

Equities

6 February 2012 | 13 pages

Cairn India (CAIL.BO)

4 for 400: 4 Reasons to Buy for a Rs400 TP

- Company Update
- Target Price Change
- Estimate Change

- **Remains our top pick** — We are reiterating our Buy on Cairn and raising our 12-mth TP to Rs400 from Rs358 as we roll forward our NAV to Mar-13E and update our model to reflect earnings adjustments. While the stock has (understandably) under-performed recently (by ~6% in 2 weeks) given its sharp ~16% outperformance in the last 4 mths, we view the current softness as providing an adding point for investors with a 1-yr time horizon. Cairn remains our top large cap sector pick predicated on the following:
- **#1: MBA growth engine targets confirmed** — Mgmt recently reiterated its target of exiting Mar-12 at a 175 kbpd production rate (125 in Dec), and achieving a 'significant part' of the basin potential of 240 by CY13. This is largely in line with our forecasts of 175/185/230 kbpd by Jun-12/Dec-12/Dec-13E, which equates to a 35% 2-yr vol CAGR.
- **#2: Positive trends for next few qtrs** — With Bhagyam production having (belatedly) commenced in Jan, the period of stagnant vols for Cairn is now behind us (have stayed at 125 kbpd for the last 5 qtrs). With approvals in the sector seemingly more forthcoming now (RIL's satellite fields being another case in point), the approval for Mangala ramp up should also be awarded soon, driving vol growth for the next 2-3 qtrs.
- **#3: Announcement of dividend policy the next key milestone** — The company recently said that a dividend distribution policy would be considered after completion of its reorganisation involving its wholly owned subsidiaries. We expect this process to take a few months and are hopeful of a policy being ready to be considered by the new board of directors when it meets to take up the company's annual results in Apr/May.
- **#4: Continue to expect a tight oil market; stock pricing in US\$80 crude** — Despite the approaching trough in global refinery throughput, Citi's Global Commodities team sees the spike potential for Brent returning. Crude prices remain supported by low inventories, a steady stream of bullish headlines (Iran, Nigeria, Sudan), and very strong refining margins on offer. The stock is still pricing in ~US\$80 LT crude (see Figure 9).

Buy	1
Price (03 Feb 12)	Rs343.95
Target price	Rs400.00
	<i>from Rs358.00</i>
Expected share price return	16.3%
Expected dividend yield	0.0%
Expected total return	16.3%
Market Cap	Rs654,526M
	US\$13,465M

Price Performance (RIC: CAIL.BO, BB: CAIR IN)



Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2010A	10,511	5.41	na	63.6	2.0	na	0.0
2011A	63,344	32.36	498.3	10.6	1.7	17.1	0.0
2012E	81,819	41.80	29.2	8.2	1.4	18.4	0.0
2013E	110,905	56.66	35.5	6.1	1.1	20.5	0.0
2014E	119,682	61.14	7.9	5.6	0.9	18.3	0.0

Source: Powered by dataCentral

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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CAIL.BO: Fiscal year end 31-Mar						Price: Rs343.95; TP: Rs400.00; Market Cap: Rs654,526m; Recomm: Buy					
Profit & Loss (Rsm)	2010	2011	2012E	2013E	2014E	Valuation ratios	2010	2011	2012E	2013E	2014E
Sales revenue	16,596	103,043	115,092	167,825	192,085	PE (x)	63.6	10.6	8.2	6.1	5.6
Cost of sales	-7,887	-28,767	-29,878	-46,759	-66,610	PB (x)	2.0	1.7	1.4	1.1	0.9
Gross profit	8,709	74,276	85,214	121,066	125,475	EV/EBITDA (x)	na	7.7	5.6	3.6	2.5
Gross Margin (%)	52.5	72.1	74.0	72.1	65.3	FCF yield (%)	-5.8	4.7	9.4	13.6	19.3
EBITDA	9,805	84,117	107,158	146,915	166,087	Dividend yield (%)	0	0	0	0	0
EBITDA Margin (%)	59.1	81.6	93.1	87.5	86.5	Payout ratio (%)	0	0	0	0	0
Depreciation	-3,570	-13,596	-20,109	-31,611	-45,610	ROE (%)	na	17.1	18.4	20.5	18.3
Amortisation	0	0	0	0	0	Cashflow (Rsm)	2010	2011	2012E	2013E	2014E
EBIT	6,235	70,521	87,049	115,304	120,477	EBITDA	9,805	84,117	107,158	146,915	166,087
EBIT Margin (%)	37.6	68.4	75.6	68.7	62.7	Working capital	-6,605	-7,614	-6,155	-19,284	-5,031
Net interest	-148	-2,909	-2,476	-2,530	-2,432	Other	4,276	-7,177	-5,230	-4,399	-795
Associates	0	0	0	0	0	Operating cashflow	7,477	69,327	95,773	123,232	160,261
Non-op/Except	4,077	1,288	4,629	8,117	12,132	Capex	-45,984	-37,392	-32,451	-31,444	-30,094
Pre-tax profit	10,163	68,900	89,202	120,891	130,176	Net acq/disposals	0	0	0	0	0
Tax	348	-5,556	-7,383	-9,987	-10,494	Other	0	0	0	0	0
Extraord./Min.Int./Pref.div.	0	0	0	0	0	Investing cashflow	-45,984	-37,392	-32,451	-31,444	-30,094
Reported net profit	10,511	63,344	81,819	110,905	119,682	Dividends paid	0	0	0	0	0
Net Margin (%)	63.3	61.5	71.1	66.1	62.3	Financing cashflow	-9,479	-7,085	-11,932	-600	0
Core NPAT	10,511	63,344	81,819	110,905	119,682	Net change in cash	-47,986	24,850	51,390	91,188	130,167
Per share data	2010	2011	2012E	2013E	2014E	Free cashflow to s/holders	-38,507	31,935	63,322	91,788	130,167
Reported EPS (Rs)	5.41	32.36	41.80	56.66	61.14						
Core EPS (Rs)	5.41	32.36	41.80	56.66	61.14						
DPS (Rs)	0	0	0	0	0						
CFPS (Rs)	3.85	35.42	48.93	62.96	81.87						
FCFPS (Rs)	-19.81	16.32	32.35	46.89	66.50						
BVPS (Rs)	174.28	205.85	247.65	304.31	365.45						
Wtd avg ord shares (m)	1,943	1,957	1,957	1,957	1,957						
Wtd avg diluted shares (m)	1,943	1,957	1,957	1,957	1,957						
Growth rates	2010	2011	2012E	2013E	2014E						
Sales revenue (%)	na	nm	11.7	45.8	14.5						
EBIT (%)	na	nm	23.4	32.5	4.5						
Core NPAT (%)	na	nm	29.2	35.5	7.9						
Core EPS (%)	na	nm	29.2	35.5	7.9						
Balance Sheet (Rsm)	2010	2011	2012E	2013E	2014E						
Cash & cash equiv.	9,294	44,847	88,907	176,589	303,151						
Accounts receivables	12,687	34,761	47,374	69,047	79,013						
Inventory	0	0	0	0	0						
Net fixed & other tangibles	99,817	120,985	142,686	148,991	140,754						
Goodwill & intangibles	253,193	253,193	253,193	253,193	253,193						
Financial & other assets	17,124	10,944	10,944	10,944	10,944						
Total assets	392,115	464,731	543,104	658,764	787,055						
Accounts payable	14,806	29,266	35,723	38,112	43,048						
Short-term debt	0	0	0	0	0						
Long-term debt	34,007	26,782	14,850	14,250	14,250						
Provisions & other liab	4,619	5,750	7,779	10,746	14,420						
Total liabilities	53,432	61,798	58,353	63,108	71,718						
Shareholders' equity	338,683	402,932	484,751	595,656	715,337						
Minority interests	0	0	0	0	0						
Total equity	338,683	402,932	484,751	595,656	715,337						
Net debt	24,713	-18,065	-74,057	-162,339	-288,901						
Net debt to equity (%)	7.3	-4.5	-15.3	-27.3	-40.4						

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Reiterating our Positive Thesis; Raising TP to Rs400

4 key drivers of our positive investment thesis

We outline below the 4 key drivers on which our positive view on Cairn India is predicated.

#1: MBA growth engine targets confirmed

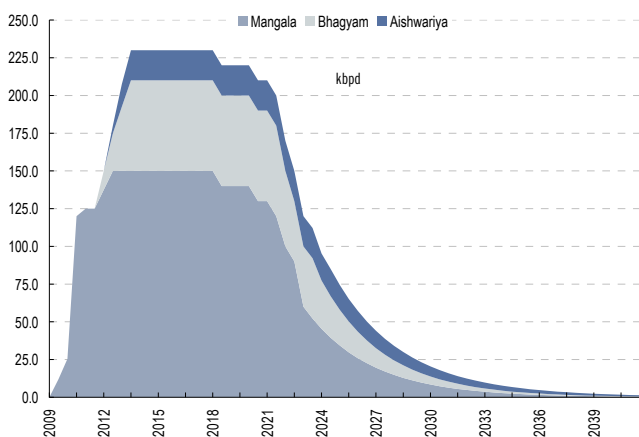
Cairn announced on Jan 19 that it has received production approval for its Bhagyam fields in Rajasthan (2nd largest after Mangala). The currently approved production plateau is 40kbpd. Subsequently, mgmt has maintained their production guidance of a 175kbpd exit rate by Mar-12 (vs. 125kbpd in Dec-11). With the current momentum on production approvals, one can reasonably expect a nod for Mangala’s peak rate hike from the current 125kbpd to 150kbpd. In our forecasts, we currently assume production to rise to 175kbpd by Jun-12. Revised FDPs for Bhagyam and Aishwariya are under preparation (former will likely be filed first, after c6 mths of production), while an FDP for Mangala EOR is slated for submission in 1HCY12. Mgmt is expecting production to be ramped up to 240kbpd by CY13, a ‘significant portion’ of which is slated to come from the MBA fields. A minor contribution is likely to be made from the other fields in the Rajasthan block (Barmer Hill, etc). This is in tune with our forecasts of MBA production rising to 230kbpd by Dec-13 (150/60/20 from M/B/A). The company has also, in the past, indicated (see Figure 3) that with a little help from non-MBA fields, production could hit 300kbpd by 2014.

Figure 1. MBA Production Ramp-Up

Year to 31-Dec kbpd	2011		2012		2013		2014	
	H1*	H2*	H1	H2	H1	H2	H1	H2
MBA – Total	125	125	150	180	208	230	230	230
-Mangala	125	125	138	150	150	150	150	150
-Bhagyam	0	0	13	25	43	60	60	60
-Aishwariya	0	0	0	5	15	20	20	20

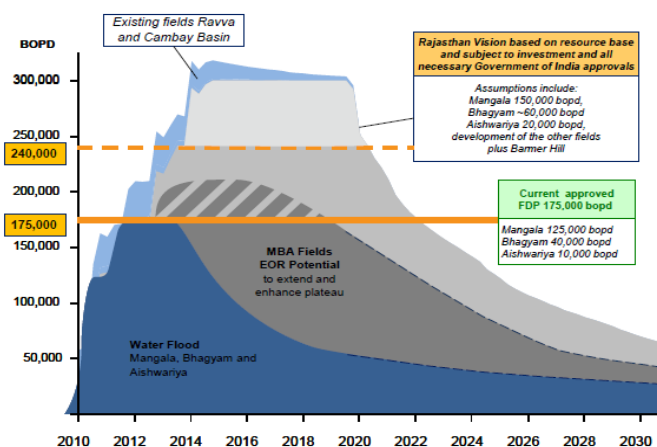
Source: Citi Investment Research and Analysis. Note: Average values for the respective periods. *Actuals.

Figure 2. MBA – Forecast production profile (CIRA forecasts)



Source: Citi Investment Research and Analysis

Figure 3. Envisaged production from Rajasthan fields (as per company)



Source: Company reports

#2: Positive trends for next few qtrs

Rajasthan production for Cairn had stagnated over the last 5 qtrs at 125kbpd. However, it seems that the momentum of approvals for the Indian E&P sector could work in Cairn's favour (if the Bhagyam production nod and the approval for drilling at satellite fields of RIL's KG block are anything to go by), leading to robust volume growth over the next 2-3 qtrs (aided by an approval for Mangala peak production hike to 150kbpd).

Figure 4. Strong momentum in earnings over FY12-14E

	FY11	FY12E	FY13E	FY14E	2-yr CAGR
EPS (Rs)	32.4	41.8	56.7	61.1	21%
PAT (Rs m)	63,344	81,819	110,905	119,682	21%

Source: Citi Investment Research and Analysis estimates

#3: Announcement of dividend policy the next key milestone

Given that Cairn India's board reconstitution is now complete, the next major milestone is likely to be regarding its dividend policy. While difficult to time, we are hopeful it could be ready by the time of its FY12 full year results announcement in Apr/May. Any clarity regarding the use of its cash (FCF yields of 13% in FY13E) is likely to be a significant positive. If one were to assume that Cairn India's new owner Vedanta might want to service the entire cUS\$4.4bn of acquisition debt that it raised (for a 59% stake) with dividends, Cairn's payout ratio could be ~20%, in our view, resulting in a ~3% dividend yield.

#4: Continue to expect tight oil market; stock pricing in ~US\$80 crude

Cairn is likely to continue to benefit from strong crude prices in the near-medium term. Citi expects continued strength in the global crude markets, as reflected in our Brent forecasts of US\$110/120 over CY12/13E. The following are extracts from recent reports published by Citi's Global Commodities Strategy team¹:

- The outlook for the Brent curve has improved significantly since last week, with spike potential returning despite the approaching trough in global refinery throughput. Inventories remain low and supportive, Iran is now threatening to remove significant volumes from Europe, and refinery margins, even for simple refiners, are excellent.
- The IEA monthly report lowered the call on OPEC to 1-m b/d below current estimated OPEC production levels. We continue to expect a reasonably tight market as any one of the potential supply disruptions (i.e. Iran, Iraq, Nigeria) could remove at least that much oil from the market. Iran exports 2.5-m b/d so if the EU and US are effective in removing even half of Iran's exports from world markets, the supply/demand balance should be tight again.
- China data for December were mixed for crude but the 4Q'11 GDP print was constructive as signs of a hard landing remain most notable by their absence.
- South Sudan has announced it is shutting in roughly 350-k b/d of production as the new country's dispute with the North intensifies, while extreme levels of violence in Northern Nigeria claimed the lives of almost 200 people last week

¹ Refer to [Crude Watch: RBOB Spike Fades But Brent Strength Returns](#); Feb 1, 2012 and [Crude Watch: Keystone and Seaway Headlines Hit Brent-WTI 'Arb'](#); Jan 24, 2012

in several gun and bomb attacks. For now this violence is far from key oil centers but the chances of a supply disruption can hardly be ruled out.

Increasing TP to Rs400

- Given Cairn's leverage to crude prices, we continue to value the company using an average Mar-13E NAV derived from two different crude scenarios: 1) Citi global crude price forecasts yielding a base NAV of Rs407, and 2) Crude futures curve yielding an NAV of Rs435. This yields us a target price of Rs400, after factoring in a 5% discount factor to account for the uncertainty regarding Cairn's use of cash, which a dividend policy announcement could help reduce, as explained earlier.
- Recovery upside from the MBA fields is included in the Core Rajasthan NAV, while upsides arising from the LPD at Barmer Hill and additional E&P upsides in Rajasthan are factored in separately.

Figure 5. Cairn India — SOTP Valuation (NAV calculation as of Mar-13)

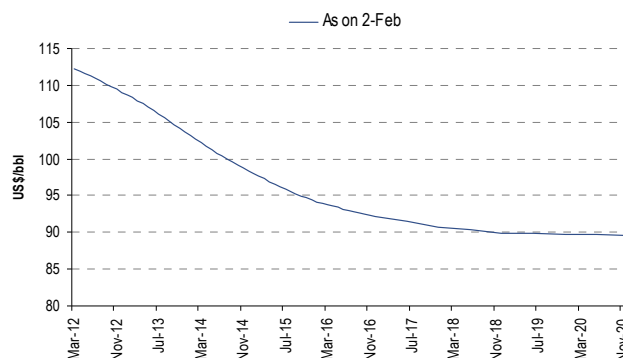
	Based on Citi crude forecasts			Based on Future's Curve			Comments
	NPV US\$m	NPV p/s Rs	EV/boe (US\$)	NPV US\$m	NPV p/s Rs	EV/boe (US\$)	
Ravva	167	4	10.6	176	4	11.2	
CB-OS/2	58	1	8.6	58	1	8.6	
Producing Fields - (a)	225	6		234	6		
Rajasthan 'Core' - (b)	9,302	235	12.0	10,105	256	13.0	Based on cash flow analysis and peak plateau of 230 kbpd Includes MBA recovery upside (total 1.12 bn boe recoverable)
Production & Development - (a)+(b)	9,527	241		10,339	261		
Overheads	(787)	(20)		(787)	(20)		Estimated based on FY12E net admin expenses
Net Cash/(Debt)	3,418	86		3,350	85		Estimated net cash as on Mar-13E
Core NAV	12,158	307		12,902	326		
LPD Reported Resource (c)	877	22	9.0	954	24	9.7	Based on disclosed 2P resource associated with LPD of 1.9 bn boe (recoverable reserves of 140 mmboe based on 7% recovery). Discount to implied EV/boe of MBA fields.
LPD Recovery Upside (d)	1,504	38	9.0	1,636	41	9.7	Upside to LPD recovery factor assumed (7% to 20%)
Exploration Upside (e)	1,566	40	9.0	1,704	43	9.7	Further upside in Rajasthan (2.5 bn boe of in-place resource; 250 mmboe recoverable)
Rajasthan Upside (c+d+e)	3,947	100		4,295	109		
Net Asset Value	16,105	407		17,197	435		
Blended NAV		421					
Premium/(discount) to NAV		-5.0%					
Target Price (blended)		400					

Source: Citi Investment Research and Analysis estimates

Figure 6. CIRA Global Brent Crude Forecasts

Year to 31-Dec	2012		2013		2014		2015	
	H1	H2	H1	H2	H1	H2	H1	H2
Brent – US\$/bbl	108	113	120	120	100	100	80	80

Figure 7. Brent Forward Curve



Source: Citi Investment Research and Analysis

Source: Citi Investment Research and Analysis

We have made some changes to our earnings for Cairn to factor in 9MFY12 performance and updated assumptions for capex, depreciation, etc., as guided by management. We now assume gross Rajasthan development capex of US\$1.25bn for CY12E and CY13E each, at the upper end of management guidance of cUS\$1.0-1.25bn (of which c65% would be towards augmentation of facilities to facilitate ramp up to 240 kbpd, and the balance would be towards EOR, Barmer Hill, exploration, etc.).

Figure 8. Cairn India Earnings Revisions

Year to 31-Mar	Sales (Rs m)			EBITDA (Rs m)			Net Profit (Rs m)			Diluted EPS (Rs m)		
	Old	New	% Chg	Old	New	% Chg	Old	New	% Chg	Old	New	% Chg
2012E	114,029	115,092	0.9%	100,126	107,158	7.0%	77,000	81,819	6.3%	39.34	41.80	6.3%
2013E	165,639	167,825	1.3%	145,836	146,915	0.7%	118,586	110,905	-6.5%	60.58	56.66	-6.5%
2014E	183,469	192,085	4.7%	157,388	166,087	5.5%	128,989	119,682	-7.2%	65.90	61.14	-7.2%

Source: Citi Investment Research and Analysis estimates

Sensitivity to crude prices and exchange rate

The following table illustrates the sensitivity of our NAV for Cairn to two key macro variables – crude prices and the INR/US\$ exchange rate. For simplicity, the values have been derived in the table below assuming the respective crude and exchange rate to stay constant throughout w.e.f. CY12E.

Figure 9. Sensitivity of Cairn's NAV (Rs/sh) to crude prices and the rupee

Brent (US\$/bbl)* →	75	80	85	90	95	100	105	110	115
INR/US\$* ↓									
52	336	364	391	418	448	472	499	525	555
51	330	358	385	413	441	464	490	516	545
50	325	352	378	406	433	456	482	507	536
49	319	348	372	399	425	448	473	498	526
48	314	342	365	392	418	440	465	489	517
47	308	336	359	385	410	432	456	480	507
46	303	330	352	380	403	424	448	472	498
45	297	324	346	373	395	416	439	463	488
44	292	318	339	365	388	408	431	454	479
43	288	312	333	358	380	400	425	447	469
42	282	306	327	351	373	392	417	438	460
41	277	300	321	344	365	387	408	429	450
40	272	294	314	337	358	379	400	420	441

Source: Citi Investment Research and Analysis. *Assumed w.e.f. CY12.

Cairn India

Company description

Cairn India was incorporated as a subsidiary of Cairn Energy PLC (UK) to own and operate all of Cairn Plc's Indian E&P assets. Cairn India has operating interests in producing fields in KG Basin and the Cambay Basin offshore. However, most reserves accrue from the Rajasthan Block where production commenced in 2009. Cairn Energy Plc has completed the sale of a substantial part of its shareholding in Cairn India to the Vedanta Group. Cairn Energy Plc currently (as of Dec-11) holds 22% of Cairn India, with the Vedanta group now holding 59% of the company.

Investment strategy

We rate Cairn India shares Buy with a target price of Rs400. Cairn India's ownership of valuable oil reserves in Rajasthan has started generating steady cash flows from FY10, with potential to generate further upside from EOR and exploration. With the issue of royalty payable now largely resolved and given Cairn's readiness to ramp up/commence production from Mangala/Bhagyam, we expect approvals to be more forthcoming, which should preclude further operational slippages (vis-à-vis guidance) and pave the way for production to ramp up steadily over the next few quarters. Besides, Cairn's gas discovery in Sri Lanka is an added positive, which could provide further upside over time by manifesting as a premium to NAV or even catalyzing a shift in valuation approach from single-asset (NAV) to going concern (P/E).

Valuation

Our Rs400 target price is based on estimated NAVs of under-development and producing assets and incorporating recovery upside. We prefer NAV to value Cairn's assets as it has long-term visible cash flows from its existing resource base, the value of which cannot be captured using traditional near-term earnings multiples. Given Cairn's leverage to crude, our target of Rs400 is based on an average Mar-13E NAV value derived using two different crude scenarios: 1) Citi global crude price forecasts yielding a base NAV of Rs407, and 2) Crude futures curve yielding an NAV of Rs435. We believe that the stock would partially factor in a combination of longer-term fundamentals and near-term momentum in underlying crude prices, till it can establish a track record of success outside Rajasthan. We factor in a 5% discount to NAV to arrive at our TP to factor in prevailing uncertainty on Cairn's future growth plans as well as use of cash following the change in ownership. Key assumptions for our NAV analysis are: crude realization at a 12% discount to Brent; royalty at ~15% of revenue; cess at Rs2,550/MT; plateau production at 230kbpd in 2H13; and total life-of-field development capex (including pipeline) of US\$7.3bn. Our target price is more leveraged to crude prices and less sensitive to operating parameters and/or reserve upside. The traditional valuation multiples (P/E, EV/DACF) will become relevant depending on the extent of exploration success.

Risks

Despite Cairn being in the project stage due to tangible oil reserves, which can be monetized, we have faith in its strong track record displayed so far in project execution and getting required approvals. In addition, Cairn has been able to negotiate the pricing terms for its crude at more or less expected levels. Key downside risks that could prevent the shares from reaching our target price include:

- 1) Delay in regulatory approvals for production ramp up, revisions to development plans, etc;
- 2) Project execution risks resulting in slow ramp up and/or cost overruns;
- 3) Infrastructure constraints in downstream capacity (pipelines, processing terminals, etc) which could cap production levels and push back ramp up timelines;
- 4) Difficulty in absorbing the crude quantities due to its viscosity and various refinery's readiness;
- 5) Lack of clarity on strategy and use of cash post the acquisition;
- 6) Sharp correction in crude prices.

Appendix A-1

Analyst Certification

The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

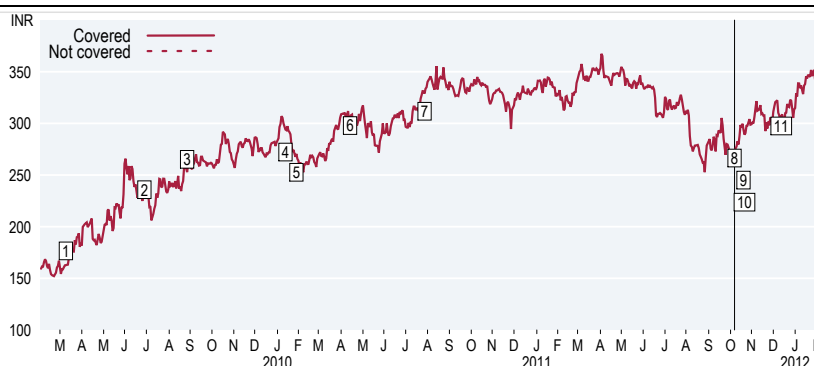
IMPORTANT DISCLOSURES

Cairn India (CAIL.BO)

Ratings and Target Price History

Fundamental Research

Analyst: Saurabh Handa
Covered since June 18 2010



	Date	Rating	Target Price	Closing Price
1	10-Mar-09	1M	*195.00	162.55
2	28-Jun-09	*2L	*237.00	234.00
3	27-Aug-09	2L	*268.00	252.80
4	13-Jan-10	*1L	*337.00	294.05

* Indicates change

	Date	Rating	Target Price	Closing Price
5	28-Jan-10	1L	*323.00	270.45
6	14-Apr-10	1L	*351.00	302.95
7	28-Jul-10	*2L	*363.00	328.90
8	7-Oct-11	Stock rating system changed		

	Date	Rating	Target Price	Closing Price
9	20-Oct-11	*1	363.00	293.90
10	21-Oct-11	1	*340.00	289.10
11	13-Dec-11	1	*358.00	307.20

Rating/target price changes above reflect Eastern Standard Time

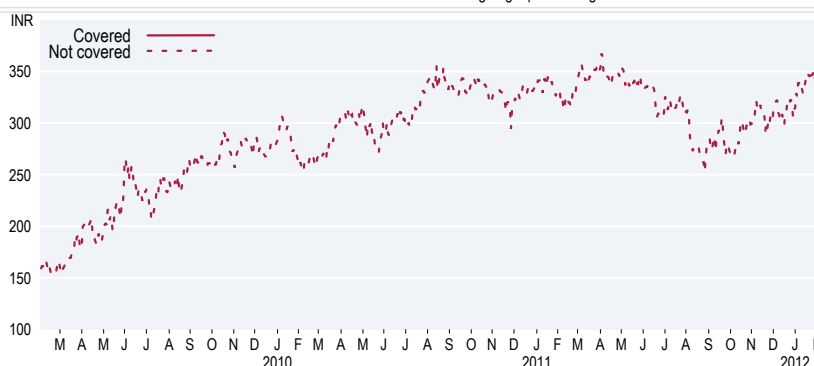
Cairn India (CAIL.BO)

Ratings and Target Price History

Best Ideas Research

Relative Call (3 Month)

Analyst: Saurabh Handa
Covered since June 18 2010



* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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