

RIL may bid for US refiner Valero

Possible RIL bid for largest independent US refiner Valero?

According to press speculation, RIL may bid for US refiner Valero (see [Valero Energy Corp., 27 October 2011](#)). Valero is the largest independent US refiner with 2.8m b/d of refining capacity (Nelson complexity of 11.3). Valero can process heavier/sourer, cheaper crudes, which means lower earnings volatility vis-à-vis peers. A bid for Valero at US\$48/share (as per some press reports) appears aggressive but would be earnings accretive if Valero's profit is over US\$2.2bn in our opinion. At BofAML's estimate of US\$3.1bn, a Valero acquisition would boost FY13 earnings by 8-19%. Retain Buy.

Acquisition EPS accretive if Valero profit over US\$2.2bn

RIL's net debt is US\$3.5bn (gross cash US\$15.6bn) and is set to turn net cash assuming no big acquisition by end of FY12. RIL has been looking for acquisitions and had even bid for LyondellBasell in 2009. We believe RIL could bid for Valero. Some reports suggest RIL's bid may be at US\$48/share (82% higher than Oct 27 closing of US\$26.2) while BofAML PO for Valero is US\$36. Acquiring a 100% stake in Valero at US\$48/share would cost US\$27.5bn (net debt US\$4.6bn). Valero's acquisition would be earnings accretive if Valero's FY13 net profit is higher than US\$2.2bn. BofAML net profit for 2012 is US\$3.1bn and consensus is US\$2.5bn. At US\$48/share its 2011-12 PE is 9.0-9.6x and EV/EBITDA 4.7-5.4x.

US and Valero's refining outlook the key

Paying US\$48/share for Valero would mean 65% higher valuation per complex barrel vis-à-vis RIL's new refinery built in 2009. We believe some premium is justified if Valero's stronger GRM in 2Q 2011 (US\$11.6/bbl vis-à-vis RIL's US\$10.3/bbl) is sustainable. 17% of Valero's throughput in US mid-continent gains from weak WTI prices but a key question is how long are these gains sustainable?

Estimates (Mar)

(Rs)	2010A	2011A	2012E	2013E	2014E
Net Income (Adjusted - mn)	158,976	202,003	236,954	253,644	280,389
EPS	48.39	61.49	72.13	77.21	85.35
EPS Change (YoY)	3.9%	27.1%	17.3%	7.0%	10.5%
Dividend / Share	7.00	7.50	8.00	8.00	8.00
Free Cash Flow / Share	32.58	22.93	25.66	46.03	57.09
GDR EPS (US\$)	2.04	2.70	2.91	3.12	3.45
GDR Dividend / Share (US\$)	0.295	0.329	0.323	0.323	0.323

Valuation (Mar)

	2010A	2011A	2012E	2013E	2014E
P/E	18.60x	14.64x	12.48x	11.66x	10.54x
Dividend Yield	0.778%	0.833%	0.889%	0.889%	0.889%
EV / EBITDA*	11.20x	8.88x	9.26x	9.20x	8.77x
Free Cash Flow Yield*	3.62%	2.55%	2.85%	5.11%	6.34%

* For full definitions of *iQmethod*SM measures, see page 8.

Bank of America Merrill Lynch

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Stock Data

Price (Common / GDR)	Rs900.00 / US\$37.24
Price Objective	Rs950.00 / US\$40.14
Date Established	16-Oct-2011 / 16-Oct-2011
Investment Opinion	B-1-7 / B-1-7
Volatility Risk	MEDIUM / MEDIUM
52-Week Range	Rs712.00-Rs1,187
Market Value (mn)	US\$59,725
Market Value (mn)	Rs2,956,669
Shares Outstanding (mn)	3,285.2 / 1,642.6
Average Daily Volume	5,472,531
BofAML Ticker / Exchange	XRELF / BSE
BofAML Ticker / Exchange	RLNIY / LIN
Bloomberg / Reuters	RIL IN / RELI.BO
ROE (2012E)	15.0%
Net Dbt to Eqty (Mar-2011A)	24.9%
Est. 5-Yr EPS / DPS Growth	12.9% / 4.2%
Free Float	45.0%

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Refer to important disclosures on page 9 to 12. Analyst Certification on Page 6. Price Objective Basis/Risk on page 6. Link to Definitions on page 6. 11103201

iQprofileSM Reliance Industries Ltd.

Key Income Statement Data (Mar)	2010A	2011A	2012E	2013E	2014E
(Rs Millions)					
Sales	2,037,397	2,658,106	3,030,820	3,164,910	2,865,677
Gross Profit	491,370	623,039	662,313	664,674	671,400
Sell General & Admin Expense	(182,431)	(233,433)	(288,678)	(288,806)	(276,976)
Operating Profit	199,481	248,295	278,377	279,616	293,662
Net Interest & Other Income	1,262	1,321	31,398	51,978	72,896
Associates	NA	NA	NA	NA	NA
Pretax Income	200,743	249,616	309,775	331,595	366,559
Tax (expense) / Benefit	(42,563)	(47,834)	(72,821)	(77,950)	(86,170)
Net Income (Adjusted)	158,976	202,003	236,954	253,644	280,389
Average Fully Diluted Shares Outstanding	3,285	3,285	3,285	3,285	3,285

Key Cash Flow Statement Data

Net Income	158,976	202,003	236,954	253,644	280,389
Depreciation & Amortization	109,458	141,311	95,257	96,251	100,762
Change in Working Capital	(156,946)	18,229	(67,101)	(6,284)	(4,238)
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	96,523	(5,458)	10,866	11,632	12,858
Cash Flow from Operations	208,011	356,085	275,977	355,243	389,770
Capital Expenditure	(100,967)	(280,759)	(191,666)	(204,034)	(202,207)
(Acquisition) / Disposal of Investments	(66,767)	(84,839)	0	0	0
Other Cash Inflow / (Outflow)	NA	NA	324,000	NA	NA
Cash Flow from Investing	(167,734)	(365,598)	132,334	(204,034)	(202,207)
Shares Issue / (Repurchase)	15,638	676	0	0	0
Cost of Dividends Paid	(22,337)	(24,970)	(24,959)	(29,969)	(29,969)
Cash Flow from Financing	(123,210)	170,713	(31,019)	(179,968)	(179,969)
Free Cash Flow	107,044	75,326	84,310	151,209	187,563
Net Debt	422,871	370,557	(12,795)	(134,036)	(291,630)
Change in Net Debt	(33,578)	33,807	(383,352)	(121,240)	(157,594)

Key Balance Sheet Data

Property, Plant & Equipment	1,678,113	1,817,560	1,589,969	1,697,752	1,799,197
Other Non-Current Assets	46,847	46,847	46,847	46,847	46,847
Trade Receivables	100,829	156,952	149,993	156,629	141,820
Cash & Equivalents	223,184	470,505	847,796	819,038	826,632
Other Current Assets	451,319	522,454	665,894	699,753	639,187
Total Assets	2,500,292	3,014,317	3,300,499	3,420,019	3,453,684
Long-Term Debt	565,506	703,532	809,140	659,141	509,141
Other Non-Current Liabilities	106,776	110,709	121,575	133,207	146,065
Short-Term Debt	80,550	137,530	25,862	25,862	25,862
Other Current Liabilities	425,856	574,467	648,858	683,070	603,457
Total Liabilities	1,178,687	1,526,238	1,605,435	1,501,279	1,284,524
Total Equity	1,321,605	1,488,079	1,695,064	1,918,740	2,169,160
Total Equity & Liabilities	2,500,292	3,014,317	3,300,499	3,420,019	3,453,684

iQmethodSM - Bus Performance*

Return On Capital Employed	8.5%	9.5%	9.8%	9.7%	10.3%
Return On Equity	13.2%	14.4%	15.0%	14.1%	13.8%
Operating Margin	9.8%	9.3%	9.2%	8.8%	10.2%
EBITDA Margin	15.2%	14.7%	12.3%	11.9%	13.8%

iQmethodSM - Quality of Earnings*

Cash Realization Ratio	1.3x	1.8x	1.2x	1.4x	1.4x
Asset Replacement Ratio	0.9x	2.0x	2.0x	2.1x	2.0x
Tax Rate (Reported)	21.2%	19.2%	23.5%	23.5%	23.5%
Net Debt-to-Equity Ratio	32.0%	24.9%	-0.8%	-7.0%	-13.4%
Interest Cover	9.7x	10.3x	12.3x	15.4x	19.9x

Key Metrics

* For full definitions of iQmethodSM measures, see page 8.

Company Description

India's largest petrochemical and refining company, Reliance, owns two refineries with 1.25mbpd capacity. It has over 2m tpa ethylene cracker and is the world's largest polyester producer. It also has large polypropylene and fibre intermediate capacity. Refining was 36%, petrochemical 38% and E&P 26% of FY11 EBIT. Its 2P reserves and resources in India are 2.6bn boe and 1.6bn boe in US shale gas.

Investment Thesis

We expect RIL's 2-year earnings CAGR in FY12-FY13E to be close to 20% driven by rise in refining and petrochemical margins and other income. RIL has large unexplored prospective acreage and, thus, large reserve-accretion potential. RIL also has a lot of cash and treasury shares, and should generate strong free cash flow. This may be used to make value-accretive acquisitions.

Stock Data

Shares / GDR	2.00
Price to Book Value	1.8x

RIL may bid for US refiner Valero Valero acquisition earnings accretive?

Would share in Valero profit exceed lower other income/higher interest?

Press reports suggest RIL may bid for US refiner Valero. Some press reports suggest RIL may pay US\$48/share for Valero. Neither company has publicly commented on the speculation. This would mean US\$14bn for 51% or US\$27.5bn for 100% stake in Valero. Acquiring Valero would thus mean lower other income and higher interest cost for RIL. Whether a Valero acquisition would be earnings accretive or not would depend on whether RIL's share of profit in Valero exceeds hit to profit from lower other income and higher interest cost

Earning accretive in FY13 if Valero profit over US\$2.2bn

Our calculations suggest Valero acquisition would be earnings accretive in FY13 if Valero's FY13 (2012) profit is higher than US\$2.2bn.

Table 1: Valero's FY13 profit over which acquisition is earnings accretive for RIL

US\$bn	Stake acquired in Valero by RIL	
	51%	100%
Lower other income/higher interest cost (pre-tax) due to acquisition	1.4	2.5
Lower other income/higher interest cost (post-tax) due to acquisition	1.1	2.0
Valero's FY13 profit over which acquisition is earnings accretive for RIL	2.2	2.0
Assumptions		
Exchange rate	45.5	45.5

Source: BofA Merrill Lynch Global Research

BofAML's 2012 Valero profit estimate at US\$3.1bn

Consensus 2012 profit estimate US\$2.5bn

Table 2: Valero's 2012 net income forecast US\$3.1bn as per BofAML

US\$ mn	2011E	2012E	2013E
Valero's net income as per			
BofAML	2,857	3,070	3,225
Consensus	2,528	2,461	1,980

Source: Bloomberg, BofA Merrill Lynch Global Research

Potential Valero acquisition could boost RIL's FY13 profit by 8-19%

At BofAML estimate of US\$3.1bn, we estimate Valero acquisition would boost FY13 earnings by 8-19%.

Table 3: Impact of acquisition on RIL's FY13 earnings

US\$bn	Stake acquired in Valero by RIL	
	51%	100%
RIL's FY13 profit estimate	5.6	5.6
Less: Hit to net profit from lower other income/higher interest cost (post-tax) due to acquisition	1.1	2.0
Add: share of Valero's FY13 profit of US\$3.07bn	1.6	3.1
RIL's FY13 profit if it acquires Valero	6.0	6.6
Upside to FY13 profit from Valero acquisition	8%	19%
Assumptions		
RIL's decline in interest income/rise in interest cost (US\$bn)	1.4	2.5
Exchange rate	45.5	45.5

Source: BofA Merrill Lynch Global Research

Valero's GRM and net profit trend

Valero's GRM lower than RIL in 2007-2010

Valero's GRM higher than RIL in 2003-06

Valero's GRM was higher than that of RIL in 2003-2006 but has been lower than that of RIL in 2007-2010.

Valero's GRM higher than RIL in 2Q 2011

Likely to be higher even in 3Q; gained from weak WTI in mid-continent

Valero's GRM in 1H 2011 at US\$9.2/bbl is lower than RIL's US\$9.8/bbl. However, in 2Q 2011 Valero's GRM at US\$11.4/bbl is higher than RIL's US\$10.3/bbl.

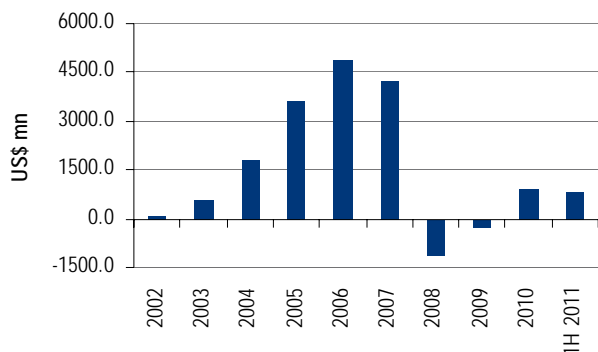
Valero gained from its refineries in mid-continent (17% of throughput) achieving GRM of US\$16.5/bbl due to weak WTI prices. We expect Valero's 3Q 2011 GRM to be higher than its 2Q GRM and therefore higher than RIL's 3Q 2011 GRM of US\$10.1/bbl. This is because US 3-2-1 cracks based on WTI are higher in 3Q 2011 at US\$31/bbl vis-à-vis US\$23.4/bbl in 2Q.

Valero implementing projects to boost EBITDA by 20%

Projects to be commissioned in 4Q 2011 to 4Q 2012

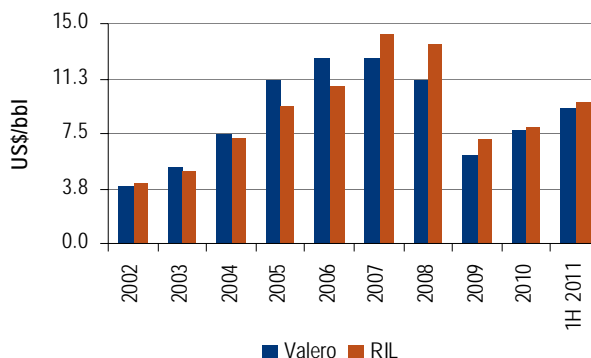
Valero is implementing projects such as FCC revamp, hydrocrackers, hydrogen plants and product pipeline. These projects, which will be commissioned between 4Q 2011 to 4Q 2012, would boost its EBITDA by 20% (see Table 12 on page 18 in [Refiners, 12 July 2011](#))

Chart 1: Valero's net profit since 2002



Source: Company

Chart 2: Valero and RIL's GRM trend since 2002



Source: Company

Valero's valuation

PE 9.0-9.6x 2011-12 EPS at price of US\$48/share

EV/EBITDA at acquisition price 4.7-5.4x

At an acquisition price of US\$48/share, Valero is trading at 9.0-9.6x on BofAML EPS estimate of US\$5 in 2011 and US\$5.35 in 2012. At this acquisition price, Valero's EV would work out to US\$32bn and its EV/EBITDA 4.7-5.4x on 2011 EBITDA of US\$5.9bn and 2012 EBITDA of US\$6.8bn.

Table 4: At US\$48/share, Valero would be valued at 9.0-9.6x 2011-12 EPS

	2011	2012
At US\$48/share, Valero's		
P/E	9.6	9.0
EV/EBITDA	5.4	4.7

Source: BofA Merrill Lynch Global Research

Valero value per complex bbl high

65% higher than RIL's new refinery

RIL built 0.58m b/d (operates at 0.7m b/d) new refinery (Nelson complexity 14) in 2009 at US\$6bn. Paying US\$48/share for Valero would mean (EV of US\$32bn for 2.8m b/d) 65% higher valuation per complex barrel.

Table 5: Valero's acquisition at US\$48/share would imply a premium to RIL's new refinery cost

	Cost (US\$ bn)	Capacity (m b/d)	Nelson complexity	Cost (US\$/bpd)	Complex
Valero (at US\$48/share)	32.1	2.8	11.3	11,429	1,011
RIL's new refinery	6.0	0.7	14.0	8,571	612

Source: BofA Merrill Lynch Global Research

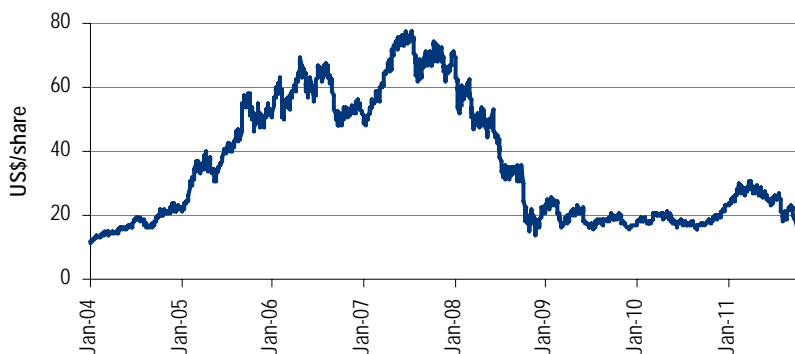
Acquisition price US\$25.8/share if valuation same as RIL new refinery

RIL's acquisition price for Valero would have to be just US\$25.8/share if Valero's value per complex barrel is to be same as that of RIL's new refinery of US\$612. Its current share price is US\$26.2/share.

Valero's share price trend

Its peak share price was US\$77.7/share in 2007

Chart 3: Valero's share price since 2004



Source: Bloomberg

Price objective basis & risk

Reliance Inds (XRELF / RLNIY)

Our PO of Rs950 (GDR US\$40.14) is a sum-of-the-parts valuation. It includes EV of RIL's 3 businesses of Rs945/share and net cash of Rs4/share. The EV of the refining, petrochemical and E&P business is calculated on a DCF basis, using a WACC of 11.8pct. Refining and marketing (Rs433) is 46pct of the EV, E&P valuation (Rs195) 21pct, and petrochemicals (Rs317) 34pct. Downside risks are (1) Refining and petrochemical margins being lower than expected due to global economic slowdown (2) 7-year income tax holiday being disallowed on gas production, which would mean lower cash flow, profit and fair value, (3) Lower-than-expected oil price, and (4) Large acquisitions that are value dilutive. Upside risks are (1) Refining and petrochemical margins being better than expected, (2) Higher-than-expected oil price, (3) Significant reserve accretion in the next 12 months and (4) Large acquisitions that increase fair value significantly.

Link to Definitions

Basic Materials

Click [here](#) for definitions of commonly used terms.

Analyst Certification

I, Vidyadhar Ginde, 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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29 October 2011

APR - Energy Coverage Cluster

Investment rating	Company	BofA Merrill Lynch ticker	Bloomberg symbol	Analyst
BUY				
	Citic Resources	CTJHF	1205 HK	Vitus Leung
	Formosa Plastics	FSAPF	1301 TT	Joon-Ho Lee
	Hindustan Petro.	XHTPF	HPCL IN	Vidyadhar Ginde
	Honam Petrochemical	HBBHF	011170 KS	Kenneth Whee
	Kunlun Energy	CNPXF	135 HK	Vitus Leung
	LG Chem	LGCLF	051910 KS	Kenneth Whee
	Nan Ya Plastics	NNYPF	1303 TT	Joon-Ho Lee
	Oil India Ltd	XLCRF	OINL IN	Vidyadhar Ginde
	Oriental Union Chemical	OLUNF	1710 TT	Joon-Ho Lee
	PetroChina	PCCYF	857 HK	Thomas Wong
	PetroChina - A	PTR	PTR US	Thomas Wong
	Reliance Inds	XRELF	RIL IN	Vidyadhar Ginde
	Reliance Inds -G	RLNIY	RIGD LI	Vidyadhar Ginde
	Sinopec	SNPMF	386 HK	Thomas Wong
	Sinopec - A	SNP	SNP US	Thomas Wong
	Sinopec Shanghai Petrochemical	SPTJF	338 HK	Joon-Ho Lee
	SK Innovation	XVERF	096770 KS	Kenneth Whee
	S-Oil	SOOCF	010950 KS	Kenneth Whee
NEUTRAL				
	BPCL	XBPCF	BPCL IN	Vidyadhar Ginde
	CNOOC	CEO	CEO US	Thomas Wong
	CNOOC	CEOHF	883 HK	Thomas Wong
	COSL	CHOLF	2883 HK	Vitus Leung
	Formosa Chemicals & Fibre	XFUMF	1326 TT	Joon-Ho Lee
	Formosa Petrochemical	FPTCF	6505 TT	Kenneth Whee
	MIE Holdings	XMEEF	1555 HK	Vitus Leung
	Sinopec Yizheng Chemical Fibre	YZCFF	1033 HK	Joon-Ho Lee
UNDERPERFORM				
	GS Holdings	GSHDF	078930 KS	Kenneth Whee
	Kolon Industries	XKLNf	120110 KS	Joon-Ho Lee
	KP Chemical	KPCHF	064420 KS	Joon-Ho Lee
	Petronet LNG Ltd	POLNF	PLNG IN	Vidyadhar Ginde
RSTR				
	Cairn India	XCANF	CAIR IN	Vidyadhar Ginde
	IOC	IOCOF	IOCL IN	Vidyadhar Ginde
	ONGC	ONGCF	ONGC IN	Vidyadhar Ginde

29 October 2011

iQmethodSM Measures Definitions

Business Performance	Numerator	Denominator
Return On Capital Employed	$\text{NOPAT} = (\text{EBIT} + \text{Interest Income}) * (1 - \text{Tax Rate}) + \text{Goodwill Amortization}$	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill
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	$\text{EV} = \text{Current Share Price} * \text{Current Shares} + \text{Minority Equity} + \text{Net Debt} + \text{Sales} + \text{Other LT Liabilities}$	
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

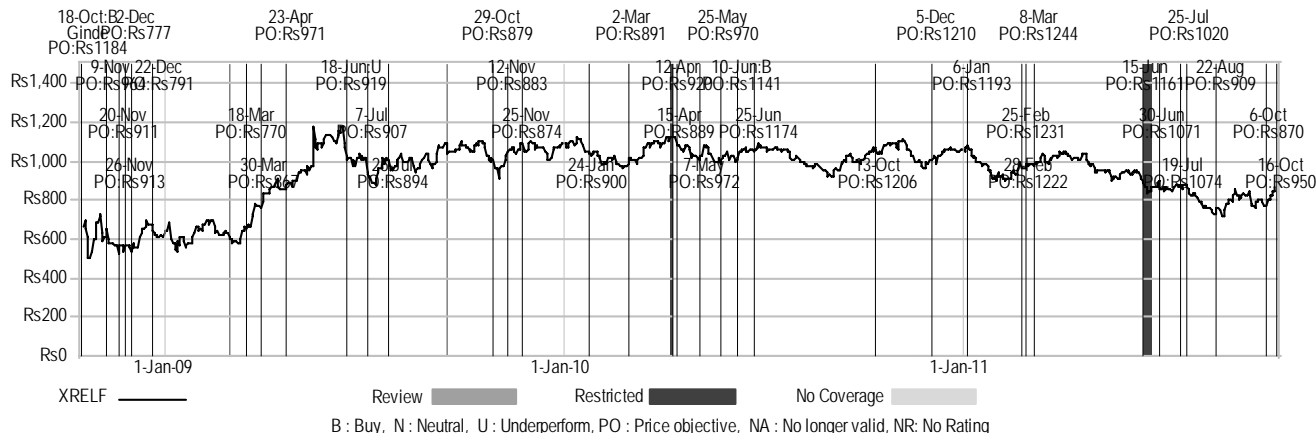
iQmethodSM is the set of BoFA Merrill Lynch standard measures that serve to maintain global consistency under three broad headings: Business Performance, Quality of Earnings, and validations. The key features of *iQmethod* are: A consistently structured, detailed, and transparent methodology. Guidelines to maximize the effectiveness of the comparative valuation process, and to identify some common pitfalls.

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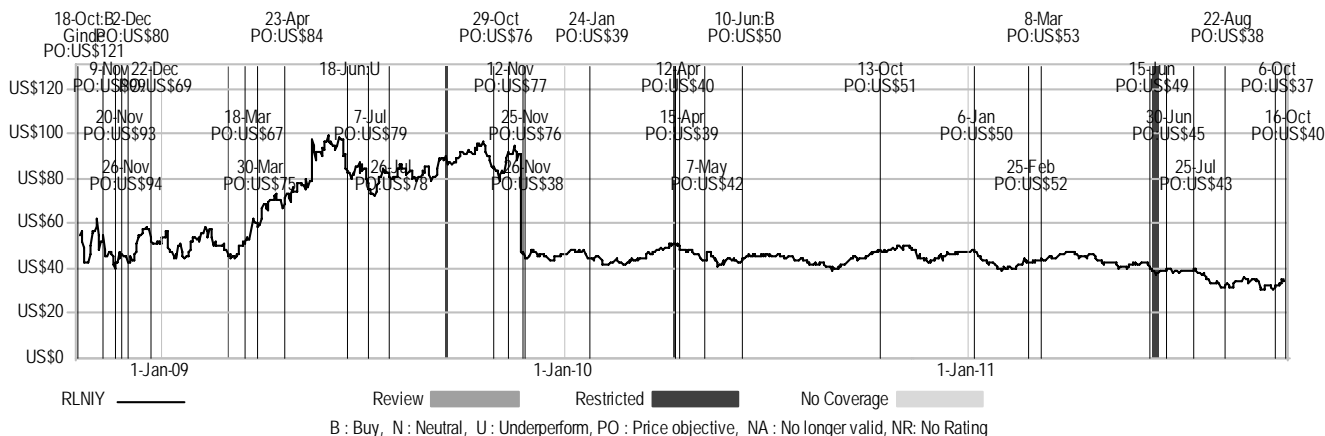
Important Disclosures

XRELF Price Chart



The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark grey shading indicates the security is restricted with the opinion suspended. Medium grey shading indicates the security is under review with the opinion withdrawn. Light grey shading indicates the security is not covered. Chart is current as of [September 30, 2011] or such later date as indicated.

RLNIY Price Chart



The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark grey shading indicates the security is restricted with the opinion suspended. Medium grey shading indicates the security is under review with the opinion withdrawn. Light grey shading indicates the security is not covered. Chart is current as of [September 30, 2011] or such later date as indicated.

Investment Rating Distribution: Chemicals Group (as of 01 Oct 2011)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	54	50.94%	Buy	22	47.83%
Neutral	29	27.36%	Neutral	16	61.54%
Sell	23	21.70%	Sell	7	30.43%

Investment Rating Distribution: Global Group (as of 01 Oct 2011)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	2073	54.13%	Buy	923	49.12%
Neutral	961	25.09%	Neutral	460	52.57%
Sell	796	20.78%	Sell	287	38.32%

* Companies in respect of which BofA Merrill Lynch or one of its affiliates has received compensation for investment banking services within the past 12 months. For purposes of this distribution, a stock rated Underperform is included as a Sell.

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster*
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

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29 October 2011

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29 October 2011

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