

Reliance Capital

Step towards finality

Yesterday IRDA approved in principle the proposed stake sale of Reliance Capital's 26% stake in Reliance Life to Nippon Life. The deal values Reliance Life at \$2.6bn (c.15% higher than the entire market cap of Reliance Capital). The company is expected to receive \$680mn from Nippon, with c.\$615mn coming into Reliance Capital and c.\$65mn flowing to Reliance Life. Whilst Reliance Capital's fundamentals have improved substantially with higher profitability in the core businesses and life insurance turning profitable, the stock price has fallen 48% YTD driven by negative news flows around the wider ADAG group. We stick with our view that there is significant fundamental value in Reliance Capital and hence retain our buy stance with a valuation of Rs.820, 98% upside from the current levels, but with the caveat that the value realisation in the short run is dependent on the ADAG group news flows.

Deal brings value to the company

Approval in principle the deal is a major step forward towards Nippon acquiring a 26% stake in Reliance Life and with only RBI approval now pending, we can expect the deal to be finalised this calendar year. We expect this deal to be significantly value accretive for shareholders:

- The deal brings c.Rs30bn into the company with c.Rs27 bn of cash added to Reliance Capital's Balance sheet, **significantly improving the capital position** which was looking strained at Reliance Capital level given Rs.30bn was infused in the life insurance business and was not available for other businesses. Also, it helps reduce a proportion of debt and thereby substantially reduce the interest cost (more than 200 crores for FY12) in the current high interest rate environment. The company intends to use this money for its core business and banking business if it gets the banking license. This should also bring in **more transparency in reporting** since the company can now consolidate the life insurance business without any impact on the overall capital position.
- The deal brings in Nippon Life's technical knowledge in the life insurance space, which should **help Reliance Life in better underwriting** and developing new products. Also, the deal has meant that Nippon and Reliance Life are in longer term agreement and the MOU signed by Reliance Capital on 2nd September clearly highlights the positives for Reliance Capital with **Nippon life willing to look at all other ventures (including asset management) for partnership.**

Core businesses performing well

- Although volumes have declined in the life insurance business in the first half, we would expect volumes to start **showing a positive a trend from the third quarter** with the base effect kicking in. Also, more importantly life insurance has **started making profits (Rs.1bn including profit from non participating business to be transferred in Q4 to shareholder's account)** and will not need any additional capital going forward.
- With most of the commercial finance book in secured loans the **drag to profits due to NPL provisions is no longer there.** This should help improve profitability by at least 50% on a YOY basis for FY12.
- Reliance AMC has been the outperformer so far in the asset management space with growth in profitability and margins despite AUM declining YOY in line with the industry, led by improvement in the quality of the book with retail debt and equity forming around half of the AUM business.

Valuation

Our SOTP values Reliance Capital at Rs. 820 (98% upside) with Rs. 405 for life insurance (EV+10x FY12 NBAP), Rs. 204 for asset management (4% of FY11 AUM), Rs. 44 for general insurance (1.3x P/BV), Rs. 136 for the financing business (1.7x BV), and Rs. 36 for the broking & distribution business (10x FY13E earnings).

Accounting & corporate governance	Amber
Franchise Strength	Green
Earnings Momentum	Amber

BUY

98% upside

Bloomberg Code	RCAPT.IN
Share Price (Rs)	413
Market Cap (Rs bn / US\$ m)	102/2,300
Free Float / FII holding	50%/22%
ADV (Rs m/ \$m)	765/17

Rs m (unless stated) March YE	2011A	2012E	2013E	2014E
Revenue	41,014	46,481	53,627	62,198
Expenses	37,472	40,960	45,456	53,659
PBT	3,543	5,521	8,171	8,540
PAT	2,964	4,141	6,128	6,405
EPS (Rs)	12	17	25	26

X (unless stated)	2011A	2012E	2013E	2014E
P/E	34	25	17	16
P/BV	1.3	0.9	0.9	0.8
PBT Margin (%)	9%	12%	15%	14%
RoE (%)	4%	4%	5%	5%
Revenue Growth (%)	-15%	13%	15%	16%
Implied P/BV	2.6	1.8	1.8	1.6

Source: Company fillings, Espirito Santo Securities

Figure 1 Historical share price performance



— Relative to BSE500 (LHS) — Absolute (RH)
Source: Bloomberg

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Risk to the investment case:

Although we have highlighted that there is a great deal of value in this stock, clearly in the shorter term it tends to react to news flow around the ADAG group and in recent times that news flow has been consistently negative. We recognise that the management has tried to ring fence the company from group concerns, implementing a number of initiatives to highlight functional independence and minimal intercompany linkages, but having a common promoter means there will always be a perception of linkage, and clearly the quantum of the promoter's stake means considerable influence. Based on all our research and discussions with management of most of the individual businesses and at the Reliance Capital level, we think that the company has been professionally and relatively independently managed. However, ADAG group has been so widely perceived as having corporate governance issues that investors remain inclined to tar Reliance Capital with the same negative governance brush.

Table 1 SOTP Valuation

Business Segment	Value per share	Methodology
Life Insurance	405	Appraisal value method (EV + 11x FY13E NBAP)
Asset Management business	204	% of AUM (4% of FY11 AUM)
Consumer Finance business	136	Excess return on equity method
Broking and distribution	31	Discounted Cash Flow
General Insurance	44	Discounted Cash Flow
Total SOTP Valuation	820	

Source: Company fillings, Espirito Santo Securities

Table 2 Old vs New estimates

	Revised estimates	Earlier estimates	% Change
Net Revenue (Rs. mn)			
FY12	46,481	45,688	2%
FY13	53,627	52,823	2%
Life Insurance PAT (Rs mn)			
FY12	3,334	2047	38%
FY13	4,878	3241	32%
Other Businesses PAT (Rs. mn)			
FY12*	4,141	5914	-30%
FY13*	6,128	7901	-22%
Total PAT (Rs. mn)			
FY12	7,475	7,961	-6%
FY13	11,006	11142	-1%

Source: Company fillings, Espirito Santo Securities *Lower earnings is mainly since we now do not expect the company to sell investments to generate cash and hence no recognition of capital gains

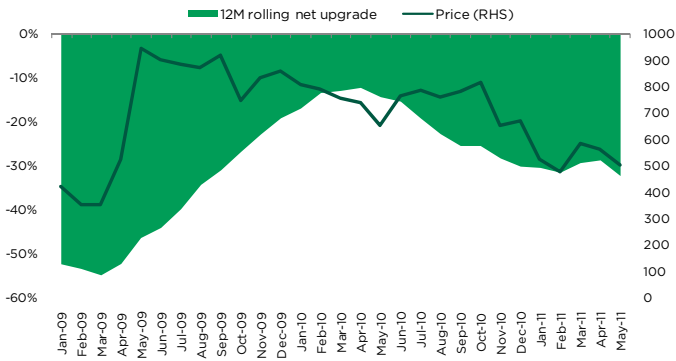
Traffic Lights

Table 3 Traffic Lights: criteria for judgement

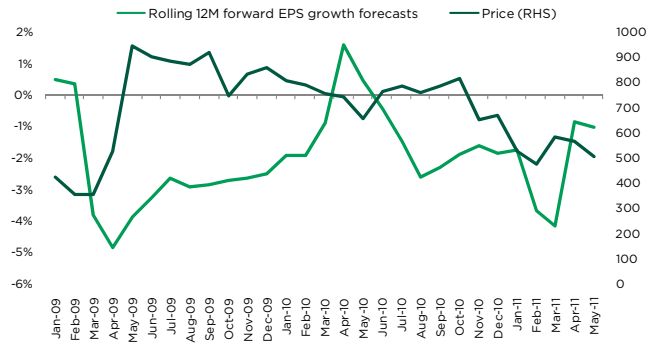
Parameter	Traffic signal	Reasons
Accounting & governance	AMBER	We find the company's insurance accounting practices to be in line with peers. However, non consolidation of the life insurance business is a negative point. Though management says that will start consolidating life insurance business going forward.
Franchise strength	GREEN	The company has strong asset management and life insurance business and further money coming capital supply remains uninterrupted. The company has a strong brand name and its presence in retail - centric businesses (alongside strong distribution) allows it utilise this brand strength.
Earnings momentum	AMBER	Earnings momentum is likely to remain weak in the short term owing to regulatory changes and weakness in Indian capital markets.

Source: Espirito Santo Securities, Company data. For more details on how the traffic lights work, please refer to our 7 Jan 2010 note

Figure 2 Earnings Momentum Charts



Source: Factset, Espirito Santo Securities



Source: Factset, Espirito Santo Securities

Summary Financials (All figures in Rs m unless stated. Year-end is March)

Reliance Capital

Recommendation:	BUY
Fair Value:	INR 820
Share Price:	INR 413
Upside / Downside	98.5%
3 Month ADV (\$m)	17
Free Float	50.0%
52 Week High / Low	882-340
Bloomberg:	RCAPT.IN
Model Published On:	14 September 2011
Shares In Issue (mm)	224
Market Cap (\$bn / Rs bn)	\$2.3 bn/ Rs. 102 bn

Valuation Metrics	2010	2011	2012E	2013E	2014E
Equity Value					
P/E	23	34	25	17	16
P/B	1.3	1.3	0.9	0.9	0.8
Leverage (x)					
Debt/Equity	1.9	2.5	2.0	2.1	2.2

Life Insurance	2010	2011	2012E	2013E	2014E
APE	36,592	23,596	25,484	30,581	35,168
NBAP	6,203	3,657	4,077	5,199	5,979
NBAP Margin	17%	16%	16%	17%	17%
Return on Net worth + Unwind of discour	4,496	5,873	5,251	6,761	8,613
PAT	10,699	9,530	9,328	11,960	14,591
ROEV	25%	24%	22%	22%	21%
Embedded Value (Balance Sheet)	-	35,960	42,533	54,493	69,084
EV per Share	-	161	190	243	308

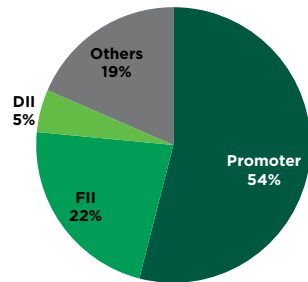
Forthcoming Catalysts

H1FY12 Results
Approval from RBI on Nippon Deal is expected in one month time

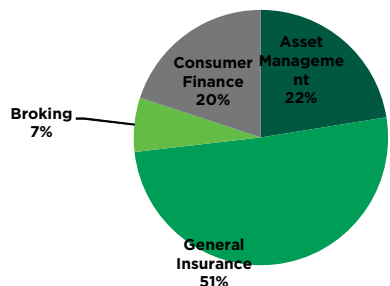
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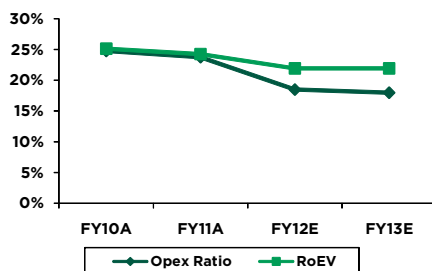
Shareholding Pattern



Revenue Breakdown



Margin Trends



P&L Summary	2010	2011	2012E	2013E	2014E
Revenues	48,465	41,014	46,481	53,627	62,198
Asset management	6,817	7,329	8,129	9,394	11,270
General Insurance	19,797	16,554	18,209	20,941	24,082
Reliance Money	2,585	2,234	2,715	3,246	3,786
Consumer Finance	7,122	6,509	8,346	10,202	12,376
Profit on sale of investments	4,845	1,454	1,454	1,454	1,454
Standalone finance and others	7,300	6,935	7,629	8,391	9,230
Total expenses	42,586	37,472	40,960	45,456	53,659
Reinsurance premium ceded	7,272	4,635	5,099	5,863	6,743
Claims incurred	11,857	10,721	10,489	10,026	10,875
Operating expenses	23,457	22,115	25,373	29,566	36,041
Asset management	4,009	4,385	4,459	5,114	6,114
General Insurance	5,330	5,721	5,244	5,013	5,947
Reliance Money	2,439	1,890	2,246	2,512	2,771
Consumer Finance	5,772	3,815	4,597	5,453	6,291
Standalone finance and others	5,907	6,305	8,826	11,474	14,917
Profit before tax (PBT)	5,880	3,543	5,521	8,171	8,540
Taxes	1,538	579	1,380	2,043	2,135
Profit after tax (PAT)	4,342	2,964	4,141	6,128	6,405
EPS	18	12	17	25	26

Growth YoY	2010	2011	2012E	2013E	2014E
Revenues		-15%	13%	15%	16%
PBT		-40%	56%	48%	5%
EPS		-32%	40%	48%	5%

Life Insurance (Growth YoY)	2010	2011	2012E	2013E	2014E
New premium	12%	-23%	8%	20%	15%
Renewal premium	56%	53%	58%	60%	60%
Total premium	34%	-1%	2%	1%	15%
Commissions	5%	-18%	-24%	7%	15%
Commissions/Total premium	10%	8%	6%	6%	6%
Opex/Total premium	25%	24%	19%	18%	17%

Balance Sheet Summary	2010	2011	2012E	2013E	2014E
Shareholder's funds	77,977	79,528	110,668	116,797	123,201
Loan Funds	145,193	201,536	221,690	243,859	268,245
Total sources of funds	223,170	281,064	332,358	360,655	391,446
Fixed assets	2,585	3,254	3,254	3,254	3,254
Investments	113,406	123,014	123,014	123,014	123,014
Cash and Bank Balances	8,628	19,290	26,665	26,665	26,665
Loans and advances	124,756	157,810	159,900	191,880	220,662
Other assets	(26,205)	(22,303)	19,526	15,843	17,852
Total application of funds	223,170	281,064	332,358	360,655	391,446

Source: Company Filings, Espirito Santo Securities

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Report Date	Recommendation	Target Price (INR)
01-Jun-11	Buy	INR 860.00
12-Jan-11	Buy	INR 881.00
15-Jun-10	Buy	INR 843.00

Source: Bloomberg, Espirito Santo Investment Bank Research

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BUY	Analyst expects at least 10% upside potential to fair value, which should be realized in the next 12 months
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SELL	Analyst expects at least 10% downside potential to fair value, which should be realized in the next 12 months

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Recommendation					
BUY	203	53,6%	29	72,5%	7,7%
NEUTRAL	109	28,8%	11	27,5%	2,9%
SELL	67	17,7%	0	0,0%	0,0%
TOTAL	379	100%	40	100%	

As at end June 2011	Total ESIB Research		Total Investment Banking Clients (IBC)		
	Count	% of Total	Count	% of IBC	% of Total
Recommendation					
SHORT TERM POSITIVE	0	0%	0	0%	0%
SHORT TERM NEGATIVE	0	0%	0	0%	0%
TOTAL	0	0%	0	0%	

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