Company Focus

29 June 2009 | 8 pages

Oil & Natural Gas (ONGC.BO)

Target price change ☑
Estimate change ☑

Sell: US$60-70 Crude Reduces Deregulation Hopes

- **Oil forecasts revised** — We are adjusting our global oil (Brent) forecasts to US$56/bbl (US$48) for 2009E, US$65 (US$55) for 2010E, and US$65 (US$60/bbl) for 2011E. Our LT assumption (2012E+) stays at US$65/bbl.
- **Modestly increasing FY10-11E earnings** — Our assumptions for ONGC are increased marginally, by 1-5% over FY10-11E. The FY10E estimate change is primarily on account of the APM gas price hike (15-20%) that we are now assuming, in line with the likely Cabinet proposal. This however falls short of the market's heightened expectations ($4.2/mmbtu). For FY11E, while our crude assumption increases from US$60 to US$65, the EPS increase is more subdued at 5%, as net realisations on domestic crude remains flat at ~US$50.
- **Subsidy burden to increase in FY11** — Our earlier FY11E assumptions incorporated only LPG/SKO under-recoveries (Rs319bn total; 1/3rd sharing) at US$60 crude, which we now expect to rise to Rs466bn (incl. auto fuel losses) at US$65 crude, suppressing net realisations. While full deregulation of auto fuels could lead to a lower figure (Rs374bn), our assumption is premised on some losses on auto fuels as well, as the quantum of price hikes will likely lag the required increases as long as crude is between US$60-70.
- **Maintain Sell; Rs910 target price** — We maintain Sell with a target price of Rs910 (Rs820 earlier) as we roll forward to Sep-10E (Mar-10E) while maintaining our 10x target P/E. The stock trades at 11x P/E, the upper end of its historical 7-11x trading band. Any move by the government to fully de-regulate auto fuel will be a positive surprise and upside risk to our estimates.

Sell/Medium Risk	**3M**
Price (25 Jun 09)	Rs1,029.00
Target price	Rs910.00
from Rs820.00	
Expected share price return	-11.6%
Expected dividend yield	2.4%
Expected total return	**-9.1%**
Market Cap	Rs2,200,900M
	US$45,356M

Price Performance (RIC: ONGC.BO, BB: ONGC IN)

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2007A	177,696	83.08	15.4	12.4	3.3	29.0	3.5
2008A	198,723	92.91	11.8	11.1	2.8	27.7	3.1
2009E	235,868	110.28	18.7	9.3	2.4	27.7	3.5
2010E	177,609	83.04	-24.7	12.4	2.1	18.0	2.4
2011E	212,608	99.40	19.7	10.4	1.8	18.9	2.4

Source: Powered by dataCentral

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Fiscal year end 31-Mar	2007	2008	2009E	2010E	2011E
Valuation Ratios					
P/E adjusted (x)	12.4	11.1	9.3	12.4	10.4
EV/EBITDA adjusted (x)	6.1	5.0	4.1	4.6	3.7
P/BV (x)	3.3	2.8	2.4	2.1	1.8
Dividend yield (%)	3.5	3.1	3.5	2.4	2.4
Per Share Data (Rs)					
EPS adjusted	83.08	92.91	110.28	83.04	99.40
EPS reported	83.08	92.91	110.28	83.04	99.40
BVPS	309.51	361.94	433.98	488.81	560.57
DPS	36.00	32.00	36.00	25.00	25.00
Profit & Loss (RsM)					
Net sales	862,762	1,018,349	1,192,209	1,094,663	1,168,529
Operating expenses	-638,486	-752,396	-880,813	-873,231	-894,117
EBIT	**224,276**	**265,953**	**311,396**	**221,432**	**274,412**
Net interest expense	1,058	-2,153	-1,406	-1,349	-1,297
Non-operating/exceptionals	52,240	45,431	50,694	50,766	50,137
Pre-tax profit	**277,574**	**309,232**	**360,684**	**270,849**	**323,252**
Tax	-98,454	-106,999	-121,190	-91,005	-108,613
Extraord./Min.Int./Pref.div.	-1,424	-3,509	-3,627	-2,234	-2,031
Reported net income	**177,696**	**198,723**	**235,868**	**177,609**	**212,608**
Adjusted earnings	177,696	198,723	235,868	177,609	212,608
Adjusted EBITDA	343,953	404,831	463,155	384,872	442,100
Growth Rates (%)					
Sales	16.2	18.0	17.1	-8.2	6.7
EBIT adjusted	8.4	18.6	17.1	-28.9	23.9
EBITDA adjusted	12.9	17.7	14.4	-16.9	14.9
EPS adjusted	15.4	11.8	18.7	-24.7	19.7
Cash Flow (RsM)					
Operating cash flow	**385,721**	**350,302**	**429,654**	**323,766**	**382,271**
Depreciation/amortization	119,678	138,878	151,759	163,440	167,689
Net working capital	92,901	15,289	39,189	-15,441	4,020
Investing cash flow	**-197,369**	**-210,154**	**-199,659**	**-204,659**	**-204,659**
Capital expenditure	-186,873	-189,907	-186,428	-191,428	-191,428
Acquisitions/disposals	-253	-7,015	0	0	0
Financing cash flow	**-89,476**	**-74,943**	**-87,408**	**-57,883**	**-57,861**
Borrowings	-6,336	-666	-3,635	-226	-203
Dividends paid	-85,468	-75,972	-85,468	-59,353	-59,353
Change in cash	**98,877**	**65,205**	**142,586**	**61,223**	**119,751**
Balance Sheet (RsM)					
Total assets	**1,102,252**	**1,246,846**	**1,446,771**	**1,554,159**	**1,729,072**
Cash & cash equivalent	225,104	270,880	479,064	579,124	739,006
Accounts receivable	48,167	70,469	81,658	74,977	80,036
Net fixed assets	249,410	280,312	276,852	292,292	305,278
Total liabilities	**431,936**	**461,271**	**503,605**	**490,082**	**509,289**
Accounts payable	78,824	98,444	95,520	102,333	113,978
Total Debt	16,005	9,445	3,617	3,255	2,930
Shareholders' funds	**670,316**	**785,575**	**943,165**	**1,064,077**	**1,219,783**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	39.9	39.8	38.8	35.2	37.8
ROE adjusted	29.0	27.7	27.7	18.0	18.9
ROIC adjusted	17.5	21.1	24.3	16.7	21.2
Net debt to equity	-31.2	-33.3	-50.4	-54.1	-60.3
Total debt to capital	2.3	1.2	0.4	0.3	0.2

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Figure 1. ONGC – Changes in key assumptions

Old	Units	FY10E	FY11E
EPS	Rs/share	81.9	94.4
Crude (gross realisation)	US$/bbl	55	60
Net realization (domestic)*	US$/bbl	46.1	50.2
Weighted avg. realization (incl. OVL)	US$/bbl	47.3	51.4
Gross industry under-recoveries	Rsbn	274	319
INR/US$	Rs/US$	47	46
New	**Units**	**FY10E**	**FY11E**
EPS	Rs/share	83.0	99.4
% change in EPS		*1.4%*	*5.3%*
Crude (gross realisation)	US$/bbl	55	65
Net realization (domestic)*	US$/bbl	46.1	50.6
Weighted avg. realization (incl. OVL)	US$/bbl	47.3	52.4
Gross industry under-recoveries	Rsbn	274	466
INR/US$	Rs/US$	47	46

Source: Citi Investment Research and Analysis estimates

*Assuming 1/3rd upstream share of gross under-recoveries.

Figure 2. ONGC – Earnings Revisions

Year to	Net Profit (Rs Mils.)		Diluted EPS (Rs)			Dividend Per Share (Rs)	
31-Mar	Old	New	Old	New	% Chg	Old	New
2010E	175,252	177,609	81.94	83.04	1.3%	25.0	25.0
2011E	201,917	212,608	94.40	99.40	5.3%	25.0	25.0

Source: Citi Investment Research and Analysis estimates

2009 Investor Conference Takeaways

ONGC presented at our India Investor Conference on June 24. Below are key takeaways from management:

- **Plans for oil reforms still in discussion —** Management said that ministry-level discussions are on to consider ways and means to free fuel pricing and make subsidy sharing more transparent and predictable. Given the fiscal implications and US$70 oil, this could take time. Gas price deregulation could be partial initially but come with a roadmap for the long term.

- **Deepwater exploration should pick up —** ONGC has two deepwater rigs but has contracted three ultra-deepwater rigs – one from Reliance in 4Q for four years and two more in end-2010/early-2011. This will provide tools to drill appraisal wells in KG-98/2 and prepare FDP in 2010. The company has also constituted a focus group for East Coast though production from KG-98/2 is likely in another two years. The recent IE discovery in KG block is however at an extremely early stage and therefore not quantifiable.

- **4Q impacted by higher DD&A —** Higher survey costs and dry wells led to depressed PAT in 4Q. The company takes into account the dry wells for a part of the June quarter also in the 4Q accounts. It also stated that the renewal of the jack-ups at $130,000-160,000/day in the last two years has also put pressure on the costs, which gets accentuated in periods of sharp crude declines like the last quarter.

Oil & Natural Gas

Company description

ONGC is India's largest E&P company. Through its subsidiary ONGC Videsh, the company has invested in overseas crude equity. It has ventured downstream, picking up a majority stake in Mangalore Refineries, and intends to set up a petro-products retailing network.

Investment strategy

We rate ONGC Sell/Medium Risk, with a Rs910 target price. Weak to moderate crude prices have started hurting ONGC, despite lower subsidy sharing, as realizations on JV and international crude suffer. Continuing losses on cooking fuels should ensure continuance of the subsidy sharing mechanism in FY10 and cap upside even if crude recovers to higher levels. Despite talk of deregulation, we feel that even if petrol and diesel prices are partly deregulated, LPG and kerosene would continue to be loss-making, implying a subsidy burden on ONGC.

Valuation

Our target price of Rs910 is based on 10x Sep-10E P/E, at the higher end of ONGC's historical median band of 7-11x. Our target multiple factors in: (i) 10-15% increase in market multiples post elections, and (ii) increased probability of partial sector de-regulation post the strong mandate. We continue to value ONGC on traditional valuation parameters as against NAV/SOTP approach due to it being a going concern. Given that its existing fields face declining or mature production profiles, it will be incorrect to value the new discoveries (say KG gas) separately in an SOTP since the new fields would anyway be required to compensate for the decline in mature fields. In terms of asset valuation, ONGC's current EV/boe of US$7.2 (on 1P reserves) is unlikely to get further re-rated given limited benefit from higher crude as well as subsidized gas prices.

Risks

We assign a Medium Risk rating on account of continued uncertainty on subsidy sharing and low visibility on a reduction in ONGC's burden despite reduced downstream under-recoveries. Upside risks to our estimates are: 1) ONGC has made substantial investments in overseas oil blocks, through its subsidiary ONGC Videsh, in Sudan, Vietnam, and Russia. ONGC remains aggressive in the search for oil equity overseas and is usually an interested bidder in such asset sales. Value accretive overseas acquisitions pose upside risks to our estimates. 2) Rupee depreciation benefits ONGC through higher domestic realisations. Continued devaluation of the rupee could pose risks to our estimates. 3) Government interference in the Indian oil sector (e.g. making upstream oil companies bear LPG/kerosene subsidy losses and gasoline/diesel retailing losses) has been a concern for the sector. Positive policy announcements leading to complete deregulation of the sector and removal of subsidy-sharing by upstream companies could significantly impact ONGC's earnings. If any of these risks has a greater impact than we anticipate, ONGC's share price could exceed our target price.

Appendix A-1

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Oil & Natural Gas (ONGC.BO)
Ratings and Target Price History
Fundamental Research
Analyst: Rahul Singh

Date	Rating	Target Price	Closing Price
1 30-Jan-07	1M	*1,100.00	914.60
2 30-Oct-07	*1L	*1,400.00	1,219.55
3 30-Oct-08	*1M	*850.00	650.05
4 10-Mar-09	*3M	*587.00	665.75
5 24-May-09	3M	*820.00	1,045.30

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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