

Equity | India | Oil & Gas Producers
10 May 2007

Negative subsidy surprise in FY07

3-9% downside risk to FY07 earnings due to higher subsidy

ONGC's FY07 subsidy seems set to be 16% higher than expected at Rs170bn (US\$3.75bn). This rise is mainly due to government decision to raise upstream companies' share in subsidy to 42% from the expected 35%. Higher than expected subsidy will shave Rs7.2/share off ONGC's FY07E EPS. Downside to FY07E EPS may be 3-9% depending on whether other potential positive surprises materialize. We are however not changing FY07 earnings forecast. Our real concern is the raising of share of upstream companies in subsidy to 42% from 33% in the past. It would adversely affect valuation if it continues even in future.

FY07 subsidy of ONGC 16% higher than expected

Upstream companies were to bear 42% of FY07 subsidy as per the sharing finalized by the government in June 2006. However upstream companies had to bear only 35% of 9M subsidy, which we assumed would continue in 4Q. In 4Q their subsidy was so fixed as to take their FY07 share to the originally envisaged 42%. ONGC's FY07 subsidy at Rs170bn therefore is 16% higher than our estimate, which assumed upstream share in FY07 subsidy at 35%.

Higher than expected subsidy to shave 9% of FY07E EPS

ONGC's FY07E EPS will likely be hit by Rs7.2 due to its subsidy being Rs23bn higher than expected at Rs170bn. Its EPS would therefore be 9% lower than our estimate of Rs82.2 at Rs75. However other potential positive surprises may materialize. Its EPS in that case would be 3% lower than our estimate at Rs79.6.

Long term unfavorable shift in subsidy sharing for ONGC?

The raising of upstream companies' share in subsidy to 42% in FY07 may have signaled a long term shift in subsidy sharing, which is unfavorable for ONGC. The Rangarajan committee proposals had first hinted at such unfavorable change.

Estimates (Mar)

(Rs)	2005A	2006A	2007E	2008E	2009E
Net Income (Adjusted - mn)	140,523	151,631	175,821	211,791	200,325
EPS	65.70	70.89	82.20	99.02	93.66
EPS Change (YoY)	49.5%	7.9%	16.0%	20.5%	-5.4%
Dividend / Share	26.67	30.00	29.00	36.00	35.00
Free Cash Flow / Share	20.49	18.28	56.96	54.94	48.55

Valuation (Mar)

	2005A	2006A	2007E	2008E	2009E
P/E	13.8x	12.8x	11.1x	9.2x	9.7x
Dividend Yield	2.9%	3.3%	3.2%	4.0%	3.8%
EV / EBITDA*	6.9x	6.1x	5.4x	4.7x	4.9x
Free Cash Flow Yield*	2.3%	2.0%	6.3%	6.0%	5.3%

* For full definitions of *iQmethod*SM measures, see page 7.



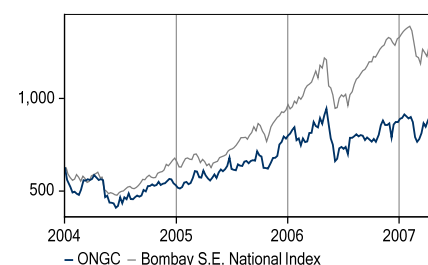
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Stock Data

Price	Rs909.35
Investment Opinion	C-2-7
Volatility Risk	HIGH
52-Week Range	Rs620.33-Rs1,009
Mrkt Val / Shares Out (mn)	US\$47,525 / 2,138.9
Average Daily Volume	202,641
ML Symbol / Exchange	ONGCF / BSE
Bloomberg / Reuters	ONGC IN / ONGC.BO
ROE (2007E)	29.0%
Net Dbt to Eqty (Mar-2006A)	-5.3%
Est. 5-Yr EPS / DPS Growth	-1.0% / 0%
Free Float	25.9%



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10 May 2007

*iQprofile*SM Oil & Natural Gas Corp. Ltd.

Key Income Statement Data (Mar)	2005A	2006A	2007E	2008E	2009E
(Rs Millions)					
Sales	597,464	723,862	967,818	1,012,895	1,007,308
Gross Profit	366,153	392,478	445,170	503,130	494,652
Sell General & Admin Expense	(85,440)	(78,608)	(90,955)	(93,102)	(98,692)
Operating Profit	204,242	214,124	257,226	312,486	294,886
Net Interest & Other Income	17,496	22,123	15,474	15,255	15,108
Associates	113	NA	NA	NA	NA
Pretax Income	221,738	236,247	272,701	327,741	309,994
Tax (expense) / Benefit	(79,416)	(81,215)	(95,471)	(114,871)	(108,677)
Net Income (Adjusted)	140,523	151,631	175,821	211,791	200,325
Average Fully Diluted Shares Outstanding	2,139	2,139	2,139	2,139	2,139

Key Cash Flow Statement Data

Net Income (Reported)	140,392	153,976	175,821	211,791	200,325
Depreciation & Amortization	76,584	99,745	96,989	97,542	101,074
Change in Working Capital	(58,925)	(98,642)	(25,145)	(24,363)	(6,180)
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	5,687	(26,489)	(10,714)	(15,414)	(33,924)
Cash Flow from Operations	163,739	128,590	236,951	269,555	261,295
Capital Expenditure	(119,919)	(89,494)	(115,118)	(152,044)	(157,453)
(Acquisition) / Disposal of Investments	3,752	(6,560)	(1)	0	0
Other Cash Inflow / (Outflow)	NA	NA	NA	NA	NA
Cash Flow from Investing	(116,167)	(96,054)	(115,119)	(152,044)	(157,453)
Shares Issue / (Repurchase)	0	0	NA	NA	NA
Cost of Dividends Paid	(57,000)	(70,304)	(82,702)	(63,307)	0
Cash Flow from Financing	(54,359)	(20,081)	(76,691)	(47,307)	18,999
Free Cash Flow	43,820	39,096	121,833	117,511	103,842
Net Debt	(61,612)	(29,656)	(87,878)	(134,384)	(169,722)
Change in Net Debt	9,428	37,768	(39,130)	(54,204)	(103,842)

Key Balance Sheet Data

Property, Plant & Equipment	473,906	618,704	653,920	731,374	811,096
Other Non-Current Assets	40,239	37,560	35,423	44,117	44,117
Trade Receivables	37,293	38,783	41,414	45,502	44,703
Cash & Equivalents	102,215	110,008	174,242	235,747	290,085
Other Current Assets	130,719	105,595	109,875	116,527	115,227
Total Assets	784,372	910,649	1,014,874	1,173,267	1,305,229
Long-Term Debt	21,129	71,353	77,363	93,363	112,362
Other Non-Current Liabilities	138,835	140,560	140,709	140,858	141,006
Short-Term Debt	19,474	9,000	9,001	8,000	8,001
Other Current Liabilities	118,148	127,654	123,208	134,021	132,234
Total Liabilities	297,585	348,566	350,281	376,243	393,603
Total Equity	486,787	562,083	664,593	797,024	911,625
Total Equity & Liabilities	784,372	910,649	1,014,874	1,173,267	1,305,229

*iQmethod*SM - Bus Performance*

Return On Capital Employed	22.3%	20.9%	20.7%	21.7%	18.0%
Return On Equity	31.6%	29.3%	29.0%	29.3%	23.7%
Operating Margin	34.2%	29.6%	26.6%	30.9%	29.3%
EBITDA Margin	47.0%	43.4%	36.6%	40.5%	39.3%

*iQmethod*SM - Quality of Earnings*

Cash Realization Ratio	1.2x	0.8x	1.3x	1.3x	1.3x
Asset Replacement Ratio	1.6x	0.9x	1.2x	1.6x	1.6x
Tax Rate (Reported)	35.8%	34.4%	35.0%	35.0%	35.1%
Net Debt-to-Equity Ratio	-12.7%	-5.3%	-13.2%	-16.9%	-18.6%
Interest Cover	NM	NM	NM	NM	NM

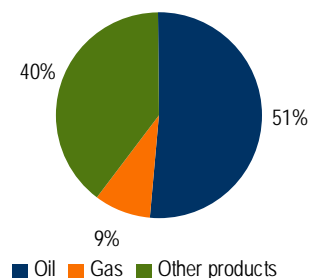
Key Metrics

* For full definitions of *iQmethod*SM measures, see page 7.

Company Description

ONGC is India's largest upstream oil company (on almost any measure) with the highest market cap. Its operations are dominated by production and exploration, both onshore and offshore. Its overseas exploration activities in Africa, Eastern Europe, the Middle East, Latin America and Southeast Asia are handled by its 100%-owned subsidiary, ONGC Videsh. ONGC also has a refining subsidiary, MRPL, with a 9.7mtpa refinery in Mangalore, India.

Chart 1: FY07 revenue breakdown



Source: DSP Merrill Lynch

Stock Data

Price to Book Value 3.0x

Table 1: 9MFY07 under-recoveries and sharing thereof

	Rs-bn	
Overall under-recoveries	426	
Borne by		
Government -oil bonds	192	45%
Upstream	148	35%
R&M companies	87	20%
	426	100%

Source: Industry sources, Petroleum Ministry, DSP Merrill Lynch

Negative subsidy surprise in FY07

ONGC's FY07E subsidy was estimated at Rs147bn

In 9M FY07 the overall subsidy (also called under-recoveries) on petroleum products (diesel, gasoline, LPG and kerosene) was Rs426bn. Upstream oil companies were required to bear Rs148bn of this subsidy, which meant their share in subsidy was 35% (see Table 1). We had therefore estimated that even in 4Q upstream oil companies would be required to bear 35% of subsidy. Thus based on our estimate of FY07E subsidy of Rs511bn, we estimated upstream companies' share in subsidy at Rs177bn.

Table 2: Our estimate of FY07 under-recoveries and sharing thereof

	Rs-bn	
Overall under-recoveries	511	
Borne by		
Government -oil bonds	241	47%
Upstream	177	35%
R&M companies	92	18%
	511	100%

Source: DSP Merrill Lynch

Our estimate of ONGC's FY07E subsidy worked out to Rs147bn (see Table 3) based on the assumption that subsidy borne by ONGC and other upstream companies would be Rs177bn.

Table 3: Our estimate of subsidy borne by upstream companies in 4Q and FY07

Rs-bn	1Q FY07	2Q FY07	3Q FY07	4Q FY07E	FY07E
ONGC	51	50	22	24	147
GAIL	3	4	3	3	13
OIL India	6	6	3	3	17
	60	60	28	29	177

Source: DSP Merrill Lynch

Table 4: FY07E under-recoveries and sharing thereof as envisaged in June 2006

	Rs-bn	
Overall under-recoveries	578	
Borne by		
Government -oil bonds	283	49%
Upstream	240	42%
R&M companies	55	10%
	578	100%

Source: Petroleum Ministry

ONGC's FY07E subsidy 16% higher than MLE

Subsidy sharing envisaged in June 2006 put upstream share at 42%

In June 2006 when Brent price was at US\$70/bbl the Petroleum Ministry had made an estimate of FY07E subsidy. It had also laid out how the subsidy would be shared by various players. We believe that this sharing formula was ratified by the government. As per this sharing formula upstream oil companies ONGC, GAIL and OIL were to bear 42% of subsidy as against just 35% they were made to bear in 9M FY07.

4Q subsidy so calculated as to take FY07 upstream share up to 42%

4Q subsidy of upstream oil companies has been so calculated as to take their share in FY07 subsidy up to 42% as originally envisaged in June 2006. Press reports, industry sources and audited results announced by GAIL now confirm this. The petroleum ministry is also believed to have sent written communication to the oil companies on 4Q subsidy sharing.

Upstream companies to bear 42% of FY07 subsidy at Rs205bn

Subsidy in FY07 is believed to be Rs494bn. Rs241bn of oil bonds have been issued, which is 49% of subsidy as envisaged in the June 2006 subsidy sharing formula. Share of upstream oil companies in FY07 subsidy was to be 42% as per the June 2006 formula. Their FY07 subsidy has therefore been fixed at Rs205bn, which is 42% of the overall subsidy of Rs494bn (see Table 5).

Table 5: FY07 under-recoveries and sharing thereof

	Rs-bn	
Overall under-recoveries	494	
Borne by		
Government -oil bonds	241	49%
Upstream	205	42%
R&M companies	48	10%
	494	100%

Source: Petroleum Ministry, Industry sources, Financial Express, DSP Merrill Lynch

ONGC's FY07 subsidy 16% higher than Mle at Rs170bn

ONGC's subsidy hit in FY07 has been fixed at Rs170bn, which is Rs23bn or 16% higher than our estimate. Our subsidy estimate was based on assumption upstream would bear 35% of subsidy. With upstream being required to bear 42% of subsidy ONGC's share in subsidy is up to Rs170bn in FY07.

Table 6: Subsidy borne by upstream companies in FY07

Rs-bn	1Q	2Q	3Q	4Q	FY07	Higher vis-à-vis Mle
ONGC	51	50	22	47	170	23
GAIL	3	4	3	5	15	2
OIL India	6	6	3	6	20	3
Upstream companies' subsidy	60	60	28	57	205	28

Source: Petroleum Ministry, Industry sources, Financial Express, DSP Merrill Lynch

Higher subsidy to mean lower FY07 earnings

Higher than expected subsidy will mean that ONGC's FY07 earnings will be lower than expected. Our forecast of ONGC's consolidated earnings stands at Rs82.2/share with standalone EPS estimated at Rs72/share.

3-9% downside to FY07E earnings

Higher subsidy to shave Rs7.2 (9%) off ONGC's FY07E EPS

FY07 subsidy being higher than estimated by Rs23bn will shave Rs7.2/share of ONGC's earnings. This will mean that FY07 earnings would be 9% lower than our estimate of Rs82.2/share at Rs75/share.

Some positive surprises may mean FY07 earnings downside is 3%

Some positive earnings surprises are possible like other income being higher than expected. Any such positive surprises will partly neutralize negative impact of subsidy being higher than expected. We estimate that even in that case ONGC's FY07 earnings would be 3% lower than our estimate of Rs82.2/share at Rs79.6/share.

Keeping FY07E earnings unchanged

We are however keeping FY07E earnings unchanged. This is because the downside to earnings may be a modest 3%. Besides the audited result of ONGC should be announced over the next 2-3 weeks. We would rather wait for the results rather than change the forecast now.

Long term shift in subsidy sharing or one-off?

Upstream bearing 42% of FY07E subsidy as against widely believed 33%

Upstream companies have been required to bear 42% of subsidy in FY07 as against the general belief that they would bear one-third of the subsidy. Is upstream companies bearing only one-third of the subsidy a thing of the past? This is the pertinent question change in subsidy sharing in FY07 raises.

FY07 subsidy sharing may signal an unfavorable change for ONGC

Upstream companies bearing 42% of subsidy may signal a long term shift in subsidy sharing, which is unfavorable for ONGC. This we believe may be the real concern emerging from the higher than expected subsidy.

Rangarajan committee had signaled the unfavorable change

The unfavorable change in subsidy sharing for ONGC and its upstream peers does not come as a complete surprise to us. The Rangarajan committee appointed by the government submitted its report in February 2006. It recommended elimination of auto fuel subsidy and reduction of LPG and kerosene subsidy. On subsidy sharing it recommended that the remaining subsidy should be shared just by the upstream companies and the government and the R&M companies should not bear any subsidy. Its recommendations on subsidy reduction have not been implemented. However its recommendation on subsidy sharing appears to be somewhat implemented with R&M companies being required to bear just 10% of subsidy in FY07.

Unfavorable subsidy sharing could affect valuation adversely

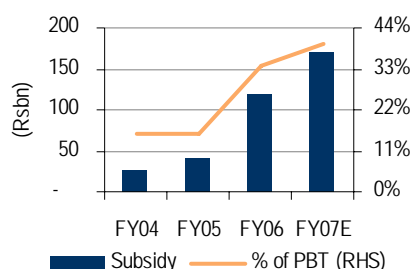
The unfavorable change in subsidy sharing vindicates the concern we had raised in our report on ONGC titled "Valuation Analysis" dated January 13, 2007. The concern was that upstream companies may have to bear higher than one-third subsidy. It has materialized in FY07. Upstream being required to bear 42% of subsidy in FY07 has hit earnings by 9%. We believe that if this trend continues it would have adverse implications for valuation of ONGC. Our current valuation of ONGC assumes upstream companies will have to bear only one-third of subsidy.

Subsidy taking away increasing share of ONGC's pre-tax profit

Subsidy is set to reduce ONGC's consolidated profit before tax (PBT) by 40% in FY07. Subsidy as a proportion of consolidated PBT has been gradually increasing. Subsidy was 15% of ONGC's consolidated PBT in FY04 when there was subsidy only on LPG and kerosene. Subsidy reduced ONGC's consolidated PBT by 34% in FY06 when even auto fuels started getting subsidized. In FY07 subsidy is set to reduce ONGC's consolidated PBT by 40% as upstream oil companies' share in subsidy is increased to 42% (see chart 1).

Oil & Natural Gas Corp. Ltd., 13 January 2007

Chart 2: Trend in ONGC's subsidy burden



Source: Company data, DSP Merrill Lynch

Analyst Certification

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Business Performance	Numerator	Denominator
Return On Capital Employed	$\text{NOPAT} = (\text{EBIT} + \text{Interest Income}) * (1 - \text{Tax Rate}) + \text{Goodwill Amortization}$	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
Quality of Earnings		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
Valuation Toolkit		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	$\text{EV} = \text{Current Share Price} * \text{Current Shares} + \text{Minority Equity} + \text{Net Debt} + \text{Sales Other LT Liabilities}$	
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

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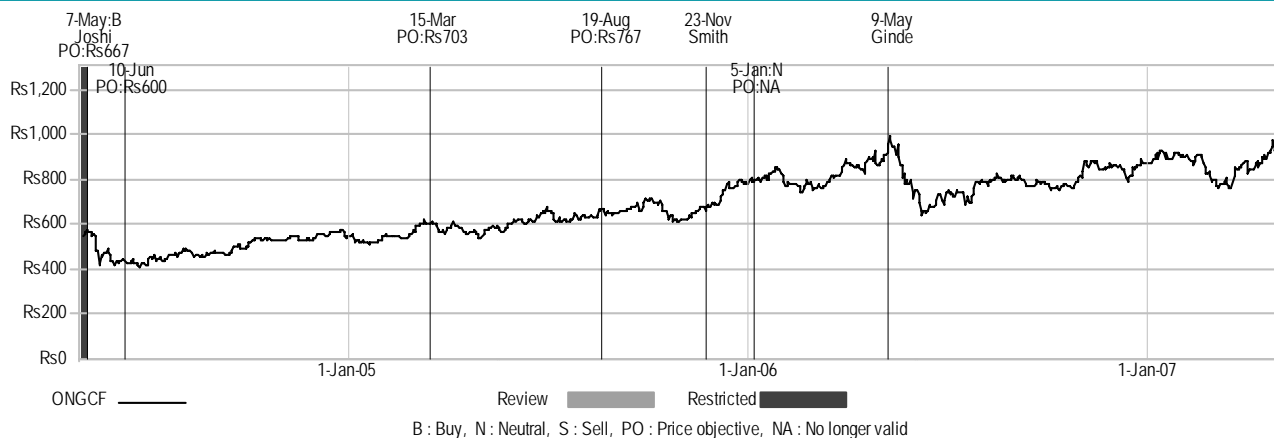
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ONGCF Price Chart



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Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	137	57.81%	Buy	48	41.03%
Neutral	92	38.82%	Neutral	24	30.38%
Sell	8	3.38%	Sell	0	0.00%

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Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1562	45.16%	Buy	415	30.09%
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Sell	282	8.15%	Sell	49	19.76%

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