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GAIL RATING: **REDUCE**

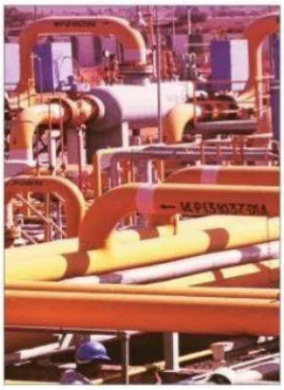
The impact of Covid-19 on demand makes outlook bleak

Marketing may be hit most; FY21/22 EPS down 43-46%; downgraded to 'Reduce' with TP lowered to ₹85

A SHARP OIL price decline has weakened GAIL's earning outlook; now, a prolonged lockdown to fight COVID-19 has weakened the demand outlook as well. We expect India's gas consumption to decline ~25% in Q1FY21F and 11% in FY21F. But we think there will be a longer-term impact, as demand may not recover fully in several segments and the new fertiliser/city gas projects will likely get delayed. Our gas demand forecasts decline by 19% for FY21F and 11-14% for FY22-25F vs our earlier forecasts.

Outlook very weak; marketing worries us the most with likely loss in FY21/22F

A sharp demand decline is worrisome for GAIL, as it has a large portfolio of LNG import contracts, particularly Henry Hub (HH) linked contracts. With weak demand, and new domestic gas from KG-basin, LNG imports outlook has become bleaker. We believe GAIL will need to dispose of HH



volumes at low spot LNG prices and incur losses. There could also be losses in FY21F from oil price-linked HH sales. To reduce prices, India is further renegotiating oil linked contracts with Qatar. Ironically, a lower oil-linked LNG price will hurt GAIL, as it will raise the break-even for its oil-linked HH sales.

Transmission ROCEs to weaken; petchem may be in losses over FY20-22F

Despite a poor HVJ tariff order last year, transmission segment earnings were resilient (4-year Ebit CAGR of 18%). With a 12% volume decline, we expect transmission Ebit to decline 17% in FY21F, while capital employed will rise as GAIL completes the Kochi-Mangalore and Jagadishpur-Haldia pipelines. We expect post-tax ROCE for the pipeline business to fall to just ~6% for FY21-22F (vs 12% as per regulation).

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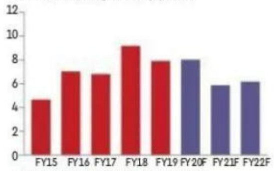
Cut TP to ₹85; downgrade to Reduce

We cut FY21/22F earnings by 43-46%. After a 20% EPS decline in FY20F, we expect a further 48% decline in FY21F. Due to large unhedged positions, marketing losses and earnings volatility can be very high. Thus, we think P/B (earlier EV/Ebitda-based SoTP) may be a better method to value GAIL at this stage. We now value GAIL at 0.45x FY22F adjusted book and add the value of listed investments at a 20% discount to their CMP to arrive at a TP of ₹85 (from ₹140), implying 19% downside. We note that from the recent March-lows, GAIL is up +51% (NIFTY: +17%). We downgrade GAIL to **Reduce** (from Buy). The stock trades at 0.66x FY22F adjusted P/B. We prefer RIL IN (Buy, TP: ₹1,900) in the India oil and gas space.

NOMURA

Natural gas transmission RoCE trends and forecasts

We expect natural gas transmission RoCE to decline to ~6% from ~8% due to lower volumes and commissioning of new pipelines



Source: Company data, Nomura estimates