India Equity Research | Oil and Gas

Company Update

RELIANCE INDUSTRIES

INR 1,127

Cash flow is king

BUY

November 24, 2008

Petrochemical margins unsustainable at the current low levels

Petrochemical margins have corrected due to the huge fall in demand on account of the ongoing global slowdown and demand destruction. Reliance Industries (RIL), however, is better off than its peers because of its focus on the domestic market and high level of integration, which shields it from offtake risks. We consider negative-to-zero cracker margins unsustainable and expect them to improve as crackers cut operating rates. Margins are, however, likely to remain below FY07 and FY08 averages, as cracker operating rates are expected to reach 85% only by FY12.

Despite the global crash, we expect RIL GRMs of USD 9.1/bbl in FY10E

Refining margins, which recently turned negative, are expected to improve as negative naphtha spreads compress (due realignment of refining slate) and operating rates of refiners fall globally. RIL's diesel-heavy, complex refinery is likely to outperform its gasoline-heavy peers as diesel demand growth remains in the positive territory, while gasoline demand growth continues to be negative. Despite the global crash in refining margins, we expect RIL to report GRMs of USD 9.1/bbl in FY10E.

Cutting earnings estimates anticipating low refining, petrochemical margins

Decline in margins for both refining and petrochemicals businesses are likely to dampen RIL's Q3FY09E earnings. Factoring in the same, we have reduced our FY09 and FY10 EPS estimates to INR 81.7 (-10%) and INR 131 (-20%), respectively. We have also cut out fair SOTP target value from INR 1,954 to INR 1,550.

Upstream business to generate huge cash flows; maintain 'BUY'

RIL has corrected significantly due to an unprecedented fall in refining and petrochemical margins, which will impact its H2FY09 earnings. However, outlook for the company's upstream business (contributing 57% to SOTP), remains intact. Cash flows from the upstream business and start of the RPL refinery imply 22% and 27% 2-year growth in profits and cash flows, respectively. At INR 1,127, RIL is trading at attractive valuations at 8.6x FY10 consolidated EPS, and at 6.1x FY10 CEPS. While triggers remain from KG-D6 gas production and RPL refinery, next value drivers for RIL are expected to be: (1) further visibility of blocks where gas reserves have been certified (NEC-25 and CBM blocks), and (2) positive drilling results and quantification of reserves from other exploration blocks. Our revised SOTP value of INR 1,550/share indicates ~37% upsides to the stock from the current levels. We maintain our **'BUY'** recommendation on it.

Financials (Consolidated)

Year to March	FY07	FY08	FY09E	FY10E
Net revenues (INR mn)	1,137,701	1,371,467	1,532,019	1,628,508
Revenue growth (%)	*37.0*	*20.5*	*11.7*	*6.3*
EBITDA (INR mn)	201,279	231,446	224,189	325,552
Net profit (INR mn)	120,747	147,897	131,025	219,195
Diluted shares (mn)	1,482	1,603	1,603	1,603
Diluted EPS (INR)	81.5	92.2	81.7	130.9
EPS growth (%)	*19.5*	*13.2*	*(11.4)*	*60.2*
Diluted P/E (x)	13.8	12.2	13.8	8.6
EV/EBITDA (x)	9.6	8.9	9.4	5.4
ROAE (%)	20.3	19.5	13.5	16.2

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Reuters	:	RELI.BO
Bloomberg	:	RIL IN

Market Data

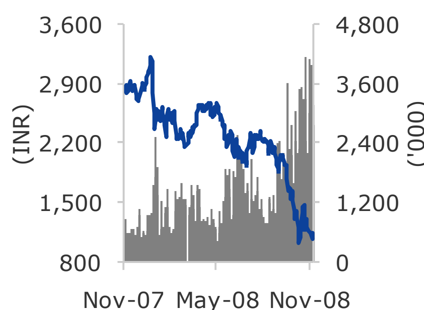
52-week range (INR)	:	3,252 / 930
Share in issue (mn)	:	1,453.8
M cap (INR bn/USD mn)	:	1,774/32,759
Avg. Daily Vol. BSE/NSE ('000)	:	5,328.0

Share Holding Pattern (%)

Promoters	:	44.8
MFs, FIs & Banks	:	9.3
FIIs	:	17.0
Others	:	28.9

Relative Performance (%)

	Sensex	Stock	Stock over Sensex
1 month	(12.3)	(29.6)	(2.3)
3 months	(38.1)	(35.0)	(11.7)
12 months	(51.9)	(59.6)	57.8



Petrochemicals' margins to improve, albeit to a lower range

Petrochemicals' margins have corrected recently due to huge fall in the demand of products. Most of the demand-fall can be ascribed to the ongoing credit crisis that has virtually removed all trade financing from the system, leading to destocking at the polymer processing level. This resulted in negative EBITDA margins that are unsustainable. We, however, expect a systemic purging of the industry by shut down of polymer capacities in high-cost locations, especially in Japan, West Europe, and South Korea. News of shutdowns or reduction in operating rates of crackers have already started trickling in.

Margins are expected to improve going forward, as more such shutdowns are likely since the industry has still not improved and global trade is yet to re-start. On the other hand, we expect margins to remain below FY07 and FY08 levels, as cracker operating rates are expected to reach 85% only by FY12. RIL is better off than its peers because of its focus on the domestic market and high level of integration, which protects it from offtake risks.

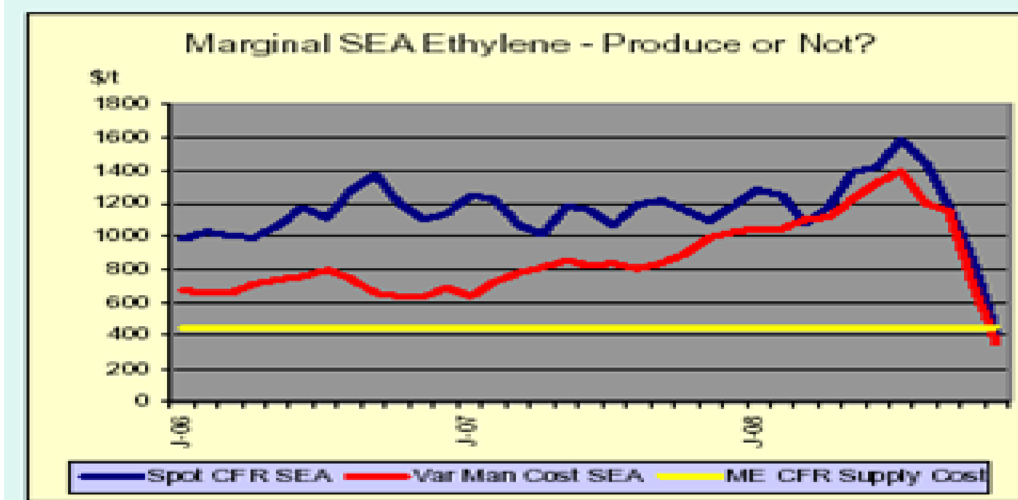
Cracker margins unlikely to improve until CY10

Past two months have been quite unprecedented for crackers. While crude prices crashed ~52%, naphtha prices fell ~67%, and ethylene prices crashed too ~65%. The current credit crisis, by withdrawing trade financing, reduced global trade, which, in turn, led to inventory pile-up of naphtha and ethylene at refiners' end. Naphtha, which traded at a 5-year average premium of USD ~4/bbl over Dubai crude, is now trading at a discount of USD ~25/bbl. Ethylene prices too have collapsed due to significant slowdown in its offtake on account of destocking at polymer processors' end, which, in turn, has led to a significant fall in crackers' margins.

Fall in cracker margins was also an after-effect of the increase in gas-based cracker capacities in the Middle East. Since the pricing of feedstock gas was low in the geography, its gas-based crackers enjoyed huge margins earlier, as ethylene prices then followed crude price movement. Impact of low-cost crackers on ethylene prices was not visible, as crude price rallied and demand continued growing, while the Middle Eastern countries kept on scaling up their gas-based cracking capacities; Middle East has emerged as a large exporter of ethylene, with its exports doubling over last year. However, as demand growth rates turned negative (around July 2008), ethylene margins crashed to levels close to total cost of production (to USD 320-380/mt) in the Middle East.

Naphtha cracking margins are close to zero at prevailing naphtha prices that are close to 60% discount to crude. This situation, however, seems unsustainable, as refiners have also started cutting operating rates and there has been a marginal change in naphtha output. Naphtha spreads over crude are now bound to improve.

Ethylene prices have dropped to levels close to cost of production in Middle East

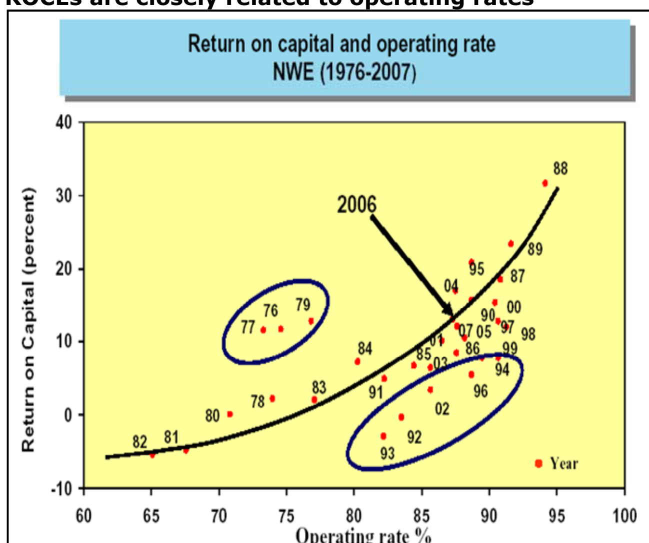


Source: Dewitt & Co

Our interaction with few downstream polymer processors makes us believe that processors are running at almost zero inventory levels. Current demand growth rate of polyethylene (PE, proxy for ethylene demand) is still at low levels, despite the industry currently running at low inventory levels. This indicates a slowdown in demand growth rate for the industry. As per Dewitt & Co's recent outlook on PE, demand is expected decline 2% in CY08, and then grow marginally by 3.0-4.0% in CY09. Growth in CY08 demand is post positive demand growth in H1CY08 over H1CY07, indicating the dramatic fall in demand in H2CY08. For the same reason, we expect margins of high-cost naphtha crackers (compared with gas-based crackers) to remain muted over CY09-10.

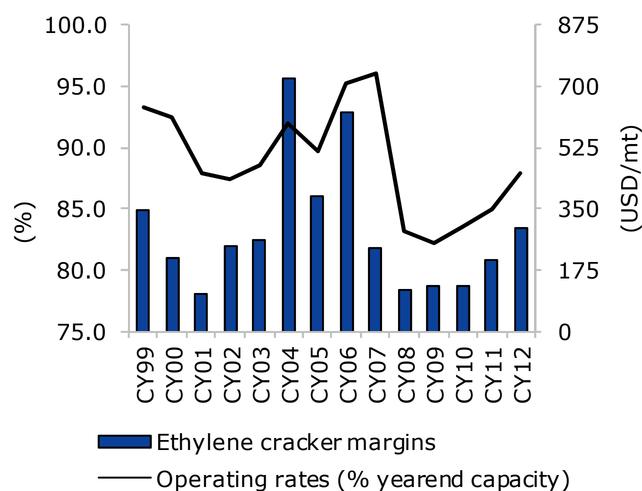
Increase in ethylene capacity, combined with a flat demand over CY07-09, is likely to lead to operating rates falling more than 6%. We see ethylene operating rate to bottom in CY10.

ROCEs are closely related to operating rates



Source: Nexant

Ethylene operating rates to recover post CY09



Source: CMAI, Edelweiss research

Owing to lower demand, integrated players are best-placed to tide the recent fall in margins. Standalone cracker units will face threat of closure as Middle East increases its market share further. Japan, West Europe, and South Korea are most disadvantaged, and are likely to face closures in the next few years. Standalone crackers have already announced production cuts (Asia – 10%, North America – 30%, and Western Europe – 20%).

Shutdown/reduction of operating rates by Asian crackers

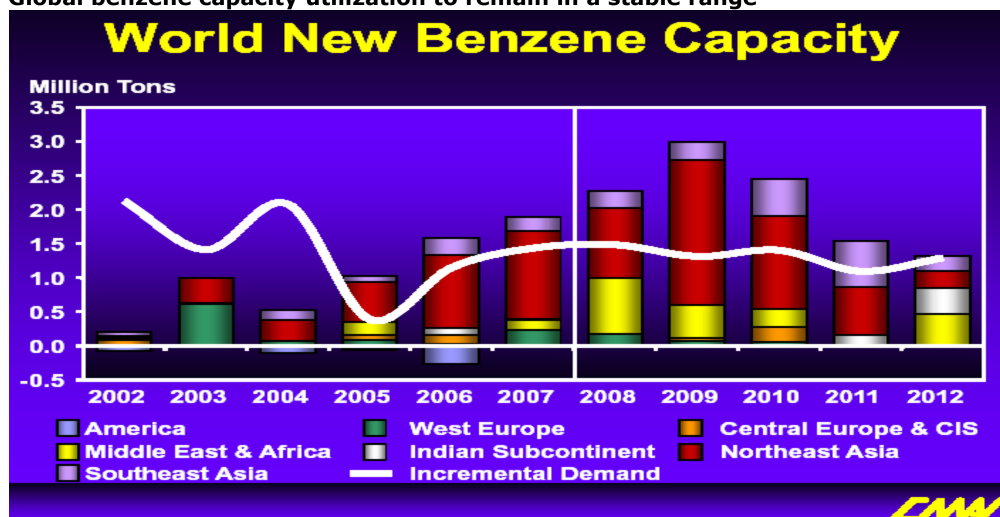
Company	Location	E/P/BD (kt/yr)	Timing	Status (%)
PCS (1)	Pulau Merbau	475/270	late Oct	!OR 70
PCS (2)	Pulau Merbau	655/350	late Oct	!OR 70
Titan	Pasir Gudang	260/160	mid-Oct	!OR 80
Titan	Pasir Gudang	407/260	mid-Oct	!OR 80
PCS (1)	Pulau Merbau	475/270	Oct	!OR 75
PCS (2)	Pulau Merbau	655/350	Oct	!OR 75
Chandra	Anyer	590 E	Sep-Oct	!OR 80
Honam	Yeochon	720/360	Nov-03	!OR70
YNCC (1)	Yeochon	857/485	late Oct	!OR 70
YNCC (3)	Yeochon	400/205	late Oct	!OR 70
YNCC (2)	Yeochon	555/270	late Oct	!OR 70
SK Energy (1)	Ulsan	200/140	Nov-Dec	!SD
Lotte Daesan	Daesan	650/325	late Oct	!OR 90
Honam	Yeochon	720/360	Oct	!OR 90
Taekwang	(PDH) Ulsan	250 P	Oct	!OR 80

Source: Platts

TA = scheduled turnaround; SD! = unplanned shutdown;SU = startup; DB = debottlenecking; OR = operating rate

Even aromatics producers have been cutting operating rates. Margins for benzene will fall further as supplies increase due to higher expected production from the Middle East. Operating rate for benzene is expected to hover at 78% for next three-four years. However, margin risks for the compound will remain as incremental capacity additions continue to be higher than the incremental demand.

Global benzene capacity utilization to remain in a stable range

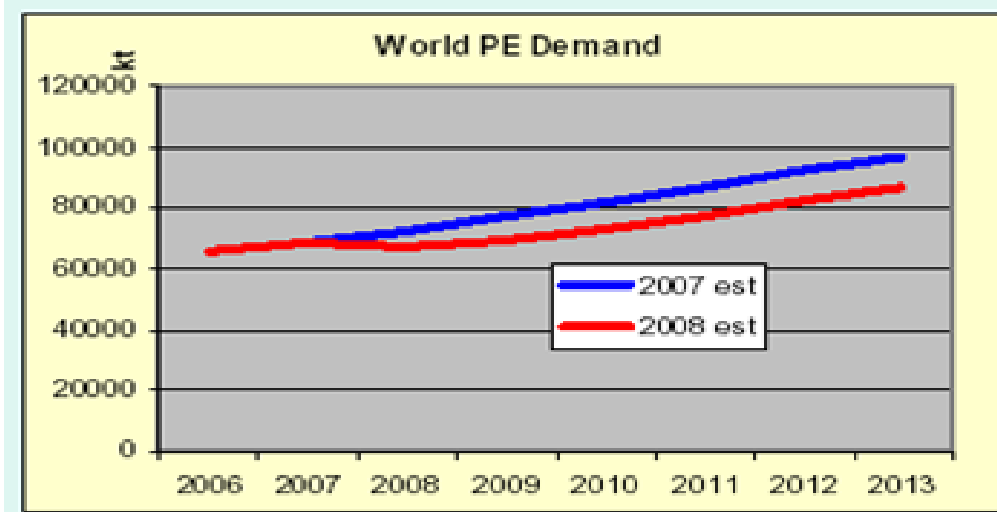


Source:CMAI

Polymer margins to be marginally impacted

Unlike cracker margins, polymer margins have been less impacted due to faster fall in crude/naphtha prices. Unusually margins at polymer levels (e.g. from ethylene to polyethylene) are very high. While PE EBITDA margins for FY07 and FY08 were at USD 139/mt and USD 299/mt, they are currently at USD 350-400/mt range. There has been a slowdown in demand of PE such CY08 growth over CY07 is expected to be -2.0% (negative demand growth) after a positive growth in H1CY08.

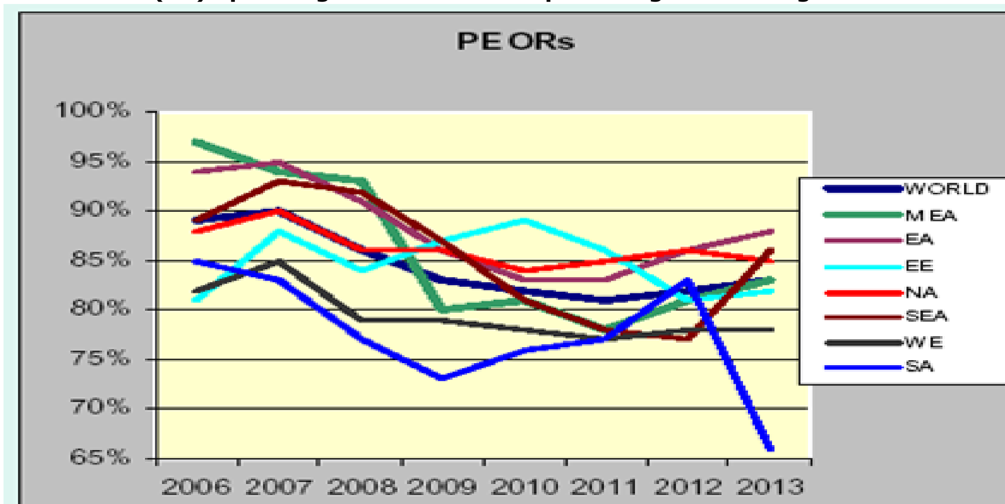
Global demand of polyethylene



Source: Dewitt & Co

The current credit crisis has led to reduction in trade financing, leading to huge fall in demand from polymer processors. Our interaction with Indian plastic downstream processors makes us believe that processors are running at almost zero-inventory levels due to fear of price correction and all purchases are for one-week visibility only, against normal inventories of three-four weeks. Our discussions with processors indicate that demand is unlikely to start till January 2009, after the holiday season is over. This has led to shutdown of facilities or reduction of operating rates for various polymer units. Significant number of crackers is running at average capacity utilisation of 70%. Global operating rates are now expected to improve only in CY11, thereby supporting our bearish view on PE margins. However, South Asian PE margins are expected to be better due to better demand-supply balance.

South Asian (SA) operating rates in PE to outperform global averages



Source: Dewitt & Co

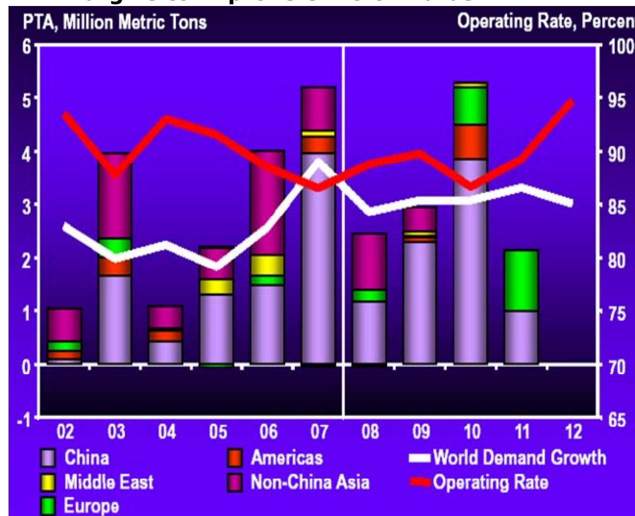
Polyester intermediates margins to have respite only from CY10

Before the recent correction in polyester margins, the entire polyester chain had been witnessing comfortable margins. Though margins are expected to improve from current levels, we expect CY08 margins to remain weak. Operating rates of paraxylene (PX) is expected to fall from ~90% levels to ~80% by CY12E. Some respite is expected in CY10 on anticipation of the PTA surplus reducing gradually as incremental demand outpaces additional capacities.

PX outlook weak till CY12

Source: CMAI

PTA margins to improve CY10 onwards

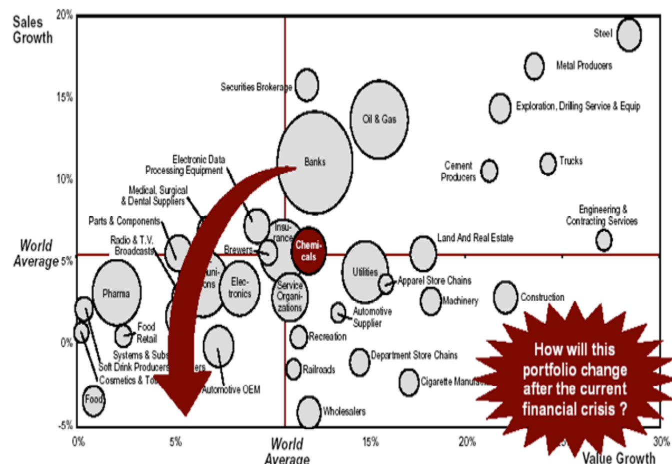


Source: CMAI

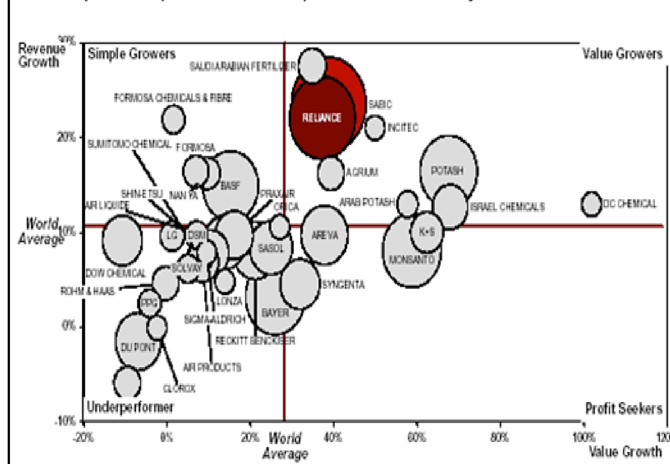
RIL benefits from domestic market and integrated facility

RIL dominates the petrochem market of the Indian Subcontinent (ISC), and thus, enjoys assured offtake. The company, is therefore, going to be moderately impacted by the current decline in global trade.

Further, RIL also gains from being an integrated player. Outperformers in this industry, over the past few years, have been players who were either integrated (scale in assets) or were focused entirely on specialty products (scale in know-how). While the petrochemical industry has grown at an average rate in terms of value and sales, there is a clear outperformance in the industry by some players, key among those are SABIC and RIL.

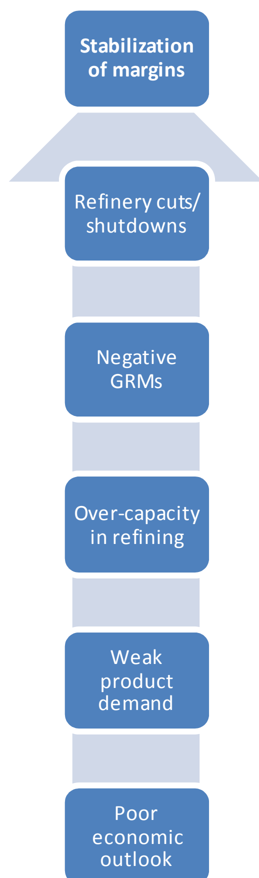


Source: A T Kearney



Source: A T Kearney

Refining margins set to improve; diesel heavy refiners to outperform



The refining industry is undergoing a tough phase with diesel spreads having collapsed, gasoline spreads hovering around the zero mark, and naphtha spreads deep in the red. A combination of all these has turned refining margins for simple-to-medium-complex refiners to negative levels. With such an inversion of the value chain, where a large chunk of products trade at discounts to the raw material, continuing operations is unsustainable.

Since the non-viability of refining sector at present GRM levels is obviously taking into account the demand scenario playing out due to the economic slowdown, structural changes (like shutdowns) and pro-active disruptive interventions (like shelving of longer-term/higher cost projects) are expected.

As the current credit crisis improves and crude/product prices stabilise, we expect the global trade of polymers and petroleum products to resume. We also expect operating rates of refineries to be cut, moving the demand-supply equation towards a balanced one. Both these factors are expected to improve the refining margins from the current levels, especially due to expected improvement in naphtha cracks. However, lower utilisation rate for refining is expected to keep refining margins at levels below those seen in the past few years.

RIL's Complex and diesel-focused refinery is expected to weather the recent downturn in refining margins. Simple and gasoline-heavy refiners will be the most impacted, and are likely to face closures. Diesel margins are expected to remain better than gasoline due to still positive demand growth of diesel, especially from Asian economies (India and China). On the other hand, negative demand of gasoline in OECD economies is likely to negatively impact gasoline spreads.

We are revising RIL's FY09 and FY10 refining margin assumptions to USD 11.4/bbl and US 9.1/bbl, respectively.

The INR has continued to fall against USD (Q3TDFY09 average 48.69 vs 43.8 for Q2FY09), which improves the refining realisations in Indian currency (as GRMs are benchmarked globally in US currency), thus providing a partial respite to Indian refiners.

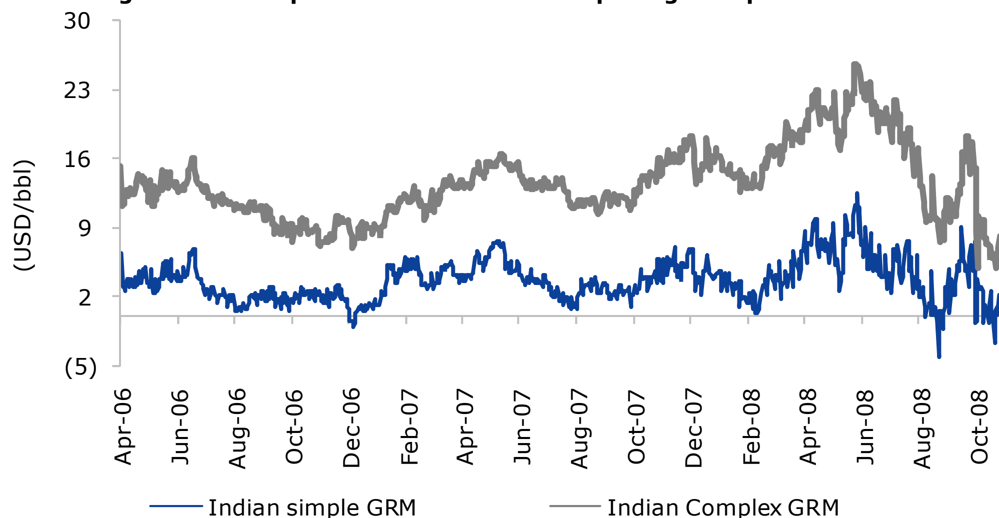
Revision of RIL's GRMs

(USD/bbl)	FY09	FY10
Revised	11.4	9.1
Earlier	12.7	11.1
Change (%)	(10.2)	(17.9)

Source: Edelweiss research

Indian complex GRMs are a proxy for RIL's refining margins.

RIL's margins have compressed due to abnormal pricing of naphtha



Source: Bloomberg, Edelweiss research

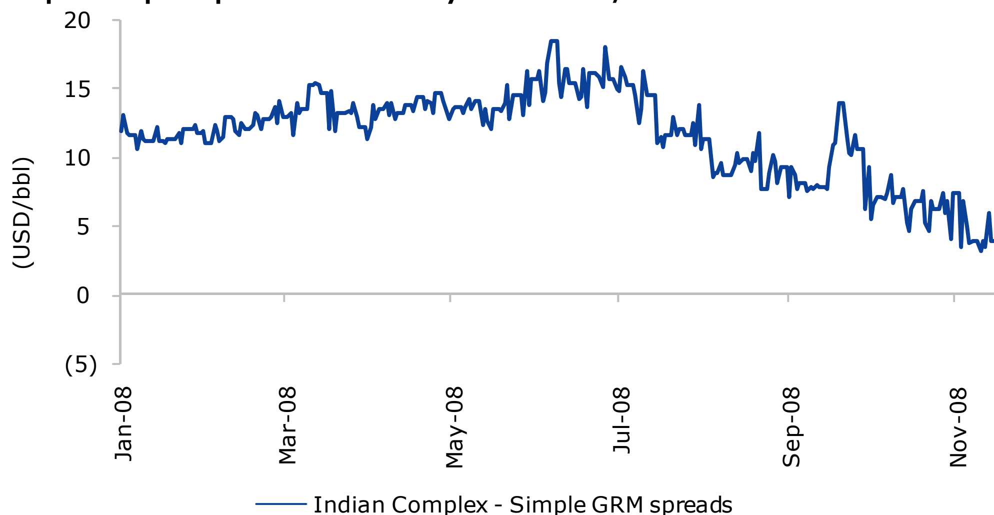
Higher complexity refiners typically produce a large fraction of higher-value products i.e. light and middle distillates; they also enjoy the advantage of being able to use the cheaper, high-sulphur heavy-crude variants. This advantage has, however, been eroded in the recent past, leading to lowered Complex-Simple GRM spreads.

Diesel-heavy refiners expected outperform the gasoline-heavy ones

Diesel heavy, complex refiners are still at a relative advantage to their gasoline-focused brethren, because middle distillates continue to have better spreads vis-à-vis light distillates. The relatively weaker demand outlook for gasoline over diesel and the recent impact on naphtha, which is expected to wane away only in the medium term, give us confidence that middle distillates will still be the drivers of margins, going forward.

Complex refiners are facing pressures due to reduction in light-heavy crude spreads due to increase in complexity of global refiners and lower demand of crude globally. However, these spreads are still significant, and are vital in keeping the Complex refiners in the green, while the Simple refiners face negative GRMs.

Simple-Complex spreads are currently at ~USD 2.5/bbl levels

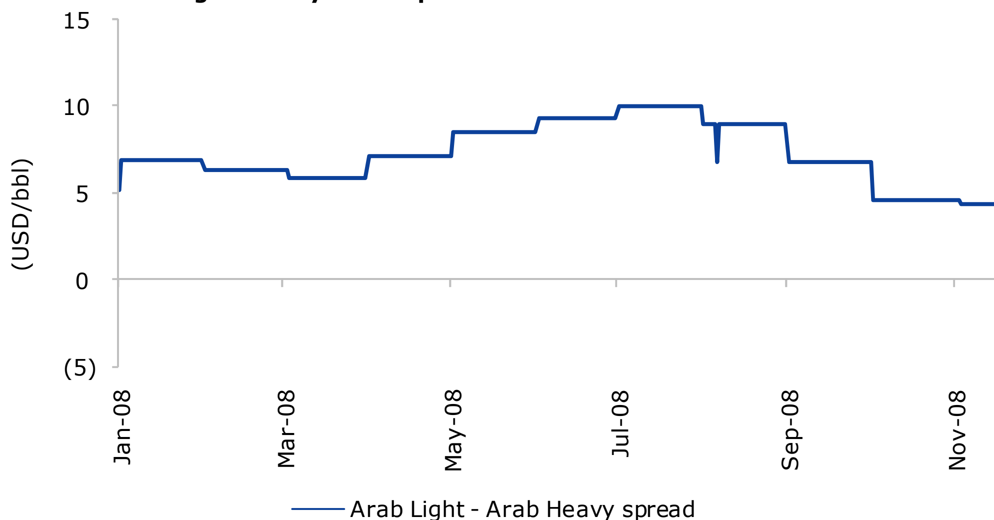


Source: Bloomberg, Edelweiss research

Reasons for the above phenomenon are as below:

Easy availability of light crude due to general over-supply in the market and OPEC production cuts from Saudi Arabia being primarily of the heavy crude, has driven down the discount that high-sulphur crude had over its low-sulphur counterpart.

Moderation in Light–Heavy crude spreads



Source: Bloomberg, Edelweiss research

Light distillate cracks have plummeted

Higher fractions of the light distillates (gasoline and naphtha), obtained through higher complexity refineries, have marred profitability since cracks for these products have turned negative. Consequently, fuel oil cracks have narrowed, since fuel oil fractions are lower in the Complex product slate vis-à-vis Simple.

For Complex refiners, positive margins of middle distillates have more than offset negative margins from light distillates; this is, however, not the case with Simple refiners who have a lower product fraction of middle distillates. Though this advantage has eroded, it is still significant, and is expected to provide support to the higher-complexity refiners like RIL in this downturn.

Refining capacity in excess; some short-term projects face delays

Major refining capacity additions across the world have caused over-capacity (*Please refer to our report 'Supply surge to crack margins', dated August 7, 2008).* The current financial crisis, and profitability concerns have caused companies to delay projects, but the drop in refined product demand is continuing to drive prices lower. [*For list of projects being delayed, please refer Appendix]*. Projects nearing completion have been delayed for short periods, which are unlikely to significantly impact the near-term overall capacity.

Major cut in refining capacity likely

The refining industry is undergoing a tough phase with diesel spreads having collapsed, gasoline spreads hovering around the zero mark, and naphtha spreads deep in the red. A combination of all these has turned refining margins for Simple-to-Medium-Complexity refiners to negative levels. With such an inversion of the value chain, where a large chunk of products trade at discounts to the raw material, continuing operations is unsustainable.

Refineries are run typically at full capacity, even if they are running at marginal cost, to maximize ROCEs on the (sunk) cost incurred. With GRMs hovering at near zero-level, continuing operations even at variable cost is impossible; and if the margins remain at these levels, production cuts are inevitable. Already, many gasoline-heavy refiners in Europe and US have started cutting production, and the trend is expected to exacerbate as product cracks decline further on the back of weakening demand.

Cancellations and postponement of some long-term projects (which are typically below 25% completion, and are expected to come online only after CY11) across the world are in the offing because of: increasing costs; high capital spent in setting up a refinery not justifiable by weak margins; and low capacity utilisations plaguing refineries' ROCEs.

The first wave of production cuts in refineries across the world

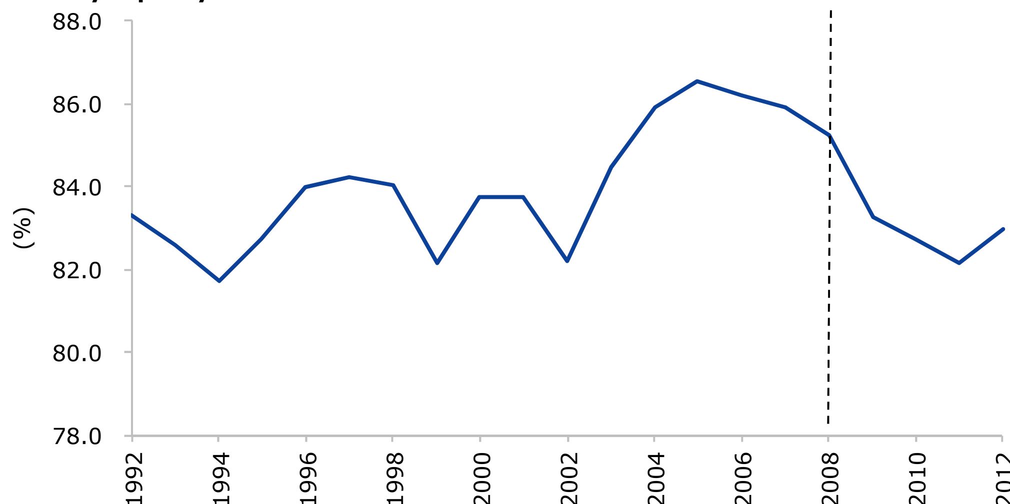
Country	Refinery	Company	Project details	Comments
France	Gonfreville refinery	Total SA	328,000 bpd	Reduced runs 10%; shut some gasoline related units
Korea	N/A	SK Energy	1.115 mbpd; average run rate-800,000 bpd	Cut crude runs at below 750,000 bpd
US	Motiva JV Convent refinery, Louisiana	Shell Oil Co.	235,000 bpd	Standby mode (no production)
Japan		Idemitsu Kosan Co.		Will reduce its crude oil refining 14% Y-o-Y, to 516 kbpd for Q408 on falling demand; company will also begin diesel exports to Mexico
China		Sinopec		Will reduce crude processing 10% in November from July's record, as the economic slowdown cuts fuel demand
Europe	Teeside refinery, UK	Petroplus Holdings AG	117,000	Announced that it had reduced run rates at its 117,000 bpd refinery
China	Hainan refinery	Sinopec	8 mn tonnes a year	Will run at 70-80% of its installed capacity
China	Maoming Petrochemical	Sinopec	13.5 mn tonnes of oil a year	Will cut production 8.3% to 1.1 mn tonnes this month
China	Yangtze Petrochemical	Sinopec	8 mn tonnes of crude a year	Will cut production to 6,20,000 tonnes in November from 700,000 tonnes last month

Source: Industry sources, Edelweiss research

Capacity utilisations for global refining is expected to improve in CY11

More cuts, shutdowns, and abandonment of projects are in the offing since refinery utilisations are too low to provide even marginal returns. Utilisations have dropped below 84% for CY08; a purge in capacities can improve the same post CY10.

Refinery capacity utilisation



Source: Edelweiss research

Expect margins to improve; GRMs to stabilise at lower levels than earlier

As the current credit crisis improves and crude/product prices stabilise, we expect the global trade of polymers and petroleum products to resume. In addition, we also expect operating rates of refineries to be cut, moving the demand-supply equation towards a balanced one. Both these factors are expected to improve refining margins from the current levels. However, lower utilisation rate for refining is expected to keep refining margins at levels below those seen in past few years.

We are revising our RIL refining margin assumptions downwards to reflect the same

Revision of RIL's GRMs

(USD/bbl)	FY09	FY10
Revised	11.4	9.1
Earlier	12.7	11.1
Change (%)	(10.2)	(17.9)

Source: Edelweiss research

For every 1 USD/bbl increase in GRMs, RIL's FY10 EPS increases by INR 10/share (refer appendix for sensitivity table)

Over-bearish market is discounting upsides and positive triggers

We have reduced earnings estimates in keeping with the weaker outlook for refining and petrochemicals; however, we believe that the market has gone overboard in assigning discount to the stock for the same. Our expectation is that the stock has significant upsides from the current levels on the back of the company's: diversification; yet to be realised upstream upsides from integrated business like natural gas; and downstream retailing returning to viability.

Incorporating lower margins from refining and petrochemicals; cut FY10 EPS 20%

We have incorporated our changed assumptions of lower margins from refining and petrochemicals segments in the earnings. This has led us to reduce RIL's FY10 EPS from INR 164/share to INR 131/share, a 20% cut.

Change in RIL's estimates

	FY09E			FY10E		
	Revised	Earlier	*Change (%)*	Revised	Earlier	*Change (%)*
Revenues (INR bn)	1,532	1,538	(0.4)	1,629	2,000	(18.6)
EBITDA (INR bn)	224	236	(5.0)	326	390	(16.5)
PAT after minority interest (INR bn)	131	144	(8.7)	210	262	(19.9)
EPS (INR/share)	81.7	91.2	(10.4)	130.9	163.6	(20.0)

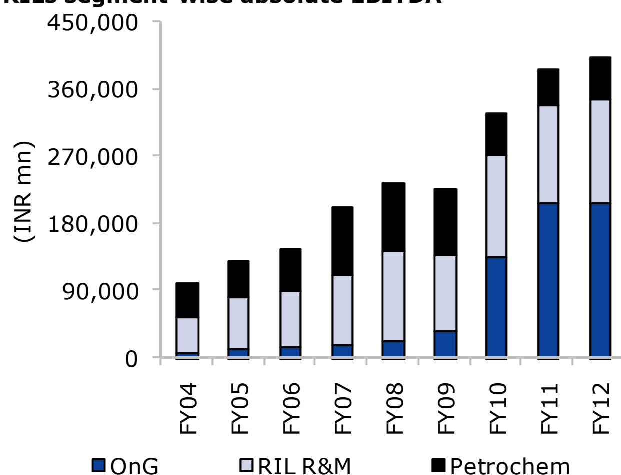
Source: Edelweiss research

RIL to emerge as a diversified O&G player in FY10

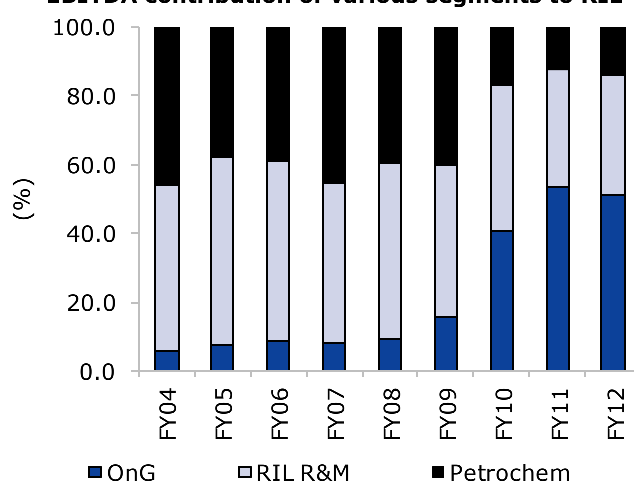
Post start-up of gas production from KG-D6, RIL is set to emerge as a diversified player in the oil and gas industry. Following this development, RIL is expected transform from a cyclical refiner and petrochemicals manufacturer to a company capturing the entire value chain of the oil and gas industry. We expect this to add huge stability to RIL's cash flows, thereby, moderating its risk profile.

We estimate RIL's core profits and cash flow from operation to grow at 2-year CAGR of 21.7% and 26.6% respectively.

RILs segment-wise absolute EBITDA



EBITDA contribution of various segments to RIL



Source: Edelweiss research

Outlook and valuations: SOTP value of INR 1550/share; maintain 'BUY'

We have cut our SOTP fair target value for RIL from INR 1,954/share to INR 1,550/share. Most of the changes to RIL's SOTP are due to reduction in its refining and petrochemical margins.

At INR 1,127, our SOTP still offers 37% upside to the stock. Start-up of the gas production and RPL refinery are positive triggers for RIL's cash flows. We believe that the next value drivers for RIL will come from two additional areas: (1) further visibility of blocks where gas reserves have been certified (NEC-25 and CBM blocks), and (2) positive drilling results and quantification of reserves from other exploration blocks that have huge upside potential for RIL.

At INR 1,127, RIL is trading at 8.6x FY10 consolidated EPS, and at 6.1x FY10 CEPS. We maintain our '**BUY'** recommendation on the stock.

SOTP for RIL revised from INR 1954 to INR 1550

Segment details	Revised Estimate (INR/share)	Earlier Estimate (INR/share)	*Change (%)*	Remarks
Exploration & Production	541	577	*(6.2)*	Change in long-term crude price assumption
RIL R&M (@ EV/EBITDA = 5.0x)	245	300	*(18.2)*	Reducing our GRM assumptions
RPL R&M (@ EV/EBITDA = 6.0x)*	264	323	*(18.2)*	Reducing our GRM assumptions
Chemicals (@ EV/EBITDA = 5.0x)	170	277	*(38.5)*	Reducing assumptions on petrochemicals business
Retailing (@P/BV = 0.5x)	36	71	*(49.8)*	Moving from 1.0x P/BV to 0.5x P/BV
SEZ (@P/BV = 0.5x)	12	25	*(50.1)*	Moving from 1.0x P/BV to 0.5x P/BV
Exploration upsides	336	338	*(0.6)*	
Total enterprise value	1,605	1,911	*(16.0)*	
Net debt	55	(43)	*NA*	
Equity Value (SOTP)	1,550	1,954	*(20.7)*	
CMP (INR)	1,127			
return on CMP (%)	37.5			

Source: Edelweiss research

** We have moved from valuing RPL on a business basis rather than as an investment basis (earlier)*

Appendix

Delays in Refining and Petrochemical projects

Country	Project and company	Project details	Delay
Saudi Arabia	PetroRabigh - Saudi Aramco, Sumitomo JV	USD 10.3 bn; upgradation of 400 kbpd of refinery capacity, and addition of a petrochemical complex	Commercial launch of operations delayed to the first quarter of 2009
China	Dushanzi (Xinjinag province) - Petrochina	100 kbpd CDU; 1 MMTPA ethylene project	Delayed from early 2008 to 2009
China	Fujian expansion - Sinopec	New major unit for expanding capacity bu 80 kbpd	Expected to start trial runs in Q1CY09, a delay of 1 quarter
China	Huizhou - CNOOC, Shell JV	240 kbpd refinery	Delayed from 2008 to 2009
Thailand	IRPC (formerly Thailand Petrochemical Industry)	USD 1.3 bn; upgradation capacity to refine residue such as asphalt into high value products	Put on hold due to costs rising due to credit crunch a sub-prime fallout
Saudi Arabia	Yanbu - Conoco-Philips , Saudi Aramco JV	New 400 kbpd integrated refinery and petrochemical complex	Halt bidding for equipment (was expected in 2011, delayed indefinitely)
USA	Tulsa (Oklahoma) - Sunoco	USD 375 mn; upgrade of 91 kbpd of refining capacity	Scrapped, looking to sell plant
Saudi Arabia	Ras Tanura - Saudi Aramco, Dow Chemicals JV	USD 25 bn refining and petrochemical complex	Delayed as the workload for front-end engineering design is proving too costly for a single firm
Saudi Arabia	Jizan - Saudi Govt. owned	Greenfield refinery	Bids delayed by a year, to March 7 2009, as ministry looks to create incentives package
Saudi Arabia	Jubail - Total SA	USD 10 bn refinery project	Delayed due to adverse market conditions

Source: Industry sources, Edelweiss research

Sensitivity of RIL earnings to GRMs

RIL GRMs (USD/bbl)	FY10 EPS (INR/share)
7.1	110.6
8.1	120.9
9.1	**130.9**
10.1	140.9
11.1	150.9

Source: Edelweiss research

Company Description

RIL is the largest private player in the refining, petrochemical, and E&P sectors in India. Historically, the refining and petrochemical segments have been contributing ~90% to its total revenues; this is, however, set to change, as the company scales up its E&P business and emerges as an integrated E&P player. RIL is also venturing into consumer retailing and urban infrastructure.

Investment Theme

RIL's strength lies in its ability to build businesses of global size and scale and execute complex, time-critical, and capital-intensive projects, which will prove advantageous in its huge plans in the E&P sector, organised retailing, and SEZ infrastructure. Also, there could be a potential upward revision to our estimated in-place reserves. With its venture into consumer retailing and SEZ infrastructure, we believe, it is ideal to play the India story.

Key Risks

RIL benefits from protected refinery margins in the Indian market ,due to duty differential between products and crude. Reduction in the duty differential will be negative for the company.

Rupee appreciation may negetively impact the company, as it is positively leveraged to the depreciating currency.

Any slowdown in global demand could result in a fall in refining and chemical margins.

Financial Statements (Consolidated)

Income statement — INR (mn)

Year to March	FY06	FY07	FY08	FY09E	FY10E
Net revenues	830,248	1,137,701	1,371,467	1,532,019	1,628,508
Raw material costs	570,479	790,170	997,631	1,182,075	1,134,943
Gross profit	259,770	347,532	373,835	349,944	493,565
Employee expenses	14,693	25,909	27,382	30,640	32,570
Other expenses	101,591	120,344	115,008	95,114	135,443
Operating expenses	116,283	146,253	142,389	125,755	168,013
Total expenditure	686,762	936,423	1,140,021	1,307,830	1,302,956
EBITDA	143,487	201,279	231,446	224,189	325,552
Depreciation & amortisation	34,949	48,995	50,042	52,184	79,968
EBIT	108,537	152,284	181,404	172,005	245,584
Interest expense	9,346	12,323	10,865	19,889	17,359
Other income	12,046	6,509	12,235	7,660	13,660
Profit before tax	111,238	146,470	182,773	159,776	241,885
Current tax	8,948	16,265	25,721	19,761	13,837
Deferred tax	7,040	9,053	8,659	8,500	8,500
Fringe tax benefit	307	406	496	490	353
Total tax	16,295	25,723	34,876	28,751	22,690
Core profit	94,943	120,747	147,897	131,025	219,195
Extraordinary/ Prior period items	(995)	-	47,335	-	-
Profit after tax	93,948	120,747	195,232	131,025	219,195
minority interest	(35)	(1)	19	-	9,285
Profit after minority interest	93,982	120,748	195,214	131,025	209,910
Equity shares outstanding (mn)	1,393	1,453	1,453	1,574	1,602
EPS (INR) basic	68.2	83.1	101.7	83.3	131.0
Diluted shares (mn)	1,394	1,482	1,603	1,603	1,603
EPS (INR) diluted	68.2	81.5	92.2	81.7	130.9
CEPS (INR)	98.3	123.0	142.1	121.8	186.2
DPS	10.0	11.0	13.0	14.0	15.0
Dividend payout (%)	17.1	15.5	14.9	19.7	13.4

Common size metrics (% net revenues)

Year to March	FY06	FY07	FY08	FY09E	FY10E
Cost of goods sold	68.7	69.5	72.7	77.2	69.7
Operating expenses	14.0	12.9	10.4	8.2	10.3
EBITDA margins	17.3	17.7	16.9	14.6	20.0
Depreciation & amortisation	4.2	4.3	3.6	3.4	4.9
Interest	1.1	1.1	0.8	1.3	1.1
Net profit margin	11.4	10.6	10.8	8.6	13.5

Growth metrics (%)

Year to March	FY06	FY07	FY08	FY09E	FY10E
Revenues	24.7	37.0	20.5	11.7	6.3
EBITDA	12.1	40.3	15.0	(3.1)	45.2
PBT	22.3	31.7	24.8	(12.6)	51.4
Net profit	25.0	27.2	22.5	(11.4)	67.3
EPS	25.0	19.5	13.2	(11.4)	60.2

Balance sheet (INR mn)

As on 31st March	FY06	FY07	FY08	FY09E	FY10E
Total equity capital	13,932	14,534	14,534	15,737	16,024
Total equity share warrants	-	-	16,824	-	-
Reserves & surplus	496,349	667,657	823,747	1,092,069	1,473,961
Shareholder's equity (A)	510,280	682,191	855,105	1,107,806	1,489,984
Minority interest (B)	4,573	34,220	40,886	28,020	40,843
Secured loans	76,649	150,468	195,765	185,017	157,594
Unsecured loans	156,779	186,047	311,196	301,702	(99,092)
Total debt (C)	233,428	336,515	506,961	486,719	58,502
Deferred tax liability (D)	49,708	69,905	77,983	87,225	95,725
Sources of funds (A+B+C+D)	**797,989**	**1,122,831**	**1,480,935**	**1,709,770**	**1,685,055**
Gross fixed assets	878,408	1,033,028	1,091,802	1,634,145	1,774,805
Depreciation	315,501	384,802	451,191	479,084	559,052
Net fixed assets	562,907	648,226	640,611	1,155,061	1,215,754
Capital WIP	88,962	293,237	498,841	125,893	87,459
Total fixed assets (A)	651,869	941,463	1,139,452	1,280,954	1,303,212
Investments (B)	66,668	52,680	95,229	96,297	96,297
Inventories	103,453	124,563	191,261	191,324	150,931
Accounts receivable	43,517	38,314	60,683	76,601	91,926
Cash and cash equivalents	26,164	19,370	44,742	88,134	59,885
Loans and advances	76,738	148,881	217,477	238,984	174,699
Other current assets	250	32	726	1,000	1,000
Current assets (C)	250,122	331,159	514,889	596,042	478,441
Current liabilities	128,709	181,853	234,175	240,802	176,517
Provisions	42,017	20,664	34,492	22,721	16,378
Current liabilities & provisions (D)	170,726	202,516	268,667	263,523	192,895
Net current assets (E)	79,396	128,643	246,222	332,519	285,546
Miscellaneous expenditure (F)	56	46	33	-	-
Uses of funds (A+B+E+F)	**797,989**	**1,122,831**	**1,480,935**	**1,709,770**	**1,685,055**
Book value per share (INR)	366	469	577	704	930

Free cash flow

Year to March	FY06	FY07	FY08	FY09E	FY10E
Net profit	93,982	120,748	195,214	131,025	209,910
Add: Depreciation	34,949	48,995	50,042	52,184	79,968
Add: Deferred tax	7,040	9,053	8,659	8,500	8,500
Add: Others	(1,302)	3,841	(45,921)	175,302	203,802
Gross cash flow	134,670	182,637	207,994	367,011	502,179
Less:Changes In working capital	(31,938)	(15,147)	(45,663)	(21,398)	(45,560)
Opertaing cash flow	102,731	167,490	162,331	345,612	456,619
Less: Capex	(113,845)	(279,461)	(266,403)	(193,686)	(102,226)
Free cash flow	**(11,114)**	**(111,971)**	**(104,072)**	**151,926**	**354,393**

Cash flow metrics (INR mn)

Year to March	FY06	FY07	FY08	FY09E	FY10E
Operating cash flow	102,731	167,490	162,331	345,612	456,619
Financing cash flow	19,165	107,361	167,168	(94,394)	(460,586)
Investing cash flow	(131,893)	(292,451)	(304,256)	(208,601)	(24,281)
Net cash flow	(9,997)	(17,600)	25,244	42,618	(28,248)
Capex	(113,845)	(279,461)	(266,403)	(193,686)	(102,226)
Dividends paid	(11,068)	(32,739)	-	(25,775)	(28,121)
Share issuance/(buyback)	4,505	52,619	0	1,203	287

Profitability ratios (%)

Year to March	FY06	FY07	FY08	FY09E	FY10E
Gross profit margin	31.3	30.5	27.3	22.8	30.3
EBITDA margin	17.3	17.7	16.9	14.6	20.0
ROACE	19.0	16.9	14.8	11.5	15.3
ROAE (%)	20.6	20.3	19.5	13.5	16.2
ROA	13.2	12.6	11.4	8.2	12.9
Current ratio	1.5	1.6	1.9	2.3	2.5
Quick ratio	0.9	1.0	1.2	1.5	1.7
Cash ratio	0.2	0.1	0.2	0.3	0.3
Receivable turnover (x)	20.1	27.8	27.7	22.3	19.3
Inventory turnover (x)	6.4	6.9	6.3	6.2	6.6
Payables turnover (x)	4.4	5.1	4.8	5.0	5.4
Receivables (days)	18	13	13	16	19
Inventory (days)	57	53	58	59	55
Payables (days)	84	72	76	73	67
Cash conversion cycle (days)	(9)	(6)	(5)	2	7
Debt-equity (x)	0.5	0.5	0.6	0.4	0.0
Debt/EBITDA	1.6	1.7	2.2	2.2	0.2
Adjusted debt/Equity	0.5	0.5	0.6	0.4	0.0
Long term debt / Capital employed (%)	29.3	30.0	34.2	28.5	3.5
Total debt / Capital employed (%)	56.9	54.2	57.6	49.0	20.6
Interest coverage (x)	11.6	12.4	16.7	8.6	14.1

Operating ratios (x)

Year to March	FY06	FY07	FY08	FY09E	FY10E
Total asset turnover	1.2	1.2	1.1	1.0	1.0
Fixed asset turnover	1.9	1.9	2.1	1.7	1.4
Equity turnover	1.8	1.9	1.8	1.6	1.3

Du pont analysis

Year to March	FY06	FY07	FY08	FY09E	FY10E
NP margin(%)	11.4	10.6	10.8	8.6	12.9
Total assets turnover	1.2	1.2	1.1	1.0	1.0
Leverage multiplier	1.6	1.6	1.7	1.6	1.3
ROAE (%)	20.6	20.3	19.5	13.5	16.2

Valuation parameters

Year to March	FY06	FY07	FY08	FY09E	FY10E
Diluted EPS (INR)	68.2	81.5	92.2	81.7	130.9
Y-o-Y growth (%)	*25.0*	*19.5*	*13.2*	*(11.4)*	*60.2*
CEPS (INR)	98.3	123.0	142.1	121.8	186.2
Diluted P/E (x)	16.5	13.8	12.2	13.8	8.6
P/BV (x)	3.1	2.4	2.0	1.6	1.2
EV/Sales (x)	2.1	1.7	1.5	1.4	1.1
EV/EBITDA (x)	12.0	9.6	8.9	9.4	5.4
Dividend yield (%)	0.9	1.0	1.2	1.2	1.3
EV/EBITDA (x)+1yr forward	8.5	8.4	9.2	6.5	4.6

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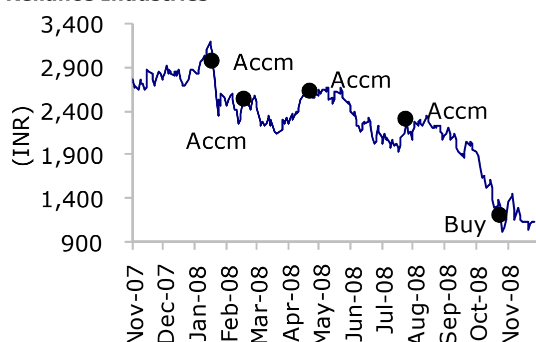
Reliance Industries



Recent Research

Date	Company	Title	Price (INR)	Recos
04-Nov-08	**Oil & Gas**	*Monthly Update*		
03-Nov-08	**HPCL**	Investory losses hit Bottomline hard; *Result Update*	208	Buy
31-Oct-08	**IOCL**	Highest-ever inventory losses; *Result Update*	349	Accum.
31-Oct-08	**BPCL**	Inventory losses raze earnings; Result update	280	Buy

Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

	Buy	Accumulate	Reduce	Sell	Total
Rating Distribution*	82	56	29	8	178

* 2 stocks under review / 1 rating withheld

	> 50bn	Between 10bn and 50 bn	< 10bn
Market Cap (INR)	67	54	57

Rating Interpretation

Rating	Expected to
Buy	appreciate more than 20% over a 12-month period
Accumulate	appreciate up to 20% over a 12-month period
Reduce	depreciate up to 10% over a 12-month period
Sell	depreciate more than 10% over a 12-month period

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