

GAIL (India)

STOCK INFO.	BLOOMBERG
BSE Sensex: 12,962	GAIL.IN
	REUTERS CODE
S&P CNX: 3,744	GAIL.BO

31 October 2006

Neutral

Previous Recommendation: Neutral

Rs256

Equity Shares (m)	845.7
52-Week Range	325/210
1,6,12 Rel. Perf. (%)	-7/-19/-55
M.Cap. (Rs b)	216.5
M.Cap. (US\$ b)	4.8

YEAR	NET SALES	PAT	EPS	EPS	P/E	P/BV	ROE	ROCE	EV/	EV/
END	(RS M)	(RS M)	(RS)	GROWTH (%)	(X)	(X)	(%)	(%)	SALES	EBITDA
03/06A	163,513	23,101	27.3	18.5	9.4	2.2	24.8	40.2	1.2	5.4
03/07E	177,786	20,727	24.5	-10.3	10.4	2.0	19.7	36.0	1.1	5.8
03/08E	161,513	24,976	29.5	20.5	8.7	1.7	21.1	44.7	1.0	4.0

- PAT at Rs4.5b was down 42.1% YoY, on the back of higher subsidy sharing, gas transmission volume impact due to floods and to some extent base effect. EBITDA at Rs5.9b was down 37% YoY, despite a sharp increase in PE and LPG margins, as higher fuel marketing loss sharing and gas transmission volume impact more than set off the gains.
- PE spread over natural gas feedstock (gross margin) was up 23% YoY, contributing towards an EBIT growth of 25.9% YoY. While LPG spread too was up sharply, gains were more than offset by fuel marketing loss sharing.
- Fuel marketing loss sharing at Rs4.2b was up 162% YoY, though part of it pertains to 1QFY07. LPG segment EBIT is negative at Rs545.4m. Gas transmission volume was down 8.6% YoY due to floods. Gas trading profit (EBIT) too was down 20.1% YoY at Rs449m, despite volume growth on account of Government disallowing margins on APM gas.
- Gas marketing margin cut (approx Rs500m) and tariff commission recommendation for a cut in KG-basin pipeline (impact of Rs1.5b) are overhangs. We have downgraded FY07 estimates to reflect higher than expected loss sharing.
- Stock trades at a P/E of 8.7x FY08E. Given that the fall in value of pipelines on account of new tariffs and petrochem / LPG prices peaking out, we believe stock upside is limited. Maintain **Neutral**.

QUARTERLY PERFORMANCE

(Rs Million)

Y/E MARCH	FY 06				FY 07				FY 06	FY 07E
	1Q	2Q	3Q	4Q	1Q	2Q	3QE	4QE		
Net Sales	36,242	40,738	44,455	42,078	47,303	43,583	43,129	43,771	163,513	177,786
Change (%)	11.8	15.6	27.9	27.2	30.5	7.0	-3.0	4.0	11.6	8.7
Finished Gds Purchase	21,439	24,473	27,787	25,396	30,552	28,088	26,800	26,750	99,096	112,190
Raw Materials Cons	2,485	3,698	4,149	4,427	5,069	4,845	4,300	4,467	14,758	18,681
Employee Costs	534	539	612	528	551	905	550	598	2,213	2,604
Other Exp (incl Stock Adj)	2,304	2,684	2,796	4,683	1,715	3,854	2,729	3,210	12,467	11,508
EBITDA	9,480	9,344	9,111	7,044	9,416	5,891	8,750	8,746	34,979	32,803
% of Net Sales	26.2	22.9	20.5	16.7	19.9	13.5	20.3	20.0	26.7	-81.5
% Change	24.1	6.4	-11.1	-3.8	-0.7	-37.0	-4.0	24.2	-5.5	-6.2
Depreciation	2,391	399	1,414	1,391	1,408	1,436	1,434	1,472	5,595	5,750
Interest	297	178	406	292	288	291	310	323	1,173	1,212
Other Income	499	1,693	1,519	844	801	1,674	926	582	4,555	3,982
PBT	7,292	10,461	8,809	6,205	8,521	5,838	7,932	7,533	32,766	29,824
Tax	2,457	2,719	2,377	2,112	2,600	1,354	2,636	2,506	9,665	9,096
Rate (%)	33.7	26.0	27.0	34.0	30.5	23.2	33.2	33.3	29.5	30.5
PAT	4,835	7,742	6,432	4,093	5,921	4,484	5,296	5,027	23,101	20,727
Change (%)	42.6	69.7	1.2	-20.8	22.5	-42.1	-17.7	22.8	3.6	-10.3

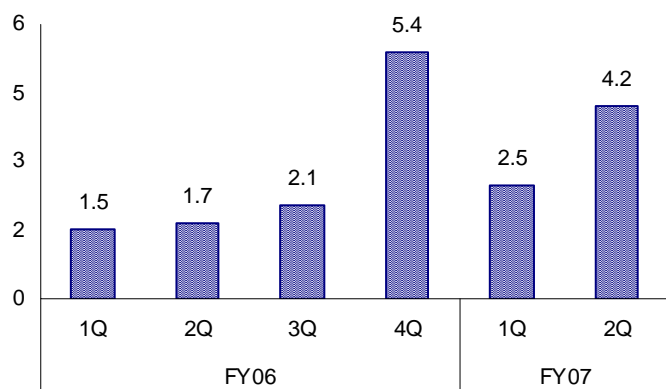
E: MOST Estimates

PAT at Rs4.5b was down 42.1% YoY, on the back of higher subsidy sharing, gas transmission volume impact due to floods and to some extent base effect. EBITDA at Rs5.9b was down 37% YoY, despite a sharp increase in PE and LPG margins, as higher fuel marketing loss sharing and gas transmission volume impact more than set off the gains.

Higher loss sharing pulls down performance

GAIL has accounted for Rs4.2b of loss sharing in 2QFY07, with a part of it pertaining to previous quarter. Higher loss sharing has pulled down LPG EBIT leading to a negative EBIT of Rs545m as against Rs1.3b last year, despite an increase in LPG margins. We estimate LPG realization growth at 35% YoY and margin growth at 40% YoY. The adjustments to loss sharing calculation formula appear to be turning more unfavourable for GAIL.

LPG / KEROSENE LOSS SHARING (RS B)



Source: Company/ Motilal Oswal Securities

Natural gas transmission volume down

Natural gas transmission volume was down 8.6% YoY on account of flood related supply disruption at Hazira. While

EBIT is down 35% YoY, part of it (about 19%) is explained by the base effect on account of lower depreciation driven by accounting change in 2QFY06.

OPERATING PERFORMANCE SUMMARY (TON) ('000)

	2QFY07	2QFY06	% CH.	1QFY07	% CH.
Natural gas trans. MMSCMD	70.2	76.8	-8.6	79.1	-11.2
Gas trading vol. MMSCMD	62.8	60.6	3.7		N.A.
Petrochem. sales	70.0	68.0	2.9	81.0	-13.6
LPG & liquid hydrocar. sales	307.0	308.0	-0.3	356.0	-13.8
LPG transmission	582.0	508.0	14.6	522.0	11.5

Source: Company/Motilal Oswal Securities

PE is the key driver of profits

PE was the key profit driver, with EBIT growth of 25.9% YoY, on the back of a sharp increase in margin. PE spread over natural gas feedstock (gross margin) was up 23% YoY, despite the 30% increase in natural gas prices YoY.

LPG transmission volume up

LPG transmission volume at 582,000 MT was up 14.6% YoY. However, EBIT was down 20.1% YoY, on account of depreciation rate change in 2QFY06. Despite the improving volumes, utilisation of LPG transmission line Vizag-Secunderabad remains abysmally low.

Gas marketing profits down

Gas marketing EBIT was down 47.1% YoY at Rs613.5m on the back of Government directive disallowing marketing margins on APM gas last year as well as base effect, despite an increase in marketing volume by 3.7%. However, this does not reflect the tariff commission recommendation to cut marketing margin from Rs5/mmbtu to Rs1.97/mmbtu, down 60.6%. A final decision is still pending.

SEGMENTWISE RESULTS (RS M)

	2QFY07	2QFY06	% CH.	1QFY07	% CH.
Transmission Services	5,788	6,268	-7.7	5,998	-3.5
Natural Gas Trading	29,237	25,748	13.5	715	3,989.6
Petrochemicals	5,456	4,212	29.5	29,777	-81.7
LPG	4,219	5,328	-20.8	5,503	-23.3
GailTel	62.7	42.7	46.8	6,406.2	-99.0
Unallocated	1,607	1,742	-7.8	793	102.7
Total	46,369	43,341	7.0	49,192	-5.7

PBIT

Transmission Services	3,744	5,658	-33.8	4,912	-23.8
Natural Gas Trading	614	1,303	-52.9	273	124.4
Petrochemicals	1,743	1,384	25.9	2,021	-13.8
LPG	-545	1,282		1,374	-139.7
GailTel	4.1	-4.9	-183.7	-0.3	
Total	5,559	9,622	-42.2	8,579	-35.2

Source: Company/ Motilal Oswal Securities

FY07 estimates cut

We have cut FY07 estimates to reflect the higher than expected loss sharing.

Looking ahead

A couple of near term earnings impact is likely to be realized in the coming quarters (not built into our current estimates):

- 1) Possible cut in KG basin tariffs - estimated impact of Rs1.5b
- 2) Implementation of cut in gas marketing margins - impact of Rs500m.

While petrochemical and LPG prices are down QoQ, the new loss sharing formula appears to be unfavourable. The impact could throw up negative earnings surprise.

On the growth front, DUPL, Jagoti-Pithampur, Dabhol-Panvel, Vijaipur-Kota and Kelaras-Malanpur are likely to be completed over the next 12 months, contributing to earnings in FY08.

Valuation and view

Stock trades at a P/E of 8.7x FY08E. Given that the fall in value of pipelines on account of new tariffs and petrochem /LPG prices peaking out, we believe stock upside is limited. Maintain **Neutral**.

GAIL (India): an investment profile

Company description

GAIL is the only gas transmission company in India currently, with interests in gas distribution, petrochemicals, LPG and telecom. It owns over 6,000 km of pipelines (including LPG transmission pipelines), over 8,000 km of optical fiber cable network, 1.3m ton LPG / other hydrocarbons capacity and 330,000 petrochemicals capacity. GAIL is also involved in city gas distribution in Mumbai and Delhi, E&P and power businesses through its joint ventures

Key investment arguments

- With minimal competition in the pipeline business, GAIL would be best positioned to take advantage of the large gas demand growth over the next 10 years
- However, near term / medium term growth remains a concern. Transmission tariff cut, marketing margin cut and fuel marketing loss sharing remain key concerns.

Key investment risks

- Returns on new pipeline investments not very attractive
- Open ended loss sharing a key risk.

Recent developments

- Loss sharing formula appears to have been reworked and is unfavourable for GAIL

Valuation and view

- Stock trades at a P/E of 8.7x FY08E. Given that the fall in value of pipelines on account of new tariffs and petrochem / LPG prices peaking out, we believe stock upside is limited.
- We maintain our **Neutral** rating

Sector view

- Strong gas demand and supply growth expected over the next five to seven years, and GAIL is likely to be the preferred gas transmission agency
- However, returns are likely to remain squeezed, given the pricing constraints with fertilizer and power sectors.
- A large part of the near-term gas supply growth is likely to flow through Reliance's own pipeline and not through GAIL's pipeline. Also, Reliance's pipeline could challenge GAIL's gas sales in some of the economic zones in the western region

COMPARATIVE VALUATIONS

		GAIL	BPCL	HPCL
P/E (x)	FY07E	10.4	11.8	11.1
	FY08E	8.7	9.2	8.6
P/BV (x)	FY07E	2.0	1.6	1.2
	FY08E	1.7	1.4	1.0
EV/Sales (x)	FY07E	1.1	0.2	0.2
	FY08E	1.0	0.2	0.2
EV/EBITDA (x)	FY07E	5.8	6.3	8.0
	FY08E	4.0	5.2	6.3

SHAREHOLDING PATTERN (%)

	SEP.06	JUN.06	SEP.05
Promoter	57.3	64.6	67.0
Domestic Inst	17.9	10.1	7.0
Foreign	21.7	22.0	22.4
Others	3.0	3.3	3.6

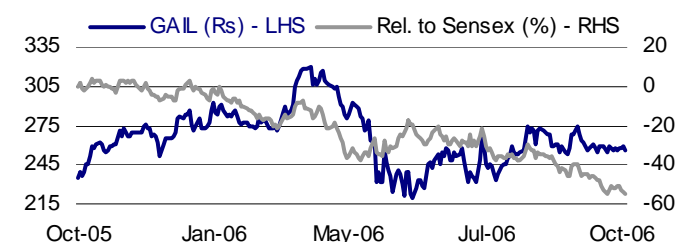
EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	24.5	27.7	-11.4
FY08	29.5	27.6	7.1

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
256	-	-	Neutral

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT					
(Rs Million)					
Y/E MARCH	2005	2006	2007E	2008E	2009E
Net Sales	136,135	163,513	177,786	161,513	160,345
Change (%)	14.0	20.1	8.7	-9.2	-0.7
Total Income	136,135	163,514	177,788	161,515	160,347
Purchase	78,537	99,096	112,190	90,904	90,904
Raw Materials	8,971	14,758	8,562	8,562	8,562
Power and fuel	3,997	4,062	4,129	4,202	4,283
Employee Costs	1,976	2,213	2,604	2,457	2,684
Other Expenditure	5,568	8,655	17,500	14,262	14,911
Change in Stocks	85	-249	0	0	0
EBITDA	37,001	34,979	32,803	41,129	39,003
% of Net Sales	27.2	21.4	18.5	25.5	24.3
Depreciation	9,399	5,595	5,750	6,650	6,650
Interest	1,311	1,173	1,212	1,075	920
Other Income	3,229	4,555	3,982	4,210	3,701
Extraordinary Items (net)					
PBT	29,520	32,766	29,824	37,615	35,134
Tax	10,034	9,666	9,096	12,639	11,805
Rate (%)	34.0	29.5	30.5	33.6	33.6
PAT	19,486	23,101	20,727	24,976	23,329
Adjusted PAT	19,486	23,101	20,727	24,976	23,329
Change (%)	3.7	18.5	-10.3	20.5	-6.6

BALANCE SHEET					
(Rs Million)					
Y/E MARCH	2005	2006	2007E	2008E	2009E
Share Capital	8,456	8,456	8,456	8,456	8,456
Reserves	77,805	91,276	102,464	117,900	131,689
Net Worth	86,261	99,732	110,920	126,356	140,145
Long Term Loans	19,975	19,166	17,719	15,575	13,505
Deferred Tax	12,552	12,997	15,074	16,886	17,687
Capital Employed	118,788	131,896	143,713	158,817	171,337
Gross Fixed Assets	142,224	144,695	177,106	177,106	177,106
Less: Depreciation	63,765	69,135	74,885	81,535	88,185
Net Fixed Assets	78,459	75,560	102,221	95,571	88,921
Capital WIP	3,091	6,156	0	0	0
Investments	7,780	14,241	8,889	8,889	8,889
Curr. Assets, L & Adv.					
Inventory	4,814	4,832	5,332	6,042	6,949
Debtors	8,229	7,535	12,231	11,137	11,059
Cash & Bank Balance	34,528	45,152	43,627	66,043	84,641
Loans & Adv. and Other Ass	16,628	15,943	12,385	12,607	12,852
Current Liab. & Prov.					
Liabilities	27,161	31,646	27,486	27,986	28,486
Provisions	7,580	5,876	13,488	13,488	13,488
Net Current Assets	29,458	35,939	32,602	54,357	73,527
Application of Funds	118,787	131,896	143,713	158,817	171,337

E: M O S t Estimates

RATIOS					
Y/E MARCH	2005	2006	2007E	2008E	2009E
Basic (Rs)					
EPS	23.0	27.3	24.5	29.5	27.6
Cash EPS	34.2	33.9	313	37.4	35.5
Book Value	102.0	117.9	1312	149.4	165.7
DPS	8.0	10.0	10.0	10.0	10.0
Payout (incl. Div. Tax.)	34.7	36.6	40.8	33.9	36.2
Valuation (x)					
P/E	111	9.4	10.4	8.7	9.3
Cash P/E	7.5	7.5	8.2	6.8	7.2
EV / EBITDA	5.5	5.4	5.8	4.0	3.7
EV / Sales	1.5	1.2	1.1	1.0	0.9
Price / Book Value	2.5	2.2	2.0	1.7	1.5
Dividend Yield (%)	3.1	3.9	3.9	3.9	3.9
Profitability Ratios (%)					
RoE	24.2	24.8	19.7	21.1	17.5
RoCE	37.9	40.2	36.0	44.7	46.7
Turnover Ratios					
Debtors (No. of Days)	21	18	20	26	25
Fixed Asset Turnover (x)	16	2.0	19	16	17
Leverage Ratio					
Net Debt / Equity (x)	-0.2	-0.3	-0.2	-0.4	-0.5

CASH FLOW STATEMENT					
(Rs Million)					
Y/E MARCH	2005	2006	2007E	2008E	2009E
OP/(Loss) before Tax	39,753	39,445	36,283	44,838	42,203
Interest Paid	-1,311	-1,173	-1,212	-1,075	-920
Direct Taxes Paid	-9,860	-9,221	-7,019	-10,826	-11,004
(Inc)/Dec in Wkg. Capital	159	4,143	1,812	662	-573
CF from Op. Activity	28,741	33,194	29,865	33,599	29,705
(Inc)/Dec in FA & CWIP	-1,375	-5,761	-26,256	0	0
(Pur)/Sale of Investments	-123	-6,462	5,352	0	0
Inc from Invst	535	0	502	502	502
CF from Inv. Activity	-963	-12,223	-20,402	502	502
Issue of Shares	0	0	0	0	0
Inc / (Dec) in Debt	-1,361	-809	-1,447	-2,144	-2,070
Dividends Paid	-7,632	-9,540	-9,540	-9,540	-9,540
CF from Fin. Activity	-8,993	-10,349	-10,987	-11,684	-11,610
Inc / (Dec) in Cash	18,786	10,623	-1,524	22,416	18,597
Add: Opening Balance	15,743	34,528	45,152	43,627	66,043
Closing Balance	34,528	45,151	43,628	66,043	84,641

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Disclosure of Interest Statement

GAIL (India)

1. Analyst ownership of the stock	No
2. Group/Directors ownership of the stock	No
3. Broking relationship with company covered	No
4. Investment Banking relationship with company covered	No

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