

MAY 24, 2010

UPDATE

Coverage view: **Cautious**

Price (Rs): **996**

Target price (Rs): **1,040**

BSE-30: **16,446**

Brothers up in arms to brothers in arms? The dissolution of non-compete agreements between RIL and R-ADAG groups may allow RIL to pursue new investment areas. However, we do not think RIL will enter the telecom or financial services industries in the near term. However, the development may have implications for the telecom sector if the ROFRs (right of first refusal) in the family separation agreement have also been cancelled. We retain our SELL rating on RIL stock.

Company data and valuation summary

Reliance Industries

Stock data		Forecasts/Valuations			
		2010	2011E	2012E	
52-week range (Rs) (high,low)	1,190-859	EPS (Rs)	49.4	61.6	79.3
Market Cap. (Rs bn)	2,962.8	EPS growth (%)	(2.3)	24.6	28.8
Shareholding pattern (%)		P/E (X)	20.1	16.2	12.6
Promoters	41.1	Sales (Rs bn)	1,924.6	2,495.6	2,624.2
FIs	20.5	Net profits (Rs bn)	162.4	202.2	260.4
MFs	2.4	EBITDA (Rs bn)	309.4	394.1	446.5
Price performance (%)		EV/EBITDA (X)	10.9	8.0	6.5
Absolute	1M (5.6) 3M (1.3) 12M (5.9)	ROE (%)	11.4	12.9	14.8
Rel. to BSE-30	0.3 (0.3) (21.4)	Div. Yield (%)	0.6	0.8	1.0

Non-compete agreements between RIL and R-ADAG groups cancelled

RIL and R-ADAG have cancelled non-compete agreements that prevented each group from entering the other's industries. However, RIL cannot enter gas-based power generation until FY2022. The possibility of RIL entering the telecom and financial services industries remains—however, we doubt this in the near term given (1) an extremely competitive telecom sector and (2) non-availability of banking licenses for industrial groups. RIL can invest in an extant telecom player and the latter point could change in the future, allowing RIL to enter the banking industry.

Unlikely to enter telecom sector but other implications for telecom sector

We think it is extremely unlikely that RIL will enter into the telecom sector at the current juncture given (1) hyper competition among several strong players, (2) regulatory risks and (3) likely slowdown in industry growth over the next 1-2 years. However, RIL can buy out an extant player. More important, RCOM may have the flexibility to partner a new entity and/or sell itself in case the ROFR with RIL has been removed. We would highlight that the ROFR with RIL had prevented RCOM from partnering with MTN about two years back.

May enter financial services sector but financial services industry has its own challenges

We doubt RIL would want to enter the financial services sector without a banking license; the rest of the financial services industry is extremely challenging (AMC, broking, IB) and competitive (insurance) and a new player would find it difficult to create meaningful value. Current government/regulatory policy prevents industrial groups from owning a bank. However, the finance minister in his FY2011 budget speech stated that the government may review this policy—"The RBI is considering new bank licenses to promoters in the private sector and also NBFCs, if they meet the eligibility criteria of the RBI."

At the risk of committing heresy, RIL's new ventures have not been very successful

We note that RIL's non-energy initiatives (retailing, SEZ) have not been very successful given specific challenges in those areas. Also, RCOM was RIL's initiative and it has been less successful than originally envisaged by us; it may have been hobbled from the beginning by its 'forced' choice of CDMA technology.

QUICK NUMBERS

- Reliance retailing business reported loss of Rs5.3 bn on sales of Rs46 bn in FY2009
- Rs75 bn of investment in SEZs up to FY2009

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Kotak Institutional Equities Research

RIL: Profit model, balance sheet, cash model, March fiscal year-ends, 2006-2014E (Rs mn)

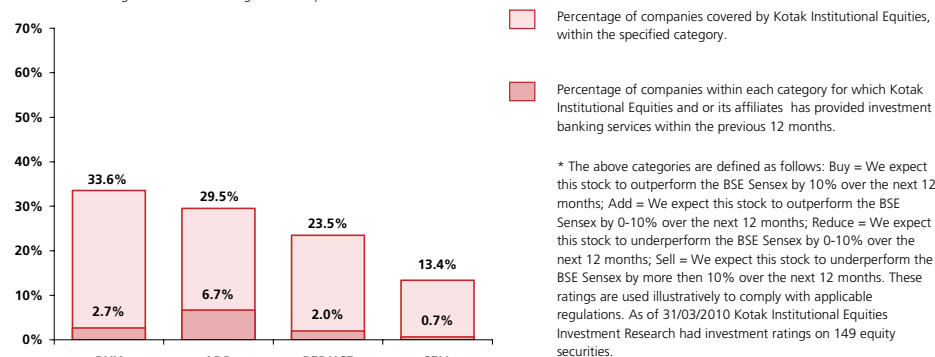
	2006	2007	2008	2009	2010E	2011E	2012E	2013E	2014E
Profit model (Rs mn)									
Net sales	809,113	1,114,927	1,334,430	1,418,475	1,924,610	2,495,632	2,624,219	2,724,442	2,738,544
EBITDA	139,991	198,462	233,056	233,139	305,810	390,498	442,904	476,630	475,198
Other income	6,829	4,783	8,953	20,599	24,600	18,140	16,807	29,295	52,812
Interest	(8,770)	(11,889)	(10,774)	(17,452)	(19,970)	(22,434)	(7,476)	(4,645)	(3,703)
Depreciation & depletion	(34,009)	(48,152)	(48,471)	(51,953)	(104,970)	(126,671)	(120,497)	(138,676)	(143,694)
Pretax profits	104,041	143,205	182,764	184,332	205,470	259,534	331,738	362,603	380,613
Extraordinary items	3,000	2,000	47,335	—	—	—	—	—	—
Tax	(9,307)	(16,574)	(26,520)	(12,634)	(31,110)	(58,256)	(75,410)	(90,985)	(98,124)
Deferred taxation	(7,040)	(9,196)	(8,999)	(18,605)	(12,000)	949	4,060	13,771	18,787
Net profits	90,693	119,434	194,580	153,093	162,360	202,227	260,388	285,389	301,276
Adjusted net profits	88,152	117,789	152,605	153,093	162,360	202,227	260,388	285,389	301,276
Earnings per share (Rs)	31.6	40.5	52.5	50.6	49.4	61.6	79.3	86.9	91.7
Balance sheet (Rs mn)									
Total equity	430,543	673,037	847,853	1,263,730	1,371,717	1,543,325	1,766,289	2,007,450	2,264,499
Deferred taxation liability	49,708	69,820	78,725	97,263	109,263	108,314	104,254	90,483	71,696
Minority interest	—	33,622	33,622	—	—	—	—	—	—
Total borrowings	218,656	332,927	493,072	739,045	624,950	359,517	118,692	116,467	116,207
Current liabilities	164,545	192,305	251,427	357,019	404,136	385,876	402,560	412,000	412,424
Total liabilities and equity	863,452	1,301,712	1,704,700	2,457,057	2,510,066	2,397,032	2,391,795	2,626,400	2,864,827
Cash	21,461	18,449	42,822	221,765	134,620	74,012	101,295	386,201	689,230
Current assets	224,283	286,566	402,721	325,358	489,160	501,032	514,318	526,670	528,067
Total fixed assets	626,745	899,403	1,081,638	1,693,869	1,653,990	1,589,693	1,543,887	1,481,234	1,415,235
Investments	(9,038)	97,294	177,519	216,065	232,295	232,295	232,295	232,295	232,295
Deferred expenditure	—	—	—	—	—	—	—	—	—
Total assets	863,452	1,301,712	1,704,700	2,457,057	2,510,066	2,397,032	2,391,795	2,626,400	2,864,827
Free cash flow (Rs mn)									
Operating cash flow, excl. working capital	119,520	164,285	180,718	174,508	244,890	303,289	351,927	376,791	368,386
Working capital	(32,188)	(13,075)	(31,071)	(37,983)	(116,686)	(30,132)	3,399	(2,912)	(972)
Capital expenditure	(94,273)	(247,274)	(239,691)	(247,128)	(148,099)	(61,550)	(65,645)	(72,772)	(71,754)
Investments	(32,364)	(105,760)	(78,953)	(10,392)	(16,230)	—	—	—	—
Other income	5,159	4,143	6,132	16,195	24,600	18,140	16,807	29,295	52,812
Free cash flow	(34,146)	(197,681)	(162,865)	(104,800)	(11,524)	229,747	306,489	330,402	348,473
Ratios (%)									
Debt/equity	45.5	44.8	53.2	54.3	42.2	21.8	6.3	5.6	5.0
Net debt/equity	41.1	42.3	48.6	38.0	33.1	17.3	0.9	(12.9)	(24.5)
RoAE	19.9	20.3	18.9	13.6	11.9	13.4	15.3	14.8	13.9
RoACE	13.8	13.9	12.7	11.2	9.3	10.9	13.5	13.4	12.5

Source: Company, Kotak Institutional Equities estimates

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Distribution of ratings/investment banking relationships



Source: Kotak Institutional Equities

As of March 31, 2010

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ADD. We expect this stock to outperform the BSE Sensex by 0-10% over the next 12 months.

REDUCE. We expect this stock to underperform the BSE Sensex by 0-10% over the next 12 months.

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Our target price are also on 12-month horizon basis.

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