India | Oil & Gas

15 December 2011

Gujarat State Petronet

Valuations attractive to ride long-term upside

- The stock is building in the risk of sub-par returns from new cross country pipelines, but does not reflect (1) improving LNG visibility in the long run and (2) value residing in the city gas venture. Upgrade to Outperform.
- Weak gas supply outlook to impact transmission volumes (cut 2-20% over FY12-15E). However, long-term outlook is cushioned by better LNG visibility. While FY13-14E EPS is cut 7-20%, impact on DCF is lower at Rs102 (Rs105).
- We factor in value destruction from new pipelines at Rs(13)/sh based on 8% equity IRR vs. COE of 14%.
- However, value accretive stake in CGD (11% of FY11 consol profits) provide upside risk; we factor in Rs11/sh.

Volume risk + value destruction from new pipelines, in the price now. GSPL's current price adequately captures gas transmission volume concerns as also sub par returns on 3 cross country pipelines. We have moderated GSPL's transmission volumes in Gujarat by 2-20% over FY12-15E. This leads to earnings cut of 7-20% over FY13-14E but DCF impact is more moderate Rs102 (Rs105) as long-term volume outlook (FY16E and beyond) is cushioned by improving LNG visibility.

Real risk of subpar returns on cross-country pipelines. We don't share management's optimism - 40% utilisation initially & IRR of 15%. Even though long-term supply outlook can improve, we build in value destruction from new pipelines at Rs(13)/sh based on estimated equity IRR at 8% only (below cost of equity).

Factoring in the CGD upside. GSPL's value accretive stake in 2 CGD's - GSPC Gas (India's largest CGD play) and Sabarmati Gas (cumulative FY11 profit of Rs1.8bn, 11% of GSPL's PAT) offer material upside risk. We value CGD at Rs11/sh based on 15x FY11 (25% discount to IGL) and a 25% holdco discount.

Tariff concerns overdone. Even as we have moderated our gas transmission volumes we have upped the tariffs to Rs850/tcm (Rs800/tcm earlier) over FY13-15E to compensate for lower volumes and high capital expenditure. Despite the changes to tariff assumptions, our post-tax RoCE remains reasonable at 11.2-12% over FY13-18E, and within the norm. We therefore don't foresee risk to tariffs.

Risks. Any change in the LNG supply outlook (especially the rise of US as an exporter) could alter the long-term capacity utilisation of GSPL's pipelines, existing and new. Sharp swings in LNG prices and continued rupee weakness could impact the affordability of LNG.

OUTPERFORM (IN LINE)

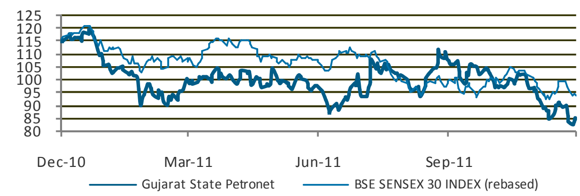
PRICE as at 14 December 2011	PRICE TARGET
Rs84.10	**Rs100.00**
Bloomberg code	**Reuters code**
GUJS IN	GSPT.BO
Market cap	**12 month range**
Rs47,313m (US$881m)	Rs82.55 - 119.30

EPS adj est change 2012E 0.4% 2013E -7.3%

Year end: March	FY11	FY12E	FY13E	FY14E
Sales (Rsm)	10,391	10,851	11,302	11,659
EBIT (Rsm)	8,320	8,058	8,169	8,230
EBITDA (Rsm)	9,620	10,069	10,518	10,847
Pretax profit (Rsm)	7,650	7,292	7,499	7,767
Earnings (Rsm) adjusted	5,064	5,082	4,964	5,142
Diluted EPS (Rs) adjusted	9.0	9.0	8.8	9.1
Diluted EPS growth (%) adj.	22.4	0.3	-2.3	3.6
DPS (Rs)	1.2	1.2	1.2	1.2
EBITDA margin (%)	92.6	92.8	93.1	93.0
EBIT margin (%)	80.1	74.3	72.3	70.6
Net margin (%)	48.7	46.8	43.9	44.1
Div payout (%)	13.6	13.6	13.6	13.6
Book value/share (Rs)	36	43	51	58
Net debt/Equity (x)	0.6	0.5	0.4	0.2
Net debt/EBITDA (x)	1.3	1.2	1.0	0.7
ROE (%)	28.4	22.9	18.8	16.8
ROCE (%)	25.6	20.4	18.5	17.4
FCF (Rsm)	-2,023	650	2,439	3,728
EV/Sales (x)	5.6	5.5	5.3	4.9
EV/EBITDA (x)	6.0	5.9	5.7	5.3
PBR (x)	2.4	1.9	1.7	1.4
PER (x)	9.3	9.3	9.5	9.2
Dividend yield (%)	1.5	1.5	1.4	1.5

Source: Company, Standard Chartered Research estimates

Share price performance



Share price (%)	-1 mth	-3 mth	-12 mth
Ordinary shares	-13	-22	-30
Relative to Index	-6	-18	-12
Relative to Sector	-	-	-
Major shareholder			Promoter (37.7%)
Free float			62%
Average turnover (US$)			3,470,947

Source: Company, FactSet

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Important disclosures can be found in the Disclosures Appendix

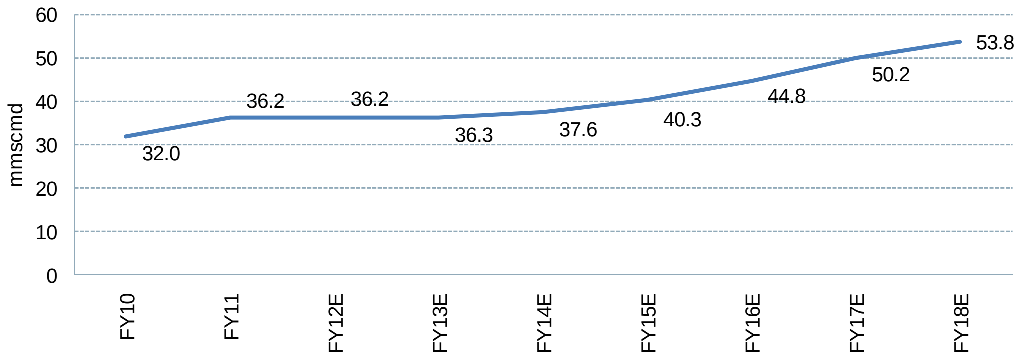
Near term hiccups, but volumes to improve in LT

Domestic gas supplies have been on a downward spiral led by production fall at RIL's KG-D6 and PMT. KG-D6 supplies, after averaging ~47mmscmd for 1HFY12, have slipped to ~40mmscmd as on 28 Nov 2011. Weak domestic supplies have been partly compensated by higher volumes at PLNG and Hazira LNG terminal. Volumes will get some support from LNG terminal expansion and new Dabhol terminal coming on stream.

Even as gas supplies remain tight, for GSPL, the bulk of incremental gas demand is expected from new gas based power plants – 1,050MW capacity addition by FY13 accounting for 4.8mmscmd volume uptick. However, limited domestic supplies and high price of imported LNG has meant the power plants are likely to remain largely non operational or operate at low operating rates.

To factor in weak supplies in medium term and reliance on power space, we have moderated our transmission volume assumption to 36/36/38 for FY12/13/14E vs earlier assumption of 37/41/47mmscmd.

Fig 1 – Gas transmission volume chart



Source: Company, Standard Chartered research estimate

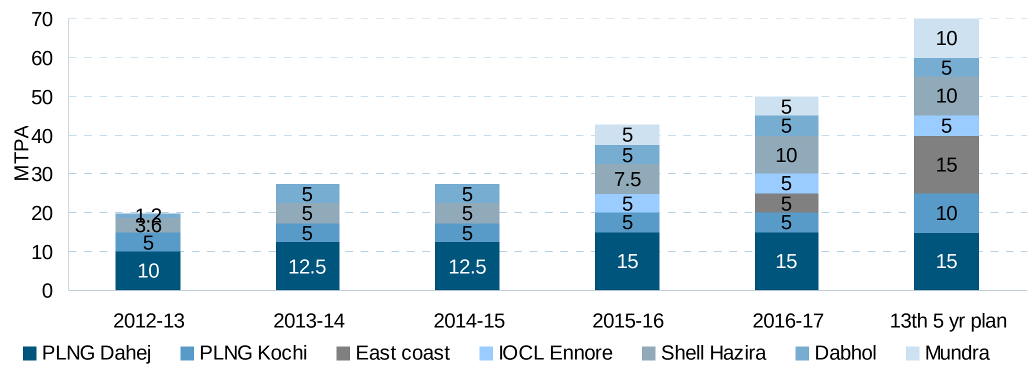
However, long-term volume to ride on improving LNG supplies

Even as supplies are expected to remain weak over the near to medium term, long-term supply improvement is likely to be led by new LNG capacities coming on stream. We expect gas supplies to improve sharply to 329mmscmd by 2017 against current supplies of 182mmscmd. This improvement will be driven by ramp up in LNG capacities, which are expected to contribute ~50% of supplies in 2017, as per the 12th Five Year Plan. However, our estimates are conservative against government's supply expectation of 394mmscmd during the same period.

Our estimates factor in slower ramp up in LNG capacities given likely delays in green-field projects as also low levels of long-term contracted volume.

For the 13th Five Year Plan, the government expects supply to ramp up to 531mmscmd by 2022. Rising supplies will support long term volume momentum for GSPL's pipeline network.

Fig 2 – India's LNG capacity buildup over next decade



Source: Infraline, GAIL

Fig 3 – Base case gas supply

(mmscmd)	FY12E	FY13E	FY14E	FY15E	FY16E	FY17E	FY18E	FY19E	FY20E
ONGC	64	64	68	70	72	90	100	100	100
ONGC-JV excl PMT	1	1	1	1	1	1	1	1	1
PMT	11	11	10	9	9	9	8	8	8
OIL India	8	8	8	8	8	8	7	7	7
GSPC			2	3	3	4	4	4	4
RIL									
KGD6	44	41	41	45	55	60	65	70	70
NEC-25					5	10	15	15	15
KGD3						10	15	20	20
LNG									
Petronet- Dahej	41	42	44	48	51	51	51	51	51
Petronet- Kochi			6	8	15	19	19	19	19
Dabhol		6	8	11	15	19	19	19	19
Shell- Hazira	13	13	19	19	19	19	19	19	19
Mundra					10	19	19	19	19
East coast					6	10	19	19	19
Total	**182**	**186**	**206**	**221**	**269**	**329**	**362**	**372**	**372**

Source: Standard Chartered research estimate

Concerns on tariff cuts overdone

Even as we take a conservative view on gas transmission volumes for GSPL, we don't share market concerns of downward revision in tariffs for the existing pipeline network in Gujarat. To factor in weak volumes and high capex of Rs15bn for FY12-14E (on existing Gujarat network), we have upped our tariff assumptions to Rs850/tcm over FY13-15E vs Rs800/tcm assumed earlier.

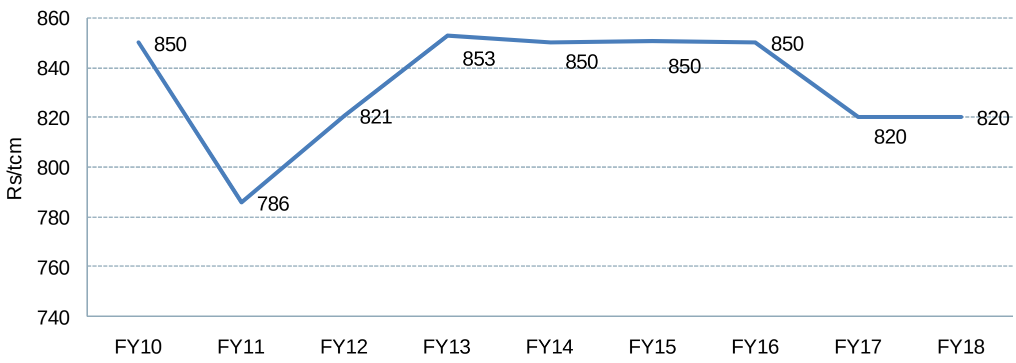
PNGRB guidelines prescribe pipeline operators to get 12% post tax RoCE over the life of the asset. GSPL's adjusted post tax RoCE over FY04-11 has averaged 10.6% led by volume ramp ups and high capex (Rs41bn) and average tariffs of Rs714/tcm. With volumes being moderated and capital expenditure high, we have increased tariffs to Rs850/tcm over FY13-15E. However, we maintain long term tariffs at Rs820/tcm.

In order to assess the normalised RoCE (to adjust for GSPL's higher depreciation rates till FY10), we define "Adjusted" post tax RoCE for FY11E onwards as:

PBIT* (1-tax)/ (Average capital employed of 2 years + estimated extra depreciation of Rs4.4bn)

GSPL followed an accelerated depreciation policy wherein the company depreciated asset over 12 years (8.33%). However, recently GSPL changed depreciation to 3.17%. We therefore add back cumulative additional depreciation charge (excess of 8.33% over 3.17%) to calculate the normalised capital employed.

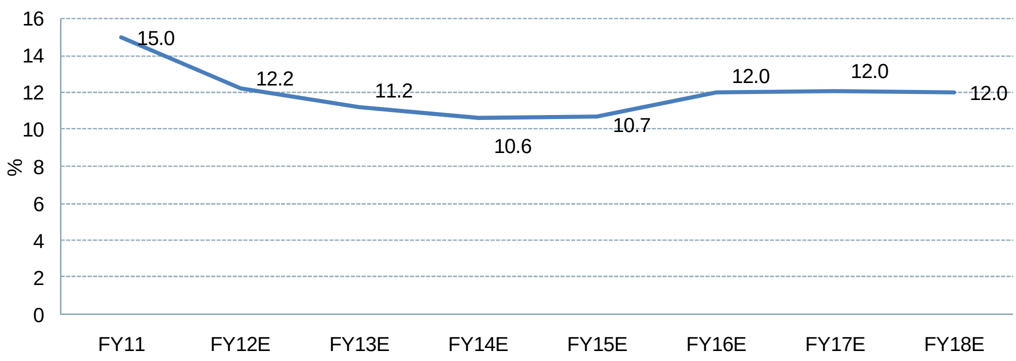
Fig 4 – GSPL's transmission tariff movement



Source: Company, Standard Chartered research estimate

Even with the changed tariff assumptions, the post-tax RoCE remains reasonable at 11-12% over FY12-18E and well within the norm. We therefore think that the risk of tariff cuts is overdone.

Fig 5 – Adjusted post-tax ROCE FY11-18E



Source: Company, Standard Chartered research estimate

Cross country pipelines: Back-ended and sub-par returns

GSPL has recently won a contract for laying three long distance pipelines 1) Mehsana (Gujarat) to Bhatinda (Punjab); 2) Bhatinda to Srinagar (J&K); and 3) Mallavaram (Andhra Pradesh) to Bhilwara (Rajasthan). These pipelines are to be built in consortium with IOCL (26% stake), BPCL (11% stake) and HPCL (11% stake) with GSPL having a majority stake of 52%.

Fig 6 – GSPL's cross country pipeline details

Name of Pipeline	Length (kms)	Project Cost (Rs bn)	GSPL's equity investment Rs bn	Levellised tariff (Rs/mmbtu)	Capacity (mmscmd)
Mehsana (Gujarat) to Bhatinda (Punjab)	1,611	45	13.5	32.6	42
Bhatinda (Punjab) to Srinagar (J&K)	740	12	3.6	9.0	31
Mallavaram (Kakinada, AP) to Bhilwara (Rajasthan)	1,688	65	19.5	29.9	52
Total			**36.6**		

Source: Company

These pipelines are to be commissioned over the next three years at a capex of Rs122bn. However, unlike the old pipelines (GSPL's existing network in Gujarat, etc) where PNGRB guidelines prescribe 12% post tax RoCE (with D/E of 1:1 and tax benefits, RoE of 20-25% is possible), for the new pipelines won in a competitive auction returns are flexible.

That coupled with competition from RIL's and GAIL's pipelines will impact the utilisation of GSPL's network, notwithstanding the green-field LNG projects expected to dot Indian shores in addition to the deep water supplies from the east coast that would come on stream.

With RIL's East-West pipeline, built with reportedly expandable capacity of 120mmscmd, against current volumes of ~40mmscmd, we believe any new RIL volume will use the captive pipeline. That apart, GAIL (PLNG stake at 12.5%) with marketing rights for ONGC supplies will mean that GSPL's cross border pipelines may need to rely largely on Mundra terminal and Deen Dayal supply (estimated to peak at 6mmscmd).

Even as management expects 40% utilisation levels to start with, largely led by opportunities in central India viz Bina and Bhatinda refinery and Naptha based fertiliser units, weak domestic supplies given long gestation of deep water and LNG projects, mean there is a real risk of equity IRRs dipping below the management target of15%. We estimate sub-par equity IRR of 8%, leading us to factor in a value destruction of Rs(13)/share in the SOTP.

City Gas Distribution- value accretive stake

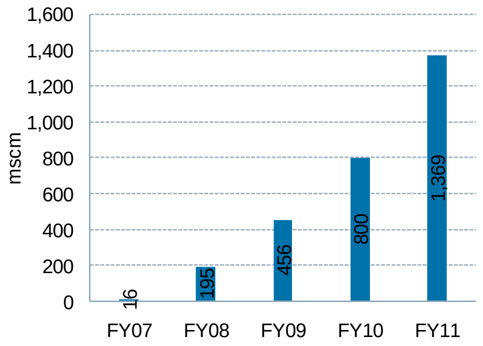
GSPL holds stakes in City Gas Distribution companies in Gujarat - 36.59% stake in GSPC Gas and 13.75% stake in Sabarmati Gas Ltd. Both the associate entities have shown strong volume momentum across CNG and PNG given rich industrial customer base.

GSPC Gas

GSPC Gas operates India's largest City Gas Distribution (CGD) business in 20 cities in south and central Gujarat and Saurashtra. The company sources gas from LNG terminals of PLNG and Shell Hazira as also BG's (Panna-Mukta-Tapti fields) and GSPC's Hazira field. Gas sales volumes have increased at >200% CAGR over FY07-11 led by strong growth across CNG and PNG with average daily volumes of 3.75mmscmd in FY11.

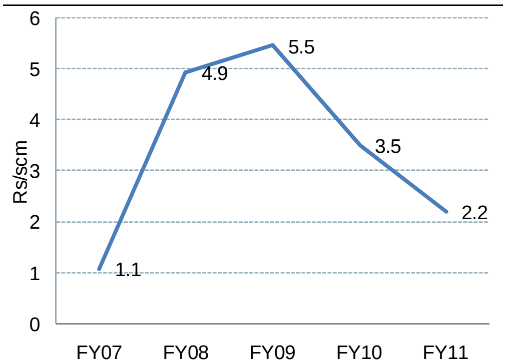
For FY11, GSPC Gas had revenue of Rs19bn and profit of Rs1.5bn. The associate company currently operates 120 CNG stations with customer base of 280,000 domestic customers and 1,000 industrial customers. Sharp volatility in gas prices have meant that GSPC Gas's gross margin have come off to Rs2.2/scm for FY11.

Fig 7 – GSPC Gas sales volume



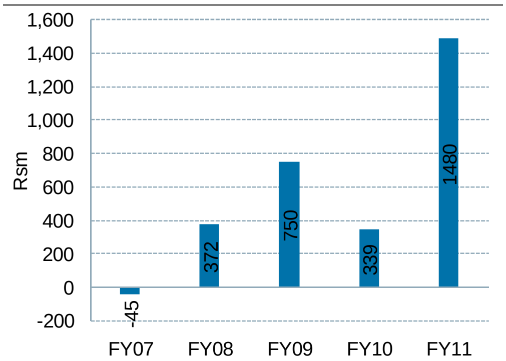
Source: Company

Fig 8 – Gross margin/scm



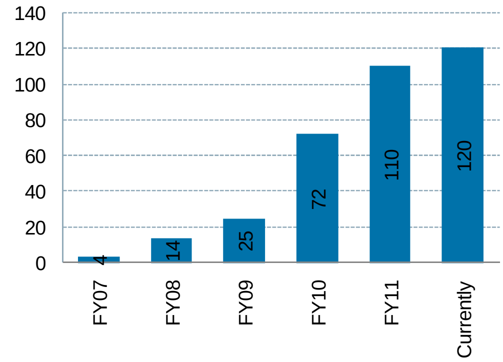
Source: Company

Fig 9 – GSPC Gas profit growth



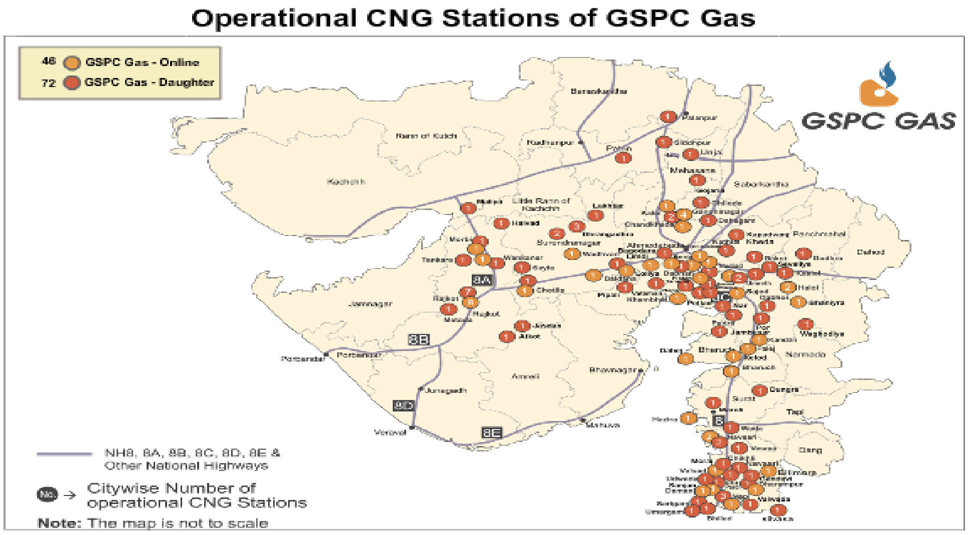
Source: Company

Fig 10 – GSPC Gas station network growth



Source: Company

Fig 11 – GSPC Gas station spread

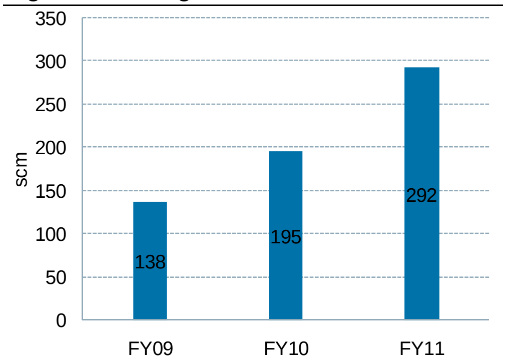


Source: Company

Sabarmati Gas:

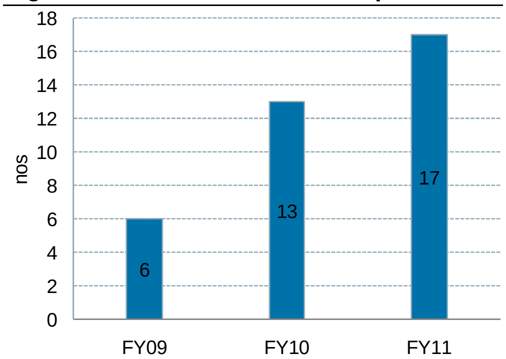
Sabarmati Gas Ltd (SGL) is a joint venture with BPCL, set up in 2006, for the development of city gas distribution networks in Gandhinagar, Mehsana and Sabarkantha districts of Gujarat. SGL's volumes have increased at a CAGR of 46% over FY09-11 to 292mscm. The associate company had revenue of Rs4.6bn for FY11 and profit of Rs270m. SGL had 17 CNG stations for FY11 and intends to nearly double station network by FY14. As of December 31, 2010 Sabarmati Gas had 39,235 (153 industrial customers, 38,882 domestic customers and 200 commercial customers) customers.

Fig 12 – SGL's gas sales volume



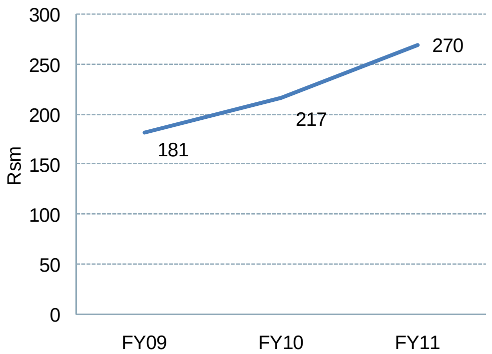
Source: Company

Fig 13 – SGL's station network spread



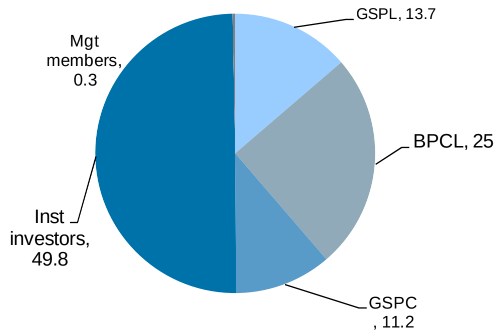
Source: Company

Fig 14 – SGL's earnings growth



Source: Company

Fig 15 – SGL's shareholding pattern



Source: Company

We have valued GSPL's stake in the two CGD companies at 15x (25% discount to IGL target multiple) and ascribed a 25% holding company discount. Accordingly, we have valued GSPL's stake at Rs11/sh.

Valuation discount to IGL is justified by (1) lower gross margin profile for GSPC Gas vs IGL (Rs2.2/scm vs Rs7.8/scm for IGL) given higher proportion of PNG sales (margins lower compared to CNG) and (2) greater exposure to price risk given the recent reference to CCI in Gujarat.

Fig 16 – GSPL CGD valuation

	GSPL stake	FY11 PAT	GSPL's share
GSPC Gas	36.59%	1,480	542
Sabarmati gas	13.75%	270	37
Total			579
IGL FY11 PER (x)			20
PER @25% discount (x)			15
GSPL stake value with 25% holdco discount (Rs m)			6,352
Value per share (Rs)			11

Source: Standard Chartered research estimate

Valuation: Incorporating CGD & value dilution from new pipelines

Our price target of Rs100 is based on DCF of core business and adding value of CGD stake and cross border pipelines

We have a DCF-based SOTP price target of Rs100for GSPL based on WACC of 11.3% and target D/E of 40%. While the core business has been valued on DCF at Rs102, CGD business is valued at Rs11 while value destruction from cross border pipelines stands at Rs(13).

Fig 17 – GSPL Target price calculation

Rs/sh	
Gujarat transmission network (DCF based)	102
Cross country pipeline	-13
City gas distribution	11
Target price	**100**

Source: Standard Chartered research estimate

Our DCF model of the existing business (ex- new pipelines) builds in a risk-free rate of 8%, risk premium of 6%, beta of 1 and terminal growth rate of 3%. We prefer DCF to traditional valuation multiples given the utility nature of the business and predictability of cash flow.

Fig 18 – GSPL's Gujarat network DCF table

Rs m	2012	2013	2014	2015	2016	2017	2018	Terminal
EBIT	8,058	8,169	8,230	8,795	10,664	11,528	12,389	12,761
Less: Tax	(1,950)	(2,237)	(2,317)	(2,573)	(3,243)	(3,634)	(4,043)	(4,211)
Less: Tax savings on interest	(387)	(422)	(422)	(422)	(422)	(422)	(422)	(435)
Add: Depreciation	2,011	2,349	2,617	2,836	2,212	2,352	2,491	2,566
Add: Decrease in net WC	(443)	126	(31)	135	612	259	276	276
Less: Capex	(6,000)	(5,000)	(4,000)	(4,000)	(4,000)	(4,000)	(4,000)	(2,949)
Free Cash Flow to Firm	**1,290**	**2,984**	**4,077**	**4,771**	**5,824**	**6,082**	**6,692**	**8,008**
Total Firm value	69117							
Less: Net Debt	11626							
Total Equity value	57491							
Value per share (Rs)	**102**							

Source: Standard Chartered Research estimate

- We estimate GSPL's FY12-14E EBITDA to post CAGR of 4% driven by higher tariffs and flat volumes.
- We expect GSPL's earnings to remain flat given rising finance and depreciation charges.

Fig 19 – Assumptions

Key assumptions	FY11	FY12E	FY13E	FY14E	FY15E
Gas transmission volumes (mmscmd)	36.2	36.2	36.3	37.6	40.3
Gas transmission tariffs (Rs/tcm)	786	821	850	850	850

Source: Standard Chartered Research estimates

Fig 20 – Earnings changes

	Old	New	% chg	Old	New		Old	New	% chg
(Rs m)	FY12	FY12		FY13	FY13	% chg	FY14	FY14	
EBIDTA	10,043	10,069	0.3	11,078	10,518	-5.1	12,586	10,847	-13.8
PAT	5,064	5,082	0.4	5,357	4,964	-7.3	6,423	5,142	-19.9

Source: Standard Chartered Research estimates

Fig 21 – Income statement

Rs mn	FY11	FY12E	FY13E	FY14E
Sales	**10,391**	**10,851**	**11,302**	**11,659**
Employee expenses	153	183	202	222
SG&A expenses & Marketing expenses	261	287	316	348
Other operating expenses	357	312	267	242
EBITDA	**9,620**	**10,069**	**10,518**	**10,847**
Depn and amort.	1,299	2,011	2,349	2,617
EBIT	**8,320**	**8,058**	**8,169**	**8,230**
Net int. income/exp.	961	1,143	1,248	1,248
Prior period adj				
Other non-op inc./exp.	291	377	579	786
PBT	7,650	7,292	7,499	7,767
Provision for taxes	2,586	2,210	2,535	2,626
Reported net profit	5,064	5,082	4,964	5,142
Reported net profit	**5,064**	**5,082**	**4,964**	**5,142**
Wtd avg # of shares	563	563	563	563
EPS (dil., adj.) (Rs)	**9.0**	**9.0**	**8.8**	**9.1**
DPS (Rs)	1.2	1.2	1.2	1.2
Divid payout ratio (%)	13.6	13.6	13.6	13.6

Source: Company, Standard Chartered Research estimates

Fig 22 – Balance sheet

Rs mn	FY11E	FY12E	FY13E	FY14E
Cash and equiv.	2,390	5,497	7,448	10,672
A/c.s receivable	698	729	759	783
Loans and adv.	5,120	5,632	6,195	6,814
Inventory	623	650	677	699
Other current assets	169	181	195	211
Total curr. assets	**8,999**	**12,688**	**15,274**	**19,178**
Accounts payable	2,430	4,925	5,417	5,959
Short term debt	53	53	53	53
Other curr. liab.	5,157	2,804	3,073	3,183
Total curr. liab.	**7,586**	**7,728**	**8,490**	**9,141**
Net curr. assets	**1,413**	**4,960**	**6,784**	**10,037**
Net fixed assets	35,363	39,352	42,003	43,386
Investments	766	766	766	766
Total assets	**37,541**	**45,077**	**49,553**	**54,188**
Long term debt	14,782	17,782	17,782	17,782
Shareholders' funds	20,066	24,342	28,519	32,845
Deferred tax liability	2,641	2,901	3,199	3,508
Total liab. and equity	**37,541**	**45,077**	**49,553**	**54,188**
BVPS (Rs)	**35.7**	**43.3**	**50.7**	**58.4**

Source: Company, Standard Chartered Research estimates

Fig 23 – Cash Flow Statement

Rs mn	FY11	FY12E	FY13E	FY14E
PAT	5,064	5,082	4,964	5,142
D&A add back	1,299	2,011	2,349	2,617
(Inc)/dec in w. cap	-1547	-443	126	-31
Cash flow from op. (A)	**4,817**	**6,650**	**7,439**	**7,728**
Cap exp. (B)	-6,839	-6,000	-5,000	-4,000
Investments	-99.96	0	0	0
Cash flow from investing	**-6,939**	**-6,000**	**-5,000**	**-4,000**
Divids pd (com. and pref.)	-803	-806	-787	-815
Inc. in equity	1	0	0	0
Inc./(dec.) in debt	2239	3000	0	0
Other financing cash flows	1,236	263	300	311
Cash flow from financing	**2,674**	**2,457**	**-487**	**-505**
Total cash flow	**551**	**3,106**	**1,952**	**3,223**

Source: Company, Standard Chartered Research estimates

Fig 24 – Valuations

	FY11E	FY12E	FY13E	FY14E
P/E (x)	9.2	9.2	9.4	9.1
Adj P/E (x) (normalised for depreciation)	9.5	8.9	9.0	8.6
P/CEPS	7.3	6.6	6.4	6.0
EV/EBITDA (x)	6.0	5.9	5.6	5.3
P/B (x)	2.3	1.9	1.6	1.4
Adj P/B (x) (normalised for depreciation)	1.9	1.6	1.4	1.3
Div yield (%)	1.5	1.5	1.4	1.5
Free cash flow yield (%)	-4.3	1.4	5.2	8.0

Source: Company, Standard Chartered Research estimates

Fig 25 – Ratios

Ratios	FY11E	FY12E	FY13E	FY14E
Pretax ROCE (%)	25.6	20.4	18.5	17.4
Post tax adj ROCE (%)	15.0	12.2	11.2	10.6
ROE (%)	28.4	22.9	18.8	16.8
Adj ROE (%)	22.7	19.1	16.1	14.6

Source: Company, Standard Chartered Research estimates

Disclosures appendix

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As of 30 September 2011

Research Recommendation

Terminology	Definitions
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