# Reliance Industries Ltd.

Company Update **BUY**

Equity | India | Chemicals-Specialty
10 December 2007

# RPL and E&P - evaluation of RIL's options

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## RPL may be merged with RIL eventually; Switch RPL to RIL

Reliance Industries (RIL) recently sold a 4% stake in Reliance Petroleum (RPL) taking it down to 71%. Chevron, which holds 5% RPLstake, has option to raise it by 24% by buying from RIL. RIL's stake in RPL would fall to 47% (below majority) in that case. This is one more reason Chevron hiking stake in RPL appears unlikely. It is likely to exit RPL by July 2009 as per the other option it has. Post Chevron exit RPL is likely to be merged with RIL like its other subsidiaries in the past. We view RIL more favorably than RPL. We reiterate switch to RIL from RPL.

## Merger not accretive unless RIL's RPL stake cancelled

RIL-RPL merger if soon done would not be earnings accretive for RIL if RIL's stake in RPL of 71% is not cancelled. In most other mergers RIL stake has not been cancelled creating treasury shares. Our calculation is based on swap ratio based on market price (12:1) and fair value (20:1). The downside to RIL's FY09-FY10E earnings in the two scenarios is 6-14%. Downside to fair value is 2-4%.

## Merger likely by July 2009; merger then may be accretive

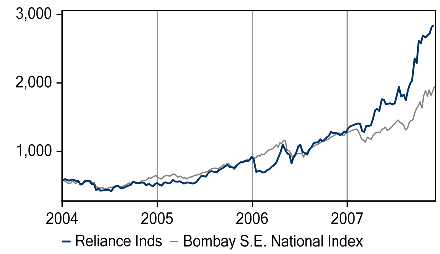
Chevron has to decide whether to hike stake in RPL or exit by July 2009. RIL-RPL merger is likely only after Chevron's exit. RIL's fair value is likely to rise further by 2009 driven by E&P, retail and SEZ. RPL's share price may however decline as refining downturn nears. Swap ratio may then be earnings and value accretive.

## E&P demerger unlikely as it would not be accretive

RIL's E&P business being demerged is expected by some. We think it is unlikely as it would not be earnings and value accretive. This is because if demerged, income tax outgo would be more as minimum alternate tax (MAT) has to be paid.

### Stock Data

| | |
|---|---|
| Price (Common / GDR) | Rs2,823 / US$143.50 |
| Price Objective | Rs2,894 / US$148.41 |
| Date Established | 25-Nov-2007 / 25-Nov-2007 |
| Investment Opinion | B-1-7 / B-1-7 |
| Volatility Risk | MEDIUM / MEDIUM |
| 52-Week Range | Rs1,181-Rs3,235 |
| Market Value (mn) | US$104,078 |
| Shares Outstanding (mn) | 1,453.4 / 726.7 |
| Average Daily Volume | 903,795 |
| ML Symbol / Exchange | XRELF / BSE |
| ML Symbol / Exchange | RLNIY / LIN |
| Bloomberg / Reuters | RIL IN / RELI.BO |
| ROE (2008E) | 17.4% |
| Net Dbt to Eqty (Mar-2006A) | 46.2% |
| Est. 5-Yr EPS / DPS Growth | 0.2% / 0.1% |
| Free Float | 52.1% |




### Estimates (Mar)

| (Rs) | 2006A | 2007A | 2008E | 2009E | 2010E |
|---|---|---|---|---|---|
| Net Income (Adjusted - mn) | 94,978 | 125,476 | 141,771 | 205,633 | 276,767 |
| EPS | 68.17 | 86.34 | 90.11 | 130.70 | 175.91 |
| EPS Change (YoY) | 33.7% | 26.6% | 4.4% | 45.0% | 34.6% |
| Dividend / Share | 10.00 | 9.91 | 11.00 | 12.00 | 15.00 |
| Free Cash Flow / Share | (113.59) | (105.18) | 40.01 | 35.03 | 127.73 |
| GDR EPS (US$) | 3.08 | 3.82 | 4.57 | 6.63 | 8.93 |
| GDR Dividend / Share (US$) | 0.452 | 0.438 | 0.558 | 0.609 | 0.761 |

### Valuation (Mar)

| | 2006A | 2007A | 2008E | 2009E | 2010E |
|---|---|---|---|---|---|
| P/E | 41.40x | 32.69x | 31.32x | 21.60x | 16.05x |
| Dividend Yield | 0.354% | 0.351% | 0.390% | 0.425% | 0.531% |
| EV / EBITDA* | 2.45x | 1.71x | 1.55x | 1.11x | 0.860x |
| Free Cash Flow Yield* | NA | NA | NA | NA | NA |

* For full definitions of *iQmethod* SM measures, see page 10.

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# *iQprofile* SM Reliance Industries Ltd.

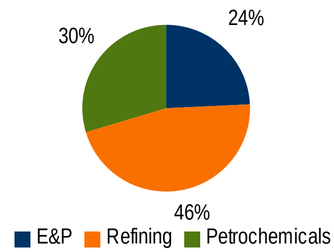
| Key Income Statement Data (Mar) | 2006A | 2007A | 2008E | 2009E | 2010E |
|---|---|---|---|---|---|
| (Rs Millions) | | | | | |
| Sales | 830,248 | 1,137,701 | 1,007,185 | 1,364,626 | 1,628,308 |
| Gross Profit | 259,770 | 347,532 | 353,449 | 489,644 | 594,864 |
| Sell General & Admin Expense | (116,283) | (141,526) | (126,959) | (172,453) | (186,453) |
| Operating Profit | 108,537 | 157,011 | 181,180 | 256,574 | 331,427 |
| Net Interest & Other Income | 2,701 | (5,814) | (3,966) | (4,001) | (6,227) |
| Associates | NA | NA | NA | NA | NA |
| Pretax Income | 111,238 | 151,198 | 177,214 | 252,574 | 325,199 |
| Tax (expense) / Benefit | (16,295) | (25,723) | (35,443) | (33,715) | (26,536) |
| Net Income (Adjusted) | 94,978 | 125,476 | 141,771 | 205,633 | 276,767 |
| Average Fully Diluted Shares Outstanding | 1,393 | 1,453 | 1,573 | 1,573 | 1,573 |
| **Key Cash Flow Statement Data** | | | | | |
| Net Income (Reported) | 94,978 | 125,476 | 141,771 | 205,633 | 276,767 |
| Depreciation & Amortization | 34,949 | 48,995 | 45,310 | 60,617 | 76,984 |
| Change in Working Capital | 18,027 | (42,218) | 120,873 | (81,707) | (61,554) |
| Deferred Taxation Charge | NA | NA | NA | NA | NA |
| Other Adjustments, Net | 7,296 | 15,469 | 49,945 | 23,893 | 30,778 |
| Cash Flow from Operations | 155,249 | 147,722 | 357,899 | 208,436 | 322,975 |
| Capital Expenditure | (313,506) | (300,591) | (294,951) | (153,317) | (122,013) |
| (Acquisition) / Disposal of Investments | 129,436 | 13,988 | (198,723) | (24,000) | 34,000 |
| Other Cash Inflow / (Outflow) | NA | NA | NA | NA | NA |
| Cash Flow from Investing | (184,070) | (286,603) | (493,674) | (177,317) | (88,013) |
| Shares Issue / (Repurchase) | 0 | 59,248 | 168,240 | 0 | 0 |
| Cost of Dividends Paid | (11,914) | (30,247) | (695) | (14,595) | (5,394) |
| Cash Flow from Financing | 18,897 | 132,088 | 155,245 | (9,835) | (97,394) |
| Free Cash Flow | (158,257) | (152,870) | 62,948 | 55,119 | 200,962 |
| Net Debt | 207,264 | 317,144 | 285,374 | 268,850 | 39,282 |
| Change in Net Debt | 40,734 | 109,881 | (31,770) | (16,524) | (229,568) |
| **Key Balance Sheet Data** | | | | | |
| Property, Plant & Equipment | 602,093 | 911,669 | 1,161,310 | 1,254,010 | 1,299,038 |
| Other Non-Current Assets | 66,668 | 52,680 | 251,403 | 275,403 | 241,403 |
| Trade Receivables | 43,517 | 38,314 | 52,176 | 98,978 | 131,428 |
| Cash & Equivalents | 26,164 | 19,370 | 38,840 | 60,125 | 197,693 |
| Other Current Assets | 180,441 | 273,475 | 133,649 | 175,843 | 208,903 |
| Total Assets | 918,883 | 1,295,508 | 1,637,379 | 1,864,359 | 2,078,465 |
| Long-Term Debt | 166,769 | 252,288 | 225,210 | 227,970 | 160,970 |
| Other Non-Current Liabilities | 49,708 | 69,905 | 81,424 | 92,091 | 100,973 |
| Short-Term Debt | 66,659 | 84,227 | 99,005 | 101,005 | 76,005 |
| Other Current Liabilities | 170,726 | 202,516 | 216,466 | 230,690 | 256,162 |
| Total Liabilities | 453,862 | 608,936 | 622,105 | 651,756 | 594,110 |
| Total Equity | 465,021 | 686,572 | 1,015,274 | 1,212,603 | 1,484,355 |
| Total Equity & Liabilities | 918,883 | 1,295,508 | 1,637,379 | 1,864,359 | 2,078,465 |
| ***iQmethod* SM - Bus Performance*** | | | | | |
| Return On Capital Employed | 14.0% | 14.4% | 11.9% | 14.9% | 17.6% |
| Return On Equity | 22.0% | 22.6% | 17.4% | 19.2% | 21.5% |
| Operating Margin | 13.1% | 13.8% | 18.0% | 18.8% | 20.4% |
| EBITDA Margin | 17.3% | 18.1% | 22.5% | 23.2% | 25.1% |
| ***iQmethod* SM - Quality of Earnings*** | | | | | |
| Cash Realization Ratio | 1.6x | 1.2x | 2.5x | 1.0x | 1.2x |
| Asset Replacement Ratio | 9.0x | 6.1x | 6.5x | 2.5x | 1.6x |
| Tax Rate (Reported) | 14.6% | 17.0% | 20.0% | 13.3% | 8.2% |
| Net Debt-to-Equity Ratio | 44.6% | 46.2% | 28.1% | 22.2% | 2.6% |
| Interest Cover | 11.6x | 12.7x | 15.8x | 22.2x | 24.7x |
| **Key Metrics** | | | | | |

* For full definitions of *iQmethod* SM measures, see page 10.

## Company Description

India's largest petchem and second largest refining company, Reliance, owns a 660kbpd refinery. Along with RPL, its total refining capacity would be 1.2mbpd by 2009. It also has a 900ktpa cracker, 1mtpa polyester, 1.9mtpa polymer and over 3mtpa of fibre intermediate capacities. Refining contributes 55% to revenues with petchem contributing 43%. The company has discovered gas with initial inplace reserves of 35tcf on the East Coast.

## Chart 1: RIL's FY09E EBIT breakdown




Source: DSP Merrill Lynch

## Stock Data

| | |
|---|---|
| Shares / GDR | 2.00 |
| Price to Book Value | 0x |

# RIL's options on RPL investment

## Chevron stake hike in RPL appears unlikely

### RIL's sold 4% stake in RPL; its stake down to 71% from 75%

RPL was formed by RIL in end-2005. RIL held 75% equity stake in RIL after its IPO in April 2006. International oil major Chevron also holds 5% equity stake in RPL with balance 20% being with minority shareholders. In November 2007 RIL sold 4.01% of its equity stake in RPL in the Indian stock exchanges on which it was listed. Following this sale RIL's stake in RPL has declined to 71% and minority shareholding is up to 24%. Chevron continues to hold 5% stake in RPL.

## Chevron has option to buy 24% stake in RPL from RIL

### Stake hike if RPL-Chevron crude supply & product offtake agreement

Chevron has an option to hike its stake in RPL to 29% by buying 24% stake from RIL. Chevron's raising stake in RPL is dependant on whether Chevron and RPL sign

- 10-year crude supply agreement for up to 35% of spot crude purchases by RPL
- 10-year product offtake agreement for up to 45% of RPL's product slate

### Stake hike decision by July 2009 if refinery commissioned as scheduled

Chevron can hike its stake in RPL from 5% to 29% 39 months (three years and three months) after it took its 5% stake, i.e. by July 2009. Technically it could be a later date, as the other reference point is three months after the refinery has operated at 80% for 30 days. Thus, if RPL achieves this utilization rate only after April 2009, Chevron could hike its stake within three months thereof.

## RIL's stake would decline to 47% if Chevron hikes stake

### RIL's stake in RPL would decline to 47% from 71% if Chevron buys 24%

RIL's stake in RPL woul decline from the current 71% to 47% if Chevron does exercise the stake hike option. This would mean RIL would stop holding majority stake in RPL in that event.

## Probability of Chevron stake hike in RPL appears low

It appears that the probability of Chevron hiking stake in RPL is low. This impression is due to the following factors

- **24% stake hike would cost Chevron US$6bn (cost of RPL refinery):** Chevron has to buy 24% stake in RPL from RIL at 5% discount to market price if it exercises option to hike stake in RPL to 29%. It would cost Chevron almost US$6bn at current market price of RPL to hike stake therein. Cost of RPL refinery is US$6bn. Thus Chevron would be spending the cost of the entire refinery to get just 24% additional equity stake therein. This appears unlikely.

- **RIL's stake sale in RPL suggests Chevron's stake hike in unlikely:** If RIL still had 75% stake in RPL, its stake in RPL would have been 51% even if Chevron exercised 24% stake hike option. However now its stake in RPL is down to 71%. Chevron hiking stake by 24% in RPL would take RIL's stake in RPL to 47% (ie below majority). It therefore means that either RIL does not mind not holding majority stake in RPL or RIL believes probability of Chevron hiking stake in RPL is low. We think the latter is more likely.

- **RPL appears confident of sourcing crude & product sale on its own:** RPL appears confident of sourcing crude and selling products even in the US on its own. RIL's existing refinery has been sourcing crude efficiently. In fact it is one of the main factors enabling it to consistently achieve far higher margins than benchmark Singapore margins. RIL also exports a large proportion of its production having converted its existing refinery in to export oriented refinery. RIL management also confirmed at recent analyst meet they are confident of marketing RPL's products in US on their own.

## Chevron's stake will go to 0% if it does not rise to 29%

### Chevron to disinvest if no crude supply & product offtake agreement

Chevron has no intention of retaining its 5% stake in RPL if the crude supply and product offtake agreements are not signed. Chevron will sell its 5% stake in RPL back to RIL if the crude supply and product offtake agreements are not signed by

- July 2009 if the refinery has operated at 80% for 30 days before April 2009
- Three months after the refinery has operated at 80% for 30 days if this date is later than April 2009

Chevron will sell back its stake to RIL even if the refinery is not commissioned by December 2009.

# RIL's options if Chevron exits RPL

Chevron may thus not exercise option to hike stake in RPL and in fact may exit RPL. RIL in that case has several options on what it can do with its refining subsidiary RPL. The options it has in our view are

- Merge RPL with RIL
- Demerge its existing refinery and merge it with RPL
- Keep RPL as a subsidiary

## Merger of RPL with RIL most likely option in our view

### All subsidiaries of RIL have been eventually merged with it

Over the years all of RIL's subsidiaries involved in refining or petrochemicals have eventually been merged with RIL. RIL's existing refinery was in a separate company also named Reliance Petroleum (RPL). The old RPL, which started operations in FY01, was merged with RIL wef FY02. RIL acquired petrochemical company IPCL in FY03 as a part of privatization in India. IPCL was merged with RIL in FY07. Even in the past several petrochemical companies either promoted by RIL or acquired by it have eventually been merged with RIL

### RPL shareholders to benefit from merger in the longer term

We believe that RPL shareholders would benefit in the longer term from merger with RIL. We believe that this gain would be due to

- **Gains from upside in E&P, retail and SEZ:** RPL shareholders gaining from upsides from RIL's E&P business after merger. We see strong value accretion in RIL's E&P business as it explores large unexplored acreage in highly prospective areas that it has. Possibly they would even gain from upsides in RIL's diversification in to organized retail and SEZs.

- **Secular rise more likely in RIL's earnings:** A secular rise in RIL's earnings is more likely than in RPL's earnings. There has been a secular rise in RIL's earnings since its inception in 1964. RIL's earnings decline in any one business is neutralized by strong growth in other businesses. This is unlikely in RPL as its earnings would mainly be from refining.

## Two other options of dealing with RPL unlikely

We believe that the options of demerging RIL's existing refinery or keeping RPL as a subsidiary are unlikely to be exercised. This is because in the longer term both options would mean the refining business would be hurt by lack of secular earnings rise. The shareholders of the refining business would also be deprived from other businesses of RIL like E&P, SEZ and organized retail.

## Impact of RIL and RPL merger on RIL's earnings

The two key issues, which will determine whether RIL-RPL merger is earnings accretive or not for RIL shareholders, are

- What is the swap ratio for RIL-RPL merger?
- Whether RIL's entire stake in RPL is cancelled on merger or are a part or entire holding converted into treasury shares?

### Two potential scenarios of swap ratio considered

We have considered two potential scenarios of swap ratios for the RIL-RPL merger. These two scenarios of swap ratio are

- **12:1 based on market price:** Swap ratio in ratio of RIL-RPL's current share price. It works out to around one share of RIL for 12 shares of RPL (ie 12:1)
- **20:1 based on fair value:** Swap ratio in ratio of our fair value of RIL and RPL. It works out to around one share of RIL for 20 shares of RPL (ie 20:1). Our fair value estimate of RIL is Rs2,894/share and that of RPL is Rs143/share.

### RIL-RPL merger not earnings accretive in both swap ratio scenarios

Our calculations suggest that RIL-RPL merger would not be earnings accretive for RIL in both the swap ratio scenarios considered by us. In both cases we have assumed that shares held by RIL in RPL are not cancelled. Thus dilution of equity on merger is far more than it would have been if its shareholding was cancelled.

### 6-7% downside to FY09-FY10E EPS if swap ratio is 20:1

Our calculations indicate that the FY09-FY10E EPS of RIL would be 6-7% lower than our current estimates if RIL-RPL swap ratio is 20:1. Thus merger would not be earnings accretive even if the swap ratio is in line with our estimate of fair value of RIL and RPL. However note that we have assumed that RIL's holding in RPL is not cancelled.

Table 1: Impact on earnings in the event of RIL-RPL merger if swap ratio is 20:1

| Rs/share | FY09E | FY10E |
|---|---|---|
| RIL's EPS if RIL-RPL merged | 121.9 | 166.3 |
| RIL's consolidated EPS (current estimate) | 130.7 | 175.9 |
| Change | -6.7% | -5.5% |

Source: DSP Merrill Lynch

### 12-14% downside to FY09-FY10E EPS if swap ratio is 12:1

Our calculations indicate that the FY09-FY10E EPS of RIL will be 12-14% lower than our current estimates if RIL-RPL swap ratio is 12:1. Thus earnings decline is steeper if swap ratio is in line with ratio of RIL and RPL's current share price.

Table 2: Impact on earnings in the event of RIL-RPL merger if swap ratio is 12:1

| Rs/share | FY09E | FY10E |
|---|---|---|
| RIL's EPS if RIL-RPL merged | 113.1 | 154.3 |
| RIL's consolidated EPS (current estimate) | 130.7 | 175.9 |
| Change | -13.5% | -12.3% |

Source: DSP Merrill Lynch

### RIL-RPL merger would be earnings accretive if RIL's RPL stake cancelled

RIL holds 71% equity stake in RPL currently. Dilution of RIL's equity due to RIL-RPL merger would be far less if RIL's 3.2bn shares in RPL (total outstanding shares 4.5bn) are cancelled on merger. The lower equity dilution will mean that merger is earnings accretive in both the swap ratio scenarios considered by us. RIL's FY09-FY10E earnings will be 0-4% higher than current forecast on RIL-RPL merger in the two swap ratio scenarios.

Table 3: Impact on earnings in the event of RIL-RPL merger if RIL's shareholding in RPL cancelled

| | If swap ratio is 20:1 | | If swap ratio is 12:1 | |
|---|---|---|---|---|
| Rs/share | FY09E | FY10E | FY09E | FY10E |
| RIL's EPS if RIL-RPL merged | 133.6 | 182.4 | 130.4 | 177.9 |
| RIL's consolidated EPS (current estimate) | 130.7 | 175.9 | 130.7 | 175.9 |
| Change | 2% | 4% | 0% | 1% |

Source: DSP Merrill Lynch

## Impact of RIL and RPL merger on RIL's fair value

RIL-RPL merger would also impact RIL's fair value. Merger would mean RPL's entire refinery would have to be included in RIL's fair value. Currently only 71% of RPL's equity value is considered when we value RIL's stake in RPL. RIL and RPL merger would however mean dilution of RIL's equity.

### RIL-RPL's merger would mean 2-4% decline in fair value

In both the swap ratio scenarios considered by us, RIL's fair value on merger with RPL would be lower than its current fair value. We estimate the downside to fair value is 2% if swap ratio is 20:1 and 4% if swap ratio is 12:1.

Table 4: Impact on RIL's fair value if RPL merged with RIL

| Rs/share | Swap ratio - 20:1 | Swap ratio - 12:1 |
|---|---|---|
| RIL's fair value | | |
| If RIL-RPL merged | 2,847 | 2,769 |
| Currently | 2,894 | 2,894 |
| Change | -2% | -4% |

Source: DSP Merrill Lynch

## Likely time of RIL-RPL merger

### RIL-RPL merger unlikely before Chevron exits (likely by July 2009) RPL

A crucial question would be if RIL and RPL are indeed merged, what is the likely time of such a merger? We believe that a merger is likely only after Chevron exits RPL. This is because given the stake hike option Chevron has in RPL, RIL-RPL merger is unlikely until Chevron exits RPL. Chevron has until July 2009 to decide whether to hike stake in RPL. Thus RIL-RPL merger appears likely only after July 2009.

### RIL's fair value likely to rise and RPL's share price decline by July 2009

As discussed RIL-RPL merger is likely after July 2009. By July 2009 RIL's fair value is likely to increase due to further reserve accretion in the E&P business. Further progress in organized retail and SEZ diversification could mean upgrade in fair value of these businesses of RIL. On the other hand the upturn in refining may be nearing its end. We expect Singapore refining margins to decline by 6-10% YoY during FY09-FY11E. The share price of RPL, which is mainly exposed to refining outlook, is thus likely to decline closer to its fair value (Rs143/share) from its current share price (Rs227).

Table 5: Singapore and RPL refining margin forecast

| US$/bbl | FY09E | FY10E | FY11E |
|---|---|---|---|
| Singapore complex refining margins | 8.4 | 7.5 | 6.8 |
| RPL refining margins | 14.7 | 13.4 | 12.2 |
| | | | |
| YoY change | | | |
| Singapore complex refining margins | -6% | -10% | -10% |
| RPL refining margins | NA | -9% | -8% |

Note: YoY change not applicable for RPL in FY09 as it is the first year of commercial operations

Source: DSP Merrill Lynch

### RIL-RPL swap ratio may be earnings and value accretive by July 2009

By July 2009 the swap ratio is likely to be far more favorable to RIL's shareholders than it currently is based on RIL and RPL's share price. Thus RIL-RPL merger after July 2009 may well be value accretive and earnings accretive without having to cancel RIL's stake in RPL.

## E&P business demerger unlikely

### E&P business will not be earning and value accretive

There has been expectation among some investors that RIL may hive off its E&P business in to a separate company. We believe that this is unlikely as E&P business demerger would not be earnings and value accretive.

### MAT at 10% on E&P profits will have to be paid if demerged

This is mainly due to the fact that minimum alternate tax (MAT) will have to be paid at 10% on book profits during the seven-year income tax holiday. RIL would not have to pay any income tax on E&P profits if it is not demerged. This is because tax on RIL's taxable businesses is likely to be higher than MAT rate of tax on its profit from all businesses.

### 7% downside to E&P valuation and 2-4% to earnings if E&P demerged

Having to pay income tax at MAT rate of 10% on its E&P profits in case of demerger would mean 7% downside to RIL's E&P valuation. RIL's E&P valuation would work out to Rs1,287/share as against Rs1,387/share if E&P business is not demerged. RIL's FY09-FY10E earnings would also be 2-4% lower than current forecast if E&P business is demerged, on our forecasts.

Table 6: Impact on RIL's earnings if E&P business demerged

| | FY09E | FY10E |
|---|---|---|
| RIL's EPS if E&P demerged | 127.9 | 169.0 |
| RIL's EPS if E&P not demerged - current estimate | 130.7 | 175.9 |
| Change | -2% | -4% |

Source: DSP Merrill Lynch

Table 7: Impact on RIL's E&P valuation if E&P business demerged

| Rs/share | |
|---|---|
| E&P valuation if E&P demerged | 1,287 |
| E&P valuation if E&P not demerged | 1,387 |
| % impact | -7% |

Source: DSP Merrill Lynch

### Strategic investors unlikely to pay as aggressively as our E&P valuation

If RIL demerges its E&P business in to a separate company it is likely that it would divest part stake to a strategic investor. 53% (US$23.7bn out of US$44.8bn) of our E&P valuation is exploration upside. Most of this is upside from blocks or prospects in existing blocks, which have not yet been drilled in. We do not expect any strategic investor being ready to pay so much for exploration upside from undrilled blocks and prospects.

## Retain Buy on RIL; Switch from RPL to RIL

We expect RPL to be merged with RIL with the merger likely after July 2009. Until then we believe that RIL is a better investment for investors than RPL. RIL's fair value is likely to gradually rise over the next few years. The main drivers of the rise are likely to be rise in reserves in the E&P business and further progress in organized retail and SEZ. RPL's share price on the other hand is likely to decline from current levels and move closer to its fair value (Rs143/share). Refining cycle peaking and then moving in to a downturn is the likely driver of this correction. We therefore reiterate a switch from RPL (RPLUF; Rs227; C-3-7; Sell) to RIL (XRELF; Rs2823; B-1-7; Buy, PO: Rs2,894).

# Price objective basis & risk

## Reliance Industries (XRELF)

RIL's price objective on a sum-of-the-parts basis works out to Rs2,894/share. The value of the core refining and petrochemical business has been calculated on DCF. The value of its investment in Reliance Petroleum is calculated upon the DCF value of RPL and by applying it to RIL's holding in RPL. We have a scenario-based valuation approach for valuing RIL's stake in RPL, with equal weighting being given to each of the four scenarios assumed. RIL's oil and gas reserves and resources are also valued on a DCF basis. RIL's Retail business is also calculated on a DCF basis.

Table 8: RIL's sum-of-the-parts valuation

| INR/share | Valuation measure used | Valuation | | |
|---|---|---|---|---|
| Business/Investment | | USDbn | Rs-bn | Rs/share |
| Petrochemicals | DCF | 16.6 | 705 | 514 |
| Refining & Marketing | DCF | 16.4 | 698 | 509 |
| Value of investment in RPL (Rs164/share) | DCF | 12.3 | 525 | 382 |
| Exploration & production | DCF | 44.8 | 1,903 | 1,387 |
| Retail | DCF | 3.3 | 140 | 102 |
| Sum of parts valuation | | 93.4 | 3,971 | 2,894 |
| | | | | |
| No of shares (excluding treasury shares) | | | | 1,372 |

Source: DSP Merrill Lynch

### Risks

Significant weakening in refining and petrochemical margins even below our expectation is a risk to our price objective. Such a decline in margins is more likely to be triggered by negative surprises on demand rather than supply. As discussed, our refining margin forecasts assume almost all possible refinery projects coming up. Large disappointments on the E&P front could be another risk to our price objective. We have valued even resources and exploration upside. Failure in the retail business would also be another risk to our valuation

# Analyst Certification

I, Vidyadhar Ginde, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

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### *iQmethod* SM Measures Definitions

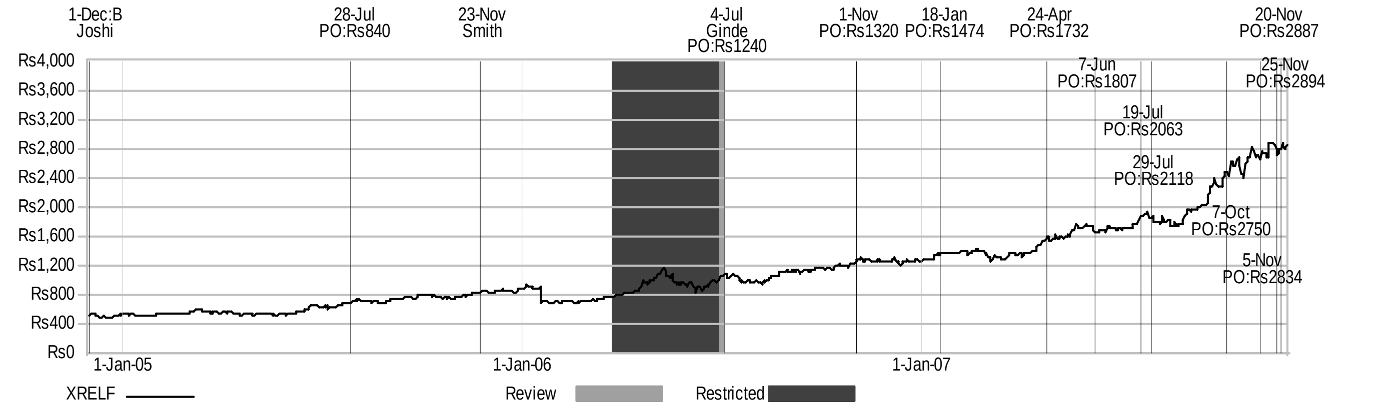
| Business Performance | Numerator | Denominator |
|---|---|---|
| Return On Capital Employed | NOPAT = (EBIT + Interest Income) * (1 - Tax Rate) + Goodwill Amortization | Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill Amortization |
| Return On Equity | Net Income | Shareholders' Equity |
| Operating Margin | Operating Profit | Sales |
| Earnings Growth | Expected 5-Year CAGR From Latest Actual | N/A |
| Free Cash Flow | Cash Flow From Operations – Total Capex | N/A |
| **Quality of Earnings** | | |
| Cash Realization Ratio | Cash Flow From Operations | Net Income |
| Asset Replacement Ratio | Capex | Depreciation |
| Tax Rate | Tax Charge | Pre-Tax Income |
| Net Debt-To-Equity Ratio | Net Debt = Total Debt, Less Cash & Equivalents | Total Equity |
| Interest Cover | EBIT | Interest Expense |
| **Valuation Toolkit** | | |
| Price / Earnings Ratio | Current Share Price | Diluted Earnings Per Share (Basis As Specified) |
| Price / Book Value | Current Share Price | Shareholders' Equity / Current Basic Shares |
| Dividend Yield | Annualised Declared Cash Dividend | Current Share Price |
| Free Cash Flow Yield | Cash Flow From Operations – Total Capex | Market Cap. = Current Share Price * Current Basic Shares |
| Enterprise Value / Sales | EV = Current Share Price * Current Shares + Minority Equity + Net Debt + Other LT Liabilities | Sales |
| EV / EBITDA | Enterprise Value | Basic EBIT + Depreciation + Amortization |

*iQmethod* SM is the set of Merrill Lynch standard measures that serve to maintain global consistency under three broad headings: Business Performance, Quality of Earnings, and validations. The key features of iQmethod are: A consistently structured, detailed, and transparent methodology. Guidelines to maximize the effectiveness of the comparative valuation process, and to identify some common pitfalls.

*iQdatabase* ® is our real-time global research database that is sourced directly from our equity analysts' earnings models and includes forecasted as well as historical data for income statements, balance sheets, and cash flow statements for companies covered by Merrill Lynch.

# Important Disclosures

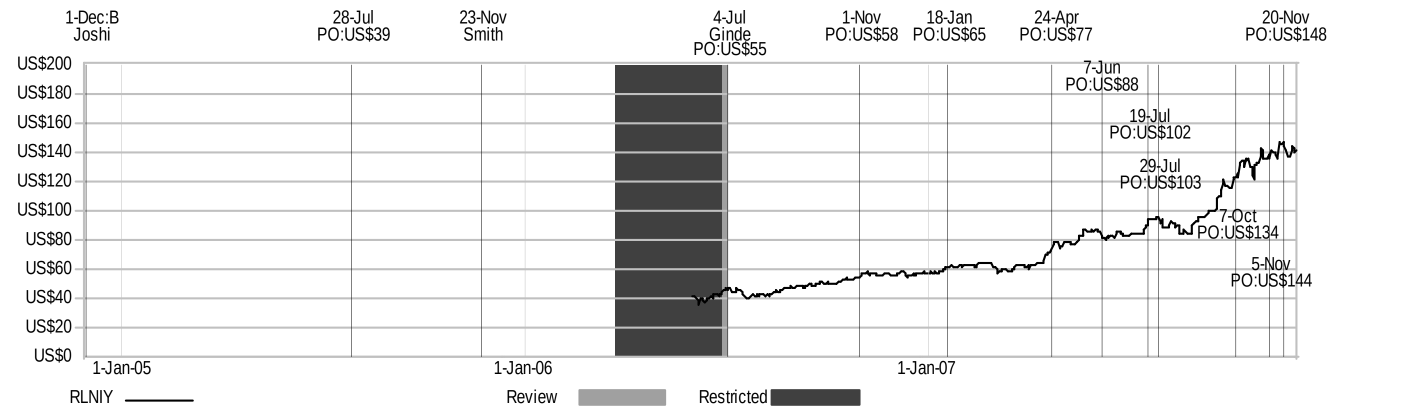
## XRELF Price Chart




B : Buy, N : Neutral, S : Sell, PO : Price objective, NA : No longer valid

The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark Grey shading indicates the security is restricted with the opinion suspended. Light Grey shading indicates the security is under review with the opinion withdrawn. Chart current as of November 30, 2007 or such later date as indicated.

## RLNIY Price Chart

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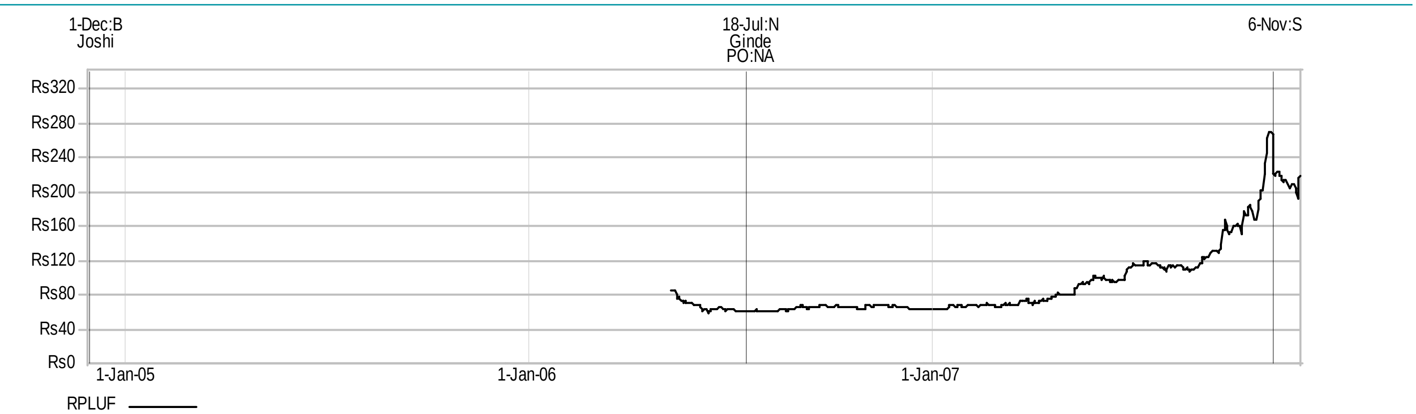
## RPLUF Price Chart




B : Buy, N : Neutral, S : Sell, PO : Price objective, NA : No longer valid

The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark Grey shading indicates the security is restricted with the opinion suspended. Light Grey shading indicates the security is under review with the opinion withdrawn. Chart current as of November 30, 2007 or such later date as indicated.

Investment Rating Distribution: Chemicals Group (as of 01 Oct 2007)

| Coverage Universe | Count | Percent | Inv. Banking Relationships* | Count | Percent |
|---|---|---|---|---|---|
| Buy | 54 | 61.36% | Buy | 7 | 14.29% |
| Neutral | 27 | 30.68% | Neutral | 9 | 39.13% |
| Sell | 7 | 7.95% | Sell | 0 | 0.00% |

Investment Rating Distribution: Energy Group (as of 01 Oct 2007)

| Coverage Universe | Count | Percent | Inv. Banking Relationships* | Count | Percent |
|---|---|---|---|---|---|
| Buy | 130 | 50.19% | Buy | 43 | 39.45% |
| Neutral | 110 | 42.47% | Neutral | 27 | 28.13% |
| Sell | 19 | 7.34% | Sell | 3 | 16.67% |

Investment Rating Distribution: Global Group (as of 01 Oct 2007)

| Coverage Universe | Count | Percent | Inv. Banking Relationships* | Count | Percent |
|---|---|---|---|---|---|
| Buy | 1701 | 47.03% | Buy | 437 | 29.15% |
| Neutral | 1611 | 44.54% | Neutral | 425 | 29.11% |
| Sell | 305 | 8.43% | Sell | 58 | 21.09% |

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