Gujarat State Petronet (GSPT.BO)

Buy: Raising TP to Rs104 as Gas Supply Visibility Improves

Rating change ☑
Target price change ☑
Estimate change ☑

- **New target price of Rs104** — Our new TP is based on our DCF-based valuation (rolled forward to Mar-09E) and assumes higher than earlier assumed gas volumes to flow through GSPL's pipeline network driven by further improvement in visibility of domestic gas supplies. The latter also lends us to lower our risk rating to Low from Medium earlier, as GSPL is now one of the most secure plays to increasing gas consumption in India, in our view.

- **What's changed?** — Our FY10-12E assumptions for volumes transmitted through the company's network move up by ~5-8mmscmd on the back of further increase in domestic gas production than earlier anticipated (contributed primarily by recent discoveries and development plans of RIL). We also factor in higher capex of Rs26bn over FY08-10E, in-line with the company's network expansion plans within Gujarat.

- **Maintain Buy (1L)** — GSPL remains one of the most highly levered companies to increasing consumption of gas in India, especially in Gujarat, India's most industrialized state and most vibrant gas market, as high operating leverage ensures a corresponding increase in profitability as volumes increase. In addition, though early days, the introduction of regulations by the PNGRB for transmission pipelines bodes well for the company's plans to expand to other parts of the country. The recent correction (down 30% from its highs) offers a good opportunity for investors to enter the stock, in our view. Reiterate Buy (1L) with a revised Rs104 target price.

Buy/Low Risk	**1L**
from Buy/Medium Risk	
Price (21 Jan 08)	Rs77.95
Target price	Rs104.00
from Rs74.00	
Expected share price return	33.4%
Expected dividend yield	0.5%
Expected total return	**33.9%**
Market Cap	Rs43,797M
	US$1,117M

Price Performance (RIC: GSPT.BO, BB: GUJS IN)

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2006A	467	1.04	95.1	74.9	4.7	7.1	0.3
2007A	894	1.65	58.4	47.3	4.4	9.5	0.6
2008E	741	1.34	-18.6	58.1	3.9	7.1	0.5
2009E	1,261	2.24	67.3	34.7	3.6	10.8	0.9
2010E	1,898	3.38	50.6	23.1	3.3	15.0	1.3

Source: Powered by dataCentral

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Fiscal year end 31-Mar	2006	2007	2008E	2009E	2010E
Valuation Ratios					
P/E adjusted (x)	74.9	47.3	58.1	34.7	23.1
EV/EBITDA adjusted (x)	24.5	18.4	16.0	11.5	9.1
P/BV (x)	4.7	4.4	3.9	3.6	3.3
Dividend yield (%)	0.3	0.6	0.5	0.9	1.3
Per Share Data (Rs)					
EPS adjusted	1.04	1.65	1.34	2.24	3.38
EPS reported	1.04	1.65	1.34	2.24	3.38
BVPS	16.74	17.79	19.96	21.42	23.61
DPS	0.25	0.50	0.40	0.67	1.01
Profit & Loss (RsM)					
Net sales	2,635	3,176	3,789	5,775	7,909
Operating expenses	-1,483	-1,521	-2,021	-2,711	-3,475
EBIT	**1,152**	**1,655**	**1,768**	**3,065**	**4,434**
Net interest expense	-413	-457	-866	-1,280	-1,640
Non-operating/exceptionals	45	175	220	125	82
Pre-tax profit	**784**	**1,373**	**1,123**	**1,910**	**2,876**
Tax	-317	-479	-382	-649	-978
Extraord./Min.Int./Pref.div.	0	0	0	0	0
Reported net income	**467**	**894**	**741**	**1,261**	**1,898**
Adjusted earnings	467	894	741	1,261	1,898
Adjusted EBITDA	1,943	2,681	3,336	5,109	7,015
Growth Rates (%)					
Sales	29.5	20.5	19.3	52.4	36.9
EBIT adjusted	81.0	43.6	6.9	73.3	44.7
EBITDA adjusted	50.2	38.0	24.4	53.2	37.3
EPS adjusted	95.1	58.4	-18.6	67.3	50.6
Cash Flow (RsM)					
Operating cash flow	**1,871**	**862**	**2,308**	**3,467**	**4,133**
Depreciation/amortization	791	1,026	1,568	2,044	2,581
Net working capital	613	-1,058	0	162	-346
Investing cash flow	**-6,047**	**-4,401**	**-8,000**	**-9,800**	**-8,200**
Capital expenditure	-6,047	-4,401	-8,000	-9,800	-8,200
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	**3,065**	**2,540**	**4,292**	**5,557**	**2,334**
Borrowings	1,350	2,852	4,362	6,000	3,000
Dividends paid	-155	-318	-260	-443	-666
Change in cash	**-1,111**	**-999**	**-1,400**	**-775**	**-1,733**
Balance Sheet (RsM)					
Total assets	**17,140**	**21,059**	**28,186**	**36,320**	**41,185**
Cash & cash equivalent	2,372	1,811	1,663	1,470	578
Accounts receivable	137	349	208	316	433
Net fixed assets	13,650	17,029	23,461	31,216	36,835
Total liabilities	**8,065**	**11,400**	**16,969**	**24,284**	**27,918**
Accounts payable	1,261	1,295	2,354	2,884	2,413
Total Debt	5,786	8,638	13,000	19,000	22,000
Shareholders' funds	**9,075**	**9,659**	**11,217**	**12,035**	**13,267**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	73.7	84.4	88.0	88.5	88.7
ROE adjusted	7.1	9.5	7.1	10.8	15.0
ROIC adjusted	7.8	7.6	6.6	8.6	9.9
Net debt to equity	37.6	70.7	101.1	145.7	161.5
Total debt to capital	38.9	47.2	53.7	61.2	62.4

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Target price increased to Rs104

We are raising our DCF-based target price to Rs104 from Rs74 earlier based on changes to some of our assumptions and as we roll forward to Mar-09E.

Figure 1. GSPL – DCF valuation

	FY09E	FY10E	FY11E	FY12E	Terminal
EBIT	3,065	4,434	4,206	4,645	4,785
Less: Tax	(97)	(166)	(154)	(305)	(315)
Add: Depreciation	2,044	2,581	3,640	3,973	3,973
Add: Decrease in net WC	162	(346)	(1,657)	22	(150)
Less: Capex	(9,800)	(8,200)	(1,636)	(1,706)	(1,800)
Free Cash Flow to Firm	(4,626)	(1,697)	4,400	6,628	6,493
NPV of cash flows	(4,626)	(1,547)	3,657	5,020	
Terminal Value					66,907
Total Firm value	74,036				
Less: Net Debt	17,530				
Total Equity value	56,506				
Value per share (Rs)	**104**				

Source: Citi Investment Research estimates

The key changes behind the increase in our target price are highlighted below:

- Increase in our assumptions for total volumes transmitted through GSPL's pipeline network – this is primarily based on further improved visibility of domestic gas supplies driven by: (1) additional gas production from RIL's MA fields in the KG-D6 block (commencing in end-FY09E and plateauing at 9mmscmd, as announced in RIL's 3Q results), (2) additional ~6mmscmd of gas production from RIL's NEC-25 block, and (3) recent, albeit yet-to-be-quantified, discoveries by RIL in some of its other blocks (Cauvery basin, KG-III-5, KG-D4). GSPL has already signed an agreement with RIL for 11mmscmd of gas to be transmitted through its network in Gujarat. Given the improved visibility of gas supplies, the volume of RIL gas that GSPL will transmit in future will likely be significantly higher, in our view. Furthermore, discoveries by ONGC and GSPC in the KG basin, though not yet appraised, could further add to domestic gas production volumes in the medium term.

  Our key volume assumptions are illustrated in Figure 2 below.

Figure 2. Gas supply and transmission assumptions (mmscmd)

	FY09E	FY10E	FY11E	FY12E
Gas transported – old	25.1	31.0	33.5	38.6
Gas transported – new	25.3	35.8	41.6	45.9
Total committed volumes	29.8	42.2	49.0	54.0
- Cairn Energy	2.5	2.5	2.5	2.5
- GSPC-Nikko	2.5	2.5	2.5	2.5
- Shell LNG	6.0	6.0	5.0	5.0
- PMT	3.0	3.0	3.0	3.0
- Petronet LNG	6.0	8.0	8.0	8.0
- Reliance (KG Basin)	8.3	15.5	20.0	20.0
- Others[1]	2.0	5.0	8.0	12.0

Source: Citi Investment Research estimates. [1]Primarily additional gas from RIL's discoveries in KG and Mahanadi basin + discoveries of ONGC and GSPC (reportedly significantly but yet to be appraised).

- Higher capex assumptions – we are now factoring in total capex of Rs26bn over FY08-10E. This is in-line with management guidance as the company seeks to nearly double its pipeline network from ~1100kms currently within Gujarat itself. Our assumptions currently do not factor in expansion of the pipeline network outside the state of Gujarat, which could provide future upside to earnings. In particular, the company's plans to expand into the neighboring state of Rajasthan and further north toward the national capital region are still preliminary and subject to necessary approvals as well as shaping up of the regulatory environment.

- Earnings adjustments – our near-term FY08-10E earnings are revised modestly, as shown below, primarily driven by the aforementioned changes in our volume and capex assumptions.

Figure 3. GSPL- Earnings Revision

Year to	Net Profit (Rs Mils.)			Diluted EPS (Rs)			Div. Per Share (Rs)	
31-Mar	Old	New	% Chg	Old	New	% Chg	Old	New
2008E	737	741	0.6%	1.33	1.34	0.6%	0.4	0.4
2009E	1,113	1,261	13.3%	1.98	2.24	13.3%	0.6	0.7
2010E	1,885	1,898	0.7%	3.35	3.38	0.7%	1.0	1.0

Source: Citi Investment Research estimates

- We continue to factor in full tax rates into our estimates, in the absence of clarity on the impact of Sec80IA benefits to the company's taxation.

Gujarat State Petronet

Company description

GSPL is a gas transmission company with a network of pipelines in the western Indian state of Gujarat. The company has a gas transmission network comprising over 1,100 kms of pipelines connecting Hazira, Vadodara, Ahmedabad, Kalol, Himmatnagar, Mehsana, Rajkot, and Vapi. GSPL's network connects all the major supply sources in Gujarat to important consumption centres in the state and currently transports c.16mmscmd of gas.

Investment strategy

We rate Gujarat State Petronet as Buy/Low Risk (1L). GSPL has seized the opportunity for setting up an "open access" pipeline network in India's most vibrant gas market, Gujarat. Gujarat has the advantage of being the landfall point of gas from India's western offshore fields (the largest source of gas for India) as well as having two LNG receiving terminals. The state is also among the most industrialized regions in India with a large presence of energy-intensive industries in addition to traditional gas-using industries. GSPL's parent, Gujarat State Petroleum Corporation, has played and continues to play an important role as an aggregator of gas demand and supplies.

Valuation

Our target price of Rs104 is based on our DCF fair value for Mar-09E. Our DCF is based on gas volumes tied up with Reliance (11-20mmscmd) and announced capex plans (Rs26bn over FY08-10E). We use 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. Our DCF valuation is based on five years of explicit forecasts, 27% CAGR of committed volumes over FY07-12E, FY12E volumes of 54mmscmd, and terminal growth of 3%. We use a WACC of 9.7% (risk free 8.0%, risk premium 6.0%, beta of 0.85, target D/E of 50%). Also, on a price/cash earnings basis, we think GSPL is at a justifiable premium to other gas utilities (13x FY10E) given our high growth expectations of its gas transmission business (EPS CAGR of 27% over FY07-10E). We prefer P/CEPS to the more traditional P/E multiple as a valuation benchmark given GSPL's aggressive depreciation policy.

Risks

We assign a Low Risk rating to GSPL as opposed to the Medium Risk suggested by our quantitative risk-rating system as improved visibility of gas supplies will likely ensure high utilization of the company's pipelines even after its ongoing expansions. The key downside risks to our target price include: 1) Government regulation of gas pipeline tariffs – with the setting up of the Petroleum and Natural Gas Regulatory Board, pipeline tariffs could come under scrutiny; 2) Gas supplies – we assume a 27% CAGR in gas volumes for GSPL. If supplies are lower than our expectations, this could impact earnings and valuations; 3) Project risk – GSPL is implementing expansion of its pipeline network that is subject to time and cost over-runs that could impact earnings. If any of these factors has a greater impact than we expect, the stock could have difficulty achieving our target price.

Appendix A-1

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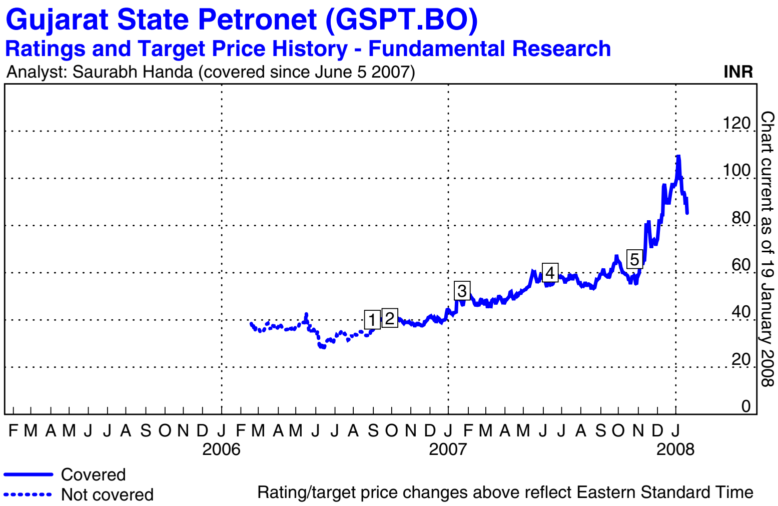

#	Date	Rating	Target Price	Closing Price
1:	31 Aug 06	1M	49.00	35.55
2:	28 Sep 06	1M	*55.00	38.35
3:	23 Jan 07	1M	*60.00	46.50
4:	13 Jun 07	1M	*72.00	54.80
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*Indicates change.

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