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Informed Investor

A retail investor's take on the Indian stock markets

Will monsoons rain on India's parade?

While the developed world reeled under the impact of the banking crisis, our policy makers remained smug in the belief that the Indian economy would grow at a healthy rate.

The predicted failure of the monsoons could yet prove the optimists wrong. The past 12 years of bountiful rains must not deter us from the fact that the Indian agriculture sector is still very much a gamble on the monsoons.

Should the monsoons still not pick up in the coming weeks, the government would be forced to divert resources to stave off rural distress.

Industry can then very well kiss goodbye to hopes of additional sops.

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Investment Idea

Cairn India

Should Employees' PF Buoy the Markets?

If the Finance Ministry's proposals to invest part of employees' provident fund in the markets go through, it would bring about a sea-change in the way social security is administered in India.

For the first time, India's organized workforce that was saddled with the limited returns offered by fixed income securities stand to enjoy the benefits of a booming economy. Unfortunately, there is also a proportionate increase in the element of risk that the provident fund corpus of employees would be exposed to.

Later this week, the trustees of the Employees Provident Fund Organization (EPFO) will sit to decide on the suggestion of the Finance Ministry. On the agenda is possible investment of up to 15 per cent of the Rs 1,82,000 cr corpus of the EPFO. If it goes through as much as Rs 25,000 cr will be available for deployment in the markets.

The UPA government may have been emboldened by the fact that it does not have to lean on the crutches of the Left parties to get such a proposal passed. Two years ago, the left parties vetoed a proposal to invest five per cent of the provident fund corpus in the markets.

The argument given then was that the hard-earned money of thousands of employees would be deployed on the whims and fancies of hot-shot fund managers with no proportionate guarantee of returns.

Since then, the National Pension Scheme has been pushed through under which prominent fund managers have been brought on board to handle contributions from investors mainly in the unorganized sector. It is too early to judge the performance of the NPS' experiment with the markets since it is barely underway.

However UTI's Unit 64 fiasco should be a pointer to what could happen when greedy fund managers collude with corrupt government officials. There is always a risk that employees' life-long savings may be used by promoters of shady companies to prop up dud stocks.

The end of the last bull-run showed that even mutual fund schemes run by some reputed fund houses were saddled with absolute lemons. Unfortunately, even strict criteria mandating investment in index stocks may not help the employees. Case in pointer is the number of over-leveraged real estate stocks featuring in several indices.

The banking crisis in the US and other developed markets have also shown the huge element of risk employees' retirement funds are subjected to if left at the mercy of the markets. Unlike in these developed countries, retirees and senior citizens in India do not even enjoy minimum social security thereby accentuating the risk they stand to face in case of adverse market conditions.

However one cannot entirely debunk the views of those backing the proposals. For one, returns on the employees provident fund corpus have been unsustainable in a low-interest rate scenario. In such a case, the government may be forced to dip into the exchequer to make up for the short-fall between the returns promised to employees and the earnings on the provident fund corpus.

Should the proposal go through its success then will depend on the risk-mitigating techniques that are sought to be put in place to protect employees' interests. ■

BSE: 532792
NSE: CAIRN
CMP (BSE): Rs 234.00

P/E (TTM): 975.0
ROCE: 3.5
ROE: 4.9
Dividend Yield: 0.0
52Wk H/L(Rs) 284.75/88.15
Debt/Equity: 7.3 (FY 10E)
3 Yr CAGR Sales (%): N.A
3 Yr CAGR Profit (%): N.A

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Here Comes the Gusher!

From a purely speculative stock, Cairn India has moved up to be a definitive play on India's oil E&P sector as the company begins to produce first oil from its Rajasthan oil fields.

Even while work continues on the pipeline that will transport oil from the company's oil fields in Rajasthan to the refinery in Gujarat, the company has arranged to transport crude to the refinery via rail lines. It has already commenced dry runs for transportation of oil and announcement of regular production will be made any day now.

For investors looking for a play on an Indian oil company, Cairn India appears to be a better bet compared to ONGC, the only other similar player in the field. Though a far smaller player compared to ONGC, Cairn does not have the disadvantages of being a public sector enterprise that is forced to subsidize loss making government-owned companies in the petroleum sector.

The company which is already producing oil from the Ravva oil fields will see bumper production from its new Rajasthan fields. Though Cairn has projected production to the tune of 1,75,000 barrels per day, analysts expect output to rise to more than 200,000 bpd by FY13.

In such a scenario, Cairn is expected to account for around 22 per cent of India's total domestic oil production and save nearly US $ 7 bn in foreign exchange.

Negotiations between Cairn India's management and the government over various regulatory issues like the grading and pricing of the oil have already been resolved and final agreements with state-owned oil companies have almost been completed.

The oil from Cairn's Rajasthan wells are likely to be priced 10 to 15 per cent lower to Brent, higher than earlier estimated. Another plus for Cairn is that ONGC its partner in the Rajathan block has agreed to spend US$1.01 bn in capex after dilly-dallying on the matter.

However Cairn may also be liable to pay a cess on oil profits at the rate of Rs 2575 per ton. Though a negative, the matter has reportedly gone in for arbitration. Of longer term impact to Cairn will be the international price of crude which have shown extreme volatility in the past months.

Investor Analysis

Investment Rationale

Cairn's performance directly co-relates with the price of international crude. Investment in Cairn is effectively a bet on global oil prices remaining at high levels in perpetuity.

According to different analysts, Cairn at its current price discounts crude at US $ 60 per barrel. This does not take into account further upsides from exploration success and implementation of Enhanced Oil Recovery (EOR) techniques to improve the quantity of oil extracted from existing wells.

The Street expects oil to rule in excess of US $ 85 per barrel in a few years' time as the global economy comes out of the recession. This would substantially increase the upside on Cairn. According to estimates by Goldman Sachs a US$1/bbl change in crude prices would impact Cairn's earnings by nearly 4.1 per cent.

With oil output reaching peak production by FY 12/13, Cairn is expected to write down much of its debt which now exceeds Rs 4200 cr. By then the company is also expected to put in place a dividend policy.

Cairn also stands to gain from further successes in its E&P efforts. It has already obtained approval from the government for Declaration of Commerciality (DOC) in case of three discoveries made in Kameshwari West 2, 3 and 6 along with a new development area of 822 sq km that is part of the Northern Appraisal area.

The discoveries in Kameshwari West 2 and 3 have extended the company's assets in Rajasthan. Further surprises on the upside may be possible from the Raageshwari fields that are presently undergoing exploration.

Downside Risks

Demand for oil fell slightly in 2008 from 2007 levels. The current financial year too is not showing any signs of improvement. This has already had an impact in Cairn's Q409 results.

However one hopes things improve when the company's crude output goes on stream.

Though Cairn India Ltd rises and falls with global crude prices, it is a stock I would hold for the long-term. ■

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