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Indian Oil Corporation Ltd.

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Paradip refinery to drive better profitability

Indian Oil Corporation Ltd. (IOCL) has a strong presence in refining, marketing, pipelines networks and petrochemicals. It is the largest oil marketing company in India with a ~43% market share. Further, it has the largest network of retail outlets across the country (more than 26,000 outlets). IOCL also has minor interest in the upstream segment.

Investment Rationale

Largest operator of crude and product pipelines: IOCL has the largest network of cross-country pipelines in India with a total length of 12,848 kilometers (kms) and capacity of 103.19 million metric tonnes per annum (mmtpa). Of its total pipeline infrastructure, 5,217 kms is used to transport crude oil with a capacity of 48.6 mmtpa while 7,491 kms is a product pipeline with a capacity of 45.1 mmtpa.

Most extensive marketing network: The company has an extensive marketing network with a market share of 42.9% as of FY17. It markets various brands of petrol, diesel, aviation fuel, lubricants and LPG. It has 26,212 retail outlets across India and reaches 114.4mn households with its cooking gas brand, Indane. Further, IOCL continued to maintain its dominant position in the Indian downstream sector with total petroleum product sales of 74.1mn tonnes in FY17.

Core GRM improving steadily: IOCL's gross refining margin (GRM) declined and stood at USD4.3/bbl (USD10.0/bbl in Q1FY17 and USD8.9/bbl in Q4FY17) mainly due to a large inventory loss of USD3.3/bbl in Q1FY18. However, core GRM (excluding inventory gain or loss) improved and stood at USD7.6/bbl (premium of $1.2/bbl to Singapore Complex GRM) as compared to USD3.6/bbl in Q1FY17 and USD6.9/bbl in Q4FY17.

Paradip refinery to drive earnings in FY19E: Paradip refinery started operating at 100+% rate since May 2017. The Paradip refinery (15 MMTPA), on full capacity utilization, can consistently generate GRMs which will be at a premium to Singapore benchmarks given its high complexity adding to IOCL's refining margins. Hence, we expect Paradip refinery to drive the company's profitability over FY17-19E and project EBITDA to grow at a CAGR of 8%.

Outlook and Valuation:

Within state oil marketing companies (OMCs), IOCL is our top pick given its diversified business model, further ramp-up of Paradeep refinery and potential upside in marketing segment. Moreover, IOCL also offers an attractive dividend yield of ~4.6%. Hence, we continue to maintain BUY rating to the stock with a target price (TP) of Rs. 468 using sum of the part (SOTP) valuation methodology wherein we value its standalone business at Rs. 427 (P/E of 10.0x for FY19E) and investments at Rs. 41.

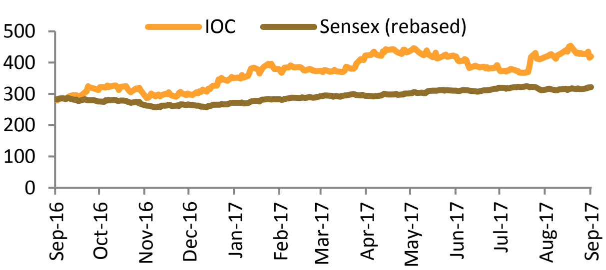
Market Data

Rating	**BUY**
CMP (Rs.)	415
Target (Rs.)	468
Potential Upside	13%
Duration	Long Term
Face Value (Rs.)	10
52 week H/L (Rs.)	463/279
Adj. all time High (Rs.)	463
Decline from 52WH (%)	10.4
Rise from 52WL (%)	48.7
Beta	0.3
Mkt. Cap (Rs.Cr)	201,569

Fiscal Year Ended

Y/E	FY16	FY17	FY18E	FY19E
Revenue (Rs.Cr)	347,176	359,873	384,552	399,017
Adj. profit (Rs.Cr)	9,878	19,106	19,275	20,346
Adj. EPS (Rs.)	41.7	40.3	40.7	42.9
P/E (x)	10.0	10.3	10.2	9.7
P/BV (x)	1.1	2.0	1.8	1.7
ROE (%)	12.7	20.3	18.6	18.3

One year Price Chart



Shareholding Pattern	Jun-17	Mar-17	Chg.
Promoters	57.3	57.3	-
FII's	6.5	5.4	1.1
MFs/Insti	10.8	11.7	(0.9)
Public	25.4	25.6	(0.2)
Others	-	-	-

Indian Oil Corporation Limited: Business overview

Indian Oil Corporation Ltd. (IOCL) was formed in 1964, following the merger of Indian Refineries with Indian Oil Company. Presently, it is the largest oil marketing company in India with a ~43% market share. It also has the largest network of retail outlets across the country (more than 26,000 outlets). Further, it has the largest refining capacity in the country at 80.7 million metric tonnes per annum (mmtpa). It has commissioned its 15.0 mmtpa refinery at Paradip which is the most complex PSU refinery. Moreover, IOCL has a large presence in pipelines and chemicals. Stable earnings from pipelines cushion it from the volatility of the refining and marketing segments. Besides, IOCL enjoys a first mover advantage and strong presence in the high entry barrier rural areas (~26%) which will enable it to ride the robust rural demand growth.

Refineries controlled

Refineries	Installed Capacities (mmtpa)
Koyali	13.7
Panipat	15.0
Mathura	8.0
Barauni	6.0
Haldia	7.5
Paradip	15.0
Bongaigaon	2.4
Guwahati	1.0
Digboi	0.7
Standalone IOCL	**69.2**
CPCL, Chennai	10.5
CPCL, Narimanam	1.0
Subsidiaries	**11.5**
Group Total	**80.7**

Source: Company, In-house research

Pipeline network

Operating Pipelines	Length (km)	Capacities (mmtpa)
Crude Oil	5,217	48.60
Product	7,491	45.09
Gas	140	9.50
Total	**12,848**	-

Source: Company, In-house research

IOCL also forayed into the Exploration & Production segment by acquiring participating interests in several domestic as well as overseas blocks. The company's present domestic Exploration & Production portfolio comprises eight domestic blocks (including two Coal Bed Methane blocks) and 9 overseas blocks, with participating interest ranging from 3.5% to 50%. Out of the 17 blocks, 5 are under production (all overseas), 4 are under development (1 overseas & 3 domestic), 3 are under appraisal (all domestic), 3 are under discovery (2 overseas & 1 domestic) and 2 are under exploration phase (1 overseas & 1 domestic). The overseas blocks are located in 8 countries, namely, Canada, Gabon, Libya, Nigeria, Russia, USA, Venezuela and Yemen.

Core GRM improving steadily

IOCL's gross refining margin (GRM) declined and stood at USD4.3/bbl (USD10.0/bbl in Q1FY17 and USD8.9/bbl in Q4FY17) mainly due to a large inventory loss of USD3.3/bbl in Q1FY18. However, core GRM (excluding inventory gain or loss) improved and stood at USD7.6/bbl (premium of $1.2/bbl to Singapore Complex GRM) as compared to USD3.6/bbl in Q1FY17 and USD6.9/bbl in Q4FY17.

Paradip refinery to drive earnings in FY19E

Paradip refinery operated at 88% utilization during Q1FY18 as compared to 82% in Q4FY17 and 32% in Q1FY17. Notably, this number is skewed by low operating rate in April 2017 and the refinery operated at 100+% rate during May and June 2017. The Paradip refinery (15 MMTPA), on full capacity utilization, will consistently generate GRMs which will be at a premium to Singapore benchmarks given its high complexity adding to IOCL's refining margins. Hence, we expect Paradip refinery to generate core GRM of USD10-12/bbl from FY19E.

Inventory loss shadows strong operational performance

IOCL's net revenue increased by 22.5% YoY (in line with expectation) due to higher refining and sales volume. Crude throughput increased by 8.8% YoY to 17.5 million metric tonnes (mmt) led by higher utilization of Paradip refinery (utilization at 88% from 32% in Q1FY17) coupled with 5.3% YoY increase in sales volume to 22.5mmt. EBITDA (reported) declined by 41.5% YoY on account of inventory loss of Rs4,040cr (refining inventory loss of Rs2,806 crore and product inventory loss of Rs1,234 crore) as against gains of Rs7,500cr in Q1FY17. However, the company also had a one-off gain on account of settlement of Rs2,810cr liability for entry tax in Haryana. After adjusting for one-off gain, EBITDA declined by 62.1% YoY. Net profit (reported) declined by 45% YoY. Going forward, we expect IOCL's adjusted net profit to grow at a CAGR of 3% over FY17-19E mainly due to lower or nil inventory gain on the back of stable crude oil prices.

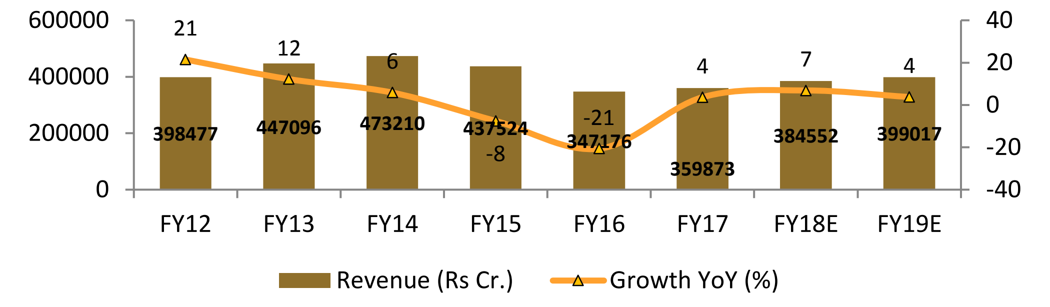
Outlook and Valuation

Within state oil marketing companies (OMCs), IOCL is our top pick given its diversified business model, further ramp-up of Paradeep refinery and potential upside in marketing segment. Besides, the successful commissioning of 15 MMTPA Paradip refinery make IOCL a pivotal player in complex refining. The full benefit (in terms of better refining margins) will start flowing from FY19E as it will start processing heavy crude oil. Moreover, IOCL also offers an attractive dividend yield of ~4.5%. Hence, we continue to maintain BUY rating to the stock with a target price (TP) of Rs468 using sum of the part (SOTP) valuation methodology wherein we value its standalone business at Rs427 (P/E of 10.0x for FY19E) and investments at Rs41.

Sum of the parts (SOTP) valuation

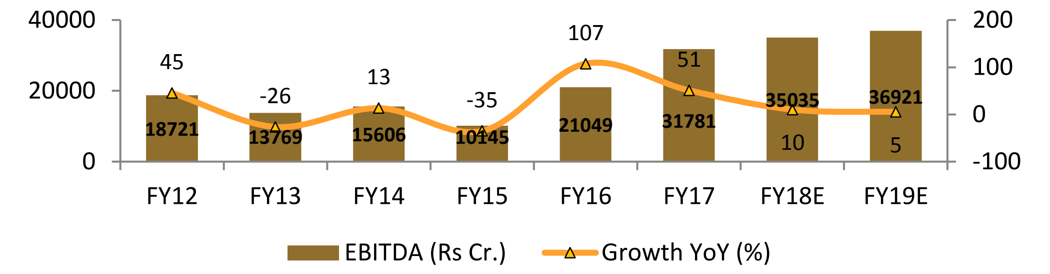
	Methodology	Multiple	Year	Value of IOC's Stake	Value Per Share (Rs.)
IOCL	EPS	10.0x	FY19E	-	427
CPCL	Market Price	-	-	3,404	7
Investments					
- Lanka IOC	Market Price	-	-	504	1
- Petronet LNG	Market Price	-	-	2,172	5
- ONGC	Market Price	-	-	15,731	33
- GAIL	Market Price	-	-	1,636	3
- Oil India	Market Price	-	-	1,137	2
				20% holding discount to investments and CPCL	-11
				Target Price	**468**

Revenue to grow at 5% CAGR over FY17-19E



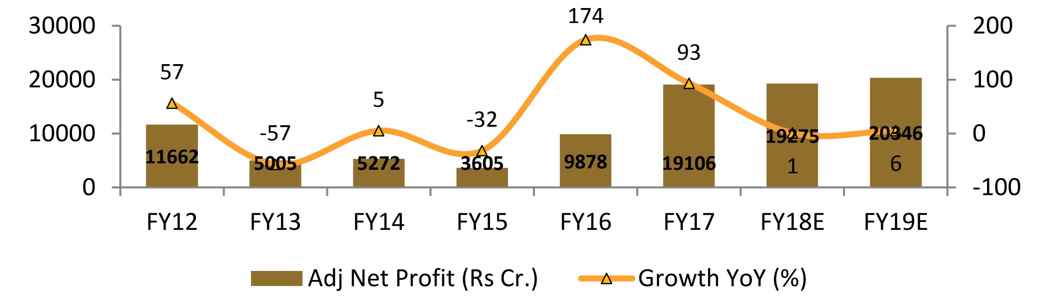
Source: Company, In-house research

EBITDA to grow at 8% CAGR over FY17-19E



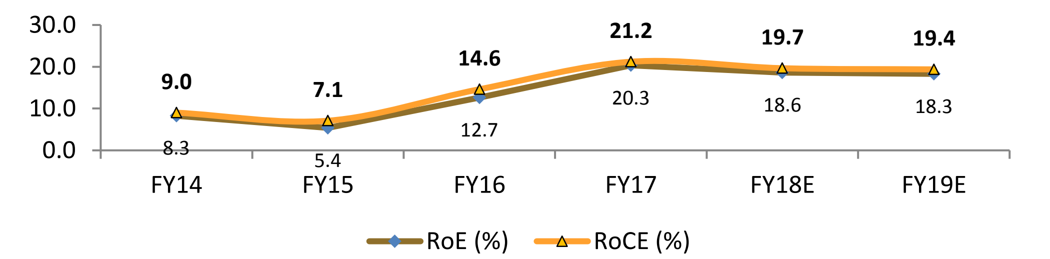
Source: Company, In-house research

PAT to grow at 3% CAGR (albeit on higher base) over FY17-19E



Source: Company, In-house research

Return ratios to improve led by strong free cash flow generation



Source: Company, In-house research

Key Risks

- Roll-back of de-regulation due to sharp rally in crude price margins.
- Any potential imposition of subsidies is likely to act as a drag on earnings as we estimate nil subsidy contribution by IOCL over FY17-19E.
- Regulatory change in the form of reduction in duty protection will lower refining margins.

Profit & Loss Account (Standalone)

Y/E (Rs. Cr)	FY16	FY17	FY18E	FY19E
Total operating Income	**347,176**	**359,873**	**384,552**	**399,017**
Raw Material cost	289,374	283,576	300,498	309,172
Employee cost	7,114	9,658	10,628	11,466
Other operating expenses	29,640	34,858	38,391	41,458
EBITDA	**21,049**	**31,781**	**35,035**	**36,921**
Depreciation	4,819	6,223	7,792	8,329
EBIT	**16,230**	**25,558**	**27,243**	**28,593**
Interest Cost	3,090	3,445	3,887	3,899
Other income	2,322	4,209	3,197	3,336
Profit before tax	**15,462**	**26,321**	**26,553**	**28,030**
Tax	5,584	7,215	7,278	7,683
PAT	**11,242**	**19,106**	**19,275**	**20,346**
Minority Interest	-	-	-	-
P/L from Associates	-	-	-	-
Adjusted PAT	**9,878**	**19,106**	**19,275**	**20,346**
E/o income / (Expense)	1,364	-	-	-
Reported PAT	**11,242**	**19,106**	**19,275**	**20,346**

Balance Sheet (Standalone)

Y/E (Rs. Cr)	FY16	FY17	FY18E	FY19E
Paid up capital	2,370	4,739	4,739	4,739
Reserves and Surplus	85,765	94,989	102,543	110,710
Net worth	**88,134**	**99,729**	**107,282**	**115,449**
Minority interest	-	-	-	-
Total Debt	42,483	50,385	52,385	54,385
Other non-current liabilities	18,157	20,964	20,964	20,964
Total Liabilities	**148,775**	**171,077**	**180,630**	**190,798**
Net fixed assets	91,347	107,879	115,825	123,234
Capital WIP	21,025	10,738	10,738	10,738
Goodwill	-	-	-	-
Investments	37,181	47,305	48,405	50,605
Net Current Assets	(17,824)	(9,481)	(9,978)	(10,010)
Other non-current assets	17,045	14,636	15,640	16,231
Total Assets	**148,775**	**171,077**	**180,630**	**190,798**

Cash Flow Statement (Standalone)

Y/E (Rs. Cr)	FY16	FY17	FY18E	FY19E
Pre-tax profit	**16,827**	**26,321**	**26,553**	**28,030**
Depreciation	4,819	6,223	7,792	8,329
Chg in Working Capital	2,254	(6,061)	(538)	81
Others	2,108	7,994	690	563
Tax paid	(3,063)	(6,726)	(7,278)	(7,683)
Cash flow from operating activities	**22,944**	**27,751**	**27,219**	**29,319**
Capital expenditure	(13,961)	(13,960)	(15,738)	(15,738)
Chg in investments	(9)	142	(1,100)	(2,200)
Other investing cashflow	1,553	(868)	3,197	3,336
Cash flow from investing activities	**(12,417)**	**(14,686)**	**(13,641)**	**(14,602)**
Equity raised/(repaid)	-	-	-	-
Debt raised/(repaid)	(3,438)	1,862	2,000	2,000
Dividend paid	(3,450)	(12,707)	(11,721)	(12,179)
Other financing activities	(3,479)	(2,429)	(3,887)	(3,899)
Cash flow from financing activities	**(10,367)**	**(13,275)**	**(13,608)**	**(14,078)**
Net chg in cash	**160**	**(209)**	**(30)**	**639**

Key Ratios (Standalone)

Y/E	FY16	FY17	FY18E	FY19E
Valuation(x)				
P/E	10.0	10.3	10.2	9.7
EV/EBITDA	6.7	7.8	7.1	6.8
EV/Net Sales	0.4	0.7	0.7	0.6
P/B	1.1	2.0	1.8	1.7
Per share data (Rs.)				
EPS	41.7	40.3	40.7	42.9
DPS	12.1	22.3	20.5	21.3
Growth (%)				
Net Sales	-20.6%	3.7%	6.9%	3.8%
EBITDA	107.5%	51.0%	10.2%	5.4%
Net profit	174.0%	93.4%	0.9%	5.6%
Margin (%)				
EBITDA	6.1	8.8	9.1	9.3
EBIT	5.3%	8.3%	7.9%	8.0%
NPM	2.8%	5.3%	5.0%	5.1%
Return Ratios (%)				
RoE	12.7	20.3	18.6	18.3
RoCE	14.6	21.2	19.7	19.4
Turnover Ratios (x)				
Sales/Total Assets	1.6	1.5	1.4	1.4
Sales/Working Capital	5.3	7.4	7.0	7.3

Rating Criteria

Large Cap.	Return	Mid/Small Cap.	Return
Buy	More than equal to 10%	**Buy**	More than equal to 15%
Hold	Upside or downside is less than 10%	**Accumulate***	Upside between 10% & 15%
Reduce	Less than equal to -10%	**Hold**	Between 0% & 10%
		Reduce/sell	Less than 0%

***** To satisfy regulatory requirements, we attribute 'Accumulate' as Buy and 'Reduce' as Sell.

***** IOCL is a large-cap company.

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