Your success is our success

Reliance Industries

Concerns overdone, attractive BUY

October 25, 2011

Reco
Buy

CMP	**Target Price**
Rs.846	Rs.1,119

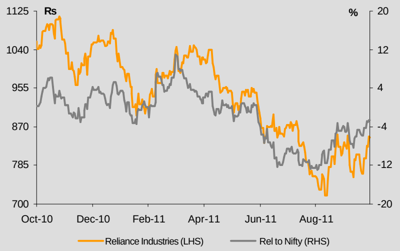
EPS change CY11E/12E (%)	NA
Target Price change (%)	NA
Nifty	5,132
Sensex	17,083

Price Performance

(%)	1M	3M	6M	12M
Absolute	5	(0)	(15)	(18)
Rel. to Nifty	3	9	(3)	(1)

Source: Bloomberg

Relative Price Chart



Source: Bloomberg

Stock Details

Sector	Oil & Gas
Bloomberg	RIL@IN
Equity Capital (Rs mn)	32744
Face Value(Rs)	10
No of shares o/s (mn)	3274
52 Week H/L	1,187/714
Market Cap (Rs bn/USD mn)	2,782/56,828
Daily Avg Volume (No of sh)	5404172
Daily Avg Turnover (US$mn)	89.0

Shareholding Pattern (%)

	Sep-11	Jun-11	Mar-11
Promoters	44.7	44.7	44.7
FII/NRI	21.6	21.9	22.2
Institutions	11.0	10.7	10.7
Private Corp	5.0	4.9	4.5
Public	17.8	17.9	17.9

Source: Capitaline

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- **Negatives like declining KG D6 gas production, lack of clarity on cash utilization and CAG report findings already priced in. See limited downsides from current levels**
- **Any positive outcome emerging from the RIL-BP tie up (in the form of increased production) or a suitable acquisition can boost sentiment and trigger a re-rating**
- **Refining business outlook also turning positive owing to the current scenario being favorable for complex refineries like RIL**
- **Valuation attractive at 10.4x FY13E and 5.9xEV/EBITDA. Favorable risk reward ratio coupled with stable/improving financials warrant a Buy on RIL. Initiate coverage with TP of Rs.1,119**

All the negatives pertaining to E&P factored in the stock price

We believe that the current stock price has factored all the negatives plaguing Reliance Industries like a) Declining production in KG D6, b) CAG reports on RIL capex on KG D6, and c) Lack of clarity on cash usage. We believe that the market is overreacting to the recent CAG report, as closer analysis reveals that most of the concerns raised in the report are on policy and implementation of policy by MoPNG and DGH with a milder mention of RIL. Also, the market is not taking into account the initiatives taken by RIL to address these concerns.

Any positive emanating from the RIL-BP tie-up or a possible acquisition to reverse prevailing sentiment and valuations

With all the negatives being priced in, we believe any positive news flow provides potential upsides. The recent RIL-BP tie up, substantial war chest to make a big ticket acquisition and improving scenario in refining business provide ample scope for positive news flow. The expertise of BP in finding hydrocarbons lends hope to resolution of production issues at KG D6 in the near future. Similarly, the current global scenario along with RIL's huge cash reserves present an ideal backdrop for a major acquisition.

Expect healthy GRMs of US$9.8/bbl and $10.2/bbl for FY12E and FY13E

We expect RIL's refining business margins to expand to $9.8/bbl for FY12E and $10.2/bbl for FY13E driven by a) Sustained average Diesel & Gasoline spreads at $16+ and $15+ per bbl YTD, b) Increase in petroleum demand to 1.1 and 1.5mnbbl per day in CY11E and CY12E respectively, C) Favorable light-heavy spreads backed by supply disruption from ME, and d) Stability in margins arising from lower effective supply (closure of 0.6mbpd capacity reducing oversupply expected from 3.4mbpd capacity addition in 2011-12).

Favorable risk-reward; Initiate coverage with a BUY and TP of Rs 1,119

At CMP, the stock trades at 10.4x FY13 EPS and 5.9x EV/EBITDA. With all the negatives priced in and scope for positive surprises, we believe the RIL stock is a good value proposition at current levels. Our SOTP value works out to Rs. 1,119, providing 32% upside. Given limited downsides from here on, improving refining business and scope for positive surprises, we initiate coverage on Reliance Industries with a BUY rating and a target price of Rs.1119.

Valuation table

Rs Mn	Net Sales	EBIDTA	EBIDTA (%)	APAT	AEPS	EPS (% chg)	RoE (%)	P/E	EV/ EBIDTA	P/ BV
FY10	1924610	266328	13.8	162357	49.6	6.0	12.3	17.0	11.4	2.0
FY11	2481700	348827	14.1	202863	62.0	24.8	14.1	13.7	8.0	1.8
FY12E	3007774	384653	12.8	241239	73.7	18.9	14.9	11.5	6.3	1.6
FY13E	2783621	385389	14.0	266214	81.3	10.4	14.5	10.4	5.9	1.4

Investment rationale

Valuation: Favorable risk-reward

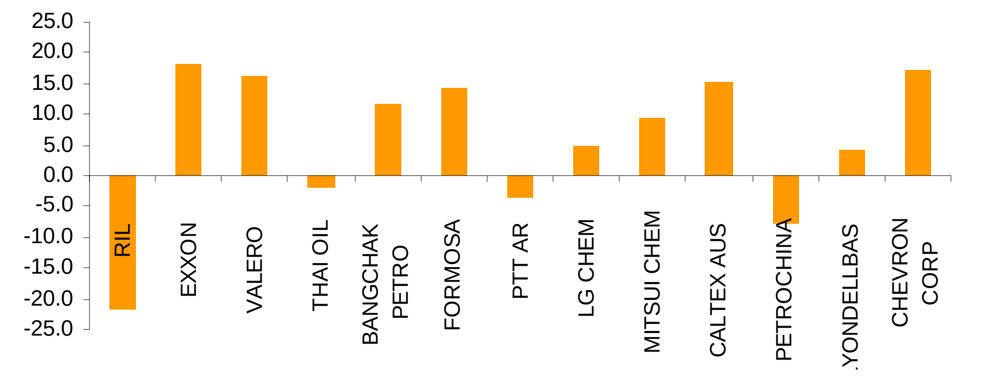
Concerns over declining gas production from KG D6, lack of clarity on cash utilization and CAG audit report have resulted in Reliance underperforming its international peers as well as Sensex in the last 12 months. RIL is down by 23% in the last 12 months compared to Sensex. On an absolute basis also, the stock has corrected significantly from Rs.950 to Rs.750, almost 26% based on the negative news hovering around its businesses. At the current level, we believe that all the negatives pertaining to its business are already priced in, thereby limiting further downside. With Reliance taking positive steps to address the above concerns, we believe entering the stock at current levels makes for a good value proposition. Our bear case value of Rs 789 (CMP Rs.846) further re-enforces our belief that there is limited downside from the current levels. Moreover, any positive news on KG D6 production or a big ticket acquisition can trigger a re-rating. Improving business profile, limited downsides, potential upside from positive developments and attractive valuations warrant a BUY on the stock. Till date, Reliance has weathered challenges pertaining to its E&P business and we believe that the current level is a good time to enter the stock rather than waiting for more clarity on E&P. We initiate coverage on Reliance Industries with a BUY rating and a target price of Rs.1,119. At CMP, the stock trades at 10.4x FY13 EPS and 5.9x EV/EBITDA.

Stock has underperformed its peers

In the last 12 months, RIL's stock has underperformed its international peers in the Refining and Petrochem segment. RIL is down by 23% from last one year, while majority of the international peers are up by 5-18% during the same period.

Stock has underperformed its International peer and Sensex by 23% and 71% respectively

RIL underperformed international peers

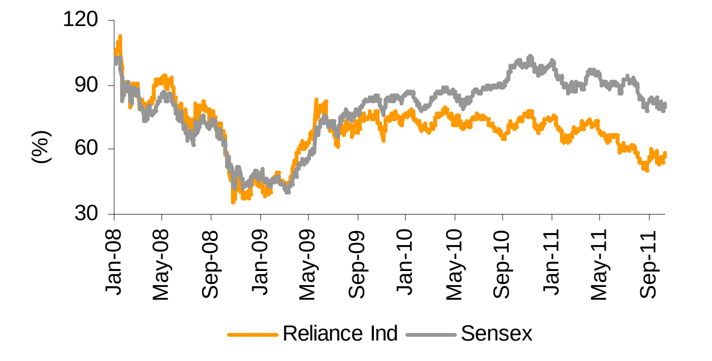


Source: Emkay Research

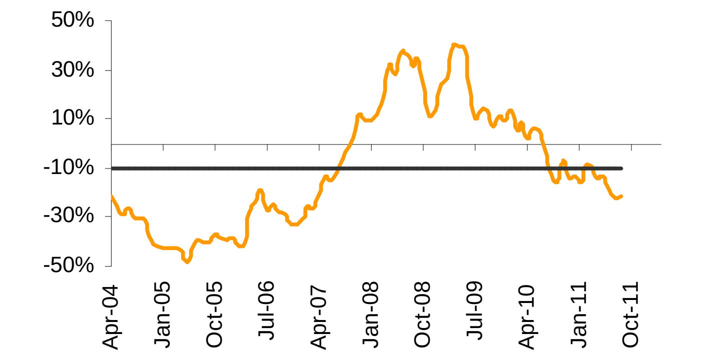
Stock has also underperformed BSE Sensex

Reliance has underperformed the BSE-30 by 71% since June 2009. Also, for the last one year, RIL has traded below its average 10% discount over Sensex.

RILunderperformed Sensex



RIL premium/(discount) over Sensex



Source: Emkay Research

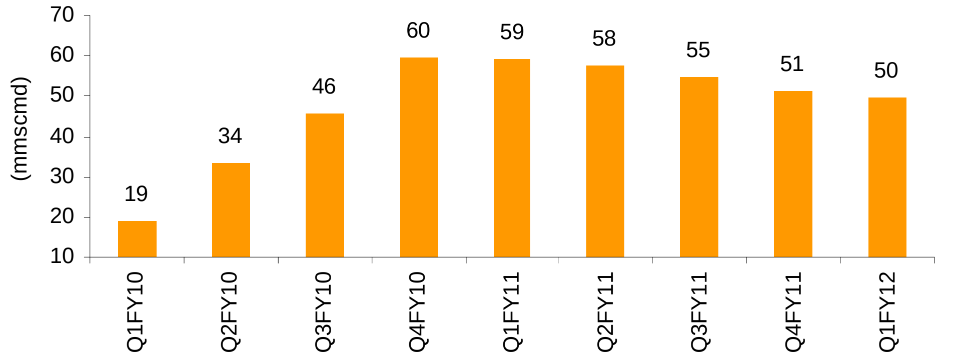
All the negatives pertaining to E&P factored in the stock price

We believe that the current valuations already factor in all the negatives but is not taking into account the initiatives taken by Reliance to address these concerns. As a result, we believe that from here on, there is only scope for positive surprises. Any positive news on KG D6 gas production pursuant to BP's involvement or an acquisition will boost positive sentiment and subsequently, valuations. We have enumerated below the various concerns priced into the stock as well as the steps taken by Reliance to address the same.

- **Declining production in KG D6:** Reliance started production in its flagship block, KG D6 in April 2009. Reliance has turned it around to be one of the fastest deepwater development projects, globally. The time from discovery to production has been one of the shortest when compared with other deepwater developments. However, after achieving peak production of 60mmscmd in March 2010, production has been steadily declining. Currently, it produces around 46mmscmd, which is 23% lower compared to its peak production and 42% lower than its targeted production. Due to lower pressure and technical problems, production has been steadily declining from its peak production.

Production has declined from its peak production of 60mmscmd to 45mmscmd currently

KG D6 production



Source: Company, Emkay Research

Banking on BP's expertise to stem/reverse the decline

BP has the best track record among global majors in finding hydrocarbons

British Petroleum (BP) has bought 30% stake in RIL's 23 oil & gas blocks in India, including KG D6block, for $7.2bn with another $1.8bn to be paid based on exploration success in the blocks. The government has also approved the RIL-BP deal. BP has the best track record among global majors in finding hydrocarbons. Its cutting edge sub-surface capabilities in optimizing production raises hope that it may be able to help stem and reverse the decline in KG-D6 gas production. With BP on board, we expect speedy and effective addressal of the issues on KG D6 production as well as other pending approvals related to field development plan. We also expect better clarity on the other E & P blocks (like NEC25, D3 and D9) which were held back owing to operational or regulatory reasons as incremental payment of $1.8bn could be paid by BP based on exploration success that results in development of commercial discoveries.

Lack of clarity on cash usage and road map on future growth: Another concern plaguing the stock has been utilization of cash. With approval of RIL-BP deal, we expect Rs.324bn ($7.2bn) during the current year on RIL's balance sheet. Also, for FY12E, it is expected to generate Rs.358bn ($7.9bn FY12E) at net operating level, virtually becoming a debt free company by the end of the year. It could be positive for such a large and diversify company to become debt free by repaying a loan (FY11 debt at $14bn) but there is lack of clarity on such matters.

Huge war chest to enable big ticket acquisition

We believe RIL would have to look at more avenues with significant cash deployment to effectively utilize its likely large cash flow generation. Given its aggressive nature for growth and desire to attain global leadership in existing businesses, we believe RIL will definitely choose inorganic growth at the right time at the right valuation. The current global turmoil is also in favour of RIL by providing an opportunity to acquire assets at attractive valuations.

CAG reports on RIL capex on KG D6: The recent CAG report has significantly dented 'Reliance Industries' goodwill and market cap in a big way. Initially, the draft report by CAG raised issues on Oil ministry and Reliance KG D6 block regarding overstating of capex on KG D6, which would result in lowering the share of government revenue. However, the language of the final report was mild on Reliance, but till then it had already adversely impacted the stock price and the goodwill of Reliance Industries.

Concerns in the CAG audit report pertain to policy implementation by MoPNG and DGH

The language of the final CAG report was mild on RIL per se. Most of the concerns raised by the CAG audit report are on policy and implementation of policy by MoPNG and DGH. So question on intention of reliance have been removed.

Our bear case value of Rs 789 (CMP Rs.840) further re-enforces our belief that there is limited downside from current levels

Bear case SOTP works out at Rs.789, limited downside risk

In order to determine **RIL's value in a worst case scenario, we assigned extremely low values to all its key variables. Even after assuming the unlikely event of a worst case scenario playing** out in each on its businesses, our bear case value works out to Rs 789, further re-enforcing our view that from here on, downsides are capped.

In our bear case, we have valued

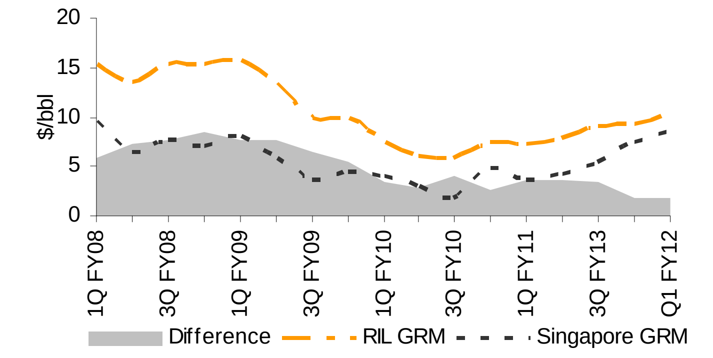
- Refining and Marketing at Rs.164 on 6x EV/EBIDTA, with GRM at $6.6/bbl (margin level during 2008-09, which is unlikely in the current improving margin scenario. Note that we expect GRM of $9.8/bbl for FY12)
- E&P business at Rs 241 after considering shale gas JV value at 1.5x invested capital(Rs.19/share) and no exploration upside.
- Petrochemical Business at Rs.195 after lowering the EV/EBITDA multiple to 6x EV/EBIDTA and a further 5% cut in petroleum prices
- Other business/investment at Rs.105 on 1x P/BV.

Bear Case scenario	EV Rs. mn	Value/share	Valuation Method
E&P			
KG D6 (D1, D3 Gas & MA Oil)		115	DCF with WACC at 11%
KG D3		22	9.3 TCF reserves at $2/boe
KG D9		11	5.2 TCF reserves at $2/boe
MN D-4		17	9 TCF reserves at $2/boe
NEC -25 (Gas)		19	DCF with WACC at 11%
Shale gas Joint Venture		19	1.5x P/BV, on invested capital
PMT		28	5x FY13E EBIDTA
Exploration Upside		0	Nil
CBM		11	3.06 TCF reserves at $3/boe, 50% Expected recovery
Total E & P		**241**	
Reliance Retail	58000	18	1x P/BV
Reliance Infotel	128260	39	1x P/BV
SEZ	52000	16	1x P/BV
Other Investment(RGTIL,RIIL, Fuel retailing, Bharti Axa, East India Hotel, Deccan 360)	105100	32	1x P/BV
Core Business			
Refining	537213	164	6x FY13E EBIDTA, GRM at $6.6 per bbl
Petrochem	639110	195	6x FY13E EBIDTA, with 5% cut in prices
Net cash /(debt)--FY12E	273015	83	Investment at 20% discount
Fair Value		**789**	

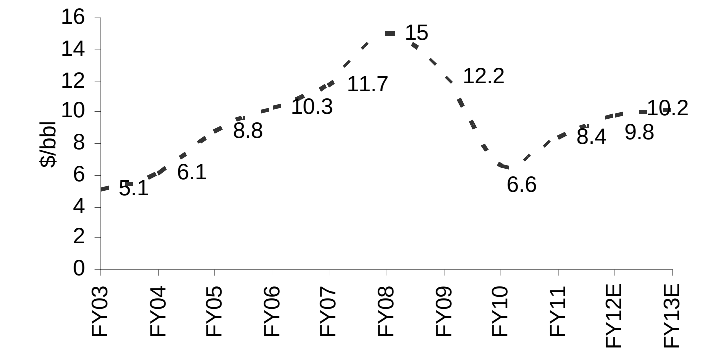
Refining & Marketing business to see uptick in GRM for FY12E at $9.8/bbl

Reliance boasts of a world class refinery in terms of both scale and complexity, which enables it to enjoy better margins than other refineries in a favorable business cycle. Robust demand for petroleum products in Asian region during FY11 saw improvement in key product cracks virtually throughout the year. We expect demand to continue to remain robust for FY12-13E, particularly in Asian region mainly India and China. Also, considering the recent global turmoil, IEA expects (View as on 13th Sep.2011) oil demand for 2011 and 2012 to be 89.3 mbpd (+1.0 mbpd YoY) and 90.7 mbpd (+1.4mbpd YoY) respectively, which is on the higher side on a YoY comparison. So based on the demand outlook, we expect petroleum demand to sustain and support the spreads of petroleum products, resulting in better margins, going forward. We believe RIL is well placed to capitalize this opportunity as it has an upper hand in both size and complexity. We expect RIL's GRM at $9.8/bbl for FY12E and $10.2 G/bbl for FY13E.

RIL GRM V/S Singapore GRM



RIL GRM for FY12-13E



Source: Bloomberg, Company, Emkay Research

Key drivers for improved GRMs

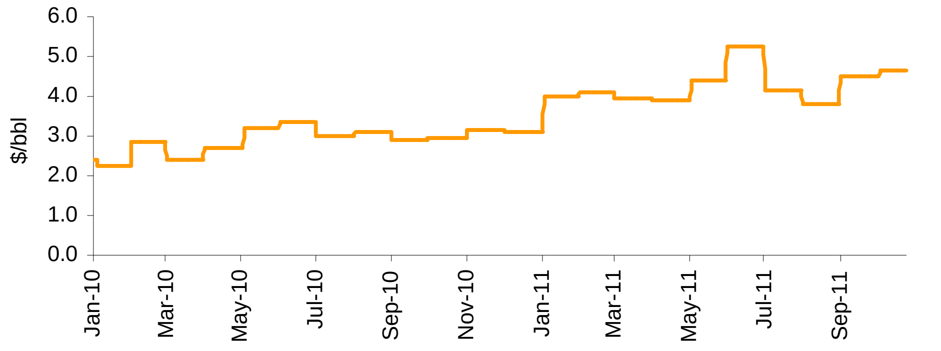
- Supply disruption from MENA (Light crude oil) have broadened light-heavy spreads, which is favorable for RIL
- Average Diesel & Gasoline spreads at $16+ and $15+ per bbl respectively from last 8 months
- Anticipate sustained increase in petroleum demand to 1.1 and 1.5mnbbl per day in CY11E and CY12E respectively
- 3.4mbpd capacity addition expected in 2011-12. However closure of 0.6mbpd capacity in 2011-12 helps in maintaining supply globally, resulting in to better margins for the complex refinery

Light-Heavy spreads to widen, benefiting complex refineries like RIL

Light-Heavy spreads averaged at $4.3/bbl, growth of 34% YoY, benefiting regional complex refineries like RIL

The MENA crisis and higher production from OPEC favor light-heavy differential from last 8 months. For FY11, Arab light-heavy differential averaged at $3.2/ bbl, an increase of 86% over the previous year. For FY12 YTD, Arab light-heavy differential averaged $4.3/bbl, 34% higher than the full year average of FY11. The growing gap between demand and oil supply, coupled with strong crude oil prices, is encouraging OPEC producers to further ramp up production. This is resulting in increased supplies of heavier crude, further impacting light-heavy differentials. We expect this to result in light-heavy spreads widening further and benefiting regional complex refineries like Reliance Industries as it processes cheaper heavy crude and subsequently, produces higher proportions of light and middle distillates that entail higher realizations and margins.

Light-Heavy spreads

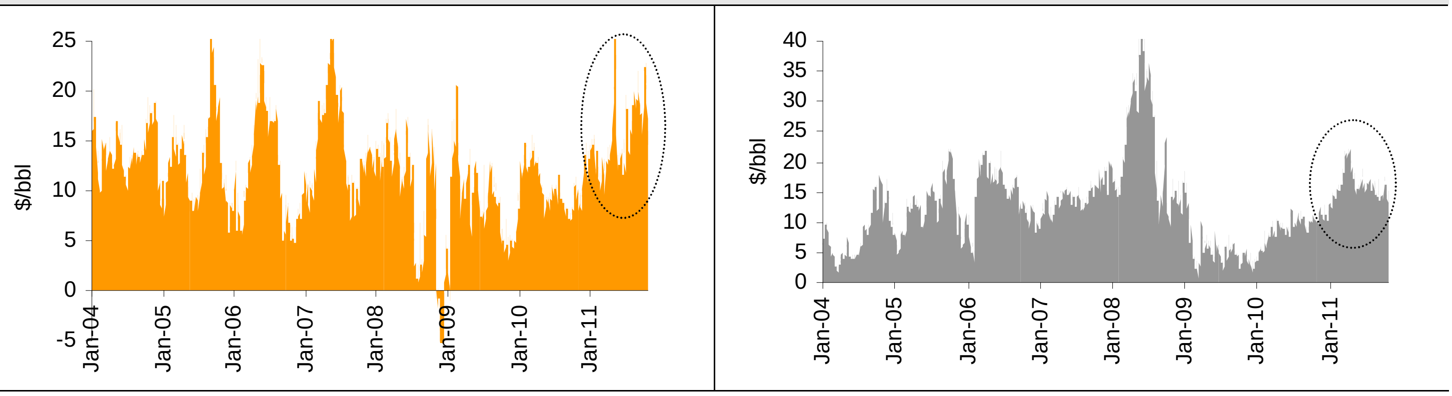


Source: Bloomberg, Emkay Research

Average Gasoline and Diesel spread at $16+ and $15+ per bbl respectively from last 8 months, resulting in better realisations and gross refining margins for Reliance.

Gasoline consumption, especially in emerging economies is underpinned by the rising incomes, younger demographics and surging car sales of China, India, Brazil and others. Also, faster and stronger economic growth in non-OECD countries has resulted in higher demand for diesel. Going forward, we expect slight decline in product spreads due to global turmoil but not as low as 2008-09 levels. Overall, demand is still on the higher side compared to last year, resulting in better realisations and gross refining margins for complex refineries such as Reliance.

Gasoline and Diesel spreads



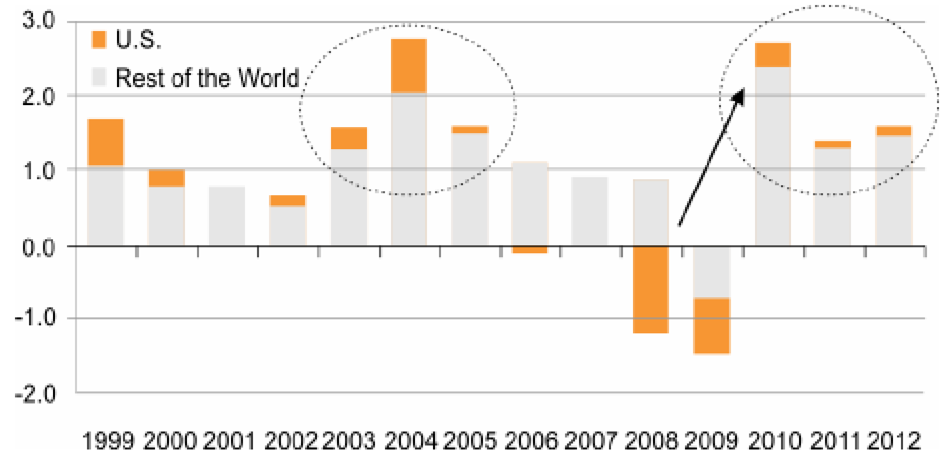
Source: Bloomberg, Emkay Research

IEA expects demand to grow by 1.1 and 1.5 mbpd in 2011 and 2012 respectively

Petroleum demand expected to further increase in CY11E and CY12E to 1.1 and 1.5mnbbl per day respectively mainly lead by higher demand from Asian region mainly India and China

As shown in the chart below, global petroleum demand bounced back and rose by 2.9 mbpd in 2010 and is expected to increase to 1.1 and 1.5 mbpd in 2011 and 2012 respectively, which is close to what IEA expects for the next few years. The major petroleum demand contributes by Asian region mainly India and China. As per above mentioned chart, we have seen a significant drop in product spreads during 2008-09 crisis where RIL clocked its lowest GRM of $6.6/bbl. But after FY10, we have seen an upward trend in petroleum demand as well as product spreads, resulting in an increase in GRMs for Reliance from FY10 onwards. The surety of the petroleum demand in FY12-13E further supports our GRM assumption of $9.8/bbl for FY12E and $10.2/bbl in FY13E.

Petroleum demand growth

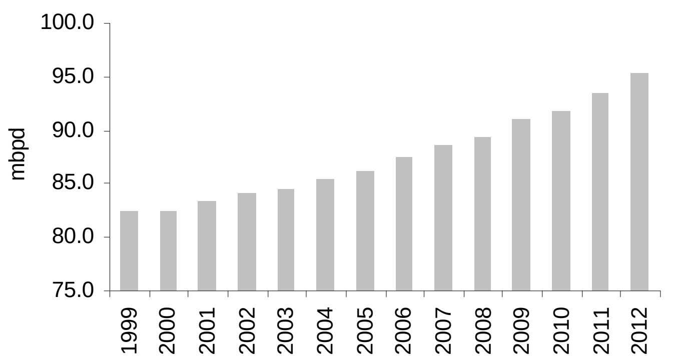


Source: Valero Energy

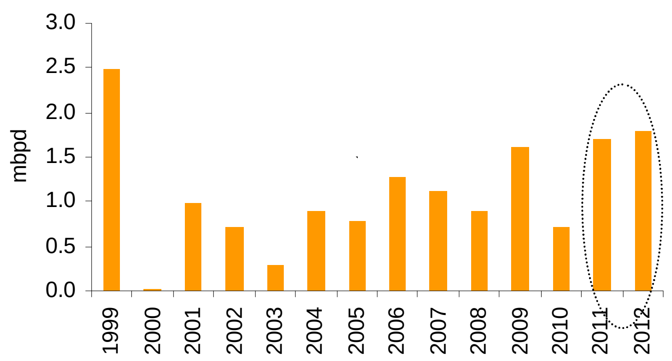
3.4mbpd capacity addition expected in 2011-12. However, closure of 0.6mbpd capacity to help maintaining supply resulting in better margins for complex refineries

Global refining industry is expected to add 3.4mbpd capacity by 2012, 1.7mbpd in 2011 and 1.8mbpd in 2012. Thus additions of 1.8mbpd in 2012 are likely to be highest since 1999.

Global refining capacity outlook



Capacity Addition



Closure of 0.6mbpd capacity in 2011-12 helps in maintaining supply globally, resulting in better margins for complex refineries

If recent global turmoil would continue for a longer period, then such large capacity addition would lead to GRM weakening significantly. However, post the last recession of 2008-09, we have seen the closure of many refining capacities in 2010, which resulted in takeoff in GRM. We believe any situation pertaining to global recession would alarm closure of marginal refineries or seeing key projects delayed or cancellations. As per below mentioned table, many large integrated players have already closed their plants and some of them have started rationing their capacities due to global turmoil and competition. So based on the below mention project, 0.6mbpd capacities in 2011-12 are expected to close, which helps in maintaining supply globally, resulting in better margins for complex refineries.

Global Refining capacity rationalization

Owner	Location	Kbpd	Year Closed
Big West	Bakersfield, CA	65	2008
Sunoco	Westville, NJ	145	2009
Western	Bloomfield, NM	17	2009
Petroplus	Teesside, UK	117	2009
Total	Gonfreville, France*	100	2009
Total	Dunkirk, France	140	2009
Nippon Oil	Mizushima/Negishi/Oita, Japan*	205	2009
Nihonkai oil	Toyama, Japan	57	2009
Petrom	Arpechim, Romania*	70	2009
Repsol	Cartagena, Spain*	100	2009
Repsol	Bilboa, Spain*	100	2009
Shell	Montreal, Canada	130	2010
Western	Yorktown,Virginia	65	2010
Petroplus	Riechstett,France	85	2010
ConocoPhillips	Wilhelmshaven, Germany	260	2010
CosmoOil	Chiba/Yokkaichi/Sakaide,Japan*	94	2010
Privat Group	Nadvornaja, Ukraine	50	2010
Tamoil	Cremona,Italy	94	2011
Hovensa	St. Croix, U.S. Virgin Islands	150	2011
ShowaShell	Keihin Ohgimachi,Japan	120	2011
Shell	Clyde,Australia	75	2011
Shell	Harburg, Germany	107	2012
Total Capacity Shutdown		**2,346**	

**Partial closer of refinery captured in capacity*

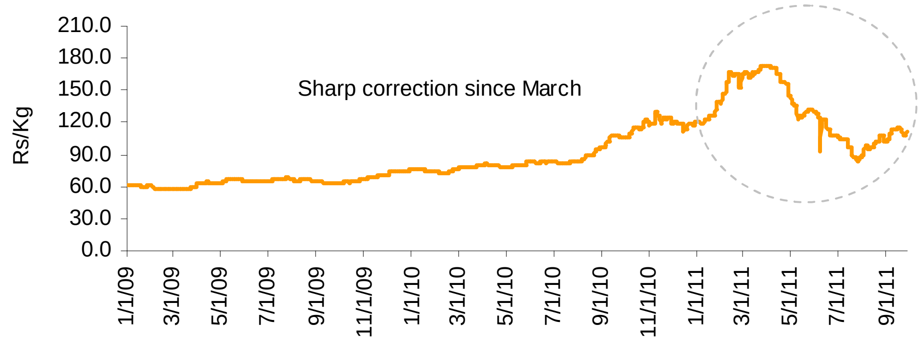
Note: this data represent refineries currently closed, ownership may choose to restart or sell listed refinery

Source: Valero Energy

Petrochemical margins to remain under pressure till FY12E and improve thereafter due to limited capacity addition from 2011-13E

The current upward trend in crude oil price has resulted in significant improvement in petrochemical margins for the last 6 quarters. But due to recent global turmoil, polyester segment has seen margin contraction in the past few months with the cotton prices correcting more than 54% since March, as well as lower demand in domestic market.

Cotton price movement

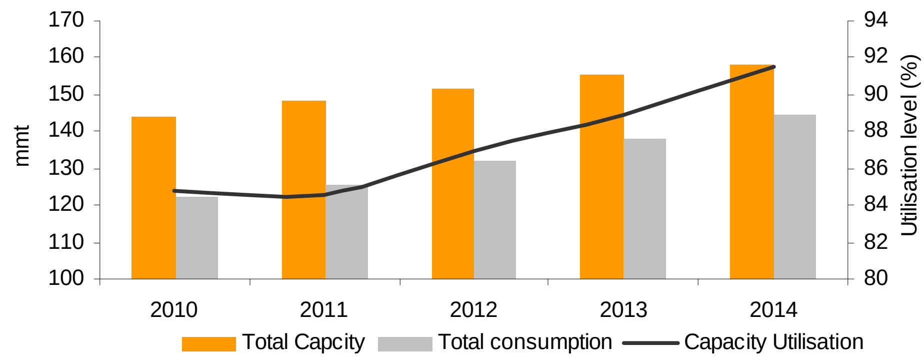


Source: Bloomberg, Emkay Research

Limited ethylene capacity from 2012-13 to lead to improvement in utilization rate to 89% and support margins in 2012-13

Also, polymer business has showed de-growth, especially in China by 4.5% mainly due to price volatility, resulting in low inventory and de-stocking of polymer products. We expect margins for the overall petrochemical chain to start picking up by end of FY12E mainly on account of limited ethylene capacity additions for next couple of years. Ethylene capacity addition is expected to be 11.4mmt in 2011-2013, much lower than 18mmt of capacity added in 2008-2010. This may help in improving the utilization level and support margins to some extent. Industry margins are forecasted to climb to a new cyclical peak around 2014-15, with returns comparable to those seen in the last major peak in 2006-07. Within this context, Asia Pacific will represent the most attractive market in terms of growth and profitability and will be a key driver for profitability of the global petrochemical sector.

Ethylene capacity and utilization



Source: Industry, Emkay Research

Future growth initiatives

In a bid to find new growth avenues to drive future growth, Reliance plans to set up a LNG import terminal on the east coast and has forayed into shale gas through 3 JVs. These initiatives, along with its other business ventures like retail, telecom, finance, infrastructure (SEZ) etc. have the potential to grow substantially and make a meaningful contribution to RIL's profits in the future.

Future growth initiatives like setting up of LNG terminal and shale gas JV to create significant value for investors

- **LNG terminal on east coast likely**

  RIL-BP plans to set up liquefied natural gas (LNG) import terminal on the east coast to meet rising demand for gas in the domestic market. For that, Reliance is likely to source LNG cargos from BP's gas fields across the globe. RIL is already producing gas from its KG-D6 fields on the eastern offshore but the fall in gas production has affected supplies to non-core industries including steel, sponge-iron, petrochemical plants and refineries. The LNG terminal will help meet the demand of RIL's own petrochemical plants and refineries as well as cater to other industries mentioned above.

- **Shale Gas Joint venture:- Exploring growth in new segments**

  In 2011, RIL forayed into the shale gas exploration market by entering into a JV with partnership in United States of America with Atlas, Pioneer Natural Resources and Carrizo Oil and Gas through three distinct joint venture agreements. In less than one year, Reliance has expanded its footprint in the US by building organizational capabilities and technological expertise for operatorship on shale gas field. Investment in shale gas will provide RIL a good experience and expertise to make a bigger player in acquiring shale gas assets in international market. Also, it will help in bagging Indian shale gas fields, as and when government opens it for exploration and development.

Reliance Shale Gas portfolio	Marcellus		Eagle Ford	Total
Gross shale acreage of RIL (Acres)	328600	104400	289000	722000
Net shale acreage of RIL (Acres)	131440	62640	118350	312430
RIL Stake (%)	40	60	41	-
JV Partner	Atlas	Carrizo	Pioneer	-
Upfront Payment ($mn)	339	340	263	942
Drilling carry ($mn)	1360	52	1052	2464
Well (#)	3000	1000	1750	5750
Resource Potential (TCF)	13.3	3.4	11.0	27.7
Net Resource Potential of RIL (TCF)	5.3	2.0	4.5	11.9

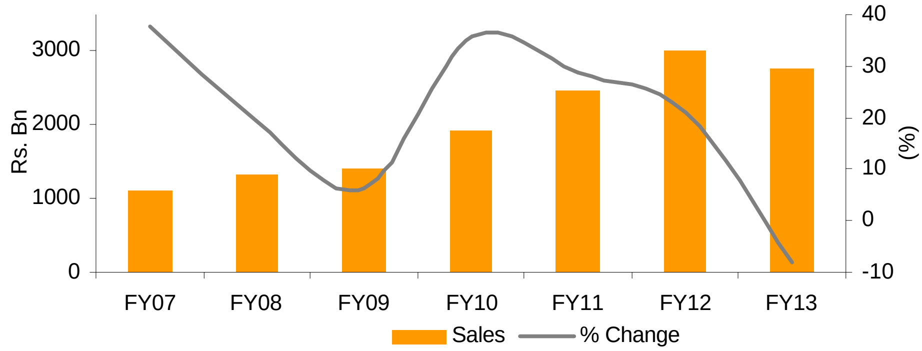
- **Other business ventures to provide diversified long term growth**

  RIL's new businesses are relatively different from its core business of R&M, Petrochem and E&P. In the last 4-5years, RIL has entered many business verticals like retail, telecom, insurance, finance, infrastructure (SEZ) etc. Its foray into new businesses is more of a knowledge-base and consumer focus, which is completely different from current business. As these all businesses are new and at a very nascent stage, company has not made or created significant value for its shareholders at this juncture. In new business segments like SEZ, shale gas, insurance and retail finance, it has tied-up with partners with strong domain knowledge in their respective businesses. Strong domain expertise of the partner ensures faster growth in its new business and promises significant value creation for its shareholders. Also, based on the past success or track record and aggression of the management, we believe entering into new business verticals would be rewarding in the long term against cyclical businesses like Refining and Petrochemical which can deliver high return on every rupee invested. So at this juncture, we have valued the other business at Rs.105/share or 1x on book value. (See Base case scenario).

Financials

We expect RIL's sales to grow at a CAGR of 5% from Rs.2,482bn in FY11 to Rs.2,757.9bn in FY13E, mainly driven by higher GRM from refining segment and better petrochemical margin outlook, post FY12E. We expect E&P business (including PMT and KG D6 production) to remain stable for the next two years.

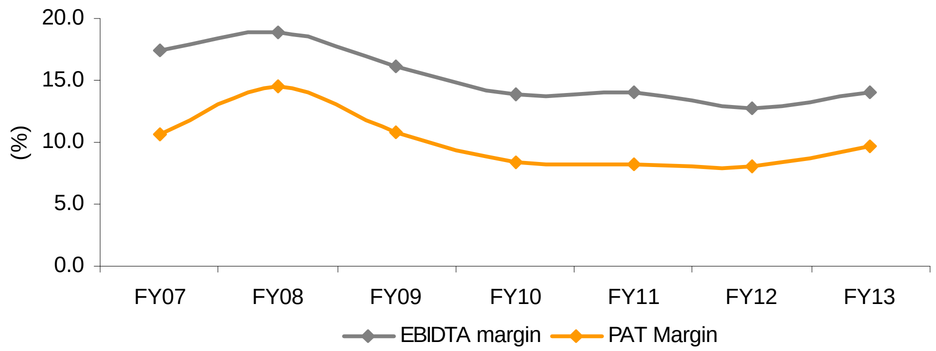
Revenue growth



Margins to decline in FY12E due to global slowdown but expect recovery in FY13E,

We expect EBIDTA to grow at 5% CAGR from Rs. 348bn in FY11 to Rs. 385.3bn in FY13E. During FY11, its EBIDTA margin was 14.1% and we expect it to be 12.8% in FY12E and 14% in FY13E. Reduction in margins in FY12E would be attributable to global meltdown. However, we expect margins to start recovering in FY13E, both in refining and petrochem segment as demand starts picking up.

Margin summary



We expect net profit to grow at 15% CAGR from Rs. 202.8bn in FY11 to Rs.266.2bn in FY13E. During FY11, its PAT margins were 8.2%, and we expect it to be 9.7% in FY13E. We believe reduction in margins at operating level in FY12E has a trickle down effect on the bottom line.

Valuations and recommendation

Concerns over declining gas production from KG D6, lack of clarity on cash utilization and CAG audit report have resulted in Reliance underperforming its international peers as well as Sensex in the last 12 months. At the current level, we believe that all the negatives pertaining to its business are already priced in, thereby limiting further downside. With Reliance taking positive steps to address the above concerns, we believe entering the stock at current levels makes for a good value proposition. We initiate coverage on Reliance Industries with a BUY rating and a target price of Rs.1,119. At CMP, the stock trades at 10.4x FY13 EPS and 5.9x EV/EBITDA.

Base Case valuation

In our base case we have factored (a) Refining and marketing at Rs.362 on 7x EV/EBIDTA (B) E&P business at Rs.327 (including exploration upside from KG D6 Rs.36) (C) Petrochemical Business at Rs.241 on 7x EV/EBIDTA and (D) other business/investment at Rs.105 on 1x P/Bv.

Base Case scenario	EV Rs. mn	Value/share	Valuation Method
E&P			
KG D6 (D1, D3 Gas & MA Oil)		115	DCF with WACC at 11%
KG D3		22	9.3 TCF reserves at $2/boe
KG D9		11	5.2 TCF reserves at $2/boe
MN D-4		17	9 TCF reserves at $2/boe
NEC -25 (Gas)		19	DCF with WACC at 11%
Shale gas Joint Venture		69	11.9 TCF reserves at $3/boe
PMT		28	5x FY13E EBIDTA
Exploration Upside		36	5 TCF reserves at $3/boe
CBM		11	3.06 TCF reserves at $3/boe, 50% Expected recovery
Total E & P		**327**	
Reliance Retail	58000	18	1x P/BV
Reliance Infotel	128260	39	1x P/BV
SEZ	52000	16	1x P/BV
Other Investment(RGTIL,RIIL, Fuel retailing, Bharti Axa, East India Hotel, Deccan 360)	105100	32	1x P/BV
Core Business			
Refining	1185434	362	7x FY13E EBIDTA
Petrochem	789880	241	7x FY13E EBIDTA
Net cash /(debt)--FY12E	273015	83	Investment at 20% discount
Fair Value		**1,119**	

Key assumption

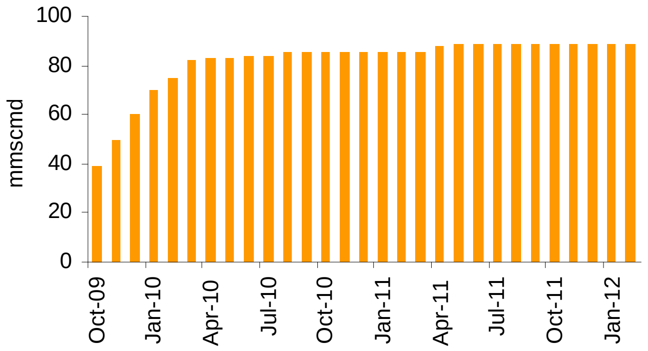
	FY11	FY12E	FY13E
Exchange Rate	45.2	45.0	45.0
Refining			
Capacity (mmtpa)	62	62	62
Crude oil Throughput (mmtpa)	67	67	67
Utilization (%)	107	108	108
GRM ($/bbl)	8.4	9.8	10.2
Petrochemical			
Volume(MMT)	9.0	9.1	9.2
EBIT ($/mt)	219	208	217
E & P			
PMT			
RIL Share - Natural Gas production (mmscmd)	3.4	3.6	3.6
RIL share - Crude oil production (MMBL)	3.1	3.5	3.5
Natural Gas realisation for Panna-Mukta ($/mmbtu)	5.7	5.7	5.7
Natural Gas realisation for Tapti ($/mmbtu)	5.6	5.6	5.6
Crude oil realisation ($/bbl)	81	85	85
KG D6			
RIL Share - Natural Gas production (mmscmd)	50	30	30
RIL share - Crude oil production (MMBL)	7.9	4.8	4.8
Natural Gas realisation ($/mmbtu)	4.2	4.2	4.2
Crude oil realisation ($/bbl)	81	95	87

Key Concern on our assumption

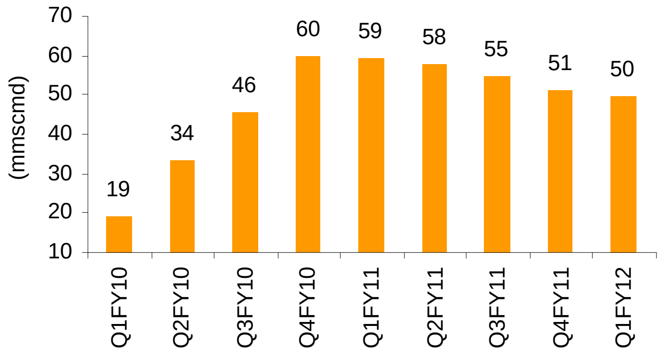
- RIL's margins are exposed to the global petrochemical and refining cycles; any further decline would impact our estimates
- Delays in the drilling program and/or negative news-flow for the new blocks (D9, D3, MN-D4)
- Further declining in KG D6 production compared to our assumption, and delays in the ramp-up of production of KG-D6 gas:

The initial plan was to reach 80mmscmd from the initial 22 wells and then add 28 additional wells (up to 50 wells in total) to maintain plateau of 80mmscmd for up to 8 years. So far 18 wells have been drilled, with another 2 wells completed but not connected to the field. A further 2 wells are expected to be completed over the coming few months and come online before the end of the current fiscal year. Based on the media news (on 24th Sep, 2011) company has drilled two new wells in its KG-D6 gas block as mentioned above, but both have turned out to be almost dry, with very little hydrocarbon presence, vindicating the company's stand that indiscriminate drilling will not help solve the problem of falling gas output. Company expects takeoff in volume to take at least two years from current level. So far we have expected 50mmscmd production for FY12E and FY13E due to lack of further clarity on KG D6 production. Any further reduction in gas production could see earnings downgrades in our numbers as we have factored 50mmscmd gas production for FY12E and FY13E as base case.

Estimated average production



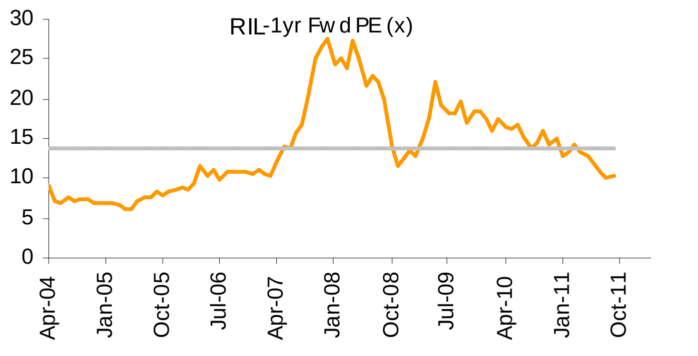
Actual gas production



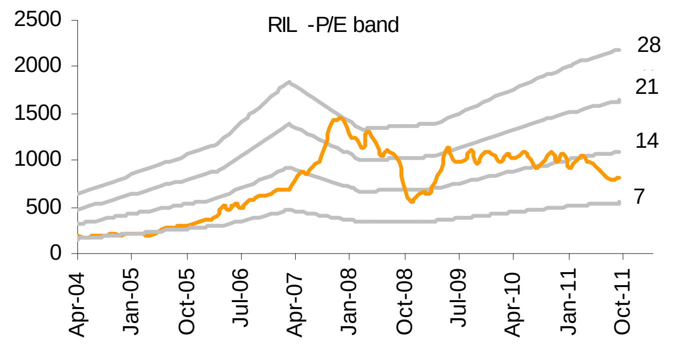
Source: Company, Emkay Research

Valuation Chart

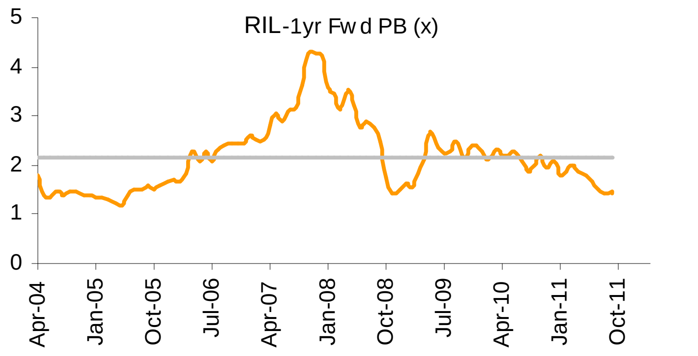
PE (x)



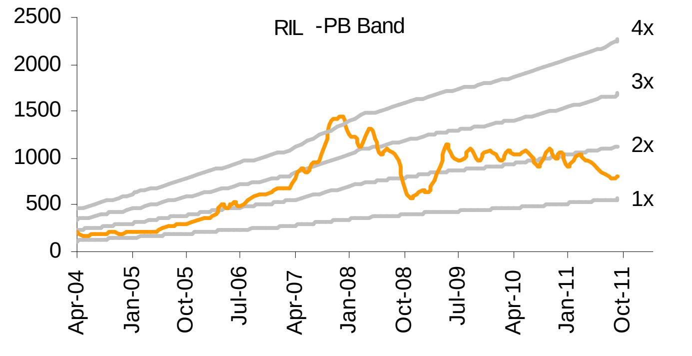
E band



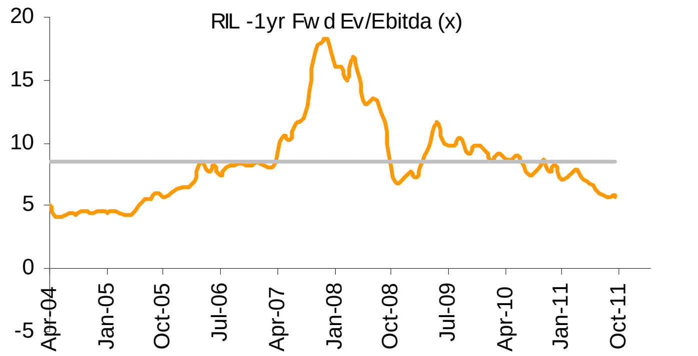
1yr Fwd PB (x)



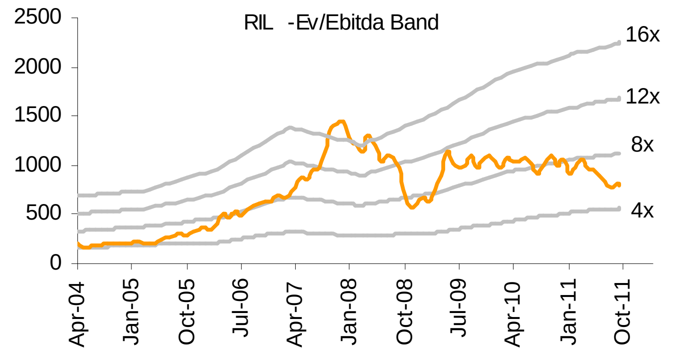
PB Band



1yr Fwd Ev/Ebitda (x)



Ev/Ebitda Band



International Peers

Petrochemical players	P/E RATIO CY11	P/E RATIO CY12	P/E RATIO CY13	PRICE/BOOK CY11	PRICE/BOOK CY12	PRICE/BOOK CY13	EV/EBITDA CY11	EV/EBITDA CY12	EV/EBITDA CY13
HANWHA CHEMICAL CORP	6.3	5.7	5.1	0.9	0.8	0.7	6.6	6.0	5.6
HONAM PETROCHEMICAL CORP	7.6	6.8	6.2	1.6	1.3	1.1	4.6	4.4	4.0
LG CHEM LTD	8.8	7.7	6.9	2.3	1.8	1.5	5.5	4.8	4.3
FORMOSA PLASTICS CORP	9.4	8.8	8.3	1.7	1.6	1.6	10.8	9.7	9.7
NAN YA PLASTICS CORP	11.7	9.9	9.0	1.7	1.6	1.6	17.6	14.6	14.3
FORMOSA CHEMICALS & FIBRE	8.6	8.7	8.0	1.5	1.4	1.3	12.1	12.7	12.8
FORMOSA PETROCHEMICAL	17.3	15.5	14.1	3.1	3.0	2.9	11.7	10.9	10.4
SIAM CEMENT PUBLIC CO	10.0	8.6	7.3	2.2	1.9	1.6	9.4	8.1	7.3
PETRONAS CHEMICALS	11.5	10.1	9.0	2.1	1.9	1.7	6.2	5.9	5.4
TORAY INDUSTRIES INC	12.0	11.0	9.9	1.4	1.2	1.1	7.0	6.4	6.0
ASAHI KASEI CORP	8.7	8.2	7.7	0.9	0.8	0.8	3.7	3.5	3.4
MITSUI CHEMICALS INC	9.3	8.2	7.1	0.6	0.6	0.6	6.1	5.7	5.3
Average	**10.1**	**9.1**	**8.2**	**1.7**	**1.5**	**1.4**	**8.4**	**7.7**	**7.4**
Refining players									
SK INNOVATION CO LTD	4.2	5.4	5.0	1.0	0.9	0.7	5.0	5.3	4.9
GS HOLDINGS	5.1	4.7	4.5	0.9	0.7	0.6	4.6	4.5	4.3
S-OIL CORPORATION	7.0	6.3	6.2	2.1	1.7	1.4	6.7	5.9	5.8
CHINA PETROLEUM & CHEMICAL	7.1	6.5	6.3	1.1	1.0	0.9	4.7	4.4	4.2
PETROCHINA CO LTD-H	9.8	9.1	8.7	1.4	1.3	1.2	5.9	5.5	5.2
CNOOC LTD	7.1	7.3	7.2	1.9	1.6	1.4	3.6	3.5	3.3
ESSO THAILAND	5.6	5.5	5.2	1.1	1.0	0.9	5.8	5.5	5.3
IRPC PCL	8.0	7.5	7.0	0.9	0.9	0.8	7.3	6.3	5.5
PTT PCL	7.6	6.8	6.4	1.4	1.2	1.1	5.8	5.2	4.9
PTT AROMATICS & REFINING	6.0	5.5	5.3	1.1	1.0	0.8	5.9	5.5	5.5
THAI OIL PCL	6.6	6.8	6.5	1.3	1.2	1.1	4.9	5.0	4.7
CALTEX AUSTRALIA LTD	10.4	8.2	7.7	0.9	0.8	0.8	5.3	4.6	4.2
Average	**7.0**	**6.7**	**6.3**	**1.2**	**1.1**	**1.0**	**5.5**	**5.1**	**4.8**
Integrated players									
EXXON MOBIL CORP	8.5	8.3	7.9	2.2	1.9	1.7	4.1	3.9	3.8
PETROBRAS -	7.0	6.7	6.6	0.8	0.7	0.6	5.3	4.9	4.6
ROYAL DUTCH SHELL	7.5	6.8	6.7	1.2	1.1	1.0	3.6	3.5	3.3
CHEVRON CORP	6.9	7.1	7.3	1.5	1.3	1.2	3.1	3.1	3.2
CONOCOPHILLIPS	7.8	7.5	7.4	1.2	1.1	1.1	3.3	3.3	3.4
ENI SPA	6.3	5.8	5.3	0.9	0.8	0.7	3.0	2.7	2.5
HESS CORP	8.2	7.6	6.8	1.0	0.9	0.8	3.1	2.8	2.6
MARATHON PETROLEUM CORP	3.9	4.6	4.7	1.0	0.9	0.7	2.4	2.7	2.6
BP PLC	5.5	5.5	5.2	1.1	1.0	0.9	3.2	3.2	3.0
Average	**6.8**	**6.7**	**6.4**	**1.2**	**1.1**	**1.0**	**3.5**	**3.3**	**3.2**

Company background

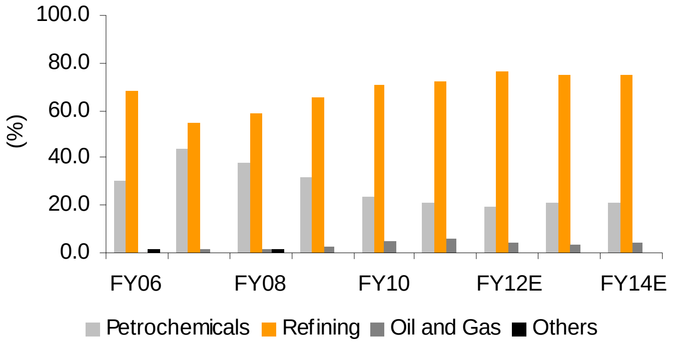
The Reliance Group, founded by Dhirubhai H. Ambani, is India's largest private sector enterprise, with businesses in the energy and materials value chain. The company operates in three business segments: petrochemicals, refining, and oil and gas. The other segment of the company includes Textile, Retail business and special economic zone (SEZ) development, Telecom, Insurance etc. It is the first private sector company from India to feature in the Fortune Global 500 list of 'World's Largest Corporations' and ranks 117th amongst the world's Top 200 companies in terms of profits.

Financial Performance

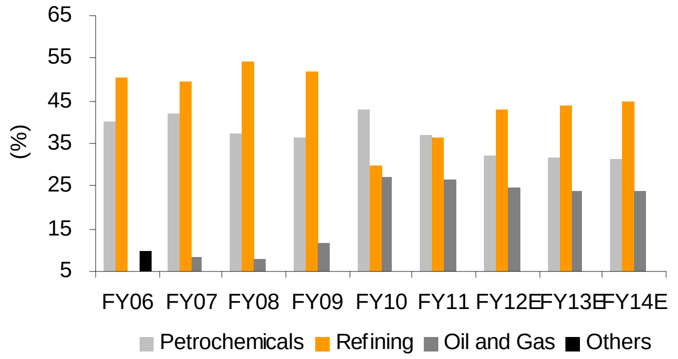
In FY11, company reported a revenue of Rs.2,586.5bn (US$ 58.0bn), cash profit of Rs.345.3bn (US$ 7.7 bn), net profit of Rs.202.8bn (US$ 4.5bn) and net worth of Rs.1,515.4bn (US$ 34.0bn).

Revenue and EBIT breakup

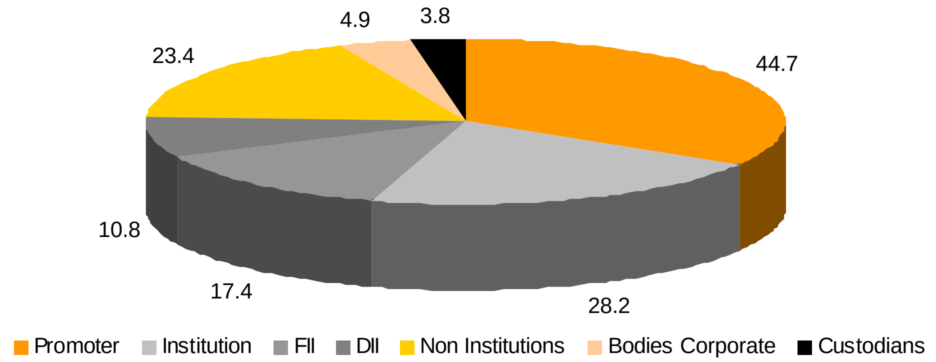
Segment wise revenue share (%)



Segmental EBIT



Share Holding pattern



Financial

Income Statement

Y/E, Mar (Rs. mn)	FY10	FY11	FY12E	FY13E
Net Sales	**1,924,610**	**2,481,700**	**3,007,774**	**2,783,621**
Growth (%)	*35.7*	*28.9*	*21.0*	*(8.2)*
Expenditure	**1,658,282**	**2,132,873**	**2,618,347**	**2,372,515**
Materials Consumed	1,509,150	1,946,982	2,378,708	2,157,399
Employee Cost	0	0	0	0
Other Exp	149,132	185,891	239,639	215,116
EBITDA	**266,328**	**348,827**	**384,653**	**385,389**
Growth (%)	*16.4*	*31.0*	*10.3*	*0.2*
EBITDA margin (%)	***13.8***	***14.1***	***12.8***	***14.0***
Depreciation	104,965	136,076	112,156	117,312
EBIT	**225,447**	**275,699**	**329,222**	**356,674**
EBIT margin (%)	***11.7***	***11.1***	***11.0***	***12.9***
Other Income	24,605	30,517	51,952	62,880
Interest expenses	19,972	23,276	19,941	17,548
PBT	**205,474**	**252,422**	**309,281**	**339,126**
Tax	**43,118**	**49,559**	**68,042**	**72,912**
Effective tax rate (%)	*21.0*	*19.6*	*22.0*	*21.5*
Adjt. PAT	**162,357**	**202,863**	**241,239**	**266,214**
Growth (%)	*6.1*	*24.9*	*18.9*	*10.4*
Net Margin (%)	***8.4***	***8.2***	***8.0***	***9.7***
(Profit)/loss from JVs/Ass/MI	-	-	-	-
Adjt. PAT After JVs/Ass/MI	162,357	202,863	241,239	266,214
E/O items	-	-	-	-
Reported PAT	162,357	202,863	241,239	266,214
PAT after MI	**162,357**	**202,863**	**241,239**	**266,214**
Growth (%)	*6.1*	*24.9*	*18.9*	*10.4*

Balance Sheet

Y/E, Mar (Rs. mn)	FY10	FY11	FY12E	FY13E
Equity share capital	32,704	32,734	32,734	32,734
Reserves & surplus	1,339,003	1,482,670	1,685,872	1,910,246
Net worth	**1,371,706**	**1,515,403**	**1,718,606**	**1,942,979**
Minority Interest	**0**	**0**	**0**	**0**
Secured Loans	116,705	105,712	43,558	38,537
Unsecured Loans	508,242	568,255	502,771	442,223
Loan Funds	**624,947**	**673,967**	**546,329**	**480,760**
Net DTL	109,263	115,618	115,618	115,618
Total Liabilities	**2,105,916**	**2,304,988**	**2,380,553**	**2,539,358**
Gross Block	2,158,647	2,212,520	2,076,971	2,172,450
Less: Depreciation	626,048	785,455	897,611	1,014,923
Net block	**1,532,599**	**1,427,065**	**1,179,360**	**1,157,526**
Capital WIP	121,389	128,196	180,233	298,466
Investment	**232,286**	**376,515**	**426,515**	**426,515**
Current Assets	**623,791**	**915,418**	**1,249,645**	**1,258,575**
Inventories	269,816	298,254	361,807	332,278
Sundry debtors	116,602	174,419	207,103	190,200
Cash & bank balance	134,627	271,349	478,132	550,030
Loans & advances	101,832	169,403	200,200	183,860
Other current assets	914	1,993	2,402	2,206
Current lia & Prov	**404,148**	**542,206**	**655,200**	**601,724**
Current liabilities	368,494	496,571	600,600	551,581
Provisions	35,654	45,635	54,600	50,144
Net current assets	**219,643**	**373,212**	**594,445**	**656,850**
Misc. exp	-	-	-	-
Total Assets	**2,105,916**	**2,304,988**	**2,380,553**	**2,539,358**

Cash Flow

Y/E, Mar (Rs. mn)	FY10	FY11	FY12E	FY13E
PBT	205,474	252,422	309,281	339,126
Depreciation	134,770	162,413	112,156	117,312
Interest Provided	19,972	23,276	19,941	17,548
Other Non-Cash items	(71,466.7)	(63,932.9)	-	-
Chg in working cap	(53,015)	695	(14,449)	9,493
Tax paid	-30,833	-42,068	-68,042	-72,912
Operating Cash flow	**204,902**	**332,805**	**358,887**	**410,567**
Capital expenditure	(219,427)	(123,661)	83,512	(213,712)
Free Cash Flow	**-14,525**	**209,144**	**442,399**	**196,855**
Others	2,026,043	2,495,741	-	-
Investments	(1,988,661)	(2,575,409)	(50,000)	-
Investing Cash flow	**-182,045**	**-203,329**	**33,512**	**-213,712**
Equity Capital	535	1,926	-	-
Loans Taken/(Repaid)	(53,024)	57,430	(127,638)	(65,569)
Interest Paid	(35,313)	(27,801)	(19,941)	(17,548)
Dividend	(22,195)	(24,309)	(38,037)	(41,840)
Income from invest.	-	-	-	-
Others	-	-	-	-
Financing Cash flow	**-109,996**	**7,246**	**-185,616**	**-124,957**
Net chg in cash	**-87,139**	**136,722**	**206,784**	**71,898**
Opening cash position	221,765	134,627	271,349	478,132
Closing cash position	**134,627**	**271,349**	**478,132**	**550,030**

Key Ratios

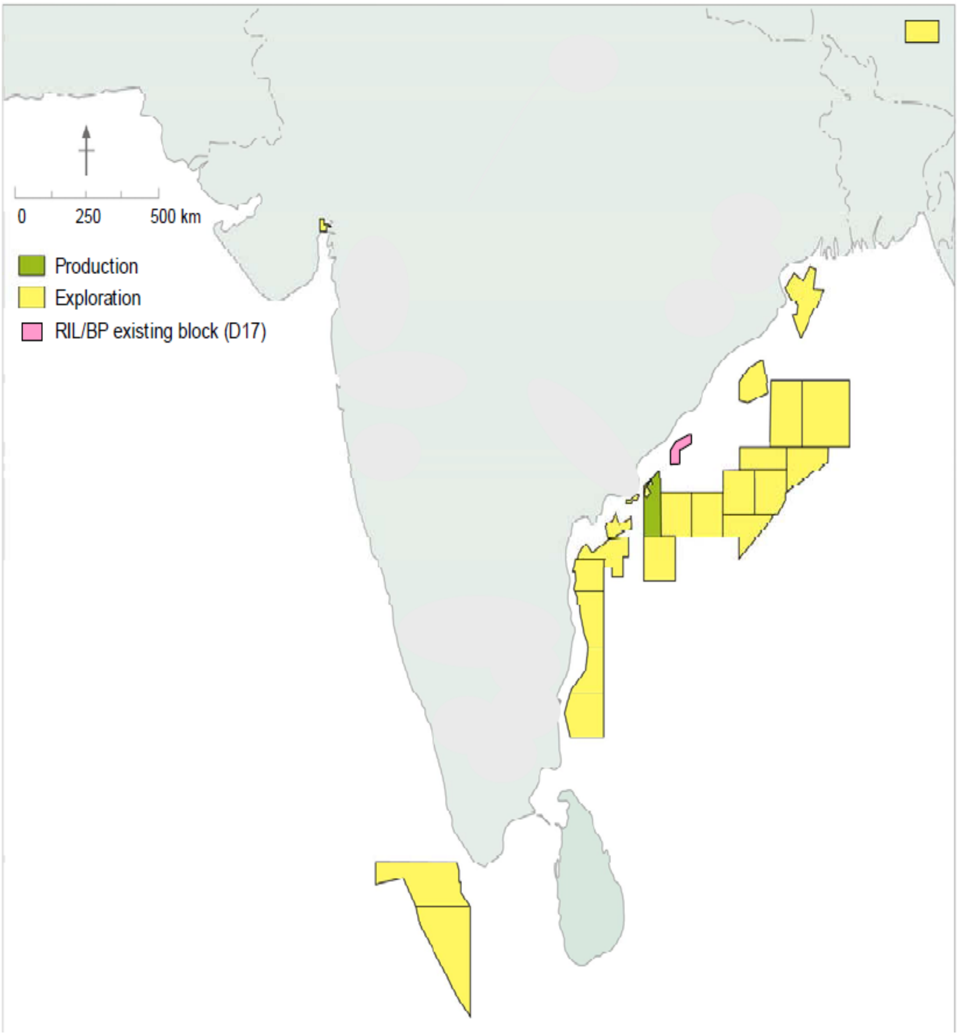
Y/E, Mar	FY10	FY11	FY12E	FY13E
Profitability (%)				
EBITDA Margin	13.8	14.1	12.8	14.0
Net Margin	8.4	8.2	8.0	9.7
ROCE	10.7	12.5	14.1	14.5
ROE	12.3	14.1	14.9	14.5
RoIC	10.2	11.8	19.3	20.9
Per Share Data (Rs)				
EPS	49.6	62.0	73.7	81.3
CEPS	90.8	111.6	108.0	117.2
BVPS	419.4	462.9	525.0	593.6
DPS	6.4	7.3	10.0	11.0
Valuations (x)				
PER	17.0	13.7	11.5	10.4
P/CEPS	9.3	7.6	7.8	7.2
P/BV	2.0	1.8	1.6	1.4
EV / Sales	1.6	1.1	0.8	0.8
EV / EBITDA	11.4	8.0	6.3	5.9
Dividend Yield (%)	0.8	0.9	1.2	1.3
Gearing Ratio (x)				
Net Debt/ Equity	0.2	0.0	(0.2)	(0.3)
Net Debt/EBIDTA	1.0	0.1	(0.9)	(1.3)
Working Cap (days)	3.4	(3.5)	(3.9)	(3.9)

Annexure

Brief on RIL-BP deal

British petroleum (BP) has bought 30% stake in RIL's 23 oil & gas block in India including KG D6 block. The 23 oil and gas blocks together cover approximately 270,000 square kilometers. BP will pay US$7.2bn for 30% interest in the 23 blocks. BP will pay another US$1.8bn as future performance payments based on exploration success that results in development of commercial discoveries. The total implied value of 100% stake comes at around $27-30bn and $23-29bn for RIL 90% stake in these blocks. However, most of the consideration of US$7.2bn BP will likely to be pay for KG D6, in which RIL has 90% stake. But in some of the blocks RIL has 100% stake as well.

Block details:- MAP



Block Details of RIL-BP Deal

Exploration blocks	Sedimentary basin	Operator	RIL's interest	RIL's partner/s	NELP
Onland blocks					
AS-ONN-2000/1	Assam -Arakan	RIL	100%		NELP 2
CB-ONN-2003/1	Cambay	RIL	100%		NELP 5
Shallow water blocks					
NEC-OSN-97/2 (NEC-25)	Mahanadi-NEC	RIL	90%	Niko Resources	NELP 1
Deepwater blocks					
KG-DWN-98/1	Krishna-Godavari	RIL	100%		NELP 1
KG-DWN-98/3 (KG D6)	Krishna-Godavari	RIL	90%	Niko Resources	NELP 1
MN-DWN-98/2	Mahanadi-NEC	RIL	100%		NELP 1
CY-DWN-2001/2	Cauvery	RIL	100%		NELP 3
CY-PR-DWN-2001/3	Cauvery-palar	RIL	100%		NELP 3
CY-PR-DWN-2001/4	Cauvery-palar	RIL	100%		NELP 3
PR-DWN-2001/1	Palar	RIL	100%		NELP 3
KG-DWN-2001/1 (KG D9)	Krishna-Godavari	RIL	90%	Hardy Oil	NELP 3
NEC-DWN-2002/1	Mahanadi-NEC	RIL	100%		NELP 4
KK-DWN-2001/1	Kerala-Konkan	RIL	100%		NELP 3
KK-DWN-2001/2	Kerala-Konkan	RIL	100%		NELP 3
KG-DWN-2003/1 (KG D3)	Krishna-Godavari	RIL	90%	Hardy Oil	NELP 5
MN-DWN-2003/1 (Mahanadi D4)	Mahanadi-NEC	RIL	85%	Niko Resources	NELP 5
KG-DWN-2004/4	Krishna-Godavari	RIL	100%		NELP 6
KG-DWN-2004/7	Krishna-Godavari	RIL	100%		NELP 6
MN-DWN-2004/1	Mahanadi-NEC	RIL	100%		NELP 6
MN-DWN-2004/2	Mahanadi-NEC	RIL	100%		NELP 6
MN-DWN-2004/3	Mahanadi-NEC	RIL	100%		NELP 6
MN-DWN-2004/4	Mahanadi-NEC	RIL	100%		NELP 6
MN-DWN-2004/5	Mahanadi-NEC	RIL	100%		NELP 6

Glossary

BBL	Barrels
CAG	Comptroller and Auditor General
GRM	Gross Refining Margin
IEA	International Energy Association
Mbpd	Million barrels per day
Mmbbl	Million barrels
Mmscmd	Million Standard Cubic Meter per day
Mmbtu	Million British thermal unit
MoPNG	Ministry of Petroleum and Natural Gas
Opec	Organization of the Petroleum Exporting Countries
OECD	Organization for Economic Co-operation and Development
PMT	Panna/Mukta Tapti
RGTIL	Reliance Gas Transportation Infrastructure Limited
RIIL	Reliance Industrial Infrastructure Limited
SEZ	Special Economic Zone
TCF	Trillion Cubic Feet

Emkay Rating Distribution

BUY	Expected total return (%) (stock price appreciation and dividend yield) of over 25% within the next 12-18 months.
ACCUMULATE	Expected total return (%) (stock price appreciation and dividend yield) of over 10% within the next 12-18 months.
HOLD	Expected total return (%) (stock price appreciation and dividend yield) of upto 10% within the next 12-18 months.
REDUCE	Expected total return (%) (stock price depreciation) of upto (-)10% within the next 12-18 months.
SELL	The stock is believed to under perform the broad market indices or its related universe within the next 12-18 months.

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