REDUCE (Downgrade from HOLD)

CMP: **INR 452** Target Price: **INR 385 (INR 425)** ▼ -15%

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28 December 2023

India | Equity Research | Company Update

Gujarat Gas

Oil & Gas

Softness in LNG prices obscures murky long-term prospects

We downgrade Gujarat Gas (GUJGA) to REDUCE, from *Hold*, as we turn increasingly worried about the company's growth trajectory beyond FY25. The recent weakness in LNG prices is a positive (assuming it is not passed through) and drives a material 6/19.1/15.3% upgrade in FY24E/25E/26E EPS, but does not detract from structural worries. Essentially: 1) growth from areas ex-Morbi remains murky, with limited traction observed from the ~INR 43bn capex over FY19-23 and a further INR 36bn estimated over FY24-26E. (volume/EBITDA CAGR over the same period at 8/14%); 2) margins remain volatile and dependent on propane price vagaries; 3) GUJGA's guidance on margins is cautious, topped with limited visibility on volume growth; and 4) The company's valuation is still at >20x FY26E EPS, leaving room for more downside risks.

Recent LNG softness boosts margins

The recent moderation in LNG costs, owing to comfortable inventory levels in Europe, and the coeval decline in crude prices are margin propellants for GUJGA. The company sources ~27% of its gas from the spot market and a further ~38% from term LNG contracts. Hence, even a USD 1/MMBtu reduction in gas costs, if not passed on, shall boost gross margins by INR 2.3/scm. While we factor in the lower gas cost trajectory to a certain extent, we hesitate to build in 100% of the margin benefit given management's recent guidance of INR 4.5-5.5/scm target margins on a sustainable-basis. This hints at the possibility that benefits thereof will be passed on, albeit partially, to protect/grow pricing competitiveness versus alternate fuels, thereby blunting a possible margin jump over H2FY24-25E.

Alternate fuels' prices, especially propane, may soften too!

Within the bracket of the last decade, LPG prices (key source for propane) saw their softest correlation to crude over the last two years (exhibit 25). With that, we see near-term prospects remaining bearish. Crude prices hovering at <USD 80/bbl for the next few months implies that propane prices will once again decline below USD 520/t by end-CY24E, opening up a discount of 17-20% versus GUJGA's industrial prices at Morbi. However, we see two significant upside risks to this estimate: 1) China's propane Dehydrogenation (PDH) plants accelerating their commissioning deadlines. 2) Crude prices and hence, LPG cracks, improving faster than expected, driving propane prices higher, thus boosting GUJGA's industrial segment's price competitiveness.

Financial Summary

Y/E March (INR mn)	FY23A	FY24E	FY25E	FY26E
Net Revenue	1,67,594	1,62,326	2,01,641	2,25,168
EBITDA	23,920	20,303	22,764	24,833
EBITDA %	14.3	12.5	11.3	11.0
Net Profit	15,255	12,291	13,704	14,832
EPS (INR)	22.2	17.9	19.9	21.5
EPS % Chg YoY	17.8	(19.4)	11.5	8.2
P/E (x)	20.3	25.2	22.6	20.9
EV/EBITDA (x)	12.5	14.6	12.7	11.4
RoCE (Pre-tax) (%)	29.3	20.5	20.5	20.0
RoE (%)	24.2	16.5	16.3	15.6

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Market Data

Market Cap (INR)	310bn
Market Cap (USD)	3,716mn
Bloomberg Code	GUJGA IN
Reuters Code	GGAS.BO
52-week Range (INR)	526 /397
Free Float (%)	25.0
ADTV-3M (mn) (USD)	5.9

Price Performance (%)	3m	6m	12m
Absolute	6.9	(3.9)	(6.0)
Relative to Sensex	9.0	13.6	18.2

Earnings Revisions (%)	FY24E	FY25E	FY26E
Revenue	(1.5)	(1.2)	(1.8)
EBITDA	4.8	14.7	11.8
EPS	6.0	19.1	15.3

Previous Reports

05-11-2023: Q2FY24 results review
04-09-2023: Company Update

Growth beyond Morbi remains below expectations

Barring the one-time boost to volumes in FY20, post the Supreme Court banning use of illegal coal/petcoke based gasifiers at Morbi, volumes over the last four years have remained flat at 9.4-9.5mmscmd levels. This is despite investing close to INR 43bn over FY19-23, highlighting the challenge GUJGA has endured in converting potential to performance over the last five years.

Our interaction with management suggests that volumes from non-legacy areas have reached 0.4-0.5mmscmd over the last four–five years. While management continues to aggressively invest in these areas (INR 12–14bn annual capex expected over FY24-26E) we see growth from the newer areas lagging the pace of investments over the next three–five years.

Valuations and view: Multiples factor in high risk-reward; downgrade to REDUCE

We raise our FY24E/25E EPS by 6%/19.1% to factor in the undoubted benefit likely from softer gas prices to GUJGA margins, even as we see limited traction to volumes beyond that what is already baked in for both years. Despite the higher earnings and momentum from margins, we recommend investors book profits in the event of a near term rally, as long-term prospects remain unclear. Valuations at 20.9x FY26E EPS/11.4x EV/EBITDA create a material downside risk hereon and we see limited upside triggers once the gas cost-led momentum fades. Downgrade to **REDUCE**.

Key upside risks: i) Sharper recovery in LPG (propane) prices, ii) faster execution of expansion plans in new areas, iii) sharp drop in LNG prices.

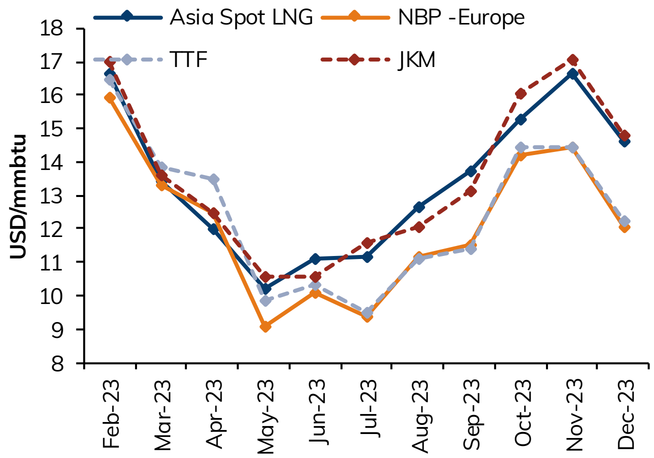
Key downside risks: i) Longer sustained weakness in propane prices, ii) slower ramp up of volumes from new areas, iii) sudden spike in spot LNG prices.

Recent gas price movements, a positive

Comfortable gas inventories in Europe, growing LNG supplies and the lack of traction in Chinese demand have pointed spot LNG prices back to <USD 14/MMBtu levels, after its brief spike to USD 18/MMBtu levels in Oct'23. Overall, with average levels in CY23 at USD 13.5/MMBtu (down USD 21.1/MMBtu YoY), there is a sense of optimism for GUIJGA's CY24 margins, CY25E even.

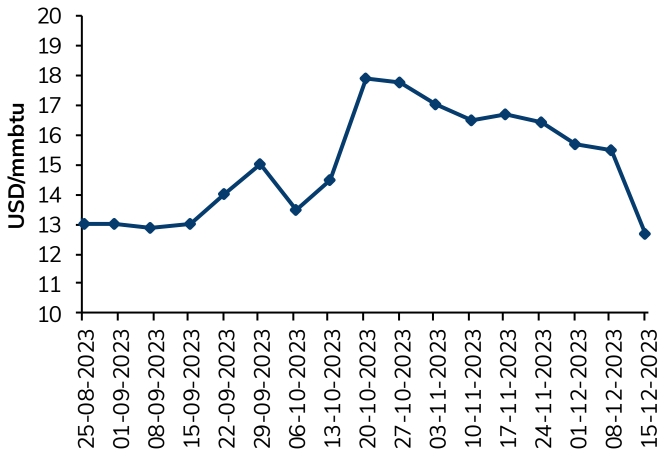
The last few months have been fairly positive for Indian gas consumers, with a relatively lower spike in spot LNG prices (vs. expectations) and visibility of higher domestic gas supply, helping boost margin prospects for H2FY24-FY25E.

Exhibit 1: International gas prices see a downtrend



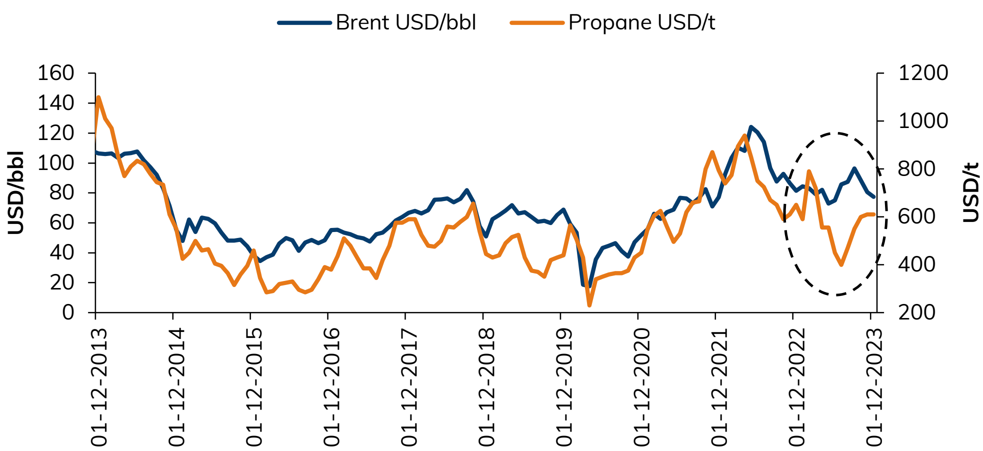
Source: Bloomberg, I-Sec research

Exhibit 2: Steep decline in spot LNG prices in recent weeks



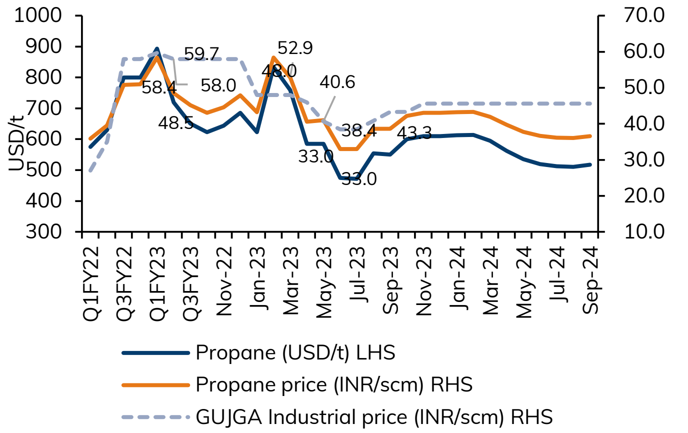
Source: Bloomberg, I-Sec research

Exhibit 3: Propane and Brent prices saw softer correlation in the last two years



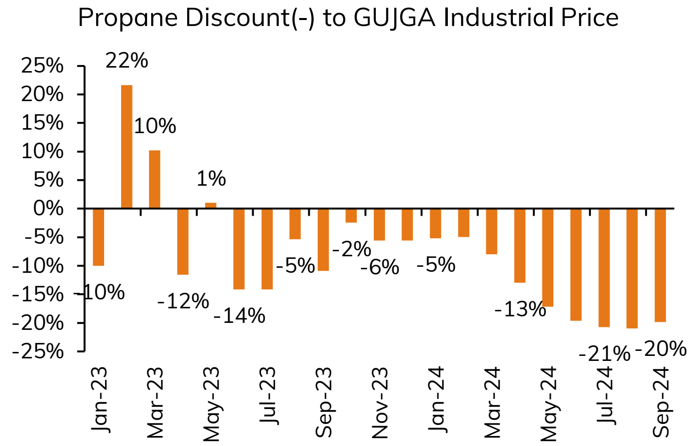
Source: Company data, Bloomberg, I-Sec research

Exhibit 4: Propane prices likely to see decline again, Mar'24 onwards...



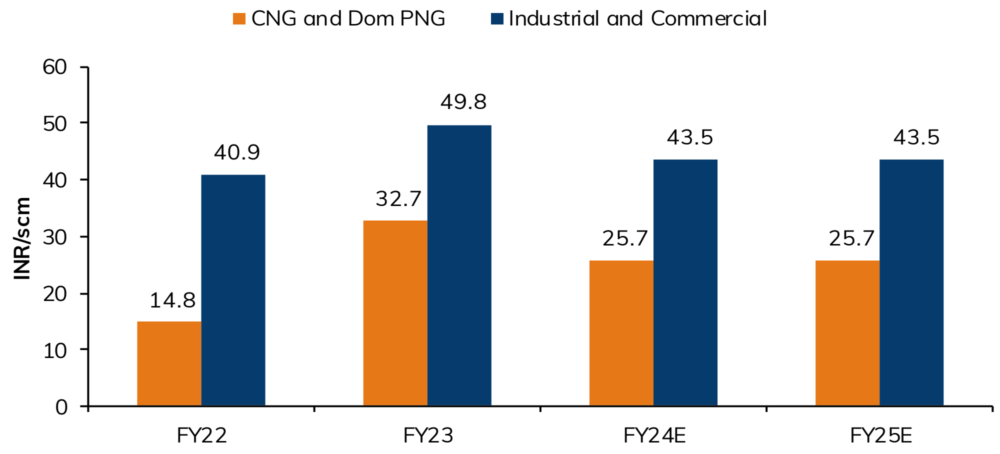
Source: Company data, I-Sec research, Note : Future prices from Nov'23 onwards

Exhibit 5: ...thus , propane discount to gas likely to increase



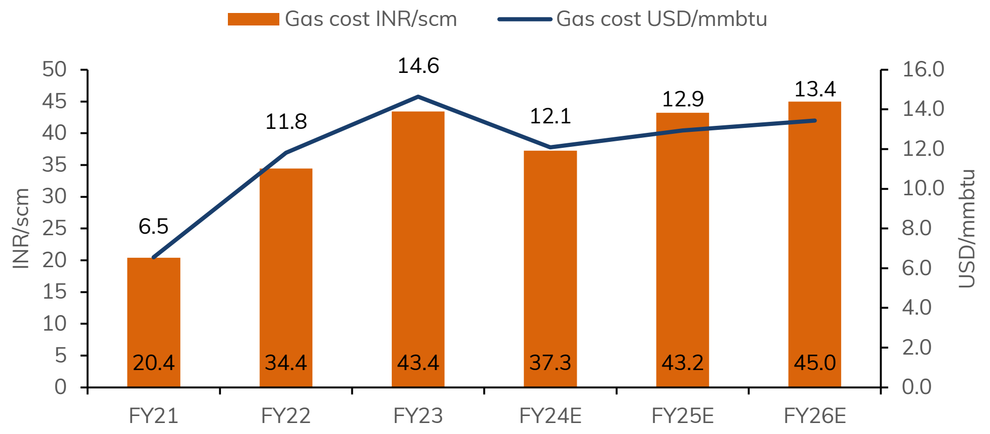
Source: Company data, I-Sec research, Note : Future prices from Nov'23 onwards

Exhibit 6: Segmental implied gas cost for GUJGA



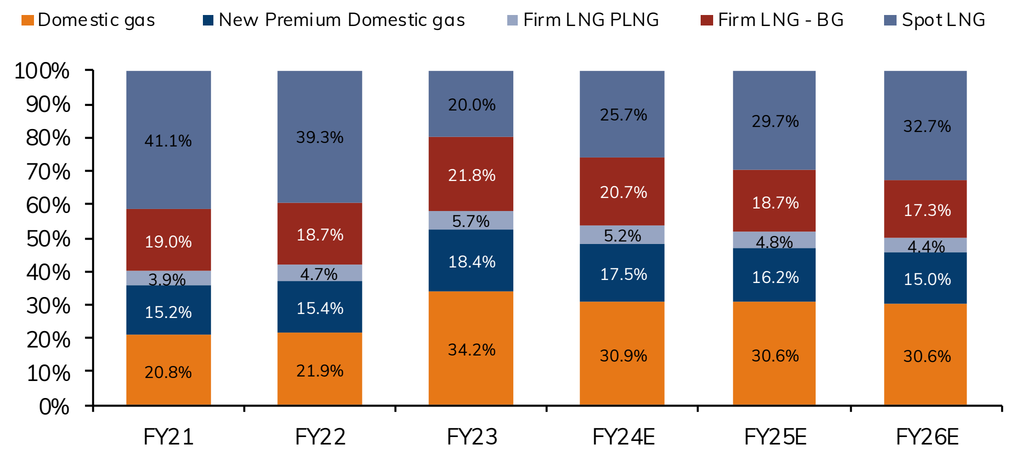
Source: Company data, I-Sec research

Exhibit 7: GUJGA's overall gas cost



Source: Company data, I-Sec research

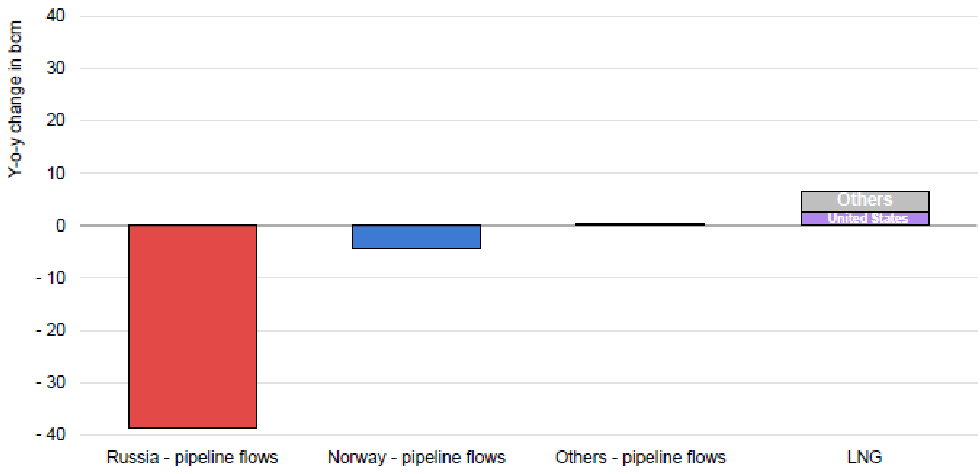
Exhibit 8: Sourcing mix more varied than before



Source: Company data, I-Sec research

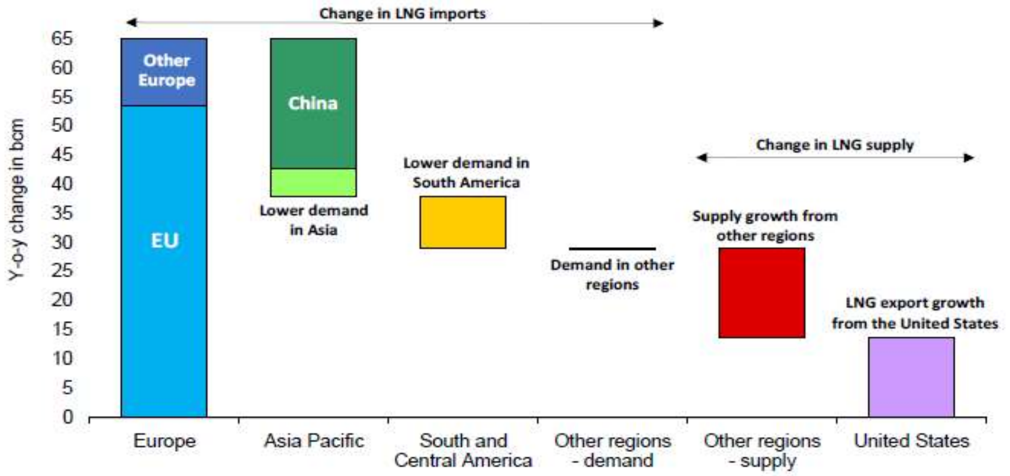
The scenario for LNG supply and the Russia-Ukraine position remain in a flux for the near term. Given the backdrop, it is evident so far that the Eurozone is managing to offset the disruption of Russian pipeline supplies fairly well helped by some demand destruction, alternate fuel imports and a significant spike in US LNG imports into Europe.

Exhibit 9: US LNG supply continued to substitute Russian piped gas in Europe's supply mix in H1CY23



Source: IEA Gas report, I-Sec research

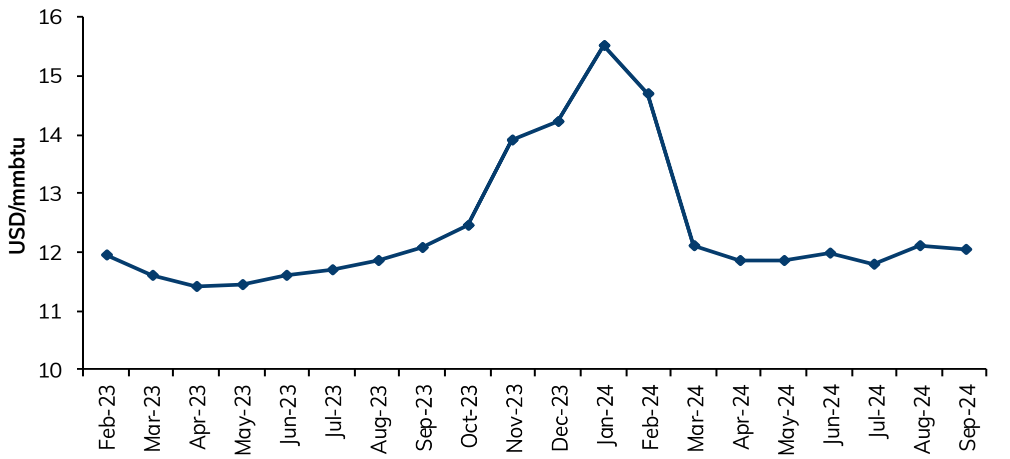
Exhibit 10: Flexible LNG played a key role in maintaining gas supply security in Europe in CY22



Source: IEA Gas report, I-Sec research

The scenario for CY24/FY25E and CY25/FY26E remains foggy, but one thing seems clear – even without an improvement in Russian gas supplies to Europe, LNG prices look unlikely to spike to the levels of USD 50-60/MMBtu, as seen in CY22.

Exhibit 11: JKM futures remain in range of USD 11-16/MMbtu for next 18 months



Source: CME futures, I-Sec research

This moderation in gas costs of course has material positive implications for GUJGA. The company can see this benefit playing out in one of two ways: 1) passing on the INR 2-2.3/scm benefit (assuming USD 1-2/MMBtu benefit for overall gas costs over H2FY24E) to customers to improve pricing competitiveness; or ii) retaining the benefit, which shall consequently add a notable INR 3.5bn to H2FY24E gross margins.

We have created the following scenarios with H2FY24 as the base for our base case estimates –

- Scenario 1: Gas price benefit of USD 1/MMbtu is passed on to customer and volume increases by 5%
- Scenario 2: Gas price benefit of USD 1/MMbtu is retained by GUJGA

Exhibit 12: Scenario of reduction in LNG price by USD 1/MMbtu

		H2FY24E	Scenario1	Scenario 2
Volume	mmscmd	9.8	10.2	9.8
Spot LNG	USD/mmbtu	15.2	15.2	14.2
Gross Margin	INR/scm	9.8	9.8	12.1
Gross Margin	INR mn	17,609	18,215	21,740
Change vs Base year			3%	23%

Source: Company data, I-Sec research

Exhibit 13: Gross margin sensitivity for USD 1/MMbtu decrease in LNG gas cost – GUJGA to benefit the most

IGL		FY25E Base case	Sensitivity	H2FY24e (basecase)	Sensitivity
Volume	mmscmd	9.0	9.0	8.5	8.5
Spot LNG	USD/mmbtu	23.8	22.8	20.0	19.0
Gross Margin	INR/scm	13.6	13.9	13.7	14.0
Gross Margin	INR mn	44,720	45,702	21186	21683
Change in gross margin			2%		2%
MGL					
Volume	mmscmd	3.7	3.7	3.6	3.6
Spot LNG	USD/mmbtu	18.0	17.0	19.3	18.3
Gross Margin	INR/scm	19.3	19.9	18.1	18.7
Gross Margin	INR mn	26,149	27,075	11,844	12,280
Change in gross margin			4%		4%
Gujarat Gas					
Volume	mmscmd	10.5	10.5	9.8	9.8
Spot LNG	USD/mmbtu	15.3	14.3	15.2	14.2
Gross Margin	INR/scm	9.4	11.8	9.8	12.1
Gross Margin	INR mn	36,019	45,351	17,609	21,740
Change in gross margin			26%		23%

Source: Company data, I-Sec research

We have duly factored in the improved margin environment in H2 and FY25E/26E earnings, assuming that GUJGA will be able to retain a major part of the cost advantage **without impacting volumes.** Consequently, EPS for the three forecast years has seen substantial upgrades.

Exhibit 14: Change in earnings estimates

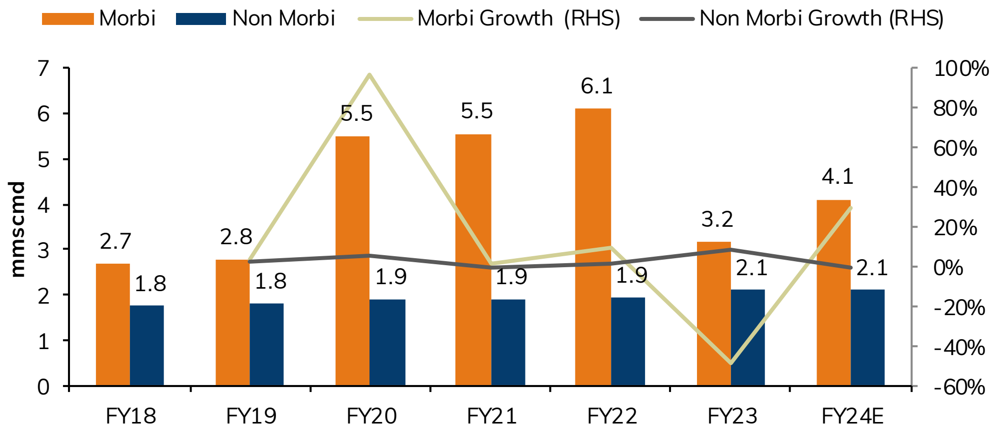
INR mn	FY24E			FY25E			FY26E		
	New Estimates	Old Estimates	% change	New Estimates	Old Estimates	% change	New Estimates	Old Estimates	% change
Revenue	1,62,326	1,64,779	-1.5%	2,01,641	2,04,153	-1.2%	2,25,168	2,29,338	-1.8%
EBITDA	20,303	19,381	4.8%	22,764	19,849	14.7%	24,833	22,217	11.8%
PAT	12,291	11,596	6.0%	13,704	11,508	19.1%	14,832	12,861	15.3%
EPS	17.9	16.8	6.0%	19.9	16.7	19.1%	21.5	18.7	15.3%

Source: Company data, I-Sec research

Disappointing volume growth post-FY20's spike

A key factor that drove the Street's optimism around GUJGA over FY19-FY21 (stock rallied from ~INR 240/share levels to >INR 640/share) was not only the spike in volumes from FY19 to FY20, but also the promise of massive traction from new areas in addition to the existing portfolio. That promise has been belied however, with limited growth in non-Morbi industrial volumes over the last four years, despite a meaningful investment in the development of these areas.

Exhibit 15: FY18-24E non-Morbi volume growth to remain muted



Source: Company data, I-Sec research

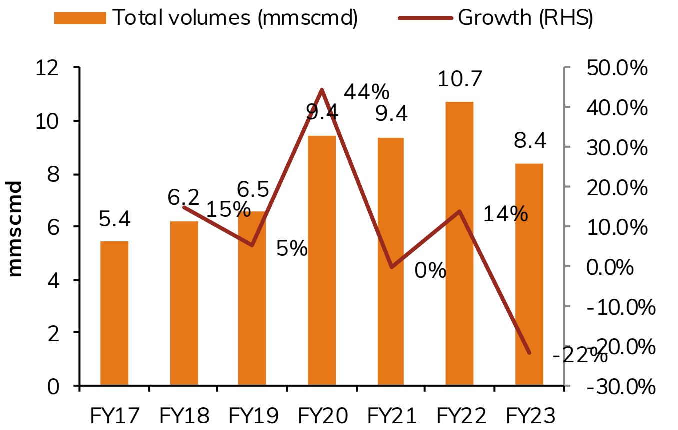
GUJGA's portfolio over the last decade has grown steadily and now encompasses an impressive 44 Districts across six states and one union territory of Dadra & Nagar Haveli, with the potential to double volumes over the medium to long term. GUJGA now has the largest footprint of any City Gas Distribution (CGD) company in India.

Exhibit 16: GUJGA – CGD licenses across 6 states and 1 UT

Source: Company data, I-Sec research

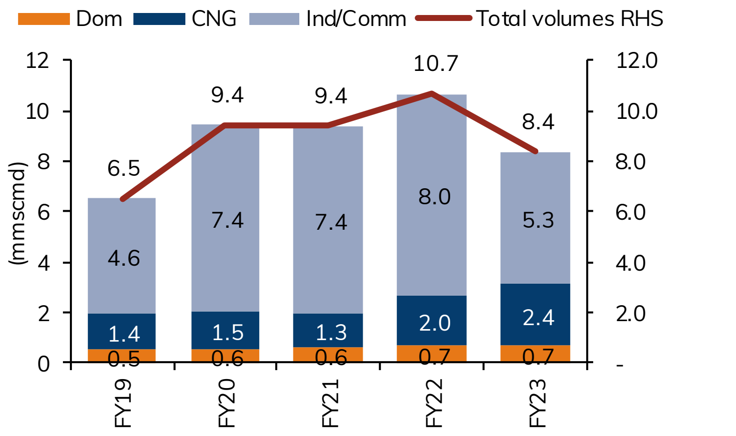
Despite its extensive presence, volumes overall have remained quite dependent on Morbi. Overall, annualised CAGR over FY20-24E of just 0.3% is reflective of limited development progress in the non-extant areas. We submit that the pandemic, over CY20-21, did crimp GUJGA's momentum; even so, progress past the pandemic's dampening has also been less than ideal. Estimated contribution of volumes from new(er) areas has only ramped up to 0.3-0.4mmscmd, out of a base of 9.4-9.5mmscmd, and has remained in this range over the last two years.

Exhibit 17: Volume growth had been weaker post-SC supported spike in FY20



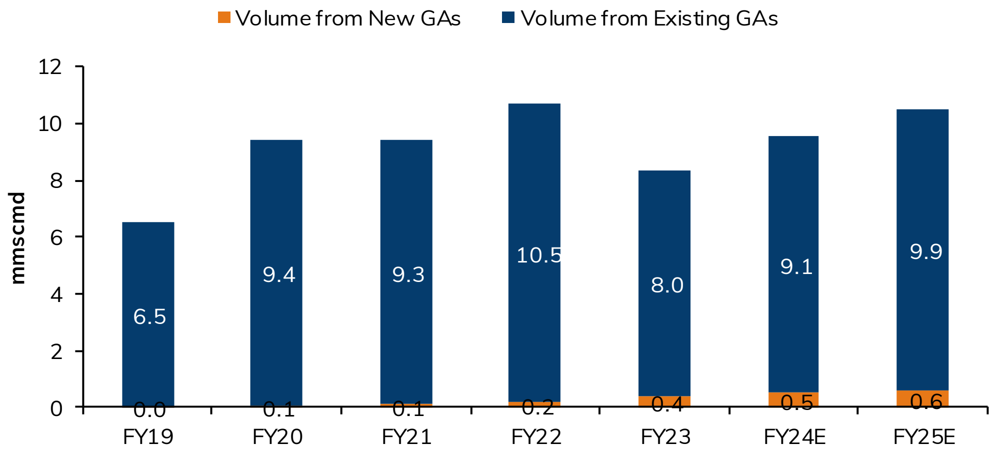
Source: Company data, I-Sec research

Exhibit 18: Industrial volumes saw a sharp fall in FY23



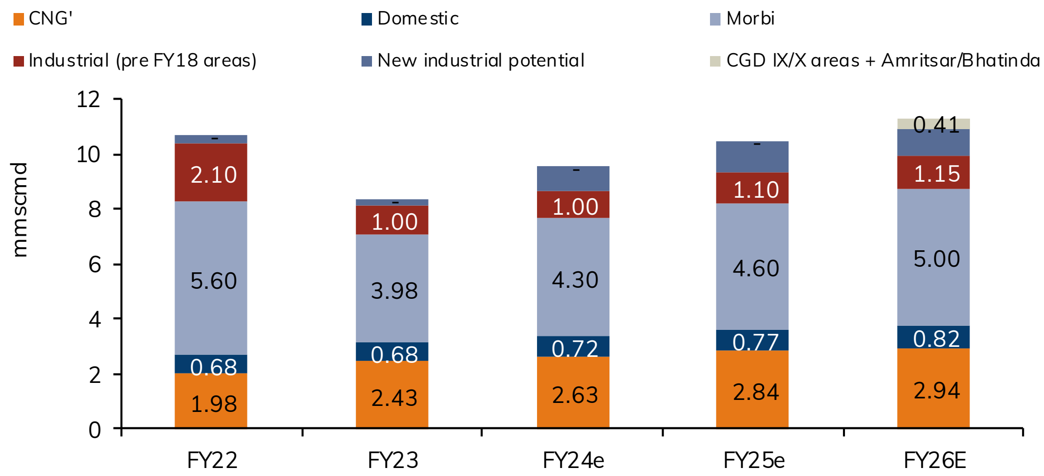
Source: Company data, I-Sec research

Exhibit 19: Growth from new GAs to remain muted over FY19-25E



Source: Company data, I-Sec research; These are I-Sec assumption

Exhibit 20: Medium-term volume potential is significant

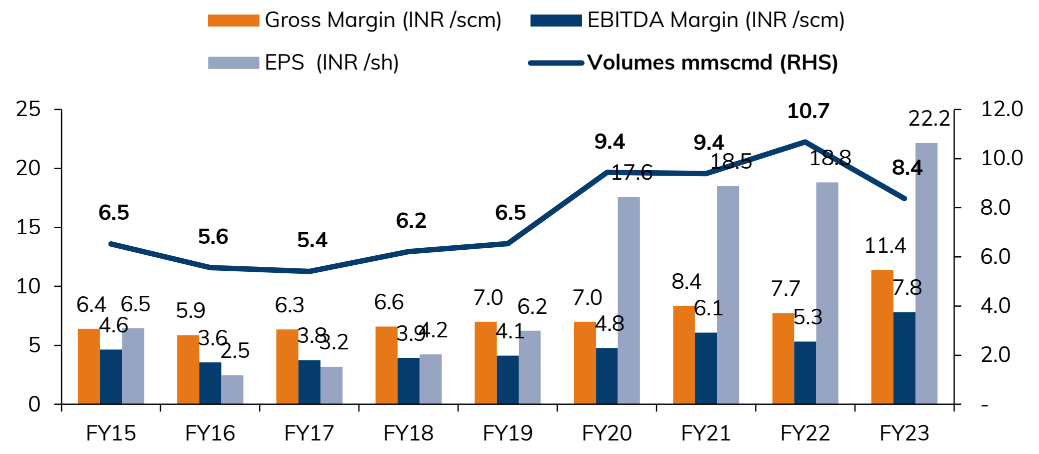


Source: Company data, I-Sec research

Material boost to investments yet to deliver returns

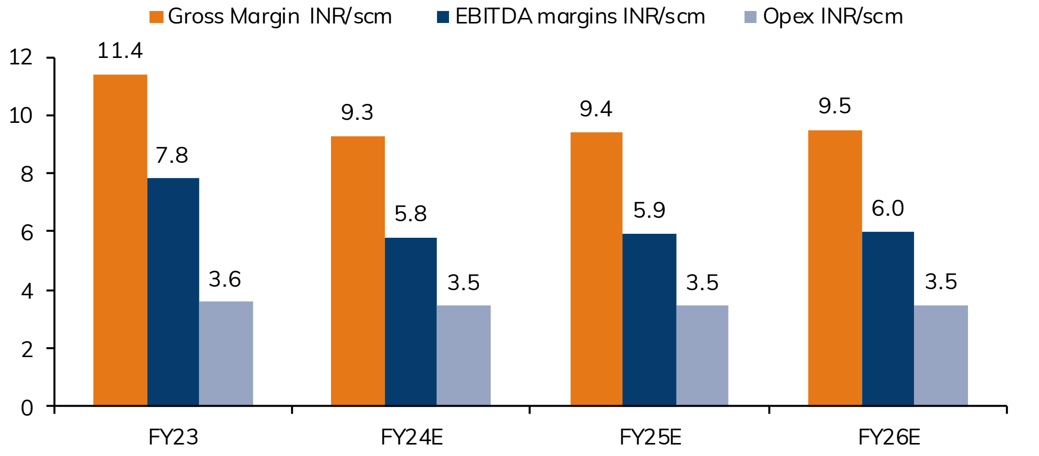
GUJGA's annualised capex of INR 74bn over FY15-24E has been material, with annual run rates ramping up to INR 9.5bn over FY20-24E versus just INR 4.8bn over FY15-19. However, returns from the additional capex have been much slower than expected to come by – profitability has still grown steadily, but that has been the result of a sharp margin improvement than any structural operational uptick during this period.

Exhibit 21: Strong margin and decent volumes drive FY15-23 EPS



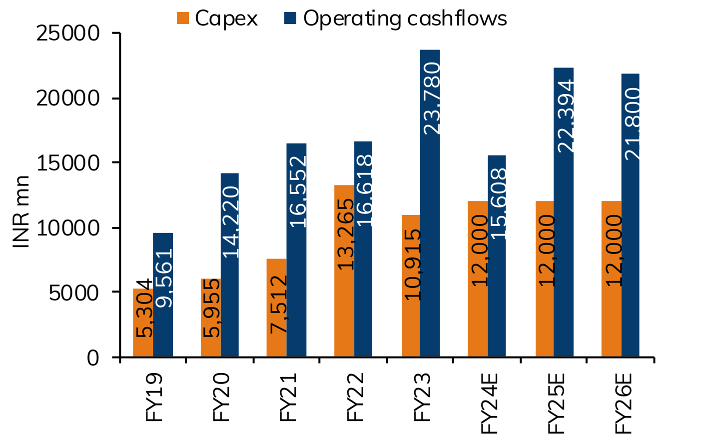
Source: Company data, I-Sec research

Exhibit 22: GUJGA's margin to sharply dip over FY23-FY26E



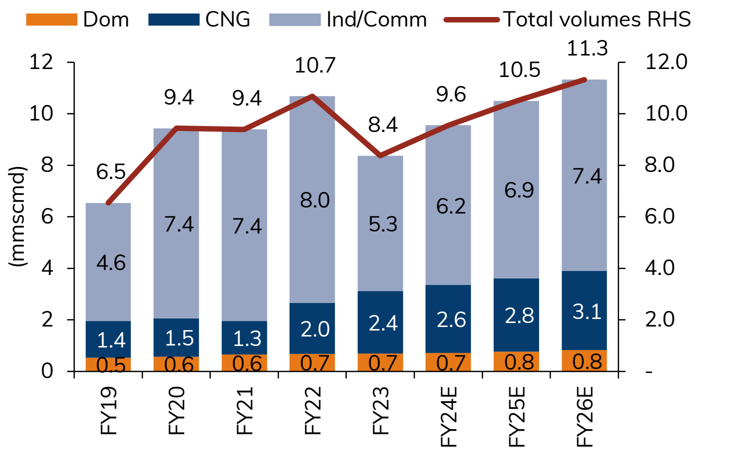
Source: Company data, I-Sec research

Exhibit 23: Capex remains higher supported by strong cash flow



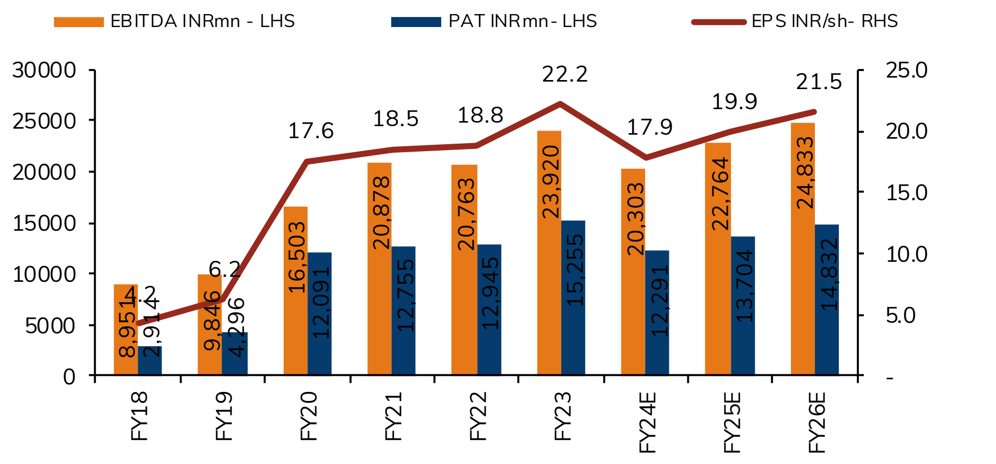
Source: Company data, I-Sec research

Exhibit 24: However, volume growth remains muted – CAGR of 3.1% FY20-FY26E



Source: Company data, I-Sec research

Exhibit 25: EBITDA/EPS to grow at CAGR of 1.9%/-1.4% over FY23-FY26E



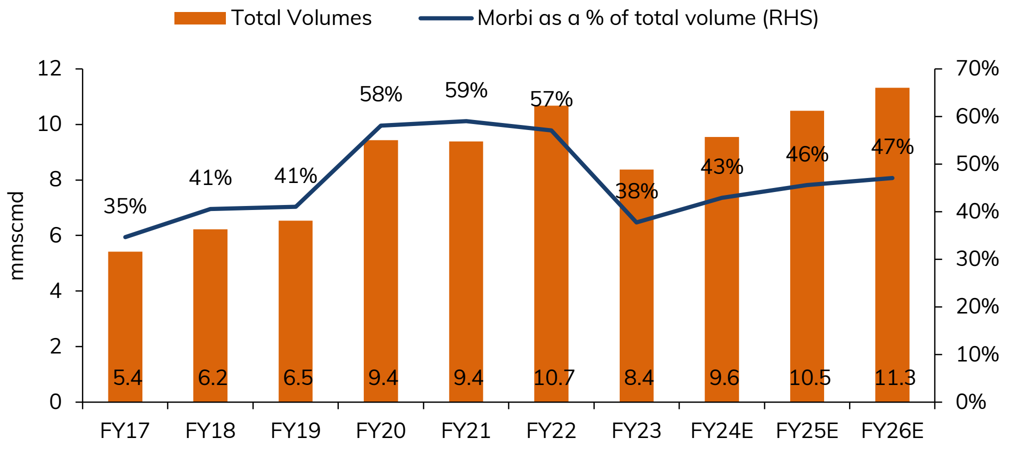
Source: Company data, I-Sec research

Going forward, this extent of margin improvement may be difficult to sustain, given increasing competitiveness of alternate fuels not just in Morbi from propane, but also from other liquid fuels (Naphtha, FO) in non-Morbi Industrial areas. GUJGA has made some strides in growing its share of CNG volumes in the overall volume mix, which should improve margin mix over the medium term. However, the dominance of I/C (industrial/commercial) volumes is unlikely to reduce materially over the next 18-24 months. This shall keep the dependence on I/C margins alive to drive earnings over FY24-26E.

Long-term returns depend on reduction on Morbi dependence

Morbi volumes are likely to increase to almost 50% of volumes after dropping to a low of 38% in FY23, highlighting the outsized importance of the region to GUJGA's fortunes. With ~50% of available units in the region now capable of converting to propane and back to gas, the vulnerability of GUJGA's volumes to fluctuations in propane prices continues to rise, underpinning our caution on visibility and certainty of volume growth.

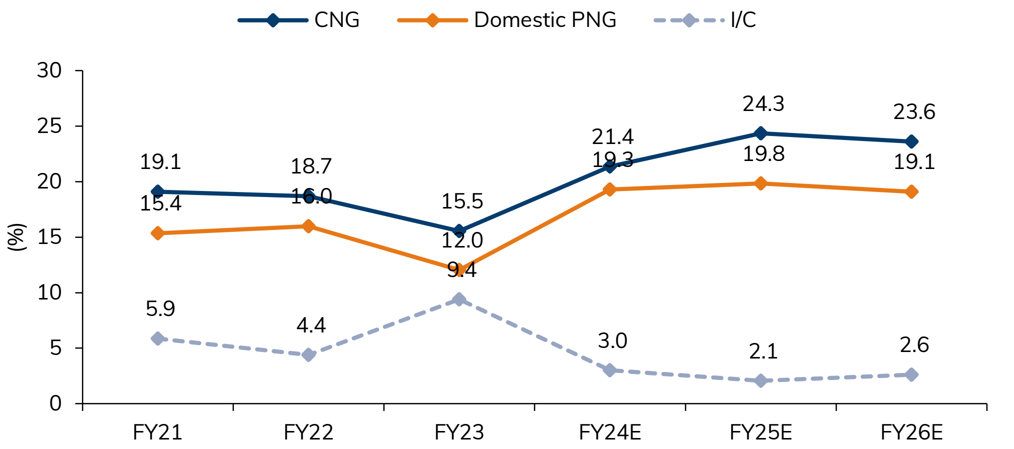
Exhibit 26: Morbi volumes remain consequential to GUJGA's overall portfolio



Source: Company data, I-Sec research

We believe that CNG's share in overall volumes needs to rise materially from its current levels of 28% (average over FY23-24E) to reduce dependence on Morbi and drive earnings over the long term.

Exhibit 27: Gross margin for I/C segment likely to remain impacted over FY24-26Es



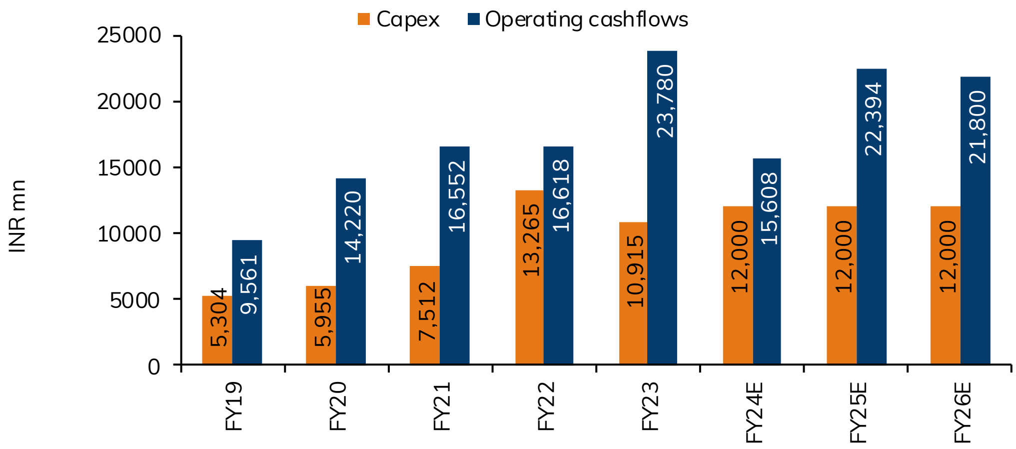
Source: Company data, I-Sec research

Balance sheet remains well funded; return ratios to decline

Our concerns on profitable investments seem well-founded, given the lack of traction in volumes despite a material INR 74bn of investment forecast over FY20-26E. However, we also submit that cash flows remain ahead of capital allocation over the forecast period, keeping leverage at comfortable levels.

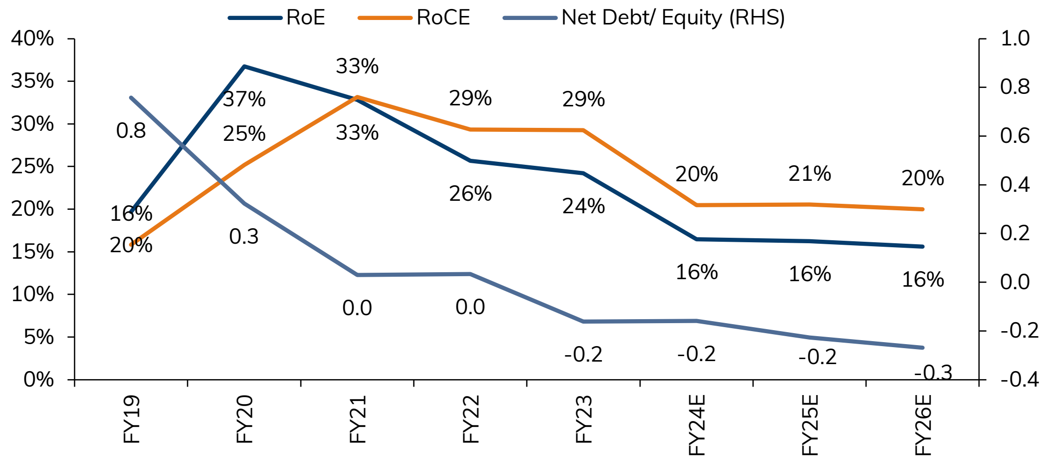
The lack of adequate returns from the capex do reflect in RoE/ROCE trends, which will likely exhibit a steadily declining trend over the next three years.

Exhibit 28: Strong operating cash flows to support higher capex over FY19-26E



Source: Company data, I-Sec research

Exhibit 29: Balance sheet remains well funded, but return ratios to decline



Source: Company data, I-Sec research

Valuation and view: Multiples factor-in high risk-reward; downgrade to REDUCE

We value GUJGA based on the DCF methodology, using a WACC of 10.9%, debt equity ratio (DER) of 25%, long-term EBITDA assumption of INR 5.5/scm. The gradual build up in volumes from multiple new areas under development and new areas won recently in bidding rounds IX/X imply returns from the same would flow through only over the long term.

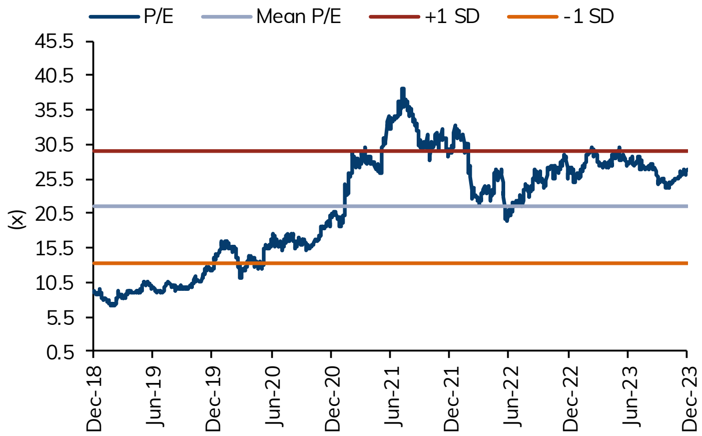
Our DCF valuation delivers a TP of INR 385, offering a 15% downside from CMP.

Exhibit 30: Valuation summary

	Assumption
Cost of Equity	12.5%
Cost of Debt	6.2%
Average D/E ratio	25.0%
WACC	10.9%
Terminal Growth rate	3.5%
Total NPV potential (INR/sh)	2,64,694
Target Price (INR/sh)	385
CMP (INR/sh)	452
Upside (downside) %	-15%

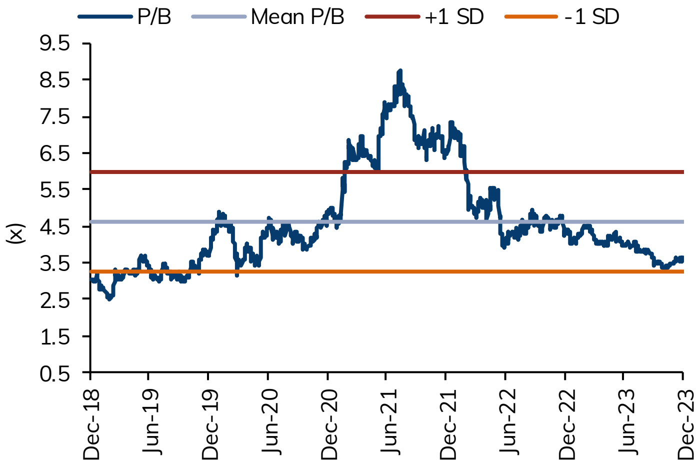
Source: Company data, I-Sec research

Exhibit 31: GUJGA's P/E is trading near higher band



Source: Company data, I-Sec research

Exhibit 32: GUJGA's P/B is trading below 5-year band



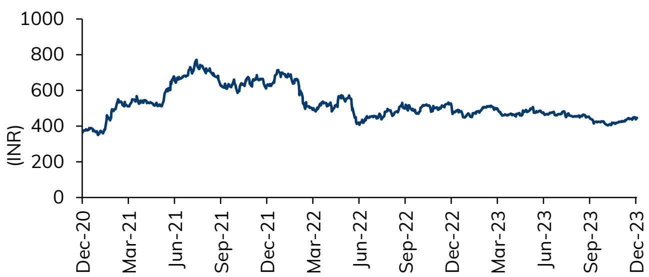
Source: Company data, I-Sec research

Exhibit 33: Shareholding pattern

%	Mar'23	Jun'23	Sep'23
Promoters	60.9	60.9	60.9
Institutional investors	17.9	17.7	16.9
MFs and others	9.8	8.4	6.6
FIs/Banks	0.0	0.0	0.0
Insurance	3.2	4.7	6.5
FIIs	4.9	4.6	3.8
Others	21.2	21.4	22.2

Source: Bloomberg

Exhibit 34: Price chart



Source: Bloomberg

Financial Summary

Exhibit 35: Profit & Loss

(INR mn, year ending March)

	FY23A	FY24E	FY25E	FY26E
Net Sales	**1,67,594**	**1,62,326**	**2,01,641**	**2,25,168**
EBITDA	**23,920**	**20,303**	**22,764**	**24,833**
EBITDA Margin (%)	14.3	12.5	11.3	11.0
Depreciation & Amortization	4,283	4,787	5,291	5,795
EBIT	19,637	15,516	17,474	19,039
Interest expenditure	404	82	42	2
Other Non-operating Income	1,013	878	757	649
PBT	**20,247**	**16,312**	**18,189**	**19,686**
Profit / (Loss) from Associates	**-**	**-**	**-**	**-**
Less: Taxes	4,992	4,022	4,484	4,854
PAT	15,255	12,291	13,704	14,832
Less: Minority Interest	-	-	-	-
Net Income (Reported)	**15,255**	**12,291**	**13,704**	**14,832**
Extraordinaries (Net)	-	-	-	-
Recurring Net Income	**15,255**	**12,291**	**13,704**	**14,832**

Source Company data, I-Sec research

Exhibit 36: Balance sheet

(INR mn, year ending March)

	FY23A	FY24E	FY25E	FY26E
Total Current Assets	19,792	18,923	26,939	32,964
of which cash & bank	6,810	7,141	13,825	19,564
Total Current Liabilities & Provisions	27,750	25,851	31,272	33,353
Net Current Assets	**(7,958)**	**(6,928)**	**(4,334)**	**(389)**
Other Non Current Assets	-	-	-	-
Net Fixed Assets	73,364	80,577	87,287	93,492
Other Fixed Assets	-	-	-	-
Capital Work in Progress	9,831	9,831	9,831	9,831
Non Investment	-	-	-	-
Current Investment	5,964	6,464	6,964	7,464
Deferred Tax assets	(8,461)	(8,461)	(8,461)	(8,461)
Total Assets	**72,740**	**81,483**	**91,287**	**1,01,937**
Liabilities				
Borrowings	**1,523**	**1,023**	**523**	**23**
Deferred Tax Liability	**-**	**-**	**-**	**-**
Lease Liability	-	-	-	-
Other Liabilities	1,261	1,286	1,312	1,338
Equity Share Capital	1,377	1,377	1,377	1,377
Reserves & Surplus	68,579	77,797	88,075	99,200
Total Net Worth	**69,956**	**79,174**	**89,452**	**1,00,576**
Minority Interest	-	-	-	-
Total Liabilities	**72,740**	**81,483**	**91,287**	**1,01,937**

Source Company data, I-Sec research

Exhibit 37: Quarterly trend

(INR mn, year ending March)

	Dec-22	Mar-23	Jun-23	Sep-23
Net Sales	36,843	39,286	37,815	38,454
% growth (YOY)	-28.4%	-15.9%	-26.9%	-3.3%
EBITDA	5,823	5,603	3,880	4,966
Margin %	15.8%	14.3%	10.3%	12.9%
Other Income	320	320	239	298
Extraordinaries	-	-	-	-
Adjusted Net Profit	3,713	3,694	2,151	2,978

Source Company data, I-Sec research

Exhibit 38: Cashflow statement

(INR mn, year ending March)

	FY23A	FY24E	FY25E	FY26E
Cash Flow from operation before working Capital	**24,336**	**20,303**	**22,764**	**24,833**
Working Capital Changes	4,052	(673)	4,114	1,820
Tax	(4,608)	(4,022)	(4,484)	(4,854)
Operating Cashflow	**23,780**	**15,608**	**22,394**	**21,800**
Capital Commitments	(10,915)	(12,000)	(12,000)	(12,000)
Free Cashflow	**34,694**	**27,608**	**34,394**	**33,800**
Others CFI	518	378	257	149
Cashflow from Investing Activities	**(10,397)**	**(11,622)**	**(11,743)**	**(11,851)**
Inc (Dec) in Borrowings	(4,779)	(500)	(500)	(500)
Interest Cost	(381)	(82)	(42)	(2)
Others	(1,624)	(3,073)	(3,426)	(3,708)
Cash flow from Financing Activities	**(6,784)**	**(3,654)**	**(3,968)**	**(4,210)**
Chg. in Cash & Bank balance	**6,599**	**332**	**6,683**	**5,739**
Closing cash & balance	6,810	7,141	13,825	19,564

Source Company data, I-Sec research

Exhibit 39: Key ratios

(Year ending March)

	FY23A	FY24E	FY25E	FY26E
Per Share Data (INR)				
Recurring EPS	22.2	17.9	19.9	21.5
Diluted EPS	22.2	17.9	19.9	21.5
Recurring Cash EPS	28.4	24.8	27.6	30.0
Dividend per share (DPS)	6.6	4.5	5.0	5.4
Book Value per share (BV)	101.6	115.0	129.9	146.1
Dividend Payout (%)	30.0	25.0	25.0	25.0
Growth (%)				
Net Sales	1.8	(3.1)	24.2	11.7
EBITDA	15.2	(15.1)	12.1	9.1
EPS	17.8	(19.4)	11.5	8.2
Valuation Ratios (x)				
P/E	20.3	25.2	22.6	20.9
P/CEPS	15.9	18.1	16.3	15.0
P/BV	4.4	3.9	3.5	3.1
EV / EBITDA	12.5	14.6	12.7	11.4
EV / Operating Income	14.5	18.1	15.9	14.4
Dividend Yield (%)	1.5	1.0	1.1	1.2
Operating Ratios				
EBITDA Margins (%)	14.3	12.5	11.3	11.0
Effective Tax Rate (%)	24.7	24.7	24.7	24.7
Net Profit Margins (%)	9.1	7.6	6.8	6.6
NWC / Total Assets (%)	(10.9)	(8.5)	(4.7)	(0.4)
Fixed Asset Turnover (x)	1.7	1.5	1.7	1.7
Working Capital Days	5.8	17.5	19.9	18.6
Net Debt / Equity %	(16.1)	(15.9)	(22.7)	(26.9)
Profitability Ratios				
RoCE (%)	22.0	15.4	15.5	15.1
RoCE (Pre-tax) (%)	29.3	20.5	20.5	20.0
RoE (%)	24.2	16.5	16.3	15.6

Source Company data, I-Sec research

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