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Reliance Petroleum and Tobin's q

Reliance Petroleum (RPL) trades at approximately six times the replacement cost of the refinery that it is building. Tobin' q, a concept developed by Nobel laureate James Tobin, is the ratio of value of a company given by financial markets with the value of a company's assets. The Tobin's q for the RPL is therefore close to six. This would be considered a premium valuation. This valuation has been given at a time when economics for the refining business are looking bad. Our estimate is price of RPL shares at Rs 190 is close to twice of what would be reasonable. Given the extra refining capacity coming up in Asia the price should be at least half of the current level. We present our case below.

First consider the replacement cost for the refinery. Why pay Rs 90,000 crores for something that has been built for less than Rs 14,000 crores. Has Reliance created a refinery which no body else can build or does it have access to some exclusive technology which can boost profit of refinery? Neither is the case. A refinery can be built by anyone. The technology used by RPL is available to anybody. Customers are not going to pay a higher price for petrol from RPL refinery. Branding has little if any importance in this business and so there is not much scope for paying a premium for assets.

Second consider the valuation of global peers with RPL. Valero, which is largest independent refiner in world, has a capacity to refine 3.1 million barrels per day (bpd). The refining capacity for RPL's refinery is 580,000 barrels per day. The valuation of Valero is $ 26 billion USD while that of RPL is close to $ 19 billion USD. RPL valuation premium is more than three times. It is also important to remember that RPL's refinery has not yet commenced operation, while Valero's refineries are functioning. Frontier Oil another company with one of best capital margins and refining mostly heavy oil (as RPL would do) has a valuation discount of more than 50 per cent compared to RPL.

Third the economics of refining business is much worse in India. RPL cannot sell anything India as it unprofitable to sell petroleum products (anyway it is in a SEZ so it cannot sell in India). Transporting petroleum products requires substantially more cost than transporting crude. It takes $ 6 per barrel to transport crude from India to US west coast something that can eliminate entire refining margin. The refining capacity that is supposed to come up in Asia in next two years is 9 million barrels, something that would be in excess of demand. The refining profits cannot be expected to come up in such scenario.

Fourth all major refineries are upgrading themselves to process heavier crude. Heavier crude used to be at a high discount since not many refineries could process them. So refineries which could process them generated much higher refining margin. This is something that has helped Reliance Industries, RPL's parent to generate higher margin. That era comes to an in 2008 and 2009 as most of refineries in US upgrade themselves to handle the heavier crude. The discount on heavier crude has gone down by almost 50 per cent and any extra profit would probably disappear sooner rather than later.

The share price movement for RPL has been irrational, if not insane. In summer of 2007 refining margin started to move down from all time high of $30 dollar per barrel. The refining margin went down substantially in all parts of the world. The profits of independent refiners and refining subsidiaries of integrated oil companies disappeared. During this period share price of RPL more than tripled. It was as if RPL had discovered a way to convert crude oil into gold. Unless Reliance Petroleum has done something to that effect the share price must come down.

"Uncertainty is not a pleasant state of mind but certainty is absurd" – Voltaire