Company Flash

28 July 2008 | 8 pages

Oil & Natural Gas (ONGC.BO)

Buy: 1Q Provides Peek into Potential; Oil Bond Discrepancy Risk

- **1Q above expectations** — ONGC's 1QFY09 net income of Rs66.4bn was up 44% YoY and significantly above our estimates, driven primarily by 1) higher net realizations on crude sales (~US$70/bbl) due to lower-than-expected subsidy burden of Rs98.1bn (in-line with the government's intention to cap upstream sharing at Rs450bn for FY09), and 2) lower statutory levies.
- **Highest ever net realisation** — Own crude sales realisation of US$69/bbl and blended (incl. JV) crude realisation of US$75/bbl was sharply up from low $50s witnessed in FY08. In addition, ONGC benefited by about Rs5.0bn from the calculation of 20% onshore royalty on the post-subsidy discount price from 1QFY09 onwards (earlier based on pre-discount prices). High DD&A remains a concern – Rs28bn in 1Q (Rs98bn in FY08) and up 60% YoY driven by survey (Rs9.6bn) and dry wells (Rs5.5bn).
- **Subsidiaries chipping in** — OVL 1QFY09 sales were 2.07 MMT, in line with expectations (OVL profits are not reported on a quarterly basis). MRPL also had a strong quarter contributing Rs2.8 to the consolidated EPS during 1QFY09.
- **Stable crude prices could reduce concerns** — Difference between the Oil Bonds figure in the Petroleum Ministry wish list (Rs1350bn) and Finance Ministry's approved figure (Rs950bn) is a concern as OMCs' 1Q09 oil bonds allocation is based on Rs950bn. However, this issue will become less relevant if crude softens to US$110-120/bbl, as it reduces the concerns regarding the sustainability of subsidy cap. ONGC offers reasonable risk-reward for a range bound crude levels of US$110-140. Maintain Buy.

Buy/Low Risk	**1L**
Price (28 Jul 08)	Rs1,002.00
Target price	Rs1,400.00
Expected share price return	39.7%
Expected dividend yield	4.4%
Expected total return	**44.1%**
Market Cap	Rs2,143,151M
	US$50,834M

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 (%)
2006A	153,976	71.99	6.0	13.9	3.8	29.5	3.0
2007A	177,696	83.08	15.4	12.1	3.2	29.0	3.6
2008E	221,192	103.42	24.5	9.7	2.7	30.7	4.4
2009E	250,489	117.11	13.2	8.6	2.3	29.6	5.0
2010E	235,107	109.92	-6.1	9.1	2.1	24.1	4.5

Source: Powered by dataCentral

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See Appendix A-1 for Analyst Certification and important disclosures.

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Figure 1. ONGC – 1QFY09 Results (Rupees in Millions)

Rs m	1QFY08	4QFY08	1QFY09	YoY	Comments
Net sales	**136,877**	**156,261**	**200,522**	**46.5%**	Driven by high crude prices
Inc/dec in stock	(359)	382	61	-116.9%	
Raw material cons	13,913	24,338	27,645	98.7%	
Staff cost	2,543	1,630	2,897	13.9%	Provision of Rs2.26bn pending finalization of employee pay revision
Statutory levies	28,991	33,802	31,353	8.1%	Decline due to 20% royalty on post-discount price (vs. pre-discount earlier) for onshore crude
Other expenditure	12,566	38,342	21,013	67.2%	
Total Expenditure	57,654	98,494	82,968	43.9%	
EBITDA	**79,223**	**57,767**	**117,554**	**48.4%**	
EBITDA margin	*57.9%*	*37.0%*	*58.6%*		
Interest	(48)	(123)	(38)	-19.8%	
Depreciation	(17,546)	(38,445)	(27,970)	59.4%	
Other income	8,388	20,337	10,500	25.2%	
Profit before tax	70,018	39,536	100,046	42.9%	
Current tax	(22,393)	(13,045)	(34,441)	53.8%	
Deferred tax	(1,520)	(220)	325	-121.4%	
Tax rate	34.2%	33.6%	34.1%		
PAT	46,105	26,271	65,929	43.0%	
Extra-ordinary	-	-	434		Insurance settlement for flood damage compensation for Hazira Gas Comlex
Reported Net Profit	**46,105**	**26,271**	**66,363**	**43.9%**	

Source: Company Reports and Citi Investment Research estimates

Figure 2. ONGC – Key Operational Parameters

	1QFY08	2QFY08	3QFY08	4QFY08	1QFY09	Comments
Crude production (MMT)	6.88	7.00	7.11	6.93	6.84	
Gas production (bcm)	6.10	6.35	6.53	6.14	6.40	
Crude sales (MMT)	5.90	6.13	5.99	6.06	5.93	
Crude sales (Rs m)	94,260	105,650	101,660	99,590	135,750	Buoyed by higher realizations and rupee depreciation
Bonny Light (US$/bbl)	71.8	78.0	91.2	100.4	125.8	
Subsidy discounts (US$/bbl)	21.6	22.1	36.7	50.7	56.7	In line with Rs450bn of upstream sharing for the year
ONGC's net realisation ($/bbl)	50.2	55.9	54.5	49.7	69.1	Highest ever reported owing to high crude prices and lower share of subsidy burden
Gas sales (bcm)	5.03	5.19	5.32	4.89	5.18	
Gas sales (Rs m)	17,940	18,330	19,170	17,940	19,770	
Gas realisation (Rs/tcm)	3,567	3,532	3,603	3,669	3,817	Aided by rupee depreciation as JV gas prices are dollar denominated

Source: Company Reports and Citi Investment Research estimates

Figure 2. FY09P vs, FY08 – Subsidy Sharing Formula

Rs bn	FY08	% of total	FY09P	% of total
Gross under-recoveries	770	100%	2,453	100%
less: Bonds	350	45%	1,350	55%
less: Upstream contribution	257	33%	450	18%
less: Price hike & Duty Cuts	-	0%	438	18%
Net under-recovery (residual)	163	21%	215	9%

Source: Bloomberg, Citi Investment Research

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 it intends to set up a petro-products retailing network.

Investment strategy

We rate ONGC as Buy/Low Risk (1L) with a target price of Rs1400. The government's intentions to revert to 1/3rd sharing formula on subsidy sharing and pre-announced oil bonds provide good visibility on ONGC's leverage to crude. ONGC's asset valuations have therefore improved with higher net realizations and likely moderate increases in gas price. Meanwhile, domestic gas prices have been on an up-move, and the structural market forces will reflect in higher realizations for ONGC's APM gas in the next 2-3 years. OVL's past acquisitions have also started bearing fruit in FY08 and beyond as they become a meaningful portion of ONGC's total production. ONGC remains reasonably priced among the Asia-Pacific E&P universe – both on traditional valuation multiples as well as asset valuations (EV/boe). This, coupled with dividend yield of ~4.0%, makes ONGC a good value pick.

Valuation

Our target price of Rs1400 is based on a PER of 12x FY09E P/E (previously 11x FY08E) on account of greater confidence in adherence to the 1/3rd subsidy-sharing formula and the company's recent successes in improving reserve replacement. In addition, Asian peers have got significantly re-rated over the last 6 months thus warranting a slightly higher multiple for ONGC now. Our new target multiple is at the higher end of historical trading ranges but remains at a material discount to regional peers. The new target price imputes EV/EBITDA of 6.0x FY09E. 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 a 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$8.3 (on 1P Reserves) is at a discount to peers.

Risks

We now assign a Low Risk (previously Medium Risk) on account of improving visibility on subsidy sharing formula given 1) reasonably solvent performance of downstream R&M companies and 2) pre-announced oil bonds. 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. There is always uncertainty over the size, scale, terms, and profitability of such planned overseas investments. More overseas acquisitions increase ONGC's geopolitical risks. Government interference in the Indian oil sector (e.g. making upstream oil companies bear LPG/kerosene subsidy losses and gasoline/diesel retailing losses) is a concern; if ONGC is made to bear the cost of any further populist measures, it would be an earnings risk. The potential sale of a stake held by IOC and GAIL would be a technical overhang and a risk to share price performance. If any of these risks has a greater impact than we anticipate, ONGC's share price could have difficulty attaining 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 (covered since October 6 2005)

#	Date	Rating	Target Price	Closing Price
1:	11 Aug 05	1M	*780.00	635.57
2:	5 Oct 05	1M	*853.33	714.47
3:	5 Feb 06	1M	*933.33	793.73
4:	9 Mar 06	1M	*882.00	760.73
5:	8 Jun 06	1M	*866.67	640.70
6:	30 Jan 07	1M	*1,100.00	NA
7:	30 Oct 07	*1L	*1,400.00	1,219.55

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