Valueoperations – White Paper

Re – inventing how to invest in the stock market

Valueoperations White Paper

April 2014

Is Oil & Exploration sector worth to invest today?

As market is trading at all-time high, Banking, Mining and Oil & Exploration sectors are the only sectors that are throwing few opportunities to invest with. In this White paper we cover the opportunities available in Oil & Exploration sector.

As a chief investment officer for Value Operations Pty Ltd, one of our priorities is to invest in a high liquid stocks. This brings my work very close by with the NSE 500 index.

There are 24 businesses that our model ranks as 'A1', 11 businesses are ranked as 'B1' and 75 businesses as 'A2' from the NSE 500 index. These are all the investment grade businesses as per Value operations philosophy and mine investment universe to study and conduct my research.

We pretty much invest almost in a range of 60% -75% of our fund with them or my job is to identify around 12-14 businesses from that basket to invest with. The remaining investments are done from all the remaining businesses that are trading on the National Stock Exchange of India.

Stock market is standing at its all-time high and climbing up steadily every week. This is the time similar to what I will compare to early 2006 to mid-2006 from the history. In mid of 2006 many stocks trading at the National Stock Exchange of India were trading at expected 2008 intrinsic values. Going further in that year and during the start of 2007, they were almost trading at expected intrinsic values of 2010 – 2011. Today when I browse stocks and compare to their expected values then I see most of the good businesses are either trading at 2015 or 2016 levels of expected intrinsic values respectively.

Trading at expected 2015 and 2016 levels today is normal for the market. But if the prices breach to our 2017 values and head towards 2018 very soon (if they climb another 12 – 15% from here) then it is the time for us to re-look at the risk –reward for our fund and start selling our holdings that we think is throwing us a very abnormal price today and where we think values will take almost three years to catch them. Also provided the economic conditions remain same as it is today (High inflation, USD $ = Rs 60 and GDP < 6%).

There are none of the 'A1' businesses trading at discount to their expected 2015 intrinsic values. There is only Cairn India, which is the 'B1' grade business trading at discount to its intrinsic values out of NSE 500. Also there are only 10 businesses from 'A2' grade which are still trading at discount to its 2015 intrinsic values.

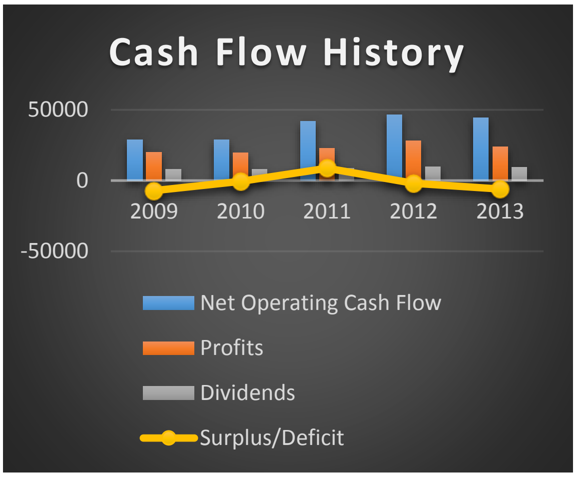
So, overall there are only 11 businesses that are trading at discount from my watchlist. The 90% of my work is being done by those filters for me, the remaining 10% has to be done by looking at the micro level picture and find out the bright prospects for their products.

Mostly, these 11 businesses belongs to either Banking, IT or mining sector. But to my surprise I have found that three businesses belong to Oil & Exploration sector. These are ONGC, Oil India and Cairn India.

ONGC

ONGC is one of the country's biggest Oil & Gas exploration business in partnership with Government of India. This business is debt free business with a very rich cash flow.

Their profitability pretty much depend on the market price of Oil & Gas in the world. They also sell their products at the subsidy price and carry those burdens with them as they are partly owned by the government and they have few social goals to achieve.



ONGC pays almost 40% of its profits as dividends every year. This is very high compare to its peers in the sector and also considering its business and business model. But with the strong cash flow generated from this business, anything is possible for them to do. Even with such a rich cash flow, four out of last five years they either had to borrow or use their own money from the bank accounts to pay dividends, maintenance and for capital expenditure.

Looking at the trend of their intrinsic values, we believe its expected intrinsic value for the year end 2014 will be Rs 274 and for 2015 to be Rs 315 and Rs 362 for the year end 2016.

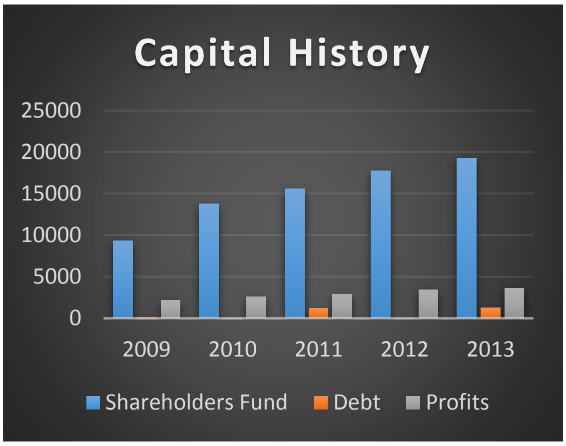
But the estimates of analysts and consensus report suggest that its expected intrinsic value for the year end 2015 will be Rs 340 and 2016 end will be 401. Their expectations have jumped up on the basis that from 1st April 2014 Oil and Gas producing companies can sell Gas at the world market price and not at subsidy prices which are half of the market price today. This will boost ONGC's profits by almost 25%. But this change has not taken place so far and we do not want to get into its politics and talk about it over here.

ONGC is trading in the middle of ours and analyst's expectation for the2015. We still believe that if this stock is not in your portfolio it is still worth to accumulate today.

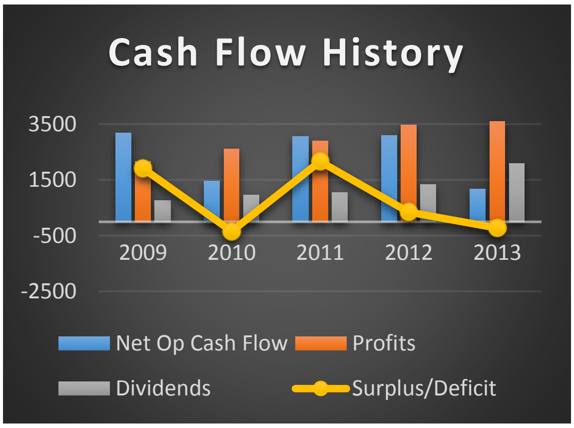
OIL India

Another initiative by the Government of India who are the promoters of this company. Oil India has a history of last 55 years and have investments overseas too through joint ventures, partnerships and sole owners of the assets.

Looking at the Capital history of this business, they are similar to ONGC and are almost debt free and rich with cash.



If we look at the cash flow history, we can see that this business is not as good as ONGC in regards to generate tremendous cash from its operations. But still management has been prudent with those cash flows. They had a shortage of cash only twice in the last five years which was minimum. They are sitting on more than ten thousand crore of surplus cash in their bank accounts.



Finally, looking at the trend of its intrinsic value, we expect their 2014 values to be Rs 542 and for 2015 to be Rs 608.

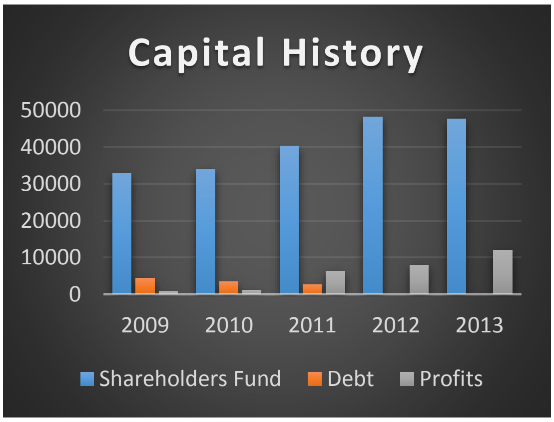
There are 21 reputed analysts who follow this business and as per their consensus earnings forecast, we are looking its 2014 values per share at Rs 456 and for 2015 to be Rs 570.

There is not a big difference between consensus earnings forecast and ours after looking at 2015 values. We anyways advocate investors to buy only if they are getting stocks at discount or always have a margin of safety. The good part is that Oil India is still trading at discount to its expected values in these high markets. Oil India turns as a better option if you are looking for a steep margin of safety today.

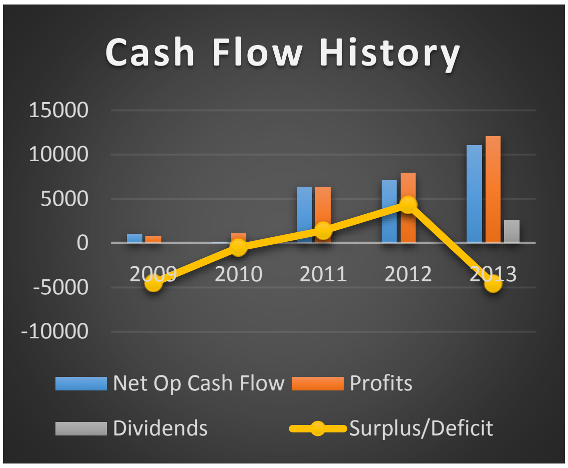
Cairn India

Cairn India is one of a flagship company of Vedanta group. Valueoperations rate this business as 'B1' and this was first time in the last seven years this business has been rated as an investment grade.

Cairn India is a debt free business and its profits are growing very fast. In other words we can say that this business is performing better from the last 3 years. They have future plans to explore as many as 500 wells by 2017 and have budgeted approximately three billion dollars of capital expenditure.



If we look at the Cash Flow History, they are not similar to Oil India or ONGC in regards to generate cash from its operations. They have burnt almost around 5,000 crore in 2013 year. Looking at the 2014 results, it still looks that they have burnt around three thousand crore, which was expected as they have a massive plan to spend in next three years.



Looking at their intrinsic values we are expecting its 2014 values to be Rs 646 and for 2015 to be Rs 530 on 40 analysts' consensus reports.

Cairn India's profits have not been that consistent and looking at analysts forecast too, even they are expecting its 2015 profits to fall by 15% compare to its 2014 profits and also 2016 to fall down from its 2015.

Investing in Cairn India today looks risky as we are expecting its returns on equity to fall down for the next two years and there is a high risk of capital loss for next two years. If we get bad news on their future exploration plans, then market can take its price trend downwards and also its business intrinsic values as we are looking at the forecast.

In saying that, if we get any good news from their future exploration plans it will add business value and take its market price upwards. There is a big gamble to invest with Cairn India today and we avoid those gambles. Unless you are confident about positive results of their future exploration and growth in volumes and profits, which we are not at the moment, we choose to let go this opportunity at the moment and go with other opportunities like Oil India and ONGC.

Investing only in the quality companies won't help to get great returns. It is also important to invest in the business who are growing their profits, maintaining their returns on equity and whose intrinsic values are growing every year.

Due to the abnormal profit behaviour of Cairn India, Valueoperations can only calculate its future intrinsic values on consensus expectations. The trend of ONGC intrinsic values are growing around 15% per year and Oil India by 13% per year.

The last financial year 2013 – 14 was not that good for all the three businesses. But reforms in the gas pricing this year will add good business values in all the three businesses. We do own few shares of ONGC and Oil India in our funds and in this market any dip within the prices of these two will be a good buying opportunity for us.