ANANDRATHI

India I Equities

Telecommunications

Sector Update

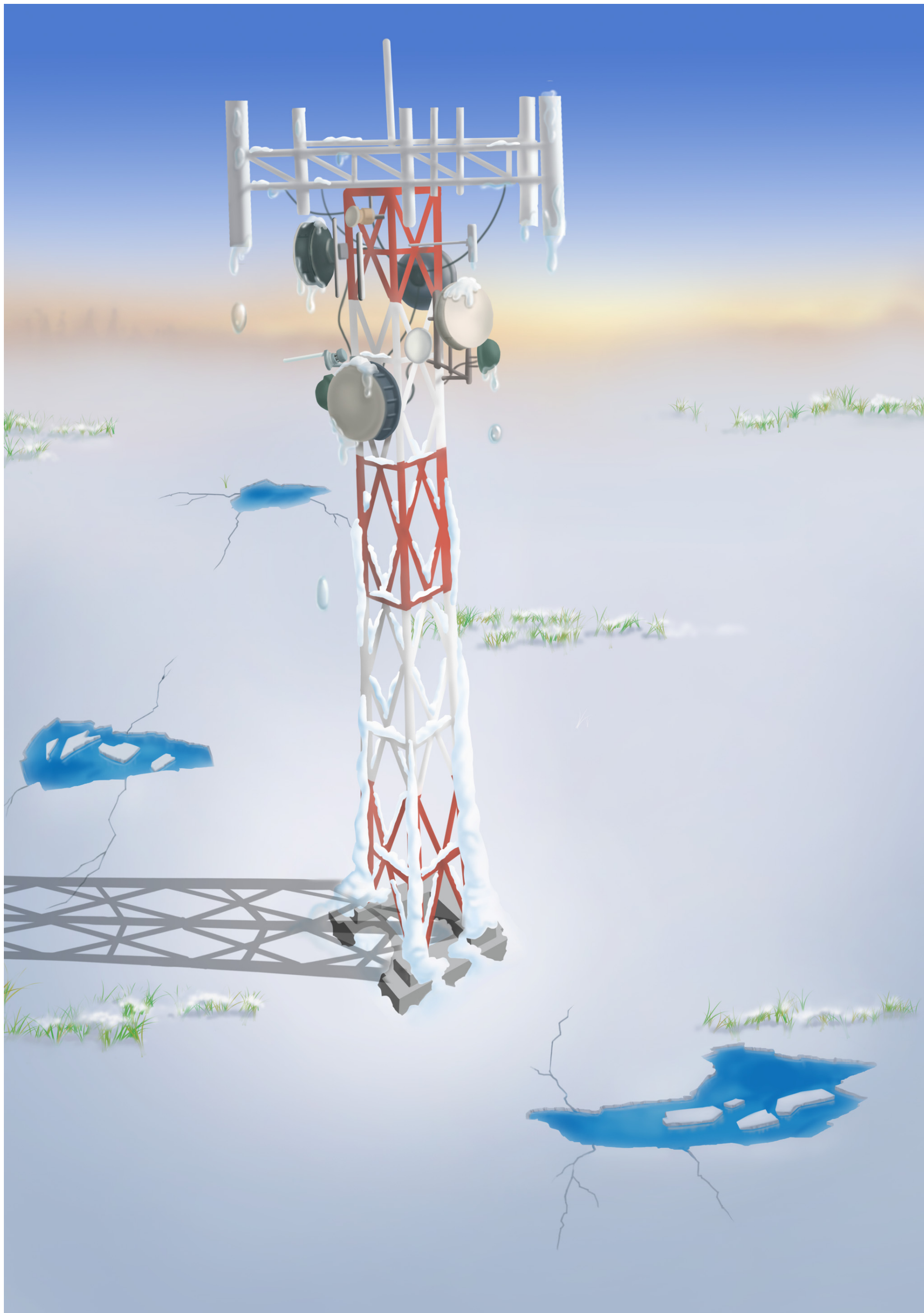
20 June 2011

India Telecom

Weight: Overweight

Thawing out from a deep freeze

Nifty/Sensex: 5366/17871



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Growth is returning to the telecom sector, with the ebbing of competitive and regulatory uncertainty (tariff wars, 3G auctions, TRAI recommendations) that had plagued the sector. Leading GSM telcos (Bharti, Idea) face manageable regulatory risks. They currently trade at 7.5-8.0x FY12e EV/EBITDA, which we believe is justified by FY12e-14e EBITDA CAGR of 15-19%. Preferred picks: Idea (TP: ₹96) and Tulip (TP: ₹225).

- **Tariff stability appears sustainable.** Average revenue per minute in the Indian wireless market has stabilized in recent quarters. We believe the stability is sustainable due to constrained investment capacity of aggressors, ineffectiveness of past tariff cuts by challengers in gaining market share, and expected rise in service differentiation (for leading telcos) as a result of 3G.
- **Industry dynamics to improve.** While regulatory bottlenecks could prevent M&A-driven consolidation in the short term, we expect the market to consolidate organically. We believe easing exit barriers could aid faster consolidation. Notably, the telecom ministry has stated the need for liberal M&A norms.
- **Regulatory risks manageable for leading telcos.** Leading GSM telcos (Bharti, Idea) are faced with limited risks beyond certain quantifiable regulatory payouts (estimated at 5-10% of our price targets). We believe the ongoing 2G investigations are mainly focussed on fresh entrants and dual-technology companies.
- **Stock views.** Our preferred picks in the sector are Idea (market share gains, operating leverage, proven execution record) and Tulip (robust growth outlook, attractive valuations). We maintain a Buy on Bharti (mix of growth and stability) and Sells on RCom and TTML – both suffered weak key performance indicators in recent quarters, high financial leverage and regulatory overhangs.

Indian telcos: Ratings and valuations

		Share price	Target	Upside	Mkt Cap	P/E (x)		EPS CAGR (%)	P/E to	EV/EBITDA (x)		EBITDA CAGR	EV/EBITDA
Year-end Mar	Rating	(₹) [a]	Price (₹)	(%)	(US$m)	FY12e	FY13e	FY12e-14e	Growth (x)	FY12e	FY13e	FY12e-14e (%)	to-Growth (x)
Bharti	Buy	380	455	20	32,193	18.3	13.6	30.6	0.60	8.1	6.7	15.1	0.54
RCOM	Sell	95	90	(5)	4,375	18.7	16.9	22.6	0.83	6.6	5.7	6.9	0.96
Idea	Buy	78	96	24	5,711	39.3	27.1	53.5	0.74	7.5	6.3	19.0	0.40
TTML	Sell	16	12	(27)	693	NM	NM	NM	NM	13.4	11.1	19.2	0.70
Tulip	Buy	156	225	44	505	6.8	6.0	27.1	0.25	5.2	3.6	22.3	0.23
Average (Wireless)						**20.9**	**15.3**	**33.7**	**0.62**	**7.7**	**6.4**	**14.3**	**0.54**

Source: Bloomberg, Anand Rathi Research [a] As on 17 June '11

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India Telecom

Thawing out from a deep freeze

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Investment Argument

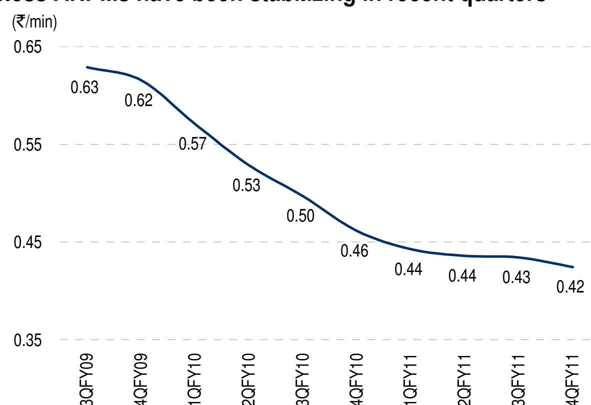
Growth is returning to the telecom sector, with the ebbing of competitive and regulatory uncertainty (tariff wars, 3G auctions, TRAI recommendations) that had plagued the sector. Leading GSM telcos (Bharti, Idea) face manageable regulatory risks. They currently trade at 7.5-8.0x FY12e EV/EBITDA, which we believe are justified by FY12e-14e EBITDA CAGR of 15-19%. Preferred picks: Idea (TP: ₹96) and Tulip (TP: ₹225).

Thawing out from a deep freeze

Tariff stability appears sustainable

After falling sharply through 1QFY10-1QFY11 (average qoq decline of ~7%), wireless average revenue per minute (ARPM) has stabilized in recent quarters (average qoq decline of 1.4% over 1QFY11-3QFY11).

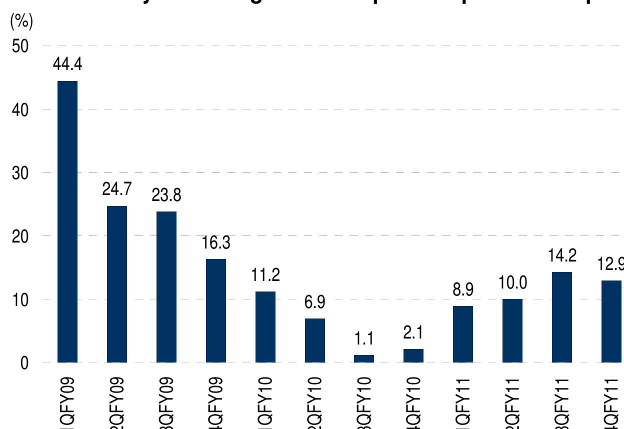
Fig 1 – Wireless ARPMs have been stabilizing in recent quarters



Source: Companies *[a] Based on data for Bharti, RCom, Idea, Vodafone, TTML, Uninor*

We believe the recent stability in wireless ARPM is sustainable owing to: i) constrained investment capacity of aggressors – such as RCom and fresh entrants; ii) slower expansion by challengers, leading to reduction in industry overcapacity; iii) ineffectiveness of past tariff cuts, by challengers in the market, in gaining market share; iv) expected service differentiation offered by 3G to leading telcos; and v) importance of non-tariff factors in protecting/gaining market share.

Fig 2 – Wireless industry revenue growth has picked up in recent quarters



Source: TRAI

Industry dynamics to improve

We believe consolidation in terms of acquisitions, mergers and exits is unlikely, at least in the short- to medium-term, due to regulatory bottlenecks. However, we believe the market would see consolidation in revenue market shares, driven by: i) lack of significant pricing differences between leaders and challengers; ii) ongoing market-share deterioration of BSNL/MTNL; ii) consolidation of spectrum ownership, following the 3G auctions last year; and iv) funding challenges for challengers (RCom, TTSL and fresh entrants).

We believe easing exit barriers in the sector in the form of liberal M&A norms could aid quicker consolidation. Notably, the telecom ministry sounds supportive of the industry, as per recent announcements. It has spoken of the need for liberal M&A norms.

Regulatory risks manageable

Even as the focus is gradually shifting to growth, proposed policy changes and ongoing 2G investigations continue to pose risks. We believe that among the wireless telcos in our coverage universe, Bharti is strongly placed to weather regulatory risks, followed by Idea. Bharti and Idea do not face significant risks from the 2G investigations, which are more focused on fresh entrants and dual-technology operators, in our view. Bharti also faces only a limited impact (vs. peers) from the proposed regulatory changes.

Fig 3 – Impact of potential regulatory changes on Indian telcos

	Bharti			Idea			RCom		
	₹bn	₹/sh	% of TP	₹bn	₹/sh	% of TP	₹bn	₹/sh	% of TP
1 One-time fee for 'excess' 2G spectrum	(43)	(11.3)	**(2.5)**	(15)	(4.6)	**(4.8)**	(1)	(0.6)	**(0.6)**
2 License renewal cost (PV)	(87)	(22.8)	**(5.0)**	(41)	(12.5)	**(13.0)**	(30)	(14.6)	**(16.2)**
3 Increase in spectrum-usage fee (SUF) as % of AGR	(46)	(12.0)	**(2.6)**	(15)	(4.5)	**(4.7)**	(3)	(1.4)	**(1.6)**
4 Levy of 6% license fee on the tower and ISP businesses	(36)	(9.4)	**(2.1)**	(8)	(2.5)	**(2.6)**	(25)	(11.9)	**(13.2)**
5 Reduction in annual license fee to a uniform 6%	80	21.0	**4.6**	38	11.5	**12.0**	23	11.0	**12.2**
Total impact	**(131.0)**	**(34.5)**	**(7.6)**	**(41.3)**	**(12.5)**	**(13.0)**	**(36.1)**	**(17.5)**	**(19.4)**
Impact excluding #4	**(95.3)**	**(25.1)**	**(5.5)**	**(33.2)**	**(10.1)**	**(10.5)**	**(11.5)**	**(5.6)**	**(6.2)**

Source: TRAI, Anand Rathi Research

In our target prices, we have largely taken into account the risks from proposed regulatory changes.

Fig 4 – Impact of proposed regulatory changes captured in our price targets

(₹/share)	Jun '12e fair value	Impact captured in our price target	Price target
Bharti	480	**(25)**	**455**
Idea	106	**(10)**	**96**

Source: Anand Rathi Research

Impact on RCom's target price is captured through a 10% discount (to the estimated fair value) that we have applied to account for regulatory risks and 2G investigations-related overhang.

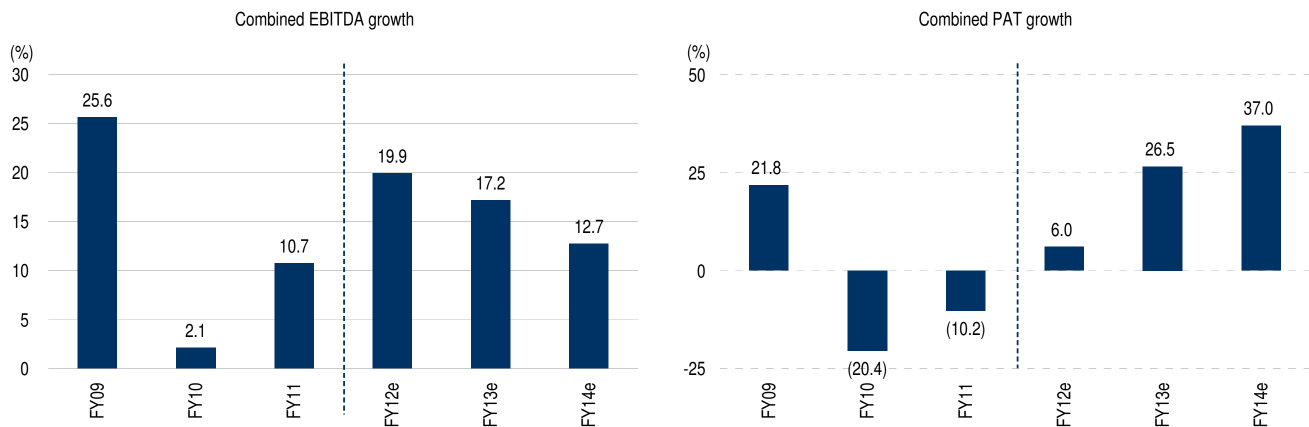
Valuations, rating and price targets

Pick-up in growth to drive valuations

Following the stability in tariffs, wireless revenues have been retracing the growth path in recent quarters. Further, given our expectations of sustainability of tariff stability and improvement in industry dynamics, we believe that growth rates in revenues and EBITDA would pick up in

FY12. A turnaround in Africa operations would be an additional growth driver in the case of Bharti. While earnings would be under pressure in FY12 (due to 3G-related costs), we expect strong EBITDA growth and FCF generation. Post-FY12, we expect FY13 to catch up as well.

Fig 5 – Emerging stability in the wireless market to drive earnings growth for our coverge companies



Source: Companies, Anand Rathi Research

Fig 6 – Indian telcos: valuations and ratings

Year end Mar	Rating	Share price (₹) [a]	TP (₹)	Upside (%)	Market cap (US$m)	P/E (x) FY12e	P/E (x) FY13e	EPS CAGR FY12e-14e	P/E to Growth (x)	EV/EBITDA (x) FY12e	EV/EBITDA (x) FY13e	EBITDA CAGR FY12e-14e	EV/EBITDA to-Growth (x)
Bharti	Buy	380	455	20	32,193	18.3	13.6	30.6	0.60	8.1	6.7	15.1	0.54
RCom	Sell	95	90	(5)	4,375	18.7	16.9	22.6	0.83	6.6	5.7	6.9	0.96
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Average (Wireless)						**20.9**	**15.3**	**33.7**	**0.62**	**7.7**	**6.4**	**14.3**	**0.54**

Source: Company, Anand Rathi Research *[a] as of 17 Jun '11*

On a growth-adjusted basis, the valuations of Indian telcos appear more attractive than emerging market peers.

Fig 7 – Emerging market wireless valuations

Year-end Dec		Share price [a]	Market cap (US$bn)	EV/EBITDA (x) CY11e	EV/EBITDA (x) CY12e	EBITDA CAGR (%) CY11e-13e	EV/EBITDA-to-Growth (x) CY11e	P/E (x) CY11e	P/E (x) CY12e	EPS CAGR (%) CY11e-13e	PEG (x) CY11e
India											
Bharti	₹	380	32.3	8.1	6.7	15.1	0.54	18.3	13.6	30.6	0.60
RCom	₹	95	4.4	6.6	5.7	6.9	0.96	18.7	16.9	22.6	0.83
Idea	₹	77.7	5.7	7.5	6.3	19.0	0.40	39.3	27.1	53.5	0.74
China											
China Mobile	HK$	69	178.0	3.4	3.1	3.6	0.95	9.4	9.2	2.9	3.25
China Unicom	HK$	15	44.8	5.5	4.6	16.7	0.33	57.5	25.8	85.8	0.67
Indonesia											
TelKom	IDR	6,850	16.0	3.7	3.4	4.3	0.85	11.1	10.3	7.6	1.45
Indosat	IDR	5,200	3.3	4.6	4.3	8.5	0.55	22.5	15.8	38.6	0.58
Excelcomindo	IDR	6,300	6.2	5.9	5.2	9.1	0.65	14.0	11.9	16.1	0.87
Middle East/Africa											
MTN	Zar	136	37.9	5.6	4.9	9.3	0.61	12.2	10.6	12.5	0.97
Latin/South America											
AMX	MXN	30	98.5	5.4	5.0	6.8	0.79	11.5	10.2	10.5	1.10
Average (India)				**7.7**	**6.5**	**14.1**	**0.55**	**18.7**	**15.4**	**21.1**	**0.88**
Average (ex India)				**4.3**	**3.9**	**6.8**	**0.64**	**11.5**	**10.6**	**7.7**	**1.49**

Source: Anand Rathi Research, Bloomberg consensus for foreign companies. [a] As of 17 Jun '11 Note: For March year-end companies, CY11e refers to FY12e and CY12e refers to FY13e

Stock calls

Bharti Airtel – Attractive mix of growth and stability

(Buy; Jun '12e target price: ₹455)

Bharti offers a mix of stability and growth via its Indian and African/other South Asia operations. We increase our target price to ₹455 for Jun '12e from ₹350 for Jun '11e, largely due to the expected recovery in the Indian wireless market. We have factored in the impact (₹25/share) of potential regulatory payouts and also introduce IFRS financial estimates.

Idea Cellular – Strong growth play on Indian wireless market

(Buy; Jun '12e target price: ₹96)

Idea has shown excellent execution skills in the wireless market, especially during the competition-marred downtrend and subsequent recovery. We believe Idea has huge potential to outperform peers' earnings growth on the back of strong revenue growth and margin expansion. We roll over our Jun '12e target price to ₹96, from ₹76 for Jun '11e.

Reliance Communications – Challenging times continue

(Sell; Jun '12e target price: ₹90)

RCom is faced with huge challenges on the operational, financial and regulatory fronts. We retain a Sell on the stock and lower our target, to ₹90 for Jun '12e from ₹110 for Mar '12e, due to estimates cut (impact of ~₹13.5/share) and factoring in the regulatory risk (₹10/share).

Tulip Telecom – Shaping up as an integrated enterprise player

(Buy; Jun '12e target price: ₹225)

Tulip Telecom is transforming itself into an end-to-end provider of enterprise services from being a niche wireless VPN player. We expect this strategy to drive strong revenue and earnings growth for Tulip. While the planned data-centre (DC) investment has raised the company's risk profile, we believe current valuations are compelling. We roll over our target price, from ₹225 for Dec '11e to ₹225 for Jun '12e.

Tata Teleservices (Maharashtra) – Steep valuations unsupported by fundamentals

(Sell; Jun '12e target price: ₹12)

Tata Teleservices Maharashtra's (TTML) revenue outlook is muted and balance sheet stretched. We believe that current valuations are not supported by the fundamentals and overestimate value from potential corporate restructuring (which may result in an open offer, delisting etc). We maintain a Sell with a revised DCF-based Jun '12e price target of ₹12 vs. ₹13 (Dec '11e) previously.

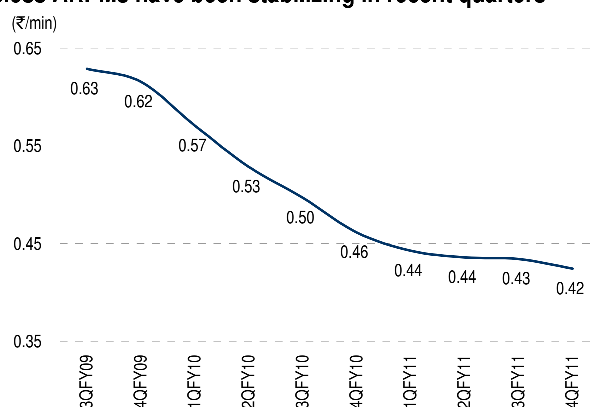
Tariff stability appears sustainable

The tariff stability that has emerged in the Indian wireless market is sustainable, in our view. We expect the increase in rural penetration, growth in usage and higher uptake of data to drive a robust 16%/19% CAGR in revenue/EBITDA over FY11-13e for leading listed telcos.

Tariffs stabilizing in recent quarters

After falling sharply through 1QFY10-1QFY11 (average qoq decline of ~7%), wireless ARPM has stabilized in recent quarters (average qoq decline of 1.4% over 1QFY11-3QFY11).

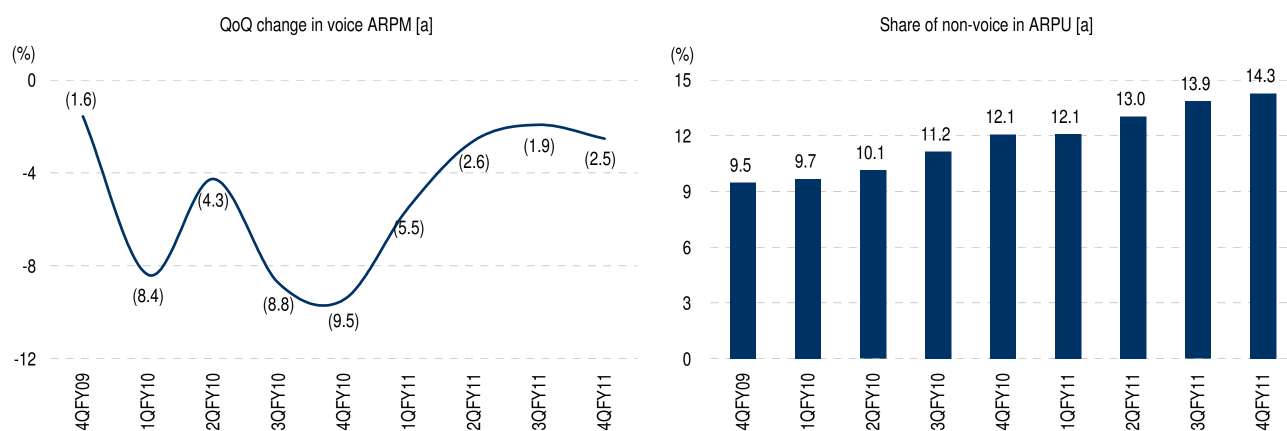
Fig 8 – Wireless ARPMs have been stabilizing in recent quarters



Source: Companies *[a] Based on data for Bharti, RCom, Idea, Vodafone, TTML, Uninor*

The stability in wireless ARPM has been driven by: i) a decline in the qoq drop in voice ARPM and; ii) an increase in the share of non-voice revenues. (Fig 9)

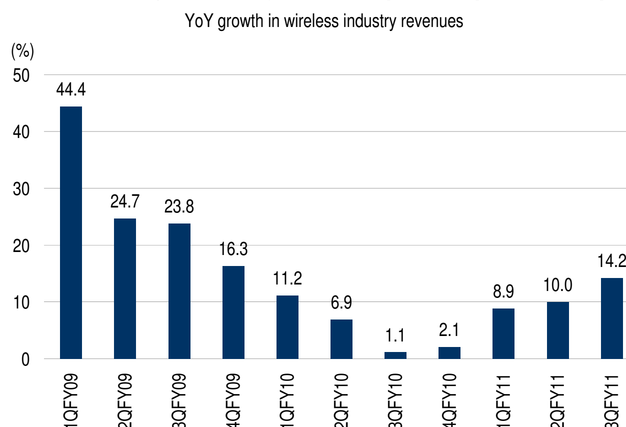
Fig 9 – Falling voice ARPM drop and higher non-voice share driving ARPM stability



Source: Companies *[a] Based on data for Bharti, Idea and TTML*

Following the stability in tariffs, wireless revenues have been retracing the growth trajectory in recent quarters.

Fig 10 – Wireless industry revenue growth has picked up in recent quarters



Source: TRAI

Steady ARPM and growth volumes to drive revenues over the medium term

We expect ARPM to be steady over FY12-15, as the increase in share of data services is likely to nullify the modest decline in voice tariffs. According to our estimates, ARPM would increase beyond FY14.

Fig 11 – Share of non-voice in revenues to increase

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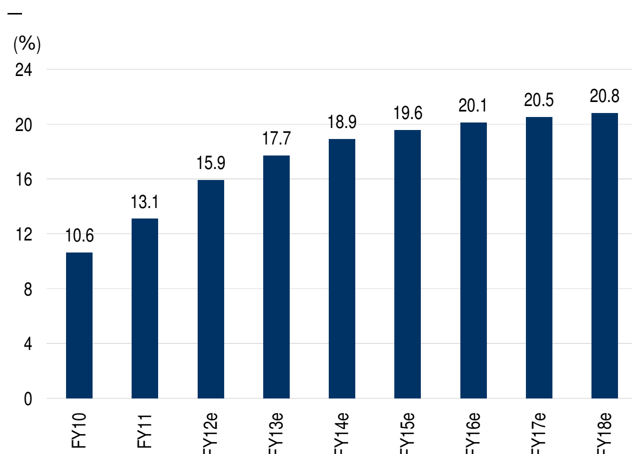
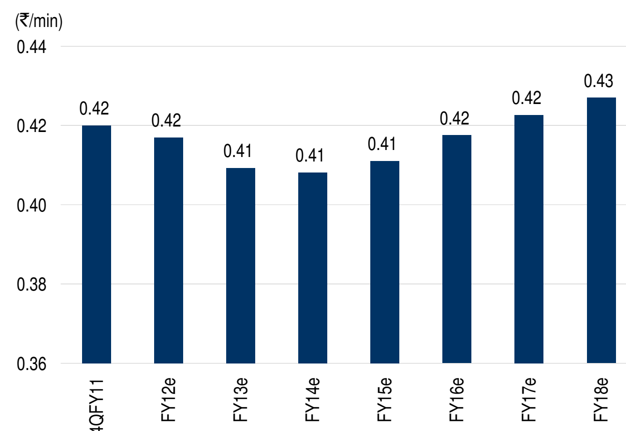


Source: Companies, Anand Rathi Research Note: Based on data for Bharti and Idea

Fig 12 – ARPM to be largely steady over FY12e-15e; and to rise in the long term



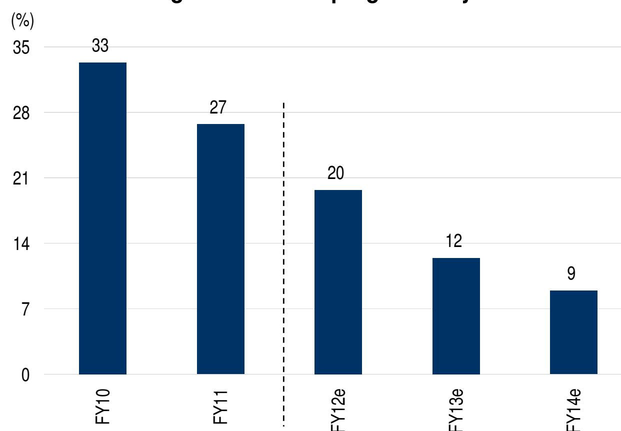
Source: Companies, Anand Rathi Research Note: Based on data for our coverage companies

In the years ahead, we expect wireless minutes growth to be lower than the 27% growth observed over FY09-FY11. We expect our coverage companies to see 16% CAGR in wireless minutes over FY11-13, driven by:

1. Increase in subscriber penetration – current wireless penetration based on active subscriber base (i.e. as per VLR data, published by TRAI) is 48%, which is still lower than other emerging market countries such as China (67%), Brazil (~110%) and Mexico (80-85%). Importantly, rural wireless penetration is still at 31% (based on total subscriber base, including inactive subscribers), which implies room for further increase;

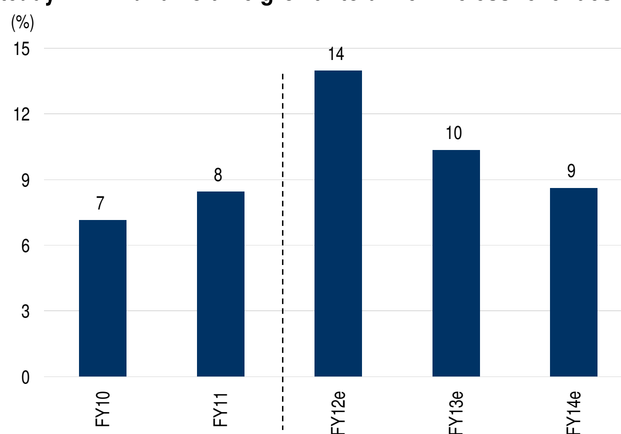
2. Increase in minutes of usage per subscriber (MOU), especially among the low-end subscribers. Disparity in usage levels is apparent from the fact that prepaid-MOU is about one-third of post-paid MOU.

Fig 13 – Wireless minutes growth to slow progressively



Source: Companies, Anand Rathi Research Note: Based on data for our coverage companies

Fig 14 – Steady ARPM and volume growth to drive wireless revenues (FY11-14e)



Source: Companies, Anand Rathi Research Note: Based on data for our coverage companies

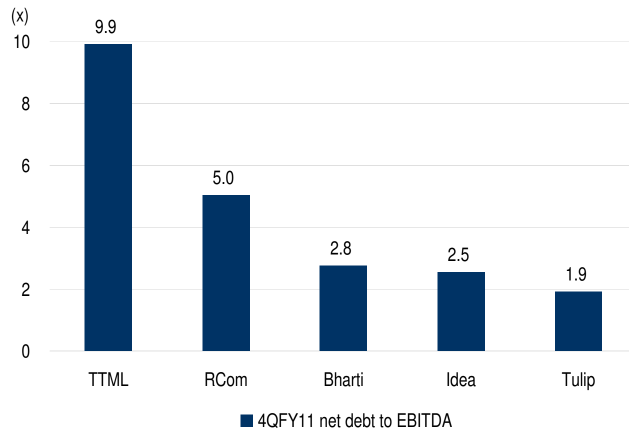
Factors expected to ensure tariff stability

Constrained investment capacity of aggressors to limit disruptive pricing

Heavy financial leverage to keep challengers' aggression in check

The telcos that had triggered tariff wars in the industry during 2HCY09 – RCom, Tata Teleservices (TTSL), and new telcos – have accumulated significant debt over the last few years due to heavy investments (GSM launch by RCom and TTSL, 3G auctions, start-up losses for new telcos). Besides, the sharp tariff cuts have put their profitability/asset productivity under pressure, resulting in elevated leverage ratios.

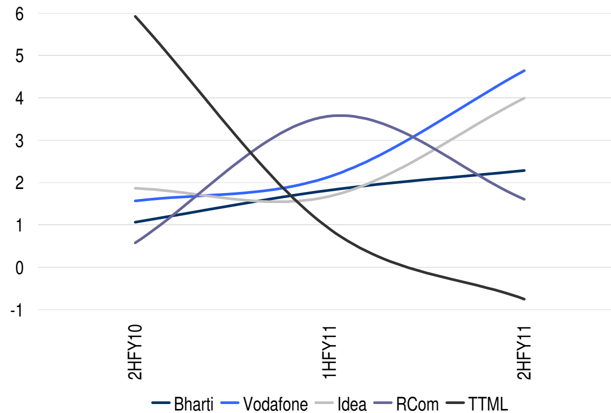
Fig 15 – Challengers grapple with high financial leverage



Source: Companies

Given the elevated leverage ratios, strained profitability, regulatory risks faced by many of the telcos, further borrowing or raising of equity would be difficult. We believe funding challenges may restrain aggressors from undertaking disruptive price cuts. Notably, telcos such as RCom and TTML have seen their elasticity declining to below that of peers in recent quarters.

Fig 16 – Tariff elasticity [a] of RCom and TTML has declined



Source: Companies [a] Tariff elasticity in 2HFY10 = % change in traffic in 2HFY10 over 1HFY10 / % change in ARPM

We believe the focus of these companies would be on leveraging their assets. RCom's management, at its recent earning calls, stated that the company's focus would shift to maximizing yield on its investments by diverting assets from low-yielding/low-margin services (free minutes, PCO business) to high-yielding ones (paid minutes, data services).

New telcos Uninor and Sistema-Shyam have suffered quarterly EBITDA losses of US$175m and US$85m, respectively

Huge cash-burn for new telcos would limit price aggression

Quarterly financials of new telcos in the Indian wireless market demonstrate the huge cash-burn these telcos are faced with. This, coupled with challenges in funding, would prevent them from further undertaking any significant price undercutting. We believe that the focus of these telcos would be on milking existing investments. Telenor has already cut back on its capex and is focusing on increasing ARPM.

Fig 17 – New telcos facing heavy cash-burn

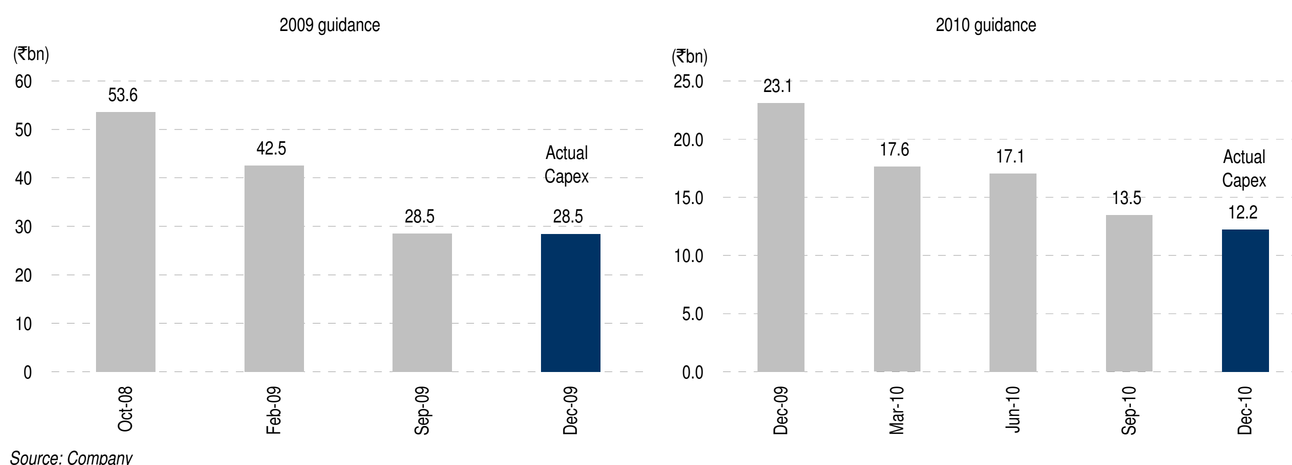
(US$m)	2QCY09	3QCY09	4QCY09	1QCY10	2QCY10	3QCY10	4QCY10	1QCY11
Uninor								
Revenues	0	0	0	10	17	36	68	97
EBITDA loss	12	23	112	170	185	188	174	181
Capex	65	326	198	124	59	33	59	57
Total cash-burn	**77**	**349**	**310**	**294**	**244**	**221**	**233**	**238**
Sistema-Shyam								
Revenues	7	10	14	17	23	32	43	43
EBITDA loss	**41**	**71**	**80**	**77**	**85**	**86**	**(82)**	**(82)**

Source: Companies

Slower capex by challengers to reduce industry overcapacity

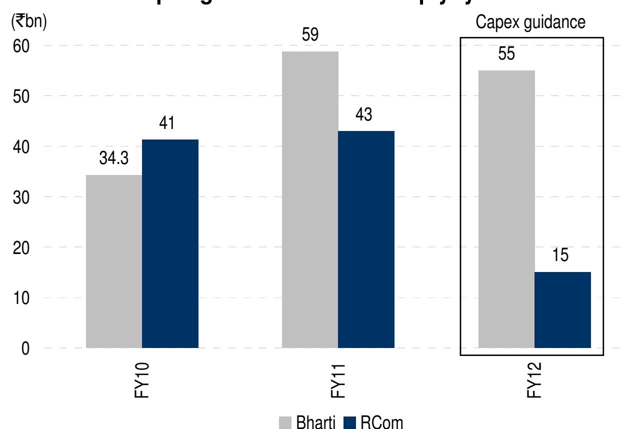
Challengers in the market have cut or are planning to cut their capex plans. In our view, this reflects their balance sheet constraints, the need to limit losses and/or their inability to generate justifiable returns on investments. Slower expansion would address the industry overcapacity.

Fig 18 – Uninor has been trimming its capex guidance



Source: Company

Fig 19 – RCom's FY12 capex guidance marks sharp yoy decline



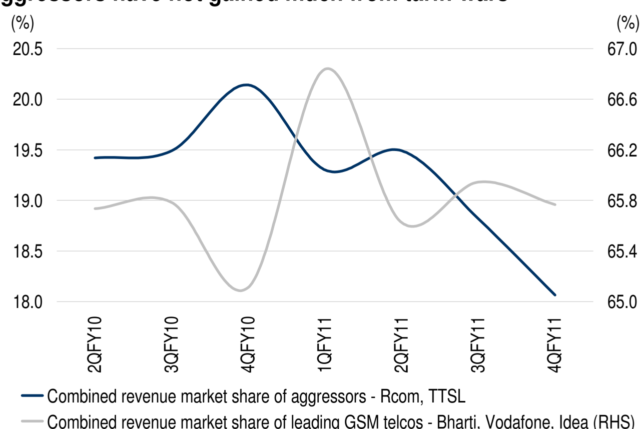
Source: Company

Tariff cuts did not help challengers gain much ground

Tariff retaliation by leading telcos helped protect and consolidate their market share

While Tata Teleservices registered a surge in wireless traffic/revenues following its aggressive per-second billing plans, the traction faded in subsequent quarters. On the other hand, RCom did not see any significant upswing in its wireless traffic/revenues. The combined revenue market share of TTSL and RCom rose initially (2QFY11-4QFY11) after sharp cuts. This was partly aided by the wait-and-watch strategy of leading GSM players, which resulted in traffic and revenue leakage in favor of aggressors (especially TTSL). However, the large GSM incumbents have managed to win back revenue share after retaliatory tariff cuts.

Fig 20 – Aggressors have not gained much from tariff wars



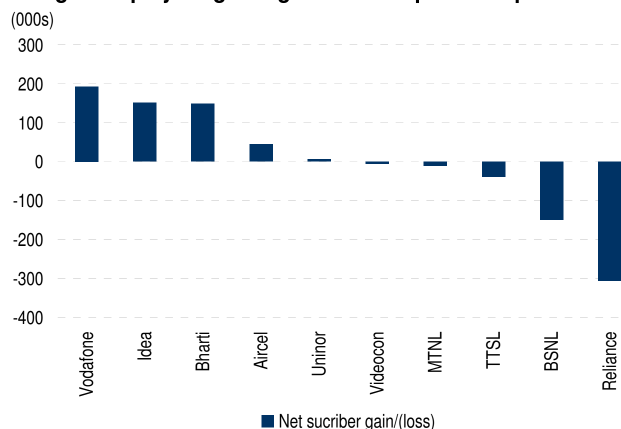
Source: Companies

We believe the story that has played out in the Indian wireless market – of the market leader protecting its market share against aggressive challengers at the cost of price/margin – is largely in line with trends in other countries and industries. This demonstrates the futility of price undercutting if market leaders intend protecting their market share.

Importance of non-tariff factors

While the leading GSM players undertook retaliatory tariff cuts, their tariffs continue to be at a premium to those of aggressors. Despite the premium, they have been able to consolidate their market share. This shows the importance of factors other than tariffs (network quality, branding and promotion, customer service, etc.) in protecting and gaining market share. It is worth noting that initial MNP data shows 'net' flow of subscribers from tariff aggressors (RCom, TTSL) towards leading GSM players (such as Bharti, Vodafone and Idea).

Fig 21 – Leading GSM players gaining in MNP despite tariff premium



Source: COAI [a] Data as of Mar '11

3G to be an important differentiator with the leaders

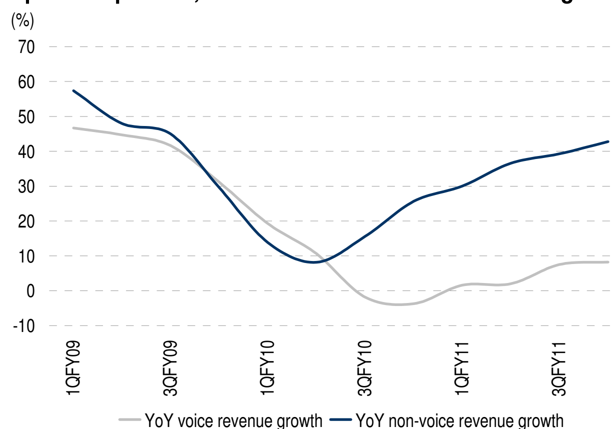
Tariff cuts in the past 18 months have mainly focused on the prepaid segment. As a result, there is no substantial premium in tariffs of leading GSM incumbents (Bharti, Vodafone, Idea) over tariffs of aggressors (RCom, Tata Tele, new telcos) in the market. However, as far as post-paid segment and data services are concerned, the leaders enjoy a tariff premium over competitors, and this could be at risk in future.

However, 3G services are likely to be a key differentiator with the leaders to protect their high-end subscribers. Note that there are likely to be only four or five private 3G operators in any circle (including 2G-only operators sharing 3G networks of others in any circle) in contrast to eight or nine 2G operators in most circles.

3G has the potential to be a significant growth driver for Indian telcos, owing to:

- **Existing base of data users:** For leading telcos such as Bharti and Idea, data already accounts for 13-15% of their wireless ARPU/revenues. In addition, these companies have seen strong growth in data revenues. We believe the present base of 2.5G data users provides a strong platform for 3G to grow in India.

Fig 22 – Despite competition, Bharti's non-voice revenues have grown stoutly



Source: Companies

The vibrant entertainment sector (film, television) and the popularity of sports (chiefly cricket) are significant positives for 3G growth in India

- **Presence of content:** A vibrant entertainment sector (film and television) and the popularity of sports (chiefly cricket) is a significant advantage for 3G growth in India. Notably, caller ring-back tunes (which are mainly popular movie songs) are a significant revenue generator for VAS companies, reportedly accounting for ~50% of their revenues. Such applications transcend the rural-urban divide and demographic barriers (illiteracy, lack of sophistication in data use). Besides entertainment/sports, a slew of other universal VAS services (which include Internet access, messaging, social networking, video calls/chats, etc.) could aid rapid uptake of 3G in the country.

Deployment of 3G networks in India itself and China (which is a few quarters ahead of India on the 3G-deployment front) would also drive economies in handset and equipment markets

- **Strong eco-system:** We believe that the annual revenues of the Indian VAS sector (ex-peer-to-peer SMS) have grown to US$1.25bn-1.5bn. The industry has established a set of diverse players – such as telecom service-providers, independent VAS-service-providers, content aggregators, content generators. We believe the existing VAS ecosystem could be easily leveraged to drive 3G growth in India. Besides the VAS eco-system, global handset- and equipment-systems are also well developed, considering 3G has been around for several years now. In addition, deployment of 3G networks in India itself and China (which is a few quarters ahead of India on the 3G deployment front) would also drive economies in handset and equipment markets.
- **Untapped opportunities:** There are several mobile VAS applications that have potential for exploitation in India. For instance, mobile payments have been a big draw for telecom/VAS service-providers in emerging markets such as Africa. However, in India, steps to exploit these markets have been initiated only recently. Besides, there are opportunities galore in the fields of mobile education, mobile health and mobile governance.

Expected consolidation in the market

While the big-bang consolidation may not be possible in the near- to medium-term due to regulatory bottlenecks, we believe the market is likely to consolidate organically (leaders gaining market share). In the long term, easing barriers to exit could aid faster consolidation (details on potential for consolidation mentioned in subsequent sections).

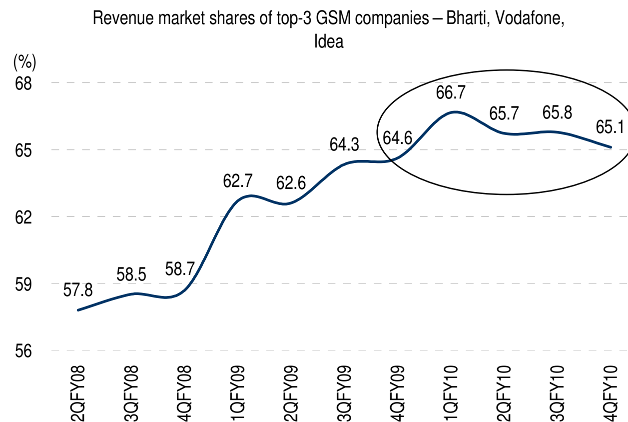
Industry structure to improve

We believe that consolidation in terms of acquisitions, mergers and exits is unlikely, at least in the near- to medium-term, due to regulatory bottlenecks. However, the market is likely to see consolidation in terms of revenue share. The lowering of exit barriers could aid quicker consolidation. Notably, the telecom ministry, in various statements, appears to be supportive of the industry.

Organic consolidation to resume

The entry of more operators (fresh entrants, GSM networks of CDMA telcos, circle expansion by regional players) in wireless markets in the past 18 months has not led to any substantial market fragmentation. However, it halted the consolidation that was underway.

Fig 23 – Entry of new players had halted industry consolidation

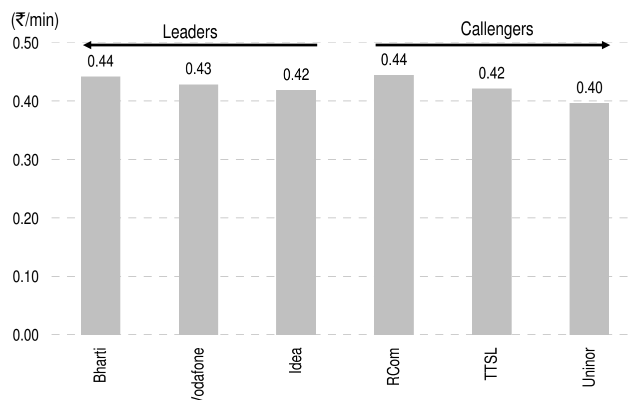


Source: TRAI

We believe that consolidation in terms of acquisitions, mergers and exits is unlikely, at least in the near-to-medium term, due to regulatory bottlenecks. However, the market would see consolidation in terms of revenue share owing to:

1. **Lack of significant pricing differences between leaders and challengers.** Following the tariff retaliation by leading telcos during the industry price wars towards end-CY09, there is currently no significant difference in the pricing of leaders and challengers.

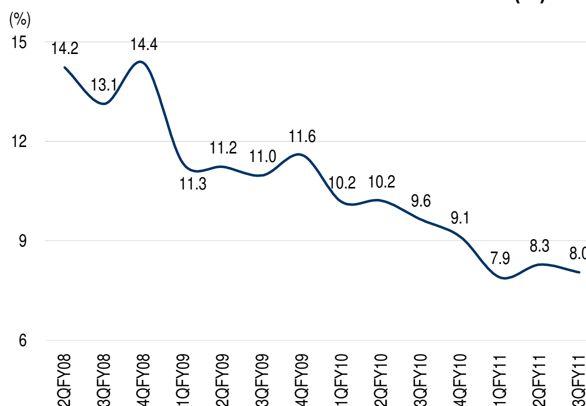
Fig 24 – ARPM comparison (3QFY11): Leaders vs. challengers



Source: Companies

2. **Ongoing market-share deterioration of BSNL/MTNL:** In the past two-and-a-half years, government-owned telcos BSNL (not listed) and MTNL (MTNL IN/MTNL.BO, not covered), have lost 6.2 percentage points (pps) of revenue market share to private telcos. In fact, the loss in market shares of these telcos has provided a cushion to other telcos. We believe the trend will continue.

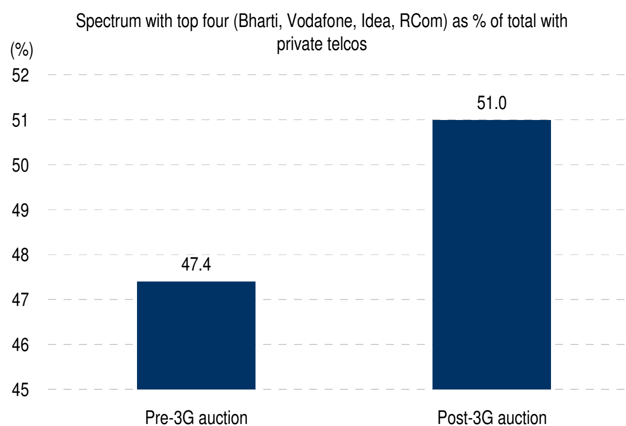
Fig 25 – Combined revenue market share of BSNL and MTNL (%)



Source: TRAI

3. **Consolidation of spectrum ownership, following the 3G auctions in May '10.** New telecom companies stayed away from the 3G auctions leading to consolidation of spectrum holdings of the telecom companies.

Fig 26 – Spectrum consolidation, post-3G auctions in May '10



Source: WPC

4. **Funding challenges for challengers** (RCom, TTSL, fresh entrants). We believe funding challenges may restrain aggressors from undertaking disruptive price cuts. Notably, telcos such as RCom and Tata Teleservices (Maharashrtra) (TTML) have seen their elasticity declining to below that of peers in recent quarters.

Easing of exit barriers could be the icing on the cake

Government plans to address outstanding regulatory and policy issues through the introduction of NTP 2011; it plans to finalize the new policy by end-2011

While presenting a progress report on the formation of a National Telecom Policy 2011 (NTP 2011), the communications and information technology minister said merger and acquisition (M&A) norms need to be made more liberal. Liberal M&A norms could result in an easier exit for telcos intending to quit.

Spectrum issue, the biggest barrier to consolidation

Present M&A regulations and those recommended by TRAI, place significant barriers to M&As in terms of the cap on spectrum holdings of the combined entity, payouts and regulatory uncertainties. This is significant as spectrum acquisition is likely to be the key motivating factor in potential M&As.

Fig 27 – Key barriers to exits, M&As and consolidation, under prevailing regulations

	Current regulations (Intra-circle M&A norms, April '08)	TRAI's May '10 recommendations	Implications
Spectrum entitlement	The combined entity can hold as much spectrum of combining entities as is entitled, as per subscriber base-linked benchmarks, and surrender the excess. However, the use of subscriber base-linked benchmarks has been practically suspended, resulting in a policy vacuum	(1) a cap of 14.4/10.0 MHz for GSM/CDMA on the spectrum held by the combined entity; excess to be returned; (2) Merged entity to pay market price on spectrum in excess of 6.2MHz; (3) a transfer charge at 5% of difference between transaction price and total spectrum price shall be paid to the government	M&A remains virtually out of bounds, as in many cases the acquirer's main interest in M&A would be the target company's spectrum
Spectrum-sharing		(1) Spectrum sharing only allowed if each telco holds no more than 4.4MHz/2.5MHz of GSM/CDMA spectrum; (2) Sharing entities will pay the pro-rated current price of spectrum beyond 6.2/5 MHz in the ratio of spectrum held by them individually	Sharing involving large telcos is ruled out as they hold spectrum beyond 4.4MHz/2.5MHz in most circles
Market share	For an M&A to be allowed, the revenue market share of the combined entity should not exceed 40%	For an M&A to be allowed, the revenue market share of the combined entity should not exceed 30%	M&A involving large telcos is ruled out

Source: DoT, TRAI, Anand Rathi Research

The telecom minister appears supportive of the industry

Minister's statements at the Roundtable Conference with telecom service providers held in Mar '11

"And this [telecom] sector is not just about pricing. It is not just about what spectrum would cost, what the service provider should pay, what the government should earn in revenue. I think if we look at it only from that standpoint, it would be a very shortsighted way of looking at this sector. This sector is a vehicle to reach the benefits of the communications and information technology revolution to the people of India. This is the ultimate aim of the sector. And so, in order to do that, we cannot kill the goose that lays the golden egg. We cannot kill the sector."

(Source: Transcript of the Roundtable Conference published on the DoT website)

Minister's statements during a press conference held on 10 Apr '11, announcing progress on NTP 2011

"Though M&A rules would be liberalized further, it would be ensured that there are at least six operators in each circle to ensure sufficient competition. They may also allow the sharing of spectrum but under certain conditions, besides conducting a regular audit of spectrum."

(Source: Media reports)

The supportive stance of the minister may be driven by:

1. **Need to resolve regulatory lock-jams in several issues (including charges for spectrum, licensing, M&As):** The ongoing 2G controversy is a huge embarrassment for the government. Even as investigations continue, the government would focus on resolving outstanding regulatory issues through NTP 2011. We believe that the support of telcos is necessary for the government to introduce the new Telecom Policy. Unilateral decisions by the government could potentially lead to litigation.
2. **Softening of stance, post-3G 'bonanza':** The 3G/BWA spectrum

auctions held in May '10 resulted in a massive bonanza for the national exchequer, with ₹1trn in proceeds. This, in addition to annual contribution in the form of license/spectrum fees (~₹150bn) and service tax, could have resulted in a softening of stance by the ministry towards the sector.

Potential benefits of easing barriers to M&A and consolidation

1. **Improved investor sentiment:** We believe that potential exits/consolidation would not lead to any immediate tangible benefits for the sector, as fresh entrants have not made significant headway in the market (in revenue market share). However, consolidation would improve assurance of tariff stability and thus is sentimentally positive for the sector.

2. **Increase in spectrum supply for incumbents:** The potential exit of new players (either through M&As or surrender of licenses) would make the additional spectrum available to large telcos.

Regulatory risks are manageable

Even as the focus is shifting towards growth, the proposed policy changes and ongoing 2G investigations continue to pose risks. We believe that of our wireless coverage universe telcos, Bharti is most strongly placed to weather regulatory risks, followed by Idea. Bharti and Idea do not face significant risks from 2G investigations, which are more focused on the fresh entrants and dual-technology operators, in our view. Bharti also faces limited impact from proposed regulatory changes, as compared with peers.

Regulatory risks: Proposed policy changes

The proposed policy changes on the lines of TRAI's May '10 and Feb '11 recommendations and recent announcements regarding NTP 2011 by the telecom minister have negative implications for all telcos. TRAI's proposals pertaining to a one-time fee on 'excess' 2G spectrum, increase in annual spectrum usage fees, license renewal fees and levy of license fees on ISP and the tower business would have a negative impact. However, the proposal to reduce annual license fee rate would offer some relief.

Fig 28– Impact of potential regulatory changes on Indian telcos

	Bharti			Idea			RCom		
	₹bn	₹/sh	% of TP	₹bn	₹/sh	% of TP	₹bn	₹/sh	% of TP
1 One-time fee for 'excess' 2G spectrum	(43)	(11.3)	**(2.5)**	(15)	(4.6)	**(4.8)**	(1)	(0.6)	**(0.6)**
2 License renewal cost (PV)	(87)	(22.8)	**(5.0)**	(41)	(12.5)	**(13.0)**	(30)	(14.6)	**(16.2)**
3 Increase in spectrum-usage fee (SUF) as % of AGR	(46)	(12.0)	**(2.6)**	(15)	(4.5)	**(4.7)**	(3)	(1.4)	**(1.6)**
4 Levy of 6% license fee on the tower and ISP businesses	(36)	(9.4)	**(2.1)**	(8)	(2.5)	**(2.6)**	(25)	(11.9)	**(13.2)**
5 Reduction in annual license fee to a uniform 6%	80	21.0	**4.6**	38	11.5	**12.0**	23	11.0	**12.2**
Total impact	**(131.0)**	**(34.5)**	**(7.6)**	**(41.3)**	**(12.5)**	**(13.1)**	**(36.1)**	**(17.5)**	**(19.4)**
Impact excluding #4	**(95.3)**	**(25.1)**	**(5.5)**	**(33.2)**	**(10.1)**	**(10.5)**	**(11.5)**	**(5.6)**	**(6.2)**

Source: TRAI, Anand Rathi Research

Key recommendations of TRAI

One-time fee for 'excess' 2G spectrum: TRAI has recommended the imposition of a one-time fee on spectrum held by GSM telcos in excess of 6.2MHz. Bharti, Idea, Vodafone and BSNL are amongst the most impacted telcos, by virtue of being the earliest entrants in the GSM market, thus accumulating excess spectrum in many of their circles. RCom and TTSL hold less than 6.2MHz of spectrum in their GSM circles (excluding Bihar in the case of RCom).

Our estimates regarding the impact on telcos is based on the following:

a) 2G price used to estimate the one-time fee is based on TRAI's Feb '11 recommendations. In Feb '11, TRAI recommended prices (₹/MHz) for excess GSM spectrum held across different circles in India. Aggregate all-India price is ₹46bn/MHz.

b) We have valued excess 900MHz spectrum and spectrum in excess of 8MHz at respectively 1.5x and 1.3x the price recommended by TRAI in May '10.

License renewal fees: TRAI has recommended that telcos, on expiry of their licenses, should pay a fee to renew their licenses for a 10-year term. Eight and nine licenses of Bharti and Idea come up for renewal by end-CY16 respectively. While RCom's renewal fee payments would be back-ended (earliest renewal in CY17), it faces renewal of two sets of spectrum

(GSM spectrum held by RCom and Reliance Telecom, and CDMA spectrum held by RCom). We have estimated the present value of renewal payments based on a 12.5% discount rate and 4% inflation rate.

Increase in spectrum usage fees: TRAI also recommended an increase in spectrum usage fees, as per the figure below.

Fig 29 – Spectrum usage fee as % of adjusted gross revenue (AGR)

Amount of spectrum	Current	TRAI reco
Upto 4.4 MHz (GSM)/ 5.0 MHz (CDMA)	3.0	**2.2/2.5**
Upto 6.2 MHz	4.0	**3.1**
Upto 8 MHz	5.0	**4.9**
Upto 10 MHz	6.0	**6.9**

Source: TRAI, DoT

Levy of 6% license fee on the tower and ISP businesses: TRAI has recommended bringing the tower and ISP businesses under the ambit of a annual revenue share-based license fee. All telcos have largely similar exposure to the tower business. However, we believe RCom has significant ISP revenues and would be most impacted (among the leading telcos) if the recommendation is accepted.

Reduction in annual license fee to a uniform 6%: TRAI has recommended a gradual decline (as per Fig 30 below) in annual revenue share-based license on mobile licenses to 6% from 6-10% at present. The proposed relief partly nullifies the impact of other recommendations.

Fig 30 – Proposed license fee structure for various telecom licenses

% of Adjusted Gross Revenues	Existing	FY11	FY12	FY13	FY14
UASL (fixed, wireless)					
Metros	10.0	10.0	9.0	8.0	6.0
A circles	10.0	9.0	8.0	7.0	6.0
B circles	8.0	7.0	6.0	6.0	6.0
C circles	6.0	6.0	6.0	6.0	6.0
ISP (excl. voice business)	0.0	4.0	5.0	6.0	6.0
IP-I (Infrastructure, tower)	0.0	4.0	5.0	6.0	6.0

Source: TRAI Recommendations, 11 May '10

For now, we do not factor in the license-fee impact on the tower and VPN businesses

We have captured the impact of TRAI recommendations (except the recommendation on the imposition of license fees on the ISP and tower businesses) in the target prices of Bharti and Idea.

Fig 31 – Impact of proposed regulatory changes captured in our price targets

(₹/share)	Jun '12e fair value	Impact captured in our price target	Price target
Bharti	480	**(25)**	**455**
Idea	106	**(10)**	**96**

Source: Anand Rathi Research

The impact on RCom's target price has been captured in a 10% discount (to estimated fair value) that we have applied to account for regulatory risks and 2G investigations-related overhang.

Reasons for excluding the license-fee impact on the tower and VPN businesses

At the roundtable conference with telecom service providers in Mar '11, the telecom minister asked telecom operators to arrive at a consensus on various issues in order to finalize a regulatory roadmap. While there are sharp differences among telcos regarding various regulatory issues, they are united against TRAI's proposal to bring the tower and the virtual private network (VPN) businesses within the license-fee ambit.

Moreover, several operators believe a license fee on the tower and VPN businesses does not satisfy the requirements of genuine licensing, as the government is not assigning any scarce resource (such as spectrum) or exclusive privileges. We believe the argument has some merit.

Besides, if the license fee is imposed on the tower and VPN businesses, a case could be made for telecom service providers to be allowed to deduct payments to tower/VPN companies from the service provider's adjusted gross revenues (AGR) so as to avoid the incidence of 'double taxation'. This treatment is similar to the one followed for interconnect charges that telcos pay to each other. If such deduction is allowed, we expect the net impact of the license fee on the tower business to be insignificant.

As a result, we focus on the impact of potential regulatory changes, apart from the levy of a license fee on the tower and VPN businesses.

Non-quantifiable risks

Unbundling of spectrum from license: Implications are back-ended

This would ease the key barrier (i.e., shortage of spectrum) to the grant of more licenses. An important implication of this change would be that prospective BWA operators (Reliance Industries, Qualcomm, Tikona) that have acquired BWA spectrum at auctions in May '10 could acquire a telecom license and use it to offer full-fledged telecom services. However, the eco-system for BWA/mobile services in the 2.3GHz spectrum band has not yet matured and large scale-deployments of full-fledged mobile services appear unlikely in the near-to-medium term.

Proposal for re-farming of the 900MHz spectrum: Early days to factor in the impact

TRAI has recommended that on the expiry of licenses, the spectrum held by a licensee in the 900MHz band should be replaced by assigning an equal amount of spectrum in 1800MHz. The freed spectrum in the 900 MHz band could then be distributed back to telcos for UMTS networks, (possibly through auctions, in our view).

We believe it is difficult to estimate the potential impact of spectrum re-farming. In our view, it is too early to capture the impact due to: i) the earliest of licenses would come up for renewal only in 2014-'15; ii) spectrum re-farming in 1800 MHz would require vacating spectrum from Defence and other government departments, which might be tedious and lengthy; iii) spectrum in 1800 MHz may not be sufficient to re-farm the 900 MHz spectrum, even after Defence vacates some spectrum; iv) TRAI has said it would undertake separate consultations to determine the process/timeline for re-farming; v) telcos may pass up the assigning of the 1800 MHz spectrum, thereby saving on renewal fees, and instead, use the proceeds to bid for 900 MHz spectrum.

Recent NTP 2011 announcement silent on details, target year-end deadline

The telecom minister has laid out the broad contours of the new Telecom Policy, NTP 2011, through press conferences in Jan '11 and Apr '11. Key announcements include:

1. De-linking of spectrum from license, which is in line with TRAI recommendations;

   Uniform revenue share-based license fee (the announcement is silent on the proposed rate of license fees; while TRAI recommended a rate of 6%, vs. the current 6-10%);

   M&A guidelines likely to be more liberal in NTP 2011; although there would be a floor of six competitors in each circle;

   Spectrum sharing to be considered;

   Formation of a committee for the National Spectrum Act. The Act could address long-term spectrum requirements, in our view.

The government aims to finalize NTP 2011 by end-CY11. The process would involve DoT finalizing its recommendations and submitting them to the Telecom Commission – its policy-making unit – for approval. DoT may have to refer its recommendations back to TRAI, if there are considerable deviations from the TRAI recommendations.

Nothing more to lose for Indian telcos

We believe that TRAI recommendations represent the maximum regulatory downside for the sector. We do not expect the telecom ministry's decision to be more negative than the TRAI recommendations, particularly as the telecom minister has taken a supportive stance of the sector in the various statements he has made so far. Besides, given the amount of negative publicity the regulatory issues have generated for the government, the ministry's focus would be on developing a robust/widely-acceptable policy rather than increasing government proceeds (especially after the bumper proceeds from the May '10 auction).

Regulatory risks: 2G investigations

The sector is facing investigations by various agencies – the Central Bureau of Investigation (CBI), the Joint Parliamentary Committee (JPC) and the Public Accounts Committee (PAC). We believe the focus of these investigations includes:

i) Loss to the exchequer due to the policy of issuing licenses (mostly to fresh entrants in early 2008) at a fixed price (benchmarked to the '02 auctions);

ii) Issue of dual-technology license (GSM spectrum to CDMA companies);

iii) Alleged bribes to secure licenses;

iv) False information in applications for telecom licenses by fresh entrants;

v) Charges that Swan Telecom was a front company for Reliance Communications.

Issues under investigation can be broadly classified as: i) policy issues

(issuing licenses at a fixed price rather than through auctioning, approval for use of dual technology); ii) criminal offences (bribes, false information in telecom licenses, etc). While the focus of the CBI will be on criminal offences, the PAC and JPC are expected to focus on policy issues.

Burden of fault in policy issues unlikely to fall on operators

On implementing unified licensing in '04, all telecom licenses were issued at a fixed price to various telcos, including incumbents such as Bharti, Vodafone and Idea as well as fresh entrants. The Comptroller and Auditor General (CAG) has said that the practice was contrary to TRAI's '03 recommendations, which were accepted by the Union Cabinet. Similarly, the allocation of GSM spectrum beyond 6.2 MHz, without any upfront fees, by the government is being questioned.

We believe the burden of fault in case of policy issues would lie with the government. In our view, beneficiary companies in these cases would not face any implications.

Criminal investigations focus on fresh entrants, dual-technology companies

We believe the focus of criminal investigations is largely on new telcos (false information in applications for telecom licenses, bribes) and RCom (links with Swan Telecom, bribes, false information in applications for telecom licenses). We understand that leading GSM telcos (Bharti, Idea and Vodafone) do not face the risk of investigation, based on information available so far.

Bharti is well placed as regards regulatory risks, followed by Idea

We estimate the potential impact (as a percentage of our target price) of the proposed policy changes on Bharti to be 6% (Fig 30), which is manageable in our view. Besides, Bharti does not face significant risks from the ongoing 2G investigations. While Idea too does not face risks from 2G investigations, the impact of the proposed regulatory changes is expected to be greater. Though policy changes do not have significant impact on RCom, the company faces strong risks from 2G investigations.

Fig 32 – Key recommendations of TRAI

Key issues for consultation		TRAI recommendation
1. Licensing issues	Spectrum limit	New licenses (UASL) should not come bundled with any spectrum
		Contracted spectrum for new licensees to be priced at 3G-winning bid; Auction of 2G spectrum (in 800/900 MHz and 1800 MHz bands) is not feasible as per TRAI
2. 2G Spectrum	Contracted amount	For existing UASL, the Contracted/Committed amount for GSM/CDMA is 6.2/5.0 MHz
	Spectrum limits	**Prescribed limit (or GSM spectrum cap) is 10MHz in Delhi/Mumbai and 8MHz in other circles**
	Allocation criteria	Subscriber-linked criteria for spectrum allocation to be done away with; **Allocation to be based on fulfilment of roll out obligations**
	Pricing	Telcos with 'excess' spectrum (>6.2MHz) should pay a One Time Fee (OTF) derived from the 'Current' price; **3G winning bid could be adopted as the 'Current' price**
		OTF to be worked out at Current price for spectrum up to 8MHz, and for spectrum beyond that it would be charged at 1.3x Current price
		900MHz spectrum to be valued at 1.5x Current price; 1800MHz valued at 1x 'Current' price
	Priority	[1] Telcos having initial spectrum i.e. 4.4/2.5MHz for GSM/CDMA; [2] Telcos having contracted spectrum awaiting further allocation upto prescribed limit; [3] New licensees awaiting start up spectrum
	Spectrum usage fee	**For both GSM and CDMA: At the rate of 0.5% per MHz for every MHz up to the contracted spectrum, and at 1% for every MHz beyond the contracted spectrum**
3. License fee		**License fee for 'access' services (wireless, wireline) should be progressively brought down to a uniform 6% of AGR by FY14, from 6-10% currently**
		ISPs and Infrastructure providers (tower cos) should be charged license fee at 6% of AGR versus NIL currently
4. License Renewal	Time frame	No change in existing regime: UASL can be renewed for additional 10 years, after the initial period of 20 years
	Spectrum reassignment	Government should reassign spectrum only up to the 'prescribed limit' or amount of spectrum before renewal, **whichever is less**
	Separate charges for license, spectrum	(1) License renewal fee of ₹200m for pan India; **(2) Spectrum reassignment fee at the 'Current' price,**
5. Roll-out obligations	New norms	Stricter obligations: 100% coverage of all habitations with population of >2000 within four years from effective license date; obligations for end of Year-2 and Year-3 also proposed
	Incentives	License fee reduction of 50bps/200bps for telcos covering 50%/100% of habitations with population of 500 to 2000
6. M&A	Maximum market share	Merged entity should have <30% market share (currently 40%) of total subs or revenues. Distinction between wireless and wireline is to be removed and entire access market treated as relevant market
	Spectrum cap	14.4/10.0 MHz for GSM/CDMA. Excess spectrum to be returned.
	Spectrum and other charges	Merged entity entitled to only 6.2MHz, and Current price is payable for balance spectrum. In addition, a transfer charge at 5% of difference between transaction price and total spectrum price is payable

Source: TRAI Recommendations – 11 May '10

Company section

20 June 2011

Bharti Airtel

Rating: **Buy**
Target Price: ₹455
Share Price: ₹380

Attractive mix of growth and stability; we reiterate a Buy

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Bharti offers a mix of stability and growth via its Indian and African/other South Asian operations. We raise our price target for Jun '12 to ₹455 (from ₹350 for Jun '11), largely due to the expected recovery in the Indian wireless market. We have factored in the impact (₹25/share) of potential regulatory payouts and introduce IFRS financial estimates.

- **Steady outlook for India operations.** Bharti has effectively dealt with industry tariff wars via a measured tariff response. Ahead, we expect it to benefit from tariff stability, steady growth in volumes and 3G contribution. The company's appeal lies in its market leadership, which is likely to result in stronger margins, return ratios and cash-flow generation. Moreover, of its peers, Bharti is the least exposed to regulatory risks.

- **African operations hold potential to raise growth profile.** We believe the macro outlook for the African wireless market is attractive. While Bharti's Africa operation has seen mixed trends since the Zain acquisition in Jun '10, we believe it holds potential to raise the company's growth profile. We value Bharti's Africa operations at Mar '12e EV of US$11bn, which implies ₹10/share equity value erosion (captured in our price target).

- **Valuation.** The stock trades at FY12e EV/EBITDA of 8.1x, which appears reasonable following the 15% EBITDA CAGR over FY12-14e. The implied EV/EBITDA-to-growth is ~0.54x, which compares favourably with the average of 0.64x for leading emerging market telcos. We maintain a Buy on Bharti. Risks: i) regulatory impact more than our estimated ₹25/share; ii) more-than-expected competition in India and Africa.

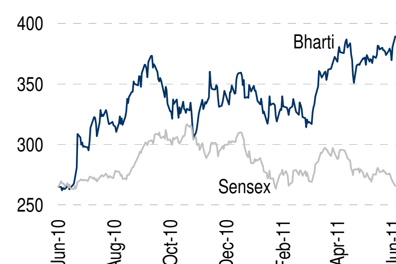
Key data	BHARTI IN / BRTI.BO
52-week high / low	₹400 / 260
Sensex / Nifty	18211 / 5460
3-m average daily volume	US$35.1m
Market Cap	₹1,432bn / US$32.0bn
Shares outstanding	3798m
Promoters (%)	68.3
Free float (%)	31.7
- Foreign institutions	17.2
- Domestic institutions	8.70
- Others	5.78

Key financials and valuations

Year-end: Mar (₹m)	FY10	FY11	FY12e	FY13e	FY14e
Revenues	418,472	594,672	710,701	808,881	889,547
EBITDA	168,609	204,041	251,282	291,700	332,804
Net profit	89,768	60,466	78,731	106,586	134,194
EPS (₹)	23.7	17.0	20.7	28.1	35.3
EPS growth (%)	6.5	(28.4)	21.9	35.4	25.9
P/E (x)	15.9	22.2	18.3	13.6	10.8
EV/EBITDA (x)	8.6	10.0	8.1	6.7	5.6
P/B (x)	3.4	2.9	2.6	2.2	1.9
RoAE (%)	16.7	16.2	17.0	17.0	17.1
Dividend yield (%)	0.3	0.3	0.5	1.3	2.0

Source: Company, Anand Rathi Research

Relative price performance



Source: Bloomberg

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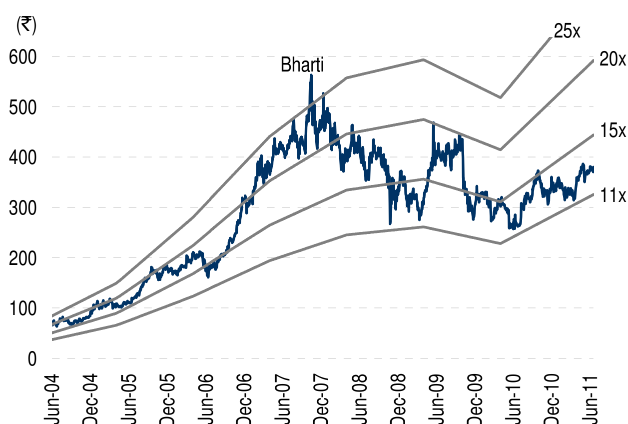
Quick Glance – Consolidated financials and valuations

Fig 1 – Income statement (₹m)

Year-end: Mar	FY10	FY11	FY12e	FY13e	FY14e
Revenues	418,472	594,672	710,701	808,881	889,547
EBITDA	168,609	204,041	251,282	291,700	332,804
Depr. & amortization	(62,832)	(102,066)	(130,477)	(135,149)	(139,450)
Net other income	468	997	1,050	1,050	1,050
EBIT	106,245	102,972	121,855	157,601	194,404
Net finance exp	(5,333)	(20,179)	(24,553)	(21,852)	(15,520)
Other income / (exp)	4,178	(6,011)	0	0	0
PBT	105,091	76,782	97,302	135,749	178,883
Tax	(13,453)	(17,790)	(17,783)	(27,212)	(40,369)
Minority interest	(1,870)	1,474	(788)	(1,951)	(4,320)
Reported net income	89,768	60,466	78,731	106,586	134,194
EPS (₹)	23.74	17.00	20.73	28.07	35.34
DPS (₹)	1.0	1.0	2.0	5.0	7.5
EBITDA growth (%)	11.2	21.0	23.2	16.1	14.1
EPS growth (%)	6.5	(28.4)	21.9	35.4	25.9

Source: Company, Anand Rathi Research

Fig 4 – Rolling 12-month forward P/E



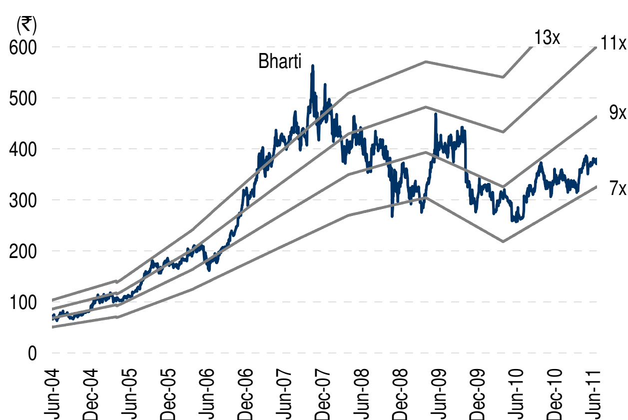
Source: Bloomberg, Company, Anand Rathi Research

Fig 2 – Balance sheet (₹m)

Year-end: Mar	FY10	FY11	FY12e	FY13e	FY14e
Share capital	18,988	18,988	18,988	18,988	18,988
Reserves & surplus	402,952	468,680	538,554	622,999	723,980
Shareholders' funds	421,940	487,668	557,542	641,987	742,968
Minority interests	25,285	28,563	29,351	31,302	35,623
Total debt	101,898	616,708	656,708	599,208	554,208
Other non-curr. liab.	34,263	46,650	47,910	50,619	51,620
Capital employed	**583,386**	**1,179,589**	**1,291,512**	**1,323,116**	**1,384,419**
Net fixed assets	482,629	651,426	689,349	710,257	719,965
Net intangible assets	59,890	637,317	613,538	589,580	568,175
Other non-curr assets	30,736	64,244	74,442	83,163	92,983
Net working capital	(67,554)	(189,941)	(149,379)	(151,607)	(145,439)
Cash & equivalents	77,685	16,543	63,562	91,723	148,736
Capital deployed	**583,386**	**1,179,589**	**1,291,512**	**1,323,116**	**1,384,419**
No. of shares (m)	3,798	3,798	3,798	3,798	3,798
Net debt/EBITDA (x)	0.14	2.94	2.36	1.74	1.22

Source: Company, Anand Rathi Research

Fig 5 – Rolling 12-month forward EV/EBITDA



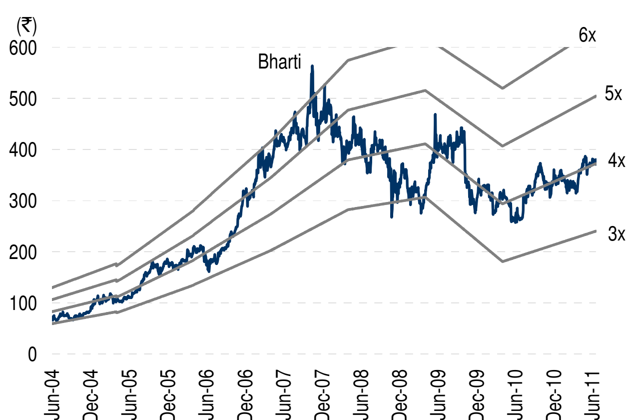
Source: Bloomberg, Company, Anand Rathi Research

Fig 3 – Cash-flow statement (₹m)

Year-end: Mar	FY10	FY11	FY12e	FY13e	FY14e
Profits before tax	105,091	76,782	97,302	135,749	178,883
Depr/amort /non-cash items	64,806	104,164	130,571	135,243	139,544
Taxes paid	(21,961)	(24,388)	(27,981)	(35,933)	(50,188)
Chg in working capital	12,227	8,203	(39,395)	4,842	(5,261)
CF from operations	**160,163**	**164,761**	**160,497**	**239,901**	**262,979**
Capex (incl. entry fee)	(130,865)	(276,865)	(140,954)	(132,099)	(125,771)
Acquisitions/Invest/others	(7,085)	(326,086)	(24,813)	(14,080)	(28,506)
Free cash flow	**22,213**	**(438,190)**	**(5,270)**	**93,722**	**108,702**
Equity raised	0	(402)	0	0	0
Debt raised/(repaid)	(1,173)	429,586	40,000	(57,500)	(45,000)
Dividends paid	(4,442)	(4,428)	(8,958)	(22,142)	(33,213)
Acquisition of MI/others	(4,038)	(5,518)	(0)	0	0
Change in cash for year	**12,560**	**(18,952)**	**25,772**	**14,080**	**30,489**
Beginning cash	12,763	24,961	6,009	31,781	45,861
Closing cash	**25,323**	**6,009**	**31,781**	**45,861**	**76,350**

Source: Company, Anand Rathi Research

Fig 6 – Rolling 12-month forward EV/sales



Source: Bloomberg, Company, Anand Rathi Research

Investment argument

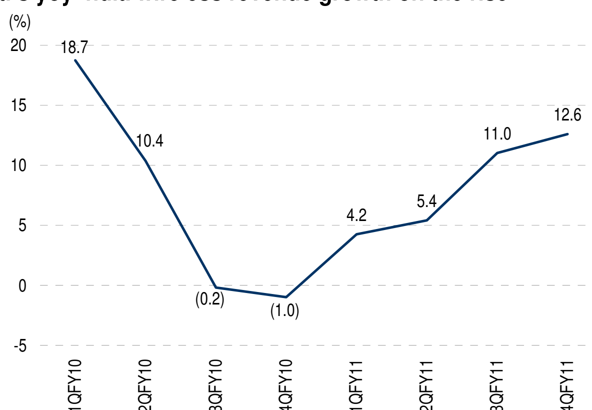
Bharti offers a mix of stability and growth via its Indian and African/other South Asia operations. We increase our target price to ₹455 for Jun '12e from ₹350 for Jun '11e, largely due to the expected recovery in the Indian wireless market. We have factored in the impact (₹25/share) of potential regulatory payouts and also introduce IFRS financial estimates.

Attractive mix of growth and stability

Emerging strongly from the industry downturn

Bharti has effectively dealt with industry tariff wars via a measured-tariff response, leading to strong traffic elasticity. While it saw strong traffic growth through 2HFY10, its revenues declined yoy due to a fall in ARPMs. However, since 1QFY11, Bharti's India wireless revenue growth has been steadily rising (Fig 7), following the stability in voice tariffs in the industry and the climbing share of non-voice services.

Fig 7 – Bharti's yoy India wireless revenue growth on the rise



Source: Company Note: Revenues based on reported subscriber and ARPU for Indian wireless operations

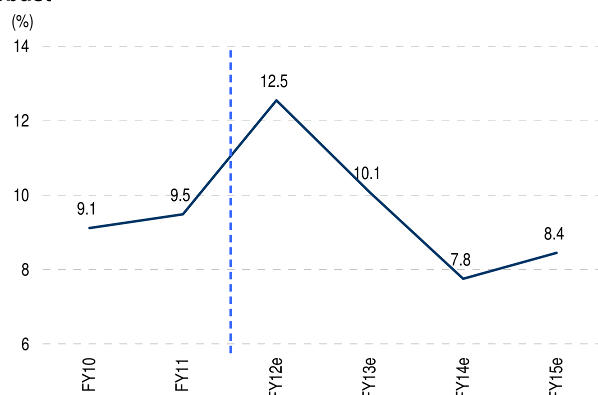
Bharti's wireless EBITDA margin continued to steadily decline through FY11, hitting a low of 33.3% in 4QFY11 (300bps lower yoy). While part of the decline may have been owing to high competition (ARPM was down 8% yoy), we believe it was also driven by: i) increase in spectrum usage fees from 1QFY11; estimated impact: ~120bps; ii) impact of Bangladesh telco – Warid Telecom; estimated impact: (30-40bps); and iii) sharp up-tick in SG&A costs, which could ease in the coming quarters.

Leadership position to help Bharti ride the recovery wave in industry

Bharti is poised to benefit from recovery in sector growth. While it may lack the growth profile of GSM peers (Vodafone, Idea, Aircel) that continue to expand their footprints, Bharti's appeal lies in its market leadership, which is likely to result in stronger margins, return ratios and cash-flow generation.

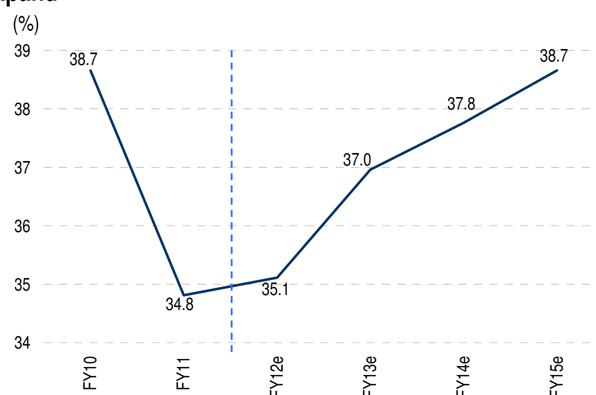
Tariff stability would offer telcos, including Bharti, opportunities to expand EBITDA margin, due to the operating leverage inherent in the telecom business. In our view, wireless EBITDA margins bottomed in 4QFY11 and would start expanding from 1QFY12. Our FY12e EBITDA margin of 35.1% is almost flat compared with FY11, but entails 180bps expansion as against 4QFY11.

Fig 8 – Wireless revenue growth (India + South Asia) to be robust



Source: Company, Anand Rathi Research

Fig 9 – Wireless EBITDA margin (India + South Asia) to expand



Source: Company, Anand Rathi Research

Bharti has an attractive portfolio of GSM and 3G spectrum. Of its GSM spectrum, ~51% is of the superior 900MHz band, the highest for a private telco. This is owing to it being the first mover in many telecom circles. Bharti has 3G spectrum (2 x 5MHz in the 2100MHz band) in 13 circles; in all except two (Orissa and Punjab), Bharti is the market leader.

Strong free cash-flow generation ahead

Management has given guidance for FY12 capex of US$1.5-1.6bn for its India + South Asia operations (ex. tower business). We estimate capex for wireless business to be ~US$1.2bn in FY12e, which implies simple FCF generation (EBITDA less capex) of ~US$2bn. After factoring in a moderation in capex requirement (owing to limited expansion in coverage, completion of initial 3G build-out), we expect the FCF to expand to US$2.5bn by FY13e. We estimate FCF for consolidated India + South Asia operations (i.e. including the non-wireless businesses) to touch US$3.2bn by FY13. This translates into an FCF yield (FCF-to-EV) of 8%, based on our target FY12e EV of US$40bn for India + South Asia.

Fig 10 – India + South Asia EBITDA, capex and simple FCF

₹bn	FY10	FY11	FY12e	FY13e	FY14e	FY15e
India + South Asia Wireless						
EBITDA	128	126	143	166	182	201
Capex	34	59	55	56	52	56
FCF (EBITDA - capex)	94	67	88	110	130	145
FCF (US$bn)	**2.1**	**1.5**	**2.0**	**2.5**	**2.9**	**3.2**
India + South Asia consolidated						
EBITDA	171	175	205	232	256	284
Capex	82	107	93	90	82	83
FCF (EBITDA - capex)	89	69	112	142	174	201
FCF (US$bn)	**2.0**	**1.5**	**2.5**	**3.2**	**3.9**	**4.5**
FCF yield (FCF-to-EV) (%) [a]	**4.8**	**3.7**	**6.0**	**7.7**	**9.4**	**10.9**

Source: Company, Anand Rathi Research *[a] based on our target FY12e EV of US$40bn for India + South Asia.*

Low impact from regulatory risks

Bharti is better placed than leading peers Idea and RCom on the regulatory risk front. We estimate the quantifiable part of the impact, of the TRAI recommendations, to be ₹25/share, which is ~5% of our Mar '12e target price (vs. 11% for Idea). Besides, Bharti is not faced with significant risk from 2G investigations, which are focused on the new entrants and dual-technology operators, in our view.

Africa has potential to raise Bharti's growth profile

Macro view of the Africa opportunity is attractive

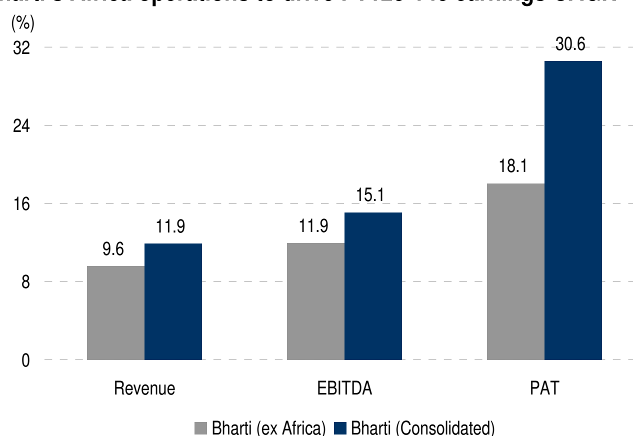
We believe investment possibilities in the African wireless market, from a macro-perspective, are attractive.

African wireless markets, generally, have low penetration, low levels of usage and less competition, thereby entailing attractive investment potential. Penetration in the 15 countries in which Bharti operates is ~40%. On the competition front, African markets are generally concentrated. In the most fragmented market of Nigeria, the top three telcos account for 85% of subscribers. Besides, a number of countries in Africa have undertaken and plan to undertake mobile number portability (MNP) implementation and reduce termination rates (mainly in countries where Bharti has a weak market position and has hence has potential to benefit), as well as 3G spectrum allocation (including countries where Bharti enjoys strong market share).

Potential to drive long-term growth

While Bharti Africa's performance since acquisition in Jun '10 has been mixed, we believe its Africa operations hold significant potential to lift overall growth profile. We expect Bharti's FY11-13e EBITDA CAGR at 27% for Africa operations (based on the annualized EBITDA for FY11), despite conservative forecasts (EBITDA of US$1.4bn in FY13e) vs. management targets (US$2bn).

Fig 11 – Bharti's Africa operations to drive FY12e-14e earnings CAGR



Source: Anand Rathi Research

We have valued Bharti's African operations at US$11bn (Mar '12e), implying ₹10/share value erosion (captured in our target price).

Valuation, Price target and Risk

Jun '12e price target of ₹455/share

We arrive at our price target based on separate DCF analysis for the company's India + South Asia as well as Africa businesses. Our target price captures a potential downside from TRAI recommendations.

Fig 12 – Price target and components

(₹bn)	FY12e EV	Implied FY13e EV/EBITDA (x)	FY12e Net debt	FY12e Equity value	Jun '12e Target price (₹)
Contribution of India + South Asia	1,773	7.8	64	1,709	465.0
India + South Asia business	1,868	8.2	64	1,804	490.0
Impact of regulatory issues	(95)			(95)	(25.0)
Contribution of Africa business	493	7.8	529	(37)	(10.0)
Bharti (consolidated)	2,266	7.8	593	1,673	455.0

Source: Anand Rathi Research

Fig 13 – Price target revision

(₹/share)	
Previous Jun '11e price target	**350**
Impact of roll over to Mar '11e	45
Revision in regulatory impact	(10)
Revision in value from African operations	15
Revision in value from Indian operations	55
Revised Jun '12e target price	**455**

Source: Anand Rathi Research

Fig 14 – DCF for India + South Asia business

Year-end: Mar (₹m)	FY12e	FY13e	FY14e	FY15e	FY16e	FY17e	FY18e	FY19e	FY20e	FY21e	FY22e
Revenue growth	11.8	11.3	7.9	8.2	7.3	6.5	4.9	4.5	4.3	4.1	3.9
EBITDA growth	16.6	13.5	10.4	10.8	9.3	7.2	5.1	4.8	4.4	4.1	3.9
FCF growth	90.4	20.5	7.9	19.8	11.1	7.6	5.1	6.4	3.1	2.8	2.5
EBITDA margin	38.8	39.5	40.5	41.5	42.2	42.5	42.6	42.7	42.7	42.8	42.8
FCF margin	18.6	20.1	20.1	22.3	23.1	23.3	23.3	23.8	23.5	23.2	22.9
Capex / sales	17.9	15.5	13.2	12.3	11.7	11.4	10.6	10.7	10.8	11.0	11.1
Return on operating assets (%)	12.9	15.2	17.1	19.7	22.2	24.4	26.5	28.7	31.0	33.3	35.4
Effective tax rate (%)	16.2	20.0	23.0	25.0	27.0	29.0	30.0	31.0	32.0	33.0	34.0
Current tax rate (%)	24.4	25.0	27.0	28.0	29.0	30.0	30.0	30.0	30.0	30.0	30.0
EBIT X (1-tax rate)	81,671	99,128	111,963	128,659	144,291	157,103	168,766	182,385	195,939	209,471	222,392
Depreciation & Amortization	83,926	84,911	88,286	90,293	91,642	92,465	92,650	92,546	92,479	92,244	91,772
	9,492	11,500	10,777	10,777	10,777	10,777	10,777	10,777	10,777	10,777	10,777
Change in net working capital	14,376	10,465	(3,433)	3,628	4,722	6,981	2,445	13,656	9,379	9,887	7,771
Operating FCF	**189,464**	**206,005**	**207,592**	**233,357**	**251,432**	**267,326**	**274,638**	**299,363**	**308,573**	**322,379**	**332,711**
Capital expenditure	(92,954)	(89,692)	(82,061)	(82,950)	(84,390)	(87,595)	(85,746)	(96,453)	(101,815)	(107,444)	(110,732)
Free cash-flow	**96,510**	**116,313**	**125,531**	**150,406**	**167,042**	**179,731**	**188,892**	**202,910**	**206,758**	**214,935**	**221,979**

Mar '12e DCF calculation	
Terminal growth (%)	4.00
Implied exit FCF multiple (x)	13.0
Implied exit EBITDA multiple (x)	6.9
NPV of cash flows	939,091
PV of terminal value	929,127
Enterprise value	1,868,219
Terminal value as % of EV	49.7
Net debt	63,905
Equity value	1,804,313
Equity value (US$ m)	40,410
Number of shares	3,798
Mar '12e equity value/share (₹)	470
Jun '12e equity value/share (₹)	**490**
Regulatory impact	(25)
Contribution to Jun '12e target price	**465**

Source: Anand Rathi Research

Attractive valuations for Bharti vs. global telcos, on growth-adjusted basis

Bharti trades at FY12e EV/EBITDA of 8.1x, which appears attractive on the back of the FY12-14e CAGR of 15%. The implied EV/EBITDA-to-growth translates into ~0.54x, which compares favorably with the average of 0.64x for leading emerging market telcos.

Fig 15 – Indian telcos: valuations

Year-end: Mar	Rating	Share price (₹) [a]	TP (₹)	Upside (%)	Market cap (US$ m)	P/E (x) FY12e	P/E (x) FY13e	EPS CAGR FY12e-14e	P/E to Growth (x)	EV/EBITDA (x) FY12e	EV/EBITDA (x) FY13e	EBITDA CAGR FY12e-14e	EV/EBITDA to-Growth (x)
Bharti	Buy	380	455	20	32,193	18.3	13.6	30.6	0.60	8.1	6.7	15.1	0.54
RCom	Sell	95	90	(5)	4,375	18.7	16.9	22.6	0.83	6.6	5.7	6.9	0.96
Idea	Buy	78	96	24	5,711	39.3	27.1	53.5	0.74	7.5	6.3	19.0	0.40
TTML	Sell	16	12	(27)	693	NM	NM	(18.6)	NM	13.4	11.1	19.2	0.70
Tulip	Buy	156	225	44	505	6.8	6.0	27.1	0.25	5.2	3.6	22.3	0.23
Average (Wireless)						**20.9**	**15.3**	**33.7**	**0.62**	**7.7**	**6.4**	**14.3**	**0.54**

Source: Company, Anand Rathi Research *[a] as of 17 Jun '11*

On a growth-adjusted basis, valuations of Indian telcos appear attractive as compared to emerging market peers.

Fig 16 – Emerging markets' wireless valuations

Year-end: Dec	Local currency/ Share price [a]		Market cap (US$bn)	EV/EBITDA (x) CY11e	EV/EBITDA (x) CY12e	EBITDA CAGR (%) CY11e-13e	EV/EBITDA-to-Growth (x) CY11e	P/E (x) CY11e	P/E (x) CY12e	EPS CAGR (%) CY11e-13e	PEG (x) CY11e
India											
Bharti	INR	380	32.3	8.1	6.7	15.1	0.54	18.3	13.6	30.6	0.60
RCom	INR	95	4.4	6.6	5.7	6.9	0.96	18.7	16.9	22.6	0.83
Idea	INR	77.7	5.7	7.5	6.3	19.0	0.40	39.3	27.1	53.5	0.74
China											
China Mobile	HKD	69	178.0	3.4	3.1	3.6	0.95	9.4	9.2	2.9	3.25
China Unicom	HKD	15	44.8	5.5	4.6	16.7	0.33	57.5	25.8	85.8	0.67
Indonesia											
TelKom	IDR	6,850	16.0	3.7	3.4	4.3	0.85	11.1	10.3	7.6	1.45
Indosat	IDR	5,200	3.3	4.6	4.3	8.5	0.55	22.5	15.8	38.6	0.58
Excelcomindo	IDR	6,300	6.2	5.9	5.2	9.1	0.65	14.0	11.9	16.1	0.87
Middle East/Africa											
MTN	Zar	136	37.9	5.6	4.9	9.3	0.61	12.2	10.6	12.5	0.97
Latin/South America											
AMX	MXN	30	98.5	5.4	5.0	6.8	0.79	11.5	10.2	10.5	1.10
Average			**427.2**	**4.6**	**4.1**	**7.5**	**0.62**	**11.9**	**10.9**	**8.6**	**1.39**
Average (ex India)			**384.7**	**4.3**	**3.9**	**6.8**	**0.64**	**11.5**	**10.6**	**7.7**	**1.49**

Source: Bloomberg consensus for foreign companies, Anand Rathi Research *[a] as of 17 Jun '11; CY11e refers to FY12e and CY12e refers to FY13e for March year-end companies*

Risks

Key risks to our estimates and rating include:

- Regulatory impact (₹25/share) beyond what we have factored in;
- More-than-expected competition in India and Africa.

Fig 17 – Key model assumptions and forecasts

Year-end: Mar (₹m)	FY11	FY12e	FY13e	FY14e	FY15e	FY16e
Operating parameters						
India Wireless						
Subscriber base (m)	162	196	220	236	248	256
ARPU (₹)	201	182	172	168	171	177
MoU/sub (mins)	456	437	417	405	404	409
ARPM (₹/min)	0.44	0.42	0.41	0.42	0.42	0.43
Voice ARPM (₹/min)	0.38	0.35	0.34	0.34	0.34	0.35
Non-voice as % of total revenues	13.3	16.5	18.0	19.0	19.5	20.0
3G data as % of total revenues		2.7	4.7	6.2	7.2	8.2
Total minutes (bn mins)	792	938	1,039	1,107	1,175	1,239
Total minutes growth (%)	29.8	18.5	10.7	6.6	6.1	5.4
Passive Infra						
Indus Towers						
Total towers	108,586	112,586	115,586	118,086	120,086	121,586
Tenancy - end of period (x)	1.85	1.98	2.11	2.19	2.25	2.29
Bharti Infratel						
Total towers	32,792	34,792	36,292	37,542	38,542	39,292
Tenancy (x)	1.76	1.92	1.99	2.07	2.13	2.17
Africa						
Subscriber base (m)	44	54	67	75	83	90
ARPU (US$)	7.6	7.3	7.1	7.0	6.8	6.6
MOU/sub (mins)	119	130	154	176	194	207
ARPM (US cents/min)	6.4	5.6	4.6	4.0	3.5	3.2
Voice ARPM (US cents/min)	5.9	5.1	4.1	3.5	3.1	2.8
Non-voice as % of total revenues	7.7	8.6	11.3	12.1	12.6	13.1
Total minutes (bn mins)	46	76	112	150	184	215
Total minutes growth (%)		65.1	46.3	34.3	22.4	16.6
Financial forecasts						
Revenues: per segment (₹m)						
Wireless (India + SA)	362,689	408,178	449,279	484,105	524,987	565,289
Telemedia	36,324	38,001	39,609	41,293	42,696	43,819
Enterprise	41,292	41,216	42,246	43,303	44,385	45,495
Passive Infra	85,555	96,966	109,949	121,169	131,253	139,955
Others	9,710	17,450	23,557	28,268	32,791	36,726
Eliminations	(71,125)	(82,448)	(86,613)	(94,429)	(101,204)	(107,160)
India + South Asia	**464,445**	**519,362**	**578,027**	**623,709**	**674,909**	**724,124**
Africa	**130,834**	**191,339**	**230,853**	**265,838**	**288,070**	**304,122**
Consolidated revenues	**595,279**	**710,701**	**808,881**	**889,547**	**962,979**	**1,028,246**
EBITDA: per segment (₹m)						
Wireless (India + SA)	126,248	143,314	166,057	181,937	200,974	220,329
Telemedia	16,330	17,802	18,555	19,344	20,001	20,528
Enterprise	9,947	10,226	10,397	10,657	11,034	11,424
Passive Infra	31,737	37,539	44,386	50,314	55,661	60,269
Others	(8,848)	(4,351)	(7,331)	(5,971)	(3,647)	(2,249)
Eliminations	(2,604)	(3,068)	(3,481)	(3,844)	(4,260)	(4,655)
India + South Asia	**172,811**	**201,462**	**228,583**	**252,437**	**279,763**	**305,646**
Africa	**31,230**	**49,820**	**63,117**	**80,367**	**89,892**	**96,216**
Consolidated EBITDA	**204,041**	**251,282**	**291,700**	**332,804**	**369,655**	**401,862**
EBITDA margin: per segment (%)						
Wireless	34.8	35.1	37.0	37.6	38.3	39.0
Telemedia	45.0	46.8	46.8	46.8	46.8	46.8
Enterprise	24.1	24.8	24.6	24.6	24.9	25.1
Passive Infra	37.1	38.7	40.4	41.5	42.4	43.1
Others	(91.1)	(24.9)	(31.1)	(21.1)	(11.1)	(6.1)
India + South Asia	**37.2**	**38.8**	**39.5**	**40.5**	**41.5**	**42.2**
Africa	**23.9**	**26.0**	**27.3**	**30.2**	**31.2**	**31.6**
Consolidated revenues	**34.3**	**35.4**	**36.1**	**37.4**	**38.4**	**39.1**
Capex						
India + South Asia wireless	58,759	55,000	55,826	51,574	56,028	59,497
India + South Asia total	**106,652**	**92,954**	**89,692**	**82,061**	**82,950**	**84,390**
As a percentage of sales	23	18	16	13	12	12
Africa	**35,595**	**48,000**	**42,407**	**43,710**	**37,541**	**35,584**
As a percentage of sales	27	25	18	16	13	12

Source: Company, Anand Rathi Research

Our previous estimates were based on US GAAP reporting and did not include Africa operations

Fig 18 – Revision of estimates

Year-end: Mar (₹m)	FY12e	FY13e	FY14e	FY15e	FY16e
India wireless revenues					
- Previous estimates	392,619	445,295	487,524	521,150	547,138
- Revised estimates	408,178	449,279	484,105	524,987	565,289
Revision (%)	*4.0*	*0.9*	*(0.7)*	*0.7*	*3.3*
Consolidated revenues					
- Previous estimates	488,706	551,812	602,907	644,537	677,898
- Revised estimates	710,701	808,881	889,547	962,979	1,028,246
Revision (%)	*NM*	*NM*	*NM*	*NM*	*NM*
Consolidated EBITDA					
- Previous estimates	186,782	213,742	235,024	253,341	267,478
- Revised estimates	251,282	291,700	332,804	369,655	401,862
Revision (%)	*NM*	*NM*	*NM*	*NM*	*NM*
Consolidated PAT					
- Previous estimates	88,257	108,233	116,554	130,525	142,348
- Revised estimates	78,731	106,586	134,194	161,780	184,782
Revision (%)	*NM*	*NM*	*NM*	*NM*	*NM*
Consolidated EPS					
- Previous estimates	23.2	28.5	30.7	34.4	37.5
- Revised estimates	20.7	28.1	35.3	42.6	48.7
Revision (%)	*NM*	*NM*	*NM*	*NM*	*NM*

Source: Anand Rathi Research *NM = Not meaningful*

India mobile business coming out of the woods

Bharti has effectively negotiated industry tariff wars through a measured-tariff response that produced good elasticity. We expect Bharti to benefit from the improved industry outlook. While it may lack the growth profile of its GSM peers (Vodafone, Idea, Aircel) that continue to expand their footprints, Bharti's appeal lies in its market leadership, which is likely to result in stronger margins, return ratios and cash-flow generation.

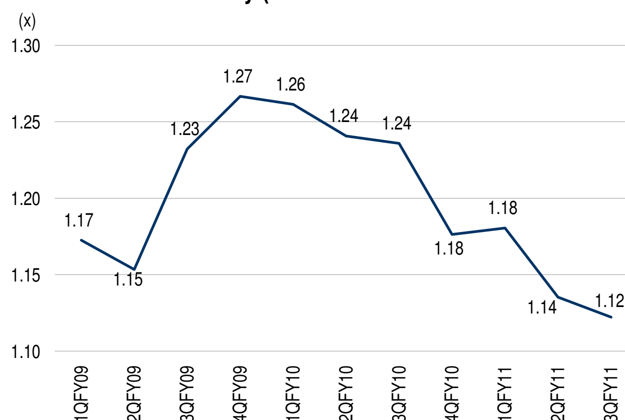
Emerging strongly from industry downturn

Tariff wars negotiated with measured response

Bharti India wireless revenues were significantly hit by industry-wide tariff cuts in 3QFY10. The company recorded a yoy decline in India wireless revenues through 3-4QFY10, as it focused on warding off aggressors (RCom, TTSL) from gaining ground. It responded to the price war by cutting tariffs only to the extent of maintaining competitiveness, and yet still holding a price premium over the lowest offering in the market.

Bharti's tariff premium over competition (which can be roughly implied from the ratio of revenue market-share to minutes market-share), which had been rising earlier, began to decline from 2QFY10 (Fig 16). Still, at end-3QFY11, Bharti's tariff was at a ~12% premium to average industry tariffs.

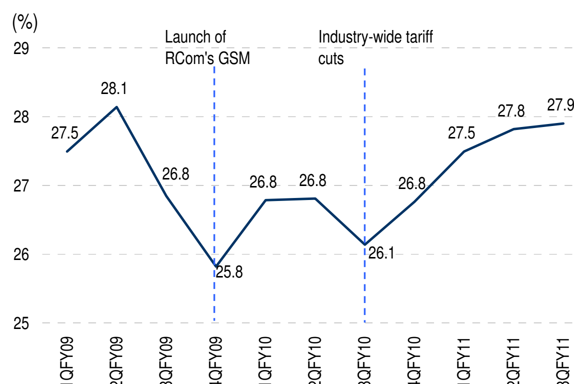
Fig 19 – Bharti's tariffs vs. industry (revenue market-share/minutes market-share)



Source: TRAI

The measured tariff cuts that Bharti undertook yielded strong traffic elasticity, driven by increased use among its subscribers, as well as won back minutes lost to competition. In fact, Bharti gained wireless minutes' traffic-share in the quarters following the price war of 3QFY10.

Fig 20 – Wireless traffic share recovered after measured tariff cuts in 3QFY10



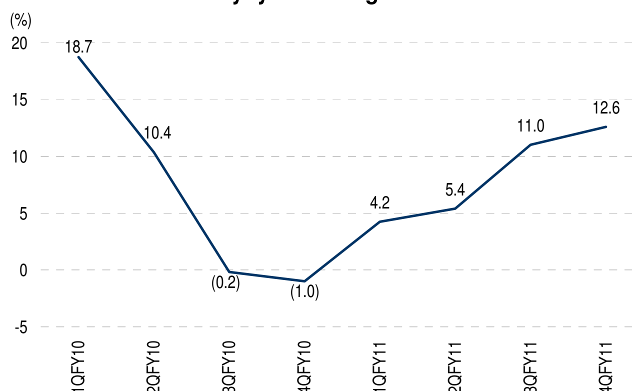
Source: TRAI, Company

Revenue growth recovering

Despite strong traffic growth through 2HFY10, Bharti's revenues declined yoy, due to a fall in ARPMs. Other leading operators (Vodafone and Idea) had the benefit of recent expansion to new circles, which helped offset the impact of falling ARPMs on overall revenues.

However, since 1QFY10, Bharti's India wireless revenue growth has been steadily increasing (Fig 20), following the stability in voice tariffs in the industry and the increasing share from non-voice services.

Fig 21 – Bharti's Indian wireless yoy revenue growth on the rise



Source: Company Note: Revenues based on reported subscriber and ARPU for Indian wireless operations

Core underlying margin appears to be stabilizing

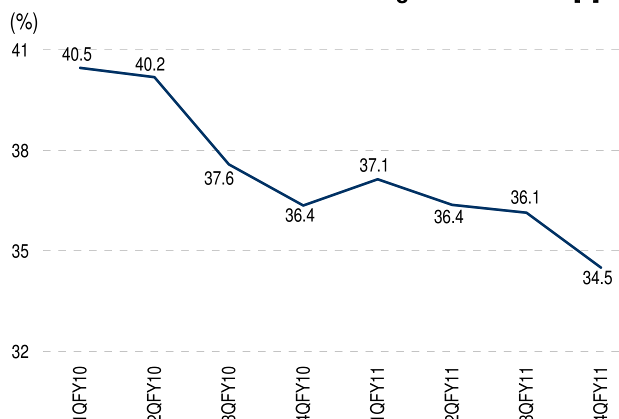
The tariff cuts of 3QFY10 led to a sharp decline in Bharti's wireless EBITDA margin, from 40.2% in 2QFY10 to 36.4% in 4QFY11. The margin continued to steadily decline through FY11, hitting the low of 33.3% in 4QFY11 (down 300bps yoy). While some of this may be owing to high completion (ARPM was down 8% yoy), we believe the decline was also driven by:

1. **increased spectrum-use fees from 1QFY11:** This has affected margins by 120bps; excluding the impact of the spectrum-fee hike, the yoy decline in the 4QFY11 EBITDA margin is 180bps;

2. **impact of Bangladesh telco – Warid Telecom:** We believe Warid Telecom has a negative EBITDA on estimated annualized revenues of US$90m. Warid Telecom was consolidated for ~35days in 4QFY10 vs. for full 4QFY11. This explains the 30-40bps decline in EBITDA margin, in our view.

3. **increase in marketing spend:** Bharti's India + South Asia SG&A expenses rose 21% in 4QFY11; we believe this increase is primarily driven by the wireless business (MNP, 3G launch, Cricket World Cup '11). We believe that SG&A costs could ease in coming quarters.

Fig 22 – India + South Asia wireless EBITDA margin has declined [a]



Source: Company [a] EBITDA margins through FY11 is adjusted for impact (120bps) of increase in spectrum fees

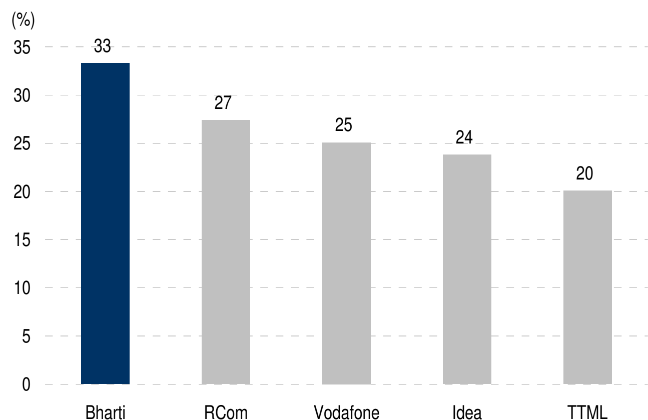
In 4QFY11, the wireless EBITDA margin was down 160bps qoq. According to management, this was driven by opex relating to 2G cell sites deployed towards the fag end of 3QFY11 and 3G sites.

Leading position to help ride the recovery wave in the industry

We believe the outlook for the Indian wireless market has improved. The tariff stability that has emerged in recent quarters is sustainable and the industry is likely to consolidate, not necessarily driven by big-band M&As, but gradually, as leaders continue to snatch market shares from smaller peers.

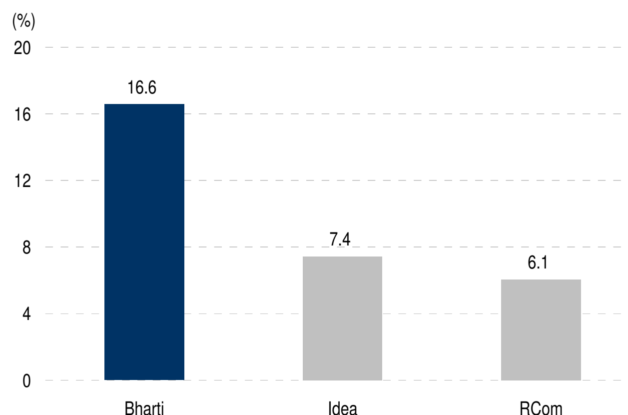
Bharti is poised to benefit from the recovery in the sector growth. While it may lack the growth profile of GSM peers that continue to expand their footprints (Vodafone, Idea, Aircel), Bharti's appeal lies in its market leadership, likely to result in stronger margins, return ratios and cash flow generation.

Fig 23 – 4QFY11 wireless EBITDA margin higher than peers [a]



Source: Companies [a] 3QFY11 data for EBITDA; 2HFY11 data for Vodafone

Fig 24 – Excl. Africa, Bharti's FY11 RoE higher than peers



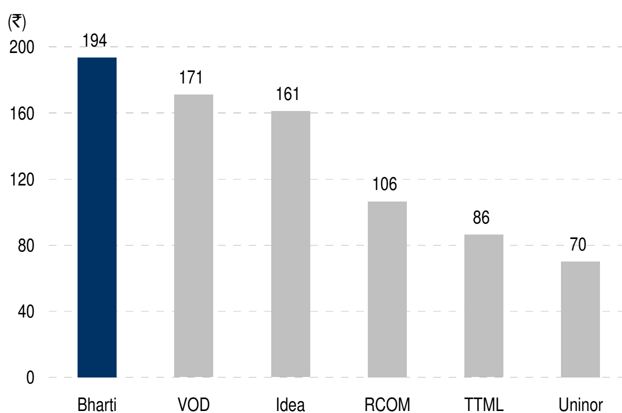
Source: TRAI, Companies, Anand Rathi Research

Bharti has the advantage of being the incumbent operator in many circles. It is a market leader (in revenue market-share) in 12 telecom circles (of the 22 in India) and is the second-largest operator in six circles. On an all-India basis, Bharti has a revenue market-share of 30% (4QFY11, TRAI data), significantly ahead of peers Vodafone (22%) and Idea (14%).

Room for margin expansion

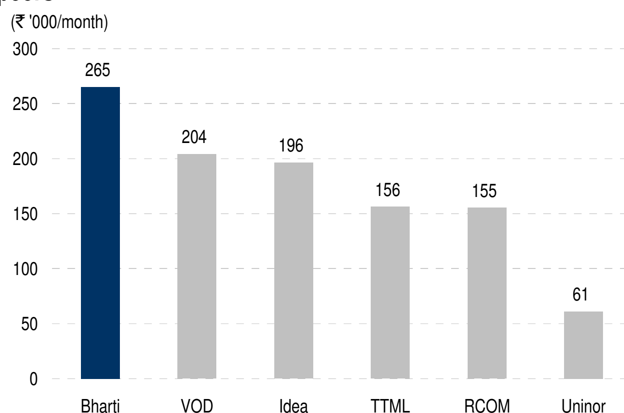
Tariff stability would offer telcos including Bharti opportunities to expand their EBITDA margin owing to the operating leverage inherent in telcos. Besides, it enjoys the first mover advantage and market leadership. This has enabled it to have strong ARPUs; its 4QFY11 ARPU of ₹198 was at a 13-20% premium to that of Vodafone and Idea. In turn, the higher ARPU helps better network utilization. We believe that the strong base of high-ARPU subscribers would aid rapid uptake of 3G services, which could lead to stronger margins (lower deterioration initially, expansion as the 3G network matures). Notably, Bharti's current revenue per cell-site is 30-35% higher than that of Vodafone and Idea.

Fig 25 – 4QFY11 ARPU higher than peers'



Source: Companies

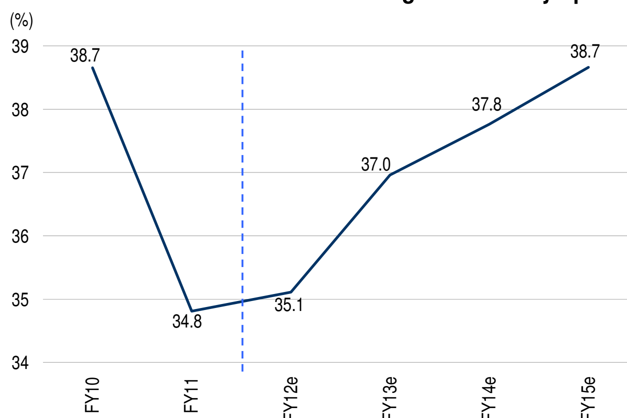
Fig 26 – 4QFY11 wireless revenue-to-cell site higher than peers'



Source: TRAI , Companies, Anand Rathi Research

We believe 4QFY11 marks the bottoming out of the wireless EBITDA margin and expect the margin to start expanding from 1QFY12. Our FY12e EBITDA margin of 35.1% is almost flat vis-à-vis FY11 levels, but marks 180bps expansion over 4QFY11. Notably, our forecasts also implicitly factor in a turnaround in Sri Lanka (SL) and Bangladesh. Operations in these countries are growing rapidly (~10% CQGR in the combined SL and Bangladesh wireless traffic through 1QFY11 to 4QFY11).

Fig 27 – India + South Asia wireless' EBITDA margin on the way up



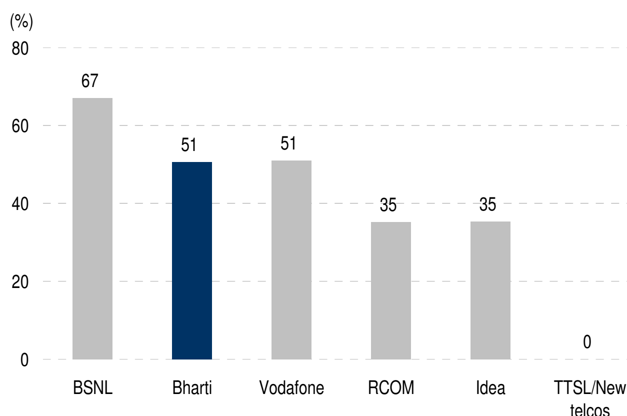
Source: Company, Anand Rathi Research

Attractive portfolio of spectrum

Bharti has an attractive portfolio of GSM and 3G spectrum. Of its total GSM spectrum, ~51% belongs to the superior 900MHz band, one of the highest for a private telco. This follows from it being the first mover in many telecom circles.

Bharti has 3G spectrum (2 x 5 MHz in the 2100-MHz band) in 13 circles; in all except two (Orissa and Punjab), Bharti is the market leader. Its 3G circles cover 61% of industry revenue (highest of the private telcos) and 69% of its own 2G revenues (behind Idea and Aircel, which have high revenue concentration in a few circles). Despite this, Idea's outlay on 3G spectrum (as a percentage of revenue) was the lowest among all telcos.

Fig 28 – Bharti's share of 900 MHz band in its total spectrum holdings among the highest



Source: Wireless Planning & Coordination (WPC)

Bharti also has BWA spectrum (20MHz in the 2.3GHz band) in four circles. Its combined 3G + BWA spectrum covers 17 circles (of the 23 in India) and 76% of all-India revenues. Notably, BWA spectrum could be

potentially used to offer wireless broadband services using the TDD LTE technology.

Fig 29 – Summary of 3G auction results held in May '10

	Bharti	Vodafone	RCom	Idea	TTSL	Aircel	S Tel
Total 3G spectrum cost (₹m)	**122,955**	**116,179**	**85,850**	**57,686**	**58,643**	**64,995**	**3,377**
Total 3G spectrum cost (US$m)	**2,652**	**2,505**	**1,851**	**1,244**	**1,265**	**1,402**	**73**
Number of 3G circles	13	9	13	11	9	13	3
All-India revenue covered (%) [a]	61	52	46	49	44	55	7
Share of own-access revenue covered (%) [a]	**69**	**68**	**55**	**79**	**43**	**91**	**100**
3G bid as % of current access revenues [a]	35	50	67	41	61	133	

Source: DoT, TRAI, Anand Rathi Research [a] based on 1QFY11 data

Strong free cash-flow generation ahead

Management has indicated FY12 capex guidance of US$1.5-1.6bn for its Indian + South Asia operations (excluding the tower business). We estimate capex for the wireless business at ~US$1.2bn, which implies simple FCF generation (EBITDA less capex) of ~US$2bn in FY12. Factoring moderate capex requirement post FY12 (limited expansion in coverage, completion of initial 3G build-out), we expect FCF to expand to US$2.5bn by FY13e. We expect FCF for consolidated India + South Asia operations (i.e. including non-wireless businesses) to touch US$3.2bn by FY13e. This translates into FCF yield (FCF-to-EV) of 8% based on our target EV of US$40bn for India + South Asia.

Fig 30 – India + South Asia EBITDA, capex and simple FCF

₹bn	FY10	FY11	FY12e	FY13e	FY14e	FY15e
India + South Asia Wireless						
EBITDA	128	126	143	166	182	201
Capex	34	59	55	56	52	56
FCF (EBITDA - capex)	94	67	88	110	130	145
FCF (US$bn)	**2.1**	**1.5**	**2.0**	**2.5**	**2.9**	**3.2**
India + South Asia consolidated						
EBITDA	171	175	205	232	256	284
Capex	82	107	93	90	82	83
FCF (EBITDA - capex)	89	69	112	142	174	201
FCF (US$bn)	**2.0**	**1.5**	**2.5**	**3.2**	**3.9**	**4.5**
FCF yield (FCF-to-EV) (%) [a]	**4.8**	**3.7**	**6.0**	**7.7**	**9.4**	**10.9**

Source: Company, Anand Rathi Research *[a] based on our target FY12e EV of US$40bn for India + South Asia.*

Low impact of regulatory risks

Bharti is better placed than leading peers Idea and RCom on the regulatory risk front. Our estimate of the impact of TRAI recommendations is ₹25/share, which is ~5% of our Mar '12e target price (vs. 11% for Idea). Besides, Bharti is not faced with significant risk from 2G investigations, which are focused on the new entrants and dual-technology operators, in our view.

Limited 'net' impact of TRAI recommendations

The proposed policy changes in line with TRAI's May '10 and Feb '11 recommendations and recent announcements regarding the proposed National Telecom Policy (NTP) '11 by the Minister of Telecommunications have negative implications for all telcos, including Bharti. TRAI's proposals pertaining to one-time fee on 'excess' 2G spectrum, increase in annual spectrum usage fees, license renewal fees and levy of license fees on ISP and the tower businesses would have an adverse affect on telecom companies. However, the proposal to reduce license fee revenue-share would provide some relief.

Fig 31 – Impact of potential regulatory changes on price targets

		Bharti			Idea			RCom		
		₹bn	₹/sh	% of TP	₹bn	₹/sh	% of TP	₹bn	₹/sh	% of TP
1	One-time fee for 'excess' 2G spectrum	(43)	(11.3)	(2.5)	(15)	(4.6)	(4.8)	(1)	(0.6)	(0.6)
2	License renewal cost (PV)	(87)	(22.8)	(5.0)	(41)	(12.5)	(13.0)	(30)	(14.6)	(16.2)
3	Increase in spectrum-usage fee (SUF) as % of AGR	(46)	(12.0)	(2.6)	(15)	(4.5)	(4.7)	(3)	(1.4)	(1.6)
4	Levy of 6% license fee on the tower and ISP businesses	(36)	(9.4)	(2.1)	(8)	(2.5)	(2.6)	(25)	(11.9)	(13.2)
5	Reduction in annual license fee to a uniform 6%	80	21.0	4.6	38	11.5	12.0	23	11.0	12.2
	Impact	**(131.0)**	**(34.5)**	**(7.6)**	**(41.3)**	**(12.5)**	**(13.0)**	**(36.1)**	**(17.5)**	**(19.4)**
	Impact [ex #4]	**(95.3)**	**(25.1)**	**(5.5)**	**(33.2)**	**(10.1)**	**(10.5)**	**(11.5)**	**(5.6)**	**(6.2)**

Source: TRAI, Anand Rathi Research

We estimate net impact of TRAI's recommendations on Bharti to be ₹25/share, which is ~5% of our price target. The impact on Idea is ~₹10/share or ~11% of the price target. The lower impact for Bharti is largely on account of the proposal to impose a license-renewal fee. While Bharti's operations in all its licensed circles have matured, Idea has entered many circles in the past two years. As such, the impact of the renewal fee is spread over a larger revenue/profit/value base in the case of Bharti.

We have not accounted for the impact of the proposals pertaining to: i) levy 6% license fee on the tower and ISP businesses; and ii) re-farming of the 900MHz spectrum.

i) Levy of 6% license fee on Towers – At the Mar '11 roundtable conference with telecom service providers, the Minister of Telecommunications had asked telecom operators to arrive at a consensus on various issues for finalizing a regulatory roadmap. While there are sharp differences among telcos regarding various regulatory issues, they are united against TRAI's proposal to bring the tower and virtual private network (VPN) businesses within the license-fee ambit.

Also, according to some operators, the license fee on the tower and VPN businesses do not stand the test of genuine licensing as the government is not assigning any scarce resource (such as spectrum) or exclusive privileges. We believe the argument has some merit.

Besides, if the license fee is imposed on the tower and VPN businesses, a

case could be made for telecom service providers to be allowed to deduct payments to tower/VPN companies from the service provider's adjusted gross revenues (AGR) so as to avoid the incidence of double taxation. This treatment is similar to that for interconnect charges that telcos pay to each other. In case such deduction is allowed, we expect the net impact of the license fee on the tower business to be insignificant.

ii) Re-farming of the 900 MHz spectrum – TRAI has recommended that, on the expiry of the licenses, the spectrum held by a licensee in the 900MHz band would be replaced by assigning an equal amount of spectrum in the 1800MHz band. The freed spectrum in the 900MHz band could then be distributed back to telcos for UMTS (Universal Mobile Telecommunications System) networks, (possibly through auctions, in our view).

We believe it is difficult to estimate the potential impact of spectrum re-farming. Besides, it might be too early to capture the impact as: i) the earliest of licenses would be up for renewal only in '14/'15; ii) spectrum re-farming in the 1,800MHz band would require vacating spectrum from the Defence and other government departments, which might turn out to be long-winding and tedious; iii) spectrum in the 1800MHz may not suffice for re-farming the 900MHz spectrum, even after Defence vacates some of the spectrum; iv) TRAI said it would undertake separate consultations to determine the process/timeline of re-farming; v) telcos may pass up the assignment of 1800MHz spectrum, saving on renewal fees and instead use the proceeds to bid for 900MHz spectrum.

Not much affected by 2G investigations

Issues under investigation can be broadly classified as: i) policy issues (issuing licenses at a fixed price rather than auctioning them, approval for the use of dual technology); ii) criminal offences (bribes, false information in telecoms licenses etc). While the focus of the CBI investigations would be on criminal offences, the Public Accounts Committee (PAC) and the Joint Parliamentary Committee (JPC) could focus on policy issues, in our view.

We believe Bharti is relatively unaffected by investigations pertaining to criminal offences. As regards policy issues, Bharti has benefited from the policy of issuing license at a fixed price rather than through auctioning; Bharti has received six licenses at a fixed price in 2004. We believe the burden of fault in case of policy issues would lie with the government. The implications for beneficiary companies in these cases are unlikely in our view.

Africa has potential to lift Bharti's growth profile

We believe that investment outlook is attractive for the overall Africa wireless market, from a macro perspective. While Bharti's performance in Africa since its acquisition has been mixed, it holds significant potential for lifting Bharti's (consolidated) growth profile, in our view. We have valued the Africa operations at US$11bn (Mar '12e), implying ₹10/share value erosion (captured in our price target).

Macro view for Africa opportunity is attractive

African markets are under-penetrated, with relatively benign competition

African wireless markets generally have low penetration, low usage and little competition, suggesting an attractive investment potential.

Combined penetration in 15 countries in which Bharti operates is ~40%. Besides, in Nigeria (the largest market, accounting for ~1/3rd of the population and 40% of subscribers in Bharti's African markets) there is high incidence of multiple SIM ownership (reportedly 30% of mobile handsets in Nigeria have dual SIM capacity), which overestimates penetration.

Usage levels have been low. We believe the average minutes of usage (MOU) per subscriber (sub) for the region would be in the 100-150 range, based on operating parameters disclosed by listed entities in Africa. Bharti's own MOU per sub is 137.

African markets are generally concentrated. In Nigeria, its most fragmented market, the top-three telcos account for 85% of subscribers.

In the most fragmented market, Nigeria, the top-three telcos account for 85% of the subscribers

Favorable economic, demographic, socio-political factors

The attractive industry outlook is supported by favorable economic, demographic and socio-political factors, which are: i) population is expected to cross 2bn (all of Africa) vs. 1bn at present; ii) GDP growth of +5% in most countries; iii) young population: median age of 17-18 years; iv) emerging political stability.

Favorable regulatory environment

Many countries in Africa have undertaken or plan to undertake:

1. **MNP implementation** (Ghana, Nigeria, Kenya, Zambia): Notably, except in Zambia, Bharti has weaker subscriber market shares (10-25%) in these countries and is likely to benefit from MNP;

2. **3G spectrum allocation** (Kenya, Zambia, Congo DRC, Malawi, Sierra Leone, Gabon, Madagascar): Except in Kenya, Bharti commands a strong market position in these countries (subscriber market-shares of 40-70%) and is likely to benefit from a 3G launch.

3. **Termination-rate cuts** (Nigeria, Kenya, Burkina Faso, Congo Brazaville, Sierra Leone, Tanzania, Zambia): Bharti has low market shares in the two key markets of Nigeria and Kenya, and is likely to benefit from termination-rate cuts.

Given its multi-country operations, Bharti's regulatory risks are diversified. However, telcos are faced with challenges pertaining to subscriber registration/verification requirements in many countries (Nigeria, Sierra Leone, Kenya, Burkina Faso, Chad, Congo Brazaville, Gabon, Niger, Tanzania).

Low penetration = high growth potential

We believe market penetration measured in terms of subscriber penetration overestimates the level of market maturity, considering low levels of usage and multiple SIM ownership. For instance, the subscriber penetration in Nigeria is 56% currently. However, modelling MOU per capita of 150 mins/month (vs. 200 mins/month for India), potential annual usage for Nigeria could be ~280bn minutes; and only ~100bn or ~35% of this potential is tapped currently (based on a subscriber base of 87m and an estimated MOU-per-subscriber of 100).

In our view, the current usage levels in Africa suggest significant growth potential there. Theoretically, this also suggests less intense competition ahead.

Elasticity is likely to be high, given low usage levels

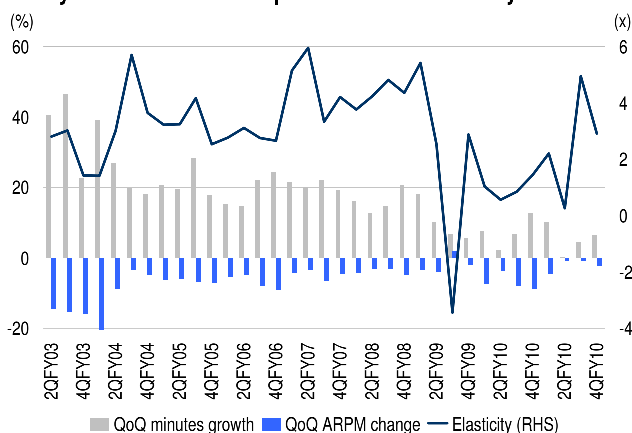
While Bharti has cut its tariffs in several African markets (evoking a retaliatory response from peers), we believe the key role of tariff cuts in the present market context would be to boost usage levels rather than capturing share for market leaders. The tariff cuts currently in place in Africa (whether intended to capture market share or not) should result in increased usage for all telcos. Given higher tariff levels, elasticity is likely to be higher.

Tariff declines in Africa could be a repeat of the India experience in the mid-2000s

We believe that the tariff cuts in Africa should not be compared to those during the Indian price war in 2HFY10, when the the Indian market was more mature than Africa at present, in our view. Besides, the cuts in India followed significantly-reduced entry barriers (GSM spectrum-allocation to fresh players, CDMA companies), which seems not to be the case in Africa at present.

The present tariff cuts in Africa are more comparable with those in India during the mid-2000s, when the cuts were followed by growth in usage, revenue and EBITDA margin. In the case of Bharti, ARPM declined ~25%/year over 1QFY03 to 1QFY10. During this period, Bharti's revenues saw 55% CAGR and consolidated EBITDA margin expanded 1,900bps. We note that elasticity dried up, and revenue and margin started to come under pressure only during the latter stages of market maturity.

Fig 32 – Elasticity in Bharti's Indian operations declined only in later stages



Source: Company

We believe that even in India, tariff cuts on various occasions were mainly driven by competition rather than being proactive moves towards boosting usage. Left with limited competition, in most cases telcos (or firms in any other industry, for that matter) are unlikely to initiate sharp tariff cuts despite the existence of elasticity, in our view. The tendency would be to maintain pricing and exploit the elasticity gradually. This might explain why tariffs in Africa (with less competition) are much higher than in more competitive markets such as India. The Indian wireless sector faced regular bouts of competition (grant of unified-access licenses to Reliance and the Tatas, grant of licenses to incumbents in newer circles, GSM spectrum allocation to CDMA telcos, entry of fresh players).

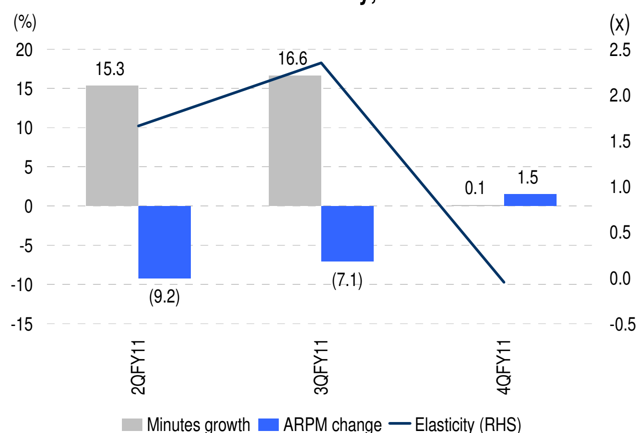
Operational feedback so far is mixed; still early days

In its Jun '10 conference call, Bharti's Africa CEO, Manoj Kohli, had stated that the company targets FY13 revenue of US$5bn and EBITDA of US$2bn, (implying a 40% margin). Bharti's operating performance in the quarters has been mixed so far – satisfactory revenue growth at best and weaker margins. Nonetheless, the CEO has since been expressing confidence for achieving the targets.

Too early to judge elasticity for Bharti

Bharti recorded qoq total minutes growth of 15-17% during 2QFY11 and 3QFY11, following ARPM drops of 6-7%. However, both minutes and ARPM were flat in 4QFY11. This could possibly be driven by capacity constraints due to under-investments prior to acquisition and supply constraints faced by Bharti's equipment vendors, post-acquisition.

Fig 33 – Bharti Africa: Mixed trend in elasticity, so far



Source: Company

Short-term margin outlook challenging

Bharti's mobile EBITDA margin (ex re-branding costs) has recovered steadily through 3-4QFY11 (26.3% by 4Q) after the fall in 2Q (23.9%). However, the margin expansion has been mainly driven by a decline in SG&A cost-to-sales, which offers limited further potential to drive margin, in our view. Importantly, the interconnect cost-to-sales has been rising, a by-product of tariff cuts, as in key markets where Bharti's position is weak (e.g., Nigeria, Kenya), the share of off-net traffic would be substantial. Further, network costs have been largely flat in the past three quarters. While this might be driven by economies of scale drawn from network outsourcing deals, we believe network costs would start increasing considerably once the network expansion gets going.

Potential to drive long-term growth

We have modelled Bharti's FY13 Africa revenues at US$5bn, in line with management targets. Our revenue growth assumptions are largely driven by a robust macro outlook for the economy/industry and initial operating results. However, EBITDA/EBITDA margin forecasts are substantially lower, at US$1.4bn (26% margin) compared with the target of US$2bn (40% margin), due to challenges highlighted in previous paragraphs.

Our FY13 forecasts imply EBITDA CAGR of 27% over FY11-13e (based on the annualized EBITDA for FY11), mainly driven by 20% revenue growth. We have modelled margins to peak at 32%, although our margin-expansion assumptions are back-ended.

We expect Bharti Africa's net loss to decline to ₹5.9bn in FY12, from ₹12.8bn in FY11, as we expect EBIT to increase while finance costs would be largely flat. Notably, Bharti's EBIT has grown steadily in the past three quarters. We have modelled Bharti Africa to turn PAT-positive in FY13.

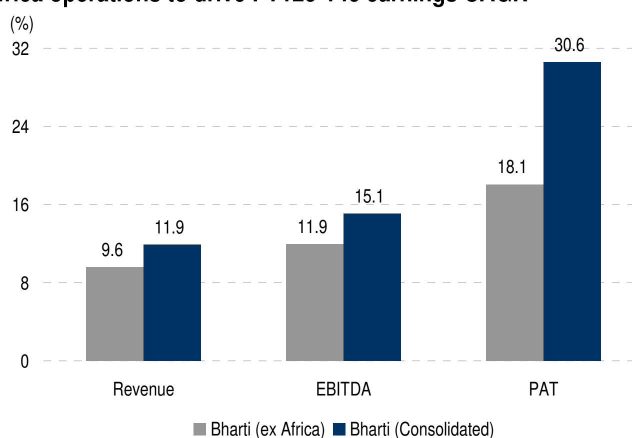
Fig 34 – Summary of KPI and financial forecasts for Africa

Year-end: Mar (₹bn)	FY11	FY12e	FY13e	FY14e	FY15e
Subscribers (m)	44	54	67	75	83
ARPU (US$)	7.6	7.3	7.1	7.0	6.8
- MOU per sub	119	130	154	176	194
- ARPM (US¢)	6	6	5	4	4
Revenues	130.8	191.3	230.9	265.8	288.1
EBITDA	**31.2**	**49.8**	**63.1**	**80.4**	**89.9**
EBITDA margin (%)	23.9	26.0	27.3	30.2	31.2
Depreciation & Amortization	(26.2)	(37.1)	(38.7)	(40.4)	(41.4)
EBIT	**5.1**	**12.8**	**24.4**	**40.0**	**48.5**
Net finance cost	(16.6)	(17.9)	(18.0)	(16.4)	(14.7)
Acqusition/re-branding costs	(2.6)	0.0	0.0	0.0	0.0
PBT	(14.2)	(5.2)	6.4	23.6	33.8
Taxes	(4.0)	0.8	0.8	(1.2)	0.3
Minority interests	2.7	2.7	2.7	2.7	2.7
PAT	(15.6)	(1.7)	9.9	25.1	36.8
Adjusted PAT	**(12.8)**	**(5.9)**	**4.5**	**16.3**	**24.4**

Source: Company, Anand Rathi Research

Bharti's Africa business has the potential to significantly lift its consolidated EBITDA and PAT growths. We expect 15%/28% CAGR in consolidated EBITDA/PAT over FY12-14e vs. 12.1%/17.6% ex Africa.

Fig 35 – Africa operations to drive FY12e-14e earnings CAGR



Source: Anand Rathi Research

Value erosion from Africa operations: ₹10/share

Fig 36 – DCF for Bharti Africa

Year-end: Mar (₹m)	FY12e	FY13e	FY14e	FY15e	FY16e	FY17e	FY18e	FY19e	FY20e	FY21e	FY22e
Revenue growth	19.9	20.7	15.2	8.4	5.6	5.2	5.6	5.4	5.1	4.9	4.7
EBITDA growth	27.4	26.7	27.3	11.9	7.0	6.1	6.6	6.2	5.1	4.9	4.7
FCF growth		(103.4)	1,290.6	65.4	36.0	12.1	15.0	6.1	1.4	0.7	0.2
EBITDA margin	26.0	27.3	30.2	31.2	31.6	31.9	32.2	32.5	32.4	32.4	32.4
FCF margin	(23)	1	8	12	15	17	18	18	17	17	16
Capex / sales	25.1	18.4	16.4	13.0	11.7	10.5	9.2	9.6	10.0	10.4	10.8
Return on operating assets (%)											
Effective tax rate (%)	(23.2)	21.8	20.0	12.0	9.0	13.0	17.0	21.0	24.0	27.0	30.0
Current tax rate (%)	(61.8)	56.1	35.0	25.0	20.0	22.0	24.0	26.0	27.0	28.0	29.0
EBIT X (1-tax rate)	20,651	10,704	25,987	36,378	43,453	46,869	49,673	52,527	55,343	58,123	60,886
Depreciation	22,772	26,280	29,760	32,590	34,932	36,835	38,250	39,375	40,438	41,434	42,357
Amortization	14,288	12,458	10,628	8,798	6,968	5,138	5,138	5,138	5,138	5,138	5,138
Change in net working capital	(53,677)	(5,529)	(1,733)	(5,613)	(2,691)	(2,515)	(1,281)	1,423	1,681	1,798	1,912
Operating FCF	**4,034**	**43,912**	**64,641**	**72,153**	**82,662**	**86,328**	**91,781**	**98,462**	**102,600**	**106,493**	**110,293**
Capital expenditure	(48,000)	(42,407)	(43,710)	(37,541)	(35,584)	(33,532)	(31,043)	(34,036)	(37,245)	(40,676)	(44,331)
Free cash-flows	**(43,966)**	**1,505**	**20,932**	**34,612**	**47,078**	**52,796**	**60,738**	**64,427**	**65,355**	**65,817**	**65,962**

Mar '12e DCF calculation		WACC Assumptions (%)		Comments
Terminal growth (%)	**4.00**	Cost of equity	15.0	Reasonable, in our view
Implied Exit FCF multiple (x)	12.6	Cost of debt	5.0	~250bps higher than cost of acquisition debt (LIBOR+195bps) to capture currency risk
Implied Exit EBITDA multiple (x)	6.2	Tax	30.0	
NPV of cash flows	230,721	Risk free rate	8.0	
PV of terminal value	261,826	Beta (x)	1.2	
Enterprise value	492,547	Equity risk premium	6.0	
Terminal value (as % of EV)	53.2	Reqd. equity market returns	14.0	
Net debt	529,240	Debt/EV (x)	0.25	Assumed long term capital structure
Equity value	(36,693)	Equity/EV (x)	0.75	
Equity value (US$ m)	(822)			
Number of shares	3,798	**WACC**	**12.25**	
Equity value/share (₹)	**(9.7)**			
Equity value/share as on June '12e (₹)	**(10.0)**			

Source: Anand Rathi Research

How much has Bharti overpaid?

Fig 37 – Bharti's acquisition price vs. our estimated fair value

	US$bn
Consideration (transaction EV) [A]	10.7
Estimated fair EV (Mar '12)	10.9
Estimated fair EV (Mar '10 [B]	8.7
(Discounting back at 12% WACC)	
Amount overpaid [B] - [A]	**2.0**

Source: Company, Anand Rathi Research

Forex fluctuations, a significant risk to Africa earnings

Depreciation in local currencies vs. the US dollar would impact revenues and profits, as the dollar is the reporting currency for the company's Africa operations. Notably, in CY09, Zain Africa's revenues declined 12% in dollar terms, though on a constant-currency basis, revenues were up 7%.

Besides, most of the acquisition-related debt is dollar-denominated. Management has spoken about managing the currency risk by changing the debt-mix – more debt at the operating company level (local-currency debt). But it has not said anything about explicit currency hedging. This is a source of risk to earnings.

As far as the impact of currency risk on valuations is concerned, in our DCF-based target price we have partially captured the higher cost of debt (5%) as against cost of acquisition-related debt of LIBOR + 195bps (2.35% at current LIBOR).

A brief on Africa markets and Bharti's operations

Bharti began operations in 15 African countries through acquisition of Zain Africa. The countries can be classified as: i) **Nigeria**; ii) **Anglophone countries** (seven English-speaking: Ghana, Kenya, Malawi, Sierra Leone, Tanzania, Uganda, Zambia); iii) **Francophone countries** (seven French-speaking: Burkina Faso, Chad, Congo Brazzaville, The Democratic Republic of Congo, Gabon, Madagascar, Niger).

Nigeria is the single-largest market with a huge population and a relatively strong economy (among the top three countries by GDP per capita). Anglophone countries account for 37% of population of the 15 countries. Bharti's market position in Nigeria and Anglophone countries is weak (subscriber market shares of 14% and 17% respectively).

Francophone countries are smaller (population share of 30%) with relatively weaker economies. Bharti enjoys a strong position in Francophone countries (average subscriber market share of 42%).

Fig 38 – Snapshot of Bharti's African markets

	Demographic/economic data			Market data	
	Population (m)	GDP/capita – PPP (US$)	GDP -PPP (US$bn)	Subscribers (m)	Penetration (%)
Nigeria	157	2,142	335	70	45
Anglophone	175	1,362	238	67	39
Francophone	136	950	129	27	20
Total	**468**	**1,503**	**703**	**165**	**35**

Source: IMF, Company, Anand Rathi Research

Fig 39 – Snapshot of Africa operations (data for CY09)

US$m	Subscribers (m)	Market share (%)	ARPU (US$)	Revenue	EBITDA	PAT	Capex	EBITDA margin (%)	Capex-to-sales (%)	Revenue CAGR ('07-09)
Nigeria	10	14	6.8	858	257	(82)	312	30	36	5.6
Anglophone	12	17	6.7	887	213	(56)	321	24	36	8.9
Francophone	11	42	9.4	1,212	395	68	252	33	21	9.2
Total	**33**	**20**	**7.6**	**2,958**	**866**	**(71)**	**884**	**29**	**30**	**8.0**

Source: IMF, Company, Anand Rathi Research

Financials

Fig 40 – Consolidated income statement

Year-end: Mar (₹m)	FY10	FY11	FY12e	FY13e	FY14e
Revenues					
India + South Asia	**418,472**	**464,445**	**519,362**	**578,027**	**623,709**
Wireless	331,275	362,689	408,178	449,279	484,105
Telemedia	34,154	36,324	38,001	39,609	41,293
Enterprise	44,798	41,292	41,216	42,246	43,303
Passive Infra	70,852	85,555	96,966	109,949	121,169
Others	5,825	9,710	17,450	23,557	28,268
Eliminations	(68,432)	(71,125)	(82,448)	(86,613)	(94,429)
Africa		**130,834**	**191,339**	**230,853**	**265,838**
Consolidated revenues	**418,472**	**595,279**	**710,701**	**808,881**	**889,547**
EBITDA					
India + South Asia	168,609	172,811	201,462	228,583	252,437
Wireless	128,053	126,248	143,314	166,057	181,937
Telemedia	14,776	16,330	17,802	18,555	19,344
Enterprise	12,578	9,947	10,226	10,397	10,657
Passive infra	24,523	31,737	37,539	44,386	50,314
Others	(9,289)	(8,848)	(4,351)	(7,331)	(5,971)
Eliminations	(2,032)	(2,604)	(3,068)	(3,481)	(3,844)
Africa		**31,230**	**49,820**	**63,117**	**80,367**
Consolidated EBITDA	**168,609**	**204,041**	**251,282**	**291,700**	**332,804**
EBITDA margin: India + South Asia	*40.3*	*37.2*	*38.8*	*39.5*	*40.5*
EBITDA margin: Africa		*23.9*	*26.0*	*27.3*	*30.2*
EBITDA margin consolidated	***40.3***	***34.3***	***35.4***	***36.1***	***37.4***
Depreciation	(60,816)	(87,072)	(106,697)	(111,191)	(118,045)
Amortisation	(2,016)	(14,994)	(23,780)	(23,958)	(21,405)
Operating profit	**105,777**	**101,975**	**120,805**	**156,551**	**193,354**
Net finance costs	(5,333)	(20,179)	(24,553)	(21,852)	(15,520)
Derivatives and forex losses	5,154	(1,634)	0	0	0
Net other income/loss [a]	(508)	(3,380)	1,050	1,050	1,050
Profit before tax	**105,091**	**76,782**	**97,302**	**135,749**	**178,883**
Current taxes	(22,317)	(23,961)	(27,981)	(35,933)	(50,188)
Deferred taxes	8,864	6,171	10,198	8,721	9,819
Profit after tax	**91,638**	**58,992**	**79,519**	**108,537**	**138,514**
Minority interests	(1,870)	1,474	(788)	(1,951)	(4,320)
Net income	**89,768**	**60,466**	**78,731**	**106,586**	**134,194**
Adjusted net income	**90,173**	**64,578**	**78,731**	**106,586**	**134,194**
Basic EPS (₹)	23.7	17.0	20.7	28.1	35.3
Diluted EPS (₹)	**23.7**	**17.0**	**20.7**	**28.1**	**35.3**
Shares outstanding - primary	3,798	3,798	3,798	3,798	3,798
Shares outstanding - fully diluted (m)	**3,798**	**3,798**	**3,798**	**3,798**	**3,798**
Growth rates (%)					
Revenue	13.2	42.1	19.5	13.8	10.0
EBITDA	11.2	21.0	23.2	16.1	14.1
Diluted EPS	6.5	(28.4)	21.9	35.4	25.9
2-year forward revenue CAGR (%)	30.3	16.6	11.9	9.1	7.5
2-year forward EBITDA CAGR (%)	22.1	19.6	15.1	12.6	9.9
2-year forward EPS CAGR (%)	(6.6)	28.5	30.6	23.2	17.3
Margins (%)					
EBITDA	40.3	34.3	35.4	36.1	37.4
Operating profit	25.3	17.1	17.0	19.4	21.7
Net profits	21.5	10.8	11.1	13.2	15.1
Current tax rate (%)	21.2	31.2	28.8	26.5	28.1
Effective tax rate (%)	12.8	23.2	18.3	20.0	22.6

Source: Company, Anand Rathi Research

Fig 41 – Consolidated balance sheet

Year-end: Mar (₹m)	FY10	FY11	FY12e	FY13e	FY14e
Property, plant and equipment	482,629	651,426	689,349	710,257	719,965
Intangible assets	59,890	637,317	613,538	589,580	568,175
Other non-current assets	30,736	64,244	74,442	83,163	92,983
Total non-current assets	**573,255**	**1,352,987**	**1,377,329**	**1,383,000**	**1,381,123**
Current assets (excluding cash)	60,000	95,534	107,755	120,651	131,641
Current liabilities (excl. borrowings)	127,554	285,475	257,135	272,258	277,080
Net current assets	**(67,554)**	**(189,941)**	**(149,379)**	**(151,607)**	**(145,439)**
Cash and cash equivalents	**77,685**	**16,543**	**63,562**	**91,723**	**148,736**
Total capital deployed	**583,386**	**1,179,589**	**1,291,512**	**1,323,116**	**1,384,419**
Equity capital	18,988	18,988	18,988	18,988	18,988
Reserves and surplus	402,952	468,680	538,554	622,999	723,980
Net worth	**421,940**	**487,668**	**557,542**	**641,987**	**742,968**
Minority interest	25,285	28,563	29,351	31,302	35,623
Borrowings (ST + LT)	101,898	616,708	656,708	599,208	554,208
Other non-current liabilities	34,263	46,650	47,910	50,619	51,620
Total capital employed	**583,386**	**1,179,589**	**1,291,512**	**1,323,116**	**1,384,419**
Leverage and return ratios (%)					
Net debt (₹bn)	24	600	593	507	405
Net debt (US$bn)	0.5	13.4	13.3	11.4	9.1
Net debt-to-equity	6	123	106	79	55
Net debt-to-EBITDA (x)	0.1	2.9	2.4	1.7	1.2
RoAE	24.7	16.7	16.2	17.0	17.0
RoACE	19.5	10.4	8.6	10.2	11.7
Return on operating assets	22.4	10.9	8.8	10.6	12.6

Source: Company, Anand Rathi Research

Fig 42 – Consolidated cash-flow statement

Year-end: Mar (₹m)	FY10	FY11	FY12e	FY13e	FY14e
Cash flows from operations					
PBT	105,091	76,782	97,302	135,749	178,883
Depreciation and amortisation	62,833	102,066	130,477	135,149	139,450
Other non-cash items	1,973	2,098	94	94	94
Net finance costs	175	21,813	24,553	21,852	15,520
Operating cash profits	**170,072**	**202,759**	**252,426**	**292,844**	**333,948**
Working capital changes	12,227	8,203	(39,395)	4,842	(5,261)
Interest received	2,038	565	556	3,260	5,178
Income tax (paid)/refunded	(21,961)	(24,388)	(27,981)	(35,933)	(50,188)
Net cash flow from operating activities	**162,376**	**187,139**	**185,606**	**265,013**	**283,677**
Cash flows from investing activities					
Purchase/(Sale) of fixed assets	(122,136)	(108,940)	(140,954)	(132,099)	(125,771)
Acquisition of intangible assets	(2,527)	(167,925)	0	0	0
Acquisitions	1	(372,676)	0	0	0
Changes in ST investments	(13,288)	46,590	(24,813)	(14,080)	(28,506)
Net cash flow from investing activities	**(137,950)**	**(602,951)**	**(165,767)**	**(146,179)**	**(154,277)**
Cash flows from financing activities					
Net proceeds for borrowings/(repayments)	(1,173)	429,586	40,000	(57,500)	(45,000)
Issue of equity/(dividends)	(4,442)	(4,830)	(8,958)	(22,142)	(33,213)
Interest paid	(6,368)	(21,595)	(25,109)	(25,112)	(20,698)
Others	117	(6,178)	0	0	0
Net cash inflow / (outflow) from financing activities	**(11,866)**	**396,983**	**5,933**	**(104,754)**	**(98,911)**
Effect of exchange rate changes	0	(123)	0	0	0
Net change in cash and equivalents	12,560	(18,952)	25,772	14,080	30,489
Add : Balance as at the beginning of the period	12,763	24,961	6,009	31,781	45,861
Balance as at the end of the period	**25,323**	**6,009**	**31,781**	**45,861**	**76,350**

Source: Company, Anand Rathi Research

ANANDRATHI

India I Equities

Telecommunications

Update

Change in Estimates ☑ Target ☑ Reco ☐

20 June 2011

Idea Cellular

Attractive growth play on the Indian wireless market; Buy

Rating: **Buy**
Target Price: ₹96
Share Price: ₹78

Idea has shown excellent execution skills in the wireless market, especially during the competition-marred downtrend and subsequent recovery. We believe Idea has vast potential to outstrip peers' earnings growth following its strong revenue growth and margin expansion. We roll over our Jun '12e target price to ₹96, from ₹76 for Jun '11e.

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- **At the forefront of industry recovery.** Idea's revenue growth for FY11 was 19.3% vs. 11.5% for the industry. The company has been gaining market share since FY09, through consolidation in established circles and expansion into new circles. In fact, it posted the highest market-share gain in FY10 (113bps).
- **Significant operating leverage potential.** At present Idea operates in new circles at sub-scale levels. Hence, it has the potential to achieve growth, even as its capex intensity moderates. (We expect capex-to-sales to moderate to ~14% in FY14 from 19% in FY11.) We estimate Idea's EBITDA margin to expand by 300bps over FY11-14 and by ~700bps in the long term.
- **Change in estimates.** Our FY12-13 EBITDA is largely unchanged. However, we raise our FY12e EPS by 87%, as we factor in the back-ended roll-out of 3G over FY12 (lower 3G amortization/interest costs). Our long-term EBITDA is up 4-8%.
- **Recommendation and Risk.** We maintain a Buy on Idea on its strong growth profile (FY12e-14e EBITDA CAGR of 19% vs. 15% for Bharti) and attractive valuations (a 7% discount to Bharti on FY12e EV/EBITDA). Risks: more-than-expected competition, regulatory impact (more than ₹10/share, which has been factored into our target price).

Key data	**IDEA IN/ IDEA.BO**
52-week high / low	₹80 / 53
Sensex / Nifty	17871 / 5366
3-m average daily volume	US$5.5m
Market Cap	₹256bn / US$5.7bn
Shares outstanding	3300m
Promoters	46.0
Free float	54.0
- Foreign institutions	9.9
- Domestic institutions	7.9
- Others [a]	36.2

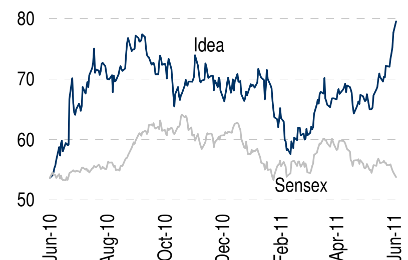
[a] Others includes Axiata (19.1%), Providence (10%), Indian Public (2.6), NRI/OCBs

Key consolidated financials [a]

Year-end: Mar, ₹m	FY10	FY11	FY12e	FY13e	FY14e
Revenues	124,471	155,032	187,814	219,011	246,684
EBITDA	33,472	37,907	47,587	56,674	67,418
Net profit	8,107	8,987	6,521	9,456	15,394
EPS (₹)	2.46	2.72	1.97	2.86	4.66
Revenue growth (%)	22.6	24.6	21.1	16.6	12.6
EBITDA growth (%)	18.6	13.3	25.5	19.1	19.0
EPS growth (%)	(17.0)	10.7	(27.4)	45.0	62.8
P/E (x)	31.6	28.5	39.3	27.1	16.7
EV/EBITDA (x)	9.6	9.5	7.5	6.3	5.1
RoAE (%)	6.5	7.4	5.0	6.9	10.4

Source: Company, Anand Rathi Research. [a] Idea's FY10 consol. financials include 16% of Indus and proportionate Spice (41%/100% for 11/1 months of FY10); Financials from FY11 include 100% of Spice and 16% of Indus

Relative price performance



Source: Bloomberg

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Quick Glance – Consolidated financials and valuations

Fig 1 – Consolidated income statement (₹m) [a]

Year-end: Mar	FY10	FY11	FY12e	FY13e	FY14e
Revenues	124,471	155,032	187,814	219,011	246,684
EBITDA	**33,472**	**37,907**	**47,587**	**56,674**	**67,418**
EBITDA margin (%)	**26.9**	**24.5**	**25.3**	**25.9**	**27.3**
Depr. & amortization	(20,149)	(23,973)	(31,753)	(33,895)	(36,888)
EBIT	13,322	13,933	15,834	22,778	30,530
Net Interest cost	(4,005)	(3,965)	(7,622)	(9,443)	(8,932)
PBT	9,317	9,969	8,212	13,335	21,598
Extraordinaries	1,436	0	0	0	0
Tax	(1,214)	(982)	(1,691)	(3,879)	(6,204)
Reported net income	9,539	8,987	6,521	9,456	15,394
Adjusted net income	**8,107**	**8,987**	**6,521**	**9,456**	**15,394**
Adjusted EPS	**2.46**	**2.72**	**1.97**	**2.86**	**4.66**
Revenue growth (%)	22.6	24.6	21.1	16.6	12.6
EBITDA growth (%)	**18.6**	**13.3**	**25.5**	**19.1**	**19.0**
EPS growth (%)	(17.0)	10.7	(27.4)	45.0	62.8

Source: Company, AR Research. [a] Includes Spice (100%) and Indus (16%) from FY11

Fig 4 – Rolling 12-month forward P/E

Source: Bloomberg, Company, Anand Rathi Research

Fig 2 – Consolidated balance sheet (₹m)

Year-end: Mar	FY10	FY11e	FY12e	FY13e	FY14e
Share capital	32,998	33,033	33,033	33,033	33,033
Reserves & Surplus	80,725	89,966	96,516	104,040	116,536
Shareholders' funds	113,724	122,999	129,549	137,073	149,569
Debt	78,593	120,228	120,598	117,018	107,158
Other non-current liab.	2,142	3,099	3,568	4,501	5,003
Capital employed	**194,459**	**246,326**	**253,715**	**258,592**	**261,730**
Fixed Assets	170,945	186,578	202,695	215,729	220,351
Investments	0	0	0	0	0
Other non-current assets	16,260	74,799	70,096	65,340	60,740
Net working capital	(6,949)	(29,828)	(38,277)	(41,398)	(41,593)
Cash & cash equivalents	14,204	14,777	19,201	18,922	22,231
Capital deployed	**194,459**	**246,326**	**253,715**	**258,592**	**261,730**
No. of shares (m)	3,300	3,303	3,303	3,303	3,303
Net Debt/EBITDA (x)	1.9	2.8	2.1	1.7	1.3

Source: Company, Anand Rathi Research

Fig 5 – Rolling 12-month forward EV/EBITDA

Source: Bloomberg, Company, Anand Rathi Research

Fig 3 – Consolidated cash flow statement (₹m)

Year-end: Mar	FY10	FY11e	FY12e	FY13e	FY14e
Profits before tax	9,317	9,969	8,212	13,335	21,598
Depr/amort/non-cash items	19,964	24,930	32,309	34,829	37,390
Taxes paid	(2,125)	(982)	(1,691)	(3,879)	(6,204)
Interest income [a]	(2,486)	(1,124)	(1,372)	(1,279)	(1,067)
Chg in working capital	(7,504)	22,879	8,449	3,121	195
CF from operations	**17,166**	**55,672**	**45,907**	**46,127**	**51,912**
Capex (incl. entry fee)	**(41,580)**	**(98,146)**	**(43,254)**	**(42,174)**	**(36,911)**
Free cash flow	**(24,414)**	**(42,474)**	**2,653**	**3,953**	**15,002**
Investments/others	2,901	1,124	1,372	1,279	1,067
Equity raised	23	289	29	0	(0)
Debt raised / (repaid)	(15,779)	41,635	370	(3,580)	(9,860)
Dividends paid	0	0	0	(1,932)	(2,899)
Change in cash	**(37,269)**	**573**	**4,424**	**(280)**	**3,310**
Beginning cash	**51,473**	**14,204**	**14,777**	**19,201**	**18,921**
Closing cash	**14,204**	**14,777**	**19,201**	**18,921**	**22,231**

Source: Company, Anand Rathi Research [a] Classified in cash flow from investments

Fig 6 – Rolling 12-month forward EV/sales

Source: Bloomberg, Company, Anand Rathi Research

Investment Argument

Idea has shown excellent execution skills in the wireless market, especially during the competition-marred downtrend and subsequent recovery. We believe it has vast potential to outstrip peers' earnings growth following its strong revenue growth and margin expansion. We roll over our Jun '12e target price to ₹96, from ₹76 for Jun '11e. We maintain a Buy on Idea due to its strong growth profile (FY12e-14e EBITDA CAGR of 19% vs. 15% for Bharti) and attractive valuations (a 7% discount to Bharti on FY12e EV/EBITDA).

Attractive growth play on the Indian wireless market

At the forefront of recovery in the wireless market in India

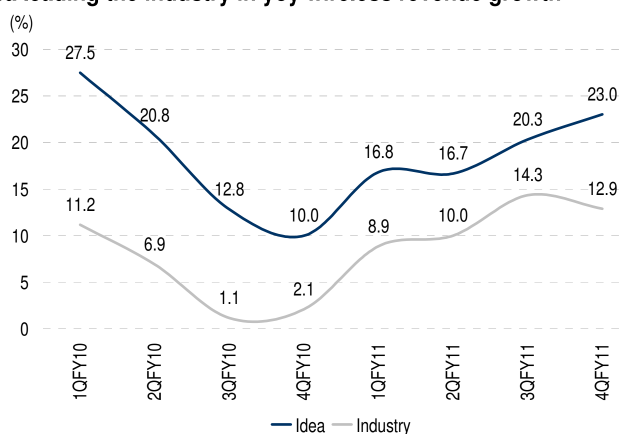
Idea has been at the forefront of the recovery in the wireless market; its yoy revenue growth for FY11 was 19.3% vs. 11.5% for the industry

Idea has been gaining market share since FY09, through consolidation in established circles and expansion in new circles. In fact, the company recorded the highest market share gains in FY11 (113bps).

We attribute Idea's growth outperformance to aggressive network expansion and focus on marketing. Idea has gained significant traction in many of its new circles. Further, it has consolidated its position in its established circles.

The wireless sector in India has been witnessing recovery from 1QFY11, with ARPMs beginning to stabilize after tariff cuts across the industry in 3QFY10. Idea has been at the forefront of this recovery. Its revenue growth in FY11 stood at 19.3% vs. 11.5% for the industry.

Fig 7 – Idea leading the industry in yoy wireless revenue growth



Source: TRAI

We believe that in light of the improved industry outlook, Idea could pursue an even more aggressive expansion, which could drive the growth rate higher. Further, Idea's 3G expansion plans appear the most aggressive among leading players. We believe 3G has potential to drive revenue growth and margin in the long term as, unlike the 2G/voice market, the 3G market would be consolidated due to fewer players.

Strong execution track record

Idea has displayed remarkable skills in strategic as well as tactical planning and execution in the areas of network expansion, M&A, fund-raising, tariff wars and 3G bidding. For instance, following Aditya Birla's buyout of

Tata's stake in Idea in '05, Idea began its aggressive expansion as the industry was growing rapidly and competition was benign. However, following the tariff wars towards end '09, Idea moderated its capex plans, anticipating lower loading of its network. Because of its strategic and tactical decisions, Idea has managed to emerge strongly through the tariff wars and the subsequent recovery in the wireless market.

On various occasions Idea has demonstrated remarkable skills in strategic as well as tactical planning and execution

In '08, Idea acquired Spice Communications, which was present in the Punjab and Karnataka circles, using the efficient 900MHz spectrum. The company funded the deal via issue of fresh equity at rich valuations to Malaysia-based Axiata (a shareholder of Spice Communications) that was keen to expand its India exposure.

Further, at the 3G spectrum auctions, Idea's spend was equivalent to 41% of its revenue, which was lowest among telcos; however, Idea's 3G circles covered 79% of its 2G revenues, which is the second highest among telcos.

Significant operating-leverage potential

Before Idea embarked on an aggressive footprint expansion in '06-07, it had a similar EBITDA margin as market leader Bharti's (~37%). However, since then, Idea's margin has declined owing to continuous expansion of the company into new circles. The current gap in wireless EBITDA margins of Idea (21.2%) and Bharti (33.5%) is indicative of EBITDA margin expansion potential for Idea.

Idea is operating in new circles at sub-scale levels which will aid the company to achieve growth even as its capex intensity moderates (expect capex-to-sales to moderate to ~15% in FY13e from ~20% in FY11), resulting in operating leverage. In this regard, the rising trend in Idea's minutes per BTS and revenue per BTS and decline in gap vis-à-vis Bharti is encouraging.

Target price, Valuation and Risk

Jun '12e price target of ₹96/share

Our Jun '12e SOTP-based price target for Idea, at ₹96/share, comprises ₹70 (based on DCF methodology for Idea excl. Indus) from the core mobile services business and ₹20 (based on DCF) from Idea's 13.4% effective stake in Indus Towers. Our price target captures potential value erosion (₹10/share) from the proposed changes in telecom policies, on the lines of TRAI recommendations.

Fig 8 – Target-price revision

(₹)	Previous target price (Jun '11e)	Revised target price (Jun '12e)	Comments
Value of wireless business	60	86	Roll forward our DCF-based target price (impact of ₹9/sh); increase in earnings
Value of Indus stake	20	20	
SOTP value	**80**	**106**	
Impact of TRAI recommendations	(4)	(10)	Capturing entire estimated impact
Target price	**76**	**96**	

Source: Anand Rathi Research

Fig 9 – Idea Cellular excl. Indus: DCF summary

Year-end: Mar, ₹m	FY11	FY12e	FY13e	FY14e	FY15e	FY16e	FY17e	FY18e	FY19e	FYFYe	FY21e	FY22e
Key assumptions (%)												
Revenue growth	19.7	20.1	16.6	12.6	9.7	7.0	6.2	5.2	4.7	4.4	4.1	4.1
EBITDA growth	14.0	27.6	18.3	19.1	13.6	9.1	9.6	6.9	6.4	6.0	5.7	5.8
FCF growth	NM	NM	(0.0)	95.7	58.5	24.2	9.8	6.1	5.3	(0.8)	2.3	4.4
EBITDA margin	**21.0**	**22.3**	**22.7**	**24.0**	**24.8**	**25.3**	**26.1**	**26.5**	**27.0**	**27.4**	**27.8**	**28.2**
FCF margin	(22.5)	4.8	4.1	7.1	10.3	12.0	12.4	12.5	12.6	11.9	11.7	11.8
Capex / Sales	**58.2**	**21.5**	**18.1**	**14.1**	**11.0**	**10.0**	**9.3**	**9.2**	**9.4**	**9.6**	**10.0**	**10.2**
Net Debt / Capital	46.2	43.9	41.7	36.2	26.3	12.2	(6.0)	(28.5)	(55.4)	(83.8)	(114.1)	(146.1)
ROCE	5.8	5.1	6.4	8.5	10.5	12.2	13.2	14.5	15.3	14.8	13.9	13.2
EBIT X (1-tax rate)	11,619	11,512	14,938	18,906	22,525	25,121	26,982	30,164	34,686	38,710	41,504	45,697
Depreciation & Amortization	21,732	29,156	30,975	33,710	35,666	37,430	38,440	38,319	37,617	37,474	38,674	38,806
Change in net working capital	22,442	8,742	2,691	(195)	(570)	1,132	1,356	1,574	2,103	108	(90)	(508)
Operating FCF	55,793	49,411	48,605	52,421	57,621	63,683	66,778	70,058	74,406	76,293	80,087	83,995
Capital expenditure	(91,041)	(40,397)	(39,593)	(34,789)	(29,683)	(28,994)	(28,705)	(29,672)	(31,871)	(34,100)	(36,904)	(38,916)
Free cash flows	**(35,248)**	**9,014**	**9,012**	**17,632**	**27,938**	**34,689**	**38,074**	**40,386**	**42,535**	**42,192**	**43,183**	**45,079**

Mar-12e DCF calculation	
Terminal growth (%)	4.0
WACC (%)	12.0
Implied Exit FCF (x)	**12.9**
Implied Exit EBITDA multiple (x)	**5.38**
NPV of cash flows (FY13e-22e)	172,466
PV of terminal value	188,684
Enterprise value	**361,150**
Terminal value as % of EV	52%
FY12e Net debt	87,721
Equity value	273,429
Equity value (US$m)	**6,214**
Number of shares (m)	3,303
Equity value/share (₹)	**82.8**
[1] Wireless business (using DCF)	82.8
[2] Value of 13.4% effective stake in Indus	20.0
[3[Regulatory downside	(10.0)
Mar-12e SOTP value (₹) [1[+[2]+[3]	**92.8**
June '12e target price (₹)	**96.0**

Sensitivity of Jun-12e target price to WACC and perpetual growth

Perpetual growth rate (%)	WACC (%)				
	12.00	**12.25**	**12.00**	**12.25**	**12.50**
3.0	89	86	89	86	83
3.5	92	89	92	89	86
4.0	96	92	**96**	92	89
4.5	100	96	100	96	92
5.0	105	101	105	101	96

Sensitivity of exit EV/EBITDA to WACC and perpetual growth

Perpetual growth rate (%)	WACC (%)`				
	12.0	**12.3**	**12.5**	**12.8**	**13.0**
3.0	5.0	5.0	5.0	5.0	5.0
3.5	5.3	5.3	5.3	5.3	5.3
4.0	5.7	5.7	**5.7**	5.7	5.7
4.5	6.1	6.1	6.1	6.1	6.1
5.0	6.5	6.5	6.5	6.5	6.5

Source: Company, Anand Rathi Research

Note: [a] Above DCF is for Idea + 100% Spice; Value of Indus stake added separately to DCF value to arrive at the target price

Our revised price target factors in most of the risks posed by TRAI recommendations

Our revised target price captures ₹10/share impact of the proposed changes in regulations, on the lines of TRAI recommendations. Earlier, we had accounted for an impact of only ₹4/share (applying a 50% discount to our then estimated impact of ₹8/share).

Fig 10 – Potential impact of TRAI recommendations on our price target

	₹ bn	₹/sh
One-time fee for excess 2G spectrum	(15)	(4.6)
License renewal cost (present value)	(41)	(12.5)
Increase in spectrum usage fee (SUF) as a percentage of AGR	(15)	(4.5)
Reduction in annual license fee to a uniform 6%	38	11.5
Total impact	**(33)**	**(10.1)**

Source: TRAI, Anand Rathi Research

Regulatory risks regarding the Spice merger

Idea faces regulatory risks related to its Spice merger. As per media (*The Economic Times* dated 7 Apr '11), the Department of Telecommunications

(DoT) has proposed a ₹3bn penalty on Idea for violation of M&A rules during the acquisition/merger of Spice Telecom. DoT has also suggested cancellation of six overlapping licenses (Idea: 2; Spice: 4). Further, DoT has approached for a stay on the Delhi High Court's order allowing the merger. While hearing the case, the HC has indicated that if any suppression of facts by the company is discovered, action would be taken against the relevant officials, although it may not pass any judgements affecting the company's shareholders.

Notably, Idea had bid for 3G spectrum in the Punjab through Spice's license, which DoT has proposed to be cancelled.

Idea has contended the penalty, arguing that it had intimated DoT about its proposal to merge Spice with itself, did not use overlapping licenses/spectrum and had itself offered to surrender the overlapping licenses during the acquisition/merger.

We believe implications of the Spice merger issue include:

i) the financial penalty, not significant in our view (~1% of market cap);

ii) forfeiture of license fees paid towards overlapping licenses (which is a sunk cost); we see no incremental impact;

iii) delay/uncertainty in allocation of 3G spectrum in the Punjab circle (one of the overlapping circles), for which the company paid ₹3.2bn. We believe cancellation of 3G spectrum is an unlikely outcome.

Discount to Bharti is unjustified

Idea trades at as much as 7% discount to Bharti on FY12e EV/EBITDA. The discount is even higher on growth-adjusted multiples (Fig 11). Despite higher risks, Idea deserves some valuation re-rating vis-à-vis Bharti, given its strong growth profile.

Fig 11 – Indian telcos: Valuations and Ratings

		Share price		Upside	Mkt Cap	P/E (x)		EPS CAGR (%)	P/E to	EV/EBITDA (x)		EBITDA CAGR (%)	EV/EBITDA
Year-end: Mar	Rating	(₹) [a]	TP (₹)	(%)	(US$ mn)	FY12e	FY13e	FY12e-14e	Growth (x)	FY12e	FY13e	FY12e-14e	to-Growth (x)
Bharti	Buy	380	455	20	32,193	18.3	13.6	30.6	0.60	8.1	6.7	15.1	0.54
RCom	Sell	95	90	(5)	4,375	18.7	16.9	22.6	0.83	6.6	5.7	6.9	0.96
Idea	**Buy**	**78**	**96**	**24**	**5,711**	**39.3**	**27.1**	**53.6**	**0.73**	**7.5**	**6.3**	**19.0**	**0.40**
TTML	Sell	16	12	(27)	693	NM	NM	(18.6)	NM	13.4	11.1	19.2	0.70
Tulip	Buy	156	225	44	505	6.8	6.0	27.1	0.25	5.2	3.6	22.3	0.23
Average (wireless)						**20.9**	**15.3**	**33.8**	**0.62**	**7.7**	**6.4**	**14.3**	**0.54**

Source: Bloomberg, Anand Rathi Research *[a] as of 17 June '11*

Risks

- More-than-expected competition in the Indian wireless market poses a risk to our estimates and price target.
- Regulatory impact of +₹10/share would be a risk to our price target.

Change in estimates

Our FY12e-13e EBITDA is largely unchanged. However, we increase our FY12e EPS by 87% as we factor in the back-ended roll-out of 3G over FY12 (lower 3G amortization/interest costs). Our long-term EBITDA is up 4-8% (Fig 12).

Fig 12 – Summary of key changes to consolidated estimates

Year-end: Mar (₹m)	FY12e	FY13e	FY14e	FY15e	FY16e
Operating revisions					
Idea subscribers (m): Previous	96.1	106.4	114.0	119.7	123.6
Idea subscribers (m): Revised	113.9	133.4	147.1	156.6	163.3
Revision (%)	***18.6***	***25.4***	***29.0***	***30.9***	***32.1***
ARPU (₹): Previous	169	167	169	170	172
ARPU (₹): Revised	153	147	146	148	151
Revision (%)	***(9.2)***	***(11.7)***	***(13.3)***	***(12.9)***	***(12.2)***
MOU: Previous	386	385	385	385	385
MOU: Revised	362	350	355	359	355
Revision (%)	***(6.4)***	***(9.1)***	***(7.9)***	***(6.6)***	***(7.9)***
ARPM incl. 3G (₹): Previous	0.44	0.43	0.44	0.44	0.45
ARPM incl. 3G (₹): Revised	0.42	0.42	0.41	0.41	0.42
Revision (%)	***(3.0)***	***(2.8)***	***(5.8)***	***(6.7)***	***(4.7)***
Financial revisions					
Revenues: Previous	183,538	209,342	234,406	254,246	269,941
Revenues: Revised	187,814	219,011	246,684	270,570	289,556
Revision (%)	***2.3***	***4.6***	***5.2***	***6.4***	***7.3***
EBITDA: Previous	48,343	57,422	67,414	75,504	82,109
EBITDA: Revised	47,587	56,674	67,418	76,526	83,611
Revision (%)	***(1.6)***	***(1.3)***	***0.0***	***1.4***	***1.8***
EBITDA margin: Previous	26.3	27.4	28.8	29.7	30.4
EBITDA margin: Revised	25.3	25.9	27.3	28.3	28.9
Revision (bps)	***(100)***	***(155)***	***(143)***	***(141)***	***(154)***
Adjusted PAT: Previous	3,477	7,504	12,932	18,851	24,106
Adjusted PAT: Revised	6,521	9,456	15,394	21,680	27,261
Revision (%)	***87.6***	***26.0***	***19.0***	***15.0***	***13.1***
Diluted EPS (₹): Previous	1.05	2.27	3.92	5.71	7.31
Diluted EPS (₹): Revised	1.97	2.86	4.66	6.56	8.25
Revision (%)	***87.4***	***25.9***	***18.9***	***14.9***	***13.0***
Capex: Previous	42,134	36,966	34,210	28,410	26,223
Capex: Revised	43,254	42,174	36,911	31,344	30,555
Revision (%)	***2.7***	***14.1***	***7.9***	***10.3***	***16.5***

Source: Anand Rathi Research

At the forefront of industry recovery

Idea has been gaining market share since FY09 through consolidation in established circles and expansion in new circles. Further, the company has been at the forefront of the recovery in the Indian wireless market; its yoy revenue growth for FY11 stood at 19.3%, vs. 11.5% for the industry. We believe that in light of the improved industry outlook, Idea is likely to pursue a more aggressive expansion.

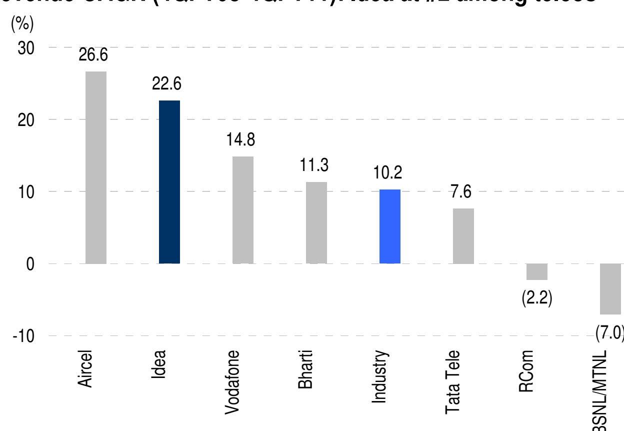
In a high growth phase

Of the leading telcos, Idea has been the second fastest growing company

We believe Idea is in a high growth phase. It is one of the fastest-growing companies, second only to Aircel. It registered a 23% revenue CAGR over 4QFY08-4QFY11, against Bharti's 11%, Vodafone's 15% and the industry's 10%. Idea's growth out-performance may be attributed to:

1. **Network expansion:** Idea undertook strong network expansion during FY06-10, increasing its cell-site count to 66,000 in FY10 from ~4,800 in FY06, in both the existing and new circles.
2. **Focus on marketing:** Idea's footprint expanding, from eight circles in FY08 to all-India at present, has made national-level brand building (TV advertising) viable. Hence, its expenditure on sales and marketing was significant over FY06-10. Idea's focus on marketing backed by aggressive network expansion has led to its high growth rate.

Fig 13 – Revenue CAGR (4QFY08-4QFY11): Idea at #2 among telcos



Source: TRAI

Good traction in new circles

Idea began aggressively expanding its footprint with launch of operations in three new circles – Uttar Pradesh (East), Rajasthan and Himachal Pradesh – in mid-CY06. Subsequently, it entered the Mumbai and Bihar circles in CY08 and concluded laying its pan-India footprint via launch of operations in the seven remaining circles over Apr-Dec '09; the company forayed into two circles – Punjab and Karnataka – by acquiring Spice Communications in CY08. Further, Idea has gained significant traction in many of its new circles (Fig 14).

Fig 14 – Idea has gained strong traction in several of its new circles

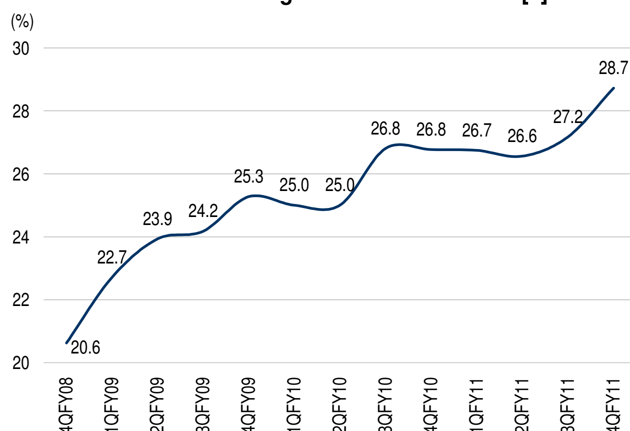
Circle	Date of launch	Rev. market share in 3QFY11 (%)	Comments on market-share changes
Bihar	3QFY09	9.0	Overtaken BSNL, RCom and Aircel; currently the fourth-largest player
Mumbai	2QFY09	7.0	Decent market share despite Mumbai being a more mature market; overtaken MTNL in market share.
Uttar Pradesh (E)	3QFY07	11.2	Overtaken RCom, TTSL and BSNL to emerge as the #3 operator
Rajasthan	3QFY07	8.9	Overtaken BSNL, RCom and TTSL; currently the third largest player

Source: TRAI, Anand Rathi Research

Consolidating its strong position in established circles

Besides its foray into new circles, Idea's high revenue growth was driven by consolidation of its position in established circles. Over the past 3-4 years, Idea has steadily increased its market share in its established circles, from 20.6% in 4QFY08 to 28.7% in 3QFY11. The rise in market share is mainly on account of continuous network expansion and focus on marketing.

Fig 15 – Revenue market shares in eight established circles [a]



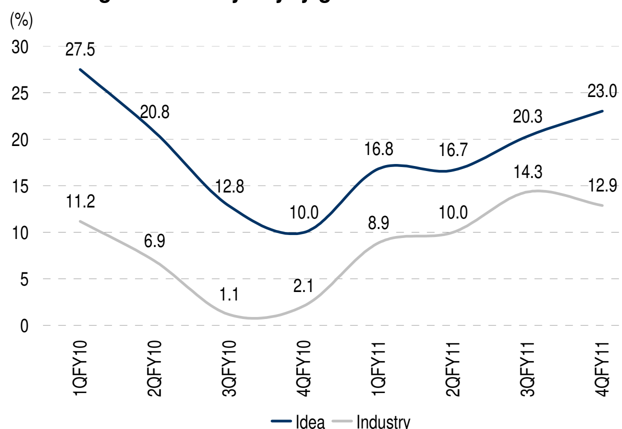
Source: TRAI *[a] Established circles are Delhi, Maharashtra, Gujarat, AP, UP (West), MP, Haryana and Kerala*

At the forefront of recovery in India Wireless

The Indian wireless market started witnessing recovery from 1QFY11, with ARPM beginning to stabilize post industry-wide tariff cuts in 3QFY10. After remaining flat during 2HFY10, industry revenue grew 9% in 1QFY11. The revenue growth gradually accelerated to 13% by 4QFY11.

Idea has been at the forefront of the recovery in the wireless market in India. Idea's revenue grew 10% in 4QFY10. The revenue growth gradually accelerated to 23% by 4QFY11. Idea's revenue growth for FY11 stood at 19.3% vs. 11.5% for the industry.

Fig 16 – Idea leading the industry in yoy growth in wireless revenue

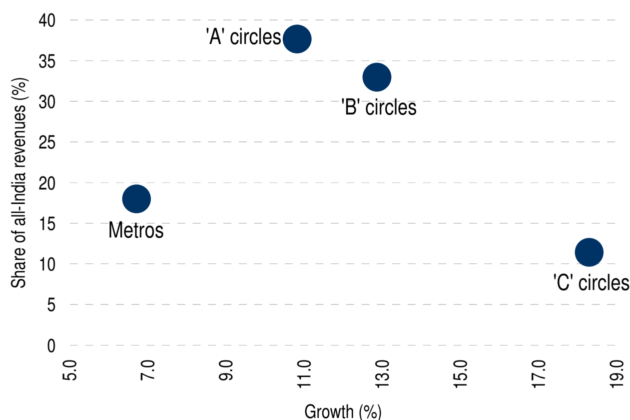


Source: TRAI

Attractive footprint

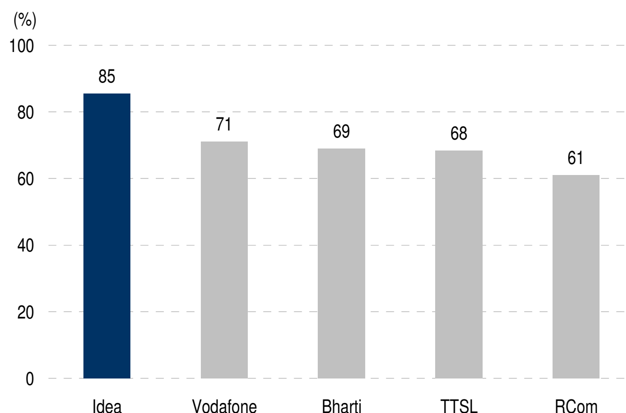
Idea derives 85% of its revenue from Category A & B circles, which have been witnessing high growth rates. In comparison, these circles account for only 60-70% of revenue in case of leading peers. While Category C circles have been recording the highest growth rates, their share of revenue market share from low.

Fig 17 – Growth and size profile of different categories of telecom circles



Source: TRAI Note: i) Growth profile based on yoy revenue growth in 4QFY11; ii) Share in all-India revenues pertains to FY11

Fig 18 – Share of categories A & B circles in operators' revenues (3QFY11)

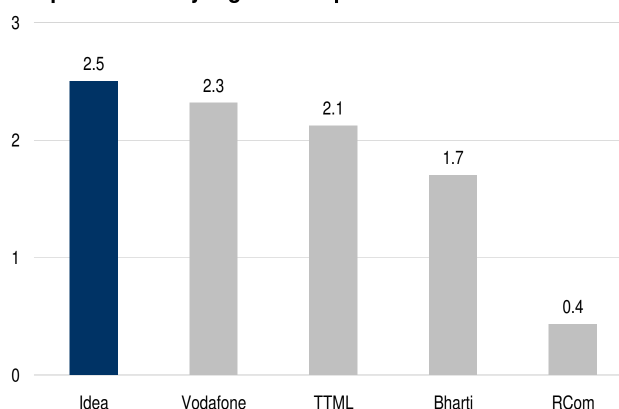


Source: TRAI

Superior subscriber base

Idea's volumes have displayed good elasticity to sharp cuts during the tariff war in 3QCY09, against subdued traffic growth for RCom and TTML despite tariff cuts. We believe the high price elasticity for Idea indicates that the quality of Idea's subscriber base is superior to those of RCom and TTML.

Fig 19 – Idea's price elasticity higher than peers'



Source: Companies
Note: Price elasticity = (cumulative % growth in wireless traffic over 1QFY10-3QFY11) / (cumulative % decline in revenue per min over 1QFY10-3QFY11)

New circles, 3G to drive growth

New circles could see stronger thrust

Since CY08, Idea has launched operations in nine circles, including the significant Mumbai, Bihar and Tamil Nadu circles. Besides, operations in Karnataka have seen considerable scale up post the acquisition of Spice Communications in Mar '08. Notably, the company has spectrum in the attractive 900MHz band. Together, the ten circles recorded 59% yoy revenue growth in 4QFY11 and accounted for 11% of the company's revenues in 4QFY11. Owing to a competitive industry environment, Idea had being selective in network roll-out in many of these circles. We believe that in light of the improved industry outlook, Idea could pursue an even more aggressive expansion, which would lead to a higher growth rate.

Aggressive push to 3G

We believe 3G has potential to drive revenue growth and margins in the long term, as, unlike the 2G/voice market, the 3G market would be consolidated due to the auction of only three 3G slots in May '10

Idea's 3G expansion plans appear to be the most aggressive among peers, with planned launches of 3G services in 750 cities and towns by end-FY11 and in 400 cities and towns by end-FY12. Bharti targets presence in 1,000 cities by end-FY12. While the varying definitions of a city/town and their constituents may mask the actual difference in the scale of the 3G roll out, we believe that Idea is likely to be on par with, if not above, other leading telcos such as Bharti and Vodafone.

Notably, in its earnings call for 1QFY11, Idea's management had stated that it plans aggressive 3G expansion (3G coverage of +25% of 2G coverage in less than a year) that would be front ended. We believe 3G has potential to drive revenue growth and margin in the long term as, unlike the 2G/voice market, the 3G market would be consolidated due to auction of only three 3G slots in May '10.

Strong execution track record

Idea has displayed remarkable skills in strategic as well as tactical planning and execution in the areas of network expansion, M&A and fund-raising as well as during the tariff wars and 3G bidding. We believe this excellent track record has placed Idea in a strong position for pursuing aggressive expansion in new circles and 3G.

Strong track record on planning and execution …

Idea has displayed remarkable skills in strategic as well as tactical planning and execution in the areas of network expansion, M&A and fundraising as well as during the tariff wars and 3G bidding. Some instances outlining the company's proficiencies are:

i) Aggressive expansion after the Aditya Birla Group took complete control

Following the Aditya Birla Group's buyout of the Tata Group's stake in Idea in '05, Idea began an aggressive expansion on the back of significant increase in capex plans. The market was in the high growth phase then, RCom's CDMA expansion had slowed ahead of its planned foray in GSM, and BSNL was facing capacity constraints on account of legal issues around its large network equipment tender. Idea's plans to aggressively expand its network, even at the cost of short-term margin pressure were supported by the industry environment.

ii) Effective response to increase in completion and industry oversupply

In '09, RCom and TTSL launched their nation-wide GSM network. Towards end '09, the industry found itself in the midst of a tariff war. In reaction to falling tariffs and increase in industry supply (launch of GSM networks by RCom and TTSL, entry of Uninor), Idea moderated its capex plans, anticipating lower loading of its network.

Further, in light of certain industry issues (stringent equipment import policy), Idea decided to undertake a measured roll-out in new circles. It maintained it plans to pursue aggressive expansion in circles where it had strong presence and a 900MHz band spectrum.

Concurrently, even though Idea reduced its tariffs so as to not lose significant ground to challengers in the market, it managed to maintain some premium over the lowest tariffs in the market.

Because of its strategic and tactical decisions, Idea has managed to emerge strongly through the tariff wars and the subsequent recovery in the wireless market

Owing to its prudent strategic and tactical decisions, Idea has emerged strong from the tariff wars and the subsequent recovery in the wireless market (as aforementioned).

iii) Effective capture of tower business value

When the concept of an independent tower company began to emerge and attract investors, Idea responded with the most compelling option – teaming with leading peers (Bharti and Vodafone) to pool their tower portfolios in a separate company, Indus Towers. Further, Idea sold 20% of its indirect stake in Indus to raise funds of ~₹20bn, for meeting its expansion needs.

iv) Tactical funding for M&A

In '08, the company acquired Spice Communications, which already had presence in the Punjab and Karnataka circles and was using the efficient 900MHz spectrum. For funding the acquisition (which appeared

considerably expensive, based on the company's prevalent fundamentals), Idea issued fresh equity to Malaysia-based Axiata, a shareholder of Spice Communications and which was keen to expand its India exposure. Through this issue, Idea raised ₹73bn via a dilution of ~15% stake at ₹157 per Idea share (Idea's all-time high share price is ₹161, attained in Oct '07). Axiata's shareholding further increased to 20% on the merger of Spice and Idea. Notably, Idea's stake sale to Axiata did not involve significant loss of management control. This is evident from the fact that despite holding 20% stake in Idea, Axiata had only one representative in Idea's 10-member board of directors.

v) Effective bidding at the 3G auctions

At the 3G spectrum auctions held in May '10, Idea spent ₹58bn on acquiring 3G spectrum in 11 circles. The outlay on 3G spectrum was equivalent to 41% of its revenue, the lowest amongst all telcos that won spectrum at the auctions. However, Idea's 3G circles covered 79% of its 2G revenues, which is second highest (following Aircel). Besides, Idea's 3G circles represent the most contiguous 3G footprint among all telcos.

Fig 20 – Outcome of 3G auctions held in May '10

	Bharti	Vodafone	RCOM	Idea	TTSL	Aircel
Number of 3G circles	13	9	13	11	9	13
All -ndia revenue covered (%)	61	52	46	49	44	55
Share of own-access-revenue covered (%)	**69**	**68**	**55**	**79**	**43**	**91**
3G bid as % of current (4QFY10) access revenues	35	50	67	41	61	133

Source: DoT, TRAI

… gives Idea a sturdy foothold

Idea has managed to emerge as a national operator with a decent 3G spectrum portfolio, even with controlled leverage

Idea's prudent planning and execution has placed it in a strong position. Until early '06, Idea had a small geographical presence, limited to eight circles. During '06-10, due to effective decision-making regarding expansion strategy, funding, M&A and 3G funding, Idea emerged as the national operator with a decent 3G spectrum portfolio, while keeping its leverage ratios in control. Idea's net debt-to-EBITDA was 2.8x in 3QFY11; we expect this to decline to 2.4x in FY12 and 1.8x in FY13.

With the industry back on the growth path, we believe Idea is in a strong position to pursue aggressive expansion on 3G expansion and in new circles.

Significant operating leverage potential

Idea is operating in new circles at sub-scale levels, which would aid it in attaining growth even as its capex intensity moderates (we expect capex-to-sales to moderate to ~14% in FY14 from 19% in FY11). Excluding Indus, we have assumed Idea's EBITDA margin to expand by 300bps over FY11-14 and by ~700bps in the long term.

Bharti's margin indicates room for expansion in Idea's margin

Before Idea embarked on aggressive footprint expansion in '06-07, it had a similar EBITDA margin as market leader Bharti's (~37%). However, since then, Idea's margin has declined owing to continuous expansion of the company into new circles. At present, Idea's wireless EBITDA margin (21% in 4QFY11) is 1,400bps lower than Bharti's wireless EBITDA margin (34.9%). We believe the difference in the EBITDA margins of Idea and Bharti is indicative of EBITDA margin expansion potential for Idea, even if one were to consider: i) Idea's ARPU at ~15% discount to Bharti and ii) the fact that Idea (unlike Bharti) is a late entrant in many circles.

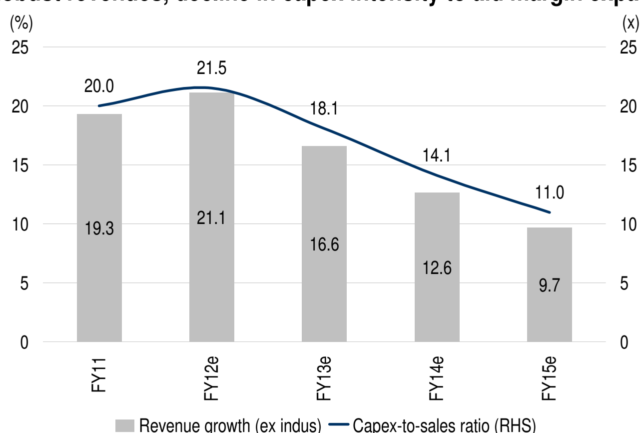
Besides, the current gap between Bharti and Idea's underlying wireless EBITDA margins appears lower than the actual. While Bharti's wireless business leases all its sites (either from Infratel, Indus, or others), Idea hosts some of its BTSs (base transceiver stations) at its owned sites/towers (~15% as of end-1QFY10); estimated positive impact on Idea's EBITDA margin is 100-150bps.

Revenue growth to back operating leverage potential

Idea's wireless revenue (ex-Indus) has seen 19% CAGR during FY09-11 (#2 among the leading telcos), driven by expansion in new circles and consolidation of its market position in established circles. We expect the company to maintain annual revenue growth of 18% over FY11-13e (vs. 11% for Bharti).

Idea is operating in new circles at sub-scale levels, which will help the company achieve growth even as its capex intensity moderates (expect capex-to-sales to moderate to ~14% in FY14 from 19% in FY11), resulting in operating leverage.

Fig 21 – Robust revenues, decline in capex intensity to aid margin expansion

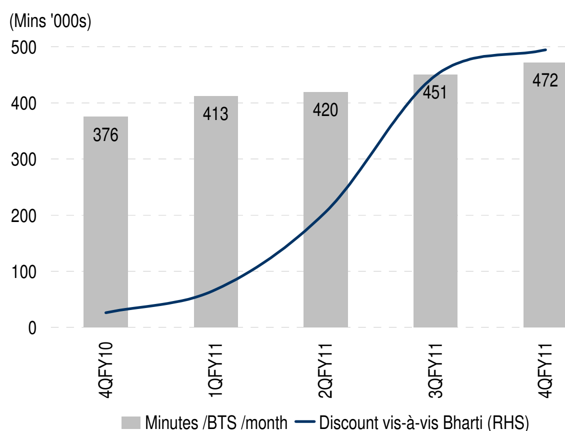


Source: TRAI, Company, Anand Rathi Research

Idea has shown promise in recent quarters

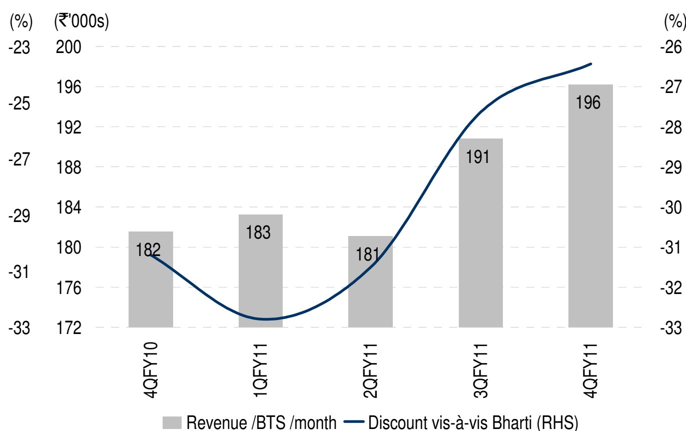
Idea's minutes per BTS (a rough barometer of network utilization) and revenues per BTS have displayed a rising trend over the past 5-6 quarters. Also, the company has managed to reduce the gap with Bharti on these metrics. This highlights Idea's ability to exploit operating leverage inherent in the business.

Fig 22 – Idea's minutes per BTS is rising ...



Source: Companies

Fig 23 – ... and so is revenue per BTS



Source: Companies

Sales & marketing costs to be a key source of margin expansion

Sales & marketing (S&M) cost accounted for ~15% of revenues in 4QFY11. We believe one third of the S&M costs pertain to dealer discount/ commissions, which are mainly subscriber acquisition costs (commission, incentives). Based on our expectations of decline in net additions going forward, we believe subscriber acquisition costs would reduce.

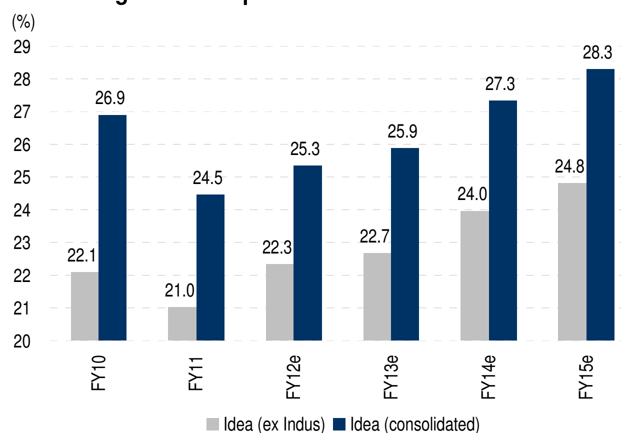
Besides, over the long term, Idea's marketing spend would spread over a larger revenue base, as revenue contribution from newly launched circles continues to increase. This would help Idea achieve faster decline in costs-to-sales vs. larger and established operators such as Bharti.

We estimate that sales & marketing costs-to-sales would gradually decline and stabilize at ~9% in the long term.

Expect 300bps expansion in EBITDA margins over FY11-14e

We have modelled Idea's ex Indus EBITDA margin to expand by 300bps over FY11-14e. Over the long-term, Idea's EBITDA margin would expand by 600-700bps in our view.

Fig 24 – EBITDA margin set to expand



Source: Company, Anand Rathi Research

Fig 25 – EBITDA margin drivers (cost breakdown as percent of revenues)

	FY11	FY12e	FY13e	FY14e
Interconnection & access costs	16.0	16.0	15.6	15.3
License & spectrum fee	11.4	11.3	11.3	11.4
Network costs	25.9	26.0	26.1	25.9
Sales & marketing costs	13.0	12.3	12.4	11.4
G&A costs	4.1	3.9	3.8	3.9
Employee costs	5.2	5.1	4.9	4.8
Total operating costs	**75.5**	**74.7**	**74.1**	**72.7**
EBITDA margin (%)	**24.5**	**25.3**	**25.9**	**27.3**

Source: Company, Anand Rathi Research

Financials

Idea's FY10 consolidated financials include 16% of Indus and a proportionate share of Spice (41%/100% consolidation for 11/1 months of FY10); financials from FY11 include 100% of Spice and 16% of Indus

Earnings are set to decline and bottom out in FY12 (impact of 3G costs–spectrum cost amortization, financing cost)

Fig 26 – Consolidated Income Statement

Year-end: Mar (₹m)	FY10	FY11	FY12e	FY13e	FY14e
Revenues	**124,471**	**155,032**	**187,814**	**219,011**	**246,684**
Operating costs					
Interconnection & access costs	(18,001)	(24,755)	(30,057)	(34,263)	(37,833)
License and spectrum fee	(13,718)	(17,728)	(21,222)	(24,840)	(28,063)
Network costs	(31,620)	(40,131)	(48,868)	(57,114)	(64,001)
Sales & marketing costs	(16,122)	(20,155)	(23,161)	(27,053)	(28,081)
G&A costs	(5,087)	(6,302)	(7,367)	(8,334)	(9,510)
Employee costs	(6,451)	(8,056)	(9,551)	(10,733)	(11,778)
Total operating costs	**(90,999)**	**(117,126)**	**(140,226)**	**(162,337)**	**(179,266)**
EBITDA	**33,472**	**37,907**	**47,587**	**56,674**	**67,418**
EBITDA margin (%)	***26.9***	***24.5***	***25.3***	***25.9***	***27.3***
Depreciation	(18,123)	(21,943)	(27,049)	(29,139)	(32,289)
Amortization of intangible assets	(2,026)	(2,031)	(4,704)	(4,756)	(4,600)
EBIT	**13,322**	**13,933**	**15,834**	**22,778**	**30,530**
Other income	0	0	0	0	0
Interest and FX income	2,809	1,124	1,372	1,279	1,067
Finance cost	(6,814)	(5,089)	(8,995)	(10,723)	(9,999)
PBT	**9,317**	**9,969**	**8,212**	**13,335**	**21,598**
Current tax expense	(30)	(25)	(1,134)	(2,945)	(5,702)
Deferred tax (liability)/asset	(1,184)	(957)	(557)	(934)	(502)
Reported PAT	**9,539**	**8,987**	**6,521**	**9,456**	**15,394**
Adjusted net profit	**8,107**	**8,987**	**6,521**	**9,456**	**15,394**
Adjusted EPS (₹)					
Primary EPS	2.46	2.72	1.97	2.86	4.66
Fully diluted EPS	2.46	2.72	1.97	2.86	4.66
Shares outstanding (mn)					
Primary shares (mn)	3,300	3,303	3,303	3,303	3,303
Fully diluted shares (mn)	3,300	3,303	3,303	3,303	3,303
Growth rates (%)					
Revenue	**22.6**	**24.6**	**21.1**	**16.6**	**12.6**
EBITDA	**18.6**	**13.3**	**25.5**	**19.1**	**19.0**
EBIT	(6.1)	4.6	13.6	43.9	34.0
Net profits	(6.4)	10.9	(27.4)	45.0	62.8
Diluted EPS	**(17.0)**	**10.7**	**(27.4)**	**45.0**	**62.8**
2-year forward Revenue CAGR (%)	22.8	18.9	14.6	11.1	8.3
2-year forward EBITDA CAGR (%)	9.0	27.9	38.9	28.3	18.2
2-year forward EPS CAGR (%)	(10.4)	2.6	53.6	51.4	33.1
Margins (%)					
EBITDA	**26.9**	**24.5**	**25.3**	**25.9**	**27.3**
EBIT	10.7	9.0	8.4	10.4	12.4
PBT	7.5	6.4	4.4	6.1	8.8
Net profits	**6.5**	**5.8**	**3.5**	**4.3**	**6.2**
Current tax rate (%)	0.3	0.2	13.8	22.1	26.4
Effective tax rate (%)	**11.3**	**9.8**	**20.6**	**29.1**	**28.7**

Source: Company, Anand Rathi Research

We expect net debt-to-EBITDA to fall sharply after peaking in FY11, mainly driven by strong EBITDA growth (FY11-13e CAGR of 28%)

Fig 27 – Consolidated balance sheet

Year-end: Mar (₹m)	FY10	FY11	FY12e	FY13e	FY14e
Equity					
Share capital	32,998	33,033	33,033	33,033	33,033
Reserves & surplus	80,706	89,947	96,497	104,021	116,517
Total equity	**113,724**	**122,999**	**129,549**	**137,073**	**149,569**
Deferred tax liability/(asset)	2,142	3,099	3,568	4,501	5,003
Debt					
Secured debt	73,166	57,801	47,804	41,724	34,364
Unsecured debt	5,427	62,427	72,794	75,294	72,794
Total debt	**78,593**	**120,228**	**120,598**	**117,018**	**107,158**
Total capital	**194,459**	**246,326**	**253,715**	**258,592**	**261,730**
Assets					
Cash	14,204	14,777	19,201	18,922	22,231
Other current assets	33,730	12,918	13,228	14,378	15,603
Current liabilities and provisions	40,680	42,746	51,505	55,776	57,195
Net working capital	**7,254**	**(15,051)**	**(19,076)**	**(22,477)**	**(19,361)**
Gross fixed assets	234,095	271,098	323,248	367,422	404,833
Less: accumulated depreciation	68,615	90,098	116,624	145,763	178,052
Net fixed assets	**165,480**	**181,000**	**206,624**	**221,659**	**226,780**
Capital WIP	5,465	5,578	-3,929	-5,929	-6,429
Net fixed assets incl. CWIP	**170,945**	**186,578**	**202,695**	**215,729**	**220,351**
Investments	0	0	0	0	0
Goodwill (from consolidation)	61	61	61	61	61
Intangible assets (entry fee)	16,199	74,738	70,034	65,278	60,679
Total assets	**194,459**	**246,326**	**253,715**	**258,592**	**261,730**
Gearing and profitability ratios (%)					
Net-debt	**64,409**	**105,470**	**101,416**	**98,115**	**84,946**
Net-debt (US$m)	**1,427**	**2,344**	**2,254**	**2,180**	**1,888**
Debt/Equity	69	98	93	85	72
Net-debt/Equity	**57**	**86**	**78**	**72**	**57**
Net-debt/EBITDA (x)	**1.9**	**2.8**	**2.1**	**1.7**	**1.3**
Net interest coverage (x) [a]	4.9	7.4	5.3	5.3	6.7
RoE (excl. Goodwill)	7.0	7.1	4.9	6.7	10.0
RoAE	**6.5**	**7.4**	**5.0**	**6.9**	**10.4**
RoACE	**6.0**	**5.8**	**5.1**	**6.4**	**8.5**

Source: Company, Anand Rathi Research *[a] Interest coverage defined as EBITDA/interest cost*

Includes 3G spectrum cost of ₹58bn

Fig 28 – Consolidated cash flow statement

Year-end: Mar (₹m)	FY09	FY10e	FY11e	FY12e	FY13e
Profits before tax	9,317	9,969	8,212	13,335	21,598
Depr/amort/non-cash items	19,964	24,930	32,309	34,829	37,390
Taxes paid	(2,125)	(982)	(1,691)	(3,879)	(6,204)
Interest income [a]	(2,486)	(1,124)	(1,372)	(1,279)	(1,067)
Chg in working capital	(7,504)	22,879	8,449	3,121	195
CF from operations	**17,166**	**55,672**	**45,907**	**46,127**	**51,912**
Capex (incl. entry fee)	(41,580)	(98,146)	(43,254)	(42,174)	(36,911)
(Purchase)/Sale of assets/investments	994	0	0	0	0
Interest/dividend received	1,906	1,124	1,372	1,279	1,067
CF from investments	**(38,680)**	**(97,022)**	**(41,882)**	**(40,895)**	**(35,844)**
Equity raised	23	289	29	0	(0)
Debt raised / (repaid)	(15,779)	41,635	370	(3,580)	(9,860)
Dividends paid	0	0	0	(1,932)	(2,899)
CF from financing	**(15,755)**	**41,924**	**399**	**(5,512)**	**(12,759)**
Change in cash for year	**(37,269)**	**573**	**4,424**	**(280)**	**3,310**
Beginning cash	**51,473**	**14,204**	**14,777**	**19,201**	**18,921**
Closing cash	**14,204**	**14,777**	**19,201**	**18,921**	**22,231**

Source: Company, Anand Rathi Research   *[a] Classified in cash flow from investments*

ANANDRATHI

India I Equities

Telecommunications
Update
Change in Estimates ☑ Target ☑ Reco ☐

20 June 2011

Reliance Communications

Challenging times continue; we reiterate a Sell

Rating: **Sell**
Target Price: ₹90
Share Price: ₹95

Reliance Communication (RCom) is faced with huge challenges on the operational, financial and regulatory fronts. We retain a Sell on the stock and lower our target for Jun '12e to ₹90 (from ₹110 for Mar '12e), mainly driven by the cut in our estimates (impact of ~₹13.5/share) and factoring in the regulatory risk (₹10/share).

- **Weak operating performance.** RCom's wireless revenue and EBITDA in the past six quarters have largely been flat, even as growth rates of leading peers in recent quarters have recovered. Besides, operational challenges exist in other segments (broadband and global) that have seen yoy revenue and EBITDA declines in the past four quarters.
- **High financial and regulatory risks.** While control on capex (FY12 guidance of ₹15bn) would partially address short-term liquidity requirements, we expect financial leverage for RCom to be substantially higher than those of peers. On the regulatory front, in addition to risks regarding TRAI recommendations (also faced by other telcos), ongoing investigations regarding the 2G spectrum controversy pose an additional overhang for RCom.
- **Change in estimates.** FY12e EBITDA is largely unchanged, but PAT is up 17% (back-ended 3G costs). We cut our long-term revenue and EBITDA forecasts by 7%-15% each, as we factor in slower expansion, in line with management's lower capex guidance.
- **Recommendation and Risk.** RCom trades at FY12e EV/EBITDA of 6.6x, at a ~19% discount to Bharti. We believe the discount is justified, given the slow growth, low return ratios and high financial and regulatory risks for RCom. We maintain a Sell. Risks: Monetization of the stake in Reliance Infratel and any M&A activity involving RCom as a target (such as a strategic stake sale).

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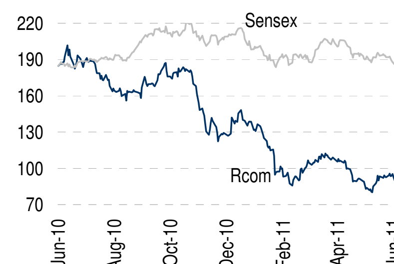
Key data	RCOM IN / RLCM.BO
52-week high / low	₹205 / ₹75
Sensex / Nifty	17871 / 5366
3-m average daily volume	US$18.7m
Market Cap	₹196bn / US$4.4bn
Shares outstanding	2064m
Promoters (%)	67.9
Free float (%)	32.1
- Foreign institutions	8.1
- Domestic institutions	9.1
- Others	14.9

RCom: Key consolidated financials

Year-end: Mar (₹m)	FY10	FY11	FY12e	FY13e	FY14e
Revenues	221,323	231,076	225,184	235,360	250,046
EBITDA	78,205	90,816	72,366	76,369	82,660
Adj. PAT [a]	20,474	14,834	10,472	11,593	15,751
EPS (₹)	9.92	7.19	5.07	5.62	7.63
EPS growth (%)	(54.8)	(27.5)	(29.4)	10.7	35.9
P/E (x)	9.6	13.2	18.7	16.9	12.5
EV/EBITDA (x)	5.7	5.7	6.6	5.7	4.8
Adj. P/B (x)	0.8	0.8	0.8	0.7	0.7
Dividend yield (%)	0.9	0.5	0.7	0.9	1.2
Adj. RoAE (%)	9.0	6.2	4.2	4.5	5.8

Source: Company *Note: [a] Adjusted PAT and EPS do not include any forex/derivative gains*

Relative price performance



Source: Bloomberg

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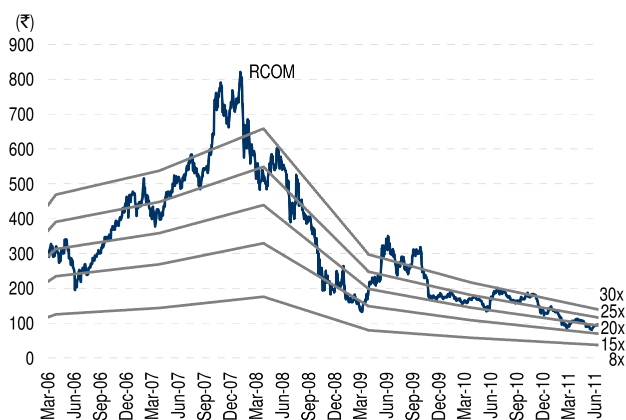
Quick Glance – Financials and Valuations

Fig 1 – Income statement (₹m)

Year-end: Mar	FY10	FY11	FY12e	FY13e	FY14e
Revenues	221,323	231,076	225,184	235,360	250,046
EBITDA	**78,205**	**90,816**	**72,366**	**76,369**	**82,660**
EBITDA margin (%)	35.3	39.3	32.1	32.4	33.1
Depr. & amortization	(37,465)	(65,038)	(45,079)	(47,729)	(47,567)
EBIT	**40,740**	**25,778**	**27,287**	**28,639**	**35,094**
Net Interest cost	(14,587)	(9,224)	(14,758)	(14,275)	(14,232)
PBT	**26,153**	**16,554**	**12,529**	**14,364**	**20,861**
Tax	(4,454)	(118)	(376)	(1,005)	(3,256)
Minority interest	(1,224)	(1,602)	(1,682)	(1,766)	(1,854)
Net Income (adj)	**20,474**	**14,834**	**10,472**	**11,593**	**15,751**
EPS (₹)	**9.92**	**7.19**	**5.07**	**5.62**	**7.63**
DPS (₹)	0.85	0.50	0.70	0.90	1.10
Revenue growth (%)	**(3.6)**	**4.4**	**(2.6)**	**4.5**	**6.2**
EBITDA growth (%)	**(17.1)**	**16.1**	**(20.3)**	**5.5**	**8.2**
EPS growth (%)	**(54.8)**	**(27.5)**	**(29.4)**	**10.7**	**35.9**

Source: Company, Anand Rathi Research

Fig 4 – Rolling 12-month forward P/E multiple



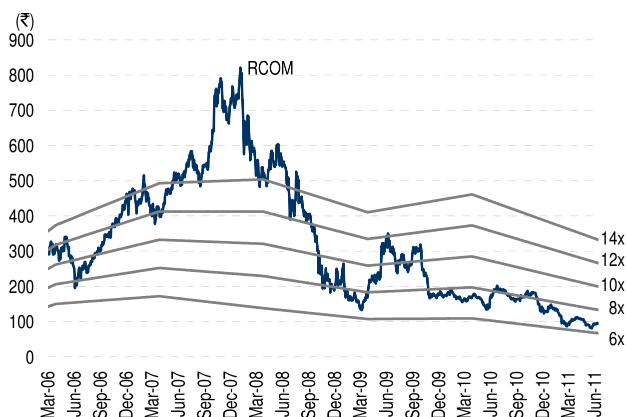
Source: Bloomberg, Company, Anand Rathi Research

Fig 2 – Balance sheet (₹m)

Year-end: Mar	FY10	FY11	FY12e	FY13e	FY14e
Share capital	10,320	10,320	10,320	10,320	10,320
Reserves & Surplus	423,286	397,174	405,960	415,387	428,490
Shareholders equity	433,606	407,494	416,280	425,707	438,810
Minority Interests	6,584	8,245	9,927	11,693	13,547
Debt	**297,154**	**373,757**	**316,757**	**266,757**	**226,757**
Other non-current liab.	991	0	(877)	(2,026)	(2,235)
Capital employed	**738,335**	**789,496**	**742,087**	**702,130**	**676,879**
Net Fixed Assets	544,351	479,590	457,116	435,952	416,945
Investments	1,200	1,089	1,089	1,089	1,089
Other non-current assets	218,163	299,794	293,427	284,915	276,402
Net working capital	**(73,964)**	**(44,249)**	**(44,513)**	**(45,137)**	**(46,554)**
Cash & cash equivalents	48,585	53,272	34,968	25,312	28,997
Capital deployed	**738,335**	**789,496**	**742,087**	**702,130**	**676,879**
Net debt / (cash)	**248,569**	**320,485**	**281,789**	**241,445**	**197,760**
Net debt-to-EBITDA (x)	**3.2**	**3.5**	**3.9**	**3.2**	**2.4**

Source: Company, Anand Rathi Research

Fig 5 – Rolling 12-month forward EV/EBITDA multiple



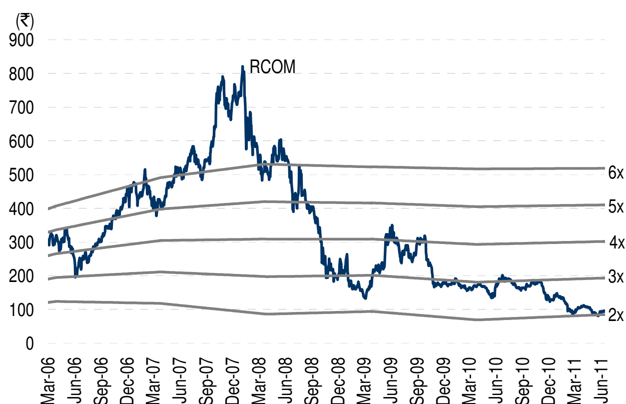
Source: Bloomberg, Company, Anand Rathi Research

Fig 3 – Cash flow statement (₹m)

Year-end: Mar	FY10	FY11	FY12e	FY13e	FY14e
Profits before tax	26,153	16,554	12,529	14,364	20,861
Depr/amort/non-cash items	33,845	63,661	45,079	47,729	47,567
Taxes paid	(3,122)	(1,718)	(1,253)	(2,155)	(3,465)
Interest income [a]	(932)	(2,494)	(2,206)	(1,507)	(1,358)
Chg in working capital	(8,403)	(15,918)	264	624	1,417
CF from operations	**47,541**	**60,085**	**54,413**	**59,055**	**65,023**
Capex (incl. entry fee)	**(41,263)**	**(133,402)**	**(16,238)**	**(18,052)**	**(20,047)**
Free cash flow	**6,278**	**(73,317)**	**38,175**	**41,003**	**44,975**
Investments/others	4,129	2,605	2,206	1,507	1,358
Equity raised	0	0	0	0	0
Debt raised / (repaid)	(69,898)	76,603	(57,000)	(50,000)	(40,000)
Dividends paid	(1,911)	(1,203)	(1,685)	(2,166)	(2,648)
Chg in cash for year	**(61,402)**	**4,687**	**(18,304)**	**(9,656)**	**3,686**
Beginning cash	109,987	48,585	53,272	34,968	25,312
Closing cash	**48,585**	**53,272**	**34,968**	**25,312**	**28,997**

Source: Company, Anand Rathi Research [a] Re-classified in cash flow from investments

Fig 6 – Rolling 12-month forward EV/Sales multiple



Source: Bloomberg, Company, Anand Rathi Research

Investment Argument

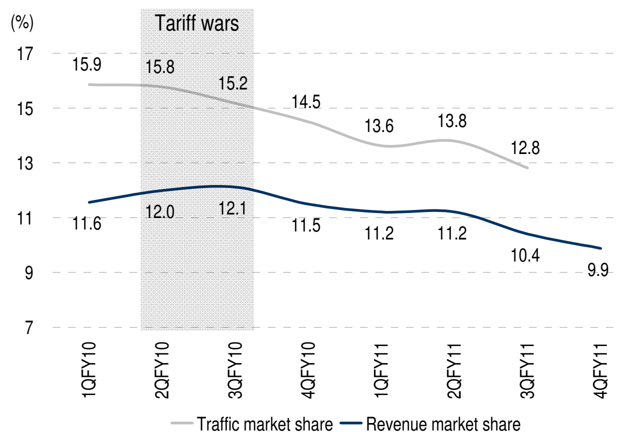
RCom continues to be faced with huge challenges on the operational, financial and regulatory fronts. We retain a Sell and lower our target price for Jun '12e to ₹90 (from ₹110 for Mar '12e), mainly driven by the cut in our estimates (impact ~₹13.5/share) and factoring in the regulatory risk (₹10/share).

Challenging times persist; we reiterate a Sell

Weak operating performance

RCom has not gained much traction in traffic or revenue growth despite being one of the two operators to kick off the tariff war in the wireless market during 2HCY09. Also, operational challenges exist in other segments (broadband and global) that have seen yoy revenue and EBITDA declines in the past three quarters. Hence, consolidated revenue and EBITDA have been flat in the past three quarters

Fig 7 – Revenue and traffic market share continue to decline



Source: TRAI, Company

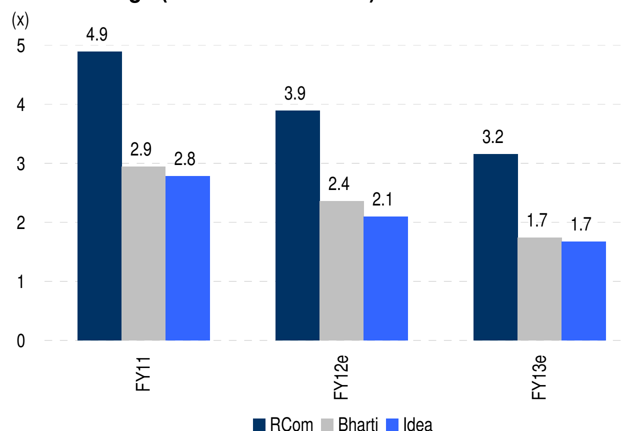
RCom's non-wireless segments are under operational pressure as well. For the past three quarters, its broadband and global segments have registered yoy declines in revenue and EBITDA.

High financial risk

RCom's balance sheet is highly leveraged, with net-debt-to-EBITDA of 4.9x (vs. ~3x each for Bharti and Idea). Further, the company has to repay significant debt in FY12.

Besides high net debt, the company has large current liabilities (possibly vendor credit) of ₹151bn (4QFY11); this is ~71% of its annualized revenues for the quarter (vs. 33% for Bharti). Decline in vendor credit would restrain RCom's FCF growth.

Fig 8 – RCom's leverage (net debt-to-EBITDA) to be elevated over FY11-13e



Source: Company, Anand Rathi Research

While the control on capex (FY12 guidance of ₹15bn) would partially address RCom's short-term liquidity requirements, we expect the company's leverage to be substantially higher than those of peers.

The company's long-pending plans to monetize its stake in subsidiaries (especially the tower company, Reliance Infratel) and raise equity have yet to fructify. Such fund-raising might help address the high leverage and liquidity requirements. However, we see limited visibility on fundraising via these options.

Reliance Infratel does not have material non-captive tenancy at present. Visibility of tenancies from Etisalat DB (which had signed up with Reliance Infratel for lease of towers) is poor, as it is faced with regulatory issues. In our view, the business case for entrants to roll out networks is challenging.

In addition, we believe fund-raising via issue of equity is unlikely in the short term owing to ongoing business, financial and regulatory risks as well as a sharp fall in the company's stock price (50%) in the past year.

High regulatory risks

Apart from the financial implications of the proposed regulatory changes (on the lines of TRAI recommendations), the company is at risk from the ongoing 2G-related investigations. Such a risk is difficult to quantify, but would be a major overhang on the stock price.

To factor in the regulatory risk, we have applied a 10% discount to RCom's Jun '12e fair value of ₹100/share to arrive at our target of ₹90.

Valuation, target price and risk

Valuations do not fully factor in risks

RCom trades at an FY12e EV/EBITDA of 6.6x, a ~19% discount to Bharti and almost on par with Idea. We believe the discount to Bharti is justified, given the slow growth and high financial and regulatory risks.

Fig 9 – Indian telcos: Valuations

Year-end: Mar	Rating	Current market price (₹) [a]	Target price (₹)	Upside (%)	Mkt Cap (US$m)	P/E (x) FY12e	P/E (x) FY13e	EPS CAGR FY12e-14e	P/E to Growth	EV/EBITDA (x) FY12e	EV/EBITDA (x) FY13e	EBITDA CAGR FY12e-14e	EV/EBITDA to-Growth
Bharti	Buy	380	455	20	32,280	18.3	13.6	30.6	0.60	8.1	6.7	15.1	0.54
RCom	**Sell**	95	90	(5)	4,387	18.7	16.9	22.6	0.83	6.6	5.7	6.9	0.96
Idea	Buy	78	96	24	5,727	39.3	27.1	46.6	0.84	7.5	6.3	17.4	0.43
TTML	Sell	16	12	(27)	695	NM	NM	(18.6)	NM	13.3	11.1	19.2	0.70
Tulip	Buy	156	225	44	507	6.8	6.0	27.1	0.25	5.2	3.6	22.3	0.23
Average (Wireless)						**20.9**	**15.3**	**33.2**	**0.63**	**7.7**	**6.4**	**14.1**	**0.54**

Source: Bloomberg, Anand Rathi Research *[a] as of 17 Jun '11*

Jun '12e target of ₹90/share

Our revised Jun '12e DCF-based fair value of ₹100/share marks a 10% reduction vs. our previous fair value/target price of ₹110, and has been driven by cuts in our long-term revenue and earnings forecasts. Further, we have applied a 10% discount (₹10/share) to our revised fair value estimate to capture the regulatory risks.

Fig 10 – DCF summary

Year-end: Mar, ₹m	FY09	FY10	FY11e	FY12e	FY13e	FY14e	FY15e	FY16e	FY17e	FY18e	FY19e	FY20e
Key assumptions (%)												
Revenue growth	20.4	(3.6)	4.4	(2.6)	4.5	6.2	5.4	4.5	3.7	3.2	2.9	2.6
EBITDA growth	**15.0**	**(17.1)**	**16.1**	**(20.3)**	**5.5**	**8.2**	**6.2**	**4.9**	**4.7**	**3.4**	**3.6**	**3.0**
FCF growth	NM	NM	NM	NM	1.8	6.5	2.0	5.4	(6.8)	(1.1)	(4.1)	(4.4)
EBITDA margin	**41.1**	**35.3**	**39.3**	**32.1**	**32.4**	**33.1**	**33.3**	**33.4**	**33.8**	**33.9**	**34.1**	**34.2**
FCF margin	(21.3)	11.6	(26.3)	23.8	23.2	23.3	22.5	22.7	20.4	19.6	18.2	17.0
Capex / sales	**58.5**	**18.6**	**57.7**	**7.2**	**7.7**	**8.0**	**7.7**	**7.6**	**8.5**	**8.8**	**9.6**	**10.3**
Debt / capital	48.1	40.7	47.8	43.2	38.5	34.1	29.1	23.6	17.6	11.3	17.7	16.8
ROCE	9.5	7.0	3.9	4.7	5.3	6.6	7.5	8.2	8.6	9.0	8.1	8.0
EBIT X (1-tax rate)	57,776	37,834	23,458	24,558	24,343	29,265	31,458	33,661	34,851	36,362	40,977	45,019
Depreciation	33,980	33,245	60,818	38,712	39,217	39,054	38,967	38,714	38,175	36,828	33,516	30,601
Amortization	2,097	4,220	4,220	6,366	8,513	8,513	8,513	8,513	8,513	8,513	8,513	8,513
Change in working capital	(8,500)	(8,403)	(15,918)	264	624	1,417	657	2,585	954	1,810	1,493	943
Operating FCF	**85,353**	**66,896**	**72,578**	**69,901**	**72,697**	**78,249**	**79,595**	**83,473**	**82,492**	**83,512**	**84,499**	**85,076**
Capital expenditure	**(134,180)**	**(41,263)**	**(133,402)**	**(16,238)**	**(18,052)**	**(20,047)**	**(20,238)**	**(20,916)**	**(24,206)**	**(25,866)**	**(29,207)**	**(32,200)**
Free cash flows	**(48,827)**	**25,633**	**(60,824)**	**53,663**	**54,644**	**58,202**	**59,357**	**62,557**	**58,286**	**57,646**	**55,292**	**52,876**

Mar '12 DCF calculation	
Terminal growth rate (%)	3.0
WACC (%)	13.00
Implied FY20e terminal FCF exit multiple (x)	10.0
Implied FY20e exit EBITDA multiple (x)	**5.3**
NPV of cash flows (FY13e-FY20e)	276,159
PV of terminal value	204,868
Enterprise Value (EV)	**481,027**
Terminal value as % of EV	43
FY11e net debt/(cash)	281,789
Equity value (₹m)	**199,237**
Equity value (US$m)	**4,427**
Number of shares (m)	2,064
Mar '12e equity value / Target Price (₹/share)	96.5
Jun '12e equity value (₹/share)	**100.0**
10% discount to factor regulatory risks (₹/share)	(10)
Jun '12e target price (₹/share)	**90.0**

Sensitivity of Jun '12e target price to WACC and perpetual growth

Perpetual growth rate (%) \ WACC (%)	12.0%	12.5%	13.0%	13.5%	14.0%
2.0%	101	90	80	70	62
2.5%	108	96	85	75	65
3.0%	115	102	**90**	79	70
3.5%	123	109	96	85	74
4.0%	131	116	103	90	79

Sensitivity of exit EV/EBITDA multiple to WACC and perpetual growth

Perpetual growth rate (%) \ WACC (%)	12.0%	12.5%	13.0%	13.5%	14.0%
2.0%	5.3	5.1	4.9	4.7	4.5
2.5%	5.6	5.3	5.1	4.9	4.7
3.0%	5.9	5.6	**5.3**	5.1	4.9
3.5%	6.3	5.9	5.6	5.3	5.1
4.0%	6.7	6.3	5.9	5.6	5.3

Source: Company, Anand Rathi Research

Risks

Key risks to our Sell rating are:

- Monetization of stakes in subsidiaries, especially Reliance Infratel
- Potential M&A activity involving RCom as a target.

Fig 11 – Key model assumptions

Year-end: Mar, ₹m	FY09	FY10	FY11e	FY12e	FY13e	FY14e	FY15e	FY16e
Wireless								
India wireless subscribers (m)	386	578	800	965	1,092	1,177	1,237	1,285
Wireless penetration (%)	33.6	49.6	67.8	80.7	90.3	96.2	100.0	102.7
RCom wireless subs (m)	**72.7**	**102.4**	**135.7**	**157.7**	**176.8**	**189.5**	**198.4**	**205.6**
RCom avg. monthly net-adds ('000)	**2,239**	**2,480**	**2,775**	**1,835**	**1,586**	**1,063**	**740**	**597**
RCom share of net-adds (%)	**20.7**	**15.5**	**15.0**	**13.4**	**15.0**	**15.0**	**14.9**	**14.9**
RCom wireless market share (%)	18.8	17.7	17.0	16.4	16.2	16.1	16.0	16.0
RCom ARPU incl. 3G (₹/month)	**244**	**158**	**116**	**106**	**98**	**96**	**95**	**96**
Change in ARPU (%)	(28.9)	(35.2)	(26.8)	(8.9)	(7.3)	(2.4)	(0.3)	0.5
RCom EBITDA/sub (US$)	18	12	8	7	7	7	7	7
RCom wireless MOU (₹/month)	**389**	**334**	**262**	**255**	**247**	**243**	**241**	**241**
RCom ARPM incl. 3G (₹)	0.63	0.47	0.44	0.42	0.40	0.39	0.40	0.40
Total wireless network minutes (bn)	277	350	375	448	496	533	562	585
Minutes growth (%)	**34**	**27**	**7**	**20**	**11**	**8**	**5**	**4**
Average EBITDA per min (₹)	**0.24**	**0.16**	**0.13**	**0.11**	**0.11**	**0.11**	**0.11**	**0.11**
Total capex/new sub (US$)	95	22	20	6	8	14	24	35
Capex/sales (%)	**46**	**19**	**18**	**3**	**4**	**4**	**4**	**5**
Global [ILD, NLD, FLAG]								
NLD minutes (m)	32,163	49,911	65,737	77,294	87,768	93,834	99,329	103,784
ILD minutes (m)	7,561	9,839	15,248	14,639	17,935	17,965	18,832	19,642
Total LD minutes	**39,725**	**59,750**	**80,985**	**91,933**	**105,703**	**111,800**	**118,161**	**123,426**
LD minutes growth (%)	**32**	**50**	**36**	**14**	**15**	**6**	**6**	**4**
Market share of all India ILD minutes (%)	26	26	31	24	27	24	24	24
Broadband								
Enteprise BB segment								
Access lines ('000)	1,385	1,469	1,514	1,556	1,592	1,622	1,646	1,670
ARPL (₹/month)	1,741	1,658	1,479	1,508	1,508	1,508	1,508	1,508
ARPL (US$/month)	38	35	33	34	34	34	34	34

Source: Company, Anand Rathi Research

Change in estimates

Our FY12 EBITDA forecast is largely unchanged. Besides, we raise our FY12 PAT estimate, as we now assume 3G-related costs (3G fee amortization, interest costs) to be charged to P&L from 2HFY12.

Nevertheless, , our long-term (from FY13) EBITDA forecasts are down 10-15% and PAT forecasts 15-20%, driven by markedly slower investments planned for the years ahead. Notably, management guidance of ₹15bn capex in FY12 is sharply lower than in the past (~₹40bn/year over FY10-11) and FY12 guidance of leading peers (₹30bn-90bn).

Fig 12 – Change in estimates

Year-end: Mar, ₹m	Unit	FY12e	FY13e	FY14e	FY15e	2016e
Wireless segment						
RCOM: Wireless subs - old	m	158	177	190	198	206
RCOM: Wireless subs - new	**m**	**158**	**177**	**190**	**198**	**206**
Revision	*(%)*	*0%*	*0%*	*0%*	*0%*	*0%*
Wireless ARPM old	(₹/min)	0.41	0.40	0.40	0.41	0.41
Wireless ARPM new	(₹/min)	0.42	0.40	0.39	0.40	0.40
Revision	*(%)*	*0%*	*-1%*	*-2%*	*-3%*	*-3%*
Wireless MOU old	(₹/min)	259	262	266	268	271
Wireless MOU new	(₹/min)	255	247	243	241	241
Revision	*(%)*	*-2%*	*-6%*	*-9%*	*-10%*	*-11%*
Wireless ARPU old	₹	107	105	108	109	111
Wireless ARPU new	₹	106	98	96	95	96
Revision	*(%)*	*-1%*	*-7%*	*-11%*	*-13%*	*-14%*
Revenues old	(₹bn)	187	212	236	254	270
Revenues new	(₹bn)	186	197	210	222	232
Revision	*(%)*	*-1%*	*-7%*	*-11%*	*-13%*	*-14%*
EBITDA old	(₹bn)	53	59	66	72	76
EBITDA new	(₹bn)	52	55	59	63	67
Revision	*(%)*	*-3%*	*-8%*	*-11%*	*-11%*	*-12%*
EBITDA margin old	(%)	28.3	28.0	28.0	28.2	28.3
EBITDA margin new	(%)	27.7	27.8	28.2	28.6	28.9
Revision	*(bps)*	*(59)*	*(30)*	*16*	*42*	*64*
Consolidated RCom model						
Revenues old	(₹bn)	227	254	282	303	321
Revenues new	(₹bn)	225	235	250	264	275
Revision	*(%)*	*-0.8%*	*-7.3%*	*-11%*	*-13%*	*-14%*
EBITDA old	**(₹bn)**	**73.1**	**82.4**	**91.8**	**98.7**	**104.4**
EBITDA new	**(₹bn)**	**72.4**	**76.4**	**82.7**	**87.8**	**92.1**
Revision	***(%)***	***-0.9%***	***-7.4%***	***-9.9%***	***-11.0%***	***-11.8%***
EBITDA margin old	(%)	32.2	32.5	32.6	32.6	32.5
EBITDA margin new	(%)	32.1	32.4	33.1	33.3	33.4
Revision	*(bps)*	*(5)*	*(2)*	*46*	*73*	*94*
EBIT old	**(₹bn)**	**27.5**	**34.3**	**42.6**	**48.5**	**53.7**
EBIT new	**(₹bn)**	**27.3**	**28.6**	**35.1**	**40.3**	**44.9**
Revision	***(%)***	***-0.7%***	***-16.5%***	***-17.6%***	***-16.9%***	***-16.4%***
			5.7			
Adjusted PAT old	(₹bn)	**9.1**	**14.6**	**20.6**	**25.7**	**29.9**
Adjusted PAT new	(₹bn)	**10.5**	**11.6**	**15.8**	**20.1**	**24.2**
Revision	(%)	***15.7%***	***-20.7%***	***-23.6%***	***-21.9%***	***-19.1%***
Adjusted EPS old	**(₹)**	**4.39**	**7.08**	**9.98**	**12.45**	**14.50**
Adjusted EPS new	**(₹)**	**5.07**	**5.62**	**7.63**	**9.73**	**11.72**
Revision	***(%)***	***15.7%***	***-20.7%***	***-23.6%***	***-21.9%***	***-19.1%***
Capex old	(₹bn)	38	38	35	32	30
Capex new	(₹bn)	16	18	20	20	21
Revision	*(%)*	*-57%*	*-52%*	*-43%*	*-37%*	*-30%*

Source: Anand Rathi Research

Weak operating performance

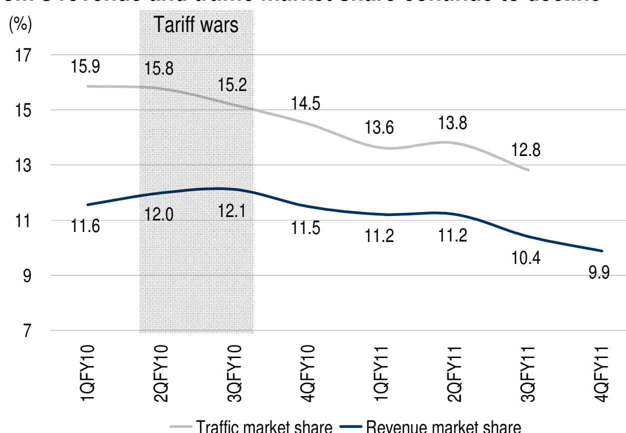
RCom's wireless revenue and EBITDA have been largely flat in the past six quarters, even as leading peers' growth rates have recovered in recent quarters. Besides, operational challenges exist in other segments (broadband and global) that have seen yoy revenue and EBITDA declines in the past four quarters.

Sharp mobile tariff cuts did not help RCom gain ground

RCom and Tata Teleservices kicked off the tariff war during 2HCY09. Following the introduction of the 'per-second billing' plan by Tata Teleservices under the GSM platform in Jun '09, RCom launched 'Simply Reliance' plans, which was at a significant discount to prevailing industry tariffs (especially in national long-distance and roaming segments) during the period.

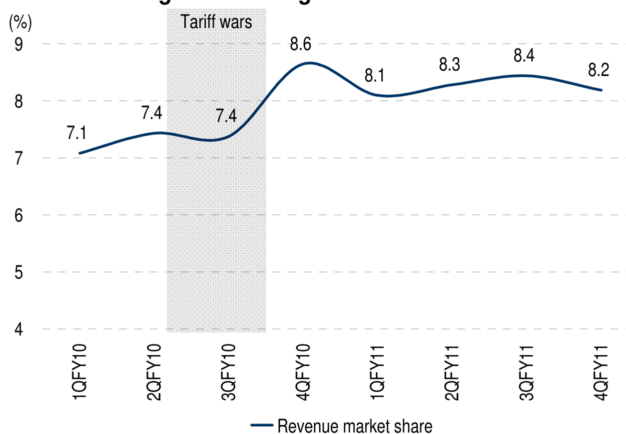
However, the sharp tariff cuts did not lead to any significant upswing in traffic growth for RCom. In fact, it continued to lose market share in traffic and revenue. Tata Teleservices, on the other hand, gained some revenue market share on the launch of GSM services and its 'per-second billing' plans.

Fig 13 – RCom's revenue and traffic market share continue to decline



Source: Company, TRAI

Fig 14 – Tata Teleservices gained some ground after tariff cuts



Source: Company, TRAI

Possible reasons for weaker response to tariff cuts

Immediate tariff retaliation by competition

Following RCom's tariff cuts in Oct '09, competitors cut tariffs as well. The competition's swift reaction was partly driven by the rising popularity of Tata Teleservice's 'per-second billing plan', which had been launched a few months earlier. While Tata Teleservice gained some ground in market share and consumer attention from its plan, the RCom value proposition was blunted by the prompt retaliation from competition.

Fig 15 – Competition's swift response to RCom's tariff cuts

Date	Company	Circle	Description	ARPMs (paise/min)
5-Oct-09	RCom	National	50p plan	40
6-Oct-09	Tata Docomo	Kerala	Rate cutter	
8-Oct-09	Idea	Bihar	Saral plan	37
8-Oct-09	Idea	Bihar	Per sec plan	41
9-Oct-09	Idea	HP	Saral plan	37
9-Oct-09	Idea	HP	Per sec plan	41
9-Oct-09	Idea	Rajasthan	Saral plan	36
9-Oct-09	Idea	Rajasthan	Per sec plan	41
10-Oct-09	Vodafone	MP	Per sec plan	42
12-Oct-09	Idea	Mumbai	50p plan	45
16-Oct-09	Vodafone	UP (East)		44
19-Oct-09	Vodafone	Bihar	Per sec plan	41
21-Oct-09	Idea	Kerala	50p plan	42
26-Oct-09	Idea	Mumai	Per sec plan	42
29-Oct-09	Aircel	Delhi	Per sec plan	41
31-Oct-09	Bharti	**National**	Per sec plan	46-49
1-Nov-09	Vodafone	UP (East)	Per sec plan	46-49
1-Nov-09	Idea	Mah'ra	Per sec plan	49
2-Nov-09	Vodafone	Kerala	Per sec plan	46-49
2-Nov-09	Vodafone	Mumbai	Per sec plan	46-49
3-Nov-09	RCOM	**National**	3min pulse	
3-Nov-09	RCOM	**National**	Per sec plan	42p
3-Nov-09	Vodafone	Kolkata	Per sec plan	46-49
4-Nov-09	Vodafone	Delhi	Per sec plan	48-52
23-Nov-09	Vodafone	UP (East)	Per sec plan	48-52
1-Dec-09	Tata Indicom	Kolkata	30p/50p plan	
2-Dec-09	MTNL	Delhi/Mumbai	Per sec plan	32

Source: Media reports, Company websites, Anand Rathi Research

Declining expenditure on marketing

In the quarters following the tariff wars, RCom's expenditure on SG&A (as percent of revenue) declined. This might be due to the company controlling expenses on sales and marketing (commission, advertising, promotions). For the same period, SG&A costs-to-sales increased for Bharti and Idea.

Fig 16 – RCom's decline in SG&A costs-to-sales vs. peers

(%)	1HFY10	2HFY10	1HFY11	2HFY11
Bharti	12.5	13.8	13.8	14.6
Idea	15.9	18.0	15.5	18.4
RCom	**17.3**	**13.0**	**15.7**	**16.2**

Source: Companies

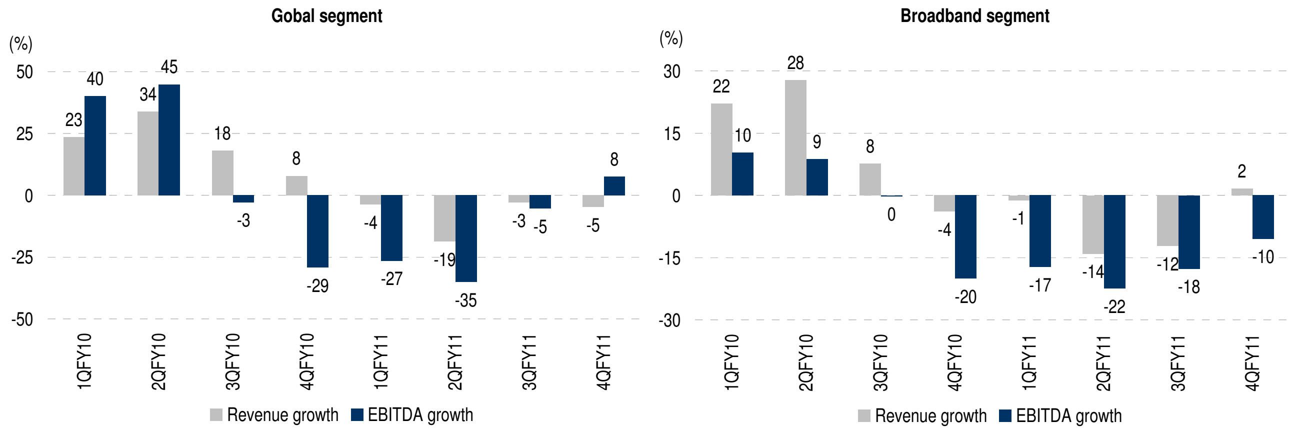
Network coverage and quality considerations

RCom may have been faced with network coverage and quality issues, as it has GSM spectrum only in 1,800 MHz in the new GSM circles. However, leading peers (Bharti, Idea and Vodafone) have spectrum in the superior quality 900 MHz band as well.

Non-wireless businesses also under pressure

RCom faces business challenges in non-wireless segments as well. Its broadband and global segments have recorded yoy declines in revenue and EBITDA in the last four quarters.

Fig 17 – Revenue and EBITDA in non-wireless segments have been declining



Source: Company

High financial risk

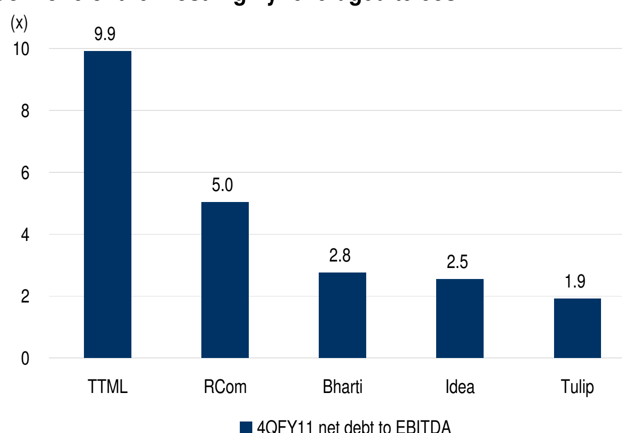
RCom's balance sheet is highly leveraged, with net-debt-to-EBITDA of 4.9x (vs. ~3x each for Bharti and Idea). Further, RCom has to redeem/repay significant debt in FY12. The company's pending monetization of its stake in subsidiaries and its plans to raise equity have yet to fructify. Given the business, regulatory and financial risks, RCom may find fund-raising to be challenging.

Highly leveraged balance sheet

RCom's balance sheet is highly leveraged, with net-debt-to-EBITDA of 4.9x (vs. ~3x each for Bharti and Idea) at end-3QFY11. Besides, it had large liabilities of ₹151bn in 4QFY11, ~71% of its annualized revenues for the quarter. This compares with current liabilities-to-revenue of 33% for Bharti (India + South Asia business only). We believe RCom's liabilities include a significant level of vendor credit, which is not a revolving source of credit. As vendor credit declines (which is likely, as fresh capex moderates), net debt levels would further soar.

As vendor credit winds down (which is likely as fresh capex moderates), net debt levels would soar further

Fig 18 – RCom one of the most highly-leveraged telcos



Source: Companies

Fig 19 – High current liabilities mask actual indebtedness

₹bn	RCom	Bharti (India + South Asia)
Revenues (4QFY11 annualized)	213	485
Current liabilities (end-34FY11)	152	158
Current liabilities-to-sales ratio	71	33

Source: Companies

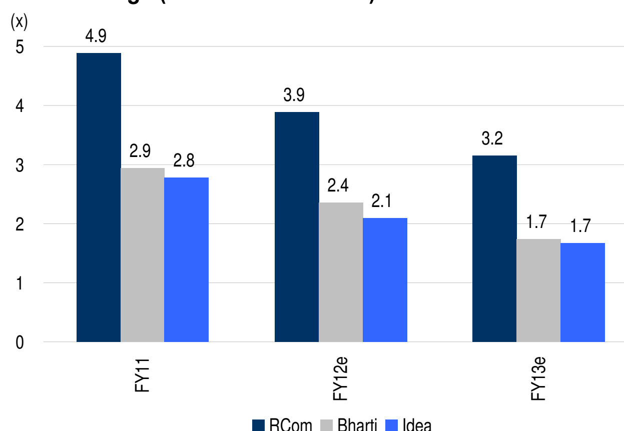
Capex control to address immediate refinancing needs to some extent

RCom is faced with the redemption of two significantly out-of-the-money FCCB issues in FY12. It has already redeemed one series of FCCBs, in May '11, while another falls due in Mar '12 (amounts outstanding estimated at ~₹65bn/~US$1.5bn). Besides, it would need to refinance its short-term debt. (It had ₹80bn of short-term loans at end-Mar '10.) In FY11, it refinanced 3G-related short-term loans with 10-year loans from Chinese banks and financial institutions.

We believe control on capex (FY12 guidance of ₹15bn) would, at least, address its immediate liquidity requirements. End-4QFY11 saw a cash

balance of ₹53bn. We estimate FCF of ₹38bn in FY12 (vs ₹18bn previously) after taking into account lower capex guidance. However, we expect the company's leverage to be substantially higher than that of peers.

Fig 20 – RCom's leverage (net-debt-to-EBITDA) to be elevated over FY11-13e



Source: Companies

Fig 21 – Details of outstanding FCCBs

	Series 1	Series 2	Total
Date of issue	9 May '06	28 Feb '07	
Proceeds from the issue (US$m)	500	1,000	1,500
Conversion price	481	661	
- % over current market price	**358**	**530**	
Yield (%)	4.65	4.95	
Date of maturity/conversion	**9-May-11**	**28-Feb-12**	
Outstanding amount (incl. redemption premium) (US$m)	350	1,100	1,450
Outstanding amount (₹bn)	**16**	**50**	**65**

Source: Company

Funding challenges may have an adverse impact

Given the high financial leverage and its significant debt re-financing requirements, RCom is likely to be up against: i) restriction on expansion plans in case of delays in refinancing, and ii) increase in borrowing costs due to risks.

Limited visibility on fundraising via the equity route

RCom has attempted to raise funds by diluting its stake in subsidiaries (Reliance Infratel, Reliance Globalcom). Besides, it obtained shareholder approval in Jun '10 to dilute up to a 26% stake. Such fundraising is likely to help address its high leverage and liquidity requirements. However, we see only limited visibility on fundraising through these options.

Monetization of Reliance Infratel stake is a key risk to our ratings & TP

RCom has informed stock exchanges that it has received formal indicative offers from several interested parties to acquire its controlling interest in its tower company, Reliance Infratel. Such a monetization of its stake is a potential risk to our target price and ratings.

Notably, RCom's efforts to partly monetize its stake in Reliance Infratel have not yet fructified. The company had twice filed a draft prospectus for an IPO (in '08 and '09) and has had an aborted deal with GTL Infrastructure. Reliance Infratel does not have significant non-captive tenancy at present. Visibility of tenancies from Etisalat DB (which had signed up with Reliance Infratel for lease of towers) is poor as it is faced with regulatory issues. In

addition, the business case for new entrants to roll out a network is challenging, in our view.

Further, we believe that fund-raising via issue of equity is unlikely in the short term due to business, financial and regulatory risks, as well as to a sharp decline in the company's stock price (50%) in the past six months.

High regulatory risks

Besides financial implications of the proposed regulatory changes (on the lines of TRAI recommendations), RCom is at risk from the ongoing 2G-related investigations; these risks are difficult to quantify but would be a major overhang on the stock. We have applied a 10% discount to RCom's Mar '12e fair value of ₹100/share to arrive at our target of ₹90, in order to capture regulatory risks.

Potential payouts under proposed policy changes

We do not expect TRAI's recommendations on one-time fee on the excess 2G spectrum to have a significant impact on RCom. However, the company would be impacted by TRAI's proposal to impose license renewal fees. The proposed reduction in annual license fee to a uniform 6% would be a relief.

Fig 22 – Impact of potential regulatory changes on target prices

		RCom			Bharti			Idea		
		₹bn	₹/sh	% of TP	₹bn	₹/sh	% of TP	₹bn	₹/sh	% of TP
1	One-time fee for 'excess' 2G spectrum	(1)	(0.6)	**(0.6)**	(43)	(11.3)	**(2.5)**	(15)	(4.6)	**(4.8)**
2	License renewal cost (PV)	(30)	(14.6)	**(16.2)**	(87)	(22.8)	**(5.0)**	(41)	(12.5)	**(13.0)**
3	Increase in spectrum usage fee (SUF) as % of AGR	(3)	(1.4)	**(1.6)**	(46)	(12.0)	**(2.6)**	(15)	(4.5)	**(4.7)**
4	Levy of 6% license fee on the tower and ISP businesses	(25)	(11.9)	**(13.2)**	(36)	(9.4)	**(2.1)**	(8)	(2.5)	**(2.6)**
5	Reduction in annual license fee to a uniform 6%	23	11.0	**12.2**	80	21.0	**4.6**	38	11.5	**12.0**
	Total impact	**(36.1)**	**(17.5)**	**(19.4)**	**(131.0)**	**(34.5)**	**(7.6)**	**(41.3)**	**(12.5)**	**(13.0)**
	Total impact [excluding #4]	**(11.5)**	**(5.6)**	**(6.2)**	**(95.3)**	**(25.1)**	**(5.5)**	**(33.2)**	**(10.1)**	**(10.5)**

Source: TRAI, Anand Rathi Research

Risks from 2G-related investigations

RCom is one of the many telcos investigated by various agencies, including the country's federal investigation agency, the CBI. The risks from 2G-related investigations are difficult to quantify but would be a major overhang on the stock price.

Fig 23 – Areas of 2G investigations

Area	Description	Agencies which highlighted, or are probing, the issue
Relation with *Swan Telecom* (now called *Etisalat DB*)	- It is alleged that Swan Telecom was a front company for RCom when the former applied for GSM spectrum in '07. Notably, regulations do not allow an entity to hold more than 10% in two licensee companies in a circle. - Swan Telecom is separately charged with having paid bribes to seek favourable treatment in the 2G-spectrum-allocation procedure. - Note that before issue of licenses to Swan Telecom, RCom had sold its stake in the company, according to a statement from RCom.	CAG, CBI
Allocation of GSM spectrum in Jan '08	- The CAG has alleged that DoT extended undue benefits to the company in grant of in-principle approval to use GSM technology and allocation of GSM spectrum	CAG

Source: Media reports, CAG report, Anand Rathi Research

Notably, in a detailed statement dated 14 Feb '11, RCom denied allegations that Swan Telecom was its front company. Besides, management stated that the approval of dual technology to RCom, Tata Teleservices and two other companies was after due process of public consultation by TRAI, recommendations by TRAI to DoT, and acceptance by the DOT/ Government of India. It added that the approval of dual technology to RCom in Oct '07 had been upheld by the Delhi High Court in a judgment in Aug '08, and by the Telecoms Tribunal – TDSAT – by an order in Mar '09.

Financials

Fig 24 – RCom: Consolidated income statement

Year-end: Mar (₹m)	FY09	FY10	FY11	FY12e	FY13e	FY14e
Revenues						
Wireless	173,676	166,396	165,762	186,113	196,681	210,195
Global	67,909	83,187	100,519	80,247	82,918	86,048
Broadband	25,243	28,386	26,469	27,786	28,492	29,090
Others	10,029	11,773	14,080	14,714	15,376	16,068
Inter/intra segment eliminations	*(47,372)*	*(68,419)*	*(75,754)*	*(83,676)*	*(88,107)*	*(91,353)*
Consolidated revenues	**229,485**	**221,323**	**231,076**	**225,184**	**235,360**	**250,046**
Interconnection & access	(23,817)	(21,377)	(26,476)	(28,148)	(29,420)	(31,256)
Network costs	(44,163)	(59,955)	(54,716)	(60,800)	(63,547)	(67,513)
Employee costs	(16,766)	(15,001)	(14,757)	(15,763)	(16,475)	(17,503)
SG&A (incl. equipment subsidies)	(38,561)	(35,334)	(32,740)	(34,597)	(35,427)	(36,112)
Total operating costs	**(135,171)**	**(143,118)**	**(140,260)**	**(152,818)**	**(158,991)**	**(167,386)**
Consolidated EBITDA	**94,313**	**78,205**	**90,816**	**72,366**	**76,369**	**82,660**
Depreciation & amortization	(36,077)	(37,465)	(65,038)	(45,079)	(47,729)	(47,567)
EBIT	**58,236**	**40,740**	**25,778**	**27,287**	**28,639**	**35,094**
Net interest expense	(11,455)	(14,587)	(9,224)	(14,758)	(14,275)	(14,232)
PBT	**46,781**	**26,153**	**16,554**	**12,529**	**14,364**	**20,861**
Extraordinaries & one-offs	15,186	26,076	(1,377)	0	0	0
Current tax expense	(490)	(3,725)	(1,718)	(1,253)	(2,155)	(3,465)
Deferred tax (expense)/income	1,008	(729)	1,600	877	1,149	209
Reported PAT	**62,485**	**47,774**	**15,059**	**12,153**	**13,358**	**17,605**
Minority interest	(2,036)	(1,224)	(1,602)	(1,682)	(1,766)	(1,854)
Reported PATAMI	**60,449**	**46,550**	**13,457**	**10,472**	**11,593**	**15,751**
Adjusted (recurring) PAT [a]	**45,263**	**20,474**	**14,834**	**10,472**	**11,593**	**15,751**
Basic EPS (adjusted) (₹) [a]	21.9	9.9	7.2	5.1	5.6	7.6
Fully diluted EPS (₹) [a]	**21.93**	**9.92**	**7.19**	**5.07**	**5.62**	**7.63**
Shares outstanding (m)	2,064	2,064	2,064	2,064	2,064	2,064
Fully diluted shares (m)	2,064	2,064	2,064	2,064	2,064	2,064
DPS (₹)	0.8	0.9	0.5	0.7	0.9	1.1
Payout ratio (%)	**3.6**	**8.6**	**7.0**	**13.8**	**16.0**	**14.4**
Dividends	1,651	1,754	1,032	1,445	1,858	2,270
Dividend tax	281	298	171	240	309	377
Growth rates (%)						
Revenues	20.4	(3.6)	4.4	(2.6)	4.5	6.2
EBITDA	**15.0**	**(17.1)**	**16.1**	**(20.3)**	**5.5**	**8.2**
EBIT	**8.0**	**(30.0)**	**(36.7)**	**5.9**	**5.0**	**22.5**
Net income	22.5	(54.8)	(27.5)	(29.4)	10.7	35.9
Diluted EPS	**22.5**	**(54.8)**	**(27.5)**	**(29.4)**	**10.7**	**35.9**
2-year Revenue CAGR	(2.3)	5.8	8.9	6.3	6.2	5.1
2-year EBITDA CAGR	(1.9)	(3.8)	(8.3)	6.9	7.2	5.6
2-year EPS CAGR	(42.8)	(28.5)	(11.6)	22.6	31.6	23.9
2-year Net Income CAGR	(52.8)	(52.6)	(7.2)	22.6	31.6	23.9
Margins (%)						
EBITDA margin (%)	**41.1**	**35.3**	**39.3**	**32.1**	**32.4**	**33.1**
EBIT margin (%)	25.4	18.4	11.2	12.1	12.2	14.0
Net profit margin (%)	26.3	21.0	5.8	4.7	4.9	6.3
Current tax rate (%)	0.8	7.1	9.0	10.0	15.0	16.6
Effective tax rate (%)	**(0.8)**	**8.5**	**(10.1)**	**3.0**	**7.0**	**15.6**

Source: Company, Anand Rathi Research. *[a] Adjusted PAT and EPS do not include any Forex/derivative gains*

Fig 25 – RCom: Consolidated balance sheet

Year-end: Mar (₹m)	FY09	FY10	FY11	FY12e	FY13e	FY14e
Equity						
Equity share capital	10,320	10,320	10,320	10,320	10,320	10,320
Reserves & Surplus	211,804	222,607	234,861	243,648	253,074	266,178
Revaluation of assets	200,679	200,679	162,313	162,313	162,313	162,313
Net worth	**422,803**	**433,606**	**407,494**	**416,280**	**425,707**	**438,810**
Minority interest	6,549	6,584	8,245	9,927	11,693	13,547
Deferred tax liability/(asset)	281	991	-	(877)	(2,026)	(2,235)
Debt						
Secured debt	30,000	30,000	50,000	50,000	50,000	50,000
Unsecured debt	361,623	267,154	323,757	266,757	216,757	176,757
Total debt	**391,623**	**297,154**	**373,757**	**316,757**	**266,757**	**226,757**
Total Invested capital	**821,256**	**738,335**	**789,496**	**742,087**	**702,130**	**676,879**
Assets						
Cash & cash equivalents	109,671	48,585	53,272	34,968	25,312	28,997
Current assets	130,316	113,388	107,512	95,369	95,143	96,470
Current liabilities & provisions	200,814	187,351	151,761	139,882	140,280	143,024
Net working capital (excl. cash)	**(70,498)**	**(73,964)**	**(44,249)**	**(44,513)**	**(45,137)**	**(46,554)**
Gross fixed assets	755,101	786,653	906,752	937,814	954,052	972,105
Less: accumulated depr. / amort.	141,144	190,671	273,406	318,485	366,214	413,780
Capital work-in-progress	113,096	116,557	96,062	81,238	83,052	85,047
Net fixed assets	**727,053**	**712,539**	**729,408**	**700,568**	**670,891**	**643,371**
Goodwill	52,215	49,976	49,976	49,976	49,976	49,976
Investments	2,815	1,200	1,089	1,089	1,089	1,089
Total assets	**821,256**	**738,335**	**789,496**	**742,087**	**702,130**	**676,879**
Leverage and profitability ratios (%)						
Net-debt (₹bn)	**281,951**	**248,569**	**320,485**	**281,789**	**241,445**	**197,760**
Net-debt (US$m)	**5,534**	**5,507**	**7,122**	**6,262**	**5,365**	**4,395**
Debt / equity	93	69	92	76	63	52
Net debt / equity	66	56	77	66	55	44
Net debt / equity [excl. revaluation]	123	104	126	107	88	68
Net debt-to-trailing EBITDA (x)	3.0	3.2	3.5	3.9	3.2	2.4
RoE (excl. re-valued assets)	**20.4**	**8.8**	**6.1**	**4.1**	**4.4**	**5.7**
RoCE (excl. re-valued assets)	**9.5**	**7.0**	**3.9**	**4.7**	**5.3**	**6.6**
Debt/Capital	48	40	47	43	38	34

Source: Company, Anand Rathi Research

Fig 26 – Consolidated cash-flow statement

Year-end: Mar (₹m)	FY09	FY10	FY11e	FY12e	FY13e	FY14e
Profits before tax	46,781	26,153	16,554	12,529	14,364	20,861
Depr / amort / non-cash items	27,318	33,845	63,661	45,079	47,729	47,567
Taxes paid	(3,926)	(3,122)	(1,718)	(1,253)	(2,155)	(3,465)
Interest income [a]	(15,944)	(932)	(2,494)	(2,206)	(1,507)	(1,358)
Change in working capital	(8,500)	**(8,403)**	**(15,918)**	264	624	1,417
CF from operations	**45,730**	**47,541**	**60,085**	**54,413**	**59,055**	**65,023**
Capex (incl. entry fee)	(134,180)	(41,263)	(133,402)	(16,238)	(18,052)	(20,047)
(Purchase) / Sale of assets/investments	0	2,441	111	0	0	0
Interest/dividend received	6,779	1,689	2,494	2,206	1,507	1,358
CF from investments	**(127,401)**	**(37,134)**	**(130,798)**	**(14,032)**	**(16,545)**	**(18,690)**
Equity raised	0	0	0	0	0	0
Debt raised / (repaid)	75,084	(69,898)	76,603	(57,000)	(50,000)	(40,000)
Dividends paid	(1,792)	(1,911)	(1,203)	(1,685)	(2,166)	(2,648)
CF from financing	**73,292**	**(71,809)**	**75,399**	**(58,685)**	**(52,166)**	**(42,648)**
Change in cash for year	**(8,380)**	**(61,402)**	**4,687**	**(18,304)**	**(9,656)**	**3,686**
Beginning cash	118,051	109,987	48,585	53,272	34,968	25,312
Closing cash	**109,671**	**48,585**	**53,272**	**34,968**	**25,312**	**28,997**

Source: Company, Anand Rathi Research *[a] Classified in cash flow from investments*

20 June 2011

Tulip Telecom

Shaping up as an integrated enterprise player; maintain Buy

Rating: **Buy**
Target Price: ₹225
Share Price: ₹156

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Tulip Telecom is transforming into an end-to-end provider of enterprise services, from being a niche wireless virtual private network (VPN) player. We expect this strategy to drive strong revenue and earnings growth. While the planned data centre (DC) investment has raised the company's risk profile, we believe current valuations are compelling. We roll over our price target, from ₹225 for Dec '11e to ₹225 for Jun '12e. We maintain a Buy.

- **Connectivity business doing well.** Tulip is a leader in the VPN market. Management says its investment in the high bandwidth, fibre-optic-based business is seeing robust traction. We expect its core business (i.e., excl. new DC) to start registering robust free cash flow (FCFs) and FCF-yields (FCF-to-EV) from FY12.
- **Incorporating DC plans.** We believe the DC business has strong growth potential, but Tulip's planned investment raises its risk profile. The net impact on our DCF-based price target is negative, at ₹10/share (DC NPV of ₹12, less impact of higher WACC of ₹22). Our FY12e/FY13e EPS is down 8%/13%, but we expect DC plans to be earnings-accretive in the long term. Our DC estimates are significantly lower than management guidance.
- **Valuation and Risk.** Tulip trades at an attractive FY12e PE of 6.8x, given the FY12e-14e 27% EPS CAGR. We believe current valuations are compelling despite a rise in the risk profile. The sale of its stake in the DC subsidiary and monetization of its equity stake in Qualcomm's broadband wireless access (BWA) venture are potential stock triggers. Key risk: disallowance of bandwidth cost deduction by the government in computing the license fee.

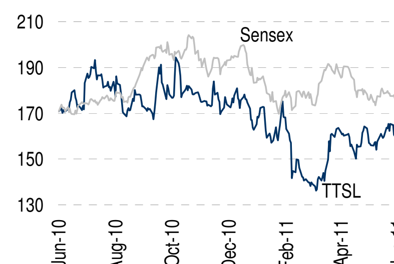
Key data	TTSL IN/ TULP.BO
52-week high / low	₹201 / 132
Sensex / Nifty	17871 / 5366
3-m average volume	US$1.1m
Market cap	₹23bn / US$505m
Shares outstanding	145m
Promoters (%)	69.0
Free float (%)	31.0
- Foreign institutions	17.8
- Domestic institutions	1.9
- Others	11.4

Tulip Telecom (TTSL IN): Key financials

Year-end: Mar (₹m)	FY10	FY11	FY12e	FY13e	FY14e
Revenue	19,664	23,511	27,951	34,093	39,610
EBITDA	5,255	6,631	7,954	9,527	11,898
Adjusted net profit	2,255	3,064	3,314	3,800	5,351
Adjusted EPS (₹)	15.6	21.1	22.9	26.2	36.9
EPS growth (%)	(6.0)	35.9	8.1	14.7	40.8
P/E (x)	10.1	7.4	6.8	6.0	4.2
EV/EBITDA (x)	6.0	5.8	5.2	3.6	2.7
P/BV (x)	2.4	1.9	1.5	1.2	1.0
RoAE (%)	28.0	28.6	24.3	22.6	25.6
Dividend yield (%)	1.0	1.0	1.3	1.5	1.8

Source: Company, Anand Rathi Research

Relative price performance



Source: Bloomberg

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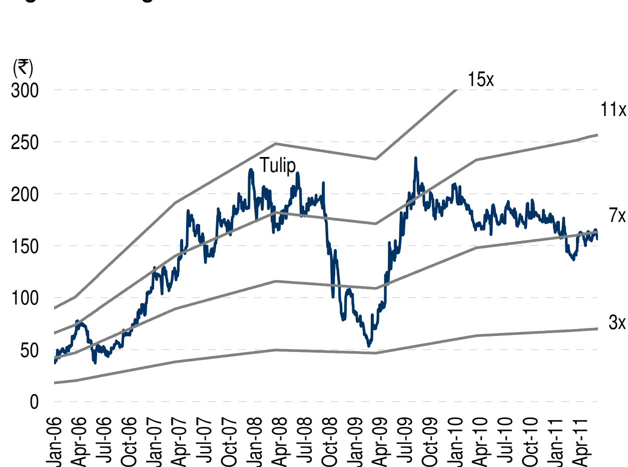
Quick Glance – Financials and Valuations

Fig 1 – Income statement (₹m)

Year-end: Mar	FY10	FY11	FY12e	FY13e	FY14e
Revenues	19,664	23,511	27,951	34,093	39,610
EBITDA	**5,255**	**6,631**	**7,954**	**9,527**	**11,898**
EBITDA margin (%)	26.7	28.2	28.5	27.9	30.0
Depreciation	(1,353)	(1,714)	(2,234)	(2,756)	(3,290)
Other income	(221)	1	-	-	-
Net interest cost	(687)	(853)	(1,162)	(1,540)	(1,765)
PBT	**3,642**	**4,065**	**4,558**	**5,231**	**6,843**
Tax	(899)	(1,001)	(1,245)	(1,431)	(1,492)
Reported net income	**2,743**	**3,064**	**3,314**	**3,800**	**5,351**
Adj. net income	**2,255**	**3,064**	**3,314**	**3,800**	**5,351**
Diluted EPS (adj.)	**15.6**	**21.1**	**22.9**	**26.2**	**36.9**
Dividend per share (₹)	1.6	1.6	2.0	2.4	2.8
Revenue growth (%)	**21.8**	**19.6**	**18.9**	**22.0**	**16.2**
EBITDA growth (%)	**56.1**	**26.2**	**20.0**	**19.8**	**24.9**
EPS growth (%)	**(6.0)**	**35.9**	**8.1**	**14.7**	**40.8**

Source: Company, Anand Rathi Research

Fig 4 – Rolling 12-month forward P/E



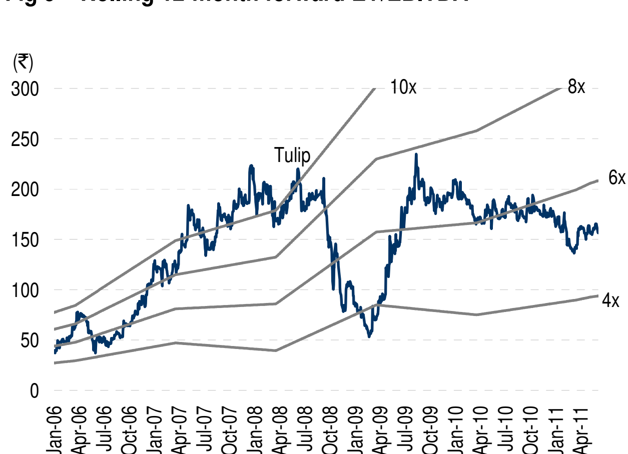
Source: Bloomberg, Anand Rathi Research

Fig 2 – Balance sheet (₹m)

Year-end: Mar	FY10	FY11	FY12e	FY13e	FY14e
Share capital	290	290	290	290	290
Reserves & Surplus	8,989	11,835	14,811	18,205	23,082
Shareholders' funds	**9,279**	**12,125**	**15,101**	**18,495**	**23,372**
Debt	12,191	17,769	18,519	19,019	17,019
Deferred tax liability	29	29	79	136	219
Capital employed	**21,499**	**29,923**	**33,699**	**37,650**	**40,610**
Net fixed assets	13,296	17,923	22,751	25,898	28,505
Investments	0	1,400	1,400	1,400	1,400
Other non-current assets	4	1,317	1,317	1,317	1,317
Net working capital	4,728	5,814	6,807	7,666	8,158
Cash & cash equivalents	3,470	3,470	1,425	1,370	1,230
Capital deployed	**21,499**	**29,923**	**33,699**	**37,650**	**40,610**
No. of shares (m)	145.0	145.0	145.0	145.0	145.0
Net Debt/EBITDA (x)	1.7	2.2	2.1	1.9	1.3

Source: Company, Anand Rathi Research

Fig 5 – Rolling 12-month forward EV/EBITDA



Source: Bloomberg, Anand Rathi Research

Fig 3 – Cash flow statement (₹m)

Year-end: Mar	FY10	FY11	FY12e	FY13e	FY14e
Profits before tax	2,998	4,065	4,558	5,231	6,843
Depreciation/amortization	1,353	1,714	2,234	2,756	3,290
Other non-cash items	(1,068)	0	0	0	0
Taxes paid	(879)	(1,001)	(1,195)	(1,374)	(1,410)
Chg in working capital	(2,312)	(1,086)	(993)	(859)	(493)
CF from operations	**91**	**3,692**	**4,604**	**5,754**	**8,231**
Capex (incl. acquisitions)	**(2,501)**	**(7,600)**	**(7,062)**	**(5,903)**	**(5,897)**
Free cash flow	**(2,411)**	**(3,908)**	**(2,457)**	**(149)**	**2,334**
Investments/others	(12)	(1,400)	0	0	0
Equity raised	0	0	0	0	0
Debt raised / (repaid)	2,694	5,578	750	500	(2,000)
Dividends paid	(271)	(271)	(338)	(406)	(473)
Change in cash for year	**0**	**(0)**	**(2,046)**	**(55)**	**(140)**
Beginning cash	3,470	3,470	3,470	1,424	1,370
Closing cash	**3,470**	**3,470**	**1,424**	**1,370**	**1,230**

Source: Company, Anand Rathi Research

Fig 6 – Rolling 12-month forward P/BV

Source: Bloomberg, Anand Rathi Research

Investment argument

Tulip Telecom is endeavoring to transform itself into an end-to-end provider of enterprise services from being a niche wireless VPN player. We expect this strategy to drive strong revenue and earnings growth for Tulip. While the planned data-centre investment has raised the risk profile of the business, we find current valuations compelling. We roll over our target price, from ₹225 for Dec '11e to ₹225 for Jun '12e. We maintain our Buy.

Shaping up to be an integrated enterprise player

Connectivity business doing well

Tulip continues to be a leader in the VPN market, largely on account of its dominance (>90% share) in the low-bandwidth/wireless-VPN market. From FY09 it embarked on an ambitious strategy to expand the addressable market. Its investments in the high-bandwidth, fibre-optic-based business are seeing robust traction, according to the management. Over 80% of its orders in 4QFY11 were for fibre-based connectivity. We expect the core business (i.e., excluding the new DC plans) to start registering robust FCFs and FCF-yields (FCF-to-EV) from FY12.

Fig 7 – FCF and FCF yield (excl. new DC)

Year-end: Mar, ₹m	FY10	FY11	FY12e	FY13e	FY14e
EBITDA	5,254	6,631	8,272	9,590	10,701
Capex	4,786	5,300	4,312	3,903	3,897
Simple FCF (EBITDA less capex)	**469**	**1,331**	**3,960**	**5,687**	**6,804**
FCF-to-EV (%)	**1.5**	**3.5**	**9.6**	**16.7**	**21.1**

Source: Company, Anand Rathi Research

DC business – bold plans, but raises risk profile

In Feb '11 Tulip acquired SADA IT Parks Pvt. Ltd., which owns a DC facility (comprising land and a building capable of hosting a DC) in Bangalore for ₹2.3bn. Tulip plans to further invest ₹6.7bn to set up a 0.9m-sqft DC (white space, i.e., usable area of 0.45m sqft). On setting up the new DC, Tulip's capacity would expand to 1m sqft (from 0.1m sqft at present).

Data Centre – industry growth outlook robust

We believe the DC business has significant growth potential. According to International Data Corporation (as reported on the CIOL website on Mar '10), India's DC services market were ₹63bn (US$1.4bn) in CY09; it is expected to grow to ₹100bn by end-CY11, at a 22.7% CAGR. The third-party DC market (non-captive) – the addressable market for Tulip – is expected to double, from ₹11bn (US$250m; 18% of the overall DC services market) in CY09 to ₹22bn (~US$500m) in CY11 (22% of the overall market). According to Tulip's presentation for investors, the third-party DC space is expected to grow, from 2m sqft in CY09 to 8.8m sqft in CY14, at a 32.8% CAGR.

A significant expansion in the DC/managed-services business would also enable Tulip to emerge as a much stronger and integrated player in the enterprise-services market. The company could leverage its client relationships to tap into the DC market. As such, both connectivity and the DC business could help drive each other's growth.

Rising risk profile

The company's DC plans, however, would significantly increase its risk profile on account of: i) execution risk, given the size (world's third-largest DC) and investment involved (₹9bn, ~40% of current market capitalization; ii) project-funding risk; induction of equity partners could lead to project delays or increased funding; and iii) delays in FCF and increase in financial leverage at the consolidated level. We have incorporated these risks into our model and in the DCF in the form of higher WACC of 13.75%, vs. 13% earlier.

Notably, we have not factored in the equity infusion into the DC subsidiary, and have assumed the project to be funded through debt. The planned equity infusion is a source of upside risk to our near-term earnings estimates. Besides, the equity funding would also reduce the risk profile of both the data centre project and the overall company. Besides, the company could liquidate its equity stake in Qualcomm's BWA venture, for which it had paid ₹1.4bn in Jul '10.

Valuation

Jun '12e target of ₹225

Our Jun '12e price target of ₹225 (vs. Dec '11e target price of ₹225 earlier) is based on DCF methodology. Our DCF analysis incorporates Tulip's core connectivity business as well as its soon-to-be-launched DC business. We have taken Tulip's 13% stake in Qualcomm's BWA venture at book value (₹1.4bn or ₹10/share).

Fig 8 – DCF summary

Year end March (₹m)	FY10	FY11	FY12e	FY13e	FY14e	FY15e	FY16e	FY17e	FY18e	FY19e	FY20e	FY21e
Key assumptions (%)												
Revenue growth	21.8	19.6	18.9	22.0	16.2	8.2	6.1	5.5	4.2	4.1	4.0	4.0
EBITDA growth	56.1	26.2	20.0	19.8	24.9	10.3	5.1	5.7	4.7	4.4	4.3	4.3
FCF growth	NM	NM	NM	(164.6)	227.5	69.6	2.7	4.9	8.0	0.3	3.4	3.5
EBITDA margin	**26.7**	**28.2**	**28.5**	**27.9**	**30.0**	**30.6**	**30.4**	**30.4**	**30.5**	**30.6**	**30.7**	**30.8**
FCF margin	(4.7)	(7.7)	(5.7)	3.0	8.5	13.3	12.9	12.8	13.3	12.8	12.7	12.7
Capex / Sales	**12.7**	**22.5**	**15.4**	**11.4**	**9.8**	**9.3**	**9.2**	**9.0**	**8.9**	**9.0**	**9.1**	**9.2**
Net Debt / Capital	40.6	47.8	50.7	46.9	38.9	26.9	16.1	3.2	(9.0)	(19.1)	(27.9)	(35.2)
ROCE	13.0	12.6	11.2	11.7	14.8	12.9	13.8	15.0	14.8	14.3	13.7	13.2
EBIT X (1-tax rate)	**2,792**	**3,713**	**4,347**	**5,146**	**6,542**	**6,311**	**6,317**	**6,646**	**6,916**	**7,169**	**7,431**	**7,706**
Depreciation & Amortization	1,353	1,714	2,234	2,756	3,290	3,811	4,193	4,474	4,745	5,024	5,318	5,612
Change in net working capital	(2,560)	(886)	(1,109)	(971)	(569)	(180)	(394)	(537)	(427)	(377)	(388)	(378)
Operating FCF	**1,585**	**4,541**	**5,472**	**6,930**	**9,263**	**9,942**	**10,115**	**10,582**	**11,234**	**11,816**	**12,361**	**12,940**
Capital expenditure	**(2,501)**	**(6,356)**	**(7,062)**	**(5,903)**	**(5,897)**	**(4,233)**	**(4,251)**	**(4,432)**	**(4,594)**	**(5,155)**	**(5,473)**	**(5,810)**
Free cash flows (FCFF)	**(916)**	**(1,815)**	**(1,590)**	**1,028**	**3,366**	**5,709**	**5,864**	**6,150**	**6,640**	**6,661**	**6,888**	**7,130**

Mar '12e DCF calculation	
WACC (%)	**13.75**
Terminal growth (%)	3.5
Implied Exit EV/FCF (X)	10.1
Implied Exit EV/EBITDA (X)	**4.2**
NPV of cash flows (FY13e-FY21e)	24,578
PV of terminal value	22,582
Enterprise value of core business [A]	**47,160**
Terminal value as % of EV	48%
Add: Investment in Qualcomm BWA (at cost) [B]	**1,400**
Less: Net debt (Mar-12e) [C]	17,094
Equity value [A + B - C]	**31,466**
Equity value (US$m)	**699**
Equity shares outstanding (m)	145.0
Mar '12e Equity value/share (₹)	**217.0**
June '12e Target Price	**225.0**

Sensitivity of Jun'12e Target Price to WACC and perpetual growth

Perpetual growth rate (%)	WACC (%)				
	13.25	**13.50**	**13.75**	**14.00**	**14.25**
2.50	218	210	202	194	187
3.00	226	217	209	201	193
3.50	235	226	**225**	208	200
4.00	246	235	226	217	208
4.50	257	246	236	226	216

Sensitivity of exit EV/EBITDA to WACC and perpetual growth

Perpetual growth rate (%)	WACC (%)				
	13.25	**13.50**	**13.75**	**14.00**	**14.25**
2.50	3.9	3.8	3.7	3.7	3.6
3.00	4.1	4.0	3.9	3.9	3.8
3.50	4.4	4.3	**4.2**	4.1	4.0
4.00	4.6	4.5	4.4	4.3	4.2
4.50	4.9	4.8	4.6	4.5	4.4

Source: Company, Anand Rathi Research

Fig 9 – Revision in target price

	₹/share
Previous target price (Dec '11e)	**225**
Change in estimates in core business	(8)
Impact of roll forward	18
Impact of the DC business	**(10)**
- Impact of higher WACC on core business	(22)
- NPV of DC business	12
Current price target (Jun '12e)	**225**

Source: Anand Rathi Research

Attractive valuations

Tulip trades at FY12e PE of 6.8x, which is attractive in our view, given the FY12e-14e 27% EPS CAGR. We believe current valuations are compelling despite the increased risk profile due to the company's DC plans. We believe equity infusion in the DC subsidiary could partly address the rise in the company's risk profile via lower financial leverage and improved sentiment (equity infusion indicates investor confidence for the company's plans). Monetization of stake in Qualcomm's BWA venture could also be a positive trigger for the stock, in our view.

Fig 10 – India telecom valuations

		Share price		Upside	Market Cap	P/E (x)		EPS CAGR (%)	P/E to	EV/EBITDA (x)		EBITDA CAGR (%)	EV/EBITDA
Year-end Mar	**Rating**	**(₹) [a]**	**TP (₹)**	**(%)**	**(US$ m)**	**FY12e**	**FY13e**	**FY12e-14e**	**Growth (x)**	**FY12e**	**FY13e**	**FY12e-14e**	**to-Growth (x)**
Bharti	Buy	380	455	20	32,193	18.3	13.6	30.6	0.60	8.1	6.7	15.1	0.54
RCom	Sell	95	90	(5)	4,375	18.7	16.9	22.6	0.83	6.6	5.7	6.9	0.96
Idea	Buy	78	96	24	5,711	39.3	27.1	53.5	0.74	7.5	6.3	19.0	0.40
TTML	Sell	16	12	(27)	693	NM	NM	(18.6)	NM	13.3	11.1	19.2	0.70
Tulip	**Buy**	**156**	**225**	**44**	**505**	**6.8**	**6.0**	**27.1**	**0.25**	**5.2**	**3.6**	**22.3**	**0.23**
Average (wireless)						**20.9**	**15.3**	**33.7**	**0.62**	**7.7**	**6.4**	**14.3**	**0.54**

Source: Bloomberg, Anand Rathi Research *[a] as of 17 Jun '11*

The stock trades at 30-35% discount to large cap telcos (on FY11e EV/EBITDA), which seems too high in the light of Tulip's strong past growth in the past (40% EBITDA CAGR over FY09-11) as well as expected growth ahead.

Risks

Key downside risk to our call is the disallowance of bandwidth cost deduction by the government in computing the license fee. Tulip deducts leased-bandwidth charges from gross revenues while paying the mandatory 6% revenue share (as license fee) to the government. Although this practice carries regulatory risk, it has aided Tulip's profits and returns so far.

Revisions in our estimates for revenue, earnings and capex are largely driven by incorporation of the DC business in our model

Also, the cut in our FY13e net profit is driven by our assumption of redemption of FCCBs, rather than conversion that was modelled earlier

Our revised EPS estimate is based on current outstanding shares; earlier, we had built in a dilution from conversion of FCCBs

Fig 11 – Key model revisions

Year-end Mar	FY12e	FY13e	FY14e	FY15e	FY16e
Revenues (₹m)					
- Previous	27,718	32,064	35,352	37,676	39,588
- Revised	27,951	34,093	39,610	42,843	45,440
Change (%)	*1*	*6*	*12*	*14*	*15*
EBITDA (₹m)					
- Previous	8,051	9,381	10,662	11,326	11,925
- Revised	7,954	9,527	11,898	13,121	13,795
Change (%)	*(1)*	*2*	*12*	*16*	*16*
EBITDA margin (%)					
- Previous	29.0	29.3	30.2	30.1	30
- Revised	28.5	27.9	30.0	30.6	30
Change	***-59bps***	***-131bps***	***-12bps***	***57bps***	***24bps***
EBIT (₹m)					
- Previous	5,974	6,972	7,966	8,373	8,738
- Revised	5,720	6,771	8,608	9,310	9,603
Change (%)	***(4)***	***(3)***	***8***	***11***	***10***
Net profit (₹m)					
- Previous	4,048	4,894	5,783	5,573	5,973
- Revised	**3,314**	**3,800**	**5,351**	**5,134**	**5,660**
Change (%)	***(18)***	***(22)***	***(7)***	***(8)***	***(5)***
Diluted EPS (₹)					
- Previous	24.92	30.13	35.59	34.30	36.76
- Revised	22.85	26.20	36.90	35.41	39.03
Change (%)	***(8)***	***(13)***	***4***	***3***	***6***
Capex (₹m)					
- Previous	3,844	3,694	3,675	3,749	3,914
- Revised	**7,062**	**5,903**	**5,897**	**4,233**	**4,251**
Change (%)	*84*	*60*	*60*	*13*	*9*
FCF (₹m)					
- Previous	1,689	2,977	4,409	4,377	4,484
- Revised	**(1,590)**	**1,028**	**3,366**	**5,709**	**5,864**
Change (%)	*(194)*	*(65)*	*(24)*	*30*	*31*

Source: Anand Rathi Research

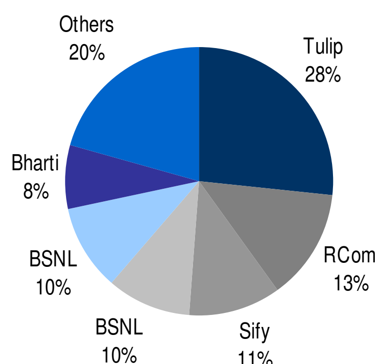
Connectivity business doing well

Tulip is a leader in the VPN market. Management says its investment in the high bandwidth, fibre-optic-based business is seeing robust traction. We expect its core business (i.e., excluding new DC plans) to start registering robust FCFs and FCF-yields (FCF-to-EV) from FY12e.

Strong and highly profitable VPN franchise

In FY10, Tulip's revenue market share (RMS) in VPN-connectivity was an estimated 30%, significantly ahead of the #2 (RCom; 12%) and #3 (Tata Communications; 12%) players. The company provides VPN on wireless last-mile access, whereas its rivals rely on fibre, copper and satellite (VSAT) access. In fact, the growth in wireless VPN has been almost entirely driven by Tulip, which commands well over 90% RMS in this sub-segment.

Table 12: VPN market shares



Source: Company presentation *as of Mar '10*

We believe the strength of Tulip's VPN franchise has been due to:

- **Widening reach:** Its wireless last-mile network covers ~1,500 cities (Dec '09);
- **Focus also on Wireless:** This has helped achieve quicker and cost-effective rollouts, especially in smaller towns and remote areas. However, this also led to Tulip catering only to the small-bandwidth requirements (typically 64-256kbps) of its enterprise customers;
- **First-mover advantage:** Thanks also to the 'voice focus' of bigger telcos in the country;
- **One-stop shop:** Tulip provides connectivity solutions along with network integration (NI) services, which is unique vis-à-vis its competitors in the NI space
- **High uptime:** Tulip can guarantee higher levels of 'uptime' (>99%), as it has leased inter-city bandwidth from multiple providers. This results in a greater degree of customer satisfaction.

Despite a continuous decline (10-15% a year) in the bandwidth/connectivity prices paid by customers, Tulip's return-on-average-equity (RoAE) has been in the 40-50% range during FY05-09 (although it has reduced to 29% in FY10). Key factors that have helped Tulip's RoAE are:

- Increase in volumes (bandwidth per link);
- Significantly higher supply (competition) at the wholesale end vs. demand at the retail end – Tulip leases/buys inter-city bandwidth (a key raw material) in bulk/wholesale from multiple providers, but sells the last-mile bandwidth in smaller/retail quantities. The different competitive intensity combined with better utilization of leased capacity (>50%), results in high gross margins (30-40% of recurring revenue). Interestingly, Tulip buys inter-city bandwidth from national integrated carriers such as Bharti, RCom and BSNL. In several instances, it has sold the same bandwidth capacity at the retail level to dealers or their enterprise customers located in smaller towns (last-mile connectivity on wireless is outsourced to Tulip).
- Capex linked to order/revenue visibility: Investment in new locations (city or point of presence) or purchase of additional inter-city bandwidth has typically taken place after securing the VPN contracts. This has led to higher utilization of owned as well as leased bandwidth capacity.

Other important factors are: i) increase in financial leverage and ii) savings on account of license fees – Tulip deducts leased-bandwidth charges from gross revenues while paying the mandatory 6% revenue share (as license fee) to the government. Although this practice carries regulatory risk, it has aided profits and returns so far.

Aggressive push towards expanding addressable connectivity market

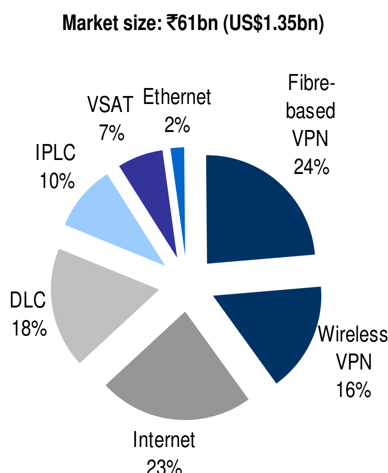
Tulip has over 90% RMS in wireless VPN. However, wireless VPN accounts for only ~16% of the EDN market (Fig 13)

From FY09 Tulip embarked on its ambitious strategy of addressing ~90% of the connectivity market through deploying intra-city fibre-optic cables and upgrading its network to tap the high-bandwidth market.

The strategy was driven by:

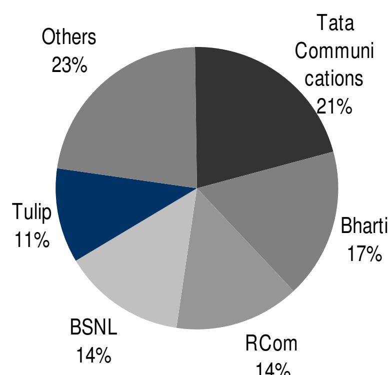
1. **Maintaining the growth momentum**: While there is potential for robust long-term growth in wireless VPN from the emerging government sector, we believe the sustainability of high, overall revenue-growth rates (>20% a year) in the medium term is uncertain, given the base effect.
2. **Improving market power**: Complete dependence on the wireless/low-bandwidth markets would have exposed Tulip to significant competitive risk for several reasons. First, it is the only player of substantial scale in the market and enjoys strong profitability; this could attract competitors. Second, a wireless network can be rolled out quickly by potential competitors. BWA roll-outs in India could be a potential threat to Tulip's wireless business.
3. **Reducing dependence on wireless spectrum**: Tulip uses spectrum in the 2.8MHz and 3.3MHz bands. The spectrum assignments do not have a fixed term and have to be renewed annually. Potential changes in spectrum policy could have resulted in non-renewal of spectrum assignment and significantly enhanced costs.

Fig 13 – Market segments: Enterprise data-connectivity



Source : Company presentation

Fig 14 – Players in enterprise-connectivity market

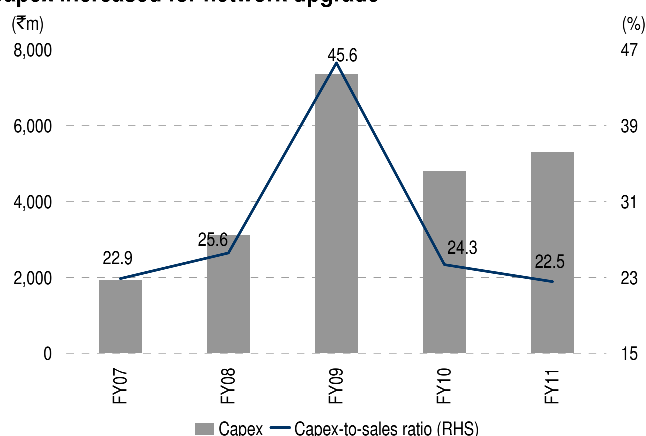


Source: Company presentation

Significant scaling-up of capex to upgrade network

Tulip has been investing in last-mile fibre connectivity in central business districts (CBDs) to tap the high-bandwidth connectivity market. Its fibre-optic network now spans 6,000km, addressing intra-city (last-mile and inter-CBD) fiber connectivity in the top-300 cities. It has also made significant investments to upgrade its core network to handle demand for high bandwidth.

Fig 15 – Capex increased for network upgrade



Source: Company Note: FY11 capex excludes acquisition cost of the DC subsidiary

Management reports robust demand for high-bandwidth business

According to the management, Tulip is seeing robust demand for last-mile intra-city fibre connectivity (+80% of its orders in 4QFY11 were for fibre-based connectivity). The company does not report separate revenue for wireless and fibre-optic divisions. However, it has been reporting addition of large/reputed clients including the Aditya Birla Group, Tata AIG, Eros International, the GMR Group, Biocon, Eros International, Verizon, Uninor, HP India and MRF.

Robust free-cash flows ahead

Tulip is expected to incur capex of ₹4.3bn (ex the DC) in FY12e, as the company continues to penetrate its network deeper into cities. However, we expect its core business to record a positive FCF for the first time in FY12. We expect the FCF and FCF yield (i.e. FCF-to-EV) to increase in the years ahead due to growth in operating cash flows and modest capex.

Fig 16 – FCF and FCF yield (excl. data centre)

Year-end: Mar (₹m)	FY10	FY11	FY12e	FY13e	FY14e
EBITDA	5,254	6,631	8,272	9,590	10,701
Capex	4,786	5,300	4,312	3,903	3,897
Simple FCF (EBITDA - capex)	**469**	**1,331**	**3,960**	**5,687**	**6,804**
FCF-to-EV (%)	**1.4**	**3.4**	**9.3**	**16.1**	**20.3**

Source: Company, Anand Rathi Research

Long-term upside from government segment

We believe the Indian government's thrust on promoting e-governance and inclusive growth would translate to significant demand for connectivity in the years ahead. The e-governance agenda includes:

- developing state-wide area networks (SWANs) to connect all state government departments and offices in each state;
- establishing national/state data centres for reliable and secure data;
- establishing common service centres (CSCs) to deliver public services;
- unique ID (UID) project to create national ID cards; and
- increased use of IT to reduce power-transmission losses under the Accelerated Power Development and Reform Program (APDRP) projects.

The government's inclusive growth agenda includes schemes such as the National Rural Employment Guarantee Scheme (NREGS) as well as financial inclusion goals (connecting post offices, regional rural banks and rural bank branches). Besides, given the ongoing thrust on reforms and Aggregate Technical and Commercial (AT&C) loss-reduction in the power sector, the APDRP is also a key emerging driver of connectivity demand.

In our view, these initiatives in the government segment potentially represent annual revenue opportunities of at least ₹40bn in the medium-to-long term (3-5 years). NI and other managed services (network and facility management) would constitute additional expenditure.

Fig 17 – Size of government segment opportunity (connectivity only)

	₹bn/year	Comments
APDRP	6.0	₹200m-250m per SEB; scaling up expected in the next 2-3 years
SWAN	10.0	Connecting state government departments and offices
CSCs	2.5	
Police HQs and stations	2.5	
National Knowledge Network	6.0	All schools/colleges, libraries, R&D centres to be connected
UID project	6.0	
Financial inclusion projects	10.0	Including regional rural banks (RRBs)
Total	**43.0**	

Source: Industry, Company, Anand Rathi Research

Making early inroads

Tulip has been executing several projects under various government programs such as SWAN and APDRP. It recently hired Rajesh Duggal, who had been heading the government business of Reliance Communications.

Fig 18 – Tulip's government projects

Project	Order size	Comments
APDRP bandwidth	₹,400m over ~five years	Provision of bandwidth for APDRP projects in five states
SWAN Network integration	₹600m over five years	Won projects in five states; projects have been transferred to a group company
SWAN bandwidth		Provision of bandwidth for Maharashtra SWAN
SWAN Managed services	₹250m over three to five years	Managed services for Gujarat SWAN

Source: Company

DC business – bold plans, but raise risk profile

We believe the DC business has strong growth potential, but Tulip's planned investment raises its risk profile. The net impact on our DCF-based target price is negative, of ₹10/share (DC NPV of ₹12 less impact of higher WACC of ₹22). Our FY12e/FY13e EPS is down 9%/17% due to incorporation of DC plans, but we expect DC to be earnings-accretive in the long term. Our DC estimates are significantly lower than management guidance.

Bold plans

In Feb '11, Tulip has acquired SADA IT Parks (Pvt), which owns a DC facility (comprising land and a building capable of hosting a DC) in Bangalore, for ₹2.3bn. Tulip plans to further invest ₹6.7bn to set up a 0.9m sqft DC (white space i.e., usable area of 0.45m sqft). On setting up the new DC, Tulip's capacity would expand to 1m sqft from 0.1m sqft at present.

Management stated that revenue from the new DC would start flowing in within 6-9 months; it expects revenue of ₹10bn a year and EBITDA margin of +50% on reaching peak utilization (likely in three years).

Tulip has already been operating a DC business. It has DC capacity of 0.1m sqft, spread over several locations in India. These DCs currently generate revenue of ₹450m a year and have the potential to generate up to ₹750m a year. The present operating margin at these DCs is ~38%.

Shaping up to be an integrated enterprise services provider

DC/managed-services business of a significant size would help Tulip emerge as an integrated enterprise-service provider, from being mostly a connectivity provider only. The company could leverage its present client relationship to tap into the DC market. As such, both the connectivity and DC businesses could help drive each other's growth.

Data centre – Industry growth outlook is robust

We believe the DC business has significant growth potential. According to IDC (as reported on the CIOL website on Mar '10), India's DC services market was ₹63bn (US$1.4bn) in CY09 and is expected to grow to ₹100bn by end-CY11, at a 22.7% CAGR. The third-party DC market (non-captive) – the addressable market for Tulip – is expected to double, from ₹11bn (US$250m; 18% of the overall DC services market) in CY09 to ₹22bn (~US$500m) in CY11 (22% of the overall market). According to Tulip's presentation for investors, the third-party DC space is expected to grow from 2m sqft in CY09 to 8.8m sqft in CY14, at a 32.8% CAGR.

Fig 19 – Indian DC-services market forecasts

Year-end: Dec (₹m)	CY09	CY11	CAGR (%)
DC-services market	63	100	26
- Captive	52	78	23
- Non-captive/third-party	**11**	**22**	**39**
Non-captive as % of total	18	22	

Source: IDC (as reported on CIOL website in Mar '10)

Rising risk profile

While the third-party DC-services market offers significant growth opportunities, Tulip's plans significantly increase its risk profile on account of:

1. **Execution risk:** Given the size (world's third-largest DC) and investment involved (₹9bn, ~40% of market capitalization), the project is exposed to execution risks. Delays in customer uptake could impact earnings and cash flows. While the DC would be developed in phases (which controls risks to some extent), we understand there would be significant upfront investments relating to facilities, which are not modular (e.g., DC land/buildings, which the company acquired for ₹2.3bn).
2. **Project funding risk:** Tulip plans to partly fund the project by diluting its equity stake in the DC subsidiary. Potential delays in inducting an equity partner (possible reasons: project risks, issues over valuations) could lead to project delays or increased debt funding. Notably, we have not factored in the equity infusion into the DC subsidiary, and assume the project to be funded via debt. The planned equity infusion is a source of upside risk to our near-term earnings estimates. Besides, the equity funding would reduce risk for both the DC project and the overall company.
3. **Delays in the FCF and increase in financial leverage (consolidated):** Without the new DC investment, Tulip would have become a largely debt-free company by FY13e (assuming conversion of FCCBs), having an FCF yield (FCF-to-EV) of ~10%. However, factoring in the DC business, we expect an FY13e FCF yield of ~3%.

We have incorporated the above risks into our model and DCF in the form of higher WACC of 13.75% vs. 13% previously.

Our forecasts

We estimate NPV of Tulip's new DC at ₹12 per Tulip share. Our DC forecasts are significantly lower than management guidance. We have modeled FY14e revenues and EBITDA margin at ₹4.2bn and 29% vs. management guidance of ₹10bn and 50% respectively. Our estimates are conservative owing to large-scale and the largely greenfield nature of the project.

We have increased our WACC estimate for Tulip to 13.75% from 13% (impact on DCF: ₹22), which is mainly on account of Tulip's DC plans. Hence, net impact of DC business on Tulip's DCF-based target price is negative, of ₹10/share.

Fig 20 – Data-centre business model

Year-end Mar (₹m)	FY12e	FY13e	FY14e	FY15e	FY16e	FY17e	FY18e	FY19e	FY20e	FY21e	FY22e
Operating parameters											
Capacity (sqft, white space)	100,000	300,000	450,000	465,231	466,560	468,491	470,989	489,829	509,422	529,799	550,991
Capacity utilization (%)	34	68	60	65	70	73	75	75	75	75	75
Monthly rentals	1,396	1,438	1,481	1,526	1,568	1,607	1,643	1,676	1,705	1,731	1,753
Financial summary											
Revenues	283	2,039	4,200	5,241	5,917	6,424	6,832	7,247	7,669	8,095	8,524
EBITDA	(318)	(63)	1,197	1,530	1,768	1,964	2,135	2,313	2,499	2,692	2,891
EBITDA margin (%)	(112)	(3)	29	29	30	31	31	32	33	33	34
EBIT	(379)	(269)	772	874	1,012	1,197	1,355	1,503	1,638	1,773	1,906
EBIT margin (%)	(134)	(13)	18	17	17	19	20	21	21	22	22
Capex	2,750	2,000	2,000	248	81	114	147	472	542	618	701
Cash-flow summary											
EBIT X (1-Tax rate)	(420)	(183)	524	593	687	813	920	1,020	1,112	1,203	1,293
Add: Depreciation	61	206	425	656	757	766	779	810	861	919	985
OPFCF	(359)	23	949	1,249	1,443	1,579	1,699	1,830	1,973	2,122	2,278
Capex	(2,750)	(2,000)	(2,000)	(248)	(81)	(114)	(147)	(472)	(542)	(618)	(701)
FCF	(3,109)	(1,977)	(1,051)	1,001	1,362	1,465	1,552	1,359	1,431	1,504	1,577

DCF summary (as on Mar '12e)		
Discount rate (%)	13.75	WACC for Tulip
Terminal growth (%)	3.50	
NPV of explicit period cash flows	1,963	
PV of terminal value	4,763	
Project EV	**6,726**	
Less: FY12e debt	4,989	Assuming FY12 capex is funded out of debt
Value of the project	**1,737**	
Value accrued to Tulip (%)	100	Not yet modelling sale of equity stake to equity partners
Value accrued to Tulip	**1,737**	
Value accrued to Tulip (₹/share)	**12**	

Source: Anand Rathi Research

Financials

EBITDA margin would be flat during FY11-13e, largely due to the lower margin in the DC business initially

Sharp rise in depreciation and finance costs over FY11-13e (driven by the DC business) would hamper EPS growth

Dip in two-year forward EPS CAGRs for both FY13e and FY14e is because of expiry of Sec 80IA income-tax benefits in FY15 (resulting in increase in the effective tax rate, from ~25% to ~33%)

Fig 21 – Consolidated income statement

Year-end: Mar (₹m)	FY09	FY10	FY11	FY12e	FY13e	FY14e
Revenues	**16,144**	**19,664**	**23,511**	**27,951**	**34,093**	**39,610**
Operating costs						
(Increase)/decrease in stock-in-trade	215	(229)	(305)	0	0	0
Cost of goods & services	(11,774)	(12,724)	(14,884)	(17,440)	(20,217)	(22,213)
Staff cost	(712)	(825)	(946)	(1,102)	(1,252)	(1,391)
Selling and distribution expenses	(42)	(47)	(54)	(64)	(74)	(81)
G&A	(464)	(585)	(691)	(790)	(922)	(1,024)
Total operating costs	**(12,777)**	**(14,409)**	**(16,880)**	**(19,997)**	**(24,567)**	**(27,712)**
EBITDA	**3,367**	**5,255**	**6,631**	**7,954**	**9,527**	**11,898**
EBITDA margin (%)	*20.9*	*26.7*	*28.2*	*28.5*	*27.9*	*30.0*
Depreciation and amortization	(414)	(1,353)	(1,714)	(2,234)	(2,756)	(3,290)
EBIT	**2,953**	**3,902**	**4,917**	**5,720**	**6,771**	**8,608**
EBIT margin (%)	*18.3*	*19.8*	*20.9*	*20.5*	*19.9*	*21.7*
Other income	20	(221)	1	0	0	0
Interest income	204	29	147	104	59	55
Finance expenses	(462)	(716)	(1,001)	(1,266)	(1,599)	(1,821)
XO, prior period items	113	648	0	0	0	0
PBT	**2,827**	**3,642**	**4,065**	**4,558**	**5,231**	**6,843**
Current tax	(330)	(879)	(1,001)	(1,195)	(1,374)	(1,410)
Deferred tax	0	(20)	0	(50)	(57)	(83)
Reported PAT	**2,498**	**2,743**	**3,064**	**3,314**	**3,800**	**5,351**
Adjusted PAT	**2,398**	**2,255**	**3,064**	**3,314**	**3,800**	**5,351**
Adj. PAT margin (%)	*14.9*	*11.5*	*13.0*	*11.9*	*11.1*	*13.5*
Adjusted EPS (₹)						
Primary EPS	16.5	15.6	21.1	22.9	26.2	37
Diluted EPS	**16.5**	**15.6**	**21.1**	**22.9**	**26.2**	**37**
Shares outstanding (m)						0
Shares outstanding (m)	145.0	145.0	145.0	145.0	145.0	145
Diluted shares (m)	145.0	145.0	145.0	145.0	145.0	145
Growth rates (%)						0
Revenue	32.4	21.8	19.6	18.9	22.0	16.2
EBITDA	**37.1**	**56.1**	**26.2**	**20.0**	**19.8**	**24.9**
EBIT	44.9	32.1	26.0	16.3	18.4	27.1
Net profits	29.8	(6.0)	35.9	8.1	14.7	40.8
Diluted EPS	**29.8**	**(6.0)**	**35.9**	**8.1**	**14.7**	**40.8**
2-year forward Revenue CAGR (%)	20.7	19.2	20.4	19.0	12.1	7.1
2-year forward EBITDA CAGR (%)	**40.3**	**23.0**	**19.9**	**22.3**	**17.4**	**7.7**
2-year forward EBIT CAGR (%)	29.0	21.1	17.3	22.7	17.3	5.6
2-year forward Profit CAGR (%)	13.0	21.2	11.4	27.1	16.2	2.8
2-year forward EPS CAGR (%)	**13.0**	**21.2**	**11.4**	**27.1**	**16.2**	**2.8**
Margins (%)						
Gross profit margin	28.4	34.1	35.4	37.6	40.7	43.9
EBITDA	20.9	26.7	28.2	28.5	27.9	30.0
EBIT	18.3	19.8	20.9	20.5	19.9	21.7
PBT	17.5	18.5	17.3	16.3	15.3	17.3
Net profits	14.9	11.5	13.0	11.9	11.1	13.5
Current tax rate (%)	11.7	24.1	24.5	24.0	24.0	24.0
Effective tax rate (%)	**11.7**	**24.7**	**24.5**	**25.0**	**25.0**	**25.0**

Source: Company, Anand Rathi Research

We assume redemption of FCCBs in FY13 (outstanding amount as of FY11 is ₹4.4bn), rather than conversion; conversion price of FCCBs is ₹227/share vs. current share price of ₹156

Investments refer to Tulip's 13% equity stake in Qualcomm's BWA venture

We expect net debt and net debt-to-EBITDA to peak out in FY12e

Fig 22 – Consolidated balance sheet

Year-end: Mar (₹m)	FY09	FY10	FY11e	FY12e	FY13e	FY14e
Equity						
Equity share capital	290	290	290	290	290	290
Reserves & Surplus	1,416	2,313	2,313	2,313	2,313	2,313
Profit & Loss account	5,113	6,676	9,523	12,498	15,892	20,769
Total shareholder equity	**6,819**	**9,279**	**12,125**	**15,101**	**18,495**	**23,372**
Deferred tax liability	9	29	29	79	136	219
Liabilities	0	0	0	0	0	0
Secured debt	5,141	5,476	8,254	8,004	6,504	4,504
Unsecured debt	6,083	6,715	9,515	10,515	12,515	12,515
Total debt	**11,224**	**12,191**	**17,769**	**18,519**	**19,019**	**17,019**
Total Invested capital	**18,053**	**21,499**	**29,923**	**33,699**	**37,650**	**40,610**
Assets						
Cash & cash equivalents	**3,470**	**3,470**	**3,470**	**1,425**	**1,370**	**1,230**
Current assets	5,252	7,567	9,368	10,208	11,191	11,792
Current liabilities & provisions	(2,821)	(2,838)	(3,554)	(3,401)	(3,525)	(3,634)
Net working capital (excl. cash)	**2,431**	**4,728**	**5,814**	**6,807**	**7,666**	**8,158**
Gross block	9,437	14,502	20,622	25,962	31,722	38,373
Less: accumulated depr/amort	(1,061)	(2,414)	(4,144)	(6,378)	(9,134)	(12,424)
Net fixed assets	8,376	12,088	16,478	19,584	22,588	25,950
Capital work-in-progress	3,772	1,209	1,445	3,166	3,309	2,555
Net fixed assets (incl. CWIP)	**12,148**	**13,296**	**17,923**	**22,751**	**25,898**	**28,505**
Investments	0	0	1,400	1,400	1,400	1,400
Misc. expenditure (not w/o)	4	4	73	73	73	73
Total assets	**18,053**	**21,499**	**29,923**	**33,699**	**37,650**	**40,610**
Gearing and profitability ratios (%)						
Net-debt incl. FCCBs	**7,755**	**8,721**	**14,299**	**17,094**	**17,649**	**15,789**
Net-debt incl. FCCBs (US$m)	152	193	318	380	392	351
Debt/Equity	165	131	147	123	103	73
Debt/capital	62	57	59	55	51	42
Net-debt/Equity	**114**	**94**	**118**	**113**	**95**	**68**
Net-debt/capital	43	41	48	51	47	39
Net-debt/EBITDA (x)	**2.3**	**1.7**	**2.2**	**2.1**	**1.9**	**1.3**
Net interest coverage (x) [a]	7.3	7.3	6.6	6.3	6.0	7
RoAE	42.5	28.0	28.6	24.3	22.6	25.6
RoACE (excl. CWIP)	18.2	13.0	12.6	11.2	11.7	14.8

Source: Company, Anand Rathi Research

We expect the company to turn FCF-positive during 2HFY13-FY14

Fig 23 – Consolidated cash flow statement

Year-end: Mar (₹m)	FY09	FY10	FY11e	FY12e	FY13e	FY14e
Profits before tax	2,841	2,998	4,065	4,558	5,231	6,843
Depreciation & amortisation	414	1,353	1,714	2,234	2,756	3,290
Other non-cash items	(129)	(1,068)	0	0	0	0
Taxes paid	(330)	(879)	(1,001)	(1,195)	(1,374)	(1,410)
Chg in working capital	(166)	(2,312)	(1,086)	(993)	(859)	(493)
CF from Operations	**2,632**	**91**	**3,692**	**4,604**	**5,754**	**8,231**
Capex	(7,365)	(4,798)	(5,300)	(7,062)	(5,903)	(5,897)
(Purchase)/Sale of assets/businesses	0	2,284	(2,300)	0	0	
(Purchase)/Sale of investments	1,858	(0)	(1,400)	0	0	0
CF from investments	**(5,507)**	**(2,513)**	**(9,000)**	**(7,062)**	**(5,903)**	**(5,897)**
Equity raised	0	0	0	0	0	0
Debt raised / (repaid)	543	2,694	5,578	750	500	(2,000)
Dividends paid	(136)	(271)	(271)	(338)	(406)	(473)
CF from financing	**407**	**2,423**	**5,307**	**412**	**94**	**(2,473)**
Change in cash for year	**(2,468)**	**0**	**(0)**	**(2,046)**	**(55)**	**(140)**
Beginning cash	5,938	3,470	3,470	3,470	1,425	1,370
Closing cash	**3,470**	**3,470**	**3,470**	**1,425**	**1,370**	**1,230**
Free cash flow	**(4,733)**	**(4,707)**	**(1,608)**	**(2,457)**	**(149)**	**2,334**

Source: Company, Anand Rathi Research

ANANDRATHI

India I Equities

Telecommunications
Update
Change in Estimates ☑ Target ☑ Reco ☐

20 June 2011

Tata Teleservices (Maharashtra)

Steep valuations, not supported by fundamentals; Sell

Rating: **Sell**
Target Price: ₹12.0
Share Price: ₹16.4

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Tata Teleservices Maharashtra's (TTML) revenue outlook is muted and balance sheet stretched. We believe current valuations are steep and i) are not supported by fundamentals; ii) imply higher-than-deserving value from potential corporate restructuring (which may result in an open offer, delisting). We roll over our DCF-based price target to ₹12 for Jun '12e vs. the earlier ₹13 for Dec '11e.

- **Losing traction, post-GSM launch euphoria.** After surging in 3QFY10, TTML's minutes and revenue growth significantly slowed over 4QFY10-4QFY11. Even so, we project a strong 30% FY11-13e EBITDA CAGR on our expectations of a ~700bps margin expansion.
- **Highly-geared balance sheet entails significant financial risk.** Despite sale of its tower assets in 1QFY11, TTML's net debt at ₹46bn is high (145% of market cap; 11x FY11 EBITDA); we estimate peak net-debt of ₹51bn in FY14.
- **Restructuring option appears to be priced in.** We believe the exit price for TTML investors, in case of any restructuring, is likely to be considerably lower than the last open offer, at ₹24.7/share in Mar '09. The intrinsic value has decreased since then due to: i) margin compression in the 2G mobile business; ii) 3G auctions.
- **Change in estimates.** We cut our FY12e-14e revenue and EBITDA by 9-15% each, in the light of the weak growth in recent quarters. The impact on our revised DCF-based Jun '12e target price of ₹12 is partly mitigated by a cut in capex estimates.
- **Recommendation and Risk.** We maintain a Sell on TTML. Risks: i) news of a potential merger with Tata Teleservices (TTSL) or delisting of TTML; ii) equity issue at a premium to our target price.

Key data	TTLS IN/ TTML.BO
52-week high/low	₹25.7 / ₹13.9
Sensex/Nifty	17871 / 5366
3-m average daily volume	US$1.4m
Market Cap	₹31bn /US$693m
Shares outstanding	1897m
Promoters	77.7
Free float	22.3
- Foreign institutions	1.4
- Domestic institutions	0.6
- Others [a]	20.3

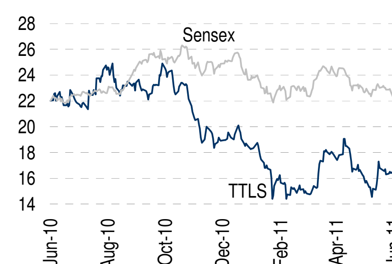
[a] Others include Indian public (17.4%), corporate bodies (2.5%)

Key financials and valuations

Year-end: Mar (₹m)	FY10	FY11	FY12e	FY13e	FY14e
Revenues	20,983	22,487	25,303	27,929	30,667
EBITDA	3,853	4,302	5,885	7,317	8,357
Reported PAT	(3,180)	499	(5,765)	(4,786)	(3,820)
Adj. PAT	(3,180)	(5,994)	(5,765)	(4,786)	(3,820)
EPS (₹)	(1.68)	(3.16)	(3.04)	(2.52)	(2.01)
Revenue growth (%)	7.8	7.2	12.5	10.4	9.8
EBITDA growth (%)	(21.0)	11.7	36.8	24.3	14.2
EBITDA margin (%)	18.4	19.1	23.3	26.2	27.3
EV/Sales (x)	3.3	3.4	3.1	2.9	2.7
EV/EBITDA (x)	18.2	17.9	13.4	11.1	9.8

Source: Company, Anand Rathi Research

Relative price performance



Source: Bloomberg

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Quick Glance – Consolidated financials and valuations

Fig 1 – Income statement (₹m)

Year-end: Mar	FY10	FY11	FY12e	FY13e	FY14e
Revenue	20,983	22,487	25,303	27,929	30,667
EBITDA	**3,853**	**4,302**	**5,885**	**7,317**	**8,357**
EBITDA margin (%)	18.4	19.1	23.3	26.2	27.3
Depr. & amortization	(5,640)	(7,507)	(7,323)	(7,471)	(7,580)
Net other income	2,112	672	600	600	600
EBIT	325	(2,533)	(838)	446	1,377
Net interest cost	(3,505)	(3,462)	(4,927)	(5,232)	(5,197)
Profit before tax	**(3,180)**	**(5,994)**	**(5,765)**	**(4,786)**	**(3,820)**
Extraordinaries	0	6,493	0	0	0
Tax	0	0	0	0	0
Net profit (reported)	**(3,180)**	**499**	**(5,765)**	**(4,786)**	**(3,820)**
Net profit (adjusted)	**(3,180)**	**(5,994)**	**(5,765)**	**(4,786)**	**(3,820)**
Adjusted EPS (₹)	(1.68)	(3.16)	(3.04)	(2.52)	(2.01)
Revenue growth (%)	**7.8**	**7.2**	**12.5**	**10.4**	**9.8**
EBITDA growth (%)	**(21.0)**	**11.7**	**36.8**	**24.3**	**14.2**

Source: Company, Anand Rathi Research

Fig 2 – Balance sheet (₹m)

Year-end: Mar	FY10	FY11e	FY12e	FY13e	FY14e
Share capital	18,972	18,972	18,972	18,972	18,972
Reserves & Surplus	(25,939)	(25,136)	(30,901)	(35,688)	(39,508)
Shareholders' funds	**(6,967)**	**(6,164)**	**(11,929)**	**(16,716)**	**(20,536)**
Debt	39,400	46,526	51,776	52,276	50,276
Capital employed	**32,433**	**40,362**	**39,847**	**35,560**	**29,740**
Net fixed assets	35,957	31,698	30,107	27,881	25,173
Intangible assets	5,603	17,861	16,479	15,098	13,716
Curr. assets (ex-cash)	6,300	8,162	8,539	8,867	9,184
Current liabilities	(15,656)	(18,106)	(19,244)	(18,152)	(17,578)
Net working capital	**(9,356)**	**(9,944)**	**(10,705)**	**(9,284)**	**(8,394)**
Cash & equivalents	230	747	3,964	1,866	-755
Capital deployed	**32,433**	**40,362**	**39,846**	**35,560**	**29,740**
No. of shares (m)	1,897	1,897	1,897	1,897	1,897
Net debt/(cash)	**39,170**	**45,779**	**47,812**	**50,410**	**51,031**
Net Debt/EBITDA (x)	10.2	10.6	8.1	6.9	6.1

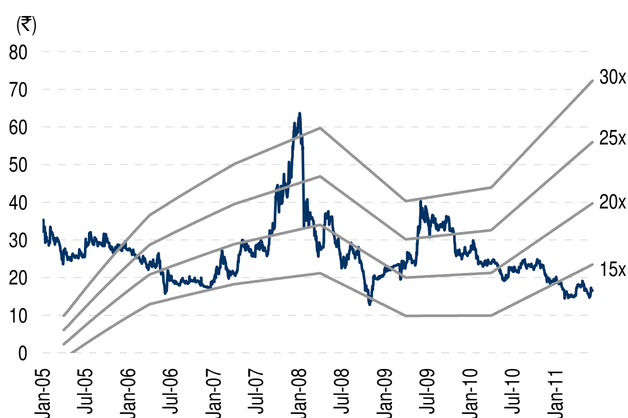
Source: Company, Anand Rathi Research

Fig 3 – Cash flow statement (₹m)

Year-end: Mar	FY10	FY11e	FY12e	FY13e	FY14e
Profits before tax	(3,180)	(5,994)	(5,765)	(4,786)	(3,820)
Depr. & amortization	5,640	7,507	7,323	7,471	7,580
Non-cash items/XO	(349)	(2,676)	0	0	0
Taxes paid	(0)	0	0	0	0
Chg in working capital	285	588	761	(1,420)	(890)
CF from operations	**2,396**	**(575)**	**2,319**	**1,265**	**2,870**
Capex (incl. entry fee)	(8,497)	(6,035)	(4,351)	(3,864)	(3,490)
Free cash flow	**(6,102)**	**(6,610)**	**(2,032)**	**(2,599)**	**(620)**
Investments/others					
Equity raised	0	0	0	0	0
Debt raised / (repaid)	5,957	7,126	5,250	500	(2,000)
Dividends paid	0	0	0	0	0
Chg in cash for year	**(145)**	**516**	**3,218**	**(2,099)**	**(2,620)**
Beginning cash	375	230	746	3,964	1,866
Closing cash	**230**	**746**	**3,964**	**1,866**	**(755)**

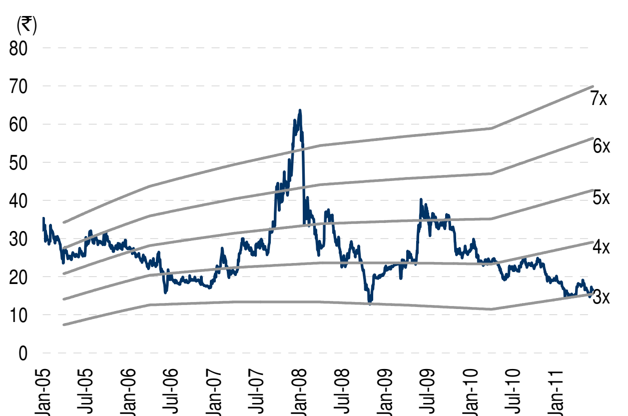
Source: Company, Anand Rathi Research [a] Adjusted for ₹13.2bn inflow from sale of tower assets

Fig 4 – Rolling 12-month forward EV/EBITDA



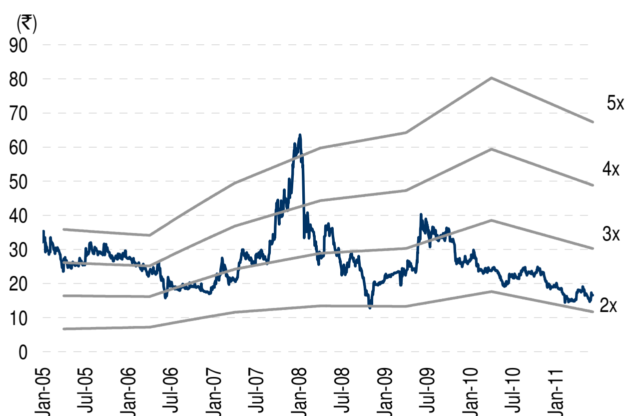
Source: Bloomberg, Company, Anand Rathi Research

Fig 5 – Rolling 12-month forward EV/sales



Source: Bloomberg, Company, Anand Rathi Research

Fig 6 – Rolling 12-month forward EV/capital employed



Source: Bloomberg, Company, Anand Rathi Research

Investment Argument & Valuation

Tata Teleservices Maharashtra's (TTML) revenue outlook is muted and balance sheet stretched. We believe current valuations are steep and i) are not supported by fundamentals and ii) imply higher-than-deserving value from potential corporate restructuring (which may result in an open offer, delisting). We roll over our DCF-based price target to ₹12 for Jun '12e vs. ₹13 for Dec '11e earlier.

Fundamentals do not support steep valuations

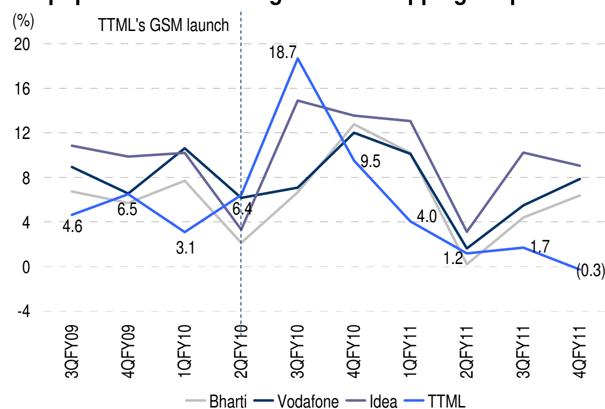
Losing traction, post-GSM launch euphoria

TTML's traffic and revenue growth have been slowing down after the initial surge following the GSM launch in 2QFY10

Large GSM incumbents have managed to win back traffic share after cutting tariffs, in response to the aggressive national tariff plans of TTSL/TTML and RCom

After reporting a surge in 3QFY10, TTML's minutes and revenue growth have seen significant slowdown over 4QFY10-3QFY11. GSM leaders – Bharti, Vodafone and Idea – have managed to win back lost traffic after slashing tariffs in response to the aggressive new offers (e.g., per-second billing) introduced by TTSL/TTML and RCom.

Fig 7 – TTML's qoq wireless minutes growth is dropping vs. peers



Source: Companies

Nonetheless, we have projected strong EBITDA growth for TTML (30% CAGR over FY11-13e), driven by 11% revenue CAGR and ~700bps expansion in EBITDA margin over the same period. Revenue growth is likely to be driven by the 2G GSM business (subscriber growth + ARPU stabilization), while margins are likely to expand due to decline in the absolute amount of CDMA handset subsidies and reduction in the overall employee/SG&A cost-to-sales.

High balance-sheet gearing entails financial risk

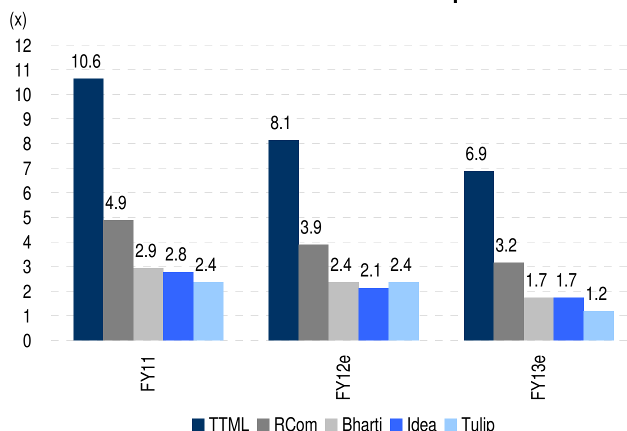
TTML's business has significant operating leverage, but needs revenue growth to play out

Despite the sale of passive infrastructure assets in 1QFY11, TTML's net-debt remains elevated at ₹46bn (10x annualized 4QFY11 EBITDA); we estimate peak net-debt of ₹50bn in FY13. Further, TTML's interest coverage (EBITDA/interest expense) dropped to 1.4x in FY11 from 2x in FY09 and is likely to remain at 1.3-1.5x over FY12e-13e, in our view.

We expect further increase in net debt ahead, as TTML is likely to remain free-cash-flow-to-firm (FCFF) negative during FY12e. TTML's cash profits have been declining since peaking at ₹3.2bn in FY08; we forecast a modest cash profit of ₹1.5bn in FY12e, which is insufficient to fund the company's capex needs. We estimate FY12 capex to be ~₹4.3bn (vs. ₹7bn in FY11). TTML largley relies on incremental borrowings and vendor credit for bridging the funding gap.

TTML's balance sheet is significantly stretched, with net debt-to-EBITDA of 10.2x in 4QFY11

Fig 8 – TTML's net debt-to-EBITDA to be elevated vs. peers



Source: Company, Anand Rathi research *Note: estimated FY11 figures for Idea*

Should the revenue and EBIDTA growth turn out less than projected, TTML may be forced to cut its capex plan to meet debt covenants. This would bring the balance sheet issues (financial risk) to the fore, potentially leading to adverse share price impact. Raising equity funds could be challenging for the company, in view of prevalent industry issues (competition/overcapacity) as well as company-specific challenges (losses, high leverage, low intrinsic value implying potentially high dilution).

Restructuring option appears to be priced in

We believe that TTML's current share price is supported by the possibility of corporate restructuring involving the Tata Group's telecom holdings. TTML offers a potential option to invest in an integrated, pan-India telecom entity post such a restructuring. Based on the already high gearing and limited funding options available to the company, we believe some form of restructuring of ownership can not be ruled out in the medium term. However, the Tata Group has neither shown inclination nor urgency to restructure its telecom entities in the short-to-medium term.

After picking up 26% equity in TTSL, Docomo acquired 12% of TTML's stock at ₹24.7/share, pursuant to a discretionary open offer in Mar '09

Such restructuring may also result in the de-listing of TTML stock. However, we believe the exit price for TTML investors in case of any restructuring is likely to be much lower than the last open offer, at ₹24.7 shares in Mar '09. The intrinsic equity value has reduced since then, due to: i) margin compression in the 2G mobile business and ii) 3G auctions. Also, the stock is already trading at ~36% premium to our Jun '12e target price.

Valuation, Target price and Risk

Valuations are uncomfortably steep

Despite our strong projected EBITDA growth over the next few years, TTML's valuation premium does not dissipate rapidly on farther years' multiples – TTML is trading at ~75% premium to Bharti on FY14e EV/EBITDA.

TTML trades at FY12e EV/EBITDA of 18x, which is at a significant premium to large-cap telcos (6.6-8.1x). While part of the valuation premium is justified by TTML's likely superior EBITDA growth (our estimate of 30% CAGR over FY11e-13e vs. 11-24% CAGR for listed peers), we believe the current valuation premium is excessive, given negative FCF generation (till FY13) and the company's high risk profile.

Further, despite our strong estimated EBITDA growth over the next 3-4 years, TTML's valuation premium does not rapidly dissipate, even on the farther years' multiples – TTML is currently trading at ~75% premium to Bharti on FY14e EV/EBITDA.

Fig 9 – Valuations at unjustifiable premium to peers

	Share price (₹)	EV/EBITDA (x) FY11	FY12e	FY13e	EBITDA CAGR (%) FY11-13e	EV/EBITDA-to-growth (x)
TTML	16	17.9	13.4	11.1	19.2	0.70
Bharti	380	10.0	8.1	6.7	15.1	0.54
Idea	78	9.5	7.5	6.3	19.0	0.40
RCom	95	10.0	8.8	7.5	11.4	0.88
Average		**8.7**	**7.7**	**6.4**	**14.3**	**0.54**
TTML's premium to average		105	75	74		30.6

Source: Bloomberg, Company, Anand Rathi research

Jun '12e price target of ₹12/share

Our Jun '12e price target of ₹12/share is based on DCF methodology. We estimate a strong, 11% revenue CAGR over FY11e-13e, which would gradually decline to 5-6% CAGR subsequently. We also forecast long-term EBITDA margin of ~29% in FY15e, up from 20% in 4QFY11. We assume a terminal growth rate of 5% in nominal FCFs beyond FY20 and WACC of 13% (12% for Bharti). Our long-term capex-to-sales assumption is ~10%.

Fig 10 – DCF-based analysis

Year-end: March (₹m)	FY09	FY10	FY11e	FY12e	FY13e	FY14e	FY15e	FY16e	FY17e	FY18e	FY19e	FY20e
Assumptions (%)												
Revenue growth	14.0	7.8	7.2	12.5	10.4	9.8	8.3	7.4	6.9	6.6	6.4	6.3
EBITDA growth	**21.0**	**(21.0)**	**11.7**	**36.8**	**24.3**	**14.2**	**11.4**	**9.2**	**8.8**	**7.7**	**7.5**	**7.4**
FCF growth	NM	NM	NM	94.2	(0.2)	69.1	50.7	12.7	4.2	(24.4)	38.1	6.5
EBITDA margin	**25.1**	**18.4**	**19.1**	**23.3**	**26.2**	**27.3**	**28.0**	**28.5**	**29.0**	**29.3**	**29.6**	**29.9**
FCF margin	(21.4)	(10.7)	0.1	12.1	9.1	14.0	19.5	20.5	19.9	14.2	18.4	18.4
Capex / sales	**41.4**	**40.5**	**26.8**	**17.2**	**13.8**	**11.4**	**10.2**	**10.1**	**10.1**	**10.1**	**10.2**	**10.3**
Debt / capital (%)	57.1	61.2	64.9	65.8	67.0	67.3	66.4	64.8	62.6	61.0	57.2	51.9
RoCE (%)	4.6	1.0	(6.3)	(2.1)	1.3	4.6	10.7	11.8	20.4	37.4	74.2	147.4
EBIT X (1-tax rate)	1,370	325	(2,028)	(671)	357	1,102	2,123	2,759	3,174	3,819	4,531	5,765
Depreciation	4,365	5,053	6,697	5,941	6,090	6,198	5,875	5,933	6,038	5,851	5,534	4,717
Amortization	266	587	810	1,382	1,382	1,382	1,382	1,382	1,382	1,382	1,382	1,382
Change in working capital	(2,116)	285	588	761	(1,420)	(890)	491	838	862	(1,186)	900	1,315
Capital expenditure [a]	(8,057)	(8,497)	(6,035)	(4,351)	(3,864)	(3,490)	(3,388)	(3,609)	(3,850)	(4,113)	(4,400)	(4,715)
Free cash flows	**(4,172)**	**(2,248)**	**32**	**3,062**	**2,544**	**4,302**	**6,482**	**7,303**	**7,606**	**5,752**	**7,947**	**8,463**

Mar-12e DCF calculation	
Terminal growth rate (%)	5.0
WACC (%)	**13.0**
Implied terminal value exit multiple (X)	13.1
Implied exit EBITDA multiple (X)	**8.1**
NPV of cash flows (FY13e-20e)	28,045
PV of terminal value	41,784
Enterprise value (₹m)	**69,829**
Terminal value as % of EV	59.8
Net Debt [FY10]	47,812
Equity value (₹m)	**22,018**
Number of shares (m)	1,897
DCF based equity value/share (₹)	**11.6**
June '12e target price (Rs)	**12.0**

Sensitivity of Jun '12e target price to WACC and perpetual growth

Perpetual growth rate (%)	WACC (%) 12.0	12.5	13.0	13.5	14.0
4.0	14.1	11.5	9.3	7.3	5.4
4.5	15.8	13.0	10.6	8.4	6.4
5.0	17.8	14.7	**12.0**	9.6	7.5
5.5	20.1	16.6	13.6	11.0	8.7
6.0	22.8	18.9	15.5	12.6	10.1

Sensitivity of exit EV/EBITDA to WACC and perpetual growth

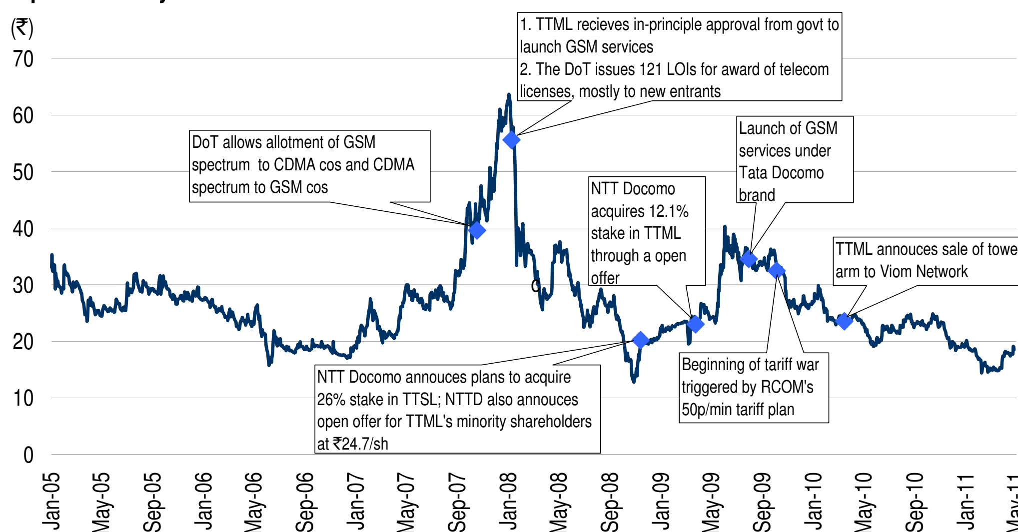
Perpetual growth rate (%)	WACC (%) 12.0	12.5	13.0	13.5	14.0
4.0	8.0	7.5	7.1	6.7	6.4
4.5	8.6	8.0	7.6	7.2	6.8
5.0	9.2	8.6	**8.1**	7.6	7.2
5.5	10.0	9.3	8.7	8.1	7.6
6.0	10.9	10.0	9.3	8.7	8.2

Source: Company, Anand Rathi research *[a] Adjusted for ₹3.2bn inflow from sale of tower assets in FY11*

Risks

1. Potential restructuring of the Tata Group's telecom business (involving TTSL, TCom, TTML) may lead to a mandatory open offer for TTML shares (and, hence, to de-listing). While the buyback price is likely to be at a premium to the intrinsic value (target price), it is unlikely to yield major upside relative to current share price.
2. Any equity infusion, if done at a significant premium to our target price, would provide only a temporary impetus to TTML's share price.

Fig 11 – Share price and key events



Source: Bloomberg, Anand Rathi Research

Change in estimates

We cut revenue and EBITDA estimates for FY12-14 by 9-15% each, in the light of the weaker growth in recent quarters; impact on DCF is partly neutralized by the cut in capex estimates

Fig 12 – Revision in estimates

₹m	FY12e	FY13e	FY14e	FY15e
Revenues: Previous	27,828	31,910	35,388	37,807
Revenues: Revised	25,303	27,929	30,667	33,228
Revision (%)	***(9.1)***	***(12.5)***	***(13.3)***	***(12.1)***
EBITDA: Previous	6,684	8,656	9,951	10,804
EBITDA: Revised	5,885	7,317	8,357	9,308
Revision (%)	***(12.0)***	***(15.5)***	***(16.0)***	***(13.8)***
EBITDA margin: Previous	24.0	27.1	28.1	28.6
EBITDA margin: Revised	23.3	26.2	27.3	28.0
Revision (bps)	***(76)***	***(93)***	***(87)***	***(56)***
Adjusted PAT: Previous	(4,571)	(3,102)	(1,859)	(461)
Adjusted PAT: Revised	(5,765)	(4,786)	(3,820)	(2,317)
Revision (%)	***26.1***	***54.3***	***105.4***	***403.2***
Diluted EPS (₹): Previous	(2.41)	(1.63)	(0.98)	(0.24)
Diluted EPS (₹): Revised	(3.04)	(2.52)	(2.01)	(1.22)
Revision (%)	*26.1*	*54.3*	*105.4*	*403.2*
Capex: Previous	5,241	3,876	3,879	3,801
Capex: Revised	4,351	3,864	3,490	3,388
Revision (%)	***(17.0)***	***(0.3)***	***(10.0)***	***(10.9)***

Source: Anand Rathi Research

Fig 13 – Key model assumptions

Year-end: Mar	FY08	FY09	FY10	FY11	FY12e	FY13e	FY14e	FY15e
Wireless (GSM, CDMA, FWLL)								
Market data (TTML circles)								
Population (m)	108	110	111	112	114	115	116	118
Subscribers (m)	34	50	69	86	97	103	108	111
Penetration (%)	31.7	45.7	62.6	76.2	85.0	89.2	92.6	94.8
TTML subscriber base (m)	4.7	7.0	12.3	16.5	19.2	20.8	21.9	22.7
TTML subscriber market share (%)	13.6	13.9	17.8	19.2	19.9	20.3	20.3	20.3
TTML net-adds share (%)	15.7	14.4	27.9	25.5	25.1	26.2	21.1	21.4
ARPU (including 3G) (₹)	257	185	119	90	83	81	83	84
MOU/sub (mins)	428	327	256	229	233	238	243	245
ARPM (₹/min)	0.60	0.57	0.47	0.39	0.36	0.34	0.34	0.34
Total minutes (m)	19.2	22.8	29.7	39.5	50.0	57.1	62.1	65.5
Total minutes growth (%)		19.0	30.1	33.3	26.4	14.3	8.7	5.5
Fixed-line								
Subscribers ('000s)	401	537	660	756	837	903	954	990
ARPU (₹/month)	1,259	1,068	854	689	634	615	609	621
Consolidated								
EBITDA margin (%)	23.6	25.1	18.4	19.1	23.3	26.2	27.3	28.0
Capex-to-sales (%)	47.7	41.5	62.0	27.3	17.2	13.8	11.4	10.2

Source: Company, Anand Rathi Research

Losing traction, post-GSM launch

After registering a surge in 3QFY10, TTML's growth in minutes and revenue significantly slowed down in the subsequent five quarters (4QFY10-4QFY11). Nevertheless, we estimate a robust revenue CAGR of 11% as well as a ~700bps expansion in EBIDTA margin over FY11-13 following an absolute decline in CDMA handset subsidies and reduction in employee/SG&A cost-to-sales.

Losing traction, post-initial GSM launch euphoria

Innovative pricing and promotion initially drove traffic growth

TTML's wireless traffic (minutes) growth picked up subsequent to GSM launch in Aug '09. Traffic growth stood at 6.4% qoq in 2QFY10 (reflecting partial benefit of GSM launch), but shot up to 18.7% in 3Q. The company's average qoq traffic growth in the four quarters preceding 2QFY10 was 3.6%.

TTML's GSM entry was one of the principal factors leading to industry-wide tariff cuts in 3QFY10

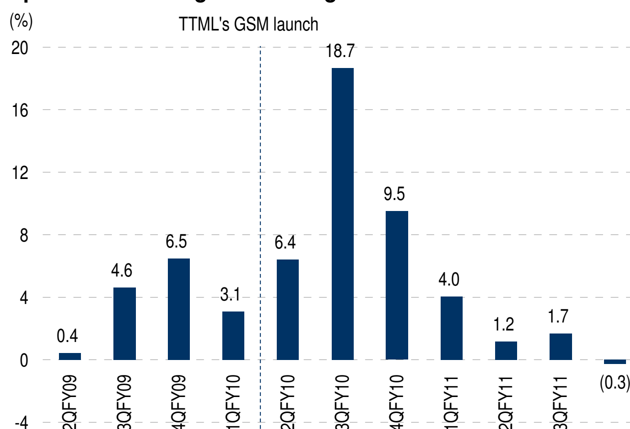
We attribute TTML's initial success in GSM to: i) novelty of per-second billing plan; ii) aggressive pricing – national long distance (NLD) tariffs of one paisa/second at par with local calling rates marked the death of distance and were at a significant discount to competitors; iii) effective marketing and promotion; iv) overall rise in multiple-SIM ownership among subscribers, partly driven by easy availability of inexpensive multi-SIM handsets; and v) initial wait-and-watch attitude adopted by competitors that resulted in traffic and revenue leakage in favor of Tata-Docomo.

Momentum lost after retaliation by competitors

Large GSM incumbents have managed to win back traffic share after cutting their tariffs in response to aggressive national tariff plans of TTSL/TTML and RCom

Large GSM incumbents have managed to win back traffic share after cutting their tariffs in response to aggressive national tariff plans of TTSL/TTML and RCom. This is reflected in strong rebound in the traffic growth reported by GSM incumbents after the slump in 2Q and early-3QFY10. Bharti, Vodafone and Idea reported average qoq traffic of 7-11% during 3QFY10-3QFY11, whereas TTML's traffic growth saw a precipitous drop to 9.5% in 4QFY10, to 4% in 1QFY11, to 1.2% in 2QFY11, to 1.7% in 3QFY11 and to (0.3)% in 4QFY11.

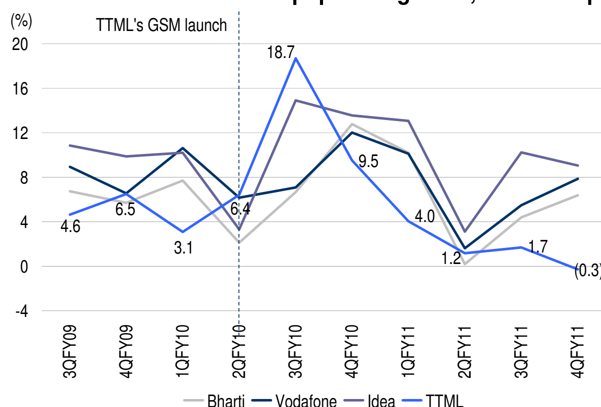
Fig 14 – Qoq wireless traffic growth losing momentum



Source: Company

We believe that after the initial euphoria surrounding cheaper per second billing (PSB) plans and rise in multi-SIM usage, subscribers are shifting back to their primary SIM card usage for most call requirements. This is being driven by: i) reduction in tariff premium (of primary SIM card operator – GSM incumbents/leaders) over new entrants, after price cuts by incumbents; ii) network coverage and quality considerations, as the older telcos have the higher-quality 900MHz spectrum in most circles as against 1800MHz spectrum owned by new entrants, including dual-technology operators; iii) superior branding and distribution of incumbent operators.

Fig 15 – Rebound in GSM incumbents' qoq traffic growth, on the response to cuts



Source: Companies

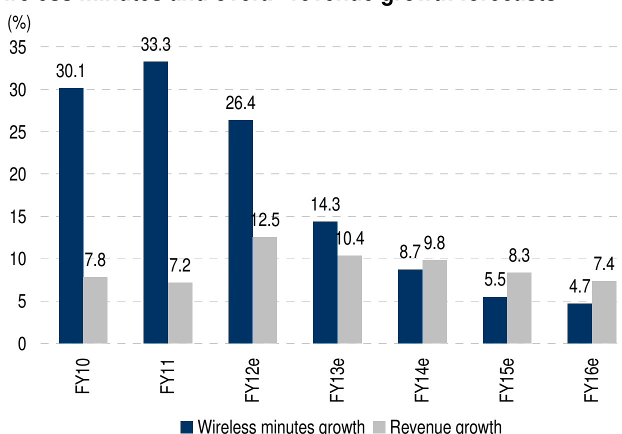
We forecast recovery, despite slowing momentum

GSM-led recovery in wireless revenue growth

We have assumed strong growth in revenue and EBITDA and EBITDA CAGR of 31% during FY11-13

On a conservative basis, we have factored in a moderate recovery in TTML's wireless traffic growth in our estimates. We factor in a 24% yoy increase in wireless traffic in FY12e (vs. 32% in FY11e), primarily led by increased GSM usage. We believe per-subscriber usage would increase if the company is successful in retaining customers for at least 3-6 months.

Fig 16 – Wireless minutes and overall revenue growth forecasts



Source: Company, Anand Rathi Research

CDMA/EVDO data segment to face competition from 3G roll-outs

Notably, non-voice revenue accounted for 22.1% of TTML's wireless revenue in 2QFY11 vs. 12-13% each for Bharti and Idea

TTML has the highest share of non-voice wireless revenues (22%) in the industry, thanks to its fast-growing *Tata Photon* high-speed mobile internet service. TTML provides mobile internet service to laptop and PC owners, on its CDMA EV-DO network, in major cities. The company had over

0.15m *Photon* subscribers at end-Jun '10, possibly generating monthly ARPUs of ~₹500. This implies revenue contribution of ₹225m per quarter (~6% of wireless revenues).

TTML achieved high growth in data revenues, mainly owing to lack of better (faster and cheaper) alternatives in the mobile internet space. RCom and MTS are the others in the high-speed mobile internet segment.

However, competition in the wireless internet/broadband is set to intensify with 3G (HSPA) networks being rolled out by peers.

TTML also provides regular wireline internet service that includes dial-up, DSL and leased lines. The company's wireline internet revenues saw a 55% CAGR during FY07-10. We forecast an internet revenue CAGR of 26% over FY10-13.

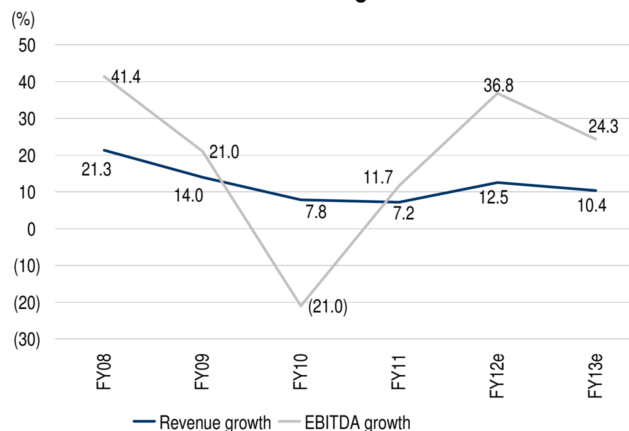
Core CDMA voice business to exhibit structural weakness

Management has indicated that TTML's CDMA FWLL (fixed wireless local loop) revenues have been declining, mainly owing to rising mobile penetration. Most FWLL lines are public-access phone lines (given to the franchisees/PCO operators) and high-ARPU, low-margin connections.

Also, TTML is seeing stagnation in its CDMA mobile voice revenues due to growing preference for GSM among subscribers (mainly owing to wider handset variety) and some cannibalization by its GSM business.

Revenues from both segments are likely to decline or, at best, remain stagnant for the medium term (FY10-13), in our view.

Fig 17 – Consolidated revenue and EBITDA growth

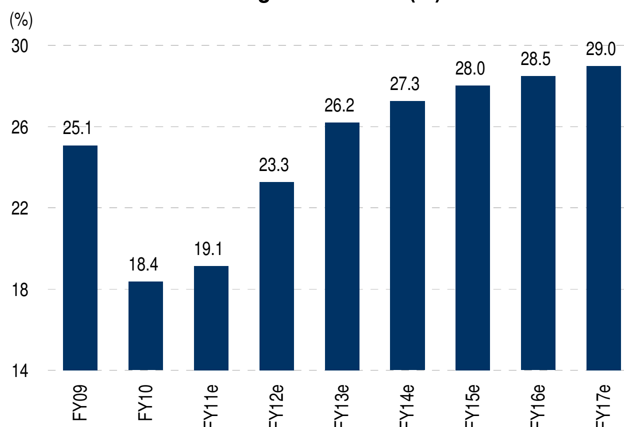


Source: Company, Anand Rathi Research

Operating leverage, lower handset subsidies to drive margins

TTML's EBITDA margin dipped from 24.5% in 1QFY10 to 14.8% in 2QFY10 driven by GSM launch expenses. However, the margin has gradually recovered since then, to 20.1% in 4QFY11. We estimate that it would increase 700bps over the next two years (FY11-13) and peak at 29% in the long term.

Fig 18 – Consolidated EBITDA margin to recover (%)

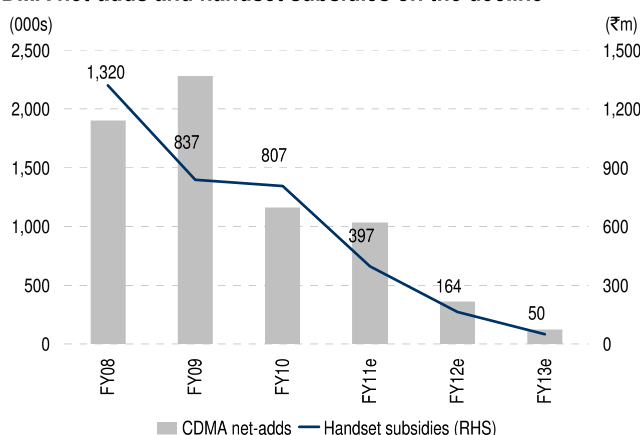


Source: Company, Anand Rathi Research

Key margin-expansion drivers

- **Decline in CDMA handset subsidies.** The company incurs a subsidy of ₹350 per handset, as per our estimate. The total subsidy expense was ₹807m (3.8% of revenues) in FY10. We expect handset subsidies to wind down over the next two to three years due to: i) decline in CDMA subscriber additions; ii) increase in CDMA handset sales from the open or off-the-shelf market; iii) decline in subsidy per handset. We estimate handset subsidy expenses to be ~₹400m in FY11 (1.8% of revenues); we expect it to further decline to ~₹160m in FY12 (0.6% of revenues), thereby contributing 120bps expansion in EBITDA margin in FY12.

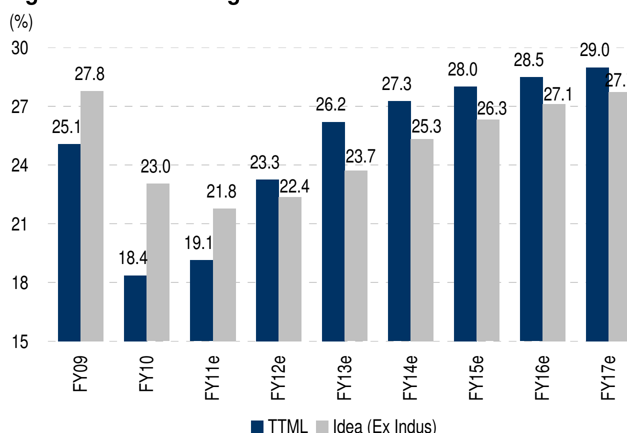
Fig 19 – CDMA net-adds and handset subsidies on the decline



Source: Company, Anand Rathi Research

- **Decline in S&M cost-to-sales.** Sales and marketing (S&M) cost-to-sales rose from 15.3% in FY09 to 17.7% in FY10, driven by 136% increase in subscriber net additions; it moderated to 14% in FY11. We forecast S&M cost-to-sales to gradually decline, driven by falling sub additions (besides drop in CDMA subsidies, as aforementioned), and stabilize to ~10% in the long-term (S&M cost-to-sales for Idea was 13.8% in 1QFY11, which we estimate would stabilize at ~8% in the long term).

Fig 20 – Long-term EBITDA margin to increase



Source: Company, Anand Rathi Research

Notably, our long-term EBITDA margin forecast for TTML (29%) is similar to our forecast for Idea Cellular. This is because the CDMA benefit (of fewer cell sites) is largely negated by the dual technology operations.

TTML also operates the CDMA network, which requires fewer cell sites than GSM network for similar capacity and, accordingly, has lower network operating costs

Fig 21 – Costs-to-sales based on FY10 data

(%)	TTML	Idea	Bharti
License/spectrum fees	9.2	11.0	10.3
Access charges [a]	21.0	14.5	11.3
Network costs [a]	14.9	25.4	19.2
Staff costs	7.1	5.0	4.3
Sales and marketing	17.7	13.0	8.0
General and admin costs	11.7	4.1	6.3
Total operating costs	**81.6**	**73.0**	**59.3**
EBITDA margins	**18.4**	**27.0**	**40.7**

Source: Company
[a] Unlike other telcos, TTML records leased line charges under access/interconnect costs, rather than network costs

We expect a ~700bps expansion in EBITDA margin over FY11-13 for TTML, largely driven by sales & marketing costs (~370bps), network O&M costs (~130bps) and G&A costs (~100bps)

Fig 22 – TTML: Cost breakdown (as percent of revenues)

	FY09	FY10	FY11	FY12e	FY13e	FY14e	FY15e	FY16e
Interconnection & access costs	24.4	21.0	20.3	20.0	19.3	19.0	18.8	18.6
License & spectrum fee	8.8	9.2	9.4	9.9	9.9	9.9	9.9	9.9
Network O&M costs	9.7	14.9	18.8	17.9	17.5	17.4	17.3	17.2
Employee costs	5.8	7.1	7.4	7.2	7.0	6.8	6.7	6.7
Sales & marketing expenses	15.3	17.7	14.3	12.0	10.6	10.2	9.9	9.9
G&A costs	10.9	11.7	10.6	9.7	9.5	9.4	9.3	9.2
Total operating cost-to-revenue (%)	**74.9**	**81.6**	**80.9**	**76.7**	**73.8**	**72.7**	**72.0**	**71.5**
EBITDA margin (%)	**25.1**	**18.4**	**19.1**	**23.3**	**26.2**	**27.3**	**28.0**	**28.5**

Source: Company, Anand Rathi Research

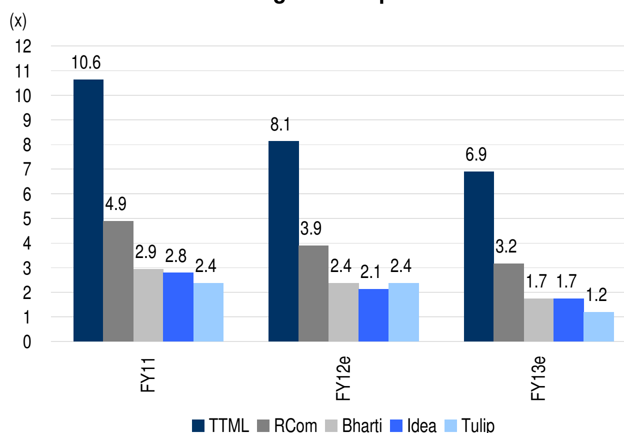
Balance sheet highly geared

Despite sale of tower assets in 1QFY11, TTML's net debt remains elevated at ₹46bn (148% of current market cap; 11x annualized 4QFY11 EBITDA). We forecast peak net debt of ₹50bn in FY13e. Further, TTML's interest coverage (EBITDA/net interest expense) dropped to 1.4x in FY11 from 2x in FY09 and is likely to remain at 1.3-1.5x over FY12e-13e, in our view. The company's highly-geared balance sheet entails significant financial risk, should revenue growth be weaker-than-expected.

High financial leverage

TTML's net debt-to-EBITDA in 3QFY11 was 11x, which is significantly higher than 3-4.5x for other listed telcos (Bharti, RCom and Idea). Despite accounting for a strong EBITDA CAGR of 30% over FY11-13e, we expect TTML's net debt-to-EBITDA to remain substantially higher than peers' due to rising net-debt (negative FCFs over FY11-13e).

Fig 23 – Net debt-to-EBITDA to be higher than peers



Source: Company, Anand Rathi Research

3G spectrum acquisition funded by sale of towers

In 1QFY11, TTML sold its tower business to Viom Networks (erstwhile Wireless Tata Tele Infrastructure), a tower company jointly owned by the SREI Group and TTSL, for an EV of ₹13.2bn (including ₹3.7bn of towerco debt assumed by Viom). This helped TTML fund the 3G spectrum cost of ₹12.6bn for the Maharashtra circle. Hence, the company's net debt remained largely unchanged. However, the net debt is set to see further growth as cash profits would remain inadequate to fund the company's capex plan over FY12-13.

Balance-sheet stress could impact growth

Since its GSM launch, TTML's quarterly EBITDA has barely been enough to cover interest expenses. The company's capex is being funded mainly from debt and vendor credit. The company's gross debt stood at ₹39.4bn as of Mar '10. We believe ~50% of this is long-term debt, which would come up for repayment only after '12, as per management. However, short-term debt would be required to be refinanced or converted into long-term debt, as we do not expect the company to generate meaningful FCF till FY13.

If revenue and EBITDA growths ahead are lower than our estimates, the company may find it challenging to meet principal repayments. Given the already high financial leverage, the revenue/EBITDA slippages may also constrain the company's capex plans and hurt its long-term growth prospects. Further, the balance sheet stress might become more evident and is likely to have an adverse impact on the company's valuations.

Limited funding options, on the sale of tower business

TTML mainly depends on incremental borrowings and vendor credit to bridge the funding gap. However, given the already higher financial leverage and a thin debt-servicing cushion, some form of equity-raising would be prudent, in our view, for reducing financial risk.

TTML has also obtained shareholders' approval to raise up to US$250m in the form of equity or convertible debt. We believe equity issuance through FPO/rights issue/QIP is challenging due to industry issues (competition/over-capacity) as well as company-specific challenges (high losses, leverage). Equity infusion by promoters to repair the balance sheet is also a possibility.

Corporate restructuring option appears priced in

We believe that TTML's current market price is supported by possibility of corporate restructuring among Tata Group telecom companies (TTML, TTSL, Tata Communications). The exit price for TTML investors in case of restructuring would be much lower than the last open offer of ₹24.7/share; tariff wars and 3G auction have since eroded the intrinsic value. Besides, the Tata Group has not shown any inclination/urgency to restructure its telecom entities in the short-to-medium term.

We believe the current share price is supported by the possibility of an open offer or delisting

TTML offers a potential option to invest in an integrated, pan-India telecom entity, post the restructuring of Tata Group's telecom holdings. Limited funding options available to TTML, in view of its high financial leverage and Tata Group's strategic objectives, may act as a catalyst for the restructuring.

Potential restructuring alternatives include:

i) Merger of TTML with unlisted TTSL, post a delisting of TTML (cash buyout of minorities)

ii) Merger of TTML with TTSL through a share swap, post a listing of TTSL. TTML shareholders would, thus, become shareholders of a listed TTSL

iii) Reverse merger of TTSL into TTML, through a share swap, leading to an indirect listing of TTSL

We believe the current market price is supported by possibility of an open offer or delisting, potentially arising from such a restructuring.

Attractive exit price unlikely even in case of restructuring

We believe the exit price for TTML investors in case of any restructuring is likely to be much lower than the last open offer of ₹24.7/share, as tariff wars and 3G auction have since eroded the intrinsic value.

NTT Docomo had made an open offer for TTML shares in Mar '09, following its acquisition of 26% stake in TTSL. We believe the open offer was not mandatory and may have been driven by the fact that the offer price (minimum price under the regulations) valued TTML at a discount to TTSL's acquisition multiples (e.g., EV/sales).

Fig 24 – TTSL and TTML valuations in NTT Docomo stake-acquisition transactions

US$m	Date	% stake acquired	Consideration	Implied equity value	FY09 net debt	EV	FY09 sales	EV/sales (x)
Stake acquisition in TTSL	Mar '09	26.0% [a]	2,600	7,999	2,000 [b]	9,999	1,325 [c]	**7.5**
Stake acquisition in TTML (Open offer)	Mar '09	12.1%	114	937	661	1,598	389	**4.1**

Source: Tata Communications' FY09 Annual Report, Bloomberg, Company, Anand Rathi Research
[a] Includes 20% through fresh equity infusion and 6% from Tata Group companies [b] Our estimate [c] Includes pro-rata (37.65%) share of TTML's revenues
Note: Exchange rate US$1=₹50 as of Mar '09

If the promoter makes an open offer for TTML shares as a result of the restructuring, the offer price is likely to be benchmarked to minimum applicable price requirement under SEBI regulations – the average of the weekly high and low of the closing share price for the past six months or the average of daily highs and lows for the past two weeks, whichever is higher. The floor price according to this formula works out to be ~₹17, which is close to the current market price.

The delisting price is decided by independent evaluators. **While minority shareholders have a greater say regarding the exit price in case of delisting, there have often been protracted differences and litigations in the past.** For instance, Cadbury India initiated a delisting process in '04-05 which is yet to be completed due to a legal battle by minority shareholders for a better exit price.

Timeline for potential restructuring is uncertain

The timeline for corporate restructuring, and resulting open offer/delisting, is uncertain, in our view

The timeline for potential restructuring and the resulting open offer/delisting is uncertain, in our view. The Tata Group has not shown any inclination/urgency for restructuring its telecom entities in the short-to-medium term. Notably, TTML's former MD, Anil Sardana, in an interview with MoneyControl.com on 24 Jun '10, focussed on operational rather than legal integration.

Financials

We estimate TTML to witness EBITDA CAGR of 30% during FY11-13, driven by revenue CAGR of 11% and ~700bps expansion in EBITDA margin over the same period. However, net losses would increase in FY12e due to 3G-related capital charges. Assuming rapid EBITDA growth from FY12, we estimate that net loss would start declining thereafter, after peaking at ₹5.7bn in FY12e. However, we do not expect the company to turnaround at the PAT level in the next 2-3 years at least.

TTML sold its tower business to Viom Networks for an enterprise value of ₹13bn in 1QFY11

Reasons for increase in network costs:
FY10: GSM launch;
FY11: GSM expansion, payment of lease rentals pertaining to towers sold to Viom Network;
FY12-13: GSM expansion, 3G launch and expansion

Decline in other income driven by phasing out of subsidy income under a USOF scheme

Net losses to be elevated in FY12, driven by 3G capital costs (spectrum-fee amortization and interest expenses on 3G-related borrowings)

Fig 25 – Consolidated income statement

Year-end: Mar (₹m)	FY10	FY11	FY12e	FY13e	FY14e
Revenues					
Wireless revenues (GSM, CDMA, 3G)	13,836	15,630	18,059	20,089	22,237
Fixed-line revenues	6,133	5,858	6,063	6,424	6,787
Infrastructure sharing revenue	993	0	0	0	0
Internet services [fixed line only]	726	944	1,180	1,416	1,643
Eliminations	(706)	9	-	-	-
Total revenues	**20,983**	**22,441**	**25,303**	**27,929**	**30,667**
Interconnection and access costs	(4,409)	(4,570)	(5,071)	(5,389)	(5,832)
License & spectrum fee	(1,940)	(2,120)	(2,509)	(2,773)	(3,037)
Network operation and maintenance	(3,125)	(4,230)	(4,523)	(4,886)	(5,340)
Employee costs	(1,488)	(1,657)	(1,819)	(1,960)	(2,099)
Sales and marketing expenses	(3,719)	(3,220)	(3,031)	(2,949)	(3,119)
G&A costs	(2,449)	(2,389)	(2,465)	(2,655)	(2,883)
EBITDA	**3,853**	**4,302**	**5,885**	**7,317**	**8,357**
Depreciation & amortisation	(5,640)	**(7,507)**	(7,323)	(7,471)	(7,580)
Other Income	2,112	672	600	600	600
EBIT	**325**	**(2,533)**	**(838)**	**446**	**1,377**
Net finance (cost)/income	(3,505)	(3,462)	(4,927)	(5,232)	(5,197)
Pre-tax profits	**(3,180)**	**(5,994)**	**(5,765)**	**(4,786)**	**(3,820)**
Extraordinary income/(charges)	-	6,493	-	-	-
Current tax	-	-	-	-	-
Deferred tax (liability)/asset	-	-	-	-	-
Reported PAT	**(3,180)**	**499**	**(5,765)**	**(4,786)**	**(3,820)**
Adjusted net profit	**(3,180)**	**(5,994)**	**(5,765)**	**(4,786)**	**(3,820)**
Basic EPS (adjusted) (₹)	(1.7)	(3.2)	(3.0)	(2.5)	(2.0)
Fully diluted EPS (₹)	**(1.7)**	**(3.2)**	**(3.0)**	**(2.5)**	**(2.0)**
Shares outstanding (m)					
Basic shares	1,897	1,897	1,897	1,897	1,897
Fully diluted shares	1,897	1,897	1,897	1,897	1,897
Growth rates (%)					
Revenues	8	7	13	10	10
EBITDA	**(21)**	**12**	**37**	**24**	**14**
2-year forward Revenue CAGR	10	11	10	9	8
2-year forward EBITDA CAGR	24	30	19	13	10
Margins (%)					
EBITDA margin	18.4	19.1	23.3	26.2	27.3
EBIT margin	1.5	(11.3)	(3.3)	1.6	4.5
Net profit margin	(15.2)	(26.7)	(22.8)	(17.1)	(12.5)
Current tax rate (%)	-	19.9	19.9	19.9	19.9
Effective tax rate (%)	**12.0**	**14.0**	**16.0**	**18.0**	**20.0**

Source: Company, Anand Rathi Research

We estimate TTML's net debt to peak at ₹50bn in FY13. Its cash profit is expected to be lower than the capex over FY12-13e and the company is unlikely to become self-funded before FY14 (i.e., when net debt would start declining, as per our forecast).

Increase in current liabilities during FY09-12e is on account of credit from equipment suppliers; faster-than-expected winding down of such credit during FY12e-14e would place an additional debt burden on the company

Change in gross block in FY11 reflects 3G spectrum acquisition cost of ₹12.6bn and sale of tower business; we estimate gross block of tower business to be ₹5bn

We expect net debt to continue rising and peak in FY13 due to insufficient internal cash generation (after making interest payments) to fund capex

Fig 26 – Consolidated balance sheet

Year-end: Mar (₹m)	FY10	FY11	FY12e	FY13e	FY14e
Equity					
Equity share capital	18,972	18,972	18,972	18,972	18,972
Reserves & Surplus	5,832	5,832	5,832	5,832	5,832
Profit & Loss account	(31,770)	(30,968)	(36,733)	(41,519)	(45,339)
Total shareholder equity	(6,967)	(6,164)	(11,929)	(16,716)	(20,536)
Liabilities	-	-	-	-	-
Secured debt	26,310	26,698	30,198	29,198	27,198
Unsecured debt	13,090	19,828	21,578	23,078	23,078
Total debt	39,400	46,526	51,776	52,276	50,276
Total Invested capital	32,433	40,362	39,847	35,560	29,740
Assets					
Cash & cash equivalents	230	747	3,964	1,866	(755)
Current assets	6,300	8,162	8,539	8,867	9,184
Current liabilities & provisions	15,656	18,106	19,244	18,152	17,578
Net working capital (excl. cash)	(9,356)	(9,944)	(10,705)	(9,284)	(8,394)
Gross block	61,636	74,780	79,678	84,042	87,632
Less: accumulated depr/amort	22,124	28,269	35,592	43,063	50,643
Capital work-in-progress	2,047	3,047	2,500	2,000	1,900
Net fixed assets	41,559	49,559	46,586	42,979	38,889
Total assets	32,433	40,362	39,846	35,560	29,740
Leverage and return ratios (%)					
Net-debt (₹m)	39,170	45,779	47,812	50,410	51,031
Net-debt (US$m)	868	1,017	1,062	1,120	1,134
Net debt/equity (excl. accumltd losses)	157.9	184.6	192.8	203.2	205.7
Net debt/Capital (excl. accumltd losses)	61.2	64.9	65.8	67.0	67.3
Net Debt-to-EBITDA (x)	10.2	10.6	8.1	6.9	6.1
RoE [a]	(12.8)	(24.2)	(23.2)	(19.3)	(15.4)
RoCE	1.0	(6.3)	(2.1)	1.3	4.6

Source: Company, Anand Rathi Research *[a] Based on net worth, excluding accumulated losses*

Despite strong EBITDA growth, we expect TTML's operating cash flow generation (after interest costs) to be minuscule in FY12, we expect the company to generate negative FCFs over FY12e-14e.

FY10 figures are as per the company annual report; the company has adjusted vendor credit against capex; actual capex for FY10 is ~₹13bn and decrease in working capital is ₹3.8bn

FY11 capex includes ₹12.6bn 3G spectrum acquisition cost

Sale of assets in FY11 refers to sale of tower arm to Viom Networks

Fig 27 – Consolidated cash flow statement

Year-end: Mar (₹m)	FY10	FY11e	FY12e	FY13e	FY14e
Operating					
Net profit before tax & extraordinaries	(3,180)	(5,994)	(5,765)	(4,786)	(3,820)
Depreciation & amortization	5,640	7,507	7,323	7,471	7,580
Taxes paid	(0)	-	-	-	-
Net finance cost	3,506	3,462	4,927	5,232	5,197
Net finance cost (paid)	(3,506)	(3,462)	(4,927)	(5,232)	(5,197)
Extraordinaries & non-cash items	(349)	(2,676)	-	-	-
Change in Net working capital	285	588	761	(1,420)	(890)
Total operating cash flow	**2,396**	**(575)**	**2,319**	**1,265**	**2,870**
Capital expenditure	(8,896)	(19,215)	(4,351)	(3,864)	(3,490)
(Purchase)/Sale of assets	399	13,180	-	-	-
Total investing cash flow	**(8,497)**	**(6,035)**	**(4,351)**	**(3,864)**	**(3,490)**
FCF	**(6,102)**	**(6,610)**	**(2,032)**	**(2,599)**	**(620)**
Financing					
Net proceeds from issue of share capital	0	-	-	-	-
Net proceeds from borrowings	5,957	7,126	5,250	500	(2,000)
Dividends paid	-	-	-	-	-
Total financing cash flow	**5,957**	**7,126**	**5,250**	**500**	**(2,000)**
Net increase/(decrease) in cash balance	(145)	516	3,218	(2,099)	(2,620)
Beginning cash & cash equivalents	375	230	746	3,964	1,866
Ending cash & cash equivalents	**230**	**746**	**3,964**	**1,866**	**(755)**

Source: Company, Anand Rathi research

Appendix 1

Analyst Certification

The views expressed in this research report accurately reflect the personal views of the analyst(s) about the subject securities or issuers and no part of the compensation of the research analyst(s) was, is, or will be directly or indirectly related to the specific recommendations or views expressed by the research analyst(s) in this report.

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