Update
SECTOR: OIL & GAS

Reliance Industries

STOCK INFO.	BLOOMBERG
BSE Sensex: 13,426	RIL IN
	REUTERS CODE
S&P CNX: 3,866	RELI.BO

Equity Shares (m)	1,393.5
52-Week Range	1,316/641
1,6,12 Rel. Perf. (%)	1/12/50
M.Cap. (Rs b)	1,780.6
M.Cap. (US$ b)	39.5

14 November 2006

Downgrade to Neutral

Previous Recommendation: Buy

Rs1,278

YEAR END	NET SALES (RS M)	PAT (RS M)	EPS (RS)	EPS GROWTH (%)	P/E (X)	P/BV (X)	ROE (%)	ROCE (%)	EV/ SALES	EV/ EBITDA
03/06A	812,113	90,693	65.1	19.8	19.6	5.9	25.8	23.8	2.4	13.7
03/07E	1,057,012	95,660	68.6	5.5	18.6	4.7	28.1	23.4	1.9	12.1
03/08E	906,118	98,561	70.7	3.0	18.1	3.8	23.4	21.4	2.2	11.3

We are downgrading our recommendation on Reliance Industries (RIL) from Buy to **Neutral**. We have cut our earnings estimates due to weaker refining margin expectations. At the current price, the stock trades higher than our revised SOTP. It has outperformed the Sensex by a significant 50% over the last 12 months. We believe that expectations on the value of new businesses and/or reserve size of new discoveries have run up well ahead of time as well as available information.

Refining capacity additions from CY08 (1.5-3.7mbpd) exceed our earlier expectation, while demand outlook appears to be weakening, leading to a **downgrade in our refining margin expectation.**

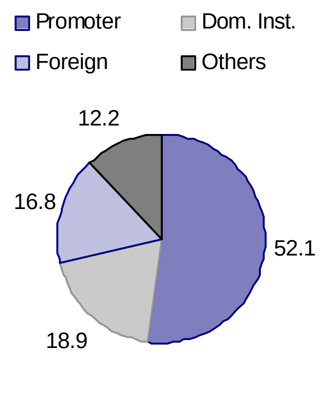
Extended up-cycle for ethylene/propylene chain is an improvement over earlier expectations, while polyester and PTA outlook remains weak, though PX and MEG appear better off. **However, most of the positives are already built into our estimates and we believe that positive surprises are unlikely.**

We are **downgrading our earnings estimate for RIL** by 4% to reflect weaker than expected refining margins and are reducing the valuation of the refining business in our SOTP. **Weaker refining margin also impacts Reliance Petroleum (RPL) valuation**, which stands cut to Rs60/share. This in-turn pulls down value of RIL's holding in RPL, reflected in our SOTP.

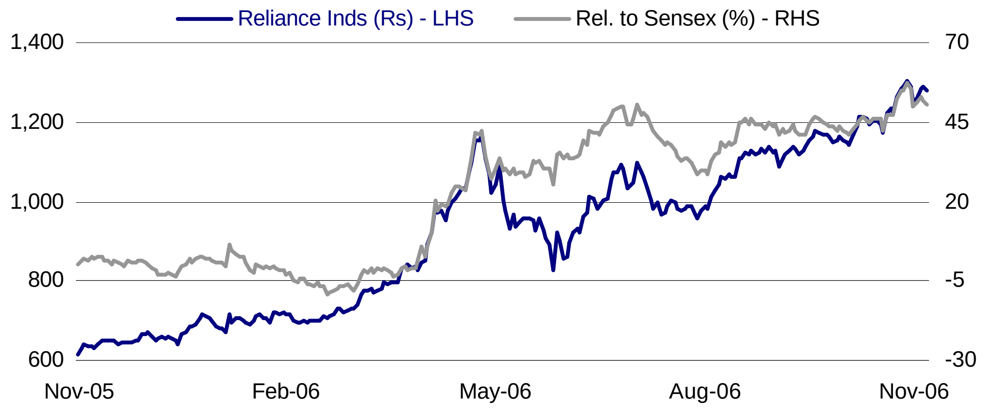
We **cut base case SOTP value from Rs1,180/share to Rs1,111/share**, due to the above. Potential upsides from CBM and Mahanadhi could add another Rs147/share (leading to SOTP of Rs1,258/share, still lower than the current price).

We downgrade the stock to Neutral. We will review our recommendation on greater visibility on new businesses and new reserve announcements.

SHAREHOLDING PATTERN SEP-06 (%)



STOCK PERFORMANCE (1 YEAR)



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We are downgrading our recommendation on Reliance Industries (RIL) from Buy to **Neutral**. We have cut our earnings estimates due to weaker refining margin expectations. At the current price, the stock trades higher than our revised SOTP. It has outperformed the Sensex by a significant 50% over the last 12 months. We believe that expectations on the value of new businesses and/or reserve size of new discoveries have run up well ahead of time as well as available information.

Refining outlook has deteriorated

Likely refining capacity additions of 1.5-3.7mbpd from CY08 exceed our earlier expectation. Further, addition of cracking capacity (upgradation of refineries by adding secondary processing units along the lines of OMCs and standalone refineries in India) by existing refineries would increase the output of light and middle distillates. **Cracking capacity addition in CY07 is expected to be about 750,000 bpd globally as against new refinery capacity addition of just 200,000 bpd.**

We believe that the scheduled refinery capacity addition would pull down refinery operating rates and in turn refining margins, as demand lags capacity growth. The demand growth required for maintaining demand-supply balance over the next three years is 1.8-4.2%, well above trendline, barring CY04. This is especially demanding given the latest trends in global GDP growth, specifically the US, the largest consumer of oil products. IEA's (International Energy Agency) continuous downgrade in demand growth estimate over the last six months is perhaps reflective of this. Forecast demand growth for CY06 has been downgraded to 1.1% from 1.8% in May 2006, while CY07 estimate is down to 1.7% (1.45mbpd) now from 1.9% (1.6mbpd) four months ago.

Margins in Asia are likely to be impacted more than other regions, as bulk of the new capacity is coming up in Asia, while US will continue to remain in deficit.

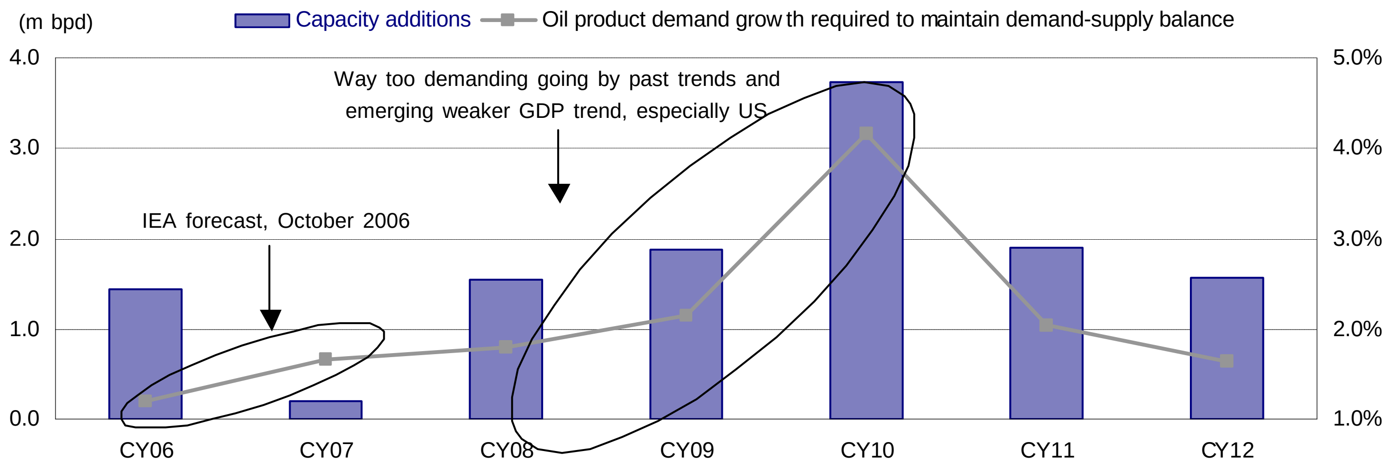
We are downgrading our Singapore complex GRM forecast, on the back of expected fall in refinery operating rates and relative surplus in Asia.

REVISION IN SINGAPORE COMPLEX GRM (OLD V/S REVISED)

FY07	US$7/bbl	to	US$6.75/bbl
FY08	US$7/bbl	to	US$6.25/bbl
FY09	US$7.5/bbl	to	US$5.5/bbl
FY10	US$7.5/bbl	to	US$5.5/bbl
FY11	US$6.5/bbl	to	US$4.75/bbl
FY12	Maintain US$4.75/bbl		

Source: Company/ Motial Oswal Securities

LARGE GLOBAL REFINING CAPACITY ADDITIONS



Source: Capacity addition data as presented by speaker from Platts

Petrochemical outlook better, but our estimates largely reflect the trend

Ethylene/propylene chain outlook has improved

Delay in new capacity and relatively strong demand growth (despite recent indications of US slowdown) appear set to stretch petrochemical up-cycle for another 24 months, with a confirmed downturn only in CY09 (pushed back by about 12 months, compared to earlier expectation). Industry experts point out that the cycle is relatively safe, even based on conservative demand estimation.

Iranian and Chinese capacities totaling over 5m tpa over the next 24 months are delayed or indefinitely postponed, with the bulk of them originally scheduled for 2HCY06 commissioning. Status of 2.3m tpa of Iranian ethylene capacity now scheduled for 2HCY07 is still uncertain. Even if commissioned on time, consistent production is not expected before 1QCY08, by which time demand growth would ensure minimal dip in operating rates and prices/ margins.

With global demand growth of 5-6m tpa (@ about 5% pa), the delay in arrival of new capacity appears set to keep petrochemical (ethylene and propylene derivative) margins strong for another 18-24 months, though margins are likely to be lower than the recent peak.

Polyester outlook remains weak

China continues to play spoilsport, adding more than 2m tpa of new polyester capacity, with total global capacity growth of 6-7% pa (or about 3m tpa), with demand growth in the best of scenarios just about matching the incremental capacity, sustaining the existing capacity overhang of over 5m ton in China alone.

The demand-supply balance leaves little scope for any meaningful improvement in polyester margin over PTA and MEG.

Polyester-intermediates are better off

PX strong: PX (paraxylene) is expected to remain strong over the next 12-18 months, with just about 1.4m ton of new capacity in CY07 as against demand growth of well over 1.8m ton. Demand growth could be much higher and would depend on polyester demand growth during the period, as over 2m ton of new PTA capacity remains inoperative for want of PX and lack of demand from polyester.

While PX margin over naphtha may not hit the dizzying US$850/ton witnessed a couple of months ago, margins are expected to remain strong.

Large new capacity (4.7m ton) scheduled for CY08 would signal the downturn in PX margins.

PTA mirrors polyester: PTA outlook very nearly mirrors the polyester situation. The large capacity addition (of about 5m ton) in CY06 (though part of it remains inoperative) has created a large capacity overhang, which has pushed operating rates well below 90%. This is hardly surprising as a large part of the new capacity addition was backward integration by polyester producers.

Given the shortage of PX as well as polyester demand growth lagging both polyester as well as PTA capacity growth, PTA margins have been close to break-even levels and are expected to remain so till polyester demand and operating rates move up significantly from current levels.

MEG robust: MEG outlook remains robust, with operating rates remaining strong till end CY07, as large capacity addition in the Middle East in CY08 is expected to pull operating rates down. However, possible delays in ethylene (cracker) commissioning could also delay MEG projects.

Other aromatics (benzene, toluene and xylene)

Aromatics are expected to follow similar seasonal patterns like CY06, though prices and margins are likely to be lower than CY06.

In CY06, there was a sharp swing in seasonal demand for aromatics on account of phase out of MTBE in the US, thus requiring large imports of toluene and xylene (~8m tpa). This in turn impacted benzene and PX production, thus pushing prices of all four products up sharply. While this is set to repeat in CY07, early stocking and preparedness would ensure lower volatility.

REVISED EARINING ESTIMATES (RS M)

	FY07E			FY08E			FY09E		
	REVISED	OLD	CHG. (%)	REVISED	OLD	CHG. (%)	REVISED	OLD	CHG. (%)
Net Sales	1,057,012	1,062,260	-0.5	906,118	910,889	-0.5	906,754	929,818	-2.5
EBITDA	166,883	172,131	-3.0	171,996	176,767	-2.7	167,633	190,697	-12.1
Net Profit	95,660	99,963	-4.3	98,561	102,378	-3.7	87,388	103,532	-15.6
EPS (Rs)	68.6	71.7	-4.3	70.7	73.5	-3.7	64.4	76.0	-15.2

Source: Motilal Oswal Securities

Cutting RIL's earnings estimates

We are adjusting refining margins down, due to the cut in Singapore GRM forecast. However, the cut in RIL's GRM is lower on account of an increase in premium (from US$4/bbl to US$4.3/bbl starting from FY08) over Singapore on the expectation of positive diesel marketing margins in FY08 and FY09, though falling crude price differentials are likely to set off part of the gain. We are cutting our earnings estimate for FY07 by 4.3% (1HFY07 at US$10.7/bbl lower than FY07 estimate of US$11/bbl, 2HFY07 too expected to fall short), FY08 by 3.7% and FY09 by 15.2%. We maintain our petrochemical pricing and margin assumptions, as they largely reflect the latest margin expectations, though with a slight upside risk.

The earnings downgrade would lead to a cut in value of refining business in our SOTP valuation by Rs22/share.

The earnings cut also raises the FY08 estimated net debt to Rs165b, pulling down SOTP value by Rs24/share.

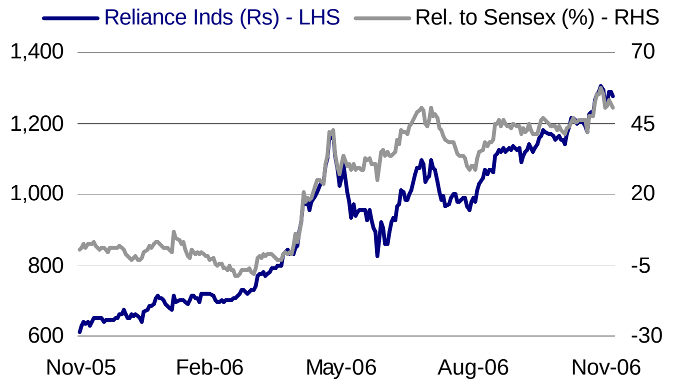
RPL valuation cut, impacts RIL's SOTP valuation

Our DCF-based target price of RPL stands cut to Rs60/share on the back of lower refining margin assumptions for FY09, FY10 and FY11. We maintain premium over Singapore complex at US$4.25/bbl. Value of RIL's holding in RPL is down to Rs162b, or Rs132/share of RIL.

Downgrading from Buy to Neutral

We are downgrading our recommendation on RIL from Buy to **Neutral**, as we believe that expectations on the value of new businesses and/or reserve size of new discoveries have run up well ahead of time as well as available information. The stock has outperformed the Sensex by over 50% in the last 12 months and now trades at a P/E of 18.1x FY08E and EV/EBITDA of 11.3x FY08E.

STOCK PERFORMANCE (1 YEAR)



The current stock price of Rs1,278, is higher than our base case SOTP value of Rs1,111/share (itself aggressive as it includes higher D-6 reserve estimate than formally announced and value of oil reserves, yet to be formally announced) by over 15%. Potential upsides from CBM and Mahanadhi (expected confirmation of reserves 15–24 months away) could add another Rs147/share, leading to SOTP of Rs1,258/share – still lower than the current price.

Potential upside risks

Key upside risks, which might drive a review of our recommendation include:

1. Large new reserve announcement (possible upgradation of D-6 reserves above Niko's announcement or significant reserves at KG-OSN-2001/1 and 2 / Saurashtra / Yemen)
2. Possible quick ramp-up in retail network – say 1,000 outlets in 18 months (indicative approximate valuation (EV) ranging between Rs120–150b, equity value of Rs100-120/share, assuming zero debt)
3. Significant developments in SEZ, providing visibility to enable valuation of business

RELIANCE VALUATION : SUM OF PARTS

BUSINESS	US$B	RSB	RS./SH.	COMMENTS
Core business: Petrochem and refining	**18.3**	**825**	**674**	**Core business EV @ 5.5x FY08E EBITDA**
E & P (including new res., largely acknowled.)	**11.4**	**511**	**418**	
Established reserves	5.4	243	199	
KG basin gas reser. val. (DCF based) (90% stake)	*2.5*	*111*	*91*	*Value of 14.5 TCF at well head price of US$2.4/mmbtu*
Panna Muktha & Tapti (30% stake)	*0.8*	*35*	*29*	
Mahanadi basin (2.35TCF-90% stake)	*0.7*	*31*	*26*	*Value of 2.35TCF based on KG basin reserve (14.5TCF) valuation framework, but at US$4/mmbtu*
CBM (3.65TCF-100% stake)	*1.4*	*65*	*53*	*Value of 3.65TCF at 20% premium to KG basin valuation adjusted for a realisation of US$4/mmbtu*
New discoveries - reserve values largely acknowled.	6.0	268	219	
KG - D6 additional basin new gas discovery	*3.6*	*163*	*134*	*Based on 9TCF additional as reported by Niko - reserve yet to be certified by DGH*
KG basin oil discovery	*2.3*	*104*	*85*	*Reserve size yet to be assessed. Value based on market news on reserves at 1b bbls, @US$6/bbl*
Investments	**27.9**	**1256**	**1,027**	
IPCL	0.6	26	21	20% discount to our target price
RPL	3.6	162	132	20% discount to our target price for RIL's 75% stake
Net debt	**-3.7**	**-165**	**-135**	**FY08E**
Base case	**30.2**	**1,359**	**1,111**	**SOTP based on 1,223m shares**
Potential upside	**4.0**	**180**	**147**	**Based on indicative values for Mahanadhi & CBM only**
CBM (Sonhat, Barmer 1 and Barmer 2)	3.6	160	131	Based on 9TCF reserve size - data from DGH projections on potential resources
Mahanadi basin	0.4	20	16	Upside potential of 1.5TCF (2P) reported and acknowledged by DGH
KG basin (KG-OSN-2001/1 & 2) gas discovery	-	-	-	Reserve size not available
Yemen oil discovery	-	-	-	Reserve size not available
New gas discoveries in Saurashtra	-	-	-	Reserve size not available
SEZ	-	-	-	Land acquisition close to completion in Navi Mumbai and Maha Mumbai SEZs
Retail venture	-	-	-	First retail outlets launched in Hyderabad
Value incl Mahanadhi and CBM	**34.2**	**1539**	**1,258**	**SOTP based on 1,223m shares**

Source: Motilal Oswal Securities

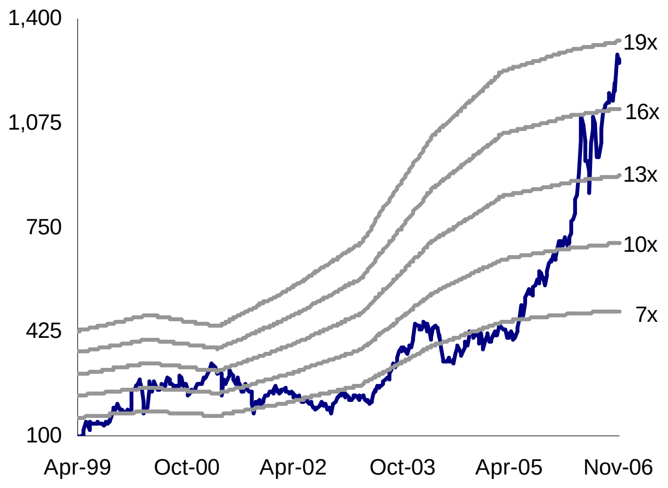
INCOME STATEMENT					(Rs Million)
Y/E MARCH	2005	2006	2007E	2008E	2009E
Net Sales	**660,513**	**812,113**	**1,057,012**	**906,118**	**906,754**
Change (%)	*27.5*	*23.0*	*30.2*	*-14.3*	*0.1*
Finished Gds Purchase	23,566	25,161	25,161	25,161	25,161
Raw Materials Cons	435,753	558,262	749,833	586,251	579,461
Sales and distribution exp	18,250	47,338	50,584	52,604	52,846
Employee Costs	8,464	9,785	11,168	12,508	14,009
Other Expenditure	41,127	49,890	53,385	57,599	67,645
Change in Stocks	5,244	-21,312	0	0	0
EBITDA	**128,111**	**142,991**	**166,883**	**171,996**	**167,633**
% of Net Sales	*19.4*	*17.6*	*15.8*	*19.0*	*18.5*
Depreciation	37,235	34,009	39,687	39,425	39,932
Interest	14,687	8,770	11,501	10,961	11,637
Other Income	14,498	6,829	963	1,591	1,552
PBT	**90,687**	**107,041**	**116,659**	**123,202**	**117,618**
Tax	14,970	16,347	20,999	24,640	30,230
Rate (%)	*16.5*	*15.3*	*18.0*	*20.0*	*25.7*
PAT	75,717	90,693	95,660	98,561	87,388
Adjusted PAT	**75,717**	**90,693**	**95,660**	**98,561**	**87,388**
Change (%)	*42.9*	*19.8*	*5.5*	*3.0*	*-11.3*

BALANCE SHEET					(Rs Million)
Y/E MARCH	2005	2006	2007E	2008E	2009E
Share Capital	13,931	13,932	13,930	13,930	13,930
Reserves	388,437	286,575	366,558	449,443	521,153
Net Worth	**402,368**	**300,507**	**380,489**	**463,373**	**535,084**
Total Loans	187,846	218,656	229,786	165,850	198,675
Deferred Tax	42,668	49,708	57,291	67,147	77,224
Capital Employed	**632,882**	**568,871**	**667,566**	**696,371**	**810,982**
Gross Fixed Assets	523,959	612,003	677,501	705,779	946,853
Less: Depreciation	223,094	252,371	292,058	331,483	371,414
Net Fixed Assets	**300,866**	**359,632**	**385,443**	**374,296**	**575,439**
Capital WIP	48,293	69,578	91,950	145,276	76,182
Investments	131,359	83,482	123,921	123,921	123,921
Curr. Assets, L & Adv.					
Inventory	74,129	101,198	157,155	128,686	128,716
Debtors	39,278	41,636	64,217	55,403	55,297
Cash & Bank Balance	152,281	41,541	1,250	790	911
Loans & Adv. and Other A:	57,993	36,349	37,071	37,807	38,559
Current Liab. & Prov.					
Liabilities	132,840	125,635	164,785	136,666	137,211
Provisions	38,476	38,910	24,312	24,575	24,863
Net Current Assets	**152,366**	**56,179**	**70,595**	**61,446**	**61,408**
Application of Funds	**632,883**	**568,872**	**671,909**	**704,939**	**836,949**

*E: MOSt Estimates *FY06E post demerger*

RATIOS					
Y/E MARCH	2005	2006	2007E	2008E	2009E
Basic (Rs)					
EPS	**54.3**	**65.1**	**68.6**	**70.7**	**64.4**
Cash EPS	81.1	89.5	97.1	99.0	93.1
Book Value	288.7	215.6	273.0	332.5	384.0
DPS	7.5	10.0	10.0	10.0	10.0
Payout (incl. Div. Tax.)	13.8	15.4	14.6	14.1	15.5
Valuation (x)					
P/E	23.5	19.6	18.6	18.1	19.8
Cash P/E	15.8	14.3	13.2	12.9	13.7
EV / EBITDA	14.2	13.7	12.1	11.3	2.2
EV / Sales	3.0	2.5	1.9	2.1	2.2
Price / Book Value	4.4	5.9	4.7	3.8	3.3
Dividend Yield (%)	0.6	0.8	0.8	0.8	0.8
Profitability Ratios (%)					
RoE	20.3	25.8	28.1	23.4	18.0
RoCE	20.1	23.8	23.4	21.4	18.8
Turnover Ratios					
Debtors (No. of Days)	20	18	18	24	22
Fixed Asset Turnover (x)	1.9	2.1	2.3	1.8	1.5
Leverage Ratio					
Net Debt / Equity (x)	0.1	0.6	0.6	0.4	0.4

RELIANCE P/E (X)BAND



Source: Company/Motilal Oswal Securities

N O T E S

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