

Reliance Communications

Rs291
OUTPERFORMER

FY09 Annual Report Analysis

Mkt Cap: Rs600bn; US\$12.5bn

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Reliance Communications' (RCOM) FY09 annual report throws light, amongst other things, on the much debated issue on why it reported interest income of Rs5.1bn in FY09 despite its year ending net debt of Rs282bn – interest charges are net of one time dividend income of Rs13.4bn. The report also provides clarity on asset revaluations done by RCOM adjusted for which its leverage stands at 1.2x vis-à-vis the reported leverage of ~0.7x. RCOM's FY09 reported capex at Rs132bn is lower than the capex of ~Rs193bn computed from its quarterly releases, which we believe is due to de-capitalization of ~Rs60bn of forex losses - which have now been adjusted against the general reserve (forex losses include Rs17.1bn of realized losses). Despite a strong 20.3%yoy revenue growth, total selling expenses declined by 6.2% to Rs21.2bn even as administrative expenses increased sharply by 63%. RCOM's DTH venture - Reliance BIG TV posted revenue of Rs1.1bn and loss of Rs842m in FY09 while its passive infrastructure subsidiary - Reliance Infratel reported revenue of Rs49.3bn, EBIDTA of Rs33.8bn and PAT of Rs16.8bn in FY09. We expect RCOM to post a robust operational performance over FY09-11 (EBIDTA CAGR of 14.7%), driven by its impressive GSM foray and a strong asset base in the long distance and enterprise business. Gearing concerns have been partially addressed by slowing capex but balance sheet leverage still remains high. We expect an equity infusion/ further value unlocking in the tower business to alleviate concerns on balance sheet stress and lead to a recovery in valuations.

□ Key balance sheet highlights

- **Reported net debt of Rs282bn includes Rs57bn credit from vendors:** RCOM's FY09 annual report pegs its gross debt at Rs392bn vis-à-vis gross debt of Rs335bn reported in its quarterly reporting. The difference of Rs57bn is on account of buyers credit availed by the company and is classified under the head Current Liabilities in quarterly reporting vis-à-vis the annual report which classifies the same under Gross Debt. Adjusting for cash and cash equivalents of Rs110bn as on March-09, Net debt works out to Rs282bn. The pricing of RCOM's Rs30bn secured NCD issue done in Q4FY09 was 11.2%.
- **Cumulative net asset revaluations at Rs182bn:** RCOM's reported net worth includes asset revaluation impact of Rs185bn pertaining to its passive infrastructure business and residual assets of Reliance Telecom as well as to the revaluation carried out for amalgamation of Reliance Gateway Net Limited (RGNL) – holding company for all the offshore investments of the company. This is besides the asset revaluation of Rs30bn during the original demerger from RIL, which takes the cumulative revaluations at Rs215bn. After netting off additional depreciation of Rs32bn charged off to these reserves, the net asset revaluation is Rs182bn.

Net asset revaluations of Rs182bn

Adjustments to Reserves	Rsbm
Fair valuation impact of passive infrastructure assets by Reliance Infratel and of remaining fixed assets by Reliance Telecom	48
Credit to Business restructuring reserve related to revaluation of passive infra assets transferred by RCOM and to Reliance Infratel	13
Fair valuation on amalgamation of Reliance Gateway	123
Asset revaluation in FY07 at the time of demerger	30
Total revaluations	215
Less: Additional depreciation charged off	32
Net Revaluations	182

Source: Company reports, IDFC-SSKI Research

- **Adjusted leverage at 1.2x:** RCOM's reported net worth of Rs423bn (without netting off goodwill which is done in the quarterly reporting) includes net asset revaluations of Rs182bn. Thus, while the company's reported leverage is ~0.7x, its adjusted leverage works out to 1.2x.

Adjusted leverage of 1.2x vis-à-vis reported leverage of 0.7x

Leverage computation (Rsbm)	FY09
Gross Debt	392
Cash and cash equivalents	110
Net Debt	282
Shareholders' funds reported	423
Shareholders' funds (adjusted for cumulative asset revaluations)	240
Net Debt/Equity (reported) (x)	0.7
Net Debt/Equity (adjusted) (x)	1.2

Source: Company reports, IDFC-SSKI Research

- **Reported capex lower at Rs132bn in FY09 (Rs193bn from quarterly reports):** The annual report pegs FY09 capex at Rs132bn (summation of segmental capex) while that computed based on reported Gross Block and CWIP (post reversal of forex losses of ~Rs60bn in FY09) is Rs256bn. We believe this difference is primarily on account of the asset revaluation impact of Rs123bn at the time of amalgamation of Reliance Gateway Net Limited (effective date March 31st 2009), adjusted for which the computed capex is Rs133bn – almost equal of the reported capex of Rs132bn (within India: 100.5bn, outside India: Rs31bn). Further, adding back the de-capitalized forex losses of ~Rs60bn, the computed FY09 capex would be Rs193bn – roughly equal of the capex of Rs194bn indicated on quarterly basis. We await further clarity on this from the management.

Capex reconciliation

Rs bn	FY08	FY09
Gross Block	464	755
CWIP	148	113
Computed Capex		256
Less:		
Revaluation impact on amalgamation of Reliance Gateway Net Limited -appointed date of March 31st 2009		123
Actual capex		133
Reported capex in segmental reporting		132
Forex losses de-capitalized due to change in accounting policy to AS 11		60
Capex as reported on quarterly basis		193

Source: Company reports, IDFC-SSKI Research

- **Capex related payables decline to Rs41.2bn:** Capex related payables which are included under CL decreased from Rs57.2bn in FY08 to Rs41.2bn in FY09. Other current liabilities increased sharply to Rs48.8bn in FY09 from Rs26.7bn in FY08 (we await clarity from the management on the same).
- **Net forex loss adjusted to general reserves includes Rs17.1bn of realized loss:** RCOM de-capitalized net forex losses of Rs57.7bn and adjusted the same from General Reserves following a change in accounting policy from Schedule VI to AS-11. The net forex losses constituted of realized forex losses of Rs17.1bn and unrealized forex losses of Rs40.6bn.

- **Provisions for disputed claims:** Provisions include an amount of Rs18.4bn towards disputed claims.

□ Key P&L highlights

- **Revenue growth at 20.3%:** Total revenue increased by 20.3% to Rs229bn in FY09 with EOP wireless subscribers growing by 59% to 73m
- **Operating costs up 26% (details of some cost break-ups not available quarterly):**
 - a) Total access charges and license fees declined by 11% and network operating costs surged by 101% in FY09
 - b) Total selling expenses declined by 6.2% to Rs21.2bn with commission & advertising expenses declining by 14.5% and 23% respectively and selling & marketing expenses growing sharply by 60%.
 - c) General administrative expenses increased sharply by 63%.

P&L Extract

Particulars (In Rsbn)	FY09	FY08	Change (%)
Total Revenue	229	191	20
Operating costs			
1) Access charges	23.8	28.2	(16)
2) License fees	11.9	12.4	(4)
3) Network charges	44.2	22.0	101
4) Employee expenses	16.8	11.7	44
5) Selling Expenses	21.2	22.6	(6)
Commission	3.5	4.1	(15)
Selling and Marketing	6.8	4.2	60
Advertisement	3.9	5.0	(23)
Customer acquisition and customer care	4.2	4.2	1.4
Cost of sale of telecom Terminals and Accessories	2.9	5.1	(44)
6) General administrative expenses	18.7	11.5	63
Total Costs	136	108	26
EBIDTA	93	82	13
EBIDTA Margin	40.5	43.2	

Source: Company reports, IDFC-SSKI Research

- **One-time dividend income leads to net interest income:** RCOM on a quarterly basis reports only the net interest income after netting off interest income and forex translation gains/losses. In its annual report, RCOM has reported interest/financial charge of Rs12.6bn, which when netted with forex gain of Rs1.9bn and financial income of Rs15.8bn leads to a net interest income of Rs5.1bn. We note that the reported financial income included Rs13.4bn as dividend income from the company's shareholders' trust. This trust in turn distributed this dividend from the proceeds of the 5% stake sale in Reliance Infratel which was done in FY08. Income from investments and interest income stood at Rs2.4bn.

Interest charges schedule

Particulars (Rsbn)	FY08	FY09
Interest expense	10.7	12.6
Interest income	10.5	15.8
Net exchange loss (gain)	(4.2)	(1.9)
Reported Net interest expense	(4.0)	(5.1)

Source: Company reports, IDFC-SSKI Research

- **Other income:** RCOM reported a very sharp jump in other income from Rs2.4bn in FY08 to Rs7bn in FY09 contributed largely by miscellaneous income of Rs3.5bn in FY09 (Rs0.4bn in FY08).
- Cash tax paid was Rs3.9bn against the reported current tax and FBT of Rs0.49bn in FY09.

Other details:

- Reliance BIG TV posted revenue of Rs1.1bn and loss of Rs842m in FY09.
- Reliance Infratel reported revenue of Rs49.3bn, EBIDTA of Rs33.8bn (EBIDTA margin of ~69%) and PAT of Rs16.8bn in FY09. Provision of passive infrastructure accounted for 80% and of OFC network accounted for the balance 20% of FY09 revenue.
- Foreign currency exposures not hedged by derivative instruments – \$3.1bn.

Reported P&L statement

Particulars (Rs bn)	FY09	FY08	Change (%)	Comments
Services revenue and other operating income	222.5	188.3	18.2	
Other income	7.0	2.4	190.4	Miscellaneous income of Rs3.5bn in FY09 (0.4bn). Profit on sale of investments of Rs3.3bn (Rs1.7bn)
Total Revenue	229.5	190.7	20.4	
1) Access charges	23.8	28.2	(15.5)	
2) License fees	11.9	12.4	(4.2)	
3) Network charges	44.2	22.0	100.7	
4) Employee expenses	16.8	11.7	43.6	
5) Selling Expenses	21.2	22.6	(6.2)	
Commission	3.5	4.1	(14.5)	
Selling and Marketing	6.8	4.2	59.8	
Advertisement	3.9	5.0	(22.9)	
Customer acquisition and customer care	4.2	4.2	1.4	
Cost of sale of telecom Terminals and Accessories	2.9	5.1	(44.0)	
6) General administrative expenses	18.6	11.7	59.6	
Total Costs (1+2+3+4+5+6)	136.4	108.5	25.7	
EBIDTA	93.0	82.2	13.3	
EBIDTA Margin	40.5	43.1		
Interest expense	12.6	10.7	17.8	4.8% implied borrowing cost on average gross debt of Rs262bn excluding FCCBs
Interest income/financial income	15.8	10.5	50.9	Dividend of Rs13.4bn received by a subsidiary in lieu of profit on 5% stake sale in RITL in FY08
Net exchange loss (gain)	(1.9)	(4.2)	(55.6)	
Net interest expense	(5.1)	(4.0)	26.8	
Gross depreciation and Amortization	46.3	39.5		
Depreciation adjusted by/transfers from business restructuring and general reserve	(10.2)	(11.4)		
Depreciation and Amortization	36.1	28.1	28.6	
Profit before adjustments pursuant to the scheme of amalgamation/Arrangement, Tax and Exceptional items	62.0	58.1	6.8	
Exceptional expense	0.1	(12.7)		(Profit on 5% stake sale in RITL in FY08)
Adjustment pursuant to the scheme of arrangements for OFC and RCIL		0		Change in accounting policy - from Schedule VI to As 11
Loss on account of change in exchange rate relating to loans/liabilities (net)	57.7			
Equivalent amount withdrawn from General Reserve	-57.7			
Adjustment pursuant to the Scheme of Arrangement for de-merger of passive infrastructure assets				
Fuel expenses	1.9			
Equivalent amount withdrawn from General Reserve	-1.9			
PBT	62.0	70.8		
Provision for Tax	(0.5)	2.8		Cash tax paid: Rs3.9bn in FY09 (Rs2.2bn)
PAT (before adjustment for minority interest and associates)	62.5	67.9		
Less: Minority interest	2.0	13.9		(Profit on 5% stake sale in RITL in FY08 reversed)
Add: Profit from associates	0.0	(0.0)		
Consolidated profit after tax	60.5	54.0		

Source: Company reports, IDFC-SSKI Research

Reported balance sheet

Particulars (Rsbn)	FY09	FY08	Comments
Sources of Funds			
Share capital	10.3	10.3	
Reserves and Surplus	412.5	279.9	Includes Rs182bn of net asset revaluations
Total shareholders' funds	422.80	290.26	
Minority interest	6.5	24.3	
Loan Funds			
Secured loans	30.0	9.5	Rs30bn NCDs raised at 11.2% in Q4FY09
Unsecured loans	361.6	248.7	FCCBs of Rs70.8bn in FY09 (Rs54.9bn)
Total loans	391.6	258.2	
Deferred Tax Liability	0.3	1.0	
Total	821.3	573.8	
Application of Funds			
Gross Block	755.1	463.4	
Less: Depreciation	141.1	89.6	
Net Block	614.0	373.8	
Capital work-in progress	113.1	149.3	
Total fixed Assets	727.1	523.1	
Goodwill	52.2	35.7	
Investments	95.7	110.0	Mostly government securities, corporate bonds and liquid funds
Current Assets			
Inventories	5.4	4.1	
Sundry Debtors	39.6	27.2	
Cash and Bank Balances	16.8	8.8	
Other current Assets	17.8	23.1	
Total current assets	79.6	63.1	
Loans and Advances	67.6	42.7	
Total Current Assets and Loans and Advances	147.2	105.8	
Less: Current Liabilities	159.7	156.2	Includes Rs41.7bn (Rs57.2bn) for capital expenditure
Less: Provisions	41.1	44.6	Includes Rs18.4bn for disputed claims
Total Current Liabilities and Provisions	200.81	200.8	
Net Current Assets	(53.6)	(95.0)	
Total	821.3	573.8	

Source: Company reports, IDFC-SSKI Research

□ Valuations & View – maintain Outperformer

Reliance Communications' (RCOM) impressive GSM foray and a strong asset base in the long distance and enterprise business would likely drive a robust operational performance over FY09-11 (EBIDTA CAGR of 14.7%). However, this is unlikely to reflect in EPS due to higher depreciation and interest charges on account of 3G-related costs. Gearing concerns have been partially addressed by slowing capex but balance sheet leverage still remains high. We expect an equity infusion/ further value unlocking in the tower business to alleviate concerns on balance sheet stress and lead to a recovery in valuations. Maintain Outperformer.

Key financials

As on 31 March	FY08	FY09*	FY10E	FY11E
Net sales (Rs m)	190,678	229,485	268,949	312,555
Adj. net profit (Rs m)	49,776	45,175	36,400	36,825
Shares in issue (m)	2,064	2,064	2,064	2,064
Adj. EPS (Rs)	24.2	21.9	17.6	17.8
% change	54.8	(9.7)	(19.4)	1.2
PE (x)	12.0	13.3	16.5	16.3
Price/ Book (x)	2.1	1.6	1.4	1.3
EV/ EBITDA (x)	8.8	9.0	8.7	8.0
RoE (%)	20.5	17.8	9.2	8.5
RoCE (%)	12.6	9.4	8.0	7.8

Source: IDFC-SSKI Research * - nos restated as per FY09 annual report, FY09 adjusted PAT excludes one-time dividend income of Rs13.4bn

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