Promising outlook for reasonably priced OMC stocks

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Investors are showing some interest in the downstream energy cycle. Refiners and marketers, especially the public sector undertaking (PSU) oil marketing companies (OMCs) could see a revival of marketing margins. Lower crude oil and gas prices may also improve margins in industries like paints, logistics, synthetic fabrics, and fertilisers.

In the medium-term, however, there could be a supply overhang affecting OMCs as new refining capacities are scheduled to be commissioned, especially in China, and this may lead to a drop in the refining margins as capacity would be surplus to demand until and unless there's a pick-up in global growth. In FY23 (2022-23 financial year), the Indian crude basket averaged $93.15 per barrel and it is down to an average of $77.92 between April and June 2023. A rough calculation suggests OMCs have a breakeven point of around $85-86 where gross marketing margins (GMMs) are concerned. So, they suffered under-recoveries through much of FY23, since prices came below that level only from December 2022.

Source: Exchanges
Compiled by BS Research Bureau

In addition, access to discounted Russian crude could boost gross refining margins (GRMs) by up to an estimated $3 per barrel. Discounted Russian crude is around 25-30 per cent of imports, after the European Union ban on Russian imports from December last year. Adjusted for cost of insurance, transportation, etc., the net discount on Russian crude is $10 per barrel.

If OMCs can maintain current marketing and refining margins, they could wipe off FY23's accumulated losses by the end of July this year.

Apart from the upcoming state and general elections in 2023 and 2024, respectively, there are some other geopolitical considerations. One is that Opec (oil and petroleum exporting countries) and Opec–plus (including Russia) may cut production to maintain international prices. Second, if there's a resolution to the Ukraine War, Russian sanctions may be lifted and, so, discounts may end.

Every $1 per barrel decline in crude oil price helps to boost blended GMM by ₹0.5 per litre (amounting to ₹7,300-7,500 crore on annualised basis based on annual volume of 145-150 billion litres). The break-even Brent crude price for OMCs is $85 per barrel to earn a blended GMM of ₹3.5 per litre.

Blended GMM is around ₹7.4 per litre at $77-78 per barrel against a negative ₹4.6 per litre in FY23. Assuming Russian imports continue and other variables don't change, OMCs could be annual beneficiaries with Indian Oil Corporation (IOCL) gaining ₹15,500 crore, Bharat Petroleum Corporation (BPCL) ₹7,200 crore and Hindustan Petroleum Corporation (HPCL) ₹5,200 crore. In FY23, Ebitda (earnings before interest, tax, depreciation and amortisation) declined from average normalised levels as follows, according to an analysis by JM Financial.

For FY23, consolidated Ebitda for IOCL was ₹26,100 crore against normalised Ebitda of ₹33,000 crore; BPCL was ₹10,900 crore against normalised Ebitda of ₹16,000 crore; and HPCL was ₹5,700 crore against normalised Ebitda of ₹13,000 crore.

Combined debt for these three OMCs rose to ₹232,900 crore, up by ₹45,300 crore in FY23. By the end of July, the Ebitda shortfalls of about ₹19,000 crore could be wiped out given the current GMM trends. Incidentally private players (including Reliance Industries) which lost market share during FY23 are now selling diesel at a discount of ₹1 per litre to try and regain share. Putting it all together, there could be a short- to medium-term opportunity for gains for investors who enter the OMCs at the current reasonable valuations.