

## Company Flash

25 June 2008 | 8 pages

# Oil & Natural Gas (ONGC.BO)

## Buy: One-Offs, Higher Depreciation Lead to Disappointing 4Q

- **Disappointing 4Q results...** — ONGC's 4Q PAT came in at Rs26.3bn, relatively flat yoy but significantly below expectations, due to: 1) one-off expense items and 2) higher depreciation expenses, though full-year DD&A remained relatively stable yoy. FY08 consolidated EPS at Rs93 came in below estimates (Rs103). 4Q subsidy of Rs85bn led to net realization of ~US\$50/bbl.
- **...Marred by several one-offs** — EBITDA was negatively affected by Rs12.7bn due to: (1) pay revision and gratuity expenses of Rs17bn, and (2) capitalization of Rs4.3bn of employee expenses. However, this was partly offset below the operating line by: (1) Rs2.0bn oil bonds for past expenses, (2) Rs7.3bn higher interest income from OVL and (3) Rs3.8bn decrease in depletion charges. DD&A, however, was up sharply qoq led by higher survey costs (up Rs8bn qoq) and one-off conservative provisioning of Rs6.1bn for the KG deepwater block. Net negative impact of all one-offs on PBT was Rs5.6bn during 4Q.
- **Healthy contribution by OVL** — OVL's oil and gas production rose 11% yoy to 7.95MMTOE primarily owing to an increase in crude oil production to 6.8MMT (5.8 MMT in FY07). OVL's PAT rose 44% yoy to c.Rs24bn (12% of consolidated PAT vs. 9% in FY07) benefiting fully from high crude prices and production volumes, despite higher depreciation and interest costs.
- **Reserve accretion improves slightly** — 3P reserve accretion of 111 MMTOE (63 from domestic, 47 from OVL) vs. 80MMTOE in FY07, with domestic reserve replacement sustained at 1.32. With hedged downside from subsidy sharing in FY09 and undemanding valuations, ONGC remains a value pick.

### Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2006A	153,976	71.99	6.0	12.0	3.3	29.5	3.5
2007A	177,696	83.08	15.4	10.4	2.8	29.0	4.2
2008E	221,192	103.42	24.5	8.4	2.4	30.7	5.1
2009E	250,489	117.11	13.2	7.4	2.0	29.6	5.8
2010E	235,107	109.92	-6.1	7.9	1.8	24.1	5.2

Source: Powered by dataCentral

<b>Buy/Low Risk</b>	<b>1L</b>
Price (25 Jun 08)	Rs864.00
Target price	Rs1,400.00
Expected share price return	62.0%
Expected dividend yield	5.1%
<b>Expected total return</b>	<b>67.1%</b>
Market Cap	Rs1,847,986M
	US\$43,243M

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



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Figure 1. ONGC – 4QFY08 Results (Rupees in Millions)

Rs m	4QFY07	3QFY08	4QFY08	yoy	Comments
<b>Net sales</b>	<b>123,970</b>	<b>151,208</b>	<b>156,261</b>	<b>26%</b>	
Inc/dec in stock	209	(293)	382	82%	
Raw material cons.	13,436	16,695	24,338	81%	
Staff cost	15,549	3,612	1,630	-90%	Rs4,328m (Rs6,308m for the year) capitalized on account of review of employee expense allocation policy
Statutory levies	28,392	32,314	33,802	19%	
Other expenditure	22,239	18,562	38,342	72%	1. Rs8,070m (Rs10,500m for the year) provided for pay revisions 2. Rs8,852 provided for Gratuity
Total Expenses	(79,825)	(70,891)	(98,494)	23%	
<b>EBITDA</b>	<b>44,145</b>	<b>80,318</b>	<b>57,767</b>	<b>31%</b>	
<i>EBITDA Margin</i>	<i>36%</i>	<i>53%</i>	<i>37%</i>		
Interest	(65)	(114)	(123)	91%	
DD&A	(28,637)	(22,118)	(38,445)	34%	1.Provision of Rs6,105m to account for acquisition and exploratory costs for deepwater block KG DWN 98/2 2.Decrease in depletion by Rs3,829m due to reduction in liability for abandonment cost 3. Survey costs up sharply by Rs8,000m on qoq basis
Other income	21,790	8,630	20,337	-7%	1. Oil bonds of Rs1,973m received for compensation on laying crude pipelines in the past 2.Interest income of Rs7,259m from higher interest rate of 6% (0.1% earlier) charged to OVL
Profit before tax	37,232	66,716	39,536	6%	
Tax	(15,167)	(23,051)	(13,265)	-13%	
<i>Tax Rate</i>	<i>41%</i>	<i>35%</i>	<i>34%</i>		
Net profit	22,066	43,665	26,271	19%	
Extra-ordinary	4,751				
<b>Reported Net Profit</b>	<b>26,816</b>	<b>43,665</b>	<b>26,271</b>	<b>-2%</b>	

Source: Company Reports and Citi Investment Research

Figure 2. ONGC – Key Operational Parameters

Year to 31-Mar	3QFY07	4QFY07	1QFY08	2QFY08	3QFY08	4QFY08	Comments
Crude production (MMT)	7.13	7.03	6.88	7.00	7.11	6.93	
Gas production (bcm)	6.44	6.35	6.10	6.35	6.53	6.14	Decline due to a plant shutdown in Bombay High
Crude sales (MMT)	6.23	6.11	5.90	6.13	5.99	6.06	
Crude sales (Rs m)	109,710	79,600	94,260	105,650	101,660	99,590	
Bonny Light (US\$/bbl)	62.1	60.4	71.8	78.0	91.2	100.4	
Subsidy discounts (US\$/bbl)	11.3	24.8	21.6	22.1	36.7	50.7	Higher subsidy sharing owing to high crude prices
Net realisation on own crude (\$/bbl)	50.9	35.6	50.2	55.9	54.5	49.7	Decline despite Bonny Light going up to US\$100/bbl
Gas sales (bcm)	5.24	5.17	5.03	5.19	5.32	4.89	Planned shutdown in Mumbai High in Feb
Gas sales (Rs m)	18,970	18,710	17,940	18,330	19,170	17,940	
Gas realisation (Rs/tcm)	3,620	3,619	3,567	3,532	3,603	3,669	

Source: Company Reports and Citi Investment Research

Figure 3. YoY DD&amp;A comparison (Rsbn)

Year to 31-Mar	FY07	FY08
Dry Well Expense	21.9	22.1
Survey Expense	21.1	25.8
Depletion	33.9	36.8
Depreciation	16.1	14.0
<b>Total</b>	<b>93.0</b>	<b>98.7</b>

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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Analyst: Rahul Singh (covered since October 6 2005)



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