

MAY 28, 2010

UPDATE

Coverage view: **Cautious**

Price (Rs): **1,022**

Target price (Rs): **985**

BSE-30: **16,666**

FY2010 annual report analysis; clarification on treasury shares required. We have updated our earnings model for RIL's FY2010 annual report but there are no major changes to our model since RIL had given the broad balance sheet figures at the time of its 4QFY10 results. We retain SELL rating with a revised 12-month SOTP-based target price of Rs985 (Rs1,040 previously). We see downside risks from weaker-than-expected margins and upside risk from weaker-than-expected rupee.

Company data and valuation summary

Reliance Industries

Stock data		Forecasts/Valuations			
		2010	2011E	2012E	
52-week range (Rs) (high,low)	1,190-859	EPS (Rs)	49.6	62.9	80.2
Market Cap. (Rs bn)	3,042.2	EPS growth (%)	(1.8)	26.6	27.5
Shareholding pattern (%)		P/E (X)	20.6	16.3	12.7
Promoters	41.1	Sales (Rs bn)	1,924.6	2,495.6	2,624.2
FIs	21.3	Net profits (Rs bn)	162.4	205.6	262.2
MFs	2.6	EBITDA (Rs bn)	309.4	397.9	449.7
Price performance (%)	1M	3M	12M		
Absolute	(3.7)	4.4	(6.5)	EV/EBITDA (X)	11.1
Rel. to BSE-30	2.2	2.9	(20.8)	ROE (%)	11.4
				Div. Yield (%)	1.3
					1.7
					2.0

Accounting of cash (Rs93.3 bn) from sale of 88.8 mn treasury shares unclear

RIL's consolidated cash flow statement shows an exceptional item of Rs86 bn (pertaining to treasury shares sale by Petroleum Trust) adjusted (reduced) from "cash flow from operating activities". However, we cannot find a matching entry in (1) "cash flow from investing activities" or "cash flow from financing activities" or (2) in RIL's standalone cash flow statement in case the cash has been transferred to RIL. The latter does not seem to be the case. We note that standalone and consolidated cash, debt and loans and advances are roughly similar. Exhibit 1 shows standalone and consolidated cash flow statement of RIL for FY2010.

FY2010 gross capex at Rs219 bn versus net capex of Rs93 bn

RIL's FY2010 gross capex was Rs219 bn broken down into Rs118 bn for E&P, Rs94 bn for R&M and Rs7.3 bn for petrochemicals against Rs93 bn of net capex (difference between gross block and C-WIP of the two periods). The difference presumably reflects (1) Rs15.3 bn of interest capitalized (contributing to increase in fixed assets) and (2) Rs141 bn of foreign currency difference (contributing to decrease in fixed assets due to rupee appreciation).

Marked improvement in operations of retailing subsidiary

RIL's retailing subsidiaries reported a net loss of Rs2.8 bn of sales of Rs44 bn in FY2010 compared to a loss of Rs4.9 bn on sales of Rs39 bn in FY2009. RIL has invested an additional Rs12.2 bn in FY2010 in Reliance Retail taking its equity investment to Rs52.2 bn. RIL's investment in its SEZ businesses has declined significantly. RIL paid Rs38 bn (Rs19.5 bn in FY2009) as power, fuel, sales and distribution charges to private companies of the major shareholder with the sharp increase reflecting a near doubling of refining volumes.

SELL rating with 12-month fair valuation of Rs985

We have fine-tuned FY2011E, FY2012E and FY2013E EPS to Rs63, Rs80 and Rs87, respectively, to reflect the FY2010 annual report. There are no changes to our volume, price and margin assumptions. We use the average of FY2011E (Rs915) and FY2012E (Rs1,060) SOTP-based fair valuation to establish our 12-month target price of Rs985.

QUICK NUMBERS

- **Rs93.3 bn of cash raised from sale of treasury shares; accounting unclear**
- **Rs219 bn of gross capex versus Rs93 bn of net capex in FY2010**
- **Rs15.3 bn of interest capitalized in FY2010**

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Comparison of standalone and consolidated cash flow statements of RIL
Cash flow model, March fiscal year-end, 2010 (Rs mn)

	Standalone	Consolidated
Operating		
Profit before tax	205,474	286,799
DD&A	134,770	140,006
Transferred from revaluation reserve	(29,805)	(29,918)
Transferred from capital reserve	—	(630)
Taxes paid	(30,819)	(31,404)
Interest expenses	19,972	20,596
Effect of exchange rate change	(18,374)	(17,994)
Profit on sale of investments	(2,384)	(2,962)
Other income	(21,108)	(17,245)
Exceptional item	—	(86,056)
Extraordinaries	191	3,132
Working capital changes	(53,015)	(59,381)
Total operating	204,902	204,943
Investing		
Capital expenditure	(219,427)	(232,781)
Sale of fixed assets	1,132	2,613
Purchase of investments	(1,988,661)	(2,011,379)
Sale of investments	1,976,607	2,037,826
Loans (to)/from companies	26,260	(191)
Interest/dividends received	22,043	21,603
Total investing	(182,045)	(182,308)
Financing		
Share issuance (including warrants)	535	535
Share issuance to minority	—	4,590
Loans (net)	(53,024)	(58,221)
Dividends	(22,195)	(22,195)
Interest paid	(35,313)	(36,044)
Miscellaneous expenditure	—	(4)
Total financing	(109,996)	(111,337)
Net change in cash	(87,139)	(88,703)
Opening cash	221,765	227,611
Closing cash	134,627	138,908

Source: Company, Kotak Institutional Equities

Clarification on accounting of and movement in treasury shares would help

We highlight two points with respect to treasury shares—(1) accounting of Rs93 bn of cash from sale of treasury shares and (2) transfer of treasury shares between entities holding the treasury shares—that require more clarity.

- ▶ **Accounting of Rs93 bn of cash from the sale of 88.8 mn treasury shares.** We are not sure about the accounting of the Rs93 bn of cash from the sale of 88.8 mn treasury shares in three tranches by the company. These shares were sold by Petroleum Trust, the beneficiary of which is Reliance Industrial Investments and Holdings Ltd (RIIHL), a 100% subsidiary of RIL. We note that the cash and debt figures in the standalone and consolidated financial statements are substantially similar (see Exhibit 2) and there doesn't seem to be any transfer of cash from the relevant subsidiary to the parent company.

Standalone and consolidated cash and debt are similar

Key balance sheet items, March fiscal year-end, 2010 (Rs bn)

	2010		2010 versus 2009	
	Standalone	Consolidated	Standalone	Consolidated
Cash	135	139	(87)	(89)
Debt	625	646	(114)	(117)
Current assets excluding cash	387	446	193	196
Loans and advances	102	106	(29)	(4)
Investments excluding subsidiary companies	105	131	55	67
Gross block and Capital work-in-progress	2,280	2,412	93	101

Source: Company, Kotak Institutional Equities

RIL's consolidated pre-tax profit of Rs287 bn includes Rs86 bn of exceptional gain from the aforementioned sale of treasury shares (see page 157 and Schedule I on page 166 of the FY2010 annual report). However, the consolidated cash flow statement (see pages 158-159 of the FY2010 annual report) of RIL shows a deduction of Rs86 bn (this amount is the same as the income from sale of RIL shares by the Petroleum Trust) from "cash flow from operating activities".

We examine two possibilities.

- **Cash with Petroleum Trust; invested by RIIHL and not transferred to RIL.** It is possible that the cash is still with Petroleum Trust and it has not been 'transferred' to RIIHL or RIL. However, this seems to be at odds with the fact that the sale of treasury shares has been accounted for in the consolidated income statement. On the other hand, the cash does not appear to reflect in the consolidated cash flow statement and in fact has been shown as a reduction from "cash flow from operating activities" as discussed above. Also, there does not seem to be a contra item in the "cash flow from investing activities" or in "cash flow from financing activities".

One possibility is that the cash may be a part of investments, loans and advances, working capital or even fixed assets (essentially any item on the asset side), but we are unable to figure out where exactly. None of the broad items are very different from the standalone figures. Also, it does not look that it has been used to repay debt—standalone and consolidated total debt and repayment amounts are very similar (please refer to Exhibits 1 and 2).

- **Cash has been transferred to parent RIL.** It does not look like the cash has been transferred to RIL from RIIHL/Petroleum Trust since it does not reflect in the standalone cash flow statement of RIL (see pages 106-107 of the FY2010 annual report). Also, RIL's loans or the disclosures on related-party transactions do not show any loan to RIL from RIIHL/RIL.
- ▶ **Transfer of treasury shares between step-down subsidiaries.** It seems that the four step-down subsidiaries of RIL (Reliance Chemicals Private Limited, Reliance Aromatics and Petrochemicals Private Limited, Reliance Energy and Project Development Private Limited and Reliance Polyolefins Limited) that held 131.4 mn shares have transferred about 100 mn shares to some other entities.

Page 137 of the FY2009 annual report shows that the abovementioned entities held 131.4 mn shares (adjusted for 1:1 bonus) of RIL. However, page 142 of the FY2010 annual report shows that only two entities (Reliance Aromatics & Petrochemicals Private Limited and Reliance Energy & Project Development Private Limited) held 30.95 mn shares of RIL. This would suggest the treasury shares have been transferred to some other entities. We would clarify that these treasury shares are different from the aforementioned treasury shares held by the Petroleum Trust.

RIL has large transactions with private companies of the major shareholder
Reliance Industries' related-party transactions, March fiscal year-ends, 2007-10 (Rs bn)

	2007	2008	2009	2010
Payments made				
Reliance Utilities and Power Limited	3	3	3	3
Reliance Utilities Private Limited	—	—	4	7
Reliance Ports and Terminals Limited	10	12	13	27
Others	1	1	2	4
Total payments	15	17	21	41
Loans and advances given				
Reliance Utilities and Power Limited	—	2	—	—
Reliance Gas Transportation Infrastructure Limited	20	—	—	—
Others	2	2	1	1
Total loans and advances given	22	3	1	1
Loans and advances balances				
Reliance Gas Transportation Infrastructure Limited	20	20	20	20
Reliance Ports and Terminals Limited	11	11	11	11
Reliance Utilities and Power Limited	2	2	2	2
Others	2	2	2	2
Total loans and advances	34	35	34	34

Source: Company, Kotak Institutional Equities

SOTP valuation of Reliance is Rs915 per share on FY2011E estimates
Sum-of-the-parts valuation of Reliance Industries, FY2011E basis (Rs)

	Valuation base (Rs bn)		Multiple (X)		EV	Valuation
	Other	EBITDA	Multiple	EV/EBITDA	(Rs bn)	(Rs/share)
Chemicals		96		7.0	675	228
Refining & Marketing		131		7.5	981	331
Oil and gas—producing (PMT and Yemen)		18		5.0	92	31
Gas—producing and developing (DCF-based) (a)	816				816	276
KG D-6	464				464	157
NEC-25	92				92	31
CBM	53				53	18
KG D-3	56				56	19
KG D-9	84				84	29
MN D-4	66				66	22
Oil—KG-DWN-98/3 (b)	81				81	27
Investments other than valued separately	105				105	35
Loans & advances to affiliates	4				4	1
Cash with subsidiary from sale of treasury shares	86				86	29
Retailing	52		80%		42	14
SEZ development	30		80%		24	8
Total enterprise value					2,905	981
Net debt adjusted for 50% of C-WIP of E&P assets					202	68
Implied equity value					2,704	913

Note:

- (a) We value KG D-6, NEC-25, CBM, KG D-3, KG D-9 and MN D-4 blocks on DCF.
(b) 180 mn bbls of recoverable reserves based on gross OOIP of 0.5 bn bbls.
(c) We use 2.976 bn shares (excluding treasury shares) for per share computations.

Source: Kotak Institutional Equities estimates

SOTP valuation of Reliance is Rs1,060 per share on FY2012E estimates

Sum-of-the-parts valuation of Reliance Industries, FY2012E basis (Rs)

	Valuation base (Rs bn)		Multiple (X)		EV (Rs bn)	Valuation (Rs/share)
	Other	EBITDA	Multiple	EV/EBITDA		
Chemicals		103		7.0	718	242
Refining & Marketing		151		7.5	1,134	383
Oil and gas—producing (PMT and Yemen)		20		5.0	98	33
Gas—producing and developing (DCF-based) (a)	800				800	270
KG D-6	400				400	135
NEC-25	99				99	34
CBM	53				53	18
KG D-3	69				69	23
KG D-9	100				100	34
MN D-4	79				79	27
Oil—KG-DWN-98/3 (b)	81				81	27
Investments other than valued separately	105				105	35
Loans & advances to affiliates	4				4	1
Cash with subsidiary from sale of treasury shares	86				86	29
Retailing	52		80%		42	14
SEZ development	30		80%		24	8
Total enterprise value					3,091	1,044
Net debt adjusted for 50% of C-WIP of E&P assets					(35)	(12)
Implied equity value					3,126	1,056

Note:

(a) We value KG D-6, NEC-25, CBM, KG D-3, KG D-9 and MN D-4 blocks on DCF.

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

(c) We use 2.976 bn shares (excluding treasury shares) for per share computations.

Source: Kotak Institutional Equities estimates

Reliance's earnings have high leverage to refining margins

Sensitivity of RIL's earnings to key variables

	Fiscal 2011E			Fiscal 2012E			Fiscal 2013E		
	Downside	Base case	Upside	Downside	Base case	Upside	Downside	Base case	Upside
Rupee-dollar exchange rate									
Rupee-dollar exchange rate	44.0	45.0	46.0	44.3	45.3	46.3	44.3	45.3	46.3
Net profits (Rs mn)	196,785	205,606	214,428	252,355	262,222	272,089	273,542	283,679	293,817
EPS (Rs)	60.2	62.9	65.6	77.2	80.2	83.2	83.6	86.7	89.8
% upside/(downside)	(4.3)		4.3	(3.8)		3.8	(3.6)		3.6
Chemical prices									
Change in prices (%)	(5.0)		5.0	(5.0)		5.0	(5.0)		5.0
Net profits (Rs mn)	200,960	205,606	210,253	257,355	262,222	267,089	278,701	283,679	288,658
EPS (Rs)	61.4	62.9	64.3	78.7	80.2	81.7	85.2	86.7	88.3
% upside/(downside)	(2.3)		2.3	(1.9)		1.9	(1.8)		1.8
Blended refining margins (US\$/bbl)									
Margins (US\$/bbl)	7.8	8.8	9.8	8.8	9.8	10.8	9.3	10.3	11.3
Net profits (Rs mn)	187,871	205,606	223,326	244,361	262,222	279,977	265,847	283,679	301,413
EPS (Rs)	57.4	62.9	68.3	74.7	80.2	85.6	81.3	86.7	92.2
% upside/(downside)	(8.6)		8.6	(6.8)		6.8	(6.3)		6.3

Source: Kotak Institutional Equities estimates

RIL: Profit model, balance sheet, cash model, March fiscal year-ends, 2006-2014E (Rs mn)

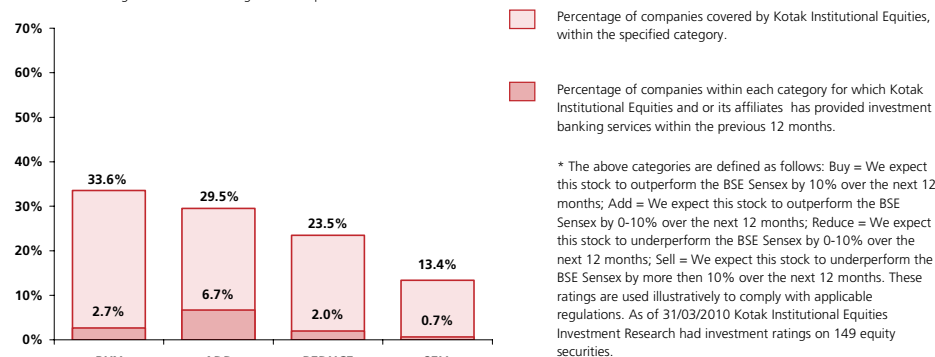
	2006	2007	2008	2009	2010	2011E	2012E	2013E	2014E
Profit model (Rs mn)									
Net sales	809,113	1,114,927	1,334,430	1,418,475	1,924,610	2,495,632	2,624,219	2,724,442	2,738,544
EBITDA	139,991	198,462	233,056	233,139	305,807	394,344	446,093	475,950	474,360
Other income	6,829	4,783	8,953	20,599	24,605	22,242	18,850	29,700	49,547
Interest	(8,770)	(11,889)	(10,774)	(17,452)	(19,972)	(24,183)	(9,511)	(6,497)	(5,555)
Depreciation & depletion	(34,009)	(48,152)	(48,471)	(51,953)	(104,965)	(131,342)	(125,123)	(143,021)	(147,844)
Pretax profits	104,041	143,205	182,764	184,332	205,474	261,062	330,310	356,132	370,507
Extraordinary items	3,000	2,000	47,335	—	—	—	—	—	—
Tax	(9,307)	(16,574)	(26,520)	(12,634)	(31,118)	(54,394)	(70,513)	(85,076)	(91,336)
Deferred taxation	(7,040)	(9,196)	(8,999)	(18,605)	(12,000)	(1,061)	2,425	12,624	18,010
Net profits	90,693	119,434	194,580	153,093	162,357	205,606	262,222	283,679	297,181
Adjusted net profits	88,152	117,789	152,605	153,093	162,357	205,606	262,222	283,679	297,181
Earnings per share (Rs)	31.6	40.5	52.5	50.6	49.6	62.9	80.2	86.7	90.9
Balance sheet (Rs mn)									
Total equity	430,543	673,037	847,853	1,263,730	1,371,706	1,512,531	1,695,575	1,885,681	2,089,288
Deferred taxation liability	49,708	69,820	78,725	97,263	109,263	110,324	107,899	95,276	77,265
Minority interest	—	33,622	33,622	—	—	—	—	—	—
Total borrowings	218,656	332,927	493,072	739,045	624,947	337,340	130,999	128,774	128,514
Current liabilities	164,545	192,305	251,427	357,019	404,148	383,752	400,931	411,346	411,771
Total liabilities and equity	863,452	1,301,712	1,704,700	2,457,057	2,510,064	2,343,947	2,335,404	2,521,076	2,706,838
Cash	21,461	18,449	42,822	221,765	134,626	19,215	49,827	290,474	545,981
Current assets	224,283	286,566	402,721	325,358	489,165	503,780	517,367	530,380	531,775
Total fixed assets	626,745	899,403	1,081,638	1,693,869	1,653,987	1,588,666	1,535,924	1,467,935	1,396,795
Investments	(9,038)	97,294	177,519	216,065	232,286	232,286	232,286	232,286	232,286
Deferred expenditure	—	—	—	—	—	—	—	—	—
Total assets	863,452	1,301,712	1,704,700	2,457,057	2,510,064	2,343,947	2,335,403	2,521,076	2,706,838
Free cash flow (Rs mn)									
Operating cash flow, excl. working capital	119,520	164,285	180,718	174,508	222,605	311,559	360,290	381,159	373,474
Working capital	(32,188)	(13,075)	(31,071)	(37,983)	(53,015)	(35,011)	3,591	(2,597)	(971)
Capital expenditure	(94,273)	(247,274)	(239,691)	(247,128)	(219,427)	(61,550)	(65,645)	(72,772)	(71,754)
Investments	(32,364)	(105,760)	(78,953)	(10,392)	14,206	—	—	—	—
Other income	5,159	4,143	6,132	16,195	22,043	22,242	18,850	29,700	49,547
Free cash flow	(34,146)	(197,681)	(162,865)	(104,800)	(13,587)	237,240	317,087	335,490	350,296
Ratios (%)									
Debt/equity	45.5	44.8	53.2	54.3	42.2	20.8	7.3	6.5	5.9
Net debt/equity	41.1	42.3	48.6	38.0	33.1	19.6	4.5	(8.2)	(19.3)
RoAE	19.9	20.3	18.9	13.6	11.8	13.5	15.5	15.2	14.5
RoACE	13.8	13.9	12.7	11.2	9.3	11.2	13.9	13.8	13.0

Source: Company, Kotak Institutional Equities estimates

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