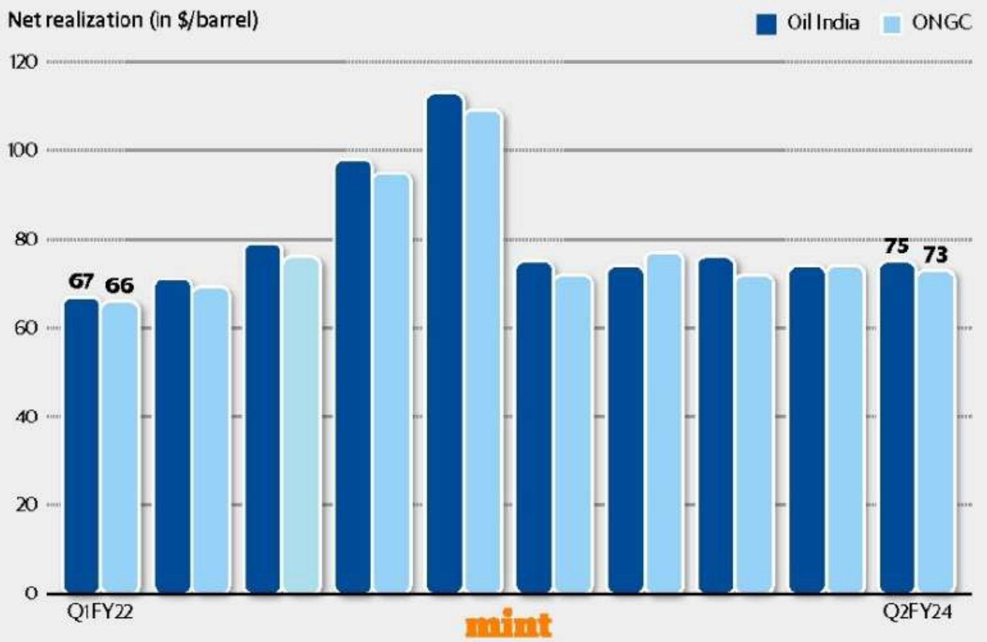
ONGC, Oil India set to grow despite crude fall

Manvi Agarwal
feedback@livemint.com

Limited traction

The realizations of upstream oil companies Oil India and ONGC have been range bound lately



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Source: Company, CLSA

PRANAY BHARDWAJ/MINT

Shares of Oil & Natural Gas Corp Ltd (ONGC) and Oil India Ltd have risen sharply, significantly outperforming the benchmark Nifty50 index with gains of 38% and 73%, respectively, so far this calendar year. These gains were fuelled by a rise in global crude oil prices, which buoyed the profitability and operating margins of these state-owned energy companies.

However, the landscape shifted when crude oil prices declined from around $100/barrel in September to approximately $80/barrel amid a market reversal despite tight supplies and escalating tensions in the Middle East.

This abrupt decline followed a shift in market concerns from supply risks to global economic uncertainties and oil demand. Despite OPEC's decision to extend supply cuts beyond December 2023, oil prices haven't responded significantly. The limited impact is attributed to the realization that the supply cut isn't enough to offset non-OPEC output growth. Moreover, lingering worries about a weakening global economy persist.

This drop in crude prices typically signals reduced net realizations for upstream producers, but the government's windfall tax has kept the outlook optimistic.

This tax was introduced in 2022. When crude prices increase, the windfall taxes also rise, and conversely, they decrease when crude prices decline.

This tax, adjusted biweekly, stabilizes net oil realizations for companies like ONGC and Oil India, ensuring consistent earnings.

JM Financial Securities Ltd said that the windfall tax adjustments by the government imply a comfortable net crude realization of about $75/barrel for Oil India and ONGC.

"Brent crude price of $75-80/barrel is a sweet spot for ONGC/Oil India, as it improves visibility for net crude realization of $75/barrel by eliminating the risk of ad-hoc fuel subsidy burden," JM Financial said in report dated 18 December.

In Q2FY24, Oil India reported a marginal 2% sequential uptick in net realizations to $75 and a 5.7% year-on-year rise in crude oil production, while ONGC saw a slight decrease in net realizations to $73, alongside a 1.6% drop in output.

OIL'S WELL

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DESPITE FALL IN CRUDE PRICE, Centre's windfall tax has kept the outlook optimistic

ASIDE from government policies, factors like production volume increases are key

Brent prices below $75/barrel could adversely affect earnings of these companies.

Going by the estimates of Emkay Global Financial Services, for every $5/barrel decline in oil prices, ONGC/Oil India's FY25 standalone earnings per share would fall 10% and 9%, respectively.

Aside from government policies, factors like production volume increases are key. ONGC is resuming operations in Mozambique and starting production in the Eastern offshore block KG-98/2.

These new assets, expected to contribute 12% to 20% of ONGC's current domestic oil and gas output, serve as potential catalysts for a favourable reassessment of the stock.

Both companies also have ambitious capital expenditure plans, with ONGC allocating over ₹20,000 crore across FY24 and FY25, and Oil India planning to spend over ₹14,000 crore in FY24.

Despite their strong dividend history, ONGC and Oil India have experienced substantial impairments in the past, especially during the commodity boom.

With the current lower oil prices and global growth concerns, investors should be cautious of potential impairments.

Ultimately, the trajectory of these stocks depends heavily on crude oil price movements.