Sharekhan by BNP PARIBAS

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Stock Update

GAIL (India) Limited

Value play; regulation supports volume growth

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. 117**	
Price Target: **Rs. 140**	↑

↑ Upgrade ↔ Maintain ↓ Downgrade

Company details

Market cap:	Rs. 52,611 cr
52-week high/low:	Rs. 133/66
NSE volume: (No of shares)	153.2 lakh
BSE code:	532155
NSE code:	GAIL
Free float: (No of shares)	216.0 cr

Shareholding (%)

Promoters	52.1
FII	15.1
DII	20.1
Others	12.7

Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	39	19	21	-6
Relative to Sensex	28	4	-10	-15

Sharekhan Research, Bloomberg

Summary

- We retain our Buy rating on GAIL with a revised PT of Rs. 140, as unified tariff regulation is structurally positive for long-term volume growth. GAIL has cash balance of ~Rs. 1,614 crore, which makes it likely strong candidate to announce share buyback among PSUs.
- Earnings outlook has also improved as a sharp increase in spot LNG price to $6/mmbtu could help reverse H1FY2021 loss in the gas trading business, while the increase in HDPE prices bodes well for sustained improvement in the profitability of the petchem business.
- GAIL is likely to be the key beneficiary of government's aim to increase share of gas in India's energy mix to 15% by 2025 (versus only 6% currently) as the same provides sustainable volume growth opportunity for its gas pipeline and trading business.
- GAIL is trading at an attractive valuation of 5.6x its FY2023E EV/EBITDA (37% discount to historical average EV/EBITDA multiple) despite sharp run-up of 39% in the stock price in the past one month.

Petroleum and Natural Gas Regulatory Board (PNGRB; pipeline regulator) had recently notified regulations for computation of unified pipeline tariff for pipeline operators. The unified tariff would be revenue neutral for GAIL, but it provides significant volume growth opportunity as a simplified tariff structure would result in higher gas penetration in India and improve GAIL's pipeline utilisation rate (which is at only 52% currently). Additionally, the recent sharp increase in spot LNG price to $6/mmbtu (versus $2-3/mmbtu in April-May) allays concerns with regards to losses in the gas trading business and could result into likely reversal of H1FY2021 EBITDA loss of Rs. 852 crore in this business segment. Moreover, GAIL has cash balance (including current investments) of ~Rs. 1,614 crore, which makes it likely strong candidate to announce share buyback among PSU companies. Overall, recent regulation in gas space (unified tariff and open access) bodes well for improvement in gas penetration in India and could act as key volume growth triggers for GAIL's pipeline and gas trading business. GAIL is trading at an attractive valuation of 5.6x its FY2023E EV/EBITDA (37% discount to historical average one-year forward EV/EBITDA multiple) and offers healthy dividend yield of ~6%. Hence, we maintain our Buy rating on GAIL with a revised PT of Rs. 140.

Our call

Valuation – Maintain Buy on GAIL with a revised PT of Rs. 140: We have increased our FY2021-FY2023 earnings estimates to factor improved profitability for the gas trading segment given the sharp rise in spot LNG prices. GAIL's stock price has run-up sharply by 39% in the past one month, led by improving earnings outlook and introduction of unified tariff regulations. Despite the recent run up, GAIL's valuation of 5.6x its FY2023E EV/EBITDA is attractive, and we expect the company to be the key beneficiary of the government's aim to increase the share of gas in India's energy mix to 15% by 2025 (versus only 6% currently) as the same provides sustainable volume growth opportunity for its gas pipeline and trading business. GAIL has cash balance (including current investments) of ~Rs. 1,614 crore, which makes it likely strong candidate to announce share buyback among PSU companies. Hence, we maintain our Buy rating on GAIL with a revised PT of Rs. 140 (higher valuation for gas trading business and increased value of listed investments).

Key risk

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	FY19	FY20	FY21E	FY22E	FY23E
Revenue	75,126	71,871	65,098	80,392	85,144
OPM (%)	12.7	11.6	9.6	11.4	11.5
Adjusted PAT	6,352	6,519	4,029	6,019	6,262
% YoY growth	38.4	2.6	-38.2	49.4	4.0
Adjusted EPS (Rs)	14.1	14.5	8.9	13.3	13.9
P/E (x)	8.3	8.1	13.1	8.7	8.4
P/B (x)	1.2	1.2	1.1	1.1	1.0
EV/EBITDA (x)	5.5	6.8	8.9	6.0	5.6
RoNW (%)	15.0	14.8	8.9	12.5	12.1
RoCE (%)	18.7	14.1	9.4	13.5	13.4

Source: Company; Sharekhan estimates

PNGRB recently notified unified tariff for gas pipeline

The Petroleum and Natural Gas Regulatory Board (PNGRB; pipeline regulator) had recently notified regulations for computation of unified tariff for gas pipeline operators. The regulator has simplified pipeline tariff structure by dividing it into two zones as compared to five zones earlier and fixed unified tariff at Rs. 33.39/mmbtu (Rs. 1,200/scm). The unified tariff would be revenue neutral for pipeline companies although tariff would change for consumers with Zone 1 tariff is kept at 40% of Zone 2 and the unified tariff would be revised on annual basis. Zone 1 for unified tariff is within 300km from the unified entry point on either side of the national grid system and Zone 2 would be beyond 300km. The unified tariff of Rs. 33.39/mmbtu is preliminary and PNGRB would come out with a final tariff in the next few months, which would be applicable till March 2021.

Implication for pipeline operators – Revenue neutral but provides massive volume opportunity as gas penetration is expected to increase in India

The unified tariff would be revenue neutral for GAIL and GSPL, but it provides significant volume opportunity for gas transportation companies as a simplified tariff structure would result into higher gas penetration in India (government's aim to increase share of gas in overall energy mix to 15% by 2025 from only 6% currently). We highlight here that GAIL's pipelines are operating at only 52% utilisation rate, which would improve considerably in the medium to long term, as gas penetration is expected to increase going forward. Moreover, we believe unified tariff regulation would help gas pipeline operator to seed up completion of the national gas grid.

Exhibit 1: Process to determination Unified Tariff as per PNGRB regulation

		Approved Tariff (a)	Actual volume of gas transported (b)	Gross Calorific Value (c)	Actual quantity of gas transported (d)	Ship or pay volumes (e)	Total Actual Volumes (f)=(d)+(e)	Transporta-tion tariff (g)=(f)*(a)
Pipelines	**Zones**	**(INR/MMBTU)**	**(SCM)**	**(Kcal/SCM)**	**(MMBTU)**	**(MMBTU)**	**(MMBTU)**	**INR**
Pipeline A	**Zone-1**	10.00	30,000	9,500.00	1,130.95	200.00	1,330.95	13,309.52
	Zone-2	20.00	40,000	9,400.00	1,492.06		1,492.06	29,841.27
	Zone-3	30.00	50,000	9,300.00	1,845.24		1,845.24	55,357.14
	Zone-4	40.00	80,000	9,600.00	3,047.62	100.00	3,147.62	1,25,904.76
	Total		**2,00,000**		**7,515.87**	**300.00**	**7,815.87**	**2,24,412.70**
Pipeline B	**Zone-1**	10.00	45,000	9,300.00	1,660.71		1,660.71	16,607.14
	Zone-2	11.00	42,000	9,400.00	1,566.67		1,566.67	17,233.33
	Zone-3	12.00	38,000	9,500.00	1,432.54	150.00	1,582.54	18,990.48
	Total		**1,25,000**		**4,659.92**	**150.00**	**4,809.92**	**52,830.95**
Pipeline C	**Zone-1**	30.00	58,000	9,546.00	2,197.10		2,197.10	65,912.86
	Zone-2	40.00	34,000	9,645.00	1,301.31		1,301.31	52,052.38
	Zone-3	45.00	30,000	9,852.00	1,172.86	350.00	1,522.86	68,528.57
	Zone-4	50.00	68,000	9,900.00	2,671.43		2,671.43	1,33,571.43
	Zone-5	55.00	85,000	9,500.00	3,204.37	150.00	3,354.37	1,84,490.08
	Total		**2,75,000**		**10,547.06**	**500.00**	**11,047.06**	**5,04,555.32**

Source: PNGRB

Exhibit 2: Calculation of unified pipeline tariff

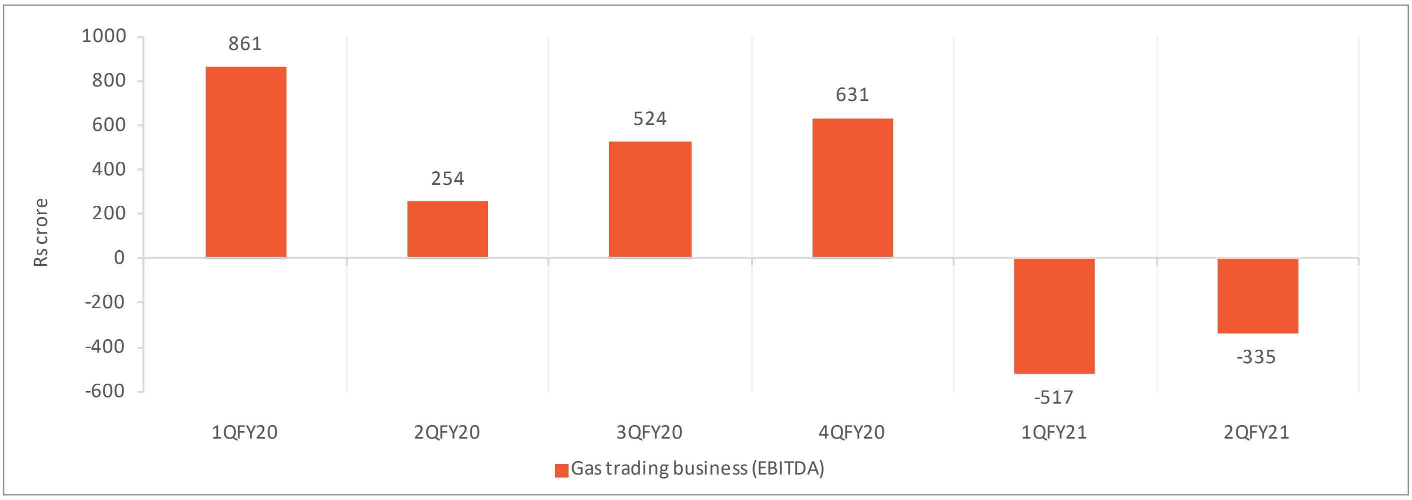
Pipelines	Revenue Entitlement	Quantity for Revenue Entitlement	Duplicate Volumes	UFT
	INR (a)	in MMBTU (b)	in MMBTU (c)	Rs./MMBTU a/(b-c)
Pipeline A	2,24,412.70	7,815.87	**255.57**	**33.39**
Pipeline B	5,04,555.32	11,047.06		
Pipeline C	52,830.95	4,809.92		
Total Revenue	**7,81,798.97**	**23,672.85**		

Source: PNGRB

Sharp increase in spot LNG price could reverse H1FY2021 EBITDA loss in the gas trading busines

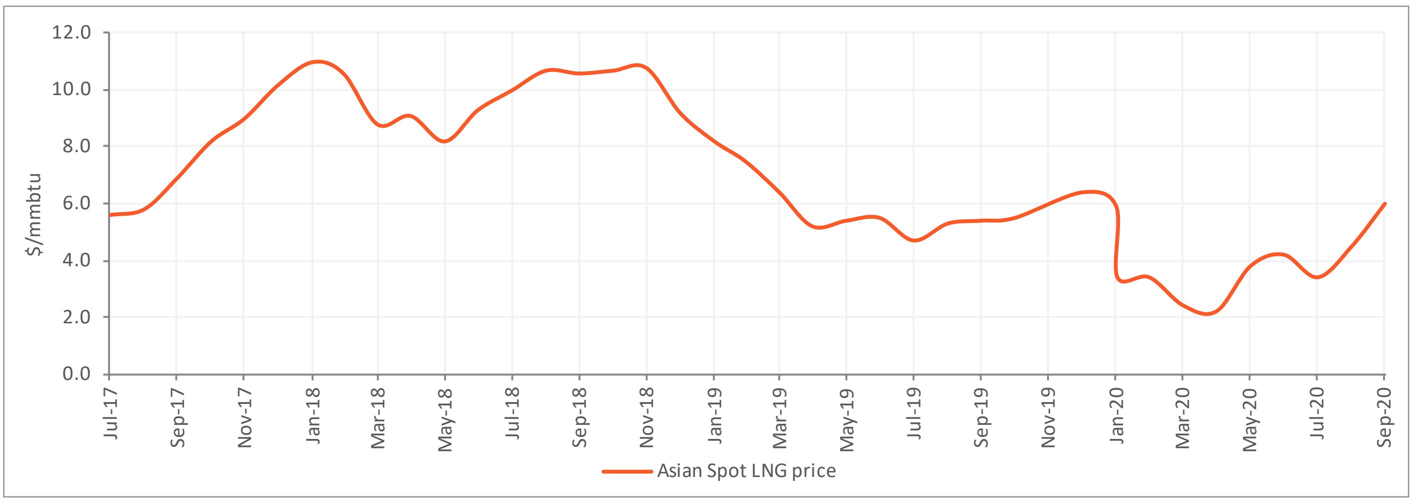
GAIL's H1FY2021 performance was impacted by EBITDA loss of Rs. 852 crore in the gas trading business due to weak spot LNG price and inventory loss. However, spot LNG prices have recovered sharply to $6/mmbtu in October as compared to lows of $2-3/mmbtu during April-May 2020. This could result into potential reversal of loss in the gas trading business in H2FY2021E and improve earnings outlook as weakness in the gas trading business (given US LNG contract of 5.8mmt) has been the key concern for GAIL.

Gas trading business EBITDA trend



Source: GAIL

Spot LNG price increased sharply to $6/mmbtu in October – could help reverse gas trading losses

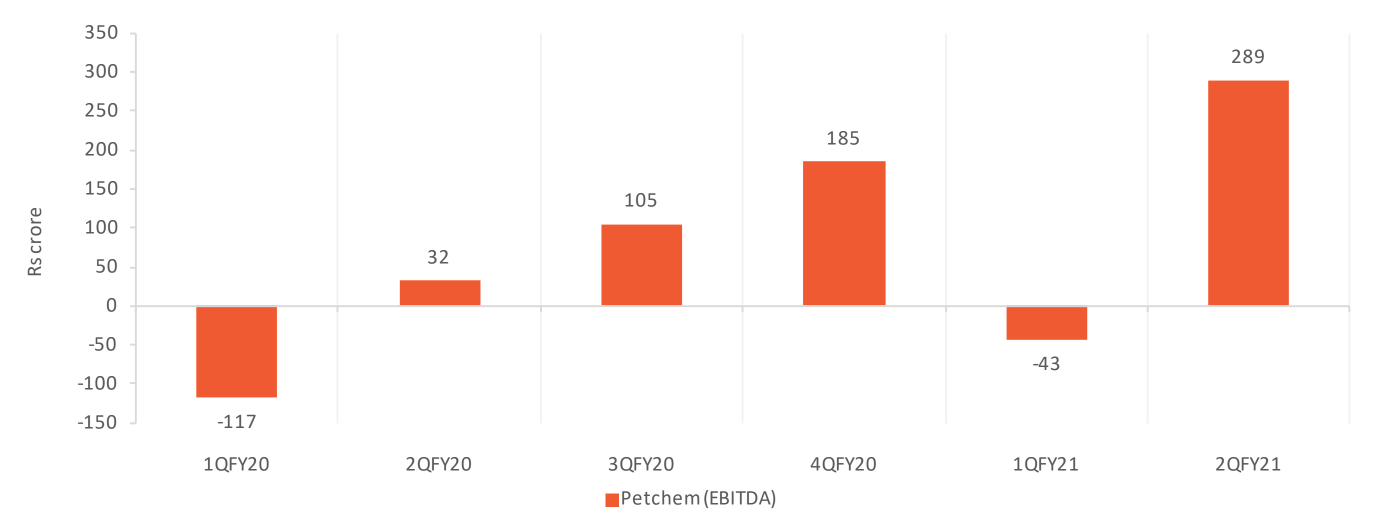


Source: Bloomberg

Higher HDPE price bodes well for improvement in performance of petchem segment

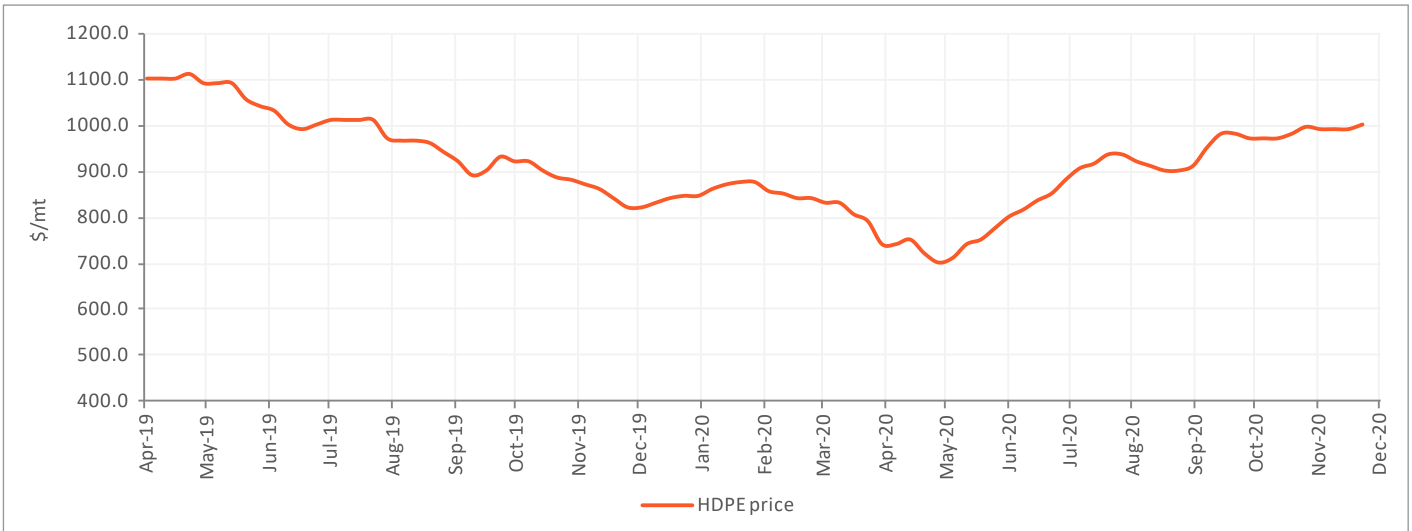
Performance of the petrochemical segment has improved considerably in Q2FY2021, led by the sharp increase in polymer prices and better plant utilisation rate, which led to higher absorption of fixed cost. With a sharp increase in HDPE price, we expect performance of the petchem segment would sustain in the coming quarters although some benefit would get offset by higher spot LNG prices.

Petchem Segment performance to sustain



Source: GAIL

Improving HDPE prices



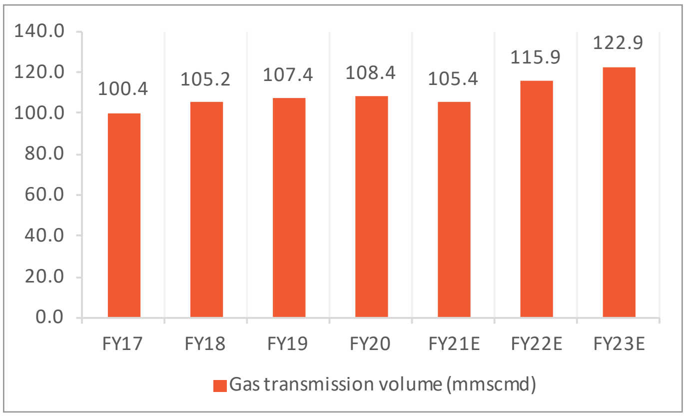
Source: Bloomberg

Cash balance of Rs1614 crore makes GAIL strong candidate for share buyback

Recently few PSU companies have announced share buyback programme to boost investor sentiments as the stock was trading at attractive valuation and in some cases below book value. GAIL has cash balance (including current investments) of Rs. 1,614 crore, which makes it likely strong candidate to announce share buyback among PSU companies. Announcement on share buyback (if at a significant premium to CMP) could act as a near-term trigger for GAIL's stock performance.

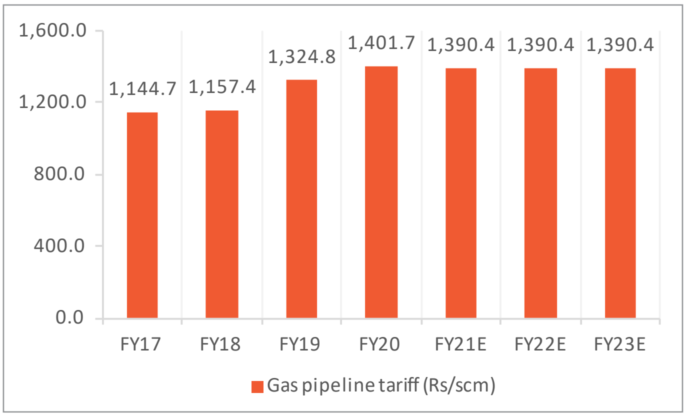
Financials in charts

Sustainable gas transmission volume growth



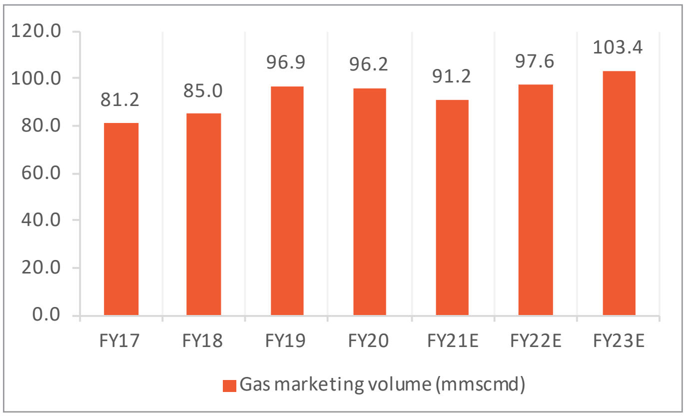
Source: Company, Sharekhan Research

Gas pipeline tariff to remain stable



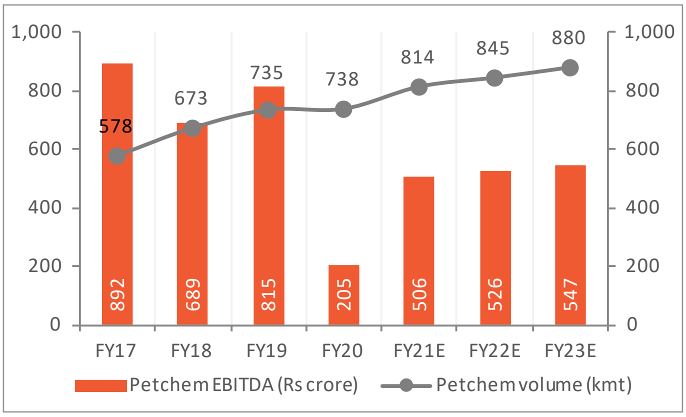
Source: Company, Sharekhan Research

Gas marketing volume to clock 6% CAGR over FY21E-23E



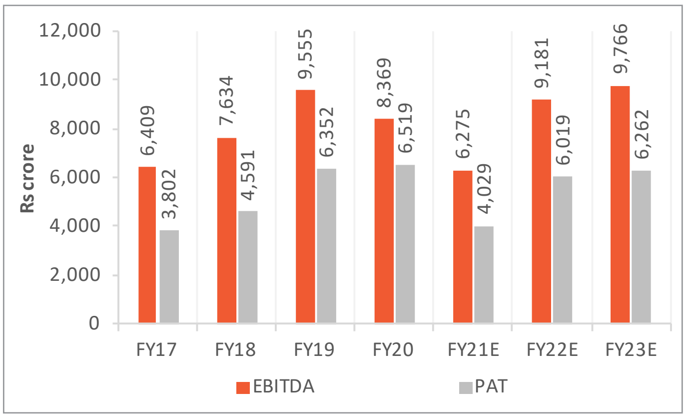
Source: Company, Sharekhan Research

Petchem utilisation and profitability to improve



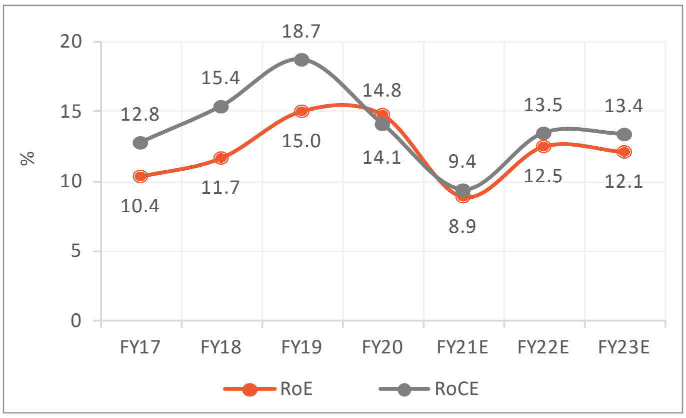
Source: Company, Sharekhan Research

EBITDA/PAT trend



Source: Company, Sharekhan Research

Return ratios to improve over FY22E-23E



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 gas cost, 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. 140**

We have increased our FY2021-FY2023 earnings estimates to factor improved profitability for the gas trading segment, given the sharp rise in spot LNG prices. GAIL's stock price has run up sharply by 39% in the past one month, led by improving earnings outlook and introduction of unified tariff regulations. Despite the recent run up, GAIL's valuation of 5.6x its FY2023E EV/EBITDA is attractive; and we expect the company to be the key beneficiary of the government's aim to increase the share of gas in India's energy mix to 15% by 2025 (versus only 6% currently) as the same provides sustainable volume growth opportunity for its gas pipeline and trading business. GAIL has cash balance (including current investments) of Rs. 1,614 crore, which makes it likely strong candidate to announce share buyback among PSU companies. Hence, we maintain our Buy rating on GAIL with a revised PT of Rs. 140 (higher valuation for the gas trading business and increased value of listed investments).

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. The recent sharp increase in spot LNG price bodes well for turnaround of the gas trading segment in H2FY2021.

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	Life Insurance Corp of India	7.0
2	Oil & Natural Gas Corp Ltd	4.8
3	ICICI Prudential Asset Management	3.8
4	HDFC Trustee Co Ltd/India	3.3
5	ICICI PRUDENTIAL EQUITY	3.2
6	HDFC Asset Management Co Ltd	2.9
7	Indian Oil Corp Ltd	2.4
8	Franklin Resources Inc	1.1
9	FRANKLIN INDIA EQUITY FUND	1.1
10	SBI Funds Management Pvt Ltd	1.0

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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