GRM




*Source: Company, Nirmal Bang Institutional Equities Research*

### Exhibit 4: Interest costs


*Source: Company, Nirmal Bang Institutional Equities Research*

**Exhibit 5: SOTP valuation**

| Particulars | BV –FY20E (Rsmn) | (Discount)/premium (%) | Current discounted book value (Rsmn) | Number of shares | Current value/share (Rs) |
|---|---|---|---|---|---|
| Refining and marketing- standalone | 1,252,574 | (20) | 1,002,060 | 9,712 | 103 |
| **Valuation of Investments** | | | | | |
| Petronet LNG (market value) | 1,21,058 | - | 1,21,058 | 9,712 | 12 |
| CPCL (market value) | 10,040 | - | 10,040 | 9,712 | 1 |
| ONGC (market value) | 39,488 | - | 39,488 | 9,712 | 4 |
| GAIL (market value) | 6,381 | - | 6,381 | 9,712 | 1 |
| Oil India (market value) | 21,538 | - | 21,538 | 9,712 | 2 |
| Others (book value) | 1,33,300 | - | 1,33,300 | 9,712 | 14 |
| **Total** | **1,584,379** | **-** | **1,33,3864** | **9,712** | **137** |

*Source: Company, Nirmal Bang Institutional Equities Research*

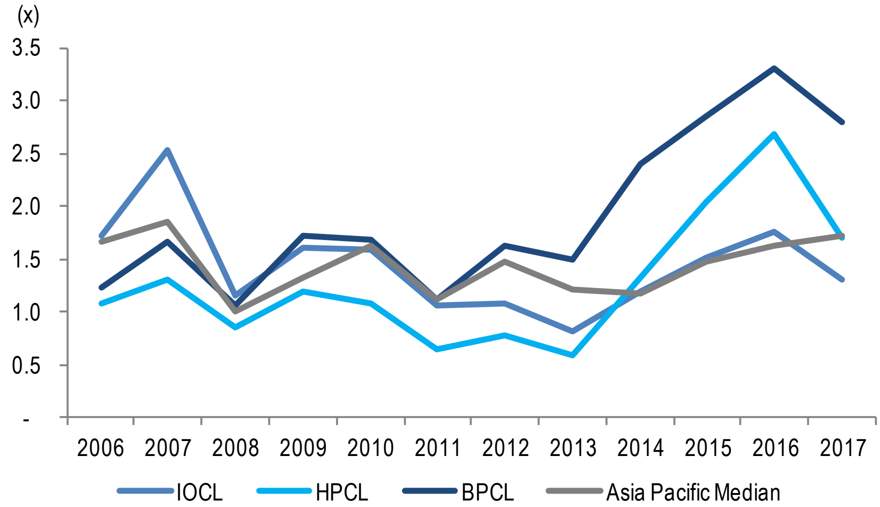
We have revised our target price on the stock from Rs207 earlier (based on 30% premium to the refining and marketing book value) to Rs137 based on 20% discount to FY20E refining and marketing book value. Our sharp downward revision of the target price is driven by:

1. Likely impact of revival of capex cycle on earnings growth.
2. Lack of control on product pricing which is expected to lead to lack of transparency in earnings.

Our reduction of 50% of book value (from 30% premium to refining and marketing book value to 20% discount to book value) is primarily driven by rising concerns over product pricing freedom of OMCs.

## Re-rating of OMCs relative to Asia Pacific peers

**Exhibit 6: Valuation - Asia Pacific peers (Price/Book Value –TTM)-**




*Source: Bloomberg, Nirmal Bang Institutional Equities Research*

Exhibit 6 shows the P/BV (TTM) of IOCL, HPCL and BPCL versus their Asia Pacific peers. We have observed that before 2014, P/BV of OMCs were generally trading below the Asia Pacific median. However, post deregulation of high speed diesel or HSD in 2014, OMCs started trading at a premium to the Asia Pacific median P/BV.

The main reasons for the historical re-rating are:

1. Beneficial impact of deregulation.
2. Marginal capex helping in reducing interest costs and depreciation.
3. Transparency in earnings with an assumption that deregulation implies freedom in product pricing.

As a result of the reasons stated above, the stocks got re-rated and they started trading at higher P/BV multiples.

However, in the past one year, the stocks have been trending downwards sharply.

## De-rating of OMCs in the past year is expected to continue

In the past one year, the stocks have got de-rated and we expect this to continue. The key reasons are:

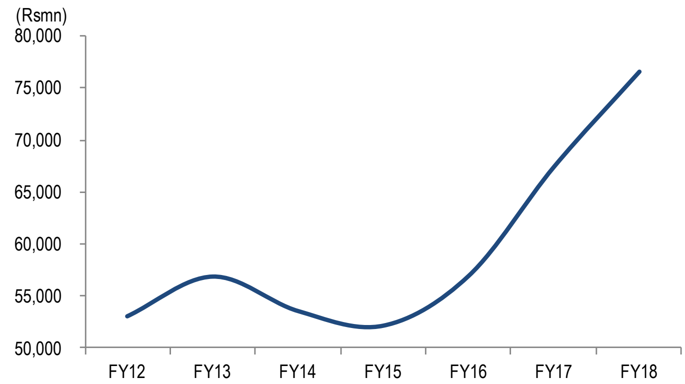
1. Capex expected to increase the pressure on earnings because of the rise in depreciation and interest costs.
2. Lack of product pricing freedom, as observed in the recent past.

## Capex cycle reverses

The start of the capex cycle exerts pressure on cash flow - increase in interest cost and depreciation. IOCL has announced aggressive capex plan for the next five years. We expect the increased capex to increase net debt, thus moving up interest costs and increasing the pressure on free cash flow. For FY19, IOCL has announced a capex of Rs2,00,000mn (refining ~40%,marketing ~25%, pipeline ~15%, petchem ~11% and others ~ 9%) which shall be partially funded through internal accruals and the balance with debt.

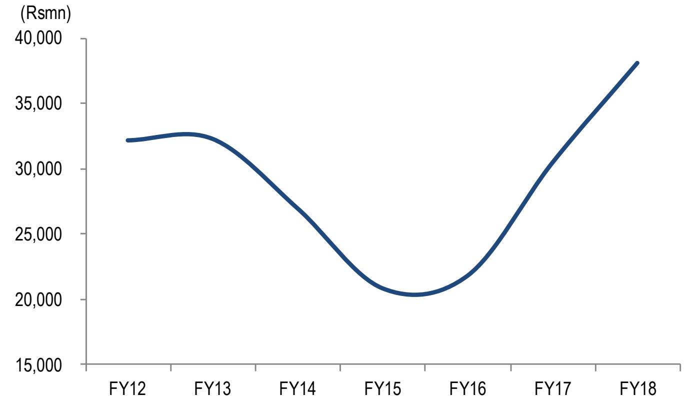
Depreciation and amortisation has increased at 5% CAGR over FY12-FY17 and interest expenses declined by 1% CAGR over the same period. However, depreciation and amortisation at Rs76.6bn in FY18 increased 13.5% YoY and interest expenses at Rs38bn rose 25% YoY.

**Exhibit 7: Depreciation and amortisation**




*Source: Company, Nirmal Bang Institutional Equities Research*

**Exhibit 8: Interest expenses**




*Source: Company, Nirmal Bang Institutional Equities Research*

## Lack of product pricing freedom

In the recent past, OMCs did not increase fuel prices just before the Karnataka assembly elections. This fuel price freeze lasted for 20 days till 14 May 2018. In the current rising crude oil price environment, we believe that: 1) There are uncertainties relating to OMCs' ability to pass on the rise in crude oil price to customers. 2) Lack of transparency in terms of fuel pricing based on the given formula.

## Consolidated financials

### Exhibit 9: Income statement

| Y/E March (Rsmn) | FY16 | FY17 | FY18E | FY19E | FY20E |
|---|---|---|---|---|---|
| **Net sales** | **3,460,447** | **3,553,101** | **4,480,501** | **4,985,437** | **5,329,306** |
| *Growth YoY (%)* | *(22.1)* | *2.7* | *26.1* | *11.3* | *6.9* |
| Operating costs | 2,850,235 | 2,751,190 | 3,985,930 | 4,450,824 | 4,768,302 |
| Staff expenses | 75,018 | 102,040 | 78,443 | 84,802 | 91,679 |
| **Other expenses** | **300,765** | **359,738** | **95,202** | **105,676** | **116,948** |
| **EBITDA** | **234,429** | **340,132** | **320,926** | **344,134** | **352,377** |
| ***EBITDA growth (%)*** | ***136.5*** | ***45.1*** | ***(5.6)*** | ***7.2*** | ***2.4*** |
| ***EBITDA margin (%)*** | ***6.8*** | ***9.6*** | ***7.2*** | ***6.9*** | ***6.6*** |
| Depreciation | 56,984 | 68,486 | 67,605 | 67,755 | 67,905 |
| **EBIT** | **177,445** | **271,646** | **253,321** | **276,379** | **284,472** |
| ***EBIT (%)*** | ***5.1*** | ***7.6*** | ***5.7*** | ***5.5*** | ***5.3*** |
| Net interest expenses | 34,690 | 37,213 | 25,405 | 32,574 | 35,774 |
| Other income | 21,865 | 45,125 | 42,616 | 42,616 | 42,616 |
| Other adjustments | (16,098) | - | - | - | - |
| **Earnings before tax** | **180,718** | **279,558** | **270,533** | **286,421** | **291,314** |
| Tax- total | 56,584 | 75,704 | 86,905 | 91,392 | 92,402 |
| *Rate of tax (%)* | *31.3* | *27.1* | *32.1* | *31.9* | *31.7* |
| **Net profit** | **124,133** | **203,854** | **183,628** | **195,029** | **198,912** |

*Source: Company, Nirmal Bang Institutional Equities Research*

### Exhibit 10: Cash flow

| Y/E March (Rsmn) | FY16 | FY17 | FY18E | FY19E | FY20E |
|---|---|---|---|---|---|
| Profit after tax | 124,133 | 203,854 | 183,628 | 195,029 | 198,912 |
| Depreciation | 56,984 | 68,486 | 67,605 | 67,755 | 67,905 |
| Other income | (7,375) | 69,421 | (42,616) | (42,616) | (42,616) |
| **Interest** | **13,963** | **10,768** | **25,405** | **32,574** | **35,774** |
| Working capital changes | 33,856 | (76,220) | 6,723 | (4,628) | 10,275 |
| Others | 34,682 | 5,370 | 700 | 700 | 700 |
| **Operating cash flow** | **256,242** | **281,680** | **241,444** | **248,814** | **270,950** |
| Capital expenditure | (160,479) | (137,802) | (195,000) | (255,000) | (255,000) |
| Investments | 2,241 | (65,382) | - | - | - |
| Other income | 22,134 | 26,821 | 42,616 | 42,616 | 42,616 |
| Cash flow from investments | (136,104) | (176,363) | (152,384) | (212,384) | (212,384) |
| Equity | - | - | - | - | - |
| Debt | (44,699) | 46,420 | 90,000 | 130,000 | 130,000 |
| Interest expenses | (39,496) | (28,021) | (25,405) | (32,574) | (35,774) |
| Dividends | (34,703) | (127,768) | (124,986) | (136,348) | (136,348) |
| Cash flow from financing | (118,897) | (109,370) | (60,390) | (38,922) | (42,122) |
| **Total cash generation** | **1,241** | **(4,053)** | **28,671** | **(2,492)** | **16,444** |
| Opening cash balance | 6,108 | 7,349 | 3,295 | 31,967 | 29,475 |
| **Closing cash & bank balance** | **7,349** | **3,295** | **31,967** | **29,475** | **45,919** |

*Source: Company, Nirmal Bang Institutional Equities Research*

### Exhibit 11: Balance sheet

| Y/E March (Rsmn) | FY16 | FY17 | FY18E | FY19E | FY20E |
|---|---|---|---|---|---|
| Share capital | 23,697 | 47,393 | 48,559 | 48,559 | 48,559 |
| Reserves and surplus | 876,099 | 973,568 | 827,370 | 875,186 | 933,886 |
| **Net worth** | **899,796** | **1,020,961** | **875,929** | **923,745** | **982,445** |
| Loans | 689,711 | 830,598 | 686,057 | 816,057 | 946,057 |
| Minority interest | 14,260 | 19,046 | 21,873 | 25,738 | 29,603 |
| Deferred tax liability | 69,708 | 68,887 | 97,558 | 98,258 | 98,958 |
| **Total capital employed** | **1,673,475** | **1,939,492** | **1,681,418** | **1,863,799** | **2,057,064** |
| | | | | | |
| Net fixed assets | 1,262,513 | 1,327,352 | 1,517,344 | 1,704,589 | 1,891,685 |
| Goodwill | 10 | 10 | 791 | 791 | 791 |
| Investments | 315,680 | 442,143 | 186,610 | 186,610 | 186,610 |
| **Current assets loans** | **737,350** | **966,105** | **1,131,451** | **1,200,201** | **1,259,694** |
| Inventories | 422,567 | 658,843 | 564,509 | 622,285 | 647,537 |
| Debtors | 76,845 | 88,992 | 108,253 | 118,717 | 126,512 |
| Cash and bank | 7,349 | 3,295 | 31,967 | 29,475 | 45,919 |
| Loans and advances | 120,506 | 93,254 | 310,984 | 320,984 | 330,984 |
| Current investments | 110,084 | 121,722 | 115,737 | 108,739 | 108,742 |
| **Less: Current liab. & prov.** | **642,080** | **796,119** | **1,154,778** | **1,228,392** | **1,281,716** |
| Current liabilities | 540,149 | 605,453 | 797,413 | 865,381 | 918,704 |
| Provisions | 101,931 | 190,665 | 357,365 | 363,011 | 363,011 |
| **Net current assets** | **95,270** | **169,986** | **(23,328)** | **(28,191)** | **(22,022)** |
| **Miscellaneous** | **-** | **-** | **-** | **-** | **-** |
| **Total capital employed** | **1,673,475** | **1,939,492** | **1,681,418** | **1,863,799** | **2,057,064** |

*Source: Company, Nirmal Bang Institutional Equities Research*

### Exhibit 12: Key ratios

| Y/E March (Rsmn) | FY16 | FY17 | FY18E | FY19E | FY20E |
|---|---|---|---|---|---|
| **Profitability and return ratios** | | | | | |
| EBITDA margin (%) | 6.8 | 9.6 | 7.2 | 6.9 | 6.6 |
| EBIT margin (%) | 5.13 | 7.65 | 5.65 | 5.54 | 5.34 |
| Net profit margin (%) | 3.5 | 5.6 | 4.0 | 3.8 | 3.7 |
| RoE(%) | 13.8 | 20.0 | 21.0 | 21.1 | 20.2 |
| RoCE (%) | 11.2 | 14.7 | 16.6 | 16.2 | 15.1 |
| **Working capital & liquidity ratios** | | | | | |
| Receivables (days) | 8 | 9 | 9 | 9 | 9 |
| Inventory (days) | 54 | 87 | 52 | 51 | 50 |
| Payables (days) | 69 | 80 | 73 | 71 | 70 |
| Current ratio (x) | 1.15 | 1.21 | 0.98 | 0.98 | 0.98 |
| **Valuation ratios** | | | | | |
| EV/sales (x) | 0.6 | 0.7 | 0.5 | 0.5 | 0.5 |
| EV/EBITDA (x) | 9.3 | 6.9 | 6.7 | 6.6 | 6.8 |
| P/E (x) | 12.1 | 7.4 | 8.2 | 7.7 | 7.6 |
| P/BV (x) | 1.7 | 1.5 | 1.7 | 1.6 | 1.5 |

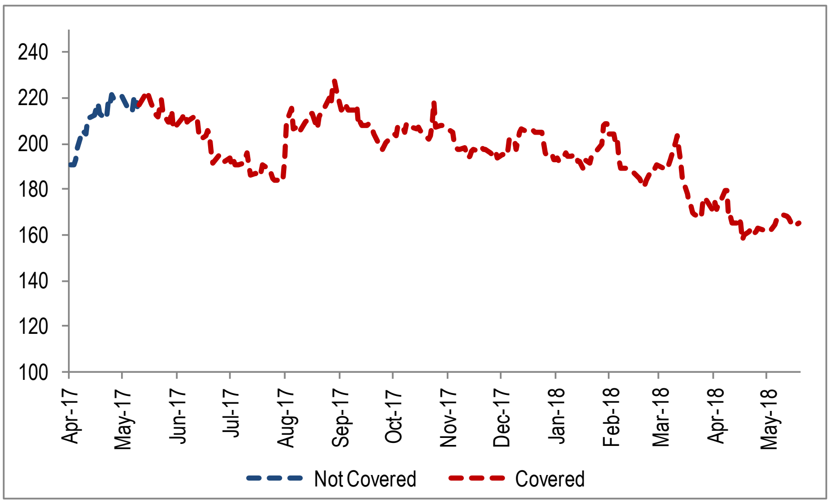
*Source: Company, Nirmal Bang Institutional Equities Research*

## 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 |

**Price after 1:1 bonus issue*

### Rating track graph



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BUY > 15%

ACCUMULATE -5% to15%

SELL < -5%

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