

January 25, 2012

## GAIL (INDIA) LTD.

**BUY**

**GAIL (India) Ltd.** (Gail) announced Q3FY12 results which was better than street estimates primarily driven by higher natural gas trading and petrochemical volume and pricing. Net revenue stood at Rs 112.6bn, compared to Rs 83.6bn recorded in the same period a year earlier and Rs 97.0bn recorded in Q2FY12. Net profit stood nearly unchanged sequentially at Rs 10.9bn, versus Rs 9.7bn in the same quarter a year ago.

### The key takeaways from the result are:

- Subsidy burden for the quarter declined 5.4% sequentially to Rs 5.4bn, which helped Gail to report better margins. However, overall under-recovery for the upstream sector has increased by nearly 52.5% Q-o-Q to Rs324bn during the quarter, which indicates that the company might have to contribute higher subsidy sharing in Q4FY12.
- Revenue from the natural gas trading segment, which contributes nearly 75% of the overall revenue, improved by a whopping 35.1% Y-o-Y to Rs 91.5bn as sales volume increased by 2.0% to 85MMSCMD. Margin for the segment improved by 49bps annually.
- In the transmission segment, volume declined compared to a year earlier and improved slightly sequentially. However, outlook for the segment is weak due to poor visibility on domestic gas supplies.
- Revenue from natural gas transmission segment grew 8.6% annually to Rs 10.9bn, whereas contribution from LPG transmission segment de-grew by 5.9% to Rs 1.2bn.
- Petrochemical segment revenue also edged up drastically by 53.7% Y-o-Y to Rs 8.8bn and LPG and liquid hydrocarbons revenue grew by 32.6% Y-o-Y to Rs 9.7bn.
- Higher gas prices and 81.6% fall in other income led to contraction in EBITDA margin by 234bps Q-o-Q to 16.1%. However, net profit remained flat at Rs 10.9bn due to lower than expected subsidy burden.

**Based on FY13 P/E multiple of 13, the fair value for the company works out to Rs 452**

### Financial Snapshot

Projections (Rs. Mn)	Q3FY11	Q3FY12	% chg	FY10A	FY11A	% chg	FY12E	FY13E
Net Revenue	83,649.9	112,598	34.6%	249,964	324,586	29.85%	402,954	436,627
Total Income	85,742.1	113,155	32.0%	255,584	331,097	29.55%	407,859	442,222
EBIDTA	15,236.9	18,162	19.2%	52,106	59,731	14.63%	69,265	74,722
EBIDTA %	18.2%	16.1%		20.8%	18.4%		17.2%	17.1%
Adj. PAT	9,676.3	10,914	12.8%	31,464	35,532	12.93%	40,917	44,059
NPM %	11.6%	9.7%		12.6%	10.9%		10.2%	10.1%
EPS (Rs.)	7.6	8.6	12.7%	24.8	28.0	12.93%	32.3	34.7
BVPS (Rs.)				132.4	151.8	14.61%	176.5	203.8
ROE %				18.7%	18.5%		18.3%	17.0%
PER x							11.4	10.6
P/B Ratio							2.1	1.8

Recommendations	<= 1 year	1 - 2 yrs	2 - 5 yrs
Strong Buy			
Buy			
Hold			
Reduce			
Sell			

**Strong Buy** – Expected Returns > 20% p.a.

**Buy** – Expected Returns from 10 to 20% p.a.

**Hold** – Expected Returns from 0 % to 10% p.a.

**Reduce** – Expected Returns from 0 % to 10% p.a. with possible downside risk

**Sell** – Returns < 0 %

### STOCK DATA

BSE / NSE Code	532155 / GAIL
CMP Rs (24th Jan'12)	367
Market Cap (Rs mn)	465,913
52 Week High-low	485.9 / 360.2

### STOCK RETURN (%)

	30D	3M	6M	1Y
Gail	-6%	-14%	-21%	-20%
Sensex	8%	0%	-9%	-11%
Nifty	9%	1%	-9%	-11%

**Gail is negotiating for long and short-term contracts with five-six players, including Sydney-based Macquarie Energy, to import more natural gas to meet rapidly increasing domestic demand**

**Of the 85mmscmd of natural gas sales during Q3FY12, 18 mmscmd is imported natural gas**

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## OTHER HIGHLIGHTS

During Q3FY12, transmission volume declined in both natural gas and LPG. However, production across all the segments (petrochemicals, LPG and other liquid hydro carbons) edged up by 14.7%, 6.0% and 16.4% Y-o-Y, respectively. Sales volume also advanced significantly across segments. Petrochemical sales advanced 39.5% Y-o-Y to 113K MT.

Revenue from the transmission segment improved 7.0% sequentially to Rs 12.1bn, however, operating margins declined in both the natural gas and LPG segment by 941bps and 155bps annually. Natural gas trading revenue improved 35.1% Y-o-Y to Rs 91.5bn and operating margin for the segment improved by 49bps to 3.5%. Sales from petrochemical division advanced 53.7% annually to Rs 8.8bn and operating margin improved by 993bps to 44.1%. LPG and liquid hydrocarbons sales also rose 32.6% annually to Rs 9.7bn and operating margin in the segment improved by 11.0% to 31.6%.

Gail's operating profit margin though declined by 208bps to 16.1% annually, profit increased by 19.2% to Rs 18.2bn. Depreciation was higher by 23% owing to capitalization of assets with respect to new pipelines. Moreover, other income was sharply lower by 89%. Interest cost too was up by 26% due to higher debt to finance pipeline projects.

In FY11, Gol has increased subsidy sharing burden from 33% to 38%. However, Gail's contribution declined by 220bps to 7% in FY11. For FY12, Gol has not announced a specific formula for subsidy sharing till date, which has raised uncertainty about the fixed leg of subsidy sharing mechanism. With domestic production of natural gas declining, we expect natural gas transmission volumes to remain flat in FY13 as the company has to depend on high priced spot LNG to meet the country's rising demand. Moreover, the ongoing attempt by PNGRB to regulate marketing margin charged on the sale of imported LNG is also a threat for the company. We have not factored this in our valuation due to lack of clarity on the issue till date. However, positive triggers for the company are exposure to high growth CGD projects, timely commissioning of LNG terminals and ramp up of ONGC supplies.

**GAIL bought four LNG cargoes from the spot market in the October-December quarter**

**The company raised USD 200mn from Bank of Tokyo in the third quarter and would raise another USD 100mn in the current quarter to meet CAPEX requirement**

**In FY13, GAIL has planned a CAPEX of Rs 90bn and Rs 50bn of borrowing, half of which may be from overseas debt**

## Financial Analysis and Projections

Particulars (Rs Mn)	FY08A	FY09A	FY10A	FY11A	FY12E	FY13E
Net Revenue	180,121	238,984	249,964	324,586	402,954	436,627
Other Income	5,808	7,966	5,415	5,186	3,805	4,495
Total Income	186,228	247,000	255,584	331,097	407,859	442,222
Operating Expenditure	140,888	197,505	203,478	271,366	338,594	367,500
Depreciation	5,710	5,599	5,618	6,503	7,737	8,165
EBIT	39,629	43,896	46,488	53,229	61,528	66,557
EBIT Margin (%)	22.0%	18.4%	18.6%	16.4%	15.3%	15.2%
Interest	796	870	700	829	1,313	1,772
Profit Before Tax	38,833	43,026	45,788	52,400	60,216	64,786
Less: Tax	12,534	13,993	14,376	16,769	19,299	20,727
Adj. Profit After Tax	26,382	29,325	31,464	35,532	40,917	44,059
PAT Margin (%)	14.6%	12.3%	12.6%	10.9%	10.2%	10.1%
ROE (%)	20.3%	19.9%	18.7%	18.5%	18.3%	17.0%
EPS (Rs)	20.8	23.1	24.8	28.0	32.3	34.7
BVPS (Rs)	102.5	116.4	132.4	151.8	176.5	203.8
<b>Valuation Ratios (x)</b>					<b>FY12E</b>	<b>FY13E</b>
P/E					11.4	10.6
P/B					2.1	1.8

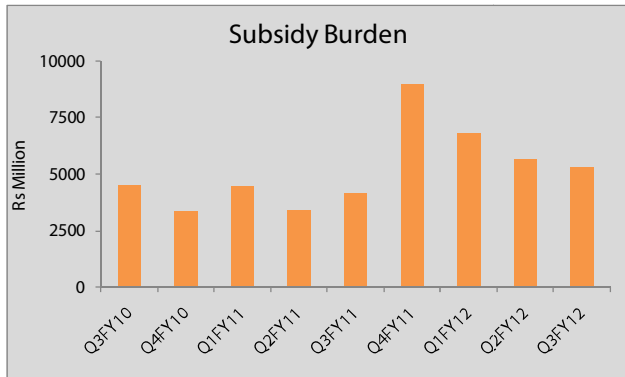
We expect Gail's revenues to grow at a CAGR of 16.0% over FY11-13 to Rs 436.6bn on a standalone basis; we further estimate that PAT would grow at a lower CAGR of 11.4% over the same tenure to Rs 44.1bn, due to rise in interest expenses.

**Based on FY13 P/E multiple of 13, the fair value for the company works out to Rs 452.**

We have reduced our target price due to concerns related to domestic gas production and increasing dependence on imported LNG. However, we reiterate our **'BUY'** recommendation on the stock due to 14% correction in the last three months.

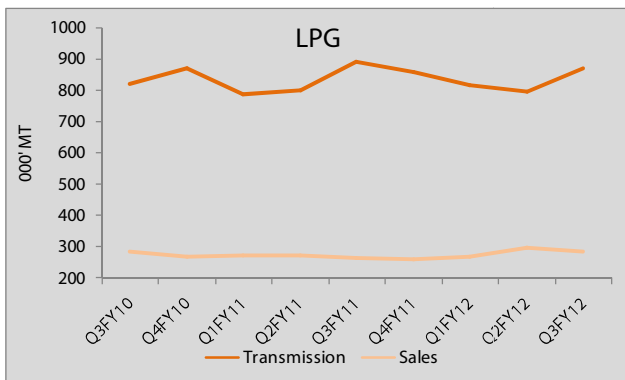
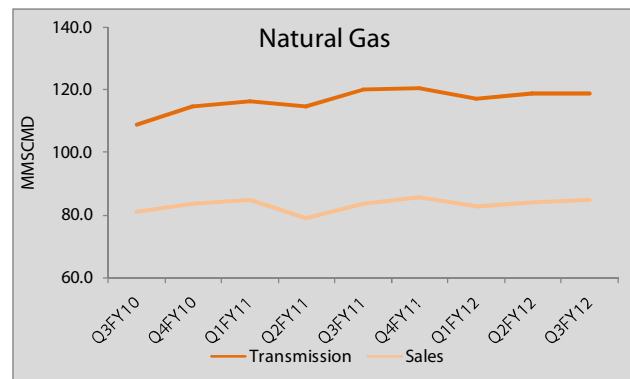
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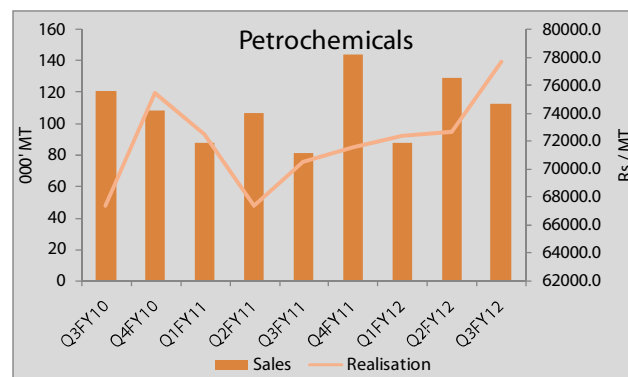
**Subsidy burden for Gail expected to increase in Q4FY12**

**Transmission segment volume to remain flat in the upcoming quarters**



**GAIL opposed the attempts by the Petroleum and Natural Gas Ministry to regulate marketing margin charged on the sale of imported LNG**

**Realization in the petrochemical segment improved drastically in the first three quarters of the year**



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