Reliance Industries

Evergreen

Stock Update

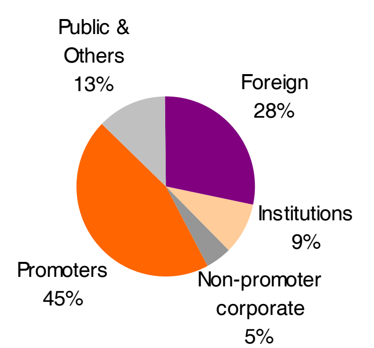
Delay in gas production from KG basin

Buy; CMP: Rs1,349

Company details

Price target:	Rs1,710
Market cap:	Rs196,152 cr
52 week high/low:	Rs3252/930
NSE volume: (No of shares)	54 lakh
BSE code:	500325
NSE code:	RELIANCE
Sharekhan code:	RIL
Free float: (No of shares)	74.3 cr

Shareholding pattern



Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	19.4	-29.8	-40.5	-49.9
Relative to Sensex	5.9	-7.3	-9.6	-6.3

KG D6 gas production could get delayed as expatriate employees refuse to return to work

Reliance Industries Ltd (RIL) has said that its plan to commence gas production from January 2009 from its Krishna-Godavari (KG) D6 field may get delayed as a majority of the expatriate employees working on the project have refused to return to work for safety reasons after the recent terror attacks in Mumbai. Engineers, reservoir specialists, geologists, geophysists and rig operators mainly from Europe and the USA are working on the project. Availability of experienced employees is key to the successful commencement of gas production from the KG D6 basin. In the absence of these employees, we believe that gas production from the KG D6 field will be affected.

Furthermore, cyclonic conditions in the Bay of Bengal in November 2008 led to the closure of work in the KG D6 field for two weeks, adding to the problems of RIL. However, the petroleum ministry has said that the bad weather conditions will not result in much delay in gas production from the KG D6 field.

Government withdraws affidavit stating gas price of USD4.2 for KG D6 field

The government had earlier filed an affidavit with the Mumbai High Court stating that RIL cannot sell gas from the KG D6 field below the government-approved price of USD4.2 per million British thermal unit (mmbtu) for five years. It has, however, withdrawn the affidavit, reducing the clarity on the ongoing dispute between RIL and Reliance Natural Resources Ltd (RNRL) over the pricing of the gas from the KG D6 field. The withdrawal follows the demand by RNRL to cross-examine government officials. The government has claimed that it has withdrawn the affidavit so that court time is not wasted on cross-examinations. We believe that the withdrawal of the affidavit will not change the government's stance on the case as it can still file a written application in the court regarding the gas price of USD4.2 per mmbtu.

Current scenario: Gas production from RIL's KG D6 block is expected to commence by Q4FY2009. However, the company cannot sell the gas produced from the KG D6 field as currently there is a stay order on the sale of gas to third parties (other than National Thermal Power Corporation [NTPC], RNRL and RIL). RIL and RNRL are fighting a legal battle over the pricing of gas from the KG D6 block in the Mumbai High Court and the next hearing on the case has been adjourned to January 12, 2009.

Valuation table

Particulars	FY2006	FY2007	FY2008	FY2009E	FY2010E
Net sales (Rs crore)	83,024.8	113,770.1	137,146.7	158,200.9	190,169.8
Adj. net profit (Rs crore)	9,497.8	12,075.0	15,326.0	15,729.8	20,596.8
Shares in issue (crore)	139.3	145.3	145.3	157.3	157.3
Adj. EPS (Rs)	68.2	83.1	105.5	100.0	130.9
% y-o-y change	*25.0*	*21.9*	*26.9*	*-5.2*	*30.9*
PER (x)	19.8	16.2	12.8	13.5	10.3
EV/EBIDTA (x)		20.8	20.8	9.2	7.1

In view of the current situation there exists the risk that RIL may not be able to produce gas from the KG D6 block in the next few months. Furthermore, there is a possibility that the losing party may file a case with the Supreme Court, appealing against the decision of the Mumbai High Court, if it is not satisfied with the decision.

We have built up two different scenarios pertaining to RIL's valuation and earnings per share (EPS) forecasts based on the possible outcome of the case either in the Mumbai High Court or in the Supreme Court.

Scenario 1: Court gives decision in favour of RIL and gas is sold at USD4.2 per mmbtu

Our earnings estimates and valuation for RIL will not be affected as long as the company is allowed to sell gas at the government-approved price of USD4.2 per mmbtu. We have factored the government-approved price of USD4.2 per mmbtu in our valuation of RIL's exploration and production (E&P) business for the first five years and then of USD5.0 per mmbtu for the remaining 15 years. This gives enterprise value/barrel of oil equivalent (boe) of USD4.5 on the 2P reserves of 18.8 trillion cubic feet.

Scenario 2: Court gives decision against RIL and gas is sold at USD2.34 per mmbtu to RNRL and NTPC

Such a decision will have a negative impact on our earnings estimates and valuation for RIL's E&P business as RIL will have to then sell contracted amount of gas to RNRL and NTPC at a price of USD2.34 per mmbtu, which shall be substantially lower than the government-approved price. If RIL sells 28 million standard cubic metre per day (mmscmd) of gas to RNRL and 12mmscmd of gas to NTPC at a price of USD2.34 per mmbtu, then our forecast of enterprise value/boe for the block would decline to USD3.6 per boe from our current estimate of USD4.5 per boe. As a result, our current price target will also reduce by Rs89.5 per share. However, we believe that in such a case, the royalty, income tax and the government's share of profit petroleum will also be calculated using a gas price of USD2.34 per mmbtu as the government cannot calculate its share at a price higher than that realised by RIL.

Impact on EPS

We have factored in gas production of 30mmscmd for FY2009, therefore there will be no change in our EPS forecast for FY2009 as the first 40mmscmd of gas produced from the KG D6 basin will be sold to the priority sectors. We have modeled gas production of 60mmscmd for FY2010. The first 40mmscd will be sold at the government-approved price of USD4.2mmbtu and the remaining 20mmscmd will be sold at USD2.34 per mmbtu. In this scenario, our EPS estimate for FY2010 will reduce by 4.2% to Rs125.4 per share.

Valuation

At the current market price, the stock trades at a price/earnings ratio of 10.3x FY2010E consolidated earnings and enterprise value/earnings before interest, depreciation, tax and amortisation of 7.1x FY2010E. Considering the fully diluted equity, the price target works out to Rs1,710 per share. We maintain our Buy recommendation on the stock.

The author doesn't hold any investment in any of the companies mentioned in the article.