

Company Flash

13 February 2008 | 6 pages

Reliance Industries (RELI.BO)

Buy: D3 Discovery Reaffirms Faith in E&P

- First discovery in KG-D3 block** — RIL today announced a natural gas discovery in the first exploratory well drilled in the deepwater KG-DWN-2003/1 (KG-D3) block in the Krishna Godavari basin. This is the first discovery in the 3,288 sq km block which was awarded in NELP-V and in which RIL holds 90% stake, with the balance held by Hardy Oil. Drilling in a second well in the block has also been commenced.
- Noteworthy, earlier-than-expected** — The well, which was drilled at a water depth of 716m to a total depth of 1937m, encountered a thick reservoir with gross hydrocarbon column of ~84m, which prima facie appears encouraging. We had anticipated drilling in the D3 block to commence towards end-08 due to shortage of rigs. However, opportunities available on the rig supply side have enabled earlier-than-expected procurement of rigs for drilling in the block. Similar windows of opportunities in future could also enable RIL to commence drilling in the deepwater D9 (with Hardy) and MN-D4 (with Niko) blocks earlier than end-08 as is currently expected.
- Reaffirms faith in E&P; reiterate Buy** — Sustained discoveries and further potential in D9 and MN-D4 reaffirm our faith in the E&P story. Despite ongoing concerns of a global slowdown and the possible impact on refining margins, we think current valuations do not fully factor in the upside from E&P. With the recent correction in the stock price (down 25% from its highs), we reiterate a strong Buy (1L) with a target price of Rs3460.

Buy/Low Risk	1L
Price (13 Feb 08)	Rs2,402.00
Target price	Rs3,460.00
Expected share price return	44.0%
Expected dividend yield	0.6%
Expected total return	44.7%
Market Cap	Rs3,491,664M US\$88,207M

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



Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2006A	90,693	65.10	19.8	36.9	11.7	26.4	0.4
2007A	119,434	82.18	26.2	29.2	5.5	25.8	0.5
2008E	148,046	101.87	24.0	23.6	4.6	21.1	0.6
2009E	198,827	136.82	34.3	17.6	3.8	23.5	0.8
2010E	231,120	159.04	16.2	15.1	3.1	22.5	0.9

Source: Powered by dataCentral

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Figure 1. Drilling programme

License	Activity	Timing
D9 (KG basin)	Drill 1-2 wells	2H08
D4 (Mahanadi basin)	Drill first well	2H08 (after completion of 3D seismic data acquisition)

Source: Hardy Oil, Niko Resources, RIL

Figure 2. E&P – Valuation based on EV/FCF

	FY11E	
Operating cash flows (Rs m)	169,007	Assuming 80+9mmscmd gas and 45kbpd oil production
Operating cash flows (US\$m)	4,225	
Less: Yearly exploration spend (US\$m)	700	Based on management guidance
FCF (US\$m)	3,525	
EV/FCF 12-mnth fwd (x)	15.0	
EV Mar-10E (US\$ bn)	53	
EV Mar-10E (Rs bn)	2115	
Imputed Mar-10 PE (x)	13.5	
EV Dec-08E (Rs bn)	1878	
EV Dec-08E (US\$m)	47	
Value per share (Rs)	1291	
Premium to NAV (%)	56%	

Source: Citi Investment Research estimates

Figure 3. RIL – Sum-of-the-parts Valuation

	Rs m	Rs/share	Comments
FY09E EBITDA forecast	216,271		Excluding contribution from KG basin
FY10E EBITDA forecast	200,275		
EV of Petrochem and Refining business	1,562,046	1,074	Valued at EV/E of 7.5x mid-FY10E
Net Debt	17,201	12	Est. as on Sep-08, excl. ST Debt and net of liquid inv., incl. profit on recent RPL stake sale
Key investments			
Reliance Petroleum	604,828	498	PER of 9x contribution to consolidated profits in FY10E
E&P assets	1,413,326	1,291	Based on 15x steady state FCF (incl. D-6 oil and gas upside in FY11E)
Organized retail	190,971	137	Based on Dec-08E
Total value of investments & other assets	2,209,125	1,927	
EV of businesses	1,502,182	1,074	
Net debt adjusted for key investments	(2,084,789)	(1,915)	
Value of treasury stock	565,325	471	At target price
Value for equity holders (Rs m)	4,152,296	3,460	
No. of shares (m)	1,454		

Source: Citi Investment Research estimates

Reliance Industries

Company description

Reliance Industries is a conglomerate with interests in upstream oil & gas (E&P), refining, and petrochemicals. It is building a super-size refinery project through its 75% subsidiary (RPL) and is now undertaking development of a

large gas find 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 Buy/Low Risk with a target price of Rs3,460. We expect regional refining margins to remain robust due to project delays in the Middle East, with RIL enjoying an enhanced premium for its superior complexity. E&P business has delivered positive surprise and looks set to become more meaningful in the next 3-4 years as KG D6 field commences production and new discoveries are brought on stream. Upgrade of reserves in KG basin adds to the value, although the NAV of the gas find depends on development capex and the demand profile from anchor customers. Given the track record of exploratory success and the evolving portfolio (much beyond KG D6), RIL's E&P business needs to be valued as a going concern rather than a combination of assets. We have therefore valued E&P business (Rs1291/share) on more traditional EV/FCF multiple rather than the consensus NAV approach. Robust demand and delay in capacity additions is likely to push the downturn in petrochemicals cycle into FY10; this should be offset by diversity of products to some extent. Factors such as diversity of revenues, integration across product chains, and volume growth should help RIL tide over downturns in product cycles.

Valuation

Our target price of Rs3,460 is based on a sum-of-the-parts value: 1) RIL's core petrochem and downstream oil business is valued on an EV/EBITDA of 7.5x mid-FY10E, at the higher end of the regional chemicals and refining peers. The increase in EV/EBITDA multiple is on account of the fact that we now capture the downturn in core businesses factored in FY10 (sharp decline in petrochemical and moderate decline in refining); 2) Total E&P assets including oil & gas prospects and other blocks are valued at Rs1291/share based on 15x steady state (FY11E) FCF. This is higher than EV/FCF multiple of 12x used earlier as we get more visibility on D6 upside, more discoveries (KG-D4, KG-III-5) in last 3-4 months even as we incorporate higher pure E&P capex (US\$700m p.a.), as guided by management; 3) Investment in RPL valued at 9x profit contribution to consolidated profits; 4) Organized retail business value is rolled forward to Dec-08E and factored in at Rs137/share, as per Citi's retail analyst, Princy Singh; and 5) Treasury stock valued at RIL's target price.

Risks

We rate RIL Low Risk, as opposed to the Medium Risk suggested by our quantitative risk-rating system, which tracks 260-day historical share-price volatility. Diversified earnings and significant value contribution from the emerging E&P business and investment in listed subsidiaries have led to qualitative changes in the value constituents of the stock. Risks that could impede the stock from reaching our target price are: RIL's margins are exposed to the global petrochemical and refining cycles; the group could be asked to offer larger discounts on products sold to oil public sector units; delays in the key KG-D6 gas development and RPL refinery project; 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.

Appendix A-1

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Analyst: Rahul Singh (covered since October 6 2005)



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