



## GAIL (India)

STOCK INFO.	BLOOMBERG
BSE SENSEX: 14,945	GAIL IN
S&P CNX: 4,482	REUTERS CODE
	GAIL.BO

8 September 2008

Buy

Previous Recommendation: Buy

Rs426

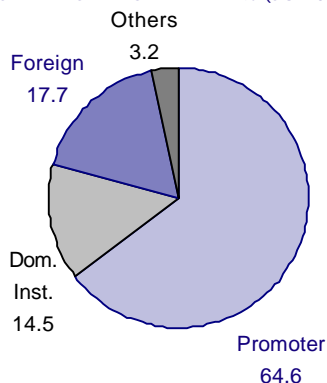
Equity Shares (m)	845.7
52-Week Range	555/306
1,6,12 Rel. Perf. (%)	6/15/41
M.Cap. (Rs b)	360.5
M.Cap. (US\$ b)	8.1

YEAR	NET SALES	Adj. PAT	EPS	EPS	P/E	P/BV	ROE	ROCE	EV/	EV/
END	(RS M)	(RS M)	(RS)	GROWTH (%)	(X)	(X)	(%)	(%)	SALES	EBITDA
03/07A	160,472	20,468	24.2	-11.4	17.6	3.2	20.9	21.1	2.2	11.6
03/08A	180,082	25,442	30.1	24.3	14.2	2.8	20.0	25.2	1.8	8.3
03/09E	219,533	33,800	40.0	32.9	10.7	2.4	22.4	28.6	1.5	6.5
03/10E	279,494	33,838	40.0	0.1	10.7	2.1	19.5	25.5	1.3	6.6

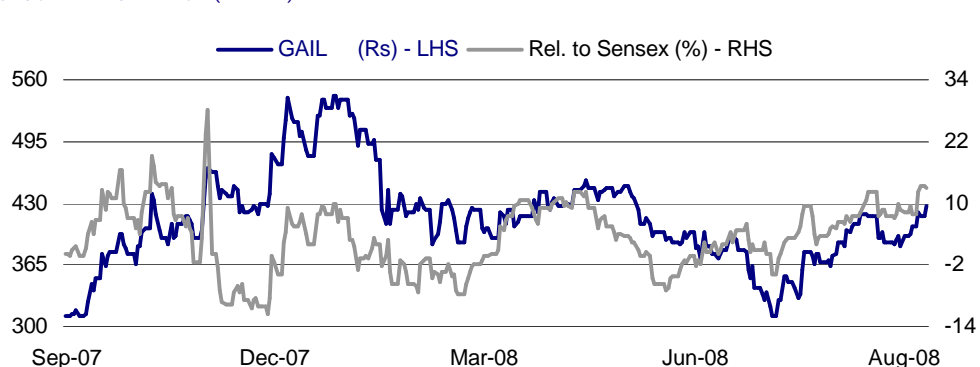
We met with the management of GAIL to understand the company's expansion plans and growth strategy.

- Reducing FY09 subsidy assumption; subsidy for remaining 3 quarters in FY09 likely similar to 1QFY09:** 1QFY09 subsidy burden (Rs3.9b) for GAIL as a percentage of the upstream subsidy burden was at 3.5% compared with 7.3% in FY07 and 5.3% in FY08. Management expects subsidy burden for the remaining 3 quarters to be at levels similar to that in 1QFY09. Also, with oil prices decreasing, the risk of a likely increase in the upstream burden would remain low. We have reduced our subsidy burden assumptions for FY09 to Rs16b from Rs22b.
- RIL gas imminent, large volume upsides in coming quarters:** GAIL is readying for RIL's new gas from the KG-block (expected in the next few months) and connectivity with Reliance's E-W pipeline is almost complete. We believe a significant portion of RIL's new gas will flow through GAIL's network as a majority of priority consumers (as per Gas Utilization Policy) such as fertilizer, LPG, power and CGD, are linked to GAIL's pipelines.
- Of the planned peak production of 80mmscmd by RIL, GAIL's management expects to target a share of up to 56-64mmscmd (70-80% share). We have increased our FY10 gas transmission volumes assumption to 140.5mmscmd from 136.5mmscmd, primarily to reflect our increased assumption of RIL's gas volumes.
- Business outlook:** We remain positive on GAIL in view of potential increase in gas transmission volumes and expect transmission volumes to increase by ~68% over the next two years. GAIL's existing and large plans for city gas distribution and E&P will provide added upsides. The recent increase in petchem capacity by 32% would provide volume upsides, though we remain bearish on the petchem cycle and expect prices to decline by 2HFY09. Concerns could arise from any change in the subsidy scheme already announced by the government.
- Increasing EPS; raising price target:** We have increased our FY09 and FY10 EPS estimate by ~8% to Rs40/share to reflect the decreased subsidy burden in FY09 and higher transmission volumes in FY10. The stock trades at 10.7x FY10 EPS of Rs40. Our fair value for GAIL is based on FY10E P/E of 13x. Our revised target price at 13x FY10E EPS and post 10% discount is Rs563/share (previous Rs528/share). Maintain **Buy**.

SHAREHOLDING PATTERN % (JUN-08)



STOCK PERFORMANCE (1 YEAR)

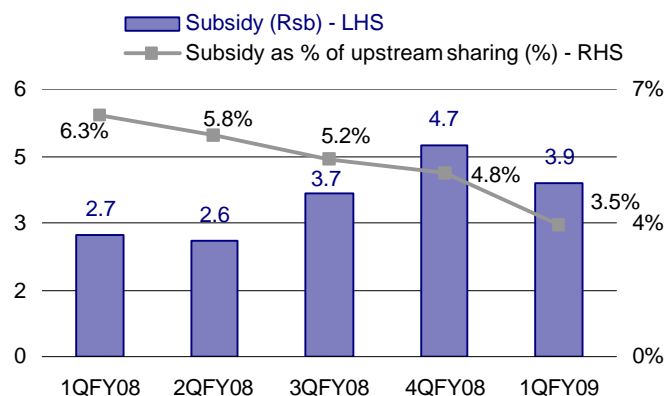


We met with the management of GAIL to understand the company's expansion plans and growth strategy. Management indicated that they have identified three focus areas: 1) strengthening transmission / distribution capability; (2) petchem business; and (3) city gas distribution.

### Cutting FY09 subsidy assumption; subsidy for remaining 3 quarters in FY09 likely similar to 1QFY09

The 1QFY09 subsidy burden (Rs3.9b) for GAIL as a percentage of the upstream subsidy burden was at 3.5% compared with 7.3% (Rs14.9b) in FY07 and 5.3% (Rs12.9b) in FY08. Management expects subsidy burden for the remaining 3 quarters to be at levels similar to 1QFY09 (ONGC management is also of a similar view for its own subsidy burden). Also with oil prices decreasing, the risk of a likely increase in the upstream burden would remain low. We have reduced our subsidy burden assumptions for FY09 to Rs16b from Rs22b.

SUBSIDY BURDEN ON GAIL HAS REDUCED IN 1QFY09



Source: Company/Motilal Oswal Securities

### Network ramp-up to meet new gas supplies

Management is focusing on the upgradation and expansion of its pipeline network to cater to future gas supplies in India. It is investing to increase its pipeline capacity significantly from the current ~150mmscmd to ~230mmscmd by end of phase 1 of its expansion (expected to be completed by end-2009/ early 2010). Phase 2 of its expansion is expected to be completed in 2012-2013, which

will more than double its pipeline capacity. Management has indicated that this pipeline network will help GAIL maintain its dominant position in gas transmission in the country.

Phase I pipelines are in various stages of implementation and are expected to be completed by end-2009 or early 2010. We believe GAIL's plans are well timed to co-ordinate with the expected new gas supplies in the country –

1. RIL's KG D6 gas production, to begin by end-2008
2. Expansion of Dahej R-LNG terminal (5 to 10mmtpa)
3. GSPC's KG block (likely in 2012)
4. ONGC's KG-DWN-98/2 block, likely to begin gas production in 2012-2013

#### NEW PLANNED PIPELINE NETWORK

PIPELINE	LENGTH	NEW CAPACITY
	KM	MMSCMD
<b>Phase I by 2009-2010</b>		
Dahej-Vijaipur/GREP Upgradation	1,115	11
Dadri-Bawana-Nangal	610	31
Chainsa-Jhajjar-Hissar	450	35
<b>Phase II by 2011-2012</b>		
Dahej-Vijaipur/GREP Upgradation		43
Dhabol- Bangalore	730	16
Kochi - Mangalore - Bangalore	840	16
Jagdishpur - Haldia	876	16
<b>Total</b>	<b>4,621</b>	<b>168</b>

Source: Company/Motilal Oswal Securities

### RIL gas round the corner, large volume upsidess in coming quarters

RIL will begin gas supply from its KGD6 block in the next few months. GAIL is readying for RIL's new gas production from the KG-block and connectivity with Reliance's East-West Pipeline is almost complete. We believe that a significant portion of this new gas will flow through GAIL's network, as a majority of the priority consumers (dictated by Gas Utilization Policy) such as fertilizer, LPG, power and CGD are linked to GAIL's pipelines.

Of the planned peak production of 80mmscmd by RIL, according to management, GAIL could target a share of up to 56-64mmscmd (70-80% share). We have increased our assumption of FY10 gas transmission volumes to

140.5mmscmd from 136.5mmscmd primarily to reflect our increased assumption for RIL's potential gas volumes (RIL's volumes to GAIL assumed at 40mmscmd in FY10).

There remains an upside risk to our FY10 gas volume estimates, however we would await greater clarity in terms of RIL's gas production ramp-up and demand scenario for the gas. For our estimates of RIL's gas production, we assume peak production would be much higher at 120mmscmd (by FY13) and could result in increased gas availability for GAIL beyond FY10. Below is the sensitivity of GAIL's FY10 EPS to likely changes in gas volumes.

#### SENSITIVITY OF EPS TO GAS VOLUMES

RIL GAS VOLUMES MMSCMD	GAIL'S SHARE		FY10 EPS RS	CHANGE	
	%	MMSCMD		%	%
80	50	40	40.0		Our base case
80	60	48	41.5		3.6
80	70	56	42.9		7.3
80	80	64	44.3		10.9

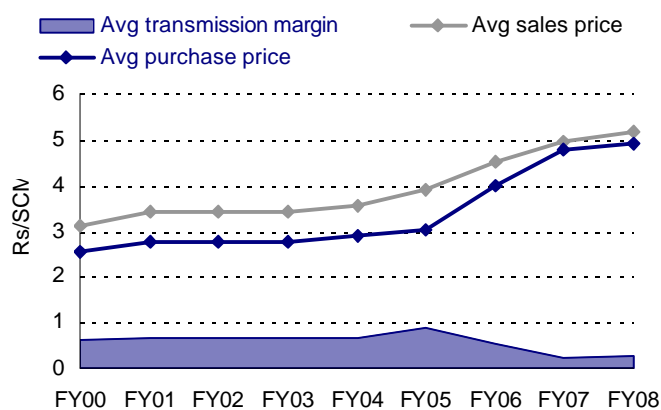
Source: Company/Motilal Oswal Securities

### Transmission tariffs expected to remain at current levels

Management expects no further cuts in the transmission tariffs, and expects tariffs to remain at current levels. GAIL's transmission tariffs were reduced over the last 2-3 years for both its HVJ network as well as its network in the KG Basin. Transmission tariffs were reduced on the HVJ network by 16% from Rs1,150/mscm to the present Rs960/mscm, in July 2006. Tariffs for the KG Basin network were reduced from the earlier average of Rs800-850/mscm to the current Rs420-450/mscm, post the tariff commission report, November 2006.

With significant reduction already having been effected in recent years and GAIL making substantial investments to increase network capacity, we believe, there is little threat of further tariff cuts by the regulator, PNGRB (Petroleum and Natural Gas Regulatory Board).

#### REDUCED TRANSMISSION MARGINS (RS/SCM)



Source: Motilal Oswal Securities

### Petchem: We expect significant decline in margins

GAIL's petchem segment margins have remained high in recent quarters primarily due to higher polymer prices led by naphtha cost push and GAIL's gas-based petchem capacities. However, we believe that downturn in the ethylene chain is impending, due to large greenfield capacity additions forthcoming in the Middle East and China.

Though, GAIL's increased pipeline capacity will be able to cushion the decline in petchem margins, to some extent in FY09, we expect margins to decline significantly by 24% in FY10. In its AGM on 4 September (FY08) GAIL announced the increase in its petchem capacity to 500 KTA and further to 800KTA. However, we are currently not building this expansion in our estimates.

#### WE EXPECT PETCHEM EBIT TO DECLINE BY 3% IN FY09 AND 24% IN FY10

	FY07	FY08	FY09E	FY10E
Petchem Production (KT)	354	391	428	431
Petchem EBIT (Rs m)	9,545	12,542	12,183	9,299
YoY Change (%)		31	-3	-24
EBIT Margin (Rs/Kg)	27.0	32.1	28.5	21.6
YoY Change (%)		19	-11	-24

Source: Motilal Oswal Securities

### CGD would yield value over longer term

GAIL already operates CGD networks in several key cities via nine JVs, and plans to expand this further to 230 cities. It has set up a 100% subsidiary, Gail Gas Ltd. for the CGD and CNG corridor business. Apart from developing city gas infrastructure, Gail Gas would build gas corridors on national highways. GAIL plans to add 17 cities in the first phase of expansion over the next two years.

### Valuation and view

We remain positive on GAIL in view of increase in gas transmission volumes going forward. We expect GAIL's transmission volumes to increase by ~68% over the next two years. The recent increase in petchem capacity by 32% would provide volume upsides, though we remain bearish on the petchem cycle and expect prices to decline by 2HFY09.

GAIL's existing and large plans for city gas distribution (CGD) (230 cities identified for CGD in a phased manner) and E&P will provide added upsides. Concerns related to

GAIL could arise from any change in the subsidy scheme already announced by the government.

### Increasing EPS; raising target price

We have increased our FY09 and FY10 EPS estimate by ~8% to Rs40/share to reflect the decreased subsidy burden in FY09 and higher transmission volumes in FY10.

The stock trades at 10.7x FY10E EPS of Rs40. Our fair value for GAIL is based on FY10E P/E of 13x. Our revised target price at 13x FY10E EPS and post 10% discount is Rs563/share (previous Rs528/share). Maintain **Buy**.

#### OUR TARGET PRICE FOR GAIL IS RS563 PER SHARE

P/E Multiple	<b>13</b>
FY10 EPS (Rs)	40.0
<b>Value Rs/Share</b>	
Core Business	520
E&P	34
Listed Investments	63
Unlisted investments	9
<b>Total Value (Rs / Share)</b>	<b>626</b>
<b>Target price post-10% discount</b>	<b>563</b>

Source: Motilal Oswal Securities

<b>INCOME STATEMENT</b>						<b>(Rs Million)</b>					
<b>Y/E MARCH</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009E</b>	<b>2010E</b>						
<b>Net Sales</b>	<b>144,594</b>	<b>160,472</b>	<b>180,082</b>	<b>219,533</b>	<b>279,494</b>						
<i>Change (%)</i>		110	2.2	219	27.3						
Purchase	82,543	94,290	102,007	126,816	164,901						
Raw Materials	12,285	17,851	17,148	22,790	41,924						
Employee Costs	2,218	2,929	4,700	5,640	6,204						
Power & fuel & other exper	12,819	16,182	17,033	12,145	13,478						
Change in Stocks	-249	-753	-299	286	0						
<b>EBITDA</b>	<b>34,979</b>	<b>29,973</b>	<b>39,492</b>	<b>51,856</b>	<b>52,986</b>						
<i>%of Net Sales</i>	24.2	8.7	219	23.6	19.0						
Depreciation	5,595	5,754	5,710	6,531	8,061						
Interest	1,173	1,071	796	808	811						
Other Income	4,555	5,450	5,564	5,800	6,090						
Extraordinary Items (net)											
<b>PBT</b>	<b>32,766</b>	<b>28,598</b>	<b>38,550</b>	<b>50,317</b>	<b>50,204</b>						
Tax	9,666	8,130	12,535	16,191	16,367						
<i>Rate (%)</i>	29.5	28.4	32.5	32.2	32.6						
<b>Adjusted PAT</b>	<b>23,101</b>	<b>20,468</b>	<b>25,442</b>	<b>33,800</b>	<b>33,838</b>						
Tax write back		3,399									
<b>Reported PAT</b>	<b>23,101</b>	<b>23,867</b>	<b>26,015</b>	<b>34,126</b>	<b>33,838</b>						
<i>Change (%)</i>		3.3	9.0	312	-0.8						

<b>RATIOS</b>					
<b>Y/E MARCH</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009E</b>	<b>2010E</b>
<b>Basic (Rs)</b>					
<b>EPS</b>	<b>27.3</b>	<b>24.2</b>	<b>30.1</b>	<b>40.0</b>	<b>40.0</b>
Cash EPS	33.9	35.0	37.5	48.1	49.5
Book Value	117.9	134.7	153.8	180.1	205.5
DPS	10.0	10.0	10.0	12.0	13.0
Payout	36.6	41.3	33.2	30.0	32.5
<b>Valuation (x)</b>					
P/E		17.6	14.2	10.7	10.7
Cash P/E		12.2	11.4	8.9	8.6
EV / EBITDA		116	8.3	6.5	6.6
EV / Sales		2.2	1.8	1.5	1.3
Price / Book Value		3.2	2.8	2.4	2.1
Dividend Yield (%)		2.3	2.3	2.8	3.0
<b>Profitability Ratios (%)</b>					
RoE	23.2	20.9	20.0	22.4	19.5
RoCE	25.7	21.1	25.2	28.6	25.5
<b>Turnover Ratios</b>					
Debtors (No. of Days)	19	18	22	19	17
Fixed Asset Turnover (x)	11	11	12	12	14
<b>Leverage Ratio</b>					
Debt / Equity (x)	0.2	0.1	0.1	0.1	0.1

<b>BALANCE SHEET</b>						<b>(Rs Million)</b>					
<b>Y/E MARCH</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009E</b>	<b>2010E</b>						
Share Capital	8,457	8,457	8,457	8,457	8,457						
Reserves	91,276	105,473	121,592	143,846	165,317						
<b>Net Worth</b>	<b>99,733</b>	<b>113,929</b>	<b>130,049</b>	<b>152,303</b>	<b>173,773</b>						
Long Term Loans	19,166	13,379	12,659	12,659	12,660						
Deferred Tax	12,997	13,187	13,187	13,591	13,968						
<b>Capital Employed</b>	<b>131,896</b>	<b>140,494</b>	<b>155,904</b>	<b>178,553</b>	<b>200,401</b>						
Gross Fixed Assets	144,695	149,326	169,579	214,579	259,579						
Less: Depreciation	69,135	74,782	80,246	86,776	94,837						
<b>Net Fixed Assets</b>	<b>75,560</b>	<b>74,544</b>	<b>89,333</b>	<b>127,802</b>	<b>164,742</b>						
Capital WIP	6,156	19,369	8,167	8,167	8,167						
Investments	14,434	14,638	14,909	12,718	12,718						
<b>Curr. Assets, L &amp; Adv.</b>											
Inventory	4,832	5,524	5,698	6,198	7,101						
Debtors	7,535	7,907	10,735	11,443	13,170						
Cash & Bank Balance	44,959	26,604	44,730	34,083	23,065						
Loans & Adv. and Other A:	65,560	37,420	42,937	43,160	43,405						
<b>Current Liab. &amp; Prov.</b>											
Liabilities	31,646	25,856	33,610	36,479	42,740						
Provisions	55,494	19,656	26,994	28,540	29,229						
<b>Net Current Assets</b>	<b>35,747</b>	<b>31,943</b>	<b>43,496</b>	<b>29,865</b>	<b>14,773</b>						
<b>Application of Funds</b>	<b>131,896</b>	<b>140,494</b>	<b>155,904</b>	<b>178,552</b>	<b>200,401</b>						

<b>CASH FLOW STATEMENT</b>						<b>(Rs Million)</b>					
<b>Y/E MARCH</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009E</b>	<b>2010E</b>						
OP/(Loss) before Tax	32,766	28,598	38,550	50,317	50,204						
Depreciation	5,605	5,752	5,739	6,531	8,061						
Other op items	-2,465	-780	488	0	0						
Direct Taxes Paid	-8,616	-8,574	-10,268	-15,796	-15,990						
(Inc)/Dec in Wkg. Capital	5,944	-10,151	-388	2,984	4,074						
<b>CF from Op. Activity</b>	<b>33,233</b>	<b>14,844</b>	<b>34,122</b>	<b>44,036</b>	<b>46,349</b>						
(Inc)/Dec in FA & CWIP	-6,104	-20,367	-2,295	-45,000	-45,000						
(Pur)/Sale of Investments	-6,462	-205	-270	2,191	0						
Inc from Invst	3,377	3,884	4,042	0	0						
<b>CF from Inv. Activity</b>	<b>-9,189</b>	<b>-16,688</b>	<b>-8,523</b>	<b>-42,809</b>	<b>-45,000</b>						
Issue of Shares	0	0	0	0	0						
Inc / (Dec) in Debt	-1,982	-6,869	-1,537	0	0						
Dividends Paid	-11,571	-9,643	-5,936	-11,872	-12,367						
<b>CF from Fin. Activity</b>	<b>-13,553</b>	<b>-16,512</b>	<b>-7,473</b>	<b>-11,872</b>	<b>-12,367</b>						
<b>Inc / (Dec) in Cash</b>	<b>10,491</b>	<b>-18,356</b>	<b>18,126</b>	<b>-10,646</b>	<b>-11,018</b>						
Add: Opening Balance	34,468	44,959	26,604	44,730	34,083						
<b>Closing Balance</b>	<b>44,959</b>	<b>26,604</b>	<b>44,730</b>	<b>34,083</b>	<b>23,065</b>						

E: M O S t Estimates



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**Disclosure of Interest Statement**

**GAIL (India)**

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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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