

4Q profit up 25% YoY if no subsidy; otherwise down 7%

4Q subsidy big impact on 4Q outlook but not on FY09E; Buy

The standalone profit of ONGC was 1% YoY lower at Rs139bn in 9M FY09. It is expected that ONGC may not have to bear any subsidy in 4Q. Whether ONGC has to bear subsidy or not will have a significant impact on its 4Q profit. However it should not have a significant impact on its FY09E profit. 4Q standalone net profit would either be 25% YoY higher or 7% YoY lower. FY09E standalone profit would either be 3% YoY higher or 2% YoY lower. ONGC's lack of earnings and volume growth in the medium term may justify it being at some discount to fair value. We think the discount of current share price to our fair value looks too steep at 63%. We retain Buy on ONGC.

ONGC may not have to bear subsidy in 4Q FY09E

A senior petroleum ministry official has been quoted in the press as saying ONGC and its upstream peers may not have to bear any subsidy in 4Q. We believe this is possible as there may effectively be no subsidy in 4Q. Over-recovery on auto fuels is likely to neutralize the LPG and kerosene subsidy.

4Q profit up 25% YoY if no subsidy; down 7% YoY otherwise

We estimate ONGC's 4Q standalone net profit to be 25% YoY higher at Rs32.9bn if it does not have to bear subsidy in 4Q. However if ONGC has to bear subsidy in 4Q we estimate its 4Q FY09E standalone profit to be 7% YoY lower at Rs24.4bn.

FY09E profit up 3% YoY if no subsidy; down 2% otherwise

We estimate ONGC's FY09E standalone profit being 3% YoY higher at Rs172bn if it does not have to bear subsidy in 4Q. However if ONGC has to bear subsidy in 4Q we estimate its standalone FY09E profit being 2% YoY lower at Rs163.6bn. Thus we believe the impact of whether ONGC has to bear subsidy in 4Q or not on its FY09E earnings is likely to be modest.

Estimates (Mar)

(Rs)	2007A	2008A	2009E	2010E	2011E
Net Income (Adjusted - mn)	185,701	203,517	208,007	186,644	207,322
EPS	86.82	95.15	97.25	87.26	96.93
EPS Change (YoY)	20.8%	9.6%	2.2%	-10.3%	11.1%
Dividend / Share	31.00	32.00	32.00	31.00	35.00
Free Cash Flow / Share	5.92	56.80	85.87	40.19	59.82

Valuation (Mar)

	2007A	2008A	2009E	2010E	2011E
P/E	8.3x	7.5x	7.4x	8.2x	7.4x
Dividend Yield	4.3%	4.5%	4.5%	4.3%	4.9%
EV / EBITDA*	3.7x	3.3x	3.4x	3.7x	3.2x
Free Cash Flow Yield*	0.8%	7.9%	12.0%	5.6%	8.3%

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

Equity | India | Oil & Gas Producers
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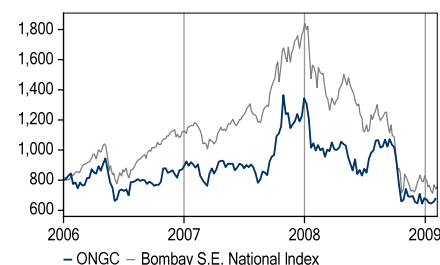
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Stock Data

Price	Rs717.15
Price Objective	Rs1,168
Date Established	26-Nov-2008
Investment Opinion	C-1-7
Volatility Risk	HIGH
52-Week Range	Rs538.10-Rs1,140
Mrkt Val / Shares Out (mn)	US\$31,577 / 2,138.9
Average Daily Volume	2,156,024
ML Symbol / Exchange	ONGCF / BSE
Bloomberg / Reuters	ONGC IN / ONGC.BO
ROE (2009E)	24.6%
Net Dbt to Eqty (Mar-2008A)	-30.4%
Est. 5-Yr EPS / DPS Growth	0.6% / 3.0%
Free Float	25.9%



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Refer to important disclosures on page 8 to 10. Analyst Certification on Page 6. Price Objective Basis/Risk on page 6.

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*iQprofile*SM ONGC

Key Income Statement Data (Mar)	2007A	2008A	2009E	2010E	2011E
(Rs Millions)					
Sales	822,615	967,824	1,136,122	914,887	1,104,167
Gross Profit	470,243	527,425	502,159	461,941	518,846
Sell General & Admin Expense	(108,298)	(123,087)	(98,903)	(100,852)	(102,345)
Operating Profit	237,031	264,805	269,343	259,066	305,041
Net Interest & Other Income	48,446	44,406	52,194	31,225	12,545
Associates	NA	NA	NA	NA	NA
Pretax Income	285,477	309,211	321,537	290,291	317,586
Tax (expense) / Benefit	(98,454)	(102,205)	(109,457)	(99,575)	(108,590)
Net Income (Adjusted)	185,701	203,517	208,007	186,644	207,322
Average Fully Diluted Shares Outstanding	2,139	2,139	2,139	2,139	2,139

Key Cash Flow Statement Data

Net Income	185,701	203,517	208,007	186,644	207,322
Depreciation & Amortization	124,914	139,533	133,913	102,023	111,460
Change in Working Capital	24,741	(55,119)	7,208	(4,899)	(3,243)
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	(163,464)	3,997	1,794	(33,428)	(29,370)
Cash Flow from Operations	171,892	291,928	350,922	250,341	286,170
Capital Expenditure	(159,226)	(170,435)	(167,248)	(164,375)	(158,223)
(Acquisition) / Disposal of Investments	(253)	(8,989)	11,705	0	0
Other Cash Inflow / (Outflow)	NA	NA	NA	NA	NA
Cash Flow from Investing	(159,480)	(179,424)	(155,544)	(164,375)	(158,223)
Shares Issue / (Repurchase)	NA	NA	NA	NA	NA
Cost of Dividends Paid	(76,440)	(77,383)	(77,386)	(74,968)	(84,641)
Cash Flow from Financing	(77,067)	(78,248)	26,321	(58,969)	(73,642)
Free Cash Flow	12,666	121,493	183,673	85,966	127,947
Net Debt	(190,751)	(241,114)	(229,137)	(255,681)	(311,538)
Change in Net Debt	64,028	(35,121)	(117,992)	(10,999)	(43,306)

Key Balance Sheet Data

Property, Plant & Equipment	647,399	700,903	836,446	924,618	985,946
Other Non-Current Assets	66,449	70,599	44,117	44,117	44,117
Trade Receivables	27,594	45,911	41,222	40,197	45,378
Cash & Equivalents	206,756	250,558	349,501	392,044	458,898
Other Current Assets	154,054	178,875	129,538	127,373	138,313
Total Assets	1,102,252	1,246,846	1,400,823	1,528,348	1,672,653
Long-Term Debt	9,521	8,655	112,362	128,361	139,360
Other Non-Current Liabilities	232,975	216,700	220,874	221,021	221,167
Short-Term Debt	6,485	789	8,001	8,002	8,000
Other Current Liabilities	182,956	235,126	135,386	133,810	143,434
Total Liabilities	431,936	461,271	476,624	491,195	511,962
Total Equity	675,457	792,315	921,542	1,034,496	1,158,030
Total Equity & Liabilities	1,107,393	1,253,586	1,398,166	1,525,691	1,669,992

*iQmethod*SM - Bus Performance*

Return On Capital Employed	20.2%	19.5%	18.1%	13.4%	14.2%
Return On Equity	30.1%	28.1%	24.6%	19.4%	19.2%
Operating Margin	28.8%	27.4%	23.7%	28.3%	27.6%
EBITDA Margin	44.0%	41.8%	35.5%	39.5%	37.7%

*iQmethod*SM - Quality of Earnings*

Cash Realization Ratio	0.9x	1.4x	1.7x	1.3x	1.4x
Asset Replacement Ratio	1.3x	1.2x	1.2x	1.6x	1.4x
Tax Rate (Reported)	34.5%	33.1%	34.0%	34.3%	34.2%
Net Debt-to-Equity Ratio	-28.2%	-30.4%	-24.9%	-24.7%	-26.9%
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.

Investment Thesis

We expect large reserve accretion and consequent re-rating of ONGC. It has a large proportion of India's exploration acreage in highly prospective areas. Though its success rate has been below 10pct in 2000-07, this is changing as its exploration focus shifts to NELP acreage from nomination. It has 57pct of its NELP acreage in highly prospective areas vs only 4pct of its nomination acreage. Already success rate has risen to 25pct in FY07 and 44pct in FY08 from just 6-9pct in FY05-06.

Stock Data

Price to Book Value 1.7x

FY09E earnings outlook

ONGC's 9M profit 1% YoY lower at Rs139.2bn

9M EBITDA up 4% YoY but hit by 32% YoY rise in DD&A

ONGC's standalone 9M profit at Rs139.2bn is 1% YoY lower. Its 9M EBITDA is 4% YoY higher at Rs252.6bn. The 4% YoY rise in 9M EBITDA is mainly due to

- Saving of Rs12.9bn from favorable changes in royalty in onshore crude
- 1% YoY higher oil price realization net of subsidy in rupee terms

Its 9M pre-tax profit and net profit are 1% YoY lower despite the rise in EBITDA due to 32% YoY rise in DD&A to Rs78.4bn. 26% YoY rise in other income to Rs36.7bn helped make up for some of the hit from the rise in DD&A.

Table 1: ONGC's 9M FY08 and 9M FY09 earnings and YoY change

Rsbm	9M FY09	9M FY08	Change
EBDITA	253	244	4%
Interest	1	0	126%
Depreciation	78	60	32%
Other Income	37	29	26%
PBT	210	213	-1%
Tax	74	75	-2%
Recurring PAT	136	138	-1%
Add: Prior period tax write back	3	3	7%
Reported PAT	139	141	-1%

Source: Company data, Banc of America Securities- Merrill Lynch

Oil price realization net of subsidy in INR 1% YoY higher

Oil price realization net of subsidy in USD 9% YoY lower

ONGC's 9M oil price realization net of subsidy was 9% YoY lower in US dollar terms at US\$49.3/bbl. However, a weaker rupee meant oil price realization in rupee terms was 1% YoY higher.

Table 2: ONGC's oil price realization net of subsidy lower in US dollar terms but higher in rupee terms

	9M FY09	9M FY08E	Change
Oil price realization net of subsidy (US\$/bbl)	49.3	53.9	-9%
Oil price realization net of subsidy (Rs/bbl)	2,203	2,178	1%

Source: Company data, Banc of America Securities- Merrill Lynch

Rs12.9bn savings from changes in royalty on onshore crude

Royalty on price net of subsidy from April 2008; on gross price earlier

The favorable change made in royalty on onshore crude since April 2008 has meant a savings of Rs12.9bn in 9M FY09. Until March 2008 royalty on onshore crude (at 20% of well-head price) was on gross oil price while from April 2008 it is on oil price net of subsidy. This has meant royalty on onshore crude was Rs21bn in 9M FY 08 but is just Rs8.2bn in 9M FY09.

Table 3: ONGC's royalty on onshore crude 61% YoY lower in 9M FY09

Rsbm	9M FY09	9M FY08	Change
Royalty on onshore crude	8.2	21.1	-61%

Source: Company data

ONGC may not have to bear subsidy in 4Q Auto fuel over-recovery may neutralize subsidy

We have assumed no subsidy for ONGC in 4Q. ONGC management has also been indicated that they may not have to bear a subsidy in 4Q. This assurance appears to have been given as there may effectively be no subsidy in 4Q. Over-recovery on auto fuels is likely to neutralize the LPG and kerosene subsidy.

LPG & kerosene subsidy Rs55bn; auto fuel over-recovery Rs53bn

We estimate the LPG and kerosene subsidy in 4Q at Rs55bn. However there was large over-recovery on auto fuels in January 2009, which we estimate at Rs28bn. The over-recovery on diesel continues even after the Rs2/litre price cut made on January 29. Thus 4Q over-recovery on auto fuels could be Rs53bn

Table 4: ONGC's oil price realization net of subsidy in 4Q FY08

	US\$/bbl
Gross oil price realization	100.4
Less: Subsidy	50.7
Net oil price realization	49.7

Source: Company data

Oil price realization net of subsidy US\$49.7/bbl in 4Q FY08

Gross oil price was US\$100.4/bbl but subsidy was US\$50.7/bbl

ONGC's gross oil price realization was US\$100.4/bbl in 4Q FY08. It had to bear US\$50.7bn of subsidy. Oil price realization net of subsidy was thus US\$49.7/bbl in 4Q FY08.

4Q FY09E oil price realization US\$48.8/bbl if no subsidy

Marker crude for ONGC's crude basket is Nigerian Bonny Light

The marker crude for ONGC's crude basket is Nigerian Bonny Light. Nigerian Bonny Light price to date in 4Q FY09 is US\$47.9/bbl (US\$2.9/bbl premium to Brent price of US\$45/bbl). Prevailing Bonny Light price is US\$48.5/bbl. We expect ONGC's gross oil price realization in 4Q to be US\$48.8/bbl based on its pricing formula.

4Q net oil price realization in INR up 20% YoY if no subsidy

Net oil price realization in USD 2% YoY lower if no subsidy

ONGC's 4Q gross oil price realization may be 51% YoY lower. However its oil price realization net of subsidy in US dollar terms will be just 2% YoY lower if it does not have to bear subsidy in 4Q. A 23% YoY weaker rupee would mean 4Q oil price realization net of subsidy in rupee terms would be 20% YoY higher in this scenario.

Table 5: ONGC's 4Q FY09E oil price realization net of subsidy 20% YoY higher in INR if no subsidy

US\$/bbl	4Q FY09E	4Q FY08	YoY change
Gross oil price realization	48.8	100.4	-51%
Less: Subsidy	0.0	50.7	-100%
Oil price realization net of subsidy (US\$/bbl)	48.8	49.7	-2%
Oil price realization net of subsidy (Rs/bbl)	2,379	1,976	20%
Exchange rate (INR vis-à-vis US dollar)	48.8	39.8	23%

Source: Company Banc of America Securities- Merrill Lynch

4QE net oil price realization in INR up just 1% YoY if there is a subsidy

Net oil price realization in USD 18% YoY lower if it has to bear subsidy

ONGC's 4Q oil price realization net of subsidy in US dollar terms will be 18% YoY lower at US\$40.7/bbl if it has to bear subsidy in 4Q. We are assuming upstream has to bear 33% of 4Q LPG and kerosene subsidy with ONGC's share therein being Rs14.4bn in this scenario. A 23% YoY weaker rupee would mean 4Q oil price realization net of subsidy in rupee terms would still be 1% YoY higher.

Table 6: ONGC's 4Q FY09E oil price realization net of subsidy 1% YoY higher in INR if subsidy assumed

US\$/bbl	4Q FY09E	4Q FY08	YoY change
Gross oil price realization	48.8	100.4	-51%
Less: Subsidy	8.0	50.7	-84%
Oil price realization net of subsidy (US\$/bbl)	40.7	49.7	-18%
Oil price realization net of subsidy (Rs/bbl)	1,987	1,976	1%
Exchange rate (Rs/US\$)	48.8	39.8	23%

Source: Company

4QE profit up 25% YoY if no subsidy; otherwise down 7% YoY Royalty on onshore crude to be Rs6.1bn lower YoY

We estimate ONGC's 4Q FY09E profit to be 25% YoY higher at Rs32.9bn if ONGC does not have to bear subsidy in 4Q. ONGC will also gain from royalty on onshore crude being lower in 4Q. We expect royalty on onshore crude to be Rs6.1bn YoY lower in 4Q FY09E. In 4Q FY08 subsidy was Rs9bn while we expect it to be not more than Rs2.9bn in 4Q FY09E.

However if ONGC has to bear subsidy in 4Q we estimate its 4Q FY09E profit being 7% YoY lower at Rs24.4bn.

Table 7: ONGC's 4Q FY09E and FY09E profit scenarios based on subsidy assumptions

Rsbm	4Q FY09E	4Q FY08	YoY chg	FY09E	FY08	YoY chg
Profit if no subsidy assumed in 4Q FY09E	32.9	26.3	25%	172.1	167.0	3%
Profit if subsidy is assumed in 4Q FY09E	24.4	26.3	-7%	163.6	167.0	-2%

Source: Company Banc of America Securities- Merrill Lynch

FY09E profit up 3% YoY if no subsidy; otherwise down 2%

We estimate ONGC's FY09E standalone profit being 3% YoY higher at Rs172bn if ONGC does not have to bear subsidy in 4Q. However if ONGC has to bear subsidy in 4Q we estimate its standalone FY09E profit being 2% YoY lower at Rs163.6bn. Thus the impact on ONGC's FY09E earnings is modest whether it has to bear subsidy in 4Q FY09E or not.

Maintain Buy

Improved exploration success and strong reserve accretion

ONGC's exploration success rate rose to 25% in FY07 and further to 44% in FY08 from less than 10% in FY01-FY06. We expect ONGC's success rate to remain high as its exploration focus shifts to NELP acreage from nomination. Only 4% of its nomination acreage is in highly prospective basins as against 54% of its NELP acreage.

Discount to fair value of Rs1,168/share far too steep

Lack of earnings growth may justify some discount to fair value

We do not view ONGC as an earnings growth story given the absence of significant volume growth and our expectation of FY10E Brent price of US\$50/bbl. ONGC's fair value of Rs1,168/share offers potential upside of 63%. The absence of expected volume and earnings growth may justify share price being at discount to fair value. However, the prevailing discount is too steep in our view. We retain Buy on ONGC.

Price objective basis & risk

ONGC (ONGCF)

Our DCF-based PO of Rs1,168 incorporates the DCF of 2P reserves (Rs965) and exploration upside (Rs44), as well as net cash (Rs113) and market value of investments (Rs46). We have assumed WACC of 14pct and a long-term oil price forecast of US\$90/bbl (Brent) while calculating DCF of ONGC. We assumed that the current scenario of a rise in subsidy taking away most of gains from rise in oil price continues in perpetuity. Thus we believe our subsidy assumptions are conservative. We think that DCF is the most appropriate measure to value E&P assets. Risks are (1) Standard oil and gas industry operating risks which include exploration, development and production risks, oil price fluctuations, currency risk and reserve estimation, (2) lower-than-expected gas price rise which may adversely hit our valuation of ONGC, and (3) sovereign risks, which include changes in the government and/or policies (eg, withdrawal of the tax holiday) which may have a direct impact on the business, cashflow and profit.

Analyst Certification

I, Vidyadhar Ginde, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

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APR - Energy Coverage Cluster

Investment rating	Company	ML ticker	Bloomberg symbol	Analyst
BUY				
	Cairn India	XCANF	CAIR IN	Vidyadhar Ginde
	China BlueChem	CBLUF	3983 HK	Timothy Bush
	Hindustan Petro.	XHTPF	HPCL IN	Vidyadhar Ginde
	IOC	IOCOF	IOCL IN	Vidyadhar Ginde
	ONGC	ONGCF	ONGC IN	Vidyadhar Ginde
	Reliance Inds	XRELF	RIL IN	Vidyadhar Ginde
	Reliance Inds -G	RLNIY	RIGD LI	Vidyadhar Ginde
	Sinofert HLDG	SNFRF	297 HK	Timothy Bush
	SK Holdings	SKCXF	003600 KS	Sonia Song
NEUTRAL				
	Aban Offshore L	XBWTF	ABAN IN	Vidyadhar Ginde
	BPCL	XBPCF	BPCL IN	Vidyadhar Ginde
	Shell Refining	SRMMF	SHELL MK	Sonia Song
UNDERPERFORM				
	Formosa Chems	XFUMF	1326 TT	Sonia Song
	Formosa Petro	FPTCF	6505 TT	Sonia Song
	Formosa Plastics	FSAPF	1301 TT	Sonia Song
	GS Holdings Corp	GSHDF	078930 KS	Duke Suttikulpanich
	Hanwha Chem Corp	HAYCF	009830 KS	Stephan Han
	Honam Petrochem	HHBHF	011170 KS	Stephan Han
	LG Chem Ltd	LGCLF	051910 KS	Stephan Han
	Nan Ya Plastics	NNYPF	1303 TT	Sonia Song
	Petronet LNG Ltd	POLNF	PLNG IN	Vidyadhar Ginde
	RPL	RPLUF	RPET IN	Vidyadhar Ginde
	SK Energy Co Ltd	XVERF	096770 KS	Sonia Song
	S-Oil Corp	SOOCF	010950 KS	Duke Suttikulpanich
	SPC	SPCJF	SPC SP	Duke Suttikulpanich

*iQmethod*SM Measures Definitions

Business Performance	Numerator	Denominator
Return On Capital Employed	$\text{NOPAT} = (\text{EBIT} + \text{Interest Income}) * (1 - \text{Tax Rate}) + \text{Goodwill Amortization}$	$\text{Total Assets} - \text{Current Liabilities} + \text{ST Debt} + \text{Accumulated Goodwill Amortization}$
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	$\text{EV} = \text{Current Share Price} * \text{Current Shares} + \text{Minority Equity} + \text{Net Debt} + \text{Other LT Liabilities}$	
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

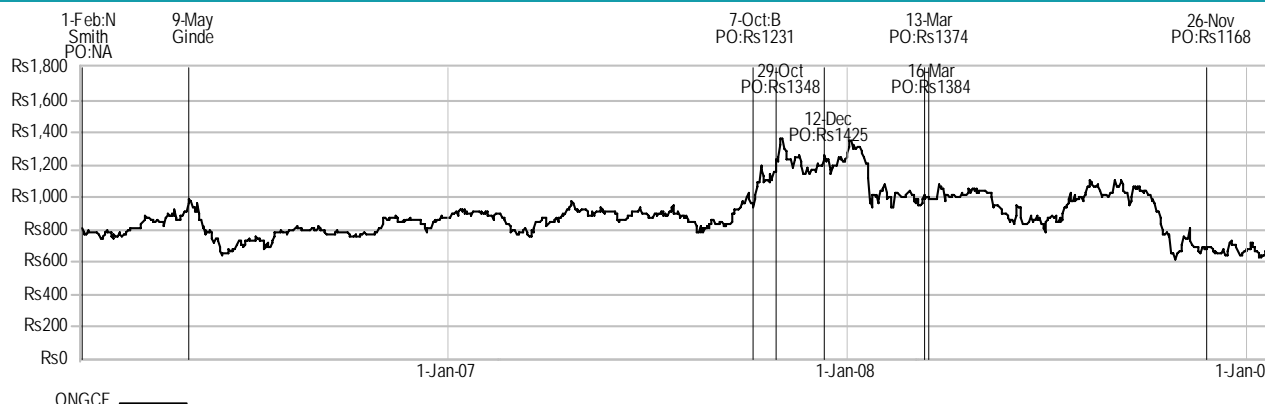
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Important Disclosures

ONGCF Price Chart



B : Buy, N : Neutral, S : Sell, U : Underperform, PO : Price objective, NA : No longer valid

*Prior to May 31, 2008, the investment opinion system included Buy, Neutral and Sell. As of May 31, 2008, the investment opinion system includes Buy, Neutral and Underperform. Dark Grey shading indicates that a security is restricted with the opinion suspended. Light grey shading indicates that a security is under review with the opinion withdrawn. The current investment opinion key is contained at the end of the report. Chart is current as of January 31, 2009 or such later date as indicated.

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Investment Rating Distribution: Energy Group (as of 01 Jan 2009)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	115	43.89%	Buy	37	36.63%
Neutral	60	22.90%	Neutral	19	36.54%
Sell	87	33.21%	Sell	12	15.79%

Investment Rating Distribution: Global Group (as of 01 Jan 2009)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1297	38.46%	Buy	314	26.81%
Neutral	859	25.47%	Neutral	210	28.23%
Sell	1216	36.06%	Sell	229	20.71%

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster*
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Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

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