Reliance Industries ---------- Maintain NEUTRAL

Refining margin expectations dominate stock performance now – a glance at EPS sensitivities **EPS: ◄► TP: ◄►**

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- Rapid escalation of demand concerns has increased the focus on refining margins, which primarily drive RIL's earnings. With the market in search of a bottom, we take a look at EPS sensitivities.
- Our FY10E base case GRM is US$11.7/bbl. In 2002, RIL reported GRM of US$5/bbl, of which ~$2/bbl came from sales tax benefits. The refinery has been upgraded since – the trough GRM on the RIL refinery's limited history would then be close to $5/bbl.
- Falling oil prices and refining utilisation pose a risk to the light heavy crude oil spread – and Reliance's GRM advantage. RIL GRM can hit the $5/bbl mark without a global refining shutdown.
- At such a bottom in GRMs, EPS impact would be high, putting valuation under stress. Under a stress case assumption of $5/bbl GRM would lower our FY10E EPS 47% from Rs163 to Rs87.
- While probabilities of such a rapid fall may be low, expectations can fall faster; marking the bottom in our view. On base case numbers, RIL valuations are currently in line with peers; with downside risk of further global commodity earnings contraction.

Bbg/RIC	RIL IN / RELI.BO	Price (7 Nov 08, Rs)			1,171.55
Rating (prev. rating)	N (N)	TP (Rs) (prev. TP)			1,969 (1,969)
Shares outstanding (mn)	1,573.39	Est. pot. % chg. to TP			68
Daily trad vol–6m avg (mn)	1.0	52-wk range (Rs)			3216.30 - 1015.50
Daily trad val–6m avg (US$ mn)	41.3	Mkt cap (Rs/US$ bn)			1,843.3/ 38.7
Free float (%)	49.0	**Performance**	**1M**	**3M**	**12M**
Major shareholders	Promoter &	Absolute	(28.6)	(49.0)	(55.9)
	Promoter Grp 51%	Relative	(13.5)	(21.0)	(12.1)

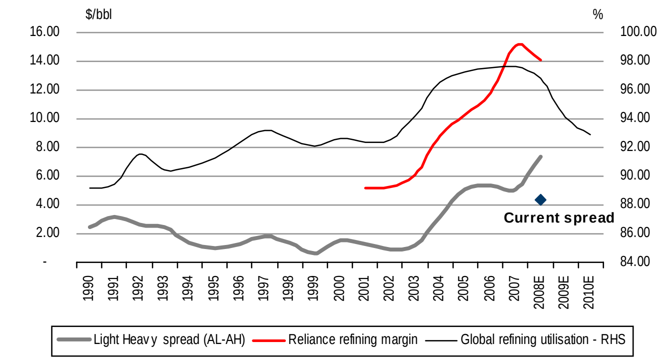
Year	3/07A	3/08A	3/09E	3/10E	3/11E
Revenues (Rs mn)	1,137,764	1,375,079	1,992,691	2,833,440	3,495,404
EBITDA (Rs mn)	201,279	231,431	285,492	459,733	525,562
Net profit (Rs mn)	120,748	195,214	156,380	256,013	323,164
EPS (Rs)	83	130	103	163	205
- Change from prev. EPS (%)	n.a.	n.a.	0	0	0
- Consensus EPS (Rs)	n.a.	n.a.	121	171	186
EPS growth (%)	23.2	56.3	(20.8)	58.2	26.2
P/E (x)	14.1	9.0	11.4	7.2	5.7
Dividend yield (%)	0.9	1.1	1.5	2.1	2.6
EV/EBITDA (x)	10.7	9.8	8.5	5.2	4.3
P/B (x)	2.6	2.0	1.7	1.4	1.2
ROE (%)	17.7	22.8	15.2	19.2	20.2
Net debt/equity (%)	42	46	52	34	19

Note 1: Ord/ADR=2. Note 2: Reliance Industries is India's largest private sector business enterprise in India. It has three business divisions: exploration & production, refining & marketing, and petrochemicals.

Refining margins – top of mind

The rapidly growing slowdown concerns have increased focus on refining margins, with the market looking for a bottom. We forecast FY10 GRM at US$11.7/bbl. On our base case, refining contributes about 48% of FY10 EBITDA with another 38% coming from E&P. The latter is less susceptible to a demand slowdown. Chemical profitability is relatively small. Movements in refining margins then, are likely to determine RIL earnings and stock performance in the near term. With the financial crisis, global oil demand is likely to slow – at a time when new refining capacity is being added. Global refining utilisations will fall, hurting margins. Light – Heavy crude oil spreads are also at risk to this easing and can impact RIL's GRM premium to benchmarks.

Figure 1: Spread between light and heavy oil drives complexity benefit



Source: Bloomberg, Credit Suisse estimates.

Earnings sensitivity to margin declines is high

Refining operating costs for RIL are at about US$2.5/bbl. RIL reported GRM of US$5/bbl in 2002, of which ~US$2/bbl came from sales tax benefits. Refining margins have gone up to US$12/bbl over the last 6 years. The lowest GRM in RIL refinery's history would then be close to US$5/bbl.

Factoring depreciation and interest costs, a decline in GRM from US$12 to US$5 will significantly hurt earnings, losing ~Rs.76/share from base of Rs.163. While EPS is also sensitive to D6 gas revenues, the business being more domestic-oriented, concerns are related more to the ramp-up in volumes than to any demand slowdown.

Figure 2: High earnings sensitivity to GRM assumptions

FY10 KG D6	Change in FY10 Gross refining margin (US$/bbl)						
output (mmscmd)	5	7	9	12	15	17	19
30	68	89	111	144	176	198	220
33	72	93	115	147	180	202	223
36	75	97	119	151	184	206	227
39	79	101	123	155	188	209	231
42	83	105	126	159	191	213	235
45 (Base case)	87	108	130	163	195	217	239
48	91	112	134	167	199	221	242
51	94	116	138	170	203	225	246
54	98	120	142	174	207	228	250
57	102	124	145	178	210	232	254
60	106	128	149	182	214	236	258

Source: Company data, Credit Suisse estimates.

Such a rapid fall to US$5/bbl should have a low probability. Also, use of natural gas at the refinery should call for a higher floor to margins. However, expectations of margins can fall faster, driven by concerns on demand, dragging valuations down with them. At current expectations, the stock is trading in line with peers, with little SoTP froth. Continued decline in global refining margins is the principal risk to valuations. Our target price and rating are under review.

Companies Mentioned *(Price as of 07 Nov 08)*
Reliance Industries (RELI.BO, Rs1217.85, NEUTRAL, TP Rs1969.00)

Disclosure Appendix

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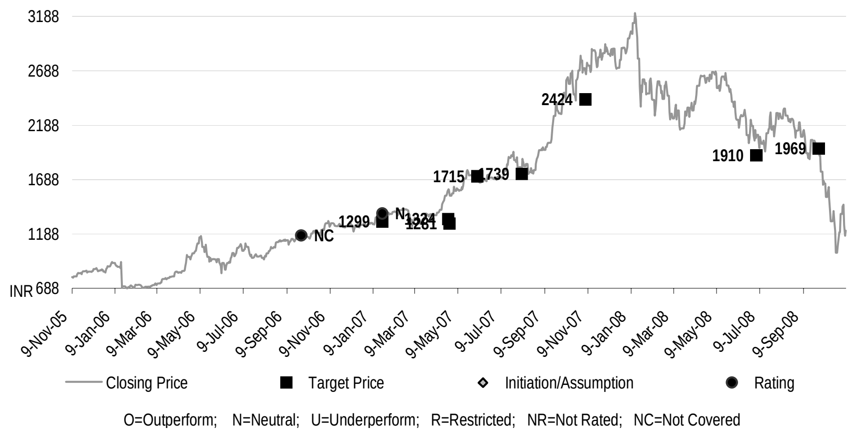
3-Year Price, Target Price and Rating Change History Chart for RELI.BO

RELI.BO Date	Closing Price (INR)	Target Price (INR)	Rating	Initiation/ Assumption
29-Sep-06	1,171.05		NC	
22-Jan-07	1,373.45	1299	N	
25-Apr-07	1,599.85	1324		
27-Apr-07	1,538.2	1281		
5-Jun-07	1,745.05	1715		
7-Aug-07	1,805.85	1739		
5-Nov-07	2,663.65	2424		
4-Jul-08	2099	1910		
30-Sep-08	1,946.35	1969		



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Price Target: (12 months) for (RELI.BO)

Method: Our target price for Reliance Industries is Rs1,969. We value the company using a discounted cash flow (DCF) based sum-of-the-parts valuation. We use a weighted average cost of capital (WACC) of 12.2%. Our DCF-based valuations for the core business - Chemicals and Refining - imply an EV/EBITDA (enterprise value/earnings before interest, tax, depreciation, amortisation) of 5.2x and 5.9x, respectively, for 2009, at a premium to its global peers. We value the existing known blocks in E&P at US$17.5bn, and the exploration at US$16bn for the reserves that have not been discovered. We value the retail business at Rs97/share, assuming revenue ramps up to $28bn by 2015 and an EBITDA margin of 6%.

Risks: There are risks on the downside to our Rs1,969 target price for Reliance Industries if: 1) global growth slows and chemical and refining margins revert back to mid-cycle faster than expected; 2) gas reserves are lower than modelleld; 3) gas pricing is lower than modelled, 4) execution of the retail business build-out is short of our expectations on either market growth, or Reliance's market share.

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