Sharekhan by BNP PARIBAS

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Gujarat Gas Ltd

Subdued Q2 on sharp margin contraction; volume growth outlook intact

Oil & Gas	Sharekhan code: GUJGASLTD

Reco/View	Reco: **Buy**	↔	CMP: **Rs. 593**	Price Target: **Rs. 840**	↓

↑ Upgrade ↔ Maintain ↓ Downgrade

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		↔	

ESG Disclosure Score NEW

ESG RISK RATING 31.85

Updated Oct 08, 2021

High Risk

NEGL	LOW	MED	HIGH	SEVERE
0-10	10-20	20-30	30-40	40+

Source: Morningstar

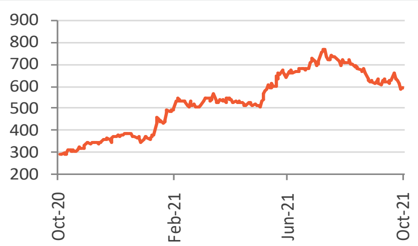
Company details

Market cap:	Rs. 40,822 cr
52-week high/low:	Rs. 787/290
NSE volume: (No of shares)	19.8 lakh
BSE code:	539336
NSE code:	GUJGASLTD
Free float: (No of shares)	26.9 cr

Shareholding (%)

Promoters	60.9
FII	7.9
DII	8.1
Others	23.2

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	-5	-16	12	101
Relative to Sensex	-6	-30	-8	50

Sharekhan Research, Bloomberg

Summary

- Q2FY22 PAT of Rs. 249 crore, down 47.5% y-o-y missed our and street estimate due to sharper than anticipated EBITDA margin decline of 50% y-o-y to Rs. 4/scm. In-line gas sales volume of 11.4 mmscmd (up 16% y-o-y).
- A sharp contraction in EBITDA margin reflects pressure on gross margin (down 41% y-o-y) given steep rise in spot LNG price. Industrial PNG/CNG volumes grew by 10.6%/52.8% y-o-y to 8.7 mmscmd/2 mmscmd while D-PNG volumes stood at 0.6 mmscmd (flat y-o-y).
- Management hinted for further hike in industrial PNG price (post a Rs. 14.5/scm increase since January 2021) to protect EBITDA margin at Rs. 4.5-5.5/scm. Volumes recovered to 12 mmscmd and retained a 10% p.a. growth guidance for next 2-3 years.
- The recent sharp correction in Gujarat Gas' (GGAS') stock price provides attractive entry opportunity as volume growth outlook remain intact and proactive price hike to cushion margins. Hence, we maintain a Buy rating on GGAS with a revised PT of Rs. 840 (reflects earnings cut to factor lower margins).

Gujarat Gas Limited (GGAS) reported weak Q2FY22 results with 38%/44% miss in operating profit/PAT at Rs. 421 crore/Rs. 249 crore, down 42.6%/47.5% y-o-y. The sharp miss in earnings was on the account of weaker-than-expected EBITDA margin at Rs. 4/scm, as gas cost increased sharply by 62%/27% y-o-y/q-o-q to Rs. 28.4/scm due to a steep rise in spot LNG prices to average of $14.5-15/mmbtu in Q2FY22. Volume recovery was on expected lines and witnessed strong 15.9% y-o-y growth to 11.4 mmscmd and current run-rate is at 12 mmscmd (5% higher than Q2 average volumes). Within the Industrial PNG segment, gas sales volume to Morbi cluster's ceramic customers increased to 6.4 mmscmd (up 14% q-o-q) while non-Morbi volumes grew by 4.5% q-o-q to 2.3 mmscmd.

Key positives

- Gas sales volumes recovered to 11.4 mmscmd, up 15.9%/14% y-o-y/q-o-q led by recovery in industrial and CNG volumes.
- Net debt fell by 83% y-o-y to Rs. 97 crore as of September 2021.

Key negatives

- Sharp miss in gross/EBITDA margin at Rs. 6.1/Rs. 4 per scm, down 40.7%/50.4% y-o-y on steep rise in spot LNG prices.

Management Commentary

- **Volume outlook** – Gas sales volume improved to 12 mmscmd, which is 5% higher than Q2 volumes. Management guided for 11.5-12 mmscmd of volumes for FY22E and is optimistic of a 10% volume growth annually over next 2-3 years.
- **Margin outlook** – GGAS has taken cumulative price hikes of Rs. 14.5/scm since January 2021 for the industrial PNG segment and is contemplating another price hike in November. This would protect EBITDA margin at Rs. 4.5-5.5/scm. The management expects 0.5 mmscmd of volume to temporarily shift to propane in near term given recent price hikes.
- **Capex guidance** – H1FY22 capex spends are at Rs. 480 crore and FY22 capex guidance of Rs. 800-900 crore. Plan to add 150 plus CNG stations in FY22 versus 50 CNG stations until now.
- **Gas sourcing mix** – Spot LNG/contracted LNG at 2.8 mmscmd/5.9 mmscmd and remaining through domestic gas for CNG/D-PNG requirement.

Revision in estimates – We have lowered our FY22E-24E earnings estimate to factor in lower margin given high gas cost.

Our Call

Valuation – Maintain Buy on GGAS with a revised PT of Rs. 840: The recent sharp 16% correction in GGAS' stock price in last three months factors in near term margin concerns and provides attractive entry opportunity as gas sales volumes growth outlook (supported by regulatory push to curb pollution and ramp-up of new GAs) remains intact for GGAS. Strong volume growth (expect a 20% CAGR over FY21-24E) and proactive pricing action to protect margins would result in robust 22% PAT CAGR over FY21-24E and superior RoE/RoCE of 29%/32%. Hence, we maintain our Buy rating on GGAS with a revised PT of Rs. 840. At CMP, the stock trades at 21.6x/17.7x its FY23E/FY24E EPS.

Key Risks

Lower-than-expected gas sales volume in case of COVID-19 led economic slowdown. A delay in development of new GAs, a sharp rise in LNG prices and adverse regulatory changes could impact outlook and valuations.

Valuation (Consolidated) Rs cr

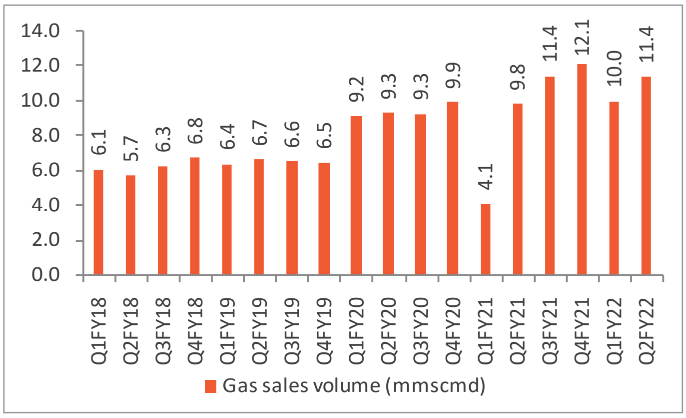
Particulars	FY21	FY22E	FY23E	FY24E
Revenue	9,854	13,956	16,425	19,020
OPM (%)	21.2	16.8	17.4	17.8
Adjusted PAT	1,278	1,510	1,890	2,304
% YoY growth	40.5	18.2	25.1	21.9
Adjusted EPS (Rs.)	18.6	21.9	27.5	33.5
P/E (x)	31.9	27.0	21.6	17.7
P/B (x)	9.0	7.2	5.8	4.6
EV/EBITDA (x)	19.8	17.0	13.4	10.8
RoNW (%)	32.6	29.7	29.6	28.9
RoCE (%)	29.7	30.7	32.0	32.3

Source: Company; Sharekhan estimates

Sharp miss in PAT on account to weak margin; in-line gas sales volume growth of 16% y-o-y

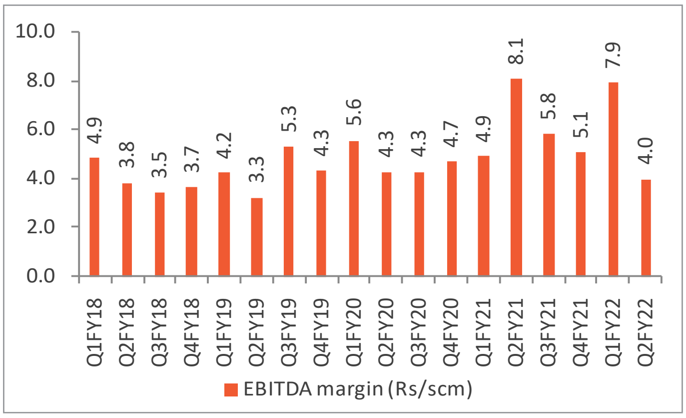
GGAS reported weak Q2FY22 results with a sharp 38% miss in operating profit at Rs. 421 crore (down 42.6% y-o-y; down 41.8% q-o-q) as a steep rise in spot LNG price led to sharp 40.7%/50.4% y-o-y contraction in gross/EBITDA margin to Rs. 6.1/Rs. 4 per scm. Gas sales volumes grew strongly by 16% y-o-y and 14% q-o-q to 11.4 mmscmd (in-line with our estimate). Industrial PNG volume grew by 10.6% y-o-y to 8.7 mmscmd, while CNG volumes were up by 52.8% y-o-y to 2 mmscmd. Domestic PNG volumes remained flat y-o-y at 0.6 mmscmd. Within the I/C segment, gas sales volume to Morbi ceramic customers increased to 6.4 mmscmd (up 14% q-o-q) while non-Morbi volume grew by 4.5% q-o-q to 2.3 mmscmd. Profit after tax (PAT) of Rs. 249 crore (down 47.5% y-o-y; down 47.7% q-o-q) was also substantially below ours and the street's estimate of Rs. 448 crore/Rs. 298 crore on a steep contraction in margins.

Gas sales volume up 16% y-o-y to 11.4 mmscmd



Source: Company, Sharekhan Research

EBITDA/scm of Rs. 4/scm significantly below estimate



Source: Company, Sharekhan Research

Results (Standalone) Rs cr

Particulars	Q2FY22	Q2FY21	YoY (%)	Q1FY22	QoQ (%)
Revenue	**3,615**	**2,513**	**43.8**	**3,011**	**20.0**
Total Expenditure	3,194	1,780	79.4	2,288	39.6
Operating profit	**421**	**733**	**-42.6**	**723**	**-41.8**
Other Income	19	21	-7.6	21	-9.7
Interest	12	34	-63.8	16	-22.7
Depreciation	94	86	9.4	91	3.5
Exceptional income/(expense)	0	0	NA	0	NA
PBT	334	634	-47.3	638	-47.6
Tax	85	160	-46.6	162	-47.3
Reported PAT	**249**	**475**	**-47.5**	**476**	**-47.7**
Equity Cap (cr)	69	69		69	
Reported EPS (Rs.)	3.6	6.9	-47.5	6.9	-47.7
Margins (%)			**BPS**		**BPS**
OPM	11.6	29.2	-1752	24.0	-1236
Tax rate	25.5	25.1	34	25.3	15
NPM	6.9	18.9	-1200	15.8	-892

Source: Company; Sharekhan Research

Key operating metrics

Particulars	Q2FY22	Q2FY21	YoY (%)	Q1FY22	QoQ (%)
Volume (mmscmd)	11.4	9.8	15.9%	10.0	14.0%
Gross margin (Rs./scm)	6.1	10.2	-40.7%	10.4	-41.9%
EBITDA margin (Rs./scm)	4.0	8.1	-50.4%	7.9	-49.5%

Source: Company; Sharekhan Research

Outlook and Valuation

■ Sector view - Gas demand at inflection point; Gujarat-based players well-placed given access to gas infrastructure

The Indian CGD sector is at an inflection point as it is a priority sector (allocation of cheap domestic gas and focus on rapid expansion of CGD infrastructure) for the government. With the government's focus to increase the share of gas in India's energy mix to 15% by 2030 (from 6% currently), consumption growth for the CGD sector is estimated at 10% annually in the next five years. Gujarat is at the forefront of CGD development in India supported by availability of the state gas grid, access to LNG terminals, and natural gas infrastructure. Post the ninth CGD bidding round, all districts of Gujarat have been authorised for CGD development and after completion of minimum work program (MWP), 100% of its GA and population would be covered by the CGD network. Gujarat accounts for 29% of India's CNG station and CNG vehicles, 35% of domestic PNG connections, 65% of PNG connections and 50% of industrial PNG connections. Massive investments linked up over the next 5-8 years and crackdown on critically/severally polluted industrial areas would provide huge volume growth opportunity for Gujarat-based CGD players such as GGAS.

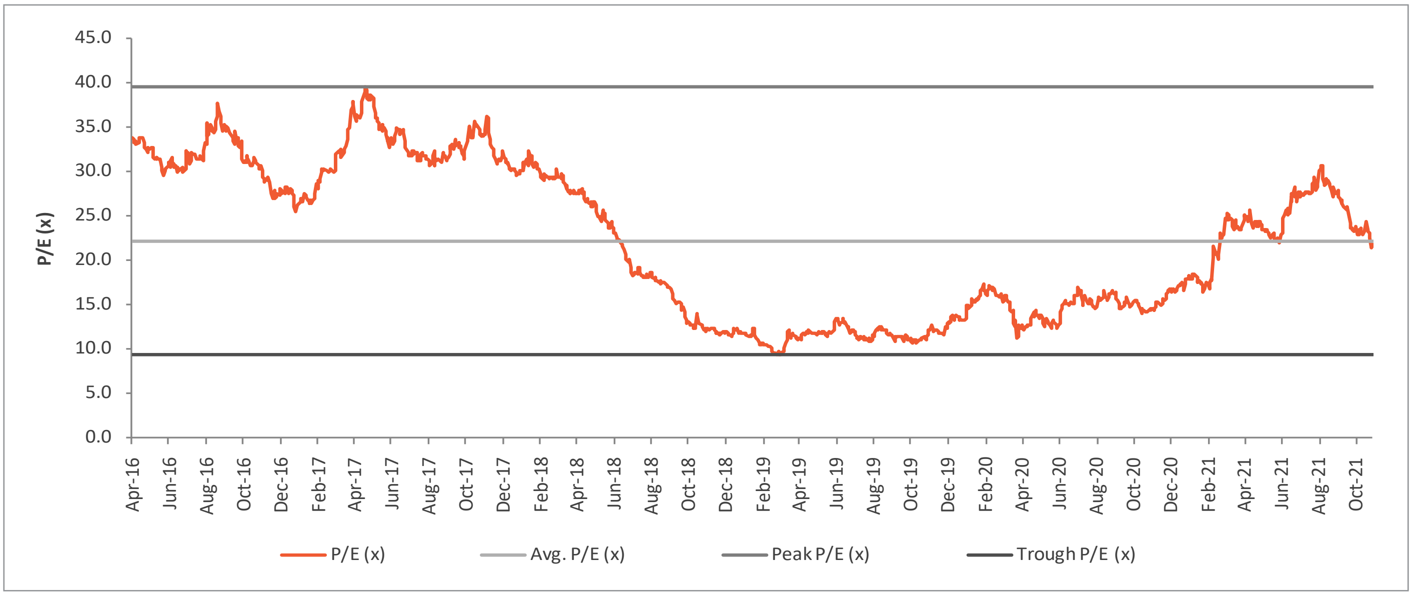
■ Company outlook - Structural gas demand drivers well placed to drive volume growth

For GGAS, we see a large gas sales volume opportunity of 2.5 mmscmd from the National Green Tribunal's (NGT's) recent strict directions to curb pollution in the identified polluted areas of Gujarat and 3-3.5 mmscmd from the development of seven new GAs in Punjab, Haryana, Madhya Pradesh and Rajasthan. Given structural gas demand drivers, we expect a sharp 26% y-o-y volume growth in FY2022E post flat y-o-y volumes in FY2021 due to COVID-19 impact on volumes in Q1FY2021. Overall, we expect 20% volume CAGR over FY2021-FY2024E. We expect GGAS's EBITDA margin to improve to Rs. 5.5-6/scm over FY2022E-FY2024E as the company is implementing frequent price hikes for industrial PNG customers.

■ Valuation - Maintain Buy on GGAS with a revised PT of Rs. 840

The recent sharp 16% correction in GGAS' stock price in last three months factors in near term margin concerns and provides attractive entry opportunity as gas sales volumes growth outlook (supported by regulatory push to curb pollution and ramp-up of new GAs) remains intact for GGAS. Strong volume growth (expect a 20% CAGR over FY21-24E) and proactive pricing action to protect margins would result in robust 22% PAT CAGR over FY21-24E and superior RoE/RoCE of 29%/32%. Hence, we maintain our Buy rating on GGAS with a revised PT of Rs. 840. At CMP, the stock trades at 21.6x/17.7x its FY23E/FY24E EPS.

One-year forward P/E (x) band



Source: Sharekhan Research

About company

Gujarat Gas Limited (GGAS) is India's gas distribution company with a volume of 9.4 mmscmd in FY2021. GGAS derives around 78% of volumes from industrial PNG, 14% from CNG, 7% from domestic PNG and remaining from commercial PNG. The company has presence spread across 23 districts in Gujarat, the Union Territory of Dadra & Nagar Haveli and Thane Geographical Area (GA) (excluding already authorised areas). In the recently concluded 10th CGD bidding round, the company has won 6 GAs in 17 cities in the Punjab, Haryana, Madhya Pradesh and Rajasthan.

Investment theme

Strong gas volume growth outlook and likely margin expansion (led by price hikes for industrial PNG and efficient gas sourcing) bode well for strong earnings growth for GGAS. Moreover, India's long-term gas demand outlook remains robust supported by regulatory push to curb pollution, and the government's thrust to increase share of gas in India's energy mix to ~15% by 2030 (from 6% currently). Additionally, the development of seven new GAs (won in the 9th and 10th CGD bidding round) has volume potential of 3 mmscmd-3.5 mmscmd over the next 3-5 years. Moreover, GGAS is expected to be biggest beneficiary of potential inclusion of natural gas under GST as the same would substantially improve industrial PNG demand. Overall, we expect strong volume growth traction for GGAS.

Key Risks

- Sharp rise in the LNG price and adverse regulatory changes could impact volume growth and margin.
- Delay in ramp-up of gas volume from new GAs.

Additional Data

Key management personnel

Anil Mukim	Chairman
Sanjeev Kumar	Managing Director
Nitesh Bhandari	Chief Financial Officer

Source: Company

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	FIL Limited	1.6
2	DSP Investment Managers Pvt. Ltd.	1.4
3	Vanguard Group Inc	1.0
4	UTI Asset Management Co. Ltd	0.9
5	Aberdeen PLC	0.9
6	Canara Robeco Asset Management Co. Ltd	0.9
7	Axis Asset Management Co. Ltd	0.9
8	Kotak Mahindra Asset Management Co. Ltd	0.8
9	Aditya Birla Sun Life Asset Management Co. Ltd	0.6
10	BlackRock Inc	0.4

Source: Bloomberg; Note: Shareholding as of August 05, 2021

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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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