Macquarie Research
Equities

INDIA

Reliance Industries

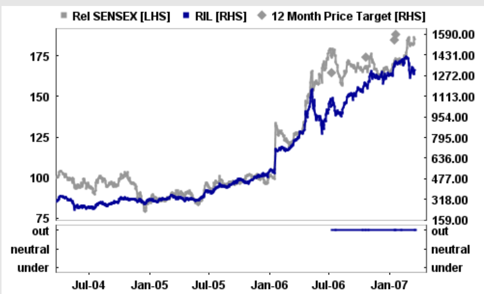
10 April 2007

RIL IN		Outperform
Stock price as of 10 Apr 07	Rs	1,384.40
12-month target	Rs	1,650.00
Upside/downside	%	+19.2
Valuation	Rs	1,833.00
- Sum of Parts		
GICS sector		energy
Market cap	Rs bn	2,012
Market cap	US$m	47,145
Number shares on issue	m	1,454

Investment fundamentals

Year end 31 Mar		2006A	2007E	2008E	2009E
Total revenue	bn	830.2	1,195.5	1,325.3	1,626.9
EBITDA	bn	143.5	213.4	238.9	305.4
EBITDA growth	%	12.1	48.7	11.9	27.9
Adjusted profit	bn	94.9	123.9	134.0	174.5
EPS adj	Rs	68.15	85.25	92.17	120.06
EPS adj growth	%	25.1	25.1	8.1	30.3
PE adj	x	20.3	16.2	15.0	11.5
Total DPS	Rs	11.42	14.75	18.44	16.81
Total div yield	%	0.8	1.1	1.3	1.2
ROE	%	22.5	21.6	17.7	19.1
EV/EBITDA	x	14.7	10.6	9.5	7.4
Net debt/equity	%	44.6	37.2	30.9	31.4

RIL IN rel SENSEX performance, & rec history



Source: Datastream, Macquarie Research, March 2007 (all figures in INR unless noted)

Other stocks discussed in this note:

Pantaloon (PF IN, Rs400, OP , TP: Rs570)
Shopper's Stop (SHOP IN, Rs621, OP , TP: Rs786)
Provogue (PROV IN, Rs489, OP, TP: Rs565)

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Watch out for the retail Goliath

Event

- Reliance Industries; (RIL) foray into the US$270bn retail sector, its most exciting and complex project yet, is now underway. We attempt to value RIL's retail subsidiary: RIL Retail (unlisted).

Impact

- **Move to tap explosive growth opportunity** in the organised retail sector, which we expect will grow at 38% CAGR over the next four years, on the back of emerging attitudes and demographics. This will likely drive organised retail penetration from a miniscule 4.6% currently to 11% in four years.
- **Staggering US$6bn capex could change the face of retail.** RIL has proved its mettle in non-core businesses, eg. entry into telecom in late 2002. In retail, RIL aims to do what it does best, that is, use its financial power and execution skills to create a paradigm shift in the business and capture rapid growth.
- **Opportunity within roadblocks.** The lack of cold/supply chain infrastructure has resulted in food & vegetable produce wastage of 25–40%. RIL aims to capture additional margins by investing in IT and infrastructure to remove middlemen and supply chain inefficiencies, reduce wastage and control inventory.
- **Execution the 'obvious' risk.** RIL plans to invest ~US$6bn to reach 100m sqf of retail space by CY10 and set up a world class 'farm-to-fork' supply chain. Ramp-up in space addition of this magnitude is unprecedented, not only in India, but globally. Managing space acquisition, IT and manpower challenges are Herculean tasks. We believe these will delay the ramp-up by 36 months. As such, we have raised our value for RIL's retail venture by 93% to US$4.2bn or Rs129/RIL share.
- **Scenario analysis highlights possibility of upside.** Our scenario analysis (Figure 5) shows that there exists significant upside potential. Under the 'blue sky' scenario, ie. assuming no delay in RIL's aggressive plans, we note that the value of the retail venture would be US$8.9bn or Rs275/ RIL share.

Earnings revision

- We incorporated RIL's latest expansion plans into the parent company's financials.

Price catalyst

- 12-month price target: Rs1,650.00 based on a Sum of Parts methodology.
- Catalyst: 1) New oil & gas finds; 2) Enhanced clarity on organised retail.

Action and recommendation

- RIL's subsidiary: RIL Retail may well turn out to be the biggest story to hit the Indian retail scene. However, we do not believe one can invest in RIL to play the retail story just yet (our sum-of-the-parts valuation attributes <10% value to retail). However, we foresee a distinct possibility of an IPO for RIL Retail in 1Q CY09, which would provide investors an opportunity to participate.
- We suggest that our (listed) preferred plays tap the emerging trends in the organised retail sector: Pantaloon (due to its high-quality expansion plans and real estate ventures), Shopper's Stop and Provogue, in that order.

Key highlights of the RIL Retail expansion plan

- **Investment**
  - ⇒ **Expected investment** over the next 4–5 years: US$6bn.
  - ⇒ **Investment routed through:** Reliance Industries (RIL) balance sheet.
  - ⇒ **Investment vehicle:** 100% subsidiary, RIL Retail.
  - ⇒ **Public listing:** We expect IPO of RIL Retail (15-25% stake dilution) in 1Q CY09.
- **Operations**
  - ⇒ **Planned retail space:** 100m sqf in ~800 cities and towns by CY10 (FY11).
  - ⇒ **Target revenues:** US$22bn by FY11.
  - ⇒ **Brands:** Reliance Fresh – food retail; Ranger Farms – wholesale-format stores.
  - ⇒ **Store lease versus ownership:** Combination (we estimate 50% owned and 50% leased).
  - ⇒ **Store formats**: Hypermarkets, smaller formats for food & general merchandise, specialty retail.
  - ⇒ **Business model:** 'Hub-n-spoke' and 'cash-n-carry' outlets in stores for distribution to local retailers. May convert local stores into Reliance franchisees
  - ⇒ **Procurement:** Direct from farmer 'mandis' (markets). Contract farming possible.

Source: Company data, Press reports

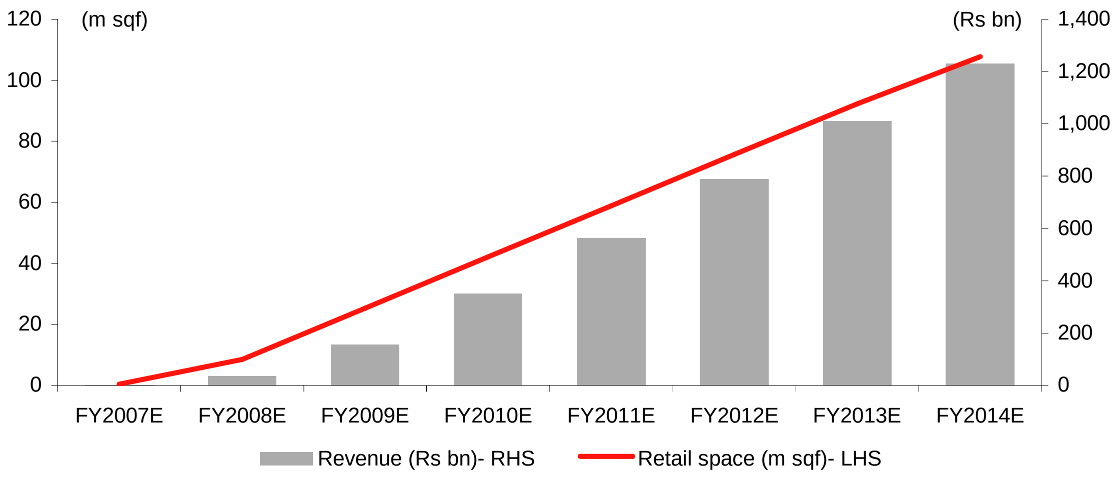
We value the retail venture at Rs129/RIL share

Assuming a 36-month delay in execution

RIL plans to invest ~US$6bn to reach 100m sqf of retail space by CY10 and set up a world-class 'farm-to-fork' supply chain. Space addition of this magnitude is unprecedented, not only in India, but globally.

The retail real estate/mall market is currently witnessing delays due to the developers' lack of experience, delays in getting regulatory approvals and lack of professionalism (in some cases). Additionally, managing IT and manpower challenges are Herculean tasks. Given the lack of operational history and scale of expansion plans, we assume a 36-month delay versus RIL Retail's stated expansion plans (Figure 1).

Fig 1 Base-case scenario: Massive space additions to drive surge in revenue



Source: Macquarie Research, April 2007

Operating assumptions based on other stocks in our coverage universe

We note that the information available on RIL's retail operations is very scanty. We forecast the financials by making assumptions, based on our experience with other retail stocks under our coverage, ie. Pantaloon and Shopper's Stop (Figures 2 & 3).

Fig 2 Basis for assumptions for base-case scenario

Assumption	Steady state assumption	Basis
Revenue per square foot		
…Hypermarkets and convenience stores	~Rs13,000 pa	Assumed 25-50% higher than "Big Bazaar"* standalone retail store average to account for wholesale business
…Department stores	~Rs11,000 pa	Assumed in line with "Shopper's Stop"
…Speciality stores	~Rs11,000 pa	Assumed in line with "Shopper's Stop"
Gross margin		
…Hypermarkets and convenience stores	30%	Assumed 2% higher than "Big Bazaar" due to procurement efficiency (but will be offset in initial years by higher freight costs)
…Department stores	34%	Assumed 2% higher than Shopper's Stop due to procurement efficiency (but will be offset in initial years by higher freight costs)
…Speciality stores	34%	Assumed 2% higher than Shopper's Stop due to procurement efficiency (but will be offset in initial years by higher freight costs)
Employee costs		
…Number of square feet per employee	250	Assumed 15-20% higher than Pantaloon and Shopper's Stop due to larger number of employees hired in the supply chain
…Growth in wages	Inflation + 3%	Supply of trained labour is likely to be an issue in the medium term
Lease versus Owned stores		
…Percentage of leased space versus owned	50%	
Lease expenses		
…Rent assumed in FY08E	Rs55 psf/month	In line with national average (anecdotal) for anchor-tenants Assumed annual increase in line with inflation
…Rent as a % of sales	3.2%	Lower than Pantaloon and Shopper's Stop due to higher proportion of owned stores
Other expenses	15%	Higher initially (at 18-19%) due to expenses related to freight and supply chain
EBITDA margin	7.6%	Higher than Pantaloon due to higher proportion of owned stores (this would reflect in higher depreciation)
Capex		
Leased stores		
…Hypermarkets and convenience stores	Rs1,500 psf	Assumed in line with "Big Bazaar"
…Department and speciality stores	Rs800 psf	Assumed in line with Shopper's Stop
Owned stores		
…Land costs	Rs1,500 psf	In line with tier-2 city average (anecdotal)
…Construction costs	Rs1,800 psf	In line with tier-2 city average (anecdotal)

* "Big Bazaar" is the brand under which Pantaloon operates its hypermarkets
Source: Company data, Macquarie Research, April 2007

Fig 3 Snapshot of financials for RIL Retail for base-case scenario

	FY07E	FY08E	FY09E	FY10E	FY11E	FY12E	FY13E	FY14E
Retail space ('000 sqf)	425	8,500	25,300	42,100	58,900	75,700	92,250	107,800
Total revenue (Rs m)	1,611	34,806	156,098	349,607	563,286	787,813	1,011,392	1,229,286
EBITDA (Rs m)	-87	-1,917	-2,230	2,142	23,449	52,667	73,670	86,430
EBITDA margin (%)	-5.4	-5.5	-1.4	0.6	4.2	6.7	7.3	7.0
PAT (Rs m)	-187	-4,013	-9,962	-13,340	-533	19,830	31,966	36,140
PAT margin (%)	-11.6	-11.5	-6.4	-3.8	-0.1	2.5	3.2	2.9

Source: Macquarie Research, April 2007

DCF-based value of Rs129/share

We use a DCF-based valuation methodology for RIL's retail venture, based on our forecasts (Figure 4). We assign a value of US$4.2bn or Rs129/RIL share to RIL Retail (Figure 4). Based on these calculations, we conclude that if RIL Retail does have an IPO in 1Q CY09, it will be valued at US$6.3bn (or Rs195/RIL share).

Fig 4 Snapshot of valuation for base-case scenario

(A) Cash flow till 2015		**WACC calculations**	
Total PV of free cash flow till 2018 (Rs m)	(143,545)	Risk-free rate	8.25%
		Market risk premium	7.0%
(B) Cash flow from 2019 to 2025	-	Total market return	15.3%
Growth rate from 2019 to 2025	12.0%	Beta (x)	1.04
		Cost of equity	15.5%
NPV of FCF as at 2019 (Rs m)	448,411	Gross cost of debt	10.0%
PV of free cash flow from 2019-2025 (Rs m)	115,566	Tax rate	33.9%
		Net cost of debt	6.6%
(C) Terminal value calculation		Debt/capital ratio	40%
Terminal growth rate from 2025	4.0%	**WACC**	**12.0%**
FCF in FY2025 (Rs m)	141,421		
Exit P/E multiple (X)	13.1	Total company value (A) + (B) + (C) (Rs m)	187,886
Terminal value (Rs m)	1,847,250	Net debt/ (cash) (Rs m)	-
		Value to equity holders (Rs m)	187,886
PV of terminal value (Rs m)	215,866	Value to equity holders (Rs/ share)	**129**

Source: Macquarie Research, April 2007

Scenario analysis highlights possibility of upside

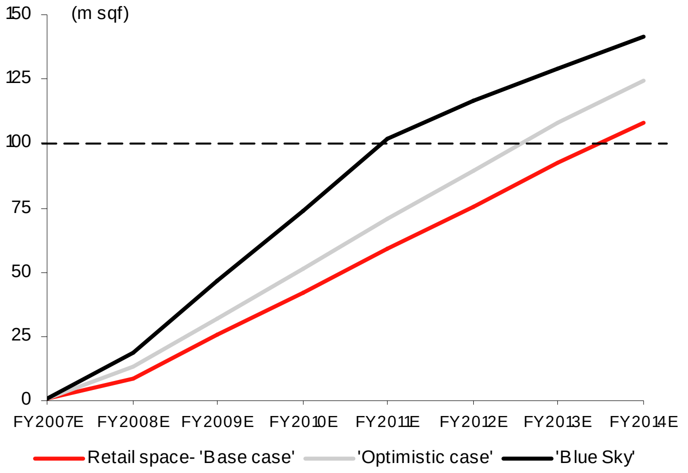
Our scenario analysis (Figure 5) also shows that there exists significant upside potential. Under a 'blue sky' scenario, that is, assuming no delay in RIL's aggressive plans, we note that the value of the retail venture would be US$8.9bn or Rs275/RIL share.

Fig 5 Scenario analysis: Valuation for RIL Retail

	Base-case scenario	Optimistic scenario	Blue-sky scenario
Delay relative to stated plans	3 years	18 months	None
100m sqf of targeted retail space achieved by:	FY14E	FY11- FY12E	FY11E
Value to equity holders (US$ bn)	4.2	5.7	8.9
Value to equity holders (Rs/RIL share)*	**129**	**178**	**275**
Value at time of IPO (US$ bn)	6.3	8.7	13.3
Value at time of IPO (Rs/RIL share)**	**195**	**270**	**412**
Probability of occurrence	*60%*	*30%*	*10%*

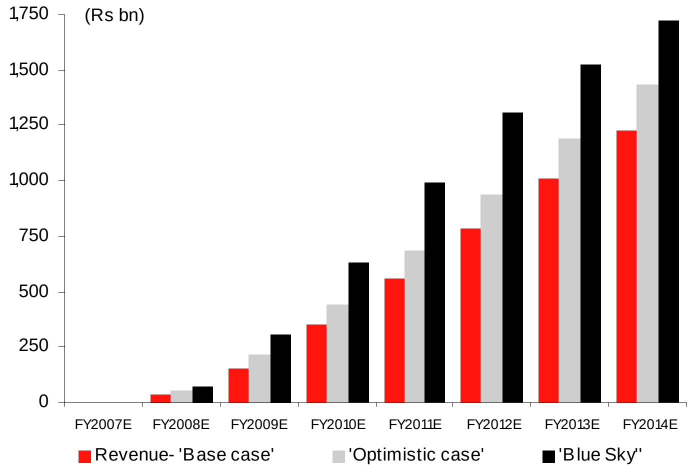
* Based on fully diluted shares outstanding
** Assuming IPO in 1Q CY09
Source: Macquarie Research, April 2007

Fig 6 Scenario analysis: Trends in space addition



Source: Macquarie Research, April 2007

Fig 7 Revenue to surge as stores start operations

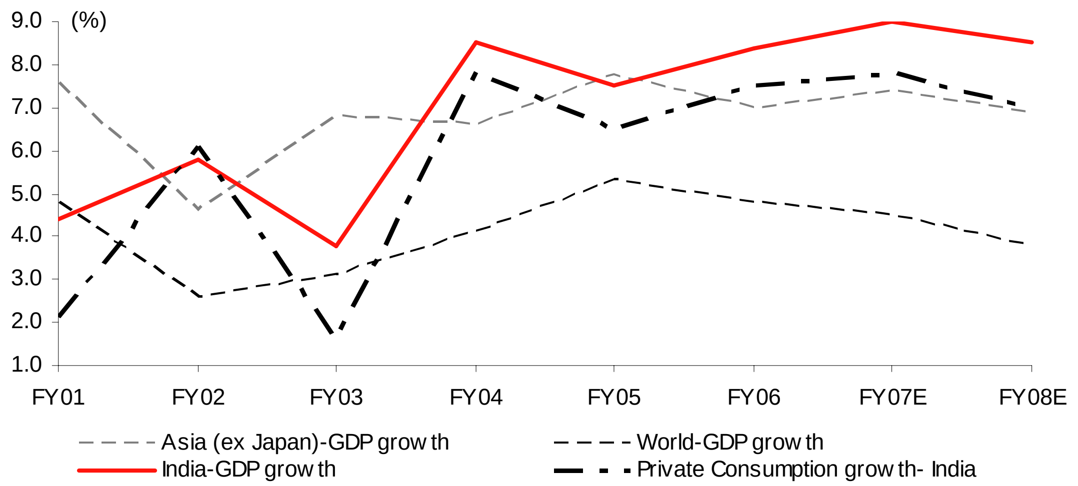


Source: NSE, Macquarie Research, April 2007

RIL Retail aims to tap the imminent consumption boom in India

India's GDP growth rate of >8% over the past three years may have come as a pleasant surprise, but we believe the best is yet to come. The recent upgrade of India's GDP growth rate by our regional economist, Bill Belchere, confirms our view. Bill forecasts that India's GDP will grow at 9.0% in FY07 and at an average ~8% in the medium term. This is despite forecasts of a relative global slowdown.

Fig 8 Macquarie's GDP and private consumption growth rate forecasts



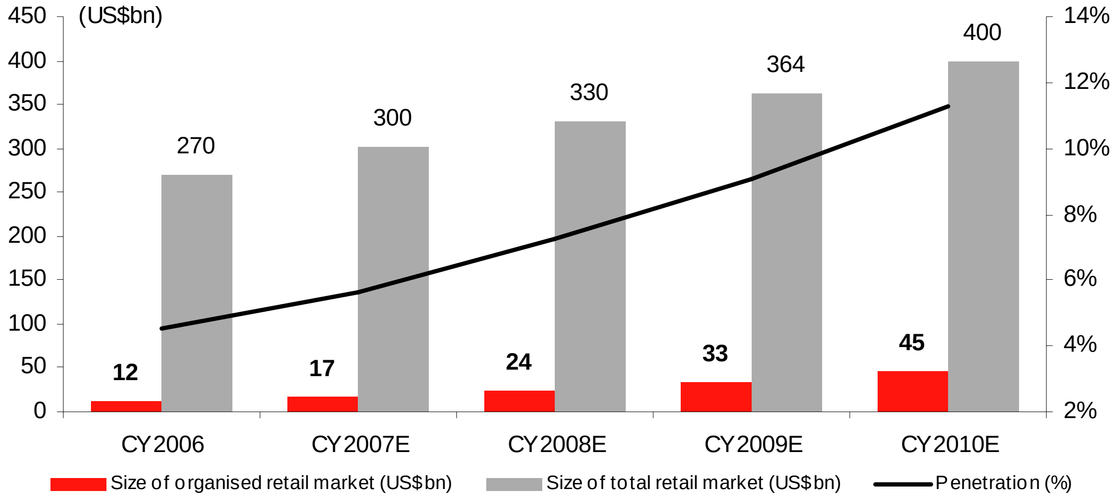
Source: Macquarie Research, April 2007

The acceleration of GDP growth has expectedly driven a commensurate increase in disposable income, notably in the burgeoning middle-class. We believe we are set to witness a consumption boom, driven by key demographic and attitude changes. RIL Retail will likely aim to tap this explosive growth opportunity with a staggering US$6bn capex. This will position it well to benefit from emerging trends.

Low base effect – expect a surge in growth

Penetration of the US$270bn Indian retail market by the organised sector is miniscule at 4.6% (Figures 9 & 10). Penetration of the organised retail sector in the US$270bn Indian retail market is miniscule at 4.6%. This is expected to grow by 11% over the next four years, driven by a 38% CAGR in the organised retail sector (Figure 9).

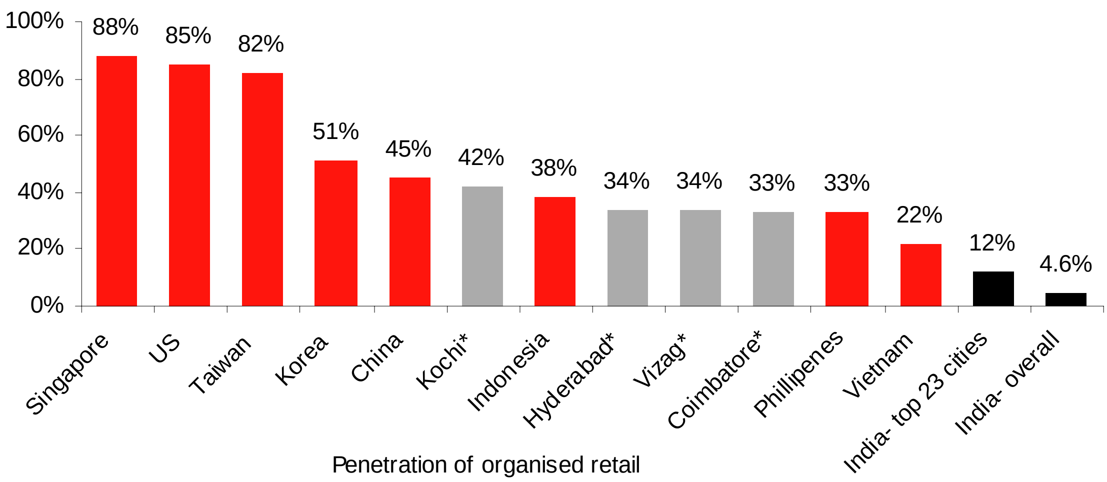
Fig 9 Organised retail: Poised for explosive growth



Source: Estimates based on data from 'India retail report 2007 – Images Research', Macquarie Research, April 2007

The precedent set by retail chains in south Indian towns (over 30% penetration in cities such as Kochi, Hyderabad, Vizag and Coimbatore) (Figure 10) leads us to believe that the success can be replicated across India.

Fig 10 Miniscule overall penetration of organised retail; impressive in pockets



* Kochi, Hyderabad, Vizag and Coimbatore are cities in south India
Source: Industry sources, ACNielsen, India retail report 2007 – Images Research, Macquarie Research, April 2007

(For a detailed discussion on the Indian retail sector, refer to our initiation report, Ride the retail tide! dated 14 February 2007.)

Available opportunity for RIL extends beyond traditional retail

The headline number for the size of the Indian retail industry is US$270bn. Having said that, we believe the opportunity available to retailers with a wide footprint is larger. There are multiple other businesses in which they can drive synergies, which would not make sense for traditional, small retailers (mom & pop stores). For example:

- Office products distribution (market size estimated at US$10bn).
- Distribution of insurance and other financial products such as mutual funds.
- Retail media, ie, sub-letting space and managing in-store advertising. Anecdotal studies suggest that 70% of purchase decision is made at point of sale as people typically leave homes with lists of product categories not brands. This opportunity could also be significant from the finding that in the US, more people are exposed to Walmart's in-house TV than any network at home.
- Fast-food outlets at the retail store.
- Providing logistics support and solutions for other retailers.

We believe that these opportunities available to retailers with a wide footprint would add at least US$40bn in revenue (~15%) to the headline market size number (US$270bn).

The initial evidence has already started to emerge:

- RIL Retail has already indicated its interest in the wholesale cash-n-carry business.
- Media reports suggest that RIL Retail and Office Depot (US office supplies retailer) are in talks for forming a JV to tap the US$10bn Indian office products market. (Pantaloon has already tied up with US firm Staples in this space.)

Large upside to retail opportunity lies in cash-n-carry

We believe the largest potential for upside lies in creating cash-n-carry hubs along with the retail stores. In this case, during the regular inventory runs, the store would be stocked with more inventory than required for sales directly from the storefront. The excess would be sold to local small retail (mom-n-pop) stores. It is also possible to enter into franchisee/co-branding agreements with local retailers. Advantages include:

- Significantly higher volume off-take from the store.
- Operating during off-market hours would increase the return on investment from every store.
- Better return on investment in the supply chain due to higher utilisation/ volumes.
- Economies of scale resulting in the ability to price more aggressively.
- Expansion of the market by expanding the store front beyond owned stores.

This is also positive for the entire retail industry as it would effectively reduce the hold of the middlemen and increase efficiency. Aggressive pricing would also help expand the market.

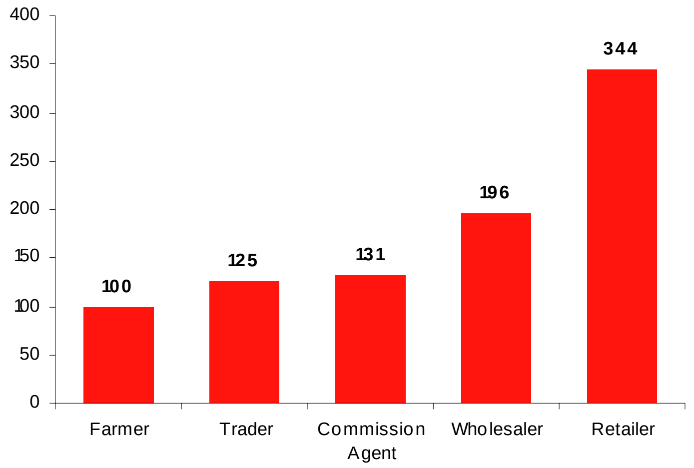
Players such as Pantaloon have already indicated their intention to exploit this opportunity (in their 'market cities'). Press reports suggest that RIL (through its wholesale format 'Ranger farms') will follow suit. We believe that this will be a market RIL Retail will definitely enter and have assumed 25-50% higher revenue per square foot for its stores (versus pure consumer retailers) to capture the upside from cash-n-carry sales.

We believe there is further upside to these estimates if RIL Retail is successful in converting traditional mom-n-pop stores into RIL Retail franchisees, thus ensuring volumes for its wholesale business.

RIL looking to exploit opportunities within 'supply chain' roadblocks

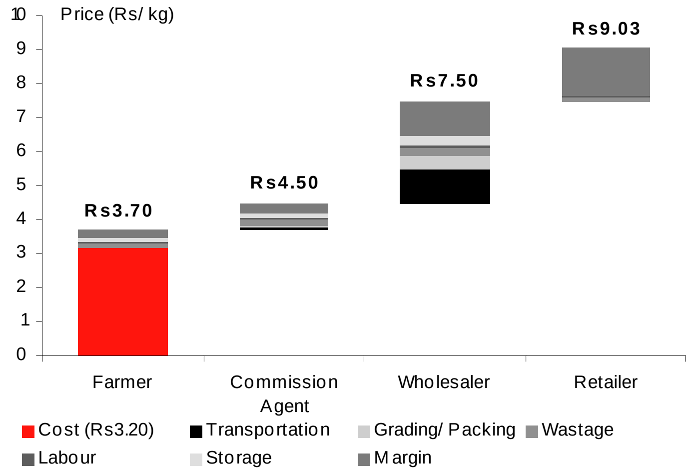
The lack of cold/supply chain infrastructure has resulted in food & vegetable produce wastage of 25-40%. To put this into perspective, "India wastes more than Australia produces". This currently results in higher prices for the consumer. Additionally, the lack of scale by unorganised players leads to the inclusion of multiple middlemen in the supply chain. Every additional link in the supply chain demands a margin while introducing additional scope for wastage and inefficiency (Figures 11 & 12).

Fig 11 Prices rise through the supply chain…



Source: Technopak Advisors, India retail report, Macquarie Research, April 2007

Fig 12 … as in the case of potatoes

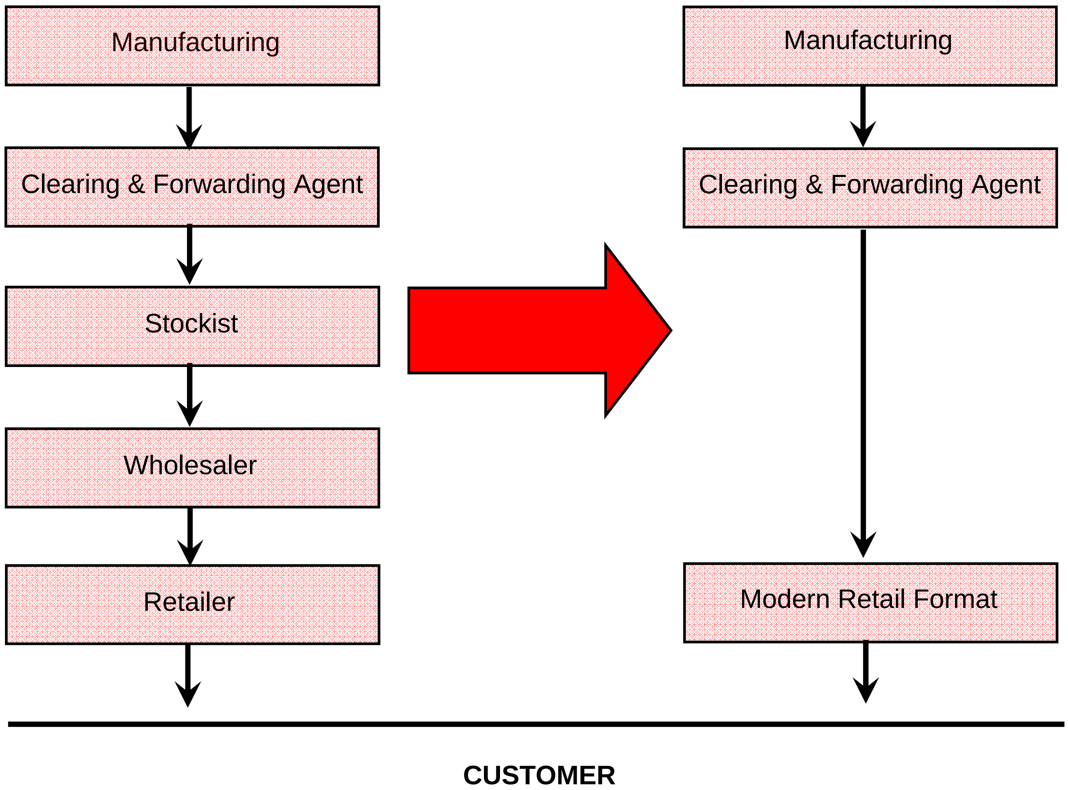


Source: Technopak Advisors, India retail report, Macquarie Research, April 2007

Straight to the source: Changing the way business is done in India

We believe this inefficiency leaves a large margin on the table for anyone who can iron these out. New entrants such as RIL Retail aim to go straight to the 'mandi' (rural markets) to remove the middlemen (Figure 13), reduce wastage and improve inventory control. Investments in IT and supply chain infrastructure are aimed at capturing these additional margins (Figure 12). Combined with discounts extended by consumer goods companies for bulk purchases (*"Walmart makes money buying not selling"*), this will help companies price their products lower and hence expand the market. We note that the evidence (though small) is now becoming apparent through RIL Retail's initial ramp-up.

Fig 13 Increasing efficiencies driven by large-scale modern retail formats



The entry of modern retail formats removes middlemen from the chain, currently employed by traditional retail
Source: TCI Supply Chain Solutions, Macquarie Research, April 2007

It is our view that players such as RIL Retail in control of the supply chain will be able to enhance profitability on two counts:

- **Aggressive pricing** and hence higher scale and market share on price sensitive products.
- **Additional margins** on products which do not belong to price sensitive categories.

Will RIL wipe out all competition?

There is concern by investors of incumbent retailers, such as Pantaloon, Subhiksha, etc., that the entry of RIL Retail may result in a monopoly with fierce price wars and cut-throat competition. However, we would like to point out that the penetration of the US$270bn Indian retail market by the organised sector is miniscule at 4.6% (Figure 10). This under-penetration is especially notable in the US$176bn food and grocery market, where penetration stands at less than 1%.

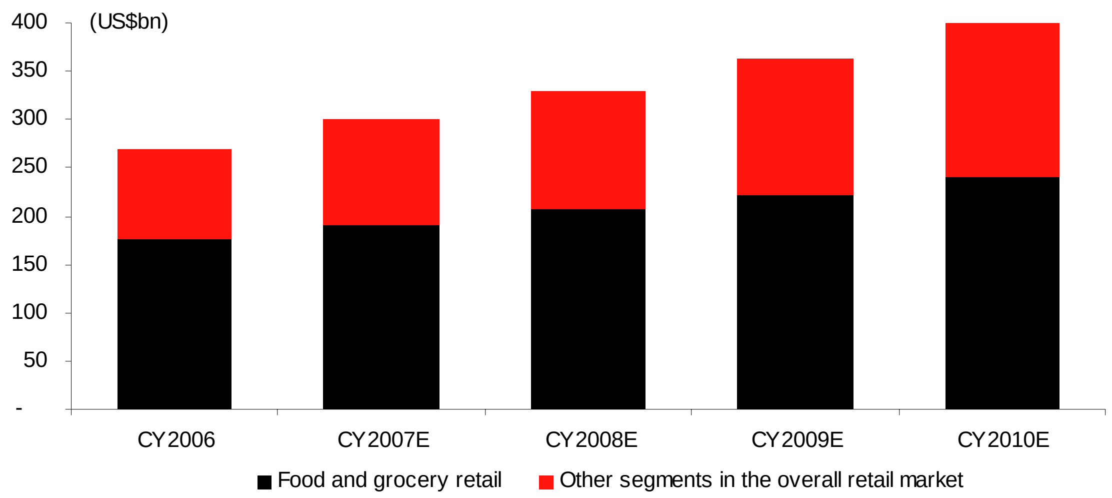
Penetration of organised retail in the overall retail market is expected to grow from 4.6% to 11% over the next four years, driven by a 38% CAGR in the organised retail sector. This will take the size of the organised retail market to US$45bn in the overall retail market of US$400bn.

While we note that RIL Retail will become a formidable force in the market, we think these facts highlight our view that the market is large enough for 5-6 large players and multiple regional players to survive. While intense competition may exist in certain areas, the doomsday scenario for other players, such as Pantaloon and Subhiksha, may not materialise.

Why is RIL going the hypermarket/convenience store way?

Hypermarkets and convenience stores give RIL Retail access to the high-potential US$176bn food and grocery retail market. We note that this segment constitutes more than 60% of the Indian retail market (Figure 14). In fact, the penetration of organised retail is extremely low at less than 1% vs 4.6% for the overall retail market.

Fig 14 Food & grocery: Largest retail segment, with 0.8% organised retail penetration



Source: Estimates based on NCAER information, Macquarie Research, April 2007

While RIL Retail has indicated that it will enter the speciality and department stores formats at some point in time, we believe the initial thrust will be in hypermarkets and convenience stores.

What formats work best?

In order to compare the profitability of various models, CRIS INFAC has studied four business models, which have seen maximum growth in the last few years. These are:

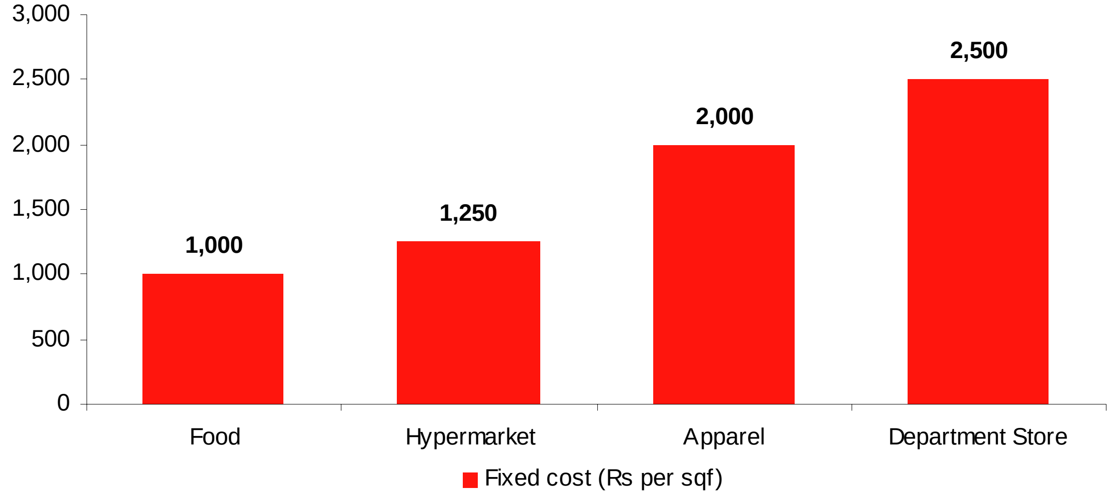
- Food retail.
- Hypermarkets (catering to the food & groceries and clothing segments in addition to other items of day-to-day consumption; these stores typically offer discounts on merchandise).

- Apparel retail.
- Department stores (catering to the apparel, accessories and lifestyles segment).

Food and hypermarkets typically require lowest fixed costs…

As most stores are acquired on lease basis, capital costs consist chiefly of the furnishing costs incurred on a store. Food retail and hypermarkets focus less on ambience than department stores and apparel retail stores. Consequently, they have comparatively lower fixed costs of setting up a store (Figure 15).

Fig 15 Apparel and department stores: Higher capex due to stress on ambience



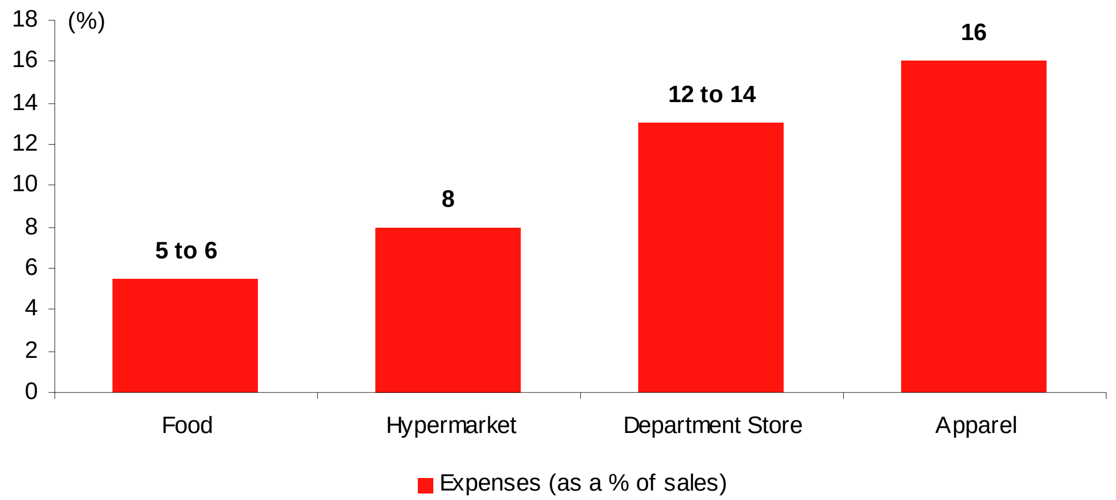
Source: Cris Infac, Macquarie Research, April 2007

…which is also the case for operational expenses

Typical operational costs for a retail store include:

- Staff costs (notably for formats, such as apparel and department stores, which require higher involvement in selling and hence more skilled sales people).
- Administration costs (include power costs, general maintenance, corporate overheads, etc).
- Selling expenses.

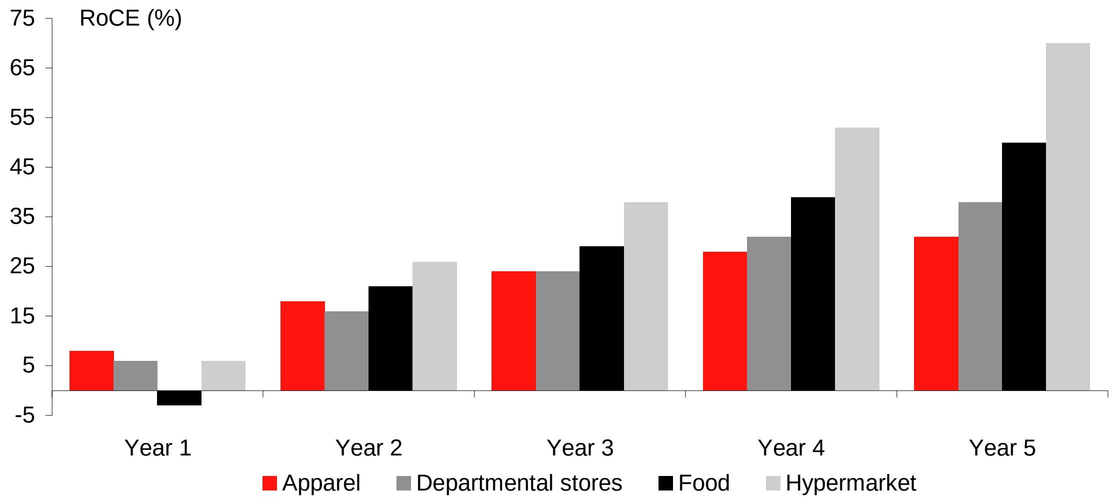
Fig 16 Food retail and hypermarkets have lowest operational costs



Source: Cris Infac, Macquarie Research, April 2007

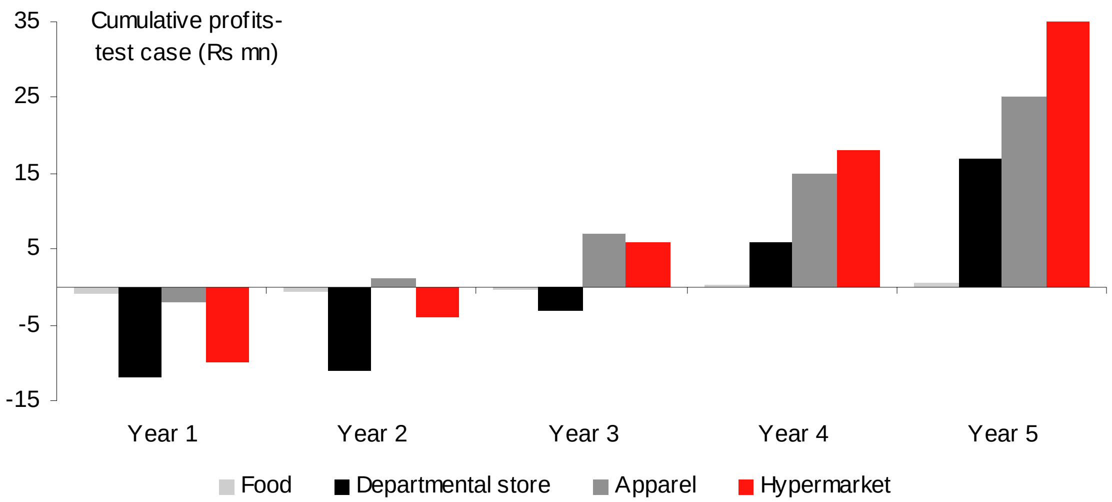
Consequently: Hypermarkets offer higher returns and have a quick payback period

Fig 17 Hypermarkets have highest returns



Source: Cris Infac, Macquarie Research, April 2007

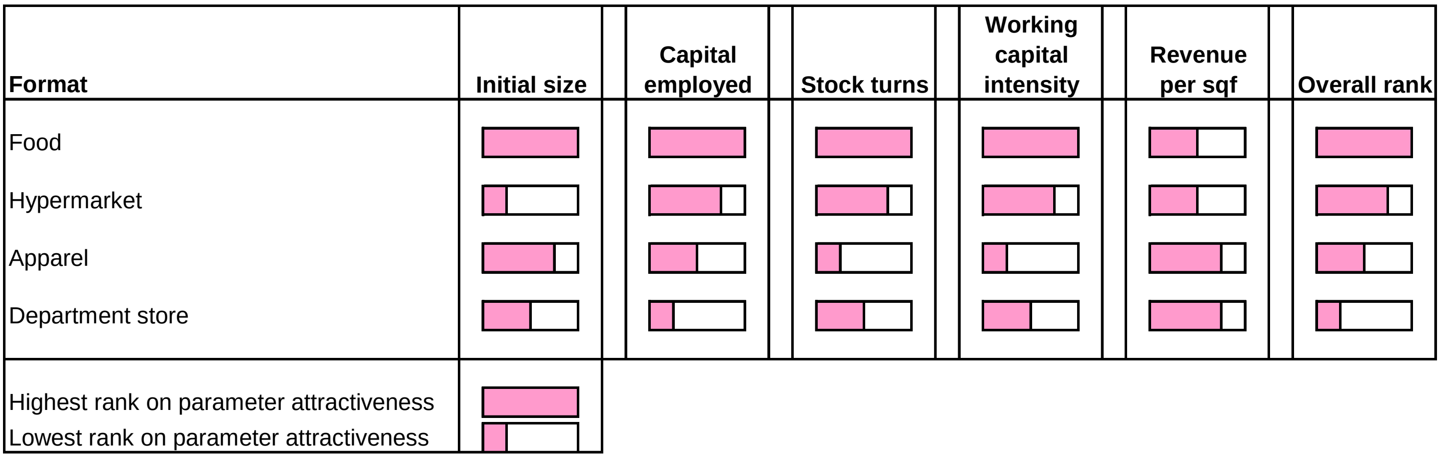
Fig 18 Payback period is best for hypermarkets and apparel retail



* Note that this graph denotes absolute profits for test cases and is not indicative of profitability. We have used this chart to only compare the payback period
Source: Cris Infac, Macquarie Research, April 2007

In summary; we rank the profitability of various formats, based on attractiveness on multiple quantifiable and subjective parameters (Figure 19). While the returns (ROCE) for all formats are attractive, food retail and hypermarkets also clearly score over the rest.

Fig 19 Overall attractivess of the four models



Source: Cris Infac, Macquarie Research, April 2007

We note that anecdotal evidence, currently in India, suggests that we are seeing the highest revenue per sqf in food retail and hypermarkets. This is due to the fact that these are extremely under-penetrated formats and provides an excellent short-term opportunity for RIL Retail (through Reliance Fresh – food retail outlets and hypermarkets).

Having said that, we expect this parameter to move towards regional trends, where the highest revenue per sqf is commanded by department stores followed by apparel retail.

Execution is the ‘obvious’ risk

RIL plans to invest ~US$6bn to reach 100m sqf of retail space by 2010 and set up a world-class ‘farm-to-fork’ supply chain. Space addition of this magnitude is unprecedented, not only in India, but globally. Managing space acquisition, IT and manpower challenges are Herculean tasks. We believe these will delay the ramp-up by 36 months.

- **Skilled manpower:** We estimate that RIL Retail requires 450k people for its massive 100m sqf expansion in retail space by FY14E. Lack of skilled manpower will be a definite bottleneck. However, we believe this issue may be slightly overrated. It is estimated that the IT/ITES (information technology enabled services) sectors will employ 1.6m people by March 2007. These are primarily graduates and engineers (12th class pass in the worst case). Manning the retail front is not necessarily a very highly skilled job (except for high value/involvement/technology products). We think the bulk of the manpower requirement can be fulfilled by people who have passed the 10th class. The squeeze will be at the middle-manager level.
- **Ability to handle pace of growth:** Retail and infrastructure industry players have to move and grow at a very fast pace, which brings some obvious problems related to financial and inventory management.
- **Competition:** This space is set to become extremely competitive over the next three years with the entry of large corporate houses and foreign players. In certain areas, this could lead to fierce price wars (prices and rentals) and margin pressure.
- **Political scenario:** We note that the penetration of organised retail is making some traders, small store owners and middlemen nervous. They constitute a large population. Consequently, there is a risk that this may lead to short-term policy decisions against organised retail players. This risk is highlighted by the experience in Indonesia, where hypermarkets have been expanded in large cities at the expense of traditional market traders. Press reports suggest that the association of traditional traders in Indonesia (APPSI) urged the government to stop issuing licences for modern retailers to open new outlets in city centres. The APSSI offered to cooperate with the Indonesian Chamber of Commerce and Industry to prepare a draft law on the market. This is expected to result in some protection and financial facility for traditional traders.

- **Rents and property prices have soared and are impacting profitability of retailers.** Relaxation of foreign direct investment (FDI) rules has expanded the mountain of capital in every sector of Indian economy. Growth in the Indian real estate sector was estimated at 30% last year, owing to FDI norms and related growth drivers. This has resulted in a surge in retail rentals over the past few years. Having said that, Macquarie Research's India property sector analyst, Siddhartha Gupta, believes that the massive supply of retail real estate should result in a slowdown in growth of property prices and rentals (some areas have seen growth as high as 30-40% in the past three years). In the case of some cities, we might even see a decline, due to oversupply in pockets. This is very positive for the growth of the organised retail sector. We believe that malls will progressively move into 'fixed rental + profit/ revenue share' agreements, which should also help relieve pressure from rentals. We also believe that the ratio of rentals for 'anchor tenants' to 'regular tenants' would go up from 1:3 seen currently (anecdotally) to as high as 1:10, in line with those prevalent in the west.

Risk mitigation strategy

Non-core business for RIL. This is a valid concern for RIL, where ~100% of profits are contributed by oil & gas, refining and petrochemicals. However, we would like to note that RIL has proved its mettle in non-core businesses. Case-in-point: Late 2002 saw RIL enter the telecom space. In retail, RIL aims to do what it does best, that is, use its financial power and execution skills to create a paradigm shift in the business and capture rapid growth.

Hiring the right people for the right jobs. RIL has built its franchise in all current businesses by hiring the most appropriate talent. Recognising that the initiative has to be driven by experienced talent, RIL has been in the news consistently for poaching top talent from related businesses (for example: Gunender Kapur of Unilever Nigeria, Bijou Kurien of Titan, Raghu Pillai of Pantaloon. *Source: Press reports*).

RIL eventually intends to directly employ 450k people for its massive 100m sqf expansion. We believe that RIL should have no trouble attracting and retaining the best talent given its strong brand name, high profile, reputable team and commitment as displayed by the size of its investment foray.

Our investment thesis on Reliance Industries

(RIL IN, Outperform, Target Price: Rs1,650)

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- RIL has embarked on a staggering capex plan of US$20bn over the next 5 years to fuel aggressive growth.
- Earnings are poised to double as expansion plans in refining and petrochemicals and investment in oil & gas and organised retail contribute over the next 5 years.
- Financing growth is not a concern as free cash flow would be sufficient to fund capex.
- ROE is expected to rise consistently due to the contribution from high-margin businesses such as oil & gas.
- Fall in gearing levels would significantly enhance flexibility to raise debt for funding stepped up capex plans.

Reliance Industries Ltd (RIL IN, Outperform, Target price: Rs1,650.00)

Profit & Loss		2002A	2003A	2004A	2005A
Revenue	**m**	**420,958**	**459,101**	**520,253**	**665,977**
Gross Profit	**m**	**107,255**	**118,974**	**144,218**	**168,638**
Cost of Goods Sold	m	313,703	340,127	376,035	497,339
EBITDA	**m**	**78,656**	**83,831**	**98,438**	**127,966**
Depreciation	m	28,162	28,375	32,508	37,274
Amortisation of Goodwill	m	-	-	-	-
Other Amortisation	m	-	-	-	-
EBIT	**m**	**50,494**	**55,456**	**65,929**	**90,692**
Net Interest Income	m	-13,098	-10,386	-9,197	-11,048
Associates	m	-	798	581	-
Exceptionals	m	4,117	-	-	306
Other Pre-Tax Income	m	3,136	2,865	5,788	11,305
Pre-Tax Profit	**m**	**44,649**	**48,734**	**63,101**	**91,255**
Tax Expense	m	-11,860	-8,701	-11,411	-14,972
Net Profit	**m**	**32,789**	**40,033**	**51,690**	**76,282**
Minority Interests	m	-	-	-	-
Reported Earnings	**m**	**32,789**	**40,033**	**51,690**	**76,282**
Adjusted Earnings	**m**	**28,672**	**40,033**	**51,690**	**75,976**
EPS (rep)		25.87	28.68	37.03	54.72
EPS (adj)		22.75	28.68	37.03	54.5
EPS Growth (adj)	%	17.64	26.06	29.12	47.17
DPS		5.26	5.00	5.00	8.59
Weighted Average Shares	m	1,267	1,396	1,396	1,394
Period End Shares	m	1,396	1,396	1,396	1,393

Profit & Loss		2006A	2007E	2008E	2009E
Revenue	**m**	**830,248**	**1,195,494**	**1,325,345**	**1,626,932**
Gross Profit	**m**	**221,503**	**266,127**	**313,675**	**425,353**
Cost of Goods Sold	m	608,745	929,367	1,011,669	1,201,579
EBITDA	**m**	**143,487**	**213,396**	**238,865**	**305,403**
Depreciation	m	34,949	54,474	61,079	80,004
Amortisation of Goodwill	m	0	0	0	0
Other Amortisation	m	0	0	0	0
EBIT	**m**	**108,537**	**158,921**	**177,786**	**225,400**
Net Interest Income	m	-4,426	-11,112	-17,206	-31,521
Associates	m	4,747	0	0	0
Exceptionals	m	-995	0	0	0
Forex Gains / Losses	m	0	0	0	0
Other Pre-Tax Income	m	2,380	5,536	6,537	8,501
Pre-Tax Profit	**m**	**110,243**	**153,345**	**167,117**	**202,379**
Tax Expense	m	-16,295	-29,461	-33,283	-29,548
Net Profit	**m**	**93,948**	**123,884**	**133,834**	**172,831**
Minority Interests	m	0	0	120	1,648
Reported Earnings	**m**	**93,948**	**123,884**	**133,954**	**174,479**
Adjusted Earnings	**m**	**94,943**	**123,884**	**133,954**	**174,479**
EPS (rep)		67.44	85.25	92.17	120.06
EPS (adj)		68.15	85.25	92.17	120.06
EPS Growth (adj)	%	25.1	25.1	8.1	30.3
PE (rep)	x	20.5	16.2	15.0	11.5
PE (adj)	x	20.3	16.2	15.0	11.5
Total DPS		11.42	14.75	18.44	16.81
Total Div Yield	%	0.8	1.1	1.3	1.2
Weighted Average Shares	m	1,393	1,453	1,453	1,453
Period End Shares	m	1,393	1,453	1,453	1,453

Profit and Loss Ratios		2006A	2007E	2008E	2009E
Revenue Growth	%	24.7	44.0	10.9	22.8
EBITDA Growth	%	12.1	48.7	11.9	27.9
EBIT Growth	%	19.7	46.4	11.9	26.8
Gross Profit Margin	%	26.7	22.3	23.7	26.1
EBITDA Margin	%	17.3	17.9	18.0	18.8
EBIT Margin	%	13.1	13.3	13.4	13.9
Net Profit Margin	%	11.3	10.4	10.1	10.6
Payout Ratio	%	16.8	17.3	20.0	14.0
EV/EBITDA	x	14.7	10.6	9.5	7.4
EV/EBIT	x	19.2	14.2	12.7	10.0
Balance Sheet Ratios					
ROE	%	22.5	21.6	17.7	19.1
ROA	%	12.7	13.3	10.9	11.9
ROIC	%	17.3	19.1	14.6	17.2
Net Debt/Equity	%	44.6	37.2	30.9	31.4
Interest Cover	x	24.5	14.3	10.3	7.2
Price/Book	x	4.2	2.9	2.4	2.0
Book Value per Share		330.5	470.8	569.6	689.7

Cashflow Analysis		2006A	2007E	2008E	2009E
EBITDA	**m**	**143,487**	**213,396**	**238,865**	**305,403**
Tax Paid	m	-16,295	-29,461	-33,283	-29,548
Chgs in Working Cap	m	-29,650	-56,882	-19,918	-17,505
Net Interest Paid	m	-4,426	-11,112	-17,206	-31,521
Other	m	38,858	54,151	7,557	4,384
Operating Cashflow	**m**	**131,974**	**170,092**	**176,015**	**231,213**
Acquisitions	m	154,059	2,271	0	0
Capex	m	-344,912	-359,060	-157,192	-261,681
Asset Sales	m	0	0	0	0
Other	m	2,380	5,536	6,537	8,501
Investing Cashflow	**m**	**-188,473**	**-351,253**	**-150,655**	**-253,180**
Dividend (Ordinary)	m	-15,907	-21,443	-26,803	-24,434
Equity Raised	m	1	601	0	0
Debt Movements	m	45,257	243,062	148,572	44,753
Other	m	7,093	141,391	36,424	22,834
Financing Cashflow	**m**	**36,443**	**363,612**	**158,194**	**43,154**
Net Chg in Cash/Debt	**m**	**-20,056**	**182,450**	**183,553**	**21,186**

Balance Sheet		2006A	2007E	2008E	2009E
Cash	m	26,164	212,752	361,304	347,491
Receivables	m	43,517	64,946	71,875	81,986
Inventories	m	103,453	153,258	162,145	163,516
Investments	m	66,668	60,260	95,260	130,260
Fixed Assets	m	602,093	873,346	973,891	1,163,650
Intangibles	m	0	0	0	0
Other Assets	m	76,988	111,874	126,173	125,393
Total Assets	**m**	**918,883**	**1,476,437**	**1,790,648**	**2,012,295**
Payables	m	124,541	169,718	179,411	173,011
Short Term Debt	m	66,659	55,215	55,215	56,716
Long Term Debt	m	166,769	421,276	569,848	613,099
Provisions	m	42,017	43,217	43,217	43,217
Other Liabilities	m	53,876	77,556	89,927	100,341
Total Liabilities	**m**	**453,862**	**766,982**	**937,617**	**986,385**
Shareholders' Funds	m	510,280	730,644	874,340	1,048,868
Minority Interests	m	4,573	25,313	25,192	23,544
Other	m	-49,832	-46,502	-46,502	-46,502
Total S/H Equity	**m**	**465,021**	**709,455**	**853,031**	**1,025,910**
Total Liab & S/H Funds	**m**	**918,883**	**1,476,437**	**1,790,648**	**2,012,295**

All figures in INR unless noted.
Source: Macquarie Research, April 2007

Important disclosures:

Recommendation definitions

Macquarie Australia/New Zealand
Outperform – return >5% in excess of benchmark return (>2.5% in excess for listed property trusts)
Neutral – return within 5% of benchmark return (within 2.5% for listed property trusts)
Underperform – return >5% below benchmark return (>2.5% below for listed property trusts)

Macquarie Asia
Outperform – expected return >+10%
Neutral – expected return from -10% to +10%
Underperform – expected return <-10%

Macquarie First South Securities (South Africa)
Outperform – expected return >+5%
Neutral – expected return from -5% to +5%
Underperform – expected return <-5%

Recommendations – 12 months

Note: Quant recommendations may differ from Fundamental Analyst recommendations

Recommendation proportions

	AU/NZ	Asia	RSA
Outperform	43.12%	58.91%	42.20%
Neutral	48.98%	22.92%	46.80%
Underperform	11.90%	18.17%	11.00%

For quarter ending 31 December 2006

Volatility index definition*

This is calculated from the volatility of historic price movements.

Very high–highest risk – Stock should be expected to move up or down 60–100% in a year – investors should be aware this stock is highly speculative.

High – stock should be expected to move up or down at least 40–60% in a year – investors should be aware this stock could be speculative.

Medium – stock should be expected to move up or down at least 30–40% in a year.

Low–medium – stock should be expected to move up or down at least 25–30% in a year.

Low – stock should be expected to move up or down at least 15–25% in a year.
* Applicable to Australian/NZ stocks only

Financial definitions

All "Adjusted" data items have had the following adjustments made:
Added back: goodwill amortisation, provision for catastrophe reserves, IFRS derivatives & hedging, IFRS impairments & IFRS interest expense
Excluded: non recurring items, asset revals, property revals, appraisal value uplift, preference dividends & minority interests

EPS = adjusted net profit / efpowa*
ROA = adjusted ebit / average total assets
ROA Banks/Insurance = adjusted net profit /average total assets
ROE = adjusted net profit / average shareholders funds
Gross cashflow = adjusted net profit + depreciation
*equivalent fully paid ordinary weighted average number of shares

All Reported numbers for Australian/NZ listed stocks are modelled under IFRS (International Financial Reporting Standards).

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Ulrike Pollak-Tsutsumi (Frankfurt)	(49) 69 7593 8747
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Thomas Renz (Geneva)	(41) 22 818 7712
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Stuart Smythe (India)	(9122) 6653 3200
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Julien Roux (London)	(44) 20 7065 5887
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Ismael Pili (Philippines)	(65) 6231 2840
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Depository Receipts - Robert Ansell	(852) 2823 4688
Derivatives - Vipul Shah	(852) 2823 3523
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Hedge Fund Sales - Darin Lester	(852) 2823 4736
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