Petronet LNG

Trading below stress valuations

PhillipCapital (India) Pvt. Ltd.

OIL & GAS: Company Update

31 January 2014

Petronet LNG (PLNG) has underperformed the O&G sector and corrected >30% over the last one year. News flows such as evacuation issues in Kochi led by delay in pipeline construction, relative unattractive fuel economics for spot LNG and slowdown in industrial activity caused this steep correction. While the headwinds are for real but we argue the steep correction ignores PLNG's utility nature of business (stable regasification margins and term contracts along with firm take or pay contract for Dahej expansion) and relatively lower regulatory risks. Improvement in fuel economics from March'14 onwards, advancement of US LNG volumes by GAIL (using time swaps) and likely new medium/long term LNG deals coupled with strong earnings growth from FY16, provides an attractive entry point to long term inventors. We believe the current valuations are undemanding and factors in all the potential risk leaving little room for disappointment on earnings (EV/CE ~0.9x FY16). We maintain a 'BUY' with a revised price target of Rs157.

Pessimism overdone: PLNG is pricing in the extremely gloomy outlook and even below our bear case valuation. In the bear case scenario, we build an extremely slow ramp up at Kochi to 4%/8%/20%/50% in FY14/15/16/17 and assume long term capacity utilization at Kochi terminal at 50%. Also, we factor in zero marketing margins at Dahej from FY17 onwards and assume a freeze in regasification tariffs hike at Dahej post CY16. Our DCF based price target (bear case) comes to ~Rs 117/share (11% upside from CMP). Southern India, being a new market, will take a longer lead time to scale up volumes, but the business case for gas as a market remains solid and we expect the Kochi terminal capacity utilization to rise to ~90% over the long term, providing a base case target price of Rs157 (50% upside from CMP). On FY16E, there seems to be a limited downside at ~8x P/E, 0.7x EV/GCI and 0.9x EV/CE. Risk reward favours entry.

Softer Spot LNG prices post winters to improve fuel economics: Our analysis of the spot LNG prices since Aug'11 against PLL's stock price reflects that stock has demonstrated a strong inverse co-relation to spot LNG prices. In the current leg of the trend, we have witnessed PLL's stock price correcting ~15% from the mid Oct'13 levels, primarily on the back of rising spot LNG prices (India destination LNG is 19% higher currently from Oct-13 (1FN)) and persistent issues on timely rollout of the southern grid pipelines. Confluence of rising spot LNG prices and weak industrial activity has led to concerns that PLNG could witness squeeze in profitability due to decline in marketing margins as well as lower throughput in Dahej terminal. However, the forward LNG Swap data points towards easing spot LNG prices, which is likely to put to rest the concerns over likely further decline in utilisation levels.

Earnings to more than double by FY18 with improved earnings quality: Despite our conservative assumption - Kochi terminal (utilisation of 40% in FY18), freeze in regas tariffs from CY16 for Dahej and reduction in trading gains (Rs20/scm in FY18E from Rs45/scm in FY13), PLNG is on course to double its earnings over FY14-18E. Moreover, with lower trading gains built in the estimates and take-or-pay contracts in place with GAIL/GSPC for the expanded Dahej capacity, we believe the earnings visibility is extremely high.

BUY

PLNG IN | CMP RS 105

TARGET RS 157 (+50%)

Company Data

O/S SHARES (MN) :	750
MARKET CAP (RSBN) :	79
MARKET CAP (USDBN) :	1.2
52 - WK HI/LO (RS) :	156 / 106
LIQUIDITY 3M (USDMN) :	1.6
FACE VALUE (RS) :	10

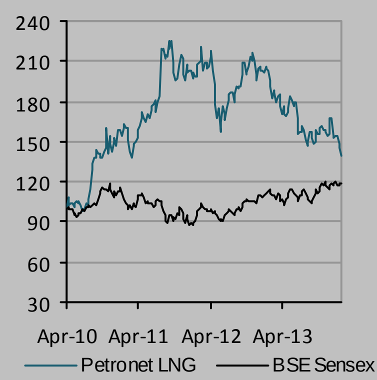
Share Holding Pattern, %

PROMOTERS :	50.0
FII / NRI :	27.0
FI / MF :	6.5
NON PROMOTER CORP. HOLDINGS :	2.4
PUBLIC & OTHERS :	14.1

Price Performance, %

	1mth	3mth	1yr
ABS	-13.6	-14.6	-30.9
REL TO BSE	-10.5	-12.1	-33.4

Price Vs. Sensex (Rebased values)



Source: Phillip Capital India Research

Other Key Ratios

Rs mn	FY14E	FY15E	FY16E
Net Sales	384,540	459,707	501,948
Ebidta	14,881	18,121	21,105
Net Profit	7,071	8,036	10,450
EPS, Rs	9.4	10.7	13.9
PER, X	11.1	9.8	7.5
EV/EBIDTA, x	6.8	5.6	4.5
EV/Net Sales, x	1.6	1.4	1.3
ROE, %	14.3	14.6	16.7
Debt/Equity, %	78.3	78.1	72.0

Source: PhillipCapital India Research Est.

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Investment Arguments

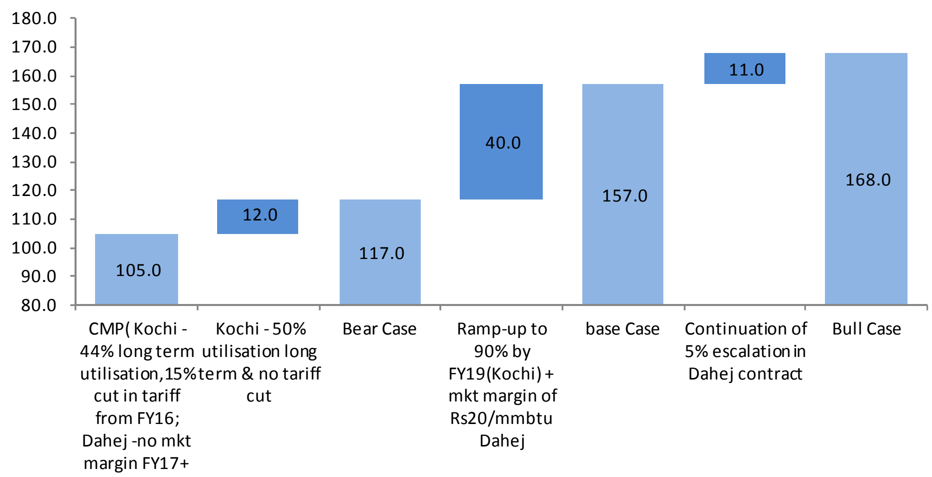
Pessimism overdone

We believe the stock is pricing in the extremely gloomy outlook and even below our bear case valuation. Based on our understanding the current market price is factoring in a perpetual utilisation of 44% capacity utilisation and 15% cut in regasification tariffs for Kochi terminal along with a freeze in regasification tariffs for Dahej post CY16 and no marketing margins beginning FY17. In terms of valuations, there seems to be a limited downside - ~8x P/E (FY16E EPS), 0.7x FY16 EV/Gross capital invested and 0.9x FY16 EV/CE. Thus risk-reward at the current juncture is highly favorable.

Even in our bear case scenario stock offers 11% upside from the CMP, despite building in margin of safety in terms of numbers. We build an extremely slow ramp up at Kochi to 4%/8%/20%/50% in FY14/15/16/17 and assume long term capacity utilization at Kochi terminal at 50% in the bear case scenario. We also factor in zero long term marketing margins at Dahej from FY17 onwards and assume a freeze in regasification tariffs hike at Dahej post CY16. On these assumptions we arrive at a DCF based PT of ~Rs 117 (11% upside from CMP).

In the base case scenario, we assume a gradual ramp up of the Kochi terminal to 90% in FY19 as the new demand centre will emerge post the connectivity with pipeline grid. Ennore LNG terminal feasibility report mentions Tamil Nadu state gas demand potential from industry, CGD and refinery sectors alone at ~13 mmscmd (~3.25MMTPA). Kochi Bangalore pipeline feasibility study points to gas demand of ~12 mmscmd (~3MMTPA). Thus the demand potential is huge at ~ 25 mmscmd. South India, being a new market, will take a longer lead time to scale up volumes, but the business case for gas as a market remains solid and we expect the Kochi terminal capacity utilization to rise to ~90% in the long term. This coupled with normative marketing margin assumption of Rs20/mmbtu (in line with marketing margins earned by PMT consortium on domestic gas marketed) for Dahej spot volumes provides a DCF based target price of Rs157.

Scenario analysis target price



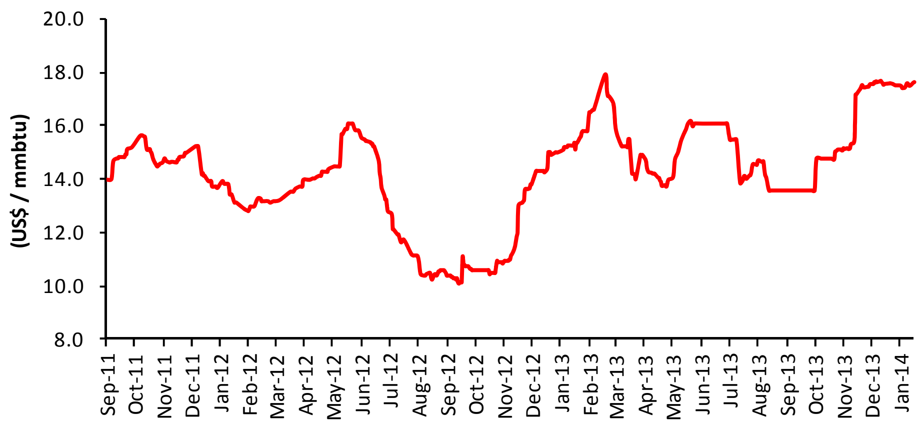
Source: Company, PhillipCapital India Research

PLNG has been increasing its Dahej regasification tariffs as per the terms of contract since CY04 and continues to guide towards a regular annual escalation till end of the contract in CY29. However, due to higher than envisaged terminal IRRs, we build a freeze annual escalation from CY17. However, with significant re-pricing of the RasGas contract already done and increasing customer acceptance for higher gas prices (Spot LNG, APM/KG D6 gas prices doubling from April'14) the probability of freeze on annual escalation is bleak. Consequently, if PLNG is able to continue with annual escalation from CY17, the fair value for the stock rises to Rs168 (60% upside from CMP).

Softer Spot LNG prices post winters to improve fuel economics

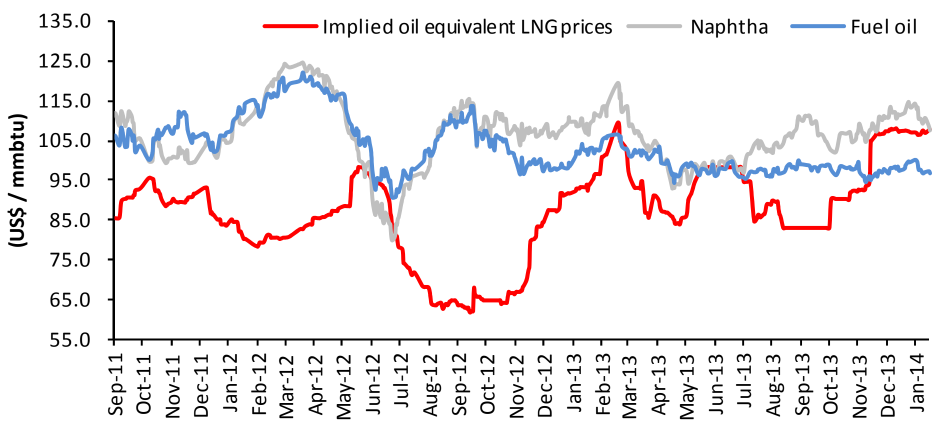
Our analysis of the spot LNG prices since Aug-2011 and PLL's stock price movement reflects that stock has demonstrated a strong inverse co-relation with spot LNG prices. In the current leg of the trend, we have witnessed PLL's stock price correcting ~15% from the mid October 2013 prices, primarily on the back of high spot LNG prices (India destination LNG prices averaging 19% higher in currently from Oct-13 (1FN) prices apart from persistent issues on timely rollout of the southern grid pipelines by GAIL.

India spot LNG prices



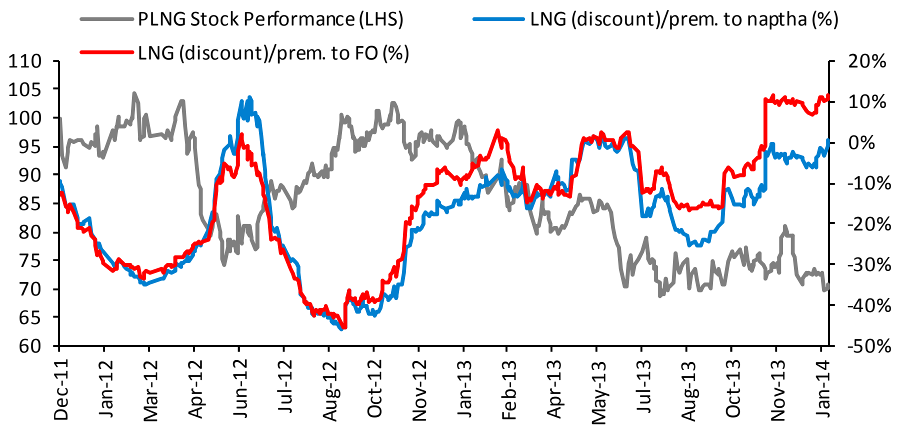
Source: Bloomberg, PhillipCapital India Research

Comparative prices of alternative fuels with LNG



Source: Bloomberg, PhillipCapital India Research

PLNG stock price has inverse correlation to movement in spot LNG prices

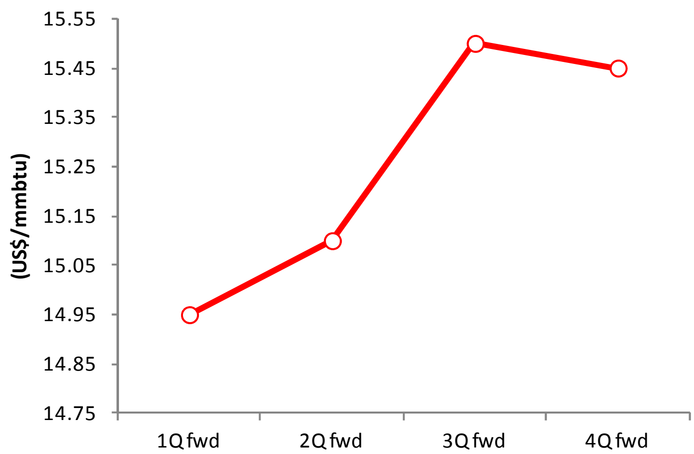


Source: Bloomberg, PhillipCapital India Research

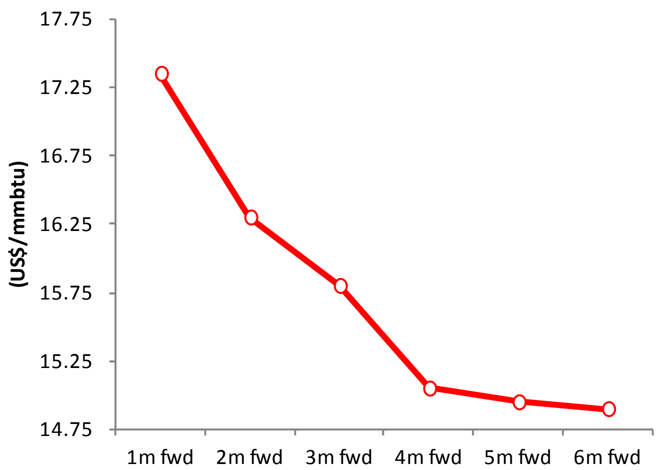
We believe confluence of rising spot LNG prices and weak industrial activity has led to concerns that PLNG could witness squeeze in profitability due to decline in marketing margins as well as lower throughput in Dahej terminal. High spot prices has resulted in LNG's discount to alternative fuels (i.e. furnace oil/ naphtha) reducing considerably (rather LNG has traded at a premium to FO in since Nov'13), compared to an average discount of ~ 17%/19% to FO & naphtha, respectively.

We expect LNG price competitiveness relative to alternative fuel oil prices to improve, going ahead, despite the near-term tightness in LNG demand-supply scenario and correction in crude oil prices. We believe spike in spot LNG prices is mainly on account of strong winter demand from Japan, Korea and China this coupled with maintenance shutdown in Qatar and Angola.

Forward LNG prices Quarterly



Monthly



Source: Bloomberg, PhillipCapital India Research

As marketing margins are volatile, the street doesn't not accord it a value…..thus any decline in earnings led by weak marketing margins is overdone

With our assumption of subdued crude prices, higher LNG supplies, we expect economics of LNG to improve over alternative fuels

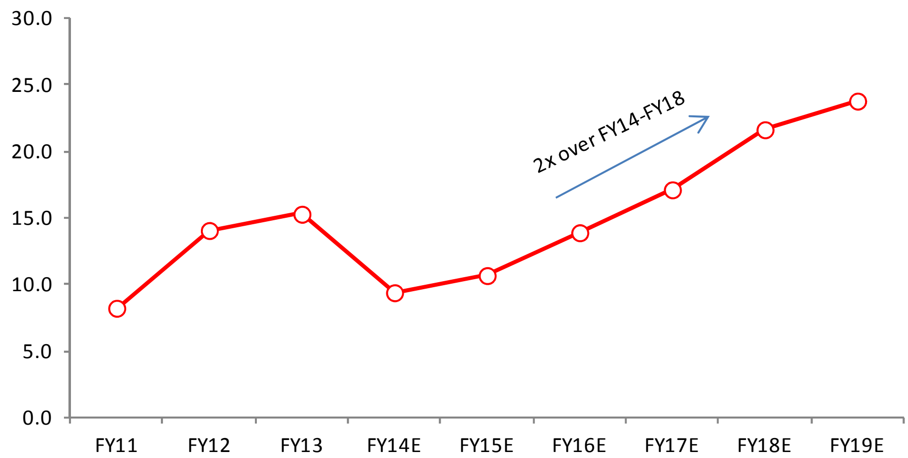
We expect LNG demand to soften from March'14 onwards, this along with resumption of supplies post maintenance schedules from Qatar and Angola should result in decline in spot LNG prices. Forward LNG Swap data points towards easing spot LNG prices, which is likely to put to rest the concerns over likely decline in utilisation levels. <u>Moreover, we believe, market perceives marketing margins as the one-off profits and does not accord a multiple to the same while valuing the stock. Thus, the decline in earnings on account of any perceived weakness in marketing margins should not result in sustainable lower stock price.</u> LNG prices are bound to track the alternative fuel prices, thus, bouts of the premium over the FO is likely to get corrected with demand adjusting based on the relative fuel economics. With our expectation of likely subdued crude oil prices, we expect fuel oil and naphtha prices to track movement in crude. Consequently LNG prices that tend to decline with a lag effect, should improve its economics over alternative fuels.

Earnings to more than double by FY18 with improved earnings quality

Despite our conservative assumption of the slower capacity ramp-up at Kochi terminal (capacity utilisation of 40% in FY18), freeze in regasification tariffs from CY16 and significant reduction in trading gains (Rs22/scm in FY18E from Rs45/scm in FY13), we believe PLNG is on course to double its earnings over FY14-18E. Moreover, with lower trading gains built in the estimates and take-or-pay contracts in place with GAIL/GSPC for the expanded Dahej capacity, we believe the earnings visibility stands to be extremely high.

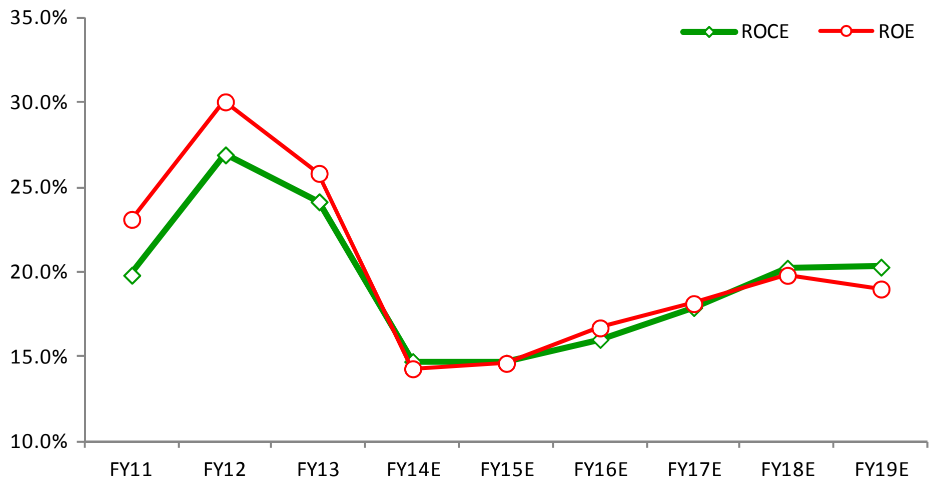
A slower ramp-up of the Kochi terminal during the first 2-3 years of its operation would act as a drag on the FY14-15 earnings on account of the jump in power costs, depreciation and interest charge due to capitalisation of the Kochi terminal. But we expect volumes to strengthen from FY16 onwards and record 18% CAGR over FY16-20 driven by ramp up of the Dahej capacity, stabilization of the Kochi terminal. This would lead to 23% earnings CAGR over FY16-20.

EPS to double over FY14-FY18



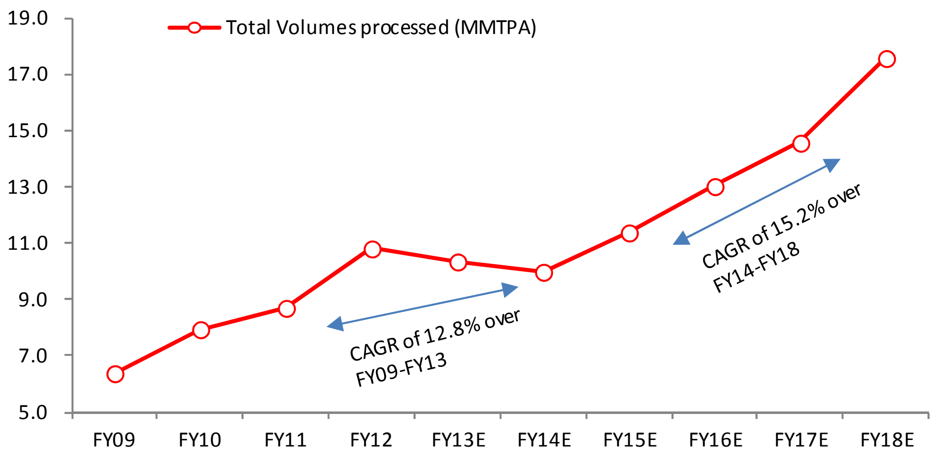
Source: Company, PhillipCapital India Research

Trend of RoE and RoCE



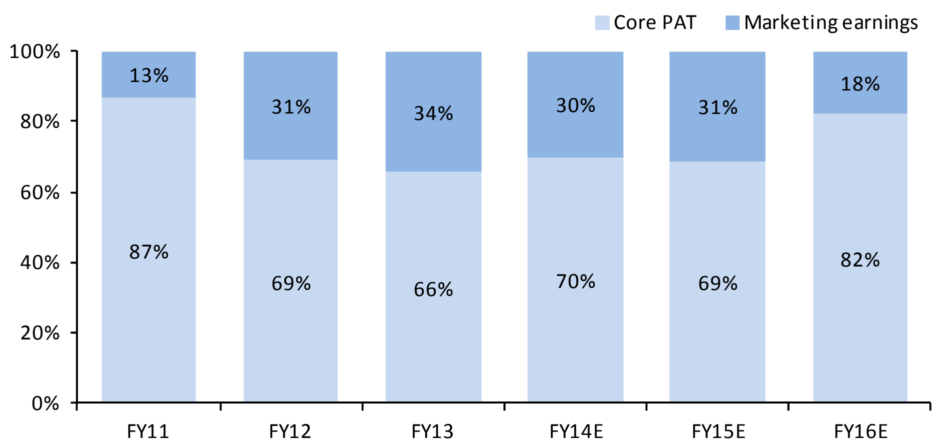
Source: Company, PhillipCapital India Research

Volumes to grow going ahead



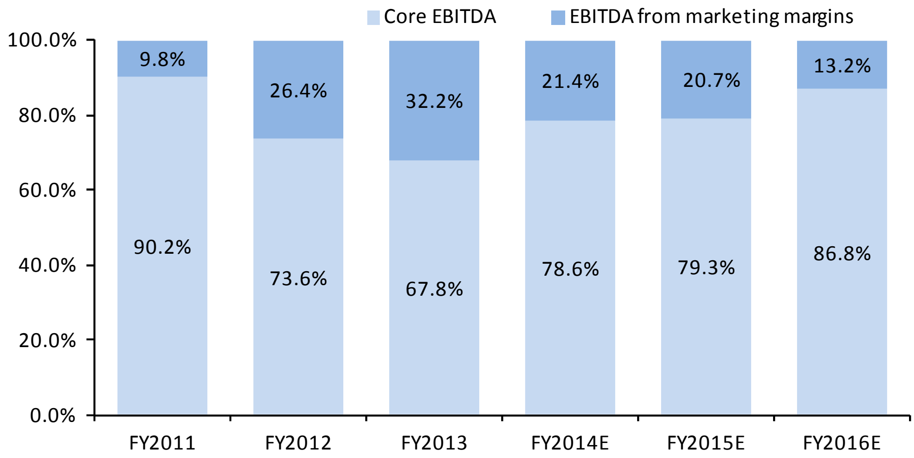
Source: Company, PhillipCapital India Research

Core PAT and marketing margins



Source: Company, PhillipCapital India Research

Core EBITDA and marketing EBITDA



Source: Company, PhillipCapital India Research

Significant first mover advantage

We would not be overly worried about a spate of recent announcements by a number of players to setup LNG terminals. The LNG eco-system is complex, and a number of factors need to fall in place viz. supply linkages, customer readiness to move from alternative fuel, pipeline connectivity etc for the terminal to attract enough volumes to make economic sense. Petronet's advantage stems from its Dahej terminal at extremely low capacity cost (~Rs35bn for 11 MMTPA) coupled with a well developed gas eco system in place. New players would enter at sufficiently higher costs, and would thus need much higher tariffs compared to Petronet, for their projects to be economically viable. Similarly, despite facing challenges at the current juncture, Petronet is the first terminal operating in the southern part of the country. Once the required LNG eco-system develops, PNG will reap the benefits of the same over the proposed terminal of Ennore and Mangalore.

Outlook and Valuation

PLNG's utility nature of business (stable regasification margins and term contracts), low regulatory risks (regasification margins are not currently under PNGRB's purview) and expanding volumes on account of strong demand estimates, hold it in good stead.

Key stock price triggers

Particulars	Expected Time period	Expectation	Impact
Softening of the Spot LNG prices	Feb-March 2014	Positive	Decline in spot LNG prices is likely to boost the volumes throughput.
Timely completion of Dahej Jetty	Q2CY14	Neutral	Dahej Jetty is likely to improve the cargo handling capacity at the port
Clarity on commissioning of the Kochi-Mangalore pipeline	Land acquisition by June-14 , completion by end of FY15	Neutral	Likely to bring connectivity with potential offtake of 1.5MMTPA (MRPL,MCF, KSEB,Kannur power)
Clarity on commissioning of the Kochi-Bangalore pipeline	Supreme court stay on land acquisition leading to delay	Neutral	Clarity over the said pipeline would result in increased confidence towards faster ramp-up of Kochi terminal
New medium/long term contract by LNG marketers	Unknown	Positive	PLNG has entered into a conditional agreement for sourcing 4MMTPA gas for 20 year period. Clarity over the final deal will lead to improved linkages for PLNG, in turn positively impact stock.
Pooling of natural gas in India	Unknown	Neutral	Reallocation of domestic demand lead to higher demand for LNG
New Urea Investment policy	Unknown	Positive	Boosts LNG demand in the country
Reforms for gas based power projects	Unknown	Positive	Boosts LNG demand in the country

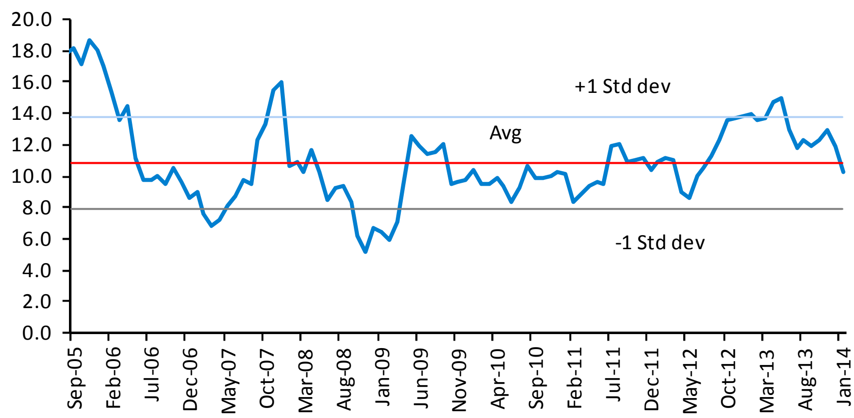
Source: Company, PhillipCapital India Research

Key Assumptions

Y/e March	FY09	FY10	FY11	FY12	FY13E	FY14E	FY15E	FY16E	FY17E
Dahej Installed Capacity (MMTPA)	5.0	10.0	10.0	10.0	10.0	10.0	12.3	12.3	12.3
Dahej volumes processed (TBTU)	325	405	444	551	528	499	561	612	612
Dahej Volumes processed (MMTPA)	6.4	7.9	8.7	10.8	10.3	9.8	11.0	12.0	12.0
Dahej Regasification charges (Rs. per mmbtu)	29.2	30.6	32.2	33.8	35.5	37.2	39.1	41.0	42.6
Marketing charges (Rs per mmbtu)	26.5	(8.0)	34.6	46.7	57.5	52.0	45.0	30.0	20.0
Kochi volumes processed (TBTU)	-	-	-	-	-	10.5	19.6	52.3	130.6
Total Volumes processed (MMTPA)	6.4	7.9	8.7	10.8	10.3	10.0	11.4	13.0	14.6
Regasification charges (Rs. per mmbtu)	-	-	-	-	-	62.5	65.6	65.6	65.6

Source: Company, PhillipCapital India Research

One-year forward rolling PE of PLNG



Source: Company, PhillipCapital India Research

Key risk

- Persistently high spot LNG prices
- Further delays in land acquisition and RoU for southern grid pipelines
- Delay in execution of the capacity expansion at Dahej

Financials

Income Statement

Y/E Mar, Rs mn	FY13	FY14E	FY15E	FY16E
Net sales	**314,674**	**384,540**	**459,707**	**501,948**
Growth, %	39	22	20	9
Total income	314,674	384,540	459,707	501,948
Raw material expenses	-293,050	-365,544	-436,747	-475,411
Employee expenses	-370	-380	-450	-495
Other Operating expenses	-2,819	-3,735	-4,389	-4,937
EBITDA (Core)	**18,436**	**14,881**	**18,121**	**21,105**
Growth, %	0.8	(19.3)	21.8	16.5
Margin, %	5.9	3.9	3.9	4.2
Depreciation	-1,866	-3,108	-4,509	-4,640
EBIT	**16,570**	**11,773**	**13,612**	**16,465**
Growth, %	0.7	(28.9)	15.6	21.0
Margin, %	5.3	3.1	3.0	3.3
Interest paid	-1,184	-1,786	-2,329	-2,317
Other Non-Operating Income	1,817	600	750	1,500
Non-recurring Items	0	0	0	0
Pre-tax profit	**17,203**	**10,587**	**12,033**	**15,648**
Tax provided	-5,710	-3,517	-3,997	-5,198
Profit after tax	**11,493**	**7,071**	**8,036**	**10,450**
Others (Minorities, Associates)	0	0	0	0
Net Profit	**11,493**	**7,071**	**8,036**	**10,450**
Growth, %	8.7	(38.5)	13.7	30.0
Net Profit (adjusted)	**11,493**	**7,071**	**8,036**	**10,450**
Unadj. shares (m)	750	750	750	750
Wtd avg shares (m)	750	750	750	750

Balance Sheet

Y/E Mar, Rs mn	FY13	FY14E	FY15E	FY16E
Cash & bank	12,685	16,545	20,308	29,249
Debtors	16,898	20,647	24,616	26,794
Inventory	10,366	12,666	15,101	16,437
Loans & advances	2,596	2,596	2,596	2,596
Total current assets	42,546	52,454	62,621	75,076
Investments	1,399	1,399	1,399	1,399
Gross fixed assets	35,796	79,937	90,101	90,101
Less: Depreciation	-12,217	-15,325	-19,834	-24,474
Add: Capital WIP	43,305	15,164	17,000	23,400
Net fixed assets	66,884	79,776	87,267	89,027
Total assets	**110,828**	**133,629**	**151,287**	**165,502**
Current liabilities	35,239	41,358	48,966	53,097
Total current liabilities	35,239	41,358	48,966	53,097
Non-current liabilities	31,092	42,883	47,403	49,919
Total liabilities	66,331	84,241	96,368	103,015
Paid-up capital	7,500	7,500	7,500	7,500
Reserves & surplus	36,997	41,888	47,418	54,986
Shareholders' equity	44,497	49,388	54,918	62,486
Total equity & liabilities	**110,828**	**133,629**	**151,287**	**165,502**

Source: Company, PhillipCapital India Research Estimates

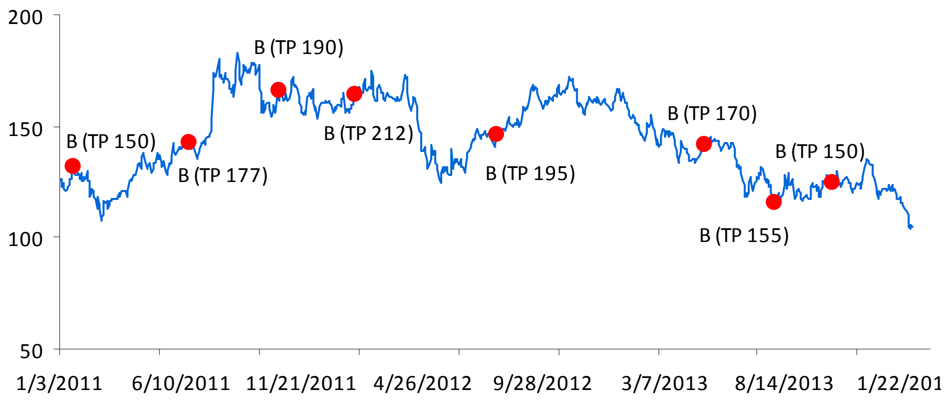
Cash Flow

Y/E Mar, Rs mn	FY13	FY14E	FY15E	FY16E
Pre-tax profit	17,203	10,587	12,033	15,648
Depreciation	1,866	3,108	4,509	4,640
Chg in working capital	5,194	70	1,203	618
Total tax paid	-5,430	-3,236	-3,677	-4,782
Cash flow from operating activities	**18,833**	**10,530**	**14,068**	**16,124**
Capital expenditure	-10,635	-16,000	-12,000	-6,400
Cash flow from investing activities	**-10,635**	**-16,000**	**-12,000**	**-6,400**
Free cash flow	8,197	-5,470	2,068	9,724
Equity raised/(repaid)	9,299	4,891	5,530	7,568
Debt raised/(repaid)	-3,158	11,510	4,200	2,100
Dividend (incl. tax)	-2,179	-2,179	-2,506	-2,882
Cash flow from financing activities	**3,962**	**14,222**	**7,224**	**6,786**
Net chg in cash	12,160	8,751	9,292	16,510

Valuation Ratios

	FY13	FY14E	FY15E	FY16E
Per Share data				
EPS (INR)	15.3	9.4	10.7	13.9
Growth, %	8.7	(38.5)	13.7	30.0
Book NAV/share (INR)	59.3	65.9	73.2	83.3
FDEPS (INR)	15.3	9.4	10.7	13.9
CEPS (INR)	17.8	13.6	16.7	20.1
CFPS (INR)	22.7	13.2	17.8	19.5
DPS (INR)	2.5	2.5	2.9	3.3
Return ratios				
Return on assets (%)	12.1	6.7	6.7	7.5
Return on equity (%)	25.8	14.3	14.6	16.7
Return on capital employed (%)	16.9	9.8	9.8	11.1
Turnover ratios				
Asset turnover (x)	5.3	5.7	5.9	6.2
Sales/Total assets (x)	3.1	3.1	3.2	3.2
Sales/Net FA (x)	5.0	5.2	5.5	5.7
Working capital/Sales (x)	(0.0)	(0.0)	(0.0)	(0.0)
Receivable days	19.6	19.6	19.5	19.5
Working capital days	(6.2)	(5.2)	(5.3)	(5.3)
Liquidity ratios				
Current ratio (x)	1.2	1.3	1.3	1.4
Quick ratio (x)	0.9	1.0	1.0	1.1
Interest cover (x)	14.0	6.6	5.8	7.1
Dividend cover (x)	6.1	3.8	3.7	4.2
Total debt/Equity (%)	61.1	78.3	78.1	72.0
Net debt/Equity (%)	32.6	44.8	41.1	25.2
Valuation				
PER (x)	6.9	11.1	9.8	7.5
PEG (x) - y-o-y growth	0.8	(0.3)	0.7	0.3
Price/Book (x)	1.8	1.6	1.4	1.3
Yield (%)	2.4	2.4	2.7	3.1
EV/Net sales (x)	0.3	0.3	0.2	0.2
EV/EBITDA (x)	5.1	6.8	5.6	4.5
EV/EBIT (x)	5.6	8.6	7.4	5.7

Recommendation History



Source: PhillipCapital India Research

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