Company Flash

21 January 2008 | 6 pages

Oil & Natural Gas (ONGC.BO)

Buy: Weak 3Q as Subsidy Burden Increases

- **3Q below expectations** — ONGC's 3QFY08 net income of Rs43.7bn was down 6%yoy and 14%qoq and below our estimates, driven primarily by 1) lower net realizations on crude sales due to higher-than-expected increase in subsidy burden and 2) lower crude sales volume.
- **Realizations decline despite record crude** — Despite the steep rise in crude, ONGC's post-subsidy realization was down marginally to US$54.5/bbl (vs.US$55.9/bbl in 2Q) on own crude (excl. JV sales). This was primarily because subsidy discounts at Rs60.8bn (Rs37.9bn in 2Q) came in higher than expected though government stuck to the 1/3rd sharing formula. This coupled with a 2% qoq decline in crude sales volumes (temporary and likely to recover in 4Q) resulted in net sales for the company declining 3% during the quarter.
- **Production volumes improve marginally** — ONGC's crude production during the quarter was 7.1MMT (7.0MMT in 2QFY08). Gas production at 6.53bcm (6.35bcm) was up marginally on account of the ramp-up in PMT production.
- **No reason to cut earnings, valuations will come to the rescue** — Despite the 3Q disappointment that will weigh on the stocks, we see no reason to change FY08-09E earnings as net realization assumptions at ~54.0/bbl are in-line with FY08 YTD and could benefit indirectly from any policy decisions (small price hike, duty cuts). OVL's performance will also benefit fully from high crude prices. At PER of 9.5x and EV/EBITDA of 4.4x FY09E, the stock remains cheap. At our target price of Rs1400, the imputed EV/EBITDA is a reasonable 6.0x.

Buy/Low Risk	1L
Price (21 Jan 08)	Rs1,149.50
Target price	Rs1,400.00
Expected share price return	21.8%
Expected dividend yield	3.8%
Expected total return	**25.6%**
Market Cap	Rs2,458,634M US$62,704M

Price Performance (RIC: ONGC.BO, BB: ONGC IN)

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2006A	153,976	71.99	6.0	16.0	4.4	29.5	2.6
2007A	177,696	83.08	15.4	13.8	3.7	29.0	3.1
2008E	221,192	103.42	24.5	11.1	3.2	30.7	3.8
2009E	250,489	117.11	13.2	9.8	2.7	29.6	4.3
2010E	235,107	109.92	-6.1	10.5	2.4	24.1	3.9

Source: Powered by dataCentral

Rahul Singh[1]
+91-22-6631-9863
rahul.r.singh@citi.com

Saurabh Handa[1]
+91-22-6631-9858
saurabh.handa@citi.com

Garima Mishra[1]
garima.mishra@citi.com

See Appendix A-1 for Analyst Certification and important disclosures.

[1]Citigroup Global Markets India Private Limited

Key Highlights from 3QFY08

Figure 1. ONGC – 3QFY08 Results (Rupees in Millions)

Year to 31-Mar	3QFY07	2QFY08	3QFY08	%yoy	Comments
Net sales	**155,645**	**154,139**	**151,208**	**-3%**	Adversely affected by lower crude realizations
Inc/dec in stock	(514)	(872)	(293)	-43%	
Raw material cons	15,406	16,987	16,695	8%	
Staff cost	5,020	3,668	3,612	-28%	
Statutory levies	30,582	31,973	32,314	6%	
Other expenditure	16,058	18,230	18,562	16%	
Total Expenditure	**(66,553)**	**(69,986)**	**(70,891)**	**7%**	Relatively flat sequentially
EBITDA	89,093	84,153	80,318	-10%	
EBITDA Margin	*57.2%*	*54.6%*	*53.1%*		
Interest	(77)	(305)	(114)	49%	
Depreciation	(25,576)	(19,871)	(22,118)	-14%	Higher depletion and survey costs. Dry wells down qoq
Other income	7,045	12,100	8,630	22%	
Profit before tax	70,485	76,077	66,716	-5%	
Current tax	(23,802)	(25,102)	(23,051)	-3%	
Tax Rate	*33.8%*	*33.0%*	*34.6%*		Slightly higher tax rates qoq
Reported Net Profit	**46,683**	**50,975**	**43,665**	**-6%**	

Source: Company Reports and Citi Investment Research

Figure 2. ONGC – Key Operational Parameters

Year to 31-Mar	1QFY07	2QFY07	3QFY07	4QFY07	1QFY08	2QFY08	3QFY08	Comments
Crude production (MMT)	6.93	6.85	7.13	7.03	6.88	7.00	7.11	Improving production trend
Gas production (bcm)	6.42	5.70	6.44	6.35	6.10	6.35	6.53	
Crude sales (MMT)	6.11	5.96	6.23	6.11	5.90	6.13	5.99	Temporary decline due to lag effect; likely to smoothen in 4QFY08
Crude sales (Rs m)	97,220	98,060	109,710	79,600	94,260	105,650	101,660	Lower realizations + lower sales volumes +rupee appreciation
Bonny Light (US$/bbl)	71.4	71.6	62.1	60.4	71.8	78.0	91.2	Record international prices during the quarter
Subsidy discounts (US$/bbl)	26.4	26.2	11.3	24.8	21.6	22.1	36.7	Steep rise owing to higher subsidy sharing and also apportioned over lower sales volume
ONGC's net realisation ($/bbl)	45.0	45.4	50.9	35.6	50.2	55.9	54.5	Down marginally despite Bonny Light going up by US$13/bbl
Gas sales (bcm)	5.31	4.58	5.24	5.17	5.03	5.19	5.32	Marginal increase on account of PMT
Gas sales (Rs m)	18,730	16,630	18,970	18,710	17,940	18,330	19,170	
Gas realisation (Rs/tcm)	3,527	3,631	3,620	3,619	3,567	3,532	3,603	Small increase due to higher PMT realizations

Source: Company Reports and Citi Investment Research

Oil & Natural Gas

Company description

ONGC is India's largest E&P company. Through its subsidiary ONGC Videsh, the company has invested in overseas crude equity. It has ventured downstream, picking up a majority stake in Mangalore Refineries, and it intends to set up a petro-products retailing network.

Investment strategy

We rate ONGC as Buy/Low Risk (1L) with a target price of Rs1400. The government's intentions to revert to 1/3rd sharing formula on subsidy sharing and pre-announced oil bonds provide good visibility on ONGC's leverage to crude. ONGC's asset valuations have therefore improved with higher net realizations and likely moderate increases in gas price. Meanwhile, domestic gas prices have been on an up-move, and the structural market forces will reflect in higher realizations for ONGC's APM gas in the next 2-3 years. OVL's past acquisitions have also started bearing fruit in FY08 and beyond as they become a meaningful portion of ONGC's total production. ONGC remains reasonably priced among the Asia-Pacific E&P universe – both on traditional valuation multiples as well as asset valuations (EV/boe). This, coupled with dividend yield of ~4.0%, makes ONGC a good value pick.

Valuation

Our target price of Rs1400 is based on a PER of 12x FY09E P/E (previously 11x FY08E) on account of greater confidence in adherence to the 1/3rd subsidy-sharing formula and the company's recent successes in improving reserve replacement. In addition, Asian peers have got significantly re-rated over the last 6 months thus warranting a slightly higher multiple for ONGC now. Our new target multiple is at the higher end of historical trading ranges but remains at a material discount to regional peers. The new target price imputes EV/EBITDA of 6.0x FY09E.

We continue to value ONGC on traditional valuation parameters as against NAV/SOTP approach due to it being a going concern. Given that its existing fields face declining or mature production profiles, it will be incorrect to value the new discoveries (say KG gas) separately in a SOTP since the new fields would anyway be required to compensate for the decline in mature fields. In terms of asset valuation, ONGC's current EV/boe of US$8.3 (on 1P Reserves) is at a discount to peers.

Risks

We now assign a Low Risk (previously Medium Risk) on account of improving visibility on subsidy sharing formula given 1) reasonably solvent performance of downstream R&M companies and 2) pre-announced oil bonds.

ONGC has made substantial investments in overseas oil blocks, through its subsidiary ONGC Videsh, in Sudan, Vietnam, and Russia. ONGC remains aggressive in the search for oil equity overseas and is usually an interested bidder in such asset sales. There is always uncertainty over the size, scale, terms, and profitability of such planned overseas investments. More overseas acquisitions increase ONGC's geopolitical risks. Government interference in the Indian oil sector (e.g. making upstream oil companies bear LPG/kerosene subsidy losses and gasoline/diesel retailing losses) is a concern; if ONGC is made to bear the cost of any further populist measures, it would be an earnings risk. The potential sale of a stake held by IOC and GAIL would be a technical overhang and a risk to share price performance. If any of these risks has a greater impact than we anticipate, ONGC's share price could have difficulty attaining our target price.

Appendix A-1

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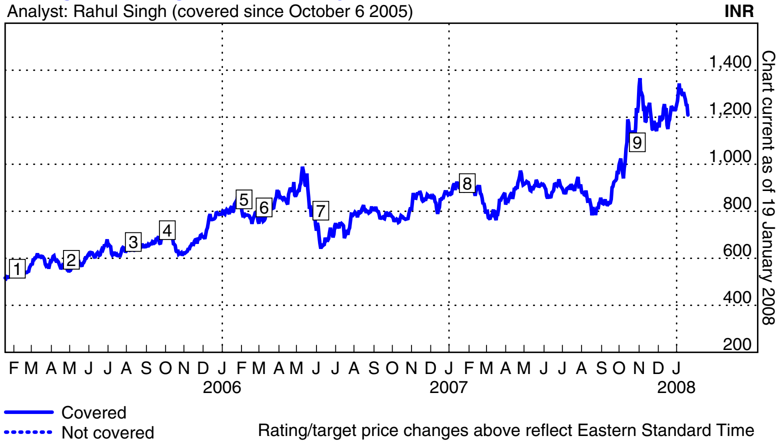
Oil & Natural Gas (ONGC.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Rahul Singh (covered since October 6 2005)



#	Date	Rating	Target Price	Closing Price
1:	7 Feb 05	1M	*640.00	548.13
2:	4 May 05	1M	*713.33	557.70
3:	11 Aug 05	1M	*780.00	635.57
4:	5 Oct 05	1M	*853.33	714.47
5:	5 Feb 06	1M	*933.33	793.73
6:	9 Mar 06	1M	*882.00	760.73
7:	8 Jun 06	1M	*866.67	640.70
8:	30 Jan 07	1M	*1,100.00	NA
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