30 July 2010

# ONGC

## *Result hit by subsidy; maintain Buy*

Rating: Buy
Target Price: Rs1,440
Share Price: Rs1,241

- **Subsidy plays spoilsport.** ONCG reported net profit of Rs36.6bn, marginally higher than we estimated on lower depreciation charges, though it was down 25% yoy on higher subsidy burden and lower crude sales volumes. It shared Rs55.2bn of subsidy during the quarter vis-à-vis Rs4.3bn in 1QFY10. The significant jump in subsidy sharing arose from higher crude prices and changes in the subsidy-sharing mechanism. The net crude price realisation, at US$48.1/bbl, was lower than 1QFY10 realisation of US$58.3. Further, its crude sales volume declined 2.6% yoy due to the shutdown of NRL refinery, resulting in lower off take.
- **Subsidy sharing continues on an ad hoc basis.** ONGC was burdened with Rs55.1bn subsidy as upstream companies were asked to share 33% of the subsidy burden during 1QFY11. The subsidy-sharing mechanism adopted was similar to that in FY07-08 and in contrast to FY10, when only the auto-fuel subsidy burden was borne by them. Awaiting clarity on subsidy sharing and diesel de-regulation, we continue to build in losses in both cooking fuels and auto fuels, with upstream companies sharing ~33% of the total subsidy burden.
- **Retain earnings.** Awaiting clarity on subsidy sharing, we retain earnings estimates for FY11/12. We expect earnings to grow following the recent steep revision in APM gas prices to US$4.2/m Btu.
- **Valuation.** We retain our target price of Rs1,440 based on a DCF-valuation of ONGC's proven and probable reserves on long-term crude price assumption of US$70/bbl and WACC of 13.5%. Our valuation implies a multiple of 11.1x FY12e EPS. Our target price includes the market value of cash and investments in MRPL and other associates.
- **Risks:** Unfavorable regulation, especially the subsidy-sharing policy, volatile movements in crude and product prices, and the exchange rate.

| Key data | ONGC IN /ONGC.BO |
|---|---|
| 52-week high/low | Rs1,347/Rs934 |
| Sensex/Nifty | 17868/5368 |
| 3-m average volume | US$38.4m |
| Market cap | Rs2650bn/US$57.0bn |
| Shares outstanding | 2139m |
| Free float | 25.9% |
| Promoters | 74.1% |
| Foreign Institutions | 4.2% |
| Domestic Institutions | 8.0% |
| Public | 13.6% |

### Standalone quarterly results

| Year end Mar | 1QFY10 | 1QFY11 | % yoy | FY09 | FY10 | % yoy |
|---|---|---|---|---|---|---|
| Net sales (Rs m) | 148,793 | 136,656 | (8.2) | 639,240 | 602,902 | (5.7) |
| EBDITA (Rs m) | 95,010 | 80,358 | (15.4) | 312,736 | 357,991 | 14.5 |
| EBDITA margin (%) | 63.9 | 58.8 | (505bps) | 48.9 | 59.4 | 1046bps |
| Interest (Rs m) | 61 | 28 | (54.8) | 1,190 | 687 | (42.3) |
| Depreciation (Rs m) | 31,789 | 31,143 | (2.0) | 120,849 | 146,588 | 21.3 |
| Other Income (Rs m) | 10,448 | 5,646 | (46.0) | 48,453 | 34,702 | (28.4) |
| PBT (Rs m) | 73,608 | 54,834 | (25.5) | 239,584 | 249,838 | 4.3 |
| Tax (Rs m) | 25,129 | 18,223 | (27.5) | 78,321 | 82,163 | 4.9 |
| PAT (Rs m) | 48,479 | 36,611 | (24.5) | 161,263 | 167,676 | 4.0 |
| EPS (Rs) | 22.7 | 17.1 | (24.5) | 75.4 | 78.4 | 4.0 |

*Source: Company, Anand Rathi Research*

### Consolidated Financials

| Year end Mar | FY11e | FY12e |
|---|---|---|
| Sales (Rsm) | 1,185,134 | 1,250,105 |
| Net profit (Rsm) | 259,820 | 276,866 |
| EPS (Rs) | 121.5 | 129.4 |
| Growth (%) | 41.8 | 6.6 |
| PE (x) | 10.2 | 9.6 |
| PBV (x) | 2.4 | 2.1 |
| EV/EBITDA (x) | 4.8 | 4.6 |
| RoE (%) | 31.0 | 28.9 |
| RoCE (%) | 41.3 | 37.6 |
| Dividend yield (%) | 4.0 | 4.3 |

*Source: Company, Anand Rathi Research*

# Results Review

**ONGC's 1QFY11 standalone net profit, at Rs36.6bn (-25% yoy), was marginally higher than we expected, on lower depreciation charges. 1Q profit was down 25% yoy on a higher subsidy burden and lower crude sales volumes. As a result, net crude price realisation was down to US$48.1/bbl, from US$58.3 in 1QFY10. Further, crude sales volumes declined 2.6% yoy due to the shutdown of the NRL refinery resulting in lower offtake.**

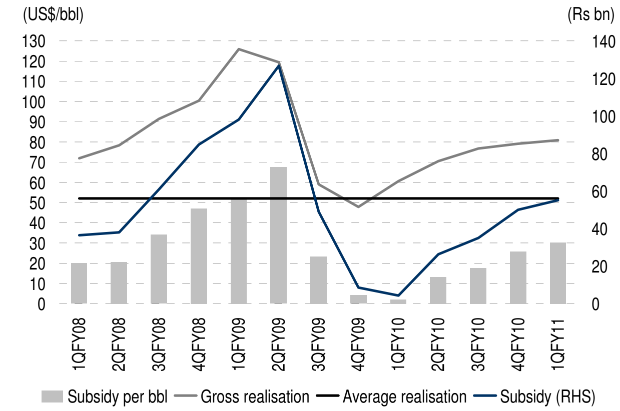
## 1QFY11 net crude price realization at US$48.1/bbl

*For 1QFY11, net realization was US$48.1. For FY10, net realisation was US$57.4/bbl*

ONGC reported 1Q net realization at US$48.1/bbl, post-subsidy discount of US$32.8/bbl. It accounted for Rs55.2bn of the total upstream share of Rs66.9bn. Of upstream companies, its share of the subsidy burden has been 82% in 1Q vis-a-vis 80% in FY10. The subsidy share increased in 1Q as GAIL's share has declined.

As seen in Fig 1, ONGC's net realization per bbl in 1QFY10 was much lower than the past three-year average of around US$52/bbl. This has been chiefly for three reasons: one, a change in the subsidy-sharing formula for FY11, where ONGC has to dole out its share of entire fuel losses, unlike FY10 when its share was based on only the auto-fuel burden. Another reason is that crude had averaged nearly US$78.6/bbl during 1QFY11, pushing up the overall subsidy burden. Also, the 2.6% yoy decline in sales volumes during the quarter led to a rise in the average subsidy per barrel of crude.

**Fig 1 – Net realization crude**




*Source: Company*

## Business-wise performance

*EBITDA margin declined on lower crude price realisation on a yoy basis*

ONGC reported operating earnings of Rs80.4bn (-15% yoy) in 1QFY11. The decline in EBITDA was mainly due to the lower crude price realization and marginally lower crude sales volume. The net realization decreased from US$58.3 to US$48.1/bbl yoy. Crude sales volumes declined 2.6% yoy due to the shutdown of the NRL refinery, resulting in lower offtake. Further, yoy rupee appreciation during the quarter also led to the decline in profits.

ONGC reported that it has passed on the subsidy burden through discounts in the sale of crude, LPG and kerosene, the latter two forming part of its value-added-products portfolio. While international LPG prices ruled at around US$666/ton, ONGC reported a 28% lower realization, at

US$482/ton.

## 1Q physical performance snapshot

**Fig 2 – Segment-wise sales volumes**

| | 1QFY10 | 1QFY11 | % yoy | FY09 | FY10 | % yoy |
|---|---|---|---|---|---|---|
| **CRUDE (m tons)** | | | | | | |
| Domestic | 5.0 | 4.9 | (2.8) | 21.2 | 20.7 | (2.7) |
| JV | 0.4 | 0.4 | | 1.7 | 1.7 | 1.2 |
| | 5.5 | 5.3 | (2.6) | 22.9 | 22.3 | (2.4) |
| **GAS (bn cm)** | | | | | | |
| Domestic | 4.5 | 4.5 | 0.9 | 17.7 | 18.2 | 2.9 |
| JV | 0.6 | 0.6 | | 2.8 | 2.4 | (16.3) |
| | 5.1 | 5.2 | 0.8 | 20.5 | 20.6 | 0.3 |
| **VAP (thousand tons)** | | | | | | |
| LPG | 258.0 | 256.0 | (0.8) | 1,028.8 | 1,107 | 7.6 |
| Naphtha | 441.0 | 435.0 | (1.4) | 1,545.1 | 1,598 | 3.4 |
| C2 C3 | 122.0 | 69.0 | (43.4) | 497.0 | 534 | 7.5 |
| SKO | 43.0 | 41.0 | (4.7) | 152.3 | 166 | 9.0 |

*Source : Company, *VAP – Value Added Products*

**Fig 3 – Product-wise price realization**

| | 1QFY10 | 1QFY11 | % yoy | FY09 | FY10 | % yoy |
|---|---|---|---|---|---|---|
| **CRUDE (US$/ bbl)** | | | | | | |
| Domestic | 55.5 | 48.0 | (13.5) | 47.9 | 54.6 | 14.1 |
| JV | 56.2 | 75.7 | 34.9 | 82.3 | 67.8 | (17.7) |
| | 55.6 | 50.2 | (9.7) | 50.4 | 55.6 | 10.4 |
| **GAS (Rs/thousand cm)** | | | | | | |
| Domestic | 3,213 | 4,480 | 39.4 | 3,191 | 3,216 | 0.8 |
| JV | 9,033 | 8,459 | (6.4) | 8,454 | 8,809 | 4.2 |
| | 3,908 | 4,951 | 26.7 | 3,914 | 3,857 | (1.4) |
| | | | | | | |
| LPG (US$/ton) | 414 | 482 | 16.3 | 483 | 418 | (13.5) |
| Naphtha (US$/bbl) | 512 | 703 | 37.4 | 80 | 73 | (9.0) |
| C2 C3 (US$/ton) | 327 | 463 | 41.8 | 434 | 405 | (6.8) |
| SKO (US$/bbl) | 449 | 443 | (1.3) | 638 | 414 | (35.1) |

*Source : Company*

## Conference call key takeaways:

- Crude sales volumes during 1QFY11 were down 2.6% yoy, though production was up 1% yoy, on lower offtake due to the shutdown of the NRL refinery.
- FDP was filed with the DGH for the northern discovery area (NDA) of the KG Block on 16 Jul '10 but FDP for the southern discovery area would be filed in 6 to 12 months. Capex for NDA is estimated at US$5bn. Cumulative production is expected to 86.97bn cubic metres of gas and 4.5m tons of oil over the field life. Production is expected to start in 2016 and would achieve peak production of 12.96bn cubic metres of gas and 0.84m tons of oil in 2016 itself.
- The company expects a gas price of US$4.2/m Btu for any IOR/EOR gas production that comes up. The "C" series gas field recently secured a gas price of US$5.25/m Btu.
- OVL achieved production of 2.3m toe (1.7m tons of crude and 0.6bn cubic metres of gas) during 1QFY11 and expects FY11 production at 8.6m toe.

- Imperial Energy is currently producing 17,000bpd and is expected to achieve similar levels in FY11. It is facing technical difficulties in ramping up capacity to the earlier announced 40,000bpd. But it says there is no issue with the reserve size.

## Appendix 1

### Analyst Certification

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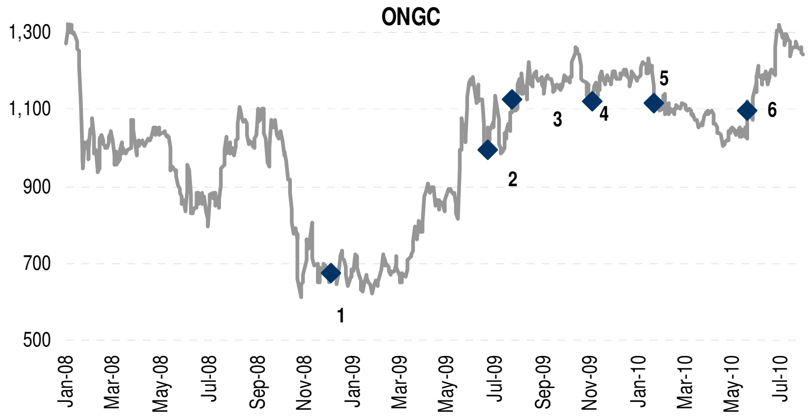
**Rating and Target Price History (as of 30 July 2010)**




| | Date | Rating | TP (Rs) | Share Price |
|---|---|---|---|---|
| 1 | 4-Dec-08 | Buy | 950 | 662 |
| 2 | 22-Jun-09 | Hold | 950 | 994 |
| 3 | 24-Jul-09 | Hold | 1,150 | 1,125 |
| 4 | 3-Nov-09 | Hold | 1,250 | 1,132 |
| 5 | 22-Jan-10 | Hold | 1,200 | 1,115 |
| 6 | 21-May-10 | Buy | 1,440 | 1,118 |

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|---|---|---|---|
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|---|---|---|---|
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