

Inpex (1605)

Buy: Lifting estimate for gains from Ichthys rights sales to in line with company plan

- Conclusion** — We revise our forecasts, so our DCF-based target price falls to ¥600,000 from ¥630,000. However we retain our Buy rating. We raise our estimate for gains on sales of Ichthys rights in FY3/13 to ¥50bn from ¥35bn, but we lower our free cash flow estimate as exploration and development costs should rise with Inpex aiming to increase production volume in the longer term. Potential catalysts for the share price include 1) posting gains on the sale of Ichthys rights (6%) to Total in H2, 2) progress for Abadi (including rights sales), and 3) the start of commercial production at the Kashagan project (mid-2013).
- NP** — We trim our NP forecast to ¥190bn from ¥195bn for FY3/13 and to ¥129bn from ¥138bn for FY3/14. Our FY3/15 forecast remains ¥130bn. For FY3/13 we lift our estimate for gains (after taxes) on the sale of Ichthys rights by ¥15bn but revise down overall as we anticipate lower one-off profits at projects in Ecuador and the Democratic Republic of Congo (-¥9bn) and lower production at Mahakam (Indonesia; -¥3bn). For FY3/14, we lower our forecast for gains on sales of Ichthys rights by ¥11bn.
- Production volume to rise** — Inpex spent ¥81.5bn to acquire rights in April-June and another ¥76.1bn for the same purpose in July-September. We think the ¥85.1bn was spent on the Prelude FLNG project in Australia (please see our March 16 memo [Inpex \(1605\) - Acquires interest in Prelude project from Shell](#)), with the ¥76.1bn spent on shale gas rights in Canada. In addition to these longer-term projects, the firm has acquired rights in projects that will help boost production volume quickly like Block 14 (an ongoing project in Angola) and the Lucius oil field in the Gulf of Mexico (US, production scheduled to begin in the latter half of 2014). Inpex remains highly dependent on Ichthys, but we see the firm's aim to boost production volume prior to Ichthys coming onstream as positive. We intend to keep a close eye on the profitability of these investments.
- Future cash flow assumptions** — Given progress in selling rights in Ichthys as well as the fact that production will begin soon at Kashagan, we now factor in 75% of future Ichthys cash flows into our forecasts (previously 70%) and 80% for Kashagan (previously 75%). We still do not factor in any cash flow from Abadi.

- Company Update
- Target Price Change
- Estimate Change

Buy	1
Price (19 Nov 12)	¥454,000
Target price	¥600,000
	from ¥630,000
Expected share price return	32.2%
Expected dividend yield	1.5%
Expected total return	33.7%
Market Cap	¥1,657,506M
	US\$20,357M

Price Performance (RIC: 1605.T, BB: 1605.JP)



Consol.	Sales		OP		RP		NP		EPS	PE
	¥M	YOY (%)	¥M	YOY (%)	OPM(%)	¥M	YOY (%)	¥M	YOY (%)	X
3/11A	943,080	12.2	529,743	14.7	56.2	508,588	15.1	128,702	20.0	35,252
3/12A	1,186,731	25.8	709,358	33.9	59.8	767,040	50.8	194,003	50.7	53,138
3/13CE	1,089,000	-8.2	587,000	-17.2	53.9	607,000	-20.9	168,000	-13.4	46,016
3/13CRE	1,099,000	-7.4	599,000	-15.6	54.5	640,000	-16.6	182,000	-6.2	49,851
3/13E	1,088,000	-8.3	590,000	-16.8	54.2	659,000	-14.1	195,000	0.5	53,412
3/13RE	1,077,000	-9.2	571,000	-19.5	53.0	644,000	-16.0	190,000	-2.1	52,042
3/14E	1,057,000	-2.8	554,000	-6.1	52.4	573,000	-13.1	138,000	-29.2	37,799
3/14RE	1,052,000	-2.3	548,000	-4.0	52.1	565,000	-12.3	129,000	-32.1	35,334
3/15E	1,054,000	-0.3	538,000	-2.9	51.0	558,000	-2.6	130,000	-5.8	35,608
3/15RE	1,078,000	2.5	549,000	0.2	50.9	566,000	0.2	130,000	0.8	35,608
3/16E	1,101,000	4.5	573,000	6.5	52.0	593,000	6.3	129,000	-0.8	35,334
3/16RE	1,114,000	3.3	577,000	5.1	51.8	598,000	5.7	129,000	-0.8	35,334
3/17E	966,000	-12.3	455,000	-20.6	47.1	479,000	-19.2	98,000	-24.0	26,843
3/17RE	968,000	-13.1	452,000	-21.7	46.7	477,000	-20.2	96,000	-25.6	26,295

A: Actuals, E: Citi Research Ests, CE: Co. Ests, RE: Citi Research Revised Ests, CRE: Co. Revised Ests, NA: Not Available, NM: Not Meaningful

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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1605.T: Fiscal year end 31-Mar						Price: ¥454,000; TP: ¥600,000; Market Cap: ¥1,657,506m; Recomm: Buy					
Profit & Loss (¥m)	2011	2012	2013E	2014E	2015E	Valuation ratios	2011	2012	2013E	2014E	2015E
Sales revenue	943,080	1,186,731	1,077,000	1,052,000	1,078,000	PE (x)	12.9	8.5	8.7	12.8	12.8
Cost of sales	-334,833	-395,442	-406,000	-409,000	-439,000	PB (x)	0.8	0.8	0.7	0.7	0.7
Gross profit	608,247	791,289	671,000	643,000	639,000	EV/EBITDA (x)	0.7	0.0	0.1	0.8	1.5
Gross Margin (%)	64.5	66.7	62.3	61.1	59.3	FCF yield (%)	2.1	4.6	-21.4	-34.3	-26.7
EBITDA (Adj)	641,564	817,687	687,000	689,000	707,000	Dividend yield (%)	1.3	1.5	1.5	1.5	1.5
EBITDA Margin (Adj) (%)	68.0	68.9	63.8	65.5	65.6	Payout ratio (%)	17	13	13	20	20
Depreciation	-111,821	-108,329	-116,000	-141,000	-158,000	ROE (%)	7.6	9.3	8.4	5.4	5.2
Amortisation	0	0	0	0	0	Cashflow (¥m)					
EBIT (Adj)	529,743	709,358	571,000	548,000	549,000	EBITDA	641,564	817,687	687,000	689,000	707,000
EBIT Margin (Adj) (%)	56.2	59.8	53.0	52.1	50.9	Working capital	-4,320	-17,061	9,000	2,000	-1,000
Net interest	8,758	10,165	10,000	5,000	3,000	Other	-361,102	-477,882	-373,000	-413,000	-414,000
Non-op/Except	-29,913	47,517	63,000	12,000	14,000	Operating cashflow	276,142	322,744	323,000	278,000	292,000
Recurring profit	508,588	767,040	644,000	565,000	566,000	Capex	-240,700	-247,100	-677,000	-846,000	-734,000
Tax	-368,696	-536,933	-446,000	-430,000	-431,000	Net acq/disposals	0	0	0	0	0
Extraord./Min.Int./Pref.div.	-11,190	-36,104	-8,000	-6,000	-5,000	Other	-603,811	-33,764	267,000	316,000	158,000
Reported net profit	128,702	194,003	190,000	129,000	130,000	Investing cashflow	-844,511	-280,864	-410,000	-530,000	-576,000
Net Margin (%)	13.6	16.3	17.6	12.3	12.1	Dividends paid	-18,010	-21,922	-26,000	-26,000	-26,000
Core NPAT	128,702	194,003	190,000	129,000	130,000	Financing cashflow	548,057	29,294	-22,000	-23,000	53,000
Per share data						Net change in cash	-32,327	68,511	-109,000	-275,000	-231,000
Reported EPS (¥)	35,252	53,138	52,042	35,334	35,608	Free cashflow to s/holders	35,442	75,644	-354,000	-568,000	-442,000
Core EPS (¥)	35,252	53,138	52,042	35,334	35,608						
EPS* (¥)	35,252	53,138	52,042	35,334	35,608						
DPS (¥)	6,000	7,000	7,000	7,000	7,000						
CFPS (¥)	75,637	88,401	88,471	76,146	79,980						
FCFPS (¥)	9,708	20,719	-96,963	-155,578	-121,066						
BVPS (¥)	546,959	596,909	641,761	669,973	698,459						
Wtd avg ord shares (m)	3.7	3.7	3.7	3.7	3.7						
Wtd avg diluted shares (m)	3.7	3.7	3.7	3.7	3.7						
Growth rates											
Sales revenue (%)	12.2	25.8	-9.2	-2.3	2.5						
EBIT (Adj) (%)	14.7	33.9	-19.5	-4.0	0.2						
Core NPAT (%)	20.0	50.7	-2.1	-32.1	0.8						
Core EPS (%)	-22.6	50.7	-2.1	-32.1	0.8						
Balance Sheet (¥m)											
Cash & cash equiv.	319,560	675,285	581,000	323,000	109,000						
Accounts receivables	95,391	119,459	94,000	92,000	94,000						
Inventory	12,137	11,977	19,000	19,000	20,000						
Net fixed & other tangibles	628,973	617,016	1,146,000	1,843,000	2,390,000						
Goodwill & intangibles	0	0	0	0	0						
Financial & other assets	1,624,318	1,642,660	1,393,000	1,068,000	922,000						
Total assets	2,680,379	3,066,397	3,233,000	3,345,000	3,535,000						
Accounts payable	23,441	30,228	21,000	21,000	23,000						
Short-term debt	4,441	4,801	9,000	12,000	38,000						
Long-term debt	268,706	313,972	314,000	314,000	367,000						
Provisions & other liab	286,408	403,203	403,000	403,000	403,000						
Total liabilities	582,996	752,204	747,000	750,000	831,000						
Shareholders' equity	1,996,889	2,179,251	2,343,000	2,446,000	2,550,000						
Minority interests	100,493	134,941	143,000	149,000	154,000						
Total equity	2,097,382	2,314,192	2,486,000	2,595,000	2,704,000						
Net debt	-46,413	-356,512	-258,000	3,000	296,000						
Net debt to equity (%)	-2.2	-15.4	-10.4	0.1	10.9						

Note: Consolidated data. * EPS: NP/Est Shares OS.

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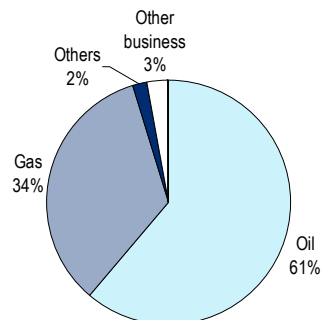
Inpex (1605) Investment Dashboard

Reasons to Buy

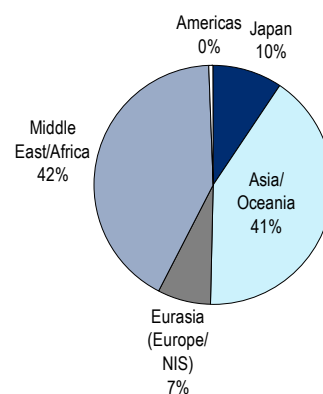
- With the FID for the major Ichthys project complete, we see the following possible catalysts: 1) the posting of gains from Ichthys rights sales and 2) a reacknowledging of Ichthys earnings forecasts
- The Kashagan (Kazakhstan) oil field is expected to begin commercial production in mid-2013

Sales breakdown (FY3/12)

By product

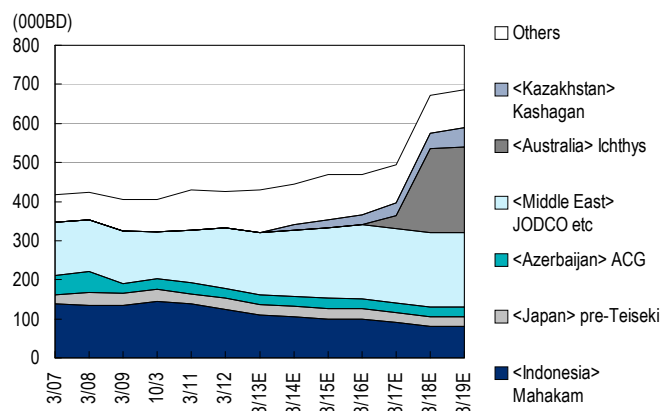


By region



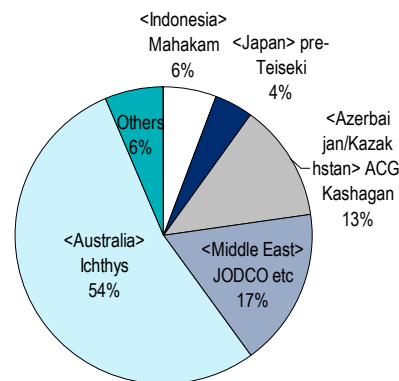
Source: Company data.

Interest in production (boed)



Source: Citi Research.

Confirmed and estimated reserves (end-FY3/12, mn bbl)

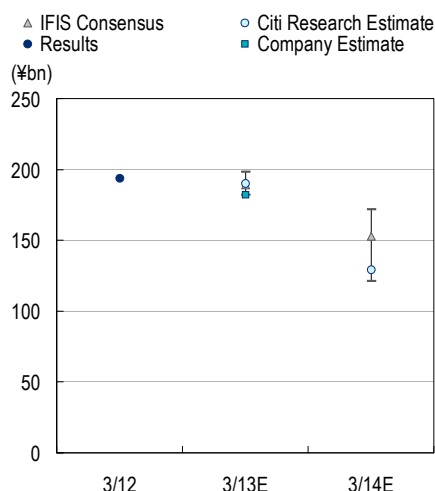


Source: Company data, Citi Research.

Alternate scenario: A more bullish case

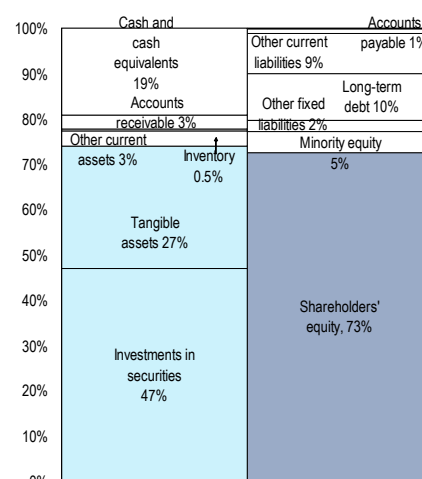
- The Ichthys and Abadi projects could progress faster than expected, resulting in the shares factoring in 100% of future cash flow
- Such a scenario could result in a theoretical share price of ¥680,000 (factoring in 100% of future cash flow from the Ichthys and Abadi projects to our forecasts and applying our DCF model)

NP forecast comparison



Source: Company data, IFIS (November 19), Citi Research.

Balance sheet (end-FY9/12)



Source: Company data.

Figure 1. Ichthys earnings model (¥bn): Assumptions are \$85/bbl for Brent crude and ¥80/\$—high profit contribution during first half of development

	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034
Revenue	239.6	486.9	494.6	488.5	482.3	476.2	470.1	463.9	457.8	451.7	445.5	439.4	433.2	427.1	421.0	421.0	421.0	421.0
# LNG	132.1	264.3	264.3	264.3	264.3	264.3	264.3	264.3	264.3	264.3	264.3	264.3	264.3	264.3	264.3	264.3	264.3	264.3
# Condensate	69.0	145.7	153.4	147.2	141.1	135.0	128.8	122.7	116.6	110.4	104.3	98.2	92.0	85.9	79.8	79.8	79.8	79.8
# LPG	38.5	76.9	76.9	76.9	76.9	76.9	76.9	76.9	76.9	76.9	76.9	76.9	76.9	76.9	76.9	76.9	76.9	76.9
Production cost	-50.5	-102.5	-104.0	-102.8	-101.6	-100.5	-99.3	-98.1	-97.0	-95.8	-94.7	-93.5	-92.3	-101.1	-101.1	-101.1	-101.1	-101.1
Interest	-15.4	-13.9	-12.4	-10.8	-9.3	-7.7	-6.2	-4.6	-3.1	-1.5								
Depreciation	-30.3	-61.4	-62.2	-61.5	-60.9	-60.2	-59.5	-58.8	-58.1	-57.4	-56.7	-56.0	-55.3	-54.6	-53.9	-53.9	-53.9	-53.9
PRRT	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-12.4	-138.4	-134.4	-132.4	-130.4	-124.5	-122.0	-122.0	-122.0	-122.0
Corporate Tax	-4.6	-25.3	-44.0	-56.2	-65.9	-73.5	-79.4	-84.0	-83.9	-48.7	-51.9	-53.4	-54.5	-53.4	-53.6	-54.6	-58.0	-58.2
Net profit (for 62% stake)	132.2	270.7	258.8	243.9	231.5	221.2	212.5	205.2	190.2	96.6	94.7	90.9	87.6	80.4	77.2	76.2	72.8	72.6
Net profit (for 100% stake)	213.9	438.0	418.8	394.7	374.6	357.9	343.9	332.0	307.8	156.4	153.3	147.1	141.7	130.1	125.0	123.3	117.8	117.5
EPS [000yen]	36.2	74.1	70.8	66.8	63.4	60.5	58.2	56.2	52.1	26.5	25.9	24.9	24.0	22.0	21.1	20.9	19.9	19.9
Tax rate	3%	9%	15%	19%	22%	25%	27%	29%	34%	66%	66%	67%	68%	69%	69%	70%	71%	71%

Note: 2017 refers to FY3/18. PRRT refers to the Petroleum Resource Rent Tax in Australia. Tax benefits on the unrecovered initial investment are high. In other words, cash recovery tends to be high during the initial stages of a project and fall off later. Depreciation is based on the production output method for production volume over 30 years. Source: Company data, Citi Research.

Figure 2. Valuations: Applying a PER of 13x (historical average) to EPS discounted using an annual rate of 10% generates a theoretical share price of ¥650,000 based on our FY3/19 forecasts

Valuation	FY3/12	FY3/13E	FY3/14E	FY3/15E	FY3/16E	FY3/17E	FY3/18E	FY3/19E	FY3/20E	FY3/21E
Dividend Yield (%)	1.3%	1.5%	1.5%	1.5%	1.5%	1.5%	1.8%	2.2%	2.2%	2.2%
PER(x) (Past 3yr Avg. 14.8x)	10.5	8.8	12.9	12.8	12.9	17.3	7.6	4.7	4.8	5.0
PBR(x) (Past 3yr Avg. 1.27x)	0.94	0.71	0.68	0.65	0.63	0.61	0.57	0.51	0.47	0.43
EV/DACF(x) (Past 3yr Avg. 6.5x)	2.6	2.6	3.8	4.6	5.2	5.6	2.5	1.2	0.8	0.2
Assumptions										
Forex [¥/\$]	79.1	80.0	80.0	80.0	80.0	80.0	80.0	80.0	80.0	80.0
Brent [\$ /bbl]	114.2	107.1	100.0	95.0	98.0	85.0	85.0	85.0	85.0	85.0
Theoretical share price via multiple methods										
EPS x15	797,000	677,000	459,000	463,000	459,000	342,000	783,000	1,268,000	1,232,000	1,182,000
10% discount		615,000	379,000	348,000	314,000	212,000	442,000	651,000	575,000	501,000
8% discount		627,000	394,000	368,000	337,000	233,000	493,000	740,000	666,000	591,000
EV/DACF x5	788,000	684,000	555,000	493,000	436,000	410,000	863,000	1,370,000	1,385,000	1,426,000

Note: Valuations based on November 19 closing prices. Source: Company data, Citi Research.

Figure 3. NAV analysis: Weighting for future project falls at a discount rate of 10%

NAV	¥/share
<Indonesia & Japan> INPEX(parent)	65,000
<Azerbaijan> ACG oil field	31,000
<UAE> JODCO	21,000
<Indonesia> Natuna	38,000
<Timor Sea> Sahul (LNG)	22,000
<Australia> Alpha Oil	41,000
<Kazakhstan> Kashagan oil field	61,000
<Australia> Ichthys (LNG)	12,000
<Indonesia> Abadi/Masela	-2,000
Net Cash / Debt	310,000
Others	21,000
Total	620,000

Source: Citi Research.

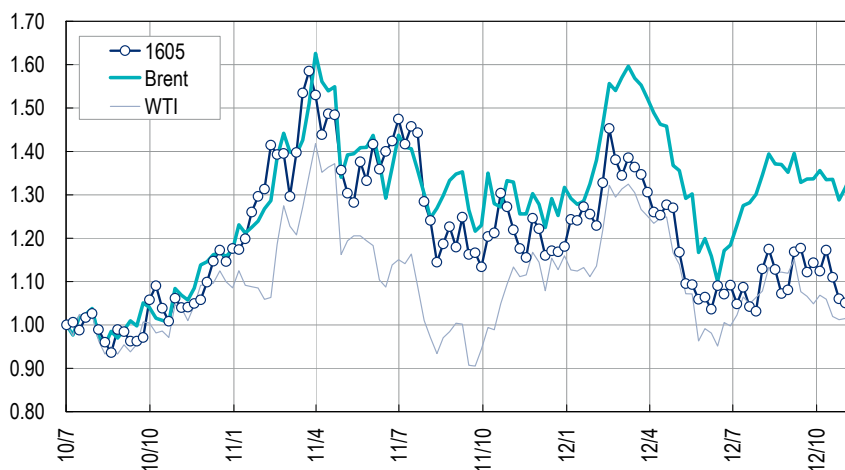
Since the announcement of a capital increase in July 2010, Inpex's share price has correlated strongly with the (yen-converted) price of Brent crude. However, given progress for the Ichthys and Abadi projects, we think the shares are set to outperform the crude price. Recently the correlation with the WTI price, which had little relationship to profits, has been high, while the shares have lagged the Brent crude price

Figure 4. Theoretical share price based on our DCF model: Main scenario is ¥600,000

DCF model	Main Scenario	Case 1	Case 2
WACC	10.00%	10.00%	10.00%
Expected Ichthys project FCF factored in	75%	0%	100%
Expected Abadi project FCF factored in	0%	0%	100%
Expected Kashagan project FCF factored in	80%	0%	100%
Total net present value for 15 year's FCF (¥mn)	1,058,000	380,000	1,337,000
Net Cash (¥mn)	1,130,000	1,130,000	1,130,000
Shareholder value (¥mn)	2,188,000	1,510,000	2,467,000
Theoretical Stock Price (¥)	600,000	410,000	680,000

Source: Citi Research.

Figure 5. Inpex share price and crude price (in yen, July 2010 = 1): Lagging behind Brent crude price



Source: Bloomberg, Citi Research.

Inpex

Investment strategy

We rate the shares of Inpex Holdings Buy (1), with a ¥600,000 target price.

We believe the current share price does not factor in the value of projects from which an earnings contribution can be expected over the medium term, such as the Kashagan oil field and the Ichthys project. Progress is being made with the development of Kashagan ahead of a 2013 production start, and with Ichthys, which we consider the most important project, the FID was finalized in January and prospects are in sight for the sale of all LNG production. Sales of stakes, including one to Total, are going smoothly.

We do not hold out much hope of a big increase in production volume before the later part of the current decade, when we expect Ichthys production to ramp up, in part because of waning production at existing projects. However, with PBR and reserve-based valuations low, we believe undervaluation looks clearer as proven reserves have jumped now that the Ichthys FID has been made. Going forward, we think the share price could easily rise as the value of Ichthys interests is reflected. We therefore rate the shares Buy.

Valuation

We derive our target price of ¥600,000 from a DCF model and earnings forecasts for each project over the 15 years through FY3/27. We use DCF as our main valuation approach as it is difficult to gauge EV on near-term earnings power alone, because in the upstream oil and gas operations, companies make large investments with an eye to long-term returns. For Ichthys (Australia) in particular, we expect investment returns to come in FY3/18 and out, but as we expect Inpex to invest ¥4trn over the coming seven years in Ichthys and other projects, we cannot determine the value of the company on single-year metrics such as EPS and EV/DACF.

We factor in the cash flow of projects we expect to contribute to future earnings into our DCF model as follows: 80% for Kashagan, where production is slated to start in 2013, 75% for Ichthys, and 0% for Abadi. If we were to factor in all of the cash flow we anticipate for the three projects, we would derive a theoretical share price of ¥680,000.

In our DCF model, based on 15 years of earnings forecasts, we assume a terminal growth rate of 0% and set WACC at 7%. Our long-term earnings forecast assumptions are for crude at \$85/bbl and the dollar/yen rate at ¥80/\$. We think a forecast range of 15 years is appropriate, as for the coming seven years we only anticipate cash outflows on the Ichthys investment, while at around year 10 we anticipate only abundant cash inflows, on the tax benefits around the start of Ichthys production. We derive a WACC of 6.65% from a risk-free rate of 3%, and equity-risk premium of 5%, and the three-year weekly adjusted beta of 0.93 from Bloomberg. We conservatively set our WACC at 10%, in part because resource prices are highly volatile.

Our target price equates to an end-FY3/13E PBR of 0.93x and end-FY3/14E PBR of 0.90x, in line with the average over the last three years of 1.01x. EV/DACF (EV/EBIDAX [earnings before interest, depreciation, amortization, and exploration expenses]) is commonly used to value overseas upstream oil companies, as it strips out differences in resource-related regulatory systems in various countries as well

as different stages of progress at various oil development projects (in terms of levels of exploration expenses, etc.). Our target price equates to EV/DACF of 4.1x based on our FY3/13 forecasts and 5.5x based on our FY3/14 forecasts, which looks reasonable given the global average range of 4x-6x. Also, the multiple based on our forecasts for FY3/19, when full production is anticipated at the Ichthys project, is 1.8x, and therefore we think our target price is achievable.

Risks

Risks that could cause the share price to remain short of our target price include 1) an unanticipated exhaustion of the company's major oil and gas fields, 2) country risk (political turmoil and heavy increases in tax burdens in oil producing countries), and 3) a plunge in the price of crude oil. Conversely, the shares could exceed our target price on 1) a substantial increase in the crude oil price and 2) the discovery of substantial additional large oil and gas reserves and large upward revisions to proven reserves. Our global oil team's North Sea Brent price estimates are \$110/bbl for 2012 and \$99/bbl for 2013. A \$1/bbl change in the crude price causes a ¥1.8bn swing in NP, while a ¥1/\$ change causes a ¥2.2bn swing.

Appendix A-1 Analyst Certification

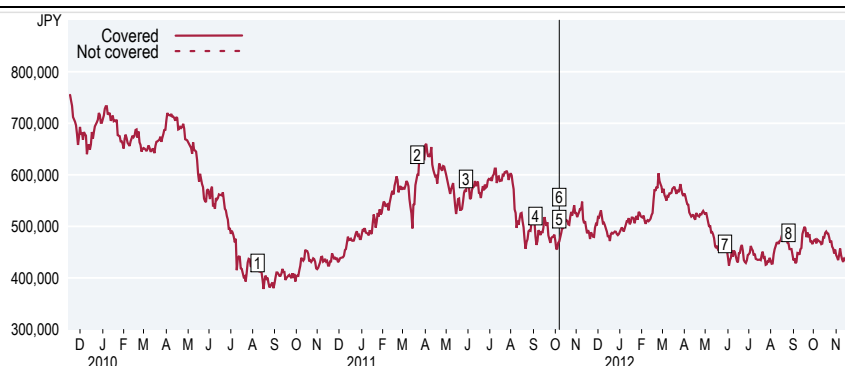
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Analyst: Takashi Miyazaki



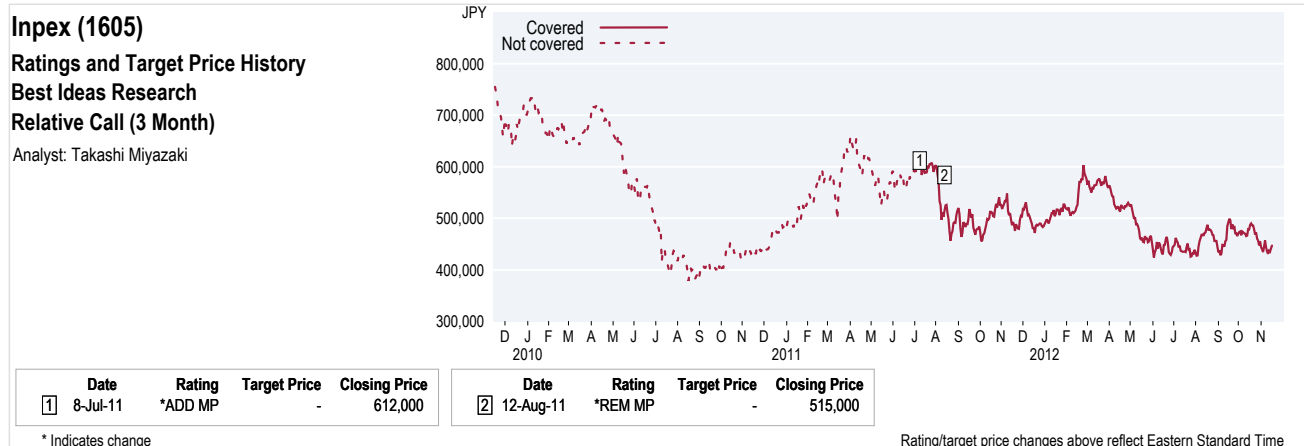
	Date	Rating	Target Price	Closing Price
1	9-Aug-10	2H	*500,000	423,500
2	22-Mar-11	*1H	*720,000	600,000
3	30-May-11	1H	*770,000	567,000

	Date	Rating	Target Price	Closing Price
4	5-Sep-11	1H	*750,000	480,500
5	7-Oct-11	Stock rating system changed		
6	7-Oct-11	*1	750,000	470,500

	Date	Rating	Target Price	Closing Price
7	29-May-12	1	*650,000	464,000
8	27-Aug-12	1	*630,000	467,000

* Indicates change

Rating/target price changes above reflect Eastern Standard Time



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Data current as of 5 Oct 2012

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% of companies in each rating category that are investment banking clients

12 Month Rating			Relative Rating		
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50%	47%	45%	59%	47%	50%

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