

# Gujarat Gas Limited

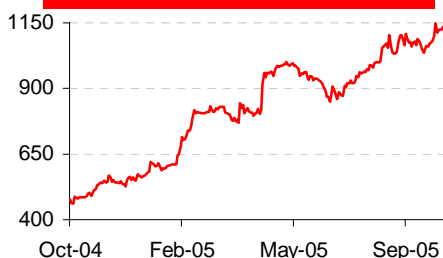
Hold

Target Price: Rs 1,450

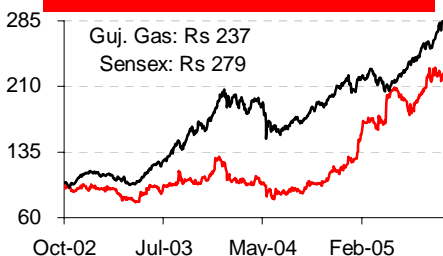
## Market data

Current price	Rs 1,118 (BSE)
Market cap	Rs 14,338 m
Face value	Rs 10.0
FY05 Div/share	Rs 10.0
NSE symbol	GUJRATGAS
No of shares	12.8 m
Free float	34.9%
52 week H/L	Rs 1,210 / 456

## Share price chart



## Rs 100 invested is worth



## Shareholding

Category	(%)
BG	65.1%
Mutual funds/Fis	15.3%
FII's	8.0%
Public	9.8%
Others	1.7%
Total	100.0%

## Report prepared by

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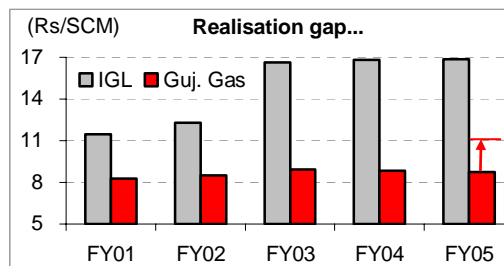
## Investment Rationale

▪ **Supply-side steadied:** Gujarat Gas has entered into gas supply agreement with private sector players, which we believe will take care of its requirements over the next three years. Cumulatively, it has entered into agreements to supply to the tune of 3.4 MMSCMD (million metric standard cubic meters per day) as compared to the FY05 sales around 1.6 MMSCMD. Of this, GAIL supplies around 5.5%, which indicates the fact that it has de-risked its dependence on GAIL and more importantly, buys a large part of requirement at market-related prices. Apart from setting the foundation to meet future gas needs, we believe that the downside to the operating margins of Gujarat Gas remains limited to the extent of increase in gas prices globally.

### Supply side secured...

Source	MMSCMD
GAIL	0.2
Cairns	1.3
Nikko	0.5
GSPCL	0.7
Panna-Mukhta-Tapti	0.7
<b>Total</b>	<b>3.4</b>
Gas supplied - FY05	1.6

▪ **Realisation and margin improvement:** We expect the company's CNG revenues to increase from the current level of 2.5% of sales to around 10% in the next three years. Given the fact that realisations are higher at Rs 21 per SCM as compared to the current realisation for the company at Rs 9 per SCM, we expect operating margins to improve (taking into account the distribution expenses). When compared with a retail player like Indraprastha Gas (average realisation of Rs 16 per SCM), there is significant scope for improvement going forward.



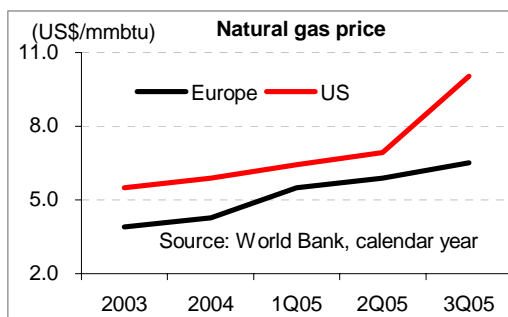
▪ **Power sector – Emerging growth driver:** Gujarat Gas is aggressively focusing on the power sector. Currently, under the CHP segment (Combined Heat & Power), there is already 130 MW of capacity for which Gujarat Gas supplies gas (0.75 SCMD). The CHP is a programme wherein the company would work with a small customer who is interested in saving power cost by setting up around 1 MW plant. But going forward, the company hopes to work with 2 to 3 large players in setting up power plants, in which it would hold a stake through an SPV (special purpose vehicle). Its role will be restricted to only being the preferred gas supplier and not with the management of the capacity. This, we believe, is a very big positive and is expected to be a major growth driver. We have not factored in the growth prospects from SPV in our assumptions and to that extent, the upside exists.

**Comparative Valuations**

FY05		Guj. Gas	IGL
<b>Key ratios</b>			
Sales	(Rsm)	5,595.0	5,248.0
3-yr CAGR	(%)	18.1	21.6
Realisation	(Rs/SCM)	8.7	16.9
Gas cost	(Rs/TSCM)	6,728.0	4,240.0
EBDITA margin	(%)	21.3	41.0
Net margin	(%)	12.2	20.6
Return on equity	(%)	29.7	29.6
Return on assets	(%)	16.8	17.2
<b>Valuations</b>			
Price	(Rs)	1,118.0	121.0
Price to earnings	(times)	18.6	18.3
Price to cash flow	(times)	14.6	12.1
Price to book value	(times)	5.5	5.4

**Investment Concerns**

- Gas prices:** Given the sharp rise in crude prices globally and the consequent urge to shift towards alternate fuels as a source of energy, natural gas prices have been on an uptrend. Given the fact that Gujarat Gas will source more than 90% of its gas in non-administered price, there could be raw material cost escalation going forward (we have factored in a CAGR increase of over 2% in the next three years). The downside risk to our raw material cost estimate exists.

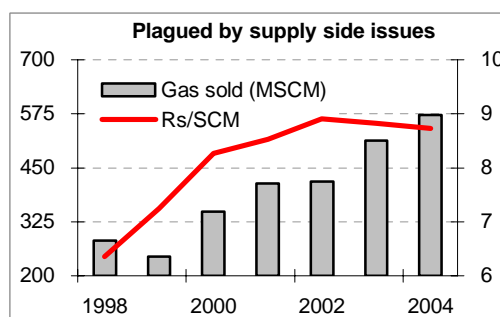


- GSPCL transmission revenue loss:** Currently, GSPCL uses the pipeline of Gujarat Gas for its transmission purpose for which it pays around Rs 0.7 per SCM. From as low as 0.6% of revenues in FY01, the contribution from transmission revenues has increased to 9.4% in FY05. But with GSPCL already in the final stages of completion of its own pipeline, Gujarat Gas stands to lose this revenue stream going forward, in the worst-case scenario. The key

concern is that this business is a significant contributor to the overall EBDITA of the company (35% to 40% in FY05).

**Background**

Gujarat Gas Company, a 65% subsidiary of the global gas major British Gas, is India's largest private sector gas distribution and transmission company and has a regional presence across three of the largest industrial cities in the state of Gujarat. With a pipeline network of over 2,000 kms (nearly 34% of GAIL's gas pipeline network), the company caters to industrial (for their energy requirements), domestic (piped natural gas or PNG) and automobile users (compressed natural gas or CNG) in the cities of Surat, Ankleshwar and Bharuch. The company has witnessed a steady growth in natural gas sales of 18.6% CAGR since FY98 while the bottomline has grown at a compounded rate of 30.2% during this period.



**Industry Prospects**

Natural gas is an attractive proposition for the industry, as alternate fuels are priced higher. The spike in crude oil prices has resulted in a jump in product prices and the consequent burgeoning of input costs. Nearly 50% of the investments in the state of Gujarat are in the petrochemicals industry and naphtha forms over 50% of the raw material costs in case of naphtha based complexes. There is a clear intention to move towards natural gas to meet their energy requirement as far as the manufacturing sector is concerned. Despite the government indicating a higher gas price in the country, given the current scenario, natural gas still remains an attractive proposition.

We believe that like the power sector, the growth prospects of the natural gas sector and in turn, the player is limited by the lack of consistent supply of gas. Demand is likely to grow at a faster rate than petroleum product sales in the next five years, given

the new project outlays in the power sector. Also, with key cities focusing on environmental control, natural gas players stand to gain in the long-term. We are convinced as far as the topline is concerned, over the next three years.

### Valuations

The stock currently trades at Rs 1,115 implying a price to earnings multiple of 9.2 times and at a price to cash flow multiple of 7.6 times our FY08 estimated consolidated estimates. Given the robust growth expected in topline over the next three years, higher operating margin prospects and upside to our estimates from implementation of the CHP initiative, we believe that the company is well poised to capitalise on the growth opportunity. We recommend

a HOLD on the stock with a price target of Rs 1,450 (10 times price to cash). However, investors have to take a two to three year view on the company to benefit from various initiatives that are currently in the process of execution by the company.

### Valuation table

(Rs m)	CY05	CY06E	CY07E	CY08E
Net sales	5,595	6,678	8,113	9,769
PAT*	769	947	1,162	1,538
FDEPS	60.0	73.9	90.6	119.9
P/E	18.6	15.1	12.3	9.3
PCF*	14.6	11.8	9.9	7.7

\* Consolidated Financials

### Financials at a glance

(Rs m)	CY04	CY05E	CY06E	CY07E
Sales	5,595	6,678	8,113	9,769
Sales growth (%)	9.1%	19.4%	21.5%	20.4%
Operating profit	1,192	1,519	1,950	2,555
Operating profit margin (%)	21.3%	22.7%	24.0%	26.2%
Net profit	769	947	1,162	1,538
Net profit margin (%)	8.8%	23.2%	22.6%	32.4%

### Balance Sheet

Current assets	606	703	1,421	2,612
Net fixed assets	2,600	3,370	3,710	3,925
Investments	1,400	1,400	1,400	1,400
Total Assets	4,607	5,473	6,531	7,937
Current liabilities	1,431	1,548	1,726	1,876
Net worth	2,599	3,349	4,328	5,685
Total debt	577	577	477	377
Total liabilities	4,607	5,473	6,531	7,937

\* Consolidated Financials

**Important Notice:** Quantum Information Services Limited (Equitymaster) is an Independent Equity Research Company.

**Disclosure:** The author of this article does not hold shares in the recommended company. QIS does not hold shares in the recommended company.

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