KHANDWALA SECURITIES LIMITED

Gail India Limited

September 30, 2008

Company Update

Company Update

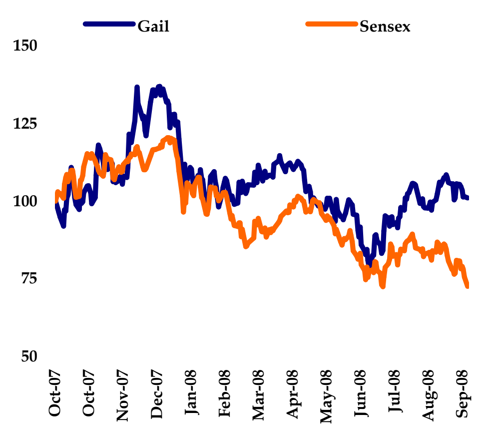
CMP: INR 401 **Target Price: INR 485** **OUTPERFORMER**

Sector View	Positive
Company Risk	Medium
BSE Sensex	12,596
S&P Nifty	3,850
BSE Oil & Gas	8,925
Bloomberg Consensus	
(BUY/SELL/HOLD)	16 / 3 / 4
BSE Code	532155
NSE Code	GAIL
Bloomberg Code	GAIL IN
Reuters	GAIL.BO
52 Wk High/Low (INR)	555 / 305
Equity (INR Mn)	8,457
Market Cap. (INR Mn)	338,768

Shareholding Pattern (%)	
Foreign	17.71
Institutions	14.49
Corporate	7.24
Promoters	0.74
Public & Others	57.35

Returns	**Abs**	**Relative to**	
(%)	**Perf**	**Sensex**	**BSE O&G**
1 Month	0.63	13.75	8.51
3 Months	20.32	26.75	21.25
1 Year	1.10	28.41	8.92

Relative Price Performance



Source: Comline Products

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Investment Arguments

- ✓ **Aggressive Capex slated ahead:** GAIL has a huge Capex of approx INR 280 bn slated in the coming five years which will increase the transmission capacity from current 150 mmscmd to 346 mmscmd. This expansion is likely to capitalize the twofold increase in the production of natural gas. Optimal mix of internal accrual and borrowing could provide good upside to our current valuation of INR 241 for the transmission business.
- ✓ **Tariff uncertainty prevails:** The transmission tariff structure is yet uncertain, awaiting decision by PNGRB. We don't see a significant deviation from the current average tariff of INR 820/tscm. However, company may find it difficult to attain reasonable rate of return as determined by government unless availability of natural gas justifies the capex incurred.
- ✓ **Default beneficiary on commissioning of KG-D6:** EGOM has prioritized power and fertilizer sector for natural gas from KG-D6 by RIL. The stranded gas based power and fertilizer plants would require gas supply via GAIL pipelines. The power and fertilizer plants planned in 11th and 12th five year plan in the north and west India region would capitalize the up gradations in Dahej-Vijaipur, GREP and Dadri-Bawana pipelines which form approx 50% of the expansion in transmission business.
- ✓ **Leveraging on High crude oil prices:** Petrochemical business is earning extraordinary margins of ~ 54% on account of high crude oil price being passed on to the end product users. Increasing global supply and competition would pressurize the product prices, thus likely to suppress the margin. We believe a gradual rise in Non-APM gas and RLNG prices, decline in crude prices and competition from Middle East could pressurize petrochemical margins going forward. We are also concerned about availability of feedstock post commissioning of Dahej C2/C3 plant by ONGC.
- ✓ **Subsidy Relief:** Government hinted rationalization by imposing burden of Rs 3.8 bn in previous two quarters, although crude oil price had risen from $98 to $126 a barrel during the same period. Reduction in crude price could further lower subsidy burden.

Financial Summary

(INR Mn)	2006-07	2007-08	2008-09E	2009-10E
Net Sales	160,472	180,082	243,386	314,890
EBITDA	35,346	39,492	51,045	51,723
PAT	23,867	26,015	33,388	32,117
EPS (INR)	28.22	30.76	39.48	37.98
P/E	14.17	13.00	10.13	10.53
ROE (%)	20.95	20.00	20.43	16.42

Valuation

The power and fertilizer plants planned in 11th and 12th five year plan in the north western region would capitalize the up gradations in Dahej-Vijaipur and Dadri-Bawana pipelines which form approx 50% of the expansion in transmission business. The volumes are expected to grow at CAGR 14% in next five years. Timely execution and optimal budgeting of capex would be a key catalyst to the valuation. Rise in Non-APM gas and RLNG prices, decline in crude prices and increasing global supply and competition would pressurize petrochemical margins going forward. Commissioning of Dahej C2/C3 plant by ONGC could threaten the availability of feedstock for petrochemical plants. With a cautious outlook towards petrochemical we have assigned EV/EBITDA 5x to petrochemical business. Decline in crude price could bring down the subsidy burden even further, triggering the valuation in LPG segment. Unlocking of exploration and city gas distribution business could enhance our valuation further. Our SOTP valuation arrives at a target price of **INR 485 representing 21% upside from CMP. We recommend 'OUTPERFOMER' rating on the stock.**

Transmission and Trading Business (DCF)	241
Petrochemical, LPG, LH (EV/EBITDA) 5x	149
Investment (Unquoted-BV & Quoted- 80%CMP)	69
Total	**459**
Add: Net Cash	26
Value Per Share (INR)	**485**

Upsides

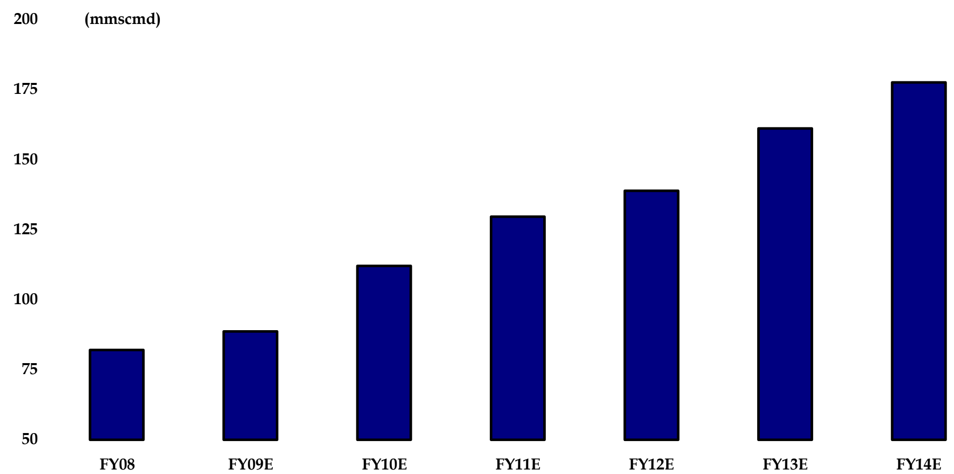
- ✓ Delay in middle east petchem capacity addition
- ✓ Higher output from KGD6
- ✓ Reduction in Gas prices
- ✓ Debottlenecking of petrochemical plant.
- ✓ Unlocking of city gas distribution and exploration business

Downsides

- ✓ Aggressive Capex leading to dilution of equity.
- ✓ Delay or lower than expected output from KG basin and Dahej terminal.
- ✓ Stiffer competition from GSPL and RGTIL
- ✓ Rise in Subsidy Burden.

Transmission Throughput

The commissioning of KGD6, NEC25, Dahej and Kochi LNG terminals is brightening the prospects of a transmission players like GAIL. The volumes are expected to grow at CAGR 14% in next five years. Efficient capacity utilization of the existing pipeline could be ensured with doubling of domestic natural gas production.



Source: Khandwala Research

High Capex for transmission

Company has lined up capex of approx INR 280 bn for the pipelines raising its capacity to 346 mmscmd. Currently ~60% of its pipeline is utilized, rest being stranded. Downside risk associated with excessive capex is a concern. Optimal mix of internal accrual and borrowing could provide good upside to our current valuation.

Pipelines	Length (In KMs)	Cost (INR Bn)	Capacity (MMSCMD)
Dadri-Bawana-Nangal	640	25	31
DVPL-GREP Upgradation	1,110	110	66
Chainsa-Jhajjar-Hissar	450	10	35
Dabhol-Bangalore	1,480	40	16
Kochi-Mangalore-Bangalore	840	35	16
Jagdishpur-Haldia	1,690	66	32

Source: Company, Khandwala Research

Supply Vis-à-vis Gail Capacity

We are concerned about underutilization of the new transmission pipelines due to relatively lower supply of natural gas and competition from RGTIL and GSPL. Company may find it difficult to attain reasonable rate of return as determined by government unless availability of natural gas justifies the capex incurred.

mmscmd	FY08	FY09E	FY10E	FY11E	FY12E	FY13E	FY14E
Gas Supply (Estimate)	111	151	171	211	236	285	300
Total Capacity GAIL	142	155	190	255	290	320	350
Capacity Excess	31	04	19	44	54	35	50

Source: Company, XI plan,Khandwala research

Project Details

Plant	Location	Prospective Pipeline Connectivity	Capacity	Qty Gas	Year
Phase 1-Upto 2011					
Utilised Lower					
Power plants along HVJ	HVJ	HVJ pipeline	1,774MW	7	2009-10
Other power capacities with lower PLF	Other than HVJ	Other than HVJ pipeline	2,535MW	10	2009-10
Fertiliser plants along HVJ	HVJ	HVJ pipeline	1.5 MT	3	2009-10
Other Fertiliser capacities with lower utilization	Other than HVJ	Other than HVJ pipeline	3.5MT	7	2009-10
Total				**27**	
Power Plant committed in XI plan	Western India	Upgraded DVPL/GREP	2,114MW	8.33	2010-11
RCF THAL	Thal	Dahej Uran-Mumbai	1MT	2	2010-11
IFFCO-Kalol	Trombay	Dahej Uran-Mumbai	0.6MT	1.2	2010-11
Other Stranded power plants	North Western India	Upgraded DVPL/GREP	1,520MW	6	2010-11
Total				**17.53**	
Phase 2-post 2011					
Pragati-Delhi	Delhi	Dadri-Bawana –Nangal	330MW	1.30	2011-12
Pragati-Bawana	Delhi	Dadri-Bawana –Nangal	1,000MW	3.94	2011-12
NFL-Nangal	Nangal	Dadri-Bawana –Nangal	0.47MT	1.26	2011-12
NFL-Panipat	Panipat	Dadri-Bawana –Nangal	0.51MT	1.35	2011-12
NFL-Bhatinda	Bhatinda	Dadri-Bawana –Nangal	0.51MT	1.35	2011-12
Total				**9.21**	
FCI-Sindri	Jharkand	Jagdishpur-Haldia	0.8MT	1.69	2012-13
FCI-Gorakhpur	Gorakhpur	Jagdishpur-Haldia	0.8MT	1.69	2012-13
HFCL Barauni	Barauni	Jagdishpur-Haldia	0.8MT	1.69	2012-13
HFCL Durgapur	West Bengal	Jagdishpur-Haldia	0.8MT	1.69	2012-13
HFCL-Haldia	West Bengal	Jagdishpur-Haldia	0.8MT	1.69	2012-13
ZIL-GOA	Goa	Dabhol-Bangalore	0.4MT	1.5	2012-13
MCFL-Mangalore	Mangalore	Dabhol-Bangalore	0.4MT	1	2012-13
MFL-Chennai	Chennai	Dabhol -Bangalore-Chennai	0.5MT	1.34	2012-13
Uran Mahgenco	Maharashtra	Dahej uran	1,040MW	4.10	2012-13
Essar Hazira	Hazira	Dahej uran	1,500MW	5.92	2012-13
Total				**22.31**	
Kannur-KPPL	Kerala	Kochi-Bangalore	513MW	2.0235	2013-14
Kawas-NTPC	Gujarat	DVPL Upgradation	1,300MW	5.13	2013-14
Gandhar-NTPC	Gujarat	DVPL Upgradation	1,300MW	5.13	2013-14
Pyghutan-GPECL	Gujarat	DVPL Upgradation	1,050MW	4.14	2013-14
Total				**16.42**	

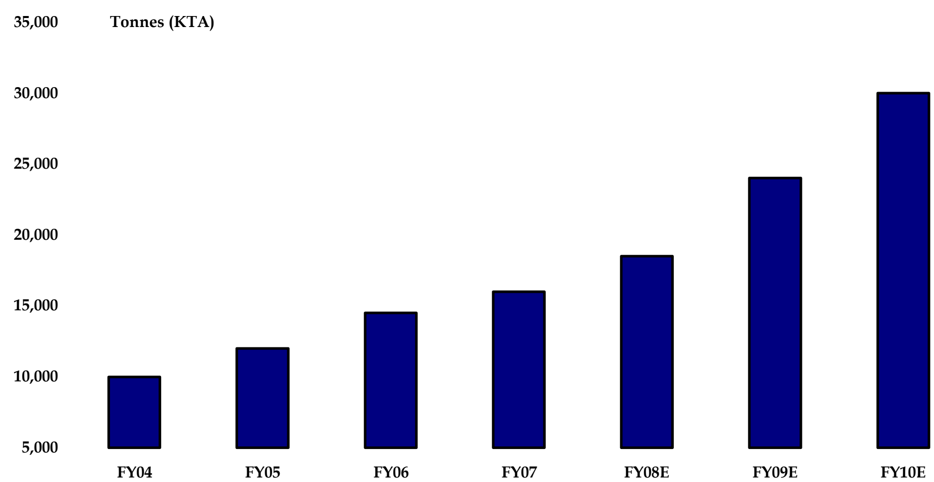
Source: Company, Khandwala Research

Petrochemical Business

Global Supply Galore

Middle East and Asia accounts for approximately 80% of the incremental global petrochemical capacity additions. Iran has approximately 6 times of its current capacity lined up for expansion in the next three years. Middle east is expected to lead the global petrochemical with huge capacity additions and would play a dominating role in determining the turn of the petrochemical cycle. The big boost in the supply is expected in the backdrop of global slowdown. The combination of incremental supply boost and slowdown in demand would pressurize the prices and thus margins.

Middle East Capacity

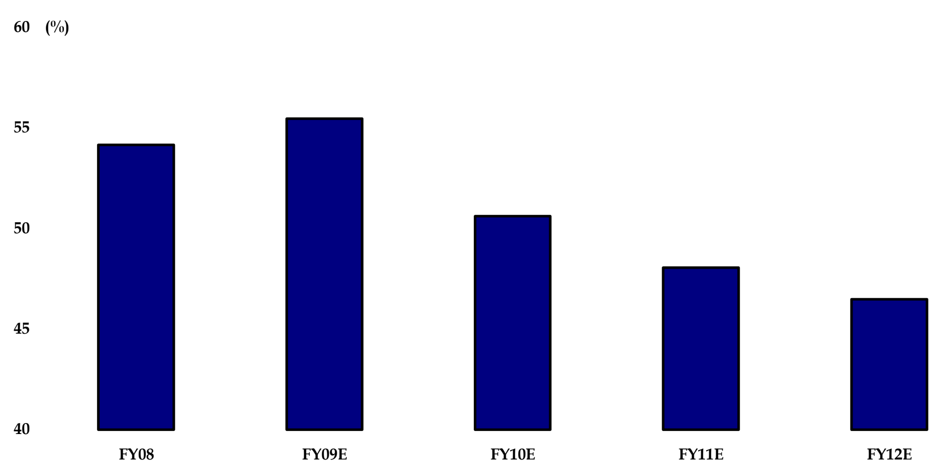


Source: Khandwala Research

Dipping margins reduces petchem valuation

The PMT gas price has been determined at $5.7/mmbtu. The price of LNG has increased in line with crude oil prices. The demand side will continue to rise with more gas based fertilizer and power plants gearing to commission. EGOM have estimated initial output from KGD6 at 25 mmscmd, turning the supply outlook even grimmer. The shortfall of natural gas would be forcing the industrial users to accept even higher price. Decline in crude prices and competition from Middle East could further pressurize petrochemical margins going forward. We have a cautious outlook towards the petchem business in the backdrop of suppressing margin.

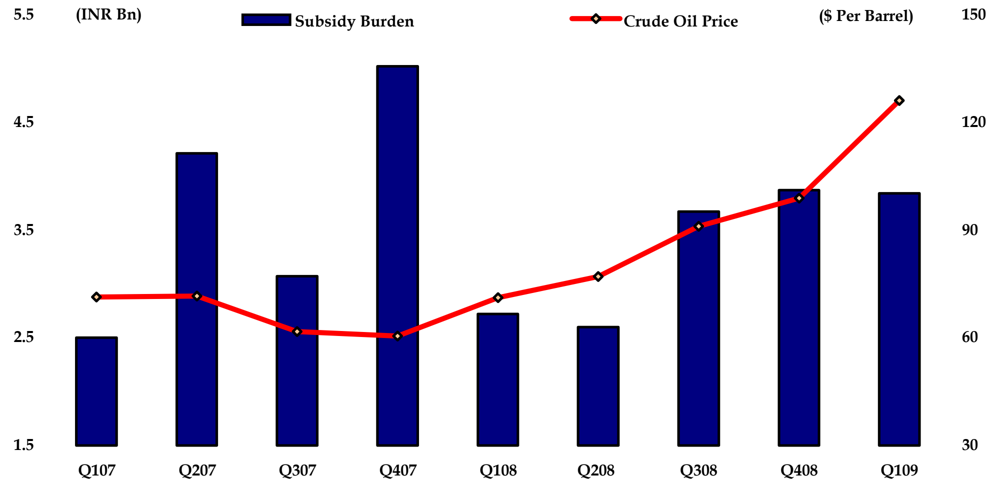
Petrochemical Margin Trend



Source: Khandwala Research

Subsidy-sharing vis-à-vis Crude oil prices

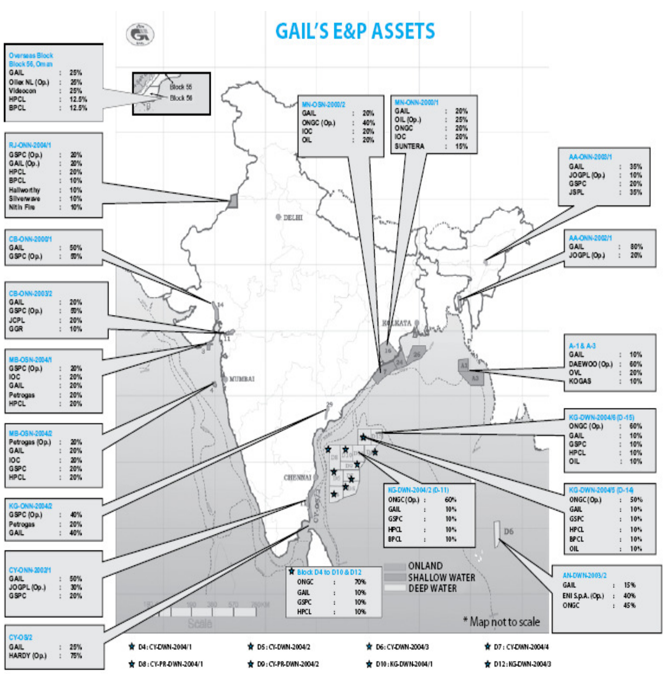
A cap on subsidy sharing companies like ONGC, Oil and GAIL at Rs 450 bn for 2007-08 at crude price of $124 per barrel was an initiation of rationalization of subsidy sharing mechanism by government. Reduction in crude price could bring the subsidy burden even further.



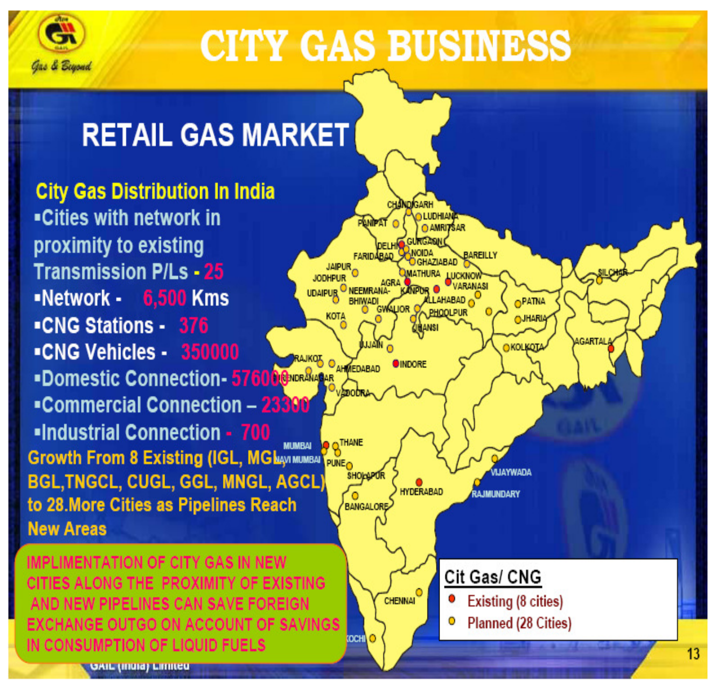
Source: Company, Khandwala Research

City Gas Distribution & Exploration - Potential to unlock

The city gas distribution is another area where GAIL is seeking a firm hold. The existing 8 companies have exclusivity and scattered over a large area in the respective cities. GAIL has recognized many more cities which would be within their reach post expansion of pipelines. Company also plans to strengthen capability and resources by participating as a major partner /operator in domestic E&P/CBM bidding. This would help in developing E&P as a self-sustainable business for augmenting additional supplies of natural gas. We have not accounted for CGD and exploration business into our valuation. However, the potential seems to be promising considering vertical integration through massive pipeline expenditure.



Source: Company



Source: Company

Financial Statements

Profit & Loss Statement

Descriptions (INR Mn)	2006-07	2007-08	2008-09E	2009-10E
Total Income	166,674	185,944	243,386	314,890
Expenditure	131,328	140,888	192,341	263,168
EBITDA	**35,346**	**39,492**	**51,045**	**51,723**
Depreciation	5,754	5,710	6,322	8,006
EBIT	29,592	33,782	44,723	43,717
Interest	(3,551)	(4,768)	(4,753)	(3,876)
EBT	28,520	38,550	49,476	47,593
Tax	8,130	12,535	16,088	15,476
PAT	**23,867**	**26,015**	**33,388**	**32,117**

Balance Sheet

Descriptions (INR Mn)	2006-07	2007-08	2008-09E	2009-10E
Equity Capital	8,457	8,457	8,457	8,457
Reserves	105,473	121,592	154,980	187,097
Shareholders Funds	113,929	130,049	163,437	195,553
Loan Funds	13,379	12,658	11,500	11,500
Deferred Tax Liability	13,187	13,197	13,197	13,197
Total	**140,494**	**155,904**	**188,134**	**220,250**
Assets	108,552	112,407	151,085	190,580
Net Current Assets	5,339	(1,234)	3,979	7,353
Cash/Bank	26,604	44,730	33,070	22,318
Total	**140,494**	**155,904**	**188,134**	**220,251**

Key Financial Ratios

Descriptions	2006-07	2007-08	2008-09E	2009-10E
Current Ratio	1.70	1.72	1.63	1.46
Debt Equity Ratio	0.12	0.10	0.07	0.06
Gross Profit Margin (%)	22.03	21.93	20.97	16.43
Net Profit Margin (%)	14.87	14.45	13.72	10.20
Return on Networth (%)	20.95	20.00	20.43	16.42
Return on Capital Employed (%)	21.06	21.67	23.77	19.85
EPS (INR)	28.22	30.76	39.48	37.98
CEPS (INR)	35.03	37.52	46.96	47.45
P/E	14.17	13.00	10.13	10.53
P/BV	2.97	2.60	2.07	1.73
EV/EBITDA	9.20	7.75	6.20	6.33
Inventory Turnover	23.78	24.73	25.00	25.00
Debtor Turnover Ratio	20.88	17.26	20.88	17.26
Asset Turnover	1.11	1.09	1.33	1.36

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