Not the time for bottom fishing

OIL & GAS. Cut in the allocation of natural gas under the APM route calls for a fresh look at the prospects for gas stocks

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Since October 17, India's listed city gas distribution (CGD) companies, specifically Mahanagar Gas (MGL), Indraprastha Gas (IGL), Gujarat Gas (GGL) and Adani Total Gas (ATGL), have shed 52.2 / 61.4 / 23.3 / 20.6 per cent respectively. The cause could be traced back to two identical events — a cut in allocation of natural gas under the administered price mechanism (APM) route to the CGD companies — effected twice in the last two months.

How is APM significant to CGDs and how exactly does the cause and effect play out here? And importantly, if you hold these stocks, what should you do now after the sharp fall?

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THE APM ROUTE

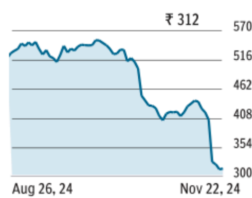
As per directions from the Ministry of Petroleum and Natural Gas, domestically-produced natural gas under the cheaper APM route is allocated to CGD companies (gas retailers) to meet the demand from priority segments – domestic piped natural gas (PNG) and compressed natural gas (CNG). This supply of domestic gas to CGD entities and allocation is implemented by GAIL (India), which operates as the nodal agency of the government.

Effective October 16, this allocation under the APM route was reduced by 20 / 21 / 16 per cent for MGL / IGL / ATGL. This was followed with another round of cut, effective November 16, which further had an impact of 18 / 20 / 13 per cent respectively. On a net basis, allocation has been effectively reduced by 34.4 per cent for MGL, 36.8 per cent forIGL and 26.9 per cent for ATGL, since October 16. Data for GGL is not available.

CAUSE AND EFFECT

The cut in allocation proposed is due to declining production volumes from the legacy oil fields earmarked for APM natural gas. While the allocation crease in demand also pulled its weight from the other side, widening the gap to 35-45 per cent now, between demand from the priority segments and allocation under APM to meet the same.

The drop in volumes sourced through the APM route will have to be filled in by increasing the mix of imported liquefied natural gas (LNG), high pressure high temperature (HPHT) natural gas and/ or new well gas, which are significantly expensive (about 23-85 per cent), in that order. This invariably will increase the input costs and expose the margins to more volat-



HOLD
MGL, IGL

AVOID
GGL, ATGL

WHY
- Allocation under APM route cut sharply
- CGDs to hike prices to preserve margins
- Possible slowdown in capex and expansion

IMPACT ON CGDS

Based on FY24 data, IGL stands the most affected with the sale-volume mix skewed towards priority segments, meaning higher dependence on the APM route for sourcing. Priority segments account for 86 per cent of the total volume sold for IGL, while it is 82 per cent for MGL. CNG accounts for the bulk of demand in the priority segment for both the companies.

The cost-per-mileage economics between CNG and petrol / diesel is relatively higher in Mumbai — key geographical area (GA) of MGL, than in Delhi (due to higher petrol and diesel relatively-better spot amidst this volatility. MGL has already hiked CNG price by ₹2 per kg, effective November 22. When and whether IGL does it needs to be watched.

GGL, largely dependent on industrial volumes, is not in the same field of play as MGL and IGL, and hence, will be less affected by this development, which answers why the correction in GGL was less severe than the above two players.

CNG also accounts for around 66.6 per cent of ATGL's sales volume. But break-up of domestic PNG is not provided by the company. ATGL is diversified into EV charging and biogas.

While the CGDs took the hit on their books and did not pass on the price hike to its customers post the allocation cut in Oc- (as MGL did) to contain the shrinkage in profitability margins.

For comparison, OMCs (oil retailers) have largely operated with a 10-year average net profit margins of 2-4 per cent. The same number for CGDs is in the range of 7-19 per cent, thanks to APM. Basis the current developments, CGDs could see their margins contract in the coming quarters and years.

And while the margins may not drop to that of OMCs, they will have to protect the volumes and hence, cannot pass on the price hikes entirely to the end-users. With India's target to increase the share of natural gas in energy mix to 15 per cent (at around 7 per cent now) by 2030, some pushback could be expected from the government to limit the price hikes, too. As the impact plays out in Q3 and Q4, a clear picture will emerge as to what the new normal in net profit margin might be.

Also, there is a possibility of slowdown in capex and expansion into new GAs, on account of a dip in profitability affecting reinvestment, and sector turning less attractive for newer players to enter and, more so, to thrive.

INVESTOR ACTION PLAN

MGL / IGL / GGL are currently trading at a trailing PE of 8.9 / 11 / 27.8 times, which are at a decent discount of around 49 / 52 / 15 per cent to their 10-year average TTM PE respectively. ATGL, on the other hand, has been trading at a three-digit PE since February 2021, which is hard to justify and incomparable with historical average.

Considering the bulk of the negatives have been priced in, existing investors could consider holding on to MGL and IGL, while not adding fresh positions. ATGL trading at unreasonable valuations, even post the recent correction on corporate governance concerns, could be avoided.

In our *bl.portfolio* edition dated September 15, 2024, we had already recommended that investors book profits in GGL