October 12, 2011

Underperformer

Indraprastha Gas Ltd.

LKP Since 1948

Industry: Oil & Gas | Industry View: Neutral

"High growth phase is behind"

Indraprastha Gas Ltd (IGL) is the sole operator in the city gas distribution (CGD) segment in the NCT of Delhi and the NCR regions of Noida & Ghaziabad. It supplies compressed natural gas (CNG) via its outlets and piped natural gas (PNG) to domestic & commercial/industrial customers. IGL has witnessed a stupendous 2.2x jump in sales volumes during FY06-11 due to a combination of latent gas demand, access to cheap gas supplies and higher cost of competing fuels. IGL has regularly demonstrated its pricing power through a series of price hikes in both the CNG & PNG segments.

Price differential eroding, FY11-16E PNG CAGR to drop to 27%

With the hike in PNG price to ₹22/scm on Sept 1, domestic PNG trades at parity to LPG whereas comm./ind. PNG is currently priced very close to fuel oil / naphtha / LSHS. Domestic LPG prices have been revised only twice in the previous 2 yrs. Downward revisions to global GDP growth and crude demand estimates are expected to result in lower crude, fuel oil & naphtha prices going forward. We expect 5 yr CAGR in PNG volumes to fall from 47% during FY06-11 to 27% during FY11-16.

CNG to grow at CAGR of 12%, already factored in

Owing to a huge price differential of ~240% over gasoline, ~90% over diesel and ~160% over auto LPG, CNG growth is expected to sustain at 12% y-o-y due to vehicle conversions and increasing availability of factory-fitted CNG models.

FY11-16E PAT CAGR to drop to 13%, return ratios to peak in FY12E

We expect PAT growth to be substantially lower going forward with CAGR falling from 20% during FY06-11 to 13% during FY11-16. We expect ROCE & ROE to peak at 34% & 31% respectively in FY12, before falling to 26% & 19% by FY16. We expect sales CAGR of 23% during FY11-16E, compared to CAGR of 27% during FY06-11.

Valuation

We believe that the CMP continues to factor in high growth even in the future. We value IGL by using DCF with WACC of 12% and terminal growth rate of 3%. Our target price of ₹385 translates into FY13E P/E of 14x and we have an **"UNDERPERFORMER"** rating on IGL.

Risks and Concerns

Imposition of regulations upon the industrial sector that mandate use of PNG instead of naphtha/fuel oil/LSHS would be beneficial for IGL and lead to stronger performance than expected.

Further reduction in availability of domestic gas may increase dependence on R-LNG and may lead to lower margins than expected by us.

Stock Data

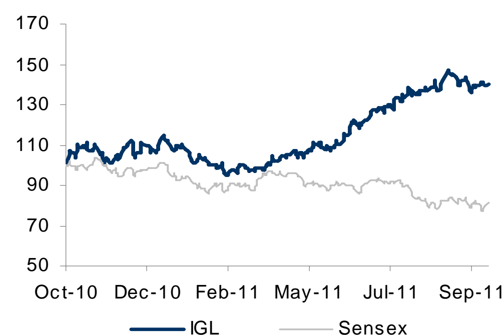
Current Market Price (₹)	426
Target Price (₹)	385
Potential upside (%)	(10)
Reuters	IGAS.CO
Bloomberg	IGL IN

Key Data

Market Cap (₹bn)	60
52-Week Range (₹)	453 / 285
Avg. Daily Trading Value (₹mn)	146
Promoters (%)	45
FII Holding (%)	17
DII Holding (%)	24
Public & Others Holding (%)	15

	FY 11	FY 12E	FY 13E
Revenues (₹mn)	17,441	24,447	30,626
EBITDA (%)	28.2	29.3	26.3
PAT (%)	14.9	14.4	12.7
EPS (₹)	18.6	25.2	27.8
EPS growth (%)	21	36	10
P/E (x)	22.9	16.9	15.3
P/B(x)	5.9	4.7	3.8
EV/EBITDA (x)	12.4	8.7	7.6
ROCE(%)	33	34	30
ROE(%)	28	31	27

Relative Price Performance



One Year Indexed

(%)	1 Month	3 Months	12 Months
Absolute	(3)	9	41
BSE Relative	(1)	21	59

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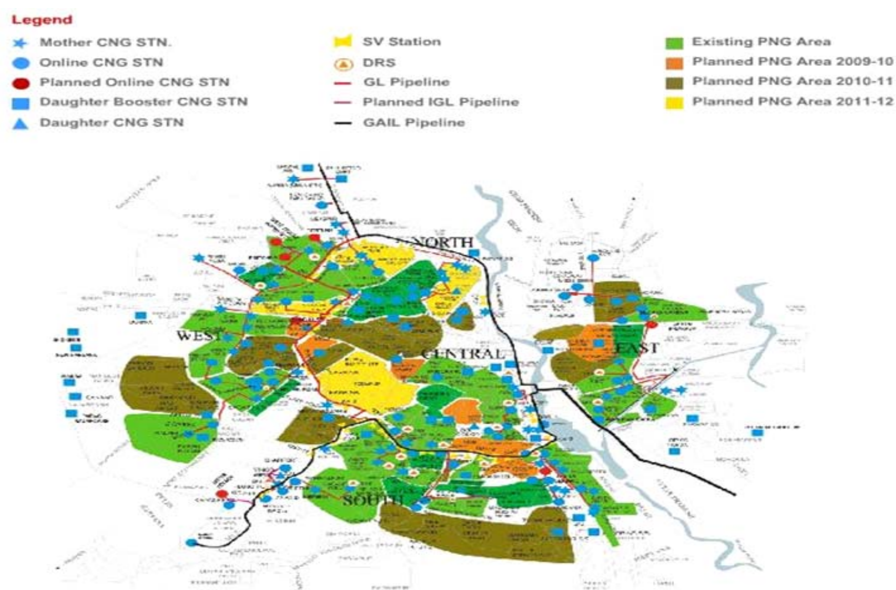
Company Profile

IGL was incorporated in 1998 and took over the Delhi CGD Project in 1999 with an objective to lay a distribution network for natural gas in Delhi. While BPCL & GAIL each account for 22.5% of IGL's equity capital, the State Govt. of Delhi holds another 5% in IGL. The company enjoys marketing exclusivity in Delhi till Dec 2011 and network exclusivity up to FY25.

IGL continues to augment its infrastructure to meet the increasing demand of CNG from the growing number of CNG vehicles in Delhi. The increase in demand of CNG is due to – factory fitted CNG car models, discretionary conversion to CNG and Delhi Government's directive making it mandatory for all LCVs operating in Delhi to run on CNG. About 20% of CNG sales are to DTC & IGL has entered into a long-term contract with them for the next 10 years. The company is going to be the exclusive supplier of CNG for the entire fleet of DTC buses. 16% of CNG sales are committed to OMC outlets. The company has also signed 5 yr exclusive agreements with the OMCs. As of Apr 2011, IGL has 240 CNG outlets in Delhi and 38 outlets in Noida & Ghaziabad.



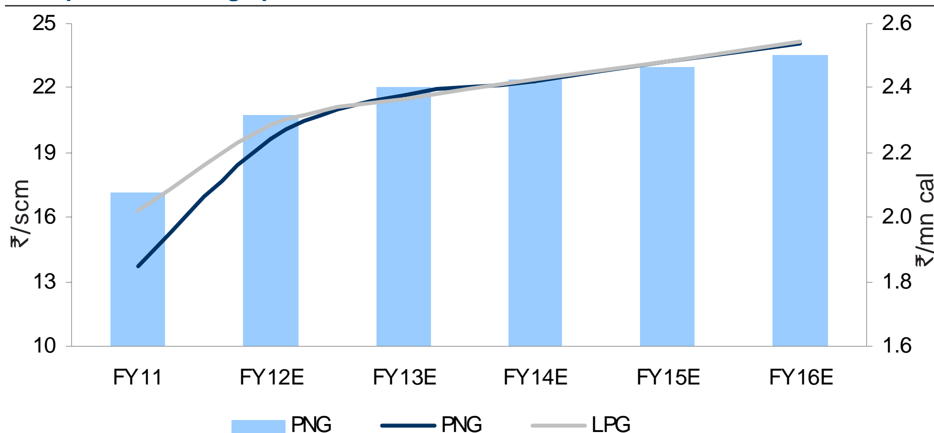
IGL is also working towards expanding its PNG network to cover all 70 charge areas of Delhi by 2012. IGL is also going to promote gas-based geysers, water heaters & gas powered generators. For gas-based power heaters, the company is collaborating with A.O. Smith, Record and Venus. For gensets, it has teamed up with Kohler. The idea is to promote greater usage of gas and provide more value to the consumers as gas usage is cheaper than electricity. In the process, IGL will also benefit as the same asset would bring higher realizations. The company will be working towards making these products available to consumers at reasonable prices.

PNG: Future growth to be lower than historical figures

a) PNG-LPG price differential eroded, pricing power to reduce

On Sept 1, 2011, IGL hiked the price of domestic PNG by 16% from ₹18.95/scm to ₹ 22/ scm. While such a magnitude of price hike was above expectations and reiterated IGL's pricing power, we note that domestic PNG is now priced similar to domestic LPG on an energy-equivalent basis. Domestic LPG prices have been revised only twice in the previous 2 yrs and we expect price hike of ₹10/cyl every year going forward. For availing a PNG connection, domestic customers are supposed to make a deposit of ₹6,000 which is refundable upon termination of the connection. We assume PNG to be priced at parity to LPG in energy equivalent terms going forward. Thus, we expect no price hike till FY13 and marginal hike of ~₹0.5/scm every year from FY14 onwards.

PNG prices catching up with LPG



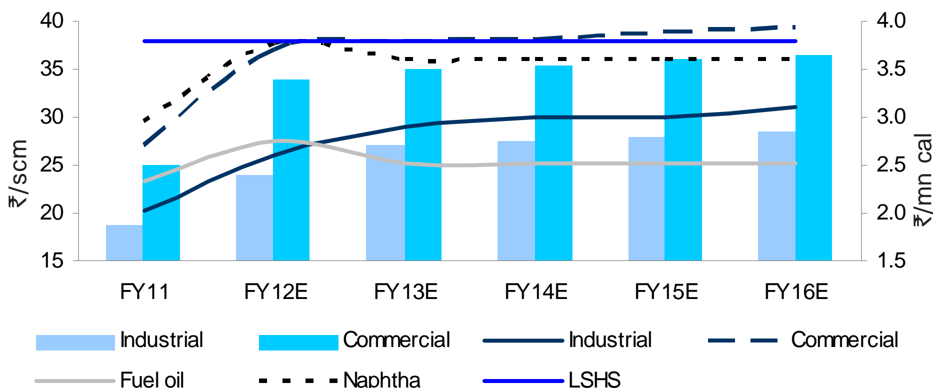
Source: Company , LKP Research

b) Price differential narrowing in ind./comm. segment too

The global economy is currently being weighed down by the fears of a double dip recession in the US and the escalating debt crisis in the Eurozone. A comprehensive solution to the problem of too much debt and anemic growth in the developed world seems far away. With the governments facing significant fiscal deficits and interest rates at historically low levels, there is not much room for further stimulus. The recognition of these stark possibilities has become clearer in the past few days and has led to a 9% fall in crude prices in Sept 2011. Meanwhile, Saudi Arabia has increased its crude output to ~10 mnbpd and exports from Libya are expected to commence soon. In light of the various social spending programmes announced by the Middle Eastern regimes, we believe that these countries will target a higher crude price compared to their historical target levels. Accordingly, we expect average Brent crude price of $ 95/ bbl from FY13 onwards.

In the industrial & commercial segment, PNG competes with fuel oil, naphtha, LSHS and bulk LPG. IGL mainly supplies R-LNG to these customers and it is priced at a premium to domestic PNG. With spiraling crude prices in FY11 leading to a similar rise in prices of crude-based derivatives like fuel oil / naphtha / LSHS etc, ind./comm. PNG was priced at discount of 45-80% to the crude derivatives. However, with the latest hike in PNG prices, ind./comm. PNG pricing is at a low single digit discount to naphtha/ LSHS/fuel oil on our FY12E estimates. At our long term Brent crude estimate of $ 95/ bbl, we see ind./comm. PNG exceeding the fuel oil price comfortably and being more expensive than naphtha & LSHS.

Price differentials narrowing significantly



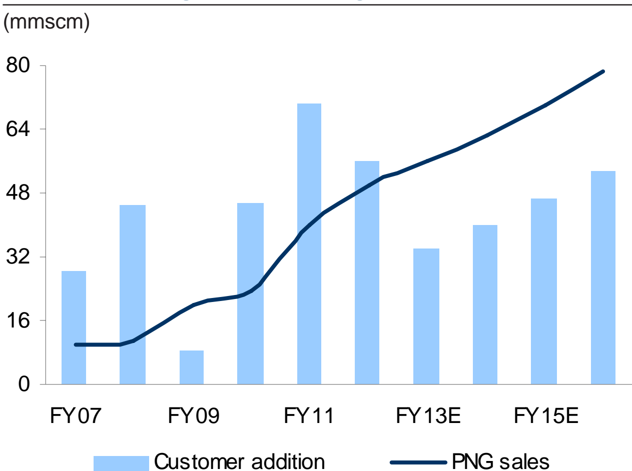
Source: Company , LKP Research

c) Expect 5-yr CAGR to drop to 27% during FY11-16

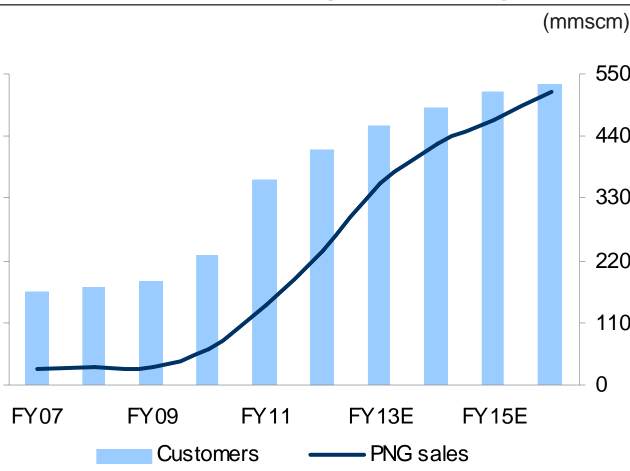
Aided by availability of cheap APM gas and favorable price differential to competing fuels, the PNG segment has shown a tremendous 47% CAGR during FY06-11. The PNG segment has grown exponentially from 46,727 customers in FY06 to 244,924 customers in FY11, which translates into CAGR of 39%. The company has added an average of ~40,000 customers every year since FY06; with FY11 witnessing an all-time high customer addition of 62,918. The commercial / industrial segment too has grown handsomely; with total customers doubling to 531 in FY11 from 256 in FY06.

However, we feel that the factors that have aided growth so far would weaken going forward due to rising cost of incremental gas supplies that have resulted in a series of price hikes. Taken together with our view of lower crude & product prices in the future, lack of significant price differential with competing fuels and high base effect is expected to result in slower pace of customer additions. The price-sensitive domestic segment is likely to be increasingly circumspect about paying a deposit of ₹6,000 and switching to PNG in the absence of any enticing price differential with LPG. The industrial segment is also likely to see a reduced pace of conversion to PNG given the narrowing price differentials with alternative fuels. Accordingly, we expect PNG CAGR of 27% during FY11-16, as against FY06-11 CAGR of 47%.

Domestic PNG growth reducing



Industrial/commercial PNG growth reducing



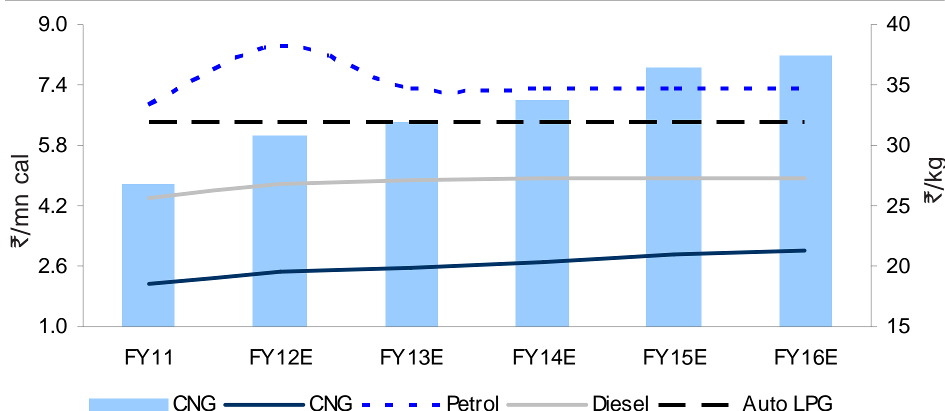
Source: Company , LKP Research

CNG: Periodic price hikes to maintain blended margins

a) Pricing power to remain intact

With its latest move, IGL has hiked the price of CNG from ₹30/scm to ₹32/scm. This was the 4th instance of price hike in the CNG segment which is a testament to IGL's pricing power. However, CNG is still very attractively priced when compared to gasoline, diesel and auto LPG. At our FY12 estimates, CNG is priced at a discount of 240% to gasoline, 93% to diesel and 160% to auto LPG. We expect these price differentials to reduce marginally going forward but we see the differentials still holding up at high levels. Hence, we assume regular price hikes in this segment to pass on increasing gas costs and to maintain blended margins.Going forward, we see increasing dependence on this segment to deliver the target margin levels and to sustain financial performance of the company.

CNG to remain attractive



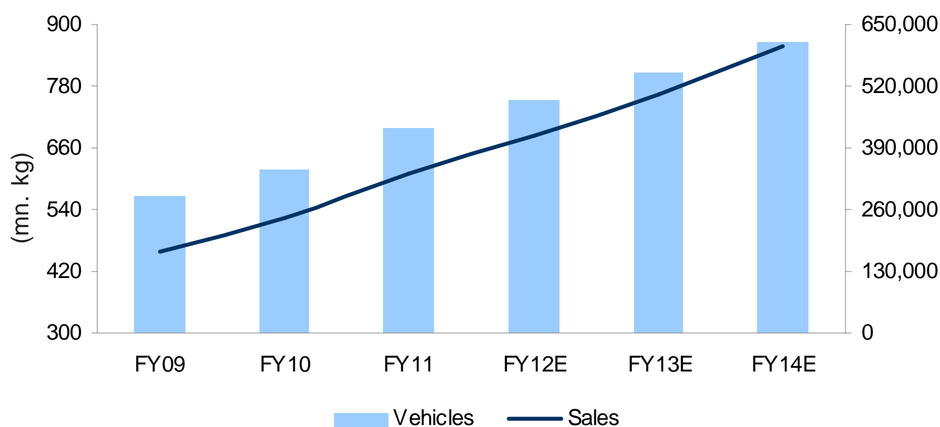
Source: Company , LKP Research

b) Expect consistent growth of 12%, but factored in

Aided by availability of cheap APM gas and favorable price differential to competing fuels, the CNG segment has shown a consistent 14% CAGR during FY06-11. The CNG segment caters to 431,381 vehicles as of Mar 2011, compared to 106,483 vehicles in FY06, which translates into CAGR of 32%. The no. of vehicles using CNG has increased at an average of ~65,000 every year since FY06; with FY11 witnessing an all-time high addition of 87,131 vehicles. Side-by-side, IGL has also increased its retail outlets from 146 in FY06 to 278 in FY11. This is necessary to maintain customer service levels for an increasing no. of CNG driven vehicles and prevent formation of long queues.

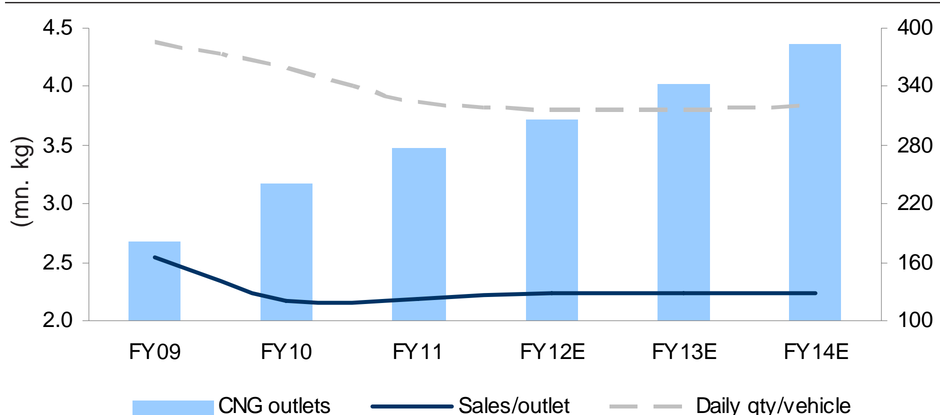
We expect the CNG segment to continue growing at CAGR of 12% going forward on the back of attractive price differential with competing fuels, increasing number of CNG outlets and increase in launches of CNG variants by OEMs. We expect yearly addition of ~60,000 vehicles to the CNG fleet in Delhi going forward. We also expect the company to construct 28 & 37 CNG outlets in FY12 & FY13 respectively to cater to the increasing no. of vehicles.

CNG growth to continue



Source: Company , LKP Research

CNG outlets to increase



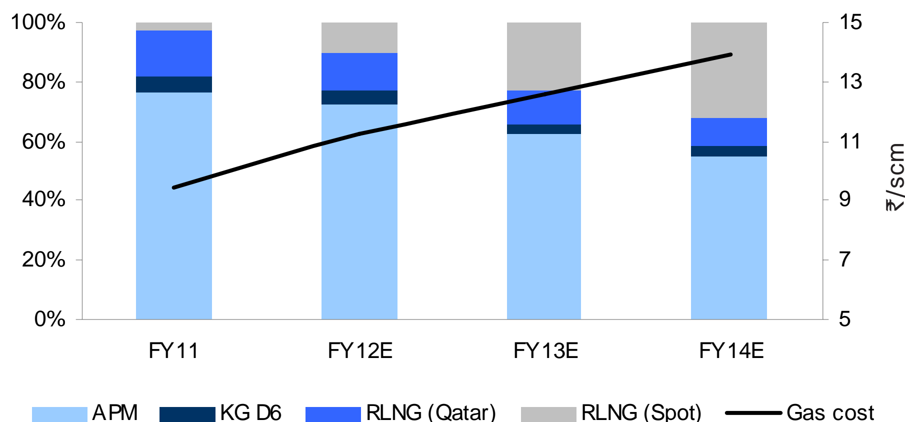
Source: Company , LKP Research

Gas cost to increase owing to increasing spot R-LNG

The priority sector in the country enjoys preferential access to cheap domestic gas supplies. The CGD segment comes fourth in the priority sector after fertilizers, power and LPG extraction plants. IGL is entitled to 2.7 mmscmd of APM gas, with a delivered price of $ 5.2/mmBtu. Out of this, 0.2 mmscmd is supplied to other players operating in Gurgaon/ Faridabad and the matter is currently being heard in the Supreme Court. A favorable verdict in this case might open up these markets to IGL and would be a positive surprise for the stock. In addition, the company has also been allocated 0.15 mmscmd on a firm basis from RIL's KG D6 basin, with a delivered price of $ 6.4/mmBtu. The company also purchases 0.44 mmscmd of RasGas R-LNG from BPCL and GAIL.

Going forward, the company would have to depend on spot R-LNG for catering to growth in demand from the CNG and PNG segments. This is because of stagnant supply of gas from domestic sources with production from new marginal fields only partly compensating declining production from mature fields. As spot LNG is much costlier compared to domestic gas, we forecast the blended gas cost to increase y-o-y. We expect gas cost of ₹11.3/scm and ₹12.6/scm in FY12 & FY13 respectively.

Gas sourcing mix



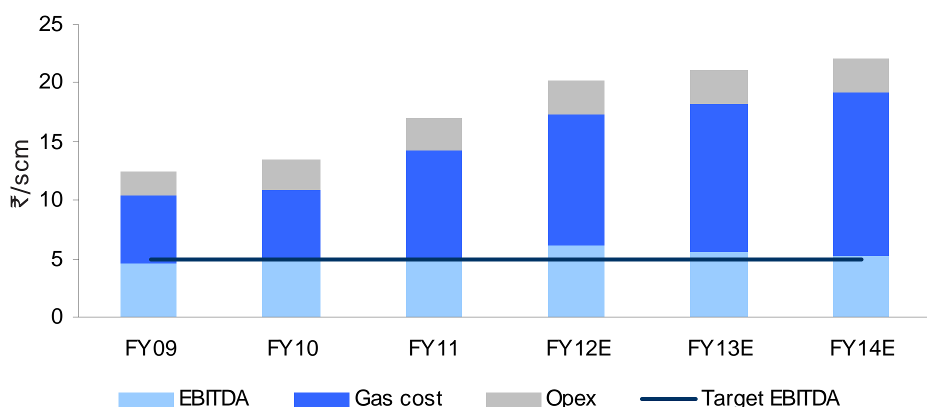
Source: Company , LKP Research

EBITDA/scm currently high, expect it to revert towards ₹5/scm

On the back of a series of price hikes in both the CNG & PNG segments, IGL has managed to pass on increasing gas cost, operating expenses and effect of rupee depreciation to its customers. Accordingly, while we expect gas cost to rise from ₹9.4/scm in FY11 to ₹11.3/scm in FY12, we expect gross realization to post a higher rise from ₹19.7/scm in FY11 to ₹23/scm in FY12. Hence, we expect the company's EBITDA/scm to rise from ₹4.9/scm in FY11 to ₹6/scm in FY12.

Going forward, we expect EBITDA/scm to narrow on account of increasing gas costs in a scenario of falling crude and crude-based fuel prices. We expect no price hike in FY13 as domestic PNG is priced same as LPG, ind./comm. PNG is priced higher than fuel oil/naphtha/LSHS and petrol price is reduced in line with falling international gasoline prices. The company's target level of EBITDA/scm is ₹5/scm; a level towards which we expect the metric to move to by FY15 and stay at these levels in the future. Accordingly, we expect EBITDA/scm of ₹5.7/scm & ₹5.2/scm in FY13 & FY14 respectively.

Cost structure of IGL



Source: Company , LKP Research

End of marketing exclusivity not a concern

IGL enjoys marketing exclusivity in the NCR & NCT regions upto Jan 2012. This means that other players are allowed to start operations in these regions from Jan 2012 onwards. However, we don't see this as a threat to the company's operations.

The biggest source of competitive advantage for IGL is its first mover advantage in Delhi. This has enabled it to garner access to 2.5 mmscmd of cheap APM gas and 0.15 mmscmd of KG D6 gas, both of which are priced at a landfall price of $ 4.2/mmBtu. Given the stagnant domestic gas production and higher priority for the fertilizer, power & LPG extraction plants, it is doubtful whether any new entrant would be allocated any APM gas. Hence, new entrants would have to bank on "expensive LNG" which would make it unviable for them to compete with IGL on price.

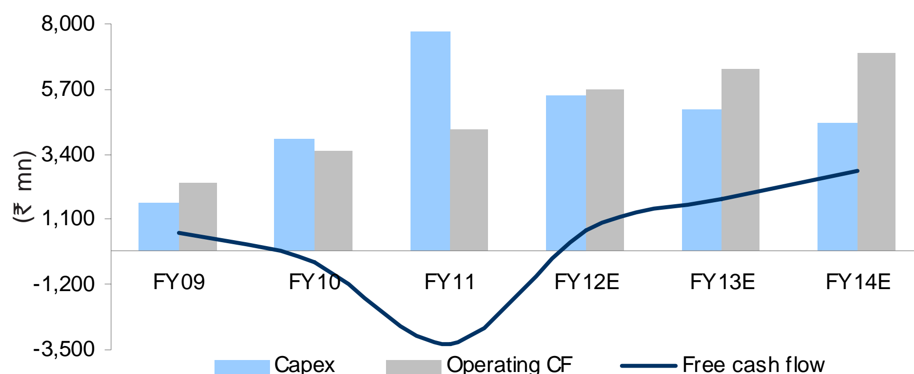
Secondly, IGL has deeply entrenched itself in Delhi with 278 CNG stations covering the entire area of the city. The company has carefully placed its CNG outlets at prime locations across the city which makes it very convenient for customers to refill their vehicles. For a new player to compete against IGL, he would first have to acquire the land required for setting up his CNG station, which in itself is a very cumbersome process involving multiple approvals. Next, the capital costs required for setting up a new CNG station has gone up over the years, led by the increasing cost of land.

As IGL enjoys network exclusivity till FY25, any other player using IGL's existing network to sell gas will have to pay network tariff to the company. The network tariff is a reasonable amount and covers the company's expenses and is an extra source of income and a potential source of profit. The company is allowed to charge network tariff which may translate into a return of up to 14%. As of now, IGL has applied to the regulator for acceptance of authorization for network tariff for the whole NCR region. The matter is with the regulator and is awaiting approval.

Expect consistent capex going forward

IGL plans to spend ₹15 bn during FY12-14E for increasing its infrastructure in Delhi and NCR towns. The company would be setting up new CNG stations in Delhi and NCR to cater to the increasing no. of vehicles running on CNG. We expect addition of 28 & 37 CNG stations respectively during FY12 & FY13 respectively. We also expect compression capacity to be expanded to cater to higher CNG volumes being sold y-o-y. On the PNG side, we expect the company to lay pipelines and cover all 70 charge areas in the city of Delhi. We expect new pipelines to be laid to industrial/commercial customers mainly in the NCR towns of Noida & Ghaziabad. We expect gross block to jump from ₹17 bn in FY11 to ₹32 bn in FY14. However, we expect stong operational cash flow to take care of capex requirements comfortably.

Free cash flow to turn positive

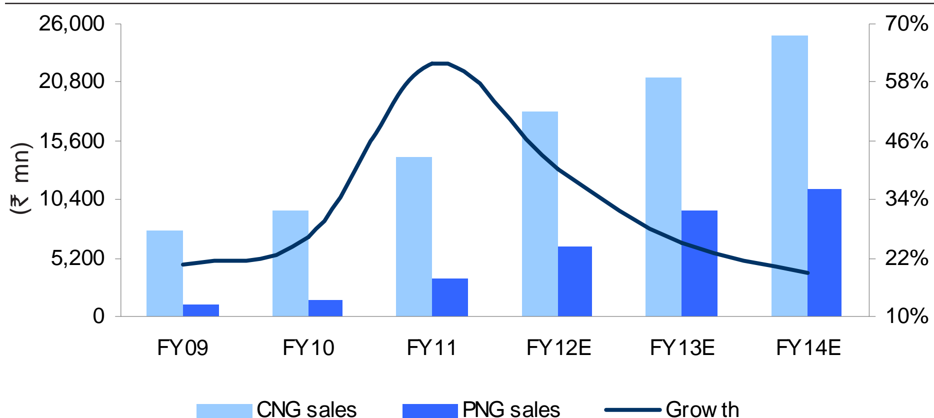


Source: Company , LKP Research

Expect revenue to double by FY14

We expect sales to jump in the near term due to steady volume growth in CNG & PNG segments aided by price hikes. We expect sales volumes to reach 1.6 bcm in FY14 from the current level of 1 bcm. We expect blended realizations also to rise from ₹17.5/scm in FY11 to ₹22.5/scm in FY14, mainly due to price hikes effected in the CNG segment.

Steady revenue growth

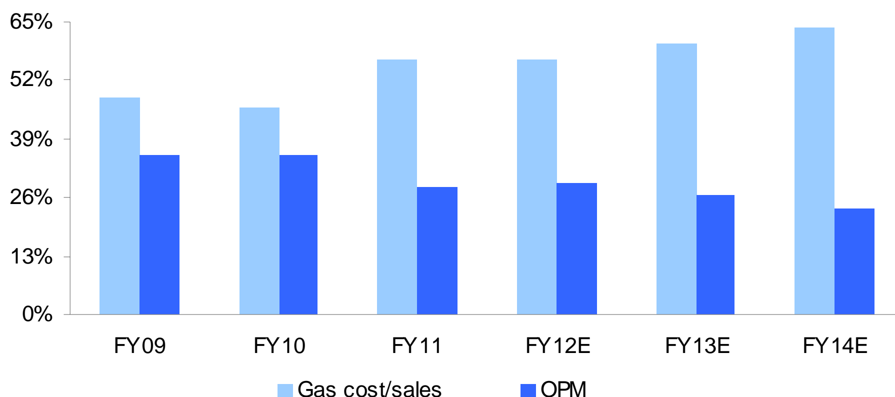


Source: Company , LKP Research

Rising gas cost to reduce OPM to 23% in FY14

Gas cost, as % of sales, is expected to rise going forward as IGL looks to service incremental demand from spot R-LNG. As spot R-LNG is costlier than domestic gas, we expect blended gas cost to increase and reduce operating margin from 28% in FY11 to 23% in FY14. Although IGL is expected to increase prices during this period, we expect EBITDA/scm to fall from ₹6/scm in FY12 to ₹5.2/scm in FY14.

Operating margin to reduce

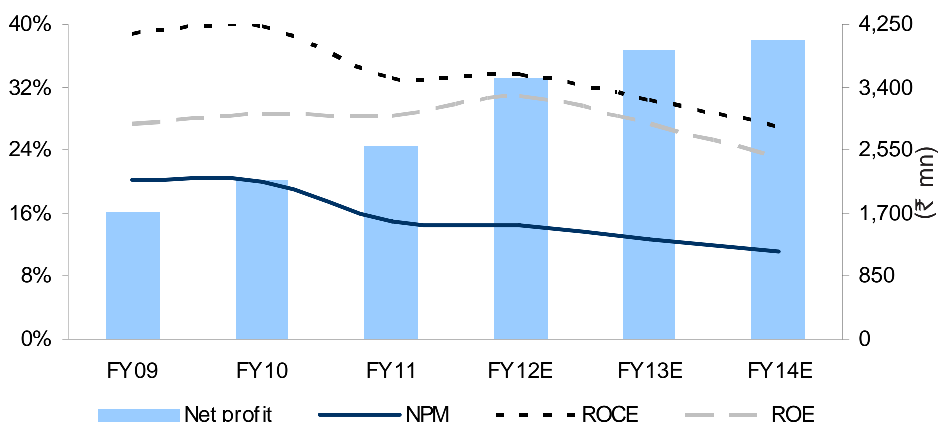


Source: Company , LKP Research

NPM & return ratios to drop from current peak levels

As a consequence of the above, we expect net profit margin to fall from 15% in FY11 to 11% in FY14. Hence, we expect slower growth in EPS from ₹18.6 in FY11 to ₹28.8 in FY14. We expect ROCE & ROE to hit their peak levels of 34% & 31% in FY12, after which these are expected to fall to 27% & 23% respectively by FY14.

Return ratios to taper off



Source: Company , LKP Research

Outlook and Valuation

We have valued IGL by carrying out DCF valuation using WACC of 12% and terminal growth of 3%. We have an **UNDERPERFORMER** rating and target price of ₹385. The price target translates into FY12E & FY13E P/E of 15.3x & 13.9x respectively. We believe that the CMP implies volume growth & price hikes to continue at the same pace as witnessed historically, which we feel is difficult in an environment where prices of alternative fuels are expected to fall. Reduced pace of customer additions and absence of price hikes in the PNG segment are the key events which are expected to play out in the near term.

Valuation

WACC (%)	12
PV of FCFF (₹mn)	18,076.2
Terminal growth (%)	3
Terminal value (₹mn)	87,013.9
PV of terminal value (₹mn)	39,360.7
EV (₹mn)	57,436.8
Net debt (₹mn)	3,484.4
Equity value (₹mn)	53,952.4
Intrinsic value per share (₹)	**385.4**

Key Risks

- Regulatory intervention mandating the use of natural gas by industries & commercial establishments would be a positive for the stock.
- Imposing limits on the no. of subsidized LPG cylinders that can be used by households would be a positive for PNG demand.
- Increased allocation of domestic gas to IGL would reduce gas costs and result in higher margins than estimated by us.
- Favorable verdict for carrying out operations in the Gurgaon/Faridabad areas would be a positive for the stock.

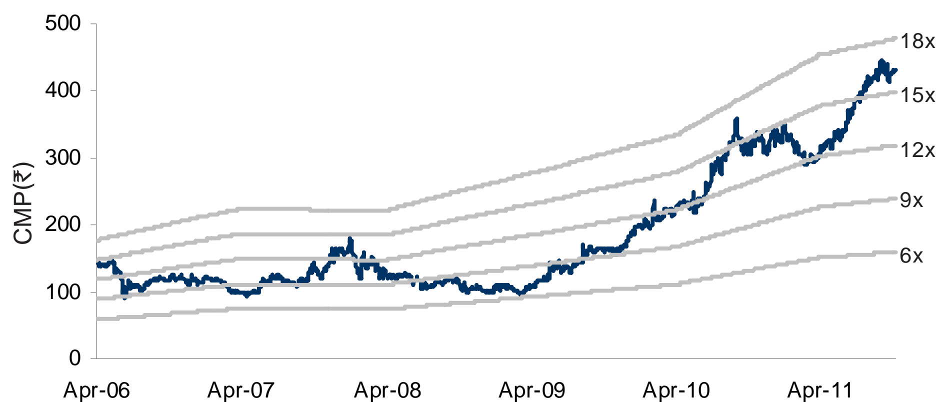
Scenario Analysis

We consider the following scenarios and estimate the effect on the company's valuation.

	Target price (₹)	Change from base case (%)
Base case	**385.4**	
Spot R-LNG costlier by $1/mmBtu	374.0	*(3.0)*
APM gas supply reduced by 0.1 mmscmd	366.9	*(4.8)*
No supply from KG D6	364.3	*(5.5)*
PNG growth 5% lower than expected	313.2	*(18.7)*

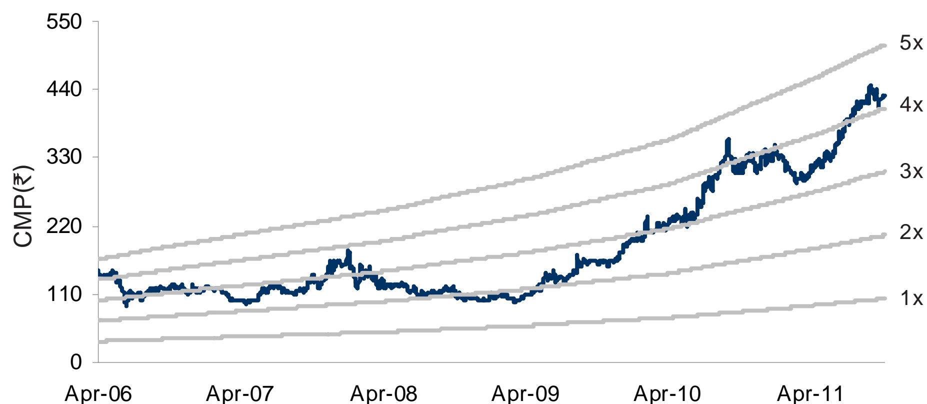
1 yr fwd Rolling valuation charts

(P/E)



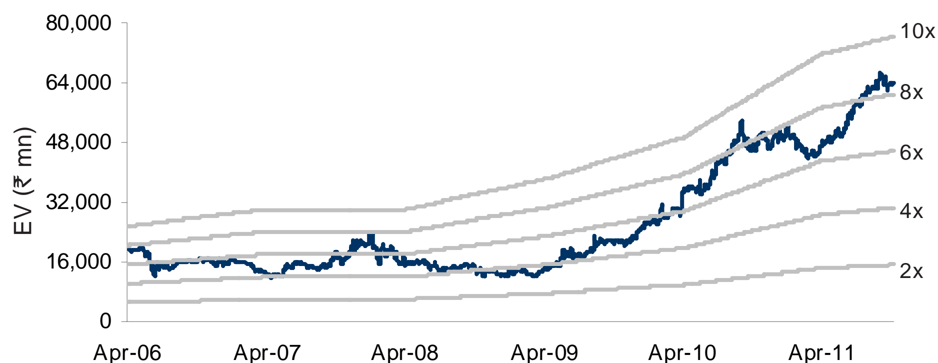
Source: Company , LKP Research

(P/B)



Source: Company , LKP Research

(EV/EBITDA)



Source: Company , LKP Research

Financial Summary

Income statement

YE Mar (₹mn)	FY11	FY12E	FY13E
Revenue	**17,441**	**24,447**	**30,626**
Cost of LNG consumed	9,843	13,889	18,435
Other Exp	2,675	3,396	4,124
Operating Profit	**4,923**	**7,162**	**8,067**
Operating Margin(%)	*28.2*	*29.3*	*26.3*
Other Income	95	84	113
Depreciation	1,029	1,493	1,887
EBIT	**3,989**	**5,752**	**6,293**
EBIT Margin(%)	*22.9*	*23.5*	*20.5*
Interest	132	484	484
PBT	**3,857**	**5,268**	**5,809**
PBT Margin(%)	*22.1*	*21.5*	*19.0*
Tax	1,259	1,738	1,917
PAT	**2,598**	**3,530**	**3,892**
PAT Margin(%)	*14.9*	*14.4*	*12.7*

Key Ratios

YE Mar (₹mn)	FY11	FY12E	FY13E
Per Share Data (₹)			
EPS	18.6	25.2	27.8
CEPS	25.9	35.9	41.3
BVPS	71.7	91.1	113.1
Cash per share	1.2	3.7	7.7
Growth Ratios(%)			
Revenue	61.8	40.2	25.3
EBITDA	29.2	45.5	12.6
PAT	20.5	35.9	10.3
Cash PAT	23.8	38.5	15.1
Valuation Ratios (X)			
P/E	22.9	16.9	15.3
P/CEPS	16.4	11.9	10.3
P/BV	5.9	4.7	3.8
EV/Sales	3.6	2.6	2.0
EV/EBITDA	12.4	8.7	7.6
Turnover Ratios (Days)			
Recievable Days	11.3	11.2	11.2
Inventory Days	430.9	467.4	480.3
Payable Days	55.4	60.0	60.0
Profitability Ratios (%)			
ROCE	33.1	33.7	30.4
ROE	28.4	31.0	27.2

Source: Company , LKP Research

Balance sheet

YE Mar (₹mn)	FY11	FY12E	FY13E
SOURCES OF FUNDS			
Equity Share Capital	1,400	1,400	1,400
Reserves & Surplus	8,639	11,355	14,433
Total Networth	10,039	12,755	15,833
Total debt	3,465	4,422	4,422
Deferred tax liability	408	408	408
Deposit from customers	1,168	1,480	1,694
Total Liabilities	**15,079**	**19,064**	**22,357**
APPLICATION OF FUNDS			
Gross Block	17,160	22,660	27,660
Accumulated Depreciation	5,566	7,059	8,946
Net Block	11,594	15,601	18,714
Capital WIP	3,423	3,423	3,423
Investments	416	416	416
Current Assets			
Cash and Bank	173	521	1,078
Inventories	359	409	459
Sundry Debtors	745	750	940
Loan, Adv & others	956	1,086	1,216
Current Liab & Prov			
Current liabilities	1,729	2,283	3,030
Provisions	859	859	859
Net Current Assets	(355)	(376)	(197)
Total Assets	**15,079**	**19,064**	**22,357**

Cash Flow

YE Mar (₹mn)	FY11	FY12E	FY13E
PAT	2,598	3,530	3,892
Depreciation	1,029	1,493	1,887
Interest	132	484	484
Chng in working capital	150	(369)	(378)
Other operating activities	(785)	(312)	(214)
CF from operations (a)	**4,261**	**5,705**	**6,371**
Capital expenditure	7,706	5,500	5,000
Chng in investments	246	0	0
CF from investing (b)	**(7,952)**	**(5,500)**	**(5,000)**
Free cash flow	(3,313)	689	1,855
Equity raised/(repaid)	0	0	0
Inc/dec in borrowings	3,465	957	0
Dividend paid (incl. tax)	814	814	814
Adj in R&S	0	0	0
CF from financing (c)	**2,651**	**143**	**(814)**
Net chng in cash (a+b+c)	(1,039)	348	557
Closing cash & cash equiv	**173**	**521**	**1,078**

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