Company

23 August 2010 | 26 pages

Reliance Industries (RELI.BO)

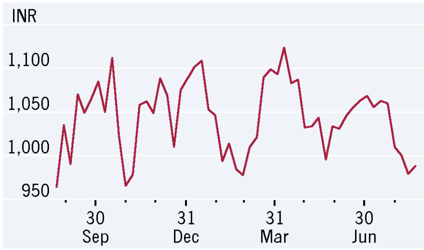
Equity ☑
Rating change ☑

Upgrade to Buy: Cyclical Risks Priced In; Structural Gas Rewards Not

- **Weak cyclical outlook reflected in under-performance** — After a 15% YTD under-performance vs. the market, we believe the unexciting refining/petchem outlook is largely priced in and reflected in RIL's valns that now stand at a 3-year low relative to Sensex. However, structural changes we see in the rapidly developing Indian gas market could provide the trigger for stock performance from a 6-9 month perspective, driving our upgrade to Buy, while maintaining our TP and estimates.
- **Stock trading closer to bear-case value** — RIL now trades close to our bear-case value of Rs930/sh (5% downside from current levels), offering attractive risk-reward. Our bear-case value is based on an avg of: (1) our bear-case SOTP that assumes lower GRMs of US$8.0/8.5 over FY11/12E, steeper yoy petchem EBITDA declines of 12/7% over the same period, and E&P valued at Rs364/sh, a moderate 15% premium to NAV, and (2) our bear-case P/E-based valn methodology that assumes 8-14% lower earnings over FY11-12E and a lower 14x Sep-11E multiple.
- **Structural changes in gas sector** — Following recent, higher prices set by the Gov't for ONGC's production from new fields (US$4.75-5.25), we expect gas prices from other domestic sources (e.g. KG) to also structurally move higher driven by: 1) cheap domestic gas (vs. expensive LNG) remaining scarce, with growth back-ended, 2) demand continuing to substantially exceed supply, 3) increasing acceptability of higher priced LNG (e.g. NTPC). Customers, however, will continue to benefit, with economics vs. naphtha/FO still remaining extremely compelling.
- **US$4.2 now a base price...possible price surprise?** — Post the APM price hike, US$4.2 is now a base price level of domestic gas, with gas from all other sources (ex-KG) now priced higher (Figure 15). With rising E&P costs and demand for higher prices to exploit new/marginal fields, there exists a case for the benchmark to move higher. Given the Government's recent moves, we believe any willingness on its part to implement higher prices for incremental KG production (possibly over the next 6-9 months) could lead to reserve value enhancements and potential earnings upsides (~3-5%) for RIL, driving stock performance.

Buy/Low Risk	**1L**
from Hold/Low Risk	
Price (23 Aug 10)	Rs976.40
Target price	Rs1,140.00
Expected share price return	16.8%
Expected dividend yield	0.7%
Expected total return	**17.5%**
Market Cap	Rs3,193,961M
	US$68,518M

Price Performance (RIC: RELI.BO, BB: RIL IN)



Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2009A	156,372	47.59	-9.3	20.5	2.5	15.2	0.7
2010A	162,360	49.65	4.3	19.7	2.3	12.3	0.7
2011E	213,746	65.36	31.6	14.9	2.1	14.7	0.8
2012E	242,062	74.02	13.2	13.2	1.9	14.9	1.0
2013E	275,235	84.16	13.7	11.6	1.7	15.2	1.0

Source: Powered by dataCentral

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

Fiscal year end 31-Mar	2009	2010	2011E	2012E	2013E
Valuation Ratios					
P/E adjusted (x)	20.5	19.7	14.9	13.2	11.6
EV/EBITDA adjusted (x)	14.3	11.3	8.3	7.3	6.1
P/BV (x)	2.5	2.3	2.1	1.9	1.7
Dividend yield (%)	0.7	0.7	0.8	1.0	1.0
Per Share Data (Rs)					
EPS adjusted	47.59	49.65	65.36	74.02	84.16
EPS reported	47.59	49.65	65.36	74.02	84.16
BVPS	384.63	419.43	468.79	522.81	586.97
DPS	6.50	7.00	8.00	10.00	10.00
Profit & Loss (RsM)					
Net sales	1,418,475	1,924,610	2,502,329	2,531,263	2,609,257
Operating expenses	-1,233,593	-1,723,770	-2,228,712	-2,231,309	-2,280,784
EBIT	**184,882**	**200,840**	**273,618**	**299,954**	**328,473**
Net interest expense	-17,450	-19,970	-23,231	-19,471	-15,471
Non-operating/exceptionals	20,180	24,600	17,184	19,851	25,152
Pre-tax profit	**187,612**	**205,470**	**267,571**	**300,334**	**338,154**
Tax	-31,240	-43,110	-53,825	-58,272	-62,920
Extraord./Min.Int./Pref.div.	0	0	0	0	0
Reported net income	**156,372**	**162,360**	**213,746**	**242,062**	**275,235**
Adjusted earnings	156,372	162,360	213,746	242,062	275,235
Adjusted EBITDA	236,835	305,810	414,771	456,375	515,327
Growth Rates (%)					
Sales	6.3	35.7	30.0	1.2	3.1
EBIT adjusted	5.8	8.6	36.2	9.6	9.5
EBITDA adjusted	6.1	29.1	35.6	10.0	12.9
EPS adjusted	-9.3	4.3	31.6	13.2	13.7
Cash Flow (RsM)					
Operating cash flow	**389,112**	**146,624**	**287,049**	**405,872**	**461,086**
Depreciation/amortization	51,953	104,970	141,153	156,421	186,854
Net working capital	180,787	-120,706	-67,851	7,389	-1,002
Investing cash flow	**-866,494**	**-93,310**	**-141,988**	**-162,361**	**-144,660**
Capital expenditure	-896,927	-93,310	-141,988	-162,361	-144,660
Acquisitions/disposals	15,485	0	0	0	0
Financing cash flow	**655,505**	**-47,652**	**-146,248**	**-165,557**	**-171,883**
Borrowings	329,060	-114,057	-88,000	-100,000	-100,000
Dividends paid	-22,118	-49,248	-59,652	-74,564	-74,564
Change in cash	**178,123**	**5,662**	**-1,187**	**77,954**	**144,544**
Balance Sheet (RsM)					
Total assets	**2,457,057**	**2,510,065**	**2,506,619**	**2,593,966**	**2,713,777**
Cash & cash equivalent	231,659	218,902	210,702	285,576	433,042
Accounts receivable	45,714	116,602	120,049	123,094	129,914
Net fixed assets	1,693,869	1,653,987	1,654,821	1,660,761	1,618,568
Total liabilities	**1,193,327**	**1,138,358**	**973,492**	**884,185**	**794,168**
Accounts payable	147,824	272,381	139,844	122,863	126,048
Total Debt	738,821	624,764	536,764	436,764	336,764
Shareholders' funds	**1,263,730**	**1,371,706**	**1,533,127**	**1,709,781**	**1,919,608**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	16.7	15.9	16.6	18.0	19.7
ROE adjusted	15.2	12.3	14.7	14.9	15.2
ROIC adjusted	11.8	9.3	12.2	12.8	14.1
Net debt to equity	40.1	29.6	21.3	8.8	-5.0
Total debt to capital	36.9	31.3	25.9	20.3	14.9

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Contents

Upgrade to Buy: Cyclical Risks Priced In; Structural Gas Rewards Not

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After 15% YTD under-performance vs. the broader market, we upgrade RIL from Hold to Buy, maintaining our Rs1,140 target price. We believe the lackluster outlook for the refining and petchem businesses and delayed ramp up of KG gas is largely priced in and reflected in RIL's valuations that now stand at a 3-year low relative to Sensex. On the other hand, any indications of a price increase for KG gas, which we believe is quite possible given recent developments in the Indian gas sector, could be a positive surprise and a much-needed driver of stock performance. The government has recently raised prices for ONGC's production from new fields to US$4.75-5.25, and KG gas price of US$4.2 is now at the lowest end of gas prices from various sources in the country. Any willingness on the government's part to implement higher prices for incremental KG production (possibly over the next 6-9 mths) could lead to enhancement in the value of KG reserves and potential earnings upsides (~3-5%) and, more critically, drive stock performance. Such a move is also unlikely to be met with any major resistance from consumers, with demand for gas far outstripping supply, and with economics vis-à-vis alternatives such as LNG and naphtha/FO still being extremely compelling. RIL now also trades close to our bear-case value of Rs930/sh (5% downside from current levels), offering favourable risk-reward. We maintain our target price of Rs1,140, which is based on an average of our sum-of-the-parts and P/E values.

Bear-case valuation provides downside support

Our bear-case value of Rs930/sh (5% below CMP) provides downside support and improves risk-reward from current levels. Our bear-case value is based on average of SOTP (Figure 2) and 14x Sep-11E P/E (vs. 15x used for our target price) on earnings that are 8-14% lower than our current estimates.

Figure 1. RIL – Bear case value of Rs930/share

	Rs/share
SOTP (see Figure 2)	905
14x P/E (Sep-11E; EPS ex-treasury = Rs68.5)	958
Average	932
Shale Gas NPV	-
Bear case value	**932**

Source: Citi Investment Research and Analysis

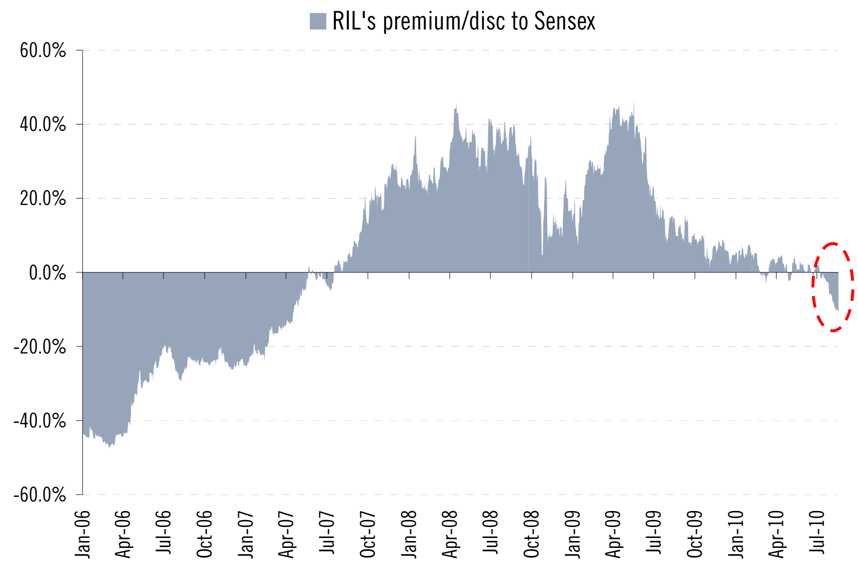
Figure 2. RIL – Bear-case Sum-of-the-parts Valuation

	Rs m	Rs/share	Comments
Sep-11E EBITDA forecast (Rs m)	241,095		For refining and petrochem (8% below current estimates) – GRMs of US$8.0/8.5 in FY11/12E; yoy petchem decline of 12/7% in FY11/12E
EV of Petrochem & Refining (Rs m) - (a)	1,687,667	516	@ EV/E of 7x mid-FY12E
Net Debt (Rs m) - (b)	291,486	89	Estimated as on Sep-10E consolidated for treasury sale cash
Key investments			
-E&P Assets	1,189,359	364	15% premium to NAV assuming 60/70 mmscmd over FY11/12E (compares to 43% premium and 63/80 in our current value of Rs464/sh)
- Organised Retail	96,838	30	Based on BV of investments so far into organised retail, SEZ, etc.
Total value of investments & other assets - (c)	1,286,196	393	
Value of Treasury stock - (d)	277,815	85	307m treasury shares at target price
Value for Equity holders (Rs m) - (a-b+c+d)	2,960,192	**905**	
No. of shares (m.)	3,270		Incl. treasury stock

Source: Citi Investment Research & Analysis estimates

RIL's valuations relative to the Sensex are now at a three-year low

Figure 3. RIL – Historical valuation premium/discount vs. Sensex



Source: Citi Investment Research and Analysis

Gas price surprise? ~3-5% potential earnings upside

As we explain in more detail in the following chapter titled, *'Gas Prices On The Rise'*, there exists a possibility, in our view, of the government expressing its willingness to implement higher price for KG gas. If the government approves a US$1 higher price for incremental production from KG-D6 (i.e., current production of 60 mmscmd for which gas sales agreements are already in place to remain priced at US$4.2), there could be ~3-5% upside to our earnings over FY12-13E. More importantly, a higher gas price could lead to expectations of RIL accelerating development of its KG and other reserves (the US$4.2 price is fixed only for D6 production; RIL has reportedly sought higher gas prices from other fields – see Figure 16) and ramping up D6 gas production, which is now stalled at 60 mmscmd. Pipeline capacities in India are currently constrained, preventing an immediate ramp-up in vols, though GAIL's DVPL/GREP expansions are set to be completed by Apr-11E, adding ~54 mmscmd capacity (of which ~11 mmscmd is to be commissioned by Oct-10E).

Having said that, it is pertinent to note that we assume a price of US$4.2 for all KG gas produced given: (i) as per the EGoM decision in 2007, a price of US$4.2 was fixed for upto 80 mmscmd of gas produced from KG-D6 for a period of 5 years from commencement of production (Apr-09) and (ii) uncertainty on the government's future actions on gas pricing which are difficult to predict and where a fair degree of subjectivity would be involved. However, even if the willingness by the government to increase gas prices may not have an immediate impact on RIL's near-term earnings, it could lead to enhancements in the value of its reserves and consequently its E&P business.

E&P – robust pipeline

- As per a recent Hardy Oil filing (10% stake in D3), RIL has recommenced drilling of its W1 well in KG-D3, after drilling was suspended in May following a problem with the rig. Three discoveries have already been made in the block. In addition, it plans to drill two more wells in the block in 1Q and 3QCY11 and plans to submit a proposal of commerciality by Feb-11.
- In NEC-25, RIL is in the midst of a drilling campaign in the southern and deeper part of the block (six successful appraisal wells so far). Though the company previously submitted a development plan for discoveries in the northern part, it may submit an integrated development plan for all discoveries after the current drilling programme is complete.
- With limited success in the KG-D9 block so far (the first well was plugged and abandoned in Oct'09), RIL is launching drilling of three further exploration wells in the block starting 4QCY10 after incorporating data from the earlier well.
- In the highly prospective MN-D4 block, a three well drilling programme is expected to commence in 1QCY11.
- In addition, appraisal activities are also underway in other blocks where the company has made discoveries such as KG-D4, CY-D5, etc.
- Lastly, the petroleum ministry recently sanctioned a three-year rig moratorium from Jan-08 to Dec-10, as per which unfinished exploratory and appraisal drilling commitments in all blocks awarded before or during the NELP-V, will be excused by the petroleum ministry. Currently, RIL has three deepwater rigs under operation, with one more expected in 2HFY11.

Figure 4. RIL – Exploration pipeline

Block	Activity	Ownership
KG-D6	-Drilling to be continued throughout FY11 and FY12; -Near-term to drill two more wells as part of D1 and D3 field-development plan	RIL (90%), Niko (10%)
NEC-25	-The NEC-25 Block has nine natural gas discoveries in the northern part of the block and six discoveries in the southern AJ area; -Five of the six discoveries within the AJ area were drilled since March 31, 2009; -One well is currently being drilled (as of Jun-10), three more wells to be drilled in the AJ area (one each in the remaining 3 quarters of FY11); -Once appraisal drilling is concluded, the company may submit an integrated development plan to the government; -A development plan was previously submitted for six of the discoveries.	RIL (90%), Niko (10%)
KG-D3	-To complete drilling of W1 exploration well during 3QCY10; -Drilling of two additional exploration wells is being planned (in 1QCY11 and 3QCY11); -Appraisal of Dhirubhai 39 and 41gas discoveries will continue; -A proposal of commerciality is planned for submission by Feb'11.	RIL (90%), Hardy (10%)
KG-D9	-The first exploration well, A1 was plugged and abandoned in Oct'09; - The first of 3 further exploration wells in the north-western portion of the block expected to commence drilling in 4QCY10, other 2 wells to follow in 2QCY11 and 4QCY11.	RIL (90%), Hardy (10%)
GS-OSN-2000/1	-In May 2010, submitted a proposal to DGH for DoC for the Dhirubhai 33 gas discovery; -Following acceptance of the commerciality proposal, a development plan will be prepared and submitted to DGH.	RIL (90%), Hardy (10%)
MN-D4	3 wells have been planned in 4QFY11, 2QFY12, and 4QFY12	RIL (85%), Niko (15%)
AS-ONN-2000/1	1 well to be drilled in 3QCY11	RIL (90%), Hardy (10%)
KG-D4, CY-D5, KG-III-5, KG-III-6	Appraisal activities are currently underway	RIL (100%) in all 4 blocks

Source: Company Reports, Hardy Oil, Niko Resources, Economic Times

Figure 5. RIL – Past discoveries

Year	Block	Discovery	Oil / Gas	Ownership
FY08	KG-DWN-98/3 (KG-D6)	Well R1	Gas	RIL (90%), Niko (10%)
FY08	GS-OSN-2000/1	Well B1	Gas	RIL (90%), Hardy (10%)
FY08	CY-DWN-2001/2 (CY-III-D5)	Well A1	Oil+Gas	RIL (100%)
FY08	KG-DWN-98/1 (KG-D4)	Well MD1	Oil	RIL (100%)
FY08	KG-OSN-2001/1 (KG-III-5)	Wells P1 and J1	Gas	RIL (100%)
FY08	KG-DWN-2003/1 (KG-V-D3)	Well A1	Gas	RIL (90%), Hardy (10%)
FY08	NEC-OSN-97/2 (NEC-25)	Well J1	Gas	RIL (90%), Niko (10%)
FY09	KG-DWN-2003/1 (KG-V-D3)	Well B1	Gas	RIL (90%), Hardy (10%)
FY09	KG-DWN-98/3 (KG-D6)	Well L1	Gas	RIL (90%), Niko (10%)
FY10	KG-DWN-2003/1 (KG-V-D3)	Well R1	Gas	RIL (90%), Hardy (10%)
FY10	CB-ONN-2003/1	Well AA1	Oil	RIL (100%)
		Well BF1	Oil	
		Well AH1	Oil	
FY11TD	CB-ONN-2003/1	Well AF1	Oil	RIL (100%)
		Well AJ1	Oil	
		Well AT1	Oil	
		Well AN1	Oil	

Source: Company Reports

Our target price remains at Rs1,140; maintaining estimates

Figure 6. RIL – TP of Rs1,140/share

	Rs/share
SOTP (see Figure 7)	1,069
15x P/E (Sep-11E, EPS ex-treasury = Rs80.2)	1,154
Average	1,111
Shale Gas NPV	30
Target Price	**1,141**

Source: Citi Investment Research and Analysis estimates

Figure 7. RIL – Sum-of-the-parts Valuation

	Rs m	Rs/share	Comments
Sep-11E EBITDA forecast (Rs m)	262,369		For refining and petrochem
EV of Petrochem & Refining (Rs m) - (a)	1,836,580	562	@ EV/E of 7x mid-FY12E
Net Debt (Rs m) - (b)	281,842	86	Estimated as on Sep-10E consolidated for treasury sale cash
Key investments			
-E&P Assets	1,516,599	464	@ EV/E of 8x Mar-12E (43% premium to NAV)
- Organised Retail	96,838	30	Based on BV of investments so far into organised retail, SEZ, etc.
Total value of investments & other assets - (c)	1,613,437	493	
Value of Treasury stock - (d)	328,130	100	307m treasury shares at target price
Value for Equity holders (Rs m) - (a-b+c+d)	3,496,304	**1,069**	
No. of shares (m.)	3,270		Incl. treasury stock

Source: Citi Investment Research & Analysis estimates

Figure 8. E&P – Valuation based on EV/EBITDA

	Mar-12E
NAV of known reserves (KG-D6, NEC-25,and CBM)	325
EV/EBITDA 12-mth fwd (x)	8.0
EV Mar-11E (Rs bn)	1,517
Per share value	**464**
Premium to NAV	43%

Source: Citi Investment Research and Analysis estimates

Figure 9. Asset-wise NAVs of known reserves

	Recovery assumed tcf/mmboe	2P+Best OGIP tcf/mmbo	Value US$m	EV/boe US$	Value/share Rs	Remarks
KG-D6 (Dhirubhai-1&3 + MA fields)	3,812	4,802	19,854	5.8	283	Based on DCF assuming 75% recovery from 2P+Best OGIP of 26.7 tcf
NEC-25	1.9	3.7	1,499	4.5	21	@ 50% recovery of 2P OGIP of 3.7 tcf
CBM (3P OGIP)	1.9	3.7	1,499	4.5	21	@ 50% recovery of 3P OGIP of 3.7 tcf
Total			**27,767**		**325**	

Source: Citi Investment Research and Analysis

Figure 10. Refining Margin Assumptions (US$/bbl)

	FY10	FY11E	FY12E	FY13E
Refinery throughput (MMT)	60.9	67.8	67.8	67.8
RIL GRMs	$6.3	$8.1	$8.9	$9.4
RPL GRMs	$7.0	$9.2	$10.0	$10.4
Merged GRMs	$6.6	$8.6	$9.5	$10.0
S'pore GRMs	$3.5	$3.8	$4.5	$4.5
Differential over S'pore GRMs	$3.1	$4.8	$5.0	$5.5

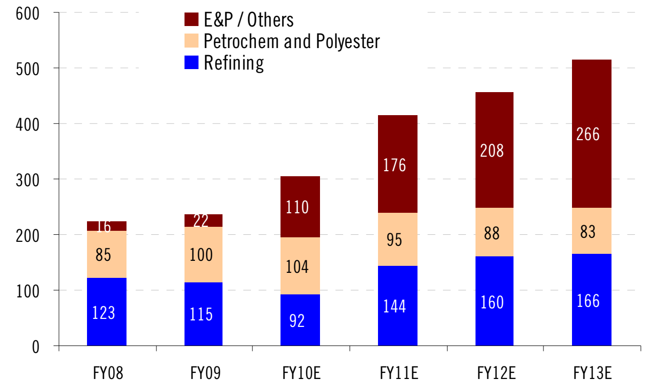
Source: Citi Investment Research and Analysis estimates

Figure 11. RIL – Petchem price and spread assumptions (US$/MT)

Year to 31-Mar	FY11E	FY12E	FY13E
PFY			
International price	1,650	1,720	1,840
PFY less MEG/PTA	590	580	587
PSF			
International price	1,270	1,340	1,470
PSF less MEG/PTA	210	200	217
PTA			
International price	910	990	1,050
PTA less PX	220	217	194
MEG			
International price	790	820	1,000
MEG less E	69	85	158
PX			
International price	1,000	1,120	1,240
PX less naphtha	295	400	445
PVC			
International price	950	960	1,040
PVC less E/EDC	375	382	421
PE			
International price	1,320	1,320	1,520
PE less E	197	176	210
PE less naphtha	615	600	725
PP			
International price	1,230	1,280	1,480
PP less P	54	83	136
PP less naphtha	525	560	685
Ethylene			
International price	1,080	1,100	1,260
Ethylene less naphtha	375	380	465
Propylene			
International price	1,120	1,140	1,280
Propylene less naphtha	415	420	485
Naphtha			
International price	705	720	795

Source: Citi Investment Research and Analysis estimates

Figure 12. RIL – Segmental EBITDA break-up (Rs bn)



Source: Citi Investment Research and Analysis estimates

Key Financials

Figure 13. RIL – Consolidated Income Statement (Rs m)

Year to 31-Mar	FY09	FY10	FY11E	FY12E	FY13E
Sales	**1,418,475**	**1,924,610**	**2,502,329**	**2,531,263**	**2,609,257**
COGS	(1,040,650)	(1,469,670)	(1,990,010)	(1,973,305)	(1,988,179)
SGA	(23,980)	(23,500)	(97,521)	(101,556)	(105,724)
Other operating costs	(117,010)	(125,630)	(27)	(27)	(27)
Total costs	(1,181,640)	(1,618,800)	(2,087,559)	(2,074,888)	(2,093,930)
EBITDA	**236,835**	**305,810**	**414,771**	**456,375**	**515,327**
Other income	20,600	24,600	17,184	19,851	25,152
Interest	(17,450)	(19,970)	(23,231)	(19,471)	(15,471)
Depreciation	(51,953)	(104,970)	(141,153)	(156,421)	(186,854)
Exceptional items	(420)	-	-	-	-
PBT	187,612	205,470	267,571	300,334	338,154
Tax	(31,240)	(43,110)	(53,825)	(58,272)	(62,920)
Tax rate	*16.7%*	*21.0%*	*20.1%*	*19.4%*	*18.6%*
PAT	156,372	162,360	213,746	242,062	275,235
EPS	**95.6**	**49.7**	**65.4**	**74.0**	**84.2**
EPS (ex-treasury shares)	**52.8**	**54.8**	**72.1**	**81.7**	**92.9**
DPS	6.5	7.0	8.0	10.0	10.0

Source: Citi Investment Research and Analysis estimates, Company Reports

Figure 14. RIL – Consolidated Balance Sheet (Rs m)

Year to 31-Mar	FY09	FY10	FY11E	FY12E	FY13E
Gross fixed assets	1,496,287	2,158,647	2,291,547	2,440,640	2,565,076
Less: Accum. depreciation	492,856	626,048	767,201	923,623	1,110,476
Net fixed assets	1,003,431	1,532,599	1,524,346	1,517,017	1,454,600
CWIP	690,438	121,388	130,476	143,744	163,968
Investments	251,519	177,371	190,307	193,536	197,089
Cash & bank balances	231,659	218,902	210,702	285,576	433,042
Accounts receivable	45,714	116,602	120,049	123,094	129,914
Inventory	148,367	269,816	255,905	254,686	257,342
Other current assets	85,929	73,386	74,835	76,314	77,822
Total current assets	280,010	459,804	450,789	454,093	465,078
Total assets	**2,457,057**	**2,510,065**	**2,506,619**	**2,593,966**	**2,713,777**
Accounts payable	147,824	272,381	139,844	122,863	126,048
Other current liabilities	179,087	96,113	96,272	96,434	96,599
Total current liabilities	326,910	368,494	236,115	219,296	222,647
Deferred tax liability	97,263	109,263	123,602	135,839	142,074
Debt	738,821	624,764	536,764	436,764	336,764
- Long-term debt	676,551	577,608	477,608	377,608	277,608
- Short-term debt	62,270	47,156	59,156	59,156	59,156
Provisions	30,333	35,837	77,011	92,286	92,684
Equity capital	16,428	32,704	32,704	32,704	32,704
Reserves & surplus	1,247,302	1,339,003	1,500,423	1,677,077	1,886,905
Shareholders' equity	1,263,730	1,371,706	1,533,127	1,709,781	1,919,608
Total liabilities	**2,457,057**	**2,510,065**	**2,506,619**	**2,593,966**	**2,713,777**

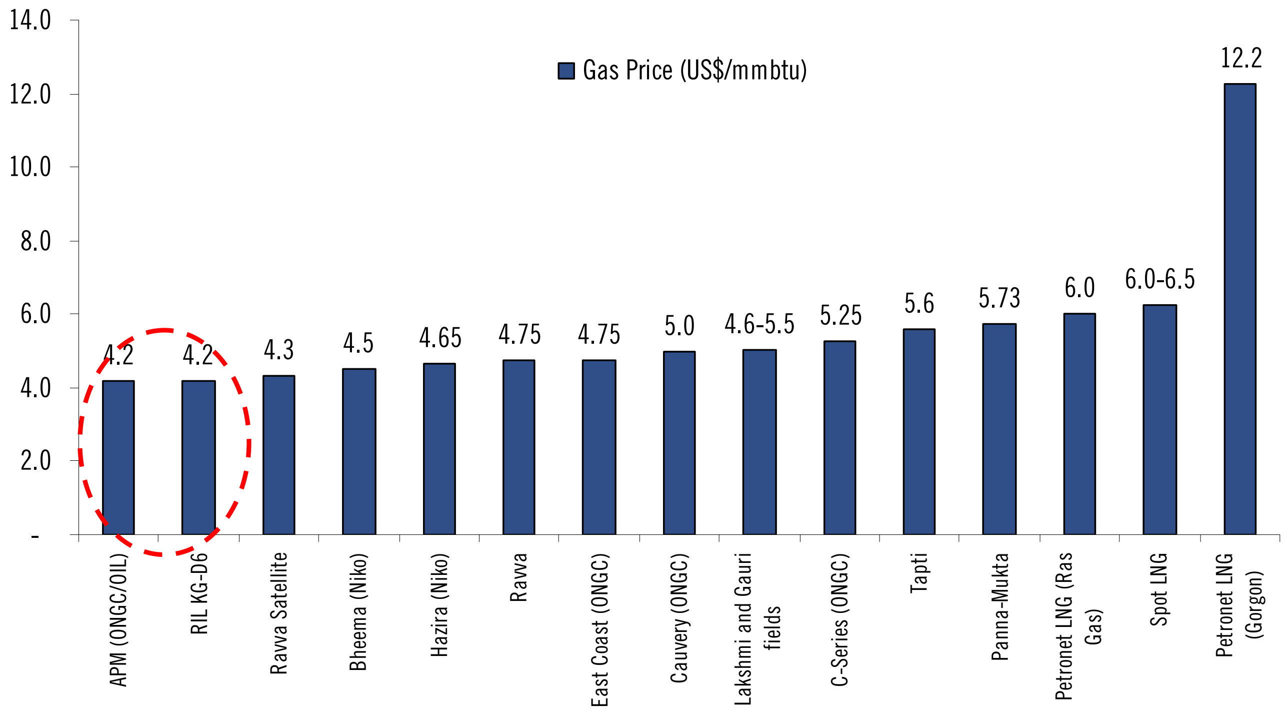
Source: Citi Investment Research and Analysis estimates, Company Reports

Gas Prices on the Rise

With commencement of production from KG-D6 in 2009, gas consumption in India has witnessed a significant uptick. While India has no uniform gas pricing in India and the government continues to set prices, with the advent of KG gas, the price of US$4.2/mmbtu has begun to emerge as a benchmark. However, with the government's recent moves approving higher prices for ONGC's production from new fields *(source: Business Standard)*, combined with the rising demand-supply gap, gas pricing in India could be structurally set to move higher.

In a bid to deregulate gas prices, the government in Jun-10 raised the price of APM (Administered Price Mechanism) gas being sold by ONGC and OIL to US$4.2/mmbtu (from ~US$2/mmbtu earlier), bringing it in line with the KG gas price. While KG and APM gas prices are set at US$4.2/mmbtu, this has now become a base level of prices in India, with prices of gas from most other sources set higher, as shown in Figure 15.

Figure 15. Gas prices prevailing in India (US$/mmbtu)



Source: Citi Investment Research and Analysis, Crisinfac, Business Line. Note: Ravva currently at US$3.5, to be revised to US$4.75. LNG prices are ex-terminal.

Gas prices set to structurally move higher

We believe that rising gas prices are here to stay driven by:

- India's increasing energy demand on the back of strong economic growth and present low consumption levels
- Lack of adequate domestic crude supplies resulting in a severe fiscal strain as the government struggles with subsidies
- India's low gas usage and better economics of natural gas/LNG vis-à-vis crude-linked alternatives such naphtha/FO

- Increasing gas demand by power, fertilizer, and industrial users and through city gas distribution (see Figure 19)
- Slower ramp-up of domestic supplies: RIL's KG gas production to remain at 60 mmscmd levels for the next few months, ONGC's KG production to come only by FY16E indicating that cheaper domestic gas is already scarce (see Figure 19)
- Increasing acceptance of higher priced LNG (NTPC's recent contract at a delivered cost of ~US$14)
- Rising costs of production and higher capex required to make gas production from new fields viable

Benchmark price of US$4.2: a revision in the offing?

The benchmark price of US$4.2/mmbtu for RIL's KG gas is valid till Mar'14; however, based on recent decisions by the government and comments by oil companies themselves, we see a case for a higher benchmark price.

Gov't has proactively raised prices in the past few months

- The government has raised APM gas prices for gas produced by ONGC and Oil India from existing fields from ~US$2/mmbtu to US$4.2/mmbtu in June this year (before this APM prices were last revised in FY06)
- In what could be viewed as a departure from the "benchmark price of US$4.2/mmbtu" (RIL's KG gas price and the APM gas price), the oil ministry has approved higher prices for ONGC's production from new fields:
  - US$4.5/mmbtu for gas from KG fields
  - US$5/mmbtu for gas from new fields in its nominated blocks in the western and northern zones
  - US$4.75/mmbtu for gas from fields in the Cauvery basin
  - Also, ONGC would get an additional US$0.25/mmbtu for gas produced from offshore fields in the above-mentioned zones (gas from C-Series in the western offshore is already priced at US$5.25/mmbtu, in-line with this new pricing arrangement).

It should be noted that this price hike is despite that unlike private players who have profit-sharing arrangements with the government through production sharing contracts (PSCs), ONGC does not share any profits with the government from its nomination blocks.

Both these decisions show an increasing willingness on the part of the government to: (1) provide a level playing field to the public sector oil companies, and (2) incentivize these companies to invest in new fields by pricing their new gas even higher. Also, with alternatives such as naphtha/FO (currently at ~US$15/mmbtu) as well as LNG (spot at ~US$6-6.5/mmbtu; long-term contracts at ~US$12/mmbtu) being priced far higher, demand is unlikely to be impacted by these pricing actions of the government.

Given this, one could potentially argue a case for RIL's US$4.2 price being revised upwards (for the incremental new production and beyond 2014 for the existing production), esp. given its higher cost of production from deepwater assets combined with profit sharing with the government. RIL has also been indicating (*source: Economic Times*) that at current gas prices, investment in new fields might not be viable.

Domestic gas prices are moving up

Below are some extracts from articles in the press, all of them indicating that either: (1) gas prices from some fields have already moved up on the back of strong demand and rising costs of production, or (2) gas prices would need to move higher from current levels to adequately incentivize both public and private players to invest in new fields.

Figure 16. Data-points indicating the rising trend of gas prices

Source	Gas Supply	Article	Comments
Domestic gas prices are moving up…			
Business Line, 11th Aug 2010	Ravva	Gas from Ravva fields in the East Coast is now likely to be priced at US$4.75/mmbtu (US$3.5/mmbtu earlier). This is in line with the price that ONGC will get for gas production from new fields in the east coast. The operator, on the other hand, had sought US$6.75/mmbtu, citing it as the "discovered price" in the region. Gas price for Ravva satellite fields, already at US$4.3/mmbtu, is also being reviewed.	
Business Standard, 1st Jul 2010	ONGC, C-Series	Gas from ONGC's C-series fields has been priced at US$5.25/mmbtu, higher than RIL's KG benchmark price.	ONGC started production from the C-series fields in 2QFY11
Business Standard, 17th May 2010	Non-APM gas	Almost all non-APM gas, barring RIL's KG gas, is now priced higher than US$4.2/mmbtu.	– PMT gas priced at US$5.7/mmbtu – Ravva Satellite at US$4.3/mmbtu (could be revised upwards) – GSPC's field development plan for its Deendayal field has been approved at a price of US$5.7/mmbtu (final selling price could be different) – ONGC's gas from new fields is now priced at US$4.75-5.25/mmbtu
Bloomberg, 6th Aug 2010	Great Eastern Energy (CBM)	Price of CBM gas from Great Eastern Energy's West Bengal block has been set at US$6.79/mmbtu, 62% higher than RIL's KG gas price	
… could move up more for future production too			
Economic Times, 10th May 2010	RIL, KG-satellite	RIL has demanded a higher gas price of US$6/mmbtu in 2014, when it brings its smaller fields in its KG-D6 block into production, stating that at the current price of US$4.2/mmbtu, production from smaller fields would be unviable.	
Indianpetro, 17th May 2010	RIL, NEC-25	RIL has also sought higher gas prices for making its discoveries in the NEC-25 block viable. As per the company's commerciality report, production from the field would be commercially viable only at US$6/mmbtu (at current reserves). If there was even a 10% downward revision in reserves, the break-even price could move up to US$7/mmbtu.	
Business Standard, 16th Apr 2010	ONGC, KG-DWN-98/2	ONGC has said that current gas prices in India are not viable for making future investments, and has sought a gas price of more than US$7/mmbtu to make future investments in gas production attractive. Moreover, its CMD R S Sharma has stated that ONGC development of its KG-DWN-98/2 field would be unviable at a price of US$4.2/mmbtu.	
Indianpetro, 6th Jun	ONGC, MN-OSN-2000/2	ONGC has also said that its MD-2A discovery in MN-OSN-2000/2 will yield a negative NPV on a projected price of US$4.2/mmbtu when sunk costs of exploration of US$142m are taken into account. In this context, the company has argued for a higher price of gas to justify continued investment in the block.	

Source: Citi Investment Research and Analysis, Press articles

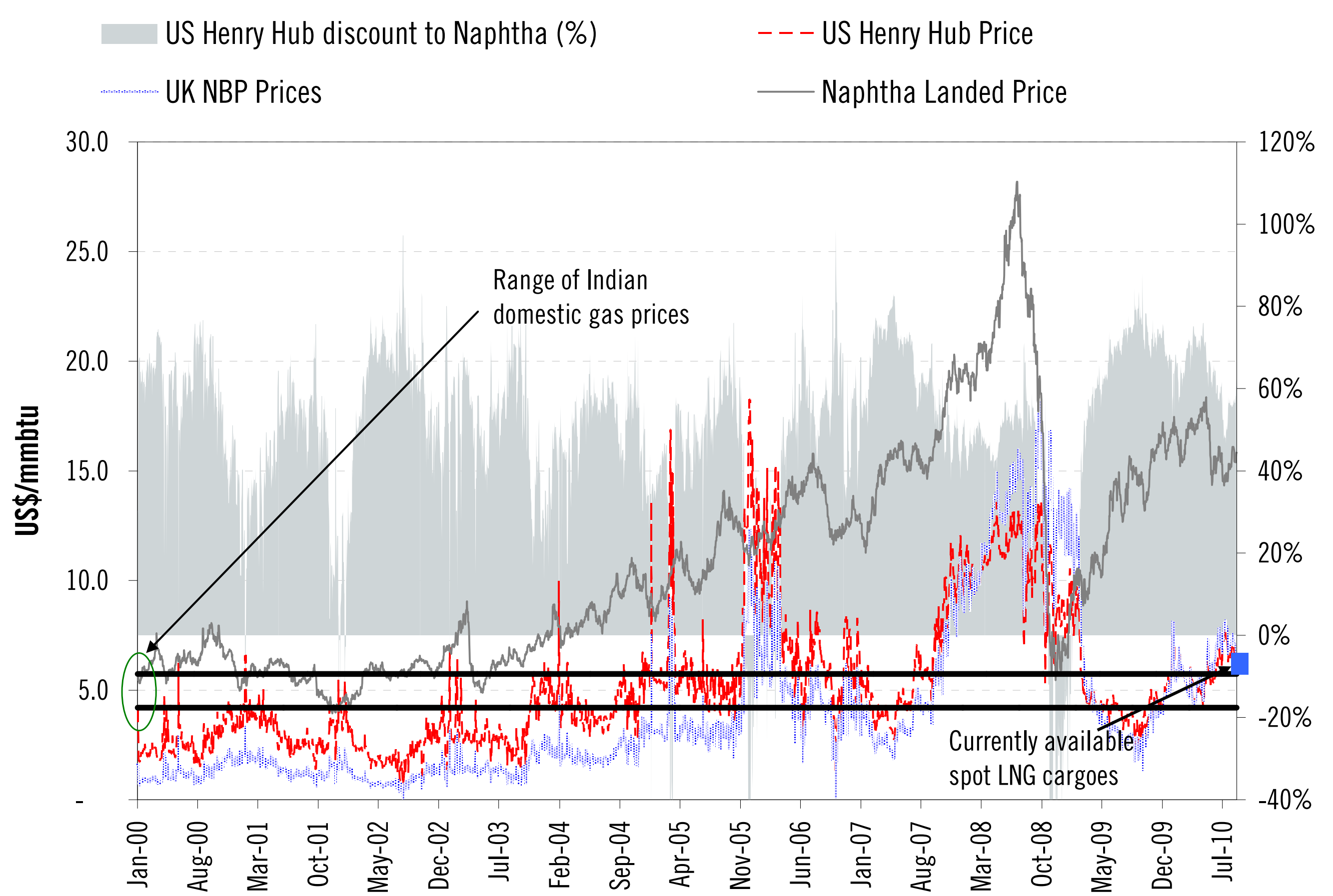
Is there a market for higher priced gas?

Since demand will likely continue to outstrip domestic supplies by a sizeable amount (see Figure 19), we believe that LNG imports are likely to grow going forward, higher prices notwithstanding.

Acceptability of LNG is also a sign that demand for domestic gas is unlikely to be impacted even if prices rise, as it will still remain cheaper than both LNG as well as alternatives like naphtha/FO (see Figure 17).

- Petronet LNG has tied-up its entire 1.5 MMTPA of LT volumes at Kochi to NTPC and Kochi Refinery at a delivered cost of ~US$14/mmbtu, indicating that there exists a market for higher priced LNG owing to low availability of cheaper domestic gas.
- GAIL, in its recent analyst meet, mentioned that given scarcity of domestic gas supply, a delivered price of US$10-12/mmbtu would soon become acceptable as a "reasonable price" going forward.
- With companies like GAIL and GSPL expanding their networks, new demand is likely to come from customers hitherto using higher priced naphtha/fuel oil and who are therefore unlikely to offer resistance to higher gas prices.

Figure 17. Comparison of Naphtha prices with US Henry Hub and UK NBP gas prices (US$/mmbtu)



Source: Bloomberg, Citi Investment Research and Analysis

India Remains Energy Deficient

We expect India's demand for energy to go up significantly in the coming years on the back of strong economic growth. While ever-increasing crude imports coupled with the subsidy situation are already widening the fiscal deficit, we believe that natural gas has significant potential to emerge as a cheaper and cleaner option.

The following are extracts from our notes, *"Oil Gauge: India's crude import dependence – Up, up and away?"* published on 6th April 2010, and *"Petronet LNG: Upgrade to Buy: KG Gas Will Likely Fall Short; Go Long LNG",* published on 8th July 2010.

India – Crude demand-supply gap set to increase

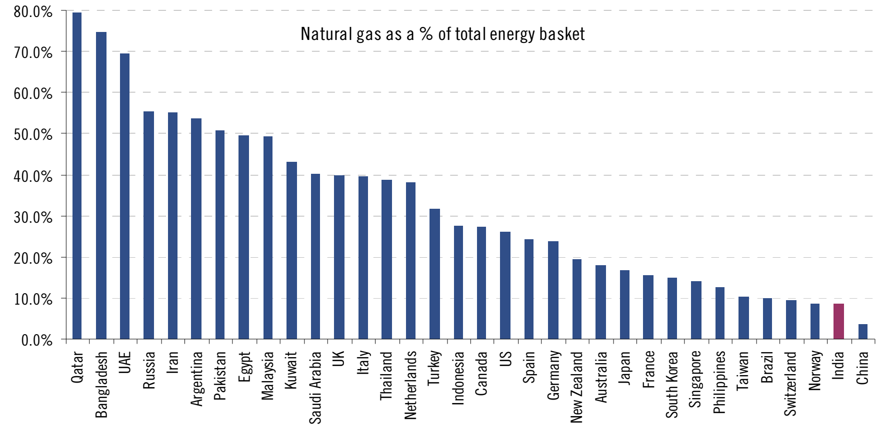
We estimate that at current production run-rate, India's dependence on imported crude is set to increase from ~75% in FY10E to ~80% in FY20E, even after incorporating Rajasthan ramp up, ONGC's Mumbai High redevelopment and its KG integrated development plans. We expect that the absolute crude demand-supply gap is set to increase two-fold from ~110 MMT in FY10E to ~200 MMT by FY20E. Significant incremental capex of ~US$35bn and ~US$65bn will be required to increase domestic oil supplies in order to bring import dependence down to 70% and 60% respectively by FY20E.

Natural gas – an important alternative

With the increase in gas supplies and switching of more and more industrial users to the cleaner fuel, naphtha consumption has been witnessing a steady decline (-24% YTD). Demand for other fuels such as diesel and petrol, however, remains robust, having grown at 10% YTD, and at 12% in 2009. With industrial growth in India forecasted to remain strong, demand of petroleum products is likely to continue rising. While consumption can be partly stemmed through removal of subsidies, a more effective and politically palatable solution would be to encourage gas as an alternative source of energy given rising domestic supplies.

Natural gas is currently a tiny fraction of India's total energy pie, accounting for only 10% of India's total energy consumption in 2009 (see Figure 19), one of the lowest amongst major economies in the world (with the exception of China) and compared to a global average of 24%.

Figure 18. Gas – proportion of total energy consumption



Source: BP Statistical Review 2010

India remains gas-deficient

Even after the ramp up of KG gas, India still faces a potential gas supply shortage. The government has already allocated ~62 mmscmd of KG gas on a firm basis and another ~30 mmscmd on a fall-back basis. Even if KG ramps up to ~120 mmscmd, we expect bulk of the incremental ~30 mmscmd to flow to R-Power (demand of 28 mmscmd still not allocated) and NTPC (demand of 12 mmscmd for Kawas/Gandhar still not allocated). Hence, we believe that there may not be enough volumes from KG left to allocate to new gas users from other industries. With KG gas output expected to be limited to 60 mmscmd for the next few months, we expect gas to become even more scarce. Further, amongst other gas fields under development, these are either back-ended (such as ONGC's KG-DWN-98/2, likely by FY16E) or would be relatively smaller in size (such as GSPC's Deen-Dayal).

Our analysis shows that despite the ramp-up of KG gas from ~60 mmscmd currently to ~110-120 mmscmd by FY13-14E, there would still be adequate demand for higher-priced spot LNG going forward. This demand is largely driven by the power and fertilizer sectors which have sizeable expansion plans for the next few years, and industrial users which are likely to switch from naphtha/fuel oil to gas (including high cost LNG) with economics still favouring the latter.

Figure 19. India – Gas Demand-Supply Scenario (mmscmd)

(mmscmd)	FY10	FY11E	FY12E	FY13E	LT (FY16E)	Comments
Demand						
Power	54	78	97	130	177	Expected demand from planned greenfield/brownfield expansions
Fertilizer	44	59	68	71	74	Expected demand from planned greenfield/brownfield expansions as well as switch-overs from naphtha/fuel oil to gas
City Gas	12	15	16	20	30	Assuming 50 new cities to be auctioned by PNGRB in the next 5-6 years; 0.3 mmscmd gas required per new city
Industrial	18	18	20	21	42	Based on current demand trends and expected users along new pipelines
Petrochem/Refineries/ Steel/ Internal Consumption	36	38	41	47	50	Expected demand from capacity expansions of refineries and petchem plants having pipeline connectivities
Total demand	**164**	**207**	**242**	**289**	**372**	
Supply	**FY10E**	**FY11E**	**FY12E**	**FY13E**	**LT (FY16E)**	
ONGC	63	62	62	72	100	Addition from new fields under development and KG-DWN-98/2
OIL	7	8	8	11	11	Higher gas sales to NRL and BCPL going forward
Others	20	20	20	20	20	Supplies from PMT/Ravva etc to largely remain constant
RIL (KG/ NEC/ CBM)	39	70	80	110	120	Incl. KG ramp-up by end-FY11E, and gas from NEC-25/CBM/satellite fields
Other CBM	1	4	5	6	10	CBM gas from GEECL, Essar, and others
GSPC	-	-	-	1	6	As per current FDP
Sub-total (1)	130	164	175	220	267	
LNG - firm contracts (2)	21	27	27	32	38	Taking into account only firm LNG contracts by Petronet
Total supply (1+2)	**151**	**191**	**202**	**253**	**304**	
Surplus/(deficit) (excl. spot)	**(13)**	**(17)**	**(40)**	**(36)**	**(68)**	Shows continued requirement of further LNG imports
Spot (others)	6	9	19	21	32	Supplies from Shell (Hazira) and Dabhol
Spot (PLNG)	7	28	28	35	37	Estimated spot LNG imports at Dahej and Kochi by Petronet
Overall Surplus/(deficit)	(0)	20	7	20	2	

Source: Citi Investment Research and Analysis, Report of the Working Group on Petroleum & Natural Gas Sector for the XI Plan, Cris Infac, India Oil & Gas, Company Reports

Volatility at all-time low. Buy Calls

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This research report is not intended for US clients other than Qualified Institutional Buyers. Investing in options is not suitable for all investors. Please see the disclosures concerning the risks of investing in options below and discuss with your Financial Advisor whether this particular options strategy is suitable for you. Note that all option prices are indications, based on prices as of August 20, 2010. Interested investors should contact our trading desk for updated price and liquidity information. Also, complex option strategies may entail higher commissions costs. Please direct all company-specific questions to Saurabh Handa and all options-specific questions to Daniel Lam.

We recommend investors buy 3M 110% calls on Reliance Industries, which cost 1.9% in premium

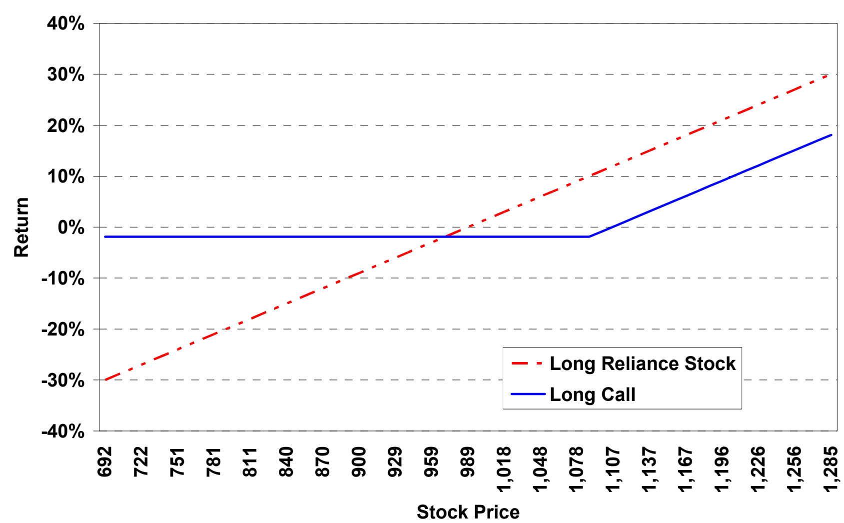
- Using 20-Aug-10 closing price at INR 988.65, strike is INR 1,088. Breakeven = (110% + 1.9%)* INR 988.65 = INR 1,106 (Figure 20)
- Investors gain upside leverage, limiting downside to premium paid (Figure 21). They may potentially unwind the option before expiry at a profit
- From a volatility perspective, while there is a spread between implied and realised, the stock is realising at its all-time low (Figure 22). Thus we believe there is value expressing our bullish stock view via upside calls

Figure 20. Reliance Industries: 3M 110% Calls

Last Price	988.65
Strike (INR)	1088
Strike %	110
Premium	1.9%
Premium (INR)	19
Breakeven vs. Stock	1106
Implied Volatility	24.8%
3M Realised	20.3%
1M Realised	16.5%

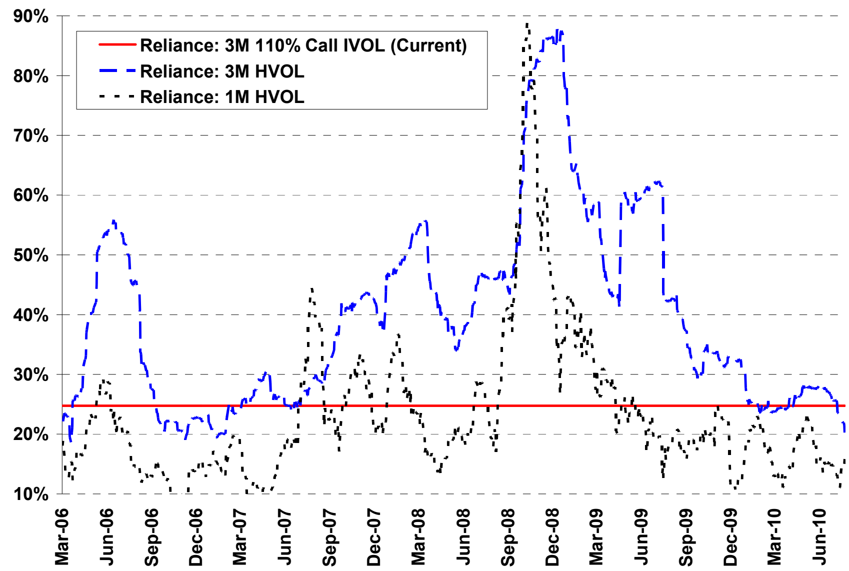
Source: Citi Investment Research and Analysis

Figure 21. Reliance Industries (RIL IN): Payoff Diagram at Expiry for 3M 110% Calls*



Source: Citi Investment Research and Analysis
* Return relative to notional, not to premium paid

Figure 22. Reliance Industries (RIL IN): Stock Realised at all-time low



Source: Citi Investment Research and Analysis

OPTIONS RISK DISCLOSURE - PLEASE READ CAREFULLY

This section discusses possible options strategies that you may choose to employ in conjunction with the company securities discussed herein. If you choose to engage in the options transactions discussed within this document, you must have an approved options account and will be subject to certain criteria which may ultimately prevent you from engaging in certain option strategies. It is important for you as an investor to know and understand that Options do involve risk and sometimes, significant risk, therefore may not be appropriate for all investors. If you buy options, the maximum loss is the premium. If you sell put options, the risk is the entire notional below the strike. If you sell call options, the risk is unlimited. The actual profit or loss from any trade will depend on the price at which the trades are executed. The prices used herein are historical and may not be available when you order is entered. Commissions and other transaction costs are not considered in these examples. Please speak to your Financial Advisor to ensure you have a full understanding of the risk and reward of the strategy you are considering. Strategies that are opened or closed differently than what is discussed in this document could have a significantly different outcome from what is described. It should be noted that certain Index options might have special settlement dates or settlement requirements that are different from traditional equity options. Commissions, taxes, and margin costs have not been included but will affect the outcome of any option transaction and should be considered. However, they can have a significant impact on the profitability of options transactions and should be considered carefully before entering into any option strategy. Because of the importance of tax considerations to all option transactions, the investor considering options should consult with his/her tax advisor as to how their tax situation is affected by the outcome of contemplated options transactions. Certain options trades/strategies must be executed in a margin account. Transactions executed in a margin account can require the investor to periodically deposit additional collateral into the account in order to maintain the positions. The preceding language is not a full description of all possible risks associated with options trading. For a more complete description on the uses and risks of options, please see the document titled Characteristics and Risks of Standardized Options. If you would like an additional copy of this document please contact Citigroup Global Markets Inc., Options Department, 390 Greenwich Street, New York, NY 10013 or from your Morgan Stanley Smith Barney Financial Advisor. Options are not suitable for all investors. Before entering into any transaction using listed options, investors should read and understand the current Options Clearing Corp. Disclosure
Document (Characteristics and Risks of Standardized Options) at
http://www.theocc.com/about/publications/character-risks.jsp
http://www.theocc.com/components/docs/May_2010_ODD_Definitive_Supplement.pdf
Investing in options other than Standardized Options may entail additional risks.

Quants View – Contrarian

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Data as of: 13-Aug-10

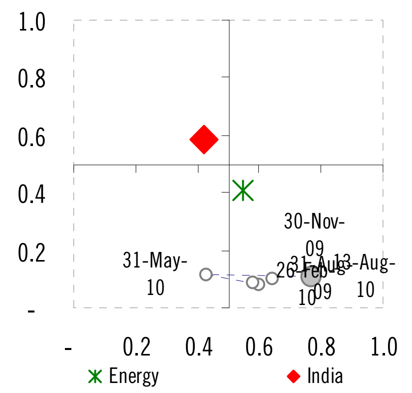
Reliance Industries lies in the Extreme corner of the Contrarian quadrant of our Value-Momentum map with relatively weak momentum but strong value scores. The stock has moved from the Unattractive quadrant to the Contrarian quadrant in the past 2 months indicating improving valuations though momentum remains weak - possibly as a result of improving earnings revisions. Compared to its peers in the Energy sector, Reliance Industries fares better on the valuation metric but worse on the momentum metric. Similarly, compared to its peers in its home market of India, Reliance Industries fares better on the valuation metric but worse on the momentum metric.

From a macro perspective, Reliance Industries is likely to benefit from falling EM yields, and a weaker US Dollar.

Radar Screen Quadrant Definitions

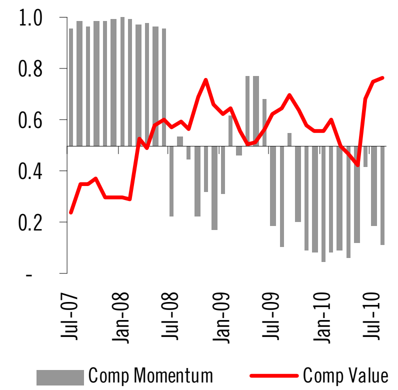
Glamor *Poor relative value but superior relative momentum*	**Attractive** *Superior relative value and superior relative momentum*
Unattractive *Poor relative value and poor relative momentum*	**Contrarian** *Superior relative value but poor relative momentum*

Figure 23. Radar Quadrant Chart History



Source: CIRA

Figure 24. Radar Valuation and Momentum Scores



Source: CIRA

Figure 25. Radar Model Inputs

IBES EPS (Actual and Estimates)

FY(-2)	52.70	Implied Trend Growth (%)	12.34
FY(-1)	54.10	Trailing PE (x)	11.90
FY0	53.40	Implied Cost of Debt (%)	4.38
FY1	70.68	Standardised MCap	3.00
FY2	83.16		

Note: Standardised MCap calculated as a Z score – (mkt cap - mean)/std dev – capped at 3

Source: Citi Investment Research and Analysis, Worldscope, I/B/E/S

Figure 26. Stock Performance Sensitivity to Key Macro Factors

Region	1.05	Commodity ex Oil	0.04
Local Market	1.18	Rising Oil Prices	0.11
Sector	0.49	Rising Asian IR's	0.15
Growth Outperforms Value	0.90	Rising EM Yields	(0.70)
Small Caps Outperform Large Caps	(0.34)	Weaker US$ (vs Asia)	1.57
Widening US Credit Spreads	0.08	Weaker ¥ (vs US$)	(0.06)

Source: Citi Investment Research and Analysis

Reliance Industries

Company description

Reliance Industries is a conglomerate with interests in upstream oil & gas (E&P), refining, and petrochemicals. It has commissioned a super-size refinery project through RPL (now merged with itself) and has commenced gas production at its large gas find in the D6 block in KG basin. RIL is foraying into organized retailing and has plans to undertake SEZ projects over the medium to long term.

Investment strategy

We rate RIL Buy/Low Risk (1L) with a Rs1,140 target price. We believe that the stock is already pricing in an unexciting refining and petchem outlook due to a slower global macro recovery, reflected in its significant under-performance and its relative valuations vs. the broader market at a three-year low. A ~40% premium to NAV looks justified for the E&P business given new discoveries and intensive exploration calendar. While KG gas production ramp up has disappointed, we believe gas prices are set to structurally rise in India, as exemplified by higher prices approved by the government for ONGC's production from new fields. Any willingness on the part of the government to increase KG gas price (which, along with APM gas, is now the cheapest in the country) would be a positive surprise and could lead to expectations of acceleration in further development of Reliance's KG reserves and increase in gas production, driving possible earnings upside and stock performance.

Valuation

Our Rs1,140 target price is based on an average of a sum-of-the-parts value (Rs1,069/share) and P/E value (Rs1,154/share) and explicitly includes NPV of the shale gas JVs of Rs30/share. Our SOTP is derived by: 1) Valuing RIL's core petchem and downstream oil business on an EV/EBITDA of 7.0x mid-FY12E, in line with regional chemicals and refining peers; this also captures the expected recovery in global refining; 2) Valuing total E&P assets including oil & gas prospects and other blocks at Rs464/share based on 8x FY12E EV/EBITDA; 3) Valuing investments in the organized retail business, SEZ, etc. at Rs30/share, based on book value of investments so far; and 4) Valuing treasury stock (post stock sale) at target price. For the P/E valuation, we ascribe a 15x mid-FY12E multiple, in line with the market multiple. We believe RPL and KG gas commencement will lead to the market focusing on FY11/12 earnings (which capture the impact of both), prompting us to give equal weightage to a multiple-based methodology and an SOTP while deducing our target price.

Risks

We rate RIL Low Risk, in line with the rating suggested by our quantitative risk-rating system, as diversified earnings and significant value contribution from the emerging E&P business partly mitigate the impact of the global slowdown on the cyclical components of its business, while commencement of the new refinery and KG gas production limit execution risks. Downside risks to our target price are: RIL's margins are exposed to the global petrochemical and refining cycles; further delays in the ramp-up of production of KG-D6 gas; delays in the drilling programme and/or negative news-flow for the new blocks (D9, D3, MN-D4).

Appendix A-1

Analyst Certification

The research analyst(s) primarily responsible for the preparation and content of all or any identified portion of this research report hereby certifies that, with respect to each issuer or security or any identified portion of the report with respect to an issuer or security that the research analyst covers in this research report, all of the views expressed in this research report accurately reflect their personal views about those issuer(s) or securities. The research analyst(s) also certify that no part of their compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this research report.

IMPORTANT DISCLOSURES

Reliance Industries (RELI.BO)

Ratings and Target Price History
Fundamental Research
Analyst: Saurabh Handa
Covered since June 18 2010

	Date	Rating	Target Price	Closing Price
1	21-Oct-07	1L	*1,430.00	1,234.60
2	17-Jan-08	1L	*1,730.00	1,498.13
3	27-Mar-08	1L	*1,425.00	1,137.50
4	9-Sep-08	1L	*1,225.00	1,071.42
5	23-Oct-08	*1M	*878.00	607.63
6	8-Jan-09	1M	*737.50	598.40
7	23-Apr-09	*2L	*917.50	881.18
8	8-Oct-09	2L	*1,100.00	1,059.60
9	3-Nov-09	*1L	1,100.00	910.33
10	27-Apr-10	*2L	*1,150.00	1,061.10
11	27-Jul-10	2L	*1,140.00	1,053.50

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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