March 5, 2009

ACTION

Sell

Oil & Natural Gas Corp. (ONGC.BO)

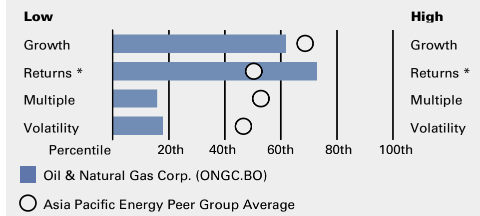
Return Potential: (14%)

Five structural issues that concern us about ONGC; reiterate Sell

Source of opportunity

We re-visit the fundamental premise for our outlook on ONGC and highlight our five top concerns, which, in our view, will likely keep ONGC stock unattractive over the medium term. Our key concerns are: **(i)** overseas growth strategy has not been very effective, **(ii)** unexciting execution track record in domestic business, **(iii)** limited focus on cost control, **(iv)** corporate governance issues with cash withdrawals by promoter, and **(v)** ONGC being structurally unattractive with downside from lower oil price but limited upside from price rebound. Also the key positive stock catalysts are in government hands – hence unpredictable.

Investment Profile



* Returns = Return on Capital For a complete description of the investment profile measures please refer to the disclosure section of this document.

Catalyst

1) Downgrades to FY10E-11E consensus estimates, which remain high, 2) lack of meaningful domestic exploration successes, 3) production decline in overseas assets; 4) price cuts in retail fuel, and 5) announcement of any expensive overseas acquisition.

Valuation

We reiterate Sell on ONGC, with P/B-based 12-month target price of Rs574, implying potential downside of 14%. Our target multiple of 1.4x FY09E P/BV, based on 2003 trough multiple, is actually generous (mainly due to ONGC's net cash position), since ONGC's FY10E ROE is likely to be much lower than FY03-04 levels. We have cut FY09E-11E EPS by 6%-15% primarily driven by lower volume and higher costs.

Though some investors like ONGC for its large government holding and for not being widely owned by institutional investors, we find it hard to own the stock, given that it has hardly any catalysts to surprise on the upside but has downside risk from adverse government action.

Key risks

1) Low subsidy payout, 2) depreciation of INR-US$ rate, 3) petroleum pricing reforms, and 4) technical support from low institutional holding.

INVESTMENT LIST MEMBERSHIP
Asia Pacific Sell List

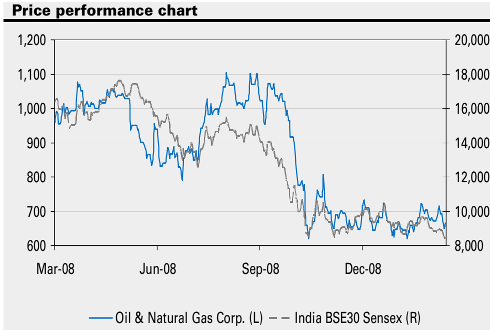
Coverage View: Cautious

India:
Oil

Key data	Current
Price (Rs)	664.45
12 month price target (Rs)	574.00
Market cap (Rs mn / US$ mn)	1,421,838.0 / 27,358.8
Foreign ownership (%)	6.4

	3/08	3/09E	3/10E	3/11E
EPS (Rs) New	**92.91**	**99.40**	**79.07**	**92.73**
EPS revision (%)	(0.2)	(14.3)	(5.5)	(7.5)
EPS growth (%)	11.8	7.0	(20.5)	17.3
EPS (dil) (Rs) New	**92.91**	**99.40**	**79.07**	**92.73**
P/E (X)	7.2	6.7	8.4	7.2
P/B (X)	1.8	1.6	1.4	1.3
EV/EBITDA (X)	4.7	2.6	3.0	2.6
Dividend yield (%)	4.8	5.1	5.1	5.3
ROE (%)	27.5	25.2	17.9	19.0

Price performance chart



Share price performance (%)	3 month	6 month	12 month
Absolute	(1.5)	(37.8)	(30.7)
Rel. to India BSE30 Sensex	7.6	9.7	34.1

Source: Company data, Goldman Sachs Research estimates, FactSet. Price as of 3/04/2009 close.

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Oil & Natural Gas Corp.: Summary financials

Profit model (Rs mn)	3/08	3/09E	3/10E	3/11E
Total revenue	**967,821.8**	**1,034,448.8**	**855,362.0**	**976,312.8**
Cost of goods sold	(250,701.7)	(256,179.3)	(179,612.1)	(226,610.9)
SG&A	(196,031.5)	(215,996.6)	(171,512.4)	(192,610.3)
R&D	--	--	--	--
Other operating profit/(expense)	(115,328.3)	(122,041.4)	(125,175.1)	(118,591.0)
EBITDA	**405,760.3**	**440,231.5**	**379,062.4**	**438,500.6**
Depreciation & amortization	(138,877.7)	(151,774.3)	(160,722.0)	(180,558.8)
EBIT	**266,882.6**	**288,457.2**	**218,340.4**	**257,941.8**
Interest income	45,410.9	49,000.1	49,000.1	49,500.1
Interest expense	(2,152.7)	(8,015.2)	(8,012.1)	(8,874.0)
Income/(loss) from uncons. subs.	0.0	0.0	0.0	0.0
Others	0.0	0.0	0.0	0.0
Pretax profits	**310,140.8**	**329,442.1**	**259,328.4**	**298,567.8**
Income tax	(106,999.1)	(112,730.1)	(89,666.1)	(99,603.3)
Minorities	(3,488.5)	(4,102.9)	(543.6)	(632.5)
Net income pre-preferred dividends	**199,653.3**	**212,609.0**	**169,118.6**	**198,332.0**
Preferred dividends	0.0	0.0	0.0	0.0
Net income (pre-exceptionals)	**199,653.3**	**212,609.0**	**169,118.6**	**198,332.0**
Post-tax exceptionals	(930.1)	0.0	0.0	0.0
Net income	**198,723.2**	**212,609.0**	**169,118.6**	**198,332.0**
EPS (basic, pre-except) (Rs)	92.91	99.40	79.07	92.73
EPS (basic, post-except) (Rs)	92.91	99.40	79.07	92.73
EPS (diluted, post-except) (Rs)	92.91	99.40	79.07	92.73
DPS (Rs)	32.00	34.00	34.00	35.00
Dividend payout ratio (%)	34.4	34.2	43.0	37.7
Free cash flow yield (%)	7.9	11.0	6.9	7.5

Growth & margins (%)	3/08	3/09E	3/10E	3/11E
Sales growth	17.7	6.9	(17.3)	14.1
EBITDA growth	15.5	8.5	(13.9)	15.7
EBIT growth	17.5	8.1	(24.3)	18.1
Net income growth	11.8	7.0	(20.5)	17.3
EPS growth	11.8	7.0	(20.5)	17.3
Gross margin	74.1	75.2	79.0	76.8
EBITDA margin	41.9	42.6	44.3	44.9
EBIT margin	27.6	27.9	25.5	26.4

Cash flow statement (Rs mn)	3/08	3/09E	3/10E	3/11E
Net income pre-preferred dividends	199,653.3	212,609.0	169,118.6	198,332.0
D&A add-back	138,877.7	151,774.3	160,722.0	180,558.8
Minorities interests add-back	0.0	0.0	0.0	0.0
Net (inc)/dec working capital	(3,904.0)	33,934.4	6,479.5	(10,805.4)
Other operating cash flow	(24,679.9)	(56,611.4)	(64,430.2)	(66,830.3)
Cash flow from operations	**309,947.0**	**341,706.3**	**271,890.0**	**301,255.1**
Capital expenditures	(168,144.0)	(212,550.0)	(200,500.0)	(221,800.0)
Acquisitions	(15,493.0)	0.0	0.0	0.0
Divestitures	0.0	0.0	0.0	0.0
Others	0.0	0.0	0.0	0.0
Cash flow from investments	**(183,637.0)**	**(212,550.0)**	**(200,500.0)**	**(221,800.0)**
Dividends paid (common & pref)	(78,217.0)	(85,319.6)	(83,121.3)	(86,159.7)
Inc/(dec) in debt	(11,341.0)	382.8	941.8	26,550.7
Common stock issuance (repurchase)	7,028.0	0.0	0.0	0.0
Other financing cash flows	0.0	0.0	0.0	0.0
Cash flow from financing	**(82,530.0)**	**(84,936.8)**	**(82,179.5)**	**(59,609.0)**
Total cash flow	**43,780.0**	**44,219.5**	**(10,789.5)**	**19,846.1**

Balance sheet (Rs mn)	3/08	3/09E	3/10E	3/11E
Cash & equivalents	250,558.5	287,008.7	276,219.2	296,065.3
Accounts receivable	80,873.1	70,720.3	56,453.1	66,040.9
Inventory	74,249.3	81,448.4	71,834.6	70,615.4
Other current assets	87,262.0	65,112.4	66,587.3	67,099.9
Total current assets	**492,942.9**	**504,289.8**	**471,094.1**	**499,821.5**
Net PP&E	700,902.4	818,020.8	917,798.8	1,021,040.0
Net intangibles	25,777.0	22,847.0	22,847.0	22,847.0
Total investments	44,821.0	52,040.6	52,040.6	52,040.6
Other long-term assets	6,739.0	6,739.0	6,739.0	6,739.0
Total assets	**1,271,182.3**	**1,403,937.3**	**1,470,519.6**	**1,602,488.1**
Accounts payable	113,828.3	123,949.2	111,079.2	110,380.1
Short-term debt	0.0	0.0	0.0	0.0
Other current liabilities	137,968.6	137,305.0	135,874.6	137,275.7
Total current liabilities	**251,796.9**	**261,254.2**	**246,953.7**	**247,655.8**
Long-term debt	9,444.6	6,796.8	6,112.4	30,036.9
Other long-term liabilities	216,700.2	217,837.5	212,863.7	207,400.9
Total long-term liabilities	226,144.9	224,634.2	218,976.1	237,437.7
Total liabilities	**477,941.8**	**485,888.4**	**465,929.8**	**485,093.5**
Preferred shares	**0.0**	**0.0**	**0.0**	**0.0**
Total common equity	**781,792.3**	**903,895.6**	**989,949.8**	**1,102,349.0**
Minority interest	11,448.3	14,153.3	14,640.0	15,045.5
Total liabilities & equity	**1,271,182.3**	**1,403,937.3**	**1,470,519.6**	**1,602,488.1**
BVPS (Rs)	**365.51**	**422.60**	**462.83**	**515.38**

Ratios	3/08	3/09E	3/10E	3/11E
ROE (%)	27.5	25.2	17.9	19.0
ROA (%)	16.7	15.9	11.8	12.9
ROACE (%)	33.7	31.9	20.8	21.7
Inventory days	97.0	110.9	155.7	114.7
Receivables days	24.8	26.7	27.1	22.9
Payable days	142.2	169.4	238.8	178.4
Net debt/equity (%)	(30.4)	(30.5)	(26.9)	(23.8)
Interest cover - EBIT (X)	NM	NM	NM	NM

Valuation	3/08	3/09E	3/10E	3/11E
P/E (analyst) (X)	7.2	6.7	8.4	7.2
P/B (X)	1.8	1.6	1.4	1.3
EV/EBITDA (X)	4.7	2.6	3.0	2.6
Dividend yield (%)	4.8	5.1	5.1	5.3

Note: Last actual year may include reported and estimated data.

Source: Company data, Goldman Sachs Research estimates.

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Our five top structural concerns with ONGC

We re-visit the fundamental premise for our outlook on ONGC and highlight our five top concerns with the company, which, in our view, will likely keep ONGC stock unattractive over medium term. Although the stock is popular with some investors for its large government holding and for not being widely owned by institutional investors, **we find it hard to own ONGC, given that it has hardly any catalysts to surprise on the upside but has downside risk from adverse government action**

Our key concerns on ONGC are as follows:

(i) Overseas growth strategy largely not been effective

(ii) Unexciting execution track record in domestic business

(iii) Rising costs in aging domestic fields; limited focus on cost control

(iv) Long-running corporate governance issues

(v) ONGC being structurally unattractive with downside from lower oil price and limited upside from oil price rebound. Also key stock catalysts are in government hands

We further note that ONGC stock has already lost its defensive nature owing to elimination of auto-fuel subsidies following the correction in oil prices. We believe that ONGC's consensus earnings for FY10E-11E remain very high and have downside risk going forward.

Overseas growth strategy has largely not been effective

Missed acquisition opportunities; in the end an expensive deal

While management had been talking about ONGC Videsh (OVL) as the growth driver for the group, we believe the company has missed good acquisition opportunities in the past to regional peers while oil prices were moving up. The one big ticket acquisition that OVL has made (Imperial Energy bid in August 2008) came at the peak of the oil cycle and we view it as having been expensive (Exhibits 1 and 2). In the end, **we see the deal as largely a political decision in order to obtain stakes in future projects (Sakhalin – III and IV) rather than an economic one**. We note that all other global state-owned E&P companies had backed out of the Imperial deal.

Exhibit 1: Imperial deal highlights ONGC's agenda on energy security over economics
OVL – Imperial deal valuation

Particulars	US$ mn	
Consideration to be paid (Equity value of 100% stake)	2,600.0	
Net Debt as of Dec 2007	236.7	
Enterprise value	2,836.7	
Valuation	**1P**	**2P**
Reserves (mn boe)	176.0	920.0
EV/boe (US$)	16.1	3.1

Source: Company data, Goldman Sachs Research estimates

Exhibit 2: OVL's Imperial Energy deal was at steep premium to median EV/boe of Russian E&Ps under coverage
Valuation snapshot of Russian E&P companies

	Ticker	Price Mar 3	Mkt cap (US$mn)	EV/DACF (X)			P/E (X)			CROCI (%)			2009E Yield (%)	2008E Net Debt/ Equity (%)	07EV/proved Reserves US$/boe	2008E P/BV (X)
				2008E	2009E	2010E	2008E	2009E	2010E	2008E	2009E	2010E				
Russian/Lat Am oils																
Gazprom (US$)	GAZP.RTS	3.01	71,059	3.4	4.3	3.3	3.0	4.7	2.6	16.7	12.2	14.1	2.1	25	1.0	0.5
Rosneft (US$)	ROSN.RTS	3.30	31,678	4.1	6.4	3.4	2.9	11.8	3.4	16.9	9.3	16.0	0.8	76	4.4	0.8
Surgutneftegaz (US$)	SNGS.RTS	0.55	23,885	2.9	2.8	1.6	6.9	5.9	6.2	11.4	8.7	12.3	4.3	(39)	1.7	0.9
Lukoil (US$)	LUKOY	30.30	25,067	2.4	3.8	2.2	2.2	7.2	2.7	18.3	8.5	14.4	2.0	15	1.6	0.5
Gazprom Neft (US$)	SIBN.RTS	2.05	9,720	1.7	3.8	2.0	1.7	9.2	2.8	25.7	8.5	15.6	2.6	11	2.8	0.6
Petrobras (US$)	PBR	25.46	109,431	4.7	7.3	5.6	5.9	11.4	7.8	18.3	10.8	12.6	3.2	22	10.9	1.4
Imperial Energy (US$)															**16.1**	
Russian median				**3.1**	**4.1**	**2.7**	**3.0**	**8.2**	**3.1**	**17.6**	**9.0**	**14.2**	**2.4**	**19**	**2.3**	**0.7**

Source: Datastream, Bloomberg, Goldman Sachs Research estimates

OVL's vision of 20mtpa by 2020E implies aggressive and potentially expensive acquisition strategy

We have also observed a marked preference of OVL to buy producing assets over exploration assets, which leaves limited possibility of value-addition for minority share-holders. In E&P, companies create value by exploration and discovery rather than by developing known/existing reserves, which are typically priced in to a large extent in such deals.

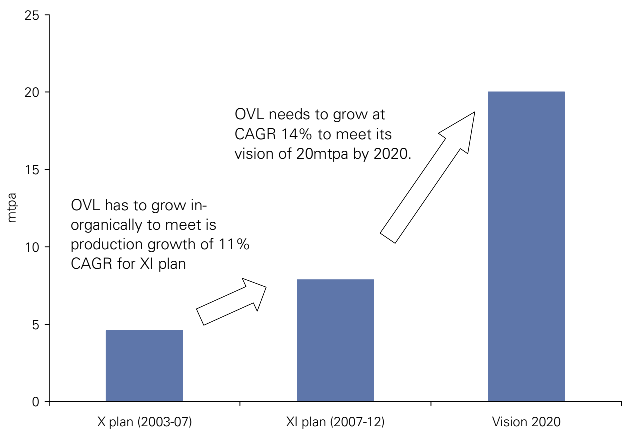
Exhibit 3: OVL's has shown a preference to acquire producing assets or assets where reserves have already been established thereby limiting their upside
Other recent major acquisitions of OVL

Year	Country (Block)	OVL stake	Acquisition cost to OVL (US$ mn)	Details of the transaction
Dec 07	Venezuela	40%	356	Reserve of 790 mn bbl net to ONGC's interest; commercial production in 3 years
Sep-06	Colombia	50%	438	Gross reserves of 300 mn bbls; was producing at 20kbpd at time of acqsn
Apr 06	Brazil-Campos Basin	15%	170	Reserves estimated at 400 mn bbls; potential to produce 100kbpd
Dec 05	Syria	NA	375	Recoverable reserve potential estimated at 300 mn bbls
Mar 03	Sudan (GNOP)	25%	771	reserves of 1bn bbls at time of acquisition; net proved reserves reported then at 94mboe
Jan-01	Russia (Sakhalin-1)	20%	315	Initial estimates show Sakhalin-I had 460 mn bbls of in-place oil and 3.4 tcf of gas on net basis to OVL
Total			**2,425**	

Source: Datastream, Bloomberg, Goldman Sachs Research estimates

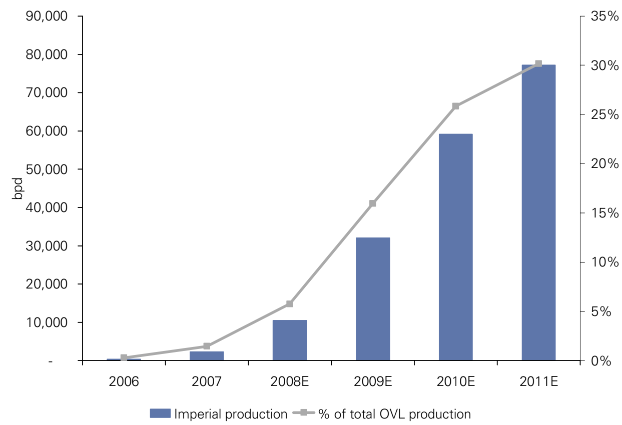
We believe that OVL's preference for known reserves stems from the fact that ONGC management has committed a very aggressive production growth target of 20 mtpa by 2020 (Exhibit 4) to the Indian government and they cannot meet these without acquiring reserves ready to produce. We view this as a structural issue with ONGC's acquisition strategy and believe it is likely to continue in the future as well.

Exhibit 4: OVL is required to grow at annual CAGR of 14% to meet its vision of 20mtpa by 2020



Source: Company data, Goldman Sachs Research estimates

Exhibit 5: Imperial's production ramp-up has execution risk and will also be partly offset by lower realizations



Source: Company data, Goldman Sachs Research estimates

Some key international assets on decline; oil reserves incrementally getting replaced by less profitable gas reserves

Some key producing assets of OVL like Sakhalin-I, Syria and Sudan are already in natural decline. These assets account for close to 90% of OVL's total oil production and their going into decline raises questions on how OVL intends to maintain/grow production levels in the near term.

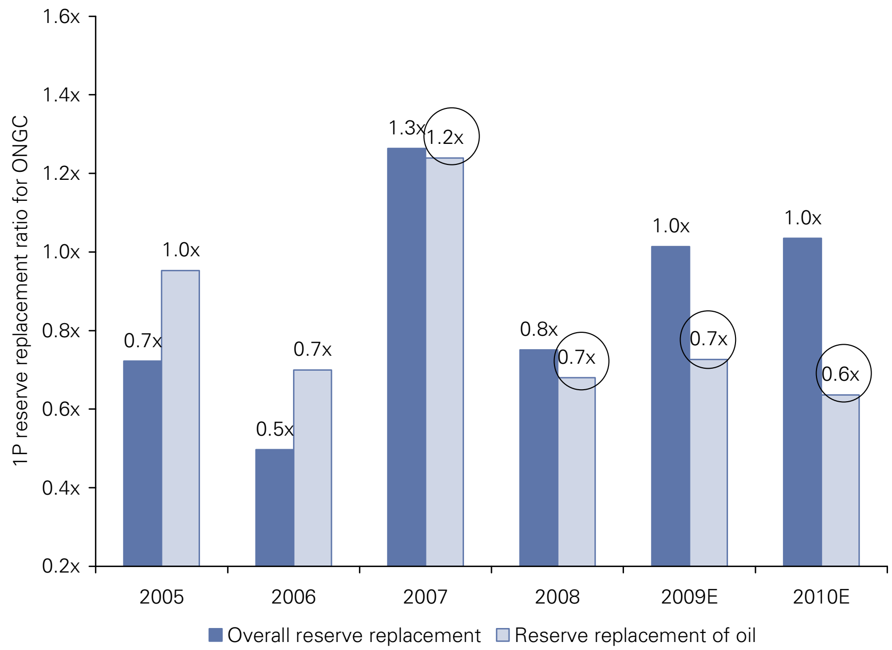
Exhibit 6: OVL's currently producing assets are in steady to declining phase
OVL's E&P portfolio

Region	OVL's portfolio			Year of acquisition of producing assets	Production Status
	Producing	Development	Exploration		
Russia	1		1	2004	Declining
Middle East	1	1	3	2005	Declining
Latin America	2	1	7	2006/2008	Steady
Africa	2	2	8	2003	Steady
Asia	1	2	5	2002	Declining
Total	**7**	**6**	**24**		

Source: Company data, Goldman Sachs Research

We also note that while ONGC's domestic reserve replacement (at 1P level) remains close to 1.0x, they have started incrementally replacing oil reserves with gas reserves, which is fundamentally a lower return business. Hence the overall reserve mix of ONGC is effectively deteriorating.

Exhibit 7: ONGC has been incrementally replacing oil reserves with gas reserves

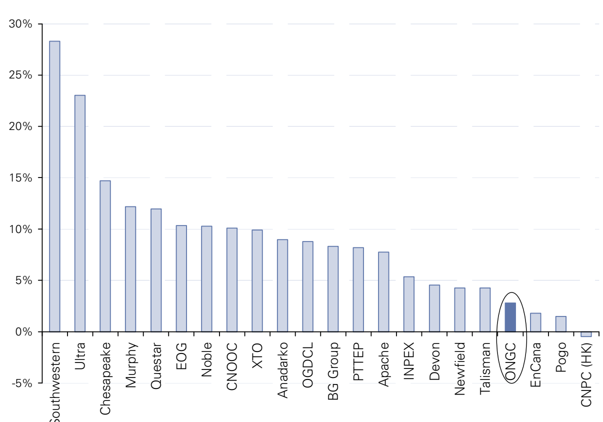


Source: Infraline, Goldman Sachs Research.

ONGC's production profile, RR ratio do not compare well vs. peers

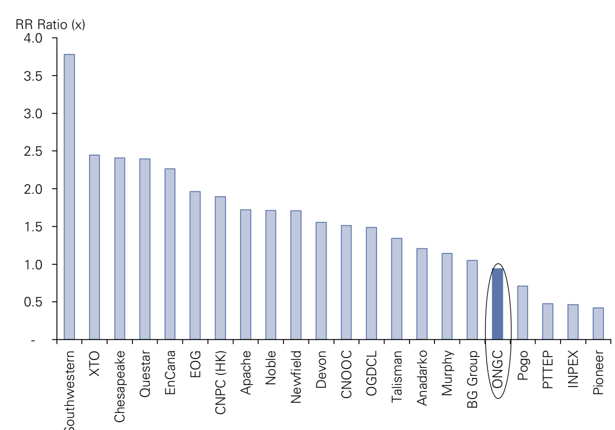
ONGC's overall production growth profile looks unimpressive compared to regional peers. Moreover, ONGC's reserve replacement ratio, on 1P reserve basis, figures in the lower deciles when compared to its peer group.

Exhibit 8: ONGC's production profile is weak vs. peers
Production growth (5-year) for various E&P companies



Source: Goldman Sachs Research estimates

Exhibit 9: ONGC's RR ratio is weak within peer group
Reserve replacement ratio (3-year average from FY05-FY07)



Source: Goldman Sachs Research estimates

ONGC's domestic execution track record remains unexciting

ONGC has not done much with the NELP blocks awarded

While ONGC has won a significant number of blocks in the New Exploration Licensing Policy (NELP) auctions which started in 1999 in most cases it is yet to drill a single well, which we see as an example of ONGC's poor track record when it comes to execution. **Moreover many of the recent bids have been at aggressive terms, for example only 14% cost recovery and up to 91% government revenue share in NELP VII, thereby impacting the viability of developing these blocks.**

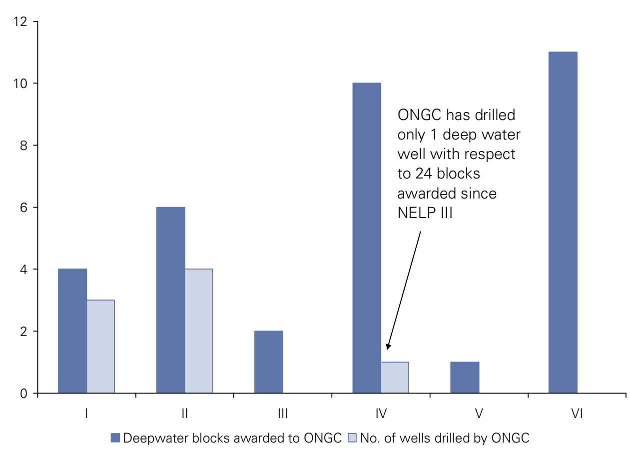
Exhibit 10: ONGC has 79 blocks from previous NELP rounds, 90% of which are yet to have a single well drilled
Total blocks awarded to ONGC under NELP program

NELP round	Number of blocks awarded			
	Shallow	Onland	Deepwater	Total
I	3	1	4	8
II	7	3	6	16
III	3	8	2	13
IV	0	5	10	15
V	2	0	1	3
VI	3	10	11	24
VII	**5**	**12**	**3**	**20**
Total	**23**	**39**	**37**	**99**

Source: Infraline, Goldman Sachs Research.

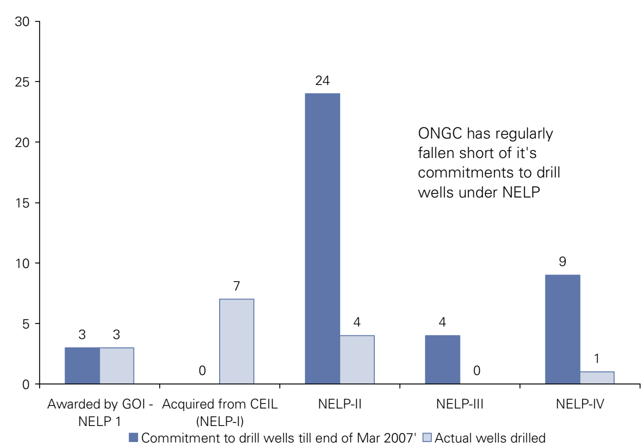
On the domestic front, ONGC has gone quiet after making a big splash about its KG Basin gas discovery. ONGC does not have deepwater capability and the target production date has been pushed out every year. As per the company's recent estimates, it would invest about $5.3 billion to develop gas and oil finds in the KG Basin to produce 25 mmscmd of gas and 8,000 barrels of oil a day by 2012-13, although we expect further delays around this latest estimate as well.

Exhibit 11: Out of 24 deepwater blocks awarded to ONGC from NELP III, ONGC has drilled just one well



Source: Infraline; Goldman Sachs Research estimates

Exhibit 12: ONGC has been regularly falling short of its commitments to drill wells under NELP

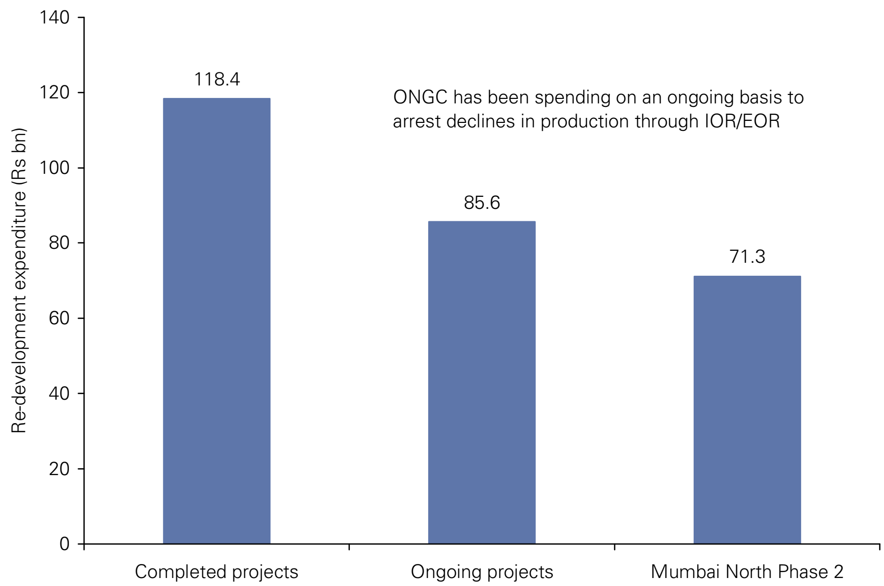


Source: Infraline; Goldman Sachs Research estimates

Costs rising in aging domestic fields; limited focus on cost control

The re-development efforts of ONGC in about 20 various projects have been steadily adding to ONGC's operating and development costs as these are expensive wells. After spending more than Rs200bn since 2001, ONGC is planning to spend another Rs 71.3 bn till Sep 2012 on the 2nd phase of the Mumbai North Redevelopment project. **This effectively means that a large part of ONGC's capex is going to maintain current level of production and not grow it.**

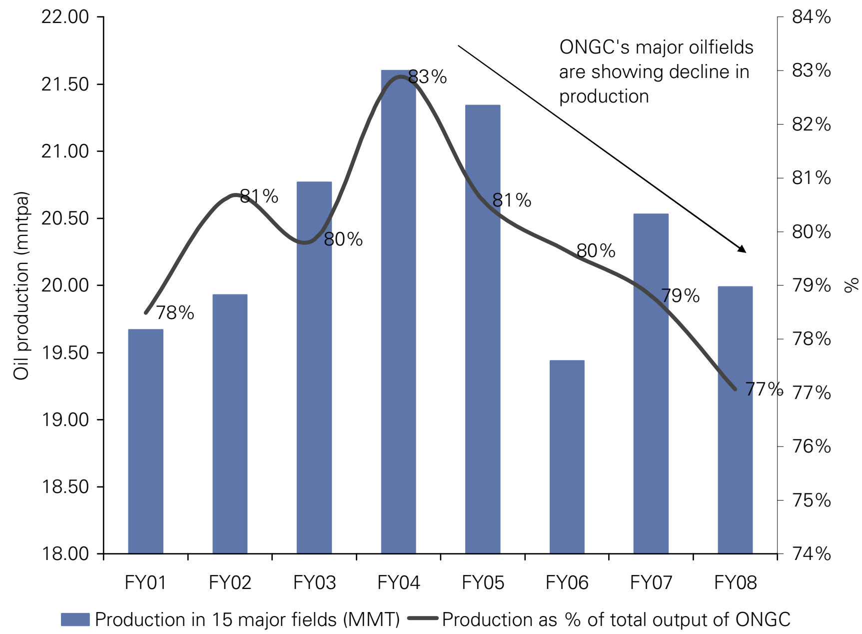
Exhibit 13: ONGC has been spending aggressively on re development efforts to arrest production decline



Source: Infraline, Company data,, Goldman Sachs Research.

Overall, fifteen major fields of ONGC, which have been producing for 25-30 years, account for 77% of ONGC's total production in 2007-08 and have now started showing signs of decline. This implies that ONGC will likely need to focus more re-development work going forward to maintain their current production profile in domestic business.

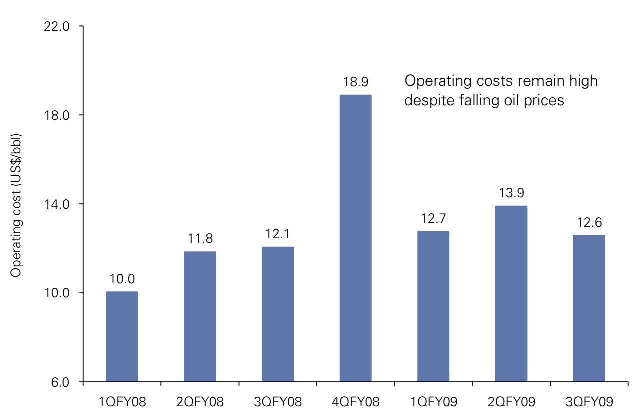
Exhibit 14: ONGC's 15 major oilfields which account for 77% of total output in 2008 are showing signs of production decline
ONGC's production from its 15 significant oilfields



Source: Infraline

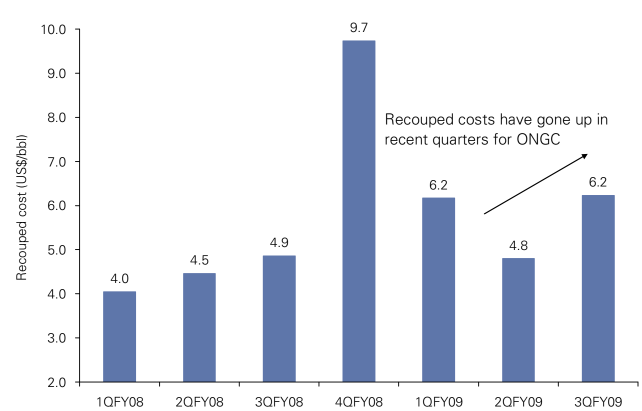
The other issue with ONGC **has been a lack of concerted effort on controlling costs**. While oil prices have been coming down, ONGC's operating costs have, in fact, been going up steadily over the last two quarters. There has been a rise in recouped costs as well while increase in staff costs resulted from provisions by the pay commission initiated by the government. This is in sharp contrast to global E&P majors, whose costs have been falling over the last two quarters.

Exhibit 15: ONGC's operating costs have remained high in recent quarters despite oil price pullback



Source: Company Data, Goldman Sachs Research estimates

Exhibit 16: Recouped costs have also moved up in recent quarters



Source: Company Data, Goldman Sachs Research Estimates

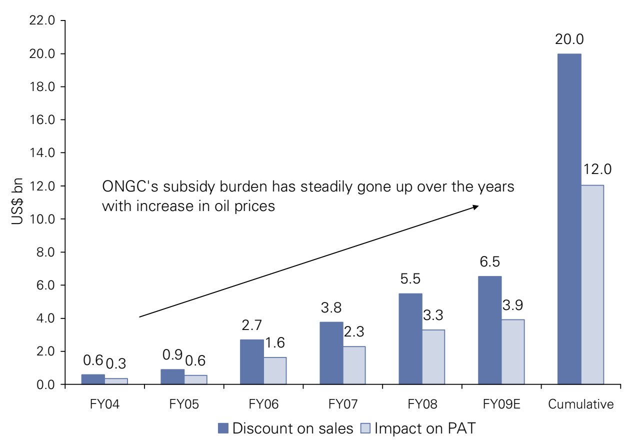
Corporate governance a recurring concern

Issues with corporate governance at ONGC are among the more serious for companies in our coverage universe, in our view. Since FY04, the promoter (Government of India which owns a 74% stake) has taken away cash from the company on a quarterly basis for subsidizing loss-making state-owned downstream companies. **So far ONGC's promoters have taken cash of almost US$20bn from the company without consulting the minority shareholders.**

Despite repeated objections raised by investors and more recently by independent directors on ONGC's board, there has not been headway on this issue.

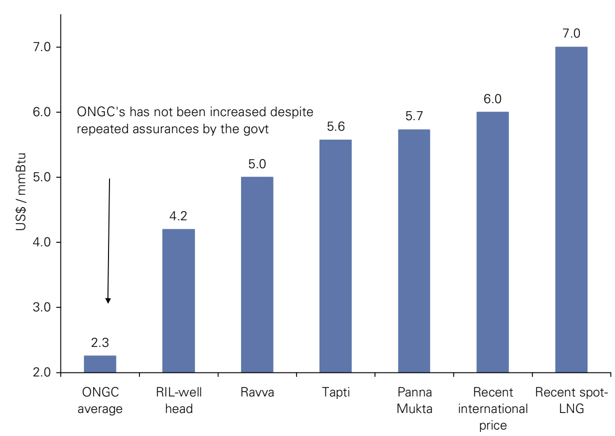
The market appears to have got used to this practice by ONGC promoters, while similar issues in privately run companies would likely cause serious concern. We believe minority shareholders are likely to suffer in a situation where their interests are poorly protected. Moreover, such ad-hoc cash withdrawals hurt ONGC even more since it has a poor production profile and revenues are effectively a function of their oil realization.

Exhibit 17: ONGC promoters have taken away total cash of almost $20 bn over last six years
Discount on sales and impact on PAT ($ bn)



Source: Company data, Goldman Sachs Research estimates

Exhibit 18: ONGC's gas prices have also not been increased despite repeated assurances by govt
Gas realizations of various players in India ($/mmbtu)



Source: Company data, Goldman Sachs Research estimates

ONGC remains structurally unattractive; catalysts in govt hands

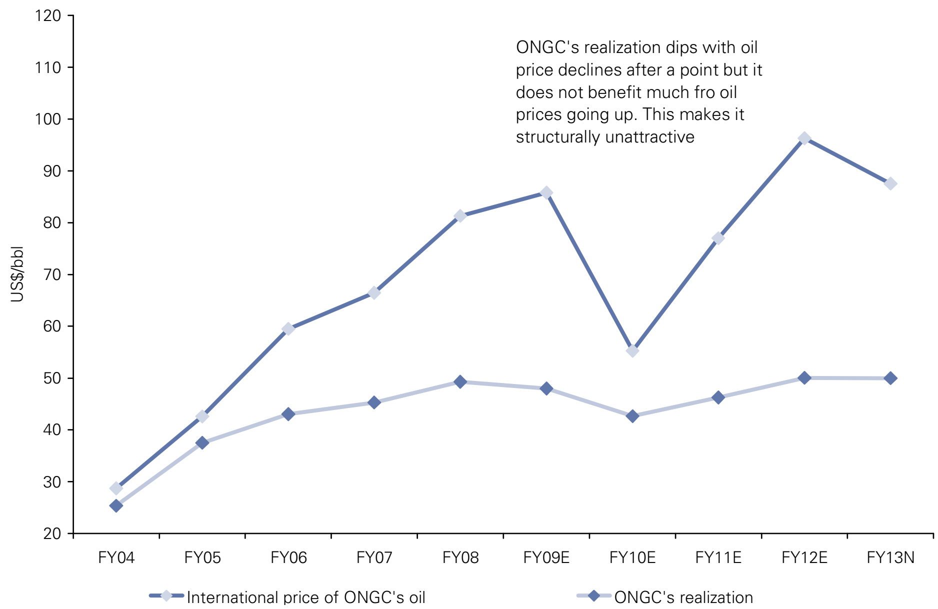
We see ONGC today as effectively in a no-man's land. It gets hurt by further decline in oil prices since the cushion of auto-fuel subsidies is gone now, making it no longer a defensive stock. **Also it does not benefit much from a rebound in oil prices as auto-fuel subsidies will again kick in if oil prices cross US$45/bbl.** The break-even oil price for auto-fuels may come down further if the government decides to cut diesel and gasoline prices again. If one takes a view that oil prices will go down, one should avoid ONGC and if the view is that oil prices will go up there are better oil plays in India and the region. If one does not wish to take an oil price view, then ONGC has enough core issues to keep it unattractive.

Moreover, ONGC has hardly any near term catalysts to get us excited about the stock. The market has started looking at execution and growth in cash flows over announcing new discoveries. ONGC's discoveries in KG Basin are unlikely to start production before FY13E.

The key catalysts may come from government action on structural reforms in petroleum product pricing and gas price hikes, timelines on which can only be speculated about. Moreover, they look uncertain as we will have a new central government in India from June 2009 onwards.

We continue to believe that the government will try to protect the oil marketing companies (OMCs) suffering from weak refining margins and strengthening US$ - INR exchange rates at the expense of ONGC, which is still profitable.

Exhibit 19: We believe ONGC net realizations will get impacted from decline in oil prices as government is likely to prefer OMCs with weak financials over upstream companies
ONGC's net realization vs. international oil price



Source: Company data, Goldman Sachs Research estimates

EPS for FY09E-11E cut due to higher costs, lower production

We have cut ONGC's FY09E consolidated earnings by 15% following the 3QFY09 results and (i) incorporating lower net oil realization assumptions and (ii) higher expenses going forward on account of higher operating and recouped costs (iii) lower other income and higher interest expense. We are also reducing FY10E-11E consolidated earnings by 6%-7% as we have now built in lower production volumes.

Exhibit 20: Our EPS estimates for FY10E are below consensus. We expect consensus numbers to decline on more clarity emerging about ONGC's higher subsidy burden
Summary of EPS estimate changes

	EPS (Rs)				
Period	**Old**	**New**	**Consensus**	**% Change**	**Comments**
FY2009E	116	99	102	-15%	Lower net realization assumption
FY2010E	84	79	94	-6%	Higher recouped costs; Lower net realization; Lower other income
FY2011E	100	93	100	-7%	Higher recouped costs; Lower net realization; Lower other income

Source: Bloomberg, Goldman Sachs research estimates.

We believe that ONGC's consensus earnings for FY10E-11E remain very high, largely driven by the hope that the government is likely to spare the company by charging less subsidy the next time. Unfortunately this has not materialized even when we have witnessed oil prices dipping to US$30/bbl during 3QFY09E. Hence the popular perception that ONGC will have net realisation of US$45-50/bbl even under weak oil prices has taken a serious beating in the recent past.

Shrouded by uncertainty on regulatory action, predicting ONGC's earnings has become taking a call on this and therefore, terming ONGC as inexpensive on valuations has become a speculative exercise. We rather choose to look at the core issues facing ONGC and we do not like the stock on analysis of these very issues.

Exhibit 21: We expect ONGC's consensus numbers to decline further on more clarity about subsidy burden and rising costs
Movement in consensus EPS estimates against price

Source: Bloomberg, Goldman Sachs research estimates

Valuation: Continue with P/BV approach; ONGC not cheap yet

Owing to sharp correction in E&P names globally, ONGC is still trading at a premium to its peers on P/BV multiple with comparable ROEs. Though it is at a discount to peer group now on earnings multiples, we believe that the current valuations still do not reflect the high degree of regulatory uncertainty that ONGC faces. Moreover, we believe that consensus earnings forecasts will further come down in the coming quarters as ONGC's net realizations remain under pressure.

Exhibit 22: ONGC's stock is at marginal discount to peer group on earnings multiples and a premium on P/BV

	Ticker	GS rating	Price Mar 3	Mkt cap (US$mn)	EV/DACF (X) 2008E	EV/DACF (X) 2009E	EV/DACF (X) 2010E	P/E (X) 2008E	P/E (X) 2009E	P/E (X) 2010E	CROCI (%) 2008E	CROCI (%) 2009E	CROCI (%) 2010E	2009E Yield (%)	2008E Net Debt/ Equity (%)	07EV/proved Reserves US$/boe	2008E P/BV (X)
International majors																	
BP plc (US$)	BP	Neutral	34.14	107,413	3.0	5.7	3.9	3.9	12.3	5.6	15.4	8.7	12.5	9.8	19	7.7	1.0
Chevron (US$)	CVX	Neutral	57.73	120,681	3.7	6.4	4.6	5.2	11.5	6.9	18.6	10.1	12.6	4.6	(1)	11.1	1.3
Exxon Mobil (US$)	XOM	Neutral	64.36	346,386	5.3	8.5	6.1	7.6	14.2	9.1	21.4	12.7	15.7	2.6	(13)	14.3	2.6
Royal Dutch Shell (US$)	RDSa.AS	Buy*	38.79	120,734	3.6	5.8	4.7	4.1	12.5	7.3	12.3	8.5	10.6	8.7	6	12.8	0.9
Total SA (EUR)	TOTF.PA	Neutral	34.61	98,911	4.5	6.7	5.2	5.7	11.5	7.1	13.7	9.2	11.5	6.6	17	13.4	1.5
International majors median					**3.7**	**6.4**	**4.7**	**5.2**	**12.3**	**7.1**	**15.4**	**9.2**	**12.5**	**6.6**	**6**	**12.8**	**1.3**
Regional majors																	
ConocoPhillips (US$)	COP	Neutral	35.27	56,920	3.3	4.8	3.5	3.3	10.5	5.2	13.9	8.8	10.7	5.4	48	7.4	1.0
ENI (EUR)	ENI.MI	Neutral	14.01	64,558	3.9	5.3	4.6	5.0	11.4	6.4	14.7	10.7	12.4	9.3	38	12.9	1.1
Occidental (US$)	OXY	Neutral	48.78	40,279	3.9	7.1	4.2	5.4	17.4	7.7	21.2	10.8	15.2	2.8	6	13.5	1.4
Marathon (US$)	MRO	Neutral	20.99	14,903	2.8	4.5	3.1	3.3	8.1	4.2	13.7	8.4	11.1	5.1	26	11.4	0.7
Regional majors median					**3.6**	**5.1**	**3.9**	**4.2**	**10.9**	**5.8**	**14.3**	**9.8**	**11.8**	**5.2**	**32**	**12.1**	**1.0**
Russian/Lat Am oils																	
Gazprom (US$)	GAZP.RTS	Buy	3.01	71,059	3.4	4.3	3.3	3.0	4.7	2.6	16.7	12.2	14.1	2.1	25	1.0	0.5
Rosneft (US$)	ROSN.RTS	Sell	3.30	31,678	4.1	6.4	3.4	2.9	11.8	3.4	16.9	9.3	16.0	0.8	76	4.4	0.8
Surgutneftegaz (US$)	SNGS.RTS	Buy	0.55	23,885	2.9	2.8	1.6	6.9	5.9	6.2	11.4	8.7	12.3	4.3	(39)	1.7	0.9
Lukoil (US$)	LUKOY	Buy	30.30	25,067	2.4	3.8	2.2	2.2	7.2	2.7	18.3	8.5	14.4	2.0	15	1.6	0.5
Gazprom Neft (US$)	SIBN.RTS	Neutral	2.05	9,720	1.7	3.8	2.0	1.7	9.2	2.8	25.7	8.5	15.6	2.6	11	2.8	0.6
Petrobras (US$)	PBR	Buy*	25.46	109,431	4.7	7.3	5.6	5.9	11.4	7.8	18.3	10.8	12.6	3.2	22	10.9	1.4
Russian median					**3.1**	**4.1**	**2.7**	**3.0**	**8.2**	**3.1**	**17.6**	**9.0**	**14.2**	**2.4**	**19**	**2.3**	**0.7**
Asian oils																	
CNOOC (HK$)	0883.HK	Neutral	6.22	34,773	3.9	6.4	3.9	5.9	12.6	6.4	24.6	14.3	19.6	2.8	(22)	11.9	1.6
ONGC (Rs) (a)	**ONGC.BO**	**Sell**	**648**	**26,685**	**3.4**	**4.0**	**3.4**	**6.5**	**8.2**	**7.0**	**17.1**	**13.3**	**14.0**	**5.2**	**(31)**	**3.4**	**1.5**
PetroChina 'H' share (HK$)	0857.HK	Sell*	5.16	118,878	3.7	5.6	4.2	6.8	15.5	7.7	18.0	10.9	13.0	3.0	9	5.8	1.0
PTT (Bt)	PTT.BK	Neutral	150	11,617	4.3	5.9	4.9	7.9	6.6	5.8	16.3	11.7	12.8	4.5	41	16.7	1.1
Sinopec 'H' share (HK$)	0386.HK	Neutral	3.87	43,018	6.6	6.0	4.4	13.3	10.7	6.0	9.2	9.2	11.1	2.4	58	16.0	0.9
Reliance (Rs) (a)	RELI.BO	Buy*	1,199	33,534	10.6	7.0	5.4	12.1	9.7	7.3	9.7	12.1	13.6	1.1	34	32.0	1.6
Asian oils median					**4.1**	**5.9**	**4.3**	**7.4**	**10.2**	**6.7**	**16.7**	**11.9**	**13.3**	**2.9**	**22**	**13.9**	**1.3**

(a) For fiscal year ending following March (i.e., FY2009E appears as 2008E).
*This stock is on our regional Conviction Buy/Sell List.
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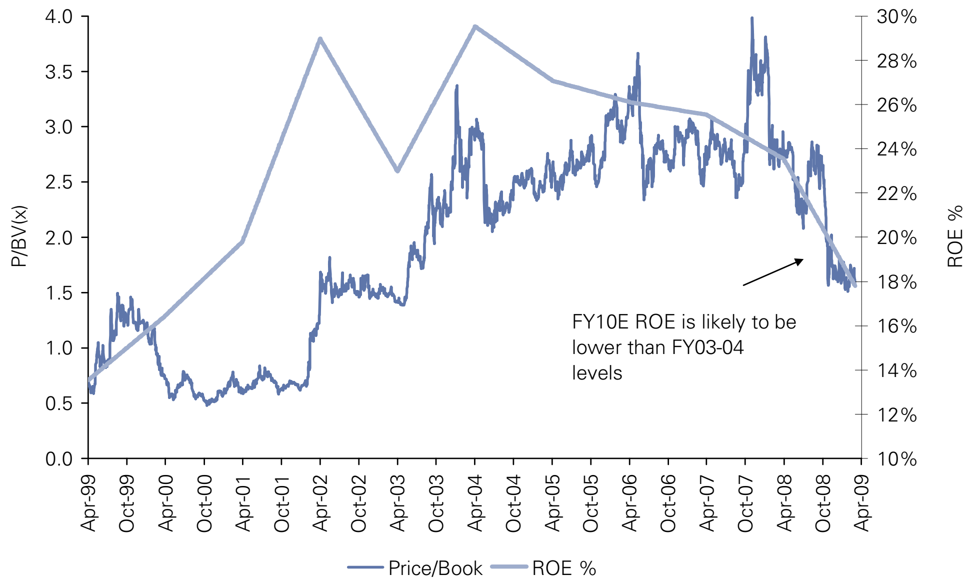
Source: Datastream, Bloomberg, Goldman Sachs Research estimates

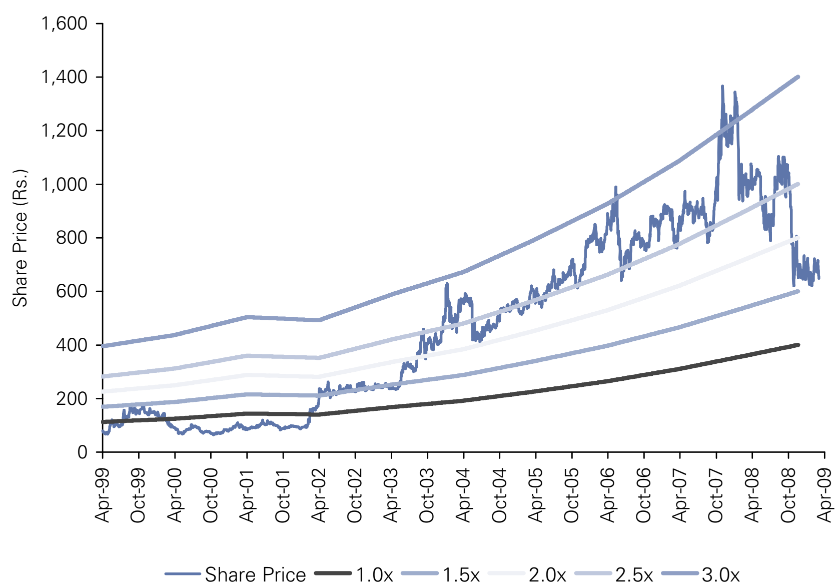
Looking at ONGC's historical trading range, we find that ONGC's trough valuation (after Administered Price Mechanism (APM) was dismantled in April 2002) has been 1.4x trailing P/BV in 2003. Since we believe that ONGC may well test its trough valuations again, we have chosen to use 1.4x FY09E P/BV as our target multiple. **This is despite the fact that FY10E ROE is likely to be lower than FY03-04 levels. Therefore, we believe that we are actually using a generous multiple for ONGC to give benefit for its net cash position.**

Exhibit 23: ONGC's current P/BV multiple still high compared to the steep decline in FY10E ROE



Source: Bloomberg, Goldman Sachs Research estimates

Exhibit 24: Our target multiple for ONGC is based on trough multiple of 1.4x FY09E P/BV



Source: Bloomberg, Goldman Sachs Research estimates

Reg AC

I, Nilesh Banerjee, hereby certify that all of the views expressed in this report accurately reflect my personal views about the subject company or companies and its or their securities. I also certify that no part of my compensation was, is or will be, directly or indirectly, related to the specific recommendations or views expressed in this report.

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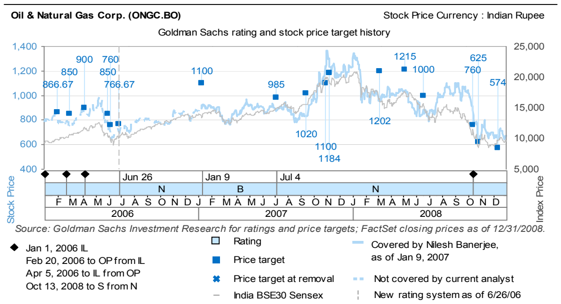

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