Oil & Natural Gas (ONGC.BO)

Equity

Sell: Strong 1Q, But Can This Sharing Formula Continue?

- **Strong 1Q driven by low subsidy** — 1QFY10 PAT at Rs48.5bn was above expectations, primarily on account of the lower subsidy burden driving higher net realisations and also lower other expenses. Even though gas sales recovered to 5.1bcm from the slight dip seen in 4Q09, crude sales remain depressed at 5.45MMT vs. FY09 average sales of 5.72MMT. Dry well expense declined from Rs18.6bn in 4Q09 to Rs10.7bn in 1QFY10, but remains high on a yoy basis (Rs5.5bn) due to a structural increase in costs and higher exploration intensity.
- **Subsidy sharing only on auto fuels** — ONGC's subsidy burden of Rs4.29bn was in-line with the oil ministry's assertion of upstream sharing for under-recoveries only on auto-fuels. This burden translates into a subsidy discount of US$2.3/bbl, resulting in healthy net realisations on own crude of US$60.6/bbl. While the government has followed up intent with action, it is difficult to extrapolate this for the full year.
- **Government policy continues to be a risk** — Even though Petmin has stuck to upstream sharing losses only on auto-fuels in 1Q, the Budget did not make requisite allocations to confirm that. Given that net under-recovery of Rs200bn (gross loss on LPG/SKO of Rs300bn minus oil bonds of Rs100bn) will be too much for the OMCs to bear (esp. when GRMs are likely to stay depressed), we see the risk on ONGC sharing the LPG/SKO subsidy as well is very much intact.
- **Maintain Sell, lacks triggers** — ONGC currently trades at 12x Sept-10E P/E, the top end of its historical 7-12x trading band. Any move by the government to fully deregulate auto fuels could take time as it has recently constituted an expert committee for pricing recos. We maintain our Sell (3M) rating.

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2007A	177,696	83.08	15.4	13.2	3.5	29.0	3.3
2008A	198,723	92.91	11.8	11.8	3.0	27.7	2.9
2009E	235,868	110.28	18.7	9.9	2.5	27.7	3.3
2010E	177,609	83.04	-24.7	13.2	2.2	18.0	2.3
2011E	212,608	99.40	19.7	11.0	1.9	18.9	2.3

Source: Powered by dataCentral

See Appendix A-1 for Analyst Certification and important disclosures.

Sell/Medium Risk	3M
Price (23 Jul 09)	Rs1,092.85
Target price	Rs910.00
Expected share price return	-16.7%
Expected dividend yield	2.3%
Expected total return	**-14.4%**
Market Cap	Rs2,337,467M
	US$48,275M

Price Performance (RIC: ONGC.BO, BB: ONGC IN)

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Fiscal year end 31-Mar	2007	2008	2009E	2010E	2011E
Valuation Ratios					
P/E adjusted (x)	13.2	11.8	9.9	13.2	11.0
EV/EBITDA adjusted (x)	6.5	5.3	4.4	5.0	4.0
P/BV (x)	3.5	3.0	2.5	2.2	1.9
Dividend yield (%)	3.3	2.9	3.3	2.3	2.3
Per Share Data (Rs)					
EPS adjusted	83.08	92.91	110.28	83.04	99.40
EPS reported	83.08	92.91	110.28	83.04	99.40
BVPS	309.51	361.94	433.98	488.81	560.57
DPS	36.00	32.00	36.00	25.00	25.00
Profit & Loss (RsM)					
Net sales	862,762	1,018,349	1,192,209	1,094,663	1,168,529
Operating expenses	-638,486	-752,396	-880,813	-873,231	-894,117
EBIT	**224,276**	**265,953**	**311,396**	**221,432**	**274,412**
Net interest expense	1,058	-2,153	-1,406	-1,349	-1,297
Non-operating/exceptionals	52,240	45,431	50,694	50,766	50,137
Pre-tax profit	**277,574**	**309,232**	**360,684**	**270,849**	**323,252**
Tax	-98,454	-106,999	-121,190	-91,005	-108,613
Extraord./Min.Int./Pref.div.	-1,424	-3,509	-3,627	-2,234	-2,031
Reported net income	**177,696**	**198,723**	**235,868**	**177,609**	**212,608**
Adjusted earnings	177,696	198,723	235,868	177,609	212,608
Adjusted EBITDA	343,953	404,831	463,155	384,872	442,100
Growth Rates (%)					
Sales	16.2	18.0	17.1	-8.2	6.7
EBIT adjusted	8.4	18.6	17.1	-28.9	23.9
EBITDA adjusted	12.9	17.7	14.4	-16.9	14.9
EPS adjusted	15.4	11.8	18.7	-24.7	19.7
Cash Flow (RsM)					
Operating cash flow	**385,721**	**350,302**	**429,654**	**323,766**	**382,271**
Depreciation/amortization	119,678	138,878	151,759	163,440	167,689
Net working capital	92,901	15,289	39,189	-15,441	4,020
Investing cash flow	**-197,369**	**-210,154**	**-199,659**	**-204,659**	**-204,659**
Capital expenditure	-186,873	-189,907	-186,428	-191,428	-191,428
Acquisitions/disposals	-253	-7,015	0	0	0
Financing cash flow	**-89,476**	**-74,943**	**-87,408**	**-57,883**	**-57,861**
Borrowings	-6,336	-666	-3,635	-226	-203
Dividends paid	-85,468	-75,972	-85,468	-59,353	-59,353
Change in cash	**98,877**	**65,205**	**142,586**	**61,223**	**119,751**
Balance Sheet (RsM)					
Total assets	**1,102,252**	**1,246,846**	**1,446,771**	**1,554,159**	**1,729,072**
Cash & cash equivalent	225,104	270,880	479,064	579,124	739,006
Accounts receivable	48,167	70,469	81,658	74,977	80,036
Net fixed assets	249,410	280,312	276,852	292,292	305,278
Total liabilities	**431,936**	**461,271**	**503,605**	**490,082**	**509,289**
Accounts payable	78,824	98,444	95,520	102,333	113,978
Total Debt	16,005	9,445	3,617	3,255	2,930
Shareholders' funds	**670,316**	**785,575**	**943,165**	**1,064,077**	**1,219,783**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	39.9	39.8	38.8	35.2	37.8
ROE adjusted	29.0	27.7	27.7	18.0	18.9
ROIC adjusted	17.5	21.1	24.3	16.7	21.2
Net debt to equity	-31.2	-33.3	-50.4	-54.1	-60.3
Total debt to capital	2.3	1.2	0.4	0.3	0.2

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Figure 1. ONGC — 1QFY10 Results

RsM	1QFY09	4QFY09	1QFY10	yoy	Comments
Net sales	**200,522**	**137,038**	**148,793**	**-25.8%**	Increase qoq due to higher crude prices and lower subsidy burden; no trading revenues (from MRPL)
Inc/dec in stock	61	(1)	(1,198)	-2080.5%	
Raw material cons	27,645	18,216	1,107	-96.0%	MoU with MRPL expired; no trading in products
Staff cost	2,897	(699)	2,512	-13.3%	Rs1.07bn of provisioning pending finalization of pay revision vs. Rs2.26bn in 1Q09
Statutory levies	31,353	27,534	30,366	-3.1%	
Other expenditure	21,013	34,191	20,996	-0.1%	
Total expenses	(82,968)	(79,240)	(53,783)	-35.2%	
EBITDA	**117,554**	**57,798**	**95,010**	**-19.2%**	
Interest	(38)	(136)	(61)	60.1%	
Depreciation	(27,970)	(42,444)	(31,789)	13.7%	QoQ decline in dry wells, although it was higher yoy
Other income	10,500	14,093	10,448	-0.5%	
Profit before tax	100,046	29,311	73,608	-26.4%	
Current tax	(34,441)	(7,073)	(22,905)	-33.5%	
Profit after current tax	65,605	22,238	50,703	-22.7%	
Deferred tax	325	(170)	(2,224)	-784.8%	
Net profit	**65,929**	**22,068**	**48,479**	**-26.5%**	
Extra-ordinary	434	-	-		
Reported Net Profit	66,363	22,068	48,479	-26.9%	

Source: Citi Investment Research and Analysis, Company Reports

Figure 2. ONGC — Key Operational Parameters

Year to 31-Mar	1QFY08	2QFY08	3QFY08	4QFY08	1QFY09	2QFY09	3QFY09	4QFY09	1QFY10	Comments
Crude production (MMT)	6.88	7.00	7.11	6.93	6.84	6.85	6.95	6.48	6.55	
Gas production (bcm)	6.10	6.35	6.53	6.14	6.39	6.43	6.45	6.16	6.39	
Crude sales (MMT)	5.90	6.13	5.99	6.06	5.93	5.67	5.72	5.57	5.45	Not recovered from the dip in 4Q
Crude sales (RsM)	94,260	105,650	101,660	99,590	135,750	107,650	76,240	88,200	113,770	
Bonny Light (US$/bbl)	71.8	78.0	91.2	100.4	125.8	119.4	59.0	47.9	60.6	
Subsidy discounts (US$/bbl)	21.6	22.1	36.7	50.7	56.7	72.7	25.0	4.5	2.3	
ONGC's net realisation (US$/bbl)	50.2	55.9	54.5	49.7	69.1	46.7	34.0	43.4	58.3	Higher owing to lower subsidy burden
Gas sales (bcm)	5.03	5.19	5.32	4.89	5.18	5.21	5.21	4.93	5.11	
Gas sales (RsM)	17,940	18,330	19,170	17,940	19,770	20,030	20,950	19,600	19,970	
Total gas realisation (Rs/tcm)	3,567	3,532	3,603	3,669	3,817	3,845	4,021	3,976	3,908	Aided by weak rupee as JV gas prices are US$-denominated
Subsidy (RsM)	36,490	37,990	60,800	84,720	98,110	126,630	48,990	8,520	4,290	Subsidy sharing only on auto fuels

Source: Citi Investment Research and Analysis, Company Reports

Oil & Natural Gas

Company description

ONGC is India's largest E&P company. Through its subsidiary ONGC Videsh, the company has invested in overseas crude equity. It has ventured downstream, picking up a majority stake in Mangalore Refineries, and it intends to set up a petro-products retailing network

Investment strategy

We rate ONGC Sell/Medium Risk, with a Rs910 target price. Weak to moderate crude prices have started hurting ONGC, despite lower subsidy sharing, as realizations on JV and international crude suffer. Continuing losses on cooking fuels should ensure continuance of the subsidy sharing mechanism in FY10 and cap upside even if crude recovers to higher levels. Despite talk of deregulation, we feel that even if petrol and diesel prices are partly deregulated, LPG and kerosene would continue to be loss-making, implying a subsidy burden on ONGC.

Valuation

Our target price of Rs910 is based on 10x Sep-10E P/E, at the higher end of ONGC's historical median band of 7-11x. Our target multiple factors in: (i) 10-15% increase in market multiples post elections, and (ii) increased probability of partial sector de-regulation post the strong mandate. We continue to value ONGC on traditional valuation parameters as against NAV/SOTP approach due to it being a going concern. Given that its existing fields face declining or mature production profiles, it will be incorrect to value the new discoveries (say KG gas) separately in an SOTP since the new fields would anyway be required to compensate for the decline in mature fields. In terms of asset valuation, ONGC's current EV/boe of US$7.2 (on 1P reserves) is unlikely to get further re-rated given limited benefit from higher crude as well as subsidized gas prices.

Risks

We assign a Medium Risk rating on account of continued uncertainty on subsidy sharing and low visibility on a reduction in ONGC's burden despite reduced downstream under-recoveries. Upside risks to our estimates are: 1) ONGC has made substantial investments in overseas oil blocks, through its subsidiary ONGC Videsh, in Sudan, Vietnam, and Russia. ONGC remains aggressive in the search for oil equity overseas and is usually an interested bidder in such asset sales. Value accretive overseas acquisitions pose upside risks to our estimates. 2) Rupee depreciation benefits ONGC through higher domestic realisations. Continued devaluation of the rupee could pose risks to our estimates. 3) Government interference in the Indian oil sector (e.g. making upstream oil companies bear LPG/kerosene subsidy losses and gasoline/diesel retailing losses) has been a concern for the sector. Positive policy announcements leading to complete deregulation of the sector and removal of subsidy-sharing by upstream companies could significantly impact ONGC's earnings. If any of these risks has a greater impact than we anticipate, ONGC's share price could exceed our target price.

Appendix A-1

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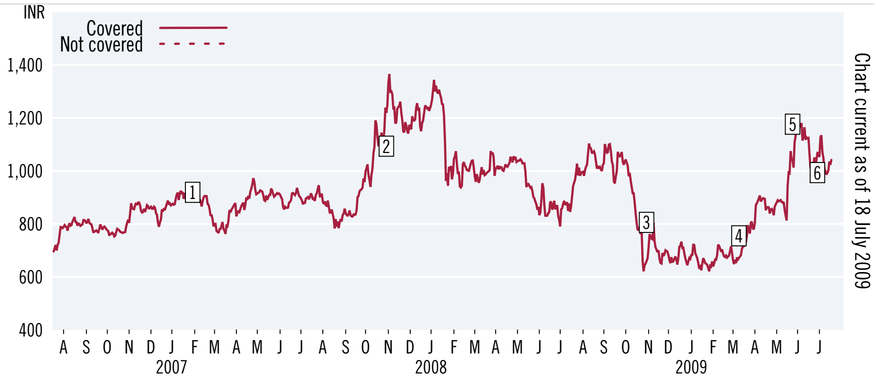
Oil & Natural Gas (ONGC.BO)

Ratings and Target Price History
Fundamental Research

Analyst: Rahul Singh



	Date	Rating	Target Price	Closing Price
1	30-Jan-07	1M	*1,100.00	914.60
2	30-Oct-07	*1L	*1,400.00	1,219.55
3	30-Oct-08	*1M	*850.00	650.05
4	10-Mar-09	*3M	*587.00	665.75
5	24-May-09	3M	*820.00	1,045.30
6	28-Jun-09	3M	*910.00	1,040.90

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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