INDIA RESEARCH

Essar Oil

Rs144
OUTPERFORMER

MANAGEMENT MEETING NOTE

Mkt Cap: Rs175bn; US$3.7bn

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We recently met the management of Essar Oil (EOL) to get an update on the company's business, international operations and E&P prospects going forward. EOL is on track for commissioning of phase I of its refinery expansion (10.5m to 16m tpa) by end-FY11, while the E&P business is also gaining momentum. Production has already commenced from EOL's CBM block in Raniganj, and the first Gas Sales Agreement (GSA) has been signed for supplying 60,000 scmd to a local industrial customer. We believe PSC terms of the CBM asset are extremely favorable for EOL, and therefore upgrade the EV/ boe multiple from this asset in our SOTP valuation. The Nigerian E&P block OPL, which is currently held by a group company, is also in the process of being transferred to EOL – the same awaiting ratification by Nigerian ministry officials. EOL is reportedly close to sealing a deal to acquire three high quality refineries based out of Western Europe from Shell, which should provide access to a distribution and storage network in the second largest market for refined products. The acquisition would also ramp up overall complexity of EOL's refining portfolio (average NCI of 9.1 at the three refineries), and therefore is expected to provide material upside over the long term. Reiterate Outperformer on the stock with a price target of Rs194, 35% upside from here.

Essar Oil - key valuation metrics

Year to 31 March	FY07	FY08	FY09	FY10E	FY11E
Net sales (Rs m)	4,740	5,623	378,867	335,784	430,435
Adj. net profit (Rs m)	(675)	(412)	(4,228)	3,787	8,020
Shares in issue (m)	1,156	1,190	1,218	1,218	1,218
Adj. EPS (Rs)	(0.6)	(0.3)	(3.5)	3.1	6.6
% growth	*nm*	*nm*	*nm*	*nm*	*111.8*
PE (x)	*nm*	*nm*	*nm*	46.2	21.8
Price/Book (x)	5.5	4.6	4.1	3.2	2.8
EV/EBITDA (x)	nm	nm	20.7	15.1	10.5
RoE (%)	*nm*	*nm*	*nm*	7.8	13.7
RoCE (%)	nm	nm	4.3	8.5	10.0

Source: Company data, IDFC-SSKI Research

❑ CBM – gaining momentum

In its latest analyst meet, EOL had updated the street about the high prospectivity of its Raniganj asset, and recent developments serve to reinforce this optimism. The company has completed minimum work commitment (MWP) on the block and has submitted the full development plan to DGH for approval, which it expects to secure shortly. The Raniganj asset is located in Eastern India and covers an area of ~500sq. km, of which EOL is concentrating on 180sq km – being the main fairway for exploration. EOL has drilled 17 core holes on the prospect, which has proved up the following key reservoir parameters: (i) gas content; (ii) coal thickness; and iii) permeability.

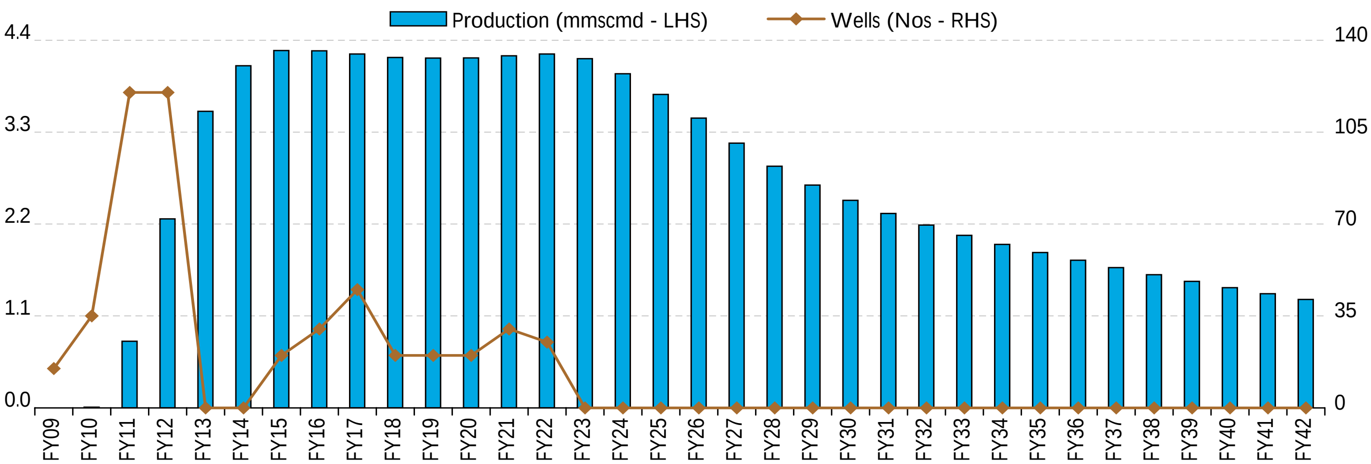
Our interaction with the management suggests that reservoir parameters on this block are comparable to some of the best CBM assets in North America, which is a leading producer of CBM gas (150 mmscmd in CY08). According to the management, the Raniganj asset compares favorably to basins such as San Juan, Black Warrior and Raton. These are some of the largest producing CBM basins in USA, and the similarity in reservoir parameters provides comfort on recoverability of the reserves and production timelines guided to by the management.

❑ Test well results point to production upgrade

Currently, EOL has drilled 15 test wells on the block, which are all producing @2,500 scmd. The CBM wells typically take 18-24 months to reach peak production, and the management expects these wells to reach peak production of 14,000-15,000 scmd by FY12. Better-than-expected performance of the core hole tests and the production test wells has led to an upgrade of peak production estimates to 3.5 mmscmd from 2.5-3 mmscmd earlier. This will be achieved through the drilling of 500+ wells over the next seven years, with 280 wells over FY10-12E and another 220 wells post FY14E. The gap is to allow the first wells to build up to plateau production and then gradually decline, before the next round of wells are drilled to offset decline from the first series.

EOL has recently signed its first GSA with a local industrial customer for 60,000 scmd starting March 2010 – this, we believe, provides comfort on offtake of production from the field. The company sees potential demand of up to 10 mmscmd in the industrial belt between Durgapur and Kolkata, which should provide a ready market for offtake of the volumes from the find.

Essar Raniganj – expected production profile



Source: IDFC SSKI, Company

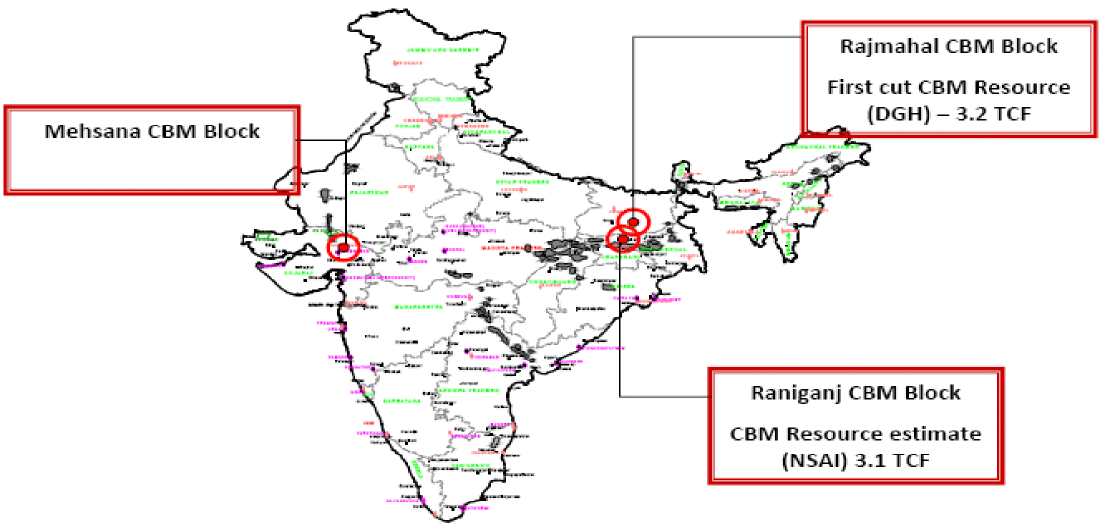
EOL expects to reach peak production of 4 mmscmd after 18-24 months post the first oil, and it expects to maintain plateau production for 14-15 years after which production is estimated to decline gradually till FY42. This is much higher than the earlier guidance of 2.5 mmscmd of peak production, and pegs the total recoverable reserves at more than 1 tcf (as certified by Netherland sewell), up from 700 bcf estimated earlier. Another factor helping the valuation prospects of this prospect are the fiscal terms, which are much more favorable than post NELP CBM blocks. EOL estimates average royalty to be ~10%, while production linked payments will average at ~10% over the life of the asset. The comparable terms for post NELP blocks such as Rajmahal, acquired by EOL in NELP VIII, are significantly higher.

EOL's guidance on capex and opex on the block is also quite favorable with total capex on the project estimated to be around US$500m (US$0.5/mmbtu), and opex at ~US$0.3/mmbtu. This implies significantly higher NPV on the block than earlier estimates.

❑ Other prospects also on the anvil

EOL also has some other prospective assets which are attractive and provide visibility on E&P growth going forward. The company has a proven oilfield (Ratna R series) in Mumbai which has ~161 mmbbl of proved reserves (EOL's share at 81 mmbbl), which is due to be approved for development by the concerned ministry shortly. The other prospects are mostly CBM assets, out of which the Rajmahal prospect has oil & gas initially in place (OGIIP) of 3 tcf, while the company is also evaluating good prospects of CBM resources on the conventional oil & gas block of Mehsana. The original PSC terms as envisaged by the MoPNG does not allow drilling and development of CBM on blocks allotted for conventional oil & gas. However, the government is currently evaluating the proposal to provide simultaneous rights for both.

EOL – CBM assets



Source: IDFC SSKI, Company

Essar Energy Holdings (EEH – the holding company of EOL) also has an attractive portfolio of international E&P assets, which are due to be transferred to EOL's books gradually. The company is quite excited about the OPL block in Nigeria, which is estimated to have reserves of ~70 mmbbls (Essar's share at 63%). EEH has put in motion the mechanism to transfer the asset to EOL books, and ratification by the Nigerian government for approving the necessary changes in the PSC is pending.

We feel that the E&P business is not adequately valued by the street, and are optimistic about the accretion from this segment to EOL. We value the total E&P business at US$2.5bn, which adds Rs97 per share to our total SOTP valuation of Rs194 per share.

EOL – SOTP valuation

	Rs bn	US$ bn	Rs/share	
Refinery EV (34 m tonnes)	426	9.1	349.8	
E & P: current reserves	119	2.5	97.3	
Less: FY11 net debt	(309)	(6.6)	(253.5)	
SOTP	**236**	**5.0**	**194**	
Fully diluted no. of shares			**1,218.1**	
E & P	Rs bn	US$ bn	Rs/share	Comments
Ratna R-series (73m bbl PI)	38	0.8	31.3	@ US$10/bbl valuation of oil
CBMs (~1.0tcf recoverable)	63	1.3	51.7	1 tcf recoverable @US$4.5/boe, 2 tcf additional resources @US$1.5/boe
OPL (67m bbl / 63% stake)	10	0.2	8.1	@ US$5/bbl valuation of oil, implying risk factor of 50% on global multiples of US$10/bbl on similar assets
Rajmahal	8	0.2	6.2	3 tcf of resources risked at 10% on base of US$3/boe
Total	**119**	**2.5**	**97.3**	

Source: IDFC SSKI, Company

❑ The Shell refinery acquisition – to transform scale

Recently, there has been a lot of buzz around the imminent acquisition by EOL of three of Shell's refineries in Western Europe with a combined capacity of ~26m tpa and presence in two countries, UK and Germany. EOL has indicated that the contours of the deal have almost been finalized, and it expects to close the deal over the next two months. The three refineries on the radar are the Heide and Harburg refineries in Germany and the Stanlow refinery in UK. Combined processing capacity of the refineries stands at 26m tpa, or 500 kb/d, with additional terminal and storage facilities as well as capacities booked on transportation pipelines owned by the assets also being part of the deal. The deal is reportedly valued at an estimated US$1bn, which will translate into EV/complexity barrel of US$200-220 – about one-third of what it will take to set up a greenfield refinery of similar complexity (average complexity of the three refineries is 9.1, which implies a manufacturing EV/ complexity barrel of US$900-1000).

We feel that the acquisition, if it goes through, provides four key benefits to EOL:

- Access to a well-established distribution and storage network in a key target market.
- World class assets at relatively cheap prices.
- Limited cash payout, as part of the deal may be financed by equity dilution of 10% in EOL to Shell (as per news reports)
- Acquisition of these refineries, at a time when marginal and inefficient refineries in Western Europe with a combined capacity of ~2.5 mb/d are under threat of closure, provides access to a market that may see tight supply over the medium term.

❑ Our view – near-term weakness obscuring long-term drivers

EOL remains on track to complete phase I of refinery expansion (10.5 to 16m tpa) by December 2010, and the financial closure of phase II is expected by end of FY10. While refiners across Asia are currently facing the heat with benchmark GRMs at historical lows, we feel margins have bottomed out. The recovery in FY11E, we believe, will be aided by (i) a global economic revival, and (ii) the imminent closure of standalone, inefficient refiners in Western Europe and North America. The timing of EOL's expansion would coincide with the expected economic revival, implying significant value addition over the long term. The company is also ramping up its focus on the E&P segment, and the CBM asset in Raniganj is expected to add materially to financial metrics over the medium term. The impending acquisition of Shell's refineries in Europe is a well-timed move, provided the valuation is right and there are no hiccups in integrating the assets into EOL's books. We maintain our Outperformer rating on the stock with a price target of Rs194 per share, 35% upside from the current levels.

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2. Neutral: Within 0-10% to Index
3. Underperformer: Less than 10% to Index

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