Bharat Petroleum Corporation Ltd.

EQUITY REPORT

June 21, 2013

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Bharat Petroleum Corporation Ltd (BPCL) is India's leading Navratna company engaged in refining, marketing & distribution of Petroleum products. Recently the company has ventured into Exploration and Production (E&P) activities. As of May 2013, the company has participating interests in 25 exploration blocks; in consortium with other companies. The current refining capacity of the company is ~30.5 Million Tonnes (MT) and with a capex of ₹3,250 mn the refining capacity is expected to increase to 47.5 MT in the years ahead. In order to deepen its presence in the downsteam busniness, BPCL has earmarked ₹700 mn for new pipelines which will ensure cost-effective transport of products.

Investor's Rationale

BPCL is going to benefit from enduring E&P activities in Mozambique and Brazil, having world class quality resources. The valuation of the company's E&P business is expected to increase once partner Videocon monetizes its 10% stake worth ₹3bn in the Mozambique block. The block has an estimated reserves of around 60 trillion cubic feet (tcf) and with the ongoing exploration activities in the appraisal blocks, this figure is expected to increase to about 100 tcf. Besides, BPCL plans to invest $1.9 bn in building downstream infrastructure in Mozambique.

Recent decontrol of diesel price bodes well for the industry as the under recoveries will be positively affected. In the current scenario BPCL is the best bet among the other state run Oil Marketing Companies (OMCs) to benefit the most. The huge amount of expansion planned by BPCL in its core business i.e refining and marketing will help it to serve the ever growing demand for energy better. The investments planned in the E&P space will also start showing returns in a span of 3-4 years.

The recent fall in global crude oil prices ($104/bbl in May '13 to $98/bbl in June'13) is also good news for OMCs as it means lower under recoveries and also the reduction in the finance cost upfront, which could also ease pressure on working capital and the debt burden.

Key risk

Rupee tumble: Oil import consumes the largest part (~35-40%) of the forex reserve. The declining rupee has hit the OMC's as every fall in rupee increases India's annual oil import bill by ₹100 bn (0.1% of GDP). Weakened rupee not ready to give any respite to the importers plunged ~₹3 in a month which may add ~₹150-200 bn additional under recovery burdens for the OMC's and hence the major players like BPCL, HPCL will paralleley see higher interest costs which impacts the bottom line.

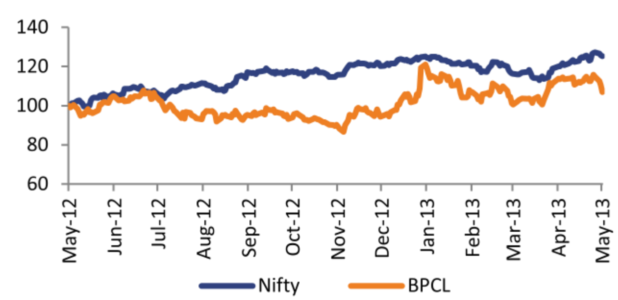
Market Data

Rating	BUY
CMP (₹)	348
Target (₹)	400
Potential Upside	~15.0%
Duration	Long Term
Face Value (₹)	10
52 week H/L (₹)	449.0/315.6
Adj. all time High (₹)	449
Decline from 52WH (%)	22.5
Rise from 52WL (%)	10.3
Beta	0.9
Mkt. Cap (₹ bn)	251.9
Price to Book Value	1.5

Fiscal Year Ended

Y/E	FY12A	FY13A	FY14E	FY15E
Revenue (₹ bn)	2,121.4	2,421.8	2,724.5	3,062.4
EBITDA (₹ bn)	48.1	66.7	77.3	87.0
Net Profit (₹ bn)	7.8	18.8	24.8	31.1
Adj EPS (₹)	21.6	26.0	34.3	43.0
P/E (x)	16.1	13.4	10.1	8.1
P/BV (x)	0.8	1.5	1.4	1.3
EV/EBITDA (x)	10.9	8.3	7.4	6.9
ROCE (%)	8.8	11.8	12.9	13.6
ROE (%)	4.9	11.2	13.9	16.4

One year Price Chart



Shareholding Pattern	Mar'13	Dec'12	Diff.
Promoters	54.9	54.9	-
FII	10.3	10.0	0.3
DII	17.4	17.7	(0.3)
Others	17.2	17.2	0

BPCL; India's leading Navratna company

BPCL's current refining capacity is nearly 30.5 Million Tonnes (MT) which is expected to increase to 47.5 MT in the coming years on the back of a capex of ₹3,250 mn.

BPCL has earmarked ₹700 mn for new pipelines which will ensure cost-effective transport of products.

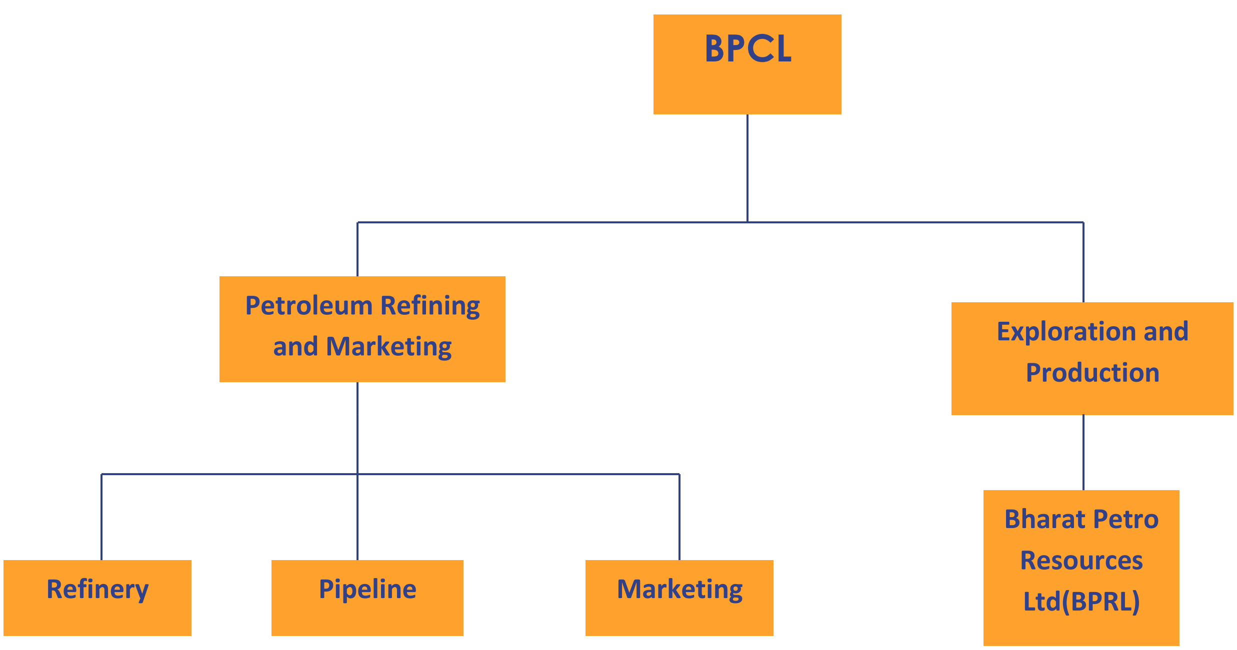
BPCL is India's leading Navratna company engaged in refining, marketing and distribution of Petroleum products. Recently the company has diversified in Exploration and Production(E&P) activities and it has proved to be a success.

The company refines the crude oil through its 4 refineries units viz. Mumbai Refinery, Kochi Refinery, Numaligarh Refinery and Bina Refinery. The Company's products include gases, which includes poly propelene feed stock, natural gas, liquefied petroleum gas (LPG) and bharat metal cutting gas; fuels, which includes marine fuels, white oils and black oils; solvents and special products; bitumen; lubricants, and sulphur. The current refining capacity is close to 30.5 Million Tonnes (MT) which is expected to increase to 47.5 MT in the coming years on the back of a capex of ₹3,250 mn.

Its marketing infrastructure includes installations, depots, retail outlets, aviation service stations and LPG distributors.The sales of all the major products like Motor Spirits, Diesel, LPG and kerosene have gone up due to increased demand from the consumers. As part of its downstream focus, BPCL has earmarked ₹700 mn for new pipelines which will ensure cost-effective transport of products. An additional ₹600 mn will go towards creation of infrastructure for gas distribution.

BPCL undertakes its upstream activities through its wholly owned subsidiary Bharat Petro Resources Ltd (BPRL). As of May 2013, the company has participating interests in 25 exploration blocks; in consortium with other companies. Of the blocks, 11 blocks are in India, 10 in Brazil, and 1 each in Mozambique, Indonesia. BPRL's total acreage holding is around 56,000 sqkm of which about 86% is offshore acreage.

Business Overview



Governments deregulation of diesel prices and fall in crude prices sparks fresh hope for OMC's

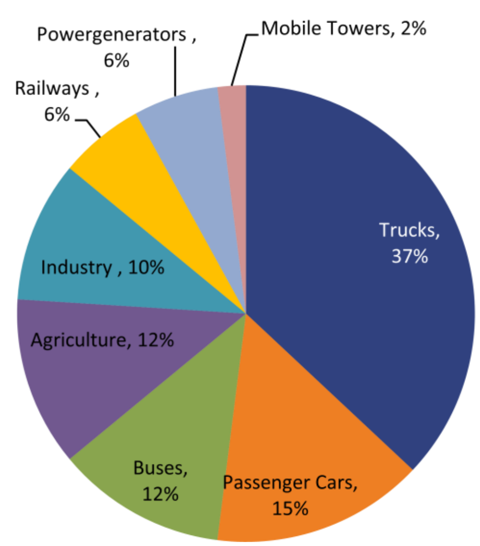
The government's decision to deregulate the diesel prices coupled with the phenomenal decline in crude oil prices is likely to slash the under-recoveries, going ahead.

The government is taking incrementally positive steps viz; the recent phased hike in diesel prices, limiting cooking fuel volumes and focus on implementing aadhaar for cash subsidies bodes well for the sector. The Government of India (GoI), on January 17, 2013, has allowed oil marketing companies (OMCs) to hike diesel prices by ₹0.45-0.50 every month, which in turn brought down state oil firms' under recoveries on diesel to ₹4.3 per litre, against ₹10 earlier. Further, the partial deregulation of diesel prices will help OMC's to lower the under recoveries on diesel, improving the outlook for oil marketing firms such as BPCL and hence bolstering the company's profitability. Since then the diesel rates have been increased for five times. Besides, the OMC's are directed to sales to bulk diesel buyers at market price, which would reduce the under-recovery on such volumes (~18% of overall diesel sales). Meanwhile, according to GoI estimates, the subsidy transfer mechanism (direct benefit transfer – DBT) could reduce gross under recoveries on kerosene by ₹75bn (H1FY13 actual: ₹143.3bn) and on LPG by ₹72bn (H1FY13 actual: ₹185.4bn).

Crude oil prices have seen a marked drop from $120/bbl in Feb'13 to $98/bbl in June'13. During the same period, petroleum product spreads have also seen a sharp collapse. From mid-Feb'13, Gasoline-Dubai crude blowout has plunged 62%, while Diesel-Dubai crude spread has nosedived 40%. Naphtha-Dubai spread has moved from a positive $1/bbl to a negative $5.4/bbl. The fall has been mainly on the back of a slowdown seen in the Chinese economy and a robust growth in US crude oil production. The rise in diesel prices, coupled with declining global crude oil prices over the last several months, has reduced the loss - or under-recovery - levels at which diesel is sold in India.

The oil companies have been permitted to raise diesel prices by a small quantum periodically till such time they are able to cover ₹9.60 per litre loss they incur on the fuel.

Bulk consumer contribute ~18% of diesel sales



E&P Activities to Show Positive Results

The ongoing E&P activities in the Mozambique and Brazil fields that contain high quality resources have started to give results BPCL in the form of increased valuations. Drilling activities have already begun in some of the blocks and commercial production is expected to commence by FY'18.

Benefits arising out of Mozambique block

BPCL has made its long-term plans clear in the Mozambique asset and is not thinking of divesting its 10% interest. It would provide long term strategic value to the company's upstream initiatives.

The company estimates the valuation for the ongoing stake sale (Videocon and Anadarko selling 10% stake, each) could exceed the Cove Energy stake sale transaction ($1.7 billion for 8.5% stake). Recent media reports have indicated that the likely valuation of a 20% (Videocon and Anadarko selling 10% stake, each) stake sale has now increased to $8-$10 billion (from $5 billion earlier).

This will boost the asset valuation of the BPCL's 10% stake substantially and will add value to the stock mprice going forward due to the balanced mix of upstream and downstream businesses.

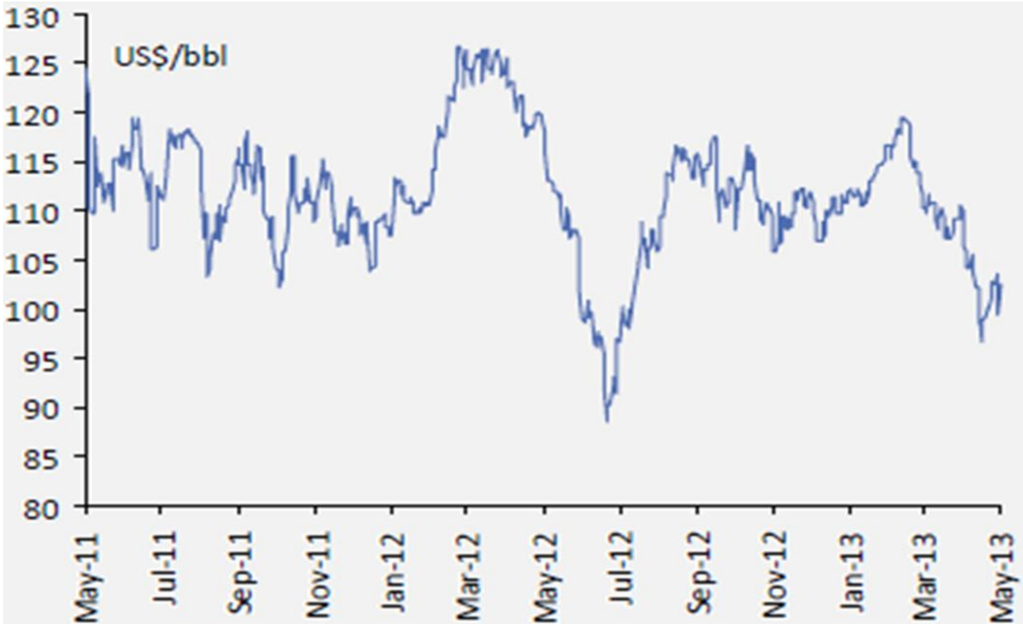
Also, the company is initially looking to develop two 5mmtpa LNG trains and talks are ongoing for initial agreements with prospective LNG purchasers. The discussions are also continuing with ENI (operator of offshore area -4 north of offshore area -1) on possible unitisation and joint development of resources.

Plummeting crude oil prices could ease subsidy burden

The fall in Brent crude oil price could ease the cost pressure of a large number of companies. Besides, it means lower subsidy burden for both, the government and companies.

The recent fall in global crude oil prices on account of higher supplies from non-Opec (Organization of the Petroleum Exporting Countries) members and weakening demand. The strengthening dollar and concerns on Europe, too, contributed to the downward trend in prices. This fall in prices will benefit OMC's lower under recoveries while it also means a reduction in the finance cost upfront, which could also ease pressure on working capital and the debt burden. The International crude oil prices for the Indian basket have fallen from $120/bbl in Feb'13 to $98/bbl in June'13. This would ease pressure on the working capital and improve the liquidity for BPCL as the borrowings are likely to reduce to ₹2,100 mn from current ₹2,700 mn. This will boost the earnings outlook for the company due to visible decline on the interest costs.

Crude oil price trend



Implementation of Export Parity Pricing (EEP) could hinder bottom line

EEP implementation could bring positives for the government as subsidy burden will reduce but on the other hand put adverse impact on OMC's profit and revenue figures.

The export parity pricing (EEP), which the finance ministry expects will bring down oil subsidy bill. In other ways, a proposed shift by the government from the pricing formula for calculating under recoveries from the current import parity scheme (currently at 20% export and 80% import parity pricing) to export parity pricing model is likely to reduce under recoveries. But it will squeeze GRMs of refiners such as BPCL as they pay heavy customs duty on importing crude. Also, there are chances that it would hit the OMC's hard as they would have no protection against the imported products against their own refined products. Going ahead, if the new pricing regime is put in place then the oil majors such as BPCL, HPCL and others are going to incur lossess. However, there remains uncertainty whether the pricing formula will be changed with the oil ministry not been pretty keen on it. The details are yet to unfold after a committee under Kirit Parikh submitted its report in the next two months to the government.

The best way to circumvent this export parity based pricing policy is by actually exporting the fuel. While private sector companies have this option and have been doing it, the option is not available to public sector OMCs given their huge distribution set-up in the country. Albeit, the future course would be decided after a committee under Kirit Parikh submitted its report within 2 months.

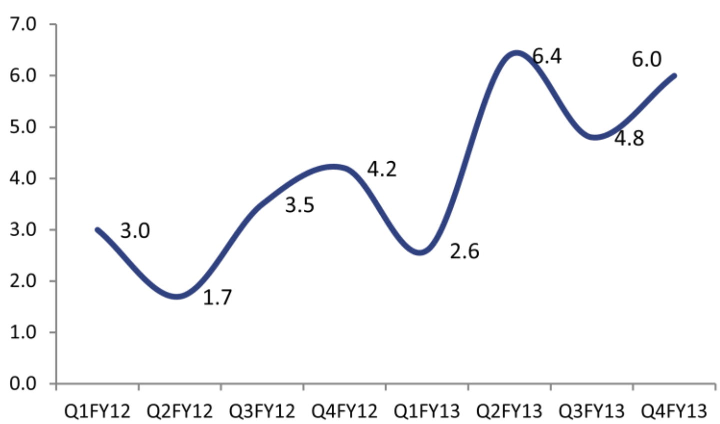
Growth in volume and GRM bodes Q4FY'13 result

BPCL reported a strong set of numbers in Q4FY'13 driven by higher volumes and GRM. The company's EBITDA grew 30% YoY to ₹66 bn in Q4FY'13 led by better GRMs and higher over recovery. GRM increased to US$6/bbl compared to $4.2/bbl in Q4FY'12. BPCL had a net over-recovery of ₹56.67 bn during Q4FY'13 compared to ₹36 bn in Q4FY'12 due to a subsidy of ₹86.70 bn from the government and a discount of ₹59.62 bn from upstream companies. In line with the strong growth in the EBITDA front, the company's net profit also increased significantly by 20% at ₹48 bn.

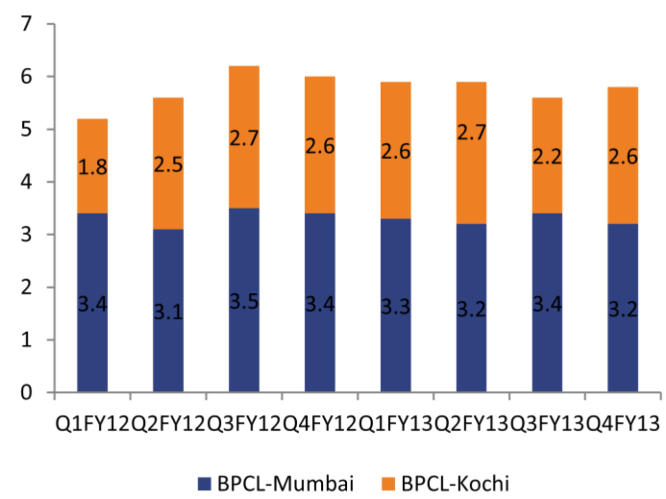
Weak rupee a concern for oil marketing compnaies

The recent slide in the Indian ruppe against the US dollar hitting a record low of around 60 for a dollar raised worries about the underrecoveries for the oil firms. The continued weakening of the rupee against the dollar, makes crude oil imports expensive. Oil firms like BPCL, HPCAL ands IOCL import around 70% of their oil requirement. A significant depreciation in the rupee against the dollar could lead to a delayed realization on under recoveries, putting pressure on profitability. In oreder to offset the adverse impact of the decling rupee on the profitability, the oil firms recently hiked the petrol price by a steep ₹ 2 a litre, the second increase in rates this month.

BPCL's GRM trend in ($/bbl)



Refinery throughput in (MMT)



Balance Sheet (Consolidated)

Y/E (₹mn)	FY12A	FY13A	FY14E	FY15E
Share Capital	3,615	7,231	7,231	7,231
Reserve and surplus	155,184	160,525	171,062	182,292
Net Worth	158,799	167,755	178,293	189,522
Minority Interest	10,351	10,766	10,766	10,766
Loans	283,816	328,604	355,113	383,956
Long term provisions	4,337	6,089	6,698	7,368
Deferred tax liability (net)	16,778	16,059	16,778	16,779
Other Long term Liabilities	1,098	781	859	945
Current Liabilities	302,957	265,603	250,416	236,564
Capital Employed	**778,136**	**795,657**	**818,924**	**845,900**
Net Fixed Assets incl. CWIP	295,224	321,846	378,194	411,077
Investments	78,906	74,698	71,732	77,667
Other Non-current Assets	66	169	186	205
Long Term Loan & Advances	20,084	20,415	20,084	20,085
Current Assets	383,856	378,528	348,727	336,866
Capital Deployed	**778,136**	**795,657**	**818,924**	**845,900**

Profit & Loss Account (Consolidated)

Y/E (₹mn)	FY12A	FY13A	FY14E	FY15E
Net Sales	2,121,396	2,421,810	2,724,536	3,062,378
Expenses	2,073,269	2,355,087	2,647,231	2,975,359
EBITDA	48,127	66,723	77,305	87,020
Other Income	14,567	15,290	16,054	16,857
Depreciation	24,108	24,627	25,858	27,151
EBIT	38,585	57,385	67,501	76,726
Interest	22,591	25,183	26,442	27,764
Profit Before Tax	15,994	32,203	41,059	48,962
Tax	7,482	12,841	15,618	17,180
Profit after tax	8,513	19,361	25,441	31,782
Minority Interest	705	553	609	669
Net Profit	7,808	18,808	24,832	31,113

Key Ratios (Consolidated)

Y/E	FY12A	FY13A	FY14E	FY15E
EBITDA Margin (%)	2.3	2.8	2.8	2.8
EBIT Margin (%)	1.8	2.4	2.5	2.5
NPM (%)	0.4	0.8	0.9	1.0
ROCE (%)	8.8	11.8	12.9	13.6
ROE (%)	4.9	11.2	13.9	16.4
Adj EPS (₹)	21.6	26.0	34.3	43.0
P/E (x)	16.1	13.4	10.1	8.1
BVPS (₹)	439.2	232.0	246.6	262.1
P/BVPS (x)	0.8	1.5	1.4	1.3
EV/Operating Income (x)	8.3	6.7	6.2	5.8
EV/EBITDA (x)	10.9	8.3	7.4	6.9
EV/EBIT (x)	2.3	2.8	2.8	2.8

Valuation and view

Globally the crude oil demand is expected to remain muted amid global fiscal uncertainties that would led to lower GRMs, going ahead. US accounted 22% of global oil demand followed by China and has been the engine of strengthening demand. GRMs of domestic refineries are also expected to remain weak over the medium term in the backdrop of subdued outlook of international refining margins and moderate import-duty differentials between petroleum products and crude oil. However, the move by the government regarding the diesel reforms will improve the earnings visibility of the OMCs.

At a current market price (CMP) of ₹348.35, the stock trades at 10.1x FY14E and of 8.1x FY15E, earnings. We recommend 'BUY' with a target price of ₹400, which implies potential upside of 15.0% to the CMP from 1 year perspective.

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