22 June 2011 | 8 pages

# Reliance Industries (RELI.BO)

## Alert: Stock Pricing in No Light at the End of the E&P Tunnel

- Company Update

- **What is the stock pricing in? Bare-bones E&P value —** Following the recent stock correction on the back of the draft CAG audit report, we have run sensitivities on our SOTP to gauge what the stock is pricing in. We conclude that it is now building in: (i) E&P back to trading on par with NAV (vs. a premium earlier), and that too of sharply lower reserves (9.3 tcf), and (ii) refining and petchem trading at 6.2x EV/EBITDA (6-8x for peers), despite refining margins remaining resilient of late. While sentiment on the stock may continue to be governed by news flow (CAG audit, KG ramp-up, doubts on reserves), the stock now seems to be pricing in a near no hope situation as far as E&P is concerned, offering good value once (and if) all the noise subsides. We highlight below what we believe are the assumptions embedded in the current price.

- **#1: Gas vols declining to 45 mmscmd and never recovering —** If we assume gas vols to decline to 45 mmscmd from current reported levels of ~47-48 (*source: indianpetro*) and stay there through the asset life before their natural decline, this yields a NAV of Rs151/sh for KG-D6, which is what the stock seems to be pricing in. This conservatively assumes gas prices to increase by only US$1 to US$5.2 w.e.f. FY15, which is in line with the prices already approved for some of ONGC's incremental gas and lower than existing prices of US$5.6-5.7 for PMT gas. This also, extremely conservatively, assumes no value for any of the other blocks and essentially completely ignores RIL's past exploration successes (as well as today's gas discovery in KG-D9).

- **#2: Pricing in recoverable reserves of 9.3 tcf —** The above assumption yields cumulative recovery of 9.3 tcf for KG-D6. This is below the 11.3 tcf 2P reserves as per the FDP filed for the block as well as below the 13.0 tcf reserves as per Niko's FY08 press release. Niko has recently published a reserve update indicating that its 2P reserves have been reduced by 17%, without disclosing the break-up of this reduction among its various assets (KG-D6, Hazira, Bangladesh). Given its other assets are relatively small, a large portion of the downgrade could admittedly be attributable to KG-D6. Even in a worst case, this would, however, be a downgrade of 2.7 tcf to its last reported reserves of 13.0 tcf, still above the 9.3 tcf being currently implied for the block.

- **#3: Imputing EV/EBITDA of 6.2x for refining/petchem —** Stripping out E&P value of Rs151/sh, the stock is imputing 6.2x EV/EBITDA for refining and petchem, at the lower end of the 6-8x band for regional peers. This is based on our GRM assumptions of US$10.0/10.5 for FY12/13E. Refining margins have held on well recently and could surprise on the upside, though they do remain exposed to a macro slowdown.

- **Refining strength could drive 1Q surprise —** S'pore GRMs have averaged US$8.8 in 1QFY12TD. Excluding 4QFY11 where Reliance's GRMs were impacted by a shutdown in its FCCU bringing down its premium to S'pore to US$1.8, the company has reported premia of US$2.5-4.4 over the preceding 8 qtrs, with an avg premium of US$3.4. Even at the lower end of this range, Reliance could report 1Q GRMs close to ~US$11 levels, well above what we or consensus are building into full-year forecasts.

| | |
|---|---|
| **Buy/Low Risk** | **1L** |
| Price (22 Jun 11) | Rs846.10 |
| Target price | Rs1,115.00 |
| Expected share price return | 31.8% |
| Expected dividend yield | 1.2% |
| **Expected total return** | **33.0%** |
| Market Cap | Rs2,769,907M |
| | US$61,766M |

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


**Saurabh Handa**
+91-22-6631-9858
saurabh.handa@citi.com

Garima Mishra
garima.mishra@citi.com

**See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.**

## Stock pricing in bare-bones E&P valuations

**Figure 1. What is the stock pricing in?**

| | Base Case Rs/sh | Basis | Bear case Rs/sh | Basis |
|---|---|---|---|---|
| Refining and petchem | 705 | @ EV/E of 7x mid-FY13E | 625 | @ EV/E of 6.2x mid-FY13E (vs. 6-8x for peers) |
| E&P assets | 307 | 25% premium to NAV of Rs245 (imputed EV/EBITDA of 9.4x mid- FY13E); implies recoverable reserves of 16.8 tcf; at 19% discount to BP valuation | 151 | Assuming gas vols declining to 45 mmscmd and never recovering, thereby implying recoverable reserves of 9.3 tcf (vs. 13.0 tcf reserves as per Niko's FY08 press release); ascribing nil premium to NAV (i.e., no value for other blocks) |
| Shale gas assets | 30 | Based on NPV of assets | 30 | Based on NPV of assets |
| Organised retail & other investments | 42 | Based on BV of investments so far into organised retail, SEZ, etc. | 42 | Based on BV of investments so far into organised retail, SEZ, etc. |
| Net debt | 61 | Estimated as on Sep-11E excluding the US$2bn advance received from BP | 61 | Estimated as on Sep-11E excluding the US$2bn advance received from BP |
| Value of treasury stock | 76 | 292m treasury shares at 20% discount to target price | 58 | 292m treasury shares at 20% discount to target price |
| **Total SOTP value** | **1,100** | | **845** | |

Source: Citi Investment Research and Analysis

## Refining/petchem also under-valued despite business showing resilience

**Figure 2. At current stock levels (Rs845/sh), refining/petchem appear under-valued even at bare-bones E&P valuations**

| | -15% | Bare-bone valuation* | +15% | Comments |
|---|---|---|---|---|
| E&P assets (Rs/sh) | 128 | 151 | 173 | As shown in Figure 1, E&P value of Rs151/sh corresponds to flat gas volume assumptions of 45 mmscmd and no value to other blocks (nil premium to NAV) |
| Imputed refining and petchem EV/EBITDA multiple to arrive at current stock price* | 6.4x | 6.2x | 6.0x | Even at bare-bone E&P valuations, refining and petchem appear under-valued at 6.0-6.4x EV/EBITDA, at the lower end of the 6-8x range for peers |

Source: Citi Investment Research and Analysis. * At current stock price of Rs845/sh

# Reliance Industries

## Valuation

Our Rs1,115 target price is based on an average of a sum-of-the-parts value (Rs1,070/sh) and P/E value (Rs1,101/sh) and explicitly adds NPV of the shale gas JVs of Rs30/sh. Our SOTP is derived by: 1) Valuing RIL's core petchem and downstream oil business on an EV/EBITDA of 7.0x mid-FY13E which yields a value of Rs705/sh; 2) Valuing total E&P assets including oil & gas prospects and other blocks at Rs307/sh based on a 25% premium to NAV of known reserves; 3) Valuing investments in the organized retail business, SEZ, telecom, etc. at Rs42/share, based on book value of investments so far; 4) Valuing treasury stock at a 20% discount to target price; 5) Subtracting net debt estimated as on Sep-11E (net of capex on future expansion projects such as petchem) of Rs200bn or Rs61/sh. For the P/E valuation, we ascribe a 13x mid-FY13E multiple, in line with the market multiple. While earnings from the E&P business are now likely to be more back-ended given delays in gas ramp-up believe, near-term earnings have support from the strong refinery and petchem outlook. This prompts us to give equal weightage to a multiple-based methodology and a sum-of-the-parts based value while deducing our target price.

## Risks

We rate RIL Low Risk, in line with the rating suggested by our quantitative risk-rating system. With the core refining and petrochemicals businesses gaining momentum, we believe that risks on slower KG ramp-up could be partly offset. Downside risks that could prevent the shares from reaching our target price include: RIL's margins are exposed to the global refining and petrochemical cycles, which could be impacted in the eventuality of a global macro slowdown; further delays in the ramp-up of production of KG-D6 gas; delays in the drilling programme and/or negative news-flow for the other blocks (D9, D3, MN-D4); charges against RIL pertaining to a 2007 case regarding insider trading in shares of RPL (an erstwhile subsidiary), which could impact stock sentiment; lack of clarity on deployment of cash and/or announcements on unrelated diversifications.

# Appendix A-1

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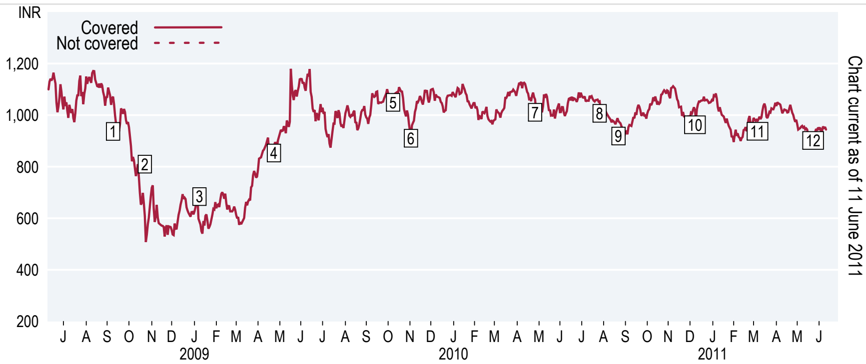
**Fundamental Research**

Analyst: Saurabh Handa
Covered since June 18 2010




| | Date | Rating | Target Price | Closing Price |
|---|---|---|---|---|
| 1 | 9-Sep-08 | 1L | *1,225.00 | 1,071.42 |
| 2 | 23-Oct-08 | *1M | *878.00 | 607.63 |
| 3 | 8-Jan-09 | 1M | *737.50 | 598.40 |
| 4 | 23-Apr-09 | *2L | *917.50 | 881.18 |
| 5 | 8-Oct-09 | 2L | *1,100.00 | 1,059.60 |
| 6 | 3-Nov-09 | *1L | 1,100.00 | 910.33 |
| 7 | 27-Apr-10 | *2L | *1,150.00 | 1,061.10 |
| 8 | 27-Jul-10 | 2L | *1,140.00 | 1,053.50 |
| 9 | 23-Aug-10 | *1L | 1,140.00 | 976.40 |
| 10 | 8-Dec-10 | 1L | *1,184.00 | 1,019.10 |
| 11 | 7-Mar-11 | 1L | *1,120.00 | 976.15 |
| 12 | 24-May-11 | 1L | *1,115.00 | 915.25 |

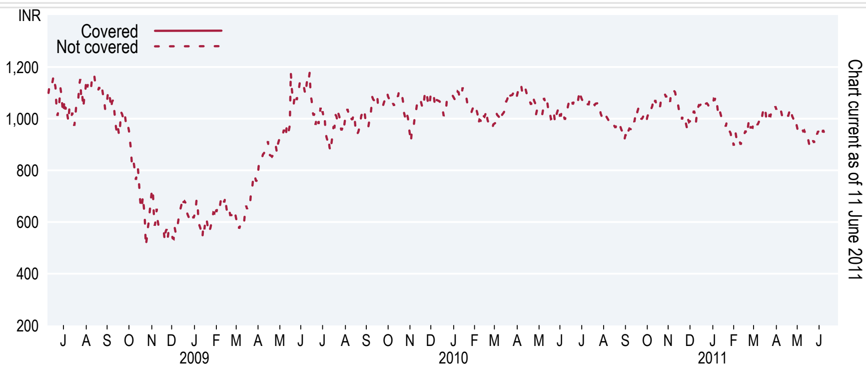
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

## Reliance Industries (RELI.BO)

**Ratings and Target Price History**
**Best Ideas Research**
**Relative Call (3 Month)**

Analyst: Saurabh Handa
Covered since June 18 2010

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|---|---|---|---|---|---|---|
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