8 January 2009 | 21 pages

Reliance Industries & Reliance Petroleum

Mean Reversion in Refining; Sell RPL, Buy RIL for E&P

- **Target prices factor in new refining margins** — We maintain Sell (3H) on RPL with reduced target of Rs74 (Rs105 earlier) and maintain Buy (1M) on RIL with a target of Rs1475 (Rs1756 earlier). GRMs for RIL/RPL are ~US$1.9-2.8/bbl lower than earlier estimates, in line with new Singapore complex GRM forecasts of US$3.0/bbl in 2009 (US$4.5) and US$3.8/bbl (US$5.0) in 2010.

- **RIL refinery relatively less affected vs. RPL** — Citi's Singapore complex GRM forecasts are down by US$1.5 in 2009 and US$1.2 in 2010 from previous estimates. Given narrowing advantage of complex refiners, RIL's GRMs are lowered more – $9.4 in FY10E, down $1.9. However, RPL would be even more affected – down US$2.8/bbl in FY10E and now only US$0.7/bbl higher than RIL because of (i) higher gasoline % and (ii) waning L-H advantage.

- **Weaker rupee softens the impact** — Impact of lower GRMs is offset to some extent by weaker rupee. However, staggered commissioning of RPL (now assumed from Apr-09), gas production from Feb-09 (Jan-09 earlier), and lower oil prices mean RIL's consolidated earnings are cut 13-18% over FY09-11E. Earnings cut for RPL is deeper at 32% in FY10E due to 100% leverage to refining.

- **RIL better placed to ride out the bumps** — We believe that current price level of ~Rs1200 offers reasonable risk reward from a 12-month perspective. RIL's successful (and growing) E&P portfolio provides potential offset to further weakness in refining/petrochemicals. Non-resolution of gas dispute with RNRL and short-term volatility in GRMs remain the key downside risks.

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	Rating		Target Price		FY10E Earnings Estimates		FY11E Earnings Estimates	
Ticker	**Old**	**New**	**Old**	**New**	**Old**	**New**	**Old**	**New**
RELI.BO	1M	1M	Rs1,756.00	Rs1,475.00	Rs157.16	Rs133.26	Rs187.61	Rs164.00
RPET.BO	3H	3H	Rs105.00	Rs74.00	Rs15.55	Rs10.56	Rs18.39	Rs14.66

See Appendix A-1 for Analyst Certification and important disclosures.

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Refining Outlook – When it's bad to be good

In recent years the tightening s/d balance in the Asian refining sector has had a clear impact on crack spreads. Transport fuels, which have led demand growth for refinery products in Asia, have seen margins skyrocket. Diesel and kerosene margins averaged US$26/bbl and US$28/bbl in 2008 compared with US$6/bbl in 2003. As a result of simple refiners being pulled into the market to satisfy demand for these products, margins for products like fuel oil and LPG have grown increasingly negative (see Figure 1). Thus, in recent years, the best refiners with high complexity, focused on transport fuels and with a high light product and middle distillate yield, have benefited most from the upturn.

Beware of refiners that have boasted a high "premium over Singapore GRM" in recent years

However, 1.3 m bbl/day of new capacity is ready to start in 1H09 (a 4% increase in Asia regional capacity) and new refineries starting up not only this year, but in the coming 3-4 years, will be significantly more complex. As utilization rates decline we expect margins on low-quality refinery products to become less negative, supporting simple refiners, and margins on transport fuels to decline significantly more than the Singapore GRM benchmark.

Figure 1. Asian Refining margins

							Our est.		Original est.		Change	
	2003	2004	2005	2006	2007	2008	2009E	2010E	2009E	2010E	2009E	2010E
Gasoline	7.9	13.7	12.9	11.7	14.5	8.9	5.0	6.0	4.0	6.0	1.0	0.0
Jet/kero	6.2	14.0	18.5	19.0	18.4	27.5	12.0	15.0	20.0	19.0	-8.0	-4.0
Gas oil (diesel)	5.7	12.2	14.9	15.1	16.7	25.7	12.0	15.0	19.0	18.0	-7.0	-3.0
HSFO	-0.2	-4.7	-8.0	-11.9	-9.6	-14.3	-4.0	-6.0	-6.0	-6.0	2.0	0.0
LPG	-1.0	-3.5	-12.4	-17.5	-16.7	-27.5	-2.0	-4.0	-12.0	-12.0	10.0	8.0
Naphtha	3.0	7.4	2.3	0.8	6.8	-4.5	-5.0	-5.0	-5.0	-3.0	0.0	-2.0
Singapore complex GRM	3.4	6.7	6.9	5.5	7.6	6.2	3.0	3.8	4.5	5.0	-1.6	-1.1

Source: Citi Investment Research

Figure 2. Asian refiners: Product yield Breakdown

	FPCC		S-Oil		SK Energy		GS Holdings		Reliance Petroleum		Reliance Industries		IOC		HPCL		Sinopec	
	FY08	FY09	FY08	FY09	FY08	FY09	FY08	FY09	FY09	FY10	FY09	FY10	FY09	FY10	FY09	FY10	FY08	FY09
Gasoline	20%	20%	10%	10%	9%	9%	11%	11%	-	36%	14%	14%	11%	11%	9%	9%	16%	16%
Jet/kero	9%	9%	24%	24%	14%	14%	15%	15%	-	6%	11%	11%	12%	13%	11%	11%	5%	5%
Gas oil	35%	35%	23%	23%	31%	31%	30%	30%	-	44%	39%	38%	40%	41%	35%	35%	39%	39%
HSFO	5%	5%	10%	10%	15%	15%	14%	14%	-	0%	0%	0%	13%	14%	14%	14%	5%	5%
LPG	5%	5%	4%	4%	3%	3%	6%	6%	-	0%	13%	13%	5%	5%	6%	6%	5%	5%
Naphtha	20%	20%	17%	17%	17%	17%	18%	18%	-	0%	26%	25%	8%	8%	15%	15%	15%	15%
Other	6%	6%	12%	12%	11%	11%	6%	6%	-	14%	-3%	-1%	11%	8%	11%	11%	16%	16%
Gasoline/diesel/kero	64%	64%	57%	57%	54%	54%	56%	56%	0%	86%	64%	63%	63%	65%	54%	54%	60%	60%

Source: Citi Investment Research

We have cut our Singapore GRM forecast for 2009 and 2010 to US$3.0/bbl and US$3.8/bbl, respectively, compared with US$6.2/bbl in 2008. However, this significantly understates the downside we envision for complex refiners. We expect the diesel and kerosene cracks to fall by US$14/bbl and US$16/bbl this year compared with 2008.

5 new refineries are ready to start

We expect about 1.3 million bbl/day of new refining capacity to start up in 1H09. Most of these five projects, representing 4% of Asian demand, are basically complete, and full commercial startups are generally being delayed due to weak market demand in our view (see Figure 3).

Figure 3. 1H09 Asian refining capacity startups

Company	Location	Capacity bbl/day
Reliance Petroleum	Jamnagar	580,000
Sinopec JV	Fujian	160,000
Sinopec	Tianjin	140,000
CNOOC Corp.	Huizhou	240,000
PetroChina	Dushanzi	200,000

Source: Citi Investment Research

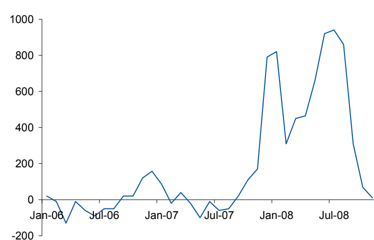
Reliance Petroleum (580,000 bbl/day) started trial runs in end-December and is expected to ramp up by April. Similarly, Sinopec's expansion at Fujian (160,000 bbl/day) and Tianjin (140,000 bbl/day) have commenced trial runs, but the timing of commercial ramp-up will depend on when domestic oil product inventories, which are very high, come down. *Xinhua News* reports that Sinopec and PetroChina's gasoline and diesel inventories totaled 86.8m bbl at the end of November 2008, up from 42.5m bbl at the beginning of 2008.

CNOOC Corp's 240,000 bbl/day at Huizhou is mechanically complete although full production could be delayed until 2Q08. PetroChina's Dushanzi project is also complete, but the company's production plan calls for only about 50% utilization in 2009 due to weak demand. And finally, we believe PetroChina's 160,000 bbl/day Fushun expansion, which started trial runs at the end of October 2008, is still in the process of ramping up.

We are especially concerned about the impact Reliance Petroleum's new refinery could have on regional margins considering that was designed as a pure export refinery, and weak demand in anticipated markets, especially the U.S. gasoline market, will make it difficult to find a home for the new volume.

China's diesel exports should pressure mid-distillate cracks

Figure 4. China: Net diesel imports (thousand tonnes/month)



Source: CEIC, Citi Investment Research

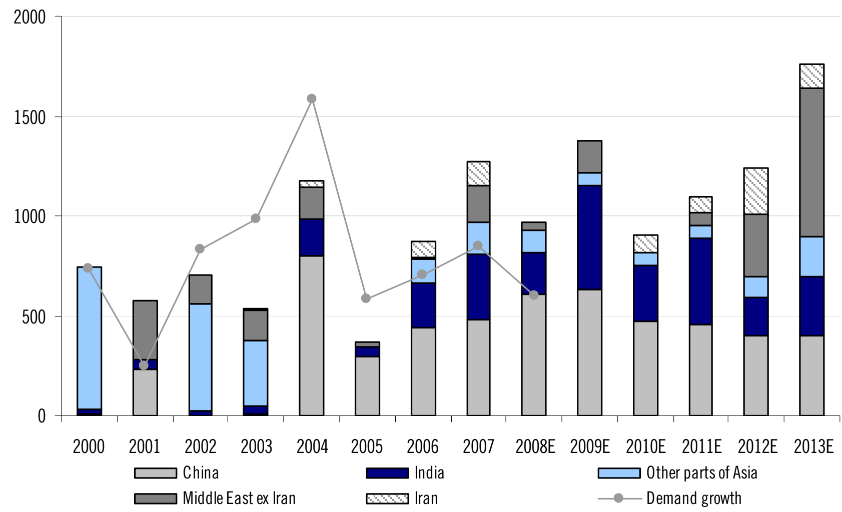
Regional diesel margins have remained relatively high, playing a key supporting role for Singapore complex GRM. Currently at about US$17/bbl, the diesel margin is the strongest component of Singapore GRM (see Figure 6 and Figure 7). However, as China becomes a net exporter of diesel in the coming months, we expect pressure on diesel and mid-distillate cracks. In 2008, China was a significant net importer of diesel (see Figure 4). In 3Q08, China imported 172,000 bbl/day (6% of apparent demand). Although this represents only about 2% of regional mid-distillate demand, it put significant pressure on the relatively illiquid regional spot market.

China's net diesel imports dropped to zero in November, and we believe turned slightly negative in December. The local press has reported that PetroChina and Sinopec plan to export about 200,000 tonnes (~50,000 bbl/day) of diesel in January. China is likely to become a significant diesel exporter in 1H09, but we do not expect China to become a large oil product exporter in the long term as government policy expressly discourages energy exports. The government suspended the VAT rebate on oil product exports in March 2006, putting domestic refiners at a significant disadvantage in the regional export market.

S/D balance set to remain weak

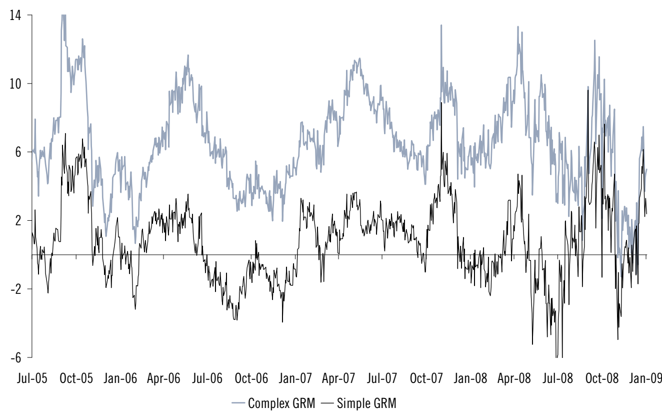
Considering demand growth in the region averages ~900,000 bbl/day each year, projected capacity growth of over 1m bbl/day in the coming years looks set to keep regional utilization rates weak (see Figure 5). It is possible that an unusually strong demand growth year such as 2004 could improve this outlook if economic growth rebounds strongly in 2010. Also, we expect the weak anticipated margin environment to lead to capex cutbacks, likely pushing back our supply growth estimates. However, late 2010 would be the earliest a cyclical recovery would be possible in our view.

Figure 5. Asia/Middle East refinery capacity growth (thousand bbl/day)



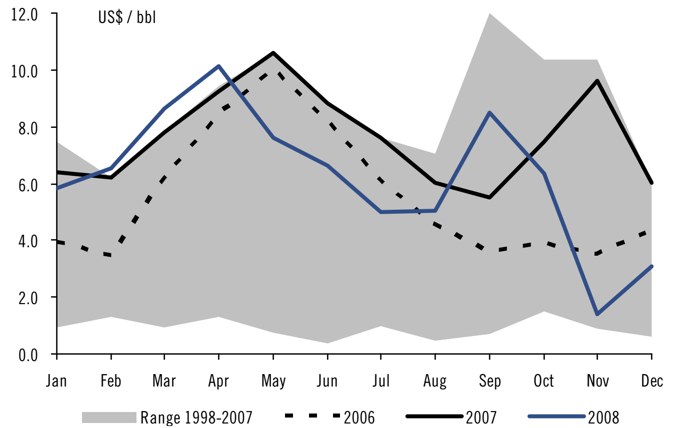
Source: Citi Investment Research

Figure 6. Singapore complex and simple GRM (US$/bbl)



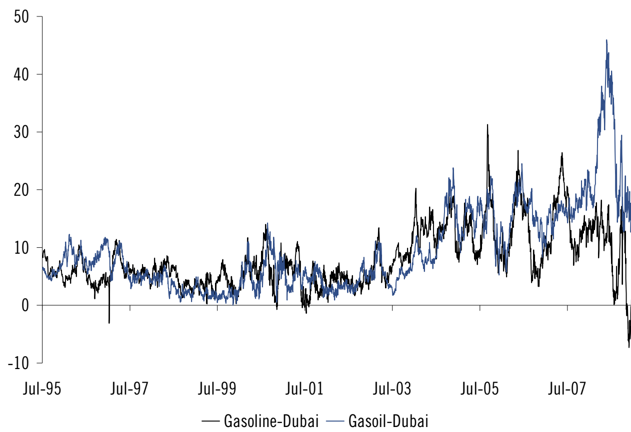
Source: Citi Investment Research

Figure 7. Singapore complex refining margin (US$/bbl)



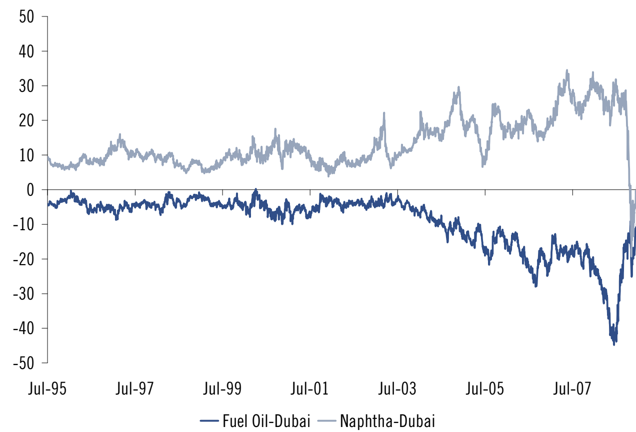
Source: Citi Investment Research

Figure 8. Crack Spreads – LTC (Gasoline and Diesel)



Source: Citi Investment Research

Figure 9. Crack Spreads – LTC (Fuel Oil and Naphtha)



Source: Citi Investment Research

Company Focus

Target price change ☑
Estimate change ☑

Buy/Medium Risk	**1M**
Price (07 Jan 09)	Rs1,196.80
Target price	Rs1,475.00
from Rs1,756.00	
Expected share price return	23.2%
Expected dividend yield	1.7%
Expected total return	**24.9%**
Market Cap	Rs1,883,509M
	US$38,883M

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

Reliance Industries (RELI.BO)

Buy: Risk Reward Favorable, Exploration Potential to Unfold in 2H09

- **New target price of Rs1475** — SOTP of Rs1475 (Rs1756 earlier) is based on (i) 13-18% cut in FY09-11E estimates led primarily by refining (ii) lower E&P value of Rs606 and (ii) lower contribution from RPL at Rs149/share (at its new target of Rs74). GRM for RIL is ~US$2.0/bbl lower than previous FY10 estimates, in-line with Citi's new Singapore GRM forecasts of US$3.0 (US$4.5) in 2009.
- **RIL refinery relatively less affected vs. RPL** — Given the narrowing advantage of complex refiners, RIL's GRMs are lowered more – US$9.4/bbl in FY10E, down $1.9. However, RPL would be affected even more – down US$2.8/bbl in FY10E and now only US$0.7/bbl higher than RIL because of (i) higher gasoline % in its product slate and (ii) waning crude advantage with lower WTI-Maya differentials.
- **Changes in RPL commissioning and gas production affects earnings** — Though impact of lower GRMs is offset to some extent by a weaker rupee, we now assume RPL to commercialize from Apr-09 (Jan-09 earlier) and assume slightly slower ramp-up in gas production. Coupled with lower oil forecasts for FY10-11E, RIL's consolidated earnings are cut 13-15% over FY10-11E.
- **E&P – Look out for 2009** — We remain confident of sustainability of E&P cash flows from new discoveries (D6 and elsewhere), as RIL embarks on exploratory drilling in 2009. E&P business contribution of Rs606/share is reduced from Rs746/share to reflect lower oil prices and now imputes only 15% premium to the NAV of known reserves (Rs529). This, we believe is conservative, given the prospects in MN-D4, KG-D4, D9, D3 and Cauvery.
- **RIL better placed to ride out the bumps** — We believe that current price level of ~Rs1200 offers reasonable risk reward from a 12-month perspective. RIL's successful (and growing) E&P portfolio provides potential offset to any further weakness in refining/petrochemicals. Short-term volatility in GRM remains the key downside risk whereas resolution of the gas dispute with RNRL and new discoveries would be positive triggers for the stock.

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2007A	119,434	82.18	26.2	14.6	2.7	25.8	0.9
2008A	152,606	105.00	27.8	11.4	2.2	21.2	1.1
2009E	146,159	92.89	-11.5	12.9	1.9	16.4	1.7
2010E	209,674	133.26	43.5	9.0	1.6	19.7	1.8
2011E	258,030	164.00	23.1	7.3	1.4	20.5	2.0

Source: Powered by dataCentral

Fiscal year end 31-Mar	2007	2008	2009E	2010E	2011E
Valuation Ratios					
P/E adjusted (x)	14.6	11.4	12.9	9.0	7.3
EV/EBITDA adjusted (x)	9.8	8.8	9.2	6.6	5.1
P/BV (x)	2.7	2.2	1.9	1.6	1.4
Dividend yield (%)	0.9	1.1	1.7	1.8	2.0
Per Share Data (Rs)					
EPS adjusted	82.18	105.00	92.89	133.26	164.00
EPS reported	82.18	133.88	92.89	133.26	164.00
BVPS	439.75	548.83	623.87	732.39	869.38
DPS	11.00	13.00	20.00	22.00	24.00
Profit & Loss (RsM)					
Net sales	1,116,927	1,334,430	1,844,325	2,100,880	2,543,729
Operating expenses	-962,438	-1,159,711	-1,662,424	-1,826,386	-2,198,155
EBIT	**154,489**	**174,719**	**181,900**	**274,494**	**345,574**
Net interest expense	-11,889	-10,774	-15,953	-28,373	-28,339
Non-operating/exceptionals	2,604	66,156	12,295	19,359	14,635
Pre-tax profit	**145,205**	**230,101**	**178,243**	**265,481**	**331,870**
Tax	-25,771	-35,519	-32,084	-41,729	-54,295
Extraord./Min.Int./Pref.div.	0	0	0	-14,078	-19,546
Reported net income	**119,434**	**194,583**	**146,159**	**209,674**	**258,030**
Adjusted earnings	119,434	152,606	146,159	209,674	258,030
Adjusted EBITDA	202,641	223,190	227,351	337,218	421,290
Growth Rates (%)					
Sales	37.5	19.5	38.2	13.9	21.1
EBIT adjusted	40.4	13.1	4.1	50.9	25.9
EBITDA adjusted	40.7	10.1	1.9	48.3	24.9
EPS adjusted	26.2	27.8	-11.5	43.5	23.1
Cash Flow (RsM)					
Operating cash flow	**169,405**	**199,875**	**295,194**	**293,527**	**385,320**
Depreciation/amortization	48,152	48,471	45,451	62,723	75,716
Net working capital	1,819	-43,180	103,584	7,051	32,029
Investing cash flow	**-434,659**	**-229,608**	**-287,850**	**-178,600**	**-144,500**
Capital expenditure	-318,103	-185,480	-287,850	-178,600	-144,500
Acquisitions/disposals	-118,975	-45,604	0	0	0
Financing cash flow	**291,187**	**65,267**	**150,366**	**-38,941**	**-42,482**
Borrowings	66,272	98,795	17,527	0	0
Dividends paid	-18,006	-21,666	-35,401	-38,941	-42,482
Change in cash	**25,933**	**35,534**	**157,709**	**75,985**	**198,339**
Balance Sheet (RsM)					
Total assets	**1,173,534**	**1,498,390**	**2,005,389**	**2,202,242**	**2,507,294**
Cash & cash equivalent	37,706	71,765	33,562	74,644	262,332
Accounts receivable	37,324	62,276	80,334	129,472	146,249
Net fixed assets	711,886	848,895	1,367,413	1,485,290	1,557,074
Total liabilities	**533,862**	**683,903**	**1,023,793**	**1,035,834**	**1,105,793**
Accounts payable	147,098	183,360	344,157	306,876	354,161
Total Debt	278,007	364,521	505,102	515,102	505,598
Shareholders' funds	**639,671**	**814,486**	**981,596**	**1,166,407**	**1,401,501**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	18.1	16.7	12.3	16.1	16.6
ROE adjusted	25.8	21.2	16.4	19.7	20.5
ROIC adjusted	20.5	16.1	12.6	15.4	17.8
Net debt to equity	37.6	35.9	48.0	37.8	17.4
Total debt to capital	30.3	30.9	34.0	30.6	26.5

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Powered by: dataCentral

New TP of Rs1475

We are reducing our target price on Reliance Industries from Rs1756 earlier to Rs1475, as illustrated in Figure 10 below.

Figure 10. RIL Sum-of-the-parts Valuation

	Rs m	Rs/share		Comments
		old	new	
FY09E EBITDA forecast	210,810			
FY10E EBITDA forecast	165,814			Only for Refining and Petrochem (excl. RPL)
EV of Petrochem & Refining (Rs m) - (a)	911,978	605	580	@ EV/E of 5.5x FY10E
Net Debt (Rs m) - (b)	148,680	78	94	Estimated as on Mar-09, post warrants conversion
Key investments				
-Reliance Petroleum	234,365	211	149	Based on TP of Rs74, EV/E of 5.5x FY10E
-E&P Assets	952,801	746	606	Based on 10x steady state FCF (incl. KG oil and gas upside in FY11E)
- Organised Retail	80,000	51	51	Based on BV of investments so far
Total value of investments & other assets - (c)	1,267,166	1,009	805	
Value of Treasury stock - (d)	292,084	221	186	At target price
Value for Equity holders (Rs m) - (a-b+c+d)	2,322,548	1,756	**1,475**	
No. of shares (m.)	1,573			Post-warrants conversion

Source: Citi Investment Research

The key changes to our target price are driven by the following, and explained in more detail in the ensuing section:

1. 13-18% reduction in our FY09-11E consolidated EPS
2. Reduction in E&P value from Rs746/share to Rs606/share
3. Reduction in our target price for RPL from Rs105 to Rs74

Reducing consolidated EPS 13-18%

Figure 11 below summarizes the key changes to our earnings estimates for RIL.

Figure 11. RIL – Earnings revision

Year to	Net Profit (Rs Mils.)		Diluted EPS (Rs)			Div. Per Share (Rs)	
31-Mar	Old	New	Old	New	% Chg	Old	New
2009E	178,604	146,159	113.52	92.89	-18.2%	20.0	20.0
2010E	247,280	209,674	157.16	133.26	-15.2%	22.0	22.0
2011E	295,180	258,030	187.61	164.00	-12.6%	24.0	24.0

Source: Citi Investment Research estimates

The key drivers of our earnings changes are as follows:

- Lower GRM assumptions – in-line with the reduction in our Singapore GRM assumptions (down from US$4.5 in CY09E to US$3.0 and US$5.0 in CY10E to US$3.8), we have reduced our GRM assumptions for RIL by US$1.0-1.9 over FY10E and FY11E respectively, as shown in Figure 12 below. This also results in a reduction in our GRM estimates for RPL. A delay in KG gas production also results in lower savings from using gas, which also affects GRMs.

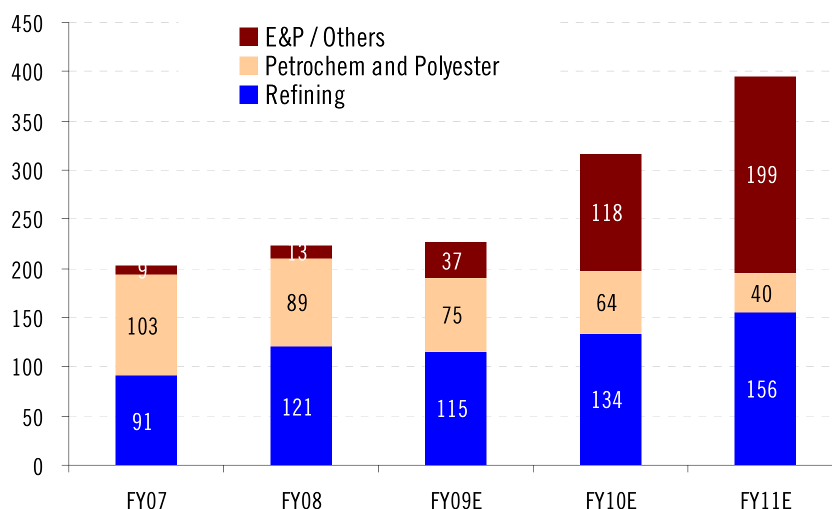
Figure 12. Refining Margin Assumptions (US$/bbl)

		FY09E	FY10E	FY11E
RIL GRMs (ex-marketing)	new	$12.5	$9.4	$10.5
	old	$14.0	$11.3	$11.5
Singapore GRMs	new	$6.5	$3.0	$3.8
	old	$6.7	$4.5	$5.0
Differential over Singapore GRMs	new	$6.0	$6.4	$6.7
	old	$7.3	$6.7	$6.5
RPL GRMs	new	-	$10.1	$11.2
	old	$14.0	$12.9	$13.2
Discount to RPL GRMs	new	-	$0.7	$0.7
	old	$0.0	$1.7	$1.7

Source: Citi Investment Research

- Lower polymer spreads – we have also lowered our spread assumptions for polymers, though continued strength in polyesters and the weaker rupee helps offset the impact. Figure 13 below shows RIL's EBITDA breakup on a consolidated basis, i.e., including the proportionate contribution from its 70.4% stake in RPL.

Figure 13. Consolidated EBITDA breakup (Rs bn)



Source: Citi Investment Research

- Change in our exchange rate assumptions, to reflect the weakness in the rupee. Our new assumptions are now Rs47/48/47 over FY09-11E, in-line with our economist's forecasts.

Valuing E&P at Rs606/share

Our E&P value has been reduced from Rs746/share to Rs606/share based on the following changes and as illustrated in Figure 14 and Figure 15 below. The result is a lower 15% premium to NAV of known reserves only (vs. 23% earlier).

- Lower crude price assumptions based on our global forecasts – US$60/66.3/76.3 over 2HFY09/FY10/FY11 vs. US$80/92.5/91.3 earlier.

- D6 gas production to commence in Feb-09 (Jan-09 earlier). Besides we assume a slightly slower ramp-up in gas production.
- Flat gas price of US$4.2/mmbtu (vs. a gradual increase assumed earlier).

Figure 14. E&P – Valuation based on EV/FCF

	FY11E		
	old	new	
EBITDA (Rs m)	203,321	178,373	
PAT (Rs m)	163,064	141,410	
Operating Cash Flows (Rs m)	163,366	139,614	Assuming 80mmscmd gas and 40kbpd oil production
Operating Cash Flows (US$m)	3,590	2,971	
Less: Yearly Exploration spend (US$m)	700	700	As per management guidance
FCF (US$m)	2,890	2,271	
EV/FCF 12-mnth fwd (x)	10.0	10.0	
EV Mar-10E (US$ bn)	29	23	
EV Mar-10E (Rs bn)	1315	1067	
Imputed Mar-10 PER (x)	8.1	7.5	
EV Mar-09E (Rs bn)	1174	953	Discounted back by 12 months
EV Mar-09E (US$bn)	26	20	
Value per share (Rs)	**746**	**606**	
Premium to NAV (%)	23%	15%	Premium relative to NAV of known reserves (KG-D6 + NEC-25 + CBM)

Source: Citi Investment Research estimates

Figure 15. 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)	3858		15,372	4.4	459	Based on DCF assuming 70% recovery from 2P+Best OGIP of 26.7 tcf
NEC-25	1.9	3.7	1,166	3.5	35	@ 50% recovery of 2P OGIP of 3.7 tcf
CBM (3P OGIP)	1.9	3.7	1,166	3.5	35	@ 50% recovery of 3P OGIP of 3.7 tcf
Total			**17,703**		**529**	

Source: Citi Investment Research

Earnings sensitivity

We present below sensitivity of RIL's earnings to (i) crude prices and (ii) GRMs.

- **Sensitivity to crude prices –** lower crude price has an impact not only on realizations of KG and PMT oil but also results in lower gas prices as per the below gas pricing formula:

**Gas Price = US$2.5 + C + (Crude price - US$25)^(0.15)** *(crude price capped at US$60)*

The following table shows RIL's earnings sensitivity to lower crude (and consequently gas) prices:

Figure 16. Earnings and E&P NAV sensitivity to crude prices

Crude US$/bbl	Gas price US$/mmbtu	NAV of known reserves Rs/share	FY10E EPS Rs/share
66.3 (base case)	4.20	529	133
60.0	4.20	506	130
55.0	4.17	498	128
50.0	4.12	502	125
45.0	4.07	488	122
40.0	4.00	483	119
35.0	3.91	468	116
30.0	3.77	450	112
25.0	2.50	260	96

Source: Citi Investment Research estimates

- **Sensitivity to refining margins –** a US$1 reduction in FY10E GRMs lowers RIL's consolidated EPS by ~Rs10, as shown in Figure 17 below.

Figure 17. Earnings sensitivity to GRMs

GRM US$/bbl	FY10E EPS Rs/share
5.0	86.5
6.0	96.5
7.0	106.6
8.0	116.6
9.0	126.4
9.4 (base case)	133.3
10.0	136.5
11.0	146.2

Source: Citi Investment Research estimates

Company Focus

Reliance Petroleum (RPET.BO)
Sell: Macro Headwinds Not Likely to Ease

Target price change ☑
Estimate change ☑

Sell/High Risk	**3H**
Price (07 Jan 09)	Rs84.00
Target price	Rs74.00
from Rs105.00	
Expected share price return	-11.9%
Expected dividend yield	0.0%
Expected total return	**-11.9%**
Market Cap	Rs378,000M
	US$7,803M

Price Performance (RIC: RPET.BO, BB: RPET IN)

- **Reducing refining margins, cutting target** — Citi's Singapore complex GRM forecasts are lowered – $3.0 in CY09 and $3.8in CY10, down $1.5 and $1.2 from previous estimates. Given the narrowing advantage of complex refiners, RPL's GRMs are lowered more – $10.1 in FY10E and $11.2 in FY11E, down $2.8 and $2.0 respectively. New target of Rs74 (Rs105) is on EV/EBITDA of 5.5x and now assumes commercial commissioning from Apr-09 (vs. Jan-09 earlier).
- **Diesel to come under pressure, L-H differential down** — While gasoline spreads have been weak, we expect the demand slowdown and overcapacity to eat into diesel spreads too. Meanwhile, WTI-Maya crude differential has declined recently from US$10-12/bbl to US$5-6/bbl.
- **Complexity is a double-edged sword** — Advantage of complex refiners has narrowed with lower oil price and tighter fuel oil supply. Singapore complex-simple GRM differential has narrowed from US$9/bbl in 2Q08 to US$1-2/bbl now, which does not bode well for complex refiners such as RPL.
- **Weaker rupee softens the earnings impact** — FY10-11E earnings are reduced by 20-32% and the impact of lower GRMs is slightly offset by the weaker rupee – INR/US$ of 48.0 in FY10 and 47.0 in FY11.

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2007A	na	na	na	na	na	na	na
2008A	na	na	na	na	na	na	na
2009E	na	na	na	na	na	na	0.0
2010E	47,530	10.56	na	8.0	2.2	27.1	1.9
2011E	65,988	14.66	38.8	5.7	1.7	32.7	3.5

Source: Powered by dataCentral

Fiscal year end 31-Mar	2007	2008	2009E	2010E	2011E
Valuation Ratios					
P/E adjusted (x)	na	na	na	8.0	5.7
EV/EBITDA adjusted (x)	na	na	na	6.9	5.4
P/BV (x)	na	na	na	2.2	1.7
Dividend yield (%)	na	na	0.0	1.9	3.5
Per Share Data (Rs)					
EPS adjusted	na	na	na	10.56	14.66
EPS reported	na	na	na	10.56	14.66
BVPS	na	na	na	38.98	50.71
DPS	na	na	0.00	1.58	2.93
Profit & Loss (RsM)					
Net sales	na	na	na	650,428	827,692
Operating expenses	na	na	na	-591,250	-752,069
EBIT	**na**	**na**	**na**	**59,178**	**75,623**
Net interest expense	na	na	na	-12,420	-12,386
Non-operating/exceptionals	na	na	na	1,164	4,149
Pre-tax profit	**na**	**na**	**na**	**47,922**	**67,386**
Tax	na	na	na	-392	-1,398
Extraord./Min.Int./Pref.div.	na	na	na	0	0
Reported net income	**na**	**na**	**na**	**47,530**	**65,988**
Adjusted earnings	na	na	na	47,530	65,988
Adjusted EBITDA	na	na	na	72,827	89,429
Growth Rates (%)					
Sales	na	na	na	na	27.3
EBIT adjusted	na	na	na	na	27.8
EBITDA adjusted	na	na	na	na	22.8
EPS adjusted	na	na	na	na	38.8
Cash Flow (RsM)					
Operating cash flow	**na**	**na**	**na**	**22,660**	**68,058**
Depreciation/amortization	na	na	na	13,650	13,806
Net working capital	na	na	na	-38,127	-10,337
Investing cash flow	**na**	**na**	**na**	**-2,000**	**-3,000**
Capital expenditure	na	na	na	-2,000	-3,000
Acquisitions/disposals	na	na	na	0	0
Financing cash flow	**na**	**na**	**na**	**10,000**	**-17,924**
Borrowings	na	na	na	10,000	-10,794
Dividends paid	na	na	na	0	-7,129
Change in cash	**na**	**na**	**na**	**30,660**	**47,135**
Balance Sheet (RsM)					
Total assets	**na**	**na**	**na**	**379,878**	**439,931**
Cash & cash equivalent	na	na	na	31,053	79,586
Accounts receivable	na	na	na	48,686	62,179
Net fixed assets	na	na	na	224,552	213,746
Total liabilities	**na**	**na**	**na**	**204,477**	**211,741**
Accounts payable	na	na	na	41,229	53,218
Total Debt	na	na	na	151,119	140,325
Shareholders' funds	**na**	**na**	**na**	**175,400**	**228,191**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	na	na	na	11.2	10.8
ROE adjusted	na	na	na	27.1	32.7
ROIC adjusted	na	na	na	19.4	24.5
Net debt to equity	na	na	na	68.5	26.6
Total debt to capital	na	na	na	46.3	38.1

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Reducing TP to Rs74

We have reduced our target price on RPL from Rs105 earlier to Rs74 mainly on the back of a reduction in our GRM assumptions (including savings from KG gas) over FY10-11E from US$12.9-13.2/bbl earlier to US$10.1-11.2/bbl. We continue to base our target price on 5.5x FY10E EV/EBITDA, in-line with the multiple ascribed to RIL's existing refinery.

Reducing GRM assumptions

Figure 18 and Figure 19 below illustrate our new refining margin assumptions for RPL and the differential relative to Singapore margins.

Figure 18. RPL – GRM assumptions

		FY09E	FY10E	FY11E
GRMs (incl. savings from gas)	new	-	$10.1	$11.2
	old	$14.0	$12.9	$13.2

Source: Citi Investment Research

Figure 19. RPL – Differential vs. Singapore GRMs

	FY10E	FY11E
RPL GRMs (ex-refinery off-gases)*	$9.6	$10.7
Singapore GRMs	$3.0	$3.8
Differential over Singapore GRMs	$6.6	$6.9

Source: Citi Investment Research estimates. *For like-to-like comparison

The new margin assumptions reflect changes in our regional refining view (see the earlier section titled *'Refining Outlook – When it's bad to be good'* for further details). Our Singapore refining margins have been pared to US$3.0/bbl and US$3.8/bbl over CY09-10E from US$4.5-5.0/bbl earlier to reflect a weakening demand environment and softening light-heavy differentials.

While Singapore margins have been reduced by US$1.5 and US$1.2 over the next 2 years, the cut in RPL's margins is much sharper at US$2.8 and US$2.0 respectively. This is mainly because we expect diesel margins to deteriorate in addition to the already weak gasoline margins. Moreover, softening light-heavy differentials and improving fuel oil cracks reduce RPL's premium over Singapore GRMs. Further, a delay in KG gas production also results in lower savings from using gas, which also negatively affects GRMs.

The result of the above changes in our margin assumptions is a 20-32% downgrade in our FY10-11E earnings, as shown in Figure 20.

Figure 20. RPL – Earnings revision

Year to	Net Profit (Rs Mils.)		Diluted EPS (Rs)			Dividend Per Share (Rs)	
31-Mar	Old	New	Old	New	% Chg	Old	New
2009E	18,065	-	4.01	-	-	0.4	-
2010E	69,972	47,530	15.55	10.56	-32.1%	2.3	1.6
2011E	82,747	65,988	18.39	14.66	-20.3%	3.7	2.9

Source: Citi Investment Research estimates

Our new earnings estimates also incorporate our revised Rs/US$ assumptions of Rs48.0 and Rs47.0 over FY10-11E, which partially mitigates the impact of lower GRMs. In addition, we now expect the refinery to commence commercial production from Apr-09 (vs. Jan-09 earlier).

Target price based on 5.5x FY10E EV/EBITDA

We apply an EV/EBITDA multiple of 5.5x on our new FY10E estimates and add the value of tax benefits to arrive at our new target price. We continue to base our target price on 5.5x FY10E EV/EBITDA, in-line with the multiple ascribed to RIL's existing refinery. We maintain a slight premium to the 5.0x multiple that we use to value regional peers and public sector peers (viz. CPCL), as RPL is likely to generate a meaningful differential over Singapore margins even during periods of soft cracks. Our target price also includes Rs17/share as the NPV of tax benefits.

Figure 21. RPL – Valuation Target

EV/EBITDA (x)	**5.5x**
EBITDA – FY10E - Rs m	72,827
EV (as on Mar-09) - US$bn	8.3
Debt (as on Mar-09) - US$bn	2.9
Equity value (as on Mar-09) - US$bn	5.4
Value per share (Rs)	58
Value of tax benefits (Rs)	17
Target price (Rs)	**74**

Source: Citi Investment Research

Reliance Industries

Company description

Reliance Industries is a conglomerate with interest in upstream oil & gas (E&P), refining, and petrochemicals. It is building a super-size refinery project through its 70% subsidiary (RPL) and is also undertaking development of a large gas find 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/Medium Risk with a target price of Rs1,475. Given the concerns on demand slowdown in developed markets, the refining outlook over the next 12-18 months has softened. However, E&P business has delivered positive surprise and looks set to become more meaningful in the next 3-4 years as KG D6 field commences production and new discoveries are brought on stream. Upgrade of reserves in KG basin adds to the value, although the NAV of the gas find depends on development capex and the demand profile from anchor customers. Given the track record of exploratory success and the evolving portfolio (much beyond KG D6), RIL's E&P business needs to be valued as a going concern rather than a combination of assets. We have therefore valued E&P business (Rs606/share) on more traditional EV/FCF multiple rather than the consensus NAV approach. Upside in other exploration blocks should provide offset to any further weakening in the refining/petrochemical cycle. Factors such as diversity of revenues, integration across product chains, and volume growth should help RIL tide over downturns in product cycles relatively better than peers.

Valuation

Our target price of Rs1,475 is based on a sum-of-the-parts value: 1) We value RIL's core petrochem and downstream oil business on an EV/EBITDA of 5.5x FY10E, in line with regional chemicals and refining peers; this also captures the impact of a global downturn in refining and petchem; 2) We value total E&P assets including oil & gas prospects and other blocks at Rs606/share based on 10x steady state (FY11E) FCF; 3) We value investment in RPL at 5.5x FY10E EV/EBITDA (in line with RIL); 4) We value organized retail business at Rs51/share, based on book value of investments so far; and 5) We value treasury stock at target price.

Risks

We rate RIL Medium Risk, as opposed to the High Risk 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. Risks that could lead to a downside to our target price are: RIL's margins are exposed to the global petrochemical and refining cycles; further delays in the key KG-D6 gas development and RPL refinery project; delays in the drilling programme for the new blocks (D9, D3, MN-D4); and the organized retail business would call for significant investment in non-core areas.

Reliance Petroleum

Company description

RPL is presently 70% owned by Reliance Industries (RIL) and is setting up a super-size greenfield refinery (580,000bpd) and polypropylene plant in Jamnagar in the State of Gujarat. The project cost is estimated at Rs270bn (US$6bn), of which 50% has been raised as equity through the promoter contribution and Initial Public Offering in early FY07. The project is scheduled to commission in 4Q2008.

Investment strategy

We rate Reliance Petroleum (RPL) Sell/High Risk (3H) with a target price of Rs74. RPL is constructing a super-sized refinery (580kbpd) targeted at export markets. Key competitive advantages that we expect to aid sustenance of superior margins include a heavier crude diet, product flexibility, and superior fuel specs. A tried-and-tested location and parent RIL's strong execution track record imparts RPL a head start over competing projects, many of which have been delayed or cancelled. However, we expect a weakening in refining product demand owing to an economic slowdown esp. in US and Europe. We believe the advantage of complex refiners has narrowed with lower L-H crude differential and tighter fuel oil supply. In addition, weak gasoline cracks and the expectation of a decline in diesel cracks are key reasons for our negative view on the stock.

Valuation

Our valuation methodology uses a traditional EV/EBITDA multiple as on Mar-09E applied on 12-mnth forward EBITDA i.e. Mar-10E (first full year of operation). In addition, we value the tax benefits separately which is added to the core value to arrive at the target price. We believe EV/EBITDA is an appropriate valuation metric as it eliminates variations due to capital structure and taxation, thus facilitating peer comparison. We use an EV/EBITDA multiple of 5.5x to reflect the further weakening of the refining outlook. However, we have faith in the company's ability to source and process dirty crude grades and sustain the differential over Singapore complex even during periods of relatively soft crack spreads, and hence value it at a slight premium over regional peers (EV/EBITDA of 5.0x) and public sector peers in India i.e. CPCL (5.0x) . Based on our GRM assumptions and the highly remunerative tax regime, we value the tax benefits to be worth NPV of Rs17/share. This together with core value based on 12-mnth forward EV/EBITDA multiple (Rs58/share) is the basis of our Mar-09E target price of Rs74/share.

Risks

We rate RPL shares as High Risk, in line with our quantitative risk-rating methodology, given the volatile crude and refining environment. The risks to margins have also increased given the uncertain extent of damage to oil products demand from an economic slowdown esp. in Europe and US.

Any of the following risk factors could result in the shares trading above our target price: 1) Strengthening of refining margins in the short-term; 2) re-investment of free cash flows in capacity additions which could be value accretive in addition to sustaining the tax breaks beyond the first 10 years; 3) sustained increase in differential enjoyed by cleaner fuels (10ppm/50ppm sulphur); and 4) higher-than-anticipated cost savings from KG basin gas.

Appendix A-1

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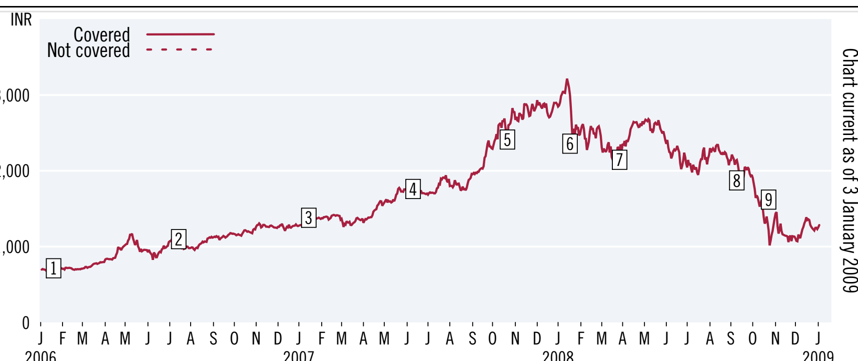
IMPORTANT DISCLOSURES

Reliance Industries (RELI.BO)

Ratings and Target Price History
Fundamental Research

Analyst: Rahul Singh



	Date	Rating	Target Price	Closing Price
1	19-Jan-06	1L	*794.00	704.20
2	14-Jul-06	*2L	*1,150.00	1,065.15
3	15-Jan-07	2L	*1,450.00	1,364.65
4	11-Jun-07	*1L	*2,005.00	1,668.20
5	21-Oct-07	1L	*2,860.00	2,469.20
6	17-Jan-08	1L	*3,460.00	2,996.25
7	27-Mar-08	1L	*2,850.00	2,275.00
8	9-Sep-08	1L	*2,450.00	2,142.85
9	23-Oct-08	*1M	*1,756.00	1,215.25

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Reliance Petroleum (RPET.BO)

Ratings and Target Price History
Fundamental Research

Analyst: Rahul Singh
Covered since July 5 2006

	Date	Rating	Target Price	Closing Price
1	4-Jul-06	*2M	*71.00	62.05
2	25-Apr-07	*1M	*100.00	80.70
3	1-Aug-07	*1L	*131.00	107.70
4	4-Oct-07	*2L	*170.00	162.00
5	17-Jan-08	*3L	*220.00	219.30
6	3-Jun-08	*1L	*204.00	172.00
7	10-Sep-08	*3L	*155.00	158.60
8	22-Oct-08	*3H	*105.00	100.05

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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% of companies in each rating category that are investment banking clients	48%	43%	38%

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Investment ratings are determined by the ranges described above at the time of initiation of coverage, a change in investment and/or risk rating, or a change in target price (subject to limited management discretion). At other times, the expected total returns may fall outside of these ranges because of market price movements and/or other short-term volatility or trading patterns. Such interim deviations from specified ranges will be permitted but will become subject to review by Research Management. Your decision to buy or sell a security should be based upon your personal investment objectives and should be made only after evaluating the stock's expected performance and risk.

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