Company Focus

30 October 2007 | 10 pages

Oil & Natural Gas (ONGC.BO)

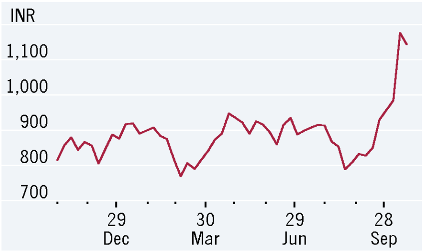
Rating change ☑
Target price change ☑
Estimate change ☑

Buy: Improving Leverage to Crude; Increasing TP to Rs1400

- **2Q results above expectations, increasing TP** — ONGC's 2Q was the best ever with EBITDA growth of 6.2%qoq and PAT 10.6%qoq. While hopes of price reforms remain slim, the not-so-dire financial situation of downstream R&M (post oil bonds) improves visibility for ONGC. We upgrade FY08-09 estimates by 4-20% and introduce FY10E. Our new target of Rs1400 is based on PER of 12x (11x earlier) FY09E, and we change the risk rating to Low from Medium.
- **Net crude realizations improved $5.7/bbl qoq** — Return to 1/3rd sharing formula improved net crude realizations to US$55.9/bbl on ONGC's own crude (US$50.2/bbl in 1QFY08 and US$45.4/bbl in 2QFY07). The "solvent" 1H performance of downstream R&M and pre-announced oil bonds (Rs240bn) indicates sustainability of the sharing formula. Our estimates, however, conservatively assume upstream share to be a tad higher at 35% for FY08-10E.
- **The valuation argument** — While the stock has had a run-up to the results and does not boast of any meaningful production growth, it remains inexpensive (PER of 10x FY09E and EV/EBITDA of 5.0x) relative to peers. At our target price of Rs1400, the imputed EV/EBITDA is a reasonable 6.0x. While the policy overhang on valuations will continue, it is offset by the fact that the peer multiples are on near-peak earnings vs. ONGC's depressed earnings.
- **Risks** — Sharp rupee appreciation, cost over-runs, and extended run of exploration failures are the key risks. Evolving political scenario and the likely impact on FY09 oil bonds allocation could affect the visibility on subsidy.

Buy/Low Risk	**1L**
from Buy/Medium Risk	
Price (30 Oct 07)	Rs1,219.55
Target price	Rs1,400.00
from Rs1,100.00	
Expected share price return	14.8%
Expected dividend yield	3.6%
Expected total return	**18.4%**
Market Cap	Rs2,608,462M
	US$66,297M

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	16.9	4.6	29.5	2.5
2007A	177,696	83.08	15.4	14.7	3.9	29.0	3.0
2008E	221,192	103.42	24.5	11.8	3.3	30.7	3.6
2009E	250,489	117.11	13.2	10.4	2.9	29.6	4.1
2010E	235,107	109.92	-6.1	11.1	2.5	24.1	3.7

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

Fiscal year end 31-Mar	2006	2007	2008E	2009E	2010E
Valuation Ratios					
P/E adjusted (x)	16.9	14.7	11.8	10.4	11.1
EV/EBITDA adjusted (x)	8.4	7.3	5.8	5.0	7.2
P/BV (x)	4.6	3.9	3.3	2.9	2.5
Dividend yield (%)	2.5	3.0	3.6	4.1	3.7
Per Share Data (Rs)					
EPS adjusted	71.99	83.08	103.42	117.11	109.92
EPS reported	71.99	83.08	103.42	117.11	109.92
BVPS	263.70	309.51	364.78	426.54	486.63
DPS	30.00	36.00	44.00	50.00	45.00
Profit & Loss (RsM)					
Net sales	742,341	862,762	962,208	988,237	984,436
Operating expenses	-535,537	-638,486	-667,327	-653,744	-672,853
EBIT	**206,804**	**224,276**	**294,881**	**334,493**	**311,583**
Net interest expense	-1,135	1,058	-1,915	-2,186	-2,129
Non-operating/exceptionals	34,245	52,240	42,045	46,635	46,069
Pre-tax profit	**239,914**	**277,574**	**335,011**	**378,942**	**355,523**
Tax	-84,932	-98,454	-112,564	-127,325	-119,455
Extraord./Min.Int./Pref.div.	-1,006	-1,424	-1,255	-1,129	-961
Reported net income	**153,976**	**177,696**	**221,192**	**250,489**	**235,107**
Adjusted earnings	153,976	177,696	221,192	250,489	235,107
Adjusted EBITDA	304,656	343,953	418,205	465,425	311,583
Growth Rates (%)					
Sales	19.2	16.2	11.5	2.7	-0.4
EBIT adjusted	-1.0	8.4	31.5	13.4	-6.8
EBITDA adjusted	7.9	12.9	21.6	11.3	-33.1
EPS adjusted	6.0	15.4	24.5	13.2	-6.1
Cash Flow (RsM)					
Operating cash flow	**231,783**	**385,721**	**386,373**	**388,229**	**216,500**
Depreciation/amortization	97,852	119,678	123,324	130,932	0
Net working capital	-18,504	92,901	43,410	9,757	-15,492
Investing cash flow	**-151,801**	**-197,369**	**-193,231**	**-188,231**	**-188,230**
Capital expenditure	-143,081	-186,873	-180,000	-175,000	-175,000
Acquisitions/disposals	-232	-253	0	0	0
Financing cash flow	**-99,663**	**-89,476**	**-106,816**	**-117,261**	**-105,365**
Borrowings	-21,630	-6,336	-4,050	-251	-226
Dividends paid	-71,224	-85,468	-104,461	-118,706	-106,836
Change in cash	**-19,681**	**98,877**	**86,325**	**82,736**	**-77,096**
Balance Sheet (RsM)					
Total assets	**926,175**	**1,102,252**	**1,274,191**	**1,427,886**	**1,552,549**
Cash & cash equivalent	109,405	225,104	354,178	466,980	551,260
Accounts receivable	44,271	48,167	65,905	67,687	67,427
Net fixed assets	215,098	249,410	258,496	276,852	292,292
Total liabilities	**354,928**	**431,936**	**484,227**	**504,590**	**499,598**
Accounts payable	57,956	78,824	68,288	70,393	73,086
Total Debt	22,342	16,005	6,118	5,506	4,956
Shareholders' funds	**571,247**	**670,316**	**789,964**	**923,297**	**1,052,949**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	41.0	39.9	43.5	47.1	31.7
ROE adjusted	29.5	29.0	30.7	29.6	24.1
ROIC adjusted	18.9	17.5	24.2	25.9	22.9
Net debt to equity	-15.2	-31.2	-44.1	-50.0	-51.9
Total debt to capital	3.8	2.3	0.8	0.6	0.5

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Earnings Raised

Figure 1. ONGC – Earnings Revisions

Year to	Net Profit (Rs Mils.)		Diluted EPS (Rs)			Div. Per Share (Rs)	
31-Mar	Old	New	Old	New	% Chg	Old	New
2008E	213,195	221,192	99.68	103.42	3.75%	40.00	44.00
2009E	207,424	250,489	96.98	117.11	20.76%	40.00	50.00
2010E	na	235,107	na	109.92	na	na	45.00

Source: Citi Investment Research estimates

Figure 2. Crude realization assumptions (US$/bbl)

Year to 31-Mar	FY07	FY08E	FY09E
ONGC domestic crude – gross realization	54.60	72.64	71.06
Discount on domestic crude	21.21	21.36	17.28
ONGC domestic crude – net realization	33.39	51.28	53.77

Source: Company Reports and Citi Investment Research estimates

The above estimates for ONGC's crude realizations are based on the following macro assumptions on the system-losses in FY08-10. It is important to note two key points:

1. We have assumed the upstream share to be 35% of the gross losses as against 33% in 1HFY08, to be on the conservative side.
2. The quantum of oil bonds required is a residual number required to keep the net under-recovery constant at Rs110bn, same as FY06 levels. We have not used FY07 as the benchmark as the downstream R&M were over-compensated in our opinion.

Figure 3. Downstream Under-recoveries and Sharing Assumptions

Rs bn	FY06	FY07		FY08E	FY09E	FY10E
		Proposed	Actual			
Gross under-recoveries	400	735	593	542	441	288
less: Bonds	115	280	241	242	177	77
less: Upstream contribution	140	240	205	190	154	101
less: Refineries sharing	30	15	9			
less: Price hike & Duty Cuts		90	90			
Net under-recovery	115	110	48	110	110	110
Upstream as a % of under-recoveries	35%	33%	35%	35%	35%	35%
Upstream as a % post-hike	na	37%	41%	35%	35%	35%

Source: Citi Investment Research estimates

Key Highlights from 2QFY08

Figure 4. ONGC- 2QFY08 Results (Rupees In Millions)

Year to 31-Mar	2QFY07	1QFY08	2QFY08	yoy	Comments
Net sales	**140,686**	**136,877**	**154,139**	**9.6%**	Led by higher sales volumes as well as higher effective realisation
Inc/dec in stock	253	(359)	(872)	-444.1%	
Raw material cons	16,994	13,913	16,987	0.0%	
Staff cost	6,274	2,543	3,668	-41.5%	
Statutory levies	29,816	28,991	31,973	7.2%	
Other expenditure	16,950	12,566	18,230	7.5%	Higher oil services cost during the quarter
Exp	(70,287)	(57,654)	(69,986)	-0.4%	
Operating profit	**70,398**	**79,223**	**84,153**	**19.5%**	
Interest	(41)	(48)	(305)	643.7%	
Depreciation	(18,473)	(17,546)	(19,871)	7.6%	
Other income	9,397	8,388	12,100	28.8%	Increase due to MRPL dividend, higher cash balance + higher interest
Profit before tax	61,282	70,018	76,077	24.1%	
Tax	(19,542)	(23,913)	(25,102)	28.5%	
Tax Rate	*31.9%*	*34.2%*	*33.0%*		
Reported Net Profit	**41,740**	**46,105**	**50,975**	**22.1%**	

Source: Company Reports and Citi Investment Research

Figure 5. ONGC- Key Operational Parameters

Year to 31-Mar	1QFY07	2QFY07	3QFY07	4QFY07	1QFY08	2QFY08	Comments
Crude production (MMT)	6.93	6.85	7.13	7.03	6.88	7.00	Steady production trend
Gas production (bcm)	6.42	5.70	6.44	6.35	6.10	6.35	Up on a yoy basis due to Gujarat floods in 2QFY07
Crude sales (MMT)	6.11	5.96	6.23	6.11	5.90	6.13	
Crude sales (Rs m)	97,220	98,060	109,710	79,600	94,260	105,650	
Bonny Light (US$/bbl)	71.4	71.6	62.1	60.4	71.8	78.0	Higher international prices
Subsidy discounts (US$/bbl)	26.4	26.2	11.3	24.8	21.6	22.1	Subsidy more or less flat on 1/3rd formula
ONGC's net realisation ($/bbl)	45.0	45.4	50.9	35.6	50.2	55.9	Highest ever net realization on ONGC owned fields
Gas sales (bcm)	5.31	4.58	5.24	5.17	5.03	5.19	
Gas sales (Rs m)	18,730	16,630	18,970	18,710	17,940	18,330	
Gas realisation (Rs/tcm)	3,527	3,631	3,620	3,619	3,567	3,532	Likely to improve once Government okays gas price hike

Source: Company Reports and Citi Investment Research

Figure 6. Global E&P – Valuation Comps

Company Name	RIC Code	Rating	Mkt cap (US$m)	Share price 30-Oct-07	Target price	P/E (x) FY08E	P/E (x) FY09E	EV/EBITDA FY08E	EV/EBITDA FY09E
Emerging Integrateds									
Lukoil	LKOH.RTS	2L	75,700	89.0	3,639	9.5	10.1	6.6	6.7
Gazprom	GAZP.RTS	1L	288,343	12.2	590	13.1	10.7	8.8	7.5
Rosneft	ROSN.RTS	2L	93,052	8.8	358	17.5	16.9	10.3	10.3
Petrobras	PBR.N	--	120,391	94.9	na	16.0	14.5	2.7	2.7
PetroChina	0857.HK	2L	453,191	19.6	88	22.6	22.0	13.0	12.7
Sinopec	0386.HK	1L	25,289	11.7	69	16.6	15.9	2.9	2.9
CNOOC	0883.HK	2L	94,227	16.6	76	23.1	19.8	13.9	12.3
CNPC (HK)	0135.HK	1H	4,188	6.7	33	13.5	12.3	13.9	12.2
CITIC Resources	1205.HK	3M	3,391	5.0	26	64.2	21.1	38.1	8.7
ONGC	ONGC.BO	1M	66,297	1,219.6	1,400	11.8	10.4	5.8	4.9
PTT E&P	PTTE.BK	2L	16,809	161.0	223	16.0	13.5	7.0	5.7
OGDC	OGDC.KA	2M	8,812	124.4	89	11.0	10.5	6.8	6.3
Woodside	WPL.AX	2M	33,951	53.5	2,071	59.6	60.3	14.8	10.7
Santos	STO.AX	2M	7,740	14.3	588	29.3	28.6	5.8	5.6
Average						**19.0**	**17.7**	**10.0**	**9.2**
North American E&P									
Anadarko Petro	APC.N	1H	27,166	58.3	2,439	14.7	13.6	5.9	5.1
Apache	APA.N	2H	33,191	100.0	3,502	14.1	11.0	5.3	4.9
Canadian Nat'l	CNQ.TO	1H	43,204	76.4	3,713	17.9	16.7	7.9	7.1
Chesapeake	CHK.N	1H	18,401	38.9	1,771	13.0	10.0	5.6	4.9
EOG	EOG.N	3H	20,790	84.9	2,833	21.3	18.1	8.5	7.2
Forest	FST.N	1H	4,154	47.2	2,085	20.8	17.8	7.2	6.5
Nexen	NXY.TO	2H	16,811	30.4	1,238	12.8	12.5	5.4	5.0
Noble	NBL.N	2H	12,630	73.8	2,597	15.0	12.9	6.5	6.0
Pioneer	PXD.N	1H	6,122	49.7	2,007	26.8	18.4	9.0	6.4
Talisman	TLM.TO	2H	20,866	19.5	990	14.8	10.4	4.8	3.5
XTO	XTO.N	2H	25,113	65.1	2,597	15.0	15.7	7.2	6.0
Average						**16.0**	**13.9**	**6.5**	**5.7**

Source: Citi Investment Research estimates. Powered by dataCentral.

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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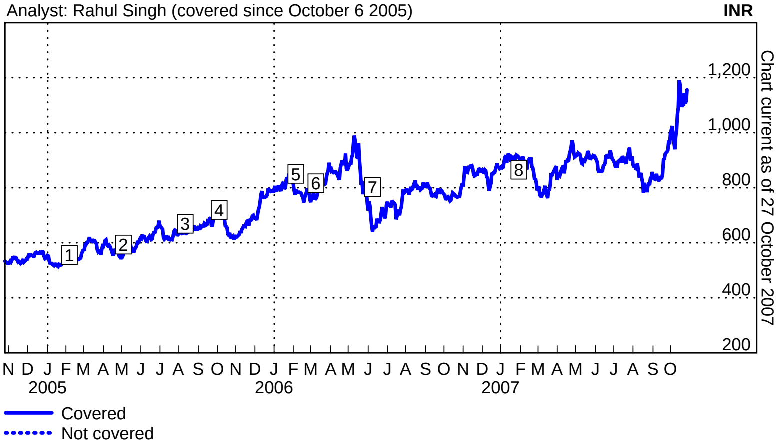
Oil & Natural Gas (ONGC.BO)

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

*Indicates change.

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