Sharekhan by BNP PARIBAS

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Stock Update

GAIL (India) Limited

Weak gas marketing performance; Pipeline monetisation key catalyst

Oil & Gas	Sharekhan code: GAIL	Result Update

3R MATRIX	+	=	-
Right Sector (RS)	✓		
Right Quality (RQ)	✓		
Right Valuation (RV)	✓		

\+ Positive = Neutral - Negative

What has changed in 3R MATRIX

	Old		New
RS		↔	
RQ		↔	
RV		↔	

Reco/View	Change
Reco: **Buy**	↔
CMP: **Rs. 134**	
Price Target: **Rs. 155**	↑

↑ Upgrade ↔ Maintain ↓ Downgrade

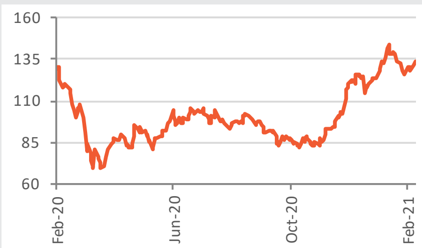
Company details

Market cap:	Rs. 60,233 cr
52-week high/low:	Rs. 146 / 66
NSE volume: (No of shares)	195.6 lakh
BSE code:	532155
NSE code:	GAIL
Free float: (No of shares)	215.9 cr

Shareholding (%)

Promoters	52.1
FII	15.6
DII	19.9
Others	12.4

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	-1.6	43.7	37.3	3
Relative to Sensex	-5.7	26.0	3.7	-21

Sharekhan Research, Bloomberg

Summary

- Q3FY2021 operating profit of Rs. 1,920 crore (up 43.4% q-o-q) missed our estimate by 12% due to EBITDA loss of Rs. 45 crore for the gas marketing business, which offset robust petchem EBITDA (up 5.2x y-o-y to Rs. 549 crore).
- Volumes across segments are back to pre-COVID-19 levels with gas transmission/marketing volume at 110 mmscmd/96 mmscmd and petchem utilisation at 106%.
- Earnings to improve over FY2022-FY2023, as higher gas demand from fertilser plants in India would address concerns of marketing of US LNG contracts, sustained high petchem profitability, and 5%-6% annual growth in gas transmission volumes.
- Valuation of 6.1x its FY2023E EV/EBITDA seems attractive given potential value unlocking from monetisation of gas pipeline assets and dividend yield of ~5%. Hence, we maintain our Buy rating on GAIL with a revised PT of Rs. 155.

GAIL's Q3FY2021 operating profit at Rs. 1,920 crore (down 7.4% y-o-y; up 43.4% q-o-q) was 12% below our estimate of Rs. 2,184 crore due to EBITDA loss of Rs. 45 crore for the gas marketing business as compared to our and street expectation of positive EBITDA contribution from the segment. However, the petrochemical segment reported very strong performance with 5.2x y-o-y and 1.9x q-o-q jump in EBITDA to Rs. 549 crore in Q3FY2021, led by higher petrochemical sales volume at 231kt (up 9.5% y-o-y) and a Rs. 8,000/tonne q-o-q improvement in realisation. Other segments largely remains stable with the gas transmission segment's EBITDA of Rs. 1,247 crore (up 2.2% y-o-y) as volume recovered to pre-COVID-19 level of 110 mmscmd. The LPG-LHC segment EBITDA was flat q-o-q (down 4.4% y-o-y) at Rs. 304 crore. Reported PAT at Rs. 1,487 crore (up 18.9% y-o-y; up 20% q-o-q) was largely in-line with our estimate as weak gas marketing performance was offset by robust petchem margin, higher other income (up 50.7% y-o-y), and lower effective tax rate at 20.4% (versus assumption of 25.2%). We expect GAIL's earnings to improve considerably over FY2022-FY2023, led by better margins in the gas marketing business (higher sale of US LNG contract in India and stablising spot LNG prices). Additionally, higher HDPE prices bodes well for sustained improvement in the profitability of the petchem business and management has guided 5-6% annual growth in gas transmission volumes (higher gas demand and benefit of unified pipeline tariff). GAIL's valuation of 6.1x its FY2023E EV/EBITDA (32% discount to historical average one-year forward EV/EBITDA multiple of 9x) seems attractive, given potential value unlocking from monetisation of gas pipeline assets and dividend yield of ~5%. Hence, we maintain our Buy rating on GAIL with a revised PT of Rs. 155.

Key positives

- Sharp improvement in profitability of the petchem segment with EBITDA of Rs. 549 crore (up 5.2x y-o-y).
- Gas transmission volume recovered back to pre-COVID-19 level of 110mmscmd; management has guided for sustainable 5%-6% growth in gas transmission volume annually.

Key negatives

- Continued weak performance of the gas trading segment with EBITDA loss of Rs. 45 crore versus EBITDA loss of Rs. 335 crore in Q2FY2021.

Our Call

Valuation – Maintain Buy on GAIL with a revised PT of Rs. 155: We have increased our FY2021-FY2023 earnings estimates to factor improved profitability for the petrochemical business, higher other income partially offset by lower profitability of the gas trading business for FY2021. We expect GAIL's earnings to improve sharply over FY2022E-FY2023E, as volumes have largely reached normal levels, profitability of gas marketing to improve as higher gas demand in India from the fertiliser plant would address concerns of marketing of US LNG contracts, and better earnings from the petchem segment. Despite the sharp 44% run-up in the stock price in the past three months, GAIL's valuation of 6.1x its FY2023E EV/EBITDA (32% discount to historical average one-year forward EV/EBITDA multiple of 9x) seems attractive, given potential value unlocking from monetisation of gas pipeline assets and dividend yield of ~5%. Hence, we maintain our Buy rating on GAIL with a revised PT of Rs. 155 (reflects higher valuation for petchem and increased value of listed investments).

Key Risks

Lower-than-expected gas transmission and marketing volumes amid COVID-19 demand slowdown. A sharp decline in LNG price and international oil prices could impact profitability of gas trading, petrochemical, and LPG-LHC segments.

Valuations (Standalone) Rs cr

Particulars	FY19	FY20	FY21E	FY22E	FY23E
Revenue	75,126	71,871	60,698	80,416	85,360
OPM (%)	12.7	11.6	10.2	11.8	11.9
Adjusted PAT	6,352	6,519	4,237	6,467	6,808
% YoY growth	38.4	2.6	-35.0	52.6	5.3
Adjusted EPS (Rs.)	14.1	14.5	9.4	14.3	15.1
P/E (x)	9.5	9.2	14.2	9.3	8.8
P/B (x)	1.4	1.4	1.3	1.2	1.1
EV/EBITDA (x)	6.3	7.7	10.3	6.6	6.1
RoNW (%)	15.0	14.8	9.4	13.4	13.1
RoCE (%)	18.7	14.1	9.9	14.4	14.4

Source: Company; Sharekhan estimates

Operating profit missed our and street estimates due to weak gas marketing performance offseting robust growth in petchem earnings; PAT in-line with estimates

GAIL's Q3FY2021 operating profit at Rs. 1,920 crore (down 7.4% y-o-y; up 43.4% q-o-q) was 12% below our estimate of Rs. 2,184 crore due to EBITDA loss of Rs. 45 crore from the gas marketing business as compared to our and street expectation of positive EBITDA contribution from the segment. However, the petrochemical segment reported very strong performance with 5.2x y-o-y and 1.9x q-o-q jump in EBITDA to Rs. 549 crore in Q3FY2021, led by higher petrochemical sales volume at 231kt (up 9.5% y-o-y) and a Rs. 8,000/tonne q-o-q improvement in realisation. Other segment largely remained stable with the gas transmission segment EBITDA of Rs. 1,247 crore (up 2.2% y-o-y) as volume recovered to pre-COVID-19 level of 110 mmscmd. The LPG-LHC segment's EBITDA was flat q-o-q (down 4.4% y-o-y) at Rs. 304 crore despite sequential improvement at 319kt (up 7.4% q-o-q) and lower APM gas price. Reported PAT at Rs. 1,487 crore (up 18.9% y-o-y; up 20% q-o-q) was largely in-line with estimate as weak gas marketing performance was offset by robust petchem margin, higher other income (up 50.7% y-o-y), and lower effective tax rate at 20.4% (versus assumption of 25.2%).

Q3FY2021 results conference call highlights

- **Volume reached pre-COVID-19 level across segments –** Management has indicated that all plants are operating at optimum utilisation level and volumes across segments are back to pre-COVID-19 levels. Gas transmission/marketing volume has achieved pre-COVID-19 level of 110mmscmd/96mmscmd in Q3FY2021. The utilisation of natural gas pipelines has improved to 54% versus 52% in Q2FY2021. There has been significant improvement in petchem plant utilisation to 106% with production volume of 233kt (up 9.5% y-o-y) in Q3FY2021.
- **Pipeline monetisation update –** Management indicated that pipeline InvIT is a complex transaction; and as of now, GAIL has not decided which all pipelines would be part of InvIT. Management would evaluate the commercial aspects of pipeline monetisation (as announced the recent budget) and communicate to investors at an appropriate time.
- **Gas marketing busines profitability outlook –** Management expects almost 50% of the US cargos would come to India, which would earn reasonable marketing margins, while LNG cargos going to the international market would be marginally profitable. The target is to bring all US LNG cargos to India by CY2022. Thus, we expect profitability of the gas marketing business to revert back to historical levels.
- **Gas transmission volume growth outlook –** Management has indicated that ~6-7 new natural gas pipelines are expected to get completed by the end of 2021 and, thus, expects 5%-7% transmission volume growth. Overall, the company would add 5,000 km of new pipelines over the next 3-4 years, which will take the total natural gas pipeline network to Rs. 18,000-19,000 kms versus 12,800 km currently.
- **Capex guidance –** Management has maintained its capex guidance of Rs. 6,600 crore for FY2021. The company has spent Rs. 3,670 crore in 9MFY2021. The company plans to spend Rs. 6,600 crore for FY2022 mainly on pipeline equity, petrochemical, and CGD business.
- **Urja Ganga pipeline –** Work on Urja Ganga pipeline is progressing well and the company has spent Rs. 10,700 crore till date (out of the total project cost of Rs. 14,500 crore). The company is regularly receiving government capital grants with receipt of Rs. 4,048 crore till date as against total grant to be received at Rs. 5,176 crore. Management has guided for gas volume of 11 mmscmd from pipeline, which help would reduce concerns on marketing of US LNG.
- **US LNG cargos –** GAIL has purchased 64 US LNG cargos in 9MFY2021. Out of this, 26 LNG cargos were outside India and the remaining cargos were brought to India. GAIL received total 23 US LNG cargos in Q3FY2021 (15 from Sabine Pass and 8 from Dominion Cove Point) as compared to 20 cargos in Q2FY2021. Out of the total cargos in Q3FY2021, 11 were sold in the overseas market and remaining were brought to India either directly or through swap agreements.
- **Segment-wise PBT performance –** In the gas transmission segment, PBT stood at Rs. 977 crore versus Rs. 1,009 crore in Q2FY2021. In the petrochemical segment, PBT increased to Rs. 423 core versus Rs. 170 crore in Q2FY2021 on account of Rs. 8,000/tonne increase in prices, and higher sales volume and lower cost of production as utilisation improved sharply in Q3FY2021. PBT for the LPG-LHC segment was at Rs. 283 crore versus Rs. 280 crore in Q2FY2021. Loss in the gas marketing segment narrowed down to Rs. 74 crore as compared to Rs. 365 crore in Q2FY2011 due to better pricing in the domestic market and higher spot crude and gas prices.

- **GAIL gas performance –** Revenue stood at Rs. 1,058 crore and PBT was at Rs. 57 crore in Q3FY2021.
- **Kochi-Mangalore gas pipeline –** The company has commissioned Kochi-Mangalore pipeline in November 2020 and is currently supplying 0.8mmscmd of gas to a fertilizer plant on the pipeline route.
- Construction work for 1,650 km pipeline network in eastern regions (at capital cost of Rs. 9,300 crore is progressing well.
- An independent gas transport system is expected to be established (as per budget announcements), which would oversee pipeline booking and charge money to manage customers.

Results Rs cr

Particulars	Q3FY21	3FY20	YoY %	Q2FY21	QoQ %
Reported net Sales	**15,454**	**17,767**	**-13.0**	**13,643**	**13.3**
Adjusted net sales	15,454	17,767	-13.0	13,643	13.3
Total Expenditure	13,535	15,695	-13.8	12,305	10.0
Reported operating profit	**1,920**	**2,072**	**-7.4**	**1,338**	**43.4**
Adjusted operating profit	**1,920**	**2,072**	**-7.4**	**1,338**	**43.4**
Other Income	471	312	50.7	724	-35.0
Interest	33	24	37.1	27	20.7
Depreciation	490	489	0.1	484	1.1
Exceptional income/(expense)	0	0		0	
Reported PBT	1,868	1,872	-0.2	1,550	20.5
Adjusted PBT	1,868	1,872	-0.2	1,550	20.5
Tax	380	621	-38.7	311	22.4
Reported PAT	1,487	1,251	18.9	1,240	20.0
Adjusted PAT	**1,487**	**1,251**	**18.9**	**1,240**	**20.0**
Equity Cap (cr)	451	451		451	
Reported EPS (Rs.)	3.3	2.8	18.9	2.7	20.0
Adjusted EPS (Rs.)	3.3	2.8	18.9	2.7	20.0
Margins (%)			**BPS**		**BPS**
Adjusted OPM	12.4	11.7	76	9.8	261
Effective tax rate	20.4	33.2	-1281	20.0	33
Adjusted NPM	9.6	7.0	259	9.1	54

Source: Company; Sharekhan Research

Segmental EBITDA Rs cr

Particulars	Q3FY21	3FY20	YoY %	Q2FY21	QoQ %
Natural gas transmission	1,247	1,220	2.2	1,281	-2.7
LPG transmission	109	108	0.9	103	5.8
Natural gas trading	-45	524	-108.6	-335	-86.6
Petrochemicals	549	105	422.9	289	90.0
LPG and Liquid hydrocarbons	304	318	-4.4	302	0.7
Others	227	110	106.4	422	-46.2
Total EBITDA	**2,391**	**2,385**	**0.3**	**2,062**	**16.0**

Source: Company; Sharekhan Research

Segment wise volume performance

Particulars	Q3FY21	3FY20	YoY %	Q2FY21	QoQ %
Natural gas transmission (mmscmd)	110	110	0.0	106	3.6
LPG transmission (kmt)	1,088	1,043	4.3	1,058	2.8
Natural gas trading (mmscmd)	96	96	-0.4	89	7.9
Petrochemicals (kmt)	231	211	9.5	224	3.1
LPG and Liquid hydrocarbons (kmt)	319	337	-5.3	297	7.4

Source: Company; Sharekhan Research

Outlook and Valuation

■ Sector view - Ramp-up of infrastructure and regulatory support to boost gas transmission volumes

We expect strong gas transmission volumes for gas utilities to be supported by robust gas demand outlook led by: 1) higher demand from the power, CGD, and fertiliser sectors; 2) regulatory push to switch to gas from polluting industrial/auto fuels; and 3) low domestic gas prices. Moreover, share of gas in India's overall energy mix is only at 6.3% as compared to the global average of 24.2%. The government's target to increase the share gas to 15% by 2025 would drive robust gas consumption. Thus, we expect sustainable mid-single digit growth in India's gas demand for the next 4-5 years.

■ Company outlook - Volume revival to aid earnings recovery

GAIL's gas transmission volumes have recovered close to pre-COVID-19 levels and are currently at above FY2020 level of 108mmscmd. The sharp recovery in volumes, >100% utilisation of petchem plants, lower domestic gas price, and improvement in petchem prices would drive earnings revival for GAIL over the next few quarters. Low gas price and regulatory support would mean sustainable 5%-6% volume growth for the gas transmission and trading business over the medium to long term.

■ Valuation - Maintain Buy on GAIL with a revised PT of Rs. 155

: We have increased our FY2021-FY2023 earnings estimates to factor improved profitability for the petrochemical business, higher other income partially offset by lower profitability of the gas trading business for FY2021. We expect GAIL's earnings to improve sharply over FY2022E-FY2023E, as volumes have largely reached normal levels, profitability of gas marketing to improve as higher gas demand in India from the fertiliser plant would address concerns of marketing of US LNG contracts, and better earnings from the petchem segment. Despite the sharp 44% run-up in the stock price in the past three months, GAIL's valuation of 6.1x its FY2023E EV/EBITDA (32% discount to historical average one-year forward EV/EBITDA multiple of 9x) seems attractive, given potential value unlocking from monetisation of gas pipeline assets and dividend yield of ~5%. Hence, we maintain our Buy rating on GAIL with a revised PT of Rs. 155 (reflects higher valuation for petchem and increased value of listed investments).

One-year forward EV/EBITDA band

Source: Sharekhan Research

About company

GAIL is a dominant domestic gas utility company primarily engaged in gas transmission and marketing businesses. The company owns ~10,900 km of gas pipelines and holds a ~78% market share in India's natural gas transmission business. GAIL also owns and operates gas-based petrochemical plants with a capacity of 880 ktpa and LPG-LHC production facilities. The company also holds a substantial interest in city gas distribution (CGD) business with stakes in CGD companies or through subsidiaries. GAIL also owns LNG import terminals.

Investment theme

Strong gas demand supported by low LNG prices and improving gas supplies (through upcoming LNG terminals and higher domestic gas production) bode well for improvement in GAIL's gas transmission volumes in the next 2-3 years. Moreover, stabilisation of petrochemical capacity would help in higher production and the benefit of better realisation (supported by stable-to-rising oil prices) bodes well for an earnings revival in the segment. The unbundling of gas transmission and marketing business could result in value unlocking for GAIL. The recent recovery in gas transmission and trading volume would aid earnings recovery.

Key Risks

- Lower-than-expected gas transmission and marketing volumes amid COVID-19 demand slowdown.
- A sharp decline in oil prices could impact petrochemical and LPG-LHC realisation and profitability of the segments.

Additional Data

Key management personnel

Manoj Jain	Chairman & MD
A.K. Tiwari	Director (Finance)
E.S. Ranganathan	Director (Marketing)

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	ICICI Prudential Asset Management	3.5
2	HDFC Asset Management Co Ltd	2.7
3	Vanguard Group Inc/The	1.3
4	Franklin Resources Inc	1.2
5	SBI Funds Management Pvt Ltd	1.1
6	BlackRock Inc	1.0
7	Norges Bank	0.8
8	Dimensional Fund Advisors LP	0.6
9	FMR LLC	0.5
10	UTI Asset Management Co Ltd	0.5

Source: Bloomberg

Understanding the Sharekhan 3R Matrix

Right Sector	
Positive	Strong industry fundamentals (favorable demand-supply scenario, consistent industry growth), increasing investments, higher entry barrier, and favorable government policies
Neutral	Stagnancy in the industry growth due to macro factors and lower incremental investments by Government/private companies
Negative	Unable to recover from low in the stable economic environment, adverse government policies affecting the business fundamentals and global challenges (currency headwinds and unfavorable policies implemented by global industrial institutions) and any significant increase in commodity prices affecting profitability.
Right Quality	
Positive	Sector leader, Strong management bandwidth, Strong financial track-record, Healthy Balance sheet/cash flows, differentiated product/service portfolio and Good corporate governance.
Neutral	Macro slowdown affecting near term growth profile, Untoward events such as natural calamities resulting in near term uncertainty, Company specific events such as factory shutdown, lack of positive triggers/events in near term, raw material price movement turning unfavourable
Negative	Weakening growth trend led by led by external/internal factors, reshuffling of key management personal, questionable corporate governance, high commodity prices/weak realisation environment resulting in margin pressure and detoriating balance sheet
Right Valuation	
Positive	Strong earnings growth expectation and improving return ratios but valuations are trading at discount to industry leaders/historical average multiples, Expansion in valuation multiple due to expected outperformance amongst its peers and Industry up-cycle with conducive business environment.
Neutral	Trading at par to historical valuations and having limited scope of expansion in valuation multiples.
Negative	Trading at premium valuations but earnings outlook are weak; Emergence of roadblocks such as corporate governance issue, adverse government policies and bleak global macro environment etc warranting for lower than historical valuation multiple.

Source: Sharekhan Research

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