India

Neutral *(no change)*

Highlighted Companies

Reliance Industries

ADD, TP Rs3369, Rs2633 close

Uptick in global refining cycle to hasten deleveraging and drive a 35% EPS CAGR over FY22-24F. We build in US$20/bbl GRM. Our analysis indicates that RIL's new energy initiatives are value-accretive and can add ~Rs170bn to EV. R-JIO and retail business remain strong.

Indian Oil Corp

ADD, TP Rs160, Rs72 close

IOCL appears to be unaffected by the export tax on diesel as it exports mainly to Bhutan and Nepal and that too, in minuscule quantity. IOCL's Nepal and Bhutan exports realization was at US$164/bbl in 1QFY23 and in Jul 2023 it stood at US$190/bbl. Clearly, the company recovered the entire export duty from its customers.

Summary Valuation Metrics

P/E (x)	Mar22-F	Mar23-F	Mar24-F
Reliance Industries	26.13	16.23	14.74
Indian Oil Corp	2.63	3.45	3.21

P/BV (x)	Mar22-F	Mar23-F	Mar24-F
Reliance Industries	2.16	1.94	1.74
Indian Oil Corp	0.51	0.48	0.45

Dividend Yield	Mar22-F	Mar23-F	Mar24-F
Reliance Industries	0.29%	0.3%	0.32%
Indian Oil Corp	16.77%	13.98%	15.37%

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Oil & Gas Refinery

Strong diesel spreads

- Closure of refineries and rising diesel demand is leading to global shortage, which is driving down OECD countries' diesel inventory to below 2006 levels.
- Given the estimates on refinery capacity addition, we expect diesel supply to lag for the next 3-4 years. We expect diesel spreads to average ~US$35/bbl.
- We like Indian diesel producers; weak gasoline is a blessing in disguise in the short run as Indian refiners are mainly diesel producers. Top picks: RIL, IOC.

Diesel shortage to be around 0.9mbpd in CY22F

Our analysis indicates that globally diesel will remain in short supply for the next three-to-four years as capacity addition will lag demand. Already, OECD countries' inventory is below 2006 levels and given the drawdown of inventory, it is likely to make a 20-year low in coming months (we have International Energy Agency or IEA data till May 2022). We have made the following assumptions to forecast a diesel shortage of 0.9mbpd: 1) OECD refineries will produce 29% diesel of their installed refining capacity (historical average has been 28.9%) while non-OECD countries' production percentage will remain around 25.7% (against historical average of 25.2%), 2) 0.15mbpd of Russian supply is out of the market because of sanctions (Phillips 66 conference call) and is unlikely to come soon, 3) in a most likely case, European diesel demand will rise by 0.3mbpd during winter as natural gas will be used for heating requirements (please see our report IN: Oil & Gas - Overall - Russian Roulette - Odds in favour of Europe), and 4) Indian and Chinese diesel demand is likely to grow in early double digits this year (YTD till Jun 2022 growth for India and China indicates double-digit growth). Given the capacity addition forecast, we expect diesel to remain in short supply for the next three-to-four years.

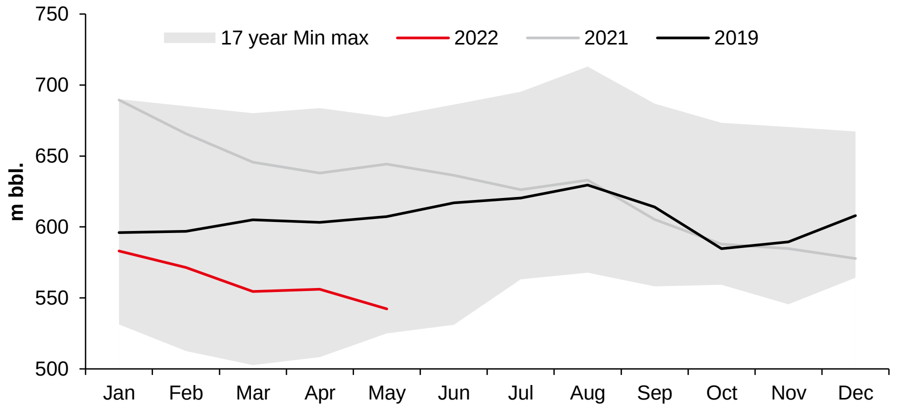
Diesel cracks to remain strong

Given the diesel shortage and high production cost in Europe, OECD diesel cracks are likely to remain in high 40's or around US$50/bbl levels. Adjusting for freight cost between Europe and Asia, Singapore spreads can remain around US$35/bbl level in the near future. Most Indian refineries are big producers of diesel (Reliance Industries or RIL ~55% of product slate and oil marketing companies or OMCs ~60%) and hence, for Indian refiners, gasoline spreads are least important. Rather, if gasoline prices fall, it will be positive for OMCs as they will start making marketing margins. Given the fall in base crude oil prices, we believe there is little sense in levying export tax on Indian refiners.

Reiterate Add rating on IOC & RIL

RIL's diesel exports from its special economic zone or SEZ are exempt from export duty and Indian Oil Corporation or IOC (which exports only to Nepal, Bhutan, and other neighboring countries) have been able to recover US$27/bbl export tax. We believe the current correction provides an attractive entry point as structural tailwinds are likely to persist for a long time.

Figure 1: OECD diesel inventory touched the lowest in last 17 years; current inventory is below 2006 levels



SOURCE: INCRED RESEARCH, COMPANY REPORTS

Diesel spreads to remain strong

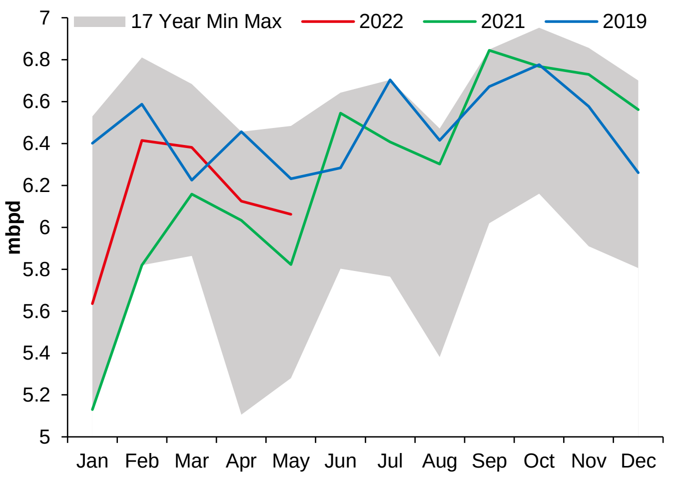
Analysis of the Organisation for Economic Cooperation and Development or OECD countries, Europe, USA, and non-OECD countries indicates that diesel shortage can exacerbate during the winter season, which will lead to higher spreads for standard Indian refiners.

OECD diesel consumption is on the rise

Because of the factors we have highlighted in our recent report: IN: Oil & Gas - Overall - Russian Roulette - Odds in favour of Europe, Europe's diesel consumption is rising, leading to an overall rise in OECD countries' diesel consumption. India and China account for increased consumption among non-OECD countries diesel consumption. Heavy crude oil processing capacity is limited, which is leading to a diesel shortage. Added to this is 0.15mbpd Russian diesel off the market, further exacerbating the diesel shortage.

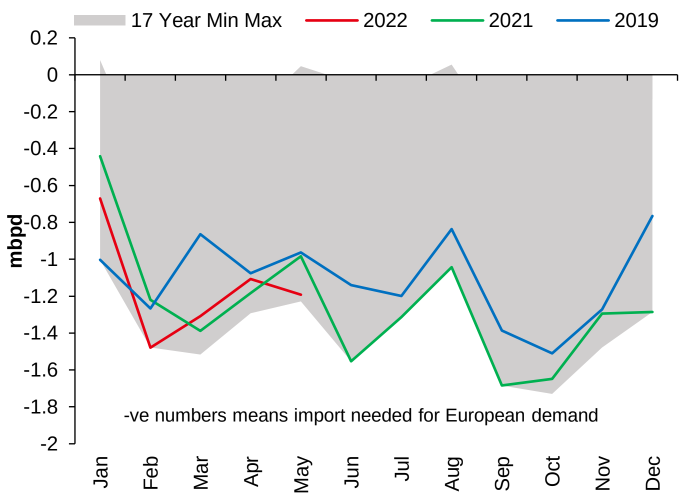
Europe's diesel consumption is rising vis-à-vis 2021 and production is not keeping pace

Figure 2: Europe's diesel production is lower vis-à-vis 2019, but demand is increasing



SOURCE: INCRED RESEARCH, COMPANY REPORTS

Figure 3: Hence, adjusted for Russian export decline, European diesel balance is much worse compared to 2019



SOURCE: INCRED RESEARCH, COMPANY REPORTS

US diesel demand is only slightly below pre-Covid pandemic levels and there too, production is lagging

Figure 4: US diesel demand nearing pre-Covid pandemic level - the difference in May 2022 vis-à-vis May 2019 levels was 0.11mbpd

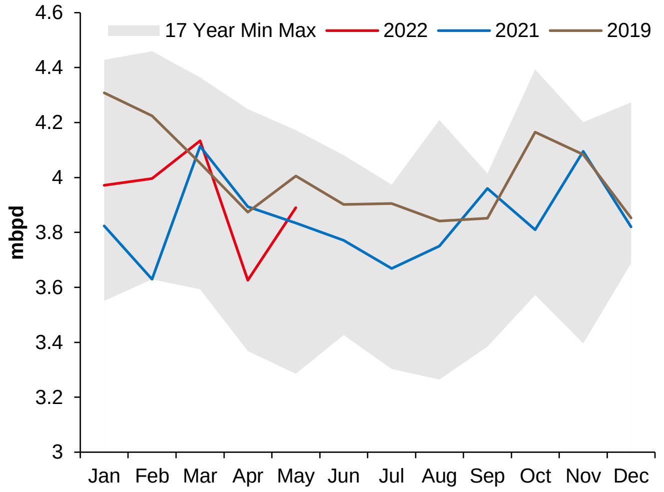


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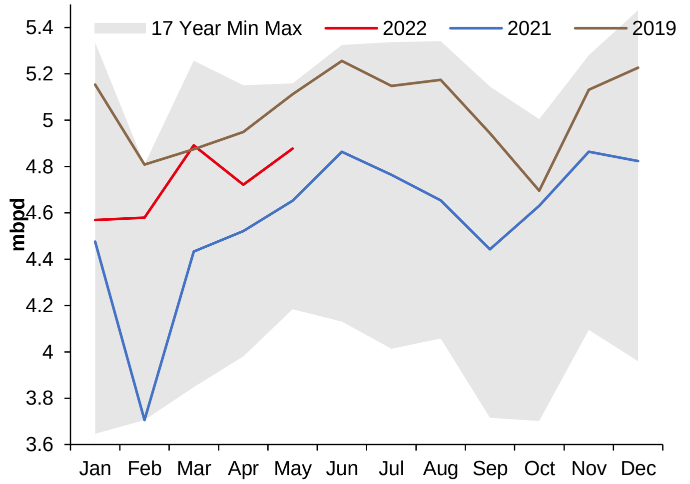
Figure 5: However, production in May 2022 was 0.23mbpd below 2019 level, resulting in tight diesel supply

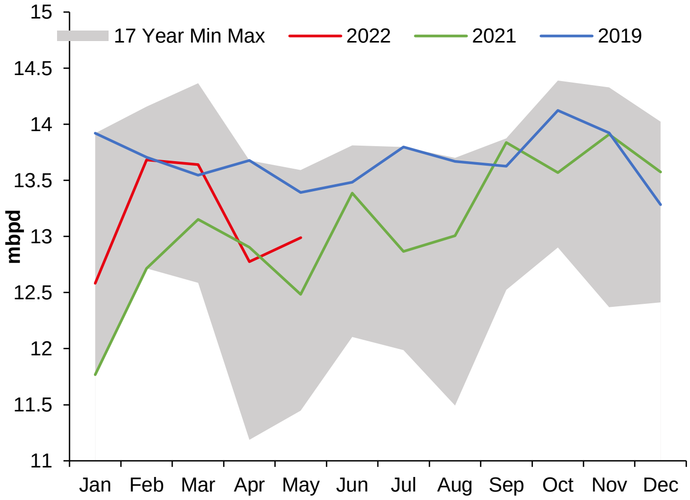


SOURCE: INCRED RESEARCH, COMPANY REPORTS

Like Europe, USA is also facing diesel shortage because of the closure of heavy crude oil processing capacity, thereby resulting in lower diesel production.

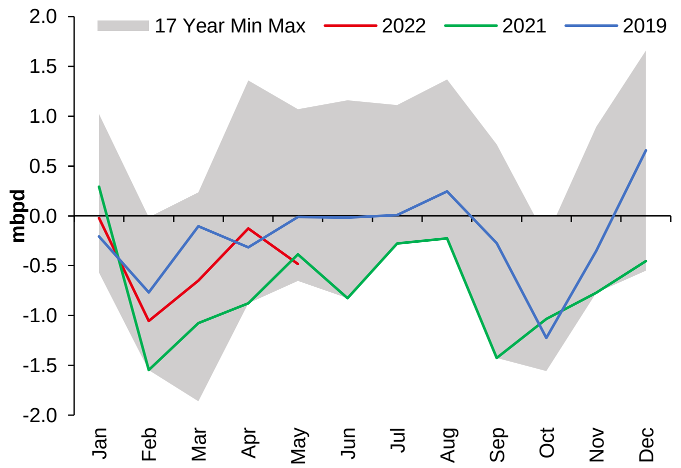
Overall OECD countries' shortage is not worse than 2021, but the shortage will get worse compared to 2021

Figure 6: Overall OECD countries' diesel demand is well below 2019 level



SOURCE: INCRED RESEARCH, COMPANY REPORTS

Figure 7: However, diesel shortage will progressively get worse compared to 2021

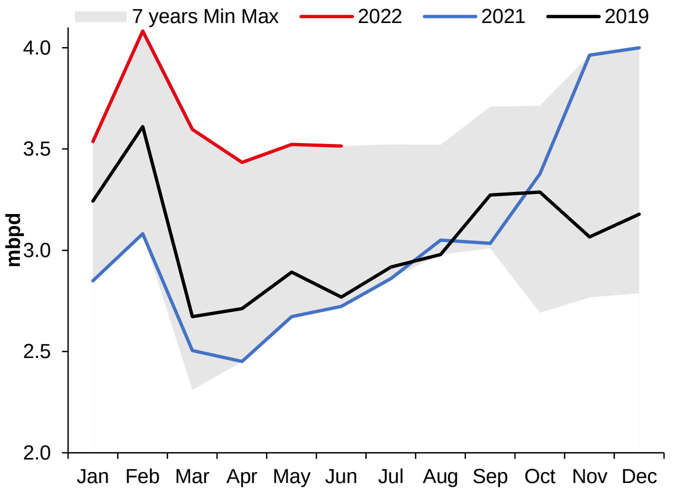


SOURCE: INCRED RESEARCH, COMPANY REPORTS

India and China diesel demand is still growing fast ›

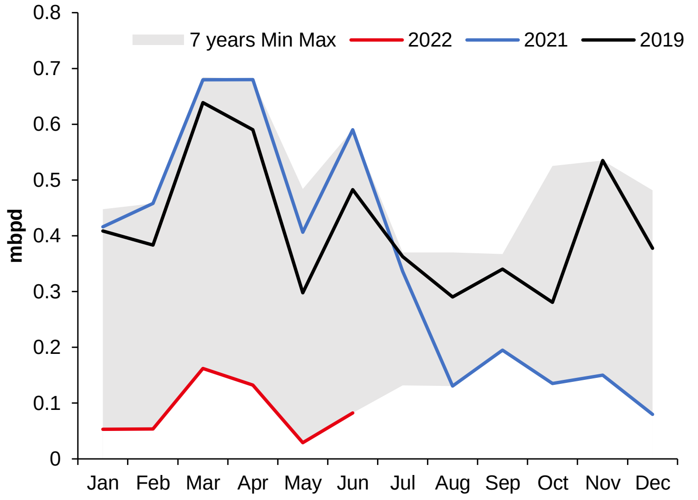
Indian diesel demand is growing at 12% yoy and Chinese diesel demand is still growing at 20%+ yoy. Both these nations alone can drive non-OECD countries' demand better than the pre-Covid pandemic level. We expect non-OECD countries' diesel demand to grow at 4% over 2019 level.

Figure 8: China's diesel demand is increasing at a scorching pace…



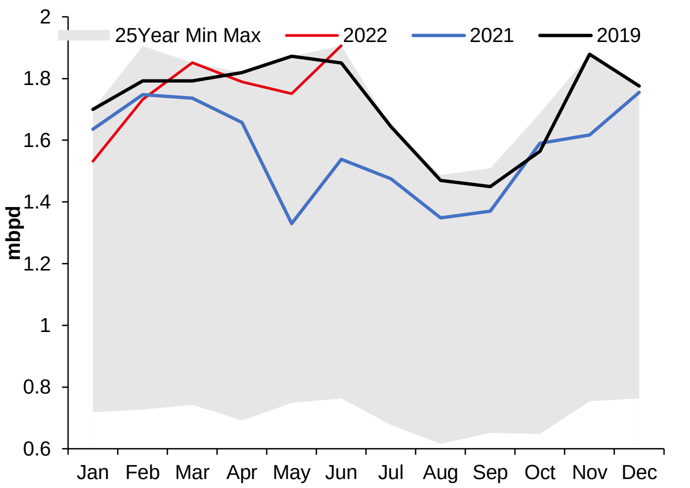
SOURCE: INCRED RESEARCH, COMPANY REPORTS

Figure 9: …and its exports are at a seven-year low



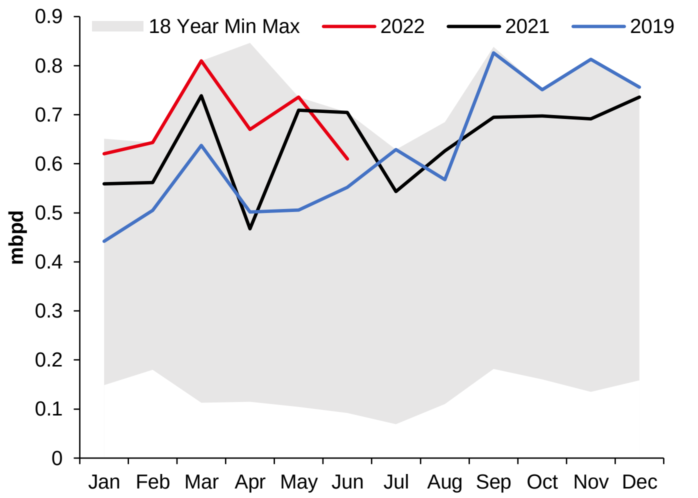
SOURCE: INCRED RESEARCH, COMPANY REPORTS

Figure 10: India's diesel demand is growing at 8% YTD and has topped pre-Covid pandemic level



SOURCE: INCRED RESEARCH, COMPANY REPORTS

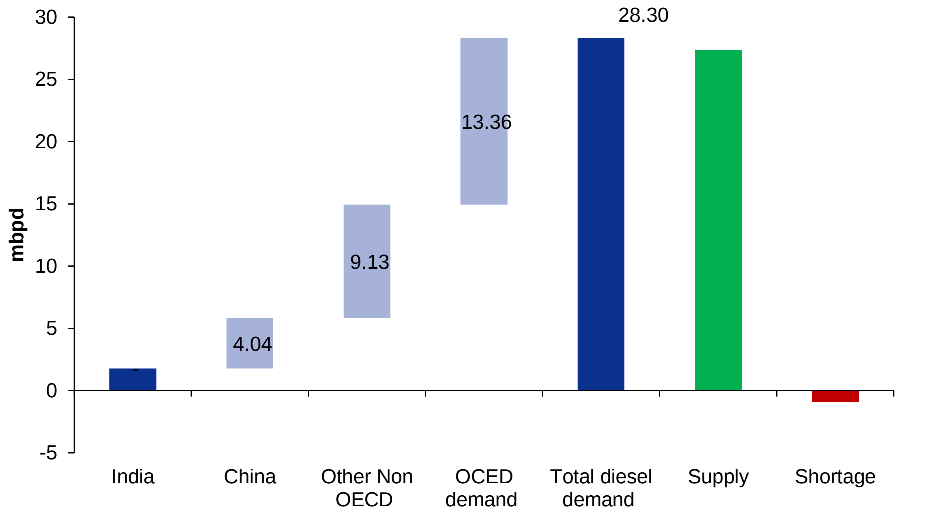
Figure 11: India's diesel exports are coming down and will decline further in coming months



SOURCE: INCRED RESEARCH, COMPANY REPORTS

Hence, there is a global shortage of diesel by ~0.9mbpd

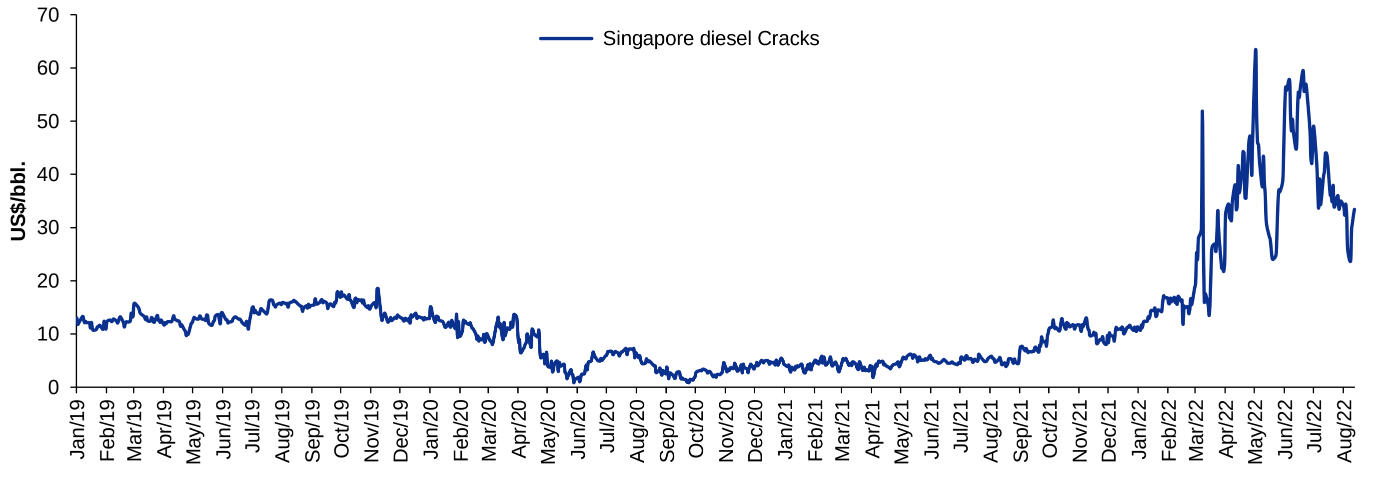
Figure 12: There is global demand-supply balance mismatch because of rapidly rising Indian and Chinese diesel demand as well as a likely increase in European demand and hence, global inventory is dwindling



SOURCE: INCRED RESEARCH, COMPANY REPORTS

Consequently, Asian diesel cracks to remain strong for the next three-to-four years

Figure 13: Singapore diesel cracks are volatile, but they are over US$30/bbl (on an average); current cracks are higher than last four-decade average and will remain so, in our view



SOURCE: INCRED RESEARCH, COMPANY REPORTS

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