Deep Industries

Buy

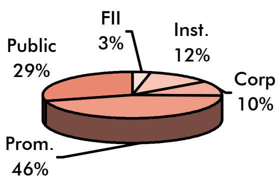
Price	Rs160
Target Price	**%upside**
Rs209	31↑
Market Capitalisation	
Rs3,193mn	(US$80mn)
52 week range H/L (Rs)	271/42
Shares o/s (mn)	**Daily vol (3m avg)**
20.0	0.23
Reuters	**Bloomberg**
DEIN.BO	DEEPI IN

Perfm(%)	**1M**	**3M**	**12M**	**YTD**
Absolute	(24.8)	(14.2)	186.4	(32.9)
Rel. to Sensex	(20.8)	(6.4)	127.8	(24.6)

BSE Sensex	**Nifty**
18,048	5,277

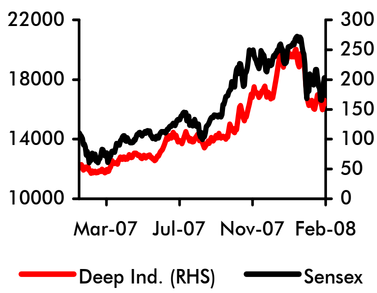
Source: Bloomberg

Shareholding pattern



Source: Capitaline

Price performance



Source: Capitaline

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AMBIT
Acumen at work

'Deep' in the money

Deep Industries (DIL) is India's largest provider of gas compression services. Expansion into work-over rigs has enlarged its portfolio of services and helped the company forge ahead in its vision of becoming an integrated oil service provider. Forward integration into exploration and production of gas, through Coal Bed Methane (CBM) and development of marginal fields, would propel the company into a higher growth trajectory once monetisation of the reserves begin circa 2010. We initiate coverage on the company and recommend a BUY with a 12-month target price of Rs209.

Investment Rationale

Leveraging on robust macro fundamentals: With an existing portfolio of fourteen gas compressors, four being added in the current financial year, the company is expected to add another two compressors, strengthening its position as the largest provider of gas compression services domestically. In addition to its presence in this segment, DIL is ramping up its fleet of work-over rigs. Operating with a fleet of three work-over rigs, the company is expected to take delivery of three 100 ton (T) rigs by the end of Q4FY08.

Forward integration a gutsy, but logical move: Having been allotted two blocks in the CBM-III round in 2006, namely Godavari (A.P) and Singrauli (M.P), the company has forayed into exploration and production of oil & gas. This move has been further reinforced by the awarding of three marginal fields by ONGC to DIL. Given the fact that reserves have already been established in these blocks, we believe monetisation of the same would materialise by FY10E.

Earnings to multiply ~4.5x by FY10E: We expect gas production from CBM (2.4mmscmd) and marginal fields (50k scmd) to materialise by FY10E with peak production to be achieved by FY16E. Traction from these businesses would be the key growth driver for the company going forward, with contribution of 30% and 44% to the topline and bottomline respectively by FY10E. On account of this, we estimate that the consolidated net profits would jump ~4.5x over FY08E-FY10E.

We have valued the company based on sum-of-the-parts (SOTP) valuation methodology, indicating a fair value of Rs209, which we believe the stock would start factoring in over the next 12 months.

Key financials

YE March (Rs mn)	FY07	FY08E	FY09E	FY10E
Total income	83	238	622	1,007
Gross profit	30	95	280	523
Net profit	8	65	152	291
EPS (Rs)	0.3	3.0	6.3	12.0
Debt/ Equity (x)	0.1	0.1	0.1	0.2
EBIDTA margin(%)	36.8	39.9	45.0	52.0
EV/EBIDTA	129.4	41.5	14.1	7.5
P/E (x)	633.5	54.0	25.4	13.3
RoE (%)	1.2	7.3	10.8	15.7
RoCE (%)	4.4	8.0	15.2	20.4

Source: Company, Ambit Capital Research estimates

Risks and Concerns

Lack of experience in Exploration & Production a constraint: DIL's core competency lies in providing gas compression and work-over rig services to E&P players. However, with the company having gained substantial experience in the oil services space, has made a foray into gas production through CBM and marginal fields. This presents the company with a significant opportunity to scale up in size. However, due to low management bandwidth in terms of experience and financial muscle, it also exposes the company to execution risks. Having said that, we believe that the company would be able to scale up its presence in this segment on account of

- Relatively lower risk in production from CBM and marginal fields as reserves are already established.
- Experience of running work-over and drilling operations one of the key constituents in the production of oil & gas. The company's core ability lies here

Also, given the fact that the company is in the final leg of obtaining Environmental Clearance (EC) for both its CBM blocks, delays on this front could defer cashflows and hence impact earnings.

Pricing risks exist: The company's revenues are a function of the day rates that are prevalent in the market place, which in turn are dependant upon the level of exploration activity being witnessed. Given the current exploration scenario domestically, day rates have been at the top end of the curve. Though we believe that this trend is expected to continue in the foreseeable future, fixing up of contracts at lower day rate or utilisation than those assumed by us would negatively impact earnings. Also significant pricing risk exists in the exploration segment as well. Lower gas price realisation / higher operating cost would have a significant negative impact on the earnings of the company.

Equity dilution risk: DIL, in a preferential allotment in Q3FY08, issued 2mn shares to promoters and others, the dilution representing 10% of the pre-diluted equity of the company. Going forward, the management has indicated its willingness to further dilute equity to partly fund its expansion in CBM (capex of Rs4.3bn). We have factored in an additional dilution of 10% of its equity in FY09E to reflect infusion of capital to fund its expansion plans. Any furthur increase in dilution, than assumed by us, would negatively impact our fair value (per share) of the company.

Interest rate risk on account of increased leverage: DIL's expansion plans, which includes acquisition of three work-over rigs, two gas compressors and development and production of CBM and marginal fields, would entail a capex of ~Rs4.5bn over the next 3-4 years. The funding for the same would primarily be done by internal accruals and debt. Any interest rate increase, therefore, could negatively impact earnings.

Upside Triggers

Significant exploratory upside : We believe that significant exploratory upside exists, particularly from the marginal fields in Northern Rajasthan that have been allotted to the company by ONGC. To put the potential upside in perspective, these blocks are very close (~65kms away) to the blocks of Focus Energy, which has struck gas reserves to the tune of 6 trillion cubic feet (tcf) in the same basin. Any potential discovery would propel the company into one of the significant gas producers in the region.

Potential order book build up: The company has currently bid for three separate gas compression contracts, floated by ONGC, which would involve a total capex commitment of Rs245mn. Given the fact that these are still at the evaluation stage (with EOI being sent out), we have not factored the same in our estimates. Any positive outcome from the same could boost earnings to that extent.

Key financials

Balance sheet

Year to March (Rs mn)	FY06	FY07	FY08E	FY09E	FY10E
Cash & equivalents	25	8	197	239	132
Debtors	21	21	59	153	176
Inventory	11	33	59	141	160
Fixed Assets	140	263	601	1,546	1,951
Other assets	100	476	366	94	92
Total assets	**297**	**801**	**1,281**	**2,172**	**2,511**
Interest bearing debt	28	62	62	311	346
Other liabilities	73	88	103	152	164
Total liabilities	**101**	**149**	**164**	**463**	**509**
Shareholders' equity	87	200	220	242	242
Reserves & surpluses	110	452	897	1,467	1,759
Total networth	**197**	**652**	**1,117**	**1,709**	**2,001**
Net working capital	52	61	298	467	391
Net debt/ (cash)	3	54	(135)	73	214

Source: Company, Ambit Capital Research estimates

Income statement

Year to March (Rs mn)	FY06	FY07	FY08E	FY09E	FY10E
Net sales	73	83	238	622	1,007
% growth	*(8.2)*	*13.3*	*187.7*	*161.7*	*62.0*
Operating expenses	42	52	143	342	484
Operating profit	**31**	**30**	**95**	**280**	**523**
% growth	*29.0*	*(1.0)*	*211.8*	*195.2*	*87.1*
EBIDTA margin (%)	42.1	36.8	39.9	45.0	52.0
Depreciation/ amortization	9	10	19	37	78
EBIT	22	21	76	243	445
EBIT margin (%)	30.0	24.8	31.9	39.0	44.2
Net interest	7	7	7	22	41
Non-operating/ exceptional items	10	0	30	10	10
Pre-tax profit	25	14	98	230	414
Tax	2	6	33	78	124
Net profit	**23**	**8**	**65**	**152**	**291**
% growth	*114.0*	*(65.8)*	*729.0*	*133.9*	*91.2*
Net profit margin (%)	31.4	9.5	27.4	24.4	28.9

Source: Company, Ambit Capital Research estimates

Cash flow statement

Year to March (Rs mn)	FY06	FY07	FY08E	FY09E	FY10E
EBIT	22	21	76	243	445
Other Income	10	0	30	10	10
Depreciation/ amortization	9	10	19	37	78
Interest paid	(7)	(7)	(7)	(22)	(41)
Tax paid	(2)	(6)	(33)	(78)	(124)
Net working capital	(32)	(27)	(48)	(127)	(30)
Others	(5)	(34)	2	2	4
Operating cash flow	**(5)**	**(43)**	**38**	**63**	**342**
Capital expenditure	(65)	(188)	(249)	(982)	(483)
Investments	7	(271)	0	271	0
Investing cash flows	**(58)**	**(458)**	**(249)**	**(711)**	**(483)**
Increase/ (decrease) in borrowings	(3)	34	0	250	34
Issuance of equity	58	450	400	440	0
Dividend paid	(0)	0	0	0	0
Financing cash flow	**54**	**484**	**400**	**690**	**34**
Net change in cash	(8)	(17)	189	42	(106)
Closing cash balance	**25**	**8**	**197**	**239**	**132**

Source: Company, Ambit Capital Research estimates

Ratio analysis

(%)	FY06	FY07	FY08E	FY09E	FY10E
EBIDTA margin	42.1	36.8	39.9	45.0	52.0
Net profit margin	31.4	9.5	27.4	24.4	28.9
Return on equity	14.1	1.2	7.3	10.8	15.7
Return on capital employed	11.8	4.4	8.0	15.2	20.4
Debt to equity (x)	0.2	0.1	0.1	0.1	0.2
Current ratio (x)	1.7	2.0	3.6	4.7	4.2

Source: Company, Ambit Capital Research estimates

Valuation parameters

	FY06	FY07	FY08E	FY09E	FY10E
EPS (Rs)	2.5	0.3	3.0	6.3	12.0
Cash earnings per share (Rs)	3.6	0.9	3.8	7.8	15.2
P/E (x)	63.1	633.5	54.0	25.4	13.3
P/CEPS (x)	43.8	180.0	41.9	20.4	10.5
EV/ EBIDTA (x)	128.2	129.4	41.5	14.1	7.5
Dividend per share (Rs)	0.4	0.0	0.0	0.0	0.0
Dividend payout (%)	20.0	0.0	0.0	0.0	0.0

Source: Company, Ambit Capital Research estimates

Industry Overview

Depleting reserves + non-core activity outsourcing = Opportunity for DIL

Depleting reserves coupled with outsourcing of non-core activities by leading E&P players to create significant opportunities for smaller players such as DIL

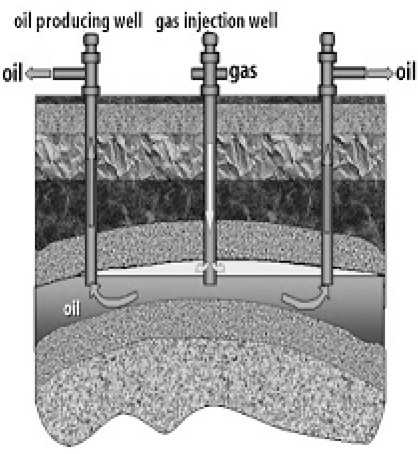
Onshore crude contributes over 36% to India's total hydrocarbon production, thereby assuming significant importance. Years of under-investment in the sector, coupled with ageing of the wells, has prompted E&P companies to employ extensive enhanced oil recovery techniques to arrest the decline from these fields. Though the process involved in using these techniques increases lifting costs substantially, record high crude oil prices have made this a viable option. Traditionally, independent E&P companies, along with their core activity of prospecting, development and production of oil & gas, used to undertake activities related to the allied oil services. However, with the opportunity cost of engaging in these non-core activities increasing (mainly on account of high oil prices), independent producers have shifted to outsourcing of these activities to enhance efficiency and reduce capital costs.

This fundamental shift has created a phenomenal opportunity for companies engaged in providing such ancilliary services. From a buyer's market, the benign scenario has transformed the market into a seller's paradise, resulting in day rates for such services increasing manifold.

Though a fair amount of this growth seems to have been factored in by the market, we believe that pockets of opportunity exist within this space, particularly in companies which are undergoing a shift in their business model, from being a single service specialist to an integrated service provider.

Gas compression presents significant opportunity

Well prdn enhancement technique through gas compression



Source: Industry sources

Over the life of an oil or gas well, natural reservoir pressure and deliverability typically decline as reserves are produced. As the natural reservoir of the well declines below the line pressure of the gas gathering or pipeline system used to transport the gas to the market, gas no longer flows naturally into the pipeline. It is at this time that compression equipment is applied to economically boost the well's production levels and allow gas to be brought to the market. Macro fundamentals suggest that gas compression is set for some interesting times ahead, driven primarily by

- Large proportion of ageing wells, leading to reduction in the well-head pressure
- Robust growth in demand for crude oil, with expected CAGR growth of 10% over the 2007-10E
- Aggressive expansion of gas pipelines, from the current ~8,000kms to ~20,000kms over the next few years
- Continuous focus of domestic E&P players on core activities, and outsourcing of compression services

Deep Industries poised to exploit this opportunity

Starting off as a provider of gas compression services to E&P players, DIL has ramped up its presence in this segment with a current fleet of 14. The company is expected to add another couple of gas compressors to its fleet by Q1FY09, thereby taking its portfolio size to 16. The current order book of the company stands at Rs 646mn, with a yearly revenue potential of Rs246mn, translating into an execution period of 2.6 years. With an asset life of 25-30 years, and contracts typically ranging from

1-3 years, we have modeled a realisation escalation of 10% every 3 years, with cost escalation of 5% every year once the current contracts expire. Given the benign energy scenario, we believe that placing of assets would not be a challenge for the company.

Gas compressor details

Operator	No. of compressors	Capacity (HP)	Project site	Mfg year	Contract start date	Contract end date	Cost (Rs mn)	Yly rev. (Rs mn)
ONGC	3	3,600	Mehsana	1999	11-Jul-07	10-Jul-09	79.3	68.62
GACL	4	1,800	Dahej	2003-07	1-Jan-08	1-Jan-09	22.5	13.20
ONGC	3	1,245	Rajamundry	2006	8-Feb-06	7-Feb-08	80.0	37.05
ONGC	3	1,250	Assam	2007	18 months		95.0	51.64
Assam Gas Company (AGC)	1	1,200	Assam	2007	1-Nov-07	31-Oct-09	25.4	15.77
GSPL	2	2,400	Gujarat	2008	1-Jun-08	31-May-13	122.0	60.00

Source: Company

Using the recent contract with GSPL as the benchmark, we have also tried to analyse and compare the profitability of adding new assets into the company's portfolio viz a viz an existing contract. What is evident from the table below is the fact that expansion at the right time has enabled the company to enjoy superior returns in excess of 20%. We reckon, further expansion would ensure more normalised returns ranging between 15%-18%, asset inflation being the primary drag.

Expansion at an opportune time has helped DIL generate superior return ratios. Expansion, from hereon, could marginally depress returns

Gas compression economics

(Rs'000)	New –GSPL	Old –AGC
Cost of compressor (1200HP)	61,000	25,400
EBIDTA margins (%)	45	40
No. of operating days in a year	365	365
% utilisation	100	100
EBIDTA	13,500	6,307
Depreciation (@4.5%)	2,745	1,143
EBIT	10,755	5,164
Tax rate (%)	34.0	34.0
Cashflow	9,843	4,551
ROCE (%)	17.6	20.3
Day rate (Rs per day)	82,192	43,200
Payback period (yrs)	*6.2*	*5.6*

Source: Ambit Capital Research

Sensitivity of payback period (yrs) with Day Rate (LHS) and utilization (%)

	80%	90%	100%
Rs 80,000	7.7	7.0	6.4
Rs 90,000	7.0	6.3	5.7
Rs 100,000	6.4	5.7	5.2

Source: Ambit Capital Research

Sensitivity of RoCE (%) with Day Rate (LHS) and utilization (%)

	80%	90%	100%
Rs 80,000	12.7	14.9	17.0
Rs 90,000	14.9	17.3	19.7
Rs 100,000	17.0	19.7	22.4

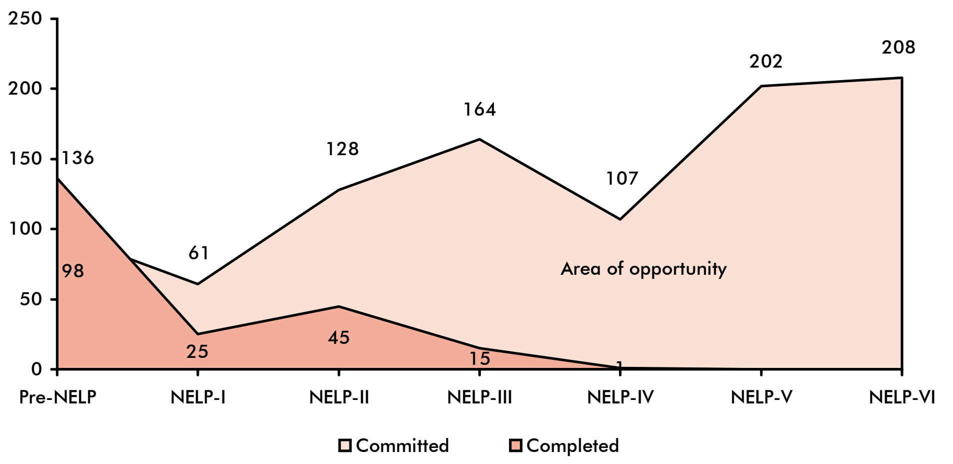
Source: Ambit Capital Research

Expansion into Work-over rigs to be value accretive

Having established its presence in the gas compression segment, DIL has diversified into providing work-over services to E&P players through its fleet of three rigs. This fleet size is expected to increase to six once the company takes delivery of three 100T work-over rigs by Q4FY08. Unlike drilling rigs, which are required at the hydrocarbon prospecting stage, work-over rigs, also called well servicing rigs, are required during the entire life-cycle of the well. Services which include well maintenance, completion etc, are essentially aimed at prolonging the life of an oil and/or gas well, thereby improving the well's recovery rate. Introduction of the NELP program, which brings with it a minimum work program for development of bidded blocks, concomitant with aging of existing wells, has provided the stimulus for increased demand of rig services (both drilling and work-over) domestically.

Minimum work commitment from blocks offered in NELP rounds to keep the rig market buoyant

NELP Minimum Work Programme: Well-drilling



Source: Ambit Capital Research

We believe, the work commitment backlog of the blocks from the various NELP rounds would keep the rig service market buoyant in the foreseeable future. To put this opportunity in perspective, the Directorate General of Hydrocarbon (DGH) expects over 126 wells to be drilled over the next five years, which in turn translates into increased demand for not only drilling rigs, but also work over services to ensure efficient utilisation of the well. Having said that, significant amount of supply is expected to enter the market. Though demand is robust enough to absorb this supply, ROIs in our view would be under pressure going forward.

DIL, with just one 100T work-over rig in May-05, has added a 30T (being upgraded to a 50T) and a 50T rig, post the IPO, at a total capital cost of Rs65mn. Currently, two of its rigs i.e. 100T and 30T have been deployed on contract basis, while the 50T rig is being used to exploit opportunities in the spot market, where day rates are 40%-50% higher than term day rates.

3 new 100T rigs to be added by the end of Q4FY08

Existing fleet

Work over rig	Total Cap (ton)	Operator	Project site	Contract start date	Contract end date	Cost (Rs mn)	Yly Rev (Rs mn)
WOR-1	100	ONGC	Rajamundry	10-Nov-06	9-Nov-08	89	49
WOR-2	30	ONGC	Ahmedabad	10-Mar-07	9-Sep-08	23	12
WOR-3	50	-	-	Deployed in spot mkt		43	-

Source: Company

Assumptions

	100T			30T			50T		
	FY08E	FY09E	FY10E	FY08E	FY09E	FY10E	FY08E	FY09E	FY10E
No. of rigs (nos)	1	1	1	1	1	1	1	1	1
No. of days in year (days)	365	365	365	365	365	365	365	365	365
Rig total availability in year (days)	365	365	365	365	365	365	365	365	365
Rig utilisation (days)	365	351	329	356	345	329	0	351	310
Rig unutilised in year (Days)	0	14	37	9	20	37	365	14	55
Rig utilisation (%)	100	96	90	98	94	90	0	85	85
Day rate (Rs/day)	135,068	135,068	148,575	31,507	31,507	34,658	80,000	80,000	88,000

Source: Company, Ambit Capital Research

Future expansion to dilute returns marginally

Going forward, the company at a total cost of Rs480mn has placed an order for 3 work-over rigs, delivery of which would be made by March '08. We have modeled these future deliveries into our earnings estimates to understand the impact on profitability from this business segment. **Assuming a day rate of Rs180,000 and peak utilisation at 95% for the new 100T rigs, our analysis of the profitability of this division suggests that the return on these new assets would dilute the ROIs' generated by the old assets**. We have also assumed a 10% increase in day rates every three years, with cost escalation of 5% every year for the entire life of the asset.

Work-over rig economics

(Rs'000)	New	Old
Cost of rig (100T)	160,000	89,022
LT operating cost	81	60
EBIDTA margin (%)	55.0	55.0
% utilisation	95.0	95.0
EBIDTA	34,328	25,759
Dep. (@4.5%)	7,200	4,006
EBIT	27,128	21,753
Tax rate (%)	34.0	34.0
Cashflow	25,104	18,363
ROCE (%)	17.0	24.4
Day rate (Rs per day)	**180**	**135**
Payback period (yrs)	6.37	4.85

Source: Company, Ambit Capital Research

Future deliveries

	Total Capacity (ton)	Cost (Rs mn)	Assumed yearly revenues (Rs mn)
WOR-4	100	160	62
WOR-5	100	160	62
WOR-6	100	160	62

Source: Company, Ambit Capital Research

Assumptions - WOR 4/5/6

	FY09E	FY10E	FY11E
No. of rigs (nos)	3	3	3
No. of days in year (days)	365	365	365
Rig total availability in year (days)	365	365	365
Rig unavailability in year (Days)	91	18	18
Rig utilisation (days)	274	347	347
Rig utilisation (%)	75.0	95.0	95.0
Day rate (Rs/day)	180,000	180,000	180,000

Source: Company, Ambit Capital Research estimates

Sensitivity of RoCE (%) with Day Rate (LHS) and utilizn (%)

	80%	90%	100%
Rs 150,000	10.6	12.4	14.3
Rs 180,000	13.6	15.8	18.1
Rs 210,000	16.6	19.2	21.8

Source: Ambit Capital Research

Sensitivity of payback (yrs) with Day Rate (LHS) and utilizn (%)

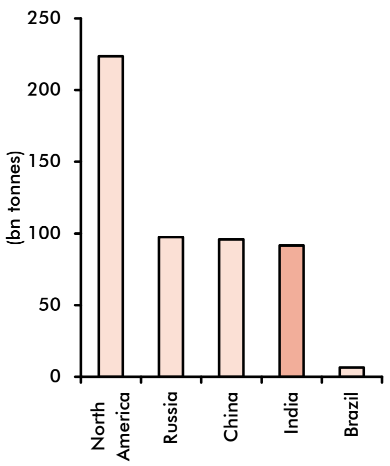
	80%	90%	100%
Rs 150,000	8.7	7.9	7.2
Rs 180,000	7.4	6.7	6.1
Rs 210,000	6.5	5.8	5.3

Source: Ambit Capital Research

Coal Bed Methane (CBM)

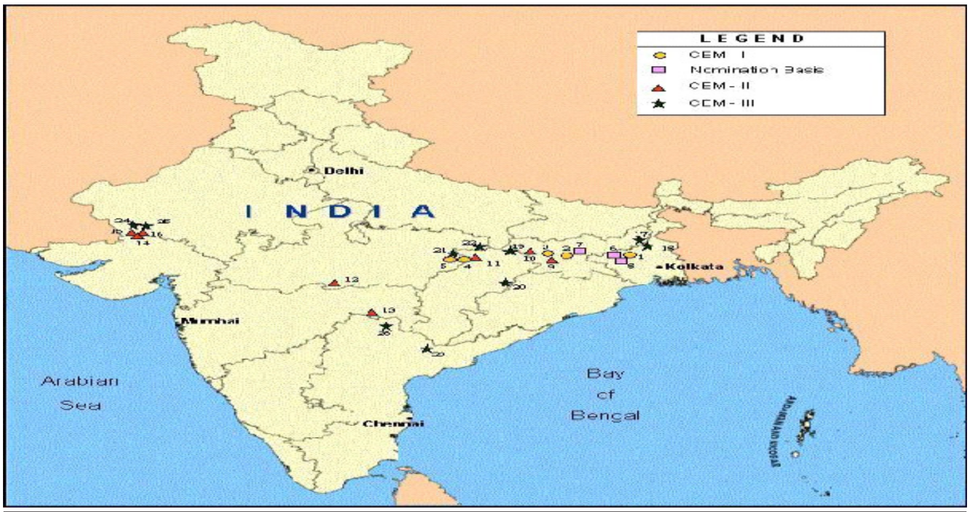
The government, in order to harness energy from unconventional sources launched the CBM program in 1997, with the first round held in 2001 which included five blocks on offer. Subsequent to this, two more rounds of CBM blocks have been held, with a total of 18 blocks being awarded and cumulative in-place reserve of 45.8tcf. Given the fact that India has the fourth largest proven coal reserves globally, it is estimated that the country holds 162 tcf of CBM resources in 44 major coal and lignite fields.

India has fourth largest proven coal reserves



Source: India Infrastructure

CBM blocks on offer

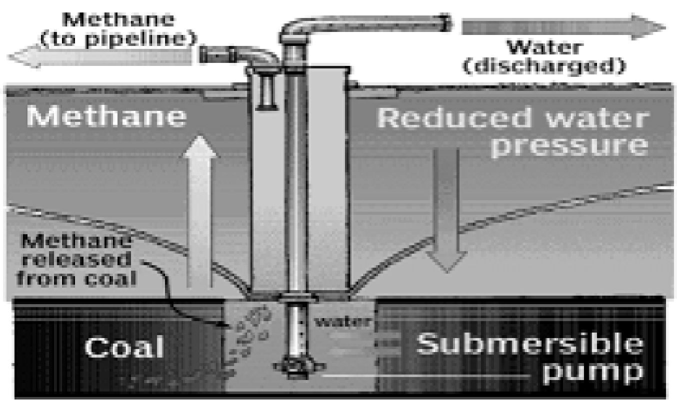


Source: DGH

Coal bed methane is a clean burning fuel with the same chemical compound as natural gas, but formed under different conditions. Methane is produced when organic material is turned into coal during burial as both the temperature and pressure increases. If, during the process, the coal is saturated with water and methane is trapped within the coal, the result is coalbed methane, known as CBM. Methane is extracted by pumping large volumes of water out of the coal in order to release the water pressure that traps the gas within the coal.

Dewatering of wells for production of CBM gas to take 6-12 months

Coal bed methane extraction process



Source: NorWest Mine Service Inc.

CBM to emerge as key growth driver for the company

Forward integration into gas production through CBM and marginal fields augments DIL's entry into the E&P space. Having been allotted two blocks in CBM-III round, one each in Singrauli (M.P) and Godavari (A.P), we find the company's future growth levered to this domestic CBM play. DGH has estimated combined reserves of ~60bcm from these two blocks, which should translate into a production plateau of 1.2mmscmd of gas from each of these blocks. What provides a kicker to earnings from this source is the attractive fiscal package provided by the government. Some of these include

Attractive fiscal package boosts commercial viability of CBM gas

- No upfront payment
- Exemption from payment of customs duty on imports required for CBM operation.
- Walkout option at the end of Phase-I & II.
- Freedom to market the gas in the domestic market at market rates.
- Provision of fiscal stability.
- Seven years tax holiday.

DIL has working interest in two blocks

DIL has a working interest of 40% in the Godavari block and 90% in the Singrauli block

DIL has a working interest of 40% and 90% in Godavari and Singrauli block respectively, with Adinath Exim (promoter owned company) and Coal Gas Mart being its partners in Godavari and Coal Gas Mart in Singrauli. While Godavari coal field lies within Adilabad, Karimnagar, Warangal and Khammam district of the state of Andhra Pradesh, the Singrauli block is an integral part of the South Reva Basin containing Sohagpur-Johilla coalfields. Spread over an area of 716 sq. kms, these two blocks have a combined resource base of ~60 billion cubic metres (bcm). To monetise these reserves the company has signed a production sharing contract (PSC) with GOI for a period of 34.5 years. However, based on the development plan envisaged by the company, coupled with our observation of the production schedule of other players (RIL, GEECL), we have modeled a 20 year production life of the CBM blocks, implying a recovery rate of ~26% of its in-place reserves.

Particulars

	Deep Industries		Reliance Industries		GEECL
Block Name	SR-CBM-2005/III	GV(N)-CBM-2005/III	SP(E)-CBM-2001/I	SP(W)-CBM-2001/I	Raniganj South
Block area (sq. Km.)	330	386	495	500	210
No of coal seams (nos.)	8	10	Top of Form 5-6	5-6	10
Seam Thickness (m (cum.))	8 - 22	15 - 20	1-15	1-15	4-46
Seam Depth (m)	300 – 700	450 – 1500	-	-	-
Permeability	Good	Good to moderate	Good	Good	Good
Gas Content (m3/t)	4	4-5	3-10	3-10	2-17
CBM Resources (BCM)	31	29.65	49.3	37	28
Consortium partner	Adinath Exim, Coal Gas Mart	Coal Gas Mart	-	-	-
Working interest (%)	90	40	100	100	100
Likely peak production (mmscmd)	1.2	1.2	5.0		3.0

Source: DGH, Company

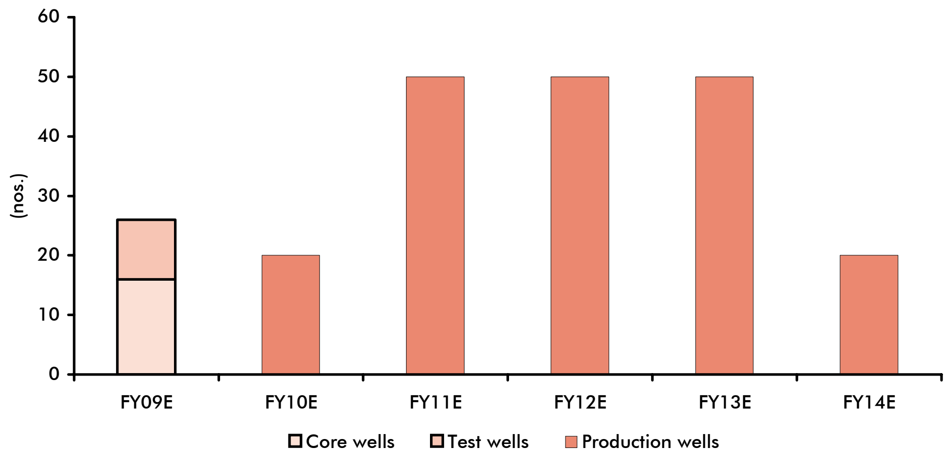
Phase-I development to commence in FY09E

The company, in FY09E, intends drilling 8 core wells and 5 test wells in each of its blocks, as part of first phase of its exploration program. While the core well drilling program is intended to test the coal samples to check for reserve potential and certification, test well drilling would help in determining the likely flow rate of the wells.

Phase-I development includes drilling of 8 core wells and 5 test wells in each block

Subsequent to this, optimising production from its blocks includes drilling of 100 production wells over FY10E-FY14E in each of its assets. Given the nature of gas extraction, each well drilled (15 days drilling time) is expected to commence production one year hence, once the de-watering process is completed.

200 production wells to be drilled over FY10E-FY14E



Source: Ambit Capital Research estimates

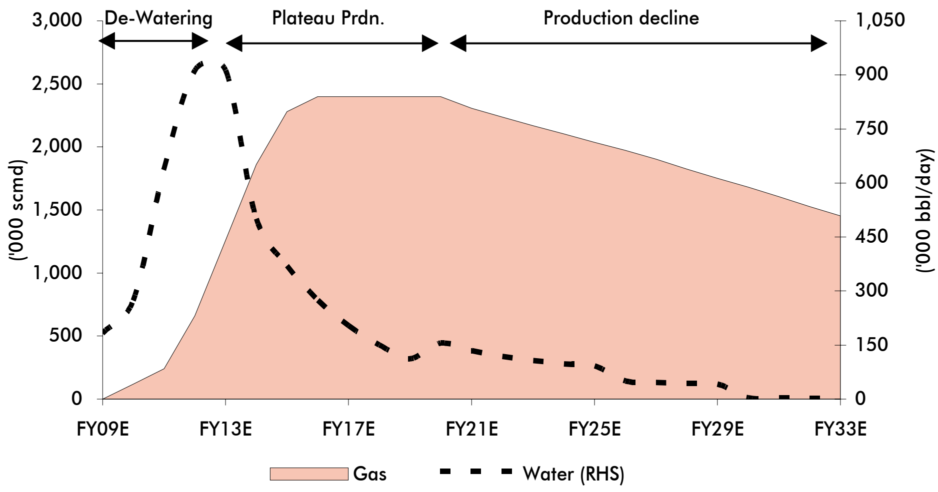
First gas expected circa FY10E; peak production at 2.4mmscmd

Average production of 12,000 scmd from each well translates into peak production of 2.4mmscmd from both blocks

We anticipate first gas from both assets to be delivered circa FY10E, with peak production of 1.2mmscmd (1.5% of in-place reserve) from each block to be achieved by FY16E. Our base case peak production assumption is based upon average per well flow rate of 12,000scmd after 12 months of de-watering, with the targeted 100 wells drilled by FY14E. We reckon, the company would be able to maintain this plateau till FY20E, after which we have modeled a 5% production decline. Given the well life cycle of a typical CBM well, decline rates vary in the range of 5%-15%, lower than a conventional gas well.

We have also incorporated an average water production of 50bpd, with a decline rate of 30%. The de-watering process is likely to average six months to a year for each well drilled, and would have to be disposed before gas production starts. Given the various water disposal techniques (surface disposal, shallow injection, deep injection, reverse osmosis), we believe that the company would employ surface disposal, ensuring its usage for various purposes.

Plateau production of 2.4mmscmd during FY16E-FY20E



Source: Company, Ambit Capital Research estimates

Project economics highly levered to gas prices

Profitability of the DIL's E&P division (CBM & marginal fields) is highly levered to gas prices. Our sensitivity analysis suggests a ~20% change in fair value of the company for every 10% change in gas prices. We have assumed a well-head gas price of Rs8.4/scm ($5.8/mmbtu) from both CBM and the marginal fields, in line with the gas price of the Panna-Mukta-Tapti (PMT) fields. We believe, given the company's intention of distributing a part of this gas for the purpose of city gas distribution (JV with IOC), the blended realisations could be much higher than assumed. Having said that, cost too would increase proportionately.

Sensitivity of fair value to gas price

	Gas price (Rs/scm)		
US/INR	7.2	8.3	9.4
38.0	160	213	267
40.0	178	**234**	290
42.0	195	254	312

Source: Ambit Capital Research

Differential gas pricing scenario across India

Gas prices	$/mmbtu	Comments
APM	2.3	Well head price for power and fertiliser plants
Panna-Mukta-Tapti	5.7	16.5 mmscmd of gas sold by the consortium to GAIL
KG Basin#	4.2	Price decided on by EGOM on a formula, with a floor of $25/bbl and cap of $60/bbl
Spot	10-18	Prices vary depending upon demand-supply situation
R-LNG	9.5	Incremental LNG import with a re-gasification charge of $0.6/mmbtu

 # gas price at a cap of $60/bbl
Source: CRISIL Research, Industry sources

Quantifying risks to our key assumptions

Particulars	Our assumptions	Deviation	NPV impact
Gas Realisation	$5.8/mmbtu	Gas price change of 10%	20%
Opex cost	Rs0.8/scm	Change of every Rs0.1/scm	5%
Peak production	12,000scm/ well	Change of 1,000scm/well	7.5%
Delay in first gas	First gas in FY10E	One year delay	10.5%

Source: Ambit Capital Research

Half of project cashflows attributable to government

Incremental gas production over the minimum production levels attracts differential proportion of production sharing with the GoI

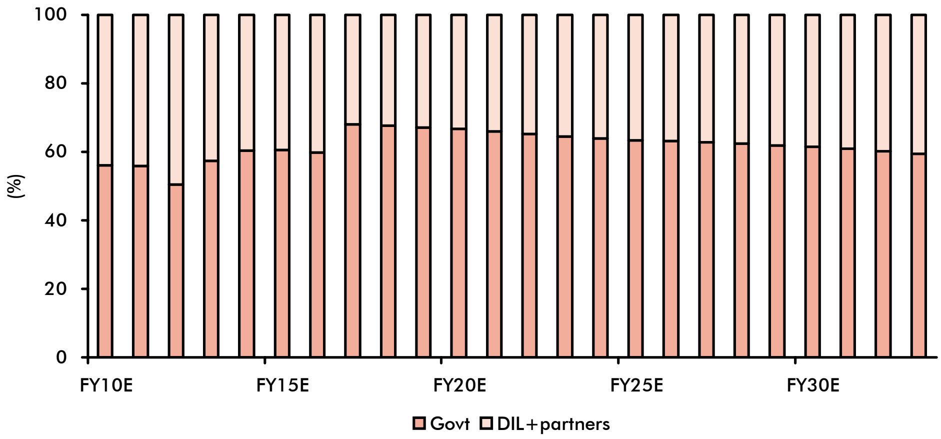
DIL has been allotted the blocks by the GOI on a production sharing basis. Beyond a minimum production of 0.5mmscmd, every 0.5mmscmd of incremental gas produced, attracts a differential proportion of production share. Accounting for the 10% royalty payable, along with maximum tax rate of 34%, we estimate that the government's share of cashflow in both the blocks would be in excess of 50%, progressively going upto as high as 70% by FY17E for the Singrauli Block.

Godavari

mmscmd	Share (%)
< 0.5	25.0
0.5 - 2	50.0
2.0 - 2.5	60.0

Source: Company

Govt share of cash flows from Godavari peaks at 68% during FY17E



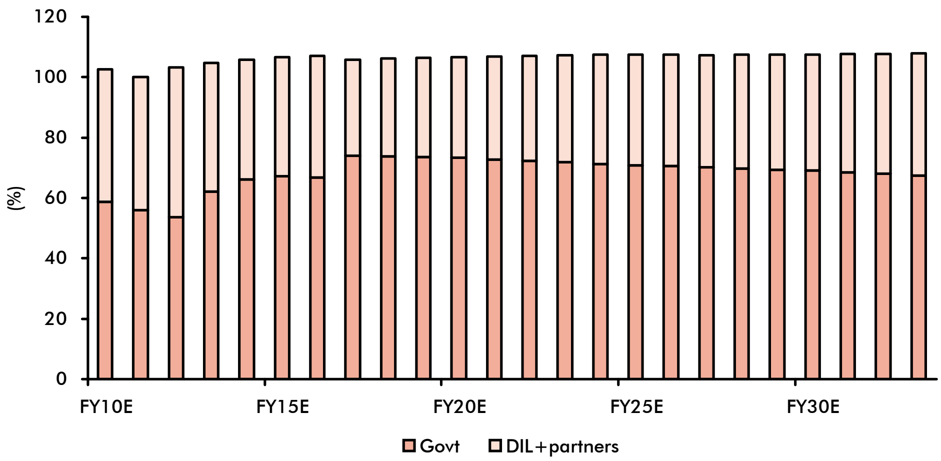
Source: Ambit Capital Research estimates

Singrauli

mmscmd	Share (%)
< 0.5	36.0
0.5 – 1	54.0
1 - 2.5	60.0

Source: Company

Govt share of cash flows from Singrauli peaks at 74% during FY17E



Source: Ambit Capital Research estimates

Clarity on evacuation strategy to enhance value

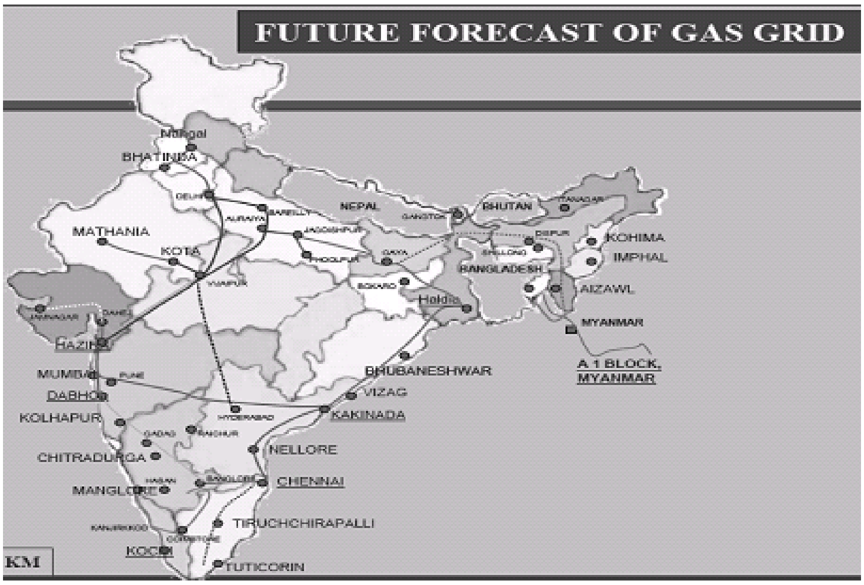
With the absence of gas infrastructure in vicinity of the two blocks, we reckon development on the same would play a pivotal role in the value accretion from these assets. Though early days, the company is currently evaluating various options as part of its evacuation strategy. We believe that the development of the national gas grid would provide possible solutions to the distribution of gas from these blocks. Fuel demand from nearby industries could also be a probable consumption centre.

We believe that City Gas distribution offers the most logical avenue as a demand point

Another likely alternative, in our view, would be its use in city gas distribution for regions surrounding the blocks. The latter, we believe, is a high possibility if one considers the recent Indian Oil Corporation (IOC) MoU with DIL for the marketing and distribution of this gas. IOC has a similar agreement with Great Eastern Energy Corp. (GEECL) for the marketing of its CBM gas from the Ranigunj block.

Considering all these alternatives, we have modeled an 80km pipeline to be constructed by DIL, which would connect the Jagdishpur-Haldia trunk pipeline of GAIL. Assuming a cost of Rs10mn per km of pipeline, this project is estimated to cost Rs800mn. As for the Godavari block, the company is considering proposals to get into a long-term contract with power plants around the region, to meet their fuel requirements. Given the vicinity of these plants, coupled with future gas grid that is expected to come up in Godavari region, courtesy KG basin gas, we have not factored in construction cost for the same.

Future forecast of gas grid



Source: GAIL

Capex of Rs4.3bn over FY09E-FY14E

The company, as a part of its phased development plans, intends drilling 100 wells in each of its blocks over FY09E-FY13E. Commencing with drilling of 16 core wells and 10 test wells in FY10E, which would cost Rs240mn and Rs250mn (gross) respectively, the company is expected to drill 200 wells (both blocks) over FY10E-FY14E. We have assumed a cost of ~Rs28mn (including cost of pipelines, compressors etc) for drilling of each production well. This also includes a 5% well failure cost which factors in the possibility of the drill program encountering a dry well. Execution of this development plan would entail a total capex commitment of Rs5.8bn, implying Rs4.3bn accruable to DIL based on its share in the blocks.

We estimate DIL's capex commitment at Rs4.3bn

Though the company is exploring various funding options, we believe that the company could have to dilute 10% of its equity to finance its Phase-I development plan which entails a total capex of Rs370mn in FY09E. Post this period, we expect the company to fund its capex largely by way of debt. We have factored in a debt-equity mix of 65:35 (for the development of these blocks) for the purpose of our base-case valuation exercise.

Sensitivity of fair value to costs

	Cap. cost (Rs mn/well)		
Opex(Rs/scm)	**20.0**	**27.5**	**40.0**
0.6	290	259	206
0.8	265	**234**	181
1.0	240	209	156

Source: Ambit Capital Research

Capex schedule

	FY08E	FY09E	FY10E	FY11E	FY12E	FY13E	FY14E	Total
Godavari	0	123	151	344	344	344	138	1,443
Singrauli	0	245	289	688	688	688	275	2,871
Gas compressors+Rigs	357	602	0	0	0	0	0	959
Marginal fields	0	12	24	96	24	0	0	156
Total	**357**	**982**	**464**	**1,127**	**1,055**	**1,031**	**413**	**5,429**
Debt	0	257	50	733	566	0	0	**1,607**
Internal accruals / Equity issuance	357	724	414	395	489	1,031	413	**3,822**

Source: Ambit Capital Research estimates

Marginal Field Development

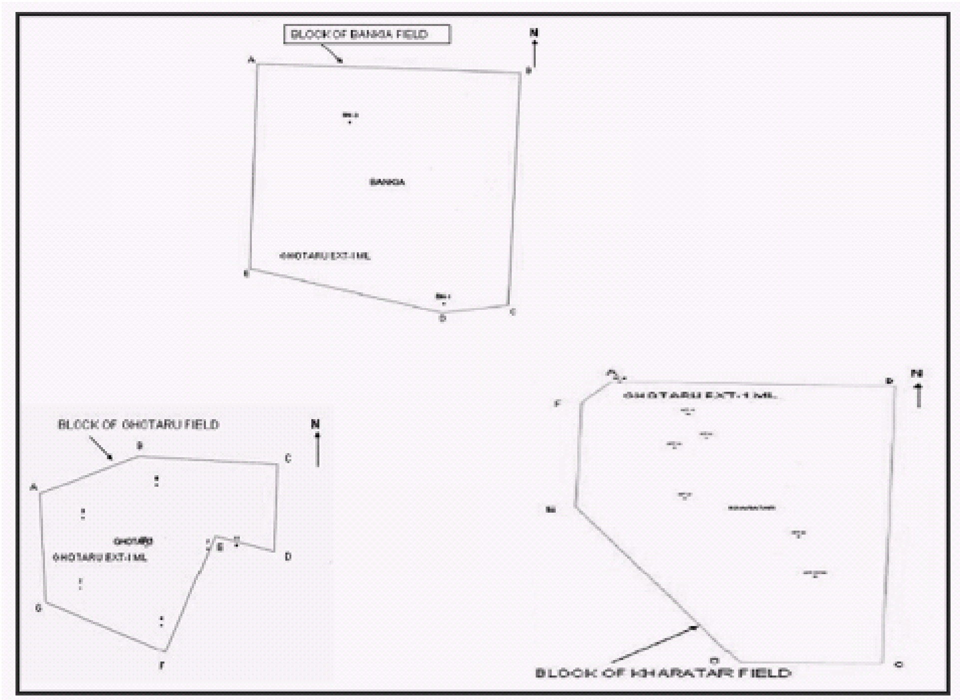
ONGC, as a part of its marginal field monetisation program, has allotted three onshore fields in northern Rajasthan to DIL for a period of 17 years starting FY09E. Aimed primarily at unlocking small pools of discovered hydrocarbon reserves, this program is one of the strategic business pursuits of ONGC. Given the establishment of proven gas reserves of 1.42bcm from the three fields, we believe DIL's foray into exploration through this medium would help it reduce risks associated with wild-cat exploration.

DIL allotted three onshore fields by ONGC; contract on production sharing basis

DIL to develop three marginal fields owned by ONGC; DIL's production share at 40% and 66% for oil and gas respectively

DIL's service contract for development of three marginal fields in northern Rajasthan includes Ghotaru, Bankia and Kharatar. These fields, which form a part of the Jaisalmer basin and spread over an area of ~94 sq. km, have a cumulative reserve base of 1.42bcm (Source: ONGC). The service contract awarded to DIL, for a period of 17 years starting FY09E, is on a production sharing basis with ONGC's share at 60% and 34% for oil and gas respectively.

Marginal fields spread over an area of ~94sq km (Jaisalmer basin)



Source: Company

Production sharing details with ONGC

Field	In-place reserves (mcm)	Oil (%) Deep	Oil (%) ONGC	Gas (%) Deep	Gas (%) ONGC
Ghotaru	973	40.0	60.0	66.0	34.0
Kharatar	298	40.0	60.0	66.0	34.0
Bankia	152	40.0	60.0	66.0	34.0

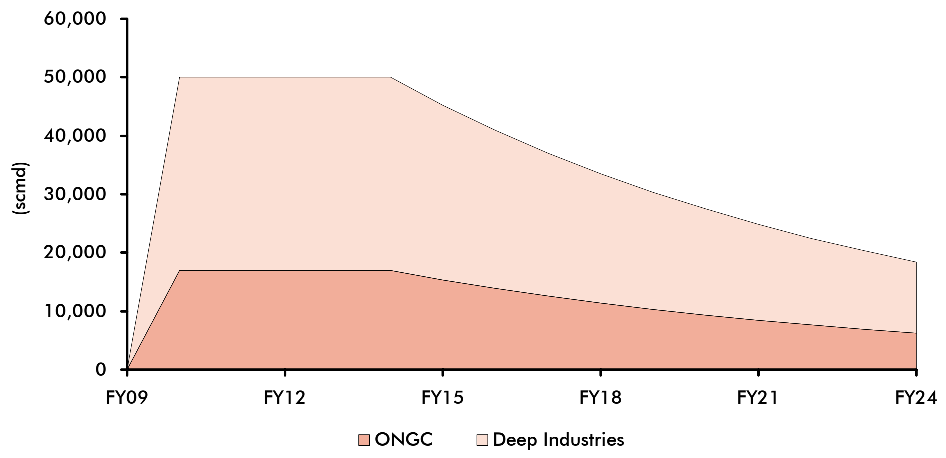
Source: Company

Production to commence in FY10E; peak production at 50,000 scmd

Peak production of 50,000scmd, implying a recovery rate of 25% of in-place reserves

The fields cumulatively have 23 wells drilled by ONGC, out of which 8 were in production when DIL was awarded the contract. A majority of these wells have been capped for a fairly long time, primarily on account of non-viability of production. Given this backdrop, the development plan drawn by the company includes ~1.5 years of work-over operation, in which time 3-4 service wells are expected to be drilled. We anticipate production peak of 50,000scmd by end of FY10E, with plateau being maintained till FY14E. Post this period, we have modeled a natural well decline of 10%, implying a recovery rate of 25% (after adjusting for 30% methane content) of the in-place reserves.

Production schedule



Source: Ambit Capital Research estimates

DIL liable to pay fixed gas price for ONGC's share

DIL to pay fixed tariff of Rs1.2/scm to ONGC

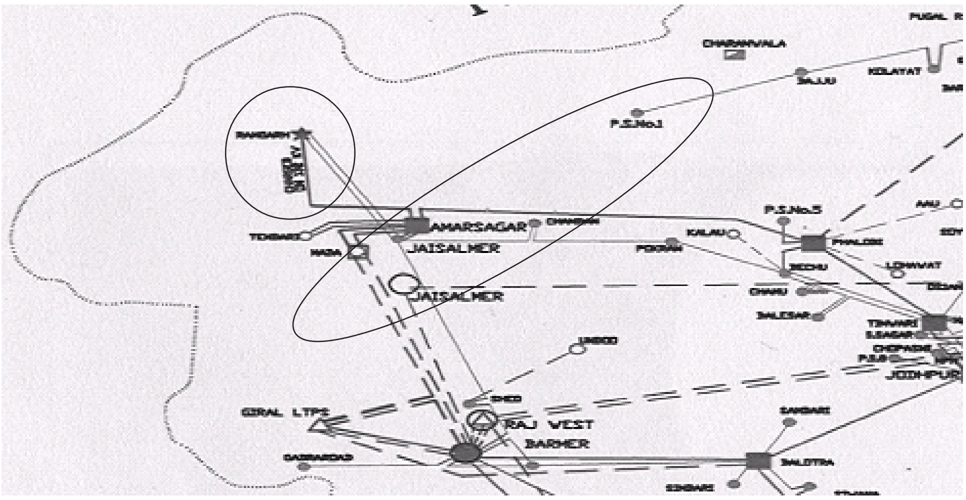
The production sharing contract with ONGC, we reckon, is a highly beneficial proposition for DIL, with the latter liable to pay a fixed tariff of Rs1.20/scm for the former's production share of 34%. This effectively implies that the differential between the market price and the fixed tariff would accrue to DIL's cashflows, translating into ONGC's effective revenue share at just 4.5% of the project's gross revenues.

Evacuation strategy might involve supply to nearby power plant

Though clarity is yet to emerge on the gas distribution strategy of the company, initial impression suggests that the company could possibly be looking at supplying this gas to the nearby Ramgarh Thermal Gas Power Station (RTGPS), a 110MW gas-based power plant. The gas requirement for the operation of the RGTPS at 90% plant load factor is projected to be 1.18 mmscmd, as against their allocation of 0.75mmscmd. The entire gas of about 0.75 mmscmd, currently available from the producing fields of ONGC (Gamnewala field) and Oil India (Dandewala field) in Jaisalmer area has been committed for supply to RTGPS.

Supplying the gas to RTGPS would however involve using the GAIL's 66km gas pipelines connecting Dandewala to RTGPS. Though the power plant would be liable to pay the transmission tariff, we have factored in a transportation cost of Rs1.20/scm which the company is likely to incur to deliver the gas to the pipeline network. Given the likely volumes from the marginal fields, we believe RTGPS offers the best alternative as the potential demand point.

Ramgarh Thermal Gas Power Station to be a potential demand point



Source: Rajasthan Rajya Vidyut Utpadan Nigam

Significant exploration upside exists

Marginal field proximity to Focus Energy's block (6tcf reserve) offers significant exploratory upside potential

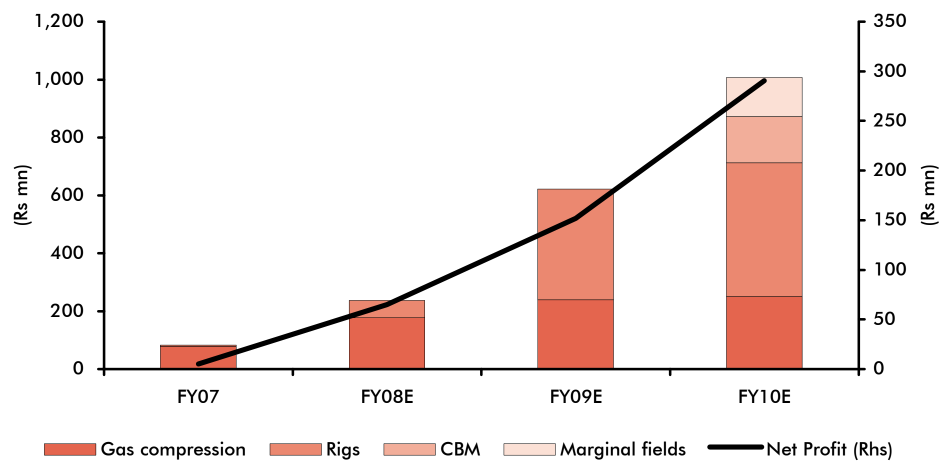
We believe that the marginal fields offer significant upside potential in terms of reserve accretion. Our conviction on the same is further strengthened on account of the largest onshore gas discovery of 6tcf (not yet certified) made by Focus Energy in block RJ-ON/6 located in Shahgarh basin of Jaisalmer district (This block is just about 25kms from the Pakistan border, and of the same stratigraphic area as the one belonging to Sawan and Miano and others -32 tcf of reserves). The marginal fields awarded to DIL are at a distance of 65kms from the RJ-ON/6 block, and could hold embedded option value on further exploration upside that might surface when the company undertakes exploratory drilling in the foreseeable future. Putting the probability of further reserve accretion in perspective, Focus Energy discovered reserves at a depth of 3,100m while fields of Ghotaru, Bankia and Kharatar have been drilled only upto a depth of 600m-700m.

Earnings to grow ~4.5x over FY08E-10E

Work-over rigs to drive growth during FY09E while CBM would contribute significantly to growth post-FY09E

Traction in the existing business on the back of fleet expansion, concomitant with contribution from new businesses (CBM and Marginal fields) circa FY10 is likely to propel the company into a high growth trajectory, with revenues and net profit expected to grow at a CAGR of ~59% and 115% respectively over FY08E-FY10E. We reckon, growth over the next two years would be driven primarily by work-over rigs operations, given three new 100T rigs expected to start contributing to the topline from Q1FY09E. This is likely to increase its contribution to the topline from 5% in FY07 to ~46% by FY10E. Post FY10E, we estimate this growth momentum to be maintained till FY15E (CBM peak production), after which flattish growth is expected.

Work-over rigs to contribute over 46% of consolidated revenues by FY10E



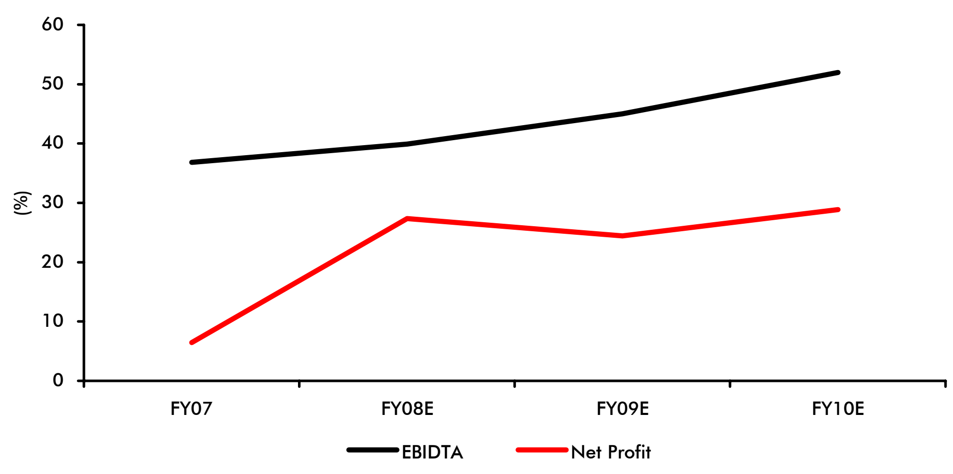
Source: Company, Ambit Capital Research estimates

Higher contribution from new assets to boost margins

Contribution from higher margin businesses set to improve operating margins; Net margins to be sustained at current levels

We expect improvement in EBIDTA margins going forward, driven by contribution from higher margin businesses i.e. rigs (~50%) and E&P (~60%). However, net margins would remain under pressure in the near future, as capex spend is likely to increase capital costs (interest & depreciation). Factoring in for this, net margins is estimated to be in the vicinity of 24%-28% over FY08-FY10E, as capital costs exhibit 4.5x increase over the same period.

Operating margins expected to expand 12pps



Source: Company, Ambit Capital Research estimates

Our earnings estimates are based on key assumptions

Our earnings estimates for different segments of the company are based on some key assumptions. For the work-over rig and gas compression business, we reckon our day rates assumptions hold key to our estimates. As far as estimates for CBM and marginal field are concerned, they are highly levered to our gas price, cost (per scm), and production assumptions.

Work-over Rigs

		100T			50T			30T			WOR 4/5/6 – 100T	
	FY08E	FY09E	FY10E	FY08E	FY09E	FY10E	FY08E	FY09E	FY10E	FY09E	FY10E	FY11E
No. of rigs (nos)	1	1	1	1	1	1	1	1	1	3	3	3
No. of days in year (days)	365	365	365	365	365	365	365	365	365	365	365	365
Rig total availability in year (days)	365	365	365	365	365	365	365	365	365	365	365	365
Rig utilisation (days)	365	351	329	0	351	310	356	345	329	91	18	18
Rig unutilised in year (days)	0	14	37	365	14	55	9	20	37	274	347	347
Rig utilisation (%)	100	96	90	0	85	85	98	94	90	75	95	95
Day rate (Rs/day)	135,068	135,068	148,575	80,000	80,000	88,000	31,507	31,507	34,658	180,000	180,000	180,000

Source: Ambit Capital Research estimates

Coal Bed Methane (Godavari / Singrauli)

	FY10E	FY11E	FY12E	FY13E	FY14E
Production (mmscm)					
Gas	19	38	106	189	256
Gas price (Rs/scm)					
Gas price	8.4	8.6	8.9	9.1	9.4
Lifting costs	0.8	0.8	0.8	0.9	0.9
Royalty (% of wellhead)	10.0	10.0	10.0	10.0	10.0
Income tax (%)	11.3	11.3	11.3	11.3	11.3

Source: Ambit Capital Research estimates

Marginal fields

	FY10E	FY11E	FY12E	FY13E	FY14E
Northern fields - Rajasthan	**18**	**18**	**18**	**18**	**18**
Gas price (Rs /scm)					
ONGC	1.3	1.3	1.3	1.3	1.3
Deep Industries	8.4	8.6	8.9	9.1	9.4
Lifting costs	2.0	2.1	2.1	2.2	2.3
Royalty (% of wellhead)	2.5	2.5	2.5	2.5	2.5
VAT (%)	6.5	6.5	6.5	6.5	6.5
Income tax (%)	34.0	34.0	34.0	34.0	34.0

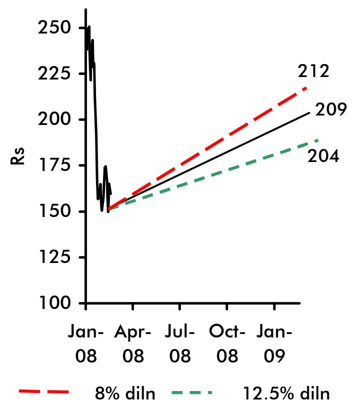
Source: Ambit Capital Research estimates

Total capex of Rs5.4bn (net) over FY08-FY14E; equity dilution a possibility

The company's expansion, we reckon, would involve a total capex commitment of Rs5.4bn over FY08E-FY14E, which includes Rs600mn for the acquisition of three work-over rigs and two gas compressors in FY09E. The remaining is expected to be used for the development of CBM and marginal fields.

As a part of the funding plan, DIL, in a preferential allotment in Q3FY08, issued 2mn shares to promoters and others, the dilution representing 10% of the pre-dilution equity of the company. The shares, being issued at Rs200 would garner Rs400m. Going forward, the company's plans of undertaking Phase-I development of CBM and marginal fields would entail a total capex of ~Rs370mn in FY09E.

Base case dilution of 10% yields fair value of Rs209/shr



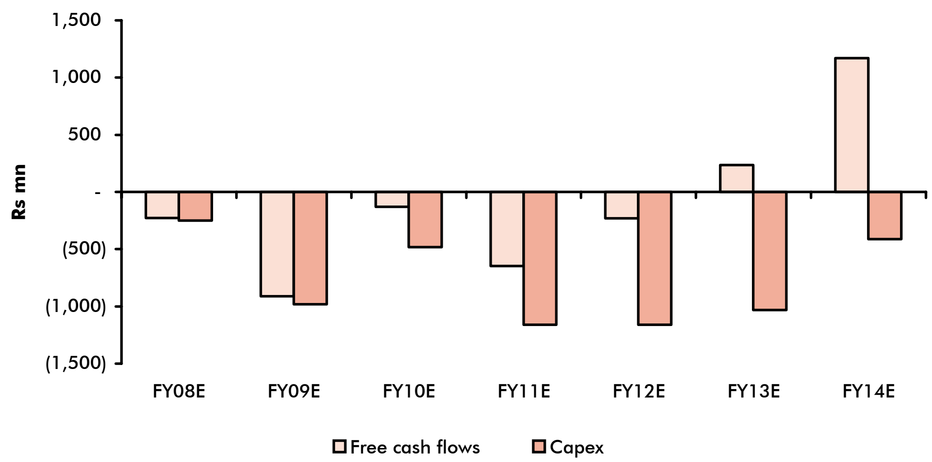
Source: Ambit Capital Research

Given the fact that a significant part of this is expected to be brought in by the company in the form of equity, we have modeled a base case dilution of 2.2mn shares (10% of pre-diluted equity of 22mn shares) at Rs200/share, aggregating to Rs440mn. Dilution would change to 8.4% and 12.5% in case equity is raised at Rs240/share and Rs160/share respectively. Post our base case dilution, the share capital of the company would stand at Rs242mn.

We expect the company to raise debt post FY09E, once production from the blocks commence. Our numbers factors in a peak debt-equity ratio of 0.5x by FY12E, with peak debt of Rs1.6bn by FY12E. Given the aggressive capex envisaged by the company, free cash flows over FY08E-FY12E are expected to be negative and turn positive from FY13E.

Due to high capex during FY10E-FY13E, free cash flows to stay negative until FY12E

Free cash flows to turn positive by FY13E



Source: Ambit Capital Research estimates

NPV based SOTP valuation indicate one year forward price of Rs209/share

With CBM contributing significantly to the company's value, cash flows from which are yet to commence, we believe NPV of its individual fields would efficiently capture fair value of the blocks. Therefore for the E&P business, we have valued the company based on NPV of individual producing block, assuming an average long term gas price of $5.8/mmbtu and a weighted average cost of capital of 13%. **Our fair value of 168/share for the CBM and marginal fields assumes a monetised reserve base of 39mmboe (DIL share), thereby implying an EV/boe of $2.6/bbl.**

Valuation case study: Great Eastern Energy Corp (GEECL)

We believe the market would start factoring DIL's cashflows flows (from the CBM blocks) into the stock price, in a way similar to that of GEECL, a pure CBM player with one block at Raniganj (south) allotted to them in CBM-I. GEECL is the only player in the country to have commenced CBM gas production from its block in Raniganj (south). Currently producing 2.5mmscf, GEECL plans to invest Rs2bn every year over the next three years to increase production to 35mmscfd of gas by 2010. Having undertaken a capital raising exercise to the tune of £19mn in Dec'05 through an issue of Global Depositary Receipts (GDRs) on the AIM market, we expect GEECL to ramp up its peak production to 3mmscmd post 2014.

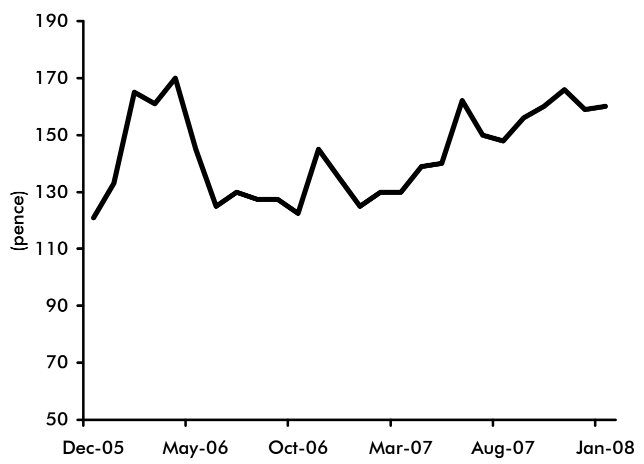
On a 3P resource base of 817bcf (146mmboe), GEECL's current market cap stands at $350mn, implying an EV/boe of $2.5of its 3P reserves. We believe that as DIL gets closer to production, the market would start valuing the CBM assets based on these multiples. In case this scenario plays out,

GEECL - CBM block details

Block Name	Raniganj South
Block area (sq. Km.)	210
No of coal seams (nos.)	10
Seam Thickness (m (cum.))	4-46
Seam Depth (m)	-
Permeability	Good
Gas Content (m3/t)	2-17
CBM Resources (BCM) [Schlumberger certified resrvs]	39
Consortium partner	-
Working interest (%)	100
Likely peak production (mmscmd)	3.0

Source:DGH

GEECL share price movement in AIM



Source: Bloomberg

Valuation gap comparison

	GEECL	DIL
EV/boe ($)	2.5	1.2
Resrv. (mmboe)#	145.5	191.8
EV ($mn)	363.0	239.2
Net debt ($mn)	0.0	5.3*
Equity value ($ mn)	363.0	233.9
Equity value (Rs bn)	14.5	9.4

* FY10E net debt #GEECL 3P reserves estimated by Schlumberger. DIL's 3P reserves assumed at 50% of in-place reserves

Source: Bloomberg, AIM documents, Ambit Capital Research estimates our analysis suggests that combined value of DIL's CBM blocks by FY10E could be ~9.4bn, implying an EV/boe of $1.2on its 3P reserves. This EV/boe is at a discount of 50% to that of GEECL, factoring in for a superior resource structure and business model.

We have also used the DCF approach to value the rig and compression business, projecting the expected cash flows over the life of the asset. We have assumed 25 years to be the life of the asset and a scrap value of 10% at the end of the period for both rigs and gas compressors. **Our fair value estimate for the rigs and gas compressor business stands at Rs43/share.**

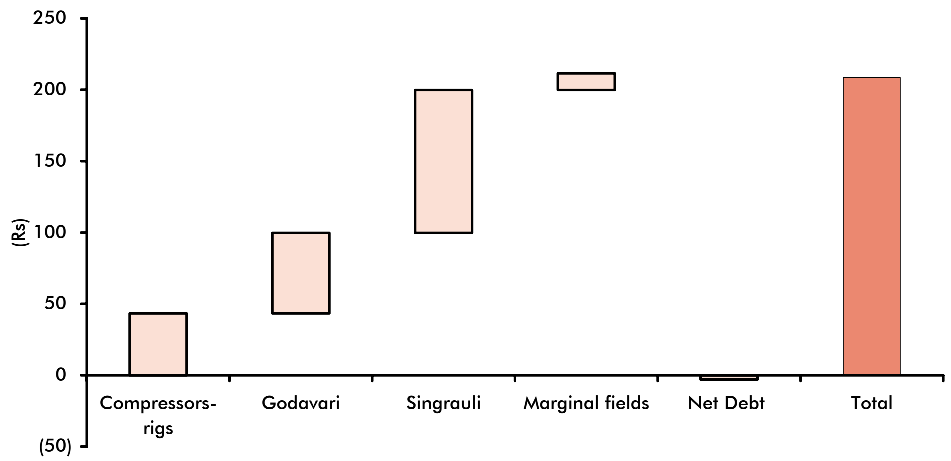
CBM blocks and the marginal field together contribute roughly 80% to DIL's fair value

SOTP-based valuation

	Method	Value (Rs mn)
Gas compression / Work over rigs	DCF	1,049
Coal Bed Methane		
Godavari	DCF	1,368
Singrauli	DCF	2,420
CBM total		3,788
Marginal fields	DCF	282
Total		5,119
Less: Net Debt		72
Equity value		5,047
No. of shares (mn)		24.2
Value per share (Rs)		**209**

Source: Ambit Capital Research estimates

SOTP-based value-break-up



Source: Ambit Capital Research estimates

We initiate coverage on the stock with a BUY recommendation and a 1-year NPV-based fair value of Rs209/share, indicating an upside of 31% from current levels.

Disclaimer

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Additional information on recommended securities is available on request.

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