ENAM Securities
India Research

CMP: Rs 821
Target Price: Rs 1,100
Potential Upside: 34%
Absolute Rating: BUY

Reliance Industries

Relative to sector: Outperformer

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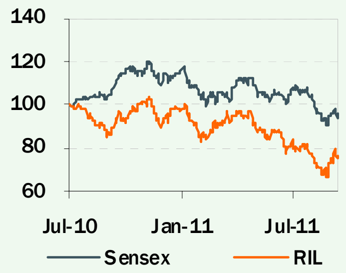
Relative Performance



Source: Bloomberg, ENAM Research

Stock data

No. of shares	: 3,273 mn
Market cap	: Rs 2,709 bn
52 week high/low	: Rs 1,187/ Rs 714
Avg. daily vol. (6mth)	: 4.7 mn shares
Bloomberg code	: RIL IB
Reuters code	: RELI.BO

Shareholding (%)		Jun-11	QoQ chg
Promoters	:	44.7	0.0
FIIs	:	17.4	(0.3)
MFs / UTI	:	2.5	(0.1)
Banks / FIs	:	8.3	0.1
Others	:	27.1	0.3

HEADING FOR A MAJOR ACQUISITION?

Huge cash reserves and ongoing corrections in valuations of petchem & refining assets globally (due to slowdown concerns in the EU/US) render RIL with an attractive option for an inorganic growth opportunity. We retain our BUY rating on the stock with a TP of Rs 1,100 (34% upside from CMP of Rs 821).

Acquisition to unlock value for shareholders

Acquisition of a large petchem/refining company in the EU/US not only offers an opportunity to grow the business in the region but also alleviates concerns over RIL's cash utilization.

Attractive valuations as investors get E&P business free!

We value RIL's extant cyclical business and its stake in Yemen, PMT & Shale Gas fields at US$ 61 bn (Rs 810/share), implying that investors are getting the E&P business free. RIL's trough case valuation comes at Rs 870/share, 6% premium to CMP.

	(USD bn)	(Rs/ Shr)	Comments
Refining, petchem	41.0	542	FY13e EV/E of 6.5x
PMT, Yemen, Shale gas	5.7	76	DCF
Treasury shares (at CMP)	5.4	71	Conversion at CMP
Total enterprise value	**52.1**	**689**	
FY12 Net Debt	(9.1)	(120)	Net of cash from BP
Total Equity value	**61.2**	**809**	
CMP	62.1	821	
Valuation ascribed to E&P	0.9	12	E&P avlbl for free
No of shares	3,273		
E&P business valuation	**21.2**	**281**	

Source: ENAM Research

Best placed in the current macro environment

RIL is best placed amongst its global peers to not only wade through weak economic outlook, but to utilize this pessimism to acquire cyclical assets at cheap valuations, which could generate significant appreciation for investors in the long-run.

Financial summary

Y/E Mar	Sales (Rs mn)	PAT (Rs mn)	Consensus EPS* (Rs)	EPS (Rs)	Change YoY (%)	P/E (x)	RoE (%)	RoCE (%)	EV/EBITDA (x)	DPS (Rs)
2010	2,037,397	158,976	-	48.6	2.2	-	12.1	11.0	-	6.3
2011	2,658,106	202,109	-	61.8	27.1	-	13.6	12.3	-	6.3
2012E	2,790,030	244,015	70.5	74.6	20.7	11.0	14.7	13.9	6.3	7.0
2013E	2,701,009	238,598	77.9	73.0	(2.2)	11.3	12.7	12.9	6.3	7.0

Source: *Consensus broker estimates, Company, ENAM estimates

ARE CAPITAL ALLOCATION ISSUES HURTING RIL?

We believe the biggest worry for RIL's shareholders has been capital allocation by the mgmt, which has resulted in the stock correcting 22% & under-performing the Sensex by 21% in the last two years. RIL has ventured into unrelated banking, telecom & Hotel biz, while sacrificing opportunities in the Petchem space due to conservative valuations.

Unrelated acquisitions have hit investor confidence

RIL has acquired cos in the banking, telecom and Hotels biz, which have been questioned by investors. Although, these acquisitions were relatively small in size (total investments of US$ 2 bn, 3% of RIL's EV), they have dented investor confidence regarding capital allocation by the company.

RIL's unrelated acquisitions

	East India Hotel	Deccan Cargo	AXA Insurance	Infotel Broadband	DE Shaw JV
Business	Hotels	Freight cargo services	Insurance	Telecom-broadband	Financial services
Time	Aug-10	Apr-10	Jun-11	Jun-10	Mar-11
Stake	14%	26-50%	74%	95%	n/a
Price paid	$218 mn	$20-30 mn	$670 mn	$1,070 mn	n/a

Source: Media reports; All data presented are as per media reports. Enam Securities Private Ltd has not independently verified accuracy/validity of the information.

Conservative outlook on prospective acquisitions have also hurt

Historically, RIL's management has adopted an astute but conservative approach while carrying out acquisitions. This approach resulted in RIL loosing out bids for Lyondell-Basell, Dow Chemicals (as per media reports) and Atlas shale gas (later taken over by Chevron).

Missed the Bus! – A little aggression might have benefited investors

In the hindsight, these acquisitions would have been value accretive and synergetic to RIL's current businesses. These firms would have provided RIL with: (a) world's largest petchem manufacturing facilities, (b) strong technology franchise with access to key patents, and (c) already established global distribution network. Further, RIL appears to have missed substantial valuation upsides (~30% in Lyondell-Basell & 16% in Dow Chem), by not acquiring these firms.

RIL's acquisition attempts in the past

Target (USD bn)	Lyondell-Basell	Dow Chemicals
EV at time of bidding	15.2[a]	46.2
Current EV	19.7	53.8
Upside lost (Notional)	**30%**	**16%**

Source: Bloomberg; All data presented are as per media reports. Enam Securities (P) Ltd has not independently verified accuracy/validity of the information. (a): RIL bid amount

FY12: US$ 16BN CASH FOR ACQUISITIONS

RIL is flushed with cash (FY12E: US$ 16 bn), post conclusion of the BP deal (US$ 7.2 bn). This would further be augmented by yearly operating cash flow of US$ 7 bn. We believe RIL's capex plans for three years would be around US$ 15 bn, implying cash levels of US$ 22 bn by FY15 end.

The company will have several options to utilize this cash including: (a) buyback or dividend payout to investors and (b) inorganic acquisitions in downstream or upstream space. **We evaluate these options and conclude that an acquisition in global petrochemical space is the most likely option.**

Buyback or dividend payout unlikely

RIL's management may not adopt defensive strategies such as buyback or dividend given its focus on growth rather than capital preservation. Further, any attempt to support stock price through buyback/dividend is also unlikely as the management can do the same by providing visibility on cash utilization, not impacting its long-term growth targets.

Overseas acquisition most likely

Going forward, we believe, RIL would be more flexible (and aggressive) in acquisitions and may utilize its cash reserves (FY12E – US$ 16 bn) to execute large acquisition.

Refining: simple refineries available for sale but may not be viable

Globally, though there is no dearth of refining assets on sale, most of them are simple refineries, which are unable to operate profitably in the current business environment (with countries stressing on environmentally compliant cleaner fuels). We believe RIL would not make acquisition in this space due to lack of availability of reasonably "complex" and profit making refineries.

Global refineries on sale or at risk of closure

Company	Location	Country	Capacity (kbpd)	Remarks
Europe				
Petroplus	Reichstett	France	85	On sale since Oct-2010; permanent closure if buyer not found
Total	Dunkirk	France		
Lyondell-Basell	Berre L-Etang	France	105	Co announced its intentions to sell on May-2011
Unipetrol	Pardubice	Czech R.	20	Nine-week shutdown beginning from Jan-2011 due to poor
Conocophillips	Wilhelmshaven	Germany	260	Cancels upgradation plans. For sale or conversion to terminal.
Shell	Harburg	Germany	110	To be converted to terminal by June-12 if buyer is not found
Conocophillips	Humber	U.K.	221	Consider selling
PKN-Orlean	Lietuva	Lithuania	200	Under-review for low profitability
Murphy	Milford Haven	Wales	130	For sale; tranaction expected in Q12011
Total	Lindsey	U.K.	221	For sale; Little progress in talks with Petroplus
Shell	Gothenburg	Sweden	78	Mulling sale since Dec-09 due to poor demand
Total European			**1,430**	
U.S.				
BP	Texas city	U.S.	475	To cover GoM spill cost; Difficult given litigation
BP	Carson	U.S.	266	As per BP's strategy to sell California assets
Sunoco	Marcus Hook	U.S.	175	Sunoco expects possible transaction in 2012
Sunoco	Philadelphia	U.S.	330	Huge impairment charges expected
Valero	Oklahoma	U.S.	92	
ConocoPhillips	Pennsylvania	U.S.	185	
Valero	Aruba	U.S.	275	Restarted in Jan-11; was shut since June-09
Murphy	Meraux	U.S.	125	Operating at reduced rates; Making losses
Murphy	Superior	U.S.	35	Operating at reduced rates; Making losses
Total U.S.			**1,958**	
Total			**3,388**	

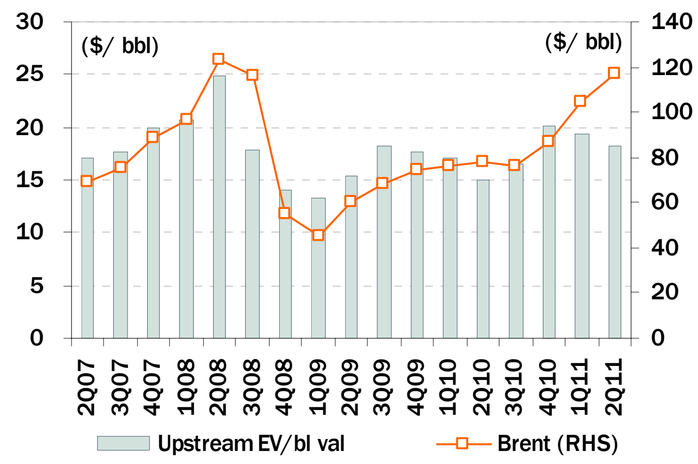
Source: Bloomberg

E&P possible, but valuations not comfortable

Any acquisition in global oil and gas assets/companies would be viewed positively by the street but valuations are rich due to high crude oil prices. EV/P1 reserves stands at US $ 18.2/bl (vs. ~US$ 13/bl in CY09).

RIL may decide against an investment in the E&P space at such valuations. Further acquisitions in the US/Canada gas space are possible given relatively low gas prices in the region (implying attractive valuations) and possibility to export gas to east-Asian countries. However, latest downgrade of Marcellus shale gas reserves by EIA could impact US plans of exporting LNG & might make RIL reluctant to acquire gas assets in the near-term.

Upstream industry EV/proved reserve multiples vs. crude prices



Source: Bloomberg; Our upstream universe include nine pure-play E&P companies namely, Occidental Petroleum, Apache Corp, Anadarko Petroleum, EOG Resources, Talisman Energy, Encana Corp, Chesapeake Energy, Southwestern Energy and Nexen Inc.

Acquisition in petrochemical space most likely

We believe RIL is most likely to evaluate inorganic opportunity in the global petrochemical space due to following reasons:

- **Aims to be a global player:** RIL is focused on consolidating its position as the world's largest integrated petrochemical player. RIL is currently undergoing a capex of US$ 10 bn to double its petrochemical capacity.
- **Access to technology:** Unlike refining or conventional E&P, profitability of the petrochemical industry is highly dependent on technology. An acquisition in global space would give RIL access to latest technology.
- **Access to distribution network:** With RIL ramping up its refining/petchem capacities significantly and domestic market not sufficient to absorb the incremental supply; marketing of these products in the key demand centers across the globe would be a key to RIL's downstream profitability. Acquisition of an international petchem company would give RIL the much needed access to distribution channels/relationship.

Major petrochemical companies across the globe

	Financials (US$ bn) (CY10/FY11)							Fwd valn multiple EV/EBITDA
	M Cap	EV	Revenue	EBITDA	Net profit	ROA (%)	ROE (%)	(CY12/FY13 fwd)
Taiwan								
Nan Ya	17.0	17.9	10.7	1.8	1.3	9.3	15.4	14.6
Formosa Plas	16.7	15.6	7.2	1.4	1.4	13.3	18.7	9.3
Formosa C&F	15.7	14.8	12.2	2.0	1.5	10.1	18.8	11.2
Korea								
LG Chem	19.4	20.2	17.1	3.1	1.9	18.3	31.7	4.4
Honam	10.2	10.7	10.9	1.4	0.7	10.3	19.2	4.3
USA								
Dow	31.1	53.8	53.7	6.1	2.3	2.9	11.5	4.9
Du Pont	41.9	54.9	31.5	4.4	3.0	7.7	37.7	6.4
Eastman	5.1	6.1	5.8	1.2	0.4	7.6	27.9	4.0
Europe								
BASF	58.0	77.5	84.7	15.8	6.0	8.2	23.4	4.2
Air Liquide	33.7	40.4	17.9	4.5	1.9	6.5	17.0	7.4
Japan								
Asahi Kasai Corp	8.7	10.3	18.7	2.4	0.7	4.3	9.3	3.1
Mitsui Chemicals	3.3	9.4	16.3	1.2	0.3	2.0	6.5	4.7
Kuraray Co Ltd	5.1	4.0	4.2	1.0	0.3	5.7	8.5	2.7
Teijin Ltd	3.4	6.9	9.5	1.2	0.3	3.2	9.1	4.0

Source: Bloomberg

Global petrochemicals industry mergers & acquisitions (CY2010/2011)

Target	Acquirer	Announced Date	Value (US$ bn)	Status
Styron Corp	Bain Capital Partners LLC	Mar-10	1.63	Completed
BorsodChem Zrt	Yantai Wanhua Polyurethanes	Jun-10	1.70	Completed
JNFL	Investor Group	Sep-10	4.75	Completed
Sino Polymer New Materials Co	Lumena Resources Corp	Nov-10	1.47	Completed
IFCO Systems NV	Brambles Investments Ltd	Nov-10	1.25	Completed
Xianglu Petrochemicals(Xiamen)	HeiLongJiang HeiHua Co Ltd	Dec-10	1.11	Pending
PTT Aromatics & Refi ning PCL	PTT Chemical PCL	Feb-11	3.78	Pending
Sued Chemie AG	Clariant AG	Feb-11	2.63	Completed
Lubrizol Corp	Berkshire Hathaway Inc	Mar-11	8.79	Pending
Rhodia SA	Solvay SA	Apr-11	4.70	Pending
Evonik-Carbon Black Business	Rhone Capital	Apr-11	1.30	Pending
International Specialty Prods	Ashland Inc	May-11	3.20	Pending
Total			**36.31**	

Source: Price Waterhouse Coopers

ATTRACTIVE VALUATIONS

Fair value of Rs 1,100/sh despite moderate margin assumptions

On the back of concerns over cash utilization, CAG audit and falling KG-D6 production, RIL has corrected 17% and has underperformed the Sensex by 11% in the last six months. Despite modeling in slightly lower refining & petrochemical margins (due to increasing concerns on global slowdown), we value RIL at Rs 1,100 /sh and see an impressive 34% upside from CMP of Rs 821/sh.

RIL: SOTP Valuation

Sum of Parts Valuation	(Rs bn)	(Rs/ Shr)	Comments
Refining	999	305	FY13E EV/EBITDA of 6.5x; FY13 GRM at $10/bl
Petrochemicals	777	237	FY13E EV/EBITDA of 6.5x
Oil and gas production (PMT, Yemen)	141	43	FY13E EV/EBITDA of 6.0x
Core business enterprise val	**1,917**	**586**	
Marcellus Shale Acquisition	42	13	DCF
Eagle ford shale	28	9	DCF
E&P business			
KG basin valuation	371	113	DCF; Cost of equity at 11.4%, 11 tcfe recovery
NEC-25	202	62	20% discount on DCF; Cost (equity) at 11.4%,
CBM	75	23	20% discount on EV/reserves based valuation
Contingent reserves valuation (KG D-6, NEC)	93	28	
Further reserve accretion (D3, D4, D9,Cauvery)	177	54	20% discount on value for future expl'n upside
E&P business valuation	**919**	**281**	Overall value in-line with RIL-BP deal
Enterprise Value	2,966	906	
Net Debt	(393)	(120)	FY12 debt adj. for CWIP, E&P investments, cash in D6 JV & exploratory success related bonus
Equity value	**3,359**	**1,026**	
Treasury stock	252	77	20% discount to our fair value
No of shares adj for treasury stock	3,273		Adjusted for warrants
Total value per share		**1,103**	

Source: ENAM Research

SCENARIO – I: E&P BIZ AVAILABLE FOR FREE; CMP PRICING THE EXTANT CYCLICAL BIZ AND CASH ONLY

We believe the recent correction and underperformance of RIL is overdone, and long-term investors should look at buying the stock at current levels. **The investors are getting RIL's impressive E&P portfolio free of cost!** The same business has been valued by BP at US$ 21.6–27 bn.

CMP pricing in extant cyclical biz only: E&P business available for free..!

	(USD bn)	(Rs/ Shr)	Comments
Refining, petchem	41.0	542	FY13e EV/E of 6.5x
PMT, Yemen, Shale gas	5.7	76	DCF
Treasury shares (at CMP)	5.4	71	Conversion at CMP
Total enterprise value	**52.1**	**689**	
FY12 Net Debt	(9.1)	(120)	Net of cash from BP
Total Equity value	**61.2**	**809**	
CMP	62.1	821	
Valuation ascribed to E&P	0.9	12	E&P avlbl for free
No of shares	3,273		
E&P business valuation	**21.2**	**281**	
KG D6	8.6	113	
NEC-25, D4, D3, D9	8.8	116	
CBM	1.7	23	
Contingent resources	2.1	28	

Source: ENAM Research

SCENARIO – II: IMPLIED EV/EBITDA FOR CYCLICAL BIZ AT 3.3X; 50% DISCOUNT TO GLOBAL PEERS

If we assume BP's valuations for RIL's E&P business to be accurate, then investors are getting RIL's strong refining and petrochemical businesses at FY13 EV/EBITDA of 3.3x. This is at a sharp ~50% discount to the global peers' valuations.

Refining and Petrochemical business trading at 3.2x EV/EBITDA

	(USD bn)	(Rs/ Shr)	Comments
E&P business valuation	**21.2**	**281**	
KG D6	8.6	113	
NEC-25, D4, D3, D9	8.8	116	
CBM	1.7	23	
Contingent resources	2.1	28	
Others	**11.1**	**147**	
PMT, Yemen, Shale gas	5.7	76	DCF
Treasury shares (at CMP)	5.4	71	Conversion at CMP
Total enterprise value	**32.3**	**427.6**	
FY12 Net Debt	(9.1)	(120)	Net of cash from BP
Total Equity value	**41.4**	**548**	
CMP	62.1	821	
Implied valuation of Refining & Petchem (A)	20.7	273	
Refining & Petchem EBITDA (FY13) (B)	6.3		
Refining EBITDA (FY13)	3.5		
Petchem EBITDA (FY13)	2.8		
Implied EV/EBITDA for cyclical biz. (A/B)	**3.3**		

Source: ENAM Research

Peer valuations: Refining & Marketing business

CY12E / FY13E Company Name	Mcap (USD mn)	EV (USD mn)	EBIDTA (USD mn)	EBIDTA Margin (%)	ROE (%)	ROA (%)	P/E (x)	EV/ EBIDTA (x)
TonenGeneral Sekiyu	6,361	7,154	997	2.8	8.4	5.4	15.7	7.1
Showa Shell	2,769	6,565	1,186	3.3	10.9	3.5	8.7	5.7
Formosa Petchem	26,423	28,986	2,975	9.7	21.1	12.5	14.3	10.1
Thai Oil	4,397	5,561	964	7.5	18.3	10.0	8.3	4.6
Caltex Australia Ltd	3,025	3,761	848	3.8	9.1	8.5	8.1	4.4
Cosmo Oil	2,146	9,815	1,706	4.6	8.1	6.1	6.8	7.7
Average				**5.3**	**12.7**	**7.7**	**10.3**	**6.6**

Source: Bloomberg and ENAM Research

Peer valuations: Petrochemical business

CY12E / FY13E Company Name	Mcap (USD mn)	EV (USD mn)	EBIDTA (USD mn)	EBIDTA Margin (%)	ROE (%)	ROA (%)	P/E (x)	EV/ EBIDTA (x)
Nan Ya Plastics	17,350	18,646	1,316	15.3	18.1	11.4	9.6	14.9
Formosa Plastics	17,061	15,997	1,660	21.2	20.6	15.6	9.0	9.5
Formosa Chemicals	16,055	18,318	1,376	12.8	18.7	12.6	9.2	11.5
Sinopec	6,392	6,987	726	4.8	12.7	6.9	6.6	9.9
LG Chem	20,929	22,449	4,390	18.5	25.9	18.4	8.2	4.8
Honam Petrochem	10,992	11,789	2,264	17.3	21.0	14.5	8.6	4.5
Toray Industries	11,246	16,934	2,743	12.2	12.0	6.0	10.7	5.6
Asahi Kasai Corp	8,758	10,422	2,921	12.8	10.8	7.3	8.4	3.1
Mitsui Chemicals	3,277	9,402	1,721	8.3	7.8	4.0	7.8	4.7
Kuraray Co Ltd	5,074	3,982	1,300	23.9	10.1	8.0	9.2	2.8
Teijin Ltd	3,503	6,975	1,436	12.5	10.4	5.7	8.3	4.1
Average				**14.5**	**15.3**	**10.0**	**8.7**	**6.8**

Source: Bloomberg and ENAM Research

SCENARIO – III: TROUGH CASE VALUATIONS AT RS 870

RIL is currently trading at a 6% discount to our Trough case valuations. Even after assuming lower GRMs (US$ 9/bl vs. US$10/bl in base-case), FY13 EV/E of 5.5x (vs. 6.5x in base-case) for petrochemicals, and taking much lower reserves for E&P valuation & multiples for the existing cyclical business, we value RIL at Rs 870/share.

RIL: Trough case valuation

Sum of Parts Valuation	(Rs bn)	(Rs/ Shr)	Comments
Refining	730	223	FY13E EV/EBITDA of 5.5x; FY13 GRM at $9/bl
Petrochemicals	658	201	FY13E EV/EBITDA of 5.5x
Oil and gas production (PMT, Yemen)	118	36	FY13E EV/EBITDA of 5x
Core business enterprise val	**1,505**	**460**	
Reliance Retail, Telecom & SEZ	61	19	50% of total investments made till date
Marcellus Shale Acquisition	42	13	DCF
Eagle ford shale	28	9	DCF
E&P business			
KG basin valuation	343	105	DCF; Cost of equity at 11.4%, 9.3 tcfe recovery
NEC-25	101	31	50% discount to our base case
CBM	37	11	50% discount to our base case
Contingent reserves valuation (KG D-6, NEC)	44	13	50% discount to our base case
Further reserve accretion (D3, D4, D9,Cauvery)	89	27	50% discount to our base case
E&P business valuation	**614**	**188**	Overall value in-line with RIL-BP deal
Enterprise Value	2,250	687	
Net Debt	(373)	(114)	FY12 debt adj. for CWIP, E&P investments, cash in D6 JV & exploratory success related bonus
Equity value	**2,622**	**801**	
Treasury stock	228	70	Valued at Rs 800/sh
No of shares adj for treasury stock	3,273		Adjusted for warrants
Total value per share		**871**	

Source: ENAM Research

Trough case Assumptions

	Base case	Bear case
Refining	FY13E EV/E of 6.5x; FY13 GRM at US$10/bl	FY12E EV/E of 5.5x; FY13 GRM at US$9/bl
Petrochemical	FY13E EV/E of 6.5x	FY13E EV/E of 5.5x
KG -D6	11tcf recovery; Peak production rate of 80 mmscmd	9.3 tcf recovery; Peak production rate of 60 mmscmd
Other blocks (NEC, MN-D4, D3, D9)	DCF assuming 20tcf recoverable reserves	50% discount to base case
BP deal	Receives US$9bn	Receives US$7.2bn
Treasury shares	Valued at Rs 865/share (20% discount to our target price)	Valued at Rs800/share
Shale gas, SEZ retail	Valued at cost	Valued at cost
Target Price (Rs/sh)	**Rs 1,100/sh**	**Rs 870/sh**

Source: ENAM Research

CASH UTILIZATION – MANAGEMENT CONSERVATIVE IN THE PAST, WOULD NOT OVER-EXTEND

Market concerns:

RIL will be flushed with cash (FY12E: US$ 16 bn), post conclusion of the BP deal (US$ 7.2 bn); and with yearly operating cash flows of US$ 7 bn. Uncertainty over the cash utilization has been an overhang given the possibilities of: (a) unrelated acquisitions (banking, telecom, etc.), and (b) any significant premium that RIL may pay out for inorganic opportunities.

ENAM view:

- **Conservative track-record of management:** Going by the track record, RIL's management has shown keen business acumen while carrying out acquisitions. We believe that it is management's philosophy to adopt conservative approach while evaluating inorganic opportunities. For instance, RIL did not pursue the acquisition of Lyondell-Basell at stretched valuations. Although the decision may appear unwise in the hindsight, it highlights the management's philosophy of not to over-stretch itself in paying unreasonable acquisition premiums.
- **Cash hoard provides inorganic growth opportunity:** In view of the uncertain global environment, we believe RIL's huge cash chest would stand it in good stead if they were to target a large acquisition. RIL may use part of its cash hoard towards its planned petrochemical expansion (capex of ~US$ 10 bn).

LOWER THAN EXPECTED PRODUCTION RAMP-UP

Market concerns:

Lower-than-expected production ramp-up from the KG-D6 block has raised questions on long term prospectively of the basin. Further, government may impose penalties, if RIL is found to be delaying the drilling of additional wells for non-concrete reasons. Lastly, any delay in approval of RIL's E&P work-program may not only hamper production ramp-up from existing fields but also impact the company's E&P prospects.

ENAM View:

- **BP entry allays concerns:** The RIL-BP deal allays concerns on long-term prospectively of the KG basin as BP would have done due diligence on the field reserves. Further, BP's deepwater expertise would not only help RIL in boosting KG-D6 production but also expedite exploratory efforts in the other 21 blocks, further improving E&P outlook. Additionally the increased production would come at the most opportune time (2014/15), when D6 gas prices are expected to be revised upwards, further improving project IRR.

- **Government penalty unlikely:** Government penalizing RIL is unlikely as an expert appointed by MoPNG has acknowledged RIL's contention that the reservoir is more complex than initially anticipated and a different approach for drilling may be required for best recovery factors from the field. Furthermore, the government consultant has indicated that there is a minimal chance of a reserve downgrade due to the current concerns on RIL's production levels.

- We have assumed gas production to plateau at 80 mmscmd in 2015. Every 10 mmscmd decrease in production would impact the firm's NPV by Rs 10/share.

CAG AUDIT – NOT ENOUGH MEAT, BP ENTRY OFFSETS THE HIT

Market concerns:

Investors have been concerned over the likely impact of the Comptroller and Auditor General of India (CAG) report on RIL.

ENAM View:

Since there are no major aspersions on RIL by the CAG audit, we believe the concerns would die down. Most of the concerns levied by the CAG audit are on the policy & implementation of the policy by DGH & MoPNG, whereas cos including RIL have been largely absolved of a wrong-doing.

- **CAG maintains its observations; but in a toned down language**: CAG has broadly maintained its observations about: (a) non-compliance of PSC terms, (b) un-quantified undue advantage to RIL, and (c) lack of monitoring by MoPNG/DGH, in its June draft report. However, we have noticed that the language of the report has been toned down substantially & questions on intentions of RIL have also been removed.

- **What next? : Parliament to take appropriate action (if required); But timing & extent unclear:** The final version of the report has already been tabled in the Parliament. As per media reports, government has assured appropriate action, if required. <u>Although timing & extent of government action on CAG recommendation is difficult to predict; we believe government would take soft stance on the issue, which is positive for RIL.</u>

- **Silent on "gold-plating" of capex; Overhang gone:** Although, CAG has made comments about front-loading of capex (and resultant reduction in govt. share of profits), <u>it is silent on the extent of overstatement of capex. This is extremely positive for RIL as it would remove the "gold plating" overhang on the stock.</u> Further, CAG has not made any comments on increase of capex from US$ 2.4 bn to US$ 8.8 bn.

- **Non-relinquishment of area; No major indictment on RIL:** The report criticized MoPNG/DGH for not forcing RIL to relinquish 25% of contracted area after completion of phase-I & II, as required by PSC.

This is in sharp contrast to the draft report, in which CAG questioned RIL's intentions; thus making government responsible for the lapse rather than the RIL itself. This is also a positive for RIL.

- **Procedural lapses on procurement activities; No material impact:** CAG has come down heavily on procedural lapses in procurement activities and recommended the review of the award of 10 specific contracts in the final audit report. The common procedural lapses pointed out are: (a) single financial bid, (b) major revisions in scope/qty/specification post bid-due date, and (c) deficiencies in pre-qualification process.
- **Doubts on extension of exploration phases:** CAG has noted that MoPNG/DGH gave unjustified extension of exploration phases to RIL resulting in the company getting undue favor. Note, MoPNG/DGH has maintained that certain delays are allowed given the complex nature of the exploration business.

PETCHEM TO PROVIDE THE NEXT LEG OF GROWTH

Huge petchem capacity addition

RIL is planning to invest US$ 10 bn in expanding its petrochemical capacities over the next 4-5 years. Post expansion, RIL would become one of the largest petrochemical players in the world. These incremental capacities are coming at the most opportune time (FY14/15), when margins would be healthy amid muted global capacity additions.

RIL: Petrochemical capacity expansion

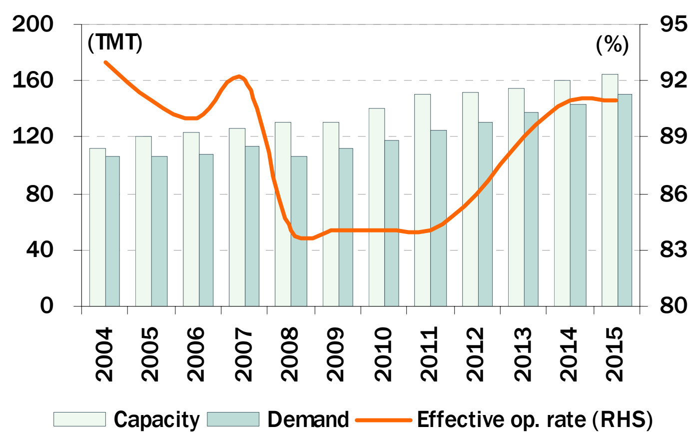
(kTPA)	Current capacity	Expansion	% increase
Polymer			
Ethylene + Propylene	2,643	1,500	57%
Polyethylene	1,118	800	72%
PVC	625	127	20%
Polyester			
Paraxylene	1,856	1,400	75%
PTA	2,050	2,300	112%
MEG	733	289	39%
PET	290	540	186%
PFY	823	535	65%
PSF	742	290	39%
Others			
Poly Butadiene Rubber	74	50	68%
SBR	–	150	–

Source: Company

Polymer margins bottomed out: Set for explosive growth by FY14-15

Ethylene margins have been under significant pressure due to the spate of capacity additions in the Middle East. However, we expect margins to bottom-out in CY11 with significant increase in capacity utilizations going ahead. Utilization of ethylene cracking capacities is expected to reach 90% through CY14/15; which could be a huge positive trigger for margins.

World Ethylene Supply-Demand Balance



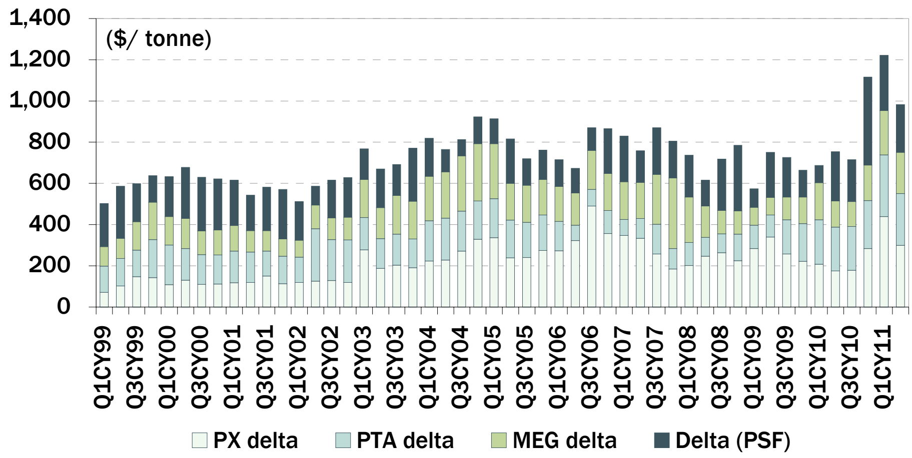
Source: Company

Polyesters chain margins healthy despite 25% correction in cotton

The polyester margins have contracted over the past few months, with over 25% correction in cotton yarn prices since early March. However, margins for the overall polyester chain have remained healthy, albeit lower than its peak in Q1CY11.

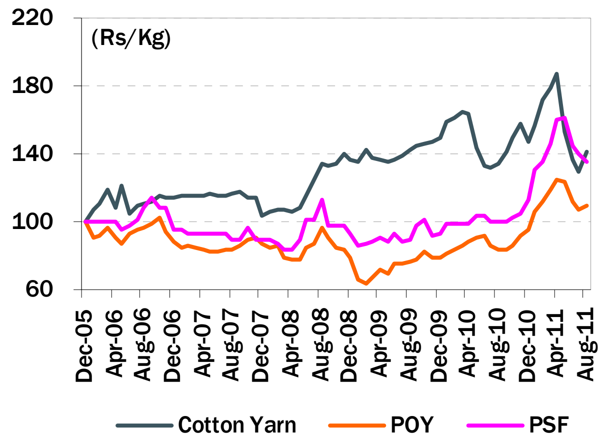
Given that cotton yarn prices are now at par with POY prices, we believe there is limited downside to POY prices & margins in the short term. Moreover, any correction in crude oil and Naphtha prices would improve margins for Polyesters.

Polyester chain deltas: Still higher than 5-yr average of $728/MT



Source: Company, Delta over PES

Index prices of cotton yarn, PSF and POY



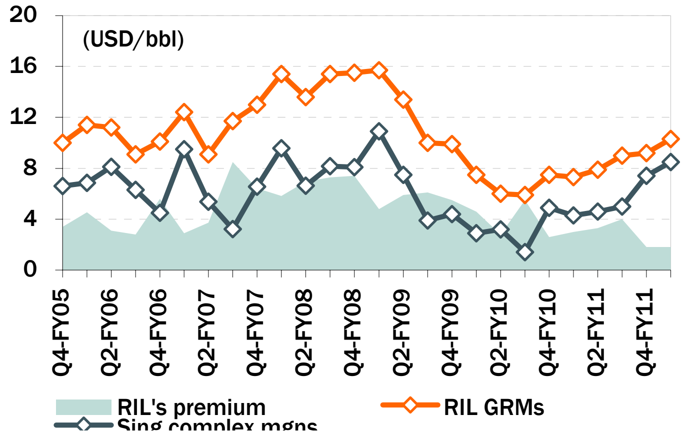
Source: Company, Bloomberg and ENAM Research

REFINING: COMPLEXITY TO AID RIL

Overall Singapore refining margins to remain robust

During 3QFY10, Singapore refining margins (complex) dropped to its historical low of US$ 1.4/bl, while RIL's margins dipped to US$ 5.9/bl. In the current uncertain scenario, where there has been substantial uncertainty over product margins and global financial markets in turmoil, Singapore margins have remained robust (Q2FY12 average at US$ 8.8/bl). Under the worst scenario of a sharp correction in margins, less complex European refiners would shutdown first, further benefiting complex refiners such as RIL.

GRMs trend – RIL vs. Singapore complex



Source: Company, Bloomberg and ENAM Research

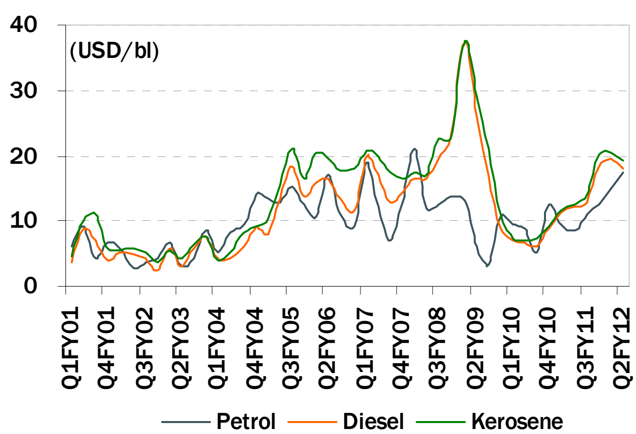
62% of the product margins are healthy

Middle distillates (diesel & SKO) contribute 46% to RIL's overall product slate, while petrol contributes 17%. Together, these three products contribute 63% to RIL's overall product slate. Margins for these products will remain robust. Petrol margins are at historically high levels, while diesel & SKO margins are also healthy at US$ 18/bl and US$ 19/bl levels.

RIL – Product Slate (%)

	Old Refinery	New Refinery	Overall
MS	9%	27%	17%
HSD	29%	38%	33%
LPG	7%	0%	4%
SKO	19%	5%	13%
Naphtha	9%	0%	5%
Reformate	9%	8%	9%
Propylene	2%	3%	2%
Sulphur	2%	2%	2%
Petcoke	8%	8%	8%
Loss	6%	11%	8%
Cap (mn t)	33	27	60

Historic product margins



Source: Bloomberg, ENAM Research

Light heavy differential could benefit complex refiners

Stabilizing margins may prompt simple refiners to restart their operations. However, most of these players being simple refiners, consume lighter grades of crude oil. This would lead to a jump in light-heavy differentials, which would continue to benefit complex refiners like RIL.

Other differentiators

Apart from our views of healthy refining margins going ahead, there are few key company specific differentiators that highlight RIL's competitive advantage to other global/domestic refineries:

- Product slate skewed towards middle distillates (46%), margins of which are expected to remain robust going forward
- Significantly low operating costs (at US $ 1.8-2.5/bl)
- Locational advantage: Located on coastal area with jetty facilities and easy access to all key demand centers across the world (Asia, Europe and US)
- Refinery integrated with petrochemical facilities

ASSUMPTIONS AND SENSITIVITY

Taking conservative approach amid global uncertainties

Our analysis of RIL's petchem margins for Q2FY12 indicates: (a) weakness in polymer margins, (b) flattish polyester margins, and (c) healthy cracker margins. However, most of the petchem product margins are well above their historic averages. Despite this, we have assumed "normalized" margin scenario, which is at a slight discount to current margins – to account for global economic uncertainties.

Similarly, although Singapore margins have remained robust (Q2FY12 avg at US$ 8.8/bl), and approaching its 2-yr high levels, we have marginally cut our refining margin assumptions from US$ 10.5/bl to US$ 10/bl.

Assumptions: Petrochemicals margins

(USD/ tonne)	FY07	FY08	FY09	FY10	FY11	FY12E	FY13E	FY14E	Q1FY12	Q2FY12 (QTD)
Polymer Margins										
PE - 1.015*Ethylene	270	485	554	535	513	375	400	490	487	557
PP - 1.01*Propylene	233	567	566	414	475	370	400	460	473	317
PVC - 0.14*Ethylene	792	1,007	961	919	1,014	800	750	900	1,189	1,112
Polyester margins										
PSF-0.87*PTA -0.35*MEG	285	279	279	255	437	400	380	325	586	462
PFY - 0.87*PTA- 0.35*MEG	328	370	367	330	411	400	375	310	378	371
PET-0.87*PTA-0.35*MEG	281	7	48	21	14	50	50	50	163	140
Paraxylene - Naphtha	463	391	416	472	508	570	550	525	534	780
PTA - 0.67*Paraxylene	359	214	222	265	302	320	300	250	479	251
MEG - 0.6*Ethylene	292	595	283	218	368	400	375	280	553	665
Others										
LAB - 0.37*Benzene	1,281	1,368	1,831	1,500	1,594	1,500	1,550	1,650	2,042	1,977

Source: Bloomberg and ENAM Research

Assumptions: Refining

		FY08	FY09	FY10	FY11	FY12E	FY13E	FY14E
Capacity	MMTPA	33	33	62	62	62	62	62
Crude throughput	MMTPA	31.8	32.0	60.9	66.6	67.0	67.0	67.0
Cap. utilisation	*%*	*96.4*	*97.0*	*98.2*	*107.4*	*108.0*	*108.0*	*108.0*
Avg. GRMs	**USD/ bbl**	**15.1**	**12.2**	**6.6**	**8.4**	**10.0**	**10.0**	**10.0**

Source: Bloomberg and ENAM Research

EARNINGS REVISION AND SENSITIVITY

Cutting estimates by 6%

We have moderately adjusted our cyclical margin assumptions downward to account for global economic uncertainties. This has resulted in 6% downward revision in our earnings estimates for FY13E. Note that every US$ 0.5/bl increase in refining margins would raise our FY13E EPS estimate by 3.5%; while every 5% increase in RIL's petchem margins from our base case would increase our FY13E EPS estimate by 4%.

Earning Revision

(Rs bn)	Old		New		% difference	
	FY12E	FY13E	FY12E	FY13E	FY12E	FY13E
EBITDA	409	411	379	361	-7.3%	-12.1%
EPS (Rs)	74.1	77.3	74.6	73.0	0.7%	-5.6%

Source: Company

Sensitivity Analysis: FY13 EPS

(Rs/sh)		Refining margins (US$/bl)				
		9.0	9.5	10.0	10.5	11.0
Petchem margins (% change from base case)	-10%	62.7	65.1	67.4	69.8	72.2
	-5%	65.4	67.8	70.2	72.6	75.0
	Base case	68.2	70.6	73.0	75.3	77.7
	+5%	71.0	73.3	75.7	78.1	80.5
	+10%	73.7	76.1	78.5	80.9	83.2

Source: Company

Company Financials

Income statement

(Rs. bn)

Y/E Mar	FY10	FY11	FY12E	FY13E
Net sales	**2,037**	**2,658**	**2,790**	**2,701**
Other operating income	0	0	0	0
Total income	**2,037**	**2,658**	**2,790**	**2,701**
Cost of goods sold	1,662	2,175	2,334	2,262
Contribution (%)	20	19	17	17
Advt/Sales/Distrn O/H	67	103	77	78
Operating Profit	**309**	**380**	**379**	**361**
Other income	22	35	50	55
PBIDT	**331**	**415**	**430**	**417**
Depreciation	109	141	99	104
Interest	21	24	24	19
Other pretax	0	0	0	0
Pre-tax profit	**201**	**250**	**306**	**294**
Tax provision	43	48	68	65
(-) Minority Interests	(1)	(0)	0	0
Associates	0	0	6	10
Adjusted PAT	**159**	**202**	**244**	**239**
E/o income / (Expense)	86	(9)	0	0
Reported PAT	**245**	**193**	**244**	**239**

Key ratios

(%)

Y/E Mar	FY10	FY11	FY12E	FY13E
Sales growth	**34.7**	**30.5**	**5.0**	**(3.2)**
OPM	**15.2**	**14.3**	**13.6**	**13.4**
Oper. profit growth	31.9	23.1	(0.3)	(4.7)
COGS / Net sales	81.6	81.8	83.7	83.8
Overheads/Net sales	3.3	3.9	2.7	2.9
Depreciation / G. block	4.9	5.9	4.6	4.5
Effective interest rate	0.0	0.0	0.0	0.0
Net wkg.cap / Net sales	0.0	0.0	0.0	(0.0)
Net sales / Gr block (x)	1.1	1.1	1.2	1.2
Incremental RoCE	18.4	46.9	(8.7)	(20.1)
RoCE	**11.0**	**12.3**	**13.9**	**12.9**
Debt / equity (x)	0.5	0.5	0.3	0.2
Effective tax rate	21.2	19.2	22.2	22.2
RoE	**12.1**	**13.6**	**14.7**	**12.7**
Payout ratio (Div/NP)	8.4	10.6	9.4	9.6
EPS (Rs.)	**48.6**	**61.8**	**74.6**	**73.0**
EPS Growth	2.2	27.1	20.7	(2.2)
CEPS (Rs.)	82.1	105.0	105.0	104.7
DPS (Rs.)	**6.3**	**6.3**	**7.0**	**7.0**

Balance sheet

(Rs bn)

Y/E Mar	FY10	FY11	FY12E	FY13E
Total assets	**2,169**	**2,501**	**2,483**	**2,605**
Gross block	2,241	2,383	2,167	2,301
Net fixed assets	1,602	1,581	1,266	1,296
CWIP	170	297	270	343
Investments	24	29	51	77
Wkg. cap. (excl cash)	126	105	(19)	(12)
Cash / Bank balance	246	488	915	901
Others/Def tax assets	0	0	0	0
Capital employed	**2,169**	**2,501**	**2,483**	**2,605**
Equity capital	30	30	30	30
Reserves	1,386	1,519	1,741	1,958
Borrowings	646	841	594	492
Others	107	111	118	124

Cash-flow

(Rs bn)

Y/E Mar	FY10	FY11	FY12E	FY13E
Sources	**249**	**508**	**78**	**216**
Cash profit	279	347	344	339
(-) Dividends	20	24	24	27
Retained earnings	258	323	320	312
Issue of equity	16	0	5	5
Borrowings	(117)	195	(247)	(102)
Others	91	(9)	0	0
Applications	**249**	**508**	**78**	**216**
Capital expenditure	73	247	(243)	207
Investments	(2)	5	22	26
Net current assets	155	(21)	(124)	7
Change in cash	23	277	423	(23)

Source: Company, ENAM Research

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CONFLICT OF INTEREST DISCLOSURE STATEMENT

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Disclosure of interest statement (As of September 6, 2011)

1. Analyst ownership of the stock	No
2. Firm ownership of the stock	No
3. Directors ownership of the stock	Yes
4. Investment Banking mandate	No
5. Broking relationship	Yes

We are committed to providing completely independent and transparent recommendations to help our clients reach a better decision.