Company In-Depth

20 October 2006 | 11 pages

Reliance Industries (RELI.BO)

2QFY07: Quarter of Role Reversals

Rating change ☐
Target price change ☐
Estimate change ☑

- 2Q materially above expectations — RIL's EBITDA growth of 7.7% qoq and 23.0% yoy was ahead of expectations as petrochemicals provided the incremental upside, led by improved volumes and margins across the board. Net profit as a result was up 9.2% yoy and 6.3% qoq.
- Petchem had everything going well — High utilization of recently commissioned capacities, robust product spreads and recovery from 1Q cracker shutdown combined to deliver the highest ever EBIT contribution, with margins expanding 510bps qoq. Though we view delay in Middle East capacity additions as a positive, such strength may not get repeated in the short term.
- Refining – Not great as expected — While GRM at US$9.1/bbl was down, the qoq decline was cushioned by lower retail losses and the unexpected absence of stock losses. Despite higher throughput, refining EBIT was down Rs5.5bn on qoq basis.
- More details on KG shortly — In the Analyst Meet, management indicated that the revised development capex and production target of KG D-6 will be disclosed in next 3-4 months. Capex is likely to be 2x the initial estimate, in line with the US$5bn factored in our NAV. Reliance also disclosed gas discovery in a new field (KG III 5), which has been notified to DGH.
- Earnings upped but new businesses more critical for the stock — While higher earnings estimate for FY07-08 (upped 3.0-4.0%) could form a support for the stock, new businesses remain nascent for any meaningful value accretion – equity investment in Reliance Retail was Rs4.0bn during 1H and Rs6.5bn cumulative and rollout will be visible gradually from 3Q onwards. Maintain Hold/Low Risk.

See page 9 for Analyst Certification and important disclosures.

Hold/Low Risk	2L
Price (19 Oct 06)	Rs1,195.65
Target price	Rs1,150.00
Expected share price return	-3.8%
Expected dividend yield	0.8%
Expected total return	**-3.0%**
Market Cap	Rs1,666,148M
	US$36,780M

Price Performance (RIC: RELI.BO, BB: RIL IN)

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/CEPS (x)	EV/EBITDA (x)	ROE (%)
2005A	75,717	54.34	43.0	22.0	14.8	14.8	20.3
2006A	90,693	65.10	19.8	18.4	13.4	12.4	26.4
2007E	101,866	73.12	12.3	16.4	11.8	11.1	31.0
2008E	101,190	72.64	-0.7	16.5	12.2	11.1	24.4
2009E	111,233	79.85	9.9	15.0	10.7	9.8	22.0

Source: Company Reports and Citigroup Investment Research

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Fiscal year end 31-Mar	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E adjusted (x)	22.0	18.4	16.4	16.5	15.0
EV/EBITDA adjusted (x)	13.0	11.9	10.6	10.4	9.1
P/BV (x)	4.1	5.8	4.5	3.6	3.0
Dividend yield (%)	0.6	0.8	0.8	0.8	0.9
Per Share Data (Rs)					
EPS (adjusted)	54.34	65.10	73.12	72.64	79.85
EPS (reported)	54.34	65.10	73.12	72.64	79.85
BVPS	288.75	205.28	267.15	328.54	396.01
DPS	7.50	10.00	10.00	10.00	11.00
Profit & Loss (RsM)					
Net sales	660,513	812,113	1,093,525	1,014,355	971,840
Operating expenses	-571,173	-702,072	-964,339	-883,449	-835,428
EBIT	**89,340**	**110,041**	**129,186**	**130,906**	**136,412**
Net interest expense	-14,687	-8,770	-10,373	-11,217	-10,498
Non-operating/exceptionals	16,034	5,770	4,661	6,799	10,489
Pre-tax profit	**90,687**	**107,041**	**123,474**	**126,488**	**136,403**
Tax	-14,970	-16,347	-21,608	-25,298	-25,170
Extraord./Min.Int./Pref.div.	0	0	0	0	0
Reported net income	**75,717**	**90,693**	**101,866**	**101,190**	**111,233**
Adjusted earnings	75,717	90,693	101,866	101,190	111,233
Adjusted EBIT	89,340	110,041	129,186	130,906	136,412
Growth Rates (%)					
EPS (adjusted)	43.0	19.8	12.3	-0.7	9.9
EBIT (adjusted)	41.0	23.2	17.4	1.3	4.2
Sales	27.5	23.0	34.7	-7.2	-4.2
Cash Flow (RsM)					
Operating cash flow	**144,871**	**117,189**	**174,210**	**148,026**	**168,658**
Depreciation/amortization	37,235	34,009	38,991	35,195	44,220
Net working capital	31,919	-7,514	33,354	11,641	13,206
Investing cash flow	**-42,746**	**2,515**	**-125,346**	**-74,000**	**-70,000**
Capital expenditure	-37,669	-126,361	-84,640	-74,000	-70,000
Acquisitions/disposals	-5,035	128,876	-40,706	0	0
Financing cash flow	**-37,120**	**-176,268**	**-29,790**	**-3,001**	**-22,080**
Borrowings	6,620	41,174	-14,117	30,889	-764
Dividends paid	-11,917	-15,885	-15,672	-15,672	-17,240
Change in cash	**65,005**	**-56,565**	**19,075**	**71,025**	**76,579**
Balance Sheet (RsM)					
Total assets	**804,198**	**718,893**	**905,113**	**996,742**	**1,086,589**
Cash & cash equivalent	70,756	14,192	33,267	104,292	180,871
Net fixed assets	349,582	441,935	487,584	526,389	552,170
Total liabilities	**401,829**	**432,909**	**532,936**	**539,048**	**534,901**
Debt	187,846	218,656	204,539	217,211	212,371
Shareholders' funds	**402,369**	**285,980**	**372,173**	**457,691**	**551,684**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	19.2	17.7	15.4	16.4	18.6
ROE adjusted	20.3	26.4	31.0	24.4	22.0
ROIC adjusted	19.3	21.2	21.3	19.8	19.6
Net debt to equity	29.1	71.5	46.0	24.7	5.7
Total debt to capital	31.8	43.3	35.5	32.2	27.8

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RIL 2QFY07 Results – Key Highlights

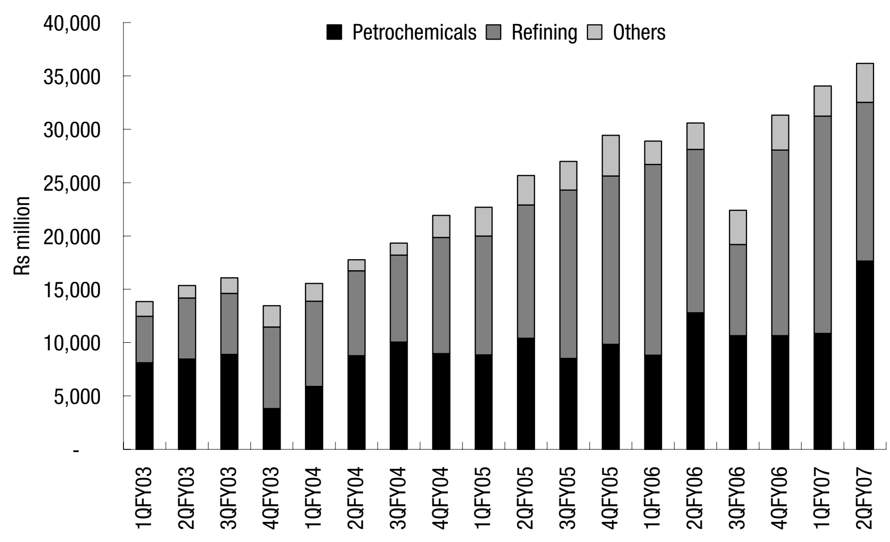
Figure 1. RIL 2QFY07 Results (Rupees in Millions)

Year to 31 Mar	2QFY06	2QFY07	% yoy	Comments
Net sales	**207,170**	**284,740**	**37.4%**	Driven by increase in volumes and absolute prices in petchem and refining
Expenditure:				
Inc/dec in stock	(7,990)	(8,730)	9.3%	
Raw materials - external purchases	152,280	223,850	47.0%	Higher price for crude and other feedstock
Staff cost	2,590	2,840	9.7%	Down on a sequential basis
Other expenditure	23,170	21,130	-8.8%	Decrease on account of lower sales tax incurrence on domestic retail sales
Total	(170,050)	(239,090)	40.6%	
EBITDA	**37,120**	**45,650**	**23.0%**	Higher than expected, driven mainly by a strong petchem quarter
EBITDA margins	*17.9*	*16.0*	*-189bps*	
Interest	(2,220)	(2,780)	25.2%	
Depreciation	(8,040)	(10,180)	26.6%	Higher due to commissioning of new petchem/polyester capacities during the quarter
Non-op income	2,220	220	-90.1%	Lower on account of lower cash balance
PBT	29,080	32,910	13.2%	
Tax	(2,510)	(3,770)		
PAT after current tax	26,570	29,140	9.7%	
Provision for deferred tax	(1,760)	(2,050)		
Tax rate (%)	*14.7*	*17.7*	*300bps*	FY07 run-rate as expected and in line with increase in MAT during the year
Net profit (reported)	**24,810**	**27,090**	**9.2%**	

Source: Company Reports and Citigroup Investment Research

Petrochemicals contributed 49% to group profitability, up from 32% in 1Q (an absolute increase of Rs6.8bn)

Figure 2. RIL – Quarterly EBIT Break-up (Rupees in Millions)



Source: Company Reports and Citigroup Investment Research

Figure 3. RIL 2QFY07 Segmental Profitability (Rupees in Millions)

Year to 31 Mar	2QFY06	1QFY07	2QFY07	%YoY	Comments
Revenues					
Petrochemicals	81,710	97,870	108,740	33.1%	Higher absolute prices and volume growth in polyester and polymers (new capacities commissioned and absorbed)
% of total	30.0%	31.4%	31.4%		
Refining	185,950	208,620	232,080	24.8%	Higher absolute prices + higher throughput
% of total	68.3%	66.9%	67.0%		
Others	4,410	5,300	5,550	25.9%	
% of total	1.6%	1.7%	1.6%		
Intra - segment sales/transfers	43,140	50,130	50,870		
Excise Duties recovered	21,760	16,440	10,760		Decline in excise duties due to lower retail sales of diesel
Net sales	**207,170**	**245,220**	**284,740**	**37.4%**	
PBIT					
Petrochemicals	12,790	10,870	17,640	37.9%	Higher polymer margins, stable polyester margins combined with volume growth
% of total	41.8%	31.9%	48.8%		
Margin	15.7%	11.1%	16.2%	0.6%	Margin improvement primarily driven by polymers and fiber intermediates
Refining	15,320	20,350	14,890	-2.8%	Lower GRMs offset by lower retail fuel losses and higher thruput
% of total	50.1%	59.7%	41.2%		
Margin	8.2%	9.8%	6.4%	-1.8%	
Others	2,470	2,840	3,650	47.8%	
% of total	8.1%	8.3%	10.1%		
Margin	56.0%	53.6%	65.8%	9.8%	
Total PBIT	**30,580**	**34,060**	**36,180**	**18.3%**	

Source: Company Reports and Citigroup Investment Research

Figure 4. Refining – Key Parameters

	Units	Q1FY06	Q2FY06	Q3FY06	Q4FY06	Q1FY07	Q2FY07	Comments
Singapore complex spreads	US$/bbl	7.4	8.2	6.0	4.6	9.0	4.8	
RIL reported GRMs	US$/bbl	11.4	10.4	9.1	10.4	12.4	9.1	From company reports
Mktg. losses/bbl of diesel sold	US$/bbl	(0.0)	(3.2)	3.6	(1.9)	(13.3)	(11.1)	Sequential decline on account of significant market share reduction
Effective marketing discount	US$/bbl	(0.0)	(0.3)	0.5	(0.3)	(1.6)	(0.3)	Adjusted for proportion of retail sales to total
RIL clean GRMs	US$/bbl	11.4	10.7	8.6	10.7	14.0	9.4	Arrived at by adding back the effective marketing discount/losses
Differential vis-à-vis clean GRMs	US$/bbl	4.0	2.5	2.6	6.1	5.0	4.6	Narrowed slightly in 2Q but still healthy; lack of inventory losses was remarkable
Crude throughput	MMT	7.9	8.0	6.7	7.9	7.5	8.2	Recovered post the planned shutdown in 1Q

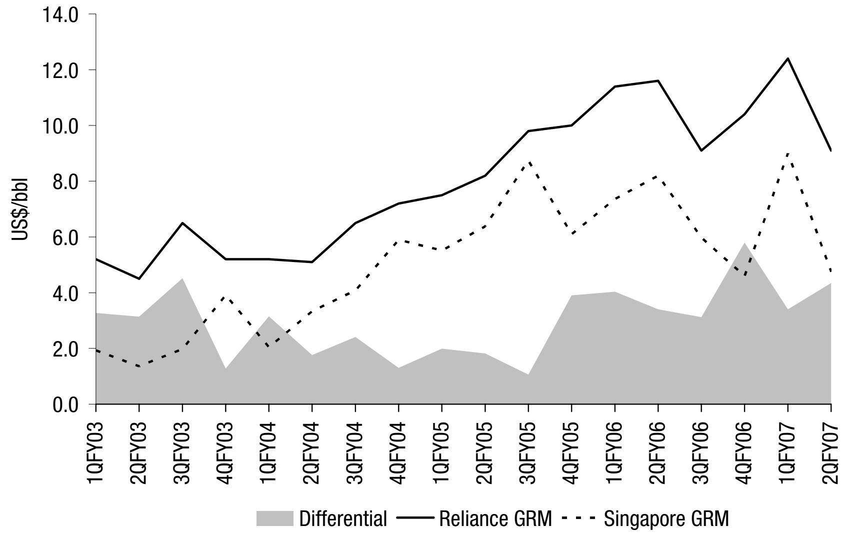
Source: Company Reports, Reuters and Citigroup Investment Research

Figure 5. Refinery Product Sales (MMT)

	Q1FY06	Q2FY06	Q3FY06	Q4FY06	Q1FY07	Q2FY07	%YoY	%QoQ	Comments
PSU	1.9	1.7	0.7	1.1	0.7	0.7	-57.6%	0.0%	On the decline as new PSU capacities commission
Captive	1.6	1.7	1.2	1.8	1.7	1.7	3.0%	0.0%	
Retail	0.6	0.6	0.9	1.1	0.9	0.2	-68.8%	-77.8%	Conscious reduction in market share due to marketing losses
Industrial sales/ Others	1.3	1.3	1.1	1.2	1.1	1.0	-25.4%	-9.1%	
Exports	2.5	2.7	2.5	3.2	3.5	5.2	91.9%	48.6%	Trend of retail sales being substituted by exports continues
Total	**7.8**	**8.0**	**6.3**	**8.4**	**7.9**	**8.8**	**10.1%**	**11.4%**	

Source: Company Reports and Citigroup Investment Research

Figure 6. Differential Between Reported GRMs and Singapore GRMs



Source: Company Reports and Citigroup Investment Research

Volume growth provides some sustainability to petrochemical performance

During 1HFY07, the production volumes of polyester products and intermediates was up by a meaningful 32% yoy and 20% yoy respectively, reflecting almost full utilization of the recently commissioned POY/PSF and PTA capacities (commissioned in July 2006). Meanwhile, the production growth in polymers was a more muted 7% during 1H , a reflection of a moderate demand growth (1% yoy) and despite capacity expansion and better demand growth in PP (9% yoy).

Earnings Revision

We have marginally increased our earnings by 3-4% primarily to reflect the lower-than-earlier-anticipated losses on retail petroleum marketing based on lower auto fuel marketing volumes.

Figure 7. RIL Earnings Revisions

Year to	Net Profit (Rs Mils.)		Diluted EPS (Rs)			Dividend Per Share (Rs)	
31-Mar	Old	New	Old	New	% Chg	Old	New
2007E	98,424	101,866	70.65	73.12	3.5%	10.00	10.00
2008E	97,775	101,190	70.18	72.64	3.5%	10.00	10.00
2009E	111,224	111,233	79.84	79.85	0.0%	11.00	11.00

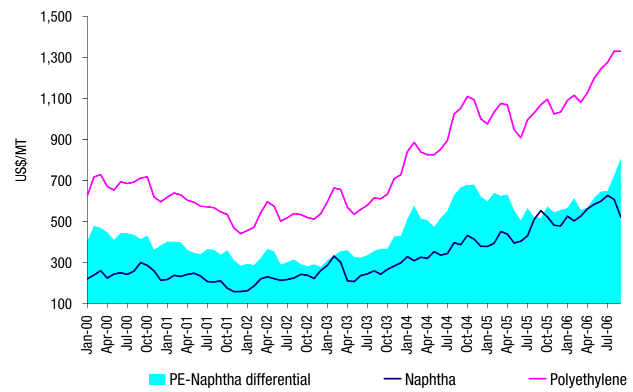
Source: Citigroup Investment Research

Figure 8. RIL Operational Parameters – Petrochemicals and E&P Business

Year to 31 Mar	Units	Q1FY06	Q2FY06	Q3FY06	Q4FY06	Q1FY07	Q2FY07	%YoY	%QoQ
Production									
Panna-Mukta									
- Crude	Tonnes	360,288	365,052	412,327	432,429	381,997	422,516	15.7%	10.6%
- Gas	mscm	333	299	331	483	347	360	20.4%	3.7%
Tapti									
- Gas	mscm	540	605	573	579	522	420	-30.6%	-19.5%
Polyester (PFY, PSF, PET)	Tonnes	279,000	270,000	284,000	296,000	361,000	364,000	34.8%	0.8%
Fiber intermediates (PX, PTA, MEG)	Tonnes	795,000	813,000	712,000	900,000	886,000	1,057,000	30.0%	19.3%
Polymers (PE, PP, PVC)	Tonnes	463,000	485,000	391,000	506,000	469,000	563,000	16.1%	20.0%
Ethylene	Tonnes	212,000	209,000	266,000	153,000	162,000	227,000	8.6%	40.1%
Propylene	Tonnes	100,000	100,000	129,000	69,000	77,000	110,000	10.0%	42.9%
Industry demand									
Polyester (PFY, PSF, PET)	'000 Tonnes	438	465	463	491	512	454	-2.4%	-11.5%
Polymers (PE, PP, PVC)	'000 Tonnes	857	1,130	899	1085	977	1030	-8.9%	5.4%

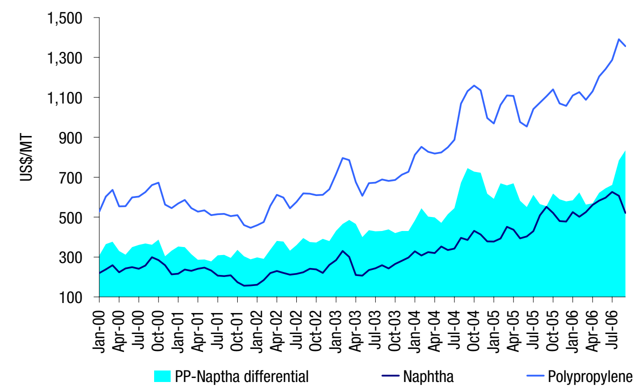
Source: Company Reports and Citigroup Investment Research

Figure 9. PE-Naphtha Differential (US$/MT)



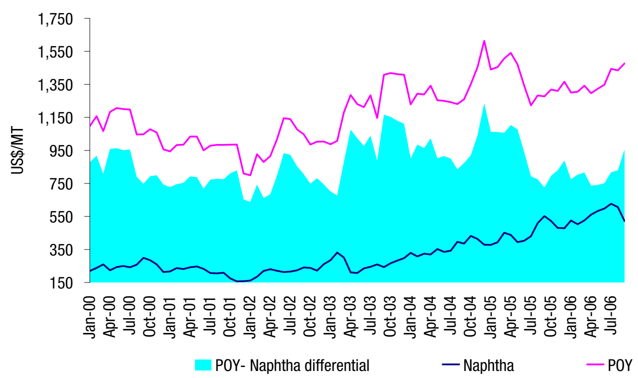
Source: Datastream

Figure 10. PP-Naphtha Differential (US$/MT)



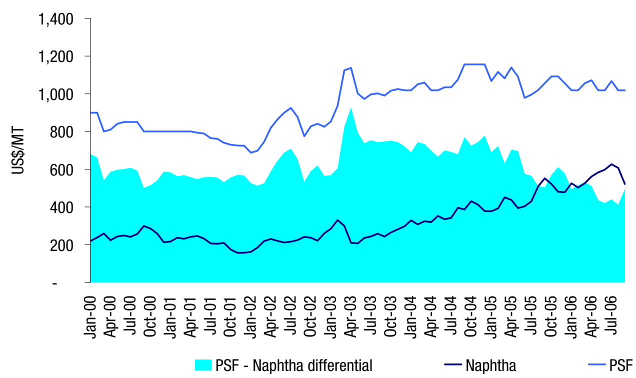
Source: Datastream

Figure 11. POY-Naphtha Differential (US$/MT)



Source: Datastream

Figure 12. PSF-Naphtha Differential (US$/MT)



Source: Datastream

Reliance Industries

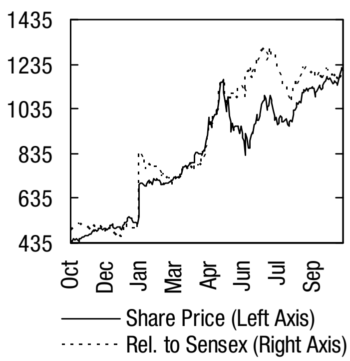
Company Description

Reliance Industries is a conglomerate with interests in upstream oil & gas (E&P), refining, and petrochemicals. It is building a super-size refinery project through its 75% subsidiary (RPL) and will be undertaking development of a large gas find in KG basin over the next 2-3 years. RIL is foraying into organized retailing and has plans to undertake SEZ projects over the medium to long term.

Investment Thesis

We rate RIL Hold/Low Risk (2L) with a target price of Rs1,150. Factors such as diversity of revenues, integration across product chains and volume growth should help RIL tide over downturns in product cycles. The volume expansion in the petrochemical and polyester chain should partly offset margin pressure in the medium term. Significant gains from the foray into retail marketing of petroleum products, while adversely affecting short-term profitability, would likely reduce dependence on the export markets and cushion volatility in the refining cycle. We expect regional refining margins to remain robust, with RIL enjoying a premium for its superior complexity. E&P looks set to become meaningful in the next 3-4 years as the KG D6 field commences gas production. Upgrade of reserves in KG basin adds to the value, although the NAV of the gas find is dependent on development capex as well as the demand profile from anchor customers. Notwithstanding the step-up in E&P's contribution from FY09E, RIL will likely report muted earnings growth in FY06-09E on account of the current cyclical peak in the refining and petrochemicals business. We believe the current valuations factor in a large part of the core business fundamentals as well as value accretion from higher KG gas reserves. While the new initiatives of organized retailing and SEZs are potential growth opportunities, we believe value accretion is still some time away.

Figure 13. Relative Price Performance



Source: Datastream

Valuation

Our target price is based on a sum-of-the-parts value: (1) RIL's core petrochem and downstream oil business valued on an EV/EBITDA of 6.0x for FY08E, in line with the regional chemicals and refining peers. (2) Our March 2007E DCF value for the KG-gas is Rs181/share based on recoverable reserves, capex, gas realizations. (3) Valuation contribution for NEC-25 is arrived at by applying the KG basin benchmark (EV/boe of US$2.1) to NEC's estimated recoverable reserves of 2.7tcf. (4) Oil discovery in KGIII 6 has been valued at US$5/boe applied to estimated reserves of 500m bbl at 50% recovery probability.
(5) Investment in IPCL and RPL has been valued at 25% discounts to target prices to reflect the holding-company structure. (6) Treasury stock has been valued at RIL's target price.

Figure 14. Price Performance (%)

	3M	6M	12M
Absolute	20.3	35.5	169.1
Relative	–4.3	24.6	70.0

Source: Datastream

Our target price is also based on a FY08E P/E of 14.0-14.5x, in line with the current benchmark Indian index (Sensex), plus the value of the treasury stock. We believe RIL should trade in line with the broad market, as significant value accretion from investment in listed subsidiaries and E&P assets offsets the cyclicality of its earnings.

Risks

We rate RIL Low Risk, as opposed to Medium Risk suggested by our quantitative risk-rating system, which tracks 260-day historical share-price volatility. Diversified earnings and significant value contribution from the emerging E&P business and investment in listed subsidiaries have led to qualitative changes in the value constituents of the stock. Risks that could impede the stock from reaching our target price are: (1) RIL's margins are exposed to the global petrochemical and refining cycles. (2) The group could be asked to offer larger discounts on products sold to oil public sector units. (3) Any delay in the key KG D6 gas and refinery expansion project. (4) The organized retailing and SEZ initiatives would call for significant investment in RIL's non-core areas. Upside risks that would result in the stock exceeding our target price include: (1) Further tightening in the refinery demand-supply scenario. (2) Increase in 1P/2P reserves in KG basin or increase in development capex could result in further value accretion. (3) Higher-than-expected oil reserves in KG Basin blocks. (4) New oil and gas discoveries. (5) Faster-than-expected implementation of the organized retailing foray and SEZs. (6) Earlier-than-expected value realization from the new initiatives.

Analyst Certification Appendix A-1

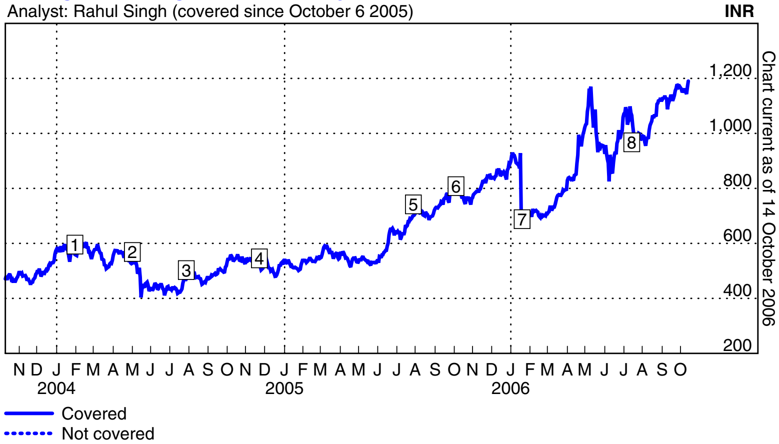
We, Rahul Singh and Pradeep Mirchandani, CFA, research analysts and the authors of this report, hereby certify that all of the views expressed in this research report accurately reflect our personal views about any and all of the subject issuer(s) or securities. We also certify that no part of our compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

IMPORTANT DISCLOSURES

Reliance Industries (RELI.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Rahul Singh (covered since October 6 2005)



#	Date	Rating	Target Price	Closing Price
1:	30 Jan 04	1L	*489.54	559.60
2:	3 May 04	1L	*511.21	528.30
3:	28 Jul 04	1L	*473.09	470.50
4:	23 Nov 04	1L	*497.01	528.30
5:	28 Jul 05	1L	*598.65	NA
6:	5 Oct 05	1L	*697.31	801.95
7:	19 Jan 06	1L	*794.00	704.20
8:	14 Jul 06	*2L	*1,150.00	1,065.15

*Indicates change.

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Citigroup Global Markets Inc. or an affiliate received compensation for products and services other than investment banking services from Reliance Industries in the past 12 months.

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Citigroup Investment Research Ratings Distribution

Data current as of 30 September 2006	Buy	Hold	Sell
Citigroup Investment Research Global Fundamental Coverage (2914)	46%	40%	14%
% of companies in each rating category that are investment banking clients	44%	43%	32%
India -- Asia Pacific (105)	59%	16%	25%
% of companies in each rating category that are investment banking clients	52%	65%	38%

Guide to Fundamental Research Investment Ratings:

Citigroup Investment Research's stock recommendations include a risk rating and an investment rating.

Risk ratings, which take into account both price volatility and fundamental criteria, are: Low (L), Medium (M), High (H), and Speculative (S).

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