INITIATING COVERAGE

Cairn India Limited — Hold

Uncertainty on discovery of new oil reserves

Cairn India Limited (CIL) is an independent oil and gas Exploration and Production (E&P) company focusing on operations in India. With E&P interests in 15 blocks, large hydrocarbon reserves and resources (more than 3.6 bnboe), strategic relations with ONGC and the Government of India (GOI) as its main customer, CIL has a potential to leverage its investment into large returns. Additional investment in Enhanced Oil Recovery (EOR) techniques will increase yields and prolong the life of existing reserves. However, all the above information has been assimilated into the current stock price and any significant increase would be based on positive news like discovery of large new reserves and/or higher realization per barrel.

Share Data

Market Cap	Rs. 278.5 bn
Price	Rs. 156.6
BSE Sensex	14964.12
Reuters	CAIL.BO
Bloomberg	CAIR IN
Avg. Volume (52 Week)	1.36 mn
52-Week High/Low	Rs. 157.7/111
Shares Outstanding	1778.4 mn

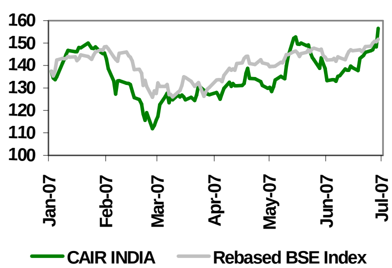
Valuation Ratios

Year to 31 December	2007E	2008E
EPS (Rs.)	1.5	1.2
+/- (%)	NM	(21.2)%
PER (x)	106.5x	135.2x
EV/ Sales (x)	21.3x	22.0x
EV/ EBITDA (x)	46.3x	49.0x

Shareholding Pattern (%)

Promoters	69
FIIs	11
Institutions	15
Public & Others	6

Relative Performance



Key Figures

Year to December	CY06	CY07E	CY08E	CY09E	CY10E	CAGR (%)
(Figures in Rs. mn, except per share data)						(CY06-09E)
Net Sales	387	11,958	11,583	32,324	79,165	278.1%
EBITDA	(66)	5,492	5,192	25,275	63,685	NM
Net Profit	(187)	2,615	2,061	15,567	40,733	NM
Margins(%)						
EBITDA	(17.1)%	45.9%	44.8%	78.2%	80.4%	
NPM	(48.2)%	21.9%	17.8%	48.2%	51.5%	
Per Share Data (Rs.)						
Normalised EPS	(0.1)	1.5	1.2	8.8	22.9	NM
PER (x)	NM	106.5x	135.2x	17.9x	6.8x	

- The company realized Rs. 1.8 bn in cash flow from operations for Q1 FY07, its first quarter of operation as an independent company.
- Due to expected production of 150,000 bbl/day in CY10, revenue is expected to increase by 278.1% from CY06 to CY10E.
- At the current price the stock is trading at a CY07E PE of 106.5x, CY08E PE of 135.2x, CY09E PE of 17.9x and CY10E PE of 6.8x. Current P/E for industry peers like ONGC and ENI India Ltd is 12.1x and 11.4x respectively. CIL's forward CY09E P/E aligns with industry P/E range when the company starts production from its oil fields in Rajasthan.
- Given the fundamental analysis and relative valuation, we feel that the stock is fairly valued with potential to increase in case of any new oil discoveries and increase in oil prices. Hence, we initiate coverage on CIL with a Hold.

Rationale

Large Resource base

CIL has had a strong track record of finding oil and gas every year since 1998. The company is actively participating in exploring and producing activities of all known oil fields in the country. Therefore, there is a probability of finding productive oil wells in the future.

The company has working interests in the following oil and gas fields-

CIL's Working interests in Rajasthan oil fields

Oil and gas fields in Rajasthan account for more than 90% of CIL's 2P reserves with a net working interest of 472 mmboe. Field Development Plans (FDP) for Mangala, Bhagyam, Aishwariya, deep Raageshwari gas, Saraswati and Raageshwari oil have been approved or submitted. Mangala, the largest oil field by reserve initially in place, is estimated to arrive online by 2010. The above fields account for about 2.2 bnboe of CIL's hydrocarbons reserve initially in place. There are 11 other fields in this block that are being explored or developed with a potential 1.4 bnboe initially in place.

CIL's stake in oil fields located in Gujarat

In addition to the current oil and gas producing fields in block CB/OS-2 (Lakshmi and Gauri gas fields) of Cambay basin, CIL is in various stages of exploring and developing CB-ONN-2002/1 and GS-OSN-2003/1 blocks.

CIL's interests in south eastern part of the country

Apart from the current productive Ravva field, CIL is exploring KG-DWN-98/2 and KG-ONN-2003/1 blocks. CIL has also secured interests in PR-OSN-2004/1 and KK-DWN-2004/1 during NELP VI.

CIL's exploration activities in the North East

Current CIL's exploration activity in the Himalayan foreland basin consists of GV-ONN-2002/1, GV-ONN-2003/1 and VN-ONN-2003/1.

Enhanced Oil Recovery (EOR) program

Squeezing oil fields for more oil

CIL is investigating implementation of slightly advanced recovery techniques to its most productive oil fields. Successful application could increase output and life of the reserves. Two techniques being considered are Polymer flooding and Alkaline-Surfactant-Polymer (ASP) flooding.

Polymer flooding is a mature and low cost process. It could increase recovery by 10% over traditional water flooding method.

ASP flooding technique is still being tested in laboratories and pilot oil fields around the world. The process is complex, expensive and takes longer to implement, but provides 25% incremental reserves over other methods.

Strong financial position

Comfortable cash flow position to service debt and ability to borrow for expansion

Riding the wave of high oil prices during Q1 FY07, CIL was able to realize USD 42.25/boe on average at a production cost of USD 6/bbl resulting in Rs. 1,801 cash flow from operations. This was based on a working interest production of 19,811 boepd from Cambay basin fields and Ravva fields.

At its peak, production from Barmer basin fields alone is expected to reach 150,000 boepd. Additional investment in EOR techniques is expected to prolong the production for several years. Despite volatility in oil prices, efficient operations will keep production costs low and allow CIL to enjoy significant profit margins.

CIL has been able to secure credit facilities totalling USD 850 mn and raise USD 600 mn via IPO during December 2006. Access to both internal and external funds has positioned CIL to expand and grow.

Government's decision prevents delay in production

Installation pipeline near the fields rather than a MRPL owned refinery near the fields

Recent decision by the GOI, allowing CIL to install pipelines from reserves in Barmer basin, notably Mangala, to Virangam in Gujarat cleared up the uncertainty regarding distribution of oil production from RJ-ON-90/1. This pipeline will provide access to 75% of the refining capacity in the country. Indications are that MRPL (Mangalore Refineries and Petrochemical Ltd, a subsidiary of ONGC and GOI nominee for off take from Rajasthan fields) is not interested in purchasing the entire output from Mangala. As a result, installation of pipeline provides CIL access to non-MRPL refineries and ability to sell at non-Production Sharing Contract (PSC) rates.

The cost for the project will be apportioned in the same proportion as the working interests in the fields (70% CIL, 30% ONGC). Approval by GOI indicates that the cost can be included in FDP and would be recoverable under the PSC.

Another significance of this decision is adherence to the schedule of producing and distributing first oil from Mangala in 2009.

Key Risks

Payment of Oil Industry Development Act (OIDA) cess

Uncertainty surrounds payment and amount of OIDA cess

GOI has notified CIL that the company is required to pay OIDA cess on oil produced from the Rajasthan block. CIL currently estimates the principal cess amount to be between Rs. 900 per metric tonne and Rs. 2,500 per metric tonne. The company also acknowledges that the actual amount could be higher than Rs. 2,500 per metric tonne. In addition, CIL will be required to pay 2% on the principal OIDA cess for educational cess and Rs. 50 per tonne in the form of NCCD. Since the details of cess were not included in the PSC, CIL intends to arbitrate this charge. Higher cess amount will negatively affect net profit.

Future exploration efforts unable to provide necessary returns

Risky exploration activities may not pay off

CIL focuses on exploring and developing acreage in India. Over time, reserves that are easily explored, developed and produced will diminish. Extensive investment in terms of technology and manpower will be required to find new hydrocarbon reserves. Given the uncertainty in the amount of oil discovered, these high investments may not payoff and the company may suffer significant losses.

Mismatch in oil prices between estimated value and PSC value

Volatility of oil prices and lag between fixing sale price and making investment decision creates significant risk

Investment in development of Rajasthan fields is based on CIL's estimated price of crude oil much earlier than PSC determined price. PSC price depends on the mix of crude oil basket approximating the quality of oil drilled, market prices of the basket of oil at the time of PSC price determination and negotiation with the GOI nominee. If the PSC price fixed is lower than the estimated price, the company may not recover the capital expenditure for the project as expected. This may affect cash flows negatively retarding investment in future positive net present value projects. Consequently, stock price may be affected negatively.

Outlook

CIL is a relatively small player in the Indian oil and gas E&P industry, but has a good potential for growth. Currently a significant amount of CIL's reserves are in the Rajasthan block with 19 fields discovered. Some of these fields are amongst the largest reserves discovered in the country in a decade. A large number of these fields are at various stages of development and a clearer picture will emerge after proper evaluation of discovered fields. Along with ONGC, CIL is actively exploring for potential reserves in the south east, north east, central, west and south west parts of the country. 2007 exploration activity includes 13-15 wells and 4-5 seismic programmes.

CIL estimates that the India has 26 basins, most of which are under explored. Hence, the company has chalked out a strategy to expand its exploration activities through organic growth, acquisition opportunities and participation in future NELP rounds.

We expect revenues to grow at a CAGR of 278.1% from CY06 to CY10E on account of 150,000 bbl/day expected production in CY10. However, we feel that the stock is fairly valued with potential to increase in case of any new oil discoveries. Hence, we initiate coverage with a Hold.

Company Background

Cairn India Limited was incorporated in December 2006 and is promoted by Cairn Energy PLC. CIL acquired all of the ownership and operated interests in Cairn Energy PLC's Indian crude oil and natural gas development and production assets and majority of its Indian crude oil and natural gas exploration assets.

CIL has 22.5% interest in block PKGM-1, 40% in block CB/OS-2 and 70% in block RJ-ON-90/1. Block CB/OS-2 consists of Lakshmi and Gauri gas fields while RJ-ON-90/1 consists of Mangala, Aishwariya, Saraswati, Raageshwari oil, Raageshwari deep gas, Bhagyam and Shakti.

The company's total gross proved plus probable (2P) reserves attributable to the fields in production or under development in which Cairn India has interests to be 754 mmboe and its net working interest in these 2P reserves to be 472 mmboe.

CIL intends to expand its operations by further exploring existing properties, acquiring suitable E&P outfits and bidding for new acreage along with larger local E&P companies.

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