EAS Invest o3

o3capital

"When perception differs from reality, an opportunity arises"

Dear Investor,

As investors, we are almost always on the lookout for opportunities to buy strong businesses when there is a negative perception around them. Such opportunities do not come all the time, but when they do, we think it is time to stock up.

More often than not, such opportunities come when there is a negative perception around a company, which, upon careful consideration, we can conclude is driven by more shorter-term considerations than anything else. When the reality is better than the perception surrounding the stock, that is when an opportunity arises.

In this newsletter, let us discuss a current, live example.

We have been holding the stock Indraprastha Gas Ltd (IGL) for a while, and recently, there have been a collection of negative reports around the stock citing the recent spurt in international natural gas prices (which have risen as a result of the Russia-Ukraine conflict) to conclude that the margins of the sector are very likely to be adversely affected, and has therefore advised its clients that the companies in the sector have been downgraded from "Outperform" to "Underperform".

Due to this, the stock price of IGL has come down to Rs.343. The 52-week high of the stock was Rs.591.

It is time to check the facts about IGL.

Fact no.1 – EBITDA margins are not as important in this business as maintenance of spreads.

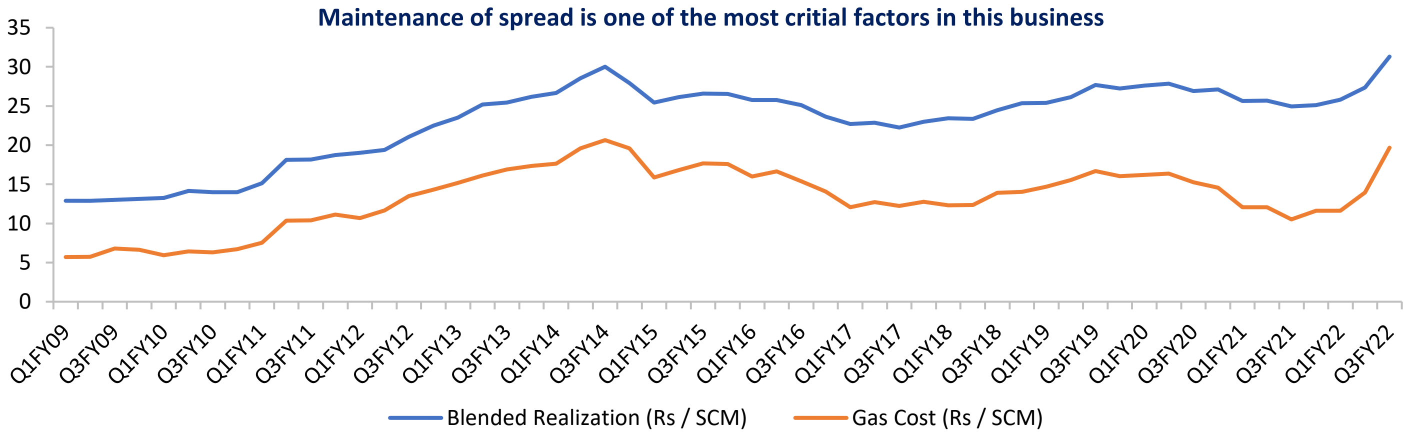
In the business of city gas utilities, the two most important aspects are (a) maintenance of spreads and (b) volume growth.

Spread can be described as the difference between the price realized by the company (per Standard Cubic Metre of gas or SCM) and the acquisition cost of the gas per SCM.

For instance, if the cost of gas is Rs.30 per SCM and the selling price is Rs.37.50, the EBITDA margin would be 20%. And if the cost of gas is Rs.50 per SCM and the selling price is Rs. 58.00, then the EBITDA margin would fall to 13.79%. But the important point is that the spread in the second case would have increased from Rs.7.50 to Rs.8.00 per SCM.

This important aspect has been overlooked by people who are focussing on the EBITDA margin in percentage terms.

13-year history of IGL's cost of gas and realization per SCM



Source: Company press releases

Fact no.2 – IGL has the ability to raise its prices and maintain its spreads.

Let us take the recent case of increase in gas prices as a result of the Russia-Ukraine war. Let us also take a look at the selling price of gas (both Compressed Natural Gas (CNG) and Piped Natural Gas (PNG) in Delhi city – one of their main markets. CNG is used for automotive uses and PNG for cooking and other domestic/commercial/industrial uses.

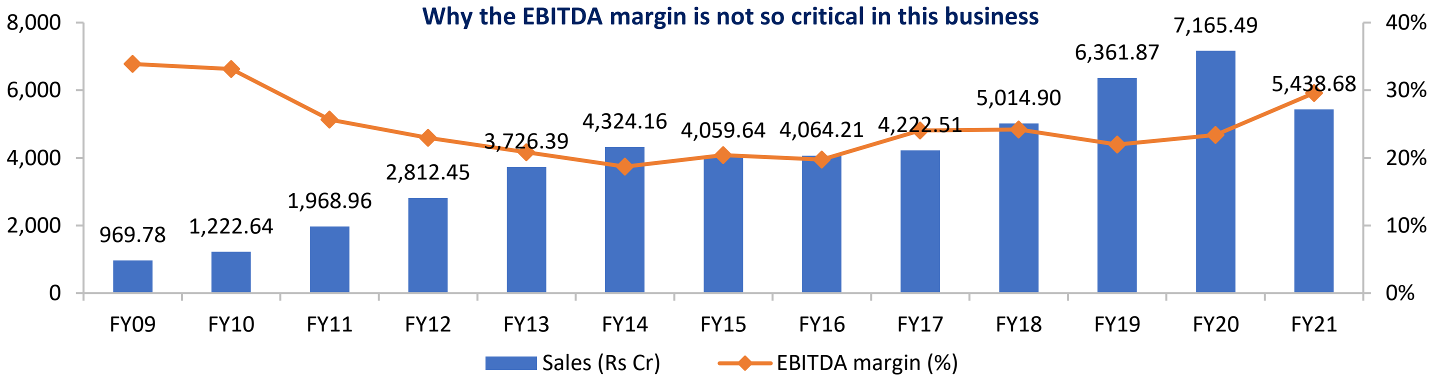
Date	CNG price (Rs per Kg)	PNG price (Rs per SCM)
24.03.2022	59.01	36.61
01.04.2022		41.61
04.04.2022	64.11	
06.04.2022	66.61	
07.04.2022	69.11	
14.04.2022	71.61	45.86

Note: the conversion of KG into SCM in case of CNG is approximately 1.35 times. Therefore, the selling price presently of CNG is Rs.53.04 per SCM. It is standard industry practice to measure gas in KGs for CNG and in SCM for other uses.

The moot point is the selling price of CNG in Delhi is 12.60 rupees more than what it was during the end of the previous financial year. Also, the price of PNG is also Rs.9.25 more per SCM than what it was during the end of the previous financial year. For those who obsess with percentages, the present prices are 21.35% and 25.26% more in the cases of CNG and PNG respectively, compared to what they were at the end of FY 2022.

Fact no.3 – When gas prices rise (and the company raises its selling prices), the EBITDA margin calculation is done on a much higher revenue base.

Indraprastha Gas Ltd – Sales (Rs crore and EBITDA margin (%) history)



Source: ACE Equity

Year	EBITDA margin %	Revenues (Rs cr)	Net profits (Rs cr)	Spread per SCM (Rs)
2009	33.9%	969.78	172.47	4.71
2014	18.7%	4,324.16	360.26	5.65
2021	29.6%	5,438.68	1,046.74	7.63

As can be seen from the table, the company had done much better in 2014 than in 2009, even though its EBITDA margin was much lower in 2014, compared to 2009.

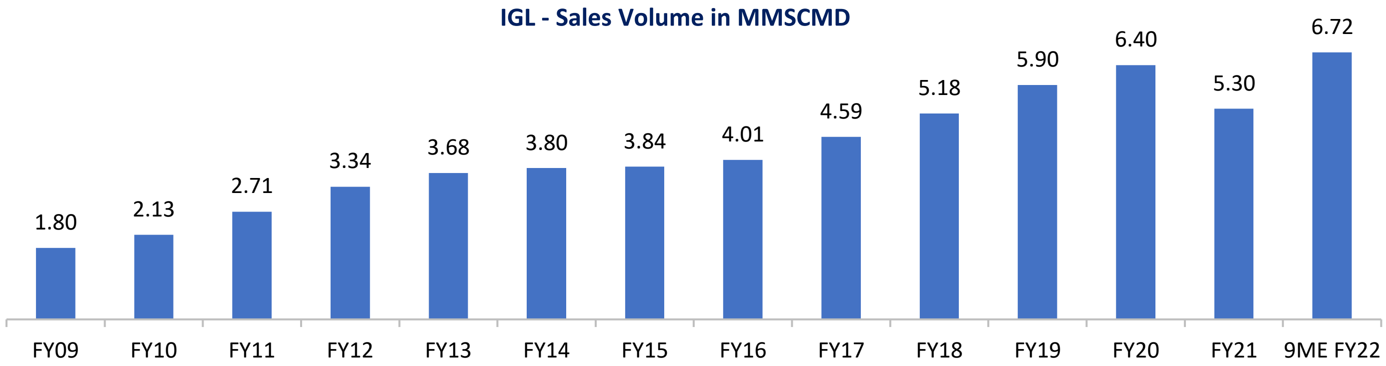
Fact no. 4 – the increased proportion of imported gas (as suggested by recent reports on the company) WILL NOT affect IGL to the extent feared

Some of the recent research reports state that IGL would have to increase its dependence on imported natural gas that is very expensive, and therefore its margins are likely to be further affected in the years forward.

- Presently, IGL gets 70% of its gas requirement domestically, and 30% is imported.
- Eighty percent of the imports are on long-term contracts obtained through GAIL, its parent, where the price fluctuation does not happen to the extent of spot prices. Twenty percent of imports (i.e., 6% of total requirement of gas) is through spot purchases of imported gas.
- The spot price of natural gas has spurted because of the Russia-Ukraine war. But then they had also spiked up in 2009, 2012, 2014 and 2018.
- For the purpose of explaining our position, we have made some very pessimistic assumptions and saw how the company fares under these assumptions.
- First, we assume that IGL procures gas for its entire incremental volume growth only through imported natural gas (for which we have assumed that the gas spot prices would remain at this elevated level perennially), and additionally, we assumed that the price of domestic gas would again double in October 2022 compared to what it is today. In such a scenario, the blended cost of gas for IGL would come to Rs.43 per SCM.
- With the standard conversion of KG to SCM, and assuming that IGL needs to maintain its gross spread only at around Rs.10 per SCM (compared to the Rs.13.79 spread it had in FY 2021), the selling price of CNG needs to be around Rs.74 per kg.
- It is pertinent to note that the selling price of CNG in Delhi is already Rs.71.61 per kg.

Conclusion – even with very pessimistic assumptions about gas costs (both imported and domestic supplies), the company is in a position to maintain its spreads.

The only other factor that one needs to consider is the possibility of volume growth. Let us have a look at the data around that.



Source: Company press releases MMSCMD = million metric standard cubic metres per day

The ONLY year in the last 13 years when the company suffered a negative volume growth was during the year of the pandemic when there were lockdowns in various parts of the country, most notably the National Capital region where this company is the most active. In the first 9 months of this financial year, it is encouraging to see that the volumes have reached record levels of 6.72 MMSCMD. Interestingly in the third quarter ending December 2021, the volumes were 7.66 MMSCMD.

Reasons why one may feel confident about continued volume growth in IGL

- The company originally started operations in Delhi city.
- They then expanded to contiguous areas of Noida, Greater Noida, and Ghaziabad.
- Through a subsidiary, they acquired the geographic regions of Kanpur, Jhansi, Unnao and Bareilly.
- Through a second subsidiary, they acquired the geographic region of Pune.
- IGL has acquired the rights for the geographic region of Gurugram which, we believe, will be as big as Delhi in the not-too-distant future.

Presently the company operates in twenty-seven geographic regions. Recent acquisitions have been, Ajmer, Pali, Rajsamand, Muzaffarnagar, Shamli, Karnal, Fatehpur, Hamirpur, Kaithal, Banda, Chitrakoot and Mahoba.

Gas continues to be cheaper compared to petrol and diesel.

- The cost of operating a CNG vehicle is estimated to be around 40% cheaper compared to a petrol vehicle and more than 20% cheaper compared to a diesel vehicle.
- With the reduction of subsidies in LPG cylinders, there is parity between piped natural gas and LPG cylinders. PNG provides the additional convenience of avoiding the frequent changes of cylinders.
- While we concede that electric vehicles would gain traction in the country, it seems highly unlikely that they would become the dominant variants in the next decade, given the constraints of charging infrastructure, the extent of improvement in battery technologies, and the issues relating to the safety of electric two wheelers. We are confident that CNG vehicles would co-exist with electric vehicles over the next couple of decades at least.

Company financials are stronger than ever.

- IGL has a zero-debt balance sheet.
- The company consistently generates Return on Capital Employed of over 20%.
- The company has generated free cash flow in nine out of the previous 10 years. Free cash flow in FY 2021 was Rs.801 crores. Five years ago, it was Rs.388 crores.

To conclude, dear Investor, the negative perception around Indraprastha Gas (IGL) is clearly worse than reality. The company retains its ability to maintain its spreads, and its volume growth, and these are the two essential ingredients for success in this business.

In our observation, if we stick to a company with strong competitive skills, a strong balance sheet, and when such a company's stock price is depressed because of reasons that are purely temporary and/or when the negative perceptions around the company are clearly outsized compared to reality, which is an opportunity to keep accumulating that stock. That is precisely what we are doing now.

The clouds that surround the stock are driven by temporary factors and need to be ignored by a discerning long-term investor.

With warm regards,

Yours sincerely,

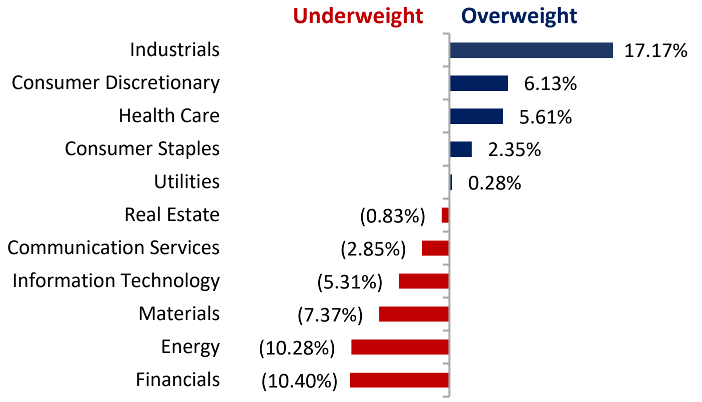
(E A Sundaram)
Chief Investment Officer and Portfolio Manager

"Positive surprises result in major appreciation for out-of-favour stocks, while having minimal impact on favourites. Negative surprises result in major drops in the price of favourites, while having virtually no impact on out-of-favour stocks"

- David Dreman

Top 10 Holding of o3 Core Value Investment Approach - Regular Option as on 29th April 2022		
Name	**GICS Sector**	**Weight**
ITC	Consumer Staples	7.91%
HDFC Ltd	Financials	4.98%
Asian Paints Ltd	Materials	4.67%
Sanofi India	Health Care	4.46%
Cummins India	Industrials	4.33%
HDFC Bank	Financials	4.31%
Blue Dart Express Ltd	Industrials	4.15%
Colgate-Palmolive I Ltd	Consumer Staples	4.10%
Bosch Ltd	Consumer Discretionary	4.02%
Indraprastha Gas Ltd	Utilities	3.98%
		46.91%

Overweight / Underweight of Regular Model Portfolio Compared to Nifty 500 as on 29th April 2022



Investment Objective: The investment objective is to achieves capital appreciation through investment in a diversified portfolio of strong businesses, purchased at reasonable valuation.

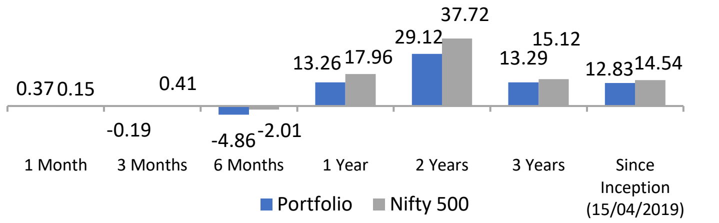
Regular Model Portfolio Details as on 29th April 2022		**Regular Model Portfolio Composition as on 29th April 2022**	
Weighted Average ROCE	20.26%	Large Cap	37.00%
Portfolio PE (1 year forward PE, based on FY24)	22.62	Midcap	41.50%
Portfolio Dividend Yield	1.63%	Small Cap	16.00%
Average Age of companies	62 Years	Cash	5.50%

- Large Cap: Market cap of the 100th company in the Nifty 500 (sorted by market cap in descending order)*
- Midcap: Market cap below 100th company to the market cap of the 250th company in the Nifty 500 (sorted by market cap in descending order)*
- Small Cap: Market cap lower than the 250th company in the Nifty 500 (sorted by market cap in descending order)*

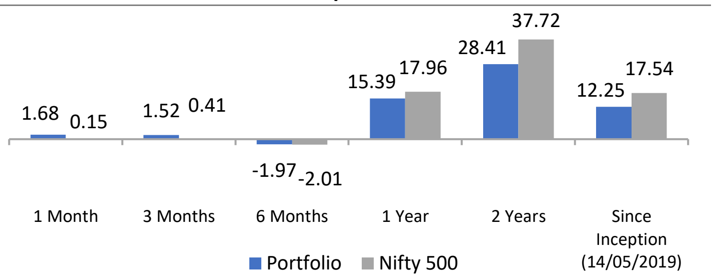
**As on last working day of the month i.e. 29th April 2022*

Regular Model Portfolio Composition as on 29th April 2022			
Model Portfolio Overlap with Nifty 500	23.27%	Model Portfolio Overlap with Nifty 50	27.60%

Consolidated Portfolio Performance of o3 Core Value Investment Approach Concentrated Option 29th April 2022



Consolidated Portfolio Performance of o3 Core Value Investment Approach Regular Option 29th April 2022



- Benchmark is Nifty 500, the portfolio is spread across different market capitalization, hence Nifty 500 is chosen as benchmark
- Since inception date stated is considered to be the date on which the first client investment was made under the investment approach

Disclaimer: Performance depicted is based on all the client portfolios existing as on such date, using Time Weighted Rate of Return (TWRR) of each client and then computing *arithmetic* average for the overall strategy. Past performance is no guarantee of future returns. The above portfolio performance is after charging of expenses. *The performance related information provided here is not verified by SEBI nor has SEBI certified the accuracy or adequacy of the contents of this Document.*

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