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ONGC-HPCL: A related-party transfusion

The merger boosted govt coffers but ended the upstream oil major's debt-free status

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A day before the Union budget for 2018-19 was to be presented, the state-owned Oil and Natural Gas Corporation (ONGC) completed the takeover of Hindustan Petroleum Corporation (HPCL) by buying out the central government's 51.1 per cent stake in the company. In one stroke, ₹369.15 billion was added into the government kitty for 2017-18, almost ₹14 billion more than what the government added in the whole of 2016-17 through the sale of minority stakes in more than a dozen companies.

The strategic sale of HPCL to another state entity enabled the government to avoid all the potential political controversies that surround privatisation of public sector undertakings (PSU). This safe playing almost resembles the bail-out of Gujarat State Petroleum Corporation when ONGC bought the Gujarat government company's Deendayal Upadhaya block for ₹77.38 billion, circumventing the need for an open bid through which private companies, too, could have participated.

In the case of HPCL, the intra-promoter sell-off also means avoiding legislative changes, since the company was formed through nationalisation of private companies over time through an Act of Parliament. For a government struggling on the fiscal front, there was nothing easier than exiting a company completely and handing over its reigns to ONGC, the biggest state-owned company in the same sector, and the largest PSU by market capitalisation after Coal India.

But the deal has consequences for ONGC, too. Six months after the Union government's in-principle approval of the sale, the ONGC board on January 19, 2018, decided to make a cash purchase of ₹473.97 per share with a total acquisition cost of ₹369.15 billion. This deal added a ₹249.91 billion loan on the books of ONGC which was, till then, a debt-free company on a standalone basis. Moreover, the remaining portion of the pay-out to the government came from the company's own resources, nearly wiping out its surplus. ONGC had cash reserves of ₹130.13 billion as on March 31, 2017, and it gave ₹119.24 billion to the government from these reserves.

How significant is this? "The company has the ability to raise money in future, so taking a loan along with almost using its entire surplus should not be a major concern going forward. ONGC can liquidate loan by selling its crossholding in other companies at a later date," says A K Srinivasan, former director (finance) at ONGC. Srinivasan was with the company when the government approved the sale in July 2017 and was involved in the structuring of the deal till he retired in October 2017.

THE DEAL

Cost of acquiring 51.11% in HPCL ₹369 billion

OPTION THAT ONGC EXERCISED

Loan	Reserves
₹250 billion	₹119 billion

OPTION ONGC COULD HAVE EXERCISED*

	ONGC holding (%)	Estimated value (₹ billion)
GAIL	4.86	40
IndianOil	13.77	280

*ONGC can sell part of its holding to retire debt

Source: BSE

ONGC could have funded the deal by selling its 13.77 per cent stake in Indian Oil Corporation and 4.86 per cent stake in GAIL India. Selling its Indian Oil stake could have fetched ONGC around ₹280 billion and GAIL could have given another ₹40 billion, obviating the need to raise debt. The company, however, tied up with State Bank of India, Punjab National Bank, Axis Bank, Bank of India, HDFC Bank, EXIM Bank and ICICI for loans.

Why did it opt for this route? Principally on account of market realities. "The market's capacity to absorb ₹250-270 billion worth of Indian Oil stock currently held by ONGC is limited. Unless

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the Life Insurance Corporation pitches in to buy shares, the sudden increase in float could create issues," an analyst pointed out. Nonetheless, even if ONGC retires some of its loan later by partly selling stakes in these two company, the fact remains that it had no other funding option.

Being a government company helped it get an exemption from the Securities and Exchange Board of India not just for an open offer to minority shareholders of HPCL, but also the applicability of Regulation 23 of the Listing Obligations and Disclosure Requirements that deals with related-party transaction. Besides, the Ministry of Corporate Affairs also pitched in by exempting the central PSUs in the oil and gas sector from Sections 5 and 6 of the Competition Act 2002 on 22 November 2017 for five years. These provisions are meant to promote competition by regulating "combinations" formed because of acquisitions, mergers or amalgamation.

The HPCL acquisition is far from being a millstone for ONGC. Indeed, it will de-risk the hydrocarbon producer's portfolio by providing a firm foothold in the downstream sector at a time when petroleum consumption is expected to slow, mainly because of the increased focus on electrification.

HPCL is the country's second-largest petroleum retailer. Since ONGC has another refining subsidiary, Mangalore Refinery and Petrochemicals Ltd (MRPL), the group is the third largest oil refiner after Indian Oil Corporation and Reliance Industries. "The acquisition of HPCL is likely to increase ONGC's market share by 18.5 per cent in the domestic space for downstream petroleum products. It could also aid in reducing the volatility in ONGC's cash flows to a certain extent, as a decline in the upstream margins of ONGC could be offset by an increase in refining margins of HPCL in the event of weakening crude prices and vice versa," says India Ratings in a recent report.

Finance Minister Arun Jaitley, in his Budget speech of 2017, set the tone for such realignment of public sector companies. "By these methods, the CPSEs [Central Public Sector Enterprises] can be integrated across the value chain of an industry. It will give them capacity to bear higher risks, avail economies of scale, take higher investment decisions and create more value for the stakeholders. Possibilities of such restructuring are visible in the oil and gas sector."

As a first step towards that he proposed to create an integrated public sector "oil major" that could match the performance of international and domestic private sector oil and gas companies.

Many combinations were discussed thereafter but what eventually materialised was the ONGC takeover of HPCL, and not the envisaged mega-entity. It, therefore, appears that the finance minister merely threw up an idea last year that was obviously easier said than implemented. In its current form, this vision has translated into a disinvestment exercise in which a public sector undertaking ended up with a debt to meet the government's fiscal needs.