Company Flash

9 May 2007 | 6 pages

GAIL (GAIL.BO)

Buy: 4QFY07 - Gas Transmission Volatility + Higher Subsidy Burden

- Disappointing 4Q — Though headline PAT of Rs6.7bn (up 66%yoy) came in ahead of our estimates, the bottom line was boosted by tax write-back of Rs3.4bn pertaining to previous years. Operating results were disappointing, driven by volatility in the gas transmission profitability and higher subsidy share.

- Transmission EBITDA declines — GAIL's transmission EBITDA declined 34% qoq (Rs3.4bn) despite gas volumes remaining steady as it received lower tariffs on gas transmitted during the quarter. Under the new mechanism for HBJ/DVPL implemented from Jun-06, the base tariff (Rs965/mscm) is adjusted up or down based on volume of gas transmitted in the previous quarter. Given the sharp rise in 3Q volumes (following the flood-disrupted 2Q), tariff for 4Q was adjusted downward, which affected transmission revenues. Tariffs for present quarter (1QFY08) are back to levels close to base tariffs.

- Subsidy share rises — While we anticipated an increase, subsidy sharing at Rs5.02bn for the quarter came in higher than expected (Rs3.15bn in 3Q). It is difficult to gauge the exact reason for this unexpected increase, given the opaqueness in process followed.

- Value pick — Notwithstanding the poor 4Q performance, we believe steady business performance and strong balance sheet have inherent value. Given the potential for value creation from GAIL's emerging role in absorbing Reliance's KG gas, we believe any short-term correction presents a buying opportunity. Reiterate Buy/Low Risk (1L).

Buy/Low Risk	**1L**
Price (09 May 07)	Rs281.00
Target price	Rs323.00
Expected share price return	14.9%
Expected dividend yield	4.3%
Expected total return	**19.2%**
Market Cap	Rs237,628M US$5,846M

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2005A	19,539	23.11	4.5	12.2	2.8	24.3	2.8
2006A	23,101	27.32	18.2	10.3	2.4	24.8	3.6
2007E	22,252	26.31	-3.7	10.7	2.1	21.0	3.9
2008E	23,347	27.61	4.9	10.2	1.9	19.7	3.6
2009E	24,377	28.83	4.4	9.7	1.7	18.2	3.2

Source: Powered by dataCentral

Rahul Singh[1]
+91-22-6631-9863
rahul.r.singh@citigroup.com

Pradeep Mirchandani, CFA[1]
+91-22-6631-9877
pradeep.mirchandani@citigroup.com

Saurabh Handa[1]
saurabh.handa@citigroup.com

See Appendix A-1 for Analyst Certification and important disclosures.

[1]Citigroup Global Market India Private Limited

Figure 1. GAIL - 4QFY07 Results (Rupees in Millions)

Year to 31 Mar	Q4FY2006	Q3FY07	Q4FY07	% yoy	Comments
Net sales	**42,078**	**51,062**	**38,834**	**-7.7%**	Lower on account of sequential decline in tariffs and higher than expected subsidy burden
Operating profit	**7,044**	**8,641**	**6,024**	**-14.5%**	
Other income	844	1,846	1,129	33.7%	
Interest	292	271	221	-24.4%	
Depreciation	1,391	1,439	1,471	5.8%	
PBT	6,205	8,778	5,461	-12.0%	
Tax	2,112	2,124	(1,347)	-163.8%	Includes prior years tax write-back of Rs3.4bn
Tax rate (%)	*34.0*	*24.2*	*(24.7)*		
Net profit	**4,093**	**6,655**	**6,807**	**66.3%**	

Source: Company Reports and Citigroup Investment Research

Figure 2. Operating and Financial Parameters

Year to 31 Mar	Q1FY06	Q2FY06	Q3FY06	Q4FY06	Q1FY07	Q2FY07	Q3FY07	Q4FY07	Comments
Gas transmission (mmscmd)	78.9	76.8	81.4	78.3	79.1	70.1	80.4	79.7	Volumes remained steady
Gas sales (mmscmd)	66.4	66.4	69.2	68.4	70.0	62.8	69.7	68.9	
LPG and liquid prodn ('000 MT)	325	308	344	350	356	304	349	341	
Petrochemical sales ('000 MT)	63	68	75	104	81	73	94	99	
LPG transmission ('000 MT)	487	508	543	690	522	582	728	659	
EBITDA breakup (Rs m)									
Gas transmission	4930	4960	5210	4530	5170	3940	5190	3440	Decline despite steady volumes due to lower tariffs
Gas trading/marketing	520	1340	-650	-600	270	620	560	360	
LPG & liquid hydrocarbons	2360	1490	2620	470	1610	-330	1130	-510	Higher subsidy share accounted for in 4Q
Petrochemicals	1680	1710	2130	3000	2380	2090	3130	3370	Sequential increase on account of higher volumes
LPG pipeline/Gailtel/unallocated	490	1540	1320	490	790	1240	480	500	
Total	**9980**	**11040**	**10630**	**7890**	**10220**	**7560**	**10490**	**7160**	

Source: Company Reports and Citigroup Investment Research

GAIL

Company description

GAIL is the dominant gas transmission and distribution company in India. Its arterial HBJ pipeline is India's largest. GAIL's other business divisions are LPG pipelines, LPG fractionation and petrochemicals.

Investment thesis

We have a Buy/Low Risk (1L) rating because we think GAIL provides a unique investment opportunity as a dominant gas pipeline owner and transporter. Increasing gas supplies and the reduced potential for falling pipeline charges remain the key positives. GAIL has lower exposure to petroleum subsidies than its peers do, and we expect the company's exposure to continue to fall. This should offset the adverse impact of a gas price hike on GAIL's internal consumption. The company's exposure to petrochemicals (ethylene chain) is limited and is unlikely to impact earnings significantly.

Valuation

Our target price is Rs323 based on DCF and the value of investments. With the rising availability and demand for natural gas, GAIL appears well positioned to capitalize on sustained growth in the Indian gas market. As gas availability prospects improve, we believe a DCF-based valuation captures GAIL's long-term growth prospects, especially as the uncertainty on near-term earnings on account of subsidy sharing and gas price hikes appears to have been resolved. The key assumptions behind our DCF calculation are as follows: overall volume growth of 59% during FY05-10E, from 71.6mmscmd to 114mmscmd, due mainly to LNG supply growth; a capex plan that incorporates visible new pipelines - Dahej Uran and Jagadishpur Haldia (JHPL); a tariff cut of 8% on HBJ from FY08E; a perpetual subsidy burden on account of LPG/SKO of about Rs2.0bn (conservative basis); mid-cycle P/E prices of US$800 in FY09E-10E; and terminal ROCE of 10.7%, in line with GAIL's WACC. Our target price is also based on a cash P/E of 9.1x for FY07E (maintaining a 20% discount to Indian market cash P/E), which we think is reasonable for a gas utility with stable regulated returns. We prefer using cash earnings multiples, as GAIL is likely to be in a high capex phase over the medium term, and the use of cash earnings multiples helps negate the impact of capex on earnings across investment cycles.

Risks

We rate GAIL as Low Risk based on our quantitative risk-rating system. The main risks that could impede the stock from reaching our target price are as follows: (1) a sharper-than-expected cut in tariffs could impact earnings; (2) GAIL's petrochemical business is cyclical in nature; (3) changes in government policy for the oil & gas sector will likely remain a risk to earnings and stock sentiment; and (4) any change in pricing of C2/C3 fractions of the rich gas, which acts as feedstock for GAIL's petrochemical/LPG units could impact earnings.

Appendix A-1

Analyst Certification

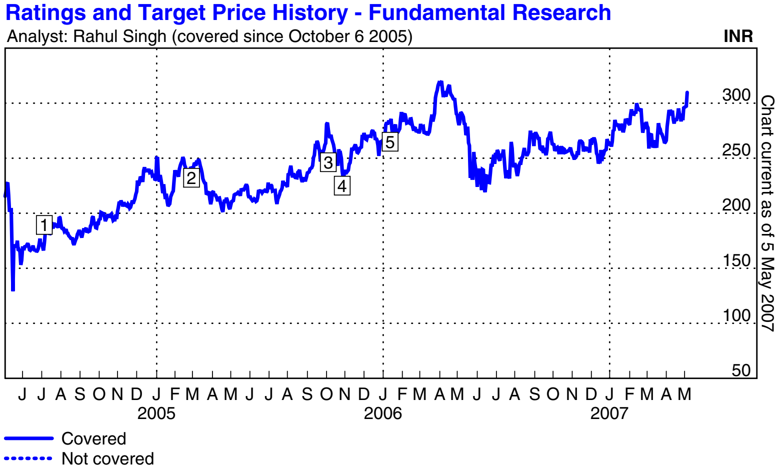
We, Rahul Singh and Pradeep Mirchandani, CFA, research analysts and the authors of this report, hereby certify that all of the views expressed in this research report accurately reflect our personal views about any and all of the subject issuer(s) or securities. We also certify that no part of our compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

IMPORTANT DISCLOSURES

GAIL (GAIL.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Rahul Singh (covered since October 6 2005)



#	Date	Rating	Target Price	Closing Price
1:	6 Jul 04	*2H	*200.00	172.65
2:	28 Feb 05	2H	*275.00	241.00
3:	5 Oct 05	*1L	*329.00	275.95
4:	27 Oct 05	1L	*318.00	237.85
5:	12 Jan 06	1L	*323.00	282.70

*Indicates change.

Citigroup Global Markets Inc. or its affiliates has received compensation for investment banking services provided within the past 12 months from GAIL.

Citigroup Global Markets Inc. or its affiliates expects to receive or intends to seek, within the next three months, compensation for investment banking services from GAIL.

Citigroup Global Markets Inc. or an affiliate received compensation for products and services other than investment banking services from GAIL in the past 12 months.

Citigroup Global Markets Inc. currently has, or had within the past 12 months, the following company(ies) as investment banking client(s): GAIL.

Citigroup Global Markets Inc. currently has, or had within the past 12 months, the following company(ies) as clients, and the services provided were non-investment-banking, securities-related: GAIL.

Citigroup Global Markets Inc. currently has, or had within the past 12 months, the following company(ies) as clients, and the services provided were non-investment-banking, non-securities-related: GAIL.

Analysts' compensation is determined based upon activities and services intended to benefit the investor clients of Citigroup Global Markets Inc. and its affiliates ("the Firm"). Like all Firm employees, analysts receive compensation that is impacted by overall firm profitability, which includes revenues from, among other business units, the Private Client Division, Institutional Sales and Trading, and Investment Banking.

For important disclosures (including copies of historical disclosures) regarding the companies that are the subject of this Citigroup Investment Research product ("the Product"), please contact Citigroup Investment Research, 388 Greenwich Street, 29th Floor, New York, NY, 10013, Attention: Legal/Compliance. In addition, the same important disclosures, with the exception of the Valuation and Risk assessments and historical disclosures, are contained on the Firm's disclosure website at www.citigroupgeo.com. Private Client Division clients should refer to www.smithbarney.com/research. Valuation and Risk assessments can be found in the text of the most recent research note/report regarding the subject company. Historical disclosures (for up to the past three years) will be provided upon request.

Citigroup Investment Research Ratings Distribution

Data current as of 31 March 2007	Buy	Hold	Sell
Citigroup Investment Research Global Fundamental Coverage (3215)	45%	40%	15%
% of companies in each rating category that are investment banking clients	45%	42%	32%
India -- Asia Pacific (130)	58%	14%	28%
% of companies in each rating category that are investment banking clients	42%	50%	42%

Guide to Fundamental Research Investment Ratings:

Citigroup Investment Research's stock recommendations include a risk rating and an investment rating.

Risk ratings, which take into account both price volatility and fundamental criteria, are: Low (L), Medium (M), High (H), and Speculative (S).

Investment ratings are a function of Citigroup Investment Research's expectation of total return (forecast price appreciation and dividend yield within the next 12 months) and risk rating.

For securities in emerging markets (Asia Pacific, Emerging Europe/Middle East/Africa, and Latin America), investment ratings are: Buy (1) (expected total return of 15% or more for Low-Risk stocks, 20% or more for Medium-Risk stocks, 30% or more for High-Risk stocks, and 40% or more for Speculative stocks); Hold (2) (5%-15% for Low-Risk stocks, 10%-20% for Medium-Risk stocks, 15%-30% for High-Risk stocks, and 20%-40% for Speculative stocks); and Sell (3) (5% or less for Low-Risk stocks, 10% or less for Medium-Risk stocks, 15% or less for High-Risk stocks, and 20% or less for Speculative stocks).

Investment ratings are determined by the ranges described above at the time of initiation of coverage, a change in investment and/or risk rating, or a change in target price (subject to limited management discretion). At other times, the expected total returns may fall outside of these ranges because of market price movements and/or other short-term volatility or trading patterns. Such interim deviations from specified ranges will be permitted but will become subject to review by Research Management. Your decision to buy or sell a security should be based upon your personal investment objectives and should be made only after evaluating the stock's expected performance and risk.

Guide to Corporate Bond Research Credit Opinions and Investment Ratings:

Citigroup Investment Research's corporate bond research issuer publications include a fundamental credit opinion of Improving, Stable or Deteriorating and a complementary risk rating of Low (L), Medium (M), High (H) or Speculative (S) regarding the credit risk of the company featured in the report. The fundamental credit opinion reflects the CIR analyst's opinion of the direction of credit fundamentals of the issuer without respect to securities market vagaries. The fundamental credit opinion is not geared to, but should be viewed in the context of debt ratings issued by major public debt ratings companies such as Moody's Investors Service, Standard and Poor's, and Fitch Ratings. CBR risk ratings are approximately equivalent to the following matrix: Low Risk Triple A to Low Double A; Low to Medium Risk High Single A through High Triple B; Medium to High Risk Mid Triple B through High Double B; High to Speculative Risk Mid Double B and Below. The risk rating element illustrates the analyst's opinion of the relative likelihood of loss of principal when a fixed income security issued by a company is held to maturity, based upon both fundamental and market risk factors. Certain reports published by Citigroup Investment Research will also include investment ratings on specific issues of companies under coverage which have been assigned fundamental credit opinions and risk ratings. Investment ratings are a function of Citigroup Investment Research's expectations for total return, relative return (to publicly available Citigroup bond indices performance), and risk rating. These investment ratings are: Buy/Overweight the bond is expected to outperform the relevant Citigroup bond market sector index (Broad Investment Grade, High Yield Market or Emerging Market), performances of which are updated monthly and can be viewed at http://www.sd.ny.ssmb.com/ using the "Indexes" tab; Hold/Neutral Weight the bond is expected to perform in line with the relevant Citigroup bond market sector index; or Sell/Underweight the bond is expected to underperform the relevant sector of the Citigroup indexes.

OTHER DISCLOSURES

The subject company's share price set out on the front page of this Product is quoted as at 09 May 2007 03:55 PM on the issuer's primary market.

For securities recommended in the Product in which the Firm is not a market maker, the Firm is a liquidity provider in the issuers' financial instruments and may act as principal in connection with such transactions. The Firm is a regular issuer of traded financial instruments linked to securities that may have been recommended in the Product. The Firm regularly trades in the securities of the subject company(ies) discussed in the Product. The Firm may engage in securities transactions in a manner inconsistent with the Product and, with respect to securities covered by the Product, will buy or sell from customers on a principal basis.

Securities recommended, offered, or sold by the Firm: (i) are not insured by the Federal Deposit Insurance Corporation; (ii) are not deposits or other obligations of any insured depository institution (including Citibank); and (iii) are subject to investment risks, including the possible loss of the principal amount invested. Although information has been obtained from and is based upon sources that the Firm believes to be reliable, we do not guarantee its accuracy and it may be incomplete and condensed. Note, however, that the Firm has taken all reasonable steps to determine the accuracy and completeness of the disclosures made in the Important Disclosures section of the Product. The Firm's research department has received assistance from the subject company(ies) referred to in this Product including, but not limited to, discussions with management of the subject company(ies). Firm policy prohibits research analysts from sending draft research to subject companies. However, it should be presumed that the author of the Product has had discussions with the subject company to ensure factual accuracy prior to publication. All opinions, projections and estimates constitute the judgment of the author as of the date of the Product and these, plus any other information contained in the Product, are subject to change without notice. Prices and availability of financial instruments also are subject to change without notice. Notwithstanding other departments within the Firm advising the companies discussed in this Product, information obtained in such role is not used in the preparation of the Product. Although Citigroup Investment Research does not set a predetermined frequency for publication, if the Product is a fundamental research report, it is the intention of Citigroup Investment Research to provide research coverage of the/those issuer(s) mentioned therein, including in response to news affecting this issuer, subject to applicable quiet periods and capacity constraints. The Product is for informational purposes only and is not intended as an offer or solicitation for the purchase or sale of a security. Any decision to purchase securities mentioned in the Product must take into account existing public information on such security or any registered prospectus.

Investing in non-U.S. securities, including ADRs, may entail certain risks. The securities of non-U.S. issuers may not be registered with, nor be subject to the reporting requirements of the U.S. Securities and Exchange Commission. There may be limited information available on foreign securities. Foreign companies are generally not subject to uniform audit and reporting standards, practices and requirements comparable to those in the U.S. Securities of some foreign companies may be less liquid and their prices more volatile than securities of comparable U.S. companies. In addition, exchange rate movements may have an adverse effect on the value of an investment in a foreign stock and its corresponding dividend payment for U.S. investors. Net dividends to ADR investors are estimated, using withholding tax rates conventions, deemed accurate, but investors are urged to consult their tax advisor for exact dividend computations. Investors who have received the Product from the Firm may be prohibited in certain states or other jurisdictions from purchasing securities mentioned in the Product from the Firm. Please ask your Financial Consultant for additional details. Citigroup Global Markets Inc. takes responsibility for the Product in the United States. Any orders by US investors resulting from the information contained in the Product may be placed only through Citigroup Global Markets Inc.

The Citigroup legal entity that takes responsibility for the production of the Product is the legal entity which the first named author is employed by. The Product is made available in Australia to wholesale clients through Citigroup Global Markets Australia Pty Ltd. (ABN 64 003 114 832 and AFSL No. 240992) and to retail clients through Citigroup Wealth Advisors Pty Ltd. (ABN 19 009 145 555 and AFSL No. 240813), Participants of the ASX Group and regulated by the Australian Securities & Investments Commission. Citigroup Centre, 2 Park Street, Sydney, NSW 2000. The Product is made available in Australia to Private Banking wholesale clients through Citigroup Pty Limited (ABN 88 004 325 080 and AFSL 238098). Citigroup Pty Limited provides all financial product advice to Australian Private Banking wholesale clients through bankers and relationship managers. If there is any doubt about the suitability of investments held in Citigroup Private Bank accounts, investors should contact the Citigroup Private Bank in Australia. Citigroup companies may compensate affiliates and their representatives for providing products and services to clients. If the Product is being made available in certain provinces of Canada by Citigroup Global Markets (Canada) Inc. ("CGM Canada"), CGM Canada has approved the Product. Citigroup Place, 123 Front Street West, Suite 1100, Toronto, Ontario M5J 2M3. The Product may not be distributed to private clients in Germany. The Product is distributed in Germany by Citigroup Global Markets Deutschland AG & Co. KGaA, which is regulated by Bundesanstalt fuer Finanzdienstleistungsaufsicht (BaFin). Frankfurt am Main, Reuterweg 16, 60323 Frankfurt am Main. If the Product is made available in Hong Kong by, or on behalf of, Citigroup Global Markets Asia Ltd., it is attributable to Citigroup Global Markets Asia Ltd., Citibank Tower, Citibank Plaza, 3 Garden Road, Hong Kong. Citigroup Global Markets Asia Ltd. is regulated by Hong Kong Securities and Futures Commission. If the Product is made available in Hong Kong by The Citigroup Private Bank to its clients, it is attributable to Citibank N.A., Citibank Tower, Citibank Plaza, 3 Garden Road, Hong Kong. The Citigroup Private Bank and Citibank N.A. is regulated by the Hong Kong Monetary Authority. The Product is made available in India by Citigroup Global Markets India Private Limited, which is regulated by Securities and Exchange Board of India. Bakhtawar, Nariman Point, Mumbai 400-021. If the Product was prepared by Citigroup Investment Research and distributed in Japan by Nikko Citigroup Ltd., it is being so distributed under license. Nikko Citigroup Limited is regulated by Financial Services Agency, Securities and Exchange Surveillance Commission, Japan Securities Dealers Association, Tokyo Stock Exchange and Osaka Securities Exchange. Akasaka Park Building, 2-20, Akasaka 5-chome, Minato-ku, Tokyo 107-6122. The Product is made available in Korea by Citigroup Global Markets Korea Securities Ltd., which is regulated by Financial Supervisory Commission and the Financial Supervisory Service. Hungkuk Life Insurance Building, 226 Shinmunno 1-GA, Jongno-Gu, Seoul, 110-061. The Product is made available in Malaysia by Citigroup Global Markets Malaysia Sdn Bhd, which is regulated by Malaysia Securities Commission. Menara Citibank, 165 Jalan Ampang, Kuala Lumpur, 50450. The Product is made available in Mexico by Acciones y Valores Banamex, S.A. De C. V., Casa de Bolsa, which is regulated by Comision Nacional Bancaria y de Valores. Reforma 398, Col. Juarez, 06600 Mexico, D.F. In New Zealand the Product is made available through Citigroup Global Markets New Zealand Ltd., a Participant of the New Zealand Exchange Limited and regulated by the New Zealand Securities Commission. Level 19, Mobile on the Park, 157 lambton Quay, Wellington. The Product is made available in Poland by Dom Maklerski Banku Handlowego SA an indirect subsidiary of Citigroup Inc., which is regulated by Komisja Papierów Wartosciowych i Gield. Bank Handlowy w Warszawie S.A. ul. Senatorska 16, 00-923 Warszawa. The Product is made available in the Russian Federation through ZAO Citibank, which is licensed to carry out banking activities in the Russian Federation in accordance with the general banking license issued by the Central Bank of the Russian Federation and brokerage activities in accordance with the license issued by the Federal Service for Financial Markets. Neither the Product nor any information contained in the Product shall be considered as advertising the securities mentioned in this report within the territory of the Russian Federation or outside the Russian Federation. The Product does not constitute an appraisal within the meaning of the Federal Law of the Russian Federation of 29 July 1998 No. 135-FZ (as amended) On Appraisal Activities in the Russian Federation. 8-10 Gasheka Street, 125047 Moscow. The Product is made available in Singapore through Citigroup Global Markets Singapore Pte. Ltd., a Capital Markets Services Licence holder, and regulated by Monetary Authority of Singapore. 1 Temasek Avenue, #39-02 Millenia Tower, Singapore 039192. The Product is made available by The Citigroup Private Bank in Singapore through Citibank, N.A., Singapore branch, a licensed bank in Singapore that is regulated by Monetary Authority of Singapore. Citigroup Global Markets (Pty) Ltd. is incorporated in the Republic of South Africa (company registration number 2000/025866/07) and its registered office is at 145 West Street, Sandton, 2196, Saxonwold. Citigroup Global Markets (Pty) Ltd. is regulated by JSE Securities Exchange South Africa, South African Reserve Bank and the Financial Services Board. The investments and services contained herein are not available to private customers in South Africa. The Product is made available in Taiwan through Citigroup Global Markets Inc. (Taipei Branch), which is regulated by Securities & Futures Bureau. No portion of the report may be reproduced or quoted in Taiwan by the press or any other person. No. 8 Manhattan Building, Hsin Yi Road, Section 5, Taipei 100, Taiwan. The Product is made available in Thailand through Citicorp Securities (Thailand) Ltd., which is regulated by the Securities and Exchange Commission of Thailand. 18/F, 22/F and 29/F, 82 North Sathorn Road, Silom, Bangrak, Bangkok 10500, Thailand. The Product is made available in United Kingdom by Citigroup Global Markets Limited, which is authorised and regulated by Financial Services Authority. This material may relate to investments or services of a person outside of the UK or to other matters which are not regulated by the FSA and further details as to where this may be the case are available upon request in respect of this material. Citigroup Centre, Canada Square, Canary Wharf, London, E14 5LB. The Product is made available in United States by Citigroup Global Markets Inc, which is regulated by NASD, NYSE and the US Securities and Exchange Commission. 388 Greenwich Street, New York, NY 10013. Unless specified to the contrary, within EU Member States, the Product is made available by Citigroup Global Markets Limited, which is regulated by Financial Services Authority. Many European regulators require that a firm must establish, implement and make available a policy for managing conflicts of interest arising as a result of publication or distribution of investment research. The policy applicable to Citigroup Investment Research's Products can be found at www.citigroupgeo.com. Compensation of equity research analysts is determined by equity research management and Citigroup's senior management and is not linked to specific transactions or recommendations. The Product may have been distributed simultaneously, in multiple formats, to the Firm's worldwide institutional and retail customers. The Product is not to be construed as providing investment services in any jurisdiction where the provision of such services would be illegal. Subject to the nature and contents of the Product, the investments described therein are subject to fluctuations in price and/or value and investors may get back less than originally invested. Certain high-volatility investments can be subject to sudden and large falls in value that could equal or exceed the amount invested. Certain investments contained in the Product may have tax implications for private customers whereby levels and basis of taxation may be subject to change. If in doubt, investors should seek advice from a tax adviser. Advice in the Product has been prepared without taking account of the objectives, financial situation or needs of any particular investor. Accordingly, investors should, before acting on the advice, consider the appropriateness of the advice, having regard to their objectives, financial situation and needs.

ADDITIONAL INFORMATION IS AVAILABLE UPON REQUEST