# Oil & Natural Gas

ONGC IN

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India
Energy/Oil, Gas & Coal

Change in Recommendation
2 February 2009

SO WHAT? THE BNP PARIBAS ANGLE — INDUSTRY OUTLOOK: ←→

- Valuing ONGC's domestic business at a 20% discount to global peers.
- Downgrading to HOLD on lack of positive catalyst.
- A pure play E&P company with limited growth prospects.

**Net Profit 09** ........ **INR187b**
.......................... (From INR168b)

**Diff from Consensus** **(17.6%)**
Consensus (mean) .........INR227b
Consensus (momentum) .......... ↓

**Target Price** ..... **INR710.00**
........................(From INR821.00)

**Diff from Consensus** **(22.4%)**
Consensus (median)... INR915.00
Consensus (momentum)........... ↓

**Current Price** .... **INR654.95**
Upside/(Downside)............... 8.4%

**HOLD**
(From Buy)

**Recs in the Market**
Positive....................................20
Neutral.......................................2
Negative ....................................4
Consensus (momentum) .......... ↓

Sources: Thomson One Analytics; Bloomberg; BNP Paribas estimates

- **Downgrade to a HOLD on continued subsidy impact and lack of positive catalysts, TP revised from 821/sh to INR710/sh.**
- **Remains a defensive pick, cash will provide cushion and also assist in possible acquisitions.**
- **SoTP based TP of INR710/sh (Standalone: INR549/sh, OVL:INR123/sh, MRPL:INR17/sh, Investments: INR21/sh).**

## Not a lot to gain, downgrade to HOLD

### ONGC hit by Subsidies for the second time in a row

Oil and Natural Gas Corporation (ONGC) reported its 3QFY09 earnings which were hit by an unexpectedly high subsidy burden. Net realization for the quarter was USD33.99/bbl after giving a discount of USD25.03/bbl. We were expecting net realization of USD47.37/bbl. The higher than expected subsidy burden is for a quarter in which crude prices average USD56/bbl and the resultant losses expected to be minimum at the OMCs. ONGC's Chairman made a statement saying that the government has assured ONGC that there won't be any subsidies for 4QFY09. But this seems to be too early to comment, especially in light of the recent fuel price cuts.

### Loses its crude hedge, Just a pure-play E&P company

At current oil prices and the presence of low subsidies, ONGC loses its crude hedge that it enjoyed when oil prices were high and was expected to pull back. At current oil prices, ONGC becomes a pure play E&P company with small refining exposure. View this with a constant government overhang, and flat-to declining production with no meaningful discoveries coming online, there is very little room for upside in the shares of ONGC. In addition, ONGC's ability to maintain the Mumbai High production levels through use of EOR techniques is also raising the cost per barrel (We estimate costs at ~USD24/bbl). In addition, low oil prices make it commercially unviable for ONGC to produce from its marginal fields, which were under production in FY08.

### Downgrade to HOLD on lack of catalysts + subsidies

We are downgrading ONGC from a BUY to a HOLD. Since our initiation, ONGC's shares have outperformed the market by 11% and it continues to be a defensive stock. We are revising our TP from INR821/sh to INR710/sh, on lower than expected reserves at ONGC Videsh (OVL) and higher-than-expected capital expenditure. We value the standalone business at 3.5x EV/EBITDA; currently global mature E&P companies trade at 4.5x EV/EBITDA. We believe the discount is warranted due to subsidy burden and nominal exploration track record. The cash of USD4.8b does provide a strong cushion to the company and might assist in M&A activities. We are valuing OVL at an EV/bbl of USD7.0, previous down cycle range for E&P companies is USD5-USD8/bbl.

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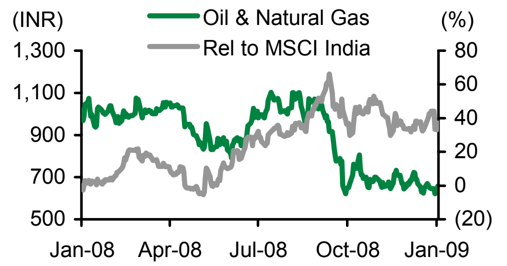
**Earnings Estimates And Valuation Ratios**

| YE Mar (INR m) | 2008 | 2009E | 2010E | 2011E |
|---|---|---|---|---|
| Revenue | 967,822 | 1,049,438 | 903,221 | 963,524 |
| Reported net profit | 198,723 | 187,405 | 175,094 | 177,112 |
| Recurring net profit | 199,653 | 186,971 | 175,094 | 177,112 |
| Previous rec net profit | 199,653 | 168,226 | 149,916 | 175,396 |
| Chg from previous (%) | — | 11.1 | 16.8 | 1.0 |
| Recurring EPS (INR) | 93.34 | 87.42 | 81.86 | 82.81 |
| Prev rec EPS (INR) | 93.34 | 78.65 | 70.09 | 82.00 |
| Rec EPS growth (%) | 7.5 | (6.4) | (6.4) | 1.2 |
| Recurring P/E (x) | 7.0 | 7.5 | 8.0 | 7.9 |
| Dividend yield (%) | 5.7 | 5.7 | 5.7 | 5.7 |
| EV/EBITDA (x) | 2.9 | 2.9 | 3.0 | 2.8 |
| Price/book (x) | 1.8 | 1.6 | 1.4 | 1.3 |
| ROE (%) | 27.6 | 22.4 | 18.7 | 17.1 |
| Net debt/equity (%) | (30.4) | (22.7) | (27.5) | (29.4) |

Sources: Oil & Natural Gas; BNP Paribas estimates

**Share Price Daily vs MSCI**




| | |
|---|---|
| Next results/event | April 2009 |
| Market cap (USD m) | 27,930 |
| 12m avg daily turnover (USD m) | 48.8 |
| Free float (%) | 10 |
| Major shareholder | President of India (74%) |
| 12m high/low (TWD) | 1,105.40/611.80 |
| ADR (USD) | Nil |
| Avg daily turnover (USD m) | Nil |
| Discount/premium (%) | Nil |
| Disc/premium vs 52-wk avg (%) | Nil |

Source: Datastream

## FY10 estimates in-line with guidance

ONGC has submitted its revenue guidance for FY10 to the Petroleum Ministry. For its FY10 estimates, ONGC has assumed crude price of USD40/bbl and we believe no subsidy assumption has gone into these calculations. Our FY10 crude price house estimate is USD59.0/bbl and we assume subsidy burden of ~USD11.3/bbl, giving us a net realization of ~USD47.7/bbl.

Based on this, we estimate FY10 Standalone crude sales to be ~INR383b – 10.7% higher than the company guidance of INR346b. Our estimate is higher mainly due to our assumption of higher net realization. For FY10 Standalone natural gas sales - our estimate of INR83b is 4% higher than company guidance of INR80b.

### Limited upside despite assuming no subsidies for FY10

Based on our sensitivity analysis, we see limited upside to ONGC's FY10 EPS and our SoTP-based TP even in a scenario where crude prices average USD55/bbl and ONGC does not have any subsidy burden. Assuming this scenario, which we believe is unlikely; our TP goes up by 6.8%, while our FY10E EPS shows an upside of 10.2%.

**Exhibit 1: TP And FY10E EPS Sensitivity To Different Subsidy Levels**

| | Base case | | | | |
|---|---|---|---|---|---|
| **Gross realisation (USD/bbl)** | **59.0** | **40.0** | **45.0** | **50.0** | **55.0** |
| **Subsidy burden (USD/bbl)** | **11.3** | **—** | **—** | **—** | **—** |
| **Net realisation (USD/bbl)** | **47.7** | **40.0** | **45.0** | **50.0** | **55.0** |
| | | | | | |
| Target price (INR/sh) | 710 | 660 | 693 | 726 | 758 |
| FY10 EPS (INR/sh) | 81.86 | 64.76 | 73.25 | 81.74 | 90.23 |
| | | | | | |
| Change in base case TP (%) | — | *(7.1)* | *(2.5)* | *2.2* | *6.8* |
| Change in base case FY10 EPS (%) | — | *(20.9)* | *(10.5)* | *(0.1)* | *10.2* |

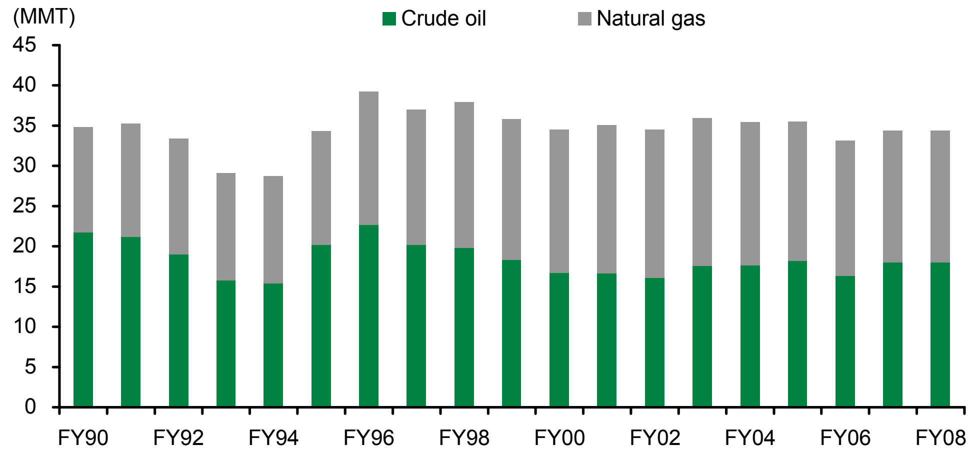
Source: BNP Paribas estimates

## Production growth from Mumbai High seems unlikely

The Mumbai High field, which contributed more than 64% to ONGC's domestic crude production for FY08, has shown flat production trend in the last decade (Exhibit 2). The Mumbai High field is an old field which started production in 1976. According to original estimates, the field was expected to get exhausted by 2010-11; but implementation of an extensive Field Redevelopment Project by ONGC is now expected to extend the field life till 2030. The first phase of the plan was launched in October 2000 and completed in December 2006 and is likely to result in incremental gain of 23.25MMT of crude oil and 6.10BCM of gas by 2030. On January 28, 2009, ONGC's Board has approved the second phase of Mumbai High Redevelopment Project and this phase is scheduled to be completed by September 2012 at a cost of USD1.45b. This phase is expected to yield incremental production of 17.35MMT of crude oil and 2.99BCM of gas by 2030. While a positive, it is not meaningful when viewed in light of the life of the field.

This project also means much higher production cost for ONGC as the company will be applying Enhanced Oil Recovery techniques which result in substantially higher costs. We estimate that the production costs at Mumbai High are around USD24/bbl, which in our view is hurting ONGC's profitability considering the current level of crude prices. Secondly, as the Mumbai High field is on a decline, the implementation of this Field Redevelopment project is not expected to lead to production growth but only arrest the decline. With ONGC 's largest field maturing and tapping smaller fields becoming unviable due to the sharp decline in the crude prices, we expect ONGC's overall domestic production to be flat or slightly declining till FY12.

**Exhibit 2: Mumbai High Production Levels (1990-2008)**




Sources: Ministry of Petroleum and Natural Gas; CMIE; BNP Paribas

## Reduction in TP – Mainly driven by OVL

We have revised our TP for ONGC to INR710/sh from INR821/sh, based on SOTP (Refer to Exhibit 3 for revised SoTP). The majority of the TP decline comes from the lower value we are assigning to OVL reserves. We are valuing OVL reserves at USD7/bbl, which is at the high end of the USD5/bbl-USD8/bbl range for E&P companies in the previous downturns. In addition, we are also seeing a decline in OVL's proven reserves since FY06 due to insufficient proven reserves additions (Exhibit 4). As a result, despite adding Imperial Energy's proven reserves, the overall OVL proven reserves base shows a decline from FY07-end reserves.

For ONGC's standalone business, we maintain our EV/EBITDA of 3.5x on standalone's business FY10 EBITDA. Currently global mature E&P companies trade at 4.5x EV/EBITDA, but we believe the discount is warranted due to ONGC's subsidy burden and nominal exploration track record. Our valuation of ONGC's standalone business changes only slightly as the negative impact of our change in FY10 crude price assumptions (from USD76.5 to USD59.0) is offset by our lower-than-previous FY10 subsidy assumptions. Our DCF-based valuation for MRPL declines to INR17/share from INR25/share, to account for the sharp decline in GRMs that simple refiners such as MRPL are facing.

**Exhibit 3: SoTP Valuation For ONGC**

| (INR/share) | Previous | Revised | Valuation methodology |
|---|---|---|---|
| ONGC Standalone | 526 | 549 | 3.5x EV/EBITDA on FY10E Standalone EBITDA |
| ONGC Videsh | 246 | 123 | EV/bbl of USD 7.0/bbl |
| MRPL | 25 | 17 | DCF-based |
| Other investments | 24 | 21 | Based on market prices |
| **Target price** | **821** | **710** | |

Source: BNP Paribas estimates

**Exhibit 4: ONGC Videsh Proven Reserves Trend**

| | FY05 | FY06 | FY07 | FY08 |
|---|---|---|---|---|
| **OVL reserves** | | | | |
| Crude oil (mmboe) | 607 | 680 | 702 | 555 |
| Gas (mmboe) | 724 | 713 | 622 | 528 |
| | | | | |
| **Imperial energy reserves** | | | | |
| Crude oil (mmboe) | | | | 146 |
| Gas (mmboe) | | | | 29 |
| | | | | |
| **Total (OVL+Imperial)** | | | | |
| Crude oil (mmboe) | 607 | 680 | 702 | 701 |
| Gas (mmboe) | 724 | 713 | 622 | 557 |
| **Total (mmboe)** | **1,331** | **1,393** | **1,324** | **1,258** |

Sources: ONGC Videsh; Imperial Energy PLC; BNP Paribas

FINANCIAL STATEMENTS

## Oil & Natural Gas

| Profit and Loss (INR m) Year Ending March | 2007A | 2008A | 2009E | 2010E | 2011E |
|---|---|---|---|---|---|
| Revenue | 822,615 | 967,822 | 1,049,438 | 903,221 | 963,524 |
| Cost of sales ex depreciation | (382,677) | (470,843) | (534,182) | (415,078) | (456,324) |
| **Gross profit ex depreciation** | 439,938 | 496,979 | 515,257 | 488,144 | 507,200 |
| Other operating income | - | - | - | - | - |
| Operating costs | (83,230) | (91,219) | (97,727) | (101,828) | (107,023) |
| **Operating EBITDA** | **356,708** | **405,760** | **417,530** | **386,316** | **400,177** |
| Depreciation | (119,678) | (138,878) | (144,706) | (153,069) | (161,576) |
| Goodwill amortisation | - | - | - | - | - |
| **Operating EBIT** | **237,030** | **266,883** | **272,824** | **233,246** | **238,601** |
| Net financing costs | 48,446 | 43,258 | 32,419 | 32,963 | 35,282 |
| Associates | 102 | 21 | - | - | - |
| Recurring non operating income | - | - | - | - | - |
| Non recurring items | (8,004) | (930) | 434 | - | - |
| **Profit before tax** | **277,574** | **309,231** | **305,677** | **266,209** | **273,883** |
| Tax | (98,454) | (106,999) | (117,058) | (89,452) | (95,232) |
| **Profit after tax** | **179,120** | **202,232** | **188,619** | **176,757** | **178,650** |
| Minority interests | **(1,424)** | **(3,509)** | **(1,214)** | **(1,663)** | **(1,538)** |
| Preferred dividends | - | - | - | - | - |
| Other items | - | - | - | - | - |
| **Reported net profit** | **177,696** | **198,723** | **187,405** | **175,094** | **177,112** |
| Non recurring items & goodwill (net) | **8,004** | **930** | **(434)** | **(0)** | **(0)** |
| **Recurring net profit** | **185,700** | **199,653** | **186,971** | **175,094** | **177,112** |
| ***Per share (INR)*** | | | | | |
| Recurring EPS * | 86.82 | 93.34 | 87.42 | 81.86 | 82.81 |
| Reported EPS | 83.08 | 92.91 | 87.62 | 81.86 | 82.81 |
| DPS | 35.85 | 37.62 | 37.44 | 37.44 | 37.44 |
| ***Growth*** | | | | | |
| Revenue (%) | 16.4 | 17.7 | 8.4 | (13.9) | 6.7 |
| Operating EBITDA (%) | 14.8 | 13.8 | 2.9 | (7.5) | 3.6 |
| Operating EBIT (%) | 11.3 | 12.6 | 2.2 | (14.5) | 2.3 |
| Recurring EPS (%) | 20.8 | 7.5 | (6.4) | (6.4) | 1.2 |
| Reported EPS (%) | 15.4 | 11.8 | (5.7) | (6.6) | 1.2 |
| ***Operating performance*** | | | | | |
| Gross margin inc depreciation (%) | 38.9 | 37.0 | 35.3 | 37.1 | 35.9 |
| Operating EBITDA margin (%) | 43.4 | 41.9 | 39.8 | 42.8 | 41.5 |
| Operating EBIT margin (%) | 28.8 | 27.6 | 26.0 | 25.8 | 24.8 |
| Net margin (%) | 22.6 | 20.6 | 17.8 | 19.4 | 18.4 |
| Effective tax rate (%) | 35.5 | 34.6 | 38.3 | 33.6 | 34.8 |
| Dividend payout on recurring profit (%) | 41.3 | 40.3 | 42.8 | 45.7 | 45.2 |
| Interest cover (x) | na | na | na | na | na |
| Inventory days | 51.6 | 51.1 | 51.0 | 62.4 | 53.9 |
| Debtor days | 20.5 | 22.4 | 25.2 | 27.8 | 24.6 |
| Creditor days | 65.2 | 68.7 | 65.9 | 77.9 | 68.0 |
| Operating ROIC (%) | 23.6 | 26.1 | 21.9 | 18.0 | 17.1 |
| Operating ROIC - WACC (%) | 7.2 | 9.7 | 5.5 | 1.5 | 0.7 |
| ROIC (%) | 21.5 | 23.5 | 19.9 | 16.5 | 15.8 |
| ROIC - WACC (%) | 5.1 | 7.1 | 3.5 | 0.1 | (0.6) |
| ROE (%) | 30.1 | 27.6 | 22.4 | 18.7 | 17.1 |
| ROA (%) | 15.3 | 14.8 | 11.8 | 9.5 | 9.0 |

** Pre exceptional, pre-goodwill and fully diluted*

| Key Assumptions (INR m) | 2007A | 2008A | 2009E | 2010E | 2011E |
|---|---|---|---|---|---|
| Crude price (USD/barrel) | 66.21 | 83.39 | 86.62 | 59.00 | 80.00 |
| Exchange Rate (INR/USD) | 45.25 | 40.26 | 46.04 | 47.25 | 43.75 |

Sources: Oil & Natural Gas; BNP Paribas estimates

Y-Y revenue decline due to lower crude price and slight decline in production

| Cash Flow (INR m) Year Ending March | 2007A | 2008A | 2009E | 2010E | 2011E |
|---|---|---|---|---|---|
| Recurring net profit | 185,700 | 199,653 | 186,971 | 175,094 | 177,112 |
| Depreciation | 119,678 | 138,878 | 144,706 | 153,069 | 161,576 |
| Associates & minorities | 1,526 | 3,530 | 1,214 | 1,663 | 1,538 |
| Other non-cash items | - | - | - | - | - |
| **Recurring cash flow** | **306,904** | **342,060** | **332,891** | **329,826** | **340,226** |
| Change in working capital | 83,415 | 9,032 | (20,617) | 18,763 | (928) |
| Capex - maintenance | - | - | - | - | - |
| Capex - new investment | (210,726) | (168,144) | (279,314) | (205,217) | (217,476) |
| **Free cash flow to equity** | **179,593** | **182,948** | **32,960** | **143,372** | **121,823** |
| Net acquisitions & disposals | - | - | - | - | - |
| Dividends paid | (76,688) | (78,218) | (80,076) | (80,076) | (80,076) |
| Non recurring cash flows | - | - | - | - | - |
| **Net cash flow** | **102,904** | **104,730** | **(47,116)** | **63,296** | **41,747** |
| Equity finance | - | - | - | - | - |
| Debt finance | (6,336) | (6,561) | 220,664 | (3,000) | (3,000) |
| **Movement in cash** | **96,568** | **98,170** | **173,548** | **60,296** | **38,747** |
| ***Per share (INR)*** | | | | | |
| Recurring cash flow per share | 143.49 | 159.93 | 155.64 | 154.21 | 159.07 |
| FCF to equity per share | 83.97 | 85.53 | 15.41 | 67.03 | 56.96 |

Strong capex plans

| Balance Sheet (INR m) Year Ending March | 2007A | 2008A | 2009E | 2010E | 2011E |
|---|---|---|---|---|---|
| Working capital assets | 181,649 | 224,787 | 240,582 | 215,071 | 226,353 |
| Working capital liabilities | (182,956) | (235,126) | (230,304) | (223,556) | (233,910) |
| **Net working capital** | **(1,307)** | **(10,339)** | **10,278** | **(8,485)** | **(7,557)** |
| Tangible fixed assets | 647,399 | 700,903 | 835,511 | 887,658 | 943,557 |
| **Operating invested capital** | **646,092** | **690,563** | **845,788** | **879,173** | **936,000** |
| Goodwill | 30,616 | 25,777 | 22,847 | 22,847 | 22,847 |
| Other intangible assets | - | - | - | - | - |
| Investments | 35,832 | 44,821 | 44,821 | 44,821 | 44,821 |
| Other assets | 5,141 | 6,739 | 6,739 | 6,739 | 6,739 |
| **Invested capital** | **717,681** | **767,901** | **920,196** | **953,580** | **1,010,407** |
| Cash & equivalents | (206,756) | (250,558) | (434,654) | (502,265) | (548,003) |
| Short term debt | 3,263 | 297 | 132 | 132 | 132 |
| Long term debt * | 12,742 | 9,148 | 229,976 | 226,976 | 223,976 |
| **Net debt** | **(190,751)** | **(241,114)** | **(204,546)** | **(275,157)** | **(323,895)** |
| Deferred tax | 81,119 | 87,376 | 93,345 | 98,997 | 104,450 |
| Other liabilities | 151,857 | 129,325 | 129,325 | 129,325 | 129,325 |
| Total equity | 667,136 | 780,866 | 889,409 | 986,090 | 1,084,664 |
| Minority interests | 8,321 | 11,448 | 12,662 | 14,325 | 15,863 |
| **Invested capital** | **717,681** | **767,901** | **920,195** | **953,580** | **1,010,407** |

** Includes convertibles and preferred stock which is being treated as debt*

| | | | | | |
|---|---|---|---|---|---|
| ***Per share (INR)*** | | | | | |
| Book value per share | 311.91 | 365.08 | 415.83 | 461.03 | 507.12 |
| Tangible book value per share | 297.60 | 353.03 | 405.15 | 450.35 | 496.44 |
| ***Financial strength*** | | | | | |
| Net debt/equity (%) | (28.2) | (30.4) | (22.7) | (27.5) | (29.4) |
| Net debt/total assets (%) | (17.2) | (19.2) | (12.9) | (16.4) | (18.1) |
| Current ratio (x) | 2.1 | 2.0 | 2.9 | 3.2 | 3.3 |
| CF interest cover (x) | na | na | na | na | na |

| Valuation | 2007A | 2008A | 2009E | 2010E | 2011E |
|---|---|---|---|---|---|
| Recurring P/E (x) * | 7.5 | 7.0 | 7.5 | 8.0 | 7.9 |
| Recurring P/E @ target price (x) * | 8.2 | 7.6 | 8.1 | 8.7 | 8.6 |
| Reported P/E (x) | 7.9 | 7.0 | 7.5 | 8.0 | 7.9 |
| Dividend yield (%) | 5.5 | 5.7 | 5.7 | 5.7 | 5.7 |
| P/CF (x) | 4.6 | 4.1 | 4.2 | 4.2 | 4.1 |
| P/FCF (x) | 7.8 | 7.7 | 42.5 | 9.8 | 11.5 |
| Price/book (x) | 2.1 | 1.8 | 1.6 | 1.4 | 1.3 |
| Price/tangible book (x) | 2.2 | 1.9 | 1.6 | 1.5 | 1.3 |
| EV/EBITDA (x) ** | 3.6 | 2.9 | 2.9 | 3.0 | 2.8 |
| EV/EBITDA @ target price (x) ** | 3.9 | 3.2 | 3.1 | 3.3 | 3.1 |
| EV/invested capital (x) | 1.7 | 1.5 | 1.3 | 1.2 | 1.1 |

** Pre exceptional, pre-goodwill and fully diluted*

*** EBITDA includes associate income and recurring non-operating income*

Sources: Oil and Natural Gas; BNP Paribas estimates

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### Recommendation structure

All share prices are as at market close on 30 January 2009 unless otherwise stated. Stock recommendations are based on absolute upside (downside), which we define as (target price* - current price) / current price. If the upside is 10% or more, the recommendation is BUY. If the downside is 10% or more, the recommendation is REDUCE. For stocks where the upside or downside is less than 10%, the recommendation is HOLD. In addition, we have key buy and key sell lists in each market, which are our most commercial and/or actionable BUY and REDUCE calls and are limited to at most five key buys and five key sells in each market at any point in time.

Unless otherwise specified, these recommendations are set with a 12-month horizon. Thus, it is possible that future price volatility may cause a temporary mismatch between upside/downside for a stock based on market price and the formal recommendation.

*In most cases, the target price will equal the analyst's assessment of the current fair value of the stock. However, if the analyst doesn't think the market will reassess the stock over the specified time horizon due to a lack of events or catalysts, then the target price may differ from fair value. In most cases, therefore, our recommendation is an assessment of the mismatch between current market price and our assessment of current fair value.