Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

GAIL (India) Ltd

Strong Q1; multiple headwinds limits upside

Oil & Gas	Sharekhan code: GAIL

Reco/View: Hold ↓	CMP: **Rs. 140**	Price Target: **Rs. 152** ↓

↑ 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 28.31

Updated July 08, 2022

Medium Risk

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

Source: Morningstar

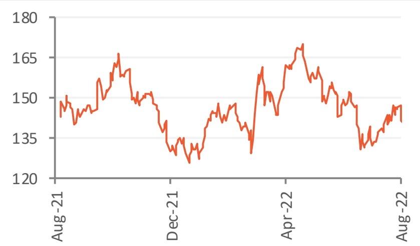
Company details

Market cap:	Rs. 61,411 cr
52-week high/low:	Rs. 173/125
NSE volume: (No of shares)	117.6 lakh
BSE code:	532155
NSE code:	GAIL
Free float: (No of shares)	210.9 cr

Shareholding (%)

Promoters	51.9
FII	19.9
DII	15.3
Others	12.9

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	4.6	-13.3	-4.4	-2.0
Relative to Sensex	-5.1	-17.9	-3.8	-8.9

Sharekhan Research, Bloomberg

Summary

- Q1FY23 PAT of Rs. 2,915 crore, up 9% q-o-q was significantly above ours and the street's estimates, led by phenomenal performance of gas marketing business that offset a sequential decline in other segments.
- Gas marketing EBITDA grew strongly by 35% q-o-q led by higher trading margin/volume growth but EBITDA from the gas transmission/petchem/LPG-LHC segments declined by 6%/66%/12% q-o-q. Petchem earnings declined due to 50% fall in sales volume while LPG-LHC got impacted by higher domestic gas price.
- Recent force majeure by Gazprom to stop supply of LNG would affect GAIL as it would hit petchem production (leading to 50% utilization), decline in gas marketing/transmission volume by 5-6 mmscmd/7 mmscmd. LHG-LHC profitability to get affected by a likely hike in domestic gas prices from October 2022. We cut our FY23/FY24 earnings estimate by 7%/8%.
- We downgrade GAIL to Hold (from Buy) with a revised PT of Rs. 152 as multiple earnings headwinds make us lower EV/EBITDA multiple across major segments and we see limited upside potential from the CMP.

GAIL (India) Limited's Q1FY23 standalone operating profit/PAT of Rs. 4,366 crore/Rs. 2,915 crore, up 17.5%/8.7% q-o-q and was 20%/19.6% above our estimate of Rs. 3,636 crore/Rs. 2,437 crore. The significant beat in earnings was primarily led by strong profitability in natural gas marketing segment (EBITDA up 5.7x/35% y-o-y/q-o-q to Rs. 2,402 crore) offsetting a sequential earnings decline in other segments. Gas trading performance was robust reflecting higher trading margins (implied EBITDA margin increased by 25% q-o-q) and 6.5% q-o-q rise in gas trading volume to 101 mmscmd. Petchem EBITDA declined sharply by 66% q-o-q to Rs. 169 crore due to 50% q-o-q fall in the sales volume to 109 kt as plant operated at 60% given cut down in LNG load at its Pata petrochemical plant due to lower LNG supplies from Gazprom which offsets 16% q-o-q rise in petchem realisation. Gas transmission EBITDA was also down by 6% q-o-q to Rs. 1090 crore due to higher operating cost while gas transmission volume stood at 109 mmscmd (up 1.8% q-o-q). LPG-LHC EBITDA declined by 12% q-o-q to Rs. 663 crore due higher gas cost given 110% hike in domestic gas price to $6.1/mmBtu.

Key positives

- Gas marketing segment's performance was strong with 35% q-o-q rise in EBITDA.

Key negatives

- Gas transmission/Petchem/LPG-LHC segment EBITDA declined by 6%/66%/12% q-o-q.
- Petchem sales volume declined by 50% q-o-q to 109 kt as plant operations got affected by a cut in LNG supply.

Management Commentary

- Gazprom invoked force majeure on LNG supply to GAIL. This would affect gas transmission/marketing volumes by 7.5 mmscmd/5-6 mmscmd and lower petchem production due to a cut in LNG supply load.
- GAIL is taking multiple measure for maintaining LNG supply to customer and avoid spot gas purchases. This includes using a 'take or pay' clause for lower LNG supply to customers, bringing unallocated US LNG cargo to India and cut in LNG load at its Pata petchem plant. GAIL would not pay the differential gas price and thus we do expect trading loss.
- LPG-LHC segment's profitability could come down with likely further hike in domestic gas price from Oct'22.
- Capex guidance of Rs. 7,500 crore for FY23.
- Commissioning of the fertiliser plants in India is as per schedule and not affected due to increase in LNG prices.

Revision in estimates – We have lowered our FY23-24 earnings estimate to factor in lower volumes across gas transmission, gas marketing and petrochemical segments.

Our Call

Valuation – Downgrade GAIL to Hold with a revised PT of Rs. 152: Global gas supply crisis (Gazprom invokes force majeure to stop LNG supply) creates volume-led earnings headwinds for GAIL's major businesses until the supply is restored by the gas supplier. The absence of an exact timeline for normalization of gas supply situation makes us cut our earnings and EV/EBITDA multiple for GAIL's gas transmission, gas marketing and petrochemical business. Thus, we downgrade GAIL to Hold (from Buy) with a revised PT of Rs. 152 as multiple earning headwinds limit upside potential. At CMP, GAIL trades at 5.7x FY23E EV/EBITDA and 5.5x FY24E EV/EBITDA.

Key Risks

Faster-than-expected resolution of gas supply issue from Gazprom and a ramp-up of domestic gas supply could improve gas volume and is key upside risk. Difficulty in sourcing of LNG cargos a reasonable price amid global gas supply crunch could act as earnings headwinds and is a key downside risk.

Valuation (Standalone) Rs cr

Particulars	FY21	FY22	FY23E	FY24E
Revenue	56,730	91,626	90,502	96,712
OPM (%)	11.4	15.1	12.6	12.6
Adjusted PAT	4,890	10,364	8,194	8,594
% YoY growth	-25.0	111.9	-20.9	4.9
Adjusted EPS (Rs)	11.2	23.6	18.7	19.6
P/E (x)	12.6	5.9	7.5	7.1
P/B (x)	1.3	1.1	1.0	0.9
EV/EBITDA (x)	10.2	4.7	5.7	5.5
RoNW (%)	10.8	20.3	14.1	13.7
RoCE (%)	10.8	20.3	14.4	13.9

Source: Company; Sharekhan estimates

Strong Q1; large earnings beat led by exceptionally robust gas marketing performance

Q1FY23 standalone operating profit/PAT of Rs. 4,366 crore/Rs. 2,915 crore, up 17.5%/8.7% q-o-q and was 20%/19.6% above our estimate of Rs. 3,636 crore/Rs. 2,437 crore. The significant beat in earnings was primarily led by strong profitability in natural gas marketing segment (EBITDA up 5.7x/35% y-o-y/q-o-q to Rs. 2,402 crore) offsetting a sequential earnings decline in other segments. Gas trading performance was robust reflecting higher trading margins (implied EBITDA margin increased by 25% q-o-q) and 6.5% q-o-q rise in gas trading volume to 101 mmscmd. Petchem EBITDA declined sharply by 66% q-o-q to Rs. 169 crore due to 50% q-o-q fall in the sales volume to 109 kt as plant operated at 60% given cut down in LNG load at its Pata petrochemical plant due to lower LNG supplies from Gazprom which offsets 16% q-o-q rise in petchem realisation. Gas transmission EBITDA was also down by 6% q-o-q to Rs. 1090 crore due to higher operating cost while gas transmission volume stood at 109 mmscmd (up 1.8% q-o-q). LPG-LHC EBITDA declined by 12% q-o-q to Rs. 663 crore due higher gas cost given 110% hike in domestic gas price to $6.1/mmBtu.

Q1FY23 key conference call highlights

- **Gazprom supply disruption update:** Out of GAIL's total LNG portfolio of 14mtpa, Gazprom accounts for 2.5 mtpa of LNG volume or 36 cargos annually. Gazprom has invoked force majeure and stopped LNG supply to GAIL since the end of May 2022. Till date, GAIL has not received 8 cargos from Gazprom. GAIL is taking several measures to keep normal supply to its customers including – 1) A cut in LNG load at its Pata petchem plant, 2) Using 'take or pay' clause for lower LNG supply to customers, 3) advancing LNG cargos scheduled for 2023 and 4) brining allocated US LNG cargo to India.
- **Multiple impact of Gazprom supply disruption –** Management indicated impact in three ways on GAIL's business – 1) lower gas marketing volume by 5-6 mmscmd from Q1FY23 level, 2) lower gas transmission volume by 7-7.5 mmscmd and 3) lower petchem production (operating at 50% utilization) due to cut in LNG supply load.
- **Impact of likely hike in domestic gas price –** Management indicated that a potential further rise in the domestic gas price from October 2022 would affect margins in the LPG-LHC segment.
- **Capex guidance –** The company has guided for Rs. 7,500 crore of capex for FY23. Out of which, GAIL has spent Rs. 1975 crore in Q1FY2023.
- **GAIL Gas:** Revenue/PBT/PAT of Rs. 2658 crore/Rs. 97 crore/Rs. 72 crore. Gas sales volume stood at 6 mmscmd.
- **Other updates –** 1) LNG accounts for 10-12% of gas requirements of priority segment of CGD Companies, 2) LPG prices have increased by Rs. 12,000/tonne from Q4FY22 out of which Rs. 4,000/tonne is due to the US Dollar impact, 3) Commissioning of the fertilizer plants is as per schedule and is not affected due to increase in LNG prices and 4) No change in status of the Kochi-Bangalore pipeline.

Results (standalone) Rs cr

Particulars	Q1FY23	Q1FY22	YoY (%)	Q4FY22	QoQ (%)
Revenue	**37,562**	**17,384**	**116.1**	**26,962**	**39.3**
Total Expenditure	33,197	14,973	121.7	23,247	42.8
Operating profit	**4,366**	**2,411**	**81.1**	**3,715**	**17.5**
Other Income	180	198	-9.0	424	-57.6
Interest	48	47	3.4	46	4.4
Depreciation	603	509	18.6	546	10.4
PBT	3,894	2,054	89.6	3,546	9.8
Tax	979	524	86.9	863	13.5
Reported PAT	**2,915**	**1,530**	**90.5**	**2,683**	**8.7**
Equity Cap (cr)	438	438		438	
Reported EPS (Rs.)	6.7	3.5	90.5	6.1	8.7
Margins(%)			**BPS**		**BPS**
OPM	11.6	13.9	-225	13.8	-215
Effective tax rate	25.1	25.5	-36	24.3	81
NPM	7.8	8.8	-104	10.0	-219

Source: Company; Sharekhan Research

Segmental EBITDA Rs cr

Segmental EBITDA	Q1FY23	Q1FY22	YoY (%)	Q4FY22	QoQ (%)
Natural gas transmission	1,090	1,176	-7.3	1,154	-5.5
LPG transmission	100	102	-2.0	101	-1.0
Natural gas trading	2,402	422	469.2	1,779	35.0
Petrochemicals	169	255	-33.7	503	-66.4
LPG and Liquid hydrocarbons	663	654	1.4	753	-12.0
Others	121	0	NA	-152	NA
Total EBITDA	**4,545**	**2,609**	**74.2**	**4,138**	**9.8**

Source: Company; Sharekhan Research

Segment-wise volume performance

Segmental volumes	Q1FY23	Q1FY22	YoY (%)	Q4FY22	QoQ (%)
Natural gas transmission (mmscmd)	109	108	1.7	108	1.8
LPG transmission (kmt)	1,055	1,023	3.1	1,065	-0.9
Natural gas trading (mmscmd)	101	96	5.1	95	6.5
Petrochemicals (kmt)	109	138	-21.0	216	-49.5
LPG and Liquid hydrocarbons (kmt)	220	250	-12.0	217	1.4

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 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.

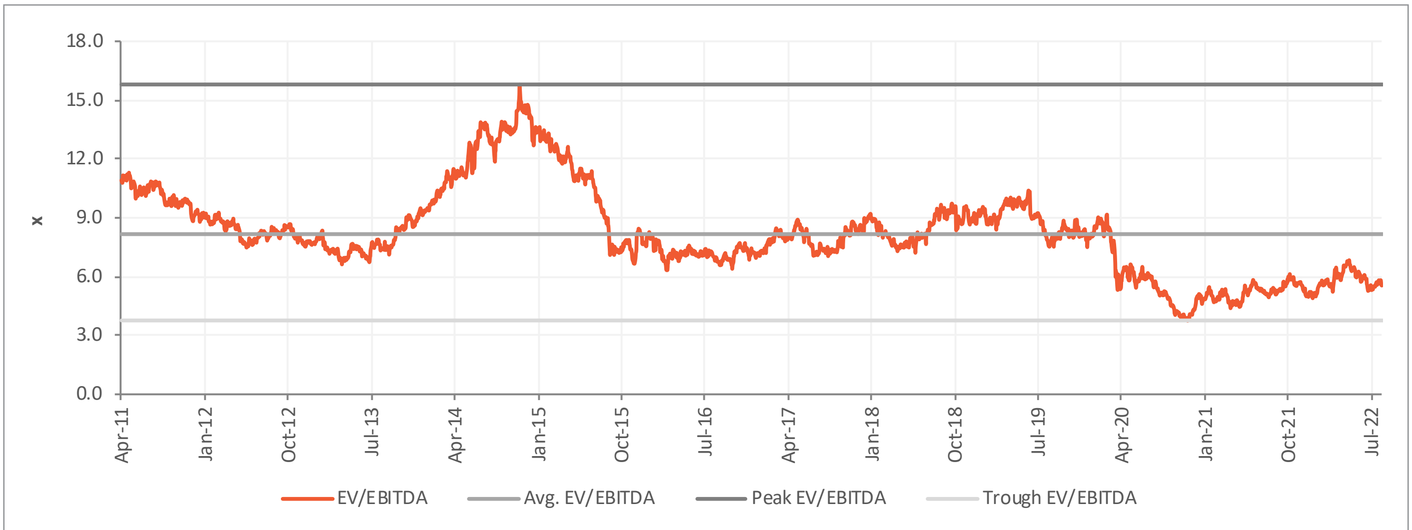
■ Company Outlook – Near-term earnings headwinds due to gas supply concern

The Russia-Ukraine crisis led to global gas supply distortions leading to high spot LNG price and thus companies taking measures to ensure gas supply to Europe. This would mean lower LNG supply for GAIL (as Gazprom stops 2.5 mtpa LNG supply) and creates volume headwinds for GAIL's gas transmission, gas marketing and petchem business. Thus, we expect GAIL's PAT to decline sharply by 21% y-o-y in FY23 and grew at slow pace of 4.9% y-o-y in FY24.

■ Valuation – Downgrade GAIL to Hold with a revised PT of Rs. 152

Global gas supply crisis (Gazprom invokes force majeure to stop LNG supply) creates volume-led earnings headwinds for GAIL's major businesses until the supply is restored by the gas supplier. The absence of an exact timeline for normalization of gas supply situation makes us cut our earnings and EV/EBITDA multiple for GAIL's gas transmission, gas marketing and petrochemical business. Thus, we downgrade GAIL to Hold (from Buy) with a revised PT of Rs. 152 as multiple earning headwinds limit upside potential. At CMP, GAIL trades at 5.7x FY23E EV/EBITDA and 5.5x FY24E EV/EBITDA.

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 long term 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. However, recent global gas supply disruptions create volume led earnings headwinds for the company. We thus downgrade GAIL to, Hold.

Key Risks

- Faster-than-expected resolution of gas supply issue from Gazprom and ramp-up of domestic gas supply could improve gas volume and is key upside risk.
- Difficulty is sourcing of LNG cargos a reasonable price amid global gas supply crunch could act as earnings headwinds and is a key downside risk.

Additional Data

Key management personnel

Manoj Jain	Chairman and MD
A.K. Tiwari	Director (Finance)
M.V. Iyer	Director (Marketing)

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Life Insurance Corp of India	6.2
2	Oil & Natural Gas Corp Ltd	4.9
3	Indian Oil Corp Ltd	2.5
4	HDFC Asset Management Co. Ltd	1.9
5	Vanguard Group Inc./The	1.8
6	SBI Funds Management Ltd	1.5
7	ICICI Prudential Asset Management Co. Ltd/The	1.3
8	Government Pensi	1.2
9	BlackRock Inc.	1.0
10	Franklin Resources Inc.	0.8

Source: Bloomberg (old data)

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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