

## Reliance Industries

STOCK INFO.	BLOOMBERG
BSE Sensex: 7,798	RIL IN
	REUTERS CODE
S&P CNX: 2,353	RELI.BO

27 October 2005

Buy

Rs751

Previous Recommendation: Buy

Equity Shares (m)	1,396.4
52-Week Range	814/472
1,6,12 Rel. Perf. (%)	3/14/3
M.Cap. (Rs b)	1,049.0
M.Cap. (US\$ b)	23.3

YEAR	NET SALES	PAT	EPS	EPS	P/E	P/BV	ROE	ROCE	EV/	EV/
END	(RS M)	(RS M)	(RS)	GROWTH (%)	(X)	(X)	(%)	(%)	SALES	EBITDA
03/05A	660,510	75,720	54.3	47.0	13.8	2.6	20.2	16.4	1.9	9.5
03/06E	855,789	92,226	66.2	21.8	11.4	2.2	20.7	19.2	1.4	8.0
03/07E	846,610	90,402	64.9	-2.0	11.6	1.9	17.3	17.9	1.5	7.6

Reliance Industries reported a net profit of Rs24.8b for 2QFY06, up 41.6% YoY on the back of strong refining margins and higher crude prices. Profits were ahead of our forecast and well ahead of consensus estimate. EBITDA was up 17.1% YoY at Rs37.1b.

Refining margin for 1QFY06 was US\$10.4/bbl as against US\$8.2/bbl last year, despite LGP / kerosene product price discounts amounting to Rs3b for 1HFY06 and losses on retail sales. Retail sales volume has turned very significant, crossing 1m tons for the quarter. Petrochemical margins were a mixed bag. While cracker margin was down 30% YoY, PE, PP, PVC spreads improved. Polyester integrated margins were largely flat.

EBITDA margin was down 170bps YoY to 17.9% on account of higher crude prices, losses on marketing and discounts on product prices.

We expect near term margins on both refining and petrochemicals to remain strong over both near term as well as next two years. Near term on account of capacity shutdown in the US while medium term strength would be driven by lack of capacity additions in refining and delays in middle-east capacity implementation in the case of petrochemicals.

We reiterate our **Buy** recommendation on the stock, with an SOTP based target price of Rs903, an upside of 20.2%. Growth outlook is robust, while value unlocking through demerger is likely to be the key near-term catalyst for stock performance. The stock trades at 11.6x FY07E EPS.

QUARTERLY PERFORMANCE									(Rs Million)	
Y/E MARCH	FY05				FY06				FY05	FY06E
	1Q	2Q	3Q	4Q	1Q	2Q	3QE	4QE		
<b>Net Sales</b>	<b>142,800</b>	<b>161,640</b>	<b>177,680</b>	<b>178,390</b>	<b>177,840</b>	<b>207,170</b>	<b>231,918</b>	<b>238,862</b>	<b>660,510</b>	<b>855,790</b>
Change (%)	14.2	27.3	42.1	26.4	24.5	28.2	30.5	33.9	27.5	29.6
Inc/Dec in Stock	-7,940	7,060	1,650	4,480	-14,900	-7,990	14,900	7,990	5,250	0
Raw Materials - External Purchases	105,040	106,570	126,870	120,830	135,400	152,280	153,488	165,000	459,310	606,168
Staff Cost	1,780	1,850	2,140	2,690	2,530	2,590	2,300	2,394	8,460	9,814
Other Expenditure	15,870	14,460	14,120	14,930	19,150	23,170	24,500	27,000	59,380	93,820
<b>EBITDA</b>	<b>28,050</b>	<b>31,700</b>	<b>32,900</b>	<b>35,460</b>	<b>35,660</b>	<b>37,120</b>	<b>36,730</b>	<b>36,478</b>	<b>128,110</b>	<b>145,988</b>
% of Net Sales	19.6	19.6	18.5	19.9	20.1	17.9	15.8	15.3	19.4	17.1
% Change	22.6	28.8	27.1	34.0	27.1	17.1	11.6	2.9	28.3	14.0
Depreciation	9,160	9,140	9,120	9,810	7,910	8,040	8,300	8,503	37,230	32,753
Interest	4,680	4,340	2,050	3,620	2,370	2,220	3,300	3,390	14,690	11,280
Other Income	3,470	2,960	3,310	4,760	1,940	2,220	1,650	2,030	14,500	7,840
<b>PBT</b>	<b>17,680</b>	<b>21,180</b>	<b>25,040</b>	<b>26,790</b>	<b>27,320</b>	<b>29,080</b>	<b>26,780</b>	<b>26,614</b>	<b>90,690</b>	<b>109,794</b>
Tax	3,310	3,660	4,130	3,870	4,220	4,270	4,570	4,507	14,970	17,567
Rate (%)	18.7	17.3	16.5	14.4	15.4	14.7	17.1	16.9	16.5	16.0
<b>PAT (before pref dividend)</b>	<b>14,370</b>	<b>17,520</b>	<b>20,910</b>	<b>22,920</b>	<b>23,100</b>	<b>24,810</b>	<b>22,210</b>	<b>22,107</b>	<b>75,720</b>	<b>92,227</b>
Change (%)	30.2	38.7	52.2	61.5	60.8	41.6	6.2	-3.5	46.7	21.8

E: MOSTiEstimates

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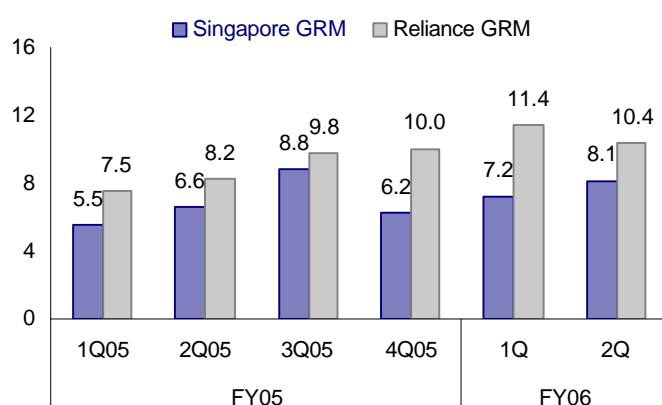
### It is the refining business again

Refining margin for 1QFY06 was US\$10.4/bbl as against US\$8.2/bbl last year. Margins for the quarter were US\$2.3/bbl higher than benchmark Singapore GRM of US\$8.1/bbl for the quarter. Margins would have been much higher, but the for higher marketing losses and Rs3b LPG / kerosene price discount.

Reliance's losses on marketing would have turned significant during the quarter, on account of a sharp increase in the retail thruput. Reliance has crossed the 1m ton mark during the quarter compared to just 0.1 m tons last year.

Reliance has paid Rs3b in the form of discount on LPG / kerosene post finalisation of discount structure with the oil marketing companies. The discount provided is for 1HFY06. Extrapolating this, full year discount is likely to be about Rs5.3b. To put this in perspective, last year Reliance had provided a discount of Rs4b on diesel sales.

REFINING MARGINS (US\$/BBL)



Source: Company, Motilal Oswal Securities

While we expect the strong refining margin trend to continue, discount on product prices is likely to pull down the reported GRM. Marketing losses are more likely to fall from current levels, which would help Reliance to report higher differential over Singapore margins, as was the case in 1QFY06. Reliance reported US\$4.2/bbl premium over Singapore margins, though a repeat appears unlikely.

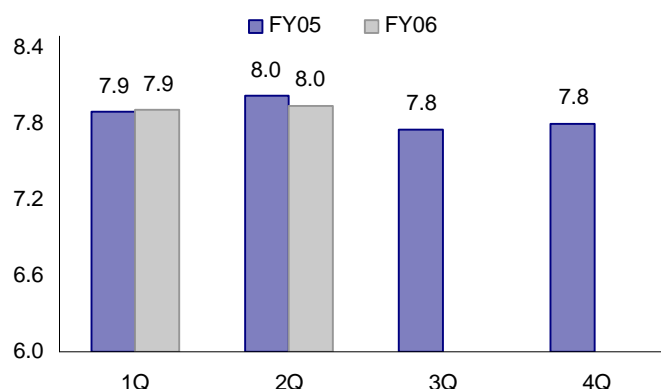
### Petrochemicals was a mixed bag

Petrochemical margins were a mixed bag. While cracker margin was down 30% YoY, PE, PP, PVC spreads improved. Polyester integrated margins were largely flat. However, potential delay in commissioning of large new capacities in China and Iran could mean a longer-than-expected upcycle, providing scope for earnings upside in FY07 and FY08. Reliance confirmed this view.

### Production volumes hit a plateau

Production volumes appear to have hit a plateau. Crude throughput at 7.95m ton was down marginally, while petrochemical volumes at 3.36m ton were up 6%, largely on account of commissioning of new 140ktpa Butadiene plant. Crude thruput in 2HFY06 would be affected on account of the partial maintenance shutdown of refinery, currently in progress. On the other hand petrochemical production is likely to grow on the back of commissioning of the expanded capacity of PP and polyester.

REFINING THROUGHPUT (M TON)



Source: Company, Motilal Oswal Securities

### Contribution from PMT up

Contribution from PMT is up significantly thanks to increasing oil and gas production as well as pricing. Oil and gas production are up 16% YoY and 13% YoY. Price realisation for oil was up at US\$59/bbl, while gas prices were increased by 24% last quarter to US\$3.86/mmbtu.

### Lower interest and tax too contribute

Interest was down sharply by 49% YoY on account of lower debt outstanding (at about Rs168b) and forex gains of Rs1.3b. Management reports a lower effective interest rate of 6.9%, with forex loans at 59% of total loan portfolio. Lower tax rate too contributed to the profit growth. Tax rate was lower at 14.7% compared to 17.3% last year and 15.4% last quarter.

### EBITDA margins down

EBITDA margin was down 170bps YoY to 17.9%. However, in a rising crude and product pricing environment, this is inevitable, despite YoY growth in EBITDA. Losses on marketing and discounts on product prices further added to the decline in the current quarter.

### Revaluation of assets

Reliance has revalued its assets to raise the book value of assets in line with international valuations. Asset value has been raised by Rs225b with effect from 1<sup>st</sup> August 2005.

### Growth drivers and outlook

#### PMT production to increase in FY07

Panna-Mukta-Tapti (PMT) fields, where Reliance holds a 30% stake, have become a significant earnings growth driver, despite their small size. Oil production is set to rise to ~2m tpa, while gas production is set to rise to 6,700m scm pa in 2HFY06 on account of redevelopment.

**Capacity expansions to drive petrochemical volume growth:** Significant capacity expansions are scheduled for

implementation over the next three years, driving petrochemical volume growth.

FY06 – PP: 280ktpa, POY: 330ktpa, PSF: 220ktpa (140ktpa of Butadiene already implemented)

FY07 – PX: 310ktpa and PTA 532ktpa

FY08 – PS: 750ktpa

**Retail outlet rollout progress satisfactory:** Retail outlet network rollout is another key driver of earnings growth over the next three years. In the current phase, 1,500 outlets are scheduled for commissioning over the next 4 three quarters. Reliance has already commissioned 850 outlets. Reliance has already achieved a market share of about 7.7%. We expect Reliance's sale through own outlet to reach about 2.5m ton once its interim target of 1,500 outlets are met. The management indicated that they would aim to achieve a market share proportionate to their refining capacity, which is ~27% or 13m ton of product sale through own outlets.

**KG basin scheduled to produce gas in 2008:** On the gas business front, spudding of development wells has commissioned, while 100% RoU for East – West pipeline has been obtained. The project cost would be US\$2.5b for development of the field and another US\$1.6b for pipeline.

### Refinery capacity expansion

Reliance has obtained environmental clearance and has finalized its technology licensors for its expansion plan raising refinery capacity to 60m tons by FY09.

### Valuation and view

We reiterate our **Buy** recommendation on the stock, with an SOTP based target price of Rs903, an upside of 20.2% from current levels. We believe refining as well as petrochemical fundamentals continue to remain robust, while value unlocking from de-merger of investments is likely to be the near term catalyst for the stock performance. The stock trades at 11.6x FY07E EPS.

## Reliance Industries: an investment profile

### Company description

A Fortune-500 company, Reliance Industries is the largest petrochemicals company and the second largest refiner in India. The group also has interests in power, telecom, biotechnology, insurance, finance and infrastructure. Reliance holds 46% in IPCL, the second largest petrochemicals company in India.

### Key investment arguments

- RIL has announced doubling of refining capacity at Jamnagar to 60 mn tpa at an investment of about Rs.25,000 crore. This will drive earnings going forward.
- Reliance is in a sweet spot riding the petrochemical and refining margin upcycle as well as strong crude price trend.

### Key investment risks

- Continuation of the freeze on price realizations for petroleum products for longer periods
- Adverse exchange rate changes and tariff structure may affect earnings going forward

### Recent developments

- With the announcement of the settlement between Ambani brothers, the company has announced a demerger scheme for Reliance Infocomm, Reliance Energy and Reliance Capital.
- Reliance has struck additional gas at the CBM blocks in Madhya Pradesh of 3.75 TCF
- Has commissioned 850 retail outlets as of date.

### Valuation and view

- Significant earnings growth of 21.8% in FY06.
- Valuations at 11.6x FY07E earnings and 1.9x FY07E book value are at a discount to market valuations.
- Buy** with an SOTP-based target price of Rs903.

### Sector view

- Refining fundamentals remain strong and upcycle expected to continue at least over the next 18 months.
- On the petrochemical front, we continue to assume FY07 would experience a sharp decline in petrochemical margins, though the chances of a delay in downturn is increasing.

#### COMPARATIVE VALUATIONS

		RELIANCE	IPCL
P/E (x)	FY06E	11.4	6.5
	FY07E	11.6	6.0
P/BV (x)	FY06E	2.2	1.5
	FY07E	1.9	1.2
EV/Sales (x)	FY06E	1.4	0.6
	FY07E	1.5	0.5
EV/EBITDA (x)	FY06E	8.0	3.3
	FY07E	7.6	2.5

#### SHAREHOLDING PATTERN (%)

	SEP.05	JUN.05	SEP.04
Promoters	46.8	46.8	46.7
Domestic Institutions	7.6	7.6	8.8
FII's/FDIs	30.1	31.8	29.9
Others	15.6	13.9	14.7

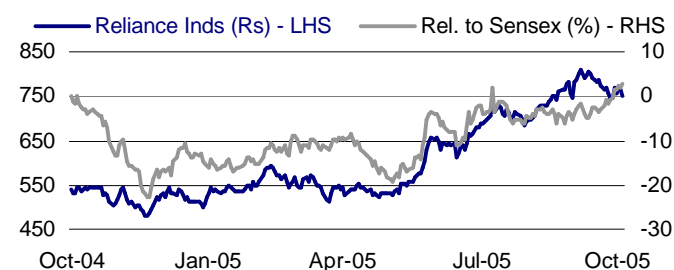
#### EPS: INQUIRE FORECAST VS CONSENSUS (RS)

	INQUIRE FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY06	66.2	62.4	6.2
FY07	64.9	65.7	-1.2

#### TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
751	903	20.2	Buy

#### STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT (Rs Million)					
Y/E MARCH	2003	2004	2005	2006E	2007E
<b>Net Sales</b>	<b>458,978</b>	<b>518,020</b>	<b>660,510</b>	<b>855,789</b>	<b>846,610</b>
Change (%)	9.0	2.9	27.5	29.6	-11
Finished Gds Purchase	34,208	22,183	24,401	24,401	24,401
Raw Materials Cons	308,569	347,210	434,909	581,767	561,650
Sales and distribution exp	17,278	22,622	21,449	22,405	25,301
Employee Costs	6,517	6,660	8,460	9,814	10,501
Other Expenditure	32,935	13,455	37,941	71,416	78,587
Change in Stocks	-22,419	6,050	5,240	0	0
<b>EBITDA</b>	<b>81,891</b>	<b>99,840</b>	<b>128,110</b>	<b>145,987</b>	<b>146,173</b>
% of Net Sales	17.8	19.3	19.4	17.1	17.3
Depreciation	28,371	32,470	37,230	32,753	35,936
Interest	15,552	14,350	14,690	11,280	10,251
Other Income	11,774	11,380	14,500	7,840	7,636
<b>PBT</b>	<b>49,743</b>	<b>63,010</b>	<b>90,690</b>	<b>109,793</b>	<b>107,621</b>
Tax	8,699	11,410	14,970	17,567	17,219
Rate (%)	17.5	18.1	16.5	16.0	16.0
PAT	41,044	51,600	75,720	92,226	90,402
<b>Adjusted PAT</b>	<b>41,044</b>	<b>52,990</b>	<b>75,720</b>	<b>92,226</b>	<b>90,402</b>
Change (%)	26.6	29.1	42.9	21.8	-2.0

BALANCE SHEET (Rs Million)					
Y/E MARCH	2003	2004	2005E	2006E	2007E
Share Capital	13,959	13,959	13,930	13,930	13,930
Reserves	286,118	329,489	393,451	471,568	547,860
<b>Net Worth</b>	<b>300,077</b>	<b>343,448</b>	<b>407,381</b>	<b>485,498</b>	<b>561,790</b>
Long Term Loans	197,600	197,039	188,984	188,815	110,317
Deferred Tax	26,848	34,748	42,668	52,001	61,148
<b>Capital Employed</b>	<b>524,525</b>	<b>575,235</b>	<b>639,033</b>	<b>726,313</b>	<b>733,255</b>
Gross Fixed Assets	478,173	499,453	548,734	575,014	623,015
Less: Depreciation	160,432	192,902	230,132	262,885	298,822
<b>Net Fixed Assets</b>	<b>317,741</b>	<b>306,551</b>	<b>318,602</b>	<b>312,129</b>	<b>324,193</b>
Capital WIP	19,944	41,344	66,944	104,744	120,824
Investments	131,138	171,143	171,143	171,143	171,143
<b>Curr. Assets, L &amp; Adv.</b>					
Inventory	75,104	72,456	92,574	118,635	115,673
Debtors	29,755	32,361	40,864	52,379	51,996
Cash & Bank Balance	13,602	2,733	23,160	69,036	48,249
Loans & Adv. and Other As:	46,906	47,165	47,995	48,843	49,707
<b>Current Liab. &amp; Prov.</b>					
Liabilities	94,909	83,303	103,428	129,319	127,136
Provisions	14,757	15,215	18,821	21,278	21,394
<b>Net Current Assets</b>	<b>55,702</b>	<b>56,197</b>	<b>82,345</b>	<b>138,297</b>	<b>117,095</b>
<b>Application of Funds</b>	<b>524,525</b>	<b>575,235</b>	<b>639,033</b>	<b>726,313</b>	<b>733,255</b>

E: MOST Estimates

RATIOS					
Y/E MARCH	2003	2004	2005E	2006E	2007E
<b>Basic (Rs)</b>					
<b>EPS</b>	<b>29.2</b>	<b>37.0</b>	<b>54.3</b>	<b>66.2</b>	<b>64.9</b>
Cash EPS	49.6	60.2	81.1	89.7	90.7
Book Value	214.9	246.0	292.3	348.4	403.1
DPS	5.0	5.3	7.5	9.0	9.0
Payout (incl. Div. Tax.)	17.1	14.2	13.8	13.6	13.9
<b>Valuation (x)</b>					
P/E		20.3	13.8	11.4	11.6
Cash P/E		12.5	9.3	8.4	8.3
EV / EBITDA		12.6	9.5	8.0	7.6
EV / Sales		2.4	1.9	1.4	1.4
Price / Book Value		3.1	2.6	2.2	1.9
Dividend Yield (%)		0.7	1.0	1.2	1.2
<b>Profitability Ratios (%)</b>					
RoE	14.2	16.0	20.2	20.7	17.3
RoCE	11.6	12.9	16.4	19.2	17.9
<b>Turnover Ratios</b>					
Debtors (No. of Days)	23	22	20	20	22
Fixed Asset Turnover (x)	14	15	18	2.1	2.0
<b>Leverage Ratio</b>					
Net Debt / Equity (x)	0.6	0.6	0.4	0.2	0.1

CASH FLOW STATEMENT (Rs Million)					
Y/E MARCH	2003	2004	2005E	2006E	2007E
OP/(Loss) before Tax	81,891	98,448	128,110	145,987	146,173
Interest Paid	-15,552	-14,347	-14,690	-11,280	-10,251
Direct Taxes Paid	-2,459	-3,510	-7,050	-8,234	-8,072
(Inc)/Dec in Wkg. Capital	-1,783	-10,571	-5,606	5,646	4,601
<b>CF from Op. Activity</b>	<b>62,097</b>	<b>70,020</b>	<b>100,764</b>	<b>132,118</b>	<b>132,452</b>
(Inc)/Dec in FA & CWIP	-38,590	-42,681	-74,881	-64,081	-64,081
(Pur)/Sale of Investments	-45,277	-40,005	0	0	0
Inc from Invst	11,774	11,381	14,500	7,840	7,636
<b>CF from Inv. Activity</b>	<b>-72,093</b>	<b>-71,305</b>	<b>-60,381</b>	<b>-56,241</b>	<b>-56,445</b>
Issue of Shares	0	0	-29	0	0
Inc / (Dec) in Debt	8,316	-1,337	-8,170	-284	-78,613
Dividends Paid	-8,077	-8,247	-11,758	-14,109	-14,109
<b>CF from Fin. Activity</b>	<b>239</b>	<b>-9,584</b>	<b>-19,956</b>	<b>-14,394</b>	<b>-92,722</b>
<b>Inc / ( Dec) in Cash</b>	<b>-9,757</b>	<b>-10,869</b>	<b>20,427</b>	<b>61,483</b>	<b>-16,716</b>
Add: Opening Balance	23,359	13,602	2,733	23,160	69,036
<b>Closing Balance</b>	<b>13,602</b>	<b>2,733</b>	<b>23,160</b>	<b>84,644</b>	<b>52,321</b>

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Disclosure of Interest Statement	Reliance Industries
1. Analyst ownership of the stock	No
2. Group/Directors ownership of the stock	No
3. Broking relationship with company covered	No
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