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Gujarat State Petronet

Company Update

ACCUMULATE

Price	**Rs37**
Target Price	**Rs42**
Investment Period	**12 months**

Stock Info

Sector	Gas Transmission
Market Cap (Rs cr)	2,102
Beta	0.7
52 Week High / Low	74/25
Avg Daily Volume	922530
Face Value (Rs)	10

BSE Sensex	10,048
Nifty	3,109

BSE Code	532702
NSE Code	GSPL
Reuters Code	GSPT.BO
Bloomberg Code	GUJS@IN

Shareholding Pattern (%)	
Promoters	37.8
MF / Banks / Indian FIs	29.3
FII / NRIs / OCBs	16.5
Indian Public / Others	16.4

Abs.	3m	1yr	3yr
Sensex (%)	7.7	(37.3)	(9.3)
GSPL (%)	26.8	(35.5)	(0.1)

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Stepping on Gas

Gujarat State Petronet (GSPL) has borne the brunt of adverse developments such as 30% profit sharing with the Government of Gujarat, delay in arrival of KG gas (due to the Gas Allocation Policy), execution risks of new pipelines and deteriorating fundamentals of the Spot LNG markets. As a result, the GSPL stock witnessed a steep 66% correction on the bourses from its highs. Nonetheless, we expect the company to remain on high growth path with concerns receding on the economics of Spot LNG and KG gas expected to flow during the year. ***We have arrived at a Fair Value of Rs42 (at a higher cost of Equity of 17%) from Rs80 for the stock factoring in the 30% profit sharing (barring which our Target Price would stand revised at Rs60) and assumption of backended volume growth. We recommend an Accumulate on the stock.***

- **Deeper connectivity and Exclusivity in Gujarat:** A strong industrial base, a developed gas transportation infrastructure and better connectivity with the end consumers have led to a steep increase in demand for natural gas in Gujarat. GSPL, being the largest gas transporter in the state, stands to benefit from the same.

- **Increasing Transmission volumes to improve fundamentals:** We believe that GSPL is the best play on the improving gas supplies in the country. Robust Spot LNG dynamics, increase in re-gasification capacity at Dahej, Hazira and commissioning of the new R-LNG terminal at Dabhol are likely to provide an opportunity to GSPL to transmit additional R-LNG volumes going ahead. RIL is also likely to start production from its KG-D6 block next month, which will augment GSPL's volumes during the latter part of FY2010. Overall, we estimate GSPL's volumes to increase significantly in FY2010E posting a robust CAGR of 20.2% over FY2008-10E from 16.8mmscmd to 24.7mmscmd.

- **Negative developments, major Execution risks factored in:** Various negative developments such as 30% profit sharing with the Government of Gujarat, uncertain volume outlook and Execution risks involved in building and capitalisation of new pipelines are largely factored in and thus, limiting further downside from current levels.

Key Financials

Y/E March (Rs cr)	FY2007	FY2008	FY2009E	FY2010E
Net Sales	**317.6**	**417.9**	**468.3**	**645.8**
% chg	*20.5*	*31.6*	*12.1*	*37.9*
Net Profit	**89.4**	**99.9**	**80.6**	**123.0**
% chg	*91.5*	*11.8*	*(19.3)*	*52.5*
OPM (%)	84.3	87.2	87.6	90.1
EPS (Rs)	**1.6**	**1.8**	**1.4**	**2.2**
P/E (x)	23.5	21.0	26.1	17.1
P/BV (x)	2.2	1.9	1.8	1.7
RoE (%)	9.3	8.8	6.8	9.7
RoCE (%)	9.1	9.6	9.6	11.7
EV/Sales (x)	8.5	6.7	6.9	5.5
EV/EBITDA (x)	10.1	7.7	7.8	6.1

Source: Company, Angel Research

Company Background

Gujarat State Petronet Limited (GSPL) is India's second largest gas transportation company with a network of pipelines in Gujarat. It has a gas transmission network of around 1,200km connecting Hazira, Vadodara, Ahmedabad, Kalol, Himmatnagar, Mehsana, Rajkot and Vapi. GSPL's network connects all major supply sources in Gujarat to important consumer centres in the state. GSPL is promoted by Gujarat State Petroleum Corporation (GSPC), a leading company in E&P of oil and gas, to construct and manage a sate-wide gas transmission network in Gujarat. GSPC currently holds 37.8% stake in GSPL.

Exhibit 1: GSPL - Over the years

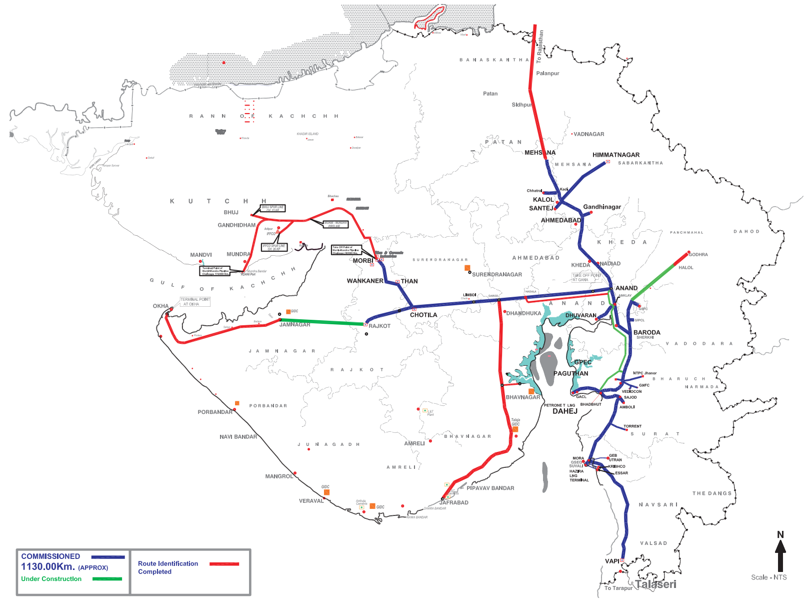
1998	GSPL was set up in December 1998 with a mandate to create a high-pressure pipeline network for natural gas transportation in Gujarat.
2000	GSPL commenced transporting natural gas following completion of first segment (Hazira-Mora pipeline of 14 km) of the network in November 2000.
2004-05	Commissions Baroda-Ahmedabad-Kalol pipeline, GACL-Petronet pipeline, Mora-Sajod pipeline, Kalol-Santej pipeline and Gandhinagar spur line, extending its network by an additional 240km.
2005-06	GSPL got listed in February 2006 at issue of Rs40 against offer price of Rs23-27.
2006-07	GSPL commissioned the Anand-Rajkot, Kalol-Himmatnagar, Kalol - Mehasana and Anklav-Dhuvaran pipelines. The agreement with RIL was also signed for transportation of 11mmscmd gas from Bharuch to Jamnagar for a period of 15 years starting from the first quarter of 2008-2009.
2008-09	The Government of Gujarat mandates 30% PBT contribution by the state-owned public companies; GSPL shareholders agree to the proposal.

Source: Company, Angel Research

GSPL's Gas Transmission Network

GSPL is the pioneer of Gujarat's state-wide gas transmission grid. The company's pipeline network has grown at a rapid pace post commencing operations in FY2001. GSPL expanded its gas pipeline network beyond the traditional markets of South Gujarat and extended it to the Central and Northern parts of Gujarat. GSPL is currently building a pipeline to the Mundra and Pipavav ports, which will improve its presence in the Western part of the State. GSPL plans to increase its pipeline capacity to around 2,000km, an addition of around 800km from current levels.

Exhibit 2: GSPL Transmission Network



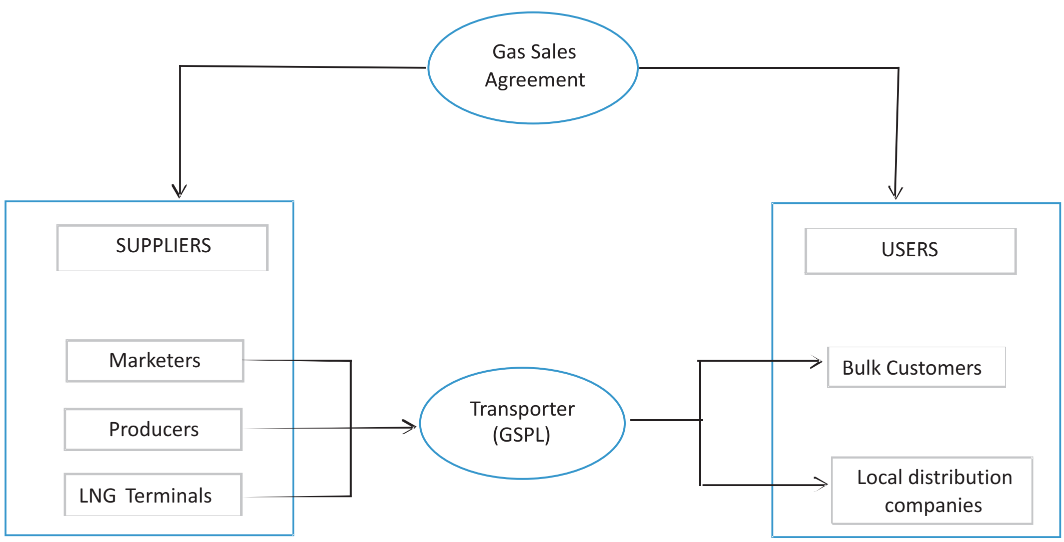
Source: Company

Business Model

GSPL is the only transmission company in India to provide an 'Open Access' gas pipeline network

GSPL is the only transmission company in India to provide an 'Open Access' gas pipeline network to ship gas between the gas suppliers and users. Gas suppliers are either the marketers of the gas or gas producers or LNG terminals, while the users are either the bulk customers or the local distribution companies. The Open Access system provides the Transmission network on a non-discriminatory basis.

Exhibit 3: GSPL - Business Model



Source: Company, Angel Research

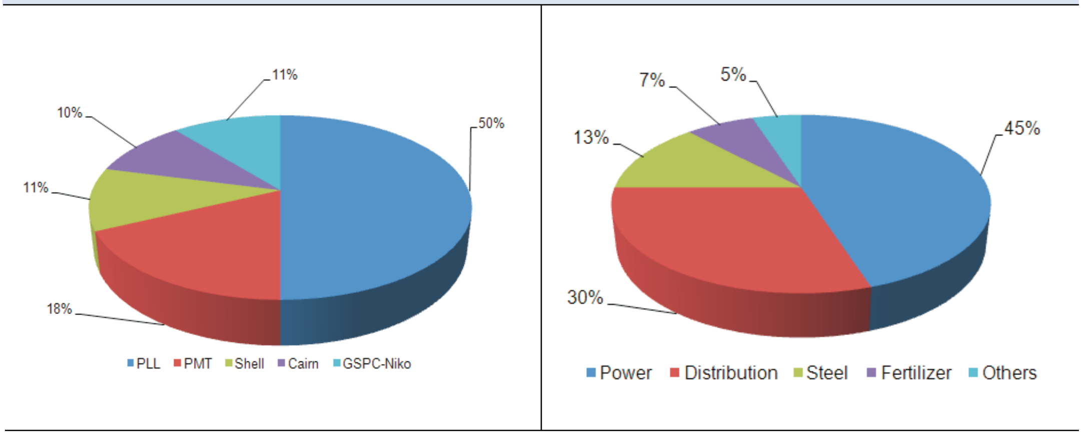
Producers/suppliers of gas have direct Gas Sale Agreements (GSA) with the buyers and either of the parties also enter the Gas Transmission Agreement (GTA) with GSPL to use its network for gas shipment. The GTAs that GSPL enters into with its customers designates the entry and exit points for the natural gas as it travels through its gas transmission network and lays down the terms including the tariffs, tenure and capacity reserved in its gas transmission network.

GSPL: Current gas Supply sources and Revenue mix

GSPL's business model currently thrives on imported LNG, which constitutes a substantial 60% of its total gas supply

GSPL's business model currently thrives on imported LNG as it constitutes a substantial 60% of the total gas supply, while domestic gas constitutes 40% of the same. Meanwhile, major part of the company's Revenue is derived from industries such as Power, Distribution and Steel.

Exhibit 4: Supply sources and Revenue mix



Source: Company, Angel Research

GSPL's current Pipeline Tariff

GSPL's Tariff primarily comprises capacity charges, which are fixed fees for the reservation of capacity and typically covers 90% of the customer's tariff commitment. Commodity charges (balance 10%), is linked to the actual transportation of natural gas through the gas transmission network. GSPL's fixed zonal tariff is based on pipeline distance, duration of contract, network utilisation, the tariff of competing pipelines and the cost of alternative fuels. GSPL's GTAs include "ship or pay" provisions, which require its customers to pay the capacity charges for the capacity reserved by them regardless of the amount of natural gas they transport. The GTA's also include provisions for payment security mechanisms such as bank guarantees and letters of credit.

Investment Arguments

Deeper connectivity and Exclusivity to benefit

GSPL estimates current demand for gas in Gujarat at around 70mmscmd

Gujarat is the second most industrialised state in the country with around 265 industrial clusters and various SEZs. A strong industrial base, a developed gas transportation infrastructure and better connectivity with the end consumers have led to steep increase in demand for natural gas in the state. GSPL estimates current demand for gas in Gujarat at around 70mmscmd (comprising known and latent customers). Similarly, according to a Crisil study, demand for natural gas in Gujarat is likely to increase to around 95mmscmd in 2010 from 54mmscmd in 2005 posting 12% CAGR.

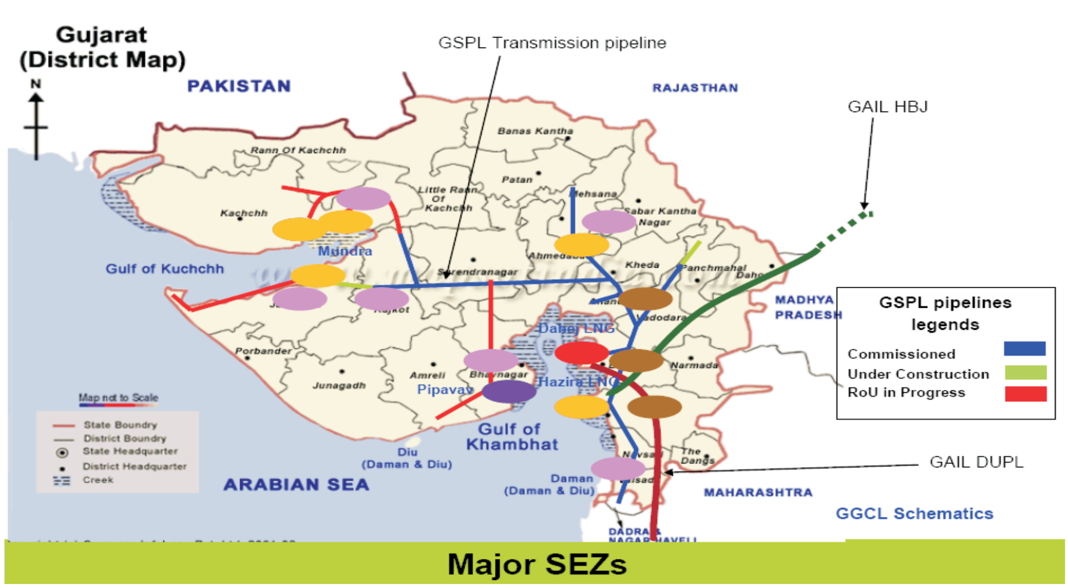
Exhibit 5: Gas Demand in Gujarat (mmscmd)

Sector	2005	2010E	CAGR (%)
Power	16.7	41.6	*20.0*
Fertilizer	9.1	11.6	*5.0*
Distribution	3.3	5.4	*10.4*
Steel	5.0	7.0	*7.0*
Other industries	19.9	29.0	*7.8*
Total	**54.0**	**94.6**	***11.9***

Source: Crisil, Angel Research

GSPL, pioneer of the state-wide gas grid, takes much of the credit for developing the strong state-wide gas infrastructure. In the past, Gujarat's gas market was not very developed, with infrastructure in place only in the Southern Gujarat markets. The reason for the same could be attributed to non-availability of gas. However, GSPL developed the infrastructure in the traditional markets by expanding its reach to Central and North Gujarat with the commencement of R-LNG supplies in the country. This resulted in GSPL's increased presence across the various industrialised segments of the state.

Exhibit 6: Gujarat - An Industrialised state



Source: Gujarat Gas

GSPL is a leveraged play on the rising gas demand in Gujarat

GSPL, the largest gas transmission player in Gujarat, stands to benefit from the increasing demand due to its deeper connectivity and reach. GSPL also enjoys the early mover's advantage in the state as the recent PNGRB Regulations have provided pipeline operators exclusivity (from the date of commencement of respective pipeline) for 25 years. GSPL is currently undergoing the process of authorisation, post which it will be the sole operator in its current areas of operation for the next around 20-25 years as most of its assets are not too old. Thus, GSPL is a leveraged play on the rising gas demand in Gujarat, the hydrocarbon capital of the country.

Increasing Transmission Volumes to improve fundamentals

We believe that GSPL is the best play on the improving gas supplies in the country. Gas supplies in India are set to increase both from the domestic fields as well as from LNG imports in the near term, and GSPL due to its location would benefit from the same.

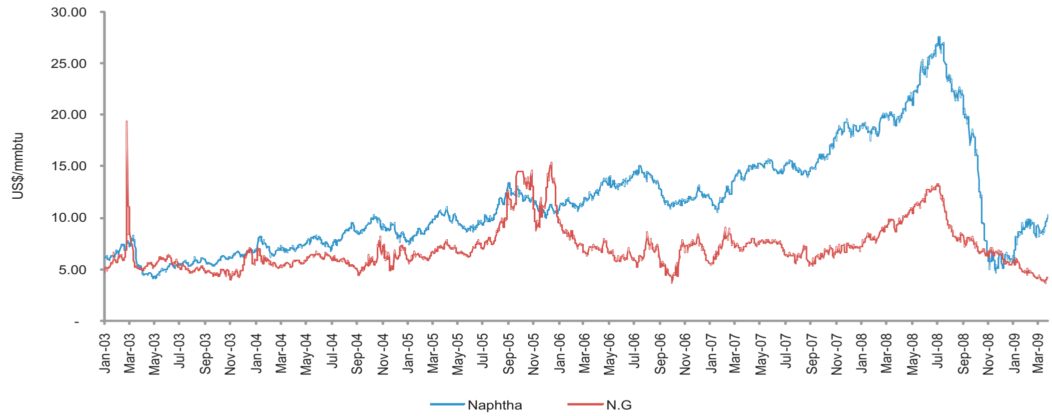
Imported LNG: Robust Spot dynamics, increasing R-LNG capacity to sweeten Asset base

State of the Spot LNG markets is an important determinant of the company's growth prospects going ahead as significant Volume addition could result from expansion of R-LNG capacity at Dahej and Hazira

A striking feature about GSPL's growth story till date has been the contribution of R-LNG (imported LNG). Over the years, R-LNG has contributed a major part of the company's total volumes. Currently, R-LNG contributes around 60% of the company's total volumes, with Spot volumes constituting half of it (around 30% of total volumes). Given the significant expansion of R-LNG capacity in Gujarat, Spot LNG component of the same will also increase.

State of the Spot LNG markets is an important determinant of the company's growth prospects going ahead as significant Volume addition could result from expansion of R-LNG capacity at Dahej and Hazira. Historically, the Spot LNG markets have thrived on the arbitrage between crude and Spot LNG prices. This was due to the fact that naphtha users shifted over to LNG due to its relatively lower prices. However, this arbitrage was impacted during 3QFY2009 following the steep correction in crude and naphtha prices. The brief period saw naphtha prices being cheaper than Spot LNG on account of surplus inventory build up in naphtha. Further, naphtha prices declined to around US $8-10/mmbtu compared to Spot LNG prices of around US $15-17/mmbtu, thus resulting in absence of fuel switching by the end users. However, things have improved since then as the Spot LNG prices have corrected to around US $5/mmbtu and naphtha prices have also seen an improvement. This has again resulted into favourable economic dynamics for Spot LNG.

Exhibit 7: Naphtha and Henry hub prices

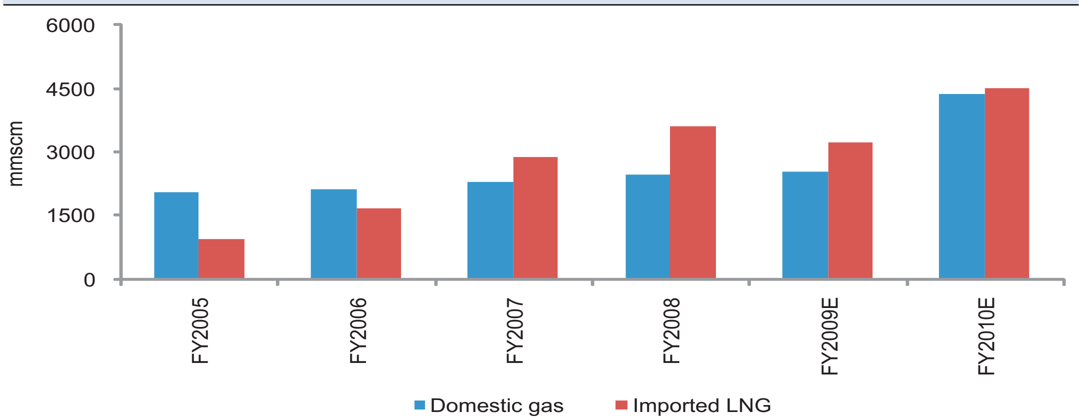


Source: Company, AngelResearch

We believe the slope of Spot LNG prices to the crude prices is likely to be lower in the range of 10-12% going forward; thus Spot LNG prices are likely to remain in the range of US $5.0- 7.0/mmbtu

Going ahead, though we do not rule out such events happening again, we believe that such trends will be short-lived and Spot LNG prices are bound to be lower than naphtha and induce users to switch to Spot LNG. Amidst a period of global slowdown and relatively easier demand-supply equation of hydrocarbons, LNG prices are likely to remain soft going ahead. Another key reason for lower LNG prices going forward is increase in the global liquefaction capacity, especially Spot LNG. We believe the slope of Spot LNG prices to the crude prices is likely to be lower in the range of 10-12% going forward, thus Spot LNG prices are likely to remain in the range of US $5.0- 7.0/mmbtu. These prices will be very competitive against the Delivery prices of KG-D6 gas in Gujarat at around US $5.5 -6.0/mmbtu. Moreover, significant LNG capacities are coming online in the current year, which could even weaken the slope of Spot LNG prices against crude prices, which in turn would improve the economics of spot LNG. On an overall basis, we expect LNG prices to be quite competitive compared to the landfall KG-D6 prices in Gujarat.

Exhibit 8: Volume composition - Domestic v/s Imported LNG



Source: Company, AngelResearch

On account of increased RLNG capacity and better Spot economics, GSPL stands to gain going ahead

India will witness a steep increase in its re-gasification capacities at Dahej and Hazira, while a new terminal is likely to come up at Dabhol. Expansions at Dahej and Hazira will result in increase in R-LNG capacity by around 24mmscmd of which the Spot component would be 12-15mmscmd. GSPL has connectivity to both these terminals and therefore is well placed to benefit from increased supplies. Further, going by historical data and as per our calculations, GSPL has transmitted almost 55-60% of the total Shell Hazira volumes, while the transmission of Spot volumes of Petronet LNG had not been very significant due to the limited spare capacity. Given that Gujarat has a much vibrant and developed gas infrastructure and with huge unmet demand for natural gas, we believe significant part of increased spot gas is likely to flow from the GSPL network. Thus, on account of increased RLNG capacity and better Spot economics, GSPL stands to gain in future as well.

Exhibit 9: Increasing R-LNG capacity in Gujarat

Particulars (mmtpa)	Petronet LNG	Shell
Current capacity	6.5	2.5
Capacity addition	5.0	1.3
Capacity post expansion	**11.5**	**3.8**

Source: Company, Angel Research

As far as demand of Spot LNG is concerned, management has over a period of time guided that there is substantial unmet as well as latent demand for the same in Gujarat. Thus, the additional Spot LNG should be consumed with ease to a significant extent by the state itself. Moreover, improved Spot dynamics could induce RIL to use Spot LNG for its internal heating and lighting purposes, which in turn would mean that the impact on GSPL's Revenue and Profitability on account of the delay in arrival of KG-D6 gas would be offset to a considerable extent.

Similarly, the Dabhol terminal is likely to come up during the year, though the terminal is meant for captive consumption we believe that if the terminal is able to tie-up gas at the competitive, allocated KG-D6 gas for the terminal could be diverted to next- in priority user, which in turn would push Reliance (RIL) up the priority list.

Overall, robust Spot LNG dynamics, increase in re-gasification capacity at Dahej, Hazira and commissioning of the new R-LNG terminal at Dabhol are likely to provide an opportunity for GSPL to transmit additional R-LNG volumes going ahead. This is likely to improve the utilisation rate of GSPL's current pipeline network leading to further Operating leverage and sweeten its Asset base.

In spite of the huge potential on account of volume flows from imported LNG, we have been conservatively assumed volumes from the Shell terminal to increase to 5mmscmd in FY2010 from 4mmscmd in FY2008. Similarly, volumes from Petronet's Dahej facility have been factored at 7.5mmscmd in FY2010 from 6mmscmd in FY2008. Thus, a combination of both - an increase of mere 2.5mmscmd as against upcoming capacities at these terminals are 24mmscmd. This could provide substantial upsides to our Volume and Profitability estimates.

Domestic gas: Incremental flows from RIL's Captive and External Sales volumes

We estimate GSPL's volumes to increase in FY2010 posting a robust CAGR of 20.2% over FY2008-10E from 16.8mmscmd to 24.67mmscmd

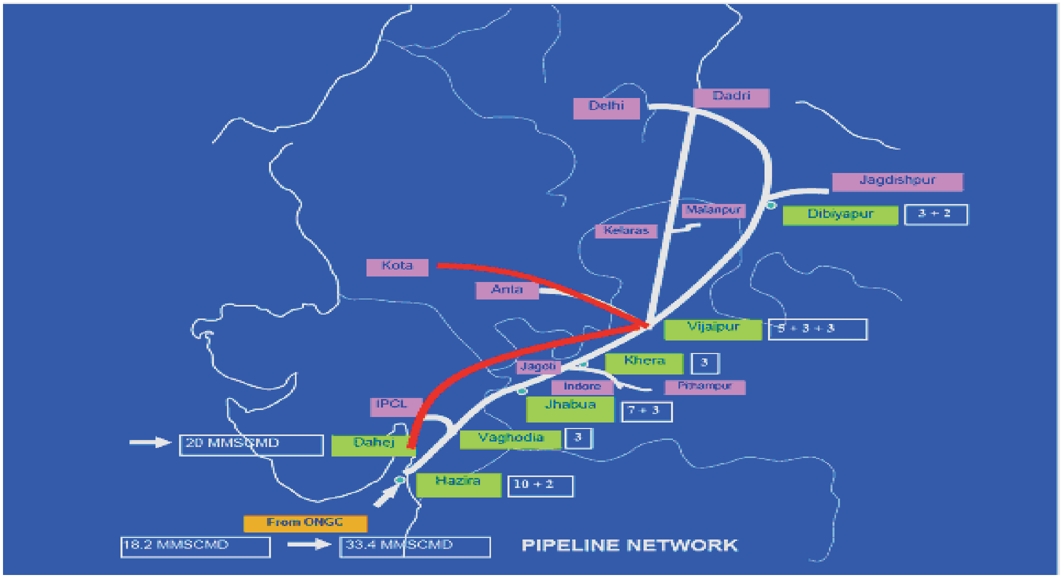
GSPL is likely to see increased volume flow also on account of domestic volumes from RIL's KG basin. RIL is likely to start production from its KG-D6 block next month. Initial volumes are estimated to be around 10-15mmscmd, which will gradually ramp up to 40mmscmd. Thus, on account of the time taken for ramping up the volumes and early molecules of the gas being consumed first in Andhra Pradesh, supply of the gas from RIL to the Gujarat-based customers is likely to commence 4 months post commencement of production (August 2009). We have factored in 5mmscmd of volumes on account of External sales into Gujarat from the initial 40mmscmd of RIL's volumes. Similarly, volumes from RIL's captive consumption is likely to flow once the fields see production levels of around 60-65mmscmd. We have factored flow of 4mmscmd for RIL's captive consumption starting 8 months from commencement of production (December 2009) from the fields. Thus, in totality, we are factoring 1,680mmscm of gas flow from RIL's domestic fields to GSPL's pipeline in FY2010. We have been conservative considering the fact that news reports have stated that RIL is likely to see peak production of 80mmscmd in December 2009. This implies it would be able to fully use 11mmscmd of gas for captive consumption in December itself. We have assumed slower ramp up from the fields and have taken 4mmscmd for captive consumption from December 2009.

GSPL well placed to capture KG Basin opportunity

Effectively GAIL's pipeline capacity is likely to be constrained till October 2010

Due to pipeline constraints at GAIL’s core pipeline asset (HVJ and DVPL), we can expect GSPL to transmit additional volumes from KG Basin. Currently, GAIL's HVJ pipeline (with capacity of 33.4mmscmd) is operating at optimum capacity of around 32.5mmscmd. The DVPL has 24mmscmd capacity while the gas rehabilitation expansion programme (GREP, from Vijaipur to Dadri) has capacity of 20mmscmd. Both these pipelines (DVPL and GREP) currently have spare capacity of 10mmscmd and 4mmscmd, respectively. Capacity upgrades are likely to be completed by October 2010 for DVPL resulting in enhanced capacity of 35mmscmd. GREP pipeline capacity is set to expand from the current 20mmscmd to 40mmscmd by December 2009. However, as the GREP pipeline is an extension of HVJ and DVPL pipelines, its expansion does not make sense till DVPL expansion is complete. Thus, effectively GAIL's pipeline capacity is likely to be constrained till October 2010.

Exhibit 10: GAIL - HVJ, DVPL and GREP Pipelines



Source: Infraline

The prevalent scenario provides GSPL the opportunity to utilise its pipeline to transmit the additional volumes till October 2010

Clearly, the prevalent scenario provides GSPL the opportunity to utilise its pipeline to transmit the additional volumes till October 2010. We estimate these volumes to be as high as around 10mmscmd in case of 40mmscmd production volumes. If the production is higher than 40mmscmd, volumes for GSPL could be higher than 10mmscmd. However, we have assumed much lower volume flows through GSPL's pipelines. Thus, any additional volume flows on faster ramp-up from the fields could provide upside risks to our assumptions. On the other hand, delays in the gas supplies could adversely impact out estimates. However, increased clarity on volume flows reduces the risks associated with the delays in capitalisation of the new Jamnagar pipelines to a large extent. Management has guided that the Jamnagar pipeline could get capitalised as soon as 1QFY2010, which implies that RIL could use Spot gas for their internal consumption.

Thus, on overall basis, we estimate GSPL's volumes to increase in FY2010 posting a robust CAGR of 20.2% over FY2008-10E from 16.8mmscmd to 24.67mmscmd.

Exhibit 11: Volume Assumptions

Volume (mmscm)	FY2005	FY2006	FY2007	FY2008	FY2009E	FY2010E
Cairn	900	864	864	864	900	900
GSPC-Niko	1,152	900	900	900	900	900
Shell LNG	0	252	1,080	1,440	1,620	1,800
PMT	0	360	540	684	720	900
Petronet LNG Terminal	936	1,404	1,800	2,160	1,620	2,700
KG RIL captive	0	0	0	0	0	480
KG External Sales	0	0	0	0	0	1,200
Total Volume	**2,988**	**3,780**	**5,184**	**6,048**	**5,760**	**8,880**
Average Volume	**8.30**	**10.50**	**14.40**	**16.80**	**16.00**	**24.67**

Source: Company, AngelResearch

We believe increased volumes will result in better Operating Margins for GSPL arising from the benefits of Operating leverage - gas transmission is a high capex business with low Operating expenditure. Thus, we estimate GSPL's OPM to improve on the back of Operating leverage (*refer Financial Analysis Section for details*).

Volumes from new pipelines to lower Tax rate

We estimate major part of GSPL's incremental volumes to flow from its new pipelines owing to which it would avail reduction in the Tax rate

In the Union Budget 2007-08, the government extended Infrastructure status to companies involved in laying and operating cross-country natural gas distribution networks. It proposed a 10-year Tax holiday for projects that commenced operations after April 1, 2007. GSPL, being a gas transmission company, would avail benefits of Sec80IA. GSPL has signed a GTA with RIL to transport 11mmscmd of the gas from its KG basin output. Similarly, GSPL has an agreement with Torrent to transport 4.9mmscmd of the gas. These two agreements together form around 16mmscmd (around 50% of the total GTA agreement signed by companies). Gas from both the agreements is likely to flow from the new pipelines. Thus, we estimate major part of GSPL's incremental volumes to flow from its new pipelines owing to which it would avail reduction in the Tax rate. Another important point worth noticing out here is the fact that GSPL is increasing its pipeline capacity from around 1,100kms at end of FY2007 to approximately 2,000kms in the next couple of years. Even if we were to assume equal gas flow across the network, the new pipeline is likely to push the tax rate to lower levels in this scenario.

City Gas Distribution (CGD) venture to be further Value accretive

GSPL is a pure gas transmission company running a low-risk business as it does not have any exposure to commodity and marketing risks. However, to further increase value and provide last mile connectivity and leveraging on the distribution opportunities created by its network, GSPL has taken strategic stakes in CGD ventures.

For establishing a distribution network in Andhra Pradesh, GSPL has formed, Krishna Godavari Gas Network (KGGNL), a joint venture (JV) with Andhra Pradesh government, INCAP and IDFC PE. Similarly, GSPL has also taken stake in two other CGD companies, viz. GSPC Gas and Sabarmati Gas. Sabarmati Gas has operations in Mehsana, Gandhinagar and Himmatnagar. GSPC gas has started operations in smaller cities such as Vapi, Valsad and Navsari. Combined throughput of these two companies is around 1.5mmscmd. These two companies have further plans to ramp up their operational presence across Gujarat by bidding for the various CGD projects as and when they come up for bidding. One can expect to add significant value from these ventures for GSPL in the long run. We have not valued these investments while arriving at our Target Price as these companies are still at a nascent stage.

Negative developments, major Execution risks factored in

On the bourses, the GSPL stock has borne the brunt of various negative factors including 30% profit sharing with the Government of Gujarat, delay in the arrival of KG-D6 gas and execution risks involved in building and capitalisation of new pipelines. We believe that the current market price of the GSPL stock captures and discounts all the headwinds much higher than warranted. Our take on the various issues surrounding the company:

(A) 30% contribution to Gujarat Socio-Economic Development Society (GSEDS) - How long will it continue: During the current fiscal, the Gujarat Government through a notification asked six profit-making state-owned companies to contribute 30% of their Profits to GSEDS for socio-economic development. Consequent to this directive by the government, GSPL approached and got shareholders' approval for the same.

We have factored in 30% profit-sharing (starting FY2009) till perpetuity as well as the Income Tax (IT) benefits arising from the same. Meanwhile, it is still unclear whether this contribution will be eligible for IT deduction. GSPL has guided that the contribution will be made only if it is treated as a deductible expenditure. Hence, we have assumed 30% PBT sharing will be allowed as a deduction, as the GSEDS will undertake only those projects, which are allowed deduction by the IT Department. On the other hand, if the GSEDS is not able to get IT exemption for the contribution made by the state companies, the idea of profit sharing could get scrapped as almost 64% of PBT (PBT and GSEDS contribution) would go to the Union and State governments, leaving too little for the company's shareholders.

Exhibit 12: Effective outflows in GSEDS contribution (Hypothetical example)

Particulars (Rs)	If Tax exemption is Allowed	If Tax exemption is Not allowed
PBT before GSEDS contribution	100	100
Less: 30% contribution to GSEDS	30	30
Reported PBT	70	70
Less: Tax	24	34
PAT	**46**	**36**
Effective Tax including GSEDS (%)	**54**	**64**

Source: Angel Research

Moreover, 30% is the upper limit of the contribution. Actual contribution could be lower than that and would depend on identification of eligible projects. It may be noted here that some Gujarat Government companies contributed around Rs20cr to GSEDS in FY2008, which till-date has not been utilised. Thus, project identification is important. GSPL proposes to make provision for the contribution post identifying the project. GSPL would also have to take shareholders' approval every year before providing the contribution to GSEDS. It is still too early to comment on how long this mechanism will work. It may be noted here that Gujarat Alkalies (GACL), a Gujarat Government Enterprise, rejected the proposal to share 30% of its pre-Tax Profits with the Gujarat government. However, we have conservatively assumed entire 30% sharing till perpetuity. Additionally, the contribution to GSEDS will also adversely impact the growth prospects of companies in other Indian states. Other states might perceive these companies as Gujarat Government enterprise and in turn might hurt growth beyond Gujarat. Similarly, if GSPL has to grow beyond its traditional footholds of Gujarat, it might get difficult for it. This even makes us question about the long-term viability of mechanism. If the 30% profit sharing is revoked, it would increase our Target Price to Rs60.

(B) Delay in arrival of KG gas: Another headwind that impacted performance of the GSPL stock on the bourses was the delays associated with the arrival of KG basin gas. Initially, the delay in the gas flow was the result of shortage of rigs and weather related issues, which pushed the production schedule backwards, and legal issues between RIL and RNRL. Lately the delay has been on account of government action, which prioritised gas from the basin for important sectors before captive consumption by RIL. However, given the ramp-up schedule of the RIL's KG basin output, there is conviction that there will not be further delay in production from the basin. Further, we have also been conservative in factor the volumes from KG basin.

Risks to our Investment Argument

Further delay in arrival of new gas: Being a gas transporter, GSPL's major growth variable is availability of new gas. Production delays or delays on account of ramping up of further capacities from the KG basin would reduce the company's volume throughput and adversely impact its performance. However, we believe that with the KG basin gas already much delayed is unlikely to get further delayed. We have conservatively assessed future ramp up of the gas from the KG basin.

Regulatory risks: GSPL's future performance could get hit by the government's future Regulatory Policy. GSPL has signed an agreement (effective November 2008) with RIL for transportation of 11mmscmd of the KG basin gas. However, due to the Gas Allocation Policy, out of first 40mmscmd produced, RIL has not been allocated any gas for captive consumption. This is one of the reasons why the GSPL stock fell over the last one year. If the government now allocates the balance 40mmscmd of gas to other users than RIL, it would prove to be another adverse event for GSPL going ahead. Moreover, risks of RIL's legal battle with NTPC and RNRL over the gas supplies, could also adversely impact performance of the stock going forward. We believe chances of above-mentioned events playing out are very slim as the gas requirement of priority sector will be largely fulfilled. Similarly, any adverse developments arising from PNGRB's new transmission tariff guidelines would prove to be a negative for the company. Management has guided that it is not likely to be impacted by the tariff guidelines. Clarity on the actual tariffs would only emerge over the next six months.

No Tax benefit on GSEDS contribution: We have assumed GSPL to get IT shield on GSEDS contribution till perpetuity. However, if GSPL fails to get tax benefit on the contribution, it will be a negative development for the company (*refer Exhibit 13*). Similarly, the same would adversely impact our DCF Target Price, and in the event of non-exemption of IT, our DCF-based Target Price would stand reduced at Rs35 (7% downside from current levels).

Exhibit 13: Impact of Tax treatment of GSEDS contribution on Earnings (Rs cr)

Particulars	Scenario I		Scenario II	
	FY2009E	FY2010E	FY2009E	FY2010E
Profit Before Tax and GSEDS	176	255	176	255
GSEDS contribution (30% of PBT)	53	76	53	76
Reported PBT	123	178	123	178
Tax	42	55	60	79
Tax Rate (%)	34.0	30.7	34.0	30.7
PAT	80.65	122.96	62.73	99.50
EPS (Rs)	1.44	2.19	1.12	1.77
% change in EPS			*(22.2)*	*(19.1)*

Source: Angel Research; Note: Scenario I (Tax shield on GSEDS contribution), Scenario II (No Tax shield on GSEDS contribution)

Spot LNG price increases: We have assumed Spot LNG prices to remain competitive against naphtha over the long term, which will help pick-up in volumes for GSPL from LNG expansion lined up at Petronet LNG and Shell's terminal. But, if the naphtha price become competitive v/s Spot LNG, as witnessed for a brief period, GSPL volumes will take a hit in turn impacting its Revenues for the period under consideration. However, as we have been conservative on volumes from the imported LNG, impact of the same is likely to be limited.

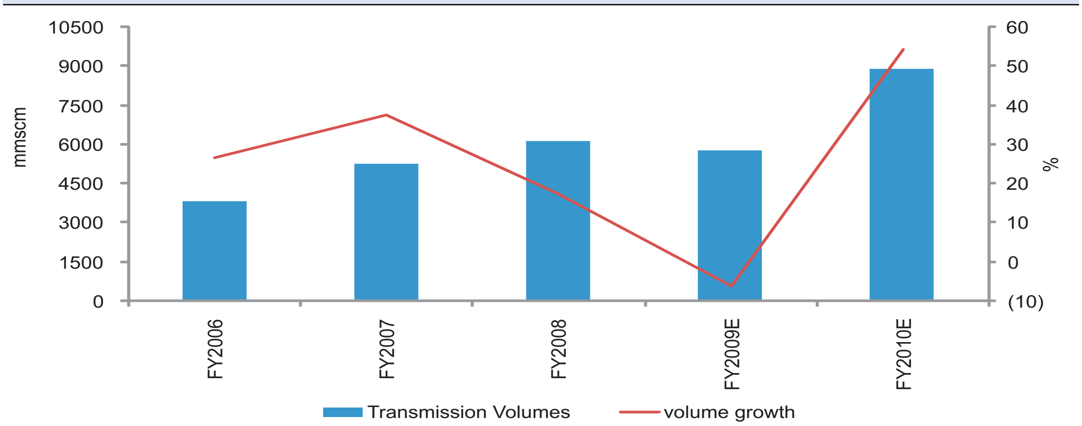
Financial Analysis

Volumes, Top-line to see unabated growth

We expect GSPL's future growth prospects to be promising as it is expected to register 20.2% CAGR in volumes over FY2008-10E

Volumes are the key driving force for determination of gas transmission companies' growth prospects. GSPL delivered impressive 26.5% CAGR in volumes during FY2005-08. Growth was largely driven by incremental contribution from LNG imports (volumes from Petronet LNG and Shell Hazira LNG). Going ahead, we expect GSPL's future growth prospects to be equally promising as it is expected to register 20.2% CAGR in volumes over FY2008-10E. Such growth would be driven by commencement of RIL's KG basin gas and increase in LNG imports in the country. Meanwhile, volumes supplied from Cairn, GSPC-Niko and PMT are likely to remain stable going forward.

Exhibit 14: Transmission Volumes and Growth

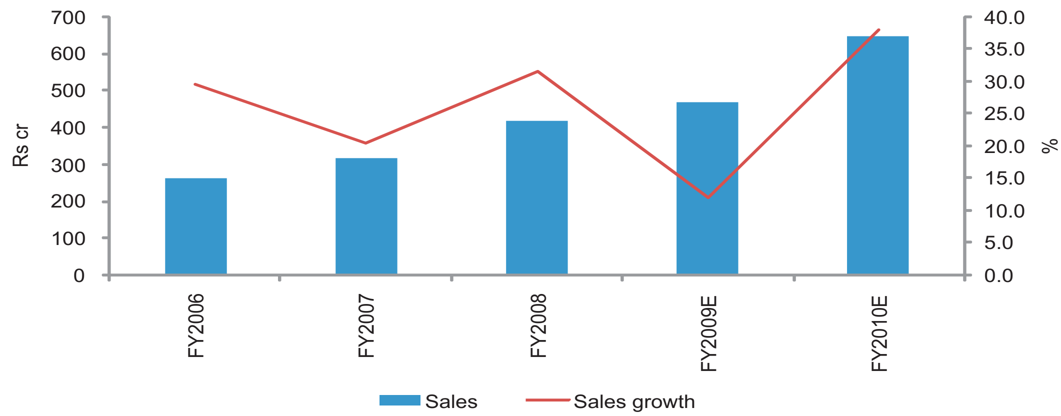


Source: Company, Angel Research

We estimate GSPL to register 24.3% CAGR in Top-line over FY2008-10

On the back of strong volume CAGR of 20.2% over FY2008-10E, we estimate GSPL to register 24.3% CAGR in Top-line in the mentioned period. Average tariff is likely to tread downwards on account of higher volume flow from low-tariff contracts such as RIL's Captive and Torrent contract. We expect average tariff to be around Rs0.81/scm in FY2009 and Rs0.73/scm in FY2010.

Exhibit 15: Sales growth trend



Source: Company, Angel Research

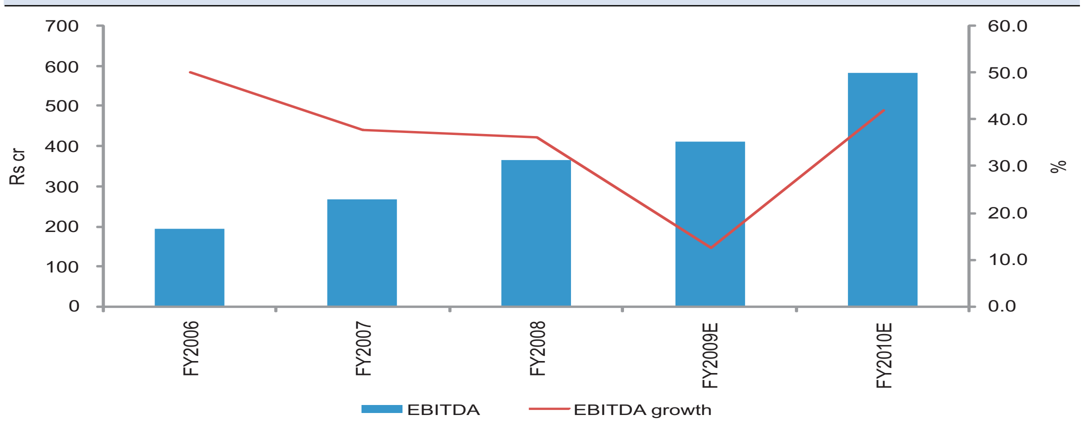
Operating leverage likely to result in higher EBDITA Margins

Overall, increase in GSPL's volumes is likely to improve its Margins with fixed costs growing at a lower pace

The Gas Transmission business entails high Operating leverage due to the high fixed cost component in Operating Expenditure. Hence, GSPL is likely to benefit from Operating leverage due to rising volumes. Operating costs comprise salary and wages, selling and general expenditure and operating and maintenance expenditure. While salary and wages are largely fixed in nature, Operating expenditure is partly variable. Thus, a large component of cost is fixed in nature. Overall, increase in volumes for GSPL is likely to improve Margins with fixed costs growing at a lower pace. This has helped GSPL consistently improve its EBDITA Margins from 63.5% in FY2005 to 73.7%, 84.3% and 87.2% in FY2006, FY2007 and FY2008, respectively. We expect the trend in EBDITA expansion to continue going forward as well. In absolute terms, EBDITA is expected to register 26.4% CAGR over FY2008-10E driven by higher volumes.

In absolute terms, EBDITA is expected to register 26.4% CAGR over FY2008-10E driven by higher volumes

Exhibit 16: EBDITA growth trend



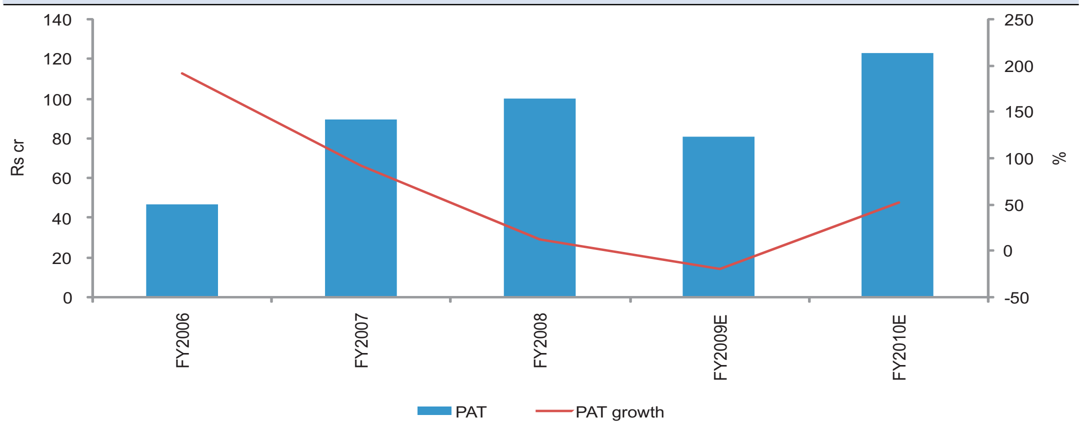
Source: Company, Angel Research

Profit growth to slow down

We expect GSPL's Profit to register a CAGR of 10.9% over FY2008-10

In spite of strong show at both Topline and EBDITA levels, GSPL is likely to register sluggish growth in Profits. We expect GSPL's Profit to register a CAGR of 10.9% over FY2008-10. The major reason for sluggish growth in Bottomline compared to EBDITA is on account of the 30% profit sharing at PBT level with the Government of Gujarat and increase in Depreciation and Interest expenditure on account of monetisation of new pipelines during FY2009 and FY2010. PBT and GSEDS's contribution is expected to register 30.7% CAGR over FY2008-10E. Thus, GSEDS contribution is the prime reason for lower Profitability growth. Interest expenditure is likely to record 23.2% CAGR to Rs123.8cr in FY2010, while Depreciation is likely to register CAGR of 17.9% over the mentioned period, which would also impact Bottom-line growth.

Exhibit 17: PAT growth trend



Source: Company, Angel Research

Owing to capitalisation of the new pipeline and better volumes, utilisation of pipeline asset is likely to improve and result in RoE improving going ahead

GSPL's RoE has been hovering at 8-9% over the last couple of years. In FY2009, we estimate RoE to be under pressure on account of the contribution to GSEDS. However, owing to capitalisation of the new pipeline and better volumes, utilisation of pipeline asset is likely to improve and result in RoE improving in the years ahead. It may be noted here that the RoE reported by GSPL is suppressed as it follows an accelerated Depreciation policy.

Exhibit 18: Du-Pont Analysis

Particulars	FY2006	FY2007	FY2008	FY2009E	FY2010E
PAT / PBT	0.60	0.65	0.67	0.66	0.69
PBT / EBIT	0.68	0.83	0.74	0.51	0.50
EBIT / Sales	0.44	0.52	0.48	0.52	0.55
Sales / Total Assets	0.17	0.17	0.19	0.18	0.21
Total Assets / Net Worth	1.73	2.00	1.94	2.20	2.48
RoE (%)	5.2	9.3	8.8	6.8	9.7

Source: Company, Angel Research

Outlook and Valuation

GSPL is a leveraged play on the increasing gas demand in the hydrocarbon capital of the country, Gujarat. Given its locational advantage, GSPL is likely to be the key beneficiary of the increasing gas supplies in the country on account of increase in domestic production and LNG imports. We estimate volume growth to continue on account of favourable Spot gas dynamics coupled with commencement of gas production from KG-basin.

On the Tariff front, we expect GSPL's average tariffs to decline from the current Rs0.81/scm to Rs0.73/scm in FY2010. The decline would be on the account of commencement of volume flows of lower tariff GTA's, viz. Reliance Captive and Torrent Power. Post FY2010, our blended tariffs decline further to stablise at around 0.65/scm for the remaining period. Resultant tariff for the FY2009-20 period leads to RoCE being lower than 12% post tax or 18.2% pre-tax as mandated by the PNGRB guidelines. Thus, there is no risk of downward revision of the tariffs in the visible future.

We have valued GSPL on DCF-based methodology given the fact that the underlying business exhibits annuity based structure. Moreover, DCF helps in capturing the long-term volume growth prospects of the company in a better manner.

For the purpose of volume calculation post FY2012E in our DCF model, we have increased our volumes forecast over and above the visible volumes by 1mmscmd per annum over FY2013-20E. This is to capture long-term volume growth prospects of the company. This in turn also helps us factor volumes from the discoveries made by ONGC (KG-DWN-98/2) and Gujarat State Petroleum Corporation (KG-OSN-2001/03).

Our DCF-based Target Price for the company stands at Rs42 in the base case scenario, where we have assumed 30% PBT sharing with the Government of Gujarat starting FY2009 with tax shield. This translates into 13% upside from current levels for the stock. However, if GSPL is not able get the benefit of tax shield for the GSEDS contribution, our DCF-based Target Price would reduce to Rs35 (7% downside from current levels). Nonetheless, we believe the company is likely to get the tax shield on the same as GSEDS is likely to undertake only tax exempted projects. **Similarly, our DCF-based Target Price would stand revised at Rs60, if the 30% profit sharing is revoked (resulting in an upside of 60% from current levels).**

Our base case scenario price comprises price from visible volumes and price from growth volumes, wherein the value per share based on visible volumes is Rs33.5 (79.2% of the Target Price), while value from the growth option is Rs8.8 (20.8% of the Target Price).

We recommend an Accumulate on the stock, with a Target Price of Rs42 (Rs80 earlier) on account of the 30% profit sharing and current assumption of backended volume growth due to the delay in commencement of gas supplies from RIL's KG production.

Exhibit 19: DCF-based Valuation

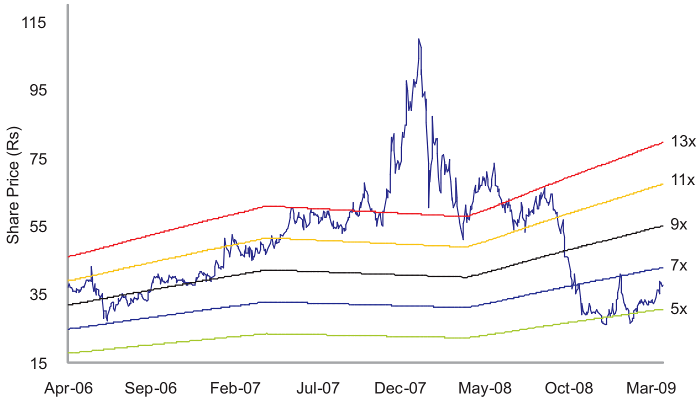
Particulars (Rs cr)	FY07	FY08	FY09E	FY10E	FY11E	FY12E	FY13E	FY14E	FY15E	FY16E	FY17E	FY18E	FY19E	FY20E
Net Sales	**318**	**418**	**468**	**646**	**844**	**877**	**905**	**934**	**963**	**992**	**1,021**	**1,049**	**1,078**	**1,107**
EBITDA	268	364	410	582	762	791	817	843	869	895	921	947	973	999
EBIT	**165**	**201**	**241**	**355**	**461**	**465**	**489**	**523**	**562**	**601**	**651**	**688**	**735**	**811**
Tax rate (T) (%)	34.6	32.6	34.0	30.7	26.9	26.5	26.3	26.1	25.9	25.7	25.5	25.4	25.2	34.0
NOPAT [EBIT*(1-T)]	**108**	**136**	**159**	**246**	**337**	**342**	**361**	**387**	**416**	**446**	**484**	**513**	**550**	**535**
(+) Depreciation	103	163	169	227	301	326	328	320	307	294	271	259	238	188
(+) Change in NWC	106	(246)	289	34	38	(30)	3	(30)	3	3	3	3	3	3
(-) Contribution to GSEDS	0	0	35	53	64	72	81	92	99	108	120	129	140	139
Operating Cash Flows	**239**	**81**	**582**	**454**	**612**	**566**	**611**	**584**	**628**	**636**	**638**	**647**	**650**	**587**
(-) Capex	440	582	340	633	420	25	25	25	25	25	25	25	25	187
FCFF	**(201)**	**(501)**	**242**	**(179)**	**192**	**541**	**586**	**559**	**603**	**611**	**613**	**622**	**625**	**400**
WACC (%)			11.7	11.7	11.7	11.7	11.7	11.7	11.7	11.7	11.7	11.7	11.7	11.7
PV of FCF (1 year forward)				**(178)**	**170**	**427**	**411**	**349**	**335**	**302**	**269**	**243**	**217**	**124**

DCF Output	Rs (cr)
PV of cashflows (FY09-20E)	2670
Add: Terminal value (PV)	1165
EV	3834
Less: Net Debt (FY10E)	1457
Equity value	2377
Shares O/s	56
Equity value per share	**42**

Calculation of WACC	
Rf	7.0%
Risk premium	7.0%
Required return	14.0%
Beta	0.85
Stock risk premium	4.5%
Ke	17.4%
Cost of debt	11.5%
Post tax cost of debt	7.6%
Debt to equity	1.39
WACC	**11.7%**

Terminal Value Calculation	
FCF in terminal year (Rs Cr)	400
EXIT FCF multiple: (1+g)/(WACC-g)	9.4
Terminal growth rate	1.0%
Terminal value of FCF (Rs Cr)	3767
Implied exit EBITDA multiple (x)	**3.8**

Exhibit 20: One-Year Forward P/E



Source: Company, Angel Research

Exhibit 21: Rolling and Median P/E

Source: Company, Angel Research

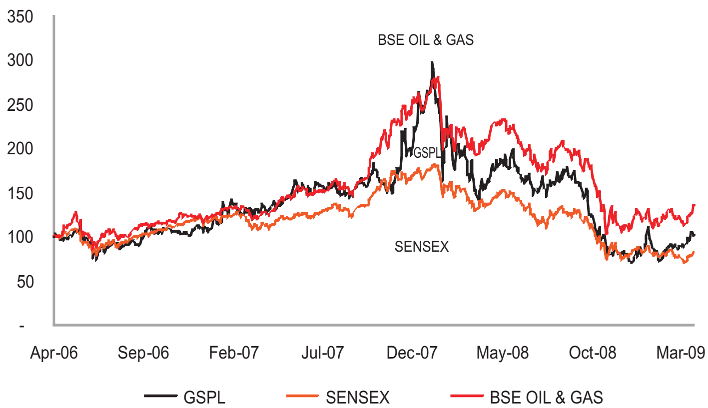
Exhibit 22: One-Year Forward P/BV

Source: Company, Angel Research

Exhibit 23: One-Year Forward EV/EBITDA

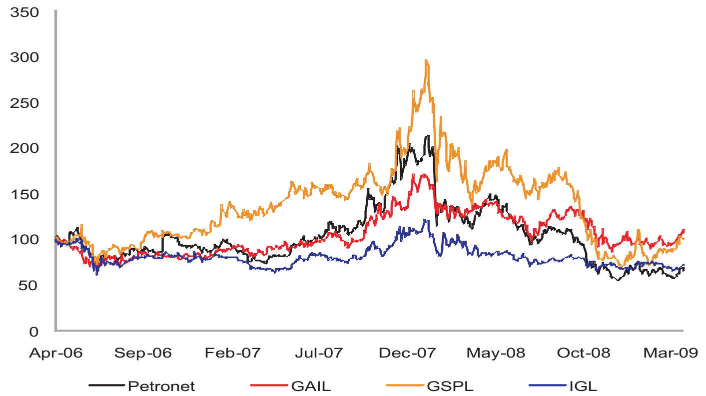
Source: Company, Angel Research

Exhibit 24: Relative Performance to Sensex - Oil & Gas Index



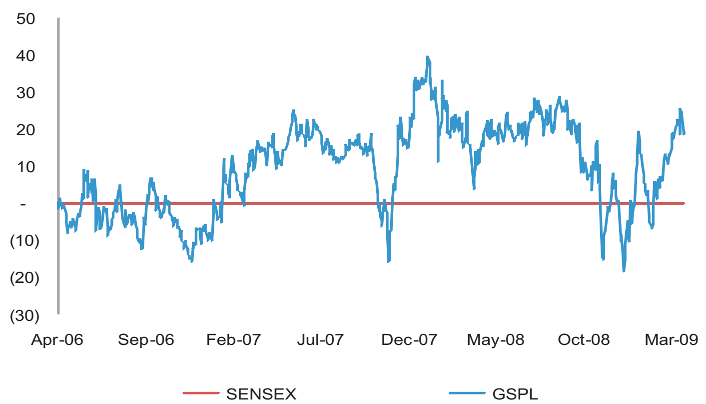
Source: Company, Angel Research

Exhibit 25: Relative Performance to Peers



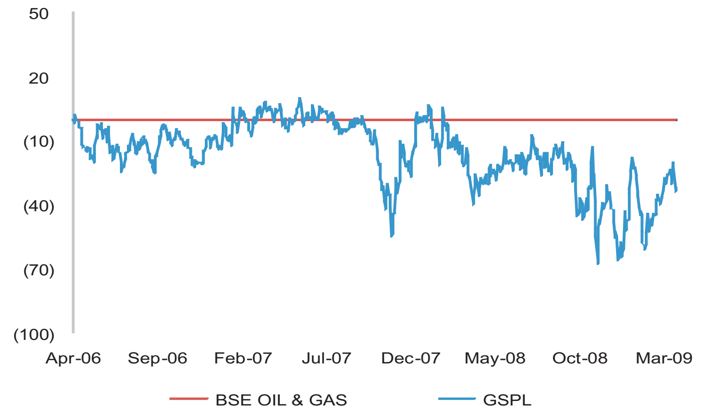
Source: Company, Angel Research

Exhibit 26: Performance Relative to Sensex



Source: Company, Angel Research

Exhibit 27: Performance Relative to OiL & Gas Index



Source: Company, Angel Research

PNGRB Natural Gas Tariff Regulations - Key Highlights

The Petroleum and Natural Gas Regulatory Board (PNGRB) recently notified the Natural Gas Pipeline Tariff Regulation, 2008, which is likely to come into effect in FY2010. Salient features of the Regulations are as below:

- **Returns:** The Regulations have provided a reasonable rate of 12% post tax on RoCE for the natural gas pipeline. This results in pre-Tax return on RoCE of 18.2% based on the existing Corporate Tax rate of 33.99%. The authorized entity is free to leverage the financing of the project in any suitable manner.
- **Methodology of calculation of Tariffs**: The Tariffs are to be computed on the DCF basis. The tariffs will be constant over the economic life of the pipeline, but will be subject to review for each Tariff period.
- **Capital Employed:** For the purpose of calculation of return, RoCE is defined as gross fixed assets (GFA) less accumulated Depreciation plus the normative Working Capital.
- **Working Capital:** Normative Working Capital is fixed equal to 30 days of Operating cost, excluding Depreciation and 18 days of natural gas pipeline tariff receivables.
- **GFA:** GFA for the purpose of calculation is lower of actual historical cost of acquisition (including the cost of any subsequent replacement or improvement or modification), or that normatively assessed by the Board.
- **Operating cost:** Operating cost is the actual operating cost or as assessed by the PNGRB, whichever is lower will be allowed for recovery.
- **Volumes for computation of Unit Network Tariff:** Regulations have laid down the capacity utilisation norms to be considered for computing the unit tariff over the economic life of the project. For example, in the first year, 60% of the pipeline capacity (own requirement + contracted) should be utilised increasing in block of 10% every year, thereby increasing to 100% by the fifth year.

SWOT Analysis

Strengths

- **Connectivity and reach:** GSPL is connected to all major natural gas suppliers, viz. Cairn Energy, GSPC-Niko, PMT Consortium, Shell's Hazira Terminal and Petronet LNG's Dahej Terminal. It also has penetration in the major industrial clusters of Gujarat, which is likely to increase with GSPL expanding to Mundra and Pipavav.

- **Strong De-risked Business Model:** GSPL has the 'Open Access' Policy for shipment of gas on a non-discriminatory basis. GSPL is a pure transmission company and does not run the risk of gas pricing and marketing nor does it have any exposure to the gas inventories.

- **Bi-directional flow of Natural Gas:** GSPL designed its transmission network to allow the flow of natural gas in two directions in each segment of the network. The bi-directional flow allows it to determine the most efficient way of transporting natural gas. It also helps in enhancing the capacity of the network without additional capital expenditure.

Weakness

- **High dependence on key customers:** GSPL transports natural gas to customers who operate Power and Fertiliser plants. Thus, exposure to the key customers is higher translating into client-specific risks.

- **No presence beyond Gujarat:** GSPL is only concentrating in Gujarat whereas its peer GAIL has much dominant position across the India, which inturn helps it to benefit higher from the increasing gas supplies, while GSPL is leverage to demand supply equation restricted to Gujarat itself.

Opportunities

- **Huge unmet demand for gas in Gujarat**: Gujarat is the gas hub of India and has huge unmet demand of gas in the country. According to Crisil, approximately 35% of India's total natural gas is consumed in Gujarat. Over the years, there has been a significant increase in natural gas demand in Gujarat, particularly by the power, fertilizers and petrochemicals industries. Additionally, we believe that industrialisation and development of SEZs would further increase the demand of the gas going forward.

- **Benefit arising from increasing gas supplies**: GSPL is the best play on the increasing gas supplies in the country, as it’s growth story is linked to both increasing domestic gas supplies as well as increase in the LNG imports.

Threats

- **Competitive pressures**: GSPL's natural gas pipelines run parallel to Gujarat Gas’s (GGCL) and GAIL's pipelines in several locations. GGCL competes with GPSL only in the Retail space as the former focuses on Distribution to Retail customers. GAIL is the largest natural gas transmission company in India and operates a natural gas transmission pipeline network of approximately 1,200kms in Gujarat that begins in Hazira. Any tariff rationalization by GAIL could be a threat for the company.

Profit & Loss Statement

Rs crore

Y/E March	FY2007	FY2008	FY2009E	FY2010E
Net Income	**317.6**	**417.9**	**468.3**	**645.8**
% chg	*20.5*	*31.6*	*12.1*	*37.9*
Total operating expenditure	49.8	53.4	58.2	63.6
EBIDTA	**267.7**	**364.5**	**410.1**	**582.1**
(% of Net Sales)	*84.3*	*87.2*	*87.6*	*90.1*
Other Income	17.5	29.4	27.2	23.1
Depreciation& Amortisation	102.6	163.2	168.9	226.9
Interest	45.7	81.5	92.7	123.8
Prior period adjustments	0.3	0.0	-	-
PBT	**137.3**	**149.1**	**175.7**	**254.6**
(% of Net Sales)	43.2	35.7	37.5	39.4
GSEDS contribution (30% of PBT)	-	-	52.7	76.4
Tax	47.9	49.2	42.3	55.3
(% of PBT)	*34.9*	*33.0*	*24.1*	*21.7*
PAT	**89.4**	**99.9**	**80.6**	**123.0**
% chg	*91.5*	*11.8*	*(19.3)*	*52.5*
(% of Net Sales)	*28.1*	*23.9*	*17.2*	*19.0*

Balance Sheet

Rs crore

Y/E March	FY2007	FY2008	FY2009E	FY2010E
SOURCES OF FUNDS				
Equity Share Capital	542.8	562.0	562.0	562.0
Reserves& Surplus	423.1	578.9	626.7	716.8
Shareholders Funds	**965.9**	**1,141.0**	**1,188.7**	**1,278.8**
Total Loans	863.8	966.0	1,320.3	1,763.3
Deffered Tax Liability (net)	91.7	99.9	104.1	113.4
Total Liabilities	**1,921.4**	**2,206.9**	**2,613.1**	**3,155.5**
APPLICATION OF FUNDS				
Gross Block	1,888.9	2,019.0	2,100.6	3,430.6
Less: Acc. Depreciation	322.8	481.9	650.8	877.7
Net Block	**1,566.1**	**1,537.1**	**1,449.8**	**2,553.0**
Capital Work-in-Progress	136.8	588.8	847.2	150.0
Investments	**-**	**35.6**	**35.6**	**35.6**
Current Assets	390.8	549.7	505.0	641.4
Current liabilities	181.5	510.6	230.8	230.8
Net Current Assets	**209.3**	**39.1**	**274.2**	**410.6**
Misc Exp	9.3	6.3	6.3	6.3
Total Assets	**1,921.4**	**2,206.9**	**2,613.1**	**3,155.5**

Cash Flow Statement

Rs crore

Y/E March	FY2007	FY2008	FY2009E	FY2010E
Profit before tax	137.3	149.1	123.0	178.2
Depreciation	102.6	163.2	168.9	226.9
(Incr)/ Decr in Misc Exp	3.0	3.0	-	-
(Inc)/Dec in Working Capital	(105.8)	246.0	(288.6)	(34.1)
Interest	45.7	81.5	92.7	123.8
Direct taxes paid	(7.0)	(41.0)	(38.2)	(46.0)
Others	(0.3)	(4.1)	-	-
Cash Flow from Operations	**175.4**	**597.7**	**57.9**	**448.8**
(Inc)/Dec in Fixed Assets	(440.1)	(582.1)	(340.0)	(632.8)
Free Cash Flow	**(264.7)**	**15.6**	**(282.1)**	**(184.0)**
(Inc)/Dec in Investments	-	(35.6)	-	-
Issue of Equity	0.8	108.0	-	-
Inc./(Dec.) in loans	285.2	102.2	354.3	443.0
Dividend Paid (Incl. Tax)	(31.8)	(32.9)	(32.9)	(32.9)
Interest	(45.7)	(81.5)	(92.7)	(123.8)
Cash Flow from Financing	**208.6**	**95.8**	**228.7**	**286.3**
Inc./(Dec.) in Cash	(56.1)	75.8	(53.4)	102.3
Opening Cash balances	**237.2**	**181.1**	**256.9**	**203.5**
Closing Cash balances	**181.1**	**256.9**	**203.5**	**305.8**

Key Ratios

Y/E March	FY2007	FY2008	FY2009E	FY2010E
Per Share Data (Rs)				
EPS	1.6	1.8	1.4	2.2
Cash EPS	3.4	4.7	4.4	6.2
DPS	0.5	0.5	0.5	0.5
Book Value	17.0	20.2	21.0	22.6
Operating Ratios				
Inventory (days)	50.8	34.7	34.7	34.7
Debtors (days)	40.1	36.4	35.5	35.5
Creditors (days)	N.A.	N.A.	N.A.	N.A.
Return Ratios (%)				
RoE	9.3	8.8	6.8	9.7
RoCE	9.1	9.6	9.6	11.7
RoIC	9.5	10.5	10.2	12.7
Dividend Payout (incl taxes)	35.5	32.9	40.8	26.7
Valuation Ratios (x)				
P/E	23.5	21.0	26.1	17.1
P/E (Cash EPS)	10.9	8.0	8.4	6.0
P/BV	2.2	1.9	1.8	1.7
EV/Sales	8.5	6.7	6.9	5.5
EV/EBITDA	10.1	7.7	7.8	6.1

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Ratings (Returns) :	Buy (Upside > 15%)	Accumulate (Upside upto 15%)	Neutral (5 to -5%)
	Reduce (Downside upto 15%)	Sell (Downside > 15%)	

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