

## GAIL (India)

STOCK INFO.	BLOOMBERG
BSE Sensex: 10.227	GAIL IN
	REUTERS CODE
S&P CNX: 2.944	GAIL.BO

18 July 2006

**Neutral**
*Previous Recommendation: Neutral*
**Rs232**

Equity Shares (m)	845.7
52-Week Range	325/208
1,6,12 Rel. Perf. (%)	-3/-26/-31
M.Cap. (Rs b)	196.0
M.Cap. (US\$ b)	4.2

YEAR	NET SALES	PAT	EPS	EPS	P/E	P/BV	ROE	ROCE	EV/	EV/
END	(RS M)	(RS M)	(RS)	GROWTH (%)	(X)	(X)	(%)	(%)	SALES	EBITDA
03/06A	163,513	23,101	27.3	18.7	8.5	1.9	24.6	29.7	1.2	5.7
03/07E	168,786	24,523	29.0	6.2	8.0	1.7	22.6	36.6	1.0	4.3
03/08E	161,513	25,007	29.6	2.0	7.8	1.5	20.2	41.0	0.9	3.6

- ✍ PAT at Rs5.9b was up 22.5% YoY, primarily on the back of a change in pipeline depreciation policy. EBITDA was flat YoY, despite a sharp increase in P/E volumes / margins and YoY increase in LPG transmission, as higher fuel marketing loss sharing and drop in gas trading earnings set off the gains.
- ✍ P/E sales volume was up 28.6%, while P/E spread over natural gas feedstock (gross margin) was up sharply YoY, contributing towards an EBIT growth of 53.3% YoY. LPG transmission volume was up 7.2% leading to an EBIT growth of 201%. We believe, part of the EBIT growth would be on account of pipeline depreciation rate change.
- ✍ Fuel marketing loss sharing was up 63.4% YoY at Rs2.5b, pulling down LPG revenues and profits. LPG segment EBIT at Rs1.4b is down 34.3% on account of higher losses. Gas trading profit (EBIT) was down 48.8% YoY at Rs270m on account of Government disallowing margins on APM gas.
- ✍ Full impact of pipeline tariff cut (approx Rs800m) and marketing margin cut (approx Rs500m) could affect future profits. Tariff commission recommendation for a cut in KG-basin pipeline (impact of Rs1.5b) is an overhang.
- ✍ Stock trades at a P/E of 7.8x FY08E. Given that more than 60% of its EBITDA currently is from petrochemicals and LPG and the fall in value of pipelines on account of new tariffs, we believe the valuation does not indicate much upside for the stock. Maintain **Neutral**.

**QUARTERLY PERFORMANCE**

(Rs Million)

Y/E MARCH	FY06				FY07				FY06	FY07E
	1Q	2Q	3Q	4Q	1Q	2QE	3QE	4QE		
<b>Net Sales</b>	<b>36,242</b>	<b>40,738</b>	<b>44,455</b>	<b>42,078</b>	<b>47,303</b>	<b>39,900</b>	<b>40,687</b>	<b>40,895</b>	<b>163,513</b>	<b>168,786</b>
Change (%)	11.8	15.6	27.9	27.2	30.5	-2.1	-8.5	-2.8	11.6	3.2
Finished Gds Purchase	21,439	24,473	27,787	25,396	30,552	22,500	23,000	23,138	78,537	99,190
Raw Materials Cons	2,485	3,698	4,149	4,427	5,069	3,950	4,000	4,162	8,971	17,181
Employee Costs	534	539	612	528	551	550	550	598	1,976	2,249
Other Exp (incl Stock Adj)	2,304	2,684	2,796	4,683	1,715	3,400	2,729	2,464	12,037	10,308
<b>EBITDA</b>	<b>9,480</b>	<b>9,344</b>	<b>9,111</b>	<b>7,044</b>	<b>9,416</b>	<b>9,500</b>	<b>10,408</b>	<b>10,533</b>	<b>34,979</b>	<b>39,858</b>
% of Net Sales	26.2	22.9	20.5	16.7	19.9	23.8	25.6	25.8	26.7	-76.4
% Change	24.1	6.4	-11.1	-3.8	-0.7	1.7	14.2	49.5	-5.5	13.9
Depreciation	2,391	399	1,414	1,391	1,408	1,435	1,435	1,472	9,399	5,750
Interest	297	178	406	292	288	271	300	300	1,339	1,159
Other Income	499	1,693	1,519	844	801	1,600	1,000	582	3,229	3,983
<b>PBT</b>	<b>7,292</b>	<b>10,461</b>	<b>8,809</b>	<b>6,205</b>	<b>8,521</b>	<b>9,394</b>	<b>9,673</b>	<b>9,343</b>	<b>32,766</b>	<b>36,931</b>
Tax	2,457	2,719	2,377	2,112	2,600	3,256	3,350	3,202	10,024	12,409
Rate (%)	33.7	26.0	27.0	34.0	30.5	34.7	34.6	34.3	30.6	33.6
<b>PAT</b>	<b>4,835</b>	<b>7,742</b>	<b>6,432</b>	<b>4,093</b>	<b>5,921</b>	<b>6,138</b>	<b>6,323</b>	<b>6,141</b>	<b>23,101</b>	<b>24,522</b>
Change (%)	42.6	69.7	1.2	-20.8	22.5	-20.7	-1.7	50.0	3.6	6.2

E: MOSt Estimates

PAT at Rs5.9b was up 22.5% YoY, primarily on the back of a change in pipeline depreciation policy. However, EBITDA was flat YoY, despite a sharp increase in PE volumes / margins and YoY increase in LPG transmission, as higher fuel marketing loss sharing and drop in gas trading earnings set off the gains.

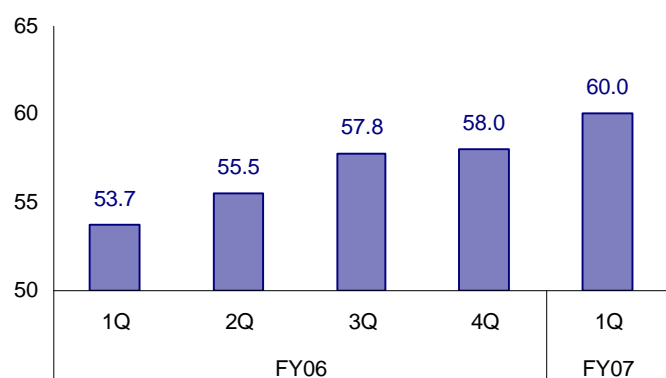
### P/E is the biggest profit driver

P/E was the key profit driver, with EBIT growth of 53.3% YoY. Both volume and margins contributed to the growth.

P/E sales volume was up 28.6%, partly on account of base effect and partly due to higher than trend sales volume. We believe, some inventory destocking in the industry would have happened, triggered by the drop in prices in April 2006. We were aware of an inventory build-up (as reflected in IPCL's last 4 quarter numbers) in the industry.

P/E spread over natural gas feedstock (gross margin) was up sharply YoY, despite higher gas prices. PE prices were up 11.8% YoY, while gas price increase was steeper. The transition from regulated gas price (of Rs2850/tscm) to free priced gas (of US\$3.86/mmbtu) happened in 1QFY06, effective May 2005. In comparison, current price stands at US\$4.75/mmbtu.

POLYETHYLENE PRICE TREND (RS/KG)



Source: Company/Motilal Oswal Securities

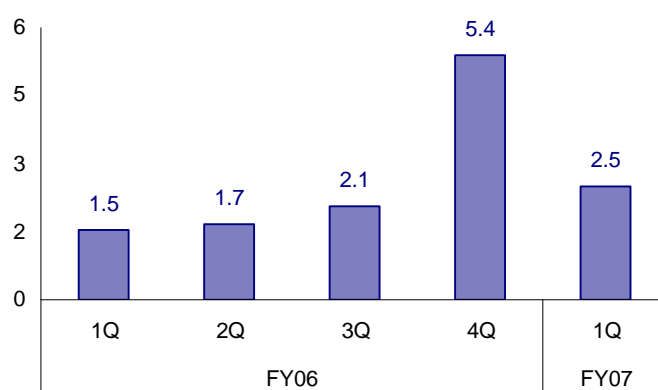
### LPG transmission volume up

LPG transmission volume at 5,22,000 MT was up 7.2% YoY. This contributed in the EBIT growth of 201%. However, we believe, part of the EBIT growth would be on account of pipeline depreciation rate change. While transmission volume is up YoY, it is down sequentially, thanks to seasonal variation as well as lower LPG production by Reliance Industries during the quarter. Utilisation of LPG transmission line Vizag-Secunderabad remains abysmally low.

### LPG business earnings neutralized by loss sharing and gas prices

Higher fuel marketing loss sharing and higher feedstock cost set off LPG profit growth. We estimate LPG (along with liquid hydrocarbons) realization growth at 25% YoY, while sales volume was up 7.9% YoY. However, LPG EBIT was down 34.3% on account of higher loss sharing and higher gas prices. Loss sharing at Rs2.5b was up 63.4% YoY, due to higher losses YoY. We believe this trend is likely to continue.

LPG / KEROSENE LOSS SHARING (RS B)



Source: Company/Motilal Oswal Securities

### Gas marketing profits down

Gas marketing EBIT was down 48.8% YoY at Rs270m on the back of Government directive disallowing marketing margins on APM gas last year. However, this does not

reflect the tariff commission recommendation to cut marketing margin from Rs5/mmmbtu to Rs1.97/mmmbtu, down 60.6%. Government order on this is pending.

## SEGMENTWISE RESULTS (RS M)

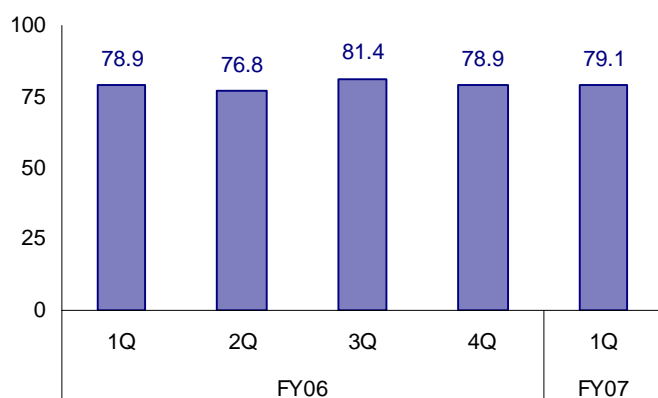
SEGMENTWISE REVENUES	1QFY07	1QFY06	YOY CH. (%)
Natural gas trading	29,780	22,050	35.1
Gas transmission	6,000	5,739	4.5
LPG transmission	710	674	5.4
P/E	5,500	3,671	49.8
LPG & liquid hydrocarbon	6,410	5,074	26.3
LPG & liquid hydrocarbon (adjus. for loss share)	8,910	6,604	34.9
Segmentwise profits (EBIT)			
Natural gas trading	270	528	-48.8
Gas transmission	4,540	3,552	27.8
LPG transmission	370	123	201.5
P/E	2,020	1,318	53.3
LPG & liquid hydrocarbon	1,390	2,115	-34.3
LPG & liquid hydrocarbon (adjus. for loss share)	3,890	3,645	6.7

Source: Company/ Motilal Oswal Securities

## Natural gas transmission volume flat

Natural gas transmission volume remained flat YoY. Barring possible adhoc imports of gas parcels, we expect the gas transmission volume to remain between 79-80 MMSCMD.

## GAS TRANSMISSION VOLUME TREND (MMSCMD)



Source: Company/ Motilal Oswal Securities

## OPERATING PERFORMANCE SUMMARY (TON)

	1QFY07	1QFY06	YOY CH. (%)
Gas transmission (MMSCMD)	79.1	78.9	0.2
LPG transmission (MT)	522,000	487,000	7.2
P/E sales (MT)	81,000	63,000	28.6
LPG & liquid hydrocar. sales (MT)	356,000	330,000	7.9

Source: Company/Motilal Oswal Securities

## Looking ahead

A couple of near term earnings impact is likely to be realized in the coming quarters (not built into our current estimates):

- 1) Full impact of new tariff (Rs965/tscm) for HBJ-DVPL system. However, annualized impact would be relatively small at Rs800m.
- 2) Implementation of cut in gas marketing margins too could pull down profits by Rs500m.

Possible implementation of KG-basin pipeline tariff cut (impact of Rs1.5b) remains an overhang, while stronger crude prices could drive up quantum of fuel marketing loss share.

On the positive side, both petrochemical and LPG prices remain buoyant, driven by strong crude prices. This would more than set off the possible fuel marketing loss share increase.

On the growth front, DUPL appears to be progressing well targeting March 2007 completion. Other regional pipelines like Jagoti-Pithampur, Dabhol-Panvel, Vijaipur-Kota and Kelaras-Malanpur are likely to be completed over the next 12 months, contributing to earnings in FY08.

## Valuation and view

Stock trades at a P/E of 7.8x FY08E. Given that more than 60% of its EBITDA currently is from petrochemicals and LPG and the fall in value of pipelines on account of new tariffs, we believe the valuation does not indicate much upside for the stock. Maintain **Neutral**.

## GAIL (India): an investment profile

### Company description

GAIL is the only gas transmission company in India currently, with interests in gas distribution, petrochemicals, LPG and telecom. It owns over 6,000 km of pipelines (including LPG transmission pipelines), over 8,000 km of optical fiber cable network, 1.3m ton LPG / other hydrocarbons capacity and 330,000 petrochemicals capacity. GAIL is also involved in city gas distribution in Mumbai and Delhi, E&P and power businesses through its joint ventures

### Key investment arguments

- ✍ With minimal competition in the pipeline business, GAIL would be best positioned to take advantage of the large gas demand growth over the next 10 years
- ✍ However, near term / medium term growth remains a concern. Transmission tariff cut, marketing margin cut and fuel marketing loss sharing remain key concerns.

### Key investment risks

- ✍ Returns on new pipeline investments not very attractive
- ✍ Open ended loss sharing a key risk.

### Recent developments

- ✍ GAIL has adopted the new pipeline tariff on HBJ-DVPL system
- ✍ GAIL has started paying a higher gas price of US\$4.75/mmbtu with effect from April 2006.

### Valuation and view

- ✍ Stock trades at a P/E of 7.8x FY08E. Given that more than 60% of its EBITDA currently is from petrochemicals and LPG and the fall in value of pipelines on account of new tariffs, we believe upside is limited.
- ✍ We maintain our **Neutral** rating

### Sector view

- ✍ Strong gas demand and supply growth expected over the next five to seven years, and GAIL is likely to be the preferred gas transmission agency
- ✍ However, returns are likely to remain squeezed, given the pricing constraints with fertilizer and power sectors.
- ✍ A large part of the near-term gas supply growth is likely to flow through Reliance's own pipeline and not through GAIL's pipeline. Also, Reliance's pipeline could challenge GAIL's gas sales in some of the economic zones in the western region

#### COMPARATIVE VALUATIONS

		GAIL	ONGC	RELIANCE
P/E (x)	FY07E	8.0	7.7	6.0
	FY08E	7.8	8.4	6.1
P/BV (x)	FY07E	1.7	2.2	1.4
	FY08E	1.5	1.9	1.1
EV/ Sales	FY07E	1.1	1.7	0.6
	FY08E	0.9	1.7	0.4
EV/EBITDA (x)	FY07E	4.3	3.7	2.5
	FY08E	3.6	3.8	2.0

#### SHAREHOLDING PATTERN (%)

	MAR.06	DEC.05	MAR.05
Promoters	64.6	67.0	67.0
Domestic Institutions	8.6	7.6	6.9
FII's/FDIs	23.6	21.5	21.5
Others	3.2	3.9	4.6

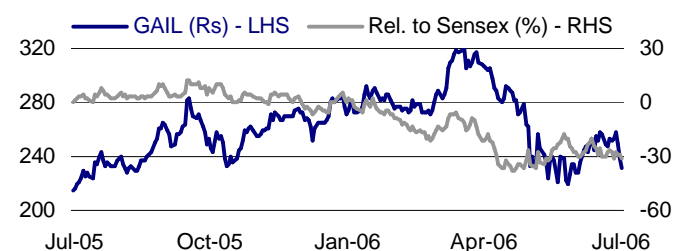
#### EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	29.0	27.2	6.8
FY08	29.6	27.5	7.5

#### TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
232	-	-	Neutral

#### STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT (Rs Million)					
Y/E MARCH	2004	2005	2006E	2007E	2008E
<b>Net Sales</b>	<b>119,373</b>	<b>136,135</b>	<b>163,513</b>	<b>168,786</b>	<b>161,513</b>
Change (%)	5.2	14.0	20.1	3.2	-4.3
<b>Total Income</b>	<b>119,373</b>	<b>136,135</b>	<b>163,514</b>	<b>168,788</b>	<b>161,515</b>
Purchase	67,071	78,537	99,096	99,190	90,904
Raw Materials	8,196	8,971	14,758	8,562	8,562
Power and fuel	3,819	3,997	4,062	4,129	4,202
Employee Costs	1,655	1,976	2,213	2,249	2,457
Other Expenditure	5,293	5,568	8,655	14,800	14,262
Change in Stocks	-396	85	-249	0	0
<b>EBITDA</b>	<b>33,735</b>	<b>37,001</b>	<b>34,979</b>	<b>39,858</b>	<b>41,129</b>
% of Net Sales	28.3	27.2	21.4	23.6	25.5
Depreciation	6,605	9,399	5,595	5,750	6,650
Interest	1,394	1,339	1,173	1,159	1,028
Other Income	2,497	3,229	4,555	3,982	4,210
Extraordinary Items (net)					
<b>PBT</b>	<b>28,233</b>	<b>29,492</b>	<b>32,766</b>	<b>36,932</b>	<b>37,661</b>
Tax	9,450	10,024	9,666	12,409	12,654
Rate (%)	33.5	34.0	29.5	33.6	33.6
PAT	18,783	19,469	23,101	24,523	25,007
<b>Adjusted PAT</b>	<b>18,783</b>	<b>19,469</b>	<b>23,101</b>	<b>24,523</b>	<b>25,007</b>
Change (%)	14.6	3.7	18.7	6.2	2.0

BALANCE SHEET (Rs Million)					
Y/E MARCH	2004	2005	2006E	2007E	2008E
Share Capital	8,456	8,456	8,456	8,456	8,456
Reserves	66,950	78,787	92,347	107,330	122,797
<b>Net Worth</b>	<b>75,406</b>	<b>87,243</b>	<b>100,803</b>	<b>115,786</b>	<b>131,253</b>
Long Term Loans	15,936	19,134	18,233	16,846	14,827
Deferred Tax	12,276	12,450	12,894	15,182	16,995
<b>Capital Employed</b>	<b>103,618</b>	<b>118,826</b>	<b>131,931</b>	<b>147,815</b>	<b>163,075</b>
Gross Fixed Assets	136,929	146,606	156,106	177,106	177,106
Less: Depreciation	54,506	63,905	69,500	75,250	81,900
<b>Net Fixed Assets</b>	<b>82,423</b>	<b>82,701</b>	<b>86,606</b>	<b>101,856</b>	<b>95,206</b>
Capital WIP	7,656	20,217	24,817	0	0
Investments	8,648	9,950	10,950	10,950	10,950
<b>Curr. Assets, L &amp; Adv.</b>					
Inventory	4,276	5,108	5,750	6,653	7,631
Debtors	8,046	9,642	11,496	11,664	11,137
Cash & Bank Balance	12,105	12,593	15,921	40,599	62,335
Loans & Adv. and Other Ass	11,844	12,011	12,195	12,397	12,620
<b>Current Liab. &amp; Prov.</b>					
Liabilities	20,690	21,752	22,252	22,752	23,252
Provisions	10,690	11,644	13,552	13,552	13,552
<b>Net Current Assets</b>	<b>4,891</b>	<b>5,958</b>	<b>9,558</b>	<b>35,009</b>	<b>56,919</b>
<b>Application of Funds</b>	<b>103,618</b>	<b>118,826</b>	<b>131,931</b>	<b>147,815</b>	<b>163,075</b>

E: M O S t Estimates

RATIOS					
Y/E MARCH	2004	2005	2006E	2007E	2008E
<b>Basic (Rs)</b>					
<b>EPS</b>	<b>22.1</b>	<b>23.0</b>	<b>27.3</b>	<b>29.0</b>	<b>29.6</b>
Cash EPS	30.0	34.1	33.9	35.8	37.4
Book Value	89.2	103.2	119.2	136.9	155.2
DPS	7.0	8.0	10.0	10.0	10.0
Payout (incl. Div. Tax.)	31.7	34.7	36.6	34.5	33.8
<b>Valuation (x)</b>					
P/E		10.1	8.5	8.0	7.8
Cash P/E		6.8	6.8	6.5	6.2
EV / EBITDA		5.5	5.7	4.3	3.6
EV / Sales		1.5	1.2	1.0	0.9
Price / Book Value		2.2	1.9	1.7	1.5
Dividend Yield (%)		3.5	4.3	4.3	4.3
<b>Profitability Ratios (%)</b>					
RoE	26.9	23.9	24.6	22.6	20.2
RoCE	41.0	33.3	29.7	36.6	41.0
<b>Turnover Ratios</b>					
Debtors (No. of Days)	23	24	24	25	26
Fixed Asset Turnover (x)	1.5	1.4	1.5	1.6	1.6
<b>Leverage Ratio</b>					
Net Debt / Equity (x)	0.1	0.1	0.0	-0.2	-0.4

CASH FLOW STATEMENT (Rs Million)					
Y/E MARCH	2004	2005	2006E	2007E	2008E
OP/(Loss) before Tax	35,506	39,798	39,534	43,338	44,838
Interest Paid	-1,380	-1,339	-1,173	-1,159	-1,028
Direct Taxes Paid	-8,373	-9,850	-9,221	-10,121	-10,842
(Inc)/Dec in Wkg. Capital	2,428	-579	-272	-773	-174
<b>CF from Op. Activity</b>	<b>28,182</b>	<b>28,030</b>	<b>28,869</b>	<b>31,286</b>	<b>32,793</b>
(Inc)/Dec in FA & CWIP	-27,217	-22,238	-14,100	3,817	0
(Pur)/Sale of Investments	-1,831	-1,302	-1,000	0	0
Inc from Invst	658	432	0	502	502
<b>CF from Inv. Activity</b>	<b>-28,390</b>	<b>-23,108</b>	<b>-15,100</b>	<b>4,319</b>	<b>502</b>
Issue of Shares	0	0	0	0	0
Inc / (Dec) in Debt	-4,535	3,197	-900	-1,387	-2,019
Dividends Paid	-6,678	-7,632	-9,540	-9,540	-9,540
<b>CF from Fin. Activity</b>	<b>-11,213</b>	<b>-4,435</b>	<b>-10,440</b>	<b>-10,927</b>	<b>-11,559</b>
<b>Inc / (Dec) in Cash</b>	<b>-11,421</b>	<b>488</b>	<b>3,328</b>	<b>24,678</b>	<b>21,736</b>
Add: Opening Balance	23,526	12,105	12,593	15,921	40,599
<b>Closing Balance</b>	<b>12,105</b>	<b>12,593</b>	<b>15,921</b>	<b>40,599</b>	<b>62,335</b>



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- |   |    |
|---|----|
| 1. Analyst ownership of the stock                       | No |
| 2. Group/Directors ownership of the stock               | No |
| 3. Broking relationship with company covered            | No |
| 4. Investment Banking relationship with company covered | No |

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