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India Research – Oil & Gas

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Important disclosure on the last page

Confidence Petroleum India Ltd

(Formerly Devarsa Gas-chem Ltd)

Quick Report

Confidence Petroleum India Ltd is in three related lines of business – bottling of LPG cylinders, manufacturing of gas cylinders, and marketing of LPG. All these business segments are expected to contribute significant growth and profits in FY07 & FY08. Besides, the company is working on a CNG cylinder manufacturing plant and this will be a significant growth driver from FY09 onwards. Revenues & PAT are likely to see exponential growth going forward.

Quick Value Estimate Rs.15 | **Price Rs.4** | **275%**

The stock currently trades at 10.2 times and 2.7 times the estimated fully diluted EPS for FY07 and FY08 respectively. We expect exponential growth in revenues and PAT in FY07, FY08 and beyond. We do a quick estimate of one-year out value at around Rs.15 based on P/E multiple of 10 times FY08E EPS of Rs.1.48. We may follow this later with DCF-based detailed valuation, as more clarity emerges on operations and financials. It may be noted that it's a quick report which is based on our ball park estimates & back of the envelop calculations and not based on detailed financial modelling that we usually do.

Key Data

Enterprise Value	Rs.944mn $21mn
Market Cap	Rs.814mn US$18mn
Shares Outstanding	202.5 mn
52 week High-Low	Rs.4.02 /Re.0.63
BSE Avg Trading Vol	No. of shares
30 Days	386,000
365 Days	97,600
BSE Scrip Code	526829
BSE Group	Z

Shareholding %	**30 Sep 05**
Promoters	74.98
Others	25.02

Multiple Valuation	**YE Mar-08E**
Market Cap/Sales	0.44x
P/E	2.7x
P/BV	1.1x

Products & Services

Bottling of LPG Cylinders	Filling LPG in cylinders from LPG tankers for HPCL, BPCL, IOC, Reliance.
Manufacture of gas Cylinders	Making gas cylinders from rolled steel sheets
Marketing of LPG	Marketing LPG in cylinders to commercial segment and in bulk to bottlers of Reliance in Maharashtra

Key Investment Points

- On consolidated basis, company made Rs.20mn in H1FY07. We estimate H2FY07 PAT at Rs.60mn. We estimate Revenues of Rs.1.8-1.9bn and PAT of Rs.300mn in FY08 contributed equally by three business segments.
- Operational LPG bottling plants are going to rise from 22 to 48 by end of FY07.
- Production of cylinders to see 7-fold jump on the back of Rs.470mn order from BPCL & IOC.
- Recent entry into marketing of LPG to commercial & industrial users to contribute around Rs.100mn to FY08 PAT.
- Promoters' 75% stake (114mn shares) and recently issued warrants (50mn shares) are currently under lock-in for 3 years and 18 months respectively. This implies that 81% of outstanding shares can not be sold & hence can not put downward pressure on stock price till the end of April-08.

Value Kickers

- Company is entering high growth business of CNG Cylinders with a sizeable project, which should contribute to growth from FY09 onwards.

Points of Concern

- The stock trades in Z group. Promoters/Management (Khara group based at Nagpur) does not appear investor-friendly. Information about the company is scanty in public domain. We have extensively sourced information from non-company sources for our research.
- Rise in price of steel sheets may impact margins in cylinder.
- Gas supply through pipelines is a long term risk.

Introduction

Confidence Petroleum India Ltd in Aug-06 merged a group company Confidence Cylinders & Petrochem Pvt Ltd (formerly Sanuj Steels Pvt Ltd) with itself effective Apr-05. The merged company is in three related business segments– bottling of LPG cylinders, manufacturing of gas cylinders, and marketing of LPG. Marketing of LPG is a recent addition to its businesses.

Prior to merger, Confidence Petroleum India Ltd (CPIL) was known as Devarsa Gas-Chem Ltd (DGCL). It had hardly any revenues or profits. It was operating just two LPG bottling plants. DGCL was started in 1993 when government had opened up distribution of domestic LPG for private sector. However, despite repeated assurance by governments, the subsidy on domestic LPG has been neither eliminated nor extended to private sector. This made domestic LPG distribution business unviable for private sector. The company then got into bottling of LPG cylinders (filling cylinders with LPG procured in tankers) for PSU oil companies – HPCL, BPCL and IOC.

The major bottling operations were however in the closely held company Confidence Cylinders & Petrochem Pvt Ltd (CCPPL), which has now been merged with DGCL to form CPIL. CCPPL had 20 bottling plants. It also has a cylinder manufacturing plant and two LPG blending plants near Mumbai in Raigarh district of Maharashtra.

Key Investment Arguments

Exponential growth expected in current year and next 2-3 years

First things first –Let's talk financials. The merged entity, on a consolidated basis, made Revenues of Rs.176mn and PAT of Rs.11mn in FY06. As the approval for merger came in Aug-06, the result for QE Jun-06 was not for merged entity, while that of QE Sep-06 was for the merged entity. In the first half of FY07, the merged company CPIL made PAT of about Rs.20mn. We estimate that it will make a PAT of about Rs.60mn in H2FY07. Thus, CPIL is expected to have a Revenue of Rs.1bn and PAT of Rs.80mn in FY07. For FY08, we estimate Revenues to be around Rs.1.8-1.9bn and PAT of about Rs.300mn. We will introduce FY09 numbers in our detailed research after taking into account economics of CNG cylinder manufacturing operations.

Financials for CPIL, the merged entity

Rs.mn	FY06	H1FY07	H2FY07E	FY07E	FY08E
Revenues	176	NA	NA	1000	180-190
PAT	11	20	60	80	300
Equity Capital (FV Re.1)	152.5	152.5	152.5	202.5*	202.5*
Dil. EPS Rs.	0.07	0.13	0.39	0.40	1.48
P/E		30.7x	5.1x	10.2x	2.7x
Net Debt	130				

* includes 50mn warrants issued in Oct-06.

We estimate that the three business segments (LPG bottling, cylinder manufacturing, and LPG marketing) will contribute approximately equally to FY08E PAT.

The long term growth of the company depends on long term growth in demand for LPG/CNG and speed with which gas pipeline infrastructure is developed in India. As per world LPG Forum, Indian LPG demand is expected to grow at 5% annually till 2008. Long term demand growth for LPG/CNG may continue to grow at this rate beyond 2008, as LPG & CNG, being cleaner fuels, are increasingly replacing other types of fuel. One such example is their use in Automobiles. Use of CNG has been mandated in some areas and for specific kind of vehicles. Even users find it cheaper to use LPG/CNG as auto fuels. At present, most of the demand for CNG cylinders is coming from Retrofitters, who fit LPG/CNG kits in vehicles running on petrol/diesel.

Supply of LPG/CNG through pipeline will take about 8-10 years, in our opinion, to dent the demand growth for gas cylinders. Then, there is replacement demand for cylinders.

Bottling of LPG cylinders – expanding at break-neck speed

Bottling of LPG cylinders involves filling of LPG cylinders with LPG procured in tankers. The company currently provides bottling assistance to BPCL, HPCL, IOC and LPG Infrastructure Pvt Ltd, a Reliance group company.

At present, CPIL has 38 bottling plants. Of these only 22 plans are operational. The company is making efforts to make them operational again. Five new bottling plants are being set up and the company is likely to get approval for setting up five more bottling plants this year. Once all plants are made operational and 10 new plants come on stream, operational plants will go up from 22 to 48. Bottling capacity will more than double. Capital cost of a bottling plant is about Rs.10mn.

AS ONGC and GAIL are also planning an entry into LPG distribution, they too will require bottling assistance. This will lead to additional business opportunity.

CPIL commissioned three bottling plants till Aug-06 this fiscal. It received an order for LPG bottling assistance from HPCL in Himachal Pradesh in Sep06 and is setting up a bottling plant at Baddi in HP for this purpose. It commissioned a bottling plant for HPCL at Uttranchal on 22 Sep 06.

Manufacturing of LPG Cylinders – seven fold jump in production

The company at present can manufacture cylinder in the range of 12 Kgs to 19 Kgs at its plant near Mumbai in Raigarh district. It has capacity to make 4000 cylinders/day. Key input in making LPG cylinders is rolled steel sheets, which it currently procures from Ispat Industries Ltd. Its main clients are PSU Oil companies. It mainly makes 14.2 Kgs (33 litres) domestic LPG cylinders.

The company was till recently making just 600 cylinders a day. In FY08, CPIL is expected to reach 100% capacity utilisation and make about 4000 cylinders/day.

In Sep-06, the company received Rs.470mn order for supply of 14.2 Kg LPG cylinders (532,000 cylinders) from IOC and BPCL. The order is to be executed by Mar-07. This one order itself will ensure 80% capacity utilisation in H2FY07.

Marketing of LPG – a recent business initiative

As marketing/distribution of domestic LPG is not a viable business due to heavy subsidy provided to PSU oil companies, the company has targeted non-subsidised segments – commercial and industrial. Another non-subsidised segment is Auto LPG, which CPIL has yet not explored.

CPIL has two blending plants in Raigarh district. It procures Butane from Reliance and Propane from GAIL and blends them to make LPG at these plants for supply to HPCL, BPCL and its own group company Gaspoint Petroleum India Ltd. However, lately there has not been much activity at these plants.

Instead of blending LPG itself, it is now procuring LPG in bulk from Reliance and selling it in cylinders to commercial users and in bulk to Reliance’s bottlers in Maharashtra.

Only company making decent profit/return in its line of businesses

In 1993, when domestic LPG distribution was opened up, a number of companies entered the business. However, due to large subsidy being extended to PSU LPG distribution companies, the business became unviable for all. Some of them entered related businesses of LPG bottling and cylinder manufacturing. However, none of them seems to be making any significant profits. CPIL is doing much better than all of them. We mention below some of these companies with their business activities and capacities. For all these companies, capacity utilisations are at very low level.

Company	Business	Plant Location	Cylinder Making Capacity/Day
Mauria Udyog Ltd	Cylinder Manufacturing	Faridabad	5000
Sarthak Industries	Cylinder Manufacturing	Pithampur, MP	1800
Expo Gas Ltd	Cylinder Manufacturing	Thane	1000
Rajasthan Cylinders	Cylinder Manufacturing LPG Bottling	Jaipur	400
Eastern Gases Ltd	LPG Bottling	NA	NA
Gagan Gases Ltd	LPG Bottling	Pithampur, MP	NA
OSIAN LPG	LPG Bottling	NA	NA
Shri Shakti LPG Ltd Asia LPG Pvt Ltd	LPG Bottling Cylinder Manufacturing	Andhra Pradesh, Bangalore	NA

Plans an entry into high margin CNG Cylinder manufacturing

Confidence Petro is planning to enter manufacturing of CNG cylinder manufacturing also. We understand that a decision to this effect has been taken and the construction work for the plant is likely to start in Jan-07. It's a high margin business where Everest Kanto Cylinders Ltd already has a presence. With mandatory use of CNG as auto fuel in many parts of the country, demand for CNG cylinders from CNG Distributors, Automobile manufacturers, and Retrofitters has been rising exponentially and is expected to rise significantly going forward.

The estimated project cost is around Rs.400-500mn for a capacity to make 3000 CNG cylinders/day. CNG plant will be a major growth driver after FY08.

The company's total capital employed as at the end of Sep-06 is estimated at Rs.310mn. An investment of Rs.400-500mn in a high value added, high margin business, high growth CNG business will catapult company to a different league altogether.

Further consolidation of group companies will improve valuations

The group has a cylinder manufacturing unit in Andhra Pradesh with a capacity of 2500 cylinders/day and many other small companies in same or similar line of businesses. There is currently no plan to merge these with CPIL. Any move to consolidate further would remove apprehensions of conflict of interest and would improve valuations further.

Compliance with listing regulations will further improve valuations

CPIL currently trades in Z category of BSE for non-compliance with some of the listing regulations. If management takes efforts to comply with these regulations, valuations will improve further.

81% of outstanding shares are under lock-in

Promoters' 75% stake (114mn shares) and recently issued warrants (50mn shares) are currently under lock-in for 3 years (till Aug-09) and 18 months (till Apr-08) respectively. This implies that 81% of outstanding shares can not be sold & hence can not put downward pressure on stock price till the end of April-08.

Risks/Concerns

Rise in Steel prices to impact profitability of cylinder manufacturing operations adversely

As the contracts with PSU oil companies do not include any escalation clause for key raw material, profitability of cylinder making will be adversely impacted in the even of sharp rise in steel prices. The main raw material for making cylinders is rolled steel sheets. Confidence Petro currently procures these sheets from Ispat Industries Ltd.

Management apathy towards minority shareholders

The company trades in Z category of BSE for non-compliance with some of the listing conditions. Not all statutory disclosures are available in public domain. This speaks volume about management's apathy towards minority shareholders.

Group companies in same line of businesses

Some of the group companies operate in same line of business. The major among these is a cylinder manufacturing unit in Andhra Pradesh with capacity of 2500 cylinders/day. We understand that other group companies do not have significant operations.

LPG/CNG supply through pipelines is a long term risk

While demand for cylinders will continue to grow in short term, cylinders will face competition from pipelines going forward. However, we estimate it will take 8-10 years before pipelines can make dent in cylinders growth.

Ownership and Management

The company is owned and managed by Khara Family based at Nagpur. They set up Confidence Cylinders & Petrochem Pvt Ltd in 1999 and acquired Devarsa Gas-chem Ltd in 2003. Promoters held 75% stake in the company at end Sep-06. This holding of about 114mn shares is under lock-in till August-2009 as pre-condition to approval of merger. The stake has been diluted to 56.5% due to issue of 50mn warrants in Oct06. Warrants have been issued to eight/nine individuals and investment companies. These warrants are under lock-in till Apr-08.

Valuation and key underlying assumptions

Everest Kanto Ltd (EKL), which is into manufacturing of CNG cylinders and other high pressure cylinders, currently trades (Rs.473) at a trailing P/E of 21. P/E based on latest quarter annualised earnings is 17 and that based on FY08E is 13.5. We value CPIL at a P/E of 10x FY08E EPS (26% discount to EKL's FY08E P/E) to take into account difference in product mix, (EKL makes only high pressure industrial & CNG cylinders), scale of operations (EKL's QE Sep06 Revenues Rs.1bn), and attitude towards minority shareholders. There is no other comparable listed company.

We may follow this with detailed DCF valuation, as more clarity emerges on its operations and financials. As we have valued CPIL on relative valuation matrix, we should add here that EKL, the benchmark, itself is under-priced. Therefore, as EKL's valuation improves, CPIL's valuation should also improve. Moreover, CPIL is entering CNG cylinders space, acquiring scale at exponential speed, and if it improves its attitude towards minority shareholders, the discount to valuation multiple should narrow.

Important Disclosure

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