Company Flash

24 October 2007 | 6 pages

Gujarat Gas (GGAS.BO)

Buy: 3QCY07 Results In-Line With Expectations

- **Results in-line** — Gujarat Gas reported consolidated net income of Rs341m in 3QCY07, in-line with our estimates. Operating margins remained robust at 21% (though down sequentially), driven by a combination of improved sales mix and a strong rupee.
- **Subdued volumes, as expected** — Gas distribution volumes were relatively flat qoq at 2.8mmscmd (259mmscm), though sharply down from the 1Q levels (3.8mmscmd). This is primarily due to discontinuation of GSPC volumes of c.0.5mmscmd from Jun-07. With additional PMT volumes having commenced in Sep-07 (to gradually ramp up to 1.65mmscmd by Dec-07E), we expect distribution volumes to recover in 4Q07 and stabilize by 1Q08.
- **Retail volumes remain strong** — Retail volumes during the quarter were 2.6mmscmd, up 22% yoy and constituting over 90% of total distribution volumes. Sales in the CNG segment were also healthy, up 57% yoy. The healthy sales mix and sustained strength in the rupee reflected in robust operating margins of 21% (Rs2.9/scm), albeit down from 2Q levels primarily due to higher spot purchases in the quarter to compensate for loss in volumes from other supply sources.
- **Reiterate Buy/Low Risk** — We reiterate our positive view and Buy/Low Risk rating on the stock. Sustained robust growth in PNG and CNG segments and an improving sales mix should offset declining transmission revenues, making Ggas a key play in our preferred city gas distributor's sub-sector.

Buy/Low Risk	**1L**
Price (24 Oct 07)	Rs310.55
Target price	Rs350.00
Expected share price return	12.7%
Expected dividend yield	1.0%
Expected total return	**13.7%**
Market Cap	Rs19,914M US$503M

Price Performance (RIC: GGAS.BO, BB: GGAS IN)

Statistical Abstract

Year to 31 Dec	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2005A	897	13.99	16.6	22.2	5.3	26.7	0.6
2006A	875	13.65	-2.4	22.8	4.5	21.3	0.8
2007E	1,307	20.39	49.4	15.2	3.6	26.3	1.0
2008E	1,608	25.08	23.0	12.4	2.9	26.0	1.0
2009E	1,836	28.63	14.2	10.8	2.4	23.9	1.0

Source: Powered by dataCentral

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See Appendix A-1 for Analyst Certification and important disclosures.

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Figure 1. Gujarat Gas – 3QCY07 Results (Rupees in Millions)

Year to 31-Mar	3QCY06	2QCY07	3QCY07	% yoy
Net Sales	**2345**	**2,835**	**2766**	**18.0%**
Raw Material	1793	1,861	1913	6.7%
Staff Cost	73	82	84	15.6%
Other expenditure	144	209	198	37.6%
EBITDA	**335**	**682**	**571**	**70.7%**
Margin (%)	*14.3%*	*24.1%*	*20.7%*	
Interest	(5)	(0)	0	-95.4%
Depreciation	(81)	(95)	(98)	20.8%
Other Income	42	47	40	-4.4%
PBT	291	635	513	76.5%
Tax	(76)	-212	(171)	144.8%
Tax rate (%)	*24.0%*	*29.8%*	*33.2%*	
PAT	214	422	343	59.8%
Minority Interest	(0.8)	(2.6)	(1.4)	
Attributable PAT	**214**	**420**	**341**	**59.7%**

Source: Company Reports and Citi Investment Research

Gujarat Gas

Company description

Gujarat Gas, a 65% subsidiary of British Gas, has a unique natural gas distribution and transportation franchise in the industrial zone of the western Indian state of Gujarat. The company's key asset is the Hazira Ankleshwar Pipeline (HAPi), which connects the landfall point of Natural Gas from the Western Offshore fields to the industrial townships of Ankleshwar and Bharuch. The company buys gas from different sources - GSPCL, PMT, Niko, GAIL, and Cairn - and sells it to a mix of industrial, domestic and commercial, and CNG consumers in and around the cities of Ankleshwar, Surat, and Bharuch, earning a distribution margin.

Investment strategy

We rate Ggas as Buy/Low Risk (1L), with a target price of Rs350. Taking advantage of increased gas availability in Gujarat, Ggas has successfully transitioned to a robust and sustainable business model over the past three years. Ggas is now a distributor, bulk trader, and transporter of gas, from being a niche distributor of piped natural gas earlier. Although Ggas' distribution margins have fallen in the process, it has de-linked its dependence on subsidized GAIL gas and has gained valuable experience in procurement and placement of larger volumes of gas, which will be critical in the changing gas market in India. Ggas generates strong cash flows and has a large pile of liquid investment (Rs1.4bn), which it plans to invest in growing its gas business with inputs from parent BG. Successful rollout of the high-margin automobile CNG along with an increasing mix of retail gas distribution should be the primary drivers of earnings growth for Ggas over the next three years, helping offset loss in transmission revenues over this period. Driven by strong growth in CNG, we expect EPS to grow at a 28% CAGR over 2006-09E.

Valuation

Our DCF-based valuation for Ggas is Rs350, on which our target price is based. Our DCF assumes a WACC of 11.0%, four years of explicit forecasts, and a terminal growth rate of 3% thereafter. We prefer DCF to value the company given the utility nature of the business, which ensures steady cash flows. Discounted cash flows also capture the value of the business over a longer term, given the new investments being made in the business and the longer-term growth opportunity for the retail gas distribution business in India. Our target price equates to a P/E of 14x 2008E, in-line with the BSE Sensex multiples. We believe this is justified due to the stable earnings profile and visible earnings growth.

Risks

We assign a Low Risk rating to Ggas based on our quantitative risk-rating system. Government/regulatory interference in gas pipeline tariffs could impact Ggas' earnings. The gas business typically involves take-or-pay clauses and Ggas' inability to sell gas contracted could lead to financial losses, while suppliers' inability to supply could lead to one-off gains. Some of Ggas' supply agreements are denominated in US$ terms, and therefore subject to currency fluctuation risks. Most of Ggas' purchased gas prices are linked to market prices of fuels. Sharp fluctuations in gas prices which Ggas is unable to pass on to its consumers could impact margins. GSPL's commissioning of a parallel pipeline in the Hazira-Ankleshwar section has impacted Ggas' transmission business. Reduction of gas supplies from GAIL could impact margins and profits adversely. If any of these risk factors has a greater impact than we expect, Ggas' share price will likely have difficulty attaining our target price. If market prices of natural gas come off sharply amid increased availability, Ggas' margins and earnings could be higher than our expectations.

Appendix A-1

Analyst Certification

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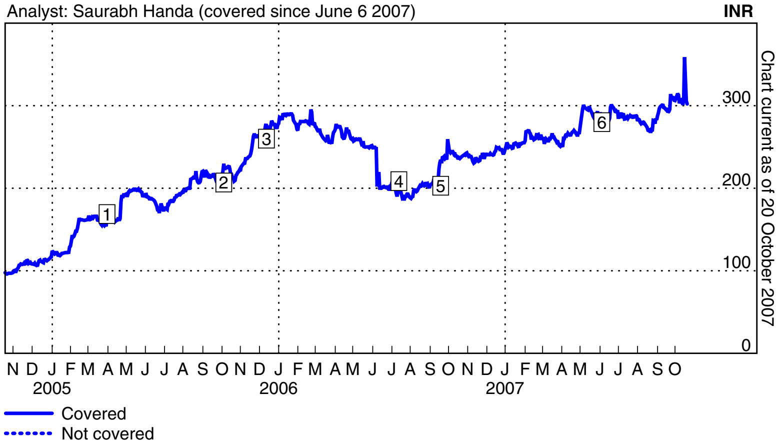
Ratings and Target Price History - Fundamental Research
Analyst: Saurabh Handa (covered since June 6 2007)



#	Date	Rating	Target Price	Closing Price
1:	31 Mar 05	*2L	*172.00	168.71
2:	5 Oct 05	2L	*230.00	229.67
3:	13 Dec 05	2L	*300.00	276.12
4:	13 Jul 06	*1L	*250.00	198.34
5:	19 Sep 06	1L	*288.00	234.37
6:	5 Jun 07	1L	*350.00	287.75

*Indicates change.

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