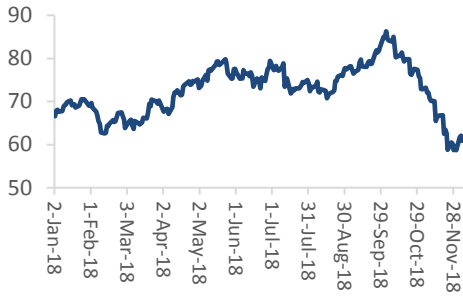


Brent Crude Price in USD/bbl



Oil prices are crucial for the Indian markets, given the high import dependence (~80% of oil requirements) of the country. Brent crude hit the year's peak of \$86/bbl in early October, sparking major fears of an economic slowdown in the country.

However, prices have eased since then to \$60-levels due to oversupply concerns and the Iran sanctions waiver. The recent slump has allowed India Inc. to breathe a sigh of relief.

In this report, we look into the impact of falling crude oil prices on select sectors that may benefit from the development.

Brent crude (Avg)	USD
Oct (Recent Peak)	86.29
Dec 5, 2018	60.92
52-week high	86.29
52-week low	56.28

INR/USD	
Dec 5, 2018	70.70/\$ (Open Price)
52 Week High	74.4/\$ (9 th Oct'18)
52-week Low	64.3/\$ (4 th Jan'18)

Source: Bloomberg

- ✦ **Paints to get back their lustre from recent dip in crude prices** coupled with price hikes taken over the last two months. **Asian Paints (APNT)**, with ~54% market share, is poised to benefit from the decorative segment's growth and planned capacity expansion.
- ✦ **Tyre-makers** are likely to benefit as their key inputs (~80%) are crude derivatives. **Apollo Tyres (APL)** seems well placed given the higher earnings growth, rise in earnings in Europe operations, & lower exposure to the competitive 2W tyre segment.
- ✦ **Decline in crude prices over the last two months comes as a relief for OMCs** & improvement in margins from current levels seems likely, albeit with a time lag. **HPCL** has greater exposure, compared to peers, to the marketing segment and may be a key beneficiary from the dip.
- ✦ **Lubricant manufacturers**, particularly, **Gulf Oil Lubricants (GOL)**, are likely to see margin improvement, supported by increase in volumes, albeit with a time lag. GOL may witness greater traction in volume owing to additional capacity, leading to increased market share.
- ✦ **Aviation may take a breather** after reeling under various cost pressures, as ATF eases from the year's high of ₹76,379/KL on Nov 01, 2018 to 68,051/KL on Dec 01, 2018. Largest aviation player **Interglobe Aviation** is likely to reap benefits as a \$5 change in crude is estimated to make its profits swing by ~35%.
- ✦ **Plastic products:** Over the last decade, yoy change in Brent crude prices has a strong correlation of 0.9 with the yoy change in average polymer prices, suggesting that plastic product manufacturers are expected to witness a decent growth in their gross margins.

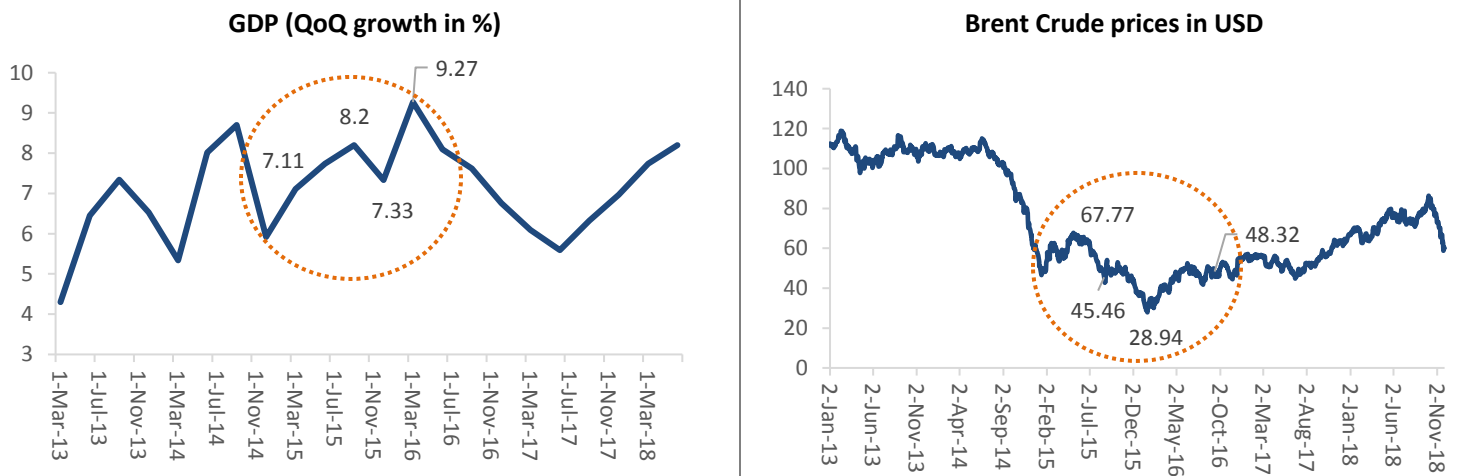
Declining Brent crude augurs well for India's macros

After what appeared to be a relentless upmove, Brent crude prices have been on the decline from the October 06, 2018 peak of \$86/bbl, shedding ~30% on concerns over a potential oversupply overhang as well as weak equities, geopolitical issues, and the subsequent softening demand.

Several concerns weigh on crude prices currently. The prime worry is the potential supply glut by OPEC+ and the US administration's waiver to Iran for supplying oil to eight countries for six months starting November 05, 2018.

The second key concern is the possible slowdown in global growth owing to trade wars, which may consequently lower demand. Although fears of further escalation in trade wars may be temporarily allayed given the progress in US-China talks at the recently held G20 meet, nevertheless, there is still lack of clarity on the agreed-upon terms between the two countries.

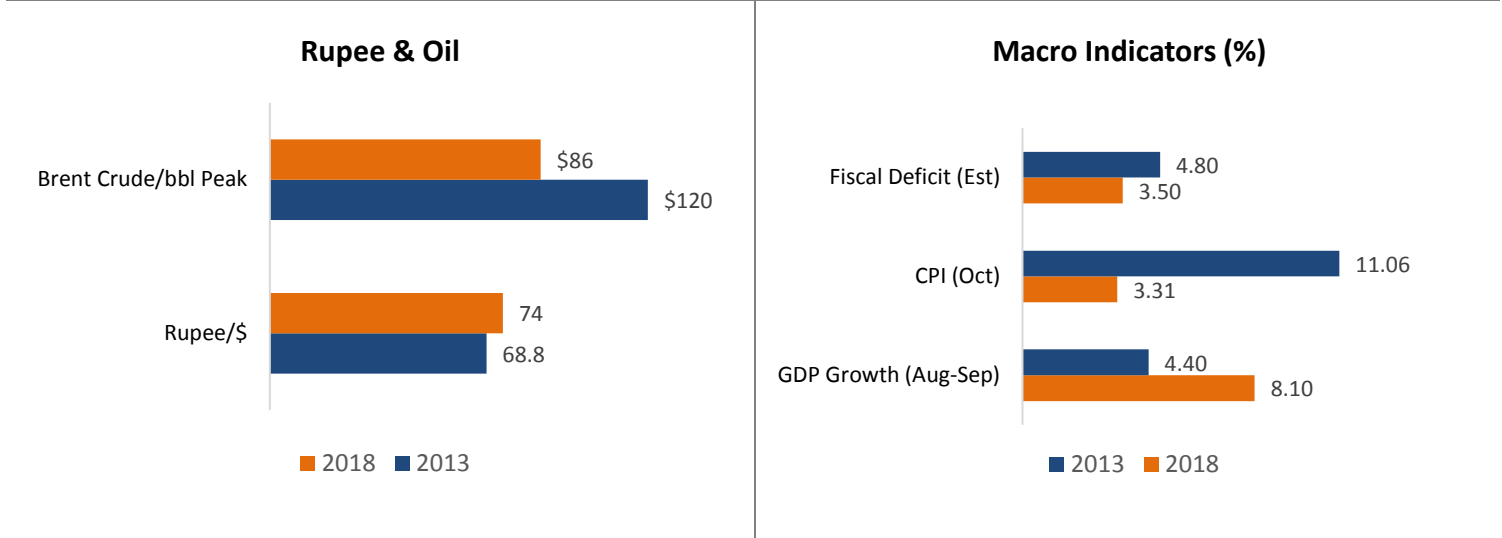
Exhibit 1: GDP & Brent crude prices



Source: IIFL Research

On the domestic front, crude prices are always a key factor impacting the economy and markets given that India remains one of the biggest net importers of crude oil. The economy is hard hit by any escalation in the prices of the commodity, directly and indirectly hitting almost every sector in the economy and also causing the deficit scenario to go awry.

Exhibit 2: 2013 vs. 2018: Macro scenario amid high crude prices



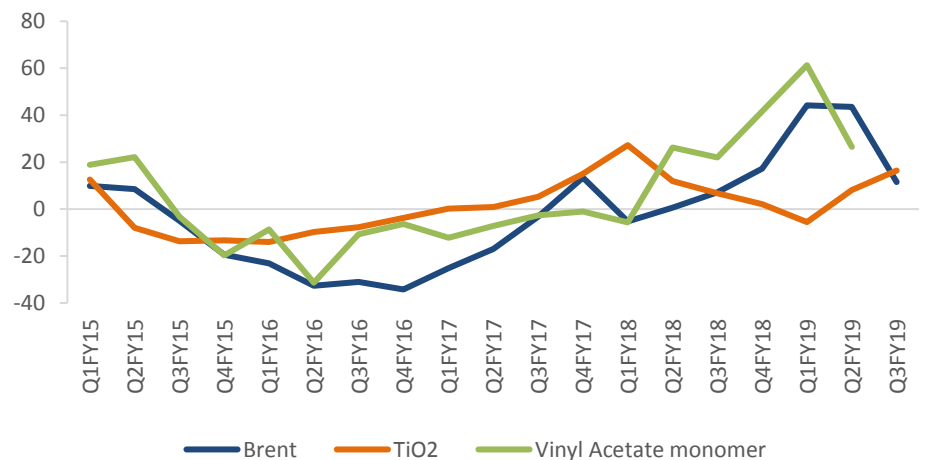
Source: IIFL Research

Considering the case in 2013/14 when crude hovered around \$110 levels, we saw the Indian GDP being knocked sharply. However, back in late 2014-early 2015 when crude eased to below \$60 levels, the country's growth bounced back to healthy levels. A recent study showed that a \$10/bbl change in crude oil prices results in 55bps impact on CAD/GDP and 30bps impact on inflation.

Paints & Adhesives to be major beneficiaries

Key inputs for paint manufacturers are monomers and titanium dioxide, which are crude oil derivatives and make for 30-35% of the total raw material cost for the sector. Vinyl acetate monomer, also a crude oil derivative, is a key raw material for adhesives, comprising 60% of the raw material cost for adhesive-maker Pidilite.

Exhibit 3: Price movement of key raw materials (%)

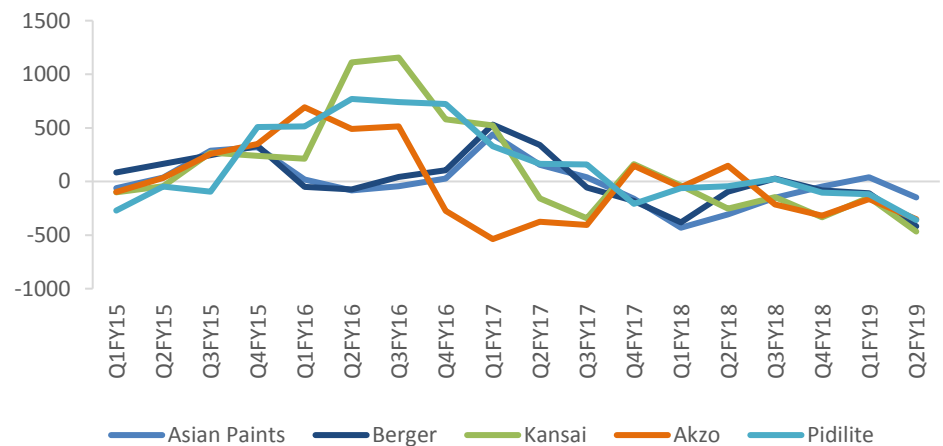


Source: Bloomberg, IIFL Research

In Q2FY19, these companies took a hard knock due to rupee depreciation and heightened crude oil prices leading to gross margins contraction of 150-470bps on a yoy basis. To cap further erosion in margins, the companies took the route of price hikes.

The drop in crude prices bodes well for Indian paint companies given that it reduces input cost burden and boosts margins. Further, a second price hike of 1.5% w.e.f. Dec 01, 2018 following the 2.35% hike on October 01, 2018 is also likely to drive the expansion in gross margins for these firms.

Exhibit 4: Movement in gross margin expansion/contraction (bps)



Source: Bloomberg, IIFL Research

Though the price of TiO₂ remains high, the sharp moderation in crude oil implies lower input costs, which is expected to aid gross margin expansion, albeit with a time lag on the back of hedges and advance purchase of materials.

Asian Paints, which owns the largest market share of ~54% among its peers, is well-placed to benefit from the decorative segment's growth as well as planned capacity expansion going forward.

The recent dip in crude comes as a relief for Tyre cos

The key inputs for tyre-makers are natural rubber and crude-linked derivatives (synthetic rubber, carbon black, chemicals, etc.), which account for ~80% of the total raw material consumed. The steep hike in crude in the recent quarters weighed on tyre-makers' gross margins.

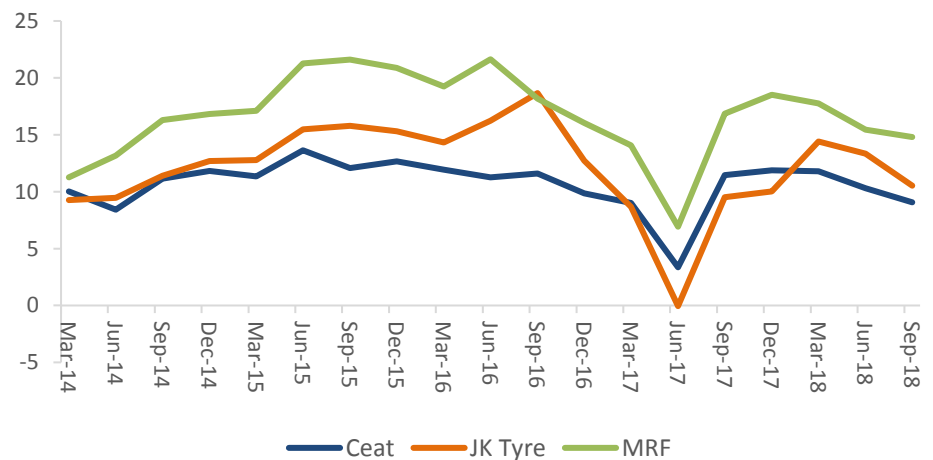
Costs of key inputs for tyre-makers

Raw Material	Q1FY18	Q2FY18	Q3FY18	Q4FY18	Q1FY19	Q2FY19
Carbon black (₹/kg)	65.00	65.00	65.00	70.00	83.00	90.00
Growth qoq (%)	0.0	0.0	0.0	7.7	18.6	8.4
Crude (\$/bbl)	47.92	57.54	66.87	70.27	79.44	82.72
Growth qoq (%)	(9.3)	20.1	16.2	5.1	13.0	4.1
Synthetic Rubber (₹/kg)	200	275	220	220	260	270
Growth qoq (%)	(11.6)	5.3	37.5	(20.0)	(0.0)	(18.2)
Aggregate Gross Margins (%)	32.3	37.1	39.1	39.0	37.8	37.0

Source: Bloomberg, IIFL Research

The Indian tyre sector is more dependent on aftermarket for its growth, given that it derives nearly 2/3rd volumes from aftermarket and only 1/3rd from OEMs.

Exhibit 5: Tyre manufacturing companies - Gross Margins (%)



Source: Bloomberg, IIFL Research

In the times of weak OEM growth, lower crude prices provide tyre companies with a cushion for growth and aid in elevating gross margins (although the effect may be seen with a lag). Within the sector, Apollo Tyres (APL) is poised to benefit from the decline in crude prices given its higher earnings growth, rise in earnings in Europe operations, & lower exposure to the competitive 2W tyre segment.

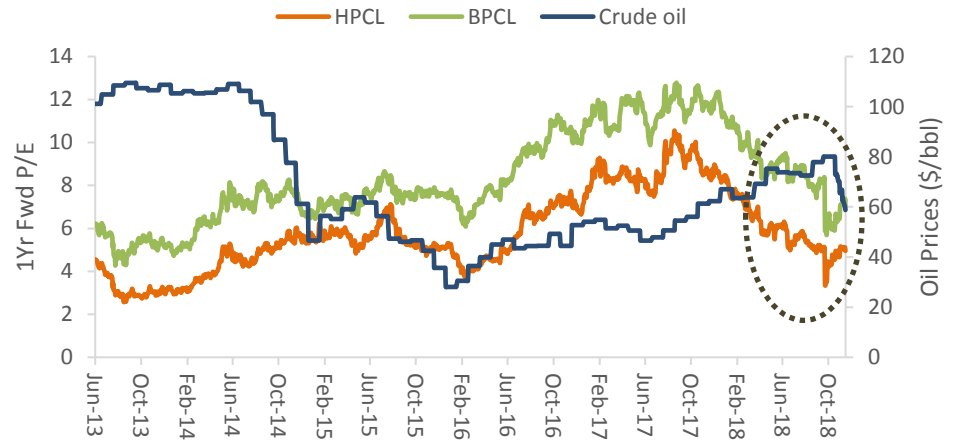
Oil Marketing Companies (OMCs) may be key beneficiaries

Although the rally in crude prices over the last two years allowed OMCs to pass on costs to consumers owing to deregulation of fuel prices by the Centre, the OMCs were asked to bear ₹1/lt of retail prices to cap retail fuel prices in early October.

This has led to investor concerns as India enters election year, and further absorption of costs by OMCs may be demanded should Brent crude rise. However, the steep fall in oil prices over the last two months provides a relief to investors for the near term. Also, positive for the sector is the possible rollback of the subsidy burden on these OMCs if the subdued oil prices persist.

An improvement in margins from current levels seems likely although it may come with a time lag.

Exhibit 6: 1-yr forward P/E Multiples of OMCs



Source: Bloomberg, IIFL Research

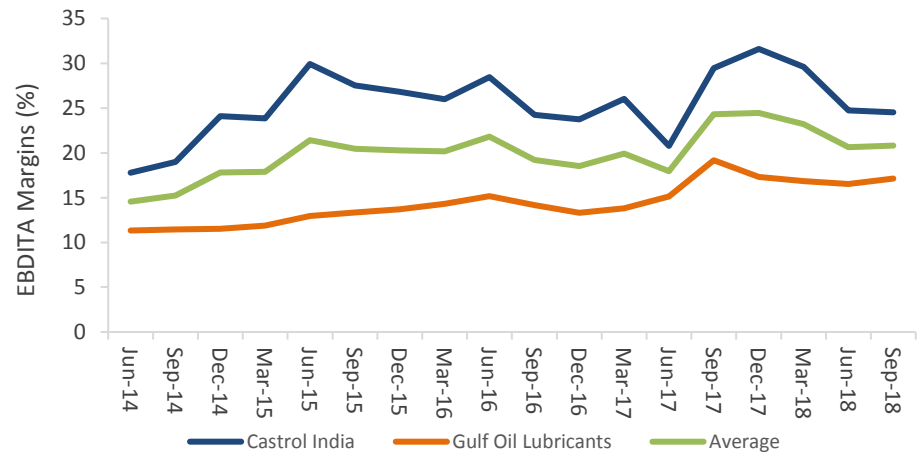
Historically, in the event of stable or declining crude prices, P/E valuations of OMCs have improved significantly. Considering the same trend, valuations may improve based on recent price levels. However, the election year will definitely weigh in on the performance of these companies should Brent crude rise.

Among OMCs, HPCL has greater exposure to the marketing segment and may be a key beneficiary from the recent oil price dip.

Lubricants to see smooth growth in gross margins

Base oil, the key raw material for lubricants, are crude derivatives and any change in crude oil price has a bearing on the cost of these firms, although with a lag. When the price of Brent crude goes up, these companies have a limited ability to pass on incremental costs to consumer owing to high competitive intensity in the industry. In periods of stable oil prices, these companies tend to drive gross margins based on the product mix. Considering the recent drop in crude prices, these firms are likely to see margin improvement, supported by increase in volumes.

Exhibit 7: EBDITA Margins impacted due to spike in crude



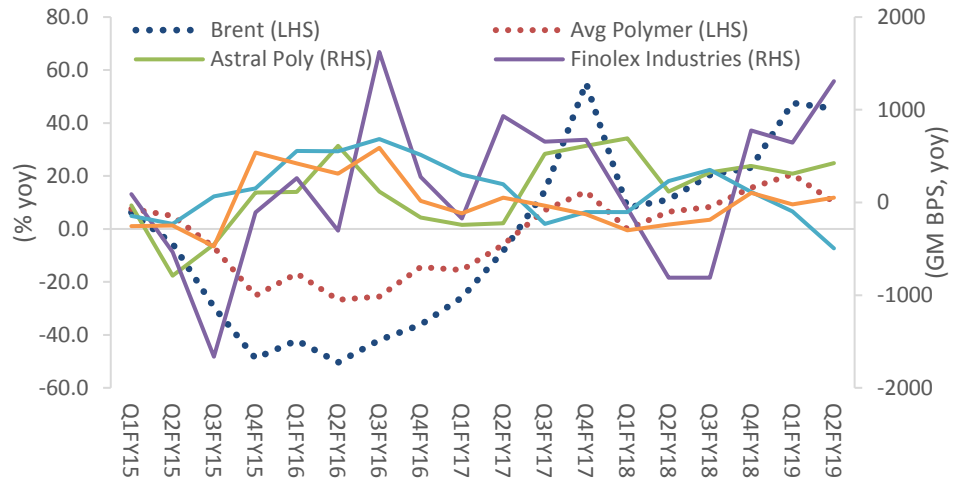
Source: Bloomberg, IIFL Research

Gulf Oil Lubricants is particularly expected to see margin improvement, supported by increase in volumes, though it may come with a time lag. The company is likely to witness greater traction in volume owing to additional capacity, leading to increased market share.

Plastic product makers to benefit from lower input prices

Polymer (the key raw material for these companies) constitutes 50-60% of sales for these firms. A comparison of yoy change in Brent crude prices with yoy change in average polymer prices over the last 10 years suggests a correlation of 0.9 between the two.

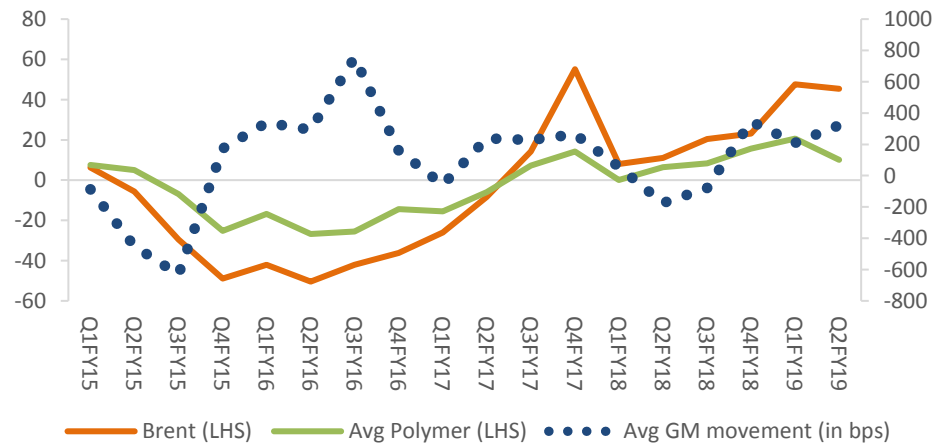
Exhibit 8: Movement of input prices vs. change in gross margins



Source: Bloomberg, IIFL Research

At the same time, there is a negative correlation (-0.4) between price movement of polymers and gross margin movement of plastic processing companies.

Exhibit 9: Avg. movement in gross margins vs. polymer & crude prices



Source: Bloomberg, IIFL Research

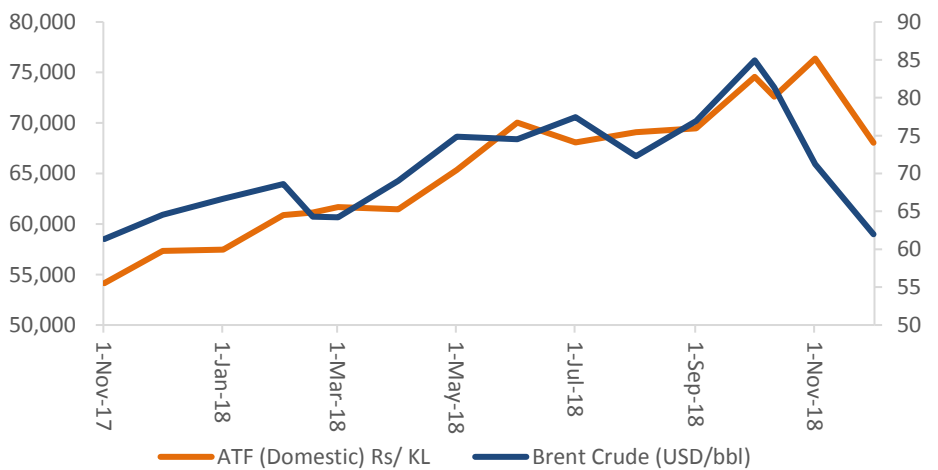
Aviation likely to breathe easy

The sharp correction in global crude prices is likely to alleviate some stress off the Indian aviation sector, which is currently reeling under tremendous pressure on account of high fuel prices, weaker rupee, and intense competition among airline operators. ATF (Air Turbine Fuel) prices in Delhi jumped 41% yoy to ₹76,379/KL on November 01, 2018 from ₹54,143/KL on November 01, 2017, however, have eased to 68051/KL on December 01, 2018.

In terms of sensitivity to Brent crude prices, for every \$5 change in Brent crude, Interglobe Aviation is estimated to witness a ~35% swing in profits. Further, the company is estimated to experience a 40-50bps change in its EBDITA margin per USD change in crude price, while Spicejet is estimated to see a 50-60bps change for the same.

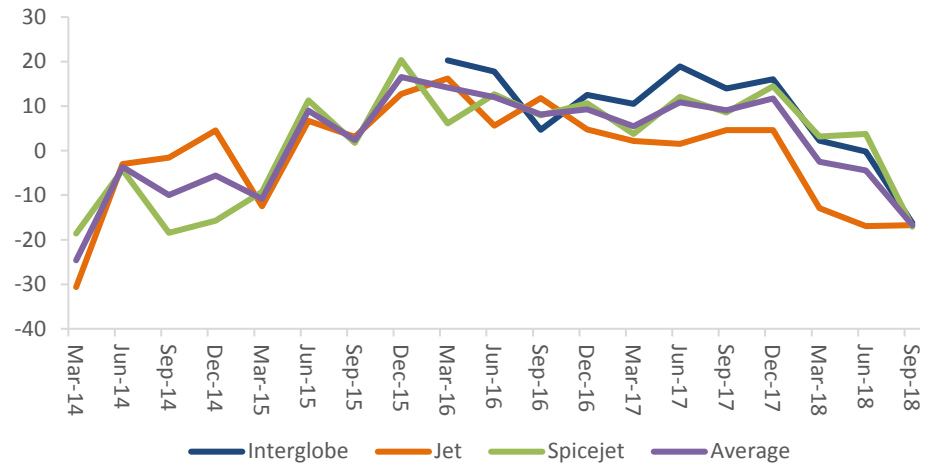
Consequent to the ~30% fall of crude from its peak of \$86 per barrel ATF prices, costs for airlines are expected to come down, as fuel expenses account for around 35% of the total operating expenses for the airline companies.

Exhibit 10: Correlation of ATF vs. Brent crude (%)



Source: Bloomberg, IIFL Research

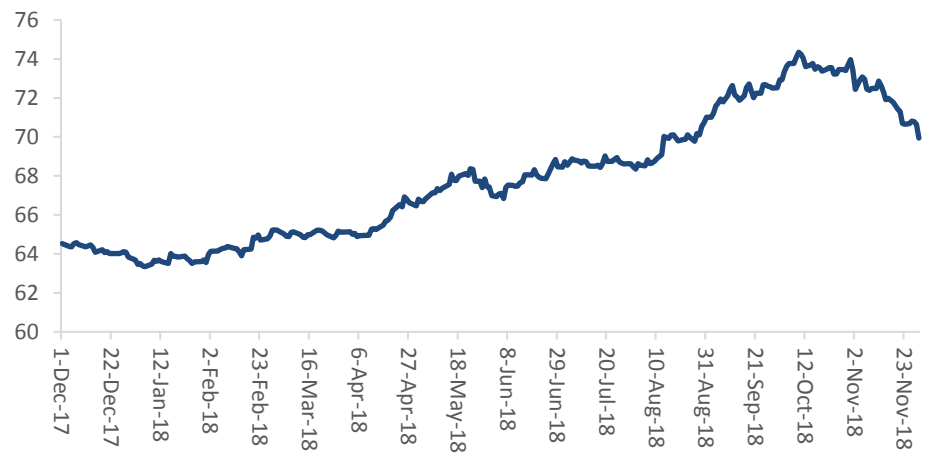
Exhibit 11: Aviation EBDITA Margins (%)



Source: Ace Equity; Interglobe Aviation listed on Nov 15, 2015

Moreover, the rupee has also started recovering from an all-time low of 74.34/\$. Given that airline companies pay their aircraft lease rentals and maintenance charges (35-40% of the total operating expenses for the firms) in dollar terms, lower oil prices are likely to have a double-benefit for these companies both in terms of lower fuel costs and subdued lease and maintenance costs.

Exhibit 12: INR/USD Depreciation



Source: Bloomberg

This scenario can potentially improve the airlines' financial performance from current levels as India's top three airlines have posted their worst quarterly performance for the quarter ending September 30, 2018.

Outlook

High oil prices have always been a pain point for the Indian markets, given that it has repercussions on the twin deficits, destroys rupee value, and sets the economy in a vicious cycle. Oil prices are currently under pressure from concerns over a supply glut; however, the waiver of Iranian oil imports for nearly six months is likely to end as the US administration seemed clear over ensuring that Iran oil exports are nil post the waiver period.

The recent talks in the G20 meet between the US and China appear to have temporarily frozen tariff war concerns, however, a large number of unresolved issues still persist between the two countries.

Low crude prices are always favorable to India's macros, keeping fuel prices in check and providing greater fiscal freedom to the government. India Inc. is also likely to benefit from this over the short term and select picks from the abovementioned sectors would be a prudent choice for investing.

Recommendation Parameters for Fundamental/Technical Reports:

Buy – Absolute return of over +10%

Accumulate – Absolute return between 0% to +10%

Reduce – Absolute return between 0% to -10%

Sell – Absolute return below -10%

Please refer to <http://www.indiainfoline.com/research/disclaimer> for recommendation parameter, analyst disclaimer and other disclosures.

IIFL Securities Limited (Formerly 'India Infoline Limited'), CIN No.: U99999MH1996PLC132983, Corporate Office – IIFL Centre, Kamala City, Senapati Bapat Marg, Lower Parel, Mumbai – 400013 Tel: (91-22) 4249 9000. Fax: (91-22) 40609049, Regd. Office – IIFL House, Sun Infotech Park, Road No. 16V, Plot No. B-23, MIDC, Thane Industrial Area, Wagle Estate, Thane – 400604 Tel: (91-22) 25806650. Fax: (91-22) 25806654 E-mail: mail@iifl.com Website: www.indiainfoline.com, Refer www.indiainfoline.com for detail of Associates.

Stock Broker SEBI Regn.: INZ000164132, PMS SEBI Regn. No. INP000002213, IA SEBI Regn. No. INA000000623, SEBI RA Regn.: - INH000000248

For Research related queries, write at research@iifl.com

For Sales and Account related information, write to customer care: cs@iifl.com or call on 91-22 4007 1000