**Quantum Information Services Private Limited**
*Independent Investment Research*
17 June, 2006

# Indraprastha Gas Limited

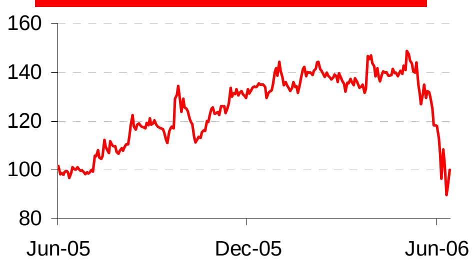
## Buy — Target price: Rs 150

**Reason for the review:** We had recommended the stock in August 2005 at Rs 108 with a target price of Rs 150. The stock breached our target price and in the recent stock market decline, is lower than our earlier recommended price. Also, given the petroleum price hike, we feel that the case for investing in companies like Indraprastha Gas for the long-term has strengthened.

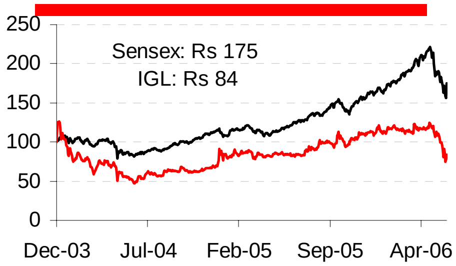
### Market data

| | |
|---|---|
| Current price | Rs 101 (BSE) |
| Market cap | Rs 14,140 m |
| Face value (Rs) | 10 |
| FY06 Div/share | 2,5 |
| NSE symbol | IGL |
| No of shares | 140.0 m |
| Free float | 55.0% |
| 52 week H/L | Rs 154 / 86 |

### Share price chart




### Rs 100 invested is worth




### Shareholding

| Category | (%) |
|---|---|
| Promoters | 45.0 |
| Banks, FIs, MFs | 18.7 |
| FIIs | 22.5 |
| Public | 10.9 |
| Others | 2.9 |
| Total | 100.0 |

### Report prepared by

Quantum Information Services
www.equitymaster.com
info@equitymaster.com

### Investment Rationale

- **The substitute effect:** Even after the recent fuel price hike in the case of diesel and petrol (LPG prices and kerosene were maintained), there is a significant subsidy element (i.e. retail prices are artificially lower). Since natural gas i.e. CNG (compressed natural gas used in automobiles) and PNG (piped natural gas used for domestic purpose) and natural gas (used by industrial consumers) is a cost effective alternative, we believe that the case for gas as against conventional fuels has strengthened. To put things in perspective, CNG is cheaper by as much as 30% to 35% (cost per kilometer) and the same for LPG is in the vicinity of 10% to 12%. We do not expect this cost advantage to narrow going forward.

  If crude prices continue to remain firm/increase, more fuel price hikes cannot be ruled out. Secondly, we do not expect commensurate revision in prices of PNG and CNG, which means that the cost advantage will continue to favour natural gas as against conventional fuels. As far as the cost of kits are concerned, the company does not foresee any issue with respect to the same and therefore, we expect a stable growth in CNG vehicle base going forward.

  We have factored in a 5% increase in CNG vehicle population in Delhi over the next two years. This could be amplified if there is a clear directive as far as the conversion of light commercial vehicles (LCVs) in the NCT. In the last three years, vehicle population for the company has grown at a CAGR of over 7%. Overall, taking PNG also into consideration, we expect the topline to grow at a CAGR of 15% over the next two years. More importantly, we do not see any major issues with respect to availability of gas, given the agreements with GAIL.

- **New city expansion:** IGL has been investing in pipelines and distribution towards expansion into surrounding cities such as Noida, Ghaziabad, Gurgaon and Faridabad. These regions constitute the industrial belt and provide immense opportunities to the CNG and PNG business. As such, IGL has been able to get an allocation of 0.7 MMSCMD of natural gas to cater to this region. While we expect the company to incur capital expenditure upfront, we have not factored in any revenues from this expansion, pending clarity on the same. To that extent, there is significant upside to our estimates, especially on the CNG front, over the next two to three years.

- **Price increases:** In June 2006, IGL increased prices of CNG gas by 6.6% to Rs 19.2 per kg, which the company attributed to higher gas cost, increase in taxes and duties. We believe that this will help IGL maintain operating margins at the current level in the near-term. Though operating margins are expected to decline over the next two years, as soon as the nearby city roll out starts (in terms of addition of customers), margins may actually increase. This is because CNG is a profitable business as compared to industrial supplies.

## Comparative Valuations

| | IGL | Guj Gas |
|---|---|---|
| **Operating ratios** | | |
| Sales CAGR (FY02-FY06) | 44.7% | 14.2% |
| EBDITA margin (FY06) | 41.0% | 22.6% |
| Profits CAGR (FY02-FY06) | 100.7% | 13.4% |
| Net profit margin (FY06) | 20.4% | 14.7% |
| EBDITA/TSCM (Rs m) | 5.5 | 2.1 |
| **Return ratios** | | |
| Return on equity (FY06) | 27.9 | 29.0 |
| Return on assets (FY06) | 18.4 | 15.9 |
| Gross asset turnover (FY06) | 1.1 | 1.3 |
| **Valuations** | | |
| Price (Rs) | 102 | 1,010 |
| Price to earnings (FY06, x) | 13.5 | 13.2 |
| Price to book value (FY06, x) | 3.8 | 3.8 |

## Investment Concerns

- **Gas prices and government intervention:** At this current juncture, IGL sources gas primarily from GAIL at administered prices. Like we had mentioned earlier, if the government decides to increase gas prices going forward, the company may not be in a position to pass on the cost to the consumer. Secondly, given that operating margins of the company are well in excess of 40% levels, in case the government forces the company to share subsidies, the performance will be affected. Added to this, currently, the cost of the gas is the same for CNG, PNG and industrial consumers. If the government increases the cost of gas supplied to only the industrial side, the company's profitability may suffer. We do not foresee any other major risks besides these.

## Background

IGL dominates the NCT (National Capital Territory) of Delhi, as it is the sole gas player in the market backed by GAIL and BPCL as its promoters. The company has benefited to a great extent from the Supreme Court's verdict to convert all public transport vehicles in Delhi to CNG compliant so as to control pollution.

IGL sources its natural gas requirements from its parent company GAIL through the HBJ pipeline. It has a network of 300 kms of pipeline for the PNG (piped natural gas) business and another 130 kms for the CNG (compressed natural gas) business, thereby surrounding the length and breadth of the NCT of Delhi. It currently has an allocation of 2 MMSCMD (million metric standard cubic meters of gas per day) and an additional allocation of 0.7 MMSCMD to cater to surrounding areas such as Noida, Gurgaon and Faridabad is also available.

## Industry Prospects

Growth prospects on the gas distribution side hinges on the following factors. Firstly, taking the case of Delhi, there is a need to shift all pubic transport from conventional fuels (petrol and diesel) to CNG to control pollution for which the Supreme Court is also in agreement. Secondly, the availability of gas, both in terms of volumes as well as in terms of distribution network, needs to improve to facilitate the shift. Thirdly, the awareness amongst consumers (retail and commercial) is also a critical factor that plays a role in driving CNG and PNG demand. In our view, like in the case of Delhi and Mumbai, we believe that other cities are likely to follow suit. Having said that, the shift towards CNG and PNG largely hinges on the availability of natural gas.

## Risk Matrix

**Sector:** Given the significant increase in fuel prices, growing concern for the environment and stringent pollution norms in key metros, we believe that demand for natural gas to increase at a robust pace over the next three to five years. Perhaps the major concerns are government intervention and more importantly, availability of gas. Thus, keeping in mind the supply side constraints, we assign a medium-risk rating of 6.

**Sales:** IGL is a focused player on two counts. One, it is pure natural gas distribution play and secondly, operating in the Delhi region both of which restricts the company ability to grow the business. Also, availability of gas also acts as a hindrance. The impact of any change in government policy on a focused company like IGL will be pronounced and therefore, we assign a high risk rating of 1.

**Current ratio:** We have taken the last five years' data for the purpose of calculating this ratio. IGL's average current ratio during the period has been 1.0 times. This indicates that IGL has a reasonably comfortable ability to pay off its short-term obligations. We assign a medium-risk rating of 6.

**Debt to equity ratio:** A highly leveraged business is the first to get hit during times of economic downturn, as companies have to consistently pay interest costs, despite lower profitability. We believe that a debt to equity ratio of greater than 1 is a high-risk proposition. Considering, IGL's average debt to equity ratio of just 0.3 over the past five fiscals, we have assigned a low-risk rating of 10 to the stock.

**Long term EPS growth:** We expect the company's net profit to grow at a compounded rate of around 15% to 18% over the next two years (growth of 100% during FY02-FY06). Though growth was higher in the last five years, it was on a lower base. Though we have factored in 17% CAGR in net profits, it could be higher if the expansion in other cities materializes. As such, the rating assigned to the stock on this factor is 6.

**Dividend payout:** A stable dividend history inspires confidence in the management's intentions of rewarding shareholders. IGL's dividend payout, though was low prior to FY04 owing to the fact that it was in its early stages, it has been at a healthy 30% in the last two years. Given the strong cash flows, we do not see any reason why the company will not sustain this payout and therefore, assign a low-risk rating of 8.

**Promoter holding:** A larger share of promoter holding indicates the confidence of the people who run it. We believe that a greater than 40% promoter holding indicates safety for retail investors. At the end of March 2006, the combined holding of GAIL and BPCL stood at 45%, which are strategic in nature. We have assigned a low-risk rating of 8.

**FII holding:** We believe that FII holding of greater than 25% can lead to high volatility in the stock price. FII holding in TCS at the end of March 2006 stood at around 22%, which is comfortably within the limits. Therefore, the rating assigned is 5.

**Liquidity:** Given the fact that it is not yet three years since IGL got listed on the stock market, the last one-year average traded volumes is well above 150,000 shares, which is good. Therefore, we assign a rating of 5.

**Margin of safety:** This is to determine the value of the stock relative to its price and the returns over a risk free rate. Margin of safety of a stock lies in its earning power, which is calculated as - EPS divided by Market price (reciprocal of P/E). Considering IGL's P/E of 13.5 times its FY06 earnings, the earning power is 7.4%, which is marginally lower than the risk free rate of return of 7.7%. Thus, the rating assigned is 1.

**Considering the above parameters, the total ranking assigned to the company is 56. This makes the stock a medium-risk investment from a long-term perspective.**

**Risk Matrix**

| | High Risk | Medium Risk | Low Risk |
|---|---|---|---|
| Rating | (1 to 3) | (4 to 6) | (7 to 10) |
| Sector | High | Medium | Low |
| Sales (US$ m) | < 500 | 501-1,000 | > 1,000 |
| Current Ratio (x) | < 1 | 1 - 2 | > 2 |
| Debt to equity ratio (x) | > 1 | 0.5 - 1 | < 0.5 |
| Long term EPS growth (%) | < 10 | 10 - 20 | > 20 |
| Dividend Payout (%) | < 15 | 15 - 25 | > 25 |
| Promoter holding (%) | < 25 | 25 - 40 | > 40 |
| FII holding (%) | > 25 | 10 - 25 | < 10 |
| Liquidity (Nos. '000) | < 100 | 100 - 200 | > 200 |
| Margin of Safety (%) | < 3 | 3 - 6 | > 6 |
| Final Rating | < 30 | 30 - 60 | > 60 |

## Valuations

At Rs 101, the stock is trading at a price to earnings multiple of 9.5 times our estimated FY08 earnings. As we had mentioned earlier, we have not factored in any upside from the potential entry into four new cities. Also, we have lowered operating margins of the company by around 150 basis points to reflect the rising gas cost.

We had recommended the stock earlier in August 2005 at Rs 108 with a target price of Rs 150, which was achieved. In light of the recent stock market decline, the stock has also fallen, prompting us to revisit our earlier recommendation. We continue to believe that there is earnings growth visibility from a long-term standpoint, given the supply side security is concerned. Given the retail focus of the company with superior operating margins, we recommend a BUY on the stock.

In the energy sector, Indraprastha Gas is one of our preferred plays. Even though it is a smaller company, as we had mentioned earlier, it is into gas distribution, which is a niche segment.

### Valuation table

| | FY05 | FY06UA | FY07E | FY08E |
|---|---|---|---|---|
| Revenue (Rs m) | 4,500 | 5,209 | 6,141 | 7,122 |
| PAT (Rs m) | 926 | 1,062 | 1,276 | 1,496 |
| EPS (Rs) | 6.6 | 7.6 | 9.1 | 10.7 |
| Price to earnings (x) | 15.5 | 13.5 | 11.2 | 9.6 |
| EV/EBDITA (x) | 7.9 | 6.6 | 5.5 | 4.4 |

### Over the past few years

| | FY03 | FY04 | FY05 | FY06UA |
|---|---|---|---|---|
| Promoter holding (%) | 45.0 | 45.0 | 45.0 | 45.0 |
| Net sales (Rs m) | 3,069 | 4,262 | 4,500 | 5,209 |
| EBDITA margin (%) | 38.9% | 39.8% | 41.0% | 41.0% |
| Net profit (Rs m) | 540 | 822 | 926 | 1,062 |
| Net margin (%) | 17.6% | 19.3% | 20.6% | 20.4% |
| Debt to equity (x) | 0.4 | 0.2 | 0.4 | 0.2 |
| Return on NW (%) | 27.9% | 32.6% | 29.6% | 28.0% |
| Dividend /share (Rs) | 0.5 | 1.5 | 2.0 | 2.5 |

### Financials at a glance

| **(Rs m)** | **FY05** | **FY06UA** | **FY07E** | **FY08E** |
|---|---|---|---|---|
| Sales | 4,500 | 5,209 | 6,141 | 7,122 |
| *Sales growth (%)* | *5.6%* | *15.8%* | *17.9%* | *16.0%* |
| Operating profit | 1,844 | 2,137 | 2,496 | 2,886 |
| *Operating profit margin (%)* | *41.0%* | *41.0%* | *40.7%* | *40.5%* |
| Net profit | 926 | 1,062 | 1,276 | 1,496 |
| *Net profit margin (%)* | *20.6%* | *20.4%* | *20.8%* | *21.0%* |
| | | | | |
| **Balance Sheet** | | | | |
| Current assets | 1,458 | 1,603 | 2,269 | 3,289 |
| Net fixed assets | 3,907 | 4,147 | 4,308 | 4,390 |
| Investments | - | - | - | - |
| **Total Assets** | **5,365** | **5,750** | **6,577** | **7,679** |
| | | | | |
| Current liabilities | 1,116 | 1,229 | 1,312 | 1,525 |
| Net worth | 3,128 | 3,794 | 4,638 | 5,627 |
| Total debt | 1,122 | 722 | 622 | 522 |
| **Total liabilities** | **5,365** | **5,744** | **6,572** | **7,674** |

### Sector Statistics

| Sales (Rs m) | | Market cap. (Rs m) | | EBDITA margin (%) | | Net profit margin (%) | | Return on NW (%) | |
|---|---|---|---|---|---|---|---|---|---|
| GAIL | 163,513 | GAIL | 197,882 | **IGL** | **41.0%** | Gujarat Gas | 25.0% | Gujarat Gas | 29.0% |
| Gujarat Gas | 6,160 | **IGL** | **14,315** | Gujarat Gas | 22.6% | **IGL** | **20.4%** | **IGL** | **28.0%** |
| **IGL** | **5,209** | Gujarat Gas | 12,953 | GAIL | 21.4% | GAIL | 14.1% | GAIL | 23.2% |

**Important Notice:** Quantum Information Services Pvt. Limited (Equitymaster) is an Independent Equity Research Company.

**Disclosure:** The author of this article does not hold shares in the recommended company. QIS does not hold shares in the recommended company.