Company Focus

29 June 2009 | 9 pages

Reliance Industries (RELI.BO)

Hold: News Flow a Bigger Driver than Crude Prices

- **Dependent on gas** — Since most of RIL's E&P revenues are dependent on gas, the company is not materially affected by changes in our global crude price forecasts.
- **Downside to fair value after the court verdict** — Our current fair value of Rs1,835 incorporates a value of Rs729 from E&P assets based on 12x FY11E EV/FCF. Following the court verdict on the RIL-RNRL case, this E&P value could decline to Rs544/share assuming that RIL begins its supply of 28mmscmd of gas FY11E onwards (which is clearly a worst-case scenario given ADAG's non-readiness of power plants to intake gas). FY11E EPS could decline to Rs151 in this case from our base case of Rs165. If 12mmscmd gas to NTPC is also sold at US$2.3/mmbtu, then E&P valuation reduces to Rs465 and EPS to Rs145.
- **NAV erosion is lesser** — Based on this judgment, we estimate that our NAV of RIL's E&P business would be reduced to Rs467/share from Rs521 earlier. If gas to NTPC is also sold at lower prices, we estimate the NAV to drop to Rs452.
- **D6 under control, new exploration will have to wait** — The company is aiming at 40mmscmd by end-Jun and 80mmscmd by end-FY10. Exploration wells in other blocks would be in 2HFY10 – with one rig from D6 and one new delivery. Entry in domestic oil retailing is likely to be gradual and at a controlled pace.
- **Balance sheet** — Net debt was Rs280bn. FY10E capex guidance at US$4.5-5.0bn includes RPL's remaining capex of US$0.5bn (total project cost of US$6.5-7.0bn).

Hold/Low Risk	2L
Price (25 Jun 09)	Rs1,959.50
Target price	Rs1,835.00
Expected share price return	-6.4%
Expected dividend yield	1.1%
Expected total return	**-5.2%**
Market Cap	Rs3,083,903M
	US$63,763M

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

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2007A	119,434	82.18	26.2	23.8	4.5	25.8	0.6
2008A	152,606	105.00	27.8	18.7	3.6	21.2	0.7
2009E	158,539	100.76	-4.0	19.4	3.1	17.7	1.0
2010E	213,395	135.63	34.6	14.4	2.6	19.7	1.1
2011E	259,019	164.62	21.4	11.9	2.2	20.3	1.2

Source: Powered by dataCentral

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See Appendix A-1 for Analyst Certification and important disclosures.

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Fiscal year end 31-Mar	2007	2008	2009E	2010E	2011E
Valuation Ratios					
P/E adjusted (x)	23.8	18.7	19.4	14.4	11.9
EV/EBITDA adjusted (x)	15.7	14.1	14.1	9.5	7.7
P/BV (x)	4.5	3.6	3.1	2.6	2.2
Dividend yield (%)	0.6	0.7	1.0	1.1	1.2
Per Share Data (Rs)					
EPS adjusted	82.18	105.00	100.76	135.63	164.62
EPS reported	82.18	133.88	100.76	135.63	164.62
BVPS	439.75	548.83	631.74	742.62	880.24
DPS	11.00	13.00	20.00	22.00	24.00
Profit & Loss (RsM)					
Net sales	1,116,927	1,334,430	1,663,124	1,916,174	2,287,476
Operating expenses	-962,438	-1,159,711	-1,479,229	-1,634,785	-1,941,181
EBIT	**154,489**	**174,719**	**183,895**	**281,389**	**346,294**
Net interest expense	-11,889	-10,774	-15,953	-28,373	-28,339
Non-operating/exceptionals	2,604	66,156	20,330	19,836	15,152
Pre-tax profit	**145,205**	**230,101**	**188,273**	**272,852**	**333,107**
Tax	-25,771	-35,519	-29,734	-45,378	-54,542
Extraord./Min.Int./Pref.div.	0	0	0	-14,078	-19,546
Reported net income	**119,434**	**194,583**	**158,539**	**213,395**	**259,019**
Adjusted earnings	119,434	152,606	158,539	213,395	259,019
Adjusted EBITDA	202,641	223,190	234,024	357,283	430,150
Growth Rates (%)					
Sales	37.5	19.5	24.6	15.2	19.4
EBIT adjusted	40.4	13.1	5.3	53.0	23.1
EBITDA adjusted	40.7	10.1	4.9	52.7	20.4
EPS adjusted	26.2	27.8	-4.0	34.6	21.4
Cash Flow (RsM)					
Operating cash flow	**169,405**	**199,875**	**300,155**	**312,081**	**392,785**
Depreciation/amortization	48,152	48,471	50,129	75,895	83,856
Net working capital	1,819	-43,180	91,488	8,712	30,365
Investing cash flow	**-434,659**	**-229,608**	**-286,075**	**-178,600**	**-144,500**
Capital expenditure	-318,103	-185,480	-286,075	-178,600	-144,500
Acquisitions/disposals	-118,975	-45,604	0	0	0
Financing cash flow	**291,187**	**65,267**	**150,366**	**-38,941**	**-42,482**
Borrowings	66,272	98,795	17,527	0	0
Dividends paid	-18,006	-21,666	-35,401	-38,941	-42,482
Change in cash	**25,933**	**35,534**	**164,446**	**94,539**	**205,804**
Balance Sheet (RsM)					
Total assets	**1,173,534**	**1,498,390**	**1,988,685**	**2,170,162**	**2,469,590**
Cash & cash equivalent	37,706	71,765	56,557	128,099	315,840
Accounts receivable	37,324	62,276	72,639	103,702	125,613
Net fixed assets	711,886	848,895	1,360,960	1,465,665	1,529,310
Total liabilities	**533,862**	**683,903**	**994,709**	**987,653**	**1,050,998**
Accounts payable	147,098	183,360	302,982	245,449	287,115
Total Debt	278,007	364,521	523,167	533,167	522,373
Shareholders' funds	**639,671**	**814,486**	**993,976**	**1,182,508**	**1,418,592**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	18.1	16.7	14.1	18.6	18.8
ROE adjusted	25.8	21.2	17.7	19.7	20.3
ROIC adjusted	20.5	16.1	12.9	15.8	18.1
Net debt to equity	37.6	35.9	46.9	34.3	14.6
Total debt to capital	30.3	30.9	34.5	31.1	26.9

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Figure 1 shows RIL's sensitivity to the recent court verdict on the RNRL gas case. Our calculations assume that RIL begins its supply of gas FY11E onwards (which is clearly a worst-case scenario given ADAG's /NTPC's non-readiness of power plants to intake gas).

Figure 1. RIL – Sensitivity to E&P

Rs/share	Base Case	28mmscmd to RNRL at US$2.3/mmbtu	28mmscmd to RNRL + 12 mmscmd to NTPC at US$2.3/mmbtu
EPS	165	151	145
NAV of E&P	521	467	452
E&P valuation	729	544	465

Source: Citi Investment Research and Analysis estimates

Figure 2. RIL Sum-of-the-parts Valuation

	Rs m	Rs/share	Comments
FY11E EBITDA forecast (Rs m)	175,341		Only for refining and petrochem (excl. RPL)
EV of Petrochem & Refining (Rs m) - (a)	1,052,045	669	@ EV/E of 6x FY11E
Net Debt (Rs m) - (b)	116,652	74	Estimated as on Mar-10, post warrants conversion
Key investments			
-Reliance Petroleum	363,371	231	Based on RIL:RPL merger ratio of 1:16
-E&P Assets	1,146,318	729	Based on 12x steady state FCF (incl. KG oil and gas upside in FY11E)
- Organised Retail	80,000	51	Based on BV of investments so far
Total value of investments & other assets - (c)	1,589,689	1,010	
Value of Treasury stock - (d)	363,236	231	At target price
Value for Equity holders (Rs m) - (a-b+c+d)	2,888,317	**1,836**	
No. of shares (m.)	1,573		Post-warrants conversion

Source: Citi Investment Research and Analysis estimates

Await better risk-reward

Our current target price of Rs1,835 doesn't leave any upside to warrant a Buy recommendation, and we consequently maintain our Hold rating.

At Rs1,835, the stock factors in:

- E&P value of Rs729/share – This is based on 12x EV/FCF to account for better visibility and lower execution risks following commencement of KG gas production in April. This leads to a higher 40% premium to NAV of known reserves, thus building in a material upside to reserves in D6 as well as from the pipeline of promising deepwater blocks. We base the E&P valuation on Mar-10.

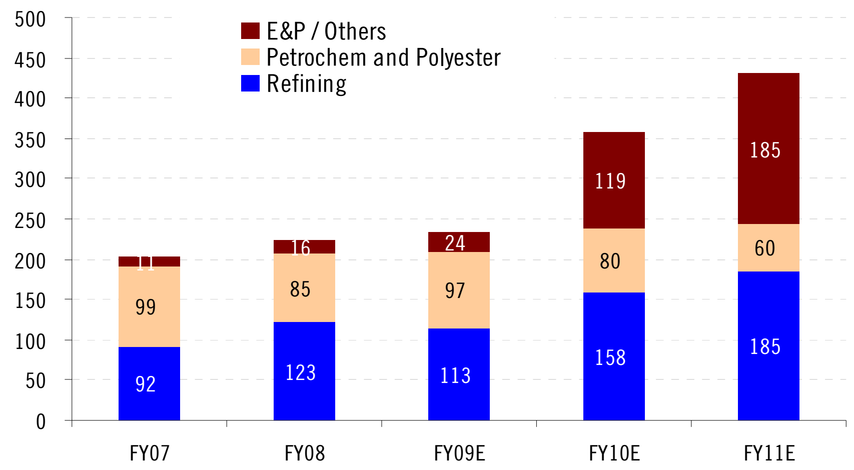
Figure 3. E&P – Valuation based on EV/FCF

	FY11E	Comments
Operating Cash Flows (Rs m)	139,614	Assuming 80mmscmd gas and 40 kbpd oil production
Operating Cash Flows (US$m)	2,971	
Less: Yearly Exploration spend (US$m)	700	As per management guidance
FCF (US$m)	2,271	
EV/FCF 12-mnth fwd (x)	12.0	
EV Mar-10E (US$ bn)	25	
EV Mar-10E (Rs bn)	1,146	
Imputed Mar-10 PER (x)	8.8	
Value per share (Rs)	**729**	
Premium to NAV (%)	40%	Premium relative to NAV of known reserves (KG-D6 + NEC-25 + CBM)

Source: Citi Investment Research and Analysis estimates

- Core petchem and refining valued at 6x EV/EBITDA – We value the core business at Rs669/share based on 6x EV/EBITDA on FY11E. The multiple takes into account the significantly (-25% yoy) lower petchem profitability that we forecast in FY11E (see Figure 4).

Figure 4. Consolidated EBITDA breakup (Rs bn)



Source: Citi Investment Research and Analysis estimates

- GRMs of US$9.7-10.8 over FY10-11E – Our GRM assumptions stand at US$9.7 in FY10E and US$10.8 in FY11E (RIL-RPL blended). These are benchmarked off our Singapore GRM assumptions of US$3.0 and US$3.8 in CY09 and CY10. While our Singapore margin assumptions might seem conservative in light of recovery from the lows of US$3.8 in 3QFY09 (averaging US$5.5 in 4QFY09, US$5.1 in 1QFY10TD), Reliance's premium over Singapore margins are still under pressure, declining to a 10-quarter low of US$4.4, driven by lower diesel cracks and lower L-H differentials. With no immediate signs of a sustainable recovery on the demand front, we maintain our margin assumptions.

- RPL contribution of Rs231/share – We attribute a value to RPL in our SOTP based on the 1:16 merger ratio announced.

Reliance Industries

Company description

Reliance Industries is a conglomerate with interest in upstream oil & gas (E&P), refining, and petrochemicals. It has commissioned a super-size refinery project through its 70% subsidiary (RPL), which it now plans to merge with itself, and has also commenced gas production at its large gas find in the D6 block in KG basin. RIL is foraying into organized retailing and has plans to undertake SEZ projects over the medium to long term.

Investment strategy

We rate RIL Hold/Low Risk with a target price of Rs1,835. Given the concerns on demand slowdown in developed markets, the refining outlook over the next 12 months has softened. Further, even though E&P business looks set to become significant in the next 3-4 years as new discoveries are brought on stream, recent delays will push back timelines on exploration drilling, thereby restricting news flow on exploration success. Given the track record of past exploratory success and the evolving portfolio (much beyond KG-D6), we value RIL's E&P business as a going concern and accord it a value of Rs729/share on traditional EV/FCF multiples, at a 40% premium to NAV of known reserves. However, the stock is already factoring in upside potential in E&P, leaving little room for error in the refining / petrochemical segments where an improvement in fundamentals would be contingent on sustained global economic recovery. Our Hold rating is premised on present valuations leaving risk-reward balanced or marginally unfavorable.

Valuation

Our target price of Rs1,835 is based on a sum-of-the-parts value: 1) We value RIL's core petrochem and downstream oil business on an EV/EBITDA of 6.0x FY11E, in line with regional chemicals and refining peers; this also captures the impact of a global downturn in refining and petchem; 2) We value total E&P assets including oil & gas prospects and other blocks at Rs729/share based on 12x steady state (FY11E) FCF; 3) We value investment in RPL at the merger swap ratio of 1:16 on RIL's target price; 4) We value organized retail business at Rs51/share, based on book value of investments so far; and 5) We value treasury stock at target price.

Risks

We rate RIL Low Risk, as opposed to the High Risk rating suggested by our quantitative risk-rating system, as diversified earnings and significant value contribution from the emerging E&P business partly mitigate the impact of the global slowdown on the cyclical components of its business, while commencement of the new refinery and KG gas production limit execution risks. Downside risks to our target price are: RIL's margins are exposed to the global petrochemical and refining cycles; delays in the ramp up of production of KG-D6 gas and RPL's refinery; further delays in the drilling programme for the new blocks (D9, D3, MN-D4); and the organized retail business would call for significant investment in non-core areas. Upside risks to our target price are: significant improvement in the refining environment (i.e. if GRMs strengthen in the near future); and announcements of new discoveries in the other E&P blocks which is likely to be a sentiment positive.

Appendix A-1

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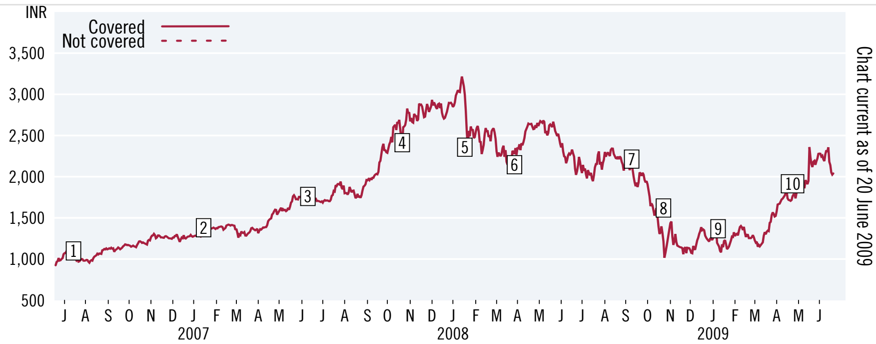
Reliance Industries (RELI.BO)

Ratings and Target Price History
Fundamental Research
Analyst: Rahul Singh



	Date	Rating	Target Price	Closing Price
1	14-Jul-06	*2L	*1,150.00	1,065.15
2	15-Jan-07	2L	*1,450.00	1,364.65
3	11-Jun-07	*1L	*2,005.00	1,668.20
4	21-Oct-07	1L	*2,860.00	2,469.20
5	17-Jan-08	1L	*3,460.00	2,996.25
6	27-Mar-08	1L	*2,850.00	2,275.00
7	9-Sep-08	1L	*2,450.00	2,142.85
8	23-Oct-08	*1M	*1,756.00	1,215.25
9	8-Jan-09	1M	*1,475.00	1,196.80
10	23-Apr-09	*2L	*1,835.00	1,762.35

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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