23 July 2009 | 8 pages

Gujarat State Petronet (GSPT.BO)

Equity

Buy: 1Q – Blockbuster Quarter

- **Blowout 1Q, well ahead of estimates** — GSPL's 1Q10 profit surged 147% yoy and 132% qoq, driven by strong volume growth and the effect of huge operating leverage. 1Q reported net profit came in at Rs805m vs. our estimate of Rs512m.
- **Transportation volumes double, revenues +76% yoy** — GSPL transported 25.3 mmscmd of volumes in 1Q vs. 12.8 mmscmd in the previous quarter. While volume growth was in line with our expectations, driven by commencement of KG gas volumes in the quarter (c6-7 mmscmd) and an increase in spot LNG volumes (c7-8 mmscmd), the surprise in top-line was due to higher than expected average transportation charge of Rs915/tcm, likely due to take-or-pay contracts, increase in volumes to customers, and longer distances. However, we await further clarity and detail from management.
- **Operating leverage to the fore; EBITDA margin of 94%** — 1Q results exhibited the huge operating leverage inherent in GSPL's business model, with the sharp spurt in volumes not translating to a proportionate increase in operating costs (which are largely fixed in nature). Higher depreciation and interest costs, on account of capitalisation of new pipelines, did partly have an impact below the operating line, but this was largely expected and in line.
- **Maintain Buy; Top gas pick** — GSPL remains our top pick among the Indian gas utilities and we maintain a Buy/Medium Risk. Outstanding results and faster than expected ramp up in volumes add upside risks to our estimates, although we await further details from the management conference call. Value accretion at 2x P/B from new pipeline approvals could add further upside.

Buy/Medium Risk	**1M**
Price (23 Jul 09)	Rs63.10
Target price	Rs70.00
Expected share price return	10.9%
Expected dividend yield	0.6%
Expected total return	**11.5%**
Market Cap	Rs35,476M US$733M

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)	Adj P/E[1] (x)	P/B (x)	Adj P/B[1] (x)	P/CEPS (x)	EV/EBITDA (x)	ROE (%)	Adj ROE[1] (%)
2007A	894	1.6	58.4	38.4	28.9	3.5	3.0	17.9	14.5	9.5%	13.7%
2008A	999	1.8	7.9	35.5	22.6	3.1	2.5	13.5	11.6	9.5%	15.3%
2009E[2]	663	1.2	(33.6)	28.8	20.0	2.9	2.2	12.1	10.0	10.4%	14.8%
2010E	1,311	2.3	97.8	20.1	12.5	2.7	1.9	7.8	5.9	13.8%	19.6%
2011E	1,658	3.0	26.4	18.8	11.6	2.4	1.6	6.8	5.7	13.5%	18.9%

Source: Citi Investment Research and Analysis.

[1]Normalised for depreciation. [2]FY09 reported PAT of Rs1,234m (EPS = Rs2.2) includes no social tax.

Saurabh Handa
+91-22-6631-9858
saurabh.handa@citi.com

Garima Mishra
garima.mishra@citi.com

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

Fiscal year end 31-Mar	2007	2008	2009E	2010E	2011E
Valuation Ratios					
P/E adjusted (x)	38.3	35.5	53.5	27.0	21.4
EV/EBITDA adjusted (x)	15.3	11.8	10.9	7.4	6.4
P/BV (x)	3.5	3.1	3.0	2.8	2.6
Dividend yield (%)	0.8	0.8	0.6	1.1	1.4
Per Share Data (Rs)					
EPS adjusted	1.65	1.78	1.18	2.33	2.95
EPS reported	1.65	1.78	1.18	2.33	2.95
BVPS	17.79	20.30	21.07	22.58	24.50
DPS	0.50	0.50	0.35	0.70	0.89
Profit & Loss (RsM)					
Net sales	3,176	4,179	4,721	7,525	9,135
Operating expenses	-1,521	-2,166	-2,266	-3,467	-4,147
EBIT	**1,655**	**2,013**	**2,455**	**4,058**	**4,988**
Net interest expense	-457	-815	-893	-1,393	-1,559
Non-operating/exceptionals	175	294	280	173	160
Pre-tax profit	**1,373**	**1,491**	**1,842**	**2,839**	**3,589**
Tax	-479	-492	-626	-676	-854
Extraord./Min.Int./Pref.div.	0	0	-553	-852	-1,077
Reported net income	**894**	**999**	**663**	**1,311**	**1,658**
Adjusted earnings	894	999	663	1,311	1,658
Adjusted EBITDA	2,681	3,645	4,163	6,611	7,975
Growth Rates (%)					
Sales	20.5	31.6	13.0	59.4	21.4
EBIT adjusted	43.6	21.6	22.0	65.3	22.9
EBITDA adjusted	38.0	36.0	14.2	58.8	20.6
EPS adjusted	58.4	7.9	-33.6	97.8	26.4
Cash Flow (RsM)					
Operating cash flow	**862**	**5,091**	**-972**	**3,290**	**4,403**
Depreciation/amortization	1,026	1,632	1,708	2,553	2,987
Net working capital	-1,058	2,460	-3,343	-574	-242
Investing cash flow	**-4,401**	**-6,177**	**-2,936**	**-5,000**	**-5,700**
Capital expenditure	-4,401	-5,821	-3,292	-5,000	-5,700
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	**2,540**	**885**	**2,767**	**3,540**	**-1,082**
Borrowings	2,852	1,022	3,000	4,000	-500
Dividends paid	-318	-329	-233	-460	-582
Change in cash	**-999**	**-201**	**-1,141**	**1,830**	**-2,379**
Balance Sheet (RsM)					
Total assets	**21,059**	**27,175**	**27,893**	**33,219**	**34,313**
Cash & cash equivalent	1,811	2,569	1,514	3,433	1,131
Accounts receivable	349	416	388	619	751
Net fixed assets	17,029	21,259	22,843	25,291	28,004
Total liabilities	**11,400**	**15,766**	**16,053**	**20,528**	**20,546**
Accounts payable	1,295	4,094	1,425	1,567	1,724
Total Debt	8,638	9,660	12,660	16,660	16,160
Shareholders' funds	**9,659**	**11,410**	**11,840**	**12,691**	**13,767**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	84.4	87.2	88.2	87.8	87.3
ROE adjusted	9.5	9.5	5.7	10.7	12.5
ROIC adjusted	7.6	8.0	8.1	12.8	13.9
Net debt to equity	70.7	62.2	94.1	104.2	109.2
Total debt to capital	47.2	45.8	51.7	56.8	54.0

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Figure 1. GSPL – 1QFY10 Results (Rupees in Millions)

Year to 31-Mar	1Q09	4Q09	1Q10	%yoy	Comments
Net sales	**1,195**	**1,320**	**2,108**	**76.4%**	Driven by: (i) higher qoq volumes and (ii) better than expected transportation charges
Employee costs	19	47	28	47.4%	4Q included provision for arrears on account of salary revision pending implementation
Gas transportation charges	0	17	4	nm	4Q included charge for final settlement with Ggas
Connectivity charges	32	0	0	-100.0%	
O&M expense of pipelines and compressors	32	78	60	86.8%	
Admin & others	36	49	36	0.9%	
Total expenditure	119	191	128	7.3%	
EBITDA	**1,076**	**1,129**	**1,980**	**84.1%**	
EBITDA margin	*90.0%*	*85.5%*	*93.9%*	*391 bps*	Huge operating leverage leading to significant increase in operating margins
Depreciation	415	439	550	32.7%	QoQ increase due to capitalisation of new pipelines
Interest	218	199	245	12.4%	QoQ increase due to capitalisation of new pipelines
Non-operating income	68	44	35	-48.5%	
Profit before tax	511	535	1,220	138.8%	
Tax	185	188	415	124.9%	No provision made for social tax contribution
- Current tax	164	94	381	132.1%	
- Deferred tax	20	93	34	66.7%	
Tax rate	*36.1%*	*35.1%*	*34.0%*	*-209 bps*	
Profit after tax	**326**	**348**	**805**	**146.6%**	
Cash profits	741	786	1,355	82.9%	
Operational parameters					
Gas transported (mmscm)	1,639	1,155	2,304	40.6%	
Gas transported (mmscmd)	18.0	12.8	25.3	40.6%	Significant pick up in volumes, albeit in line with estimates, driven by KG gas and spot LNG
Avg. transportation charge (Rs/tcm)	729	1,143	915	25.5%	

Source: Citi Investment Research and Analysis, Company Reports

Gujarat State Petronet

Company description

GSPL is a gas transmission company with a network of pipelines in the western Indian state of Gujarat. It has a gas transmission network of over 1,100 kms of pipeline connecting Hazira, Vadodara, Ahmedabad, Kalol, Himmatnagar, Mehsana, Rajkot, and Vapi. GSPL's network connects all major supply sources in Gujarat to important consumption centres in the state and transports c18-19 mmscmd of gas.

Investment strategy

We rate Gujarat State Petronet shares Buy / Medium Risk (1M). GSPL has set up an "open access" pipeline network in India's most vibrant gas market, Gujarat. Gujarat is the landfall of gas from India's western offshore fields (India's largest source of gas) with 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, continues to play an important role as an aggregator of gas demand and supplies. GSPL is highly levered to increasing supplies of gas in India, and gas production from Reliance's KG block as well as increasing imported LNG volumes, which will boost its transmission volumes, are key positives.

Valuation

Our target price of Rs70 is based on our DCF fair value for March-2010E. Our DCF assumptions are based on gas volumes tied up with Reliance (11 mmscmd), expected incremental volumes of c10 mmscmd to be consumed in Gujarat, and announced capex plans. We use DCF given the utility nature of the business, with steady cash flows, and to capture the value of the business over the longer term. Our valuation is based on explicit forecasts until FY12E, 39% CAGR of volumes over FY09-12E, FY12E transported volumes of 42 mmscmd, and a terminal growth of 3.0%. We use a WACC of 10.6% (risk-free 6.5%, risk premium 6.0%, beta of 1.0, cost of equity 12.6%, cost of debt 11.0%, target D/E of 0.7x). Also, on an adjusted P/B basis, GSPL would trade at 2.2x FY10E and 1.9x FY11E on our target price, which we believe is reasonable given adjusted ROEs increasing to 17-19% over the next few years as utilizations increase.

Risks

We assign a Medium Risk rating to GSPL shares. Key downside risks that could prevent the shares from reaching our target price include: 1) worsening of economics of spot LNG, which could impact our volume estimates; 2) political risk - the directive by the state government for the company to contribute 30% of pre-tax profits towards socio-economic projects is an adverse step; any move to increase this would be negative; 3) adverse impact, if any, of regulation of gas pipeline tariffs by the Petroleum and Natural Gas Regulatory Board; 4) project risk - GSPL is implementing expansion of its pipeline network that is subject to time and cost over-runs that could impact earnings.

Appendix A-1

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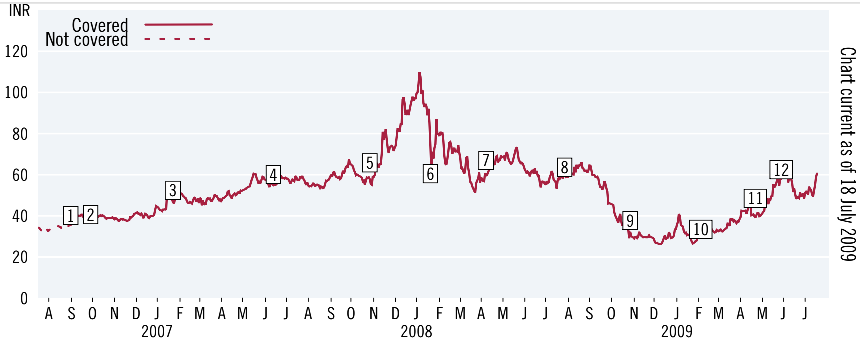
Fundamental Research
Analyst: Saurabh Handa
Covered since June 5 2007



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
5 26-Oct-07	1M	*74.00	57.75
6 21-Jan-08	*1L	*104.00	73.50
7 8-Apr-08	1L	*84.00	59.60
8 28-Jul-08	1L	*79.00	59.65
9 28-Oct-08	*2M	*36.00	32.25
10 4-Feb-09	*1M	*42.00	30.10
11 22-Apr-09	1M	*50.00	39.05
12 28-May-09	1M	*70.00	58.00

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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