

Nat Resources & Energy
Oil & Gas
Equity – India

Overweight

Target price (INR)	350.00
Share price (INR)	301.45
Potential return (%)	16.1

Note: Potential return equals the percentage difference between the current share price and the target price

Performance	1M	3M	12M
Absolute (%)	1.1	8.0	-4.3
Relative ^A (%)	11.0	11.7	15.8

Index^A BOMBAY SE IDX

RIC CAIL.BO
 Bloomberg CAIR IN

Market cap (USDm) 10,986
 Market cap (INRm) 573,526

Enterprise value (INRm) 476,097
 Free float (%) 38

Note: (V) = volatile (please see disclosure appendix)

1 December 2011

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Cairn India Limited (CAIR IN)

OW: Regulatory approvals to be next catalyst

- ▶ **We believe new promoters will support Cairn India's production growth endeavours**
- ▶ **We expect approvals for production ramp-up to be expedited now that the vexed issues have largely been resolved**
- ▶ **Reiterate OW rating and target price of INR350. Our valuation is based on conservative estimates of Brent at USD90/barrel and a USD/INR exchange rate of 45 in FY13e**

We expect regulatory approvals to be the next catalysts for the stock. Government of India has in principle approved the Cairn/Vedanta deal after Cairn India agreed to share royalty and cess on its production from Rajasthan fields; however, some routine approvals are due. We expect these approvals by the end of the year, which should pave the way for production growth from 125,000bopd currently. Furthermore, we believe the new promoters namely Vedanta Group will support Cairn India's ramp-up endeavours as they have done with their previous acquisitions (details in the note).

The current environment of stronger oil prices, rupee depreciation and narrow heavy-light spread should benefit Cairn. Despite worries concerning global growth, crude oil has remained around the current level of more than US100/bbl. Our analysis indicates that the Brent oil price is unlikely to fall below USD90/bbl (refer to the note by our global oil team: '[2009 all over again? We doubt it](#)' dated 11 August 2011). Also, rupee depreciation is likely to benefit Cairn India, which sells crude oil in US dollar denomination. With the return of oil production from Libya, the spread between heavy-light crude has fallen, which could also moderately decrease the discount that the company offers on its Rajasthan crude. Our valuations are for Brent of USD90/bbl, INR45/USD and an 11% discount to Brent against current crude oil price of USD110/bbl and USD/INR of 52.

Rajasthan block, the main value driver has significant upside potential. Our detailed analysis indicates substantial reserves upside in CIL's Rajasthan block, which is currently producing 125,000bopd. We believe the in-place oil volume can more than double with the consequent increase in probability-weighted reserves by c40%. It is important to note that the Rajasthan block constitutes c95% of our current valuation for CIL.

Valuation and risks. We reiterate OW on the stock with a target price of INR350. We value Cairn India on DCF for production from known reserves, and a risk-weighted multiple for reserves upsides. Lower crude oil price, rupee appreciation and slower pace of production ramp-up are key risks to our rating.

Financials & valuation

Financial statements

Year to	03/2011a	03/2012e	03/2013e	03/2014e
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Profit & loss summary (INRm)

Revenue	102,779	167,565	166,124	169,133
EBITDA	85,229	115,159	104,827	96,525
Depreciation & amortisation	-13,596	-16,231	-20,119	-21,849
Operating profit/EBIT	71,633	98,929	84,708	74,676
Net interest	-2,909	-3,719	-5,415	-5,415
PBT	68,900	91,420	85,508	76,042
HSBC PBT	68,900	91,420	85,508	76,042
Taxation	-5,556	-8,628	-8,096	-7,244
Net profit	63,344	82,792	77,413	68,798
HSBC net profit	63,344	82,792	77,413	68,798

Cash flow summary (INRm)

Cash flow from operations	72,238	122,437	98,605	91,848
Capex	-36,544	-26,913	-20,411	-18,973
Cash flow from investment	-36,439	-26,913	-20,411	-18,973
Dividends	0	0	0	0
Change in net debt	-36,704	-68,420	-78,194	-72,875
FCF equity	34,359	71,810	71,579	65,693

Balance sheet summary (INRm)

Intangible fixed assets	254,135	253,193	253,193	253,193
Tangible fixed assets	119,904	131,529	131,821	128,946
Current assets	90,553	207,311	287,350	362,213
Cash & others	55,792	169,430	247,624	320,499
Total assets	464,593	592,033	672,364	744,352
Operating liabilities	18,250	18,053	20,971	24,161
Gross debt	26,782	72,000	72,000	72,000
Net debt	-29,010	-97,430	-175,624	-248,499
Shareholders' funds	402,932	485,724	563,137	631,935
Invested capital	390,551	404,550	403,769	399,692

Ratio, growth and per share analysis

Year to	03/2011a	03/2012e	03/2013e	03/2014e
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Y-o-y % change

Revenue	533.3	63.0	-0.9	1.8
EBITDA	763.2	35.1	-9.0	-7.9
Operating profit	1036.4	38.1	-14.4	-11.8
PBT	573.4	32.7	-6.5	-11.1
HSBC EPS	502.0	30.6	-6.5	-11.1

Ratios (%)

Revenue/IC (x)	0.3	0.4	0.4	0.4
ROIC	17.8	22.5	19.0	16.8
ROE	17.1	18.6	14.8	11.5
ROA	15.4	16.3	13.0	10.4
EBITDA margin	82.9	68.7	63.1	57.1
Operating profit margin	69.7	59.0	51.0	44.2
EBITDA/net interest (x)	29.3	31.0	19.4	17.8
Net debt/equity	-7.2	-20.1	-31.2	-39.3
Net debt/EBITDA (x)	-0.3	-0.8	-1.7	-2.6
CF from operations/net debt				

Per share data (INR)

EPS reported (fully diluted)	33.36	43.56	40.73	36.20
HSBC EPS (fully diluted)	33.36	43.56	40.73	36.20
DPS	0.00	0.00	0.00	0.00
Book value	212.22	255.55	296.27	332.47

Key forecast drivers

Year to	03/2011a	03/2012e	03/2013e	03/2014e
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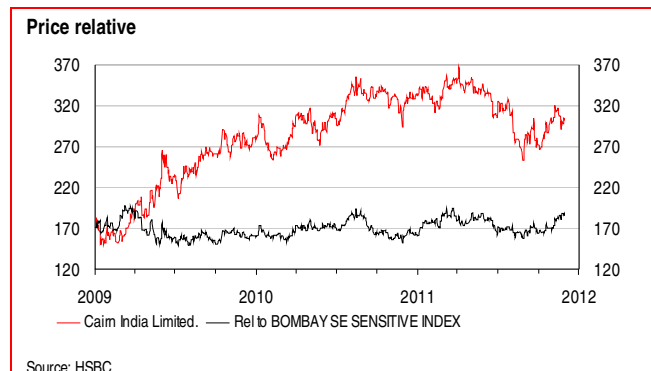
Brent price (USD/bbl)	87	112	90	90
INR/USD exchange rate	46	48	45	45

Valuation data

Year to	03/2011a	03/2012e	03/2013e	03/2014e
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EV/sales	5.3	2.8	2.4	1.9
EV/EBITDA	6.4	4.1	3.8	3.4
EV/IC	1.4	1.2	1.0	0.8
PE*	9.0	6.9	7.4	8.3
P/Book value	1.4	1.2	1.0	0.9
FCF yield (%)	6.0	12.5	12.5	11.5
Dividend yield (%)	0.0	0.0	0.0	0.0

Note: * = Based on HSBC EPS (fully diluted)



Note: price at close of 30 Nov 2011

Investment view

Cairn's Rajasthan Block is likely to have further upsides. We believe the Rajasthan block constitutes c95% of Cairn India's valuation. Our detailed analysis shows 40% potential upside in the resource base in Rajasthan over what has been guided by management. Our analysis is based on the potential c100% upside in oil-in-place volume from an unconventional oil-bearing source, the Barmer reservoir, overlying the main reservoir. Another reason is a set of geological features ('stratigraphic traps') that are yet to be explored fully. Our probability-weighted estimate of the upside is equivalent to c40% of the current recoverable resource base. These upgrades over the next one to two years could ensure reserve replacement for a considerable period.

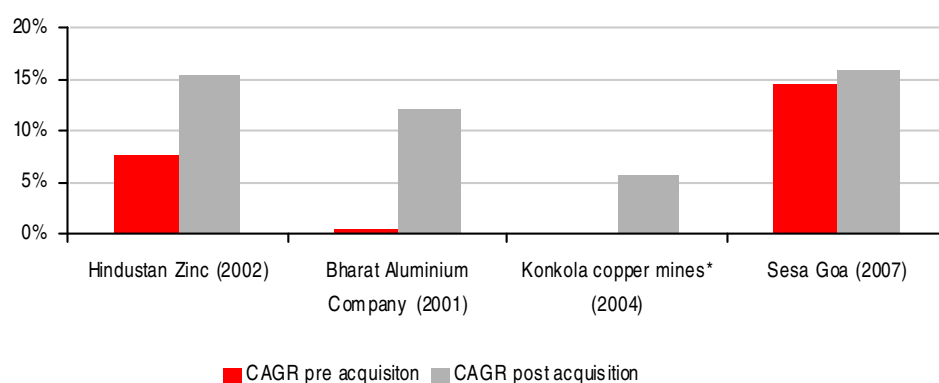
Status of production ramp-up of Rajasthan block

Field	Approved Development plan (bopd)	Company planned production (bopd)	Existing production (bopd)	Remark
Mangala	125,000	150,000	125,000	Production budget is yet to be approved for an additional 50,000bopd production beyond the current 125,000bopd production
Bhagyam	40,000	50,000	-	
Aishwarya	10,000	20,000	-	
Saraswati	-	-	0.25	
Total	175,000	220,000	125,000	

Source: Company, HSBC

We expect new promoters to help accelerate production ramp-up. Studying the track-record of the new promoter namely Vedanta Group, we can see that the group has been able to accelerate the production growth of companies that it acquired, as evidenced by the higher CAGR post acquisition of various companies/assets.

Production growth rate for companies acquired by Vedanta group pre and post acquisition (year of acquisition in brackets)



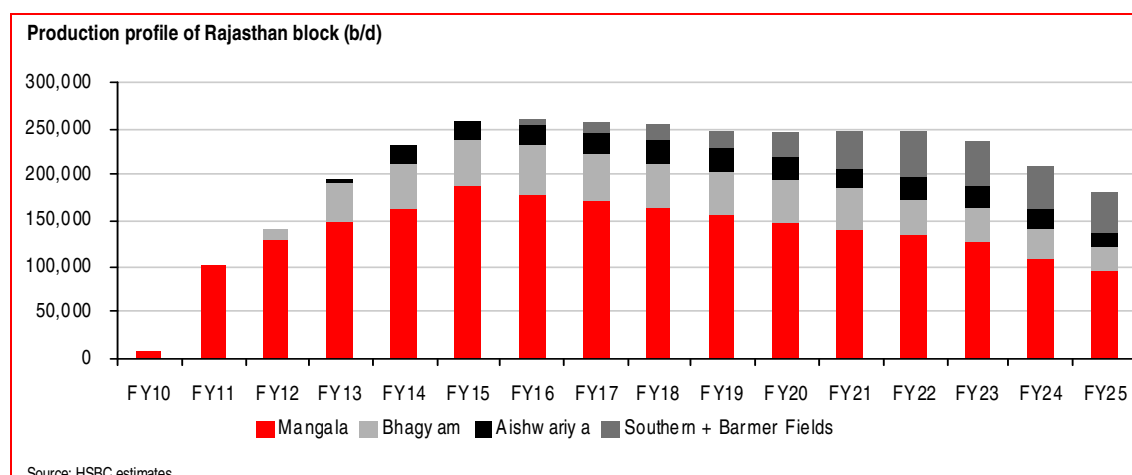
*Pre-acquisition data for Konkola copper mines is unavailable
Source: Company data

Key changes in forecasts

Key changes in forecasts

		FY12e	FY13e	FY14e	Comments
EBITDA (INRm)	New	167,656	104,827	96,525	We increase our FY12 EBITDA estimate to adjust for higher oil prices (now USD112/bbl versus USD110/bbl earlier and INR/USD of 47 versus 45 earlier). We maintain our assumptions for FY13/14.
	Old	111,285	104,252	95,950	
	Change	3.5%	0.6%	0.6%	
PAT (INRm)	New	82,792	77,442	68,825	We change our estimates marginally to reflect the negative one-off impact of royalty for previous quarters and positive impact of forex gains.
	Old	83,711	76,641	68,264	
	Change	-1.1%	1.0%	0.8%	
EPS (INR/share)	New	43.6	40.7	36.2	As a result, our earnings estimate change only marginally.
	Old	44.0	40.3	36	
	Change	-1.1%	1.0%	0.8%	

Source: HSBC estimates



Valuation

The value of Cairn is essentially the value of its reserves in Rajasthan, Ravva and Cambay. We value these reserves on a DCF basis, using a WACC of 11%, Brent oil price of USD90/bbl and INR/USD of 45. We assume an 11% discount to Brent for valuing Rajasthan crude oil and also assume payment of royalty to the government apart from factoring in delay in production ramp-up.

Valuation of Cairn India

	Working interest	Gross recoverable reserves mm boe	Net recoverable reserves mm boe	Value as at end FY12			1Yr Target price
				USDm	USD/boe	INR/share	INR/share
Rajasthan block (including exploration upside)	70%	1365	955	9,640	10.1	228.2	236.0
Ravva	23%	45	10	213	20.9	5.0	5.2
CB-OS/2	40%	10	4	78	19.0	1.9	1.9
Sub total		1,420	970	9,931	10.2	235.1	243.1
Additional exploration upside (HSBC estimate)	70%	439	307	1551	5.0	36.7	38
Net cash (debt) - end FY12				1927		45.6	64.5
Exploration upside in KG-DWN-98/2	10%	369	37	92	2.5	2.2	2.3
Total valuation			1,314	13,501	10.3	319.6	348

Source: HSBC estimates

Our DCF-based target price is INR350. Under our research model, for stocks without a volatility indicator, the Neutral band is 5ppt above and below our hurdle rate for Indian stocks of 11%, or 6-16% above the current share price. Our 12-month target price of INR350 implies a potential return of 16.1%; hence, we maintain Overweight rating for the stock. Potential return equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated.

Sensitivity analysis and risks

A company-specific downside risk that we see is non-renewal of the underlying PSC in 2020, slow ramp-up of production, which can lead to a reduction in our target price. Generic risks for E&P companies include a fall in the crude oil price different from our assumed crude price, the failure to convert upside into reserves and new discoveries. It is important to note though that our valuation is based on a USD/INR exchange rate of 45 and crude oil price of USD90/barrel for Brent in FY13, escalated by USD1/barrel per year thereafter. The two numbers are well below the current exchange rate of 52 and current oil price of USD110/barrel.

Sensitivity of target price and FY13e EPS for various exchange rate and crude oil prices

USD/INR	FY13e EPS at various Brent prices (USD/bbl)							Target price at various Brent prices (USD/bbl)					
	70	80	90	100	110	120		70	80	90	100	110	120
35.0	18	23	28	34	39	44		211	237	266	295	324	353
40.0	23	29	35	41	46	52		244	274	307	340	373	406
45.0	27	34	41	47	54	61		278	311	350	385	422	460
50.0	32	39	47	54	62	69		316	348	389	430	472	513
55.0	37	45	53	61	69	77		350	385	430	475	521	566

Source: HSBC estimates (base case has been shaded)

Sensitivity of our target price to various scenario

Scenario	% change
USD10/bbl increase in Brent price	11%
INR1/USD increase in exchange rate	2%
Non renewal of PSC after 2020	-17%

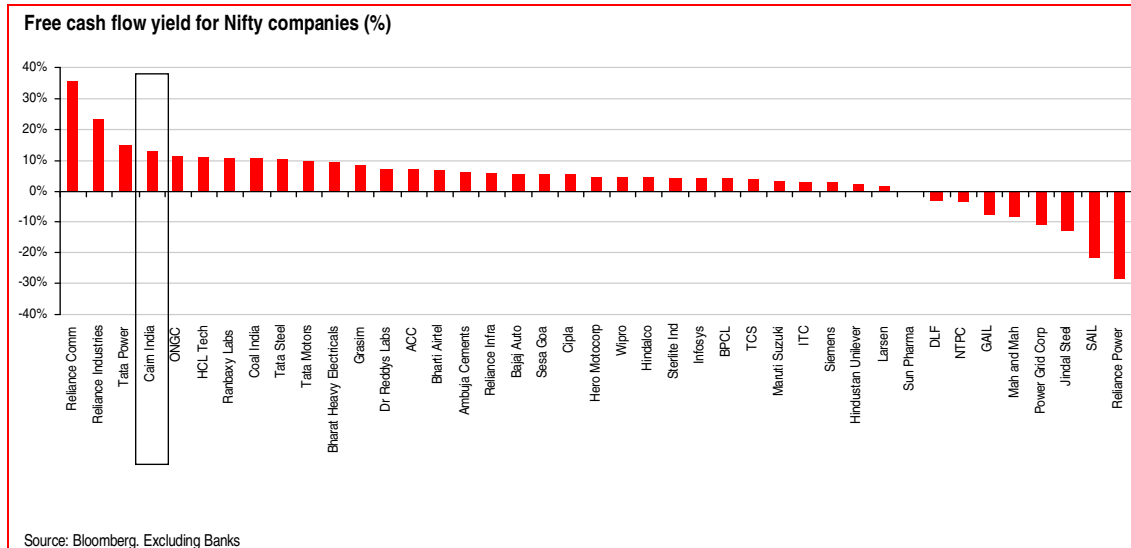
Source: HSBC estimates

Sensitivity analysis if discount to Brent is different from our assumption of 11%

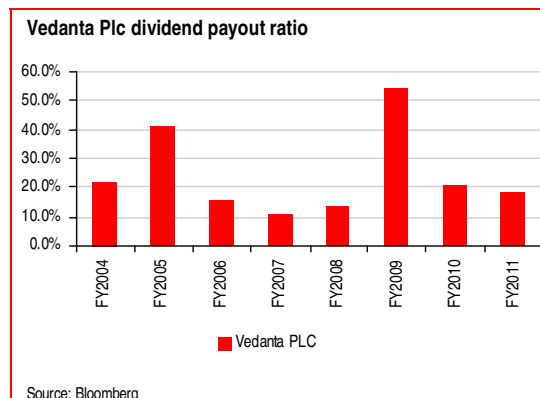
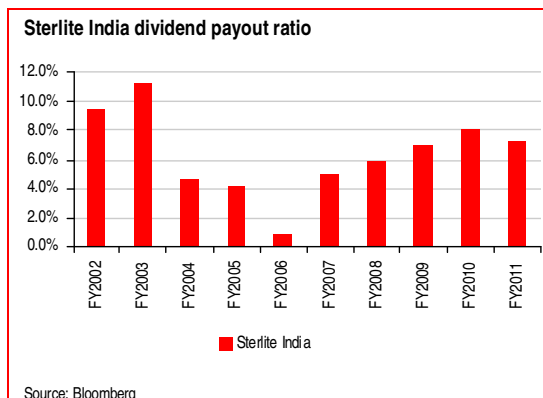
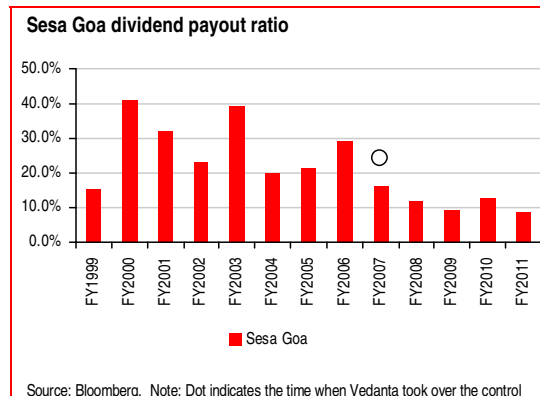
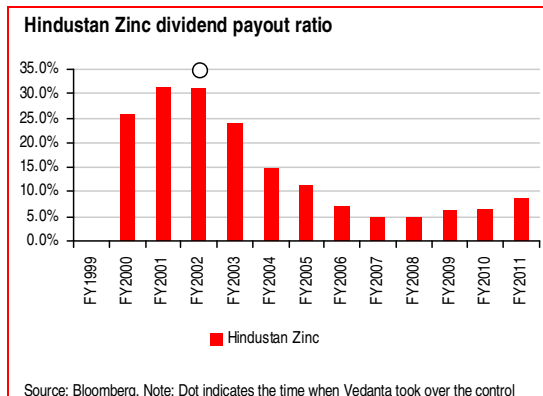
	Target price	% change	FY13e EPS	% change
5%	375	7.1%	44.6	10%
8%	361	3.1%	42.7	5%
HSBC estimate- 11% (base case)	350		40.7	

Source: HSBC estimates

Appendix – free cash flow yield of Cairn India and dividend payout ratio of Vedanta group companies



Next are the dividend payout ratios of key Vedanta Group companies:



Disclosure appendix

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Our ratings are re-calibrated against these bands at the time of any 'material change' (initiation of coverage, change of volatility status or change in price target). Notwithstanding this, and although ratings are subject to ongoing management review, expected returns will be permitted to move outside the bands as a result of normal share price fluctuations without necessarily triggering a rating change.

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stocks which we do not consider volatile may in fact also behave in such a way. Historical volatility is defined as the past month's average of the daily 365-day moving average volatilities. In order to avoid misleadingly frequent changes in rating, however, volatility has to move 2.5 percentage points past the 40% benchmark in either direction for a stock's status to change.

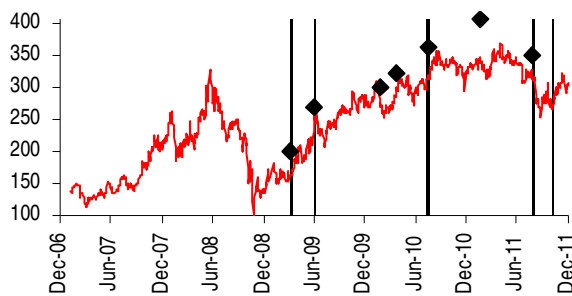
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As of 01 December 2011, the distribution of all ratings published is as follows:

Overweight (Buy)	54%	(27% of these provided with Investment Banking Services)
Neutral (Hold)	35%	(22% of these provided with Investment Banking Services)
Underweight (Sell)	11%	(13% of these provided with Investment Banking Services)

Share price and rating changes for long-term investment opportunities

Cairn India Limited. (CAIL.BO) Share Price performance INR Vs HSBC rating history



Source: HSBC

Recommendation & price target history

From	To	Date
Neutral (V)	Overweight (V)	06 March 2009
Overweight (V)	Neutral (V)	01 June 2009
Neutral (V)	N/A	12 July 2010
N/A	Overweight	14 July 2010
Overweight	Neutral	26 July 2011
Neutral	Overweight	03 October 2011
Target Price	Value	Date
Price 1	200.00	06 March 2009
Price 2	267.00	01 June 2009
Price 3	300.00	21 January 2010
Price 4	322.00	24 March 2010
Price 5	N/A	12 July 2010
Price 6	360.00	14 July 2010
Price 7	405.00	21 January 2011
Price 8	350.00	26 July 2011

Source: HSBC

HSBC & Analyst disclosures

Disclosure checklist

Company	Ticker	Recent price	Price Date	Disclosure
CAIRN INDIA LIMITED	CAIL.BO	301.45	30-Nov-2011	2, 5

Source: HSBC

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- 1 This report is dated as at 01 December 2011.
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