Company Focus

18 January 2008 | 8 pages

Reliance Petroleum (RPET.BO)

Downgrade to Sell; All in the Price

Change in opinion ☑
Rating change ☑
Target price change ☑
Estimate change ☑

- **Valuations leave no room for upside** — We downgrade RPL to Sell/Low Risk from Hold/Low Risk notwithstanding the positive view on the refining cycle. Our revised target price of Rs220 is based on a rich 12-month forward target EV/EBITDA of 7.5x as on Sep-08.
- **Asset valuations also appear rich** — At the current stock price, RPL is trading at EV per complexity bbl of US$3,500, well in excess of peers and replacement cost of US$2,000-2,200. Even adjusting for RPL's material tax breaks (NPV of US$3.3bn), the EV/complexity bbl at US$3,100/bbl is even higher than its parent RIL's (which also enjoys tax benefits) US$3,000 at target multiples.
- **Upgrading refining margins to US$17.0-17.5/bbl** — Our new GRM assumptions are US$17.0-17.5/bbl for FY09-11E (earlier at US$15.0-15.5/bbl). This includes roughly US$1.0/bbl savings from KG gas and is at US$10.5/bbl premium to Singapore complex and US$3.2-3.4/bbl higher than RIL's assumptions.
- **Chevron's stance unclear** — RIL's partial stake sale in RPL raises question marks on Chevron's intentions; we think any move by Chevron to sell their 5% stake back to RIL could pave the way for RPL's eventual merger with RIL. Upside risks to our target price could come from: i) any move to increase RPL's capacity further, and ii) increased differential of clean fuels (50/10ppm sulphur).

Sell/Low Risk	**3L**
from Hold/Low Risk	
Price (17 Jan 08)	Rs219.30
Target price	Rs220.00
from Rs170.00	
Expected share price return	0.3%
Expected dividend yield	0.0%
Expected total return	**0.3%**
Market Cap	Rs986,850M
	US$25,168M

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

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2009E	62,660	13.9	na	15.7	5.2	na	0.5
2010E	113,427	25.2	81.0	8.7	3.4	47.3	1.4
2011E	114,356	25.4	0.8	8.6	2.6	34.3	2.0
2012E	109,315	24.3	-4.4	9.0	2.1	26.0	2.4
2013E	104,803	23.3	-4.1	9.4	1.8	20.9	2.3

Source: Powered by dataCentral

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Fiscal year end 31-Mar	2009E	2010E	2011E	2012E	2013E
Valuation Ratios					
P/E adjusted (x)	15.9	8.8	8.7	9.1	9.5
EV/EBITDA adjusted (x)	16.1	8.0	7.4	7.1	6.8
P/BV (x)	5.2	3.5	2.6	2.2	1.8
Dividend yield (%)	0.6	1.7	2.3	2.7	2.6
Per Share Data (Rs)					
EPS adjusted	13.92	25.21	25.41	24.29	23.29
EPS reported	13.92	25.21	25.41	24.29	23.29
BVPS	42.53	63.96	84.29	102.51	119.97
DPS	1.39	3.78	5.08	6.07	5.82
Profit & Loss (RsM)					
Net sales	406,389	764,191	762,326	753,751	746,951
Operating expenses	-340,168	-647,380	-647,536	-647,692	-647,900
EBIT	**66,221**	**116,810**	**114,789**	**106,059**	**99,050**
Net interest expense	-3,561	-4,775	-4,918	-4,371	-5,579
Non-operating/exceptionals	0	2,098	6,764	11,504	17,091
Pre-tax profit	**62,660**	**114,134**	**116,636**	**113,192**	**110,562**
Tax	0	-707	-2,280	-3,877	-5,760
Extraord./Min.Int./Pref.div.	0	0	0	0	0
Reported net income	**62,660**	**113,427**	**114,356**	**109,315**	**104,803**
Adjusted earnings	62,660	113,427	114,356	109,315	104,803
Adjusted EBITDA	66,221	130,460	128,595	120,021	113,220
Growth Rates (%)					
Sales	na	88.0	-0.2	-1.1	-0.9
EBIT adjusted	na	76.4	-1.7	-7.6	-6.6
EBITDA adjusted	na	97.0	-1.4	-6.7	-5.7
EPS adjusted	na	81.0	0.8	-4.4	-4.1
Cash Flow (RsM)					
Operating cash flow	**62,660**	**81,497**	**126,035**	**120,104**	**113,772**
Depreciation/amortization	0	13,650	13,806	13,962	14,170
Net working capital	0	-44,872	153	705	559
Investing cash flow	**-90,000**	**-2,000**	**-3,000**	**-3,000**	**-4,000**
Capital expenditure	-90,000	-2,000	-3,000	-3,000	-4,000
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	**27,340**	**3,734**	**-22,618**	**-34,080**	**21,024**
Borrowings	27,340	10,000	-5,604	-11,209	48,353
Dividends paid	0	-6,266	-17,014	-22,871	-27,329
Change in cash	**0**	**83,231**	**100,417**	**83,025**	**130,796**
Balance Sheet (RsM)					
Total assets	**266,119**	**432,719**	**524,457**	**599,693**	**725,520**
Cash & cash equivalent	0	83,938	186,635	273,537	410,093
Accounts receivable	0	56,296	56,142	55,438	54,879
Net fixed assets	226,201	214,552	203,746	192,785	182,615
Total liabilities	**74,726**	**144,913**	**145,166**	**138,415**	**185,640**
Accounts payable	0	44,440	44,440	44,440	44,440
Total Debt	68,460	78,460	72,855	61,647	110,000
Shareholders' funds	**191,394**	**287,806**	**379,291**	**461,278**	**539,880**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	16.3	17.1	16.9	15.9	15.2
ROE adjusted	32.7	47.3	34.3	26.0	20.9
ROIC adjusted	24.9	41.1	38.3	36.2	34.4
Net debt to equity	35.8	-1.9	-30.0	-45.9	-55.6
Total debt to capital	26.3	21.4	16.1	11.8	16.9

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Valuations pricing in bullish GRMs

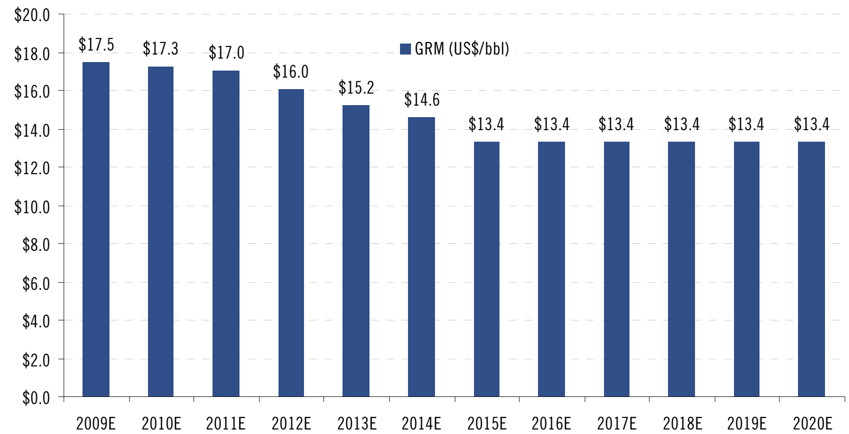
Our new target is based on 7.5x 12-months forward EBITDA (as on Sep-08). The higher target price of Rs220 (previously Rs170) is based on a material upgrade in GRM assumptions (by about US$2.0/bbl) and includes the NPV value of tax benefits. The tables below enumerate the valuation target, GRM and earnings changes. Please note that the new GRM assumptions of US$17.0-17.5/bbl over FY09-11E is US$3.2-3.4/bbl in excess of RIL, which we believe is more than reasonable for the difference in their complexity levels.

Figure 1. RPL – Refining Margin Revisions

US$/bbl	FY09E	FY10E	FY11E
RPL – old	15.5	15.2	15.2
RPL – new	17.5	17.3	17.0
RIL	14.3	13.9	na
Differential over RIL	3.2	3.3	na
Singapore Complex	7.0	6.5	6.0
Differential over Singapore	10.5	10.8	11.0

Source: Citi Investment Research estimates

Figure 2. RPL – Refining Margin Assumptions



Source: Citi Investment Research estimates

Figure 3. RPL - Earnings Revision

Year to	Net Profit (Rs m)		Diluted EPS (Rs)			Dividend Per Share (Rs)	
31-Mar	Old	New	Old	New	% Chg	Old	New
2009E	53,859	62,660	11.97	13.92	16.3%	1.2	1.4
2010E	89,604	113,427	19.91	25.21	26.6%	3.0	3.8
2011E	97,638	114,356	21.70	25.41	17.1%	4.3	5.1
2012E	95,268	109,315	21.17	24.29	14.7%	5.3	6.1

Source: Citi Investment Research estimates

Figure 4. RPL – Valuation Framework

EV/EBITDA (x)	**7.0x**	**7.5x**	**8.0x**
EBITDA - 12m fwd as on Sep'08 - Rs m	131,451	131,451	131,451
EV (as on Sep-08) - US$bn	23.0	24.6	26.3
Debt (as on Sep-08) - US$bn	3.3	3.3	3.3
Equity value (as on Sep-08) - US$bn	19.7	21.4	23.0
Value per share	175	190	205
Value of tax benefits	30	30	30
Target price	**205**	**220**	**235**

Source: Citi Investment Research estimates

Figure 5. Asset Valuation Comparables

Company	RIC Code	Share Price	EV (US$m)	Throughput (kbpd)	Nelson's Complexity	EV/ bbl (US$)	EV/complexity bbl (US$)
RPL	RPET.BO	221	28,535	580	14.0	49,199	3,514
RIL (EV/EBITDA of 7.5x)	RELI.BO	3,098	22,326	660	11.3	33,827	2,994
Chennai Petroleum	CHPC.BO	376	1,846	210	7.0	8,790	1,256
Mangalore Refinery	MRPL.BO	128	6,298	250	9.0	25,190	2,799
Bongaigaon Refinery	BNGR.BO	89	477	48	6.0	9,928	1,655
S-Oil	010950.KS	63,400	5,438	580	7.0	9,376	1,339
SK Energy	096770.KS	146,500	6,850	1,115	4.5	6,143	1,365
Thai Oil	TOP.BK	74	3,566	275	8.4	12,966	1,544
Sunoco	SUN.N	58	8,939	900	8.5	9,933	1,169
Tesoro	TSO.N	36	5,882	658	9.5	8,939	941
Valero	VLO.N	54	36,226	3260	11.2	11,112	992

Source: Citi Investment Research

Reliance Petroleum

Company description

RPL is presently 75% 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 mid-2008.

Investment strategy

We rate Reliance Petroleum (RPL) Sell/Low Risk (3L) rating with a target price of Rs220. 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 mix, 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. We also expect tightening fuel specs, especially in the US and Europe, will continue to drive demand for high-quality, differentiated products. However, the stock has undergone a sharp re-rating over the last six months on the back of favorable global environment, rising replacement costs and demonstrated strong execution. This leaves no upside to our target price.

Valuation

Our valuation methodology uses a traditional EV/EBITDA multiple as on September-08 applied on 12-mnth forward EBITDA i.e. 2HFY09E plus 1HFY10E. 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 believe that RPL, with its level of complexity (which we believe accords sustainability to margins) warrants a valuation at the higher end of peers i.e., a 12-month forward EV/EBITDA of 7.5x. We have upgraded the multiple from 7.0x earlier due to RIL's ability to source challenged crude grades and sustain the differential over Singapore Complex even during periods of soft crack spreads. Based on our GRM assumptions and the highly remunerative tax regime, we value the tax benefits to be worth NPV of US$3.3bn (Rs30/share). This together with core value based on 12-mnth forward EV/EBITDA multiple (Rs190/share) is the basis of our new target of Rs220/share.

Risks

Our quantitative risk rating system suggests a Low Risk rating to RPL. Any of the following risk factors could result in upside to our target price: 1) Further strengthening of refining margins; 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 the KG basin gas.

Appendix A-1

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Reliance Petroleum (RPET.BO)

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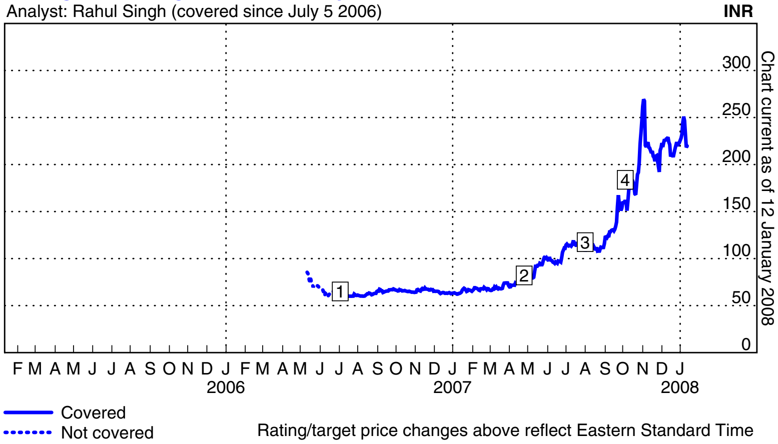
Analyst: Rahul Singh (covered since July 5 2006)



#	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

*Indicates change.

Rating/target price changes above reflect Eastern Standard Time

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