ONGC

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BUY

Rs901

July 11, 2007

Market cap	
Rs bn 1,285	
US$ bn 32	
Avg 3m daily volume	
1,219,066	
Avg 3m daily value	
USD mn 27	
Shares outstanding (mn)	
1,426	
Reuters	
ONGC.BO/ONGC.NS	
Bloomberg	
ONGC IN	
Sensex	
14,911	
Nifty	
4,387	

Shareholding (%)

Promoters	*74.1*
FII's	*8.7*
MFs	*1.3*
Insurance Co.	*3.1*
Others	*12.8*

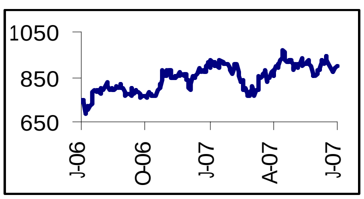
Share price performance

52-week high/low (Rs) 990/680

	-1m	-3m	-12m
Abs (%)	5.6	2.3	21.3
Rel* (%)	-0.2	-11.3	-19.5

*to Nifty

Stock chart



Non-recurring expenses subdue profitability

ONGC's profitability came under pressure in Q4FY07; during the quarter, the company's net margins fell to 18% from 21%YoY and 30%QoQ. This was as the result of one-time provisioning for staff cost and higher discounts on sale of crude and other products.

We believe that OVL, a 100% subsidiary of ONGC, which has operations in Sakhalin, Sudan, and Syria, will be the future growth driver for ONGC. OVL's production has increased by 25% YoY to 7.95 MTOE for FY07. ONGC's stock is trading at 9.7x FY09E EPS of Rs 93.10 and 5.1x EV/EBITDA FY09E. We remain positive on the stock considering the valuation discount to domestic and international peers; our view is also supported by the triggers of significant reserve accretions, higher gas price realisations, and lower subsidy discounts . We maintain our "BUY" rating on the stock.

- **Net sales up by 4% YoY but down 20% QoQ:** ONGC's net sales increased YoY primarily due to higher volumes of crude oil sales that increased by 7% to 6.11MMT in Q4FY07. The growth in sales was adversely affected by higher discounts offered to oil marketing companies on sales of crude oil, LPG, and SKO. The discounts increased by 37% YoY and 112% QoQ to Rs46,680mn in Q4FY07; this translated into a discount of $23.63/bb for the quarter.
- **Operating profits fall by 34% YoY and 50% QoQ to Rs44bn:** ONGC's EBITDA margins declined from 57% in Q4FY06 to 36% in Q4FY07(PLEASE CHECK). This was due to higher staff cost, statutory levies, and other expenditure, besides the increase in discounts on sales. The staff cost increased by more than 2x YoY and QoQ due to the inclusion of one-time payments and provisions of Rs12,870bn for post-retirement benefits and golden jubilee incentives. The statutory levies were higher by 55% YoY due to an increase in cess on crude oil from Rs1,800 per MT in FY06 to Rs2,500MT in FY07.
- **Other income increases by more than 2x YoY and QoQ to Rs21,789mn:** ONGC received a one-time sum of Rs11,600mn from GAIL on account of the surplus in gas pool a/c. The company also received interest income from loan disbursed to OVL for a period of 9 months in FY07.
- **Net profits down by 13% YoY and 43% QoQ:** ONGC's net profit for Q4FY07 fell to Rs26,817mn, from Rs30,858mn in Q4FY06 and Rs46,685mn in Q3FY07. The profits were impacted by a steep rise in staff cost due to a one-time expense of Rs12,870mn, higher statutory levies, and crude

discounts of Rs46,680mn. The fall, however, was cushioned by higher other income and extraordinary gains in terms of claims accrued on BHN platform fire.

Key Investment Highlights

Reserve accretion improves Reserve replacement ratio

ONGC has positively surprised the market by achieving the highest Initial In-place (IIP) Accretion of 169MTOE (1,243mn barrels) in the past 10 years. As a group, ONGC has recorded an ultimate reserve accretion of 80.29MTOE with 65.56MTOE coming from ONGC operated fields, 4.77MTOE from domestic J/V(PSC), and 9.96MTOE from Overseas JV.

With a production of 48.49MTOE in FY07, ONGC was able to attain a Reserve Replacement Ratio (RRR) of 1.35x. This is much higher than the company's average RRR of 0.50x for the past three years. The management has also indicated a low finding cost of $1.5/bbl for FY07, with 22 discoveries including 13 new pools. The company had been plagued by concerns of not adding a major find during the past years. This reversal in trend signals positive development for the company and may improve market sentiments, resulting in the re-rating of the stock.

Gas pricing to unlock value

As per the recommendation of the Tariff Commission, the producer price of APM gas needs to be revised to Rs3,600scm(2.21/mbtu) from the present Rs3,200scm(1.97/mbtu). The time of implementation is not yet certain. Nevertheless, since 90% of the present gas volume sold by the company is of APM category, the potential upside from the de-regulation would be significant.

New find – KG DWN-98/2 Block

As per media reports, the block contains estimated reserves of 2-14tcf of natural gas. DGH is yet to approve the commerciality and the quantum of reserves. With the exploration of block still in progress, a revision of current estimates resulting in potential upside cannot be ruled out.

Subsidy sharing in Rupee denomination

In the near future, the Government of India is expected to announce a package for the oil industry in respect of subsidy sharing. The package would indicate the amount to be shared by various oil industry players for FY08. The company expects that the subsidy shared by it in form of discounts will be on Rupee denominated price of crude instead of USD. This is likely to protect ONGC's profitability from volatility in exchange rates.

ONGC

Table 1. Quarterly comparison of sales volume, value and discounts

Sales volumes	Q4FY07	Q4FY06	YoY (%)	Q3FY07	QoQ (%)
Crude oil (MMT)	6.11	5.70	7%	6.23	-2%
NG (BCM)	5.17	5.10	1%	5.24	-1%
LPG (MMT)	0.26	0.30	-12%	0.28	-6%
Naphtha (ARN) (MMT)	0.40	0.40	-1%	0.39	3%
C2 C3 (MMT)	0.14	0.10	41%	0.15	-5%
Sales value (Rs mn)					
Crude oil	79,600	85,650	-7%	109,710	-27%
NG	18,710	16,680	12%	18,970	-1%
LPG	3,000	2,600	15%	3,910	-23%
Naphtha	10,110	8,790	15%	9,290	9%
C2C3	2,350	1,660	42%	2,370	-1%
Discounts					
Rs mn	46,680	34,069	37%	22,040	112%
$/bbl	23.63	18.43		10.75	

Source: IISL research, company

Table 2. Quarterly result table

Rs mn	Q4FY07	Q4FY06	YoY (%)	Q3FY07	QoQ (%)
Net Sales	123,969	118,983	4%	155,645	-20%
(Increase)/Decrease in Stock-in-trade	209	(2,090)	110%	(513)	141%
Purchases (Trading)	12,542	7,571	66%	13,788	-9%
Consumption of raw materials	894	2,365	-62%	1,617	-45%
Staff expenditure	15,548	5,027	209%	5,020	210%
Statutory Levies	28,392	18,275	55%	30,582	-7%
Other Expenditure	22,238	20,579	8%	16,057	38%
Total Expenditure	79,823	51,727	54%	66,551	20%
Operating profit	44,146	67,256	-34%	89,094	-50%
Other Income	21,789	6,298	246%	7,044	209%
PBIDT	65,935	73,554	-10%	96,138	-31%
Depreciation	28,637	31,573	-9%	25,575	12%
EBIT	37,298	41,981	-11%	70,563	-47%
Interest	65	323	-80%	76	-14%
Profit before Tax	37,233	41,658	-11%	70,487	-47%
Provision for Tax	15,166	17,205	-12%	23,802	-36%
Profit After Tax	22,067	24,453	-10%	46,685	-53%
Extraordinary items	4,750	6,405	-26%	-	
Net Profit	26,817	30,858	-13%	46,685	-43%
No of Shares	2,139	1,426		2,139	
EPS	12.5	21.6		21.8	
Key ratios %					
Gross margin	66%	78%	-15%	71%	-7%
Employee cost to sales	13%	4%	197%	3%	289%
EBITDA margin (%)	36%	57%	-37%	57%	-38%
EBIT margin (%)	30%	35%	-15%	45%	-34%
Effective Tax Rate (%)	41%	41%	-1%	34%	21%
Net Profit Margin (%)	18%	21%	-13%	30%	-41%

Source: IISL research, company

ONGC

Valuations

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