SECTOR: AUTO ANCILLARY

Gulf Oil Lubricants

STOCK INFO.	BLOOMBERG
BSE Sensex:28560	**GOLI:IN**
S&P CNX: 8556	

1 December 2014 | **Buy**

Initiating Coverage | INR494

(INR CRORES)

Y/E MARCH	FY15E	FY16E	FY17E
Net sales	993	1,150	1,336
EBITDA	131	169	197
A.PAT	76	102	121
BV/Share (INR)	39	53	69
Adj. EPS (INR)	15.4	20.5	24.3
EPS growth (%)		33	19
P/E (x)	32.1	24.1	20.3
P/BV (x)	12.6	9.4	7.2
EV/EBITDA (x)	20.0	15.5	13.4
Div yld (%)	1.0	1.2	1.4
ROE (%)	39	39	35
RoCE (%)	37	43	43

KEY FINANCIALS

Shares Outstanding (cr)	5.0
Market Cap. (INR cr)	2449
Market Cap. (US$ m)	394
Past 3 yrs Sales Growth (%)	14
Past 3 yrs PBIT Growth (%)	15

STOCK DATA

52-W High/Low Range (INR)	500/250
Major Shareholders (as of September 2014)	
Promoter	60.0
Non Promoter Corp Holding	20.3
Public & Others	19.8
Average Daily Turnover(6 months)	
Volume	43977
Value (INR cr)	1.41
1/6/12 Month Rel. Performance (%)	39/NA/NA
1/6/12 Month Abs. Performance (%)	46/NA/NA

Maximum Buy Price :INR530

We recommend a BUY on Gulf Oil Lubricants with a target of INR 600 - valuing the company at 27x Sep 2016E EPS.

De-merger of high quality lubricant business to lead to value creation: Demerger of the lubricant business from other unrelated businesses (mining, explosives & realty) under the erstwhile holding company indicates the promoter's intent to create value for all stakeholders. The demerged entity will now focus on improving its market share through innovation and brand building initiatives. The lubricant business is relatively non-cyclical since their consumption is non-discretionary (B2C: 75% of sales) and is dependent on the total vehicle fleet in the country. The EBITDA margins have consistently increased from 7.7% in FY10 to 13.0% in 1HFY15 which highlights the company's pricing power amid a challenging economic environment.

Gulf to outpace industry growth by 2-3x: Over the last 4 years, Gulf's volumes grew at a CAGR of 7% while industry volumes increased by 3%. Gulf aims to grow its volumes at 2-3x industry growth. Gulf's capacity is slated to increase from 75,000 kl to 170,000 kl by FY16/17. This offers significant growth visibility which is absent in any other listed players. We expect Gulf to grow its volumes at 10% CAGR over FY14-17E.

Increase in market share to continue: Gulf's MS has increased from 4.4% in FY07 to 6.9% in FY14 in the bazaar segment (80% of market). We believe the company is poised to continue to gain MS on the back of investments in brand building, tie-ups with OEMs and expansion of distribution network. Gulf's ad-spends have risen from 2.5% in FY07 to 7.1% in FY14. Gulf's distribution outlets have grown from 30k to 55k in the last 6 years and the management aims to take it to 75k in the next 3-4 years.

Valuations & View: Earlier, the high-quality (high margin with pricing power, strong return ratios and healthy free cash flow generation) business of lubricants was clubbed with the other low-margin businesses of Gulf Oil Corp. Hence post-demerger, we see potential of value unlocking in the demerged entity, as it would be now directly comparable to Castrol. Castrol has an enviable ROCE of over 100%, earnings growth of 8% CAGR over FY14-16E and trades at 39x Sep 2016E. While Gulf has a respectable ROCE of 37%, it offers significantly higher earnings growth of 24% CAGR and trades at almost half of Castrol's valuation at 22x Sep 2016E. We believe that Gulf deserves better valuations and thus value it at INR 600 at 27x Sep 2016E EPS (30% discount to Castrol).

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ANALYSING THE REASONS FOR HIGH INDUSTRY PROFITABILITY - PORTER'S 5 FORCES MODEL

Bargaining power of buyers LOW

- Lubricant is a small fraction of buyers' maintenance cost, but extremely critical for longevity of the vehicle.
- Buyers are small and fragmented. Hence, despite many players in the industry, buyer power varies from moderately high to low across segments (high for a major auto OEM, low for an individual buyer, small fleet owner).

Threat of New Entrants LOW

(1) Access to complex and expensive technology is a major barrier. (2) High minimum economies of scale needed to challenge established players; globally, the industry is dominated by few large players. (3) Gaining access to distribution network is a challenge. (4) Heavy investments required for brand building.

Industry Rivalry LOW

Intensity of rivalry is low, despite presence of numerous players and the fact that firms sell similar goods, which are substitutes and thus price sensitive. Key reasons are (1) ex post limit to competition (not imitable) and (2) demand is endogenous - allowing market segmentation and differentiation strategies to work.

Bargaining Power of Suppliers MODERATE

- Most global/ local players are fully integrated.
- Many competitive suppliers; product is standardized.

Threat of Substitutes LOW

There are no substitutes which can replace lubricants.

Robust ROCE; healthy scope for margin expansion: We expect Gulf to post an ROCE of 37% in FY15E which is slated to increase to 43% in FY16E, with an expansion in margins. Gulf's EBITDA margins are expected to rise from 12.3% in FY14 to 14.7% in FY16E on the back of a decline in base oil prices which are derivatives of crude oil. Any decline in crude oil prices from current levels is likely to provide further expansion in margins. The benefit of lower costs is generally passed to the B2B segment (25% of revenue) with a lag of three months. With regards to the B2C segments, the company retains bulk of the benefits.

CONCERNS

Lack of clarity on royalty payments: Gulf paid 1.4% of sales as royalty to its parent company Gulf Oil International (Mauritius). The current royalty rate is fixed until FY17, post which it shall be renewed. The management is unwilling to commit the exact rate at which it will renew the royalty agreement; however it has broadly indicated that the rate will be at similar levels. Any increase in the royalty rates would have a negative impact on the company.

Longer oil drain intervals: Over the last decade, volume growth in the lubricants market has been low at 4%, despite strong growth in the automobile industry. This has primarily been due to advances in technology, resulting in steadily increasing drain intervals. For trucks, the drain interval improved from 9,000km to 18,000km in 2002, then to 40,000km in 2006, and now to 80,000km in 2010.

Exchange rate volatility: Gulf imports ~60% of its raw material requirements, and raw materials account for ~60% of its sales. As such, it is exposed to exchange rate volatility. Nonetheless, Gulf has been able to pass on any adverse impact and maintain fairly stable margins.

Gulf Oil Lubricants Financials & Valuation

INCOME STATEMENT (INRCR)

Y/E MARCH	FY14	FY15E	FY16E	FY17E
Revenues	**882**	**993**	**1150**	**1336**
Growth (%)	2	13	16	16
COGS	514	596	673	782
Gross Profit	**368**	**397**	**477**	**555**
GP Margin(%)	41.7	40.0	41.5	41.5
Employee Cost	37	42	48	56
Other Expenses	222	224	260	302
EBITDA	**108**	**131**	**169**	**197**
EBITDA Margin(%)	12.3	13.2	14.7	14.7
Depreciation	3	5	7	8
Other Income	0	7	5	5
PBIT	**105**	**133**	**167**	**194**
PBIT Margin(%)	12.0	13.4	14.5	14.5
Interest Cost	22	18	13	11
PBT	84	116	154	183
Tax	35	39	52	62
Rate(%)	42	34	34	34
Adjusted PAT	**55**	**76**	**102**	**121**
Growth(%)	0	38	33	19

RATIOS

Y/E MARCH	FY14	FY15E	FY16E	FY17E
Adjusted EPS (INR)	**-**	**15.4**	**20.5**	**24.3**
Book Value	-	39	53	69
Div Per Share	-	5.0	6.0	7.0
Dividend Payout(%)	-	38	34	34
Net Debt / Equity	-	0.5	0.4	0.2
P/E	**44.2**	**32.1**	**24.1**	**20.3**
P/BV	-	12.6	9.4	7.2
EV/EBITDA	24.3	20.0	15.5	13.4
EV/Sales	3.0	2.6	2.3	2.0
Dividend Yield	-	1.0%	1.2%	1.4%
ROCE		**37%**	**43%**	**43%**
PBIT Margin	12.0%	13.4%	14.5%	14.5%
Asset Turnover (x)	-	2.7	3.0	3.0
EBITDA Margin	12.3%	13.2%	14.7%	14.7%
PAT Margin	6.3%	7.7%	8.8%	9.0%

BALANCE SHEET (INRCR)

Y/E MARCH	FY14	FY15E	FY16E	FY17E
Share Capital	-	10	10	10
Reserves	-	185	252	332
Networth	**-**	**195**	**262**	**342**
Loans	-	168	126	108
SOURCES OF FUNDS	**-**	**363**	**388**	**450**
Gross Fixed Assets	-	142	192	226
Less: Depreciation	-	32	39	47
Net Fixed Assets	**-**	**110**	**153**	**180**
Capital WIP	-	0	0	0
Inventories	-	176	204	237
Debtors	-	113	131	152
Cash & Investments	-	78	32	33
Loans & Advances	-	18	21	24
Other Curr Assets	-	1	2	2
Curr. Assets	-	386	390	449
Creditors and Prov.	-	134	155	180
Net Current Assets	**-**	**253**	**235**	**269**
APPLICATION OF FUNDS	**-**	**363**	**388**	**450**

CASH FLOW (INRCR)

Y/E MARCH	FY14	FY15E	FY16E	FY17E
EBITDA	-	-	169	197
Adjustments	-	-	0	0
(Inc)/Dec in W.Cap	-	-	(28)	(33)
Pre Tax OCF	-	-	141	164
Tax Paid	-	-	(52)	(62)
CF from Operations	**-**	**-**	**89**	**101**
(Inc)/Dec in FA	-	-	(50)	(35)
Interest Received	-	-	5	5
CF from Investing act.	**-**	**-**	**(45)**	**(30)**
Inc/(Dec) in Debt	-	-	(42)	(18)
Interest Paid	-	-	(13)	(11)
Divd Paid (incl Tax)	-	-	(35)	(41)
CF from Financing act.	**-**	**-**	**(90)**	**(70)**
Inc/(Dec) in Cash	**-**	**-**	**(46)**	**1**
Add: Opening Balance	-	-	78	32
Closing Balance	**-**	**-**	**32**	**33**

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