September 11, 2008 | **Morning Note**

	BSE	NIFTY
Close	14663	4400
Change	-238.15	-68.45
52 Week High / Low	21207/12514	6357/3790

Sectoral Indices	Days' close	Previous close	P/E
Automobiles	3665	3688	11.83
Capital Goods	14589	14729	28.86
Cement	7017	6982	7.42
FMCG	3639	3647	22.03
Infotech	3291	3296	17.44
Construction	16303	16496	31.40

Other Markets	Close	Change
Dow Jones	11269	38.19
FTSE 100	5366	-49.40
Nasdaq	2229	18.89

Trade Data 10/09	BSE	NSE
Turnover (Rs. bn)	51.86	119.88
Change	5.99	15.85
Adv/ Dec/ unchanged	11/21/1	15/41/1
	Buying	Selling
FII's (Rs. bn) 08/09	33.56	25.98
MF's (Rs. bn) 08/09	7.13	6.13

Interbank Closing	Close	Change
Rs/US $	45.14	-0.31
Rs/UK £	79.34	-0.34
Rs/EURO	63.74	-0.27

Commodity Prices	Close	Change
Crude ($/Bbl)	102.58	-0.68
Copper ($/tn)	6860	-65
Gold Std (Rs/10GM)	11640	-190
Silver (Rs/Kg)	18600	-400
Aluminium ($/tn)	2555	-15
Zinc ($/tn)	1696	-8

ADR / GDR	Latest	Previous	Change
Infosys	39.19	38.45	0.74
ICICI Bank	31.17	30.24	0.93
Wipro	11.30	11.32	-0.02
Tata Motors	9.38	9.37	0.01
Satyam	21.49	21.25	0.24
Dr. Reddy's	12.43	12.65	-0.22
HDFC Bank	88.66	86.94	1.72

10 year G-Sec yield : 8.4%

FOCUS OF THE DAY

OIL & NATURAL GAS (ONGC)

CMP (Rs): 1076.60
Mkt Cap(Rs Bn): 2303
Mkt Cap ($ Bn): 517

Imperial acquisition at reasonable price but has no near term benefit

ONGC Videsh (OVL), the wholly owned subsidiary of ONGC, has made an offer to acquire 100% of Imperial Energy Corp (Imperial) an oil E&P company with assets in Russia and Kazakhstan for USD 2.59 Bn (Stock 1250 pence/share and convertible bonds), subject to regulatory approvals by the Russian government.

ONGC seems to have paid a reasonable price at USD 2.8/boe for Imperial against the average valuation of Russian peers at USD 2.5/boe, mainly considering the potential upside to the reserve accretion through Imperial. However as per the management, Russia has one of the toughest fiscal regimes with manifold tax (extraction tax, corporate tax @24%, export tax as high as 75%) and generally trades at 5~10% discount to Brent crude. These taxes and discounts keeps the net realization under check at about USD 25 ~ 30/bbl.

We believe, given the support of Imperial's management, OVL's presence in Sakhalin, Russia, and India's cordial relations with the Russian Government, approvals may come through. However, this is not expected to be a near term trigger as we believe that Imperial's financials are unlikely to impact ONGC's financials in the medium term given the size of ONGC's balance sheet and profits. We note that the main issue for ONGC is the clarity on subsidy sharing more than any thing else in the medium term, which alone would drive the stock price.

Though oil price keeps sliding, if the political noise is anything to go by the petro price roll back is very likely, thus leaving the subsidy burden intact even in the falling oil price scenario. Also the refusal by private refiners to subsidise oil, OMCs unable to shoulder further subsidy and considering India's fiscal deficit that is already around 7%, we expect the incremental subsidy burden to be borne by ONGC.

We have oil price assumption of USD 100/bbl & USD 80/bbl for FY09E and FY10E. We estimate the upstream's share in subsidy at Rs 460 bn & Rs 230 bn in FY09E & FY10E. Accordingly, our subsidy estimates for ONGC is at Rs 382 bn & Rs 194 bn for FY09E and FY10E. We expect the net realizations for ONGC to be at $50.9/bbl and $54.6/bbl in FY09E & FY10E. Though ONGC management is confident of its share in subsidy coming down from about 28% to about 15~18% (as is the case for Q1FY09), we expect with any fall-in crude oil prices, the absolute subsidy burden of Rs 380 bn will be maintained and not reduced. At 10.2x FY10E EPS and $7.2 EV/boe, the stock is attractive. With modest production and realization growth, remote chances of a gas price hike and risk of subsidy increase, we maintain the Underperformer rating on the stock at a target price to Rs 972 (11% downside). Only exploration successes (considering the large acreage in the highly prolific KG basin), positive pronouncements from the government on deregulation in gas prices or a reduction in subsidy burden, will enthuse us to upgrade our rating to an Outperformer.

Impact analysis on ONGC

BK Chaturvedi's recommendation of ceiling upstream players' realization at USD 75/bbl

As per media reports, upstream players could earn a maximum realization of USD 75/bbl for crude oil and any price above that would go to the government in the form of special oil tax for pre-NELP blocks. It also means that the upstream companies do not have to share the subsidy burden. ONGC's most producing blocks belong to pre-NELP rounds. Historically, its net realization (after giving out discounts/subsidy) has been hovering in the band of USD 40-54/bbl in the past. We believe net crude oil realisaton of USD 75/bbl can give a huge kicker (about 37% to Rs 144) to ONGC's earnings in FY10E.

	FY05	FY06	FY07	FY08	Q109
Net realisation in USD/bbl	39.3	43.8	46.1	52.3	69.1

A move from trade parity related pricing to export parity related pricing

As of now, when a refiner sells its petro products to OMCs, it is billed on import parity pricing, which means, freight and insurance components are included to arrive at the final product price. These are notional costs and it increases the under recovery for the industry. In trade parity pricing 80% weight is assigned to IPP and 20% to export parity pricing. The government, with a view to bring down its estimated subsidy burden from Rs 2,450 bn to Rs 2,000 bn is considering a move to export parity pricing. This move could be negative for refiners as their GRMs could come under pressure. However, RIL exports about 65% of its produce; so we expect the impact on such a move to be marginally negative to neutral. For upstream companies like ONGC, OIL & Gail, it probably means that subsidy burden may not go up from Rs 450 bn (ONGC's share has been capped at Rs 380 bn)

Our View

While a move to the above two could only be positive for ONGC, we believe its implementation could be a challenge. Though oil price keeps sliding, if the political noise is anything to go by the petro price roll back is very likely, thus leaving the subsidy burden intact even in the falling oil price scenario. Also the refusal by private refiners to subsidise oil, OMCs unable to shoulder further subsidy and considering India's fiscal deficit that is already around 7%, we expect the incremental subsidy burden to be borne by ONGC.

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The Imperial Acquisition - at reasonable price but has no near term benefit

- Imperial has 2P (Proved and possible) reserves of 920mn boe (94% is oil) and additional contingent and risk reserves of ~ 600 mn boe. ONGC's 2P oil reserve could increase by 20%.
- Imperial produces about 2300 bpd and has plans to ramp up its capacity to 25,000 bpd by CY08 and to 80,000 bpd by CY11. The expansion is expected to cost USD 600 Mn; however Imperial is completely funded for this, post the equity rights issue in April this year.
- ONGC Videsh (OVL), the wholly owned subsidiary of ONGC, has made an offer to acquire 100% of Imperial Energy Corp (Imperial) an oil E&P company with assets in Russia and Kazakhstan for USD 2.59 Bn (Stock 1250 pence/share and convertible bonds), subject to regulatory approvals by the Russian government.
- ONGC seems to have paid a reasonable price at USD 2.8/boe for Imperial against the average valuation of Russian peers at USD 2.5/boe, mainly considering the potential upside to the reserve accretion through Imperial. However as per the management, Russia has one of the toughest fiscal regimes with manifold tax (extraction tax, corporate tax @24%, export tax as high as 75%) and generally trades at 5~10% discount to Brent crude. These taxes and discounts keeps the net realization under check at about USD 25 ~ 30/bbl.

Imperial Financials

	CY06	CY07	% Chg
Total Production (bpd)	353	2316	557
Total oil sales (US$ mn)	3.1	19.9	542
Operating loss (US$ mn)	-15.2	-39	157
Average realized price (US $/bbl)	24.4	33.4	37

Imperial reserve estimates as of end-2007

(mboe)	**1P**	**2P**	**3P**
Oil	146	864	3307
Gas	29	56	99
Imperial	**175**	**920**	**3406**

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Russian Oil major valuation comparison

	2P Reserves (mboe)	EV (USD bn)	EV/boe
Gazprom	141,724	279	2.0
Rosneft	34,910	104	3.0
Lukoil	32,700	64	2.0
Novatek	7,562	22	2.9
Gazprom Neft	7,433	27	3.6
Tatneft	8,196	11	1.4
Imperial Energy	920	3	2.8

Results for Q1 FY09

Particulars	Q1FY08	Q4FY08	Q1FY09	% YoY chg	% QoQ chg
Net sales	136,877	156,261	200,522	46.5	28.3
Other income	8,388	20,337	10,500	25.2	(48.4)
Total Income	145,265	176,598	211,022	45.3	19.5
Total Expenditure	57,654	98,494	82,847	43.7	(15.9)
(as % of sales)	42.1	63.0	41.3		
Inc/(dec) in stock in trade	-359	382	-61	(83.1)	(115.8)
Purchases	12,942	21,870	25,177	94.5	15.1
Consumption of raw materials	971	2,468	2,468	154.2	0.0
Total material cost	13,554	24,720	27,585	103.5	11.6
(as % of sales)	9.9	15.8	13.8		
Staff expenditure	2,543	1,630	2,897	13.9	77.7
(as % of sales)	1.9	1.0	1.4		
Statutory levies	28,991	33,802	31,353	8.1	(7.2)
(as % of sales)	21.2	21.6	15.6		
Other expenditure	12,566	38,342	21,013	67.2	(45.2)
(as % of sales)	9.2	24.5	10.5		
Operating profit excluding OI	79,223	57,767	117,675	48.5	103.7
Operating profit including OI	87,611	78,104	128,175	46.3	64.1
Interest	48	123	38	(19.8)	(69.1)
Gross profit	87,563	77,980	128,137	46.3	64.3
Depreciation	17,546	38,445	27,970	59.4	(27.2)
Profit before tax	70,018	39,536	100,167	43.1	153.4
Provision for taxation	23,913	13,265	34,117	42.7	157.2
Profit after tax	46,105	26,271	66,050	43.3	151.4
Net Profit	46,105	26,271	66,050	43.3	151.4
Earning per share	22	12	31	45.3	151.4
CEPS	30	30	44		
Ratios (%)					
OPM (excl OI)	57.9	37.0	58.7		
OPM (incl OI)	60.3	44.2	60.7		
Interest/Sales	0.0	0.1	0.0		
GPM	60.3	44.2	60.7		
Tax/PBT	34.2	33.6	34.1		
NPM	31.7	14.9	31.3		

Results for Standalone & Consolidated FY08

	Standalone			Consolidated		
Particulars Rs mn	**FY07**	**FY08**	**YoY%**	**FY07**	**FY08**	**YoY%**
Net Sales	566,328	598,485	5.7	822,529	967,824	17.7
Other income	42,431	50,107	18.1	47,527	45,541	(4.2)
Total Income	608,759	648,592	6.5	870,056	1,013,365	16.5
Inc/Dec in stock	197	-1,141	(678.4)	-9,815	-1,101	(88.8)
As % of Sales	0.0	-0.2	(647.3)	-1.2	-0.1	
Consumption of raw material	3,928	6,817	73.6	192,445	251,803	30.8
As % of Sales	0.7	1.1	64.2	23.4	26.0	
Purchase of traded goods	59,401	65,115	9.6	0	1	
As % of Sales	10.5	10.9	3.7	0.0	0.0	
Employees cost	29,818	11,454	(61.6)	30,705	13,285	(56.7)
As % of Sales	5.3	1.9	(63.7)	3.7	1.4	
Other expenditure	183,504	215,432	17.4	253,192	299,499	18.3
As % of Sales	32.4	36.0	11.1	30.8	30.9	
Total expenditure	276,848	297,677	7.5	466,526	563,486	20.8
Operating profit	331,912	350,915	5.7	403,530	449,879	11.5
Interest	215	590	174.3	1,906	1,135	12.4
Gross profit	331,697	350,325	5.6	401,625	448,744	11.4
Depreciation	94,994	97,979	3.1	124,153	139,533	(40.4)
Profit before tax	236,702	252,346	6.6	277,472	309,211	(4.2)
Provision for taxation	80273	85329	6.3	99,776	106,999	16.5
Paid up equity capital	21389	21389		21,389	21,389	
EPS	73.14	78.09		83.08	94.54	
Profit after tax	156429	167017	6.8	177,696	202,211	7.2
Ratios (%)						
OPM (excl OI)	62.9	67.6		43.3	41.8	
OPM (incl OI)	58.6	58.6		49.1	46.5	
GPM	58.6	58.5		48.8	46.4	
Tax/PBT	33.9	33.8		36.0	34.6	
NPM	27.6	27.9		21.6	20.9	

Valuation Summary

Y/E Mar, Rs mn	**FY2006**	**FY2007**	**FY2008**	**FY2009E**	**FY2010E**
Net Sales	706,808	822,615	935,823	955,398	989,687
Core EBIDTA	324,469	372,380	404,338	388,678	416,051
EBIDTA margins, %	45.9	45.3	41.8	40.7	42.0
Net profit	150,333	171,496	198,723	201,836	227,476
EPS, Rs	72	83	93	94	105
EPS Growth, %	7.4	15.4	11.8	0.7	12.7
PER, x	15.0	13.0	10.6	11.5	10.2
EV/EBIDTA, x	4.7	5.8	5.1	5.3	4.2
EV/Net Sales, x	2.1	2.6	2.3	2.2	1.4
Price/Book Value, x	2.7	3.5	3.0	2.6	1.8
ROE, %	26.7	25.9	27.9	26.5	27.6
Dividend Yield, %	4.2	2.8	2.8	3.2	3.0