Change in ☑ Estimates ☐ Rating ☐ Target

IIFL
INDIA PRIVATE CLIENTS

Petronet LNG

Opportune play on gas deficit

India has been a **gas starved country for long**. The **situation has only worsened** with 1) declining production at RIL's KG-D6 field, 2) natural decline at ONGC's high profile fields and 3) robust increase in demand. In such a scenario, **LNG imports have partly met the supply deficit** and Petronet LNG, country's largest importer has been the biggest beneficiary of this. **Demand for LNG is expected to remain strong** in the country given 1) shortage of power supply, 2) our expectations of a fall in LNG prices on the back of rising global supply and weakening Japanese demand and 3) muted ramp up expected in domestic gas production.

To leverage on this **Petronet has embarked on an expansion program** whereby 1) it is commencing its new terminal at Kochi with a capacity of 5mtpa in FY14, 2) its expanding capacity at Dahej in two phases a) expansion of marine facilities by end of FY14 and b) increase in regasification and storage capacities by latter half of FY16, 3) new terminal on the east coast at Gangavaram by FY17. Eventually, **the company will have a capacity of 25mtpa by end of FY17E** as compared to 10mtpa currently.

We like Petronet due to its **robust business model** wherein it passes any fluctuations in currency and LNG to its customers, thereby protecting its earnings in a gyrating global LNG market. Furthermore, with **substantial volumes being locked in through long term contracts** with suppliers and consumers, revenue visibility is robust. On the customer side, it has **offtake agreements with GAIL, IOC and BPCL**. It charges a fixed **re-gasification margin (which rise 5% per annum)** on the volumes handled and thereby operates in an annuity like business model.

Given the robust business model and expansion of capacity, we expect Petronet to report **revenue CAGR of 26% over FY12-14E**. Further, with limited threat to re-gasification margins, **earnings visibility is also robust**. Notably, Petronet **RoE's have sustained above 20% for the last 5 years**. With **regulatory risks also limited**, we maintain our BUY recommendation with a price target of Rs187.

Financial summary

Y/e 31 Mar (Rs m)	FY12	FY13E	FY14E	FY15E
Revenues	226,959	291,360	361,373	479,148
yoy growth (%)	72.0	28.4	24.0	32.6
Operating profit	18,292	20,913	23,640	29,559
OPM (%)	8.1	7.2	6.5	6.2
Reported PAT	10,575	11,735	11,469	14,845
yoy growth (%)	70.6	11.0	(2.3)	29.4
EPS (Rs)	14.1	15.6	15.3	19.8
P/E (x)	11.6	10.4	10.7	8.2
Price/Book (x)	3.5	2.7	2.2	1.8
EV/EBITDA (x)	7.8	7.1	6.1	5.1
Debt/Equity (x)	0.9	0.7	0.5	0.4
RoE (%)	34.1	29.2	22.9	24.1
RoCE (%)	26.3	26.2	25.0	27.7

Source: Company, India Infoline Research

December 11, 2012

Rating:	BUY
Target (9-12 months):	**Rs187**
CMP:	**Rs162**
Upside:	**15.4%**

Sector:	**Oil & Gas**
Sector view:	**Neutral**
Sensex:	19,410
52 Week h/l (Rs):	180 / 122
Market cap (Rscr) :	12,128
6m Avg vol ('000Nos):	1,405
Bloomberg code:	PLNG IB
BSE code:	532522
NSE code:	PETRONET
FV (Rs):	10

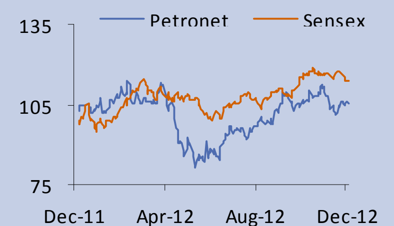
Price as on Dec 10, 2012

Company rating grid

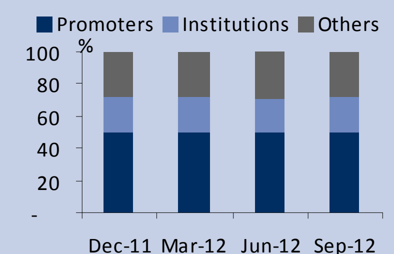
Low → High

	1	2	3	4	5
Earnings Growth			■		
Cash Flow			■		
B/S Strength				■	
Valuation appeal			■		
Risk		■			

Share price trend



Share holding pattern



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Company Report

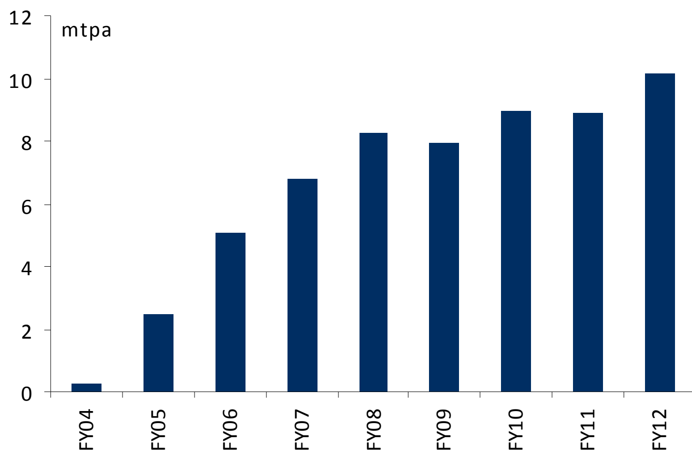
LNG Market outlook

Widening deficit in supply-demand of domestic natural gas

Contribution of natural gas in India's primary energy consumption has risen from 7.8% in CY04 to 10% in CY11. The drivers for this increase have been 1) increase in domestic gas production and 2) robust LNG imports. In the recent past, domestic gas production has been under pressure owing to continued decline at RIL's KG-D6 field. This was partially offset by sharp increase in LNG imports. Over the past eight years LNG imports have seen a CAGR of 22%. Given its advantages (cleaner fuel, relatively inexpensive and high calorific value), the demand for natural gas is expected to remain strong. It is anticipated that natural gas will account for 20% of India's primary energy consumption by 2025. However, domestic production growth will lag demand growth. This would translate into robust opportunities for LNG importers.

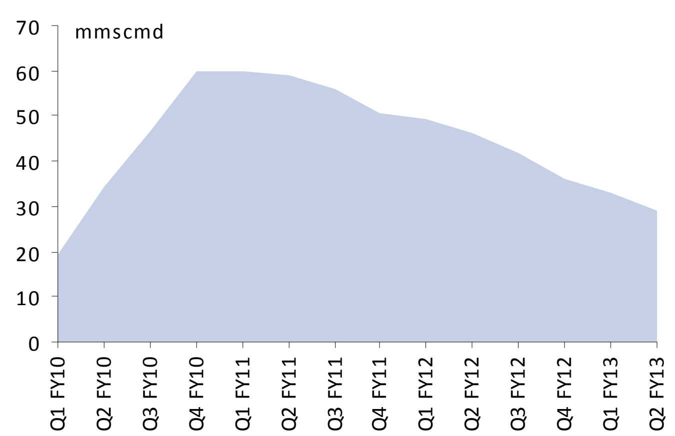
It is anticipated that natural gas will account for 20% of India's primary energy consumption by 2025

Increasing LNG imports in India



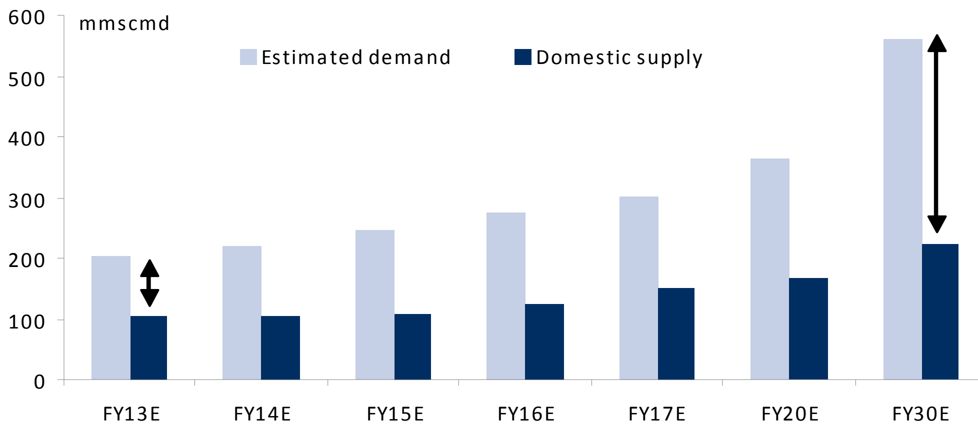
Source: PPAC, India Infoline Research

Falling gas production from KG-D6



Source: RIL, India Infoline research

Natural gas demand to far overshoot domestic gas supplies



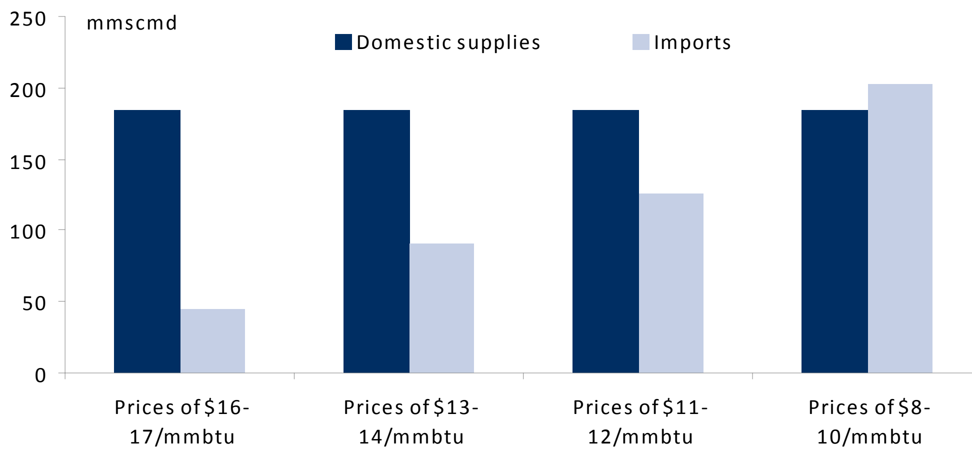
Source: Company, India Infoline Research

High LNG prices have kept substantial portion of demand latent..

LNG prices have been historically higher than domestic gas prices thereby preventing the penetration of LNG in various price sensitive industries. However, in light of consistent declines witnessed in domestic gas production, many gas fired projects have been afflicted with falling utilization levels. While long term contracts in LNG assure gas supplies and provide better project viability, the high prices have been the only deterrent in attracting demand from such sectors. According to Vision 2030, there is ~21bcm of latent demand which could be unlocked on back of lower prices and better gas infrastructure.

Many gas fired projects have been afflicted with falling utilization levels. Amidst this scenario, assured LNG gas provide better project viability, though demand is sensitive to price.

Price sensitive latent demand: Scenario - Demand & Supplies 2015



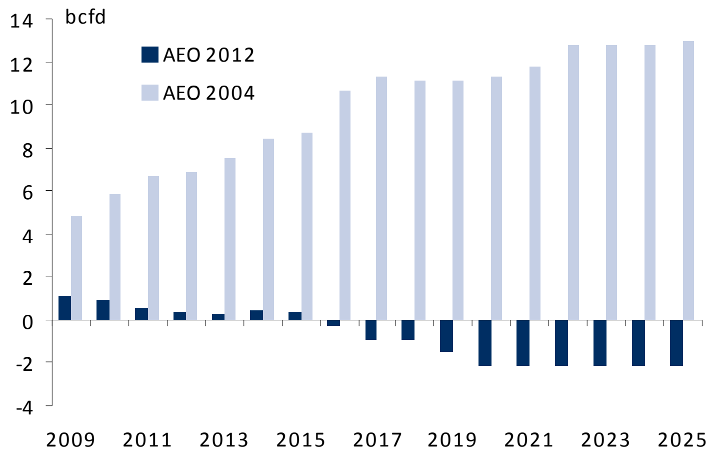
Source: Company, India Infoline Research

LNG prices expected to soften in medium term

Post the earthquake in Japan (March 2011), LNG requirement shot up to substitute the nuclear power outages. In FY12, Japanese imports rose sharply thereby driving Asian prices to levels of US$17/mmbtu. The prices have remained sticky since then and have softened only little affecting the Asia pacific region demand. Going ahead, as the nuclear power plants restart gradually in Japan, we expect the growth in LNG demand to come from mainly India and China. On the supply side we foresee USA to become a net exporter of gas by 2018 on back its shale boom.

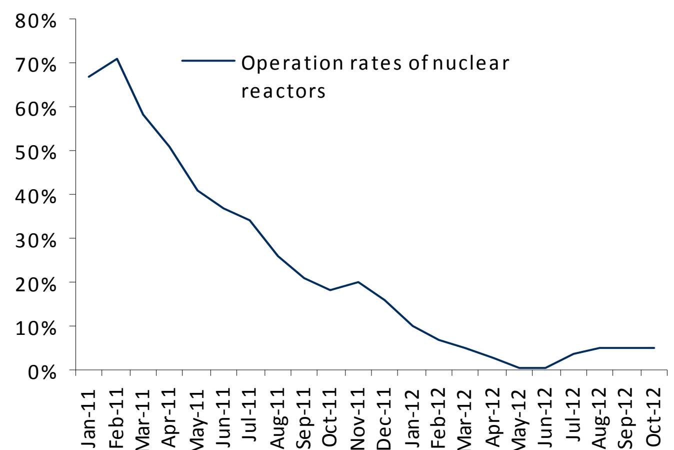
We foresee significant overcapacity building up in the LNG market against primary demand drivers being only India, China.

USA's LNG import estimates downwardly revised



Source: EIA Annual energy outlook, India Infoline Research

Japan nuclear power outages have driven demand



Source: FEPC Japan, India Infoline Research

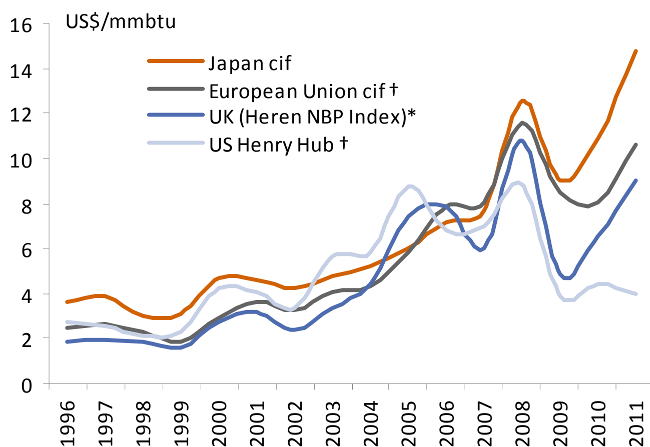
Apart from US, Qatar the largest exporter of LNG has also scaled up its capacity from nil to 77mtpa over the last 14 years. Within next 3-4 years, additional 25-30mtpa capacity increase is expected to come up in Russia. Australia is set to increase its LNG capacity fourfold to 80mtpa by 2018 when major projects come on stream making it the worlds' largest exporter. Thereby, we believe that substantial overcapacity is being built up in the market with the primary demand drivers being only India and China (USA – de growth, Europe – 1% growth). The trend strongly indicates for a correction in LNG prices in medium to long term, which will help the price sensitive demand.

The overcapacity is expected to put downward pressure on LNG prices in medium term.

Prices heavily segmented against the Asian market

The LNG prices observed in the global market are tied to various benchmarks, wherein the majority Asian LNG contracts are have a linkage to crude. While the crude linkage is expensive, the US Henry hub prices are being observed at all time lows on back of shale gas splurge. Going ahead, as supplies for Asian countries get diversified with USA and Australia starting supplies, we expect the price differentials to reduce significantly.

Gas price benchmarks over the years



Source: BP statistical review 2012, India Infoline Research

Gas landed price across the world (US$/mmbtu)

Source: Company, India Infoline Research

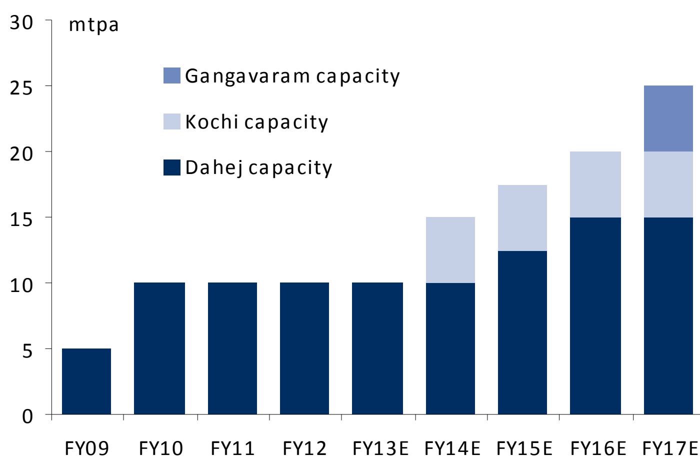
Opportune capacity expansion

Cumulative capacity of 25mt by FY17E

Petronet has a current capacity of 10mtpa on its Dahej terminal wherein it has been operating at more than 100% utilization levels. The company is carrying on marine and re-gasification capacity expansion at the terminal which will take its cumulative capacity to 15mtpa by FY15E. With its Kochi terminal (5mtpa) ready for commissioning in the near future, we expect Petronet to benefit from the rising demand from southern gas markets. Moreover, the recently announced 5mtpa terminal to be built on Gangavaram port in Andhra Pradesh is estimated to come up by FY17. It will strategically position Petronet on the eastern coast enabling it to cater to the new markets. We believe with such opportune expansion (25mtpa by FY17E), Petronet would be the biggest beneficiary of the LNG growth story in India.

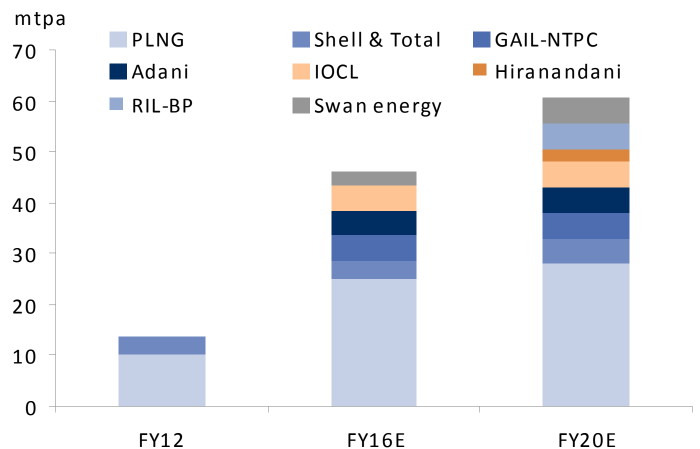
Through greenfield terminals of Kochi, Gangavaram and expansion at Dahej, we foresee the capacity at Petronet growing 2.5x in next four years.

Petronet capacity expansion trend



Source: Company, India Infoline Research

Petronet best positioned to participate in LNG growth story in India



*Source: Company, India Infoline Research. *includes existing, under construction, proposed and possible capacities.*

Volume ramp up to start reflecting from FY14: Project status

The Kochi terminal has been connected to the nearby customers (mainly BPCL) through phase-I of the pipeline (45km pipeline connecting the immediate neighborhood) and waits commissioning in Q4 FY13. The phase-II of the pipeline (Kochi-Mangalore-Bangalore via Tamil Nadu) is expected to be completed by end of CY13 and will enable the terminal to process higher volumes. Recent media articles have indicated a quarter delay in commissioning of the plant. Factoring that, we expect the terminal to process 0.75mtpa in FY14.

At Dahej terminal work on second jetty is ongoing and it is expected to be completed by early CY14. It would help increasing the marine capacity and enable the terminal to handle volumes beyond the current 11mtpa. Meanwhile for the regasification capacity expansion, process of environmental approvals and awarding of EPC contracts is ongoing presently and the scheduled target of the project is end of 2015. Considering the expansion, while we expect flat volumes in FY13, we expect volumes of 11.8mtpa, 12.3mtpa in FY14E and FY15E respectively.

Gangavaram terminal is in the stage of pre-project activity and the land based unit is expected to come up only by FY17. However, management indicates of plans to hire a floating re-gasification unit (FSRU) by end of CY14 to service the demand and build the customer base. We do not build in any volumes from the FSRU, and expect the volumes to flow in from FY17 onwards.

Other players signing LNG contracts augur well for Petronet

Besides supplying contracted volumes and spot cargos, Petronet also provides re-gasification services for other players. Presently GSPC and GAIL use the capacities of Petronet's terminals for re-gasifying the cargos brought by them. Such contracts are of take or pay nature in which the Petronet is assured of the re-gasification charges according to the capacities booked. Recent announcements about various players signing LNG import contracts augur well for Petronet as there is limited re-gasification capacity planned in the country going ahead. We note that 70% of the phase-II expansion capacity of Dahej has been booked already by GAIL (2.5mtpa) and GSPC (1mtpa).

Recent announcements about various players signing LNG import contracts augur well for Petronet as there is limited re-gasification capacity planned in the country.

Recent LNG agreements signed by GAIL

Date	Supplier	mtpa	Deliveries	Type
Oct-12	Gazprom	2.5	2018	20 year deal signed
Aug-12	GDF SUEZ	0.8	2013-2014	Medium term agreement
Aug-12	Gas Natural Fenosa	0.8	Jan-13	3 year supply agreement
Dec-11	Cheniere Energy	3.5	2017	20 year SPA signed

Source: GAIL, India Infoline Research

Market access for Petronet to improve by the expanding domestic gas transmission network

One of the key reasons restricting the demand growth for LNG has been the lack of gas transmission pipeline capacity along with an uneven spatial distribution. Majority of the pipelines are in the western and northern India. Southern and Eastern parts of the country are lagging behind. The current operational LNG terminals are also located mainly in the western India. With GAIL embarking on an aggressive capacity expansion program whereby it plans to double its transmission capacity over the next three years, we believe the demand will get a boost from newer markets within the country. The total pipeline capacity is estimated to grow more than two times to 540mmscmd by 2016 (present 240mmscmd).

GAIL embarking on an aggressive capacity expansion program would help in boosting demand from newer markets within the country.

Robustness in business model

70% of Petronet volumes on long term contracts
Petronet has worked in a business model wherein 70-75% of volumes are tied in long term contracts thereby providing greater visibility. Presently the company sources 7.5mtpa on long term contract with Rasgas of Qatar for its Dahej terminal. For its Kochi terminal, it has tied up 1.4mtpa in a 20 year supply deal from Exxon Mobil's Gorgon project in Australia which will start supplies 2014 onwards. It has also signed a MoU with Gazprom to buy 2.5mtpa for 25 years, for which the supplies would start around FY18-19E. Petronet continues to scout for other long term contracts at attractive prices.

Greater visibility in volumes stems from the fact that ~70% of volumes are tied on long term contracts.

Meanwhile, 1.5mtpa is on short term contracts which are likely to be renewed in the near term. Furthermore, Petronet provides re-gasification services which ensure higher utilization of its terminals. At Dahej, GAIL and GSPC have reserved 0.8mtpa capacity which is on take or pay basis. Additionally, 70% of the phase-II expansion capacity of Dahej has been booked by GAIL (2.5mtpa) and GSPC (1mtpa). On the customer side Petronet has long term purchase agreements, with BPCL, IOC and GAIL amounting to majority of its volumes.

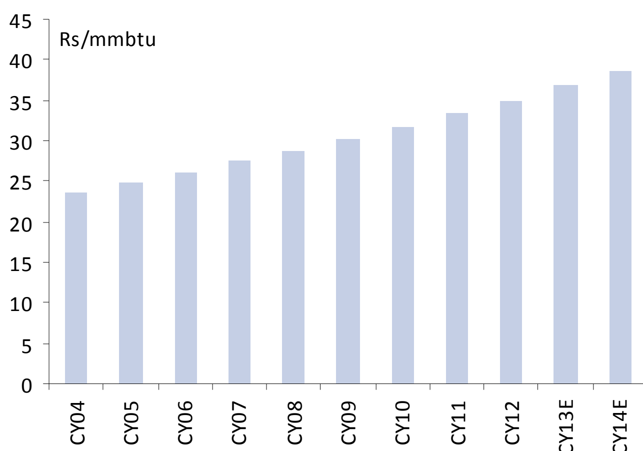
Additionally, Petronet ensures higher utilization levels for its terminal by providing re-gasification services to other players.

Passes on fluctuations in LNG prices and forex to customers
Petronet operates on a business model wherein it does not take any pricing risk (arising from forex fluctuations or changing LNG prices) on itself. It locks in the price with suppliers and buyers thereby enabling the company to earn clean re-gasification margins on the volumes processed.

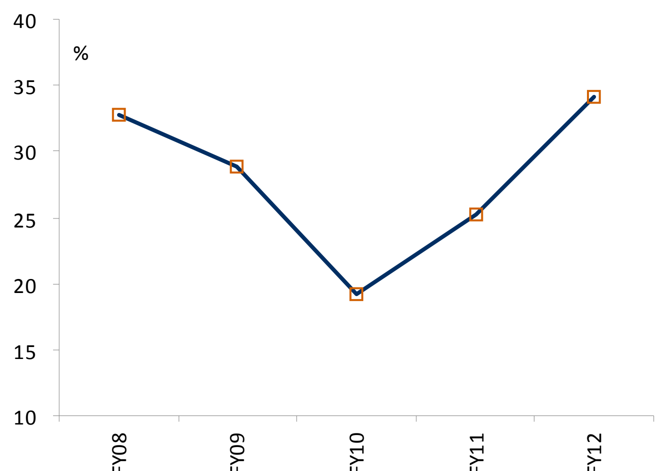
Re-gasification charges continuing to rise
Petronet's re-gasification charges for its Dahej terminal were fixed at Rs23.7/mmbtu for CY04 with a 5% escalation per annum. Considering this the current tariffs are at Rs35/mmbtu. The original formula was based on the capacity of 5mtpa and initial project costs of Rs25bn to enable the company earn equity IRR of 16%. However, Petronet has increased the capacity since then through de-bottlenecking and expansion which has brought the per ton capital cost of the project much below the initial estimates. This has resulted in a RoE of more than 20% for the past few years. For Kochi terminal, owing to higher capex, management has guided for higher regas tariffs.

Regas charges rise 5% per annum thereby enabling the company to clock higher RoE's consistently.

Petronet re-gas charges rise 5% p.a.



RoE's clocked higher than 20% consistently



Source: Company, India Infoline Research

Regulatory concerns… Not material

Financials driven mainly by Re-gas charges

Petronet processes volumes on different types of contracts as mentioned before. While the company earns a re-gasification charge on all kinds of volumes handled, an additional trading margin is earned on the short term and spot volumes. Some media articles suggest that oil ministry plans to introduce uniform marketing margins on domestic gas but exempt the rules on CGD and LNG imported gas. However irrespective of the speculations, we believe that earnings of the company are mainly driven by the re-gasification charges (~80% of the contribution) which are going to rise by 5% per annum going ahead. While Reliance charges US$0.135 per unit marketing margin for supplying its KG-D6 gas, Gail levies US$0.17 per unit for supplying imported gas and gas supplied from the Panna-Mukta and Tapti fields.

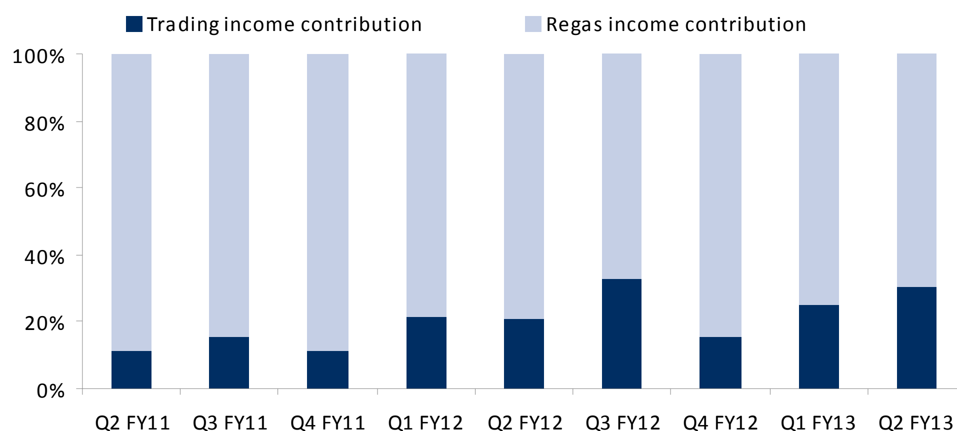
We believe that earnings of the company are mainly driven by the re-gasification charges (~80% of the gross margin) which are going to rise by 5% per annum going ahead.

Estimated calculations of marketing margins

Marketing margins*	Q2 FY11	Q3 FY11	Q4 FY11	Q1 FY12	Q2 FY12	Q3 FY12	Q4 FY12	Q1 FY13	Q2 FY13
Regas tariffs (Rs/mbtu)	31.7	31.7	33.3	33.3	33.3	33.3	35.0	35.0	35.0
Total Contribution#	3,020	3,615	3,663	4,310	4,430	5,570	4,410	4,904	5,373
Regasification income	3,159	3,527	3,737	3,823	3,930	4,103	4,198	4,095	4,117
Marketing margin (residual contribution)	406	633	471	1,031	1,045	2,012	757	1,354	1,801
MM Rs/mbtu	96.8	57.1	29.2	41.8	37.7	81.5	28.7	64.5	65.8
MM US$/mbtu	2.1	1.3	0.6	0.9	0.8	1.6	0.6	1.2	1.2

Source: Company, India Infoline Research
*Assumed internal consumption loss of Rs4/tbtu; #excluding services

Contribution to gross margins



Source: Company, India Infoline Research

Existing capacity not affected by the LNG terminals eligibility norms

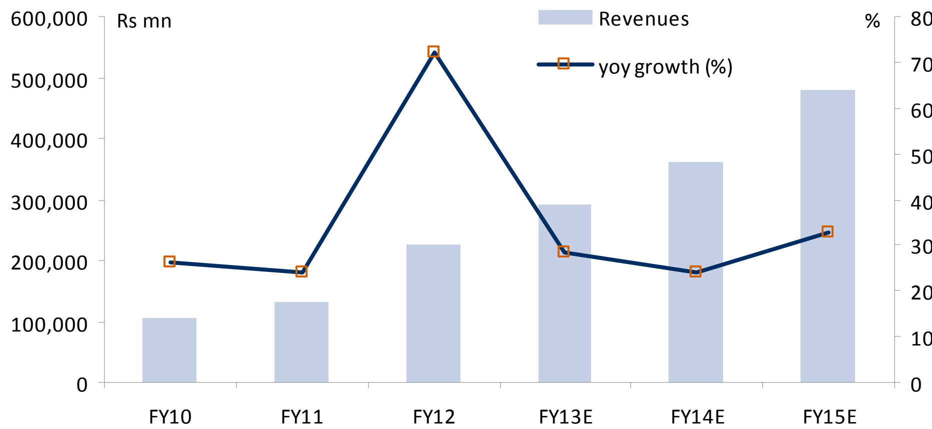
MoPNG has notified of rules for registration of the new and operating LNG terminals recently. The ministry makes it mandatory for the terminals to have a common carrier capacity of 20% of the short term (less than five year) uncommitted re-gas capacity or 0.5mtpa whichever is higher. Petronet LNG already processes much higher tolling volumes than the levels mandated in the notification. Notably in FY12, Petronet processed 73tbtu (1.5mtpa) of tolling volumes for GSPC and GAIL. Thereby we find that the new rules are unlikely to have any impact on the existing capacity of Petronet LNG.

Petronet LNG already processes much higher tolling volumes than the levels mandated in the recent notification on LNG terminals eligibility.

Robust volume spurt to drive earnings growth

During FY12-15E, we expect Petronet to report revenue CAGR of 26%. The growth would be primarily driven by increase in capacity from 10mn tons in FY12 to about 18mn tons in FY15. While we expect volumes from Dahej to be at 13mn tons in FY15 from 11mn tons in FY12, Kochi terminal is estimated to be operating at its full capacity of 5mn tons by FY15. Robust volume growth aided by 5% per annum increase in re-gas charges would drive the earnings going ahead.

Petronet revenue growth



Source: Company, India Infoline Research

Recommend BUY with a target price of Rs187

With robust LNG demand and strong visibility owing to contracted volumes we are confident of the fundamentals of the LNG business in India. Given superior visibility in the business among its peers in the Oil & gas space, we value the stock at 12x FY14E EPS and thereby recommend a BUY with a 9-month target price of Rs187.

Risks

- The re-gasification margins coming under regulations could dent our earnings estimates.
- There has been some delay on part of GAIL to construct the 1,114kms pipeline connecting Kochi terminal to Mangalore. This has led to delay in commissioning the terminal to its full capacity until end of 2013. Further delays on part of GAIL to build the pipelines connecting its customers, could impact our volume assumptions.

Financials

Income statement

Y/e 31 Mar (Rs mn)	FY12	FY13E	FY14E	FY15E
Revenue	226,959	291,360	361,373	479,148
Operating profit	**18,292**	**20,913**	**23,640**	**29,559**
Depreciation	(1,842)	(2,578)	(4,242)	(4,762)
Interest expense	(1,774)	(1,820)	(3,281)	(3,641)
Other income	849	1,000	1,000	1,000
Profit before tax	**15,525**	**17,514**	**17,117**	**22,156**
Taxes	(4,950)	(5,780)	(5,649)	(7,312)
Net profit	**10,575**	**11,735**	**11,469**	**14,845**

Balance sheet

Y/e 31 Mar (Rs mn)	FY12	FY13E	FY14E	FY15E
Equity capital	7,500	7,500	7,500	7,500
Reserves	27,698	37,707	47,451	60,571
Net worth	**35,198**	**45,207**	**54,951**	**68,071**
Debt	30,340	30,340	27,340	30,340
Deferred tax liab (net)	3,630	2,692	2,692	2,692
Total liabilities	**69,168**	**78,239**	**84,983**	**101,102**
Fixed assets	58,113	73,213	77,213	96,213
Investments	1,399	1,399	1,399	1,399
Net working capital	**(185)**	**256**	**529**	**1,934**
Inventories	7,124	9,163	11,381	15,115
Sundry debtors	12,859	16,540	20,544	27,285
Other current assets	2,775	3,179	3,642	4,176
Sundry creditors	(12,686)	(16,317)	(20,267)	(26,917)
Other current liabilities	(10,257)	(12,309)	(14,771)	(17,725)
Cash	9,841	3,372	5,842	1,557
Total assets	**69,168**	**78,239**	**84,983**	**101,102**

Cash flow statement

Y/e 31 Mar (Rs mn)	FY12	FY13E	FY14E	FY15E
Profit before tax	15,525	17,514	17,117	22,156
Depreciation	1,842	2,578	4,242	4,762
Tax paid	(4,950)	(5,780)	(5,649)	(7,312)
Working capital Δ	386	(441)	(274)	(1,405)
Operating cashflow	12,803	13,872	15,436	18,202
Capital expenditure	(10,902)	(17,678)	(8,242)	(23,762)
Free cash flow	**1,901**	**(3,806)**	**7,195**	**(5,560)**
Equity raised	(454)	-	-	-
Investments	10,250	-	-	-
Debt financing/disposal	(1,822)	-	(3,000)	3,000
Dividends paid	(1,725)	(1,725)	(1,725)	(1,725)
Other items	150	(938)	-	-
Net Δ in cash	**8,301**	**(6,469)**	**2,470**	**(4,285)**

Key ratios

Y/e 31 Mar	FY12	FY13E	FY14E	FY15E
Growth matrix (%)				
Revenue growth	72.0	28.4	24.0	32.6
Op profit growth	50.4	14.3	13.0	25.0
EBIT growth	57.3	11.8	5.5	26.5
Net profit growth	70.6	11.0	(2.3)	29.4
Profitability ratios (%)				
OPM	8.1	7.2	6.5	6.2
EBIT margin	7.6	6.6	5.6	5.4
Net profit margin	4.7	4.0	3.2	3.1
RoCE	26.3	26.2	25.0	27.7
RoNW	34.1	29.2	22.9	24.1
RoA	12.7	11.8	10.1	11.2
Per share ratios				
EPS	14.1	15.6	15.3	19.8
Dividend per share	2.0	2.0	2.0	2.0
Cash EPS	16.6	19.1	20.9	26.1
Book value per share	46.9	60.3	73.3	90.8
Valuation ratios				
P/E	11.6	10.4	10.7	8.2
P/CEPS	9.8	8.5	7.8	6.2
P/B	3.5	2.7	2.2	1.8
EV/EBIDTA	7.8	7.1	6.1	5.1
Payout (%)				
Dividend payout	16.3	14.7	15.0	11.6
Tax payout	31.9	33.0	33.0	33.0
Liquidity ratios				
Debtor days	21	21	21	21
Inventory days	11	11	11	12
Creditor days	20	20	20	21
Leverage ratios				
Net debt / equity	0.6	0.6	0.4	0.4
Net debt / op. profit	1.1	1.3	0.9	1.0

Du-Pont Analysis

Y/e 31 Mar	FY12	FY13E	FY14E	FY15E
Tax burden (x)	0.68	0.67	0.67	0.67
Interest burden (x)	0.90	0.91	0.84	0.86
EBIT margin (x)	0.08	0.07	0.06	0.05
Asset turnover (x)	2.72	2.93	3.19	3.61
Financial leverage (x)	2.69	2.47	2.27	2.16
RoE (%)	**34.1**	**29.2**	**22.9**	**24.1**

IIFL INDIA PRIVATE CLIENTS

After receiving two reputed awards for being the 'Best Broker' in 2011, IIFL has now bagged the Best Broking House with Global Presence in 2012.

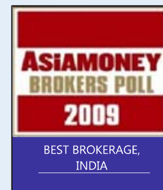
'Best Equity Broker of the Year' – Bloomberg UTV, 2011

IIFL was awarded the 'Best Equity Broker of the Year' at the recently held Bloomberg UTV Financial Leadership Award, 2011. The award presented by the Hon'ble Finance Minister of India, Shri Pranab Mukherjee. The Bloomberg UTV Financial Leadership Awards acknowledge the extraordinary contribution of India's financial leaders and visionaries from January 2010 to January 2011.

'Best Broker in India' – Finance Asia, 2011

IIFL has been awarded the 'Best Broker in India' by Finance Asia. The award is the result of Finance Asia's annual quest for the best financial services firms across Asia, which culminated in the Country Awards 2011

Other awards



Recommendation parameters for fundamental reports:

Buy – Absolute return of over +10%

Market Performer – Absolute return between -10% to +10%

Sell – Absolute return below -10%

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