JOINDRE CAPITAL SERVICES LTD.

SEBI REGN NO. INH000002061 / INZ000174034

RESEARCH REPORT

17th Dec 2018

MAHANAGAR GAS LIMITED

BSE : MGL | **Sector: NATURAL GAS** | **BSE: 539957**

View - BUY

CMP : Rs. 871

Target Price: Rs 1053 (In next 12 to 18 mths)

BUSINESS BACKGROUND

Mahanagar Gas Ltd (MGL) is one of the India's leading Natural Gas Distribution Companies. MGL is engaged in supplying natural gas in Mumbai and is presently the sole authorized distributor of compressed natural gas (CNG) and piped natural gas (PNG) in Mumbai, its adjoining areas and the Raigarh district in the state of Maharashtra. MGL is a joint venture between GAIL (India) Ltd and the BG Group, (U.K.) - both together held 65% (32.5% each) of equity (before the latest part stake sale by BG group). MGL plans to expand its gas distribution network in its current geographical areas (GA), i.e. Greater Mumbai (GA1) and surrounding regions (GA2) such as Mira-Bhayander, Thane (Urban) -Vashi-Belapur, Kharghar-Panvel-Taloja, Kalyan-Dombivali-Ambernath and Ulhasnagar. Besides Mumbai, Thane, Mira Bhayander and Navi Mumbai, MGL is expanding its distribution reach in new area of Kalyan, Dombivali, Ambernath, Badlapur, Ulhasnagar, Bhiwandi Panvel, Taloja and Kharghar. As at March 31, 2018, MGL had a supply network of over 5000.kms of pipelines and 230 CNG filling stations, MGL also supplies CNG to more than 0.6mn Vehicles

INVESTMENT HIGHLIGHTS

Strong Financial Performance in H1 FY19 –

MGL reported a steady set of FY18 numbers with net sales at Rs 2233. crs as compared to a revenue of Rs 2033.98. crs last year, with EBIDTA placed at Rs 780.10 crs from Rs 644.16 crs last year with the PAT placed at Rs 478.89 crs from Rs 392.76 crs. MGL has declared a dividend of 190% for FY18.

For MGL H1FY19 was also steady with Sales up by 22% at Rs 1439 crs with PAT at Rs 265 crs from Rs 249 crs up by 6% YoY.

MGL enjoys strong parentage – GAIL and Shell (BG) having deep understanding of the gas business –

GAIL and BG Asia Pacific Holdings Pte Ltd are promoters of MGL, holding 32.5% equity stake each in the company. MGL made its OFS in July 2016 to provide partial exit to the promoters (pre-IPO stake was 49.75% each). GAIL is India’s largest natural gas company having a market share of over 80% in natural gas transmission.

Through its subsidiaries and associated companies, BG Asia Pacific Holdings Pte Ltd (BGAPH) is engaged in the business of exploration and production of oil and natural gas, LNG importation and marketing, and transmission and distribution of natural gas.

Both these promoters have deep understanding of Gas markets which will enable MGL to take advantage of emerging opportunities in the CGD space

KEY DATA

FACE VALUE Rs	10.00
DIVD YIELD %	2.18
52 WK HI/LOW	1174/757
NSE CODE	MGL
BSE CODE	MGL
MARKET CAP	RS 8607 CRS

SHAREHOLDING PATTERN

PROMOTERS	-	43%
BANKS, MFs & DIIs	-	24%
FIIs	-	19%
PUBLIC	-	14%

KEY FUNDAMENTALS

YE	FY19	FY20	FY21
Rev Gr%	18	15	15
EBIDTA Gr%	8	11	15
PAT Gr%	11	8	13
EPS Gr%	11	8	13
EPS (Rs)	53.66	58.22	65.81
ROE %	23	22	21
ROCE %	20	19	20
P/E(x)		15	13

MGL's Business Divisions and Services include the following –

Key Business Divisions (1) Domestic PNG, (2) Commercial PNG (3) CNG (4) Industrial PNG (5) Gas Geysers

Domestic PNG –

MGL is leading and pioneer in natural gas distribution network in Mumbai and its adjoining areas. Over 10.37 lacs domestic customers are connected through its wide network

Commercial PNG –

MGL connects customers of commercial PNG across a wide network that includes hospitals, hotels, power, charitable trusts and industries.

CNG –

CNG (Compressed Natural Gas) is a fossil fuel substitute for other auto fuels such as petrol, diesel, Auto LPG etc. For use in Automobiles as fuel, Natural Gas is compressed & dispensed to vehicles at high pressure of 200 bar to enhance the vehicle on board storage capacity.

Industrial PNG –

Industrial PNG is used across the all industry for melting, Heat treatment, smelting, fabrication, Moulding Casting, Baking, Steam generation, and process heating, etc. Boiler, Furnace, Kiln, Oven, Thermo pack, VAM, Natural Gas Fired Gensets are common natural gas appliances used in various industries.

Gas Geysers –

The Instantaneous Water Heaters (i.e. Gas Geysers) is an appliance where the heating of water is directly dependent on the draw off. The appliances shall be manufactured and tested in accordance with all the requirements of IS 15558, or BSEN 26 standards.

Areas of Operation	Mumbai & Greater Mumbai	Mira-Bhayander, Navi Mumbai, Thane City, Kalyan, Taloja, Ambernath, Dombivli, Ulhasnagar, Badlapur, Bhiwandi, Kharghar and Panvel	Raigad District (adjacent to existing area of operation)
Population (mn)	20.7 mn population and 3 mn households [1]		
Infrastructure Exclusivity	2020	2030	2040
MGL Pipeline [2]	4,838 kms		
MGL PNG Connections [2]	~ 0.94 mn		
MGL CNG Stations [2]	203		
MGL CNG Customers [2]	~ 0.54 mn		

Strong infrastructure network, expanding operations to drive growth –

MGL has built a strong infrastructure network in Mumbai and its adjoining areas in 20 years. It is currently the sole authorised distributor of CNG and PNG in Mumbai, its adjoining areas and Raigad district in Maharashtra

MGL has infrastructure exclusivity in Mumbai, its adjoining areas and Raigad district for 25 years, ending in 2020, 2030 and 2040, respectively. The exclusivity period is further extendable for a period of 10 years as per Petroleum and Natural Gas Regulatory Board (PNGRB) regulations, which provides the company an additional advantage.

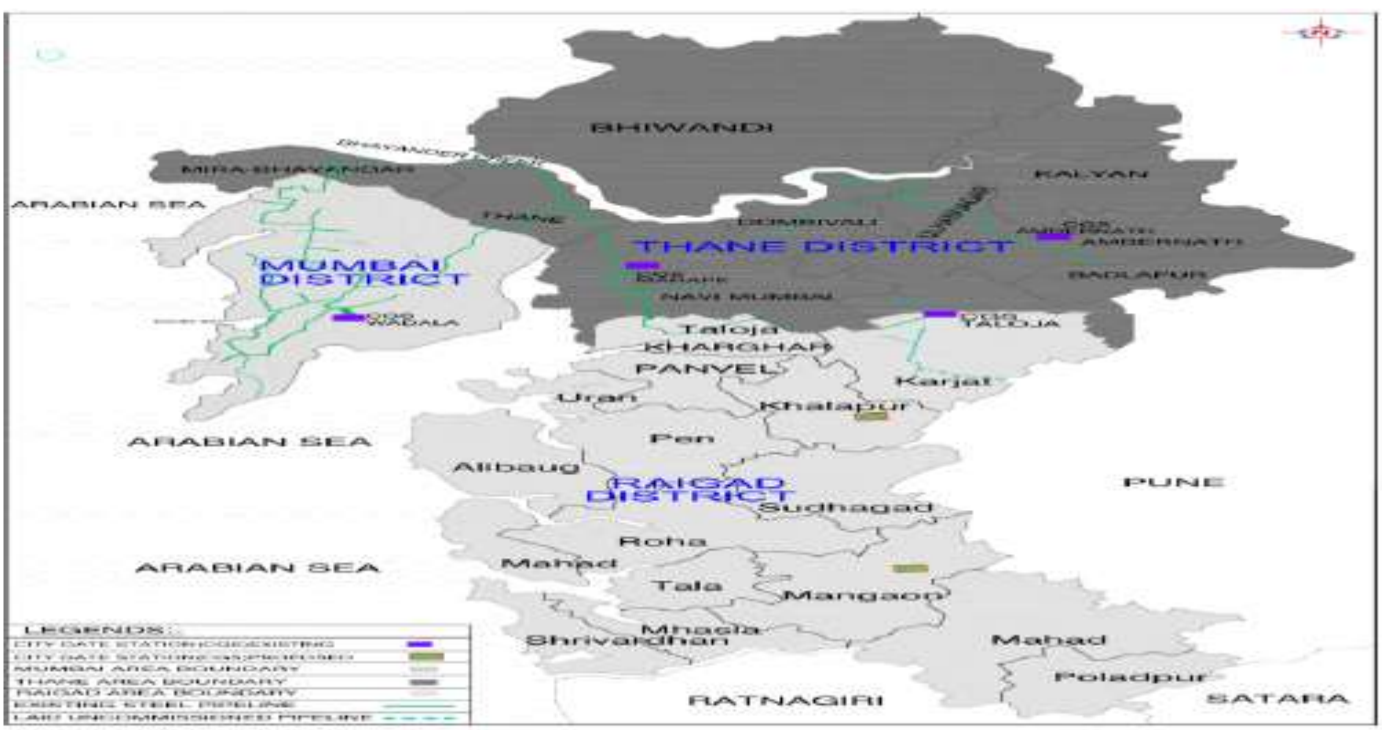
We believe it would be difficult for any new player to operate in MGL's areas of operations, as they would have to pay transportation tariff to MGL on usage of its distribution network, which serves as an entry barrier for competitors. In addition, regulatory approvals, lead-time in allocation of domestic natural gas and need for large investments to establish CGD network would remain a challenge for any new entrants.

While the company is expanding its reach in Mumbai and its adjoining areas, it has also commenced project activities in the Raigad district and proposes to lay, build and develop infrastructure in that area.

MGL plans to add 25-30 CNG stations over the next five years to the existing gas supply infrastructure of 427 km of steel pipeline, 4615 km of polyethylene (PE) pipeline and an exclusive network of 230 CNG stations in FY18.

Majority of MGL's capital expenditure will be allotted to the adjoining areas of Mumbai to further strengthen the infrastructure network in underpenetrated areas. The swift pace of change in these suburban areas has the potential to catapult MGL to a further higher trajectory of growth.

MGL gas pipeline infrastructure –



Favourable sourcing of natural gas provides competitive edge –

The CGD sector has benefited in a significant manner from the government's decision to prioritise allocation of domestic natural gas for CNG, domestic PNG customers. This has enabled MGL to access cheaper gas for CNG and domestic business segments, constituting 86% of total sales volumes.

Also, these segments have lower volatility in volumes and sustainable growth compared to commercial and industrial customers, giving MGL an advantage over competing fuels

As per the Ministry of Petroleum and Natural Gas (MoPNG) guidelines, MGL has access to cost effective domestic natural gas equal to 110% of CNG and domestic PNG requirements, which is classified under the "priority sector" list. MGL currently sources domestic natural gas at US$2.8 per mmbtu (NCV), significantly lower than imported LNG prices.

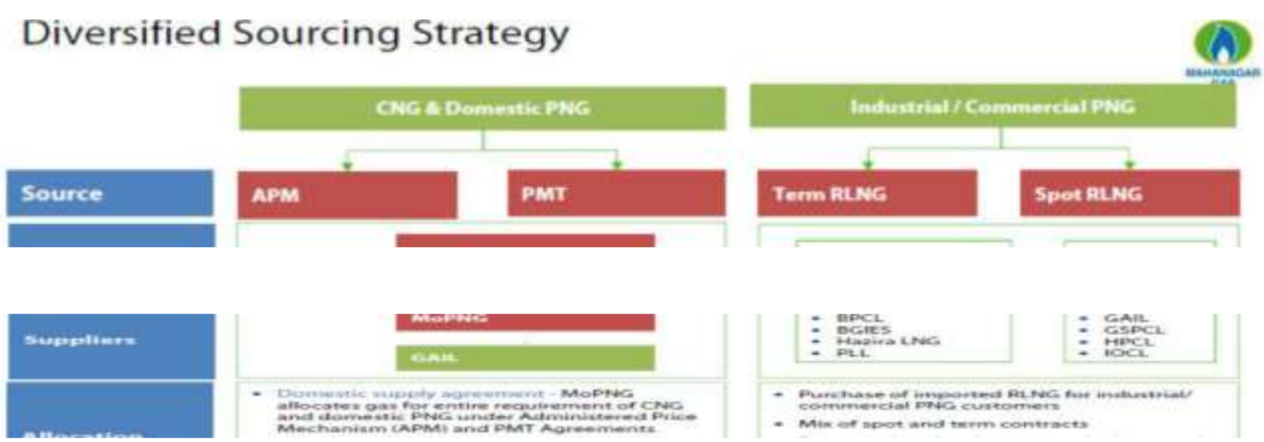
High spreads between CNG and other competing fuels, mainly petrol and diesel, have led to favourable economics in the usage of natural gas as CNG and PNG by price for sensitive customers.

Currently, CNG has a cost advantage of 37.5% and 38.6% over petrol and diesel prices, respectively. In addition, a competitive break-even period for conversion from alternative fuels will enhance the conversion of private volumes to CNG.

With respect to PNG, there is some difference between prices of comparable subsidised LPG cylinders and domestic PNG. However, convenience, safety and hassle-free supply of domestic PNG outweigh the tediousness of LPG cylinders, which will drive the growth of domestic PNG volumes in future.

Also, the cap on maximum subsided LPG cylinders to 12 per annum and nil subsidy for salaried individuals above Rs 12 lakh bode well for domestic PNG growth. Commercial PNG prices are cheaper by 50% than unsubsidised cylinders, leading to economics in favour of PNG usage.

We believe favourable gas sourcing, an apt sales mix and advantage of CNG pricing economics over competing fuels will enhance the conversion of private volumes to CNG as well as help the company to maintain pricing power.



MGL has considerable legroom for growth from both CNG and PNG customers over the next 3-5 years going ahead –

MGL's CNG gas sales volumes have increased at 6.7% CAGR over the last five years and were at 1.98 mmscmd in FY18. The company catered to 609000 customers in CNG segment while in the PNG segment it catered to 1037000 customers in FY18.

The number of CNG vehicles that MGL catered to has grown at 17.6% CAGR in FY11-17. Domestic, commercial and industrial customers have increased at a CAGR of 11.1%, and 17.3%, respectively, over the same period.

In spite of strong growth in CNG vehicles over the last five years, the current penetration of CNG vehicles as a percentage of total vehicles is only 19%, representing a huge opportunity for MGL in conversion of private non-CNG vehicles to CNG.

A total number of 4100 vehicles per month were converted to CNG in FY16. This has further increased to around 6000 cars per month to CNG, as per the management which would drive CNG volumes ahead. We expect the total number of CNG vehicles would increase at 12-13% CAGR over FY18-21E increasing the penetration of CNG vehicles to 22-23% in FY21E.

MGL has also recently commenced trial run of CNG fuelled two wheelers, where two wheelers are retrofitted with 1.2 kg CNG filling capacity giving a mileage of 90 km per kg. The resultant operational cost for running CNG two-wheeler reduces to Rs 0.6 per km against Rs 1.3 per km for petrol fuelled two wheelers. The success of CNG two-wheelers can significantly increase MGL's existing CNG volumes in future.

With respect to the PNG segment, volumes have grown at 7% CAGR in the last five years and were at 0.72 mmscmd in FY18. Domestic PNG segment volumes, which contribute 44% to PNG segment volumes, have grown at 9.2% CAGR in the same period and been the key volume growth driver. However, the industrial and commercial PNG volumes growth rates have remained relatively subdued at 5.3% during the last five years. Over the next two years, PNG segment volumes are expected to increase 6.1% CAGR mainly on account of 7% CAGR in domestic PNG volumes over the same period. Strong addition of 90,000-1,00,000 domestic PNG customers per annum will lead to an increase in domestic PNG volumes.

Industrial and commercial PNG volumes are also expected to increase 5.3% over FY18-21E due to better volume growth in the commercial PNG segment Going forward, we expect increased penetration, expanding geographical reach and a favourable pricing scenario will lead to growth of 6% and 5.5% CAGR in CNG and PNG volumes, respectively, in the next 3 years.

Any regulatory decision to promote clean fuel like natural gas, similar to that of the Delhi government and the latest Supreme Court verdict would provide the company with additional volume stimulus in this space.

Strong parentage to facilitate in capturing growing CGD market opportunities –

MGL has strong promoters, Gail and BG group (now acquired by Shell), which have expertise and rich experience in CGD business operations. Gail and Shell's leadership in natural gas transmission, LNG imports and marketing will provide MGL with a competitive edge in sourcing natural gas, and expansion into existing and new geographical areas.

The government has set an ambitious target to increase the share of natural gas share in India's energy mix from 6.5% to 15% over the next few years. The CGD sector, which contributes 12% of total natural gas consumption, will play a vital role in increasing the consumption of natural gas given the cost economies and ecological benefits.

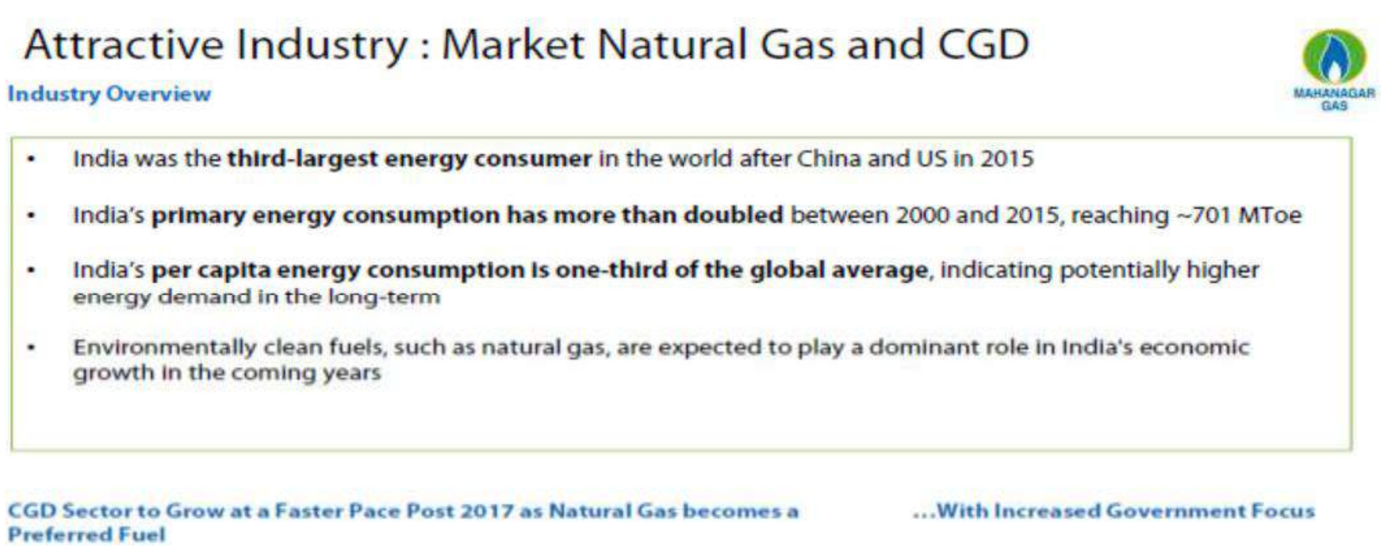
The Petroleum and Natural Gas Regulatory Board (PNGRB) has a rollout plan to bring more than 300 geographical areas (GAs) under the CGD network in a phased manner. Over the last few years, PNGRB has invited bids for 66 GAs providing ample of opportunities for CGD players like MGL with seven GAs in Maharashtra and the rest in other cities of India, providing scope to MGL for growth beyond Mumbai.

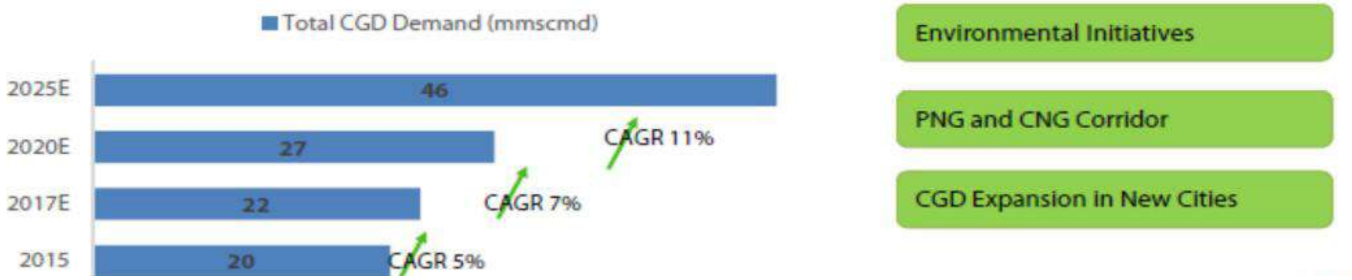
CGD Industry Overview –

The CGD sector comprises of Compressed Natural Gas (CNG) and Piped Natural Gas (PNG) customers, CGD network covers various cities supplying gas for domestic consumers, public transport, and commercial/ industrial entities.

CGD demand is poised for healthy growth over the long term because of;

Favourable economics of CNG usages compared with the alternative fuels,
Convenience in use of PNG (domestic) for households,
Moderate outlook for PNG (industrial) and PNG (commercial) with the likely pick up in manufacturing sector growth,
Government plans to set up approximately 15,000 kilometres of new gas transmission pipelines would also aid expansion of the CGD into newer areas or Tier-2 and Tier-3 cities,





In 2016, new bidding rounds were rolled out by the PNGRB. Bids were invited for the development of CGD networks for five GAs under the seventh round and another eight Gas (Geographical Areas) under the eighth round. While the seventh round was deferred due to issues of uncertain/distant natural gas pipeline connectivity, the eighth round is currently in its bidding phase.

Commercial success of a CGD venture depends upon the consumer mix including number of passenger vehicles, households, commercial and industrial establishments in a particular geographical area (GA), capex required and competitiveness in gas sourcing. The government has set a target to provide PNG connections to 10 million households by 2019.

In total 3.6 million households in the country are connected with PNG. Almost half of these connections are in Gujarat (1.6 million) followed by Maharashtra (1.0 million), New Delhi (0.52 million) and UP (0.27 million).There is thus significant opportunity for CGD operators in the next few years. New gas pricing formula for domestic gas sales (approved in October 2014) has helped to the sector's growth over the years. The price of natural gas would be the volume weighted average of gas prices at Henry Hub (US), Alberta Gas Reference Point (Canada), National Balancing Point (NBP) (UK) and the Russian domestic market. Gas prices will be determined on a half-yearly (April and October) basis and based on trailing four quarter prices at these hubs, with a one quarter lag.

In order to promote CNG (transport) and PNG (domestic) and for a developed CGD sector in the country, Ministry has taken a decision to meet 100% requirement (to the maximum extent possible) of CNG (transport) and PNG (domestic) of all CGD entities across the nation without any discrimination amongst entities.

The Ministry is formulating guidelines relating to grant of rights to entities for sale of CNG as transportation fuel through CNG Stations. The intent of the envisaged guidelines is to promote setting up of several CNG stations in various cities/towns across the country, including along highways, and also to foster competition amongst eligible entities in the CNG segment, analogous to that in liquid transportation fuel (MS, HSD and ATF) segment. This would lead to faster rollout of large number of CNG stations pan india.

Inorganic growth through CGD bidding rounds will help MGL going forward –

Government of India plans to develop CGD infrastructure across India by inviting bids from interested developers. PNGRB has identified 223 areas where they invite bids through multiple CGD bidding rounds.

Also NITI Aayog has planned to expand CGD in 326 cities by 2022, from the existing 87 authorized geographical areas. Participation in further bidding rounds to expand its area of operations could help to expand its presence in new cities, and also help report organic growth, going forward.

PNG-domestic volumes to increase at 12% CAGR over FY17-20 –

MGL's PNG volumes have grown at 7% CAGR during FY11-17, led by domestic PNG volumes, which grew at 9% during the same time. Commercial and industrial PNG volumes grew at 6% and 5%, respectively. Management expect total PNG volumes to grow at 11% CAGR during FY17-22E.

While industrial PNG volumes are expected to grow at just 2% CAGR in existing areas, rest addition growth of Raigad 0.05mmscmd of industrial volumes by FY20 which would take the growth in industrial segment to 10% CAGR during FY17-20.

MGL is in process of expanding the CGD network in new geographical areas –

MGL has lagged by IGL mainly on an account of regulatory factor such as city buses in Delhi are required to run on CNG while there is no such rule in Mumbai. Management expects total volume would grow at 6% CAGR over the FY18-20E as compare to 4% CARG over FY15-18E as government is focusing on clean fuel adoption in metros and adjoining cities

MGL focusing more in GA2 and GA3 (Thane and Raigad) in opening new CNG station which would drive growth forward. Raigad is expected to witness exponential growth, led by upcoming International Airport and Trans-Harbor link. Successfully commenced one CNG station three more in pipeline.

Recent Developments post Q2FY19 conference call –

Round 10 of CGD auction: On 5th November the 10th round of CGD auction covering 124 districts was announced. Due to aggressive bidding by competitors, MGL did not win any GA in the 9th CGD round; it would continue to focus on ROI during the upcoming 10th round.

Infrastructure: Currently MGL has 1.1mn household consumers, above 3,700 industrial & commercial consumers, 220 CNG stations, 0.65mn vehicle demand and 5,130km of pipeline.

Growth: Volume rose 9.5% YoY. Management has given a volume growth guidance of 6–7%. It targets is add at least 20 outlets a year on account of complexity in opening and getting permissions. To date, three have been opened and eight have been upgraded.

Volumes: Sales volumes have grown 4.2% QoQ. Industrial volumes have been 0.237mmscmd and commercial volumes 0.180mmscmd. Q3 volumes may have a slight impact on account of the recent strike by Ola and Uber.

PNGRB tariff revision: There has been a one-time impact of Rs 110 crs on account of the tariff revision by the regulator for the Dahej-Uran pipeline compared to Q1.

Vehicle conversion: There has been a spike in vehicle conversion to CNG YoY to 21,000- plus in Q2FY19 versus 10,000 in Q2FY18.

Raigad: MGL has six stations in Raigad, which sell around 2,000–2,500kg and cater to 700–800 consumers.

Estimated capex Rs 300 crs with 12–15% of maintenance capex

MGL enjoys a strong balance sheet and both Topline and Bottomline growth is likely to remain strong going ahead –

MGL has maintained a strong balance sheet over the years with virtually no debt as on March 2018. The company has also enjoyed healthy operating cashflows. Operating cashflows between FY15-FY18 has grown at a CAGR of 15% where MGL continues to be a debt free and where its growth in revenue and profitability has been consistent over the last few years.

MGL has also reported average RoE of 22-23% during the past 3 years, thus showing strong commitment on delivering shareholders return. Hence going ahead we expect that MGL has the capability to sustain the robust financials performance given its strong order scenario, strong operating margins and strong free cash flow generated.

We expect that going ahead overall bottomline growth in the next 3 years starting FY19 onwards should easily increase at a CAGR of 14-15% and going ahead also we believe that net cash flows generated will remain healthy going ahead.

MGL has been consistently profitable over the last five years and has paid dividends regularly to the equity shareholders. MGL has been a debt free company for more than a decade. It has regularly paid dividends to the Shareholders of the Company with a dividend pay out of Rs 214.13 crs during FY18.

Business Outlook & Stock Valuation –

On a rough cut basis, in FY19, Topline will see a steady rise wherein Topline is expected to touch Rs 2634 crs in FY19E.

On the bottomline level we expect the company to record a PAT of Rs 530 crs in FY19E. Thus on a conservative basis, MGL should record a EPS of Rs 53.66 for FY19E. For FY20E and FY21E our expectation is that earnings traction for MGL would continue to be strong wherein we expect a EPS of Rs 58 and Rs 65 respectively.

The price of domestic gas has come down sharply over the past few years thanks to the formula based pricing mandated by the government. The cost of imported gas used to supply PNG to commercial and industrial customers, has also come down due to weakness in international prices.

With customs duty on liquefied natural gas (LNG) cut from 5% to 2.5% imported gas should get more price-competitive. MGL is also expected to benefit from new taxi scheme which is expected to announced by the government, introduction of 2 wheelers on CNG, addition of new uses by BEST and low natural gas prices

MGL continues to maintain its debt-free balance sheet with robust return ratios, strong free cash flows from operation at around Rs 400cr and healthy return on equity (RoE) of 20%+ for the last 3years, hence is well positioned to capture healthy demand prospects having maintained a healthy dividend Pay out of around 50%

Further, high entry barrier in CGD business due to stringent regulatory requirements and huge capex, make this IPO offering lucrative. Rising concerns over the pollution and banning of high capacity diesel engines in key states would be the demand driver for the consumption of CNG. Thus, we believe that MGL is in a best position to benefit from huge untapped market in Maharashtra and its adjoining areas

The ongoing and upcoming bidding for new CGD areas also presents MGL with a scope to expand its business further. Also, MGL's strong financial position provides it with required flexibility to expand its network in its existing markets and enter new markets

In conclusion we believe that MGL is supported by a competent management team and promoters, and is well positioned to ride the next growth wave in the domestic CGD sector and believe that MGL is well positioned for long term sustainable growth.

Hence we believe that the MGL stock should be purchased at the current price for a price target of around Rs 1053 over the next 18 months.

FINANCIALS

For the Year Ended March RsCrs	FY17A	FY18A	FY19E	FY20E	FY21E
Net Sales	2033.98	2233.00	2634.94	3030.18	3484.71
EBIDTA	644.16	780.1	843.18	939.36	1080.26
EBIDTA %	31.67	34.94	32.00	31.00	31.00
Interest	1.02	0.09	0.30	0.35	0.20
Depreciation	95.13	111.18	120.00	130.00	140.00
Non Operational Other Income	52.65	57.68	57.00	55.00	55.00
Profit Before Tax	600.66	726.51	779.88	864.01	995.06
Profit After Tax	392.76	478.89	530.00	575.00	650.00
Diluted EPS (Rs) FV Rs 10	39.77	48.49	53.66	58.22	65.81
Equity Capital	98.77	98.77	98.77	98.77	98.77
Reserves	1741.25	1998.56	2328.56	2703.56	3218.56
Borrowings	2.70	1.20	1.20	1.20	1.20
GrossBlock	1711.82	1884.67	2184.67	2459.67	2459.67
Investments	465.66	687.68	787.68	887.68	1.57

Source Company our Estimates

KEY CONCERNS

MGL sources majority of its natural gas supply requirements from domestic allocation of natural gas. The CNG and domestic PNG business segments are classified as “priority sectors” by the government (MoPNG) while pricing is calculated as per the New Domestic Natural Gas Pricing Guidelines 2014

Hence, any increase in cost price of natural gas or any reduction in allocation amount of domestic natural gas may have an adverse impact on the company’s volumes and margins, leading to lower profitability.

MGL is the sole operator conducting CGD operations in Mumbai and adjoining areas. However, as per PNGRB’s notice to MGL, its marketing exclusivity period in Mumbai and adjoining areas has ended in 2012 and 2014, respectively. MGL is a party/co-petitioner along with Indraprastha Gas, which has filed a writ petition against the PNGRB notice in the high court. An adverse decision by the high court may impact MGL in the short run. However, given high entry barriers for competitors and lack of additional profit incentives in MGL’s current areas of operations, we believe MGL will be able to maintain market leadership

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DISCLAIMERS AND DISCLOSURES

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