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PhillipCapital

Indian Lubricants Sector

The road to recovery

INDIA | OIL & GAS | Sector & Initiating

22 September 2016

Read this report:

- **To understand why the recent recovery in lubricants volume is sustainable**
- **How a benign raw material environment will keep costs under control**
- **How premiumisation would lead to structural growth in margins**

After years of tepid volume growth, the Indian lubricants space has seen traction in CY16. Core volumes of major listed entities – Castrol India and Gulf Oil Lubricants – have grown by 7%/13% yoy in CY16 YTD, versus a 5-year CAGR of -3%/+7%. Recent growth was driven by continued momentum in personal mobility space coupled with some recovery in commercial vehicle and industrial segments. We see steady margins and volume recovery based on a benign oil price environment, strong auto and industrial fuel consumption, slowing drain interval growth and push towards premiumisation. We expect lubricant marketers to see better profitability and initiate coverage on Castrol India/Gulf Oil with Buy ratings and target prices of Rs 550/950.

Volume acceleration on steady personal mobility plus CV and industrial recovery

Our industry analysis and channel checks imply industry volume growth recovering from a past 5-year CAGR of 2-3% to 5-6% in CY16, driven by healthy personal mobility sales due to 10%+ petrol consumption implying more frequent oil changes. CV/diesel engine oils have also seen traction, indicated by diesel demand improvement since FY14 and ~17% yoy growth in CV sales in 1HCY16 (M&HCV at 20%+). Industrial fuels like bitumen and furnace oil have also seen 15-18% demand growth in FY16-17, which should push lube sales. Acceleration in mining and road construction activity can be further drivers going forward. Companies have indicated signs of recovery from 1QCY16; both Castrol and Gulf Oil saw 9-10% growth during that quarter.

Comfortable raw material environment would alleviate pressure on margins

The 50% decline in oil prices in the last two years has lowered raw material base oil prices by 30-40%. Additive prices have also dropped by ~5% in CY15 despite otherwise being inflationary in nature. This has eased cost pressures significantly and helped Castrol/Gulf Oil Lubricants record ~30%/15% gross margin expansion during this period. We build a Brent price of US$ 45/50 per barrel in FY17/18 and expect unit base oil costs to remain under control and in line with oil prices. Base oil/additives/packaging forms ~50/35/15% of the raw material mix. An appreciating currency is also positive for the sector. We build in Rs 66-67/USD in our CY16-FY18 estimates.

Premiumisation and power brands to drive realisations and margins

The lube industry is characterised by brand building, innovation, and premiumisation, which aids market share gains and pricing power. New products are launched based on largely homogenous specifications (like viscosity), though branding helps to boost customer preference. CV customers however are value chasers seeking better economics (long drain, pricing, distribution reach etc). Castrol is at the helm of brand recall and Gulf Oil Lubricant is in the top-3 in terms of brand positioning. In the last 5 years, realisations rose by 5-7% CAGR and fell only last year (only 0.3% for Castrol) due to sharp decline in oil prices resulting in schemes/discounts. We expect blended realisation to keep on increasing, driving margins.

Initiate coverage on Castrol and Gulf Oil Lubricant with Buy ratings

We estimate Castrol/GOLI to record 6%/12% volume growth, 8% each EBITDA/litre growth, and 16%/25% EPS CAGR from CY15/FY16 to CY17/FY18. We value them at 33x/30x, CY17/FY18 EPS of Rs 16.7/31.7 to arrive at our target prices of Rs 550/950, which provides 30%/35% upside. We initiate coverage with Buy ratings. Spike in oil prices, destructive competition/pricing, and adverse currency are key risks.

Companies

Castrol India Ltd

Reco	Buy
CMP, Rs	423
Target Price, Rs	550

Gulf Oil Lubricants India Ltd

Reco	Buy
CMP, Rs	705
Target Price, Rs	950

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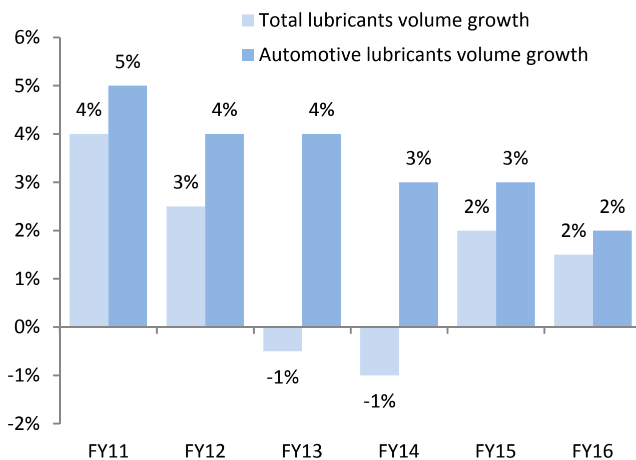
Note: Certain data and information in this report are derived through channel checks and interaction with industry participants. In absence of a common industry data platform, figures may not be fully accurate or match between different sources.

Investment Arguments

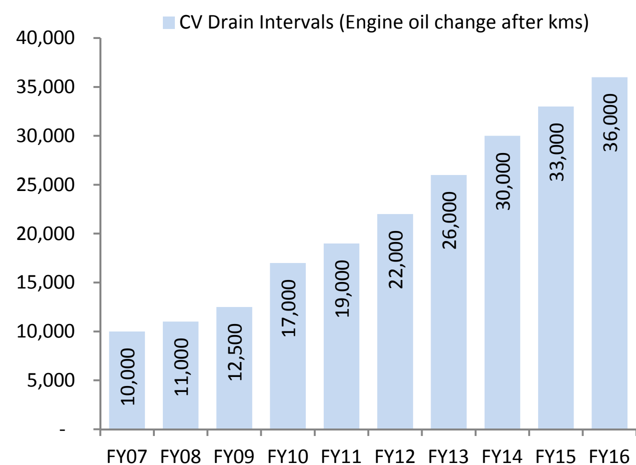
Volume acceleration on steady personal mobility and CV/industrials recovery

Lubricant demand volume growth slowed down in the last 5-6 years
Industry estimates (though varying) suggest that against an annual growth of 4-5% in CY10, it was flat to slightly negative in CY12/13, followed by some recovery (1-3%) in CY14/15, which was still weak. The deceleration was both in automotive and industrial segments.

Lubricant volume growth in India



Drain interval of CVs over the last 9-10 years



Source: Industry, PhillipCapital India Research

Diesel and petrol consumption growth, which is an indicator of automotive lubricant demand, slowed down to -1%-+5% in FY13-14. New automobile sales and vehicle population growth in the country remained dull.

Lubricant volumes took a beating due to dull vehicle sales and the introduction of smaller, more-efficient engines, and durable engine oils – which led to the drain intervals lengthening

Additionally, the introduction of smaller, more-efficient engines, and durable engine oils led to the drain intervals lengthening, resulting in a structural decline in per-vehicle lube consumption – a trend particularly seen in the sensitive CV segment, where transporters and fleet operators are quick to shift to value-based/cheaper options. Although realisations of long-drain oils were better, headline volume numbers weakened.

Demand growth scenario of major auto and industrial fuels

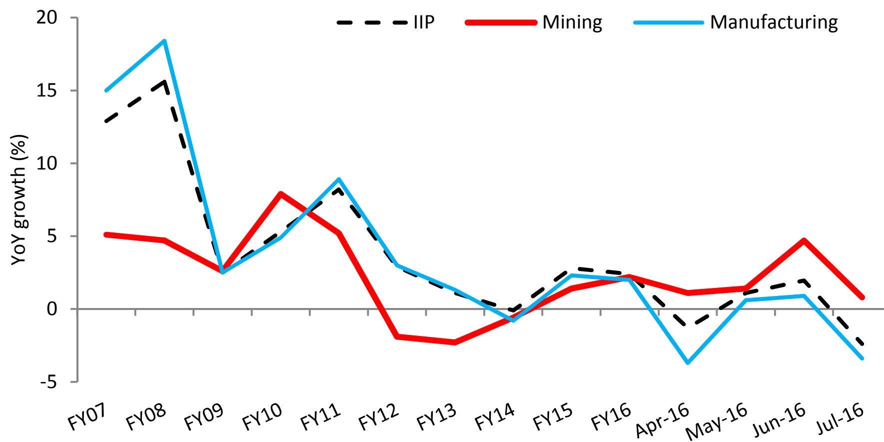
mmt	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17 YTD
Diesel	42.9	47.7	51.7	56.2	60.1	64.8	69.1	68.4	69.4	74.6	32.1
Growth	7%	11%	8%	9%	7%	8%	7%	-1%	2%	8%	6%
Petrol	9.3	10.3	11.3	12.8	14.2	15.0	15.7	17.1	19.1	21.8	10.0
Growth	7%	11%	9%	14%	11%	6%	5%	9%	11%	15%	14%
FO/LSHS	12.6	12.7	12.6	11.6	10.8	9.3	7.7	6.2	6.0	6.7	3.1
Growth	-2%	1%	-1%	-8%	-7%	-14%	-18%	-19%	-4%	12%	18%
Bitumen	3.8	4.5	4.7	4.9	4.5	4.6	4.7	5.0	5.1	5.8	2.4
Growth	9%	18%	5%	4%	-8%	2%	1%	7%	1%	15%	15%
Total	120.7	128.9	133.6	137.8	141.0	148.1	157.1	158.4	165.5	183.5	80.4
Growth	6.7%	6.8%	3.6%	3.2%	2.3%	5.0%	6.0%	0.9%	4.5%	10.9%	9.3%

Source: PPAC, PhillipCapital India Research

During this period, non-automotive segment (industrial) was also weak due to mining, infrastructure, and general economic slowdown. The mining sector, an intensive lubricant user (8% target market in industrial lubricants), saw bans in eastern India (Odisha, Bihar) – which led to considerable demand weakness.

Industrial indicator-fuels such as furnace oil and bitumen also saw weaker demand during this period.

IIP data: Stabilising



Source: MOSPI, PhillipCapital India Research

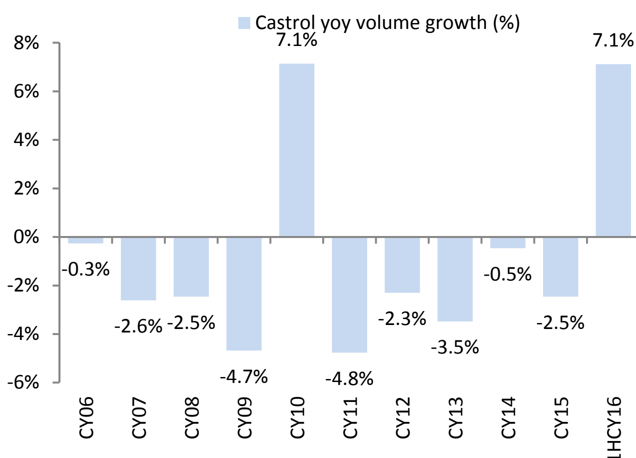
Lubricants showing signs of recovery in CY16, justified by cos headline numbers

CY16 is seeing traction in lubricants consumption. Major listed pure-play entities – Castrol/Gulf Oil Lubricants (GOLI) have recorded 7%/13% yoy headline volume growth in CY16 YTD versus a five-year CAGR of -3%/+7%. Castrol's numbers are particularly important – its dominant position in the crucially profitable 'bazaar' segment with a high volume base makes it the bellwether to the industry.

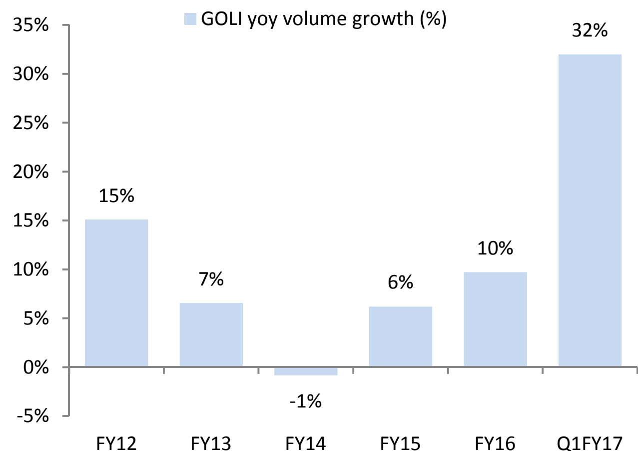
Signs of recovery – bellwether Castrol has seen 7% growth in volumes CY16 YTD

Castrol had seen -3% CAGR over the last 5-10 years, partly due to its deliberate focus on the high-margin personal mobility (PM) segment (13% CAGR in the last 10 years) at the cost of the less lucrative CV and industrial segments (5% negative CAGR each). Market share gains by smaller players and technological progress also contributed to the decline.

Castrol's volumes grew 7% in 1HCY16 – first time in five years



GOLI also outperformed



Source: Company, PhillipCapital India Research

Sharp volume jumps in CY16 were driven by continued momentum in the PM space coupled with a recovery in CV and industrial segments. The traction in the PM segment (industry wide) is due to a reversal of factors that had dampened lubricants growth earlier; higher petrol and diesel consumption are now leading to more frequent engine oil change cycles and there is an increase in vehicle population and new vehicle sales.

There is a reversal of factors that had dampened lubricants growth earlier

While smaller private players like GOLI will continue to outperform bigger entities like Castrol, industry momentum would help Castrol retain its 20%+ market share and increase volumes.

New vehicle sales in India – marked improvement in 2016 almost across the board

Growth	CY07	CY08	CY09	CY10	CY11	CY12	CY13	CY14	CY15	1HCY16
All Vehicles	30%	-10%	28%	0%	50%	6%	1%	9%	1%	12%
PVs	54%	-12%	34%	4%	38%	10%	-8%	1%	8%	4%
CVs	48%	-16%	11%	12%	54%	5%	-16%	-12%	7%	17%
LCVs	57%	-9%	30%	4%	64%	19%	-8%	-17%	-5%	13%
M&HCVs	42%	-21%	-7%	22%	43%	-12%	-29%	0%	30%	23%
3W	27%	-16%	28%	-4%	33%	1%	-6%	6%	-3%	22%
2W	25%	-9%	28%	-1%	53%	6%	4%	12%	0%	12%

Source: Ace Equity, PhillipCapital India Research

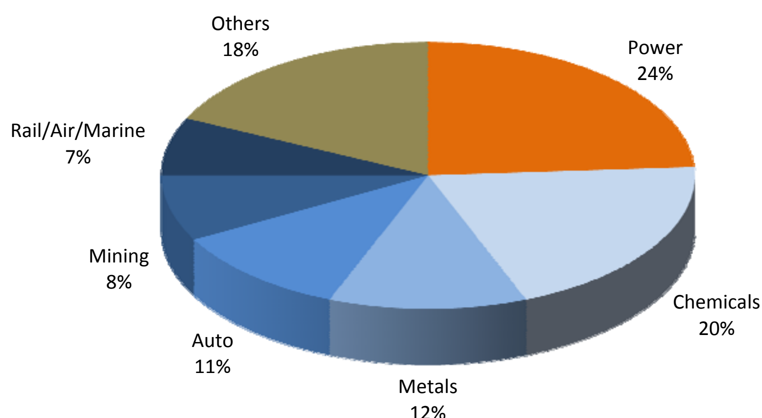
New vehicle sales are recovering – while these are generally low-margin, they push out a batch to the lucrative replacement market (bazaar trade segment)

The CV segment recovery is largely due to rising economic and logistic activity, which has particularly driven the replacement market. New vehicle sales have also picked up considerably, especially in CY16, with LCVs rebounding from -5% yoy in CY15 to +13% in 1HCY16; M&HCVs have been strong at 23% vs. 30% in CY15. 3Ws have clocked a sharp 22% recovery (vs -3%) while 2Ws are up from flat to +12%. Only PV sales have slowed down to 4% from 8%. New vehicles are part of the low-margin OEM business; however, they push out a batch to the replacement market – which is essentially the lucrative bazaar trade.

Mining recovery, road infra can boost industrial lube volumes significantly

The industrial lubricant segment comprises of sectors such as power, chemicals, metals, automotive manufacturing, mining, road construction, and non-road transportation. The ballpark indicator for industrial lubes growth is the IIP Index, which has seen stabilisation in FY17. Strengthening of the industrial recovery from campaigns like “Make in India” and “Smart Cities” could result in improved lube demand. However, mining (which has target volume share of 8% of the industrial segment but is currently consuming very low volume) and road infrastructure sector (expected share at 10%+) could see a revival (specifically due to new government policies) thereby boosting industrial lube demand.

Target sectoral volume share of industrial lubricants



Source: Industry, PhillipCapital India Research

Industrial recovery tends to percolate into higher logistics activity, thereby driving CV automotive lube demand indirectly. As per company managements and our industry sources, such a trend is already visible in CY16, which aided Castrol/GOLI’s 1HCY16 numbers.

Specialised industrial oils such as cutting oils, chain oils, cleaners, corrosion preventives, and heat treaters are lucrative industrial sub-segments with better prices and margins. These are mostly used by manufacturing sectors such as automobiles, machinery, and metals. Due to its global OEM approvals and market leadership, Castrol is well placed to tap opportunities in this space – the company has already renewed its focus on such categories. Other players including GOLI are also pursuing entry, which generally takes ~2years for OEM approvals.

Due to its global OEM approvals Castrol is well placed to tap opportunities in specialised industrial oils used by manufacturing sectors such as automobiles, machinery, and metals

Overall lubricants volume growth to recover to ~6% ahead

Our channel checks and industry analysis suggest volume growth recovering to 5-6% in CY16 (from a five-year CAGR of 2-3%) and continue at this rate ahead, with healthy PM sales and 10%+ petrol consumption driving more frequent oil change cycles.

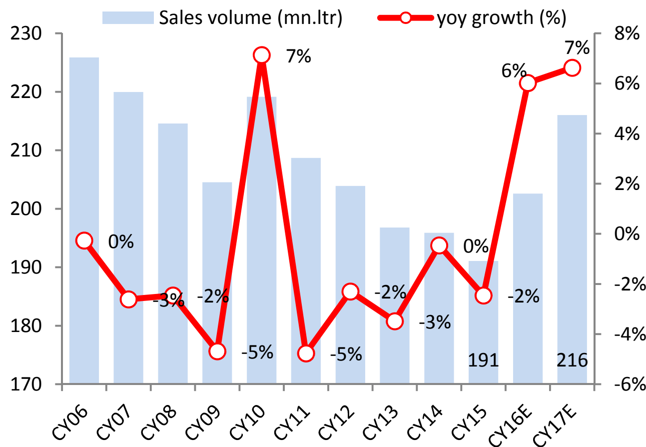
Automotive lubricants industry demand model

	CY13	CY14	CY15	CY16E	CY17E	CY18E
2W						
Population (mn)	80.0	87.2	95.0	101.7	109.8	118.6
Drain Interval (kms)	2,000	2,100	2,300	2,450	2,622	2,779
Engine Tank Size (litre)	1.0	1.0	1.0	1.0	1.0	1.0
Annual Run (kms)	10,000	10,500	11,130	11,909	12,743	13,507
Annual Lube Consumption (mn.litre)	400	436	460	494	534	577
MCO Growth		9%	5%	7%	8%	8%
Cars						
Population (mn)	20.0	21.6	23.3	25.0	27.0	29.1
Drain Interval (kms)	5,000	5,500	6,000	6,500	6,955	7,372
Engine Tank Size (litre)	4.0	4.0	4.0	4.0	4.0	4.0
Annual Run (kms)	12,000	12,600	13,356	14,291	15,291	16,362
Annual Lube Consumption (mn.litre)	192	198	208	220	237	258
PCMO Growth		3%	5%	6%	8%	9%
New Generation Trucks						
Population (mn)	5.2	5.4	5.6	5.9	6.2	6.5
Drain Interval (kms)	30,000	32,000	35,000	36,000	37,800	39,690
Engine Tank Size (litre)	15.0	15.0	15.0	15.0	15.0	15.0
Annual Run (kms)	90,000	94,500	98,280	1,03,194	1,08,354	1,13,771
Annual Lube Consumption (mn.litre)	234	237	237	254	267	280
CVO/DEO Growth		1%	0%	7%	5%	5%
Old Generation Trucks/Buses						
Population (mn)	3.0	3.1	3.1	3.2	3.2	3.3
Drain Interval (kms)	15,000	16,000	17,000	17,500	18,025	18,566
Engine Tank Size (litre)	18.0	18.0	18.0	18.0	18.0	18.0
Annual Run (kms)	60,000	60,600	61,206	61,818	62,436	63,061
Annual Lube Consumption (mn.litre)	216	209	202	202	202	201
CVO/DEO Growth		-3%	-3%	0%	0%	-1%
Tractors						
Population (mn)	4.5	5.0	5.2	5.8	6.2	6.6
Drain Interval (kms)	15,000	17,000	19,000	20,000	21,000	22,050
Engine Tank Size (litre)	15.0	15.0	15.0	15.0	15.0	15.0
Annual Run (kms)	20,000	20,400	20,808	21,848	22,941	24,088
Annual Lube Consumption (mn.litre)	90	90	86	95	102	108
CVO/DEO Growth		0%	-4%	10%	8%	6%
Total Lube Consumption (mn.litre)	**1,132**	**1,170**	**1,193**	**1,265**	**1,342**	**1,424**
yoy Growth	**3%**	**3%**	**2%**	**6%**	**6%**	**6%**

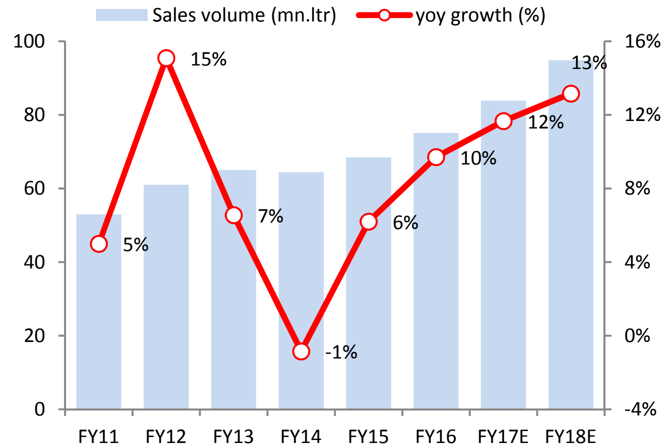
Source: Company, Industry, PhillipCapital India Research, Note: We are using a lower drain interval in PM segment as users tend to change earlier. 5,000/10,000kms is claimed by the industry as drain intervals for 2W/PVs

CV/diesel engine oils (CVO/DEO) have seen traction – indicated by diesel demand improvement since FY14 and 15-20% growth in new CV sales, including 20%+ for M&HCV. Our channel checks lead us to believe that the increase in drain intervals will taper off across categories (in the last five years it doubled for CVs). Industrial fuels (furnace oil and bitumen) saw 15-18% demand growth in FY16-17, which implies higher lube sales, which could also receive a boost with acceleration in mining and road construction activity.

Castrol's sales volume trend and outlook



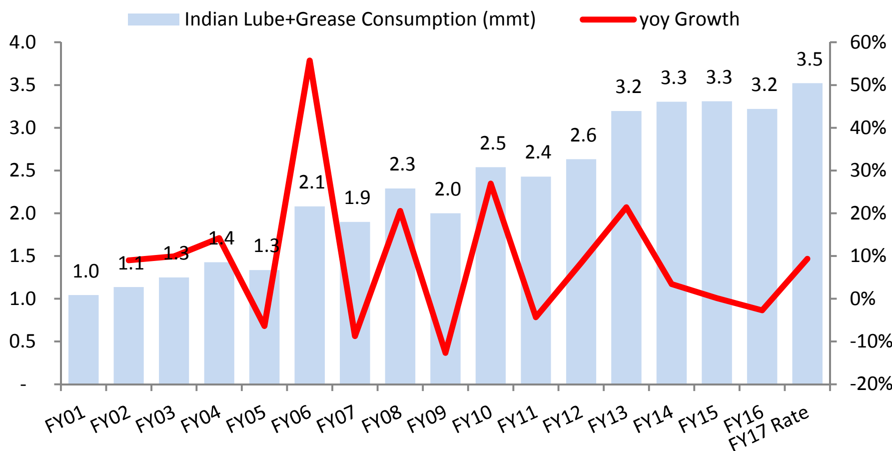
GOLI's sales volume trend and outlook



Source: Company, PhillipCapital India Research

For Castrol, we build in 6%/7% yoy volume growth in CY16/17 – to touch 216mn litres in CY17. With its smaller size, GOLI should post higher growth as seen in the past; besides, the management has always targeted 2-3x the industry growth. Therefore, we build in 12%/13% yoy volume growth in FY17/18 to 95mn litres by FY18. Automotive comprise 85% of Castrol's total volumes and 67% of GOLI's (though GOLI classifies factory fills as industrial).

PPAC lubes and grease consumption in India



Source: PPAC, PhillipCapital India Research

Government data on domestic lube consumption implies gross lubes and grease demand has also seen traction in FY17 with YTD growth at over 9% versus almost stagnant average volumes in the last three years.

Comfortable raw material environment to alleviate margin pressure

Sharp drop in oil prices lowered raw material costs

The 50% crash in oil prices in the last two years lowered raw material base-oil prices by 30-40%. The benchmark base-oil price has reduced to ~US$ 700/mt in CY15-16 from US$ 1,100/mt in CY12-13 as Brent prices fell to less than US$ 50/bbl from US$ 110/bbl. Consequently, Castrol's per litre base oil cost has reduced to Rs 45 from Rs 65, despite the rupee depreciating to 67 from from 50 (per USD).

The 50% crash in oil prices in the last two years lowered raw material base-oil prices by 30-40%.

Castrol/GOLI recorded ~30%/15% gross margin expansion between CY12-13 and CY15-16. Additionally, additive costs fell by 5% for Castrol in CY15 against a continuous growth since CY03. Additives include base oils as a key ingredient. Packaging costs also fell 6% yoy in CY16. We believe a benign oil price environment would keep various raw material heads under control, thereby benefiting lubricant players.

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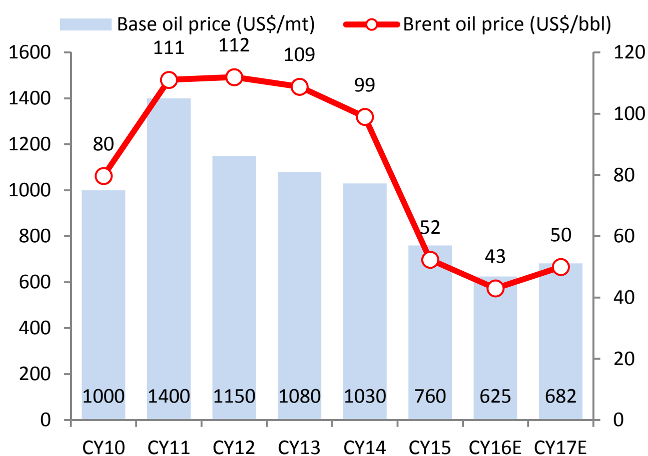
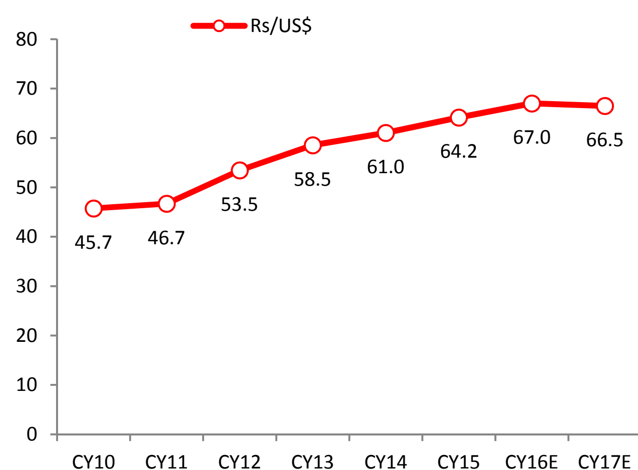
Crude oil and base oil prices



INR/USD movement – currently stable



Source: Industry, Bloomberg, PhillipCapital India Research

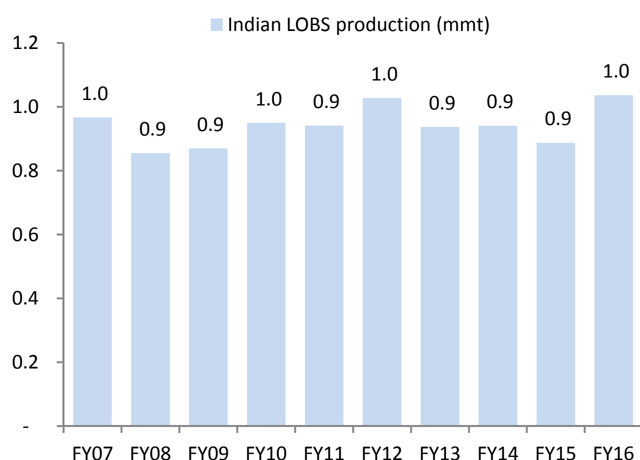
Base oil market dynamics to remain unchanged for Castrol/GOLI

In India, against a total lubricant demand of ~2.80mmtpa, domestic base oil (LOBS) production is ~1.04mmtpa. Imports are generally from the US and the Middle East, though in recent times South Korea has started exporting Group-3 grades. Domestically, HPCL Mumbai Refinery is the largest producer at 0.42mmtpa followed by BPCL Mumbai Refinery at 0.27mmtpa and IOCL's Chennai and Haldia refineries at 0.20mmtpa and 0.15mmtpa.

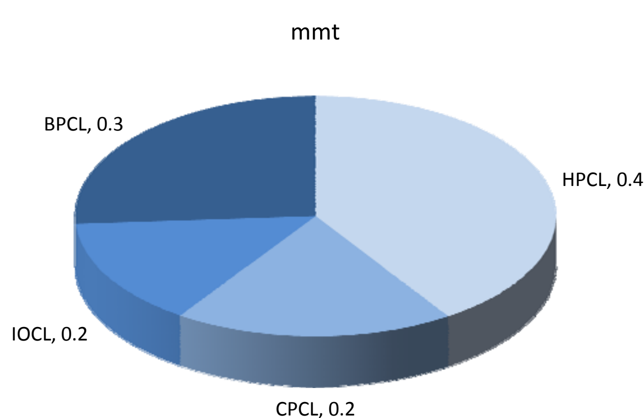
India meets about 37% of its base-oil demand of 2.80mmtpa through domestic production; huge capacity expansions in production seem unlikely

Over the last 10 years, base oil production has remained unchanged in India, except for up-gradation to Group-2 and 3 types from Group-1. HPCL Mumbai can now produce 0.23mmtpa of Group-2/3. New refinery expansion plans by companies have not indicated any major base-oil capacities, but our channel checks suggest some capacity expansion in Haldia refinery and Mumbai refineries coupled with more up-gradation to Group 2/3.

India's base oil production



Base oil production by Indian companies



Source: Company, PPAC, PhillipCapital India Research

We expect base oil dynamics of private lube players like Castrol and GOLI to remain unchanged with share of imports likely to remain at 55-60% as – (1) OMCs themselves are aggressive about their lube marketing plans, and (2) incremental capacity, at best, would be equivalently distributed.

Global base oil outlook is stable for lubricant blenders and marketers

Globally, base-oil supply is likely to remain comfortable with capacity expansions outstripping demand growth and resulting in a surplus market. Hence, we do not expect base oil cracks to deviate from current levels and can actually decline if oil prices spike.

The global base-oil demand in CY15 was ~38mmtpa (with Group-1 at ~20mmtpa, Group-2 at ~10mmtpa, Group-3 at ~4mmtpa, and naphthenics at ~3mmtpa) while production capacity was above 50mmtpa, implying an oversupplied market. Group-1 volumes are gradually declining due to substitution with better quality and environmental friendly Group-2 and 3 grades.

The global base-oil demand in CY15 was ~38mmtpa (with Group-1 at ~20mmtpa, Group-2 at ~10mmtpa, Group-3 at ~4mmtpa, and naphthenics at ~3mmtpa) while production capacity was above 50mmtpa, implying an oversupplied market.

Global lubricants and base-oil demand supply for CY16 and ahead – Total's view

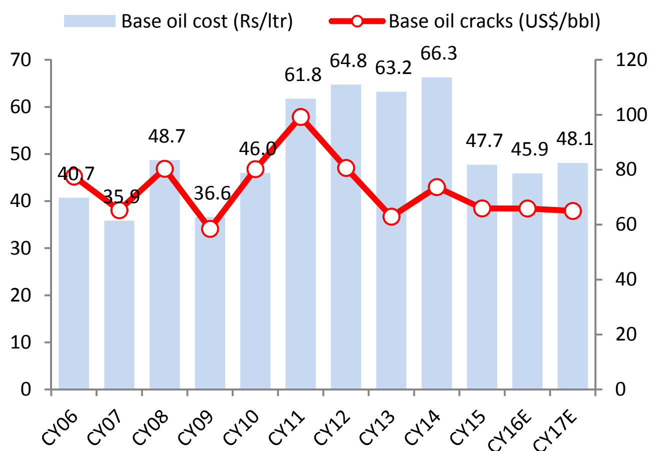
- Global lubricants demand to moderately decline in CY15/16; it should ease in CY17 with weak expansion thereafter – hence outlook is stable
- OECD Europe and North America would see demand declines of 1.0-1.5% yoy. Robust growth seen in emerging economies of Asia, Middle East and Africa, but not South America.
- ~1.5mmtpa of lube capacity has closed over CY14-15 and 1.1mmtpa is likely to have shut in 1HCY16. A large number of previously announced projects have been postponed to CY20+, or cancelled altogether.
- The large oversupply of base oils shows little sign of abating in the near to medium term. US refiners have been affected by depressed prices and margins, especially for Group-1 and 2 light neutrals.
- Over the past two years, 4mmtpa of previously announced capacity additions have been delayed, some indefinitely, or cancelled altogether. Only 0.87mmtpa of those may still come about before the end of the decade. Another 0.65mmtpa of projects that were to upgrade to Group-2 and 3 have been pushed back by a couple of years, possibly longer. Latest forecasts show a marked reduction of capacity additions from just two years ago.
- Nevertheless, 17 major capacity additions are still possible by CY20 of which five started in CY15, representing 1.2mmtpa and five more are awaiting start-up or are under construction for streaming in CY16, totalling 2.2mmtpa; four additional capacities may add 0.8mmtpa in CY18-19 while three were announced for late in the decade, representing 2.5mmtpa.
- Adding PAOs (synthetics), naphthenics, some smaller projects and the retrofit grade shifts, coupled with normal capacity creeping expansion, by CY20, there could be 9.5mmtpa of additions against a backdrop of little or no increase in demand.
- CY16 would see 2.7mmtpa capacity additions. While CY17 would be quiet, CY18 could see another surge. Additions will be mainly Group-3 in Asia and Europe.
- Currently the surplus is ~5mmtpa and the loss has been limited only by five recent closures and an industry plant utilisation of about 70-75%. By the end of the decade, surplus could grow by 6mmtpa+, necessitating further closures.
- Migration from Group-1 to Group-2 is active. By CY20, Asia will be the largest producer of all Groups (1, 2, and 3). Middle East and Europe will see higher production of Group 2, though Group 3 production will remain range bound.

Source: Total

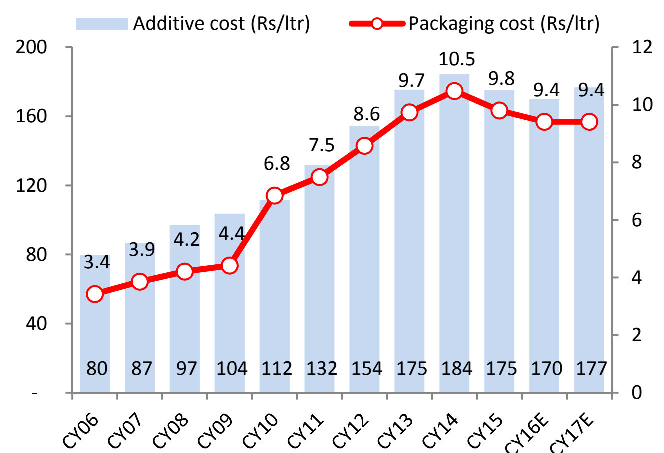
Build in US$ 45/50 Brent in FY17/18; expect benign raw material cost environment
Base oils comprise ~50% of raw material cost, additives ~35%, and packaging ~15% based on latest run-rate. We build in US$ 45/50 per barrel Brent price for FY17/18 and stable base oil cracks for Castrol and GOLI. In India, additives are supplied by three players – Chevron, Afton, and Lubrizol. We expect additives prices to remain weak in CY16, similar to base oil prices, but we assume a 3-4% yoy growth thereafter. We see similar trends for packaging.

We build in currency (INR/USD) at 67.0/66.5 for the next two years. Any rupee appreciation is positive for players as raw materials are priced in USD and retail products in INR.

Castrol's base oil cost and base-oil-to-crude cracks



Castrol's additives and packaging cost calculation



Source: Company, PhillipCapital India Research

We expect raw-material costs to remain under control ahead and realisations to be a major driver of gross margins. Lubricant players did not cut retail prices during the last 2-3 years, but increased schemes and discounts; despite this, book realisations were down only marginally – with Castrol's falling just 0.3% yoy in CY15 and GOLI seeing a 5% drop in FY16. The raw material scenario should remain conducive for lube players to maintain core margins. Higher share of premium products and power brands would lead to an overall improvement in sales mix and reported margins.

We expect raw-material costs to remain under control ahead and realisations to be a major driver of gross margins.

Lubricants companies also engage in trading of products, which include related products such as greases, coolants, and batteries. This forms a part of the purchases, where costs are reflective of revenue growth. Trading forms a small part of overall sales.

Base oil inventory is generally at three months for lubricants blenders, hence costs reflect after a quarter's lag. Some companies hedge their base-oil exposure, though GOLI mentioned that it does not (only hedges currency).

Companies also hoard base oils in storage tanks in periods of rising prices, which leads to better margins and cost structure in ensuing periods.

Premiumisation and power brands to drive realisations and margins

Core product specifications are largely homogenous and barriers of entry are low
Lubricants in general are homogenous products, largely based on specifications (viscosity, deposit protection, sludge control, seal compatibility, oxidation resistance, wear protection, emission control, detergency) that are approved by agencies like American Petroleum Institute (API) and Japanese Automotive Standards Organization (JASO, mostly for motorcycles). Automobile manufacturers are also involved and provide OEM approvals for products depending on tie-ups and specifications. Globally, players innovate products through R&D, but technology transfer is rampant and entry barriers are minimal, as it is a blending process. Base oil availability and additives are open-access in nature.

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API and JASO specification up-grades are generally announced after an interval. For example, API SN for gasoline engines was introduced in CY10 while the previous API SM was six years ago in CY04. Similarly, API CJ-4 for diesel engines was introduced in CY06 while API CI-4 Plus was in CY04.

Examples of API and JASO specifications

API SN	Introduced in October 2010	Designed to provide improved high temperature deposit protection for pistons, more stringent sludge control, and seal compatibility.
API SM	Introduced in November 2004	Designed to provide improved oxidation resistance, improved deposit protection, better wear protection, and better low-temperature performance over the life of the oil.
SL	2001	For use in service typical of gasoline engines in present and earlier passenger cars, sports utility vehicles, vans and light trucks operating under vehicle manufacturers recommended maintenance procedures.
JASO FA		Original spec established regulating lubricity, detergency, initial torque, exhaust smoke, and exhaust system blocking.
JASO MA		Japanese standard for special oil, which can be used in 4-stroke motorcycle engine with one oil system for engine, gearbox, and wet clutch system. Fluid is non-friction modified.

Source: Industry, PhillipCapital India Research

Branding, sales promotion, product differentiation are key volume/pricing drivers
The retail lubricant industry is characterised by brand building, innovation, and premiumisation (similar to the FMCG sector) which is an important driver to boost customer preference for commanding both market share and pricing power. New product launches are frequent among players and product differentiation in quality and performance coupled with new packaging are widely seen.

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There are three types of marketing activity in this industry: (1) new product launches and makeovers, (2) advertising in print and electronic media, and (3) below-the-line activities involving customers and important intermediaries such as distributors, retailers, mechanics, and drivers.

Product launches: These are an important element to renew brand position and drive sales by highlighting new products with better features. These include new products altogether based on specifications, minor overhauls, and new packaging. Product launches are often accompanied by heavy marketing and branding activity, depending on the target market. Castrol has continuously launched new products, which has kept it on top of the innovation curve. GOLI has also been active in launches. In last 6-7 years, the launches list of both companies is noteworthy – though Castrol is ahead.

Product launch chronology

Castrol

CY10	Activ 4T relaunched with improved protection formula Specialty Products relaunched
CY11	Relaunched Power 1 with advance power release formula Activ Scooter launched for gearless 2W Edge relaunched with advanced titanium strength technology
CY12	Activ relaunched with unique protection molecules Magnatec relaunched with refreshed brand proposition CRB relaunched with Durashield boosters CRB Plus relaunched in agri markets RX Super relaunched through below the line activity
CY13	New Power 1 pack launched Magnatec Diesel, RX Super Max (Tata CBO), Magnatec Stop Start, Activ Scooter Zipboosters launched
CY14	Edge Professional, Vecton launched
CY15	Vecton RX Fuel Saver launched
CY16	GTX Ultraclean, GTX Eco launched

GOLI

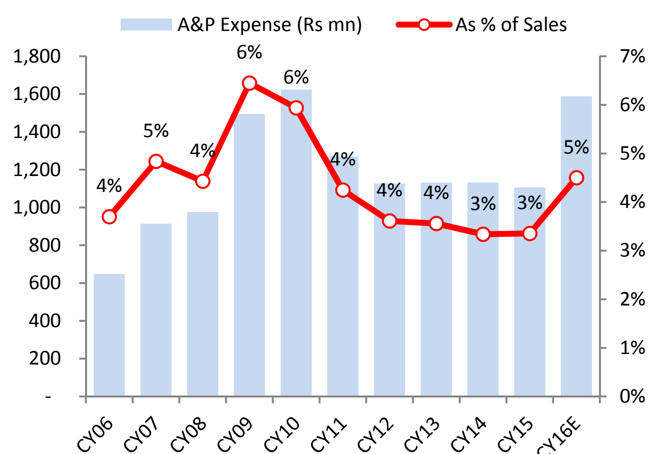
FY11	CBO diesel oil, Gulf Superfleet Long Drain oil launched
FY12	-
FY13	Superfleet Turbo range launched
FY14	Formula GX (syth), CBO diesel & hydarulic oils launched
FY15	Pride Scooter launched
FY16	Ultrasynth X with detoxifiers, Powertrac (synthetic) launched

Source: Company, PhillipCapital India Research

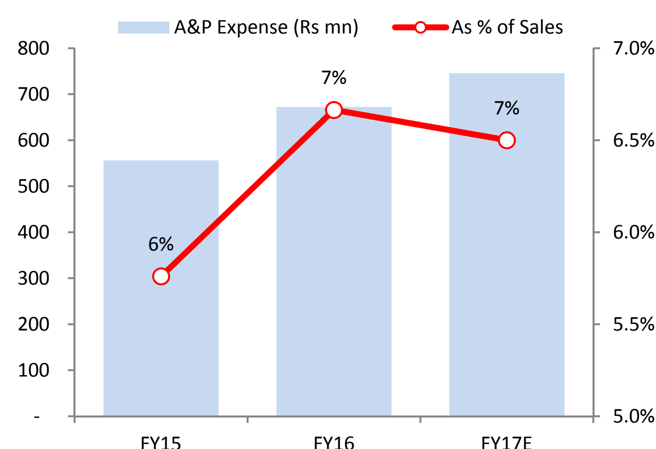
Advertising and promotion: Being FMCG B2C in nature advertising and promotion (A&P) plays a crucial role; this includes both print media (outdoor campaigns, hoardings, shop upliftment) and electronic channels like TV, FM radio, and social media. Advertising and promotion expense as a % of sales has remained steady for Castrol while it has increased for GOLI.

A&P spend trend for Castrol and GOLI: Current year has seen more traction

Castrol



GOLI



Source: Company, PhillipCapital India Research

Lubricant players associate themselves with sporting and other events to gain traction. Both Castrol and GOLI are actively associated with cricket, motocross, car rallies, and Bollywood. GOLI had roped-in cricketer MS Dhoni in CY11 as its brand ambassador while being a partner in the Indian Premier League.

A&P chronology

Castrol

CY10	Buy Power 1 and meet C Ronaldo in Madrid Sanjeevani (CRB) consumer contact program reached 1mn+ tractor owners ICC partnership for World Cup
CY11	Expanding presence in social media Sachin Tendulkar and Brett Lee in brand promotion program On the ground promotion of CRB Turbo CRB for tractor promoted
CY12	Power 1 Moto GP and Indian GP promotion BP Vanellus Turbo aggressively marketed Promotions through Cricket
CY13	Activ promotion in ICC Champions trophy Facebook fans of 1mn+ Magnatec through outdoor promotions GTX Sludgebusters through street plays CRB promotion for mini LCVs and tractors Cricket (T20)+social media
CY14	Power Biking App Brand Ambassador John Abraham promotes new variant of Power 1 Magnatec Stop Start, CRB Mini Truck promoted Customer engagement in CRB Customer visits to ICC Academy Dubai Football (FIFA World Cup) engagement
CY15	Retail outlet branding for Magnatec Online promotion of Edge Active Scooter, Vecton, CRB promotion Cricket World Cup engagements, Rural customer reachout
CY16	

GOLI

FY11	Brand promotions in airports Pride 4T Plus promotions Kisan Mela in Maharashtra Motorsports & MRF event
FY12	MS Dhoni endorses Gulf Shop branding, Signages, motorsports, customer events, Cricket (IPL/CSK) Below the line activities
FY13	Aston Martin team promotion MS Dhoni-based promotions Motorsports (rallies) Cricket, posters, fairs, promotion of long drain CBOs
FY14	Cricket (IPL) related promotions Bike rally; Bollywood related promotions Industrial fairs
FY15	Aston Martin team promotion Cricket (incl. IPL/CSK), bike fest, car & bike racing MS Dhoni is brand ambassador; advertising (TV, social media, outdoor campaigns)
FY16	MS Dhoni key brand ambassador Associations with cricket (Pune IPL team), football (Manchester United) 2W, car rally; social media campaigns; OEM oils promotion Attendance in Industrial fairs
FY17	Manchester United branding for synthetic PCMO oil

Source: Company, PhillipCapital India Research

Below-the-line activity: This is crucial for growth in a market like India, which is rural and tier-2 and 3 city dominated. This involves engagement with distributors, dealers, retailers, mechanics, drivers, and customers. Lubricant companies offer discounts, schemes, branding programs, and other rewards to all the stakeholders in the chain, besides setting up training workshops for mechanics to hone their skills and thereby create good will. Mechanic training is an important element and forms part of CSR activity of several lubricant players.

Below-the-line activity across stakeholders

Distributors, dealers, retailers	Cash discount and volume discount, gift coupons, rewards like incentives, holidays, free offers etc
Drivers and customers	Cashbacks, discounts, free offers, gifts
Mechanics	Training and skill development, workshops, OEM plant visits, rewards, conversion of garages into exclusive centres

Source: Industry, PhillipCapital India Research

Distribution channels comprise of spare-parts shops, dedicated lube shops, workshops and garages, and other outlets.

The distribution architecture is very much linked to below-the-line activity. In general, distribution channels comprise of spare-parts shops, dedicated lube shops, workshops and garages, and other outlets. Both Castrol and GOLI have promoted exclusive workshops termed Bikepoint/Bikestop/Pitstop/Carstop which are multi-brand vehicle garages through offer of equipment and mechanic training. GOLI has targeted 10-12% increase in distribution outlets annually. These companies also have exclusive showrooms for selling their products. Currently, sale through online portals (Amazon, Snapdeal, and Flipkart) has also picked up.

Diesel engine oil (DEO/CVO) customers are value chasers, seeking better economics (long drain, pricing, distribution reach); hence, accessibility to value propositions, lube facility, and proper distribution channels is required – besides pricing competitiveness.

Below-the-line chronology

Castrol

CY11	Mechanic skill contest; Rewarding key dealers
CY12	Unique mobile car mechanic training unit incorporated; GTX mechanic incentive offer launched; 6,000 non franchised motorcycle garages enrolled as Bikepoints; Pitstop Express Car Maintenance centres set up; Sub distributors set up in rural markets; Exclusive Castrol Points set up countrywide
CY13	8,000+ mechanics were trained through mobile unit on Magnatec; opportunity for mechanics to visit Silvassa plant; Tata workshop skill contest; basic maintenance training to 0.15mn+ 2W mechanics; Engine Experts Loyalty Club has 30k mechanics
CY14	-
CY15	Mobile mechanic training unit for updating mechanics
CY16	-

GOLI

FY12	Awarding distributors
FY13	Non-Stop Express launched to deepen distribution; Pilots for rural penetration
FY14	
FY15	Gulf Rural Stockist program launched for MCO and TO
FY16	Select garages for Gulf Carstops; Industrial customer offsites

Source: Company, PhillipCapital India Research

As per industry research, Castrol is at the helm of brand recall and GOLI has a top-3 brand positioning.

Distribution reach

Castrol	CY15
Plants	3
Delivery Centres	3
Warehouses	23
Distributors	420
Town Locations	
Retail Outlets	80,000
B2C Customers	80,000
B2B Accounts	3,000

GOLI	FY16
Plants	1
Delivery Centres	
Warehouses	
Distributors	350
Town Locations	
Retail Outlets	55.000
B2C Customers	55,000
B2B Accounts	-

Source: Company, PhillipCapital India Research

OEM activity: Low on margins, but high on goodwill

Lubricant players enter into OEM tie ups such as engine oil fills and refills in factories (factory fill) and authorised service centres, besides branding partnerships which result in genuine (GO) and co-branded oils (CBO). Although OEM tie-ups and approvals are a low margin business (due to royalty, margin sharing), they are necessary for goodwill in the replacement market, as users there seek reassurance on product quality and image.

The OEM market comprises only ~20% of automotive lubricants

The OEM market comprises only ~20% of automotive lubricants. Being the dominant industry player with arguably the strongest brand, Castrol is less reliant on OEM tie-ups compared to others, and is mostly into engagements rather than launches. The company is not directly into genuine oils except for a single Maruti product for Euro-1 and 2 engines. On the other hand, GOLI, which is targeting higher sales and a deeper brand positioning, is going for more launches like co-branded and genuine oils with Mahindra and Ashok Leyland among others.

OEM engagements are continuous for all lubricant players including the PSU OMCs. Castrol's predominant OEM tie-ups are with the Volkswagen Group (including Skoda, Audi, and BMW), Tata Motors, and Maruti. GOLI's tie up includes (the Hinduja Group company) Ashok Leyland, and Mahindra, Swaraj, Schwing Stetter among others. OEM tie-ups exist in industrial categories as well – like John Deere and ACE CNC for Castrol and L&T Komatsu and Greaves for GOLI.

OEM activity chronology

Castrol

CY10	VW is a strong global partner Signed a three years partnership with Skoda India Renewed agreement with Tata for five years CRB Prima recommended and pushed by Mahindra
CY11	BMW, VW extend global partnership to India business Conducted technology day at Tata and Maruti Lube learning centre in Tata Pune plant Strategic alliance with ACE CNC tool manufacturer Recognition from John Deere, SKF Lubnet service to L&T
CY12	Conducted technology day at Ford Safety MoU with Tata Engagement with Audi, Skoda, Jaguar Maruti conducted successful audit of Silvassa plant Learning centre set up in Assam with Tata Renewed alliance with ACE
CY13	Safety awareness with Tata; other engagements with Tata Cricket related engagements with VW and Maruti
CY14	Set up Liquid Engineering Centre in Maruti Gurgaon plant Magnatec Professional co-developed with Tata Set up a new product development blender in Silvassa for OEMs Award by Bosch Agreement with Triumph for India
CY15	Signed local supplier contract with VW Recognition from John Deere Engagements with Tata
CY16	-

GOLI

FY11	CBO launched with Mahindra Supply agreement with Essar
FY12	Agreement with L&T Komatsu for CBO, AL Tie up with AL Nissan/Deere
FY13	-
FY14	CBO launched with Mahindra, Toshiba
FY15	Agreement with Schwing Stetter M&M co-developed XHD tractor oil launched
FY16	Technical partnership with Milwaukee BMW Team
FY17	Engagement with Swaraj

Source: Company, PhillipCapital India Research

Compensation to OEM makers is in the form of royalties for aftermarket sales, though factory fills are tendered at competitive prices and low margins. As per our channel checks, Japanese and Korean OEMs are less attractive than European and American counterparts due to high royalty rates and preference for oil makers of their region.

OEM tie ups of major lubricant players including genuine and co-branded oils

Castrol	GOLI - Gulf	IOCL-Servo	BPCL-MAK	HPCL-HP Lubes	Tide Water-Veedol
Tata Motors, Volkswagen Group, Maruti, Suzuki, Ford, GM, JCB, LT Komatsu, Bosch, Triumph, Suzlon, SKF, Tata Cummins, Timken, John Deere, JSW Steel, ZF, Federal Mogul etc	Ashok Leyland, Mahindra, Swaraj, Schwing Stetter, Volvo Engines, MAN, Greaves, LT Komatsu, Bharat Benz, Scania, Leyland-Deere, Leyland-Nissan etc	Skoda, Hyundai, Maruti, Ashok Leyland, Eicher, Force, HMT, Tata Motors etc	Hero, TVS, Tata Motors, GM, Honda, LT Komatsu etc	Bajaj, Enfield, JCB, Mahindra, Komatsu, Gabriel, San Engineering etc	Hero, Honda Motors, Yamaha, Honda Siel Cars, SML Isuzu, LT Komatsu, Kobelco, Kubota Agri etc

Source: Company, PhillipCapital India Research

Premiumisation/ power brands lead to secular growth in realisations and margins

Premiumisation, new product launches, and brand promotion is a virtuous cycle to improve the sales mix resulting in higher average realisations and margins for a lubricant player. Castrol has termed its premium products “power brands” and over time it has focussed on pushing this high-margin category. GOLI and other players also follow the same strategy. Power brands form a subset of the PM segment, mostly as DEO/CVO are more price elastic and value-based, though with new generation CVs, premium oils are introduced in this category too.

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Castrol's power brands

	Brand	Type	Viscosity/Products	Sub-brands
Car Engine Oils	Edge	Fully synthetic	0W-40, 5W-40	
	Magnatec	Part synthetic	5W-30, 10W-40, 15W-40	Magnatec Stop Start, Ultraclean, Magnatec, Magnatec Diesel
	GTX	Mineral based	15W-40	GTX, GTX Diesel, GTX CNG (LPG), GTX Eco
Bike Engine Oils	Activ	4 stroke	10W-30, 20W-40, 20W-50	Activ Scooter, Activ 4T
	Power 1	4 stroke	10W-30, 15W-40, 20W-50	Power 1 4T, Power 1 Racing 4T

Source: Company, PhillipCapital India Research

Castrol has three power brands in the car engine-oil category – Edge, Magnatec, and GTX – while for 2W it has two – Activ and Power 1. These are high-specification products in general going by their viscosity index and characteristics (synthetic, semi synthetic, mineral based) that are aggressively branded and packaged. Castrol Edge is a fully synthetic oil. In the car segment, it has two other brands – namely GTD and Maruti Genuine Oil – which are not labelled as power brands; both are OEM products. In 2W, Castrol Go is the only remaining brand.

Product pricing (DLP) among select players

PCMO (Rs/litre)	Castrol	GOLI	Tide	IOCL
15W-40 Modern Engine	340	280	260	
15W-40 CNG	302			
10W-40 (Premium)	409	335		
5W-30 (Premium)	451	372	290	
5W-40 (Premium)	661	807	829	776
0W-40 (Premium)	788			
20W-50		261	238	
Co-branded DEO	312	255		

MCO (Rs/litre)	Castrol	GOLI	Tide	IOCL
4T 20W-40	275		265	244
4T 20W-50	294	210	-	244
4T 10W-30	292	269	268	244
10W-50 Racing (Premium)	651		326	523
10W-30 (Premium)	367	342	281	
20W-50 (Premium)	348	270		
4T 20W-40 (Low End)	248	205		
15W-50		226	268	
Scooter 10W-30	303	275		272
2T 20W-40	326	240	219	254

Source: Industry, PhillipCapital India Research

Power brands currently comprise 50% of Castrol's PM segment or 20% of total volumes

Compared to Go 4T, power brand Activ 4T is 10% expensive, i.e., almost Rs 30/litre dearer – this illustrates how a power brand can have better realisations as well as margins. Even in DEO, premium products can be successful. Vecton, which is a relatively newer product, is priced at Rs 50/litre or at a 15% premium to similar-grade CRB Turbo, which is labelled a mass-market product. Power brands currently comprise 50% of Castrol's PM segment or 20% of total volumes, which aids in maintaining market-leading pricing, margins, and structural realisation growth.

GOLI does not have mineral-based power brands like Castrol, but it is also intensifying semi-synthetic and synthetic grades, which it has priced higher. Most of its 2W range is branded as Pride; within this, its price differs depending on specifications among mineral-based grades. However, one of its synthetic grade – 4T Synth – is priced at a steep Rs 70/litre, or at a 30% premium to the mass-market grades. In cars, too, it has products priced at a material premium. MAX is the predominant brand for GOLI in PCMO while Super and XHD are its core brands in CVO and tractor oils respectively.

Synthetic oils share is small, but growing fast

Fully-synthetic oils are expensive and are used specially in Formula 1 racing, sports cars, and premium automobiles and bikes. Exxon Mobil and Castrol are predominant players

Lubricating oils are classified according to their raw-material base oil. Low-quality Group-1 and current mass market Group-2 base oils are essentially mineral-based oils while Group-3 is of higher quality. Group-4, which is termed polyalphaolefin (PAO), is fully-synthetic and polymer based. Fully-synthetic oils are expensive and are used specially in Formula 1 racing, sports cars, and premium automobiles and bikes. Exxon Mobil and Castrol are predominant players selling premium 0W-40 grades priced at Rs 900-1,000/litre+ while Shell, GOLI, Total, and IOCL also market next-in-line 5W grades, also priced at Rs 900-1,000/litre+.

Selected synthetic engine oils in India

Brands/Products	Retail Price (Rs/litre)
Mobil 1 0W-40	1,185
Castrol Edge 0W-40	900
Shell Helix 5W-40	900
Gulf Formula GX 5W-40	1,100
Total Quartz 5W-40	1,050
IOCL Servo Futura Synth 5W-50	907
Average Price	957

Source: Industry, Amazon, PhillipCapital India Research

Margin profile of mineral, semi-synthetic, and synthetic oils

	Mineral		Semi synthetic		Synthetic	
Rs./litre	Low	High	Low	High	Low	High
Price	200	250	400	500	900	1,250
Raw Mat Cost	100	120	200	250	500	650
Gross Margin	100	130	200	250	400	600

Semi-synthetic oils are generally Group-2 and Group-3 blended, with specialised additives. These are pricier than ordinary oils and are of better quality. While it is difficult to ascertain the composition and specifications of such oils, they are heavily promoted as premium products, and marketed at materially higher prices than ordinary mineral grades.

Synthetic oils is a small segment for now, but it is fast-growing

Currently, the share of synthetic grades in India is low – for Castrol and GOLI their share is only ~2% of total volumes. Nevertheless, this segment is growing rapidly. GOLI has quoted close to 20% yoy increase in volumes.

Viscosity grading

Fully synthetic
0W-30: Fuel economy
0W-40: Enhances engine performance/power
5W-40: Protection from wear and deposit build-up, good starting, and circulation in cold conditions, Mobility within the engine

Semi-synthetic
5W-30: Better protection
10W-40: Good protection during starting out
15W-40: Better at reducing engine wear, increased drain intervals

Mineral based
10W-40: Basic protection
15W-40: Mass-market product

Engine oil grading was established by the Society of Automotive Engineers according to their viscosity characteristics. Currently, most oils are multi-grade – with a wide temperature range – particularly in winters and when the engine remains shut, to summers, and full-running and heating-up conditions respectively. Viscosity is inversely proportional to temperature. In a multi-grade oil with 5W-40 grading, the 5W bit (W is winter) implies the oil has a certain maximum viscosity/flow at low temperature. The lower it is, the better the oil's performance under cold conditions. The 40 after W implies the thinning property at higher temperature. Higher the number, lower the thinning. Good quality oil should not lose its properties under different conditions, hence with higher grading range, the oil is considered superior. New-generation oils are more eco-friendly as well.

India's move to BS-6 by CY20 would also open up the scope for further innovation and modification in oil properties and can lead to higher realisations and margins

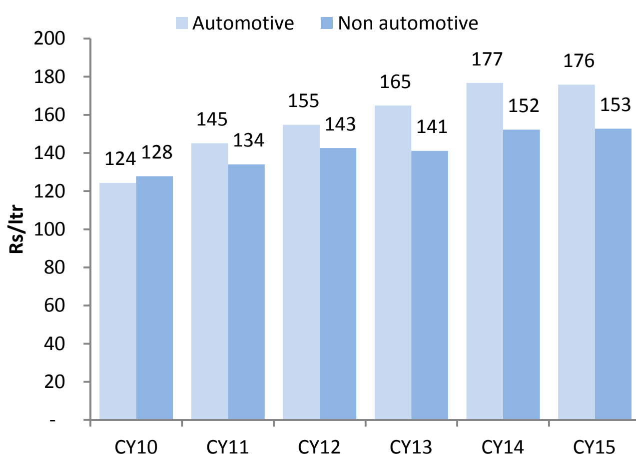
With greater focus on pollution and emission control, lubricant makers are bracing for cleaner oils. This year, Castrol launched the GTX Eco in India – which it claims reduces CO2 emissions by 10% and extends engine life. While GTX Eco is priced at the same level as its regular GTX grade, there is scope for premium pricing in this category as eco-friendly oils start commanding a higher share. India's move to BS-6 by CY20 would also open up the scope for further innovation and modification in oil properties and can lead to higher realisations and margins.

Industrial segment realisations and margins lower, but opportunities exist
The industrial segment is price sensitive, being B2B in nature, and the market as such is aggressive and competitive. There is an OEM advantage – for oil change during the warranty period for imported and branded engines and equipment. Pricing is, to some extent, formula-linked – but by nature, it is more favourable to a lube player under low crude oil and base-oil pricing. The industrial segment caters to a wide range of consuming sectors (marine and aerospace, oil & gas, mining, power generation, road construction, automobile manufacturing, metals, and machinery).

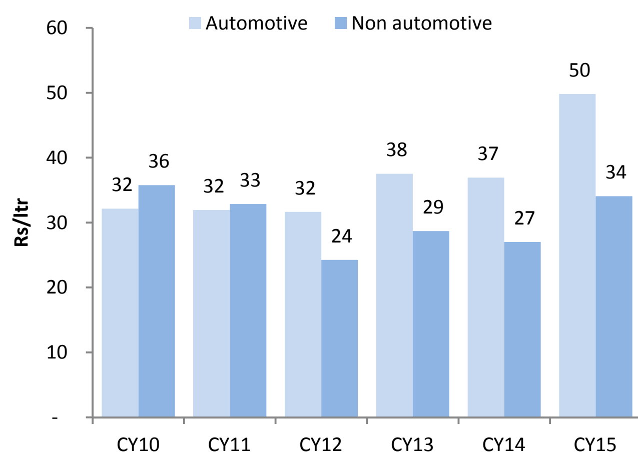
Pure industrial segment excludes process and transformer oils; Castrol and GOLI do not have a material presence in these. Industrial oils include hydraulic oils, heavy engine distillate oils, gearbox, air compressor, turbine, turbocharger oils, greases, seal oil, chain oil, cutting oil, and circulating oil. The industrial segment is marked by heavy lubricant consumption due to continuous engine/equipment operations. Therefore, an industrial and mining recovery could lead to a quick jump in lubricant consumption. Additionally, in this segment, promotion expenses are lower (though sectors like mining are located remotely, and hence require an efficient distribution system).

The industrial segment is marked by heavy lubricant consumption due to continuous engine/equipment operations

Castrol's segmental net realisation



Castrol's segmental EBIT margin



Source: Company, PhillipCapital India Research

The 'tender' business is PSU dominated
The industrial segment includes tender-based procurement in segments such as coal, railways, and defence. For example, Coal India has sizeable lubricant consumption for equipment such as excavators, dumpers, and dozers. However, this type of business is led by L1 bidders; hence, it is mostly PSU OMCs dominated. As per our channel checks, receivable recovery is slow; hence, private players shy away from it while PSU OMCs have an edge, as they supply diesel as well, which strengthens their position and bargaining power. Nevertheless GOLI has won government and Transport Corporation tenders which has helped clock sharp volume jump.

PSU OMCs have an edge, as they supply diesel as well, which strengthens their position and bargaining power.

Stable oil prices to keep industrial segment margins steady
About 5-6 years ago, Castrol's automotive and industrial net realisations and margin were similar – with only a Rs 4-5/litre difference. However, since then, premiumisation in automotive led to this segment's realisations steadily increasing and after oil prices peaked out in CY12-13, margins started rising. Against that, growth in industrial segment realisation was muted due to industrial slowdown and competitive pressure and margins remained weak before recovering in CY15, when oil prices dropped. We believe industrial pricing and margins will remain healthy under a stable oil price scenario, and that the automotive segment would be the main driver for margin accretion going forward.

However, specialised industrial products such as cutting oils, metal working fluids, broaching oil, and honing oil, used in automobile manufacturing and other medium-scale industries, are niche markets – where realisations and margins are better. Castrol is already a leader in many such segments, and continues to be aggressive with new product launches and tie-ups.

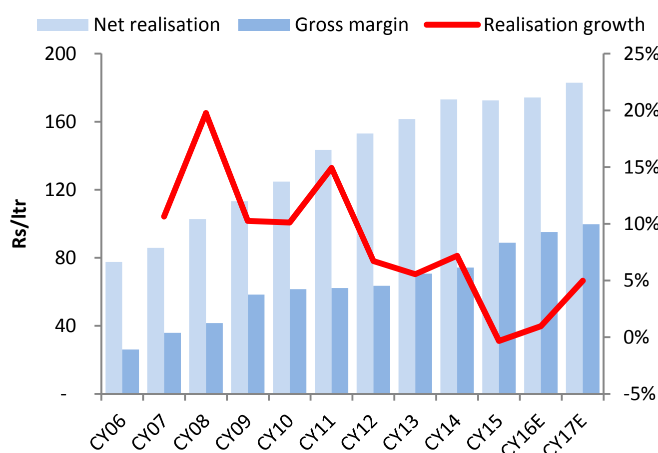
Expect realisations to structurally keep improving due to premium sales mix

We expect Castrol and GOLI's average net realisations to keep growing, aided by improving sales mix and premiumisation – and an overall non-destructive pricing environment. Despite a fall in oil prices, lubricant players have not cut retail prices officially – they have resorted more to discounts and schemes, which can be easily rolled back. In the last 5 years, Castrol/GOLI's realisations saw CAGRs of 7%/5%; growth was only down last year, and that too by 0.3%/5%.

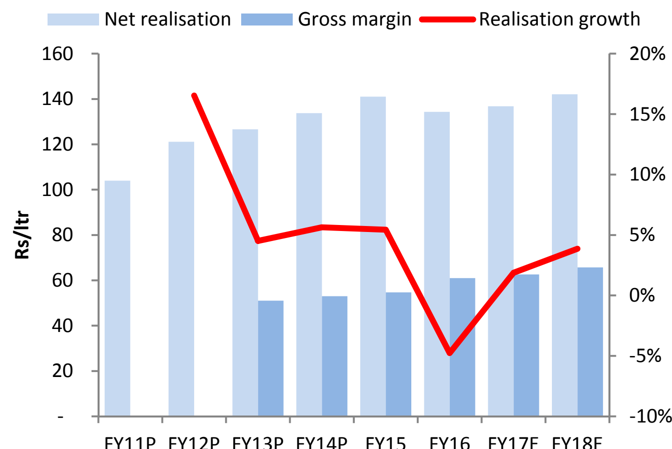
With oil prices likely to remain stable, we expect gross margins to keep on expanding and see Castrol recording 1%/5% yoy increase in net realisation in CY16/17 and 7%/5% increase in gross margin. For GOLI, we estimate 2%/4% increase in net realisation yoy in FY17/18 and 3%/5% increase in gross margin. Our CY17/FY18 run-rate is slightly higher, as we assume oil prices will rise by US$ 5/bbl to US$ 50/bbl on an average; hence, we anticipate some hike in prices or rollbacks in discounts and schemes. Under a normal scenario, we would assume a 2-3% realisation increase for Castrol and 1-2% for GOLI.

See Castrol recording 1%/5% yoy increase in net realisation in CY16/17 and 7%/5% increase in gross margin. For GOLI, we estimate 2%/4% increase in net realisation yoy in FY17/18 and 3%/5% increase in gross margin

Castrol's net realisation and gross margin trend



GOLI's net realisation and gross margin trend



Source: Company, PhillipCapital India Research

Castrol: Primary volume growth and margin assumption

Rs/litre	CY11	CY12	CY13	CY14	CY15	CY16E	CY17E
Sales volume (mn litre)	209	204	197	196	191	203	216
Growth	-5%	-2%	-3%	0%	-2%	6%	7%
Gross margin	62	64	71	74	89	95	100
OPEX	30	33	36	38	42	44	45
Growth	6%	10%	8%	5%	11%	5%	2%
EBITDA	32	31	35	37	47	51	55
Clean EBITDA (Rs mn)	6,697	6,229	6,875	7,167	8,949	10,374	11,822
Growth	-8%	-7%	10%	4%	25%	16%	14%

GOLI: Primary volume growth and margin assumption

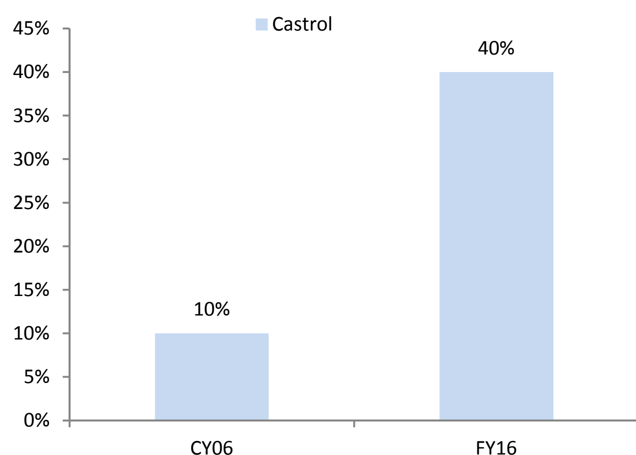
Rs/litre	FY12P	FY13P	FY14P	FY15	FY16	FY17E	FY18E
Sales volume (mn litre)	61	65	64	68	75	84	95
Growth	15%	7%	-1%	6%	10%	12%	13%
Gross margin		51	53	55	61	63	66
OPEX		35	35	36	40	40	41
Growth		3%	1%	2%	11%	5%	2%
EBITDA		16	18	19	21	22	25
Clean EBITDA (Rs mn)		1,050	1,145	1,272	1,565	1,859	2,333
Growth			9%	11%	23%	19%	26%

Source: Company, PhillipCapital India Research; P are provisional estimates figures and are not reported by Co.

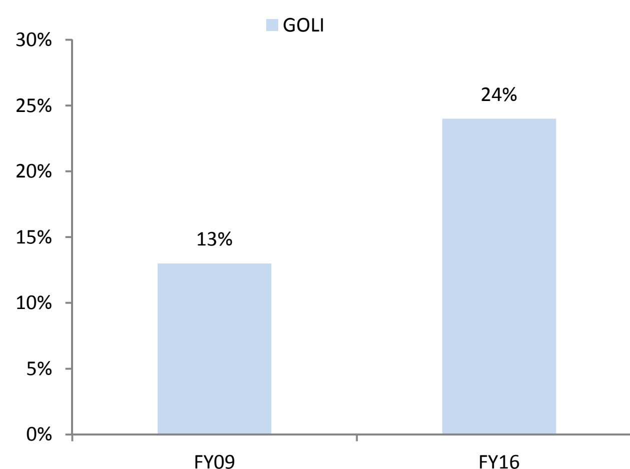
OPEX comprises of employee cost, freight, royalty, processing charges, A&P expense, and other expenditure. We are building in an OPEX/litre growth of 5%/1% in the current fiscal and 2% each next year for Castrol/GOLI.

Share of PM to overall volumes between now and then

Castrol



GOLI



Source: Company, PhillipCapital India Research

Takeaways from our interaction with a lubricant sector expert

We recently hosted a lubricant sector veteran to understand his views and insights on the industry.

Volumes: Signs of recovery, expect growth rate to double to 5%+ from ~3% CAGR

- In the last five years, the Indian lubricants market saw ~3% CAGR in volumes to 1.7bn litres. Major players IOCL/HPCL/Castrol saw total market share reduce to 30%/15%/14% in FY14-15 from 35%/20%/18% in FY09, while BPCL/Tide Water/Gulf maintained their positions at 11%/4%/4%. However, other smaller players saw their shares doubling to 20% from 10%.
- From here, volume growth is likely to increase to 5-6% yoy, driven by growth in vehicle sales, high petrol/diesel consumption (pointing towards increasing vehicle runs and lube-change cycles), drain intervals in CVs/passenger cars nearly at optimal levels, and recovery in manufacturing and mining sectors under the industrial space.

Automotive: Drain interval cycle seems to have peaked

- The automotive segment has a 60% share of total lubricants sales; of this 50-60% is CVs, ~10% is tractors, 20-25% is passenger cars, and 15-20% two wheelers. The split between OEM and bazaar trade (replacement demand) is 20% and 80%.
- Over the last 5-6 years, drain intervals in CVs/cars have almost doubled to 36,000/10,000kms from 18,000/5,000kms earlier – mainly due to a decrease in engine size (which lowers volume requirement and increases consumption efficiency) and high quality oils that last longer. However, this improvement has nearly hit a physical peak now. Lubes also have a definite shelf life and are affected by the environment.
- Even though some lube players claim to have oils that have 70-80,000kms drain intervals, engine makers have not approved them. Hence, these claims are unsubstantiated and not followed by transporters/fleet operators. In reality, even if a vehicle owner needs a change after 36,000kms, oil is usually changed after just 20,000kms – this is because the prescribed drain interval is only if ideal conditions prevail (45km/hour speed, constant operation, no elevation, and no idle running). It is actually on a timescale; drain interval needs to be measured. This way, intervals would be different for different vehicles
- Passenger cars and two-wheeler oil sales have seen a steady growth rate, which is likely to continue with new-generation vehicles. OEMs will remain an important mode, though with new multi-brand service centres, second-hand car shops and organised taxi fleets, bazaar trade would get fillip.
- Diesel engine oil (DEO) demand depends on the CV cycle. Over the years, due to elongating drain intervals, the CV segment saw a fall in lube usage. However, with this elongation peaking, volumes are likely to recover somewhat. Ahead, this segment would depend on an industrial recovery and manufacturing revival, which would push up logistics activity.
- Tractors have done well for a while now, with higher penetration and usage, and increasing number of high horsepower haulage/construction tractors.
- Currently, market share for Castrol/PSUs/Gulf/Tide Water/Others in the automotive segment is 22%/30%/7%/7%/34%. For Castrol, it has declined from 25% five years ago, while for PSUs, it has increased from 22% earlier.

Smaller players saw their shares doubling to 20% from 10%.

Industrial: Mining recovery possible; others would move in line with economy

- Industrial segment (40% share) target market can be broken up as 25% power, 20% chemicals, 10% mining, 10% automobile manufacturing, and 10% metals.
- Of this, mining currently is almost nil as operations in the eastern mining belt have virtually stopped. Some signs of recovery are visible – with state governments allowing mining restarts. Hence, mining could be a significant volume driver in the future.
- In manufacturing, metals sector is seeing an uptick, particularly steel. Specialised applications like metal cutting and honing are gaining traction. These applications require premium oils that could be both volume and margin accretive.

- OEM tie-ups in specialised industrial applications (machines) is a strength for players. MNCs have an edge on imported machines with pre-approvals due to global tie-ups; hence, players like Castrol are targeting these segments for volume growth.

Margins: To remain stable on an annualised basis, bazaar trade is most lucrative

- With decline in base oil prices, the margin scenario has improved for all players. At a peak oil price of US$ 110/bbl, Indian base oil prices (per litre) were at ~Rs 70, which fell to Rs 35 when oil hit US$ 30/bbl – currently, they hover at Rs 42. The movement in prices would depend on oil prices. However, the base oil market remains well supplied with no global shortages.
- Lube players did not cut prices, as retail pricing is sticky. However, they increased discounts and schemes to drive sales. For distributors, companies offered volume discounts while for retailers, cash-back coupons. For customers, free offers and discounts were introduced. However, these are highly elastic and dependent on raw material pricing. Many of these offers are realised at the end of the financial year. Premium product suppliers, in fact, do not want prices to fall, as this would affect their products' perception.
- On an annualised basis, margins are likely to be maintained even if there is some recovery in oil and base oil prices.
- Personal mobility (cars and two wheelers) is a high-margin business and lube players will continue to innovate premium products to improve realisations and margins in this segment. New-generation oils are focussing on clean technology to complement environment friendly fuels like Euro-5 and 6.
- Among vehicle types, two-wheeler command the highest margins at ~25%, while passenger cars are at 22%, and CVs at 15%. The corresponding pricing is Rs 350/litre, Rs 300/litre, and Rs 300/litre (diesel engine oils however are costlier to manufacture).

Oil is usually changed after just 20,000kms – this is because the prescribed drain interval is only if ideal conditions prevail

In industrial, specialised oils can command higher margins.

- Bazaar trade entails the highest premiums, followed by OEM service centres – where both dealer margins and royalty are higher. Factory-fill is the most unattractive segment, as automobile companies basically off-take at nil or even negative margins if raw material prices go up in the intermediate period.
- Player-wise, Castrol is always at a premium. On a net realisation per litre of Rs 250 for Castrol, Gulf/Tidewater would be at Rs 210/190 and PSUs (OMCs) at Rs 170. Other MNC players are similar to or higher than Castrol.
- As vehicles come out of the OEM market due to warranty expiry and cheaper alternatives, bazaar sale of lubes grow and margins improve.

Products and raw materials – Mostly homogenous

- Lube products are primarily homogenous among manufacturers, as specifications are uniformly made by agencies like API (USA) and JASO (Japan). There are no significant technological entry barriers, as it is a blending process where base oil and additive suppliers are universally accessible.
- Perception and brand power plays a main role in customer preferences. Hence, lubricants is a marketing-driven business.
- Indian lubes are similar to global grades, though a new technology would take a year or two to transfer.
- Currently, the Indian base oil market is Group-2 dominated. Only a small share of old vehicles, taxis, and dump trucks use Group-1-based lubes. Group-3 lubes, on the other hand, are increasingly used by new generation vehicles (~20%) – their high sheer strength and extreme thinness is ideal for small compact engines; they does not lose their properties at different temperature ranges.
- While Group-2 lubes are priced at Rs 42/litre, Group-3 would be priced at Rs 50/litre.
- In India, base oil is manufactured by HPCL Mumbai Refinery, IOCL Haldia Refinery, CPCL Chennai Refinery, and BPCL Mumbai Refinery. Mostly Group-2 is available in India, though Haldia has started a Group-3 line. HPCL's Mumbai Refinery may also be capable of producing Group-3.
- Private players import base oil from Iran/Middle East (Group 1 and 2) and South Korea (Group 2 and 3).

- Additives are highly priced and very specialised. Only three companies supply these in India.
- Lube players hoard base oil if they expect prices to rise. They have their own storages while third-party tankages are also available in ports, terminals, etc.

Marketing – Below-the-line is more important

- In the Indian market, below-the-line promotion activities are very important as channel partners (distributors, dealers, retailers, and garages/mechanics) are key drivers. It takes years to build a brand at the grass-root level. Companies have to create goodwill. Strong players such as Castrol, Gulf, Tide Water, and even PSUs invest heavily into this by being in constant touch with their partners, giving them incentives and gifts, and organising workshops and meets.
- Advertising is also important, but it alone will not work. Many MNCs (Mobil, Shell, Motul) have not been able to expand due to lack of focus below the line, concentrating only on ads.
- Castrol has a definite first-mover advantage as it developed the bazaar trade initially and is an old player. Despite lower margins, retailers have maximum Castrol products considering customer recall and preferences. Castrol should retain this advantage and therefore, any recovery in the lube cycle would first percolate to Castrol.
- Gulf is also very aggressive. However, it is equally focussed on advertising, as it wants to increase brand recall among target customers such as two-wheelers. In CVs, Gulf has a natural advantage due to its Hinduja connection in Ashok Leyland where it is an OEMs. Against Castrol's 4-5% dealer margin, other players offer 7-8%. Retailer margins are higher at 15% due to lower volumes.
- Though less attractive, OEMs are required – this pushes the brand in the bazaar trade and no retailer likes to stock products that do not have OEM approvals. This is the case with customers too.
- PSUs share of sales in fuel stations have declined significantly. Currently, the share is only 10% with 90% being bazaar trade. Among OMCs IOCL continues to remain a market leader with significant bulk industrial exposure (like railways) and lowest prices, but BPCL and HPCL have become aggressive in recent years.
- In any case, PSUs will always be behind other players in decision making due to their administrative and reporting structure. Hence, they are not quick in their pricing and scheme decisions.
- OEM approvals generally take 1-2 years. However, MNCs have pre approvals due to global tie-ups. OEM oils are generally genuine oils, which are branded in the name of the automobile manufacturer.
- Co-branded oils have the name of both parties. Most players have genuine oils, except Castrol, who only goes for co-branded oils at the most.
- Castrol's retailer network is almost twice Gulf/Tide Water's. Addition of outlets is necessary for distribution reach.

Market share for Castrol/psus/Gulf/Tide Water/Others in the automotive segment is 22%/30%/7%/7%/34%

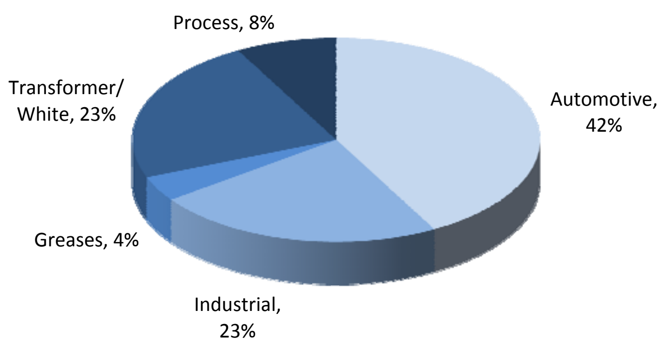
Others

- Markets – The Western India market is the most lucrative, followed by southern, then northern, and finally eastern. Castrol is strong in western and northern markets, while it is Gulf in the south (due to the Ashok Leyland legacy). Elf is strong in the north. Tide Water is also strong in the west. Global markets vary – developed countries are mostly organised; sales there are through supermarkets too, and servicing is mostly done at authorised centres. Western markets have grown slower (1% CAGR) while China is the fastest growing.
- Synthetic oils: Group-3-based oils are marketed as synthetic/semi synth. In reality, synthetic is not mineral-based – it is a compound named polyalphaolefins marketed by Mobil and Chevron. It is almost 7-8x pricier and is used in super luxury/premium sports/F1 cars.
- Brand power: Castrol remains at the top across the chain. Gulf is #3 in terms of brand recall as per a survey.
- New players: New players are not able to make a dent on the broader market, yet they are profitable based on specific target markets – like Shell for aviation lubricants, Mobil for Marine, and Valvoline for Cummins' generators.

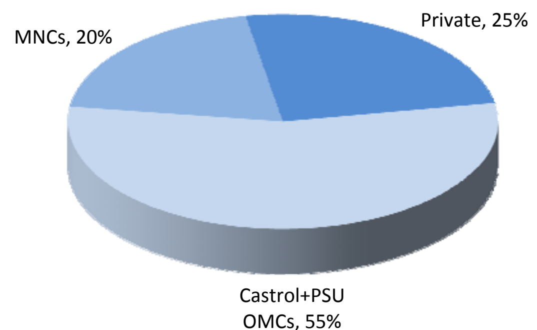
Indian lubricants sector

The Indian lubricants sector is a 2.8mmtpa (3.1bn litre, conversion of 1.11x) market with the automotive segment holding 42% volume share, industrial 23%, transformer & white oils 23%, process oils 8%, and greases 4%. The market has over 30 players, both PSU and private, domestic and industrial, integrated and standalone. Castrol's estimates that it commands ~55% market share along with PSU OMCs (IOCL, BPCL, HPCL) in the bazaar trade, 20% is with MNCs (international players like Total, Shell, Mobil, Valvoline, Motul), and 25% is with other private players (including Gulf/GOLI, Tide Water Oil, Savita, Raj).

Volume share among lubricant types



Broader bazaar market share

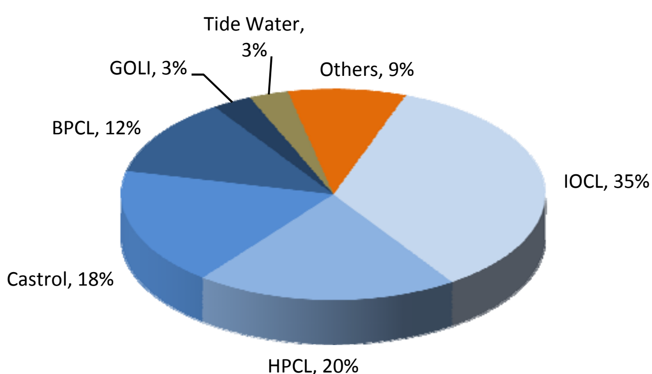


Source: Industry, PhillipCapital India Research

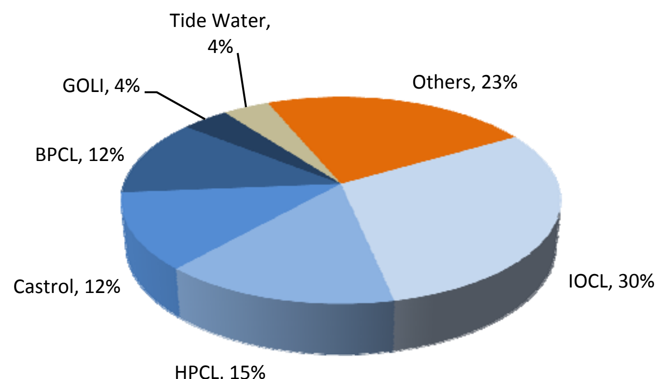
Automotive and pure industrial lubricant (excluding transformer and process oils, greases) market is dominated by the PSU OMCs with an almost 60% market share, followed by Castrol at 12%, GOLI and Tide Water Oil at 4% each, and over 20% by remaining players. However, over the last 5-6 years, larger players lost market share while smaller ones gained due to base effect.

Market share trend of Indian lube players

FY10 – Size 1,750mn litre



FY16 – Size 2,000mn litre



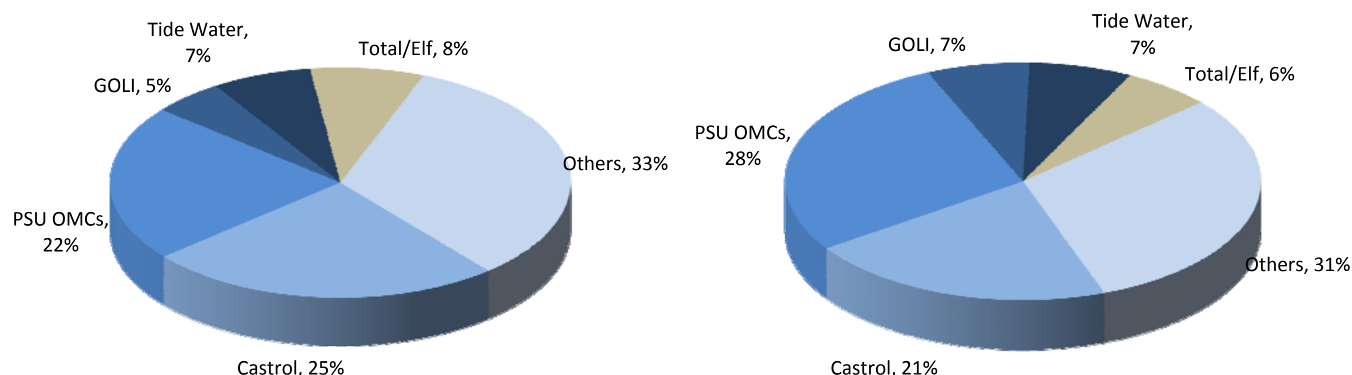
Source: Industry, PhillipCapital India Research

Automotive lubricants

Automotive lubricants comprise of primarily engine oils (80% share) with gear oil, transmission oils, and grease occupying smaller proportions. Engine oils are broadly classified as 2W or motorcycle oils (MCO), passenger vehicle oils (PV), CV oils (CVO/DEO), and tractor oils (also diesel). 2W and PV, which together form the PM segment, mostly comprise of petrol engine oils with diesel forming only a small part. CV and tractor oils are mostly diesel. The size of the Indian market in FY16 was 1.3bn litres. CVs comprise most of automotive lube consumption – at 60%+ – followed by tractors at 12%, 2Ws at 10%, PVs at 5%, 3W at 5% and others (like agri pumps and gensets) having 7-8% share. In the last 5-6 years, the automotive segment is estimated to have grown by 3-4%.

Market share trend of Indian lube players in the automotive segment

FY10 – Size 1,100mn litre **FY16 – Size 1,300mn litre**



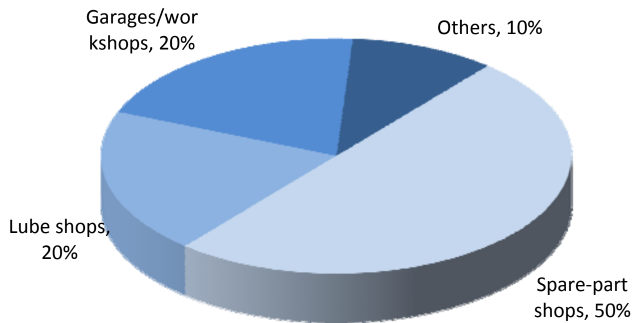
Source: Industry, PhillipCapital India Research

In the automotive market, Castrol is the leader with 20%+ market share followed by the PSU OMCs with a 30% combined share, GOLI and Tide Water Oil at 7% each, Total/Elf with 6%, and others having a 30% share. Over the last 5-6 years, Castrol and Total have lost market share against flat to gains by others, with PSU OMCs posting the biggest gain due to their low base and focus on the bazaar segment. These figures, as per our checks, include OEMS and factory-fills to some extent.

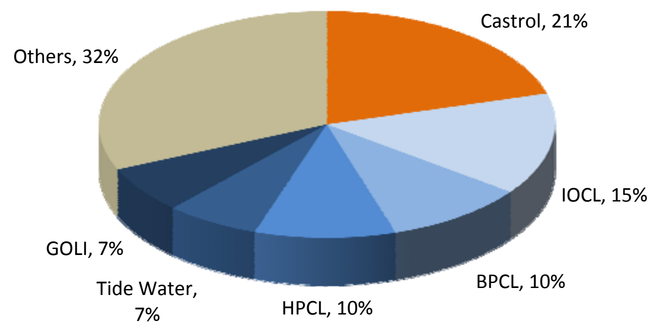
Bazaar trade

Bazaar trade is defined as direct retail sales in the replacement market and excludes fuel pump sales, which are dominated by the PSU OMCs. Currently, 80% of the automotive lubricants are in the replacement market – of which only 20% are fuel-pump and non-bazaar sales. Traditionally, fuel pumps used to have higher sales, but with the advent of private competition, auto lube business took on a more FMCG-type character and sales tilted to spare-part shops, lube shops, and garages/workshops. PSU OMCs have themselves also started focussing more on bazaar trade with only transporters and fleet operators being lube customers in fuel outlets.

Breakup of bazaar trade



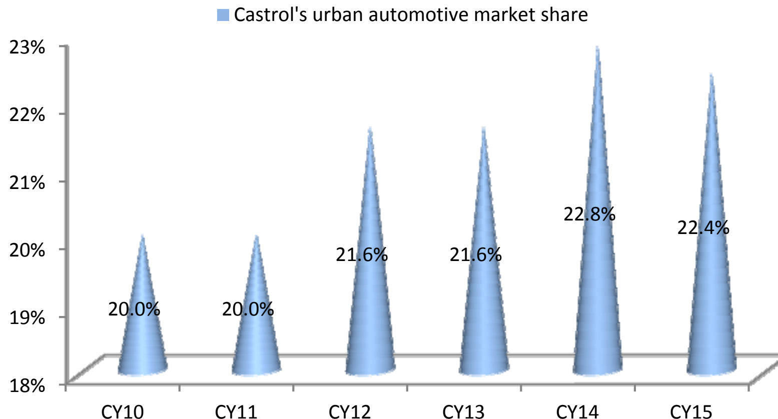
Market share in the bazaar trade



Source: Industry, PhillipCapital India Research

Spare-part shops comprise a bulk 50% of bazaar trade, followed by dedicated lube shops and garages/workshops at 20% each. Castrol is the market leader in the bazaar segment, with 21% market share, followed by IOCL at 15%. Castrol separately states a market share comprising of it's primary focus, the urban automotive bazaar market, where it has grown over the last 5-6 years – to 22%+ from 20%. The company's PM market share is a significant – 30%+ (MCO: ~30% and PCMO: ~40%) while for CVO it is below 20%.

Castrol's targeted bazaar segment market share



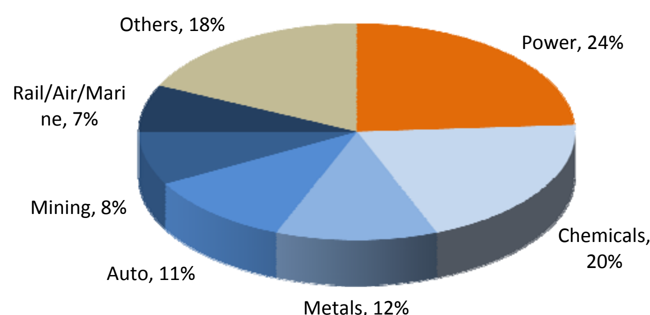
Source: Company, PhillipCapital India Research

GOLI has estimated its market share at 7%+, which include 8% market share in CVs, 5% in tractors, 9% in 2W/MCO, and 4-5% in PVs.

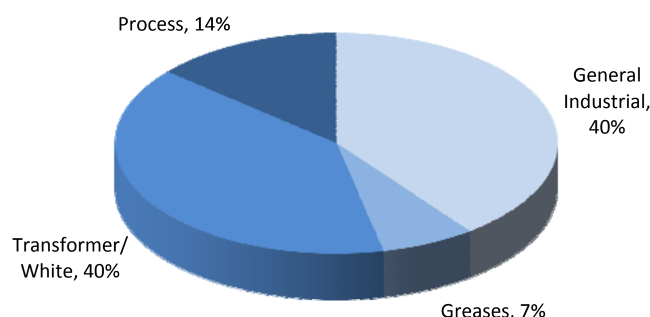
Industrial lubricants

The industrial segment is dominated by PSUs and a different set of private players in segments such as transformer oils and process oils. The industrial or non-automotive segment, with a 1.8bn litre size, comprises of sectors such as power, oil & gas, mining, metals, industries, road construction, marine, railways, and aviation etc. While general industrial lubricant occupies 40% share in the industrial space, transformer oil used in the power sector is also a large segment with a 40% share. Process oils and industrial greases have a 14% and 7% respectively. Almost 30% of industrial oil is hydraulic oil, followed by 20-25% of industrial engine oils. Cutting oils are estimated to have a 20-25% share

Target sectoral volume share of industrial lubes



Share of types of industrial oils – 1,800 mn litre



Source: Industry, PhillipCapital India Research

IOCL is the market leader in industrial lubricants with a market share of ~20% followed by Apar Industries at 15%, Columbia Petro at 10%, Raj Lubricants and Savita Chemicals at 8% each, HPCL at 6%, Shell at 5% and so on.

The aviation lubricant business is populated by MNCs due to global OEM approvals and strict norms, while marine business also has a sizeable MNC presence though Indian companies are entering it. Volume-wise, Castrol's industrial exposure is 15% while GOLI's is 15% if pure industrial is considered as factory fills and tender business, though part of the B2B category are automotive in general.

Focus areas

Lubricant players have specific focus areas. Castrol has continued its aggressive strategy in the PM segment, circulating around lube shops, spare-part shops, and garages/workshops. It has also become aggressive in the industrial space, particularly in high-margin specialised applications and is capitalising on global OEM tie-ups.

GOLI has also followed a similar bazaar trade strategy, but has focused on OEM tie-ups to improve brand positioning and traction in the tractor market, tender business (particularly government departments and transport corporations, which have helped in periodic volume spurt for the company), and engagements in the CV space, particularly through authorised dealers. It is also following Castrol's footstep by opening exclusive workshops that it has name 'Carstop' (1,000 in no.s) and 'Bikestop' (4,000 in no.s) respectively.

Focus areas of different lube players

	PM	Tractor	CV	Industrial
OEMS	Tide, Shell, BPCL, Elf	GOLI	GOLI, BPCL	Castrol, OMCs, Tide, Elf
Fuel Pumps	OMCs	OMCs	OMCs	
Spare-part Shops	IOCL, GOLI, Tide, Elf, Castrol		GOLI, Elf	
Lube Shops	IOCL, GOLI, Tide, Elf, Castrol		GOLI, Elf	
Workshops	Castrol		GOLI, Elf	
Authorised Dealers	GOLI, Mobil	Elf, GOLI	GOLI, Elf	Elf

Source: Industry, PhillipCapital India Research

PSU OMCs are aggressive in the bazaar trade, besides maintaining their engagements in auto fuel outlets. OEM tie-ups are also pursued. MNCs mostly concentrate on authorised dealers and OEM tie ups, though they have to enhance below-the-line activity to increase foothold. Companies like Valvoline Cummins, Mobil, and Shell have leadership positions in niche markets like diesel gen-sets, marine, and aviation space respectively due to OEM support.

Capex and new capacities
On a recurring scale, lubricants is a low-capex business; only minor modifications in existing plants can change assembly line configuration/product specifications. However, due to capacity constraints and logistic/market needs, companies are planning new blending plants. GOLI expanded the annual capacity of its Silvassa facility to 90 mn litre last year (from 75mn litre) at a capex of Rs 450mn. It is now constructing a new plant in Chennai with a capacity of ~50mn litre involving a capex of Rs 1.5bn, which will strengthen its supply position in the crucial southern market and lower freight cost. Castrol has also indicated possibility of new project capex if volume growth escalates. If not for the plant, Castrol's recurring capex would have been meagre (Rs 400-500mn in last three years) against its FCF of Rs 4-7bn. HPCL is also planning to set up two new plants in Mumbai and one in Kasna (UP).

Brief profile of key lubricant players (bazaar segment)
Castrol India: Castrol, promoted by BP, is one of the key players in India. It has three blending plants in Silvassa, Patalganga (Maharashtra), and Paharpur (Bengal) with a combined capacity of 200mn litres+, three delivery centres, 23 warehouses, 420 distributors, and 80,000+ retail outlets. Castrol is present in automotive as well as industrial lubricants – though its presence in the tender business and transformer/process oils is minimal. Castrol's marquee brands are Edge (fully synthetic), Magnatec (semi-synth), GTX, and GTD (OEM DEO) in PCMO, Activ, Power 1 and Go in MCO/2W, and Vecton, CRB and RX in CVO. Besides these, it also markets CNG oils, transmission fluids, antifreeze/coolants, driveline fluids, fork oils, and greases. In non-automotive/industrial, Castrol supplies to marine, oil & gas, automobile manufacturing, aviation and aerospace, machinery, power generation, metals, and mining-sectors products such as hydraulic oils, cylinder oils, heavy engine oils, compressor oils, turbocharger oils, seal oils, transformer oils, cutting oils, circulating oils, cleaners, chain oils, corrosion preventives etc. Castrol is the price leader among major companies in India.

Gulf Oil Lubricants India: GOLI, promoted by Gulf Oil International, a Hinduja group company is one of the top-three domestic private lubricant marketers in India. It has a blending plant located in Silvassa with a capacity of 90mn litre, 350 distributors, and 55,000+ retail outlets. GOLI also has exposure to tender business of transport corporations. GOLI's marquee brands are Gulf Formula GX, Tec, Ultrasynth and MAX in PCMO, Gulf Pride in MCO/2W, Gulf Supreme, Superduty, Superfleet, Super Diesel and Master in CVO, Gulf XHD in tractors and Gulf Supreme in 3W/CNG. Besides these, it also markets CNG oils, gear oils, greases, brake fluid, fork oils, greases and coolants. In non-automotive/industrial, GOLI's profile is similar to Castrol's – with brands such as Harmony, Security, Crest, Fidelity, Select, and Quench. Pricing wise, GOLI claims to be at a 10-15% discount to Castrol. The company also has minor battery business, where it markets imported 2W batteries. GOLI was demerged from Gulf Oil Corporation as a pure-play lubricants company in CY15.

Tide Water Oil Company: Tide Water, promoted by Andrew Yule, a PSU, is also a top-three domestic private lubricant marketer in India. It has five blending plants located in Silvassa, Turbhe, Oragadam, Faridabad and Ramkristopur with a combined capacity of 100mn litre+, 55 depots, 50 distributors, 350 dealers and 50,000+ retail outlets. Tide's umbrella brand is Veedol, which it acquired from BP while sub brands include Syntron, Powertron, Blue Blood and Turbostar in PCMO, Super Swift and Take Off in MCO/2W, Max Pro and Turbo in CVO and Prima in tractors. Besides these, it also markets CNG engine oils, gear and transmission oils, greases, brake fluid, fork oils, and industrial grades. Pricing wise, Tide is at a 15-20% discount to Castrol as per our channel checks. Tide has an annual sales volume of ~75mn litre. Tide is also foraying abroad with Nepal, Bangladesh, and Europe among focus areas.

Indian Oil Corporation: IOCL, an integrated downstream PSU, is a major pan-India lubricant player with a blending capacity of 450mn litre+ and total lube sales of 418mn litre in FY16 (4.4% yoy growth) of which institutional portion was 276mn litre and retail 142.5mn litre. IOCL is strong in the tender business, involving railway, defence, and industrial PSU monopolies like Coal India. IOCL claims to have a 27.5% market share in finished lubes as a market leader. IOCL's umbrella brand is Servo and sub brands include Servo Pride, Premium, and Super Plus in CVO/DEO category, Servo Futura (synthetic), Superior and Xee in PCMO and 2T/4T in MCO/2W. Servo has multiple co-branded oils with automobile manufacturers like Hyundai, Eicher, Force Motors, and HMT. Servo also markets transmission fluids, gear oils, brake fluids, agri application oils, and boat engine oils. IOCL's bulk industrial lubricants comprise of various categories mentioned for players above along with small scale industry oils. IOCL and other PSU OMCs products are priced at a 20%+ discount to Castrol as per our channel checks.

Hindustan Petroleum: HPCL is also a PSU OMC though about half the size of IOCL with a strong presence in the lubricant space due to its base oil production facility in the Mumbai refinery. It has 7 blending plants with a combined capacity of 275mn litre while gross lube sales in FY16 was 590 mn litre (a growth of 27% yoy) against LOBS production of 465mn litre. HP Lubes has 208 distributors, 13,600 dealers/auto fuel outlets and 96 CFAs which amounts to 45% of automotive lubricant volume share. HPCL is the fastest growing PSU with 4% market share gain recorded in FY16 among PSUs, as per the company. HPCL's brands include Hylube, Milcy, Laal Ghoda and Railroad in DEO, Extra Super, Cruise and Racer in PCMO and MCO respectively. HPCL also markets CNG oils, gear oils, transmission fluids, fork oil, brake fluids, coolants, and greases. HPCL is present in industrial lubricants space and tender business, including defence.

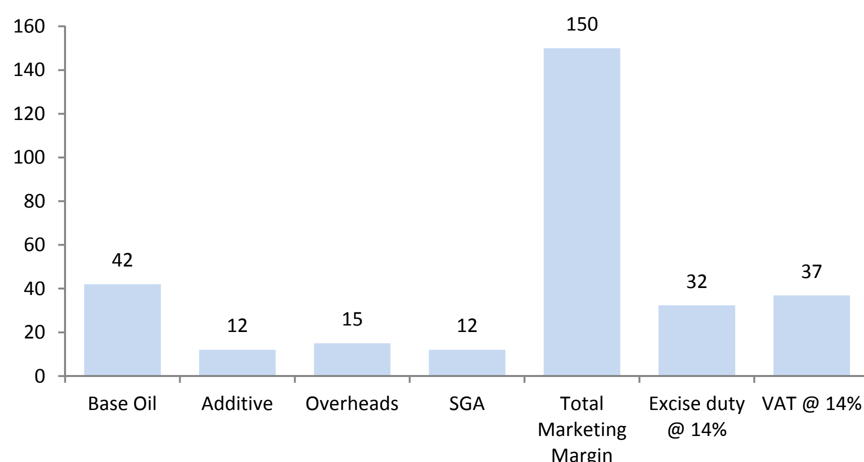
Bharat Petroleum: BPCL is a PSU OMC similar to HPCL. BPCL has 3 blending plants with a combined capacity of 250mn litre, 4 lube filling plants, 13,000 auto fuel outlets, 591 distributors, 60,000+ retail outlets and 54 depots. BPCL claims to have a 21% market share among PSU OMCs in automotive lubricants. BPCL's umbrella brand is MAK and sub brands include Elite, Diamond, Supreme and Classic in PCMO, V3 and Diamond in DEO/CVO and 4T in MCO/2W. BPCL also markets CNG oils, gear oils, transmission fluids, fork oil, brake fluids, coolants and greases. BPCL is present in industrial lubricants space.

Other players: MNCs and smaller private entities like Shell (brands include Helix, Advance, Rimula), Valvoline Cummins, Exxon Mobil (Mobil, Mobil 1), Total (Elf, Quartz), Petronas, Idemitsu, Motul, Raj Lubricants, Savita (Savsol) and GP Petroleum (previous Sah/IPOL, ~15mn litre volumes).

GST can lower prices and provide scope for margin upside

Current taxation on lubricants comprises of excise duty of ~14% and a VAT rate of 14-15%. If effective taxation gets lowered through GST, then there would be room to cut prices as well as increase margins, which is positive for the sector. Hence, depending on the GST rate, the lubricant sector can be a GST play.

Automotive lubricant price build-up (Rs/litre)



Source: Industry, PhillipCapital India Research

Key risks

- **Adverse oil price and base oil pricing scenario:** Raw material cost fluctuation would impact margins if retail pricing is sticky. This would include additives and packaging.
- **Currency risk:** Since base oil and additives are dollar and retail products are rupee denominated, currency risk is inherent in the business with a depreciating Rs/USD being adverse on margins.
- **Competitive risk:** Predatory and destructive pricing by competitors, crowding of new players. Intense promotional activities can lead to a jump in advertising and other expenses.
- **Other risks:** Plant outage, industrial relations, adverse taxation, JV and related party risks.
- **Higher drain intervals:** Structural decline in lube consumption due to efficient and smaller engines and long drain oils by lubricant players.

Generally, margin accretion in long drain oils offset volume decline, keeping profitability intact. While players introduced oils with increasing drain intervals (GOLI introduced the last 72,000kms long drain CVO/DEO in CY11 post which it has not launched any more. Castrol Vecton has a drain interval of 60,000kms), our channel check has indicated that approval from engine maker is required before OEMs and service centres accepts these. We assume CV drain intervals to increase to 45,000kms in next five years (from current 36,000kms), based on our interaction with a lube expert and due to nameplate drain intervals applicable only in ideal conditions - which are hardly met; yet lube companies themselves have said that drain intervals could grow to 100,000kms during this period. This is a key risk to our volume estimates though it would be offset by higher realisations.

Some of GOLI's long drain oils

FY07	Launched 36,000kms drain interval oil named Gulf Superfleet LE Max 15W-40, India's first 10,000km MCO named Pride 4T Plus 20W-40
FY11-12	First M&M co-branded 10,000km diesel oil named Gulf Super Diesel X-10, First 72,000km diesel oil named Superfleet LE Dura Max 15W-40
FY13	India's longest drain interval rear axle oil for 0.15mn.km, India's longest drain gear box oil for 0.24mn.km named Gulf MTF PNG

Source: Industry, PhillipCapital India Research

Electric vehicles: A longer-term risk as electric engines would have minimal lube consumption with almost nil engine oil usage. However, it is premature at the moment considering the global reliance on hydrocarbon-based engines. Battery making is a future diversification option.

BP's stake sale in Castrol: Castrol India's promoter, Castrol Ltd, a wholly owned subsidiary of BP Plc, divested 11.5% stake in the company in May 2016 to financial investors, lowering its shareholding from 71% to 59.5% – thereby raising ~US$ 308mn (Rs 20.8bn). BP's divestment proceeds globally are used to meet the Gulf of Mexico oil spill demands. In 1HCY16, BP raised US$ 1.9bn from divestment including Castrol India stake sale against oil-spill payment of US$ 2.7bn. BP's cumulative charge for the oil spill is US$ 62bn, of which US$ 20bn had been paid. Divestment target for CY16 is US$ 3-5bn, but this would go down to historical levels of US$ 2-3bn thereafter. BP's oil price assumption for managing cash-flows is ~US$ 50/bbl.

This stake sale had been an overhang for the Castrol India stock, which earlier corrected by 15% in May to the block price of Rs 365/share. BP has maintained its intention to be Castrol India's majority shareholder with no impact on such transactions on the employees, customers and contractors. As per media reports, second tranche of stake sale has been announced recently wherein BP would divest 8.5% additional stake to reduce its shareholding to 51%, just above the 50% threshold level. We do not see any business related concerns about the motive of Castrol's stake sale and believe the divestment is part of oil-spill payments. We recommend subscribing such an issue.

Financial characteristics of lubricant companies – a high return, asset light model

The lubricant business is marked by high return ratios due to a strong asset turnover. Most players are zero-debt entities, as the sector is not capital intensive. FCF generation is stable and robust and yields are decent at 3-4%. EBITDA margin under current oil prices is 15-30% depending on pricing power and sourcing efficiency. Castrol operates at negative working capital due to high creditor days while GOLI's inventory levels are higher due to which book working capital is of ~40 days.

DuPont analysis

Castrol	CY10	CY11	CY12	CY13	CY14	CY15
PAT/PBT	66%	67%	67%	67%	65%	65%
PBT/EBIT	105%	111%	112%	116%	107%	111%
EBIT/Sales	26%	22%	19%	21%	20%	26%
Sales/Assets	530%	546%	524%	447%	756%	610%
Assets/Networth	93%	91%	92%	95%	90%	94%
ROE	89%	80%	69%	68%	96%	107%

GOLI	FY15	FY16
PAT/PBT	67%	65%
PBT/EBIT	93%	100%
EBIT/Sales	13%	15%
Sales/Assets	237%	225%
Assets/Networth	218%	181%
ROE	41%	40%

Source: Company, PhillipCapital India Research

Valuation

Due to an apparent simplified and clean business model and financial metrics with zero debt and very high RoE/RoCEs, lubricant players get premium multiples.

Absolute valuation

Castrol traded at an average PE of 33x during CY13-15, before de-rating in CY16, which we believe was accentuated by promoter stake sale. In CY14, Castrol went for a capital reduction scheme where its face value reduced from Rs 10 to Rs 5, by returning Rs 5 to shareholders. During that year, Castrol traded at a peak of over 43x PE as RoE jumped from ~70% to almost 100%.

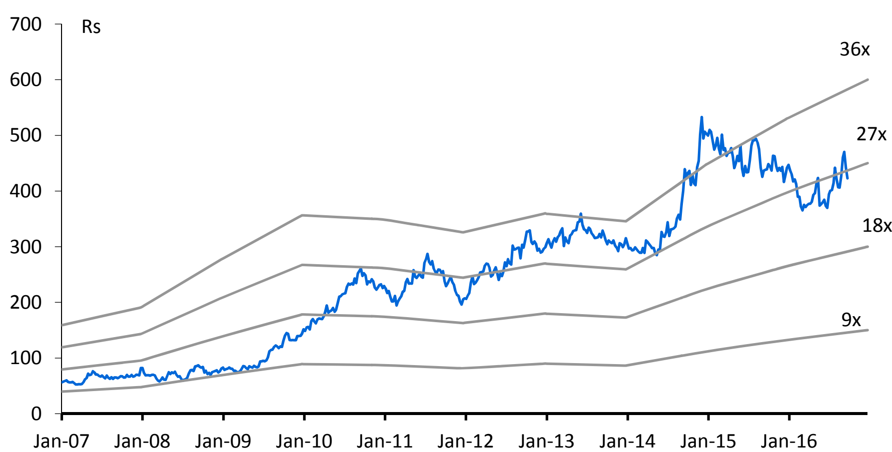
While such an event cannot be ruled out in the future, along with special dividends, bonus shares and buybacks, we would not assume a similar rerating; besides, the BP divestment has removed the potential delisting premium from valuations too. However, since CY14, RoEs have remained above 100% and we expect the same in

CY16/17. This is coupled with return of volume growth, low oil prices, and a conservative margin assumption, which can beat our expectations.

Therefore, we assign a 33x base case target PE multiple on CY17 EPS of Rs 16.7 to arrive at Castrol's fair value of Rs 550. Further rerating to 35x+ is possible depending on corporate actions mentioned above, market condition and earnings beating estimates. At CMP, Castrol is trading at 25x CY17 EPS while its 10-year average PE is 23.5x. We do not expect a de-rating to these levels as the structural RoE up-move in CY14 to 100%+ is continuing. Nevertheless, 23.5x implies a 7% downside to current levels, which we believe is a bear case for Castrol within its current business outlook and financial position.

Due to its relatively new listing, we would tie GOLI's valuations to Castrol's. Apparently, GOLI's return ratios are weaker at 39-40% with upside unlikely unless GOLI also goes for corporate actions. Nevertheless, GOLI is a growth story and earnings CAGR is estimated at 1.5x of Castrol. Hence, we would assign a 30x multiple for GOLI on FY18 EPS of Rs 31.7 which implies a fair value of Rs 950, which is our base-case scenario, though depending on market leader Castrol's re/de-rating, GOLI's multiples could also change equivalently. GOLI's promoters have raised stake in the company from ~60% during the demerger and relisting to ~69% currently, which has also improved sentiment for the stock.

Castrol's one-year forward PE band chart



Source: PhillipCapital India Research

Comparative valuation (to FMCG companies)

Due to lubricant players' similarity to FMCG companies in terms of financial metrics and consumer centric business, we compare Castrol with FMCG peers. Castrol's 110%+ RoE is only next to HUL's 147% while it trades at a 37% discount to HUL with a better profit growth outlook. The average RoE of our FMCG proxy universe is ~45% while PE multiple is 33x. Hence, we are comfortable with our 33x target PE multiple for Castrol.

GOLI's profit growth is stronger than most of the players in our FMCG proxy universe except AgroTech Foods, which, however, has just a 12% RoE. Asian Paints is the most similar to lubricant players, and it currently trades at a PE of 47x on an ROE of 31% and PAT growth of 13%/15% in FY17/18. Hence, in comparison, Castrol and GOLI's valuation seems reasonable and attractive.

Castrol/GOLI's comparative valuations versus FMCG players

	EBITDA margin			PAT growth			RoE			PE (x)			PB (x)		
	FY16	FY17E	FY18E	FY16	FY17E	FY18E	FY16	FY17E	FY18E	FY16	FY17E	FY18E	FY16	FY17E	FY18E
Castrol	**27%**	**29%**	**30%**	**30%**	**19%**	**13%**	**107%**	**112%**	**113%**	**34.0**	**28.7**	**25.3**	**36.3**	**32.2**	**28.6**
GOLI	**16%**	**16%**	**17%**	**30%**	**24%**	**26%**	**40%**	**39%**	**38%**	**34.8**	**28.1**	**22.3**	**14.1**	**10.9**	**8.5**
AgroTech Foods	7%	8%	9%	-13%	-37%	52%	7%	10%	12%	55.0	36.0	27.0	4.0	3.0	3.0
Bajaj Corp	31%	31%	31%	11%	9%	13%	51%	54%	58%	25.0	23.0	21.0	13.0	13.0	12.0
Britannia	13%	13%	14%	49%	14%	19%	46%	39%	36%	51.0	46.0	38.0	24.0	18.0	14.0
Colgate	24%	25%	26%	33%	3%	16%	65%	52%	49%	36.0	35.0	30.0	23.0	18.0	15.0
Dabur	21%	20%	20%	18%	12%	11%	30%	28%	27%	42.0	37.0	33.0	13.0	11.0	9.0
Emami	26%	27%	27%	-26%	80%	18%	23%	37%	38%	86.0	46.0	38.0	17.0	15.0	12.0
GCPL	18%	18%	19%	24%	18%	14%	22%	22%	21%	50.0	43.0	38.0	11.0	9.0	8.0
GSKConsumer	15%	16%	17%	18%	10%	13%	28%	27%	27%	39.0	35.0	31.0	11.0	9.0	8.0
HUL	16%	17%	18%	7%	10%	11%	112%	124%	143%	49.0	45.0	40.0	55.0	55.0	58.0
Marico	17%	20%	20%	26%	23%	14%	34%	35%	33%	54.0	43.0	38.0	18.0	15.0	13.0
Nestle	20%	22%	22%	-52%	121%	14%	38%	38%	37%	59.0	50.0	44.0	22.0	19.0	16.0
Asian Paints	17%	17%	18%	65%	13%	15%	32%	31%	31%	63.0	55.0	47.0	20.0	17.0	15.0
ITC	37%	37%	37%	-2%	11%	6%	29%	30%	32%	34.0	30.0	28.0	9.0	9.0	6.0
Average	**20%**	**21%**	**22%**	**14%**	**22%**	**17%**	**44%**	**45%**	**46%**	**47.6**	**38.8**	**33.5**	**19.5**	**17.1**	**15.2**

Source: Company PhillipCapital India Research, * FMCG estimates are from PhillipCapital consumer team

Stock performance of lubricant players to other oil & gas downstream/distribution companies

Since the 50%+ crash in oil prices in the last two years, petroleum and gas downstream and distribution companies have delivered superior returns with OMCs witnessing 40-140% returns in two years, refiners 24-180%, and gas downstream companies 70-80%. In comparison, Castrol only yielded 6% returns despite improvement in margins and profitability. This may be due to rerating in CY14 and promoter stake sale in CY16. However, we expect a mean reversion due to volume growth recovery and earnings traction. GOLI, due to its fresh demerger to a pure play lubricant player, yielded 130%+ returns – though going forward we expect it to track the lubricant sector, with valuations moving in tandem with Castrol. The BSE Sensex was 3% down during this period due to underperformance of upstream players.

Castrol's returns have underperformed other distributors in last two years, when oil prices halved

%	1Y	2Y	3Y
IOCL	42.8	43.4	146.4
BPCL	38.7	78.8	300.3
HPCL	47.9	141.8	538.6
MRPL	54.0	24.1	141.5
CPCL	29.8	182.8	349.1
Essar	40.6	108.5	342.1
IGL	65.8	79.4	189.2
Petronet	97.8	72.1	190.6
Castrol	**(2.3)**	**6.3**	**30.1**
GOLI	**50.1**	**133.6**	**na**
Nifty	10.2	7.0	48.2
Sensex	8.7	3.8	42.4
BSE Oil & Gas	26.6	(2.8)	28.7
Brent	7.3	(49.4)	(56.6)
Rs/US$	(1.1)	(10.6)	(5.7)

Source: Bloomberg, PhillipCapital India Research

PhillipCapital

Castrol India Ltd (CSTRL IN)

Growth is back

INDIA | OIL & GAS | Initiating Coverage

22 September 2016

Volumes record 7% yoy growth in CY16 against 3% negative CAGR in the last five years

This growth was driven by steady double-digit volume growth in the PM segment coupled with traction in CV and industrials. Our analysis reveals a 10-year volume CAGR of 13% in the PM segment, which derives higher realisations and margins compared to CVO and industrials, where the company recorded 5% negative CAGR due to a deliberate attempt to maintain its premium position. Share of PM in total volumes has grown to 40% currently (from 10% in CY06 and 20% in CY10). Castrol's market share in the urban bazaar market has improved slightly to 22.4% in CY15 from 20% in CY10, despite intense competition and a high volume base. Castrol gained market share in PCMO to 40% while MCO share stands at 30%. CVO and industrial market share ranges from 18-20% in relevant markets.

New strategy focuses on profitable volume growth and premiumisation

Castrol initiated a new strategy 1-2 years ago to focus on profitable volume growth, which includes renewed push on the high-margin PM segment while also building inroads into lucrative pockets of other segments. The company has widely promoted its power brands, which currently form 50% of PM volumes and 20% of overall volumes, and entails better realisations and margins. With growing share of power brands, volume mix would continue to improve, thereby leading to a structural improvement in realisations, which, under a benign oil price environment would result in continued improvement in margins. Castrol's gross margins saw a 13% CAGR in the last 10 years, and we expect it to grow by 5-7% in the next two years. In industrial, Castrol is aggressive in specialised cutting and metal working oils, which entails higher realisations and margins. Castrol's global OEM tie-ups help maintain its position as a preferred brand for specialised engines and equipment.

Estimate 15-16% earnings CAGR on volume growth of 6%

We expect Castrol to record a volume CAGR of 6% and EBITDA/litre CAGR of 8%; EBITDA and PAT should grow at a 15% and 16% CAGR respectively during CY15-17 (vs 5% PAT CAGR in CY10-15). Our EBITDA/litre estimate is based on 3% realisation growth, and 6% and 10% increase in COGS and opex respectively. We estimate ROEs to remain robust at 110%+ while EBITDA margin would be stable at close to 30%. Castrol's balance sheet is estimated to remain comfortable and debt-free, even if new capex is made on capacity expansion. We estimate a stable FCF yield of ~3%. We build in a 75% dividend payout, which implies a yield of 2-3%.

Initiate coverage with a Buy rating and target price of Rs 550

We value Castrol at 33x our CY17 EPS of Rs 16.7. Castrol has traded at an average valuation of 33x during CY13-15 while peak valuation crossed 43x (CY14 end). While BP's stake sale removes scope of a potential delisting story, we believe a 33x multiple is justified considering recovery in volume after five years of de-growth and low oil prices favouring margins. We initiate coverage on Castrol with a target price of Rs 550, which provides 30% upside. Recommend Buy

BUY

CMP RS 423

TARGET RS 550 (+30%)

COMPANY DATA

O/S SHARES (MN) :	495
MARKET CAP (RSBN) :	209
MARKET CAP (USDBN) :	3.1
52 - WK HI/LO (RS) :	478 / 360
LIQUIDITY 3M (USDMN) :	7.9
PAR VALUE (RS) :	5

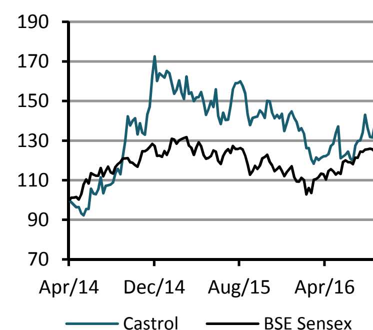
SHARE HOLDING PATTERN, %

	Jun 16	Mar 16	Dec 15
PROMOTERS :	59.5	71.0	71.0
FII / NRI :	9.7	5.9	6.3
FI / MF :	13.4	8.0	7.6
NON PRO :	4.3	1.2	1.2
PUBLIC & OTHERS :	13.1	14.0	13.9

PRICE PERFORMANCE, %

	1MTH	3MTH	1YR
ABS	4.0	13.0	-3.6
REL TO BSE	2.0	5.5	-12.8

PRICE VS. SENSEX



Source: Phillip Capital India Research

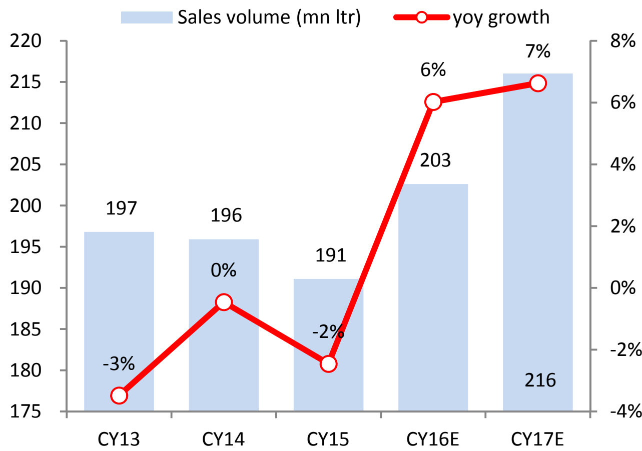
KEY FINANCIALS

Rs mn	CY15	CY16E	CY17E
Net Sales	32,980	35,304	39,517
EBIDTA	8,949	10,374	11,822
Net Profit	6,153	7,311	8,247
EPS, Rs	12.4	14.8	16.7
PER, x	34.0	28.7	25.3
EV/EBIDTA, x	22.6	19.4	17.0
P/BV, x	36.3	32.2	28.6
ROE, %	106.9	112.1	112.9

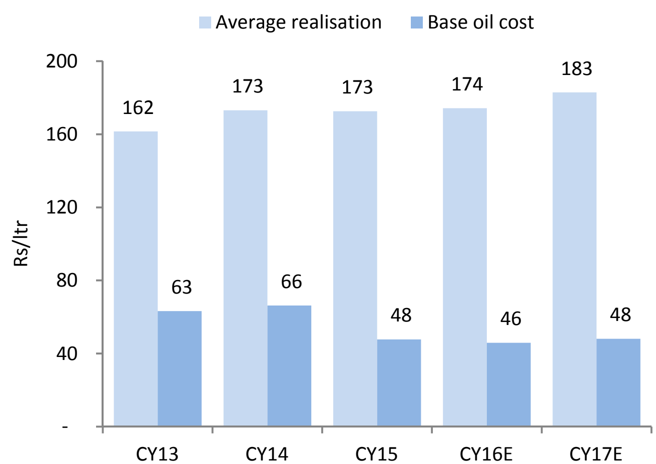
Source: PhillipCapital India Research Est.

Key parameters

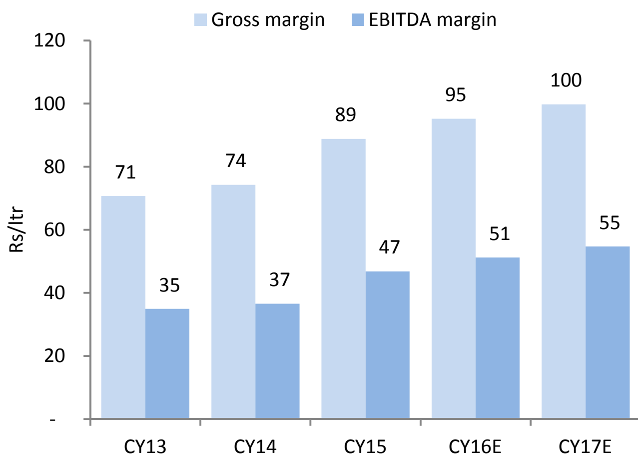
Volume and growth



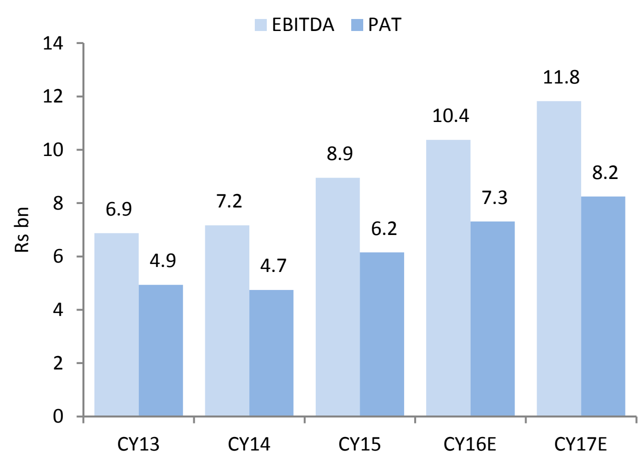
Realisation and base oil cost (calculated)



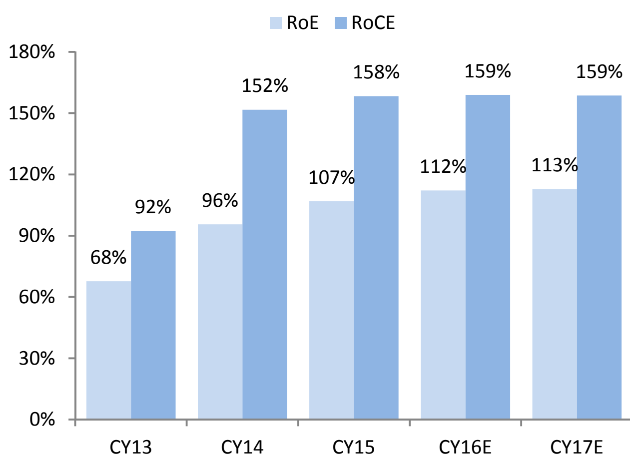
Gross and EBITDA margin



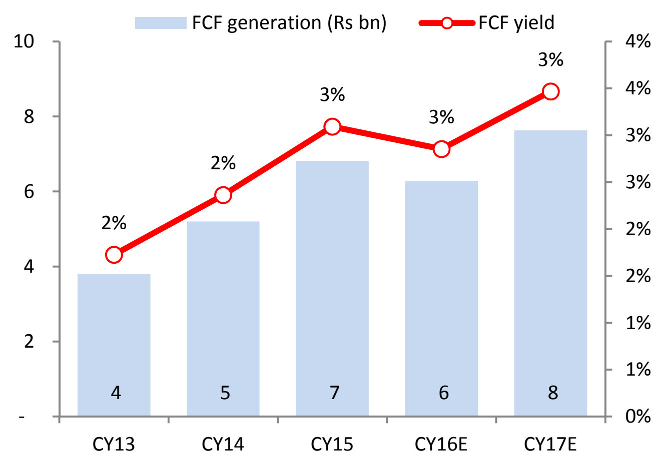
Earnings



Return ratios



FCF and yield



Source: Company, PhillipCapital India Research

Financials & valuation

Y/E, December 31	CY13	CY14	CY15	CY16E	CY17E
Revenues (Rs.mn)	31,796	33,923	32,980	35,304	39,517
EBITDA (Rs.mn)	6,875	7,167	8,949	10,374	11,822
Reported PAT (Rs.mn)	5,086	4,746	6,153	7,271	8,247
Adjusted PAT (Rs.mn)	4,933	4,746	6,153	7,311	8,247
Growth	10%	-4%	30%	19%	13%
Reported EPS (Rs.)	10.3	9.6	12.4	14.7	16.7
Adjusted EPS (Rs.)	10.0	9.6	12.4	14.8	16.7
Adjusted PE (x)	42.4	44.0	34.0	28.6	25.3
PB (x)	27.8	42.1	36.3	32.2	28.6
EV/EBITDA (x)	29.5	28.6	22.6	19.4	17.0
RoE	68%	96%	107%	112%	113%
RoCE	92%	152%	158%	159%	159%
Debt:Equity (x)	-	-	-	-	-
EBITDA/litre (Rs.)	34.9	36.6	46.8	51.2	54.7
Sales Volume (mn.litre)	197	196	191	203	216
Growth	-3%	0%	-2%	6%	7%

Source: Company, PhillipCapital India Research

Valuation

Rs./sh	CY13	CY14	CY15	CY16E	CY17E
Castrol's Adjusted EPS	10.0	9.6	12.4	14.8	16.7
Target Multiple (x)					33.0
Target Price					550

Source: PhillipCapital India Research

Company description

Castrol India traces its origin from C C Wakefield & Co which entered the Indian market in 1910. It was incorporated in 1979 as Indrol Lubricants and Specialities Pvt Ltd and rechristened Castrol India in 1990. Presently, Castrol is promoted by Castrol Ltd (59.5% stake), which is a wholly owned subsidiary of global petroleum major BP (British Petroleum) Plc.

Castrol operates in automotive and industrial lubricants and its product line includes engine oils and other associated items like gear oils, transmission fluids, coolants, and greases under automotive and hydraulic oils, compressor oils, cutting oils, and corrosion preventives under the non-automotive industrial category, which includes marine oils. It has three blending plants located in Silvassa, Patalganga (Maharashtra) and Paharpur (Bengal).

The company board comprises of Mr Omer Dormen, MD, and two functional directors namely Ms Rashmi Joshi Director Finance and Mr Jayanta Chatterjee Director Supply Chain. Mr SM Datta is Chairman with three nominee directors from parent BP and two independent directors. The company reported revenues of Rs 33bn and PAT of Rs 6bn in CY15. Current market cap stands at Rs 209bn.

Financials

Consolidated Income Statement

Y/E Dec, Rs mn	CY14	CY15	CY16e	CY17e
Net sales	**33,923**	**32,980**	**35,304**	**39,517**
Growth, %	6.7	(2.8)	7.0	11.9
Total income	33,923	32,980	35,304	39,517
Raw material expenses	-19,375	-16,008	-16,020	-17,965
Employee expenses	-1,616	-1,766	-1,942	-2,098
Other Operating expenses	-5,766	-6,258	-6,967	-7,632
EBITDA (Core)	**7,167**	**8,949**	**10,374**	**11,822**
Growth, %	4.3	24.9	15.9	14.0
Margin, %	21.1	27.1	29.4	29.9
Depreciation	-361	-390	-421	-370
EBIT	**6,806**	**8,559**	**9,952**	**11,451**
Growth, %	3.6	25.8	16.3	15.1
Margin, %	20.1	26.0	28.2	29.0
Interest paid	-24	-8	0	0
Other Non-Operating Income	481	959	1,064	1,044
Non-recurring Items	**0**	**0**	**0**	**0**
Pre-tax profit	7,263	9,510	11,016	12,496
Tax provided	-2,518	-3,357	-3,746	-4,249
Profit after tax	**4,746**	**6,153**	**7,271**	**8,247**
Net Profit	**4,746**	**6,153**	**7,311**	**8,247**
Growth, %	(3.8)	29.6	18.8	12.8
Net Profit (adjusted)	**4,746**	**6,153**	**7,311**	**8,247**
Unadj. shares (m)	495	495	495	495
Wtd avg shares (m)	495	495	495	495

Balance Sheet

Y/E Dec, Rs mn	CY14	CY15	CY16e	CY17e
Cash & bank	4,315	6,965	7,464	8,490
Debtors	2,715	2,365	2,531	2,833
Inventory	3,655	3,046	3,260	3,649
Loans & advances	1,716	1,822	1,950	2,183
Other current assets	26	67	72	80
Total current assets	12,426	14,265	15,278	17,236
Gross fixed assets	3,762	3,915	4,511	5,108
Less: Depreciation	-2,041	-2,427	-2,783	-3,154
Add: Capital WIP	157	364	368	371
Net fixed assets	1,877	1,853	2,096	2,325
Non-current assets	1,877	1,853	2,096	2,325
Total assets	**14,303**	**16,117**	**17,374**	**19,561**
Current liabilities	6,759	6,979	7,240	8,043
Provisions	3,084	3,758	3,900	4,333
Total current liabilities	9,843	10,737	11,140	12,376
Non-current liabilities	-508	-376	-250	-122
Total liabilities	9,336	10,361	10,890	12,253
Paid-up capital	2,473	2,473	2,473	2,473
Reserves & surplus	2,495	3,283	4,010	4,835
Shareholders' equity	4,968	5,756	6,483	7,308
Total equity & liabilities	**14,303**	**16,117**	**17,374**	**19,561**

Source: Company, PhillipCapital India Research Estimates

Cash Flow

Y/E Dec, Rs mn	CY14	CY15	CY16e	CY17e
Pre-tax profit	7,263	9,510	11,016	12,496
Depreciation	361	390	421	370
Chg in working capital	580	1,128	-111	303
Total tax paid	-2,470	-3,277	-3,625	-4,127
Other operating activities	-259	-350	-1,129	-1,044
Cash flow from operating activities	**5,476**	**7,400**	**6,573**	**7,997**
Capital expenditure	-504	-370	-600	-600
Chg in marketable securities	3	0	0	0
Other investing activities	364	392	1,064	1,044
Cash flow from investing activities	**-137**	**23**	**464**	**444**
Free cash flow	5,339	7,423	7,037	8,442
Equity raised/(repaid)	-2,473	0	0	0
Dividend (incl. tax)	-4,494	-4,772	-6,544	-7,422
Cash flow from financing activities	**-6,966**	**-4,772**	**-6,538**	**-7,416**
Net chg in cash	-1,628	2,651	499	1,026

Valuation Ratios

	CY14	CY15	CY16e	CY17e
Per Share data				
EPS (INR)	9.6	12.4	14.8	16.7
Growth, %	(3.8)	29.6	18.8	12.8
Book NAV/share (INR)	10.0	11.6	13.1	14.8
FDEPS (INR)	9.6	12.4	14.8	16.7
CEPS (INR)	10.3	13.2	15.6	17.4
CFPS (INR)	10.5	13.8	12.7	15.4
DPS (INR)	7.5	9.0	11.0	12.5
Return ratios				
Return on assets (%)	105.8	113.8	116.7	114.3
Return on equity (%)	95.5	106.9	112.1	112.9
Return on capital employed (%)	151.7	158.3	158.9	158.7
Turnover ratios				
Asset turnover (x)	7.6	6.1	5.6	5.5
Sales/Total assets (x)	7.6	6.1	5.6	5.5
Sales/Net FA (x)	18.1	17.8	16.8	17.0
Working capital/Sales (x)	0.1	0.1	0.1	0.1
Receivable days	29.2	26.2	26.2	26.2
Inventory days	39.3	33.7	33.7	33.7
Payable days	73.4	83.4	83.4	83.4
Working capital days	(4.9)	(23.6)	(23.6)	(23.6)
Liquidity ratios				
Current ratio (x)	1.2	1.2	1.3	1.3
Quick ratio (x)	0.7	0.9	0.9	0.9
Interest cover (x)	286.0	1,031.2	-	-
Dividend cover (x)	1.3	1.4	1.3	1.3
Net debt/Equity (%)	(0.9)	(1.2)	(1.2)	(1.2)
Valuation				
PER (x)	44.0	34.0	28.7	25.3
PEG (x) - y-o-y growth	(658.5)	114.6	158.1	188.7
Price/Book (x)	42.1	36.3	32.2	28.6
Yield (%)	1.8	2.1	2.6	3.0
EV/Net sales (x)	6.0	6.1	5.7	5.1
EV/EBITDA (x)	28.6	22.6	19.4	17.0
EV/EBIT (x)	30.1	23.6	20.2	17.5

PhillipCapital

Gulf Oil Lubricants India (GOLI IN)

Rapid expansion story

INDIA | OIL & GAS | Initiating Coverage

22 September 2016

Robust volume growth at 2-3x of industry due to smaller size

With a 7% market share and a low base, GOLI is a fast-growing lubricant player. The company was able to deliver on its target of achieving 2-3x industry growth with 6%/10% volume growth in FY15/16 against 0%/-2% growth by market leader Castrol in CY14/15. In Q1FY17, GOLI recorded a stellar volume growth of 32% yoy, aided by an institutional government tender of 2.4mn litres. Despite this, volumes grew by 17% yoy against 6% growth recorded by Castrol during the same quarter. Due to its smaller size and aggressive strategies, GOLI is growing strongly in the automotive category with 20%+ yoy growth in Q1FY17; periodic tender-based volume jumps and further inroads into categories like marine oils have led to double-digit volume growth in B2B (automotive factory fill + industrial) category since the last three quarters. In PM also, GOLI's volume share rose from 13% to 23-25% in the last 7-8 years. We believe that as the lubricants sector goes through the volume recovery phase, GOLI would outperform larger peers with higher growth rates. Its new markets include LCVs, rural, and agri sectors.

Strong focus on bazaar trade with promotion campaigns to improve brand positioning

GOLI is aggressive in the bazaar trade with focus on all categories, namely product launches and makeovers, advertising and below-the-line activities. A&P spends as a percentage of sales have increased from less than 5.8% in FY15 to 6.7% in FY16/17 with 50% of this spent below-the-line. It has MS Dhoni as a brand ambassador since CY11, unleashing an intense media campaign. The company is actively engaging with OEMs like Mahindra/Swaraj, which has supported tractor oil sales. GOLI has strong OEM tie up with sister company Ashok Leyland in CVO/DEO category, which provides factory fill opportunities. It has an 8% market share in B2C CVO and 40% volume share. In MCO, it has a healthy 9% market share and 18% volume share. In PCMO, market share is low at 5% though it is a key target area and in Q1FY17, it recorded a 20% yoy growth while CVO/MCO volumes were also up 11%/15%. 35% of GOLI's volume is B2B of which 15% is pure industrial. GOLI has progressed into shipping sector adding customers. GOLI is investing Rs 1.5bn in a new 50mn litre plant in Chennai, which is expected to be completed by CY17 end and (1) lower freight cost on 30% of volumes sold in the southern market by Rs 3-4/litre and (2) improve its standing (pricing, volumes, customer service) in the southern market.

Estimate 22-25% earnings CAGR on volume growth of 12%

We expect GOLI to record a volume CAGR of 12% and EBITDA/litre CAGR of 8% and estimate EBITDA and PAT to grow at a 22% and 25% CAGR respectively during FY16-18. We estimate ROEs to remain stable at near 40% while EBITDA margin would be steady at 16-17%. We estimate a stable FCF yield of ~2% assuming Chennai capex, full benefit of which would percolate only in FY19. The company has already become net cash positive in FY16 end. Dividend payout has been 35% in FY16.

Initiate coverage with a Buy rating and target price of Rs 950

We value GOLI at 30x our FY18 EPS of Rs 31.7, which is at a 10% discount to Castrol due to lower return ratio of ~40% and margins; however, its growth would outperform significantly. We initiate coverage on GOLI with a target price of Rs 950, which provides 35% upside. Recommend Buy.

BUY

CMP RS 705

TARGET RS 950 (+35%)

COMPANY DATA

O/S SHARES (MN) :	50
MARKET CAP (RSBN) :	35
MARKET CAP (USDBN) :	0.5
52 - WK HI/LO (RS) :	760 / 452
LIQUIDITY 3M (USDMN) :	0.2
PAR VALUE (RS) :	2

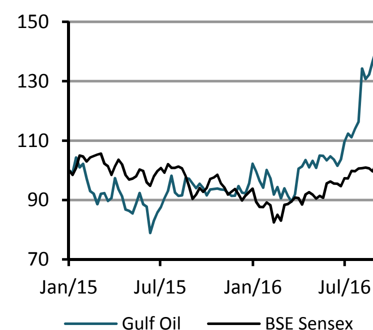
SHARE HOLDING PATTERN, %

	Jun 16	Mar 16	Dec 15
PROMOTERS :	68.7	64.9	64.9
FII / NRI :	5.9	10.7	10.1
FI / MF :	12.0	11.8	12.1
NON PRO :	2.7	0.7	0.6
PUBLIC & OTHERS :	10.9	11.9	12.3

PRICE PERFORMANCE, %

	1MTH	3MTH	1YR
ABS	2.6	33.7	42.2
REL TO BSE	0.6	26.2	33.0

PRICE VS. SENSEX



Source: Phillip Capital India Research

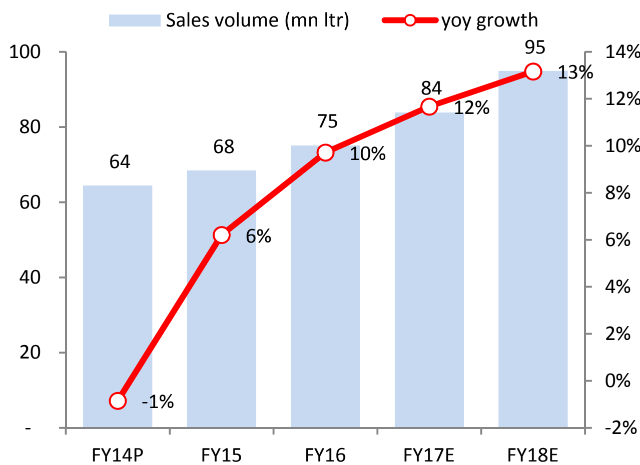
KEY FINANCIALS

Rs mn	FY16	FY17E	FY18E
Net Sales	10,114	11,503	13,517
EBIDTA	1,592	1,887	2,363
Net Profit	1,003	1,243	1,569
EPS, Rs	20.2	25.1	31.7
PER, x	34.8	28.1	22.3
EV/EBIDTA, x	21.7	18.3	14.5
P/BV, x	14.1	10.9	8.5
ROE, %	40.4	38.8	38.1

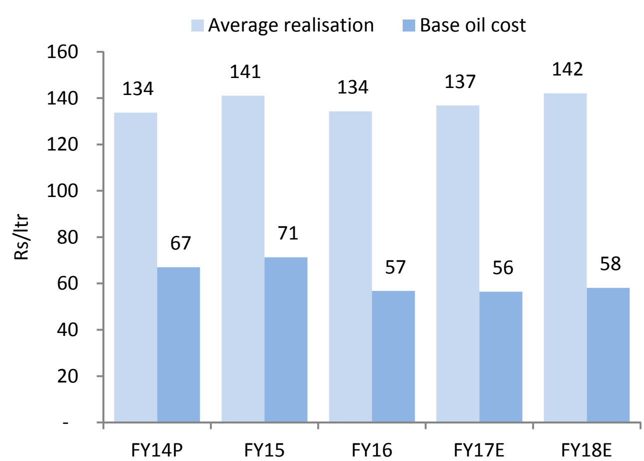
Source: PhillipCapital India Research Est.

Key parameters

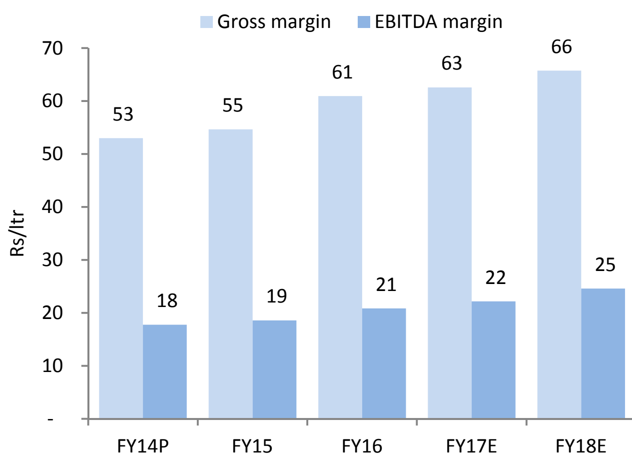
Volume and growth



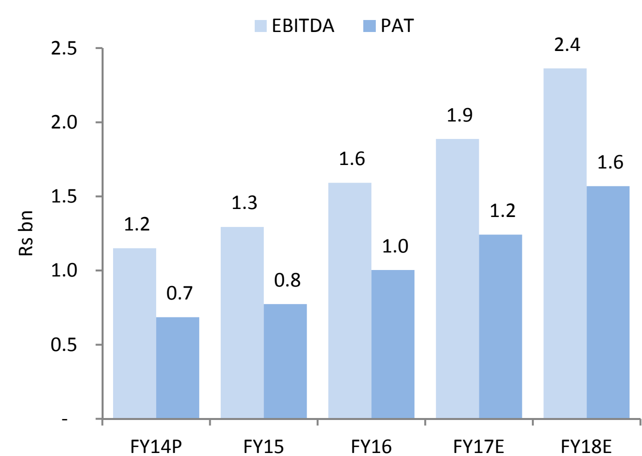
Realisation and base oil cost (calculated)



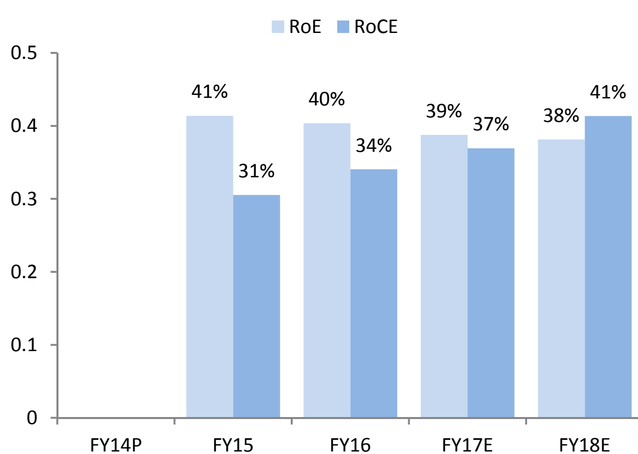
Gross and EBITDA margin



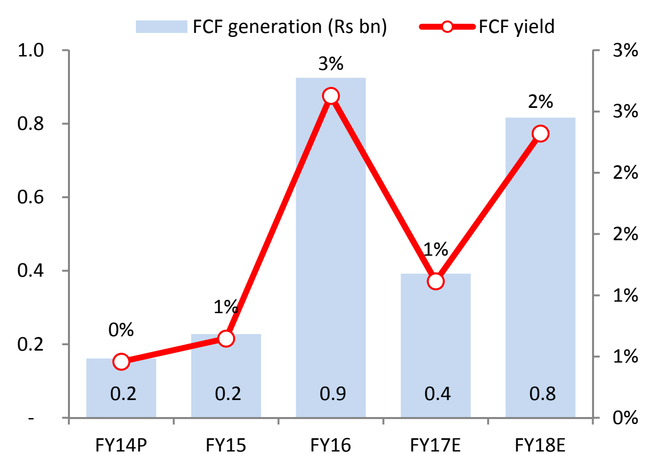
Earnings



Return ratios



FCF and yield



Source: Company, PhillipCapital India Research, P are provisional numbers not officially reported by Co.

Financials & valuation

Y/E, March 31	FY14P	FY15	FY16	FY17E	FY18E
Revenues (Rs.mn)	8,625	9,675	10,114	11,503	13,517
EBITDA (Rs.mn)	1,150	1,294	1,592	1,887	2,363
Reported PAT (Rs.mn)	685	774	1,003	1,243	1,569
Adjusted PAT (Rs.mn)	685	774	1,003	1,243	1,569
Growth			30%	24%	26%
Reported EPS (Rs.)	13.8	15.6	20.2	25.1	31.7
Adjusted EPS (Rs.)	13.8	15.6	20.2	25.1	31.7
Adjusted PE (x)	51.1	45.2	34.8	28.1	22.3
PB (x)	-	18.7	14.1	10.9	8.5
EV/EBITDA (x)	30.0	27.3	21.7	18.3	14.5
RoE	-	41%	40%	39%	38%
RoCE	-	31%	34%	37%	41%
Debt:Equity (x)	-	1.2	0.8	0.5	0.3
EBITDA/litre (Rs.)	17.8	18.9	21.2	22.5	24.9
Sales Volume (mn.litre)	64	68	75	84	95
Growth		6%	10%	12%	13%

Source: Company, PhillipCapital India Research

Valuation

Rs./sh	FY14P	FY15	FY16	FY17E	FY18E
GOLI's Adjusted EPS	13.8	15.6	20.2	25.1	31.7
Target Multiple (x)					30.0
Target Price					950

Source: PhillipCapital India Research

Please note FY14 numbers of GOLI are provisionally reported as company was officially demerged effective FY15 with reported FY14 numbers largely correct

Company description

Gulf Oil Lubricants India Ltd is 68.7% owned by Gulf Oil International, which is a Hinduja group company. The brand Gulf was acquired from Chevron in 1980 and the parent company has rights in all countries except Portugal, Spain, and USA. Gulf has been present in India since 1920. Previously, the lubricant business was part of Gulf Oil Corporation. It was demerged as a pure play lubricant company in CY15 with separate financial statements available from FY15.

GOLI operates in the segments of automotive and industrial lubricants and its product line include engine oils and other associated items like gear oils, transmission fluids, brake fluids, and fork oil under automotive and hydraulic oils, compressor oils, cutting oils, and rust preventives under the industrial category, which includes marine oils. It has a blending plant in Silvassa (90mn litre capacity) and a second one is under construction in Chennai with a capacity of 50mn litres, capex of Rs 1.5bn, and commissioning by CY17 end.

GOLI also has minor battery business where it markets imported 2W batteries; this contributed ~Rs 200mn in revenues in FY16. The company board comprises of Mr Ravi Chawla, MD, and Mr Sanjay Hinduja Chairman with three independent directors and a non-independent non-executive director. Mr Manish Gangwal is the CFO. The company reported revenues of Rs 10bn and PAT of Rs 1bn in FY16. Current market cap stands at Rs 35bn.

Financials

Consolidated Income Statement

Y/E Mar, Rs mn	FY15	FY16	FY17e	FY18e
Net sales	**9,675**	**10,114**	**11,503**	**13,517**
Growth, %		4.5	13.7	17.5
Total income	9,675	10,114	11,503	13,517
Raw material expenses	-5,911	-5,509	-6,226	-7,249
Employee expenses	-440	-574	-652	-715
Other Operating expenses	-2,030	-2,438	-2,739	-3,191
EBITDA (Core)	**1,294**	**1,592**	**1,887**	**2,363**
Growth, %		23.0	18.6	25.2
Margin, %	13.4	15.7	16.4	17.5
Depreciation	-48	-60	-67	-69
EBIT	**1,246**	**1,531**	**1,820**	**2,294**
Growth, %		22.9	18.8	26.1
Margin, %	12.9	15.1	15.8	17.0
Interest paid	-178	-178	-125	-74
Other Non-Operating Income	92	179	185	157
Pre-tax profit	**1,160**	**1,533**	**1,880**	**2,377**
Tax provided	-386	-529	-637	-808
Profit after tax	**774**	**1,003**	**1,243**	**1,569**
Net Profit	**774**	**1,003**	**1,243**	**1,569**
Growth, %		29.6	23.9	26.3
Net Profit (adjusted)	**774**	**1,003**	**1,243**	**1,569**
Unadj. shares (m)	50	50	50	50
Wtd avg shares (m)	50	50	50	50

Balance Sheet

Y/E Mar, Rs mn	FY15	FY16	FY17e	FY18e
Cash & bank	1,804	2,351	2,002	1,922
Debtors	1,141	1,064	1,211	1,423
Inventory	1,416	1,569	1,784	2,097
Loans & advances	256	360	409	481
Other current assets	16	22	25	30
Total current assets	4,634	5,366	5,431	5,952
Investments	35	32	0	0
Gross fixed assets	1,237	1,469	1,524	1,550
Less: Depreciation	-345	-400	-467	-536
Add: Capital WIP	84	19	684	1,185
Net fixed assets	976	1,088	1,741	2,199
Non-current assets	1,011	1,120	1,741	2,199
Total assets	**5,645**	**6,486**	**7,172**	**8,151**
Current liabilities	1,334	1,702	1,921	2,228
Provisions	253	313	353	407
Total current liabilities	1,586	2,015	2,273	2,635
Non-current liabilities	2,188	1,985	1,693	1,400
Total liabilities	3,774	4,001	3,966	4,035
Paid-up capital	99	99	99	99
Reserves & surplus	1,772	2,386	3,107	4,017
Shareholders' equity	1,871	2,485	3,206	4,116
Total equity & liabilities	**5,645**	**6,486**	**7,172**	**8,151**

Source: Company, PhillipCapital India Research Estimates

Cash Flow

Y/E Mar, Rs mn	FY15	FY16	FY17e	FY18e
Pre-tax profit	1,160	1,533	1,880	2,377
Depreciation	48	60	67	69
Chg in working capital	340	21	-156	-239
Total tax paid	-338	-497	-630	-801
Other operating activities	103	62	-60	-84
Cash flow from operating activities	**1,314**	**1,178**	**1,101**	**1,323**
Capital expenditure	-353	-183	-720	-528
Chg in investments	-26	-5	32	0
Other investing activities	93	156	185	157
Cash flow from investing activities	**-286**	**-33**	**-502**	**-370**
Free cash flow	1,028	1,146	598	953
Debt raised/(repaid)	450	-227	-300	-300
Dividend (incl. tax)	326	-373	-647	-733
Cash flow from financing activities	**776**	**-599**	**-947**	**-1,032**
Net chg in cash	1,804	546	-349	-80

Valuation Ratios

	FY15	FY16	FY17e	FY18e
Per Share data				
EPS (INR)	15.6	20.2	25.1	31.7
Growth, %		29.6	23.9	26.3
Book NAV/share (INR)	37.7	50.1	64.7	83.0
FDEPS (INR)	15.6	20.2	25.1	31.7
CEPS (INR)	16.6	21.5	26.4	33.0
CFPS (INR)	4.6	18.7	7.9	16.5
DPS (INR)	5.5	7.0	8.8	11.1
Return ratios				
Return on assets (%)	19.0	22.3	25.2	28.3
Return on equity (%)	41.4	40.4	38.8	38.1
Return on capital employed (%)	30.5	34.1	36.9	41.3
Turnover ratios				
Asset turnover (x)	2.4	2.2	2.3	2.4
Sales/Total assets (x)	2.4	2.2	2.3	2.4
Sales/Net FA (x)	9.9	9.3	6.6	6.1
Working capital/Sales (x)	0.3	0.3	0.3	0.2
Receivable days	43.1	38.4	38.4	38.4
Inventory days	53.4	56.6	56.6	56.6
Payable days	42.1	56.1	56.1	56.1
Working capital days	54.3	38.9	38.9	38.9
Liquidity ratios				
Current ratio (x)	2.9	2.7	2.4	2.2
Quick ratio (x)	1.9	1.7	1.4	1.3
Interest cover (x)	7.0	8.6	14.5	31.1
Dividend cover (x)	2.8	2.9	2.9	2.9
Total debt/Equity (%)	1.2	0.8	0.5	0.3
Net debt/Equity (%)	0.2	(0.2)	(0.1)	(0.1)
Valuation				
PER (x)	45.2	34.8	28.1	22.3
PEG (x) - y-o-y growth	347.1	117.7	117.9	84.8
Price/Book (x)	18.7	14.1	10.9	8.5
Yield (%)	0.8	1.0	1.2	1.6
EV/Net sales (x)	3.6	3.4	3.0	2.5
EV/EBITDA (x)	27.3	21.7	18.3	14.5
EV/EBIT (x)	28.3	22.6	19.0	15.0

Rating Methodology

We rate stock on absolute return basis. Our target price for the stocks has an investment horizon of one year.

Rating	Criteria	Definition
BUY	>= +15%	Target price is equal to or more than 15% of current market price
NEUTRAL	-15% > to < +15%	Target price is less than +15% but more than -15%
SELL	<= -15%	Target price is less than or equal to -15%.

Management

Vineet Bhatnagar (Managing Director) (91 22) 2483 1919
Kinshuk Bharti Tiwari (Head – Institutional Equity) (91 22) 6667 9946
Jignesh Shah (Head – Equity Derivatives) (91 22) 6667 9735

Research

Automobiles
Dhawal Doshi (9122) 6667 9769
Nitesh Sharma, CFA (9122) 6667 9965

Banking, NBFCs
Manish Agarwalla (9122) 6667 9962
Pradeep Agrawal (9122) 6667 9953
Paresh Jain (9122) 6667 9948

Consumer & Retail
Naveen Kulkarni, CFA, FRM (9122) 6667 9947
Jubil Jain (9122) 6667 9766
Preeyam Tolia (9122) 6667 9950

Cement
Vaibhav Agarwal (9122) 6667 9967

Economics
Anjali Verma (9122) 6667 9969

Engineering, Capital Goods
Jonas Bhutta (9122) 6667 9759
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