Sharekhan by BNP PARIBAS

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Stock Update

GAIL (India) Ltd

Deep value; pipeline monetisation to unlock value

Oil & Gas	Sharekhan code: GAIL	Company 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. 153**	
Price Target: **Rs. 196**	↔

↑ Upgrade ↔ Maintain ↓ Downgrade

Company details

Market cap:	Rs. 67,893 cr
52-week high/low:	Rs. 170/81
NSE volume: (No of shares)	150.4 lakh
BSE code:	532155
NSE code:	GAIL
Free float: (No of shares)	213.9 cr

Shareholding (%)

Promoters	51.8
FII	17.0
DII	19.4
Others	11.8

Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	5.0	0.4	13.8	85
Relative to Sensex	-2.0	-13.2	-5.8	21

Sharekhan Research, Bloomberg

Summary

- A sharp rally in Asian spot LNG price to $20/mmBtu makes GAIL's US LNG contracts attractive as it is available at half the spot LNG prices. We thus expect GAIL's gas trading margin/EBITDA to recover to FY19 level (EBITDA of Rs. 2,859 crore).
- India's gas consumption has increased by 11.3% to ~173 mmscmd in July 2021 versus July 2019 and this augurs well for growth in GAIL's gas transmission volumes (we expect a 7% CAGR over FY21-24E).
- The government's National Monetisation Pipeline plans to monetise GAIL's two gas pipelines (2,229 km) in FY22E and another 5,925 km of pipelines over FY23E-25E. Asset monetisation could unlock value for GAIL.
- Recent under-performance in stock price provides investors an entry point given attractive valuation of 6x FY23E EVE/EBITDA on expectation of a 24% PAT CAGR over FY21-24E. We maintain a Buy on GAIL with an unchanged PT of Rs. 196.

GAIL (India) Limited's gas marketing business is expected to benefit from recent sharp surge in Asian spot LNG price to ~$20/mmBtu as it would help in higher trading margins, given its US LNG contracts are available at ~$10/mmBtu (half of spot LNG prices). India's gas consumption is up 11.3% to ~173 mmscmd in July 2021 over July 2019 and the same would drive robust growth in GAIL's gas transmission volumes in the coming quarters. Strong performance of marketing & transmission would largely offset recent softness in HDPE margin in Q2FY22 but the same has recovered sharply to above $500/tonne in August 2021. Overall, we expect GAIL's earnings to grow strongly by 24% CAGR over FY21-FY24E along with considerable improvement in RoE to ~16% (versus only 10.8% in FY2021).

- **High spot LNG prices bode well for earnings of gas marketing business –** GAIL's US LNG contracts (5.8mtpa) are available at steep discount of ~50% to Asian spot LNG high price of ~$20/mmBtu and the same augurs well for a strong margin-led earnings recovery for gas marketing business. We thus expect profitability of gas marketing business to reach FY2019 levels (reported EBITDA of Rs. 2,859 crore). Ramp-up/ commissioning of domestic fertilizer plants (volume potential 10-12 mmscmd) would further improve earnings visibility for the segment.
- **Rising domestic gas consumption to drive strong growth in gas transmission volume –** India's gas consumption has witnessed a sharp increase of 11.3% to ~173 mmscmd in July 2021 over July 20219 led by high demand from fertilizer and CGD sectors given ramp-up in the domestic gas production to 93mmscmd (up 25% y-o-y). We expect GAIL's gas transmission volume to clock 7% CAGR over FY21-24E. Potential inclusion of natural gas under the GST regime could further improve gas demand in India.
- **Asset monetisation to unlock value –** The government's National Monetisation Pipeline (NMP) has hinted plans to monetise GAIL's two pipelines (2,229 km) - Dabhol-Bengaluru and Dahej-Uran-Panvel-Dabhol in FY22E and another 5,925 km of pipelines over FY23E-25E. Gas pipeline asset monetisation could unlock value and possibility improve dividend payout going forward.

Our Call

Valuation – Maintain Buy on GAIL with an unchanged PT of Rs. 196: GAIL's valuation of 6x its FY2023E EV/EBITDA (at a 30% discount to historical average one-year forward EV/EBITDA multiple of 8.6x) seems attractive, given expectations of a strong earnings revival and potential value unlocking from monetisation of gas pipeline assets. Hence, we maintain a Buy rating on GAIL with an unchanged PT of Rs. 196.

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.

Valuation (Standalone) Rs cr

Particulars	FY21	FY22E	FY23E	FY24E
Revenue	56,730	81,632	90,005	95,434
OPM (%)	11.4	13.6	13.9	14.1
Adjusted PAT	4,890	7,910	8,798	9,316
% YoY growth	-25.0	61.8	11.2	5.9
Adjusted EPS (Rs)	11.0	17.8	19.8	21.0
P/E (x)	13.9	8.6	7.7	7.3
P/B (x)	1.5	1.3	1.2	1.1
EV/EBITDA (x)	11.2	6.4	6.0	5.9
RoNW (%)	10.8	16.2	16.4	15.8
RoCE (%)	10.8	16.4	16.5	15.9

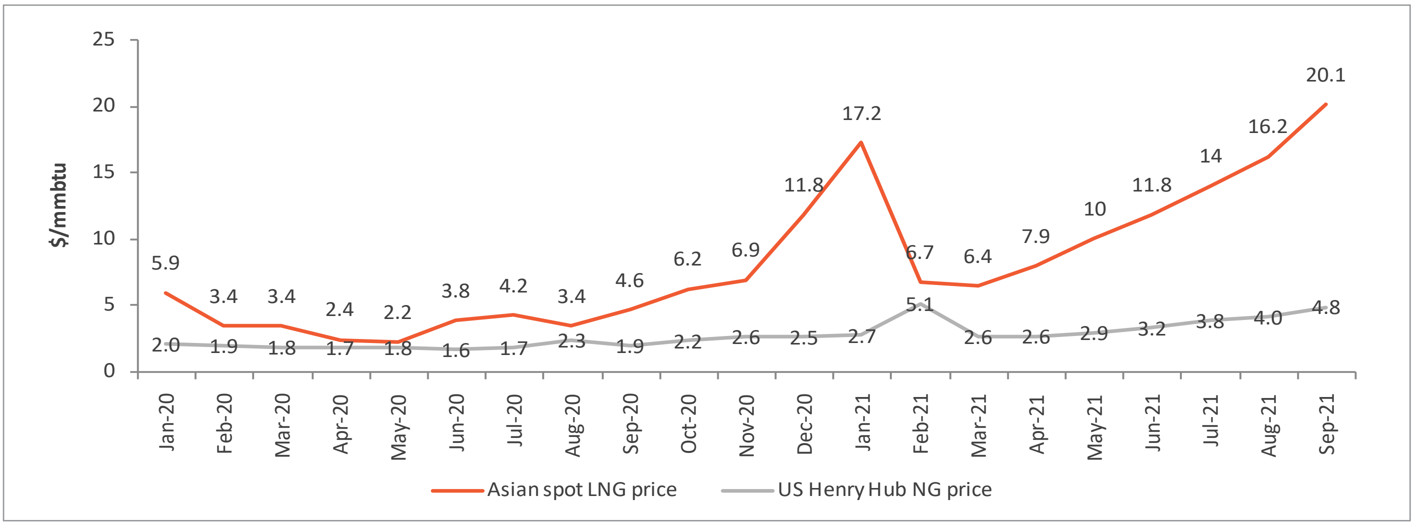
Source: Company; Sharekhan estimates

High spot LNG price improves margin and earnings outlook for gas marketing business

Asian spot LNG prices have rallied to $20/mmBtu in September 2021 as compared to $6.4/mmBtu in March 2021 primarily on the account of strong gas demand recovery globally and supply concerns. Elevated spot LNG price are likely to sustain in near term as winter demand would further support gas demand and likely delay in commissioning of a new LNG project amid COVID-19.

We expect GAIL to be key beneficiary as its US LNG contracts for 5.8 mtpa (linked to Henry Hub natural gas prices) are available at half the spot LNG price and offer a scope for higher trading margin for the gas marketing business. We thus expects profitability of gas marketing business to reach FY2019 levels (reported EBITDA of Rs. 2,859 crore).

Rising price differential between Asian spot LNG price and US gas price to aid gas marketing margins



Source: Bloomberg; Industry reports; Sharekhan Research

GAIL marketing margin could revert to FY2019 level

Particulars	Q1 FY19	Q2 FY19	Q3 FY19	Q4 FY19	Q1 FY20	Q2 FY20	Q3 FY20	Q4 FY20	Q1 FY21	Q2 FY21	Q3 FY21	Q4 FY21	Q1 FY22
Gas marketing EBITDA	551	1045	675	588	861	254	524	631	-517	-335	-45	299	422
Gas marketing volume	97.2	96.2	96.0	98.4	96.6	94.7	96.0	97.8	81.2	88.6	95.6	91.4	96.0
Implied EBITDA ($/scm)	0.25	0.46	0.29	0.26	0.38	0.11	0.23	0.26	-0.25	-0.15	-0.02	0.13	0.18

Source: Company; Sharekhan Research

Scenario analysis on profitability of GAIL's US LNG contracts

Particulars	Profitability of GAIL's US LNG at various price assumptions					Current scenario
Oil price ($/bbl)	40	50	60	70	80	75
Henry Hub gas price ($/mmBtu)	2.5	3.0	3.5	4.0	4.5	4.5
Indexation	115%	115%	115%	115%	115%	115%
Price ($/mmBtu)	2.9	3.5	4.0	4.6	5.2	5.2
Capacity charge ($/mmBtu)	3	3	3	3	3	3
Swapping of gas	50%	50%	50%	50%	50%	50%
Transportation cost ($/mmBtu)	0.5	0.5	0.5	0.5	0.5	0.5
Landed price in Asia ($/mmBtu)	6.4	7.0	7.5	8.1	8.7	8.7
Spot LNG price slope to oil price	13%	13%	13%	13%	13%	27%
Spot LNG price	5.2	6.5	7.8	9.1	10.4	20.1
Trading profit/(Loss) on US LNG contracts versus spot LNG price ($/mmBtu)	**-1.2**	**-0.4**	**0.3**	**1.0**	**1.7**	**11.4**

Source: Sharekhan Research

Strong domestic gas demand and likely start of new pipelines to drive 7% CAGR in gas transmission volume

We expect GAIL's transmission volume to improve in the coming quarters supported by recent uptick in the India's gas consumption, which rose by 11.3% (up 21% y-o-y on low base) to ~173 mmscmd in July 2021 over July 20219. This was led by strong demand recovery from the fertiliser and CGD sectors given ramp-up in the domestic gas production to 93 mmscmd (up 25% y-o-y).

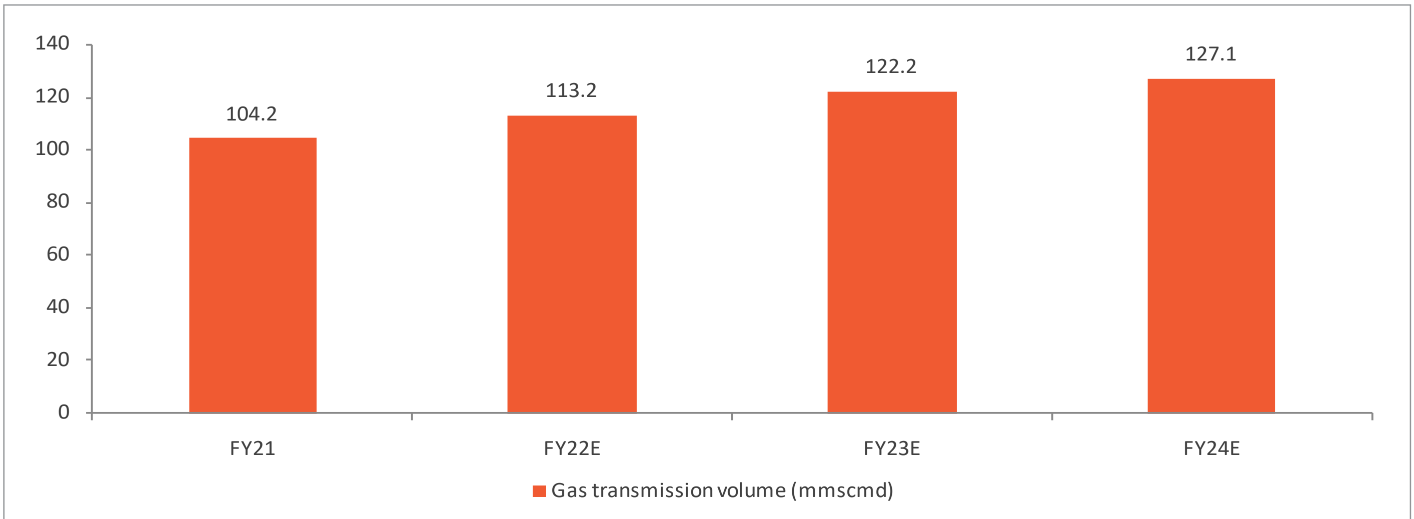
GAIL is expected to commission major pipelines such as Urja Ganga and Barauni-Guwahati over FY2022E-FY2023E and would get connectivity to fertiliser plants, refineries, and city gas distributor areas across the pipeline. The management had guided for 10-12mmscmd incremental gas transmission volume with ramp-up of four fertiliser plants (current volume of 2.5 mmscmd). In addition, potential inclusion of natural gas under GST regime and government focus to increase share of gas to 15% by 2030 in India overall energy mix could substantially improve gas consumption in India and act as a key trigger for GAIL's gas transmission volume. We thus expect GAIL's gas transmission volume to clock 7% CAGR over FY2021-2024E and reach 127 mmscmd by FY2024E.

India's natural gas consumption grow strong by 11.3% in July 2021 versus July 2019

mmscm	Jul-19	Jul-20	Apr-21	May-21	Jun-21	Jul-21	y-o-y growth (%)	Increase over July 2019
Domestic natural gas production	2718	2443	2651	2740	2777	2892	18%	6.4%
Domestic natural gas production meant for sale	2118	1864	2108	2181	2242	2338	25%	10.4%
LNG imports	2738	2963	2655	2587	2391	2528	-15%	-7.7%
Sector wise domestic gas consumption	4808	4414	4859	4744	4980	5350	21%	11.3%
Fertiliser	1303	1474	1416	1414	1502	1616	10%	24.0%
CGD	939	509	886	813	868	989	94%	5.3%
Power	933	993	846	847	835	832	-16%	-10.8%
Refinery	638	638	579	485	541	569	-11%	-10.8%
Petrochemical	316	278	289	219	106	266	-4%	-15.8%
Others	679	523	844	997	1096	1086	108%	59.9%

Source: PPAC India; Sharekhan Research

Gas transmission volume to witness strong growth over FY22E-24E

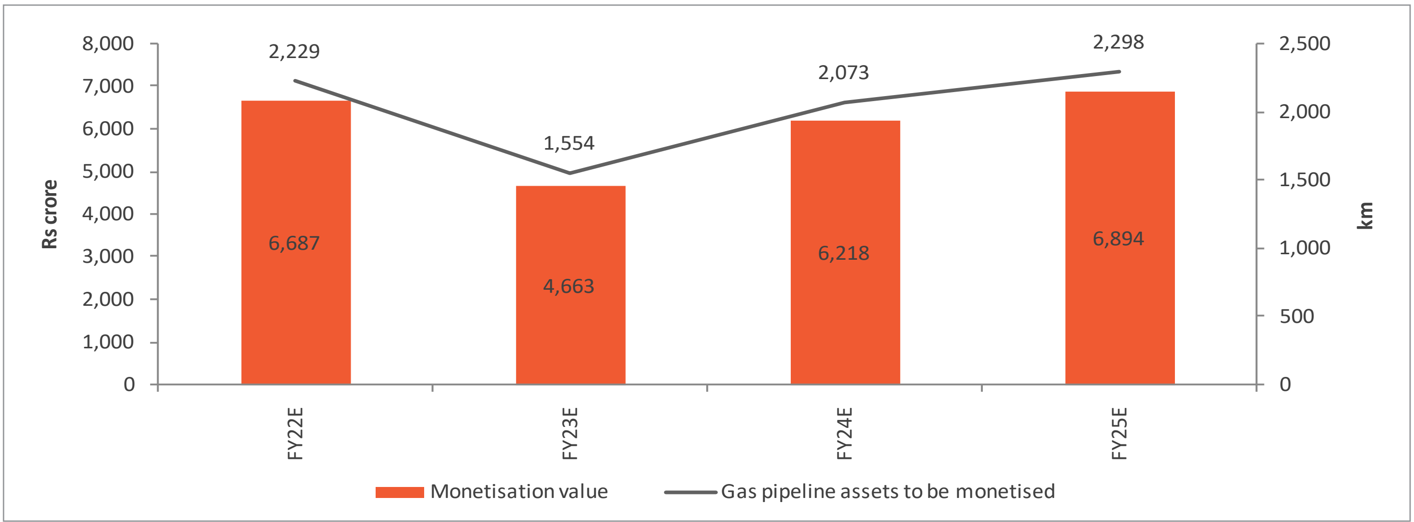


Source: Company; Sharekhan Research

Pipeline asset monetization to unlock real value for GAIL

The government has identified gas pipelines with an aggregate length of ~8,154 km (7,928 km are from the existing operational pipeline assets and the rest from pipelines that are expected to become operational during the NMP period) over FY2022E-2025E. Two pipelines (total length of 2,229 km) namely, Dabhol-Bengaluru pipeline (length of 1,414 km & capacity of 16 mmscmd) and Dahej-Uran-Panvel-Dabhol pipeline (length of 815 km & capacity of 20 mmscmd) have been identified for monetization in FY2022. Over the balance NMP period (FY23-25), a total of 5,925 km of pipeline assets have been considered for monetisation (~1,554 km in FY2023, ~2,073 km in FY2024 and ~2,298 km in FY2025). The total value of assets considered for monetisation is estimated at Rs24,462 crore during FY2022E-2025E. GAIL is the major gas pipeline operator with an existing gas pipeline network of 13,389 km (capacity of 204 MMSCMD). We believe that majority of gas pipelines coming up for monetization would from GAIL's pipeline portfolio and could result in value unlocking for GAIL.

Government's gas pipeline monetisation plans



Source: NITI Aayog NMP presentation; Sharekhan Research

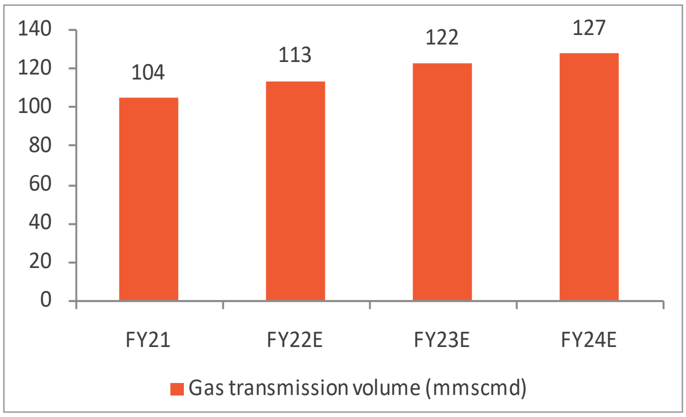
GAIL's operational natural gas pipelines (Common Carrier + Dedicated)

S. No.	Network/ Region#	Length (KM)*
1	Hazira-Vijaipur-Jagdishpur & Gas Rehabilitation and Expansion Project & Dahej-Vijaipur Pipeline Network (HVJ-GREP-DVPL-I)	5,030
2	Dahej-Vijaipur Pipeline (II) & Vijaipur-Dadri Pipeline Network	1,290
3	Tripura Network	60
4	Cauvery Basin	242
5	Chhainsa-Jhajjar-Hissar Pipeline Network (CJPL)	304
6	Dahej-Uran-Panvel-Dabhol Pipeline Network	935
7	Dadri-Bawana-Nangal Pipeline Network	868
8	Dabhol-Bengaluru Pipeline Network (DBPL)	1,148
9	Gujarat Regional Pipeline Network	663
10	Jagdishpur Haldia & Barauni Guwahati Pipeline Network (JHBDPL)	1,098
11	KG Basin Pipeline Network	889
12	Kochi-Koottanad-Bengaluru-Mangaluru Pipeline Network (KKBMPL)	504
13	Mumbai Regional Pipeline Network	125
14	Dedicated Networks	233
	Total Length	**13,389**

Source: NITI Aayog NMP presentation; Sharekhan Research

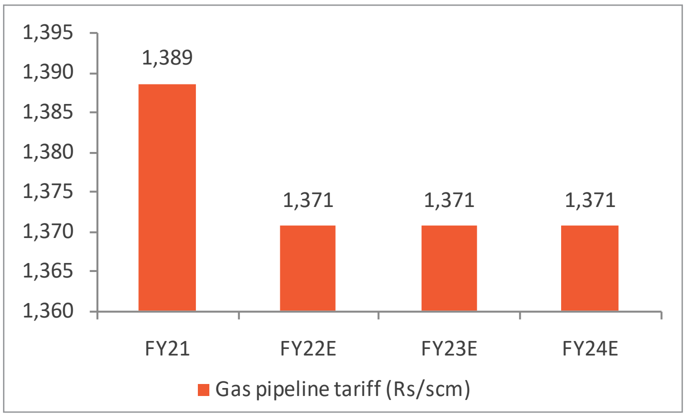
Financials in charts

Sustainable gas transmission volume growth



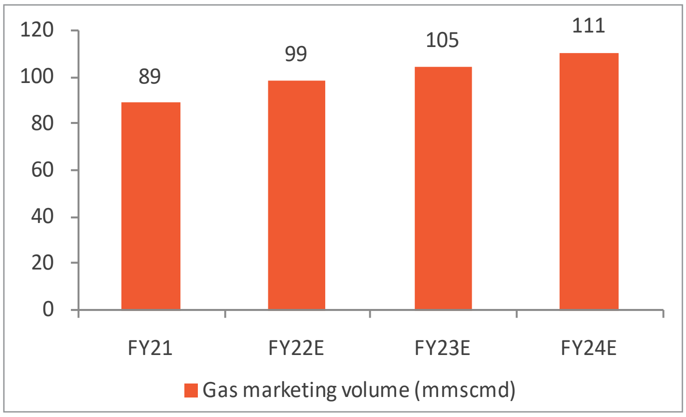
Source: Company, Sharekhan Research

Gas pipeline tariff to remain largely stable



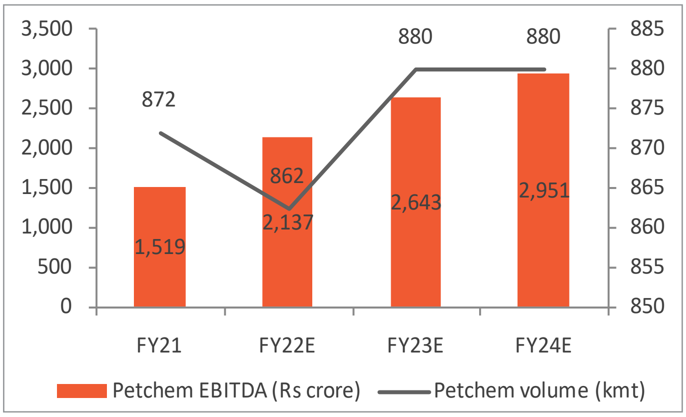
Source: Company, Sharekhan Research

Gas marketing volume to post 8% CAGR over FY21-24E



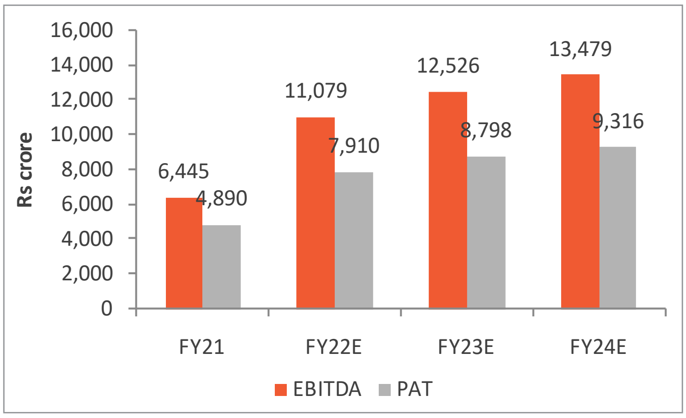
Source: Company, Sharekhan Research

Petchem profitability to improve sharply



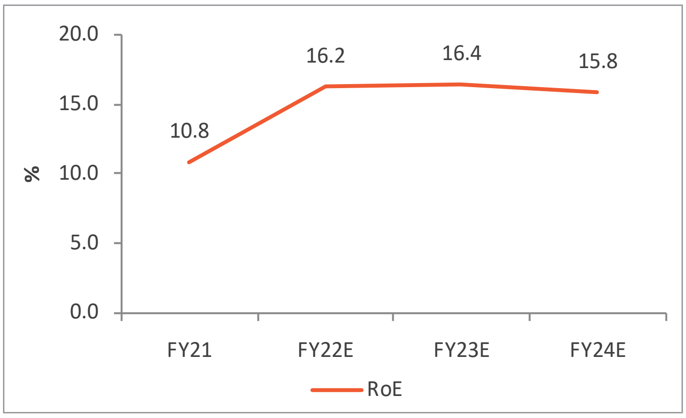
Source: Company, Sharekhan Research

EBITDA/PAT to clock 28%/24% CAGR over FY21-24E



Source: Company, Sharekhan Research

RoE trend



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 for a shift to gas from polluting industrial/auto fuels; and 3) low domestic gas prices. Moreover, the 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 of gas to 15% by 2030 would drive robust gas consumption. Thus, we expect sustainable mid-single digit growth in India's gas demand for the next 4-5 years.

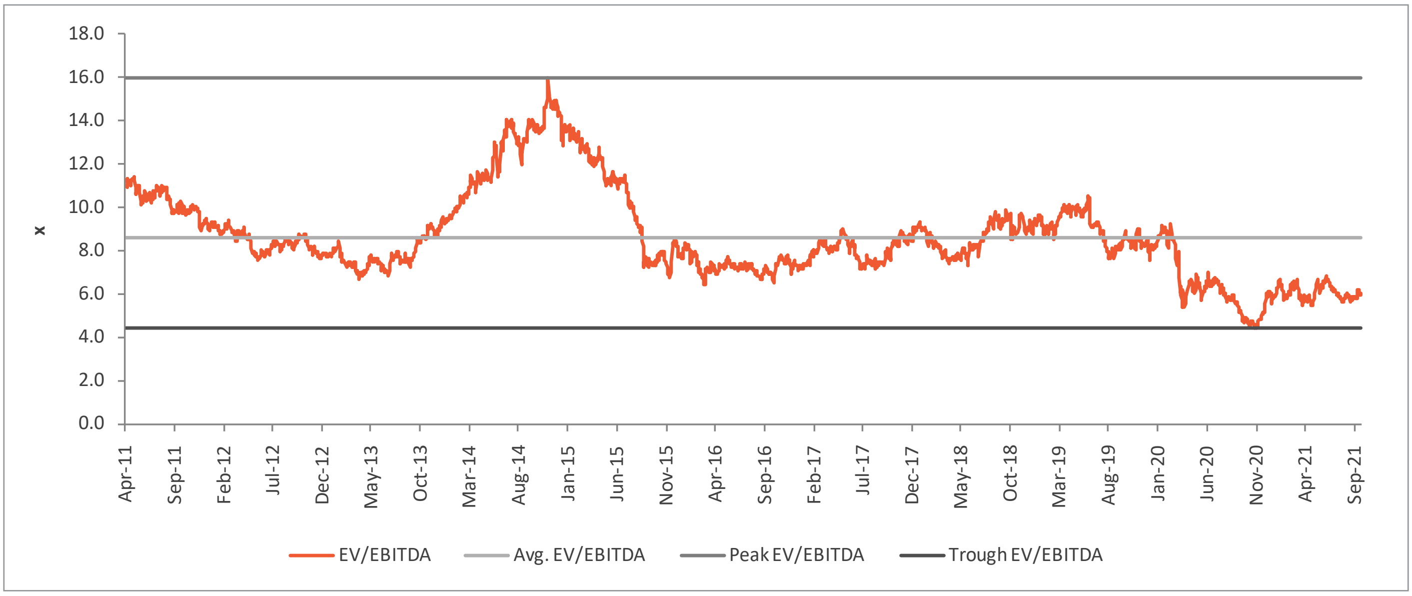
■ **Company outlook - High commodity price and volume growth bodes well for earnings growth**

Earnings outlook for GAIL's petchem and LPG-LHC segment s has improved considerably, given a sharp rally in crude oil prices to <$75/bbl. Moreover, high spot LNG price of $20/mmBtu bodes well for sustained improvement in profitability for the gas trading business and provides confidence on normalisation of EBITDA to Rs. 2,200-2,500 crore. Moreover, regulatory support would mean sustainable 6-8% volume growth for the gas transmission and trading business over the medium to long term. Hence, we expect GAIL's PAT to post a 24% CAGR over FY2021-FY2024E.

■ **Valuation - Maintain Buy on GAIL with an unchanged PT of Rs. 196**

The recent under-performance of GAIL's stock price (flat versus 13% rise in Sensex in the last three months) provides a good entry opportunity for long term investors as earnings outlook (expect a 24% PAT CAGR over FY21-FY24E) remains strong given sustained high-crude linked commodity prices and a potential sharp improvement in RoE to ~16% in FY2024E. GAIL's valuation of 6x its FY2023E EV/EBITDA is attractive, and we expect the company to be a key beneficiary of the government's aim to increase the share of gas in India's energy mix, as the same provides sustainable volume growth opportunity for its gas pipeline and trading business. Additionally, potential value unlocking from monetisation of gas pipeline assets would act as a key re-rating catalyst. Hence, we maintain a Buy rating on GAIL with an unchanged PT of Rs. 196.

One-year forward EV/EBITDA (x) 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 favourable regulatory environment 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. Potential inclusion of natural gas under GST and likely monetisation of gas pipeline assets are key catalysts for GAIL in FY2022.

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 and MD
A.K. Tiwari	Director (Finance)
E.S. Ranganathan	Director (Marketing)

Source: Company

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	LIC ULIP Growth Fund	8.6
2	ICICI Prudential Asset Management Company	2.8
3	HDFC Asset Management Co. Ltd.	2.0
4	Vanguard Group Inc.	1.5
5	BlackRock Inc.	1.1
6	SBI Funds Management Pvt. Ltd.	1.0
7	Franklin Resources Inc.	0.9
8	Deutsche Bank Trust Company Americas	0.7
9	Government Pension Fund Global	0.7
10	Dimensional Fund Advisors LP	0.6

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

Sharekhan

by BNP PARIBAS

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