

FEBRUARY 19, 2010
UPDATE

Price ONGC/Oil India

(Rs): 1,110 / 1,148

Target price: ONGC/Oil India

(Rs): 1,200 / 1,150

A gas price increase may be around the corner. We see the recent government decision to increase urea prices as removing a potential roadblock for a long-pending increase in the price of APM natural gas. The petroleum ministry has proposed a 29% increase in price of APM gas and will seek the cabinet's approval for the same over the next few weeks. We compute a modest positive impact on EPS of OIL (+4.8%) and ONGC (+4.6%) of the proposed price increase.

Company data and valuation summary

Oil & Natural Gas Corporation

Stock data

52-week range (Rs) (high,low) 1,278-637

Market Cap. (Rs bn) 2,373.7

Shareholding pattern (%)

Promoters 74.1

FIs 4.5

MFs 2.3

Price performance (%)

	1M	3M	12M
Absolute	(7.3)	(4.6)	63.2
Rel. to BSE-30	0.1	(1.1)	(8.8)

Forecasts/Valuations

	2010	2011E	2012E
EPS (Rs)	90.1	107.8	133.0
EPS growth (%)	(0.8)	19.7	23.3
P/E (X)	12.3	10.3	8.3
Sales (Rs bn)	1,002.2	1,063.5	1,175.7
Net profits (Rs bn)	192.7	230.7	284.4
EBITDA (Rs bn)	465.8	515.0	580.6
EV/EBITDA (X)	4.4	3.7	3.1
ROE (%)	14.4	15.8	17.8
Div. Yield (%)	3.2	4.0	4.5

Company data and valuation summary

Oil India

Stock data

52-week range (Rs) (high,low) 0-0

Market Cap. (Rs bn) 260.8

Shareholding pattern (%)

Promoters 78.4

FIs 3.2

MFs 2.6

Price performance (%)

	1M	3M	12M
Absolute	(6.6)	(5.7)	0.0

Forecasts/Valuations

	2010	2011E	2012E
EPS (Rs)	110.5	111.7	116.3
EPS growth (%)	9.2	1.1	4.1
P/E (X)	10.4	10.3	9.9
Sales (Rs bn)	76.1	81.0	87.6
Net profits (Rs bn)	25.1	26.8	28.0
EBITDA (Rs bn)	44.7	51.2	56.2
EV/EBITDA (X)	3.7	3.1	2.6
ROE (%)	16.3	15.6	14.7

Price increase on urea may allow for a modest gas price increase

The 10% price increase in selling price of urea from April 1, 2010 may allow the government more leeway to raise APM gas prices without impacting the government's overall subsidy burden. The petroleum ministry had recently circulated a note on increasing APM gas price to various ministries. As per press reports, the fertilizer and power ministries have opposed an increase in natural gas prices on account of the consequent increase in subsidies on fertilizers and in prices of electricity.

Modest impact on government's subsidy burden or consumer even in the case of full deregulation

Exhibits 1 and 2 show that the impact of a full deregulation (natural gas price at Rs7.5/cu m versus Rs3.2/cu m currently) is about Rs39 bn in the case of the fertilizer sector and Rs54 bn in the case of the power sector. We see these amounts as very reasonable in the context of likely fertilizer subsidy of Rs600 bn in FY2011E and 820 bn units of power generation in FY2011E in India. The proposed price increase to Rs4.14/cu m from Rs3.2/cu m will hardly have an impact on the government's budget (Rs9 bn) or the Indian consumer, in our view.

Modest impact on EPS of OIL and ONGC of the proposed gas price increase

We compute a 4.8% and 4.6% impact on EPS of OIL and ONGC in case the government was to raise APM natural gas price to Rs4.14/cu m from Rs3.2/cu m as has been proposed by the petroleum ministry. However, we already model APM natural gas price at Rs4/cu m for FY2011E for both OIL and ONGC and see limited impact on our FY2011E earnings of the two companies in case the government does increase natural gas prices to the proposed level of Rs4.14/cu m.

QUICK NUMBERS

- Rs9 bn impact on fertilizer subsidy of proposed gas price increase to Rs4.14/cu m
- 4.6-4.8% impact on EPS of OIL and ONGC in the case of first phase of APM natural gas price increase
- Rs20-21 impact on EPS of OIL and ONGC of full deregulation

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The real impact could come if the government was to fully deregulate APM gas price over time

The petroleum ministry has proposed a roadmap for full deregulation by FY2013E through annual increases in APM natural gas price. It eventually proposes to raise the price of APM gas to US\$4.2/mn BTU, the government-approved price for gas produced from RIL's KG D-6 block. Exhibits 3 and 4 show that the EPS of both OIL and ONGC would increase by about Rs20 under a scenario of APM natural gas price of Rs7.5/cu m (US\$4.2/mn BTU).

We expect a small impact on the fertilizer sector even in case of full deregulation

Estimation of impact on fertilizer sector of a gas price increase (Rs bn)

Consumption of gas by fertilizer sector (bcm)	9
Current ceiling price of gas in India (Rs/cu m)	3.2
Likely market price after full deregulation (Rs/cu m)	7.5
Impact of gas price increase on fertilizer sector	39
Fertilizer subsidy in FY2010E	500
Impact of gas price increase/fertilizer subsidy (%)	8
Fiscal deficit in FY2010E (BE)	4,010
Impact of gas price increase/fiscal deficit (%)	1.0

Source: Kotak Institutional Equities estimates

We expect a small impact on the power sector even in case of full deregulation

Estimation of impact on power sector of a gas price increase (Rs bn)

Consumption of gas by power sector (bcm)	13
Current ceiling price of gas in India (Rs/cu m)	3.2
Likely market price after full deregulation (Rs/cu m)	7.5
Impact of gas price increase on power sector	54
Power generation by all power plants in FY2009 (bn units)	724
Increase in power price per unit (Rs/KWh)	0.1
Current average power selling price in India (Rs/KWh)	3.0
Increase in average consumer price (%)	2.5

Source: Kotak Institutional Equities estimates

OIL should be a big beneficiary of gas price increase in India

Impact of gas price increase on OIL's earnings (Rs)

Gas sales in FY2009 (bcm)	1.7
Average gas price in FY2009 (Rs/cu meter)	3.4
Average gas price in FY2009 (US\$/mn BTU)	2.0
Long-term delivered price of gas (US\$/mn BTU)	5.0
Pipeline tariff and royalty (US\$/mn BTU)	0.8
Average long-term wellhead price (US\$/mn BTU)	4.2
Increase in gas price (US\$/mn BTU)	2.2
Increase in pretax profits (Rs bn)	7
Pretax profits in FY2009 (Rs bn)	34
% increase in pretax profits (%)	19
Increase in post-tax profits (Rs bn)	4
Increase in EPS (Rs)	20

Source: Company, Kotak Institutional Equities estimates

ONGC should be a big beneficiary of gas price increase in India

Impact of gas price increase on ONGC's earnings (Rs)

Gas sales in FY2009 (bcm)	20.5
Average gas price in FY2009 (Rs/cu meter)	3.9
Average gas price in FY2009 (US\$/mn BTU)	2.3
Long-term delivered price of gas (US\$/mn BTU)	5.0
Pipeline tariff and royalty (US\$/mn BTU)	0.8
Average long-term wellhead price (US\$/mn BTU)	4.2
Increase in gas price (US\$/mn BTU)	1.9
Increase in pretax profits (Rs bn)	67
Pretax profits in FY2009 (Rs bn)	310
% increase in pretax profits (%)	22
Increase in post-tax profits (Rs bn)	44
Increase in EPS (Rs)	21

Source: Company, Kotak Institutional Equities estimates

Key assumptions for Oil India, March fiscal year-ends, 2006-2012E

	2006	2007	2008	2009	2010E	2011E	2012E
Rs/US\$ rate	44.3	45.3	40.3	45.8	47.3	46.0	46.0
Subsidy share scheme loss (Rs mn)	9,775	19,938	23,051	30,233	17,818	19,500	26,250
Import tariff on crude oil (%)	5.1	5.1	5.2	0.9	—	—	—
Crude/natural gas prices							
Crude price							
Crude price, Bonny Light (US\$/bbl)	57.2	64.8	78.9	83.0	67.5	70.0	75.0
Net crude price, OIL-India (US\$/bbl)	49.7	47.9	60.9	56.2	53.4	54.7	55.0
Natural gas price							
Ceiling natural gas price, India (Rs/cu m)	3.52	3.20	3.20	3.20	3.20	4.00	4.50
Ceiling natural gas price, India (US\$/mn BTU)	2.12	1.89	2.12	1.87	1.81	2.32	2.61
Net natural gas price, OIL-India (Rs/cu m)	3.16	2.88	2.88	2.88	2.88	3.60	4.05
Net natural gas price, OIL-India (US\$/mn BTU)	1.91	1.70	1.91	1.68	1.63	2.09	2.35
Sales volumes—Domestic fields							
Crude oil (mn tons)	3.1	3.0	3.0	3.4	3.7	3.8	3.9
Natural gas (bcm)	1.7	1.8	1.8	1.7	1.9	2.2	2.9
Total sales (mn toe)	4.7	4.6	4.7	4.9	5.4	5.8	6.5
Total sales (mn boe)	34	34	34	36	39	42	48
Crude oil (%)	67	66	65	68	68	66	60
Natural gas (%)	33	34	35	32	32	34	40

Source: Company, Kotak Institutional Equities estimates

Key assumptions for ONGC, March fiscal year-ends, 2006-2012E

	2006	2007	2008	2009	2010E	2011E	2012E
Macro assumptions							
Rs/US\$ rate	44.3	45.3	40.3	45.8	47.3	46.0	46.0
Subsidy share scheme loss (Rs bn)	119.6	170.2	220.0	282.3	129.2	138.7	178.7
Import tariff on crude oil (%)	5.1	5.1	5.2	0.9	—	—	—
Pricing and volumes assumptions							
Crude price							
Crude price, Bonny Light (US\$/bbl)	57.2	64.8	78.9	83.0	67.5	70.0	75.0
Net crude price, ONGC-India (US\$/bbl)	43.8	46.1	54.2	51.2	50.8	51.8	52.0
Natural gas price							
Ceiling natural gas price, India (Rs/cu m)	3.52	3.20	3.20	3.20	3.20	4.00	4.50
Ceiling natural gas price, India (US\$/mn BTU)	2.12	1.89	2.12	1.87	1.81	2.32	2.61
International operations							
Net natural gas price, OVL-Vietnam (Rs/cu m)	3.1	3.2	2.8	3.2	3.3	3.2	3.2
Net crude price, OVL-Sudan (Rs/ton)	8,118	9,384	10,142	12,136	10,212	10,294	11,021
Net crude price, OVL-Russia (Rs/ton)	8,320	9,633	10,434	12,493	10,488	10,578	11,333
Sales volumes—Domestic fields (a)							
Crude oil (mn tons)	22.5	24.4	24.1	22.9	22.7	24.1	25.4
Natural gas (bcm)	20.5	20.3	20.4	20.5	20.7	20.4	19.9
Sales volumes—Overseas fields							
Crude oil (mn tons)	4.6	5.8	6.8	5.8	5.3	6.0	6.7
Natural gas (bcm)	1.8	2.1	2.0	2.2	2.7	2.9	2.9
Total sales							
Crude oil (mn tons)	27.0	30.2	30.9	28.7	28.1	30.1	32.1
Natural gas (bcm)	22.3	22.5	22.4	22.8	23.4	23.3	22.8
Total sales (mn toe)	46.9	50.3	50.9	49.0	48.9	50.9	52.4
Total sales (mn boe)	342	367	372	358	357	371	383
Crude oil (%)	58	60	61	59	57	59	61
Natural gas (%)	42	40	39	41	43	41	39

(a) Includes ONGC's share of production from joint venture fields.

Source: Company, Kotak Institutional Equities estimates

Profit model, balance sheet, cash model of OIL, March fiscal year-ends, 2006-2012E (Rs mn)

	2006	2007	2008	2009	2010E	2011E	2012E
Profit model (Rs mn)							
Net sales	55,502	53,892	60,819	72,414	76,082	80,982	87,570
EBITDA	26,554	22,292	23,852	28,339	37,142	41,001	45,417
Other income	3,639	5,335	6,770	9,372	7,575	10,175	10,825
Interest	(152)	(151)	(383)	(26)	(38)	(24)	(9)
Depreciation and depletion	(3,314)	(2,595)	(3,093)	(3,768)	(6,654)	(10,480)	(13,877)
Pretax profits	26,728	24,881	27,145	33,916	38,024	40,673	42,357
Tax	(9,347)	(7,406)	(8,538)	(11,910)	(12,739)	(13,691)	(14,427)
Deferred tax	(498)	(1,020)	(707)	(343)	(185)	(134)	30
Net profits	16,883	16,454	17,901	21,663	25,100	26,848	27,960
Earnings per share (Rs)	78.9	76.9	83.6	101.2	110.5	111.7	116.3
Balance sheet (Rs mn)							
Total equity	58,483	68,491	79,330	93,310	136,336	152,653	169,644
Deferred tax liability	7,013	8,033	8,655	8,998	9,184	9,317	9,287
Liability for abandonment cost	10	11	11	15	15	15	15
Total borrowings	3,341	8,140	1,749	565	375	213	—
Current liabilities	11,668	10,320	17,541	30,914	30,171	30,625	31,100
Total liabilities and equity	80,515	94,995	107,286	133,801	176,080	192,823	210,046
Cash	31,015	32,757	42,808	60,700	90,632	98,458	108,352
Current assets	14,540	22,350	18,957	22,853	24,755	25,652	26,859
Total fixed assets	30,658	35,813	40,633	45,361	55,807	63,825	69,948
Investments	4,302	4,075	4,887	4,887	4,887	4,887	4,887
Deferred expenditure	—	—	—	—	—	—	—
Total assets	80,515	94,995	107,286	133,801	176,080	192,823	210,046
Free cash flow (Rs mn)							
Operating cash flow, excl. working capital	19,843	18,357	20,104	27,246	22,115	23,287	24,982
Working capital changes	5,884	(8,696)	7,435	2,368	(2,644)	(443)	(732)
Capital expenditure	(6,108)	(9,370)	(9,492)	(8,496)	(14,851)	(14,498)	(14,000)
Investments	(2,482)	226	(811)	—	—	—	—
Other income	1,670	2,892	4,214	5,470	7,575	10,175	10,825
Free cash flow	18,807	3,409	21,450	26,587	12,195	18,521	21,074
Ratios (%)							
Debt/equity	5.7	11.9	2.2	0.6	0.3	0.1	—
Net debt/equity	(33.1)	(32.8)	(31.9)	(31.9)	(44.3)	(44.4)	(45.5)
RoAE	28.1	23.2	21.8	22.8	20.3	17.5	16.4
RoACE	28.0	23.0	21.5	22.7	20.2	17.5	16.4
Key assumptions							
Rs/dollar rate	44.3	45.3	40.3	45.8	47.3	46.0	46.0
Crude fob price (US\$/bbl)	57.2	64.8	78.9	83.0	67.5	70.0	75.0
Ceiling/actual natural gas price (Rs/'000 cm)	3,515	3,200	3,200	3,200	3,200	4,000	4,500
Subsidy loss (Rs bn)	9.8	19.9	23.1	30.2	17.8	19.5	26.3

Source: Company, Kotak Institutional Equities estimates

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

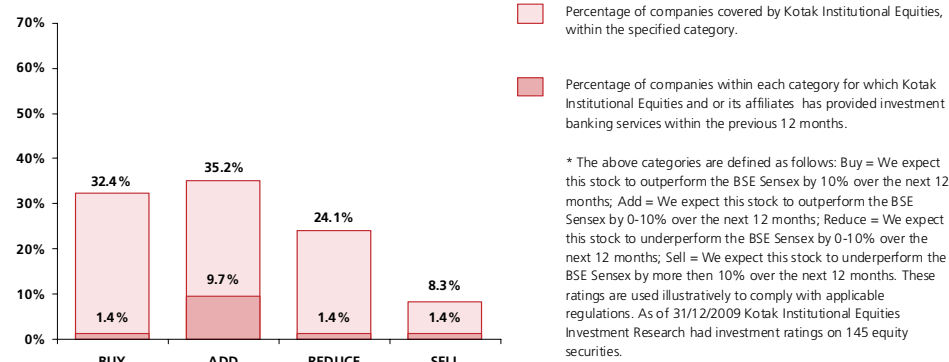
	2006	2007	2008	2009	2010E	2011E	2012E
Profit model (Rs mn)							
Net sales	807,603	966,542	1,091,644	1,200,176	1,002,197	1,063,509	1,175,703
EBITDA	310,054	358,001	407,790	419,527	430,280	464,288	513,470
Other income	27,350	45,378	53,565	56,197	35,529	50,742	67,125
Interest	(537)	394	(12,027)	(11,442)	(3,531)	(352)	(2,346)
Depreciation and depletion	(97,726)	(119,550)	(138,624)	(153,985)	(168,665)	(171,214)	(160,478)
Pretax profits	239,141	284,222	310,705	310,298	293,613	343,463	417,771
Tax	(71,196)	(88,986)	(102,908)	(111,333)	(95,008)	(111,074)	(123,906)
Deferred tax	(13,612)	(9,264)	(6,471)	(3,495)	(3,275)	609	(6,581)
Net profits	154,596	178,414	203,076	201,292	195,330	232,998	287,285
Net profits after minority interests	153,542	176,922	199,466	197,908	192,728	230,654	284,448
Earnings per share (Rs)	71.8	82.7	93.3	92.5	90.1	107.8	133.0
Balance sheet (Rs mn)							
Total equity	578,830	670,137	786,657	929,353	1,030,385	1,148,001	1,302,854
Deferred tax liability	71,557	80,976	87,227	92,076	95,352	94,743	101,324
Liability for abandonment cost	128,675	151,857	129,325	171,451	171,451	171,451	171,451
Total borrowings	28,767	21,826	22,039	73,633	23,377	40,224	114,124
Current liabilities	142,435	187,051	251,797	293,480	279,985	294,567	310,923
Total liabilities and equity	950,264	1,111,847	1,277,045	1,559,994	1,600,551	1,748,986	2,000,676
Cash	90,743	206,262	249,807	224,671	312,178	482,057	663,061
Current assets	240,210	192,652	257,384	309,494	259,814	269,421	285,440
Total fixed assets	565,722	643,219	695,227	871,287	869,079	833,089	887,754
Goodwill	14,172	27,686	22,847	111,108	111,108	111,108	111,108
Investments	35,753	36,888	45,041	36,926	41,866	46,806	46,806
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	1,559,994	1,600,552	1,748,987	2,000,676
Free cash flow (Rs mn)							
Operating cash flow, excl. working capital	216,736	252,772	284,517	274,321	244,876	289,153	317,210
Working capital changes	46,461	(4,990)	(24,929)	(109,306)	27,106	158,040	336
Capital expenditure	(113,738)	(135,049)	(166,427)	(208,137)	(82,265)	(75,767)	(150,909)
Investments	(28,912)	53,822	(7,348)	(92,159)	(4,940)	—	—
Other income	14,537	20,422	22,822	31,612	35,529	50,742	67,125
Free cash flow	135,083	186,976	108,636	(103,668)	220,306	422,168	233,762
Ratios (%)							
Debt/equity	5.0	3.3	2.8	7.9	2.3	3.5	8.8
Net debt/equity	(10.7)	(27.5)	(29.0)	(16.3)	(28.0)	(38.5)	(42.1)
RoAE	25.9	25.5	24.8	21.2	18.2	19.8	21.8
RoACE	22.0	22.1	21.9	18.5	15.9	17.2	19.3
Key assumptions							
Rs/dollar rate	44.3	45.3	40.3	45.8	47.3	46.0	46.0
Crude fob price (US\$/bbl)	57.2	64.8	78.9	83.0	67.5	70.0	75.0
Ceiling/actual natural gas price (Rs/'000 cm)	3,515	3,200	3,200	3,200	3,200	4,000	4,500
Subsidy loss (Rs bn)	119.6	170.2	220.0	282.3	129.2	138.7	178.7

Source: Company, Kotak Institutional Equities estimates

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Distribution of ratings/investment banking relationships



Source: Kotak Institutional Equities

As of December 31, 2009

Ratings and other definitions/identifiers

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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.

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