# GAIL's gas trading biz in Q2 disappoints Street

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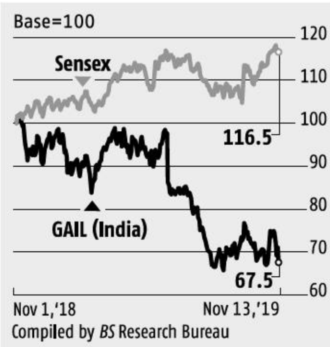
New Delhi, 13 November



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The disappointment with the July-September quarter (second quarter, or Q2) performance of India's largest gas transmission and trading company, GAIL (India), added to the already soft Street sentiment. The stock, which had slipped from ₹180-levels in June, was down more than 5 per cent and closed at ₹123.80 on Wednesday. Even though GAIL's performance on the volume front remained decent in Q2, its soft operating performance disappointed investors. The one-offs in its largest gas trading/marketing and transmission segments, coupled with weak profitability of the liquefied petroleum gas (LPG) and liquid hydrocarbon segments, resulted in a lower-than-expected operating performance.

Operating profit declined 30.8 per cent sequentially and by 47 per cent year-on-year (YoY) to ₹1,563 crore in Q2. These were much lower than estimates of analysts, such as those at Motilal Oswal Financial Services, who had anticipated an operating profit of ₹2,329 crore. However, the outlook is not as bad as the stock may be reflecting.

The shutdown at some of the country's fertiliser plants and delay in commissioning of few others forced the company to sell some contracted volumes in the spot market, which impacted profitability of its gas trading/marketing business. Its profit or earnings before interest and tax was down almost 74 per cent YoY in Q2.

GAIL's gas transmission segment, too, saw a 10 per cent decline in profit, with the company taking a one-time hit for retrospective adjustment in tariffs of some pipelines, such as Hazira-Vijaipur-Jagdishpur and Dadri-Panipat.

While natural gas prices continued to decline, margin in petrochemicals business, too, is under pressure, with realisations being impacted by the supply glut. The 8 per cent and 25 per cent fall in market price of petrochemicals and liquid hydrocarbons, respectively, coupled with lower gas prices in the international market, adversely impacted GAIL's profits in Q2, compared to the first quarter of 2019-20 (FY20).

Moving forward, while concerns on petrochemicals, LPG and liquid hydrocarbon segments remain due to realisation pressures, the Street will be watchful of recovery in the largest gas trading and transmission segments, which contribute over 80 per cent to GAIL's financial performance. But there are positives, too. Following the Q2 miss, while analysts have lowered their FY20 estimates for GAIL, they also see triggers for higher volumes and profitability in GAIL's gas transmission and trading segments, which they believe will boost 2020-21 numbers.

On the demand side, soft gas prices, better gas availability in the country, expansion by city gas distributors into new regions, and pollution curbs on industrial units should drive up gas demand and improve volumes for GAIL.

The compressed natural gas demand by automobiles, too, will continue rising, as it is a much cheaper and cleaner fuel vis-à-vis gasoline and diesel. Analysts at Motilal Oswal expect GAIL's gas transmission volumes rising 30 per cent by 2022-23 with improved gas availability.

Transmission volumes should also get a boost from ramp-up of Petronet LNG's recently added capacities, as the Kochi-Mangaluru pipeline is expected to commission in December 2019 and completion of pipelines in East India by 2021-22. Take or pay clauses for fertiliser plants should also kick in after the end of 2019, points out Nilesh Ghughe at HDFC Securities, and drive profitability.

Further, the completion of three fertiliser plants along the eastern India pipelines, combined with the contribution from Matix/Ramagundam fertiliser plants and conversion of Mangalore Chemicals & Fertilizers' plant for gas usage, will likely derisk 60 per cent of the contracts, say analysts.

Overall, analysts maintain their positive stance on GAIL. Those at JM Financial add that most of the negatives are already captured. The stock has corrected almost 30 per cent over the past one year. Target prices of these brokerages indicate up to 53 per cent potential upside for the stock.

## EARNINGS RECOVERY IN FY21

| (in ₹crore) | Q2FY20 | FY20E | FY21E |
|---|---|---|---|
| **Net sales** | **18,040** | **67,722** | **69,906** |
| % change YoY | -6.0 | -9.5 | 3.2 |
| **Ebitda** | **1,563** | **8,996** | **10,074** |
| Ebitda margin (%) | 8.7 | 13.2 | 14.4 |
| **Net profit *** | **1,064** | **5,912** | **6,374** |
| % change YoY | -46.0 | -6.9 | 7.8 |

E: Estimates; * adjusted for one-offs; Ebitda: Earnings before interest, tax, depreciation, and amortisation
Source: JM Financial Institutional Securities