

Telecoms, Media & Technology  
 Diversified Telecoms  
 Equity – India

## Underweight (V)

|                             |       |
|-----------------------------|-------|
| Target price (INR)          | 80.00 |
| Share price (INR)           | 95.10 |
| Forecast dividend yield (%) | 0.0   |
| Potential return (%)        | -15.9 |

Note: Potential return equals the percentage difference between the current share price and the target price, plus the forecast dividend yield

| Performance    | 1M   | 3M   | 12M  |
|----------------|------|------|------|
| Absolute (%)   | 22.5 | 13.6 | 0.5  |
| Relative^A (%) | 8.6  | 10.6 | -0.9 |

Index^A BOMBAY SE IDX

|                         |         |
|-------------------------|---------|
| RIC                     | RLCM.NS |
| Bloomberg               | RCOM IN |
| Market cap (USDm)       | 3,971   |
| Market cap (INRm)       | 196,289 |
| Enterprise value (INRm) | 558,415 |
| Free float (%)          | 35      |

Note: (V) = volatile (please see disclosure appendix)

10 February 2012

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This report must be read with the disclosures and the analyst certifications in the Disclosure appendix, and with the Disclaimer, which forms part of it

# Reliance Communications (RCOM)

Downgrade to UW(V): Data strategy without capex

- ▶ **3Q FY12 minutes growth remains poor; we believe subscriber churn in CDMA continues**
- ▶ **RCOM plans to leverage CDMA and 3G to drive data-centric growth; upsides limited if capex not increased, in our view**
- ▶ **Downgrade to UW(V), cut target price to INR80 from INR92**

**3QFY12 results were marginally below estimates with PAT c4% below estimates.**

Consolidated revenues were 4% below our estimates and flat on a sequential basis. Similarly, consolidated EBITDA was flat on a sequential basis. Minutes growth was 1% and revenue per minute improved marginally, by 0.3%. Depreciation expenses were down 7%, and interest expenses increased 60%. PAT declined 26% on a sequential basis. Management suggested that a change in methodology by the tower unit from written-down value to straight line resulted in lower depreciation charges, and lower finance income led to an increase in finance expenses.

**Data-centric focus.** Management cited data as the key growth driver, which now accounts for c20% of wireless revenues, and RCOM expects data revenues to move up to c40% of revenues over the next 2-3years. RCOM plans to use a combination of CDMA and 3G to drive data. However, the company doesn't see the need to increase capex in the next 12-18 months. While we understand that CDMA-led data growth may not require meaningful incremental capex, we believe capex needs to be increased to drive growth via 3G. Present capex for RCOM at 5% of sales are even below spends by developed-market operators (Figure 2, page 3). In our view, continuing with such low levels of capex may prevent the company from capturing the upsides in data. We note that capex by RCOM peers represents between 15-20% of sales, and that inability to increase capex is driven by a stretched balance sheet.

**Catalysts.** Tower monetization has been a notable catalyst for RCOM stock, as it allows the company to deleverage its balance sheet. In our view, the possibility of RCOM's being able to finalize tower monetization any time soon is low. However, the company could benefit if Reliance Industries (RIL IN, INR853, rated Neutral by Kumar Manish, target price INR800) decided to use RCOM towers for its LTE rollout. This may improve chances of tower monetization, as well.

**We are downgrading our rating to Underweight (V) from Neutral (V) and cutting our 12-month target price to INR80 from INR92.** We are reducing our FY13 estimates of sales by 5%, EBITDA by 7%, and PAT by 13%. We continue to value RCOM using a blended approach of PE and DCF. The key upside risk, we believe, include the sale of tower assets and a boost in tower tenancy by RIL's rollout.

## Financials & valuation

### Financial statements

| Year to                                 | 03/2011a | 03/2012e | 03/2013e | 03/2014e |
|---|----------|----------|----------|----------|
| <b>Profit &amp; loss summary (INRm)</b> |          |          |          |          |
| Revenue                                 | 231,076  | 203,792  | 230,577  | 257,469  |
| EBITDA                                  | 90,815   | 65,382   | 73,150   | 79,962   |
| Depreciation & amortisation             | -65,039  | -40,364  | -44,775  | -48,648  |
| Operating profit/EBIT                   | 25,776   | 25,018   | 28,375   | 31,314   |
| Net interest                            | -10,723  | -13,789  | -13,241  | -13,262  |
| PBT                                     | 15,176   | 11,217   | 15,134   | 18,052   |
| HSBC PBT                                | 15,053   | 11,230   | 15,134   | 18,052   |
| Taxation                                | -117     | -325     | -606     | -2,708   |
| Net profit                              | 13,457   | 8,433    | 12,104   | 12,824   |
| HSBC net profit                         | 13,334   | 8,446    | 12,104   | 12,824   |

### Cash flow summary (INRm)

|                           |          |         |         |         |
|---------------------------|----------|---------|---------|---------|
| Cash flow from operations | 19,149   | 42,055  | 82,099  | 102,537 |
| Capex                     | -95,013  | -14,672 | -16,176 | -23,967 |
| Cash flow from investment | -105,136 | -28,384 | -29,417 | -37,229 |
| Dividends                 | 0        | 0       | 0       | 0       |
| Change in net debt        | 121,597  | 41,641  | -52,682 | -65,309 |
| FCF equity                | -84,898  | 12,191  | 52,682  | 65,309  |

### Balance sheet summary (INRm)

|                         |         |         |         |         |
|-------------------------|---------|---------|---------|---------|
| Intangible fixed assets | 0       | 0       | 0       | 0       |
| Tangible fixed assets   | 729,408 | 744,016 | 715,417 | 690,736 |
| Current assets          | 160,784 | 194,220 | 199,832 | 196,743 |
| Cash & others           | 53,272  | 48,000  | 48,000  | 48,000  |
| Total assets            | 891,281 | 939,516 | 916,530 | 888,759 |
| Operating liabilities   | 126,860 | 136,470 | 151,637 | 173,831 |
| Gross debt              | 373,757 | 410,126 | 357,444 | 292,136 |
| Net debt                | 320,485 | 362,126 | 309,444 | 244,136 |
| Shareholders funds      | 357,518 | 352,019 | 364,123 | 376,947 |
| Invested capital        | 710,060 | 753,766 | 715,612 | 665,648 |

### Ratio, growth and per share analysis

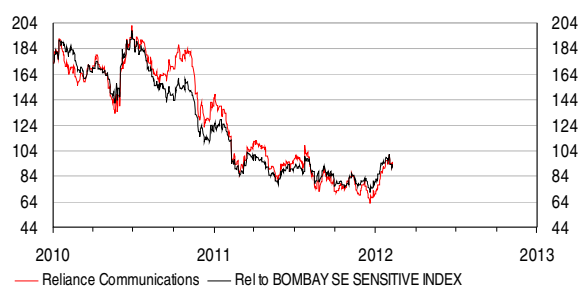
| Year to                      | 03/2011a | 03/2012e | 03/2013e | 03/2014e |
|------------------------------|----------|----------|----------|----------|
| <b>Y-o-y % change</b>        |          |          |          |          |
| Revenue                      | 3.9      | -11.8    | 13.1     | 11.7     |
| EBITDA                       | 15.1     | -28.0    | 11.9     | 9.3      |
| Operating profit             | -37.7    | -2.9     | 13.4     | 10.4     |
| PBT                          | -71.3    | -26.1    | 34.9     | 19.3     |
| HSBC EPS                     | -72.0    | -36.7    | 43.3     | 5.9      |
| <b>Ratios (%)</b>            |          |          |          |          |
| Revenue/IC (x)               | 0.3      | 0.3      | 0.3      | 0.4      |
| ROIC                         | 3.8      | 3.3      | 3.7      | 3.9      |
| ROE                          | 3.6      | 2.4      | 3.4      | 3.5      |
| ROA                          | 2.9      | 2.7      | 2.9      | 2.9      |
| EBITDA margin                | 39.3     | 32.1     | 31.7     | 31.1     |
| Operating profit margin      | 11.2     | 12.3     | 12.3     | 12.2     |
| EBITDA/net interest (x)      | 8.5      | 4.7      | 5.5      | 6.0      |
| Net debt/equity              | 87.6     | 99.8     | 82.0     | 62.2     |
| Net debt/EBITDA (x)          | 3.5      | 5.5      | 4.2      | 3.1      |
| CF from operations/net debt  | 6.0      | 11.6     | 26.5     | 42.0     |
| <b>Per share data (INR)</b>  |          |          |          |          |
| EPS reported (fully diluted) | 6.52     | 4.09     | 5.86     | 6.21     |
| HSBC EPS (fully diluted)     | 6.46     | 4.09     | 5.86     | 6.21     |
| DPS                          | 0.00     | 0.00     | 0.00     | 0.00     |
| Book value                   | 173.22   | 170.55   | 176.42   | 182.63   |

### Valuation data

| Year to            | 03/2011a | 03/2012e | 03/2013e | 03/2014e |
|--------------------|----------|----------|----------|----------|
| EV/sales           | 2.2      | 2.7      | 2.2      | 1.7      |
| EV/EBITDA          | 5.7      | 8.5      | 6.9      | 5.5      |
| EV/IC              | 0.7      | 0.7      | 0.7      | 0.7      |
| PE*                | 14.7     | 23.2     | 16.2     | 15.3     |
| P/Book value       | 0.5      | 0.6      | 0.5      | 0.5      |
| FCF yield (%)      | -43.3    | 6.2      | 26.8     | 33.3     |
| Dividend yield (%) | 0.0      | 0.0      | 0.0      | 0.0      |

Note: \* = Based on HSBC EPS (fully diluted)

### Price relative



Source: HSBC

Note: price at close of 09 Feb 2012

Figure 1: Reliance Communications: Key events for RCOM stock and likely timelines

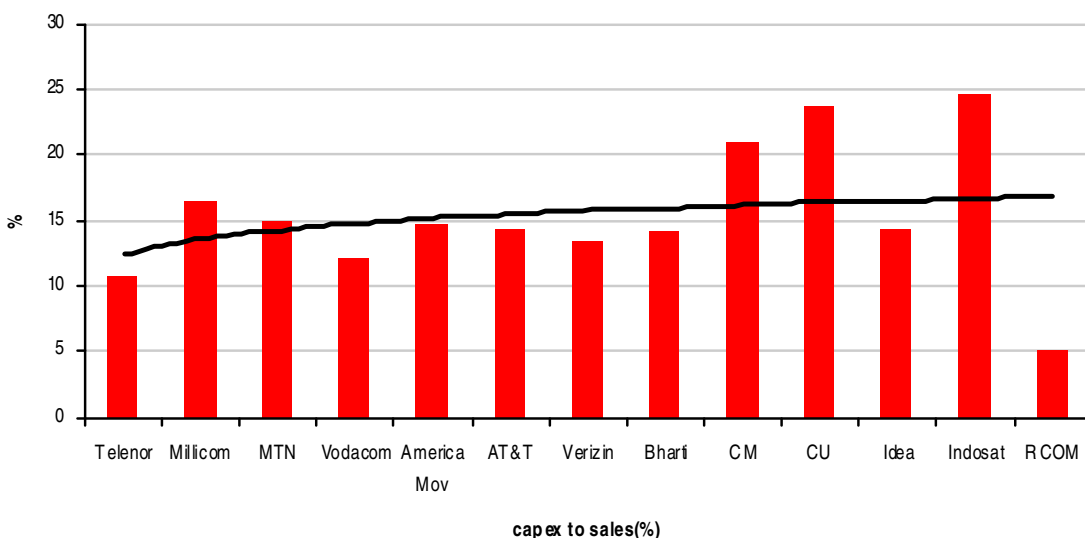
| Event  | Expected time frame | Key factor to be watched   | What is in the price   |
|--|---------------------|--|--|
| Tower monetisation                           | Delayed             | Investors need to focus on valuations, sale of tower assets, RIL tenancy factor and format of the deal.  | The stock's recent rally has been driven by news flow around the tower catalyst. However, we expect a delay, and as such, expect the stock to correct from current levels.                                       |
| Rollout by Long Term Evolution (LTE) players | Six to 12 months    | As RCOM towers are bundled with fibre, they could have strategic value for serious LTE players.  | Markets somewhat pricing in an RIL commitment for RCOM tower assets; however, any such announcement could still have a positive impact on the stock.   |
| Data pickup/3G rollout                       | Nine to 12 months   | In our view, ramp-up by CDMA is positive. Except for the metros present, 3G footprint not very impressive. 3G to see focus on data cards, as well. | Markets not expecting RCOM to benefit significantly from 3G; however, they assume some benefits with the data cards on the CDMA platform to continue. Capex needs to increase to benefit from data, in our view. |
| Regulatory policies                          | Six months          | The policy in proposed form is least negative for RCOM, we believe. Significant payments by large GSM incumbents could be positive for RCOM.       | Markets focused on the RCOM leverage, FCCB issue. Any clarity on getting additional spectrum on GSM would be positive, we believe.   |

Source: HSBC

## Valuation and risks

We are cutting our 12-month target price to INR80 from INR92. We derive our RCOM target price from a blend of PE and DCF values (equal weighting). For our DCF valuation, we assume cost of equity of 14%, cost of debt 10.5%, and a WACC of 14%. We arrive at a DCF-based value of INR119 per share (previously INR134). We are cutting our medium-term (FY13e-15e) estimates of EBITDA, as we do not expect subscriber quality to improve in the wireless business, given the low capex.

Figure 2: Telcos' capex-to-sales, FY13e



Source: HSBC

For our PE valuation, we use a multiple of c10x (in line with the 12-month average) applied to FY13e EPS, given poor earnings visibility. This generates a value of INR59 per share (previously INR67). We are reducing our FY13 net income estimate by c13%. Assigning equal weightings to DCF and PE and providing for the possible negative impact of Telecom Regulatory Authority of India (TRAI) recommendations, we arrive at our new target price of INR80.

Under our research model, for stocks with a volatility indicator, the Neutral band is 10ppts above and below the hurdle rate for Indian stocks of 11%, or 1-21% around the current share price. Our new target price implies a potential return of -15.9%, which is below the Neutral band; therefore, we are downgrading our rating to Underweight (V) from Neutral (V). Potential return equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated.

The key upside risk, in our view, would be an ability to introduce a strategic investor through a 26% stake sale in the company, the sale of tower assets, and a boost in tower tenancy because of RIL's LTE rollout.

Figure 3: Reliance Communications: New vs old estimates

| (INRm)            | FY12e   | FY13e   |
|-------------------|---------|---------|
| <b>Sales</b>      |         |         |
| New               | 203,792 | 230,577 |
| Old               | 209,963 | 243,973 |
| Change            | -3%     | -5%     |
| <b>EBITDA</b>     |         |         |
| New               | 65,382  | 73,150  |
| Old               | 66,774  | 78,616  |
| Change            | -2%     | -7%     |
| <b>Net income</b> |         |         |
| New               | 8,433   | 12,104  |
| Old               | 9,043   | 13,922  |
| Change            | -7%     | -13%    |

Source: HSBC

Figure 4: RCOM target price computation

| (INR)               |            | New estimates | Old estimates |
|---------------------|------------|---------------|---------------|
| India core business | PE and DCF | 89            | 101           |
| TRAI adjustments    |            | -9            | -9            |
| Target price        |            | 80            | 92            |

Source: HSBC

**Figure 5: Reliance Communications: 3Q FY12 results analysis (INRM unless otherwise specified)**

|                         | Actual | HSBC estimates | Actual vs. HSBC | 2QFY12 | 3QFY11 | QoQ    | YoY    | Consensus | Variance   |
|-------------------------|--------|----------------|-----------------|--------|--------|--------|--------|-----------|--|
| <b>Overall business</b> |        |                |                 |        |        |        |        |           |  |
| Revenue                 | 50,521 | 52,789         | -4.3%           | 50,402 | 50,041 | 0.2%   | 1.0%   | 51,051    | -1%  |
| EBITDA                  | 16,111 | 16,516         | -2.5%           | 16,051 | 16,680 | 0.4%   | -3.4%  | 16,636    | -3%  |
| EBITDA margin (%)       | 31.9%  | 31.3%          | 0.6%            | 31.8%  | 33.3%  | 0.0%   | -1.4%  | 32.6%     | -1%  |
| Net profit              | 1860   | 1,975          | -5.8%           | 2,521  | 4,803  | -26.2% | -61.3% | 2,096     | -11%   |
| EPS (INR)               | 0.9    | 1.0            | -5.8%           | 1.2    | 2.3    | -26.2% | -61.3% | 1.0       | -11%   |
| <b>Mobile segment</b>   |        |                |                 |        |        |        |        |           |  |
| ARPU (INR)              | 100    | 102            | -2.3%           | 101    | 111    | -1.0%  | -9.9%  |           |  |
| MoU (minutes)           | 224    | 224            | 0.2%            | 227    | 251    | -1.3%  | -10.8% |           | Minutes' growth continues to be marginal as RCOM continues to reduce free airtime and focus on driving profitable minutes. |
| Mobile revenues         | 44,471 | 46,075         | -3.5%           | 44,170 | 40,644 | 0.7%   | 9.4%   |           |  |
| EBITDA                  | 11,823 | 11,979         | -1.3%           | 11,756 | 11,792 | 0.6%   | 0.3%   |           |  |
| EBITDA margin (%)       | 26.6%  | 26.0%          | 0.6%            | 26.6%  | 29.0%  | 0.0%   | -2.4%  |           |  |

Source: HSBC , Company reports, Bloomberg consensus

# Disclosure appendix

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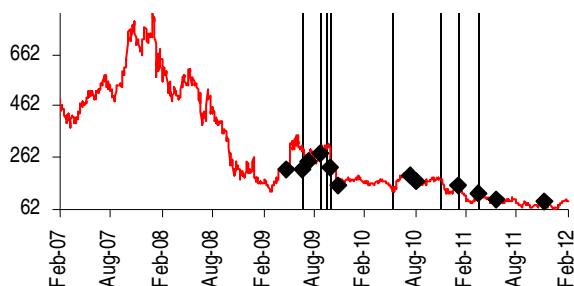
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As of 10 February 2012, the distribution of all ratings published is as follows:

|                           |     |  |
|---------------------------|-----|--|
| <b>Overweight (Buy)</b>   | 52% | (26% of these provided with Investment Banking Services) |
| <b>Neutral (Hold)</b>     | 36% | (21% of these provided with Investment Banking Services) |
| <b>Underweight (Sell)</b> | 12% | (13% of these provided with Investment Banking Services) |

## Share price and rating changes for long-term investment opportunities

Reliance Communications (RLCM.NS) Share Price performance INR Vs HSBC rating history



Source: HSBC

### Recommendation & price target history

| From            | To              | Date              |
|-----------------|-----------------|-------------------|
| Neutral (V)     | Underweight (V) | 29 June 2009      |
| Underweight (V) | Neutral (V)     | 01 September 2009 |
| Neutral (V)     | Restricted      | 25 September 2009 |
| Restricted      | Underweight (V) | 07 October 2009   |
| Underweight (V) | Neutral (V)     | 20 May 2010       |
| Neutral (V)     | Underweight (V) | 08 November 2010  |
| Underweight (V) | Neutral         | 11 January 2011   |
| Neutral         | Neutral (V)     | 22 March 2011     |
| Target Price    | Value           | Date              |
| Price 1         | 218.00          | 05 May 2009       |
| Price 2         | 214.00          | 29 June 2009      |
| Price 3         | 250.00          | 23 July 2009      |
| Price 4         | 280.00          | 01 September 2009 |
| Price 5         | Restricted      | 25 September 2009 |
| Price 6         | 227.00          | 07 October 2009   |
| Price 7         | 158.00          | 02 November 2009  |
| Price 8         | 197.00          | 21 July 2010      |
| Price 9         | 170.00          | 13 August 2010    |
| Price 10        | 152.00          | 11 January 2011   |
| Price 11        | 122.00          | 22 March 2011     |
| Price 12        | 101.00          | 31 May 2011       |
| Price 13        | 92.00           | 14 November 2011  |

Source: HSBC

## HSBC & Analyst disclosures

### Disclosure checklist

| Company                 | Ticker  | Recent price | Price Date  | Disclosure |
|-------------------------|---------|--------------|-------------|------------|
| RELIANCE COMMUNICATIONS | RLCM.NS | 95.10        | 09-Feb-2012 | 2,5        |

Source: HSBC

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