Gas Transmission & Dist

The false hope is fading

- Contrary to expectations of government intervention in the gas sector, APM price of natural gas has gone up by US$2.5/mmBtu or Rs6.7/scm.
- Given the likely LNG scarcity in CY23F, urea subsidy can at least be US$24 bn in FY24F, leading to a serious risk of APM gas volume diversion to urea.
- Given policy uncertainty, CGD companies should trade like oil marketing companies and need to derate significantly from current average P/BV of 4.5x.

Rising urea subsidy & LNG prices put APM gas availability at risk

We estimate that given the current scenario, Russian gas inflow to Europe can trickle down to 20bcm in CY23F, against a likely 65bcm in CY22F. Assuming that Europe will be able to prune demand by 10% next winter (5% now and 5% next year), even then Europe will require around 150bcm gas from spot market, which will lead to skyrocketing LNG prices. Indian fertilizer sector's import requirement will be around 14-15bcm of LNG in FY24F while that of CGD companies will be additional. It's possible that India may not get 24-25mt or 32-34bcm gas from international market or even if it gets, it will be at a very high price of more than US$30-35/mmBtu. In this scenario, the government will have two choices: 1) Cut down CGD companies' gas volume as petrol and diesel are anyway controlled and hence, provide an inflation-less alternative to consumers. 2) Divert APM gas volume to urea -makers. 3) Industrial users of gas can always shift to cheap propane. Please note that India imports around 10mt of urea and rising gas prices will lead to higher urea prices as well (it's just a matter of time, urea prices will rise as US liquefaction terminal becomes operational).

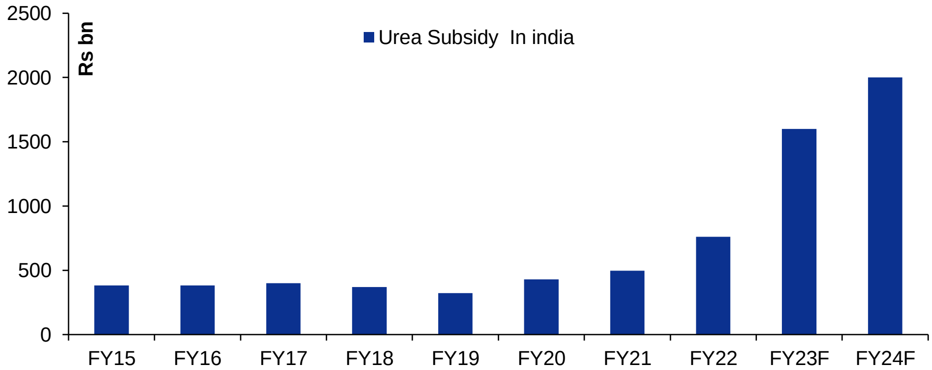
CGD companies face multiple risks

City gas distribution or CGD companies face multiple risks: 1) Government increasing the administered pricing mechanism or APM gas price (it is unlikely to control the price given big private sector involvement and controlling it has hardly any benefit for fighting inflation) rather than funding the gap of urea-makers via subsidy makes more sense. 2) Diversion of APM gas to urea-makers, as LNG will be at least 4x costly in coming years. 3) Industrial customers may renege to cheaper fuels. Their volume growth is at risk. At a lower volume, they can make good margins, but the growth multiple enjoyed by these companies shall fade.

Valuation too high vis-à-vis risk

Compared to OMCs, Indian CGD companies trade at 900% premium valuation on P/BV. We don't say that CGD companies will go the OMC way but given the macro as well as policy uncertainty, they should trade at a 50% lower valuation. Retain REDUCE rating on India GCD companies. Gujarat Gas is our top REDUCE-rated stock.

Figure 1: Rising LNG prices will lead to urea subsidy surging to Rs2,000bn by FY24F



SOURCE: INCRED RESEARCH, COMPANY REPORTS

India

Underweight *(no change)*

Highlighted Companies

Gujarat Gas

REDUCE, TP Rs410, Rs503 close

Rising APM gas price, continued scarcity of LNG which should keep LNG price around US$50/mmBtu are key headwinds for the CGD segment. Consensus earnings are in for disappointment as either gross profit will decline, or volume growth will disappoint. Gujarat Gas is our Top REDUCE-rated stock.

Mahanagar Gas

REDUCE, TP Rs642, Rs832 close

Consensus earnings estimates are too high and need a massive cut (>30%). We retain REDUCE rating on the stock with a target price of Rs642.

Indraprastha Gas

REDUCE, TP Rs277, Rs397 close

Over the last 12 years, the stock has, on an average, traded at 17.6x one-year forward EPS. Compared to OMCs, Indian city gas distribution companies or CGDs trade at a valuation of 9x P/BV.

Summary Valuation Metrics

P/E (x)	Mar22-A	Mar23-F	Mar24-F
Gujarat Gas	31.83	32	28.34
Mahanagar Gas	16.35	15.54	15.56
Indraprastha Gas	20.62	25.21	23.83

P/BV (x)	Mar22-A	Mar23-F	Mar24-F
Gujarat Gas	6.34	5.41	4.62
Mahanagar Gas	2.2	1.93	1.72
Indraprastha Gas	3.74	3.35	3.02

Dividend Yield	Mar22-A	Mar23-F	Mar24-F
Gujarat Gas	0.4%	0.4%	0.4%
Mahanagar Gas	3.97%	1.2%	1.2%
Indraprastha Gas	0.91%	0.91%	0.91%

Analyst(s)

Satish KUMAR
T (91) 22 4161 1562
E satish.kumar@incredcapital.com

Abbas PUNJANI
T (91) 22 4161 1562
E abbas.punjani@incredcapital.com

The false hope is fading

After looking at what happened to Indian oil and gas producers as well as refineries, there was hope in the market that the government will somehow protect CGD companies as well by not revising APM price. However, that hasn't happened this time. However, during some other price revision this can happen. The energy sector is becoming highly prone to intervention, which is not at all good for minority shareholders. It's best to keep away from oil refiners as well as CGD companies. We retain Underweight rating on the sector.

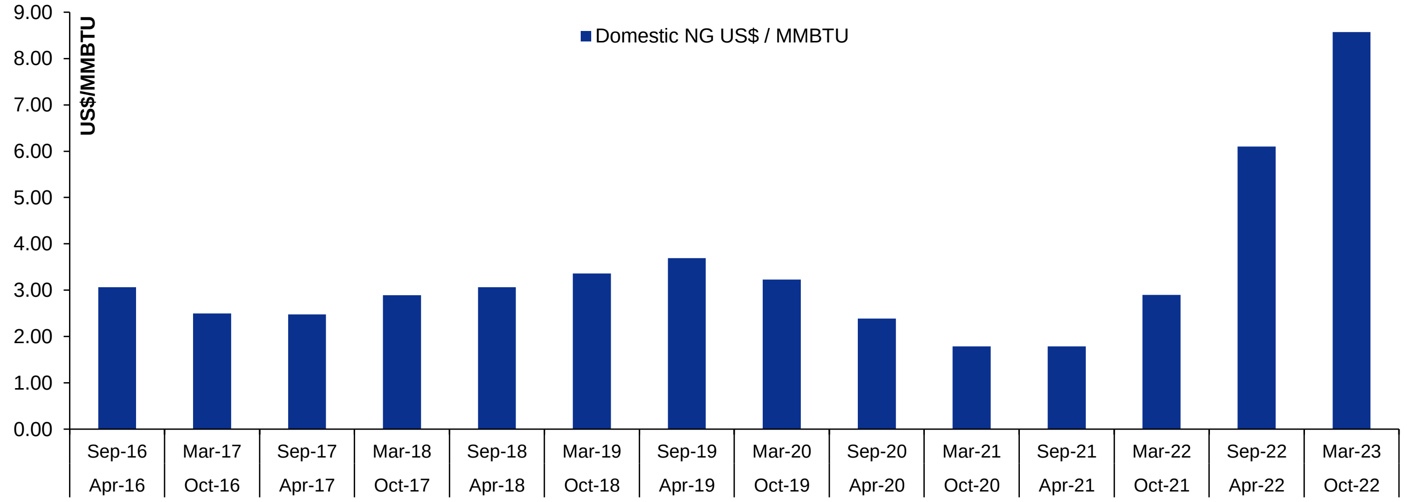
CGD segment has multiple headwinds

Rising APM price and continued scarcity of LNG should keep LNG price around US$50/mmBtu, which is the key headwind for CGD companies. The rise in prices of compressed natural gas or CNG price will make CNG lose its attractiveness vis-à-vis petrol and diesel.

Government has raised APM gas price

In a recent move, Indian government raised APM gas price to US$8.57/mmBtu and peak price has been capped at US$12.46/mmBtu.

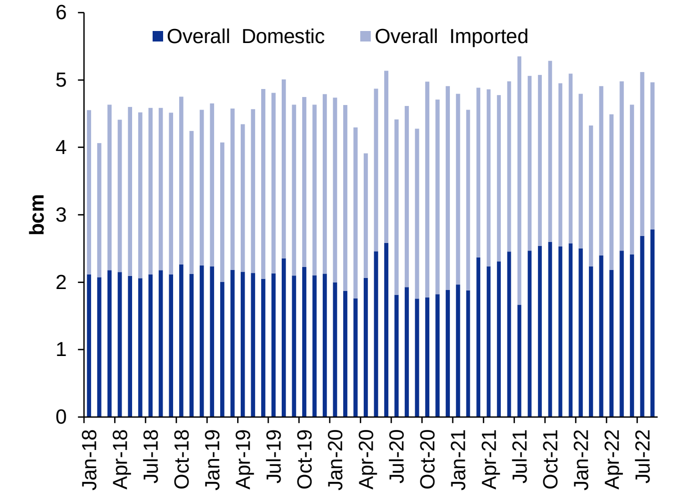
Figure 2: Hike in APM gas price means that gas price should be raised by Rs8/scm so that CGD companies can post gross margin (Rs/scm) equal to that in 2QFY23F in coming quarters



SOURCE: INCRED RESEARCH, COMPANY REPORTS

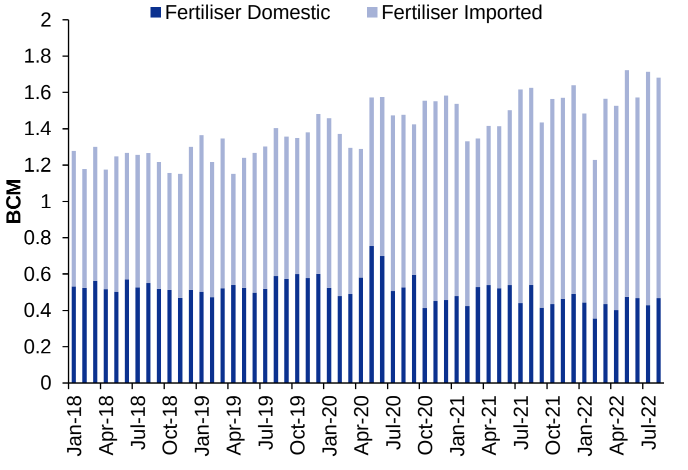
Indian domestic gas availability for key sectors is at the same level ➤

Figure 3: Indian industry has accepted the challenge to increase domestic gas production



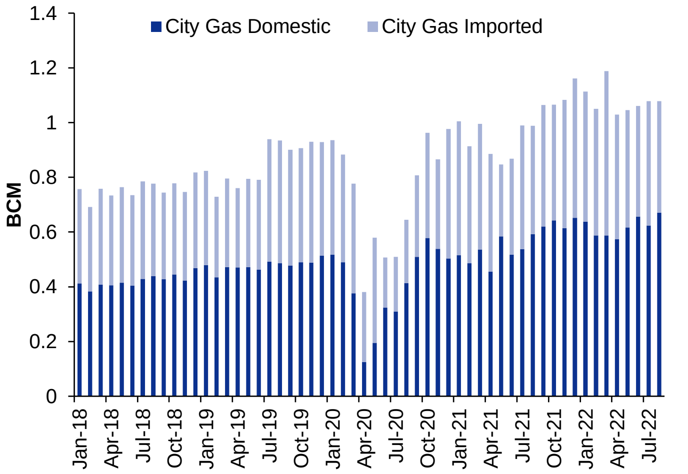
SOURCE: INCRED RESEARCH, COMPANY REPORTS

Figure 4: In an interesting move, govt is ready to subsidize fertilizers and let the industry depend on imported gas



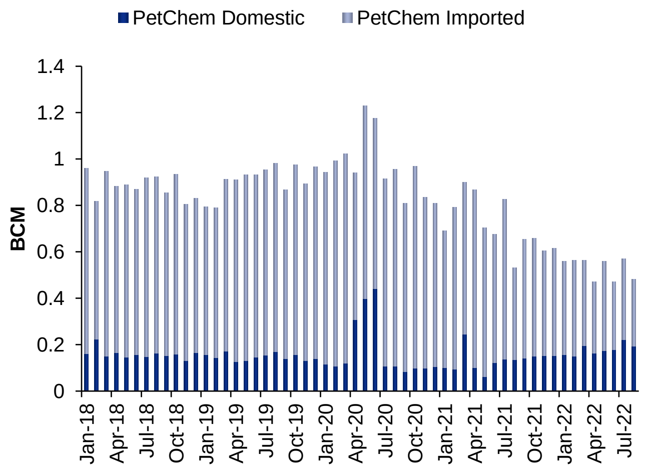
SOURCE: INCRED RESEARCH, COMPANY REPORTS

Figure 5: Gas availability to CGD companies is improving despite the challenges



SOURCE: INCRED RESEARCH, COMPANY REPORTS

Figure 6: Expectedly, the petchem industry is languishing



SOURCE: INCRED RESEARCH, COMPANY REPORTS

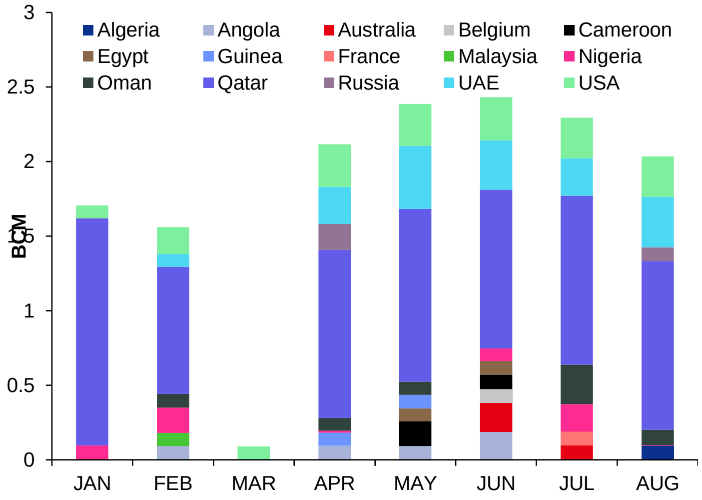
Government's strategic intent seems incentivising domestic gas production➤

1. Increasing APM gas price has become a necessity for Indian government, as one of the main producers of gas is in the private sector and any arbitrary move would result in lower future investment.
2. On the other hand, by increasing APM gas volume to CGD companies and sacrificing the domestic fertilizer industry (leaving it to the mercy of imported gas) will raise the subsidy burden for the government.

Till now, India has been lucky that most international gas suppliers have adhered to their contracts➤

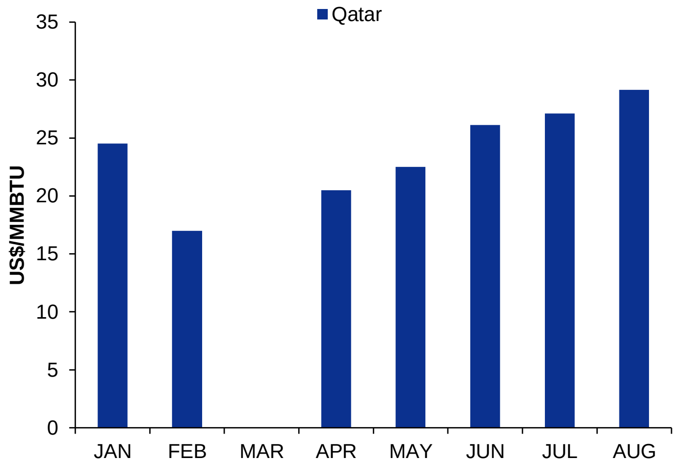
Despite all the bickering over not overtly opposing Russia over its Ukraine invasion, USA has been the cheapest gas supplier to India while the gas from Qatar is the costliest.

Figure 7: It's a relief for India that Qatar has not reneged from its contracts



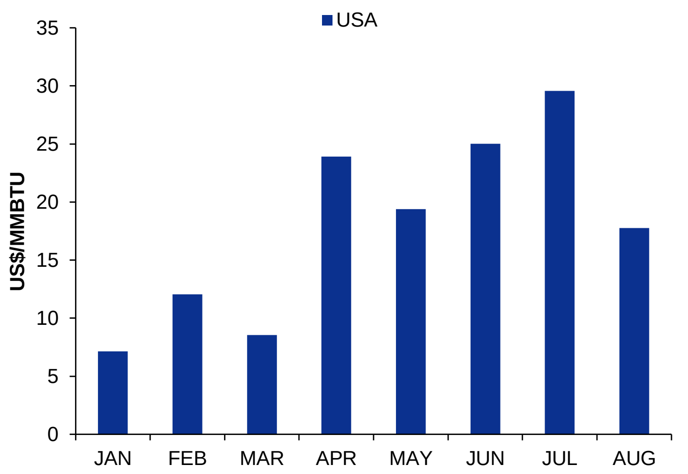
SOURCE: INCRED RESEARCH, COMPANY REPORTS

Figure 8: However, the gas price charged by Qatar is close to the spot rate



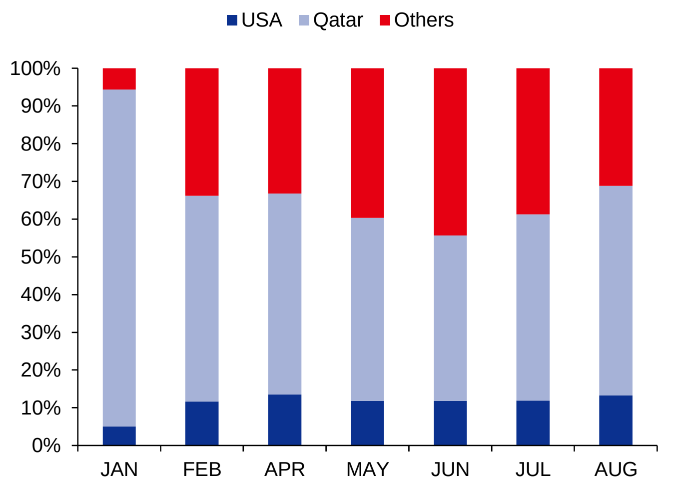
SOURCE: INCRED RESEARCH, COMPANY REPORTS

Figure 9: Despite all the differences, the USA has been more reasonable when it comes to gas price



SOURCE: COMPANY REPORTS, INCRED RESEARCH

Figure 10: However, gas imports from USA are miniscule compared to imports from Qatar

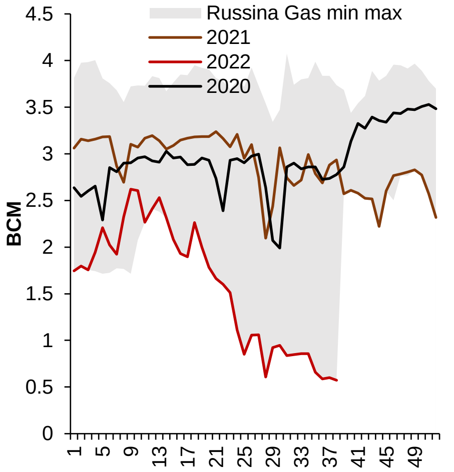


SOURCE: COMPANY REPORTS, INCRED RESEARCH

LNG demand was lower from Europe so far in CY22 (compared to the likely scenario in CY23F) as Russian gas supply was trickling in ➤

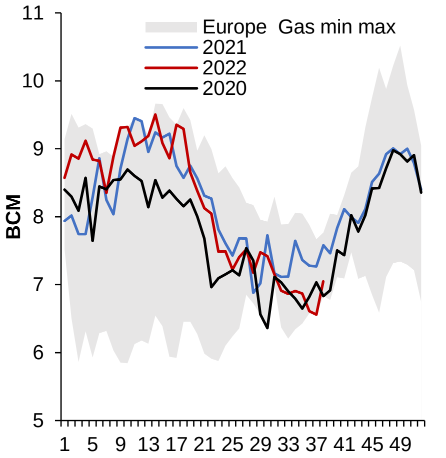
2022 is still OK for the world as Russian gas supply is still trickling into Europe. Please note that Russia is still likely to supply 62-65bcm gas to Europe as against 150bcm supplied in CY21. Europe's LNG imports have increased by 67.3% and at the current rate, Europe will be importing ~156bcm LNG, which is 60bcm higher than in CY21.

Figure 11: Russian gas supply to Europe in CY22F can be ~65bcm



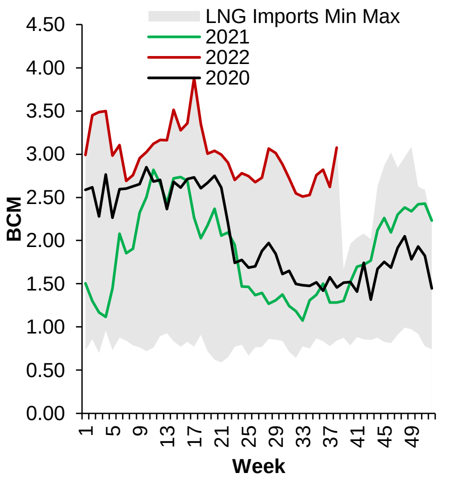
SOURCE: INCRED RESEARCH, COMPANY REPORTS

Figure 12: Still, Europe manages to get gas at last year's level…



SOURCE: INCRED RESEARCH, COMPANY REPORTS

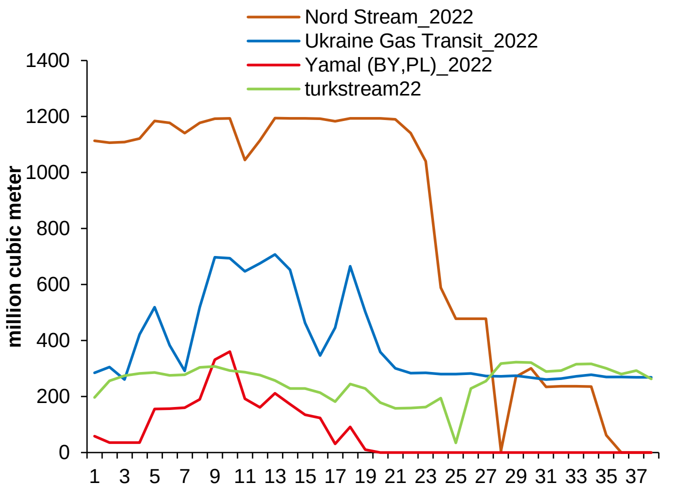
Figure 13: …as its LNG imports have gone up by 67.3%



SOURCE: INCRED RESEARCH, COMPANY REPORTS

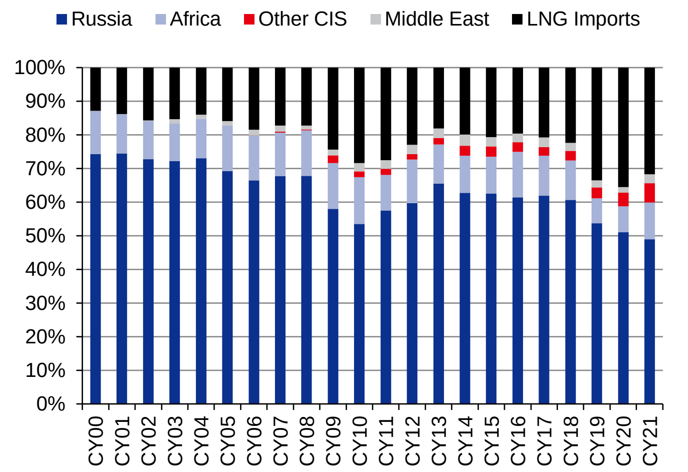
However, in CY23F Europe will be completely dependent on LNG

Figure 14: Nord Stream-1 gas supply has completely stopped and so is the case with Yamal pipeline



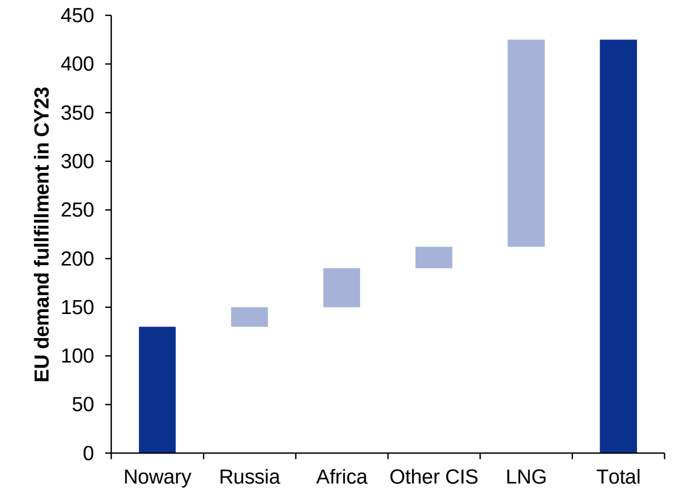
SOURCE: INCRED RESEARCH, COMPANY REPORTS

Figure 15: In CY21, Europe imported ~50% of its gas requirement (341bcm) from Russia



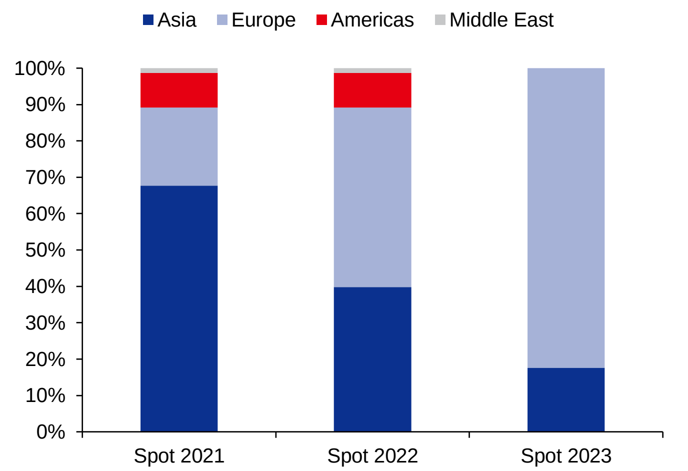
SOURCE: INCRED RESEARCH, COMPANY REPORTS

Figure 16: If Europe doesn't cut demand, then its LNG dependence will be very high (~37% of global market)



SOURCE: INCRED RESEARCH, COMPANY REPORTS

Figure 17: In an as-it-is scenario, Asia will get hardly anything when it comes to spot LNG

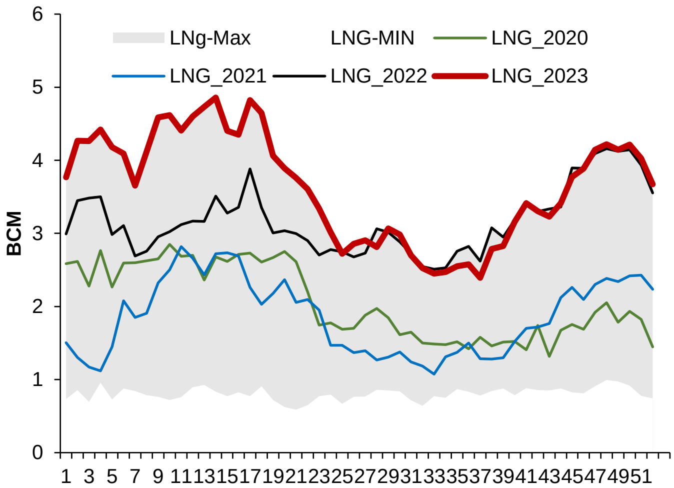


SOURCE: INCRED RESEARCH, COMPANY REPORTS

Hence, Asia and India are looking towards Europe for demand management ➤

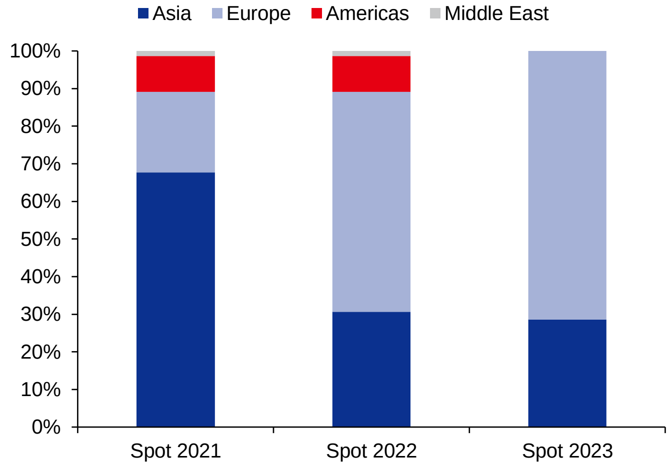
Assuming Europe cuts its demand from Sep 2022 by 5% every month till Dec 2023F, its overall LNG import requirement will be 190bcm in CY23F.

Figure 18: Assuming Europe's gas demand declines 5% from now on till the end of 2023F, Europe needs 190bcm LNG



SOURCE: INCRED RESEARCH, COMPANY REPORTS

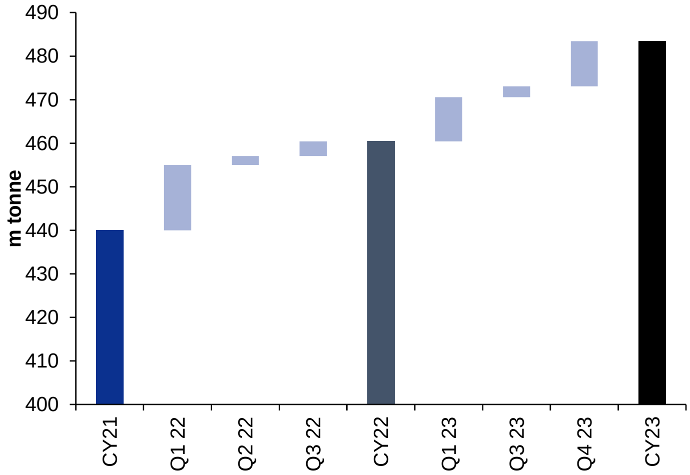
Figure 19: Even in this scenario, Asia won't get more than 20-25% lower LNG price compared to its CY21 purchase price



SOURCE: INCRED RESEARCH, COMPANY REPORTS

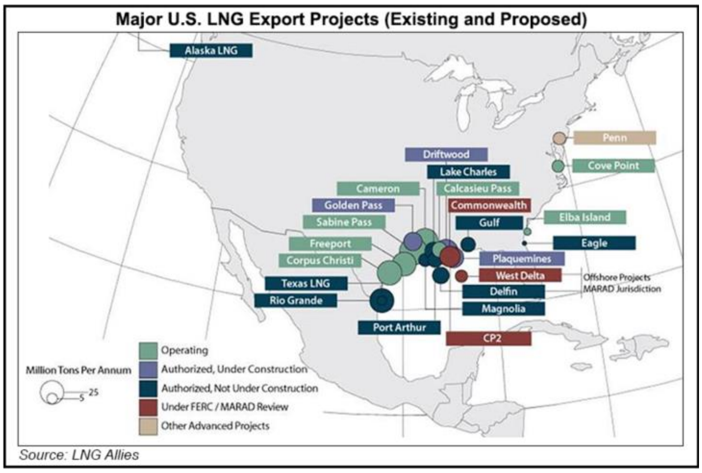
Our calculations assume that around 20mt incremental LNG over CY22F will be available in CY23F ➤

Figure 20: We assume that ~460mt liquefaction capacity will be available through the year in CY23F



SOURCE: INCRED RESEARCH, COMPANY REPORTS

Figure 21: Most of the present and coming liquefaction projects are in hurricane zone

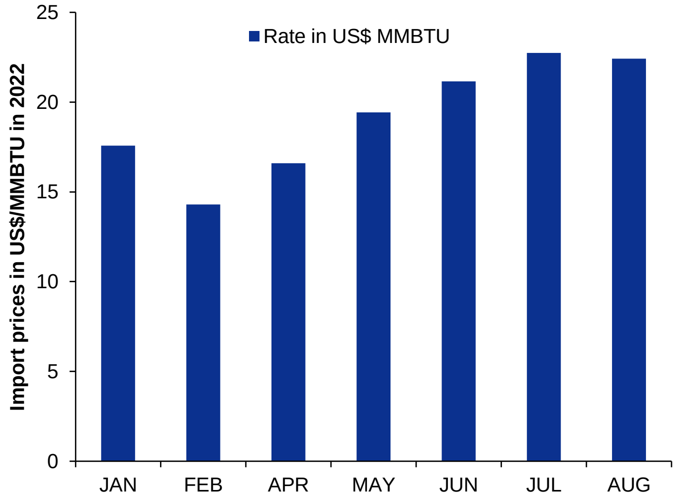


SOURCE: INCRED RESEARCH, HTTPS://WWW.NATURALGASINTEL.COM/PROPOSED-PENNSYLVANIA-LNG-EXPORT-TERMINAL-IN-TALKS-TO-COMMERCIALIZE-PROJECT/

However, it's pertinent to note that given the location of major current and upcoming projects, they are mostly in the zone prone to hurricanes whose intensity has increased over time. Any damage to the infrastructure because of the hurricanes will lead to scarcity in already tight market conditions.

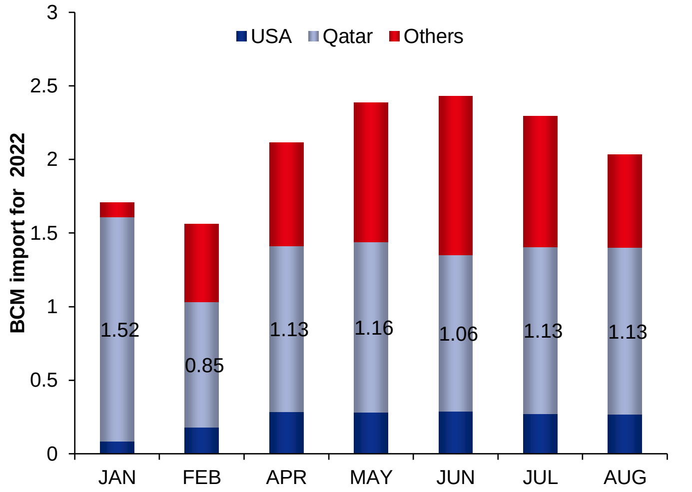
Indian gas import prices are already rising and we expect them to rise further in coming months; also the country-specific dependence is just too high

Figure 22: Indian LNG import prices have already touched US$22/mmBtu



SOURCE: COMPANY REPORTS, INCRED RESEARCH

Figure 23: India's dependence on Qatar gas is just too high for comfort

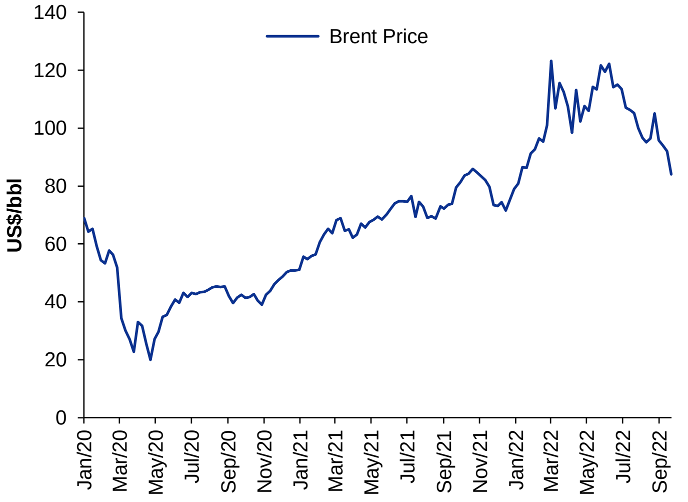


SOURCE: COMPANY REPORTS, INCRED RESEARCH

The LNG slope is rising vis-à-vis crude oil, which is further bad news for Indian LNG users

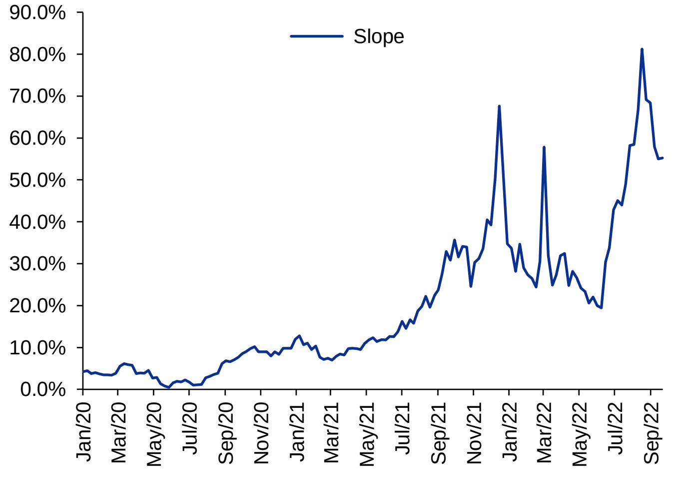
European buying is raising the LNG slope, which is very bad news. This means that despite the correction in crude oil prices, LNG prices will not fall commensurately.

Figure 24: Crude oil prices have corrected by ~US$35/bbl from their peak



SOURCE: INCRED RESEARCH, COMPANY REPORTS

Figure 25: However, correction in the LNG slope from an astronomical 80% is still 55% only



SOURCE: INCRED RESEARCH, COMPANY REPORTS

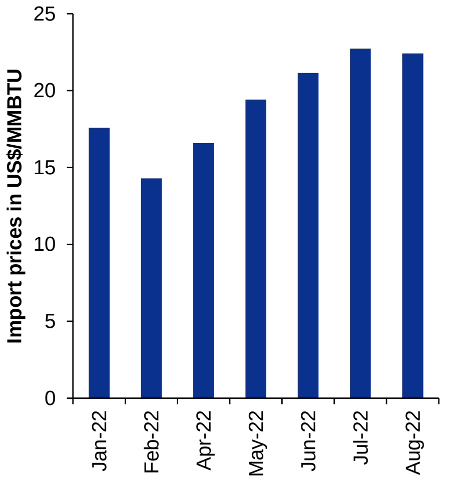
So, in all probability, Indian LNG purchase prices will rise in coming weeks

While the Western world was paying US$50-60/mmBtu for LNG, courtesy Qatar, India managed to ride it out. It remains to be seen how Qatar behaves in coming weeks. The recent fiasco with Qatar over a statement by a ruling party spokesperson and the reaction of Qatar over some minor event is noteworthy. (Please click the link here). Qatar has a great leverage over India now and if Indian diplomacy makes even a minor mistake, then it can invoke the force majeure clause. As a recent Gazprom incident showed, breaching the long-term contract and supplying to spot market is much more beneficial (Please click the link here).

Indian government's hands will be tied next year and, at best, it won't reduce APM gas volume for CGD companies ➤

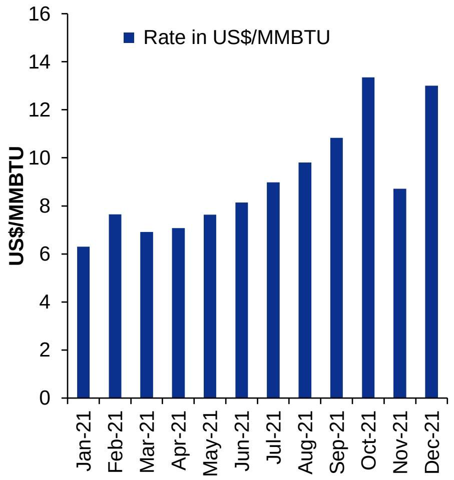
Unless India's gas production increases significantly, the government's hands will be tied, and it will be forced to reduce APM gas volume. Catering to urea production is the prime responsibility of the government.

Figure 26: Indian LNG import price has already touched US$22/mmBtu…



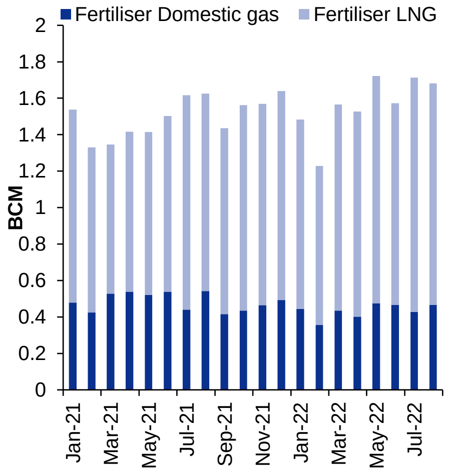
SOURCE: INCRED RESEARCH, COMPANY REPORTS

Figure 27: .. against the average import price of 2021 at US$9.1/mmBtu



SOURCE: INCRED RESEARCH, COMPANY REPORTS

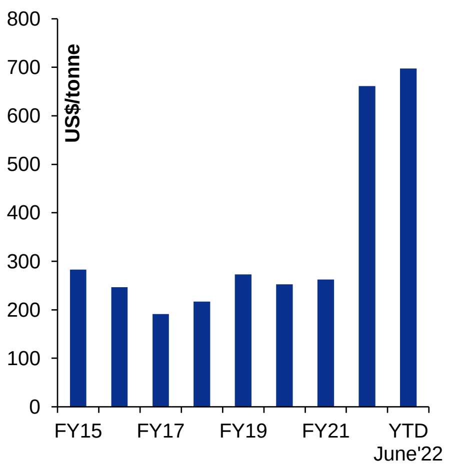
Figure 28: 70% of the fertilizers produced use imported LNG



SOURCE: INCRED RESEARCH, COMPANY REPORTS

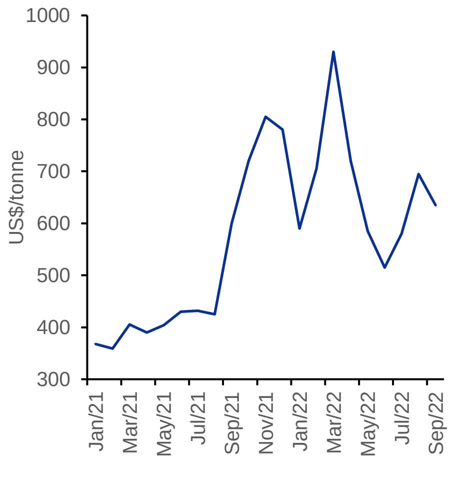
LNG supply will tighten going ahead for CGD players. Assuming the gas supply to urea-makers remains at 5.6bcm in FY23F, India's urea subsidy bill will rise to US$20bn.

Figure 29: India's urea import price in first three months of FY23 has been close to US$700/t



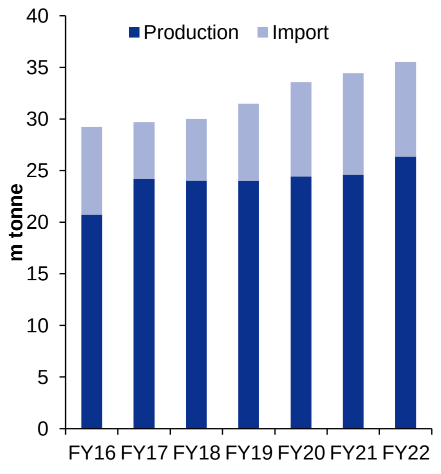
SOURCE: INCRED RESEARCH, COMPANY REPORTS

Figure 30: Global urea prices have cooled off a bit, but they are still quite high



SOURCE: INCRED RESEARCH, COMPANY REPORTS

Figure 31: India has been importing 9-10 mt of urea



SOURCE: INCRED RESEARCH, COMPANY REPORTS

Given current LNG prices and India's import requirement, total urea subsidy in FY23F can be US$20bn, and in FY24F it can be US$25bn.

Figure 32: India's urea subsidy bill is likely to be US$20bn in FY23F

Internal urea prices in US$/tonne	Import prices of LNG in US$/mmBtu: 25	26	27	28	29	30
600.00	18,332	18,802	19,272	19,742	20,212	20,682
650.00	18,832	19,302	19,772	20,242	20,712	21,182
700.00	19,332	19,802	20,272	20,742	21,212	21,682
750.00	19,832	20,302	20,772	21,242	21,712	22,182
800.00	20,332	20,802	21,272	21,742	22,212	22,682
850.00	20,832	21,302	21,772	22,242	22,712	23,182
900.00	21,332	21,802	22,272	22,742	23,212	23,682
1,000.00	22,332	22,802	23,272	23,742	24,212	24,682

SOURCE: INCRED RESEARCH, COMPANY REPORTS

Figure 33: However, it can increase to US$24bn+ in FY24F; please note that rising gas prices will force a rise in ammonia prices and hence, push up urea prices

Internal urea prices in US$/tonne	Import prices of LNG in US$/mmBtu: 27	28	29	30	31	32
600.00	19,900	20,394	20,888	21,382	21,876	22,370
650.00	20,400	20,894	21,388	21,882	22,376	22,870
700.00	20,900	21,394	21,888	22,382	22,876	23,370
750.00	21,400	21,894	22,388	22,882	23,376	23,870
800.00	21,900	22,394	22,888	23,382	**23,876**	24,370
850.00	22,400	22,894	23,388	23,882	24,376	24,870
900.00	22,900	23,394	23,888	24,382	24,876	25,370
1,000.00	23,900	24,394	24,888	25,382	25,876	26,370

SOURCE: INCRED RESEARCH, COMPANY REPORTS

CGD companies can have a worst scenario in FY24F vis-à-vis FY23F ➤

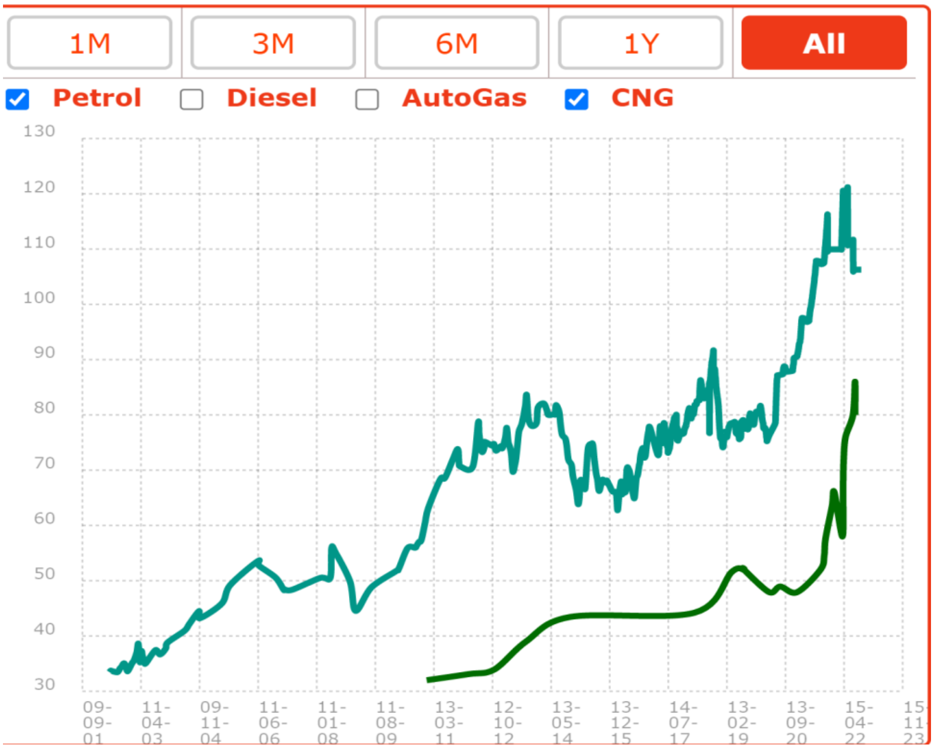
CGD companies can stare at two possible scenarios next year.

1. Government reduces APM gas volume for CGD companies and transfers it to urea-makers i.e., the worst outcome.
2. Government doesn't reduce APM gas volume but doesn't increase it as well.

APM gas price can keep rising and global LNG prices can also go up, making CNG uncompetitive ➤

As global gas prices rise, accordingly APM prices will be revised upwards and there is always a possiblity that the government caps APM price as well, but that will be detrimental to its long-term policy. Moreover, unlike poor public sector undertakings or PSUs in the gas sector, many big private sector companie are also involved, which makes policy reversal that much more tricky. The current rise of US$2.5 makes gas costly by Rs6.7/scm.

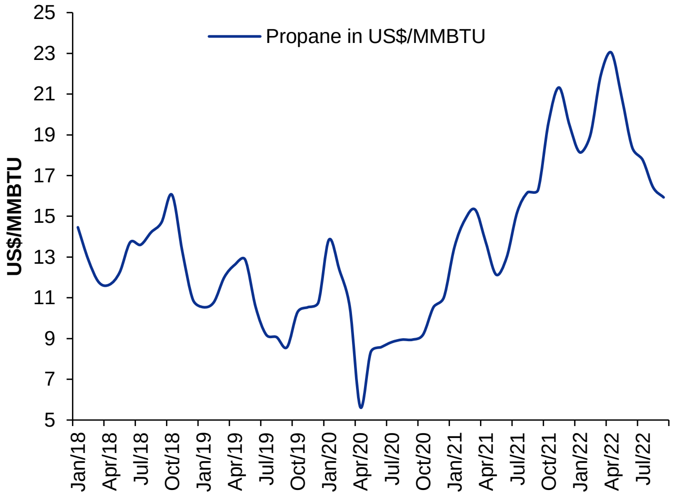
Figure 34: As of now, CNG price differential with petrol is lowest since the last decade, making it uncompetitive vis-à-vis petrol



SOURCE: HTTPS://WWW.MYPETROLPRICE.COM/3/3/MUMBAI-CNG-PRICE-CHART

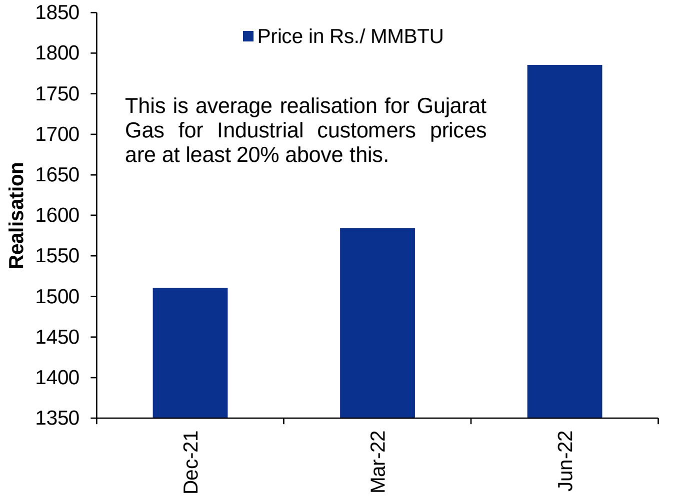
Natural gas price is also becoming uncompetitive against propane - a big negative for industrial supply

Figure 35: Currently, propane price is US$15.93/mmBtu or Rs1,274/mmBtu



SOURCE: COMPANY REPORTS, INCRED RESEARCH

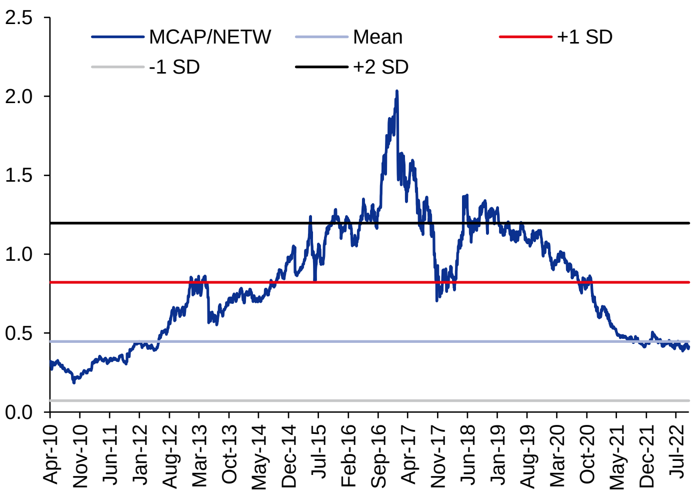
Figure 36: However, Gujarat Gas price is way above propane price (Rs/ mmBtu)



SOURCE: COMPANY REPORTS, INCRED RESEARCH

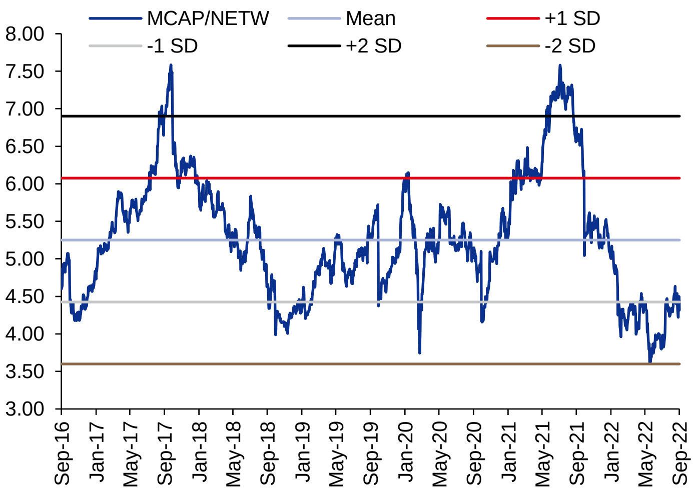
In the emerging headwinds context, P/BV multiple of CGD companies is way above fair value; retain REDUCE rating

Figure 37: The P/BV valuation of OMCs is near 0.5x



SOURCE: INCRED RESEARCH, COMPANY REPORTS

Figure 38: We don't say that CGD companies should trade at 0.5x P/BV but given the uncertainty, they don't deserve 4.5x P/BV valuation



SOURCE: INCRED RESEARCH, COMPANY REPORTS

DISCLAIMER

This report (including the views and opinions expressed therein, and the information comprised therein) has been prepared by Incred Research Services Private Ltd.(formerly known as Earnest Innovation Partners Private Limited) (hereinafter referred to as "IRSPL"). IRSPL is registered with SEBI as a Research Analyst vide Registration No. INH000007793. Pursuant to a trademark agreement, IRSPL has adopted "Incred Equities" as its trademark for use in this report.

The term "IRSPL" shall, unless the context otherwise requires, mean IRSPL and its affiliates, subsidiaries and related companies. This report is not directed or intended for distribution to or use by any person or entity resident in a state, country or any jurisdiction, where such distribution, publication, availability or use would be contrary to law, regulation or which would subject IRSPL and its affiliates/group companies to registration or licensing requirements within such jurisdictions.

This report is being supplied to you strictly on the basis that it will remain confidential. No part of this report may be (i) copied, photocopied, duplicated, stored or reproduced in any form by any means; or (ii) redistributed or passed on, directly or indirectly, to any other person in whole or in part, for any purpose without the prior written consent of IRSPL.

The information contained in this report is prepared from data believed to be correct and reliable at the time of issue of this report.

IRSPL is not required to issue regular reports on the subject matter of this report at any frequency and it may cease to do so or change the periodicity of reports at any time. IRSPL is not under any obligation to update this report in the event of a material change to the information contained in this report. IRSPL has not any and will not accept any, obligation to (i) check or ensure that the contents of this report remain current, reliable or relevant; (ii) ensure that the content of this report constitutes all the information a prospective investor may require; (iii) ensure the adequacy, accuracy, completeness, reliability or fairness of any views, opinions and information, and accordingly, IRSPL and its affiliates/group companies (and their respective directors, associates, connected persons and/or employees) shall not be liable in any manner whatsoever for any consequences (including but not limited to any direct, indirect or consequential losses, loss of profits and damages) of any reliance thereon or usage thereof.

Unless otherwise specified, this report is based upon reasonable sources. Such sources will, unless otherwise specified, for market data, be market data and prices available from the main stock exchange or market where the relevant security is listed, or, where appropriate, any other market. Information on the accounts and business of company(ies) will generally be based on published statements of the company(ies), information disseminated by regulatory information services, other publicly available information and information resulting from our research. Whilst every effort is made to ensure that statements of facts made in this report are accurate, all estimates, projections, forecasts, expressions of opinion and other subjective judgments contained in this report are based on assumptions considered to be reasonable as of the date of the document in which they are contained and must not be construed as a representation that the matters referred to therein will occur. Past performance is not a reliable indicator of future performance. The value of investments may go down as well as up and those investing may, depending on the investments in question, lose more than the initial investment. No report shall constitute an offer or an invitation by or on behalf of IRSPL and its affiliates/group companies to any person to buy or sell any investments.

The opinions expressed are based on information which are believed to be accurate and complete and obtained through reliable public or other non-confidential sources at the time made. (Information barriers and other arrangements may be established where necessary to prevent conflicts of interests arising. However, the analyst(s) may receive compensation that is based on his/their coverage of company(ies) in the performance of his/their duties or the performance of his/their recommendations. In reviewing this report, an investor should be aware that any or all of the foregoing, among other things, may give rise to real or potential conflicts of interest. Additional information is, subject to the duties of confidentiality, available on request.

The report is not a "prospectus" as defined under Indian Law, including the Companies Act, 2013, and is not, and shall not be, approved by, or filed or registered with, any Indian regulator, including any Registrar of Companies in India, SEBI, any Indian stock exchange, or the Reserve Bank of India. No offer, or invitation to offer, or solicitation of subscription with respect to any such securities listed or proposed to be listed in India is being made, or intended to be made, to the public, or to any member or section of the public in India, through or pursuant to this report.

The research analysts, strategists or economists principally responsible for the preparation of this research report are segregated from the other activities of IRSPL. Information barriers and other arrangements have been established, as required, to prevent any conflicts of interests.

The research analysts, strategists or economists principally responsible for the preparation of this research report are segregated from the other activities of IRSPL. Information barriers and other arrangements have been established, as required, to prevent any conflicts of interests.

IRSPL may have issued other reports (based on technical analysis, event specific, short term views etc.) that are inconsistent with and reach different conclusion from the information presented in this report.

Holding of Analysts/Relatives of Analysts, IRSPL and Associates of IRSPL in the covered securities, as on the date of publishing of this report

	Analyst/ Relative	Entity/ Associates
any financial interests in the company covered in this report (subject company) and nature of such financial interest	NO	NO
actual/beneficial ownership of 1% or more in securities of the subject company at the end of the month immediately preceding the date of publication of the research report or date of the public appearance;	NO	NO
any other material conflict of interest at the time of publication of the research report or at the time of public appearance	NO	NO
received any compensation from the subject company in the past twelve months for investment banking or merchant banking or brokerage services or investment advisory or depository or distribution from the subject company in the last twelve months for products/services other than investment banking or merchant banking or broker- age services or investment advisory or depository or distribution from the subject company in the last twelve months	NO	NO
managed or co-managed public offering of securities for the subject company in the last twelve months	NO	NO
received any compensation or other benefits from the subject company or third party in connection with the research report	NO	NO
served as an officer, director or employee of the subject company	NO	NO
been engaged in market making activity for the subject company	NO	NO

Analyst declaration

- The analyst responsible for the production of this report hereby certifies that the views expressed herein accurately and exclusively reflect his or her personal views and opinions about any and all of the issuers or securities analysed in this report and were prepared independently and autonomously in an unbiased manner.
- No part of the compensation of the analyst(s) was, is, or will be directly or indirectly related to the inclusion of specific recommendations(s) or view(s) in this report or based any specific investment banking transaction.
- The analyst(s) has(have) not had any serious disciplinary action taken against him/her(them).
- The analyst, strategist, or economist does not have any material conflict of interest at the time of publication of this report.
- The analyst(s) has(have) received compensation based upon various factors, including quality, accuracy and value of research, overall firm performance, client feedback and competitive factors.

IRSPL and/or its affiliates and/or its Directors/employees may own or have positions in securities of the company(ies) covered in this report or any securities related thereto and may from time to time add to or dispose of, or may be materially interested in, any such securities.

IRSPL and/or its affiliates and/or its Directors/employees may do and seek to do business with the company(ies) covered in this research report and may from time to time (a) buy/sell the securities covered in this report, from time to time and/or (b) act as market maker or have assumed an underwriting commitment in securities of such company(ies), and/or (c) may sell them to or buy them from customers on a principal basis and/or (d) may also perform or seek to perform significant investment banking, advisory, underwriting or placement services for or relating to such company(ies) and/or (e) solicit such investment, advisory or other services from any entity mentioned in thisreport and/or (f) act as a lender/borrower to such company and may earn brokerage or other compensation. However, Analysts are forbidden to acquire, on their own account or hold securities (physical or uncertificated, including derivatives) of companies in respect of which they are compiling and producing financial recommendations or in the result of which they play a key part.