Rational Investment Research Pvt. Ltd.
7-A Birat Complex (Near Krishna Apartment) Patna 800013
Phone: 91-612-2570270 Website: www.rirlimited.com, **June 10, 2008**

Reliance Petroleum is Overvalued at Rs 120/share

Reliance Petroleum shares have risen in last one year. Despite the correction it still seems that buyers of the stocks are confused about the sector to which the company belongs. The company will be engaged in refining crude oil. It is not in any way engaged in production of crude oil. While the crude oil production is limited, refining capacity is certainly not limited. As a matter of fact while the crude production has become more profitable in recent times the same cannot be said about business of refining crude.

The first critical thing to understand about refining business is that any number of refineries can be built. Crude oil might have a limited supply because it is running out. However, any number of refineries might be built. Additionally, there is little reason for consumers to pay even a slight premium for products of one refinery versus others. Branding has a very limited value for petroleum products. So in case existing refineries earn super normal profits, new refineries will come up and margins would become normal if not sub normal.

Reliance Petroleum collected a total of little less than Rs 14,000 crores from its IPO and initial funding from Reliance Industries. This money, along with debt of similar amount is being used for building the refinery and funding its working capital requirement. Reliance has not made any innovations in design of refining. The machinery bought by Reliance can be bought by anybody else too. There is no sense of paying a price of Rs 54,000 crores for something that has been bought for Rs 14,000 crores and is not exclusive.

Going through the latest annual report for Reliance Petroleum one finds a reference to 'Golden era refining'. This is one is really surprising. At least we are not seeing such an era currently and it seems unlikely that we will see such an era in near future. All major oil companies including Exxon Mobil, Chevron, BP etc. have seen their refining margins slump. Independent refiners like Valero, Tesoro etc. have seen their earnings slump and they trade at around 7-8 time trailing earnings. That implies that the outlook for refining margin is negative. That seems logical. While consumption of petroleum products have stagnated because of high crude oil prices there are a number of green field and brown field projects of refineries which are coming up. These projects would significantly expand capacity at a time of slowing demand. Just in Asia Pacific about 9 million barrels per day of capacity is expected to come up in next three years which would be three time the increase in demand. Overall that should keep the refining margins in check.

Another cost that would keep Reliance Petroleum profits some what subdued is cost to transport petroleum products. While crude is transported very efficiently in Very Large Crude Carriers, the ships for transporting products are small and costly. It takes up to 6 USD to transport crude from India to US west coast. That was alright when refining margin was close to 30 USD for some products. In future that could be a difference between making significant profit and marginal profit.

It seems difficult to pay Rs 54,000 crores for equity in machines worth Rs 14,000 crores when the outlook is as bad as it is now. However at present times holders are paying more than Rs 70,000 crores, that what a share price at more Rs 160 implies for Reliance Petroleum. It is only 30 % less than Valero Energy Corp, which more than 5 times bigger and is situated in US, which is much more attractive market compared to India.