

SEPTEMBER 25, 2009

UPDATE

Coverage view: **Attractive**

Price (Rs): **1,150**

Target price (Rs): **1,400**

BSE-30: **16,781**

Allaying some key concerns. We are encouraged by the management's guidance of (1) an increase in oil production to 29 mn tons by FY2013E from 25.4 mn tons in FY2009 and (2) an increase in gas production to 72 mcm/d by FY2013E and 100 mcm/d by FY2016E from 62 mcm/d currently. We believe these moves will help in allaying the street's concern regarding a likely decline in ONGC's production. We retain our BUY rating with a 12-month target price of Rs1,400 based on 10X FY2011E EPS.

Company data and valuation summary

Oil & Natural Gas Corporation

Stock data		Forecasts/Valuations			
		2009	2010E	2011E	
52-week range (Rs) (high,low)	1,230-538	EPS (Rs)	89.6	115.8	136.4
Market Cap. (Rs bn)	2,459.7	EPS growth (%)	(3.4)	29.2	17.8
Shareholding pattern (%)		P/E (X)	12.8	9.9	8.4
Promoters	74.1	Sales (Rs bn)	1,216.6	1,092.1	1,168.3
FIs	5.6	Net profits (Rs bn)	191.6	247.7	291.9
MFs	1.9	EBITDA (Rs bn)	462.7	548.9	610.0
Price performance (%)		EV/EBITDA (X)	4.6	3.6	2.9
Absolute	1M 3M 12M	ROE (%)	16.6	18.9	19.8
	(3.8) 9.4 8.3	Div. Yield (%)	2.8	3.7	4.2
Rel. to BSE-30	(10.4) (6.0) (11.6)				

Production set to increase versus street's concerns of possible decline

The management (in its AGM) has proffered guidance suggesting an (1) increase in standalone oil production to 29 mn tons by FY2013E from 25.4 mn tons in FY2009 and (2) increase in standalone gas production to 72 mcm/d by FY2013E and 100 mcm/d by FY2016E from 62 mcm/d currently. We expect the contribution from G1 and GS-15 fields in KG basin, B and C series fields in Mumbai offshore area and redevelopment projects to increase domestic oil and gas production. We believe this announcement will help in addressing the street's concern regarding a possible decline in ONGC's production in the medium term. We have given details of these projects later in the note.

Concerns regarding subsidy-sharing seems to be overdone

We believe that the concerns regarding a possible unfavorable subsidy-sharing mechanism may be overdone. Our scenario analysis reveals robust earnings for ONGC under various subsidy-sharing formulas (see Exhibit 1). We currently assume that upstream companies will bear 50% of the auto-fuel subsidy burden. On the other hand, we see potential upside to our earnings estimates if the upstream companies have to bear less than 50% of the auto-fuel subsidy burden. Our FY2010E and FY2011E (consolidated) EPS would rise to Rs120 (versus Rs116) and Rs139 (versus Rs136) if upstream companies were to bear only 33.3% of the auto-fuel subsidy (which is the subsidy borne by upstream companies in 1QFY2010).

Reserve accretion has been encouraging

One of the key concerns has been ONGC's ability to find hydrocarbons. However, we are encouraged by the addition of 68.9 mn tons or 503 mboe of proved reserves in ONGC (standalone without overseas and domestic joint ventures) in FY2009, which results in reserves replacement ratio (RRR) of 1.44X. We note that ONGC's RRR has been higher than 1X for the past five years, which should dispel concerns regarding its ability to find hydrocarbons (see Exhibit 2).

QUICK NUMBERS

- Management stated increase in standalone production of oil to 29 mn tons and of gas to 72 mcm/d by FY2013E
- FY2010E EPS would jump by 4-6% if ONGC is to share a lesser burden on auto fuel subsidy

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Details of major projects boosting ONGC's oil and gas production

C-series fields

- ▶ ONGC is awaiting approval from the government for pricing of natural gas to commence production of 3 mcm/d of gas from these fields. The cumulative production is likely to be 15.14 bcm of gas and investment of Rs17.9 bn. GAIL has contracted to buy the entire output from C-Series fields at US\$5.5/ mn BTU. However, the government has sought details of the pricing of gas from this field.

G1 and GS-15 fields

- ▶ This project will increase gas production by 2.6 mcm/d. The cumulative production is 5.92 bcm of gas and 0.98 mn tons of oil over 15 years. The project is due to commence production in May 2011 and will cost Rs12.6 bn.

Vasai East project

- ▶ The project envisages cumulative production of 4.7 mn tons oil and 6.22 bcm of gas by FY2021. It is due to commence production in FY2010E and will cost Rs16.9 bn.

B-22 and B-193 cluster fields

- ▶ The B-22 cluster comprises of B-22, adjoining BS-12, BS-13, B-149 marginal fields/pools on the western side of Bassein Field. This project is estimated to enhance production of oil by 8,190 b/d, condensate by 6,680 b/d and gas by 4.5 mcm/d. The cumulative production is likely to be 2.46 mn tons of oil, 1.13 mn tons of condensate and 6.56 bcm of gas over 10 years.

B-193 project consists of eight marginal fields (B-193, B-172, B-178, B-179, B-180, B-28A, B-23A and B-28). Peak oil production is estimated at 28,150 b/d, with condensate production of 1,870 b/d and gas production of 1.52 mcm/d, which would enable cumulative production of 5.57 mn tons, 0.75 mn tons of condensate and 5.12 bcm of gas in 15 years. The facilities of B-22 and B-193 have been combined and the project is scheduled to be completed by FY2012E at an estimated cost of US\$1.7 bn.

B-46 cluster fields

- ▶ The project involves the development of four small gas fields (B-46, B-48, B-105, and B-188) with a cumulative production of 4.5 bcm of gas in 11 years. The project is expected to be completed by May 2012 at an estimated cost of Rs14.3 bn.

Mumbai High South Phase-II

- ▶ ONGC's Mumbai High South-Phase II redevelopment project will result in additional oil production of 20.7 mn tons and gas production of 3.3 bcm until FY2030. The project is due for completion in April 2011 and will cost Rs80.6 bn.

Mumbai High North Phase-II

- ▶ ONGC's Mumbai High North-Phase II redevelopment project will result in additional oil production of 17.4 mn tons and gas production of 3 bcm until FY2030. The project is due for completion in September 2012 and will cost Rs71.3 bn.

Heera and South Heera projects

- ▶ This redevelopment project will result in additional oil production of 10.9 mn tons and gas production of 2.3 bcm until FY2030. The project is due for completion in June 2010 and will cost Rs23.1 bn.

We expect ONGC to benefit from a favorable subsidy-sharing arrangement

ONGC's earnings under different crude price assumptions and subsidy-sharing arrangements, March fiscal year-ends, 2010E-2012E

Subsidy-burden on auto fuels (%) (a)	US\$65/bbl			US\$70/bbl			US\$75/bbl		
	20	33	50	20	33	50	20	33	50
FY2010E									
Net income (Rs bn)	264	257	248	280	262	239	298	272	244
EPS (Rs)	123	120	116	131	122	112	140	127	114
FY2011E									
Net income (Rs bn)	301	297	292	321	308	291	342	319	290
EPS (Rs)	141	139	136	150	144	136	160	149	135
FY2012E									
Net income (Rs bn)	337	333	326	358	343	335	378	353	322
EPS (Rs)	158	155	153	167	160	157	177	165	150

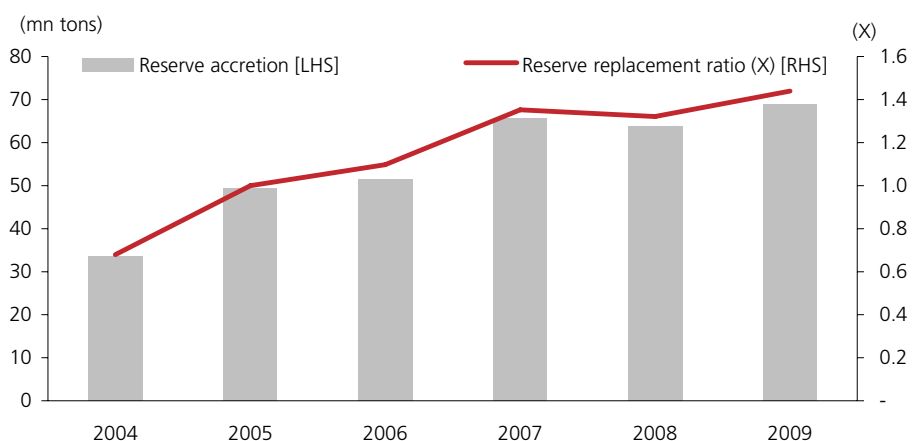
Note:

(a) We assume upstream companies will bear 20%, 33.3% or 50% of the auto fuel subsidy.

Source: Kotak Institutional Equities estimates

ONGC's reserve replacement ratio has been encouraging

Reserve accretion and production data, March fiscal year-ends, 2004-09 (mn tons)



Source: Company, Kotak Institutional Equities

Consolidated profit model, balance sheet, cash model of ONGC, March fiscal year-ends, 2006-2012E (Rs mn)

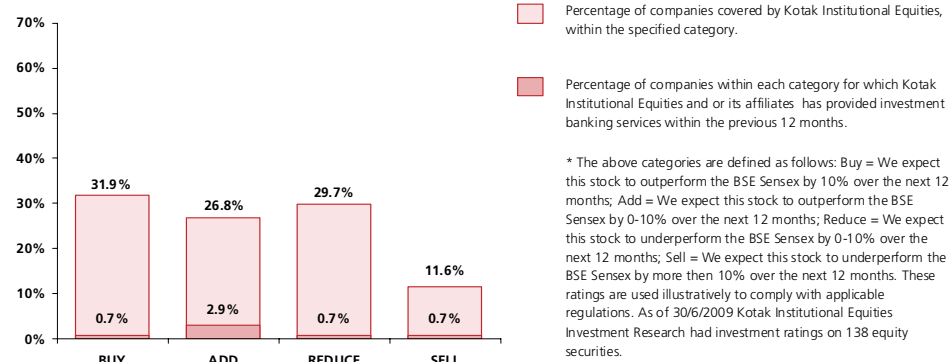
	2006	2007	2008	2009	2010E	2011E	2012E
Profit model (Rs mn)							
Net sales	807,603	966,542	1,091,644	1,216,576	1,092,110	1,168,267	1,243,922
EBITDA	310,054	358,001	407,790	407,761	503,464	545,833	568,368
Other income	27,350	45,378	53,565	54,918	45,463	64,211	84,954
Interest	(537)	394	(12,027)	(10,248)	(9,037)	(4,136)	(3,181)
Depreciation and depletion	(97,726)	(119,550)	(138,624)	(148,515)	(158,044)	(168,354)	(156,213)
Pretax profits	239,141	284,222	310,705	303,915	381,846	437,555	493,927
Tax	(71,196)	(88,986)	(102,908)	(106,301)	(131,625)	(144,925)	(151,032)
Deferred tax	(13,612)	(9,264)	(6,471)	(4,692)	66	1,596	(4,545)
Net profits	154,596	178,414	203,076	198,697	250,287	294,226	338,350
Net profits after minority interests	153,542	176,922	199,466	195,312	247,672	291,850	335,251
Earnings per share (Rs)	71.8	82.7	93.3	91.3	115.8	136.4	156.7
Balance sheet (Rs mn)							
Total equity	578,830	670,137	786,657	902,504	1,044,933	1,215,896	1,420,306
Deferred tax liability	71,557	80,976	87,227	91,919	91,853	90,257	94,802
Liability for abandonment cost	128,675	151,857	129,325	164,957	164,957	164,957	164,957
Total borrowings	28,767	21,826	22,039	28,610	32,524	60,870	111,770
Current liabilities	142,435	187,051	251,797	273,369	276,968	290,321	302,288
Total liabilities and equity	950,264	1,111,847	1,277,045	1,461,359	1,611,234	1,822,301	2,094,124
Cash	90,743	206,262	249,807	300,157	465,216	684,821	912,683
Current assets	240,210	192,652	257,384	290,139	262,121	273,137	285,132
Total fixed assets	565,722	643,219	695,227	804,761	812,655	788,161	820,127
Goodwill	14,172	27,686	22,847	22,847	22,847	22,847	22,847
Investments	35,753	36,888	45,041	36,949	41,889	46,829	46,829
Deferred expenditure	3,663	5,141	6,739	6,506	6,506	6,506	6,506
Total assets	950,264	1,111,848	1,277,045	1,461,359	1,611,234	1,822,301	2,094,124
Free cash flow (Rs mn)							
Operating cash flow, excl. working capital	216,736	252,772	284,517	270,492	296,402	336,065	351,920
Working capital changes	46,461	(4,990)	(24,929)	(114,114)	62,536	115,403	(28)
Capital expenditure	(113,738)	(135,049)	(166,427)	(160,859)	(100,757)	(85,275)	(128,222)
Investments	(28,912)	53,822	(7,348)	(15,164)	(4,940)	—	—
Other income	14,537	20,422	22,822	31,998	45,463	64,211	84,954
Free cash flow	135,083	186,976	108,636	12,354	298,704	430,403	308,625
Ratios (%)							
Debt/equity	5.0	3.3	2.8	3.2	3.1	5.0	7.9
Net debt/equity	(10.7)	(27.5)	(29.0)	(30.1)	(41.4)	(51.3)	(56.4)
RoAE	25.9	25.5	24.8	21.2	23.6	24.2	24.1
RoACE	22.0	22.1	21.9	18.4	20.8	21.4	21.6
Key assumptions							
Rs/dollar rate	44.3	45.3	40.3	45.8	48.0	47.8	47.5
Crude fob price (US\$/bbl)	57.2	64.8	78.9	83.0	65.0	65.0	70.0
Ceiling/actual natural gas price (Rs/'000 cm)	3,515	3,200	3,200	3,200	3,600	4,000	4,500
Subsidy loss (Rs bn)	119.6	170.2	220.0	282.3	45.0	26.3	75.0

Source: Company, Kotak Institutional Equities estimates

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Distribution of ratings/investment banking relationships



Source: Kotak Institutional Equities

As of June 30, 2009

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BUY. We expect this stock to outperform the BSE Sensex by 10% over the next 12 months.

ADD. We expect this stock to outperform the BSE Sensex by 0-10% over the next 12 months.

REDUCE. We expect this stock to underperform the BSE Sensex by 0-10% over the next 12 months.

SELL. We expect this stock to underperform the BSE Sensex by more than 10% over the next 12 months.

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