

INDIA

GAIL (India)

9 May 2007

GAIL IN Underperform

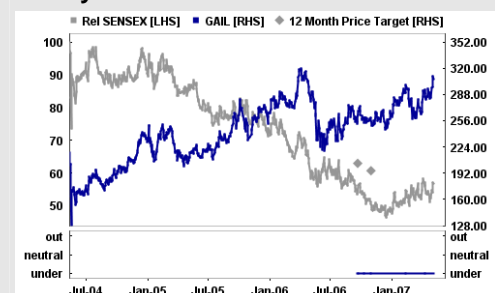
Stock price as of 08 May 07	Rs	293.55
12-month target	Rs	223.00
Upside/downside	%	-24.0
Valuation	Rs	248.00
- Sum of Parts		

GICS sector		utilities
Market cap	Rs m	248,241
30-day avg turnover	Rs m	49.4
Market cap	US\$m	6,120
Number shares on issue	m	845.7

Investment fundamentals

Year end 31 Mar		2007A	2008E	2009E	2010E
Total revenue	bn	165.4	178.8	192.7	233.0
EBITDA	bn	32.5	39.1	38.6	40.5
EBITDA growth	%	-14.3	20.1	-1.3	4.9
Reported profit	bn	25.3	24.3	23.5	25.0
Adjusted profit	bn	25.3	24.3	23.5	25.0
EPS adj	Rs	29.86	28.77	27.77	29.59
EPS adj growth	%	1.1	-3.6	-3.5	6.6
PE adj	x	9.8	10.2	10.6	9.9
Total DPS	Rs	10.45	10.07	9.72	10.35
Total div yield	%	3.6	3.4	3.3	3.5
ROA	%	14.4	15.4	13.3	12.4
ROE	%	22.8	19.2	16.5	15.8
EV/EBITDA	x	7.2	6.0	6.0	5.7
Net debt/equity	%	-13.1	-13.3	-5.9	-2.4
Price/book	x	2.1	1.8	1.7	1.5

GAIL IN rel SENSEX performance, & rec history



Source: Datastream, Macquarie Research, May 2007 (all figures in INR unless noted)

Analysts

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Look beyond the headline

Event

- GAIL announced 4Q FY3/07 results today, and the headline suggests outperformance vs the consensus. However, adjusting for a non-recurring tax write-back, PAT declined by 17% YoY to Rs3.4bn, coming in >30% short of consensus expectations and our forecast.

Impact

- Sales grew by 6.0% YoY to Rs39bn, driven by a 16% increase in gas trading revenues (~72% of total revenues). However, this did not translate into a corresponding increase in the bottom line because this business yields a normalised EBIT margin of less than 2% (Figures 1, 4).
- The tariff in natural gas transmission, the primary business, fell due to adjustments for higher tariffs charged in the preceding quarter. That resulted in respective declines of 15% and 31% YoY in segment revenues and EBIT.
- The LPG business reported negative EBIT due to a 59% QoQ rise in the subsidy burden. This occurred because GAIL had underprovisioned for subsidies in 3Q FY3/07, and EBITDA declined by 31% YoY and 13% QoQ, even if we exclude the effect of higher subsidies.
- The positive offset was the performance of the petrochemicals division, for which EBIT increased by 14% YoY, driven by a corresponding rise in gas-based petrochemical margins due to a 13% YoY increase in polyethylene prices. This was despite the 23% YoY increase in the price of gas feedstock, which led to a 13% YoY increase in raw material costs.

Earnings revision

- No change.

Price catalyst

- 12-month price target: Rs223.00 based on a Sum of Parts methodology.
- Catalyst: Final pipeline policy and new sources of gas.

Action and recommendation

- Although Reliance has entered into a memorandum of understanding to supply gas to GAIL, it is very preliminary because neither the volume nor the transmission tariff has been fixed yet. In addition, we believe that Reliance is likely to give first priority to its own company, potentially leaving GAIL with concerns about gas availability.
- Contrary to the popular perception that GAIL is a utility, about 40% of EBITDA comes from the deep-cyclical petrochemicals and LPG businesses. Revenue is affected by falling oil prices and increases in subsidy contributions.
- We reaffirm our Underperform recommendation and target price of Rs223.

Please refer to the important disclosures on inside back cover of this document, or on our website www.macquarie.com.au/research/disclosures.

Fig 1 GAIL: 4Q FY3/07 results snapshot

(Rs m)	4Q FY07	4Q FY06	% change YoY	3Q FY07	% change QoQ
Net sales	38,834	36,598	6%	43,784	-11%
Expenditure	(37,890)	(35,034)	8%	(42,421)	-11%
EBITDA	944	1,564		1,363	
Depreciation	(1,471)	(1,391)		(1,439)	
Other Income	6,209	6,324		9,125	
EBIT	5,682	6,497	-13%	9,049	-37%
Interest	(221)	(292)		(271)	
PBT	5,461	6,205		8,778	
Tax	(2,053)	(2,112)		(2,124)	
PAT (recurring)	3,408	4,093	-17%	6,655	-49%
PAT (reported)	6,807	4,093		6,655	

Source: Company data, Macquarie Research, May 2007

Fig 2 GAIL: 4Q FY3/07 segment revenue

(Rs m)	4Q FY07	4Q FY06	% change YoY	3Q FY07	% change QoQ
Transmission Services					
Natural Gas	4,762	5,635	-15%	6,410	-26%
LPG	915	944	-3%	990	-8%
Natural Gas Trading	29,701	25,495	16%	31,490	-6%
Petrochemicals	7,437	6,729	11%	7,310	2%
LPG and Liquid Hydrocarbons	4,332	4,682	-7%	6,260	-31%
Gail Tel	69	45	55%	70	-1%
Other	984	740	33%	1,660	-41%
Less: Inter segment revenue	(6,844)	(5,480)	25%	(5,430)	26%
Gross sales	41,356	38,790	7%	48,760	-15%

Source: Company data, Macquarie Research, May 2007

Fig 3 GAIL: 4Q FY3/07 segment EBIT

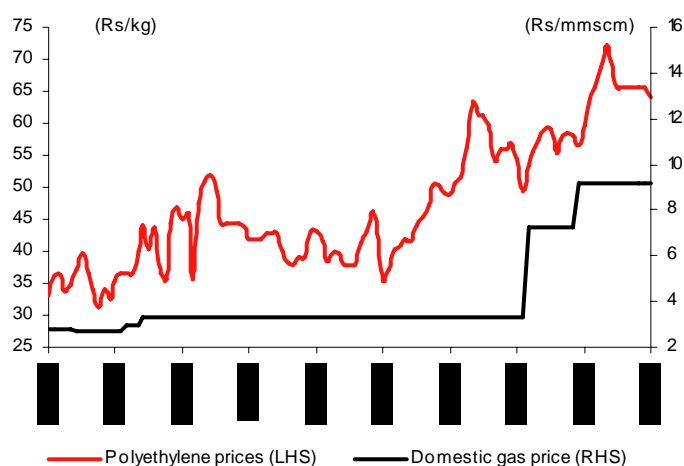
(Rs m)	4Q FY07	4Q FY06	% change YoY	3Q FY07	% change QoQ
Transmission Services					
Natural Gas	2,767	4,011	-31%	4,550	-39%
LPG	487	497	-2%	600	-19%
Natural Gas Trading	492	(615)	N.M.	560	N.M.
Petrochemicals	3,008	2,645	14%	2,770	9%
LPG and Liquid Hydrocarbons	(732)	249	-394%	900	N.M.
Gail Tel	5	(4)	N.M.	4	N.M.
Other	-	-		(335)	N.M.
Gross EBIT	6,028	6,782	-11%	9,049	-33%

Source: Company data, Macquarie Research, May 2007

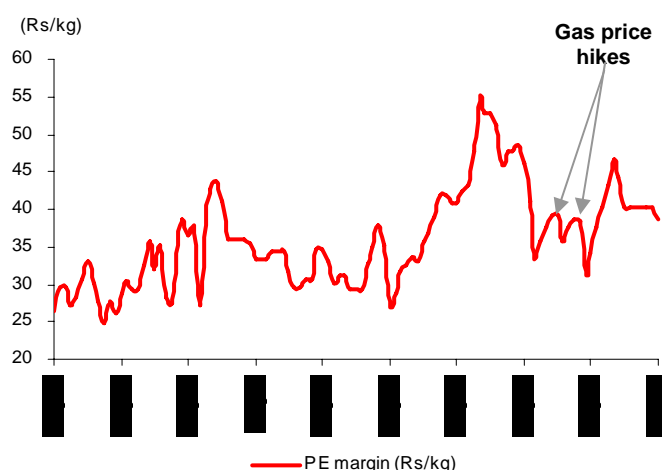
Fig 4 GAIL: 4Q FY3/07 segment EBIT margin

	4Q FY07	4Q FY06	% change YoY	3Q FY07	% change QoQ
Transmission Services					
Natural Gas	58.1%	71.2%	-13%	71.0%	5%
LPG	53.2%	52.6%	1%	60.6%	6%
Natural Gas Trading	1.7%	-2.4%	4%	1.8%	0%
Petrochemicals	40.4%	39.3%	1%	37.9%	6%
LPG and Liquid Hydrocarbons	-16.9%	5.3%	-22%	14.4%	27%
Gail Tel	7.8%	-9.4%	17%	5.7%	-1%

Source: Company data, Macquarie Research, May 2007

Fig 5 Petrochemical (product) and gas (input) prices

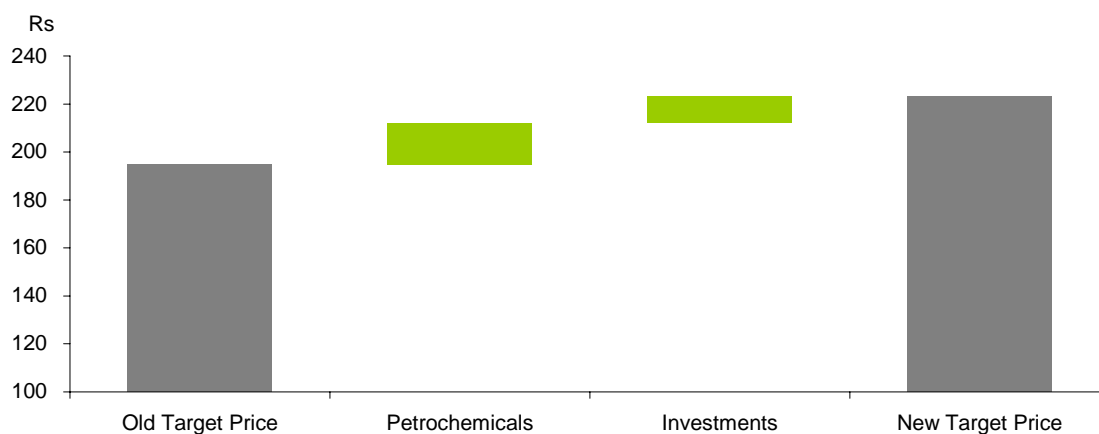
Source: Macquarie Research, February 2007

Fig 6 Margins affected by hike in input gas prices

Source: Macquarie Research, February 2007

We have upgraded our target price by 14% to Rs223

- **Petrochemicals business:** We value GAIL's petrochemicals business using the EV/EBITDA of IPCL (IPCL IN, Rs317, Not rated) as a benchmark multiple. IPCL's stock price has appreciated by 37% in the past two months, resulting in a corresponding increase in the multiple. We have upgraded our valuation of GAIL's petrochemicals by Rs17/share.
- **Value of investments and treasury stocks:** We value GAIL's investment in ONGC (ONGC IN, Rs923, Underperform, TP: Rs695), Indraprastha Gas (IGL IN, Rs99, Not Rated), Petronet LNG (PLNG IN, Rs45, Neutral, TP: Rs47) and China Gas (3 HK, HKD17.3, Not Rated) at market prices. The recent increase in the market prices of these stocks has resulted in a rise of Rs11/share in the contribution of these investments in the sum-of-parts valuation.

Fig 5 Contribution of various factors in reaching the new target price

Source: Macquarie Research, May 2007

Fig 6 Contribution of different businesses in the Sum-of-parts Valuation

	Contribution to value of GAIL (Rs mn)	Contribution to value of GAIL (Rs/ share)	Fair value (Rs/ share)	Basis for valuation
Core current business				
Gas and LPG transmission and trading business*	88,439	105	94	DCF based valuation
Petrochemicals	37,815	45	40	Using 1 year forward EV/ EBITDA for IPCL as benchmark
LPG and Liquid hydrocarbons	25,577	30	27	Using 1 year forward EV/ EBITDA for IPCL as benchmark
Contribution from main business segments	151,831	180	162	
Other assets and investments				
Value of stake in ONGC	47,185	56	50	Based on market price
Value of stake in IGL	3,106	4	3	Based on market price
Value of stake in PLNG	4,200	5	4	Based on market price
Value of stake in China Gas	3,629	4	4	Based on market price
Contribution from assets and investments	58,120	69	62	
Total value per share	209,951	248	223	

Source: Macquarie Research, May 2007

GAIL (India) Ltd (GAIL IN, Underperform, Target price: Rs223.00)

GAIL (India) Ltd (GAIL IN, Underperform, Target price: RS225.00)						GAIL (India) Ltd (GAIL IN, Underperform, Target price: RS225.00)					
Profit & Loss		2003A	2004A	2005A	2006A	Profit & Loss		2007A	2008E	2009E	2010E
Revenue	m	113,432	119,452	138,822	167,707	Revenue	m	165,423	178,784	192,657	233,018
Gross Profit	m	36,141	40,787	46,129	47,439	Gross Profit	m	47,221	44,109	42,044	59,576
Cost of Goods Sold	m	77,291	78,665	92,693	120,268	Cost of Goods Sold	m	118,202	134,676	150,612	173,441
EBITDA	m	30,354	33,699	37,597	37,972	EBITDA	m	32,531	39,076	38,572	40,474
Depreciation	m	6,420	6,640	9,825	6,019	Depreciation	m	6,216	8,474	9,605	10,595
Amortisation of Goodwill	m	0	0	0	0	Amortisation of Goodwill	m	0	0	0	0
Other Amortisation	m	0	0	0	0	Other Amortisation	m	0	0	0	0
EBIT	m	23,934	27,059	27,772	31,954	EBIT	m	26,315	30,602	28,968	29,880
Net Interest Income	m	-1,860	-1,354	-1,509	-1,341	Net Interest Income	m	-1,217	-1,258	-1,258	-1,258
Associates	m	0	0	0	0	Associates	m	0	0	0	0
Exceptionals	m	0	0	0	0	Exceptionals	m	0	0	0	0
Other Pre-Tax Income	m	3,190	2,440	3,555	4,630	Forex Gains / Losses	m	0	0	0	0
Pre-Tax Profit	m	25,264	28,145	29,818	35,243	Other Pre-Tax Income	m	5,591	4,973	5,405	6,663
Tax Expense	m	-8,790	-9,453	-9,585	-10,254	Pre-Tax Profit	m	30,689	34,317	33,115	35,285
Net Profit	m	16,474	18,693	20,234	24,989	Tax Expense	m	-5,435	-9,985	-9,635	-10,266
Minority Interests	m	0	0	0	0	Net Profit	m	25,254	24,333	23,480	25,019
	m					Minority Interests	m	0	0	0	0
Reported Earnings		16,474	18,693	20,234	24,989	Reported Earnings	m	25,254	24,333	23,480	25,019
Adjusted Earnings	m	16,474	18,693	20,234	24,989	Adjusted Earnings	m	25,254	24,333	23,480	25,019
	m										
EPS (rep)		19.48	22.10	23.93	29.55	EPS (rep)		29.86	28.77	27.77	29.59
EPS (adj)		19.48	22.10	23.93	29.55	EPS (adj)		29.86	28.77	27.77	29.59
EPS Growth (adj)	%	40.09	13.47	8.24	23.5	EPS Growth (adj)	%	1.1	-3.6	-3.5	6.6
	%				9.5	PE (rep)	x	9.8	10.2	10.6	9.9
					9.5	PE (adj)	x	9.8	10.2	10.6	9.9
Total DPS		7.00	8.00	9.08	10.00	Total DPS		10.45	10.07	9.72	10.35
Weighted Average Shares	%	846	846	846	846	Total Div Yield	%	3.6	3.4	3.3	3.5
Period End Shares	%	846	846	846	846	Weighted Average Shares	m	846	846	846	846
						Period End Shares	m	846	846	846	846

Profit and Loss Ratios					Cashflow Analysis						
		2007A	2008E	2009E	2010E		2007A	2008E	2009E	2010E	
Revenue Growth	%	-1.4	8.1	7.8	20.9	EBITDA	m	32,531	39,076	38,572	40,474
EBITDA Growth	%	-14.3	20.1	-1.3	4.9	Tax Paid	m	-5,435	-9,985	-9,635	-10,266
EBIT Growth	%	-17.6	16.3	-5.3	3.1	Chgs in Working Cap	m	1,132	846	3,022	7,805
Gross Profit Margin	%	28.5	24.7	21.8	25.6	Net Interest Paid	m	-1,217	-1,258	-1,258	-1,258
EBITDA Margin	%	19.7	21.9	20.0	17.4	Other	m	-3,014	534	515	549
EBIT Margin	%	15.9	17.1	15.0	12.8	Operating Cashflow	m	23,997	29,212	31,217	37,304
Net Profit Margin	%	15.3	13.6	12.2	10.7	Acquisitions	m	0	0	0	0
Payout Ratio	%	35.0	35.0	35.0	35.0	Capex	m	-29,650	-23,265	-22,500	-20,000
EV/EBITDA	x	7.2	6.0	6.0	5.7	Asset Sales	m	0	0	0	0
EV/EBIT	x	8.8	7.6	8.0	7.8	Other	m	5,591	4,973	5,405	6,663
						Investing Cashflow	m	-24,059	-18,292	-17,095	-13,337
Balance Sheet Ratios						Dividend (Ordinary)	m	-8,839	-8,516	-8,218	-8,757
ROE	%	22.8	19.2	16.5	15.8	Equity Raised	m	0	0	0	0
ROA	%	14.4	15.4	13.3	12.4	Debt Movements	m	0	0	0	0
ROIC	%	27.7	21.0	17.6	15.0	Other	m	6	-0	0	-0
Net Debt/Equity	%	-13.1	-13.3	-5.9	-2.4	Financing Cashflow	m	-8,832	-8,516	-8,218	-8,757
Interest Cover	x	21.6	24.3	23.0	23.8						
Price/Book	x	2.1	1.8	1.7	1.5	Net Chg in Cash/Debt	m	-8,895	2,404	5,904	15,210
Book Value per Share		140.8	159.5	177.6	196.8						

Balance Sheet					Balance Sheet						
		2007A	2008E	2009E	2010E		2007A	2008E	2009E	2010E	
Cash	m	36,504	38,908	29,812	25,022	Cash	m	36,504	38,908	29,812	25,022
Receivables	m	7,708	8,412	9,143	11,270	Receivables	m	7,708	8,412	9,143	11,270
Inventories	m	4,961	5,414	5,885	7,254	Inventories	m	4,961	5,414	5,885	7,254
Investments	m	14,024	14,024	29,024	49,024	Investments	m	14,024	14,024	29,024	49,024
Fixed Assets	m	110,869	125,660	138,555	147,961	Fixed Assets	m	110,869	125,660	138,555	147,961
Intangibles	m	0	0	0	0	Intangibles	m	0	0	0	0
Other Assets	m	15,415	15,415	15,415	15,415	Other Assets	m	15,415	15,415	15,415	15,415
Total Assets	m	189,480	207,833	227,834	255,946	Total Assets	m	189,480	207,833	227,834	255,946
Payables	m	16,002	16,822	18,553	23,184	Payables	m	16,002	16,822	18,553	23,184
Short Term Debt	m	829	829	829	829	Short Term Debt	m	829	829	829	829
Long Term Debt	m	20,130	20,130	20,130	20,130	Long Term Debt	m	20,130	20,130	20,130	20,130
Provisions	m	6,016	6,324	6,975	8,716	Provisions	m	6,016	6,324	6,975	8,716
Other Liabilities	m	27,433	28,840	31,198	36,675	Other Liabilities	m	27,433	28,840	31,198	36,675
Total Liabilities	m	70,409	72,946	77,685	89,534	Total Liabilities	m	70,409	72,946	77,685	89,534
Shareholders' Funds	m	119,071	134,887	150,149	166,412	Shareholders' Funds	m	119,071	134,887	150,149	166,412
Minority Interests	m	0	0	0	0	Minority Interests	m	0	0	0	0
Other	m	0	0	0	0	Other	m	0	0	0	0
Total S/H Equity	m	119,071	134,887	150,149	166,412	Total S/H Equity	m	119,071	134,887	150,149	166,412
Total Liab & S/H Funds	m	189,480	207,833	227,834	255,946	Total Liab & S/H Funds	m	189,480	207,833	227,834	255,946

All figures in INR unless noted.

Source: Macquarie Research, May 2007

Important disclosures:**Recommendation definitions****Macquarie Australia/New Zealand**

Outperform – return >5% in excess of benchmark return (>2.5% in excess for listed property trusts)
 Neutral – return within 5% of benchmark return (within 2.5% for listed property trusts)
 Underperform – return >5% below benchmark return (>2.5% below for listed property trusts)

Macquarie Asia

Outperform – expected return >+10%
 Neutral – expected return from -10% to +10%
 Underperform – expected return <-10%

Macquarie First South Securities (South Africa)

Outperform – expected return >+5%
 Neutral – expected return from -5% to +5%
 Underperform – expected return <-5%

Recommendations – 12 months

Note: Quant recommendations may differ from Fundamental Analyst recommendations

Recommendation proportions

	AU/NZ	Asia	RSA
Outperform	44.37%	58.37%	42.60%
Neutral	44.01%	21.30%	46.80%
Underperform	11.62%	20.33%	10.60%

For quarter ending 31 March 2007

Volatility index definition*

This is calculated from the volatility of historic price movements.

Very high–highest risk – Stock should be expected to move up or down 60–100% in a year – investors should be aware this stock is highly speculative.

High – stock should be expected to move up or down at least 40–60% in a year – investors should be aware this stock could be speculative.

Medium – stock should be expected to move up or down at least 30–40% in a year.

Low–medium – stock should be expected to move up or down at least 25–30% in a year.

Low – stock should be expected to move up or down at least 15–25% in a year.

* Applicable to Australian/NZ stocks only

Financial definitions

All "Adjusted" data items have had the following adjustments made:

Added back: goodwill amortisation, provision for catastrophe reserves, IFRS derivatives & hedging, IFRS impairments & IFRS interest expense
 Excluded: non recurring items, asset revals, property revals, appraisal value uplift, preference dividends & minority interests

EPS = adjusted net profit / efpowa*

ROA = adjusted ebit / average total assets

ROA Banks/Insurance = adjusted net profit / average total assets

ROE = adjusted net profit / average shareholders funds

Gross cashflow = adjusted net profit + depreciation

*equivalent fully paid ordinary weighted average number of shares

All Reported numbers for Australian/NZ listed stocks are modelled under IFRS (International Financial Reporting Standards).

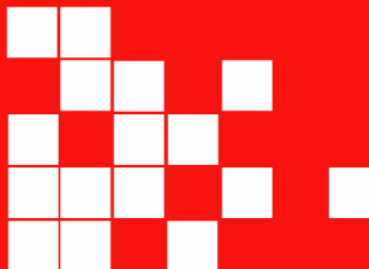
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