

Company Focus

4 October 2007 | 12 pages

Reliance Petroleum (RPET.BO)

 Change in opinion
 Rating change
 Target price change
 Estimate change

Re-Rating Nearing End? Downgrade to Hold

- All priced in, downgrade from Buy to Hold** — Our new target of Rs170 is a result of i) earnings upgrade (10-11% over FY10-12E) factoring in the potential savings from KG gas; ii) notwithstanding impact of rupee appreciation; iii) value of tax benefits (US\$2.8bn=Rs26/share); and iv) roll forward to Sep-08. Refining margin assumptions remain unchanged at US\$14.0-14.5/bbl.
- Premium to replacement cost justified but little room to improve** — RPL is trading at EV/bpd of US\$37,000 and EV per complexity bbl of US\$2,641, at premium to replacement costs - US\$25,000 and US\$2,000 respectively and RIL's imputed multiples. Even adjusting for the value of tax benefits (US\$2.8bn= US\$345 per complexity bbl) and benefits of Polypropylene unit, the current valuations do not leave much room for further re-rating.
- Cost savings from captive KG gas factored in** — We believe RPL could potentially gain from the differential between KG gas' delivered price (~US\$5.5/mmbtu) and likely pricing of refinery off-gases for the proposed ethylene cracker (at some discount to Naphtha prices). However, these assumptions are contingent on likely transfer pricing between RIL and RPL.
- Risks** — Stronger rupee and sharp decline in refining margins would be negative catalysts. Though there has been some debate on re-investment possibilities and its impact on value accretion and/or higher tax benefits, we believe it could be sometime away and partially factored into our valuations.

Hold/Low Risk	2L
<i>from Buy/Low Risk</i>	
Price (04 Oct 07)	Rs159.60
Target price	Rs170.00
<i>from Rs131.00</i>	
Expected share price return	6.5%
Expected dividend yield	0.0%
Expected total return	6.5%
Market Cap	Rs718,200M
	US\$18,233M

Price Performance (RIC: RPET.BO, BB: RPET IN)



Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2009E	53,859	12.0	na	13.4	3.9	29.4	0.7
2010E	89,604	19.9	66.4	8.0	2.8	40.4	1.7
2011E	97,638	21.7	9.0	7.4	2.1	32.7	2.5
2012E	95,268	21.2	-2.4	7.6	1.8	25.5	3.0
2013E	90,526	20.1	-5.0	7.9	1.5	20.4	2.8

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	2009E	2010E	2011E	2012E	2013E
Valuation Ratios					
P/E adjusted (x)	13.4	8.0	7.4	7.6	7.9
EV/EBITDA adjusted (x)	13.9	7.2	6.2	5.7	5.3
P/BV (x)	3.9	2.8	2.1	1.8	1.5
Dividend yield (%)	0.7	1.9	2.7	3.3	3.1
Per Share Data (Rs)					
EPS adjusted	11.97	19.91	21.70	21.17	20.12
EPS reported	11.97	19.91	21.70	21.17	20.12
BVPS	40.77	57.70	75.05	90.93	106.02
DPS	1.20	2.99	4.34	5.29	5.03
Profit & Loss (RsM)					
Net sales	310,697	546,004	574,741	569,238	562,437
Operating expenses	-252,991	-452,271	-475,512	-475,668	-475,876
EBIT	57,706	93,733	99,229	93,570	86,561
Net interest expense	-3,847	-5,347	-5,469	-4,862	-5,803
Non-operating/exceptionals	0	1,837	5,850	9,894	14,733
Pre-tax profit	53,859	90,223	99,610	98,602	95,491
Tax	0	-619	-1,972	-3,334	-4,965
Extraord./Min.Int./Pref.div.	0	0	0	0	0
Reported net income	53,859	89,604	97,638	95,268	90,526
Adjusted earnings	53,859	89,604	97,638	95,268	90,526
Adjusted EBITDA	57,706	107,383	113,034	107,531	100,730
Growth Rates (%)					
Sales	na	75.7	5.3	-1.0	-1.2
EBIT adjusted	na	62.4	5.9	-5.7	-7.5
EBITDA adjusted	na	86.1	5.3	-4.9	-6.3
EPS adjusted	na	66.4	9.0	-2.4	-5.0
Cash Flow (RsM)					
Operating cash flow	53,859	70,240	107,767	106,347	100,289
Depreciation/amortization	0	13,650	13,806	13,962	14,170
Net working capital	0	-32,394	-1,705	452	559
Investing cash flow	-90,000	-2,000	-3,000	-3,000	-4,000
Capital expenditure	-90,000	-2,000	-3,000	-3,000	-4,000
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	36,141	4,614	-19,673	-31,993	17,621
Borrowings	36,141	10,000	-6,233	-12,466	41,438
Dividends paid	0	-5,386	-13,441	-19,528	-23,817
Change in cash	0	72,855	85,094	71,354	113,910
Balance Sheet (RsM)					
Total assets	266,119	395,455	475,005	538,279	646,426
Cash & cash equivalent	0	73,474	160,539	235,227	354,103
Accounts receivable	0	40,020	42,127	41,674	41,115
Net fixed assets	226,201	214,552	203,746	192,785	182,615
Total liabilities	82,646	135,819	137,258	129,081	169,334
Accounts payable	0	30,118	31,703	31,703	31,703
Total Debt	77,260	87,260	81,027	68,562	110,000
Shareholders' funds	183,473	259,636	337,747	409,198	477,092
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	18.6	19.7	19.7	18.9	17.9
ROE adjusted	29.4	40.4	32.7	25.5	20.4
ROIC adjusted	21.7	33.7	34.5	33.2	31.3
Net debt to equity	42.1	5.3	-23.5	-40.7	-51.2
Total debt to capital	29.6	25.2	19.3	14.4	18.7

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Earnings upgraded, factoring in cost savings

RPL proposes to use KG gas for captive power/steam generation and other utilities.

1. We have assumed 50% of the Fuel & Loss (8%) to comprise refinery off-gases which can be replaced by natural gas for generating power and steam for the refinery.
2. While delivered price of KG gas is likely to be ~US\$5.5/mmbtu (it could be higher also), RPL is likely to get higher realization for its refinery off-gases which will be benchmarked to Naphtha (US\$16/mmbtu). This will provide additional revenues for RPL. We have assumed mid-point of prevailing natural gas price and Naphtha to estimate the likely revenue accretion.
3. Please note that the above assumptions are subject to the transfer pricing arrangement between RIL and RPL for natural gas as well as refinery off-gases.
4. Also, RPL's power and steam requirements will be met by an affiliate company, Reliance Utilities and Power Ltd. (RUPL), which presumably would be the main consumer of natural gas for converting to power/steam. Our calculations assume RUPL operates on a cost-plus basis (like all utilities) with the variable fuel cost being a pass-through.

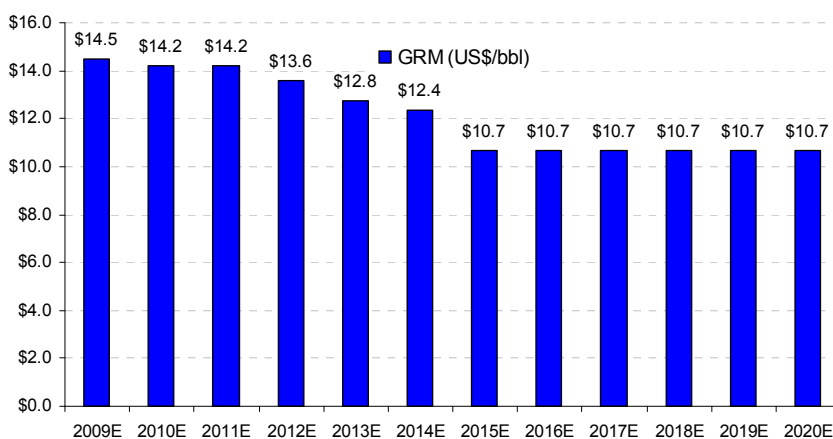
So while our refining margin assumptions remain unchanged at US\$14.0-14.5/bbl over FY2009-11E, our earnings upgrade is primarily a result of the savings from KG gas notwithstanding stronger rupee assumptions.

Figure 1. RPL – Earnings revisions

Year to	Net Profit (Rs Mils.)		Diluted EPS (Rs)			Divi. Per Share (Rs)	
	Old	New	Old	New	% Chg	Old	New
31-Mar							
2009E	49,486	53,859	11.00	11.97	8.8%	1.1	1.2
2010E	81,148	89,604	18.03	19.91	10.4%	2.7	3.0
2011E	88,500	97,638	19.67	21.70	10.3%	3.9	4.3
2012E	85,889	95,268	19.09	21.17	10.9%	4.8	5.3

Source: Citi Investment Research estimates

Figure 2. Refining Margin Assumptions



Source: Citi Investment Research estimates

Valuation target upped to Rs170

Our target price (rolled forward to Sep-08) is based on:

Core value at 12-month forward EV/EBITDA of 7.0x (in line with peers) as on Sep-08. We estimate 12-mnth fwd EBITDA as sum of 2HFY09E and 1HFY10E.

+

Present value of tax benefits as on Sep-08 = US\$2.8bn = Rs26/share

Figure 3. Valuation framework

EV/EBITDA (x)	6.0x	6.5x	7.0x	7.5x	8.0x
EBITDA - 12m fwd as on Sep'08 - Rs m	111,398	111,398	111,398	111,398	111,398
EV (as on Sep-08) - US\$bn	16.7	18.1	19.5	20.9	22.3
Debt (as on Sep-08) - US\$bn	3.3	3.3	3.3	3.3	3.3
Equity value (as on Sep-08) - US\$bn	13.4	14.8	16.2	17.6	19.0
Value per share	119	132	144	157	169
Value of tax benefits			26		
Target price (Rs)			170		

Source: Citi Investment Research estimates

Asset valuations leave little room to improve

RPL is trading at EV/complexity bbl of US\$2,641/complexity bbl, significant premium to prevailing replacement costs of US\$2,000-2,200/complexity bbl. Though a part of this premium (US\$345/complexity bbl to be precise) can be attributed to the NPV of tax benefits (US\$2.8bn), the valuations are rich even after adjusting for that. Notwithstanding the current tightness in the EPC

market and the soaring costs, we believe RPL's valuations are at the higher end of replacement costs and leave little room for further re-rating. Recently announced expansion of Shell's Port Arthur Refinery (Texas, US) at US\$21,500 is also reflective of the current replacement costs.

This is also borne out of the peer comparison (see Figure 4 below); infact RPL is trading at significant premium to even its more established parent (RIL's) imputed EV/bpd. Please note that RIL's refinery also enjoys material tax benefits and is therefore a closer comparable to RPL.

Figure 4. Asset Valuation Comparables

	RIC Code	EV (US\$m)	Throughput (kbpd)	Nelson's Complexity	EV/ bbl (US\$)	EV/ complexity bbl (US\$)
RPL (at CMP)	RPET.BO	21,445	580	14.0	36,974	2,641
RPL (at target)	RPET.BO	22,425	580	14.0	38,664	2,762
RIL (EV/E of 6.5X)	RELI.BO	16,262	660	11.3	24,639	2,180
Chennai Petroleum	CHPC.BO	1,688	210	8.0	8,039	1,005
Thai Oil	TOP.BK	3,724	241	8.4	15,453	1,844
Mangalore Refinery	MRPL.BO	3,734	250	9.0	14,936	1,660
Bongaigaon Refinery	BNGR.BO	366	48	6.0	7,622	1,270
SUN.N	Sunoco	8,741	900	8.5	9,713	1,143
TSO.N	Tesoro	6,545	658	9.5	9,946	1,047
VLO.N	Valero	41,036	3260	11.2	12,588	1,124

Source: Citi Investment Research estimates

Figure 5. Global Refining – Valuation Comparables

Company Name	RIC Code	Rating	Mkt Cap (US\$m)	Price 2-Oct-07	Target price	P/E (x)		EV/EBITDA (x)		P/BV (x)		Div. Yield (%)		ROCE (%)	
						FY08E	FY09E	FY08E	FY09E	FY08E	FY09E	FY08E	FY09E	FY08E	FY09E
Asia															
CPCL	CHPC.BO	1L	1,078	287	360	6.2	7.5	4.9	5.2	1.4	1.2	5.7%	4.7%	13.7%	11.5%
PTT	PTT.BK	1L	29,463	332	349	11.1	10.1	7.7	6.8	2.7	2.3	3.8%	3.8%	20.7%	21.2%
Thai Oil	TOP.BK	1M	5,663	88	94	11.4	9.6	10.6	9.1	2.0	1.8	5.9%	5.4%	13.9%	16.5%
Sinopec	0386.HK	3L	21,619	10	8	13.2	12.1	2.5	2.5	2.8	2.3	1.8%	2.0%	14.6%	14.1%
S Sh Pechem	0338.HK	2M	1,912	6	6	18.9	19.4	4.8	4.1	2.2	2.0	2.0%	2.0%	8.1%	10.0%
Formosa Petro	6505.TW	2L	28,525	101	85	14.9	14.7	11.3	10.4	3.9	3.8	6.2%	6.2%	18.0%	18.3%
Asia Avg.						13.0	12.2	7.7	7.0	3.0	2.8	4.2%	4.2%	17.5%	17.9%
Japan															
Cosmo Oil Co Ltd	5007.T	3H	3,103	535	540	13.4	18.0	7.1	7.8	1.0	1.0	1.5%	1.5%	4.2%	3.3%
Nippon Oil	5001.T	3H	13,630	1,079	1,110	21.0	27.2	7.2	7.7	1.2	1.2	1.1%	1.1%	3.2%	2.7%
Npn Min Holdings	5016.T	1M	9,180	1,146	1,500	10.6	10.6	10.5	11.9	1.5	1.3	1.4%	1.4%	9.6%	9.4%
AOC Holdings	5017.T	1H	1,226	1,837	2,760	7.5	17.3	7.0	10.0	1.0	1.0	0.8%	0.8%	8.6%	4.0%
TonenGeneral	5012.T	2M	5,865	1,164	1,340	17.1	15.9	9.2	9.6	3.0	3.4	3.4%	3.7%	9.9%	10.2%
Showa Shell	5002.T	3M	4,863	1,494	1,160	14.8	20.1	8.0	9.4	1.5	1.4	2.4%	2.4%	6.3%	4.6%
Japan Avg.						16.0	19.4	8.4	9.3	1.6	1.6	1.7%	1.8%	6.4%	5.8%
US															
Valero	VLO.N	2H	37,605	68	68	7.3	8.9	4.2	5.4	2.2	1.9	0.7%	0.7%	20.3%	14.6%
Tesoro	TSO.N	2H	6,485	47	51	7.7	7.0	3.6	4.0	1.9	1.5	0.7%	0.8%	20.5%	17.5%
Delek US Hldg	DK.N	2S	1,307	25	27	9.2	13.8	5.5	6.9	2.5	2.2	1.4%	0.6%	26.4%	16.0%
Sunoco	SUN.N	2H	8,560	71	75	8.2	8.3	4.5	4.9	3.1	2.5	1.5%	1.5%	18.8%	14.8%
US Avg.						7.6	8.7	4.2	5.2	2.3	2.0	0.9%	0.9%	20.2%	15.0%
Canada															
Imperial Oil Ltd	IMO.TO	2M	44,386	48	53	15.4	16.0	8.1	7.8	5.5	4.2	0.7%	0.8%	29.5%	26.3%
Petro-Canada	PCA.TO	2M	27,192	56	60	10.6	11.1	3.6	4.0	2.3	1.9	0.9%	0.9%	23.5%	19.8%
Suncor Energy	SU.TO	1M	42,663	92	116	18.4	16.0	10.6	9.6	3.8	3.1	0.4%	0.5%	13.5%	12.7%
Canada Avg.						15.4	14.8	8.0	7.6	4.1	3.2	0.7%	0.7%	22.1%	19.7%
Europe															
ERG	ERG.MI	2H	3,242	15	18	15.0	7.9	6.1	4.9	1.6	1.4	1.3%	3.2%	7.6%	10.0%
Hellenic Petroleum	HEPr.AT	2H	4,862	11	11	13.3	13.1	9.1	8.3	1.4	1.3	3.8%	3.8%	7.9%	8.0%
MOL	MOLB.BU	3H	17,334	28,110	24,000	14.0	14.4	7.4	9.3	5.4	4.1	1.9%	2.1%	16.9%	15.6%
Motor Oil	MORr.AT	1M	2,901	19	26	10.6	10.5	8.1	8.2	4.8	4.6	9.0%	9.1%	19.7%	18.9%
Neste Oil	NES1V.HE	1L	9,185	25	28	11.5	10.5	7.7	7.0	2.7	2.4	4.3%	4.8%	16.8%	15.8%
OMV	OMVV.VI	2H	20,635	49	54	9.6	9.0	5.1	4.8	1.8	1.6	2.3%	3.2%	14.4%	14.9%
Europe Avg.						11.9	11.2	6.7	7.0	3.1	2.6	2.9%	3.4%	14.9%	14.6%
EMEA															
Sasol	SOLJ.J	1M	28,873	318	350	12.7	10.3	7.2	6.7	3.2	2.6	2.8%	3.3%	19.2%	18.3%
PKN ORLEN	PKNA.WA	2M	9,161	57	62	10.7	8.2	6.1	5.3	1.1	1.1	2.8%	3.7%	9.1%	10.2%
Tupras	TUPRS.IS	2M	6,517	32	19	12.8	12.8	9.7	8.8	2.8	2.7	6.3%	6.3%	19.8%	21.2%
Petrol Ofisi AS	PTOFS.IS	2H	2,540	6	6	68.3	12.5	6.5	7.4	1.8	1.6	0.0%	0.0%	16.4%	12.3%
Gazpromneft	SIBN.RTS	2M	20,245	4	4	6.9	8.0	4.9	5.2	1.7	1.4	3.0%	2.6%	27.4%	22.0%
Surgutneftegaz	SNGS.RTS	3H	48,945	1	1	13.9	15.5	5.6	5.9	2.0	1.9	1.6%	1.4%	21.4%	16.7%
Tatneft	TATN.RTS	3H	12,092	6	5	10.7	12.0	8.0	9.1	1.3	1.3	3.2%	2.5%	10.5%	8.8%
Lukoil	LKOH.RTS	2L	71,958	85	78	9.6	10.5	6.7	7.0	1.8	1.6	2.6%	2.4%	17.6%	14.3%
TNK-BP Holding	TNBPI.RTS	1S	32,488	2	2	7.1	8.3	4.2	4.7	3.3	2.8	7.0%	6.0%	29.4%	22.9%
EMEA Avg.						11.1	11.1	6.1	6.3	2.2	1.9	3.2%	3.0%	20.4%	16.9%
Total Avg.						12.3	12.3	6.8	6.8	2.7	2.3	2.5%	2.5%	18.8%	16.5%

Source: Powered by dataCentral. Note: All averages are simple averages.

Reliance Petroleum

Company description

RPL is presently 75% owned by Reliance Industries (RIL) and is setting up a super-size greenfield refinery (580,000bpd) and polypropylene plant in Jamnagar in the State of Gujarat. The project cost is estimated at Rs270bn (US\$6bn), of which 50% has been raised as equity through the promoter contribution and Initial Public Offering in early FY07. The project is scheduled to commission in mid-2008.

Investment strategy

We rate Reliance Petroleum (RPL) Hold/Low Risk (2L) rating with a target price of Rs170. RPL is constructing a super-sized refinery (580kbpd) targeted at export markets. Key competitive advantages that we expect to aid sustenance of superior margins include a heavier crude mix, product flexibility, and superior fuel specs. A tried-and-tested location and parent RIL's strong execution track record imparts RPL a head start over competing projects, which are getting delayed. RPL's proposed refinery would operate as swing capacity catering to product-specific demand across refining basins. We expect tightening fuel specs, especially in the US and Europe, will continue to drive demand for high-quality, differentiated products. However, the stock has undergone a sharp re-rating over the last 6 months on the back of favorable global environment, rising replacement costs and demonstrated strong execution leaving moderate upside potential.

Valuation

Our valuation methodology uses a traditional EV/EBITDA multiple as on September-08 applied on 12-mnth forward EBITDA i.e. 2HFY09E plus 1HFY10E. In addition, we value the tax benefits separately which is added to the core value to arrive at the target price. We believe EV/EBITDA is an appropriate valuation metric as it eliminates variations due to capital structure and taxation, thus facilitating peer comparison.

We believe that RPL, with its level of complexity (which we believe accords sustainability to margins) continues to warrant a valuation at the higher end of peers i.e., a 12-month forward EV/EBITDA of 7.0x (earlier 6.5x). Based on our GRM assumptions and the highly remunerative tax regime, we value the tax benefits to be worth NPV of US\$2.8bn (Rs26/share). This together with core value based on 12-mnth fwd EBITDA multiple (Rs144/share) is the basis of our new target of Rs170/share.

Risks

Our quantitative risk rating system suggests a Low Risk rating to RPL. We believe that RPL's strong parentage and remarkable project progress mitigate the execution risks to a large extent and lend support to the Low Risk rating. Favorable demand-supply economics in refining and RPL's positioning to take advantage from the situation provide further comfort.

Any of the following risk factors could result in downside risk to our target price: 1) Sharp decline in refining margins due to demand slowdown and/or quicker-than-expected commissioning of greenfield capacities globally; 2) Decline in L/H crude differential; and 3) Continued rupee appreciation. In the long term, any move to merge with the parent, RIL, could pose risks to the stock although Chevron's present stake of 5% (and option to acquire further 24%) would act as impediments.

Any of the following risk factors could result in upside to our target price: 1) Further strengthening of refining margins; 2) Re-investment of free cash flows in capacity additions which could be value accretive in addition to sustaining the tax breaks beyond the first 10 years; and 3) Higher than anticipated cost savings from the KG basin gas.

Appendix A-1

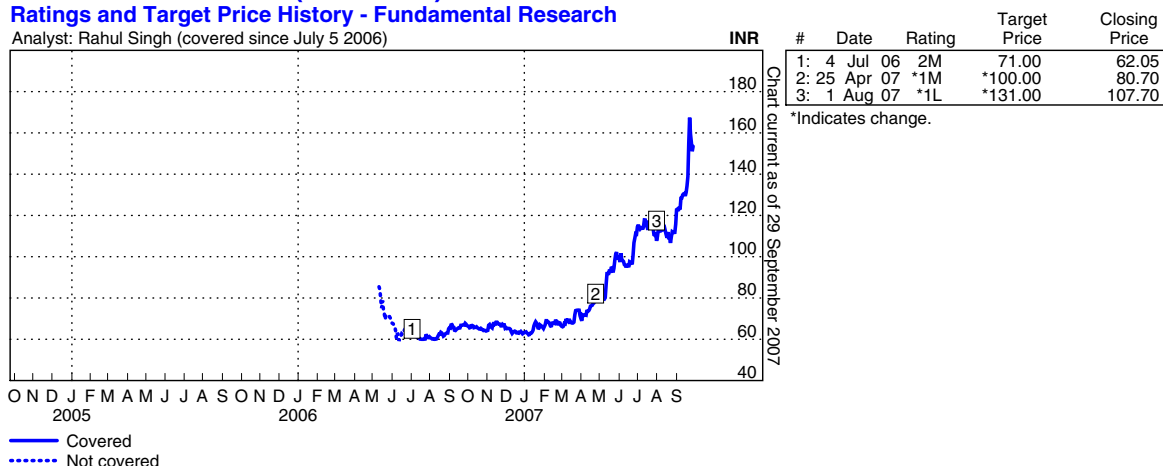
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IMPORTANT DISCLOSURES

Reliance Petroleum (RPET.BO) Ratings and Target Price History - Fundamental Research

Analyst: Rahul Singh (covered since July 5 2006)



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Reliance Petroleum (RPET.BO)

4 October 2007

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