ONGC – BUY

ONGC IN	Rs1,437	Oil & Gas	27 September 2010	Company update

OVL - steady performance

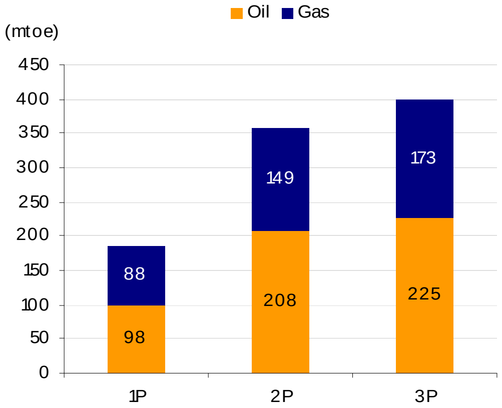
OVL's new producing assets—BC-10 and Imperial Energy—helped cushion declines from Sakhalin and GNOP in FY10. A ramp-up of c2.5x in BC-10's production since then, along with Imperial Energy and Block 06.1, Vietnam, will sustain production level over FY11-13ii. The company's 400kbpd heavy-oil project, Carabobo, along with gas from Myanmar, will augment production from FY14. Domestic production will be augmented by marginal fields that ONGC expects will contribute 76mmt of recoverable oil and 63bcm of recoverable gas. We see strong tailwinds to ONGC's earnings from continued reforms (diesel price deregulation) and settlement of the Rajasthan royalty issue leading up to the FPO. We reiterate BUY with a target price of Rs1,528/share.

Reserves declined YoY, but new assets helped sustain production: OVL reported a 2.2% YoY decline in reserves, primarily due to BC-10 and Imperial Energy. A ramp-up in production in BC-10 to 34kbpd (increased further to the current 80kbpd), Block 06.1 Vietnam and Imperial Energy (16kbpd) helped offset declines at Sakhalin and GNOP. The under development Lan Tay field in Vietnam is scheduled to commence production in FY13.

Development assets to ramp up production from FY14ii: OVL's Orinoco heavy-oil acquisition in Venezuela is expected to contribute 2.2mmtpa production starting FY14. Its gas Blocks A-1 and A-3 in Myanmar with combined oil in place of 5.35TCF are scheduled to start production from FY14.

Continued reforms provide earnings support; we retain BUY on ONGC: With marginal fields expected to augment domestic production and OVL's production sustained by new assets, we see ONGC's net realisations improving on continued reforms in the sector. There is a possibility of GoI settling the Rajasthan royalty issue leading up to the FPO. We retain BUY with a target price of Rs1,528/share.

Reserves profile of OVL



Source: Company, IIFL Research

Financial Summary

Y/e 31 Mar	FY09	FY10	FY11ii	FY12ii	FY13ii
Revenues (Rs m)	1,045,884	1,017,546	1,171,238	1,317,324	1,570,110
EBITDA Margins (%)	39.9	43.6	42.9	44.3	41.5
Pre-Exceptional PAT (Rs m)	197,190	193,635	225,914	274,709	311,651
Reported PAT (Rs m)	197,953	194,035	225,914	274,709	311,651
EPS (Rs)	92.5	90.7	105.6	128.4	145.7
Growth (%)	-0.4	-2.0	16.4	21.6	13.4
PER (x)	**15.5**	**15.8**	**13.6**	**11.2**	**9.9**
ROE (%)	24.5	21.1	21.4	22.5	22.2
Debt/Equity (x)	-0.1	-0.1	-0.1	-0.2	-0.3
EV/EBITDA (x)	**7.2**	**6.7**	**5.8**	**4.8**	**4.1**
Price/Book (x)	3.8	3.3	2.9	2.5	2.2

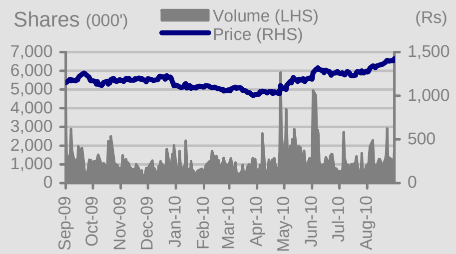
Price as at close of business on 24 September 2010

12-mth TP	*(Rs) 1,528 (6%)*
Market cap (US$ m)	**67,933**
52Wk High/Low (Rs)	1,453/934
Diluted o/s shares (m)	2,139
Daily volume (US$ m)	36
Dividend yield FY10 (%)	2.3
Free float (%)	25.9

Shareholding pattern (%)	
GoI	74.1
FII	4.2
DIIs	8.0
Others	13.7

Price performance (%)	**1M**	**3M**	**1Y**
ONGC	11.0	19.3	22.6
Rel. to Sensex	3.1	7.4	3.8
Reliance	2.1	-5.8	-5.1
Cairn India	-3.9	6.0	25.6

Stock movement



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OVL reports decline in 1P reserves in FY10

OVL reported a 2.2% decline in 1P reserves YoY to 186mtoe. It reported 1P reserve decline in Imperial Energy (4%) and BC-10, Brazil (15%).

Figure 1: 1P reserves declined 2.2% in FY10

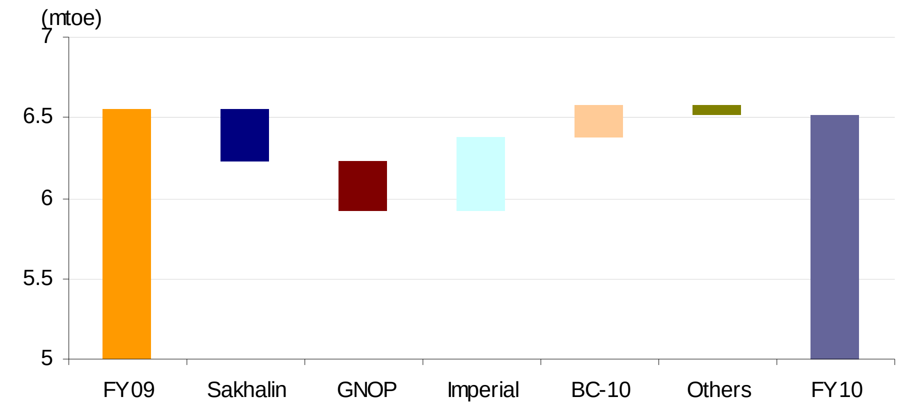
(mtoe)	FY09	FY10	% change
Imperial	22.8	21.9	-4%
BC-10	2.5	2.2	-15%
OVL	190.2	186.0	-2%

Source: Company, IIFL Research

Marginal YoY increase in production in FY10

OVL's total production increased from 8.78mtoe in FY09 to 8.87mtoe in FY10. Crude-oil production dropped marginally to 6.51mmt, while gas production grew 6% to 2.36bcm. The increase in gas production was driven by Block 06.1 in Vietnam, where ONGC is in discussions with PetroVietnam to acquire British Petroleum's 35% stake that it has put up for sale. Crude production was flat despite a sharp decline in two major producing fields (Sakhalin, GNOP Sudan and Al Furat), thanks to a ramp-up in production at BC-10 Brazil and Imperial Energy.

Figure 2: OVL FY10 crude production flat on BC-10 and Imperial ramp-up



Source: Company, IIFL Research

Crude production at Sakhalin and GNOP Sudan declined 17% and 13% respectively, while production in BC-10 was ramped up to 34kbpd and that of Imperial Energy to 16kbpd.

Figure 3: Three declining fields contribute 67% of FY10 production

Producing property	Country	PI	Operator	FY09 production (mtoe)	FY10 production (mtoe)
Block 06.1	Vietnam	45%	British Petroleum	1.89	2.01
Sakhalin-I	Russia	20%	ENL	2.23	1.92
Block 5A	Sudan	24%	WNPOC	0.29	0.25
GNOP	Sudan	25%	Joint operator	2.44	2.13
Al Furat	Syria	10.3%-9.2%	Shell	0.81	0.72
Block BC-10	Brazil	15%	Shell		0.19
San Cristobal	Venezuela	40%	Joint operator	0.67	0.70
Mansarovar Energy	Columbia	25%-50%	Joint operator	0.37	0.41
Imperial Energy	Russia	100%	OVL	0.08	0.54
Total				8.78	8.87

Source: Company, IIFL Research

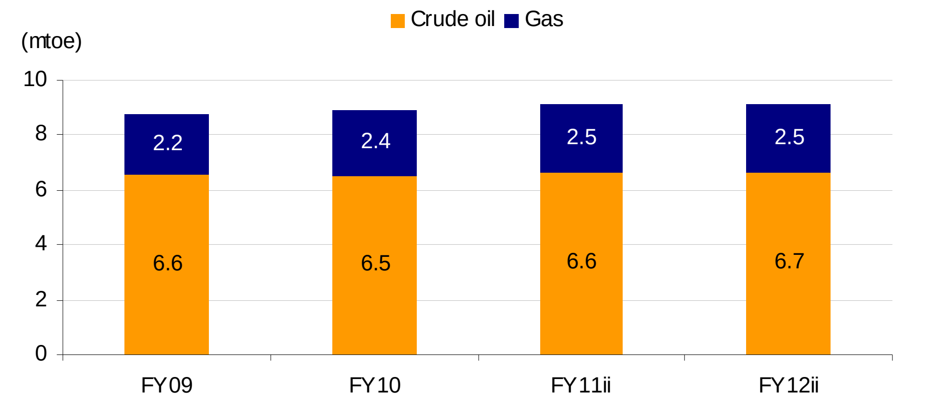
BC-10 and Imperial Energy should sustain OVL production over FY11-13

Production in BC-10 Brazil has been ramped up from 34kbpd in FY10 to 80kbpd currently. BC-10 should add 0.4mmt YoY to OVL's production (proportional to its economic interest) in FY11ii.

Imperial Energy's current production rate of 17kbpd should add 0.3mmt YoY to OVL's production. OVL drilled only 12 exploration and appraisal wells in FY10 that led to four discoveries. The company is undertaking hydro-fracturing to stimulate the reservoir. It plans to drill 43 exploratory and appraisal wells over 2HFY11 (peak winter in Russia), and expects these wells to augment production in early FY12. It is currently mobilising rigs for these wells.

Block 06.1, Vietnam, will also augment OVL's production over FY11-13. The Lan Tay field, currently under production, is ramping up fast (gas production up 6.5% YoY), while the Lan Do field in the same block is under development and is expected to commence production in CY2012.

Figure 4: OVL production should sustain over FY11-13



Source: Company, IIFL Research

Development assets will augment production from FY14

Carabobo, Venezuela: OVL acquired 11% PI in the Carabobo heavy-oil field in the Orinoco basin in Venezuela for a total investment of US$1.33bn. The development plan for the block was approved in July 2010. The project has an estimated 27bn barrels of oil in place. OVL's economic interest translates to 300mmbbls.

Carabobo will target production of 400kbpd of extra-heavy oil (OVL's economic interest is 2.2mmt per annum), of which half will be upgraded into light crude oil. The project is expected to go into production in FY14.

A-1, A-3 Myanmar: OVL has 20% PI in these blocks that will fall to 17% after Myanmar Oil and Gas Enterprise exercises its back-in rights of 15%. Block A-1 has initial in-place reserves of 3.83TCF, while Block A-3 has initial in-place reserves of 1.52TCF.

OVL has 20% PI in the offshore downstream pipeline company to bring the gas to the landing point. It also has 8.3% PI in the onshore pipeline project to carry gas from the landing point to the Myanmar-China border. Both pipelines are scheduled to be completed by end-FY13. A-1 and A-3 are expected to go into production in FY14.

Figure 5: Carabobo and A-1, A-3 will go into production by FY14

Project	Country	Hydro carbon	Terrain	PI	Operator	Comment
Carabobo	Venezuela	heavy oil	onshore	11%	Joint operator	Estimated OIP of 27bn bbl; production to commence in 2013
Block A1	Myanmar	gas	offshore	20%	Daewoo	In-place reserves of 3.83tcf; production to commence in mid-2013
Block A3	Myanmar	gas	offshore	20%	Daewoo	In-place reserves of 1.52tcf; production to commence in mid-2013
Farsi	Iran	gas	offshore	40%	OVL	Development service contract under negotiation with NIOC
Block 24	Syria	oil	onshore	60%	IPRMEL	Estimated ultimate reserve of 6.12mmt
North Ramadan	Egypt	oil	offshore	70%	IPR Red Sea	Discovered oil in 2 of the 3 wells drilled

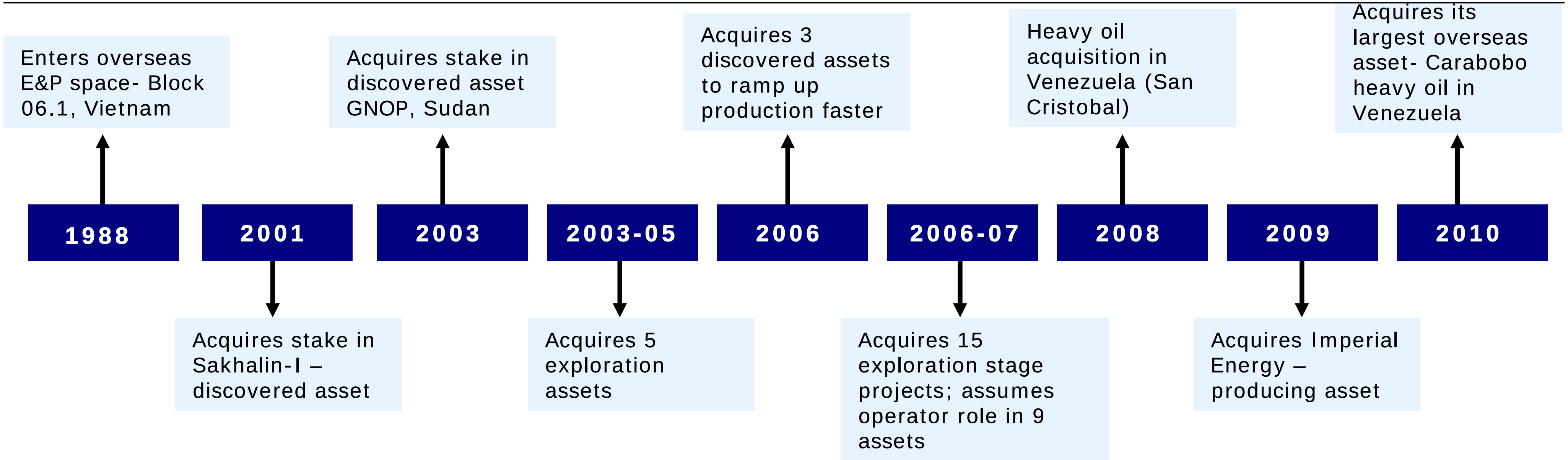
Source: Company, IIFL Research

Investment in Nemed, Egypt could be written off

Though the initial in-place estimate of gas in the block is 1.536TCF, the operator, Shell, has communicated that the development will not be commercially viable. Shell has not responded to OVL's request for independent advice on commercial feasibility of the block. OVL has invested US$235m in the block till date, and is carrying Rs2.8bn of exploration expenses in CWIP (the rest has been provided for under doubtful carry finance). This amount could be written off in FY11, if Shell does not change its stance on the block.

Focusing on discovered/producing fields to ramp production

Figure 6: OVL's strategy shifts to acquiring discovered/producing assets



Source: Company, IIFL Research

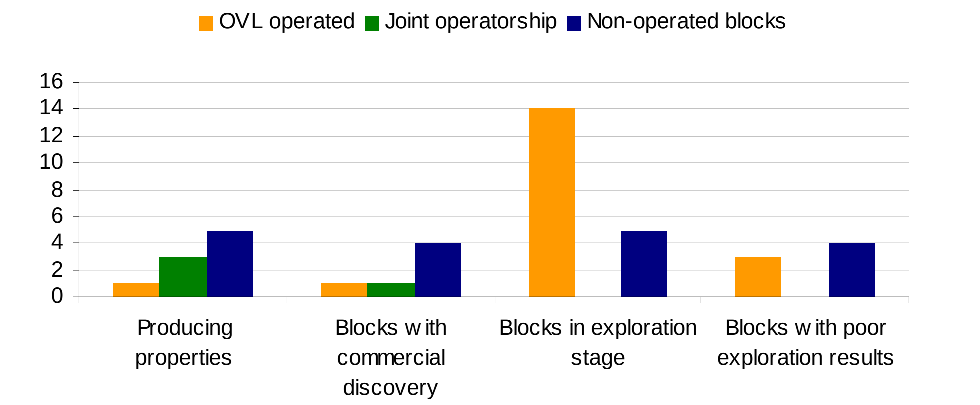
Bidding for largest unallocated hydrocarbon fields in Russia

The company has recently entered the fray to bid for Trebs and Titov deposits, the largest unallotted hydrocarbon fields remaining in Russia. The fields, located in the Arctic region, have estimated recoverable reserves of more than 200mmt of oil, report media sources. Estimates of the bid are in the region of US$3bn.

ONGC is the operator in 15 out of 19 exploration blocks

Of its 15 producing and discovered blocks, OVL is the operator in only two blocks. In 2006-07, the company picked up a number of exploration acreages, where it is the operator. OVL's exploration expertise will determine the future of these blocks.

Figure 7: OVL is the operator in most of its exploratory acreage



Source: Company, IIFL Research

Figure 8: OVL operates 15 of the 19 blocks in its exploratory acreage

Project	Country	PI	Operator
Block 8	Iraq	100%	OVL
Block 25, 26, 27, 28, 29, 35A,36	Cuba	30%	Repsol YPF
Block 128	Vietnam	100%	OVL
Block 34	Cuba	100%	OVL
Block 35	Cuba	100%	OVL
Contract area 43	Libya	100%	OVL
Block RC-8	Columbia	40%	OVL
Block RC-9	Columbia	50%	Ecopetrol
Block RC-10	Columbia	50%	OVL
Block AD-2	Myanmar	100%	OVL
Block AD-3	Myanmar	100%	OVL
Block AD-9	Myanmar	100%	OVL
Block SSJN-7	Columbia	50%	Pacific
Block CPO-5	Columbia	70%	OVL
Block BM-S-73	Brazil	44%	OVL
Block BM-ES-42	Brazil	100%	OVL
Block BM-SEAL-4	Brazil	25%	Petrobras
Block BM-BAR-1	Brazil	25%	Petrobras
Block OPL 285	Nigeria	32%	OMEL

Source: Company, IIFL Research

We retain BUY with a target price Rs1528/share

OVL is expected to sustain production over FY11-13ii with major increments likely in FY14 from Carabobo and Myanmar.

GoI's decision to deregulate petrol price and its stated intention to deregulate diesel price provide strong tailwinds to ONGC's earnings by reducing the under-recovery burden. With crude price ruling in a band (US$70-80/bbl), we expect the government to announce diesel price deregulation by 4QFY11. The change in management control of Cairn India has also created an opportunity for the GoI to address ONGC's long-outstanding royalty issue in Rajasthan.

We see strong tailwinds to ONGC's earnings from the likelihood of further reforms in the sector. We retain BUY with a target price of Rs1,528/share.

Figure 9: Our target price for ONGC is Rs1,528/share

	1P(mmboe)	EV/bbl (US$)	EV (US$ m)	Rs/share
ONGC standalone	**5695**	**10.0**	**56954**	**1225**
OVL				
Russia	944	4.5	4206	90
Sudan	194	10.0	1935	42
Others	226	17.3	3915	84
OVL total				216
Add:				
MRPL				37
Investments @20% discount to market				50
ONGC target price				**1528**

Source: IIFL Research

Financial summary

Income statement summary (Rs m)

Y/e 31 Mar	FY09	FY10	FY11ii	FY12ii	FY13ii
Revenue	1,045,884	1,017,546	1,171,238	1,317,324	1,570,110
EBITDA	416,899	443,496	502,618	583,344	650,860
EBIT	**262,595**	**256,307**	**306,865**	**374,037**	**428,825**
Interest expense	-1,135	-2,385	-5,022	-3,784	-3,674
Exceptional items	-930	763	401	0	0
Others items	-2,385	-5,022	-3,784	-3,674	-1,924
Profit before tax	**763**	**401**	**0**	**0**	**0**
Tax expense	50,721	52,728	47,358	54,037	57,533
Minorities	311,695	304,414	350,439	424,401	484,434
Net Profit	**-110,093**	**-107,138**	**-120,832**	**-145,391**	**-164,824**

Cashflow summary (Rs m)

Y/e 31 Mar	FY09	FY10	FY11ii	FY12ii	FY13ii
Profit before tax	311,695	304,414	350,439	424,401	484,434
Depreciation & Amortization	154,246	187,174	195,753	209,307	222,035
Tax paid	-110,093	-107,138	-120,832	-145,391	-164,824
Working capital change	4,825	-16,195	-54,173	-12,626	-18,226
Other operating items	-18,209	-80,734	-35,413	-41,439	-44,600
Operating Cash-flow	289,977	287,521	335,774	434,253	478,820
Capital expenditure	-291,729	-194,229	-190,455	-211,160	-212,160
Free cash flow	**-1,752**	**93,292**	**145,320**	**223,093**	**266,660**
Equity raised	0	0	0	0	0
Investments	10,018	-16,790	7,850	0	0
Debt financing/disposal	49,676	-3,039	-13,491	-50	0
Dividends paid	-80,076	-82,575	-94,884	-115,378	-130,894
Other items	-2,385	-5,022	-3,784	-3,674	-1,924
Net change in Cash & cash equivalents	**-24,626**	**-14,133**	**41,011**	**103,992**	**133,843**

Source: Company data, IIFL Research

Balance sheet summary (Rs m)

Y/e 31 Mar	FY09	FY10	FY11ii	FY12ii	FY13ii
Cash & cash equivalents	156,331	149,704	190,714	294,706	428,549
Sundry debtors	71,814	71,424	72,015	81,477	93,950
Trade Inventories	65,424	82,400	68,640	79,968	93,743
Other current assets	220,084	210,549	211,601	211,601	211,601
Fixed assets	**885,517**	**1,011,591**	**1,073,463**	**1,140,162**	**1,196,545**
Intangible assets	114,039	95,385	89,221	85,986	82,752
Other assets	34,803	51,593	43,744	43,744	43,744
Total assets	**1,548,011**	**1,672,647**	**1,749,398**	**1,937,644**	**2,150,883**
Sundry creditors	200,232	226,819	158,563	166,727	174,749
Other current liabilities	82,158	75,158	77,124	77,124	77,124
Long-term debt/Convertibles	65,591	62,669	49,178	49,128	49,128
Other long-term liabilities	263,682	277,503	299,312	315,812	332,312
Minorities/other Equity	14,114	16,432	20,124	24,425	32,385
Networth	**922,235**	**1,014,066**	**1,145,097**	**1,304,428**	**1,485,185**
Total liabilities & equity	**1,548,011**	**1,672,647**	**1,749,398**	**1,937,644**	**2,150,883**

Ratio Analysis

Y/e 31 Mar	FY09	FY10	FY11ii	FY12ii	FY13ii
Sales growth (%)	8.1	-2.7	15.1	12.5	19.2
Core EBITDA growth (%)	3.0	6.4	13.3	16.1	11.6
Core EBIT growth (%)	-1.2	-2.4	19.7	21.9	14.6
Core EBITDA margin (%)	39.9	43.6	42.9	44.3	41.5
Core EBIT margin (%)	25.1	25.2	26.2	28.4	27.3
Net profit margin (%)	18.9	19.0	19.3	20.9	19.8
Dividend payout ratio (%)	40%	43%	42%	42%	42%
Tax rate (%)	35.3	35.2	34.5	34.3	34.0
Net Debt/Equity (%)	-9.8	-8.6	-12	-19	-26
Return on Equity (%)	24.5	21.1	21.4	22.5	22.2
Return on Assets (%)	19.2	17.8	19.2	20.8	21.0

Source: Company data, IIFL Research

Key to our recommendation structure

BUY - Absolute - Stock expected to give a positive return of over 20% over a 1-year horizon.
SELL - Absolute - Stock expected to fall by more than 10% over a 1-year horizon.

In addition, **Add** and **Reduce** recommendations are based on expected returns relative to a hurdle rate. Investment horizon for **Add** and **Reduce** recommendations is up to a year. We assume the current hurdle rate at 10%, this being the average return on a debt instrument available for investment.

Add - Stock expected to give a return of 0-10% over the hurdle rate, ie a positive return of 10%+.
Reduce - Stock expected to return less than the hurdle rate, ie return of less than 10%.
