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OIL SECTOR - AN OUTLOOK

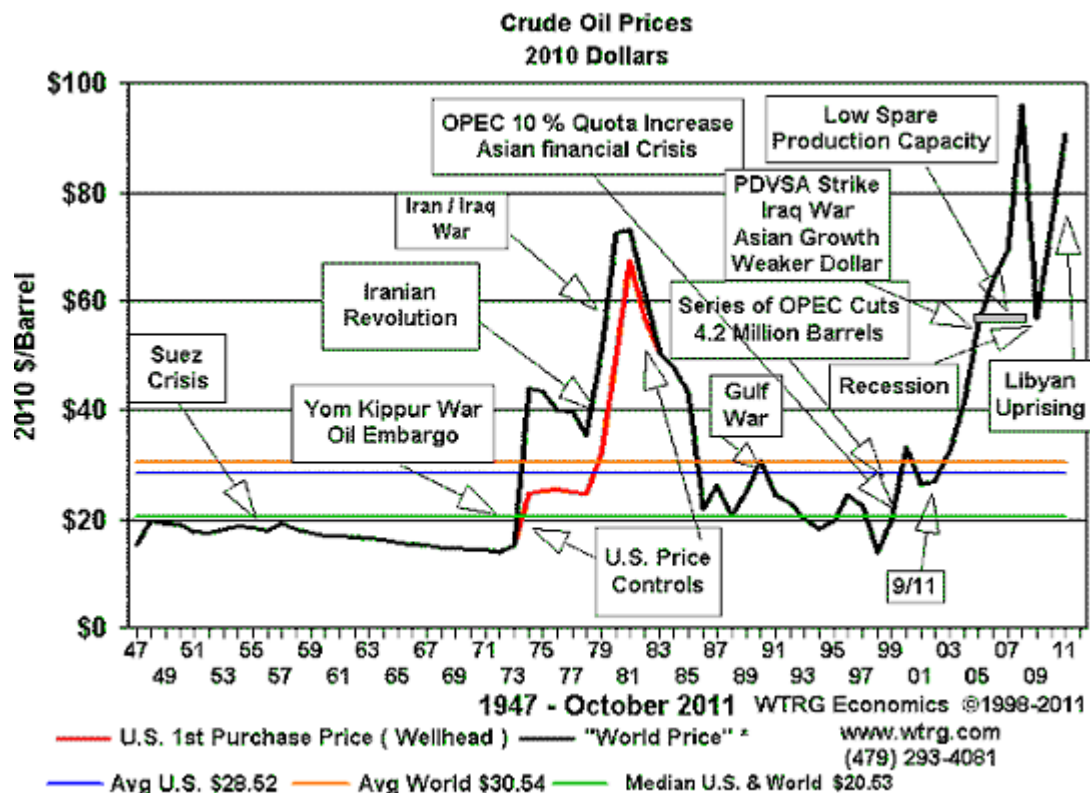
The oil sector for the past few months has been passing through a difficult phase. 2011 saw the price of oil oscillating within a range and the euro zone crisis worsening. But on a net basis, most of the companies in the oil sector were not able to perform up to the expectations of the market. To get a clear picture of what is actually going on in the sector, we need to analyze the prospects and strengths of the industry as a whole.

For the past eighty years, since crude oil was discovered in the Arabian Peninsula, the world has become strongly addicted to Arabian crude oil. Currently most of the oil is still produced from here. But it is a well known fact that the oil reserves in the Middle East are slowly falling. Currently, the largest oil field in the world is the Ghawar Oil field in Saudi Arabia. Though it is not accurately known the amount of reserves remaining in the field today, it is widely believed that the production would peak out in a few years from now. Taking this fact into account, from the 1980's onwards, many multi national companies in the oil exploration space began to cross the boundaries of traditional oil exploration business into deep sea exploration in various geographies and continents. With the help of advanced technology it has been found that oil reserves are present in many other parts of the world. But the cost for exploring oil out from these reserves was uneconomical and thus producing them, was totally out of question. As years passed by, the number of new oil well discoveries in the Middle East began to shrink and the emergence of countries like China and India has increased the consumption of oil at a much faster rate than the west. According to "BP energy Outlook 2030" published in Jan 2011, in 20 years time, the world would need 40% more energy than it consumes today. In the case of India, the consumption of oil has trebled in the past twenty years and is likely to double in the next twenty years.

Though India is expected to witness a phenomenal growth in oil consumption in the coming decades, Oil exploration and Production Companies as well as Oil Marketing Companies have not been able to reflect it on their bottomline numbers. Apart from this, the oil sector does involve a whole lot of risks attached with it. There are a lot of reasons for this. They include:

- Subsidized Fuel prices:** The government policy of price regulation and providing subsidized diesel and LPG continues to hurt the oil sector. We believe that this is one of the greatest threats to the oil sector. This has led the companies to accumulate losses which has not been squared up by the government. The total accumulated debt by IOC, HPCL and BPCL is currently 1.40 lakh crores. Cash flow has now emerged as the biggest challenge for oil companies in the short term. This is a repeated phenomenon every year. With the government already in a huge deficit. How much the government would be able to square off these losses in the short term is a question of concern. Going forward, we are not expecting the government to further raise the price of cooking gas as this would lead to high inflation causing a devastating effect on India's economic growth. Companies that generally come under the ambit of government regulations have not known to be great wealth creators for its investors in the long run. These companies generally have to either raise funds through debt or by equity. In both cases earnings dilution is the eventual long term outcome. Prolonged government intervention continues to be an overhang to the sector as a whole.

- Volatility in Oil prices:** Oil continues to show high volatility in its prices in recent times. We believe that this is likely to continue mainly due to the fact that demand supply mismatch is likely to widen in the future as oil exploration and production as a whole may not see a remarkable growth going forward. This is because though there are a lot reserves which are currently unexplored. They are scattered in various areas and access to these reserves is still unviable. Though low oil prices have been good for India, sustained periods of low oil prices have not been the norm of the day in recent times. So a general assumption is that oil prices are likely to hover around \$ 100 range at least for the next year.
- Highly Capital Intensive:** Apart from all the problems that were mentioned above, oil companies are generally highly capital intensive. This we believe would be the trend going forward. As oil reserves keep on depleting, more expenditure would be needed in the capex front to keep on with the pace. Oil exploration is generally a high risk business with huge investment requirements. The only positive is that oil prices are likely to keep on increasing but how much this would materialize into profits is a concern for the oil sector as a whole. India is known to have off shore reserves but producing it would require to step beyond the boundaries of conventional thinking. Huge investments would have to be made and no one actually knows the amount and quality of reserves with accuracy. For eg, the production of oil in the KG D6 Block has fallen unexpectedly leading Reliance Industries Ltd to forge an alliance with British Petroleum, a pioneer in deep sea oil exploration.
- Safety and Management:** Offshore drilling is among the most risky businesses to be in. The Gulf of Mexico incident which resulted to one of the worst oil spills in the history of oil exploration. It is one of the major risks that the E&P company faces. Increased safety and risk management standards are needed to prevent the likelihood of another incident. An occurrence in that scale can be catastrophic leading to litigation entanglements as well as vast destruction to the ecological balance of the eco system. Deep water exploration and development technology is likely to keep on evolving and going forward, new challenges are likely to come.
- Currency Fluctuation:** The high volatility in the rupee against the dollar in recent times affects the profits of oil marketing companies in a negative manner. Most of the oil consumed in India is still imported and devaluation coupled with high volatility can negatively impact the profitability of these companies.



For us to become bullish on the oil sector

1. Hike in diesel and LPG prices:- We believe that unless the price of diesel and LPG are deregulated, there is no reason to become optimistic about the sector as a whole.
2. A cut in excise duty could be a positive trigger for the sector as a whole.
3. Cut in import duty on petrol and diesel prices.

Are woes in the sector likely to continue?

The oil sector as a whole has not fared well in recent times. The main problems surrounding the sector are high government intervention and regulation, currency fluctuations, escalating crude oil prices, huge capex spends are all risk overhangs as far as the sector is concerned. For companies to make money in the oil sector, these companies will have to eventually be the price maker in the industry. Being a very generic product and contributing to a sizable portion of the expenditure of the common man, the government is unlikely to deregulate the prices of diesel and LPG. Another major problem for the industry is the fact that India is an oil consumer and not a producer. In the oil industry, oil producing countries always have the upper hand in profit making. When oil prices are soaring, they make windfall gains and still manage to operate with moderate gains in difficult times. In contrast, India is not an oil producer, and crude oil prices play a crucial role in the profitability of companies in India. So in general, the underlying economics of the oil sector which include the oil exploration and production as well as the oil marketing industry in India are not really working in its favor. So we would recommend minimizing one's exposure for the time being.

Pockets in the oil space of which we are bullish in the long term.

The oil sector is inextricably interlinked with India's growth story. Though we are not very much enthusiastic with the oil sector as a whole we feel that there are pockets within this space which provides ample scope for creating wealth in the long term. We are very much bullish in the long term prospects of the lubricant industry in India which is a by product of crude oil. This subsector does not come under the government's regulatory bracket and also has the ability to create a franchisee value of its own. With industrial activity and auto sector going to keep on growing in the coming years, we could see huge demand in the coming years. We are also bullish on the plastic market in the long term. Plastic utensils and plastic furniture are all products which are directly related to India's growth story. We would like to suggest a few companies in the oil space directly related to India's growth story.

- **Castrol India Ltd:** The company is an established player in the lubricant business space. We believe that it is a good pick because of its superior brand value and its pricing power. The fundamentals of the company are excellent with low debt and high return on equity. The auto industry has been growing around 12% and going forward we are expecting the auto sales in both the commercial vehicle as well as the passenger car space to keep on growing. We believe that Castrol India Ltd is well positioned to be the ultimate beneficiary of this situation on the basis of its good market share and superior brand name.
- **Supreme Industries Ltd:** A well established player in the plastic segment, the company is a manufacturer of plastic furniture, plastic trays for industrial and the commercial segments. We are bullish on this sector on the basis that demand for these products is likely to keep on growing in the immediate future. However the concern we have in the sector currently is high debt in the company. Its direct link with the consumption story of India and its consistent performance even in the global slowdowns gives us ample reasons to assume that the company's long term prospects and earnings growth are quite predictable.

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