

INDIA RESEARCH

OIL &amp; GAS

COMPANY UPDATE

BSE SENSEX: 16162

23 SEPTEMBER 2011

# Reliance Industries

Diversification: prescience or folly?

OUTPERFORMER

Rs771

Mkt Cap: Rs2.52trn; US\$50.9bn

A wave of negative news-flow pertaining to E&P disappointment, regulatory actions and sustainability of return ratios has buffeted Reliance Industries' (RIL) stock over the last six months. However, we see substantial earnings potential in existing businesses despite lower E&P volumes over FY12-13E. The CMP is factoring in exaggerated negatives around all existing businesses (gold plating of D6 capex, reserve downgrade, declining petchem spreads and little exploration upside), which we believe is too pessimistic. Additionally, the significant investments by RIL (US\$25bn) across energy and non-energy businesses have the potential to transform the face of the company, albeit subject to several external and internal factors going its way. The transformation is being driven by the management's desire to tap into the multi-billion dollar Indian consumer opportunity which, we believe, is a prudent strategic move. Reiterate Outperformer, with a 12-month SoTP based price target of Rs1109/share 44% upside from here.

**Existing businesses remain resilient:** The strength in Singapore GRMs and domestic demand trends for petrochemicals point to steady earnings in both these segments over FY12-13E, even as we see some moderation from H1FY12 levels. While E&P remains a concern, we believe the BP deal will drive momentum in activity and news flow over the medium term and do not expect a reserve downgrade on D6.

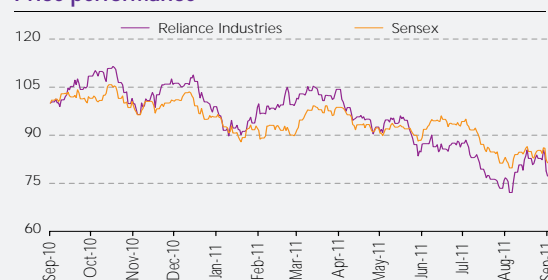
**Significant investment plans into non-energy businesses augur well:** RIL plans to invest up to ~US\$15bn in the new business ventures over FY12-15, with an additional US\$10bn to almost double petchem capacity by FY14E. We believe that just telecom and retail could deliver a combined PAT of US\$0.5bn by FY17E, while insurance and financial services business could take longer to start contributing to profits. Additionally, petchem EBITDA could double from ~Rs90bn currently, compensating for the hiccups in E&P.

**Valuations attractive; Outperformer:** The stock appears to be building in (i) flat GRMs, (ii) declining petchem spreads, (iii) reserves of only 6tcf on D6, and (iv) limited exploration upside. We find the assumptions too pessimistic, even as we do adjust our D6 production estimates and exploration risk factors which reduces our SoTP by ~Rs50 to Rs1,109 per share. Overall, while the uncertainty around the long-term shape of the "new RIL" will take 18-24 months to dissipate, the stock price ignores the formidable earnings profile of the existing business.

## Key valuation metrics

As on 31 March	FY09	FY10	FY11	FY12E	FY13E
Net sales (Rs m)	1,512,240	2,037,400	2,658,110	2,871,945	2,842,158
Adj. net profit (Rs m)	149,503	158,980	202,110	221,009	253,362
Shares in issue (m)	3,270	3,270	3,270	3,270	3,270
Adj. EPS (Rs)	45.7	48.6	61.8	67.6	77.5
% change	(23.4)	6.3	27.1	9.4	14.6
PE (x)	16.9	15.9	12.5	11.4	9.9
Price/ Book (x)	2.1	1.9	1.7	1.2	1.1
EV/ EBITDA (x)	13.0	10.0	7.4	6.4	5.5
RoE (%)	14.2	12.4	14.1	12.4	11.9
RoCE (%)	8.8	9.5	11.5	11.0	10.4

## Price performance



**Bloomberg: RIL IN** 6m avg daily vol. (m): 4.61  
**1-yr High/ Low (Rs): 1187/712** Free Float (%): 55.3

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## INVESTMENT ARGUMENT

- CMP discounts too much bad news; we do not agree
- Refining and petrochemical volumes stay healthy, while we believe E&P disappointments are already priced in
- The stock is attractively priced; we see ~40% upside from here
- Avenues in energy not enough to consume the cash being thrown up by RIL
- The new strategy emphasizes de-risking and focuses on the Indian consumer
- Each new business has strong prospects, albeit with some caveats
- Success would depend on management bandwidth as also mindset change

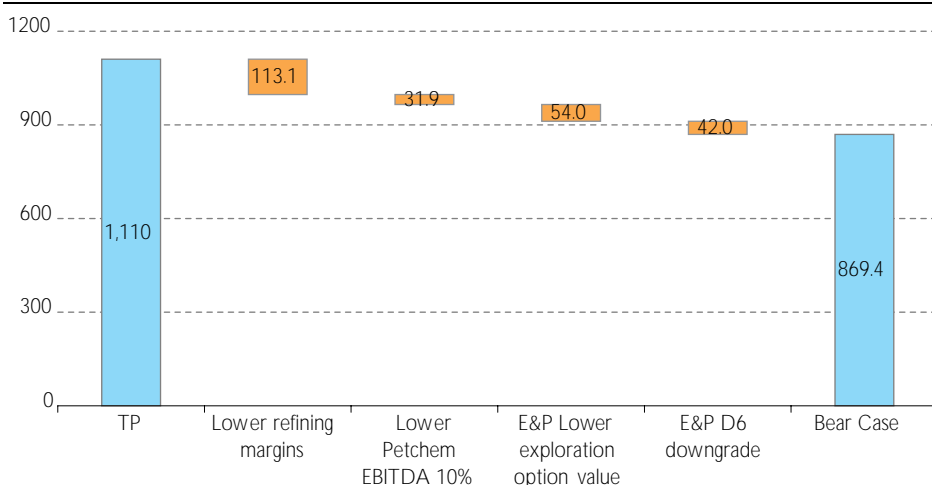
### Current valuations discount too much pessimism

A look at the stock performance implies that the current stock price factors in a very pessimistic scenario for RIL over the next three years or so. Our estimates would suggest that CMP seems to be factoring in the following:

*Current price levels build in an overly gloomy scenario for RIL in the next three years*

- A muted refining margin environment for the medium term, with Singapore GRMs stuck below US\$6/bbl over FY12-14E
- RIL GRMs therefore imputed at an average of US\$8.5-9/bbl for the period
- Petrochemical blended spreads decline by ~25% over FY12-13E with no upward revisions coming through on EBIT from this segment over FY12-14E
- KG D6 production at ~44 mmscmd for the next five years, recoverable reserves at only 5-7 tcf
- No new developments in E&P coming on stream over the next five years
- Shale gas stagnates at current levels
- Policy moves against any future capex on D6, limited price increase in FY14E

#### Exhibit 1: RIL CMP seems to be factoring in too many negatives



Source: IDFC Securities Research, Company

## Refining market remains strong, though some moderation likely

We are encouraged by the performance of Singapore benchmark margins over the last six months with improvement in both gasoline and diesel spreads, along with LPG and kerosene. We assume Singapore benchmark margins at ~US\$6.5/ bbl, and RIL's GRMs at US\$10.8/bbl for FY12E and US\$11.2/bbl for FY13E on better economic environment and higher demand.

## Petrochemical business to reflect demand-supply rebalancing from FY13

With most global supply additions completed by H1FY12E, we would expect demand growth to start offsetting oversupply concerns by H2FY13E, with our estimates still factoring in a 8% decline in EBITDA for FY12E and flat EBITDA over FY13E. While the estimates are conservative, we would await some clarity coming through on the global economy before revising these assumptions.

## E&P – KG D6 ramp-up pushed to FY15E; recoverable reserves at 11 tcf

With the consummation of the BP deal, we remain confident of ramp-up of production at KG D6 from ~45 mmscmd currently to ~65 mmscmd by FY14E, and we do not assume any reserve downgrades on the prospect. Having said that, the slower ramp-up of production from the asset results in a drop in our estimated NAV to Rs170/ share from Rs197 earlier.

We also refine our assumptions for exploratory upsides from RIL's portfolio downwards, to account for the delays in clearances for development activity on the NEC 25 and satellite fields and the resultant slower drilling momentum for RIL. Thus, our value for RIL's exploration upside drops to Rs50/share from Rs95 earlier.

## Exhibit 2: RIL – key assumptions

	Units	FY12E	FY13E
Singapore GRMs	\$/ bbl	7.4	7.5
RIL GRMs	\$/ bbl	10.8	11.2
KG D6 output	mmscmd	46.0	50.0
Refining throughput	m tonnes	64.0	64.1
Capex	Rs bn	45.2	80.4
Petchem EBITDA	Rs bn	91.5	92.6
Petchem Spreads			
HDPE - Naphtha	\$/tonne	470.3	465.5
LLDPE - Naphtha	\$/tonne	364.3	360.7
LDPE - Naphtha	\$/tonne	401.8	393.8
PP- Naphtha	\$/tonne	498.8	473.8
POY- Naphtha	\$/tonne	988.0	1,027.5
PSF- Naphtha	\$/tonne	884.0	919.4
PET- Naphtha	\$/tonne	470.1	488.9

Source: IDFC Securities Research, Company

## Exaggerated pessimism built into stock price

We use the EV/ EBITDA methodology for valuing refining and petrochemical businesses, with DCF used for valuing producing and developed E&P assets and EV/boe multiple used on risked recoverable reserves for exploratory prospects. Our SoTP based valuation points to a price target of Rs1,109/share for RIL.

*We remain conservative on our petchem estimates and await clarity on the global economic drift before revisiting them*

*We lower our assumptions for exploratory upsides to factor in delay in clearances*

*Our SoTP valuation throws up a price target of Rs1110*

### Exhibit 3: RIL – our SoTP valuation indicates a target price of Rs1109 per share

Segment	Method	Fair multiple (x)	EBITDA (FY12E)	EV (Rs m)	Rs per share
Refining	EV/EBITDA	7.0	178,980	1,252,861	423.1
Petrochemical	EV/EBITDA	7.0	92,627	648,389	219.0
E&P	DCF/ EV/Boe	3.5	5,474	869,804	293.8
RIL Retail	CE	1.0		50,000	16.9
Less: (Net Debt FY13E)/ Net cash				464,049	156.7
Fair Value : FY13E				3,285,103	1,109
				Fully Diluted shares	2,960.9
<b>Current price</b>					<b>771</b>
<b>Upside</b>					<b>44.0%</b>

Source: IDFC Securities Research, Company

We remain confident of the inherent earnings ability of RIL's existing businesses which, we believe, does not reflect in the current stock price. The refining and petrochemical business remains strong, while the E&P business has been discounted to negligible levels by the street, in our opinion. We reiterate Outperformer on the stock with our target price implying ~445% upside from here.

*We believe the earnings potential of RIL's businesses is not reflected amply in the current price*

On a relative basis, RIL trades at a discount to peers in the refining and E&P space, implying the pessimism surrounding these two segments for investors. In the petchem space however, RIL maintains a premium, reflecting the stronger demand scenario in the domestic Indian markets compared to regional peers.

### Exhibit 4: RIL Relative valuations

Relative Valuation		P/E			EV/EBITDA			P/BV		
		FY11	FY12E	FY13E	FY11	FY12E	FY13E	FY11	FY12E	FY13E
<b>Reliance</b>	RIL -at current price	12.5x	11.4x	9.9x	7.4x	6.4x	5.5x	1.7x	1.2x	1.1x
	RIL - at target price	18.0x	16.4x	14.3x	10.2x	9.4x	8.3x	2.4x	1.8x	1.6x
<b>Peer Group</b>		<b>CY10</b>	<b>CY11</b>	<b>CY12</b>	<b>CY10</b>	<b>CY11</b>	<b>CY12</b>	<b>CY10</b>	<b>CY11</b>	<b>CY12</b>
<b>Refining</b>	All Nippon	29.7x	36.2x	20.8x	8.0x	6.7x	5.7x	1.3x	1.2x	1.1x
	Valero	36.8x	5.0x	5.0x	4.6x	2.7x	2.7x	0.8x	0.7x	0.6x
	Sunoco	18.5x	91.0x	17.1x	5.1x	10.2x	6.6x	1.4x	1.6x	1.5x
	Galp Energia	28.0x	35.1x	20.1x	16.2x	15.4x	11.1x	4.6x	4.0x	3.6x
	Showa Shell Sekiyu	15.4x	5.5x	8.8x	8.2x	5.0x	5.6x	0.9x	0.8x	0.7x
	<b>Average</b>	<b>24.7x</b>	<b>34.1x</b>	<b>12.8x</b>	<b>8.5x</b>	<b>8.3x</b>	<b>6.5x</b>	<b>1.9x</b>	<b>1.8x</b>	<b>1.6x</b>
<b>Petrochemicals</b>	Petrochina	11.0x	9.6x	9.0x	7.1x	5.9x	5.5x	1.6x	1.4x	1.3x
	Dow Chemical	15.6x	9.5x	8.0x	9.0x	6.4x	5.9x	1.8x	1.3x	1.2x
	Sinopec	7.0x	8.1x	7.3x	10.5x	11.7x	10.1x	1.1x	1.0x	0.9x
	<b>Average</b>	<b>11.2x</b>	<b>9.1x</b>	<b>8.1x</b>	<b>8.9x</b>	<b>8.0x</b>	<b>7.2x</b>	<b>1.5x</b>	<b>1.2x</b>	<b>1.1x</b>
<b>E&amp;P</b>	Woodside Petroleum	17.0x	16.7x	12.8x	11.2x	10.4x	6.9x	2.4x	2.2x	1.9x
	BG plc	20.2x	15.6x	13.2x	9.0x	7.2x	6.2x	2.7x	2.3x	2.0x
	Repsol	5.4x	10.5x	8.5x	3.7x	4.9x	4.2x	1.0x	1.0x	0.9x
	PTT E&P	13.4x	11.5x	9.3x	6.4x	5.2x	4.2x	3.1x	2.6x	2.2x
	Noble Energy	19.6x	16.1x	11.5x	8.5x	5.7x	4.3x	2.1x	2.0x	1.7x
	Anadarko	49.8x	22.7x	18.9x	8.0x	5.7x	5.0x	1.8x	1.7x	1.6x
	Santos	21.5x	20.3x	17.7x	12.0x	6.9x	5.7x	1.3x	1.3x	1.2x
	<b>Average</b>	<b>21.0x</b>	<b>16.2x</b>	<b>13.1x</b>	<b>8.4x</b>	<b>6.6x</b>	<b>5.2x</b>	<b>2.1x</b>	<b>1.9x</b>	<b>1.6x</b>

Source: IDFC Securities Research, Bloomberg

### The CAG report – less severe than expected

The recent submission of the CAG report on the Indian hydrocarbon sector has raised some important concerns around capex, opex and procedure followed on several fields

*Concerns around lacunae by private players on several fields highlighted by CAG report...*

operated by private players, including RIL's KG D6 field, Cairn's Rajasthan asset and the Panna Mukta Tapti consortium (RIL, ONGC and BG India).

The findings of the CAG center around i) some excess opex allowed to be made part of cost recovery, ii) non relinquishment of excess contract area by the operator without undertaking drilling activity on the same, and iii) non compliance with Production Sharing Contract (PSC) norms with respect to exploration timelines and appraisal program. The Auditor has recommended i) redrawing of the contract area for identifying relinquishment area on D6, ii) evaluation of well depth as a biddable criteria, iii) examination of the investment multiple method in the PSC regime, and iv) evaluation of current monitoring mechanisms for such large projects, indicating the inability of the DGH and the ministry (MoPNG) to effectively monitor the same.

*...not as severe as feared by the Street, with consequences on RIL far lesser than expected*

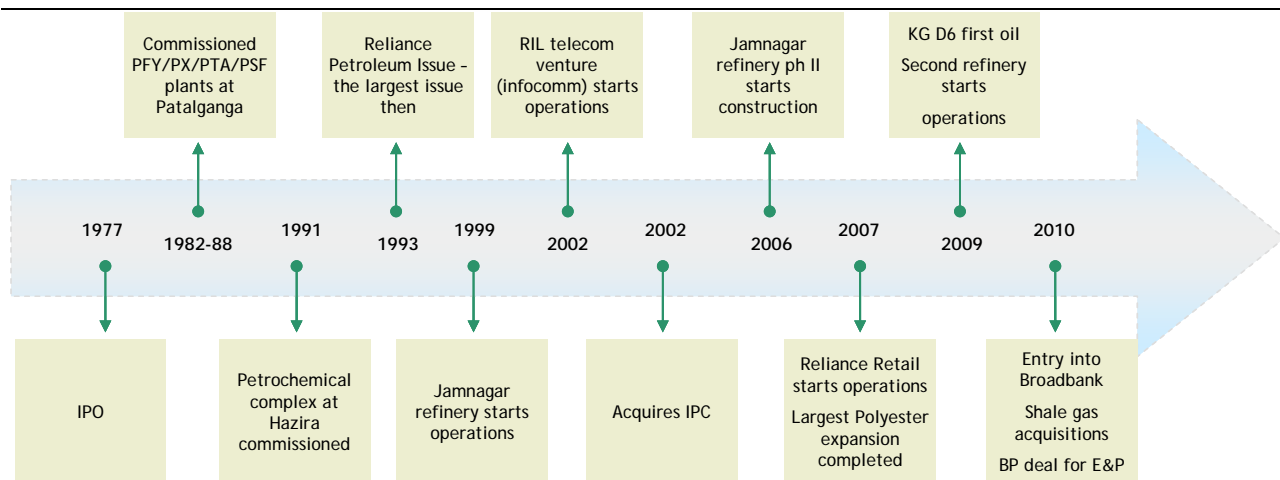
We believe that while the findings do point fingers at each private operator looked at (RIL, Cairn and BG), and also recommend some punitive action against the players, the tone and extent of the accusations are somewhat milder than what was circulating on the street earlier. With the focus being on the monitoring mechanism of the DGH/ MoPNG, the existing PSC regime itself and the use of the investment multiple method to compute profit petroleum, we believe the apprehension of dire consequences for RIL (penalty/ investigation of all capex done so far on D6, stoppage of further development, etc) due to this report may not come about.

## RIL 2.0: Larger, but will it be better?

*RIL has planned multi-billion dollar non-energy forays over the next several years...*

In each of the pivotal moments in RIL's history, an ongoing project has always been the precursor to the "next big thing". The foray into polyester was the precursor to entry into petchem, the petchem foray leading up to refining, and then the much-celebrated and now-derided E&P business. On the sidelines, the pre-split RIL has also consistently tried to build up a consumer-related and non-energy portfolio through the Reliance Communications venture (RCoM; now ADAG group owned), the retail foray and SEZ development. The difference between then and now, however, is the absence of a complementary suite of energy projects to go along with the non-energy forays planned over the next several years.

Exhibit 5: RIL: Evolution over 1980-2010



Source: IDFC Securities Research, Company

## The avenues in energy are there, but how much cash can they consume?

The question that RIL has had to consistently strive to answer over the last year or so, has been to find avenues for deploying the huge cash that is going to be generated from the existing business (specifically, the E&P business). We estimate that RIL will generate ~US\$6bn of operating cash flows annually over the next 2-3 years from the core businesses of refining, petchem and E&P.

We do not contest the scope of the opportunity in the oil and gas space for RIL. In fact, the prospects apart from D6 present a prospective resource base of 12bn boe. However, the fact that most of these assets have not progressed much over the last three years (barring NEC 25 and the D6 satellite fields) implies that development timelines for the E&P portfolio for RIL will take longer than earlier estimates. Further, each of these developments may not be undertaken simultaneously, and which would restrict the capital requirement for these projects to US\$5bn at best over the next 5-7 years. Additionally, RIL has announced expansive investment plans for the petrochemical business, with ~Rs420bn of investments lined up in the space over the next 3-5 years. We believe this move is again a bet on the Indian economy, where demand for polymers and plastic is expected to grow at 12-15% yoy over the next decade, fuelling RIL's ambitions to grow the petrochemical business.

### Exhibit 6: RIL – key projects in petrochemicals

Unit	Investment (Rs bn)	Expected completion
Off gas Cracker unit	160	2015
Coke Gasification plant	150	2015
PX plant	69	2016
Additional processing units	45	2015-16
<b>Total</b>	<b>420</b>	

Source: IDFC Securities Research, Company

With healthy cash flows, successful deployment of the same is essential to grow profitability and sustain the return ratios that have ensured RIL's premium to global peers (barring the last two years). With this in mind, RIL is targeting a spend of ~US\$15bn on various non-energy initiatives including insurance, retail, telecom and financial services over the next five years.

## The contours of the new strategy

With the stated aim of "transforming the DNA" of RIL from being a predominantly energy major to a more consumer focused business group, RIL has laid out some brief highlights of the business plan over the next decade. In this respect, the speeches by the Chairman, Mr.Mukesh Ambani, at the last two AGMs are quite instructive. Here, Mr. Ambani laid out his vision of the areas he expects RIL to focus on over the next decade. Refer to the following excerpts from his said speeches:

- RIL clearly moving away from focusing on just the energy business, to create a larger more diversified conglomerate
- Shift focus from cyclical, project businesses to stable consumer focused business to capitalize on consumer opportunities in the Indian economy
- Continue to devote maximum energies of the group domestically, with little emphasis on creating a more global profile (barring the shale gas business venture)
- While major investments would still be done in the energy business, the thrust is also on the petrochemical business where an explosion of demand has taken place due

... looking to evolve the DNA of a consumer-focused conglomerate

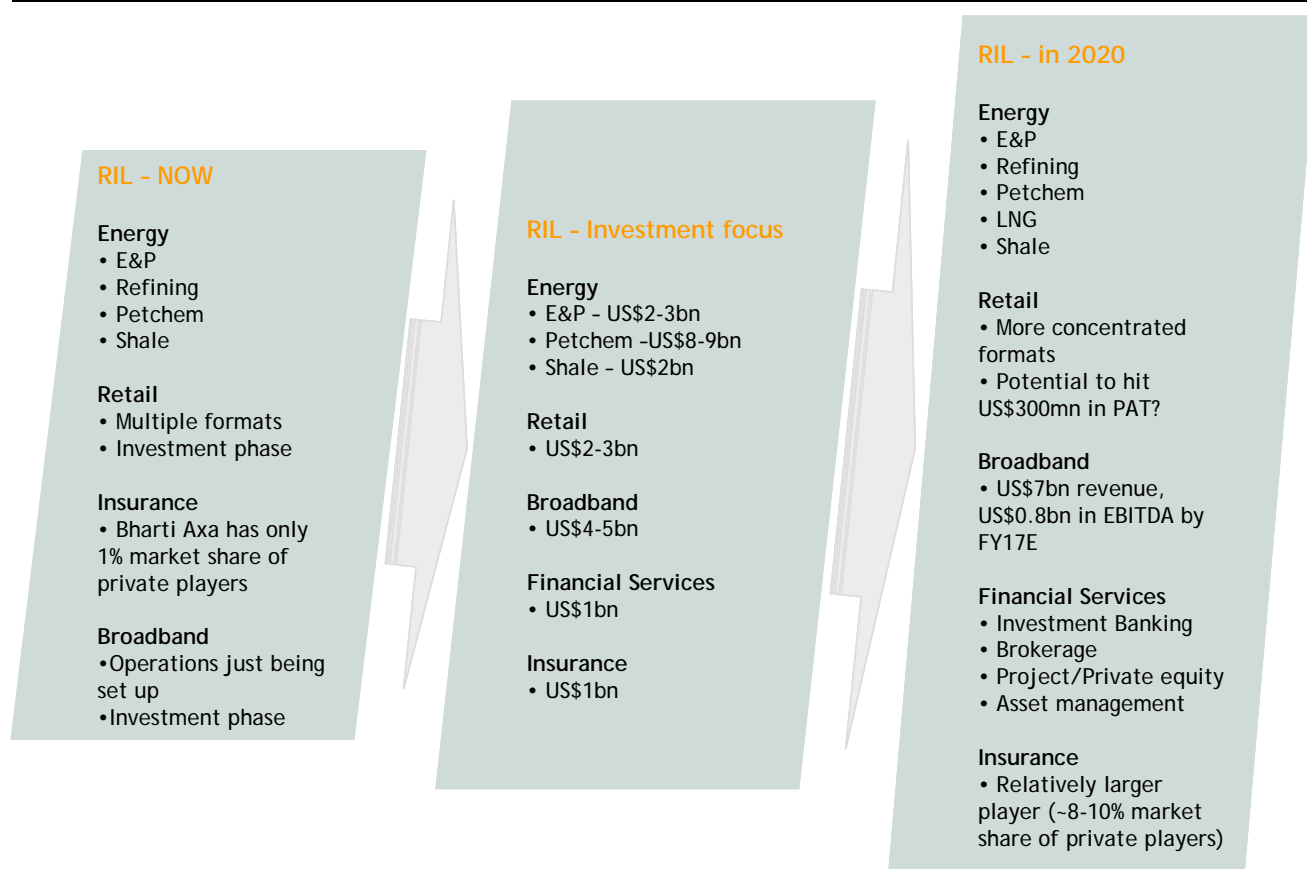
...by mining the vast consumer opportunities offered by the India story

*New businesses to include retail, financial services and telecom among others*

to the growing demand for plastics and polymers in a rapidly growing and urbanizing economy

- The core areas of new business would be i) retail, ii) financial services, iii) telecom, and iv) other infrastructure, including but not limited to power
- Total investments in all these ventures would aggregate more than US\$20bn over the next five years alone
- De-risking of business risks is a reality that RIL has to face, and the Chairman indicated no reluctance or discomfiture in accepting JVs as the way to go for some of the new ventures, indeed even some of the existing businesses from now on (a case in point being the BP deal for the E&P business of RIL)

#### Exhibit 7: RIL in 2020: The "transformed" RIL



Source: IDFC Securities Research, Infraline, Company

The bottom line is clear; RIL will make a concerted effort to shift from being a project led execution specialist to a consumer led conglomerate over the next decade. Why is this shift necessary however? We attempt to put forward some of our thoughts on this strategic direction:

#### Betting on the Indian consumer opportunity

Mr Mukesh Ambani has often alluded to the enormous potential offered by the Indian consumer space and feels the need to leverage than for creating value in RIL going forward. We believe that the thrust into various consumer focused businesses is an attempt to meet this strategic intent.

*Mukesh Ambani's strategic intent to leverage consumer space...*



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Notably, the maximum investments announced in the Indian energy space by RIL have been in the petrochemicals space, once again a proxy for the strength in the Indian economy and resultant demand coming through for plastics, polymers and chemicals from the automobile, infrastructure and agriculture segments. Additionally, the scope for investment in the refining business is anyways limited, due to huge supply additions planned over FY12-14E. That leaves E&P; where the potential for significant investment is dependant on further exploration success as well as regulatory clearances.

*...amply evident in the thrust on petchem, a proxy for India's economic growth story*

- The E&P game is one of probability anyways, and therefore the chances that all of the planned capex would come about in the timeframe expected are remote at best. We reckon that the estimated capital expenditure on the asset portfolio would prove optimistic over the near term.
- The regulatory environment around the E&P sector has turned increasingly hostile over the last year, with the Directorate General of Hydrocarbons (DGH) functioning and policies governing the hydrocarbon sector coming under question by various regulatory entities such as the Comptroller and Auditor General (CAG) and the Parliamentary Action committee (PAC).

In this kind of environment, diversification is an attractive option for RIL, with the forays in non-energy businesses intended as much to create value as to hedge against the stalling of the E&P segment. We believe the focus on the Indian consumer space is timely and would generate significant value for RIL going forward. The move to “de-risk” the business, or at least offset the cyclical nature of the downstream energy business, is not necessarily a bad one, even though it may lead to a lower return profile in the near term.

*Scope of oil & gas opportunity is unquestionable, but E&P development timelines may get stretched*

At the same time, we concede that RIL has excelled at businesses requiring project execution rather than consumer interface so far. The group's record in the consumer facing businesses it has attempted (telecom, retail and financial services) is not inspiring so far. Using back of the envelope calculations and industry growth assumptions of our respective sector teams, we arrive at potential revenue of US\$7-8bn in a blue sky scenario, with a profit potential of US\$0.2-0.3bn for RIL by FY17E alone. With limited visibility on the exact scope of the financial services JV as of now, we exclude that segment from these projections. We believe these numbers do point to a significant opportunity for RIL to create value from the new ventures, albeit subject to getting the business models right. We, therefore, attempt to look at the four key business segments being entered into by RIL over the next five years to get a better idea about the potential and pitfalls of each. We focus on the retail, life insurance, broadband and financial services segments.

### Demographics, savings trends and products to drive insurance prospects

Explosive growth of the life insurance business over the last decade has been underpinned by the entry of private players, increase in income across population groups and popularity of ULIPs as a vehicle to participate in the Indian equity markets. However, changes in regulations regarding lock in period for ULIPs to five years from three and the guaranteed return from pension products to 4.5% pa has reduced the economic attractiveness of such products for both insurers and customers. This, coupled with the correction in equity markets after a sustained secular bull run from FY02-08, has caused premium growth over FY10-11 to stutter. RIL's entry into this space at this time, by acquiring one of the smaller players (Bharti Axa Life has only 1.2% market share out of private players), came in as a surprise. We believe that RIL has

*Rs420bn lined up for petchem an indication of RIL's bet on the India story...*

*...so is RIL's entry into the insurance business, whose prospects remain robust in the long term*

taken the decision for the long haul, and the long-term prospects of the insurance business, specifically life insurance, remain robust:

- Penetration, at ~4%, is still low compared to developed economies. More importantly, given that a significant percentage of the business comes from investment products (ULIPs), pure insurance penetration rates are abysmal
- The savings rate of ~35% and a growing middle income group are both positives for sector. This, coupled with a demographic make-up where majority of the population is in the earnings accumulation phase, makes the sector attractive
- India lacks an organized social security net; thus, majority of the population has to rely on private initiatives such as insurance for the retired phase.

### Retail – drivers intact, but business models changing

*The hugely underpenetrated retail space has been stabilizing...*

In the aftermath of the recent 'clean up' in the retail industry, economically unviable stores have closed, inefficient players have exited and property lease agreements are being renegotiated. Going forward, we expect a less cluttered sector with fewer players, lesser number of formats and more emphasis on growing profitably rather than relying on the Balance Sheet. The ~US\$30bn organized retail opportunity remains rock solid in the country, with only ~6% of the total retail market being organized.

*...after the honeymoon phase in the post-liberalization era led to a flurry of failed formats*

The overall retail space is growing in double digits annually, with organized retail growing 2x that rate (20-25% annually). Even if RIL can grab a ~3% market share of the total retail opportunity by FY20E, the business could be generating revenues of ~US\$4bn and PAT of US\$150m (assuming a PAT margin of ~3%). With the new model and management in place, RIL is clearly focused on creating profitability in this segment over the next 3-5 years. The factors that will drive growth for RIL in this space are summarized below:

*RIL has injected new management talent to re-invigorate its retail business...*

- RIL has cleaned up its store portfolio over the last two years, shutting down an estimated ~100 stores
- RIL has brought in new management talent in the last six months to reinvigorate the segment. The reported hiring of former Wal-Mart executives, Mr. Rob Cissell (CEO) and Shawn Gray (COO), indicates the emphasis on supply chain efficiencies and strengthening the back end – an Achilles heel in the past
- RIL plans to focus on a mix of retail and wholesale cash and carry formats, with an initial rollout of 14 such stores in select cities pan-India under the name 'Reliance Market'. In some cases, the existing hypermarkets will be expanded to merge with the new business model

*...which will be a mix of retail and wholesale cash and carry*

### Broadband – untested, but scalable?

*At ~Rs200bn worth of investments, the segment is RIL's biggest non-energy bet*

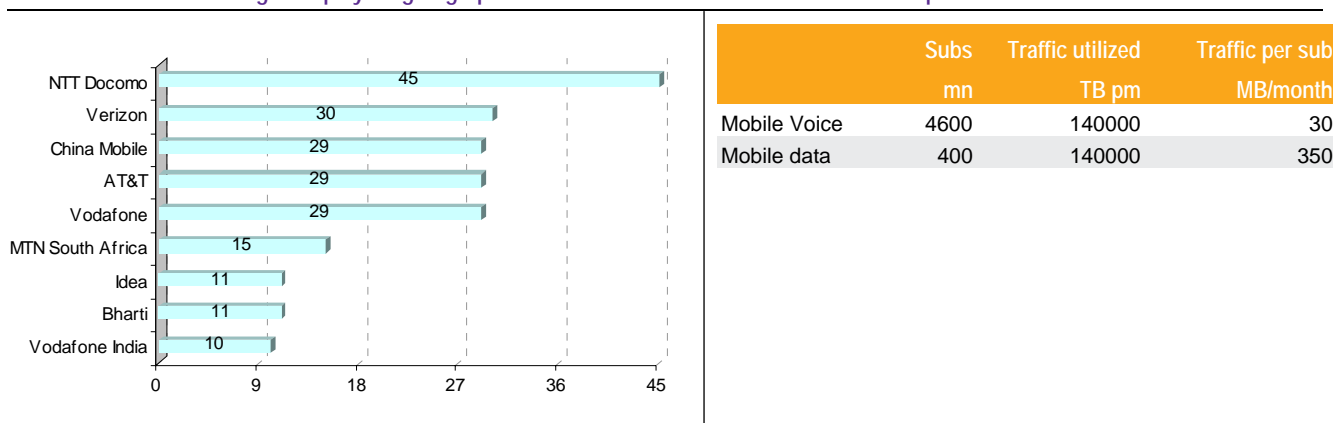
RIL has initially invested ~Rs130bn to acquire a 95% stake in Infotel Broadband Services (P) Ltd, which has a pan-India license for Broadband Wireless Access (BWA) Spectrum. RIL plans to invest a further Rs70bn in the venture over the next 2-3 years. Broadband services will be offered using the LTE (Long Term Evolution) platform, a next generation technology that can be scaled up on the GSM platform unlike the requirement of setting up parallel infrastructure for Wimax. Notably, the LTE platform is still evolving and industry experts see it taking at least a couple of years to mature. Having said that, the broadband penetration in the country remains abysmally low at ~1%, and we believe the stage is set for 8x expansion in the segment to ~100m subscribers by FY20E. We believe the opportunity provided by this space warrants optimism from RIL's point of view:

- With LTE formats gaining credence globally, the technology ecosystem to implement the system will be in place earlier than people estimate
- Data services as a percent of business for telecom companies are rising globally, and we expect the trends to replicate in India

*Abysmally low broadband penetration supports the company's optimism*

**Exhibit 8: Data as a % of global players going up**

**as non-voice traffic expands**



Source: IDFC Securities Research, Company

With an investment requirement of US\$5bn, and a return profile indicating potential sustainable EBITDA of US\$400m-US\$800m, we see long-term promise in the opportunity. RIL has repeatedly been ahead of the curve in identifying and developing nascent business segments in India, and we think it is no different this time. While the near-term implications on earnings are minimal, we believe the deal will add materially to RIL's earnings and, thus, valuation in the long term.

### Financial services – DE Shaw JV is the joker in the pack

RIL has recently announced entry into the financial services space (in addition to insurance) in a JV with US-based DE Shaw & Co, an international financial services firm managing ~US\$20bn globally. The venture has indicated plans to enter into several segments of the financial value chain including (i) private and project equity, (ii) investment banking and brokerage, (iii) asset management, and (iv) advisory services.

*RIL planning presence in broad range of services including private equity, brokerage and advisory...*

We, however, believe that the Indian financial services space is facing a triple whammy of weak equity markets, slowing growth and policy paralysis impeding infrastructure investment – all combining to reduce deal activity and soften margins. The biggest impact has been felt in the institutional brokerage and investment banking space, with asset management businesses also feeling the pinch. In this scenario, what will perhaps help change the game is a focus on the retail segment and the diversification into areas such as real estate broking and online delivery of services, something which DE Shaw is guiding to doing anyways.

*...but weak equity markets and slowing growth pose challenges to profitability*

## EXISTING BUSINESSES REMAIN RESILIENT

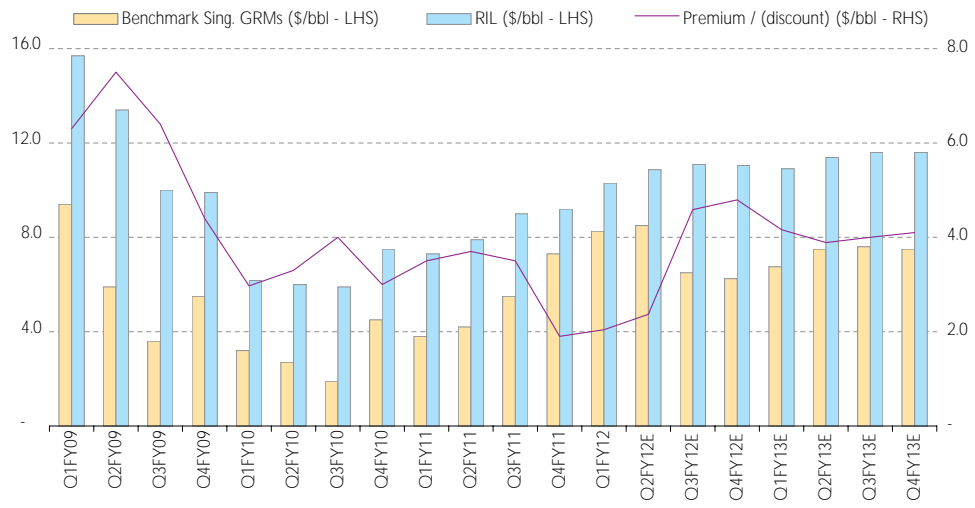
- Current businesses will continue to drive double digit growth over FY11-13E, despite E&P disappointment
- Refining margins remain strong; we expect 28% yoy growth for RIL in FY12, even with softening of benchmark margins over H2FY12E
- Petrochemical business will remain muted with supply overhang over FY12E, we expect EBITDA decline of ~8% over FY12
- We remain optimistic on the E&P potential despite the D6 disappointment over the last year
- The BP deal should act as a trigger for renewed momentum in activity and news flow

### Refining – some moderation expected over H2FY12-FY13E

RIL GRMs to reach US\$11/bbl by end of FY12E...

The strength in Singapore GRMs seen over the last six quarters has been remarkable with both yoy and qoq growth over this period. The nuclear accident in Japan, coupled with a renewed spurt in fuel demand in Asia, have led to a surge in diesel spreads, while gasoline spreads have also grown, albeit at a slower pace. While we do not expect Singapore GRMs to sustain at the current levels given the weakness in the global economy and the resultant drop in demand growth, benchmark GRMs could still grow ~35% yoy to US\$7.4/bbl. RIL is expected to reap the benefits of the same, with FY12E exit GRMs at US\$11.1/ bbl.

Exhibit 9: GRMs to grow strongly over FY12-13E



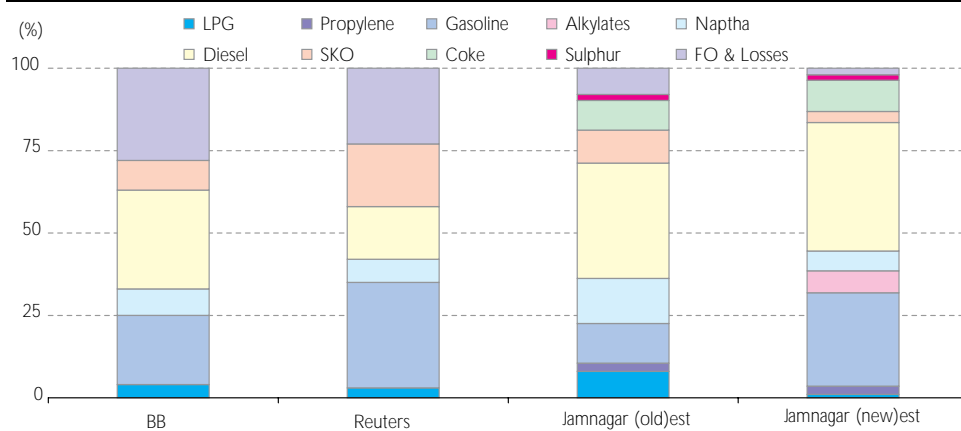
Source: IDFC Securities Research, Bloomberg, Company

Overall, we expect the following factors to support our assertion of better GRMs over the next 12-18 months:

- The dynamics of global supply are such that most new supply sources are slated to be of the heavier, inferior quality. This implies that light sweet crude oil will get scarcer going forward, which would ensure strong AH-AL spread and support margins for highly complex refiners such as RIL

- RIL is one of the lowest cost refiners in the world with one of the most complex configurations for a refinery of comparable size and scale. With its superior sourcing flexibility and product slate, it has historically outperformed the benchmark margins, and we expect that to sustain going forward.

**Exhibit 10: RIL's refinery configuration is far superior to benchmarks**



*Superior sourcing flexibility and product portfolio have helped it stay ahead of benchmark*

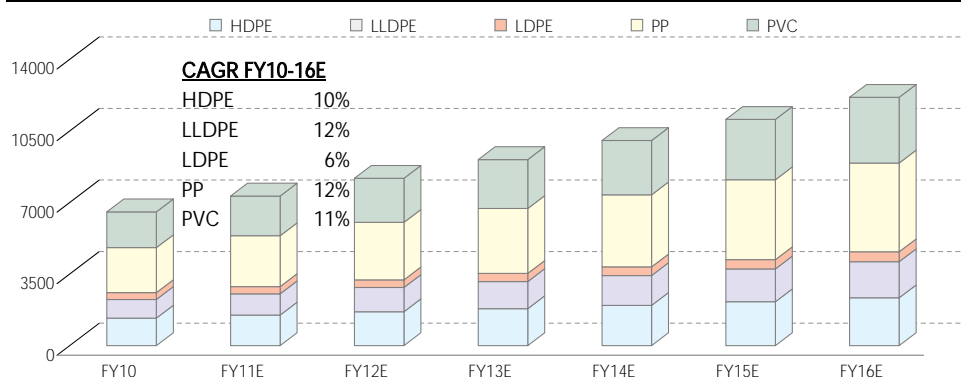
Source: Company, IDFC Securities Research

### Petrochemicals to show muted growth

The wave of global capacity additions in the petrochemicals space over the last two years has affected Indian margins and prices as well. However, the strong double-digit demand growth across polymer products implies that India will remain a net importer over the next five years, barring a small period in CY12-13 when capacity additions by RIL and ONGC Petro Additions (OPaL) would be commissioned. Strong demand from each product segment is expected to support the ambitious capacity expansion plans of Indian majors like GAIL (580k tpa, FY13-14E), IOC (1,650k tpa, FY12E) and RIL (1,500k tpa, FY15E), which are betting on strong sustained growth across consuming segments such as auto, food processing and packaging, FMCG, consumer durables, agriculture and construction.

*Strong domestic demand to help offset weakness in spreads somewhat*

**Exhibit 11: Domestic polymer demand trend (FY10-16E)**

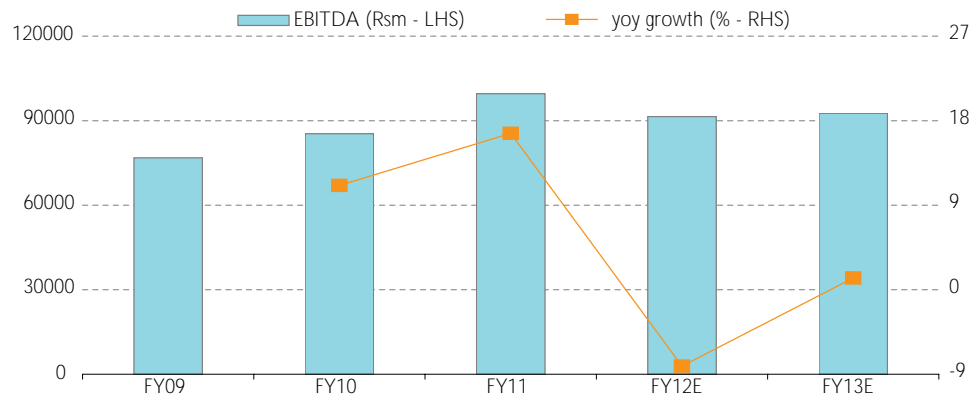


Source: IDFC Securities Research, OPaL presentation at 'India Petrochem 2010', Crisil Research

Therefore, while spreads across the product chain will moderate in line with global demand supply trends, we expect RIL to do relatively better than global peers on the

capacity utilization and pricing front. Even so, we do build in an 8% decline in EBITDA margins over FY12E and largely flat EBITDA in FY13E.

**Exhibit 12: Petchem EBITDA to decline over FY12E**



Source: IDFC Securities Research, Company

### E&P - the BP deal provides comfort

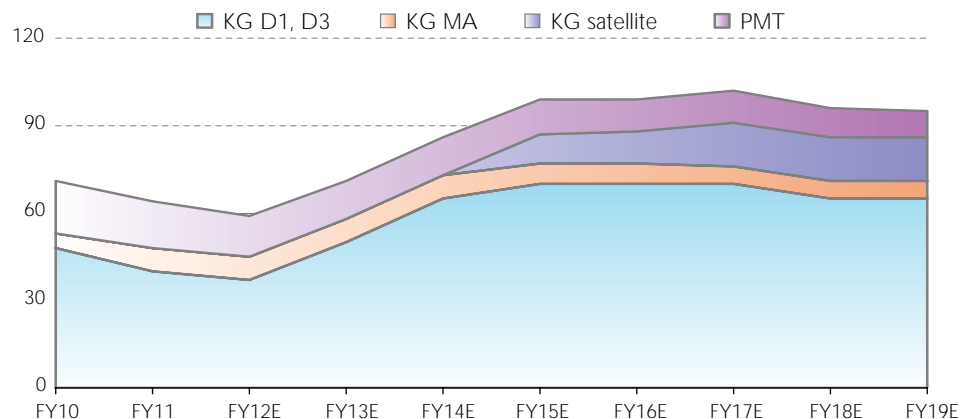
*The BP deal provides downside support to the E&P business...*

*...and also reinvigorates exploration capabilities on RIL's prospects*

With formalization of the recent deal with BP to sell a 30% stake in 23 of RIL's 33 blocks for a consideration of US\$7.2bn, we believe the deal provides a downside cap to RIL's E&P business. The deal also provides partnership with one of the most experienced and admired deepwater operators in the world, with an extensive track record of operating deepwater assets in some of the most harsh and difficult geologies in the world. We believe the deal will reinvigorate exploration intensity on RIL's prospects, along with adding to understanding and operations of the D6 block itself. With an exploration track record that is competitive with global benchmarks and an expansive exploration portfolio in place, we believe the market is discounting too much pessimism around this business.

We have built in a slower ramp up of production from E&P, with our FY12/13E production assumptions now at ~46mmscmd/50 mmscmd against 50/55 mmscmd earlier. This, along with deferment of full ramp up to 80 mmscmd to H2FY15 from H2FY14E earlier results in a reduction in our valuation of D6 to ~Rs170/share from ~Rs203 earlier.

**Exhibit 13: RIL gas production**



Source: IDFC Securities Research, Company

While we have built in flat production from D6 for FY12-13E as well as higher risk factors on the exploratory upsides owing to delays and uncertainties around timelines for development, we do not subscribe to the bearish view prevailing on D6. We also do not believe that the ongoing issues with raising output would lead to a permanent downgrade of recoverable reserves on the field.

*We do not see a permanent downgrade of recoverable reserves at D6*

#### Exhibit 14: RIL - E&P valuation

E&P Valuation	OOIP (mmboe)	Recovery (%)	Recovered reserves (mmboe)	EV/ Boe (\$/bbl)	EV (\$ m)	Per share	Comments
CBM	540	70	378	2.0	756	11.5	
KG-D6	2,930	69	2,008	5.6	11,160	169.6	Reduced by Rs30/share
NEC - 25	617	30	187	1.6	292	4.4	
PMT	174	100	174	12.9	2,237	34.0	
Marcellus	2,250	77	1,742	0.9	1,601	24.3	
Exploratory upside	16,292	6	986	3.3	3,283	49.9	Reduced by Rs28/share
<b>Total</b>	<b>22,802.4</b>	<b>24</b>	<b>5,473.7</b>	<b>3.6</b>	<b>19,518</b>	<b>293.8</b>	<b>Reduction of ~Rs58/share</b>

Exploratory upside	Unrisked resource (bn boe)	Risk weight (%)	Riskd resource (bn boe)	EV/ Boe (\$/ bbl)	EV (\$ bn)	Rs m	Rs/share
KG -D6	1.27	5.0	0.06	3.5	0.22	9,977.6	3.4
KG-D3	0.63	5.0	0.03	3.5	0.11	4,961.3	1.7
KG-D9	6.84	7.5	0.51	3.5	1.79	80,742.6	27.3
GS-01	0.07	5.0	0.00	3.5	0.01	551.3	0.2
CY-III-D5	0.84	5.0	0.04	3.5	0.15	6,615.0	2.2
MN-D4	4.90	5.0	0.25	3.0	0.74	33,075.0	11.2
KG-D4	0.70	5.0	0.04	3.0	0.11	4,725.0	1.6
MN-D10	0.70	5.0	0.04	3.0	0.11	4,725.0	1.6
Overseas	0.35	5.0	0.02	3.0	0.05	2,362.5	0.8
<b>Total</b>	<b>16.29</b>	<b>6.0</b>	<b>0.99</b>	<b>3.3</b>	<b>3.28</b>	<b>147,735.2</b>	<b>49.9</b>

Source: IDFC Securities Research, Infraline

#### Long-term outlook remains intact

With the kind of mindshare being expended by RIL on the various non-energy businesses over the last six months, one would naturally assume a slowdown in investments along the energy value chain. However, a perusal of pronouncements by RIL in the last one year will prove otherwise. RIL has announced substantial new investments along the petrochemical chain in particular, while the E&P business would also require an estimated US\$4bn-6bn in investments over the next five years, depending on the progress in exploration activity and the results thereon.

We expect the refining and petrochemical businesses to remain strong going forward, even as margins in the petrochemical business are muted due to the global oversupply and slowing growth in India due to the economic weakness. The E&P business remains a key monitorable, even as we see KG D6 volumes steady at ~45-50 mmscmd over FY12-13E, before slowly rising FY14E onwards.

## INSURANCE: A RACE GONE HAYWIRE, OR TIME TO BUILD?

- The contours of the industry changed post 1997, when private players were allowed entry
- However, the CY10 regulation on ULIPs has stalled the growth momentum
- Realignment of products, distribution channels in the offing
- We believe growth will be driven by demographics, savings rate and low penetration
- Focus on profitability, costs to be the key for RIL and other private players

### Private players add zing to the insurance space...

*Entry of private players and regulatory push led to 4x expansion of the sector...*

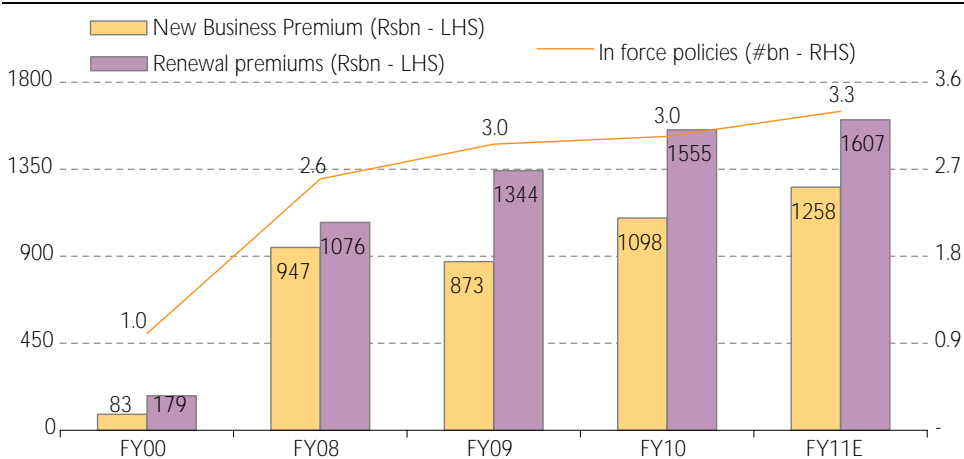
The contours of the insurance industry changed remarkably post 1997, when the sector was thrown open to the private sector, including foreign players (subject to certain restrictions). The resultant boom in insurance companies, and the subsequent regulatory overhaul of the segment, provided the impetus for a 4x expansion in sector penetration. We believe that a combination of factors led to the explosion in growth in the insurance sector:

- The advent of private players led to a spurt in product design, more aggressive marketing of insurance products and higher awareness of benefits of insurance
- The introduction of ULIPs gave the Indian middle class a readily acceptable proxy to participate in the booming equity markets
- Selling/ Positioning of insurance as a savings/ investment product rather than a risk cover

*...leading to a significant rise in premium income in FY00-11*

The above factors meant that premium income jumped substantially between FY00-11, as the number of policies also grew substantially.

### Exhibit 15: Explosive growth in Indian Life Insurance segment



Source: IDFC Securities Research, Life Insurance Council, IRDA

However, after the initial spurt and blue sky projections of growth and profitability, regulatory pressures and changing customer perceptions have tempered the enthusiasm around the sector.



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### ...but regulatory changes spoil the party

The single biggest factor behind the slump in the industry over the last few years has been the changes in the norms for ULIPs and pension plans that were introduced by the Insurance Regulatory and Development Authority (IRDA) in September 2010. The changes to lock in periods for ULIPs and guaranteed returns of 4.5% for pension products made the products less attractive for consumers and also made them difficult to market. Additionally, capping of incentives to distribution channels and surrender charges meant that economics of these products for insurance companies and agencies went downhill. This has resulted in a sharp drop in premiums and the number of policies issued over the last year or so.

*Premiums, however, registered a sharp drop in the past year...*

### The markets in a bearish mode; hurting fund performance

The economic downturn from FY09 onwards is another factor affecting demand for insurance products. A bearish stock market has adversely affected the performance of all equity linked investment products, including ULIPs. The BSE Sensex is in fact trading lower today than it was in January 2010, indicating muted returns for all equity linked products.

### Realignment of products, distribution channels in the offing

The current changes occurring in the sector should be beneficial in the long run, as a shift to more traditional products was long overdue. With ULIPs constituting more than 80% of new business premium for private players, the shift to more traditional products will improve the sales mix for insurers, in addition to:

*Changes in the insurance landscape hint at a return of traditional products...*

- De-risking the product portfolio towards a more steady asset class than only equity linked products
- Offering a different value proposition to customers
- Increasing persistency ratios, as the lock in period on traditional products is longer and customers do not view these as pure investment vehicles
- Allowing agents to make better returns as, under the new regulatory regime, commission charges and incentive structure for traditional products are higher than for ULIPs

*...led by new ULIP/ pension norms and capping of distributors' incentives*

*...which bodes well for both customers and agents*

The other aspect is the focus on strategic tie-ups with banks, which have gained tremendous importance for insurers in India. The recent IRDA norms also lay down the contours for Bancassurance tie-ups going forward, and we believe that this channel would play an important role in the insurance intermediation process over the next decade.

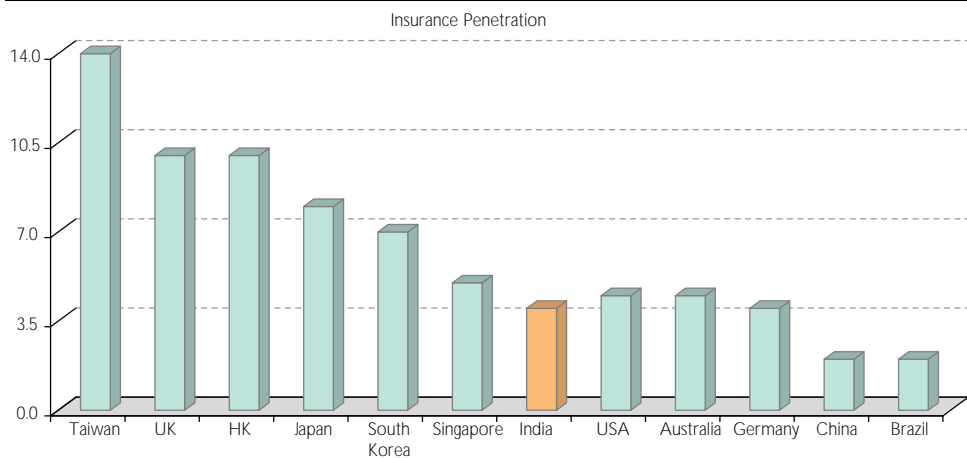
*Bancassurance channel to play a bigger role*

### The road ahead – potential intact and penetration story remains relevant

Despite the current setbacks, the potential of the insurance industry is not in any doubt. The demographic make-up of the country, inadequate social security, an extremely high savings rate, relatively low penetration and a growing income pattern should all drive growth of life insurance over the next decade or so. With penetration at ~4%, the insurance industry offers enormous scope for growth. Interestingly, penetration rate is still a 4x increase over the last decade or so, since the IRDA act came into existence in 1997 and allowed private players' participation in the life insurance segment. The resultant spurt in growth (185% CAGR in premiums for private players) benefited the incumbent monopoly LIC as well, which saw 20% CAGR in premiums over FY00-10.

*Inadequate social security, high savings rate and growing incomes imply high growth potential for the sector*

**Exhibit 16: Indian insurance penetration compared with other economies**



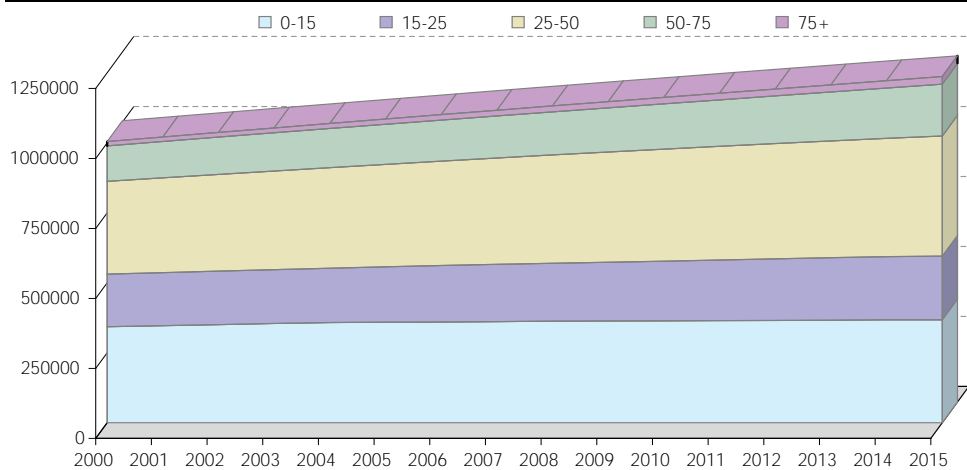
Source: IDFC Securities Research, IRDA, Life Insurance Council

### Demographics/ Savings behavior in favour of insurance sector

With > 45% of the population in the age group of 25-50 years and a savings rate of ~35% (among the highest in the world), the Indian market remains an extremely under insured market. While the advent of private players over the last 15 years has led to an expansion in both reach and volumes, the potential is largely untapped in view of the rapid expansion in economic growth, rise of the middle income group, and the absence of pure protection and pension plans indicating lack of awareness and marketing of these products.

*Spreading awareness of insurance products key to tap huge potential opened up by rapid economic growth*

**Exhibit 17: A high degree of population in the accumulation phase of income cycle**



Source: IDFC Securities Research, Global Demographics Ltd

### A high savings rate and no social security net – key growth drivers

A key factor that underpins the potential of insurance is the savings rate in the country, which has consistently stayed above ~32% for the last five years. More importantly, there exists a significant gap between savings and investments, which can be filled partly via the insurance route as a large majority of Indians remain under-insured. India remains a country without an effective social security net, with the result that a large section of population remains out of reach of any public support system, particularly in their old age. We believe that the absence of any government-sponsored social security system will continue to drive growth of insurance products over the next decade.

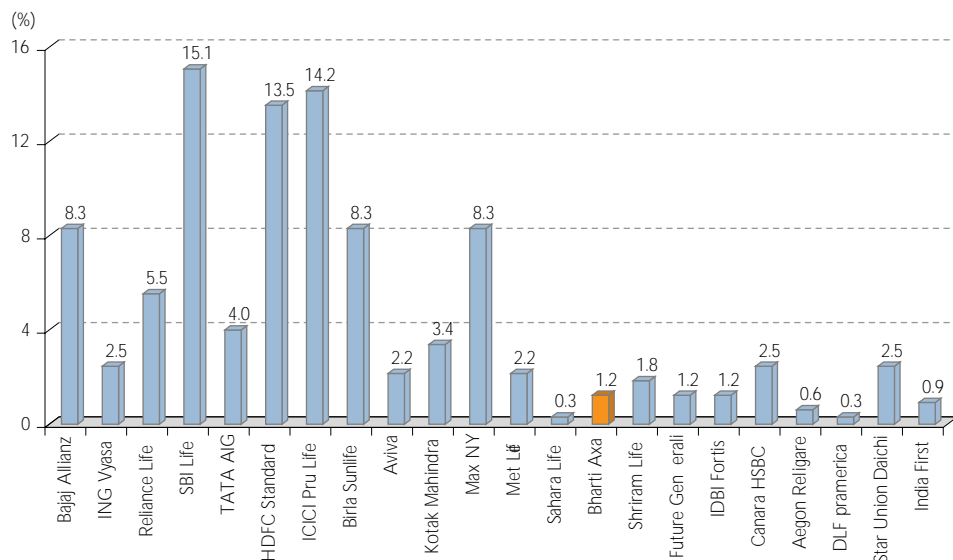
*Insurance players need to target the growing gap between savings and investments*

## Bharti Axa Life – one of the smaller private players

RIL entered the insurance segment through acquisition of Bharti's stake in Bharti Axa Life Insurance in June 2011, for a consideration of ~Rs22bn. With just ~1% market share among the private players, Bharti Axa life JV is one of the relatively smaller entrants in the Indian insurance space. Commercial operations for the player started only in 2006. FY11 saw the venture collecting premiums of Rs7.9bn while the general insurance arm collected gross direct premiums of Rs5.5bn.

*Life premiums of Rs7.9bn and general insurance premiums of Rs5.5bn clocked in FY11*

### Exhibit 18: ...and Bharti Axa among the smaller players

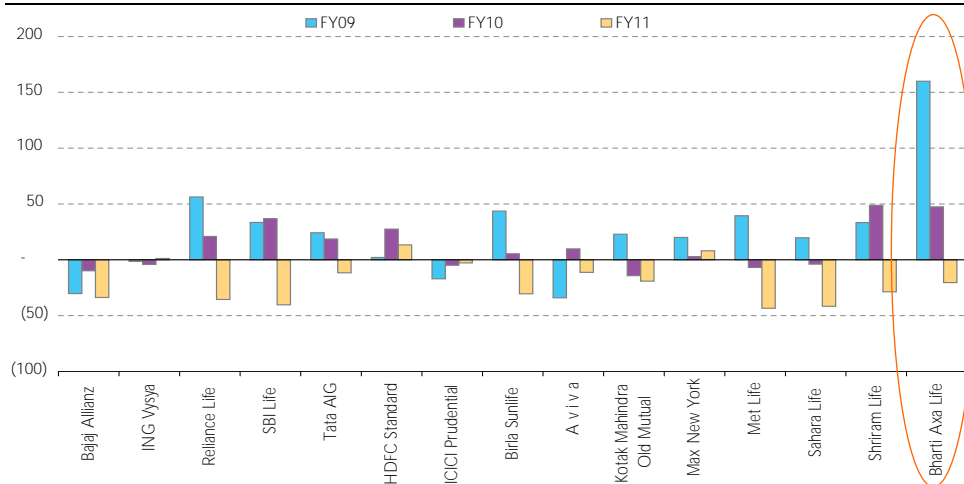


Source: IDFC Securities Research, Life Insurance Council, IRDA

With the slowdown in the broader sector, the venture has seen its business decelerate – in line with the broader industry trends - over the last few months. However, with RIL now acquiring Bharti's 74% stake, we would expect a larger capital infusion into the venture and more aggressive distribution roll-out. For RIL, the ability and intent to invest capital and management bandwidth into this segment will determine its future in the business.

*We expect RIL to significantly invest in the venture, leading to a more aggressive distribution roll-out*

### ...Exhibit 19: All players have seen a decline in premium income



Source: IDFC Securities Research, Life Insurance Council, IRDA

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## RETAIL: TIME FOR A MIDCOURSE CORRECTION?

- The sector has seen torrid times, with escalating costs and unviable formats leading to unsustainable business models
- Recent times have seen a midcourse correction, with closure of unviable formats and focus on costs/profitability
- Players now concentrating on growing private labels, renegotiating lease rental arrangements and minimizing formats
- RIL needs to avoid mistakes of the past; growth at the cost of profitability not a viable option
- Sustained focus on the backend infrastructure seen as the key to monetizing the Indian customer opportunity

### Too many players, too many formats

*RIL's teething problems in retail common to most players in the past decade...*

The advent of organized retail in the country was in anticipation of a significant boom in consumer spending as a result of the buoyant economic growth and the coming of age of the Indian Middle Class, an aspirational and upwardly mobile set of millions of people who were expected to deliver growth for retail for years to come. While all of the above expectations have been met, the retail sector has still not managed to make money, primarily because the number of players jostling for space in a crowded market place have been too many, and the wide range of formats experimented with by the players has turned out to be uneconomic and/ or unattractive to consumers. Hyper competition and too much experimentation have therefore meant that while volumes have grown for organized retail at a substantial pace, profitability has remained a challenge.

*...With a crowd of competitors and formats jostling for space*

### Competition led to unsustainable rentals

*Lease rentals in India rose 60% over FY05-07, reaching 4-5x that of the global average of ~6% of sales*

With competition getting into a no-holds-barred contest to grab the most lucrative locations and prevent other players from getting into the same space, lease rentals of store space at malls got to unsustainable territory. Globally, lease rentals typically form ~6% of total sales of a store, but in India lease rentals climbed more than 60% over FY05-07, to levels 4-5x that of the global average. This, coupled with lower commensurate volume growth, meant that economics of the business went for a toss over this period.

### Opex costs increased to very high levels

*Opex costs, driven up by aggressive store openings, caused huge drag on margins*

With simultaneous entry of a host of players, their operating costs, specifically manpower costs, rose rapidly for over the last four years. Aggressive store opening plans meant that manpower costs rose to more than 6-7% of sales, again much higher than global rates. This has also created a significant drag on margins.

### Backend – the Achilles' heel for all

In the frenzy to expand at any cost, most players overlooked investment in what is the life blood of the business - the back end, i.e. logistics infra, technology platform and supply chain management. This resulted in inventory mismatch, over and/ or under stocking, poor SKU management, etc. This also contributed to perception issues, as customers walking into an organized retail outlet would expect fresher and more varied items than the neighborhood store.

---

## But, things are changing

Retailers, at least the larger ones, have finally turned their focus on profitability and players are also aggressively closing stores, renegotiating lease rental arrangements (moving to revenue share from fixed cost formats) while also making significant investments into the back end. In a hard-to-survive scenario, players with inherently unprofitable business models and/ or weak balance sheets have exited the business, further helping the sector streamline itself.

*...which led to players upping investments for boosting their sourcing chain and logistics set-up*

- The focus on profitability has seen more use of analytics to understand and adapt to changing customer behavior
- Manpower costs being controlled tightly through a combination of lower hiring and emphasis on increasing productivity
- Increase in backend investment: Sourcing chain, technology and logistics set-up are being ramped up considerably

## RIL betting on the potential of retail

Despite witnessing frenetic growth over FY05-09, organized retail constitutes ~5% of the estimated US\$400bn-500bn retail space in the country. With the improvements being put in place, we see no reason why this share should not triple over the next decade. A US\$50bn opportunity awaits RIL then, and this is the reason why the group chairman sees value creation potential in the business. Even if RIL were to capture ~10% share of this incremental growth, the retail venture could be a US\$5bn business by FY20E, and that is material enough even for a company the size of RIL.

*Organized retail just 5% of India's US\$400bn-500bn retail space...*

*...which implies a US\$5bn opportunity for RIL by FY20E*

While the above may be a simplistic way to look at the numbers involved, they do provide a sense of the rationale behind investing in the retail business in India. However, with PAT margins only at ~3%, we would await further trends to emerge on profitability to venture a guess on impact of the business on RIL's return ratios.

*PAT margins in the space is just 3%; we wait for trends to mature to put a number on return ratios*

## What needs to happen though, to make this work?

We have highlighted above the sheer scale and potential of the organized retail opportunity. Having said that, we believe a number of things went wrong for RIL in the past, some of which it needs to avoid while trying to reinvigorate this segment.

- Break-neck expansion announcements, which push up lease rentals/ real estate costs in the target market, which adversely affects the economics
- Runaway operating costs, which did not deliver on productivity parameters
- Too many formats at one go, which stretches management and supply chain bandwidth and does not deliver profitability
- Limited differentiation on supply chain, creating inefficient pricing power, which is what has set the likes of Wal-Mart apart from the competition globally

We believe that several factors need to work in concert for a re-rating of the sector from current environment:

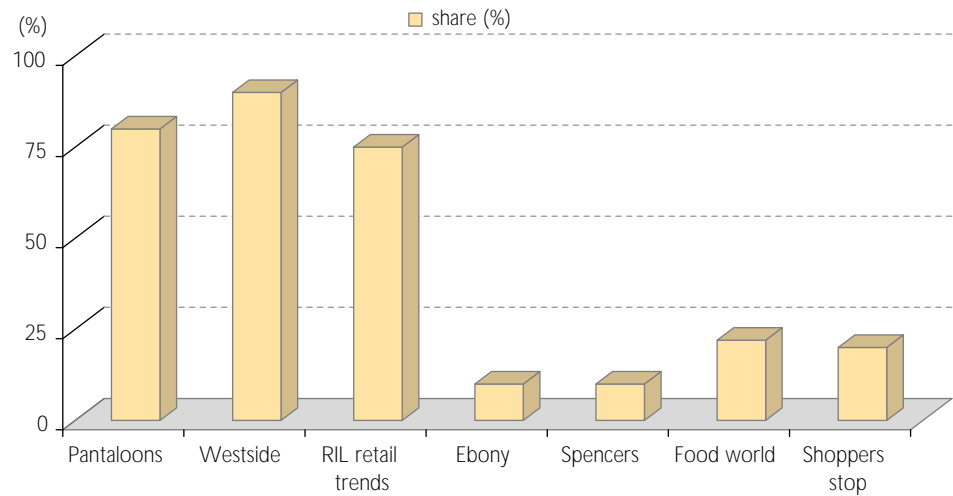
### *Growth of private labels in the portfolio of retailers*

The problems faced in merchandising, and the resultant losses have meant increasing willingness for Indian retailers to control the product value chain from production to delivery, and hence the growing trend of private labels among the product portfolios of

*RIL's 'Trends' format has been a frontrunner in the area, with 75% of sales coming from private labels*

major retailers. Further, private labels as a percentage share of total occupy only ~12% of Indian retailers' products, as against an average of >17% globally, leaving ample opportunity for Indian players to ramp up this segment. RIL Retail's 'Trends' format has been a frontrunner in this area, with a whopping 75% of sales coming via private labels, with only Pantaloons and Westside higher among the national chains.

**Exhibit 20: Private labels as a % of sales**



Source: IDFC Securities Research, Company

### ***Successful renegotiation of rental arrangements***

The most important consequence of the economic slowdown has been the closure of several unprofitable stores as well as the exit of some players altogether, which validates that the existing rental arrangements are not sustainable. Hence, many players have started to renegotiate arrangements and have moved to a revenue-share arrangement that shares some of the risks and rewards of the store with the land owners. This at least alleviates some burden during the lean periods, while also reducing the upside during bullish times for the retailers.

### ***Significant focus on costs***

Some of the big retailers, including RIL, in the past had paid a large amount of money to attract top talent. This did not result in expected gains, as poorly planned expansions and inadequate investments into backend resulted in bloated costs and an inefficient supply chain. In this round, retailers such as RIL need to focus on creating a leaner costs structure, specifically in the employee cost segment, while also focusing on driving productivity increases.

### ***Invest in the supply chain!***

Significant investments in the backend are an absolute necessity if big retailers have to create a differentiating factor with other local retailers. This is an area where organized retail has faltered in the past, and we believe focus on the following would be a key driver of profitable growth going forward:

- Direct product sourcing from farm gate/producer
- Efficient store formation
- Warehousing, distribution and logistics

*Many players have been moving to revenue-share arrangements, a trend boosted by the economic slowdown*

*An efficient back-end would prove to be a key competitive edge for serious players in organized retail*

- 
- ERP systems and supporting infrastructure
  - Storage and fulfillment, store replenishment of inventory

***Consumer sentiment remains buoyant***

Favorable demographics, rising incomes and a consistently growing economy have been taken so much for granted for the last decade that any slowdown is unlikely to be treated as more than a blip by even the most pessimistic of economists. The retail story is closely tied-in to India's economic fortunes and, therefore, the expected per capita income CAGR of ~13% implies strong growth prospects ahead for India's retail sector.

*Notwithstanding the ongoing slowdown, the per capita income CAGR of ~13% bodes well for retail growth*

At ~US\$450bn, India is estimated to be among the top 10 retail markets in the world and is growing at the rate of 20-22% every year, as per our retail research team. If we were to assume the current rate of growth for organized retail (~20-25%) would continue for even the next decade, the share of organized retail would grow to ~17%, implying a market opportunity of US\$115bn+ for RIL to cater to over the next five years. Even at ~7% market share and a 3.5% PAT margin, this translates to a US\$8bn revenue and US\$0.3bn PAT segment, a not immaterial opportunity by any means!

## BROADBAND: TECHNOLOGY AT THE FOREFRONT

- The re-entry into telecom was widely expected
- Huge opportunity, with just ~1% broadband penetration in the country
- Data services gaining a lion's share of telecom company revenues globally, trend expected to be replicated in India
- A bullish scenario sees RIL generating US\$1bn EBITDA from the business by FY17E
- Choice of technology the key monitorable; the LTE platform adopted is a relatively newer technology globally

### RIL had been looking at re-entry into the telecom space for some time

RIL announced its entry into the telecom/ technology space by acquiring a substantial stake in Infotel Broadband Services (P) Ltd, which emerged as a successful bidder in all the 22 circles of the auction for Broadband Wireless Access (BWA) Spectrum conducted by the DoT. RIL has invested ~Rs48bn by way of subscription to fresh equity capital at par to be issued by Infotel Broadband. Post this investment, RIL owns 95% of the equity and Infotel Broadband will be a subsidiary of Reliance Industries. Infotel, the only company to successfully obtain an All India license, gets access to 20 MHz of broadband spectrum for a consideration of Rs128.5bn.

*RIL has expressed its intent to enter telecom and is targeting the highly under-penetrated broadband market*

Post the scrapping of the non-compete arrangement with Anil Ambani owned Reliance Natural Resources Ltd (RNRL), RIL has been considering various business opportunities and a foray into telecom was widely expected. RIL has indicated that it is looking to provide broadband services using the LTE (Long Term Evolution) technology platform, a next generation technology which can be scaled up on the GSM platform unlike the requirement of setting up parallel infrastructure for Wimax. But, the LTE platform is still evolving and will take at least a couple of years to mature. Infotel is targeting launch of services in H2CY11E. RIL has indicated its intent to share passive infrastructure with other players in the space, while also entering into strategic partnerships with equipment suppliers to support its "asset light" strategy going forward.

### The opportunity is undeniable

The opportunity in the Indian broadband space is formidable, with a penetration rate of ~1% (only 12.5m subscribers). With the government targeting 100m subscribers by 2014, growth prospects seem robust. RIL does have the opportunity to play a game changing role in the Indian data services market, similar to what it had achieved when it launched CDMA services in the country back in 2000-2001. With BWA and 3G auction prices at extremely competitive rates compared to global benchmarks of US\$/MHz/population (US\$0.06 vs US\$0.5-0.7 elsewhere), the license costs are not prohibitive.

Further, with LTE platforms rapidly gaining credence across the world, the technology providers and equipment suppliers necessary to create the new ecosystem for the platform will be in place sooner later. The payment terms that have been disclosed indicate that RIL pays out ~Rs130bn (Rs48bn for equity in Infotel and an additional Rs80bn for the License) upfront, using 50% own equity and 50% debt. However, while material revenues and therefore cash flows from this segment will take at least 4-5 years

*Broadband penetration is just ~1%, plus the government is looking to cover 100m subscribers by 2014...*

*...which promise RIL Rs80bn in revenues and Rs25bn EBITDA by FY17E*



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to fructify. We believe the company could potentially generate Rs80bn in revenues and Rs25bn in EBITDA by FY17, assuming it grabs ~30% share of the data/broadband market.

### Rapid growth expected in data services

With the advent of 3G and Wimax/ BWA, the technology environment in Indian telecom, both in voice and data segments, is set to undergo a massive transformation. We believe the next wave of growth in India will come from scale-changing increase in the non-voice segment, and this is the area that RIL is looking to tap going forward. As per latest TRAI subscriber data for July 2011, India currently has only 12.5m broadband subscribers, up 28% yoy. Broadband subscribers account for ~60% of the total internet subscribers and are expected to be the major driver of growth in internet penetration (currently just ~1.7% of the population; ~8% of households). On the other hand, stupendous growth in mobile telephony and availability of affordable GPRS-enabled handsets has led to a surge in subscribers using data services on mobiles (~381m in Mar 2011 vs 178m in March 2010).

*We believe the next wave of growth in telecom will come from non-voice...*

What this implies is that broadband subscriptions could see the kind of phenomenal growth that has made the Indian mobile phone market a huge success story. Industry estimates point to total broadband subscribers growing to 100m from 12.5m currently over the next five years. We believe the enormous growth potential of broadband services in India would be largely met by the development of wireless technologies. Due to higher cost of laying a fixed line network, the wireline subscriber penetration in the country has been restricted and the absence of unbundling of local loop has slowed down the progress of private players as well. We believe the growth of broadband data services would be similar to mobile telephony in India which was boosted by development of affordable devices and competitive tariffs on the back of increasing competition. RIL, as the only player with an All-India License, is thus in a unique position to tap this impending revolution, with its intent to roll out a Pan-India network within the first 2-3 years. RIL intends to deploy ~20,000 towers at a cost of ~US\$1bn over the next two years to establish this network, assuming sharing of assets with existing tower companies.

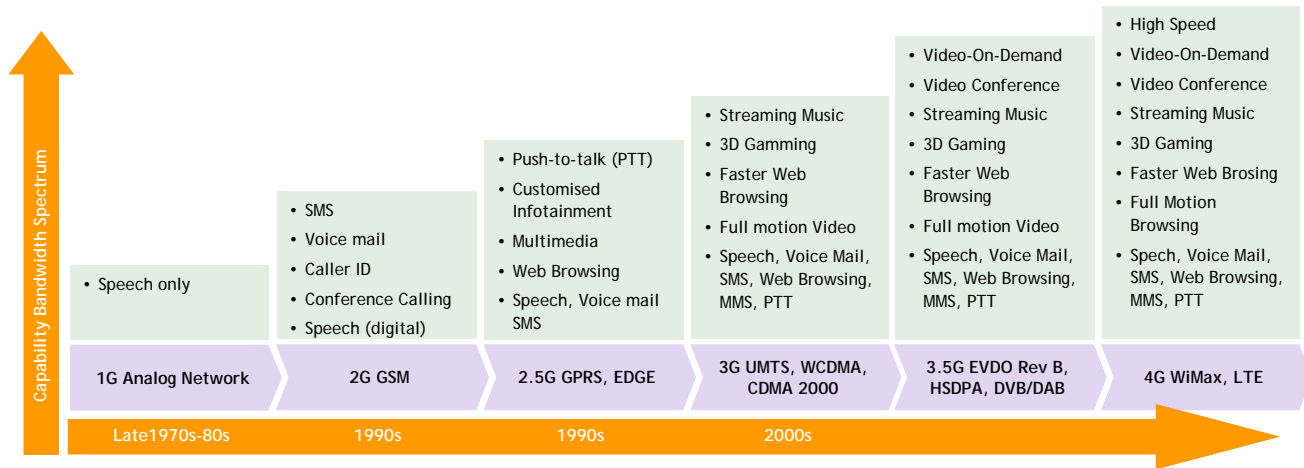
*...possibly replicating the success story of Indian mobile telephony*

*RIL, the only player with an all-India license, is best positioned to tap the explosion in wireless broadband*

### Choice of technology is crucial - Is LTE the next big thing?

LTE is a part of the GSM evolutionary path beyond 3G technology, following EDGE, UMTS and HSPA. The overall objective for LTE is to provide an extremely high performance radio-access technology that offers full vehicular speed mobility and that can readily coexist with HSPA and earlier networks. Because of scalable bandwidth, operators will be able to easily migrate their networks and users from HSPA to LTE over time. LTE assumes a full Internet Protocol (IP) network architecture and is designed to support voice in the packet domain. However, similar to 3G, LTE systems will coexist with 3G and 2G systems in an integrated network. Multimode devices would be developed to function across LTE/3G or even LTE/3G/2G, depending on market circumstances. LTE uses Orthogonal Frequency Division Multiple Access (OFDMA) on the downlink, capable of delivering peak data rates of up-to 270mbps with 20MHz bandwidth, which is what RIL has managed to obtain as part of its All-India License.

## Exhibit 21: The LTE framework



Source: IDFC Securities Research, Company

### Broadband could be a billion dollar business in five years

*With its all-India license, RIL should be able to capture 30-35% of the multi-billion dollar market by FY17E*

With the growth in broadband expected to explode over the next five years, we believe the potential size of the broadband, or total non-voice, segment could increase to Rs290bn-300bn over the next five years, assuming a total subscriber base of 45m and an average ARPU of Rs550 pm. Given the dominant nature of RIL's license and the plans to quickly roll out a pan-India network, we expect RIL to capture up to 30-35% share of the non-voice market by FY17, implying a revenue base of ~Rs89bn and EBITDA of ~Rs35bn. These estimates lend comfort on management's guidance of turning cash positive in this business in the next four years or so.

### Exhibit 22: RIL BWA business - to generate US\$1bn EBITDA by FY17E?

	No of subs m	ARPU Total revenues		RIL's market share		EBITDA	
		Rs pm	Rs bn	%	Rs bn	% margin	Rs bn
Base	45	550	297	30	89	40	35.6
Median	50	550	330	33	109	45	49.0
High	65	600	468	35	164	50	81.9

Source: IDFC Securities Research, Company

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## INSTITUTIONAL FINANCIAL SERVICES: TOO CROWDED!

- A natural attempt to leverage the economic growth and rising incomes
- DE Shaw an experienced global operator, with history of effectively using technology to broaden the service offering for customers
- However, the current state of the industry slightly vulnerable, with too much competition and weak equity markets adversely affecting profitability
- Diversification into related areas such as real estate broking and focusing on online delivery of services to reduce capital requirement, we believe, would be the way going forward

### Leveraging DE shaw's US experience

In addition to straddling retail, broadband, telecom and insurance, RIL also wants to cash in on the rising incomes and economic growth in the country by venturing into the Institutional brokerage, investment banking and private equity space. RIL recently entered into a JV with DE Shaw to cover the entire gamut of financial services including:

- Private equity
- Investment banking
- M&A advisory
- Asset management

The venture is already operational, and plans to launch an India-specific, sector-agnostic private equity fund by the end of the year. Further, infrastructure for trading Indian equities and futures to support the institutional broking business will be set up by the middle of next year, with plans to make it operational from FY13E. The new firm will target local institutions and high net worth individuals.

DE Shaw is an internationally diverse financial and technology group, with nearly US\$21bn in investment capital. The firm specializes in using a combination of class leading quantitative models and qualitative research to advise clients on investment strategy, and is known for leveraging technology platforms and online services to boost service offering to clients. An instance is a service offering developed by DE Shaw, where broking and banking was offered online to customers (under "Farsight Financial Services"). This business was later taken over by Morgan Stanley to be adopted as the base of its online service platform. The company would be looking to do the same in India, combining innovation in products and the leveraging of upcoming broadband network of RIL to deliver the same to customers.

### Indian asset management and investment banking space currently in flux

While the credentials of the entities running the JV are impeccable, what is of concern is the state of affairs in the brokerage and investment banking business, which is one of the focus areas for the new entity. The mutual fund industry has seen redemptions overtaking investments as stock markets have weakened. The brokerage and investment banking industry has seen yields drop due to competitive pressure and weak market performance, even as volumes have continued to grow - particularly in the derivative segment.

*Armed with a JV with DE Shaw, RIL is looking to cover a wide spectrum of the financial services industry...*

*...with plans afoot to set up an India-specific, sector-neutral PE fund by the end of the year*

*...but might run into a host of problems in brokerage and investment banking due to the weak stock market*

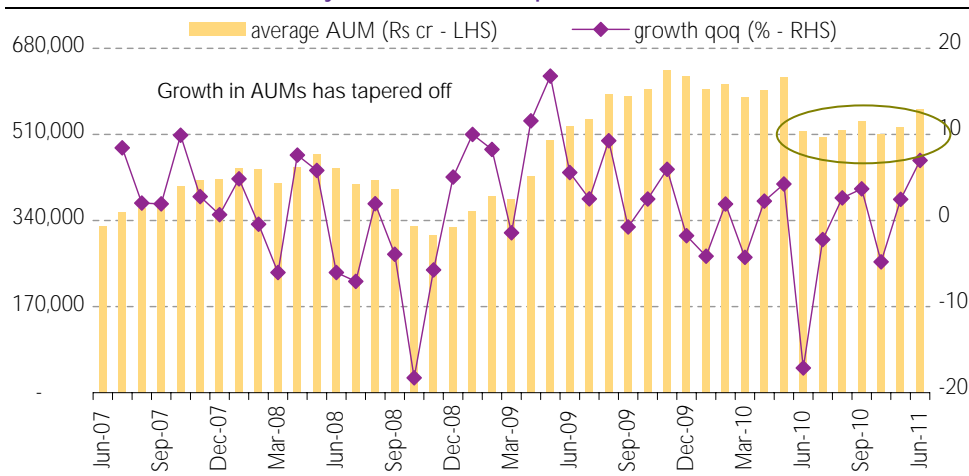
*Commissions have dipped sharply both in brokerage and investment banking...*

*... hit by a shift in transactions from cash to derivatives*

Over the past three years, the size of the commission pool for stockbrokers has not grown at all, although operational costs and competition have gone up. From Rs150bn in FY08, commissions went down to around Rs90bn a year later and now hover in the range of Rs110bn-130bn. A similar situation prevails in the investment banking business, where the commission pool has hovered between Rs35bn-45bn for the last three years. Notably, the drop in yields reflects the changing nature of transactions in the Indian equity markets, wherein trades have moved substantially away from the cash segment to the derivatives segment. Yields in the derivatives segment are typically a fraction of yields in the cash segment, thereby affecting profitability of all players.

The weakness is reflected in the performance of mutual funds as well, where AUMs have struggled to grow meaningfully over the last two years. More importantly, the equity part of AUMs has been especially sluggish, reflecting the pressure on the markets over this period.

**Exhibit 23: While the MF industry has seen AUMs drop**



Source: IDFC Securities Research, Company, Bloomberg

### What could the RIL- DE Shaw JV do to grow the business?

With the industry facing tough times, established players in the brokerage space are diversifying their revenue streams and widening product profiles. They are also focusing on the retail segment to offset sluggish margins from the institutional business. Further, newer products in the markets are expected to boost volumes, even though the primacy of equity markets is unlikely to go away anytime soon.

*DE Shaw mulling expansion into real estate broking and infra financing to sail through the challenging environment*

- Established players are foraying into real estate broking and infrastructure financing; something that DE Shaw is anyways contemplating
- Volumes are growing in commodity trading and the currency markets, and this is an area that the JV may get into once base operations are underway
- Substantial expansion of retail distribution network would be required to grow the retail business; this could be also handled through reaching more customers online, which seems to be the preferred way to go for the JV

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## APPENDIX

### CAG audit: Final version points fingers, but milder than expectation

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Recent news flow around RIL has not been particularly encouraging, and the CAG performance audit dealing with the production sharing contracts of three large privately operated blocks, KG D6, Cairn India's Rajasthan asset and the Panna Mukta Tapti (PMT) fields, has added to the pain. A draft report which got leaked was found to be very critical of RIL with respect to the field, with some findings apparently insinuating 'gold plating' of capex and opex, as also errors in complying with other PSC norms relating to the relinquishment of unexplored area on the block post the expiry of the stipulated time period.

However, the final report which was submitted to the Parliament, which includes rebuttals and clarifications from DGH, MoPNG and RIL, has toned down the allegations. While the findings remain critical of the way RIL was allowed to retain the whole area of the block despite not having carried out drilling activity, the allegations of 'gold plating' or fudging of expenditure are not so harsh. Summary findings of the CAG are presented below:

- RIL failed to relinquish ~25% of the contract area post completion of phase I activity of the D6 prospect. Here, DGH and MoPNG have stated that since the resources on the discovered area were found to be contiguous in nature, the area even beyond the eligible block was allowed to remain with RIL. RIL, therefore, hoarded acreage and violated the PSC
- DGH should have stopped work on Phase II: DGH response is same as above.
- DGH and MoPNG are ill-equipped to monitor the production sharing contracts in their entirety: resources are not enough to monitor each aspect of the contract procurement process
- CAG has recommended scrapping of the investment multiple method altogether and moving to a fixed percentage profit share system
- More specifically on capex and opex, RIL has been accused of over-stating opex by ~US\$200m

In response to the allegations, RIL has pointed out the extensive audits and benchmarking studies performed by internationally credible consultants. RIL has issued a press release indicating that all these studies point to D6 as being one of the best managed projects of its kind in the world. RIL had engaged Ernst & Young (E&Y), a global consulting firm; IPA Inc., an industry leader in quantitative analysis of project management systems; and Daniel Johnston & Co. Inc., an independent US based consulting firm with experience of working with 40 governments and numerous independent oil companies worldwide. Brief highlights of the three reports indicate the positive impression that the consultants have drawn from the D6 project.

#### E&P. (procurement audit and confirmations that cost was correctly allocated to the KG-D6 project)

- No evidence of over-statement of costs

- Confirmation of transaction documentation and authenticity from ~92% of the vendors for transactions of >US\$10m
- Only ~1% of transaction costs of US\$8.2bn was through related parties

#### **IPA (global benchmarking)**

- On five essential criteria i) cost overrun, ii) cost competitiveness, iii) execution, iv) schedule competitiveness, and v) operability, the project was deemed successful
- Successful outcomes on cost growth, cost competitiveness, operability performance and schedule competitiveness
- It rated the KG-D6 FDP as being very comprehensive when compared with industry standards, besides being more detailed than other similar Asian projects

#### **Daniel Johnston (comment on the CAG report)**

- The appraisal activities which RIL has carried out in relation to the various discoveries in the KG-D6 block are consistent with the letter and spirit of the commercial provisions of the KG-D6 PSC. These discoveries were appraised sufficiently and in a manner consistent with good international petroleum industry practices (GIPIP)
- Extensive drilling, seismic and geological activity undertaken in the KG-D6 make the block one of the most extensively appraised frontier, ultra-deep water blocks in the world. With advances in seismic technology, seismic test data is almost on par with actual well drilling results, specifically when tied up to existing well information, as was the case for D6
- The final cost of Phase-1 appears to have been within 10% of the estimate of costs given in the AIDP. This is well within any reasonable margin of error and is accommodated in the PSC
- The petroleum fiscal system currently in force in India does not create any incentive for the contractor to indulge in overspending
- The exploration, appraisal and development operations carried out by RIL in the KG-D6 block are entirely consistent with GIPIP. Based upon the technical (G&G) data available at the relevant times, DGH's decision to treat the entire block as a Discovery Area was a reasonable decision fully supported by the data and the situation.
- The actions taken by RIL, the Management Committee and the DGH are fully consistent with the relevant provisions of the PSC

By bringing in global heavyweights to benchmarking against most global projects of this size, as well as commenting on its operational activities being in line with the PSC, RIL is seeking to offset discussions around 'gold-plating' of capex and deliberate slippage in project costs and timelines. It is also significant that the Daniel Johnston report has stated multiple times that the project activity was carried out in line with PSC provisions, as it seeks to shift the discussion to the PSC structure itself and the current cost/ profit sharing mechanism.

This is also what the CAG report alluded to in its audit report by picking flaws in the structure if E&P contracts itself under the NELP regime. We believe the reports will provide a strong defense to RIL against the allegations floating around excess expenditure. However, the other issue of non-relinquishment of ~25% of the contract

area post Phase I is a difficult one, as the interpretation/ acceptance of seismic data instead of physical wells drilled might be taken differently by the government than what the DGH and the Johnston report have taken.

While deliberation on the nature of PSC itself is an extremely complicated issue, we believe suggestions made on scrapping the PSC system altogether and not having an investment multiple are in variance with similar systems followed in most developed energy markets in the world. In fact, the profit sharing systems followed by the government are quite competitive compared to other systems globally. We also find it difficult to agree with the assertion that non-relinquishment of the contract area led to revenue losses for the government, as this assumes there were operators willing to take up exploration activity on that block - which is not the case.

Also, it is difficult to see how the government can move to a system which provided an even lesser incentive to E&P players to invest in India's upstream sector, which anyways suffers from limited interest from international majors. Overall, the report is very clearly not a big negative for RIL, as the stress is more on the system and contract structuring of the country than on specific players. We do not see any material impact of this report on RIL, and in fact see it as materially damaging to the exploration and production sector in the country

## Non energy business – Additional charts

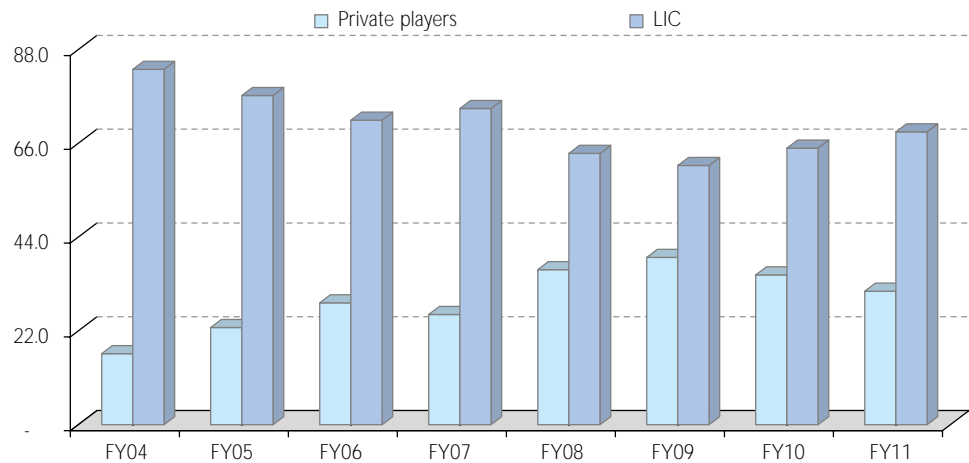
### Life Insurance

#### Exhibit 24: Summary of regulatory changes

Change	Impact
Remuneration to Corporate agents in the form of commission only	Lowered annual incentives for agents, average commissions to drop to 8-10% from ~20-25% earlier
Minimum lock in period increased to 5 years from earlier levels of 3 years	Investors looking at ULIPs as an investment product will be discouraged, will have a negative impact on sales
All Products to compulsorily have minimum mortality or health cover	The flexibility of products reduces somewhat;also the economics of a products changes for insurers
Minimum premium payment period of 5 years from 3 years earlier	Investors looking at ULIPs as an investment product will be discouraged, will have a negative impact on sales
<b>Pension products</b> I. to carry a guaranteed return of 4.5% II. guaranteed return payable on maturity III. No partial withdrawal allowed during accumulation phase IV. Compulsory annuitisation of 2/3rd of accumulated fund value on vesting date	Drastically changes the economics of the product for insurers, also reduces the propensity of customers to again see the product as a short term investment

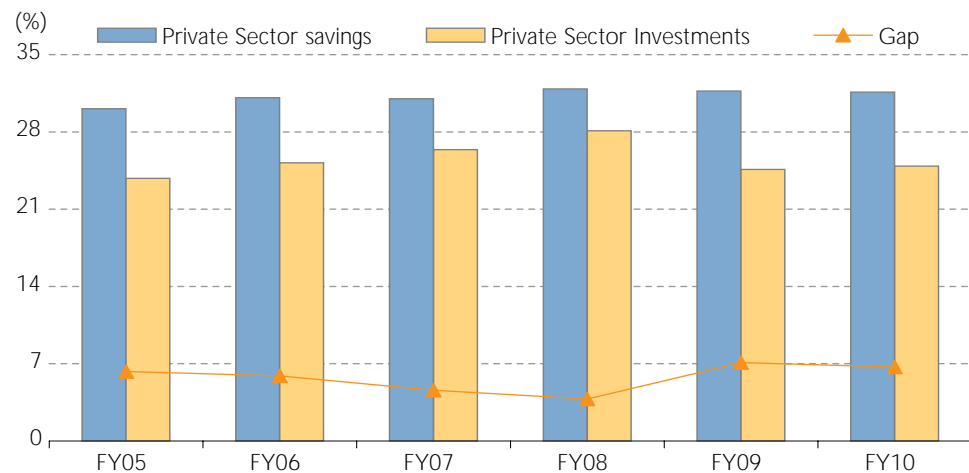
Source: IDFC Securities Research, IRDA, Life insurance council

**Exhibit 25: Private players have only ~35% market share, after a decade of operations...**



Source: IDFC Securities Research, Life Insurance Council, IRDA

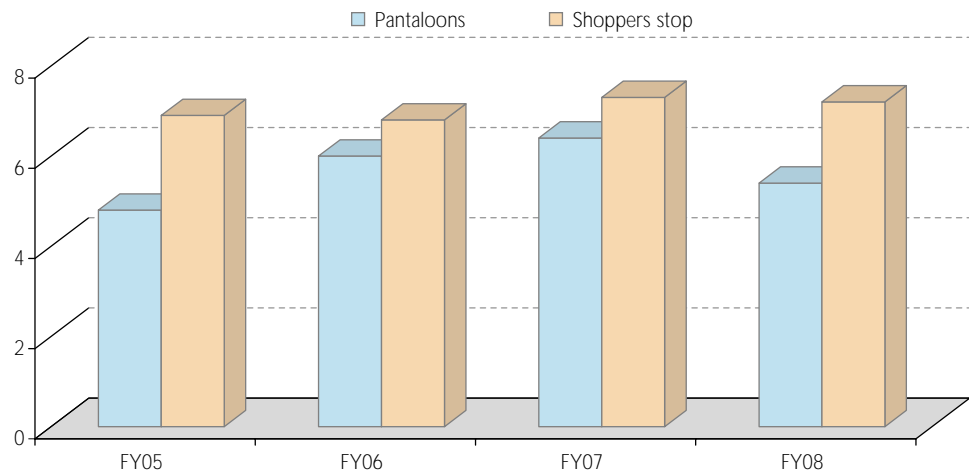
**Exhibit 26: India's gross savings have remained at ~33% over the last decade**



Source: IDFC Securities Research, Global Demographics Ltd

## Retail

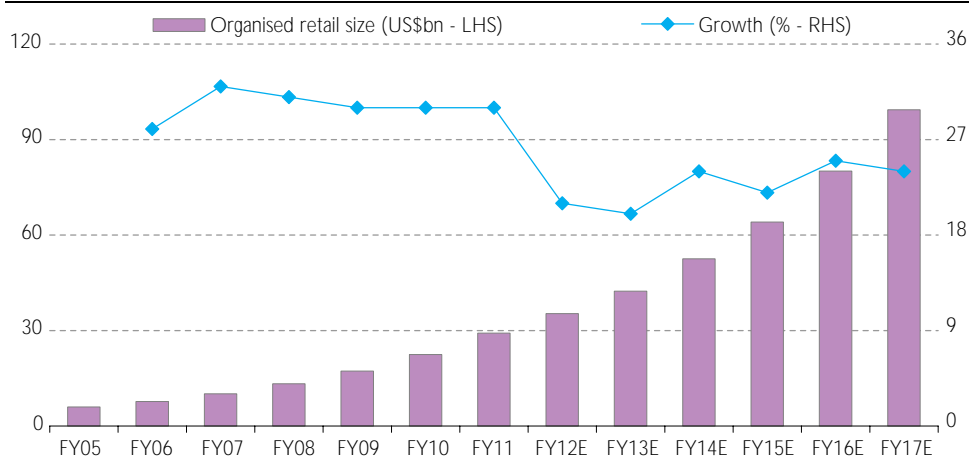
**Exhibit 27: Manpower costs, a big drag on profitability**



Source: IDFC Securities Research, Company annual reports



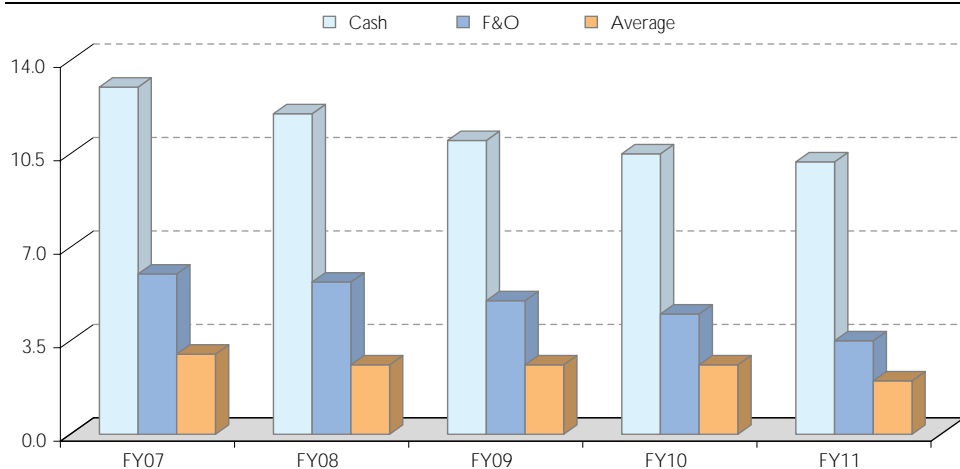
**Exhibit 28: The organized retail space**



Source: IDFC Securities Research, Industry sources

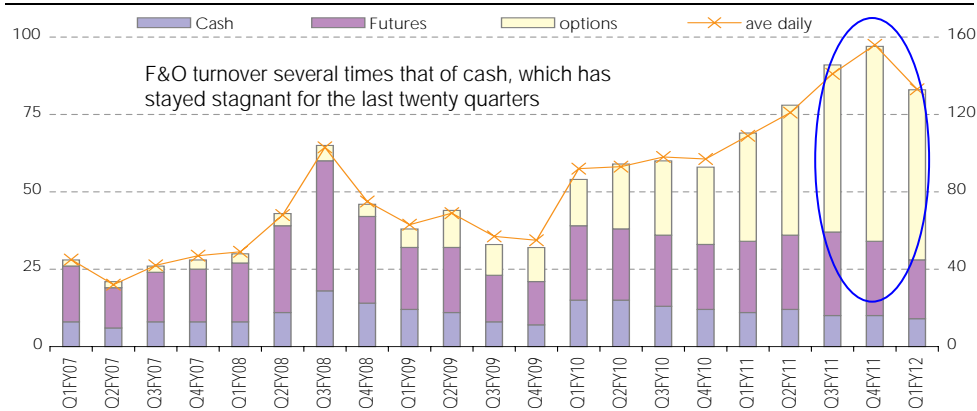
## Financial Services

**Exhibit 29: The brokerage industry has seen yields soften...**



Source: IDFC Securities Research, ICRA, Bloomberg

**Exhibit 30: ...reflecting the skewed growth in volumes**



Source: IDFC Securities Research, ICRA, Bloomberg

### Income statement (consolidated)

Year to 31 Mar (Rs bn)	FY09	FY10	FY11E	FY12E	FY13E
<b>Net sales</b>	<b>1,512.2</b>	<b>2,037.4</b>	<b>2,658.1</b>	<b>2,871.9</b>	<b>2,842.2</b>
% growth	10.3	34.7	30.5	8.0	(1.0)
Operating expenses	1,278.0	1,728.5	2,268.5	2,506.6	2,455.5
<b>EBITDA</b>	<b>234.2</b>	<b>308.9</b>	<b>389.6</b>	<b>365.3</b>	<b>386.7</b>
% change	1.2	31.9	26.1	(6.2)	5.8
Other income	19.1	21.9	25.4	52.7	72.0
Net interest	(18.2)	(20.6)	(24.1)	(37.1)	(28.4)
Depreciation	77.1	109.5	141.2	95.7	103.3
Pre-tax profit	178.7	200.7	249.7	285.2	326.9
Deferred tax	16.5	11.3	-	-	-
Current tax	12.7	31.3	47.8	64.2	73.6
<b>Profit after tax</b>	<b>149.5</b>	<b>158.2</b>	<b>201.9</b>	<b>221.0</b>	<b>253.4</b>
Preference dividend	-	-	-	-	-
Minorities	-	0.8	0.2	-	-
Non-recurring items	-	86.0	-	-	-
Net profit after non-recurring items	149.5	245.0	202.1	221.0	253.4
% change	(23.4)	63.9	(17.5)	9.4	14.6

### Balance sheet (consolidated)

As on 31 Mar (Rs bn)	FY09	FY10	FY11E	FY12E	FY13E
Paid-up capital	13.7	27.5	27.5	27.5	27.5
Reserves & surplus	1,198.8	1,321.5	1,491.5	2,004.3	2,193.4
Total shareholders' equity	1,213.9	1,350.4	1,520.4	2,033.2	2,222.2
Total current liabilities	388.7	371.6	453.7	520.2	540.6
Total debt	762.6	688.6	573.8	584.1	438.7
Deferred tax liabilities	95.5	95.5	95.5	95.5	95.5
Total liabilities	1,246.8	1,155.7	1,122.9	1,199.8	1,074.8
<b>Total equity &amp; liabilities</b>	<b>2,460.7</b>	<b>2,506.2</b>	<b>2,643.3</b>	<b>3,233.1</b>	<b>3,297.1</b>
Net fixed assets	1,808.9	1,878.7	1,823.1	1,772.6	1,749.7
Investments	64.4	64.4	64.4	64.4	64.4
Total current assets	587.5	563.1	755.9	1,396.1	1,483.0
Working capital	198.7	191.4	302.2	875.9	942.4
<b>Total assets</b>	<b>2,460.7</b>	<b>2,506.2</b>	<b>2,643.3</b>	<b>3,233.1</b>	<b>3,297.1</b>

### Cash flow statement

Year to 31 Mar (Rs m)	FY09	FY10	FY11E	FY12E	FY13E
Pre-tax profit	178.7	200.7	249.7	285.2	326.9
Depreciation	77.1	109.5	141.2	95.7	103.3
Chg in working capital	230.2	(102.8)	(5.0)	(33.4)	8.5
Total tax paid	(12.7)	(31.3)	(47.8)	(64.2)	(73.6)
Operating cash inflow	473.2	176.1	338.1	283.3	365.2
Capital expenditure	(719.6)	(179.3)	(85.6)	(45.2)	(80.4)
Free cash flow (a+b)	(246.4)	(3.2)	252.5	238.1	284.8
Chg in investments	51.5	-	-	-	-
Debt raised/ (repaid)	255.6	(74.0)	(114.8)	10.4	(145.4)
Capital raised/ (repaid)	151.6	-	-	-	-
Dividend (incl. tax)	(22.2)	(22.5)	(32.2)	(32.2)	(64.3)
Misc	(7.5)	(10.5)	0.2	324.0	-
Net chg in cash	182.7	(110.1)	105.7	540.3	75.0

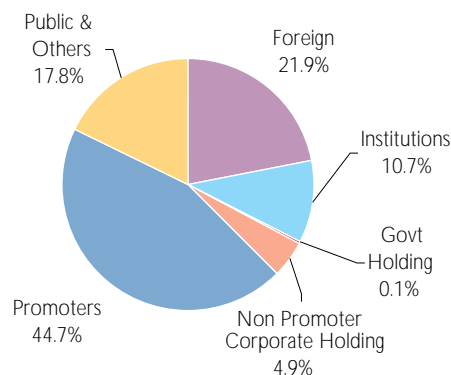
### Key ratios

Year to 31 Mar	FY09	FY10	FY11E	FY12E	FY13E
EBITDA margin (%)	15.5	15.2	14.7	12.7	13.6
EBIT margin (%)	10.4	9.8	9.3	9.4	10.0
PAT margin (%)	9.9	7.8	7.6	7.7	8.9
RoE (%)	14.2	12.4	14.1	12.4	11.9
RoCE (%)	8.8	9.5	11.5	11.0	10.4
Gearing (x)	0.6	0.5	0.4	0.3	0.2

### Valuations

Year to 31 Mar	FY09	FY10	FY11E	FY12E	FY13E
Reported EPS (Rs)	45.7	74.9	61.8	67.6	77.5
Adj. EPS (Rs)	45.7	48.6	61.8	67.6	77.5
PE (x)	16.9	15.9	12.5	11.4	9.9
Price/ Book (x)	2.1	1.9	1.7	1.2	1.1
EV/ Net sales (x)	2.0	1.5	1.1	0.8	0.7
EV/ EBITDA (x)	13.0	10.0	7.4	6.4	5.5
EV/ CE (x)	1.5	1.4	1.3	0.9	0.8

### Shareholding pattern



As of June 2011

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Shirish Rane	Co-Head of Research: Construction, Power, Cement	shirish.rane@idfc.com	91-22-662 22575
Nikhil Vora	Co-Head of Research: Strategy, FMCG, Media, Education, Exchanges, Mid Caps	nikhil.vora@idfc.com	91-22-662 22567
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