ONGC -- Maintain NEUTRAL

Spurt of acquisition activity at OVL – project execution key to extracting value **EPS: ◄► TP: ◄►**

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- OVL has recently displayed a propensity to bid and acquire near discovered reserves after a year of adding to an exploratory portfolio. It has bid for Imperial Energy and is reported to be interested in stakes in Tanganyika Oil and Block 32 in Angola.
- Imperial has reserves in Russia but little production. Tanganyika has heavy oil reserves in Syria that need to be developed. Block 32 in deep-water Angola is yet to begin project development.
- Buying multibillion-dollar assets through competitive bids is unlikely to leave much value on the table now, while OVL will run capex and project-completion risks.
- Upside at such acquisitions can be generated by project execution—getting production volume to more than current estimates; and/or via a sustained high-oil-price environment.
- ONGC's strategy of bidding for such assets implies that it is banking on its execution ability—a good sign, in our view. We await completion of the acquisitions and more details on cost and production before updating our valuations. Maintain NEUTRAL.

Bbg/RIC	ONGC IN / ONGC.BO	Price (8 Sep 08, Rs)			1,099.25
Rating (prev. rating)	N (N)	TP (Rs) (prev. TP)			1,012 (1,012)
Shares outstanding (mn)	2,138.87	Est. pot. % chg. to TP			(8)
Daily trad vol–6m avg (mn)	0.3	52-wk range (Rs)			1366.10 - 790.25
Daily trad val–6m avg (US$ mn)	8.4	Mkt cap (Rs/US$ bn)			2,351.2/ 52.8
Free float (%)	14.0	**Performance**	**1M**	**3M**	**12M**
Major shareholders	Indian Government 74%	Absolute	3.3	17.1	29.2
		Relative	4.9	22.0	34.8

Year	3/07A	3/08A	3/09E	3/10E	3/11E
Revenues (Rs mn)	1,124,752	1,303,927	1,997,481	1,832,728	2,002,057
EBITDA (Rs mn)	381,489	431,283	476,654	447,727	424,672
Net profit (Rs mn)	177,464	198,723	240,833	215,838	191,808
EPS (Rs)	83	93	113	101	90
- Change from prev. EPS (%)	n.a.	n.a.	0	0	0
- Consensus EPS (Rs)	n.a.	n.a.	114	114	129
EPS growth (%)	(23.2)	12.0	21.2	(10.4)	(11.1)
P/E (x)	13.2	11.8	9.8	10.9	12.3
Dividend yield (%)	2.8	2.9	3.5	3.2	2.8
EV/EBITDA (x)	5.8	5.0	4.5	4.7	4.9
P/B (x)	3.5	3.0	2.6	2.3	2.0
ROE (%)	26.3	25.1	25.8	20.4	16.4
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash

Note 1: Oil & Natural Gas Corp Ltd specializes in the exploration and production of crude oil and gas. It has joint ventures in oil fields in Vietnam, Norway, Egypt, Tunisia, Iran & Australia. Other activities are deep sea explorations and coal bed methane.

OVL re-enters the bidding game

ONGC's overseas arm, OVL, has been in the news, having bid for Imperial Energy in the UK. *The Business Standard* reported on 9 Sept. that OVL also put in a bid, estimated at more than $1.5 bn, to acquire a 20% stake in Block 32 in Angola from Marathon Oil. *Live Mint* also reported on Sept 5 that OVL is interested in acquiring a stake in Tanganyika Oil Co. The Angola block has already seen bids from two Chinese companies while any bid for listed companies such as Imperial and Tanganyika is open to competition. The renewed acquisition imperative at ONGC comes after a period of building an exploration portfolio and after earlier failures in global bidding.

Imperial bid yet to be closed

ONGC has bid to acquire Imperial Energy, which has assets in the Tomsk region of Western Siberia. The deal is in progress and may yet see competing bids from other companies. Please refer to our note dated 27 Aug 2008 for more details. Imperial has about 900 mmbbl of 2P reserves but little current production. Further capex and project development is needed to ramp up production volume.

Tanganyika Oil is similar—reserves but low production

Tanganyika Oil has gross 2P reserves (in 2007) of 851 mmbbl across assets in Syria while net production was a low 6,000 bopd. We understand most of this is heavy oil; significant capex and work are needed to ramp up production volume. Syrian contract terms also do not seem very favourable; there is a base production deduction and a royalty of 12.5%. The cost of oil in a year ranges from 48% to 70%, with the government keeping 70% of the remaining profit in oil. With the contractor keeping a small portion of volume upside, controlling costs will be an important factor in generating returns from such an acquisition. While ONGC may be attracted by the large reserves it can book (at a relatively low cost) through such an acquisition, return generation from any such acquisition will require significant management attention.

Angola Block 32—large ultra deepwater development

ONGC is also reported to have bid to buy a 20% stake in Block 32 from Marathon Oil. Total is the operator for the block, which is estimated to have close to 1 bn bbl of recoverable (p+p) reserves. Two Chinese companies are reported to have bid $1.5 bn for the 20% stake while Marathon is reported to be looking at $2 bn. While the government take in this block is not as onerous as in Syria, there is significant capex and execution risk, this being an ultra-deepwater development. Working with Total on such a development, though, should be a good deep-water-learning experience for ONGC.

Signs of increasing confidence at ONGC?

ONGC may have several objectives in mind when bidding for such assets globally. India imports a majority of its crude and securing volumes could be one of ONGC's strategic mandates. Production from domestic fields will decline; overseas assets will compensate. Such acquisitions also contribute to healthy reserve replacement.

With all these being competitive bids, no value is likely to be left on the table, based on current information. Upside will be available only through proper project execution—increasing reserves and production beyond what is known today in a timely manner. ONGC, though, will run capex and political risk at these properties. That the company chooses to focus on such assets implies a degree of confidence in its ability to manage costs and execute on time. We await more details on costs and plans before updating valuations. Maintain NEUTRAL.

Companies Mentioned *(Price as of 08 Sep 08)*
Oil & Natural Gas Corporation Limited (ONGC.BO, Rs1099.25, NEUTRAL, TP Rs1012.00)
Imperial Energy (IEC.L, 1167.00 p)
Marathon Oil Corp (MRO, $43.90, OUTPERFORM, TP $58.00)
Total (TOTF.PA, Eu45.28, NEUTRAL, TP Eu53.00)
Tanganyika Oil Co Ltd (TYK CN, C$22, NOT RATED)

Disclosure Appendix

Important Global Disclosures

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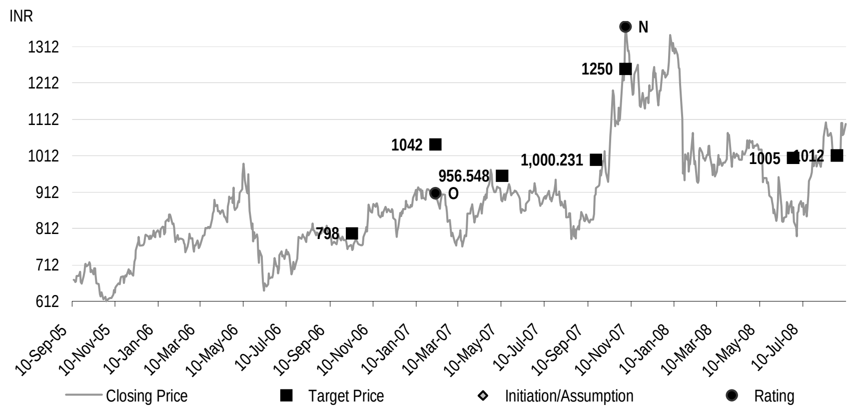
See the Companies Mentioned section for full company names.

3-Year Price, Target Price and Rating Change History Chart for ONGC.BO

ONGC.BO Date	Closing Price (INR)	Target Price (INR)	Rating	Initiation/ Assumption
11-Oct-06	752.6	798		
6-Feb-07	908.25	1042	O	
11-May-07	886.8	956.548		
21-Sep-07	923.35	1,000.231		
2-Nov-07	1,366.1	1250	N	
26-Jun-08	870.35	1005		
27-Aug-08	1,005.65	1012		



O=Outperform; N=Neutral; U=Underperform; R=Restricted; NR=Not Rated; NC=Not Covered

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Price Target: (12 months) for (ONGC.BO)

Method: We use a sum-of-the-parts (SOTP) methodology for setting our 12-month target price of Rs1012 for ONGC. The upstream business (India, Vietnam, Sakhalin, Sudan and others) and the refining business are valued using a discounted cash flow (DCF) methodology. We use a long-term oil price assumption of US$100/bbl, and a long-term simple refining margin of US$3.5/bbl. Investments are valued at market price. We use a weighted average cost of capital (WACC) of 12.2%

Risks: Risks to our 12-month target price of Rs1012 for ONGC are: 1) loss sharing percentage being variable and more than 33% 2) loss sharing being delinked from crude prices

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