Indbank Merchant Banking Services Ltd (A Subsidiary of Indian Bank)

GAIL (India) Ltd.

EQUITY REPORT

November 7th, 2014

BSE Code:	532155	NSE Code:	GAIL	Reuters Code:	GAIL.NS	Bloomberg Code:	GAIL:IN

GAIL (India) Ltd, established in 1984, is the leading state-run gas transmission and marketing company in India. The company has a presence along the entire hydrocarbon value chain spanning across E&P, LNG, pipelines, LPG, petrochemicals, city gas distribution, etc. The company operates through it five business segments, namely, Transmission services, Natural gas marketing, Petrochemicals, LPG & Liquid hydrocarbons and other segments. Internationally, Gail (India) operates through its two main subsidiaries, namely, GAIL Global (Singapore) Pte Ltd. and GAIL Global (USA) Inc.

Investor's Rationale

Witnessed mixed performance in Q2FY15 and H1: While the company witnessed a robust growth in its standalone net profit at ₹13,029.0 mn in Q2FY15, up by 42.3% YoY from the corresponding period of the previous year, while, revenue from operations grew marginally by 0.9% YoY to ₹140,631.8 mn, during the quarter on standalone basis. The increase in revenue was on account of rise in revenue from LPG and Liquid hydrocarbon and petrochemical business by 64% and 13%, respectively. In H1FY15, GAIL clocked a growth of 11.6% in its standalone net profit while posting a growth of 2.2% YoY in revenue from operations. We remain positive for H2FY15 and FY15 as a whole on the back of growth in profitability led by higher gas prices with effect from November 2014. *We estimate ~18.3% and ~6.6% YoY growth in net profit in FY15E and FY16E, respectively, while the revenue is expected to grow by ~21% and 20% YoY in FY15E and FY16E.*

Gas price hike – a key positive development: The recent announcement by the government of India (GoI) for a price hike in natural gas prices has turn out to be a positive development for GAIL as it will help to reduce the subsidy burden on the company and the company will now be able to earn higher marketing margins, which would subsequently boost the profitability. The GoI has revised the gas prices to $5.61 mn British thermal unit (mmBtu) from $4.2 mmBtu with effect from November 01.

Leadership position in inter-state gas transmission business: GAIL enjoys a dominant position in the natural gas transmission business with a market share of 71% with its large pipeline network covering 10,900 km. The dominant market share, along with regulated returns on the capital employed, has resulted in healthy profitability and stable cash generation for GAIL. The RoCE for gas transmission/trading division remained stable at around 28-32% during FY09-FY12. On the back of ~21% revenue growth and a rise in profitability by ~18.3% expected in FY15E, we believe the company's market share will increase significantly in the coming time.

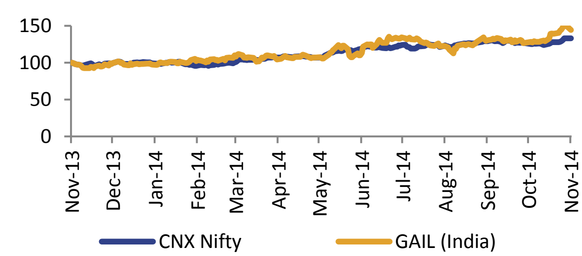
Market Data

Rating	**BUY**
CMP (₹)	485
Target (₹)	**582**
Potential Upside	20%
Duration	Long Term
Face Value (₹)	10.0
52 week H/L (₹)	551.9/318.0
Adj. all time High (₹)	551.9
Decline from 52WH (%)	12.1
Rise from 52WL (%)	52.5
Beta	1.1
Mkt. Cap (₹bn)	615.2
Enterprise Value (₹bn)	771.7

Fiscal Year Ended

Y/E	FY13A	FY14A	FY15E	FY16E
Revenue (₹bn)	510.9	619.2	749.2	899.1
EBITDA (₹bn)	74.8	80.0	101.9	119.1
Net Profit (₹bn)	43.7	47.9	56.6	60.4
EPS (₹)	34.5	35.3	44.4	47.3
P/E (x)	14.1	13.8	10.9	10.3
P/BV (x)	2.1	1.9	1.7	1.5
EV/EBITDA (x)	10.1	9.6	7.9	7.0
ROCE (%)	14.9	13.4	14.8	14.9
ROE (%)	15.2	13.8	15.5	14.8

One year Price Chart



Shareholding Pattern	Sep'14	Jun'14	Diff.
Promoters	56.1	56.1	-
FII	19.1	18.8	0.3
DII	20.9	21.3	(0.4)
Others	3.9	3.8	0.1

GAIL (India) Ltd # the youngest Maharatna company

GAIL, the largest state-owned natural gas processing and distribution company, operates through its five business segments, namely, Transmission services, Natural gas marketing, Petrochemicals, LPG & Liquid hydrocarbons and other segments

Headquartered in New Delhi, GAIL India is the largest state-owned natural gas processing and distribution company in India. The company was established in 1984 as a Public Sector Undertaking (PSU) under the Ministry of Petroleum & Natural Gas (MoP&NG), with GoI holding 56.11% stake as on 31st March 2014. Being the youngest PSU it has received Maharatna Status by the GoI in February 2013. While operating through its five business segments, namely, Transmission services, Natural gas marketing, Petrochemicals, LPG & Liquid hydrocarbons and other segments, GAIL is now engaged in the transportation of natural gas through pipeline; manufacturing of basic chemicals, fertilizer and nitrogen compounds, plastics and synthetic rubber in primary forms; extraction of crude petroleum; extraction of natural gas and electric power generation, transmission and distribution.

GAIL has grown organically by building large network of Natural Gas Pipelines covering more than 10,900 km with a capacity of around 200 MMSCMD; two LPG Pipelines covering 2,040 km with a capacity of 3.8 MMTPA of LPG; seven gas processing plants for the production of LPG and other Liquid Hydrocarbons, with a production capacity of 1.4 MMTPA; and a gas based integrated Petrochemical plant of 410,000 TPA polymer capacity which is further being expanded to a capacity of 900,000 TPA. In order to fulfill the requirement of growth and consolidation, the company has moved into upstream of gas value chain i.e. Exploration & Production and currently has stake in 20 E&P blocks including 2 blocks overseas (in Myanmar). GAIL also has stake in some of the country's key players like Brahmaputra Cracker and Polymer Limited (BCPL), ONGC Petro-additions Limited (OPaL), NTPC etc.

GAIL is a pioneer in City Gas Distribution (CGD) business in India, with Indraprastha Gas Limited (IGL) in Delhi and Mahanagar Gas Limited (MGL) in Mumbai being its biggest success stories.

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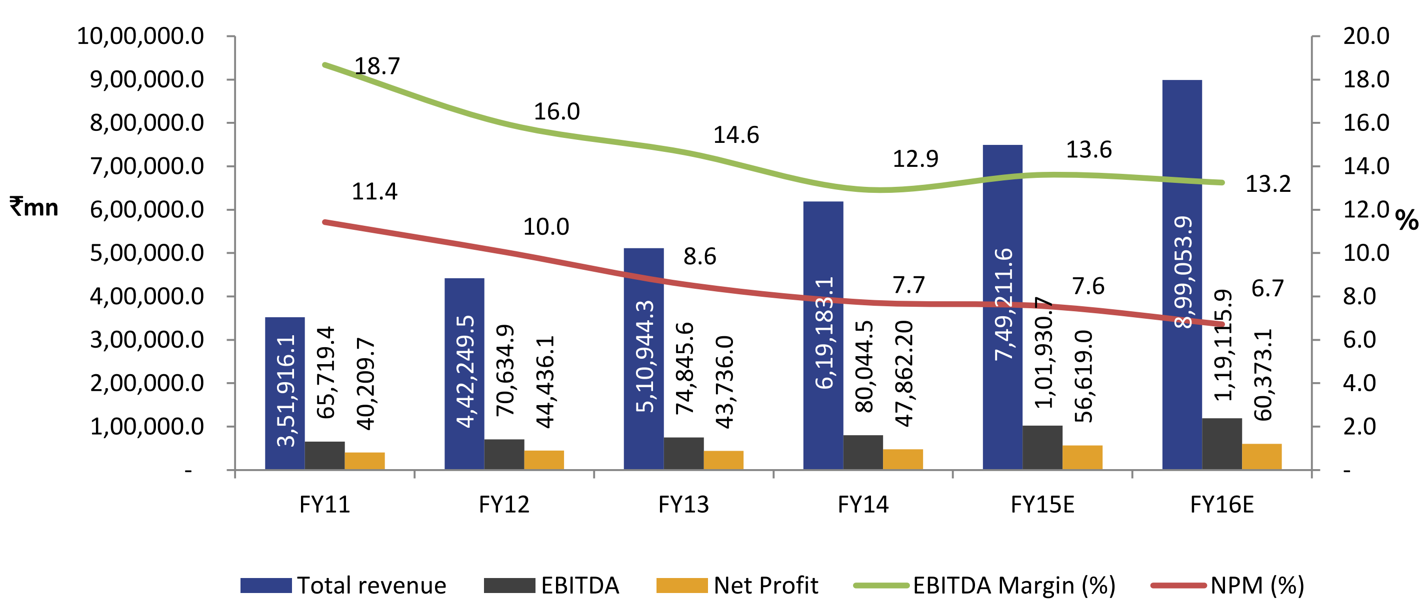
Consistent growth in revenue and profitability over years reflects promising outlook for GAIL



Reported mixed numbers in Q2FY15

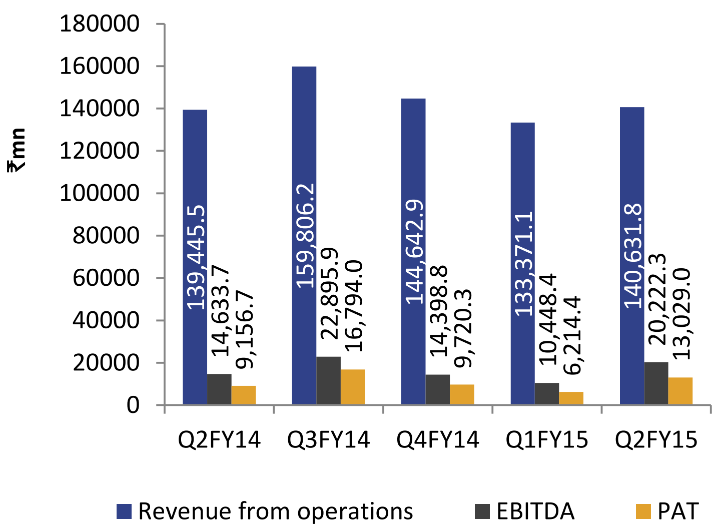
While net profit grew strongly by 42.3% YoY to ₹13,029.0 mn, revenue from operations grew marginally by 0.9% YoY to ₹140,631.8 mn, in Q2FY15.

EBITDA margin expanded by 386bps YoY to 14.3% in Q2FY15 as against 10.5% in the same period a year earlier.

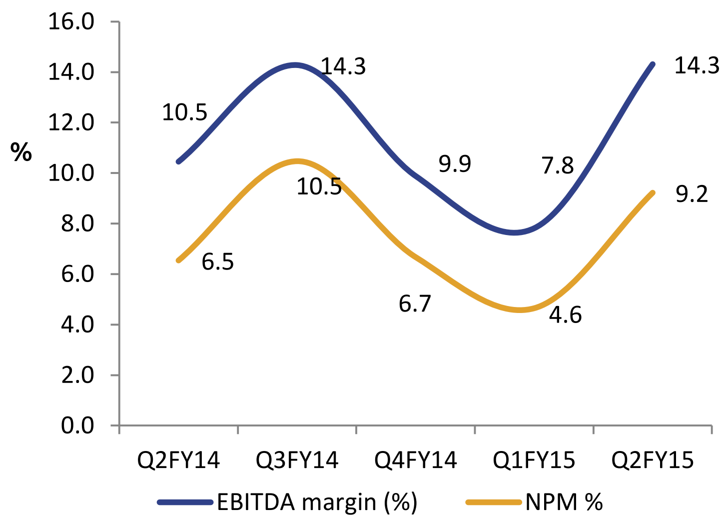
GAIL (India) showcased a mixed numbers in Q2FY15 on standalone basis, with 42.3% YoY increase in its net profit at ₹13,029.0 mn as against ₹9,156.7 mn in the corresponding period of the previous year, while income from operations, during the quarter under review, grew by less than a percent (+0.9% YoY) only to ₹140,631.8 mn, as against ₹139,445.5 mn in the same period a year ago on lower revenue from natural gas. Though, revenue from LPG & Liquid hydrocarbons (contributed ~12.1% to the total revenue in Q2FY15) and Petrochemicals business (contributed ~9.1% to the total revenue in Q2FY15) grew by 64% and 13% to ₹17,037.4 mn and ₹12,814.1 mn in Q2FY15 as against ₹10,388.0 mn and ₹11,336.2 mn in Q2FY14, respectively; while, the revenue from natural gas marketing (contributed ~84% to the total revenue in Q2FY15) declined 4.5% to ₹118,188.0 mn from ₹123,784.9 mn, resulting in a muted growth in revenue. The company however managed to contain its operations costs during the quarter, with the total expenditure declined by 3.4% YoY to ₹121,074.9 mn. Consequently, EBITDA grew significantly by 38.2% YoY to ₹20,222.3 mn in Q2FY15. EBITDA margin, as a result, expanded by 386bps YoY to 14.3% in Q2FY15 as against 10.5%.

During H1FY15, GAIL (India) registered a total turnover of ₹2,75,019.5 mn up from the turnover of ₹2,69,022.5 mn in H1FY14 on standalone basis. Net profit of the company grew modestly by 11.6% YoY to ₹19,243.4 mn as against ₹17,238.4 mn in the corresponding period a year ago. On margins front, EBITDA margin grew just by 11bps YoY to 11.2%, while NPM grew by 59bps YoY to 7.0%, during the period under review.

Quarterly performance trend



Margins grew considerably on YoY and QoQ basis



LPG and Liquid hydrocarbon business remained the show-stopper in Q2FY15; outlook seems brighter

LPG and Liquid hydrocarbons business witnessed a robust performance with 64.0% YoY surge in revenue at ₹17,037.4 mn as the segment benefitted from lower subsidy burden on a YoY basis.

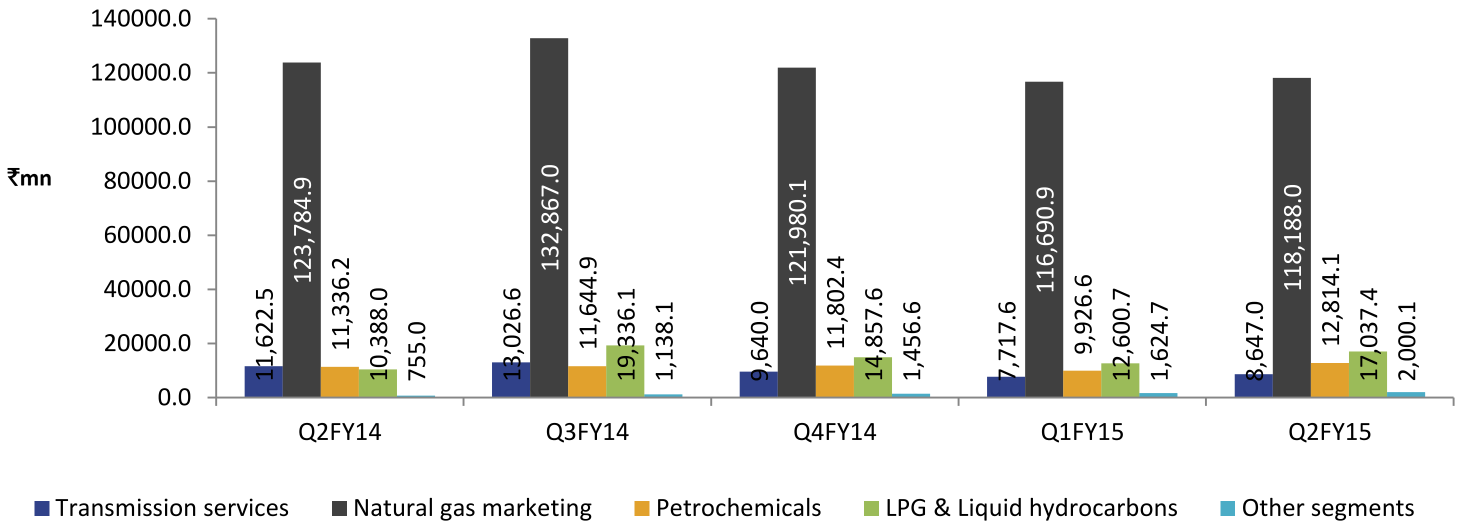
During Q2FY15, the company's LPG and Liquid hydrocarbons business witnessed a robust performance with 64.0% YoY surge in revenue at ₹17,037.4 mn as the segment benefitted from lower subsidy burden. The company shared nil LPG subsidy burden during the quarter compared to a burden of ₹6.98 bn in Q2FY14. Though revenue from Petrochemicals business increased 13% YoY to ₹12,814.1 mn in Q2FY15 led by higher international petrochemical product prices; EBITDA margin slipped significantly from 34% to 12% in Q2FY15 due to natural gas supply at higher price.

Though revenue from the petrochemicals business grew by 13% YoY, margins slipped from 34% to 12% in Q2FY15 due to natural gas supply at higher price.

Moving ahead, natural gas transmission revenue (contributed ~5.5% to total revenue) declined significantly by 28.1% YoY to ₹7,668.8 mn due to lower volume (stood at 91.18 MMSCMD against 95.21 MMSCMD in Q2FY14) and cut in tariff by Petroleum & Natural Gas Regulatory Board (PNGRB) for various pipeline networks (effective from November 20, 2008). Revenue from natural gas marketing business fell 4.5% YoY to ₹118,188.0 mn due to lower volume (Natural Gas trading volume was down by 13.9% YoY to 68.95 MMSCMD).

On margins front, natural gas marketing margins slipped marginally by 11bps YoY to 3.82% in Q2FY15, while margins from natural gas transmission business slipped from 54% to 34.17% due to cut in tariff by PNGRB for various pipeline networks. LPG & liquid hydrocarbon business margin improved YoY to 52.89% due to lower subsidy burden. Petrochem margins slipped significantly from 34% to 12% in Q2FY15 due to natural gas supply at higher price.

Revenue from the LPG & liquid hydrocarbons grew strongly by 64% YoY in Q2FY15



Physical performance remained weak in Q2FY15; Petrochemicals performed better

The company's performance remained discouraging on physical front in Q2FY15 as the transmission, sales and production data showed weak numbers.

The country's leading natural gas processing and distribution company's physical performance remained quite discouraging in Q2FY15 with a decline in natural gas sales by 12.7% YoY to 69 MMSCMD as against 79 MMSCMD in Q2FY14. Sale of other liquid hydrocarbons also declined by 16.9% YoY to 59 TMT in Q2FY15 as against 71 TMT in the corresponding period previous quarter. However, petrochemicals sale grew marginally by 1.9% YoY to 110 TMT during the quarter, against 0.108 MMT in the same period a year earlier. Further, natural gas transmission volumes stood at 91.0 mmscmd, down by 4.2% YoY; LPG volumes, on the other hand, declined 3.8% YoY to 701 TMT from 729 TMT in Q2FY14. Moving ahead, production of petrochemicals grew by 4.4% YoY to 119 TMT during the period under review, while production of LPG and other liquid hydrocarbons declined by 0.4% and 18.3% YoY to 264 TMT and 58 TMT, respectively.

H2FY15 performance also remained muted: The company performance continued to be muted in the first half of the current fiscal as natural gas sales was down by 9.4% YoY to 72.72 mmscmd in H1FY15 as against 80.33 mmscmd in H1FY14. The LPG and other liquid hydrocarbons sales declined by 6.1% YoY to 645 TMT compared to 685 TMT in the corresponding period previous year. The petrochemical sales during the first half of the year fell by 14% YoY to 197 TMT against 229 TMT in H1FY14. While the transmission of natural gas stood at 94.04 mmscmd, against 97.25 mmscmd in the corresponding period of previous quarter, down by 3.3% and transmission of LPG volumes advanced by 7% to 1,533 TMT against 1,428 TMT in H1FY14. On production front, the production of petrochemicals declined by 6.0% YoY to 217 MMT (231 MMT in H1FY14), while production of LPG and other liquid hydrocarbons declined by 5.3% YoY to 649 TMT.

Physical Performance

	unit	Q2FY14	Q2FY15	% change
Transmission				
Natural gas	mmscmd	95.0	91.0	-4.2
LPG	000mt	729	701.0	-3.8
Production				
Petrochemicals	000mt	114	119.0	4.4
LPG	000mt	265.0	264.0	-0.4
Other liquid hydrocarbons	000mt	71.0	58.0	-18.3
Sales				
Natural Gas	mmscmd	79.0	69.0	-12.7
Petrochemicals	000mt	108.0	110.0	1.9
LPG	000mt	266	263.0	-1.1
Other liquid hydrocarbons	000mt	71	59.0	-16.9

Gas price hike - key positive development; lack of subsidy burden to boost profitability

The government has raised the gas prices to $5.61 (mmBtu) from $4.2 mmBtu. Gail (India) is one of the key beneficiaries of the hike as it would not have to pay for under-recoveries (revenue loss for selling it under product cost).

However, the company's JV with Bharat Petroleum, Indraprastha Gas Ltd, decided not to raise rates despite input cost going up, in the interest of its consumers in Delhi, Noida, Greater Noida and Ghaziabad.

GAIL is all set to raise the domestic price of liquefied natural gas (LNG) by 10 cents per million British thermal unit (mmBtu), in a move to force the local consumers such as power projects and fertilizer plants to finalize their purchase plans to avail the benefits of cheaper gas prices. The company said in a report that it plans to increase the prices by the middle of November or latest by 1 December. The move came on the backdrop of the government's announcement for a 33% hike in natural gas prices, with effect from November 1. The government has raised the gas prices to $5.61 (mmBtu) from $4.2 mmBtu. Gail (India) is one of the key beneficiaries of the hike as it would not have to pay for under-recoveries (revenue loss for selling it under product cost).

Meanwhile, Mahanagar Gas Ltd (MGL), one of the leading natural gas distribution companies and a joint venture (JV) between GAIL and the UK based BG group, hiked CNG prices by ₹4.50 per kg to ₹43.45. Similarly, it also raised tariff for piped natural gas (PNG) supplied to households for cooking purposes by ₹2.49 to ₹26.58 per cubic meters, thereby raising the company's prospects for higher profitability. However, the company's JV with Bharat Petroleum, Indraprastha Gas Ltd, decided not to raise rates despite input cost going up, in the interest of its consumers in Delhi, Noida, Greater Noida and Ghaziabad. As per IGL, the company may incur a loss of ~₹100 crore for holding prices, but it is likely to hold rates till BJP is able to cobble a government in the national capital or till fresh assembly elections are held. All in all, we believe, the move will help the state-run company to lower down its subsidy burden and will also push the marketing margins, which will ultimately boost the company's profitability.

The robust demand prospects for natural gas in India provides huge opportunity for GAIL's growth in gas transmission and marketing segments over the long term; however, profits would be constrained in the next 2-3 years due to low domestic production volumes and limited regasification capacity in the country.

In order to meet the growing appetite of Indian market, GAIL has been expanding its global presence to secure long term gas supplies.

Healthy demand prospects for natural gas in India provides huge opportunity for GAIL's growth in gas transmission and marketing segments over the long term

Overall demand for gas in India is expected to rise to around 360 MMSCMD by FY20 from the current demand potential of more than 260 MMSCMD. It is to be highlighted that actual consumption was only around 140 MMSCMD in FY13, which has declined in the last two years from 170 MMSCMD in FY12 and 177 MMSCMD in FY11 due to constrained gas availability. The rising demand deficit would necessitate higher dependence on LNG, for which India would need to source additional LNG on a long-term basis (in addition to contracted LNG volumes from Australia and mid-term contracts signed by GAIL). The robust demand prospects for natural gas in India provides huge opportunity for GAIL's growth in gas transmission and marketing segments over the long term; however, profits would be constrained in the next 2-3 years due to low domestic production volumes and limited regasification capacity in the country.

Securing long-term contracts; long-term prospects seem promising

In order to meet the growing appetite of Indian market, GAIL has been expanding its global presence to secure long term gas supplies. GAIL has signed a 20 year Sales and Purchase Agreement with Sabine Pass Liquefaction LLC, a unit of Cheniere Energy Partners, USA for the supply of 3.5 mn tonnes per year of LNG. In addition, the company has signed a long-term LNG supply contract for 2.5 mn tonnes per annum with Gazprom Marketing and Trading Ltd., Singapore for 20 years. GAIL has also signed a Terminal Service agreement for 2.3 mn tonnes per year LNG liquefaction capacity with Dominion Cove Point LNG, USA. GAIL is also poised to make its foray into LNG shipping business with long-term charter hiring of multiple LNG vessels, mainly to transport LNG volumes from GAIL's US portfolio to India, thereby raising the long-term prospects for the company.

Key Concerns

Gas supply risks leading to under-utilisation of recently added pipeline capacities over the next 2-3 years: Due to lower domestic gas production and significant capacity added over last couple of years, transmission capacity of GAIL would remain under-utilised over the next 2-3 years. Since Natural gas transmission already posted a decline in revenue by 28.1% YoY in Q2FY15, significant under-utilisation would be a key concern with regard to profit of transmission segment. However, we believe that the gas supply is expected to increase materially following increase in domestic production and anticipated additions in regasification capacities. Despite overhang in the next 2-3 years, GAIL is expected to benefit from rise in gas supplies over the longer term.

Uncertainty related to subsidy sharing levels: In view of the material rise in the domestic gas prices, it is likely that GAIL's share in under-recovery sharing would reduce from FY15 onwards. However, there is uncertainty with regards to GoI's policy and a significant subsidy sharing burden could have a direct impact on the earnings of the company.

Balance Sheet (Consolidated)

Y/E (₹mn)	FY13A	FY14A	FY15E	FY16E
Share Capital	12,684.8	12,684.8	12,684.8	12,684.8
Reserve and surplus	275,261.8	311,884.7	351,876.5	394,592.5
Net Worth	**287,946.6**	**324,569.5**	**364,561.3**	**407,277.3**
Minority Interest	14,566.2	17,587.8	21,984.8	24,183.2
Total debt	155,010.6	171,056.3	205,476.5	248,499.1
Provisions	20,256.7	21,425.3	25,710.4	30,852.4
Deferred tax liability (net)	24,264.9	27,303.5	33,037.2	39,644.7
Other Liabilities	95,820.5	106,476.9	127,756.3	154,628.5
Total equity & liabilities	**597,865.5**	**668,419.3**	**778,526.5**	**905,085.2**
Fixed assets	426,794.8	462,692.6	545,977.3	633,333.6
Investments	12,535.2	11,759.8	11,759.8	11,759.8
Loans & advances	73,477.3	92,057.6	98,433.9	107,779.6
Cash	30,646.2	32,111.1	39,023.5	53,867.0
Other Current Assets	54,412.0	69,798.2	83,332.0	98,345.1
Total assets	**597,865.5**	**668,419.3**	**778,526.5**	**905,085.2**

Profit & Loss Account (Consolidated)

Y/E (₹mn)	FY13A	FY14A	FY15E	FY16E
Operating revenue	**510,944.3**	**619,183.1**	**749,211.6**	**899,053.9**
Expenses	436,098.7	539,138.6	647,280.8	779,937.9
EBITDA	**74,845.6**	**80,044.5**	**101,930.7**	**119,115.9**
Other Income	8,292.8	9,182.1	9,182.1	9,182.1
Depreciation	13,186.8	16,442.2	18,086.4	20,256.8
EBIT	**69,951.6**	**72,784.4**	**93,026.4**	**108,041.2**
Interest	4,373.1	6,687.1	7,890.8	9,626.7
Profit Before Tax	**65,578.5**	**66,097.3**	**85,135.7**	**98,414.5**
Tax	22,411.8	21,948.3	29,191.2	38,824.3
Exceptional Items	-	(3,126.9)	-	-
PAT	**43,166.7**	**47,275.9**	**55,944.4**	**59,590.1**
Less: MI	(62.7)	2.6	2.6	2.6
Add: share of profit of asso.	506.6	588.9	677.2	785.6
Net profit	**43,736.0**	**47,862.2**	**56,619.0**	**60,373.1**

Key Ratios (Consolidated)

Y/E	FY13A	FY14A	FY15E	FY16E
EBITDA Margin (%)	14.6	12.9	13.6	13.2
EBIT Margin (%)	13.7	11.8	12.4	12.0
NPM (%)	8.6	7.7	7.6	6.7
ROCE (%)	14.9	13.4	14.8	14.9
ROE (%)	15.2	13.8	15.5	14.8
EPS (₹)	34.5	35.3	44.4	47.3
P/E (x)	14.1	13.8	10.9	10.3
BVPS (₹)	227.0	255.9	287.1	320.5
P/BVPS (x)	2.1	1.9	1.7	1.5
EV/Net Sales (x)	1.5	1.2	1.1	0.9
EV/EBITDA (x)	10.1	9.6	7.9	7.0

Valuation and view

We expect the company to maintain the growth momentum due to dominant market position in gas transmission. While the company's performance remained mixed in H2FY15 with a robust growth in profitability and muted incline in revenues, we expect the company to resume growth in FY15 with new supplies from the LNG terminals at Kochi, Dahej and incremental gas in the KG basin from RIL and ONGC. Further, the company's move to raise gas prices, which was in line with the government's announcement of a hike in gas prices, is likely to generate improved marketing margins, thereby aiding to the profitability. Further, cap on subsidized LPG cylinders and deregulation of diesel prices are positive for the stock.

We initiate BUY rating on GAIL. At a current CMP of ₹485, GAIL is currently trading at P/E of 10.9x FY15E and 10.3x FY16E. Considering the company's strong fundamentals, we recommend 'BUY' with a target price of ₹582, which implies potential upside of ~20% to the CMP from 1 year perspective.

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