

Oil&Gas and  
Petrochemicals

Target price Rs99

## Earnings revision

	FY10E	FY11E	FY12E
Sales	-	↑ 3.1	↑ 3.1
EBITDA	-	↑ 3.3	↑ 3.3
EPS	↓ 3.0	↑ 0.1	↓ 1.3

## Shareholding pattern

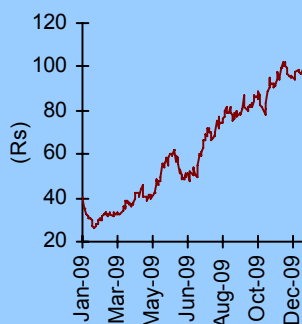
	Mar '09	Jun '09	Sep '09
Promoters	37.8	37.8	37.8
Institutional investors	20.5	21.9	27.3
MFs and UTI	4.5	7.3	9.8
FIs, Banks, Insurance Cos.	3.5	3.5	4.9
FII	12.5	11.1	12.6
Others	41.7	40.3	34.9

Source: NSE

## Target price revision

Rs99 from Rs104

## Price chart



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INDIA

## Gujarat State Petronet

**HOLD**

Downgrade from Buy

## EPC shocker – New pipeline bids to fail

**Rs99**

Reason for report: Recommendation change

We downgrade Gujarat State Petronet (GSPL) to HOLD from Buy as we exclude the option value of the Mehsana-Bhatinda pipeline from its valuations. That infrastructure (EPC) companies such as GMR, Larsen & Toubro (L&T) and Nagarjuna Construction are expected to bid for new pipelines in the latest round of bidding is a major negative for existing gas transportation companies such as GSPL. EPC companies have done so given assured EPC business from new pipelines, resulting in valuation upside. However, in our view, EPC companies may fail to understand the business risk concomitant with a pipeline company, especially under the new regulations under which the gas volume risk lies with the operator. Hence, bids from EPC companies could be more competitive vis-à-vis that from GAIL and GSPL. We exclude the option value of new pipeline bids for GSPL. Also, we roll over our valuations to March '11 and value GSPL's core business at Rs99/share from Rs92/share earlier.

- **Unexpected risks for new pipeline bids.** The interest from EPC companies in new pipelines was unanticipated – we had expected that only GAIL, GSPL and Essar will bid for these pipelines. EPC companies may bid aggressively for these pipelines so as to enhance their EPC orderbook and generate significant value, thus winning the bids at the expense of the existing players.
- **Expansion into wind power intriguing.** GSPL's plans to enter into wind power generation is intriguing given that there is sufficient opportunity to expand the extant pipeline business, which carries lower risk and possibly provides better returns. Just three months prior to the opening of pipeline bids (which might necessitate investments in excess of Rs35bn for a single pipeline), such an investment in wind power is risky and seems ill-timed. Stress on the balance sheet due to possible investment of Rs3.2bn (10% of the current gross block) could be an overhang.
- **Unexpected awarding of new pipelines could revive the stock.** GSPL may underperform in the short term as it is trading near its target price and there is lack of a positive trigger. However, if the company wins any bid for a new pipeline, the stock could receive a major boost.

Market Cap	Rs55.6bn/US\$1.2bn
Reuters/Bloomberg	GSPT.BO/GUJS IN
Shares Outstanding (mn)	562
52-week Range (Rs)	105/26
Free Float (%)	62.2
FII (%)	12.6
Daily Volume (US\$/'000)	5,486
Absolute Return 3m (%)	23.8
Absolute Return 12m (%)	140.6
Sensex Return 3m (%)	4.1
Sensex Return 12m (%)	70.9

Year to March	2009	2010E	2011E	2012E
Revenue (Rs mn)	4,875	10,364	10,722	11,311
Net Income (Rs mn)	1236	4259	4431	4763
EPS (Rs)	2.2	7.6	7.9	8.5
% Chg YoY	21.1	244.7	4.0	7.5
P/E (x)	45.9	13.3	12.8	11.9
CEPS (Rs)	5.2	11.9	13.7	15.4
EV/E (x)	15.8	7.4	6.9	5.9
Dividend Yield (%)	0.7	1.0	1.0	1.0
RoCE (%)	7.7	17.0	15.5	15.4
RoE (%)	10.5	30.5	25.1	22.0

Please refer to important disclosures at the end of this report

## Presence of EPC companies surprising

### GMR, L&T and Nagarjuna Construction likely to bid aggressively

The Petroleum & Natural Gas Regulatory Board (PNGRB) has extended the dates for the final bids to be submitted to mid February due to some reservations by the bidders. This would mean that the final allocation of the pipelines would be done by March '10. As per media reports, nine players have already indicated their interest in building and operating the Mehsana-Bhatinda pipeline (MBPL).

In line with our estimates, Essar, GAIL and GSPL have bought the bid document. But surprisingly, even EPC companies such as L&T, Nagarjuna Construction and GMR have bought the document. The presence of these companies in the fray weakens our expectations of GSPL and GAIL winning the bids.

**Table 1: List of possible bidders**

GSPL
GAIL
L&T
Essar Projects
Nagarjuna Construction
EIL (Engineers India)
GMR

Source: Industry, PNGRB

### Assured EPC business, the key rationale

Assured EPC business is the key rationale for the high interest shown by the EPC companies in our view. Also, EPC companies may bid aggressively for these projects. Moreover, since GAIL and GSPL are pure pipeline transportation companies and will most probably outsource the EPC part to a contractor, the value enhancement for the EPC part of the project would not be retained by them.

Hence, we expect GAIL and GSPL to lose out to EPC companies, who would be able to bid aggressively for these projects and are at present, in the driving seat.

### EPC companies to generate Rs2bn value from EPC contracts alone

Based on our calculations (11% EBITDA margin) and execution period of three years, we value the EPC business from the ~Rs35bn MBPL bid at Rs2bn. The additional value would enable EPC companies to bid more aggressively for the pipeline business.

**Table 2: EPC business – DCF**

(Rs mn)

	FY11E	FY12E	FY13E	FY14E	FY15E	FY16E	FY17E	FY18E
Sales	7,000	10,500	17,500	1,750	1,750	1,750	1,750	1,750
EBITDA Margin (%)	11	11	11	11	11	11	11	11
EBITDA	770	1,155	1,925	193	193	193	193	193
Working Capital outflow required	350	525	875	(1,750)				
Net Cash Inflow	166	249	415	1,879	129	129	129	129
PV Of cash Flows	148	198	295	1,194	73	65	58	52
<b>Total value Added (FY10 end)</b>	<b>2,085</b>							

Source: I-Sec Research

As per our calculations, the value from the EPC business alone will be ~15% of the value of the pipeline business. Hence, EPC companies may be in a position to bid at an RoCE of 11.15% vis-à-vis GAIL's and GSPL's bid at 12% RoCE.

**Table 3: Pipeline business – DCF**

(Rs mn)

	FY11E	FY12E	FY13E	FY14E	FY15E	FY16E	FY17E	FY18E	FY19E	FY20E
Transmission volumes (mmscmd)			12	15	20	22	25	27	27	27
EBITDA			4,115	5,144	6,858	7,544	8,573	9,259	9,259	9,259
Depreciation			1,859	1,859	1,859	1,859	1,859	1,859	1,859	1,859
Interest			2,320	2,241	2,021	1,703	1,302	815	276	-
PBT			(64)	1,044	2,978	3,982	5,412	6,585	7,124	7,400
Operating cashflow					1,795	2,725	4,331	5,164	6,350	7,324
Capex	20,000	15,000	20,000	15,000	3,100	700	700	700	700	700
Working Capital investment					235	59	98	39	59	39
Debt taken (D:E::4:1)	16,000	12,000	16,000	12,000	1,000	(1,966)	(3,533)	(4,425)	(5,592)	(6,585)
FCFE	(4,000)	(3,000)	(540)	-	-	-	-	-	172	7,301
PV of FCFE (11.9% cost of equity)	13,582									
<b>Per share value at end-FY10 (Rs/sh)</b>	<b>24</b>									

Source: I-Sec Research

**Table 4: EPC companies to have better valuations for a similar business**

(Rs mn)

Value for a pipeline company	13,582	12% RoCE, 80:20 debt equity
Value for the EPC business	2,085	11% EBITDA margin
EPC as % of pipeline value	15.4	

Source: I-Sec Research

## Entry into wind power baffling

GSPL has opted for a postal ballot by shareholders so as to enable the company to invest in wind power. This will help GSPL benefit from the tax shield available for the companies investing in wind power.

GSPL plans to invest Rs3.2bn in setting up a total capacity of 52MW in Gujarat. This total investment would be allowed 80% depreciation in the first year of investments alone, implying cash tax savings of Rs0.9bn in the first year of operation. This would mean a net investment of Rs1.3bn in the business.

## Risks galore in the wind mill business

Inherently, the wind mill business is risky due to the lower pay load factor (PLF) and requirement of regulatory support from the Government. Moreover, power generation from wind mills tends to be seasonal, highly variable and high maintenance. Though, the management is expecting mid-20% PLF (for IRR of ~16%), failure to attain the PLF could risk the company's investment.

## Small investment, hence valuation impact minimal

Since investment in the wind power business is expected to be minimal (Rs4/share), the actual impact on our NPV would be immaterial.

**Balance sheet could be stretched further**

GSPL's debt, as of FY10E end, is projected to be Rs16.5bn and the company may have to raise further debt to finance its current capex plans. Also, the company will have to spend Rs3-5bn more for capacity expansion of the Anand-Kalol-Mehsana pipeline. Moreover, if GSPL wins the bid for new pipelines, its balance sheet may be further stretched as its capex plans would increase significantly.

We expect the borrowing cost to increase substantially if GSPL goes ahead with its plans to invest in wind power.

**Unrelated business expansion surprising**

Since there are enough opportunities available in the existing gas transportation business, especially given the huge investments required in India, the decision to enter the wind power business seems untimely. And unless the Government guarantees future returns from the business, the venture could be a drag on profitability.

**Uncertainty on power tariffs**

Tariffs for the wind power business are uncertain. Also, the identity of the buyer is unclear. If GSPL is forced to buy self generated power at higher costs, it could result in higher operating costs. Uncertainties remain on if the cost recovery for higher costs would be allowed by the PNGRB.

With such high risks for GSPL's investments in the wind power business, we believe risk-reward is unfavourable vis-à-vis the current gas transportation business. We build in no value enhancement from GSPL's foray into wind power generation.

## Valuations – Rolling over to March '11

We roll over our target price for GSPL's extant business to March '11 and now value its core business at Rs99/share. However, we exclude the option value for the new bids as we believe that the gas transportation companies would not be able to compete with EPC companies in the recent round of bidding. Since the stock is currently trading at 2% premium to our March '11 fair value, we downgrade GSPL to HOLD from Buy.

Though we are positive on the long-term gas story, GSPL is pricing in most of the benefits in its current price. We will await further triggers for the stock.

**Table 5: GSPL valued at Rs99/share**

(Rs mn)

		Remarks
Cost of Equity (%)	11.9	
PV of FCFE from FY12E to FY24E	35,378	Base year FY11
Terminal Value	72,473	Terminal growth at 2%
PV of terminal value	16,803	
Enterprise Value	52,181	
Add: Net cash	3,427	FY11 end
Value for shareholders	55,608	
Total shares outstanding	562.1	
GSPL extant business value (Rs/share)	99	

Source: I-Sec Research

## Financial Summary

Table 6: Profit and Loss statement

(Rs mn, year ending March 31)

	FY09	FY10E	FY11E	FY12E
<b>Operating Income (Sales)</b>	<b>4,875</b>	<b>10,364</b>	<b>10,722</b>	<b>11,311</b>
<b>Operating Expenses</b>	<b>626</b>	<b>585</b>	<b>658</b>	<b>708</b>
<b>EBITDA</b>	<b>4,249</b>	<b>9,780</b>	<b>10,064</b>	<b>10,603</b>
Depreciation & Amortisation	1,705	2,454	3,269	3,877
Gross Interest	870	1,090	1,254	1,047
Other Income	243	209	150	320
<b>Recurring PBT</b>	<b>1,918</b>	<b>6,444</b>	<b>5,691</b>	<b>5,999</b>
Add: Extraordinaries	(2)	23	(2)	(2)
Less: Taxes	682	2,184	1,260	1,237
- Current tax	537	1,933	1,038	1,003
- Deferred tax	145	251	222	234
<b>Net Income (Reported)</b>	<b>1,234</b>	<b>4,283</b>	<b>4,430</b>	<b>4,761</b>
<b>Recurring Net Income</b>	<b>1,236</b>	<b>4,259</b>	<b>4,431</b>	<b>4,763</b>

Source: Company data, I-Sec Research

Table 7: Balance sheet

(Rs mn, year ending March 31)

	FY09	FY10E	FY11E	FY12E
<b>Assets</b>				
Total Current Assets	5,615	8,912	9,022	10,792
of which cash & cash eqv.	975	922	2,083	5,030
Total Current Liabilities & Provisions	5,331	7,654	6,395	5,110
<b>Net Current Assets</b>	<b>284</b>	<b>1,258</b>	<b>2,626</b>	<b>5,682</b>
<b>Investments</b>				
of which	<b>356</b>	<b>782</b>	<b>782</b>	<b>782</b>
Strategic/Group	356	782	782	782
<b>Net Fixed Assets</b>	<b>24,132</b>	<b>31,651</b>	<b>32,598</b>	<b>30,364</b>
Capital Work-in-Progress	6,446	8,438	1,912	322
<b>Total Assets</b>	<b>24,772</b>	<b>33,691</b>	<b>36,006</b>	<b>36,828</b>
<b>Liabilities</b>				
Borrowings	11,509	16,522	14,839	11,324
Deferred Tax Liability	1,144	1,395	1,617	1,851
Equity Share Capital	5,621	5,621	5,621	5,621
Face Value per share (Rs)	10	10	10	10
Reserves & Surplus*	6,531	10,156	13,928	18,032
Less: Misc. Exp. n.w.o.	33	3	-	-
<b>Net Worth</b>	<b>12,119</b>	<b>15,773</b>	<b>19,549</b>	<b>23,653</b>
<b>Total Liabilities</b>	<b>24,772</b>	<b>33,691</b>	<b>36,006</b>	<b>36,828</b>

\*excluding revaluation reserves; # not written-off

Source: Company data, I-Sec Research

Table 10: Quarterly trend

(Rs mn, year ending March 31)

	Dec-08	Mar-09	Jun-09	Sep-09
Net sales	1,174	1,320	2,108	2,548
% growth (YoY)	6.2	13.7	76.4	114.8
EBITDA	1,016	1,129	1,980	2,406
Margin (%)	86.5	85.5	93.9	94.4
Other income	58.5	44.2	35.0	58.8
Add: Extraordinaries	-	-	-	24.9
Recurring net profit	276	348	805	1,076

Source: Company data, I-Sec Research

Table 8: Cashflow statement

(Rs mn, year ending March 31)

	FY09	FY10E	FY11E	FY12E
<b>Operating Cash flow</b>	<b>2,844</b>	<b>6,756</b>	<b>7,772</b>	<b>8,554</b>
Working Capital Changes	(1,488)	(1,027)	(208)	(109)
Capital Commitments	(4,579)	(10,399)	(4,216)	(1,644)
<b>Free Cash Flow</b>	<b>(3,223)</b>	<b>(4,669)</b>	<b>3,349</b>	<b>6,801</b>
<b>Cash flow from Investing Activities</b>	<b>243</b>	<b>209</b>	<b>150</b>	<b>320</b>
Issue of Share Capital	2	-	-	-
Buyback of shares	-	-	-	-
Inc (Dec) in Borrowings	1,849	5,013	(1,683)	(3,515)
Dividend paid	(493)	(658)	(658)	(658)
<b>Extraordinary Items</b>	<b>(2)</b>	<b>23</b>	<b>(2)</b>	<b>(2)</b>
<b>Chg. in Cash &amp; Bank balance</b>	<b>(1,595)</b>	<b>(52)</b>	<b>1,160</b>	<b>2,947</b>

Source: Company data, I-Sec Research

Table 9: Key ratios

(Year ending March 31)

	FY09	FY10E	FY11E	FY12E
<b>Per Share Data (Rs)</b>				
Diluted Recurring EPS	2.2	7.6	7.9	8.5
Recurring Cash EPS	5.2	11.9	13.7	15.4
Dividend per share (DPS)	0.7	1.0	1.0	1.0
Book Value per share (BV)	21.6	28.1	34.8	42.1
<b>Growth Ratios (%)</b>				
Operating Income	16.7	112.6	3.5	5.5
EBITDA	16.6	130.1	2.9	5.4
Recurring Net Income	21.1	244.7	4.0	7.5
Diluted Recurring EPS	21.1	244.7	4.0	7.5
Diluted Recurring CEPS	10.8	128.3	14.7	12.2
<b>Valuation Ratios (x)</b>				
P/E	45.9	13.3	12.8	11.9
P/CEPS	19.3	8.5	7.4	6.6
P/BV	4.7	3.6	2.9	2.4
EV / EBITDA	15.8	7.4	6.9	5.9
EV / Operating Income	13.8	7.0	6.5	5.6
EV / Operating FCF	49.6	12.6	9.2	7.5
<b>Operating Ratio</b>				
SG&A/Sales (%)	8.0	4.7	5.0	4.9
Other Income / PBT (%)	12.7	3.2	2.6	5.3
Effective Tax Rate (%)	35.6	33.9	22.1	20.6
NWC / Total Assets (%)	(2.8)	1.0	1.5	1.8
Working capital cycle (days)	(107.4)	(6.2)	15.0	19.3
Receivables (days)	35.9	27.4	32.6	29.9
D/E Ratio (%)	104.4	113.6	84.2	55.7

**Return/Profitability Ratio (%)**

Recurring Net Income Margins	25.3	41.1	41.3	42.1
RoCE	7.7	17.0	15.5	15.4
RoNW	10.5	30.5	25.1	22.0
Dividend Payout Ratio	34.2	13.1	12.7	11.8
Dividend Yield	0.7	1.0	1.0	1.0
EBITDA Margins	87.2	94.4	93.9	93.7

Source: Company data, I-Sec Research

*I-Sec investment ratings (all ratings relative to Sensex over next 12 months)*

**BUY:** +10% outperformance; **HOLD:** -10% to +10% relative performance; **SELL:** +10% underperformance

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