



GAIL (India)

STOCK INFO.	BLOOMBERG
BSE Sensex: 8,701	GAIL IN
S&P CNX: 2,584	REUTERS CODE
	GAIL.BO

24 October 2008

Buy

Previous Recommendation: Buy

Rs198

Equity Shares (m)	1,268.5
52-Week Range	370/187
1,6,12 Rel. Perf. (%)	7/15/29
M.Cap. (Rs b)	250.7
M.Cap. (US\$ b)	5.0

YEAR	NET SALES	Adj. PAT	EPS	EPS	P/E	P/BV	ROE	ROCE	EV/	EV/
END	(RS M)	(RS M)	(RS)	GROWTH (%)	(X)	(X)	(%)	(%)	SALES	EBITDA
03/07A	160,472	20,468	16.1	-11.4	12.2	2.2	20.9	21.1	1.5	7.9
03/08A	180,082	25,442	20.1	24.3	9.9	1.9	20.0	25.2	1.2	5.5
03/09E	222,631	33,485	26.4	31.6	7.5	1.7	21.8	28.3	1.0	4.6
03/10E	261,310	33,642	26.5	0.5	7.5	1.5	19.5	26.0	0.9	4.6

- GAIL reported EBITDA of Rs14.3b v/s est of Rs13.5b (up 63% YoY and 2% QoQ). It reported PAT of Rs10.2b (v/s our est of Rs9b), up 79% YoY and 14% QoQ. Higher than expected EBITDA and PAT are largely due to higher LPG realizations though moderated to some extent by lower petchem sales. Provisional subsidy burden stood at Rs4b (in line), up 53% YoY (Rs2.6b in 2QFY08) and up 3% QoQ (Rs3.9b in 1QFY09).
- Petchem EBIT at Rs3.3b is up 3% YoY and down 25% QoQ. Large QoQ decline is primarily due to lower sales volume led by destocking by downstream customers. Petchem sales volume declined 28% QoQ at 75KTA.
- High LPG and liquid HC EBIT at Rs5.8b (up 1.6 times YoY and 81% QoQ) was primarily due to increase in gross LPG realization at US\$984/MT, up 43% YoY and 9% QoQ, and due to subsidy burden at Rs4b.
- Transmission volumes at 81.7mmcmd (our est 80mmcmd) were marginally down ~3% QoQ due to an accident at PMT fields leading to partial shutdown for almost a month.
- We are cutting our FY09 and FY10 EPS estimates by 4% to factor in the reduction in our LPG price assumption based on recent sharp correction in crude prices. We have also reduced FY10 gas volumes to 130mmcmd to account for delay in commencement of RIL's gas production to 4QFY09. Our FY09 estimates could see a boost if subsidy burden is reduced due to fall in oil prices. The stock trades at 7.5x FY09E EPS. Our SOTP based target price is Rs372/share. We reiterate **Buy**.

QUARTERLY PERFORMANCE

(Rs Million)

Y/E MARCH	FY08				FY09				FY08	FY09E
	1Q	2Q	3Q	4Q	1Q	2Q	3QE	4QE		
Net Sales	42,457	45,289	42,983	49,353	57,307	61,293	51,420	52,611	180,082	222,631
Change (%)	4.1	22.2	-1.8	27.1	35.0	35.3	19.6	6.6	12.2	23.6
Finished Gds Purchase	23,529	25,398	24,190	28,890	33,281	36,224	29,310	31,040	102,007	129,854
Raw Materials Cons	4,314	4,503	4,725	3,607	4,962	5,511	5,656	6,313	17,148	22,443
Employee Costs	688	824	985	2,203	866	1,180	1,357	1,766	4,700	5,170
Other Exp (incl Stock Adj)	3,540	5,782	4,360	3,053	4,204	4,063	5,054	1,971	16,735	15,292
EBITDA	10,387	8,783	8,723	11,600	13,995	14,314	10,044	11,519	39,492	49,872
% of Net Sales	24.5	19.4	20.3	23.5	24.4	23.4	19.5	21.9	21.9	22.4
Change (%)	10.3	49.1	0.9	92.6	34.7	63.0	15.1	-0.7	31.8	26.3
Depreciation	1,407	1,492	1,387	1,425	1,430	1,386	1,455	1,684	5,710	5,954
Interest	204	201	196	195	190	189	198	230	796	808
Other Income	913	1,806	1,848	997	1,148	2,289	1,800	1,063	5,564	6,300
PBT	9,689	8,897	8,988	10,976	13,522	15,029	10,190	10,669	38,550	49,409
Tax	2,837	3,171	2,775	3,752	4,554	4,794	3,444	3,606	12,535	16,398
Rate (%)	29.3	35.6	30.9	34.2	33.7	31.9	33.8	33.8	32.5	33.2
PAT	6,852	5,725	6,213	7,224	8,969	10,234	6,746	7,063	26,015	33,012
Change (%)	15.7	27.7	-6.6	112.0	30.9	78.8	8.6	-2.2	27.1	26.9
Adj PAT	6,852	5,725	6,213	6,651	9,442	10,234	6,746	7,063	25,442	33,485

* adjusted for subsidy in 1QFY09 and 4QFY08 E: MOST Estimates

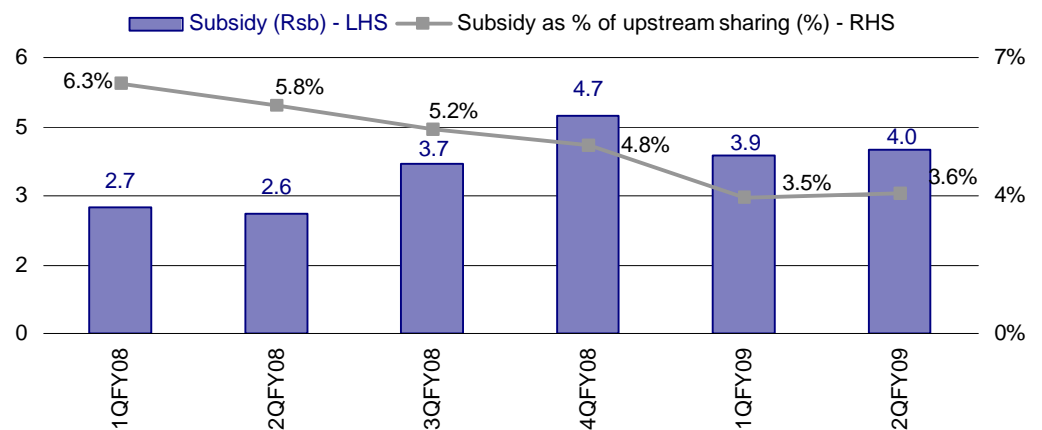
GAIL reported EBITDA at Rs14.3b (v/s est of Rs13.5b), up 63% YoY from Rs8.8b and 2% QoQ from Rs13.9b. It reported PAT at Rs10.2b (v/s our est of Rs9b), up 79% YoY from Rs5.7b and 14% QoQ from Rs8.9b. Higher than expected EBITDA and PAT is largely due to higher LPG realizations though moderated to some extent by lower petchem sales.

Other Income was higher at Rs2.3b, up 27% YoY and 99% QoQ primarily due to dividend income in 2Q and one time write-back of ~Rs360m of excise duty. Other income in 2Q is typically higher for GAIL due to dividend income on its investments.

Subsidy burden in-line; lower oil prices could further reduce subsidies

Provisional subsidy burden stood at Rs4b (in-line), up 53% YoY (Rs2.6b in 2QFY08) and up 3% QoQ (Rs3.9b in 1QFY09). Management expects final subsidy burden to be in-line with the provisional subsidy. GAIL's share subsidy in upstream burden had reduced to 3.5% in 1QFY09 compared to 5-6% historically. We estimate that even 2QFY09 subsidy burden is lower at ~3.5% of upstream burden.

REDUCED SHARE IN UPSTREAM SUBSIDY BURDEN



Source: Company/MOSL

We factor in subsidy burden of Rs16b for FY09 in our estimates. Our FY09 estimates could see a boost if subsidy burden is reduced due to fall in oil prices.

Mixed operating performance: Strong LPG; weak petchem

GAIL's overall EBIT increased to Rs15.2b (up 67% YoY and 11% QoQ) led by strong performance in LPG business, though moderated to some extent by weak performance in petchem segment.

LPG and Liquid HC: EBIT at Rs5.8b (v/s Rs2.2b in 2QFY08 and Rs3.2b in 1QFY09). Gross LPG realizations were significantly higher than expectation helping GAIL report significant profits in this division. We estimate gross LPG realizations at \$984/MT, up 43% YoY and up 9% QoQ. GAIL's LPG prices are communicated by IOC at the beginning of

the month and hence there is some lag effect in pricing, which we believe resulted in the higher price realization to GAIL than the average price during the quarter.

SEGMENT-WISE 2QFY09 EBIT PERFORMANCE (RSB)

	FY08				FY08	FY09		2QFY09 (%)	
	1Q	2Q	3Q	4Q		1Q	2Q	YOY	QOQ
Transmission									
1. Natural Gas	3.7	4.0	4.1	3.8	15.5	4.3	4.0	-0.1	-8.9
2. LPG	0.5	0.5	0.6	0.7	2.3	0.5	0.5	3.5	15.4
Petrochemicals	3.4	3.2	2.3	3.6	12.5	4.4	3.3	2.9	-25.2
LPG & Liquid HC	2.0	2.2	1.3	3.5	9.0	3.2	5.8	157.5	81.0
Natural Gas Trading	0.3	0.7	0.4	0.7	2.0	0.9	1.1	58.2	17.5
GAILTEL & Unallocated	0.0	(1.5)	0.5	(1.1)	(2.1)	0.4	0.6	nm	nm
Total EBIT	9.9	9.1	9.2	11.2	39.3	13.7	15.2	67.3	11.0

Source: Company/ MOSL

Petchem: EBIT at Rs3.3b is up 3% YoY and down 25% QoQ. Large QoQ decline is primarily due to lower sales volume led by destocking by downstream customers (delay in purchases in a falling crude price scenario). Petchem sales volume declined 28% QoQ at 75kta v/s 104kta in 1QFY09. Lower sales volumes during the quarter have resulted in the inventory increase; however, the management believes that with the significant decline in the prices, it will be able to clear the current inventory in the subsequent quarter.

Transmission business: Volumes at 81.7mmscmd (our est 80mmscmd) were marginally down 1% YoY and down ~3% QoQ. QoQ decline was primarily due to an accident at PMT fields leading to partial shutdown for ~1month. Transmission tariffs during the quarter were higher at Rs836/mscm compared to Rs813mscm in 1QFY09, however at EBIT level, tariffs were lower at Rs532/mscm compared to Rs567/mscm in 1QFY09. LPG transmission volumes at 650kt were marginally up YoY and up 5.5% QoQ due to lower consumption in 1QFY09 led by seasonality.

OPERATIONAL HIGHLIGHTS ('000 MT)

	FY08				FY08	FY09		2QFY09 (%)	
	1Q	2Q	3Q	4Q		1Q	2Q	YOY	QOQ
Transmission									
1. Natural Gas (mmscmd)	79	82	85	82	82	84	82	-0.6	-2.8
2. LPG	621	640	710	783	2,754	616	650	1.6	5.5
Petchem Sales	105	97	81	108	391	104	75	-22.7	-27.9
LPG & Liquid HC Sales	354	355	309	330	1,348	346	361	1.7	4.3
Gas - Trading	68	70	69	69	69	80	79	12.3	-1.2

Source: Company/ MOSL

We take 27% decline in FY10 Petchem EBIT: GAIL had increased its petchem capacity by 32% to 410kta in 4QFY08. GAIL's petchem segment margins have remained high in recent quarters primarily due to its gas based capacity. However, we believe that downturn in the ethylene chain is impending, due to large greenfield capacity additions forthcoming in the Middle East and China.

Also, recently it had announced further capacity expansion by 22% to 500kta with a planned capex of Rs970m. Over the long term GAIL has plans to increase the capacity to 800kta. Our estimates currently do not factor in these newly announced petchem expansions.

LIKELY DECLINE IN PETCHEM MARGINS

	FY07	FY08	FY09E	FY10E
Petchem EBIT (Rsm)	9,545	12,542	12,959	10,418
YoY Change (%)		31	3	-20
EBIT Margin (Rs/Kg)	27.0	32.1	33.1	24.2
YoY Change (%)		19.0	3.3	-27.0

Source: Company/MOSL

Valuation and view

We remain positive on GAIL in view of increase in gas transmission volumes going forward. We expect GAIL's transmission volumes to increase by ~55% in FY10 to ~130mmcmd. The recent increase in petchem capacity by 32% provides volume upsides, though we remain bearish on petchem cycle in view of new gas-based middle-east capacities coming online and expect prices to decline in 2HFY09. GAIL's plans for city gas distribution and E&P will provide added upsides.

We are cutting our FY09 and FY10 EPS estimates by 4% to factor in the reduction in our LPG price assumption based on recent sharp correction in crude prices. We have also reduced FY10 gas volumes to 130mmcmd to account for delay in commencement of RIL's gas production to 4QFY09. Our FY09 estimates could see a boost if subsidy burden is reduced due to fall in oil prices. The stock trades at 7.5x FY09E EPS. Our target price is Rs372/share. We reiterate **Buy**.

P/E Multiple	13
FY10 EPS (Rs)	26.5
Value Rs/Share	
Core Business	345
E&P	23
Listed Investments	40
Unlisted investments	6
Total Value (Rs / Share)	414
Target price post-10% discount (Rs/Share)	372

Source: Company/ MOSL

GAIL (India): an investment profile

Company description

GAIL is a major gas transmission, processing, distribution and marketing company in India, with interests in gas distribution, petrochemicals, LPG, and telecom. It owns ~7,000km of pipelines (including LPG transmission pipelines), 410KTA petchem capacity, 1.3m ton LPG / other hydrocarbons capacity and over 13,000 km of optical fiber cable network. GAIL is also involved in city gas distribution, E&P and power businesses through its joint ventures.

Key investment arguments

- ✂ GAIL will be one of the key beneficiaries of several gas finds in India in recent years. We expect GAIL's transmission volumes to grow by 55% to 130mmscmd by FY10 driven by RIL's gas.
- ✂ GAIL's transmission tariffs for most of its network were reduced over last two years. As GAIL is ramping up investments significantly to upgrade and expand its network, we do not expect any further tariff cuts in the near term, despite the appointment of new regulator and upcoming regulations.
- ✂ GAIL's 32% increased petchem capacity to 410kta from January 2008 provides volume upsides. However, we remain bearish on the polymer cycle in view of large greenfield capacity expansion in ME & China.
- ✂ It already operates the CGD network in several key cities via nine JVs and plans to add a further 130 cities over the next 6-7years. It has stakes in 29 E&P blocks in India and overseas and has encountered hydrocarbon finds in five of its blocks.

Key investments risks

- ✂ Earlier than expected downturn in the petchem cycle.
- ✂ Significant increase in subsidies would impact its LPG business.
- ✂ Decline in LPG realizations in low oil price environment

Recent developments

- ✂ Set-up a subsidiary company for CGD and CNG corridor business in March 2008.
- ✂ Announced expansion of its petchem capacity to 500kt in short term and 800kt over longer term.

Valuation and view

- ✂ Stock currently trades at 7.5x FY09E.
- ✂ Our SOTP-based price target for GAIL is Rs372/share. We maintain **Buy**.

Sector view

- ✂ Gas sector in India is poised for a major upturn due to significant increase in gas availability from gas supplies coming from large-scale gas finds in India.
- ✂ GAIL as a monopoly in long distance gas transmission (excluding RIL's network and GSPL's network in Gujarat) would be key beneficiary.
- ✂ CGD holds a large potential as gas supplies improve. Post the recent notification of key regulations for CGD; we expect heightened activity in this space in form of bidding and awarding of licenses for new cities.

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
198	372	89.0	Buy

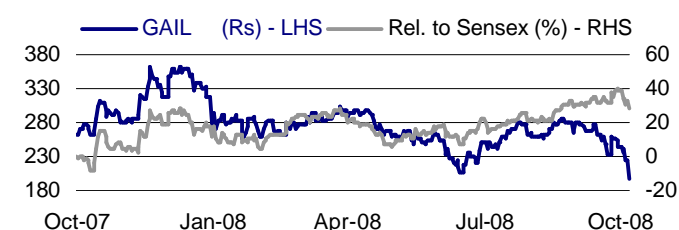
SHAREHOLDING PATTERN (%)

	SEP-08	JUN-08	SEP-07
Promoter	64.6	64.6	64.6
Domestic Inst	16.3	14.5	10.9
Foreign	15.9	17.7	22.1
Others	3.2	3.2	2.4

EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY09	26.4	25.1	5.1
FY10	26.5	26.8	-1.2

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT					
(Rs Million)					
Y/E MARCH	2006	2007	2008	2009E	2010E
Net Sales	144,594	160,472	180,082	222,631	261,310
Change (%)		110	12.2	23.6	17.4
Purchase	82,543	94,290	102,007	129,854	154,173
Raw Materials	12,285	17,851	17,148	22,443	39,197
Employee Costs	2,218	2,929	4,700	5,170	5,687
Power & fuel & other expe	12,819	16,182	17,033	15,741	9,178
Change in Stocks	-249	-753	-299	-449	0
EBITDA	34,979	29,973	39,492	49,872	53,075
% of Net Sales	24.2	18.7	21.9	22.4	20.3
Depreciation	5,595	5,754	5,710	5,954	8,061
Interest	1,173	1,071	796	808	811
Other Income	4,555	5,450	5,564	6,300	6,615
Extraordinary Items (net)					
PBT	32,766	28,598	38,550	49,410	50,819
Tax	9,666	8,130	12,535	16,398	17,177
Rate (%)	29.5	28.4	32.5	33.2	33.8
Adjusted PAT	23,101	20,468	25,442	33,485	33,642
Tax write back		3,399			
Reported PAT	23,101	23,867	26,015	33,012	33,642
Change (%)		3.3	9.0	26.9	19

BALANCE SHEET					
(Rs Million)					
Y/E MARCH	2006	2007	2008	2009E	2010E
Share Capital	12,685	12,685	12,685	12,685	12,685
Reserves	87,048	101,244	117,364	138,503	159,783
Net Worth	99,733	113,929	130,049	151,188	172,468
Long Term Loans	19,166	13,379	12,659	12,659	12,660
Deferred Tax	12,997	13,187	13,197	13,348	13,729
Capital Employed	131,896	140,494	155,904	177,195	198,857
Gross Fixed Assets	144,695	149,326	169,579	214,579	259,579
Less: Depreciation	69,135	74,782	80,246	86,200	94,261
Net Fixed Assets	75,560	74,544	89,333	128,378	165,318
Capital WIP	6,156	19,369	8,167	8,167	8,167
Investments	14,434	14,638	14,909	12,718	12,718
Curr. Assets, L & Adv.					
Inventory	4,832	5,524	5,698	6,265	6,866
Debtors	7,535	7,907	10,735	11,630	12,844
Cash & Bank Balance	44,959	26,604	44,730	32,846	20,544
Loans & Adv. and Other A	65,560	37,420	42,937	43,160	43,405
Current Liab. & Prov.					
Liabilities	31,646	25,856	33,610	36,979	40,976
Provisions	55,494	19,656	26,994	28,991	30,029
Net Current Assets	35,747	31,943	43,496	27,931	12,653
Application of Funds	131,896	140,494	155,904	177,195	198,857

E: M0St Estimates

RATIOS					
Y/E MARCH	2006	2007	2008	2009E	2010E
Basic (Rs)					
EPS	18.2	16.1	20.1	26.4	26.5
Cash EPS	22.6	23.4	25.0	30.7	32.9
Book Value	78.6	89.8	102.5	119.2	136.0
DPS	7.0	7.0	7.0	8.0	8.0
Payout	38.4	43.4	34.9	30.3	30.2
Valuation (x)					
P/E		12.2	9.9	7.5	7.5
Cash P/E		8.5	7.9	6.4	6.0
EV / EBITDA		7.9	5.5	4.6	4.6
EV / Sales		15	12	10	0.9
Price / Book Value		2.2	1.9	1.7	1.5
Dividend Yield (%)		3.5	3.5	4.0	4.0
Profitability Ratios (%)					
RoE	23.2	20.9	20.0	21.8	19.5
RoCE	25.7	21.1	25.2	28.3	26.0
Turnover Ratios					
Debtors (No. of Days)	19	18	22	19	18
Fixed Asset Turnover (x)	1.1	1.1	1.2	1.3	1.3
Leverage Ratio					
Debt / Equity (x)	0.2	0.1	0.1	0.1	0.1

CASH FLOW STATEMENT					
(Rs Million)					
Y/E MARCH	2006	2007	2008	2009E	2010E
OP/(Loss) before Tax	32,766	28,598	38,550	49,410	50,819
Depreciation	5,605	5,752	5,739	5,954	8,061
Other op items	-2,465	-780	488	0	0
Direct Taxes Paid	-8,616	-8,574	-10,268	-16,247	-16,796
(Inc)/Dec in Wkg. Capital	5,944	-10,151	-388	3,681	2,976
CF from Op. Activity	33,233	14,844	34,122	42,798	45,060
(Inc)/Dec in FA & CWIP	-6,104	-20,367	-12,295	-45,000	-45,000
(Pur)/Sale of Investment:	-6,462	-205	-270	2,191	0
Inc from Invst	3,377	3,884	4,042	0	0
CF from Inv. Activity	-9,189	-16,688	-8,523	-42,809	-45,000
Issue of Shares	0	0	0	0	0
Inc / (Dec) in Debt	-1,982	-6,869	-1,537	0	0
Dividends Paid	-11,571	-9,643	-5,936	-11,872	-12,362
CF from Fin. Activity	-13,553	-16,512	-7,473	-11,872	-12,362
Inc / (Dec) in Cash	10,491	-18,356	18,126	-11,884	-12,302
Add: Opening Balance	34,468	44,959	26,604	44,730	32,846
Closing Balance	44,959	26,604	44,730	32,846	20,544

N O T E S



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Disclosure of Interest Statement

GAIL (India)

- | | |
|---|----|
| 1. Analyst ownership of the stock | No |
| 2. Group/Directors ownership of the stock | No |
| 3. Broking relationship with company covered | No |
| 4. Investment Banking relationship with company covered | No |

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