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Change in opinion ☑
Rating change ☑
Target price change ☑
Estimate change ☑

Petronet LNG (PLNG.BO)

Downgrade to Sell: Running Out Of Gas

- **Downgrade to Sell (3M)** — With Petronet up 47% in 1 month, we believe the stock more than adequately reflects the high capacity utilizations (95%) that we assume in our numbers in the longer term. Inherent structural challenges (increasing domestic supplies + globally high LNG prices) lend us to believe that the risk is now more on the downside and warrants us to change our recommendation. The DCF values are quite sensitive to capacity utilization – every 5% dip in utilization affects fair value by Rs6. We consequently downgrade to Sell (3M) from Buy (1M) with TP of Rs78 on roll-forward.
- **LNG markets are hot** — Global LNG projects continue to be delayed, and prices continue to rise. Qatar's 20-year contract for 2.1MMTPA to Korea is at ~US$11/mmbtu and Woodside's reported price for 3-4MMTPA 20-yr supply to PetroChina is ~US$10/mmbtu. By comparison, market prices for domestically produced gas in India are US$4.0-5.5/mmbtu, making LNG economics unfavorable esp. in light of ever increasing indigenous supply prospects.
- **Long-term supply tie-ups critical** — In the current high price environment for LNG, the likelihood of Petronet entering into a long-term agreement anytime soon to secure supplies for its Dahej expansion and greenfield Kochi terminal appear unlikely. Spot volumes will continue to drive earnings in the near term (FY09-10E earnings increased by 11-12%); despite increasing domestic supplies, we build in high long-term utilizations driven by sustained growth in gas demand. Power plans, though interesting, are at a preliminary stage and completely contingent on competitive pricing for long-term LNG.

Sell/Medium Risk	**3M**
from Buy/Medium Risk	
Price (25 Sep 07)	Rs86.30
Target price	Rs78.00
from Rs74.00	
Expected share price return	-9.6%
Expected dividend yield	1.7%
Expected total return	**-7.9%**
Market Cap	Rs64,725M
	US$1,638M

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

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2006A	1,949	2.60	785.3	33.2	6.0	20.0	0.0
2007A	3,133	4.18	60.7	20.7	5.1	26.7	1.4
2008E	3,518	4.69	12.3	18.4	4.3	25.4	1.7
2009E	4,083	5.44	16.1	15.9	3.6	24.9	1.7
2010E	4,411	5.88	8.0	14.7	3.2	23.0	2.3

Source: Powered by dataCentral

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

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Fiscal year end 31-Mar	2006	2007	2008E	2009E	2010E
Valuation Ratios					
P/E adjusted (x)	33.2	20.7	18.4	15.9	14.7
EV/EBITDA adjusted (x)	15.1	11.3	10.4	10.0	9.4
P/BV (x)	6.0	5.1	4.3	3.6	3.2
Dividend yield (%)	0.0	1.4	1.7	1.7	2.3
Per Share Data (Rs)					
EPS adjusted	2.60	4.18	4.69	5.44	5.88
EPS reported	2.60	4.18	4.69	5.44	5.88
BVPS	14.29	17.01	19.99	23.72	27.32
DPS	0.00	1.25	1.50	1.50	2.00
Profit & Loss (RsM)					
Net sales	38,372	55,090	65,999	72,347	90,663
Operating expenses	-34,500	-49,629	-59,815	-65,449	-83,339
EBIT	**3,872**	**5,460**	**6,184**	**6,898**	**7,324**
Net interest expense	-1,116	-1,070	-1,065	-1,095	-1,095
Non-operating/exceptionals	194	366	178	347	413
Pre-tax profit	**2,950**	**4,756**	**5,297**	**6,150**	**6,642**
Tax	-1,001	-1,623	-1,780	-2,066	-2,232
Extraord./Min.Int./Pref.div.	0	0	0	0	0
Reported net income	**1,949**	**3,133**	**3,518**	**4,083**	**4,411**
Adjusted earnings	1,949	3,133	3,518	4,083	4,411
Adjusted EBITDA	4,882	6,481	7,200	7,944	9,226
Growth Rates (%)					
Sales	97.3	43.6	19.8	9.6	25.3
EBIT adjusted	621.4	41.0	13.3	11.5	6.2
EBITDA adjusted	224.4	32.8	11.1	10.3	16.1
EPS adjusted	785.3	60.7	12.3	16.1	8.0
Cash Flow (RsM)					
Operating cash flow	**1,412**	**5,106**	**6,965**	**6,365**	**6,219**
Depreciation/amortization	1,010	1,020	1,016	1,046	1,901
Net working capital	-2,292	-131	1,245	-141	-332
Investing cash flow	**-732**	**-3,665**	**-9,627**	**-9,608**	**-13,730**
Capital expenditure	-732	-3,665	-9,627	-9,608	-13,730
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	**0**	**136**	**1,717**	**4,717**	**8,290**
Borrowings	0	1,233	3,000	6,000	10,000
Dividends paid	0	-1,097	-1,283	-1,283	-1,710
Change in cash	**679**	**1,578**	**-944**	**1,474**	**779**
Balance Sheet (RsM)					
Total assets	**25,898**	**34,936**	**44,526**	**55,355**	**70,083**
Cash & cash equivalent	2,506	3,405	5,062	6,497	7,276
Accounts receivable	1,278	3,313	3,074	3,370	4,223
Net fixed assets	18,627	21,273	29,884	38,474	50,302
Total liabilities	**15,179**	**22,181**	**29,536**	**37,564**	**49,592**
Accounts payable	1,368	3,125	6,254	6,864	8,612
Total Debt	12,599	13,832	16,832	22,832	32,832
Shareholders' funds	**10,719**	**12,755**	**14,990**	**17,790**	**20,491**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	12.7	11.8	10.9	11.0	10.2
ROE adjusted	20.0	26.7	25.4	24.9	23.0
ROIC adjusted	14.9	17.4	16.1	13.6	11.1
Net debt to equity	94.2	81.7	78.5	91.8	124.7
Total debt to capital	54.0	52.0	52.9	56.2	61.6

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An LNG Snapshot

The following is an extract from "Woodside Petroleum Ltd – This is a Huge Deal", dated 6 September 2007, by our Australia analyst, Di Brookman.

Soaring construction costs, sustained higher oil prices, and a shortage of LNG before 2012 has encouraged producers such as Indonesia, until last year the world's biggest exporter, to demand significantly higher long-term prices from consumers.

Indonesia, for example, is now seeking to renegotiate the price of an LNG deal to South Korea, less than a year after it forced a major Chinese customer to pay more.

And while demand for LNG from countries like Japan, where electricity needs are growing, is likely to continue even at the high prices, demand from China and India to date has been more price sensitive.

Qatar recently sold 2.1Mt/yr of LNG to Kogas under a 20-year contract at prices quoted in the press of US$11/MMbtu when oil prices are US$60/bbl. Further, China recently paid US$8.15/MMbtu & US$8.30/MMbtu for spot cargoes from Algeria & Oman respectively.

China has been unwilling to pay high prices till recently

Until recently China had only signed two long-term contracts. The first contract was finalized with the North West Shelf JV for 3.3Mt/yr at around US$3.15/MMbtu and the second contract was signed with Indonesia's Tannguh Project for 2.6Mt/yr. The last LNG contract was formalized in 2003.

China walked away from the negotiating table when LNG prices started to surge in late 2005. Japan stepped in and filled the gap, successfully securing foundation supply from numerous Australian LNG plants then in the conceptual stage. At that time China appeared happy to take a back seat, expecting LNG prices to ease back.

..But China is now getting with the program

Significant LNG developments include:

- Shell signed a conditional Heads of Agreement (HOA) with PetroChina to supply 1Mt/yr for 20 years from the Gorgon field offshore Western Australia. Shell holds a 25% equity in the Gorgon field and each participant was responsible for marketing their own share of LNG produced. Shell had previously agreed to sell the LNG to its marketing division, suggesting that the LNG could be sold spot.

  The HOA covers the key terms of the transaction and provides that Shell and PetroChina will work together to conclude and execute a detailed LNG Sale and Purchase Agreement (SPA) before December 2008.

There was some discussion in the Chinese press that the deal was done at around US$10/MMbtu, significantly higher than PetroChina's city gate price of US$4.73/MMbtu on gas through the west to east pipeline.

- Woodside signed key term Agreement with PetroChina for 3–5 Mt/yr for 20 years from the Browse LNG Project, also located offshore Western Australia. At this stage the deal is with Woodside, however Woodside is not precluding inclusion of the remainder of the JV at some stage.

What are LNG prices doing?

- Qatar recently sold 2Mt/yr of LNG to Kogas under a 20-year contract at prices quoted in the press of US$11/MMbtu when oil prices are US$60/bbl. Kogas' hunger for LNG has been exacerbated by a strong economy and continued production problems in Indonesia. Since 1999 Indonesian supplies of LNG have been cut by 22%.
- As Australia only supplies Korea with 2% of its current LNG needs, an opportunity to supply Korea with more volumes going forward may exist. What seems particularly interesting is that Korea is keen to sign term contracts at prices greater than the parity of oil.
- The Indonesian Tannguh project recently diverted some cargoes destined to Sempra at Baja California to Japan. We understand that there are diversion rights against 50% of the 3.7Mt/yr contracted with Sempra.

Let's look at the LNG market

Eighteen months ago, in a Woodside study by Citi titled, "Strong leverage to favourable pricing outcomes," dated 28th February 2006, we argued in order to mobilize the supply chain for LNG greater indexation to oil prices would be required. What we underestimated at the time was the developing rampant cost of inflation across the sector. Yes, we got indexation within what seemed like months, but project economics did not improve for long. Realizing this we now recognize that increasingly pricing premiums over oil or high-priced floors will be required to mobilize the supply chain. This is likely to make the future for LNG increasingly vulnerable to demand destruction. How high a price can the buyers bear before they choose pipeline gas or other energy sources?

The US, in particular, needs to change its mindset to price, as LNG in Asia is sold based on the price of the JCC. With some pricing premiums being paid for term contracts over the JCC, the Americans are falling increasingly behind the curve.

It is possible that as long as PetroChina pays above the Henry Hub equivalent prices for LNG, that it will be able to dissuade sales to the west coast of the USA.

Why is LNG demand so strong in AsiaPac?

- **Project delays:** Prices may have strengthened, but it seems that the supply chain is struggling as capital and operating costs have increased significantly in recent years. Further skilled resources are tight, and the environmental challenges are becoming increasingly onerous. This situation may be playing into Woodside's hands as other projects like Gorgon (10Mt/yr) and the Algerian Gassi Touil (4.4Mt/yr) are now delayed.

- **The Japanese power industry is in tatters:** The Japanese are around 17% short of meeting their Kyoto Protocol commitments. In an attempt to remedy this they had planned for around 80% of the 25,000MW of power required by 2011 to be sourced from nuclear and gas. Within this amount it was suggested that 8,000MW or 32% would be fuelled by gas and the remaining 17,000Mw sourced from nuclear. Currently, Japan is the third-biggest nuclear generator with 55 operating nuclear plants, which provides 30% of the country's electricity. Some 15% of Japan's current nuclear fleet is old having been in operation for at least 30 years and presently 5% of installed capacity has been shut-in.

  However, despite the country's wide use of nuclear power, the industry has been plagued by safety issues and illegal reporting. The Japanese government has only recently learned that Tokyo Electric and 11 other utilities companies had not reported some 316 separate incidents involving illegal operations, such as a fatal nuclear chain reaction, data fabrication and safety breaches. We think the nuclear industry's credibility in Japan is in tatters.

  With this in mind it adds credence to the minimal estimate for LNG demand over the next 10 years. We note that the 3% annual increase in demand for LNG is twice what we currently have included in the CIR global LNG model and may support the observation that Japan continues to pay high prices to secure long-term volumes ahead of its rivals in Europe and the US.

Increasing FY09E-10E earnings on higher utilizations

We are increasing our FY09E and FY10E earnings estimates by 11% and 12%, respectively, to factor in higher regassification volumes at Dahej than earlier assumed. We are now factoring in regas volumes of 6.7MTPA in FY09E (vs. 6.3MTPA earlier) and 10MTPA in FY10E (9.5MTPA). Despite the sharp increase in volumes in FY10E, the corresponding earnings growth is relatively modest primarily due to higher depreciation (Dahej expansion to be commissioned in 2HFY09E).

Figure 1. Petronet LNG – Earnings Revisions

Year to	Net Profit (Rs Mils.)		Diluted EPS (Rs)			Div. Per Share (Rs)	
31-Mar	Old	New	Old	New	% Chg	Old	New
2008E	3,518	3,518	4.69	4.69	0.0%	1.5	1.5
2009E	3,683	4,083	4.91	5.44	10.9%	1.5	1.5
2010E	3,939	4,411	5.25	5.88	12.0%	2.0	2.0

Source: Citi Investment Research estimates

Our DCF-based fair value, which we now roll forward to Mar-08E, correspondingly increases to Rs78 (Rs74 earlier). Figure 2 below captures the sensitivity of our target price to long-term capacity utilizations. As illustrated, a 5% change in capacity utilization results in ~Rs6 change in our fair value. Even full utilization of its regassification capacity yields a fair value of Rs83 per share, still a downside from current levels.

Figure 2. Sensitivity of fair value to long-term capacity utilization

Long-term capacity utilization (FY11E and beyond)	75%	80%	85%	90%	95%	100%
Fair value (as of Mar-08E)	54	60	66	72	78	84

Source: Citi Investment Research estimates

Petronet LNG

Company description

Petronet (PLL) was promoted as a joint venture of four state-owned oil & gas companies (GAIL, IOC, ONGC, and BPCL), which together hold 50% of its equity. Gaz De France owns 10% of PLL's equity. PLL runs a 5MMTPA LNG receiving and regassification terminal at Dahej on the western coast of India. Regassified LNG from the Dahej terminal has access to the developed gas markets of Gujarat and, through GAIL's Dahej-Vijaipur pipeline, its gas is piped to the consumption centers linked to GAIL's HBJ pipeline.

Investment strategy

We rate PLL as Sell/Medium Risk (3M). PLL earns a fixed, steady regassification charge and has de-risked its business model from the commodity cycles. It is, however, investing a substantial part of its cash flow in expanding its LNG business, and is exposed to project-execution risks. Also, though PLL has a strong first-mover advantage in the LNG market and is taking advantage of shared infrastructure to raise capacities at a low cost, high global prices of LNG could impact its economics vs. domestic gas in the long term, despite the continued growth that the Indian gas market is likely to witness.

Valuation

Our target price of Rs78 is based on 10% discount to our DCF-based fair value estimate of Rs87 for March 2008. We believe a 10% discount is justified given the back-ended nature of the returns from the project. We use a DCF-based valuation, as we think it captures the value of the projects over their lifetime, especially given that PLL's near-term cash flow is affected by its aggressive expansion. In our DCF analysis, we have used explicit forecasts for 10 years, a terminal growth rate of 2%, and a WACC of 11.5%. On our target price, the stock would trade at 9.3x FY10E P/CEPS, in-line with other gas utilities, which have more stable and visible earnings growth.

Risks

We assign a Medium Risk rating for PLL based on our quantitative risk-rating system. Upside risks to our target price include: (1) higher utilization or faster commissioning of regassification capacities than assumed by us, (2) better acceptability of higher-priced LNG by the domestic market, and (3) power plans, albeit preliminary, could add value over the medium to long term.

Appendix A-1

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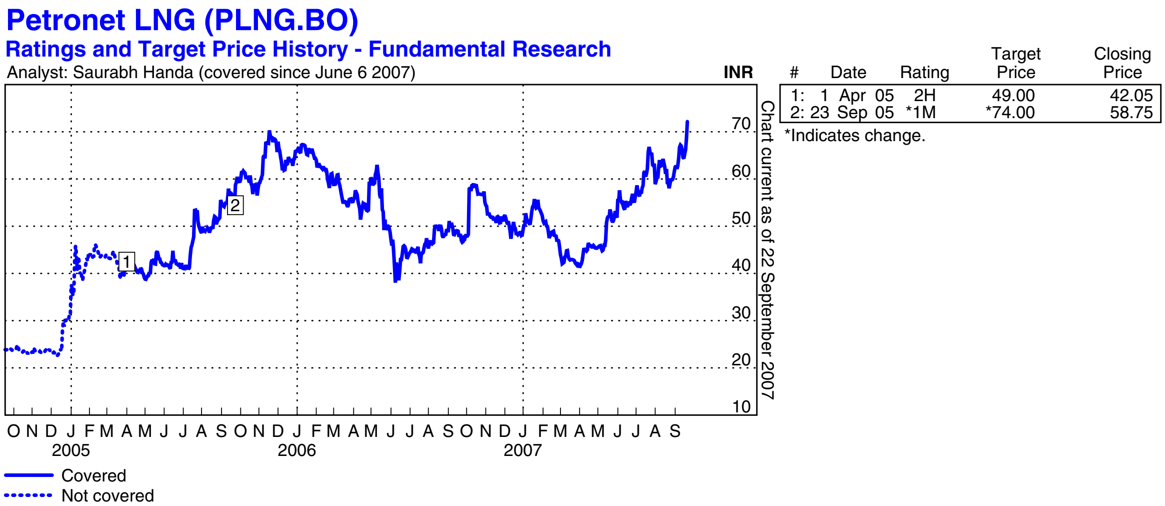

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