Reliance Industries Ltd.

Earnings Review **BUY**

Equity | India | Chemicals-Specialty
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Another strong operating performance

Merrill Lynch

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Strong operating performance but modest 2Q earnings rise

Reliance (RIL) has achieved yet another strong operating performance in 2Q as reflected in the 23% YoY jump in EBITDA and 18% YoY rise in EBIT. The strong operating performance has been driven mainly by a 38% YoY jump in petrochemical EBIT. Strong petrochemical margins and volume growth boosted EBIT. Despite strong operating performance, 2Q net profit was up just 9% YoY due to a steep decline in other income and a sharp rise in depreciation, interest and income tax.

2Q earnings higher than MLe; surprise mainly in refining

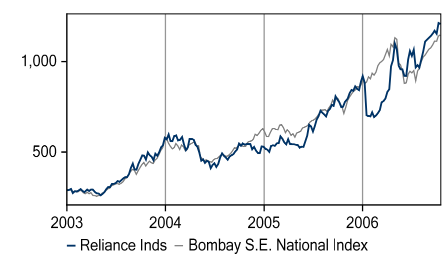
RIL's 2Q net profit growth at 9% YoY is higher than MLe and consensus by 5%. The earnings surprise is mainly attributable to refining EBIT being higher than expected. RIL has not accounted discount on sale of LPG and kerosene to oil PSUs of Rs2.0bn in 2Q as expected by us, which explains the higher EBIT.

2H outlook encouraging; news flow on E&P may be positive

We are keeping our FY07E EPS forecast unchanged at Rs77.5, which means a 19% YoY jump. This means that RIL's 2H net profit will have to be 30% YoY higher. We believe that this is achievable. Gains of Rs8.2bn from the Target plus export scheme expected to be accounted in 2H will mean that the balance of 2H profit will just have to be 10% YoY higher (see Table 4). This is achievable, in our view, given that we expect petrochemical margins to be YoY higher in 2H. Even refining profit is unlikely to be YoY lower in 2H FY07 given the lower base in 2H FY06 due to weak refining margins and refinery shutdown in 3Q FY06. Even news flow on E&P is likely to be positive in 2H with potential to boost RIL's valuation. We retain Buy on RIL.

Stock Data

Price (Common / GDR)	Rs1,196 / US$52.75
Price Objective	Rs1,240 / US$54.87
Date Established	5-Jul-2006 / 5-Jul-2006
Investment Opinion	C-1-7 / C-1-7
Volatility Risk	HIGH / HIGH
52-Week Range	Rs566.91-Rs1,221
Market Value (mn)	US$36,763
Shares Outstanding (mn)	1,393.2 / 696.6
Average Daily Volume	1,342,021
ML Symbol / Exchange	XRELF / BSE
ML Symbol / Exchange	RLNIY / LIN
Bloomberg / Reuters	RIL IN / RELI.BO
ROE (2007E)	20.1%
Net Dbt to Eqty (Mar-2006A)	39.6%
Est. 5-Yr EPS / DPS Growth	0.2% / 0.1%
Free Float	52.1%



Estimates (Mar)

(Rs)	2005A	2006A	2007E	2008E	2009E
Net Income (Adjusted - mn)	75,717	90,693	107,978	99,223	106,054
EPS	54.35	65.10	77.51	71.22	76.12
EPS Change (YoY)	47.0%	19.8%	19.1%	-8.1%	6.9%
Dividend / Share	7.50	10.00	10.00	10.00	10.00
Free Cash Flow / Share	57.94	47.89	50.52	34.02	(119.48)
GDR EPS (US$)	2.49	2.92	3.42	3.15	3.36
GDR Dividend / Share (US$)	0.344	0.449	0.442	0.442	0.442

Valuation (Mar)

	2005A	2006A	2007E	2008E	2009E
P/E	22.00x	18.37x	15.43x	16.79x	15.71x
Dividend Yield	0.627%	0.836%	0.836%	0.836%	0.836%
EV / EBITDA*	15.29x	13.58x	11.08x	12.03x	10.88x
Free Cash Flow Yield*	4.85%	4.01%	4.23%	2.85%	-9.99%

* For full definitions of *iQmethod* SM measures, see page 7.

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Refer to important disclosures on page 8 to 9. Analyst Certification on page 6. Price Objective Basis/Risk on page 6.

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iQprofile SM Reliance Industries Ltd.

Key Income Statement Data (Mar)	2005A	2006A	2007E	2008E	2009E
(Rs Millions)					
Sales	652,413	803,727	1,029,988	932,982	876,511
Gross Profit	121,884	137,255	168,112	154,871	171,301
Sell General & Admin Expense	NA	NA	NA	NA	NA
Operating Profit	84,649	103,245	129,686	114,905	126,126
Net Interest & Other Income	6,038	3,795	(371)	1,145	529
Associates	NA	NA	NA	NA	NA
Pretax Income	90,687	107,041	129,315	116,051	126,655
Tax (expense) / Benefit	(14,970)	(16,347)	(21,337)	(16,827)	(18,765)
Net Income (Adjusted)	75,717	90,693	107,978	99,223	106,054
Average Fully Diluted Shares Outstanding	1,393	1,393	1,393	1,393	1,393
Key Cash Flow Statement Data					
Net Income (Reported)	75,717	90,693	107,978	99,223	106,054
Depreciation & Amortization	37,235	34,009	38,426	39,965	45,175
Change in Working Capital	NA	NA	NA	NA	NA
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	4,969	41,497	16,405	6,222	6,208
Cash Flow from Operations	117,921	166,200	162,809	145,410	157,438
Capital Expenditure	(37,209)	(99,487)	(92,421)	(98,013)	(323,895)
(Acquisition) / Disposal of Investments	(30,801)	112,053	(40,500)	(3)	67,497
Other Cash Inflow / (Outflow)	NA	NA	NA	NA	NA
Cash Flow from Investing	(68,009)	12,566	(132,921)	(98,016)	(256,398)
Shares Issue / (Repurchase)	(3,602)	2	0	0	2
Cost of Dividends Paid	(8,289)	(11,914)	(13,935)	(13,932)	(13,104)
Cash Flow from Financing	(16,066)	(193,393)	(38,935)	(47,932)	62,993
Free Cash Flow	80,712	66,713	70,388	47,397	(166,458)
Net Debt	151,758	197,195	158,242	126,779	174,163
Change in Net Debt	(37,984)	26,345	(15,953)	(33,463)	73,428
Key Balance Sheet Data					
Property, Plant & Equipment	350,823	626,745	665,267	707,842	971,089
Other Non-Current Assets	167,854	38,418	78,918	98,965	31,468
Trade Receivables	39,278	41,636	53,357	48,332	47,563
Cash & Equivalents	36,088	21,462	12,414	11,877	9,453
Other Current Assets	211,820	202,691	221,052	185,592	171,646
Total Assets	805,863	930,952	1,031,008	1,052,608	1,231,219
Long-Term Debt	153,439	165,158	140,158	106,158	143,618
Other Non-Current Liabilities	42,668	49,708	59,407	66,950	75,441
Short-Term Debt	34,407	53,499	30,499	32,499	39,999
Other Current Liabilities	171,315	164,545	224,329	200,567	175,890
Total Liabilities	401,829	432,909	454,392	406,174	434,947
Total Equity	404,033	498,043	576,616	646,434	796,272
Total Equity & Liabilities	805,863	930,952	1,031,008	1,052,608	1,231,219
iQmethod **SM - Bus Performance***					
Return On Capital Employed	12.1%	13.1%	14.1%	12.3%	11.7%
Return On Equity	20.2%	20.1%	20.1%	16.2%	15.1%
Operating Margin	13.0%	12.8%	12.6%	12.3%	14.4%
EBITDA Margin	18.7%	17.1%	16.3%	16.6%	19.5%
iQmethod **SM - Quality of Earnings***					
Cash Realization Ratio	1.6x	1.8x	1.5x	1.5x	1.5x
Asset Replacement Ratio	1.0x	2.9x	2.4x	2.5x	7.2x
Tax Rate (Reported)	16.5%	15.3%	16.5%	14.5%	14.8%
Net Debt-to-Equity Ratio	37.6%	39.6%	27.4%	19.6%	21.9%
Interest Cover	5.8x	11.8x	13.4x	12.8x	12.7x

Key Metrics

* For full definitions of *iQmethod* SM measures, see page 7.

Company Description

India's largest petchem and second largest refining company, Reliance, owns a 660bpd refinery with plans to upgrade to 1mn bpd by 2009. It also has a 900ktpa cracker, 1mtpa polyester, 1.9mtpa polymer and over 3mtpa of fibre intermediate capacities. Refining contributes 55% to revenues with petchem contributing 43%. The company has discovered gas with initial inplace reserves of 14tcf on the East Coast.

Stock Data

Shares / GDR	2.00
Price to Book Value	2.9x

2Q FY07 earnings above expectation

2Q FY07 earnings up 9% YoY; 5% above MLe and consensus

RIL's 2Q FY07 net profit is 9% YoY higher at Rs27.1bn. The 2Q net profit is 5% higher than MLe and consensus net profit of Rs25.7bn. RIL's 1H FY07 net profit is 10% YoY higher at Rs53.6bn.

Table 1: RIL's 1H and 2Q FY07 results

Rs-m	2Q FY07	2Q FY06	% Change	1H FY07	1H FY06	% Change
Net sales	284,740	207,170	37.4	529,960	385,010	37.6
Total expenditure	239,090	170,050	40.6	441,940	312,230	41.5
EBDITA	45,650	37,120	23.0	88,020	72,780	20.9
EBDITA margin	16.0%	17.9%		16.6%	18.9%	
Interest	2,780	2,220	25.2	5,440	4,590	18.5
Depreciation	10,180	8,040	26.6	19,250	15,950	20.7
Other Income	220	2,220	-90.1	660	4,160	-84.1
PBT	32,910	29,080	13.2	63,990	56,400	13.5
Tax	5,820	4,270	36.3	11,430	8,490	34.6
Net profit	27,090	24,810	9.2	52,560	47,910	9.7
EPS (Rs/share)	19.4	17.8	9.2	37.7	34.4	9.7

Source: Company, DSP Merrill Lynch

Strong operating profit growth but modest earnings growth

RIL's 2Q EBITDA is 23% YoY higher, at Rs45.7bn (see Table 1), while operating profit (EBIT) is 18% YoY higher at Rs36.2bn (Table 2). Thus RIL's operating performance is once again strong in 2Q like in 1Q FY07. However, like in 1Q, despite strong operating profit growth, earnings growth is far more modest. Over 25% YoY rise in depreciation, interest cost and 90% decline in other income has meant that pretax profit is up just 13% YoY despite 23% jump in EBITDA. The rise in depreciation and interest is due to large capex incurred in the last 2-3 quarters. Large capex and Rs68bn investment in Reliance Petroleum's equity has also meant lower surplus cash and therefore other income. 36% YoY rise in income tax has meant that net profit growth is even more modest at 9% YoY.

Jump in operating profit driven mainly by petrochemicals

The rise in RIL's operating profit in 2Q has been mainly driven by a 38% YoY jump in petrochemical EBIT (see Table 2). The surge in petrochemical EBIT is driven by a jump in petrochemical margins and also volume growth. The rise in margins was mainly in polymers and paraxylene. The rise in petrochemical sales volume is driven by polyester, paraxylene, PTA and polymer capacity additions made in 2H FY06 and 1H FY07.

Table 2: Business wise EBIT break-up in 2Q FY07 and 1H FY07

Rs-m	2Q FY07	2Q FY06	Change	1H FY07	1H FY06	Change
EBIT break-up						
Petrochemicals	17,640	12,790	38%	28,510	21,610	32%
Refining	14,890	15,320	-3%	35,240	33,200	6%
Others	3,650	2,470	48%	6,490	4,660	39%
	36,180	30,580	18%	70,240	59,470	18%
	2Q FY07	2Q FY06		1H FY07	1H FY06	
Petrochemicals	49%	42%		41%	36%	
Refining	41%	50%		50%	56%	
Others	10%	8%		9%	8%	
	100%	100%		100%	100%	

Source: Company, DSP Merrill Lynch

Modest decline in refining EBIT hit by lower refining margins

RIL's 2Q FY07 refining EBIT is 3% YoY lower, at Rs14.9bn. The decline in refining EBIT is mainly due to decline in RIL's refining margin to US$9.1/bbl in 2Q FY07 from US$9.6/bbl in 2Q FY06 (see Table 3).

Table 3: Performance of refining division in 2Q FY07

	2Q FY07	2Q FY06	Change
Crude throughput (mmt)	8.2	8.0	3%
Refining Margin including sales tax (US$/bbl)	9.1	10.4	-13%
Refining Margin excluding sales tax (US$/bbl)	9.1	9.6	-5%
Exports (mmt)	5.2	2.7	93%

Source: DSP Merrill Lynch

EBIT from E&P up sharply, driven by higher volumes and prices

RIL's EBIT from E&P (classified as others) has increased by 48% YoY to Rs3.65bn. The rise in EBIT has been driven by higher oil and gas price realization as well as rise in sales volumes. While gas price realization is up 17% YoY to over US$4.5/mmbtu, oil price realization jumped by over 15% YoY to US$69/bbl.

Reasons for positive earnings surprise

The main reasons for the higher than expected 2Q profit are:

- Refining EBIT being Rs2.3bn higher than expected. The refining EBIT is higher than expected mainly due to refining margins at US$9.1/bbl being higher than our expectation of US$8.8/bbl. Even crude throughput at 8.21mmt was higher than our expectation.

- E&P EBIT being higher than our estimate by Rs810m. We had not anticipated the rise in oil and gas sales volumes in 2Q FY07

Refining surprise due to RIL not selling subsidized products at discount

The main reason for the refining margin and therefore refining EBIT being higher than expected appears to be that RIL did not give discounts on the sale of subsidized products (LPG and kerosene) to oil marketing companies (OMC) in 2Q. Our earnings forecast assumed that RIL would give discounts on the sale of LPG and kerosene to OMCs at Rs240/tonne of crude throughput as required by the government. RIL has indicated that it does not intend to give these discounts and has therefore not accounted these discounts in 2Q as well as 1Q. In 2Q if RIL had given discounts as assumed by us its pre-tax profit would have been lower than the reported number by Rs1.97bn, while net profit would have been lower than the reported number by Rs1.6bn, at Rs25.5bn. Thus RIL's 2Q net profit would have been line with consensus and MLe if it had accounted discounts on sale of LPG and kerosene to the OMCs.

FY07E earnings outlook

FY07E EPS forecast kept unchanged at Rs77.5 (up 19% YoY)

We are keeping RIL's FY07E EPS forecast unchanged at Rs77.5, which means 19% YoY jump in earnings. This means that RIL's 2H FY07E net profit will have to be 30% YoY higher at Rs55.4bn for its FY07E net profit to be in line with our forecast. We believe that this is achievable due to:

- Export benefit under the Target plus scheme, which we expect to be accounted in 2H, would boost RIL's net profit in H2 FY07 by Rs8.2bn. If this export benefit is indeed accounted in 2H, then the balance of 2H profit will just have to be 10% YoY higher (see Table 4)

Table 4: RIL's 2H net profit if FY07E has to be in line with our current forecast

Rs-m	1H	2H	Target plus profit expected in 2H	FY07E
FY07E	52,560	47,218	8,200	107,978
FY06	47,910	42,780		90,690
YoY change	10%	10%		19%

Source: DSP Merrill Lynch

- We expect YoY improvement in petrochemical margins in 2H FY07. Petrochemical margins had strengthened in 2Q FY07. Margins have receded from their 2Q FY07 peaks but are still significantly higher on a YoY basis.

Table 5: 2HFY07E petrochemical margins

US$/mt	Ethylene - Naphtha Spread	Propylene - Naphtha Spread	Asian Naphtha cracking
2HFY07E	540	502	746
2HFY06	427	447	649
Change	113	54	96
Change (%)	26%	12%	15%

Source: Merrill Lynch, Datastream

- Singapore refining margins were relatively weak at US$6/bbl in 2H FY06 and therefore, despite the recent weakness in Singapore refining margins, it appears that 2H FY07E refining margins may not be lower on a YoY basis. 2HFY06 refining profit was also adversely affected by refinery shutdown and weak refining margins in 3QFY06. Singapore refining margins are at US$6/bbl in October 2006.

Retain Buy rating

2H earnings outlook encouraging

As discussed, RIL's 2H FY07E earnings outlook is encouraging due to the prevailing strength in petrochemical margins, low base effect especially in refining, and prospects of gains from Target plus export scheme being accounted in 2H.

Positive news flow on E&P likely

Positive news flow on E&P is also likely in 2H. It may be in the form of:

- The upstream regulator Director General of Hydrocarbons (DGH) approving a revised development plan with plateau gas production from D6 block being higher at 80mmscmd instead of the current estimate of 40mmscmd. RIL has hinted at this in its 2Q earnings press release. RIL's partner in D6 block, Niko Resources, as well as the DGH have already indicated that plateau gas production may be much higher than 40mmscmd.

- More clarity on past discoveries and possible new discoveries. RIL has in its 2Q FY07 presentation indicated that commerciality proposal for the MA-1 oil discovery in the D6 block will be shortly submitted to the regulator.

Price Objective Basis & Risk

RIL's price objective on a sum of parts basis works out to Rs1,240/share. The value of the core refining and petrochemical business has been calculated on DCF. Value of its investment in Reliance Petroleum is calculated on DCF value of RPL and applying it to RIL's holding in RPL. Its oil and gas reserves and resources are also valued on a DCF basis. RIL's investment in IPCL is valued at current market price.

Significant weakening in refining and petrochemical margins even below our expectation is a risk to our price objective. Such a decline in margins is more likely to be triggered by negative surprises on demand rather than supply, in our view. As discussed, our refining margin forecasts assume almost all possible refinery projects coming up. Large disappointments on the E&P front could be another risk to our price objective. We have valued even resources and exploration upside.

Analyst Certification

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iQmethod SM Measures Definitions

Business Performance	Numerator	Denominator
Return On Capital Employed	NOPAT = (EBIT + Interest Income) * (1 - Tax Rate) + Goodwill Amortization	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill Amortization
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
Quality of Earnings		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
Valuation Toolkit		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	EV = Current Share Price * Current Shares + Minority Equity + Net Debt + Other LT Liabilities	Sales
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

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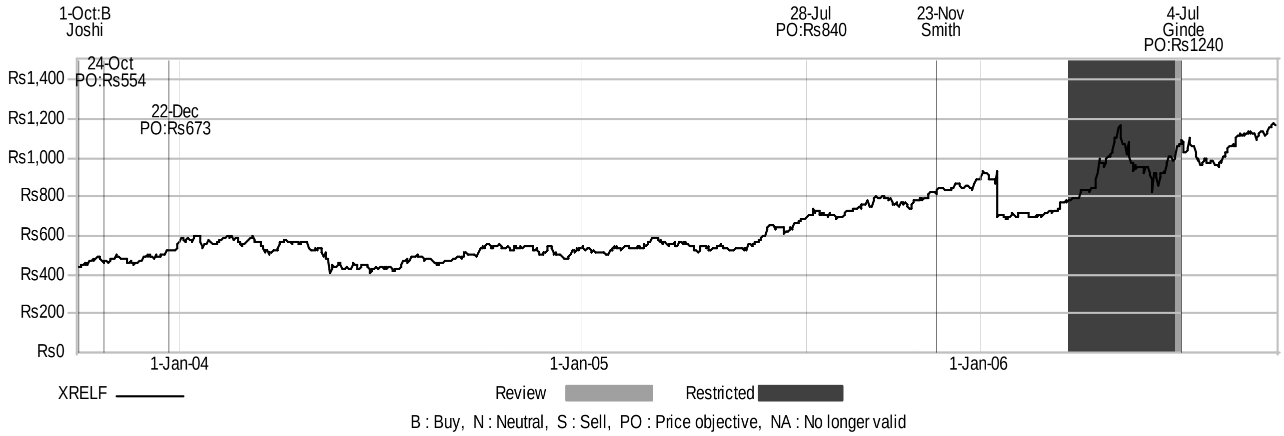
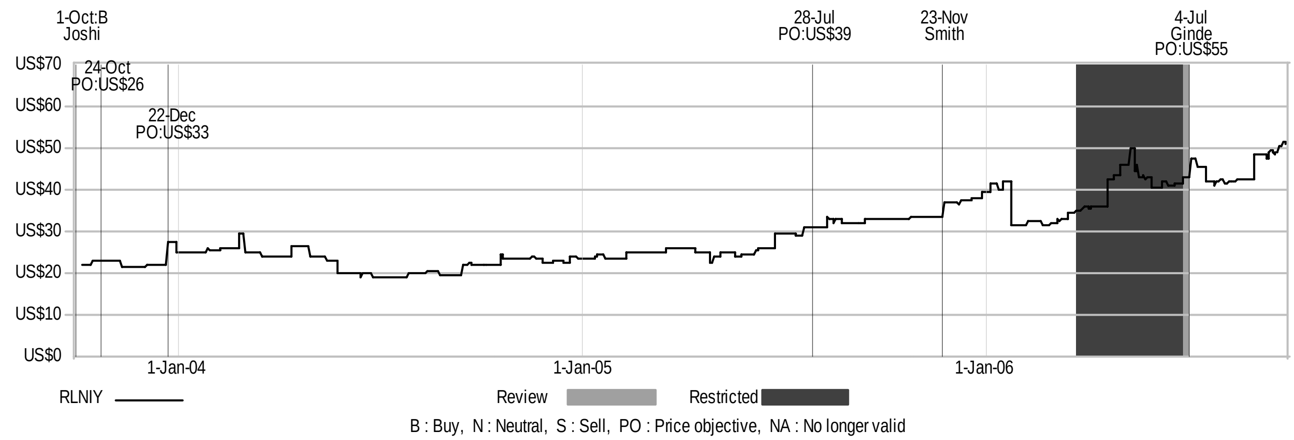


The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark Grey shading indicates the security is restricted with the opinion suspended. Light Grey shading indicates the security is under review with the opinion withdrawn. Chart current as of September 30, 2006 or such later date as indicated.

RLNIY Price Chart



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Investment Rating Distribution: Chemicals Group (as of 30 Sep 2006)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	29	45.31%	Buy	5	17.24%
Neutral	31	48.44%	Neutral	8	25.81%
Sell	4	6.25%	Sell	0	0.00%

Investment Rating Distribution: Global Group (as of 30 Sep 2006)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1325	44.76%	Buy	434	32.75%
Neutral	1420	47.97%	Neutral	412	29.01%
Sell	215	7.26%	Sell	48	22.33%

* Companies in respect of which MLPF&S or an affiliate has received compensation for investment banking services within the past 12 months.

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