Reliance Capital Ltd.

Initial Opinion **BUY**

Equity | India | Services-Consumer/Commercial
16 March 2007

A 'Play' on financial services

Merrill Lynch

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Initiating coverage with Buy; PO of Rs850

We initiate coverage on Reliance Capital (RCAP) with 'Buy' and a PO of Rs850 i.e. >35% upside. RCAP could, in our view, emerge among the top 3-5 in each of its businesses – Asset management, general insurance, retail brokerage and consumer finance – driven by expanding distribution, aggressive marketing and RCap's comprehensive product range.

Insurance, brokerage and consumer fin. to drive valuations

Biggest contributors to future growth are likely to be a) life insurance business, b) brokerage and c) consumer finance (latter two to be launched in next 3 months) accounting for around 70% of its sum of parts value.

Life venture to grow 5x in FY07-09; 9% mkt. share in FY10

We expect >5x rise in total premium over FY07-09E (to Rs48.2bn) resulting in a 4x rise in NBAP (new business achieved profit) to Rs5.4bn by FY09. We expect Rel. Life to attain mkt. share of 9% by FY10 – making it one of the top 5 insurers. Rel. Life, can, one year from now, be arguably valued upto 17x FY09E NBAP (in line with multiples assigned to other insurers) implying a value of US$2.1bn.

Brokerage, consumer finance launch to be the catalysts

One year from now, brokerage to be valued at 12x FY09E earnings (US$410mn), i.e. at a 15% discount to the market multiples; while consumer finance is valued at 1.5x FY09E book i.e. US$621mn based on estimated ROE of 18-20%. Adding current value of listed investment i.e.US,$986mn, value of AMC at US$495mn (4% of AUM) and general insurance at US$172mn on FY09E we estimate, RCap could, 1 year from now, have market cap of US$4.8bn i.e. Rs852/share. Leverage to market and execution delays are the risks to our PO.

Estimates (Mar)

(Rs)	2005A	2006A	2007E	2008E	2009E
Net Income (Adjusted - mn)	317	5,714	5,060	6,399	9,717
EPS	2.48	25.58	20.64	26.11	39.64
EPS Change (YoY)	-81.6%	930.8%	-19.3%	26.5%	51.8%
Dividend / Share	2.99	3.19	4.00	5.00	7.00

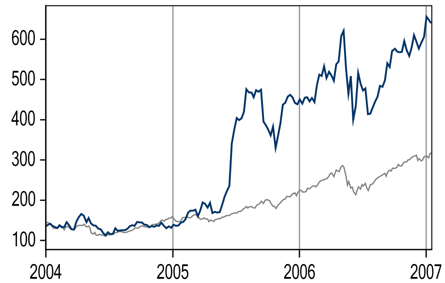
Valuation (Mar)

	2005A	2006A	2007E	2008E	2009E
P/E	240.93x	23.37x	28.96x	22.90x	15.08x
Dividend Yield	0.500%	0.534%	0.669%	0.836%	1.17%

* For full definitions of *iQmethod* SM measures, see page 38.

Stock Data

Price	Rs597.80
Price Objective	Rs850.00
Date Established	16-Mar-2007
Investment Opinion	C-1-7
Volatility Risk	HIGH
52-Week Range	Rs320.10-Rs729.00
Mrkt Val / Shares Out (mn)	US$3,311 / 245.1
Average Daily Volume	553,649
ML Symbol / Exchange	RLCCF / BSE
Bloomberg / Reuters	RCFT IN / RLCP.BO
ROE (2007E)	13.6%
Net Dbt to Eqty (Mar-2006A)	NA
Est. 5-Yr EPS / DPS Growth	30.0% / 20.0%
Free Float	48.0%



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Refer to important disclosures on page 39 to 40. Analyst Certification on page 37. Price Objective Basis/Risk on page 36.

iQprofile SM Reliance Capital Ltd.

Key Income Statement Data (Mar)	2005A	2006A	2007E	2008E	2009E
(Rs Millions)					
Sales	3,918	9,014	18,076	33,314	56,996
Gross Profit	NA	NA	NA	NA	NA
Sell General & Admin Expense	NA	NA	NA	NA	NA
Operating Profit	1,324	6,154	5,465	7,437	12,258
Net Interest & Other Income	NA	NA	NA	NA	NA
Associates	(864)	(69)	0	0	0
Pretax Income	460	6,085	5,465	7,437	12,258
Tax (expense) / Benefit	(128)	(336)	(405)	(1,038)	(2,541)
Net Income (Adjusted)	317	5,714	5,060	6,399	9,717
Average Fully Diluted Shares Outstanding	128	223	245	245	245
Key Balance Sheet Data					
Property, Plant & Equipment	2,334	1,902	3,436	3,364	3,359
Other Non-Current Assets	NA	NA	NA	NA	NA
Trade Receivables	NA	NA	NA	NA	NA
Cash & Equivalents	362	2,016	6,162	7,240	8,932
Other Current Assets	NA	NA	NA	NA	NA
Total Assets	29,866	47,175	38,355	74,736	121,821
Long-Term Debt	13,136	2,419	3,400	39,511	82,537
Other Non-Current Liabilities	NA	NA	NA	NA	NA
Short-Term Debt	NA	NA	NA	NA	NA
Other Current Liabilities	NA	NA	NA	NA	NA
Total Liabilities	14,935	5,061	6,267	42,627	85,926
Total Equity	14,931	42,114	32,088	32,109	35,895
Total Equity & Liabilities	29,866	47,175	38,355	74,736	121,821
iQmethod SM **- Bus Performance***					
Return On Equity	2.1%	20.0%	13.6%	19.9%	28.6%

* For full definitions of *iQmethod* SM measures, see page 38.

Company Description

Reliance Capital is one of India's leading and fastest growing private sector financial services companies. It is one of the largest asset management companies in India. It also offers life insurance and general insurance products through its subsidiaries. It has sizable private equity and proprietary investments and is now pursuing interests in stock broking, consumer financing and the asset recovery business.

Table 1: Valuations based on Sum of Parts

FY09 Estimated value (US$mn)	Value	Value per share
Life insurance	2,118	376
General Insurance	172	30
Asset Management	495	88
Broking	410	73
Mkt. price of listed inv.	986	175
Consumer financing	621	110
	4,802	852

Source: Company Reports, Merrill Lynch Research Estimates

Stock Data

Price to Book Value	4.6x

Initiating with Buy; PO of Rs850

We are initiating coverage on Reliance Capital (RCap), a leading non-bank finance company (NBFC) with a 'Buy' recommendation and a Price objective (PO) of Rs850 based on our sum of parts valuation (summarized in Table 3) implying a +35% upside from present levels.

Traditional valuations can't capture growth of businesses

On traditional valuation parameters (see table below), RCAP trades at 22x FY08E earnings and 4.4x FY08E book with a forecast ROE of >25%. The reported P/E and P/Book could be however slightly different depending on the extent of profit on the sale of investments that RCAP decides to unlock from its unrealized gains of around US$700mn.

Table 2: Valuations

Traditional Valuation Metrics (Rs mn)	FY08	FY09
Current Market cap (@Rs620/share)	151,962	151,962
Less:		
Market value of listed investments	(42,645)	(42,645)
Market value of Insurance	(55,522)	(91,069)
Adjusted market value	53,795	18,248
Consolidated PAT	6,399	9,717
Less: Profit on sale of investments	4,000	4,200
Adjusted PAT	2,399	5,517
Net Worth - Reported	32,109	35,895
Less:		
Investment in listed entities	(11,789)	(11,789)
Cumulative profit on sale of investments	(8,000)	(12,200)
Adjusted net worth	12,320	11,907
Reported Nos		
P/E	23.7	15.6
P/Bk	4.7	4.2
ROE		29%
Adjusted nos (for equity gains and life insurance)		
P/E	22.4	3.3
P/Bk	4.4	1.5
ROE		46%

Source: Company Reports, Merrill lynch Research Estimates

We however strongly contend, that RCAP cannot be valued on traditional valuation measures as one of its fastest growing businesses –life insurance business – is likely to show a reported loss owing to high contingency provisions (not consolidated in our accounts). Further, the other key future valuation drivers are the brokerage and consumer finance business which are yet to be launched.

We believe a more relevant methodology would be to adjust the current market cap for i) the market value of RCap's listed investments and ii) estimated value of the life insurance business; the adjustment is done by way of deducting it from the market price (adding to the book value would amount to double counting).

The net profit is adjusted for the profit on the sale of investments and the net worth is adjusted for i) the cumulative profit on sale of investments over FY07-09E (built into our estimates) and ii) the cost price of the listed investments (the consolidated net worth is already adjusted for the investment in subsidiaries).

Adjusting for these two RCap trades at a P/E multiple of 22x FY08E and 4.3x FY08E Adj book; however the valuations look very compelling on FY09E (due to the sharp rise in value of insurance and rising profits from broking and consumer financing business) i.e. a P/E of 3.3x FY09E and a P/Bk of 1.5x with a forecasted ROE of 46%.

We however re-iterate our view that Rcap has to be valued on a sum of parts methodology valuing each of the businesses separately.

Sum of parts: key metric for valuing Rcap

We have valued each of the businesses of Rcap separately factoring in the distinct characteristic of each business. In the table below we have given the summary of the valuation methodology of each of the businesses, which is detailed below in the relevant business' section.

Currently, the market, in our view, is largely discounting the value of its businesses, on a one year forward (FY08E) multiple as shown below. However, we strongly believe the market is not assigning much value to the rapid growth expected in some of its key business lines, namely life insurance and the brokerage and consumer finance business.

Hence, one year out, based on the forecast FY09 multiples that each business could trade at (and adding the market value of the listed investments), we arrive at our sum of parts value of US$4.8bn, implying >35% upside. This is equivalent to a PO of RS850/share.

Table 3: Valuation based on Sum of Parts

US$ mn	Valuation Methodology- Based on FY09E	Based on FY08E	Based on FY09E
Life Insurance Business (100% owned)	Assuming a multiple of 17x FY09E NBAP; Market share, estimated at 8.4% in FY09 (from 4% now); Total premium to grow >5x over FY07-09 to Rs48.2bn in FY09	1,291	2,118
General Insurance (100% owned)	Assuming a multiple of 0.5x FY09E Net Premium income; implying a value of P/E multiple of 15.6x FY09E - normalised earning, and a P/Bk multiple of 2.2x. Gross written premium to grow 4x over Fy06-09.	95	172
Reliance Capital Asset Management (100% owned)	Based on 16x P/E on FY09E earnings; implying Price to AUM of 4% for equity AUM and 2% for Debt AUM. AUM to grow +25% in FY08-09 to Rs719bn. Earnings to grow at 65%CAGR, ROE of 45%.	411	495
Reliance Money - Broking (100% owned)	Based on a P/E multiple of 12x FY09E earnings (i.e. 15% discount to the market multiple); earnings are around 35% of Indiabulls estimated PAT (from broking business) in FY09	184	410
Market value of listed subsidiaries	Unrealised gains on holding in Adlabs, R Com, Reliance Energy and Reliance Industries. The cost price of these investments is adjusted by way of deduction from the net worth.	986	986
Consumer financing business	Valuing the adjusted networth (net worth net of investments in other subsidiaries) at 1.5x FY09E book	526	621
		3,492	4,802
Value per share (Rs)		680	852

Source: Company Reports, Merrill Lynch Research Estimates

Life business to be valued at US$2.1bn, one year forward
As detailed in the table (and explained in the report in detail later), one year from now (Mar’08), we estimate the value of its life insurance business to increase by almost 80% to US$2.1bn based on a 17x FY09E NBAP, in line with multiples assigned to other life insurers (refer to our in-depth report on the life insurance sector titled ‘Life insurers – high growth and under valued’ dated 2nd February 2007). We expect the total premium to rise >5x over FY07-09E (to Rs48.2bn) resulting in a 4x rise in the NBAP (new business achieved profit).

Strategic partner in life insurance business could see some value unlocking
Unlike most other private life insurance companies (where Indian partners hold a 74% stake in the company and the foreign partner has a right to increase its stake to 49% as and when regulations permit), Reliance Capital has 100% economical ownership of the life insurance business. Thus, as and when regulations are relaxed, (and even prior to that up to 26%) Reliance Capital would have an option to dilute its holding in the business **at the then prevailing market value.**

One year from now Brokerage to be valued at US$410mn
Similarly, we expect RCAP to also make strong headway in the brokerage business given the extensive distribution network it has already created. One year from now, the brokerage business, could trade at 12x FY09E earnings (i.e. at a 15% discount to the market multiples) implying a value of US$410mn. RCap has already done a soft launch of its broking business and has entered into agreements with >950 franchisees with plans to launch operations in over 2,200 outlets simultaneously.

Consumer finance could be valued at 1.5x FY09E book, one year out
RCap’s foray into consumer financing would enable it to leverage its current free net worth (estimated at Rs14bn) up to 10x and generate sustainable ROE of over 18-20% in the next two years. Hence we believe that the consumer financing business could, one year from now, be valued at 1.5x FY09E book implying a value of US$621mn.

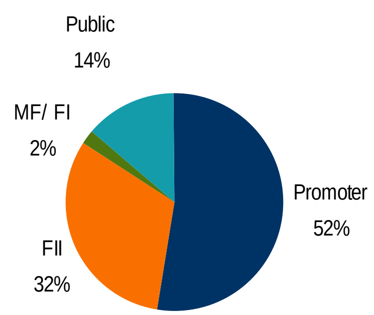
Key Risk: highly leveraged to markets, execution delays
Most of RCAP’s businesses like Asset management, broking, and unrealized gains on listed investments have high correlation to equity markets; correction in equity markets could, therefore, impact the growth (and the valuations) for these businesses significantly. On the flip side stronger than expected equity markets could positively impact our valuation, again, owing to the high leverage.

Also with launch of broking and consumer financing business expected to be the catalyst for the stock, a delay in the launch of these business or an execution risk could significantly impact the valuations / earnings forecast for these businesses.

Management track record provides us comfort
As highlighted earlier, successful execution is the key risk. However the Anil Dhirubhai Ambani Group (ADAG) management has, in the past, demonstrated its ability to build scale and manage aggressive growth across businesses. Reliance Communication (part of the same group) emerged as the 2nd largest player in Indian telecom space, despite its late entry, owing to an aggressive marketing strategy and differentiated pricing.

Further RCap has already become the top 2-3 companies in the asset management and general insurance industry. In the life insurance space too, despite their late entry (they were in the top 15), in the last 9 months they have emerged in the top 8 with an estimated market share of 4% re-instating the management’s capability on delivering growth .

Chart 1: Current shareholding pattern



Source: Company Reports, Merrill Lynch Research Estimates

Company Overview

Reliance capital (RCAP), the largest Non Banking Financial Services Company (NBFC) in India, is the flagship financial services company of the Anil Dhirubhai Ambani Group (ADAG), one of India's leading industrial groups.

Initially focused on the asset management business, RCAP, in the last couple of years (after formation of ADAG), has significantly expanded its product offering and currently offers a range of financial products and services though its group companies, including life insurance, general insurance and asset management. More importantly, it seeks to / has already emerged as amongst the top 3 in these businesses.

Over next six months the company plans to launch 3 new businesses

1. Broking which has already seen a soft launch.
2. Consumer financing business (to be launched in 1QFY08) and
3. Asset reconstruction company (awaiting RBI approval)

Play on India's expanding financial services sector (ex-banking)

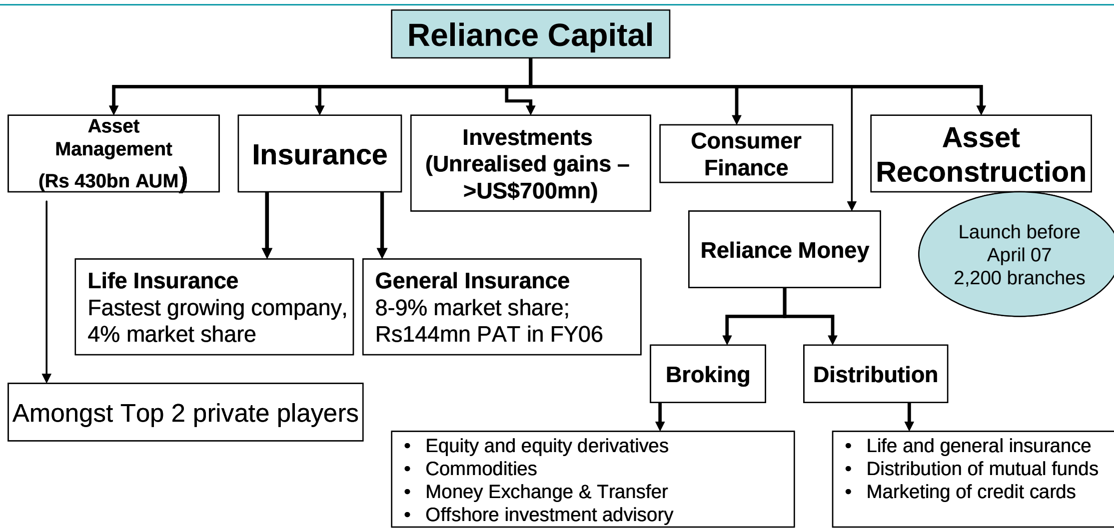
We believe RCAP offers one of the more leveraged plays to India's rapidly expanding financial sector (ex-banking) by virtue of its various businesses that it is planning to / has made a foray into, particularly the life insurance business.

We continue to be very positive about the medium and long term growth trends for the financial services sector. While we are anticipating some moderation in retail loan growth, especially mortgage lending (owing more to a rise in property prices than interest rates), we still expect growth to be +20% for retail loans; +30% for personal loans; +25-30% for asset management; and +35-40% for insurance business (new premia written). The underlying growth is led by India's changing demographics, rising income levels and changing consumer spending patterns.

RCAP could, in our view, emerge as amongst the leading non-banking financial service providers over the next 3 years given the aggressive marketing, expanding distribution network and comprehensive product offering including asset management, life insurance, general insurance, brokerage and consumer financing.

We believe RCAP could have amongst the largest retail client base of the private sector companies. A key growth driver for the company would be effective cross selling of its retail products to its rapidly rising retail client base across its various businesses (in the group) including mobile customers, utility customers and asset management / insurance customers.

Chart 2: Group structure



Source: Company Reports, Merrill Lynch Research Estimates

Reliance Life Insurance Co

RLI (100% economically owned by RCAP) is the fastest growing insurance company in India (New business premium has grown >800%yoy in 9MFY07) with a market share of 4% (amongst private insurers). We expect Reliance Life to become one of the top 5 in the rapidly rising life insurance market by 2010 with an estimated market share of around 9% and AUM of Rs140bn.

Reliance General Insurance

RGI (100% owned by RCAP) is the fastest growing general insurance company (also the 4th largest) in India with a market share of 9% amongst private general insurers. In a fast growing industry (driven by de-regulation and increasing penetration) we believe Reliance general could become a key competitor with its gross premium estimated to grow over 4x in next two years driven by expansion of distribution network and effective cross selling.

Reliance Capital Asset management

RCAM (100% subsidiary) is the largest asset management company in India with total AUM of >Rs430bn (debt equity split of 55:45) and a retail client base of >3.2mn. We believe RCAM will continue to be amongst the top three in the fast growing asset management industry with its total AUM estimated to grow to Rs719bn in FY09. Given the strong growth trajectory and minimal capital requirement, we believe earnings from this business could grow at >65% CAGR and can deliver a sustainable ROE of +45%.

Broking and consumer financing to be the next growth drivers

While RCAP has already seen some aggressive growth in its existing businesses, it is planning to make a strong foray into two new businesses i.e. broking and consumer financing over the next 3-6 months.

RCAP has already done a soft launch of its broking business and a retail roll out is expected in the next two months and with a network of >2,200 outlets at the time of launch it would become the largest retail broking company in India (in terms of distribution network).

RCAP's foray into the consumer financing business (expected to be launched in 1QFY08) would enable the company to effectively utilize the group's high net worth by leveraging to borrow up to 10x of the net-worth to lend in the consumer financing space.

Asset Reconstruction Company

Reliance Capital has floated an asset reconstruction company and is awaiting RBI approval to begin operations. RCap holds a 49% stake in this while the balance share holding is divided between General Insurance Corporation of India (GIC), Corporation Bank, Indian Bank and two FIIs. The company is headed by Mr Rajendra Kakkar (Ex chairman of the ARCIL- the first asset reconstruction company in India) and will have a business model similar to ARCIL.

Un-realized gains of Rs31bn

Reliance Capital also invests their proprietary funds in various companies both, in the form of private equity investments as well as by way of buying in secondary markets. These investments are valued on the books at their cost / market price whichever **is lower,** in line with the conservative Indian accounting standards.

As on 31st March 2006, Reliance Capital had a total investment book of Rs24bn of which Rs10bn is invested in listed equities which includes their holdings in Reliance Industries, Reliance Communication, Reliance Energy and Adlabs Ltd.

Table 4: Listed investments

As on Mar-06 (Rs mn)	Qty ('000)	Rs mn	Cost /share	Current Price	Market Value	Unreal. Gain
Adlabs Films Ltd.	1,255,000	125	99	420	527	403
Adlabs Films Ltd.	20,600,000	3,580	124	420	8,652	5,072
Reliance Communication Ventures Ltd.	17,940,295	1,935	108	428	7,678	5,743
Reliance Energy Ltd.	11,995,089	2,949	246	487	5,842	2,892
Reliance Industries Ltd.	13,460,295	1,650	123	1,325	17,835	16,185
Reliance Natural lResources Ltd.	16,471,295	27	2	27	444	417
Spanco Telesystems & Solutions Ltd.	3,550,000	323	91	190	675	352
Total	108,028,716	11,506			42,645	31,138

Source: Company Reports, Merrill Lynch Research Estimates

The market value of these listed investments, based on the prices as on 9th March 2007, was around Rs43bn translating to an unrealized gain of Rs31.1bn i.e. around US$700mn.

Key risk

We have valued these investments at their current market prices in our sum of parts valuations and hence to that extent our estimates carry some upside / downside on these investments depending on the market valuations.

We have not factored in any upside / downside from future investments (strategic/ financial) likely to be done by the company, though the management has mentioned that it is open for buying long term stakes in emerging companies.

Further we have taken the unlisted equity investments (excluding investments in subsidiaries) at their book value in our sum of parts and hence to that extent there could also be some upside to our sum of parts value.

Earnings Outlook

Consolidated earnings to grow at 20% CAGR

Rcap's consolidated earnings (cons. for the financing, general insurance, AMC and broking businesses and **excluding** life insurance) we estimate to grow at a CAGR of 20% to Rs9.7bn by FY09.

Core earnings (excluding the profit on sale of investments which accounts for >40% of PAT in FY09 v/s 80% in FY06) are estimated to grow at a CAGR of >150% to Rs5.5bn.

65% CAGR in net profit from Asset Mgt. business - Rs1.3bn in FY09

RCAM's net profit we estimate to grow 138% in FY07, followed by 39% growth in FY08E and 36% in FY09E mainly driven by rising AUM and stable margins. With minimal pricing pressure on the asset management fees (due to rising demand for asset management companies), RCAM's EBITDA margins are estimated to remain stable at 49%. Given the low capital requirement of the business, we believe RCAM's ROE could be +45% in coming years (could be higher if they increase dividend payout).

Brokerage to account for 27% of core net profit in FY09E- Rs1.5bn

The retail broking business we estimate to be fastest growing business with RCap likely to have sizable market share gains over the next two years owing to its attractive pricing and vast distribution network. The net profits per customer for Rcap we however estimate at 40-50% lower than its peers, factoring in the lower commission structure and the profit sharing (franchisee) model.

Financing business to remain the main stay: net profit of Rs2.4bn

Despite the strong growth in other businesses, the non banking financing business of the group should continue to account for almost 45% of the 'core' net profit as Rcap leverages its 'surplus' networth to drive volume growth in consumer financing business. Net profit from the consumer financing business is estimated at Rs1.2-1.3bn while the balance would be interest income from other investments.

For the consumer financing business we have factored in gross spreads of 8-9% (yields are estimated to be around 20% while the cost of funds are likely to be around 11-12%: lower than other NBFCs owing to the strong promoter background of RCap and its underleveraged balance sheet). We have also built in provisions at 4-5% of disbursements, in line with our estimated default rates. Operating exp. would be covered by loan processing fees (estimated at 2% of disbursements).

General insurance to break even in FY09: estimated profit of Rs250mn

On a reported earnings basis, general insurance business would break even only in FY09, primarily due to the conservative accounting norms. However the business, on our estimates, has a much higher profitability (discussed in detail later) with its normalized earnings estimated to be around 3% of its net premium.

Life insurance to have accounting losses for next 5-6 years: not to be consolidated

The life insurance business would also report accounting losses for the next 5-6 years (in line with what most other life insurance companies have witnessed) owing to the conservative accounting norms and high reserve requirements. The losses would, however, not be consolidated in RCap's accounts as Rcap has a direct holding of only 16% in the company whereas the balance is invested through other 100% subsidiary companies.

Unlocking value on listed investments could swing reported earnings

As highlighted earlier, RCap has unrealized gains of Rs31bn on its listed investments which the company plans to unlock gradually. We have, in our estimates, assumed the profit on sale of investments to be around Rs4bn for FY07-09. With these profits estimated to account for almost 40% of PAT in FY09, a higher / lower than estimated unlocking would impact our earnings forecast.

Table 5: Income Statement

Year Ending March (Rs mn)	FY05	FY06	FY07E	FY08E	FY09E
Operational Income	4,775	4,673	13,968	31,221	59,477
- Consumer financing	2,282	1,762	2,081	6,349	14,628
-AMC	443	894	2,041	2,807	3,528
-General Insurance	2,051	2,017	9,731	20,705	37,962
-Broking	-	-	115	1,359	3,359
Operational Expenses	3,862	3,041	12,451	26,409	49,326
- Interest Expenses	1,511	452	211	2,360	7,323
- General Ins (Re-insurance, claims, reserves and commissions)	1,282	1,197	9,365	18,679	33,848
- Operating Expenses	1,069	1,391	2,875	5,370	8,155
Net operational income	913	1,633	1,517	4,812	10,151
Other income	664	4,804	4,319	4,453	4,843
- Profit on sale of investments	335	4,572	4,000	4,000	4,200
EBITDA	1,577	6,436	5,837	9,265	14,993
Depreciation and Amort.	296	256	322	328	335
Pre-provision Profit	1,281	6,181	5,515	8,937	14,658
Total Provision	(52)	15	50	1,500	2,400
PBT	1,333	6,165	5,465	7,437	12,258
Provision for Tax	128	336	405	1,038	2,541
PAT	1,205	5,829	5,060	6,399	9,717

Source: Company Reports, Merrill Lynch Research Estimates

Reliance Life Insurance

Background

Reliance Life Insurance, a 100% economically held company of RCAP, was a late entrant in the life insurance space as its started its operation only in July-05 by acquiring AMP Sanmar Life Insurance company for a consideration of Rs970mn, and renaming it as Reliance Life Insurance company (RLIC).

It has however been the fastest growing life insurance company in India (has grown 800%yoy- 9MFY07 albeit off a very low base), and has an incremental market share of 4% amongst private insurers (based on New Business Premium (NBP) on Annualised Premium Equivalent (APE) basis).

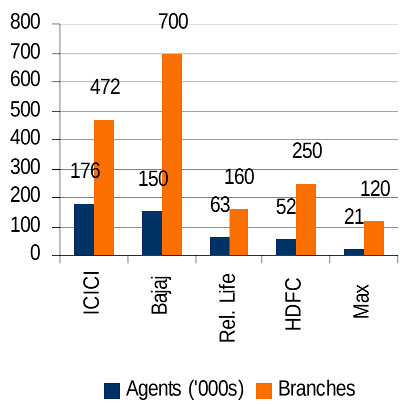
While it is 100% ‘economically’ held by RCap, technically RCap holds only a 16% stake in it while the balance 84% is held through subsidiaries or associate companies. The indirect holding structure results in tax benefits; also due to <51% direct holding in the life insurance company, the accounts are not consolidated for the losses in the life insurance company.

Business Profile

Like most private insurers much of the growth for Reliance Life has been driven by unit linked products that have accounted for 80% of the total NBP-APE in the first 9MFY07. Around 20% of its total NBP is from single premium policies, in line with the sector average. Reliance Life currently covers an estimated 30mn lives with total Sum Assured of Rs136bn across 229,000 policies.

The strong growth has been driven by a) a relatively lower base, b) rising demand for unit linked products and c) aggressive expansion of distribution network.

Chart 3: Distribution network of key players



Source: Company Reports, Merrill Lynch Research Estimates

Distribution Network

In less than two years of operation Reliance Life has been able to build the 3rd largest agent forces amongst private life insurers (around 63,000 agents as on Dec-06) and a strong network of 160 branches. The distribution network, in the past, has been one of the key success factors for the life insurance companies as companies like Bajaj Aliianz and RLIC have seen sizable market share gains after they ramped up their distribution network.

However, due to its late entry in the life insurance space, Reliance Life has not been able to enter into a bancassurance tie up with any of the large banks (most banks already have a tie up in place and are restricted from marketing life insurance products of more than one insurer). Hence almost 90-95% of its total business is generated from its own agent sales force while the balance mainly coming from insurance brokers.

The agency network would remain the mainstay for new business generation as the company plans to more than double its agent force by Mar-08. While the company would enter into some banassurance tie ups, on our estimates, the agency network would account of >80% of new business v/s a sector average of 60-70%.

Industry to grow 30-40%p.a.; Private insurers at 40-50%

The life insurance industry has been one of the fastest growing markets in India with total NBP growth in 9MFY07 being in excess of 130% yoy led by a sustained rise in penetration levels and doubling of average premia size led by strong macro growth, rising income levels and greater awareness for insurance. The extra-ordinary growth was however also driven by a sharp rise in demand for unit linked products supported by buoyant equity markets and scarcity effect (investors bought unit linked policies ahead of some regulatory changes). (Refer to our detailed report on Indian life insurance sector dated 2nd February 2007, titled ‘Life insurers- high growth and under valued’)

While private sector insurers have led the growth in the past three years; in FY07 the strong growth has been supported by LIC (has grown 150% yoy in 9MFY07), the largest state owned insurance company, which had a monopoly in this sector till 10 years back when the sector was opened up for private insurers.

Growth likely to moderate; long-term prospects still bullish

We however expect the growth to moderate sharply in FY08, owing to a high base and absence of scarcity effect. In addition, consolidation in equity markets could have some impact on overall buoyancy in the unit linked products which have been the mainstay of the recent growth.

We expect yoy growth rates to come off sharply, from >100% in FY07E to 40% in FY08E and 29% in FY09E, sustaining at 20-25% beyond FY10E. Despite the strong growth rate in recent years; the Indian life insurance industry, in our view, still offers strong potential due to the reasons given below (please refer to our In-depth sector report on the Indian life insurance industry dated 2nd February 2007 titled ‘Life Insurers- High growth and under valued’):

1. At <3% of GDP, life insurance penetration is very low and is set to expand rapidly
2. Buoyant economic outlook and rapidly expanding middle class to drive demand for the insurance products
3. Introduction of new products like health insurance
4. Strong marketing and distribution expansion by private insurers
5. Regulatory reforms for the insurance sector

We expect India's total life insurance premium, including renewal premiums, (**Non** APE) to grow from Rs926bn in FY06 (US$21bn) to Rs3.1tn in FY10 (US$72bn) growing at CAGR of 35%. NBP (APE) is estimated to grow at a CAGR of 47% for FY06-10E, i.e. from Rs220bn in FY06 to Rs1,022bn by FY10E.

Table 6: Sector Premium Trends & Forecast

Rs bn	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY06-10 CAGR
Total Premium	655	772	926	1,423	1,910	2,469	3,117	35%
- FYP	132	156	205	415	585	759	966	18%
- Renewal Premium	469	517	567	648	890	1,209	1,599	17%
- Single Premium	54	99	154	360	436	500	552	14%
APE- New Business	138	166	220	451	628	809	1,022	47%
APE- Overall Business	606	683	787	1,099	1,518	2,018	2,620	35%
Total Premium (US$bn)	15.1	17.8	21.3	32.7	43.9	56.7	71.7	
yoy growth in total premium	22%	18%	20%	54%	34%	29%	26%	
yoy growth in new business - APE	16%	21%	33%	105%	39%	29%	26%	

Source: Company Reports, IRDA, ML Estimates

Average growth in first year premiums for private insurers is expected to remain at 55-60% over FY06-10 (i.e. from Rs78bn in FY06 to Rs461bn in FY10E), with market share of private insurers (NBP-APE) estimated to rise to 45% by FY10.

Rel. life to be amongst top 5 insurers by 2010

While ICICI Prudential will, in our view, remain the largest private insurance company with an estimated market share of around 26% (amongst private insurers), Reliance life could, in our view, emerge as one of the top 5 players with an estimated market share of 9%. Other large insurers would be Bajaj Allianz (15% market share), SBI Life (10%) and HDFC Standard Life (9%). (please refer to our In-depth sector report on the Indian life insurance industry dated 2nd February 2007 titled 'Life Insurers- High growth and under valued'):

Table 7: Market Share (on NBP-APE)

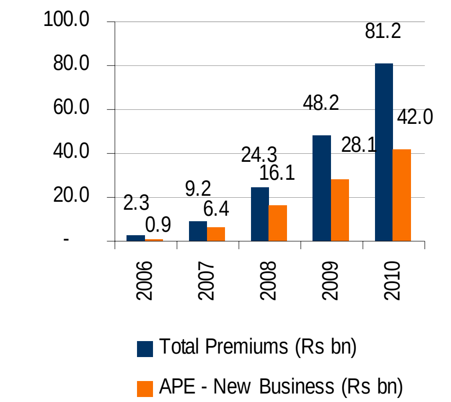
Year Ending March	YTD	2007	2008	2009	2010
ICICI Prudential	30.4%	28.5%	27.7%	26.7%	25.8%
HDFC Standard Life	9.1%	9.2%	8.7%	8.8%	8.6%
MNYL	5.7%	5.4%	5.1%	5.0%	4.9%
Bajaj Allianz	16.6%	16.9%	16.3%	15.2%	14.7%
TATA AIG	5.0%	NA	NA	NA	NA
SBI Life	9.4%	10.1%	10.3%	10.3%	10.1%
Kotak Old Mutual	3.4%	NA	NA	NA	NA
Reliance Life	3.7%	4.4%	6.9%	8.4%	9.1%
Other Private Players	12.7%	25.5%	24.2%	25.6%	26.8%
Total Private Sector	100.0%	100.0%	100.0%	100.0%	100.0%

Source: Company Reports, IRDA, ML Estimates

Reliance's new business expected to grow 7x in 3 years

We believe Reliance Life will continue to gain market share over next three years (estimated to rise to 9% v/s 4% currently) with its total NBP-APE estimated to grow at a CAGR of +85% over FY07-10 to Rs42bn in FY10 driven by

Chart 4: Premium growth for Rel. Life



Source: Company Reports, Merrill Lynch Research Estimates

1. Rising demand for insurance (discussed above)

2. **Aggressive expansion of distribution network** with agent force estimated to more than double by Mar-08 and rise three fold by Mar-09 (currently at 63,000) and branch network to increase from 160 to >350 (has already received regulatory approvals).

3. Distribution network, in our view, remains the single largest contributor to growth for the life insurance industry and would be also the key driver of growth for Reliance Life. The expansion would also be supported by an **aggressive marketing campaign** enabling Reliance Life to build its brand image in a market where one of the key concerns of the investor is the credit worthiness of the insurance company.

4. **New product launches**: Compared to peers Reliance Life has a relatively smaller product offering, due to its recent entry in the business. Product expansion, including new products like health and pension would be amongst the key drivers of the growth

5. **Effective cross selling across its vast and rapidly expanding retail customer base** across the group. We believe Reliance Life's key strength will be its ability to cross sell life insurance products to its vast consumer client base (across group companies- for ex. RCom has a client base of over 35mn which is estimated to grow at +45%p.a. for next 2-3 years while Reliance AMC has a client base of >3mn clients).

   A recent example of effective cross leveraging was when Reliance Capital offered free life insurance cover to Reliance Communication customers, with sum assured ranging from Rs5,000-Rs50,000 (depending on customer profile, billing amounts etc), valid for six months. On expiry of the period of free life cover it has been able to sell insurance products to the same set of people.

Table 8: Key Financials for Reliance's Life insurance business

Year to March (Rs mn)	2004	2005	2006	2007	2008	2009	2010
FYP	216	270	732	6,225	15,875	27,781	41,671
Renewal Premiums	39	216	410	914	5,711	17,269	36,040
Single Premiums	56	642	1,202	2,103	2,734	3,144	3,459
Total Premiums	311	1,127	2,344	9,242	24,320	48,194	81,170
New Business	272	912	1,934	8,329	18,609	30,925	45,130
APE - New Business	221	334	853	6,436	16,148	28,095	42,017
APE - total Business	260	549	1,262	7,349	21,859	45,364	78,057
					151%	74%	50%
Growth Rate (yoy)							
FYP	241%	25%	172%	750%	155%	75%	50%
Renewal Premiums	2453%	460%	90%	123%	525%	202%	109%
Single Premiums	#DIV/0!	1037%	87%	75%	30%	15%	10%
Total Premiums	380%	263%	108%	294%	163%	98%	68%
New Business	331%	235%	112%	331%	123%	66%	46%
APE - total Business	302%	112%	130%	482%	197%	108%	72%
Persistency Rate	*59.5%*	*84.8%*	*84.4%*	*80%*	*80%*	*80%*	*80%*

Source: Company Reports, Merrill Lynch Research Estimates

Capital infusion of Rs10-13bn estimated over next 2-3 years

Reliance Capital has to date infused Rs3.7bn in the life insurance business. Based on our growth estimates and the likelihood of changing product mix (endowment products require higher capital v/s unit linked products), we believe RCap would need to infuse further capital of Rs10-13bn over next three years taking its total capital base to Rs14-17bn (compared of ICICI Prudential's capital of Rs12bn in FY06) .

Hence in order to arrive at the fair net worth, we have deducted the required infusion from the existing net-worth of Reliance Capital (discussed in detail later).

Valuations- on NBAP methodology

(For **<u>details on valuation methodology and calculation of NBAP for life insurance companies</u>** please refer to our In-depth sector report on the Indian life insurance industry dated 2nd February 2007 titled 'Life Insurers- High growth and under valued')

Valuing life insurers in India is difficult as all private life insurers currently are at early stages of their life cycle and are not required to provide disclosures on embedded value (EV), etc.

While traditional valuation tools like EV, in our view, is the best measure to value life insurance companies, we believe it cannot be applied to Indian Life insurance companies, as most are in the early stages of their life cycle. Moreover, there are no disclosures on EV by these companies.

We believe Indian life insurance companies should be valued on a multiple to their NBAP, in the absence of any EV estimates. NBAP is the present value of the profits arising from the business underwritten in the particular year. Value of the insurance firm is then calculated by assigning a multiple to the particular year's NBAP to arrive at the economic value of all new business to be generated by the insurance company. The multiple is based on the estimated growth trajectory of the business (and is similar to P/E ratio for other industries).

We believe Indian insurance companies can be valued up to 16-18x one year forward NBAP given their strong growth trajectory. While Indian insurance companies don't disclose their embedded value, in our estimate, these valuations, will imply P/EV of 3.0-4.0 for the established companies.

Reliance Life valued at US$2.1bn

RLIC could, one year from now, be valued at US$2.1bn, based on a 17x multiple to its FY09E NBAP (in line with valuation for its peers). Despite a much stronger growth trajectory than most of its peers, we have given Reliance Life a similar NBAP multiple due to a) lack of a foreign partner and b) relatively late entry of Reliance Life in the sector.

This implies a value of Rs376/share of Reliance Capital in FY09 or around 60% of its existing market cap. Improvement in NBAP margins (due to change in product mix) without growth slowing down also positively impact margins, and valuations.

Table 9: Valuation methodology for the life insurance business

Valuation Table (Rs mn)	FY05	FY06	FY07E	FY08E	FY09E	FY10E
FYP	270	732	6,225	15,875	27,781	41,671
Single Premium	642	1,202	2,103	2,734	3,144	3,459
Renewal Premium	216	410	914	5,711	17,269	36,040
Total Premium	1,127	2,344	9,242	24,320	48,194	81,170
YoY Growth	73%	129%	594%	144%	74%	49%
NBAP margin (%)	24%	21%	20%	19%	19%	19%
NBAP (Rs mn)	80	183	1,267	3,085	5,357	8,004
Multiple (x)	21	20	19	18	17	16
Value of the Company (Rs mn)	1,672	3,651	24,064	55,522	91,069	128,064
Value of the Company (US$ mn)	38	84	560	1,291	2,118	2,978
Value of Reliance Capital's stake (US$ mn)	38	84	560	1,291	2,118	2,978
Value per Share of Reliance Cap (Rs)	7	16	98	226	376	521

Source: Company Reports, Merrill Lynch Research Estimates

NBAP Margins estimated at 19-20%

By definition, NBAP margins are **(Present value of future profits of a policy) / (First year premium).** (For **details on calculation of NBAP margins** please refer to our In-depth sector report on the Indian life insurance industry dated 2nd February 2007 titled 'Life Insurers- High growth and under valued')

We arrive at NBAP margins for different policies by doing a DCF for each policy forecasting a) the loading, b) expected savings on mortality risk premium owing to improved life expectancy, c) gains due to economies of scale and d) asset management charges on products. (ex. of regular ULIP policy is given below)

Table 10: Calculation of NBAP margins for a ULIP product

ULIP - Regular Premium	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Premium Income	100,000	90,000	81,000	72,900	65,610	59,049	53,144	47,830	43,047	38,742
Less										
Agent Commission	(16,000)	(4,500)	(4,050)	(2,916)	(2,624)	(1,181)	(1,063)	(957)	(861)	(775)
Risk Premium	(1,305)	(1,145)	(966)	(784)	(598)	(406)				
Operating Expenses	(600)	(630)	(662)	(695)	(729)	(766)	(804)	(844)	(886)	(931)
Amount invested	82,095	174,062	267,088	362,815	461,500	565,318	674,354	789,295	911,256	1,041,419
Return on Investment @ 12%	9,851	20,887	32,051	43,538	55,380	67,838	80,922	94,715	109,351	124,970
Inv. At the end of the year	91,946	194,950	299,139	406,353	516,880	633,156	755,277	884,011	1,020,606	1,166,390
Asset Management Fees	(1,609)	(3,184)	(4,829)	(6,511)	(8,259)	(10,079)	(12,010)	(14,054)	(16,224)	(18,539)
Net AUM	90,337	191,766	294,310	399,842	508,621	623,077	743,266	869,956	1,004,383	1,147,851
Insurance company's income										
Mortality Savings (assumed at 15%)	196	172	145	118	90	61	-	-	-	-
Actual Operating Expenses	(848)	(2,236)	(3,202)	(3,863)	(4,226)	(5,281)	(6,402)	(6,183)	(7,225)	(8,339)
AUM	1,609	3,184	4,829	6,511	8,259	10,079	12,010	14,054	16,224	18,539
Total	957	1,120	1,772	2,765	4,123	4,858	5,608	7,871	8,998	10,200
Cumulative PV for Ins. Co.	19,408									
NBAP margin	19.4%									
IRR for the policy holder	8.9%									
Sum Assured	750,000									
Cost of Risk Cover p.a. per Rs100,000 of SA	174									

Source: Company Reports, Merrill Lynch Research Estimates

The NBAP margins across the different policies are given below. As shown NBAP margins for ULIP's are lower at around 20% v/s traditional policies owing to the absence of any investments that can be retained by the insurer (upto 10% can be retained in a traditional policy like endowment) and lower load charges.

Table 11: Product wise profitability for an insurance company

Product	NBAP Margin
Single Premium - ULIP	2.5-3.0%
Regular Premium - Unit Linked	19.0-20.0%
Traditional Endowment	30.0-35.0%
Term Assurance	30.0-35.0%

Source: Company Reports, IRDA, ML Estimates

For Reliance Life we have assumed the NBAP margin on FYP and single premium policies to be in line with the market at 19% and 2.5% respectively. Based on the product mix, we arrive at a blended NBAP margin of 19.1% for FY09E.

Table 12: NBAP margin

NBAP Calculation	2005	2006	2007	2008	2009	2010
NBAP Margin (FYP)	20.0%	20.0%	19.5%	19.0%	19.0%	19.0%
NBAP Margin (Single Premium)	4.0%	3.0%	2.5%	2.5%	2.5%	2.5%
NBAP Margin (Total)	23.8%	21.4%	19.7%	19.1%	19.1%	19.0%

Source: Company Reports, Merrill Lynch Research Estimates

Tie up with foreign partner could positively impact valuations

Reliance Life is the largest 100% owned Life Insurance Company and would, in our view, be an attractive partner for any foreign insurance company willing to set up its business in India. Reliance Capital would thus have an upside to dilute its stake in Reliance Life, at the then prevailing price, implying a significantly higher value creation for the Indian promoter.

A tie up with foreign partner would, in our view, positively impact valuations as the stake sale would provide a greater comfort on managing the risk over a longer term and b) also provide a benchmark valuation.

Reliance General Insurance

Background

Reliance General Insurance, a 100% subsidiary of Reliance Capital, is the fastest growing (has grown 450%yoy- 9MFY07) and the 4th largest general insurance company in India with a market share of 9% amongst private players.

Reliance general insurance, prior to Jun-05, used to primarily underwrite general insurance for the Reliance group (pre dominantly Reliance Industries) and hence had a low growth trajectory in first few years of operation. However post Jun-05, the company strategically exited out of the group business, focusing pre-dominantly on retail business.

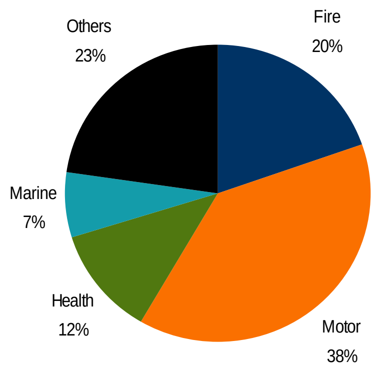
Distribution network

Over the past one and a half years, the company has aggressively expanded its distribution network and currently has a network of 51 branches and around 15,000 point of contact sales person (includes direct agents, dealers etc). The company has also opened a representative office in London to handle the re-insurance business.

Business profile

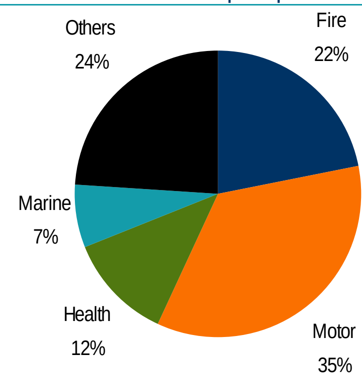
Reliance General offers a comprehensive product offering including Protection against Fire, Marine Insurance, Auto insurance, Health insurance and other miscellaneous insurance cover. The core focus for Reliance is, like most other insurers, the most profitable motor insurance followed by health and other retail insurance products. Within motor insurance almost +95% is insurance against 'Own damages' while 'Third party' insurance, which has been a loosing proposition for all national insurance companies (due to regulated and extremely low tariffs), accounts for <5%.

Chart 5: Premium Break up for Sector



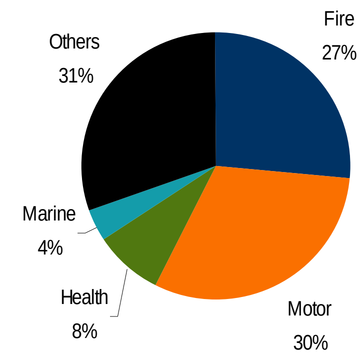
Source: Company Reports, Merrill Lynch Research Estimates

Chart 6: Premium Break up for private sector



Source: Company Reports, Merrill Lynch Research Estimates

Chart 7: Premium Break up for Rel. general



Source: Company Reports, Merrill Lynch Research Estimates

In 1HFY07 of the total gross premium written (GWP) by Reliance General of Rs3.8bn around 27% of business came from Fire insurance, 30% from Motor insurance and 8% from Health Insurance; the split of corporate to retail being 60:40.

Retention Ratio of <40%

While Reliance general insurance has bagged a few large ticket deals (Rs400mn insurance premium from Indian railways), as a strategy, it re-insures all high value projects (with a risk cover of over Rs0.5mn) with a re-insurer on which it makes a gross commission of around 10-15%. The highest proportion of risk retained on the balance sheet is that from motor insurance, where the company retains almost 80% of the origination. As highlighted earlier this is the most profitable segment in the general insurance space with claim ratios being 60-65% for private players.

9MFY07 Gross Written Premium has grown five fold

In the first nine months Reliance general's gross written premium has grown five fold to Rs6.1bn driven by an expanding general insurance market, aggressive expansion of distribution network and widening product offering. As mentioned earlier it has been the fastest growing general insurance company in India and has managed to garner a 9% market share amongst all private insurers.

Industry back ground

General insurance industry in India has historically been a bleeding industry characterized by a tariff regime, fraudulent practices, inefficiencies due to bureaucracy and poor awareness about general insurance amongst the middle class. Until the restriction on entry of private insurers, the industry was represented by four national general insurance companies and one national re-insurer.

Motor 'third party insurance' was a highly losing proposition for all insurance companies owing to a very low premium (which was regulated) and companies cross subsidized this by charging higher premiums for 'Own Damage' insurance.

Post liberalization while private insurers were allowed to enter into the space most of the premiums were still regulated until January 2007. Post Jan-07 the tariffs have been partially de-regulated (insurance companies are allowed to set their own prices for all insurance products except ‘Third party insurance’ subject to a gradual increase / decrease in premiums from the tariff prices).

Private insurers gain market share; have better profitability

In the past five years private sector insurers have grown at a CAGR of >50% driven by expansion of their distribution network, rising awareness of general insurance due to aggressive marketing campaigns and gaining market share from national companies (mainly corporate business) owing to their better efficiency levels. Pricing has not been a consideration to date (as it was a tariff regime); however it could, going forward, be one of major factors for market share swings.

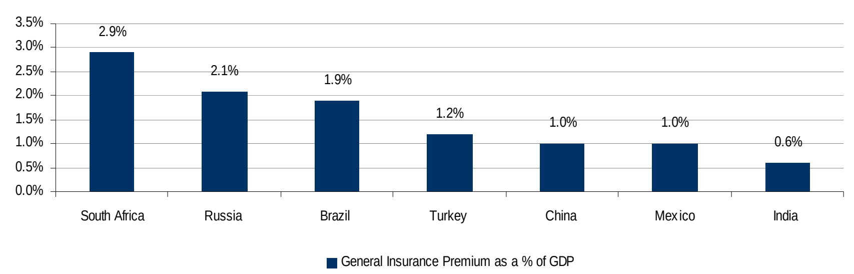
More important than the market share gains; private insurance companies have enjoyed a better track record with lower claim ratios leading to better underwriting profits led by a better quality of underwriting. Most private insurance companies don't write the ‘Third party’ motor insurance which is one of the key loss making areas; also the checks for preventing fraud in cases like ‘Health insurance’ are much higher than that for public sector undertakings The recent de-tarrifing would further allow private companies to adjust their premiums in commensuration with the risk of business, improving profitability.

India still an under-penetrated market; to grow at +30% p.a

Unlike the life insurance segment, the general insurance market in India has not yet seen the exponential growth. Most of the growth for private sector insuers has come at the expense of loss of market share for national insurance companies; the overall market has grown at <20%p.a..

With total GWP being at 0.6% of GDP, India is one of the most under-penetrated markets globally, even compared to emerging economies. In many regions non life insurance penetration is ~40-50% of life insurance market, for India it is <20%.

Chart 8: General insurance penetration



Source: Company Reports, Merrill Lynch Research Estimates

We believe general insurance industry can grow at +30%CAGR for next three to four years with private insurers estimated to grow at +50% CAGR as they benefit from an expanding economy and increasing awareness of general insurance products amongst India’s burgeoning middle class. The share of private insurers of total GWP is estimated to rise to >50% by FY10 v/s 35% in 1HFY07.

Table 13: Market share in general insurance industry

Market share	FY04	FY05	FY06	YTD FY06	YTD FY07
Royal Sundaram	1.7%	1.9%	2.2%	2.2%	2.4%
Tata AIG	2.3%	2.7%	3.0%	2.9%	3.1%
Reliance General	1.0%	0.9%	0.8%	0.7%	3.3%
IFFCO-Tokio	1.9%	2.9%	4.4%	3.9%	4.8%
ICICI-lombard	3.2%	5.0%	7.8%	8.1%	12.5%
Bajaj Allianz	3.0%	4.9%	6.3%	6.4%	7.0%
HDFC CHUBB	0.7%	1.0%	1.0%	1.0%	0.8%
Cholamandalam	0.6%	1.0%	1.1%	1.2%	1.2%
Private sector	14.5%	20.3%	26.6%	26.4%	35.1%
New India	25.9%	24.0%	23.4%	22.8%	20.0%
National	21.9%	21.7%	17.3%	17.6%	14.8%
United India	19.6%	16.8%	15.4%	15.7%	14.2%
Oriental	18.1%	17.2%	17.3%	17.5%	15.9%
Total	100.0%	100.0%	100.0%	100.0%	100.0%
Total GWP (Rs mn)	156,211	175,308	203,786	150,122	185,589

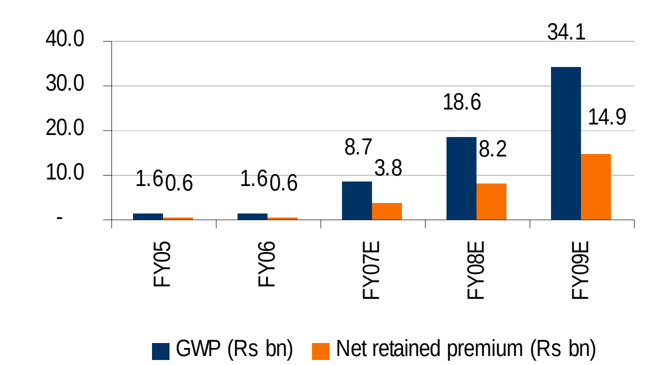
Source: Company Reports, Merrill Lynch Research Estimates

Reliance to become a key player, GWP to grow 4x by FY09

We believe Reliance General will emerge as one of the key players in general insurance space as it capitalizes the rapid expansion of its distribution network and also as it effectively leverages the vast client base of the group companies (~45mn retail customers including 35mn customers of Reliance Communications and 5mn customers of Reliance Energy).

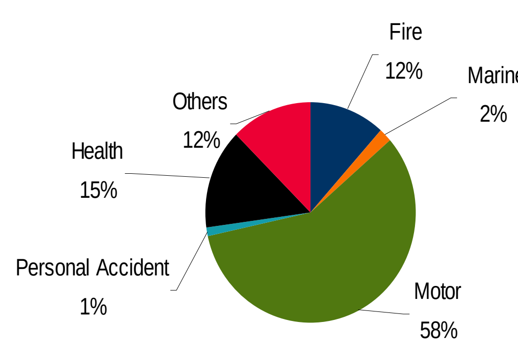
We expect Reliance General's total GWP to grow 4x over FY07-09E Rs34bn in FY09 with its market share likely to be around 15-18%. Net retained premium (i.e. premium net of re-insurance) is also estimated to grow 4x to Rs15bn by FY09E. The net retention ratio is expected to improve from 34% in FY06 to 44% in FY09E due to increasing share of retail business (Reliance general retains most of the retain business on its books, while most of the high ticket exposure is re-insured).

Chart 9: Premium growth- Reliance general



Source: Company Reports, Merrill Lynch Research Estimates

Chart 10: Premium Composition – Reliance General (FY09)



Source: Company Reports, Merrill Lynch Research Estimates

Premium ratio to change in favour of motor / other retail insurance

With the increasing thrust on retail, we expect the share of miscellaneous insurance (i.e. the non fire and marine insurance) to increase to 84% of the total portfolio v/s 76% in FY06 and 63% in FY05. Within miscellaneous insurance, motor (mainly 'Own damages') is expected to be the largest (67%) followed by health (17%).

Break even expected in FY09

General insurance companies in India typically break even in 3-4 years due to the conservative accounting practices as per which while the premium is recognized over the duration of the insurance cover, the costs associated with it has to be recognized up front. Further insurance companies are required to create a ‘Reserve for unexpired risk’ equivalent to 50-100% of their net retained premium for the particular financial year (is reversed in the next year).

While Reliance general insurance had reported profits in FY05 and FY06 the same was on account of the flat revenue line of the company; given its current high growth trajectory we expect the company to report accounting losses for the next two financial years and a nominal profit in FY09.

We have also built in an increase in the net claim ratio from 62% currently to 66% to normalize the cyclical nature. However we would like to highlight that an increasing proportion of Reliance general’s business that is being retained is retail and mainly motor which is a very profitable segment.

As detailed in the table below we believe Reliance general can, on a normalized basis, deliver a post tax return of >3% of net retained premium and RoE of 18-20%, in line with some of the more mature insurers in the industry. As discussed earlier accounting profits could be delayed owing to the conservative accounting norms.

Table 14: Normalised P&L for Reliance's general insurance business

Normalised P&L for general insurance business	
GWP	100.0
Less: Re-inaurance	55.0
Net Retained premium	45.0
Less: Claims (estimated at 70%)	31.5
Underwriting profit	13.5
Add: Investment income (5-6% of Net Retained premium)	2.7
Less: Operating expeses	14.0
PBT	2.2
Less: Taxes	0.7
Net Profit	1.5
Net Profit as a % of net Retained premium	3.2%

Source: Company Reports, Merrill Lynch Research Estimates

General Ins. valued at US$172mn on FY09E

Globally general insurance companies are valued on price to book multiple based on their RoE or price to earnings ratio based on their estimated growth trajectory. However, given the conservative accounting standards in India, companies like Reliance general insurance are unlikely to have any significant accounting profits over the next three years owing to their +100%yoy premium growth.

Hence a more relevant benchmark matrix would be market cap to premium underwritten. In the table below we have shown valuations for regional companies on this parameter which is the range of 0.3-1.0x one year forward premium income.

Table 15: Valuation for global general insurance companies

Name of the company	Price *	M Cap **	P/E - CY07 /FY08	P/E - CY08 /FY09	P/Book CY07 /FY08	P/Book - CY08 /FY09	Mkt cap/ Prem - CY07	Mkt cap/ Prem - CY08
Samsung	155,000	8,091,000	24.1	18.4	2.5	2.3	1.0	0.8
Dongu Insurance	24,700	1,748,760	16.1	13.5	2.5	2.2	0.5	0.4
Hyundai Marine and Fire	12,700	1,135,380	49.8	23.5	2.3	2.2	0.3	0.3

Source: Company Reports, Merrill Lynch Research Estimates

Reliance general insurance could, in our view, also trade at similar multiples; however on a conservative note we value it on a multiple of the net premium retained (which is <50% of the gross underwritten premium). Accordingly one year from now, Reliance general, could, in our view, be valued at 0.5x of net premium for FY09 implying a value of US$172mn.

These valuations imply a P/ book multiple of 2.2x one year forward (after factoring in the capital infusion over the next three years to comply with the reserve requirements) and a P/E multiple of 15.6x FY09E ***normalized*** earnings (assuming a normalized PAT of 3%-as discussed above; reported earnings would however be negligible owing to the high reserve requirements).

Table 16: Valuation for Reliance general

Valuation Matrix (Rs mn)	FY05	FY06	FY07E	FY08E	FY09E
Gross Premium Written (GWP)	1,617	1,623	8,714	18,632	34,140
Net Premium Income (NPI)	620	555	3,793	8,237	14,947
Net Worth	1,384	1,528	1,837	2,445	3,433
Indicative Mkt cap / NPI multiple				0.5x	0.5x
Estimated Value of the business (Rs bn)				4.1	7.5
Estimated Value of the business (US$mn)				95	172
Implied P/BV multiple				1.7	2.2
Implied P/E multiple *				15.6	15.6

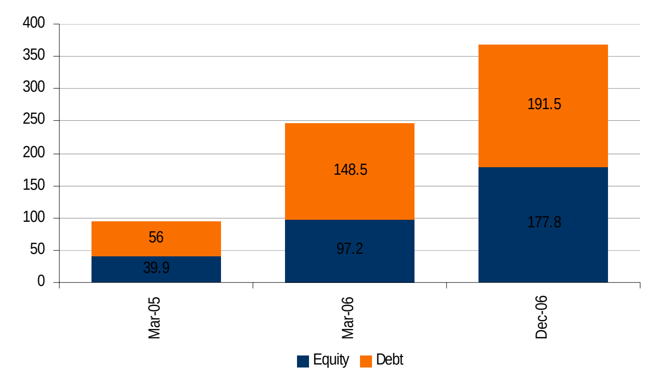
Source: Company Reports, Merrill Lynch Research Estimates * Assuming a post tax return of 9%

Asset Management Company

Background

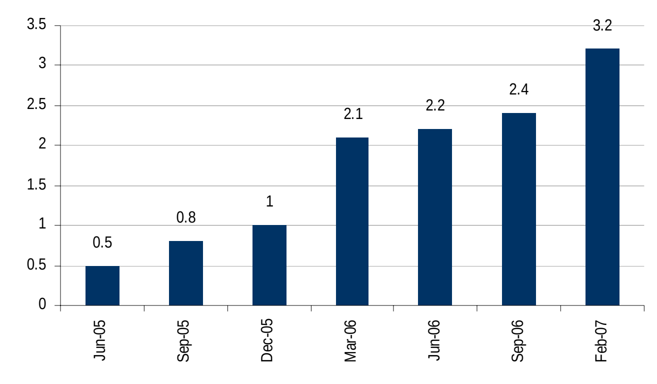
Reliance Capital Asset Management (RCAM), a 100% subsidiary of Reliance Capital, is the largest private asset management company in India with total Assets under management (AUM) of >Rs430bn. It has been one of the fastest growing AMC (total AUM has grown at a CAGR of +100% in past 3 years) and its market share over same period has doubled from 5% in FY04 to 12% in Dec-06.

Chart 11: Asset Under management of RCAM



Source: Company Reports, Merrill Lynch Research Estimates

Chart 12: No of Customers – RCAM



Source: Company Reports, Merrill Lynch Research Estimates

Distribution network

RCAM has a presence in over 95 cities with an agent force / distribution network of >15,000. It also has the largest retail customer base amongst private sector mutual funds (over 3.2mn customers) and around 40-50% of its total AUM is from retail customers.

Business Profile

Of its total AUM of Rs370bn as on Dec-06 ratio of debt to equity has been almost 50:50 with most of the equity AUM being retail money. RCAM's strong growth has been supported by a buoyant equity market but has also been driven by an aggressive expansion of distribution network, aggressive marketing strategy (it was the first Mutual fund in the world to launch online redemption through ATMs).

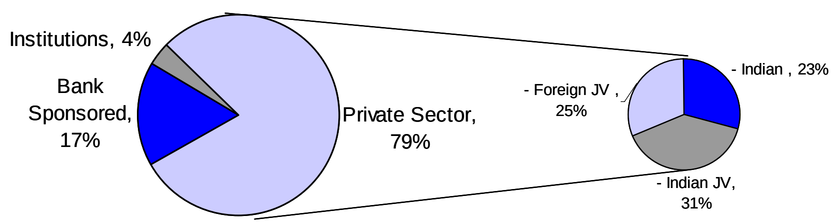
It currently offers around 30 schemes across debt and equity including few sector specific funds. RCAM has also set up an offshore fund (based in Mauritius) which is basically an open ended, India dedicated fund with current AUM of US$60mn.

RCAM also offers Portfolio management services (PMS) – both discretionary and advisory and total AUM of PMS group is around Rs18bn. In line with the market structure the revenue structure is a mix of asset management charges or asset management charges **plus** a carry on the returns in excess of the hurdle rate.

Indian asset management industry

Indian asset management industry, compared to other regions, has considerably fewer players, but still is highly fragmented within the existing players. Led by low entry barriers the industry has seen many companies entering and exiting from the business over the past few years. It is also one of few spaces within financial service industry which is dominated by private sector players, who account for almost 80% of total AUM.

Chart 13: Break down of AUM- Industry

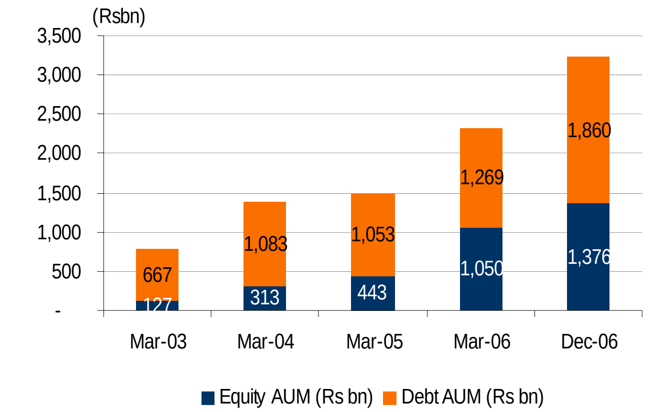


Source: Company Reports, Merrill Lynch Research Estimates

Most private sector players (excluding RCAM and Tata AMC) have joint venture with a foreign partner with the latter also holding a majority stake in few cases. Amongst non – private players UTI Mutual fund is the largest AMC in the country with total AUM of around Rs400bn, followed by SBI MF and LIC who have Rs150bn and Rs120bn AUM.

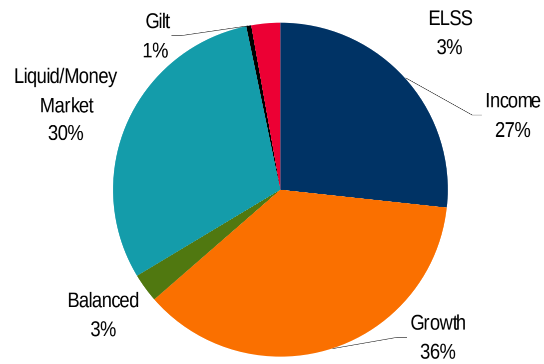
Over the past three years the total AUM of the industry have grown > four fold supported by buoyant economy and equity markets, India's fast expanding middle class and rising awareness of mutual funds as an investment option. The proportion of equity in total AUM is also estimated to have steadily increased from 15-20% in FY03 to around 45-50% currently.

Chart 14: Industry AUM



Source: Company Reports, Merrill Lynch Research Estimates

Chart 15: Composition of AUM



Source: Company Reports, Merrill Lynch Research Estimates

Table 17: Key financials for the industry

Rs in bn	Mar-00	Mar-01	Mar-02	Mar-03	Mar-04	Mar-05	Mar-06
Total AUM (Rs bn)	1,130	906	1,006	795	1,396	1,496	2,319
Total AUM (US$ bn)	26	21	23	18	32	34	53
yoy growth		-20%	11%	-21%	76%	7%	55%
as a % of GDP	5.8%	4.3%	4.4%	3.2%	5.1%	4.8%	6.6%
as a % of Bank Deposits	14.0%	9.5%	9.2%	6.2%	9.3%	8.4%	11.0%
Break of AUM							
- Equity	56%	41%	31%	16%	22%	30%	45%
- Debt	33%	43%	62%	67%	48%	34%	28%
- Money Market / Liquid funds	11%	16%	7%	17%	30%	36%	27%
Equity AUM (Rs bn)	633	371	312	127	313	443	1,050
yoy growth		-41%	-16%	-59%	146%	41%	137%
as a % of GDP	3.2%	1.8%	1.4%	0.5%	1.1%	1.4%	3.0%
Equity AUM (US $ bn)	15	9	7	3	7	10	24
Debt AUM		534	694	667	1,083	1,053	1,269
yoy growth		NA	30%	-4%	62%	-3%	21%
Sensex	5,001	3,604	3,469	3,049	5,591	6,493	11,280
Market Cap (Rs bn)	2,807	2,681	2,749	2,511	6,252	7,256	14,241
Market Cap (US$ bn)	65	62	63	58	144	167	327
Returns		-28%	-4%	-12%	83%	16%	74%

Source: Company Reports, Merrill Lynch Research Estimates

Key Drivers: Demographics, Consolidation, Globalization

Despite the strong growth witnessed by the MF industry in the past three years, India continues to be one of the under penetrated markets in the region with total AUM of <9% of GDP and equity AUM of <4% of GDP.

We believe the three key themes that will dominate the Indian asset management industry will be

1. the changing demographics with expanding middle class driving the need for savings which would be supported by increasing adaptability of mutual funds as a savings option v/s traditional savings products
2. consolidation in the mutual fund industry with the relatively smaller companies being acquired by the larger companies
3. gloabalisation as more international fund managers set up / expand their presence in India with many of them likely to raise local money
4. Regulatory changes allowing pension and insurance money to flow into equities

Gloablilisation would, in our view, increase the awareness of mutual funds to the average Indian middle class household benefiting the entire industry. The single biggest catalyst, in our view, would be allowing pension money to be invested into equities.

We believe total AUM in the industry could continue to grow at 25-30% p.a. for the next two to three years (including appreciation / depreciation in the market) with equity accounting for 45-50% of total AUM.

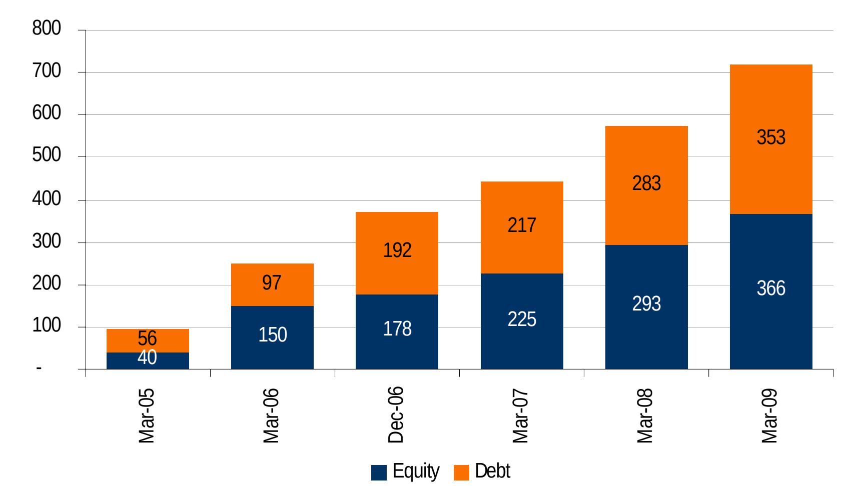
SIP's: an encouraging trend, lends stability to the business

A recent phenomena in the Indian mutual fund industry has been increasing demand for 'Systematic Investment Plan –SIP' owing to their inherent advantages over longer periods of time. A rising proportion of fresh investments in the form of SIP provides asset managers a sense of stability and reduces redemption pressure in volatile markets.

RCAM to remain amongst top 3 in the industry

We believe RCAM will maintain its position as one of the top 3 in the industry with its total AUM estimated to grow 30% in FY08 and 25% in FY09 to Rs719bn by FY09. The key growth driver is likely to be the aggressive expansion plan of the group companies (setting up of over 2,200 retail broking outlets which would also distribute Reliance mutual fund products – discussed in detailed later) supported by rising demand for mutual fund as an asset class.

Chart 16: AUM – RCAM



Source: Company Reports, Merrill Lynch Research Estimates

Key drivers are performance, ability to launch new products

We believe the two key determinants of market share gains in asset management business are i) the performance chart and ii) the ability of the asset manager to pro-actively launch new offerings in line with the needs of the market.

Reliance Capital has been a consistent performer (Reliance growth fund was ranked No. 1 in terms of performance globally over 5 and 10 year period by Lipper) and has also been very aggressive and pro-active in new product launches. RCAM was one of the first MF to launch a long-short fund which was the largest new fund offering in the Indian mutual fund industry where Reliance mobilized over Rs57bn (>US$1.2bn).

Margin pressure to be minimal

While we expect the competition to increase in the coming period, we believe the pressure on asset management fees is likely to be minimal as most Indian funds still operate at significantly lower cost structure v/s hedge funds which are becoming more popular globally.

However in the recent past most mutual funds have seen severe competition from the unit linked product offered by life insurance companies which has a much less annual maintenance charge and has a wider distribution network.

While insurance companies have an edge over mutual funds owing to their wider distribution network and incentive based selling model, we believe the factors working in favour of mutual funds would be absence of a lock-in period, lower exit loads (for shorter duration policies) and **most importantly asset management skills**.

A profitable model, but highly leveraged to markets

While the asset management business is highly leveraged to the capital market, it is globally, one of the best business models within financials services, with a number of desirable characteristics like:

1. Recurring revenues: the business model smoothes out the peaks and troughs, as fees are generally billed on average assets under management.
2. Low capital intensity -- no inventory, no receivables, little capital equipment, and no minimum capital requirements as with banks and other NBFCs. The biggest cost is compensation, which is flexible.
3. Equity assets have a bias toward growth
4. There is little price sensitivity on part of consumer if performance is good – growing demand for hedge fund (who work on a profit sharing model)
5. Globally asset management companies have excellent pre-tax operating margins averaging 45-50% (RCAM margins are also similar)

RCAM's earnings to grow at +65% CAGR; ROE of +45%

RCAM's net profit is estimated to grow 138% in FY07 (has grown 190%yoy in 9MFY07) followed by a 39% growth in FY08 and 36% in FY09 (to Rs1.3bn in FY09) mainly driven by the rising AUM and stable margins.

EBITDA margins estimated at 49%, Net margins to be +35%

With minimal pricing pressure on the asset management fees and the rising demand for asset managers, we expect RCAM to maintain its EBITDA margins at around 49%. Pre-tax margins and net margins are, however, likely to improve marginally with normalization of depreciation and complete write off of the deferred revenue expenses.

ROE to remain at 45%

Asset management business, is a high ROE model, owing to the low regulatory capital requirement of the business and minimal working capital etc. With low capital infusion and high ROE's, RCAM has been able to deliver an ROE of as high as 66% in FY06. We believe the ROE could sustain at +45% in coming years (could be higher if they increase the dividend pay out ratios) driven by the strong earnings growth trajectory.

PMS could be a wild card

As mentioned earlier, RCAM is aggressively scaling up its PMS business, which basically operates on a fee + carry structure. Given the strong market returns in FY07 contribution from this segment to total revenue is estimated to increase to around 18% (v/s 14% in FY06). While the share of the PMS business in FY07 is estimated at 24% it is mainly due to the higher carry component (given the strong market returns); for FY08-09 however, we have built in normalized market returns and have accordingly forecasted a decline in the 'carry' part. Advisory fees are however estimated to more than double in next two years led by rising AUM.

A superior market return could thus, result in a significant upside to our earnings estimate for the company owing to the rising carry

Table 18: Key financials for the Asset management business

Year ending march (Rs mn)	FY04	FY05	FY06	FY07E	FY08E	FY09E
Total Operating Income	321	443	894	2,041	2,807	3,528
Investment management and adv fees	321	437	773	1,551	2,290	2,912
PMS fees	-	5	121	490	518	616
EBITDA	92	142	422	1,007	1,332	1,716
PAT	75	121	300	715	993	1,347
Networth	168	301	614	1,340	2,343	3,690
Margins (%)						
EBITDA Margin		32%	47%	49%	47%	49%
Pre Tax Margin		41%	49%	52%	52%	56%
Net Profit Margin		27%	34%	35%	35%	38%
ROE		52%	66%	73%	54%	45%

Source: Company Reports, Merrill Lynch Research Estimates

RCAM valued at US$495mn based on FY09E

Globally (US and European asset managers) trade at a 20-30% premium to their respective markets, while Canadian asset managers trade at a discount on forward earnings (although earnings are generally not the main valuation driver for the Canadian companies). (see tables)

Table 19: P/E multiple for Global asset management companies

P/E multiple	0A	+1E	+2E
U.S. Asset Managers	22.4x	19.1x	16.9x
S&P 500	16.2x	15.5x	14.6x
U.S. Premium	38%	23%	16%
European Asset Managers	19.5x	16.3x	14.3x
Pan-Europe index	13.7x	12.2x	NA
European Premium	42%	34%	NA
Canadian Asset Managers	20.4x	16.5x	15.2x
S&P/TSX Composite	17.4x	18.3x	16.3x
Canadian	17%	-10%	-7%

Source: Company Reports, Merrill Lynch Research Estimates

Table 20: Valuations- Global asset management companies

Asset Managers (in Mn in local currency)	Price	M Cap	AUM (bn)	P/E - CY07	P/E - CY08	Mkt Cap / AUM
W P Stewart	10.7	506	8	11.7	11.6	6.3%
Rathborne group	1,198.0	506	11.1	15.4	13.9	4.6%
Azimuht Holding Spa	10.2	1,469	13.4	13.2	10.4	11.0%
Partners group	147.0	3,925	16.9	23.7	19.6	23.2%
Cohen and steers	24.8	1,074	26	17.7	14.9	4.1%
GAMCO	38.5	1,088	27	16.4	15.7	4.0%
Wadell & Reed	22.9	1,917	46	14.9	12.6	4.2%
Affiliated Managers Group	107.2	3,209	211	29.0	22.8	1.5%
Franklin Resources	114.7	29,096	526	18.8	16.7	5.5%
Alliance Bernstein	83.0	7,133	680	19.2	16.6	1.0%

Source: Company Reports, Merrill Lynch Research Estimates

We believe most asset managers should trade at a premium to their broader markets given the strengths of the business model – strong free cash flow, recurring revenues, low capital requirements, and asset growth supported over time by market appreciation.

In India while there are no listed asset managers, in the past the mutual fund industry has seen some consolidation with asset management companies being acquired at as high as 9% of AUM (as compared to 2-4% for global acquisition) owing to the strong growth trajectory of the industry and the higher profitability.

Table 21: Recent acquisition deals in Indian mutual fund industry

Acquirer	Target	Valuation	Amount	Date
Franklin Templeton MF	Pioneer ITI	6.0% of AUM	Rs2,400mn	Jul-02
Standard Life	HDFC AMC	4.0% of AUM	Rs3,400mn	Jun-03
Principal MF	IDBI MF	9.2% of AUM	Rs1,880mn	Jun-03
BNP Paribas	Sundaram AMC	7.2% of AUM	Rs2,012mn	Oct-05

Source: Company Reports, Merrill Lynch Research Estimates

We believe RCAM could trade at higher end of valuation range of asset management companies owing to its dominant retail franchise, strong growth trajectory and high ROEs.

Thus on a conservative note we believe RCAM could trade in line with the market multiples i.e., one year from now, at 16x FY09E earnings, implying a valuation of US$495mn.

At this range it effectively translates to a Price to AUM of 3% (4% of equity AUM and 2% of Debt AUM) still at a significant discount to the recent deals that have happened in India. While on a price to book it translates to a multiple of 5.8x FY09E book, we believe it is justified given the high RoE of almost 45%.

Table 22: Valuations- RCAM

Valuation Matrix for RCAM (Rs mn)	FY07	FY08	FY09
Assets under Management	442,500	575,250	719,063
- Equity	225,150	292,695	365,869
- Debt	217,350	282,555	353,194
Net Profit	715	993	1,347
Net Worth	1,340	2,343	3,690
Estimated P/E multiple		18	16
Estimated Value of the business (Rs bn)		18	22
Estimated Value of the business (US$mn)		411	495
Implied Market Cap as a % of AUM		3.1%	3.0%
- Debt		2.0%	2.0%
- Equity		4.0%	4.0%
Implied Price / Book		7.63	5.84

Source: Company Reports, Merrill Lynch Research Estimates

Brokerage business

Background and business model

Reliance Capital also plans to offer brokerage and related services through its 100% subsidiary, Reliance Money. The company has done a soft launch and plans to do a formal retail launch in the next two months.

Following a Revenue per customer (RPU) model

RM has a completely differentiated business model, with the company focusing on a RPU model i.e. trying to maximize the revenue per customer by offering them a host of products and services at a very nominal price.

RM would offer a wide range of product and services to its customers including

1. Brokerage services for equity and derivative products
2. Commodities trading: RM would be the first broker to offer this online
3. Offshore investment advisory (discussed later)
4. Depository services
5. Distribution of third party products like mutual funds
6. Insurance ***brokers*** for life insurance and general insurance players: being brokers RM would have the flexibility to market products for all the insurance companies
7. Money transfer and money exchange
8. Wealth management services (in association with RCAM)
9. Consumer financing (in association with Reliance capital, the parent company) and
10. Marketing of white labeled credit cards

While a host of the above services are offered by different companies, there is no single large non banking financial services company (NBFC) in the country that offers all the above services under a single physical set-up (India bulls is the closest competitor but it doesn't offer offshore investment advisory and foreign exchange remittance services). RM's biggest strength, in our view, would be its ability to leverage its financial expertise (across group companies) and strong retail domain to maximize the RPU.

RM would also be amongst the first companies to offer online trading of commodities and more importantly offshore investment services. RBI allows Indians to invest up to US$50,000 in securities abroad, which RM plans to capitalize by offering advisory services and has already tied up with some of the international players. RM plans to offer almost 3,500 contracts (including equities, commodities etc) to begin with and would eventually scale it up depending on the demand.

RCap had recently acquired Travel mate, the second largest foreign exchange provider in India (after Thomas Cook), which would enable the company to offer money transfer and money exchange facility both as a standalone operations and also for it's offshore investment model.

Pricing and distribution are the key

We believe the key success factors for RM's strategy are a vast distribution network and Reliance group's traditional strategy of low pricing.

Largest distribution network and lowest pricing structure

As mentioned earlier, RM has already done a soft launch of its operations, and, has entered into >950 franchise agreements spread over 625 cities and towns. It plans to unveil its retail distribution network of over 2,200 outlets (68 are owned by RM while rest are franchisees) in the next two months. This would be the most extensive distribution network by any NBFC in country and would be almost 3.5x larger than the network of Indiabulls.

RM would also offer a host of alternative delivery channels like kiosks (that will offer connectivity to Reliance Money's website) and a 350 seater dedicated call center to offer a 'Call and trade' facility and also address any investor concerns.

RM also plans to leverage on a relatively differentiated product offering (a flat fee structure) and a relatively more secured business model. It would charge a flat fee of Rs500/- for two months per customer allowing them to trade up to Rs1mn in delivery **or** Rs10mn in derivatives and intra day trading. These rates are around 40-50% lower than the current rates and hence are likely to result in sizable market share gains for RM; especially in the day traders and speculator segment, who are more price sensitive

Changing competitive landscape to drive consolidation

We believe RM's differentiated and competitive pricing structure would change the competitive landscape in the Indian retail broking industry, something similar to what we saw in the telecom space when Reliance Communication launched its CDMA technology at a significantly discounted pricing v/s other national players.

Reliance's telecom launch saw a huge round of price cut across all telecom service providers significantly bringing down the rates, but also led to sharp rise in the number of customers and the average usage per customer, benefiting Reliance as well as others in the industry.

We believe RM's flat fee structure will also lead to a round of cuts in the retail brokerage rates across players, pushing up the volumes, but more importantly driving the much needed consolidation within the retail brokerage industry.

Retail brokerage is an under-penetrated and a highly fragmented market

Retail participation in equities in India, is amongst the lowest in the world, with <5% of household sector financial saving invested in equity / equity related assets. However >60% of volumes on Indian markets (BSE and NSE combined) are from retail segment (a large proportion of same is from intra-day traders / speculators) which is relatively under-serviced and dependent largely on sub-brokers. This segment (on-line and off-line) is dominated by Indiabulls, Kotak Securities, ICICIDirect, and Sharekhan.

The industry is also highly fragmented with the top 5 brokers (including Indiabulls) accounting for only 15% market share. Most retail investors traditionally have been relying on sub-broker networks for facilitating investment in equities. This segment does not have access to research or organized brokerage services supported by a secure technology platform, and almost no dedicated relationship managers with which a customer can interact on a continuous basis.

It thus offers a significant opportunity for companies that can offer a value proposition to retail customers. A classic example has been Indiabulls, which with its superior customer proposition and nationwide network has, in the past four years, become the largest retail broker with a market share of >6%.

The industry has seen some consolidation in the past three to four years (share of top 5 /10 companies has doubled in past four years) as smaller companies have lost market share or have been acquired by some of the larger companies.

Changing demographics to drive penetration rise; further consolidation expected

The retail segment is in our view amongst the fastest growing segment, supported by expanding middle class underpinned by the changing demographics.

As per forecasts of Tata Statistical Outline, an additional 32mn households will enter the upper middle-class categories over the next five years with most of them being in the 20-34 age category. This new class of earners who are more at ease with technology and financial markets are likely to considerably increase the size of addressable population for integrated retail brokers like RM that can provide these customers with a superior value proposition at an attractive price.

The fact that the retail mass market wants access to various financial products within the securities industry, but is currently under-serviced by the mainstream is further helping Indiabulls capitalise on this large and rapidly growing opportunity.

Although the entry barrier is relatively low, the relatively low commission rates and the expansive branch network required have so far constrained many of the larger institutional players from entering into this segment directly.

Target population of >15mn customers

Indiabulls has expanded its client base to >0.4mn customers in the last four to five years, we however estimate there are >15mn customers in the country with a need for non-banking products hence providing enough growth opportunities for a few more large national brokers.

Going forward we expect further consolidation driven by aggressive price cuts making it difficult for the smaller comapnies with lower volumes and limited access to funding (for providing margin finance) to survive in this place.

We expect the share of the top 5 to increase to >30% with the top companies like RM and Indiabulls having a market share of almost 8-10%.

Reliance Money to become one of the top 3

We believe RM would emerge as one of the top 3 in the retail brokerage space with an estimated market share of 6-8% of the total equity volumes. The growth, as stated earlier, would be led by the market share gains from smaller players led by aggressive pricing structure and a nation wide distribution network.

Initially many of the day traders and speculators could move to the Reliance platform as RM’s effective brokerage rates for these types of clients would be 40-50% lower than prevailing rates (>60% lower than rates charged by smaller companies). However gradually we expect the share of retail investors (i.e. delivery based trades) to increase with higher proportion of retail savings flowing into equities.

We believe RM could, over the next two years i.e. by Mar-09 expand its total client base to over 0.4mn (Indiabulls currently has a similar customer base with less than 1/3 of RM's distribution network) and would also expand its presence in over 1,000 cities and towns with a network of over 3,500 offices.

RM could in our view garner a market share of around 6-8% in equity and derivatives volume and around 5-6% market share in the total commodity trading. The market share in derivatives and commodity trading could be higher as these markets are more sensitive to the pricing structure v/s the delivery based trader who assign a higher priority for research and support services.

Multiple products, operating efficiency to offset lower brokerage rates

While RM could have a higher market share, its brokerage revenue would be <40% of Indiabulls in FY09E owing to its low pricing and more importantly the revenue sharing – franchise structure.

However one of the biggest revenue driver for RM would be its ability to cross sell multiple financial products (insurance, mutual funds, credit cards) to its expanding retail client base thereby pushing up the average revenue per customer. We believe despite much lower brokerage revenue (v/s Indiabulls), RM's total revenues in two years could be >40% of Indiabulls FY09 estimated revenue as it benefits from a higher RPU.

However the positive aspect of running 'franchisee' model is a much lower fixed operating cost and a higher EBITDA margin compared to Indiabulls as most of the operational costs are borne by the franchisee. Hence RM's EBITDA margins could be as high as 70-75% v/s 55% EBITDA margin for Indiabulls.

Brokerage to be valued at US$410mn on FY09E

RM could, as per our estimates, deliver a post tax profit of Rs1.5bn i.e. around 35% of Indiabulls broking business, factoring in the above discussed.

Despite a higher growth trajectory, we have valued RCap's broking business at a 15% discount to the multiples of Indiabulls (i.e market multiples) factoring in the execution risk. Based on a P/E of 12x FY09E earnings, the brokerage is valued at at US$410mn of Rs73/share.

Table 23: Valuation for the brokerage business

Year ending march	FY08E	FY09E
Estimated net income (Rs mn)	500	1,500
Market P/E ratio	16	14
Estimated P/E ratio for Reliance Money	16.0	11.9
Implied value of Brokerage business (Rs bn)	8.0	17.9
Implied value of Brokerage business (US$mn)	184	410

Source: Company Reports, Merrill Lynch Research Estimates

The key downside risk is relating to a sharp and sustained correction in equity markets which could result in a de-rating of the multiple. In contrast, a buoyant market could see multiples rising in sync with market, with upside to earnings.

Factoring in deceleration in volume growth

Over the past 3-4 years volumes (combined turnover in cash and derivatives segments) on Indian stock exchanges (BSE + NSE) have grown at 50-70%p.a (YTD up 27%yoy in FY07) led by the strong momentum, rising FII participation and new public offerings.

Going forward, owing to our cautious stance on the markets we have factored in a sharp deceleration in market volumes; estimating it to grow at <20% p.a. for the next two years.

Consumer Financing

Reliance Capital also plans to roll out its consumer financing business in next 6 months. The company will provide unsecured loans and two-wheeler financing to salaried and professional people (i.e. the 'prime' segment). This area is currently dominated by private banks (government banks don't focus on unsecured loans), as most NBFC's mainly focusing on the sub-prime lending.

Despite the high competition in this space from larger banks, we believe RCAP could become a sizable player owing to its relatively extensive distribution network (compared to private sector banks).

Foray in consumer financing would allow it to leverage its net worth

The foray into this business would allow RCAP to leverage its net worth and grow its balance sheet size. We believe the group can deploy Rs12-13bn in this business (US$300mn) (discussed in detail in the capital adequacy section) and assuming a capital gearing of 10x it can achieve a loan book size of up Rs120bn (US$3bn) over the next two years.

Adequate capital to fund consumer financing

Reliance Capital group has a cumulative net worth of around Rs46bn; however most of the group's net worth is invested in the subsidiaries and the group's financial investments. Netting off all the investments (including likely capital infusion in subsidiaries over next two years) we believe the group has a free capital of Rs13-14bn which it can deploy in its consumer financing business (see table below)

Table 24: 'Networth' of the consumer financing business

		Rs mn
Existing net worth		46,678
Less:		
Investment in listed investments		11,506
Investment in subsidiaries		
- Life insurance	3,700	
- General Insurance	1,400	
- Broking	1,100	
- AMC	110	
- ARC	490	
- Consumer financing	-	6,800
Existing adjusted net worth		28,371
Less: Fresh investments over FY07-09		
- Life insurance	11,000	
- General Insurance	2,500	
- Broking	500	
- AMC	-	
- ARC	500	
- Consumer financing	-	14,500
Free networth (Rs mn)		13,871
Free networth (US$ mn)		319

Source: Company Reports, Merrill Lynch Research Estimates

Consumer financing valued at 1.5x FY09E book

We believe the business, once launched, could be valued at 1.5x its one year forward net-worth, owing to the strong growth trajectory and an estimated sustainable ROE of 18-20%.

Hence one year from now, the business could be valued at 1.5 FY09E adj net worth (including the ROE in FY08 and FY09), implying a valuation of US$621mn.

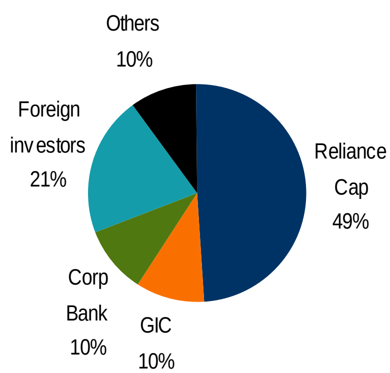
Table 25: Valuation for the consumer financing business

	FY08	FY09
Capital infused in consumer financing	13,500	15,255
ROE	13%	18%
Adjusted net worth at the year end	15,255	18,001
Multiple	1.50	1.50
Estimated value (Rs bn)	23	27
Estimated value (US$mn)	526	621

Source: Company Reports, Merrill Lynch Research Estimates

Asset reconstruction: too early to value

Chart 17: Shareholding pattern of the ARC



Source: Company Reports, Merrill Lynch Research Estimates

Reliance Capital has also floated an Asser reconstruction company and is awaiting RBI approval to begin operations. It is the only company of the group where Reliance Capital has a <100% stake (holds a 49% stake) while the balance share holding is divided between General Insurance Corporation of India (GIC), Corporation bank and two foreign institutional investors.

The company would be headed by Mr Rajendra Kakkar who is the ex-CEO of ARCIL, the largest and the first asset reconstruction company in India. The business model of the company would be similar to ARCIL, i.e. an AMC model wherein it would buy out distressed assets from banks and financial institution and against that issue ‘Security receipts’ which would be held by the seller. Hence any upside / downside on the realization would continue to reside with the bank / financial institution while Reliance Capital would basically get an asset management fees.

Asset reconstruction business in India is still at a nascent stage, mainly due to regulatory restriction on ability of these companies to raise capital which restricts these companies to completely buy out distressed assets from banks. Also banks / financial institutions have a tendency to sell out distressed assets only in extreme cases where they are not able to recover money for a prolonged period. We believe the system could see strong growth in coming years as ARC’s ability to buy out distressed asset improves and banks / financial institutions also start considering selling distressed at an early stage as a more prudent measure.

We believe Reliance Capital could potentially emerge as one of the key players in this space given the early mover advantage (being only the second company to enter this business actively). However we believe it is too early to assign any value to this business as it is still awaiting regulatory approvals.

Financials

Table 26: Income Statement

Year Ending March (Rs mn)	FY05	FY06	FY07E	FY08E	FY09E
Operational Income	4,775	4,673	13,968	31,221	59,477
- Consumer financing	2,282	1,762	2,081	6,349	14,628
-AMC	443	894	2,041	2,807	3,528
-General Insurance	2,051	2,017	9,731	20,705	37,962
-Broking	-	-	115	1,359	3,359
Operational Expenses	3,862	3,041	12,451	26,409	49,326
- Interest Expenses	1,511	452	211	2,360	7,323
- General Ins (Re-insurance, claims, reserves and commissions)	1,282	1,197	9,365	18,679	33,848
- Operating Expenses	1,069	1,391	2,875	5,370	8,155
Net operational income	913	1,633	1,517	4,812	10,151
Other income	664	4,804	4,319	4,453	4,843
- Profit on sale of investments	335	4,572	4,000	4,000	4,200
EBITDA	1,577	6,436	5,837	9,265	14,993
Depreciation and Amort.	296	256	322	328	335
Pre-provision Profit	1,281	6,181	5,515	8,937	14,658
Total Provision	(52)	15	50	1,500	2,400
PBT	1,333	6,165	5,465	7,437	12,258
Provision for Tax	128	336	405	1,038	2,541
PAT	1,205	5,829	5,060	6,399	9,717

Source: Company Reports, Merrill Lynch Research Estimates

Table 27: Balance Sheet

As at March (Rs mn)	FY05	FY06	FY07E	FY08E	FY09E
Equity Capital	1,278	2,234	2,451	2,451	2,451
Reserves & Surplus	13,653	39,385	29,637	29,658	33,444
Shareholders' funds	14,931	41,619	32,088	32,109	35,895
Warrants and Minority Interest	351	882	387	387	387
Loans	13,136	2,419	3,400	39,511	82,537
Current liabilities	1,449	2,255	2,481	2,729	3,002
Total liabilities	29,866	47,175	38,355	74,736	121,821
Investments	17,560	23,938	21,412	21,412	21,412
Fixed Assets	2,334	1,902	3,436	3,364	3,359
Advances	1,536	12,239	-	35,000	80,000
Current assets	8,367	9,035	13,461	14,925	17,024
Misc Exp (not written off)	69	62	47	35	26
Total Assets	29,866	47,175	38,355	74,736	121,821

Source: Company Reports, Merrill Lynch Research Estimates

Table 28: Key Ratios for each business

Year Ending March (Rs mn)	FY05	FY06	FY07E	FY08E	FY09E
Life Insurance					
Total New Business Premium- APE	334	853	6,436	16,148	28,095
yoy growth	51%	155%	655%	151%	74%
Total Premium	1,127	2,344	9,242	24,320	48,194
AUM	1,333	3,511	11,061	31,049	72,121
Market share	0.8%	1.1%	4.4%	6.9%	8.4%
General Insurance					
Gross Written Premium	1,617	1,623	8,714	18,632	34,140
yoy growth		0%	437%	114%	83%
Net Retained Premium	620	555	3,793	8,237	14,947
Asset Management					
Total AUM	95,430	246,700	442,500	575,250	719,063
yoy growth	32%	159%	79%	30%	25%
Market share	6.4%	10.6%	12.3%	11.9%	11.4%
Net Income	121	300	715	993	1,347
ROE	51.6%	65.7%	73.2%	53.9%	44.7%
Consolidated Entity					
Cost-Income ratio	19%	4%	6%	4%	2%
Cost Asset Ratio	1.0%	0.5%	0.8%	0.4%	0.3%

Source: Company Reports, Merrill Lynch Research Estimates

Table 29: Valuation Ratios

Valuation Ratios	FY05	FY06	FY07E	FY08E	FY09E
EPS	2.5	25.6	20.6	26.1	39.6
Earnings growth	-81.6%	930.8%	-19.3%	26.5%	51.8%
BV/share	117	186	131	131	146
ROAA	1.0%	14.9%	11.8%	11.3%	9.9%
ROAE	2.2%	20.2%	13.7%	19.9%	28.6%
Equity / Assets	50.0%	88.2%	83.7%	43.0%	29.5%
P/E	249.9	24.2	30.0	23.7	15.6
P/BV	5.3	3.3	4.7	4.7	4.2

Source: Company Reports, Merrill Lynch Research Estimates

Price Objective Basis & Risk

Valued on the basis of sum of parts

1. life insurance business valued at US$2.1bn based on 17x NBAP FY09E
2. general insurance valued at US$172mn based on 0.5x FY09E net retained premium
3. asset management valued at US$495mn 16x FY09E earnings
4. broking valued at US$410mn based on 15% discount to the market multiple
5. consumer financing business valued at US$621mn based on 1.5x adjusted networth
6. listed value of investments taken as on current date i.e. US$986mn

Based on the above we arrive at a consolidated value of US$4.8bn equivalent to Rs852/share underpinning our PO of Rs850.

Leverage to markets and execution risks are the risks to our PO.

Analyst Certification

I, Aashish Agarwal, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

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Business Performance	Numerator	Denominator
Return On Capital Employed	NOPAT = (EBIT + Interest Income) * (1 - Tax Rate) + Goodwill Amortization	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill Amortization
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
Quality of Earnings		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
Valuation Toolkit		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	EV = Current Share Price * Current Shares + Minority Equity + Net Debt + Other LT Liabilities	Sales
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

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Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	93	38.11%	Buy	47	50.54%
Neutral	140	57.38%	Neutral	69	49.29%
Sell	11	4.51%	Sell	4	36.36%

Investment Rating Distribution: Global Group (as of 31 Dec 2006)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1306	42.74%	Buy	406	31.09%
Neutral	1509	49.38%	Neutral	446	29.56%
Sell	241	7.89%	Sell	53	21.99%

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