

JULY 13, 2011

UPDATE

Coverage view: **Cautious**

Price (Rs): **287**

Target price (Rs): **370**

BSE-30: **18,596**

**Much to gain, not much to lose.** We reiterate our positive view on ONGC and would not be overly concerned about (1) potential cap on crude price realization and (2) uncertain subsidy-sharing arrangement as current valuations already reflect these issues. On the contrary, we do not rule out potential upside from (1) subsidy share for upstream companies reverting to 33.3% of the gross under-recoveries and (2) lower royalty on crude oil produced from Cairn's Rajasthan block. We retain our BUY rating on the stock with a 12-month target price of ₹370 (9X FY2013E EPS plus value of investments) given favorable risk-reward balance.

#### Company data and valuation summary

Oil & Natural Gas Corporation

Stock data		Forecasts/Valuations			
		2011	2012E	2013E	
52-week range (Rs) (high,low)	368-248	EPS (Rs)	25.2	39.8	40.0
Market Cap. (Rs bn)	2,455.0	EPS growth (%)	9.9	57.8	0.4
Shareholding pattern (%)		P/E (X)	11.4	7.2	7.2
Promoters	74.1	Sales (Rs bn)	1,247.5	1,601.0	1,621.9
FIs	4.4	Net profits (Rs bn)	215.8	340.5	341.9
MFs	2.1	EBITDA (Rs bn)	540.2	729.0	752.5
Price performance (%)		EV/EBITDA (X)	4.1	3.0	2.6
Absolute	1M 6.7 3M (0.7) 12M (10.1)	ROE (%)	14.7	20.6	18.0
Rel. to BSE-30	4.8 5.2 (13.1)	Div. Yield (%)	3.0	4.4	4.5

#### Subsidy-sharing remains uncertain but already factored in our earnings estimates

We admit that there is significant uncertainty regarding the potential share of upstream companies in the gross under-recoveries in light of the increase in their share in FY2011. However, we note that our earnings estimates already assume upstream share at 39% for FY2012-14E. On the contrary, we see a significant upside to our estimates if the government was to revert to 33.3% share for the upstream companies (4-8% upside) in FY2012E and beyond. We also see potential upside to ONGC's earnings (₹2.5/share for FY2012E) from it bearing royalty on only its share of crude oil produced from Cairn's Rajasthan block.

#### Proposed cap on crude realization poses earnings risk but stock is discounting low realization

There have been some concerns on the reported subsidy-sharing scheme of effectively capping upstream companies' net crude oil price realization at US\$55-60/bbl. We note that the current stock price is already discounting a net crude price realization of US\$53/bbl assuming (1) gross realization of US\$95/bbl and (2) current level of retail prices for regulate products. We had raised our concerns on the likely acceptability of a fixed-price formula in our note **'Selling equity instead of bond'** released on July 4, 2011. The government is not considering any such formula as per our understanding.

#### Postponement of FPO will likely remove near-term overhang

The postponement of the proposed FPO will likely remove the near-term overhang of pricing of the issue being at a potential discount to the current stock price. We note that there is an expectation of a potential discount being offered in the FPO, which has acted as an overhang on the stock performance. However, the stock has performed well whenever there has been a postponement of the same. The FPO is now scheduled for September 2011 but we do not rule out further delays given (1) no clarity from government on the subsidy-sharing scheme and (2) volatile crude oil prices.

#### QUICK NUMBERS

- 4-8% upside to FY2012-13E EPS if upstream sharing is reduced to one-third of gross under-recoveries
- Stock price implies net crude price realization of US\$53/bbl
- 29% potential upside from current levels

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### Several areas of upside, one area of downside

We look at several potential areas of upside for ONGC's earnings and fair valuation. The key downside risk is that the government caps the crude price of ONGC at a low level (US\$55/bbl or so) in order to reduce its own share of under-recoveries.

- ▶ **More favorable subsidy arrangement.** Exhibit 1 gives our scenario analysis of the likely earnings of ONGC at different levels of subsidy burden. In our base-case numbers for FY2012E and FY2013E, we assume share of upstream companies at 39%. We note that the upstream companies will bear 33.33% share of gross under-recoveries in 1QFY12; the figures have already been communicated to the companies. We highlight that the Secretary, Ministry of Petroleum and Natural Gas had recently stated (at Kotak's Capital Ideas Forum) that the share for upstream companies should revert to 33.3% for FY2012E.
- ▶ **A more favorable structure for extracting subsidies from ONGC versus the current system of discounts on crude sold.** We note that there are better structures that can achieve the government's objective of sharing of subsidies among various government-owned upstream companies.
  - **Compensation from additional dividends.** We had discussed compensation from additional dividends from upstream companies as one option in our July 4, 2011 note.
  - **Tiered structure of taxes on revenues above a certain floor price.** A tiered structure of taxation on revenues of upstream companies as recommended by the Kirit Parikh Committee is another and will result in substantially higher net realized prices compared to US\$48-56/bbl range seen in FY2008-11. We would add that the Secretary, MoPNG has stated that the tiered formula as reported by the press (effectively capping net realized crude oil price at US\$55-60/bbl for upstream companies) is not being considered by the government. Exhibit 2 gives potential downside risk to earnings from the proposed scheme.
- ▶ **OVL to drive earnings in FY2012E even if standalone earnings are capped.** We would note that even if the government was to effectively cap ONGC's standalone earnings at FY2011 levels (₹22) through either higher share of under-recoveries or cap on crude realization, its consolidated FY2012E earnings would still touch ₹30. We model OVL's EPS to increase to ₹7.8 from ₹3.1 in FY2011 due to higher global crude oil prices yoy and higher volumes; we model Dated Brent crude price for FY2012E at US\$105/bbl compared to US\$84/bbl in FY2011. We note that OVL's revenues are outside the purview of the subsidy-sharing system. ONGC will gain an additional ₹2.5/share due to a favorable resolution of the royalty issue on crude oil production from Cairn's Rajasthan block. Finally, MRPL's earnings should also increase yoy due to higher tariff protection as a result of changes to import duties on June 24, 2011.
- ▶ **No upside from further deregulation of oil and gas prices.** Our model assumes that there would be no further increase in retail selling prices of diesel, kerosene and LPG and of natural gas prices throughout our forecast period (up to FY2014E). This is a very conservative assumption and we would expect domestic selling prices of diesel to be gradually aligned to market levels. Also, the government is working on better targeting subsidies to needy customers through a system of direct cash transfers (see our report *A new approach to some old problems* dated July 11, 2011). Finally, it would be too much to expect that natural gas prices in India will remain at US\$4.2/mn BTU in perpetuity.

**Potential upside to ONGC's earnings if upstream companies have to bear one-third of subsidy losses**  
ONGC's EPS estimates, March fiscal year-ends, 2012-13E (Rs)

	2012E	2013E
Assuming 39% subsidy burden on upstream companies (base case)	40	40
Assuming 33.3% subsidy burden on upstream companies	43	42
<b>Potential upside (%)</b>	<b>8</b>	<b>4</b>
Assuming no subsidy burden on upstream companies	60	51
<b>Potential upside (%)</b>	<b>52</b>	<b>26</b>

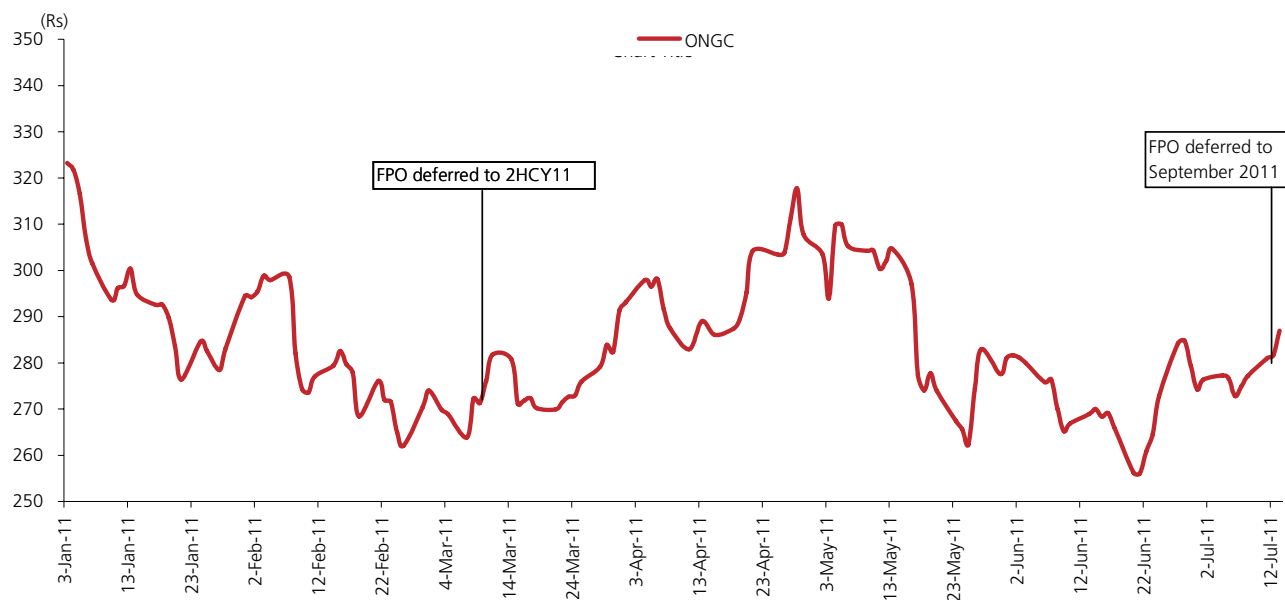
Source: Kotak Institutional Equities estimates

**Potential downside to ONGC's earnings if crude price realizations are capped**  
ONGC's EPS estimates, March fiscal year-ends, 2012-13E (Rs)

	2012E	2013E
Base case	40	40
Assuming cap on crude price realizations	39	34
<b>Potential upside (%)</b>	<b>(2)</b>	<b>(15)</b>

Source: Kotak Institutional Equities estimates

**ONGC stock price reflects FPO overhang**  
ONGC stock price since January 2011 (Rs)



Source: Bloomberg, Kotak Institutional Equities

## Fair value of ONGC (Rs/share)

FY2013E EPS	40
Less: income from investments valued separately	0
Adjusted EPS for FY2013E	40
P/E (X)	9
Valuation	356
Investments	16
Indian Oil Corp.	11
GAIL	4
Petronet LNG	1
<b>Fair value</b>	<b>372</b>

Source: Kotak Institutional Equities estimates

## Key assumptions for ONGC, March fiscal year-ends, 2007-2014E

	2007	2008	2009	2010	2011E	2012E	2013E	2014E
<b>Macro assumptions</b>								
Rs/US\$ rate	45.3	40.3	45.8	47.4	45.6	45.5	44.0	44.0
Subsidy share scheme loss (Rs bn)	170.2	220.0	282.3	115.5	248.9	286.9	146.4	119.9
Import tariff on crude oil (%)	5.1	5.2	0.9	0.4	5.2	1.2	—	—
<b>Pricing and volumes assumptions</b>								
<b>Crude price</b>								
Crude price, Bonny Light (US\$/bbl)	64.8	78.9	83.0	67.1	84.0	105.0	95.0	90.0
Net crude price, ONGC-India (US\$/bbl)	46.1	52.9	47.7	55.9	53.8	62.9	72.6	72.0
<b>Natural gas price</b>								
Ceiling natural gas price, India (Rs/cu m)	3.20	3.20	3.20	3.20	6.78	7.50	7.50	7.50
Ceiling natural gas price, India (US\$/mn BTU)	1.89	2.12	1.87	1.80	3.98	4.41	4.56	4.56
<b>International operations</b>								
Net natural gas price, OVL-Vietnam (Rs/cu m)	3.2	2.8	3.2	3.3	3.2	3.2	3.1	3.1
Net crude price, OVL-Sudan (Rs/ton)	9,384	10,142	12,136	10,173	12,223	18,730	16,401	15,545
Net crude price, OVL-Russia (Rs/ton)	14,985	16,231	19,433	16,253	19,573	24,413	21,360	20,236
<b>Sales volumes—Domestic fields</b>								
Crude oil - own fields (mn tons)	22.6	22.3	21.2	20.5	20.4	20.2	20.6	21.0
Crude oil - JV (mn tons)	1.8	1.8	1.7	1.8	2.6	3.8	4.6	4.6
Natural gas - own fields (bcm)	17.9	17.8	17.7	18.1	18.2	18.5	18.8	18.8
Natural gas - JV (bcm)	2.4	2.7	2.8	2.5	2.0	2.2	2.0	1.9
<b>Sales volumes—Overseas fields</b>								
Crude oil (mn tons)	5.8	6.8	6.6	6.5	6.8	7.7	8.3	8.8
Natural gas (bcm)	2.1	2.0	2.2	2.4	2.7	2.7	2.9	3.0
<b>Total sales</b>								
Crude oil (mn tons)	30.2	30.9	29.4	28.8	29.7	31.6	33.5	34.4
Natural gas (bcm)	22.5	22.4	22.8	23.0	22.9	23.4	23.7	23.6
<b>Total sales (mn toe)</b>	<b>50.3</b>	<b>50.9</b>	<b>49.8</b>	<b>49.3</b>	<b>50.1</b>	<b>52.5</b>	<b>54.6</b>	<b>55.5</b>
<b>Total sales (mn boe)</b>	<b>367</b>	<b>372</b>	<b>363</b>	<b>360</b>	<b>366</b>	<b>384</b>	<b>399</b>	<b>405</b>
Crude oil (%)	60	61	59	58	59	60	61	62
Natural gas (%)	40	39	41	42	41	40	39	38

Source: Company, Kotak Institutional Equities estimates

Consolidated profit model, balance sheet, cash model of ONGC, March fiscal year-ends, 2007-2014E (₹ mn)

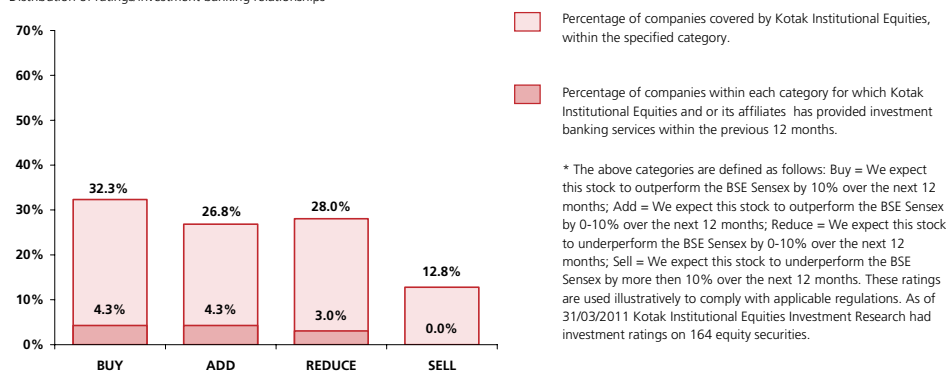
	2007	2008	2009	2010	2011E	2012E	2013E	2014E
<b>Profit model (Rs mn)</b>								
Net sales	966,542	1,091,644	1,200,176	1,070,520	1,247,463	1,600,991	1,621,885	1,623,807
<b>EBITDA</b>	<b>357,906</b>	<b>408,423</b>	<b>419,955</b>	<b>445,845</b>	<b>510,110</b>	<b>675,047</b>	<b>687,667</b>	<b>674,397</b>
Other income	45,378	53,565	50,721	50,409	30,130	53,996	64,828	76,571
Interest	394	(12,027)	(5,966)	(3,019)	(4,826)	(3,681)	(2,943)	(4,400)
Depreciation and depletion	(119,550)	(138,624)	(153,985)	(186,838)	(206,027)	(227,479)	(253,758)	(249,666)
Pretax profits	284,127	311,338	310,725	306,397	329,387	497,883	495,794	496,902
Tax	(88,986)	(102,908)	(111,333)	(95,580)	(107,997)	(144,870)	(143,042)	(140,681)
Deferred tax	(9,264)	(6,471)	(3,495)	(11,457)	(7,191)	(9,594)	(8,475)	(10,594)
Net profits	178,318	203,710	201,719	199,951	228,375	343,419	344,277	345,627
<b>Adjusted net profits after minority interests</b>	<b>181,772</b>	<b>198,963</b>	<b>194,664</b>	<b>196,409</b>	<b>215,817</b>	<b>340,495</b>	<b>341,913</b>	<b>343,663</b>
<b>Earnings per share (Rs)</b>	<b>21.2</b>	<b>23.3</b>	<b>22.8</b>	<b>23.0</b>	<b>25.2</b>	<b>39.8</b>	<b>40.0</b>	<b>40.2</b>
<b>Balance sheet (Rs mn)</b>								
Total equity	670,137	786,657	929,353	1,024,615	1,162,780	1,379,719	1,592,954	1,807,879
Deferred tax liability	80,976	87,227	92,076	102,669	109,860	119,454	127,929	138,523
Liability for abandonment cost	151,857	129,325	171,451	174,590	186,226	186,226	186,226	186,226
Total borrowings	21,826	22,039	73,633	61,274	71,396	114,296	88,796	61,870
Current liabilities	187,051	251,797	293,499	306,532	389,100	379,376	387,993	395,684
<b>Total liabilities and equity</b>	<b>1,111,847</b>	<b>1,277,045</b>	<b>1,560,013</b>	<b>1,669,680</b>	<b>1,919,361</b>	<b>2,179,070</b>	<b>2,383,899</b>	<b>2,590,182</b>
Cash	206,262	249,807	224,671	222,348	285,774	364,241	546,386	773,965
Current assets	192,652	257,384	309,514	306,619	369,995	443,593	449,906	455,833
Total fixed assets	643,219	695,227	871,287	986,293	1,129,307	1,236,951	1,253,321	1,226,098
Goodwill	27,686	22,847	111,108	92,455	92,455	92,455	92,455	92,455
Investments	36,888	45,041	36,926	53,551	33,871	33,871	33,871	33,871
Deferred expenditure	5,141	6,739	6,506	8,413	7,960	7,960	7,960	7,960
<b>Total assets</b>	<b>1,111,848</b>	<b>1,277,045</b>	<b>1,560,013</b>	<b>1,669,680</b>	<b>1,919,362</b>	<b>2,179,071</b>	<b>2,383,899</b>	<b>2,590,183</b>
<b>Free cash flow (Rs mn)</b>								
Operating cash flow, excl. working capital	252,772	284,517	274,321	302,059	322,511	411,424	425,265	412,311
Working capital changes	(4,990)	(24,929)	(109,306)	(29,693)	84,192	(33,322)	50,027	1,764
Capital expenditure	(135,049)	(166,427)	(208,137)	(207,849)	(248,463)	(220,052)	(153,711)	(105,438)
Investments	53,822	(7,348)	(92,159)	(11,021)	15,288	—	—	—
Other income	20,422	22,822	31,612	22,154	30,130	53,996	64,828	76,571
<b>Free cash flow</b>	<b>186,976</b>	<b>108,636</b>	<b>(103,668)</b>	<b>75,650</b>	<b>203,659</b>	<b>212,046</b>	<b>386,409</b>	<b>385,207</b>
<b>Ratios (%)</b>								
Debt/equity	3.3	2.8	7.9	6.0	6.1	8.3	5.6	3.4
Net debt/equity	(27.5)	(29.0)	(16.3)	(15.7)	(18.4)	(18.1)	(28.7)	(39.4)
RoAE	25.5	24.9	21.2	18.6	19.0	24.9	21.5	19.0
<b>RoACE</b>	<b>22.1</b>	<b>22.0</b>	<b>18.2</b>	<b>16.1</b>	<b>15.7</b>	<b>22.0</b>	<b>19.3</b>	<b>17.3</b>
<b>Key assumptions</b>								
Rs/dollar rate	45.3	40.3	45.8	47.4	45.6	45.5	44.0	44.0
Crude fob price (US\$/bbl)	64.8	78.9	83.0	67.1	84.0	105.0	95.0	90.0
Ceiling/actual natural gas price (Rs/'000 cm)	3,200	3,200	3,200	3,200	6,783	7,500	7,500	7,500
Subsidy loss (Rs bn)	170.2	220.0	282.3	115.5	248.9	286.9	146.4	119.9

Source: Company, Kotak Institutional Equities estimates

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Source: Kotak Institutional Equities

As of March 31, 2011

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