Company Focus

30 June 2009 | 10 pages

Reliance Industries (RELI.BO)

Gas Verdict – Implementation Issues & Unanswered Questions

- **Micro and macro implications** — We focus on four key issues: (i) Practicality of allowing RIL to supply gas to RNRL from "its quota of profit gas", (ii) Does the Court ruling supersede GoI's gas allocation policy and the PSC, (iii) Status of NTPC contract, and (iv) Impact on fresh demand. While the issue might land up in the higher court, we analyze above issues arising out of the Court order.
- **#1: Supply from Contractor's share may not be bankable** — Court has specified that RIL supplies RNRL from its quota of gas (read RIL's share of profit gas), as a means to supply at the lower price ($2.34) w/o impacting govt's profit share. However, as per our KG-D6 model, RIL's share starts at 90% but declines to only 15% after 10-11 yrs. Given that Reliance Power's units might take 3-4 yrs to start, it would be left with only about 7 yrs of assured volumes. However, it is unclear whether the PSC allows the Contractor to claim its profit share in kind.
- **#2: Where does the gas allocation policy stand?** — Supply to RNRL will impact current and future allocations to existing power/fertilizer units, thus questioning the relative standing of govt's gas allocation policy under the PSC.
- **#3: NTPC's $2.34 price not yet approved** — The contract for 12mmscmd is not yet consummated. As a result, the pricing is yet to be approved under the PSC though the EGoM price decision ($4.2) did take note of its sub-judice status.
- **#4: New demand might get discouraged** — New allocation, ex-RNRL/NTPC, could take a backseat if the issue goes to the higher court and uncertainty lingers on. This could impact gas demand and ramp-up beyond 80 mmscmd.

Hold/Low Risk	2L
Price (30 Jun 09)	Rs2,023.35
Target price	Rs1,835.00
Expected share price return	-9.3%
Expected dividend yield	1.1%
Expected total return	**-8.2%**
Market Cap	Rs3,184,392M US$66,307M

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 (%)
2007A	119,434	82.18	26.2	24.6	4.6	25.8	0.5
2008A	152,606	105.00	27.8	19.3	3.7	21.2	0.6
2009E	158,539	100.76	-4.0	20.1	3.2	17.7	1.0
2010E	213,395	135.63	34.6	14.9	2.7	19.7	1.1
2011E	259,019	164.62	21.4	12.3	2.3	20.3	1.2

Source: Powered by dataCentral

Rahul Singh[1]
+91-22-6631-9863
rahul.r.singh@citi.com

Saurabh Handa[1]
+91-22-6631-9858
saurabh.handa@citi.com

Garima Mishra[1]
garima.mishra@citi.com

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Fiscal year end 31-Mar	2007	2008	2009E	2010E	2011E
Valuation Ratios					
P/E adjusted (x)	24.6	19.3	20.1	14.9	12.3
EV/EBITDA adjusted (x)	16.2	14.6	14.5	9.8	7.9
P/BV (x)	4.6	3.7	3.2	2.7	2.3
Dividend yield (%)	0.5	0.6	1.0	1.1	1.2
Per Share Data (Rs)					
EPS adjusted	82.18	105.00	100.76	135.63	164.62
EPS reported	82.18	133.88	100.76	135.63	164.62
BVPS	439.75	548.83	631.74	742.62	880.24
DPS	11.00	13.00	20.00	22.00	24.00
Profit & Loss (RsM)					
Net sales	1,116,927	1,334,430	1,663,124	1,916,174	2,287,476
Operating expenses	-962,438	-1,159,711	-1,479,229	-1,634,785	-1,941,181
EBIT	**154,489**	**174,719**	**183,895**	**281,389**	**346,294**
Net interest expense	-11,889	-10,774	-15,953	-28,373	-28,339
Non-operating/exceptionals	2,604	66,156	20,330	19,836	15,152
Pre-tax profit	**145,205**	**230,101**	**188,273**	**272,852**	**333,107**
Tax	-25,771	-35,519	-29,734	-45,378	-54,542
Extraord./Min.Int./Pref.div.	0	0	0	-14,078	-19,546
Reported net income	**119,434**	**194,583**	**158,539**	**213,395**	**259,019**
Adjusted earnings	119,434	152,606	158,539	213,395	259,019
Adjusted EBITDA	202,641	223,190	234,024	357,283	430,150
Growth Rates (%)					
Sales	37.5	19.5	24.6	15.2	19.4
EBIT adjusted	40.4	13.1	5.3	53.0	23.1
EBITDA adjusted	40.7	10.1	4.9	52.7	20.4
EPS adjusted	26.2	27.8	-4.0	34.6	21.4
Cash Flow (RsM)					
Operating cash flow	**169,405**	**199,875**	**300,155**	**312,081**	**392,785**
Depreciation/amortization	48,152	48,471	50,129	75,895	83,856
Net working capital	1,819	-43,180	91,488	8,712	30,365
Investing cash flow	**-434,659**	**-229,608**	**-286,075**	**-178,600**	**-144,500**
Capital expenditure	-318,103	-185,480	-286,075	-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**	**164,446**	**94,539**	**205,804**
Balance Sheet (RsM)					
Total assets	**1,173,534**	**1,498,390**	**1,988,685**	**2,170,162**	**2,469,590**
Cash & cash equivalent	37,706	71,765	56,557	128,099	315,840
Accounts receivable	37,324	62,276	72,639	103,702	125,613
Net fixed assets	711,886	848,895	1,360,960	1,465,665	1,529,310
Total liabilities	**533,862**	**683,903**	**994,709**	**987,653**	**1,050,998**
Accounts payable	147,098	183,360	302,982	245,449	287,115
Total Debt	278,007	364,521	523,167	533,167	522,373
Shareholders' funds	**639,671**	**814,486**	**993,976**	**1,182,508**	**1,418,592**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	18.1	16.7	14.1	18.6	18.8
ROE adjusted	25.8	21.2	17.7	19.7	20.3
ROIC adjusted	20.5	16.1	12.9	15.8	18.1
Net debt to equity	37.6	35.9	46.9	34.3	14.6
Total debt to capital	30.3	30.9	34.5	31.1	26.9

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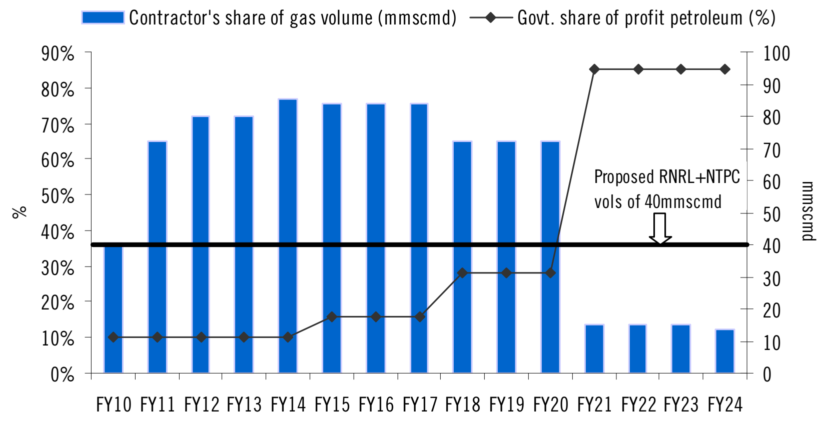
RIL's profit share drops sharply after 2.5x investment recovery

The PSC envisages the government's share of profit petroleum starting at 10% in the initial years (when the investment recovery is <1.5x) and increases significantly to 85% after the 2.5x investment has been recovered from the operating cash profits. As per our forecasts for the D6 cash flows, that happens after the first 10-11 years. RIL's share of gas (assuming it is allowed to take it in kind and not cash) would reduce from 90% to 15%, i.e., from 80-90mmscmd to 10-20mmscmd. If the court order were to be implemented and RIL made to supply gas from its share, it would not be enough for RNRL/NTPC requirements after the initial 7 years, assuming the full power capacity (~7,000 MW, 10,000 MW incl. NTPC) takes at least 3 years to come up. There is a lack of clarity on RNRL's right on future gas discoveries as per the MoU, and the court order is also silent on that.

Figure 1. RIL's share of KG gas volumes vs. Govt. share of profit petroleum



Source: Citi Investment Research and Analysis

It's all about the price

The price of US$2.34/mmbtu for gas supplies to RNRL decided at the time of the MoU was based on the draft GSPA with NTPC.

1. However, the NTPC agreement has not yet consummated with the issue being sub-judice and the ongoing dispute on the clause of unlimited liability in the eventuality of non-supply of gas. Due to the GSPA still pending, government approval for the price has not been sought so far.

2. In addition, when RIL and RNRL had submitted the US$2.34/mmbtu price for approval under the GSMA, it was denied by the government in July 2006 as it did not meet the PSC criteria of arms-length sales.

3. The EGoM statement (dated September 2007) fixing the gas price at US$4.2/mmbtu, however, did mention that its decision will be without prejudice to the NTPC vs. RIL and RNRL vs. RIL court cases.

Existing gas allocations will be affected

The gas supply contracts with the existing customers includes a clause which will necessitate reducing supplies to them in order for RIL to supply 28 mmscmd (+ 12 if NTPC does not happen) to RNRL. That could result in the existing gas-deficient units once again relying on liquid fuels for their energy needs. If the issue lingers on especially if RIL chooses to appeal in Supreme Court, it could discourage emergence of demand from new power/fertilizer plants. It is important to note that the existing units are amenable to signing 3- to 5-year contracts, as they are replacing costlier liquid fuels whereas a new power unit would require a long-term (20 years) supply contract.

So while 80 mmscmd could get absorbed by the demand from existing units (power, fertilizer, process industries, etc.), the next leg up, i.e., 100-120 mmscmd might be delayed till either Reliance Power or NTPC unit comes on. If Reliance Power's units come up in phases, it could also hold up new demand from emerging.

Figure 2. KG Gas Allocation

	Region/State	mmscmd
KG Gas allocated to Fertilizer Plants		
Nagarjuna Fertilizer	AP	1.6
National Fertilizers, Vijaipur	MP	0.7
Iffco, Phulpur	UP	0.5
Kribhco-Shyam, Sahajahanpur	UP	1.0
Tata Chemical, Babrala	UP	0.9
Indo gulf Fertilizer, Jagdishpur	UP	0.5
Kribhco, Hazira	Gujarat	1.4
GSFC, Vadodara	Gujarat	0.7
GNFC, Bharuch	Gujarat	0.3
Iffco, Kalol	Gujarat	1.3
RCF, Trombay	Maharashtra	1.0
RCF, Thal	Maharashtra	2.1
Chambal, Gadepan I & II	Rajasthan	1.2
Shriram Fertilizer, Kota	Rajasthan	0.6
Total (fertilizers)		**13.6**
KG Gas allocated to Power Plants		
Plants already commissioned	Within AP	2.8
Plants not commissioned	Within AP	3.4
Central sector plants	Outside AP	5.4
State sector plants	Outside AP	1.3
Private sector plants	Outside AP	5.1
Total (power)		**18.0**
KG Gas allocated to Steel Plants		
Essar Steel	Gujarat	2.9
Ispat Industries	Maharashtra	0.5
Vikram Ispat	Maharashtra	0.4
Total (steel)		**3.8**
Total KG gas allocated		**35.4**

Source: Indianpetro, Economic Times, Livemint, CIRA

Reliance Industries

Company description

Reliance Industries is a conglomerate with interest in upstream oil & gas (E&P), refining, and petrochemicals. It has commissioned a super-size refinery project through its 70% subsidiary (RPL), which it now plans to merge with itself, and has also 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 Hold/Low Risk with a target price of Rs1,835. Given the concerns on demand slowdown in developed markets, the refining outlook over the next 12 months has softened. Further, even though E&P business looks set to become significant in the next 3-4 years as new discoveries are brought on stream, recent delays will push back timelines on exploration drilling, thereby restricting newsflow on exploration success. Given the track record of past exploratory success and the evolving portfolio (much beyond KG-D6), we value RIL's E&P business as a going concern and accord it a value of Rs729/share on traditional EV/FCF multiples, at a 40% premium to NAV of known reserves. However, the stock is already factoring in upside potential in E&P, leaving little room for error in the refining / petrochemical segments where an improvement in fundamentals would be contingent on sustained global economic recovery. Our Hold rating is premised on present valuations leaving risk-reward balanced or marginally unfavorable.

Valuation

Our target price of Rs1,835 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 6.0x FY11E, 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 Rs729/share based on 12x steady state (FY11E) FCF; 3) We value investment in RPL at the merger swap ratio of 1:16 on RIL's target price; 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 Low 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, 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; delays in the ramp up of production of KG-D6 gas and RPL's refinery; further 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. Upside risks to our target price are: significant improvement in the refining environment (i.e. if GRMs strengthen in the near future); and announcements of new discoveries in the other E&P blocks which is likely to be a sentiment positive.

Appendix A-1

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Reliance Industries (RELI.BO)

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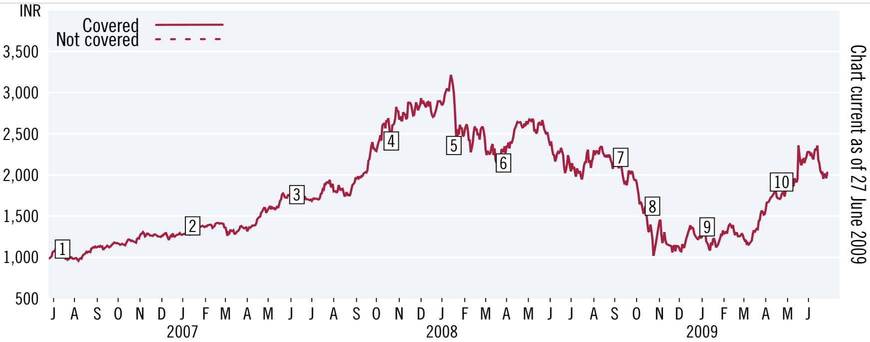
Fundamental Research

Analyst: Rahul Singh



Date	Rating	Target Price	Closing Price
1 14-Jul-06	*2L	*1,150.00	1,065.15
2 15-Jan-07	2L	*1,450.00	1,364.65
3 11-Jun-07	*1L	*2,005.00	1,668.20
4 21-Oct-07	1L	*2,860.00	2,469.20
5 17-Jan-08	1L	*3,460.00	2,996.25
6 27-Mar-08	1L	*2,850.00	2,275.00
7 9-Sep-08	1L	*2,450.00	2,142.85
8 23-Oct-08	*1M	*1,756.00	1,215.25
9 8-Jan-09	1M	*1,475.00	1,196.80
10 23-Apr-09	*2L	*1,835.00	1,762.35

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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