Sharekhan by BNP PARIBAS

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Stock Update

Result Update

GAIL (India) Ltd

Weak Q2; Near-terms headwinds persist

Oil & Gas	Sharekhan code: GAIL		
Reco/View: Hold ↔	CMP: Rs. 90	Price Target: Rs. 97 ↓	

↑ 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

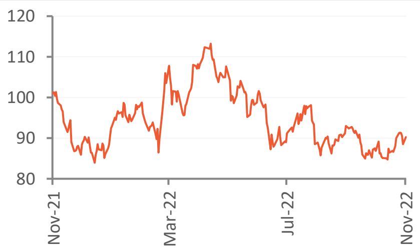
Company details

Market cap:	Rs. 59,340 cr
52-week high/low:	Rs. 116/83
NSE volume: (No of shares)	106.1 lakh
BSE code:	532155
NSE code:	GAIL
Free float: (No of shares)	316.3 cr

Shareholding (%)

Promoters	51.9
FII	19.8
DII	13.9
Others	14.4

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	16.2	14.0	-5.4	11.9
Relative to Sensex	13.0	11.2	-14.9	13.7

Sharekhan Research, Bloomberg

Summary

- Standalone operating profit/PAT of Rs. 1,765 crore/Rs. 1,537 crore, down 60%/47% q-o-q was 25%/10% below our estimates due to weak profitability (ex-LPG transmission) across business segments. Gas marketing/LPG-LHC/gas transmission EBITDA fell by 81%/21%/7% q-o-q to Rs. 452 crore/Rs. 524 crore/Rs. 1,010 crore; petchem posted EBITDA loss of Rs. 210 crore.
- The big miss was driven by the gas marketing division, which had to face double whammy of weak marketing margin/volume, down 80%/8% q-o-q. Petchem loss was due to lower utilization of only 43% and 10% q-o-q decline in realisation while the LPG-LHC segment got impacted by higher domestic gas price and 16% q-o-q fall in realisation.
- H2FY23 earnings would continue to face headwinds with LHG-LHC profitability to get affected by APM gas price hike, likely continued loss in petchem on weak utilisation/high LNG price and opex while gas marketing earnings to remain volatile and unpredictable in near term. We cut our FY23 earnings estimate by 10% to factor weak H1FY23 performance.
- We maintain our Hold rating on GAIL with a revised PT of Rs. 97 (lowered to reflect higher net debt) given a limited upside potential from the CMP and continued concerns of earnings across segments.

Q2FY23 standalone operating profit of Rs. 1,765 crore (down 49.2% y-o-y; down 59.6% q-o-q) was 25% below our estimate of Rs. 2,361 crore due to weaker-than-expected gas marketing volume/margin, steep decline in LPG-LHC earnings, higher-than-expected petchem EBITDA loss and a marginal miss in gas transmission EBITDA owing to higher opex. Gas marketing EBITDA declined sharply by 81% q-o-q to Rs. 452 crore due to weaker-than-expected gas marketing margin (implied EBITDA margins declined by 80% q-o-q which could be attributed narrowing down of spread between oil-indexed LNG and HH-linked LNG prices) and volumes (down 8% q-o-q to 92.5 mmscmd) were also hit by LNG supplies issues. Given LNG supply issues, GAIL had also reduced LNG supply to its petchem plant, which in turn had impact of a very low utilization rate of 43% in Q2FY23 (versus 60%/98% in Q1FY23/ Q2FY22) along with lower petchem realisation by 10% q-o-q and thus petchem segment posted EBITDA loss of Rs. 210 crore (versus positive EBITDA of Rs. 169 crore/Rs. 482 crore in Q1FY23/Q2FY22). LPG-LHC segment margin were hit by 16% q-o-q decline in realisation, given lower LPG price and higher domestic gas price and resultantly EBITDA from segment plunged by 26%/21% y-o-y/q-o-q to Rs. 524 crore. Gas transmission volumes (down 2% q-o-q to 108 mmscmd) had limited impact from LNG supply issues and its blended transmission tariff was also up 4% q-o-q but still the segment EBITDA declined by 7% q-o-q to Rs. 1,010 crore due steep rise in operating cost. LPG transmission (relatively small business for GAIL) posted 33%/30% q-o-q rise in EBITDA to Rs. 130 crore led by 4%/11% q-o-q rise in volume/tariff.

Key positives

- LPG transmission EBITDA increased by 30% q-o-q to Rs. 130 crore led by higher volume/tariff.
- JHBDPL network with 16mmscmd capacity is expected to be fully commissioned within the next 2 years.

Key negatives

- Gas marketing/LPG-LHC EBITDA declined steeply by 81%/21% q-o-q.
- Petchem posted EBITDA losses of Rs. 210 crore on weak utilization of only 43%, high cost and lower petchem realisation.

Management Commentary

- The management highlighted that due to supply disruption the company was taking steps to mitigate the shortfall for meeting by reducing internal consumption and by sourcing from IGX and others.
- Management highlighted that the transmission volumes were not severely affected as compared to marketing volumes since it was GAIL which faced supply disruptions while others player did not have supply issues and were able to source and supply to customers using GAIL's pipelines
- Gas marketing spreads in Q2FY23 were lower due to well supplied market, higher gap between Henry Hub versus Spot LNG and due to cut in supply to customers who are on take or pay basis
- Management cited JBF plant would be commissioned within 24 months after the acquisition process is complete. The investment required would be Rs. 1,800-2,000 crore to make the plant operational.

Revision in estimates – We have lowered our FY23 earnings estimate to factor weak H1FY23 performance and have fined tuned our FY24 earnings estimate.

Our Call

Valuation – Maintain Hold with a revised PT of Rs. 97: Global gas supply crisis creates, elevated LNG prices, lower PE/LPG price and higher domestic gas price creates earnings uncertainties for GAIL's major businesses. Moreover, JBF's petchem plant acquisition would increase debt level and pressure on earnings would impact return ratios. We thus maintain our Hold rating on GAIL with a revised PT of Rs. 97 (lowered to reflect higher net debt). At CMP, GAIL trades at 6.1x FY23E EV/EBITDA and 5.4x FY24E EV/EBITDA.

Key Risks

A faster-than-expected resolution of gas supply issue from Gazprom and a ramp-up of domestic gas supply could improve gas volume and is a key upside risk. Difficulty in sourcing of LNG cargos a reasonable prices 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	88,142	96,712
OPM (%)	11.4	15.1	11.7	12.6
Adjusted PAT	4,890	10,364	7,391	8,594
% YoY growth	-25.0	111.9	-28.7	16.3
Adjusted EPS (Rs.)	7.4	15.8	11.2	13.1
P/E (x)	12.1	5.7	8.0	6.9
P/B (x)	1.3	1.1	1.0	0.9
EV/EBITDA (x)	9.9	4.6	6.1	5.4
RoNW (%)	10.8	20.3	12.8	13.8
RoCE (%)	10.8	20.3	13.1	14.0

Source: Company; Sharekhan estimates

Weaker-than-expected performance across segments

Q2FY23 standalone operating profit of Rs. 1,765 crore (down 49.2% y-o-y; down 59.6% q-o-q) was 25% below our estimate of Rs. 2,361 crore due to weaker-than-expected gas marketing volume/margins, a steep decline in LPG-LHC earnings, higher-than-expected petchem EBITDA loss and a marginal miss in gas transmission EBITDA owing to higher opex. Gas marketing EBITDA declined sharply by 81% q-o-q to Rs. 452 crore due to weaker-than-expected gas marketing margin (implied EBITDA margins declined by 80% q-o-q which could be attributed narrowing down of spread between oil-indexed LNG and HH-linked LNG prices) and volumes (down 8% q-o-q to 92.5 mmscmd) were also hit by LNG supplies issues. Given LNG supply issues, GAIL had also reduced LNG supply to its petchem plant, which in turn was affected by a very low utilization rate of 43% in Q2FY23 (versus 60%/98% in Q1FY23/Q2FY22) along with lower petchem realisation by 10% q-o-q and thus petchem segment posted EBITDA losses of Rs. 210 crore (versus positive EBITDA of Rs. 169 crore/Rs. 482 crore in Q1FY23/Q2FY22). LPG-LHC segment margin were hit by 16% q-o-q decline realisation, given lower LPG price and higher domestic gas price and resultantly EBITDA from segment plunged by 26%/21% y-o-y/q-o-q to Rs. 524 crore. Gas transmission volumes (down 2% q-o-q to 108 mmscmd) had limited impact from LNG supply issues and its blended transmission tariff was also up 4% q-o-q but still the segment's EBITDA fell by 7% q-o-q to Rs. 1,010 crore due steep rise in operating cost. LPG transmission (relatively small business for GAIL) posted 33%/30% q-o-q rise in EBITDA to Rs. 130 crore led by 4%/11% q-o-q rise in volume/tariff.

Q2FY23 key conference call highlights

- **Gazprom supply disruption update:** Gazprom had invoked Force Majeure and has stopped LNG supply to GAIL since May 2022.Gail has not received 13 LNG cargoes in Q2FY23 and 17 LNG cargoes in H1FY23. This resulted in short fall of supplies to the tune of 8.5mmscmd -9mmscmd. However, as GAIL has contracted to fulfill its obligations with others it mitigated the impact of shortfall by reducing internal consumption and by sourcing from IGX and others. GAIL reduced 2.7mmscmd of volumes to Fertilizer sector and 3mmscmd at PATA plant while remaining was shortfall was sourced. GAIL intends to source 1-1.5 cargos sourced each quarter to mitigate this shortfall.
- **Gas marketing spreads significantly lower in Q2FY23:** The management stated that in Q1FY23 gas marketing spreads were significantly higher than normal. Hence, on q-o-q comparison gas marketing spreads would seem to have fallen sharply in Q2FY23. The gas marketing spreads in Q2FY23 were lower due to a well-supplied market, higher gap between Henry Hub versus Spot LNG and due to cut in supply to customers who are on take or pay basis.
- **Dismal performance from Petchem:** Petchem The petchem segment's profits were significantly down in Q2FY23 due to lower volumes on account of LNG supply issues and higher gas prices. The Pata petrochemical plant curtailed operations due the supply issues and Petrochemical utilisation levels fell to 40% and remains at the same levels currently. The management indicated Petrochemical ramp up would depend on market prices of petchem and if more gas is available.
- **Gas transmission:** Management highlighted that the transmission volumes were not severely impacted compared to marketing volumes since it was Gail which faced supply disruptions while others player did not have supply issue and were able to source and supply to customers using Gail's pipelines. The management also clarified that tariff realization was also higher on account of higher volumes from Jagdishpur Haldia pipeline which has higher tariffs compare to other pipelines. The management stated that pipeline tariffs would be revised this month.
- **JBF acquisition:** The management cited JBF acquisition is now in legal process and stated that it would be difficult to give clear timeliness however they felt that 3m-6m would be required to conclude the process. The management stated that they would commission the plant within 24 months after the acquisition process is complete. The investment required would be 1800-2000Cr to make the plant operational.

- **Dabhol LNG Terminal:** The management mentioned that Dabhol terminal's breakwater is expected to become operational by March 2023.
- **Capex guidance:** The management guided for a capex of Rs. 7500 crore for FY23 and has completed capex of Rs. 3967 crore in H1FY23.

Results (standalone) Rs cr

Particulars	Q2FY23	Q2FY22	YoY (%)	Q1FY23	QoQ (%)
Revenue	**38,479**	**21,511**	**78.9**	**37,562**	**2.4**
Total Expenditure	36,714	18,036	103.6	33,197	10.6
Reported operating profit	**1,765**	**3,475**	**-49.2**	**4,366**	**-59.6**
Other Income	799	774	3.2	180	344.4
Interest	68	42	61.0	48	41.9
Depreciation	619	524	18.1	603	2.7
Reported PBT	1,876	3,682	-49.1	3,894	-51.8
Tax	339	819	-58.6	979	-65.4
Reported PAT	**1,537**	**2,863**	**-46.3**	**2,915**	**-47.3**
Equity Cap (cr)	658	658		658	
Reported EPS (Rs.)	2.3	4.4	-46.3	4.4	-47.3
Margins (%)			**BPS**		**BPS**
OPM	4.6	16.2	-1157	11.6	-704
Effective tax rate	18.1	22.3	-419	25.1	-708
NPM	4.0	13.3	-931	7.8	-377

Source: Company; Sharekhan Research

Segmental EBITDA Rs cr

Particulars	Q2FY23	Q2FY22	YoY (%)	Q1FY23	QoQ (%)
Natural gas transmission	1,010	1,314	-23.1	1,090	-7.3
LPG transmission	130	98	32.7	100	30.0
Natural gas trading	452	1,124	-59.8	2,402	-81.2
Petrochemicals	-210	482	NA	169	NA
LPG and Liquid hydrocarbons	524	703	-25.5	663	-21.0
Others	658	528	24.6	121	443.8
Total EBITDA	**2,564**	**4,249**	**-39.7**	**4,545**	**-43.6**

Source: Company; Sharekhan Research

Segment-wise volume performance

Particulars	Q2FY23	Q2FY22	YoY (%)	Q1FY23	QoQ (%)
Natural gas transmission (mmscmd)	108	114	-5.8	109	-1.6
LPG transmission (kmt)	1,100	1,054	4.4	1,055	4.3
Natural gas trading (mmscmd)	93	98	-5.3	101	-8.2
Petrochemicals (kmt)	108	221	-51.1	109	-0.9
LPG and Liquid hydrocarbons (kmt)	231	262	-11.8	220	5.0

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.

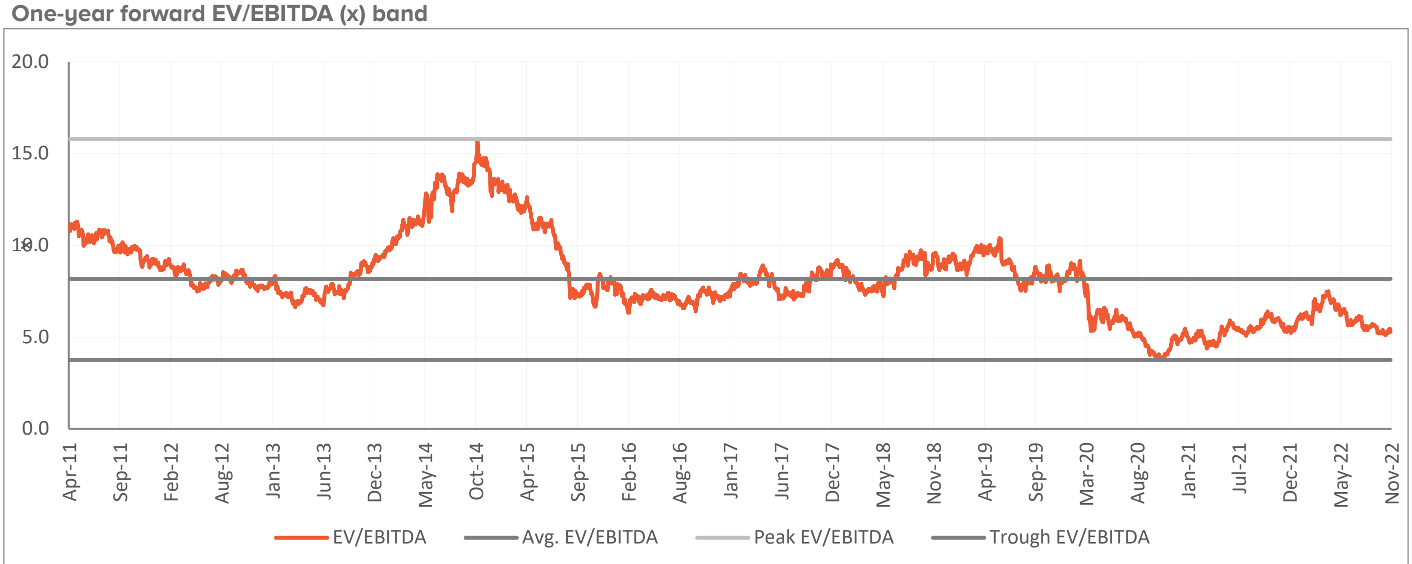
■ Company Outlook – Near-term earnings headwinds due to gas supply concerns

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 29% y-o-y in FY23.

■ Valuation – Maintain Hold with a revised PT of Rs. 97

Global gas supply crisis creates, elevated LNG price, lower PE/LPG price and higher domestic gas price creates earnings uncertainties for GAIL's major businesses. Moreover, JBF's petchem plant acquisition would increase debt level and pressure on earnings would impact return ratios. We thus, maintain our Hold rating on GAIL with a revised PT of Rs. 97 (lowered to reflect higher net debt). At CMP, GAIL trades at 6.1x FY23E EV/EBITDA and 5.4x 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.

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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