

RELIANCE INDUSTRIES

Refining: Positive longer-term view

India Equity Research | Oil, Gas and Services



Edelweiss
Ideas create, values protect

Refining margins have soared recently by USD2/bbl due to unplanned large outages in refineries. While we expect moderation in refining margins as capacities come back, in the long term, we continue to remain positive on them as we believe that capacity closures will keep net capacity addition at 1.9 mbpd, lower than 2.3 mbpd demand surge. We like Reliance Industries (RIL) due to its high refining complexity, large planned capex in refining & petchem and earnings growth from investment in shale gas. Maintain 'BUY' with target price of INR906/share.

Unplanned outages spur refining margins

Fires, mostly in US and Japan, have led to unplanned closures of refineries of ~1.0 mbpd (1.2% of refining capacity). Most notable has been the closure of Richmond refinery in California (see table). These led to increase in product spreads and hence margins. Gasoline-Dubai and Diesel-Dubai spreads, which averaged USD14/bbl and USD 13/bbl, respectively, in Q1FY12, moved to USD19/bbl and USD18/bbl, respectively. Increase in product spreads led to USD2/bbl surge in Singapore GRMs.

Current rise temporary; positive on long-term margin

As refineries come back on line, refining margins are bound to moderate. Our readings on the outage are: (1) refineries like Richmond will be shut for around six months benefiting refiners like RIL, who can supply products to the strict Californian market; (2) sharp increase in refining margins reveals the fragility of industry supply chain; and (3) rising fires show the impact of ageing industry capacity. While we note that such temporary upsides will exist in future, we are also positive on refining margins from the long-term perspective. Our view emerges from estimated 3.2 mbpd closure of refining capacity in CY12-14, which will lead to net refining capacity addition of 1.9mbpd, much lower than demand growth of 2.3 mbpd.

Outlook and valuations: Positive; maintain 'BUY'

We remain positive on refining and particularly RIL due to its ongoing capex in refining, petrochemicals and US shale. The company's earnings are highly leveraged to refining margins and every USD1/bbl increase in GRMs increases PAT 9%. We estimate it to report Q2FY13 GRMs at USD8.5-9.0/bbl. Our FY13/14 base case assumes GRMs of USD8.5/9.0 per bbl. Maintain 'BUY/Sector Outperformer' on the stock.

Financials

(INR mn)

Year to March	FY11	FY12	FY13E	FY14E
Net revenue	2,658,106	3,585,010	3,432,362	3,496,083
EBITDA	380,436	345,080	338,448	366,661
Net profit	192,715	197,170	206,256	224,507
Diluted EPS (INR)	64.7	66.2	70.6	76.8
Diluted PE (x)	12.6	12.3	11.6	10.6
EV/EBITDA (x)	7.3	7.4	7.2	6.5

EDELWEISS 4D RATINGS

Absolute Rating	BUY
Rating Relative to Sector	Outperformer
Risk Rating Relative to Sector	Medium
Sector Relative to Market	Overweight

MARKET DATA (R: RELI.BO, B: RIL IN)

CMP	: INR 816
Target Price	: INR 906
52-week range (INR)	: 905 / 673
Share in issue (mn)	: 3,274.6
M cap (INR bn/USD mn)	: 2,672/ 47,995
Avg. Daily Vol.BSE/NSE('000)	: 4,739.9

SHARE HOLDING PATTERN (%)

	Current	Q4FY12	Q3FY12
Promoters %	45.1	44.8	44.7
MF's, FI's & BK's	11.2	10.7	11.3
FII's	17.0	17.6	17.0
others	26.7	27.0	26.9
* Promoters pledged shares (% of share in issue)	:	NIL	

PRICE PERFORMANCE (%)

	Stock	Nifty	EW O & G Index
1 month	13.3	2.6	4.6
3 months	20.7	8.5	14.7
12 months	7.5	5.7	4.1

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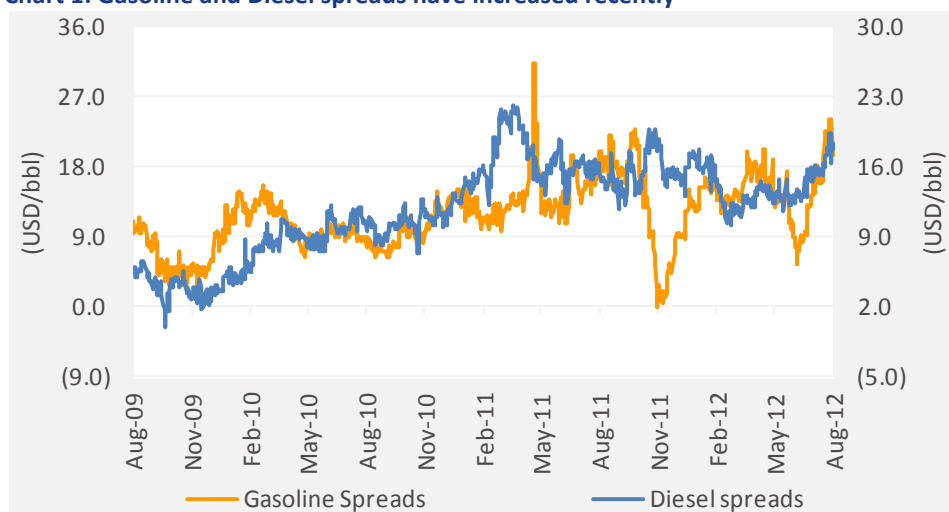
August 17, 2012

Table 1: Indicative list of refinery outages of ~1.0 mbpd

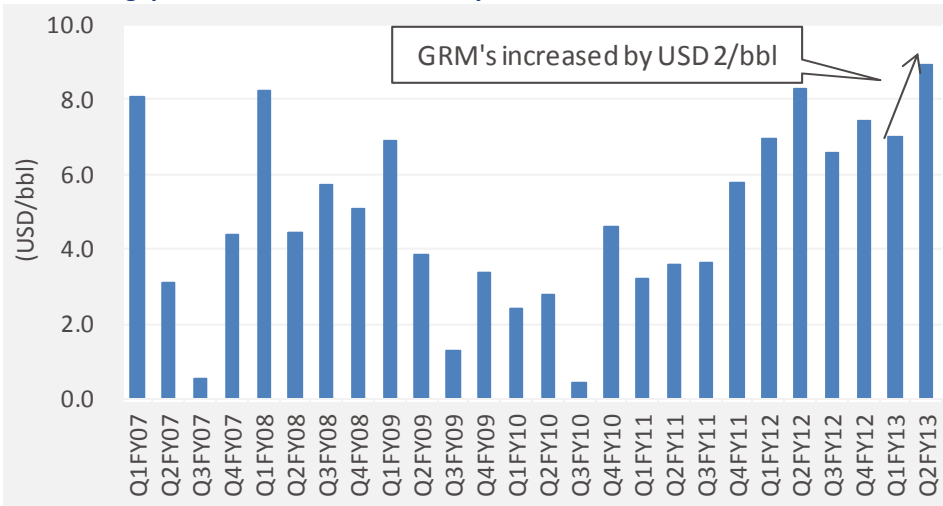
Company	Location	From date	To date	Capacity impacted (bpd)	Reason
Chevron Corp	Richmond refinery, California, USA	8-Aug-12	NA	240,000	Fire on 06-Aug; Refinery producing at reduced capacity; FCCU & hydrocracking unit running at 60% capacity, lube plant running at low rates; 16 percent of the region's daily gasoline supply; Probably shut for 6 months
Holly Frontier Corp	Oklahoma, USA	2-Aug-12	NA	65,000	Fire in hydrotreater. Rates cut by 30-40 kbbpd; East plant's 65,000 bpd crude unit is also shut.
Idemitsu Kosan Co Ltd	Chiba, Japan	19-Jul-12	3-Aug-12	220,000	No. 2 CDU of 220,000 bpd shut after fire; Restarted now
JX Nippon Oil & Energy	Oita refinery, South Western Japan	17-Aug-12	NA	136,000	Leakage of LPG; Temporary shutdown
Royal Dutch Shell PLC	Motiva refinery; Port Arthur; USA	11-Jun-12	NA	325,000	New refinery unit; Crude unit restart abandoned after multiple deficiencies surfaced during startup. Expected to restart in early 2013
Total				986,000	

Source: Bloomberg, Edelweiss research

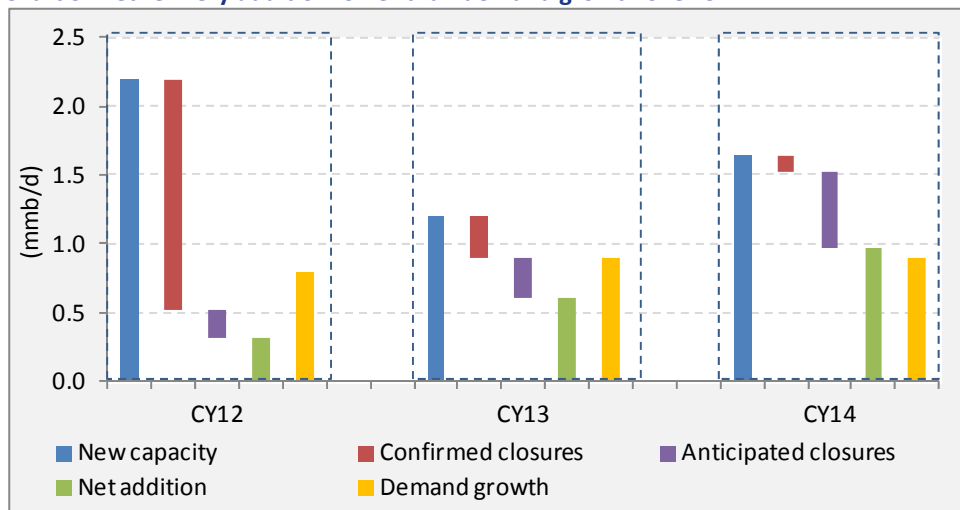
Chart 1: Gasoline and Diesel spreads have increased recently



Source: Bloomberg, Edelweiss research

Chart 2: Singapore GRM's have increased by USD 2+/bbl


Source: Edelweiss research

Chart 3: Net refinery addition lower than demand growth over CY12-14


Source: Edelweiss research

Table 2: Refinery closure over CY12-14

Year closed	Company	Location	Capacity (kb/d)
2012	Lyondell Basell	Berre, France	105
2012	Shell	Harburg, Germany	107
2011	Showa Shell	Keihin Ohgimachi, Japan	120
2014	Indemistu Kosan	Japan	120
2011	Hess Corp	Hovensa, St Croix, BVI, USA	150
2011	Sunoco	Marcus Hook, Pennsylvania, USA	178
2014	Nippon	Japan	200
2011	Hestya (COP earlier)	Wilhelmshaven, Germany	260
2012	Hess Corp	Hovensa refinery, St Croix, BVI, USA	350
Total			1,590

Source: Edelweiss research

Table 3: Potential Refinery closure over CY12-14

Owner	Location	Capacity (kb/d)
Chevron	Kapolei, HI	54
Phillips 66	Whitegate, Ireland	70
ENI	Porto Marghera, Italy	70
Shell	Gothenburg, Sweden	80
Imperial Oil	Dartmouth, Nova Scotia	88
Tesoro	Kapolei, HI	94
Petrobras/Nansei Sekiyu	Okinawa, Japan	100
Lloyndell Basell	Berre, France	105
Murphy Oil	Milford Haven, UK	108
Caltex	Lytton, Brisbane	109
Caltex	Kurnell, Sydney	135
Petroplus	Couronne refinery, France	161
PKN	Mazeikai, Lithuania	190
Petroplus	Coryton refinery, UK	220
StatOil	Mongstad, Norway	220
Phillips 66	Belle Chase, LA	247
SK Group	Incheon, South Korea	275
JX Energy	Various Japanese locations	400
BP	Texas City, TX	475
Total		3,201

Source: Edelweiss research

Company Description

RIL is the largest private player in the refining, petrochemical and E&P sectors in India. While RIL's refining complex in Jamnagar is the largest in the world and among the most complex, it is also among the largest integrated petrochemical producers globally. Apart from E&P in India, RIL has made significant investments in US shale gas. In terms of EBIT, Petrochemicals contribute 38%, Refining 40% and E&P 22%. RIL is also expanding its presence in the areas of consumer retailing and telecom, but EBIT contribution from these 'other' businesses is <1%. RIL has a weight of 9.1% in BSE Sensex and 7.5% in S&P CNX Nifty.

Investment Theme

RIL's strength lies in its ability to build businesses of global scale and execute complex, time-critical, and capital-intensive projects which will prove advantageous as it embarks on large investments in all core segments.

We expect non-regulated segments (refining, chemicals and shale) to contribute ~90% of incremental EBITDA over the next few years.

We are positive on both refining and chemicals, as current refining margins are not sustainable for upcoming capacity additions, and global utilization rates have bottomed out in chemicals.

RIL is currently in a capex phase, investing in world-scale projects like petcoke gasification and off-gas crackers, which are expected to drive future growth.

Its investment in US shale gas is already bearing fruit, and is expected to contribute ~12% of EBITDA by FY15.

Key Risks

Slow down in global demand or larger than expected capacity additions could impact RIL's refining and chemical margins.

Delays in government approvals for India E&P or weak domestic gas prices could hamper progress in upstream.

Weak US natural gas prices could lower the profitability of shale gas assets, though it could be offset by the liquids-rich acreages which are currently highly profitable.

Rupee appreciation may impact negatively as RIL is positively leveraged to the depreciating currency.

Financial Statements

Key assumptions

Year to March		FY10	FY11	FY12	FY13E	FY14E
Macro -	GDP(Y-o-Y %)	8.4	8.4	6.5	6.4	7.0
	Inflation (Avg)	3.6	9.9	8.8	7.0	6.0
	Repo rate (exit rate)	5.0	6.8	8.5	7.3	6.8
	USD/INR (Avg)	47.4	45.6	47.9	53.5	50.0
Sector -	Brent Crude (USD/bbl)	70.0	87.3	115.4	95.0	95.0
	Under-recovery (INR bn)	460	782	1,385	1,044	1,038
	% sharing by upstream	31.2	38.7	39.7	39.0	40.0
	USD/INR (Avg)	47.5	45.6	47.9	53.5	52.5
Company -	KG-D6 gas price (USD/mmbtu)	4.2	4.2	4.2	4.2	4.2
	Net gas production (mmscmd)	39.1	52.8	33.9	19.3	16.2
	GRM (USD/bbl)	6.6	8.4	8.6	8.5	9.0
	Refining throughput (mmt)	61	67	68	68	68

Income statement

(INR mn)

Year to March		FY10	FY11	FY12	FY13E	FY14E
Net revenue		2,037,397	2,658,106	3,585,010	3,432,362	3,496,083
Materials costs		1,546,027	2,044,237	2,981,910	2,807,836	2,828,281
Operating expenses		182,431	233,433	258,020	286,078	301,141
EBITDA		308,939	380,436	345,080	338,448	366,661
Depreciation & Amortization		109,458	141,208	124,010	121,322	126,668
EBIT		199,481	239,228	221,070	217,126	239,992
Other income		21,775	25,428	61,940	72,680	73,134
Interest expenses		20,596	24,107	28,930	33,498	32,511
Profit before tax		200,660	240,550	254,080	256,308	280,615
Provision for tax		42,563	47,834	56,910	50,052	56,108
Net profit		158,097	192,715	197,170	206,256	224,507
Profit after minority interest		245,031	192,937	197,240	206,829	223,825
Shares outstanding (mn)		2,978	2,981	2,979	2,922	2,922
Diluted EPS (INR)		53.4	64.7	66.2	70.6	76.8
CEPS (INR)		93.9	113.3	109.4	109.9	118.1
Dividend per share (INR)		7.0	8.0	8.5	9.0	9.5

Common size metrics - as % of net revenues

Year to March		FY10	FY11	FY12	FY13E	FY14E
Gross margin		24.1	23.1	16.8	18.2	19.1
EBITDA margins		15.2	14.3	9.6	9.9	10.5
EBIT margins		9.8	9.0	6.2	6.3	6.9
Net profit margins		7.8	7.3	5.5	6.0	6.4

Growth ratios (%)

Year to March		FY10	FY11	FY12	FY13E	FY14E
Rev. growth (%)		34.7	30.5	34.9	(4.3)	1.9
EBITDA		31.9	23.1	(9.3)	(1.9)	8.3
Net profit		5.7	21.9	2.3	4.6	8.8
EPS growth (%)		2.9	21.3	2.3	6.6	8.7

Balance sheet

(INR mn)

As on 31st March	FY10	FY11	FY12	FY13E	FY14E
Equity capital	29,780	29,810	29,790	29,220	29,220
Reserves & surplus	1,380,250	1,511,117	1,664,660	1,777,110	1,966,173
Shareholders funds	1,410,030	1,540,928	1,694,450	1,806,330	1,995,393
Minority interest (BS)	5,735	8,022	7,990	7,890	8,014
Secured loans	116,944	105,785	100,980	91,255	81,255
Unsecured loans	529,111	735,277	823,010	741,677	741,850
Borrowings	646,055	841,062	923,990	832,932	823,105
Deferred tax liability	106,776	110,709	115,670	109,156	103,264
Sources of funds	2,168,596	2,500,721	2,742,100	2,756,309	2,929,776
Gross block	2,241,253	2,382,925	2,334,760	2,445,087	2,591,432
Depreciation	639,340	801,931	946,610	1,068,393	1,194,720
Net block	1,601,913	1,580,994	1,388,150	1,376,694	1,396,711
Capital work in progress	170,337	297,423	253,630	313,348	449,664
Total fixed assets	1,772,249	1,878,417	1,641,780	1,690,042	1,846,375
Investments	131,123	215,961	385,960	385,960	385,960
Inventories	343,933	385,194	466,920	463,930	483,458
Sundry debtors	100,829	156,952	169,390	152,353	148,828
Cash and equivalents	138,908	301,390	407,310	398,225	444,566
Loans and advances	106,472	134,643	164,950	127,365	111,563
Other current assets	914	2,617	35,600	30,536	28,054
Total current assets	691,057	980,796	1,244,170	1,172,408	1,216,469
Sundry creditors and others	388,906	527,165	485,780	439,302	463,585
Others current liabilities	36,950	47,303	44,030	52,799	55,443
Total current liabilities & provisions	425,856	574,467	529,810	492,102	519,028
Net current assets	265,201	406,329	714,360	680,307	697,441
Miscellaneous expenditure	23	14	-	-	-
Uses of funds	2,168,596	2,500,721	2,742,100	2,756,309	2,929,776
Book value per share (INR)	473.5	516.9	568.9	618.1	682.8

Free cash flow

(INR mn)

Year to March	FY10	FY11	FY12E	FY13E	FY14E
Net profit	245,031	192,937	197,240	206,829	223,825
Depreciation	109,458	141,208	124,010	121,322	126,668
Deferred tax	11,314	3,710	4,650	(6,514)	(5,892)
Others	(5,894)	(1,534)	(33,066)	(39,282)	(40,499)
Gross cash flow	359,909	336,321	292,834	282,355	304,102
Less: Changes in WC	154,973	(21,354)	202,112	(24,968)	(29,207)
Operating cash flow	204,936	357,675	90,722	307,323	333,309
Less: Capex	232,781	338,646	163,810	170,045	282,661
Free cash flow	(27,845)	19,029	(73,088)	137,278	50,649

Cash flow metrics

Year to March	FY10	FY11	FY12E	FY13E	FY14E
Operating cash flow	204,936	357,675	90,722	307,323	333,309
Investing cash flow	(182,308)	(328,168)	(16,101)	(97,365)	(209,526)
Financing cash flow	(111,337)	111,732	(842)	(219,306)	(77,627)
Net cash flow	(88,710)	141,238	73,779	(9,348)	46,156
Capex	(232,781)	(338,646)	(163,810)	(170,045)	(282,661)
Dividends paid	(22,195)	(27,719)	(29,410)	(33,431)	(35,288)

Profitability & efficiency ratios

Year to March	FY10	FY11	FY12	FY13E	FY14E
ROAE (%)	12.1	13.1	12.2	11.8	11.8
ROACE (%)	9.9	11.1	9.5	9.2	9.8
Inventory day	64	65	52	61	61
Debtors days	13	18	17	17	16
Payable days	88	82	62	60	58
Cash conversion cycle (days)	(10)	1	7	17	19
Net Debt/Equity	0.4	0.4	0.3	0.2	0.2
Interest coverage	9.7	9.9	7.6	6.5	7.4

Operating ratios

Year to March	FY10	FY11	FY12	FY13E	FY14E
Total asset turnover	1.0	1.1	1.4	1.2	1.2
Fixed asset turnover	1.5	1.7	2.4	2.5	2.5
Equity turnover	1.6	1.8	2.2	2.0	1.8

Valuation parameters

Year to March	FY10	FY11	FY12	FY13E	FY14E
Diluted EPS (INR)	53.4	64.7	66.2	70.6	76.8
Y-o-Y growth (%)	2.9	21.3	2.3	6.6	8.7
CEPS (INR)	93.9	113.3	109.4	109.9	118.1
Diluted PE (x)	15.3	12.6	12.3	11.6	10.6
Price/BV (x)	1.7	1.6	1.4	1.3	1.2
EV/Sales (x)	1.4	1.0	0.7	0.7	0.7
EV/EBITDA (x)	9.1	7.3	7.4	7.2	6.5
Dividend yield (%)	0.9	1.0	1.0	1.1	1.2

Peer comparison valuation

	P/E		P/BV		ROE		EV/EBITDA	
	FY13E	FY14E	FY13E	FY14E	FY13E	FY14E	FY13E	FY14E
RIL	11.6	10.6	1.3	1.2	11.8	11.8	7.2	6.5
Global Independent E&P (Median)	15.8	12.8	1.4	1.3	10.4	12.2	5.5	4.9
Asian Refining & Marketing (Median)	11.6	10.0	1.2	1.1	10.4	10.4	7.5	6.9
Global Petchem (Median)	13.4	9.6	1.6	1.5	9.4	10.7	7.4	6.0

Source: Bloomberg, Edelweiss research

Company	Absolute reco	Relative reco	Relative risk	Company	Absolute reco	Relative reco	Relative Risk
Aban Offshore	REDUCE	SU	H	Bharat Petroleum Corporation	BUY	SO	M
Cairn India	HOLD	SO	M	Chennai Petroleum Corporation	BUY	SO	H
Essar Oil	BUY	SO	H	GAIL (INDIA)	HOLD	SP	L
Gujarat State Petronet	HOLD	SP	M	Hindustan Petroleum Corporation	BUY	SO	L
Indian Oil Corporation	BUY	SO	M	Indraprastha Gas	BUY	SO	M
ONGC	BUY	SO	L	Petronet LNG	BUY	SO	L
Reliance Industries	BUY	SO	M				

ABSOLUTE RATING

Ratings	Expected absolute returns over 12 months
Buy	More than 15%
Hold	Between 15% and - 5%
Reduce	Less than -5%

RELATIVE RETURNS RATING

Ratings	Criteria
Sector Outperformer (SO)	Stock return > 1.25 x Sector return
Sector Performer (SP)	Stock return > 0.75 x Sector return
	Stock return < 1.25 x Sector return
Sector Underperformer (SU)	Stock return < 0.75 x Sector return

Sector return is market cap weighted average return for the coverage universe within the sector

RELATIVE RISK RATING

Ratings	Criteria
Low (L)	Bottom 1/3rd percentile in the sector
Medium (M)	Middle 1/3rd percentile in the sector
High (H)	Top 1/3rd percentile in the sector

Risk ratings are based on Edelweiss risk model

SECTOR RATING

Ratings	Criteria
Overweight (OW)	Sector return > 1.25 x Nifty return
Equalweight (EW)	Sector return > 0.75 x Nifty return
	Sector return < 1.25 x Nifty return
Underweight (UW)	Sector return < 0.75 x Nifty return

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Coverage group(s) of stocks by primary analyst(s): Oil, Gas and Services

Aban Offshore, Bharat Petroleum Corporation, Cairn India, Essar Oil, GAIL (INDIA), Gujarat State Petronet, Hindustan Petroleum Corporation, Indraprastha Gas, Indian Oil Corporation, Chennai Petroleum Corporation, ONGC, Petronet LNG, Reliance Industries

Recent Research

Date	Company	Title	Price (INR)	Recos
14-Aug-12	Essar Oil	Benefits of higher complexity emerging; <i>Result Update</i>	54	Buy
13-Aug-12	Bharat Petroleum Corporation	GRMs benefit from lower crude inventories; <i>Result Update</i>	351	Buy
11-Aug-12	ONGC	Earnings beat on lower dry well expenses; <i>Result Update</i>	279	Buy

Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

	Buy	Hold	Reduce	Total
Rating Distribution*	104	60	18	183
* 1 stocks under review				
	> 50bn	Between 10bn and 50 bn	< 10bn	
Market Cap (INR)	114	58	11	

Rating Interpretation

Rating	Expected to
Buy	appreciate more than 15% over a 12-month period
Hold	appreciate up to 15% over a 12-month period
Reduce	depreciate more than 5% over a 12-month period

DISCLAIMER

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