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

GAIL (INDIA) LTD

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GAIL (India) Ltd is a major integrated gas company with presence across the natural gas value chain and more than 70% market share in both gas transmission and marketing. It transmits more than 160 mmscmd of gas through its large network of trunk pipelines, covering a distance of ~11,000 km and accounts for about three-fourth of the natural gas transmitted in India. With a market capitalization of over ₹580 billion, GAIL aims to be a ₹1,000 billion turnover company by 2016-17.

Investor's Rationale

- At a juncture, when their increasing thrust on developing cleaner energy sources gas like natural gas and its high consumption growth rate of 21.8% and 21.5% in China and India, respectively, GAIL has maintained its strong position in the global gas-utility space by taking effective steps to consolidate its position in the entire gas value chain.

- Under its strategic plan to reach a turnover of about ₹1,000 billion by 2016-17, GAIL is well on its road to establish a pan-India presence by expanding its gas transmission network to over 14,500 km and has outlined a mega capex plan of ₹286.41 billion for the next 3 years from FY'12E to FY'14E, of which 39% will be dedicated towards expanding its pipeline infrastructure.

- In order to tap the emerging potential in petrochemical segment, the company is in process to double the capacity at its Pata plant to 0.9mtpa by FY14 and is also setting up 0.3mtpa petrochemical complex in Assam, through its subsidiary Brahmaputra Cracker and Polymer Ltd (BCPL), to mark a significant growth in its domestic market share from its present 20% domination.

- India is planning to launch its first auction round for shale gas exploration blocks in 2012. To consolidate its presence in shale gas assets in the US and gain expertise for the exploration of an increasingly important fuel source ahead of India's plans to auction shale gas blocks, the company made it first stake purchase in the US shale gas asset in Q2FY12 and is planning to buy further stakes in other shale gas assets in the US during the coming six months.

- Under, the petroleum ministry's 'Vision 2015', 200 cities are likely to be covered under the City Gas Distribution (CGD) network, GAIL aims to ramp up its presence to 50 cities in the next four to five years from its current presence in 12 cities. This move of the company is expected to fuel up its operating margins as the target consumers are likely to be small industries for piped natural gas (PNG).

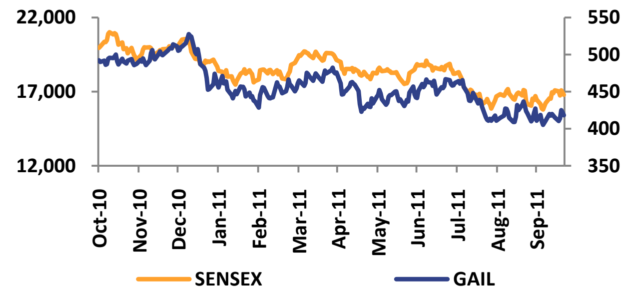
Market Data

Rating	**BUY**
CMP (₹)	429
Target (₹)	**515**
Potential Upside (%)	~20
Duration	Medium Term
52 week H/L (₹)	538/400
All time High (₹)	538
Decline from 52WH (%)	79.9
Rise from 52WL (%)	7.0
Beta	0.50
Mkt. Cap (₹ bn)	544.2
Enterprise Val (₹ bn)	611.7

Fiscal Year Ended

	FY10A	FY11A	FY12E	FY13E
Revenue (₹bn)	270.3	352.1	405.0	437.4
Net Profit(₹bn)	32.9	39.8	41.0	47.2
Share Capital	12.6	12.6	12.6	12.6
EPS (₹)	26.0	31.4	32.4	37.2
PE (x)	16.5	13.7	13.2	11.5
P/BV (x)	16.5	13.7	13.2	11.5
EV/EBITDA (x)	10.9	9.2	9.7	8.7
ROE (%)	18.5	18.8	16.3	15.9
ROCE (%)	18.6	18.9	15.0	14.0

One-year price chart

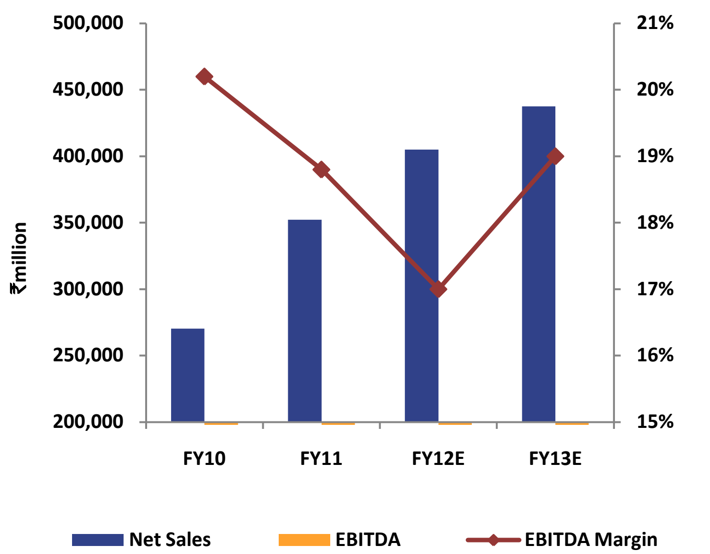


Shareholding Pattern	Sep'11	Jun'11	Diff.
Promoters	57.3%	57.3%	-
Institutional	38.6%	38.7%	(0.10)
General Public	1.9%	2.0%	(0.10)
Others	2.0%	2.0%	0.20

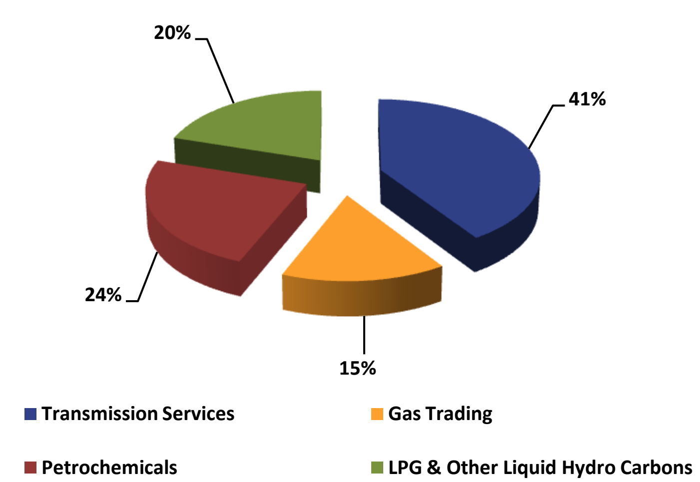
Higher revenues from gas trading lifted Q2FY12 earnings

During Q2FY12, the Navratna gas and pipeline of the country reported a turnover of ₹96.99 billion, reflecting a growth of 20% from ₹81.04 billion in the same period a year ago, backed by significant contribution of ₹67.35 billion revenues from gas trading business. GAIL's revenues from LPG and Liquid Hydrocarbons business increased by 34% at ₹9.88 billion as against ₹7.37 billion in the corresponding period of last year while that from natural gas trading increased by 20% at ₹75.75 billion as against ₹62.90 billion last year. Sales from petrochemicals business have seen a rise of 30% at ₹9.38 billion year on year. The operating profit increased by 12% to ₹17.92 billion during the quarter against ₹16.07 billion in the corresponding period last year. Despite a subsidy burden of ₹5.67 billion, the country's largest gas marketing, transmission and Distribution Company, posted a net profit of ₹10.94 billion, higher by 18.45% from the year-ago period. Going further, we expect the earnings to grow at a reach ~₹43 billion in the coming 2 years with ~30-50 basis point increase in operating margins.

Operating margins likely to stay elevated in long run



Segmental contribution in the Q2FY12 operating profit



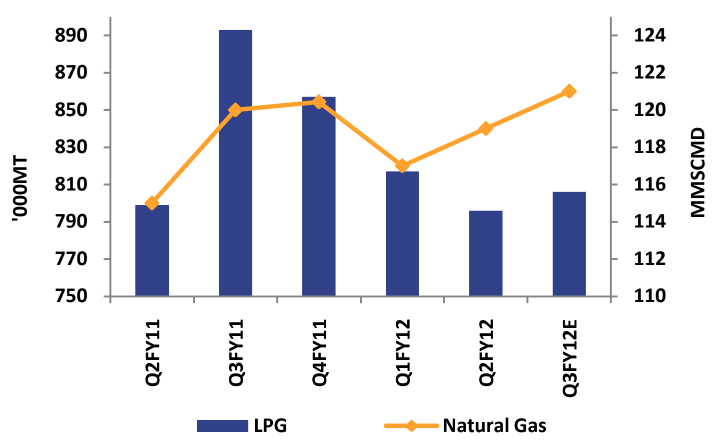
Natural gas transmission capacity to see a CAGR growth of over 30% in next 2 years

GAIL is the only company in India that owns and operates pipelines for exclusive LPG transmission for third party usage. It has a capacity to transport upto 3.8 MMTPA of LPG and transmission throughput of about 3.33 MMTPA. During Q2FY12, GAIL's natural gas transmission volume and tariff gained marginally by 1.3% to 118.6mmscmd and 1.9% to 0.84/scm respectively on QoQ, mainly driven by higher volume off-take of spot and APM gas. However transmission EBIT margin has declined sequentially by 56bps to 3.8% mainly due to higher other expenditure (forex loss on ECB and bad debts provision). Going further, transmission volume of the company is expected to stay around 119-121mmscmd in Q3 and Q4FY12. Beside, GAIL's present Natural gas transmission capacity of over 170 MMSCMD is likely to see a significant growth to over 300 MMSCMD by the end of FY14.

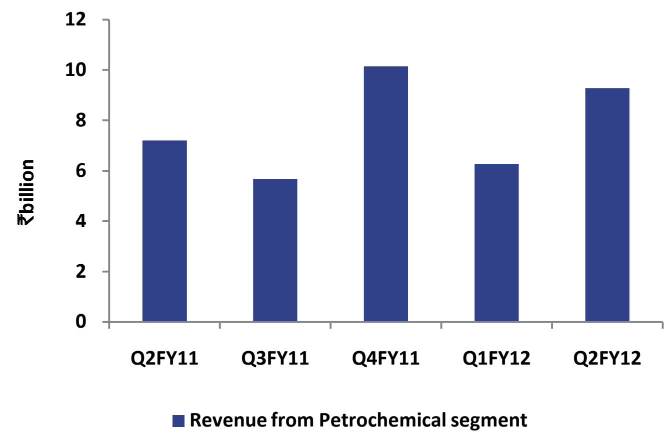
Capacity expansion in the Petrochemical segment provides strong revenue visibility

The company has identified this segment as a strategic business segment for future growth. In this segment, the company has an operating capacity of 0.45 mtpa of HDPE/ LLDPE at Pata, Uttar Pradesh, which is operating over 100% capacity utilization. During FY11, this segment had sales volume of 0.42mn tonnes, with revenue of ₹30 billion. The petrochemical plant of GAIL is operationally efficient as compared to other operator's plant in India, as it uses natural gas to produce the final product. GAIL has presence in petrochemical business with domestic market share of around 20%. This business segment is expected to grow at higher rate taking into consideration the lower per capita plastic consumption of around 8KG. Besides, the company had planned a CAPEX of ₹79 billion over FY12-14. The company is in process to double the capacity at Pata 0.9mtpa by FY14. Also the company is setting up 0.3mtpa petrochemical complex in Assam, through its subsidiary Brahmaputra Cracker and Polymer Ltd (BCPL).

Productivity in the transmission segment to stay buoyant



One year revenue trend from the petrochemical business



GAIL eyes more shale gas assets in the US

After marking its first stake purchase in the US shale gas asset in Q2FY12, GAIL is planning to buy further stakes in other shale gas assets in the US during the coming six months, as it intends to consolidate its presence in shale gas assets in the US and gain expertise for the exploration of an increasingly important fuel source ahead of India's plans to auction shale gas blocks. India plans to launch its first auction round for shale gas exploration blocks by next year.

In Q2FY12, the company purchased 20% stake in Houston-based Carrizo Oil & Gas Inc.'s Eagle Shale Ford acreage via wholly owned unit GAIL Global (USA) Inc. for an outlay of $95 million and intends invest about $300 million in the asset over five years. Under the joint venture arrangement with Carrizo, GAIL will drill an additional 139 wells in the shale acreage, which is producing 2,350 barrels of oil equivalent a day. GAIL will get 470 barrels of oil equivalent a day as its share. The alliance is also expected work together in exploring shale gas opportunities in India and other countries outside of the US.

This transaction represents a major step in GAIL's efforts to establish its presence in North America. As the next logical step, GAIL Global will consider expanding its business portfolio in the North American market by pursuing various upstream and midstream opportunities, including liquefied natural gas export to India. A decline in production of gas in India is driving demand for imported LNG, boosting earnings of companies such as Petronet LNG Ltd. and GAIL, which import the super-cooled fuel.

GAIL to open LNG trading desk in Singapore in Q3 FY12

GAIL is actively scouting for LNG from various sources for both its long-term as well as short-term requirement. In this regard, the company intends to setup a LNG trading desk in Singapore during Q3FY12, to source fuel for meeting growing energy demand of the country. Apart from, identifying potential LNG suppliers for long term, short term and spot supplies, and undertaking commercial negotiation for LNG supplies, the desk would also look at logistics and shipping requirements for moving LNG to India. Besides, GAIL would also enter into price and supply hedging, and would develop model for long term, medium term and short term sales purchase agreements. Also, it would trade LNG quantities for Arbitrages in India and Abroad.

GAIL to join hands with GCGSC to strengthen presence in Bengal

GAIL has received clearance from the State-government of West Bengal to form a joint venture with Greater Calcutta Gas Supply Corporation (GCGSC) for reviving and expanding supply of natural gas as green fuel to automobiles and households in the region. The joint venture agreement likely to be signed in the second week of November 2011, will be held equally by GAIL and refiner-marketer Hindustan Petroleum with 37% stake while GCGSC will have 26% equity and veto power in the joint venture board. GAIL has also proposed setting up a new plant at Dankuni to augment supplies to Kolkata. The upcoming joint venture would allow GAIL to have access in the areas where Greater Calcutta Gas already has a presence while it will bid for new areas in the forthcoming licensing round. GAIL also plans to invest in building a transmission network for gas imported in ships in Bengal, to bank on growing demand in the state.

Expanded pipeline network - opens new avenues for GAIL

Most gas players have planned pipeline expansions. Gas is a sector where supply will help increase consumption. There is huge requirement for natural gas in the country. With supply likely to increase on account of the KG basin gas and higher LNG supplies, demand is likely to increase further. To meet the higher demand, pipeline connectivity is likely to be needed. The expanded pipeline is likely to open new avenues for demand; thus, increasing transmission volumes. GAIL is the only company in India which owns and operates pipeline for exclusive LPG transmission. There are two pipeline transmission systems with a total length of about 2,038 KM. This segment has a capacity to transport 4 mtpa of LPG. LPG transmission was about 3 mn tonnes in FY11, with revenue of ₹5 billion. Management expects increase of 10-15 mmscmd (currently producing ~120 mmscmd) in FY12, also being quiet optimistic on domestic supply scenario in long term. Moreover, GAIL is expected to transport gas sourced from Turkmenistan-Afghanistan-Pakistan-India (TAPI) pipeline, which is anticipated to supply around 38 mmscmd of gas to India by 2014-15.

New Pipeline Capacity Built-up

Pipeline projects	Approved Cost (₹ bn)	Capacity (mmscmd)	Length (km)	Anticipated completion (status)
Dvpl pipelines – Phase II	58.37	24 to 78	610	Mainline compressor commissioned at Jabhua and Vijaipur. Standby machine at Jhabua by June 11 and Vijaipur Dec 11.
Vijaipur Dadri Pipelines	49.27	20 to 80	499	Vijaipurdadri pipeline commissioned compressor at Kailaras and Chainsa: Commissioning by Dec 2011.
Dadribawana- Nangal Pipeline	23.58	31	594	Dadri bawana pipeline commissioned. Bawana nangal: commissioning by Dec 2011
Chainsajhajjar- Hissar Pipeline	13.15	35	349	Chainsa Sultanpur: Commissioned. Sultanpur Neemrana: Commissioned
Jagdishpurhaldia Pipeline	75.96	32	2050	Being implemented in phased manner 201314 onwards
Dhabolbangalore Pipeline	49.94	16	1414	Phase I – Aug 2012 Phase II – December 2012
Kochikoottanad-Mangalore	32.63	16	1,126	Phase I – August 2012 Phase II – December 2012
TOTAL	**302.90**		**6,642**	

Potential upside from presence in city gas distribution (CGD)

According to the petroleum ministry's 'Vision 2015', 200 cities are likely to be covered under the CGD network. GAIL is present in 12 cities, either directly or through joint ventures and is planning to ramp up its presence to 50 cities in the next four to five years. However, the approvals for setting up CGD networks need to come from the PNGRB. Currently, Indraprastha Gas (IGL IN, NR), one of GAIL's joint ventures, distributes gas in the National Capital Region, while Mahanagar Gas, another joint venture, distributes in Mumbai. GAIL's gas distribution business has the potential to reach 20mmscmd by 2015.

GAIL has set up GAIL Gas, a 100% subsidiary, to develop CGD networks—in line with the PNGRB proposal, which states that the CGD business needs to be separate from the gas marketing business. Since its incorporation, GAIL Gas has bid to set up CGD networks in nine cities and has won the rights for four (Dewas, Meerut, Sonepat and Kota). The company is further planning to participate in upcoming PNGRB bidding rounds for other city gas projects. The CGD business is likely to help improve EBITDA margins as the target consumers are likely to be small industries for piped natural gas (PNG). Compressed natural gas (CNG) also is likely to take precedence in the CGD network as the government is keen to move towards greener fuel for transportation.

Hike in fuel price ~ feel good factor for upstream companies

The recent fuel price hike (diesel price by ₹3/litre, LPG prices by ₹50/cylinder and Kerosene by ₹2/litre) coupled with re-jigging of the duty structure by the Empowered Group of Ministers (EGoM), provided the much needed relief to both upstream companies and OMC's which are in a distress scenario considering the under recoveries and subsidy burden.

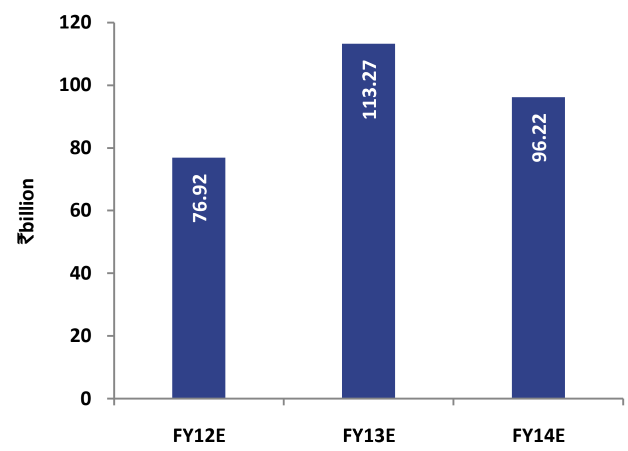
The much awaited measures results in lessening of under recoveries by ₹700 billion accumulation of ₹210 billion on account of price hikes and ₹490 billion on account of duty cuts. The ballpark under recoveries remains over ₹970 billion in FY'12 and ₹1,030 billion in FY'13 against ₹1,675 billion and ₹1,725 billion for FY'12E & FY'13E before price hike. As a result, the subsidy sharing of upstream companies is likely to fall to ₹789.7 billion in FY'12E and to ₹835.9 billion in FY'13E against ₹1,356.7 billion &₹1,397.3 billion estimated for FY'12E & FY'13E, if the price hike and duty cuts were not under taken by the government based on 81% sharing formula.

Under recoveries in FY'11 and FY'12E is lower than FY'08 and FY'09 despite $15-20 higher crude oil price. During Q2 FY'12 GAIL contributed ₹5.67 billion against ₹6.82 billion during Q1 FY'12 to subsidize cooking gas which was sold by state oil marketing companies below market price. Upstream companies have shared only 33.3% of total subsidy and GAIL paid only 4.5% of total upstream share. A moderation in crude prices from FY'12E to FY'14E would ease subsidy burden and augment profit. The proposed cap on subsidized LPG cylinders per household, if implemented, would also lower subsidy burden and augment earnings.

Elevated Capex level

GAIL expects to incur substantial capex in the transmission segment in view of the incremental gas volumes expected from the KG basin, GSPC, marginal fields and new LNG terminals. However, stagnant production at the KG basin and higher LNG prices are a cause of concern on the volume front. The management has outlined a mega capex plan of ₹286.41 billion for the next 3 years from FY'12E to FY'14E, of which 39% will be dedicated towards expanding its pipeline infrastructure, which would strain returns in the medium term as the capex is expected to yield returns starting FY'15E. GAIL plans to double its pipeline capacity over the next 3 years will result in a pipeline capacity of 300+mmscmd, increasing pipeline network to 14000+km and higher share of the Transmission Segment in its overall business mix.

Aggressive Capex plan to boost growth further



Dominant market position

Given that domestic supply of natural gas would not be adequate to meet demand over the medium to long term, India would have to rely on either imported LNG or gas sourced through transnational pipelines to meet a part of the incremental demand. There has not been much progress on the proposed Iran-Pakistan-India (IPI) pipeline. And while we await further milestones to materialise to consider the potential flow of 38 MMSCMD of gas through the Turkmenistan-Afghanistan-Pakistan-India (TAPI) pipeline, the analysis here focuses on the available opportunities for GAIL in the gas transmission space in the Indian market.

Foray into Power business to add another revenue wing

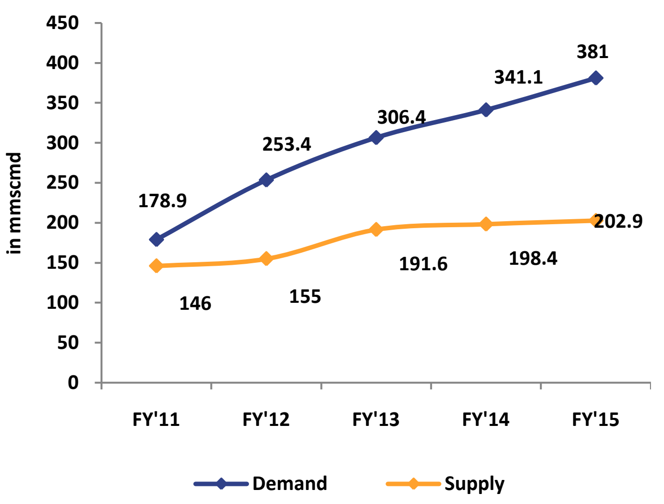
Under its initiative to foray into the power sector, GAIL has also tied up with Uttarakhand Jal Vidyut Nigam Limited (UJVN), the state-run hydropower company to set up two gas-based power plants of 350 Mw each in Uttarakhand. A total of ₹25 billion is proposed in the two power plants at Kashipur and Haridwar towns. The majority of the power from these power plants would be sold to Uttarakhand through a long-term power purchase agreement (PPA). However, both the projects are yet to receive Cabinet's approval. This move of the company wouldn't only add another wing to its revenue basket bit would also revenue reduce dependency on its core business.

The Oil & Gas Industry

Robust economic outlook supporting surge in demand

Demand for crude has remained robust on the back of improved economic outlook for world economy including USA, ease in liquidity concerns in European economies and, rapid industrialization in emerging economies like India, China and, Brazil. Global oil demand in 2012 is expected to rise by 1.5 mb/d year-on-year to 91.0 mb/d, on the back of surge in global GDP growth of 4.4% during 2012 against 4.2% expected in 2011 by IMF. The Asian giants, China and India are expected to grow at 9.6% and 8.2% respectively for 2011, as per the IMF. The non-OECD countries will account for this growth, with OECD demand declining slightly. The global estimate for 2011 is raised by0.2 mb/d to 89.5 mb/d (+1.2 mb/d year-on-year), with upward non-OECD baseline revisions outweighing downward adjustments in the OECD on persistent high prices and weaker economic activity.

Present & future gas demand-supply Scenario



Indian demand by products

Products (000, barrels/day)	Demand			% Change	
	2010	2011	2012	2011	2012
LPG & Ethane	455	495	523	8	6.3
Naptha	200	194	183	-3.3	-5.5
Motor Gasoline	338	363	388	7.6	6.7
Jet Fuel	299	306	310	2.1	1.4
Gas/Diesel	1,290	1,365	1,440	5.8	5.5
Residual Fuel	194	187	192	-3.5	2.2
Others	560	555	558	-1	0.6
Total	3,337	3,461	3,593	4	4

Indian Scenario

Indian demand rose by 5.7% year-on-year in May, following slower growth of 3.3% in April, with LPG (+12.8%), gasoil (+10.2%) and gasoline (+7.8%) posting the strongest gains. In June 2011, authorities raised domestic prices for gasoil, LPG and kerosene (by 9%, 14% and 20%, respectively). The government also reduced tariffs on imported diesel and gasoline to 2.5% from 7.5% in an effort to provide offsetting relief from the move.

IEA has envisaged Indian oil demand in 2011; continue to be driven primarily by outlook of strong economic growth (+8.2%). Total petroleum demand is seen mounting by 3.7% (+125 kb/d) to 3.5 mb/d. In 2012, GDP growth slows slightly to 7.8%. Yet, oil demand growth is seen maintaining its pace, expanding by 3.8% (+130 kb/d) to 3.6 mb/d, led by gasoil, LPG and gasoline.

Global Scenario

In near future, the entry of new players globally will expand the market and develop new trade flows. Presently, developed world economies are still recovering from the financial meltdown that began towards the end of 2008 and continued through 2009 with additional concern on Europe crisis. The global economic recovery would consequently lead to price and volume recovery in the LNG trade. With the US retooling its re-gasification terminals for LNG, LNG market has changed significantly. This will have a major impact on countries like Qatar, which were gearing up their LNG supply chain with super-sized LNG trains of 7.8 mmtpa capacity.

Outlook

Given India's growing energy requirements and unlikelihood of matching the demand-supply gap, despite some significant oil & gas finds recently, the import dependence is only going to accentuate sharply in the coming years. By 2025, India is expected to be dependent on imports for around 44% of its supply and would require nearly 5,100 mmscmd of imported gas. India's LNG import capacity is expected to surge to 47.5 million tonnes annually in 2015-16 and 62.5mtpa in 2019-20.

Balance Sheet (Consolidated)

(₹million)	FY10A	FY11A	FY12E	FY13E
Share Capital	12,684.8	12,684.8	12,684.8	12,684.8
Reserve and surplus	165,414.7	199,453.9	238,793.4	284,284.5
Net Worth	178,099.5	212,138.7	251,478.2	296,969.3
Minority Interest	2,302.2	5,471.9	5,471.9	5,471.9
Loan funds	54,007.5	69,041.0	124,292.6	183,254.8
Deferred Tax Liability	14,650.0	17,151.0	17,151.0	17,151.0
Capital Employed	249,059.2	303,802.6	398,393.7	502,847.0
Gross fixed assets	251,640.3	266,051.4	323,425.3	452,411.3
Less: acc. depreciation	98,336.1	106,429.4	115,393.2	127,863.0
Net Fixed assets	153,304.2	159,622.0	208,032.1	324,548.3
Capital WIP	48,818.4	106,367.9	151,187.4	132,965.7
Total Fixed Assets	202,122.6	265,989.9	359,219.5	457,514.0
Investment	10,651.3	12,362.5	12,500.0	12,500.0
Net Current Assets	36,285.3	25,450.4	26,674.2	32,833.0
Capital Deployed	249,059.2	303,802.8	398,393.7	502,847.0

Profit & Loss Account (Consolidated)

(₹million)	FY10A	FY11A	FY12E	FY13E
Operating Income	**270,305.5**	**352,190.0**	**405,018.5**	**437,420.0**
Operating Expenses	215,775.5	285,990.0	336,165.4	354,310.2
EBITDA	**54,530.0**	**66,200.0**	**68,853.1**	**83,109.8**
EBITDA Margin (%)	20.2	18.8	17.0	19.0
Depreciation	8,234.3	8,879.8	8,963.8	12,469.8
EBIT	**46295.7**	**57320.2**	**59889.3**	**70640.0**
EBIT Margins (%)	17.1	16.3	14.8	16.1
Interest	3,850.0	3,778.6	6,750.0	8,712.7
Other Income	5,800.0	4,450.0	5,550.0	5,550.0
PBT	**48,245.7**	**57,991.6**	**58,689.3**	**67,477.3**
Tax	15,310.0	18,181.0	17,606.8	20,243.2
Net Profit	**32,935.7**	**39,810.6**	**41,082.5**	**47,234.1**
Net Profit Margin (%)	12.2	11.3	10.1	10.8

Key Ratios

	FY10A	FY11A	FY12E	FY13E
EBITDA Margin (%)	20.2	18.8	17.0	19.0
EBIT Margin (%)	17.1	16.3	14.8	16.1
NPM (%)	12.2	11.3	10.1	10.8
ROCE (%)	18.6	18.9	15.0	14.0
ROE (%)	18.5	18.8	16.3	15.9
EPS (₹)	26.0	31.4	32.4	37.2
CEPS(₹)	32.5	38.4	39.5	47.1
P/E (x)	16.5	13.7	13.2	11.5
BVPS	140.4	167.2	198.3	234.1
P/BVPS (x)	16.5	13.7	13.2	11.5
EV/Operating Income (x)	2.2	1.7	1.6	1.7
EV/EBITDA (x)	10.9	9.2	9.7	8.7

Valuation and view

GAIL has a long term strategy to capitalize on the prevailing strong and steady demand for Oil & Gas in India. The company's strategy to aggressively expand its assets based, enhanced visibility over transmission volumes, tied with apt management would augurs well for the company in ensuring days.

GAIL is attractively placed at P/E of ~ 11.5x FY13E despite concerns regarding subsidy share. Considering the above aspects, we rate the stock as 'BUY' at the current market price of ₹429 the stock is expected to attract 'Premium' over other players.

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