

SEPTEMBER 10, 2009

UPDATE

Coverage view: **Attractive**

Price (Rs): **2,168**

Target price (Rs): **1,600**

BSE-30: **16,184**

Over-exuberant technicals and sentiment provide opportunity to book profits.

We advise investors to use the recent sharp run-up in RIL stock to book profits as we see no change in RIL's fundamentals regardless of (1) the stock's large underperformance in the past six months or (2) recent spurt in underlying commodity prices due to weakening dollar. We continue to see large downside risks to our below-consensus earnings estimates.

Company data and valuation summary

Reliance Industries

Stock data		Forecasts/Valuations			
		2009	2010E	2011E	
52-week range (Rs) (high,low)	2,535-930	EPS (Rs)	103.4	109.3	158.3
Market Cap. (Rs bn)	2,977.3	EPS growth (%)	(1.5)	5.7	44.9
Shareholding pattern (%)		P/E (X)	21.0	19.8	13.7
Promoters	42.4	Sales (Rs bn)	1,499.7	1,663.6	1,932.4
FIs	19.6	Net profits (Rs bn)	157.1	171.9	249.1
MFs	2.7	EBITDA (Rs bn)	239.8	321.6	422.6
Price performance (%)		EV/EBITDA (X)	13.2	9.5	6.8
Absolute	1M 3M 12M	ROE (%)	15.1	13.7	17.6
Rel. to BSE-30	1.7 (10.8) (6.8)	Div. Yield (%)	0.6	0.6	0.8

Recent run-up provides good opportunity to book profits

We advise investors to exit RIL stock given (1) its strong outperformance over the past few days, (2) the stock is trading well above our SOTP-based 12-month target price of Rs1,600. RIL stock has rallied 12.3% in the past week versus the BSE-30 Index's 5.1% increase over the same period (see Exhibit 1) without any real change in fundamentals and versus expectations. We highlight that the current stock price is discounting ~35tcf of additional gas discoveries. We see significant downside risk to our earnings estimates and fair valuation from (1) weaker-than-expected chemical and refining margins and (2) possible unfavorable outcome of ongoing RIL-RNRL and RIL-NTPC legal disputes.

Underperformance of stock not enough reason to buy

We see the street's argument about the stock's likely catch-up on its recent (three and six months) underperformance versus the market as purely of a technical nature. More important, fundamentals remain weak and weaker versus expectations despite modest improvement in refining margins over the past 2-3 weeks. We highlight that RIL stock has underperformed the market (BSE-30 Index) by 26.3% since April 1, 2009 (see Exhibit 2) but this alone cannot be a reason to buy the stock.

RIL is not a commodity play; it does not own basic resources

We find the street's willingness to club RIL with other Indian and global resources or commodity plays somewhat simplistic. Global commodity stocks have rallied on spurt in commodity prices led by recent weakness in the US dollar (see Exhibit 3). We highlight that RIL is not a pure resource play but a 'converter'. Thus, RIL's profitability is dependent on margins (chemical and refining) and less so on underlying commodity (crude oil, in case of RIL) prices. Also, its gas selling price is fixed in US Dollar terms. On the contrary, any weakness in dollar versus the Indian rupee is a negative for RIL. A Rs1/US\$ increase in rupee-US Dollar exchange rate would reduce Reliance's FY2010E and FY2011E EPS to Rs106.1 and Rs154.5 from our base case EPS estimates of Rs109.3 and Rs158.3 (see Exhibit 4).

QUICK NUMBERS

- **26% downside to our fair value of Rs1,600 from current levels**
- **Current stock price discounting 68 tcf of additional gas reserves over the next six years**
- **Trough-case valuation comes to Rs1,275**

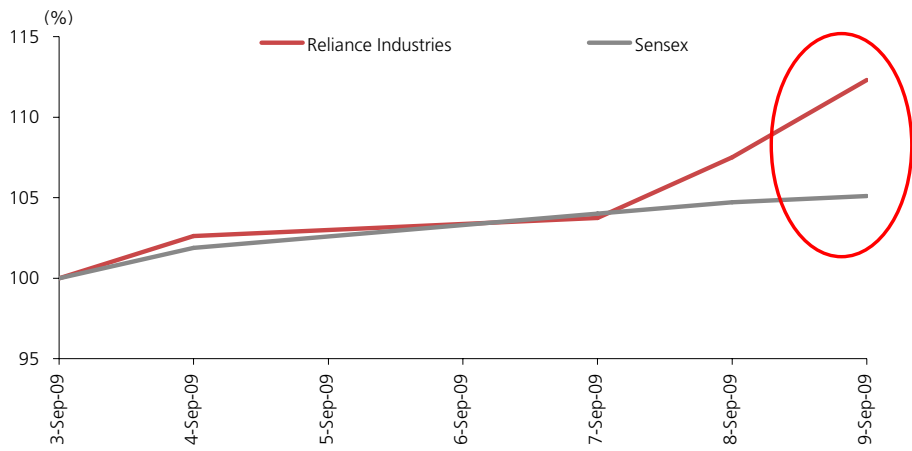
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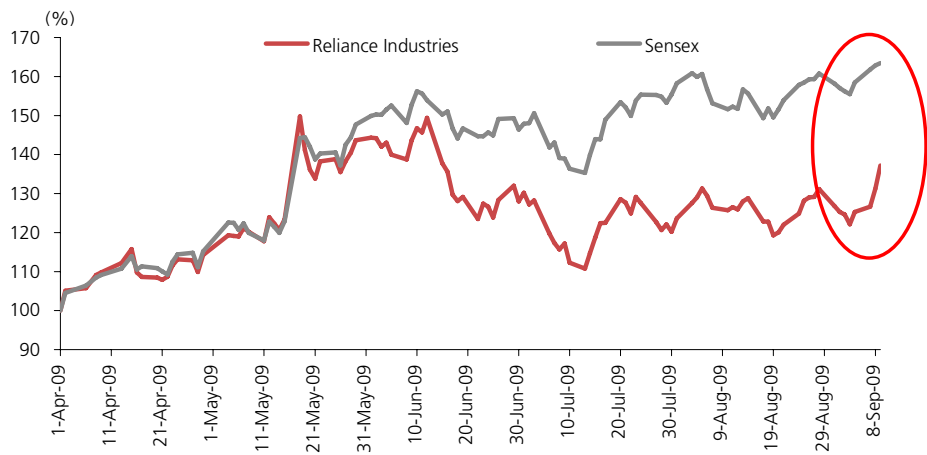
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Reliance Industries stock has outperformed the broad market in the last week
 Relative performance of Reliance Industries and BSE-30 Index (%)



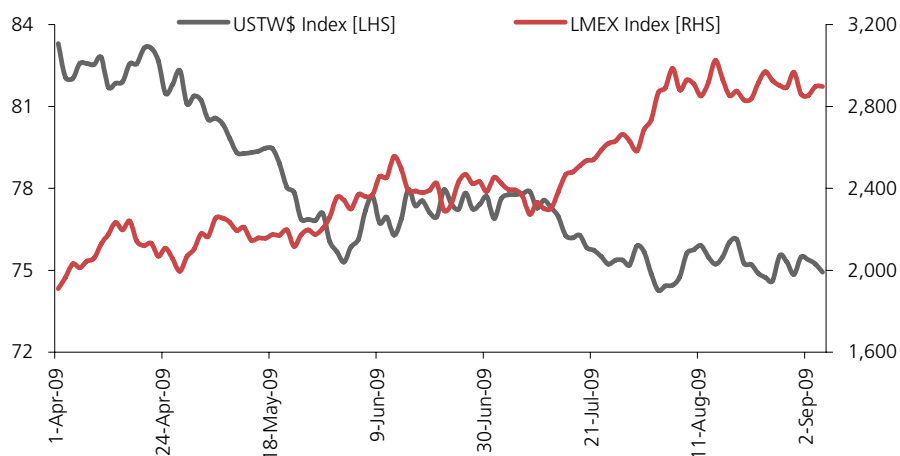
Source: Bloomberg, Kotak Institutional Equities

Reliance Industries stock has underperformed the broad market since April 2009
 Relative performance of Reliance Industries and BSE-30 Index (%)



Source: Bloomberg, Kotak Institutional Equities

Global commodity prices have increased sharply since April led by weakening of US dollar
Performance of US\$ Index and LME Metals Index



Source: Bloomberg, Kotak Institutional Equities

Reliance's earnings have high leverage to refining margins

Sensitivity of RIL's consolidated earnings to key variables

	Fiscal 2010E			Fiscal 2011E			Fiscal 2012E		
	Downside	Base case	Upside	Downside	Base case	Upside	Downside	Base case	Upside
Rupee-dollar exchange rate									
Rupee-dollar exchange rate	47.0	48.0	49.0	46.8	47.8	48.8	46.5	47.5	48.5
Net profits (Rs mn)	166,986	171,911	176,836	243,026	249,071	255,116	303,292	310,129	316,966
EPS (Rs)	106.1	109.3	112.4	154.5	158.3	162.1	192.8	197.1	201.5
% upside/(downside)	(2.9)		2.9	(2.4)		2.4	(2.2)		2.2
Chemical prices									
Change in prices (%)	(5.0)		5.0	(5.0)		5.0	(5.0)		5.0
Net profits (Rs mn)	166,969	171,911	176,853	244,903	249,071	253,239	305,679	310,129	314,579
EPS (Rs)	106.1	109.3	112.4	155.7	158.3	161.0	194.3	197.1	199.9
% upside/(downside)	(2.9)		2.9	(1.7)		1.7	(1.4)		1.4
Refining margins (US\$/bbl)									
Margins (US\$/bbl)	7.5	8.5	9.5	9.6	10.6	11.6	10.2	11.2	12.2
Net profits (Rs mn)	158,791	171,911	185,027	234,569	249,071	263,571	295,718	310,129	324,540
EPS (Rs)	100.9	109.3	117.6	149.1	158.3	167.5	187.9	197.1	206.3
% upside/(downside)	(7.6)		7.6	(5.8)		5.8	(4.6)		4.6

Source: Kotak Institutional Equities estimates

Current stock price implies 7 bn boe of additional crude oil reserves

As highlighted previously, we see a big gap between the stock price (which reflects expectations regarding Reliance's E&P segment) and the fair value of its extant businesses (around Rs927, including value of investments). The gap between the stock price (expectations of future) and the fair value of extant businesses is about US\$37 bn (see Exhibit 5) currently. Although, Reliance has made significant discoveries in its prolific KG D-6 block and in other blocks, it is yet to disclose reserves in the new discoveries.

RIL stock price is implying US\$21 bn of new discoveries of hydrocarbons in the future
Estimation of implied valuation of new businesses of Reliance Industries (US\$ bn)

		Comments
1. Valuation of extant businesses		
Chemicals, RIL refinery, extant oil and gas		
FY2009 EPS of Reliance (standalone) (Rs)	103	FY2009 EPS
FY2009 EPS adjusted for treasury shares (Rs)	112	Adjusted for 199 mn treasury shares and shares issued on merger of RPET
Effective tax rate in FY2009 (%)	16.5	
FY2009 EPS adjusted for tax rate	89	Normalized for 34% tax rate for extant earnings
Appropriate P/E multiple (X)	7	Reasonable given near peak-cycle margins, earnings in FY2009 and cost of equity of 12.5%
Valuation of extant businesses excluding RPET (Rs)	622	
Valuation of extant businesses excluding RPET	19	Reasonable in the context of replacement value, returns
FY2011E earnings of RPET (US\$ bn)	1	
FY2011E EPS of RPET (Rs)	31	
Appropriate P/E multiple (X)	9	
Valuation of RPET refinery (Rs)	282	
Valuation of extant businesses (including RPET) (Rs)	904	
Valuation of extant businesses	27	
2. Valuation of investments		
Others (without Reliance Retail)		
Other investments (Rs)	23	
Valuation of RIL ex-new E&P, retailing, SEZs (Rs)	927	
Current stock price	2,168	
3. Valuation of new businesses		
Emerging E&P business, retailing, SEZs		
Market-ascribed value of new businesses	1,242	
Market-ascribed value of new businesses (US\$ bn)	37	
Estimated valuation of retailing (US\$ bn)	1.0	Valued at 0.8X of amount invested (Rs60 bn) at end-FY2009E
Estimated valuation of SEZs (US\$ bn)	1.0	Value will take time to emerge
Market-ascribed value of emerging E&P business	35	Seems high based on official reserves, announced discoveries
Estimated value of Reliance's stake in KG D-6 (gas)	8.0	Based on gas production of 18.2 tcf, US\$8.8 bn capex and sale of 40 mcm/d of gas to RNRL and NTPC at US\$2.34/mn BTU
Estimated value of Reliance's stake in KG D-6 (oil)	1.8	0.5 bn bbls of OOIIP assumed versus current announced reserves of 180 mn bbls
Estimated value of Reliance's stakes in NEC-25	2.6	Based on 5.3 tcf of production, US\$1.15 bn capex, US\$4.5/mn BTU
Estimated value of Reliance's stakes in CBM	1.5	Based on 2.8 tcf of production
Implied value of new discoveries	21	

Source: Kotak Institutional Equities estimates

In Exhibit 6, we show that Reliance's current stock price is implying around 35 tcf of additional gas reserves (recoverable). This compares with about 25 tcf of net recoverable reserves assumed by us in the valuation exercise for Reliance's KG D-6 block. The 35 tcf of additional gas reserves being implied by today's stock price would mean that Reliance would need to bring on stream the equivalent of 68 tcf of recoverable gas reserves assuming a typical discovery-to-production period of six years and cost of capital of 12%.

Reliance's current stock price is implying additional recoverable reserves of ~35 tcf of gas today
Valuation of Reliance's E&P segment and implied valuation for potential discoveries (US\$ bn)

		Comments
DCF valuation of KG D-6 block, gas for D1 & D3 fields	9.9	15.4 tcf of net recoverable gas reserves
Valuation of KG D-6 block, oil for MA-1 field	1.8	450 mn bbls of net proved oil reserves at EV/bbl of US\$10
Valuation of Reliance's stakes in NEC-25	2.6	4.6 tcf of net recoverable gas reserves
Valuation of Reliance's stakes in CBM blocks	1.5	2.8 tcf of net recoverable gas reserves
Total valuation of extant announced reserves	16	
Total recoverable reserves (tcf)	25	
Implied valuation of new E&P discoveries	21	
Implied additional recoverable reserves in stock price (tcf)	35	This is what Reliance needs to announce today
# of years from discovery to production	6	KG D-6 first gas discovered in Oct-02, production in 2HFY09
Cost of capital (%)	12	
Additional gas reserves required to be added in six years (tcf)	68	This is what Reliance needs to bring in production in six years

Note:

(a) The above exercise assumes that all future gas and oil discovery would have similar PSC terms as the KG D-6 block.

Source: Kotak Institutional Equities estimates

Significant risks exist for RIL's earnings

We see significant downside risks to our earnings assumptions and fair valuation emerging from (1) weaker-than-expected refining and chemical cycles and (2) unfavorable outcome in RIL-RNRL and RIL-NTPC legal disputes. We discuss the same in detail below. We highlight that our trough-case valuation comes to Rs1,275 (see Exhibit 7).

Trough-case SOTP valuation of Reliance is Rs1,275 per share on FY2011E estimates

Sum-of-the-parts valuation of Reliance Industries, FY2011E basis (Rs)

	Valuation base (Rs bn)		Multiple (X)		EV (Rs bn)	Value share (Rs)
	Other	EBITDA	Multiple	EV/EBITDA		
Chemicals		56		6.5	367	254
Refining & Marketing		141		6.5	919	637
Oil and gas—producing		27		5.0	133	92
Gas—developing (DCF-based) (a)	304	—	100%	—	304	210
Oil—KG-DWN-98/3 (b)	86	—	100%	—	86	60
Investments						
Others	27	—	100%	—	27	19
Loans & advances to affiliates less accounts payables to affiliates	83	—	100%	—	83	58
Retailing	60	—	80%	—	48	33
SEZ development	62	—	80%	—	50	34
Total enterprise value					2,018	1,398
Net debt					191	133
Implied equity value					1,826	1,265

Note:

(a) We reduce chemical margins by US\$50/ton versus our base-case margins.

(b) We reduce refining margin by US\$1/bbl versus our base-case assumption.

(c) We value the KG D-6 gas find on DCF and offshore Orissa (NEC-25) and CBM discoveries based on KG D-6's valuation.

(d) 180 mn bbls of recoverable reserves based on gross OOIP of 0.5 bn bbls.

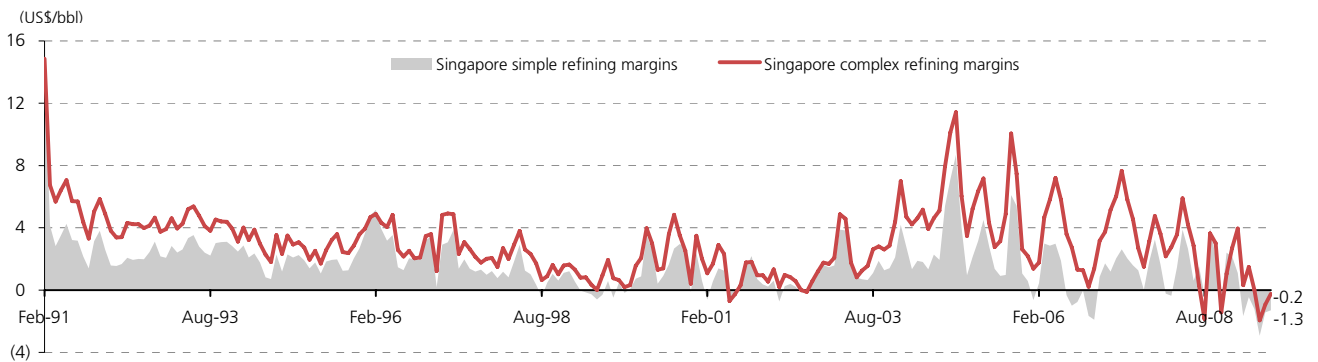
(e) Net debt reflects is for consolidated entity.

(f) We use 1.443 bn shares post merger of RPET with RIL (excluding treasury shares) for per share computations.

Source: Kotak Institutional Equities estimates

- ▶ **Chemical margins likely to tumble in 2HCY09/1HCY10.** We highlight that chemical margins have remained strong in 1HCY09 led by a delay in the commissioning of new capacity in Middle East including (1) Yansab's 1.3 mtpa cracker which was scheduled to start in 4QCY08, (2) Petro Rabigh's 1.3 mtpa cracker which was scheduled to start in CY2008 and (3) SHARQ's 1.2 mtpa cracker which was scheduled to start in 2HCY08. However, we do not rule out a steep decline in chemical margins in 2HCY09 due to start of PetroRabigh (1.3 mtpa) and Yansab (1.3 mtpa); SHARQ is expected to commence operations in December 2009. We see significant supply additions (20.6 mn tons of ethylene) in CY2009-11E, which may keep a lid on chemical margins over this period.
- ▶ **Refining margins continue to be weak and still well below our assumed levels.** We highlight that refining margins have been terrible over the last two quarters even though they have recovered modestly in the past 2-3 weeks. Singapore refining margins have plummeted to -US\$0.3/bbl in FY2010YTD from US\$2.1/bbl in FY2009 (see Exhibit 8). We expect refining margins will likely remain subdued over the next 12-24 months due to (1) global demand weakness and (2) large refining capacity additions in CY2009-10E. We highlight that light-heavy differential has also collapsed to US\$0.7/bbl in FY2010YTD versus US\$8/bbl in FY2009 (see Exhibit 9). We are increasingly doubtful that RIL's refining margin can reach our assumed blended refining margin of US\$7.8/bbl for FY2010E and US\$9.8/bbl for FY2011E.

Refining margins remain subdued in the recent weeks
Singapore refining margins (US\$/bbl)



Simple refining margins, March fiscal year-ends (US\$/bbl)										
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010 YTD
1Q	1.3	0.5	0.3	1.0	1.7	3.0	2.5	2.3	2.4	(1.5)
2Q	2.5	0.4	0.1	1.2	3.1	2.8	(0.7)	1.0	1.7	(1.2)
3Q	1.7	1.1	1.4	1.6	6.5	2.2	(1.2)	2.3	1.3	
4Q	0.2	(0.0)	3.0	2.9	2.1	1.1	1.2	0.2	0.7	
Average	1.4	0.5	1.2	1.7	3.3	2.3	0.5	1.5	1.5	(1.4)

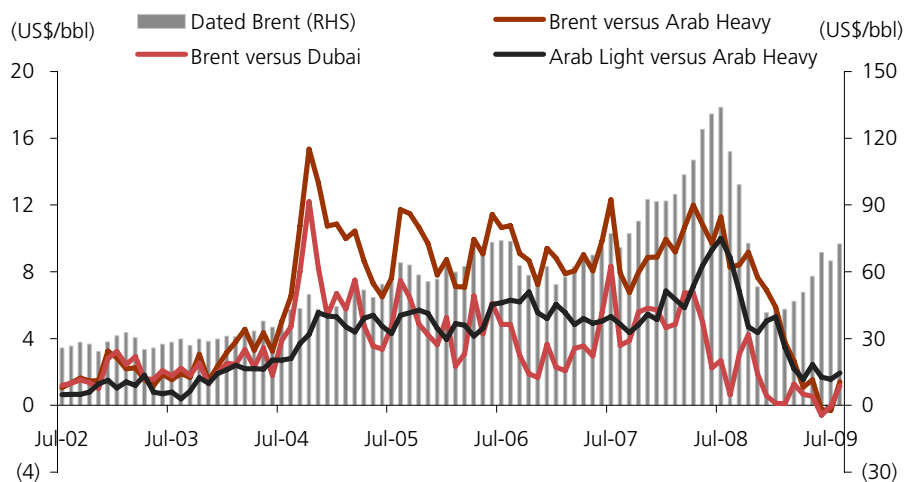
Complex refining margins, March fiscal year-ends (US\$/bbl)										
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010 YTD
1Q	1.9	1.3	0.8	1.2	4.6	4.9	6.2	6.6	4.3	(0.1)
2Q	4.0	0.6	0.1	2.3	5.8	6.1	2.5	2.9	0.7	(0.5)
3Q	2.3	1.2	1.6	3.2	9.0	3.9	1.0	3.9	1.0	
4Q	1.6	0.6	3.7	5.4	5.0	2.8	4.1	2.8	2.4	
Average	2.4	0.9	1.5	3.1	6.1	4.4	3.4	4.0	2.1	(0.3)

Weekly margins				
Current	-1 Wk	-2 Wk	-3 Wk	-4 Wk
0.0	(1.1)	(1.3)	(1.3)	(1.5)

Weekly margins				
Current	-1 Wk	-2 Wk	-3 Wk	-4 Wk
0.5	(0.3)	(0.5)	0.1	(0.3)

Source: Bloomberg, Kotak Institutional Equities

Premium of light, sweet crude oils versus heavy, sour crude oils (US\$/bbl)



Source: Bloomberg, Kotak Institutional Equities

- **Unfavorable outcome of RIL-RNRL and RIL-NTPC litigation.** We see Rs68/share upside to our 12-month SOTP-based fair valuation of RIL of Rs1,600 (based on FY2011E estimates) in case the Supreme Court rules in favor of RIL and RIL does not have to supply any amount of gas at the disputed price of US\$2.34/mn BTU. However, we see a further downside of Rs112 to our fair valuation in case the Supreme Court rules in favor of RNRL and the government uses US\$4.2/mn BTU for valuation of natural gas produced from RIL's KG D-6 block to determine the government's take of profit petroleum, royalty and income tax. In our view, the government will use US\$4.2 mn/BTU or a price as per the government-approved pricing formula for computation of its share of profit petroleum, royalty and income tax irrespective of whether the selling price to NTPCL and RNRL is US\$2.34/mn BTU or US\$4.2/mn BTU.

Also, we note that our volume assumption for gas production from KG D-6 block at 45 mcm/d for FY2010E may be optimistic; 1QFY10 production was 19 mcm/d and August production rate was 35 mcm/d. We assume gas price at US\$4.2/mn BTU for FY2010-12E and do not see any scope for positive surprises from the same since the government has fixed natural gas price for five years (up to FY2014E).

SOTP valuation of Reliance is Rs1,600 per share on FY2011E estimates
Sum-of-the-parts valuation of Reliance Industries, FY2011E basis (Rs)

	Valuation base (Rs bn)		Multiple (X)		EV (Rs bn)	Value share (Rs)
	Other	EBITDA	Multiple	EV/EBITDA		
Chemicals		74		6.5	483	334
Refining & Marketing		163		6.5	1,058	733
Oil and gas—producing		27		5.0	133	92
Gas—developing (DCF-based) (a)	465	—	100%	—	465	322
Oil—KG-DWN-98/3 (b)	86	—	100%	—	86	60
Investments						
Others	27	—	100%	—	27	19
Loans & advances to affiliates less accounts payables to affiliates	83	—	100%	—	83	58
Retailing	60	—	80%	—	48	33
SEZ development	62	—	80%	—	50	34
Total enterprise value					2,434	1,686
Net debt					148	103
Implied equity value					2,286	1,583

Note:

- (a) We value the KG D-6 and NEC-25 gas discoveries on DCF and CBM discoveries based on KG D-6's valuation.
 (b) 180 mn bbls of recoverable reserves based on gross OOIP of 0.5 bn bbls.
 (c) Net debt is for 'merged' entity.
 (d) We use 1.443 bn shares post merger of RPET with RIL (excluding treasury shares) for per share computations.

Source: Kotak Institutional Equities estimates

RIL consolidated with RPL: Profit model, balance sheet, cash model, March fiscal year-ends, 2006-2012E (Rs mn)

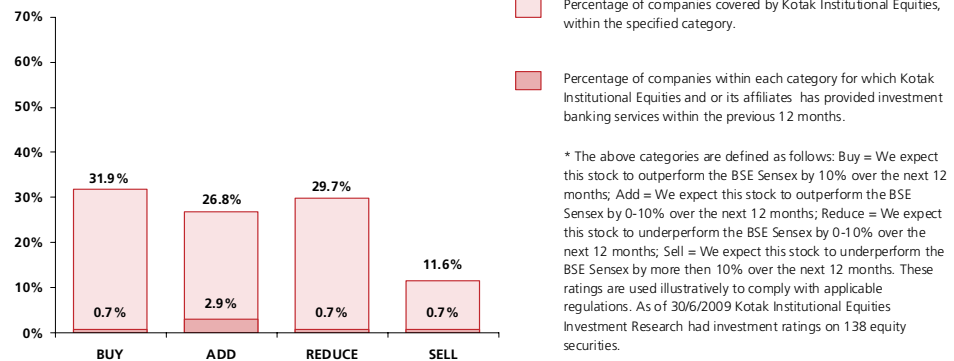
	2006	2007	2008	2009E	2010E	2011E	2012E
Profit model (Rs mn)							
Net sales	809,113	1,114,927	1,334,430	1,499,690	1,663,627	1,932,427	2,030,470
EBITDA	139,991	198,462	233,056	236,220	318,026	418,991	493,345
Other income	6,829	4,783	8,953	20,570	32,070	33,680	40,654
Interest	(8,770)	(11,889)	(10,774)	(17,450)	(44,249)	(30,497)	(16,397)
Depreciation & depletion	(34,009)	(48,152)	(48,471)	(51,720)	(92,029)	(102,219)	(113,344)
Pretax profits	104,041	143,205	182,764	187,620	213,817	319,956	404,258
Extraordinary items	3,000	2,000	47,335	(3,700)	—	—	—
Tax	(9,307)	(16,574)	(26,520)	(21,290)	(30,173)	(62,659)	(87,167)
Deferred taxation	(7,040)	(9,196)	(8,999)	(9,000)	(7,640)	5,153	10,654
Minority interest	—	—	—	(249)	(4,093)	(13,378)	(17,616)
Net profits	90,693	119,434	194,580	153,381	171,911	249,071	310,129
Adjusted net profits	88,152	117,789	152,605	156,472	171,911	249,071	310,129
Earnings per share (Rs)	63	81	105	103	109	158	197
Balance sheet (Rs mn)							
Total equity	430,543	673,037	847,853	1,130,178	1,269,103	1,480,204	1,738,833
Deferred taxation liability	49,708	69,820	78,725	87,725	95,366	90,213	79,560
Minority interest	—	33,622	33,622	33,832	34,654	43,314	52,964
Total borrowings	218,656	332,927	493,072	710,346	500,979	360,660	218,012
Current liabilities	164,545	192,305	251,427	301,513	240,627	256,406	256,586
Total liabilities and equity	863,452	1,301,712	1,704,700	2,263,594	2,140,729	2,230,796	2,345,954
Cash	21,461	18,449	42,822	256,703	128,526	212,244	352,431
Current assets	224,283	286,566	402,721	483,779	499,004	533,227	539,697
Total fixed assets	626,745	899,403	1,081,638	1,333,592	1,323,680	1,295,806	1,264,307
Investments	(9,038)	97,294	177,519	189,519	189,519	189,519	189,519
Deferred expenditure	—	—	—	—	—	—	—
Total assets	863,452	1,301,712	1,704,700	2,263,594	2,140,729	2,230,796	2,345,954
Free cash flow (Rs mn)							
Operating cash flow, excl. working capital	119,520	164,285	180,718	168,460	235,949	320,325	383,180
Working capital	(32,188)	(13,075)	(31,071)	(30,973)	(76,111)	(18,444)	(6,290)
Capital expenditure	(94,273)	(247,274)	(239,691)	(238,171)	(74,940)	(73,616)	(82,895)
Investments	(32,364)	(105,760)	(78,953)	(12,000)	—	—	—
Other income	5,159	4,143	6,132	20,570	32,070	33,680	40,654
Free cash flow	(34,146)	(197,681)	(162,865)	(92,114)	116,968	261,945	334,649
Ratios (%)							
Debt/equity	45.5	44.8	53.2	58.3	36.7	23.0	12.0
Net debt/equity	41.1	42.3	48.6	37.2	27.3	9.5	(7.4)
RoAE	19.9	20.3	18.9	15.0	13.7	17.4	18.6
RoACE	13.8	13.9	12.7	9.9	10.9	14.7	16.7

Source: Company, Kotak Institutional Equities estimates

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Kotak Institutional Equities Research coverage universe

Distribution of ratings/investment banking relationships



Source: Kotak Institutional Equities

As of June 30, 2009

Ratings and other definitions/identifiers

Definitions of ratings

BUY. We expect this stock to outperform the BSE Sensex by 10% over the next 12 months.

ADD. We expect this stock to outperform the BSE Sensex by 0-10% over the next 12 months.

REDUCE. We expect this stock to underperform the BSE Sensex by 0-10% over the next 12 months.

SELL. We expect this stock to underperform the BSE Sensex by more than 10% over the next 12 months.

Our target price are also on 12-month horizon basis.

Other definitions

Coverage view. The coverage view represents each analyst's overall fundamental outlook on the Sector. The coverage view will consist of one of the following designations: **Attractive, Neutral, Cautious.**

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