

# ONGC-HPCL Acquisition Update

22 January 2018

ONGC (Oil and Natural Gas Corporation) acquires 51.11% of President of India in HPCL (Hindustan Petroleum Corporation Limited) at a price of Rs473.97 per share (a premium of 13.8% on closing price of 19<sup>th</sup> January 2018 and 11.3% premium on past 60 days weighted average market price of Rs425.63 ).

As per the filing with BSE, rationale for the acquisition is 1) Capacity to bear higher risk. 2) Avail economies of scale 3) Take higher investment decisions and create stakeholder value 4) Create an oil major which is able to match the performance of national and international oil and gas companies. 5) Performance of integrated oil companies balance upstream and downstream pressures and provide stability despite volatility in crude prices.

In the long term with global OMCs consolidating, ONGC purchase of HPCL will combine the upstream and downstream oil & gas operations and we could observe some benefit of integration in terms of efficiencies and stability in earnings in a volatile crude price environment. However, in the short to medium term we expect strong probability that HPCL will buy the shareholding of MRPL from ONGC. This, together with increasing capex of HPCL will further increase the pressure on the cash flow. We might even see a higher interest cost impacting the margins negatively. We reiterate our SELL on HPCL with a Target Price of Rs 321.

ONGC to buy Govt stake in HPCL- Key points

- **First Stage: ONGC buys 51.11% government stake in HPCL**
- **Second Stage: How ONGC could plan to fund the acquisition**
- **Increased debt for HPCL if he has to buy MRPL stake – increasing interest cost (impacting margins negatively) and pressure on cash flows**
- **The benefit of integration – improved efficiencies and minimizing risk**

**First Stage: ONGC buys 51.11% government stake in HPCL:** ONGC will buy 51.11% government's stake in HPCL at a price of Rs473.97 per share (a premium of 13.8% on closing price of 19<sup>th</sup> January 2018 and 11.3% premium on past 60 days weighted average market price of Rs425.63 ) leading to a total outflow of Rs 3,69,150mn.

**Second Stage: How ONGC could plan to fund the acquisition:** ONGC will pay Rs 3,69,150mn for the purchase for 51.1% Government's stake in HPCL. ONGC has cash and cash equivalents (as of FY17) worth Rs 1,30,136mn. The balance of funding could be expected from 1) ONGC borrowing Rs2,39,014mn increasing its Gross Debt to Rs7,95,833mn 2) Sale of ONGC's stake in MRPL (around 71.63%) to HPCL (based on closing price of MRPL as on 19<sup>th</sup> January 2018) which would be amounting to Rs1,58,511mn and borrowing the balance Rs80,463mn. 3) HPCL to issue additional 372mn (based on past 60 day average price of HPCL) shares in lieu of purchasing 71.63% stake of MRPL. 4) Sale of 13.77% stake in IOCL (Indian oil corporation limited) worth Rs2,57,833mn (based on closing price of IOCL as on 19<sup>th</sup> January 2018).

**Increased debt for HPCL if he has to buy MRPL stake:** Our estimate of operating cash flow and capex for HPCL for FY18 is INR 57,556million and INR 66,000million respectively. HPCL may have to purchase ONGC's stake in MRPL to fund the balance Rs1,58,511mn leading to increased debt for HPCL. Net Debt of HPCL as of FY17 is around Rs1,78,958mn (FY17) which could increase to Rs3,37,509mn to undertake this transaction. This may lead to increased interest cost and impact HPCL's margins negatively.

**Benefit of integration:** We have seen global firms like Exxon Mobil and Royal Dutch which have consolidated their exploration, refining and marketing operations and ONGC is following the path. The consolidation could help in improving efficiencies and also help in minimizing the risk related to the volatility of crude prices.

**We reiterate our SELL on HPCL with a target price of Rs321:** Increasing concerns on the balance sheet health. If HPCL were to purchase ONGC stake in MRPL, the Net debt will increase from INR 1,78,958 million to Rs3,37,509mn. This would put incremental pressure on the margins with the increased interest costs. It could give the combined entity a greater ability to bear risk and improve efficiencies to some extent but the increased debt for HPCL would be a negative trigger.

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Y/E March (Rs mn)	FY16	FY17	FY18E	FY19E	FY20E
Revenues	1,755,890	1,874,263	2,202,148	2,346,022	2,492,015
YoY(%)	(11.9)	6.7	17.4	6.5	6.2
EBITDA	79,657	108,130	110,765	120,989	130,926
EBITDA (%)	53.0	35.7	2.4	9.2	8.2
PAT	38,627	82,358	64,310	68,577	70,282
YoY (%)	41.3	113	(22)	6.6	2.5
EPS (Rs)	25.4	54	42.2	45.0	46.1
RoE (%)	21.0	28.0	24.5	22.4	20.1
EV/EBITDA (x)	7.5	5.4	5.4	5.4	5.5
P/E (x)	17.5	10.9	10.5	9.9	9.6

Source: Nirmal Bang Institutional Equities Research

## Exhibit 1: Net Debt of OMCs

Particulars (Rsmn)	ONGC	HPCL	IOCL
Gross Debt	556,819	180,322	588,300
Cash and Cash Equivalents	130,136	1,364	4,098
<b>Net Debt</b>	<b>426,683</b>	<b>178,958</b>	<b>584,203</b>

Source: Respective companies, Nirmal Bang Institutional Equities Research

## Exhibit 2: Cross Holdings

Held By/Held In	ONGC	Oil India	Indian Oil Corporation	HPCL	MRPL
ONGC	-	-	13.77%	-	71.63%
Oil India	-	-	5%	-	-
Indian Oil Corporation	7.69%	-	-	-	-
HPCL	-	-	-	-	16.96%

Source: Respective companies, Nirmal Bang Institutional Equities Research

## Exhibit 3: Market Capitalization of OMCs as of 19<sup>th</sup> Jan 2018

Market Capitalization (Rsmn)	ONGC	Oil India	Indian Oil Corporation	HPCL	MRPL
	2,484,514	283,158	1,872,922	634,748	221,353

Source: Respective companies, Nirmal Bang Institutional Equities Research

## Financials

### Exhibit 4: Income statement

Y/E March (Rs mn)	FY16	FY17	FY18E	FY19E	FY20E
Net sales	1,755,890	1,874,263	2,202,148	2,346,022	2,492,015
Growth YoY (%)	(11.9)	6.7	17.5	25.2	6.2
Operating costs	1,617,724	1,636,424	2,026,877	2,157,301	2,289,971
Staff expenses	23,145	29,694	25,518	26,794	28,133
Other expenses	35,364	100,015	38,988	40,938	42,985
EBITDA	79,657	108,130	110,765	120,989	130,926
EBITDA (%)	4.5	5.8	5.0	5.2	5.3
% growth	53.0	35.7	2.4	11.9	8.2
Depreciation	26,803	27,763	26,330	29,411	34,284
EBIT	52,854	80,367	84,435	91,579	96,643
EBIT (%)	3.0	4.2	3.8	13.9	3.9
Net interest expense	5,818	6092	2,175	3,503	6,637
Other income	14,282	37,700	13,868	14,431	15,051
Other adjustments	3,937	0	0	0	0
Earnings before tax	57,381	111,974	96,128	102,507	105,056
Tax-total	18,753	29,616	31,818	33,930	34,773
Rate of tax (%)	32.7	26.4	33.1	33.1	33.1
Net profit	38,627	82,358	64,310	68,577	70,282
% growth	41.3	113	(22)	(16.7)	2.5
EPS (FD)	25	54	42	45	46
% growth	41.3	113	3.3	6.6	2.5
DPS	8	13	13	15	15
Payout ratio (%)	36.4	24.0	36.7	37.9	37.0

Source: Company, Nirmal Bang Institutional Equities Research

### Exhibit 6: Balance sheet

Y/E March (Rsmn)	FY16	FY17	FY18E	FY19E	FY20E
Share capital	3,390	10,159	10,159	10,159	10,159
Reserves and surplus	180,171	212,068	252,764	295,366	339,673
Net worth	183,561	222,227	262,923	305,525	349,832
Loans	213,368	212,118	245,118	321,118	391,118
Deferred tax liability	48,105	49,105	50,105	51,105	52,105
Capital employed	445,033	483,449	558,145	677,747	793,054
Net fixed assets	353,227	387,101	427,271	528,360	634,576
Investments	60,090	60,590	61,090	61,590	62,090
Current assets, loans & adv.	291,392	317,389	347,664	376,201	392,932
Inventories	127,091	128,928	141,621	151,994	159,277
Debtors	41,927	47,635	52,582	56,018	59,504
Cash and bank	70,245	88,196	100,331	114,559	120,022
Others	52,130	52,630	53,130	53,630	54,130
Less Current liabilities	259,676	281,631	277,879	288,404	296,544
Current liabilities	238,108	243,608	239,757	247,709	255,765
Provisions	21,568	38,022	38,122	40,695	40,779
Net current assets	(38,528)	(52,437)	(30,547)	(26,762)	(23,634)
Total capital employed	445,033	483,449	558,145	677,747	793,054

Source: Company, Nirmal Bang Institutional Equities Research

### Exhibit 5: Cash flow

Y/E March (Rs mn)	FY16	FY17	FY18E	FY19E	FY20E
Profit after tax	38,627	82,358	64,310	68,577	70,282
Depreciation	26,594	24,746	25,830	28,911	33,784
Other income	(14,282)	(14,857)	(13,868)	(14,431)	(15,051)
Interest	5,818	2,980	2,175	3,503	6,637
Working cap changes	(6,184)	4,357	(21,891)	(6,146)	(3,128)
Others	3,304	999	1,000	1,000	1,000
Operating cash flow	53,878	80,505	57,556	81,413	93,524
Capex	(52,762)	(58,620)	(66,000)	(130,000)	(140,000)
Investments	(645)	(500)	(500)	(500)	(500)
Other income	14,282	14,857	13,868	14,431	15,051
Cash flow from investments	(39,125)	(44,263)	(52,632)	(116,069)	(125,449)
Equity	(0)	0	0	(0)	0
Debt	10,014	(1,250)	33,000	76,000	70,000
Interest expenses	(5,818)	(2,980)	(2,175)	(3,503)	(6,637)
Dividends	(9,985)	(14,061)	(23,614)	(23,614)	(25,975)
Cash flow from financing	(5,790)	(18,291)	7,211	48,883	37,387
Total cash generation	8,964	17,951	12,135	14,228	5,463
Opening cash balance	61,281	70,245	88,196	100,331	114,559
Closing cash balance	70,245	88,196	100,331	114,559	120,022

Source: Company, Nirmal Bang Institutional Equities Research

### Exhibit 7: Key ratios

Y/E March	FY16	FY17	FY18E	FY19E	FY20E
<b>Profitability and return ratios</b>					
EBITDA margin (%)	4.5	5.3	5.0	5.2	5.3
EBIT margin (%)	3.0	4.1	3.8	3.9	3.9
Net profit margin (%)	2.2	3.1	2.9	2.9	2.8
RoE(%)	21.0	28.0	24.5	22.4	20.1
RoCE (%)	16.2	23.5	20.7	17.9	15.6
<b>Working capital &amp; liquidity ratios</b>					
Receivables (days)	9	9	9	9	9
Inventory (days)	26	24	23	24	23
Payables (days)	15	17	17	17	17
Current ratio (x)	0.9	0.8	0.9	1.0	1.0
<b>Quick ratio(x)</b>	<b>0.5</b>	<b>0.5</b>	<b>0.6</b>	<b>0.6</b>	<b>0.6</b>
<b>Valuation ratios</b>					
EV/sales (x)	0.3	0.3	0.3	0.3	0.3
EV/EBITDA (x)	7.5	5.4	5.4	5.4	5.5
P/E (x)	17.5	10.9	10.5	9.9	9.6
P/BV (x)	2.5	2.0	1.7	1.5	1.3

Source: Company, Nirmal Bang Institutional Equities Research

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