

Company Focus

3 June 2008 | 11 pages

Reliance Petroleum (RPET.BO)

 Change in opinion
 Rating change
 Target price change

Upgrade to Buy: Can't Wait to Start

- Target of Rs204** — Our new Rs204 target price is based on 12-mth forward EV/EBITDA of 7.0x and value of tax breaks at Rs28/share. Stock is down ~25% since Jan-08. Notwithstanding fears of a slowdown, the current level of crack spreads and L-H differential provides strong support (and even upside) to our margin assumptions.
- What if RPL existed today? GRM > US\$30/bbl** — Based on average product spreads and L-H differential over last 12 months, 6 months, and 1 week, RPL would have reported GRMs of US\$16.6/bbl, US\$19.5/bbl, and US\$30.9/bbl respectively. This compares very favorably against our base case of US\$16.3-16.5/bbl for FY09-10E. The inherent cushion available to RPL's GRMs justifies target EV/EBITDA at 7.0x (higher end of peers, but lowered from 7.5x).
- Don't underestimate L-H differentials** — Even if diesel spreads come off (main driver of the GRMs recently) and demand slows, RPL's gains from the sustained increase in L-H differential, which has accompanied high oil prices, will provide strong support. The WTI-Maya differential at over US\$16/bbl in the past six months (>US\$20/bbl now, CIR base case at US\$14/bbl) will be a key driver of GRMs given RPL's heavy crude diet (average API = 24).
- Risks** — There have been fears of the government imposing windfall tax/export tax to bridge the subsidy gap; however, these are proposals at this stage with low probability of being implemented. Downside to our target could come from: 1) sharp downturn in global oil demand, and 2) Potential valuation issues in any move to merge with RIL.

Buy/Low Risk	1L
<i>from Sell/Low Risk</i>	
Price (03 Jun 08)	Rs169.35
Target price	Rs204.00
<i>from Rs220.00</i>	
Expected share price return	20.5%
Expected dividend yield	0.0%
Expected total return	20.5%
Market Cap	Rs762,075M
	US\$17,973M

Price Performance (RIC: RPET.BO, BB: RPET IN)



Figure 1. Reliance Petroleum – Statistical Abstract

Year to	Net Profit	Diluted	EPS	EV/EBITDA	P/E	P/B	P/CEPS	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(x)	(x)	(%)	(%)
2009E	62,660	13.9	na	na	12.4	4.1	12.4	na	0.8
2010E	113,427	25.2	81.0	6.5	6.8	2.7	6.1	47.3	2.2
2011E	114,356	25.4	0.8	6.1	6.8	2.0	6.1	34.3	2.9
2012E	109,315	24.3	-4.4	5.6	7.1	1.7	6.3	26.0	3.5
2013E	104,803	23.3	-4.1	5.1	7.4	1.4	6.5	20.9	3.4

Source: Citi Investment Research estimates

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See Appendix A-1 for Analyst Certification and important disclosures.

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¹Citigroup Global Markets India Private Limited

Fiscal year end 31-Mar	2009E	2010E	2011E	2012E	2013E
Valuation Ratios					
P/E adjusted (x)	12.4	6.8	6.8	7.1	7.4
EV/EBITDA adjusted (x)	12.8	6.3	5.7	5.3	4.8
P/BV (x)	4.1	2.7	2.0	1.7	1.4
Dividend yield (%)	0.8	2.2	2.9	3.5	3.4
Per Share Data (Rs)					
EPS adjusted	13.92	25.21	25.41	24.29	23.29
EPS reported	13.92	25.21	25.41	24.29	23.29
BVPS	42.53	63.96	84.29	102.51	119.97
DPS	1.39	3.78	5.08	6.07	5.82
Profit & Loss (RsM)					
Net sales	406,389	764,191	762,326	753,751	746,951
Operating expenses	-340,168	-647,380	-647,536	-647,692	-647,900
EBIT	66,221	116,810	114,789	106,059	99,050
Net interest expense	-3,561	-4,775	-4,918	-4,371	-5,579
Non-operating/exceptionals	0	2,098	6,764	11,504	17,091
Pre-tax profit	62,660	114,134	116,636	113,192	110,562
Tax	0	-707	-2,280	-3,877	-5,760
Extraord./Min.Int./Pref.div.	0	0	0	0	0
Reported net income	62,660	113,427	114,356	109,315	104,803
Adjusted earnings	62,660	113,427	114,356	109,315	104,803
Adjusted EBITDA	66,221	130,460	128,595	120,021	113,220
Growth Rates (%)					
Sales	na	88.0	-0.2	-1.1	-0.9
EBIT adjusted	na	76.4	-1.7	-7.6	-6.6
EBITDA adjusted	na	97.0	-1.4	-6.7	-5.7
EPS adjusted	na	81.0	0.8	-4.4	-4.1
Cash Flow (RsM)					
Operating cash flow	62,660	81,497	126,035	120,104	113,772
Depreciation/amortization	0	13,650	13,806	13,962	14,170
Net working capital	0	-44,872	153	705	559
Investing cash flow	-90,000	-2,000	-3,000	-3,000	-4,000
Capital expenditure	-90,000	-2,000	-3,000	-3,000	-4,000
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	27,340	3,734	-22,618	-34,080	21,024
Borrowings	27,340	10,000	-5,604	-11,209	48,353
Dividends paid	0	-6,266	-17,014	-22,871	-27,329
Change in cash	0	83,231	100,417	83,025	130,796
Balance Sheet (RsM)					
Total assets	266,119	432,719	524,457	599,693	725,520
Cash & cash equivalent	0	83,938	186,635	273,537	410,093
Accounts receivable	0	56,296	56,142	55,438	54,879
Net fixed assets	226,201	214,552	203,746	192,785	182,615
Total liabilities	74,726	144,913	145,166	138,415	185,640
Accounts payable	0	44,440	44,440	44,440	44,440
Total Debt	68,460	78,460	72,855	61,647	110,000
Shareholders' funds	191,394	287,806	379,291	461,278	539,880
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	16.3	17.1	16.9	15.9	15.2
ROE adjusted	32.7	47.3	34.3	26.0	20.9
ROIC adjusted	24.9	41.1	38.3	36.2	34.4
Net debt to equity	35.8	-1.9	-30.0	-45.9	-55.6
Total debt to capital	26.3	21.4	16.1	11.8	16.9

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Target price of Rs204

Our target price is based on EV/EBITDA of 7.0 x (7.5x earlier) 12-mth fwd and adds the value of tax benefits separately (Rs28/share). The lower valuation multiple is in line with lowered multiple assumed for its parent RIL (6.5x) but maintaining a slight premium for 1) much lower petrochemical exposure and 2) higher complexity. The target valuation is also at the higher end of peer valuations.

Figure 2. Reliance Petroleum – Valuation Target

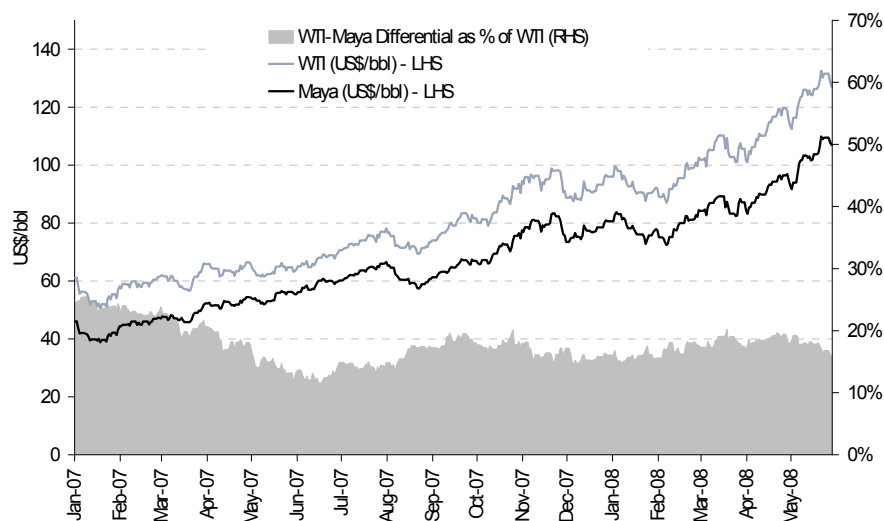
EV/EBITDA (x)	6.5x	7.0x	7.5x
EBITDA - 12m fwd as on Sep-08 – Rs m	131,451	131,451	131,451
EV (as on Sep-08) – US\$bn	21.4	23.0	24.6
Debt (as on Sep-08) – US\$bn	3.3	3.3	3.3
Equity value (as on Sep-08) – US\$bn	18.1	19.7	21.4
Value per share – Rs	161	175	190
Value of tax benefits – Rs	28	28	28
Target price – Rs	189	204	218

Source: Citi Investment Research estimates

Sustained L-H Differentials

We believe light-heavy crude differentials will remain healthy due to a combination of demand and supply-related factors. We believe that the differential has been primarily driven by the relative demand pattern for end-products (particularly diesel) as well as limited and slow upgrading of simple refineries. While new complex capacities (capable of processing heavy- sour grades) would ease the mismatch, progressively tighter fuel specifications and sustained growth in distillate demand would likely offset this to some extent. The WTI-Maya differentials in absolute terms have risen from US\$14.7/bbl in Jan-08 to US\$22.1/bbl in May-08. This makes our base case US\$14/bbl spread appear easily achievable.

Figure 3. WTI-Maya Differentials (US\$/bbl)



Source: Bloomberg, Citi Investment Research

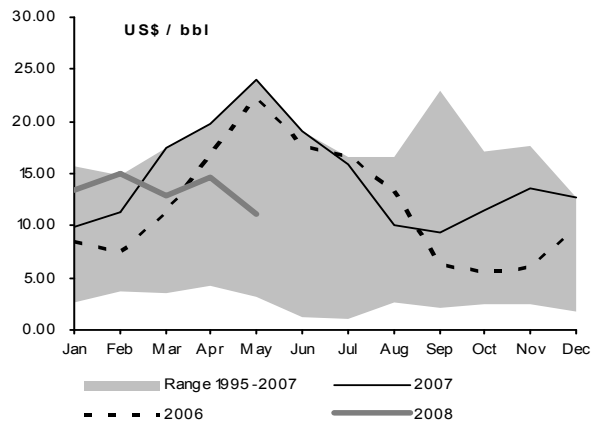
Besides the advantage of L-H differentials, RPL also gains from the record product differentials seen over the past few months. A GRM sensitivity analysis (shown in Figure 4) done on the basis of actual international crude and product prices indicates that our current assumptions are, in fact, a base case and substantial upside exists to our current US\$16.5/bbl GRM assumption for FY09 even if the differentials were to come off a little in the near term.

Figure 4. Reliance Petroleum – GRM Sensitivity Analysis

	Actual International Prices			CIR Assumptions	
	Last 1 week	Last 6 months	Last 1 year	First 6 months of operation	
WTI-Maya Differential (US\$/bbl)	\$20.60	\$16.40	\$14.40	\$14.00	
Product Differentials (US\$/bbl)	Product Slate				
Diesel	42%	\$35.9	\$18.50	\$13.70	\$11.00
Gasoline	35%	\$8.70	\$7.80	\$7.80	\$12.00
Jet/Kerosene	5%	\$35.20	\$17.40	\$13.80	\$7.50
Petcoke	6%	(\$20.00)	(\$20.00)	(\$10.00)	(\$10.00)
Propylene	3%	(\$4.10)	\$1.70	\$5.40	\$4.00
Sulphur	1%	(\$10.00)	\$7.10	\$0.60	\$1.00
Alkylates (jobbing margin)	additional product	\$2.00	\$2.00	\$2.00	\$2.00
Petchem (US\$/T)					
P-PP spread		\$145.00	\$245.00	\$261.00	\$180.00
Cash Cost		\$30.00	\$30.00	\$30.00	\$30.00
GRM (US\$/bbl)*		\$30.9	\$19.5	\$16.6	\$16.5

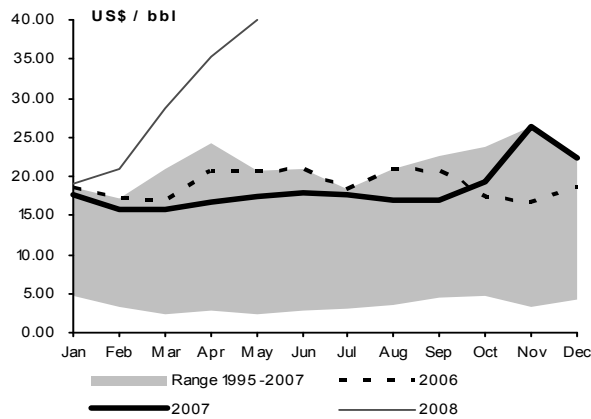
Source: Citi Investment Research, Bloomberg *Excluding margins from refinery off-gases.

Figure 5. Asian Gasoline Crack Spread vs. Dubai (US\$/bbl)



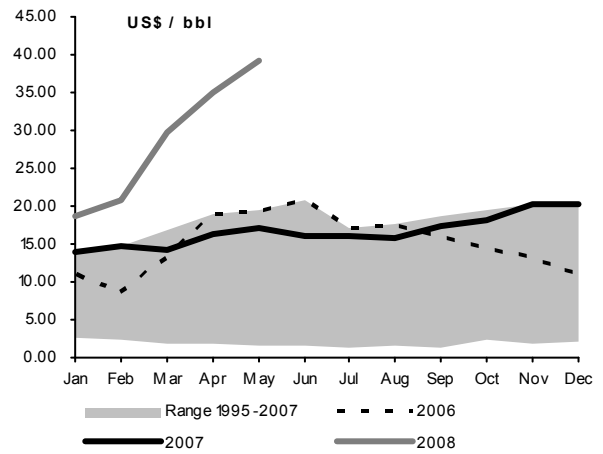
Source: Citi Investment Research and Reuters

Figure 7. Asian Jet-Kerosene Crack Spread vs. Dubai (US\$/bbl)



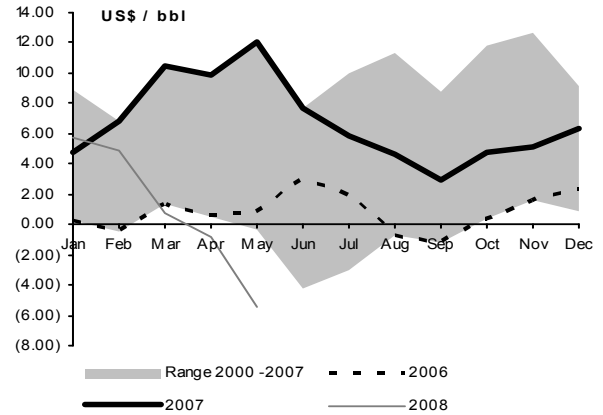
Source: Citi Investment Research and Reuters

Figure 6. Asian Diesel Crack Spread vs. Dubai (US\$/bbl)



Source: Citi Investment Research and Reuters

Figure 8. Asian Naphtha Crack Spread vs. Dubai (US\$/bbl)



Source: Citi Investment Research and Reuters

Figure 9. Reliance Petroleum – Global R&M Valuation Comparables

Company Name	RIC Code	Rating	Mkt cap (US\$m)	Share price 2-Jun-08	Target price	P/E (x)		EV/EBITDA (x)		P/BV (x)		Div. Yield (%)		FCF Yield (%)		ROCE (%)	
						FY09E	FY10E	FY09E	FY10E	FY09E	FY10E	FY09E	FY10E	FY09E	FY10E	FY09E	FY10E
Asia																	
HPCL	HPCL.BO	3M	1,932	242	184	6.5	6.5	9.7	11.6	0.7	0.7	4.6%	4.6%	1.3%	20.0%	3.2%	2.6%
Indian Oil	IOC.BO	3M	11,842	421	494	7.1	6.8	6.7	7.2	1.1	1.0	3.3%	3.5%	8.9%	13.1%	6.4%	5.7%
CPCL	CHPC.BO	1L	1,128	321	454	6.9	9.0	4.7	5.4	1.3	1.2	4.4%	3.7%	4.8%	1.0%	12.7%	9.4%
PTT	PTT.BK	1L	27,867	322	461	8.0	7.9	5.7	5.7	2.1	1.8	3.9%	4.2%	8.8%	12.8%	22.3%	21.0%
Thai Oil	TOP.BK	1L	3,727	60	94	6.2	7.3	5.0	4.9	1.5	1.4	8.1%	7.4%	22.8%	17.4%	21.4%	18.0%
Sinopec	0386.HK	1L	17,524	8	11	14.5	11.6	2.8	2.4	2.1	1.8	1.7%	2.1%	4.0%	-0.6%	10.6%	11.7%
S Sh Pechem	0338.HK	2M	958	3	3	61.5	38.6	7.7	4.5	1.1	1.1	0.6%	0.9%	-4.0%	-1.3%	0.2%	3.4%
Formosa Petro	6505.TW	2L	27,207	89	91	14.7	11.9	9.3	9.9	3.3	3.2	6.2%	6.7%	7.8%	12.1%	15.2%	15.0%
S Oil	010950.KS	1L	8,026	73,700	79,000	10.1	11.3	6.1	7.1	2.1	2.0	7.0%	6.8%	-6.4%	4.9%	15.5%	11.7%
Asia Avg.						11.4	10.0	6.4	6.6	2.2	2.0	4.4%	4.7%	6.7%	9.7%	15.2%	14.4%
US																	
Valero	VLO.N	1H	27,947	53	59	9.5	8.1	5.0	4.7	1.4	1.3	1.1%	1.1%	2.8%	1.8%	10.9%	11.0%
Tesoro	TSO.N	2S	3,796	28	30	21.2	7.0	7.5	4.5	1.2	1.0	1.5%	1.5%	-14.7%	4.0%	4.3%	9.8%
Sunoco	SUN.N	2H	5,544	47	51	15.6	11.9	6.2	5.6	2.2	2.0	2.5%	2.5%	-7.6%	-7.6%	6.4%	7.6%
US Avg.						11.6	8.5	5.5	4.8	1.5	1.4	1.3%	1.4%	-0.5%	0.7%	9.6%	10.4%
Europe																	
ERG	ERG.MI	2H	3,379	14	15	15.9	15.4	5.6	7.1	1.6	1.5	2.8%	2.9%	-7.5%	-14.6%	8.2%	5.1%
MOL	MOLB.BU	3H	16,560	23,395	19,500	13.5	14.2	7.9	7.7	2.2	2.0	3.6%	3.2%	3.5%	6.8%	12.3%	11.5%
Motor Oil	MORr.AT	1M	2,648	15	18	13.2	13.7	9.3	9.7	4.6	4.8	8.1%	7.3%	2.0%	7.0%	13.8%	13.4%
Neste Oil	NES1V.HE	2M	8,330	21	22	12.4	11.1	7.9	7.4	2.1	1.9	3.9%	4.4%	1.1%	4.6%	11.8%	11.1%
OMV	OMVV.VI	3H	24,435	52	45	9.3	9.2	5.5	5.4	1.7	1.5	3.0%	3.5%	-1.1%	4.3%	12.5%	11.4%
Europe Avg.						11.6	11.6	6.7	6.7	2.0	1.9	3.6%	3.7%	0.4%	4.1%	12.1%	11.1%
EMEA																	
Sasol	SOLJ.J	1L	38,152	465	500	12.8	8.3	8.1	6.0	4.0	2.9	2.7%	3.5%	6.8%	9.1%	22.9%	29.4%
PKN ORLEN	PKNA.WA	1M	7,963	41	62	5.8	4.7	4.2	3.5	0.8	0.7	5.2%	6.4%	11.3%	13.2%	10.2%	11.8%
Tupras	TUPRS.IS	1M	6,262	31	35	11.8	10.5	8.0	7.3	2.7	2.4	5.9%	6.7%	8.0%	9.8%	22.5%	25.8%
Petrol Ofisi AS	PTOFS.IS	2H	2,281	6	6	11.4	11.1	6.8	6.8	1.4	1.3	0.0%	0.0%	6.4%	7.8%	12.3%	10.9%
Gazpromneft	SIBN.RTS	1M	36,271	8	7	6.1	8.2	4.5	5.4	2.2	2.0	7.0%	5.3%	17.7%	12.1%	45.0%	31.2%
Surgutneftegaz	SNGS.RTS	1H	43,693	1	1	7.9	9.9	3.2	3.7	1.5	1.3	2.8%	2.2%	9.1%	7.3%	29.1%	20.0%
Tatneft	TATN.RTS	3H	17,430	8	7	6.1	6.6	4.7	4.5	1.4	1.3	4.9%	4.6%	13.4%	11.0%	20.7%	17.3%
Lukoil	LKOH.RTS	1L	94,072	111	128	7.0	8.6	4.8	5.5	1.7	1.5	2.3%	1.8%	2.6%	6.0%	24.0%	16.9%
TNK-BP Holding	TNBPI.RTS	1S	33,597	2	3	5.1	5.7	3.3	3.6	3.3	2.6	9.8%	8.8%	17.3%	15.0%	39.1%	32.7%
EMEA Avg.						7.7	8.2	4.8	5.0	2.2	1.8	4.2%	3.8%	9.0%	9.1%	28.5%	22.9%
Total Avg.						9.2	9.0	5.4	5.5	2.1	1.8	3.9%	3.7%	7.0%	8.0%	22.4%	18.9%

Source: Powered by dataCentral Note: 1.Using FY09E and FY10E for the Indian companies (31-Mar year-ending); correspondingly using CY08E and CY09E for the other companies 2. All averages are market capitalization weighted

Reliance Petroleum

Company description

RPL is presently 75% owned by Reliance Industries (RIL) and is setting up a super-size greenfield refinery (580,000bpd) and polypropylene plant in Jamnagar in the State of Gujarat. The project cost is estimated at Rs270bn (US\$6bn), of which 50% has been raised as equity through the promoter contribution and Initial Public Offering in early FY07. The project is scheduled to commission in mid-2008.

Investment strategy

We rate Reliance Petroleum (RPL) Buy/Low Risk (1L) rating with a target price of Rs204. RPL is constructing a super-sized refinery (580 kbpd) targeted at export markets. Key competitive advantages that we expect to aid sustenance of superior margins include a heavier crude diet, product flexibility, and superior fuel specs. A tried-and-tested location and parent RIL's strong execution track record imparts RPL a head start over competing projects, many of which have been delayed or cancelled. We also expect tightening fuel specs, especially in the US and Europe, will continue to drive demand for high-quality, differentiated products. Sustained growth in distillate demand (esp. diesel) and slow upgrading of simple refineries will drive superior margins for complex refiners like RPL. Superior project economics, tax incentives, and demanding valuations are additional drivers of our positive view on the stock.

Valuation

Our valuation methodology uses a traditional EV/EBITDA multiple as on September-08 applied on 12-mnth forward EBITDA i.e. mid-FY10E. In addition, we value the tax benefits separately which is added to the core value to arrive at the target price. We believe EV/EBITDA is an appropriate valuation metric as it eliminates variations due to capital structure and taxation, thus facilitating peer comparison. We believe that RPL, with its level of complexity (which we believe accords sustainability to margins) warrants a valuation at the higher end of peers i.e., a 12-month forward EV/EBITDA of 7.0x. We have downgraded the multiple from 7.5x earlier to factor in the growing global risks. However, we have faith in the company's ability to source and process dirty crude grades and sustain the differential over Singapore complex even during periods of relatively soft crack spreads. Based on our GRM assumptions and the highly remunerative tax regime, we value the tax benefits to be worth NPV of US\$3.2bn (Rs28/share). This together with core value based on 12-mnth forward EV/EBITDA multiple (Rs175/share) is the basis of our new target of Rs204/share.

Risks

Our quantitative risk rating system suggests a Low Risk rating to RPL. Any of the following risk factors could result in downside to our target price: 1) weakening of refining margins; 2) sharp downturn in global demand for refined products; 3) decrease in differentials enjoyed by cleaner fuels (10ppm/50ppm sulphur); 4) lower than anticipated cost savings from the KG basin gas; and 5) introduction of taxes by the government to reduce downstream subsidies.

Appendix A-1

Analyst Certification

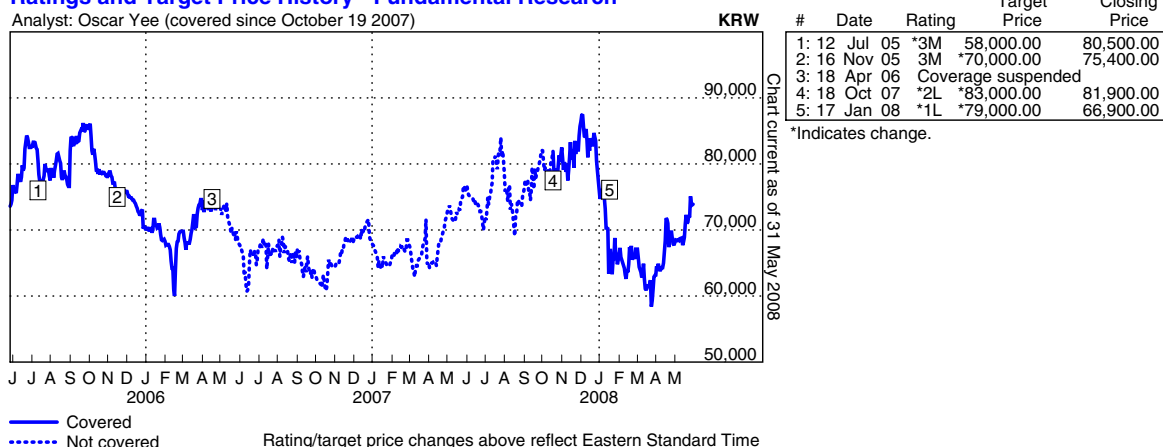
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IMPORTANT DISCLOSURES

S-Oil (010950.KS)

Ratings and Target Price History - Fundamental Research

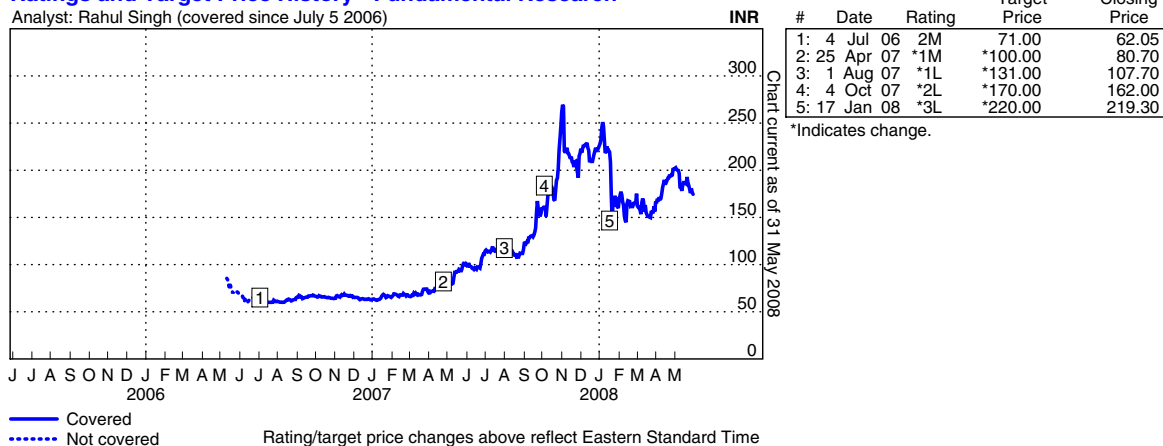
Analyst: Oscar Yee (covered since October 19 2007)



Reliance Petroleum (RPET.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Rahul Singh (covered since July 5 2006)



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Reliance Petroleum (RPET.BO)

3 June 2008

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