ASK SECURITIES*

5 June 2007

# GAIL

**Rs300; Buy**

**Initiating Coverage**

**Sector: Oil & Gas**

| | |
|---|---|
| **Target Price** | **Rs379** |
| Market cap (bn) | Rs253.4/US$6.3 |
| 52-week range | Rs340/213 |
| Shares in issue (mn) | 845.7 |
| 6-mon avg daily vol (no of shares) | 836,844 |
| 6-mon avg daily vol (mn) | Rs250.8/US$6.2 |
| Bloomberg | GAIL IN |
| Reuters | GAIL.BO |
| BSE Sensex | 14,496 |
| Website | www.gailonline.net |

**Shareholding Pattern (%)**

| | |
|---|---|
| Government of India | 57.3 |
| FIIs | 16.2 |
| Banks/MFs/FIs | 13.5 |
| Others | 13.0 |

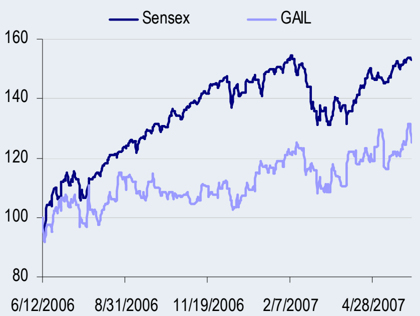
*(As of 31 March 2007)*

**Price Performance (%)**

| | 1M | 3M | 12M |
|---|---|---|---|
| Absolute | (3.3) | 8.0 | 26.1 |
| Relative* | (7.3) | (4.5) | (12.6) |

** To the BSE Sensex*

**Relative Performance**




*(As of 4 June 2007)*


**Analysts:**

**Kenin Jain**
kjain@asksecurities.com
Tel: (91 22) 6646 0039

**Rohit Ahuja**
rahuja@asksecurities.com
Tel: (91 22) 6646 0028


# Stamping its pipeline authority

## Investment highlights

- **Favourable supply environment:** Domestic natural gas supply scenario is expected to show a marked improvement (more than 240 mmscmd) over next 3-5 years as gas discoveries at KG basin by exploration majors like Reliance Industries (RIL), GSPC, ONGC, etc., are likely to go on stream (at around 80-160 mmscmd). Not to be missing out on this surge in supply, GAIL has already entered into MoUs with RIL and ONGC for marketing and supply of natural gas.
- **Doubling of pipeline capacity in 4-5 years:** GAIL's pipeline business is a cash cow for the company earning steady cash flows. Citing the improving gas supply scenario, GAIL has announced Rs180 bn capex to more than double its pipeline capacity from current 130 mmscmd to 360 mmscmd in 4-5 years. Cash flows from the new pipelines are expected to contribute around Rs65/share to GAIL's fair value, making it an attractive long-term bet on the buoyant domestic gas sector.
- **Low gearing provides room for scalability:** Funding the Rs180 bn pipeline capex will not be an issue for GAIL considering its low 0.1x debt/equity ratio. Even after factoring this capex (0.1x debt/equity for FY09E), GAIL would be comfortably placed to finance its additional capex (around Rs70 bn) for the proposed Assam Gas cracker complex (Rs56 bn capex) and E&P over the next five years.

## Investment concerns

- **Subsidies continue to haunt:** Concerns for GAIL are issues relating to subsidies, tariff regulation, delayed gas production and competition. However, subsidies are the key concern considering government's adhoc subsidy sharing mechanism that has impacted GAIL's profitability over the past two years. We have assumed the subsidy burden for GAIL to remain at current levels (Rs15 bn for FY07) for next two years.

## Financials and valuations

- **Undemanding valuations:** Based on our sum-of-the-parts valuation (DCF for pipeline business and EBITDA multiples for others), we have arrived at our one-year target price of Rs379 for GAIL, offering a 26% upside from current levels. At this price, GAIL would be trading at reasonable 8.3x FY09E cash earnings. The company's proposed expansion of pipeline grid and improving supply situation makes it an attractive bet on the domestic gas industry. We recommend Buy.

**Exhibit 1: Financial summary** **(Rs mn)**

| Y/E March | FY05 | FY06 | FY07 | FY08E | FY09E |
|---|---|---|---|---|---|
| Net Sales | 135,914 | 144,594 | 160,472 | 220,167 | 254,617 |
| EBITDA | 36,039 | 34,979 | 29,973 | 44,818 | 48,792 |
| EBITDA (%) | 26.5 | 24.2 | 18.7 | 20.4 | 19.2 |
| PAT | 19,547 | 23,101 | 23,867 | 29,307 | 30,397 |
| EPS (Rs) | 23.1 | 27.3 | 28.2 | 34.7 | 35.9 |
| EPS growth (%) | | | 3.3 | 22.8 | 3.7 |
| CEPS (Rs) | 34.3 | 33.9 | 35.0 | 42.7 | 45.5 |
| ROCE (%) | 25.0 | 24.7 | 19.0 | 18.1 | 17.9 |
| RONW (%) | 22.7 | 23.2 | 21.5 | 17.4 | 16.3 |
| PE (x) | 13.0 | 11.0 | 10.6 | 8.7 | 8.3 |
| EV/EBITDA (x) | 6.4 | 6.1 | 7.7 | 4.7 | 4.8 |

*Source: Company data, ASK Securities. Note :Valuations as of 4 June 2007.*

# Investment highlights

*India's leading marketer and supplier of gas on the verge of doubling its gas transmission infrastructure*

**GAIL is India's largest gas transmission and marketing entity, with 5,600 km pipeline assets spanning across the western and northern corridors of India. Over next 4-5 years, the company plans to double its pipeline assets to more than 10,000 km through the recently announced Rs180 bn capex. This would lead to completion of the long delayed national gas grid that would significantly enhance GAIL's profitability and authority in domestic gas industry. The company has presence in petrochemicals and LPG businesses as well, which together constitute around 25% of its revenues. The company has also forayed into exploration and production (E&P) and City Gas Distribution (CGD), which, although insignificant at this stage, completes the value chain for the company from production to marketing of gas.**

## Favourable demand-supply dynamics

*Domestic supply scenario to change completely once production from East Coast commences.*

- **Supply situation to improve:** India's gas supply outlook is set to undergo a marked change over the next 3-5 years buoyed by the start of gas production from the prolific discoveries at KG basin on the East Coast by RIL, GSPC and ONGC. The expected supply from East Coast alone is expected to touch 130 mmscmd over the next 4-5 years resulting in the country's gas supply to exceed 240 mmscmd (more than 2.5x current supply of 90 mmscmd). This would result in enough supply for GAIL and thereby a ready market to transmit gas through its expanded infrastructure.

*Demand would still chase supply, assuming international initiatives do not materialise.*

- **Demand would still lead supply:** With crude trading at US$70/bbl levels, we believe that demand for natural gas would be buoyant going forward considering the huge policy led investment lined up for power, petchem and other industrial sectors. Gas is also more efficient and economical compared to other conventional sources of energy. In spite of supply situation expected to change remarkably over the next 10 years, demand would clearly outstrip supply (Exhibit 2).

**Exhibit 2: Demand-supply scenario (mmscmd)**

| | 2006-07 | 2011-12 | 2014-15 | CAGR (2007-15) (%) |
|---|---|---|---|---|
| Gas Supply | | | | |
| Existing sources (ONGC, Petronet, etc) | 94 | 130 | 149 | |
| New sources (KG Basin, etc) | | 115 | 185 | |
| Total Supply | 94 | 245 | 334 | 14 |
| Total Demand | 160 | 281 | 423 | 10 |
| Shortfall (Supply-Demand) | (66) | (36) | (89) | |

*Source: Industry.*

## Doubling of pipeline capacity in 4-5 years

*New pipeline grid will more than double GAIL's pipeline EBITDA.*

- **Surge in operating income post expansion:** GAIL has recently announced a capex of Rs180 bn to add five new pipelines and the augmentation of its three existing pipelines. Of the total capex, the company has earmarked Rs105 bn for the new pipelines and Rs75 bn for capacity augmentation of existing pipelines. The overall pipeline capacity post expansion is expected to increase more than 2.5x at 360 mmscmd from current 130 mmscmd. Accordingly, we expect EBITDA from natural gas pipelines to more than double (2.5x) from current Rs21.6 bn to Rs58 bn over the next five years, a key positive considering that the new pipelines would be initially generating relatively lower operating margin (at around 65%) compared to existing pipelines (at around 85%).

*Pipeline business alone contributes Rs223 per share to GAIL's fair value.*

- **Major upside from pipeline business:** Based on our DCF calculation (WACC of 13.3% and 2% terminal growth), we have arrived at a fair value of Rs203/share for natural gas pipeline business (Exhibit 4). Cash flows from new pipelines are expected to contribute around Rs65 to the overall value of GAIL. However, cash flows from existing pipelines would continue to remain a major contributor to GAIL's EV (around Rs138/share). With regards to LPG pipelines, we have capped volumes at current levels, as the fading demand for LPG domestically would not justify any need for GAIL to augment LPG pipeline capacity. Based on our DCF calculation (13.3% WACC and 1% terminal growth), the LPG transmission business contributes Rs20/ share to GAIL's EV.

### Exhibit 3: WACC assumptions

| | |
|---|---|
| Risk free return (%) | 8 |
| Beta (x) | 0.76 |
| Equity risk premium (%) | 7 |
| We have assumed zero debt as its component is very low | |

*Source: ASK Securities.*

### Exhibit 4: Valuation of transmission business

| | Contribution to GAIL's EV (Rs bn) | Per share value (Rs) | Fair value (Rs) | Comments |
|---|---|---|---|---|
| Existing pipelines | 123 | 145 | 138 | DCF based valuation |
| New pipelines | 69 | 81 | 65 | DCF based valuation |
| LPG pipelines | 18 | 21 | 20 | DCF based valuation |
| **Total transmission** | **209** | **247** | **223** | |

*Source: ASK Securities.*

## Low gearing provides room for scalability

*0.1x debt-equity gives enough room to scale up.*

- **Room for scalability:** One of the key positive factors for GAIL is its low leverage at 0.1x, especially considering that the company has announced its Rs180 bn capex (Exhibit 5 on the next page) for completing the proposed pipeline grid. The company would be raising Rs25 bn in FY08 through a combination of ECBs and borrowings from domestic banks to fund this capex. Even after factoring this, the company would still be comfortably placed at 0.1x debt/equity for FY09E. This gives the company enough leeway to finance other long-lead projects like Assam Gas cracker complex and E&P activities over the next five-seven years. However, we have factored ONGC stake sale (around Rs45 bn) to happen in FY08 in our estimates. Failing this, the company would need to raise additional debt over next five years.

## Exhibit 5: Pipeline capex details

| New Pipelines | Overall capex (Rs mn) | Length (km) | Rs mn/km | Capacity |
|---|---|---|---|---|
| Dadri-Bawana-Nangal | 25,000 | 610 | 41.0 | 25 |
| Chainsa-Gurgaon-Jhajjhar-Hissar | 10,000 | 310 | 32.3 | 25 |
| Jagdishpur-Haldia | 20,000 | 876 | 22.8 | 12 |
| Dabhol-Bangalore | 25,000 | 730 | 34.2 | 12 |
| Kochi-Kanjirkkod-Bangalore | 25,000 | 840 | 29.8 | 12 |
| **Total** | **105,000** | **3,366** | **31.2** | **86** |
| **Augmentation of existing capacity** | | **Length (kms)** | **Current cap. (mmscmd)** | **Capacity add. (mmscmd)** |
| Dahej- Vijaipur | 25,000 | 610 | 24 | 50 |
| Vijaipur-Dadri | 25,000 | 505 | 12 | 12 |
| Vijaipur-Auraiya-Jagdishpur | 25,000 | 571 | 20 | 54 |
| **Total** | **75,000** | **1,686** | **56** | **116** |
| **Overall** | **180,000** | **5,052** | **-** | **202** |

*Source: Company, ASK Securities.*

***Additional Rs70 bn capex for petchem and E&P not factored into our estimates.***

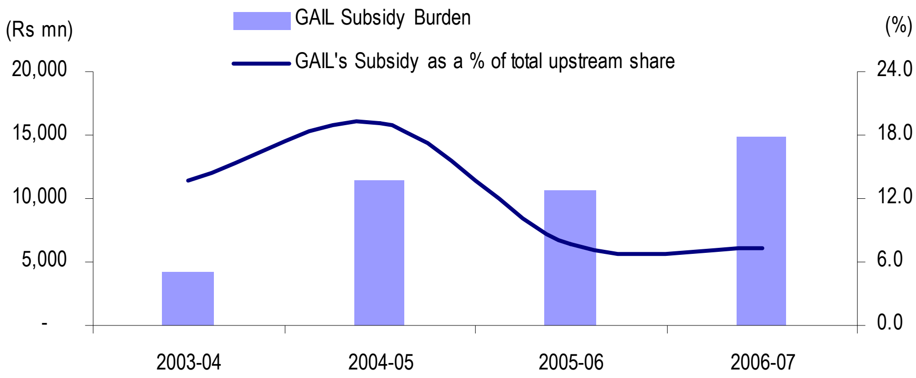
- **Rs70 bn additional capex:** GAIL has also recently announced additional capex of Rs70 bn for the proposed Assam gas cracker (Rs56 bn) and E&P. This would take the overall capex for the company to Rs250 bn, for which the company would be raising around Rs150 bn debt over next five-six years. We have, however, not factored in this additional capex into our estimates, as both Petchem and E&P are long-lead items requiring regulatory approvals. The company also plans to dilute its holding in ONGC worth Rs46 bn (Rs54/share), which, coupled with FY07 cash in books worth Rs25 bn, places GAIL in a comfortable position to fund this capex. However, GAIL's return ratios would be under pressure, with RoCE/RoE declining from FY06 levels of 25%/23% to around 19%/17% in FY09E after factoring the pipeline capex till FY09 and ONGC stake sale.

# Investment concerns

*Subsidies continue to remain a key risk to GAIL's profitability.*

- **Subsidies continue to haunt:** GAIL, being a public sector undertaking, is forced to bear a share of upstream subsidies to account for losses of OMCs. But the adhoc nature of these subsidies is a key risk to GAIL's profitability going forward. With oil hovering around US$65-70/ bbl band currently, it is almost certain that under-recoveries to OMCs is expected to be around Rs540 bn for FY08E. This burden is likely to be shared between the OMCs, upstream companies (GAIL, ONGC and OIL) and government (through oil bonds). GAIL's subsidy burden for FY07 has increased in absolute terms by 40% YoY at around Rs14.8 bn. However, its percentage share in upstream subsidy is declining since FY05, and currently stands at 7.3% for FY07 compared to 19% in FY05 (Exhibit 6). But given the adhoc nature of these subsidies, there is no certainty for this trend to continue going forward. We have assumed the subsidy burden for GAIL to remain at Rs14.8 bn/year for the next two years, in spite of lower under-recoveries compared to FY07 levels (around Rs690 bn).

**Exhibit 6: Subsidy trends over the years**




*Source: Company, ASK Securities.*

*Regulation of GAIL's tariffs could impact pipeline profitability.*

- **Tariff regulation:** Currently, GAIL's pipeline tariffs are regulated on the HVJ and DVPL trunk pipelines. However, with the appointment of the pipeline regulator, there is a possibility going forward that the regulator could once again review GAIL's transmission tariff. The pipeline tariffs are arrived at on the basis of a 14% post tax return over the entire life of the pipeline, and hence any further revision of these tariffs on the lower side would further depress attractiveness of its core business. Also some clarity is awaited on issues like common carrier and more than one operator in one zone.

*Delay in supplies from East Coast could lead to low asset utilization.*

- **Delayed gas availability:** Low gas supply is a major issue for GAIL, as it currently operates at around 50% of its pipeline capacity. There are further details awaited regarding GAIL's MoU with RIL with regards to operations and other issues like tariffs, revenue sharing, etc. Any delay in production of the KG basin gas can have a significant impact on GAIL's profitability, as its capacity utilization for new pipelines would get affected.

- **Competition from state transmission companies:** Going forward GAIL could face some competition from the mid-size state transmission companies like Gujarat State Petronet (GSPL) and inter-state transmission companies like Reliance Gas Transmission Infrastructure (wholly owned subsidiary of RIL). Till recently GAIL was the undisputed leader in India when it comes to transmission, with its focus being on cross-country pipelines. Gujarat is a key example of pipeline competition; as demonstrated by GSPL that has build a well connected pipeline network within Gujarat, making GAIL's entry in laying local pipeline network unviable. GSPL is also mulling upon the idea of setting up a similar kind of SPV in Andhra-Pradesh.

# Financials and valuations

*Attractively valued at 6.5x FY09E cash earnings.*

**Based on our sum-of-the-parts valuation (DCF for pipeline business and EBITDA multiples for others), we have arrived at our one-year target price of Rs379 for GAIL, offering a 26% upside from current levels. At this price, GAIL would be trading at reasonable 8.3x FY09E cash earnings. At the CMP of Rs300, GAIL is attractively valued at 8.7x FY08E earnings and 8.3x FY09E earnings. Based on cash earnings too the company is attractively valued at 6.5x FY09E CEPS. With the dynamics of domestic gas industry set to change with significant supplies coming in over the next three-five years, we believe that GAIL is an ideal play on the sector as a whole. We recommend a Buy.**

*Fair value of Rs379 based on sum-of-the-parts methodology.*

- **Sum-of the-parts justifies undemanding valuations:** We have valued GAIL's four diverse businesses separately, and arrived at a fair value of Rs379 (Exhibit 7). Citing the long-term visibility of revenues from the pipeline business, we have valued it on a DCF basis (13.3% WACC and 2% terminal growth). Cash flows from existing and new pipelines have been valued separately, considering the low operating margin (in 65-75% range) and 80IA tax benefits for new pipelines. We have valued the Petrochemicals and LPG businesses at 4x FY08E EV/EBITDA, and derived their fair value at 5% discount to their expected EV/share. As new pipelines are at least 4-5 years away, we have valued it at a 20% discount to its expected value/share of Rs81. With exploration business being inherently riskier in nature, we have discounted its expected EV/share by 20% to obtain its fair vaue. We have valued the company's investments in listed entities like ONGC, Petronet, etc at 20% discount to current price to adjust for volatility in market rates.

### Exhibit 7: Sum-of-the-parts valuation for GAIL

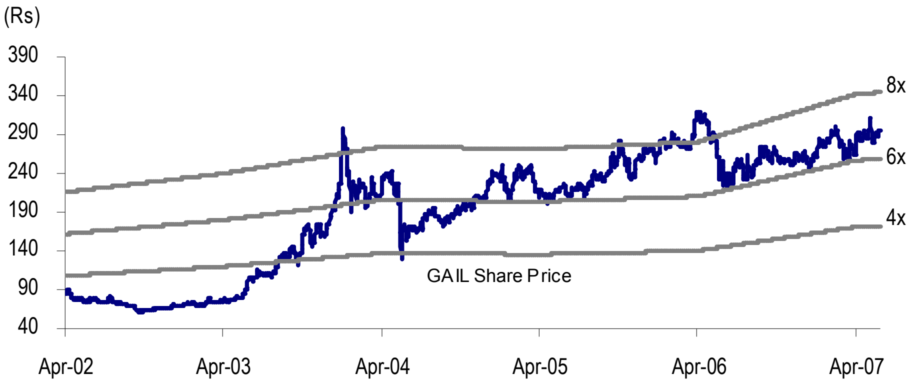
| | Contribution to GAIL's EV (Rs bn) | Per share value (Rs) | Our fair value per share (Rs) | Comments |
|---|---|---|---|---|
| **Transmission Business** | | | | |
| Existing gas pipelines | 122 | 145 | 138 | DCF based Valuation, fair value @5% discount |
| New gas pipelines | 69 | 81 | 65 | DCF based Valuation, fair value @20% discount |
| LPG pipelines | 18 | 21 | 20 | DCF based Valuation, fair value @5% discount |
| **Petrochemical Business** | **47** | **56** | **53** | **Valued at 4x its FY08E EBITDA, fair value@5% discount** |
| **LPG and other Liquid Hydrocarbon Business** | **9** | **10** | **9** | **Valued at 4x its FY08E EBITDA, fair value@5% discount** |
| **Total of all the core businesses** | **264** | **313** | **285** | |
| Investments / Holdings | 57 | 67 | 54 | Investments in ONGC, IGL, Petronet, etc @20% discount |
| Exploration and production assets | 32 | 38 | 30 | Value of its Myanmar and CBM blocks @20% discount |
| Less Debt | 16 | 19 | 19 | |
| Add Cash | 25 | 30 | 30 | |
| **Equity Value for GAIL** | **362** | **428** | **379** | |

*Source: ASK Securities.*

***We recommend Buy offering a 26% upside.***

- **Rolling PE and P/CEPS justify sum-of-the-parts value:** Over the past one-year, GAIL has traded in a band of 6-8x, due to a build-up of bleak outlook for its operating margin (due to tariff regulations) and stagnant volumes (due to inadequate supply domestically). Delays in capacity additions and cost overruns added to its woes. However, we believe that the company's outlook has changed considerably after factoring the new pipeline capex (with expression of interests for most of the projects already invited) and improved domestic gas supply scenario. We expect margins and volumes to revive from this year as its new pipelines become operational starting with Dahej-Uran and Dabhol-Panvel pipelines. At our sum-of-the-parts value of Rs379, GAIL would be trading at 8.3x FY09E cash earnings, a 15% premium to its 5-year mean P/CEPS of 7.2x. Considering the overall change in outlook for the company's core pipeline business, a 15% premium for its cash earnings multiple is well justified. With the dynamics of domestic gas industry set to change with significant supplies coming in over the next three-five years, we believe that GAIL is an ideal play on the sector as a whole (also offer 4% dividend yield). We recommend a Buy.

**Exhibit 8: Rolling 1-year forward PE**




*Source: Bloomberg, ASK Securities.*

# Business highlights

## City gas distribution and E&P have good scale-up potential over long-term

*CGD business provides scalability in volumes over long-term.*

- **Attractive long-term outlook for CGD business:** GAIL, in its quest to complete its presence throughout the gas value chain (from production to marketing of gas), has forayed into city gas distribution (CGD) business by floating a separate (state-wise) dedicated SPV with OMCs to supply gas to households, commercial users and the transport sector. With its maiden venture through Indraprastha Gas (IGL) being a major success, the company has already floated around eight SPVs in different states of India to tap the potential of natural gas as a key alternative to conventional fuels like petrol, diesel and LPG. The company also plans to create around 40 more such SPVs (may also venture with RIL) throughout India as part of the Government of India's initiative called 'Blue sky' to promote clean fuels. The company has also ventured in this business internationally by making strategic investments (of Rs1.5 bn) in gas distribution companies in overseas markets (two companies in Egypt and one in China).

*High-risk high-return E&P business could provide additional trigger.*

- **E&P could be a trigger:** GAIL, in consortium with exploration majors like ONGC/GSPC, has diversified into high-risk exploration business and has seen success in some blocks. The company currently holds 10-80% participating interest in 30 exploration blocks (in different phases of exploration). These blocks are located in basins such as Mahanadi, Bengal, Gujarat-Saurashtra, Mumbai, Cambay, Assam-Arakan and Cauvery. The developments in these kinds of businesses usually takes time to fructify and hence are long lead in nature. As is true with any E&P business, a significant discovery in any of its block can completely change the valuation for this business and could be a significant trigger to GAIL's fair value. We have valued this part of the business by valuing its net interest in its three key hydrocarbon properties (Exhibit 9) and arrived at an EV/share value of Rs30.

### Exhibit 9: E&P business valuation

| Block | Reserves (mboe) | % Stake | Recovery factor (%) | GAIL' share (mboe) | Total EV (Rs mn) | EV/boe (US$) | Value/share (Rs) | Fair value (@ 20% discount) |
|---|---|---|---|---|---|---|---|---|
| CB-ON-2000/1 (Cambay) | 3.5 | 50 | 25 | 0.4 | 108 | 6.0 | 0.1 | 0 |
| Myanmar Block - A1, A3 | 1800 | 10 | 10 | 18 | 2,602 | 3.5 | 3 | 2 |
| CBM (3 Blocks) | 994 | 35 | 25 | 87 | 12,570 | 3.5 | 15 | 12 |
| | 338 | 35 | 25 | 30 | 4,279 | 3.5 | 5 | 4 |
| | 749 | 45 | 25 | 84 | 12,172 | 3.5 | 14 | 12 |
| CBM total | 2,081 | | | 201 | 29,021 | 3.5 | 34 | 27 |
| **Total** | **3,884** | | | **219** | **31,731** | **3.5** | **38** | **30** |

*Source: Company, ASK Securities.*

## No major triggers from Petchem and LPG businesses

*HdPE/lldPE realizations expected to decline marginally over next two years*

- **Muted petchem revenue growth due to fall in realizations:** GAIL operates a gas cracker at Pata, Uttar Pradesh, with a capacity to produce 400,000 tpa of ethylene (expandable to 500,000 tpa). Downstream units include a linear low-density polyethylene (lldPE)/ high-density polyethylene (hdPE) polymer plant of 310,000 tpa capacity. At present, GAIL is expanding its lldPE/hdPE capacity to 410,000 tpa at a capex of Rs3.8 bn. Average realizations for hdPE/ lldPE have risen by around 40% in FY07 led by robust demand internationally.

  Going forward, we believe that polymer product prices would be under pressure in FY08 on account of the recent fall in crude oil prices despite robust demand. Accordingly, we expect hdPE/lldPE prices to decline marginally considering their recent spurt, in spite of the demand outlook being robust over the next two years. Hence, we expect revenue growth for petchem business to be muted at 3% in FY08E at Rs28.3 bn in spite of an 18% volume growth (considering capacity expansion).

*High cost of gas to pressurise petchem margins.*

- **Margin pressures to aggravate:** The government had revised the natural gas prices upwards by 30% from Rs6.7/scm to Rs8.6/scm in April 2006 for all non-priority sectors including petrochemicals. We expect gas prices to rise further by 9% in FY08E and 11% in FY09E. With gas being a primary feedstock for GAIL's petchem business and estimated correction in hdPE/lldPE prices going forward, we expect the company's petchem margins to decline by 76 bps in FY08E and a further 550 bps in FY09E. Accordingly, we expect 8% YoY growth in petchem EBITDA in FY08E at Rs11.8 bn and 16% YoY decline at Rs9.9 bn in FY09E. Valuing this business at 4x FY08E EBITDA (20% discount to IPCL's average EV/EBITDA of 5x), its fair value comes to around Rs53 (Exhibit 10).

### Exhibit 10: Petchem valuation

| Particulars | FY06 | FY07 | FY08E | FY09E |
|---|---|---|---|---|
| Volumes ('000 MT) (HDPE/LLDPE) | 311 | 347 | 410 | 410 |
| Gross realizations (Rs/MT) | 62,332 | 74,068 | 69,089 | 67,016 |
| Revenues (Rs mn) | 19,415 | 25,702 | 28,326 | 27,477 |
| EBITDA (Rs mn) | 8,487 | 10,922 | 11,821 | 9,936 |
| EBITDA (%) | 43.7 | 42.5 | 41.7 | 36.2 |
| **EV (@ 4x FY08E EBITDA)** | **47,282** | | | |
| Value / share (Rs) | 55.9 | | | |
| **Fair value per share (@ 5% discount) (Rs)** | **53** | | | |

*Source: Company, ASK Securities.*

***Subsidies to haunt LPG business profitability for at least 2-3 years.***

- **Subsidies continue to impact LPG profitability:** GAIL's LPG and liquid hydrocarbon business has been experiencing rough weather over the last one year. The major reason for this are rising input costs and spiraling crude prices leading to a 50% increase in subsidy burden at Rs14.4 bn in FY07. Net realizations for the LPG business has declined by 25% in FY07, leading to a steep decline in the operating margin from 31% in FY06 to 9% in FY07. Although the net under-recoveries for oil marketing companies is expected to be lower at Rs540 bn due to correction in crude prices, we have maintained current subsidy figures of Rs14.8 bn for the next two years for the company. Going forward, we expect net realizations to be marginally higher by 5% YoY in FY08E and FY09E, as we believe the government might offer some respite to oil marketing companies by allowing them to raise LPG prices. Despite better realizations, we expect the company's operating margins in the LPG business to remain flat at 9% in FY08E and decline by 140 bps in FY09E due to higher cost of inputs. We have valued LPG business at 4x FY08E EBITDA and arrived at a fair value of Rs9 per share (Exhibit 11).

### Exhibit 11: LPG business valuation

| | FY06 | FY07 | FY08E | FY09E |
|---|---|---|---|---|
| Volumes (MMT) | 1.0 | 1.3 | 1.3 | 1.3 |
| Net realizations (Rs/MT) | 21,130 | 15,799 | 17,125 | 18,516 |
| **Revenues (Rs mn)** | **22,017** | **21,219** | **22,998** | **24,867** |
| EBITDA (Rs mn) | 6,940 | 1,900 | 2,104 | 1,925 |
| EBITDA (%) | 31.5 | 9.0 | 9.1 | 7.7 |
| **EV @ 4x FY08E EBITDA (Rs mn)** | **8,417** | | | |
| Value / share (Rs) | 10 | | | |
| **Fair value per share @ 5% discount (Rs)** | **9** | | | |

*Source: Company, ASK Securities.*

## Long-term visibility for pipeline business

*Long-term visibility attributes GAIL's low-risk pipeline business.*

- **Steady cash flows for foreseeable future:** GAIL's transmission business offers good long-term visibility of earnings, given the high entry barriers in this business and nascent status of domestic gas industry. GAIL's existing 5,600 km pipeline network connects a majority of power and fertilizer units across the western and northern corridors. Due to the limited availability of gas and infrastructure constraints, customers once tied up would not prefer to switch to another source of supply. This gives GAIL's transmission business a first-mover advantage over competitors (if any) and a sustained source of revenue over the long-term.

  Within five years, GAIL would enjoy the distinction of operating more than 10,000 kms national pipeline grid connecting all the major demand centres across the country (Exhibit 12 on the next page). This makes it mandatory for a major portion of gas produced domestically or imported into India to avail the company's pipeline infrastructure for transmission. GAIL's recently signed MoUs with RIL and ONGC for transmission and marketing of KG basin gas stand testimony to this fact.

*New pipelines to offer around Rs65/ share upside.*

- **Significant upside from new pipelines:** Based on our DCF calculation (WACC of 13.3% and 2% terminal growth), we have arrived at a fair value of Rs203/share for natural gas pipeline business. Cash flows from new pipelines are expected to contribute around Rs65 to the overall value of GAIL, assuming an average capacity utilization of 54% over the next 15 years. Although the company management has indicated a four-year time frame for commissioning of the new pipeline grid, we have built in a year's delay in our model and have accordingly factored around 10% of capex as cost overruns. However, considering the surge in domestic gas supplies over the next five years, we believe there is a high possibility of utilization rates of these pipelines being much higher.

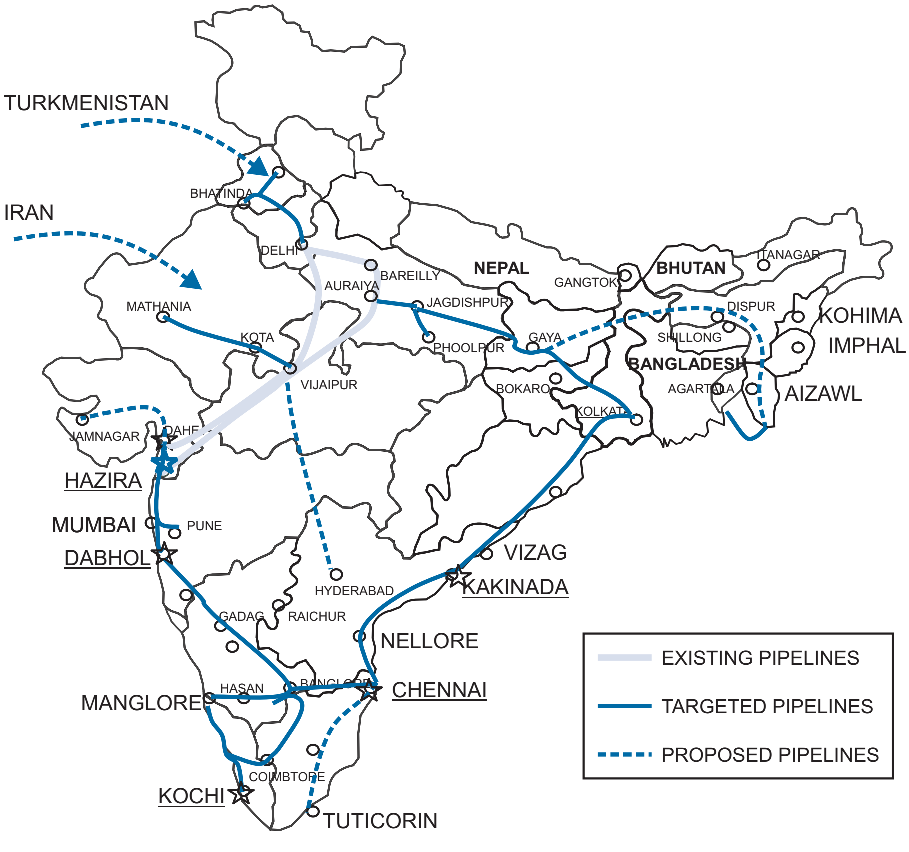
*Cash flow from existing pipelines constitutes around 36% of GAIL's fair value.*

- **Existing pipelines - a cash cow:** Cash flows from existing pipelines would continue to remain a major contributor to GAIL's EV (around Rs138/share). Volumes from these pipelines are expected to increase by around 52% from current 79 mmscmd to around 120 mmscmd over the next five years considering increased supplies from western shores (Petronet LNG, Shell Hazira and PMT capacity augmentation). However, utilization rates of these pipelines remain at 50% levels going forward after factoring the augmented capacity of these pipelines. With regards to LPG pipelines, we have capped volumes at current levels (2.5 MMT), as the fading demand for LPG domestically would not justify any need for GAIL to augment LPG pipeline capacity. Based on our DCF calculation (13.3% WACC and 1% terminal growth), the LPG transmission business contributes Rs20/share to GAIL's EV in our valuation model.

***International initiatives, if they materialise, could be a long-term trigger.***

- **International initiatives could be a significant trigger:** GAIL's highly debated initiative to secure natural gas supply from Iran through the gigantic 2,700 km (US$7.5 bn) Iran-Pakistan-India pipeline could be a major volume trigger going forward. The company would be importing around 80 mmscmd of gas into the Indian subcontinent, which is equivalent to its current transmission volumes. Due to political and pricing issues, the agreement between the three participating countries is not yet finalised. However, this pipeline, if it materializes, would be a key trigger in terms of securing gas supply and effective utilization of the company's domestic pipeline network. Another project, on similar lines, called the Turkmenistan-Afghanistan-Pakistan-India pipeline would also be a key development to watch out for.

### Exhibit 12: GAIL's current and proposed pipeline network




Source: Company, ASK Securities.

# Financials

***Sales growth (CAGR) 26% over FY07-09E due to petchem expansion and increase in transmission volumes.***

***Margins to remain flat in FY08-09E due to low petchem realizations and new pipeline volumes.***

***Interest rates at around 8-9% for FY08-09E.***

***Low tax rate in FY07 due to Rs3.4 bn tax write back.***

***EPS growth slows down in FY09 due to low other income.***

## Profit & Loss statement (Rs mn)

| Y/E March | FY05 | FY06 | FY07 | FY08E | FY09E |
|---|---|---|---|---|---|
| **Net Sales** | **135,914** | **144,594** | **160,472** | **220,167** | **254,617** |
| Purchases | 78,532 | 82,543 | 94,290 | 128,784 | 154,518 |
| (Inc)/Dec in stock | 269 | (249) | (753) | - | - |
| Emp cost | 2,058 | 2,213 | 2,923 | 3,800 | 4,560 |
| Operating and other expenses | 19,016 | 25,109 | 34,038 | 42,765 | 46,747 |
| **EBITDA** | **36,039** | **34,979** | **29,973** | **44,818** | **48,792** |
| **EBITDA (%)** | **26.5** | **24.2** | **18.7** | **20.4** | **19.2** |
| Other income | 3,491 | 4,555 | 5,450 | 6,444 | 5,400 |
| Depreciation | 9,467 | 5,595 | 5,754 | 6,824 | 8,059 |
| EBIT | 26,573 | 29,384 | 24,219 | 37,994 | 40,733 |
| Interest | 1,341 | 1,173 | 1,071 | 2,571 | 3,321 |
| **PBT** | **28,722** | **32,766** | **28,598** | **41,867** | **42,813** |
| Tax | 9,175 | 9,666 | 4,731 | 12,560 | 12,416 |
| Tax rate (%) | 31.9 | 29.5 | 16.5 | 30.0 | 29.0 |
| **PAT** | **19,547** | **23,101** | **23,867** | **29,307** | **30,397** |
| Shares (mn) | 845.7 | 845.7 | 845.7 | 845.7 | 845.7 |
| **EPS (Rs)** | **23.1** | **27.3** | **28.2** | **34.7** | **35.9** |

*Source: Company, ASK Securities.*

***We have assumed ONGC stake sale in FY08 for funding the pipeline capex.***

***Cash component surges in FY08 due to ONGC stake sale.***

## Balance sheet (Rs mn)

| Y/E March | FY05 | FY06 | FY07 | FY08E | FY09E |
|---|---|---|---|---|---|
| Equity share capital | 8,457 | 8,457 | 8,457 | 8,457 | 8,457 |
| Capital reserve account | - | - | - | 40,502 | 40,502 |
| Reserves and surplus | 77,805 | 91,276 | 102,702 | 119,568 | 137,524 |
| **Networth** | **86,261** | **99,733** | **111,159** | **168,526** | **186,483** |
| **Total Debt** | **19,974** | **19,166** | **16,166** | **41,166** | **41,166** |
| Liabilities | 27,161 | 31,646 | 33,590 | 40,270 | 44,347 |
| Provisions | 7,580 | 5,876 | 7,114 | 14,892 | 17,379 |
| **Current liabilities** | **34,742** | **37,522** | **40,704** | **55,162** | **61,726** |
| Deferred tax liability | 12,552 | 12,997 | 15,921 | 18,603 | 18,603 |
| **Total liabilities** | **153,529** | **169,418** | **183,949** | **283,457** | **307,978** |
| **Gross Block** | **142,224** | **144,695** | **149,895** | **186,495** | **216,495** |
| Less:Depreciation | 63,765 | 69,135 | 74,889 | 81,713 | 89,772 |
| Net Block | 78,459 | 75,560 | 75,006 | 104,781 | 126,723 |
| CWIP | 3,091 | 6,156 | 36,600 | 55,000 | 75,000 |
| Investments | 7,840 | 14,434 | 14,624 | 9,061 | 9,061 |
| Others | 270 | 397 | 397 | 397 | 397 |
| Inventories | 4,814 | 4,832 | 5,276 | 6,635 | 7,534 |
| Sundry debtors | 8229 | 7535 | 8353 | 11461 | 13254 |
| Cash and bank | 34468 | 44959 | 25224 | 74970 | 52226 |
| loans/advances | 16,359 | 15,546 | 18,470 | 21,152 | 23,784 |
| **Total current assets** | **64,140** | **73,269** | **57,720** | **114,615** | **97,195** |
| **Total assets** | **153,529** | **169,418** | **183,949** | **283,457** | **307,978** |

*Source: Company, ASK Securities.*

## Cash Flow Statement (Rs mn)

| Y/E March | FY05 | FY06 | FY07 | FY08E | FY09E |
|---|---|---|---|---|---|
| **PBT** | **28,722** | **32,766** | **28,598** | **41,867** | **42,813** |
| **Add** | | | | | |
| Depreciation | 9,467 | 5,595 | 5,754 | 6,824 | 8,059 |
| Ineterest | 1,341 | 1,173 | 1,071 | 2,571 | 3,321 |
| **Less** | | | | | |
| Other income | 3,491 | 4,555 | 5,450 | 6,444 | 5,400 |
| Change in working capital | 81 | (5,847) | 2,243 | 469 | 1,247 |
| Tax | 9,451 | 9,175 | 9,666 | 4,731 | 12,560 |
| Others | 1,801 | 660 | 6,298 | - | - |
| **Net cash from operations (a)** | **28,308** | **32,311** | **24,362** | **39,618** | **34,985** |
| Change in capital reserve account | - | - | - | 40,502 | - |
| Change in investments | (120) | (6,594) | (190) | 5,563 | - |
| Capex | (1,322) | (5,536) | (35,644) | (55,000) | (50,000) |
| Other income | 3,491 | 4,555 | 5,450 | 6,444 | 5,400 |
| Others | (1,217) | (691) | 0 | 0 | - |
| **Cash flow from investments (b)** | **831** | **(8,266)** | **(30,385)** | **(2,491)** | **(44,600)** |
| Dividends + dividend tax | (7,632) | (11,571) | (9,643) | (9,810) | (9,810) |
| Inc/dec in loans | (1,361) | (808) | (3,000) | 25,000 | - |
| Interest | (1,341) | (1,173) | (1,071) | (2,571) | (3,321) |
| Others | (16) | (1) | 0 | 0 | 0 |
| **Financial cash flow ( c )** | **(10,350)** | **(13,554)** | **(13,713)** | **12,620** | **(13,130)** |
| **Net inc/dec in cash (a+b+c)** | **18,789** | **10,491** | **(19,735)** | **49,747** | **(22,745)** |
| Opening cash balance | 15,680 | 34,469 | 44,959 | 25,224 | 74,971 |
| Closing cash balance | 34,469 | 44,959 | 25,224 | 74,971 | 52,225 |

*Source: Company, ASK Securities.*

***Capex to be funded mostly through internal accruals.***

***Dividend yield of 4% another positive factor for GAIL.***

***Company could raise higher debt in case they do not dilute ONGC stake.***

## Key Ratios

| Y/E March | FY05 | FY06 | FY07E | FY08E | FY09E |
|---|---|---|---|---|---|
| **Growth (%)** | | | | | |
| Sales | 13.8 | 6.4 | 11.0 | 37.2 | 15.6 |
| EBITDA | 6.9 | (2.9) | (14.3) | 49.5 | 8.9 |
| EPS | 4.5 | 18.2 | 3.3 | 22.8 | 3.7 |
| **Valuation (x)** | | | | | |
| PER | 13.0 | 11.0 | 10.6 | 8.7 | 8.3 |
| P/CEPS | 8.7 | 8.8 | 8.6 | 7.0 | 6.6 |
| EV/EBITDA | 6.4 | 6.1 | 7.7 | 4.7 | 4.8 |
| **Profitability (%)** | | | | | |
| EBITDA margin | 26.5 | 24.2 | 18.7 | 20.4 | 19.2 |
| ROCE (%) | 25.0 | 24.7 | 19.0 | 18.1 | 17.9 |
| RONW (%) | 22.7 | 23.2 | 21.5 | 17.4 | 16.3 |
| **Turnover (days)** | | | | | |
| Inventory | 12.9 | 12.2 | 12.0 | 11.0 | 10.8 |
| Debtors | 22.1 | 19.0 | 19.0 | 19.0 | 19.0 |
| Creditors | 36.5 | 38.4 | 39.0 | 39.5 | 40.0 |
| **Financials (x)** | | | | | |
| Debt/Equity | 0.2 | 0.2 | 0.1 | 0.1 | 0.1 |
| Interest Coverage | 22.4 | 28.9 | 27.7 | 17.3 | 13.9 |
| P/BV | 2.9 | 2.5 | 2.3 | 1.5 | 1.4 |

*Source: Company, ASK Securities.*

***Undemanding valuations make GAIL an attractive bet.***

***Return ratios to be under pressure over the capex period.***

***In case the ONGC stake sale does not happen in FY08, debt/equity would still be low at 0.4-0.5x.***

# Appendix

### Exhibit 13: Gas demand-supply scenario over next 10 years

| Gas Supply (mmscmd) | 2006-07 | 2011-12 | 2014-15 | CAGR (2007-15) |
|---|---|---|---|---|
| **Existing sources** | | | | |
| ONGC | 48 | 46 | 42 | |
| Petronet LNG | 17 | 34 | 49 | |
| Shell Hazira | 4 | 9 | 18 | |
| Dabhol LNG | | 18 | 18 | |
| Others (including OIL and Pvt JV's) | 25 | 23 | 22 | |
| **New sources** | | | | |
| RIL KG D6 | | 70 | 90 | |
| RIL Mahanadi basin | | | 10 | |
| GSPC KG basin | | 20 | 40 | |
| ONGC Mahanadi basin | | 20 | 30 | |
| CBM | | 5 | 15 | |
| **Total Supply** | **94** | **245** | **334** | **14%** |
| **Gas Demand (mmscmd)** | | | | |
| Power | 70 | 150 | 255 | 14% |
| Fertilizer | 35 | 54 | 70 | 7% |
| Sponge Iron Plants | 6 | 8 | 10 | 5% |
| Refineries | 25 | 38 | 49 | 7% |
| City Gas Distribution | 11 | 14 | 18 | 5% |
| Industrial | 14 | 18 | 21 | 4% |
| **Total Demand** | **160** | **281** | **423** | **10%** |
| **Shortfall (Supply-Demand)** | **(66)** | **(36)** | **(89)** | |

*Source: Company, ASK Securities.*

Notes

## Notes

# Notes

## Rating Structure

**Our Rating Structure is based on the following levels of expected Absolute Returns:**

| Rating | Target Price (if the value exceeds the Current Market Price) |
|---|---|
| **Buy** | by more than 15% |
| **Hold** | by 8% to 15% |
| **Sell** | is below 8% |

**The above rating structure has to be looked at in conjunction with the following:**

- Our ratings structure is primarily meant to reflect our directional view on the stock.
- The target price is purely indicative and may not entirely capture certain non-quantifiable triggers and qualitative aspects of a company, which may influence our rating.
- Our ratings and target price are with a 12-month view. Thus, our ratings would not necessarily be revised based on short-term stock-price volatility. But we would review both periodically depending upon events that we believe are significant.


## Contact Details – Sales & Dealing Team

**Sales Team**
**Tel:** (91 22) 6646 0017
**E-mail:** asksales@bloomberg.net

| Sales Trading & Dealing Team | Derivatives Team |
|---|---|
| **Tel:** (91 22) 2497 5601-05 | **Tel:** (91 22) 2497 5601-05 |
| **E-mail:** askdealing@bloomberg.net | **E-mail:** askdealing@bloomberg.net |

ASK SECURITIES INDIA PRIVATE LIMITED

(Formerly known as ASK RAYMOND JAMES & ASSOCIATES PVT. LTD.)

**MEMBER, BOMBAY AND NATIONAL STOCK EXCHANGES**

Bandbox House (Rear), 1st Floor, 254-D, Dr Annie Besant Road, Worli, Mumbai-400 025. (India).
Tel: +91 22 6646 0000 • Dealers: +91 22 2497 5601-05 • Fax: +91 22 2498 5666 • E-mail: broking@asksecurities.com


### Analyst Certification

The research analysts, with respect to each issuer and its securities covered by them in this research report, certify that:

- All of the views expressed in this research report accurately reflect his or her personal views about all of the issuers and their securities; and
- No part of his or her compensation was, is, or will be directly or indirectly related to the specific recommendations or views expressed in this research report.