

JUNE 28, 2011

UPDATE

Coverage view: **Cautious**

Price (Rs): **307**

Target price (Rs): **340**

BSE-30: **18,492**

Another twist. In a further development to the pending deal between Cairn Energy (CNE) and Vedanta Resources (VED), the parties have agreed to remove the non-compete fee of ₹50/share for sale of 40% stake of Cairn India. We would not speculate if this development reflects that the parties have agreed to the government's condition of treating royalty as a cost recoverable item and would await a formal communication on the same. We retain our REDUCE rating on the stock given the potential downside of ₹59/share for minority shareholders if royalty is made cost recoverable.

Company data and valuation summary

Cairn India

Stock data

52-week range (Rs) (high,low)	372-283
Market Cap. (Rs bn)	584.1

Shareholding pattern (%)

Promoters	62.2
FIs	11.7
MFs	1.6

Price performance (%)

	1M	3M	12M
Absolute	(11.4)	(13.2)	(1.5)
Rel. to BSE-30	(12.5)	(11.0)	(5.4)

Forecasts/Valuations

	2011	2012E	2013E
EPS (Rs)	33.3	61.8	63.1
EPS growth (%)	501.1	85.6	2.0
P/E (X)	9.2	5.0	4.9
Sales (Rs bn)	110.4	197.3	231.9
Net profits (Rs bn)	63.3	117.6	119.9
EBITDA (Rs bn)	85.4	152.6	158.9
EV/EBITDA (X)	6.6	3.5	2.9
ROE (%)	16.9	25.9	22.7
Div. Yield (%)	0.0	1.6	6.5

QUICK NUMBERS

- CAIR stock is discounting US\$86/bbl crude price in perpetuity
- ₹59/share downside if royalty is made cost recoverable

Change to the CNE-VED deal—(1) deal in two tranches and (2) removal of non-compete fee

The terms of the long-due CNE-VED have been revised— (1) the parties have agreed to the removal of the non-compete fee of ₹50/share to be paid by VED for acquiring a 40% stake in Cairn India. (2) VED has agreed to buy 10% stake in Cairn India before July 11, 2011 and subsequent 30% stake in Cairn India once they receive necessary approval from the government. We note that VED/Sesa Goa and CNE will hold 28.5% and 52.2% stakes in Cairn India after sale of first tranche of 10%.

Media speculates on acceptance of pre-condition of royalty being made cost-recoverable

As per media reports, the removal of non-compete fee reflects the acceptance of the government's precondition of making royalty a cost-recoverable item. However, we would await a confirmation on the same before reviewing our earnings estimates and fair valuation of the company. We note that we do not assume royalty to be a cost-recoverable item and our fair value for Cairn India would decline by ₹59/share if royalty is made cost recoverable.

CCEA to meet on June 30, 2011 to consider the deal

We note that the Cabinet Committee on Economic Affairs (CCEA) is scheduled to meet on June 30, 2011 to consider the CNE-VED deal. The Group of Ministers (GoM) constituted for the proposed CNE-VED deal had firmed its view on the deal in its meeting on May 29, 2011 and had referred the matter back to CCEA to take the final decision.

Retain REDUCE with a target price of ₹340

We retain our REDUCE rating on Cairn with a 12-month DCF-based target price of ₹340 noting (1) modest 11% upside from current levels and (2) potential downside of ₹59/share from the unfavorable development on the royalty issue. We note that the stock price is discounting US\$86/bbl in perpetuity without considering the downside impact of royalty being treated as a cost-recoverable item.

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Crude price discounted at various levels of stock price of Cairn

Stock price (Rs/share)	Crude price discounted (US\$/bbl)
460	118
445	115
430	112
415	109
400	105
385	102
370	99
355	95
340	92
325	89
310	86

Note:

- (1) Crude price discounted from FY2012E in perpetuity.
- (2) Exchange rate assumption (FY2013E onwards) is Rs44/US\$.
- (3) Inflation assumption of 2% in crude prices from FY2015E onwards.

Source: Kotak Institutional Equities estimates

We value Cairn India stock at ₹340

EV and equity value of Cairn (US\$ mn)

	Now	+ 1-year	+ 2-years
RJ-ON-90/1	12,996	13,197	11,921
CB-OS-2	63	38	18
Ravva	187	159	133
Upside potential (KG-DWN-98/2)	100	112	125
Total	13,346	13,506	12,197
Net debt	(397)	(1,096)	(2,723)
Equity value	13,743	14,602	14,920
Equity shares (mn)	1,902	1,902	1,902
Equity value per share (Rs/share)	329	338	345

Source: Kotak Institutional Equities estimates

Profit model, balance sheet, cash model of Cairn, calendar year-ends, 2006-07, March fiscal year-ends, 2009-14E (₹ mn)

	2006	2007	2009 (a)	2010	2011E	2012E	2013E	2014E
Profit model (Rs mn)								
Net sales	18,254	16,561	25,156	22,627	110,446	197,344	231,906	221,909
EBITDA	7,521	6,817	9,098	9,874	84,117	148,507	153,134	107,640
Other income	1,100	1,324	5,510	4,077	1,288	4,094	5,748	7,290
Interest	(201)	(27)	(64)	(148)	(2,909)	(1,478)	(558)	—
Depreciation	(497)	(4,589)	(4,382)	(3,570)	(13,596)	(20,243)	(24,477)	(25,923)
Pretax profits	7,923	3,524	10,162	10,232	68,900	130,880	133,847	89,008
Extraordinary items	—	(2,120)	(283)	(69)	—	—	—	—
Tax	(2,254)	(740)	(1,221)	(739)	(4,397)	(10,366)	(12,892)	(8,980)
Deferred taxation	(22)	(764)	(623)	1,087	(1,159)	(2,952)	(1,016)	7
Net profits	5,648	(100)	8,035	10,511	63,344	117,563	119,939	80,035
Earnings per share (Rs)	3.2	(0.1)	4.3	5.5	33.3	61.8	63.1	42.1
Balance sheet (Rs mn)								
Total equity	292,804	294,358	328,023	338,683	402,932	489,800	548,418	550,524
Deferred tax liability	4,258	4,916	5,540	4,453	5,612	8,564	9,580	9,572
Total borrowings	5,122	3,124	43,564	34,007	26,782	13,282	—	—
Current liabilities	39,716	8,372	16,132	14,806	29,266	4,671	8,308	13,575
Total liabilities and equity	341,900	310,771	393,259	391,949	464,592	516,316	566,305	573,672
Cash	61,348	1,504	18,968	6,269	44,847	61,504	119,833	150,461
Current assets	6,470	19,029	53,712	17,465	34,761	40,986	45,247	44,014
Total fixed assets	17,609	25,157	62,660	92,904	99,054	118,724	95,646	70,330
Net producing properties	2,354	4,390	3,014	4,995	20,850	30,024	40,500	43,787
Investments	4	7,129	1,713	17,124	10,945	10,945	10,945	10,945
Goodwill	254,115	253,193	253,193	253,193	253,193	253,193	253,193	253,193
Deferred expenditure	—	370	—	—	943	943	943	943
Total assets	341,900	310,771	393,259	391,949	464,592	516,317	566,306	573,672
Free cash flow (Rs mn)								
Operating cash flow, excl. working capital	4,505	6,387	8,213	6,501	63,806	115,152	121,061	85,595
Working capital changes	34,256	(908)	1,213	(7,082)	(5,032)	(30,820)	(624)	6,500
Capital expenditure	(5,619)	(11,739)	(31,613)	(33,662)	(32,558)	(47,217)	(10,364)	(2,444)
Investments/Goodwill	(252,717)	(53,863)	(25,062)	25,194	6,180	—	—	—
Other income	1,100	1,298	1,518	2,360	1,288	4,094	5,748	7,290
Free cash flow	(218,474)	(58,824)	(45,730)	(6,689)	33,684	41,209	115,821	96,941
Key assumptions								
Gross production ('000 boe/d)	91.0	75.4	68.1	64.3	150.6	204.6	262.3	262.3
Net production ('000 boe/d)	25.1	19.4	17.8	21.0	87.9	124.5	167.3	169.4
Dated Brent (US\$/bbl)	65.3	70.3	87.4	67.0	86.7	105.0	95.0	90.0
Discount of Rajasthan crude to Dated Brent (US\$/bbl)	—	—	—	5.0	10.0	8.0	8.0	8.0

Note:

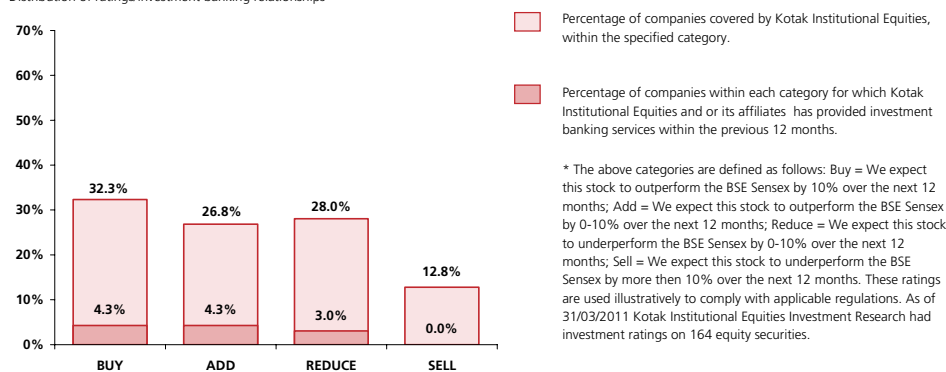
(a) 15 months period starting from January 1, 2008 to March 31, 2009.

Source: Kotak Institutional Equities estimates

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Source: Kotak Institutional Equities

As of March 31, 2011

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