

July 26, 2006

Stock Rating
Overweight

Industry View
Attractive

Oil & Natural Gas Corp. Higher Realization + Higher Production = Higher Profits

Quick Comment: ONGC reported impressive F1Q07 results that were about 15% higher than our expectations, with operating profits up 32.1% YoY and 20.6% sequentially, despite a 78% hike in petroleum product subsidy on a year-on-year basis. Operating profit growth was driven by higher sales realization and volumes sold of crude oil and by gas prices.

Recouped costs were up 65.0% YoY but 29.3% lower sequentially. Non operating income was up 40.7% YoY, 20% above our expectations, but lower by 33.3% sequentially. All this led to growth in net profits of 23.2% YoY and 68.4% sequentially.

ONGC also declared a bonus of one share for every two shares held by shareholders, subject to shareholder approval. The record date has not yet been announced.

How do the results affect our estimates? The potential changes could be due to (1) Higher sales realization due to high crude oil prices, net of subsidy, and (2) Higher volumes sold. Together, these factors could **have a 7-8%** positive impact on our F2007 forecasts. However, there is uncertainty on regulation and hence we maintain our estimates for the time being, as well as our Overweight rating on the stock. Our positive view on the stock is based on: 1) our forecast that ONGC's production will grow 8.7%/year over F2006-8E; 2) option value on gas, which is controlled by the government; 2) ONGC's international acquisition strategy, which seems to be paying rich dividends, and 4) attractive valuations. ONGC has underperformed the market by 14.25% YTD, 18.63% in the last six months, and is the cheapest E&P stock in our Asian universe, trading at F2007E P/E of 8.6x, dividend yield of 4.2%, EV/EBITDA of 3.8x, an implied crude oil price of \$30/bbl, and current EV/Boe of US\$4.95, making valuations look attractive, in our view.

Key Ratios and Statistics

Reuters: **ONGC.BO** Bloomberg: **ONGC IN**

India Oil & Gas

Price target	Rs1,405.00
Shr price, close (Jul 26, 2006)	Rs1,138.25
Mkt cap, curr (mn)	Rs1,623,063
52-Week Range	Rs1,514.00-854.00
Sh out, basic, curr (mn)	1,425.9
EV, curr (mn)	Rs1,562,037
Net debt/cap (06e) (%)	(33.1)
ROE (06e) (%)	31.7
Sh out, basic, per-end (06e) (mn)	1,426
S'hldr eqty (06e) (mn)	Rs568,604
RNOA (06e) (%)	33.6

e = Morgan Stanley Research estimates

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ONGC's Net Crude realization up 23.1% YoY, 5.5% sequentially in dollar terms

In F2005, ONGC was asked to share 19% of the overalls subsidy; in F2006, the subsidy share went up to 28%, and in F1Q07 we estimate it at 29%. **In absolute terms in F1Q07**, ONGC reportedly paid a subsidy of Rs51.2 billion, equating to US\$26.4/bbl, i.e., it realized **US\$45.0/bbl net** of subsidy, or US\$71.4/bbl gross of subsidy. Had it not been for the subsidy, net profit would have risen Rs31.2 billion, touching Rs 72.4 billion.

We had estimated ONGC would realize US\$42.65/bbl in F1Q07 and about US\$44.1/bbl for F2007 as a whole. For every US\$/bbl hike in ONGC's net realization, its bottom line improves by Rs 5.8 bn, or 3% of its profits.

Due to firming up of the dollar by 2.5%, to Rs 45.5, in the quarter, ONGC gained **Rs 3.5 bn in revenues** and Rs 1.8 bn in profits. Thus, ONGC's YOY growth in its crude realization in Rs/ton was even better than its US\$/bbl realization at 25.8 %

Crude Sales volumes for the quarter up 5.3% YoY, 6.6% sequentially

ONGC set up a Floating Production System (FPSO) in May 2006 to augment production from Mumbai High North to 252,000 bopd, equal to production levels prior to the loss of the BHN platform on 27 July, 2005. The company has a target to step up production to 300,000 barrels of oil per day (bopd) on a sustained basis by March 2007. This led to higher production in F1Q07.

The company's sales to production ratio grew from an average of 84.9% in F2006 to 88.25% in F1Q07, largely due to SAP implementation and better inventory management. This led to a higher growth rate in sales as compared to production.

Gas production for the quarter was up 15.7% YoY, 2.9% sequentially

ONGC's gas business was also affected by the augmentation in production in Mumbai High North.

Partial Decontrol of gas led to higher gas realization of 34.3% YoY

The government partially decontrolled gas prices, effective July 1, 2005 — ONGC now gets US\$1.9/mmbtu for 85% of its production and US\$4.75/mmbtu for 15% of its production, up from US\$1.25/mmbtu and US\$3/mmbtu, respectively, on April 1, 2005.

ONGC's gas realization improved 8.4% YoY, 9.1% sequentially in F1Q07.

The company said it has been making pleas to the government to remove gas price controls. If gas price controls were lifted, we estimate it could mean as much as Rs90 billion in additional revenue per year and Rs60 billion in additional profits (i.e., Rs42/share).

F1Q07 Overall Subsidy Burden at Rs 174 billion

Based on our discussions with Indian Oil & Gas companies, we estimate the Indian Oil subsidy burden in F1Q07 at Rs.174 bn (US\$ 3.9bn) as against Rs.109 bn (US\$2.45bn) in F4Q06. Despite the government's raising retail prices of petrol and diesel by 8.1% and 6.1%, respectively, on June 5th, the subsidy burden increased by 59.5% on a sequential basis due to higher crude oil prices. Crude oil (WTI) prices averaged US\$70.6/bbl in F1Q07, up 33% YoY and 10% sequentially. The subsidy share amongst Indian energy companies in F1Q07 is shown in Exhibit 1.

Company Description

ONGC is India's dominant E&P company, with a virtual monopoly in the production of crude oil and natural gas. It has 6.5 mmboe of proven oil & gas reserves. ONGC is India's biggest company in terms of net profits and market capitalization. The government owns 74% of the company.

Industry View: Attractive

Organic growth, attractive valuations, strong GRMs and impressive pickup in demand, are key triggers for the industry.

MSCI Country: India

Asia Strategist's Recommended Weight: 4.1%
MSCI Asia/Pac All Country Ex Jp Weight: 5.4%

We now estimate the overall subsidy to increase to Rs643billion for F2007 at WTI of US\$70/bbl (OPEC basket of US\$65/bbl)

We estimate the country's petroleum basket is priced at US\$48/bbl of WTI basket, which is currently trading at US\$76/bbl. Thus, marketing margins are currently around negative US\$25-26/bbl. Every US\$1 hike in WTI increases our subsidy by US\$513 mn for the year, since the overall products, which are subsidized, equate to 70 mntpa.

Conclusions

We see upside to our F2007E earnings for two reasons: The company's production estimates are about 0.5 mntpa higher than our own; ONGC has been realizing as much as US\$70-74/bbl in certain months this year, net of the subsidy share of Rs210 billion.

Forecast earnings could move even higher if crude prices remain at current levels for the rest of the year. Together, these factors could **have a 7-8%** positive impact on our F2007 forecasts. However, given the uncertainty regarding the subsidy, we leave our estimates unchanged.

Exhibit 1

ONGC: F1Q07 Results

(Rs mn)	F1Q07	F1Q06	% Chg	F4Q06	% Chg
(period ending)	30-Jun-06	30-Jun-05	YoY	30-Jan-06	QoQ
Income from Services	146,028	108,697	34.3%	118,983	22.7%
Increase / Decrease in Inventory	248	(18)		(2,091)	
Consumption of Raw Materials	771	335	130.3%	2,365	-67.4%
Staff Expenditure	2,975	2,454	21.2%	5,027	-40.8%
Statutory Levies	31,140	24,996	24.6%	18,275	70.4%
Other Expenditure	13,078	10,171	28.6%	20,582	-36.5%
Total Expenditure	64,933	47,293	37.3%	51,730	25.5%
Operating Profit	81,094	61,404	32.1%	67,253	20.6%
Recouped Costs	22,309	13,517	65.0%	31,574	-29.3%
EBIT	58,786	47,887	22.8%	35,680	64.8%
Other Income	4,200	2,986	40.7%	6,299	-33.3%
Interest	33	22	50.5%	323	-89.8%
PBT	62,952	50,851	23.8%	41,655	51.1%
Tax	21,763	17,428	24.9%	17,202	26.5%
PAT	41,190	33,423	23.2%	24,453	68.4%
Extraordinary Items	-	(234)		6,405	
Reported PAT	41,190	33,189	24.1%	30,858	33.5%
Cash Profits	61,156	46,706	30.9%	62,432	-2.0%
Operating margins (%)	55.5	56.5		56.5	
Net margins (%)	28.2	30.7		20.6	
Effective tax rate (%)	34.6	34.3		41.3	
Sales Volumes					
Crude Oil (MMT)	6.11	5.80	5.3%	5.73	6.6%
Gas (MSCM)	5.30	4.58	15.7%	5.15	2.9%
Sales to production (%)	88.2	87.3		86.7	
Production Volumes					
Crude Oil (MMT)	6.93	6.64	4.3%	6.61	4.8%
Gas (MSCM)	6.42	5.73	12.1%	6.30	1.9%
Sales Realisation					
Crude Oil (Rs/ton) (Net)	15,912	12,648	25.8%	14,946	6.5%
Crude Oil (US\$/bbl) (Net)	45.0	36.6	23.1%	42.6	5.5%
Gas (Rs /tscm)	3,534	3,259	8.4%	3,239	9.1%
Subsidy Burden (Rs Million)	51,200	28,760	78.0%	34,069	50.3%
Subsidy (US\$/bbl)	26.4	16.2	62.9%	17.9	47.8%
Crude Realization (Gross of Subsidy) US\$/bbl	71.4	52.8	35.3%	60.5	18.0%

Source: Company data, Morgan Stanley Research

Exhibit 2

India Oil & Gas – Petroleum Subsidy Burden Split

	F1Q07E	F1Q06	F4Q06	F2006	F2007E
Crude Prices (WTI)	\$70.57	\$53.14	\$63.88	\$59.43	
Singapore GRMs	\$11.23	\$9.00	\$2.02	\$6.12	
Total Subsidy(Rs Million)	173,980	110,261	109,039	420,000	643,000
Government of India	70,750	6,500	121,200	6,500	283,000
Burden*	103,230	103,761	(12,161)	413,500	360,000
BPCL	5,757	14,020	(7,890)	24,100	23,028
HPCL	6,125	19,360	(22,293)	23,400	24,499
IOCL	30,798	31,940	(11,274)	66,700	63,099
IBP	841	5,871	(15,732)	5,000	3,363
ONGC	51,200	28,760	34,118	119,580	211,152
GAIL	2,820	1,530	5,440	10,700	8,560
OIL	5,690	2,280	1,567	8,355	20,288
Refiners	-	-	3,904	155,665	6,000
Total	103,230	103,761	(12,161)	413,500	360,000
R&M Share	43,520	71,191	(57,190)	119,200	119,989

E = Morgan Stanley Research Estimates.*Considering Government to issue oil bonds to R&M companies worth Rs 283 bn in F2007 and Rs 70bn in F1Q07.

Source: Government of India, Press Reports, Company data, Morgan Stanley Research

Exhibit 3

**India Oil & Gas – Petroleum Subsidy Burden Split
(% of Total)**

(%)	F1Q07E	F1Q06	F4Q06	F2006	F2007E
Total (%)	100	100	100	100	100
Government of India (%)	41	6	111	2	44
Burden (%)	59	94	-11	98	56
BPCL (%)	3	13	-7	6	4
HPCL (%)	4	18	-20	6	4
IOCL (%)	18	29	-10	16	10
IBP (%)	0	5	-14	1	1
ONGC (%)	29	26	31	28	33
GAIL (%)	2	1	5	3	1
OIL (%)	3	2	1	2	3
Refiners (%)	0	0	4	37	1
Total (%)	59	94	-11	98	56
R&M Share (%)	25	65	-52	28	19

Source: Morgan Stanley Research Source: Government of India, Press Reports, Company data, Morgan Stanley Research



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Industry Coverage: India Oil & Gas

<u>Company (Ticker)</u>	<u>Rating (as of)</u>	<u>Price (07/26/2006)</u>
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GAIL (India) (GAIL.BO)	U (04/19/2006)	Rs264.80
Hindustan Petroleum (HPCL.BO)	U (07/07/2005)	Rs221.15
Indian Oil Corp (IOC.BO)	++	Rs393.70
Oil & Natural Gas Corp. (ONGC.BO)	O (05/31/2004)	Rs1138.25
Reliance Petroleum Limited (RPET.BO)	O-V (06/15/2006)	Rs62.35

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