

Gujarat Gas Company Limited

Sell

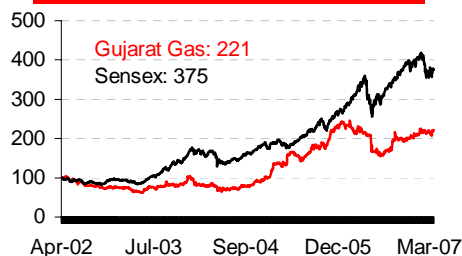
Market data

| | |
|----------------|---------------|
| Current price | Rs 1329(BSE) |
| Market cap | Rs 17,044 m |
| Face value | Rs 10.0 |
| CY06 Div/share | Re 12.5 |
| NSE symbol | GUJRATGAS |
| No of shares | 12.8 m |
| Free float | 34.9% |
| 52 week H/L | Rs 1400 / 900 |

Share price chart



Rs 100 invested is worth



Shareholding

| Category | (%) |
|--------------------|-------|
| Promoters | 65.1 |
| Banks, MFs and FIs | 4.5 |
| FIIIs | 16.2 |
| Public | 8.3 |
| Others | 5.9 |
| Total | 100.0 |

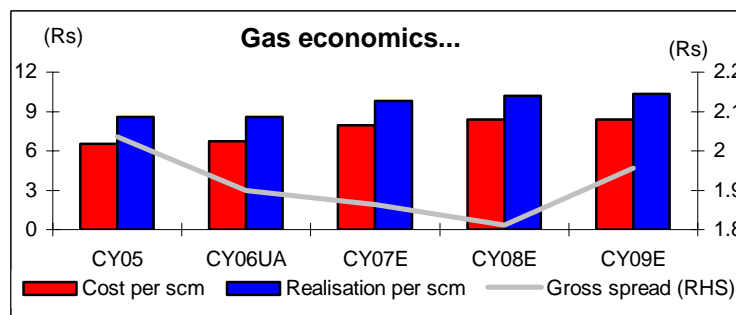
Report prepared by

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

Investment Concerns

- Valuations running ahead of fundamentals:** At the current price of Rs 1,329, the stock is trading at multiples of 12.5 and 9 times its CY09E earnings and cash earnings respectively. Gujarat Gas (GGCL) is likely to witness robust growth over the next couple of years; however benefits from the same are largely factored into the prices. Based on the return ratios and our analysis of company's business model, we arrive at a fair value of Rs 1,449 for the stock, translating into a CAGR of just 3%.

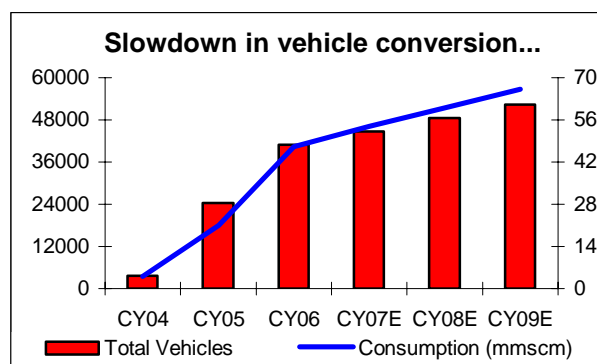
According to our estimates, while sales volumes are likely to register a CAGR of 14.3% between CY06 and CY09, a chunk of it will be diverted towards the low margin bulk segment, as developing retail market takes time. This will have the effect of generating subdued returns on incremental capital. However, the impact of the same will not be as severe as it was in CY03, when major chunk of gas supplies from Cairn India were supplied to bulk customers.



- Long-term supply concerns:** The company has successfully added one supplier every year since 2002. However, inspite of superior sourcing policy, it might see supply constraints in the future. Gas supplies from ONGC's Gandhar field are likely to further decline from the current level, which is reflected in the table below. Also, the GSPCL contract (up for renewal in June 2007) is not likely to renew. Much of the volumes growth is likely to come from Panna-Mukta-Tapti (PMT), where GGCL's parent BG has 30% stake. Thus, the supplies are also likely to see a concentrated pattern going forward. The medium-term supply concerns have however eased with significant volume addition from PMT.

| Supply mix | CY05 | CY06UA | CY07E | CY08E | CY09E |
|-----------------------|-------|--------|-------|-------|-------|
| Cairn | 34.0% | 38.0% | 24.6% | 20.1% | 23.4% |
| GAIL | 7.0% | 5.0% | 3.8% | 3.1% | 2.8% |
| GSPCL | 22.0% | 14.0% | 4.8% | 0.0% | 0.0% |
| NIKO | 13.0% | 10.0% | 8.2% | 6.7% | 6.4% |
| RLNG | 3.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| PMT | 21.0% | 33.0% | 58.6% | 70.0% | 69.0% |
| Gas purchases (mmscm) | 819 | 1,097 | 1,280 | 1,564 | 1,644 |

- **CNG growth to taper off:** Gujarat Gas has seen a spurt in CNG sales over the past few years, aided largely by government policies with respect to fuel to be used for autos. However, with majority of autos being already converted to CNG, the incremental growth is likely to be on the lower side. The potential of conversion of private car to CNG, if at all it happens is likely to be on the lower side. With margins in CNG being the highest, this is likely to drag down the overall margins for the company.



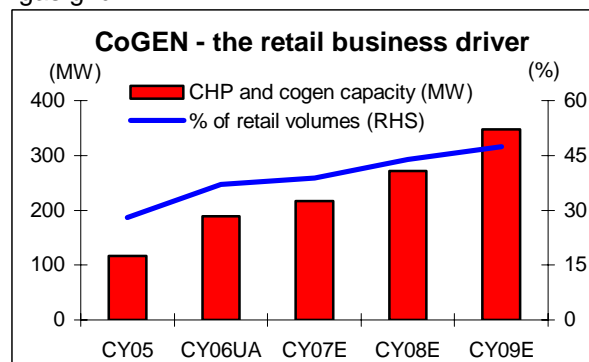
- **Competition in bulk segment:** GGCL and GSPL (Gujarat State Petronet Limited) have overlapping geographical presence in some parts of Gujarat, which can have an impact over the margins in the bulk segment.

Investment Rationale

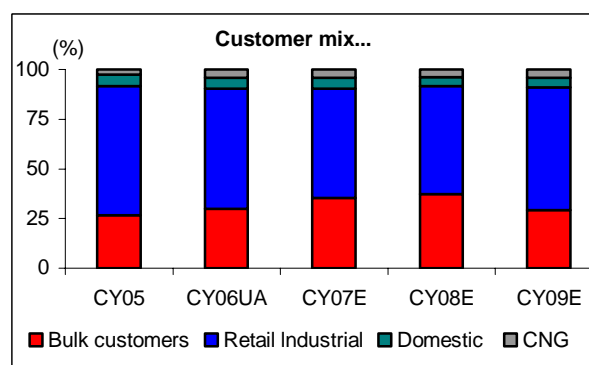
- **COGEN- the retail driver:** Gross gas spread for the company has seen an improvement in the past few years and a lot of it can be attributed to the growth in the CHP segment (combined heating and power segment). The share of CHP segment in the retail volumes has increased from 17% (in CY02) to 37% (in CY06) and the same is further likely to increase to 48% in CY09 as per our estimates. The company expects to add around 15-20 MW of COGEN capacity every year for the next few years. Increase of COGEN and CHP segment is expected to improve the ability to maintain margins for the company.

COGEN is a cost effective way to produce electricity and it also uses the waste heat in an optimal manner. Under this segment, the company builds plants for producing electricity and leases them out to the customers and also provides gas on a strategic basis. Thus, apart from the sales of the natural gas, GGCL receives lease rental on the operational plants. As per our understanding, the lease rental for

every Mega Watt of the capacity is likely to be around Rs 8 m. As per the management, the IRR's from the segment are likely to be in the region of 15% to 20%. Also, the inherent risk in the business is low due to favorable spark spread enjoyed by the company over the state gas grid.



- **Striking a right balance between retail and bulk segment:** GGCL has improved its customer mix from low margin bulk business to high margin retail business. The bulk segment contributed 30% of the CY06 volumes, while the retail segment contributed the remaining. Bulk segment provides an opportunity for the company to negotiate cost from suppliers and ensure volumes offtake, while the retail drives margins. Thus, a fine mix between both the segments helps the company to maintain its gross gas spreads.



- **Strong parent:** British Gas, GGCL's parent has the required expertise to operate complex business such as COGEN and develop new gas applications. Also, the upstream ventures of BG can assure further supplies for the company in the long term. PMT, a BG joint venture, currently produces around 10 MMSCMD, with only half allowed to be marketed by the private partners. With increase in supplies from other domestic sources, (KG basin) the government might increase the allocated marketing share of the

private partners. The share of BG is most likely to go to GGCL, thus giving a supply boost to the latter.

Background

Gujarat Gas Company (GGCL), a 65% subsidiary of the global gas major British Gas, is India's largest private sector gas distribution and transmission company and has a regional presence across three of the largest industrial cities in the state of Gujarat. With a pipeline network of over 2,100 kms (nearly 35% of GAIL's gas pipeline network), the company caters to industrial (for their energy requirements), domestic (piped natural gas or PNG) and automobiles (compressed natural gas or CNG) in the cities of Surat, Ankleshwar and Bharuch. Currently, company is building pipeline network in Vapi. GGCL supplies approximately 3 million standard cubic meters per day (MMSCMD) to 1.9 lakh domestic, 2,200 commercial, 41,000 automobiles, and 650 industrial customers. GGCL pioneered the concept of gas distribution to industrial, commercial and domestic customers in Ankleshwar and Bharuch in 1989 and later expanded to Surat in 1991.

Industry Prospects

Natural gas is the cleanest source of energy available at the disposal of the mankind. It forms 23% of the total energy consumption globally, while in India it accounts for just 9% of the Indian energy matrix. The lower share could largely be attributed to supply side constraints. The demand side of the story continues to be buoyant with the same consistently outpacing supply. Supply side constraints were largely a factor of government regulation in Exploration and Production (E&P) along with the regulations on the pricing of natural gas. With increased E&P activity due to success of NELP (News Exploration Licensing Policy), the supply side business also looks promising.

Going forward, major gas supplies are likely to come from private players (majorly Reliance), which in turn, is likely to deregulate the pricing of natural gas in the country. The government has allowed private players to market their gas directly to the consumers; following this stance the Panna-Mukta-Tapti consortium (joint venture between ONGC, British Gas and Reliance) has started selling gas at price of US\$ 4.75 per MMBTU (million metric British thermal units).

Risk Analysis

Sector: Going forward we might see significant increase in the natural gas supplies in the country,

which is going to lead to fuel displacement (from liquid to gas) in the industry. We believe that demand for natural gas is set to increase at a robust pace. An existence of superior infrastructure to transport natural gas in Gujarat along with acceptance of market based pricing, makes Gujarat a matured gas market in the country. Also, lower volatility and relatively stable natural gas prices make it a preferred fuel for industries. Thus, based on our understanding we impart a rating of 6 to the sector.

Sales: Gujarat Gas Company (GGCL) is pure natural gas distribution play, which has moved up the value chain by superior gas placement and improved business mix. The company has registered a growth of 20.8% in revenues over the past five years. Sales growth for the gas distribution companies is largely a function of gas availability. We are optimistic of the medium term sales prospects of the company and therefore, assign a medium risk rating of 3.

Current ratio: We have taken the last six years' data for the purpose of calculating this ratio. GGCL's average current ratio during the period has been 0.4 times. However, in lieu of its strong cash flow generating ability, we do not foresee any problems. We thus 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, the fact that GGCL has lower debt equity ratio of 0.3, the rating assigned is 7.

Long term EPS growth: We expect the company's net profit to grow at a CAGR of 16% over the next three years (CY07 to CY09). As such, the rating assigned to the stock on this factor is 4.

Dividend payout: A stable dividend history inspires confidence in the management's intentions of rewarding shareholders. GGCL's average dividend payout for the last five years has been 18%. 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 6.

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 December 2006, the promoter holding the company stood at 66%, which is strategic in nature. We have thus 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 GGCL at the end of December 2006 stood at around 16.2%, which is comfortably within limits. Therefore, the rating assigned is 5.

Liquidity: Average daily volume for the GGCL's stock over the past 5 year is above 5,000. This is fairly low. Moreover, despite stock split, the liquidity is still likely to be lower going forward. We thus assign a low risk rating of 1.

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 (a reciprocal of P/E). Considering GGCL's P/E of 19.5 based on trailing twelve months earnings, the earning power is 5.1%, which is much lower than the risk free rate of return of 8.2%. Thus, the rating assigned is 2.

The aggregate of all the points based on above parameters is 48. This makes the company a medium-risk proposition from a long-term point of view.

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

As mentioned earlier, the current valuations of the company seem to be running ahead of fundamentals. We are of the view that the valuations of a company have a strong co- relation to returns and value growth. In view of suppressed margins

and lack of supply visibility over the long-term, the potential for expansion of both of these parameters from the current levels are low and hence our 'SELL' recommendation. Having said that, faster ramp up of retail operations than expected and tying up of additional long-term supply agreements might present an upside risk to our estimates. Further, the unlocking of its 1% stake in GSPCL might also add around Rs 150 to its per share value. However, the company is still to take a decision on this and hence, we have not factored this into our assumptions.

Valuation table

| (Rs m) | CY06 | CY07E | CY08E | CY09E |
|--------------------|-------|--------|--------|--------|
| Revenues | 9,685 | 12,955 | 16,529 | 17,623 |
| PAT | 875 | 962 | 1,158 | 1,382 |
| EPS (Rs) | 68.2 | 75.0 | 90.3 | 107.7 |
| PE (x) | 19.5 | 17.7 | 14.7 | 12.3 |
| Price to sales (x) | 1.8 | 1.3 | 1.0 | 1.0 |
| Price/BV (x) | 3.8 | 3.3 | 2.8 | 2.3 |

Comparative Valuation

| | IGL | Guj. Gas* |
|----------------------------------|--------|-----------|
| Operating Ratios | | |
| Sales CAGR (FY02-FY06) | 44.7% | 16.3% |
| EDBDITA margins (FY06/CY06) | 41.1% | 15.4% |
| Profit CAGR(FY02-FY06) | 100.7% | 12.1% |
| Net profit margins (FY06/CY06) | 20.4% | 9.0% |
| Return Ratios | | |
| Return on equity (FY06/CY06) | 28.1% | 19.6% |
| Gross asset turnover (FY06/CY06) | 1.1 | 0.8 |
| Valuations | | |
| Price | 97 | 1329 |
| PE (FY09/CY09) | 7.7 | 12.5 |
| Price / CEPS (FY09/CY09) | 5.8 | 9.2 |

* Based on CY06UA

Over the years

| Particulars | CY03 | CY04 | CY05 | CY06 |
|--------------------|-------|-------|-------|-------|
| Promoter holding | 65.1% | 65.1% | 65.1% | 65.1% |
| Net sales (Rs m) | 7,089 | 6,531 | 7,468 | 9,685 |
| EBDITA (%) | 16.1% | 20.4% | 19.7% | 15.4% |
| Net profit (Rs m) | 707 | 769 | 981 | 875 |
| Net margin (%) | 10.0% | 11.8% | 13.1% | 9.0% |
| Debt to equity (x) | 0.7 | 0.7 | 0.7 | 0.7 |
| RONW (%) | 30.5% | 26.1% | 26.0% | 19.6% |
| DPS (Rs) | 10.0 | 10.0 | 10.0 | 12.5 |

Financials at a glance

| (Rs m) | CY06UA | CY07E | CY08E | CY09E |
|-----------------------------|--------|--------|--------|--------|
| Sales | 9,685 | 12,955 | 16,529 | 17,623 |
| Sales growth (%) | | 33.8% | 27.6% | 6.6% |
| Operating profit | 1,492 | 1,702 | 2,077 | 2,444 |
| Operating profit margin (%) | 15.4% | 13.1% | 12.6% | 13.9% |
| Net profit | 875 | 962 | 1,158 | 1,382 |
| Net profit margin (%) | 9.0% | 7.4% | 7.0% | 7.8% |

Balance sheet

| | | | | |
|--------------------------|--------------|--------------|---------------|---------------|
| Current assets | 1,264 | 1,423 | 2,043 | 2,519 |
| Fixed assets | 5,637 | 6,603 | 7,555 | 8,490 |
| Investments | 1,400 | 1,400 | 1,400 | 1,400 |
| Other assets | 38 | 24 | 12 | 5 |
| Total Assets | 8,339 | 9,451 | 11,009 | 12,414 |
| Net worth | 4,463 | 5,229 | 6,177 | 7,345 |
| Minority interest | 33 | 39 | 46 | 53 |
| Loan funds | 1,373 | 1,023 | 873 | 873 |
| Other Liabilities | 2,470 | 3,160 | 3,913 | 4,144 |
| Total liabilities | 8,339 | 9,451 | 11,009 | 12,414 |

Sector Statistics

| Sales (Rs m) | Market cap. (Rs m) | EBDITA margin (%) | Net profit margin (%) | Return on NW (%) |
|-------------------|--------------------|-------------------|-----------------------|-------------------|
| GAIL 163,513 | GAIL 238,050 | IGL 41.1% | IGL 20.4% | IGL 28.1% |
| Gujarat Gas 9,365 | Gujarat Gas 17,044 | Gujarat Gas 15.4% | GAIL 14.1% | GAIL 23.2% |
| IGL 5,209 | IGL 13,538.00 | GAIL 21.4% | Gujarat Gas 9.0% | Gujarat Gas 19.6% |

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

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