Oil sector offers investment opportunities

Oil is all over the place. All talk everywhere trickles down to nothing else, but crude. Even as the man on the street frets over the snowball effect of rising prices, number-crunchers work at a hypnotic pace to figure out its next milestone. And governments across the world, especially those in the developing world, shudder over the fast-narrowing options at their disposal to deal with a catch-22 situation.

While the current spike in crude oil prices is hurting the industry and the economy, there are sections of the industry, which are actually gaining from the same. The market capitalisation of Cairn India has risen 18% since the beginning of May '08, against the 7.5% fall in the BSE Sensex during the same period. Cairn India, which is developing its oilfields in Rajasthan, is likely to gain from high crude oil prices. Similarly, there are quite a few companies operating in the petroleum value chain which are likely to benefit from rising crude prices. ETIG does a value check.

India's largest crude oil producer, ONGC, has long suffered the burden of sharing subsidy and this reflects in its stock performance. However, the company is slated to benefit from the oil production of its subsidiary, ONGC Videsh (OVL), and its share in joint ventures in India, as it can sell this oil and gas at market prices. OVL contributed over 13% to ONGC's total production of 60.8 million metric tonnes of oil & oil equivalent gas (O&OEG) during FY07, which is expected to go up to around 20% during FY08.

Smaller companies operating in the crude oil exploration and drilling business, such as Selan Exploration, Hindustan Oil Exploration and Assam Oil, will also benefit from rising crude prices. However, important factors, including the rate of production, in-place reserves and the government's share under the production sharing contract (PSC), must be studied before investing in these scrips. As the prices of petroleum products such as petrol and diesel have gone up globally in line with the spurt in crude prices, the petroleum refining business continues to earn higher refining margins.

Gross refining margins (GRMs) represent the difference between the realisation through sale of petroleum products and the cost of crude oil required to produce them. Strong refining margins will help standalone public sector refiners such as Mangalore Refinery and Petrochemicals (MRPL), Chennai Petroleum (CPCL) and Bongaigaon Refinery and Petrochemicals (BRPL). However, BRPL is currently facing problems of sourcing crude oil and is not able to utilise its capacities optimally.

Similarly, the ratio for its merger with IndianOil (IOC) has already been fixed, which limits the returns available on the scrip. Essar Oil has commenced commercial production at its refinery at Vadinar in Gujarat, which will start reflecting in its quarterly results from June '08 onwards. While this will boost Essar Oil's revenues substantially from the current levels, a similar spurt in interest and depreciation costs is also expected. Further, the refinery has a limited ability to process lower grades of crude oil and its profitability is expected to remain under pressure.

The 580,000-barrels per day (bpd) refinery being set up by Reliance Petroleum under the special economic zone (SEZ) at Jamnagar is expected to be commissioned before the end of '08. This will not only bring in additional revenues and profits for RPL, but will also improve the bottomline of its parent company, Reliance Industries (RIL).

With the petroleum refining business remaining outside the subsidy-sharing mechanism of the government, a number of new projects are coming up in the country. BPCL's 6-million tonne per annum (mtpa) refinery in Bina, Madhya Pradesh will get commissioned next year, while HPCL's Bhatinda refinery in Punjab will go onstream in '11. Considering the very high costs and delivery delays, two players, viz Cals Refineries and Nagarjuna Oil, have decided to set up refineries from second-hand equipment.

Cals will set up a 5-mtpa refinery in Haldia in West Bengal, which is expected to be commissioned by '10 and Nagarjuna Oil will set up a 6-mtpa refinery in Cuddalore in Tamil Nadu. Even as crude prices soar to unprecedented levels, exploration activities worldwide are gathering pace.

As they say, the only people who made money in the great Californian gold-rush were the suppliers of spades. Similarly, the firms helping oil companies in their exploration efforts are benefiting from the rush for crude. Over the past couple of years, these companies have been increasing their asset base, which is likely to pay off in the next couple of years.

Aban Offshore, which operates a fleet of 25 offshore drilling rigs required in petroleum exploration and production (E&P) activities in the deep seas, is growing fast. As the demand exceeds the availability of rigs, the charter rates for its vessels have more than doubled over the past couple of years.

Jindal Drilling, which acquired a 49% stake in Singapore-based Virtue Drilling, has posted stagnant profits over the past three quarters. However, the company has contracts worth over Rs 2,500 crore and the arrival of its new rig in the next couple of months is likely to boost its future profitability. Seamec's March '08 financial performance suffered heavily as one of its clients in the US went bankrupt and two of its vessels remained dry-docked. However, things may take a turn for the better as its fourth vessel commissioned operations in March '08.

Dolphin Offshore has better prospects with three new vessels expected to join it by the end of '08.

Shiv-Vani Oil, which is India's largest services provider for onshore exploration and production activities, is currently operating 32 rigs and expects to add another eight rigs by end '08. The company is currently carrying orders worth Rs 3,200 crore, which are likely to go up further.

Considering its FY08 turnover of Rs 410 crore, the growth opportunity is significant. Deep Industries, which originally provided solutions in natural gas compression and transmission, has now diversified into mainstream petroleum exploration. The company has obtained two marginal gas blocks and is developing

them. At the same time, its charter hire business of compression equipment and work-over rigs is growing fast.
While the rise in crude oil prices has put one section of the industry under immense pressure, retail investors can find lucrative investment opportunities in other segments.
Besides the standalone refining and petroleum E&P companies, companies providing support to the E&P players also hold excellent growth prospects.

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