

Annual report analysis

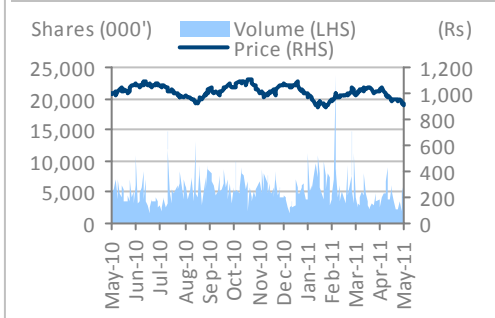
Our analysis of RIL's FY11 annual report shows a strong improvement in operating cashflows that fully funded cash capex. Operating metrics improved YoY, with reduction in net debt and improvement in ROE. RIL took significant 1P reserve write-offs in its PMT Block that is likely to increase depletion charge per unit going forward. Losses at the retail business doubled YoY. We understand that RIL has communicated its inability to the government of India to increase production from KG-D6 for the next three years. RIL expects production to fall to 46mmscmd in the interim. We have cut FY12 and FY13 EPS estimates by 6.4% and 9.2%, respectively. We retain ADD with a target price of Rs1,010/share.

Key takeaways:

- Operating profit growth, high upstream depreciation and better working-capital management led to sharp improvement in operating cashflows.
- Operating cashflows of Rs333bn (excluding Rs90bn received from BP shown as deposits) funded the cash capex.
- New businesses of telecom and shale gas accounted for 75% of FY11 capex. Domestic upstream accounted for only 8%. Cash capex was higher due to reduction in payables and interest capitalisation.
- ROE improved 125bps YoY on improved asset turnover and higher headline leverage. Net debt improved on receipt of US\$2bn from BP.
- Wrote-off 2.7% of its 1P-gas reserves and 13% of its 1-P crude reserves in FY11. The write-off pertains to the PMT Block.
- Six new wells to be drilled in Panna will add 3kbpd production in 2HFY12.
- Wrote-off Rs8bn capex in overseas blocks and Rs1.1bn investment in Delta Hydrocarbons.
- The retail business, a key growth engine, more than doubled its reported losses YoY to Rs5.4bn.

Possibility of KG-D6 production not increasing before FY15 major overhang; downgrade EPS estimates: We understand that RIL has told Gol it cannot increase production in KG-D6 for three years, as it has not procured long-lead items required for tying-in new production wells. It expects production to fall to 46mmscmd in the interim. Polyester margins have also come off earlier than anticipated on c30% correction in cotton prices over the past month. We have cut our FY12 and FY13 EPS estimates by 6.4% and 9.2%, respectively to factor these in. We retain ADD.

Company update

CMP	Rs923	Price performance (%)			
12-mth TP (Rs)	1010 (9%)		1M	3M	1Y
Market cap (US\$ m)	67,158	Reliance Inds	-10.0	-1.3	-7.7
Bloomberg	RIL IN	Rel. to Sensex	-4.1	-1.9	-18.6
Sector	Oil & Gas	ONGC	-7.2	2.1	-2.0
		Cairn India	-2.6	7.5	22.0
		Indian Oil Corp	-4.4	-1.2	-2.0
Shareholding pattern (%)		Stock performance			
Promoters	44.7	Shares (000')  (Rs)			
FIIIs	17.7				
DIIIs	10.8				
Public	26.8				
52Wk High/Low (Rs)	1,187/841				
Shares o/s (m)	3274				
Daily volume (US\$ m)	110				
Dividend yield FY12ii (%)	0.9				
Free float (%)	55.3				

Financial summary (Rs m)

Y/e 31 Mar	FY09A	FY10A	FY11A	FY12ii	FY13ii
Revenues (Rs m)	1,512,240	2,037,397	2,658,106	2,763,563	2,930,329
EBITDA Margins (%)	15.5	15.2	14.3	14.0	14.6
Pre-Exceptional PAT (Rs m)	152,990	158,973	202,109	223,455	261,568
Reported PAT (Rs m)	149,687	245,031	192,937	223,455	261,568
EPS- fully diluted (Rs)	47.6	48.6	58.9	68.3	79.9
Growth (%)	-29.2	2.2	21.2	15.9	17.1
IIFL vs consensus (%)				-7.3	-4.5
PER (x)	19.4	19.0	15.7	13.5	11.6
ROE (%)	12.3	11.3	12.5	12.7	13.0
Debt/Equity (x)	0.4	0.4	0.4	0.1	0.0
EV/EBITDA (x)	14.7	11.4	9.4	8.3	7.2
Price/Book (x)	2.4	2.1	2.0	1.7	1.5

Source: Company, IIFL Research. Priced as on 20 May 2011

Consolidated PAT lower on Block write-offs, higher depreciation, and lower other income

RIL's consolidated PAT at Rs193bn was lower than standalone PAT of Rs203bn. Adjusted for Rs8bn write-offs related to Oman Block 18 and East Timor and another Rs1.1bn write-off related to investments in Delta Hydrocarbons, RIL's consolidated PAT was Rs202bn.

Figure 1: Adjusted for write-offs in overseas acreages, consolidated PAT was almost same as standalone PAT

Rs m	Consolidated	Standalone	Difference	Comments
Revenue	2,658,106	2,481,700	176,406	
EBITDA	380,436	381,257	-822	Consol EBITDA lower on write-offs in Oman Block 18, East Timor and investments in Delta Hydrocarbons
Adjusted EBITDA	389,608	381,257	8,351	
Depreciation	141,208	136,076	5,132	Higher consolidated depreciation on account of retail and shale gas business
EBIT	239,228	245,182	-5,953	
Adjusted EBIT	248,400	245,182	3,219	
Interest expense	24,107	23,276	831	
Other Income	25,428	30,517	-5,089	
PBT	240,550	252,422	-11,873	Lower other income, higher depreciation and write-offs lead to lower consolidated PBT
Adjusted EBT	249,722	252,422	-2,701	
PAT	192,937	202,863	-9,926	
PAT (Adjusted)	202,106	202,863	-757	

Source: Company, IIFL Research

ROE improves 125bps YoY

RIL's core ROE improved 125bps YoY to 12.5%. The improvement in ROE was driven by an increase in asset turnover and higher headline leverage (not adjusted for cash and liquid investments). However, ROE

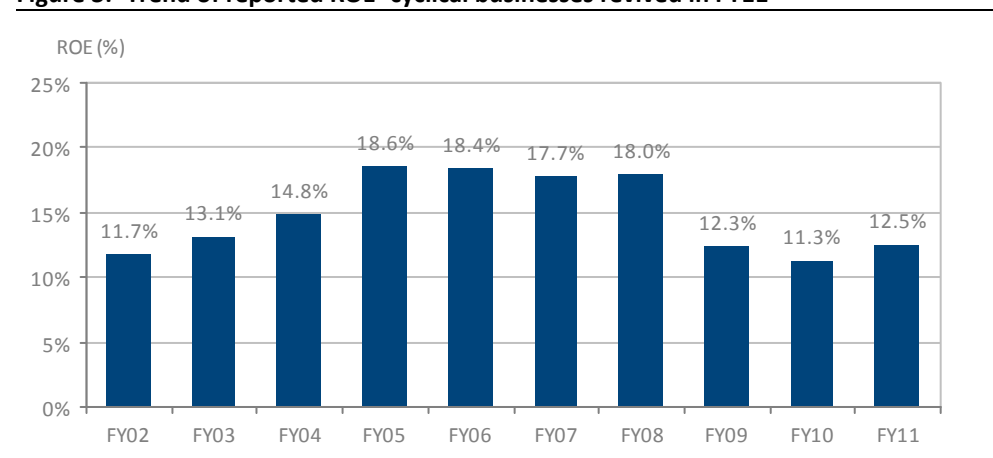
growth lagged earnings growth owing to large cash balance (cash and equivalents of Rs410bn).

Figure 2: ROE improved on better asset turns and higher headline leverage

	FY10	FY11
Profit Margin	8%	7%
Asset T/O	0.79	0.86
Equity multiplier	1.8	2.0
ROE	11.3%	12.5%

Source: Company, IIFL Research

Figure 3: Trend of reported ROE- cyclical businesses revived in FY11

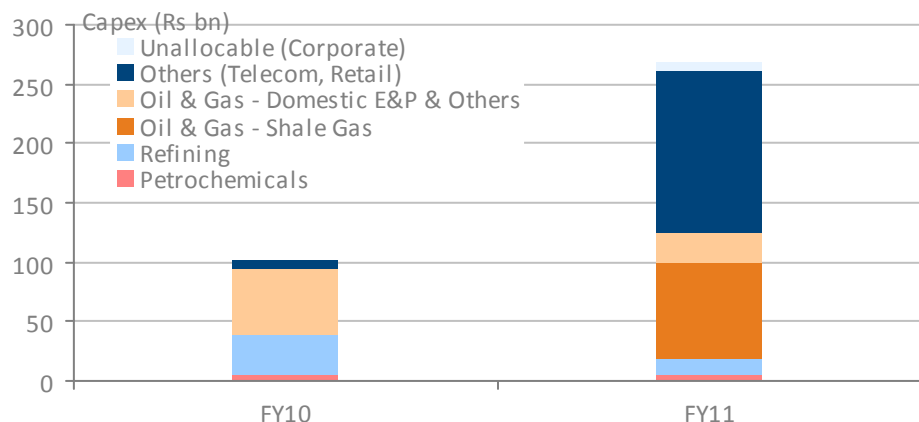


Source: Company, IIFL Research

Entire cash capex funded through operating cashflows

RIL reported FY11 capex of Rs268bn. New businesses (telecom and US shale gas) accounted for 75% of the total capex. The domestic upstream business accounted for only 8% of FY11 capex, as the company drilled only two development wells in KG-D6 during the year. New petchem capacity, which is at a very early stage of development, hardly attracted any capex in FY11.

Figure 4: Telecom (US\$2.7bn) and shale gas (US\$1.77bn) accounted for 75% of FY11 capex

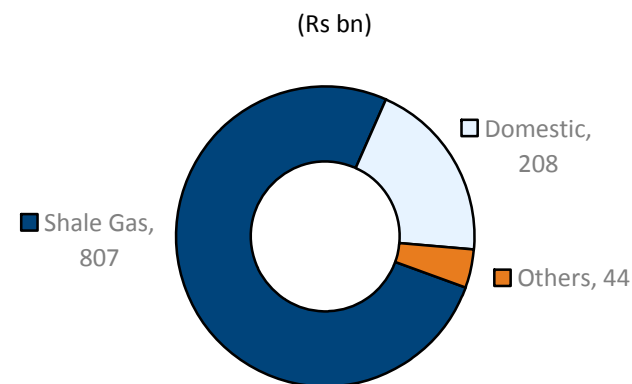


Source: Company, IIFL Research

RIL invested a total of US\$1.77bn in its shale gas acreages in FY11—US\$0.94bn in upfront payments and US\$0.83bn in drilling carry. The company invested US\$607m in Atlas, US\$788m in Pioneer and US\$370m in Carrizo. FY11 exit production from Atlas and Pioneer had ramped up to 2.5mmscmd (gross) on aggressive drilling.

The company invested only Rs21bn capex in the domestic upstream business. It announced five discoveries in CB-ONN-2003/1 and one more in KG-DWN-2003/1 during the year.

Figure 5: US\$1.77bn investment in shale gas JVs accounted for majority of upstream capex



Source: Company, IIFL Research

Cash capex came in at Rs336bn in FY11, up from Rs230bn in FY10. Reduction in accounts payable related to capex (Rs48bn) and interest capitalised during the year (Rs10.2bn) explain a major part of the difference with FY11 capex.

Figure 6: Cash capex grew YoY driven by telecom, shale gas and reduction in payables

FY11 - (Rs m)		
Increase in Gross Block	141,672	
Increase in CWIP	127,086	
Total	268,758	
Segmental breakdown-		
Petrochemicals	5,486	
Refining	13,277	Catalyst change in old refinery
E&P	105,918	
Shale Gas	80,712	\$1.77bn invested in shale gas
Domestic	20,840	
Others	4,366	
Others	135,888	
Telecom	123,120	
Retail and SEZ	12,768	Will sell 45% stake in Haryana SEZ to IL&FS
Un-allocable	8,189	
Total	268,758	
Reduction in payables	48,234	Related to capex
Interest Capitalized	10,234	
Forex Gain in Gross Block and CWIP	411	
Unknown	8,403	
Total Cash Capex	336,039	

Source: Company, IIFL Research

Operating cashflows improved sharply YoY aided by operating profit growth, higher upstream depreciation and better working-capital management with strict control on inventory management. Operating cashflows were adequate to fund cash capex during the year. The improvement in core operating cashflows is expected to continue on improved performance in refining and volume growth in petchem

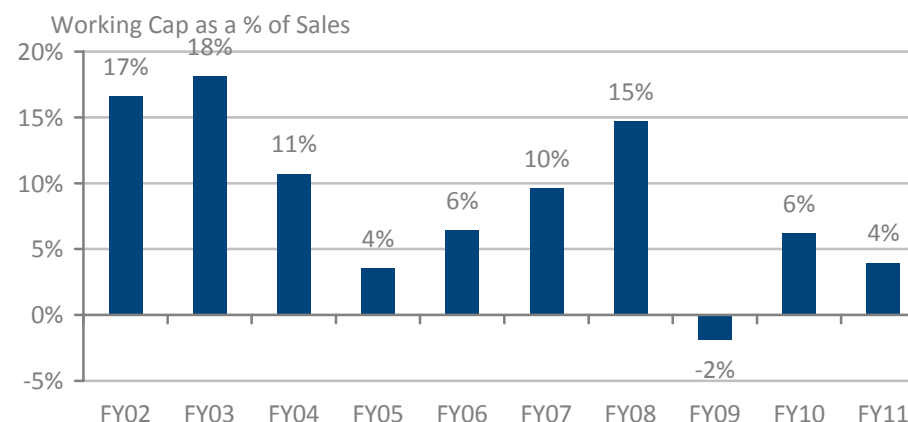
business. RIL accounted for the US\$2bn received from BP as 'deposits received' under cashflow from investing activities.

Figure 7: Operating cashflows excluding receipt of first tranche from BP deal (US\$2bn) covered cash capex for FY11

Consolidated Cash Flow (Rs millions)	FY07	FY08	FY09	FY10	FY11
Net profit before tax from P&L	146,470	230,108	178,691	286,799	240,550
Operating profit before WC changes	201,974	232,763	240,078	295,735	386,095
Working Capital Changes	-15,147	-45,663	-57,725	-59,381	-10,287
Other Adjustments	-19,336	-24,769	-19,479	-31,411	-42,428
Net cash from operating activities	167,490	162,331	162,874	204,943	333,380
Change in Fixed Assets	-279,461	-266,403	-277,320	-230,168	-336,039
Change in Investments	24,314	43,351	33,663	26,447	-81,021
Deposits Received *					90,040
Loans & Advances/ Interest & Dividend Income	-37,304	-81,203	12,624	21,412	6,584
Net cash from investing activities	-292,451	-304,256	-231,034	-182,308	-320,437

Source: Company, IIFL Research. *US\$2bn from BP

Figure 8: Working capital improved on tighter inventory management



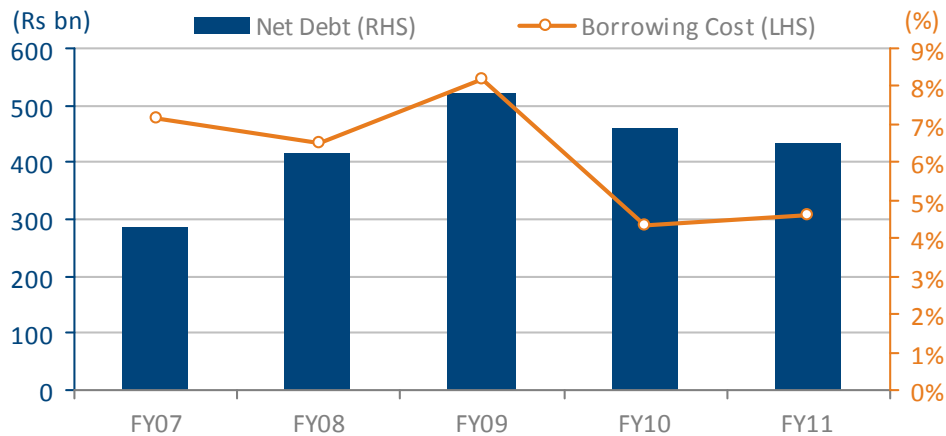
Source: Company, IIFL Research

Net debt continues to improve; interest costs marginally up YoY

RIL's consolidated gross debt increased Rs195bn YoY to Rs841bn. More than 95% of the debt is forex denominated. Borrowing costs increased 30bps YoY to 4.6% in FY11.

RIL's net debt improved marginally YoY to Rs432bn, aided by Rs90bn received from BP as first tranche of the US\$7.2bn transaction. Cash and liquid investments stood at Rs410bn or 26% of networth. Net debt should continue to improve over FY12 on receipt of balance transaction value from BP. RIL is evaluating the best use of the cash received on the transaction, and management's guidance on cash usage is a key parameter to watch out for.

Figure 9: Net debt continued the improving trend, clarity on usage of cash is key



Source: Company, IIFL Research

Significant reserve write-offs in PMT

RIL wrote-off 2.7% of its 1P gas reserves and 13% of its 1P crude reserves in FY11. The entire write-off was attributed to the PMT Block that is witnessing a natural decline. The write-off in PMT's reserves is equivalent to four years of RIL's proportionate share of annual production from the block. We understand that ONGC, part of the consortium that operates the Block, did not take any write-off from the Block in FY11.

Figure 10: Large 1P reserve write-offs attributed to PMT Block

Reserves Gas (mmscm)	Proved (1P)		
	FY11	FY10	% Change
Beginning	211,214	220,468	-4%
Addition		5,353	
Deletion	5,771		
Production	19,622	14,607	134%
Closing	185,821	211,214	-12%
Deletion as % of Opening balance	2.7%		

Oil (MMT)	Proved (1P)		
	FY11	FY10	% Change
Beginning	11.11	11.02	1%
Add		1.13	
Del	1.44		
Production	1.38	1.04	133%
Closing	8.29	11.11	-25%
Deletion as a % of Opening	13.0%		
Total Reserve (MMBoE)	1.3	1.5	-13%

Source: Company, IIFL Research

RIL follows a 'Full Cost' method of accounting for its upstream business. In this method, all costs incurred in the upstream business are capitalised, with the country as the designated cost centre (i.e. unsuccessful exploration efforts are not expensed in the year of incurrence but are capitalised). This cost base is depleted based on total production-to-reserve ratio for the country as a whole. The 13% YoY decline in RIL's reserve base (as a result of production and write-offs) will result in higher depletion charges per unit of production in FY12.

Drilling programme in Panna to increase production; write-offs in overseas acreages

The company intends to undertake drilling of six new production wells in the Panna field in FY12. The estimated reserves are 7mmbbls. The incremental crude oil production of 3kbpd is expected from the latter half of FY12.

The company wrote-off US\$177m (Rs8bn) of capex incurred on Oman Block 18 and East Timor Block owing to limited success. The company also wrote-off Rs1.1bn investments in Delta Hydrocarbons Luxembourg in FY11.

Retail business reports losses

Revenues of RIL’s retail business grew 36% YoY in FY11. RIL opened 90 new stores. Reliance Fresh and value formats put together are the country’s largest organised food retailer. Despite the traction in the business, reported losses more than doubled YoY to Rs5.4bn.

Shale gas JVs are at very early stage of production. Even so, Pioneer JV reported PAT of Rs159m. Reliance Exploration and Production DMCC reported PAT loss of Rs8.8bn, owing to write-off of investments in Oman and East Timor.

Figure 11: Retail business losses doubled YoY

Rs m	Sales		PBT		PAT	
	FY11	FY10	FY11	FY10	FY11	FY10
Retail Business	73,662	54,135	-7,047	-4,583	-5,421	-2,592
Shale Gas Business	725	NA	-150	NA	-150	NA
Haryana SEZ	647	58	-71	7	-71	4
Recron (Malaysia) Sdn Bhd	46,276	39,261	2,097	159	1,780	223
Gapco Kenya Limited	38,720	26,719	319	322	211	216
Reliance Exploration and Production DMCC	820	668	-8,816	-3,343	-8,816	-3,343

Source: Company, IIFL research

Adopting JV model for growth

RIL has adopted the JV model for growth in its core as well as new business areas. In its core business of E&P, the JV with British Petroleum allows it access to critical deepwater technology, lowers the risk of cUS\$20bn of expected capex in its exploration acreage and allows it to grow faster.

In new areas like shale gas, SEZ development and retail finance, it has tied-up with partners with strong domain knowledge in their respective businesses. This will allow RIL to develop the necessary competencies from its partners, while ensuring faster growth on the back of the partner’s domain expertise.

Possibility of KG-D6 production not growing before FY15 major overhang, polyester margins have peaked, downgrade earnings

Media reports indicate RIL has communicated to GoI that it will not be able to increase production from KG-D6 for the next three years. This is because it has not procured long-lead items for tying-in new production wells to the gathering infrastructure. It expects production to fall to 46mmscmd in the interim. The new production profile can be confirmed when the FY12 budget for the Block is approved. We have reduced our crude and gas production estimates for KG-D6 for FY12 and FY13.

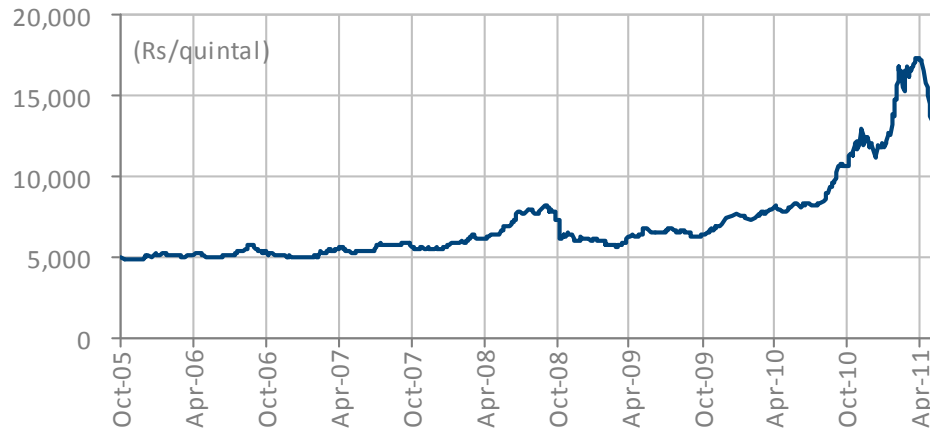
Figure 12: Cutting KG-D6 production estimates based on RIL’s communication to DGH

	FY12		FY13	
	Before	Now	Before	Now
Crude production rate (kbpd)	20	17	40	16
Gas production (mmscmd)	52	48	60	46

Source: IIFL Research

We have also eliminated the savings accruing to RIL’s refineries owing to use of KG-D6 gas as fuel over FY12 and FY13, as the gas will now be supplied to priority sectors.

Note that polyester margins that were at a decade-high in 4QFY11 have started to soften, owing to a sharp correction (c30%) in domestic cotton prices since mid-April. With cotton supply exceeding demand, prices are likely to correct further. We feel polyester margins have peaked out earlier than anticipated, and hence we cut our margin assumptions.

Figure 13: Sharp correction in domestic cotton prices is softening polyester margins


Source: Bloomberg, IIFL Research

We have cut our FY12 and FY13 EPS estimates by 6.4% and 9.2%, respectively to incorporate lower production from KG-D6, lower GRM in refining and lower polyester margins. We feel approval of a workplan and budget for the KG-D6 block by DGH and clarity on usage of cash that will be received from BP will be key drivers of stock performance. We retain ADD with a target price Rs1,010/share.

Figure 14: We cut RIL's consolidated EPS estimates for FY12 and FY13

	FY12ii	FY13ii
Current	68.2	79.9
Old	72.9	88.0
% change	-6.4%	-9.2%

Source: IIFL Research

Figure 15: RIL valuation summary

Valuation summary	EV (Rs bn)	Rs/share	Comment
E&P			
KG-D6	469	143	Reduced production for FY12ii to present level
PMT	111	34	5.6x EV/EBITDA
NEC-25	96	28	
CBM	67	21	
Interest in Atlas Energy	52	16	
Exploration upside	270	83	Gas resources \$2.5/boe, Oil resources \$8/boe
Refining	1,198	366	7x EV/EBITDA
Petrochemicals	920	281	7x EV/EBITDA
Investments	117,260	36	Book value of telecom, retailing & SEZ
Treasury shares	88	27	
Enterprise value	120,510	1,035	
Less: Net debt	88	-27	
Equity value		1,010	

Source: Company, IIFL Research

Assumptions

Y/e 31 Mar	FY09A	FY10A	FY11	FY12ii	FY13ii
Refining					
Crude throughput (mmbbl)	234.6	446.8	488.2	488.2	488.2
GRM (\$/bbl)	12.2	6.6	8.8	9.7	10.2
Petchem					
Volume (mmt)	7.4	8.6	8.6	9.2	9.8
Blended margin (\$/mmt)	545	480	554	580	590
E&P					
KG-D6 gas production (mmscmd)		39	56	48	46
KG-D6 crude production (kbpd)	3	10.2	21	17	16
Crude realisation (\$/bbl)	85	69.8	86.5	90	92
Gas realisation (\$/mmbtu)		4.2	4.2	4.2	4.2
Exchange rate (INR/US\$)	45.8	47.4	45.6	46.0	46.0

Source: Company data, IIFL Research

Financial summary

Income statement summary (Rs m)

Y/e 31 Mar	FY09A	FY10A	FY11A	FY12ii	FY13ii
Revenue	1,512,240	2,037,397	2,658,106	2,763,563	2,930,329
EBITDA	234,222	308,939	380,436	386,069	428,333
EBIT	177,712	199,481	239,228	265,368	295,124
Interest expense	-18,163	-20,596	-24,107	-24,107	-24,107
Others items	19,142	107,913	25,428	35,008	50,305
Profit before tax	178,691	286,799	240,550	276,269	321,322
Tax expense	-29,188	-42,563	-47,834	-53,035	-59,976
Net Profit	149,687	245,031	192,937	223,455	261,568

Cash flow summary (Rs m)

Y/e 31 Mar	FY09A	FY10A	FY11A	FY12ii	FY13ii
PBT	178,691	286,799	240,550	306,269	351,322
Depreciation & Amortization	57,254	110,088	141,861	120,700	133,209
Tax paid	-19,479	-31,411	-42,428	-48,035	-54,976
Working capital change	-57,725	-59,381	-10,287	-27,514	-604
Other operating items	4,133	-101,152	3,685	24,107	24,107
Operating Cash-flow	162,874	204,943	333,380	375,527	453,058
Capital expenditure	-277,320	-230,168	-336,039	64,928	-247,488
Free cash flow	-114,446	-25,225	-2,659	440,455	205,570
Equity raised	151,648	5,125	1,957	0	0
Investments	33,663	26,447	-81,021	0	0
Debt financing/disposal	165,145	-58,221	207,014	0	0
Dividends paid	-19,085	-22,195	-24,309	-32,215	-37,715
Other items	-34,718	-14,635	61,459	-63,868	-24,107
Net change in Cash & equivalents	182,206	-88,703	162,441	344,373	143,748

Source: Company data, IIFL Research

Balance sheet summary (Rs m)

Y/e 31 Mar	FY09A	FY10A	FY11A	FY12ii	FY13ii
Cash & equivalents	227,421	138,908	301,390	645,763	789,511
Sundry debtors	48,450	100,829	156,952	153,824	159,580
Inventories - trade	201,096	343,933	385,194	428,200	439,883
Other current assets	110,494	107,386	137,259	177,020	177,020
Fixed assets	1,808,902	1,772,249	1,878,417	1,692,788	1,807,067
Investments	64,355	131,123	215,962	215,962	215,962
Total assets	2,460,718	2,594,429	3,075,174	3,313,558	3,589,022
Sundry creditors	357,570	388,906	527,165	539,529	556,363
Other current liabs	31,150	36,950	47,303	47,303	47,303
Long-term debt/CBs	762,566	646,055	841,062	841,062	841,062
Other long-term liabs	95,513	106,776	110,709	115,709	120,709
Minorities/other equity	1,353	5,712	8,009	8,009	8,009
Net worth	1,212,565	1,410,030	1,540,928	1,761,946	2,015,577
Total liabs & equity	2,460,718	2,594,429	3,075,174	3,313,558	3,589,022

Ratio analysis

Y/e 31 Mar	FY09A	FY10A	FY11A	FY12ii	FY13ii
Sales growth (%)	10.3	34.7	30.5	4.0	6.0
Core EBITDA growth (%)	1.2	31.9	23.1	1.5	10.9
Core EBIT growth (%)	-2.0	12.2	19.9	10.9	11.2
Core EBITDA margin (%)	15.5	15.2	14.3	14.0	14.6
Core EBIT margin (%)	11.8	9.8	9.0	9.6	10.1
Net profit margin (%)	10.1	7.8	7.6	8.1	8.9
Tax rate (%)	16.3	14.8	19.9	19.2	18.7
Net Debt/Equity (%)	44.1	36.0	35	11	3
Return on Equity (%)	12.3	11.3	12.5	12.7	13.0

Source: Company data, IIFL Research

Key to our recommendation structure

BUY - Absolute - Stock expected to give a positive return of over 20% over a 1-year horizon.

SELL - Absolute - Stock expected to fall by more than 10% over a 1-year horizon.

In addition, **Add** and **Reduce** recommendations are based on expected returns relative to a hurdle rate. Investment horizon for **Add** and **Reduce** recommendations is up to a year. We assume the current hurdle rate at 10%, this being the average return on a debt instrument available for investment.

Add - Stock expected to give a return of 0-10% over the hurdle rate, ie a positive return of 10%+.

Reduce - Stock expected to return less than the hurdle rate, ie return of less than 10%.

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